Joint Session of the Fifth Committees of the
Chamber of Deputies (Budget, Treasury and Planning) and of the
Senate of the Republic (Economic Planning and Budget)

Preliminary hearing on the budgetary provisions for the three years 2019-2021

Testimony of the Deputy Governor of the Bank of Italy

Luigi Federico Signorini

Chamber of Deputies

Roma, 9 November 2018

Mr President, Honourable Members of Parliament,

I wish to thank you for giving the Bank of Italy this opportunity to provide its technical assessment as part of the consultations on the budgetary provisions.

I will make only a brief reference to the general economic situation, which I described in detail before these committees a month ago.

The information that has become available in recent weeks confirms the signs that the economy is weakening. According to the provisional estimate released by Istat, GDP stagnated in the third quarter. Our latest assessments are that industrial production was basically stationary in September and may have diminished in October. The Purchasing Managers' Index for that month has fallen below the threshold compatible with an expansion of production, both in manufacturing and in services. More positive signals are coming from the demand side: consumer confidence showed an improvement in October, returning to the same level as at the end of last year; according to monthly data on foreign trade, goods exports to EU countries increased in the summer. Financial market volatility has sharpened and risk premia remain high.

Overall, given these developments, achieving the growth targets set by the Government for next year is an ambitious goal.

The assessment we provided a month ago regarding the macroeconomic effects of the budgetary provisions is largely confirmed in the light of the measures under discussion.[1] The expansionary impact projected by the Government appears considerable.[2] As I have already remarked, estimates of the macroeconomic impact have a broad margin of uncertainty that also depends on the timing and the details, as yet unknown, of some of the measures.

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1 In this speech, the budgetary provisions are defined as the full set of measures incorporated in the 'fiscal decree' (Decree Law 119/2018) and in the draft budget law for 2019.

2 With regard to the multipliers of the Bank of Italy's econometric model see, for example, the work of Bulligan G., Busetti F., Caivano M., Cova P., Fantino D., Locarno A. and Rodano I., 'Il modello econometrico della Banca d'Italia: un aggiornamento delle principali equazioni di elasticità', Banca d'Italia, *Temi di Discussione (Working Papers)*, 1130, July 2017.

1. The budgetary provisions: an overview

The Government's budgetary provisions increase net borrowing, with respect to the current-legislation projections, by an average of 1.3 percentage points of GDP per annum in the three years 2019-2021, de-activating the safeguard clauses for next year and reducing, though only slightly, the amount for the following two years.

2019. – The Government plans to carry out expansionary intervention next year to the value of €34 billion, just over a third of which will be financed by increasing revenue and reducing expenditure. The deficit will increase by almost €22 billion (see attached table).

Cancelling the increase in VAT rates and customs duties envisaged by the safeguard clauses will lead to a €12.5 billion reduction in revenue.

In 2019, it is planned to introduce the 'citizen's income and pension' and to modify the pension system, although the details and the method of implementation of these measures are yet to be defined. The budgetary provisions simply institute two, intercommunicating funds (in the order of €7 billion each) that fix the maximum net cost of the prospective measures. The provisions also allocate additional resources for public sector investment (€3.5 billion).

Other expansionary measures include expenditure increases worth €3.4 billion and reductions in revenue of about €1 billion.

The measures will be financed to the tune of more than two thirds by raising revenue. The main contribution will come from an increase in taxation of the financial sector and the abolition of the optional tax system applying to some categories of business (IRI – tax on unincorporated business income).

The 2019 deficit will come to 2.4 per cent of GDP, which is 1.2 percentage points higher than the current-legislation projection and more than half a percentage point above the Government's estimate for 2018. According to the Government's assessments, structural net borrowing will increase by 0.8 points, to 1.7 per cent. As we know, this budget target is under discussion with the European authorities.

Last spring the European Commission deemed that Italy was compliant with the debt-reduction rule even though the debt to GDP ratio was not in line with the numerical parameter because it took into account the 'relevant factors', including, in particular, compliance with the preventive arm of the Stability and Growth Pact.

The budget targets set out in last September's Update to the 2018 Economic and Financial Document diverge from the rules of the Pact's preventive arm. Instead of moving towards equilibrium, the structural deficit – that is, net of the effects of the economic cycle and other temporary factors – would increase by 0.8 percentage points of GDP in 2019 and stabilise in the following two years.

In a letter dated 5 October, the European Commission requested a revision of the budget targets. The Government confirmed the programme for the next three years by publishing the 2019 Draft Budgetary Plan. On 18 October, the Commission noted a 'clear and significant deviation from the recommendations adopted by the Council as part of the Stability and Growth Pact' and asked the Government to provide a justification. Given the deviation, and considering that, as in the past, the reduction in the debt to GDP is not in line with the numerical benchmark, the debt reduction rule will not be respected. On 22 October, the Government confirmed its plans, citing the need to support the economy, and engaged to take all the measures necessary to avoid overshooting the projected net borrowing level.

On 23 October, the Commission issued a negative opinion on the Draft Budgetary Plan. As well as noting the failure to comply with the rules of the Pact for 2019, the Commission expressed the opinion that some of the prospective measures (notably the tax amnesty and the change in pension requirements) could represent a step backwards with respect to past reforms and that, should the downside risks for economic performance projected by the Parliamentary Budget Office materialise, the deterioration in the public finances in 2019 would be greater than forecast by the Government. The Commission asked Italy to present a new Draft Budgetary Plan by 13 November. On 29 October, the Commission also announced that it would re-assess Italy's position with regard to the debt reduction rule and asked the country to submit all the elements it regarded as significant for an overall assessment of compliance with European budget rules. On 5 November, the Eurogroup stated that it was in agreement with the European Commission's assessment and hoped that, through an open and constructive dialogue, Italy would cooperate with the Commission in drawing up a new Draft Budgetary Plan that was compliant with the rules of the Stability and Growth Pact.

