Anything But a “Superbonus” for Italy’s Debt Sustainability

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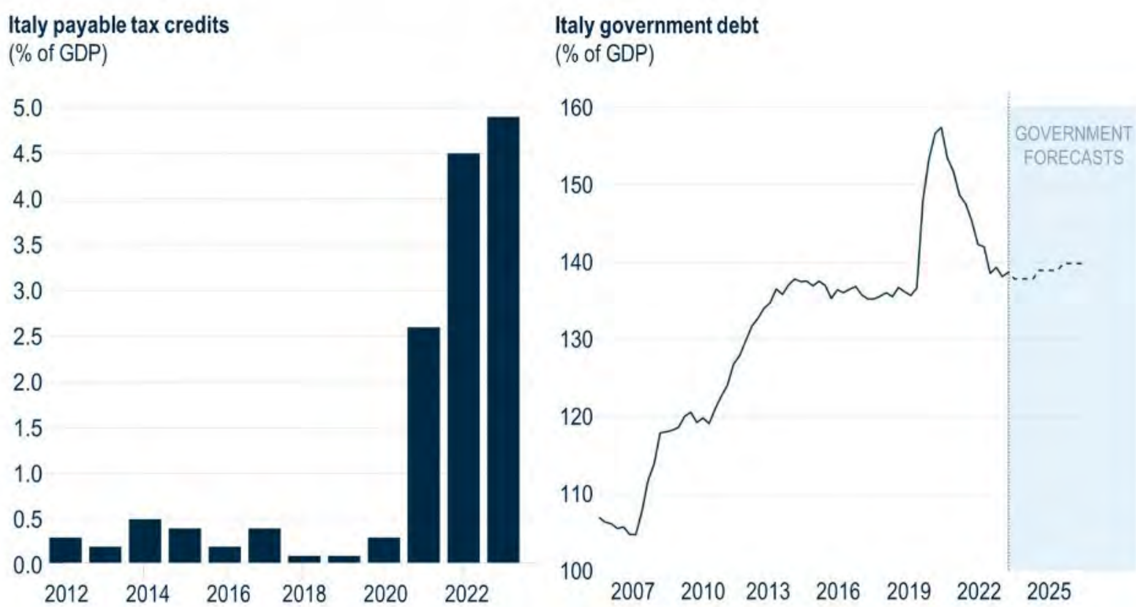
An unintended consequence of a pandemic-related tax credit has once again put Italian debt-to-GDP on an upward trajectory. This is happening against a backdrop of heightened investor concerns around fiscal sustainability, as demonstrated by the UK mini-budget debacle in 2022 and France’s recently announced snap elections, which will be followed by a convergence of events this Autumn that could test the market appetite for Italian sovereign debt.

Despite these strains, we continue to see positive prospects for Italy amidst substantive EU guardrails and more recent improvements on the supply side in line with our previous update on Italy. That said, Italian GDP growth and EU unity remain the key ingredients for the country’s debt sustainability.

The “Superbonus” is an extremely generous tax credit for home energy efficiency improvements, such as updated heating and air-conditioning systems, that was introduced during the pandemic in an effort to stimulate growth.[1] Italians quickly embraced the subsidy as total tax credits to date are in excess of €200 billion, or roughly equivalent to Italy’s entire eligible Next Generation EU allocation.[2] **Put another way, the tax credits from 2021, 2022, and 2023 amount to about 10% of Italian GDP - i.e. they are huge (Figure 1).**

FIGURE 1: Italy’s surging tax credits and resulting increase in its budget deficit may lead to another jump in its debt-to-GDP



Source: Macrobond, Italy Ministry of Economy and Finance.

Beyond the tax credit's popularity, its swift, yet lingering, fallout is partially due to accounting rules. The tax credits were issued by the government at the time of construction, but were intended to be redeemed at a later point in order to spread the cost over a few years. However, Eurostat clarified that the fiscal costs of the tax credits must be accounted for in the year that they were issued, not redeemed.

