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**Assessment of the 2017 stability programme for
Italy**

(Note prepared by DG ECFIN staff)

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1. INTRODUCTION

On 27 April 2017, Italy submitted its 2017 stability programme (hereafter, stability programme), covering the period 2017-2020. The stability programme was adopted by the government on 11 April and endorsed by Parliament on 26 April.

Italy is currently subject to the preventive arm of the stability and Growth Pact (SGP) and should ensure sufficient progress towards its MTO. As the debt ratio was 132.6 % of GDP in 2016, exceeding the 60 % of GDP reference value, Italy is also subject to the debt reduction benchmark.

Due to Italy's *prima facie* non-compliance with the debt rule in 2015, on 22 February 2017 the Commission issued a report under Article 126(3) of the TFEU, which concluded that "*unless the additional structural measures, worth at least 0.2 % of GDP, that the government committed to adopt at the latest in April 2017 are credibly enacted by that time in order to reduce the gap to broad compliance with the preventive arm in 2017 (and thus in 2016), the current analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently not complied with. However, a decision on whether to recommend opening an EDP would only be taken on the basis of the Commission 2017 spring forecast, taking into account outturn data for 2016 and the implementation of the fiscal commitments made by the Italian authorities in February 2017*". In response, the Italian government adopted a decree law that entails additional consolidation measures of a structural nature of around 0.2 % GDP (DL 50/2017 of 24 April to be endorsed by Parliament within 60 days).

This document complements the Country Report published on 22 February 2017 and updates it with the information included in the stability programme.

Section 2 presents the macroeconomic outlook underlying the stability programme and provides an assessment based on the Commission 2017 spring forecast. Section 3 presents the recent and planned budgetary developments, according to the stability programme. In particular, it includes an overview of the medium-term budgetary plans, an assessment of the measures underpinning the programme and a risk analysis of the budgetary plans based on Commission 2017 spring forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission 2017 spring forecast. Section 5 provides an overview on long term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The modest economic recovery that started in 2014 continued in 2016, when real GDP increased by 0.9 %. Output growth was largely driven by domestic demand, as investment benefited from tax incentives and the positive impact of the accommodative monetary policy stance on financing conditions. In addition, consumption outpaced GDP growth on the back of solid job creation supported by the reduction of the tax wedge. By contrast, exports and imports both decelerated mirroring global trade developments.

In compliance with the Code of Conduct, the stability programme includes two macroeconomic scenarios, a baseline scenario assuming unchanged policies and a policy scenario incorporating the impact of fiscal measures and structural reforms presented in the National Reform Programme. External assumptions are identical in both scenarios and in line with those in the Commission 2017 spring forecast for 2017 and 2018.

Compared to the 2017 Draft Budgetary plan (DBP) of October 2016, the stability programme revises real GDP growth in 2017 slightly upwards from 1.0 % to 1.1 % in the policy

scenario.¹ The main reason is the revision of the external assumptions, which translates into a stronger foreign demand and a more favourable nominal effective exchange rate. Both effects contribute to a more dynamic export growth and a lower negative growth contribution from net trade in 2017. In principle, the more favourable external assumptions should also have a positive impact for the 2018 outlook. Projections for real GDP in 2018 have instead been revised downwards from 1.2 % in the DBP to 1.0 % as two factors are assumed to more than offset the positive impact from the external side. First, the recent increase in interest rates also implies by assumption a higher interest rate level over the full forecast horizon. Second, this more cautious approach is explained by the high uncertainty at the global and EU level. Real GDP projections for the year 2019 in the policy scenario are slightly lower than in the DBP (1.0 %, as against 1.2 %), and the 1.1 % projection for 2020 is in line with the assumed trend.

Growth projections for 2017 and 2018 are broadly aligned in the stability programme and the Commission 2017 spring forecast. About the composition of growth in 2017, the stability programme and the Commission 2017 spring forecast both expect domestic demand to maintain an important driving role thanks to rather buoyant investment, while private consumption is set to decelerate as higher inflation affects real disposable income. Exports are slightly more dynamic in the stability programme, implying a smaller negative contribution to growth from net trade. For 2018, the stability programme projects private consumption to decelerate further, while the Commission 2017 spring forecast expects a stronger growth in this component. The key factor behind this divergence is the assumed higher fiscal burden due to the legislated VAT hike (0.9 % of GDP) related to the “safeguard clause” which is not included in the Commission scenario (see Section 3). This notwithstanding, real GDP growth projections remain close to the Commission 2017 spring forecast as the lower positive contribution from domestic demand is predicted to be compensated by a positive impact from net trade due to the significantly lower import dynamics. The policy scenario for the outer years of the stability programme appears consistent with the external assumptions. The negative output gap (-1.7 % of potential output in 2016), as recalculated by the Commission based on the information in the programme following the commonly agreed methodology, is expected to close and turn positive in 2019 due to potential real GDP growth estimated to average ½ % over the programme period, i.e. below the 1 % average actual growth.

For 2017, projections of employment growth and compensation of employees in the stability programme are aligned with those in the Commission 2017 spring forecast. Labour productivity (based on full-time equivalent employment) is expected to reverse the negative trend experienced in recent years and increase modestly. The increase in compensation of employees in 2018 is, however, visibly lower in the stability programme (1.2 % as against 1.6 %) despite similar employment dynamics and a higher (inter alia VAT-induced) inflation. Part of the difference might be explained by a lower rebound in social contributions expected in the stability programme after the three-year exemption for new hiring with open-ended contracts in 2015. As a result, the rise in unit labour costs is more restrained than in the Commission 2017 spring forecast. The increase in unit labour costs is expected not to exceed 2 % and to remain below the rise in the GDP deflator, implying some improvement in profit margins over the programme period. The unemployment rate is expected to decline in line with the projected modest output expansion. The jobless rate is thus set to decrease to 11.1 % by 2018, slightly below the Commission 2017 spring forecast, and drop to 10.0 % only by 2020.

On balance, the macroeconomic scenario underpinning the stability programme appears to be slightly optimistic since risks to the growth outlook appear to be tilted to the downside. Main downside risks to the stability programme projections relate to a potentially less supportive

¹ For comparison, the policy scenario in the 2016 stability programme projected higher real GDP growth, at 1.2 % in 2016, 1.4 % in 2017, 1.5 % in 2018 and 1.4 % 2019.

external environment, inter alia associated with a rise in trade protectionism and depending on the outcome of the negotiations with the UK on leaving the EU as well as a possible appreciation of the euro. By contrast, a stronger-than-expected recovery of global demand and a faster easing of financing conditions would benefit economic activity. Furthermore, in 2018 and 2019 the negative impact of the planned fiscal consolidation on growth might be stronger than assumed in the stability programme. The Parliamentary Budget Office (PBO), Italy's independent fiscal council, validated both the baseline and policy scenario in April 2017.² However, the macroeconomic projections of the stability programme in the policy scenario are positioned at the upper bound of the forecast range used for the assessment by the Office, in particular in 2018 and 2019, and thus subject to downside risks, inter alia because of the high degree of uncertainty affecting the current fiscal policy set-up.³

Table 1: Comparison of macroeconomic developments and forecasts

	2016		2017		2018		2019	2020
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	0.9	0.9	0.9	1.1	1.1	1.0	1.0	1.1
Private consumption (% change)	1.4	1.4	0.8	0.9	1.0	0.6	0.7	0.7
Gross fixed capital formation (% change)	2.9	2.9	3.6	3.6	3.3	3.0	2.7	3.2
Exports of goods and services (% change)	2.4	2.4	3.4	3.7	3.6	3.2	3.5	3.5
Imports of goods and services (% change)	2.9	2.9	4.5	4.4	4.7	2.9	3.4	4.1
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	1.4	1.4	1.1	1.2	1.2	0.9	1.0	1.1
- Change in inventories	-0.5	-0.5	0.0	0.0	0.1	0.0	0.0	0.1
- Net exports	-0.1	-0.1	-0.2	-0.1	-0.2	0.1	0.1	-0.1
Output gap ¹	-1.7	-1.7	-0.8	-0.8	0.0	-0.2	0.2	0.5
Employment (% change)	1.3	1.3	0.5	0.6	0.6	0.8	0.8	0.7
Unemployment rate (%)	11.7	11.7	11.5	11.5	11.3	11.1	10.5	10.0
Labour productivity (% change)	-0.5	-0.4	0.2	0.4	0.3	0.3	0.2	0.2
HICP inflation (%)	-0.1	-0.1	1.5	1.2	1.3	1.7	2.1	1.8
GDP deflator (% change)	0.8	0.8	0.8	1.2	1.2	1.7	1.9	1.7
Comp. of employees (per head, % change)	0.3	0.3	0.9	1.0	1.6	1.2	1.5	1.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.5	2.5	1.8	2.2	1.6	2.5	2.7	2.8
<p><u>Note:</u></p> <p>¹In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.</p> <p><u>Source:</u></p> <p>Commission 2017 spring forecast (COM); Stability Programme (SP).</p>								

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2016 AND 2017

The 2016 government deficit was notified at 2.4 % of GDP, down from 2.7 % in 2015.⁴ The primary surplus increased marginally compared to 2015 and stabilised at 1.5 % as a share of

² http://www.upbilancio.it/wp-content/uploads/2017/04/UPB_Lettera-validazione-QMP-Def-2017.pdf

³ http://www.upbilancio.it/wp-content/uploads/2017/04/Audizione_DEF_2017.pdf

⁴ The 2015 deficit was revised slightly up from the 2.6% of GDP in the previous notification, mainly due to new information on expenditure at local government level.

