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2019 Budgetary Policy Report

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SUMMARY

In 2018 the expansion of the Italian economy weakened significantly, coming to a halt in the second half of the year. The cyclical slowdown has also affected other countries, both in the euro area and outside Europe.

In October, the Government presented policy forecasts for Italian GDP growth of 1.2 per cent in 2018 and 1.5 per cent in 2019 and on average for the next two years. The PBO did not endorse these projections, noting the excessive optimism with regard both to the real variables (investment in particular) and, above all, the nominal changes that most impact the public finance balances. The decision was broadly supported by the assessment of short-term economic developments, which showed rapid deterioration in the autumn. In addition, several downside risks were underscored, mainly of external origin, but with a strong impact on Italy.

In December, the Government revised its macroeconomic forecasts, reducing expected growth in real GDP (to 1.0 per cent for both 2018 and 2019) and nominal GDP. The PBO conducted a rapid assessment exercise. Although the 2019 forecast for GDP growth (0.8 per cent) was lower than that formulated by the Ministry for the Economy and Finance (MEF), the MEF scenario was considered plausible, as the forecasts for nominal GDP growth produced by the two institutions coincided (2.3 per cent). However, significant downside risks were noted, especially for the next two years. The economic data released subsequently heightened the risks, including in the short term.

In addition to updating the forecasts, the PBO analysed the impact of the Budget Act on economic activity, using the MeMo-It macroeconometric model. Taking account of the funding sources for the various measures adopted, the impact of the fiscal stimulus on GDP in 2019 would be 0.3 percentage points (marginally lower than that estimated by the MEF).

On 23 October 2018, the European Commission asked the Government to submit a revised Draft Budgetary Plan (DBP) after the DBP presented on 15 October did not comply with the Council's recommendations to Italy of 13 July 2018 or the objectives previously set in the 2018 Stability Programme. The MEF therefore sent a new version of the DBP in which the budget targets were unchanged from the original version, including the structural deterioration expected for 2019, in contrast to the improvement requested by the Council last July. The Commission therefore prepared a new report pursuant to Article 126(3) of the TFEU for Italy's prima facie non-compliance in 2017 with the rule for the reduction of the debt as a ratio of GDP. The report stated that an excessive deficit procedure under the debt rule was justified in the case of Italy.

Following negotiations subsequent to the Commission's announcement that it was considering opening of a procedure against Italy and in response to the Commission's findings, in December the Government significantly modified the scale and composition

of the budget measures under discussion in Parliament. The revision of both the structure of the budget package and the underlying macroeconomic scenario modified the nominal – trend and policy – and structural (i.e. net of cyclical effects and one-off measures) public finance balances. According to government estimates, these changes should make it possible to resume the path towards the medium-term objective (MTO) as from 2020, after broad structural stability net of payments for unusual events in 2019, and to project a slight reduction in the debt/GDP ratio over the 2019-2021 period, after the increase expected for 2018 (attributable to economic conditions).

More specifically, the policy deficit following the budget measures is now expected to rise to 2.0 per cent in 2019, compared with 1.9 per cent in 2018, and decline thereafter, to 1.8 per cent in 2020 and 1.5 per cent in 2021. The policy scenario, which envisages no change in 2018, forecasts a deterioration in the structural balance of 0.2 percentage points in 2019, following by an improvement of one-tenth of a point in 2020 and two-tenths in the following year.

The budget measures include expansionary measures whose impact remains at between 2.1 and 2.4 per cent of GDP over the planning period. By contrast, net of the effects of the safeguard clauses, the new measures produce an increasing impact, rising from 1.5 per cent in 2019 to 2.4-2.3 per cent of GDP in the following two years. Given the planned increase in the deficit, the resources to cover the measures are smaller but they do increase from 1.5 per cent of GDP in 2019 to 1.8 per cent in 2021.

For 2019, the expansionary measures amount to €38.6 billion, for which resources of €27.1 billion have been identified, with a consequent increase of €11.5 billion in the deficit. For the fourth consecutive year, the most significant expansionary measure is the deactivation of the safeguard clause increasing VAT rates, amounting to about €12.5 billion for 2019. The other main measures regard early retirement, social inclusion and the fight against poverty through the minimum income and pension support programmes, the start of the recovery of public investment at the national and local levels and investment to secure and maintain infrastructure, as well as public employment funding for new hiring and wage increases under contract renewals, and the launch of a number of tax relief mechanisms for companies and self-employed workers.

On the funding side, just over 50 per cent will be generated by higher revenues, which will include increases in revenues from companies, especially banks, and insurance premiums, the repeal of the proportional business income tax system (IRI), which was scheduled to begin in 2019, and the allowance for corporate equity (ACE), as well as an increase in taxation on gaming and tobacco products.

For 2020-2021, the greater impact of many of the expenditure increase measures – particular those on capital account – will be accompanied by the growing impact and extensions of measures already provided for in 2019 and additional measures affecting tax relief mechanisms. As far as raising the resources to cover the expenditure is concerned, the proportion of revenue increases will rise compared with 2019, reflecting in particular the greater impact of the safeguard clauses and increasing revenues from measures to combat tax evasion and the tax amnesties provided for in Decree Law 119/2018.

Given the budget package, achievement of the new public finance policy objectives is exposed to a number of risks.

For 2019, the public finance framework appears transitory in nature, owing to a series of one-off revenue measures and temporary spending programmes, and above all affected by uncertainty – as underscored by the provision to freeze €2 billion to guarantee compliance with the deficit target – in particular with regard to the actual design and feasibility of the measures, such as, for example, the programme of additional real estate sales.

The amendments introduced during the passage of the budget through Parliament also changed the nature of the budget, reversing the sign of the overall net impact on capital expenditure. Under the initial version of the budget package, in 2019 this expenditure was increased by about €1.8 billion over its trend level, while in the final version it was cut by €2 billion.

In 2020-2021, the achievement of the policy deficit/GDP ratio depends entirely on the safeguard clauses raising VAT rates and excise duties. Their impact was already significant in the initial version of the Budget Bill and was increased further in the final law (to 1.2 per cent GDP in 2020 and 1.5 per cent in 2021). These clauses are crucial factors in the planned reduction of the debt/GDP ratio in 2020-2021.

In the light of past experience, replacing the clauses appears, at the very least, to be a challenging prospect. Expenditure cuts would probably not involve, except to a limited extent, investment programmes, which the Government is seeking to strengthen; social programmes, which have been expanded with this budget; or compensation of employees, which will be increased by contract renewals. Given these exclusions, the remaining expenditure items available for reductions, represented in large part by healthcare expenditure, would undergo substantial cuts. One area of intervention could regard – as touted for years – so-called tax expenditures, although the Budget Act actually extends some of these.

Another problem is the fact that the budget does not quantify the impact on the general government accounts of spending related to the contractual renewals at government departments other than State entities. Finding these resources remains the responsibility of the decentralised bodies.

Finally, the Government's public finance policy aggregates appear to be exposed to risks and uncertainties associated with the macroeconomic environment.

As regards compliance with the European fiscal rules, the European Commission, having noted the positive outcome of the negotiations with the Government, decided it was no longer necessary to open an excessive deficit procedure at that stage, provided that the agreed measures, including the specific provisions to secure compliance with the deficit targets, were definitively approved by Parliament, as subsequently occurred in the final days of December. The Commission will carefully monitor developments in the Italian public finances and, in particular, the effective implementation of the 2019 Budget Act.

With regard to the structural balance rule, the estimated adjustment for 2018 appears inadequate compared with the requested change, as the improvement of two-tenths of a point in the balance is smaller than that required by the Commission after the application of its "degree of discretion", i.e. three-tenths of a point. This deviation would generally not be considered significant. However, at the time the discretion was applied, the Commission stated that no further deviations from the required adjustment would be permitted.

Moreover, although halved compared with that calculated on the basis of the data in the DBP, a significant deviation from the required structural adjustment would remain in 2019, even taking account of the Government's request for flexibility of 0.2 percentage points for spending on exceptional events and to address hydrogeological instability and secure the road network.

For 2020, the forecast points to an annual deviation of -0.5 percentage points, i.e. at the limit of significance, and -0.4 points of GDP in 2021, or not significant. A significant deviation in two-year terms is also projected for both years.

Despite the decline in the public debt over the 2019-2021 period envisaged by the Government, there is no compliance with the debt reduction rule over the planning period, either with the backward-looking criterion until 2021, or the forward-looking criterion until 2019, nor with the cyclically adjusted criterion.

With more specific regard to the provisions of the budget package, in addition to the deactivation and replanning of the VAT increase clauses noted earlier, the budget contains a number of measures that have significant effects on the taxation of businesses and self-employed workers and on the financial condition of households, on public employment, on the healthcare sector, on capital expenditure and on local government finance. Other measures are also aimed at combating tax evasion and facilitating the settlement of tax disputes.

As far as businesses and the self-employed are concerned, the increase in the tax burden caused by the repeal of the IRI and ACE is accompanied by measures to reduce that burden, including an extension of the preferential regime at a single rate of 15 per cent paid on profit determined using a notional profit rate for self-employed workers and sole proprietors with revenues of less than €65,000 and the introduction of another flat-rate system at a rate of 20 per cent for self-employed workers and sole proprietors with revenues of between €65,000 and €100,000. Another such measure is the reduced-rate taxation of profits re-invested by corporations, partnerships and other entities excluded from the above tax regimes in purchases of capital goods or to expand fixed-term and open-ended employment. In addition, the "hyper-depreciation" mechanism has been extended for 2019 for all firms, albeit in more limited form compared with previous years. The new taxation scheme increases the fragmentation of the system and introduces a number of important structural changes. With regard to fragmentation, the IRI – although an optional mechanism – made the choice of the legal form of an enterprise more tax neutral. Its repeal and the introduction of the new system for the self-employed and sole proprietors bases taxation not only on the legal nature of an enterprise but also on its size, essentially creating three taxation systems: the progressive IRPEF personal income tax regime (for sole proprietors opting for ordinary accounting and partnerships) and the proportional IRES system (for corporations) are now joined by a new proportional system for individuals eligible for the two flat-rate mechanisms (sole proprietors and self-employed workers), which, by extending the pool of beneficiaries, can no longer be considered a preferential tax scheme like the existing simplified mechanism for certain categories of low-turnover workers (*regime dei minimi*). Overall, the most highly penalised under the new taxation system are sole proprietors with revenue of over €100,000 and partnerships. Finally, the budget package also contains measures to increase taxes on banks and insurance companies (deferment over ten years of the deductibility for IRES and IRAP purposes of credit losses resulting from the first time of application of IFRS 9; changes in the timing of the deductibility of the amortisation of goodwill and other intangible assets and of the writedowns of loans that in the past resulted in the recognition of deferred tax assets convertible to tax credits; and a further increase over the level established with the 2018 Budget Act in the payment on account of the tax on insurance premiums).

Many of the spending measures in the budget package are designed to support families and fight poverty. With the exception of a small portion of the resources intended to refinance funds for social policies, households, non-self-sufficiency and assistance for disabled students, the remainder has been allocated to two funds pending the definition of specific measures: the Citizenship Income Fund and the Pension System Revision Fund. In both cases the Budget Act defers the detailed provisions to subsequent regulatory measures to be financed out of the appropriations allocated to these funds, which therefore represent a ceiling on expenditure. However, the two funds are connected: without prejudice to the total annual amount of resources appropriated for each of the funds, any savings generated with the measures implementing a fund's purpose may be used to offset any higher expenditures connected with the implementation of measures under the other fund, with the concomitant redefinition of the specific expenditure limits. Any expenditure savings that are not used in this offsetting mechanism can be returned to the funds. On the pension side, other provisions change the rules for indexing pensions to the cost of living, which become more favourable for pension amounts up to 4 times the minimum INPS benefit and less favourable for larger pensions, and introduce a solidarity contribution for direct pension benefits that, taken as a whole for a pensioner, exceed a threshold of €100,000 gross per year.

The 2019 Budget Act proposes a series of measures in the area of public employment. The renewal of contracts for the 2019-2021 period will have the most significant financial impact (from €1.1 billion in 2019 to nearly €1.8 billion in 2021, for the personnel of State entities only). Several other measures authorise new hiring, including as exceptions to the staff turnover restrictions envisaged under current legislation (drawing from a special fund refinanced by the Budget Act) or by raising authorised staffing levels, in order to address the shortfalls generated by the expenditure containment measures implemented since 2009 or, in certain cases, to meet extraordinary needs. These measures involve all the main sectors of public employment (ministries, law enforcement and the armed forces, schools and universities). Other provisions authorise the hiring of staff for government entities that were reformed or created by the Budget Act or other recent measures. A preliminary estimate puts the total gross spending envisaged in the budget package for government hiring in 2019 at about €360 million, rising to €1.35 billion in 2021.

Regarding the healthcare system, the 2019 Budget Act essentially leaves the funding of the National Health Service (NHS) for 2019 unchanged at €114.439 billion and sets funding for 2020 and 2021 at the level of that in 2019, increased by €2 billion and €3.5 billion, respectively, provided that a new Health Pact is signed. This will result in healthcare expenditure cuts compared with the trend of about €170 million in 2020 and €1 billion in 2021. The Budget Act and Decree Law 119/2018 also provide for certain other measures involving increases in current and capital expenditure for the healthcare sector, amounting to about €100 million in 2019 and 2020 and €300 million in 2021, as well as several provisions aimed primarily at addressing certain emergencies, such as staff shortages and the regulation of pharmaceutical spending.

Increasing capital expenditure is one of the Government's declared objectives. However, the measures adopted during the process of approving the reductions in the budget balances required by the European Commission included many to reduce the deficit – especially 2019 – that in fact impact investment and investment grants.

The tools to expand capital spending consist of both an increase in the resources appropriated in the Budget Act as from 2020 and amendments of the regulatory framework (in particular the Public Contracts Code, pending a comprehensive reform of the system, and the budget rules for local authorities) with simplification and corrective measures, and finally, tools to address the technical and organisational deficiencies of government entities, especially local authorities, in planning, designing and evaluating public investments (establishment of an office for the design of public assets and buildings and a coordinating and planning entity, called “InvestItalia”, directly under the authority of the President of the Council of Ministers).

More specifically, the most significant measures provide for the establishment of two new funds for investment and investment grants, one for central government departments and one for local authorities. In terms of the actual implementation of the expenditure, the overall expected impact on the general government accounts compared with the current legislation trend is €1.5 billion in 2019, €3.5 billion in 2020 and €3.9 billion in 2021.

Various measures in the Budget Act are designed to increase the spending capacity of local authorities. One of the most important of these is the revision of local government finance rules, taking account of a number of rulings of the Constitutional Court. The budget balance rule has been reworked, exempting local authorities (with the exception of the ordinary statute regions (OSRs) until 2020, and with some limitations for local governments running a deficit) from the requirement to comply with the implementing provisions of Law 243/2012, therefore paving the way for extensive use of resources deriving from surpluses and from borrowing. However, Government documents envisage a gradual and relatively modest impact on the public finances over the next three years. Other measures involve the elimination of the funding cuts provided for in existing legislation for the ordinary statute regions (partly replaced by the requirement to post surpluses), the transfer of capital resources to the different sectors of local authorities (offset, for municipalities, by a cut of €563 million to the Municipal Solidarity Fund established with Decree Law 66/2014) and measures to support the finances of certain local authorities. The adverse impact of the so-called “fiscal peace” on local authority revenue and the potential positive effects of not extending the freeze on local tax increases are other factors to be considered. Overall, the risk of expenditure increasing more rapidly than estimated in the technical report cannot be excluded, not only because of the elimination of restrictions on the use of surpluses, which will certainly benefit virtuous local entities, but also because of the greater freedom to borrow and increase the fiscal burden that the Budget Act grants to local authorities.

The budget package continues the introduction of measures to combat tax evasion and one-off measures for the facilitated settlement of tax disputes. The former include the extension until 30 June 2022 of the reverse-charge mechanism for VAT purposes for certain specific transactions, in line with developments in European legislation in this area, and the introduction of an obligation for the digital registration and transmission of data on proceeds of the sale of goods and services, which vendors can currently adopt on optional basis in exchange for a series of administrative benefits and simplifications. The latter measure is intended to counter VAT evasion by focusing attention on the final stage of the retail transaction chain (final consumers), seeking to reduce evasion connected with failure to submit VAT returns. The measure is accompanied by other tools such as the quarterly VAT reports, periodic VAT settlements and electronic invoicing that had previously been limited to business-to-business transactions. All of these tools, which increase the supply and timeliness of information will help increase tax authorities' capacity for analysis and preventive control, improve the relationship between tax authorities and taxpayers and increase voluntary compliance. In addition, they will also lend further impetus to the digitisation of the country, reducing costs and enhancing the efficiency of business processes. A degree of uncertainty remains, however, concerning the possibility that the digital registration and transmission of transaction information will encourage VAT payers to more actively seek out opportunities for consensual tax evasion (i.e. an agreement to evade between buyer and seller), rather than reducing evasion in sales to final consumers. Exposing costs through mandatory electronic invoicing could be accompanied by a loss of revenue that, however, could be countered with appropriate controls of the stability and credibility of firms' margins. The introduction of a receipt lottery does not seem sufficient to create a conflict of interest to counter consensual evasion in the final stage of the chain of transactions. A significant contribution could come from the introduction of appropriate limits in the use of cash (i.e. making current restrictions more stringent).

The second group of measures include the facilitated settlement of violations reported in audit findings, assessment notices and pending tax disputes as well as the facilitated settlement of tax arrears sent for collection and the discharge of prior-year liabilities of less than €1,000 sent to collection agents between 1 January 2000 and 31 December 2010. The common feature of these tax amnesty measures is that they provide for the settlement of disputes with payment of the tax due free of penalties and interest over a long time frame. The repeated introduction of various forms of facilitated settlement rewards less-deserving taxpayers and weakens the sense of tax compliance of taxpayers, and compromises future revenues.

1 THE MACROECONOMIC ENVIRONMENT

1.1 *Recent economic developments*

1.1.1 *The international economy*

The first clear signs of a slowdown in the global expansion emerged last year. The US administration's tariff announcements and measures slowed trade, and the leading international forecasters lowered their expectations for world economic growth. The correction announced by the International Monetary Fund (IMF) in October compared with its summer forecasts was two-tenths of a percentage point in both 2018 and 2019 (now at 3.7 per cent in each of those years). In November, the European Commission lowered its estimate for last year by a similar extent (to 3.9 per cent, from 4.1 per cent) but cut its forecast for 2019 more sharply (to 3.7 per cent, from 4.1 per cent). Also in November, the OECD reduced its forecasts for world GDP growth, cutting it by a-tenth of a point for 2018 (to 3.7 per cent) and by four-tenths for 2019 (to 3.5 per cent).

In the United States, GDP growth, although buoyed by the fiscal stimulus, decelerated between the second and third quarters of the year. Public and private consumption were the main engine of growth, while the net contributions of investment and exports were more erratic. Growth slowed in China despite the economic policies implemented to counteract the impact of tariffs (foreign trade contracted sharply). For both countries, the IMF, the European Commission and the OECD have reduced their GDP growth forecasts for 2019. Among the emerging countries, the forecasts for Russia and India have been corrected downward for 2019; for Brazil, whose economy appears to have experienced a smaller-than-expected slowdown, the revisions mainly regarded 2018.

In the euro area, GDP decelerated sharply compared with developments in 2017 (by 0.7 per cent on average). Last summer, the performance of the exporting economies offered an unpleasant surprise. Germany and Italy recorded a contraction (-0.2 per cent on the previous quarter) and the Netherlands slowed (to 0.2 per cent). By contrast, France and Spain, which are less affected by developments in foreign demand, were relatively more dynamic (expanding by 0.4 and 0.6 per cent respectively). The cyclical deterioration in the area mainly involved the industrial sector, whose output declined from the third quarter on.

The weakening of economic activity was reflected in world trade, the forecasts for which were revised downwards by the leading analysts (Table 1.1). The actions taken by the US administration, as well as the threats to impose further tariffs, adversely impacted trade flows. The year-on-year change in the three-month moving average of the world trade index produced by the Central Planning Bureau (CPB) gradually decreased (from 5.2 per cent to 3.7 per cent between January and October); similarly, the pace of growth in industrial production went from 3.8 per cent to 2.5 per cent. The global confidence index for purchasing managers (JP Morgan – Global Composite PMI) also deteriorated, especially in the manufacturing segment.

Table 1.1 – World demand

	Percentage growth rates			Differences with previous forecasts		
	2018	2019	2020	2018	2019	2020
MEF [1] (18 December)	4.0	3.6	-	-0.3	-0.4	-
European Commission (9 November)	4.1	3.9	3.5	-0.8	-0.5	-
International Monetary Fund (3 October)	4.2	4.0	-	-0.6	-0.5	-
OECD (21 November)	3.9	3.7	3.7	-0.8	-0.8	-

Sources: MEF, European Commission, IMF, OECD.
(1) For the MEF, the figures regard growth in Italy's key foreign markets. Differences with previous forecasts are calculated on the basis of the 2018 Update.

In its December update of the macroeconomic scenario, the Ministry for the Economy and Finance (MEF) took account of the deterioration of the international environment compared with the previous September, revising Italy's foreign demand downwards.

The price of Brent rose last year until the beginning of October, reaching more than $85 a barrel. It then slid to below $55 due both to excess production and moderate demand. Only at the end of the year, with a new agreement between the major oil producers to cut output by 1.2 million barrels a day from January 2019, did the price rise to $60 a barrel. The average price of Brent in 2018 was $71.7; for 2019 the MEF's December projection was $61.5 a barrel, somewhat higher (by about $3) than the most recent futures prices.

In the first four months of 2018, the exchange rate of the dollar against the euro remained in the 1.20-1.26 range. US GDP growth and the Federal Reserve's normalisation of monetary policy subsequently fostered an appreciation of the US currency, which fluctuated around 1.12-1.18 against the euro from the beginning of the summer. The technical assumption adopted by the MEF, namely an unchanged exchange rate over the forecast period, generated only a small difference compared with the actual figure for 2018. For 2019, however, for which the technical assumption implies an exchange rate of 1.135, the forecast is close to market expectations (around 1.165).

1.1.2 The Italian economy

The Italian economy clearly slowed in 2018, as did other European countries such as Germany (Figure 1.1). On the supply side, Italian national accounts data signalled a marked deterioration in output in industry excluding construction, while that in services and construction held its ground. Among the components of domestic demand, the pace of private consumption slowed progressively before contracting in summer compared with the previous three months. Investment spending remained buoyant, although highly volatile. Recent qualitative indicators point to a less favourable situation for capital accumulation, as suggested by both the Bank of Italy survey on the general economic situation and in the Istat survey on access to credit. During the summer, foreign trade absorbed the sharp contraction experienced at the beginning of the year, albeit at a much slower rate of growth compared with 2016-2017.

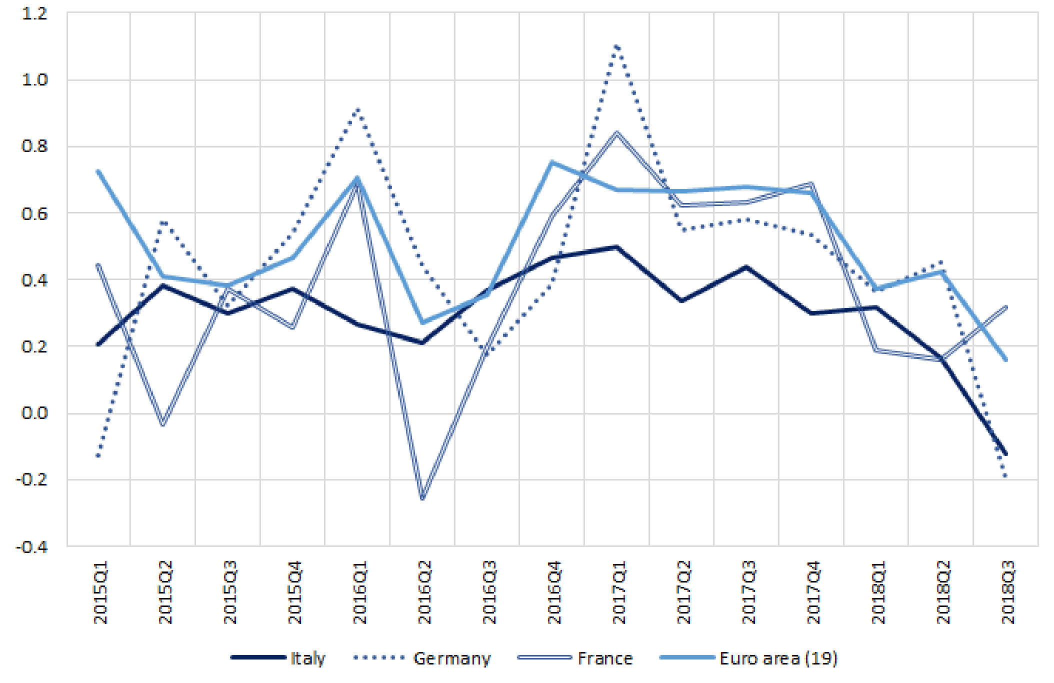
Industry excluding construction has weakened since last winter, when output began show declines on the previous periods. At the same time the number of sectors posting a positive growth rate decreased, as indicated by developments in the PBO diffusion index. The deterioration in manufacturing activity also appeared in business surveys' results, including both the Istat confidence survey and the PMI survey. In the other sectors (market services, retail trade and construction), confidence deteriorated mainly in the second half of the year.

Economic indicators produced by various institutions also declined steadily last year. The Bank of Italy’s ITA-coin coincident indicator of underlying growth turned negative in the final months of the year, for the first time since October 2016. The Istat leading indicator continued its downward trend, which has been under way since the end of 2017. The weakness of economic conditions is reflected in the estimates generated by the PBO’s short-term models, which show a slight decline in economic activity in the fourth quarter of 2018. The main factor in the contraction was a modest decline in industrial activity, reflecting the uncertainties in the international environment and the fall in demand for capital goods.

The slowdown in production also affected labour demand. Employment, which in the spring had risen to close to its level prior to the 2008 crisis, subsequently stabilised in the second half of the year. The greater increase in hours worked compared with value added caused hourly productivity to decline in all main sectors. The deterioration in productivity, wage increases and the expiry of contribution relief measures led to an increase in unit labour costs.

Inflation remained moderate last year, below the euro-area average, and was driven mainly by its more volatile components. Core inflation, i.e. excluding the prices of energy and unprocessed food, was consistently below 1 per cent. The modest price increases were accompanied by a decline in the inflation expectations of households and firms as from the summer months.

Figure 1.1 – GDP growth in the euro area and in its three largest economies
(percentage change on previous period)



Source: Eurostat.

1.2 The macroeconomic forecasts

1.2.1 The Government scenario

In the macroeconomic scenario published in September in the Update to the Economic and Financial Document (the Update), which was later confirmed in the Draft Budgetary Plan (DBP), the Government forecast GDP growth of 1.2 per cent for 2018 and 1.5 per cent both this year and on average in the next two years (Table 1.2).

For 2018, growth was expected to be driven by domestic demand (with a contribution of 1.4 percentage points net of changes in inventories), with net foreign demand making a small negative contribution (0.3 percentage points); the change in inventories provided a marginal contribution. On the inflation front, the GDP deflator was expected to accelerate sharply to 1.3 per cent, from 0.5 per cent in 2017. Nominal GDP growth, a significant variable for public finance measures, was forecast at 2.5 per cent.

In the Update's policy scenario, the expansionary impact of the budget package made itself felt quickly, with GDP growth (1.5 per cent) exceeding its pace in the trend scenario by six-tenths of a point in 2019.[1] The economic policy measures involved a strong stimulus to capital accumulation, which benefited from greater public investment, but also a marked improvement in the machinery, equipment and transport equipment segment. Private consumption spending was boosted by the suspension of the increase in VAT rates, expanding by about half a percentage point compared with the trend scenario. The indirect taxation measures helped to broadly stabilise inflation (as measured by the private consumption deflator) at just under 1.5 per cent, while in the trend scenario it was expect to increase by more than 2 per cent. These developments had a limited impact on the GDP deflator, which declined by two-tenths of a point compared with the unchanged-policy scenario.

Overall, nominal GDP was forecast to rise by 3.1 per cent in 2019, with the difference compared with the trend scenario (0.4 points) entirely attributable to real growth.

Table 1.2 – The macroeconomic scenario in the Update

	2018		2019		2020		2021	
	Trend	Policy	Trend	Policy	Trend	Policy	Trend	Policy
GDP	1.2	1.2	0.9	1.5	1.1	1.6	1.1	1.4
Contributions to GDP growth								
Net exports	-0.3	-0.3	0.1	-0.1	0.2	-0.1	0.1	-0.1
Inventories	0.1	0.1	-0.1	-0.1	0.0	0.1	0.0	0.1
Domestic demand net of inventories	1.4	1.4	0.9	1.6	0.8	1.6	1.0	1.4
GDP deflator	1.3	1.3	1.8	1.6	1.7	1.9	1.5	1.7
Nominal GDP	2.5	2.5	2.7	3.1	2.8	3.5	2.6	3.1

Source: based on data in the 2018 Update.

[1] The budget has no impact on 2018, so trend forecasts are equal to policy forecasts.

For 2020-2021, the stimulus to economic activity produced by the October policy measures was forecast to be only slightly smaller, but still high. GDP growth exceeded that in the current legislation scenario by about half a percentage point in 2020 and three-tenths of a point in 2021. The growth of both public and private investment remained strong, while household spending, which in 2020 would be faced with a VAT increase (due to the only partial deactivation of the safeguard clause), continued to grow at a pace close to projected for 2019. The increases in indirect taxation sustained inflation: the GDP deflator in the two-year period averaged 1.8 per cent, two-tenths of a point higher than the trend scenario. Taking account of the developments in real growth, this resulted in nominal GDP growth of 3.5 per cent in 2020 and 3.1 per cent in 2021.

On 21 November, the European Commission issued a new report pursuant to Article 126(3) of the TFEU on the assessment of compliance with the debt rule in 2017, in which it considered it appropriate to open an excessive deficit procedure against Italy. In response, the Government began negotiations with the Commission to revise the macroeconomic and public finance policy scenario in order to ensure its consistency with the rules of the Stability and Growth Pact. Following these talks, in December the Government sent the European Commission a plan proposing significant amendments of Budget Bill and revised the macroeconomic forecasts (Table 1.3). In addition to reflecting the impact of these amendments, it was necessary to update the macroeconomic scenario to take account of economic developments.

The updating of the exogenous variables in the December forecasts does not involve significant changes compared with the scenario in the Update, except for oil price. More specifically, the projections for international trade growth were adjusted only marginally, confirming the slowdown in trade in 2018, which is expected to continue this year. The new assumptions for exchange rates reflect the strengthening of the dollar in the autumn (the exchange rate of the dollar against the euro is 1.14, compared with 1.16 in the Update). The MEF's new forecasts include a downward revision of oil price, due to the fears of oversupply that emerged in the autumn. Taking account of developments in forward prices, oil price in 2019 are expected to decline by more than $10 a barrel compared with those assumed in the Update.

In the MEF's December macroeconomic scenario, Italian GDP growth declined from 1.6 per cent in 2017 to around 1 per cent in 2018 and in the next three years (1.0, 1.1 and 1.0 per cent respectively in 2019, 2020 and 2021). Economic activity is be almost entirely driven by domestic demand, as the contribution of net foreign trade would be barely positive only in 2019. Among the components of expenditure, gross fixed investment stands out, although it decelerates over the forecast period. Private consumption expands moderately, slightly slower than GDP. As for prices, the consumption and GDP deflators increase to 1.4 per cent next year (from 1.1 per cent this year), and then rise further in the subsequent two years, reflecting the planned increase in indirect taxation provided for in the Budget Act. Nominal GDP growth, equal to 2.1 per cent in 2018, strengthens slightly this year and more robustly in 2020, driven by inflation.

Compared with the Update, in December the MEF reduced its forecasts for growth (Table 1.3), only slightly for 2018 (-0.2 percentage points) but to a greater extent over the rest of the forecast period (-0.5, -0.5 and -0.4 points respectively in 2019, 2020, 2021). The revision of GDP for 2018 is consistent with the deterioration in economic indicators, which became more evident after the publication of the Update (the contraction in GDP in the summer quarter, noted in section 1.1.2, was announced by Istat on 30 November). On the other hand, the revision of 2019 growth, equal to five-tenths of a percentage point, is probably attributable both to the smaller statistical carry-over effect and to the smaller fiscal stimulus from the budget package. The expansionary impact of the Budget Act on GDP in 2019 is estimated by the MEF at 0.4 percentage points, while in the Update it was 0.6 points. The new MEF forecasts for prices entail a slight downward revision of the GDP deflator (0.2 percentage points for both 2018 and 2019).

Table 1.3 – The Government's macroeconomic scenario (Update and December estimates) (1)

		MEF December 2018		MEF Update/DBP		Differences	
	2017	2018	2019	2018	2019	2018	2019
Growth and demand							
GDP	1.6	1.0	1.0	1.2	1.5	-0.2	-0.5
Imports	5.2	1.8	2.3	1.7	3.0	0.1	-0.7
Final domestic consumption	1.1	0.5	0.7	0.9	1.2	-0.4	-0.5
Consumption of households and non-profit institutions serving households	1.5	0.7	0.8	1.1	1.3	-0.4	-0.5
General government expenditure	-0.1	0.1	0.4	0.4	1.1	-0.3	-0.7
Investment	4.3	4.1	2.4	4.4	3.7	-0.3	-1.3
Exports	5.7	1.0	2.4	0.4	2.6	0.6	-0.2
Contributions to GDP growth							
Net exports	0.3	-0.2	0.1	-0.3	-0.1	0.1	0.2
Inventories	-0.3	0.2	-0.1	0.1	-0.1	0.1	0.0
Domestic demand net of inventories	1.6	1.0	1.0	1.4	1.6	-0.4	-0.6
Prices							
Import deflator	3.5	2.5	2.0	2.0	1.8	0.5	0.2
Export deflator	1.6	1.8	1.8	1.8	1.7	0.0	0.1
GDP deflator	0.5	1.1	1.4	1.3	1.6	-0.2	-0.2
Nominal GDP	2.1	2.1	2.3	2.5	3.1	-0.4	-0.8
Consumption deflator	1.1	1.1	1.4	1.3	1.4	-0.2	0.0
Labour market							
Unemployment rate	11.2	10.6	10.3	10.6	9.8	0.0	0.5
Assumptions for international variables							
World trade	5.2	4.0	3.8	3.9	3.9	0.2	0.0
Oil, dollars per barrel	54.8	72.3	61.5	72.6	73.8	-0.3	-12.3
Exchange rate, dollars for 1 euro	1.13	1.18	1.14	1.20	1.20	-0.02	-0.06

Source: 2018 Update and *Aggiornamento del Quadro Macroeconomico e di finanza pubblica*, December 2018.
(1) Percentage changes except for contributions to GDP growth (percentage points), the unemployment rate, the exchange rate and the oil price. Due to rounding of growth rates to the first decimal place, the sum of changes in quantities in volume terms and the associated deflators may not equal nominal changes.

1.2.2 *The endorsement exercise and the effects of the budget measures*

Last year the Parliamentary Budget Office (PBO) performed its customary endorsement exercise for the MEF's macroeconomic forecasts in the Update.

The endorsement exercise for the Update is performed on the basis of a comprehensive analysis of the MEF's macroeconomic scenarios, drawing on a variety of information sources: 1) the PBO forecasts for short-term developments in GDP and the components of demand; 2) the annual forecasts obtained by the PBO using the PBO-Istat econometric model, used within the scope of the framework agreement with that institution; 3) the annual forecasts produced by the independent forecasters (CER, Prometeia and REF.ricerche) that make up the PBO forecasting panel; and 4) monitoring of the most recent projections available from other national and international institutions. The overall assessment, based on these instruments, takes account of the uncertainty that characterises forecasting. In order to perform a like-for-like comparison with the MEF's projections, the forecasts of the PBO panel members (including the PBO's projections) were formulated on the basis of the same assumptions for exogenous international variables adopted by the MEF, whose reliability is also assessed. In addition, for the policy scenario, the PBO panel based their estimates on the same assumptions used for the budget package, developed by the PBO taking account of the Update and information received from MEF on the differences between the public finance assumptions incorporated in the policy scenario and those in the trend scenario.

