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## **Assessment of the 2016 Stability Programme for**

**Italy**

*(Note prepared by DG ECFIN staff)*

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## 1. INTRODUCTION

This document assesses Italy's 2016 Stability Programme (hereafter, Stability Programme). The Stability Programme was adopted by the Italian government on 8 April and, after being endorsed by the Italian Parliament, was submitted in the original language to the Commission on 28 April. The Stability Programme covers the period 2016-2019 and presents the fiscal targets for the forthcoming years, which will be the basis for the 2017 Stability Law to be adopted by end-2016. However, the government could revise these targets in September 2016 in case of changes in the relevant macroeconomic and fiscal outlook.

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 123.3% of GDP in 2012 (the year in which Italy corrected its excessive deficit), exceeding the 60% of GDP Treaty's reference value, Italy was also subject to the transitional arrangements as regards compliance with the debt reduction benchmark during the three years following the correction of the excessive deficit. After the transition period, as of 2016, Italy is required to comply with the debt reduction benchmark.

On 18 May 2016, the Commission issued a report<sup>1</sup> under article 126(3) TFEU, as Italy did not make sufficient progress towards compliance with the debt rule in 2015. The report concluded that, after the assessment of all the relevant factors, the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with. The Commission will review its assessment of the relevant factors in a new report under Article 126(3) TFEU based on the Commission 2016 autumn forecast, as further information on the credibility and appropriateness of Italy's resumption of the adjustment path towards the MTO for 2017 becomes available.

This document complements the Country Report published on 26 February 2016<sup>2</sup> 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 2016 spring forecast. The following Section presents the recent and planned budgetary developments, according to the stability programme. In particular, it includes an overview on the medium term budgetary plans, an assessment of the measures underpinning the stability programme and a risk analysis of the budgetary plans based on Commission forecast. Section 4 assesses compliance with the rules of the SGP, including on the basis of the Commission forecast. Section 5 provides an overview on long-term sustainability risks and Section 6 on recent developments and plans regarding the fiscal framework and the quality of public finances. Section 7 provides a summary.

## 2. MACROECONOMIC DEVELOPMENTS

In 2015, real GDP in Italy grew by 0.8%, halting the economic slump that followed the sovereign debt crisis. The recovery was supported by positive external factors including a weaker euro and lower oil prices. Yet, over the course of 2015, the pace of growth declined and resulted in only a modest positive carry-over for 2016. As foreseen in the Code of

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<sup>1</sup> COM(2016) 305 final: [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/30\\_edps/126-03\\_commission/2016-05-18\\_it\\_126-3\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/126-03_commission/2016-05-18_it_126-3_en.pdf)

<sup>2</sup> "Country Report Italy 2016 - Including an In-Depth Review on the prevention and correction of macroeconomic imbalances": [http://ec.europa.eu/europe2020/pdf/csr2016/cr2016\\_italy\\_en.pdf](http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_italy_en.pdf)

Conduct, the 2016 Stability Programme contains two macroeconomic scenarios, a *trend* one based on the hypothesis of unchanged legislation and a *policy* one including the planned fiscal measures and the impact of structural reforms presented in the National Reform Programme. External assumptions are common to both scenarios and broadly in line with those in the Commission 2016 spring forecast for 2015 and 2016.

In the policy scenario, the Stability Programme revises real GDP growth downwards in 2016 compared to the 2016 Draft Budgetary Plan (DBP) policy scenario (1.2% vs. 1.6%). The revision is explained by two factors. First, growth in the final quarter of 2015 was lower than expected by the government, leading to a lower carry-over for 2016 by 0.3 percentage points of GDP. Secondly, a revision of the external assumption leads to a less favourable external environment in 2016 than in the DBP. More in detail, the positive impact of the lower oil price is more than offset by an expected lower foreign demand and by a less favourable nominal effective exchange rate. These factors ultimately translate into lower export growth in 2016 compared to the DBP projections. This update of the external environment affects negatively the outlook for 2017 as well. In the policy scenario, the Stability Programme revises GDP growth downwards in 2017 (1.4% vs. 1.6%). This downward revision takes into account two divergent factors: the less favourable external assumptions lead to a downward revision, which is only partially compensated by a less restrictive fiscal stance. In fact, in the Stability Programme, the government plans to repeal the legislated increases in VAT worth around 0.9% of GDP overall in 2017 and replace them with expenditure cuts related to the ongoing spending review, the fight against tax evasion and lower tax expenditures yet to be specified, worth around ½% of GDP overall. As a result, the Stability Programme policy projections factor in expansionary fiscal measures worth 0.4 percentage points of GDP relative to the trend scenario. Real GDP growth projections in 2018 and 2019 (1.4% and 1.3% respectively) remain broadly in line with those in the DBP, supported by an overall improvement of economic conditions.

The 2016 Stability Programme growth projections and the Commission spring forecast for 2016 and 2017 are broadly aligned (the former being 0.1 percentage points higher than the latter), also in terms of composition of growth with domestic demand becoming the main driver of growth. The Stability Programme projects slightly less dynamic exports and domestic demand, especially investment, in both 2016 and 2017. As investment appears to be more import-intensive than private consumption, import growth is weaker in the Stability Programme than in the Commission forecast, which ultimately explains why the government projections are marginally higher than the Commission forecast. For the outer years of the policy scenario, the Stability Programme appears consistent with the external assumptions. The negative output gap, as recalculated by the Commission based on the information in the Stability Programme following the commonly agreed methodology, is expected to close by 2018, from around -3% of potential GDP estimated for 2015.

The Stability Programme shows similar employment and employees' compensation to the Commission forecast for 2016. For 2017, despite similar employment and inflation projections, employees' compensation is set to grow more strongly in the Stability Programme, thus entailing more buoyant tax revenues. The unemployment rate is projected to decline as the economic recovery continues. After falling to 11.4% in 2016, in 2017 the Stability Programme projects that the unemployment rate will decline to 10.8%, i.e. below the Commission forecast (11.2%), despite a similar real GDP growth. This is mainly explained by a stronger increase in headcount employment. The unemployment rate is then projected to diminish further to 9.6% by 2019. In the Stability Programme, labour productivity (measured on full time equivalent employment) is expected to recover over the forecast horizon, broadly in line with the Commission forecast. As nominal compensation per employee is expected to

increase roughly in line with productivity growth, nominal unit labour costs remain broadly stable in 2016 in both the Government and the Commission forecast. In the Stability Programme, nominal compensation per employee is then projected to increase more strongly than productivity from 2017, leading to accelerating unit labour costs that, however, would remain well below 2% and below the GDP deflator. This would imply a recovery in profit margins after the squeeze recorded in the crisis years.

**Table 1: Comparison of macroeconomic developments and forecasts**

	2015		2016		2017		2018	2019
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	0.8	0.8	1.1	1.2	1.3	1.4	1.5	1.4
Private consumption (% change)	0.9	0.9	1.5	1.4	1.1	1.4	1.7	1.6
Gross fixed capital formation (% change)	0.8	0.8	3.2	2.2	4.1	3.0	3.2	2.4
Exports of goods and services (% change)	4.3	4.3	2.4	1.6	4.0	3.8	3.7	3.4
Imports of goods and services (% change)	6.0	6.0	3.8	2.5	4.7	3.8	4.6	4.2
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	0.5	0.5	1.5	1.3	1.5	1.3	1.5	1.5
- Change in inventories	0.5	0.5	-0.1	0.0	-0.1	0.0	0.1	0.0
- Net exports	-0.3	-0.3	-0.3	-0.2	0.0	0.1	-0.2	-0.2
Output gap <sup>1</sup>	-2.9	-2.8	-1.6	-1.6	-0.4	-0.4	0.6	1.2
Employment (% change)	0.6	0.6	0.7	0.9	0.6	1.0	0.9	0.7
Unemployment rate (%)	11.9	11.9	11.4	11.4	11.2	10.8	10.2	9.6
Labour productivity (% change)	-0.1	0.2	0.2	0.3	0.4	0.4	0.6	0.7
HICP inflation (%)	0.1	0.1	0.2	0.2	1.4	1.3	1.6	2.0
GDP deflator (% change)	0.8	0.8	0.8	1.0	1.2	1.1	1.6	1.8
Comp. of employees (per head, % change)	0.5	0.5	0.3	0.4	0.5	1.0	2.0	1.8
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.4	2.3	2.5	2.6	2.4	2.6	2.4	2.3
<b>Note:</b>								
<sup>1</sup> In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
<b>Source:</b>								
Commission 2016 spring forecast (COM); Stability Programme (SP).								

Risks to the Stability Programme growth projections appear to be slightly tilted to the downside. In particular, the external assumptions pose some downside risks as regards to weak external demand and possibly stronger exchange rate. Moreover, persistent uncertainty on economic prospects might limit the recovery in investment and employment.

Overall, in light of the above assessment, the macroeconomic projections in the Stability Programme appear to be plausible. The Parliamentary Budget Office (PBO), Italy's independent fiscal monitoring institution, validated both the trend and the policy scenario in April 2016.<sup>3</sup> However, the Office also highlighted that growth projections in the Stability Programme are positioned in the higher part of the forecast range used for its assessment.<sup>4</sup>

<sup>3</sup> [http://www.upbilancio.it/wp-content/uploads/2016/04/UPB\\_Lettera-validazione-programmatico-2016.pdf](http://www.upbilancio.it/wp-content/uploads/2016/04/UPB_Lettera-validazione-programmatico-2016.pdf)

<sup>4</sup> [http://www.upbilancio.it/wp-content/uploads/2016/04/Audizione-19\\_4-sul-DEF-20161.pdf](http://www.upbilancio.it/wp-content/uploads/2016/04/Audizione-19_4-sul-DEF-20161.pdf)

### 3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

#### 3.1. Deficit developments in 2015

Italy notified a headline deficit at 2.6% of GDP in 2015 (down from 3% in 2014), in line with the 2016 DBP and with the 2015 Stability Programme. This has been achieved despite lower one-off revenues, mainly thanks to slightly lower interest expenditure (at 4.2% of GDP from 4.6% in 2014).

More in detail, while current primary expenditure stabilised in nominal terms, overall primary expenditure increased by 0.9% year-on-year in 2015, as a result of capital expenditure dynamics (+10.9% year-on-year). This was in turn affected by public investment, bottoming out after five years of contraction, and capital transfer dynamics reflecting sizeable one-off measures (i.e. EUR 1.7 bn related to the resolution of four small banks, which was more than compensated by EUR 2.3 bn of one-off contributions paid by the banking sector, and EUR 2.2 bn of pension arrears related to a Constitutional Court ruling against the complete de-indexation carried out in 2012-2013). On the revenue side, overall revenues increased less than nominal GDP (by 1% vs. 1.5%). The current tax burden declined marginally, although improving economic conditions translated into positive developments for personal and corporate income tax revenues. In particular, the tax wedge on labour declined mainly due to the exemption from the regional tax on economic activity (IRAP) of labour costs for permanent employees, while VAT revenues benefited from discretionary measures to increase tax compliance, such as the reverse charge system introduced for payments made by the public administrations (so-called *split payment*). Capital revenues fell markedly relative to 2014 mainly because of lower transfers from the EU as well as one-off taxes.