GDP, while interest expenditure fell to 4.0 % of GDP (from 4.1 % in 2015). The 2.4 % of GDP deficit outturn compares with the 2.3 % planned in the 2016 stability programme, but that target was based on a higher nominal GDP growth (2.2 %, as against the 1.6 % outturn). Current primary expenditure increased by 1.7 % y-o-y in nominal terms (i.e. broadly in line with actual nominal GDP growth but significantly more than the 0.4 % estimate of nominal potential growth for that year), also due to some exceptional transactions, such as the reclassification of the national broadcaster (RAI) within the general government sector and higher subsidies linked to the production of renewable energy implying additional expenditure (overall around 0.2 % of GDP) offset by additional taxes. Compensation of employees increased by 1.3 % y-o-y also due to the resources earmarked for the education reform (*buona scuola*) and a bonus of EUR 80 per month for security/defence officers linked to the fight against the terrorism threat. Social transfer in cash, which at more than 20 % of GDP represent nearly half of current primary expenditure, increased by 1.4 % y-o-y thanks to rather moderate pension expenditure dynamics (+0.9 % y-o-y). Other social transfers in cash increased more strongly (+3.3 % y-o-y). Healthcare expenditure continued to increase moderately (by 1.2 % y-o-y) and remained broadly stable as a share of GDP (6.7 % of GDP from 6.8 % in 2015) also thanks to the implementation of centralised procurement practices. Public investment declined by 4.5 % compared with 2015 (from 2.2 % to 2.1 % of GDP). However, excluding investment projects financed through EU funds, which dropped from EUR 3.1 billion in 2015 to EUR 0.3 billion in 2016 as the new 2014-2020 programming period started to be implemented, public investment increased by around 3 % y-o-y. Other capital expenditure fell significantly mainly due to the sizeable impact of one-off outlays in 2015⁵. On the revenue side, indirect taxes fell by 3.1 % y-o-y due to the impact of a permanent reduction of the labour tax wedge (close to 0.5 % of GDP due to the deduction of permanent employment costs from the tax base of IRAP, the regional tax on economic activities) and of the abolition of the property tax on first residences (TASI, 0.2 % of GDP). Direct taxes rose by 2.3 % y-o-y, i.e. more than nominal GDP, thanks to rather strong job creation and higher corporate profits. Social contributions decelerated significantly (to +1.1 % y-o-y from +2.2 % in 2015), mainly because of the negative impact of the temporary (three-year) relief for new hiring with open-ended contracts. Thus, the current tax burden fell to 42.7 % of GDP in 2016 (from 43.4 % in 2015). Finally, capital taxes rose significantly (by around EUR 4 billion) due to the one-off intake related to the voluntary disclosure of assets held abroad, while other capital revenues dropped due to lower EU transfers, as mentioned above.

In 2017, the deficit target is 2.1 % of GDP, i.e. 0.3 percentage points higher than the 1.8 % deficit target put forward in the 2016 stability programme. The difference might be explained by a lower nominal GDP growth (2.3 % as against 2.5 %) and the 0.1 percentage points higher 2016 deficit base. The deficit in the stability programme is however lower than the 2.3 % of GDP deficit targeted in the 2017 Draft Budgetary Plan. The revision is due to the fact that in April the government adopted additional fiscal consolidation measures entailing an improvement of a structural nature of around 0.2 % of GDP (DL 50/2017). Those additional fiscal measures were enacted in response to a letter of the Commission of 17 January 2017 (see also Report under Article 126(3) TFEU issued on 22 February 2017)⁶. After considering the impact of DL 50/2017,⁷ revenues as a share of GDP would remain broadly unchanged in 2017 compared with 2016. The stability programme projects expenditure relative to GDP to fall by around 0.5 percentage points in 2017 compared with 2016 as all the main components

⁵ Namely, support to four small banks through the national resolution fund (partly offset by one-off revenues) and repayment of pension arrears following a Constitutional Court ruling.

⁶ COM(2017) 106 final

⁷ The impact of DL 50/2017 is not incorporated in the SP revenues and expenditure presented in Table 2 as they are trends based on unchanged legislation compiled before its adoption.

are planned to increase less than the estimated 2.3 % nominal GDP growth. More specifically, compensation of employees is projected to increase by 1.6 %, considering the additional resources earmarked for the renewal of contracts after a freeze in public wages since 2010. Social transfers in cash are projected to accelerate and increase by 2.2 %. Specifically, pension expenditure is projected to rise by 1.3 %, also due to the increase in low pensions and somewhat easier prerequisites needed to retire adopted through the 2017 budget. Other transfers in cash are projected to increase by more than 5 % due to additional resources earmarked for reducing poverty, supporting families with new-born children and the extension of unemployment benefits. Healthcare expenditure is instead planned to continue increasing moderately (1.4 % y-o-y). As a result, overall current primary expenditure is expected to increase by 1.4 % y-o-y in nominal terms. Public investment is set to increase by around 3 % y-o-y thanks to a higher absorption of EU funds for investment purposes, which are expected at EUR 2 billion in 2017 (from EUR 0.3 billion in 2016). This suggests that investment financed with national resources is set to decrease by around 2 % y-o-y in 2017. Finally, other capital spending is projected to remain broadly stable in nominal terms in 2017 compared with 2016.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The stability programme plans significant improvements in the headline and structural balances over 2018-2019. More specifically, the deficit is projected to decline to 1.2 % in 2018 and to 0.2 % in 2019, while a headline balanced budget is set for 2020.

After worsening by 0.7 percentage points of GDP in 2016 and by 0.3 percentage points in 2017, the structural balance is projected to improve by 0.8 percentage points in both 2018 and 2019 and broadly stabilise in 2020 according to the programme taken at face value. As a result, a broadly balanced budgetary position in structural terms would be reached by 2019 and maintained in 2020. The structural balance recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology shows a somewhat smaller improvement over the programme period. In addition, also due to a different starting point estimate of the output gap in 2016 (-1.7 % of potential GDP as against -2.7 % in the programme at face value), the recalculated structural balance still points to a small structural deficit (0.3 % of GDP) in both 2019 and 2020. The MTO chosen by Italy, i.e. a balanced budget position in structural terms, reflects the objectives of the Pact.

The headline deficit target for 2018 has been revised to 1.2 % of GDP, from 0.9 % in the 2016 stability programme, reflecting a worse 2017 base (2.1 % of GDP as against 1.8 % in the previous programme) and lower real GDP growth (1.0 % as against 1.5 %). Detailed budgetary projections in the stability programme (Table 2) are based on unchanged legislation trends that do not consider the impact of the additional fiscal consolidation measures amounting to 0.2 % of GDP enacted in 2017 (DL 50/2017) and they incorporate sizeable additional revenues related to VAT hikes legislated as a "safeguard clause" to achieve the medium-term budgetary targets.⁸ Accounting for the partial sterilisation enacted thanks to the permanent fiscal consolidation of DL 50/2017, the positive budgetary impact of the VAT hike would be around 0.9 % of GDP in 2018 (from 1.1 % before DL 50/2017). Additional unspecified corrective measures of 0.1 % of GDP would still be needed to achieve the 1.2 % of GDP deficit target. Furthermore, current primary expenditure is projected to decelerate further and increase by only 1 % y-o-y, mainly thanks to a reduction in compensation of employees (-0.5 %) as, under the unchanged legislation criterion, no further resources are

⁸ According to the stability programme, using a no-policy-change assumption would increase expenditure by around 0.1% of GDP over 2018-2020, while the level of revenues would remain unchanged compared with the unchanged legislation scenario.

expected to be allocated to the renewal of contractual wages. These developments in public wages also affect healthcare expenditure, which is expected to increase by a moderate 0.8 % y-o-y in nominal terms. By contrast, social transfers in cash are set to accelerate and increase by 2.6 % y-o-y, also due to the impact of ex-post indexation (i.e. the expected inflation in 2017).

