MEF Dipartimento del Tesoro

Relevant Factors Influencing Public Debt Developments in Italy

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Ministero dell'Economia e delle Finanze

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OVERVIEW

- At the request of the European Commission, and in accordance with Article 126(3) of the TFEU, this report discusses factors that the Italian government deems "relevant in order to comprehensively assess in qualitative terms the excess (of the public debt ratio) over the reference value" in 2019. The report also summarizes Italy's Stability Program for 2020-2021 and reiterates the government's commitment to a long-term debt-reduction program.
- The premise of the Commission's request is twofold. Firstly, Italy's public debt in 2019 remained stable at 134.8 percent of GDP, which may imply that the debt-reduction criterion was not fulfilled. Secondly, in the Stability Program that was released on 24 April the government raised its budget deficit projections for 2020 and 2021 to well above 3 percent of GDP due to the unprecedented drop in business activity caused by the Covid-19 pandemic and to the vigorous fiscal measures that have been enacted in order to support the economy.
- With respect to the 2019 outturns, the most relevant factor to consider is **Italy's compliance with the preventive arm of the Stability and Growth Pact**. Indeed, the public finances improved markedly in 2019. Failure of the public debt ratio to decline in line with the fiscal rules is largely explained by low nominal GDP growth. In turn, the latter was adversely affected by the global slowdown engendered by international trade tensions.
- In fact, the general government budget deficit in 2019 fell to 1.6 percent of GDP, from 2.2 percent in 2018, as the primary surplus rose to 1.7 percent of GDP, from 1.5 percent. Importantly, the structural balance improved by 0.8 percentage points of GDP (Commission estimate), well in excess of the Council recommendation (0.6 percentage points).
- Higher-than-expected **growth in tax revenue was the key driver of the structural improvement in the budget balance**. Revenue outperformance was explained not only by growth in employment and earnings, but also by **improved tax compliance** on the back of policy measures such as compulsory digital invoicing and advanced taxpayer profiling.
- Italy's fiscal performance is also remarkable because 2019 saw **major progress on social inclusion and investment policies**, with an attendant increase in government outlays. In particular, the introduction of the 'Citizenship Income' scheme reduced the poverty rate and inequality, filling gaps previously highlighted by Commission reports on social inclusion. Public investment rose to 2.3 percent of GDP, from 2.1 percent in 2018, reversing years of decline.
- The **strong performance of the public finances was set to continue this year** even as the 2020 Budget financed a long-recommended **cut in the tax wedge on labor and various pro-growth and social inclusion measures**. Before Covid-19 put a break in economic activity, the borrowing requirement of the general government in the first two months of 2020 was 8.9 billion lower than a year ago, as tax revenue continued to exceed expectations.

- Another relevant factor is that **low nominal GDP growth continues to hinder Italy's debt-reduction efforts**. Real GDP in 2019 increased by 0.3 percent, while the GDP deflator rose by 0.9 percent, yielding a nominal growth rate of 1.2 percent. Against this low nominal increase, the average cost of funding remains high, albeit declining over time, due to legacy factors. Given this 'snowball effect,' a marked reduction in the debt ratio would have required a large primary budget surplus. However, in the context of sluggish European and global growth, further compression of domestic demand via restrictive fiscal policies would have been self-defeating.
- It is also worth reiterating that, due to longstanding problems with the estimation of Italy's potential growth under the common methodology, the output gap remains ostensibly understated. With a more realistic output gap estimate, the structural balance in 2019 would have been closer to the Medium-Term Objective, highlighting that **Italy's key macroeconomic problem is the weakness of aggregate demand rather than fiscal laxity**.
- In turn, **aggregate demand weakness is explained not only by exogenous factors** such as the slowdown in global trade and the uncertainty caused by the abrupt change in US trade policy, **but also by deflationary mechanisms within the Euro area**. Among the latter, the most significant ones in the pre-Covid-19 situation were the tightness of the aggregate Euro area fiscal policy stance, a largely export-oriented economic model and a lack of dynamism and innovation. Moreover, over the past two decades a host of tax incentives and preferential regimes in other EU member states have eroded Italy's tax base, leading to a rise in tax rates that, in turn, has diminished Italy's attractiveness as a location of production and residence.
- The Commission's analysis has traditionally attributed Italy's slow productivity growth and high post-crisis unemployment to **structural factors** such as a high tax burden on labor and other mobile tax bases, the alleged inefficiency of the public administration, excessive bureaucracy, the length and complexity of legal cases, restrictions to competition in services and educational and skills gaps.
- **Social inclusion was the priority of Italy's reform agenda in 2018-2019** following years of public expenditure restraint, corporate restructuring and offshoring, widening social and regional inequalities. In the 2020 Country Report, the Commission indeed finds that Italy made significant progress on inclusion policies, reducing the tax burden on labor, improving tax compliance and reforming the public administration. **A more determined effort in terms of productivity-enhancing reforms could have undermined social cohesion**. It is also questionable that, given a more uncertain and sluggish global context, such an approach would have produced higher rates of GDP growth and a sizable drop in the public debt ratio.
- Building on the advances in social inclusion, and aligning itself with the agenda of the new Commission, earlier this year the new government launched **broad consultations aimed at revitalizing the structural reform process**. Furthermore, the 2020 Budget earmarked additional funding for a new **Green and Innovation Deal**, which aims to align Italy with the European Green Deal initiative and promote sustainable growth, digitization and innovation.

- A balanced assessment of Italy's public debt developments should also consider that although the average yield at issuance in 2019 was very low from a historical perspective (0.93 percent), **Italy's sovereign yield levels remained high in comparison with other large Euro area countries**. As a result, **the average cost of funding did not fall far enough given the slow nominal growth environment**. While this was partly due to perceptions about political risks, Italy's spread and rating levels look penalizing given the country's solid budgetary performance. (Among the large Euro area member states, the primary surplus was the second highest behind Germany.) A consistently pessimistic assessment of Italy's growth potential and economic outlook by the international organizations might have contributed to this strong headwind slowing Italy's debt reduction efforts.
- Turning to the **forward-looking assessment**, the Commission notes that in response to the pandemic and the associated drop in economic activity **Italy's Stability Program 2020 projects a general government deficit well in excess of 3 percent of GDP**. Indeed, based on an official real GDP growth forecast of -8 percent, the budget deficit is expected to reach 10.4 percent of GDP this year, before declining to 5.7 percent of GDP in 2021, when economic activity is expected to recover part of the lost ground, with GDP rising by 4.7 percent.
- **The increase in this year's budget deficit is almost entirely explained by the steep drop in GDP and by temporary support measures**. The collapse in GDP alone explains 4.1 percentage points of the expected increase in the budget deficit while 4.5 percentage points are related to economic support measures that were partly enacted on 17 March (1.2 percent of GDP), 7 April and this week (3.3 percent of GDP).
- With the three bills, the Government has boosted the resources available to the national health care system and the civil protection agency. In addition, it has broadened the layoff fund to all sectors of the economy and introduced a temporary income support for the self-employed and small businesses. With the May package, an emergency income scheme has also been introduced for citizens who are not eligible for other schemes such as Citizenship Income. A large program of State guarantees on bank loans has been launched and the government has also devised a mechanism to provide a mix of grants, capital contributions and tax credits to firms of different sizes in the most affected sectors of the economy.
- Resources are also devoted to research and to investment aimed at improving the energy efficiency of the economy. The economic purpose of the overall strategy is to protect the incomes of the most affected workers and households and also to prevent such a huge temporary shock from causing a permanent reduction in the productive capacity of the economy.
- Unlike the previous interventions, **the fiscal package that has been enacted this week also contains measures that will impact on the deficit in 2021** and in the following years, namely certain incentives on environmental and anti-seismic housing renovation investment and the repeal of the VAT and excise tax hikes that were due to go into effect in early 2021 and 2022. Taken together, the impact of these structural measures on the primary budget is worth 1.4 percent of GDP in 2021 and 1.8 percent in 2022.

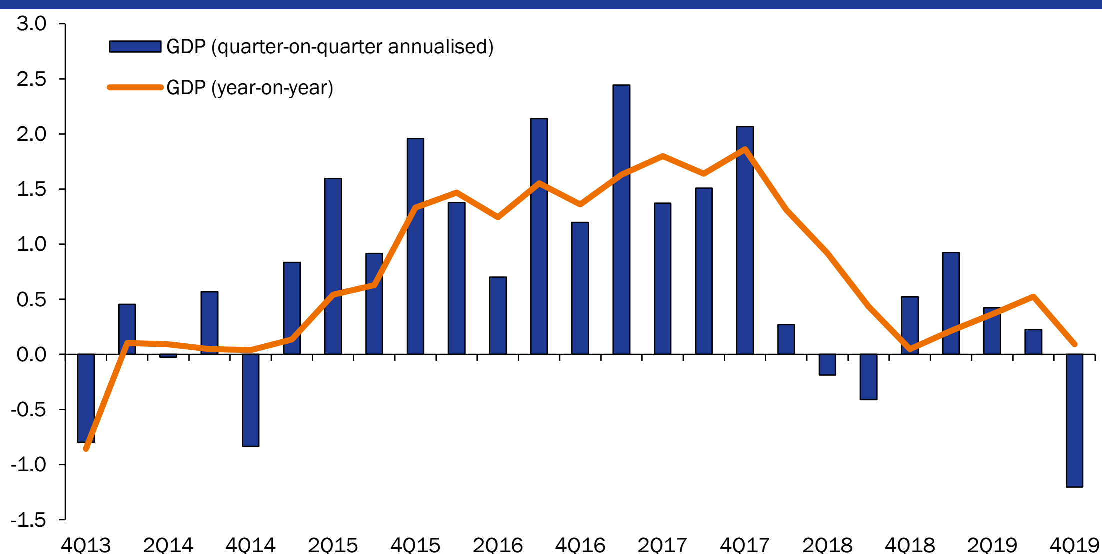
- **However, the government has already stated that the key goal of repealing the VAT is to improve the transparency of budgetary projections** and align them with those of the Commission. The next planning documents will feature a longer time horizon and will set new budgetary targets and policies that will offset at least in part the repeal of the VAT hikes.
- In March the Commission announced that, given the severity of the pandemic and of the impending recession, it was triggering the general escape clause of the Stability and Growth Pact. In the subsequent Spring forecast that was issued on 6 May, the Commission presented budgetary projections for all Member States in which temporary fiscal measures related to Covid-19 are treated as structural. As a result, in Italy's case, the Commission's deficit projections (11.1 percent of GDP in 2020 and 5.6 percent in 2021) imply structural deficits of 6.3 percent this year and 3.7 percent in 2021, sharply higher than the 1.5 percent-of-GDP structural deficit estimated by the Commission for 2019.
- As noted above, **most of the fiscal measures enacted since the start of the pandemic are temporary by construction and the budget deficit will decline markedly in 2021** (even without including the beneficial impact of higher GDP growth in the policy scenario). Consistent with the rebound in GDP and with a lower deficit, the gross debt-to-GDP ratio will fall from a peak of 155.7 percent this year, to 152.7 percent in 2021.
- The Government believes that, in view also of the likely duration of the pandemic, fiscal policy in 2021 should remain accommodative. **If by mid-2021 economic activity looks set to return to its pre-crisis level, the 2022 Budget will aim to begin a process of further deficit reduction**.
- **The debt-reduction strategy will rest on policy measures and reforms aimed at raising the growth potential of the economy** via investment in research and innovation, digitization, transportation networks and environmental sustainability, as well as improved efficiency of the public sector and of the legal system and a simplification of bureaucratic procedures.
- A policy mix based on structural reforms, investment and innovation, together with an adequate fiscal policy, will put the **public debt ratio on a sustainable and significant reduction path**.

