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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Italy

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Italy

{C(2017) 8019 final}

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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of Italy

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COMMISSION OPINION

on the draft budgetary plan of Italy

1. INTRODUCTION

Italy submitted its Draft Budgetary Plan (DBP) for 2018 on 17 October 2017,[1] in line with Regulation (EU) No 473/2013 of the Two-Pack. Italy is subject to the preventive arm of the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its medium term budgetary objective (MTO). As the debt ratio was 132.0% of GDP in 2016, Italy also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2017 autumn forecast (Commission forecast). The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the SGP. A box on the application of constrained judgement is contained in this section for those Member States flagged by the plausibility tool. Section 5 provides an analysis on the composition of public finances and on fiscal-structural issues, including reducing the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Italy's 2018 DBP revised upward real GDP growth for 2017 (see Box 1) to 1.5%, compared to the 1.0% projected in the 2017 Stability Programme (SP). This is mainly due to a higher-than-expected outturn for the first half of 2017 and positive readings of short-term indicators related to the third quarter. As projected in the SP, increasing private domestic demand is set to be the main growth driver, while stock building is expected to be growth-neutral. After incorporating national accounts data for the first half of 2017, the Commission forecast for real GDP growth in 2017, at 1.5%, is aligned with the DBP also in terms of contribution from GDP components, although with somewhat higher imports and lower investment. The projected GDP deflator in the DBP, at 0.6% for 2017, is markedly lower than in the SP and in line with the Commission forecast.

[1] Italy submitted its DBP on 17 October 2017 and resubmitted an updated version on 20 October 2017. The cut-off date for this assessment and the Commission 2017 autumn forecast is 20 October 2017.

For 2018, the DBP projects higher real GDP growth than the SP (1.5% compared to 1.0%), still supported by domestic demand, in particular private and public investment. By contrast, the Commission forecast expects marginally lower real GDP growth, at 1.3%, with a similar positive contribution from domestic demand and a negative one from net exports. However, the Commission expects a slightly lower rise in private consumption in line with slowing employment growth but higher investment spending, supported by benign financing conditions. Concerning price developments, the DBP expects HICP headline inflation to rise in 2018 to 1.4% (from 1.3% in 2017), visibly lower than in the 2017 SP, but higher than in the Commission forecast (1.2%). The DBP expects the unemployment rate to decline marginally more than the Commission forecast, albeit remaining at high levels (10.7% compared to 11.2%) also due to rising participation rates.

Overall, the macroeconomic projections outlined in Italy's 2018 DBP appear plausible for 2017. However, the outlook for 2018 appears slightly optimistic as regards both real and nominal GDP growth. Recent government actions in the banking sector might help unclog bank lending, but the fragility of the Italian banking sector remains a downside risk, together with a potential slowdown in external demand.

Box 1: The macro economic forecast underpinning the budget in Italy

Italy's 2018 DBP is based on the macroeconomic scenario outlined in the update of the Economic and Financial Document (DEF) of 23 September 2017. The DEF presents a trend scenario, based on the hypothesis of unchanged legislation, and a programme scenario, including the impact of the measures proposed in the DBP. Both macroeconomic scenarios have been prepared by the government and endorsed by the Parliamentary Budget Office (PBO), Italy's independent fiscal monitoring institution. After the initial validation of the trend scenario, the PBO proceeded with endorsing also the programme one, after the government raised the DBP deficit target for 2018 to 1.6% of GDP from 1.2% in the updated DEF, despite lifting the projection for real GDP growth to 1.5%.

The endorsements, mentioned in the DBP, took the form of two letters (dated 15 September and 3 October 2017, respectively)[2] addressed to the Italian Minister of Economy and Finance and publicly available on the PBO's website. The letters state that both the trend and the programme forecast scenarios for 2017-2018 are validated, given the information currently available. However, real GDP growth in 2018 is subject to a significant downside risk. In its parliamentary hearing, the PBO noted that growth in 2018 is above the upper bound of its forecast range, and thus on the optimistic side.

[2] See www.upbilancio.it/wp-content/uploads/2017/09/Lettera-di-validazione-e-allegato-QMT-NADEF-2017.pdf and www.upbilancio.it/wp-content/uploads/2017/10/UPB_Lettera-validazione-QMP-NADEF-2017.pdf

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	0.9	1.1	1.5	1.5	1.0	1.5	1.3
Private consumption (% change)	1.5	0.9	1.4	1.4	0.6	1.4	1.1
Gross fixed capital formation (% change)	2.8	3.6	3.1	2.5	3.0	3.3	3.8
Exports of goods and services (% change)	2.4	3.7	4.8	4.8	3.2	3.6	3.8
Imports of goods and services (% change)	3.1	4.4	5.5	5.9	2.9	4.1	4.7
Contributions to real GDP growth:							
- Final domestic demand	1.5	1.2	1.5	1.4	0.9	1.5	1.4
- Change in inventories	-0.4	0.0	0.1	0.1	0.0	0.0	0.1
- Net exports	-0.1	-0.1	-0.1	-0.1	0.1	-0.1	-0.2
Output gap[1]	-1.9	-0.8	-0.6	-0.6	-0.2	0.5	0.3
Employment (% change)	1.3	0.6	1.2	1.2	0.8	0.9	0.9
Unemployment rate (%)	11.7	11.5	11.2	11.3	11.1	10.7	10.9
Labour productivity (% change)	-0.4	0.4	0.2	0.4	0.3	0.6	0.4
HICP inflation (%)	-0.1	1.2	1.3	1.4	1.7	1.4	1.2
GDP deflator (% change)	0.8	1.2	0.6	0.6	1.7	1.6	1.3
Comp. of employees (per head, % change)	0.5	1.0	0.8	0.5	1.2	1.1	1.5
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.5	2.2	2.1	2.3	2.5	1.9	2.4

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

Italy's DBP projects that the general government deficit will decrease to 2.1% in 2017, from 2.5% of GDP in 2016 (see Table 2). This is in line with the headline deficit planned in the SP. The Commission forecast also projects a deficit of 2.1% of GDP in 2017, following positive developments in the first three quarters and based on the assumption of a strict budgetary execution in the final months of the year. Moreover, both the DBP and the Commission assume for the time being a zero (one-off) impact on the 2017 deficit from the recent liquidation of two Italian regional lenders (*Banca Popolare di Vicenza* and *Veneto Banca*) and the precautionary recapitalisation of *Banca Monte dei Paschi di Siena*, although both operations pose risks.[3] Past pension reforms and moderate increases in both public wages,