Table 2: Composition of the budgetary adjustment

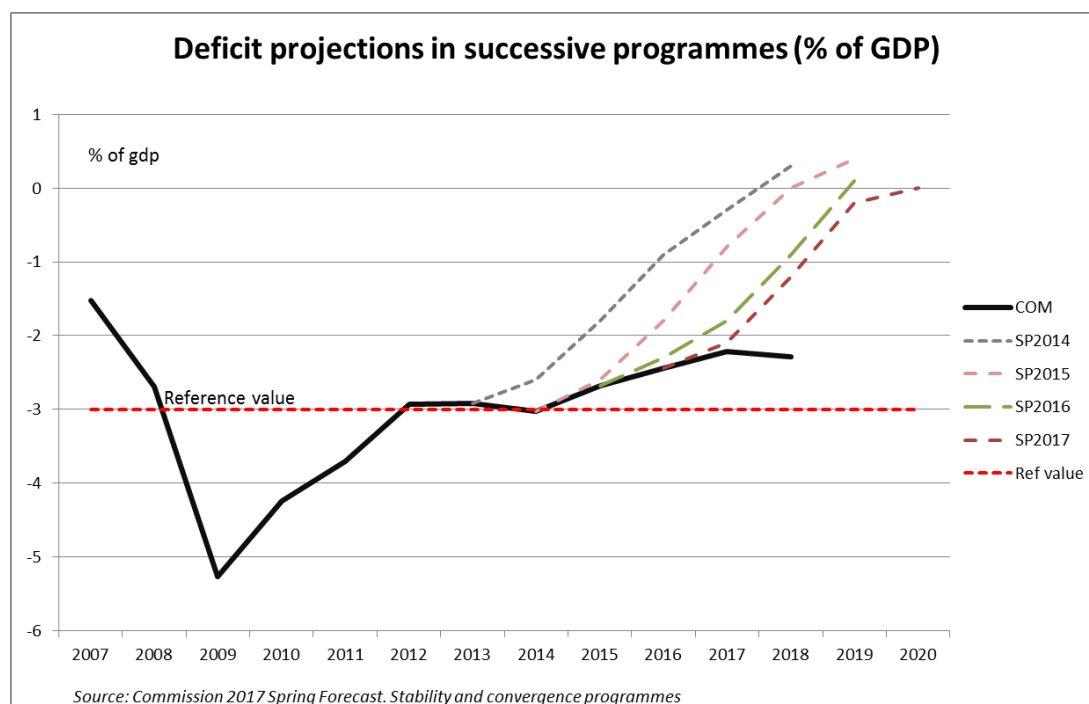
(% of GDP)	2016	2017		2018		2019	2020	Change: 2016-2020
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	47.1	47.2	46.8	46.9	47.0	47.0	46.5	-0.6
<i>of which:</i>								
- Taxes on production and imports	14.5	14.7	14.5	14.7	15.5	15.5	15.4	0.9
- Current taxes on income, wealth, etc.	14.9	14.7	14.6	14.4	14.0	13.9	13.7	-1.2
- Social contributions	13.2	13.3	13.1	13.5	13.2	13.4	13.3	0.1
- Other (residual)	4.6	4.6	4.6	4.3	4.3	4.2	4.1	-0.5
Expenditure	49.6	49.5	49.1	49.2	48.3	47.6	47.0	-2.6
<i>of which:</i>								
- Primary expenditure	45.6	45.6	45.2	45.4	44.6	43.9	43.2	-2.4
<i>of which:</i>								
Compensation of employees	9.8	9.8	9.8	9.6	9.4	9.2	9.0	-0.8
Intermediate consumption	5.4	5.4	5.4	5.3	5.2	5.1	5.1	-0.3
Social payments	22.8	22.9	22.8	23.0	22.6	22.5	22.4	-0.4
Subsidies	1.8	1.8	1.7	1.8	1.6	1.5	1.5	-0.3
Gross fixed capital formation	2.1	2.1	2.1	2.2	2.2	2.1	2.0	-0.1
Other (residual)	3.6	3.6	3.5	3.6	3.5	3.4	3.3	-0.3
- Interest expenditure	4.0	3.9	3.9	3.8	3.7	3.7	3.8	-0.2
General government balance (GGB)	-2.4	-2.2	-2.1	-2.3	-1.2	-0.2	0.0	2.4
Primary balance	1.5	1.7	1.7	1.5	2.5	3.5	3.8	2.3
One-off and other temporary	0.2	0.2	0.3	-0.1	0.1	0.0	0.0	-0.2
GGB excl. one-offs	-2.6	-2.4	-2.4	-2.2	-1.3	-0.2	0.0	2.6
Output gap ¹	-1.7	-0.8	-0.8	0.0	-0.2	0.2	0.5	2.2
Cyclically-adjusted balance ¹	-1.5	-1.8	-1.7	-2.3	-1.1	-0.3	-0.3	1.3
Structural balance²	-1.7	-2.0	-2.0	-2.2	-1.2	-0.3	-0.3	1.5
Structural primary balance ²	2.2	1.9	1.9	1.5	2.5	3.4	3.5	1.3
Notes:								
¹ Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.								
² Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
Source:								
Stability Programme (SP); Commission 2017 spring forecasts (COM); Commission calculations.								

For 2019 and 2020, additional unspecified corrective measures with an impact of at least 0.5 % of GDP relative to the trend scenario based on unchanged legislation would be necessary to achieve the deficit targets, on top of the legislated VAT hike amounting to around 1.0 % of GDP in each of those years.

Overall, the stability programme delays the reduction in the headline deficit towards a balanced budget position compared with previous programmes (Figure 1). Part of the revision in the budgetary targets is arguably due to the more modest economic recovery than initially foreseen after a deep and protracted economic recession that ended only in 2014. The revision

in the budgetary targets is also partially due to a delayed adjustment, since the Italian authorities asked to deviate from the adjustment path towards the MTO over 2016 and 2017 following the Commission Communication of 13 January 2015 on "Making the best use of the flexibility within the existing rules of the SGP" as well as for expenditure related to unusual events outside the control of the government, as defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 (see Section 4).

Figure 1: Government balance projections in successive programmes (% of GDP)



3.3. MEASURES UNDERPINNING THE PROGRAMME

The 2017 budget (DL 193/2016 and Law 232/2016) entails a worsening of Italy's headline balance (taken at face value) relative to the trend projections based on unchanged legislation of EUR 12 billion (or 0.7 % of GDP) in 2017, EUR 6.6 billion (or 0.4 % of GDP) in 2018 and EUR 2.8 billion (or 0.2 % of GDP) in 2019.

For 2017, revenues are reduced relative to trend projections by EUR 6.3 billion (or 0.37 % of GDP). Specifically, lower revenues are mainly related to the repeal of a previously legislated increase in VAT and excise duties (EUR 15.4 billion or 0.9 % of GDP). Higher one-off revenues are projected through the decision to forgo sanctions and fines related to unpaid taxes since the year 2000 (EUR 2.3 billion or 0.13 % of GDP) for taxpayers voluntarily regularising their past tax position (so-called "*rottamazione delle cartelle esattoriali*") and through the extension of the deadline for the "voluntary disclosure" of assets held abroad (EUR 1.6 billion or 0.09 % of GDP) to end-July 2017. Additional structural revenues are expected from the higher tax compliance associated with provisions on the communication of invoices and VAT data (overall EUR 2.3 billion or 0.13 % of GDP), as well as from the reduction from 4.75 % to 2.3 % in the notional return on new equity capital or reinvested earnings exempted from the payment of CIT under the so-called "allowance for corporate equity" (EUR 1.7 billion or 0.1 % of GDP)⁹. On the expenditure side, the increasing impact of

⁹ Despite the low interest rates, this decision to reduce the ACE rate could be premature, considering that banks' financing conditions remain difficult, in particular for SMEs, and that additional equity is needed to support

the 2017 budget relative to trend projections based on unchanged legislation is EUR 5.7 billion (or 0.33 % of GDP). Additional resources are earmarked for the renewal of public-sector contracts and additional spending on education (overall EUR 2 billion or 0.12 % of GDP) and for increasing low pensions and easing the pension requirements for some categories of workers (EUR 1.6 billion or 0.09 % of GDP). Moreover, resources have been earmarked for capital expenditure, including those linked to recent earthquakes, and the influx of refugees/migrants.

For 2018, further tax cuts included in the 2017 budget consist in the extension of incentives for companies to invest through the possibility to deduct 140 % of the amount spent, as well as a new "hyper-amortisation" rate of 250 % for digital investments and the introduction of a flat tax on small firms' entrepreneurial income (IRI). However, VAT and excise duties hikes previously legislated remained officially in force (EUR 19.6 billion – or 1.3 % of GDP – then partially sterilised to EUR 15.7 billion – or 0.9 % of GDP – through DL 50/2017).

The Commission 2017 spring forecast does not incorporate the EUR 2.3 billion one-off revenues from the "*rottamazione delle cartelle esattoriali*" in 2017 as the final outturn is highly uncertain.