As a result, late last year, the Italian government cited the spiraling costs of the Superbonus behind its significant revision of 2023's deficit from 4.5% to 7.4% of GDP and its revisions to deficits from prior years. In addition to the jump seen in Figure 1, the uptake of the Superbonus experienced a particular surge in Q4 2023 prior to a proposal to tighten eligibility criteria, meaning that Italy's deficit could be revised even higher.

Furthermore, the credit's reduction in federal tax revenue and the consequent increase in debt issuance is treated on a cash basis, therefore the impact on Italy's debt-to-GDP will become most evident in the next three years or so, particularly in a scenario where growth moderates from current levels. That said, the consensus has caught up with our more constructive view on Italian growth prospects, and we see GDP growth of 0.8% in 2024 and 1.0% in 2025.

The Concerns

While upcoming events in France will capture investors' attention in the weeks ahead, the effects of the Superbonus are set to collide with upcoming policy and political events that could further rattle markets in the second half of the year. At the outset, the Italian government has delayed publishing its fiscal plans until Autumn 2024, thus placing even greater scrutiny on the plans to manage the country's debt sustainability, which will pose the first significant test for Italy's PM Meloni. Contrary to expectations, Italy's growth could slow due to the impact of the looming fiscal decisions or the fading economic effects of the Superbonus, possibly revealing underlying fragilities.

The pressure on Meloni - and any signs of political susceptibility amidst a weakening economy - could trigger a rise in anti-EU rhetoric from other Italian right-wing parties, such as Lega.

Then there is the ECB, which has provided various forms of support for European sovereign debt for years. One of these forms - the reinvestments of its Pandemic Emergency Purchase Programme (PEPP) - will be phased out starting in Q3 and will conclude by the end of the year. **As the ECB steps back, markets will need to absorb an exceptionally large volume of Italian bonds.** Italy's cash financing needs are currently around €150 billion and expected to remain significantly higher over the next few years compared to the pre-pandemic average of approximately €50 billion.

Details of another form of support, the ECB's Transmission Protection Instrument (TPI), remain vague, and it is yet to be tested, potentially introducing a dose of market uncertainty should it come into use. And while ECB rates started moving in the right direction for Italy, they may not come down by as much or as soon as expected, putting additional pressure on the country as it services its legacy debt (Figure 2).

FIGURE 2: Uncertainty and risk-free rates have combined to push Italian yields higher (%)

Source: Macrobond.