Were the Commission to re-issue a negative opinion on Italy's plan, it could recommend that the Council open an excessive deficit procedure.

2020-2021. – The expansionary measures will be greater in these two years (on average by almost €37 billion per year) as a result of extending the *regime forfettario* and introducing a substitute tax for sole proprietorships and self-employed workers, granting a special tax rate for firms that re-invest their profits, as well as increasing the funds allocated to public investment and public sector employment.

As to the financing of these measures, the absence of the temporary revenue from the 2019 measures relating to the financial sector will be offset by abolishing the ACE (tax allowance for corporate equity) and taking action to counter tax evasion.

In the Government's policy scenario, while the deficit will continue to be significantly higher than the current-legislation projection, it will begin to diminish again in 2020-2021. A contribution will come from the increase in VAT and customs duties as a result of activating the remaining part of the safeguard clauses: these will yield 0.7 percentage points of GDP in 2020 and 0.8 points in 2021. The Government has in any case already announced that it will not in fact apply this increase, but will instead replace it with other, as yet unspecified, measures to reduce expenditure and improve tax collection.

In the period 2020-21, structural net borrowing is expected to remain unchanged at the level estimated for 2019. The Government intends to resume the path of adjustment in 2022, the first year after the end of the planning horizon; this could be brought forward, but only if GDP and employment return to their pre-crisis levels before the end of 2021.

2. The main expansionary measures

More than three quarters of the additional expenditure envisaged under the budgetary provisions (on average €24.2 billion per year) will be used to create or increase the Funds set up to finance the introduction of the 'citizen's income and pension', to lower the minimum requirements for obtaining a pension, and to revive public investment.[3]

In the first two instances, resources will be set aside for reforms that have not yet been finalised. Moreover, if the expenditure of one of the funds proves to be lower than expected, the residual amount may be transferred to the other.

It is also the Government's intention to set up special tax regimes for self-employed workers and sole proprietorships, as well as to provide incentives for businesses. The cost of these measures will mainly concern the two years 2020-21. Lastly, funds will be set aside for public sector employment.

The Fund for the 'citizen's income and pension'. – The Fund for the introduction of the 'citizen's income and pension' will have a total endowment of €9 billion per annum (about €7 billion net of the sums coming from the Fund to combat

[3] For public sector investment, this also includes the funds allocated to local governments.

poverty, which are presently set aside to finance the 'inclusion income scheme'). The draft budget law only indicates the purpose of the measures: combating poverty, inequality and social exclusion and guaranteeing the right to work.

Following the economic crisis, the absolute poverty ratio has risen considerably among households, from 3.5 per cent in 2007 to 6.9 per cent in 2017. The increase has been particularly marked (from 1.9 to 9.6 per cent) among households with a younger 'reference person', i.e. under 35 years of age, which include a larger proportion of foreigners (in 2016, in 60 per cent of younger poor households the reference person was foreign). Instead, the poverty ratio is stable – and below average – for households whose head is over 65 years of age (4.8 per cent in 2007 and 4.6 per cent in 2017).

Given the amount of resources allocated, the 'citizen's income' should be considerably more generous than the current 'inclusion income scheme', not only as regards its amount but also in terms of the number of beneficiaries. It is very important, therefore, that it should be designed so as not to discourage the supply of regular employment by providing for efficacious incentives and sufficient checks to prevent misuse.[4]

The budgetary provisions allocate part of the Fund's resources (€1 billion in 2019 and in 2020) to reinforce the employment centres, which at the moment play only a marginal role in matching the demand and supply of labour.

If the measures to reinforce the employment centres are to be promptly effective, organisational and regulatory changes will almost certainly be needed as well. Responsibility for the employment centres is split between several levels of government, and the ways in which they cooperate with private sector agencies continue to be ill-defined despite the institution of the National Agency for Active Labour Policies in 2015. We calculate, based on Istat data, that in 2017, only slightly over 25 per cent of job-seekers contacted an employment centre; the share of unemployed workers who found permanent work in the private sector through an employment centre was 2 per cent. People who, because of individual and family characteristics, are at greatest risk of poverty make even less recourse to the employment centres and are less likely to find work through them. Even in countries with greater experience of active labour policies, the likelihood of an unemployed worker finding a job through an employment centre is not high: in 2016, the proportion in France and Germany was 7 per cent.

Lastly, in areas with low labour demand in particular, it is important for the employment centres to be able to pass on job proposals originating in other regions.

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4 See 'Preliminary hearing on the Update to the 2018 Economic and Financial Document', Testimony of the Deputy Governor of the Bank of Italy, L. F. Signorini, Chamber of Deputies, Rome, 9 October 2018.

Pension system revision fund. – The budget establishes a 'Fund for the revision of the pension system through the introduction of additional forms of early retirement as well as incentives for hiring younger workers'. The Fund will have an endowment of €6.7 billion in 2019 and €7 billion starting in 2020.

Given that the information on the measures planned is incomplete, it is not possible at this stage to comment on the possible effects.