In the autumn the PBO had endorsed the trend macroeconomic scenario in the Update for 2018-2019[2] but did not endorse the policy scenario.[3]

For 2018-2019, the trend GDP growth rate projected by the Government fell within an acceptable forecasting range, despite a slight deviation for 2018. The variables for the labour market, costs and prices in the Update were consistent with the other main indicators of the trend macroeconomic scenario and, with the exception of the unemployment rate, had similar dynamics to those adopted by the PBO panel.

The overall endorsement of the Update trend scenario for 2018-2019 was based on: a) the modest extent of any overshooting, taking due account of the degree of uncertainty about the short-term outlook; and b) a forecast in the Update for nominal GDP – a variable of direct relevance to the public finances – in line with the upper bound of the range produced by the PBO panel. However, there were significant downside risks at both short and medium term. In particular, the medium-term growth forecast in the Update for 2020 and 2021,[4] although acceptable compared against the range of forecasts produced by the panel, appeared relatively high when compared with the main international institutions' assessments of Italian economic potential.

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[2] The endorsement letter for the trend macroeconomic scenario in the Update is available on the PBO website at http://en.upbilancio.it/wp-content/uploads/2018/10/Lettera-Allegato_validazione-QMT-NADEF-2018_EN.pdf.

[3] The letter informing the MEF that the policy macroeconomic scenario in the Update had not been endorsed is available on the PBO website at http://en.upbilancio.it/wp-content/uploads/2018/10/Lettera-non-validazione-QMP-2018_13_con-allegatoEN.pdf.

[4] The 2020-2021 period did not go through the endorsement process of the PBO, which nevertheless expressed its views of the plausibility of the Government forecasts.

With specific regard to risk scenarios, it was noted that they mainly involved exogenous factors with major implications for the Italian economy. At the international level, the uncertainty about protectionist developments and trends in energy commodity markets was emphasised. There was also a risk that the reversal of the economic and financial cycle, with monetary and fiscal authorities having less scope for action than in previous cyclical peaks, would lead to an increase in the risk premiums required by investors for assets with low credit ratings. This eventuality has already come to pass in part, raising the rates that the Italian Treasury has to pay, with probable repercussions on the confidence of households and firms. Finally, other global risk factors were highlighted, such as the normalisation of monetary policies in Europe and the United States, where this has been associated with an expansionary fiscal policy, and uncertainty about the Brexit negotiations.

The policy forecast in the October Update, which was subsequently retained in the DBP sent to the European Commission, was not endorsed by the PBO. This was due to the significant and extensive deviations in the main variables of the 2019 policy scenario from those projected by the PBO panel of forecasters, in both volume and price terms (Figure 1.2). The decision was corroborated by the analysis of economic developments, which were already indicating a slowdown, and short-term expectations.

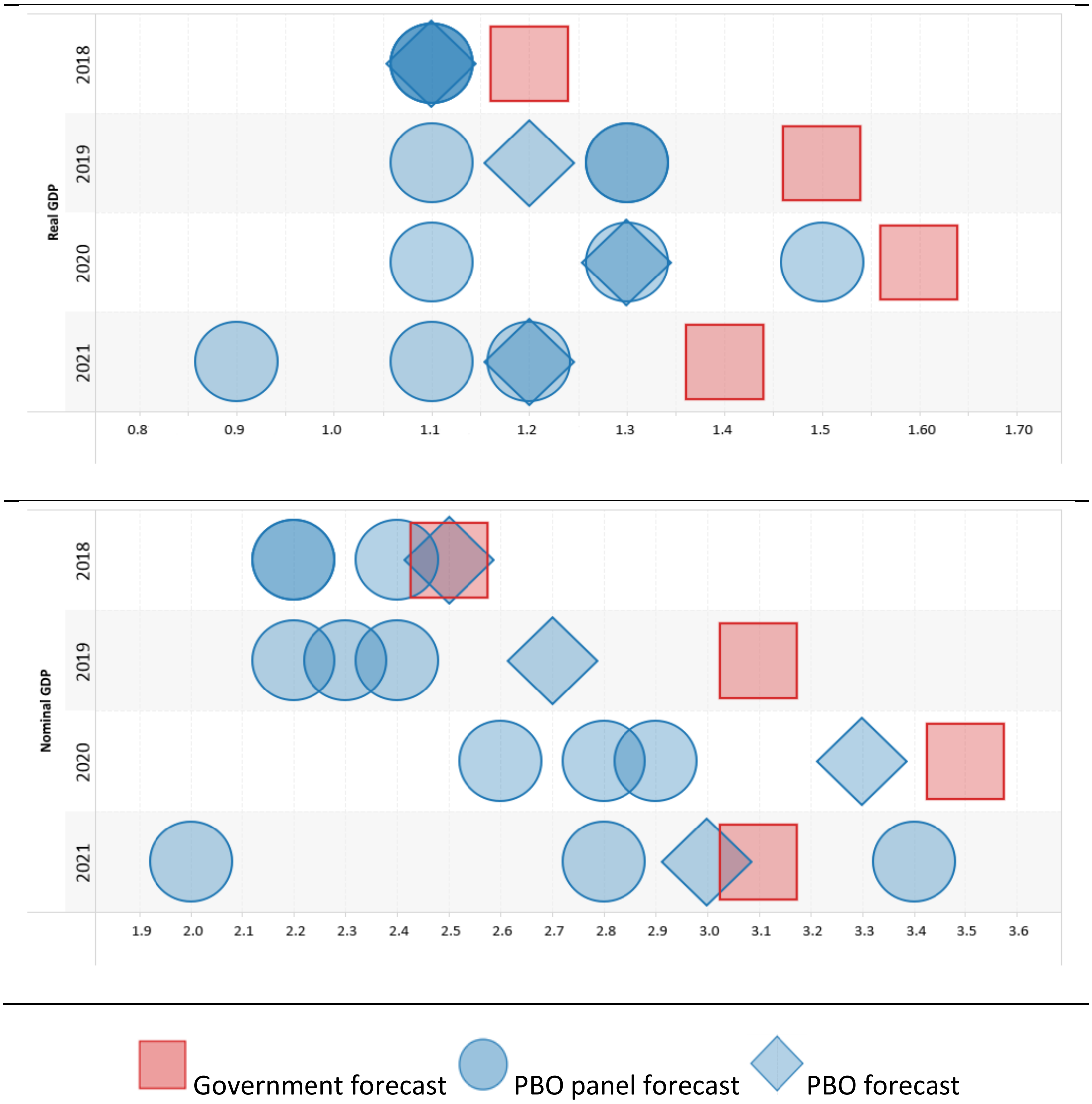
The divergence of the Government's forecasts from those of the PBO panel mainly regarded developments in the main components of domestic demand. More specifically, the increase in investment in capital goods (the total net of construction, which mainly regards the private sector) appeared to have been overestimated. Having returned to the level prevailing before the sovereign debt crisis, such investment would require improved profit expectations to accelerate in the coming years. Moreover, some initial signs of tighter lending conditions, likely prompted by the increase in risk premiums in the yields of government securities, suggested prudence in having forecasts for private investment that were much higher than those in the trend scenario.

The endorsement exercise for the 2019 policy scenario revealed major differences compared with the panel estimates with regard to prices.

In consideration of the deviations in both quantities and prices, nominal GDP growth, a variable directly linked to the main public finance aggregates, differed considerably from the panel consensus. In previous years, the PBO had endorsed the macroeconomic scenario with minor divergences in real growth, but with nominal GDP forecasts that lay within the range of panel forecasts.

In conclusion, the negative assessment of the 2019 macroeconomic scenario in the Update was based on a number of factors: a) divergences with the panel forecasts for the main macroeconomic variables, as well as those produced by the leading external forecasters; b) weak short-term economic trends, which made sharp differences with the trend scenario (endorsed by the PBO) unrealistic for 2019; and c) the risk that owing market expectations the demand stimulus generated by the expansion of borrowing would be curbed by a simultaneous increase in financial turbulence.

Figure 1.2 – Update policy forecasts and PBO panel projections for real and nominal GDP growth



The concerns about 2019 also held, perhaps even more strongly, for 2020-2021, a period that lay outside the time range considered in the endorsement exercise. The short- and medium-term risks already noted in the endorsement exercise for the trend scenario also remained.

On 18 December the Government sent a notice to the European Commission in which it modified both the public finance programme and the macroeconomic forecasts (briefly described in section 1.2.1).[5] The MEF subsequently asked the Parliamentary Budget Office to assess the reliability of the new forecasts. The PBO therefore carried out a

[5] The macroeconomic scenario is set out in Annex 2 of the letter send on 18 December 2018 by the President of the Council of Ministers and the Minister for the Economy and Finance to the President, Vice-President and Commissioner for Economic and Monetary Affairs of the European Commission. The scenario was subsequently incorporated in *Aggiornamento del Quadro Macroeconomico e di finanza pubblica*, published on the MEF website on 3 January 2019.

forecasting exercise for 2018-2019 that incorporated the new exogenous variables used by the MEF and the revised budget measures in light of the Government's notice to the European Commission. The analysis was performed and communicated to the MEF very quickly (on December 22),[6] meaning that time constraints made it impossible to conduct a standard endorsement exercise with the involvement of the entire PBO panel (which includes three other independent forecasters).[7]

In the exercise performed in December by the PBO (Table 1.4), Italian economic growth for 2018 is consistent with that envisaged by the MEF, but is slower (by two-tenths of a percentage point) for 2019, at 0.8 per cent. Among the components of demand, the PBO scenario has similar developments in consumption to those assumed by the MEF, while the projections for capital accumulation are more cautious. The contribution of net exports in 2019 is slightly better for the MEF, due to slower growth in imports, despite the less dynamic performance of exports.

Table 1.4 – Comparison of macroeconomic forecasts (MEF and PBO) (1)
(percentage changes and percentage points)

	MEF December		PBO December		Differences	
	2018	2019	2018	2019	2018	2019
GDP and components of demand						
GDP	1.0	1.0	1.0	0.8	0.0	0.2
Final domestic consumption	0.5	0.7	0.6	0.7	-0.1	0.0
Investment	4.1	2.4	4.0	2.1	0.1	0.3
Contributions to GDP growth						
Net exports	-0.2	0.1	-0.2	0.0	0.0	0.1
Inventories	0.2	-0.1	0.1	-0.1	0.1	0.0
Domestic demand net of inventories	1.0	1.0	1.2	0.9	-0.2	0.1
Prices						
Nominal GDP	2.1	2.3	2.1	2.3	0.0	0.0
GDP deflator	1.1	1.4	1.1	1.4	0.0	0.0

Source: PBO December 2018 forecasts; for the MEF, *Aggiornamento del Quadro Macroeconomico e di finanza pubblica*, December 2018.
(1) Percentage changes, except for contributions to GDP growth (percentage points). Due to rounding of growth rates to the first decimal place, the sum of changes in quantities in volume terms and the associated deflators may not equal nominal changes.

[6] The PBO letter notifying the findings of the assessment of the MEF's new macro scenario is available at http://en.upbilancio.it/wp-content/uploads/2019/03/Valutazione_finale-22_12_2018_EN.pdf.
[7] The update of the MEF's macroeconomic scenario in December at the time of the approval of the Budget Act was an exceptional event. The PBO therefore conducted its assessment using a different timetable and procedure from that adopted in the normal endorsement exercises for Government forecasts. First, the scope of the assessment was limited to 2018-2019, as that is the period for which the PBO's endorsement is required. Second, in order to accelerate the process only the econometric model of the PBO was used, without involving the independent members of the PBO panel (CER, Prometeia, REF.ricerche). Note that the absence of the panel forecasts only made it impossible to define a range of acceptable values against which the MEF projections could be compared, leaving the final assessment unaffected. If other forecasters had been involved and they produced lower values than those of the PBO, the latter would have still represented the upper bound of the range.

On the price front, the developments in the GDP deflator are consistent in the two scenarios, although the MEF forecasts for 2019 point to a slightly larger increase for the consumption component (the difference with the PBO scenario is offset by that on the terms of trade). The nominal GDP growth forecast by the PBO is similar to that produced by the MEF, despite the forecast for slower real growth.[8]

Ultimately, the macroeconomic scenario of the MEF and that developed by the PBO are similar for 2018 with regard to both real growth and nominal variables. For 2019, there is a divergence of 0.2 percentage points in real GDP growth, but the changes in nominal GDP growth are consistent. As in the past, where the PBO has considered scenarios with differences in real growth rates but consistent nominal changes to be acceptable, the MEF forecast for 2019 was considered plausible, although it is exposed to significant downside risks. In December, these risks were assessed to be greater with regard to the forecasts for 2020 and 2021.

Data released after the assessment of the MEF's December scenario for both the Italian and European economies have further increased the fears of adverse developments, even in the short term. An update of the analysis of the condition of the Italian economy and of outlook for the 2018-2020 period will be published by the PBO in February.

Assessment of the macroeconomic impact of the budget package

The PBO has evaluated the impact of the budget package on 2019 GDP growth using the MeMo-It annual econometric model. In addition to the measures envisaged in the Budget Act, the analysis also considers the provisions of Decree Law 119/2018, although these have very limited macroeconomic effects.

In the following, the measures are organised into four main categories: deactivation of the safeguard clauses, measures in support of firms and the self-employed, measures for families and the fight against poverty, expenditure on public investment and investment grants. A further aggregate ("Other fiscal measures") includes the remaining measures. In order to interpret the results appropriately, it is important to note that the resources covering the expenditure programmes, which in the budget package mainly regard revenue measures, are already included within the categories indicated above; accordingly, the estimated macroeconomic effects consider the net balances of the four categories under consideration.

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8 Nominal GDP growth is reconstructed on the basis of time series for GDP in volume terms and the associate deflator. Approximating both the two components and their sum to one decimal point may give rise to inconsistencies.

The first category contains the restructuring of the indirect tax increases provided for in the so-called safeguard clauses, which is entirely neutralised for the current year. The expansionary effect on this year's GDP is estimated at 0.1 percentage points.

Measures in support of firms and the self-employed include various measures: the restructuring of incentives for depreciation; the extension of the flat-rate preferential tax regime for enterprises with revenues of up to €65,000; and the optional flat-rate taxation of self-employment and business income for individuals with revenues of between €65,000 and €100,000. This aggregate also includes a number of funding measures affecting firms – primarily banks and financial companies – and the repeal of a number of tax relief mechanisms (in particular, the IRI and the ACE). The overall effect of these measures on GDP growth compared with the trend would be essentially nil.

Measures for families and the fight against poverty mainly concern the launch of the "Citizenship Income" (an income support scheme), which includes expanding job centres, and the revision of the pension system aimed at encouraging early retirement. In the exercise, this proved to be the measure with the greatest expansionary impact, equal to 0.2 percentage points of GDP in 2019.

Spending on public investment and investment grants in 2019 has a negligible macroeconomic impact. The resources available for capital expenditure would be virtually unchanged compared with the current-legislation scenario. Moreover, resources for transfers to the Italian State Railways and spending by ministries have been cut.

The other fiscal measures include, on the expenditure side, the renewal of employment contracts for 2019-2021 for public employees and, among the provisions funding the expenditure, measures to rationalise spending. Revenue measures include those for fighting tax evasion, tax amnesties and changes in taxes on gaming and tobacco products.

Overall, the impact of the budget measures on GDP growth in 2019 is estimated at around 0.3 percentage points, just below the MEF forecasts (0.4 points).

Based on Svimez simulations[9] carried out on the basis of the Budget Bill presented in November, the budget package would have a relatively larger impact on the regions in the South than those in the Centre and North. The main social assistance measures would have a greater impact on the South and would boost household spending. Employment would also receive a stronger stimulus in the South than in the rest of the country, reflecting the greater scope for expanding employment to pre-crisis levels. On the supply side, Svimez emphasises the dualism of the scope for expanding production, for which in the South the impact on the start of new businesses or the growth of existing enterprises could be limited.

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[9] Rapporto Svimez 2018. *L'economia e la società del Mezzogiorno*. November 2018. Available at: http://www.svimez.info/517 .

Box 1.1 – The heterogeneity and uncertainty of fiscal multipliers

The quantification of the effects of the discretionary measures in the budget on the macroeconomic scenario is usually summarised by the multiplier, i.e. by the variation in output in real terms associated with the adoption of a discretionary (exogenous) expenditure or revenue measure. Normally, in order to ensure that results are comparable and interpretable, the changes in the deficit and the individual measures are normalised *ex ante* to one percentage point of nominal GDP in the first year of the baseline scenario.

The PBO has emphasised on various occasions that fiscal multipliers depend on many factors, can vary over time and are characterised by considerable uncertainty.[10] Under normal conditions, multipliers change on the basis of the structural characteristics of economies,[11] being larger in economic systems with few imports and rigid labour markets. They also depend on monetary and currency conditions, which may limit the increase in interest rates induced by a budget deficit, especially in countries with fixed exchange rates or within monetary unions. Multipliers also vary in accordance with certain characteristics of the public debt, being larger when the debt/GDP ratio is low and when government securities are held mainly by non-residents (in both cases crowding out is reduced).[12] Further, it is essential to consider the efficiency of government, both in levying taxes and implementing spending programmes.

In the literature, the size of multipliers differs significantly among the various expenditure and revenue components. In particular, in models that do not consider rational agents, the stimulus to growth of a discretionary variation in expenditure is greater than that from a similar change in revenue. Another aspect to be considered, which acquired new relevance following the 2008 financial crisis, concerns the effect of cyclical conditions on the level of fiscal multipliers. It has been observed that in a recession, characterised by spare capacity and liquidity constraints on households and firms, short-term spending multipliers would be even higher than revenue multipliers.

Another important aspect is the fact that a fiscal stimulus produces different effects depending on how it impacts the expectations of households and firms. These effects depend not only on the expectations of a future budget consolidation, but also – in the short term as well – on the level of fiscal policy uncertainty. A long-established literature[13] has shown that excessively uncertain and unpredictable economic policies would induce households to increase precautionary saving and firms to postpone investment plans. The empirical quantification of such phenomena is complex, however, and depends on strong assumptions.[14] For the Italian case, it has been estimated that the expansionary effects of budget measures can be entirely neutralised by the perceived uncertainty of economic policy, so that the final outcome could be an undesirable reduction in output and employment (non-Keynesian behaviour).[15] Shocks to the level of the budget and to the volatility of macroeconomic aggregates, due to uncertainty about economic policy, therefore have opposing macroeconomic impacts. The formation of agents' expectations could therefore be among the factors underlying heterogeneity, with regard to both

[10] See Budgetary Policy Report 2016, p. 24; Budgetary Planning Report 2017, p. 34.

[11] See Batini, N., Eyraud, L. and Weber, A. (2014), "A Simple Method to Compute Fiscal Multipliers", IMF Working Paper wp/14/93, June.

[12] See Broner, S., Clancy, D., Erce, A. and Martin, A. (2018), "Fiscal Multipliers and Foreign Holdings of Public Debt", ESM WP Series 30/2018.

[13] See Brainard, W.C. (1967), "Uncertainty and the Effectiveness of Policy", American Economic Review, Vol. 57 No. 2.

[14] One empirical approach is to assume that the stochastic component of discretionary budget measures is characterised by variable stochastic volatility. See, for example, Fernàndez-Villaverde, J., Guerròn-Quintana, P. A., Kuester, K. and Rubio-Ramìrez, J. (2015), "Fiscal Volatility Shocks and Economic Activity", American Economic Review, Vol. 105 No.2; Born, B. and Pfeifer, J. (2014), "Policy risk and the business cycle", Journal of Monetary Economics, Vol. 68(C).

[15] See Anzuini, A., Rossi, L. and Tommasino, P. (2017), "Fiscal policy uncertainty and the business cycle: time series evidence from Italy", Temi di discussione no. 1151, Banca d'Italia.

the magnitude and the sign of multipliers, as the literature has found. The cyclical phase is also relevant in this case, since the recessionary impact of an increase in volatility is accentuated during recessions, as probably happened during the global crisis of 2008.

Multipliers are not directly observable. They are obtained through quantitative analyses, for which they strongly depend on the econometric tool used. In the stylised neoclassical models, assuming rational expectations and the absence of adjustment costs, the Ricardian equivalence principle holds. In this framework, a fiscal consolidation measure signals fewer fiscal adjustments in the future, so it is not necessarily reflected in a reduction in current private spending. Fiscal restrictions can also attenuate uncertainty and thus reduce precautionary savings and encourage consumption and investment. These are the so-called “non-Keynesian effects” of a fiscal consolidation that characterise real business cycle models, for a given structure of agents’ preferences and behavioural functions.

The further one moves from the assumption of Ricardian behaviour, the more these effects dissipate and more conventional impacts of fiscal policy emerge. These characterise multi-equation structural econometric models, in which the contraction in disposable income induced by the fiscal restriction entails lower consumption expenditure. In the case of structural models, multipliers are obtained as a non-linear combination of parameters. Since these parameters are estimated with a range of variability, defined by the statistical confidence interval, multiplier estimates are also affected by uncertainty. Technically, multipliers can be considered as random variables whose values follow a probability distribution (for example, conditional on the phases in the business cycle), for which they are themselves characterised by a degree of variability.

One factor of uncertainty peculiar to fiscal multipliers, compared with monetary policy multipliers, for example, concerns interactions with automatic stabilisers, i.e. changes in government spending related directly to the business cycle. An increase in the scope of automatic stabilisers tends to limit the impact of discretionary budget measures. A widely used methodology for breaking down changes in the budget into an endogenous component (linked to predominantly cyclical factors) and an exogenous component (regarding discretionary measures) is the instrumental variables method (the narrative approach).[16] This approach, however, can lead to extremely inaccurate statistical inference,[17] resulting in a wider confidence interval around the specific estimate of the fiscal multiplier.[18][19]

Ultimately, the multipliers differ depending on the specific measures considered and vary in accordance with the analytical instrument used. In addition, even with the same econometric model, multipliers change over time (with the updating of the parameter estimates) and with changes in the time horizon (short-term effects are often smaller than the medium-term impact). Again with no changes in the model, the value of multipliers strongly depends on the assumptions made about the response of other economic policies and the process of forming expectations.

Evaluating a budget law solely on the basis of average multipliers is only useful as a first approximation, but it can be misleading at the detailed level. Quantifying the impact of economic policy measures requires an evaluation of the different effects of all the numerous measures in a budget package. The latter, if analysed in detail, impacts the economy in proportion to the

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[16] See Romer, C. and Romer, D.H. (2010), “The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks”, American Economic Review, Vol.100.

[17] A discretionary policy change is used as an instrumental variable to identify the effect of a fiscal policy. However, if that variation is weakly correlated with the endogenous variable, the inference may lead to more uncertain estimates.

[18] See Hebous, S. and Zimmermann, T. (2018), “Revisiting the Narrative Approach of Estimating Tax Multipliers”, Scand. J. of Economics, 120(2).

[19] The approach is also exposed to the risk of overestimating fiscal multipliers, as noted in Favero, C. and Giavazzi, F. (2009), “Measuring Tax Multipliers: The Narrative Method in Fiscal VARs”, American Economic Journal: Economic Policy 2012, 4(2)

magnitude of the individual measures, meaning that that the "implicit" fiscal multiplier often differs from the estimate of the *ex ante* multiplier (in which the incidence of each individual measure is usually calculated on the basis of a historical average).[20] Second, focusing on the impact of fiscal measures on GDP may lead to neglect other important economic policy effects, such as the impact on the labour market variables or on prices.

Even when considering the fiscal multipliers specific to each individual measure, the bias in the assessment of the impact of the policy measures tends to be accentuated in anomalous phases of the business cycle. This is the case, for example, of deep recessions, characterised by nominal policy interest rates close to zero, which reduce the effectiveness of monetary policy. In such circumstances, multipliers can reach, or even exceed, the bounds of the confidence interval estimated under normal macroeconomic conditions. Ultimately, the overall assessment of a set of budget measures cannot be simplified by a few average fiscal multipliers, but must be conducted by simulating econometric models and by calculating *ex post* "implicit" multipliers resulting from the change in GDP following the fiscal stimulus.

The PBO uses the MeMo-It simultaneous equation model, originally supplied by Istat. In this model, similar to other such tools, the parameters are estimated from time series covering a few decades, meaning that the implicit multipliers used to assess the effects of budgetary policies reflect average developments over the entire time interval. By construction, these models do not provide different responses depending on the state of the business cycle. These limitations, typical of traditional econometric tools, have prompted investigation of the state dependency of fiscal multipliers using, for example, regime switching VARs with or DSGE models with nominal rigidities. Recent studies for Italy[21] have found that in a recession the impact of public consumption is slightly higher than unity and increases even further in the case of a joint consumption and investment spending shock.

For Italy, a recent PBO study[22] analyses the main fiscal multipliers during the double-dip recession, which began in 2008. The economic crisis was characterised by the simultaneous deterioration of the financial-banking system, with policy interest rates close to zero and widespread liquidity constraints, as well as the simultaneous occurrence of fiscal tightenings in other European countries. Based on this analysis, in the crisis period (2008-2014), fiscal multipliers were higher than those estimated for the entire sample period (1970-2014), but they entail higher uncertainty. The analysis uses the MeMo-It econometric model, which was specially modified for the study, such that the multipliers obtained may differ from those that the model produces in its basic version.

Consistent with a broad empirical literature, the study finds that the strongest macroeconomic impacts are associated with expenditure measures. During the crisis, a permanent shock to intermediate consumption produced a 1-year output multiplier of more than unity, while that estimated for the entire period was equal to 0.9 (Figure B1.1.1). A larger divergence is found for government expenditure on investment and investment grants, whose overall impact multiplier in the crisis period is estimated at greater than 2, well outside the confidence interval for the multiplier computed for the whole period (between 0.8 and 1.1, with a significance level of 5 per

[20] See Mineshima, A. and Weber, A. (2014), "Fiscal Multipliers", in Cottarelli, C., Gerson, P. and Sendhadji, A. (eds.), "Post-Crisis Fiscal Policy", Cambridge, MIT Press.

[21] See Locarno, A., Notarpietro, A. and Pisani, M. (2013), "Sovereign risk, monetary policy and fiscal multipliers: a structural model-based assessment", Temi di discussione, no. 943, Banca d'Italia; Caprioli, F. and Momigliano, S. (2013), "The Macroeconomic Effects of Expenditure Shocks During Good and Bad Times", in *Fiscal Policy and Growth*, Workshop and Conferences, Banca d'Italia, June 2013; Batini N., Callegari G. and Melina G. (2012), "Successful austerity in the United States, Europe and Japan", IMF Working Paper 12/190; Cimadomo, J. and D'Agostino, A. (2015), "Combining time-variation and mixed-frequencies: an analysis of government spending multipliers in Italy", Journal of Applied Econometrics, Vol. 31.

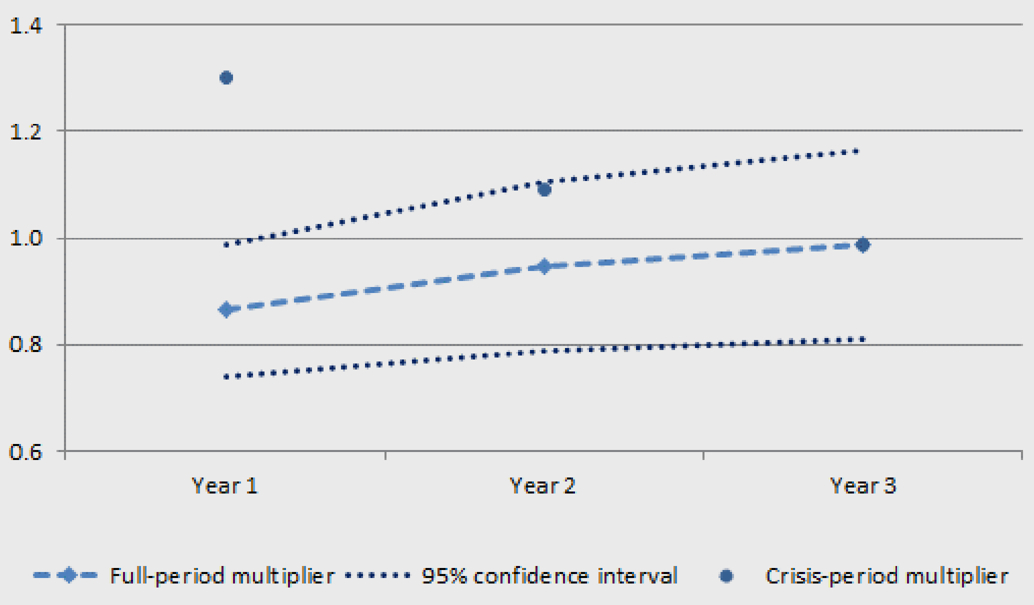
[22] See de Nardis, S. and Pappalardo, C. (2018), "Fiscal Multipliers in Abnormal Times: the Case of a Model of the Italian Economy", PBO Working Paper no. 1/2018.

cent). The impact of government transfers on GDP (equal to about 0.6) is significantly higher than that for the entire sample (on the order of 0.2). Overall, the average 1-year expenditure multiplier was close to unity in the crisis period, compared with around half that on average over the entire period.

Similar considerations regard revenue, although the increase compared with the period average appear to be less pronounced by comparison with expenditure. The increase in multipliers is statistically significant for personal income taxes (0.6, compared with 0.2 for the whole period) and for VAT rates (0.3, from 0.1), while no statistically significant differences emerge for social security contributions. The average revenue multiplier during the crisis was around 0.3 (compared with 0.1 over the entire period).

The multipliers obtained in the study were also used to conduct a counterfactual exercise, in which the forecast error related to the change in GDP for the 2012-2014 period was decomposed into a specific component referring to the fiscal multipliers and one referring to international exogenous variables. Despite the limitations associated with a comparative statics exercise, it is demonstrated that using specific multipliers for the crisis period would have significantly reduced the forecast error for the 2012-2014 period.

Figure B1.1.1 – Intermediate consumption multiplier: estimation for full period and during the crisis



Source: based on PBO data.

2 PUBLIC FINANCE POLICY SCENARIO AND COMPLIANCE WITH THE FISCAL RULES

2.1 *The public finances in 2018-2021 and the budget measures for 2019*

2.1.1 *The general government accounts*

In the *Aggiornamento del Quadro Macroeconomico e di finanza pubblica*, the Government estimated net borrowing of 1.9 per cent of GDP for 2018, a decrease of 0.5 percentage points compared with 2017 (Table 2.1). The estimate is slightly higher than forecast in the Update to the Economic and Financial Document (EFD), in the initial version of the DBP and in the DBP revised in mid-November 2018 (1.8 per cent of GDP). For the first time in four consecutive years of deficit reduction, an increase in the primary surplus, from 1.4 per cent to 1.8 per cent of GDP, contributed to the decline. The increase in the primary surplus reflected a reduction in primary expenditure as a proportion of GDP – in particular capital expenditure, which was also impacted in 2017 by extraordinary measures to support the banking sector – only partly offset by a decline in total revenue as a proportion of GDP. Interest expenditure, while increasing more sharply compared with initial estimates due to the greater-than-expected rise in government securities yields, continued to decline compared with 2017 both in absolute value and in terms of GDP (from 3.8 to 3.7 per cent).

Estimated net borrowing is now three-tenths of a percentage point higher than the target of 1.6 per cent of GDP set in the EFD due both to higher interest expenditure (0.1 percentage points of GDP) and a smaller primary surplus (0.1 points). The composition of current primary expenditure changes compared with the EFD: reductions in social benefits (which, as has been the case for some time, are certified ex post) and compensation of employees (with increases in subsequent years connected with the postponement of a number of contractual renewals) substantially offset an increase in intermediate consumption (attributable in part to higher healthcare spending).

The expected deterioration in revenue reflects slower growth in taxable income than forecast in the EFD and, to a lesser extent, the carry-over of a number of downward revisions made by Istat last September to the level of revenue in past years.

Table 2.1 – Public finance indicators (1)
(percentage of GDP; plus sign = improvement in balance)

	2018	2019	2020	2021
Trend net borrowing (a)[2]	**-1.9**	**-1.4**	**-1.0**	**-1.0**
Change (a')	*0.5*	*0.5*	*0.4*	*0.0*
Trend one-off measures	0.0	-0.1	0.0	0.0
Net measures (b)		**-0.6**	**-0.8**	**-0.5**
of which: *deactivation/new safeguard clauses (c)*		*-0.7*	*0.2*	*0.5*
Policy net borrowing (d=a+b)	**-1.9**	**-2.0**	**-1.8**	**-1.5**
Change (d')	*0.5*	*-0.1*	*0.2*	*0.3*
Interest expenditure (e)	-3.7	-3.7	-3.8	-4.0
Change (e')	*0.1*	*0.0*	*-0.1*	*-0.2*
Cyclical component of policy budget balance (f)	-0.9	-0.8	-0.6	-0.6
Policy net borrowing adjusted for the cycle (g=d-f)	-1.0	-1.3	-1.2	-0.9
Policy one-off measures (h)	0.0	0.0	0.0	-0.1
Structural primary surplus (i)	2.6	2.4	2.6	2.9
Change (i')	*0.0*	*-0.2*	*0.2*	*0.3*
Policy structural balance (l=g-h)	**-1.1**	**-1.3**	**-1.2**	**-1.0**
Change (l')	*0.2*	*-0.2*	*0.1*	*0.2*
Flexibility clauses (m)	0.0	0.2	0.0	0.0
Change in policy structural balance including flexibility clauses (n)	***0.2***	***0.0***	***0.1***	***0.2***

Source: based on data from *Aggiornamento del quadro macroeconomico e di finanza pubblica*, December 2018.
(1) Totals may not match due to rounding of decimals. – (2) Trend net borrowing in 2020 and 2021 was calculated as the algebraic sum of the policy balance and the impact of the budget measures.

On the 21st September Istat published revisions for GDP and the general government accounts: net borrowing in absolute values was corrected upwards for the 2014-2017 period, while as a percentage of GDP it worsened only in 2017, the year in which the deficit was revised from 2.3 to 2.4 per cent of GDP. The primary surplus as a percentage of GDP also deteriorated by one-tenth of a point to 1.4 per cent. The fiscal burden was revised downwards, from 42.5 to 42.2 per cent, due in part to the upward revision of nominal GDP in the denominator. The most substantial revisions concerned taxes and capital expenditure. The former declined as a result of an increase in tax rebates. In addition to the effects of normal updates of statistical sources, capital spending was increased to take account of the transfer of more than €600 million to Alitalia following the reclassification of the loan granted in 2017.

As for the subsequent three years, following the negotiations with the European Commission after the latter had announced it was considering opening an excessive deficit procedure, the Government introduced amendments to the budget package under discussion in Parliament.

The revisions made by the Government in December 2018 to the budget package and to growth forecasts also produced changes in both the nominal – trend and policy – and structural (i.e. net of cyclical effects and one-off measures) public finance balances. According to government estimates, these changes should make it possible to resume the adjustment path towards the medium-term objective (MTO) as from 2020, after broad structural stability net of outlays for unusual events in 2019, and to project a slight reduction in the debt/GDP ratio over the 2019-2021 period, after the increase expected for 2018 (attributable to economic conditions).

The trend deficit was revised upwards by two-tenths of a point of GDP in 2019, three-tenths in 2020 and five-tenths in 2021 compared with the DBP.[23] The policy deficit resulting from the budget measures is expected to rise to 2.0 per cent in 2019, before declining to 1.8 per cent in 2020 and 1.5 per cent in 2021. The policy scenario therefore reflects budget measures that worsen the nominal deficit by 0.6 points of GDP in 2019, 0.8 points in 2020 and 0.5 points in 2021.

The policy scenario, after no change in 2018, envisages a deterioration in the structural balance of 0.2 percentage points in 2019 and an improvement in each of the following two years (one-tenth of a point in 2020 and two-tenths the following year; Table 2.1). The structural deficit, estimated at 1.1 per cent of GDP in 2018, is expected to increase to 1.3 per cent in 2019 and then fall to 1.2 per cent and 1 per cent thereafter. However, for 2019, in view of the exceptional and urgent nature of certain planned measures, the Government has asked the European Commission to grant budgetary flexibility equal to just under 0.2 per cent of GDP. These measures, which will be funded with resources for both new investments and investments already budgeted for in previous years, involve initiatives connected with an extraordinary plan for securing areas affected by flooding and road network infrastructure, such as viaducts, bridges and tunnels. Taking account of the multi-year nature of the extraordinary intervention plan, the Government also intends to request budget flexibility for exceptional expenditure that it will face after 2019. Overall, the Government plans to use €2.6 billion euros in 2019, €3.7 billion in 2020 and €4.2 billion in 2021.