[3] The overall fiscal impact of the two operations is currently being investigated by the competent statistical authorities, EUROSTAT and ISTAT.

frozen since 2010, and healthcare spending still curb expenditure dynamics. The tax burden is expected to remain broadly stable despite a reduction in the corporate income tax rate, mainly due to the additional revenue measures adopted in April 2017. Overall, Italy's DBP projects a structural deterioration[4] of 0.4% of GDP in 2017, in line with the Commission forecast but worse than the 0.3% of GDP worsening in the (recalculated) structural balance planned by the Stability Programme. The main reason behind this worsening is that in 2017 Italy incurred higher-than-expected (by around EUR 2 billion or 0.12% of GDP) capital transfers to the financial sector for DTAs due to large losses recorded by some banks in 2016 to clean up their balance sheets[5], and emerging savings from the rationalisation of public spending were earmarked (Decree Law 148/2017) to finance new current and capital expenditure, including subsidies to the Italian railway company, rather than to cover the mentioned capital transfers.

For 2018, the DBP plans that the government headline deficit will marginally decline to 1.6% of GDP, up from 1.2% targeted in the SP notwithstanding higher economic growth projections (real growth at 1.5% in lieu of 1.0%). In fact, the additional deficit-increasing measures envisaged in the DBP include the repeal of a VAT hike worth 0.9% of GDP previously legislated as a safeguard clause.[6] After incorporating the DBP measures, the Commission forecast expects the headline deficit to be 1.8% of GDP in 2018. The difference with the DBP is mainly explained by lower nominal GDP growth (2.6% compared to 3.1%) as well as by stronger expenditure dynamics than that underlying the DBP, where ambitious spending cuts are foreseen at all levels of government. Overall, Italy's DBP projects a (recalculated) structural improvement of 0.2% of GDP in 2018, significantly below the (recalculated) structural improvement of 0.8% of GDP planned in the Stability Programme and broadly in line with the 0.1% of GDP fiscal effort estimated on the basis of the Commission forecast.

In the government projections, the overall net deficit-increasing impact of the measures enshrined in the DBP accounts for close to 0.6% of GDP, almost entirely on the revenue side, while expenditure remains broadly stable. These expansionary measures are expected to have a positive impact on real GDP growth in 2018 (increasing to 1.5% in the programme scenario, up from 1.2% in the trend scenario). In comparison, based on the Commission forecast, where the "safeguard clauses" have not been included since autumn 2016, the overall net impact of the measures enshrined in the DBP is deficit-decreasing by close to 0.3% of GDP (namely, revenues would be 0.2 percentage points higher and expenditure 0.1 percentage points lower) and the impact on growth only marginal.

In 2018, total revenues (in nominal terms) are projected by the DBP to increase below nominal GDP growth (at 1.8% compared to 3.1%), thus shrinking by 0.6 percentage points as a share of GDP. Part of this (around 0.25% of GDP) is related to lower one-off revenues. In terms of composition, the projected marked decrease in current taxes on income and wealth as a share of GDP is also due to the impact on personal and corporate income tax of measures

[4] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

[5] These capital transfers are not considered as one-off measures. It should be noted that the increase recorded in 2017 will be reversed in 2018, facilitating the fiscal adjustment next year other things being equal.

[6] Italian legislation (Law 190/2014, as modified by Decree Law 50/2017 and Decree Law 148/2017) still foresaw an increase in reduced VAT rates from 10% to 11.14% in 2018 and from 11.14% to 12% in 2019 and an increase in standard VAT rates from 22% to 25% in 2018 and from 25% to 25.4% in 2019. The Budget Law 2018 provides for the reduced VAT rate to be 10% in 2018 and 11.5% in 2019 and for the standard VAT rate to be 22% in 2018 and 24.2% in 2019.

enacted in the 2017 Budget, although a simplified tax regime for small enterprises was postponed to 2019 (see Section 3.3 for further details). On the expenditure side, primary expenditure as a share of GDP is projected to decrease by 0.9 percentage points in 2017, as its increase in nominal terms (1.2% year-on-year) is lower than the projected nominal growth. Namely, current primary expenditure is projected to increase by 1.2% year-on-year, driven by social transfers. Compensation of employees is also projected to increase slightly in 2018 in nominal terms (by 1.3% of GDP), mainly due to further resources earmarked to increase public wages. As regards public investments, these are projected to increase by 6.0% y-o-y in nominal terms thanks to measures supporting investment in the DBP, and thus to remain broadly stable as a share of GDP (see Section 3.3 for further details).

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Italy currently standing at around 2.0%.[7] As a consequence, total interest payments by the general government have steadily decreased as a share of GDP. Based on the information included in the DBP, interest expenditure in Italy is expected to fall from 4.0% of GDP in 2016 to 3.8% in 2017 and is projected to decrease further next year, to 3.6% of GDP, well below the 5.2% recorded back in 2012 at the peak of the euro area sovereign debt crisis. The pattern is broadly confirmed by the Commission forecast. Against the background of falling interest expenditure, the deterioration in the structural balance projected in the DBP for 2017-2018 (0.2% of GDP, overall) is accompanied by a more pronounced deterioration in the structural primary balance (0.6% of GDP, overall). The Commission forecast points to similar conclusions.

As regards 2017, the Italian authorities pointed in the 2017 DBP and 2017 SP to exceptional expenditures related to the ongoing refugee crisis and the need to set up a comprehensive policy of migration management, and a preventive investment plan for the protection of the national territory against seismic risks, in particular by addressing hydrogeological risks and securing schools. As regards migration, the Italian authorities indicated that the budgetary impact of the exceptional inflow of refugees was significant and should be considered 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. More specifically, this expenditure was estimated in the 2018 SP at 0.22% of GDP in 2016 and 0.25% of GDP in 2017. The Commission quantified 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 SP, net of the 0.09% of GDP deviation already granted in 2015 and 2016, so as to avoid double-counting. As regards seismic activity, the DBP for 2017 requested an additional allowance of 0.18% of GDP consisting in earthquake-related expenditures, which was confirmed by the 2017 SP. The Commission Opinion on Italy's 2017 DBP considered Italy eligible for an *ex ante* allowance under the "unusual event clause" of 0.18% of GDP in 2017. Overall, last Spring the Commission provisionally assessed Italy to be eligible for an allowance of 0.34% of GDP in 2017 under the unusual events clause, of which 0.16% of GDP in relation to costs considered to have a clear and direct link to refugee inflows; and 0.18% of GDP for a preventive investment plan for the protection of the national territory against seismic risks. Italy's 2018 DBP confirms these amounts. The Commission will make a final assessment, including on the eligible amounts, in spring 2018 on the basis of observed data as provided by the authorities. In particular, given the need to verify implementation of the preventive investment plan for the protection of the national territory against seismic risks, the Commission should be provided with an *ex post* assessment by the authorities to be able to confirm the granted