#### 3.2. Medium-term strategy and targets

For 2016, the Stability Programme projects a slight decline in the headline deficit, to 2.3% of GDP, from 2.6% in 2015. This is substantially higher than the 1.8% of GDP headline deficit target projected in the 2015 Stability Programme (see Figure 1). The supportive nature of the 2016 Stability Law explains this marginal decline, despite an improvement in cyclical conditions, namely real GDP accelerating to 1.2% and nominal GDP growth expected to increase to 2.2% (from 1.6% in 2015), a further drop in interest expenditure by 0.2 percentage points of GDP compared to 2015, and a broadly stable primary surplus (at 1.7% of GDP in 2016 vs. 1.6% in 2015).

First, in its 2016 DBP, Italy requested to avail itself, pursuant to the Commission Communication “*Making the Best Use of the Flexibility within the existing Rules of the Stability and Growth Pact*”,<sup>5</sup> of a deviation of 0.4% of GDP from the required adjustment path towards its medium term of objective. This was in addition to the allowance already granted by the Council in July 2015 under the so-called *structural reform clause*, whereby Italy had been recommended to pursue a fiscal effort of at least 0.1% of GDP in 2016, in lieu of 0.5%. More in detail, Italy requested in its 2016 DBP an allowance of 0.3% of GDP under the so-called *investment clause*, as well as 0.1% of GDP under the *structural reform clause* - reaching the maximum deviation of 0.5% of GDP attainable under this clause. The request of flexibility in the 2016 DBP was coupled with planned deficit-increasing measures, raising Italy’s 2016 headline deficit target to 2.2% of GDP, from 1.8% in the 2015 Stability

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<sup>5</sup> COM(2015) 12 final of 13 January 2015

Programme. In addition, Italy requested an allowance of 0.2% of GDP for 2016 for the expenditures incurred in relation to the exceptional inflow of refugees, considered to be an “unusual event and exceptional circumstance”. The 2016 DBP indicated that, if the latter additional allowance had been granted, it would have been used to reduce corporate taxation in 2016 (namely, lowering corporate income tax rate from 27.5% to 24%), thereby increasing the headline deficit target further to 2.4% of GDP (from 2.2%). This revised target, conditional upon the fiscal flexibility requested in relation to the exceptional inflow of refugees, was endorsed by the Parliament.

Second, the 2016 Stability Law provided for additional expenditure in security, with an impact in 2016 of around EUR 3.2 bn (or 0.2% of GDP), “*also in consideration of the terrorism threat*” after the November 2015 attacks in Paris. This led to a further worsening of the 2016 headline deficit target to 2.4% of GDP, relative to the 2.2% projected in the 2016 DBP. Namely, the Stability Law legislated the following expenditure: (i) around EUR 1 bn (or 0.06% of GDP) to enhance cyber security and defence, particularly of institutional venues, as well as police forces (including through a monthly increase in their wages); (ii) around EUR 1 bn (or 0.06% of GDP) on school building and requalification of urban areas; (iii) around EUR 0.5 bn (or 0.03% of GDP) for cultural activities; and (iv) around EUR 0.7 bn (or 0.05% of GDP) for a reserve fund (“*fondo per le esigenze indifferibili*”), recorded as expenditure but liable to be used in case of need, including to reduce the deficit target.

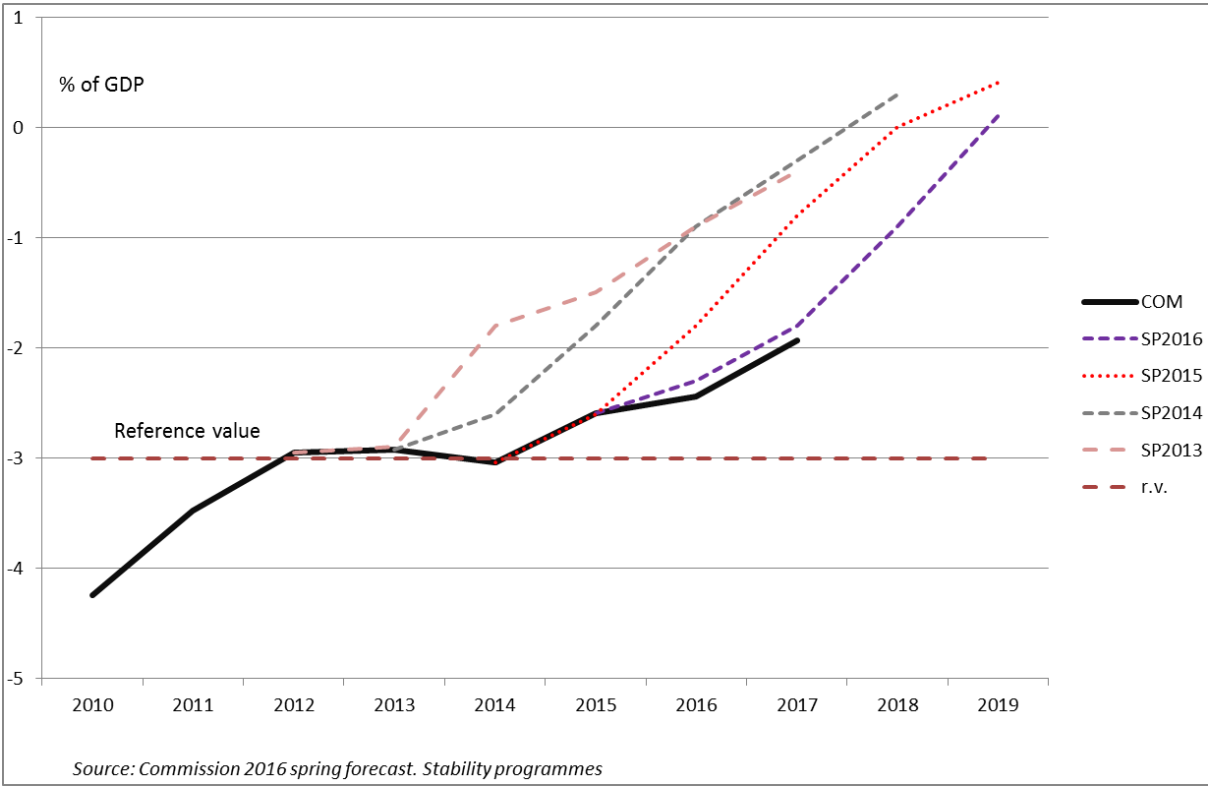
Third, in spite of a downward revision to growth compared to the DBP (to 1.2% from 1.6%), the 2016 Stability Programme projects a reduction in the 2016 deficit target to 2.3% of GDP, from 2.4% in the 2016 Stability Law, without however indicating any supplementary budgetary measures. This is meant to be achieved through a series of unspecified administrative measures, as well as by taking advantage of a downward revision in interest expenditure (to 4.0% of GDP from 4.2% in the 2016 DBP) and of additional one-off revenues, amounting to 0.2% of GDP, related to the so-called “*voluntary disclosure*” of assets held abroad.

The Commission 2016 spring forecast, after taking into account the measures enshrined in the 2016 Stability Law and Stability Programme, points to a headline deficit of 2.4% of GDP in 2016. The slightly higher deficit in the Commission forecast than in the Stability Programme is mainly explained by somewhat more muted revenue developments, mainly related to lower forecast nominal GDP growth (1.9% vs. 2.2% in the Stability Programme), as well as to a more cautious assessment by the Commission of the effectiveness of the planned measures to fight tax evasion and irregular gambling. The Commission forecast also discounts the existence of the abovementioned reserve in the budget (amounting to around EUR 0.7 bn), which the government should not spend if it wants to achieve its deficit target.

More in detail, the 2016 Stability Programme projects primary expenditure to increase in nominal terms in 2016 by 0.5% compared to 2015, in line with the Commission forecast. Compensation of public employees is anticipated to increase (by 1.4% year-on-year in the Stability Programme and by 1.2% in the Commission forecast) for the first time since 2010 due to new hiring in education and higher wages in the security sector. Moreover, in both cases, past reforms are expected to curb pension expenditure dynamics to around 1% year-on-year, while additional social benefits also due to new measures to fight poverty are expected to affect other social transfer dynamics. Outlays related to the migrant influx are estimated by the government at around 0.2% of GDP in 2016, 0.04 percentage points higher than in 2015. On the revenue side, annual changes in current taxes are projected in both the Commission forecast (-0.2% year-on-year) and the Stability Programme (stable year-on-year) to be much lower than nominal GDP growth (1.9% and 2.2%, respectively), mainly due to further cuts to the labour tax wedge and the abolition of property taxation on primary residences. This is

partially compensated by higher one-off capital taxes related to the so-called ‘voluntary disclosure’ of assets held abroad (0.2% of GDP).

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



The 2016 Stability Programme plans the headline deficit to decline to 1.8% of GDP in 2017, up from a no-policy change "trend" scenario of 1.4% of GDP. In particular, the 2016 Stability Programme declares the intention of the government to repeal the VAT hike legislated for 2017 (amounting overall to 0.9% of GDP) as a safeguard clause through the 2017 Stability Law and partially compensate it, in order to reach the deficit target of 1.8% of GDP, through a still unspecified mix of spending review, including tax expenditures, and measures to enhance tax compliance. Beyond 2017, the Stability Programme plans a headline deficit target of 0.9% in 2018, while for 2019 a 0.1% surplus is projected. As already highlighted, this represents a significant deterioration of the deficit target compared to the 2015 Stability Programme, where a headline deficit of 0.8% was originally planned for 2017 and a 0.4% surplus for 2019, despite markedly lower interest expenditure now projected throughout the programme horizon. Steadily increasing primary surpluses projected in the outer years (from 2.0% in 2017 to 3.6% in 2019) also explain the planned improvement in the headline targets.