Figure 2.1 shows the change in policy scenario net borrowing by component:

- the change in the structural primary surplus best represents the discretionary (and permanent, i.e. net of one-off measures) action of fiscal policy in each year compared with the previous period. This action is moderately expansionary for 2019, with a deterioration in the structural primary surplus of two-tenths of a percentage point of GDP, which is more than recovered in the following two years, with improvements of two- and three-tenths of a point, made possible by the activation of the safeguard clause for indirect taxes (see also section 2.2);

- interest expenditure, which in each year from 2013 to 2018 contributed to improving the balance, has a negative impact in 2020-2021, reflecting an increase in interest rates;

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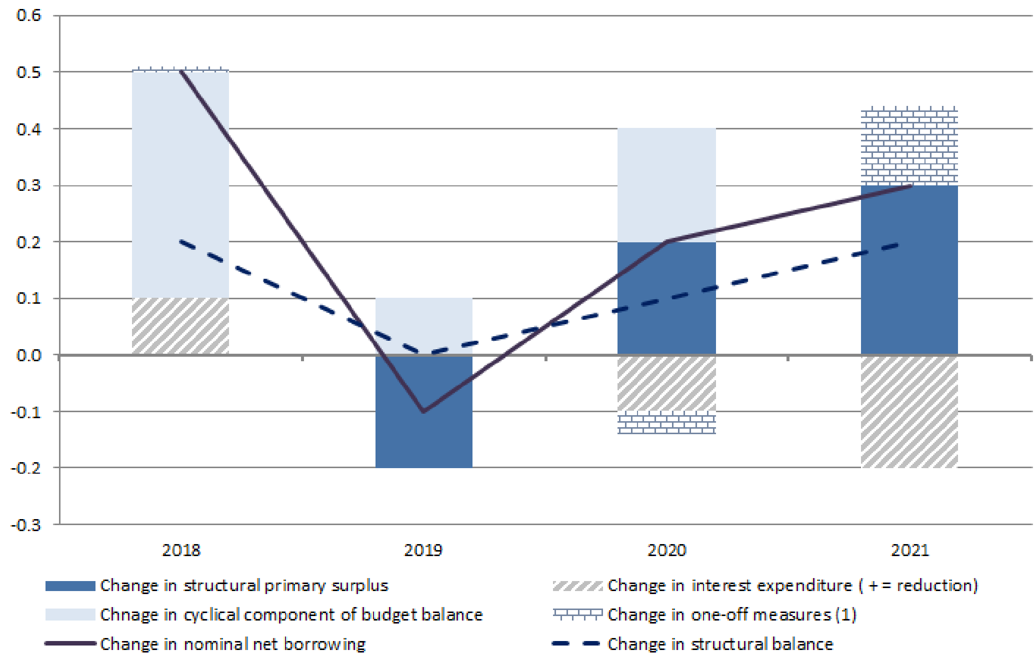
[23] Trend net borrowing in 2020 and 2021 is calculated as the algebraic sum of the policy balance and the impact of the budget measures.

Figure 2.1 – Change in the components of the policy budget balance
(percentage changes)



Source: based on data from Table 2.1.
(1) A plus sign indicates one-off deficit reduction measures.

- the cyclical component of the budget improves the balance in the Government's projections over the entire forecast period: although still negative, this component decreases between 2018 and 2021 from -0.9 to -0.6 per cent of GDP, positively affected by the gradual end of the unfavourable phase of the cycle (the output gap, which measures the difference between actual and potential GDP, is expected to decline in absolute terms from -1.7 per cent in 2018 to -1.1 per cent of GDP in 2021);

- developments in the one-off component of the budget measures will cause the overall balance to deteriorate in 2021.

Note that both the nominal and the structural budget balances reflect the full deactivation of the increases in VAT and excise duties in 2019, followed by an increase in the two subsequent years.

2.1.2 Developments in the debt/GDP ratio

The forecast for developments in the public debt/GDP ratio has been revised repeatedly in the various official policy documents, reflecting in particular changes in the macroeconomic scenario and the budget package. In the policy scenario presented in the Update to the EFD, after reaching 131.2 per cent in 2017, the debt/GDP ratio was projected to decline from a forecast 130.9 per cent in 2018 to 126.7 per cent in 2021, about 4 percentage points of GDP less than the level in 2017 but about 2 points more than the trend scenario in the Update.

According to revised projection in the DBP presented in November, the policy path of the debt/GDP ratio shows a steeper decline. Thanks to an increase – for 2019 – to 1 per cent of GDP in the proceeds expected from disposals and other revenue related to the Government Bond Sinking Fund from the previous estimate of 0.3 per cent of GDP in the Update to the EFD, the debt will decline to 129.2 per cent of GDP in that year (compared with 130 in the Update) and then 127.3 per cent in 2020 (128.1 in the Update) and 126.0 in 2021 (126.7 in the Update). Under the revised DBP, the increase in proceeds in 2019 would represent a prudent safety margin to ensure achievement of the debt reduction targets approved by Parliament, even if the expected nominal GDP growth does not fully materialise. Moreover, the increased proceeds would also reduce debt issues on the market and therefore also decrease interest expenditure.

Finally, according to the *Aggiornamento del Quadro Macroeconomico e di finanza pubblica* published after the negotiations between the Government and the European Commission, the debt/GDP ratio is forecast to increase by half a percentage point in 2018 compared with the previous year, to 131.7 per cent, and then decline at a more modest pace compared with the path set out in the revised DBP despite retaining the assumption of privatisation proceeds equal to 1 per cent of GDP in 2019, falling to 130.7 per cent that year, 129.2 in 2020 and 128.2 in 2021 (Table 2.2).

Among the determinants of the change in the debt/GDP ratio, the reduction can only be attributed to primary surpluses in the 2019-2021 period, which would produce a decline of over 6 percentage points of GDP. The impact of the snowball effect, connected with the differential between interest expenditure and the contribution of nominal GDP growth, would remain unfavourable and, over the forecast period, would contribute one and a half points of GDP to the increase in the debt/GDP ratio. The contribution of the stock-flow adjustment to the change in the debt, even considering the almost zero impact on 2019 connected with the new assumption of privatisation proceeds equal to 1 per cent of GDP, would have an adverse impact of about 1 percentage point in 2019-2021.

Table 2.2 – Determinants of the change in the debt/GDP ratio (1)
(percentage of GDP)

	2016	2017	2018	2019	2020	2021
	2019 Budget Act					
Policy debt/GDP ratio	**131.4**	**131.2**	**131.7**	**130.7**	**129.2**	**128.2**
Change in debt/GDP ratio	-0.2	-0.2	0.5	-1.0	-1.5	-1.0
Primary surplus	-1.4	-1.4	-1.7	-1.6	-2.0	-2.4
Snowball effect, of which:	1.0	1.1	1.0	0.7	0.1	0.7
Interest expenditure/nominal GDP	*3.9*	*3.8*	*3.7*	*3.7*	*3.8*	*4.0*
Contribution of nominal GDP growth	*-2.9*	*-2.7*	*-2.7*	*-3.0*	*-3.7*	*-3.3*
memo: Average cost of debt	*3.1*	*3.0*	*2.9*	*2.9*	*3.0*	*3.2*
Stock-flow adjustment	*0.2*	*0.1*	*1.2*	*-0.1*	*0.4*	*0.7*
	DBP (Nov. 2018)					
Policy debt/GDP ratio	**131.4**	**131.2**	**130.9**	**129.2**	**127.3**	**126.0**
Change in debt/GDP ratio	-0.2	-0.2	-0.3	-1.7	-1.9	-1.3
Primary surplus	-1.4	-1.4	-1.8	-1.3	-1.7	-2.1
Snowball effect, of which:	1.0	1.1	0.4	-0.3	-0.6	0.0
Interest expenditure/nominal GDP	*3.9*	*3.8*	*3.6*	*3.7*	*3.8*	*3.9*
Contribution of nominal GDP growth	*-2.9*	*-2.7*	*-3.2*	*-4.0*	*-4.4*	*-3.9*
memo: Average cost of debt	*3.1*	*3.0*	*2.8*	*2.9*	*3.0*	*3.2*
Stock-flow adjustment	0.2	0.1	1.1	-0.2	0.4	0.8

Source: based on data from 2019 DBP and 2019 Budget Act.
(1) Totals may not match due to rounding of decimals and the lack of detailed information on certain components.

Given the unfavourable developments in interest rates in conjunction with the uncertainties surrounding economic conditions in Italy, interest expenditure as a proportion of GDP in the policy scenario interrupts the decline that began in 2013, estimated at 3.7 per cent of GDP for the 2018-2019 period before rising to 3.8 per cent in 2020 and 4 per cent in 2021. The average cost of the debt also follows the same pattern, beginning to rise again after 2018 and reaching 3.2 per cent at the end of the period.

With regard to the stock-flow adjustment, according to the only information available, which dates back to the Update to the EFD, the increase in the MEF's liquidity holdings of 0.3 per cent of GDP in 2018 is intended to handle the greater volume of maturing government bonds in 2019 (up about €18 billion compared with the previous year). In the years from 2019 to 2021, the scenario envisages an annual reduction of more than 0.1 per cent of GDP in the Treasury's liquid assets.

The forecasts for the decline in the debt/GDP ratio incorporate expected privatisation proceeds of 1 per cent of GDP in 2019 following the increase introduced in the revised DBP, and 0.3 per cent of GDP in 2020. As already noted by the PBO at hearings on past policy documents, the Government did not provide sufficient information to assess the privatisation programme.

It is important to assess the sensitivity of the policy scenario to changes in the underlying assumptions. Figure 2.2 shows how the debt/GDP ratio would change if the increases in VAT rates and excise duties currently envisaged from 2020 onwards are not implemented. While the 2019 Budget Act completely sterilised the increase in indirect taxes envisaged under current legislation for 2019, the latest amendments have increased the impact of these clauses over the next two years (which, as noted in section 2.1.3, rises to 1.2 points of GDP in 2020 and 1.5 points from 2021). In this scenario, therefore, it is assumed that the clauses will be deactivated in 2020-2021 and the shortfall financed with deficit borrowing.

The exercise takes account of the impact on GDP of this budget shock (measured using the specific multiplier for indirect taxes in the PBO model) and the effect of the measure on the growth of the GDP deflator (which is also calculated on the basis of the elasticity of the GDP deflator to a shock to indirect taxes estimated by the PBO model) and, through this channel, on the average cost of the debt.

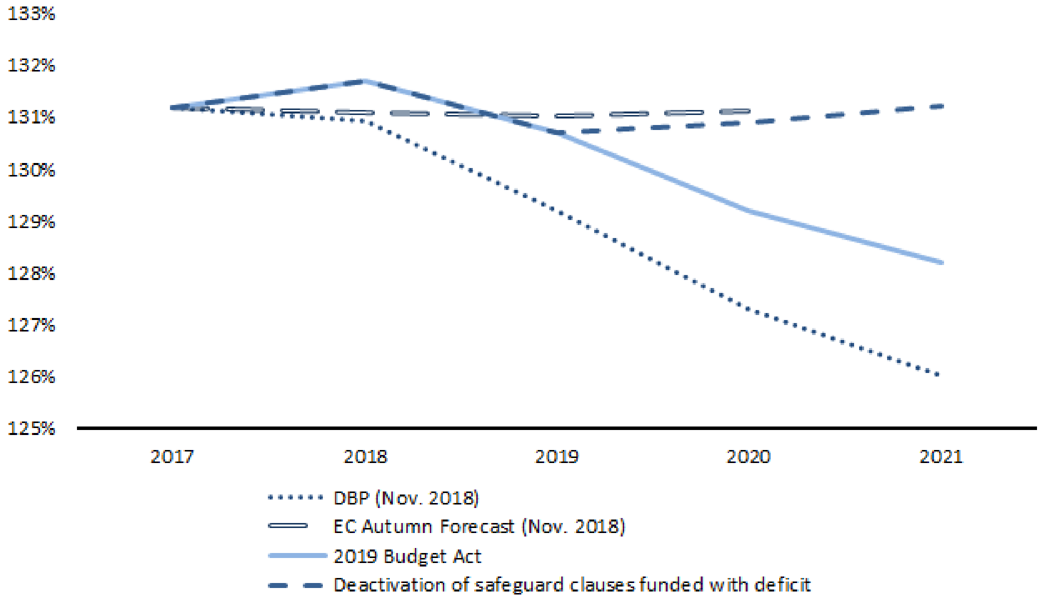
The simulation shows that, under these assumptions, in the 2020-2021 period the level of debt in relation to GDP would rise slightly compared with 2019.

In addition, the debt developments envisaged in the Budget Act are compared with what would happen in two alternative interest rate scenarios (Figure 2.3): a scenario in which the differential between interest rates and nominal GDP growth is particularly unfavourable in the 2019-2021 period (corresponding to the seventy-fifth percentile of the value of the variable over the last 18 years, i.e. the fifth worst year) and an especially favourable scenario (corresponding to the twenty-fifth percentile, or the fifth most favourable year).[24]

As we can see, in the former case, the current policy scenario would keep the debt/GDP ratio broadly stable over the time horizon of the budget package, while an especially favourable trend in rates would obviously facilitate the reduction of the ratio. The scenario currently forecast by the Government, thanks in part to the significant VAT increases envisaged for 2020-2021, tracks the favourable scenario for the evolution of the difference between average cost of debt and nominal GDP growth fairly closely.

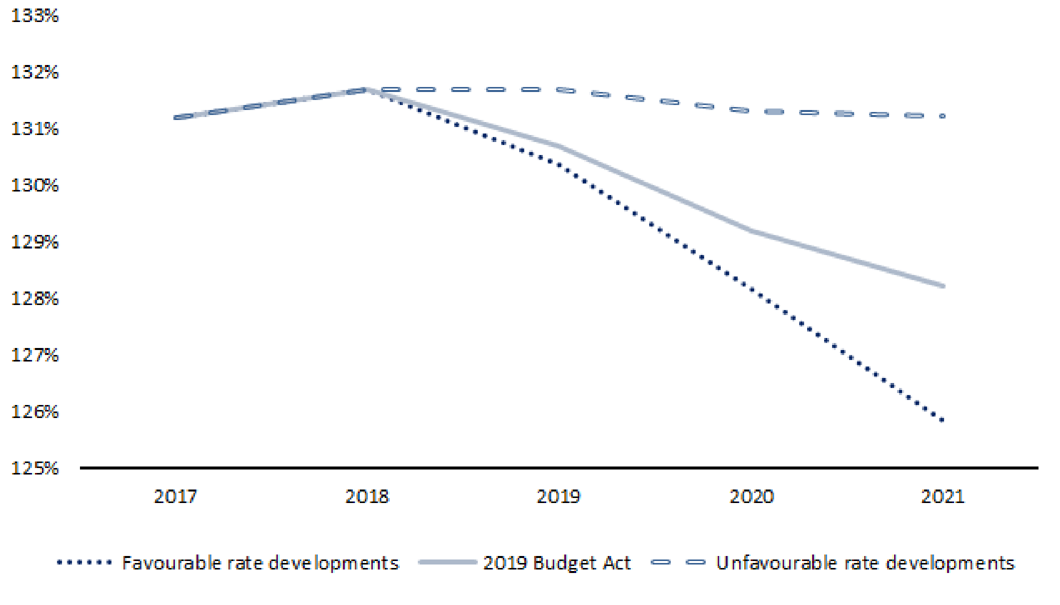
[24] In other words, considering the time series for the differential between interest rates and the growth of nominal GDP from 2000 to 2017, the 25th percentile corresponds to the value to whose left lie the first quarter (i.e. 25 per cent) of the values of the increasing ordered series, which in this case is the value for the differential registered in 2000: in only four other years in the series was the difference between the interest rate and the rate of nominal GDP growth smaller. Accordingly, that value was used to simulate a scenario in which interest rate developments were relatively favourable with respect to nominal growth. Symmetrically, the 75th percentile corresponds to the value to whose right lie the last quarter of the values of the increasing ordered series, which in this case is the value for the differential in 2011.

Figure 2.2 – Developments in the debt/GDP ratio
(percentage of GDP)



Source: based on data from 2019 DBP, 2019 Budget Act and 2018 Autumn Forecast of the European Commission.

Figure 2.3 – Developments in the debt/GDP ratio under alternative scenarios for interest rates
(percentage of GDP)



Source: based on data from 2019 Budget Act.

2.1.3 The budget package: Decree Law 119/2018 and the 2019 Budget Act

After the negotiations that followed the Commission's announcement that it was considering opening an excessive deficit procedure and in response to the Commission's remarks, the Government significantly modified the scale and composition of the budget package.

The revised package envisages a deterioration compared with trend general government net borrowing of 0.6 percentage points of GDP in 2019 (it was 1.2 percentage points in the initial version), 0.8 percentage points in 2020 (initially 1.4 percentage points) and 0.5 percentage points in 2021 (initially 1.3 percentage points).

Note that that all references to the effects of the budget measures take account of the financial impact of Decree Law 119/2018 in the final version approved by Parliament. For reasons related to the procedural mechanisms of the budget session, the budget variation note and, therefore, the official documents (in particular "Annex 3", or the annex reporting the financial effects of the Budget Act, which in the final part summarises those of Decree Law 119/2018) instead report the financial impact of the initial version of the decree when it first was presented to Parliament.

The budget package include expansionary measures whose impact remains at between 2.1 and 2.4 per cent of GDP over the planning period. By contrast, net of the effects of the safeguard clauses, the new measures produce an increasing impact, rising from 1.5 per cent in 2019 to 2.4-2.3 per cent of GDP in the following two years. Given the planned increase in the deficit, the resources to cover the spending are smaller but they do increase from 1.5 per cent of GDP in 2019 to 1.8 per cent in 2021.

In the tables, the value of the uses and of the resources to fund the outlays do not take account of a number of items that, in the overall consideration of the financial effects of Decree Law 119/2018 and the 2019 Budget Act, have a net effect of zero. These are increases in the two funds (one for the reduction of the fiscal burden and one for multi-annual grants) provided for in Article 26, paragraphs 1 and 2, of the Tax Decree, which were repealed by Article 1, paragraph 766, of the 2019 Budget Act. The amounts are "transferred" from one measure to another through an increase in funds (in Decree Law 119/2018) and subsequently used (in the Budget Act) to cover expenditure. Resources also do not consider the reduction in the Anti-Poverty Fund pursuant to Legislative Decree 147/2017 concerning the Inclusion Income, in order to finance the Citizenship Income and Pensions Fund (minimum income and pensions support), which is reported in the table – under uses – net of this funding.

The budget package shows strongly divergent trends between net expenditure and net revenue. Excluding the safeguard clauses, the package provides for greater net revenue in 2019 (€8.5 billion), which falls by half as early as the second year (€4.3 billion) and decreases again in 2021 (to €2.6 billion), accompanied by a slightly smaller increase in net expenditure expenses in the first year (€7.6 billion), a sharp increase in the second year (€22.7 billion) and a slight decrease (to €21 billion) in 2021; the higher net spending is largely of a current nature.

Table 2.3 – Decree Law 119/2018 and 2019 Budget Act: 2019-2021 budget measures and impact of Decree Law 119/2018 on 2018
(millions of euros and percentages of GDP)

	2018	2019	2020	2021
USES (1)	**1,790.1**	**38,646.2**	**44,873.1**	**44,008.9**
As a % of GDP	*0.1*	*2.1*	*2.4*	*2.3*
Increases in expenditure	1,225.0	20,417.3	32,069.1	30,138.2
Current	*170.0*	*14,935.7*	*22,380.5*	*19,790.2*
Capital	*1,055.0*	*5,481.7*	*9,688.6*	*10,348.1*
Decreases in revenue	565.1	18,228.9	12,804.0	13,870.7
Deactivation of safeguard clauses		*12,471.9*		
As a % of GDP		*0.7*		
Uses net of deactivation of safeguard clauses	**1,790.1**	**26,174.3**	**44,873.1**	**44,008.9**
As a % of GDP	*0.1*	*1.5*	*2.4*	*2.3*
RESOURCES (1)	**1,797.1**	**27,102.5**	**30,364.8**	**34,774.3**
As a % of GDP	*0.1*	*1.5*	*1.6*	*1.8*
Increases in revenue	222.8	14,285.9	21,014.3	25,654.4
Increases from safeguard clauses			*3,910.0*	*9,182.2*
As a % of GDP			*0.2*	*0.5*
Decreases in expenditure	1,574.3	12,816.6	9,350.5	9,119.8
Current	*1,046.9*	*5,276.1*	*5,874.8*	*5,893.5*
Capital	*527.4*	*7,540.5*	*3,475.7*	*3,226.3*
Resources net of increases from safeguard clauses	**1,797.1**	**27,102.5**	**26,454.8**	**25,592.1**
As a % of GDP	*0.1*	*1.5*	*1.4*	*1.3*
NET REVENUE	**-342.3**	**-3,943.0**	**8,210.4**	**11,783.7**
NET REVENUE net of safeguard clauses	**-342.3**	**8,528.9**	**4,300.4**	**2,601.5**
NET EXPENDITURE	**-349.3**	**7,600.7**	**22,718.6**	**21,018.4**
Current	*-876.9*	*9,659.6*	*16,505.8*	*13,896.6*
Capital	*527.6*	*-2,058.9*	*6,212.9*	*7,121.8*
NET BORROWING	**7.0**	**-11,543.7**	**-14,508.3**	**-9,234.7**
As a % of GDP	*0.0*	*-0.6*	*-0.8*	*-0.5*

Source: based on data from the summary schedules detailing the financial effects of Decree Law 119/2018 and the 2019 Budget Act.
(1) Uses and resources are reported net of the Fiscal Burden Reduction Fund, the Fund for Discounting Long-term Grants and the reduction in the Anti-Poverty Fund referred to in Legislative Decree 147/2017 regarding the Inclusion Income.

For 2019, the expansionary measures amount to €38.6 billion, for which resources of €27.1 billion have been identified, with a consequent increase of €11.5 billion in the deficit. For the fourth consecutive year, the most significant spending measure is the sterilisation of the safeguard clause increasing VAT rates, amounting to about €12.5 billion for 2019. The other main measures regard early retirement, social inclusion and the fight against poverty through the income and pension support programmes, the start of the recovery of public investment at the national and local levels and investment to secure and maintain buildings, roads and lands, as well as funding public employment for new hiring and wage increases under contract renewals, and the start of a number of tax relief mechanisms for companies and self-employed workers.

On the funding side, just over 50 per cent will be generated by higher revenues, which will include increases in revenues from companies, especially banks, and insurance premiums, the repeal of the proportional business income tax system (IRI), which was scheduled to begin in 2019, and the allowance for corporate equity (ACE), as well as an increase in taxation on gaming and tobacco products. Expenditure will be cut mainly by reducing the indexation of pensions, cutting ministry budgets, rationalising immigration centres and defunding and replanning transfers, notably to the Italian State Railways, as well as numerous specific measures to rationalise spending.

For 2020-2021, the effects of many of the expenditure increases – in particular those on capital account – are accompanied by the rising impact and extensions of measures already planned for 2019 (especially the repeal of the ACE and the introduction of a web tax), with further measures involving tax relief mechanisms. As regards finding the resources to cover the expenditure, revenue increases will account for an increasing proportion compared with 2019 (going from 52.7 per cent in 2019 to 69.2 per cent in 2020 and 73.8 per cent in 2021), reflecting in particular the increased impact of the safeguard clauses and the increasing revenue to be generated by measures to combat tax evasion and the amnesties provided for in Decree Law 119/2018. Among the expenditure cuts, which are smaller than those envisaged for 2019, those affecting capital spending will decline over time, while cuts to current spending will increase, especially for the healthcare sector in 2021.

The resources to cover the expenditure include many one-off measures and others whose impact is limited in time. The former include measures to combat tax evasion and amnesties, and those redefining the account payment for the tax on insurance premiums. The latter measures regard in particular the application of the new accounting treatment of writedowns of bank loans as well as the revision of the timing of transfers to the Italian State Railways and certain reductions in capital expenditure.

The main measures of the budget package

Looking in more detail at the budget package, the main uses are shown in table 2.4.

As already noted, the budget provides for the now customary full deactivation, in the first year, of the safeguard clauses increasing VAT rates and excise duties, but implements the increases in the following two years, raising €23.1 billion in 2020 (equal to 1.2 per cent of GDP) and €28.8 billion in 2021 (1.5 per cent of GDP).

Table 2.4 – Impact of the main measures in Decree Law 119/2018 and the 2019 Budget Act on the general government accounts
(millions of euros)

	2018	2019	2020	2021
NET REVENUE	**-342.3**	**-3,943.0**	**8,210.4**	**11,783.7**
Safeguard clauses		-12,472	3,910	9,182
NET REVENUE NET OF SAFEGUARD CLAUSES		**8,528.9**	**4,300.4**	**2,601.5**
Repeal of optional entrepreneurial income tax regime (IRI)		1,986	1,236	1,260
Repeal of allowance for corporate equity		228	2,373	1,453
Restructuring of deductibility of DTA on goodwill		1,308	926	658
Deferral over ten years of deduction of reduction in value of loans and other financial assets deriving from application of IFRS 9		1,170	-130	-130
Deferral until 2026 of deduction of 10% of loan writedowns		950	0	0
Increase in payment on account of tax on insurance premiums from 59% to 85% in 2019, from 74% to 90% in 2020 and from 74% to 100% as from 2021		832	-320	320
Settlement of formal violations and irregularities with no impact on taxable income (Decree Law 119/2018)		680	410	-130
Mandatory electronic reporting of receipts as from 1 July 2019 (Decree Law 119/2018)		337	1,338	1,823
Facilitated settlement of tax liabilities sent for collection and the discharge of liabilities of less than €1,000 sent to collection agents between 1 January 2000 and 31 December 2010	-355	-3	1,046	1,348
Revaluation of value and increase in rate of tax on equity investments and land		457	248	248
Broadband - increase in proceeds from 5G frequency auction		200	200	200
Pending disputes (Decree Law 119/2018)		78	104	104
Facilitated settlement of tax liabilities of parties required to pay tax on consumption of tobacco substitutes and liquid inhalation products (Decree Law 119/2018)	-177	0	0	0
Measures for gaming and betting		768	697	697
Provisions concerning the taxation of processed tobacco products		135	135	135
Web tax		150	600	600
Tax credit for environmental upgrading, remodelling and green spaces		35	-595	-887
Revision of INAIL rates		-410	-351	-453
Extension of special flat-tax of 15% to eligible taxpayers with revenue of up to 65,000		-332	-1,821	-1,374
Reduced rate of 15% on profits invested in capital goods and expanding employment		0	-1,948	-1,808
Extension of 21% tax on income from rental of commercial premises for new leases in 2019		-261	28	-163
Extension and restructuring of hyperdepreciation of technology goods and *software*		0	-405	-810
Separate taxation of income from self-employment and enterprises		0	-109	-1,131
NET EXPENDITURE	**-349.3**	**7,600.7**	**22,718.6**	**21,018.4**
CURRENT EXPENDITURE	*-876.9*	*9,659.6*	*16,505.8*	*13,896.6*
Fund for citizens income and pensions (net of reduction in Anti-Poverty Fund)		4,902	5,897	6,187
Fund for revision of pension system		3,968	8,336	8,684
Renewal of State employee contracts 2019-2021		650	925	1,275
Extension of “baby *bonus*”		204	240	
Increase in fund to finance hiring of personnel		131	328	434
International peace-keeping missions		0	1,450	0
Hiring of teacher's aides			280	280
Social Policy Fund		120	120	120
Fund for the non-self-sufficient		100	100	100
Family policies		100	100	100
Career reorganisation			100	100
Assistance for disabled students		75	75	75
Cuts to ministry budgets (Decree Law 119/2018 for 2018 only and 2019 Budget Act)	-705	-435	-434	-405
Reduction in indexation of pensions		-415	-1,222	-2,014
Reduction of pension income in excess of €100,000 for five years		-138	-145	-152
Revision and rationalisation of spending to run immigration centres		-400	-550	-650
Deferral of public hiring		-198		
Reduction in fund for the procurement of cleaning service materials			-280	-280
Redetermination of level of standard national healthcare funding requirement for 2019-2022	0	0	-175	-1,000
CAPITAL EXPENDITURE	*527.6*	*-2,058.9*	*6,212.9*	*7,121.8*
Financing of Rete Ferroviaria Italiana (RFI) (Decree Law 119/2018)	600	0	0	0
Increase in fund for SME guarantees (Decree Law 119/2018)	435	0	0	0
Fund for central government investment		415	1,185	1,700
Fund for local government investment		1,080	2,342	2,249
Fund for investment to counter hydraulic and hydrogeological risks		600	800	900
Fund for investment for regions hit by atmospheric disturbances Sept.-Oct. 2018 (Decree Law 119/2018)		475	50	
Investment by municipalities to secure and maintain schools, roads, public building and municipal assets and territory and investment by regions for buildings and territories		490	290	575
Increase in national emergencies fund: extension of 2016 earthquake state of emergency for Central Italy		200	120	40
Refinancing of “new Sabatini” capital equipment mechanism - Support for SME investment and promotion		138	116	96
National plan for water sector		100	100	100
Technology infrastructure for electronic medical visit reservation system		75	75	100
Refunding of national emergencies fund		60	100	100
Prevention of seismic risk		50	50	50
Tax credit for purchase, replacement or upgrade of cash registers		36	196	0
Cuts to ministry budgets (Decree Law 119/2018 and 2019 Budget Act)	-114	-235	-215	-206
Replanning of transfers to State Railways		-1,740	600	440
Property disposals		-950	-150	-150
Replanning of national cofinancing funds		-850	150	150
Replanning of Development and Cohesion fund		-800		
Defunding of transfers to State Railways		-600		
Reduction and replanning of defence spending		-163	-180	-136
Repeal of tax credit for IRAP payers without payroll employees		-163	-163	-163
Reduction in tax credit for purchase of capital goods for use in facilities in Southern Italy		-150	0	0
Amendment of rules for R&D tax credit		0	-300	-300
Reduction of Development and Cohesion Fund in 2014-2020 programming cycle (Decree Law 119/2018)	-300	0	0	0
NET BORROWING	**7.0**	**-11,543.7**	**-14,508.3**	**-9,234.7**
as a % of GDP	*0.0*	*-0.6*	*-0.8*	*-0.5*

Source: based on data from the financial schedules attached to Decree Law 119/2018 and 2019 Budget Act.

Among the other main measures, the most relevant from a financial point of view concern *measures for families and the fight against poverty*, with substantial resources dedicated to the establishment of two funds that represent expenditure limits for purposes that are in the process of being implemented with specific legislation, relating to the introduction of the Citizenship Income (minimum income support), with the concomitant reinforcement of job centres, and the revision of the pension system, aimed at introducing additional early retirement options and measures to incentivise the employment of young people. The second section of the Budget Act also contains provisions for refinancing social programmes in particular, such as the fund for social policies, the fund for the non-self-sufficient, policies for the family and assistance for disabled students (see section 3.4). The so-called “baby bonus” is also extended.

As regards capital expenditure, the budget package envisages a reduction in 2019 (€2 billion), in particular for investment grants, and increases in 2020-2021 (€6.2 billion and €7.1 billion). In this case, too, the resources have been placed in two funds, one for the recovery of central government investment and the development of the country and one for local governments for a variety of purposes. These include financing the use of local government surpluses, eliminating the contribution to the public finances of the ordinary statute regions, and financing the security plans for the maintenance of roads and schools of the provinces in ordinary statue regions. The funds for national emergencies and the special capital account fund have also been increased. In 2020-2021, after the significant cut in 2019, transfers to the State Railways will be increased (see section 3.6).

Various measures regard *firms and self-employed workers*. The main provisions include: preferential taxation of profits invested in purchasing capital goods and in expanding fixed-term and permanent employment; the extension and restructuring of the increase in the deduction of the depreciation and amortisation of assets that fall within the Industry 4.0 category and of software; the extension of the flat-rate tax regime for tax payers with revenues of up to €65,000; the optional flat-rate regime in lieu of ordinary income tax for the self-employment and business income of individual persons with revenue of between €65,000 and €100,000 (see section 3.1).

Resources have also been appropriated for *public employment*, both for the renewal of the employment contracts of State personnel for 2019-2021 and to increase the fund for the hiring of permanent staff as a priority measure to recruit professionals with skills in specific areas (see section 3.3).

IRPEF (personal income tax) deductions have been retained, albeit in partially reduced form, for spending on building renovations, energy upgrading projects and projects to enhance green spaces.

Finally, the budget also funds international peace-keeping in 2020.

With regard to the resources to fund these measures (Table 2.4), in addition to those specified in the Tax Decree (Decree Law 119/2018), other provisions affect companies in particular, especially banks and other financial intermediaries, with the repeal of a number of preferential tax mechanisms introduced previously. Cuts are also envisaged for the healthcare sector, with defunding and replanning and additional expenditure rationalisation measures.

Decree Law 119/2018 contains measures to *combat tax evasion,* including a requirement to electronically transmit receipt data to the Revenue Agency, which will come into force on 1 July 2019 for retail businesses with a turnover of more than €400,000 and 1 January 2020 for all retailers (see section 3.2).

The Tax Decree also makes provision for a variety of facilitated mechanisms for settling tax litigation, including a new version of the regime for settling tax arrears that have already been sent to collection agents and the settlement of pending litigation. The decree also introduces the possibility of settling formal violations and irregularities that do not have an impact on the determination of taxable income (see section 3.2).

Measures for enterprises include those affecting banks and insurance companies (deferral over ten years of the deductibility for IRES and IRAP purposes of value adjustments on loans resulting from the first time application of International Financial Reporting Standard 9); the restructuring of the timing of deductions of amortisation charges for goodwill and other intangible assets and of writedowns of loans that in the past led to the recognition of deferred tax assets convertible into tax credits; an additional increase beyond that provided for in the 2018 Budget Act for 2018 of payment on account of the tax on insurance premiums; the repeal of the optional preferential business income tax (IRI) and the repeal of the allowance for corporate equity (ACE; see section 3.1.1). In addition, the web tax introduced with the 2018 Budget Act, which was scheduled to come into force in 2019, was replaced with a new version.

Other tax measures include: the extension to 2019 of the provisions governing the determination of the purchase value of equity investments and undeveloped land; an increase in the tax on gaming and betting; and measures on the taxation of tobacco products.

In the healthcare sector, cuts are planned for 2020 and, above all, for 2021, with a consequent downward correction of the trend in health care expenditure estimated in the last Update (see section 3.5).

Capital expenditure provisions in the second section of the Budget Act comprise substantial replanning and defunding measures affecting, among others, transfers to the State Railways for 2019 only and permanent cuts to the capital expenditure of ministries, accompanied by savings from cuts to defence spending (see section 3.6). In addition, divestments of public real estate will be expanded.

Finally, *other measures* include numerous minor interventions to rationalise spending, accompanied by other provisions that generate savings from the revision and rationalisation of expenditure for running immigration centres and from permanent cuts to the current expenditure of ministries.

An overview of the budget package

The budget measures increase the deficit, both with respect to the trend deficit and, for 2019, with respect to the expected outturn for 2018. In 2020-2021 net borrowing is expected to return below the level estimated for 2018.

Given the budget package, achievement of the new public finance policy objectives is exposed to a number of risks.

For 2019, the public finance framework appears transitory in nature, owing to a series of one-off revenue measures and temporary spending programmes, and above all affected by uncertainty – as underscored by the provision to freeze €2 billion to guarantee compliance with the deficit target – in particular with regard to the actual design and feasibility of the measures, such as, for example, the programme of additional real estate sales.

The amendments introduced during the passage of the budget through Parliament also changed the nature of the budget, reversing the sign of the overall net impact on capital expenditure. Under the initial version of the budget package, in 2019 this expenditure was increased by about €1.8 billion over its trend level, while in the final version it was cut by €2 billion.

In 2020-2021, the achievement of the policy deficit/GDP ratio depends entirely on the safeguard clauses raising VAT rates and excise duties. Their impact was already significant in the initial version of the Budget Bill and was increased further in the final law (to 1.2 per cent GDP in 2020 and 1.5 per cent in 2021). If the clauses are not activated, the deficit, in purely mechanical fashion, would rise to 3 per cent of GDP in both 2020 and 2021, with evident risks for the future sustainability of the public finances.