[7] 10-year bond yields at 1.76% as of 6 November 2017. Source: Bloomberg.

amount of flexibility. As regards 2018, refugee-related expenditures for relief operations, healthcare, reception and education are estimated by the authorities, net of EU contributions, at 0.27% of GDP (or EUR 4.7 billion), broadly stable compared to 2017.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**46.9**	**46.8**	***47.0***	**47.0**	**47.0**	***46.4***	**46.7**	**-0.5**
of which:								
- Taxes on production and imports	14.4	14.5	*14.7*	14.7	15.5	*14.7*	14.5	0.2
- Current taxes on income, wealth, etc.	14.7	14.6	*14.6*	14.6	14.0	*14.2*	14.3	-0.6
- Capital taxes	0.3	0.2	*0.1*	0.3	0.1	*0.0*	0.2	-0.3
- Social contributions	13.2	13.1	*13.2*	13.2	13.2	*13.2*	13.3	0.0
- Other (residual)	4.2	4.4	*4.4*	4.3	4.2	*4.3*	4.3	0.1
Expenditure	**49.4**	**49.1**	**49.1**	**49.1**	**48.3**	**48.0**	**48.5**	**-1.4**
of which:								
- Primary expenditure	45.4	45.2	45.3	45.3	44.6	44.4	44.8	-1.0
of which:								
Compensation of employees	9.8	9.8	9.7	9.7	9.4	9.5	9.6	-0.2
Intermediate consumption	5.4	5.4	5.4	5.4	5.2	5.3	5.2	-0.1
Social payments	22.7	22.8	22.6	22.7	22.6	22.5	22.7	-0.3
Subsidies	1.8	1.7	1.7	1.8	1.6	1.6	1.7	-0.2
Gross fixed capital formation	2.1	2.1	2.1	2.0	2.2	2.1	2.0	0.0
Other (residual)	3.6	3.4	3.8	3.8	3.6	3.4	3.5	-0.2
- Interest expenditure	4.0	3.9	3.8	3.8	3.7	3.6	3.6	-0.4
General government balance (GGB)	**-2.5**	**-2.1**	**-2.1**	**-2.1**	**-1.2**	**-1.6**	**-1.8**	**0.9**
Primary balance	**1.5**	**1.7**	**1.7**	**1.7**	**2.5**	**2.0**	**1.8**	**0.5**
One-off and other temporary measures	0.2	0.3	0.3	0.3	0.1	0.0	0.0	-0.2
GGB excl. one-offs	**-2.7**	**-2.4**	**-2.4**	**-2.4**	**-1.3**	**-1.6**	**-1.8**	**1.1**
Output gap[1]	-1.9	-0.8	-0.6	-0.6	-0.2	0.5	0.3	2.4
Cyclically-adjusted balance[1]	-1.5	-1.7	-1.8	-1.8	-1.1	-1.9	-2.0	-0.4
Structural balance (SB)[2]	**-1.7**	**-2.0**	**-2.1**	**-2.1**	**-1.2**	**-1.9**	**-2.0**	**-0.2**
Structural primary balance[2]	2.3	1.9	1.7	1.7	2.5	1.7	1.6	-0.6

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/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 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.2. Debt developments

In 2017, the DBP projects the debt-to-GDP ratio to decrease to 131.6% (see Table 3), down by 0.4 percentage points from the 2016 level. By contrast, the SP for 2017 targeted an increase in the debt-to-GDP ratio of 0.5 percentage points this year. The difference is mainly due to the upward revision in projected nominal GDP growth, despite lower privatisation proceeds projected in the DBP (at 0.2% of GDP compared to the originally planned 0.3%). Compared to the DBP, the Commission forecast expects the debt ratio to further increase, even if only slightly, to 132.1% of GDP in 2017, as a result of a larger debt-increasing stock-flow adjustment (at 0.7% of GDP compared to 0.2% in the DBP). Around 0.3% of GDP of that difference stems from the larger impact of two recent bank resolution cases incorporated by the Commission in its debt forecast (at around EUR 15.6 billion or 0.9% of GDP compared to around EUR 10.2 billion or 0.6% of GDP in the DBP).[8] Moreover, while the government projects 0.2% of GDP of privatisations proceeds by the end of 2017, the Commission does not incorporate them *ex ante*, given the feasibility risks over such a short period of time and the track record of privatisations until now.

Table 3. Debt developments

[8] Pending a final decision by EUROSTAT, the Commission incorporated in its 2017 debt forecast the already identified impact of the two Veneto banks' resolution cases (around EUR 10.2 billion), plus the maximum impact related to the recapitalisation of Banca Monte Paschi di Siena (EUR 5.4 billion). The DBP assumes a smaller impact for the two bank resolution cases (around EUR 4.8 billion) but the same amount for the recapitalisation of Banca Monte Paschi di Siena.

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**132.0**	**132.5**	**131.6**	**132.1**	**131.0**	**130.0**	**130.8**
Change in the ratio	0.5	0.5	-0.4	0.1	-1.5	-1.6	-1.4
Contributions[2] *:*							
1. Primary balance	**-1.5**	**-1.7**	**-1.7**	**-1.7**	**-2.5**	**-2.0**	**-1.8**
2. "Snow-ball" effect	**1.7**	**1.0**	**1.0**	**1.2**	**0.3**	**-0.4**	**0.4**
Of which:							
Interest expenditure	4.0	4.0	3.8	3.8	3.8	3.6	3.6
Growth effect	-1.2	-1.4	-1.9	-1.9	-1.3	-1.9	-1.7
Inflation effect	-1.0	-1.5	-0.8	-0.8	-2.2	-2.1	-1.6
3. Stock-flow adjustment	**0.2**	**1.2**	**0.2**	**0.7**	**0.7**	**0.8**	**0.1**
Of which:							
Cash/accruals difference	-0.8	0.4	0.2	0.4	0.3	0.7	0.4
Net accumulation of financial	1.0	0.7	0.8	0.3	0.3	0.1	-0.3
of which privatisation proceeds	-0.1	-0.3	-0.2	0.0	-0.3	-0.3	-0.2
Valuation effect & residual	0.0	0.4	-0.7	0.0	0.4	0.0	0.0