I. ITALY'S ECONOMIC AND FISCAL PERFORMANCE IN 2019

I.1 CYCLICAL DEVELOPMENTS

According to ISTAT's preliminary estimates, in 2019 GDP grew by 1.2 percent in nominal terms and 0.3 percent in real terms, with a deceleration from the growth rates recorded in 2018, 1.7 percent and 0.8 percent, respectively. The real growth profile showed a gradual weakening during 2019, becoming negative in the fourth quarter, with a downturn of 0.3 percent quarter-on-quarter, probably exaggerated by calendar effects.

FIGURE I.1: GROSS DOMESTIC PRODUCT



Source: ISTAT.

Final domestic demand in 2019 continued to expand, albeit at lower rates than in the previous year, while stock-building subtracted 0.6 points from growth. Such a sharp decline had not been recorded since 2012, when inventories subtracted 1.2 percentage points from growth. Net exports, provided a positive contribution to growth of 0.5 percentage points. Considering the main components on the demand side, private consumption growth halved to 0.4 percent, from 0.9 percent in the previous year. Consumption weakened despite the activation, from May onwards, of the Citizenship Income scheme, as well as a positive labor market dynamic and favorable conditions for access to credit. The propensity to save increased during the year, to 8.2 percent, from 8.1 percent in 2018. Consumers maintained a cautious attitude and in the second half turned more pessimistic about economic prospects even as domestic financial market conditions improved, with the spread on sovereign bonds tightening.

Household balance sheets remained solid: household debt in the third quarter of 2019 was 61.7 percent of disposable income, well below the euro area average (94.9 percent). The sustainability of household debt was also supported by low interest rates.

Investment growth continued (1.4 percent), albeit at a lower rate than in 2018 (3.1 percent). Investment in machinery and equipment slowed sharply compared to 2018, (from 2.9 percent to 0.2 percent), while deceleration in construction was more moderate. The residential component was up 3.2 percent, infrastructure rose by 2.0 percent.

Exports performed well despite the slowdown in global trade growth, thanks in part to sectoral and geographic composition effects. Imports declined (-0.4 percent from +3.4 percent in 2018) as a result of the weakening of domestic demand and in particular of the industrial cycle.

As for the supply side, the manufacturing industry showed the first drop (-0.5 per cent) after six years of growth. Industrial production data sow an average fall in the index (corrected for calendar effects) of -1.4 percent (from a 0.6 percent increase in the previous year). Consumer goods, including non-durable goods, still showed a positive performance linked to factors such as the accumulation of stocks by the United Kingdom, in preparation for Brexit, and sustained demand from the USA. Production of intermediate and capital goods decreased significantly. The auto industry suffered a decrease in production compared to the previous year by 9.6 percent and also a decrease in turnover and orders (-7.8 percent and -9.9 percent respectively).

The construction sector continued to grow (2.6 per cent), with only a slight deceleration from 2018 (2.8 per cent). After the expansion in 2018, the value added of agriculture declined again. The services sector grew modestly (0.3 percent, from 0.5 percent in 2018). Growth in real estate, information and communication services remained favorable (1.7 percent and 2.2 percent, respectively) while the value added of professional activities and public administration, defense, education, health and social services declined (-0.2 percent and -0.7 percent respectively); trade, housing and catering services, transport and storage recorded only a slightly positive growth (0.1 per cent). Finance and insurance assets were stable.

Despite the slowdown in economic activity, the labor market in 2019 continued to improve. Overall, employment grew by 0.6 percent on a national accounts basis, from 0.8 percent in 2018. Hours worked increased by 0.4 percent (from 1.0 percent in 2018), with a reduction in per capita hours worked of 0.3 percent, after the slight increase recorded in the previous year.

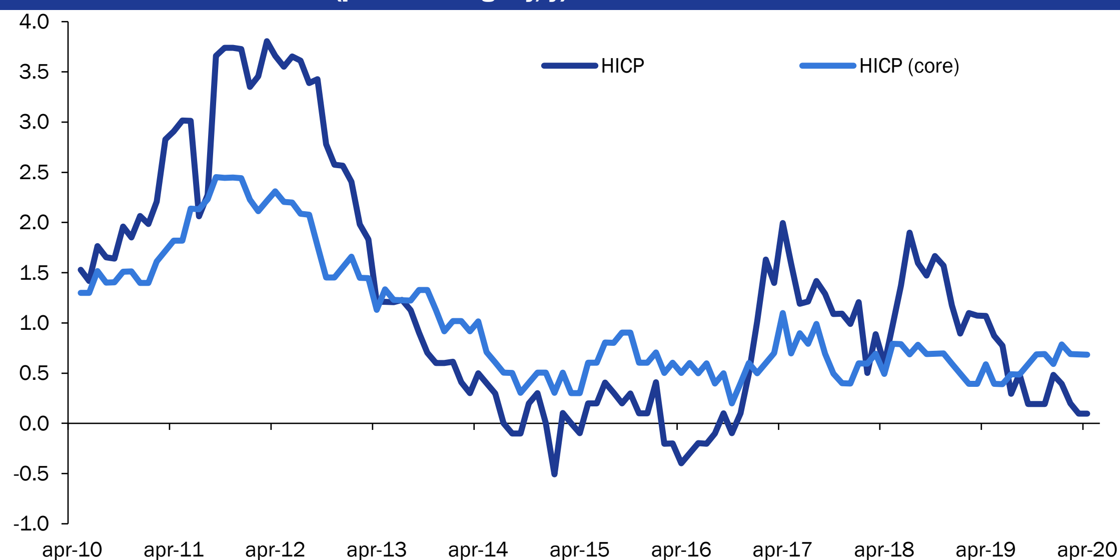
I.2 TRENDS IN INFLATION AND GDP DEFLATOR

The average inflation rate in 2019 fell to 0.6 percent, from 1.2 percent in 2018, following a declining trend during the year. The impetus toward lower inflation came primarily from a decline in energy prices. Indeed, core inflation decelerated only marginally compared to 2018, to 0.6 percent from 0.7 percent.

Even so, domestic inflation pressures remained extremely moderate. Hourly contractual wages in 2019 grew by a mere 1.0 percent. Even though employment grew moderately, the unemployment rate remained relatively high, at an average of 10.0 percent. Slack in the labour market is the key factor explaining low wage growth and continuing moderation in the GDP deflator growth, which remained stable at 0.9 percent.

Sluggish nominal growth remains a key hindrance to the reduction in the public debt ratio. While there are also domestic reasons for the ultra-low inflation that has been recorded in recent years, in the 2018-2019 period the global and European economic slowdown has been a key factor undermining business and consumer confidence and aggravating deflationary pressures.

FIGURE I.2: CONSUMER PRICES (percent changes y/y)



Source: ISTAT.

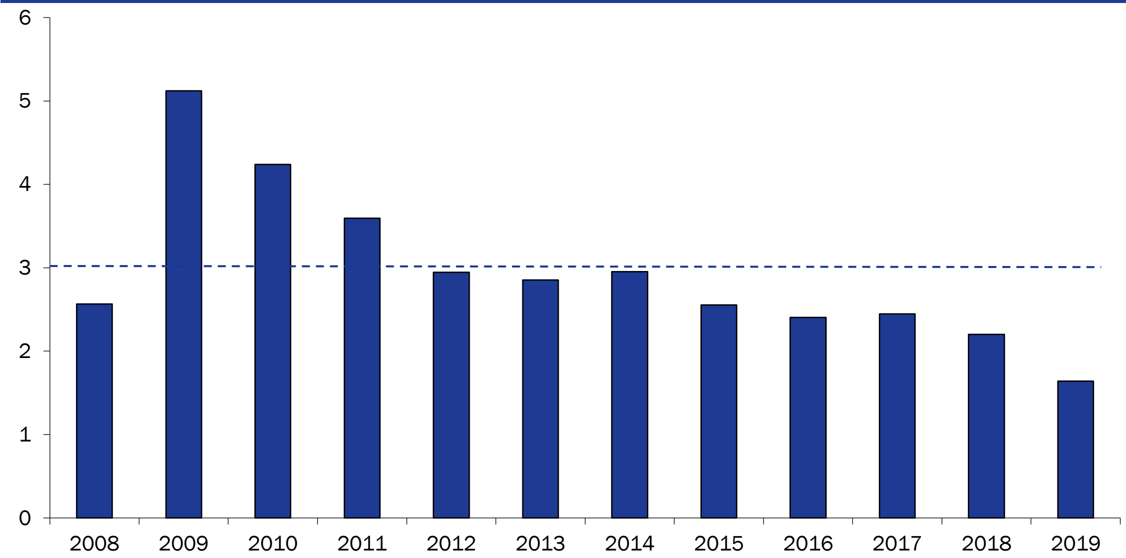
I.3 FISCAL PERFORMANCE AND ITS KEY DRIVERS

The general government budget deficit declined to 1.6 percent of GDP in 2019, from 2.2 percent in 2018. The outturn was significantly better than the original target, which was originally set at 2.0 percent of GDP in the final version of the 2019 Budget approved by Parliament and then revised up, as economic growth projections were lowered, to 2.4 percent of GDP in the Stability Program 2019 and then back down to 2.2 percent (thanks to an upward revision of tax revenue projections) in the Update of the Stability Program in September.

The 2019 deficit-to-GDP ratio is the lowest recorded in the last twelve years. Higher-than-expected growth in tax revenue was the key driver of the structural improvement in the budget balance. In fact, tax revenues were more than EUR 10 billion higher than the forecasts contained in September's Update. Revenue outperformance was explained not only by growth in employment and earnings, but also by improved tax compliance on the back of policy measures such as compulsory digital invoicing and advanced profiling of very small businesses.

The decline in net borrowing in 2019 was due to an increase in the primary surplus to 1.7 percent of GDP, from 1.5 percent in the previous year, and to a 0.3 percentage point decline in the interest expenditure as a share of GDP, from 3.7 percent in 2018 to 3.4 percent in 2019.