Excluding the clauses, sources and uses are comparable in 2019 (both equal to 1.5 per cent of GDP), but they diverge by one percentage point of GDP in the two following years (Table 2.3, in 2020 sources are equal to 1.4 per cent of GDP, while uses amount to 2.4 per cent; in 2021 sources are equal to 1.3 per cent and uses equal to 2.3 per cent).

The policy structural deficit, excluding of the clauses, would rise from 1.3 per cent in 2019 to 2.4 per cent in 2020 and 2.5 per cent in 2021. These clauses are also crucial to achieving the planned reduction in the debt/GDP ratio in 2020-2021 (see section 2.1.2).

The progressive and partial deactivation of the clauses has been a common feature of budgetary policy in recent years. Following the increase in VAT and excise duties introduced for 2019 with the 2017 Budget Act, the recently approved Budget Act envisages – again – an increase in 2020 and an even larger one from 2021 (Table 2.5).

However, maintaining the activation of the increases in VAT rates and excise duties in the years following the first in the budget horizon has so far been used to ensure a decreasing profile for the structural balance in order to achieve the MTO over the programming period. Retaining these clauses – as currently included in the budget package – would only keep the structural balance broadly stable at the levels expected for 2018 and produce a relatively slight decline in the debt, one that is less pronounced than indicated in previous policy scenarios.

Table 2.5 – Activation and deactivation of safeguard clauses for VAT and excise duties
(millions of euros)

	2015	2016	2017	2018	2019	2020	2021
2015 Stability Act (Law 190/2014)							
Activation	0	12,814	19,221	21,965	21,965	21,965	21,965
2016 Stability Act (Law 208/2015)							
Deactivation		-12,814	-4,088	-2,394	-2,394	-2,394	-2,394
Net effect		0	15,133	19,571	19,571	19,571	19,571
2017 Budget Act (Law 232/2016)							
Deactivation			-15,133	0	0	0	0
Increase in clauses					3,679	3,679	3,679
Net effect			0	19,571	23,250	23,250	23,250
Decree Law 50/2017							
Deactivation				-3,828	-4,363	-4,088	-3,679
Net effect				15,743	18,887	19,162	19,571
Decree Law 148/2017							
Deactivation				-835	-340	0	0
Net effect				14,908	18,547	19,162	19,571
2018 Budget Act (Law 205/2017)							
Deactivation				-14,908	-6,075	0	0
Net effect				0	12,472	19,162	19,571
2019 Budget Act (Law 145/2018)							
Deactivation					-12,472	0	0
Increase in clauses						3,910	9,182
Net effect					0	23,072	28,753

Source: based on data from the technical reports of the measures cited in the table.

The Update to the EFD postponed to April 2019 – with the presentation of the Stability Programme – the specification of "measures modifying current expenditure and improving the collection of taxes that enable the complete elimination of the safeguard clauses", even though these clauses had previously been for smaller amounts, equal to €13.7 billion and €15.6 billion respectively. Therefore, as in recent years, we are faced with a considerable degree of uncertainty over the composition and scale of future fiscal policies, this time against a background in which a significant structural increase in public spending is expected.

In the light of past experience, replacing the clauses appears, at the very least, to be a challenging prospect. Expenditure cuts would probably not involve, except to a limited extent, investment programmes, which the Government is seeking to strengthen; social programmes, which have been expanded with this budget; or compensation of employees, which will be increased by contract renewals. Given these exclusions, the remaining expenditure items available for reductions, represented in large part by healthcare expenditure, would undergo substantial cuts. One area of intervention could regard – as touted for years – so-called tax expenditures, although the Budget Act actually extends some of these.

Note that, as indicated in the technical report annexed to the Budget Act, for the purposes of calculating the new safeguard clauses, unlike past practice in previous sterilisations, the increases in VAT rates have not been parameterised on the basis of the historical values underlying the quantification of the various clauses that have been adopted over the years, but rather on the basis of the latest available data on VAT revenue. This means that each percentage point of increase in rates, both of the reduced 10 per cent rate and the ordinary rate, corresponds to greater revenue compared with previous estimates. Under the provisions of the new VAT clause, therefore, the same amount of revenue can be generated with slightly smaller rate increases.

Another problem is the fact that the budget does not quantify the impact on the general government accounts of spending related to the contractual renewals at government departments other than State entities. Finding these resources remains the responsibility of the decentralised bodies.

Uncertainty also surrounds the effectiveness of expenditure rationalisation measures, given the containment of expenditure growth by now under way for years. In the budget package, numerous specific rationalisation measures are accompanied by cuts in ministry spending that are specified by economic category only and which follow on from those so recently enacted for 2018 with Decree Law 119/2018. The defunding and replanning indicated in the second section of the Budget Act appear easier to implement.

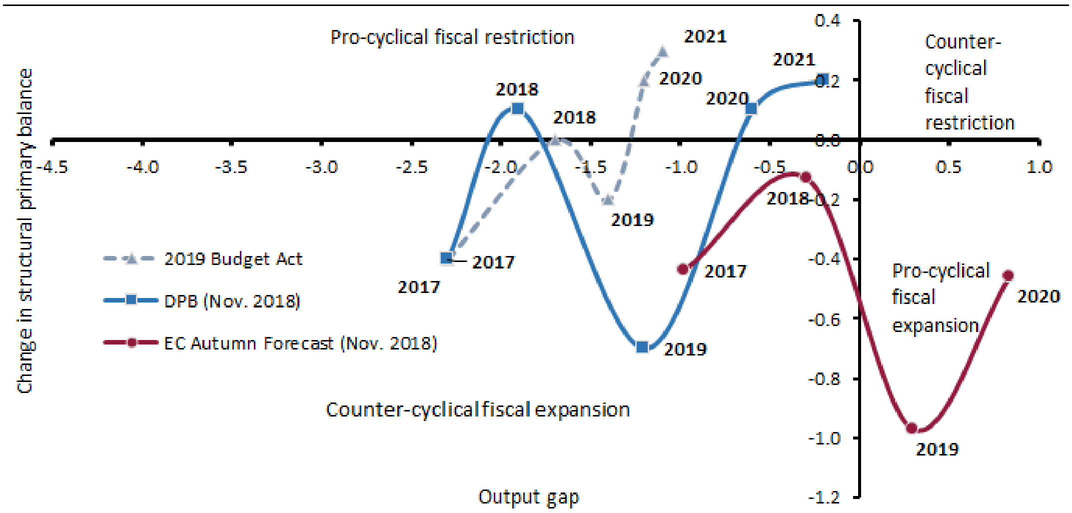
Finally, the Government's public finance policy aggregates appear to be exposed to risks and uncertainties associated with the macroeconomic environment. Current economic developments appear to point to slower GDP growth than that forecast in the scenario recently updated by the Government, with a likely impact on the public finance balances.

2.2 *Analysis of the fiscal stance*

The analysis of the fiscal stance assesses the orientation of fiscal policy in relation to cyclical conditions in the economy. Generally, the direction and intensity of fiscal measures are measured by the change in the structural primary balance compared with the previous year (which, if positive, indicates a restrictive stance, and vice versa), while the position of the economy in the cycle is evaluated using the output gap, i.e. the difference between actual output and potential output, expressed as a ratio of potential output. Accordingly, in the presence of a positive output gap, an expansionary budget will be pro-cyclical, while a restrictive budget will tend to bring output closer to its potential, making it counter-cyclical, and vice versa.

The policy scenario presented by the Government in the DBP last November forecast an output gap of -1.2 percentage points for 2019, making the deterioration of 0.7 points in the structural primary balance caused by the budget measures counter-cyclical (Figure 2.4). In the following two years, the gradual closure of the output gap was accompanied by a substantially neutral stance, with small improvements in the structural primary surplus (+0.1 points in 2020 and +0.2 in 2021), essentially reflecting the activation of the safeguard clauses for indirect taxes without sterilisation in the budget package.

Figure 2.4 – Changes in the structural primary balance and the output gap *(percentage of GDP)*



Source: based on data from the 2019 DBP, the 2019 Budget Act and the Autumn Forecast 2018 of the European Commission.

Following the Government's revision of the policy scenario on 18 December, the stance of the package set out in the Budget Act is visibly different. The downward revision of the growth forecasts for 2019 (from 1.5 to 1 per cent) is partly the result of a deterioration in cyclical conditions, with actual output diverging farther from potential in 2019 and considerably slowing down its path towards potential in the subsequent two years: the updated estimates of the output gap put it at -1.4 points in 2019, and still equal to -1.1 points two years later. At the same time, the reduction in net borrowing from 2.4 per cent to 2 per cent in 2019 and by about 0.3 points of GDP in 2020 and 2021 (mainly reflecting the further increase in indirect taxes) translates into a less expansionary fiscal stance in 2019 and a more restrictive position in 2020-2021 compared with the forecasts set out in the DBP, thus making it pro-cyclical in these two years.

The Autumn Forecasts published at the beginning of November by the European Commission – which obviously do not take account of the Government's more recent revisions of the policy scenario – painted a rather different picture: the estimate for the output gap indicated the start of a favourable phase of the cycle already in 2019, for which the sharp deterioration in the structural primary surplus (estimated at almost one point of GDP) would have been pro-cyclical. In the following year, a further intensification of the expansionary phase would be accompanied by a new (and clearly pro-cyclical) reduction in the structural primary surplus.[25]

[25] The substantial divergence between the European Commission's forecasts and those of the MEF for the change in the structural primary surplus after 2019 is explained by differences in the criteria used to produce the trend public finance scenario. Essentially, the Commission does not consider the impact of the activation of the safeguard clauses.

2.3 The public finance scenario in the light of the fiscal rules

2.3.1 Dialogue between the Government and the European Commission

On 23 October last year,[26] the European Commission asked the Government under the provisions of Article 7(2) of Regulation (EU) No. 473/2013 to submit a revised DBP within three weeks, as the DBP presented on October 15 did not comply with the recommendations addressed to Italy by the Council on 13 July 2018 or with the commitments previously assumed with the 2018 Stability Programme.[27]

Furthermore, on 29 October, the European Commission,[28] considering the particularly serious non-compliance with the recommendations such as to represent a material change in the relevant factors in the overall assessment of compliance with the debt rule, announced the preparation of a new report under Article 126(3) of the TFEU for Italy's prima facie non-compliance with the debt reduction benchmark in 2017. Accordingly, the MEF was asked to indicate, by November 13, any new relevant factors. The preparation of an Article 126(3) report is the necessary prerequisite for the possible opening of an excessive deficit procedure against a Member State. Note that the procedure for violation of the deficit rule and that for breach of the debt rule are both referred to as the excessive deficit procedure under EU rules.

Last spring, the Commission had already prepared an Article 126(3)[29] report for prima facie non-compliance with the debt benchmark in 2017. In the report, after examining all the relevant factors and, in particular, Italy's compliance with the preventive arm of the SGP in 2017, the Commission concluded that the debt rule had been complied with in 2017 on the basis of the information available at that time.

On 13 November, the MEF then submitted a new version of the DBP[30] and the report on the factors deemed relevant by the Italian Government for the purposes of assessing compliance with the debt rule.[31] However, in the revised DBP the budget targets were unchanged from the original version, including the structural deterioration forecast for 2019. The changes were limited, and consisted essentially of an increase in the target for privatisation proceeds in 2019 (1 per cent of GDP, instead of 0.3 per cent). This objective contributed to reducing the debt forecast, and therefore only involved a different policy scenario for the debt/GDP ratio.

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26 For more details on the dialogue between the MEF and the Commission, see Box 2.1.
27 https://ec.europa.eu/info/sites/info/files/economy-finance/2019_dbp_commission_letter_it_20181023_en.pdf
28 http://www.mef.gov.it/inevidenza/documenti/A.Rivera_LetterIT.pdf.pdf.
29 http://www.mef.gov.it/inevidenza/documenti/article_0320.pdf
30 https://ec.europa.eu/info/sites/info/files/economy-finance/draft_bp_2019.pdf
31 http://www.mef.gov.it/inevidenza/documenti/Italy_Relevant_Factors_November_2018.pdf

Box 2.1 – The exchange of letters between the Ministry for the Economy and Finance and the European Commission

Following the publication of the Update to the EFD in October 2018, an exchange of letters took place between the MEF and the European Commission.

First, in a letter dated 4 October, the Minister for the Economy and Finance informed the European Commission of the Government's request to Parliament to authorise a revision of the adjustment path towards the MTO.[32] In the letter, the Minister emphasised the need to modify the public finance scenario for 2019-2021 in order to implement a programme of socio-economic reforms and investment against the background of the decelerating Italian and European economies. The Minister's letter reaffirmed the Government's intention to resume the process of structural debt reduction when the level of real GDP and the unemployment rate had returned to their pre-crisis levels.

In its reply of 5 October,[33] the Commission recalled that the recommendation addressed to Italy for 2019, endorsed by the European Council last June and formally adopted by the Council of Ministers of the EU on 13 July 2018 – in both cases unanimously – called for Italy to make structural adjustment of 0.6% of GDP. However, the Update to the EFD contained a deterioration of 0.8 percentage points of the structural balance in 2019 and a stable balance in 2020-2021. The Commission thus noted that this pointed to a significant deviation in 2019 from the fiscal path recommended by the Council.

Subsequently, a few days after the Italian Government submitted the DBP, the European Commission, with a new letter dated 18 October,[34] noted three particularly serious violations of the budget policy obligations under the Stability and Growth Pact (SGP): 1) failure to comply with the recommendations of the Council of the EU for 2019; 2) failure to comply with the preventive arm of the SGP, following the significant deviation planned for 2019; and 3) failure of the PBO to endorse the macroeconomic forecast contained in the DBP.

In the Minister's reply on 22 October 2018,[35] it was acknowledged that the budget policy was indeed not in compliance with the rules of the SGP but was considered necessary in the light of the persistent delay in returning GDP to its pre-crisis GDP levels and the economic conditions of the most disadvantaged sections of Italian society.

The letter also emphasised the significant decline expected in the debt/GDP ratio over the next three years as a result of the growth-enhancing measures to be introduced with the 2019 Budget Act, including, in particular, the recovery of public investment.

With regard to the lack of the PBO's endorsement of the macroeconomic scenario, the Minister pointed out that the "comply or explain" procedure envisaged by Italian law (Article 18, paragraph 3, Law 243/2012) was followed through in the second hearing before the Budget Committees of 10 October, in which the Minister confirmed the scenario contained in the Update.

The MEF document on the relevant factors underscored four main factors: 1) the recent increase in the downside risks to the outlook for nominal GDP growth, such that excessive fiscal adjustments could prove counterproductive; 2) the underestimation of the severity of Italian

[32] http://www.mef.gov.it/ufficio-stampa/comunicati/2018/documenti/October_2018_Letter_to__EC_Vice_President_04_10_2018_16H30.pdf.
[33] https://ec.europa.eu/info/sites/info/files/com_reply_minister_tria_0.pdf.
[34] https://ec.europa.eu/info/sites/info/files/economy-finance/18_10_18_commission_letter_to_italy_en_0_1.pdf.
[35] https://ec.europa.eu/info/sites/info/files/economy-finance/letter_to_vd_and_pm_-_22-10-2018.pdf.

economic conditions, even after the revision of the "commonly agreed methodology" for calculating the output gap; 3) the relevance of measures for social inclusion (Citizenship Income) and for the recovery of public investment at the basis of the 2019 DBP in relation to the Council recommendations issued in 2018 to increase social spending and to reform active labour market policies on the one hand and, on the other, to foster research, innovation, digital skills and infrastructure through better targeted investment; and 4) the series of structural reforms to support growth planned by the Government in various sectors (from the judicial system to the public sector). In addition, the report highlighted the reduced threats to the long-term sustainability of the public debt and its affordability, given the continuing low level of interest expenditure, the low level of contingent liabilities and the low level of private sector debt (and that of households in particular).

On 21 November the Commission published both its opinion on the new revised Italian DBP[36] and its new Article 126(3) report on compliance with the debt benchmark in 2017.[37]

With regard the new DBP, the Commission confirmed its opinion finding a risk of a significant deviation both in 2019 and in 2018 and 2019 taken together.

That conclusion would not change even if the budgetary impact (around 0.2 percentage points 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 following adverse weather conditions were considered as unusual events outside the control of the Member State concerned.

Furthermore, the Commission noted that both on the basis of the revised DBP policy scenario and the Commission's Autumn forecast, the debt reduction benchmark would not be complied with in either 2018 or 2019.

In the new Article 126(3) report, the Commission highlighted three key aspects: 1) the fact that macroeconomic conditions, despite recently intensified downside risks, cannot be argued to explain Italy's large gaps to compliance with the debt reduction benchmark, given nominal GDP growth above 2 per cent since 2016; 2) the fact that Government plans imply a backtracking on past growth-enhancing structural reforms, in particular the past pension reforms; 3) the risk of significant deviation from the adjustment path towards the medium-term budgetary objective in 2018 and the particularly serious non-compliance for 2019 with the recommendation addressed to Italy by the Council on 13 July 2018.

Accordingly, the Commission concluded that the debt rule should be considered as not complied with in 2017 and that a debt-based excessive deficit procedure was warranted for Italy.

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36 https://ec.europa.eu/info/sites/info/files/economy-finance/c-2018-8028-it_en_0.pdf.

37 https://ec.europa.eu/info/sites/info/files/economy-finance/1263_commission_report_211118_-_italy_en_1.pdf.

On 29 November 2018, the Economic and Financial Committee of the European Union, in accordance with Article 126(4) of the TFEU, concurred with the Commission's view on the existence of grounds for opening an excessive deficit procedure.

Subsequently, the Government began negotiations with the European Commission on the possible revision of the public finance policy scenario for 2019 and the subsequent years in order to make it more compliant with the rules of the Stability and Growth Pact.

On 18 December, with a letter to the Commission, the Government expressed its intention[38] to modify the budget balances. The letter also highlighted the need to revise the macroeconomic policy scenario in light of the slowdown in economic activity. In addition, the letter confirmed the request for flexibility, already present in the revised DBP of 13 November, in relation to the implementation of the extraordinary plan to ensure the safety of road infrastructure and manage hydrogeological risks. Finally, the Government expressed its intention to introduce a safeguard clause to ensure achievement of the target balances, which provides for a freeze on specific appropriations that would become available again if monitoring during the year finds that budgetary developments were consistent with the policy objectives.

The European Commission, in its reply of 19 December,[39] took note of the positive outcome of the dialogue with the Government. In particular, according to the Commission, the agreed measures correct the previous situation of serious non-compliance with the recommendations of the Council of the Union issued last July regarding the rules of the Stability and Growth Pact. As a result, the Commission felt that opening an excessive deficit procedure at this stage was no longer necessary, provided that the agreed measures, including the safeguard clause, were definitively approved by Parliament, as then subsequently occurred in the closing days of December. The Commission will carefully monitor budgetary developments in Italy and, in particular, the execution of the 2019 Budget Act.

The remainder of this section offers a summary assessment of compliance with the structural balance rule and the debt rule.

[38] For the letter and the annexes, see https://ec.europa.eu/info/sites/info/files/economy-finance/lettera_commissione_europea_pm.pdf and https://ec.europa.eu/info/sites/info/files/economy-finance/20181219_italy_letter_to_commission_-_annex.pdf.

[39] https://ec.europa.eu/info/sites/info/files/economy-finance/7351969_letter_to_prime_minister_conte_and_minister_tria.pdf. See also the press conference of Vice President Dombrovskis, http://europa.eu/rapid/press-release_SPEECH-18-6886_en.htm and that of Commissioner Moscovici, http://europa.eu/rapid/press -release_SPEECH-18-6885_en.htm.

2.3.2 The structural balance rule

The policy scenario outlined in the *Aggiornamento del Quadro Macroeconomico e di finanza pubblica* of January 3, 2019[40] coincides almost entirely with that set out in the annexes to the letter of the President of the Council of Ministers to the European Commission of 18 December 2018, with the exception of a slightly higher ratio of interest expenditure to GDP in 2018-2019 and in 2021. However, both scenarios differ from that in November's revised 2019 DBP, due mainly to the reduction in deficits in 2019-2021 and the resumption in 2020-2021 of the approach path towards the MTO.

These revisions prevented the opening of an excessive deficit procedure because, according to the European Commission, the agreed measures would correct the previous situation of particularly serious non-compliance with the Stability and Growth Pact. However, a significant deviation from the required structural adjustment remains in 2019, although only half of that calculated on the basis of the DBP data. More generally, for each year of the 2018-2021 period, if the deviations discussed in this section were to be confirmed by *ex post* data, the European Commission will conduct an overall assessment that also takes account of the expenditure benchmark – an analysis of which is not currently possible due to the lack of relevant information in the *Aggiornamento* – in order to assess whether or not the preventive arm of the Stability and Growth Pact has been complied with and whether opening a significant deviation procedure is warranted.

The excessive deficit procedure is part of the corrective arm, and can be activated in the event of *ex post* failure to comply with the debt rule, i.e. compliance with a maximum debt/GDP ratio of 60 per cent or – if greater than this threshold – the annual reduction of the ratio by one twentieth of the part exceeding the limit. It can also be opened in response to *ex ante* or *ex post* failure to comply with the nominal deficit rule, i.e. a nominal deficit/GDP ratio of no more than 3 per cent. The significant deviation procedure is part of the preventive arm, and can be opened for a significant *ex post* deviation determined by the Commission on the basis of deviations in the adjustment of the structural balance from the required adjustment and deviations in the increase in net expenditure from the growth benchmark.

Table 2.6 uses the new Government forecasts for 2018-2021 to illustrate the main factors to consider in assessing the structural adjustment rule and the conclusions to be drawn about estimated deviations (on a one-year and two-year basis) from the fiscal rules.

[40] http://www.mef.gov.it/inevidenza/article_0385.html.

Table 2.6 – Assessment of compliance with the structural balance rule (1)
(percentage of potential GDP)

Structural balance rule	2017	2018 (2)	2019	2020	2021
Structural balance adjustment required excluding flexibility (a)	0.6	0.6	0.6	0.6	0.6
Flexibility for exceptional events (spending on refugees and earthquake 2017, road transport and hydrogeological risk 2019) (b)	0.4	0.0	0.2	0.0	0.0
Flexibility for degree of discretion (c)	0.0	0.3	0.0	0.0	0.0
Adjustment required including flexibility for exceptional events and degree of discretion (d=a-b-c)	0.2	0.3	0.4	0.6	0.6
Annual structural adjustment (e)	**-0.3**	**0.2**	**-0.2**	**0.1**	**0.2**
Deviation from required adjustment on one-year basis (f=e-d) (3)	-0.5	-0.1	-0.6	-0.5	-0.4
Compliance on one-year basis	***Dev. close to sign.***	***Dev. not sign.***	***Sign. dev.***	***Dev. close to sign.***	***Dev. not sign.***
Deviation from required adjustment on two-year basis (3)	-0.4		-0.4	-0.6	-0.5
Compliance on two-year basis	***Sign. dev.***		***Sign. dev.***	***Sign. dev.***	***Sign. dev.***

Source: based on data from *Aggiornamento del Quadro Macroeconomico e di finanza pubblica* of the MEF and the Autumn Forecast 2018 of the European Commission.
(1) Totals may not match due to rounding of decimals. – (2) The deviation for 2018 on a two-year basis is not reported as, following application of its "degree of discretion", the European Commission will assess that year only with regard to full compliance (i.e. with no scope for deviation) with the rule on a one-year basis. – (3) Compliance is achieved if the deviation of the structural adjustment from the required effort is nil or positive. If the one-year deviation is negative and between 0 and -0.5 (0 and -0.25 for the deviation over two years taken together), then the deviation is not significant. If the one-year deviation is negative and greater than -0.5 (-0.25 for the deviation over two years taken together), then the deviation is significant.

For 2018, there is no change from the figures already noted on the occasion of the hearing on the Update.[41] In annual terms, the *Aggiornamento* confirms the estimated improvement of around 0.2 percentage points of GDP in the structural balance. The required adjustment before flexibility is 0.6 percentage points, lowered to 0.3 points following application the "degree of discretion" by the European Commission. This would result in an estimated deviation of -0.1 percentage points. This deviation would generally be considered not significant; however, at the time it applied its degree of discretion, the Commission had stated that no further deviations from the required adjustment would be allowed. Therefore, the estimated adjustment for 2018 appears inadequate to meet the requirement.

For 2019, the *Aggiornamento* forecasts a structural deterioration of 0.2 percentage points. The adjustment required before flexibility is 0.6 percentage points. This adjustment would be reduced to 0.4 percentage points as a consequence of the request for flexibility of 0.2 percentage points for exceptional events, contained in the revised DBP and in the *Aggiornamento*, for expenditure on actions to address hydrogeological instability and to secure the road network.

41 http://www.upbilancio.it/wp-content/uploads/2018/10/Audizione-NADEF-2018.pdf.

Therefore, for 2019 the estimated deviation is equal to -0.6 percentage points of GDP in annual terms and -0.4 points in two-year terms, both of which are significant.

As regards 2020-2021, the policy scenario contained in the *Aggiornamento* envisages a structural adjustment of 0.1 percentage points of GDP in 2020 and 0.2 points in 2021. This means that the adjustment path towards the MTO is expected to resume, compared with the halt provided for in the 2018 Update and the 2018 DBP. However, as the required adjustment is equal to 0.6 percentage points in each year, the scenario forecasts a deviation of -0.5 percentage points of GDP in one-year terms in 2020, i.e. at the limit of significance, and one of -0.4 points of GDP in 2021, or not significant. A significant deviation in two-year terms is also expected in both years.

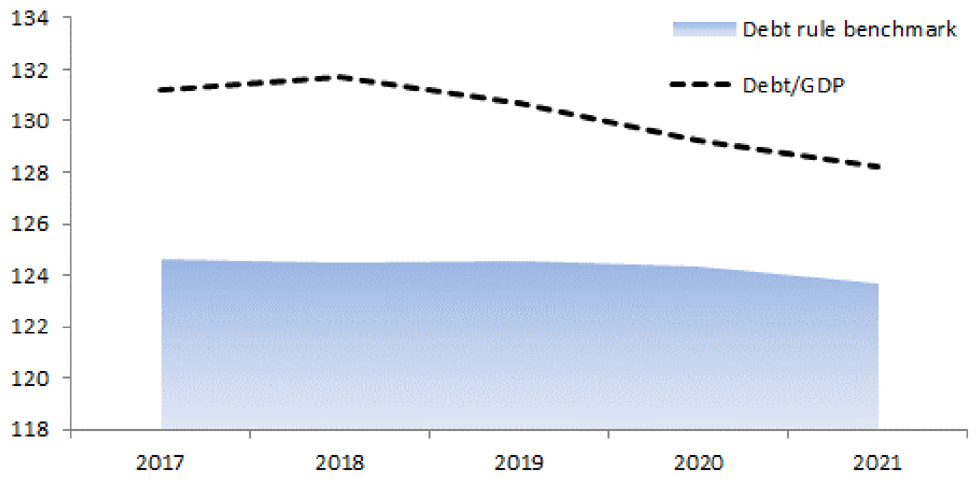
2.3.3 The debt reduction rule

The trend in the policy ratio between the public debt and GDP described in the *Aggiornamento del Quadro Macroeconomico e di finanza pubblica* shows a small increase in 2018 (from 131.2 per cent of GDP to 131.7 per cent), compared with the reduction estimated in the 2019 DBP, followed by a gradual reduction to 130.7 per cent in 2019 and then to 129.2 per cent in 2020 and 128.2 per cent in 2021. Despite the Government's forecast decline in the debt over the 2019-2021 period, the debt reduction rule is not complied with in the period, either with the backward-looking criterion until 2021 (Figure 2.5) or the forward-looking criterion until 2019, nor with cyclically adjusted criterion.

As noted in previous PBO publications, compliance with the rule using the forward-looking method in a given year is the equivalent of complying with the rule using the backward-looking approach two years after the reference year. For example, not complying with the rule using the backward-looking approach in 2021 implies non-compliance with the rule in 2019 using the forward-looking criterion. This also means that given the current state of information it is not possible to assess compliance with the rule using the forward-looking approach for 2020-2021, because that would require projections for the debt/GDP ratio for 2022-2023.

Recall that the European Commission, considering the failure to comply with the rule in 2017, prepared a report under Article 126(3) of the TFEU in May 2018 that concluded that the rule had been complied with, postponing preparation of a new report to the spring of 2019.

Figure 2.5 – Compliance with the public debt/GDP reduction rule
(percentage of GDP)



Source: based on data from the *Aggiornamento del Quadro Macroeconomico e di finanza pubblica* of the MEF for the backward-looking rule.

However, due to the material changes reported in the 2019 DBP, the Commission prepared a new report earlier, in November 2018, recommending the opening of an excessive deficit procedure for non-compliance with the debt criterion in 2017 because of the "particularly serious non-compliance" with the Stability and Growth Pact. The objectives and measures set out in the *Aggiornamento* would eliminate this "particularly serious non-compliance". Accordingly, the European Commission said that definitive approval by Parliament of the measures announced by the Government, as in fact occurred at the end of December, would allow the Commission not to recommend the opening of an excessive deficit procedure against Italy for non-compliance with the debt rule.

3 COMMENTS ON SOME OF THE MAIN MEASURES OF THE BUDGET PACKAGE

3.1 *Measures concerning taxation*

The budget package for 2019 contains measures with a significant quantitative and qualitative impact on the taxation of business and self-employment income that are expected to increase the tax burden by a total of €6.4 billion in 2019 and €0.3 billion in 2020, and reduce it by €1.1 billion from 2021 (Table 3.1).

The increase in revenue in 2019 is largely due to extraordinary measures targeted primarily at the financial and insurance industries (about €4.3 billion) and the repeal of the optional IRI (entrepreneurial income tax) scheme for partnerships and sole proprietors (€2 billion), which was due to enter into force on 1 January 2019 (after having been postponed by one year with the 2018 Budget Act).

More specifically, the budget provides for a further increase compared with the 2018 Budget Act in the payment on account for the tax on the insurance premiums of insurance companies, which rises from 59 to 85 per cent in 2019, from 74 to 90 per cent in 2020 and from 74 to 100 per cent in 2021. This will increase revenue by €0.8 billion in 2019.

Table 3.1 – Business taxation measures
(millions of euros)

	2019	2020	2021
Extension of simplified flat-tax mechanism to include taxpayers with revenue of up to €65,000 at a tax rate of 15%	-331	-1,816	-1,370
Separate taxation of self-employment and business income	0	-109	-1,129
Reduced tax rate of 15% for profits invested in capital goods or increasing employment	0	-1,948	-1,808
Extension and restructuring of hyperdepreciation of technology goods and software	0	-405	-810
Repeal of optional IRI scheme	1,986	1,235	1,256
Repeal of ACE	228	2,373	1,453
Restructuring of deductibility of DTAs on goodwill over 11 years (1)	1,308	926	658
Deferral until 2026 of deductibility of 10% of loan writedowns (1)	950	0	0
Increase in payment on account of tax on insurance premiums from 59% to 85% for 2019, from 74% to 90% for 2020 and from 74% to 100% from 2021 (1)	832	-320	320
Deferral over 10 years of deductibility of any reduction in the value of loans and other financial assets deriving from the application of IFRS 9 (1)	1,170	-130	-130
Modification of rules governing R&D tax credit	0	-300	-300
Web tax	150	600	600
Elimination of reduced IRES rate for non-commercial entities	118	158	158
Total	**6,411**	**264**	**-1,102**

Source: based on data from the technical reports attached to the 2019 Budget Act and Decree Law 119/2018.
(1) Temporary measures.

For the banking sector, the measures provide for the deferral over ten years of the deductibility for IRES and IRAP purposes of loan writedowns resulting from the first-time application of International Financial Reporting Standard (IFRS) 9 and the restructuring of the deductibility of amortisation charges for goodwill and other intangible assets and of loan writedowns that previously gave rise to the recognition of deferred tax assets convertible into tax credits. Overall, these measures are expected to generate more than €3.4 billion in revenue in 2019.

From 2020, the lagged effects of the elimination of the IRI scheme (€1.2 billion once fully in place) and the effect of the abolition of the ACE (about €2.4 billion in 2020 and €1.5 billion thereafter) are more than offset by other tax reduction measures. These include the extension of the 15 per cent flat rate regime (so-called *regime forfettario*) for self-employed workers and sole proprietors with turnover of less than €65,000 euros and the introduction of a substitute tax regime (another single-rate mechanism) with a 20 per cent rate in lieu of ordinary progressive personal income tax (so-called *regime sostitutivo*) for self-employed workers and sole proprietors with turnover between €65,000 and €100,000 (€1.9 billion in 2020 and €2.5 billion thereafter; see section 3.1.2). Other measures include a reduction of 9 percentage points in the tax rate on part of taxable income for corporations, partnerships and other enterprises not eligible for the mechanisms noted above (€1.9 billion in 2020, €1.8 billion in 2021 and €2.2 billion in 2022; see section 3.1.1). Moreover, all enterprises will still be able to take advantage of the so-called hyper-depreciation mechanism in 2019 (€0.4 billion in 2020 and €0.7 billion in 2021), albeit in more limited form than in previous years.

Table 3.2 shows the beneficiaries and the sign of the impact on the tax burden of the individual measures on the basis of the legal status of the enterprises.

The new tax scheme increases the fragmentation of the system and introduces a number of important structural changes that will be explored in the following sections.

Table 3.2 – Business taxation measures by type of enterprise
(+ increase in taxation; - decrease in taxation)

Self-employed and sole proprietors (1)		Sole proprietors subject to ordinary accounting regulations		Partnerships		Corporations	
		Abolition of IRI	(+)	Abolition of IRI	(+)		
Flat-rate regime (if applicable)	(-)						
Substitute tax regime (if applicable)	(-)						
		Reduced tax rate	(-)	Reduced tax rate	(-)	Reduced tax rate	(-)
		Abolition of ACE	(+)	Abolition of ACE	(+)	Abolition of ACE	(+)
		Hyper-depreciation	(-)	Hyper-depreciation	(-)	Hyper-depreciation	(-)

(1) The ordinary personal income tax (IRPEF) system remain in effect for self-employed workers and sole proprietors with turnover of more than €100,000.

With regard to fragmentation, the IRI scheme – although an optional mechanism – made the choice of the legal form of an enterprise more tax neutral. Its repeal and the introduction of the new regimes for the self-employed and sole proprietors make taxation dependent not only on the legal nature of an enterprise but also on its size, essentially creating three taxation systems: the progressive IRPEF regime (for partnerships and sole proprietors subject to ordinary accounting rules) and the proportional IRES system (for corporations) are joined by new proportional systems for sole proprietors and self-employed workers (the flat rate regime and the substitute tax regime), which, by extending the pool of beneficiaries, can no longer be considered favoured tax schemes like the existing simplified mechanism for certain categories of low-turnover agents (so-called *regime dei minimi*).

Two other changes were introduced during parliamentary approval of the Budget Act.

The first is the introduction of a new web tax, which according to official estimates is expected to generate revenue amounting to €0.15 billion in 2019 and €0.6 as from 2020.

The web tax introduced with the Budget Act for 2018, which was due to enter into force in 2019 and provided for a 3 per cent levy on gross revenue from the electronic provision of services to Italian residents by both residents and non-residents was repealed. At the same time, the budget established a new 3 per cent tax on gross revenue from the provision of specific digital services that represent a broader tax base than the previous levy. The new regime unilaterally adopts the digital services tax mechanism proposed by the European Commission pending the establishment of a long-term solution at the EU level. Like the repealed tax, it will be essential to define the procedures for applying the tax and the methods for assessing and collecting the revenue in order to take account of the unilateral nature of the tax, which will have to be applied to a tax base characterised by considerable scope for avoidance and evasion.

The second change is the repeal of the subsidised IRES rate for certain non-economic entities performing social, cultural and welfare activities, as well as autonomous social housing institutions. This measure is expected to generate €0.1 billion in 2019 and €0.2 billion as from 2020. The revenue for 2019 is guaranteed by the early collection of the additional tax due in payments on account. Given the special purposes of these entities, the change, which was designed to prevent opportunistic behaviour on the part of companies seeking to mask profit-making enterprises behind social activities, threatens to have a major impact on the operations of this sector.