Table 3: Main budgetary measures

Revenue	Expenditure
2017	
<ul style="list-style-type: none"> • Repeal of VAT hike (-0.9 % of GDP) • Tax compliance (0.1 % of GDP) • Reduction of allowance for corporate equity (ACE) rate (0.1 % of GDP) • Tax arrears - one-off (0.1 % of GDP) • Voluntary disclosure – one-off (0.1 % of GDP) 	<ul style="list-style-type: none"> • Public sector wages (0.1 % of GDP) • Pensions (0.1 % of GDP)
2018	
<ul style="list-style-type: none"> • Tax compliance (0.2 % of GDP) • Reduction ACE (0.1 % of GDP) • Tax arrears - one-off (0.1 % of GDP) • Tax incentives for investment (-0.1 % of GDP) • Tax on small firm revenue (IRI) (-0.1 % of GDP) 	<ul style="list-style-type: none"> • Pensions (0.1 % of GDP)
<p>Note: The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

investment in innovation. See SWD(2017) 77 final (https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-italy-en_0.pdf)

Regarding the impact of DL 50/2017 (finalised after the adoption of the stability programme and thus not included in the Table 2 and Table 3), the Commission 2017 spring forecast incorporates structural corrective measures amounting to 0.19 % of GDP. The main measures concern the extension of the split payment procedure for VAT collection, already in force since 2015 for invoices paid by public administration bodies, to publicly-owned companies and companies listed on the stock exchange. Moreover, the improper compensation of tax dues with unwarranted tax credits has been made more difficult by requiring the validation of a professional accountant for compensations above EUR 5 000 and by extending the electronic checking of compensations by the tax agency (Agenzia delle Entrate). For prudential reasons, the Commission 2017 spring forecast incorporates only half of the revenues (i.e. around EUR 0.5 billion in 2017 and around EUR 1 billion in 2018) projected by the government for the latter measure, given the uncertainties surrounding the outcome.

3.4. DEBT DEVELOPMENTS

Italy's public debt-to-GDP ratio has been on an increasing path since 2007 (Figure 2), mainly due to the impact of the protracted recession. Over 2011-2015 (Table 4), the main driver of the marked increase in the debt-to-GDP ratio (by more than 3 percentage points of GDP per year, on average) was the large snowball effect, which included high (although declining in more recent years) interest expenditure, low inflation, and negative real GDP growth. Moreover, the stock-flow adjustment had a sizeable debt-increasing impact also due to the financial support to euro-area programme countries. The primary surplus limited only to some extent the increase in the debt ratio, as it was rather low in that period owing also to unfavourable cyclical conditions. In 2016, the debt ratio rose by 0.5 percentage points, to 132.6 % of GDP, partly due to the accumulation of liquid assets and a snowball effect influenced by low inflation and low growth. The reduction due to privatisation proceeds was very small (less than 0.1 % of GDP).¹⁰ In the stability programme, the debt-to-GDP ratio is projected to broadly stabilise in 2017 (-0.1 percentage points) and to decline from 2018 onwards, reaching 125.7 % in 2020, also thanks to (unspecified) privatisation proceeds now projected at 0.3 % of GDP per year (0.5 % in previous stability programmes).

The difference between the debt ratio in the stability programme and the Commission 2017 spring forecast in 2017 (132.5 % of GDP as against 133.1 %, respectively) is largely explained by the lower nominal GDP growth in the latter, implying a bigger snowball effect. Both the stability programme and the Commission 2017 spring forecast include the support for the banking sector¹¹ in the stock-flow adjustment, largely offset by the reduction in the liquidity buffer. For 2018, the no-policy-change Commission 2017 spring forecast displays a much smaller contribution in the debt reduction from the primary surplus and from inflation than the stability programme. Hence, the Commission 2017 spring forecast expects a significantly smaller reduction in the debt ratio than in the stability programme (0.6 percentage points of GDP, as against 1.5 percentage points).

¹⁰ Privatisations in 2016 were essentially limited to the sale of a minority stake in ENAV SpA, the company in charge of air-traffic control in Italy.

¹¹ DL 237/2016

Table 4: Debt developments

(% of GDP)	Average 2011-2015	2016	2017		2018		2019	2020
			COM	SP	COM	SP	SP	SP
Gross debt ratio¹	126.5	132.6	133.1	132.5	132.5	131.0	128.2	125.7
Change in the ratio	3.3	0.6	0.5	-0.1	-0.6	-1.5	-2.8	-2.5
<i>Contributions² :</i>								
1. Primary balance	-1.6	-1.5	-1.7	-1.7	-1.5	-2.5	-3.5	-3.8
2. “Snow-ball” effect	4.0	1.8	1.6	0.8	0.7	0.2	-0.1	0.3
<i>Of which:</i>								
Interest expenditure	4.7	4.0	3.9	3.8	3.8	3.7	3.7	3.8
Growth effect	0.7	-1.1	-1.2	-1.4	-1.5	-1.3	-1.3	-1.4
Inflation effect	-1.4	-1.0	-1.0	-1.5	-1.6	-2.2	-2.5	-2.1
3. Stock-flow adjustment	0.9	0.3	0.6	0.8	0.2	0.8	0.8	1.0
<i>Of which:</i>								
Cash/accruals diff.	0.2	-1.0	0.0	0.4	0.0	0.3	0.5	0.7
Acc. financial assets	0.7	1.2	0.6	0.7	0.2	0.3	0.1	0.0
Privatisation	-0.3	-0.1	-0.2	-0.3	-0.2	-0.3	-0.3	-0.3
Val. effect & residual	0.0	0.0	0.0	0.4	0.0	0.4	0.3	0.4

Notes:

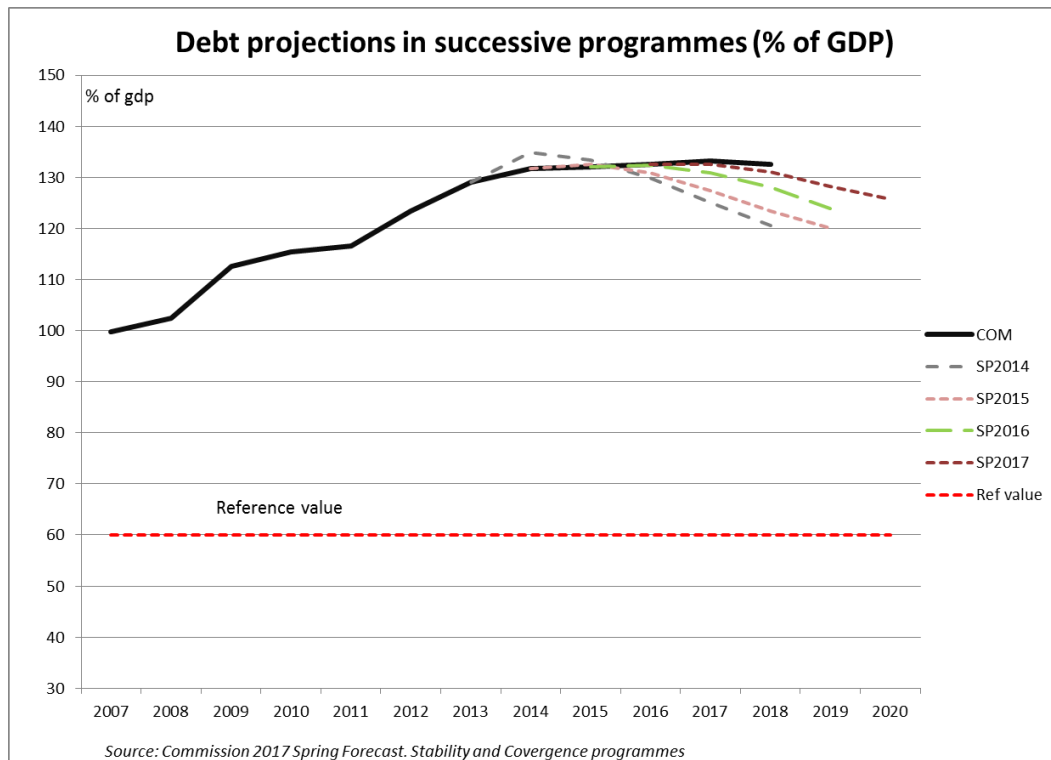
¹ End of period.

² The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source :

Commission 2017 spring forecast (COM); Stability Programme (SP), Comission calculations.

Figure 2: Government debt projections in successive programmes (% of GDP)



3.5. RISK ASSESSMENT

The Commission 2017 spring forecast, which incorporates almost entirely the impact of the new measures adopted in April (structural impact of 0.19 % of GDP), projects the 2017 deficit at 2.2 % of GDP. This is slightly higher than the 2.1 % deficit target of the programme and is mainly explained by more dynamic primary expenditure expected in the Commission 2017 spring forecast (+1.6% y-o-y as against 1.3 % in the stability programme). This difference suggests a challenging budgetary implementation for the authorities in order to achieve their expenditure objectives for 2017. By contrast, the stability programme seems to be rightly cautious on the underlying revenue developments. In fact, revenues are expected to increase broadly in line with those projected in the Commission 2017 spring forecast¹² despite the more optimistic nominal GDP growth.