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

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

For 2018, the DBP projects a further decline in the debt-to-GDP ratio to 130.0%, mainly triggered by stronger nominal GDP growth together with lower interest expenditure and an improvement in the primary surplus compared to 2017. Additionally, the DBP plans a debt-reducing impact from projected privatisation proceeds of around 0.3% of GDP, although precise details on the planned operations are not available. The 2017 SP projected a similar reduction in the debt ratio for 2018, although less related to the nominal growth but following a larger improvement in the primary surplus. The Commission expects a somewhat smaller decline in the debt-to-GDP ratio in 2018, to 130.8%. The difference with the DBP is mainly related to lower nominal growth and the fact that the Commission incorporates only half of the 0.3% of GDP privatisation proceeds projected by the government for 2018. Risks to both the Commission and the DBP debt projections for 2017 are related to a larger-than-anticipated impact of the bank resolution cases. Risks to both the Commission and the DBP debt projections for 2018 are mainly related to a worse-than-anticipated growth outlook, lower privatisation proceeds, and lower inflation.

3.3. Measures underpinning the draft budgetary plan

The measures in the DBP translate into a deficit target of 1.6% of GDP, up from 1.0% in the trend scenario (based on unchanged legislation), after taking into account the higher real GDP growth stemming from those measures (at 1.5%, up from 1.2% in the trend scenario). In particular, the DBP measures result in a decline in revenues of around 11 billion or 0.6% of GDP and broadly stable expenditure relative to the trend scenario, thereby leading to a deterioration of the headline position. The net impact of the DBP is different based on the Commission forecast, because the "safeguard clauses" are not incorporated in the baseline (see Section 3.1).

Among the main measures included in the DBP with a gross negative impact on the deficit are: (i) the full repeal in 2018 and the partial repeal in 2019 of a previously legislated increase in VAT and other taxes (the so-called "safeguard clauses") legislated for those years by the 2017 Budget Law (worth around EUR 15 billion or 0.9% of GDP in 2018 and EUR 6 billion or 0.4% of GDP in 2019); (ii) the permanent halving of social security contributions paid on new young hires for the first three years of an open-ended contract, in order to support job creation (worth around EUR 0.4 billion or 0.02% of GDP in 2018 and EUR 1 billion or 0.06% of GDP in 2019); (iii) various measures to support investment, R&D and firm competitiveness, including through the extension of a previously legislated *superammortamento* and *iperammortamento*[9] rate on new investment (worth overall around EUR 0.9 billion or 0.05% of GDP in 2018 and EUR 1.7 billion or 0.1% of GDP in 2019); (iv) further resources earmarked to increase public employees' wages (amounting to EUR 0.9 billion or 0.05% of GDP per year as of 2018) and to fight poverty and social exclusion (amounting to EUR 0.3 billion or 0.02% of GDP in 2018 and EUR 0.7 billion or 0.04% of GDP in 2019). It should be noted that the 2018 DBP also includes "other expenditure measures" amounting to around EUR 1.9 billion or 0.11% of GDP in 2018, which were not included in the Commission forecast due to lack of details by the cut-off date (20 October).

On the financing side, the main components of the Italian budgetary strategy include:

(i) a spending review at both ministerial and local level, which represents the first implementation of the recent reform of the budgetary process. Namely, the DBP projects the spending review to entail additional gross expenditure savings of around EUR 3.2 billion (or 0.18% of GDP) in 2018, partly through the rationalisation of ministries’ expenditure but also through planned lower transfers to local public bodies;

(ii) various measures to increase tax compliance and fight tax evasion. Namely, the DBP projects enhanced tax compliance to entail additional revenues of EUR 2.2 billion or 0.12% of GDP overall. However, around half of the latter (EUR 1.3 billion or 0.07% of GDP in 2018, overall) refer to the expected *one-off* impact of the extension of the possibility for taxpayers to avoid sanctions and fines by spontaneously regularising their past tax position (so-called "*rottamazione delle cartelle esattoriali*") and to increase the value of some assets in their balance sheet by paying a substitutive tax. The remaining half is related to: (i) the extension of compulsory electronic invoicing to all private sector transactions, except those among

[9] The 2018 Budget Law confirmed the possibility for companies to deduct 140% of the amount spent on investment in 2017 (so-called "*superammortamento*") and introduced a new "*iperammortamento*" rate of 250% for digital investments as part of the "Industry 4.0" strategy. The 2018 Budget Law extends to new investment made in 2018 and 2019 (under specific conditions) the "*iperammortamento*" rate of 250% on digital equipment functional to the technological development of firms and the "*superammortamento*" rate of 140% on software and of 130% on equipment instrumental to the firm's activity.

taxpayers subject to a simplified tax regime[10], as of 2019 and as of July 2018 for public procurement and fuels (worth EUR 0.2 billion or 0.01% of GDP in 2018 and EUR 1.7 billion or 0.09% of GDP in 2019) in line with a country-specific recommendation (see Section 5); and (ii) other measures to reduce tax fraud, mainly of VAT, by further limiting the automatic compensation of tax credits with tax dues, lowering the threshold for enhanced tax checks by the public administration, and introducing a new system of preventive fulfilment of tax obligations in the case of intra-EU transactions in mineral oils. Moreover, additional resources of around EUR 2 billion or 0.11% of GDP in 2018 are related to the postponement to 2019 of a simplified tax regime (IRI) for small enterprises (previously legislated as of 2018 by the 2017 Budget Law). It should be noted that the 2018 DBP also includes "other revenue measures" amounting to around EUR 1.5 billion or 0.09% of GDP in 2018, which were not included in the Commission forecast due to lack of details by the cut-off date (20 October).

[10] Namely, taxpayers subject the so-called "regime di vantaggio" pursuant to Law 111/2011 and the "regime forfetario" pursuant to Law 190/2014, are excluded from compulsory electronic invoicing.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Taxes on production and	0	-0.8	-0.2
Current taxes on income,	0	0.1	-0.1
Capital taxes	0	0.1	0.0
Social contributions	0	0.0	-0.1
Property Income			
Other			
Total	0	-0.6	-0.3

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Compensation of employees	0	0.0	0.0
Intermediate consumption	0	0.1	0.1
Social payments	0	0.0	0.0
Interest Expenditure			
Subsidies			
Gross fixed capital formation	0	0.0	-0.1
Capital transfers	0	0.1	0.0
Other	0	-0.1	-0.2
Total	0	0.0	-0.3

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2018

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

Italy is subject to the preventive arm of the Pact and should ensure sufficient progress towards its MTO. Box 2 reports the latest country-specific recommendation in the area of public finances. Italy is also subject to the debt reduction benchmark.