As we have said several times in the past, it is certainly possible to make the current rules more flexible, for example as regards minimum pension requirements. In our opinion, however, intervention of this kind should recognise that the financial sustainability and intergenerational equity of our system is based on the relationship between contributions paid in and benefits paid out. In other words, the amount of an early retirement pension should be adjusted in line with the lower amount of contributions and the anticipated longer disbursement period. Failure to meet this criterion would jeopardise the system's long-term equilibrium, increasing the burden on future generations.

Public investment. – A substantial share of resources is allocated to public investment: a total of around €16 billion over the three-year period (€3.5 billion in 2019, €5.6 billion in 2020 and €6.5 billion in 2021), of which almost €9 billion for central government investment and the rest for local government investment.

General government expenditure on gross fixed investment has declined very considerably in recent years, more than in the rest of the euro area. In nominal terms it has decreased by almost 4 per cent a year on average compared with 2008; as a percentage of GDP, it has fallen from 3 per cent in 2008 to 2 per cent. The largest reduction has been at local government level.

The analyses at our disposal suggest that Italy lags significantly behind its European partners in this respect.[5] Italy's delay is not only due to scarce financial resources: compared with other countries, costs and average implementation times are higher, even when taking differences between areas into account.

[5] See 'Public investment for developing the economy', address by Ignazio Visco, Governor of the Bank of Italy, at the 64th Conference on Government Studies, Varenna, 22 September 2018.

Fixed investment by local government departments (excluding the effects of privatization receipts) fell by almost 40 per cent between 2008 and 2017 (to €18.3 billion), reaching the lowest point in terms of ratio to GDP of the last 40 years. The decline was common to all areas of the country, but was especially evident in the regions of the South and Islands.

The failure of local investment to gain momentum in recent years may be due in part to the friction caused by an overlapping of the implementation phases of several reforms, and particularly to the misalignment between the new harmonised accounting standards (which came into force in 2015) and the balanced budget principle (applied since 2016, replacing the Internal Stability Pact).

The Draft Budgetary Law simplifies the framework of the rules to which local authorities are subject by bringing the method of computing the outturn for harmonised accounting closer into line with the method used for the outturn considered for compliance with the balanced budget principle, thereby freeing up funds to allocate for investment. All the local authorities will be affected by the changeover, except the ordinary statute regions, for which the new system will come into force in 2021.

On several occasions we have argued that it is desirable to shift public spending from current to investment expenditure. Investment spending, in addition to boosting demand (as its multipliers are usually higher than those of current expenditure), helps to raise the productive potential of the economy as long as the projects are carefully selected and efficiently implemented. It can also help to adopt transparent cost-benefit analyses when selecting projects and procedures to ensure the efficient and relatively rapid execution of the work.

It is important to underline that for the macroeconomic effects expected in 2019 to be fully deployed the measures need to be implemented from the beginning of the year.

The budgetary provisions also envisage the creation of two new organisational units: the Central Office for Public Works Planning and InvestItalia. The role of the Central Office will be to assist government departments, both central and local, in the assessment of the economic and financial aspects of any intervention, during the planning stage, and throughout the project management. InvestItalia will be charged with analysing and evaluating plans for tangible and intangible investment, assessing the needs for infrastructure modernisation, checking the state of progress of work, and preparing financial and legal feasibility studies. A potential overlapping of competences between the two new units and between them and other existing bodies needs to be clarified.

Special tax regimes for sole proprietorships and self-employed workers. – The budget provides for a reduction in the tax burden for sole proprietorships and self-employed workers. From 2019 the scope of the *regime forfettario* for small businesses will be extended, with an increase in the turnover threshold to €65,000; from 2020 a new substitute tax regime will be introduced for taxpayers with a turnover of between €65,000 and €100,000. These measures will entail a decrease in revenue of €0.3 billion in 2019, €1.9 billion in 2020 and €2.5 billion when fully operational.

Currently, the regime forfettario applies to taxpayers that meet certain requirements regarding the amount of their annual turnover (which must be below a threshold ranging from €25,000 to €50,000 depending on their branch of activity), the amount of their expenditure on auxiliary workers, permanent employees and collaborators, and the cost of capital goods. From 2019 the threshold for annual revenue would be raised for all branches of activity to €65,000; the other requirements would lapse. The regime forfettario *has a tax rate of 15 per cent, calculated on a tax base that is the result of applying to turnover different profit margin ratios according to the branch of activity. This tax would replace IRPEF and IRAP, and businesses opting for the regime forfettario would not be subject to VAT. There would also be a 35 per cent reduction in social security contributions for sole proprietorships.*

The substitute tax system that would come into force in 2020 envisages a 20 per cent tax rate, which in this case would be based on analytically computed income. There would be no reductions in social security contributions.

It can be estimated that the number of taxpayers subject to the *regime forfettario* will increase by around 60 per cent.[6] About half of this increase will be the result of the higher turnover threshold. For new beneficiaries, we estimate that their tax rate will be reduced by an average of about 4 percentage points, to 11 per cent. For those who will benefit from the substitute tax regime from 2020, the 20 per cent preferential tax rate will reduce the average rate by about 7 points.

Although the objective of simplification is laudable, some efficiency and equality issues raised by these measures will have to be carefully evaluated. The step effects at the thresholds of €65,000 and €100,000 could discourage firms from expanding and encourage elusive or evasive behaviour in order to keep income levels below the thresholds. Furthermore, the tax burdens of people with similar incomes could vary considerably.

