ECONOMIC AND FINANCIAL COMMITTEE

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EFC Opinion under Article (TFEU) 126(4) on the Commission's report prepared in accordance with Article (TFEU) 126(3)

on Italy

1. Preliminary considerations

The Commission presented a report under the third paragraph of Article 126 TFEU on Italy on 5 June 2019. The Economic and Financial Committee has examined this document on the basis of the provisions of the fourth paragraph of Article 126 TFEU, the Protocol on the excessive deficit procedure and Council Regulation (EC) n° 1467/97 "on speeding up and clarifying the implementation of the excessive deficit procedure", as amended by Council Regulation (EC) n° 1056/2005 and Regulation (EU) n° 1177/2011. Specific provisions for euro area Member States under excessive deficit procedure (EDP) are laid down in Regulation (EU) n° 473/2013.

On 23 May 2018, the Commission issued a report under Article 126(3) TFEU concluding that the deficit and debt criterion should be considered as complied with at the time, having regard in particular to Italy's ex-post compliance with the preventive arm in 2017. The report also noted a risk of significant deviation from the adjustment path towards the Medium-Term budgetary Objective (MTO) recommended by the Council for 2018, based on both the government plans and the Commission 2018 spring forecast. The report concluded that compliance would be reassessed on the basis of ex-post data for 2018 to be notified in spring 2019.

On 16 October 2018 Italy submitted its Draft Budgetary Plan, which implied a deterioration of the (recalculated) structural balance of 0.9% of GDP in 2019. The Commission's Opinion of 23 October 2018 on the Draft Budgetary Plan identified a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018 and requested Italy to submit a revised Draft Budgetary Plan.

On 5 November 2018, a discussion took place at the Eurogroup on the Commission's Opinion on the Draft Budgetary Plan. Terms of reference were published expressing agreement with the Commission assessment.

On 13 November 2018, Italy submitted a revised Draft Budgetary Plan. On 21 November 2018, the Commission adopted its Opinion on Italy's revised Draft Budgetary Plan, confirming the particularly serious non-compliance with the Council's fiscal recommendation for 2019 as changes were very limited.

The Commission issued a report under Article 126(3) TFEU on 21 November 2018 concluding that while the deficit criterion was currently complied with, the debt criterion as defined in the

Treaty and in Regulation (EC) No 1467/1997 should be considered as not complied with, and that a debt-based EDP was thus warranted.

The Committee adopted its Opinion on the Commission's report under art 126(4) TFEU on 29 November 2018.[1] At that time, the Committee was of the opinion that the debt criterion should be considered as not complied with and that, a debt-based excessive deficit procedure (EDP) was thus warranted. The Committee also noted that further elements might emerge from the then ongoing dialogue between the Commission and the Italian authorities.

In December 2018, the Commission decided not to launch the following steps of the EDP procedure after Italy revised its macroeconomic projections more in line with the Commission's 2018 autumn forecast (and had them validated by Italy's national fiscal council), and amended its 2019 budget, to avoid a deterioration of the structural balance in 2019, thereby according to the Commission putting an end to the situation of "particularly serious non compliance" with the preventive arm of the SGP.

Italy submitted its 2019 Stability Programme on 19 April 2019.

2. *Application of the criteria given in Treaty Article (EC) 126(2) and the Protocol on the excessive deficit procedure*

The Committee considers that when the government finances of a Member State do not comply with one or both of the criteria given in the second paragraph of Article 126 TFEU, this fact constitutes prima facie evidence of the existence of an excessive general government deficit. When assessing compliance with the deficit and the debt criteria, the Council (and the Commission) shall consider all relevant factors, according to the specific provisions spelled out in Article 2(4) of Regulation 1467/97.

2.1 The deficit criterion

Criterion 1: whether the ratio of the planned or actual government deficit to GDP exceeds the reference value of 3%, unless

- either the ratio has declined substantially and continuously and reached a level that comes close to 3% of GDP;
- or, alternatively, the excess over the 3% of GDP is only exceptional and temporary and the ratio remains close to 3% of GDP.