Box 2. Council recommendations addressed to Italy

On 11 July 2017, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended that Italy should pursue a substantial fiscal effort in 2018, in line with the requirements of the preventive arm of the Stability and Growth Pact, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Italy's public finances; ensure timely implementation of the privatisation programme and use windfall gains to accelerate the reduction of the general government debt-to-GDP ratio; shift the tax burden from the factors of production onto taxes less detrimental to growth in a budget-neutral way by taking decisive action to reduce the number and scope of tax expenditures, reforming the outdated cadastral system and reintroducing the first residence tax for high-income households; and broaden the compulsory use of electronic invoicing and payments.

The Council recalled that in 2018, in the light of its fiscal situation and in particular of its debt level, Italy is expected to further adjust towards its medium-term budgetary objective of a balanced budgetary position in structural terms. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, 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.

4.1. Compliance with the debt criterion

As the debt ratio was 132.0% of GDP in 2016, Italy needs to comply with the debt reduction benchmark.

In 2016, based on the Commission forecast, Italy did not comply with the debt reduction benchmark (gap of 5.8% of GDP). On 22 February 2017, the Commission issued a report under article 126(3) TFEU as Italy had not made sufficient progress towards compliance with the debt criterion in 2015. The report concluded that the debt reduction benchmark should be considered as not complied with at that stage, unless additional measures worth 0.2% of GDP were delivered. Following the enactment of those measures through Decree Law 50/2017, the Commission indicated in its 2017 Spring Package that no further assessment of compliance with the debt criterion in 2015 would be needed, and a new assessment of compliance with the debt criterion in 2016 based on the Commission 2017 autumn forecast was announced[11].

The DBP does not project compliance with the debt reduction benchmark either in 2017 (gap of 2.8% of GDP) or in 2018 (gap of 1.1% of GDP).

[11] Recital 11 states that "…*The Commission will reassess Italy's compliance with the debt criterion in autumn 2017, based on notified data for 2016 and the Commission 2017 autumn forecast, which will incorporate new information on budgetary implementation in 2017 and actual budgetary plans for 2018…*".

Based on the Commission forecast, Italy is not expected to comply with the debt rule, as its debt-to-GDP ratio is set to be considerably above the debt benchmark in both 2017 and 2018 (gaps of 5.3% and 5.6% of GDP, respectively).

Overall, based on an overall assessment of Italy's DBP, the debt reduction benchmark is expected not to be met in 2017 and not to be respected in 2018.

Table 5. Compliance with the debt criterion

	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	132.0	132.5	131.6	132.1	131.0	130.0	130.8
Gap to the debt benchmark [1,2]	5.8	3.2	2.8	5.3	2.0	1.1	5.6
Structural adjustment [3]	-0.9	-0.3	-0.4	-0.4	0.8	0.2	0.1
To be compared to:							
Required adjustment [4]	n.a	n.a	n.a	n.a	n.a	n.a	n.a

Notes:

[1] Not relevant for Member Sates 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 minimum 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 (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

4.2. Adjustment towards the MTO

The preventive arm of the SGP requires Member States with a general government debt ratio above 60% of GDP, not yet at their MTO, and experiencing "normal times" (i.e. an estimated output gap between -1.5% and 1.5% of potential GDP based on the relevant Commission forecast vintages), as is the case for Italy in both 2017 and 2018, to deliver a structural adjustment towards the MTO of 0.6% of GDP or more. Italy’s DBP projects a (recalculated) structural deterioration of 0.4% of GDP in 2017 and a (recalculated) structural improvement of 0.2% of GDP in 2018 (see also Section 3.1).

For 2017, based on DBP, the expenditure benchmark[12] points to a risk of significant deviation (see Table 7) both over one year (gap of 1.2% of GDP) and over 2016 and 2017 taken

[12] As part of the agreement on the EFC Opinion on "Improving the predictability and transparency the SGP: a stronger focus on the expenditure benchmark in the preventive arm", which was adopted by the EFC on 29 November 2016, the expenditure benchmark, that is the maximum allowable growth rate of expenditure net of discretionary revenue measures, is expressed in nominal terms as from 2018.

together (gap of 0.6% of GDP per year, on average) as, according to the information provided in the DBP, the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate (-1.4% y-o-y in real terms) in 2017. The same conclusion can be reached on the basis of the structural balance pillar, as the (recalculated) structural deterioration planned by the government points to a risk of significant deviation from the required 0.6% of GDP adjustment towards the MTO both over one year (gap of 1.0% of GDP) and over 2016 and 2017 taken together (gap of 0.7% of GDP per year, on average). The expenditure benchmark is positively impacted by a slightly higher GDP deflator that included a later repealed VAT hike. Taking this into account, the conclusion of a risk of significant deviation is confirmed. The structural balance, in turn, is negatively impacted by revenue shortfalls and positively impacted by a decline in interest expenditure and in nationally-financed public investments, leaving the conclusion unchanged. Overall, Italy's DBP plans a significant deviation from the required adjustment towards the MTO in 2017. Subtracting from the preventive arm requirement the projected budgetary impact of the exceptional inflow of refugees (estimated at 0.16% of GDP) and of the preventive investment plan for the protection of the national territory against seismic risks (estimated at 0.18% of GDP) in 2017 would not change that conclusion.

For 2017, the Commission forecast also expects Italy's structural balance to deteriorate by 0.4% of GDP, reaching -2.1% of GDP (i.e. below Italy's minimum benchmark of -1.5% of GDP). The expenditure benchmark points to a risk of significant deviation both over one year (gap of 0.9% of GDP) and over 2016 and 2017 taken together (gap of 0.4% of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate (-1.4% y-o-y in real terms) in 2017. The same conclusion can be reached on the basis of the structural balance pillar both over one year (gap of 1.0% of GDP) and over 2016 and 2017 taken together (gap of 0.7% of GDP per year, on average). The expenditure benchmark is positively impacted by a slightly higher GDP deflator that included a later repealed VAT hike. Taking this into account, the conclusion of a risk of significant deviation is confirmed. The structural balance, in turn, is negatively impacted by revenue shortfalls (0.2% of GDP) and positively impacted (0.2% of GDP) by a decline in interest expenditure and in nationally-financed public investments, leaving the conclusion unchanged. Taking into account those factors, the overall assessment points to a risk of significant deviation in 2017 based on the Commission forecast.