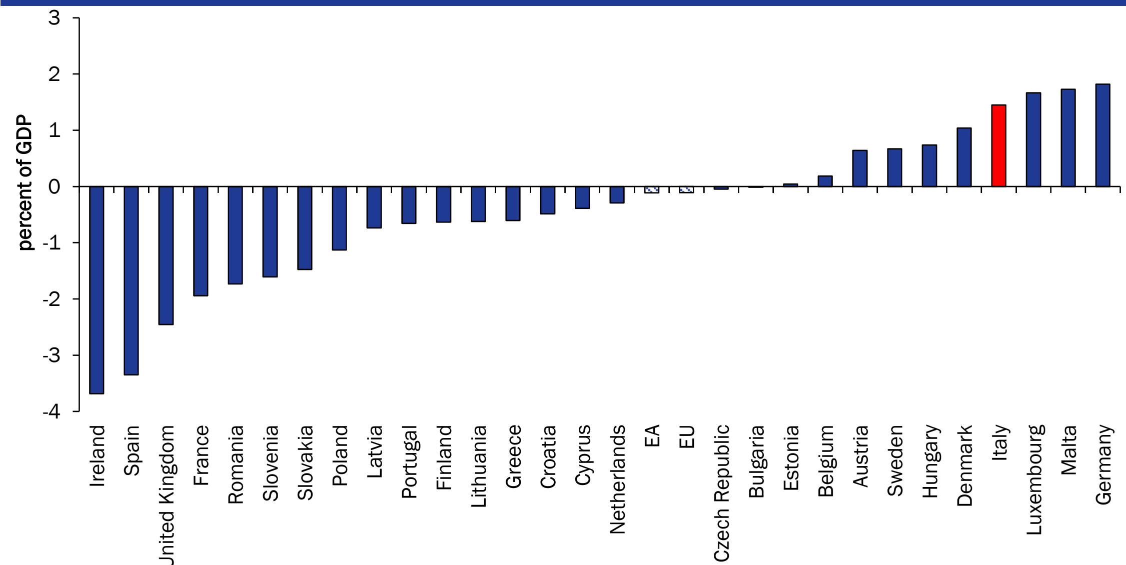
FIGURE I.3: GENERAL GOVERNMENT DEFICIT, EDP (percent of GDP)



Source: ISTAT.

Since the economic and financial crisis, fiscal consolidation has been a central feature of Italy's economic policy and the decline in net borrowing has been ensured by the maintenance of positive primary balances: Italy has recorded one of the highest primary surpluses in the Euro area and the European Union over the period 2010-2019 (1.5 percent of GDP, as shown in Fig. I.4). During that period, both the Euro area and the European Union recorded a slight primary deficit of about 0.1 percent of GDP on average.

FIGURE I.4: GENERAL GOVERNMENT PRIMARY BALANCE, EDP (average 2010-2019)



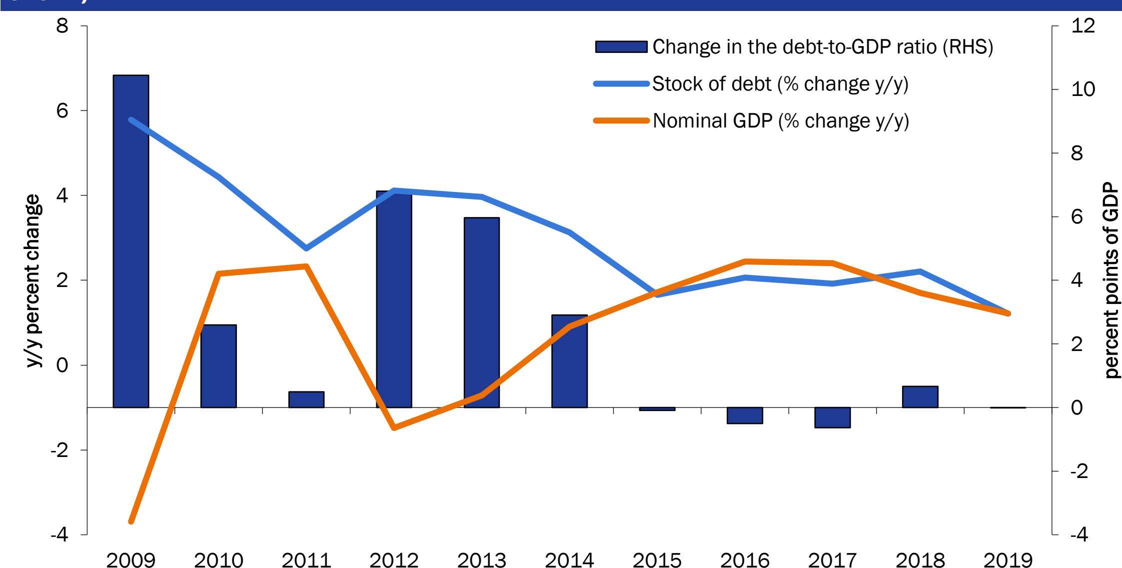
Source: AMECO database.

Benefiting from the particularly better net borrowing than the policy-scenario objective set in September 2019, the debt ratio in 2019 was fully stabilized at a level

well below the 135.7 percent projected in the Update. The zero annual change in the debt-to-GDP ratio of 2019 is the fourth best result since the global financial crisis. Read in conjunction with the positive budgetary data for early 2020, this result highlights the underlying improvement in Italy's public finances.

The attainment of a significant primary surplus has contributed to the stabilization of the debt-to-GDP ratio in recent years. The 2019 value is much higher than the forecasts of last April, which placed it at 1.2 percent, and almost completely offsets the snow-ball component (which quantifies the automatic impact of the difference between interest rates and nominal GDP growth on debt dynamics), which has grown to 1.8 percent currently, from 1.4 percent in 2018. The snowball effect is estimated to increase for the second consecutive year, due to the weakening of nominal GDP growth, offset only in part by the reduction in interest expenditure, which has declined from 3.7 percent to 3.4 percent of GDP.

FIGURE I.5: KEY DRIVERS OF GENERAL GOVERNMENT DEBT, EDP (percent changes y/y and percent points of GDP)



Source: ISTAT.

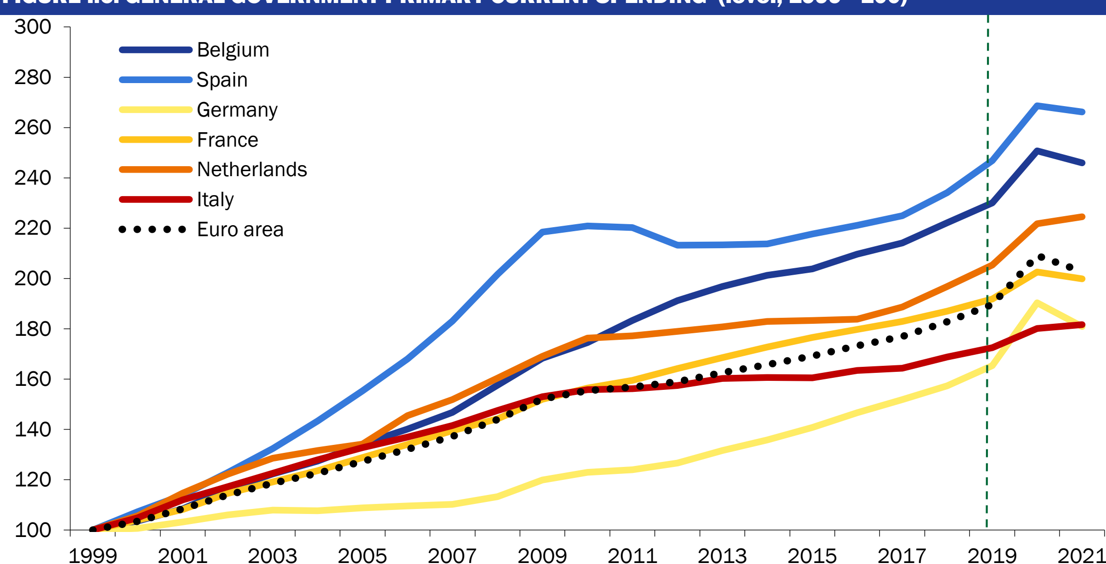
The stock-flow component, having contributed to the increase in the debt ratio over three consecutive years, showed a moderate change of trend in 2019, acting slightly in favor of debt change in 2019, by 0.02 percentage points of GDP. The following factors contributed to the result: i) an estimate of the public sector's borrowing requirements for 2019 slightly better than in 2018, mainly due to higher tax revenues; ii) technical factors, such as the issue gaps and the so-called up-lift, i.e. revaluation effect compared to 2018, with a favorable impact of around 0.2 percentage points of GDP. In 2019, the reduction in yields led to some bonds being issued above par, while lower inflation compared to 2018, both Italian and European, which occurred helped reduce the principal revaluation of outstanding inflation-linked securities

The corrective arm of the SGP explicitly mentions the development of primary expenditure as a relevant factor to be considered for the purpose of the Excessive Deficit Procedure (Art. 3, of Regulation 1467/1997). As already stressed in previous

reports on relevant factors, the soundness of Italy's primary surplus was supported by the restraint of current noninterest expenditure.

Current expenditure of the general government excluding interest declined to 41.1 percent in 2017 and then increased to 41.5 percent of GDP in 2018 and to 41.9 percent in 2019. The positive change is driven by the recent newly social inclusion measures that were the priority of Italy's 2018-2019 reform agenda following years of stability in nominal expenditure. In 2019, the year-on-year change in current primary expenditure was 2.1 percent in nominal terms, driven by welfare expenditure (+3.7 percent), which in turn was due to measures relating to early retirements and Citizenship income. Nevertheless, the trend in current noninterest expenditure has remained more moderate than in other Euro area member states.

FIGURE I.6: GENERAL GOVERNMENT PRIMARY CURRENT SPENDING (level, 1999= 100)



Source: AMECO. For 2020-2021 EC 2020 Spring Forecast, for Italy projections based on unchanged legislation of the Stability Program 2020, net of the EUR 80 measure, increases to EUR 100 as for July 2020.

In 2019, employment costs grew at a rate of only 0.4 percent. That confirms the return of Italy's public sector compensation to the previous trend following a 3.1 percent increase in 2018, which was due to a new public-sector labor contract covering three years ending in 2018 (with the attendant payment of arrears). The ratio of compensation to GDP declined in 2019, and on a comparative basis its share of GDP is only higher than Germany's.