Incentives for businesses. – The Government partially confirms some business incentives for high-tech investments and, under certain conditions, is introducing a special tax rate for firms that re-invest their profits. The effects on the public accounts will be modest in the first year of application; in 2020-21 they will be considerable (almost €2.5 billion a year).

For tech-intensive investments the budget extends the hyper-amortisation measure, the size of which depends on the amount of the investment concerned (over certain

[6] Calculations based on the BIMic microsimulation model. For a description of the model, see N. Curci, M. Savegnago and M. Cioffi (2017), 'BIMic: the Bank of Italy microsimulation model for the Italian tax and benefit system', Banca d'Italia, *Questioni di Economia e Finanza (Occasional Papers)*, 394.

thresholds, the special treatment would be cancelled). The incentive has so far supported the adoption of advanced technologies, whose returns can be as high as they are uncertain.

While abolishing the ACE, which was designed to strengthen firms' capital, the budget provides for the introduction of a special tax treatment in the case of re-invested profits to increase employment and invest in tangible capital goods. This measure is a permanent one. It will benefit firms when they make a profit, thus being more effective in favourable phases of the economic cycle.

The aim of the measures – to support investment and employment – is certainly commendable, but when introducing changes to incentive schemes, it should be borne in mind that the stability and simplicity of the framework are among the most important 'boundary' conditions for business activity.

Public sector employment. – The budget allocates €2.9 billion, distributed over the three-year period, for the renewal of the contract for public sector employees. This is in addition to the amounts already allocated today (about €1.5 billion). According to official estimates, the total amount of funds available would lead to an increase in average wages over the three years, reaching just under 2 per cent when fully phased in.

Compensation of public sector employees as a share of GDP diminished by over 1 percentage point from 2011 to 2017, falling to 9.5 per cent at the end of last year. It decreased less in the euro area over the same period (0.8 percentage points), reaching 9.8 per cent. From 2011 to 2017, compensation of public sector employees in Italy fell by more than 10 per cent in real terms, while it was basically stable on average in the euro-area countries.

The draft budget law also authorises the recruitment, in addition to what is possible under current legislation, of more than 15,000 public sector employees, allocating over €1.5 billion for this purpose over the three years.

There has been a sharp contraction in staff turnover in general government since 2012. This resulted in a decrease of around 135,000 jobs per year between 2011 and 2017. For the three-year period 2016-18, expenditure on newly recruited staff is limited to 25 per cent of the expenditure on staff terminated in the previous year. According to the current-legislation projections set out in last April's Economic and Financial Document, public sector employment is expected to stabilise next year.

In past years, the limits on staff turnover and the collective bargaining freeze helped considerably to keep current expenditure down: between 2010 and 2017, primary current expenditure increased on average by about 1 per cent per annum, while expenditure on compensation of employees decreased by an average of 0.7 per cent.

After several years of restriction, a cautious easing can be justified. However, it will be important to make use of the opportunity of contract renewals to introduce or strengthen incentive mechanisms, and to ensure that the recruitment of new public sector employees takes due account of the skills, including emerging ones, that are needed to improve the efficiency of general government.

3. Funding

On average, over the next three years, the budgetary provisions would generate resources of around €11 billion per year, enough to cover just under a third of the expansionary measures; the remainder will increase the deficit to the extent I have already mentioned.

The increase in revenue would amount to almost €9 billion per annum for the next three years. In 2019 more than half would come from a temporary increase in taxation on the financial sector; in the following two years the loss of this temporary revenue would be offset by the cancellation of ACE and by the measures to counter tax evasion and recoup revenue.

Other revenue measures of note include the abolition of the tax on unincorporated business income (IRI), which was otherwise due to come into force on 1 January 2019.

The tax on unincorporated business income was expected to reduce taxation by nearly €2 billion in the first year and about €1.3 billion from 2020. The optional system, which reduced taxation of sole proprietorships and partnerships with a basic accounting system in order to achieve tax neutrality with respect to their form of incorporation, was introduced in the 2017 Budget Law and should have taken effect from 2018. Last year, its entry into force was postponed until 2019; under the draft budget law it will be abolished.

The spending cuts would amount to €3.7 billion next year, €1.5 billion in 2020, and €2.2 billion in 2021. Over the next three years, the cuts will represent, on average, more than one fifth of the resources generated by the budgetary provisions. These include, in 2019, the deferral to the following two-year period of capital transfers to the Italian State Railways.

Like last year, part of the cost savings will come from cuts to ministries' spending budgets (€1.6 billion on average per annum over the three-year period).

About a third of these cuts would come from rationalising expenditure on management of the immigration centres; a reduction in military spending would be included (cumulatively €0.5 billion in the three years).

The other measures to reduce expenditure would include new, lower limits on tax credits for R&D (the deductible amount would drop from 50 to 25 per cent and the ceiling would be brought down from €20 to €10 million). The expected saving would amount to about €0.3 billion in each of the two years 2020-21.

Financial sector taxation. – The budgetary provisions raise taxation on the banking and insurance sectors in the next three years: by €4.3 billion in 2019, €0.5 billion in 2020 and €0.8 billion in 2021. The measures envisaged postpone the deductibility of a number of cost items and increase the amount of tax advances; accordingly, they have a deferment effect.

The abolition of the ACE, recalled earlier, will make future recapitalisations more burdensome for financial intermediaries as well.