Again, subtracting from the preventive arm requirement the projected budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks would not change that conclusion. Moreover, the implementation of the "constrained judgement" approach in the case of Italy (see Box 3), while usefully complementing the analysis of the estimates of Italy's output gap, would not affect Italy's compliance status under the SGP for 2017 as mentioned above.

Box 3. Implementation of the "constrained judgement" approach and its impact on 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, it was agreed, alongside a revision of the methodology for the estimation of the non-accelerating wage rate of unemployment, to introduce a "constrained judgement" approach for cases where the commonly agreed methodology appears to produce "counterintuitive" output gap results for individual Member States. This has already been implemented in the assessment of the 2017 Draft Budgetary Plans and the 2017 Stability and Convergence Programmes.

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 flags the estimate of a Member State's output gap using 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 clear indications that the output gap estimated on the basis of the commonly agreed methodology for 2017 (i.e. -0.6% of potential GDP) may be counterintuitive, since it falls outside the estimated confidence interval at a rather high level of confidence (90%).

The value for Italy's output gap obtained by the plausibility tool would be -1.7% of potential GDP in 2017, i.e. some 1.2 percentage points of GDP wider than that based on the commonly agreed methodology. Applying this difference also to the output gap estimate for 2018 based on the commonly agreed methodology, i.e. 0.3% of potential GDP, the tool would point for analogy to a "plausible" estimate of -0.9% of potential GDP in 2018.

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 (close to 11%), very low core inflation, and sluggish dynamics of unit labour costs based on the Commission 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 is postponed beyond 2018.

Based on the output gaps estimated on the basis of the "constrained judgement" approach for 2017 and 2018, the required structural effort as per the preventive arm matrix would not change in the case of Italy either for 2017 or for 2018 (i.e. it would remain at 0.6% of GDP at least in both years). In the case of 2017, in particular, while the "plausible" estimate of the output gap would point, as per the preventive arm matrix, to "bad economic times" and as such to a lower requirement of 0.5% of GDP, it would not satisfy the conditions of the so-called "unfreezing principle".[13] 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 2017, the Member State's compliance status under the SGP would not be affected under an alternative "constrained judgement" approach to estimating it.

[13] See the EFC agreement on "*'Unfreezing' the fiscal requirement under the preventive arm of the SGP*" endorsed by the ECOFIN Council in December 2016, reviewing the arrangements in place for updating the fiscal requirements contained in the Council's country-specific recommendations.

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2016	2017		2018	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	-1.7	-2.1		-2.0	
Structural balance based on freezing (COM)	-1.6	-2.0		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2016**	**2017**		**2018**	
	COM	**DBP**	**COM**	**DBP**	**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	-0.4	-0.4	0.2	0.1
One-year deviation from the required adjustment[7]	-0.4	-1.0	-1.0	-0.4	-0.5
Two-year average deviation from the required adjustment[7]	-0.2	-0.7	-0.7	-0.7	-0.8
Expenditure benchmark pillar					
Applicable reference rate[8]	0.8	-1.4		-0.2	
One-year deviation adjusted for one-offs[9]	0.1	-1.2	-0.9	-0.1	-0.5
Two-year average deviation adjusted for one-offs[9]	0.3	-0.6	-0.4	-0.6	-0.7
PER MEMORIAM: One-year deviation[10]	0.5	-1.1	-0.8	-0.3	-0.8
PER MEMORIAM: Two-year average deviation[10]	0.5	-0.3	-0.2	-0.7	-0.8
Conclusion					
Conclusion over one year	Overall assessment	Significant deviation	Significant deviation	Overall assessment	Overall assessment
Conclusion over two years	Overall assessment	Significant deviation	Significant deviation	Significant deviation	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 2016) was carried out on the basis of Commission 2017 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.

Source :

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

For 2018, based on DBP, the expenditure benchmark points to a risk of some deviation (see Table 7) over one year (gap of 0.1% of GDP) and to a risk of significant deviation over two years (gap of 0.6% of GDP per year, on average) as, according to the information provided in the DBP, the growth rate of government expenditure, net of discretionary revenue measures, will exceed the applicable expenditure benchmark rate (-0.2% y-o-y in nominal terms) in 2018. The same conclusion can be reached on the basis of the structural balance pillar, as the (recalculated) structural effort planned by the government points to a risk of some deviation from the required 0.6% of GDP adjustment towards the MTO over one year (gap of 0.4% of GDP) and to a risk of significant deviation over 2017 and 2018 taken together (gap of 0.7% of GDP per year, on average). The structural balance is negatively impacted by revenue shortfalls, which are offset by the positive impact of a decline in interest expenditure and a slightly higher point estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark. Overall, Italy's DBP plans a significant deviation from the required adjustment towards the MTO in 2018.

For 2018, the Commission forecast expects Italy's structural balance to improve by 0.1% of GDP, reaching -2.0% of GDP. The expenditure benchmark points to a risk of significant deviation both over one year (gap of 0.5% of GDP) and over 2017 and 2018 taken together (gap of 0.7% of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate (-0.2% y-o-y in nominal terms) in 2018. The same conclusion can be reached on the basis of the structural balance pillar, which points to a risk of some deviation over one year (gap of 0.5% of GDP) and to a risk of significant deviation over 2016 and 2017 taken together (gap of 0.8% of GDP per year, on average). The structural balance is negatively impacted by revenue shortfalls (0.3% of GDP), which are offset by the positive impact of a decline in interest expenditure (0.1% of GDP) and a slightly higher point estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark (0.2% of GDP). The expenditure benchmark is thus considered to appropriately reflect the underlying fiscal effort of Italy. Taking into account those factors, the overall assessment points to a risk of significant deviation in 2018 based on the Commission forecast.

Following an overall assessment based on the Draft Budgetary Plan and the Commission's 2017 autumn forecast, the adjustment path towards the MTO points to a risk of significant deviation from the adjustment path towards the MTO in both 2017 and 2018.

