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The New EU Stability and Growth Pact and its Fiscal Implications for Italy[1]

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4th of July, 2024

Abstract

On the 30th of April 2024, the new EU Stability and Growth Pact (SGP) entered into force following an approach based on country-specific fiscal adjustments. This paper presents illustrative scenarios for Italy's public finances, carried out using the DSA framework developed by the Parliamentary Budget Office and adapted to be broadly consistent with the new SGP. The scenarios are compared with those consistent with the requirements set in the initial legislative proposals put forward by the European Commission in April 2023 and with the ones that assume the convergence of the structural balance to the medium-term budgetary objective (MTO), one of the main rules of the previous SGP. These scenarios show that the multiannual fiscal consolidation, broadly consistent with the new SGP, is estimated in an annual adjustment of the structural primary balance of around 1 percentage point of GDP with a 4-year adjustment path and of around 0.5-0.6 percentage points with a 7-year adjustment path. No substantial difference emerges between the adjustment required by the final version of the new SGP and the one required by the European Commission proposal. Indeed, the paper shows that, in the case of Italy, the debt sustainability safeguard, introduced in the final version of the new SGP, is not binding, while the deficit resilience safeguard binds only after the adjustment period, although just in some scenarios and for a limited number of years. Finally, the comparison between the fiscal consolidation consistent with the previous convergence to the MTO and the one consistent with the new SGP, shows that the latter implies either the same annual adjustment or a lower one during a 7-year adjustment period, while it requires a greater one during a 4-year adjustment period. However, in the new framework, a considerably smaller correction is required after the adjustment period.

JEL classification: H63, H68

Keywords: Sovereign Debt Management, Fiscal Policy Forecasts, Public Debt Sustainability

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1. Introduction

On the 30th of April 2024, the new legislative package reforming the Stability and Growth Pact (SGP) entered into force after a long process that started at the beginning of 2020, just before the Covid-19 pandemic. In February 2020, the European Commission published the Communication on the economic governance review,[3] in which the main drawbacks of the SGP previously in force were identified and analysed. Moreover, the Communication called on stakeholders to provide, by the end of 2020, an assessment of the economic governance framework and proposals for its reform.

The scope of the February 2020 Communication was to assess whether the European economic governance framework, reformed in 2011, had been effective in achieving its key objectives, i.e.: (i) ensuring sustainable government finances and growth, as well as avoiding macroeconomic imbalances; (ii) providing an integrated surveillance framework enabling closer coordination of economic policies in particular in the euro area; (iii) promoting the convergence of economic performances among Member States.

In the Communication, the European Commission emphasised that Member States' fiscal policies remained procyclical also after the 2011 reform. The ability to steer the euro area fiscal stance was limited also by the lack of a central fiscal capacity with stabilisation features. In addition, the fiscal framework did not manage to sufficiently preserve the level of public investment during periods of fiscal consolidation, making public finances less growth-friendly.

The Communication also highlighted the complexity of EU fiscal rules, including the compliance with multiple indicators, such as the structural balance rule, the expenditure benchmark and the debt rule, and their reliance on unobservable variables, such as the output gap and potential output. The framework lacked transparency and its complexity hampered national ownership and predictability. Finally, while the reform of the national fiscal frameworks and the establishment of new independent fiscal institutions (IFIs) in many Member States increased national ownership and fiscal discipline, their effectiveness was heterogenous across countries.

With the outbreak of the Covid-19 pandemic, the process of reforming the EU fiscal framework was put on hold. Only in 2021, with the publication of another Communication by the European Commission on the implications of Covid-19 for economic governance,[4] the process of consultation and review was resumed. The European Commission also committed to provide orientations on possible changes to the economic governance

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[3] European Commission (2020), "Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions on the Economic governance review", 5th of February.

[4] European Commission (2021), "Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions on The EU economy after COVID-19: implications for economic governance", 19th of October.

framework with the objective of achieving a broad-based consensus on the way forward before 2023.

Several contributions to the debate on how to reform the SGP, in particular to make it simpler, more transparent and effective and less procyclical, were put forward by scholars and stakeholders in both academia and institutions. Overall, the debate on how to reform the SGP diverged from the approach followed until then by the EU, which consisted mainly in setting common fiscal adjustments for all EU Member States and making rules more complex through incremental changes to the regulations. Such an approach was rejected in favour of more country-specific fiscal adjustments with the aim to reinforce national ownership.[5]

In this regard, the Italian Parliamentary Budget Office (PBO, Ufficio parlamentare di bilancio) contributed to this debate by identifying some key issues to be addressed,[6] specifically: i) the role of public investment and the introduction of some form of a "golden rule" in the fiscal rules, allowing the debt financing of expenditure with long-term benefits on potential growth; ii) the use of the debt-to-GDP ratio as a medium-term anchor for the new framework, including a revision of the target level as well as a differentiation among countries of the pace of convergence to it; iii) the simplification of the surveillance system, by adopting a single expenditure aggregate to monitor the convergence of the debt-to-GDP ratio to its target level; iv) the need for a common fiscal capacity for both macroeconomic stabilisation purposes in the euro area and to finance the provision of European public goods.

[5] Among the contributions to the debate on reforming the SGP, it is worthwhile recalling: Martin, P., Pisani-Ferry, J. and Ragot, X. (2021), "Reforming the European Fiscal Framework", Les notes du Conseil d'analyse économique, n. 63, April. They proposed to set country-specific medium-term debt targets, endorsed by the European Commission and the Council, assessed by national IFIs on the basis of a common debt sustainability analysis (DSA) and monitored by the European Fiscal Board (EFB). Such country-specific debt targets would be reached through 5-year primary expenditure growth ceilings. In addition, the authors proposed a central fiscal capacity for stabilisation and investment purposes. The paper of Bordignon et al. (2021), in a similar vein, called for a simplification of the existing rules through the presentation by Member States of a debt reduction plan monitored through a single expenditure indicator. A central EU fiscal capacity was also envisaged (see Bordignon, M. and Pisauro, G. (2021), "On Reforming the EU Fiscal Framework", Astrid, December). An analogous approach was taken by the International Monetary Fund, which, in addition, maintained the EU treaty thresholds for debt and deficit as reference parameters to distinguish between high- and low-risk countries and emphasised the importance of a central fiscal capacity as an instrument for macroeconomic stabilisation and for the provision of EU public goods (see Arnold, N., Balakrishnan, R., Barkbu, B., Davoodi, H., Lagerborg, A., Lam, W.R., Medas, P., Otten, J., Rabier, L., Roehler, C., Shahmoradi, A., Spector, M., Weber, S. and Zettelmeyer, J. (2022), "Reforming the EU Fiscal Framework: Strengthening the Fiscal Rules and Institutions", Departmental Paper 2022/014, International Monetary Fund, September). The proposal of Blanchard et al. (2021) was more far-reaching (see Blanchard, O., Leandro, A. and Zettelmeyer, J. (2021), "Redesigning EU fiscal rules: from rules to standards", *Economic Policy*, April). They suggested "the abandonment of fiscal rules in favour of fiscal standards", i.e. country-specific qualitative policy prescriptions whose assessment would have been based on solid quantitative analyses carried out by national IFIs or by the European Commission, using stochastic debt sustainability analyses.

[6] Ufficio parlamentare di bilancio (2022), "Audizione della Presidente dell'Ufficio parlamentare di bilancio nell'ambito dell'esame della Comunicazione della Commissione al Parlamento europeo, al Consiglio, alla Banca centrale europea, al Comitato economico e sociale europeo, al Comitato delle regioni – L'economia dell'UE dopo la COVID-19: implicazioni per la *governance* economica (COM(2021)662 *final*)", 16th of March (in Italian).

Taking stock of the proposals for reform, the European Commission published a Communication[7] in November 2022 illustrating orientations on the reform of the EU economic governance framework. Relying on the results of the public consultation, the European Commission proposed to reform the SGP through a risk-based country-specific medium-term approach. In particular, Member States with risks to the sustainability of public finances were required to present a multiannual consolidation path of 4 years (with a possible extension to 7 years by committing to the implementation of investments and structural reforms), consistent with a technical trajectory set by the European Commission on the basis of a debt sustainability analysis (DSA). Over the medium-term, such plans had to ensure a plausible reduction in the debt-to-GDP ratio and for deficit to remain below the 3 per cent of GDP threshold, in the absence of further fiscal policy measures (no-policy-change assumption). A single expenditure indicator would have been used to monitor compliance with the plan. The design of the new EU economic governance framework proposed by the European Commission already contained the main features of what would have been the newly approved framework and represented a fundamental change in the structure of the SGP.

The debate inside the EU Council, following the publication of the orientations on the reform of the EU economic governance framework, highlighted some areas of convergence of views among Member States, as well as issues where further clarifications and discussions were needed.[8] More in detail, the Council agreed that, in order to ensure a sufficient debt reduction (or in order to maintain it at prudent levels) and prevent the back-loading of fiscal efforts, the introduction of common safeguard provisions in the European Commission's technical trajectories should have been explored. In addition, the work on the appropriateness and design of common quantitative benchmarks to support the reformed framework would have continued.[9]

In April 2023, the European Commission put forward an official proposal to modify the regulations underpinning the EU economic governance framework.[10] With respect to the proposal presented in the orientations, the European Commission introduced, among other things, some numerical safeguards, common to all Member States. In particular, besides the no backloading requirement for fiscal adjustments, it required that the debt-to-GDP ratio at the end of the 4-year or 7-year adjustment period had to be below the level registered the year before the beginning of the adjustment.

[7] European Commission (2022), "Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee, the Committee of the Regions: Communication on orientations for a reform of the EU economic governance framework", 9th of November.

[8] ECOFIN Council (2023), "Orientations for a reform of the EU economic governance framework. Revised draft Council conclusions", 14th of March.

[9] In this regard, Germany put forward a technical non-paper with a number of proposals on specific elements of the EU economic governance framework, identified by the ECOFIN Council of march 2023 for further discussion.

[10] European Commission, (2023), "New economic governance rules fit for the future", 26th of April.

In the second half of 2023, long lasting negotiations were undertaken inside the Council to find a compromise on the new EU economic governance framework. A compromise agreement inside the Council was finally reached in December 2023,[11] which was followed by the final agreement between the Council and the European Parliament of February 2024.[12]

In all the phases of the reform of the EU economic governance framework, the Italian PBO provided technical contributions, feeding into the national debate on the matter.[13] In this regard, it is of some relevance to note that in the PBO's view, the new European economic governance framework favours the transition to effective multiannual budget planning, as advised in various contributions by the PBO itself and the Network of EU IFIs.[14]

Against this backdrop, in line with the approach followed by Darvas et al. (2023, 2024),[15] who provided, for all EU Member States, a quantitative evaluation of the initial proposal by the European Commission and the final version of the reformed SGP, the objective of this paper is to present illustrative scenarios for Italy's public finances broadly consistent with the new EU economic governance framework. The illustrative medium-term scenarios have been carried out using the DSA framework developed by the PBO,[16] which was adapted to be broadly consistent with the new set of EU fiscal rules, as described in the European Commission's latest Debt Sustainability Monitor.[17] However, it is important to note that for certain assumptions and parameters this paper departs from those used

[11] ECOFIN Council, (2023), "Economic governance review: Council agrees on reform of fiscal rules", Press release, 21st of December.

[12] ECOFIN Council (2024), "Economic governance review: Council and Parliament strike a deal on reform of fiscal rules", Press release, 21st of February.

[13] In this regard, see: Ufficio parlamentare di bilancio (2023), "Audizione nell'ambito dell'esame della "Comunicazione sugli orientamenti per una riforma del quadro di governance economica dell'UE", 1st of March (in Italian); Ufficio parlamentare di bilancio (2023), "Audizione della Presidente dell'Ufficio parlamentare di bilancio nell'ambito dell'esame di Atti dell'Unione europea", 18th of October (in Italian); Ufficio parlamentare di bilancio (2024), "Rapporto sulla Politica di Bilancio", 19th of June (in Italian).