As far as banks are concerned, the budgetary provisions would include changes to the deductibility, on the one hand, of loan write-downs associated with the start of IFRS9 and, on the other, of cost items resulting in deferred tax assets convertible into tax credits (these are loan write-downs made up to 2015 as well as depreciation allowances for goodwill and other intangibles entered in the balance sheet up to 2014). Overall, these measures would produce an increase of €4.8 billion in revenue in the next three years, which would be offset by a reduction in receipts of the same amount in the following years.

For the insurance sector, the budgetary provisions envisage an increase in the tax paid on account on insurance premiums. Currently, following the increases introduced in the 2018 Budget Law, the tax paid on account amounts to 59 per cent for 2019 and 74 per cent for the years after. The provisions would increase this to 85 per cent in 2019, 90 per cent in 2020 and 100 per cent in 2021. The expected revenue in the next three years is officially estimated at about €0.8 billion. Again, this would represent an advance on revenue.

The fight against tax evasion and measures to recoup revenue. – Revenue from the fight against tax evasion and the recovery of tax receipts, which are relatively modest in 2019 (€0.6 billion), represents over one quarter of the total funding in 2020 and almost one third in 2021 (€2.7 and €3.6 billion respectively).

More than half of the revenue (€0.3, €1.4 and €1.9 billion in 2019, 2020 and 2021 respectively) is expected to come from the introduction on 1 January 2020 (1 July 2019 for firms with a turnover above €400,000) of mandatory electronic transmission of data on daily collections deriving from the sale of goods and services. This measure should favour the emergence of the tax base in transactions with final consumers, thanks to the greater timeliness of the information available to the national revenue agency.

For the two years 2019-20, there would be a contribution of 50 per cent towards the cost of purchasing or adapting the data recording and transmission equipment required by the regulation, up to a maximum of €250 for purchases and €50 for adaption.

The remainder of the revenue is mostly of a temporary nature, stemming primarily from the redefinition and expansion of the procedure for the settlement of tax liabilities first introduced under the 2017 budgetary package. Taken together, the provisions are expected to generate an increase in revenue of €1.5 billion per year on average in 2020 and 2021.

The budget also makes provision for the automatic cancellation of debts of up to €1,000 on individual tax bills assigned to revenue collectors from 1 January 2000 to 31 December 2010 and a new tax amnesty, to which no increase in revenue is prudentially ascribed.

Under the amnesty, taxpayers would be able to use the DIS tax adjustment form to declare taxable amounts not reported up to 31 December 2017. The adjustment, to be submitted by 31 May 2019, would be permissible up to a limit of €100,000 yearly taxable amount and in any case could not exceed 30 per cent of declared income. The additional taxable amounts reported would be taxed without adding any fines, interest or other fees and at lower rates than those normally applying (with the exception of VAT). The sums owed could be paid in ten half-yearly instalments.

The introduction of mandatory electronic transmission of collections data, along with the other instruments to combat tax evasion adopted in recent years (such as the split payment mechanism, new compensation procedures between tax credits and debts, and the extension of e-invoicing to the private sector), aims to exploit the increased availability of data to make controls more incisive and at the same time to encourage greater voluntary compliance and cooperation between taxpayers and the revenue agency. If properly implemented, it can help achieve a structural improvement in the efficiency, fairness and transparency of tax collection.

Other measures, especially the tax amnesty, could discourage the regular fulfilment of tax obligations; they should therefore be weighed very carefully.

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The growth gap between Italy and the rest of the euro area is a structural problem. Its most salient features were recalled a few days ago by the Governor of the Bank of Italy:[7] low productivity of firms; a population that is on average older than that of other countries; a lower rate of labour force participation; young people and adults with gaps in knowledge and skills compared with other Europeans; general government that is somewhat inefficient; a less favourable business climate than elsewhere; little public and private investment. The list is well known, has been widely discussed and is, I believe, the subject of broad consensus. As the Governor recently affirmed, 'the road to structural reform requires a significant commitment, as results mature slowly. Yet reform is essential'.

The reforms implemented in recent years, or rather decades, have begun to bear fruit. The recovery has generated more jobs than might have been expected: even if GDP remains about 4 per cent below its 2007 level, the number of persons in employment has reached a historical high. The labour force participation rate of women and people in the higher age brackets has increased. The pension system has returned to a sustainable path, following two decades of reform that has risen to the challenge of an ageing population. More recently there have been improvements in the administration of justice and on other fronts. Much, however, remains to be done to tackle the outstanding issues. This is the best way to increase future economic growth potential and thereby to create the resources needed to combat poverty and alleviate the hardship of those who have been left behind.

While useful in especially adverse cyclical phases, an expansionary fiscal policy does not guarantee growth in the medium term, and in the long run can jeopardise it. Between 2000 and 2006, before the global financial crisis, Italy achieved a fiscal expansion of almost 5 percentage points of GDP, compared with 1 point in the rest of the euro area. In the same period our economy grew at an average rate of 1.5 per cent, against 2.3 per cent in the rest of the area. In those years the deterioration in the primary surplus, which declined from almost 4 to less than 1 per cent, corresponded with the interruption of the gradual reduction of the debt to GDP ratio, which was substantially unchanged at just over 100 per cent after falling by 12 percentage points in the previous six years.

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7 See the speech by the Governor of the Bank of Italy, Ignazio Visco, delivered at the 2018 *World Savings Day* organised by the Associazione di Fondazioni e di Casse di Risparmio SpA, Rome, 31 October 2018.