The Commission Communication on the 2017 European Semester of May 2017[14] stated that the Commission stands ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment is particularly significant. The country-specific recommendations adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. Box 4 presents a qualitative assessment of the strength of the recovery in Italy while giving due consideration to its sustainability challenges.

Overall, Italy does not seem to face short-term sustainability challenges, although in the medium term the overall risks to fiscal sustainability are assessed as high. The recovery in Italy appears fragile. In particular, real GDP and investment remain below their pre-crisis

[14] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

levels, while the unemployment rate is still much higher than before the crisis, which, together with persistently weak productivity, undermines Italy's growth prospects. Moreover, the estimated output gap is subject to uncertainty as flagged by the plausibility tool.

Box 4. Assessment of the cyclical situation of ITALY

According to the S0 indicator, Italy does not appear to face short-term sustainability challenges, in view of the low risks from the macro-financial context. Nonetheless, the high debt-to-GDP ratio (132.0 % of GDP in 2016) and the related rollover needs (around 20% of GDP each year) pose potential risks.

Moreover, government debt is projected at around 132.1% of GDP in 2017 and sustainability risks are considered to be high in the medium term according to the medium-term fiscal sustainability risk indicator S1. In particular, the 1.6% of GDP structural primary surplus expected in 2018 by the Commission forecast would not allow any reduction in the debt-to-GDP ratio over the medium term.

On the other hand, the recovery in Italy appears fragile. The Italian economy has been growing since mid-2014, but real GDP remains below its pre-crisis level. In the first half of 2017, real GDP rose by 1.4% year-on-year, which is close to the expected output growth in the autumn forecast (1.5% in 2017 as a whole). Despite positive developments in 2017, in Q2-2017, the real GDP level was still 6.4% below pre-crisis level (Q1-2008), with the level of investment over 25% below its pre-crisis level and the capital stock declining. The potential growth is currently estimated at slightly above zero for 2017 (vs. around 1% before the crisis), implying a fast closure of the negative output gap despite the moderate recovery. Moreover, the estimated output gap is subject to uncertainty as flagged by the plausibility tool. More specifically, Italy's output gap would turn positive as of 2018, from -1.7% of potential GDP estimated for 2016 (the OECD and IMF estimates larger output gaps in 2016, at -3.4% and -2.7% respectively). Despite the fast closure of the output gap, the Italian economy does not show any sign of inflationary pressures, since contractual wages were growing only moderately (0.4%) and core inflation was weak (0.8%) in the first half of 2017. The unemployment rate is still much higher than before the crisis (11.2% in Q2-2017 compared to around 6% in 2007), with around 3 million people looking for a job (compared to 1.5 million in 2007). Employment growth in 2015-16 was driven to a large extent by fiscal incentives, but the recovery of the labour market has become more self-sustained in 2017. The low level of investment and the high unemployment rate, together with persistently weak productivity growth, undermine Italy's growth prospects.

In these circumstances, the impact of the fiscal adjustment of 0.6% of GDP derived from the matrix on growth and employment is expected to be particularly significant.

In order to balance the current stabilisation needs with the existing sustainability challenges, according to the Commission, a fiscal structural effort of at least 0.3% of GDP is required, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary government expenditure not exceeding 0.5%. Taking that into account in the overall assessment, Italy's fiscal adjustment cannot be considered adequate, in light of the sustainability challenges that Italy faces, on the basis of the Commission 2017 autumn forecast.

5. Composition of public finances and Implementation of fiscal structural reforms

Italy has taken some steps to reduce the labour tax wedge (see Box 5) and, more generally, to reform the taxation system and increase tax compliance. In particular, the DBP provision extending the existing compulsory electronic invoicing for transactions with the public administration to private sector transactions, except those among taxpayers subject to a simplified tax regime, as of 2019 (and as of 2018 for public procurement and fuels) is a step in line with the first country-specific recommendation asking Italy to "broaden the compulsory use of electronic invoicing and payments". Moreover, other new provisions to reduce tax fraud put forward in the DBP, for instance by further limiting the automatic compensation of tax credits with tax dues, lowering the threshold for enhanced tax checks by the public administration, and introducing a new system of preventive fulfilment of tax obligations in the case of intra-EU transactions in mineral oils, appear to be steps in the right direction to tackle Italy's large VAT gap.

However, as regards the broader reform of tax policy, there seem to be delays with respect to several elements included in the 2017 country-specific recommendations: (i) a reform of the outdated cadastral system; (ii) concrete actions to reduce the number and scope of tax expenditures; and (iii) measures to increase property taxation on high-income households. Moreover, a large part of the measures envisaged in the DBP to enhance tax compliance, such as the extension of the possibility for taxpayers to avoid sanctions by spontaneously regularising their past tax position (so-called "*rottamazione delle cartelle esattoriali*") and to revaluate participations and building areas by paying a substitutive tax, are set to generate additional revenues largely of a one-off nature.

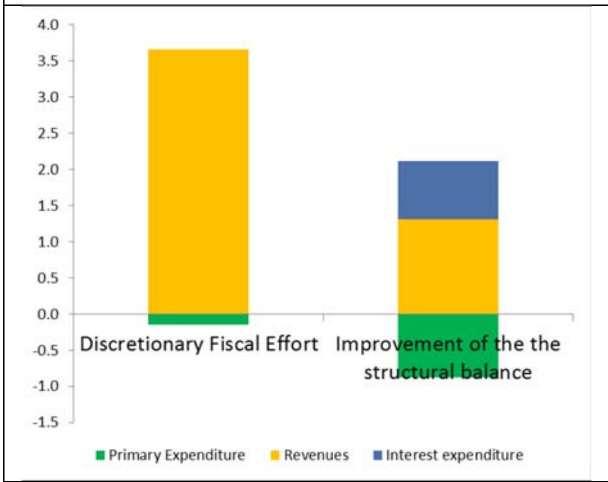
On the expenditure side, further action to rationalise public spending has been taken during 2017. Namely, with the 2018 Budget the government has implemented for the first time the reformed budgetary process that aims at performance-budgeting over the medium term and ensuring that the spending review becomes a more permanent feature of the budgetary process across all levels of government. In particular, Ministers have been directly involved in selecting areas within their own budgets liable to be subject to targeted savings, and the DBP projects the spending review to entail additional gross expenditure savings of around EUR 3.2 billion (or 0.18% of GDP) in 2018, partly through the rationalisation of ministries' expenditure but also through planned lower transfers to local public bodies. The latter might however result in lower public investment.