**Table 2: Composition of the budgetary adjustment**

(% of GDP)	2015	2016		2017		2018	2019	Change: 2015-2019
	COM	COM	SP	COM	SP	SP	SP	SP
<b>Revenue*</b>	<b>47.9</b>	<b>47.2</b>	<b>47.2</b>	<b>46.7</b>	<b>46.9</b>	<b>47.1</b>	<b>47.1</b>	<b>-0.8</b>
<i>of which:</i>								
- Taxes on production and imports	15.2	14.6	14.7	14.9	15.4	15.6	15.5	0.3
- Current taxes on income, wealth, etc.	14.8	14.7	14.7	14.4	14.3	14.1	14.0	-0.8
- Social contributions	13.4	13.2	13.1	13.0	13.0	13.1	13.3	-0.1
- Other (residual)	4.5	4.7	4.7	4.3	4.2	4.3	4.3	-0.2
<b>Expenditure*</b>	<b>50.5</b>	<b>49.7</b>	<b>49.6</b>	<b>48.6</b>	<b>48.4</b>	<b>47.5</b>	<b>46.7</b>	<b>-3.8</b>
<i>of which:</i>								
- Primary expenditure	46.3	45.7	45.6	44.8	44.6	43.9	43.2	-3.1
<i>of which:</i>								
Compensation of employees	9.9	9.8	9.8	9.6	9.5	9.2	8.9	-1.0
Intermediate consumption	5.4	5.3	5.3	5.2	5.2	5.0	5.0	-0.4
Social payments	23.0	23.0	22.9	22.8	22.7	22.5	22.4	-0.6
Subsidies	1.7	1.7	1.7	1.7	1.4	1.4	1.3	-0.4
Gross fixed capital formation	2.3	2.3	2.3	2.2	2.3	2.3	2.2	-0.1
Other (residual)	4.0	3.6	3.6	3.4	3.5	3.4	3.2	-0.8
- Interest expenditure	4.2	4.0	4.0	3.8	3.8	3.6	3.5	-0.7
<b>General government balance (GGB)</b>	<b>-2.6</b>	<b>-2.4</b>	<b>-2.3</b>	<b>-1.9</b>	<b>-1.8</b>	<b>-0.9</b>	<b>0.1</b>	<b>2.7</b>
<b>Primary balance</b>	<b>1.6</b>	<b>1.6</b>	<b>1.7</b>	<b>1.9</b>	<b>2.0</b>	<b>2.7</b>	<b>3.6</b>	<b>2.0</b>
One-off and other temporary	-0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.1
<b>GGB excl. one-offs</b>	<b>-2.5</b>	<b>-2.5</b>	<b>-2.4</b>	<b>-1.9</b>	<b>-1.8</b>	<b>-0.9</b>	<b>0.1</b>	<b>2.6</b>
Output gap <sup>1</sup>	-2.9	-1.6	-1.6	-0.4	-0.4	0.6	1.2	4.0
Cyclically-adjusted balance <sup>1</sup>	-1.1	-1.6	-1.5	-1.7	-1.6	-1.2	-0.5	0.5
<b>Structural balance<sup>2</sup></b>	<b>-1.0</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.7</b>	<b>-1.6</b>	<b>-1.2</b>	<b>-0.5</b>	<b>0.5</b>
Structural primary balance <sup>2</sup>	3.2	2.3	2.4	2.1	2.2	2.4	3.0	-0.2
<b>Notes:</b>								
* From 2017, revenues and expenditures in the Stability Programme are based on trends instead of targets.								
<sup>1</sup> 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.								
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.								
<b>Source:</b>								
Stability Programme (SP); Commission 2016 spring forecasts (COM); Commission calculations.								

The 2016 Stability Programme implicitly confirms the MTO of a balanced budgetary position in structural terms, which reflects the objectives of the Stability and Growth Pact. In structural terms, the government plans enshrined in the 2016 Stability Programme imply an improvement in the recalculated structural balance<sup>6</sup> by 0.2% of GDP in 2015, followed by a deterioration of 0.6% of GDP in 2016, with a structural position still in deficit in 2016 (at 1.6% of GDP). This takes into account Italy's request to avail itself of an admissible temporary deviation under the structural reform and investment clauses, as well as by

<sup>6</sup> This refers to the cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the information provided in the Stability Programme]

exceptional expenditure on security related to the terrorism threat and to face the inflow of refugees, to justify a deviation from the 0.5% of GDP otherwise required. Beyond 2016, the (recalculated) projections entail a broadly stable structural balance in 2017 and a structural deficit of ½ % of GDP in 2019 (vs. a ¼% of GDP structural surplus in the 2015 Stability Programme). Therefore, the attainment of the MTO is not projected by the end of the programme (i.e. 2019), while the 2015 Stability Programme projected it by 2018 and the 2014 Stability Programme by 2016. The (recalculated) structural primary surplus is now projected at 3% of GDP in 2019 (vs. 4% in the 2015 Stability Programme).

The Commission forecast, under a no-policy-change assumption, expects a headline deficit at 1.9% of GDP in 2017. The forecast for 2017 includes around half of the 0.9% of GDP VAT hike legislated as a safeguard clause at end-2015, of which the government announced the repeal. In fact, in a letter to the Commission, the government committed to make this repeal strictly conditional upon legislating, in the next Stability Law, credible compensatory measures needed to achieve the planned deficit target of 1.8% of GDP (up from a trend of 1.4% that includes the full VAT hike). The slightly higher deficit forecast by the Commission in 2017 than in the Stability Programme is entirely due to the higher deficit base in 2016 (nominal GDP growth in 2017 being the same at 2.5%). In structural term, the Commission estimates Italy to have carried out a structural effort of 0.1 percentage points of GDP in 2015 and forecasts a structural deterioration of 0.7 percentage points of GDP in 2016 and a stable structural balance (at -1.7% of GDP) in 2017.

### **3.3. Measures underpinning the programme**

Italy's 2016 Stability Programme confirms the measures underpinning the 2016 DBP over the programme horizon, with a few exceptions.

The main deficit-increasing measures included in the 2016 DBP and confirmed by the 2016 Stability Programme are: (i) the repeal of a previously legislated increase in VAT and other taxes legislated for 2016 by the 2014 and 2015 Stability Laws (worth around EUR 16.8 bn or 1% of GDP); (ii) the abolition of recurrent property taxation on first residences (worth overall EUR 3.6 bn or 0.22% of GDP), with a full compensation to Municipalities of the related lost revenue; (iii) a cut of property tax on agricultural real estate and immovable machinery for productive use (amounting together to EUR 0.9 bn or 0.06% of GDP); (iv) subsidies and other measures to fight poverty and social exclusion (amounting to EUR 0.6 bn or 0.04% of GDP in 2016 and further EUR 0.4 bn or 0.02% of GDP in 2017); (v) tax breaks on productivity premiums to promote second-level firm bargaining (worth around EUR 0.4 bn or close to 0.03% of GDP in 2016); (vi) a reduction by 40%, for an overall duration of two years, on employers' social contributions to be paid on new permanent employees hired in the course of 2016 (with a negative impact on social contribution revenues of EUR 0.8 bn or 0.05% of GDP in 2016 and further EUR 1.2 bn or around 0.08% of GDP in 2017); (vii) the introduction of incentives for companies to invest through the possibility to deduct 140% of the spent amount instead of 100% (with a negative impact on revenues mainly in 2017, by EUR 0.9 bn or 0.05% of GDP); (viii) other measures with smaller negative budgetary impact, including a broader "no tax area" for pensioners, additional flexibility for women to opt for earlier retirement but with entitlement recomputed under the notional defined contribution system, as well as resources for local administrations to undertake investment and to renew public sector contractual wages. In addition to these measures, the 2016 Stability Law legislated additional expenditure measures amounting to EUR 3.2 bn or 0.2% of GDP in 2016, including: around EUR 1 bn (or 0.06% of GDP) to enhance cyber security and defence, particularly of institutional venues, as well as police forces (including through a monthly increase in their

wages); (ii) around EUR 1 bn (or 0.06% of GDP) on school building and requalification of urban areas; (iii) around EUR 0.5 bn (or 0.03% of GDP) for cultural activities; and (iv) around EUR 0.7 bn (or 0.05% of GDP) for a reserve fund ("*fondo per le esigenze indifferibili*"), recorded as expenditure but passible to be used in case of need, including to reduce the deficit target. The legislated reduction of 3.5 percentage points (to 24% from 27.5%) in the corporate income tax rate ("IRES") from 2017 is confirmed, leading to lower revenues of around EUR 3 bn (or 0.17% of GDP) in 2017 and around EUR 4 bn (or 0.24% of GDP) as of 2018.

On the financing side, the main components of the Italian budgetary strategy enshrined in the 2016 DBP and confirmed by the 2016 Stability Programme are the following: (i) spending review measures across all levels of government, projected to entail additional gross expenditure savings of around 0.5% of GDP in 2016. Around half of these are related to the rationalisation of central government expenditure, while the rest is to be achieved through lower transfers to Provinces and Regions, in the latter case also related to the enforcement of the balanced budget rule, as well as through centralised public procurement for both central and local administrations. Overall, the net impact of expenditure savings, i.e. around EUR 0.5 bn, is markedly below the EUR 10 bn (or 0.6% of GDP) announced in the 2015 Stability Programme, also due to a still pending rationalisation of tax expenditures; (ii) the one-off impact, estimated at around EUR 3.4 bn (or 0.2% of GDP) of the "voluntary disclosure" of national assets held abroad; (iii) higher tax rates on gaming and from new selection procedures for providers acting in the field of betting on sport events, projected to deliver around EUR 1.2 bn (or 0.07% of GDP).

Regarding 2017, in the 2016 Stability Programme the government announced the repeal of the increase in VAT standard rates by 2 percentage points (from 22% to 24%) and in VAT reduced rates by 3 percentage points (from 10% to 13%), corresponding overall to EUR 15.1 bn (0.9% of GDP) revenues, which had been legislated by the 2016 Stability Law as a safeguard clause to guarantee the achievement of planned fiscal targets in the programme scenario. Namely, the government announced the partial compensation of the VAT hike in order to reach the deficit target of 1.8% of GDP (up from 1.4% in the trend no-policy-change scenario with full VAT hike), through a still unspecified mix of spending review, including tax expenditures, and measures to enhance tax compliance. No explicit mention is made of the further increase in standard VAT rates and excise duties foreseen in the legislation for 2018 as a safeguard clause and amounting to additional EUR 4 bn (or 0.3% of GDP). The measures adopted in 2015 and the first months of 2016 by the Italian authorities amount to an overall negative impact on the budgetary position of around 1.1 percentage points of GDP in 2016 and 2017. After incorporating the positive impact on economic growth, they lead to a deficit target of 2.3% of GDP in 2016 and a trend deficit, based on unchanged legislation of 1.4% in 2017 (the Stability Programme announces however a deficit target of 1.8% of GDP for that year – see Section 3.2). In 2016, these measures are projected to have a cumulative reducing impact of around EUR 19 bn on revenues (without considering the growth effect) and of around EUR 0.5 bn on expenditure. In 2017, the cumulative reducing impact is estimated by the authorities at EUR 22.4 bn on revenues and EUR 3.3 bn on expenditure.