TABLE I.1: COMPENSATION OF EMPLOYEES: GENERAL GOVERNMENT (euro bn)

	2012	2013	2014	2015	2016	2017	2018	2019
France	268,5	273,1	278,5	281,3	284,0	290,9	293,8	297,5
Germany	214,7	220,5	227,5	233,0	240,7	250,0	259,3	271,7
Italy	168,0	166,8	165,2	163,9	166,4	167,2	172,5	173,3
Spain	113,6	114,4	115,0	119,2	121,5	123,5	127,6	134,1

Source: AMECO. For 2020-2021 EC 2020 Spring Forecast, for Italy projections based on unchanged legislation of the Stability Program 2020.

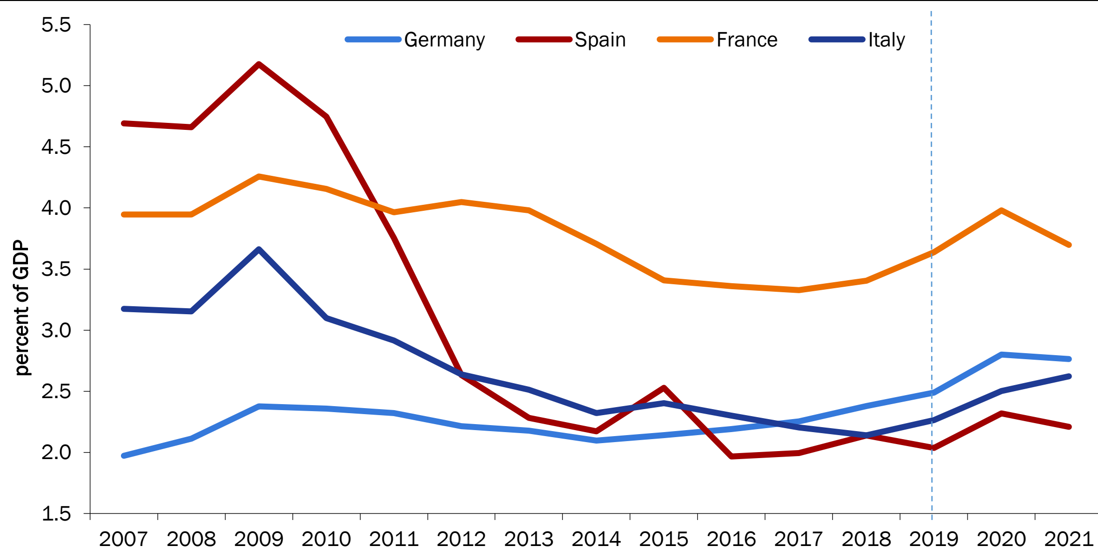
TABLE I.2: COMPENSATION OF EMPLOYEES: GENERAL GOVERNMENT (percent GDP)

	2012	2013	2014	2015	2016	2017	2018	2019
France	12.9	12.9	13.0	12.8	12.7	12.7	12.4	12.3
Germany	7.8	7.8	7.8	7.7	7.7	7.7	7.8	7.9
Italy	10.3	10.3	10.2	9.9	9.8	9.6	9.8	9.7
Spain	11.0	11.2	11.1	11.1	10.9	10.6	10.6	10.8
EU	10.6	10.6	10.5	10.3	10.2	10.1	10.1	10.1

Source: AMECO. For 2020-2021 EC 2020 Spring Forecast, for Italy projections based on unchanged legislation of the Stability Program 2020.

On the other hand, capital expenditure in 2019 increased by 3.6 percent, compared with a fall of 11.7 percent in 2018. Gross fixed capital formation grew by 7.2 percent, a positive figure related to the relaunch of extraordinary interventions for the safety and maintenance of infrastructure, in particular for the contrast to hydrogeological risk and on the road network for which a 0.18 percent of GDP budgetary flexibility was agreed with the European Commission.

FIGURE I.7: GENERAL GOVERNMENT FIXED CAPITAL FORMATION (percent of GDP)



Source: AMECO. For 2020-2021 EC 2020 Spring Forecast, for Italy projections based on unchanged legislation of the Stability Program 2020.

Public investment in 2019 rose to 2.3 percent of GDP, from 2.1 percent in 2018. The increase in public investment marks a reversal of the sustained decline in previous years. A similar evolution is projected for the current year and 2021 in the scenario based on existing legislation of the Stability Program 2020, where gross fixed capital formation is expected to reach 2.5 percent of GDP.

The government is working on new measures to support public investment, by simplifying administrative procedures in some areas crucial to the relaunch of public and private investment, among which procurement, and procedures for public works and ultra-broadband (see Chapter 3 of this Report for additional details).

The aim of the forthcoming structural policies is to bring capital accumulation back towards pre-crisis levels. Indeed, there is still a significant gap of about 1.4

percentage points of GDP (which corresponds to an expenditure gap of more than 17 billion) compared to the peak of 3.7 percent reached in 2009.

I.4 COMPLIANCE WITH THE PREVENTIVE ARM OF THE STABILITY PACT AND WITH THE DEBT RULE

The assessment of compliance with European fiscal rules occurring in the current European semester takes place in a new and unprecedented context. What happened in early 2020 led to an unprecedented fall in economic activity all across the European Union; this prompted the activation of the General Escape Clause, which had never occurred before. In particular, for the year 2020 full flexibility has been granted with respect to all expenses related to the ongoing emergency. At the same time, the EU Commission provided guidance on how to report public finance projections in accordance with the incumbent fiscal rules provisions, which were not suspended. As a result, while the public finance outcomes for 2019 can be assessed consistently with the usual criteria, the new public finance projections for the near term are primarily considered in terms of their capability to tackle the Covid-19 emergency within the framework of a coordinated response at EU level.

Concerning the fiscal year 2019, as part of the specific recommendations made in July 2018, the Commission and the European Council asked Italy to continue its effort towards the achievement of its medium-term objective – coinciding with a balanced structural budget balance – by adjusting to 0.6 per GDP percentage points in structural terms. At the same time, public expenditure growth should not exceed 0.1 percent growth. [1]

Subsequently, the collapse of the Morandi Bridge in Genoa on 14 August 2018 and the occurrence of extreme weather conditions prompted the Government to request the application of a flexibility clause for exceptional events for an expenditure amount equal to 0.2 percent of GDP. According to the updated data on the reporting of the works, the expenditure sustained in the year 2019 to counter the hydrogeological risk is estimated to be about EUR 1,324 million, while the expenditure realised for new projects of extraordinary maintenance of the road network amounted to EUR 1,884 million. All details are reported in the 2020 Stability Program.

Concerning the 2019 budgetary performance, compliance with the required convergence toward the MTO was assured even if not taking into account the aforementioned 0.2 percent flexibility for unusual events. As already mentioned, ISTAT notified to Eurostat that the net borrowing of the public administrations was -1.6 percent of GDP, compared with -2.2 percent in 2018. According to a provisional estimate contained in the Stability Program the structural balance improved by 0.6 percent of potential GDP with respect to the year 2018. It is also to be noted that the estimates of the EU Commission points toward an even better result (0.8 percent improvement), as from the recently published Spring 2020 forecasts. Concerning the

[1] Council Recommendation of 13 July 2018 on Italy's National Reform Program 2018 and delivering a Council opinion on Italy's 2018 Stability Program (2018/C 320/11).

expenditure rule, the performance was less favorable, even if better than expected[2]. Overall, this result represents a significant achievement, related to the capability to widen the tax base[3] and maintain employment despite the modest GDP growth.

It is also worth pointing out that the level of the structural deficit is not relevant in terms of compliance with the preventive arm, as the key variable under assessment is the change with respect to the previous year (i.e. the annual fiscal effort). However, the size of the structural budget dictates the required fiscal stance in the medium term; the farther away the structural budget is from the MTO, the higher will be the number of years in which a restrictive budgetary stance is required. On this ground, we continue to argue that the Commission projections underestimate potential output. For the year 2019, the Commission Autumn forecast set the output gap for Italy at a value equal to -0.2 percent of potential output.
Such number was in the lower range of estimates produced by international and national organizations before the Covid-19 outbreak (see Table I.3). For instance, in the November 2019 OECD Economic Outlook the output gap stood at -2.3 percent; the Bank of Italy in its January Economic Bulletin provided a central value of -1.9 percent, with the lower estimate being equal to -0.5 percent and higher one to -3.0 per cent[4].

TABLE I.3: OUTPUT GAP ESTIMATES BY DIFFERENT INSTITUTIONS, (percent of potential GPD)

	2019	2020	2021
Bank of Italy	-1.8	-1.9	-1.6
IMF	-1.0	-0.8	-0.5
OECD	-2.3	-2.0	-1.6
European Commission	-0.2	-0.1	0.2

Source: Bank of Italy, Economic Bulletin, January (1/2020), https://www.bancaditalia.it/pubblicazioni/proiezioni-macroeconomiche/2020/estratto-boleco-1-2020.pdf.
Data from: FMI, World Economic Outlook, October 2019; OCSE, OECD Economic Outlook, November 2019; European Commission, European Economic Forecast Autumn 2019, November 2019.

In any case, compliance with the preventive arm of the Stability and Growth pact is deemed to be among the most relevant factors when assessing the breach of the debt benchmark, to be commented below.

Italy in 2019 was not able to meet the very strict requirements of the debt rule in any its configurations. Several remarks are in order.

First, the ratio debt-to-GDP did not increase with respect to the 2018. The latest data released by ISTAT[5] and the Bank of Italy[6] confirm previous estimates of the debt-to-GDP ratio for both 2017 (134.1 percent) and 2018 (134.8 percent). The preliminary estimate for 2019 points to an unchanged ratio of 134.8 percent. The stabilization

[2] There is indeed a deviation from the path indicated by the expenditure rule, but this finding should be further qualified. According to the rule, revenue outperformance is not considered a discretionary increase and is therefore excluded from the computation of the expenditure aggregate. However, a permanent increase in revenue due to policy measures (e.g. electronic invoicing) implemented since 2018 has led to a permanent improvement in the budget. Thus, unlike the MTO rule, the expenditure rule does not capture this underlying improvement in the public finances.

[3] On this regard, see the Italian Stability Program, pages 62-67.

[4] For a comparison amongst national and international estimates and methodologies see also the following research paper by the Italian parliamentary budget office
(http://www.upbilancio.it/wp-content/uploads/2020/01/Nota-1_2020_-output-gap.pdf)

[5] Communiqué 'GDP and debt AP' of 2 March 2020 and 'Notification of net debt and general government debt according to the Maastricht Treaty' of 22 April 2020.

[6] Banca d'Italia, 'Statistical Bulletin of Public Finance, Needs and Debt', 15 April 2020.

represented a very positive outcome when compared to the expected annual increase of about 0.9 percentage points foreseen in the 2019 Update of the Stability Program, published last September.