[14] On this subject, see: Network of EU IFIs (2021), "EU fiscal and economic governance review: A contribution from the Independent EU Fiscal Institutions"; Network of EU IFIs (2021), "How to strengthen fiscal surveillance towards a medium-term focus?", Contribution to the EFB Annual Conference, 26th of February; Ufficio parlamentare di bilancio (2019), "Audizione del Consigliere dell'UPB Chiara Goretti nell'ambito dell'attività conoscitiva concernente i risultati della prima attuazione dell'art. 22-bis della L. 196/2009 in materia di programmazione finanziaria e accordi tra ministeri", 13th of March (in Italian); Network of EU IFIs (2018), "Medium-Term Budgetary Frameworks, A contribution to definitions and identification of good practices", 4th of May.

[15] Darvas, Z., Welslau, L. and Zettelmeyer, J. (2023) "A quantitative evaluation of the European Commission´s fiscal governance proposal", Working Paper 16/2023, Bruegel, 18th of September, and Darvas, Z., Welslau, L. and Zettelmeyer, J. (2024), "The implications of the European Union's new fiscal rules", 20th of June.

[16] Gabbriellini, C., Nocella, G. and Padrini, F. (2021) "Assessing Italy's public debt dynamics in the medium term with the PBO framework: Illustrative scenario analysis for the post-Covid period", Nota di lavoro 2/2021, Uffcio parlamentare di bilancio, November.

[17] European Commission (2024), "Debt Sustainability Monitor 2023", European Economy Institutional Paper 271, 22nd of March.

by the European Commission, notably to take better into account the specificities of the Italian economy.[18]

The scenarios, consistent with the final version of the new economic governance framework, are compared with those consistent with the requirements set in the legislative proposals put forward by the European Commission in April 2023. Finally, to assess whether the new EU economic governance framework requires a greater adjustment than the one previously in force, the scenarios consistent with the new framework are compared to the ones that assume the convergence of the structural balance to the medium-term budgetary objective (MTO), in line with one of the main rules of the previous SGP.

The paper is structured as follows. In Section 2 the main features of the new EU economic governance framework are presented in detail, outlining the differences with respect to the legislative proposals by the European Commission and with respect to the structural balance rule of the previous SGP. Section 3 presents the illustrative scenarios for Italy and the main underlying assumptions. Section 4 provides some concluding remarks.

2. The main features of the new EU economic governance framework

2.1 The European economic governance review

On the 30th of April 2024 the new legislative package reforming the SGP entered into force.[19] The package is based on the proposal presented by the European Commission in April 2023, and it is the result of intense negotiations with the Council and the European Parliament. The new fiscal framework aims to strengthen Member States' debt sustainability, while promoting sustainable and inclusive growth through reforms and investments. The multilateral fiscal surveillance is risk-based, as fiscal requirements are differentiated among Member States according to their fiscal situations and sustainability challenges.

The medium-term fiscal structural plan (FSP) is the cornerstone of the new framework. In the national FSP Member States set out their fiscal targets, priority reforms and

[18] As an example, the PBO analyses use the fiscal multipliers of MeMo-It, i.e. the macro-econometric model used in the endorsement of the official forecast, rather than the multiplier commonly used by the European Commission.

[19] The package is composed of Regulation (EU) 2024/1263 of the European Parliament and of the Council on the effective coordination of economic policies and on multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97; Council Regulation (EU) 2024/1264 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure; Council Directive (EU) 2024/1265 amending Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.

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investments. The FSP covers a period of four or five years, depending on the regular length of the legislative term of the Member State concerned.[20]

Member States with a public debt exceeding 60 percent of GDP or a government deficit exceeding 3 percent of GDP are required to put debt on a plausible downward path or maintain it at prudent levels, and to bring and maintain the deficit below 3 per cent of GDP over the medium-term. The adjustment period should last four years, with a possible extension to a maximum of seven years if the Member State underpins its national FSP with a set of reforms and investments that are growth-enhancing, support fiscal sustainability, address the common priorities of the Union and respond to the relevant country-specific recommendations under the European Semester, as well as the country-specific investment priorities.[21]

The design of the fiscal adjustment should also be consistent with two common safeguards: the debt sustainability safeguard and the deficit resilience safeguard. The former one requires for the projected debt-to-GDP ratio to decrease by a minimum annual average of 1 percentage point as long as the debt-to-GDP ratio exceeds 90 percent (or 0.5 percentage points if the debt-to-GDP ratio falls between 90 and 60 percent).[22] The average decrease is computed from the year before the start of the reference trajectory or the year in which the excessive deficit procedure (EDP) is projected to be abrogated, until the end of the adjustment period. The deficit resilience safeguard requires the fiscal adjustment to continue until the structural deficit falls to a level of 1.5 percent of GDP, thus providing a common resilience margin relative to the deficit reference value of 3 percent of GDP.[23] Indeed, the common resilience margin should ensure the build-up of fiscal buffers to manage adverse shocks. The annual improvement in the structural primary balance to achieve the required margin is equal to 0.4 percentage points of GDP, reduced to 0.25 percentage points of GDP in the case of an extension of the adjustment period to 7 years.

To Member States with debt above 60 per cent of GDP and/or a deficit above the reference value of 3 per cent of GDP, the European Commission transmits a reference trajectory covering an adjustment period of four years with a possible extension of up to three years.[24] The reference trajectory provides guidance to Member States in preparing their national FSPs and setting out their fiscal adjustment path. The reference trajectory

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[20] The deadline for submitting the first national FSPs to the European Commission is the 20th of September 2024, unless the Member State and the European Commission agree to extend that deadline by a reasonable period, as stated in the European Semester Spring Package published by the European Commission on the 19th of June 2024.

[21] When a Member State requests an extension of the adjustment period, the national fiscal targets should also ensure that the level of nationally-financed public investment over the period of the plan is not lower than the medium-term level before the start of the plan, considering the scope and scale of the country-specific challenges.

[22] The debt sustainability safeguard is defined in Article 7 of Regulation (EU) 2024/1263.

[23] The deficit resilience safeguard is defined in Article 8 of Regulation (EU) 2024/1263.

[24] Member State with government debt not exceeding 60 per cent of GDP and government deficit not exceeding 3 per cent of GDP might request fiscal guidance from the European Commission in the form of technical information. This will also ensure that fiscal targets are coherent with the deficit resilience margin.

complies ex ante with the debt sustainability safeguard and the deficit resilience safeguard (see Section 3.2).

The new fiscal framework is based on a single operational indicator anchored in the DSA, i.e. net nationally financed primary expenditure.[25] This indicator is used to set out the expenditure path and to carry out annual fiscal surveillance by EU institutions. After the European Commission assesses whether the national FSP presented by the Member State complies with the new SGP, the Council adopts a recommendation setting out the net expenditure path the Member State concerned should follow during the period covered by the FSP. The fiscal adjustment set out in the national FSP should be coherent with the corrective net expenditure path recommended by the Council in case an EDP is projected to be or has already been launched.

The reform of the SGP has changed the launch of a debt-based EDP. In particular, the debt-based EDP is now triggered by observed deviations from the net expenditure path, which exceed the annual or cumulative thresholds established in the Regulation.[26] The rules of the deficit-based EDP remain unchanged, requiring a minimum annual structural improvement of at least 0.5 per cent of GDP as a benchmark. However, during the transition period from 2025 to 2027, when proposing a corrective path for the first planning cycle, the European Commission will adjust such a benchmark to take into account the increase in interest payments compared to the period before the plan.

2.2 The original proposal by the European Commission

The new preventive arm of the SGP is based on the legislative proposal to reform the EU economic governance framework,[27] presented by the European Commission on the 23rd of April 2023. The legislative negotiations that followed with the Council of the EU and the European Parliament confirmed many of the key features of that proposal, notably the risk-based surveillance framework and the medium-term approach to national planning, while strengthening the requirements for the fiscal adjustment path. First of all, the original European Commission proposal did not include the deficit resilience safeguard. Indeed, Member States were required to ensure that the budget balance at the end of the adjustment period was sufficient for the government deficit to remain durably below the 3 percent of GDP threshold, taking in due consideration the evolution of the costs of ageing or unfavourable interest-growth differentials. Secondly, the original proposal required the public debt ratio at the end of the planning horizon to be below the

[25] The reference expenditure aggregate is computed as follows: government expenditure net of interest expenditure, discretionary revenue measures, one-offs and other temporary measures, expenditure on Union programmes fully matched by revenue from Union funds, national expenditure on co-financing of programmes funded by the Union, as well as cyclical elements of unemployment benefit expenditure.

[26] As stated in Article 2, par.2 of Regulation (EU) 2024/1264.

[27] European Commission (2023), "Proposal for a regulation of the European Parliament and of the Council on the effective coordination of economic policies and multilateral budgetary surveillance and repealing Council Regulation (EC) No 1466/97", 26th of April .

ratio recorded the year before the start of the fiscal adjustment. This requirement was, in general, made stricter by the Council through the introduction of the debt sustainability safeguard with the aim of improving the predictability of the new fiscal framework.[28]

2.3 A comparison with the preventive arm of the previous SGP

The preventive arm of the SGP[29] defines a multilateral surveillance procedure aiming for a closer coordination of economic policies and a sustained convergence of the economic performance of Member States. Under the previous Regulations, compliance with the preventive arm was assessed on the basis of two pillars: the convergence of the structural balance to the MTO, and the expenditure benchmark.[30] Before the reform, the preventive arm required Member States to attain a country-specific MTO.[31] The MTO aimed at: *(i)* providing a country-specific safety margin with respect to the deficit reference value of 3 percent of GDP, which consisted in a minimum benchmark taking into account past output volatility and budgetary sensitivity to output fluctuations; *(ii)* ensuring sustainability or rapid progress towards it, through the convergence to prudent levels of debt ratios, with due consideration to the impact of ageing populations; *(iii)* allowing room for budgetary manoeuvre, in particular for the needs for public investment. Following these criteria, every three years the European Commission revised the country-specific MTOs. Since 2005 the MTO was defined as the cyclically-adjusted general government balance net of one-off and other temporary measures.

For Member States that did not reach their MTO, the Council recommended country-specific adjustments set on an annual basis in terms of changes in the structural balance and the expenditure benchmark. The annual adjustment to the structural balance was specified by the so-called matrix of requirements,[32] where the fiscal effort was calibrated on the economic cycle, the debt level and the sustainability risks of each Member State

[28] There is a requirement for the technical trajectory that was removed from the original proposal: the growth rate of net nationally financed expenditure was required to remain below medium-term output growth, on average, as a rule over the horizon of the plan.

[29] Based on Article 121 of the Treaty on the Functioning of the European Union.

[30] The expenditure benchmark was introduced with the Six Pack in 2011 as a tool in order to help reach and maintain the MTO. The expenditure benchmark set a cap on the annual growth rate of net government expenditure, which should not exceed the medium-term potential growth rate, unless the excess is matched by additional discretionary revenue measures. For Member States that did not reach their MTO, the expenditure benchmark took into account the convergence margin, i.e. the additional impact on expenditure growth in line with the effort necessary to pursue the structural adjustment towards the MTO.

[31] The legal basis for the MTO is Article 2a of Regulation (EC) 1466/97. For euro-area and Exchange Rate Mechanism (ERM2) Member States the MTO corresponds to a ceiling of at least -1 percent of GDP. Contracting Parties of the TSCG agreed to set the MTO to a ceiling of at least -0.5 percent of GDP, unless their debt ratio was significantly below 60 percent of GDP and long-term sustainability risks were low. In those cases, the lower limit was -1 percent of GDP. For more details, see: European Commission (2019), "Vade mecum on the Stability and Growth Pact – 2019 edition", Institutional Paper n.101, European Commission, April.