## Main budgetary measures <sup>7</sup>

Revenue	Expenditure
<b>2016</b>	
<ul style="list-style-type: none"> <li>• Repeal by the 2016 Stability Laws of a previously legislated increase in VAT and other taxes (-1% of GDP)</li> <li>• Abolition of recurrent property tax on first residences, agricultural real estate, and immovable machinery for productive use (-0.28% of GDP)</li> <li>• 2-year reduction by 40% in employers' social security contributions for new open-ended hires in 2016 (-0.05% of GDP)</li> <li>• "Voluntary disclosure" of national assets held abroad (0.2% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Additional spending in cyber security, defence, and police forces (0.06% of GDP)</li> <li>• Savings from health care (-0.1% of GDP)</li> </ul>
<b>2017</b>	
<ul style="list-style-type: none"> <li>• Repeal by the 2016 Stability Law of previously legislated increase in VAT other taxes (-0.65% of GDP)</li> <li>• Abolition of recurrent property tax on first residences, agricultural real estate, and immovable machinery for productive use (-0.28% of GDP)</li> <li>• 2-year reduction by 40% in employers' social security contributions for new open-ended hires in 2016 (-0.13% of GDP)</li> <li>• 140% deduction of investments (-0.05% of GDP);</li> <li>• Reduction of 3.5 percentage points (to 24% from 27.5%) in the corporate income tax rate ("IRES"), (-0.17% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Net savings from Regions and local bodies (-0.3% of GDP)</li> </ul>
<b>2018</b>	
<ul style="list-style-type: none"> <li>• Repeal by the 2016 Stability Law of previously legislated increase in VAT other taxes (-0.5% of GDP)</li> <li>• 2-year reduction by 40% in employers' social security contributions for new open-ended hires in 2016 (-0.13% of GDP) –last year</li> <li>• Reduction of 3.5 percentage points (to 24 % from 27.5%) in the corporate income tax rate ("IRES"), (-0.24% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>• Net savings for Regions and local bodies (-0.4% of GDP)</li> </ul>

<sup>7</sup> 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.

### 3.4. Debt developments

Italy's government debt-to-GDP continued to increase in 2015, although only marginally, and reached 132.7% (see Table 3). The main debt-increasing factor remain the so-called “snow-ball” effect (by 2.2 percentage points, vs. 4.2 percentage points on average over the period 2010-2014), i.e. the impact on the debt-to-GDP ratio due to the difference between the implicit interest rate paid on debt and GDP growth. While the latter benefitted from real growth turning positive in 2015 after three years of recession, persistently low inflation (GDP deflator growth of 0.8%) continued to hamper debt reduction through a still large debt-increasing impact of implicit real interest rates (by 3.2 percentage points, vs. 3.5 percentage points on average over 2010-2014, as indicated by the difference between interest expenditure and inflation effect in Table 3). The primary surplus had the same debt-decreasing impact as in 2014 and only marginally larger than the average recorded over 2010-2014. The stock-flow adjustment helped curb debt dynamics in 2015. In particular, it benefitted from the debt-decreasing impact of privatisation proceeds and the reduction of the liquidity buffer accumulated in previous years (0.7% of GDP) but was negatively affected by the debt-increasing impact of derivative contracts (0.4% of GDP) settled before the crisis, mainly in order to fix interest rates on part of the debt (at around 4.4% on average) and thus limit possible risks related to higher refinancing costs.<sup>8</sup>

Regarding 2016, the Stability Programme projects a slight decrease in the debt-to-GDP ratio, to 132.4%. The decline would be mainly driven by a marginally higher primary surplus and a lower debt-increasing impact of the “snow-ball” effect (1.2 percentage points). This would, in particular, benefit from higher real GDP growth and lower impact of the implicit real interest rates (2.7 percentage points, also due to a GDP deflator growth of 1%). The stock-flow adjustment is projected by the Stability Programme to have a minor debt-increasing impact in 2016, as the planned privatisation proceeds (0.5% of GDP) are more than offset by debt-increasing “below-the-line” transactions, including in derivatives. The debt ratio is projected to further decrease in the outer years of the programme and reach 123.8% of GDP in 2019 thanks to a steadily increasing primary surplus, a “snow-ball” effect becoming debt-decreasing as the GDP deflator accelerates towards the ECB inflation target, and further privatisation proceeds (0.5% of GDP per year over 2016-2018 and 0.3% in 2019).

The 2016 Stability Programme provides estimates about the sensitivity of interest expenditure to changes in market interest rates. For instance, given the debt structure and an average maturity of around 6.5 years at end-2015, a financial market shock triggering a sudden increase of 100 basis points in the entire yield curve for government securities would imply a 0.13% of GDP higher interest expenditure in the first year, 0.28% in the second year, 0.4% in the third year and 0.5% in the fourth year.

In the Commission 2016 spring forecast, debt developments in 2016 and 2017 are slightly less benign than in the Stability Programme (see Figure 2). The debt-to-GDP ratio is set to stabilise in 2016, mainly due to lower inflation (GDP deflator growth of 0.8%) than in the government projections. In 2017, the Commission 2016 spring forecast expects a smaller decrease in the debt-to-GDP ratio than the Stability Programme (of -1.0%, vs. -1.5%), due to

<sup>8</sup> See also *Public Debt Report 2014*, Italian Ministry of the Economy and Finance, retrievable at [www.dt.tesoro.it/export/sites/sitodt/modules/documenti\\_en/debito\\_pubblico/presentazioni\\_studi\\_relazioni/Pubblic\\_Dept\\_Report\\_2014.pdf](http://www.dt.tesoro.it/export/sites/sitodt/modules/documenti_en/debito_pubblico/presentazioni_studi_relazioni/Pubblic_Dept_Report_2014.pdf) and *Indagine conoscitiva sugli strumenti finanziari derivati* (2015), retrievable at [www.dt.tesoro.it/export/sites/sitodt/modules/documenti\\_it/debito\\_pubblico/presentazioni\\_studi\\_relazioni/Audizione\\_alla\\_Camera\\_dei\\_Deputati\\_-\\_febbraio\\_2015\\_-\\_Indagine\\_conoscitiva\\_sugli\\_strumenti\\_finanziari\\_derivati.pdf](http://www.dt.tesoro.it/export/sites/sitodt/modules/documenti_it/debito_pubblico/presentazioni_studi_relazioni/Audizione_alla_Camera_dei_Deputati_-_febbraio_2015_-_Indagine_conoscitiva_sugli_strumenti_finanziari_derivati.pdf)

a less favourable assessment of the stock-flow adjustment (0.4%, vs. -0.1%), also related to lower privatisation proceeds (at 0.3%, vs. 0.5%), whose details are not yet available.

**Table 3: Debt developments**

(% of GDP)	Average 2010-2014	2015	2016		2017		2018	2019
			COM	SP	COM	SP	SP	SP
<b>Gross debt ratio<sup>1</sup></b>	<b>123.4</b>	<b>132.7</b>	<b>132.7</b>	<b>132.4</b>	<b>131.8</b>	<b>130.9</b>	<b>128.0</b>	<b>123.8</b>
Change in the ratio	4.0	0.2	0.0	-0.3	-1.0	-1.5	-2.9	-4.2
<i>Contributions<sup>2</sup> :</i>								
<b>1. Primary balance</b>	<b>-1.4</b>	<b>-1.6</b>	<b>-1.6</b>	<b>-1.7</b>	<b>-1.9</b>	<b>-2.0</b>	<b>-2.7</b>	<b>-3.6</b>
<b>2. “Snow-ball” effect</b>	<b>4.2</b>	<b>2.2</b>	<b>1.5</b>	<b>1.2</b>	<b>0.5</b>	<b>0.6</b>	<b>-0.3</b>	<b>-0.4</b>
<i>Of which:</i>								
Interest expenditure	4.7	4.2	4.0	4.0	3.8	3.8	3.6	3.5
Growth effect	0.7	-1.0	-1.4	-1.6	-1.7	-1.8	-1.9	-1.7
Inflation effect	-1.2	-1.0	-1.1	-1.3	-1.6	-1.4	-2.0	-2.2
<b>3. Stock-flow adjustment</b>	<b>1.2</b>	<b>-0.4</b>	<b>0.1</b>	<b>0.2</b>	<b>0.4</b>	<b>-0.1</b>	<b>0.1</b>	<b>-0.1</b>
<i>Of which:</i>								
Cash/accruals diff.	0.3	0.1	0.4	0.4	0.1	0.1	0.1	-0.1
Acc. financial assets	0.9	-0.5	-0.3	-0.2	0.3	-0.2	-0.1	-0.1
<i>Privatisation</i>	-0.2	-0.4	-0.2	-0.5	-0.3	-0.5	-0.5	-0.3
Val. effect & residual	0.0	0.0	0.0	-0.1	0.0	-0.1	0.0	0.1

Notes:

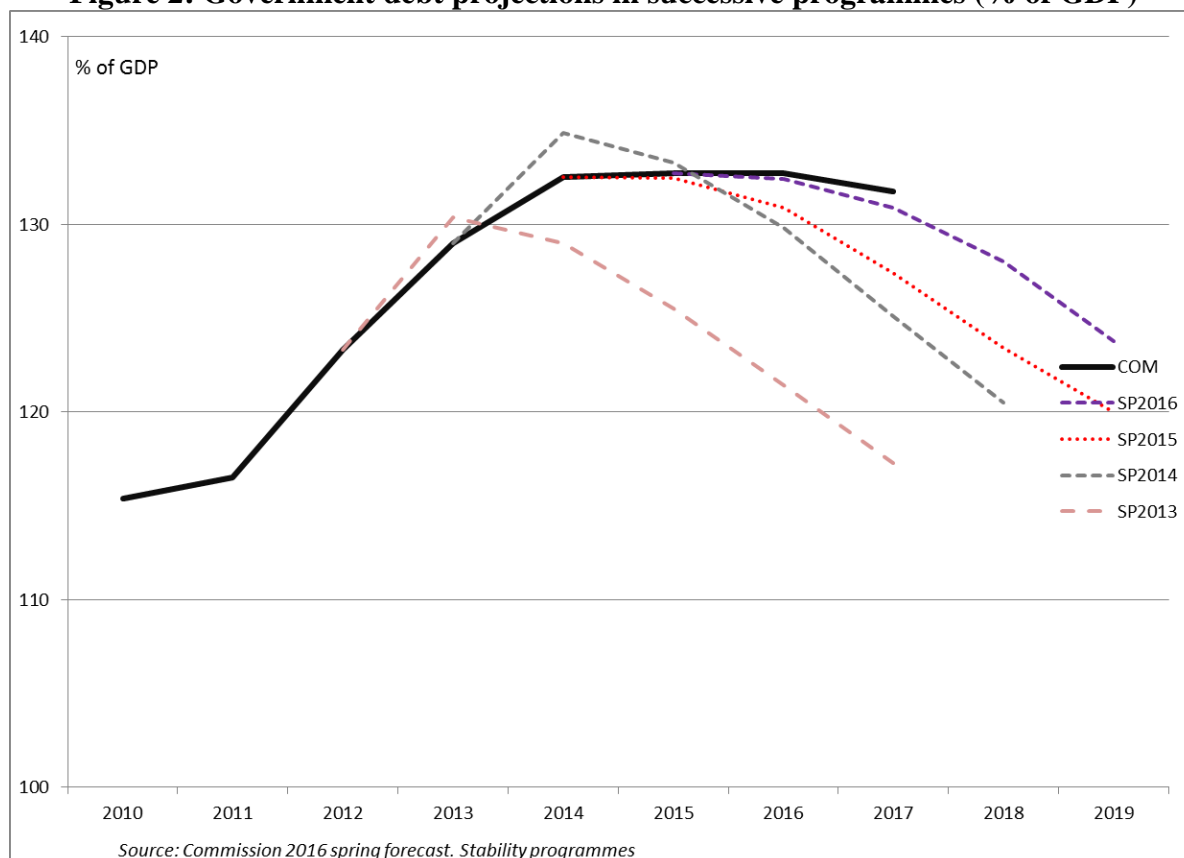
<sup>1</sup> End of period.