The Longer-Term Case for Optimism

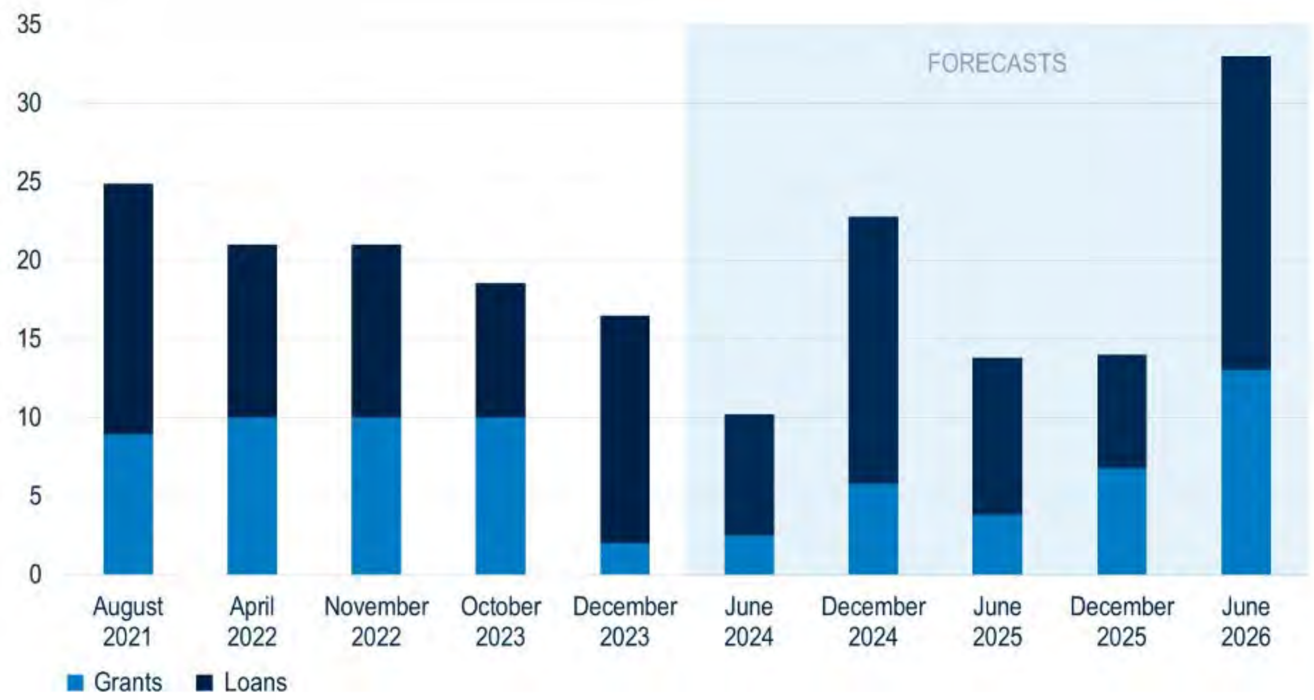
Our longer-term case for optimism starts with the basic premise that Italy is at a vastly different starting place than prior bouts of EU volatility. For one, Italian politics have been relatively stable and less combative when it comes to the European Union, particularly amidst the tangible benefits from EU guardrails.

Indeed, senior Italian policymakers have signaled their willingness to comply with EU fiscal rules, which are due to come into effect again later this year (they were suspended due to COVID and Russia's invasion of Ukraine). Although Italy will come under an Excessive Deficit Procedure (EDP), the amended EU framework creates more fiscal space for countries in the EDP, whilst being endorsed by the EU.

Despite its vagueness, Italy also remains eligible for the ECB's untested TPI program, which has equally vague triggers as it can be "activated to counter disorderly market dynamics" (e.g., an excessive widening in Italian spreads to Bunds). Moreover, the benefits of the TPI include its use in scenarios where spreads widen due to events outside of the sovereign's control, offering investors additional reassurance of reduced contagion risks. For example, depending on the outcome of France's snap elections, the TPI could be deployed to mitigate the risk that Italian spreads widen further.

After Italy's significant deficit revision, the fiscal side will remain under close surveillance as the government has signaled that it remains committed to the 4.3% fiscal deficit for 2024, underscoring the challenging decisions that lie ahead for PM Meloni. Yet, the country may finally experience a Superbonus reprieve and some incoming support. Indeed, eligibility for the Superbonus has been tightened, and April data show a sharp drop in claimed tax credits. A (small) portion of the tax credits could be also restructured to smooth the impact on debt-to-GDP. On the support side, this year and next are peak disbursement years for Next Gen EU funds (Fig. 3), with no sign of significant delays or risks to the disbursements.

FIGURE 3: Disbursement of New Generation EU Funds by year (€, in billions)



Source: European Commission.

Conclusion

While there are risks in the pipeline as described above, the key ingredients to Italy's debt sustainability remain centered on GDP growth and EU unity, with the latter supported by new EU fiscal rules, NextGen EU funding, and the ECB.

The starting point for Italy's debt-to-GDP is also at an improved point, and any further growth impulse from the Superbonus could see an upward revision to growth this year. And although we mentioned the risk of moderating growth once the effects of the Superbonus fade, exports and services have joined the construction sector as notable drivers of growth in recent years. There are also signs that Italy's supply side potential has improved amidst increased labor market participation and unemployment rates sitting at multi-decade lows.

1.The Superbonus tax credit was introduced in 2020 at a rate of 110%.

2."Italy: Europe's Sleeping Beauty," PGIM Fixed Income, November 1, 2022.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of June, 2024.
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