In 2018, the Commission 2017 spring forecast points to a deficit of 2.3 % of GDP, i.e. significantly higher than the 1.2 % deficit target in the stability programme despite a similar real GDP growth. That target is very demanding, especially because the government confirmed (in the stability programme and in several statements) its intention of not activating the VAT hike legislated as a "safeguard clause" (around 0.9 % of GDP in 2018, not incorporated in the no-policy-change Commission 2017 spring forecast). No details about possible alternative compensating measures are provided in the stability programme. Moreover, once social transfers in cash are excluded, current primary expenditure projections for 2018 show a decline of 0.5 % y-o-y in nominal terms in the stability programme. These already ambitious trend developments seem to leave little room for additional sizeable savings from the ongoing spending review. Finally, the stability programme indicates the government's intention to find additional room for expansionary measures and to further reduce the tax burden in the coming years. In this context, the uncertainty on the composition and implementation of the medium-term budgetary strategy of the stability programme entails downside risks for both the growth projections and the achievement of the budgetary targets. In particular, the Commission 2017 spring forecast expects almost the same real GDP growth for 2018 as the 2017 stability programme, in spite of a significantly higher deficit. The highlighted downside risks for budgetary and nominal GDP growth projections in the stability programme are compounded by additional risks for debt-to-GDP projections. The fact that general elections will be held by spring 2018 adds non-negligible implementation risks to the stability programme's targets.

Finally, the track record of Italy's past stability programmes shows that the authorities have been continuously delaying the year of attainment of a balanced budget, and thus an adequate reduction of the debt-to-GDP ratio (see Figure 1 and Figure 2). Arguably, in recent years, this was at least in part justified by a low growth / low inflation environment. However, the vulnerability of the economy to the financial risks associated with a high public debt should also be considered, while a progressively improving fiscal position, in line with the stability programme targets, would help to maintain financial markets' confidence and thus low real interest rates (Country Report 2017).¹³

¹² This comparison is made after adding the impact of April's fiscal package to the unchanged-legislation figures presented in the stability programme.

¹³ SWD(2017) 77 final (https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-report-italy-en_0.pdf)

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 1. Council recommendations addressed to Italy

On 12 July 2016, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended to Italy to "in 2016, limit the temporary deviation from the required 0.5 % of GDP adjustment towards the medium-term budgetary objective to the amount of 0.75 % of GDP allowed for investments and the implementation of structural reforms, subject to the condition of resuming the adjustment path towards the medium-term budgetary objective in 2017. Achieve an annual fiscal adjustment of 0.6 % or more of GDP towards the medium-term budgetary objective in 2017".

4.1. Compliance with the debt criterion

Italy's general government debt-to-GDP ratio further increased in 2016 (to 132.6 % of GDP, i.e. well above the Treaty reference value of 60 %) and, based on the Commission 2017 spring forecast, Italy was not compliant with the debt rule in that year (gap to the debt benchmark of 6.9 % of GDP – see Table 5). Expected debt developments in both the Commission 2017 spring forecast and the stability programme show that Italy is not projected to comply with the debt reduction benchmark in 2017 and 2018 either. Gaps to compliance based on the Commission 2017 spring forecast are particularly large in both years (6.6 % and 6.0 % of GDP respectively). These gaps would be significantly lower (3.2 % and 2.0 % of GDP, respectively, based on the forward-looking configuration of the benchmark), if the ambitious targets put forward in the stability programme for the period 2018-2020 were achieved.

Table 5: Compliance with the debt criterion

	2016	2017		2018	
		SP	COM	SP	COM
Gross debt ratio	132.6	132.5	133.1	131.0	132.5
Gap to the debt benchmark ^{1,2}	6.9	3.2	6.6	2.0	6.0
Structural adjustment ³	n.a.	n.a.	n.a.	n.a.	n.a.
<i>To be compared to:</i>					
Required adjustment ⁴	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

¹ Not relevant for Member States that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

² Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

³ Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

⁴ Defines the remaining annual structural adjustment over the transition period which ensures that - if followed - Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (S/CP) budgetary projections for the previous years are achieved.

Source:

Commission 2017 spring forecast (COM); Stability Programme (SP), Commission calculations.

4.2. Compliance with the MTO or the required adjustment path towards the MTO

Assessment of requests for deviating from SGP requirements

For 2016, Italy was recommended to limit the temporary deviation from the required 0.5 % of GDP adjustment towards the MTO to the amount of 0.75 % of GDP allowed under the structural reform and investment clause. However, 0.35 % of GDP of the latter allowance¹⁴ was made conditional on: (i) the existence of credible plans for the resumption of the adjustment path towards the MTO as of 2017; (ii) the effective use of a deviation from the adjustment path for the purpose of increasing investments; and (iii) progress with the structural reform agenda, taking into account the Council recommendations.

Overall, after incorporating the structural impact of 0.19 % of GDP from the fiscal consolidation measures adopted with the decree law 50/2017 of 24 April 2017, and after taking into account the *ex-ante* allowance of 0.34 % of GDP related to unusual events (see below), the Commission assesses that the conditionality to grant the requested deviation from the adjustment path towards the MTO in 2016, i.e. the resumption of the adjustment in 2017, was fulfilled. Regarding the investment clause, the stability programme reports the overall impact of potentially eligible public expenditure at around EUR 3.5 billion or 0.21 % of GDP in 2016, i.e. below the 0.25 % *ex-ante* allowance. One of the eligibility criteria of the investment clause is that co-financed expenditure should not substitute for nationally financed investments, so that total public investment are not decreased in the year of application of the clause. One factor behind the slowdown in investment in 2016 was uncertainty associated with the transition to the new code of public procurement and concessions, which was revised in line with the Country Specific Recommendations. Moreover, and even more importantly, the decline of around EUR 1.6 billion in Italy's total public investment in 2016 compared with 2015 was affected by the sharp fall in the amount of investment financed through EU funds (from EUR 3.1 billion in 2015 to EUR 0.3 billion in 2016) due to the start of the new programming period. Net of that external financing, nationally financed public investment actually increased in 2016, although marginally (by around EUR 1.1 billion). Therefore, as the expenditure related to the investment clause did not substitute for nationally financed investment, an allowance of 0.21 % of GDP can be granted under the investment clause in 2016.

Furthermore, the 2016 DBP indicated that the expected budgetary impact linked to the exceptional inflow of refugees and security-related measures in 2016 was significant and provided adequate evidence of the scope and nature of these additional budgetary costs. Based on outturn data, the stability programme indicates that the expenditure (excluding EU contribution) incurred to face the exceptional influx of refugees, particularly in terms of sea rescue operations and hospitality, healthcare and education costs, increased gradually since 2012 and amounted to EUR 2 billion (0.12 % of GDP) in 2014, EUR 2.6 billion (0.16 % of GDP) in 2015, and EUR 3.6 billion (0.22 % of GDP) in 2016. As the Commission clarified that only additional refugee-related expenditure¹⁵ actually incurred by the country based on observed data could be taken into account when assessing Member States' fiscal effort for 2016, the Commission assesses that the eligible additional allowance for expenditure related to the exceptional influx of refugees that can be taken into account *ex post* in 2016 amounts to 0.06 % of GDP. As regards exceptional security measures, Italy's 2016 budget law included a package of provisions amounting to 0.2 % of GDP, but the Commission considered that only

¹⁴ Namely, 0.25 % of GDP under the investment clause and 0.1 % of GDP under the structural reform clause. See: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_en.pdf

¹⁵ In fact, as fiscal efforts required under the SGP are set in terms of change in the structural balance, allowances for "unusual events", including the refugee crisis, should only reflect elements that directly affect the change in the structural balance in a certain year

0.06 % of GDP of them represented additional security-related expenditure affecting the structural effort in 2016. As that amount is confirmed by the stability programme, the Commission assesses that the eligible allowance for the exceptional expenditure linked to the terrorist threat that can be taken into account in the *ex post* overall assessment of compliance with the preventive arm in 2016 amounts to 0.06 % of GDP.

Overall, as regards 2016, the Commission assesses that Italy can benefit from an overall temporary deviation of 0.83 % of GDP, of which: (i) 0.5 % of GDP related to the structural reform clause; (ii) 0.21 % of GDP linked to the actual amount of expenditure that is considered eligible for the investment clause; (iii) 0.06 % of GDP due to the additional expenditure for the exceptional inflow of refugees; and (iv) 0.06 % of GDP for security-related expenditure related to the terrorist threat.

For 2017, the 2017 DBP made the case of a further temporary deviation from the adjustment path towards the MTO to cater for the budgetary impact of the costs related to the exceptional inflow of refugees this year. The Opinion on the 2017 DBP¹⁶ indicated that the Commission would stand ready to consider an additional deviation due to the persistent exceptional inflow of refugees/migrants in Italy, also in the light of the October 2016 European Council conclusions recognising the "*significant contribution, also of financial nature, made by frontline Member States in recent years*". In the stability programme, the budgetary impact of the exceptional inflow of refugees/migrants is projected to be significant in 2017, as it would further increase and reach EUR 4.2 bn or 0.25 % of GDP (up from 0.22 % of GDP in 2016). As the exceptional inflow of refugees can be regarded as an unusual event outside the control of the government, as defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97, the Commission quantifies the additional allowance to be granted *ex ante* for the refugee-related expenditure in 2017 at 0.16 % of GDP, corresponding to the overall cost projected for 2017 by the stability programme (0.25 % of GDP), net of the 0.09 % of GDP deviation already granted in 2015 and 2016, so as to avoid double-counting.