<sup>2</sup> 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 2016 spring forecast (COM); Stability Programme (SP), Commission calculations.

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



### 3.5. Risk assessment

As analysed in Section 2, Italy's real GDP growth projections put forward in the Stability Programme for 2016 and 2017 are only slightly higher than the Commission 2016 spring forecast. Nevertheless, risks appear to be tilted to the downside as weaker-than-expected demand from extra-EU countries as well as still high uncertainty also related to very low inflation could curb growth prospects, in particular for investment. A lower nominal growth would have negative effects on the budgetary outcomes and in particular on debt-to-GDP ratio developments. The PBO also highlighted that growth projections in the Stability Programme are positioned in the higher part of the forecast range used for its assessment (see Section 2).

Regarding the fiscal strategy presented in the 2016 Stability Programme, the lack of details about the measures that the government intends to adopt in autumn 2016 to partially compensate the announced repeal of the VAT hike legislated through the 2016 Stability Law (amounting to 0.9% of GDP for 2017) represents a risk for the 2017 deficit target of 1.8% of GDP (up from the trend deficit of 1.4% that includes the entire VAT hike). However, in an exchange of correspondence with the Commission (see Section 4.2), the government committed to keep at least part of the VAT hike if needed to achieve its budgetary targets. The Commission 2016 spring forecast includes around half of the legislated VAT hike (see Section 2), which impact the forecast inflation. Therefore, if the government actually repealed the entire amount of the VAT hike in 2017, as announced in the Stability Programme, this could have a downward impact on nominal GDP in that year, with negative implications on the debt-to-GDP ratio.

Furthermore, the government is working on some proposals in order to make labour market exit more flexible compared to the provisions enshrined in the last pension reform adopted at

end-2011. This could have a direct negative budgetary impact as well as a negative impact on the potential growth of the economy by affecting labour market participation, which in Italy is already among the lowest in the EU.

Regarding risks related in particular to debt-to-GDP ratio developments, beyond the risk of higher deficits, the main risk stems from persistently low inflation. The latter would *ceteris paribus* increase the “snow-ball” effect by making the implicit real interest rate paid to service the debt higher.

Finally, past track records show that Italy has persistently revised upwards its deficit and debt targets (see Figure 1 and Figure 2), partly due to a worsened economic (and inflation) environment but also because the authorities have asked to be granted sizeable fiscal flexibility following the Commission Communication on this issue.<sup>9</sup>

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

##### **Box 1: Council recommendation addressed to Italy**

On 14 July 2015, 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 achieve a fiscal adjustment towards the medium-term budgetary objective of at least 0.25% of GDP in 2015 and of at least 0.1% of GDP in 2016, taking into account the allowed deviation for the implementation of major structural reforms, by taking the necessary structural measures in both years; ensure that the spending review is an integral part of the budgetary process; swiftly and thoroughly implement the privatisation programme and use windfall gains to make further progress towards putting the general government debt ratio on an appropriate downward path; and implement the enabling law for tax reform by September 2015, in particular the revision of tax expenditures and cadastral values and the measures to enhance tax compliance.

##### **4.1. Compliance with the debt criterion**

According to the notified data, in 2015 Italy's government debt to GDP ratio was above the reference value of 60%. Over 2013-2015 Italy was in a transition period and did not make sufficient progress towards compliance with the debt criterion as per the required Minimum Linear Structural Adjustment (MLSA). More specifically, based on the Commission 2016 spring forecast, Italy had to make an annual structural adjustment of 0.9% of GDP each year in the transition period 2013-2015, implying an overall cumulative adjustment of 2.7% of GDP over the three years. Given that over 2013-2014 Italy delivered only 0.1% of GDP adjustment (instead of the required 1.8% over the two years), in 2015 it had to deliver what was left, i.e. 2.6% of GDP (see Table 4). Based on notified data for 2015, the Commission 2016 spring forecast indicates a structural adjustment of only 0.1% of GDP in 2015.<sup>10</sup> This

<sup>9</sup> [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/2015-01-13\\_communication\\_sgp\\_flexibility\\_guidelines\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf)

<sup>10</sup> Compared to the Commission 2013 autumn forecast, the MLSA based on the Commission 2016 spring forecast increased from 0.6% to 0.9% per year, raising the structural surplus needed to comply with the debt rule in 2015 from around 0.5% to around 1.5% of GDP. This upward revision, which can be attributed to worse than expected economic conditions, including lower inflation, partly explains the 2.5% of GDP gap estimated at the end of Italy's 2013-2015 transition period.



provides evidence of a *prima facie* risk of the existence of an excessive deficit in Italy in the sense of the Treaty and the Stability and Growth Pact. On 18 May 2016, the Commission has therefore prepared a report under Article 126(3) TFEU analysing whether or not Italy is compliant with the debt criterion of the Treaty. The report concluded that, after the assessment of all the relevant factors, notably: (i) the currently unfavourable macroeconomic conditions and in particular still very low inflation – which make the respect of the debt rule particularly demanding, (ii) the expectation that compliance with the required adjustment towards the MTO in 2016 is broadly ensured after taking into account a temporary allowance of 0.75% of GDP for structural reforms and investment and the additional spending of 0.1% of GDP related to the exceptional inflow of refugees and to exceptional security measures directly related to combatting terrorism, and (iii) the expected implementation of ambitious growth-enhancing structural reforms in line with the authorities' commitment, which is expected to contribute to debt reduction in the medium/long term, the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with. Italy is not expected to comply with the debt rule in 2016 either based on the (recalculated) government plans (gap to the debt benchmark of 3% of GDP) or based on the Commission 2016 spring forecast (gap to the debt benchmark of 5.6% of GDP). Table 4 shows that the Commission 2016 spring forecast still expects a 4.7 of GDP gap to the debt benchmark in 2017, based on a no-policy change assumption. Also the Stability Programme does not project compliance in 2017, although the gap is much smaller (0.2% of GDP in the forward looking configuration) also thanks to the ambitious privatisations planned over 2016-2019. In the 2016 Stability Programme, the Italian authorities plan to comply with the debt rule as of 2018 in a forward-looking dimension (i.e. as of 2020), whereas projections based on the Commission 2016 spring forecast expect compliance only by 2020 in a forward-looking dimension (i.e. as of 2022), under a no-policy-change assumption until 2017 and assuming thereafter structural efforts in line with the preventive arm requirement (i.e. 0.6 percentage points per year until the attainment of the MTO).

**Table 4: Compliance with the debt criterion**

	2015	2016		2017	
		SP	COM	SP	COM
Gross debt ratio	<b>133</b>	<b>132.4</b>	<b>132.7</b>	<b>130.9</b>	<b>131.8</b>
Gap to the debt benchmark <sup>1,2</sup>	n.r.	3.0	5.6	0.2	4.7
Structural adjustment <sup>3</sup>	0.1	-0.6	-0.7	0.0	0.0
<i>To be compared to:</i>					
Required adjustment <sup>4</sup>	2.6	n.r.	n.r.	n.r.	n.r.
<b>Notes:</b>					
<sup>1</sup> 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.					
<sup>2</sup> 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.					
<sup>3</sup> Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.					
<sup>4</sup> 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.					
<b>Source :</b>					
<i>Commission 2016 spring forecast (COM); Stability Programme (SP), Commission calculations.</i>					

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

### Assessment of requests for deviating from SGP requirements

For 2015, thanks to the enhanced consideration of relevant cyclical conditions introduced by the January 2015 Communication, Italy was recommended to deliver a structural adjustment of 0.25% of GDP (in lieu of 0.5%) in order to make sufficient progress towards its MTO.

For 2016, Italy was recommended in July 2015 to deliver a structural effort of 0.1% of GDP in lieu of 0.5% of GDP, benefitting from a 0.4% of GDP temporary deviation from the required adjustment towards the MTO under the structural reform clause.<sup>11</sup> In addition, Italy's 2016 DBP requested an additional allowance of 0.4% of GDP for 2016 under the structural reform and the investment clause as well as in relation to the extraordinary inflow of refugees and extraordinary security-related expenditure (see Section 3.2).

### Assessment of eligibility for the structural reform clause and investment clause

The Commission opinion on Italy's 2016 DBP<sup>12</sup> announced that it would assess Italy's possible eligibility for a temporary deviation under the SGP on the basis of: (i) the existence of credible plans for the resumption of the adjustment path towards the MTO; (ii) whether a deviation from the adjustment path is being effectively used for the purposes of increasing investments; and (iii) progress with the structural reform agenda, taking into account the Council recommendations. These conditions are discussed in order.

As regards condition (i), in a letter to the Commission,<sup>13</sup> the Italian government publicly declared its intention to resume its adjustment path towards the MTO beyond 2016, by committing to repeal the legislated VAT hike for 2017 “*conditional upon implementing deficit reduction measures to comply with the preventive arm of the SGP in 2017*”. This public commitment was further confirmed by subsequent reassurances made by the Italian government to the Commission.<sup>14</sup> This notwithstanding, it appears difficult at this stage to fully assess Italy's plans to resume the adjustment path towards the MTO in 2017, for two reasons. First, the 2017 Stability Law will only be adopted in autumn 2016 and, in its absence,

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<sup>11</sup> For the granting of the 0.4 percentage point allowance under the structural reform clause, please refer to European Commission (2015), “*Assessment of the 2015 Stability Programme for ITALY*”, retrievable at: [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/20\\_scps/2015/12\\_it\\_scp\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2015/12_it_scp_en.pdf). As regards the impact of Italy's structural reforms, the document specifies that “*the positive impact on the sustainability of public finances is two-fold: on the one hand an increase in GDP leads to an automatic decrease in the debt ratio everything else being equal; on the other, higher GDP growth usually leads to a larger tax intake and to a decrease in nominal deficit and debt (respectively by 0.8 and 2 percentage points of GDP by 2020 for the whole reform package with respect to the baseline). The improvement in the Z indicator associated with the reforms is estimated at 1.1 percentage points of GDP by 2025. Those virtuous effects accumulate over time, leading to a substantial improvement of public finances sustainability*”.