Looking at the determinants of debt dynamics, the primary surplus in 2019 increased to 1.7 percent of GDP from the estimated value of 1.5 percent in 2018, thus almost offsetting the snowball effect. This last component reached 1.8 percent from 1.4 percent in 2018, due to the weakening of nominal GDP growth, and a small reduction in interest expenditures (from 3.7 percent to 3.4 percent of GDP). After having contributed to the increase of the debt ratio over three consecutive years, the stock-flow component showed only a moderate change in 2019 (0.02 percentage points of GDP)[7]. Another factor contributing to the debt-ratio stabilization is the decline in liquidity stock of the Treasury, which decreased by around 0.1 percent of GDP in one year, in line with the original projection in the Stability Program.

Despite the positive outcome, compliance with the debt rule was not achieved. As already pointed out, low nominal growth levels made it extremely difficult to push the ratio downwards. Full compliance would have required harsh fiscal measures, which would ultimately be further deflationary and counterproductive in terms of economic growth both in the short and medium terms.

I.5 PROGRESS ON SOCIAL INCLUSION: REDUCING INEQUALITIES AND POVERTY

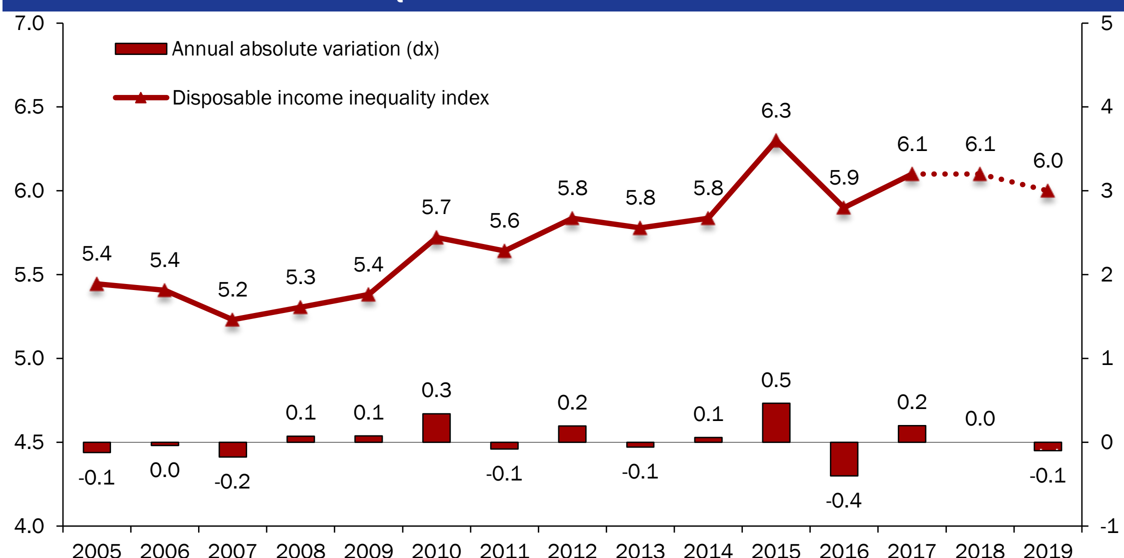
Inequality: recent trends and policies

Insights on social inclusion in Italy are provided by the recent trends in inequality, as shown in Figure I.8 concerning the income quintile share ratio (S80/S20). This indicator is calculated as the ratio of total income received by the 20 percent of the population with the highest income (top quintile) to that received by the 20 percent of the population with the lowest income (bottom quintile). The S80/S20 ratio is one of the headline indicators of the social scoreboard adopted with the European Pillar of social rights and is systematically considered along with other eleven Equitable and Sustainable Well-being indicators in the Italian budgetary process.[8]

[7] The following factors contributed to the result: i) an estimate of the public sector's borrowing requirements for 2019 slightly better than in 2018, mainly due to higher tax revenues; ii) technical factors, such as the issue gaps and the so-called up-lift, i.e. revaluation effect compared to 2018, with a favorable impact of around 0.2 percentage points of GDP. In 2019, the reduction in emission rates allowed issues above par, while lower inflation, both Italian and European, which occurred compared to 2018, helped to reduce the scale of the revaluation. These factors counterbalanced the failed privatization objectives set in the April 2019 EFD at 1.0 percent of GDP and revised to zero last September. In the course of 2019 the revenues from this source were, as in 2018, zero.

[8] The data used to calculate the indicator comes from the Eu-Silc survey released at time t and referred to time t-1. The last year available is 2018, while for the year 2019 ISTAT provides an estimate, obtained through a macroeconomic approach. The figures presented for the years 2020-2022 are pre Covid-19 estimates by the Ministry of Economy and Finance (MEF) using the tax-benefit micro-simulation model of the Department of Finance, which integrates the data of the Istat Eu-Silc Survey with administrative data.

FIGURE I.8: DISPOSABLE INCOME INQUEALITY INDEX – YEARS 2005-2019*



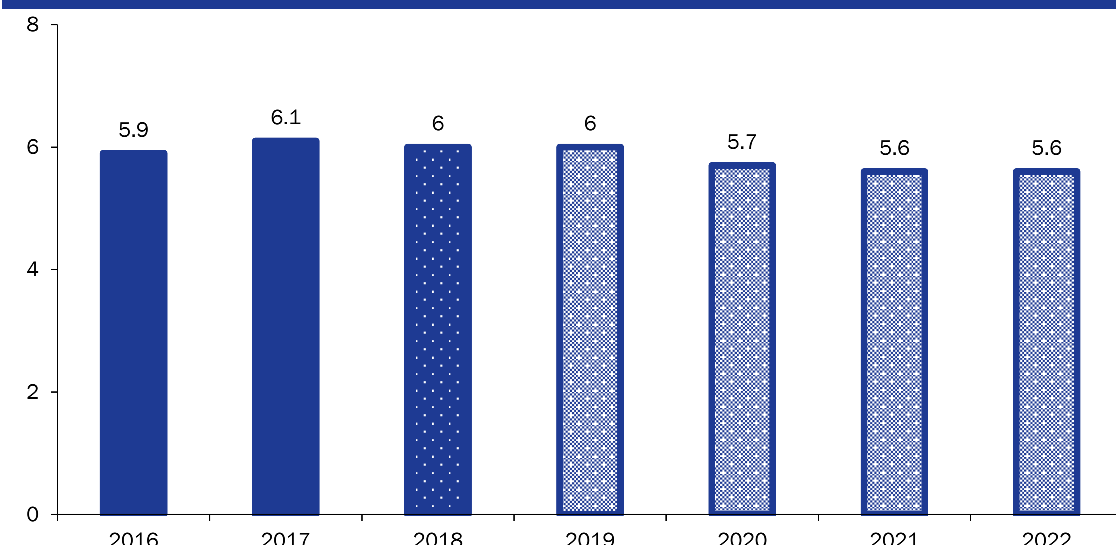
Source: ISTAT, Eu-silc survey.
* 2018 Istat provisional data; 2019: anticipated estimate by Istat.

The figure below reveals a generally upward trend following the economic and financial crisis, reaching a peak in 2015, improving thereafter. According to estimates by Istat for 2018 and 2019, the inequality index has fallen by 0.3 percentage points compared to 2015.

In the Minister's Report on ESW indicators to Parliament last February (*Relazione BES 2020*), forecasts by the Ministry of Economy and Finance showed a marked improvement compared to 2018 with a reduction of 0.3 points (see figure below), though the current estimate by Istat is lower. For 2020 (as for 2021 and 2022), a further reduction of 0.1 percentage points was expected. The assessment did not take into consideration the Covid-19 emergency and was based principally on the impact of the citizenship income (operational since April 2019) and additional transfers and tax deductions for employees introduced from July 2020.

Several measures introduced by the Government since February to address the social and economic consequences of the Covid-19-19 pandemic in Italy, although not directly aimed at reducing inequality, can avoid its increase. The measures introduced to support the income of workers and families, the suspension and extensions of mortgage payments and the expansion of the beneficiaries of the Family Card contribute to this stabilization. Further measures of support will be introduced with the new Decree Law approved by the Government this week. All these measures will contrast the potentially negative impact of the Covid-19 crisis on the inequality index in Italy.

FIGURE I.9: DISPOSABLE INCOME INQUEALITY INDEX – YEARS 2016-2022*



Source: ISTAT, EU-Silc survey.
* 2016-2017: Istat, Eu-Silc; 2018: anticipated estimate by Istat; 2019-2022: estimated by MEF-DF (tax-benefit microsimulation model).

Absolute poverty: recent trends and policies

Recent trends in poverty, as measured by the absolute poverty index, were improving up to the outbreak of the Covid-19-19 emergency. The absolute poverty index, developed in Italy since 1997[9], is based on the comparison between household consumption expenditure, calculated on the microdata of Istat's Household Budget Survey, and specific poverty thresholds.[10]

In 2019 the percentage of people belonging to families in conditions of absolute poverty decreased (Figure I.10). Specifically between 2014 and 2017 at the individual level the incidence of absolute poverty increased by 1.6 percentage points and then stabilized in 2018 at a the value of 8.4 percent, followed by a contraction of 0.7 percentage points during 2019.

At the household level, the incidence of absolute poverty grew by 1.2 percentage points between 2014 and 2018, the year in which it reached 7.0 percent, and then decreased by 0.5 percentage points in 2019.

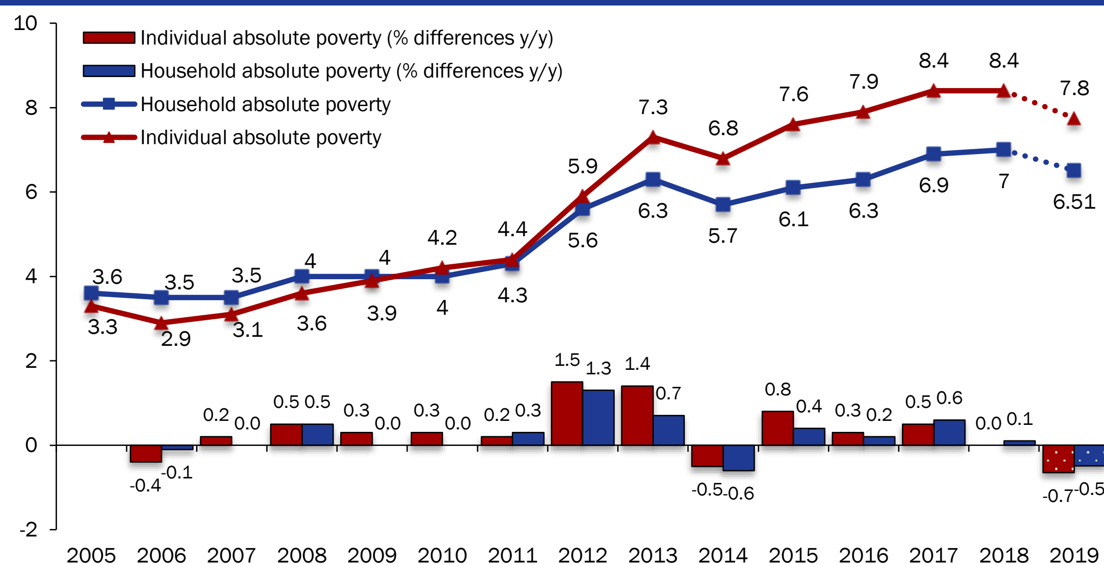
In 2019 the income inequality indicator shows a clear improvement with respect to 2018, with a reduction of 0.3 percentage points, falling from 6.0 to 5.7. This improvement is essentially due to the Citizenship Income (from April 2019, before that date the Inclusive Income scheme provided support to poor, eligible families) and

[9] The Italian National Statistics Office (Istat) publishes estimates on absolute poverty in Italy annually. The head count ratio for absolute poverty is also one of the equitable and sustainable well-being indicators (ESW) that were incorporated into the policy making process according to the reform law n. 163/2016, which modified the budget law n. 196 of 2009.