The general government deficit in Italy in 2018 as validated by Eurostat was 2.1% of GDP, down from 2.4% of GDP in 2017. According to both the Stability Programme and the Commission 2019 spring forecast, the deficit is projected to respect the Treaty reference value in 2019. According to the Stability Programme, the deficit would increase to 2.4% of GDP in 2019, while the Commission 2019 spring forecast projects a deficit of 2.5% of GDP in 2019.

The Commission forecast projects that the Treaty reference value will be exceeded in 2020 with a deficit of 3.5% of GDP under a no policy change assumption, whereas the Stability Programme projects a deficit of 2.1% of GDP in 2020.

[1] ecfin.cef.cpe(2018) 6671890

Therefore, the Committee concludes that the *deficit criterion* of the Stability and Growth Pact is currently considered as *fulfilled* based on the information contained in the Commission 126(3) report.

2.2 The debt criterion

Criterion 2: whether the ratio of gross government debt to GDP exceeds the reference value of 60%, unless

- the ratio is sufficiently diminishing and approaching the 60% of GDP level at a satisfactory pace.

According to the spring 2019 notification as validated by Eurostat, the general government gross debt-to-GDP ratio, after having stabilized at 131.4% between 2016 and 2017, increased by 0.8% of GDP to reach 132.2% in 2018, well above the 60% of GDP reference value. That increase was mainly due to a large debt-increasing stock-flow adjustment (0.9% of GDP) also related to a marked rise in the Treasury liquidity reserves. The debt-reducing impact of the higher primary surplus (1.6% of GDP, up from 1.4% in 2017) almost entirely offset a debt-increasing "snowball" effect (1.5%). Italy's public debt-to-GDP ratio is the second largest in the EU and one of the largest in the world. In the Stability Programme, the debt-to-GDP ratio is expected to rise further to 132.6% in 2019, before decreasing to 131.3% in 2020. The Commission 2019 spring forecast projects the debt-to-GDP ratio to rise much more markedly in 2019 and 2020, to 133.7 % and 135.2 %, respectively. The difference is due to a lower nominal GDP growth forecast, and, for 2020, also to a much lower primary balance as the Commission does not incorporate in its forecast the increase in VAT rates (worth 1.3% of GDP) legislated as safeguard clause, given the systematic repeals recorded in recent years and the lack of details on possible alternative measures. Moreover, the Commission assumes lower privatization proceeds than the government. In this context, it should be noted that privatisation proceeds of around zero in 2018 significantly underachieved the 0.3% of GDP target planned by the government.

Following the amendments to the SGP in 2011, the debt requirement has been put on an equal footing with the deficit requirement in order to ensure that, for countries with a debt-to-GDP ratio above the 60% reference value, the ratio is brought below (or sufficiently declining towards) that value.

Based on the notified data, Italy did not comply with the debt reduction benchmark in 2018 (gap to the benchmark of 7.6% of GDP). Based on the Stability Programme, Italy is not planning to comply with the debt reduction benchmark in 2019 (gap to the debt benchmark of 5.1% of GDP) or in 2020 (gap of 4.5% of GDP). This is confirmed based on the Commission forecast (gap to the debt benchmark of 9.0% and 9.2% of GDP in 2019 and 2020 respectively).

Therefore, the Committee concludes that the *debt criterion* in the sense of the Stability and Growth Pact is *prima facie not considered to be complied with* based on the information contained in the Commission 126(3) report, before considering relevant factors.

2.3 Relevant factors

Articles 2(3) and 2(4) of Regulation (EC) No 1467/97 stipulate that all relevant aggravating and mitigating factors shall be taken into account in a balanced overall assessment for the steps leading to the decision on the existence of an excessive deficit when assessing compliance on the basis of the debt criterion. The Committee takes note of the Commission's assessment of relevant factors that need to be considered when assessing compliance with the debt criterion, including its assessment that the adherence to the MTO or the adjustment path towards it, structural reforms and economic conditions are three key relevant factors.