3.1.1 Changes in the taxation of partnerships and corporations

The new corporate tax rule for retained profits establish a dual system of tax rates in which the ordinary rate is lowered by 9 percentage points (falling to 15 per cent for corporations, and to between 14 and 34 per cent for companies liable to IRPEF) on the portion of taxable income corresponding to the sum of the depreciation charges for incremental investments in capital goods and the cost of personnel reflecting the rise in employment within the company each year. The maximum amount is fixed at the previous financial year's retained profits (in both cases, the portion of the preferential tax base excludes the costs of replacing capital goods and employees of the previous year). Furthermore, the rule takes account of the company's multi-year life span by including a mechanism to carry forward to subsequent years both the portion of retained earnings exceeding the portion of the tax base that can benefit from the tax break for the year, as well as the portion of incremental investments and employment that exceeds the retained profits of the previous year.

Therefore, a company is guaranteed an annual tax saving, capped at the capacity of the retained profits from previous years starting from 2018, based on its rate of investment and the increase in employment.

The extension of the "hyper-depreciation" mechanism allows for an increase in depreciation rates, up to 170 per cent, for investments in capital goods that fall within the high-technology content category of the Industry 4.0 Plan and for an amortisation rate of 40 per cent for the purchase of software. However, the provisions extending the former call for a restructuring of the incentive with respect to previous legislation (the depreciation rates fall more rapidly as the investment rises, up to a limit of €20 million, beyond which no tax advantage is available). The incentive applies to investments undertaken up to December 2020 where a down payment of at least 20 per cent has been paid by the end of 2019. Conversely, the super-depreciation scheme on all other tangible capital goods has not been extended.

Some general comments can be made on these measures.

a) A **new system of tax incentives based on the size and composition of company capital and on the choice of financing sources** has been established. The abolition of the ACE (allowance for corporate equity) and the introduction of the new preferential rate mechanism (with tax revenue from non-financial corporations estimated to be almost the same at least for the first year) means that for most companies subject to the ordinary corporate income tax system there have been two major changes to the structure of the tax.

   - First, the broad incentive to strengthen companies' capital, which was implicit in the ACE, has been replaced by the new preferential rate scheme, with an incentive for new investment and incremental employment. The link between the preferential tax base and new capital produces a State subsidy for the investment cost and personnel costs in the first year of around 9 per cent (a little less for investments due to the deferral of the benefit in depreciation and amortisation charges). Furthermore, for companies with a preferential rate, combining the two incentives increases the subsidy to 45 per cent from 36 per cent of the cost for Industry 4.0 capital goods, while it can climb to 18.6 from 9.6 per cent for software (for partnerships, the benefit may be higher where the partners pay marginal rates above 24 per cent). Note that the rule generically refers to personnel costs in the financial statements without specifying whether they comprise salaries only or also include social security contributions. In the latter case, an implicit and non-transparent form of taxation could emerge.[42]

- Second, the ACE's goal of ensuring fiscal neutrality[43] in the choice of financing sources has been abandoned and a new advantage for self-financing has been created with potential effects on corporate dividend/profit distribution policies, while maintaining the tax advantage of debt (even if this has been reduced by the limitations on its deductibility introduced in recent years) over new equity capital.

b) There are some **incentives for growth**, but not for all companies.

- The focus has been shifted to a more general reduction of the tax burden, increasing corporate competitiveness at home and abroad, but targeting the incentives at "healthy" companies (profitable, and therefore more mature on average) and expanding (even if only potentially) firms (the increase in capital and labour would be driven by an expansion in production and revenue). In these terms, the preferential treatment of profits could also be significant for newly-established companies likely to grow and generate profits in the short term.

- The potential effectiveness of the new rules depends on the ability of companies to successfully reduce their tax burden. The risk is that companies in temporary difficulty would not have sufficient fiscal leverage to strengthen their situation and that to address this it remains advantageous to increase their exposure to debt (with insufficient or non-existent cash flow, borrowing becomes not only advantageous for tax purposes but also necessary), making them even more vulnerable in a new economic downturn. In fact, it is the companies that suffered the greatest losses in the recent economic crisis that could remain excluded from the benefit.[44]

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42 The provision includes the item for "other charges" (Article 2425, paragraph 1, letter B number 14) of the Civil Code). In this case, in view of the fact that personnel costs largely do not fall under that item, it is not clear which sub-items firms should include.

43 In the design of corporate income tax, financing with debt receives more favourable tax treatment (which increases as the tax rate rises), owing to the deductibility of interest in the calculation of taxable profit, giving it an advantage over equity financing. The ACE, which was introduced in 2011, was intended to make financing decisions neutral, allowing the deduction of a notional interest rate on equity and only taxing the remaining profits.

44 This had already been noted when the super- and hyper-depreciation incentives were introduced, although in that case firms only had to start generating profits again to benefit from the scheme but not in order to take advantage of the benefit.

- In more general terms, the incentive nature of the mechanism is mitigated by the permanent nature of the preferential treatment of investment and new employment.

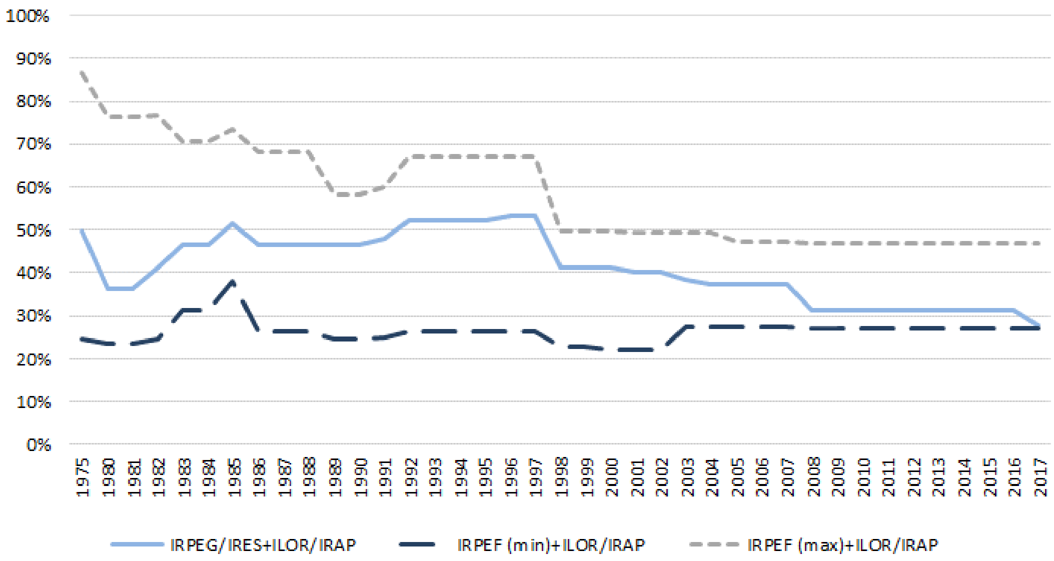
- Finally, the pro-cyclical effects of the automatic variation in implicit tax rates, which fall during expansions, should be taken into account.

c) Sole proprietorships with revenues of more than €100,000 and partnerships would appear to be the most heavily penalised under the new tax rules.

This is a result of the repeal of the voluntary IRI entrepreneurial income tax mechanism (proportional taxation for sole proprietorships and partnerships), only partly offset by the reduction in the tax rate on a portion of the tax base, and the exclusion of these enterprises from the expansion of the *flat rate regime* and from the *substitute tax regime* mechanisms providing for a single-rate tax of 15 per cent or 20 per cent depending on turnover (section 3.1.2).

The IRI mechanism introduced proportional taxation on retained profits for sole proprietorships and partnerships using the ordinary accounting regime. The rate was 24 per cent, in line with the IRES rate levied on corporations. The aim was to remove the existing disparity in tax treatment between partnerships and sole proprietorships on the one hand and corporations on the other. As shown in Figure 3.1, the tax differential between the two legal forms has widened in recent years when considering the maximum IRPEF tax rate. In the 1990s the IRES rate was much closer to the highest IRPEF bracket, but from the start of this century it has been closer to the minimum, with a 19 percentage-point differential compared with the top marginal rate of IRPEF.

Figure 3.1 – Business income tax rates



For enterprises with higher incomes taxed at higher marginal rates, the IRI would have made the taxation system neutral with respect to the choice of legal form.[45] Furthermore, limiting proportional taxation solely to retained profits (continuing to tax distributed profits at progressive rates) would have helped strengthen the capitalisation of small- and medium-sized enterprises, in line with the objective of the ACE.

The new preferential treatment of reinvested earnings provided for in the 2019 Budget Act may be more favourable than the repealed IRI mechanism only for partnerships and sole proprietorships who face marginal rates of less than 24 per cent, or those who would not have gained any advantage in opting for the IRI regime. While corporate retained earnings are taxed, in the event of reinvestment in the company, at a rate of 15 per cent regardless of the level of profit, for these enterprises the tax rate can reach 34 per cent on profits receiving preferential treatment, leaving unchanged the difference of 19 percentage points with the tax rate for corporations. In addition, note that the tax will no longer be neutral even under the IRPEF system, since partnerships whose level of turnover would qualify them for the *flat rate regime* or *substitute tax regime* are ineligible because of their legal form (section 3.1.2).

Preliminary comments on the redistributive effects of the reduced rate on reinvested profits

The PBO’s micro-simulation model (Medita) was used for non-financial corporations[46] to generate an initial estimate of the redistributive effects of the repeal of the ACE and the introduction of the new preferential rate.[47] Note that this is a preliminary analysis of the effects in the first year of application, while an evaluation of the measure over a longer-term perspective awaits further study.[48]

There is a slight tax saving for non-financial corporations (based on the implicit tax rate, there is an estimated reduction of about 0.2 percentage points) from the combined effect of the two measures. In general, both measures produce effects that depend on the ability of companies to actually earn enough taxable income as so to be able to take full advantage of the potential benefits (about 62.5 per cent of the companies fall into this category, with higher than average percentages among medium-sized enterprises), with large enterprises naturally accounting for the lion’s share of the reduction in overall tax revenue.

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[45] As it had already been possible for corporations with the option to adopt the partnership approach.
[46] The analysis does not consider sectors in Ateco categories K and M, which mainly comprise holding companies, whose structural characteristics differ from those of other firms.
[47] For a description of the characteristics of the model, see Gastaldi, Pazienza, Pollastri, (2018) “The 2017 Budget Law and recent changes in corporate taxation”, RomaTre Press.
[48] The simulation is based on a number of assumptions. First, the 2016 financial statements of the population of firms is used, the most recent year available. Consequently, the 2019 rules are applied to the same 2016 population. Second, the repeal of the ACE is simulated on a current legislation basis, taking account of the elimination of super-depreciation of 1.3 per cent on capital goods.

However, the assessment of the change in tax for individual companies is more complex. Excluding the public services sector, these measures can be evaluated both in terms of the size and location of enterprises. The change in the tax – which for the segment examined here corresponds to a reduction of 0.7 per cent in total tax revenue and a decrease about 0.2 percentage points in the implicit rate – is distributed unevenly by company size (Table 3.3).

In general, under the ACE regime, the size of the tax savings and the reduction in the implicit rate (hence the increase in the tax burden with its repeal) is greatest for small and very large companies. By contrast, benefits are greater for medium-large companies under the new system. As a result, very small companies (those with turnover of less than €250,000) are unable to offset the loss caused by the ACE repeal with the new preferential treatment. For companies with turnover of up to €100,000 (around 35 per cent of the total population) taxes rise by an average of 2.2 per cent and their implicit rate by 0.5 percentage points. On the other hand, medium-sized firms receive relatively larger benefits (for companies with turnover of between €2 million and €5 million, taxes decline by 1.6 per cent and the tax rate falls by 0.4 percentage points). The overall advantage remains, albeit declining, as firms' turnover increases.

With regard to company location, the new preferential scheme is particularly favourable on average for companies in the south of Italy, both in terms of tax savings and the reduction in the implicit rate. Respectively, the average advantage comes to 1.6 per cent and 0.4 percentage points net of the effects of the ACE repeal (Table 3.4).

Taking account of differences in companies' capacity to exploit the tax benefits fully and the different business parameters – the change in equity with the ACE, and that in reserves and in capital and labour with the preferential reduced rate – the new system changes the composition of the beneficiaries. On the one hand, 27.7 per cent of the companies that benefitted from the ACE, especially the very small, are not eligible for the new regime, while 33.8 per cent of the companies, mainly larger firms, that did not use the ACE could instead adopt the preferential rate (Table 3.5).

Table 3.3 – The new preferential tax regime: impact on the tax liability of non-financial corporations
(turnover, thousands of euros)

	% change in tax revenue			Percentage point change in implicit tax rate		
	Repeal of ACE	Preferential tax rate	Net impact	Repeal of ACE	Preferential tax rate	Net impact
Up to 100	2.9	-0.7	2.2	0.7	-0.2	0.5
from 100 to 250	3.2	-1.9	1.3	0.7	-0.4	0.3
from 250 to 1000	2.6	-2.9	-0.4	0.6	-0.7	-0.1
from 1,000 to 2,000	2.1	-3.4	-1.3	0.5	-0.8	-0.3
from 2,000 to 5,000	2.0	-3.6	-1.6	0.5	-0.9	-0.4
from 5,000 to 10,000	2.1	-3.3	-1.2	0.5	-0.8	-0.3
from 10,000 to 50,000	2.0	-2.7	-0.7	0.5	-0.6	-0.2
from 50,000 to 250,000	2.5	-3.0	-0.5	0.6	-0.7	-0.1
over 250,000	3.0	-3.3	-0.3	0.7	-0.8	-0.1
Total	**2.4**	**-3.0**	**-0.7**	**0.6**	**-0.7**	**-0.2**

Source: based on simulations performed using the PBO's model (Medita).

Table 3.4 – The new preferential tax regime: impact on the tax liability of non-financial corporations
(by geographical area)

	% change in tax revenue			Percentage point change in implicit tax rate		
	Repeal of ACE	Preferential tax rate	Net impact	Repeal of ACE	Preferential tax rate	Net impact
North	2.5	-2.9	-0.4	0.6	-0.7	-0.1
Centre	2.1	-2.9	-0.8	0.5	-0.7	-0.2
South	2.2	-3.8	-1.6	0.5	-0.9	-0.4
Total	**2.4**	**-3.0**	**-0.7**	**0.6**	**-0.7**	**-0.2**

Source: based on simulations performed using the PBO's model (Medita).

Table 3.5 – Firms exiting the ACE system and entering the preferential rate system
(turnover, thousands of euros)

	Firms no longer receiving preferential treatment	Firms receiving new preferential treatment
Up to 100	58.0	29.7
from 100 to 250	32.9	26.9
from 250 to 1000	20.7	32.5
from 1,000 to 2,000	14.3	37.0
from 2,000 to 5,000	11.5	39.2
from 5,000 to 10,000	9.8	40.9
from 10,000 to 50,000	9.5	42.2
from 50,000 to 250,000	8.5	36.3
over 250,000	7.2	31.2
Total	**27.7**	**33.8**

Source: based on simulations performed using the PBO's model (Medita).

3.1.2 *Tax cut measures for the self-employed and sole proprietors*

The 2019 Budget Act establishes significant changes to the taxation of sole proprietors and the self-employed, extending the current flat-rate scheme reserved for "*dei minimi*" taxpayers to those with turnover of up to €65,000[49] and introducing a 20 per cent flat-rate tax for enterprises with turnover of between €65,000 and €100,000. It effectively removes them from the progressive tax structure of IRPEF. At the same time, the IRI mechanism, which would have given sole proprietors, the self-employed and partnerships a preferential regime for retained income, has been repealed before coming into force.

The extension of the flat rate regime also provides for the removal of a number of important restrictions that previously limited access to sole proprietorships and self-employed with a "minimal" organisation, i.e. personnel costs of less than €5,000 and fixed assets (excluding real estate) of less than €20,000. The anti-avoidance clause that previously denied eligibility for the scheme to individuals with employee compensation and pension income exceeding €30,000 was also amended, limiting the exclusion only to those who have business dealings with employers for whom they were employees in the previous two years. The calculation of presumed costs (with a notional rate of profitability differentiated by sector) and the taxation of the resulting income at a single rate of 15 per cent (5 per cent for new enterprises) remain in place. Local surtaxes on IRPEF and, where applicable, IRAP are not due. In addition, enterprises that participate in the scheme are exempt from VAT obligations and benefit from a 35 per cent discount on social security contributions.

The substitute tax regime, which is also voluntary, sets a single rate of 20 per cent in lieu of ordinary personal income tax to be applied to business or professional income determined using ordinary accounting rules. Also in this case, they are exempt from local surtaxes on IRPEF, IRAP and VAT obligations. However, there is no social security contribution discount.

Before describing the effects of the legislative changes, note that they influence the size of the change in the disposable income of the taxpayers involved to varying degrees, thereby determining whether opting for the voluntary regime is advantageous.

1) The application of the flat rate scheme impacts the level of taxable income. Taxable income is calculated by applying a notional rate of profitability – which is differentiated by sector – to revenues.[50] If the notional profit rate is lower

[49] This regime was previously limited to enterprises with revenues under a ceiling of between €30,000 and €50,000, depending on sector.
[50] The profit ratio is 40 per cent for retail enterprises (54 per cent for street vendors), restaurants and the food industry; 62 per cent for intermediaries in commerce, 78 per cent for the professions and 86 per cent for construction and real estate activities. For other sectors, the coefficient is 67 per cent.

than the effective profit rate, the mechanism will give rise to a reduction in taxable income and therefore lower taxes, and vice versa.

2) Participation in the flat rate regime grants the taxpayer a 35 per cent reduction in social security contribution rates. The savings from social security contributions are partially offset by the reduction in tax deductions, which increases taxable income.

3) With the flat rate regime, income from self-employment is exempt from IRPEF personal income tax and is taxed at a fixed rate of 15 per cent (or at 20 per cent in the substitute tax regime). Any other income will continue to be taxed at the ordinary progressive rates. In the switch from progressive to proportional taxation, the benefit increases as income rises. However, if no other income subject to IRPEF is received, it will not be possible to continue benefitting from other possible deductions or tax credits (for dependents, expenses, etc.). In certain cases, it is possible that the tax reduction resulting from opting out of IRPEF in favour of the flat rate regime will be smaller than the corresponding reduction under the substitute tax regime. In general, the self-employed who participate in substitute tax regime and who also have other sources of income tend to achieve greater tax savings.[51]

Taxpayers who opt for the flat rate and substitute tax regimes do not apply VAT to sales, but cannot deduct VAT paid on purchases of intermediate goods and services. If the self-employed worker (or the sole proprietor) is able to charge a price equal to the price including VAT charged previously, he will increase revenues (as the VAT component is no longer payable), and hence income. The VAT paid on purchases will still represent a tax increase. The balance between these two components forms the gain (or loss) resulting from the exemption from VAT obligations. The simulations carried out using the PBO micro-simulation model, which will be discussed later, take account of this effect, assuming a scenario in which sales to final consumers are concluded at the same price as previously (the percentage increase in revenues equals the VAT rate), while the price on sales to enterprises subject to VAT obligations is equal to the net price previously charged (no increase in revenues).[52] The benefits will be greater for sole proprietors and the self-employed who sell goods and services to purchasers not subject to VAT obligations (consumers and government).

[51] For a given level of income of self-employment, the reduction in tax attributable to leaving the IRPEF system is greater when the taxpayer has other sources of income, as the scale of the benefit corresponds to the taxpayer's marginal IRPEF rate.

[52] The share of sales to final consumers has been estimated by sector on the basis of information drawn from schedule VT of the VAT returns of natural persons in the revenue categories corresponding to the revenue brackets eligible for the flat-rate mechanism. The same source can be used to determine the average sectoral VAT rates on sales to buyers subject and not subject to VAT obligations and on purchases.

Results of the analyses carried out with the PBO micro-simulation model

The analyses conducted using the PBO's micro-simulation model[53] allow the identification of the pool of taxpayers eligible in accordance with the qualifying criteria set out in the new legislation and to select, on the basis of the overall impact on taxes and contributions, those who benefit from participating.[54]

The analyses found that the €100,000 revenue ceiling excludes about 20 per cent of the total number of self-employed persons and sole proprietors as potential participants in the new schemes. Of the remaining 80 per cent of taxpayers under the €100,000 ceiling, about 19 per cent already participate in the previous "*dei minimi*" mechanism, while the expansion of the flat rate system would include roughly 17 per cent of the total number of self-employed and sole proprietors and the substitute tax option in lieu of IRPEF would be applicable to around 8 per cent of the pool of eligible beneficiaries (Figure 3.2). The remaining 36 per cent of sole proprietors and self-employed would not participate in the new mechanisms either because they do not meet all the eligibility criteria, or because they are unprofitable or because they would not benefit from participating in the new regime. Overall, the share of these taxpayers subject to single-rate taxation would be 44 per cent. Similarly, the new regime increases the share of income excluded from the progressive IRPEF regime to around 43 per cent from the current 7 per cent (the share of income that is subject to the new substitute tax is 18 per cent).

Table 3.6 shows the results of the simulation of the impacts of the changes introduced with the new legislation, highlighting the distribution of the benefit by preferential regime (extension of flat rate and substitute tax) and by taxpayer category (self-employed and sole proprietors).

[53] The model can be used to assess the impact of alternative policies with regard to personal income tax and the main monetary transfers. The model simulates the impact of the tax system on the public finances and on the income distribution for a representative sample of the Italian population obtained on the basis of the Survey on Income and Living Conditions conducted by Istat, with the addition of administrative information on actual tax bases and on transfers. The model can currently be used to conduct static simulations, but development is under way on modules to analyse the behavioural response of agents to changes in the legislative framework. The analyses presented here do not take account of the impact with regard to IRAP owing to the lack of sufficient information.

[54] The simulation enabled the joint calculation, for each taxpayer in the representative sample, of the effects described above (transition from IRPEF to the new flat-tax regimes, reduction in social security contributions, VAT effects). In line with the criterion set out in the technical report accompanying the measures, participation in the substitute tax regime was influenced by the consequent change in disposable income. It is assumed that all taxpayers benefitting from the new system and those losing up to €1,000 but benefitting from simplified accounting will participate in the mechanism.

Figure 3.2 – Distribution of sole proprietors and the self-employed by tax regime

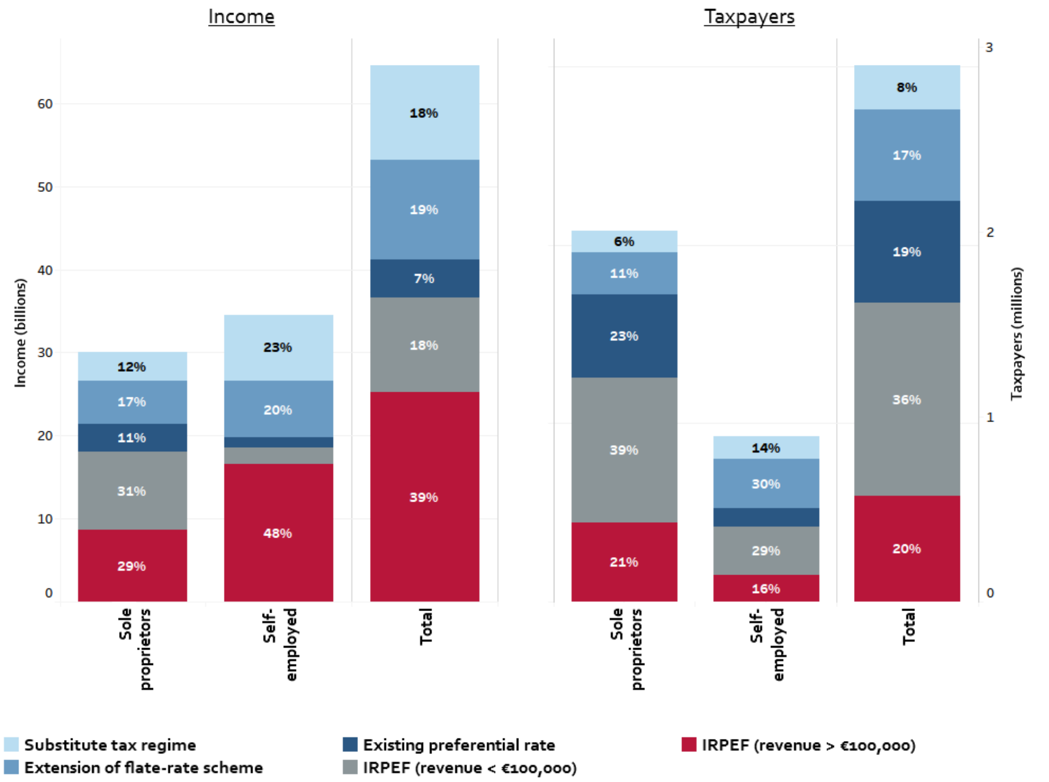

Table 3.6 – Average impact by regime and type of taxpayer
(euros and percentages)

		Extension of flat-rate regime	Substitute tax regime	Average of two regimes
Total	**Average benefit**	**5,095**	**5,684**	**5,298**
	Benefit as proportion of income (1) of which:	**18.1%**	**15.2%**	**16.9%**
	VAT benefit	*4.5%*	*5.6%*	*5.0%*
	Social security	*7.1%*	*0.0%*	*4.2%*
	IRPEF savings	*17.8%*	*29.3%*	*22.5%*
	Substitute tax	*-11.2%*	*-19.7%*	*-14.7%*
Self-employed	**Average benefit**	**5,621**	**7,237**	**6,203**
	Benefit as proportion of income (1) of which:	**17.2%**	**15.4%**	**16.4%**
	VAT benefit	*3.1%*	*4.5%*	*3.7%*
	Social security	*6.4%*	*0.0%*	*3.5%*
	IRPEF savings	*17.6%*	*31.0%*	*23.6%*
	Substitute tax	*-9.9%*	*-20.1%*	*-14.5%*
Sole proprietors	**Average benefit**	**4,527**	**3,743**	**4,271**
	Benefit as proportion of income (1) of which:	**19.6%**	**14.8%**	**18.0%**
	VAT benefit	*6.6%*	*8.4%*	*7.2%*
	Social security	*8.2%*	*0.0%*	*5.3%*
	IRPEF savings	*18.1%*	*25.3%*	*20.6%*
	Substitute tax	*-13.2%*	*-18.9%*	*-15.2%*

(1) Total pre-reform taxable income, including income under new regimes and other income.

Overall, the measures generate an overall average benefit for the participating taxpayers of approximately €5,300, equal to about 16.9 per cent of their income.[55] About half of this derives from switching to substitute tax regime from IRPEF, 5 percentage points are due to the VAT exemption and the remaining 4.2 percentage points to the social security contribution relief.

The average benefit in monetary terms is slightly larger for taxpayers participating in the substitute tax regime (around €5,700 compared with about €5,100 for those in the flat rate system). The former have a greater advantage in terms of income tax (a benefit of about 9.6 percentage points of income) but do not benefit from the social security contribution relief.

The reform is more beneficial to the self-employed[56] than sole proprietors[57] (by an average of about €2,000). The difference between the two categories is wider under the substitute tax regime, where the monetary benefit for the self-employed is about double that for sole proprietors. The main reason is that for broadly equal revenues (between €65,000 and €100,000), sole proprietors tend to have higher production costs and, therefore, lower income than the self-employed. The latter, therefore, enjoy greater savings from the repeal of the progressive income tax regime (31 points of income tax savings against 25.3 points for sole proprietors).

For the same reason, the tax savings generated by the VAT exemption, which are linked to sales volume, are greater for sole proprietorships as a proportion of income (an 8.4 percentage point benefit compared with 4.5 points for the self-employed). The advantage for the latter also holds, albeit on a smaller scale, for those participating in the flat rate regime (those with revenue of up to €65,000). In this case, the self-employed have smaller tax savings from contribution relief (as they pay lower contribution rates). Note that, in this case, the effective substitute tax rate is lower than the "nominal" 15 per cent rate because the application of below-average profitability ratios generates further tax savings (which are larger for professionals).

The distribution of total monetary gains between sole proprietors and the self-employed is detailed in Figure 3.3. The red dot indicates the average gain, the top horizontal line marks the 75th percentile (25 per cent of the taxpayers involved have a larger gain than this value) and the bottom line indicates the 25th percentile (25 per cent of the taxpayers have a smaller gain).

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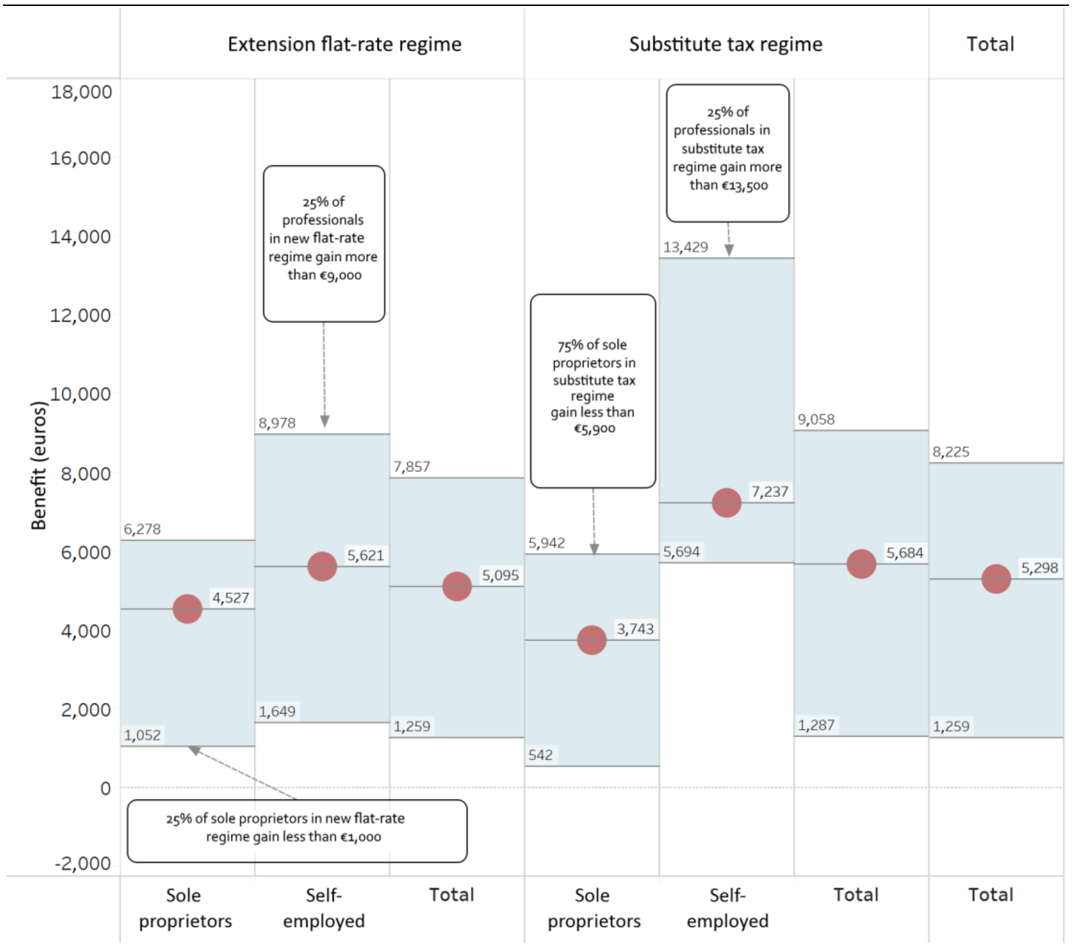
[55] This refers to taxable income subject to IRPEF on an unchanged legislation basis. It also include any compensation of employment, rent on real estate and other categories.
[56] Taxpayers involved in the arts and professions; sole proprietors mainly include artisans and small retailers.
[57] With a higher average income for the self-employed, the greater benefit translates into a lower incidence on income.

Figure 3.3 – Distribution of benefits by regime and type of taxpayer *(euros)*

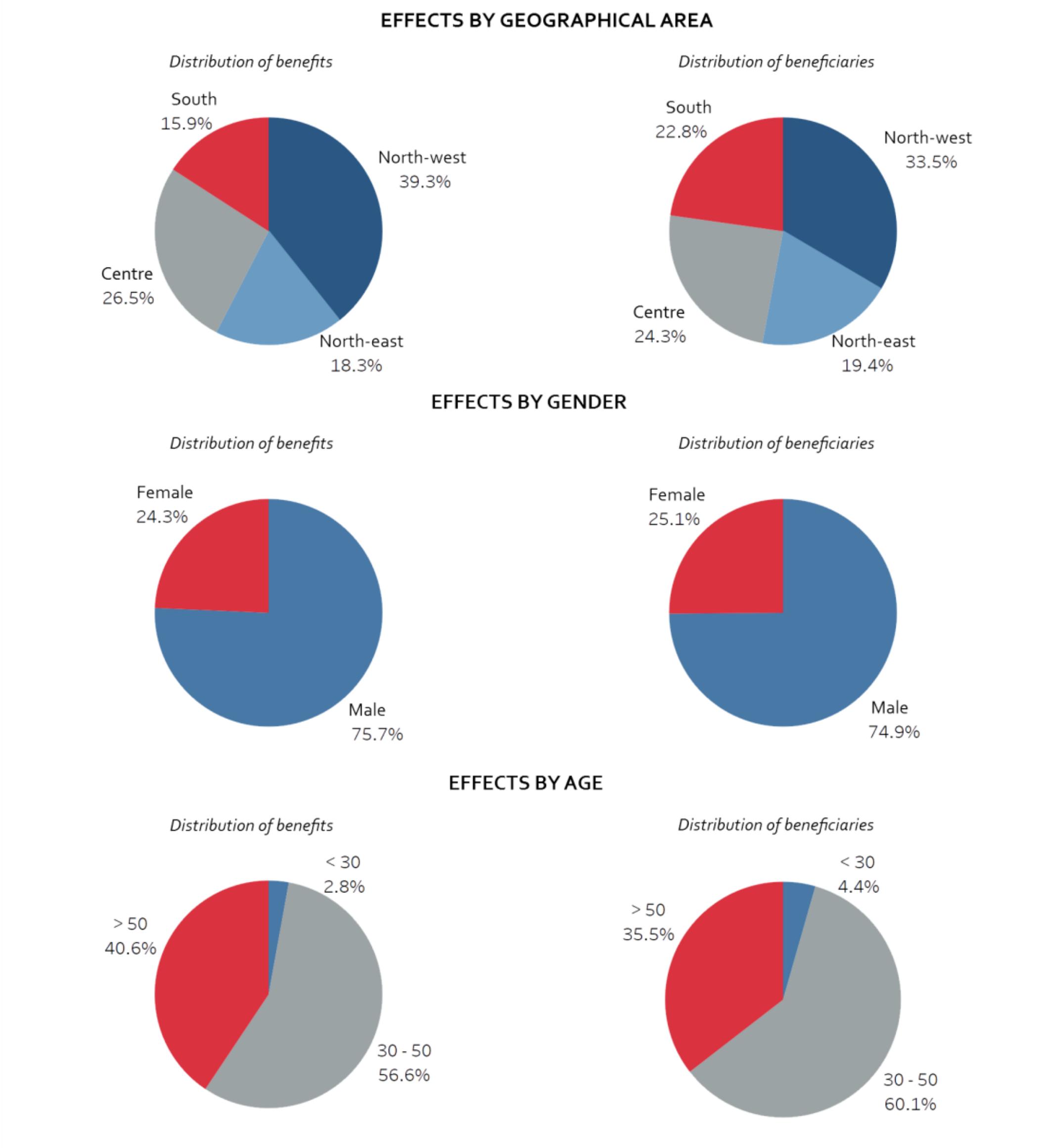


Benefits can differ considerably. For an appreciable number of taxpayers the gain is small: a quarter of those participating in the flat rate regime gain less than €1,300 (less than €1,000 for sole proprietors), while 25 per cent of the self-employed gain more than €9,000. For the substitute tax regime, as noted above, the differences between the two categories are more marked: 75 per cent of sole proprietors gain less than €5,900, while 75 per cent of the self-employed gain more than €5,700. There are some particularly large gains among the self-employed under the substitute tax regime regime, with a quarter gaining more than €13,500.