<sup>12</sup> See: [http://ec.europa.eu/economy\\_finance/economic\\_governance/sgp/pdf/dbp/2015/it\\_2015-11-16\\_co\\_en.pdf](http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_en.pdf)

<sup>13</sup> See the cover letter accompanying the note “*Relevant Factors Influencing Debt Developments in Italy*” (May 9<sup>th</sup> 2016), retrievable at [http://www.tesoro.it/inevidenza/documenti/lettera\\_2840\\_del\\_09.05.2016\\_-\\_Min\\_Padoan\\_-\\_Mr\\_Dombrovskis\\_-\\_Moscovicix1x.pdf](http://www.tesoro.it/inevidenza/documenti/lettera_2840_del_09.05.2016_-_Min_Padoan_-_Mr_Dombrovskis_-_Moscovicix1x.pdf)

<sup>14</sup> An exchange of letters took place between the European Commission and the Italian government. The letters can be retrieved at: [www.mef.gov.it/inevidenza/documenti/20160516Letter\\_to\\_Padoan.pdf](http://www.mef.gov.it/inevidenza/documenti/20160516Letter_to_Padoan.pdf) (letter from the Commission to Italy) and [www.mef.gov.it/inevidenza/documenti/Letter\\_to\\_Dombrovskis\\_x\\_Moscovicix\\_-\\_17\\_May\\_2016.pdf](http://www.mef.gov.it/inevidenza/documenti/Letter_to_Dombrovskis_x_Moscovicix_-_17_May_2016.pdf) (Italy's reply to the Commission).

the Commission 2016 spring forecast for next year is based on a no-policy change assumption. Second, the 2016 Stability Programme highlights "*the criticalities affecting the current methodology for the calculation of the output gap, often leading to underestimations or results that are at odds with macroeconomic intuitions and provide a biased indication of Italy's actual compliance with the preventive arm of the SGP*" among the relevant factors that explain why "*the government deems it inappropriate and counterproductive to achieve the fiscal consolidation*" requested by the preventive arm rules, whereby the structural balance should improve in 2017 by more than 0.5 percentage points. Additional work will be carried out in the EPC-OGWG to analyse the issues raised by Italy and other Member States on the agreed methodology. On the basis of the Commission 2016 spring forecast, the Commission assessment of the planned fiscal effort for 2017 indicates a gap of between 0.15% and 0.2% of GDP – depending on the precise parameters used for the calculation of the output gap (see Box 2) – to ensure broad compliance with the preventive arm of the SGP in 2017 based on the expenditure benchmark. However, given Italy's public commitment to comply with the preventive arm of the SGP in 2017, condition (i) can be considered to be complied with, albeit a full assessment of Italy's plans for 2017 will only be possible in autumn, when the draft budget is available.

As mentioned in Section 4.1, the Commission will reassess the relevant factors in a new report under Article 126(3) TFEU as further information on the credibility and appropriateness of Italy's resumption of the adjustment path towards the MTO for 2017 becomes available.

As regards condition (ii), Italy's government gross fixed capital formation is forecast by the Commission to increase further in nominal terms in 2016 and 2017 (by 0.9% and 0.6%, respectively). As a result, public investment is expected to remain broadly stable as a share of GDP (at around 2.3%). The 2016 Stability Programme projects similar developments for public investment over 2016-2017. In this context, the 2016 Stability Programme expects national expenditure in investment projects co-financed by the EU to reach around EUR 5 bn or 0.3% of GDP in 2016, which corresponds to the allowance invoked under the investment clause. While the information provided seems to confirm that Italy's deviation from the adjustment path towards the MTO is being effectively used for the purposes of increasing investments, it does not dispel all reasonable doubt on the feasibility of the reported amount of co-financed investment for 2016, which matters for the magnitude of the requested allowance. For instance, as regards the EUR 1 bn projects expected under the *Connecting Europe Facility* (CEF), only around EUR 0.35 bn appear feasible in the course of 2016, as some EUR 0.65 bn have not yet been successfully submitted to a CEF call to receive EU funding and are thus unlikely to be carried out in 2016. On this basis, it seems that an allowance of at most 0.25% of GDP could be granted under the investment clause for 2016, but with the *caveat* that significant downside risks exist and that the Commission will carry out an ex-post assessment in order to verify the actual amount of the national expenditure in co-financed investment projects and the related allowance to which Italy is eligible under the so-called "investment clause".

As regards condition (iii), the 2016 National Reform Programme broadly confirms the reform timetable put forward in the 2016 DBP, where the additional allowance under the clause was requested. The ambitious reform agenda includes a new competition law for 2016, the completion of the implementation of the labour market reform, as well as the long-awaited revision of the statute of limitations and measures concerning collective bargaining. It also encompasses measures to support access to finance, the implementation of the education and public administration reforms according to the respective timetables, and a systematic revision of tax expenditures. As regards the specific reforms for which the additional

allowance was requested, i.e. measures to reduce the stock of non-performing loans and reform insolvency procedures, reasonable progress seems to be confirmed. Overall, given the extent of the structural reforms put forward by the government in the 2016 National Reform Programme, their state of legislative progress/implementation, as well as the methods used to simulate their effects, it seems that Italy could benefit in 2016 from the maximum amount of admissible temporary deviation allowed under the structural reform clause, i.e. 0.5% of GDP.

Overall, the abovementioned conditions for Italy to be allowed an additional temporary deviation from the adjustment path towards the MTO under the structural reform and investment clause in 2016 appear to be satisfied.

### **Box 2: Impact of extended forecast horizon for the estimation of potential growth**

Eight Member States, including Italy, expressed their concern regarding the commonly agreed methodology for the estimation of the output gap in a letter sent to the Commission on 18 March 2016. The letter highlighted some criticalities affecting the current methodology for the estimation of the output gap, particularly “*in times of persistently weak economic growth, in times of changes in economic cycles and when implementation of reforms brings about structural shifts*”. The EPC-OGWG has been mandated to analyse the issues raised by Italy and other Member States.

However, the Commission has already tentatively compared the potential growth estimates based on an ad-hoc four-year forecast (i.e. over 2016-2019) with those based on the two-year horizon (i.e. over 2016-2017) of its 2016 spring forecast. On this basis, Italy’s potential growth improves by around 0.1 percentage points per year on average over 2015-2017, and the negative output gap widens by around 0.5 percentage points of GDP by 2017, but its closure is only very marginally affected. Overall, the assessment of Italy’s compliance with the preventive arm would not significantly change using an extended forecast horizon, as the change in the gap relative to the required fiscal effort to ensure broad compliance with the preventive arm of the SGP in 2017 would be in the order of 0.05 pp. of GDP.

### **Assessment of eligibility to the "unusual events" provision**

The 2016 Stability Programme also invokes additional allowances in relation to the expenditure related to two “unusual events”, the inflow of refugees and the terrorist threat. The provisions defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 allow catering for this additional expenditure, in that the inflow of refugees as well as the severity of the terrorist threat are exceptional events, their impact on Italy’s public finances is significant and sustainability would not be compromised by allowing for a deviation from the adjustment path towards the medium-term budgetary objective.

First, the Italian government estimates that the net expenditure incurred to face the exceptional inflow of refugees, particularly in terms of sea rescue operations and hospitality, healthcare and education costs, have increased gradually since 2012 and amounted to EUR 2 bn (0.13% of GDP) in 2014, and EUR 2.6 bn (0.16% of GDP) in 2015. The refugee-related expenditure is projected at EUR 3.3 bn (0.2% of GDP) in 2016. The Commission clarified that, for the purposes of fiscal surveillance and on a temporary basis (i.e. solely for 2015 and 2016), additional refugee-related expenditure actually incurred by country based on observed data, would be taken into account when assessing Member States’ fiscal efforts. 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. In the case of Italy,

the additional refugee-related expenditure that can be taken into account *ex post* for 2015 is 0.03% of GDP. A preliminary assessment suggests that for 2016 only 0.04% of GDP is currently expected to affect Italy's structural effort. Regarding 2016, a final assessment, including on the eligible amounts, will be made in spring 2017 on the basis of observed data as provided by the Italian authorities.

Second, Italy's 2016 Stability Law explicitly mentioned a package of exceptional security measures, adding up to 0.2% of GDP, to be taken into account by the Commission in assessing Italy's compliance with the preventive arm. Overall, it appears that the link to security of some of the mentioned provisions is only indirect, as in the case of EUR 1 bn earmarked for the requalification of urban areas and incentives to young people to attend cultural events. A preliminary assessment thus suggests that only 0.06% of GDP represents additional directly security-related expenditure affecting the structural effort in 2016. A final assessment on the 2016 amount will be made on the basis of observed data provided by Italy in next year's Stability Programme.

### **Adjustment towards the MTO**

Overall, the Commission has assessed Italy to be eligible, at this stage, for the following allowances: (i) 0.03% of GDP in 2015, due to the additional refugee-related expenditure incurred in that year, which leads to a corrected requirement of 0.22% of GDP for 2015 (instead of the 0.25% recommended in July 2015); (ii) 0.35% of GDP in 2016 under the structural reform and investment clause taken together, which leads to a corrected requirement of -0.25% of GDP for 2016, once added to the 0.4% of GDP temporary deviation already allowed in spring 2015. The actual additional spending related to the refugee crisis and to direct security measures (currently estimated at 0.04% and 0.06% of GDP respectively) will be taken into account *ex-post*.

For 2015, Italy is recommended to deliver a structural adjustment of 0.22% of GDP, so as to make sufficient progress towards its MTO. Both for 2015 alone and for 2014 and 2015 taken together, the Commission 2016 spring forecast suggests some deviation (a gap of 0.1 percentage points of GDP) from the requirement based on the structural balance pillar, while the expenditure benchmark points to compliance. Namely, based on the outturn data, the growth rate of government expenditure, net of discretionary revenue measures, in 2015 did not exceed the applicable expenditure benchmark growth rate (-0.45%). This calls for an overall assessment. The deviation measured by the structural balance pillar was affected by negative potential growth and low inflation. Overall, based on the outturn data and the Commission 2016 spring forecast, the *ex-post* assessment suggests that the adjustment path towards the MTO was broadly appropriate and compliant with the requirement of the preventive arm of the Pact in 2015.