The Committee acknowledges the macroeconomic slowdown in Italy from the second half of 2018, with nominal GDP growth falling below 2 % in 2018 and over 2019-2020 based on the Commission spring forecast. The Committee acknowledges the Commission's assessment that, while the fiscal adjustment needs to be modulated carefully to avoid a significant impact on growth, the ongoing economic slowdown can be seen as a mild mitigating factor that only partly explains Italy's large gaps to compliance with the debt reduction benchmark.

As regards 2018, based on notified data the expenditure benchmark points to an inadequate fiscal adjustment in 2018, as the growth rate of Italy's government expenditure, net of discretionary revenue measures and one-offs, at 2%, is expected to have exceeded the 0.5% increase recommended by the Council (after considering the "margin of discretion"). Moreover, based on notified data, and the Commission 2019 spring forecast, Italy's structural balance is estimated to have deteriorated by 0.1% of GDP in 2018, falling short of the requested structural effort of 0.3% of GDP. The overall assessment by the Commission thus points to Italy's non-compliance with the adjustment path towards the medium-term budgetary objective recommended by the Council for 2018, even after taking into account the so-called "margin of discretion".

Based on the Stability Programme, the expenditure benchmark points to a risk of significant deviation both in 2019 and over 2018 and 2019 taken together. The same indication is provided by the structural balance pillar, as the Stability Programme projects the (recalculated) structural balance to deteriorate by 0.2% of GDP in 2019, while the Council in July 2018 recommended a structural improvement of 0.6% of GDP. This points to a risk of significant deviation both over one year and over 2018 and 2019 taken together. The Commission's overall assessment points to a risk of significant deviation from the adjustment path towards the MTO, which is confirmed on the basis of the Commission 2019 spring forecast. The conclusion of the overall assessment would not change even if the budgetary impact (around 0.2% of GDP) of the extraordinary maintenance programme for the road network and connections following the collapse of the Morandi bridge in Genoa and of a preventive plan to limit hydrogeological risks were considered as unusual events and preliminarily subtracted from the preventive arm requirement.

For 2020, based on the Stability Programme, the expenditure benchmark points to a risk of some deviation in 2020 and to a risk of significant deviation over 2019 and 2020 taken together. The same indication is provided by the structural balance pillar. Based on the Commission 2019 spring forecast, the overall assessment based on the recalculated government plans is confirmed. For both pillars, the gaps to compliance in 2020 are significantly larger based on the Commission forecast than based on the Stability Programme, as the former does not include the legislated VAT safeguard clauses and projects a worse fiscal outlook in 2020.

Despite past progress in important reform areas, low productivity growth keeps constraining Italy's potential growth and hampers a fast reduction of the debt ratio. In this context, the Committee notes that based on the Commission's assessment in the Country Report, overall, Italy has made limited progress in addressing the 2018 Country-Specific Recommendations and that the structural reform agenda outlined in the 2019 National Reform Programme largely builds on reforms already in the pipeline in different areas, showing broad continuity compared to past National Reform Programmes. There has been some progress in fighting corruption, in reducing the stock of non-performing loans in the banking sector, and in implementing the reform of active labour market policies. There has been limited progress in tackling tax evasion, in improving market-based access to finance, in enforcing the framework for publicly owned enterprises, in encouraging women to work, and in fostering research, innovation, digital skills and infrastructure and vocational-oriented tertiary education. There has been no progress in shifting taxation away from productive factors, in reducing the share of old-age pensions in public spending (on the contrary there was some backtracking in that area), in reducing trial length in civil justice, and in addressing restrictions on competition. In addition, Italy still experiences excessive macroeconomic imbalances mainly related to very high public debt and low productivity growth, while unemployment remains high and the overall stock of non-performing loans in Italian banks' balance sheets remains elevated.

