Dear Vice President, Dear Commissioner,

with reference to your letter dated 18 October 2018 in which you seek clarifications on the Draft Budgetary Plan (DBP) sent by the Government at the beginning of last week, I note the following.

In your letter, you raise three issues: the change of the structural budget balance compared with the requirements of the Stability and Growth Pact, the possible need for a review of the conclusions of the Report pursuant to Article 126(3) TFEU on procedures governing the reduction of government debt and the fact that the Parliamentary Budget Office (UPB) did not endorse the 2019 macroeconomic forecast.

As regards the structural budget balance path, the Italian Government recognises that the chosen budget policy approach does not fulfil the rules of the Stability and Growth Pact. It was a difficult but necessary decision because our GDP remains well below pre-crisis levels and the most disadvantaged sectors of the Italian society are experiencing dramatic economic conditions. In addition, the Government wants to implement the economic and social program on which it obtained a confidence of the Italian Parliament. The Update of the Economic and Financial Document, and the accompanying Report to Parliament, explain that the Government envisages moving away from the structural adjustment program in 2019 but does not intend to further expand the structural deficit in the two following years. The Government commits to bringing the structural balance back towards the medium-term objective from 2022 onwards. If real GDP returns to the pre-crisis high earlier than projected in the DBP, the Government will accelerate the adjustment path.

The above considerations also apply to the assessment of compliance with the debt rule. A decade after the start of the crisis, the Government considers the current economic and social conditions particularly unsatisfactory and
believes that an acceleration of economic growth is necessary. The dynamics of GDP are obviously crucial in assessing developments in the debt-to-GDP ratio. Moreover, it should be noted that the debt ratio is expected to significantly decrease over the next three years, unlike what has been experienced over the last decade. This evolution is the result of the growth-enhancing measures that will be introduced with the next Budget. These include the revitalization of public investment, which will benefit not only from increased financial resources but also from regulatory simplifications and new capacity building tools that will increase the speed of their implementation.

Finally, with regard to the macroeconomic policy forecasts and the non-endorsement by the UPB, it should be recalled that the Italian legislation (Article 18(3), Law no. 243/2012) provides that in the event of non-endorsement of the macroeconomic framework by the UPB, the Government is required to comply or explain. Consistent with this procedure, the Government explained to the Budget Committees of the two Houses of Parliament the reasons why it deemed appropriate to confirm the forecasts contained in the Update of the economic and financial document. We also note that the European Commission, with its Report of 22 February 2017, did not question the correctness of this procedure.

As regards the forecasts, it should be noted that the baseline forecasts were validated by the UPB. The difference is therefore limited to the assessment of the impact of the fiscal policy plan on GDP growth. The Budget increases the deficit by 1.2 percentage points of GDP, with an impact on growth of 0.6 percentage points, which is fully in line with standard estimates of fiscal multipliers. The UPB has highlighted two crucial aspects: public investment and government bond yields.

The Draft Budgetary Plan provides for an increase of public investment of 0.2 percentage points of GDP in 2019 and of 0.3 percentage points per year from 2020 onwards. This is a key part of the fiscal plan that will be implemented with concrete measures overcoming the limitations that have held back public investment, including the establishment of a national project support centre and a streamlining of the procurement code. The Project support centre will provide with organizational and technical assistance to central and local administrations, while the reform of the procurement code will allow public works to be carried out in compliance with the rules and in a more timely fashion. The Government believes that these innovations will let public and private companies invest in
infrastructure to hasten their investment plans and raise their levels. More broadly, the revitalization of public investment and the upgrading of infrastructure will raise the returns on private-sector investment and hence its level.

As far as yields on government bonds are concerned, the policy scenario in the DBP is based on government bond yield levels that are lower than those observed in recent days but consistent with those recorded prior to the cut-off date. Furthermore, the yield levels used for the policy scenario are higher than those underlying the baseline scenario in order to take account of market developments that occurred in the meantime.

In sum, the Government is confident to be able to effect a recovery in investment and GDP growth and that the rise in bond yields will be reversed once investors are fully cognisant of all the details of the measures envisaged in the Budget.

Finally, the fiscal projections in the policy scenario are estimated starting from the baseline and inserting the proposed fiscal measures. As feedback effects of higher GDP growth are not included in the estimates, the latter are not directly influenced by the growth differential between the two scenarios. As a result, the assessment of the effects of the policy measures does not entail an underestimation of the budget deficit. At any rate, the projected budget balance is the upper limit authorised by Parliament.

To date, the public discussion about the Budget has been limited to numbers and indicators and has not yet focused on the structural reforms that will be an integral part of the 2019 Budget and accompanying draft legislation. These reforms will have a significant impact on perceptions and behaviours of citizens, companies and investors. In particular, there will be measures aimed at improving the investment climate, such as: streamlining administrative procedures for companies, the digitalization of government services, the review of the procurement code, the reform of the Civil Code, in particular of Contract law, streamlining civil case procedures and a reduction of trial times. The actions already implemented in terms of tax simplification, fight against corruption and transparency in financing political parties and other-related entities, as well as the measures for electronic invoicing and the electronic transmission of proceeds, will significantly improve tax enforcement. The Government is
convinced that all these measures will stimulate economic growth, ensuring at the same time the long-term sustainability of the public finances and accelerating the reduction in the debt-to-GDP ratio.

In this respect, should the debt-to-GDP and the deficit-to-GDP ratios deviate from the planned paths, the Government commits to adopting the necessary measures in order to fulfil those targets.

The Government is confident that what I just illustrated will suffice to clarify its budget policy strategy and that the latter does not pose a risk for the financial stability neither of Italy nor of the other EU Member States. Indeed, we believe that improving Italy’s economic performance is in the interest of the entire European economy.

While we acknowledge the difference in our respective assessments, the Government will continue a constructive dialogue as laid down by the institutional rules governing the Euro Area. Italy belongs to Europe and to the Euro zone.

Yours faithfully,

Giovanni Tria

Mr. Valdis Dombrovskis
Vice President

Mr. Pierre Moscovici
Commissioner, Economic and Financial Affairs

European Commission
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