When the financial crisis struck, the already high deficit and debt reduced the room for manoeuvre of fiscal policy, hindering its full anticyclical deployment. Without such a high debt, Italy would not have suffered the consequences of the sovereign debt crises as violently as it did; it would not have been obliged to adopt markedly pro-cyclical fiscal policies in 2011 and 2012 to preserve investor trust and to avert the risk of being unable to refinance the public debt.

From 2014 to 2017, as financial conditions stabilised, the fiscal policy stance turned expansionary (by a little over half a percentage point per year on average). The primary surplus remained at around 1.5 per cent of GDP and the ratio of debt to GDP stabilised at just above 130 per cent. We said last year, at the preliminary hearing on the 2017 Update to the Economic and Financial Document, that to plot a gradual, but assured, path to debt reduction from these levels was the 'bare minimum' required and that the commitment to ensure orderly public finances had to be credible in order to avert a widening of the gap between the cost of the public debt and economic growth and therefore a deterioration in debt dynamics.

The Government shares the aim of reducing the ratio of public debt to GDP. This goal is nonetheless pursued not by focusing on the achievement of budgetary balance but rather on the stimulus imparted by fiscal expansion. It envisages a significant reduction in the primary surplus in 2019; it does not contemplate a rebalancing in subsequent years.

Econometrics is not an exact science, even though its statistical and mathematical tools are highly formalised; assessments of the impact on the economic cycle of the prospective expansionary measures might well vary depending on the hypotheses adopted and the models employed. The multipliers implicit in the budgetary provisions ought to be considered relatively high, even if there is widespread uncertainty about their estimated value. Much will depend on how and when the measures are implemented. The selection of investments and their timely commencement will also be important.

The effects of fiscal policy, however, cannot be assessed as though it existed in a void; they are affected by the broader financial conditions, especially important when the debt is so high, which in turn are influenced by announcements and policies. The protracted uncertainty of investors about Italy's fiscal plans and the credibility of its commitment to bring the debt steadily down, and last, but by no means least, the debate with the EU bodies on compliance with the common rules, have considerably raised the interest rates that Italy pays on its debt. This increase has already cost taxpayers almost €1.5 billion in additional interest expense in the last six months, compared with what it would have accrued at the rates that the markets expected in April; if the rates remain consistent with current market expectations, it would cost over €5 billion in 2019 and around €9 billion in 2020.

As the Governor explained in the same speech I mentioned earlier, the increase in the sovereign spread affects the entire economy (households, firms, financial institutions). The increase in interest rates on the public debt has an effect that is somewhat comparable to a monetary squeeze; a squeeze which, however, is much sharper and more rapid than any imaginable (future, gradual) normalisation of the Eurosystem's policy. This risks thwarting the expansionary stimulus expected from fiscal policy.

Faced with a possible new recession Italy would find itself with a relatively high deficit, as before the crisis, and an even higher debt to GDP ratio. The room for manoeuvre would be even narrower.

It is not my role to provide indications or formulate precise forecasts, which would in any case be impossible, but to highlight the risks. I believe there is a general consensus that the danger of triggering a vicious circle of deficit, interest rates, confidence and growth has to be avoided. Given the present international financial situation, unexpected episodes of volatility cannot be ruled out, however unlikely they may seem at the moment. Instead, credible control over the dynamics of the deficit and the debt is self-fuelling, and in the final analysis it will expand the amount of resources available to the community.

The spread has to be reduced. The signals captured by investors are important.

I hope, therefore, that the discussions under way with the European Commission and Council will lead to a solution that de facto reconciles compliance with the rules that bind Italy as a member of the Monetary Union and ensure a credible process of consolidation in the medium term, with judicious measures to support the economy and with the pursuit of the political objectives of the Government and Parliament.

TABLE AND FIGURES

Table 1

Effects of the measures incorporated in the 2019 budgetary provisions on the general government consolidated accounts (1)

(millions of euros)