[32] ECOFIN Council (2017), "Revised Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes (Code of Conduct of the Stability and Growth Pact)", 18th of May.

(see Section 3.4). In particular, the matrix distinguished between larger fiscal efforts to be undertaken during good times and smaller fiscal efforts to be undertaken during bad times, requiring larger adjustments from Member States with unfavourable fiscal positions. In normal times, Member States with debt above 60 percent of GDP had to pursue an annual structural adjustment of more than 0.5 percentage points of GDP as a benchmark.

3. Illustrative simulations of the fiscal implications for Italy

3.1 The analytical framework underpinning the new economic governance

As described above, the new regulation foresees that, before Member States present their national FSPs, the European Commission will submit country-specific reference trajectories to countries with public debt above 60 per cent of GDP or with a general government deficit above 3 per cent of GDP. These trajectories describe the evolution of fiscal and macroeconomic variables that guarantee a plausible reduction of the debt-to-GDP ratio over the medium-term. The reference trajectory provides a 4-year fiscal adjustment path described in terms of net nationally financed primary expenditure, which can be extended up to 7 years with a commitment to implement structural reforms and public investments. To determine the reference trajectory that puts the debt-to-GDP ratio on a plausibly downward path, the European Commission will use the DSA methodology developed in the past for its annual fiscal surveillance under the European semester and now adjusted for the new EU economic governance framework.[33]

The reference trajectory ensures that, without further fiscal efforts, three criteria are met: *(i)* by the end of the adjustment period at the latest, and over the 10 following years, debt declines or stays below 60 percent of GDP both in the adjustment scenario and under all three deterministic stress tests; *(ii)* in the 5 years following the adjustment period, debt declines with a sufficiently high probability, i.e. at least 70 percent; *(iii)* the deficit is brought and remains below 3 percent of GDP over the 10 following years.

The fiscal adjustment should be sufficient to ensure that debt plausibly declines also under more adverse macroeconomic and financial circumstances than assumed in the baseline scenario. Therefore, three deterministic stress tests are applied: *(i)* "Lower SPB" where the structural primary balance is assumed to be reduced by 0.25 pp. a year for the first two years, and to remain at that level afterwards, plus changes in the costs of ageing; *(ii)* "Adverse r-g", where the interest-growth differential is permanently increased by 1 pp. over the projection horizon; and *(iii)* "Financial stress", where market interest rates are assumed to temporarily increase for one year by 1 pp. plus a risk premium for high-debt countries. The three stress tests apply from the first year after the end of the

[33] For further information on the DSA methodology used by the European Commission, see European Commission (2024), "Debt Sustainability Monitor 2023", Institutional Paper 271, 22nd of March.

adjustment period. Moreover, the DSA methodology includes also stochastic simulations after the adjustment path, with 10,000 shocks affecting the governments' budgetary positions, economic growth, interest rates and exchange rates. These shocks are generated based on the historical distribution of shocks in each country.

Finally, the reference trajectory should satisfy the two safeguards on debt sustainability and deficit resilience. This implies that the average annual reduction of the projected debt-to-GDP ratio should be of at least 1 percentage point (calculated during the period of adjustment or from the year in which the EDP is expected to be abrogated to the last year of adjustment) and that consolidation continues until the structural deficit falls to 1.5 per cent of GDP, with annual improvements of the structural primary balance of 0.4 percentage points with a 4-year adjustment or 0.25 percentage points of GDP with a 7-year adjustment.

For the first FSPs, the adjustment starts in 2025, taking the fiscal position in 2024 as the initial level. During the adjustment period, the reference trajectory assumes a fiscal consolidation path that is basically linear, though there may be some deviations from such a linear rule as a result of some exceptions in place for the first round of FSPs and in the case of adjustments required by EDPs. Beyond the adjustment period, primary expenditure is maintained constant except for changes in the costs of ageing, as projected in the 2024 Ageing Report,[34] while revenue remains broadly stable as a share of GDP.

3.2 The macro-financial assumptions of the deterministic scenarios

Based on the methodology developed by the PBO,[35] we simulate different medium-term scenarios, that describe the evolution of public debt and of the main public finance variables, broadly in line with the approach defined in the legislative regulations on the new EU economic governance framework. This allows us to draw some preliminary conclusions on the fiscal effort that will be required by Italy, by comparing the initial legislative proposals by the European Commission of April 2023 with the version of the legislation that entered into force in 2024. In addition, we show the fiscal adjustment under the previous structural balance rule, which foresees the convergence to the MTO.

The starting point to construct the reference trajectories is the development of two no-policy-change scenarios to project the debt-to-GDP ratio up to the year 2041. To this end, we consider the macroeconomic forecasts and sensitivity analyses for public finances for the years 2024-27 developed by the PBO for the assessment of the 2024 Economic and

[34] European Commission (2024), "2024 Ageing Report: Economic and Budgetary Projections for the EU Member States (2022-2070)", Institutional Paper 279, 18th of April.
[35] See Ufficio parlamentare di bilancio, (2023), "Rapporto sulla politica di bilancio", June (in Italian).

Financial Document (EFD).[36] These are modified to consider a no-policy-change forecast from 2025, assuming no discretionary fiscal adjustment until the end of the projection horizon, compared to 2024. This implies a constant structural primary balance from 2025 to the end of the forecast period, which remains at the same level estimated for 2024.

The DSA requires assumptions on the macro-financial variables that influence the dynamics of the debt-to-GDP ratio in the medium-term. Regarding the evolution of potential GDP, we assume that it follows a trend trajectory. Since estimates of potential GDP are subject to high volatility and instability, especially in the current economic environment, characterised by the possibility of a reversal of the cycle or by unusual dynamics of GDP caused by extraordinary events (such as uncertainty over the structural impact of the pandemic and energy crises, which had unfavourable consequences on the economy, and, on the other hand, the effects of investments and reforms planned in the National Recovery and Resilience Plan (NRRP), which, instead, should have favourable impacts).

Therefore, for the medium-term evolution of potential GDP, we assume it follows a trend, based on two alternative scenarios (Figure 1):

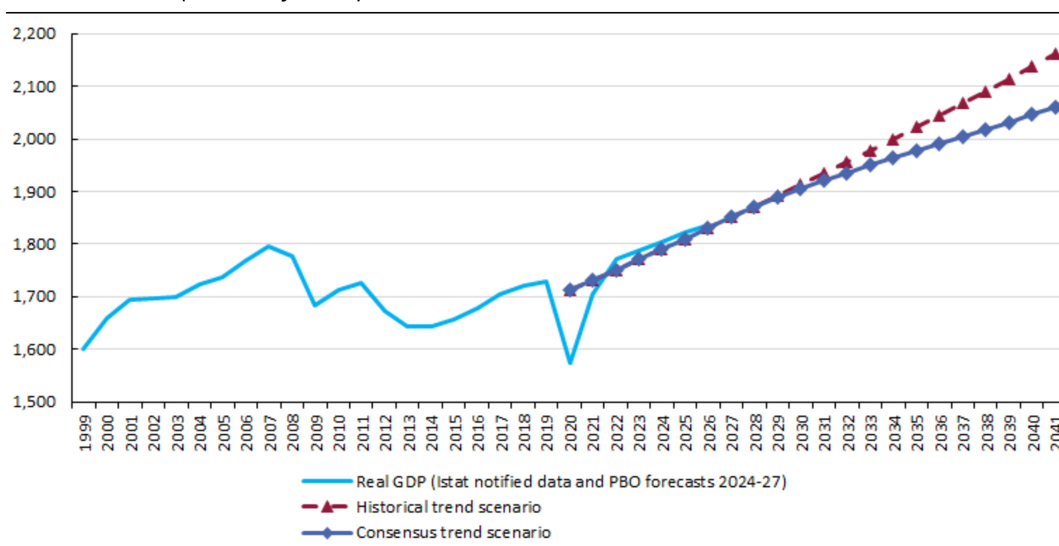
- the historical trend scenario, in which potential GDP evolves over the entire projection period following a linear path determined by the average GDP growth observed in the years 2014-19, which was the expansionary phase before the Covid-19 pandemic, equal to 1.1 per cent. However, under the conservative assumption that the measures adopted by the government contributed only partially to avoid the structural deterioration of the economy, we assume that the level of potential GDP is permanently below the average values observed in 2014-19 by around 2.4 percentage points. This value corresponds approximately to the average annual GDP loss shown after the crisis of 2008-13.

- the Consensus trend scenario, in which we assume that until 2027 the level of potential GDP is identical to that of the baseline scenario, after which, from 2028 its growth rate converges in 6 years to a lower trend value of 0.7 per cent. This value is consistent with recent estimates of medium-term growth for Italy developed by Consensus Forecast.[37]

[36] See Section 3.2.2 in Ufficio parlamentare di bilancio, (2024), "Audizione della Presidente dell'Ufficio parlamentare di bilancio nell'ambito dell'attività conoscitiva preliminare all'esame del Documento di economia e finanza 2024", 22nd of April (in Italian).

[37] See Consensus Forecasts (2024), "G7 & Western Europe Long-Term Consensus Forecast Datafile", 8th of April.

Figure 1 – Evolution of the level of potential or trend GDP in alternative scenarios
(billions of euros)



Source: PBO calculations based on the 2024 Stability Programme (SP) and Istat.

The evolution of real GDP from 2028 to 2033 in each scenario is based on the additional assumption of a gradual and linear closing of the output gap estimated for 2027 in 6 years. In subsequent years, real GDP grows in line with its potential.[38]

In detail, for the period 2028-41 we assume: a) a gradual convergence in 6 years of the GDP deflator growth rate to the ECB inflation rate target of 2 per cent which is then held constant from 2033 until 2041; b) a gradual convergence in 6 years of the weighted average of interest rates at issuance to 1.9 per cent for short-term government bonds (with a maturity equal to or lower than 1 year) and to 3.5 per cent for long-term bonds (these values are equal to their respective medians during the period 1999-2023), which are then assumed to be constant from 2033 to 2041;[39] c) a value for the stock-flow adjustments, in each year, equal to the median value recorded between 1999 and 2023 (0.3 per cent of GDP).

[38] Other assumptions are described in Gabbriellini, C., Nocella, G., and Padrini, F. (2021), "Assessing Italy's public debt dynamics in the medium term with the PBO framework: Illustrative scenario analysis for the post-Covid period", Nota di lavoro 2/2021, Ufficio parlamentare di bilancio, November.

[39] In the approach adopted by the European Commission, market interest rates and inflation rates are assumed to converge over a 10-year horizon to country specific values reflecting financial market expectations. Beyond this horizon, they further converge over a longer horizon to common values in line with the latest Ageing Report for interest rates and with the monetary policy targets for inflation. According to the Fiscal Sustainability Report 2021, market expectations for interest rates in the medium-term are approximated by the Bloomberg forward rates relative to the 3-month interbank rate for short-term rates and relative to the 10 year sovereign bond rate for long-term rates. Regarding market expectations for the determination of the medium-term inflation rate, the European Commission, in line with the approach adopted by the ECB, uses information from swap contracts for inflation-indexed securities. According to the Debt Sustainability Monitor 2023, beyond t+10, the short-term and long-term interest rates identified on the basis of market expectations converge in t+30 to 2 and 4 per cent respectively. Similarly, beyond t+10, the inflation rate converges to the ECB inflation target of 2 per cent in t+30.