[10] The absolute poverty thresholds, equal to the value of a basket of goods and services considered essential to avoid serious forms of social exclusion, vary in number, age of the components, geographical distribution and type of municipality they belong to and are updated annually based on the variations the consumer price indices specific to the categories of goods and services that make up the basket, distinctly by geographical breakdown.

related policies introduced to help households and individuals at the lowest income quintiles.

FIGURE I.10: HOUSEHOLD AND INDIVIDUAL ABSOLUTE POVERTY (percentage value) - YEARS 2005-2019*



Source: Istat's Household Budget Survey.
(*) 2019: Istat, anticipated estimate by Istat.
Note: any differences between the data shown in the graphs and those in the text are attributable to rounding.

By calculating the incidence of poverty, both for individuals and families, using the absolute poverty thresholds of 2018 instead of those of 2019 (Table II.1), Istat shows that part of the reduction in the indicator has been eroded by inflation; specifically in 2019 in the absence of inflation the reduction in the incidence of poverty would have been slightly more marked both at an individual (-0.8 percentage points instead of -0.6 percentage points) and at a family level (-0.6 percentage points instead of - 0.5 percentage points).

Istat's preliminary estimates indicate that the incidence of absolute poverty at individual level has decreased in the three territorial divisions (North, Center, South), but with different intensities: in the North it is slightly decreasing (-0.1), while in the Center and in the South the changes are decidedly more robust, falling by -0.8 percentage points and -1.2 percentage points, respectively.

Also at the household level, for 2019 the situation is different in the various areas: in the North there is a slight deterioration in the indicator (+0.1 percentage points) while in the Center and in the South there are robust improvements equal to -0.6 percentage points and -1.3 percentage points, respectively. The inflation recorded in 2019 at a divisional level had an impact of 0.1 percentage points in the North and Center, while it is slightly higher in the South, at 0.2 percentage points.

The emergency measures introduced to contrast the diffusion of the Covid-19pandemic have had a negative impact on almost all economic and social indicators, including that of absolute poverty. Measures undertaken by the Government to support the income of workers and families (among which extending and activating social safety nets for different categories of workers, preventive measures against layoffs,

measures to ensure liquidity for businesses and families, enlargement of beneficiaries of the Family Card) will counter the increase in poverty during and in the aftermath of the current crisis.

TABLE I.4: ABSOLUTE POVERTY OF FAMILIES AND INDIVIDUALS (incidence of families and individuals - data 2018 and preliminary estimates 2019)

FAMILIES	North	Center	South	Italy
2018 Incidence of absolute poverty	5.8	5.3	10.0	7.0
data 2019 with 2018 thresholds (preliminary estimate) Incidence of absolute poverty	5.8	4.7	8.5	6.4
data 2019 with 2019 thresholds (preliminary estimate) Incidence of absolute poverty	5.9	4.7	8.7	6.5
INDIVIDUALS	**North**	**Center**	**South**	**Italy**
2018 Incidence of absolute poverty	6.9	6.6	11.4	8.4
data 2019 with 2018 thresholds (preliminary estimate) Incidence of absolute poverty	6.7	5.8	10.0	7.6
data 2019 with 2019 thresholds (preliminary estimate) Incidence of absolute poverty	6.8	5.8	10.2	7.8
INTENSITY	**North**	**Center**	**South**	**Italy**
2018 Intensity of absolute poverty (average value in percentage)	18.8	18.0	20.5	19.4
2019 (provisional) Intensity of absolute poverty (average value in percentage)	20.1	18.1	21.2	20.3

Source: Istat's Household Budget Survey.
(*) 2019: Istat, anticipated estimate by Istat

II. THE REFORM AGENDA

II.1 REFORM STRATEGY AND EMERGENCY RESPONSE TO CORONAVIRUS

Italy was severely hit by the Covid-19 pandemic and has followed a consistent policy to control the spread of the virus via social distancing, selective lockdowns and the closure of nearly half of the sectors of the economy. The Government is responding through measures to support workers, businesses and households, knowing that it is crucial to minimize the adverse economic and social consequences and restart the economy as soon as the infection is brought under control.

There is, therefore, a need for a long-term policy strategy, which includes also a change in the growth model that has characterized Italy in the past two decades. The increased pollution and global warming, trade tensions, Brexit, and now the Covid-19 pandemic highlight the need to combat climate change and achieve greater environmental and social sustainability within a stronger and inclusive European Union. The complex and dramatic times in which we are living can only reinforce the commitment that the government has already taken to embark on a path of investment and innovation to revitalize the Italian economy in a sustainable way.

While emergency support measures have been the utmost priority over the past two months, policy actions must now focus on increasing the resilience of the economy and its growth potential. Investment projects that are already in the pipeline will be expedited via a determined but transparent simplification process.

So far, Italy has not captured the full potential of digital technologies. It is now necessary to catch up and to face the new challenge of environmental sustainability. The current crisis has highlighted how digital technologies can be leveraged and disseminated in the public administration, boosting efficiency and the quality of services provided.

Italy will also support the development or revitalization of sectors that are crucial for national security and wellbeing, ensuring for instance that the shortages of medical devices experienced during the early stages of the pandemic will not happen again in the future.

The Green Deal and sustainable investment will be the themes that tie together the European choices for the next decade and, hopefully, those at the global level. These issues bring with them a resource-efficient and competitive new development model. Italy wants to make this a priority of its Government agenda. Taxation, investment decisions, financing, licensing, training and innovation should therefore prioritize the ‘green’ long-term view.

High public debt is a source of vulnerability for Italy and reduces fiscal space in times of need. The Government will therefore pursue a marked reduction in the debt to GDP ratio over the medium to long term.

The forthcoming National Reform Program identifies five thematic areas of action: taxation and finance; labor, social and demographic issues; investment and business.

II.2 THE GREEN AND INNOVATION DEAL

Italy supports with conviction the European Green Deal initiative launched by the European Commission while recognizing its high level of ambition and the policy and socio-economic challenges it poses for EU member states. With the 2020 Budget, the government has launched a national Green and Innovation Deal (GRIND), linking the increase in resources for public investment and incentives for private investment to the objectives of environmental and social sustainability, innovation and the circular economy.

In particular, the Italian Green New Deal was launched with the establishment of a Fund for financial operations that will be managed by the Economy and Finance Ministry, mainly through guarantees and, for the same purposes, the indirect participation in venture capital and/or debt, even of a subordinate nature. The fund is designed to create a leverage effect, attracting public and private funding for green investments and has a budget of 470 million for 2020, 930 million for 2021 and 1,420 million for each of the years 2022 and 2023, for a total amount of 4.24 billion for the period. Part of this package – for a share of no less than 150 million for each of the years 2020 to 2022 – will be earmarked for measures aimed at reducing greenhouse gas emissions, promoting the circular economy and reducing pollution. The environmental objective of Green New Deal will be threefold: strategies for mitigation and adaptation to climate change; combating and reducing pollution and its impact on health; supporting the development of a circular economy.

The Green and Innovation Deal also covers innovation and research funds and entails a significant increase in resources to be devoted to environmental and social sustainability interventions, also benefiting from the resources of the Central Government Investment Fund. Alongside the establishment of the fund, other investment programs and projects with an innovative and high environmental sustainability will be identified, including the regeneration and selective disposal of nonstrategic assets.

II.3 KEY ACTIONS IN RESPONSE TO THE COUNCIL RECOMMENDATIONS AND ANNUAL GROWTH SURVEY

The European Commission has recently reaffirmed in the 2020 Country Report on Italy that the main vulnerabilities of the country stem from high government debt and low productivity growth. According to the Commission's analysis, which was carried out before the spread of Covid-19 in Italy, public debt represents a significant medium-term macroeconomic imbalance. Market regulation has contributed to the unsatisfactory productivity dynamics. Significant regional disparities persist.

In December 2019, when the emergency health had not yet hit Europe, the European Commission defined the priorities of the Annual Sustainable Growth Strategy (ASGS), as a response to both short-term uncertainty factors (in particular, trade tensions in manufacturing and geopolitical uncertainty) and long-term ones (ageing population and environmental risks). In particular, the key priorities were identified in

the following areas: I) environmental sustainability; II) productivity growth; III) fairness and IV) macroeconomic stability.

With regard to fiscal policy, the Government shares the emphasis on debt reduction and the improvement in the structural balance, as suggested by the Commission. As already mentioned, once the emergency has been fully addressed, the Government will focus on a credible plan for debt reduction in the medium term, which will provide space for social measures and promote sustainable economic growth.

A reduction of the tax wedge on labor and a comprehensive review of taxation towards greater fairness and competitiveness are two of the main lines of action of the Government. Measures to combat tax evasion, such as incentives for electronic payments and electronic invoicing, in addition to stricter penalties, can give a useful contribution to the reduction of public debt. As for expenditure, the spending review will continue, with the aim of making expenditure more efficient and shifting resources towards public investment.

As regards the second area of action relating to employment and education, the Government is taking action to support the income and the employment condition of those most affected by the lockdown caused by health crisis. Previously, Italy has already introduced measures to reinforce social security and welfare benefits.

The Government is also committed to strengthen active labor policies in the implementation of the ‘Citizen Income’ scheme, through the reinforcement of the Employment Centers, also in terms of quantity and quality of the staff employed. In addition, the Government adopted further measures to boost employment for the most vulnerable members of the labor market (young people and women) and to reduce the area of inactivity. The Budget Law for 2020 also launched a strategy of reorganization and systematization of policies in support of families and people with disabilities.

Public resources for education, research, dissemination of innovation, digitalization and interconnection in production processes and computer skills were increased, also in qualitative terms. This includes, in particular, ‘Transition Plan 4.0’, the enhancement of secondary technical education and the recruitment of researchers and teachers.