The DBP for 2017 also requested an additional allowance due to the exceptional expenditure related to a preventive investment plan for protection of the national territory against seismic risks, including by addressing hydrogeological risks and securing schools. The amount of around 0.18 % of GDP earmarked by the Italian authorities for the preventive investment plan in 2017 is confirmed by the stability programme. Since the Commission Opinion on Italy's 2017 DBP stated that Italy has been facing exceptional seismic activity in the past months and that expenditure earmarked in the budget for emergency management and for prevention against seismic risks could be considered to have an integrated nature, making the distinction between emergency and prevention intervention less clear-cut, the Commission quantifies the related *ex-ante* allowance under the "unusual event clause" at 0.18 % of GDP in 2017.

Overall, as regards 2017, the Commission assesses that Italy can benefit ex-ante from an overall temporary deviation of 0.34 % of GDP, of which: (i) 0.16 % of GDP due to the exceptional inflow of refugees/migrants; and (ii) 0.18 % of GDP for the preventive investment plan for the protection of the national territory against seismic risks. However, both allowances should be confirmed ex-post based on outturn data for 2017. Given uncertainties on the actual impact of the preventive investment plan on the anti-seismic properties of buildings, the latter should be closely monitored by the authorities and the Commission be provided with an ex-post assessment allowing to reassess the amount of granted flexibility.

¹⁶ C(2016) 8009 final

Adjustment towards the MTO¹⁷

In 2016, Italy's structural balance is estimated to have deteriorated by 0.7 % GDP based on the Commission 2017 spring forecast. Therefore, with respect to the allowed structural deterioration of 0.33 % of GDP (after correcting the 0.5 % of GDP structural effort required under the preventive arm for the mentioned 0.83 % of GDP allowance under the flexibility clauses plus the outturn budgetary impact of the exceptional inflow of refugees and security-related measures), the Commission 2017 spring forecast points to some deviation based on the structural balance pillar (deviation of -0.4 % of GDP) and to compliance based on the expenditure benchmark adjusted for discretionary revenue measures and one-offs. Over 2015 and 2016 taken together, the Commission 2017 spring forecast points to some deviation (-0.2 % of GDP per year, on average) based on the structural balance pillar and to compliance based on the expenditure benchmark adjusted for discretionary revenue measures and one-offs. This calls for an overall assessment. The discrepancy between the two indicators is mainly due to the fact that the reading of the fiscal effort based on the expenditure benchmark pillar in 2016 is positively impacted by the use of a GDP deflator inflated by a VAT hike already legislated as a safeguard clause but subsequently repealed. Taking that into consideration and after taking into account the granted allowance of 0.83 % of GDP, an overall assessment points to some deviation from the recommended adjustment path towards the MTO in 2016 and over 2015 and 2016 taken together.

In 2017, the stability programme and the Commission 2017 spring forecast expect Italy's structural balance to deteriorate, respectively by 0.3 and 0.2 percentage points of GDP. Taking into account the preventive arm requirement of a structural effort of 0.6 % of GDP, the Commission 2017 spring forecast points to a risk of a significant deviation based on both the structural balance pillar and the expenditure benchmark adjusted for discretionary revenue measures and one-offs over one year (deviation of -0.8 % of GDP for both pillars). Over 2016 and 2017 taken together, the Commission 2017 spring forecast points to a risk of a significant deviation based on both the structural balance pillar (deviation of -0.6 % of GDP per year, on average) and the expenditure benchmark adjusted for discretionary revenue measures and one-offs (deviation of -0.3 % of GDP per year, on average). The reading of the fiscal effort based on the expenditure benchmark adjusted for discretionary revenue measures and one-offs partially benefits from the use of a slightly-higher GDP deflator (compared with that underlying the current estimate for the structural balance), which is half-based on the Commission 2016 spring forecast that included part of a later-repealed VAT hike. However, the reading of the fiscal effort based on the expenditure benchmark adjusted for discretionary revenue measures and one-offs is also negatively impacted by around the same amount by the use of a lower medium-term potential GDP growth (compared with the slightly higher point estimate of potential GDP growth underlying the structural balance). The structural balance pillar, instead, is negatively impacted by a revenue shortfall in both 2016 and 2017, when revenue developments are set to have fallen short of what could be expected based on standard elasticities. On this basis, the expenditure benchmark adjusted for discretionary revenue measures and one-offs is thus chosen to assess compliance with the required adjustment path towards the MTO in 2017. Taking these factors into consideration, an overall assessment based on the Commission 2017 spring forecast points to a risk of a significant deviation from the recommended adjustment path towards the MTO in 2017 and over 2016 and 2017 taken together. That conclusion would however change to a risk of some deviation, based on the expenditure benchmark pillar adjusted for one-offs, if the budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of

¹⁷ The assessment in this subsection is based exclusively on the Commission 2017 spring forecast and not also on the government plans, as the detailed budgetary projections reported in the stability programme do not include either the additional consolidation measures taken with Decree Law 50/2017 or the further measures needed to achieve the budgetary targets as of 2018 (see also Section 3)

the national territory against seismic risks (preliminarily estimated at 0.34 % of GDP, overall) were deducted from the preventive arm requirement in 2017.

In 2018, in the light of its fiscal situation and notably of its debt level, Italy is expected to further adjust towards its medium-term budgetary objective of a balanced budget in structural terms. According to the commonly agreed adjustment matrix under the SGP, that adjustment translates into a requirement of a nominal rate of reduction of net primary government expenditure¹⁸ of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP. In 2018, the stability programme plans a structural improvement of 0.8 percentage points of GDP, while the Commission 2017 spring forecast expects Italy's structural balance to further deteriorate by 0.3 percentage points of GDP and reach a level of -2.2 % of GDP. Taking into account the preventive arm requirement, the Commission 2017 spring forecast points to a risk of a significant deviation based on both the structural balance pillar (deviation of -0.9 % of GDP) and the expenditure benchmark adjusted for discretionary revenue measures and one-offs (deviation of -1.0 % of GDP) in 2018. Over 2017 and 2018 taken together, the Commission 2017 spring forecast points to a risk of a significant deviation based on both the structural balance pillar (deviation of -0.8 % of GDP per year, on average) and the expenditure benchmark adjusted for discretionary revenue measures and one-offs (deviation of -0.9 % of GDP per year, on average). The reading of the fiscal effort based on the structural balance pillar is positively impacted by slightly higher potential GDP growth, compared with the medium-term potential GDP growth used in the expenditure benchmark adjusted for discretionary revenue measures and one-offs. An overall assessment based on the Commission 2017 spring forecast points to a risk of a significant deviation from the recommended adjustment path towards the MTO in 2018 and over 2017 and 2018 taken together.

In summary, based on the Commission 2017 spring forecast, Italy appears to be broadly compliant with the preventive arm requirements regarding progress towards the MTO in both 2016 and 2017.¹⁹ Instead, pending the 2018 DBP, a risk of a significant deviation from the adjustment path towards the MTO is to be expected in 2018.

These assessments are based on the matrix of preventive arm requirements agreed with the Council, which takes into account (i) the cyclical position of the economy, as assessed on the basis of output gap estimates using the commonly agreed methodology as well as the projected real GDP growth rate, and (ii) debt sustainability considerations. Given the current cyclical conditions and the uncertainty surrounding them, it is important that the fiscal stance strikes the right balance between both safeguarding the ongoing recovery and ensuring the sustainability of Italy's public finances. The Commission noted that, in carrying out its future assessments, it stands ready to use its margin of appreciation in cases where the impact of large fiscal adjustment on growth and employment is particularly significant. In that context, it will make use of any updated information regarding the projected position in the economic cycle of each Member State and work closely with the Council to that effect.

¹⁸ Net government expenditure is comprised of total government expenditure excluding interest expenditure, expenditure on Union programmes fully matched by Union funds revenue and non-discretionary changes in unemployment benefit expenditure. Nationally financed gross fixed capital formation is smoothed over a 4-year period. Discretionary revenue measures or revenue increases mandated by law are factored in. One-off measures on both the revenue and expenditure sides are netted out.

¹⁹ Provided that the budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks (preliminarily estimated at 0.34 % of GDP, overall) is deducted from the fiscal effort required under the preventive arm.