Finally, in a no-policy-change projection from 2025, we assume that the structural primary balance remains constant at its level in 2024 for the whole forecast horizon, net of the costs of ageing. To determine the primary balance needed for computing the net expenditure growth and the evolution of the debt-to-GDP ratio over the medium-term, we add the cyclical component of the budget balance, derived as the output gap multiplied by the semi-elasticity of the budget balance to economic growth estimated by the European Commission, which for Italy is equal to 0.54. Furthermore, we also add the change in age-related expenditure (net of taxation on pensions and property income) published in the 2024 Ageing Report,[40] prepared by the European Commission in cooperation with the Ageing Working Group.[41]

3.3 Illustrative simulations for Italy

For each of the two no-policy-change scenarios, we simulate stylized adjustment paths which are consistent with the new European economic governance framework described in Section 2.1. Starting from 2025, the first path assumes a multiannual adjustment lasting 4 years and ending in 2028, whereas the second one assumes a 7-year adjustment path ending in 2031.

In the historical trend scenario, the annual adjustment in the structural primary balance consistent with the requirements of the new economic governance framework over the 4-year period 2025-28 is estimated at 0.95 percentage points of GDP. This adjustment allows to comply with the debt sustainability safeguard, which in 2028, following the abrogation of the EDP foreseen for 2027, implies a decrease in debt of 1.8 percentage points of GDP. Furthermore, the deficit resilience safeguard is activated in 2029 and again in 2032, requiring further annual adjustments of 0.4 percentage points of GDP, to allow the structural deficit to fall to a level no higher than 1.5 per cent of GDP, respectively in 2030 and in 2033.

Instead, with a 7-year adjustment in the historical trend scenario, the annual improvement in the structural primary balance consistent with the requirements of the new economic governance framework is estimated at approximately 0.5 percentage points of GDP in each year of the 2025-2031 period.[42] This adjustment allows to comply with the debt sustainability safeguard, which in the period 2030-31, following the abrogation of the EDP foreseen for 2029, implies an annual decrease in debt, on average, of approximately 1.4 percentage points of GDP. Furthermore, the deficit resilience

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[40] European Commission (2024), "The 2024 Ageing Report", Institutional Paper n. 279, 18th of April.

[41] For the no-policy-change assumption, the change in age-related expenditures is computed taking 2024 as the initial year. Instead, for the 4-year or 7-year fiscal adjustment paths, the change in age-related expenditures is computed starting from the final year of the adjustment period.

[42] With the exception of 2028, where the adjustment in the structural primary balance is equal to 0.63 percentage points of GDP, to allow an improvement in the structural balance of 0.5 percentage points of GDP, as required by the EDP in the corrective arm of the SGP.

safeguard is activated in the three-year period 2032-34, requiring a further annual adjustment of 0.25 percentage points of GDP, to allow the structural deficit to fall to a level no higher than 1.5 per cent percent of GDP in 2035.

In the Consensus trend scenario, the annual adjustment in the structural primary balance consistent with the requirements of the new economic governance framework over a 4-year period is estimated at 1.1 percentage points of GDP each year in the 2025-2028 period. This adjustment allows to comply with the debt sustainability safeguard, which, on average, in the period 2027-2028, following the abrogation of the EDP foreseen for 2026, implies an annual decrease in debt of 1 percentage point of GDP. In this scenario, the deficit resilience safeguard is not activated.

Instead, in the Consensus trend scenario with a 7-year adjustment path, the annual improvement in the structural primary balance consistent with the requirements of the new economic governance framework is equal to 0.6 percentage points of GDP in each year of the 2025-2031 period. In this scenario, the excessive deficit procedure is abrogated in 2028. The debt sustainability safeguard is satisfied, with an average reduction in the debt-to-GDP ratio of 1.2 percentage points over the period 2029 to 2031. Following a structural deficit above the 1.5 percent of GDP threshold in 2034, due to an increase in the costs of ageing, the deficit resilience safeguard is activated in 2035, requiring a further adjustment in the structural primary balance of 0.25 percentage points of GDP.

In the simulations with a fiscal adjustment over 4 or 7 years, the use of dynamic fiscal multipliers, estimated for the Italian economy using the macroeconomic forecasting model MeMo-It managed by the PBO, allows to redetermine the dynamics of real GDP by including the contractionary effects on real GDP growth of multiannual measures of budget consolidation, compared to the no-policy-change scenarios, further widening the cyclical component of the budget balance, in case of negative output gaps.[43]

In the no-policy-change scenarios, the public debt-to-GDP ratio increases from 2026, reaching, in the historical trend scenario, a level of around 178 per cent of GDP in 2041, 40 percentage points higher than in 2024, at the beginning of the simulation. In the Consensus trend scenario, public debt increases even more, to a level of 186 per cent of GDP in 2041, 8 percentage points higher compared to the historical trend scenario. These dynamics are the result of the technical assumptions of no fiscal adjustment and of the change in the costs of ageing, namely the costs related to pensions, healthcare and long-term care (net of taxation on pensions and property income).

In the simulations with multiannual fiscal adjustments, the debt-to-GDP ratio follows a continuously decreasing path. Overall, the 4-year adjustment path allows to reduce the

[43] In line with the assumptions used by the European Commission, we assume that the output gap closes after the fiscal adjustment. In our projections, we assume that it closes in the 6 years following the last year of budget consolidation.

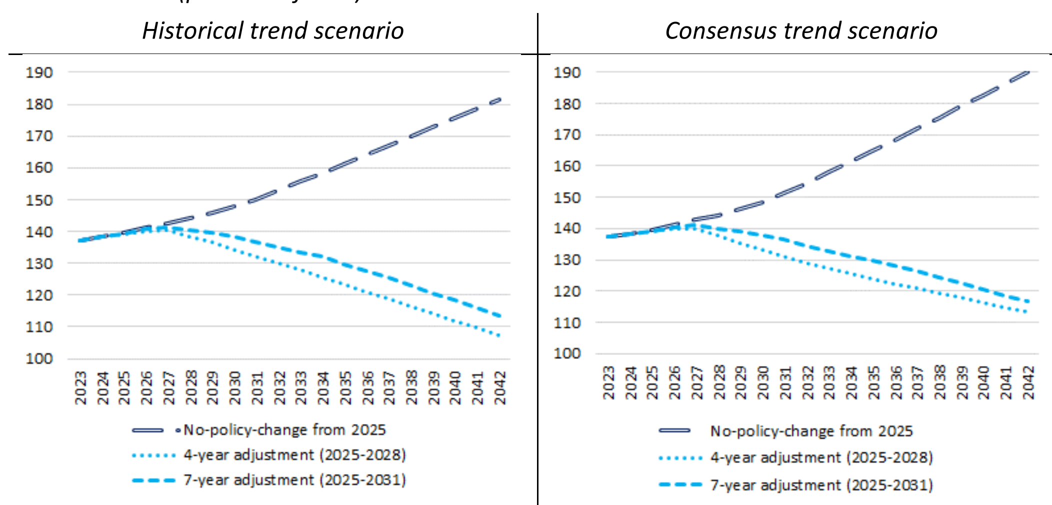
debt ratio more than the 7-year adjustment path, mainly thanks to a faster reduction in interest expenditure as a percentage of GDP (Figure 2).

In the historical trend scenario, at the end of the projection horizon (2041), the level of public debt falls slightly below 110 per cent of GDP, diminishing by 28 percentage points, with a 4-year adjustment, and to 116 per cent, decreasing by 22 percentage points, with a 7-year adjustment. In the Consensus trend scenario, with a 4-year adjustment the debt-to-GDP ratio falls to around 115 per cent by 2041, while with a 7-year adjustment it falls to 118.5 per cent at the end of the projection horizon (2041).

To obtain the reduction in the debt-to-GDP ratio observed in the historical trend scenario with fiscal adjustments, the general government deficit reaches a level of 1.9 per cent of GDP at the end of the 4-year adjustment (2028) and a level of 2.1 per cent of GDP at the end of the 7-year adjustment (2031, Figure 3). The general government deficit falls below the 3 per cent threshold from 2027 with a 4-year adjustment path and from 2029 with a 7-year adjustment path. Notice that, after a 4-year adjustment, a further adjustment of 0.4 percentage points of GDP in the structural primary balance is required in 2029 and in 2032, activated by the deficit resilience safeguard, because the structural deficit increases above the 1.5 per cent of GDP threshold in the previous years. Likewise, after a 7-year adjustment, further consolidation, amounting to an annual reduction in the structural primary balance of 0.25 percentage points of GDP, is required in the period 2032-34 to comply with the deficit resilience safeguard, to lower the structural deficit to 1.5 per cent of GDP.

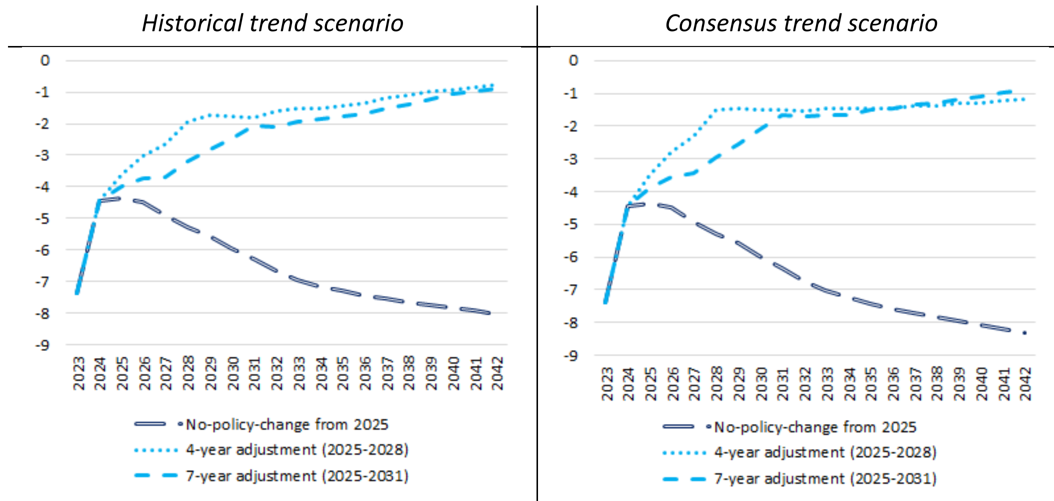
In the Consensus trend scenario, the general government deficit reaches a level of 1.5 per cent of GDP at the end of a 4-year adjustment, while it reaches a level of 1.7 per cent of GDP at the end of a 7-year adjustment. In this scenario, the general government deficit falls below the 3 per cent of GDP threshold from 2026 with a 4-year adjustment and from 2028 with a 7-year adjustment.

Figure 2 – Evolution of public debt
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

Figure 3 – Evolution of the general government balance
(per cent of GDP)



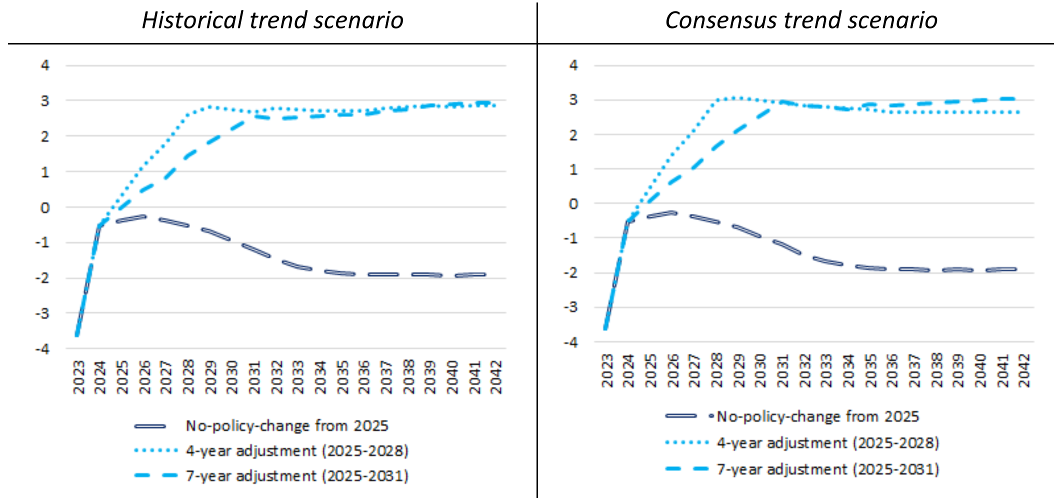
Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

Notice that after a 7-year adjustment in the Consensus trend scenario, there is a further adjustment of 0.25 percentage points in the structural primary balance in 2035, because the deficit resilience safeguard is activated by an increase in the structural deficit above the 1.5 per cent of GDP threshold in the previous year. In both scenarios, the general government balance in the no-policy-change scenario deteriorates markedly, reaching a deficit of around 8 per cent of GDP at the end of the projection period (2041).