Figure 3.4 offers an analysis of how benefits are distributed by geographical location, gender and age. With regard to location, more than half of the benefitting taxpayers are in Northern Italy (52.9 per cent versus 24.3 per cent in the Centre and 22.8 per cent in the South) and secure 57.6 per cent of the entire benefit in tax terms (compared with 26.5 per cent in the Centre and 15.9 per cent in the South). Savings are larger in the North-west of the country than in the North-east (respectively 39.3 per cent of the benefit versus 18.3 per cent) due to the larger number of self-employed compared with sole proprietors.

Three out of four beneficiaries are males, who receive essentially an equivalent share of the resources distributed. Finally, few of the benefits go to self-employed workers who are less than 30 years old, who account for less than 5 per cent of total beneficiaries and less than 3 per cent of the total benefit.[58]

Figure 3.4 – Distribution of benefits by geographical area, gender and age
(euros)



[58] It was not possible to assess differences in the impact of the preferential reduced rate for start-ups among the various age classes.

Considerations on efficiency and equity

As discussed above, the new rules involve a major restructuring of taxation for the self-employed and sole proprietors, with a significant impact on efficiency (in terms of incentives to work and to expand the size of a business) and on the overall vertical and horizontal equity of the system.

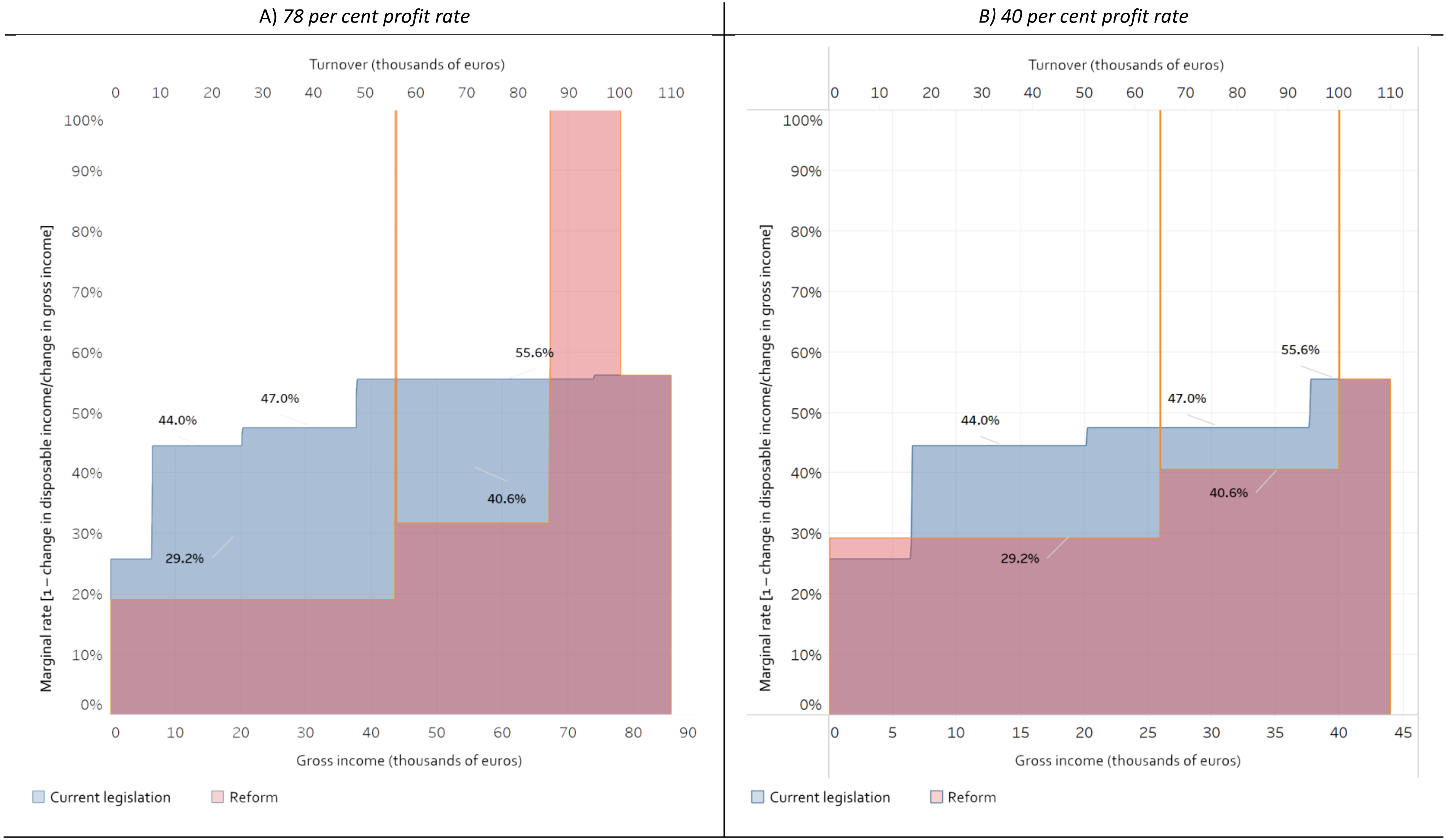
Although it has a positive effect on disposable income, the application of a single tax rate in place of progressive taxation significantly reduces the disincentive to work by lowering the overall marginal rate (social security contribution and tax). Figure 3.5 shows the evolution of the overall marginal rate with respect to the change in gross income at different levels of profitability. In particular, the figure considers the notional profit rates for professionals and small retailers of 78 per cent and 40 per cent respectively.[59] Marginal rates are shown on the vertical axis with respect to gross income (horizontal axis at the bottom) and the corresponding revenue (horizontal axis at the top).

The reduction in marginal rates is very significant for high earners (Figure 3.5a): the marginal rate differential is around 14.8 percentage points up to revenues of about €26,000 (around €20,000 in gross income and €15,000 in taxable income), rising to 17.8 percentage points for revenues of up to about €49,000 and reaching 26.4 points with revenues up to €65,000 (corresponding to a gross income of about €50,000 and a taxable income of around €37,500). When revenues reach the level – between €65,000 and €100,000 – at which the new 20 per cent substitute tax is levied, the difference is smaller, at 15 percentage points, in part because the contribution relief does not apply. The ordinary IRPEF system applies when revenues exceed €100,000, which corresponds to a taxable income of approximately €58,000 (78 per cent profitability).

For low earners (Figure 3.5b), the reduction in marginal rates is smaller as the revenue limits to be eligible for the new schemes kick in at a lower level of taxable income. The reduction in the marginal rate for taxpayers with low profitability is 14.8 percentage points with revenues up to €50,000, while it drops to 6.4 percentage points when applying the substitute tax regime. Applying the ordinary income tax regime eliminates the marginal rate difference when revenues exceed €100,000, which corresponds to a taxable income of about €30,000.

[59] It is assumed that effective profitability is equal to presumed profitability.

Figure 3.5 – Overall marginal rates



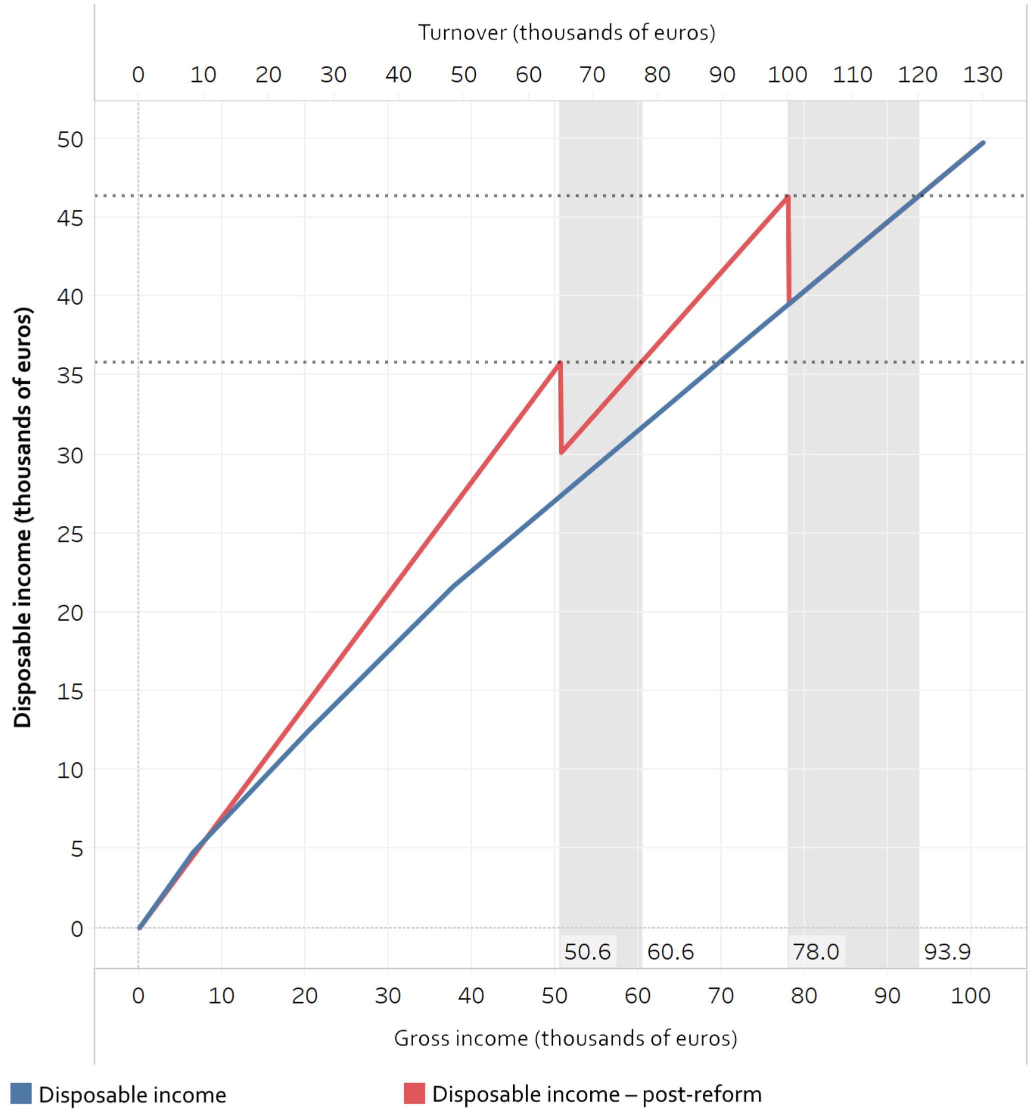
However, a so-called poverty trap (when the marginal rate exceeds 100 per cent) emerges in the switch from the flat rate system to the substitute tax regime (when revenues top €65,000) because the schemes are designed around taxation at a single rate for income classes rather than by progressive tax brackets. If an increase in revenue causes the taxpayer to exceed the ceiling for the flat rate scheme, the five percentage point increase applies to the entire amount, not just the amount over that threshold as is the case with a progressive tax regime (Figure 3.6). With a profit margin of 78 per cent, an increase of one euro in revenues over the threshold of €65,000 causes a loss of around €5,700 of disposable income[60] as a result of the increase in the tax rate and the loss of the contribution relief. With costs unchanged, it would take about €10,000 in extra income to recoup that decline. Tax rates also increase when revenues top the €100,000 threshold and ordinary progressive taxation resumes. In this case, exceeding the threshold implies an increase of about €6,800 in tax. Thus, at the thresholds, a strong disincentive to increase revenues emerges, which can also encourage tax evasion. Bear in mind that the VAT exemption can also impact the level of tax compliance: it removes the conflict of interest with the seller of intermediate goods and services, and compliance tools are weakened by the simplification of accounting obligations related to the VAT system and the lack of a requirement to use electronic invoicing.

It is worth noting that the flat rate regime impacts decisions about factors of production. Under the ordinary regime the effective cost of purchasing the means of production (goods or services) is lowered by the reduction in taxes associated with the increase in costs: cost is equal to the purchase price, net of VAT, discounted at the overall marginal tax rate. For example, the purchase of a capital good at the net price of €1,000 would imply an effective cost of €530. On the other hand, the cost for the purchase of the same asset would be €1,220 under the flat rate regime as the tax rate is determined by a predetermined "profitability ratio" and VAT deductions on purchases are not allowed.

A tax that is essentially determined by the amount of revenues and not by the income actually generated, as in the case of the flat rate regime, means it is not neutral with respect to the allocation of factors of production. The marginal cost of factors of production is greater and essentially, at equal income, those with higher production costs are penalised more heavily. In addition, the existence of two rates – a higher rate for taxpayers with revenues above a given threshold – ends up putting businesses with lower profitability at a disadvantage, as is evident from the distributive effects, which is far less favourable for sole proprietors than the self-employed.

[60] Social security contribution rate of 25.72 per cent.

Figure 3.6 – Poverty traps



Finally, it is worth noting that, unlike the previous flat rate scheme, which was reserved for very small enterprises with the goal of simplifying paperwork, the reform introduced with 2019 Budget Act applies to a large portion of self-employment. Around 80 per cent of the self-employed and sole proprietors fall within the €100,000 revenue threshold. These rules set up a special system of taxation for specific types of taxpayers (sole proprietors and the self-employed) that exists in parallel with the progressive personal taxation to which employees, pensioners and other taxpayers not eligible for the preferential system remain subject. Taxpayers with the same ability to pay can face large and increasing differentials in their tax burdens as income rises (for example, an employee with €40,000 of income pays about €5,000 more in income tax than a self-employed person in the flat rate regime; the gap widens to about €11,500 for a taxable income of €80,000). The coexistence of these two schemes appears difficult to justify on the basis of horizontal tax equity. Moreover, in the ordinary IRPEF regime, the qualitative discrimination between income from payroll employment and self-employment works in the opposite direction, granting larger tax credits for employees, who do not deduct the costs of producing income.

The financial impact on the public accounts

According to official assessments, the extension of the flat rate system would, when fully operational, result in a cost to the public finances of about €1.4 billion (of which €0.3 billion from the impact on social security contributions and €0.4 billion from the VAT reduction) and the introduction of substitute tax regime one of around €0.9 billion (of which €0.2 billion from lower VAT).

The analysis conducted using the PBO's micro-simulation model estimates a total cost[61] of between €2.2 billion and €3.3 billion with a confidence interval of 95 per cent, putting the official figure slightly above the lower end of the PBO estimation interval. Estimating the financial effects of a voluntary regime is a complex matter, because, among other things, it is conditional on the actual take-up of the measure, which is difficult to quantify in advance. Moreover, the estimate is made uncertain by the fact that the advantages of the new regime could encourage taxpayers with revenues above the thresholds to scale back their economic activity in order to qualify for the new system or to reduce their fiscal compliance.

It is precisely because of these considerations that it would be advisable to carry out an *ex post* assessment of the measure to enable detailed monitoring of costs and identify possible occurrences of opportunistic behaviour (the clustering of taxpayers around the thresholds).

[61] With regard to the costs concerning mandatory contributions, the assessment does not differ from the official valuation, given the limited amount of information currently available to us on the contribution mechanisms that apply to the taxpayers affected by the reform and the possibility that those taxpayers might decide to participate in the optional regime and not take advantage of the contribution relief in order to have a higher pension in the future.

3.2 Measures to fight tax evasion and concerning tax amnesties

Among the measures to cover expenditure referred to in the technical report of the Budget Act, €1.1 billion in 2019, €2.8 billion in 2020 and €3.3 billion in 2021 are expected to be generated by measures to combat tax evasion and one-off measures facilitating the settlement of tax litigation introduced with Decree Law 119/2018 and ratified with Law 136/2018.

The former include the extension until 30 June 2022 of the reverse-charge mechanism for VAT purposes for certain specific transactions,[62] in line with developments in European legislation in this area, and the introduction of an obligation for the digital registration and transmission of data on proceeds of the sale of goods and services, which vendors can currently adopt on optional basis in exchange for a series of administrative benefits and simplifications. The obligation will commence from 1 July 2019 for retail businesses with a turnover of more than €400,000 and will then be extended to all retailers from 1 January 2020. The extra revenue that the latter measure is expected to generate amounts to €0.3 billion in 2019, €1.3 billion in 2020 and €1.8 billion in 2021. A tax credit is also envisaged for costs incurred in the purchase, replacement and upgrading of the equipment necessary for the registration and transmission of transaction data (with a net cost of €36 million in 2019 and €178 million in 2020).[63]

The requirement to digitally register and transmit receipt data is intended to counter VAT evasion by focusing attention on the final stage of the retail transaction chain (final consumers), seeking to reduce evasion connected with failure to submit VAT returns. The measure accompanies other tools such as the quarterly VAT reports, periodic VAT settlements and electronic invoicing that had previously been limited to business-to-business transactions. All of these tools, which increase the supply and timeliness of information, will help increase tax authorities' capacity for analysis and preventive control, improve the relationship between tax authorities and taxpayers and increase voluntary compliance. In addition, they will also lend further impetus to the digitisation of the country, reducing costs and enhancing the efficiency of business processes.

A degree of uncertainty remains, however, concerning the possibility that the digital registration and transmission of transaction information will encourage VAT payers to more actively seek out opportunities for consensual tax evasion (i.e. an agreement to evade between buyer and seller), rather than reducing evasion in sales to final consumers. Cost surfacing through mandatory electronic invoicing could determine a loss of revenue that, however, could be countered with appropriate controls of the stability and credibility of firms' margins.

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[62] Without the extension, it would have only been possible to apply the mechanism until the end of 2018.
[63] In 2019 and 2020 the tax credit will be equal to 50 per cent of the costs incurred, with a maximum of €250 in the case of purchases and €50 for upgrades.

The introduction of a receipt lottery, previously provided for in the 2017 Budget Act and never implemented, does not seem sufficient to create a conflict of interest to counter consensual evasion in the final stage of the chain of transactions. As emphasised on other occasions, a significant contribution could come from the introduction of appropriate limits in the use of cash (i.e. making current restrictions more stringent).

The second group of measures include the facilitated settlement of violations reported in audit findings, assessment notices and pending tax disputes as well as the facilitated settlement of tax arrears sent for collection and the discharge of prior-year liabilities of less than €1,000 sent to collection agents between 1 January 2000 and 31 December 2010. The common feature of these tax amnesty measures is that they provide for the settlement of disputes with payment of the tax due free of penalties and interest over a long time frame (5 years). Official estimates put the extra revenue at €0.1 billion in 2019, €1.2 billion in 2020 and €1.5 billion in 2021.

Both the facilitated settlement of pending litigation and that for tax arrears sent for collection have advantages over previous versions of these mechanisms.

In the former case, in addition to providing for longer payment times, account is taken of intermediate outcomes of disputes and the presence of at least one ruling in favour of the taxpayer by a judge in determining the percentage reduction of the amount due.

In the second case, payments can be made in instalments over a longer period (5 years compared with a maximum of 3 years in the previous versions) with lower interest rates (2 per cent instead of 4.5 per cent) and can be offset by valid, certain, liquid and enforceable receivables for supplies, tenders and services, including professional services, in respect of government entities. Finally, for the first time, the measure permits the facilitated settlement of Community tax liabilities (duties, VAT on imports, etc.). In this case, however, the part of the interest that represents Community revenue that individual States may not waive is due, and no offsetting is allowed.

During the parliamentary process of ratifying the decree into law, among other things, the number of possible instalments was raised from 10 to 18 and it was established that they will not be of equal size. More specifically, 10 per cent of the total amount due must be paid with the first and second instalments, while the remaining 80 per cent can then be divided into 16 equal instalments due at the end of February, May, July and November of each year starting from 2020. In addition, the penalties for delayed payments have been mitigated: payments made within 5 days of the instalment due date do not void the facilitated settlement agreement and no interest is due.

The new version of the facilitated settlement of tax arrears sent for collection is accompanied by the discharge of debts up to €1,000 sent to collection agents from 2000 to 2010. These amounts would be difficult to recover in any event, as they regard deceased, bankrupt or destitute debtors. Their cancellation will make it possible to discontinue collection activities whose cost is no longer justifiable and to clean up the accounts, making the value of the accumulated stock of debt more realistic. The inclusion of debts to municipal governments makes it necessary to consider the impact of this measure on the accounts of these entities.

The repeated introduction of various forms of facilitated settlement rewards less-deserving taxpayers and weakens the sense of tax compliance of taxpayers, and compromises future revenues.

During the ratification of the decree into law, the full amnesty originally envisaged in Decree Law 119/2018, whose revenue effects were prudentially not estimated, was eliminated. It was replaced with a mechanism for regularising past formal irregularities, violations, non-compliance of other obligations that have no impact on the determination of taxable income for the purposes of income tax, VAT, IRAP and other taxes with the payment of €200 for each tax period in which they occurred (to be paid in two instalments: 31 May 2019 and 2 March 2020). This measure is expected to generate extra revenue of €0.7 billion in 2019 and €0.4 billion in 2020, and reduce revenue by €0.1 billion in 2021.

The original amnesty eliminated with the amendment allowed taxpayers to file a special supplemental tax return to report undeclared taxable income up to 31 October 2017, with an overall limit of €100,000 per tax period and in any case no more than 30 per cent of the declared amount. More specifically, the extra taxable income would be subject, for each tax year, to a 20 per cent tax in lieu of income tax and related surtaxes, withholding taxes, IRAP and social security contributions, and to a VAT calculated at the average rate (i.e. the ratio of VAT on taxable transactions to declared turnover) or, if this is not possible to calculate, at the ordinary rate. The amount could be paid in 10 semi-annual instalments (5 years) without penalties, interest or other ancillary charges.

3.3 Measures for public employees

The 2019 Budget Act proposes a series of measures in the area of public employment, some of which follow the path traced by the provisions of the previous year's budget package. In the majority of cases, the measures authorise new hiring, including as exceptions to the staff turnover restrictions envisaged under current legislation (drawing from a special fund refinanced by the Budget Act) or by raising authorised staffing levels, in order to address the shortfalls generated by the expenditure containment measures implemented since 2009 or, in certain cases, to meet extraordinary needs. Other measures authorise the hiring of staff for government entities that were reformed or created by the Budget Act or other recent measures, and provisions also regard national and decentralised bargaining in various sectors of public employment.

Public employment figures published by Istat (October 2018) indicate that in 2017 full-time-equivalent labour units (FTE) had decreased by 6.6 per cent compared with 2009 (-234,000 units), expenditure on compensation of employees fell by almost €7.5 billion in nominal terms and that in real terms by more than €26 billion.[64] The data in the annual accounts of the Department of the State Accountant General (Table 3.7), which are measured using different criteria and are not yet available for 2017, confirm that this trend has involved almost all bargaining sectors, albeit to different extents: non-economic public bodies (including social security institutions) have seen their personnel shrink by about 25 per cent between 2009 and 2016. Ordinary statute regions (OSRs) and local governments have also experienced a substantial contraction (-15.8 per cent), as has the aggregate composed of ministries, tax agencies and the Presidency of the Council of Ministers (-14.1 per cent).

The measures with the greatest impact include the expansion of the fund for the hiring of permanent staff, in addition to hiring authority under current legislation but in compliance with existing authorised staffing levels (paragraph 298). Established with the 2017 Budget Act with an appropriation of about €45 million a year, the fund has been refinanced in the amount of €130.7 million in 2019, €328.4 million in 2020 and €433.9 million from 2021.

[64] Adjusting for inflation measured using the harmonised consumer price index (base year 2015).

Table 3.7 – Personnel of government departments at 31 December each year by bargaining sector
(number of personnel)

	Personnel at 31 December each year from the annual accounts								
	2009	2010	2011	2012	2013	2014	2015	2016	% change 2009-2016
Schools, universities, research entities & art academies	1,224,963	1,188,737	1,160,199	1,155,052	1,168,284	1,178,232	1,221,512	1,239,936	1.2
National health service	734,137	728,900	717,628	705,559	702,510	698,023	690,882	690,024	-6.0
Police, armed forces and firefighters	560,939	553,870	553,628	542,236	537,080	536,573	528,203	522,287	-6.9
Regions and other local entities	578,308	569,299	551,289	535,946	527,334	521,739	502,654	486,764	-15.8
Ministries, tax agencies and Presidency Council of Ministers	238,768	232,439	226,187	220,582	218,226	214,114	207,973	205,061	-14.1
Public non-economic entities	56,975	55,361	52,433	51,312	48,985	46,617	43,724	42,795	-24.9
Courts, diplomatic corps, prefects and correctional institutions	13,276	12,939	12,808	12,916	12,968	13,102	12,719	12,791	-3.7
Subtotal	**3,407,367**	**3,341,545**	**3,274,172**	**3,223,603**	**3,215,386**	**3,208,400**	**3,207,667**	**3,199,658**	**-6.1**
Special statute regions and autonomous provinces (1)	84,343	84,924	106,982	105,688	105,689	105,795	103,046	102,637	21.7
Entities referred to in Art. 60 para. 3 and 70 para. 4, independent authorities and other entities on S13 list (2)	11,516	11,434	14,218	14,588	14,725	52,188	52,258	54,396	372.4
Overall total	**3,503,225**	**3,437,902**	**3,395,372**	**3,343,879**	**3,335,800**	**3,366,383**	**3,362,971**	**3,356,691**	**-4.2**

Source: Annual accounts of the Department of the State Accountant General and 2019 Budget Act.
(1) The positive (and anomalous) value of the rate of change in this aggregate in 2009-2016 is attributable to the inclusion of the personnel of the Region of Sicily in the survey (about 20,000 employees) in 2011. The rate of change in 2011-2015 was -4.1 per cent. – (2) The positive (and anomalous) value of the rate of change in this aggregate in 2009-2016 is attributable to the inclusion of the personnel of other entities on the Istat S13 list (nearly 38,000 employees) in 2014. The rate of change in 2014-2016 was +4.2 per cent.

At the same time, the Budget Act authorises the use of these resources for hiring personnel at various State entities that, as required by the provisions establishing the fund, have staff shortages. Overall, the measures will enable the hiring of around 10,000 personnel in the three-year period (mostly non-management staff), many of whom in the Ministries sector: more than 3,000 at the Ministry of Justice, over 1,000 at the Ministry for the Cultural Heritage and Activities and at the National Labour Inspectorate, 775 at the Ministry of the Interior, 420 at the Ministry of the Environment, 300 at the Ministry of Foreign Affairs, about 100 at the Ministry of Economic Development and 50 at the Ministry of Infrastructure and Transport. In addition, paragraph 301 reserves part of the fund resources (about €33 million in 2019, over €95 million when fully implemented) for additional hiring at the Court of Auditors, the Department of Prison Administration of the Ministry of Justice, the Ministry of Labour, the Ministry of Education, Universities and Research, the Agency for Digital Italy (AGID), the Presidency of the Council of Ministers and the National Social Security Institute (INPS).

The amounts provided in the technical report indicate that – after the amendments introduced during parliamentary consideration of the bill – these hirings will absorb almost the entire amount refinanced each year.

From a procedural point of view, the law establishes that the hirings financed with fund resources shall be authorised by a decree of the Minister for Public Administration (in agreement with the Minister for the Economy and Finance), "taking account of specific requests intended to meet especially important and urgent service requirements in relation to actual needs, within the limits of the staffing shortfall". The Budget Act adds that such hirings shall be made using unified public competitive selection procedures (regardless of the entity to which the personnel will be assigned) managed by the Department of Public Administration as part of the Government Entity Renewal Project (RIPAM), without prejudice to specific requirements connected with the recruitment of personnel with highly specific skills or in certain specific careers. Paragraph 362 addresses the practice of repeated extensions of the validity of rankings of selections' winners, establishing that only the most recent (approved from 2014 onwards) can be used for the direct recruitment of suitable staff. Those approved before 2010 shall lapse, while the candidates included in the lists published between 2010 and 2013 are required to attend training and refresher courses (organised by the entities concerned) and pass an exam-interview.

Another public employment measure concerns the completion of the five-year plan to eliminate shortages of law enforcement personnel, initiated with the 2018 Budget Act. The resources appropriated in the Budget Act total about €350 million over the three years and to a little more than €360 million a year once fully implemented (partly recouped by cutting other expenditure items). The funds will be used to hire almost 6,500 personnel divided between the Police, the Carabinieri, the Finance Police and the Corrections Police. In addition, the budget authorises the extraordinary recruitment of 1,500 firefighters in the next two years, with a cost of around €20 million in 2019 and almost €65 million once fully implemented. As from the end of the three-year period, the staffing levels of the Coast Guard will also be increased, with additional expenditure of €4 million in 2021 and almost €24 million once fully implemented. With regard to other measures concerning personnel in the defence and security sector, a fund (with €100 million in annual financing from 2020) has been established to meet the costs arising from the reorganisation of the careers of police and armed forces personnel pursuant to Decree Law 113/2018 (the "Security Decree").

With regard to schools and universities, starting in 2019 resources have been allocated for the expansion of full-time attendance at primary school (€23 million in 2019 and about €77 million from 2021), corresponding to about 2,000 additional jobs (paragraph 729). Other provisions increase – by 400 and 290 positions respectively – the staff of secondary-school music academies (with spending of almost €5 million in the first year and about €22 million at full implementation) and expand the authorisation to recruit educational staff in state educational institutions (about €10 million per year at full implementation). Another fairly important measure concerns the recruitment of janitorial staff. Paragraph 760 establishes that, as from 2020, the cleaning of schools shall be carried out exclusively by janitorial employees of the schools themselves. Accordingly, funding is provided to hire the permanent employees of companies holding contracts for the provision of cleaning services. The technical report estimates that some 11,850 staff will be hired, with a gross cost of €280 million annually (offset by the reduction in spending on the purchase of goods and services and by the tax and contribution revenues originated by the measure itself).

An additional €20 million in 2019 (becoming close to €60 million from the following year) have been allocated to the fund for the ordinary financing of public universities to support the extraordinary plan to recruit university researchers, providing resources for the recruitment of 1,000 senior researchers. At the same time, the "*Fondo per le cattedre universitarie del merito Giulio Natta*" for the recruitment of prominent academics has been defunded, generating savings of €22 million in 2019 and €70 million from the following year, given that three years after the fund's creation (2016 Stability Act) no action to recruit staff had yet been taken. Other funds (about €6.7 million per year once fully implemented) have been appropriated for the staffing needs of the experimental Scuola Superiore Meridionale to be established at the University of Naples Federico II, based on the model of the Scuola Superiore Normale of Pisa.

Among the measures for healthcare spending, the authorised staffing level of the Ministry of Health has been increased and, at the same time, the hiring (including in derogation from the ceilings on the ministry's hiring authority under existing legislation) of about 108 non-management staff and 210 second-level managers has been authorised (of whom 155 will be recruited by giving permanent contracts to staff already appointed for similar tasks). The cost will be borne in part by drawing on the fund referred to earlier and in part by cuts to other expenditure items. Furthermore, the number of specialist training contracts for physicians[65] has been raised (by about 900 per year), for a total cost of almost €23 million in 2019 and €100 million per year starting from 2023.

As discussed in section 3.7, the Budget Act establishes an Office for the planning of public assets and buildings (in place of the Centre for public works planning initially envisaged in the Budget Bill), with a maximum of 300 employees, "most of whom shall have technical qualifications" (of whom 120 will be temporarily assigned to the unified provincial contracting entities). They will be recruited using specific public selection procedures and their duties involve assisting the government entities requesting their help in the various phases leading to the construction of public works. To accelerate the start-up phase of the office's activities, it will initially be able to recruit 50 staff already on the government payroll. The office will be financed with a transfer to the State Property Agency of €25 million in 2019, €60 million in 2020 and €80 million from 2021 (only part of which will go towards covering staff costs). Moreover, in order to provide greater administrative support for carrying out public investments, for the regions that

[65] The Budget Act provides for an increase of about €10 million as from 2019 of the annual amount of the National Healthcare Fund earmarked to fund scholarships for the training of general practitioners ("family doctors") with a view to reducing the shortage of such physicians in the National Health Service; see section 3.5.

implement measures to strengthen the planning and implementation of investments, the Budget Act allows the hiring on fixed-term contracts in the next three years of 50 non-management technical staff, with skills related to the procedures governed by the Public Contracts Code. These hirings – which exceed the ordinary recruitment authorisations of the entities – must nevertheless be financed from resources already available under current legislation.

Among the measures affecting hiring by local governments, the Budget Act provides for the hiring, as from 2019, of a total of 4,000 staff to be assigned to job centres (with an increase in their authorised staffing levels) to implement the regions' responsibilities in the field of active labour policies following the introduction of the Citizenship Income (see section 3.4). The budgeted cost of the measure will be about €120 million in 2019 and €160 million from 2020, to be funded with resources from the general fund for the implementation of the citizenship income. In addition, paragraph 272 allows ANPAL (the national agency for active labour policies) and the competent local authorities to commute into permanent positions the contracts of personnel responsible for providing employment services also in those cases where giving them permanent contracts would cause the authorities to exceed their hiring limits.

The budget package also contains measures regarding the recruitment of personnel in the ordinary justice system (granting authorisation to hire judges in 2019 to be selected from among the winners of competitive exams that have already been held and, from 2020 to 2022, authorisation to hold competitive exams for 200 positions per year) and in the administrative justice system (20 judges for the Regional Administrative Courts, 12 councillors of state and 26 non-management personnel) in excess of ordinary recruitment authority. The aim of the measure is to accelerate legal proceedings. The personnel of the Court of Auditors, responsible for monitoring the public accounts, has also been increased by 27. At the same time, the State Attorney's Office has been authorised to expand its authorised staffing level and has received authorisation to hire administrative staff (85 non-management personnel and 6 second-level managers) and legal staff (10 attorneys and 10 prosecutors).

Other measures with a smaller financial impact regard the hiring of small number of staff at entities belonging to various sectors of government, as well as provisions authorising the hiring personnel in derogation from the restrictions in applicable legislation to respond to emergency situations (mainly related to the earthquake of 2016).

On the resources front, note that paragraph 399 raises up to €100 million (net of social security contributions charged to employers) for 2019 by preventing the Presidency of the Council of Ministers, ministries, non-economic public bodies and tax agencies from hiring permanent staff (under their respective *ordinary* hiring authority for 2019 only) with financial and legal effect prior to 15 November this year.[66] The same constraint has been imposed on universities until 1 December 2019, with the exception of "automatic" appointments of senior researchers to associate professor positions.

Overall – stated in terms of net borrowing and not taking account of social security contributions charged to employers or the cuts in items of the same nature provided for in the Budget Act – a preliminary estimate of the total resources that the Budget Act appropriates for government hiring amounts to about €360 million in 2019, about €1 billion in 2020 and about €1.35 billion in 2021. The social security contributions charged to employers associated with these measures amount to just under half of the increase in expenditure, coming to more than €175 million in 2019, about €503 million in 2020 and almost €660 million in 2021.

It is important to bear in mind that the measures in the Budget Act must be coordinated with the provisions of the so-called "Substance Bill" ("*Disegno di legge Concretezza*"), presented by the Minister for Public Administration and approved by the Council of Ministers at the end of October.[67] This bill contains a number of measures for the reorganisation and monitoring of the activities of government administration, with a likely impact on public employment. For example, consider the establishment of the "unit for substantive actions to improve administrative efficiency" and the task of preparing a "three-year plan of substantive actions to enhance the efficiency of government entities", which has been entrusted to the Department of Public Administration. Moreover, the bill provides for the resumption of the complete use (for new hires) of the resources freed up by terminations in the previous year, compared with the current limit of 25 per cent for State entities and other bodies, regional governments and local authorities.[68] Note, however, that current legislation already exempts schools and the security sector from the turnover restrictions (a total of about 1.6 million employees) and permits a higher turnover rate (75 per cent) for territorial governments (about 500,000 employees, without considering the special autonomous regions) that meet certain economic and financial conditions. Moreover, the available data suggest that most terminations in the next three years will come in these sectors of public employment.

As regards pay in the government sector, the budget package contains various measures regarding collective bargaining and the pay of personnel belonging to the individual

[66] The language of the provision appears to permit hiring with financial and legal effect prior to that date, as long as it is authorised under hiring authority regarding previous years or in derogation from the *ordinary* hiring authority for 2019, such as, for example, those who use the resources of the fund refinanced under paragraph 298 of the Budget Act.

[67] Senate Act no. 920, presented on 6 November 2018.

[68] Established with the 2016 Stability Act. However, the restrictions imposed by that law were valid for 2016-2018, so a return to full turnover (100 per cent of terminated employees) beginning in 2019 seems to have already been envisaged, for most of government, under existing legislation.

sectors or entities.[69] Two of these are of particular importance. The first concerns the defence and security sector and consists in financing (€100 million annually from 2020, equal to €51.5 million annually net of social security contributions charged to employers) the fund established to meet the costs arising from the reorganisation of career paths of law enforcement personnel and members of the armed forces provided for in the Security Decree.