The Committee notes that the Italian authorities have put forward several relevant factors, including: (i) their consistent track record of sizable primary surpluses coupled with solid fundamentals and a strong financial position, (ii) their commitment to fiscal consolidation and to reducing the debt-to-GDP ratio over the coming years, (iii) the underestimation of the degree of slack in Italy's economy, (iv) their track record of growth-enhancing structural reforms including improving social inclusion and revitalising public investment and (v) Italy's low fiscal sustainability risks in the long-term. The Committee acknowledges that the Commission's analysis covers most of the factors put forward by the authorities and it broadly concurs with the Commission assessments of those factors.

The Committee notes the indication by the Italian authorities of the existence of possible upside risks to the 2019 budget balance thanks to higher-than-expected revenues and lower-than-projected public expenditure on measures in the 2019 budget which appear plausible overall to the Commission, but that can only be confirmed later in the year, when more data will be available. [2]

The Committee notes that the estimation of Italy's output gap and potential growth based on the "commonly agreed methodology" has been discussed extensively in the Output Gap Working Group, leading to a number of country specific adjustments to the "commonly agreed methodology" in the case of Italy.

The Committee notes that the size of the deviation from the recommended adjustment path towards the MTO is set, based on the Commission forecast, to further widen in 2020, in a situation where Italy's headline deficit is expected to be above the 3% of GDP deficit threshold under the no-policy-change assumption. The Committee takes note that the Italian authorities in their letter concerning relevant factors have reiterated the commitment, already included in the Parliamentary endorsement of the Stability Programme, to implement alternative financing measures to ensure the achievement of the targets on nominal and structural deficit included in the 2019 Stability Programme for 2020 and have announced a spending review and revenue enhancement in this respect[3].

The Committee agrees with the Commission that Italy's public debt remains a major source of vulnerability for the economy. The measures to extend the possibility for early retirement, together with adverse demographic trends, partly reverse the positive trends generated by past pension reforms and weaken long-term fiscal sustainability. Long-term fiscal sustainability was also hampered by the increase in interest rates on government bonds observed in 2018 and

[2] Government statement of June 5th 2019 concerning the Report ex art. 126.3 TFEU from the European Commission available at http://www.governo.it/it/node/12047

[3] See Minister Tria's accompanying letter to the Report on relevant factors influencing Public debt developments in Italy available at http://www.mef.gov.it/inevidenza/documenti/Tria_letter_to_Commissioners_xENx.pdf

through early 2019. The Committee notes that Italy's fiscal sustainability risks are assessed to be low in the short term, but high in the medium and long term according to the Fiscal Sustainability Report 2018.

The fact that debt-servicing costs absorb a large amount of public resources in Italy (comparatively larger than in the rest of the euro area) also takes a toll on the country's productive spending. Despite additional efforts to increase investments envisaged in the Stability Programme, public investment does not appear to represent a mitigating factor justifying Italy's lack of compliance with the debt reduction benchmark, given its broad decline over time.

Overall, the Committee is of the Opinion that, based on the assessment of the relevant factors as put forward in the Commission 126(3) report, the debt criterion should be considered as not complied with. The Committee invites Italy to take the necessary measures to ensure compliance with the provisions of the SGP in accordance with the EDP process.

3. Conclusion

In accordance with the fourth paragraph of Article 126 TFEU, the Economic and Financial Committee has examined the report on Italy prepared by the Commission under the third paragraph of Article 126 TFEU.

On the basis of the elements mentioned above and taking into account the Commission's overall analysis of the relevant factors as set out in its report of 5 June 2019, the Committee is of the Opinion that the debt criterion in the second paragraph of Article 126 should be considered as not complied with, and that a debt-based EDP is thus warranted. Further elements that Italy may put forward could be taken into account by the Commission and the Committee.