	2019	2020	2021
SOURCES OF FUNDS	**12,129**	**10,165**	**11,174**
Increased revenue (A)	**8,439**	**8,701**	**8,929**
Measures relating to the financial sector (net effect)	4,260	476	848
Repeal of ACE (tax allowance for corporate equity)	228	2,373	1,453
Repeal of IRI (tax on unincorporated business income)	1,986	1,236	1,260
Measures to counter tax evasion	337	1,356	1,912
Settlement of tax liabilities (net effect)	243	1,337	1,641
Measures relating to gaming and tobacco	372	370	370
Reflex effects of measures on public sector employment	428	764	1,024
Other	586	789	420
Decreased expenditure (B)	**-3,690**	**-1,464**	**-2,245**
Current expenditure	-1,049	-1,414	-2,335
Measures to reduce expenditure of ministries	*-1,045*	*-1,230*	*-1,327*
of which: to rationalise expenditure on management of immigration centres	*-400*	*-550*	*-650*
Other	*-5*	*-184*	*-1,009*
Capital expenditure	-2,641	-50	91
Reprogramming of expenditure	*-1,640*	*650*	*740*
Measures to reduce expenditure of ministries	*-401*	*-398*	*-345*
Other	*-600*	*-302*	*-304*
USES OF FUNDS	**33,976**	**36,959**	**36,443**
Decreased revenue (C)	**-13,533**	**-10,724**	**-10,546**
Remodulation of VAT and customs duties safeguard clauses	-12,472	-5,500	-4,001
Extension of the regime forfettario for small businesses (net effect)	-331	-1,816	-1,370
Subsitute tax on sole proprietorships and self-employed workers (net effect)	0	-109	-1,129
Cancellation of debts up to €1000 in hands of tax collection agents	-99	-99	-99
Special tax treatment of re-invested profits	0	-1,948	-1,808
Extension and modification of hyper-amortisation	0	-368	-728
Extension of deductions for property renovations (net effect)	35	-595	-887
Other	-666	-290	-524
Increased expenditure (D)	**20,444**	**26,235**	**25,897**
Current expenditure	16,024	19,218	18,172
Fund for 'citizen's income and pensions' (2)	*6,802*	*6,842*	*6,870*
Fund for pension system review	*6,700*	*7,000*	*7,000*
Public sector employment	*883*	*1,568*	*2,105*
of which: contract renewals	*650*	*925*	*1,275*
Fund for implementation of the government programme	*185*	*430*	*430*
Other	*1,455*	*3,378*	*1,767*
Capital expenditure	4,419	7,017	7,726
Fund for central government investment	*2,200*	*3,000*	*3,500*
Investment by local authorities	*1,300*	*2,562*	*2,994*
Business support measures	*211*	*247*	*221*
Compensation scheme for savers (3)	*46*	*296*	*396*
Other	*663*	*912*	*615*
Net change in revenue (E=A+C)	**-5,094**	**-2,023**	**-1,617**
Net change in expenditure (F=B+D)	**16,753**	**24,771**	**23,652**
current	*14,975*	*17,805*	*15,836*
capital	*1,778*	*6,967*	*7,816*
Change in net borrowing (G=F-E)	**21,847**	**26,794**	**25,269**
as a percentage of GDP (4)	*1.2*	*1.4*	*1.3*

(1) Calculations based on official estimates contained in the Parliamentary proceedings relating to the draft Budget Law for 2019 and Decree Law 119/2018. – (2) Net of the reduction in the National Fund to combat poverty and social exclusion (€2.2 billion on average per year). – (3) Net of the reduction in the Financial Compensation Fund set up under the 2018 Budget Law (€25 million per year). – (4) Based on nominal GDP in the policy scenario set out *in the Update to the 2018 Economic and Financial Document*.

Table 2

Public finance overview (1)

(per cent of GDP)

	Update to the 2018 Economic and Financial Document									
	Current legislation scenari				o	Policy scenario (2)				
	2017	2018	2019	2020	2021	2017	2018	2019	2020	2021
Net borrowing	**2.4**	**1.8**	**1.2**	**0.7**	**0.5**	**2.4**	**1.8**	**2.4**	**2.1**	**1.8**
Primary surplus	**1.4**	**1.8**	**2.4**	**3.0**	**3.3**	**1.4**	**1.8**	**1.3**	**1.7**	**2.1**
Total revenue	**46.4**	**46.2**	**46.3**	**46.3**	**46.0**	**46.4**	**46.1**	**45.8**	**45.7**	**45.2**
of which: *incidence of taxation*	*42.2*	*41.9*	*42.2*	*42.3*	*42.1*	*42.2*	*41.8*	*41.8*	*41.7*	*41.3*
Primary expenditure	**44.9**	**44.3**	**43.9**	**43.3**	**42.7**	**44.9**	**44.3**	**44.6**	**44.1**	**43.2**
of which: *current*	*41.1*	*41.2*	*40.7*	*40.2*	*39.7*	*41.1*	*41.1*	*41.4*	*40.7*	*39.9*
capital	*3.9*	*3.2*	*3.2*	*3.1*	*2.9*	*3.9*	*3.2*	*3.3*	*3.4*	*3.3*
Interest expense	**3.8**	**3.6**	**3.6**	**3.7**	**3.8**	**3.8**	**3.6**	**3.7**	**3.8**	**3.9**
GDP growth *(percentage change)*	***1.6***	***1.2***	***0.9***	***1.1***	***1.1***	***1.6***	***1.2***	***1.5***	***1.6***	***1.4***
Debt (3)	**131.2**	**130.9**	**129.2**	**126.7**	**124.6**	**131.2**	**130.9**	**130.0**	**128.1**	**126.7**

(1) Rounding of decimal points may cause discrepancies. – (2) Revenue and primary expenditure are calculated based on data from the Update to the *2018 Economic and Financial Document*, the draft 2019 Budget Law and Decree Law 119/2018. – (3) Includes financial support to EMU countries.

Table 3

Main public finance indicators for general government (1)

(per cent of GDP)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	45.2	45.9	45.7	45.7	47.9	48.1	47.9	47.7	46.5	46.4
Expenditure (2)	47.8	51.2	49.9	49.4	50.8	51.1	50.9	50.3	49.1	48.7
of which: *interest expense*	*4.9*	*4.4*	*4.3*	*4.7*	*5.2*	*4.8*	*4.6*	*4.1*	*3.9*	*3.8*
Primary surplus (3)	2.3	-0.8	0.1	1.0	2.3	1.9	1.5	1.5	1.4	1.4
Net borrowing	**2.6**	**5.2**	**4.2**	**3.7**	**2.9**	**2.9**	**3.0**	**2.6**	**2.5**	**2.4**
Borrowing requirement	3.1	5.5	4.3	3.9	4.1	4.8	4.1	3.0	2.6	3.4
Borrowing requirement net of privatisation receipts	3.1	5.6	4.3	4.0	4.6	4.9	4.3	3.4	2.6	3.4
Debt	**102.4**	**112.5**	**115.4**	**116.5**	**123.4**	**129.0**	**131.8**	**131.6**	**131.4**	**131.2**

Source: Based on Istat data for general government consolidated account items.
(1) Rounding of decimal points may cause discrepancies in totals. – (2) The proceeds of sales of public assets are recorded as a deduction from this item. – (3) A negative value corresponds to a deficit.