Over the period 2011-2017, Italy's fiscal effort has been mostly on the revenue side and helped by downward trending interest expenditure, while primary expenditure has increased slightly, relative to Italy's sluggish potential output (see Graph 1). Moreover, Italy's public expenditure appears to be increasingly biased towards the elderly, while growth-enhancing spending has been markedly restrained during the crisis. This has contributed to the increase in the weight of social spending in total expenditure over the past years, at the expense of investment, severely curtailed during the crisis, and public wages, frozen since 2010 (see Graph 2).

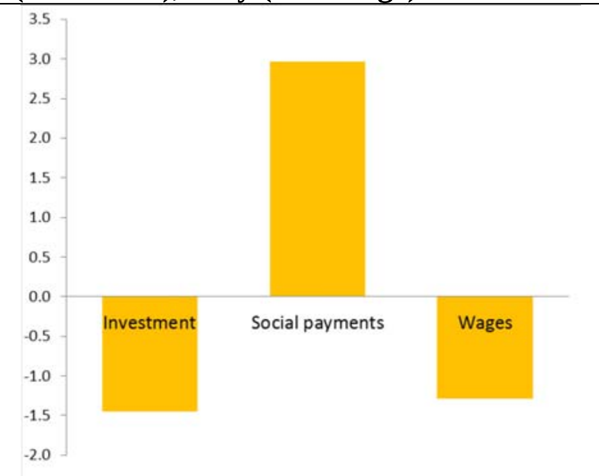
As regards 2018, based on the Commission forecast, the net deficit-decreasing impact of the measures enshrined in the DBP by 0.3 percentage points of GDP is mostly related to higher revenues, which partly compensate previous tax cuts. Instead, net expenditure remains broadly stable. In fact, the targeted savings across public bodies are largely reused for measures to support investment, R&D and firms competitiveness, to increase public employees' wages, and to fight poverty and social exclusion.

The repeated strategy to legislate safeguard clauses (mostly VAT hikes) that are subsequently repealed the following year constrains the government to continuously identify compensatory measures and casts doubts on the credibility of Italy's budgetary strategy to reach its MTO. More specifically, the three-year budget envisaged since the 2009 reform of the budgetary process was meant to give more certainty about the measures that the government wanted to implement in order to achieve its medium-term targets. However, the practice of including large tax increases to fill the gap between trends and targets in the three-year budget and of repealing them later on has made the budget unreliable in the outer years. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be made in the 2018 Country Reports and in the context of the country-specific recommendations adopted by the Commission in May.

Graph 1: Composition of the fiscal effort (2011-2017), Italy (% GDP)



Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Italy (% change)



<u>Source</u>: Draft Budgetary Plans 2018, European Commission 2017 autumn forecast.

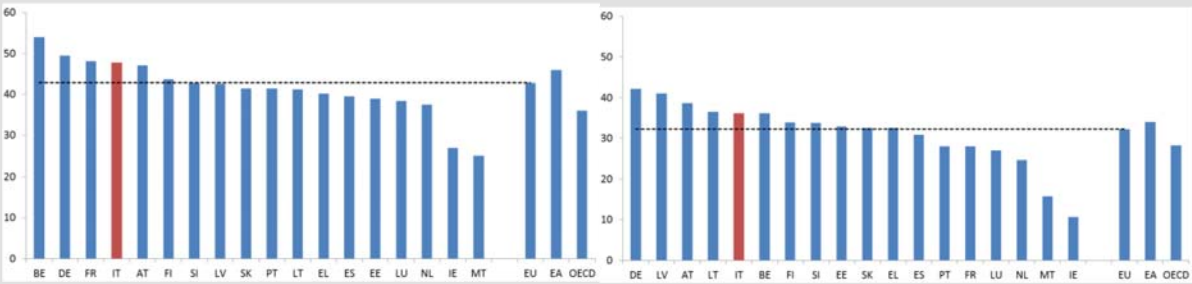
Graph 1 shows the Discretionary Fiscal Effort (DFE) which combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 (http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf)

Box 5 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Italy for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Italy at the average wage and at low wage (2016)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.
Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

In the context of the 2017 European Semester, Italy was issued the recommendations to "*Shift the tax burden from the factors of production onto taxes less detrimental to growth in a budget-neutral way by taking decisive action to reduce the number and scope of tax expenditures, reforming the outdated cadastral system and reintroducing the first residence tax for high-income households*."

Italy's Draft Budgetary Plan contains the following measure that affects the tax wedge on labour: (i) the permanent halving of social security contributions (within the limit of EUR 3000 per year) paid by private employers on new hires below the age of 30 (and below the age of 35 for new contracts starting in 2018) for the first three years of an open-ended contract, and for the first year of an apprenticeship contract; private employers are fully exempted (within the limit of EUR 3000 per year) if they hire under an open-ended contract students (below the age of 30 and below the age of 35 in 2018) who had previously spent periods of apprenticeship or traineeship ("*alternanza scuola lavoro*") with them.

This measures aims at increasing competitiveness and supporting employment growth by targeting a specific groups of workers, namely the youth. Its budgetary impact is projected to be limited in the first year (less than EUR 500 million or 0.02% of GDP) but to become substantial after the measure is taken up by private sector employers offering new contracts ("*contratti a tutele crescenti*") to young people. Namely, it is projected to reach EUR 1 billion or 0.06% of GDP in 2019 and EUR 1.5 billion or 0.08% of GDP in 2020.

6. OVERALL CONCLUSION

Based on both the Draft Budgetary Plan and the Commission 2017 autumn forecast, Italy is not expected to comply with the debt rule in 2017 and 2018.

The estimated structural deterioration of 0.4% of GDP based on both the Draft Budgetary Plan and the Commission forecast points to a risk of a significant deviation from the required adjustment path towards the MTO in 2017. This conclusion does not change when the budgetary impact of the exceptional inflow of refugees and of a preventive investment plan for the protection of the national territory against seismic risks (overall 0.34% of GDP, to be confirmed *ex-post*) is subtracted from the preventive arm requirement.

Regarding 2018, the estimated structural improvement based on the Draft Budgetary Plan (0.2% of GDP) and the Commission forecast (0.1% of GDP) points to a risk of a significant deviation from the required adjustment path towards the MTO in 2018.

Italy's structural adjustment for 2018 does not appear adequate even after taking into account the need to balance the two objectives of strengthening the ongoing recovery and ensuring fiscal sustainability effect that a large fiscal adjustment would have on Italy's ongoing recovery.