Achieving a greater impact on the level of economic activity will require improvements in the policy design process for public investment. Particular attention will be paid to investments for the protection of the environment and saving energy, including those for the regeneration and development of public buildings.

In the implementation of the Green Deal, the Government will carry out a first review of the measures adopted or to be adopted in the implementation of the National Plan for Innovation and Sustainability. The objective of climate neutrality by 2050 set by the Commission can be achieved through the combination of financial instruments designed under the Green Deal, notably through the European funds allocated under the Just Transition Mechanism and with the use of Structural Funds 2020-2027.

The justice system is crucial for investment. In this context, in January 2020 the new rules for the statute of limitation came into force in order to ensure a reasonable duration and effectiveness of the trial . The Government has also approved a draft enabling law for the reform of the civil trial focused on the simplification and reduction

of the length of court proceedings. A similar bill was also approved for the reform of criminal proceedings. Investments and organizational efforts for the digitalization of legal cases will continue.

Finally, with reference to the banking system and the availability of financing for businesses, consolidation of credit institutions and the disposal of non-performing loans continue at a rapid pace. Moreover, the reform of cooperative credit institutions has been completed. The recent emergency measures support credit extension via State guarantees and a coordinated action with the *Cassa Depositi e Prestiti*. Access to finance for SMEs will be further improved with the support to venture capital funds through the National Innovation Fund and a dedicated fund for the South of Italy ('Grow in the South'). Finally, additional resources for the Guarantee Fund and the extension of the New Sabatini law will offer an important contribution to financing businesses through channels alternative to the banking sector.

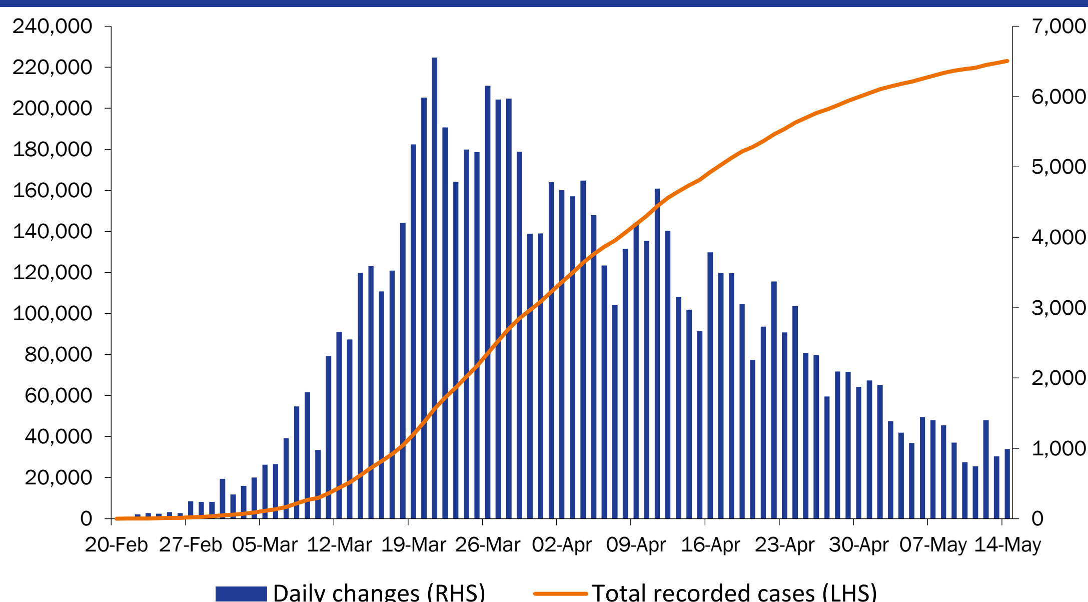
III. HIGHLIGHTS OF THE 2020 STABILITY PROGRAM

III.1 ECONOMIC OUTLOOK

The epidemic caused by the new Coronavirus (Covid-19) first hit China and then spread globally, affecting Italy most severely from the end of February. On 12 March, the World Health Organization (WHO) declared that Covid-19 had become a pandemic. The perniciousness of the virus and the high rate of fatality, in particular among the elderly with other ailments, required the adoption by the Italian authorities of increasingly restrictive health and social distancing rules. From an initial intervention to control outbreaks in a few municipalities of Lombardy and Veneto, restrictions on the movement of persons and productive activities were subsequently extended to whole national territory.

At the beginning of the year, economic activity rebounded from a moderate pullback in the fourth quarter, with industrial production and construction activity posting significant gains. In March, however, as the epidemic spread and control measures were implemented, most sectors of the economy suffered a fall that is unprecedented in the history of the post-war period. Output fell further in April, as almost half of the economy was virtually shut down. In early May, as the rate of new infections fell and the number of patients in intensive care dropped to less than a quarter of the peak recorded in early April, the government decided to fully reopen the manufacturing and construction sectors and the ease social distancing rules.

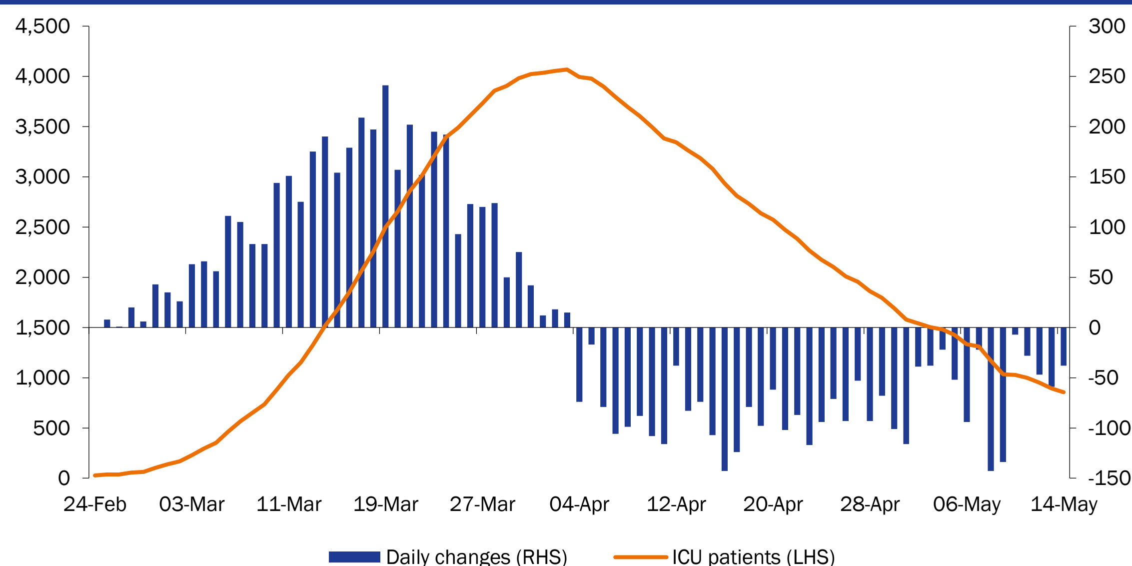
FIGURE III.1: RECORDED CASES OF CORONAVIRUS INFECTIONS



Precautionary measures will have to remain in force for a reasonable period and, in the meantime, the pandemic has spread to most of Italy's trading partners. In addition to the heavy output loss recorded in March and April, the economy will thus be affected by social distancing measures and weak global demand for some time to come – with the evolution of the pandemic crisis and its economic fallout hinging in particular on advances in medical treatment and vaccines.

The official macroeconomic forecast featured in Italy's Stability Program 2020 is based on information available as of 31 March. The forecast was endorsed by Italy's independent fiscal institution, the Parliamentary Budget Office, on 16 April.

FIGURE III.2: CORONAVIRUS PATIENTS IN INTENSIVE CARE UNITS (ICU)



The new forecast is predicated on the assumption that the shutdown of non-essential sectors and social-distancing measures would be gradually lifted from May onwards, leading to a gradual recovery in economic activity from the third quarter of this year. Moreover, it was assumed that the pandemic would fade out in 2021, with the economy returning to close to normal conditions in the first quarter of next year. However, the report also considered an alternative scenario in which Italy would suffer a new peak in contagion in the final months of the year and recovery would not set in before the second quarter of 2021.

According to the new forecast, real GDP in 2020 will fall by 8.1 percent on the basis of calendar-adjusted quarterly data and 8.0 percent based on annual figures. The previous forecast, which was featured in October's Draft Budgetary Plan, called for a 0.6 percent increase, an outturn that would have been well within reach without the Covid-19 scourge.

This year's unprecedented contraction in GDP would be explained for about a third by the fall in international trade in goods and services and for the remainder by social distancing measures, changes in consumer behavior and cuts in firms' investment plans. Household consumption would drop by slightly less than GDP, while the fall in investment would be much more pronounced. Imports would fall more than exports, resulting in a net contribution of foreign trade to growth.

TABLE III.1: OFFICIAL MACROECONOMIC FORECAST – 2020 STABILITY PROGRAM (1)
(percentage changes, unless otherwise indicated)

	2019	2020	2021
GDP	0.3	-8.0	4.7
GDP deflator	0.9	1.0	1.4
Deflator consumption	0.5	-0.2	1.7
Nominal GDP	1.2	-7.1	6.1
Employment (FTEs) (2)	0.3	-6.5	3.4
Employment (CLFS) (3)	0.6	-2.1	1.0
Unemployment rate	10.0	11.6	11.0
Current account balance (balance as % of GDP)	3.0	3.0	3.7

(1) Any inaccuracies result from rounding.
(2) Employment expressed in terms of Full-time equivalent units.
(3) Number of employees based on the sample survey of the Continuous Labour Force Survey (CLFS).

The quarterly profile of the real GDP forecast is -5.5 percent in the first quarter and -10.5 percent in the second. These very steep drops would be followed by a rebound of 9.6 percent in the third quarter and 3.8 percent in the fourth, which, however, would leave GDP in the final quarter of the year almost 4 percent below the corresponding period of 2019. After the forecast was published, Istat released a flash estimate of first-quarter real GDP showing a 4.7 percent drop. If confirmed in subsequent releases, this slightly better-than-expected outturn would leave a small margin in the event of weaker outcomes in the remainder of the year.

The official forecast then calls for a 4.7 percent increase in real GDP in 2021. The forecast assumes that a vaccine against Covid-19 will be available on a large scale next year and that this will lead to a further recovery in economic activity. The improvement would be moderate, though, and real GDP in the fourth quarter of 2021 will still be 3.2 percentage points below the fourth quarter of 2019 and almost six percentage points compared to the quarterly forecast in the Draft Budgetary Plan. Although it can be assumed that in the following years GDP will recover some of the ground lost in 2020-2021, the forecast prudently assumes that in the near term the cycle will not follow a 'V-shaped' profile.