Table 6: Compliance with the requirements under the preventive arm

(% of GDP)	2016	2017		2018	
Initial position¹					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance ² (COM)	-1.7	-2.0		-2.2	
Structural balance based on freezing (COM)	-1.6	-2.0		-	
Position vis-a -vis the MTO³	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	2016	2017		2018	
	COM	SP	COM	SP	COM
Structural balance pillar					
Required adjustment ⁴	0.5	0.6		0.6	
Required adjustment corrected ⁵	-0.3	0.6		0.6	
Change in structural balance ⁶	-0.7	-0.3	-0.2	0.8	-0.3
One-year deviation from the required adjustment ⁷	-0.4	-0.9	-0.8	0.2	-0.9
Two-year average deviation from the required adjustment ⁷	-0.2	-0.6	-0.6	-0.3	-0.8
Expenditure benchmark pillar					
Applicable reference rate ⁸	0.7	-1.4		-0.2	
One-year deviation adjusted for one-offs ⁹	0.1	n.a.	-0.8	n.a.	-1.0
Two-year deviation adjusted for one-offs ⁹	0.3	n.a.	-0.3	n.a.	-0.9
PER MEMORIAM: One-year deviation ¹⁰	0.46	n.a.	-0.79	n.a.	-1.27
PER MEMORIAM: Two-year average deviation ¹⁰	0.31	n.a.	-0.17	n.a.	-1.03
Conclusion					
Conclusion over one year	Overall assessment	n.a.	Significant deviation	n.a.	Significant deviation
Conclusion over two years	Overall assessment	n.a.	Significant deviation	n.a.	Significant deviation
Notes					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.					
² Structural balance = cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1. Ex post assessment (for 2014) is carried out on the basis of Commission 2015 spring forecast.					
⁷ The difference of the change in the structural balance and the corrected required adjustment.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
¹⁰ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<u>Source:</u>					
Stability Programme (SP); Commission 2017 spring forecast (COM); Commission calculations.					

Box 2. Implementation of the "constrained judgement" approach and its impact in the context of the fiscal surveillance

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response to this mandate from the Council, two concrete decisions were taken in agreement with the Member States in October 2016.

First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment (NAWRU) would be introduced in the commonly agreed methodology. Second, it was agreed to introduce a "constrained judgement" approach for cases where the commonly agreed methodology appears to produce "counterintuitive" output gap results for individual Member States. Both changes have already been implemented in the assessment of 2017 Draft Budgetary Plans.

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gap estimates for individual Member States estimated on the basis of the common method. To this end, the Commission developed an objective screening tool - based on a set of cyclically relevant indicators as well as thresholds/ranges - to signal cases when the outcomes of the commonly agreed methodology could be interpreted as being subject to a large degree of uncertainty and therefore deserving of further investigation on the part of the Commission. If this plausibility tool identifies possibly "counterintuitive" results from the common methodology, the Commission carries out an "in depth" analysis which could lead to the application of a "constrained" degree of judgement in conducting Member States' budgetary assessments.

In the case of Italy, the plausibility tool provided some indications that the output gap estimated on the basis of the commonly agreed methodology for 2016 (i.e. -1.7 % of potential GDP) may be counterintuitive. In fact, this falls just outside the confidence interval indicated by the "plausibility" tool, although at a rather low level of confidence (68 %), so that overall the indication coming from the tool may be regarded as borderline. The value for Italy's output gap obtained by the plausibility tool would be -2.2 % of potential GDP in 2016, i.e. some 0.5 percentage points of GDP wider than that based on the commonly agreed methodology. Applying this difference also to the output gap estimate for 2017 and 2018 based on the commonly agreed methodology, i.e. -0.8 % and 0% of potential GDP, respectively, the tool would point for analogy to a "plausible" estimate of -1.3 % and -0.5% of GDP, respectively.

It should be noted that the output gap estimates obtained with the commonly agreed methodology are surrounded by uncertainty. In particular, the closure of the output gap in 2018 appears difficult to explain in the face of still high unemployment rates (above 11 %), low core inflation, and rather moderate dynamics of unit labour costs based on the Commission 2017 spring forecast. The "plausibility" tool appears to capture the uncertainty related to the mentioned issues and to tackle it to the extent that the closure of the output gap estimated under a "constrained judgement" approach would be beyond 2018.

Based on the output gaps estimated on the basis of the "constrained judgement" approach for 2016, 2017, and 2018, the required structural efforts as per the preventive arm matrix would however not change in the case of Italy (i.e. they would remain at 0.5 % of GDP in 2016 and at least 0.6 % of GDP in 2017 and 2018). Moreover, Italy's estimated structural balance would not improve enough to make these requirements imply an overachievement of the MTO.

Overall, while the "plausibility" tool usefully complements the analysis of the estimates of Italy's output gap for 2016, the Member State's compliance status under the SGP would not be affected under an alternative "constrained judgement" approach to estimating it.

5. LONG-TERM SUSTAINABILITY

Italy does not appear to face fiscal sustainability risks in the short run. Nonetheless, there are some indications that the fiscal side of the economy poses potential challenges, mainly related to high debt-to-GDP ratio.²⁰

Based on Commission 2017 spring forecasts and a no-fiscal policy change scenario beyond forecasts, government debt, at 132.6 % of GDP in 2016, is expected to broadly stabilise by 2027, thus remaining above the 60 % of GDP Treaty threshold. Over this horizon, government debt is projected to peak in 2017 at more than 133 % of GDP. This highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the stability programme would put debt on a decreasing path by 2027, although remaining above the 60 % of GDP reference value in 2027.

The medium-term fiscal sustainability risk indicator S1 is at 6.5 percentage points of GDP, primarily related to the high level of government debt contributing with 5.2 percentage points of GDP, thus indicating high risks in the medium term. The full implementation of the stability programme would put the sustainability risk indicator S1 at 4.9 percentage points of GDP, leading to a similar medium-term risk classification. Overall, risks to fiscal sustainability over the medium-term are, therefore, high. Fully implementing the fiscal plans in the stability programme would nevertheless decrease those risks.

The long-term fiscal sustainability risk indicator S2 (which shows the adjustment effort needed to ensure that the debt-to-GDP ratio is not on an ever-increasing path) is 0.2 percentage points of GDP. In the long-term, Italy therefore appears to face low fiscal sustainability risks as both the initial budgetary position and the projected ageing costs are close to zero. Full implementation of the programme would put the S2 indicator at -1.9 percentage points of GDP, leading to a similar long-term risk, but making the S2 indicator more resilient to possible upward revision of ageing costs.²¹

²⁰ This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 12 fiscal and 13 financial-competitiveness variables. The fiscal and financial-competitiveness sub-indexes (reported in Table 5) are based on the two sub-groups of variables respectively. For sustainability risks arising from the individual variables, by country, see the Commission's Debt Sustainability Monitor 2016 (page 57).

²¹ The stability programme warns that the recent downward revision of long-term population projections by the national statistical office (ISTAT) has not been considered yet and would likely entail higher ageing costs than currently assumed.

Table 7: Sustainability indicators

Italy				
Time horizon	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	LOW risk			
S0 indicator ^[1]	0.4			
Fiscal subindex	0.5	HIGH risk		
Financial & competitiveness subindex	0.4	LOW risk		
Medium Term	HIGH risk			
DSA ^[2]	HIGH risk			
S1 indicator ^[3]	6.5	HIGH risk	4.9	HIGH risk
of which				
Initial Budgetary Position		1.2	-0.9	
Debt Requirement		5.2	5.6	
Cost of Ageing		0.0	0.1	
of which				
Pensions		0.1	0.2	
Health-care		0.2	0.1	
Long-term care		0.1	0.1	
Other		-0.3	-0.3	
Long Term	LOW risk		LOW risk	
S2 indicator ^[4]	0.2		-1.8	
of which				
Initial Budgetary Position		0.2	-1.9	
Cost of Ageing		0.0	0.1	
of which				
Pensions		-0.8	-0.8	
Health-care		0.5	0.5	
Long-term care		0.6	0.6	
Other		-0.4	-0.3	
Source: Commission services; 2017 stability/convergence programme.				
Note: the 'no-policy-change' scenario depicts the sustainability gap under the assumption that the structural primary balance position evolves according to the Commissions' spring 2017 forecast covering until 2018 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2015 Ageing Report.				
[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.				
[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.				
[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2031. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2019 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.				
[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.				
* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2016.				

6. FISCAL FRAMEWORK

Italy's national fiscal framework is based on two main legal texts: (i) Law 243/2012, which includes the main implementation provisions of the balanced budget principle pursuant to article 81(6) of the Constitution and can be amended only through a reinforced procedure (i.e. requiring the majority of Members of Parliament). Law 243/2012 *inter alia* requires consistency of national budgetary targets with the EU legislation; and (ii) Law 196/2009, the Government Accounting and Public Finance Act, which includes all the detailed implementation provisions to manage Italy's public finances at central and local level.

In 2016, two remaining enacting decrees of Law 196/2009 were adopted together with a reform of the structure of budget itself.²² Therefore, the reform of the budgetary process in Italy can be considered formally concluded. Starting from the 2018 budget, there are also the conditions for the spending review to become a systematic feature of the budget process.

The Economic and Financial Document, which includes the stability programme and the national reform programme, serves as the national medium-term fiscal plan in the sense of Regulation (EU) No 473/2013, although there is no statement in this respect in the stability programme.²³ The content requirement (referred to in Art. 4.1 of Regulation 473/2013) to list the expected economic returns on non-defence public investment projects that have a significant budgetary impact is only partially reflected. Namely, the stability programme indicates that additional resources have been earmarked for public investment and a specific Fund has been established to this purpose. However, the stability programme does not present precise estimates of the expected economic returns from additional public investment.