In the historical trend scenario, the primary balance reaches a level of 2.6 per cent of GDP both in 2028, at the end of a 4-year adjustment, and in 2031, at the end of a 7-year adjustment (Figure 4). In the Consensus trend scenario, the change in the primary balance needs to be even greater. Budget consolidation allows to achieve a primary surplus of 3 per cent of GDP both in 2028, after a 4-year adjustment, and in 2031, after a 7-year adjustment. On the contrary, with a no-policy-change assumption, after reaching a primary deficit of 0.3 per cent of GDP in 2026, the primary balance deteriorates considerably over time reaching a primary deficit of 1.9 per cent of GDP in 2041 in both scenarios.

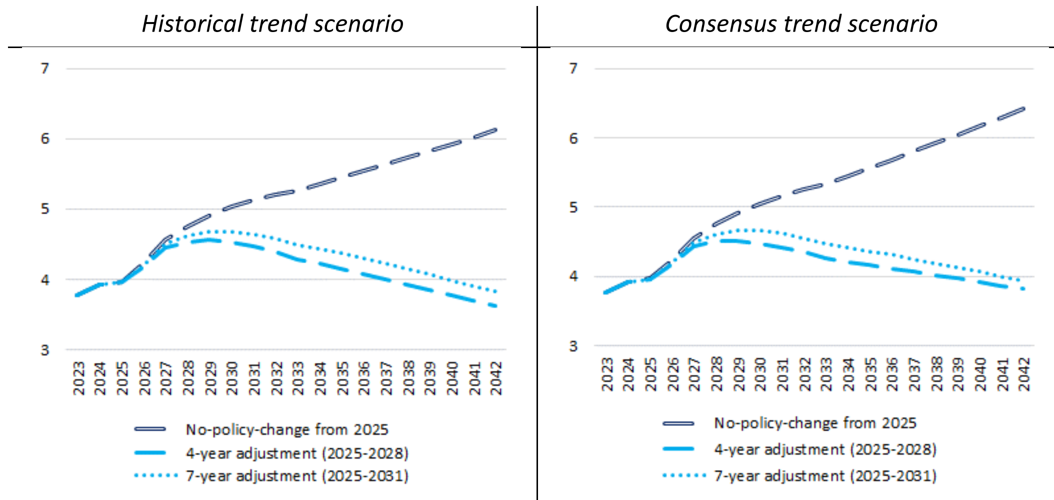
In the historical trend scenario, interest expenditure reaches a peak of 4.6 per cent of GDP in 2029, with a 4-year adjustment, and a peak of 4.7 per cent of GDP in 2030, with a 7-year adjustment (Figure 5). Subsequently, given the assumption of constant yields on short-and long-term debt, the ratio of interest expenditure-to-GDP decreases steadily in both scenarios, as a consequence of the gradual reduction in the stock of debt. On the contrary, under a no-policy-change assumption, interest expenditure increases over time until it reaches a level of 6 per cent of GDP at the end of the simulation horizon (2041). A similar pattern is shown in the Consensus trend scenario, where interest expenditure also reaches a peak of 4.5 per cent of GDP in 2028, with a 4-year adjustment, and a peak of 4.7 per cent of GDP in 2030, with a 7-year adjustment, while, under a no-policy-change assumption, it increases over time until reaching 6.3 per cent of GDP at the end of the simulation horizon (2041).

Figure 4 – Evolution of the primary balance
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

Figure 5 – Evolution of interest expenditure
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

In the historical trend scenario, the structural deficit, starting from 4.9 per cent of GDP in 2024, falls below the 1.5 per cent of GDP threshold in 2029, one year after the end of the 4-year adjustment, thanks to the additional consolidation effort required by the activation of the deficit resilience safeguard. Due to the increase in age-related expenditure, the structural deficit rises again slightly above the 1.5 per cent threshold in 2031, spurring an additional structural adjustment in 2032, activated by the deficit resilience safeguard. In the following years, the structural deficit fluctuates around a level of 1.1 per cent of GDP until 2038, when the output gap closes. In the last three years of the projection period, the structural deficit decreases to 0.9 per cent of GDP in 2041, thanks to the favorable impact of the change in age-related expenditure. With a 7-year adjustment in the

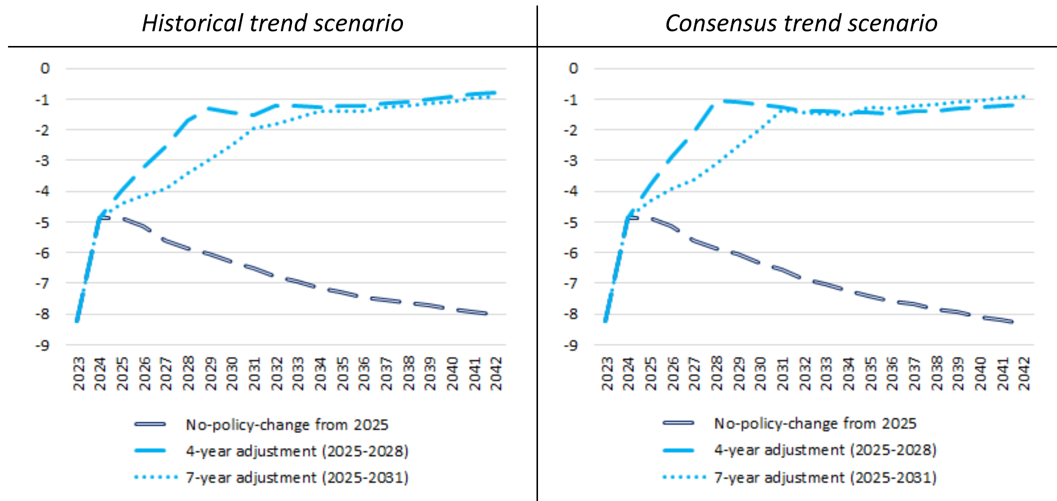
historical trend scenario, the structural deficit falls below the 1.5 per cent of GDP threshold in 2034, three years after the end of the 7-year adjustment, thanks to the additional annual consolidation effort of 0.25 percentage points of GDP, required by the activation of the deficit resilience safeguard, and remains below the threshold from then on (Figure 6), reaching, after the closing of the output gap in 2040, a level of 0.9 per cent of GDP at the end of the projection period (2041).

In the Consensus trend scenario, the structural deficit falls below the 1.5 per cent of GDP threshold in 2028, at the end of a 4-year adjustment, and stays below such threshold for the remaining years of the projection period. In 2041, the structural deficit reaches 1.2 per cent of GDP. With a 7-year adjustment in the Consensus trend scenario, the structural deficit falls below the 1.5 per cent of GDP threshold in 2031 and, with the exception of 2034, spurring an additional structural adjustment in 2035, activated by the deficit resilience safeguard, remains below the threshold for the remaining years of the simulation period. In 2041, the structural deficit reaches 1 per cent of GDP. Under the no-policy-change assumption, the structural deficit deteriorates constantly due to the impact of the increase in age-related costs. At the end of the simulation period (2041), the structural deficit reaches a level that is close to 8 per cent in both historical and Consensus trend scenarios.

In the historical trend scenario, the structural primary balance, starting from a deficit of 0.9 per cent of GDP in 2024, reaches a surplus of 2.8 per cent of GDP in 2028, at the end of the 4-year adjustment period. In 2029, as the impact of the change in age-related expenditure kicks in, the structural primary balance reaches a surplus of 3.2 per cent of GDP, due to the activation of the deficit resilience safeguard, which requires a further adjustment of 0.25 percentage points of GDP, to ensure that the structural deficit falls below the 1.5 per cent of GDP threshold. Afterwards, the structural primary surplus fluctuates around 3 per cent of GDP until the end of the projection period, thanks to the constant age-related expenditure. With a 7-year adjustment, the structural primary balance reaches a surplus of 2.7 per cent of GDP in 2031. In the following three years the adjustment continues, due to the activation of the deficit resilience safeguard, which requires further consolidation efforts of 0.25 percentage points per year, to ensure that the structural deficit falls below the 1.5 per cent of GDP threshold. In 2034, the structural primary surplus peaks at 3 per cent of GDP and remains constant in the following years (Figure 7).

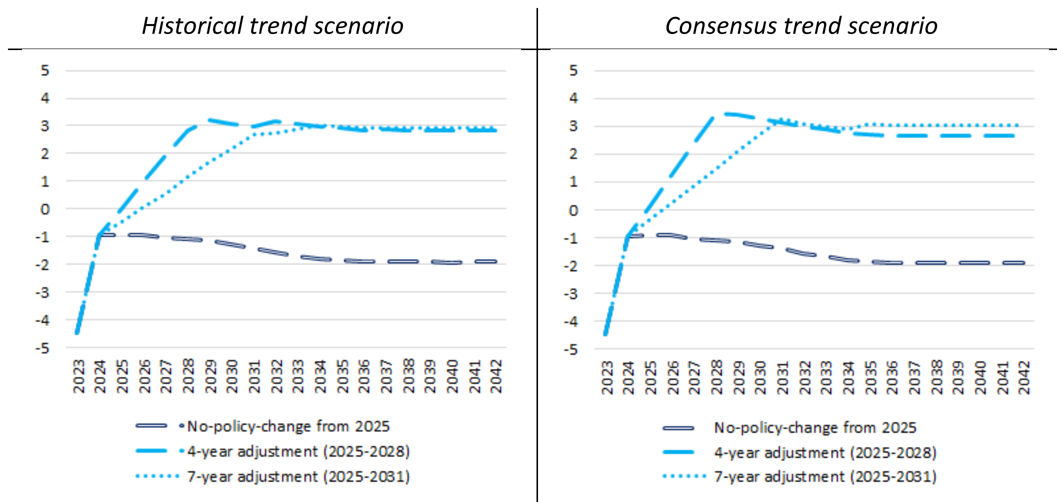
In the Consensus trend scenario, the structural primary balance, from a deficit of 0.9 per cent of GDP in 2024, peaks in 2028 at a surplus of 3.5 per cent of GDP, at the end of a 4-year adjustment. Afterwards, it gradually declines to 2.7 per cent of GDP in 2041. With a 7-year adjustment, the structural primary balance peaks in 2031, at the end of a 7-year adjustment period, at a surplus of 3.3 per cent of GDP. In the following years, it declines gradually to 2.7 per cent of GDP in 2041. Instead, with a no-policy-change assumption, the structural primary deficit, starting at 0.9 per cent of GDP in 2024, deteriorates steadily until reaching a level of 2 per cent of GDP in 2036, maintained constant in the following years.

Figure 6 – Evolution of the structural balance
(per cent of potential GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

Figure 7 – Evolution of the structural primary balance
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

In line with the technical specifications published by the European Commission,[44] we ran a series of stress tests to verify that in the reference trajectories public debt continues to fall even in the case of adverse shocks after the end of the adjustment period. These stress tests consider three alternative deterministic simulations and a stochastic simulation.