Figure 1

Profile of VAT rates in the policy scenario

(per cent)

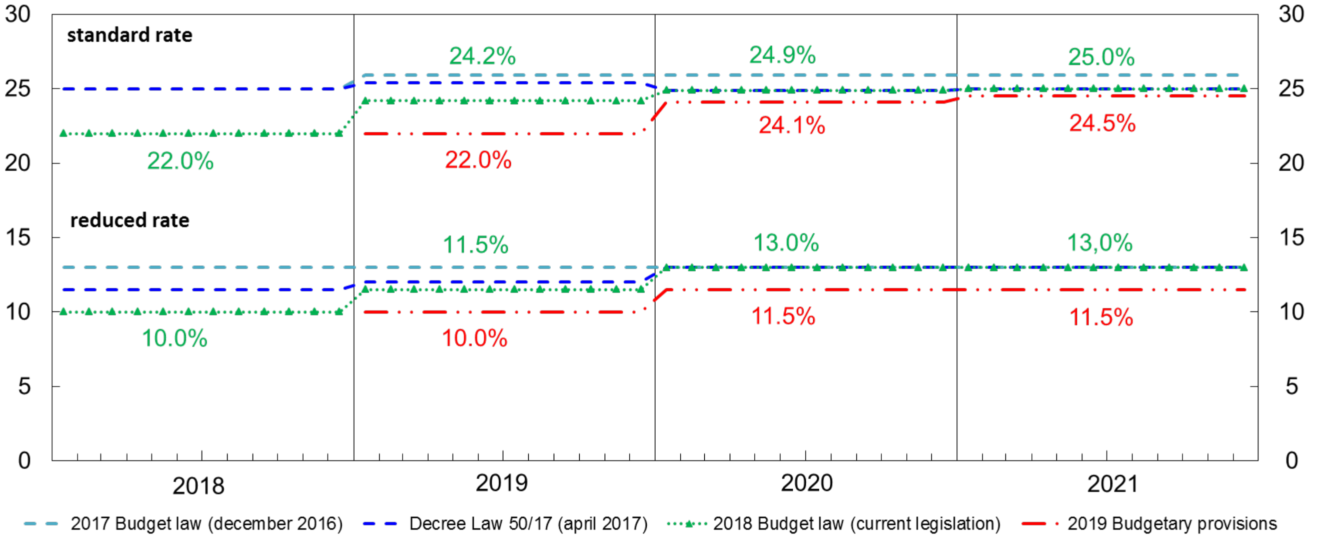
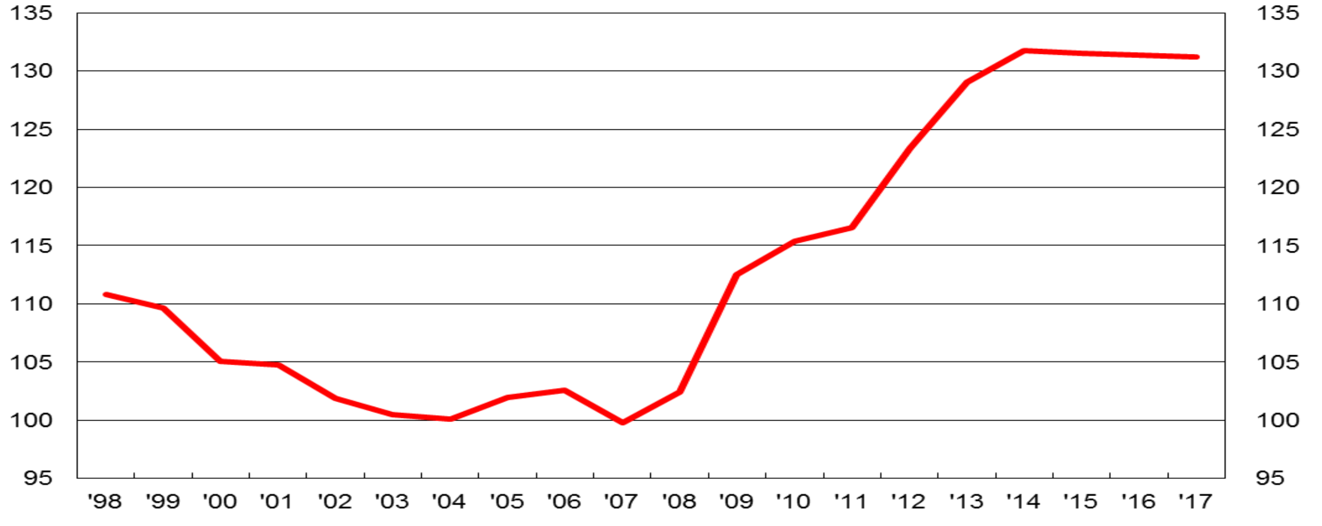


Figure 2

General government debt

(per cent of GDP)



Source: For GDP, Istat.

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