For 2016, the government plans and the Commission 2016 spring forecast expect Italy's structural balance to deteriorate by 0.6 and 0.7 percentage points of GDP, respectively. Therefore, once taking into account the corrected preventive arm requirement of -0.25% of GDP including the allowance granted for the structural reform and investment clause in 2016, both the government plans and the Commission 2016 spring forecast point to a risk of some deviation (a gap of -0.3 and -0.4 percentage points of GDP, respectively) from the structural balance pillar over one year in 2016. The expenditure benchmark points to compliance based on the Commission 2016 spring forecast, as the growth rate of government expenditure, net of discretionary revenue measures, will not exceed the applicable expenditure benchmark rate (0.6%) in 2016. Over 2015 and 2016 taken together, based on both the government plans and the Commission 2016 spring forecast and taking into account the corrected preventive arm requirements, there is a risk of some deviation (a gap of -0.2 percentage points of GDP in both

cases) from the structural balance pillar. The expenditure benchmark points to compliance based on the Commission 2016 spring forecast. This calls for an overall assessment. The discrepancy between the two indicators is mainly due to the fact that the expenditure benchmark benefits in 2016 from both significant one-offs, as well as from the use of a higher GDP deflator frozen on the basis of the Commission 2015 spring forecast, which incorporated a VAT hike enacted by the government as a safeguard clause but subsequently repealed.

Following an overall assessment, a risk of some deviation from the adjustment path towards the MTO is to be expected in 2016. This conclusion would not change should the budgetary impact (i.e. 0.1% of GDP) of the exceptional inflow of refugees as well as the security costs incurred in 2016 be excluded from the assessment.

For 2017, both the government plans and the Commission 2016 spring forecast expect Italy's structural balance to remain stable at around -1.7% of GDP. Therefore, both the government plans and the Commission 2016 spring forecast point to a risk of a significant deviation (a gap of -0.6 percentage points of GDP) from the structural balance pillar over one year in 2017. The expenditure benchmark also points to the same conclusion based on the Commission 2016 spring forecast,<sup>15</sup> as the growth rate of government expenditure, net of discretionary revenue measures, will exceed the applicable expenditure benchmark rate (-1.4%) in 2017. Over 2016 and 2017 taken together, based on both the government plans and the Commission 2016 spring forecast, there is a risk of a significant deviation (a gap of -0.5 percentage points of GDP) from the structural balance pillar. The expenditure benchmark also points to the same conclusion based on the Commission 2016 spring forecast.

Overall, pending the 2017 DBP, a risk of a significant deviation from the adjustment path towards the MTO is to be expected in 2017, putting at risk the compliance with the requirements of the preventive arm of the Pact.

In summary, based on both the government plans and the Commission 2016 spring forecast, Italy appears to be broadly compliant with the preventive arm requirements regarding progress towards the MTO in 2015 and 2016, although rigorous implementation of the 2016 budget remains crucial in this respect. The allowed temporary deviation from the adjustment path towards the MTO of 0.75% of GDP under the structural reform and investment clause takes into account Italy's public commitment to comply with the preventive arm of the SGP in 2017 (see above), as well as the actual and expected progress in terms of structural reforms and co-financed investment. Given the uncertainties hindering the possibility at this stage to fully assess Italy's plans to resume the adjustment path towards the MTO beyond 2016, the Commission will review its assessment of the relevant factors in a new report under Article 126(3) TFEU based on the Commission 2016 autumn forecast, as further information on Italy's compliance with the preventive arm of the SGP in 2017, in line with the government's public commitment, becomes available.

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<sup>15</sup> It should be noted that the expenditure benchmark indicator based on the (recalculated) government plans enshrined in the 2016 Stability Programme is computed under a no-policy-change scenario including the full VAT hike, and thus based on a trend deficit of 1.4% of GDP in lieu of the actual programme target of 1.8%. For this reason, the indicator based on the (recalculated) government plans is hereby ignored.

**Table 5: Compliance with the requirements under the preventive arm**

(% of GDP)	2015	2016				2017	
<b>Initial position<sup>1</sup></b>							
Medium-term objective (MTO)	0.00	0.00				0.0	
Structural balance <sup>2</sup> (COM)	-1.0	-1.7				-1.7	
Structural balance based on freezing (COM)	-0.7	-1.7				-	
<b>Position vis-a-vis the MTO<sup>3</sup></b>	Not at MTO	Not at MTO				Not at MTO	
(% of GDP)	<b>2015</b>	<b>2016</b>				<b>2017</b>	
	COM	SP		COM		SP	COM
		Vis-à-vis the CSR	Including additional clauses	Vis-à-vis the CSR	Including additional clauses	Vis-à-vis the CSR	
<b>Structural balance pillar</b>							
Required adjustment <sup>4</sup>	0.25	0.5				0.6	
Required adjustment corrected <sup>5</sup>	0.22	-0.25	-0.35	-0.25	-0.35	0.6	
Change in structural balance <sup>6</sup>	0.1	-0.6		-0.7		0.0	0.0
One-year deviation from the required adjustment <sup>7</sup>	-0.1	-0.3	-0.2	-0.4	-0.3	-0.6	-0.6
Two-year average deviation from the required adjustment <sup>7</sup>	-0.1	-0.2	-0.1	-0.2	-0.2	-0.5	-0.5
<b>Expenditure benchmark pillar</b>							
Applicable reference rate <sup>8</sup>	-0.5	0.6	0.8	0.6	0.8	-1.4	
One-year deviation <sup>9</sup>	0.2	-0.1	0.0	0.1	0.2	0.0*	-0.7
Two-year average deviation <sup>9</sup>	0.2	0.0	0.1	0.1	0.2	-0.1*	-0.3
<b>Conclusion</b>							
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment	n.a.*	Significant deviation
Conclusion over two years	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Overall assessment	n.a.*	Significant deviation
Notes							
<sup>1</sup> 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.							
<sup>2</sup> Structural balance = cyclically-adjusted government balance excluding one-off measures.							
<sup>3</sup> Based on the relevant structural balance at year t-1.							
<sup>4</sup> 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).							
<sup>5</sup> Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.							
<sup>6</sup> 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.							
<sup>7</sup> The difference of the change in the structural balance and the corrected required adjustment.							
<sup>8</sup> 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.							
<sup>9</sup> 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.							
<sup>*</sup> The 2017 expenditure benchmark in the Stability Programme is computed based on the trend deficit of 1.4% of GDP instead of the deficit target of 1.8%. The structural balance is instead computed based on data that are consistent with the 1.8% of GDP deficit target.							
<i>Source:</i> Stability Programme (SP); Commission 2016 spring forecast (COM); Commission calculations.							

## 5. FISCAL 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.<sup>16</sup> In particular, Italy's high debt level implies that each year the rollover of expiring securities amounts to around 20% of GDP, exposing the country to possible risk aversion of investors in periods of financial market stress. In addition, the government has to rely on financial markets to finance a budgetary position that is still in deficit. Finally, Italy's low nominal growth and a still rather high implicit interest rate paid to service the debt imply a sizeable debt-increasing “snow-ball” effect in the short run.

Based on Commission forecasts and a no-fiscal policy change scenario beyond forecasts, government debt, at 132.7% of GDP in 2015, is expected to decrease to around 115% in 2026, thus remaining above the 60% of GDP Treaty threshold. Over this horizon, the government debt is projected to peak at 132.7% of GDP in 2015-2016. This highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the stability programme would nonetheless put debt on a more marked decreasing path; although at around 103% of GDP, it would remain above the 60% of GDP reference value in 2026.

Table 6 shows that the medium-term fiscal sustainability risk indicator S1 is at 4.8 percentage points of GDP, primarily related to the high level of government debt contributing with 5.3 percentage points of GDP. This indicates high risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at 4.1 percentage points of GDP, leading to similar medium-term risk. Overall, risks to fiscal sustainability over the medium-term are, therefore, high.

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 at -0.6 percentage points of GDP. In the long-term, Italy therefore appears to face low fiscal sustainability risks, thanks to almost stable projected ageing costs that would benefit from the full implementation of past pension reforms (see Section 3.5 for risks in this respect). Full implementation of the programme would put the S2 indicator at -1.3 percentage points of GDP, leading to a similar long-term risk.

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<sup>16</sup> This conclusion is based on the short-term fiscal sustainability risk indicator S0, which incorporates 14 fiscal and 14 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 Fiscal Sustainability Report 2015 (page 67).



**Table 6: Sustainability indicators**

<i>Time horizon</i>	<b>No-policy Change Scenario</b>		<b>Stability / Convergence Programme Scenario</b>	
<b>Short Term</b>	<b>LOW risk</b>			
<b>S0 indicator</b> <sup>[1]</sup>	0.2			
Fiscal subindex (2015)	0.3	LOW risk		
Financial & competitiveness subindex (2015)	0.1	LOW risk		
<b>Medium Term</b>	<b>HIGH risk</b>			
<b>DSA</b> <sup>[2]</sup>	HIGH risk			
<b>S1 indicator</b> <sup>[3]</sup>	4.8	HIGH risk	4.1	HIGH risk
<i>of which</i>				
IBP	-0.2		-1.6	
Debt Requirement	5.3		5.6	
CoA	-0.2		0.0	
<b>Long Term</b>	<b>LOW risk</b>		<b>LOW risk</b>	
<b>S2 indicator</b> <sup>[4]</sup>	-0.6		-1.3	
<i>of which</i>				
IBP	-0.5		-1.4	
CoA	-0.1		0.1	
<i>of which</i>				
Pensions	-0.9		-0.7	
HC	0.6		0.5	
LTC	0.6		0.6	
Other	-0.4		-0.3	

Source: Commission services; 2016 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 2016 forecast until 2017. 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 reflects up to date evidence on the role played by fiscal and financial-competitiveness variables in creating potential fiscal risks. It should be stressed that the methodology for the S0 indicator is fundamentally different from the S1 and S2 indicators. S0 is not a quantification of the required fiscal adjustment effort like the S1 and S2 indicators, but a composite indicator which estimates the extent to which there might be a risk for fiscal stress in the short-term. The critical threshold for the overall S0 indicator is 0.43. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.35 and 0.45.

[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. See Fiscal Sustainability Report 2015.

[3] The medium-term sustainability gap (S1) indicator shows the upfront adjustment effort required, in terms of a steady adjustment in the structural primary balance to be introduced over the five years after the forecast horizon, and then sustained, to bring debt ratios to 60% of GDP in 2030, including financing for any additional expenditure until the target date, arising from an ageing population. The following thresholds were used to assess the scale of the sustainability challenge: (i) if the S1 value is less than zero, the country is assigned low risk; (ii) if a structural adjustment in the primary balance of up to 0.5 p.p. of GDP per year for five years after the last year covered by the spring 2015 forecast (year 2017) is required (indicating an cumulated adjustment of 2.5 pp.), it is assigned medium risk; and, (iii) if it is greater than 2.5 (meaning a structural adjustment of more than 0.5 p.p. of GDP per year is necessary), it is assigned high risk.

[4] The long-term sustainability gap (S2) indicator shows the immediate and permanent adjustment required to satisfy an inter-temporal budgetary constraint, including the costs of ageing. The S2 indicator has two components: i) the initial budgetary position (IBP) which gives the gap to the debt stabilising primary balance; and ii) the additional adjustment required due to the costs of ageing. The main assumption used in the derivation of S2 is that in an infinite horizon, the growth in the debt ratio is bounded by the interest rate differential (i.e. the difference between the nominal interest and the real growth rates); thereby not necessarily implying that the debt ratio will fall below the EU Treaty 60% debt threshold. The following thresholds for the S2 indicator were used: (i) if the value of S2 is lower than 2, the country is assigned low risk; (ii) if it is between 2 and 6, it is assigned medium risk; and, (iii) if it is greater than 6, it is assigned high risk.