In more detail, we ran the following deterministic simulations:[45]

[44] See European Commission (2024), "Debt Sustainability Monitor 2023", Institutional Paper 271, 22nd of March.
[45] In these simulations, the stress tests do not include the activation of the deficit benchmark (EDP) or the deficit resilience safeguard, in line with the Debt Sustainability Monitor 2023.

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1. An increase of 1 percentage point in the snowball effect, namely the difference between the average cost of debt and the GDP growth rate. This is simulated assuming, from the year following the end of the adjustment period, a permanent reduction in (real and potential) GDP growth of 0.5 percentage points, compared to the no-policy-change assumption, and an increase in market interest rates of 0.5 percentage points.

2. A temporary increase, limited to the year following the end of the adjustment period, in market interest rates of 100 basis points, plus a risk premium[46] which is activated only for countries with debt above 90 per cent of GDP. In the case of Italy, these assumptions imply a temporary increase in market interest rates of 4 percentage points only for the year following the end of the adjustment period.

3. A permanent deterioration in the structural primary balance of 0.5 percentage points over the two years following the end of the adjustment period (namely 0.25 percentage points a year).[47] In the following years, the structural primary balance remains constant and changes only to account for the variation of the costs of ageing.

In both the historical and the Consensus trend scenarios, the adjustment over 4 or 7 years contributes to guarantee that the dynamics of the debt-to-GDP ratio follow a decreasing or stable trajectory, even following shocks to market interest rates, to GDP growth and to the structural primary balance (Figures 8 and 9). In all scenarios, the temporary increase in market interest rates of 4 percentage points determines a trajectory which is only temporarily higher than the other ones, while in the simulation with an increase in the difference between interest rates and GDP growth the debt level stabilizes in the medium-term at a level between 130 and 135 per cent of GDP.

The plausibility of a decreasing government debt trajectory after a multiannual adjustment is also evaluated through stochastic simulations.[48] This procedure allows to judge whether the probability that debt is put on a decreasing path is high enough (Figures 10 and 11). Notice how, in all the scenarios, the debt-to-GDP ratio shows a tendency to decline with high probability after the adjustment period. In particular, the fifth year after the end of the adjustment period, namely in 2033 with a 4-year adjustment path and in 2036 with a 7-year adjustment path, the probability that the debt-to-GDP ratio is lower compared to the last year of adjustment (respectively 2028 and 2031) is higher than 70

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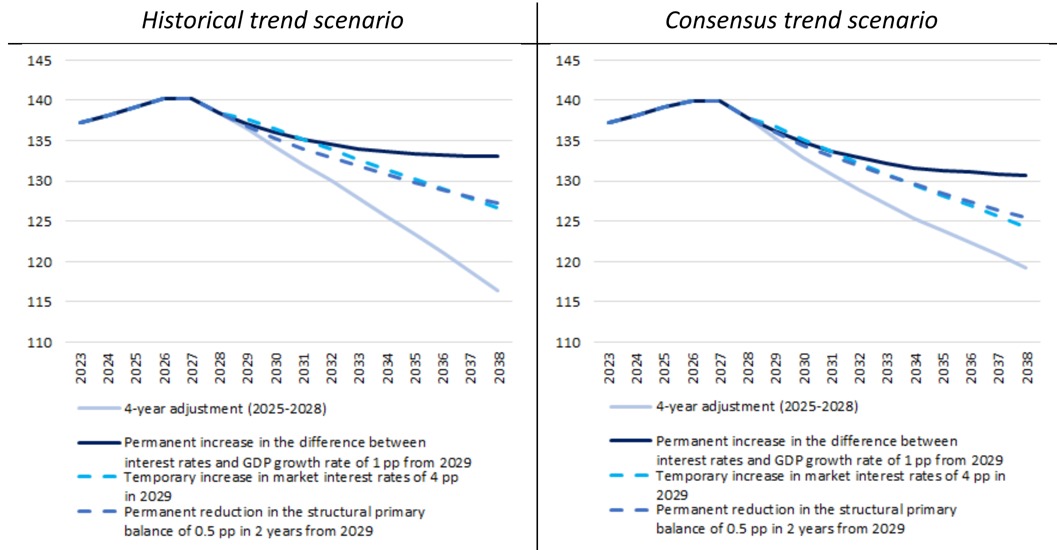
[46] The risk premium is calculated by multiplying the differential between the debt-to-GDP ratio in 2023 and the 90 per cent threshold by a parameter equal to 0.06. For more details see Pamies, S., Carnot, N. and Patarau, A. (2021), "Do fundamentals explain differences between Euro Area sovereign interest rates", European Economy Discussion Paper 141, 11th of June.

[47] In line with the assumptions of the Debt Sustainability Monitor 2023, we also assume that this deterioration in the structural primary balance has an expansionary effect on GDP through the operation of the fiscal multipliers.

[48] In order to derive the percentile intervals, 5,000 stochastic simulations have been carried out.

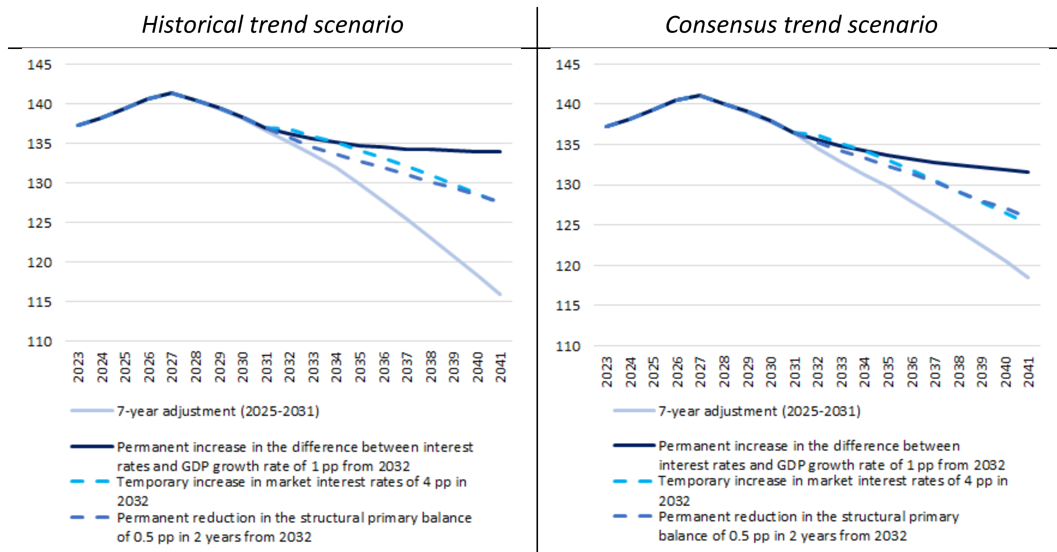
per cent, in line with the requirements of the new economic governance framework (see Section 3.1).[49]

Figure 8 – Evolution of public debt with stress tests on a 4-year adjustment path
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

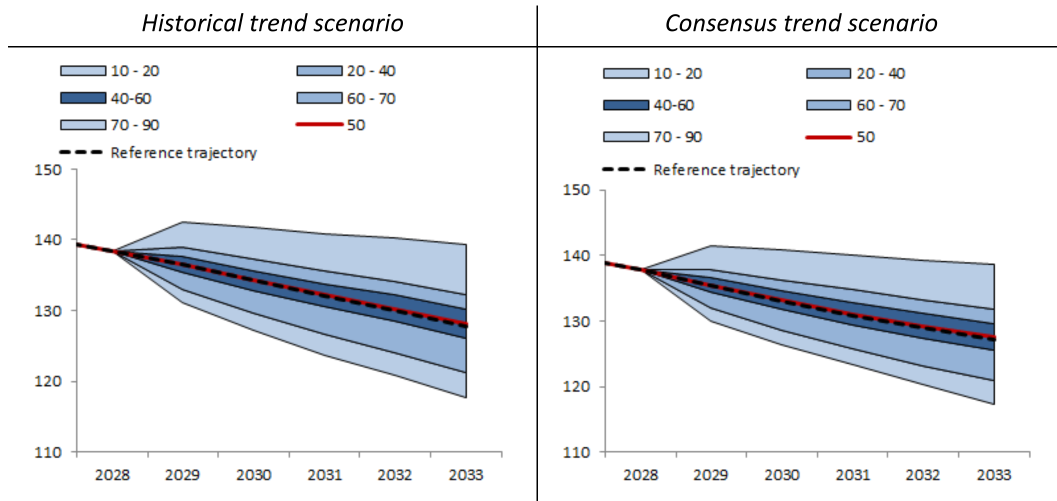
Figure 9 – Evolution of public debt with stress tests on a 7-year adjustment path
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

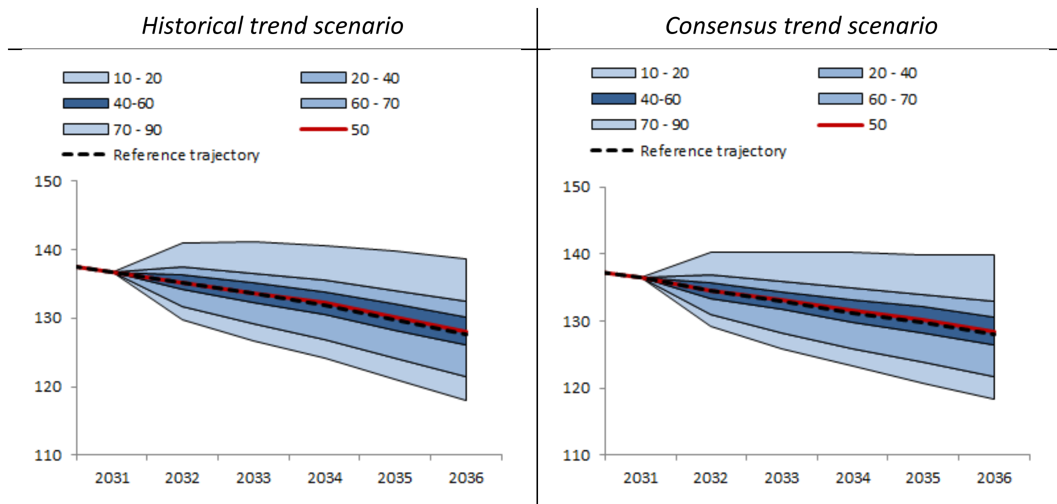
[49] See European Commission (2024), "Debt Sustainability Monitor 2023", Institutional Paper 271, 22nd of March.

Figure 10 – Stochastic analysis of public debt dynamics with a 4-year adjustment path *(per cent of GDP)*



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

Figure 11 – Stochastic analysis of public debt dynamics with a 7-year adjustment path *(per cent of GDP)*



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

3.4 A comparison with the initial European Commission proposal

The 7- and 4-year adjustment paths previously described, that are consistent with the new EU economic governance framework, are compared here to those resulting from the initial European Commission proposal,[50] to assess whether the common safeguards that were introduced afterwards would imply an additional fiscal effort. To this end, we

[50] For more details see the legislative proposals published by the European Commission on the 26th of April 2023: New economic governance rules fit for the future.