The second measure concerns the renewal of public employment contracts for the 2019-2021 period. The Budget Act quantifies the total maximum amount earmarked for this purpose at €1.1 billion in 2019, €1.42 billion in 2020 and €1.77 billion as from 2021. The impact on net borrowing, however, is significantly smaller, given the higher tax and contribution revenue generated by the wage increases (€315 million in 2019, €449 million in 2020 and almost €620 million from 2021) and the resources already appropriated under current legislation (€450 million in 2019 and €500 million from 2020), almost all of which will be used to pay the indemnity covering the "status quo" period ("*vacanza contrattuale*"), as specified in national collective bargaining agreements (and offset upon renewal of the bargaining agreements). The total amounts correspond to an average increase in the State sector compensation of 1.95 per cent in 2021 over 2018, the final year of the previous contract period, compared with an increase of 3.48 per cent provided for in the bargaining agreement for 2016-2018.

As usual, the amounts referred to above do not reflect the renewal of contracts of employees of entities, institutions and public bodies that do not form part of the State sector, as well as university professors and researchers, the costs of which are charged to their respective budgets. Note that the expenditure for compensation of employees associated with these institutions accounts for about half of the total for all general government.

[69] Examples of the latter measures include an increase in the fund for decentralised personnel of the Ministry of the Interior, incentive pay for management personnel of law enforcement authorities, increases in the funds for hazard and position-linked pay for firefighters and the fund for the productivity of Revenue Agency personnel.

3.4 *Measures for households and fighting poverty*

The Budget Act appropriates €9.1 billion in 2019, €14.5 billion in 2020 and about €14 from 2021 for families and anti-poverty measures. With the exception of a small portion of these resources (€0.6 billion in 2019 and €0.2 billion in 2020) allocated to refinance funds for social policies, households, non-self-sufficiency and assistance for disabled students, the remainder has been allocated to two funds pending the definition of specific measures: the Citizenship Income Fund and the Fund for the Reform of the Pension System through the introduction of additional forms of early retirement and measures to encourage the hiring of young people (henceforth the "Pension System Reform Fund").

The appropriations for the Citizenship Income Fund amount to €7.1 billion for 2019, €8.1 billion for 2020 and €8.3 billion from 2021 and are intended to fund, as mentioned in the Budget Act, measures to fight poverty, inequality and social exclusion, guaranteeing the right to work, freedom of career choice, as well as the right to information, education, training and culture. This funding also draws on the resources currently available in the Anti-Poverty Fund to finance the benefits envisaged under the Inclusion Income mechanism (about €2.2 billion in 2019 and 2020 and €2.1 billion from 2021),[70] which will continue to be paid until the Citizenship Income is effectively implemented. Appropriations therefore increased by €4.9 billion in 2019, €5.9 billion in 2020 and €6.2 billion in 2021. Of this, €1 billion in 2019 and 2020 will be used to expand job centres and an additional €10 million have been appropriated for 2019 for the National Agency for Active Labour Policies (ANPAL Servizi Spa). Finally, from 2019 the regions have been authorised to use these funds to employ up to 4,000 staff to be assigned to job centres (€0.1 billion in 2019 and €0.2 billion from 2020).

The appropriation for the Pension System Reform Fund amounts to €4 billion in 2019, €8.3 billion in 2020, €8.7 billion in 2021, €8.2 billion in 2022 and €7 billion from 2023. The funding will be used to finance the introduction of additional early retirement mechanisms and measures to encourage the hiring of workers (the so-called "*quota 100*",[71] the freezing/slowing of the progression of the requirements for early retirement and for retirement for early workers,[72] the renewal of the so-called "woman's option" and the early retirement programme for employed in heavy works ("*APE sociale*"). A detailed assessment of the adequacy of the resources in the fund to fully financing the reform of the pension system will only be possible when the implementing measures are announced. It is advisable that the design of these measures ensures the actuarial

[70] Funding to strengthen actions and territorial social services has not been eliminated.
[71] Retirement with an age of at least 62 and 38 years of contributions and the establishment of specific time periods ("windows") for payment of the first pension.
[72] Without changes, as from 2019 the age requirement for early retirement and retirement for early workers (as well as the age requirement for old-age pension) would rise by 5 months owing to its linkage to increases in life expectancy.

equivalence of benefits in order to preserve the long-term sustainability of the pension system and, therefore, of public finances.

In both cases the Budget Act defers the detailed provisions to subsequent regulatory measures to be financed out of the appropriations to these funds, which therefore represent a ceiling on expenditure. However, the two funds are connected: without prejudice to the total annual amount of resources appropriated for each of the funds, any savings generated with the measures implementing a fund's purpose may be used to offset any higher expenditures connected with the implementation of measures under the other fund, with the concomitant redefinition of the specific expenditure limits. Any expenditure savings that are not used in this offsetting mechanism can be returned to the funds.

For a detailed analysis of the content of the measures, their financial impact on public finances and the income redistribution effects, please refer to future PBO publications after the enactment of the decree law introducing them.

Other pension measures. – The Budget Act also modifies the rules for indexing pensions to the cost of living.[73] In the absence of any changes, the three-bracket scheme (Table 3.8, second line),[74] which until 2018 had been temporarily replaced by a five-bracket system[75] (first line), would have come back into effect from 1 January 2019. For a complete comparison between indexation mechanisms, it is necessary to consider that in the previous one (second line) total pension income was split into parts falling in different progressive brackets and each part indexed according to the correspondent percentage (indexation by bracket); on the contrary, with the new mechanism (line three) total pension income is indexed according to the percentage of the highest bracket in which it falls (indexation by amount range). Taken into account this difference, the new indexation system is more favourable for pension amounts up to approximately 4 times the minimum INPS pension benefit,[76] but is more penalising for higher pensions.

With the support of data from the pensioners' register and assuming inflation equal to the consumption deflator reported in the 2018 Update of the Economic and financial document, the technical report estimates expenditure savings increasing over time, from just over €0.4 billion in 2019 to over €2 billion in 2021, before decreasing slightly to about €1.9 billion in 2028. Net of tax effects,[77] these savings would go from just over €0.25 billion in 2019 to over €1.2 billion in 2021, and then gradually decline to around €1.1 billion in 2028.

[73] For a summary of the rules governing indexation, see also Ufficio parlamentare di bilancio (2015), **"**The revaluation of pensions in the wake of Decree Law 65/2015: redistributive effects and impact on the public finances", Focus Paper no. 4, June (text in Italian).

[74] Law 388/2000, Article 69, paragraph 1.

[75] The combined provisions of Law 147/2013, Article 1, paragraph 483 (2014 Stability Act) and Law 208/2015, Article 1, paragraph 286 (2016 Stability Act).

[76] The minimum INPS pension for 2018 is €6,596.46 a year (€507.42 a month).

[77] Assuming an average marginal rate of 39 per cent over the entire time horizon considered.

Table 3.8 – Indexing of pension benefits

<table>
<tr><th></th><th colspan="7">Value of pension as a proportion of the minimum INPS benefit</th></tr>
<tr><th></th><th>Up to 3 times</th><th>Between 3 and 4</th><th>Between 4 and 5</th><th>Between 5 and 6</th><th>Between 6 and 8</th><th>Between 8 and 9</th><th>More than 9</th></tr>
<tr><td>System in force until 31/12/2018</td><td>100%</td><td>95%</td><td>75%</td><td>50%</td><td colspan="3">45%</td></tr>
<tr><td>System from 2019 without 2019 Budget Act</td><td>100%</td><td colspan="2">90%</td><td colspan="4">75%</td></tr>
<tr><td>System for 2019-2021 with 2019 Budget Act</td><td>100%</td><td>97%</td><td>77%</td><td>52%</td><td>47%</td><td>45%</td><td>40%</td></tr>
</table>

As a further intervention to contain pension expenditure, for 2019-2023 the Budget Act introduces a solidarity contribution on pension incomes exceeding a threshold of €100,000 gross per year. The solidarity contribution is applied only on income from direct pensions and excludes pensions calculated entirely on contributory basis as well as disability pensions. The size of the solidarity contribution is determined according to five progressive brackets: from 15 per cent on the part of pension income falling between €100,000 to €130,000, to 40 per cent on the part of pension income exceeding €500,000. The net value of pension income after levying the solidarity contribution cannot in any case be less than €100,000 gross per year.

With the help of INPS data on the composition by amount and calculation system of pensions being paid, and assuming that each year 1,600 new pensions over €100,000 are paid, the technical report estimates expenditure savings of just under €0.1 billion in 2019, rising to almost €0.2 billion in 2023. Net of tax effects, these savings would go from about €76 million in 2019 to almost €90 million in 2023.[78]

Finally, for a maximum of five years, the Budget Act introduces a separate tax rate of 7 per cent on foreign pension income of retirees who transfer their tax residence to Southern Italy.

[78] Assuming an average marginal rate of 45 per cent over the entire time horizon considered.

3.5 *Measures for healthcare*

The 2019 Budget Act essentially leaves the funding of the National Health Service (NHS) for 2019 broadly unchanged at €114.439 billion[79] (€113.405 billion in 2018), including the reduction of €604 million to offset the failure of the special statute regions (SSRs) to contribute to consolidating the public finances as required in the 2016 Stability Act. Furthermore, the funding for 2020 and 2021 has been established for the first time, with increases of €2 billion and €3.5 billion respectively from the 2019 level. The technical report does not analyse the impact of these provisions on the public finances. However, the summary table of financial effects shows that this will result in cuts in healthcare expenditure, compared with its trend level, of about €170 million in 2020 and €1 billion in 2021. The Budget Act and Decree Law 119/2018 also provide for a number of other measures of the opposite sign involving current and capital expenditure on healthcare, amounting to about €100 million in 2019 and 2020 and €300 million in 2021 (Table 3.9, which shows the measures with the most significant impact on the budget).

Overall, beginning with the trend forecast for health expenditure contained in the Update to the Economic and Financial Document, taking account of the effects of the Budget Act and using the updated policy GDP growth figure, current healthcare spending would decrease from 6.6 per cent of GDP in 2018 to 6.3 per cent in 2021. This confirms allocative policies which imply a reduction in healthcare spending with respect to nominal GDP growth.

Table 3.9 – Healthcare: funding, spending and budget measures
(millions of euros)

	2018	2019	2020	2021
Standard national healthcare funding requirement (State contribution)	113,405	114,439	116,439	117,939
Current healthcare expenditure in EFD	115,818	116,382	118,572	120,894
Change in trend forecast between EFD and Update	513	857	880	909
Current healthcare expenditure in Update	116,331	117,239	119,452	121,803
Reduction in funding from trend			-175	-1,000
Training of general practitioners		10	10	10
Training of specialists (net of revenue increases)		12	23	35
Current policy expenditure (1)	116,331	117,261	119,310	120,848
Electronic reservation system to shorten waiting lists (2)		75	75	150
Healthcare building (3)				100
Total budget measures (including investment) (1)		**97**	**-67**	**-705**

Source: based on data from the financial schedules attached to the 2019 Budget Act and Decree Law 119/2018.
(1) The table does not include minor measures and spending on hiring personnel at the Ministry of Health. – (2) Funding of measures to shorten waiting lists is reported under capital expenditure. – (3) In Table 2.4, this amount is included under investment.

[79] The previously determined funding level was increased by €4 million to expand neonatal screening.

In order for the regions to access to the increased resources for the 2020-2021 period compared with 2019, the Budget Act requires that a new Health Pact be signed in the State-Regions Conference by the end of March 2019.[80]

The deadline for signing the agreement was postponed by two months beyond that specified in the Budget Bill with an amendment that incorporated the Government-Regions agreement on healthcare of 1 December 2018. It also eliminated the ban on granting new resources for 2019 if an agreement is not reached. The amendments, agreed with the regions, seek to avoid causing additional liquidity problems in the management of regional health services, given the multiple issues to be addressed and the brevity of the time initially set for the joint definition of interventions by the State and the regions. Also as a result of the agreement, certain earmarks in the NHS funding have been transferred to the general fund (health assistance to foreigners not enrolled in the NHS in the amount of about €31 million and enhancement of healthcare assistance and "*intamoenia*" professional activity in the maximum amount of about €41 million). The measures financed with these sums now seem to be more exposed to cuts, however the regions enjoy greater flexibility in the use of the funds, which could otherwise remain partly unused.

The new Health Pact should contain measures for planning and improving the quality of care and services and increasing efficiency.

More specifically, the main issues, which are fairly broad in scope, include: 1) a review co-payments in order to ensure greater fairness of access; 2) compliance with planning obligations at the national and regional level as part of the reorganisation of hospital and territorial supply networks, with particular attention to the issues of chronic diseases and waiting lists; 3) assessment of staffing needs, considering the consequences both for training and recruitment, and revising the benchmark for personnel standards; 4) implementing the interconnection of information systems with infrastructure and organisational measures, taking account of the existence of the Health card system and the Electronic health record, to track patients as they move through the healthcare system; 5) fostering research; 6) enhancing the efficiency and appropriateness of the use of public resources and the orderly planning of recource to accredited external providers (to undergo prior monitoring of outcomes and evaluation using indicators), possibly updating the associated expenditure ceiling; 7) assessment of the need for infrastructure measures for technological modernisation.

The temporal breakdown of the granting of additional resources in 2019-2021 compared with those available in 2018 makes simultaneously addressing the most urgent issues facing NHS, which largely fall within the new 2019-2021 Health Pact, a challenging endeavour. The regions will therefore be forced to establish priorities for intervention. These include the following: funding the new Essential Care Standards (*livelli essenziali di assistenza*), which although they were introduced in January 2017 are not yet fully implemented, basically due to the need for more resources;[81] the supply of innovative

[80] The most recent Health Pact covered the period 2014-2016.

[81] The President of the Council of Ministers Decree of 12 January 2017 on the specification and updating of the Essential Care Standards made the entry into force of the provisions concerning specialist out-patient care and prosthetics care subject to publication of the associated maximum fees, which have not yet been determined (see the hearing of 2 August 2018 of Minister Grillo on the Ministry of Health policy programme before a joint session of the Social Affairs Committees of the Senate and the Chamber of Deputies).

pharmaceuticals;[82] financing the 2016-2018 bargaining agreement (that for physicians has not yet been signed) and that for 2019-2021 (see section 3.3), as well as agreements with external providers, the costs of which continue to be borne by the regions; personnel shortages,[83] which in addition to the problem of funds will also require dealing with training issues, the problem of hiring constraints and the issue of correctly assessing needs. On the staffing side, the consequences of introducing more favourable retirement mechanisms, provided for with the introduction of the Fund for the Revision of the Pension System in the Budget Act, must also be considered.

The acceleration in the retirement of workers with respect to forecasts would make shortfall of NHS personnel even more dramatic. The concomitant reduction in personnel costs could, however, leave scope for new hiring, perhaps even outpacing the number of terminations, since the new employees would receive on average lower pay than the employees they replace, even with the same qualifications (this effect might only be partly reduced by the impact of promotions allowed by the retirements). The timing of early retirements (which would depend on the design of the new early retirement mechanisms) could be misaligned with the timing of new hiring and the ability of the training system to facilitate the integration of new personnel into their units. Although it would be desirable[84] to refresh the workforce, excessively rapid turnover could lead to the loss of a wealth of knowledge and experience.

Various provisions (see also section 3.3) in this area with limited or no financial effect have been introduced in the Budget Act, some through amendments during the approval process.

The increase in study grants for general practitioners (with funding of €10 million in addition to the €38.7 million already available) and that in specialist training contracts (according to the technical report it will be possible to finance 900 further grants for specialist training) are intended to eliminate bottlenecks in the training process. Other provisions appear to be emergency solutions to staff shortages: physicians in specialist training, if enrolled in the last year of their course of study, are allowed to participate in competitions for healthcare managers (the winners, who are entered in separate list, may only be hired after they have received their specialist qualification and after all physicians already holding a specialist qualification at the time the call for applications expires have been hired from the regular list); grant holders in at least three of the last five years may be hired on a fixed-term basis at institutes for science-based care and research (IRCCS) and experimental veterinary institutes (IZS); the requirements to operate in palliative care networks have been extended to physicians already in service with at least three years of experience in this field; those who have worked in certain health professions for at least 36 months in the last 10 years may continue to do so even if they are not entitled to enrol in professional registers (which have now established for all health professions following Law 3/2018), provided that they are entered in specific special lists maintained by the new professions;[85] the Ministry of Health is now allowed to make new hires (and hire existing

[82] Through August 2018, nearly €850 million had been spent, compared with €1 billion a year available in the two funds (which were not fully used in 2017). New oncology pharmaceuticals have been authorised recently.

[83] Which may also worsen as a result of the need to comply with European directives on working hours.

[84] Among other issues, disability leaves and certified work limitations are more common among older personnel, making it more difficult to organise shifts and ensure compliance with working hours regulations for everyone.

[85] Certain regional or specific training qualifications obtained no later than 2005 have also been made equivalent to first-level university degrees, but new courses of that type in the healthcare professions have been banned.

temporary staff on a permanent basis) in derogation from the ceilings on its current hiring possibility and with simplified procedures.

Other personnel measures include a provision incorporating the exclusivity indemnity of medical, veterinary and health managers in salaries, although this will only begin with the 2019-2021 bargaining period. This is a long-standing request from these managers and one of the most controversial points impeding completion of the 2016-2018 agreement (to which, in any case, it does not apply) owing to the costs the measure would entail. However, the costs will be borne by the NHS.

Many provisions on pharmaceutical governance were introduced during the parliamentary debate to the measures of the budget package. In particular, action was taken to facilitate the application of the pay-back mechanism.[86]

An attempt was made with last year's Budget Act to close litigation with pharmaceutical companies over reimbursements by reaching settlement agreements between the companies and the Italian Medicines Agency (AIFA) for the 2013-2015 period. The technical report estimates the total pay-back due for that period at €930 million, as recalculated to take account of those settlements. However, the total value of the agreements signed by AIFA amounted to €373 million, paid into the 2013-2014-2015 pay-back fund (set up at the MEF) and not yet transferred to the regions.[87] With the ratification of Decree Law 119/2018 into law, it was established that the settlement agreements would be valid, for the public sector, with the sole signature of AIFA. This streamlines the procedure, and the regions can finally receive the funds paid by the companies following the agreements.

Other provisions have been introduced in the Budget Act seek to simplify the operation of the pay-back mechanism in the future with regard to expenditure for direct purchases by NHS bodies, seeking to facilitate the estimation of expenditure overruns and the size of reimbursements, which in the past had given rise to uncertainties and a lack of transparency (the technical report does not attribute any financial effects to these provisions). First, the ceiling for direct purchases of medicines has been reduced to 6.69 per cent of NHS funding (from 6.71) as direct purchases of medical gases have been excluded from the aggregate (a new ceiling of 0.2 per cent has been established for them). In addition, reimbursement of breaches of the ceiling (calculated without including vaccines and innovative pharmaceuticals) will be made by companies in proportion to market shares, rather than on the basis of the allocation in company budgets. For innovative pharmaceuticals, any overruns of the associated funds (which have been transferred from the Ministry of Health's budget to that of the MEF within the financing for the standard NHS funding requirement to which the State contributes) shall be reimbursed by the companies who hold the right to sell those pharmaceuticals, again in proportion to the market share. In order to improve the monitoring of spending by the AIFA, the latter will measure the turnover of each company[88] using the electronic invoice data for the reference year (as a

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[86] The governance arrangements of the pharmaceuticals sector provide for part of any breaches of the expenditure ceiling to be reimbursed by the pharmaceutical companies (the pay-back mechanism). A paragraph in the Budget Act also seeks to activate the pay-back system for medical devices, as provided for in Decree Law 78/2015 but subsequently not implemented, by using data drawn from the electronic invoicing system. According to the technical report, the overrun of the expenditure limits was more than €1 billion.

[87] Note that the validity of the agreements was subject to a requirement that the companies pay the pay-back amounts for 2016. This restriction, which was intended to discourage litigation for 2016 as well, reduced the possibility of reaching agreements for previous years.

[88] The calculation considers pharmaceuticals in Class A (reimbursed by the NHS) and Class H (paid by the NHS), except vaccines, innovative and innovative cancer drugs (up to the limit of their respective special

precautionary measure, those collected by the New Health Information System until the end of 2021[89]) and determine the market shares of each company. The technical report notes that previously one reason for litigation was the fact that the burden for innovative drugs and a wide range of orphan medicines was placed on companies that did not produce them and that this mechanism has now been revised in part.

The proportion of the spending overruns to be reimbursed by pharmaceutical companies is still 50 per cent (with the remaining 50 per cent still borne by the regions, in proportion to the size of their overruns). The companies will make payment directly to the regions on the basis of AIFA notices, which allocate the amounts to the regions on a per capita basis. Finally, a number of mechanisms have been introduced to ensure the financial effects of the pay-back mechanism are achieved even if companies fail to pay. First, the receivable of the regions may be offset (through the NHS) against payables for direct purchases. Second, the Budget Act establishes that the increase in the pharmaceutical expenditure ceiling, calculated as a percentage of NHS funding, linked to the planned rise in the latter over the 2019-2021 period compared with 2018, shall be subordinated to repayment of the amount due for 2013-2017 by 15 February 2019, and will not be implemented until the entire amount has been recovered in full.

Finally, an agreement on the pay-back mechanism was recently reached between the regions and the Farmindustria trade association that could pave the way for settlement of past years' repayment liability, albeit in a smaller amount than that calculated by AIFA, and promote additional changes in governance for the future. However, this agreement would have to be implemented with future regulatory measures.

With regard to pharmaceutical spending,[90] it has been decided to revise the procedures for negotiations between the AIFA and companies on the prices of drugs charged to the NHS using a decree of the Ministry of Health, in consultation with the MEF, after obtaining the opinion of the State-Regions Conference. In addition, the AIFA may reconsider the terms of agreements before those agreements expire, re-opening negotiations if the use of a product is expected to increase or a therapy turns out to be more expensive than available alternatives.

In addition, more stringent regulations have been introduced for health advertising (by private healthcare providers and members of the health professions, including companies operating in the dental sector), focusing it on the information needed to guarantee the safety of health treatments and excluding promotional or suggestive language. This rule would seem to foster more appropriate treatments whose costs are

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funds) and the orphan pharmaceuticals listed in the associated register of the European Union. This criterion is more restrictive than the previous standard, which also excluded orphan drugs on the national AIFA list from the overrun reimbursement requirement. Spending on direct purchases of medical gases is accounted for separately. Turnover for each company is calculated net of a deduction of up to €3 million and of a number of other reimbursement and restitution items by the companies provided for in the complex regulations governing the pharmaceutical industry.

[89] The information is provided by wholesalers and pharmaceutical companies. The data are checked monthly and validated electronically by the pharmaceutical companies. They can temporarily be used to verify, and supplement if necessary, the data drawn from electronic invoices.

[90] The turnover threshold for pharmacies to qualify for the reduced discounts to be given to the NHS has also been lowered from €300,000 to €150,000 and, in this case, the preferential treatment is full exemption from the discount (both that based on price and the additional 2.25 per cent reduction). The determination of turnover has also been revised (without prejudice to the decisions already taken by the regions).

borne by the public, but also those paid for by the NHS, in particular in the case of providers operating under agreements with the NHS.

As for the so-called "super co-payment", i.e. the fixed charge of €10 per prescription on specialist outpatient assistance,[91] the regions have been given greater scope to replace this measure with others of equal impact on the budget and the appropriateness of treatment.

The National agency for regional healthcare services (AGENAS) has been given responsibility for developing a system for the analysis and overall monitoring of the performance of NHS bodies, including an alert mechanism to detect deviations in financial performances, organisational aspects, clinical effectiveness standards, fairness and transparency, as already required under the provisions of the 2014-2016 Health Pact.

In ratifying Decree Law 119/2018 into law, the regulations governing the operation of special commissioners appointed to reorganise regional health services subject to financial restructuring plans were modified.

This legislation has been amended multiple times, seeking to strike a delicate balance between safeguarding the standard of care provided and ensuring financial balance, on the one hand, and respect for the concurrent legislative autonomy of the regions, on the other. More specifically, the amendment of the original decree extends to a case that had been previously excluded[92] the incompatibility of appointment to the position of commissioner with taking up or continuing in any institutional position in the government of the region subject to special administration[93] – including the position of regional president. Such a case is that in which a region subject to a financial restructuring plan, and not complying with the plan itself – and therefore warned by the President of the Council of Ministers to take, within fifteen days, the actions necessary to ensures achievement of the plan objectives – does not comply with the warning or implements actions that are determined to be unsuitable or insufficient by the compliance verification group and by the standing committee for the verification of essential care standards. The requirements commissioners must meet have also been revised: while previously candidates had to demonstrate qualified and proven healthcare management skills and experience, providing evidence of previous results, now they must demonstrate specific administrative or management experience with public or private organisations in the healthcare industry or dealing with especially complex situations, including the prevention of corruption and safeguarding the rule of law. Decree Law 119/2018 also addressed existing commissioners, calling for the Council of Ministers to appoint new commissioners within ninety days where situations of incompatibility were found. The purpose of the provision is to always grant powers to someone other than the person ultimately responsible for the problems and shortcomings that led to imposition of special administration. The controversial aspect of this arrangement is the risk of worsening the

[91] The 2018 Budget Act established a fund of €60 million per year to reduce this super co-payment in order to ensure greater fairness and foster access to treatment for specific groups of vulnerable people. An initial draft of the decree allocating that fund was withdrawn by the current Government, which presented another. The latter draft provides for the distribution of 90 per cent of the fund on the basis of the percentage access to national healthcare funding for 2018 and 10 per cent in proportion to the difference between revenue that could be theoretically generated by application of the fixed charge and actual revenue raised. .

[92] Exclusion established with Law 232/2016.

[93] Incompatibility established with Law 190/2014.

contradiction inherent in putting regulatory power, which in some cases substantially translates into legislative authority, in the hands of an unelected person.[94]

Also worth mentioning is the funding of €150 million in 2019 and €100 million in 2020 and 2021 appropriated for the construction and modernisation of technology infrastructure related to electronic medical visit reservation systems in order to shorten waiting lists. Another €50 million was appropriated for 2020 for the same purpose in Decree Law 119/2018. The estimated impact on net borrowing is smaller, as shown in Table 3.9. Upgrading electronic reservation systems would appear to help improve the management of waiting lists, but reducing the length of time patients remain on the lists also requires the expansion of human resources and the capacity to handle a larger patient flow.

Finally, in order to increase the resources available for healthcare building and technology modernisation projects, the appropriations of the long-term programme of interventions introduced in 1988 (Law 67/1988, subsequently revised, most recently with Law 191/2009) were increased from €24 billion to €28 billion, mainly in order to give new resources to the regions that had depleted their funds. The refinancing will be funded as from 2021 with a reduction of €100 million of the fund for local authority investment established with the Budget Act (€300 million from 2023 to 2025, €400 million from 2026 to 2031, €300 million for 2032 and €200 million in 2033).

The programme is implemented through programme agreements and the resources are allocated on the basis of the state of progress of the projects. The regions that have signed agreements whose projects would use all available resources are[95] Valle d'Aosta, Lombardy, the Autonomous Province of Bolzano, Veneto, Friuli Venezia Giulia, Emilia Romagna, Tuscany, Umbria, Marche (99.9 per cent of the resources), Basilicata and Liguria. The latter is the only region that has had to implement a restructuring plan.[96] However, for many of these regions, the percentage of resources disbursed under the programme agreements has remained limited. This share reaches 100 per cent (or almost) in the case of Piedmont (99.8 per cent), Valle d'Aosta, Province of Trento, Marche, Molise, Campania, Puglia, Calabria (97 per cent), Sicily and Sardinia.

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[94] For more on the role of special commissioners, see: Gabriele, S. and Viceconte, N. (2012) "La sanità e la tutela della salute", in Mangiameli, S. (eds.), "Rapporto sulle Regioni in Italia 2012"; Gabriele, S. (2016) "La sanità e la tutela della salute", in Mangiameli S. (eds.), "Rapporto sulle Regioni in Italia 2015".

[95] Corte dei conti (2018), "Rapporto 2018 sul coordinamento della finanza pubblica".

[96] Liguria underwent a financial restructuring in 2007-2009 and then exited the procedure.

3.6 *Measures for public investment*

Increasing capital expenditure is one of the objectives of the Government's strategy. However, as part of the measures adopted during the process of approving the budget measures to reduce the balances requested by the European Commission, many of the deficit containment measures – especially for 2019 – target investment and investment grants.

The tools to expand capital expenditure consist of both an increase in the resources available in the Budget Act as from 2020, measures to amend the regulatory framework (notably the Public Contracts Code and the budget rules for local authorities) with simplification and corrective measures, and finally, measures to remedy the technical-organisational deficiencies of government entities, especially local authorities, in planning, designing and evaluating public investments.

Against a background of a continuing decline in investment spending in 2017 to €33.8 billion, more than €20 billion lower than in 2009, the MEF estimates a further contraction in 2018 to around €33 billion.

In recent years, the uncertainty connected with the new Code governing public tenders and concession contracts, which entered into force in April 2016 (Legislative Decree 50/2016), and was amended with a corrective decree in 2017 (Legislative Decree 56/2017), may have contributed to the decline in investment.

Currently, fewer than half of the implementing instruments (ministerial decrees, orders of the Prime Minister and ANAC guidelines) provided for in the new Code have entered into force and that two of the most novel elements, namely the qualifying system for contracting entities and the simultaneous reduction of their number, on the one hand, and the company rating system, on the other, are not yet operational.

In a joint document signed in July 2018, the Building Construction Association (ANCE) and the Association of Italian Municipalities (ANCI) offered a number of proposals for revision of the Code, including: a) a return to a single regulatory source, b) qualification by right (i.e. without verification) of metropolitan cities and provinces as contracting entities; c) easing of the integrated tender ban; d) raising the value of works that can be awarded using the "lowest price" criterion (currently set at €2 million, following the corrective decree of 2017, compared with the €1 million initially envisaged by the Code).

More recent data appears to signal a resumption of tenders for public works. After a contraction in 2016, in 2017 the total value tendered for public works (calls for tenders worth at least €40,000) amounted to €23.1 billion, an increase of 12.5 per cent compared with the previous year.[97] The positive trend in the public works market seen in 2017 seems to have continued according to data from the first quarter of 2018, as reported by ANAC (the National Anti-

[97] ANAC (2018), "Relazione annuale 2017".

Corruption Authority), which show an increase of 51 per cent in the value of tenders for public works compared with the first quarter of 2017.[98]

The new Government had announced it would present legislation for a comprehensive reform of the Code for the autumn. To that end, last summer the Ministry of Infrastructure and Transport launched a public consultation on numerous articles of the Code in order to gather recommendations from stakeholders. The consultation covered 29 rules, and in particular all the main changes introduced by the new legislation: the qualification system for contracting entities, the ban on integrated procurement, company ratings, award criteria, soft law and ANAC guidelines.[99] On November 28, the Ministry of Infrastructure and Transport published a summary report on the consultation, which received over 1,900 responses,[100] mostly from private-sector companies and sole proprietors. Many of the responses focused on reforming the soft law, changes to the qualification procedures for contracting entities, the integrated tender, company ratings and bonuses paid for project work performed by the technical staff of government departments, which are currently prohibited under the new Code.

For the time being, the announced legislative measures have not yet been presented. However, in order to accelerate tender procedures and pending the overall reform of the Public Contracts Code, the Budget Act allows, in derogation from the Code and for 2019 only, contracting entities to award contracts for works with a value equal to or greater than €40,000 and less than €150,000 directly after consultation with three contractors, if available. For works with a value equal to or greater than €150,000 and less than €350,000, the contracting entities may use the negotiated procedure, consulting at least 10 contractors.[101] Basically, the scope of contracting entities to award contracts for works without completing a competitive tender procedure has been expanded. Note that in 2017 works with a value of between €40,000 and €150,000 represented 51 per cent of public works tenders.[102] In terms of value, however, they represented about 6 per cent of the total value of public works (€1.5 billion euros out of a total of €23.1 billion).[103]

The budget package envisages a reduction of €2 billion in capital expenditure in 2019, largely attributable to replanning and defunding of investment grants, and increases in

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98 Based on data from ANAC (2018), "Relazione quadrimestrale, primo quadrimestre 2018".

99 http://consultazioni.mit.gov.it/.

100 http://www.mit.gov.it/sites/default/files/media/notizia/2018-11/Report_consultazione_pubblica.pdf.

101 See Article 1, paragraph 912 of the Budget Act. The Public Contracts Code permits the direct award of contracts for projects with a value of up to €40,000 and calls for use of the negotiated procedure subject to consultation of at least 10 contractors for amounts above €40,000 and less than €150,000. For works with value equal to or greater than €150,000 and less than €1 million, the Code calls for the use of the negotiated procedure with consultation of at least 15 contractors, where available. The procedure envisaged in the Budget Act for works with a value of between €40,000 and €150,000 to be awarded directly subject to consultation of 3 contractors represents an innovation.

102 See ANAC (2018), "Relazione annuale 2017". The ANAC reports considers completed procedures for public works with a value equal to or greater than €40,000 (tenders with a base value equal to or greater than €40,000).

103 ANAC (2018), *op. cit.*

the following two years, with an increase of €6.2 billion in 2020 and €7.1 billion in 2021. A summary of the main capital expenditure measures contained in the budget is shown in Table 3.10.

Table 3.10 – Main capital expenditure measures
(millions of euros)

	2019	2020	2021
Central government investment fund	415	1,185	1,700
Local government investment fund, of which:	1,080	2,342	2,249
Investment and investment grants of the OSRs to reduce their contribution to the consolidation of the public finances, with partial earmarking for capital expenditure	*800*	*1,658*	*1,033*
Capital expenditure of local governments from redefinition of balanced budget constraint and consequent possible use of budget surpluses and resources from borrowing		*404*	*711*
Investment of provinces of OSRs to finance safety plans for road and school maintenance	*250*	*250*	*250*
Fund for investment in Friuli Venezia Giulia and Sardinia (agreement to be reached by end of January 2019)	*34*	*30*	*194*
Investment of regions for healthcare building programmes			*100*
Implementation and modernisation of technology infrastructure for electronic medical visit reservation systems	*75*	*75*	*100*
Fund for investment to address hydraulic and hydrogeological risk	600	800	900
National plan for water sector	100	100	100
Investment by municipalities to secure and maintain schools, roads, public building and municipal assets and territory and investment by regions for buildings and territories	490	290	575
Projects for underground rail, major roads and road platforms of Rome	75	55	45
Funding to Western Ligurian Sea Port Authority to implement extraordinary plan for the development of the port system, intermodality and city-port integration	20	50	50
Fund for investment for regions hit by atmospheric disturbances Sept.-Oct. 2018 (Decree Law 119/2018)	475	50	
Increase in national emergencies fund: extension of 2016 earthquake state of emergency for Central Italy	200	120	40
Prevention of seismic risk (second section of Budget Act)	50	50	50
Replanning of Central Italy earthquake programme (second section of Budget Act)		50	300
Increase in fund for reconstruction of areas hit by May 2012 earthquake	18	18	
Refunding of national emergencies fund (second section of Budget Act)	60	100	100
Increase in fund for urgent safety and reclamation measures	20	20	20
Programme for energy upgrading of government buildings	25	40	40
Fund for mountain areas	10	10	10
Grant to National Research Council and increase in fund for research bodies and institutes	40	30	30
Replanning of transfers to State Railways (second section of Budget Act)		600	440
Replanning of national cofinancing funds (second section of Budget Act)		150	150
Replanning of transfers to State Railways (second section of Budget Act)	-1,740		
Defunding of transfers to State Railways (second section of Budget Act)	-600		
Replanning of national cofinancing funds (second section of Budget Act)	-850		
Replanning of Development and Cohesion fund	-800		
Cuts to ministry budgets (Decree Law 119/2018 and 2019 Budget Act - second section)	-235	-215	-206
Reduction and replanning of defence spending	-163	-180	-136
Property disposals	-950	-150	-150
Total capital expenditure measures	**-2,059**	**6,213**	**7,122**

Source: based on data from the financial schedules attached to the 2019 Budget Act (including Section II) and Decree Law 119/2018.

The most significant measures provide for the establishment of two new funds for investment and investment grants, one for central government departments and one for local authorities. In terms of the actual implementation of the expenditure, the overall expected impact on the general government accounts compared with the current legislation trend is €1.5 billion in 2019, €3.5 billion in 2020 and €3.9 billion in 2021.