The Parliamentary Budget Office (PBO), the national fiscal monitoring institution established on the basis of Law 243/2012, has endorsed both the trend and the policy macroeconomic scenarios presented in the stability programme. The endorsement took the form of letters sent to the Minister of Finance. The Office indicated that growth projections in policy scenario are positioned in the higher part of the forecast range used for its assessment, in particular for 2018 and 2019 (see also Section 2).

Overall, based on the information provided in the stability programme, the past, planned and forecast fiscal performance in Italy appears to broadly comply with the requirements of the applicable national numerical fiscal rules, although compliance over the programme horizon remains subject to risks, as highlighted by the PBO.²⁴ According to the Office, the structural balance over 2018-2020 appears to be fully compliant with national rules, but the projected decline in the debt-to-GDP ratio is not sufficient to ensure compliance with the debt reduction rule within the policy horizon. Moreover, the policy scenario remains largely undefined, and there is a risk that past policies might have a negative impact on compliance with the structural balance requirements. In particular, there is a risk of significant deviation in 2017, when considering developments over 2016-2017.

²² Enacting Decrees 90/2016 and 93/2016 and Law 163/2016

²³ Law 196/2009

²⁴ Parliamentary hearing of the PBO on the 2017 *Documento di Economia e Finanza*, 19 April 2017

7. SUMMARY

In 2016, Italy's structural balance deteriorated by 0.7 % of GDP based on the Commission 2017 spring forecast, which points to some deviation from the required adjustment towards the MTO once taking into account the following allowances: (i) 0.5 % of GDP under the structural reform clause; (ii) 0.21 % of GDP under the investment clause; (iii) 0.06 % of GDP due to the additional expenditure for the exceptional inflow of refugees/migrants; and (iv) 0.06 % of GDP for security-related expenditure related to the terrorist threat. The *ex-post* assessment thus suggests that Italy's adjustment path towards the MTO was broadly compliant with the requirements of the preventive arm of the SGP in 2016 and over 2015 and 2016 taken together.

The debt-to-GDP ratio increased in 2016 to 132.6 % of GDP, i.e. well above the Treaty reference value of 60 %, and, based on the Commission 2017 spring forecast, Italy was not compliant with the debt rule in that year and is not expected to comply in 2017 and 2018, either. Due to Italy's *prima facie* non-compliance with the debt rule in 2015, on 22 February 2017 the Commission issued a report under Article 126(3) TFEU, which concluded that *"unless the additional structural measures, worth at least 0.2 % of GDP, that the government committed to adopt at the latest in April 2017 are credibly enacted by that time in order to reduce the gap to broad compliance with the preventive arm in 2017 (and thus in 2016), the current analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently not complied with"*. In response to that request, the Italian government adopted a decree law with additional consolidation measures of a structural nature of around 0.2 % GDP. After incorporating those measures, the Commission 2017 spring forecast expects Italy's structural balance to deteriorate by 0.2 % of GDP in 2017, broadly in line with the 0.3 % of GDP worsening in the (recalculated) structural balance planned by the stability programme. That fiscal path is broadly compliant with the required adjustment path towards the MTO in 2017 and over 2016 and 2017 taken together, once the budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks (preliminarily estimated at 0.34 % of GDP, overall) is deducted from the preventive arm requirement. As a result, the Commission assesses also that the conditionality to grant the requested deviation from the adjustment path towards the MTO in 2016 (i.e. the resumption of the adjustment in 2017) was fulfilled.

In 2018, in the light of its fiscal situation and notably of its debt level, Italy is expected to further adjust towards its medium-term budgetary objective of a balanced budget in structural terms. According to the commonly agreed adjustment matrix under the SGP, that adjustment translates into a requirement of a nominal rate of reduction of net primary government expenditure of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP. In 2018, the stability programme plans a structural improvement of 0.8 % of GDP, while the Commission expects Italy's structural balance to further deteriorate by 0.3 % of GDP, reaching a level of -2.2 % of GDP, i.e. below the country's minimum benchmark of -1.3 % of GDP. The difference is mainly due to the fact that the Commission 2017 spring forecast does not include a VAT hike (amounting to around EUR 16 billion or 0.9 % of GDP) legislated for 2018 as a "safeguard clause" to ensure the achievement of the budgetary targets, as the stability programme confirms the intention to repeal it without specifying the compensating measures. Taking into account the preventive arm requirement, an overall assessment based on the Commission 2017 spring forecast points to a risk of a significant deviation from the recommended adjustment path towards the MTO in 2018 and over 2017 and 2018 taken together. These assessments are based on the matrix of preventive arm requirements agreed with the Council, which takes into account (i) the cyclical position of the economy, as assessed on the basis of output gap estimates using the commonly agreed methodology as well as the projected real GDP growth rate, and (ii) debt sustainability considerations. Given the current cyclical conditions and the uncertainty surrounding them, it

is important that the fiscal stance strikes the right balance between both safeguarding the ongoing recovery and ensuring the sustainability of Italy's public finances. The Commission noted that, in carrying out its future assessments, it stands ready to use its margin of appreciation in cases where the impact of large fiscal adjustment on growth and employment is particularly significant. In that context, it will make use of any updated information regarding the projected position in the economic cycle of each Member State and work closely with the Council to that effect.

8. ANNEX

Table I. Macroeconomic indicators

	1999-2003	2004-2008	2009-2013	2014	2015	2016	2017	2018
Core indicators								
GDP growth rate	1.5	1.0	-1.6	0.1	0.8	0.9	0.9	1.1
Output gap ¹	1.1	1.3	-2.9	-3.8	-2.8	-1.7	-0.8	0.0
HICP (annual % change)	2.4	2.4	2.0	0.2	0.1	-0.1	1.5	1.3
Domestic demand (annual % change) ²	1.9	0.8	-2.2	0.2	1.4	1.0	1.1	1.4
Unemployment rate (% of labour force) ³	9.4	7.1	9.5	12.7	11.9	11.7	11.5	11.3
Gross fixed capital formation (% of GDP)	20.5	21.3	19.0	16.7	16.8	17.0	17.6	18.0
Gross national saving (% of GDP)	20.6	20.2	17.5	18.9	18.8	19.6	19.5	19.8
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-2.6	-3.1	-3.8	-3.0	-2.7	-2.4	-2.2	-2.3
Gross debt	104.4	101.4	119.4	131.8	132.1	132.6	133.1	132.5
Net financial assets	-97.0	-92.6	-105.9	-130.5	-132.3	n.a	n.a	n.a
Total revenue	44.3	44.1	46.6	47.9	47.8	47.1	47.2	46.9
Total expenditure	46.9	47.2	50.4	50.9	50.5	49.6	49.5	49.2
<i>of which: Interest</i>	5.8	4.7	4.7	4.6	4.1	4.0	3.9	3.8
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	-0.3	-0.6	1.4	2.9	2.6	3.7	3.0	3.0
Net financial assets; non-financial corporations	-97.3	-122.6	-118.7	-122.1	-121.1	n.a	n.a	n.a
Net financial assets; financial corporations	-11.1	-3.8	26.7	34.6	32.2	n.a	n.a	n.a
Gross capital formation	10.9	11.0	9.5	9.1	9.4	9.1	9.5	9.8
Gross operating surplus	24.0	22.8	20.6	20.6	20.7	21.1	20.9	20.9
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	2.9	2.4	1.0	2.2	1.6	1.2	1.0	0.9
Net financial assets	199.6	200.6	176.0	191.9	194.5	n.a	n.a	n.a
Gross wages and salaries	27.0	28.0	29.2	29.0	29.2	29.5	29.6	29.5
Net property income	15.6	14.2	11.3	10.5	10.3	9.8	9.9	9.9
Current transfers received	20.6	21.1	23.9	24.7	24.7	24.7	24.8	25.0
Gross saving	9.9	10.0	7.7	7.7	7.1	7.2	7.1	7.1
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	0.0	-1.3	-1.5	2.1	1.6	2.5	1.8	1.6
Net financial assets	7.7	20.9	27.0	30.9	31.4	n.a	n.a	n.a
Net exports of goods and services	1.0	-0.3	-0.2	2.9	2.9	3.5	2.7	2.5
Net primary income from the rest of the world	-0.4	-0.1	-0.2	0.0	-0.6	0.2	0.2	0.2
Net capital transactions	0.1	0.1	0.1	0.2	0.2	-0.1	-0.1	-0.1
Tradable sector	45.4	42.6	40.4	40.2	40.5	n.a	n.a	n.a
Non tradable sector	44.6	47.4	49.6	49.6	49.1	n.a	n.a	n.a
<i>of which: Building and construction sector</i>	4.6	5.3	5.0	4.3	4.3	n.a	n.a	n.a
Real effective exchange rate (index, 2010=100)	85.9	97.6	100.2	100.0	95.8	95.9	94.8	94.2
Terms of trade goods and services (index, 2010=100)	104.9	101.0	99.0	100.0	102.3	104.9	102.6	102.6
Market performance of exports (index, 2010=100)	126.4	110.6	100.1	98.8	98.0	97.1	96.6	95.8
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source:								
AMECO data, Commission 2017 spring forecast								