III.2 MEASURES ADOPTED IN RESPONSE TO THE COVID-19 PANDEMIC

At the end of February the Council of Ministers approved a Decree-Law in favor of the areas initially affected by the Covid-19 outbreak, consisting of measures in support of households, employees and the self-employed. In the following days, in view of the likely economic consequences of the social distancing measures and plant lockouts that had been gradually introduced since March, the Government decided to develop a comprehensive package of economic support measures. The preliminary step was to obtain an authorization from the Parliament to raise the deficit ceiling -- after informing the European Commission, as required Italy's fiscal rules.

Law Decree n.18, 17 March 2020, the so-called ***Cura Italia***, has an estimated impact on net borrowing of the general government of €20 billion in 2020 and intervenes in four main areas:

- Resources available to the health system and the civil protection are increased in order to ensure staff, tools and means necessary to assist people affected by the disease and contain the epidemic.
- Measures are introduced to protect incomes and employment in order to avoid a worsening of inequalities and unemployment. The layoff fund (wage supplementation scheme) is extended to all companies forced to reduce or stop their activity due to the epidemic. Firing for economic reasons is prohibited for the duration of the emergency period.
- Liquidity support is provided to firms and households. Tax and social security contributions are postponed for selected categories. Banks are required to maintain existing credit lines to small and medium-sized enterprises (SMEs), including unused margins. Maturing mortgage loans must be rolled over until September. The State will give banks a one-third guarantee on new lending related to the portfolio constraint. The government provides additional resources to the Central Guarantee Fund for SMEs and to the State long-term credit institution *Cassa Depositi e Prestiti* for on-lending to banks and other intermediaries that provide financing to companies affected by the emergency and operating in specific sectors.
- Specific support measures are introduced for the most affected sectors, such as transportation, lodging, restaurants, bars, entertainment, sport and education.

The *Cura Italia* decree was followed by a second significant package via Law Decree n.23, 8 April 2020, the so-called '**Liquidity Decree**,' which strengthens credit support for households and businesses via:

- A further postponement of tax payments due by workers and businesses;
- The provision of guarantees provided to SACE Simest, a credit institution controlled by *Cassa Depositi e Prestiti*, for loans to SMEs and exporters;
- Faster payments of the public administration to its suppliers;
- The extension of golden power, i.e. the instrument that allows the government to authorize corporate actions in strategic sectors such as credit, insurance, water and energy.

On the whole, the Liquidity Decree provides guarantees on credit extension of up to 400 billion, which come on top of the 350 billion subject to moratorium or guaranteed by *Cura Italia*.

The third package was approved by the Council of Ministers on 13 May and is the most sizable one in terms of budgetary impact, €55 billion in 2020, an amount that includes the loss provision for the loan guarantees provided by the Liquidity Decree. Specifically, the new Law Decree (named ***Rilancio***, meaning 'restart') is organized around the following main areas:

- Health and safety: additional resources for the health system, civil protection, police and armed forces;
- Credit, liquidity and capitalization of businesses;

- Payments of the public administration: measures to accelerate payment times;
- Work and inclusion: refinancing of the Layoff Fund for an additional nine weeks with enhanced mechanisms, benefits for self-employed workers, domestic workers and caregivers, income support for citizens not covered by other forms of assistance such as seasonal and occasional workers, childcare vouchers, support for parental leaves, measures to monitor safety at work;
- Territorial authorities: support for the inclusion policies and investments of local and regional authorities;
- Tax authorities and reliefs: postponement of certain tax obligations and support for businesses and self-employed;
- Targeted interventions in the sectors most affected by the emergency: measures to support businesses and workers in sectors that are likely to remain subject to limitations in the coming months;
- Immediate interventions in favor of the transportation and logistics sectors;
- Tourism and culture: measures for workers, operators and businesses to support demand and restart the sectors;
- Justice: interventions for the efficient resumption of judicial activity and boosting technological innovation in the justice system;
- Education and schooling: investments and simplifications in technological innovation, school buildings, non-university tertiary training, support for nurseries and kindergartens;
- Higher education and research: measures to support the functionality of universities, high artistic training and public research bodies;
- Technological innovation: digitalization, simplification, technological innovation in the public administration and in the country.

In addition, the VAT and excise increases provided for in the legislation in force for 2021 and the following years are repealed. As for the financial impact of the *Rilancio* decree, the Government has obtained parliamentary approval to raise the general government net borrowing by a further 55.3 billion for 2020 including the additional interest payments, which is equivalent to 3.3 percent of GDP, and 26.3 billion (1.5 percent of GDP) for 2021, also inclusive of the added interest burden.

Once the urgent measures have been completed, a full-blown economic revitalization strategy will be developed, building on the experience gained over the past few weeks and the changes taking place as a result of social distancing and technological and behavioral innovations triggered by the pandemic.

The first step will be to speed up new public works already at an advanced stage of design and maintenance of existing infrastructure. On a longer view, the Government considers it strategic to promote investment in the circular economy and to promote the ecological transition by increasing the competitiveness and resilience of production systems to environmental and health shocks.

Investments to promote a new model of productive and industrial development, resource-efficient, competitive and innovative, will be prioritized. These innovations will be aligned with the European Green Deal. At the national level, as already

discussed in chapter II, work will be carried out on the implementation of the Green and Innovation Deal that has been financed by the 2020 Budget.

III.3 2020-2021 BUDGETARY PROJECTIONS

In last October's 2020 Draft Budgetary Plan (DBP), the policy objective of net borrowing of the general government was set at 2.2 percent of GDP for 2020 and 1.8 percent of GDP in 2021. In light of the improvement in public accounts for 2019 described in Chapter I and of the good performance of revenues in the first two months of 2020, it can be estimated that if the economy had not been affected by the Covid-19 pandemic, the net borrowing in 2020 would have been no more than 1.8 percent of GDP. However, the macroeconomic scenario has changed dramatically in a short period of time: the lowering of the GDP growth forecast compared to the DBP, by 8.6 percentage points in terms of annual growth, raises the deficit estimate by 4.1 percentage points of GDP.

In the Stability Program that was approved by the Council of Ministers on 24 April, the deficit projection for this year has been raised from 2.2 to 10.4 percent of GDP, including the combined effects of the three stimulus packages described above (4.5 percent of GDP). The general government debt stock is projected to reach 155.7 percent of GDP at the end of 2020.

In 2021, thanks to the expected recovery in economic activity and to the fact that most of the measures in the *Cura Italia* and *Rilancio* decrees are temporary, the deficit is expected to drop to 5.7 percent of GDP and the debt ratio will decrease to 152.7 percent. It is important to note that the nominal GDP forecast used for all these computations does not include the expansionary effects of the *Rilancio* decree. As such, the projections presented in the Stability program should be viewed as prudential estimates and will be updated once all the urgent measures have been issued and as more economic data become available.

The sharp rise in the debt-to-GDP ratio caused by the pandemic calls for a subsequent normalization strategy. It is clear that after a shock such as the one experienced this year, the economy will need a healing and recovery phase during which restrictive fiscal policy measures would be counterproductive. At present, there is also a high degree of uncertainty about the pandemic's evolution and the timing of the recovery phase. It is thus premature to define the details of the medium and long-term strategy to reduce public debt.

However, it is not too early to state the general principles of the strategy. First, Italy's sovereign debt is sustainable and the debt-to-GDP ratio will be brought back toward the euro-area average over the next decade following an approach that, in addition to adequate primary budget surpluses, will aim to raise the investment rate and the growth potential of the economy. The greater the credibility of the reform strategy, the lower the sovereign yield spread and the debt-reduction process.

TABLE III.2: PUBLIC FINANCE INDICATORS (% OF GDP) (1)

	2018	2019	2020	2021
NEW POLICIES SCENARIO				
Net borrowing	-2.2	-1.6	-10.4	-5.7
Primary balance	1.5	1.7	-6.8	-2.0
Interest	-3.7	-3.4	-3.7	-3.7
Public debt (gross of support) (3)	134.8	134.8	155.7	152.7
Public debt (net of support) (3)	131.5	131.6	152.3	149.4
TREND SCENARIO UNDER UNCHANGED LEGISLATION				
Net borrowing	-2.2	-1.6	-7.1	-4.2
Primary balance	1.5	1.7	-3.5	-0.6
Interest	-3.7	-3.4	-3.6	-3.6
Structural net borrowing (2)	-2.5	-1.9	-3.6	-3.0
Structural change	-0.4	0.6	-1.7	0.6
Public debt (gross of support) (3)	134.8	134.8	151.8	147.5
Public debt (net of support) (3)	131.5	131.6	148.4	144.3
MEMO: DBP 2020				
Net borrowing	-2.2	-2.2	-2.2	-1.8
Primary balance	1.5	1.3	1.1	1.3
Interest	3.7	3.4	3.3	3.1
Structural net borrowing (2)	-1.5	-1.2	-1.4	-1.2
Structural change	-0.1	0.3	-0.1	0.2
Public debt (gross of support) (4)	134.8	135.7	135.2	133.4
Public debt (net of support) (4)	131.5	132.5	132.0	130.3
Nominal GDP at unchanged legislation (absolute value x 1,000)	1,766.2	1,787.7	1,661.4	1,763.5

(1) Any inaccuracies result from rounding.

(2) Net of one-off and cyclical components.

(3) Gross or net of the stakes of Italy in loans to Member States of the EMU, whether bilateral or through the EFSF, and the contribution to the capital of the ESM. At the end of 2019, the amount of these allowances was approximately 57.8 billion, of which 43.5 billion for bilateral loans and via the EFSF and 14.3 billion for the ESM program (see Bank of Italy, 'Statistical Bulletin on Public Finance, Borrowing requirement and Debt' of 15th April 2020). It is assumed that MEF cash stocks will be reduced by 0.8 percent of GDP in 2020 and increased of 0.4 percent of GDP in 2021. The interest rates scenario used for the estimates is based on the implicit forecasts arising from the forward rates on Italian government bonds during the period of compilation of this document.

(4) Gross or net of the stakes of Italy in loans to Member States of the EMU, whether bilateral or through the EFSF, and the contribution to the capital of the ESM. The estimates consider privatisation proceeds and other financial incomes of 0.2 percent of GDP per annum over the period 2020-2021 and a reduction in MEF cash stocks of 0.1 percent of GDP for each year from 2019 to 2021.

The debt-reduction strategy will be fully compatible with the objectives of environmental and social sustainability that Europe and Italy have set for themselves. Improved tax compliance and the introduction of environmental taxes, together with a fairer income tax regime and a comprehensive review of public expenditure, will be the pillars of the strategy to improve budget balances and reduce the debt-to-GDP ratio over the next decade.

The Government's action will also be directed towards the introduction of innovative European instruments that can ensure an adequate fiscal policy response to the severity of the crisis and, at the same time, improve the prospects for long-term growth and improve the sustainability of the public finances of member states.

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