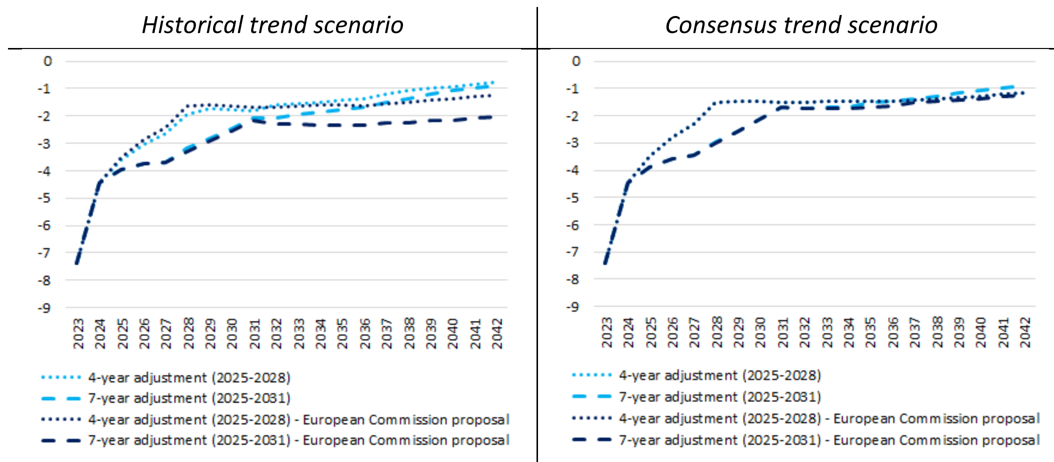
present, for both historical trend and Consensus trend scenarios, the evolution of the general government balance and of public debt, in line with the initial proposal by the European Commission described in Section 2.2.

As mentioned, the main differences in these trajectories, compared to those consistent with the new economic governance framework, are, on the one hand, the absence of the deficit resilience safeguard and, on the other hand, a different specification of the debt sustainability safeguard. In particular, the latter in the European Commission proposal provided for the debt-to-GDP ratio at the end of the 4- or 7-year adjustment period to be lower than the ratio recorded the year before the start of the fiscal adjustment. *Prima facie*, such an arrangement may imply a smaller required improvement in the general government balance and a consequently smaller reduction in public debt at the end of the forecast horizon, compared to the debt sustainability safeguard that was finally agreed on. Nonetheless, this may not always be the case.

Indeed, in the historical trend scenario, with a 4-year adjustment path in line with the European Commission proposal, the general government balance follows a slightly steeper path than the one resulting from the new EU framework until the end of the fiscal adjustment period (2028). In this case, the annual adjustment required in the years 2025-2028 is equal to 1.05 percentage points of GDP, whereas according to the new framework the annual adjustment is lower, amounting to 0.95 percentage points of GDP. The greater adjustment resulting from the European Commission proposal is needed to comply with the requirement according to which the debt-to-GDP ratio at the end of the adjustment period (2028) has to be lower than the one recorded the year before the start of the fiscal adjustment path (2024) (Figure 12). In fact, with an annual adjustment of 0.95 percentage points of GDP, as the one required by the new framework, in 2028 the debt-to-GDP ratio resulting from the initial European Commission proposal would be 0.3 percentage points higher compared to the level in 2024, thus not satisfying the safeguard envisaged by the regulation proposed by the European Commission in April 2023. Instead, in the following years the deficit-to-GDP ratio resulting from the European Commission proposal lies below the trajectory stemming from the new framework, as in this case the deficit resilience safeguard is activated in 2029 and in 2032, requiring further fiscal adjustments.

With a 7-year adjustment path in the European Commission proposal, the general government balance follows a similar pattern as the one required by the new framework for the period 2025-31. On the contrary, from 2031 afterwards, it lies on a lower path compared to the one resulting from the new framework, as in the latter case the deficit resilience safeguard is activated in the 2032-2034, period, requiring further consolidation efforts (Figure 12).

Figure 12 – Evolution of the general government balance: comparison with the European Commission proposal
(per cent of GDP)



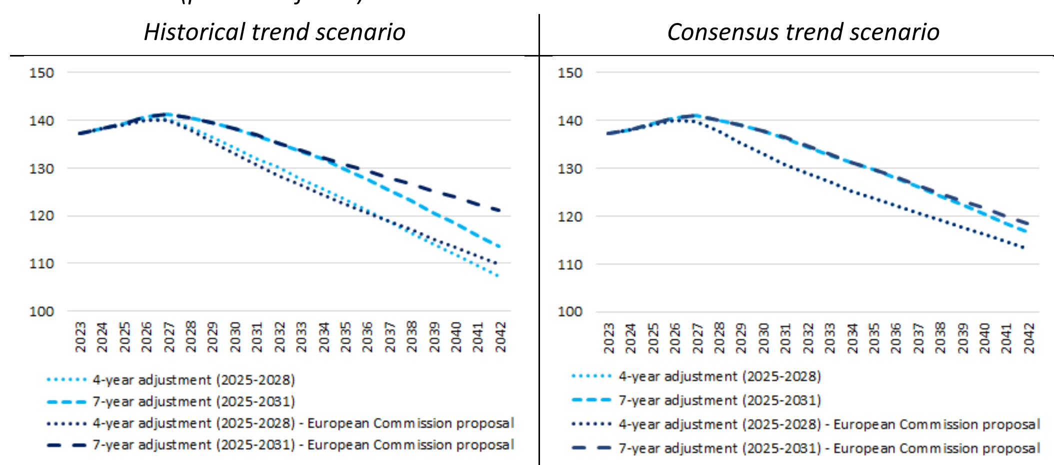
Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

In the Consensus trend scenario, the general government balance stemming from the 4-year adjustment path in the European Commission proposal is the same as the one resulting from the new framework. Instead, with a 7-year adjustment, the difference in the general government balance between the European Commission proposal and the new framework is quite small, with the latter being just a bit higher as a consequence of the activation of the deficit resilience safeguard in 2035.

In the historical trend scenario, with a 4-year adjustment path in the European Commission proposal, public debt initially follows a slightly steeper declining path than the one resulting from the new framework, as the annual structural adjustment in the period 2025-2028 is higher. However, in the outer years of the projection period, as the effect of the deficit resilience safeguard kicks in, the declining path in the debt-to-GDP ratio resulting from the new framework becomes steeper than the one in line with the European Commission proposal. In 2041 public debt reaches a level of 111.6 per cent of GDP with the European Commission proposal, only 2 percentage points higher than the level reached with the requirements of the new framework. With a 7-year adjustment path in the European Commission proposal, public debt follows a similar path compared to the new framework until 2031 and then lies well above it due to the activation, in the trajectory consistent with the new framework, of the deficit resilience safeguard in the period 2032-34 (Figure 13). In 2041 public debt with the European Commission proposal reaches a level equal to 122.5 per cent of GDP whereas with the requirements of the new framework the debt-to-GDP ratio falls to 116 per cent in the historical trend scenario.

In the Consensus trend scenario, with a 4-year adjustment path, there is no difference between the trajectory stemming from the European Commission proposal and the one consistent with the new framework, while the difference is negligible in the case of a 7-year adjustment path, due to the activation of the deficit resilience safeguard in 2035.

Figure 13 – Evolution of public debt: comparison with the European Commission proposal
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

After defining the trajectories with a multiannual adjustment, we can calculate the path of the net nationally financed primary expenditure underpinning those trajectories. This expenditure aggregate represents the indicator used as a ceiling or upper bound for annual monitoring.[51]

In the historical trend scenario, with a 4-year adjustment path, the upper bound to the net expenditure growth rate is equal to 1.2 percentage points according to the new framework and to 1 percentage point according to the European Commission proposal, due to the higher adjustment required in the latter case. Instead, with a 7-year adjustment path, the ceiling to the net expenditure growth rate is equal to 2.1 percentage points according to the new framework (2.2 according to the initial European Commission proposal). In all cases, the growth rate of the net expenditure aggregate is well below that of nominal potential GDP (Table 1).

In the Consensus trend scenario, with a 4-year adjustment path, the upper bound to the net expenditure growth rate is equal to 0.9 percentage points, whereas with a 7-year adjustment path, the ceiling to the net expenditure growth rate is equal to 1.8 percentage points. This growth rate is consistent with the European Commission proposal.

[51] We derive the ceiling or upper bound for the growth rate of net nationally financed primary expenditure, following the Debt Sustainability Monitor 2023, on the basis of the adjustment paths described above. The ceiling is calculated by adding the yearly potential growth rate and the inflation rate (measured by the GDP deflator) and subtracting the ratio between the required change in the structural primary balance and the primary expenditure-to-GDP ratio.

Table 1 – Upper bound (ceiling) to the growth rate of net nationally financed primary expenditure and growth rate of nominal potential GDP (1)
(annual average during the adjustment period, percentage points)

		Upper bound to the growth rate of net nationally financed primary expenditure	Growth rate of nominal potential GDP
Historical trend scenario	4-year adjustment (2025-2028) - European Commission proposal	1.0	3.4
	4-year adjustment (2025-2028)	1.2	3.4
	7-year adjustment (2025-2031) - European Commission proposal	2.2	3.3
	7-year adjustment (2025-2031)	2.1	3.3
Consensus trend scenario	4-year adjustment (2025-2028) - European Commission proposal	0.9	3.3
	4-year adjustment (2025-2028)	0.9	3.3
	7-year adjustment (2025-2031) - European Commission proposal	1.8	3.2
	7-year adjustment (2025-2031)	1.8	3.2

Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.
(1) The growth rate is the average growth rate calculated from 2025 to 2028 for the 4-year adjustment and from 2025 to 2031 for the 7-year adjustment.

It is important to underline that the expenditure aggregate that must comply with the upper bound presented in Table 1 is calculated by subtracting expenditure not directly controlled by the government, namely interest expenditure and cyclical unemployment expenditure, from overall public expenditure. Additionally, one-off and other temporary expenditure and the incremental impact of discretionary revenue measures is subtracted from the aggregate. A higher overall public expenditure is allowed if it is matched by new discretionary revenue measures. On the other hand, a reduction in net expenditure is necessary if discretionary revenue measures are taken to reduce public revenues.

3.5 A comparison with the previous structural balance rule

It is of some interest to gauge whether the new specification of the EU economic governance framework requires greater adjustments than the one previously in force. To this aim, the adjustment paths consistent with the new EU economic governance framework are compared here to the ones assuming the convergence of the structural balance to the MTO, in line with the rule previously in force in the preventive arm of the SGP.[52]

[52] Simulations in line with the debt rule of the corrective arm of the previous SGP, which implies a reduction of 1/20th of the excess of the debt-to-GDP level with respect to the 60 per cent threshold have not been run. Notice, in fact, that the compliance with the preventive arm of the SGP, in particular the structural balance rule or convergence to the MTO, has been considered in the past as a mitigating relevant factor for not proceeding with the opening of an EDP.

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For both the historical trend and Consensus trend scenarios, we present the evolution of public debt and of the general government balance, in line with the convergence of the structural balance to the MTO. This rule implies annual adjustments of the structural balance until reaching the MTO, which for Italy was equal to a surplus of 0.25 per cent of GDP.

The annual improvement in the structural balance was determined on the basis of the matrix of adjustments, as a function of the cyclical conditions of the economy, proxied by the output gap and real vs. potential growth, of the level of the debt-to-GDP ratio and of sustainability risks. For example, for a country like Italy, with a debt-to-GDP ratio higher than the 60 per cent threshold, in normal times, namely with an output gap between -1.5 and 1.5 per cent of potential GDP, the required annual reduction in the structural deficit should have been more that 0.5 per cent, which in the simulations illustrated here is assumed equal to 0.6 per cent of GDP.[53]

As in previous simulations, also in this case the budget consolidation determines, through the operation of dynamic fiscal multipliers estimated from the macroeconomic model MeMo-It used by the PBO, a reduction in the growth rate of real GDP, compared to a no-policy-change simulation. As a result, during the convergence of the structural balance to the MTO, the output gap, in both historical trend and Consensus trend scenarios, starts positive in 2025, when the fiscal adjustment begins, then turns negative in 2029 and reaches its minimum level in 2034, when the MTO is attained and, finally, closes in 2040.