Additional funding has been earmarked to finance measures for smaller enterprises and to remedy hydraulic and hydrogeological risks (€600 million in the first year and €800 million and €900 million for each of the following two), for projects to secure and maintain roads, buildings and lands by municipalities and regions (€490 million, €290 million and €575 million), for projects to address the problems connected with the atmospheric events of September-October 2018 (€475 million in 2020 and €50 million in 2021), to respond to the seismic emergency (€268 million in 2019, €238 million in 2020 and €390 million in 2021). The national emergencies fund of the Civil Defence Department has also been refinanced (€60 million in the first year and €100 million in each of the following two).

The budget also contains expenditure reduction measures, especially for 2019. These include cuts in transfers to the State Railways, which envisage a reduction of €600 million for 2019 and replanning provisions that reduce funds by more than €1.7 billion in 2019, largely by postponing them to the subsequent two years. The National Cofinancing Fund and the Development and Cohesion Fund have also been replanned, with expenditure cuts of €850 million and €800 million respectively in 2019. Other reductions include cuts in ministry budgets (over €200 million a year) and in defence spending (on average €160 million a year). Finally, additional disposals of public real estate have also been planned, above all in 2019 (€950 million, falling to €150 million in each of 2020 and 2021).

The fund for central government departments (€0.4 billion in 2019, €1.2 billion in 2020 and €1.7 billion in 2021) is consistent with that provided for in the 2017 Budget Act and refinanced in the 2018 Budget Act. Those departments are also affected by changes in the rules governing the verification that resources for measures in the Southern Italy have been allocated in proportion to the local population. In particular, the specification of verification programmes has been made more visible as they will be published in the Economic and Financial Document, rather than in a directive issued by the Prime Minister. To this end, the departments concerned must transmit a list of the programmes for which they are responsible to the Minister for the South by the end of February each year. In the initial application of this provision, the programmes will be identified in the 2019 Update to the EFD.

The appropriations in the fund for local authorities cover some of the capital projects of local authorities contained in the measure: the associated amount is in fact recognised both as an increase in expenditure for the provision establishing the Fund itself and as a reduction in spending with regard to the use of the Fund's resources by other provisions. Therefore the amounts entered in the Fund cancel out[104] and only those regarding substantive measures remain (the impact of which is equal to net borrowing of about €1.1 billion in 2019, €2.3 billion in 2020 and €2.2 billion in 2021; Table 3.10).

This legislative technique, apparently intended to facilitate the parliamentary amendment modification of the uses of the resources entered in the Budget Act, makes it more difficult to understand the law as approved: the presence of duplicate items of the opposite sign does not make it easy to distinguish the substantive provisions from those present with the opposite sign and therefore having a formal nature only.

Table 3.11 shows, in terms of the net balance to finance, the link between the formal appropriations of the fund and their substantive use.

All the measures to be financed by the Fund have equivalent effects in terms of the cash balance and net borrowing, with the exception of the deactivation of the cuts envisaged under current legislation for the OSRs. This measure is partially funded for 2019-2020, for the purposes of the cash balance and net borrowing, in the requirement to post budget surpluses, a requirement that in turn gives rise, again in terms of the cash balance and net borrowing, to greater costs from 2021, when the surpluses reported in the previous two years can be spent (see section 3.7). The net effect of these factors concerning the replanning of the budget for the OSRs, is the sole reason for the difference in the impact ascribed in the summary table attached to the provision to the investment fund in terms of the net balance to be financed, and the borrowing requirement and net borrowing.

[104] This full offsetting of appropriations and uses of the fund occurs at the level of the net balance to be financed, whereas at the level of net borrowing, the net effect is negative (uses are greater than appropriations). This apparent discrepancy reflects the fact that the fund is used in part to cover provisions that have different impact on the three balances (they are greater on net borrowing and the cash balance than on the net balance to be financed). The residual appropriation of the fund net of this offsetting, which in turn has different effects on the three balances (they are smaller on net borrowing and the cash balance than on the net balance to be financed) was allocated as a transfer to certain special statute regions (Article 1, paragraph 126), the effects of which are necessarily the same on the three balances. It follows that the establishment and concomitant use of the fund gives rise to a larger negative impact on the general government balances, which is funded within the overall budget package.

Table 3.11 – Allocation of local authority investment fund – impact in terms of net balance to be financed
(millions of euros)

Provision	Description	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	From 2034	Total 2019-2034
Art. 1, para. 122	**Fund for local authority investment, of which:**	**2,780**	**3,180**	**1,255**	**1,855**	**2,255**	**2,655**	**2,755**	**2,590**	**2,445**	**2,245**	**2,245**	**2,245**	**2,245**	**2,195**	**2,150**	**1,500**	**36,595**
Art. 1, para. 555	*Financing school building programmes*			*100*	*100*	*300*	*300*	*300*	*400*	*400*	*400*	*400*	*400*	*400*	*300*	*200*		*4,000*
Art. 1, para. 819-824	*Use of surpluses to deactivate budget balance rule, of which:*		*404*	*711*	*1,334*	*1,528*	*1,931*	*2,050*	*1,891*	*1,678*	*1,500*	*1,500*	*1,500*	*1,500*	*1,500*	*1,500*	*1,500*	*22,027*
	Local authorities		349	466	695	500	500	500	500	500	500	500	500	500	500	500	500	7,510
	Special statute regions (SSRs)		55	66	106	220	264	155	200	200	200	200	200	200	200	200	200	2,666
	Ordinary statute regions (OSRs)			179	533	808	1,167	1,395	1,191	978	800	800	800	800	800	800	800	11,851
Art. 1, para. 841-843	*Funding from deactivation of cuts provided for in current legislation for OSRs*	*2,496*	*2,496*															*4,992*
Art. 1, para. 889-890	*Financing of safety plans in OSR's provinces*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*	*250*		*3,750*
Art. 1, para. 126	*Fund for investment in Friuli Venezia Giulia and Sardinia (agreement to be reached by end of January 2019)*	*34*	*30*	*194*	*171*	*177*	*174*	*155*	*49*	*117*	*95*	*95*	*95*	*95*	*145*	*200*	*0*	*1,826*

Source: based on information in the text of the 2019 Budget Act.

In addition to the measures in the investment fund for local authorities, additional resources have been appropriated in the Budget Act for capital expenditure of local authorities. The most significant of these involve:

- measures for securing roads and schools and other road works (in addition to the €250 million per year granted, for the same purpose, to the provinces and metropolitan cities of the OSRs under the fund for the investments of local authorities). Funding for this purpose is provided in particular: to small municipalities in the amount of €400 million in 2019, with an impact on the borrowing requirement and net borrowing of €300 million in 2019 and €100 million in 2020;[105] to the region of Sicily in the amount of €20 million a year in 2019 and 2020 and €100 million annually from 2021 to 2025;[106] to municipalities entitled to restoration of revenue from the municipal services tax (TASI), which municipalities can no longer levy following the elimination of this tax for primary residences, in the amount of €190 million per year from 2019 to 2033;[107] to the provinces involved in the maintenance of the bridges of the Po basin, in the amount of €50 million annually from 2019 to 2023 (with the exception of ANAS' share);[108] to the city of Rome to address the road safety emergency, in the amount of €40 million in 2019 and €20 million in 2020, plus €5 million per year in 2019-2021 for the purchase of equipment for the restoration of road platforms;[109] to Rome for the completion of the underground line C and extraordinary maintenance on lines A and B, in the amount of €55 million for 2019, €65 million for 2020 and €25 million for €2021.[110]

- measures to secure buildings and lands. The budget provides for grants amounting to about €3.2 billion to the regions and €4.55 billion to municipalities, in both cases spread over 13 years (from 2021 to 2033).[111]

- other investment grants, including investment grants of €50 million annually from 2021 to 2033, paid through a bonus mechanism to regions that voluntarily adopt the current expenditure reductions envisaged in current legislation;[112] three-year grants to the national mountain area fund, amounting to €10 million per year; investment grants to the region of Val d'Aosta in the amount of €10 million per year in 2019-2020 and €20 million per year from 2021 to 2025.

From the point of view of the feasibility of the expenditure programmes, it is assumed that, with a few exceptions (appropriations for the Rome underground, grants to small

[105] See paragraph 107.
[106] See paragraph 883.
[107] See paragraph 892.
[108] See paragraph 891.
[109] See paragraphs 933 and 934.
[110] See paragraph 931.
[111] See paragraphs 134 and 139.
[112] See paragraph 844.

municipalities), local authorities will spend all of the funding received from the State in the year in which it is received. This implicitly assumes a significant acceleration in the time it takes to implement expenditure compared with the current pace, obviously relying on the effectiveness of the changes introduced in the procedural framework. However, the possibility that actual spending may be more gradual, at least in the initial phase, cannot be ruled out.

Conversely, it is assumed that spending of the own resources held on the books of local authorities (surpluses and resources deriving from debt), which have now become available as a consequence of the redefinition of the balanced budget constraint (see section 3.7 on local government finances), will be especially gradual. It does not seem possible to exclude the possibility that spending will increase more rapidly, both because part of these resources can be used to increase current expenditure (not included in the summary table of the Budget Act) and because the removal of the restrictions on spending surpluses is a long-standing request of the local authorities with large surpluses, much of which can now be used to fund new investment spending.

With regard to the replanning of the budget measures borne by the OSRs – which is expected to increase capital expenditure by €800 million in 2019, €1.7 billion in 2020 and about €1 billion in 2021 (see section 3.7) – it appears plausible that some of this may instead be allocated by them to current expenditure.

While the burden on the OSRs has been eased, they are required to allocate their increased spending capacity to capital expenditure, but this restriction only applies to part of their greater expenditure (more specifically, in 2020, €750 million is not subject to restrictions). Moreover, similar constraints in the past have not ultimately produced the expected increase in actual investment.

Finally, with regard to the improvement of procedures, in order to address the technical and organisational deficiencies of government entities, the Budget Act provides for the creation of an Office for the planning of public assets and buildings,[113] which central and local government entities can access, subject to prior agreement and without direct charges. The name, location, organisation and functions of this new office will be established in an order of the Prime Minister within 30 days of the entry into force of the Budget Act.

The office's staff may not exceed 300, hired on permanent contracts. To ensure that it can begin operation immediately, the office may recruit its first 50 staff from among permanent government employees, including by way of temporary secondments, under specific memoranda of understanding with other government departments or for individual projects of specific interest to those departments, with costs to be borne by the office. Of the planned 300 employees, 120 will be temporarily assigned to the

[113] See Article 17 of the initial version (AC 1334), in which the unit was called "Design Centre" and Article 1, paragraphs 162-170 of the definitive version of the law.

provinces of the OSRs to perform the activities of the unified provincial contracting entities. The Budget Act also provides for the establishment of a unit, called "InvestItalia", directly under the authority of the President of the Council of Ministers, to support the coordination of Government policies and the policy-making and administration of ministers in the area of public and private investment.[114]

InvestItalia is only temporary, however, and would close with the end of the term of the Government that established it. Its duties are: a) analysing and evaluating investment programmes and infrastructure projects, b) conducting studies of the financial-legal feasibility of investment projects, c) monitoring the progress of infrastructure projects; d) developing solutions, including regulation, to eliminate obstacles and problems in implementing investments. The unit will be staffed by employees, including non-government personnel, with high scientific and professional qualifications, selected by means of public procedures.

The establishment of centralised bodies to provide coordination and technical assistance to government entities could help to fill one of the shortcomings of the process of implementing public investments in Italy, namely those entities' lack of planning capabilities, something that has probably gotten worse in recent years. However, it is reasonable to assume that the positive effects of these measures will only unfold over a relatively long time, taking account of the time necessary for the entities to be formed and begin full operation.

It should be noted that government entities can already take advantage of a number of technical assistance programmes. In particular, the European Investment Bank provides this type of service free of charge to government bodies, sometimes in collaboration with national institutions, independently from whether the Bank or the EU has granted financing (see Box 3.1). In addition, the main lines of action in the new 2019-2021 business plan of Cassa Depositi and Prestiti (CDP) include a plan to assist local authorities called "CDP Public Sector and Infrastructures".

[114] See Article 18 of the initial version (AC 1334) and Article 1, paragraphs 179-183 of the definitive version of the law.

Box 3.1 – Technical assistance from the European Investment Bank and the European Commission

The main activity of the European Investment Bank (EIB) is to provide loans at preferential rates for public interest projects, raising capital by issuing bonds, which currently have a triple A rating. In addition to its lending function, the EIB makes its technical and financial experience available to develop and implement investment projects and programmes. In fact, the EIB provides three types of service: lending, blending and advising. The first involves making loans to support growth and employment, the second combines its own financing with contributions from other sources, while the third regards the provision of technical advice and assistance.

As for lending to local authorities, the EIB provides loans, through financial intermediaries, with a value of to €25 million. The EIB also makes direct loans for large investment projects of more than €25 million. Local public authorities can receive technical assistance for urban development projects through the JESSICA programme, which combines lending with a technical and financial assistance service. In addition, local authorities can participate in the ELENA initiative, which provides 3-4 years of funding to cover up to 90 per cent of the costs of technical assistance or the development of projects for energy efficiency projects, distributed renewable energy and urban transport, with amounts exceeding €30 million.

In addition, in 2015 the European Commission and the EIB founded the European Investment Advisory Hub (EIAH), one of the pillars of the Investment Plan for Europe (Juncker Plan), which provides tailored assistance to identify, prepare and develop investment projects in EU countries. The Hub acts as a single point of entry to a range of advisory and technical assistance services. The services provided to public bodies are free of charge, while a contribution may be requested from private sector beneficiaries. The Hub works in collaboration with a network of partner institutions in many countries, known as National Promotional Institutions. In Italy, this partner is Cassa Depositi and Prestiti (CDP).

In particular, the Hub offers support services to development projects, financial advice, and guidance and training on methods and procedures, including tenders and cost-benefit analyses. The advisory work may be done by EIB experts, external experts or in collaboration with partners in Member States, such as the CDP in Italy. In Italy, applicants can request support directly on the web portal, through the EIB or via the CDP. Advice can be provided for investments in a variety of areas: research, development and innovation; development of the energy sector; development of innovative transport infrastructure and technologies; financial support; development of information and communication technologies; environmental and resource efficiency; human capital, culture and health. The Hub also provides assistance for horizontal activities that are not related to any specific project, such as circular economy projects, and through the URBIS programme for urban investment projects.

Currently, a call for proposals launched by the Hub is under way for National Promotional Institutions only, i.e. the Hub partners in the various countries. The objective of the call is the provision of investment advisory services for public and private investments in the Member States with the support of the Hub. The activities eligible for financing, for a maximum of 18 months, are: delivery of investment advisory services at local level; establishment or developing organisational capacity; and knowledge transfer for developing a local advisory capacity. The costs actually incurred for staff and advisory services are reimbursed upon completion and applications can be submitted each quarter until June 2020.[115] The CDP participated in the call, mainly to expand its unit, active since last year, that provides financial support for public-private partnership activities.

In 2015-2016, the Hub received 341 requests for assistance from all Member States, of which 26 from Italy, the largest number. More specifically, 86 requests were received from the public

[115] For more information on the call, see: http://eiah.eib.org/about/local-delivery-of-investment-advisory.htm.

sector. In 2017 alone, the Hub received another 300 requests, of which 119 from the public sector and 24 from Italy. Therefore, since its creation, the Hub has processed 70 requests from Italy, of which 53 per cent from the public sector. Only 20 per cent are requests for technical assistance alone, while 34 per cent are requests for financing and technical assistance and 23 per cent are requests for funding only. The Hub has responded to all requests, either by providing sufficient information for the projects to proceed or by delivering advisory services provided or financed by the Hub.

All public and private project promoters can send requests to the Hub. In particular, the new URBIS platform has recently been launched for municipalities, offering support and technical assistance for the development of urban projects to facilitate investments at the municipal level. The URBIS services are open to municipal governments of any size in all the Member States of the European Union and are provided free of charge to public bodies. Each request is tracked individually and there are no specific limitations on the size of the projects that can benefit from the technical assistance provided by the Hub, provided that the planning and structuring of the projects is already in progress and are not merely ideas.

In its initial phase, also to simplify access to existing advisory programmes and services, URBIS will consist of the following three modules:[116]

- increased awareness raising of existing instruments, programmes, services;
- tailor-made technical and financial advice to cities, and;
- exploring innovative financing approaches for city investments.

Another EU programme is the InnovFin Advisory programme, which guides clients in structuring their investment projects in order to improve their access to finance. Public and private research and investment projects that have a minimum investment of €15 million, fit the objectives of the Horizon 2020 but which are not yet mature for a financing appraisal are eligible.

The EIB also operates the European PPP Expertise Centre (EPEC), which since 2008 has been providing support to the public sector in delivering public-private partnerships. The EPEC professionals serve 41 national organisations, including for Italy the Department for Economic Policy Planning and Coordination at the Presidency of the Council of Ministers. CDP also collaborates with the EIB on EPEC.

Finally, JASPERS is a technical assistance partnership between the EIB, the European Commission and the European Bank for Reconstruction and Development, focused on environmental projects with costs exceeding €50 million and projects in the transport and other sectors with costs exceeding €75 million. More specifically, the programme provides support for projects that are subsequently co-financed by the EU structural funds in the sectors of road, air and maritime transport, public transport, water, solid waste and energy. Activities in Italy are coordinated in collaboration with the Agency for Territorial Cohesion. In the 2014-2020 period in Italy, JASPERS has contributed and is expected to contribute, among other things, to the following projects: nationwide implementation of the broadband project; energy efficiency of the Piombino steel industry; various sections of the Naples-Bari, Palermo-Messina, Palermo-Catania, Metaponto-Sibari-Paola and Bari-S. Andrea Bitetto railway lines; the railway nodes of Bari and Palermo; the Port of Augusta; UNESCO sites in Naples; environmental reclamation of the Flegrei Lakes; completion of the redevelopment and recovery of the Sarno river; the Ports of Naples and Salerno; and the “Vesuvio SS268” state highway.

[116] For more information on the URBIS programme, see: http://eiah.eib.org/about/initiative-urbis.htm.

The plan seeks to mobilise €25 billion to assist local authorities in building infrastructure and improving public utilities, strengthening the partnership with government and the focus on territories. In order to accelerate infrastructure development, the CDP intends to set up a dedicated unit that will support local authorities in the design, development and financing of the works. The CDP will thus supplement its traditional role as a provider of finance with that of promoter of new strategic works, involving industrial companies in public-private partnerships. Collaboration with government will also be strengthened to revive investment and innovation, with renegotiations and advances to facilitate access to national and European funds and settle debts with companies.

The InvestItalia unit, too, is being created to address the need for coordination with others existing or planned entities. To achieve this, the Budget Act provides for a decree of the President of the Council of Ministers to establish the measures necessary to coordinate the activities of the two units, as well as those of the other entities with responsibilities in the field of investment and infrastructure development, including the "Strategia Italia Control Room", provided for in Article 40 of Decree Law 109/2018 (the "Genoa Decree").

3.7 *Measures for local government finance*

Part of the budget package is designed to increase the expenditure capacity of local authorities. Also contributing to increasing this capacity is the revision of local finance rules, which is also intended to take account of a number of rulings of the Constitutional Court.

Among these, the Constitutional Court ruled that local authorities should be allowed full use of surpluses registered in their accounts, as well as the resources allocated to the multi-year fund for committed expenditures (Fondo pluriennale vincolato, FPV) even if the corresponding resources were raised through borrowing (rulings 247/2017 and 101/2018) and to not reduce resources to local authorities as a mere extension of cuts provided for in previous budgets (ruling 103/2018).

The main measures in the Budget Act and the Tax Decree affecting local authorities, whose effects are summarised in Table 3.12, include:

- the redefinition of the balanced budget requirement. The rule is now defined in terms of mere compliance with the balance called for under Legislative Decree 118/2011 for all local governments with the exception of the ordinary statute regions (OSRs), which until 2020 remain subject to the implementing provisions of Law 243/2012.[117] This gives those governments extensive access to the resources available from surpluses from previous years ("*avanzi di amministrazione*" and from debt. For local authorities running a deficit the rule is applied with certain restrictions.[118]

This eliminates the dual budget balance constraint, one founded on accounting rules (Legislative Decree 118/2011), the other on the basis of rules borrowed from EU regulations (first through the Domestic Stability Pact, then through Law 243/2012, whose definition of balance differed from that given in Legislative Decree 118/2011). The decision to eliminate the second constraint appears to be a response to the rules of the Constitutional Court, which noted that the balance defined in Law 243/2012 should be considered as a "statistical benchmark" in assessing the overall balance of local authority accounts and not as an operational rule that limits the full availability of their own resources. For 2019, the obligation to increase allocations to the fund for hard-to-collect receivables ("*Fondo crediti di difficile esigibilità*", FCDE) to 85 per cent of uncollectible credits has been made optional.[119]

- the elimination of the cuts provided for in current legislation for the OSRs (€2.5 billion a year for 2019 and 2020) and their partial replacement with a requirement to post surpluses (€1.7 billion in 2019 and €800 million in 2020)

[117] Article 1, paragraphs 820-826, of Law 145/2018.
[118] Article 1, paragraphs 897-898.
[119] Article 1, paragraph 1015.

(Table 3.13).[120] The budget cuts for special statute regions (SSRs) envisaged under current legislation have been retained. During the parliamentary examination of the provision, a number of agreements regarding the contribution to the public finances of certain special autonomous regions (Val d'Aosta, Sicily, Sardinia and Friuli-Venezia Giulia) were amended, with the grant of new capital transfers to those areas;

- the transfer of capital resources to the various levels of local government, mainly aimed at securing schools, roads, public buildings and municipal property, as well as resources for other specific investment purposes (the underground and roads in Rome, bridges in the Po basin, the fund for mountain areas, the fund for areas bordering the SSRs, bonuses for regions that adopt the savings measures provided for in current legislation);

- the introduction of measures to alleviate the financial situation of certain local authorities (renegotiation of MEF loans to local authorities;[121] advances to local authorities involved in long-term financial restructurings; advances for the payment of trade payables;[122] transfer of part of Rome's debt to the special commissioner, as this debt indirectly regards the period preceding the start of special administration);[123]

- as part of the tax amnesty pursuant to Decree Law 119/2018, the cancellation of tax arrears of up to €1,000 transferred to collection agents from 2000 to 2010.[124] This provision appears to affect local authorities since some of the lost revenue (estimated at around €99 million per year from 2019 to 2023) pertains to them;

- the implicit confirmation of the permanent nature of the reduction in transfers to municipalities, provided for by Decree Law 66/2014 until 2018 (Article 47, paragraph 8). That this reduction is now permanent can be inferred from the failure to increase the Solidarity Fund for local authorities. During parliamentary examination of the measure, the criteria for allocating that fund were kept unchanged from those applied in 2018.

Also affecting local authorities is the absence of any extension of the freeze on tax increases introduced with the 2016 Stability Act[125] and subsequently extended until 2018.

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[120] Article 1, paragraph 841.
[121] Article 1, paragraphs 961-964.
[122] Article 1, paragraphs 849-872.
[123] Article 1, paragraphs 922-930.
[124] Article 4 of Decree Law 119/2018.
[125] Article 1, paragraph 26, of Law 208/2015.

Table 3.12 – Main measures for local government in the 2019 Budget Act *(millions of euros)*

Primary purpose	Description	Impact on net borrowing		Net balance to be financed			Borrowing requirement and net borrowing		
				2019	2020	2021	2019	2020	2021
Restructuring of public finance constraints	Elimination of cuts provided for in current legislation for 2019-2020 for OSRs and partial replacement with requirement to post surpluses for balanced budget purposes pursuant to Law 243/2012	s	k	2,496	2,496	0	800	1,658	1,033
	Redefinition of balanced budget requirement for local authorities with consequent possibility of using surpluses	s	k	0	0	0	0	404	711
	Option for local authorities to provision 80% rather than 85% of uncollectible credits in the FCDE	s	c				30		
Capital grants to secure schools, roads, public buildings and municipal property	Provinces of the ordinary statute regions	s	k	250	250	250	250	250	250
	Grants to regions	s	k			135			135
	To municipalities	s	k			250			250
	To small municipalities	s	k	400	0	0	300	100	0
	To municipalities entitled to restoration of TASI surcharge	s	k	190	190	190	190	190	190
Measures for special autonomous regions and provinces	Fund for investment under agreement between the State, Sardinia and Friuli-Venezia Giulia	s	k	34	30	194	34	30	194
	Reduction of contribution of the region of Val d'Aosta to the public finances	s	c	10			10		
	Transfers for investments in the region of Val d'Aosta	s	k	10	10	20	10	10	20
	Grant to the region of Sicily for extraordinary maintenance of roads and schools			20	20	100	20	20	100
Measures to address specific local needs	Completion of Rome underground and Rome road safety emergency	s	k	100	90	30	75	55	45
	Fund to secure bridges in the Po basin	s	k	50	50	50	50	50	50
Other measures	Bonus for investment by regions that adopt savings measures provided for in current legislation	s	k			50			50
	National mountain area fund referred to in Article 2 of Law 97/1994	s	k	10	10	10	10	10	10
	Renegotiation of debt of local authorities for loans managed by Cassa Depositi e Prestiti Spa on behalf of the Ministry for the Economy and Finance	s	c	13	13	13	13	13	13
	Increase in fund to enhance and promote disadvantaged areas bordering special statute regions and the autonomous provinces of Trento and Bolzano referred to in Article 6, paragraph 7, of Decree Law 81/2007	s	c	10	6	20	10	6	20

Source: based on data from the summary schedule attached to the 2019 Budget Act (Law 145/2018).

Table 3.13 – Budget measures impacting the ordinary statute regions
(millions of euros; minus sign = deterioration in public finances)

Description of measure	Impact on public finances	Net balance to finance			Borrowing requirement and net borrowing		
		2019	2020	2021	2019	2020	2021
Public finance measures borne by OSRs on current legislation basis (a):							
Reduction of transfers	Increased non-tax revenue of State	2,496.2	2,496.2				
	Decreased current and/or capital expenditure by OSRs				2,496.2	2,496.2	
Public finance measures borne by OSRs following 2019 Budget Act (b):							
Requirement to post surpluses in 2019-2020. Those surpluses can be spent as from 2021	Decreased current and/or capital expenditure by OSRs in 2019-2020 and increased capital expenditure in 2021				1696.2	837.8	-1033.2
Reduction in public finance measures borne by the OSRs under 2019 Budget Act (b-a):							
Elimination of reduction provided for under current legislation (using the apparent grant of new transfers in order to cut the latter), partially replaced by a requirement to post surpluses in 2018-2019, which can be spent as from the following year. The difference can be used by the regions to increase expenditure funded by own resources, with partial restriction on allocation of capital expenditure	Decreased non-tax revenue of State	-2,496.2	-2,496.2				
	Increased regional current expenditure (limited to €750 million in 2020) and capital expenditure (for the remainder)				-800.0	-1,658.4	-1,033.2

Source: based on data from the summary schedule attached to the 2019 Budget Act (Law 145/2018).

The following table summarises the main measures with an impact on the public finances for the OSRs (the table does not consider measures affecting the healthcare sector and emergency measures, which are addressed in separate sections of this report).

In addition to the increase in capital resources, discussed in section 3.6, a major effort has been made to simplify the rules for local finance, with the elimination of the dual budget balance constraint. The current framework has proved complex to apply and, owing to certain features of the design of the rules, has reduced the spending capacity of local governments, especially the most virtuous, with a particular impact on investment spending. The measures produce effects in two important areas of local authority accounts: the use of surpluses and recourse to borrowing.

Use of surpluses. In view of the magnitude of surpluses available for expenditure, the impact of this new regulatory structure on the expenditure capacity of local authorities appears potentially quite large, albeit exposed to considerable uncertainty. The technical report assumes that spending will only begin to increase moderately as from

2020, stressing compensatory resources available under current legislation and assuming an only gradual rise in local government spending.

Against the significant surpluses carried by local authorities on their accounts that are available for expenditure – which an initial estimate puts at about €15.3 billion for governments other than OSRs, of which €11.6 billion for municipalities, €2.4 billion for provinces and metropolitan cities and €1.2 billion for SSRs and autonomous provinces[126] – Government estimates assume a very gradual increase in spending, with no effect in 2019 and moderate rises over the next two years of the budget horizon (€404 million and €711 million). Spending increases more sharply as from 2022 (€1.3 billion), reaching a peak of €2 billion in 2025 before declining to €1.5 billion annually from 2028. The moderate financial impact of the measure is due in part to the fact that existing legislation provides funding coverage for some years (such as that envisaged with the grant of financial flexibility to local authorities to mitigate the effect of the balanced budget constraint under Law 243/2012: that is no longer necessary as a result of the elimination of this restriction) and in part to the assumption that local authorities will increase spending gradually.

A geographical analysis of the impact of the measure shows differences between areas of the country, with a greater concentration of available surpluses in the North, especially for municipalities. A preliminary examination of the data for 2017 shows that the area with the largest surpluses potentially available for new expenditure are in the Centre-North.

The impact of the measures on the public finances are exposed to a degree of uncertainty. Local authorities with surpluses and cash holdings could use those resources more rapidly than the Government assumes, especially considering the fact that the projects have been long postponed under the spending restrictions in previous years. It is useful to remember that, under current legislation, the criteria for the use of *avanzi di amministrazione* establish a priority order of uses[127] that allows them to be allocated, at least in part, to cover non-recurring current expenditure (for example, maintenance of parks or roads). In addition, even for local authorities running deficits, which are allowed to allocate surpluses to make up previous deficits (including in derogation from restrictions on their use), the need for consolidation would be reduced from the first year, with the elimination of the associated compression of current expenditure as well. Finally, surpluses that become available for expenditure include resources earmarked for current expenditure (such as healthcare for the SSRs).

[126] For a discussion of this estimation, please consult the forthcoming Focus Paper of the Parliamentary Budget Office.

[127] Article 187, paragraph 2, of Legislative Decree 267/2000 establishes the following order of priority for the unencumbered portion of surpluses (the remainder is already earmarked for other purposes): off-balance-sheet liabilities, measures necessary to ensure budget balance, investment expenditure and non-permanent current expenditure.

The possibility of an increase in current spending, which is more easily achievable in a short time frame, is not considered in the Government forecasts, which in the summary schedules only assume an increase in capital expenditure.

Recourse to borrowing. The Budget Act allows for each local government to finance investments with new borrowing, with the sole limit being the sustainability of the repayment plan for outstanding debts.

The sustainability condition is represented by the limit placed on the ratio between the interest payable, increased by the principal instalments of outstanding loans, and the total of the first three revenue categories (taxes, current transfers and non-tax revenue). This ratio may not exceed 10 per cent for local authorities and 20 per cent for regions.[128] The denominator of the ratio includes all revenue, including earmarked amounts and difficult-to-collect revenue.

Article 60 of the Budget Act, in defining local authority budget balance, refers only to Legislative Decree 118/2011, which allows the inclusion of borrowings in compliance with the sustainability condition referred to earlier. Accordingly, the additional constraint established with Article 10 of Law 243/2012 no longer holds. The article had provided for a procedure managed at the regional level designed to ensure that the additional expenditure financed through recourse to borrowing would be offset by a corresponding decrease in spending by other local authorities, so that overall the local governments in a region would balance revenue (excluding borrowing) and expenditure (excluding loan repayments). The procedure, which at least stabilised local government debt in volume terms, was incorporated in law in order to implement the constitutional provision (Article 119, paragraph 6) establishing that borrowing to finance investment was allowed "on the condition that budget balance is respected for all local authorities in each region as a whole". Under the proposed rules, compliance with the constitutional budget balance requirement for local authorities at the regional level seems to be tautologically assured when each local authority achieves balance as defined in Legislative Decree 118/2011, i.e. including resources from debt in revenue.

The measure appears to enable an acceleration of investment expenditure already financed by loans through the free use of the restricted long-term fund funded by debt, as well as recourse to new debt from the first year, with an immediate impact on the general government deficit and debt.

Currently, the limit imposed on the ratio appears to be amply respected by the vast majority of local authorities. The latter have in fact progressively reduced their recourse to borrowing under the public finance restrictions provided for in Law 243/2012. Now that this constraint has been removed, governments may decide to take advantage of

[128] See Article 204, paragraph 1, of Legislative Decree 267/2000 and Article 10, paragraph 2 of Law 281/1970, respectively.

the fiscal space and significantly expand their debt-funded investment expenditure. Furthermore, the fact that the denominator of the ratio also includes earmarked amounts and difficult-to-collect revenue, which do not seem appropriate for assessing the capacity to repay debt, helps to weaken the significance of the ceiling. While it is likely that local authorities with significant surpluses will not need to increase their recourse to borrowing until they use the resources already available to them, it is possible to expect an increase on the part of local authorities that do not have their own resources.

The technical report mentions the increase in expenditure from use of the restricted long-term fund financed by debt (the quantification is included in the overall impact of the measure, as already indicated above) but it is unclear whether and to what extent it also considers the possibility of an acceleration in recourse to borrowing.

Another important aspect of the local finance measures concerns the restoration of the power of local authorities to manage their own tax revenue, with consequent positive effects in terms of restoring their budgetary autonomy, which may however be accompanied by the risk of an increase in the local fiscal burden. The new autonomy creates scope for diversified increases in rates both by size of the entity and by geographical distribution. The rates applied in most large municipalities are in fact already at their maximum level (for example, this is the case of Rome and Milan), although in certain cases this has been accompanied by exemptions for the most disadvantaged social groups. The same applies for governments with fewer resources, which currently already impose high or maximum tax rates (the latter is mandatory for cities undergoing financial restructuring).

The local authorities that will benefit most from the possibility of drawing on surpluses may not find it necessary, at least in the short to medium term, to raise tax rates. However, the need to fund contract renewals could prompt them to turn to tax increases.

A final problem that needs to be examined concerns the need for greater transparency and intelligibility in the local finance measures, an issue raised in numerous Constitutional Court rulings (see, for example, rulings 247/2017 and 101/2018), which the Budget Act appears to address only partially. The following list offers a number of examples of grey areas that hinder an immediate understanding of the effects and purpose the measures implemented:

- with regard to municipalities, the budget contains no explicit language extending the reduction of transfers, in the amount of €563 million, provided for under current legislation until 2018 (Article 47, paragraph 8, of Decree Law 66/2014), which is de facto incorporated in the value of the Municipal Solidarity Fund recorded in the budget. The need to lend greater visibility to this type of measure also seems necessary in consideration of the findings of unconstitutionality issued by the Constitutional Court for similar measures, such as the extension until 2020 of the reduction in resources to be borne by the OSRs implemented with Decree Law 66/2014, which was censured with ruling 103/2018, an extension that has in fact been reversed in this budget;

- with regard to the OSRs, the practice of creating an unclear relationship between the State and the regions is continued, characterised by intertwined transactions involving earlier measures as well. In particular, the following substantive aspects of the budget package are unclear (summarised in Table 3.13):

    - the contribution to fiscal restructuring envisaged for 2019-2020 under current legislation (through a reduction in transfers)[129] is implemented through the transfer of additional resources, which are simultaneously cancelled.

The repeal of cuts provided for under current legislation is obscured by the apparent allocation of new resources for investment spending (Article 1, paragraphs 834 and 836), a transfer which is then reversed in a subsequent provision (Article 1, paragraph 841). Rather than the absence of effects that these two actions of the opposite sign would produce, the cost attributable to the cancellation of the cuts provided for under current legislation is quantified in the net balance to be financed.

- the requirement to post a surplus (for budget balance purposes of Law 243/2012), in partial replacement of the cancelled expenditure cuts, to the extent that it will result in *avanzi di amministrazione* (for the purposes of Legislative Decree 118/2011) is a transitory effect of lower expenditure that will permit a corresponding increase in expenditure from 2021 (when the constraint under Law 243/2012 will also be eliminated for the OSRs, with the consequent use of the surpluses currently required).

- the OSRs are not in fact allocated any additional resources from the investment fund for local authorities in 2019-2020 (compared with the nominal appropriation of €2.5 billion in 2019 and €1.8 billion in 2020). The greater expenditure capacity of the regions derives from the failure to apply the cuts envisaged in current legislation.

[129] The only exception is a reduction of €750 million for 2020, which was ruled unconstitutional and expressly repealed.

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