In both scenarios, from 2025 to 2028, as the general government deficit is projected to be higher than 3 per cent of GDP, the EDP is activated and, in line with the regulation previously in force, the required adjustment of the structural deficit is set to be equal to an annual reduction of 0.5 percentage points of GDP. In 2029, the EDP is abrogated and from that year until 2033 an annual reduction of 0.6 per cent of GDP in the structural balance is required to comply with the rule, given that the cyclical conditions are in normal times, i.e. the output gap is between -1.5 and 1.5 per cent of potential GDP. Finally, in 2034, when the MTO is eventually reached, the required adjustment is the one remaining to close the distance with the target, that is a little more than 0.1 per cent of GDP. After reaching the MTO, from 2035 onwards, the structural balance remains constant at the level of the MTO.[54]

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[53] In other cases, the matrix implied annual adjustments that, in good times, namely with an output gap equal to or higher than 1.5 per cent of potential GDP, were equal to at least 0.75 per cent of GDP or at least 1 per cent of GDP if real growth was higher than potential growth. Instead, in bad times, namely with an output gap between -3 and -1.5 per cent of potential GDP, the annual adjustment should have been equal to 0.5 per cent of GDP if real growth was higher than potential growth or 0.25 per cent of GDP if real growth was lower than potential growth. In very bad times, namely with an output gap between -4 per cent and -3 per cent of potential GDP, the annual adjustment should have been equal to 0.25 per cent of GDP. Finally, in exceptionally bad times, namely with an output gap below -4 per cent of potential GDP or with negative real growth, no adjustment was required. For more details see European Commission (2019), "Vade Mecum on the Stability and Growth Pact – 2019 edition", Institutional Paper 101, 2nd of April.

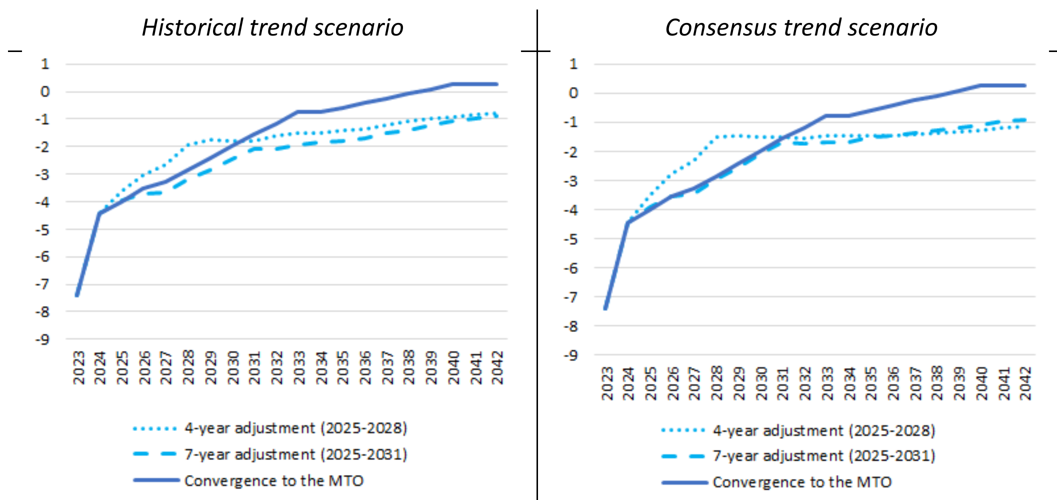
[54] We assume that, after the end of the adjustment period, starting from 2035, the output gap closes linearly in 6 years.

In the historical trend scenario, with the convergence to the MTO, until 2029 the path of the general government balance remains between the trajectories obtained on the basis of the new framework with an adjustment of 4 and 7 years. In 2029, the general government deficit is projected to be equal to 2.4 per cent of GDP with the convergence to the MTO, compared with a deficit of 1.7 per cent of GDP in the 4-year adjustment path and 2.9 per cent in the 7-year adjustment path. In 2031, the general government deficit, with the convergence to the MTO, is estimated to reach a level of 1.6 per cent of GDP, 0.6 percentage points higher than the deficit projected with a 7-year adjustment path.

Instead, in the Consensus trend scenario, the general government deficit stemming from the adjustment to the MTO and from the 7-year adjustment path coincide from 2025 to 2031. After 2031, with the framework previously in force, the adjustment continues until 2034, when the MTO is reached, and the general government balance keeps increasing to higher levels than those consistent with the new economic governance framework. In 2040 and 2041 the general government balance reaches the MTO, equal to a surplus of 0.25 per cent of GDP, while with the new framework the government deficit remains around 1 per cent of GDP in both 4- and 7-year adjustment paths (Figure 14).

In the historical trend scenario, with the convergence to the MTO, the path of the debt-to-GDP ratio lies between the two trajectories consistent with the new framework and only from 2036 decreases faster than the trajectory resulting from the 4-year adjustment. At the end of the forecast horizon, with the convergence to the MTO, public debt reaches a level of about 105 per cent, compared to a level of almost 110 per cent and 115 per cent that is reached respectively with a 4-year and a 7-year adjustment paths.

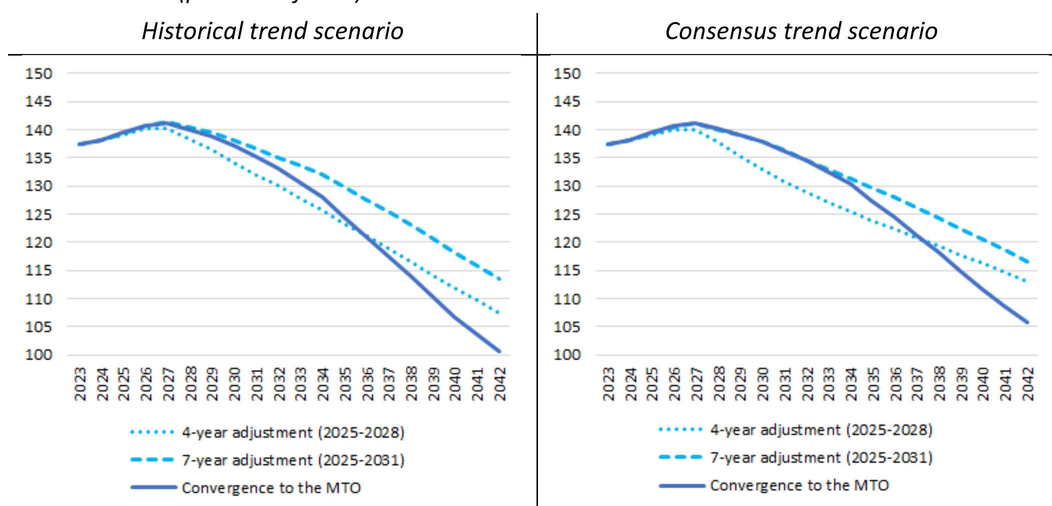
Figure 14 – Evolution of the general government balance: comparison with the convergence to the MTO
(per cent of GDP)



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

Instead, in the Consensus trend scenario, the descending path of the debt-to-GDP ratio resulting from the convergence to the MTO is quite similar to that stemming from a 7-year adjustment path at least until 2033. Afterwards, as the structural balance is bound to stay at the level of the MTO, the debt-to-GDP ratio starts declining faster (Figure 15). At the end of the forecast horizon, with the convergence to the MTO, government debt reaches a level of about 110 per cent compared to a level of almost 115 per cent and 120 per cent that is reached respectively with a 4-year and a 7-year adjustment paths.

Figure 15 – Evolution of public debt: comparison with the convergence to the MTO *(per cent of GDP)*



Source: PBO calculations based on the 2024 SP, Bank of Italy and Istat.

4. Concluding remarks

The new EU economic governance framework, that entered into force in April 2024, is a modified version of the original proposal by the European Commission, but maintains the main objectives of ensuring the sustainability of public debt and promoting medium-term budget planning.

Indeed, the new framework focuses on debt dynamics, which is a crucial aspect to consider when assessing the sustainability of public finances. Country-specific adjustment plans foreseen by the new legislation allow for consolidation efforts tailored to the needs of each Member State. A stronger national ownership reinforces the commitment to sustainable public finances and the credibility of multiannual adjustment plans. A simplified monitoring mechanism – based on a net nationally financed primary expenditure path – makes it easier to trace the effective implementation of the plan, striking a reasonable balance between ex ante complexity and ex post simplification.

On the basis of the methodology developed by the PBO, the illustrative scenarios presented in this paper show that the multiannual fiscal consolidation, broadly consistent with the new EU economic governance framework, is equal to an annual adjustment of

around 1 percentage point of GDP with a 4-year adjustment path and 0.5-0.6 percentage points with a 7-year adjustment path. These results are in line with those obtained for Italy by similar analyses developed by Darvas *et al.* (2023, 2024).[55]

No substantial difference emerges between the adjustment required by the final version of the SGP, which added the two common numerical safeguards, and the one required by the legislative proposals put forward by the European Commission in April 2023. Indeed, the results obtained in this paper show that, in the case of Italy, the debt sustainability safeguard is not binding, while the deficit resilience safeguard binds only after the adjustment period, although just in some cases and for a limited number of years. Only in the historical trend scenario, at the end of the projection period (2041), the debt-to-GDP ratio declines by almost 2 percentage points more with a 4-year adjustment path, and by a little over 6 percentage points more with a 7-year adjustment path, as a consequence of the application of the deficit resilience safeguard. In the latter case, a permanently higher primary balance is required at the end of the projection period (2041), compared to what is needed to ensure fiscal sustainability purely on risk-based requirements, as envisaged in the initial European Commission proposal. Nonetheless, common numerical safeguards on debt and deficit might unnecessarily restrain the scope for fiscal stabilization in Member States and at the EU level.

The introduction of common safeguards reflects the concern that country-specific adjustment plans might not ensure a level playing field in the EU, failing to provide equal treatment across countries. Yet, equal treatment can be facilitated by adopting common standards and best practices for policy assessment and monitoring. IFIs provide a standard for prudent assessments based on common methodologies, high level technical expertise, and, most importantly, independence.

Finally, the comparison between the fiscal consolidation consistent with the previous framework, which required annual adjustments in the structural balance to converge to the MTO, and the one consistent with the new framework, shows that the latter implies either the same annual adjustment or a lower one during a 7-year adjustment period, while it requires a greater one during a 4-year adjustment period. However, in the new framework, a smaller adjustment is required in the medium-term, i.e. after the adjustment period.

Further future work on the DSA framework developed by the PBO, in view of assessing the medium-term dynamics of public debt, may include: *i)* comparing the no-policy-change and the multiannual adjustment simulation results of the PBO with those by the European Commission and the Government, once their methodologies are fully disclosed; *ii)* better accounting for the sensitivity of public finances and debt dynamics to shocks to

[55] Darvas, Z., Welslau, L. and Zettelmeyer, J. (2023) "A quantitative evaluation of the European Commission´s fiscal governance proposal", Working Paper 16/2023, Bruegel, 18th of September and Darvas, Z., Welslau, L. and Zettelmeyer, J. (2024), "The implications of the European Union's new fiscal rules", 20th of June.

the inflation rate;[56] *iii)* assessing whether recent analyses and estimates of the natural or neutral interest rate could provide elements for an anchor to the medium-term projections of the average cost of public debt service;[57] *iv)* assessing the magnitude of fiscal multipliers as estimated by the European Commission and the Italian Government vis-à-vis those adopted by the PBO.

[56] For a recent contribution on this, see for example Bańkowski, K., Checherita-Westphal, C., Jesionek, J and Muggenthaler, P. (2023), "The effects of high inflation on public finances in the euro area", Occasional paper series n. 332, European Central Bank, December.

[57] For a brief review of recent literature on natural or neutral interest rates see Bernardini, M., D'Arrigo, L., Lin, A. and Tiseno, A. (2024), "Real interest rates and the ECB's monetary policy stance", Occasional papers n. 857, Banca d'Italia, June.