## 6. FISCAL FRAMEWORK

Both the no-policy-change and the programme macroeconomic scenarios underlying the 2016 Stability Programme have been endorsed by the Parliamentary Budget Office (PBO), the national fiscal monitoring institution operational since September 2014. This endorsement, mentioned in the programme itself, took the form of two separate letters addressed to the Italian Minister of Economy and Finance (see Section 2). However, the Office highlighted that growth projections in the Stability Programme are positioned in the higher part of the forecast range used for its assessment (see also Section 3.5 on risk assessment).

As envisaged in the Italian legislation,<sup>17</sup> the *Documento di Economia e Finanza*, 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. 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 2016 Stability Programme outlines the higher expenditures related to the investment projects with the highest financial impacts, particularly infrastructural ones but no estimates of their expected economic returns are made available.

The 2016 Stability Programme budgetary targets, especially as regards the procedure to be followed to allow for temporary deviations from the adjustment path towards the MTO, seem to be at odds with national fiscal rules, in particular Law 243/2012<sup>18</sup>, to the extent that they refer to EU rules as a benchmark. In fact, the government advocated exceptional circumstances to further postpone the achievement of its medium-term budgetary objective to 2019, or even beyond the programme period according to the recalculations made by the Commission based on the commonly agreed methodology. It must be recalled that the Commission has not called for the general escape clause due to “exceptional circumstances” and that the PBO<sup>19</sup> highlighted the tendency of Italy’s stability programmes to repeatedly postpone over time the attainment of the MTO also due to lack of compliance with the adjustment path towards it pursuant to the preventive arm of the SGP. In this context, however, the provisions defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 allow catering for “exceptional events” in the form of additional expenditure related to the refugee crisis and to the severity of the terrorist threat (see Section 4.2). Therefore, Italy’s required adjustment towards the medium-term budgetary objective for 2015 has been reduced to take into account additional refugee-related costs. Regarding 2016, a final assessment, including on the eligible amounts, will be made in spring 2017 on the basis of observed data as provided by Italian authorities.

Overall, based on the information provided in the stability programme, the past, planned and forecast fiscal performance in Italy appears to comply only partially with the requirements of the applicable national numerical fiscal rules, with particular regard to the procedure to be followed to allow for temporary deviations from the adjustment path towards the MTO.

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<sup>17</sup> Law 196/2009

<sup>18</sup> Article 6 of Law 243/2012 (on provisions for the application of the balanced budget principle pursuant to article 81.6 of the Constitution) establishes that exceptional events have to be identified in line with EU legislation. The same Article also sets the procedure to follow to revise the budgetary objectives

<sup>19</sup> [www.upbilancio.it/wp-content/uploads/2016/05/Rapporto-sulla-programmazione-2016.pdf](http://www.upbilancio.it/wp-content/uploads/2016/05/Rapporto-sulla-programmazione-2016.pdf)

Moreover, although important initiatives to reform Italy's fiscal framework are underway, only limited steps have so far been implemented to secure the contribution of the spending review to fiscal consolidation. In particular, the spending review targets have been further reduced and the fact that the spending review is not fully integrated into the budgetary process weighs on the overall efficiency of the exercise. Still, two enacting decrees of the 2009 reform of the budgetary process and public accounting were adopted in May 2016 and, once pending legislation reforming the budget law is adopted, the spending review is expected to become a systematic feature of the budget process, thereby endowed with a more performance-oriented approach.

Last but not least, the implementation of the extension to the regional level of centralised public procurement, envisaged by the Public Spending Rationalisation Programme, is still pending and the harmonisation of balance sheets at the local level, after passing an experimental phase, is gradually being implemented. For both regions and local governments, the Domestic Stability Pact has been replaced by a balanced budget rule, also taking into account the abovementioned harmonization of the accounting systems. A draft bill aimed at amending the related fiscal rules in the Law 243/2012 is still pending in the Parliament and an absolute majority of the members of each Chamber will be required to approve it.

## 7. CONCLUSIONS

In 2015, Italy's structural balance improved by 0.1% of GDP, showing some deviation from the required adjustment towards the MTO. On the other hand, the growth of government expenditure, net of discretionary revenue measures, did not exceed the expenditure benchmark rate. 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 2015. However, the structural effort in 2015 falls significantly short of the required MLSA under the transitional debt rule.

On 18 May 2016, the Commission issued a report under article 126(3) TFEU, as Italy did not make sufficient progress towards compliance with the debt rule in 2015. The report concluded that, after the assessment of all the relevant factors, the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with. The Commission will review its assessment of the relevant factors in a new report under Article 126(3) TFEU based on the Commission 2016 autumn forecast, as further information on the credibility and appropriateness of Italy's resumption of the adjustment path towards the MTO for 2017 becomes available.

Italy plans a worsening in the (recalculated) structural balance of 0.6% of GDP in 2016 followed by a zero structural effort in 2017, with a (recalculated) budgetary position still indicating a structural deficit of ½% of GDP in 2019. The Commission 2016 spring forecast expects Italy's structural balance to deteriorate by 0.7% of GDP, followed by a stable structural balance in 2017. This fiscal path is broadly compliant with the required adjustment towards the MTO in 2016, once taking into account the maximum temporary deviation of 0.75% of GDP from the required 0.5% of GDP adjustment towards the MTO allowed for investments and the implementation of structural reforms, subject to the condition of resuming the adjustment path towards the MTO in 2017. The expenditure benchmark points to compliance based on the Commission 2016 spring forecast, as the growth rate of government expenditure, net of discretionary revenue measures, will not exceed the applicable expenditure benchmark rate in 2016. Overall, a risk of some deviation from the adjustment path towards the MTO is to be expected in 2016. This conclusion would not change should the 0.1% of GDP budgetary impact of the exceptional inflow of refugees as

well as of the exceptional security measures be excluded from the assessment. As regards 2017, pending the 2017 DBP, a risk of a significant deviation from the adjustment path towards the MTO is to be expected based on the Commission 2016 spring forecast, putting at risk the compliance with the requirements of the preventive arm of the Pact.

Italy is not expected to comply with the debt rule in 2016 based on either the (recalculated) government plans or the Commission 2016 spring forecast. The latter still expects a 4.7% of GDP gap to the debt benchmark in 2017 based on a no-policy change assumption, while the gap is much smaller based on the Stability Programme, also thanks to ambitious privatisations planned over 2016-2019. In the 2016 Stability Programme, the Italian authorities plan to comply with the debt rule as of 2018 in a forward-looking dimension (i.e. as of 2020), whereas projections based on the Commission 2016 spring forecast expect compliance only by 2020 in a forward-looking dimension (i.e. as of 2022), under a no-policy-change assumption until 2017 and assuming thereafter structural efforts in line with the preventive arm requirement (i.e. 0.6 percentage points per year until the attainment of the MTO).

All in all, Italy is broadly compliant with the required adjustment path towards the MTO in both 2015 and 2016 but rigorous implementation of the 2016 budget remains essential and the conclusion for 2016 crucially hinges upon the admissible temporary deviation for exceptional expenditures related to the refugee inflow in 2015 (for an amount of 0.03% of GDP) and for the structural reform and investment clause in 2016 (for an overall amount of 0.75% of GDP). The latter allowance takes into account Italy's public commitment to comply with the preventive arm of the SGP in 2017, as well as the actual and expected progress in terms of structural reforms and co-financed investment. Given the uncertainties hindering the possibility at this stage to fully assess Italy's plans to resume of the adjustment path towards the MTO beyond 2016, the Commission will review its assessment of the relevant factors in a new report under Article 126(3) TFEU based on the Commission 2016 autumn forecast, as further information on Italy's compliance with the preventive arm of the SGP in 2017, in line with the government's public commitment, becomes available.

## 8. ANNEX

### Table I. Macroeconomic indicators

	1998-2002	2003-2007	2008-2012	2013	2014	2015	2016	2017
<b>Core indicators</b>								
GDP growth rate	1.8	1.2	-1.4	-1.7	-0.3	0.8	1.1	1.3
Output gap <sup>1</sup>	1.1	1.1	-2.0	-4.3	-3.9	-2.9	-1.6	-0.4
HICP (annual % change)	2.2	2.3	2.4	1.2	0.2	0.1	0.2	1.4
Domestic demand (annual % change) <sup>2</sup>	2.3	1.2	-1.9	-2.6	-0.4	1.1	1.4	1.4
Unemployment rate (% of labour force) <sup>3</sup>	9.9	7.4	8.4	12.1	12.7	11.9	11.4	11.2
Gross fixed capital formation (% of GDP)	20.2	21.2	19.8	17.2	16.6	16.5	16.9	17.5
Gross national saving (% of GDP)	20.8	20.4	17.6	17.8	18.2	19.0	19.3	19.7
<b>General Government (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-2.5</b>	<b>-3.3</b>	<b>-3.7</b>	<b>-2.9</b>	<b>-3.0</b>	<b>-2.6</b>	<b>-2.4</b>	<b>-1.9</b>
<b>Gross debt</b>	<b>106.4</b>	<b>101.0</b>	<b>114.0</b>	<b>129.0</b>	<b>132.5</b>	<b>132.7</b>	<b>132.7</b>	<b>131.8</b>
<b>Net financial assets</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Total revenue	44.6	43.9	46.0	48.1	48.2	47.9	47.2	46.7
Total expenditure	47.1	47.1	49.8	51.0	51.2	50.5	49.7	48.6
<i>of which: Interest</i>	6.4	4.7	4.7	4.8	4.6	4.2	4.0	3.8
<b>Corporations (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>-0.2</b>	<b>-0.1</b>	<b>0.4</b>	<b>2.3</b>	<b>3.7</b>	<b>3.6</b>	<b>3.5</b>	<b>2.9</b>
<b>Net financial assets; non-financial corporations</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
<b>Net financial assets; financial corporations</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Gross capital formation	10.8	11.0	10.0	8.5	8.2	8.6	8.8	9.3
Gross operating surplus	23.9	23.0	21.1	20.3	20.3	20.2	20.8	20.9
<b>Households and NPISH (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>3.2</b>	<b>2.4</b>	<b>1.0</b>	<b>1.5</b>	<b>1.4</b>	<b>1.4</b>	<b>1.5</b>	<b>1.4</b>
<b>Net financial assets</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Gross wages and salaries	26.9	27.7	29.1	29.1	29.2	29.4	29.4	29.1
Net property income	16.2	14.2	12.0	10.7	10.3	10.0	9.8	10.1
Current transfers received	20.5	21.0	23.3	24.7	24.8	24.8	24.8	24.7
Gross saving	10.0	10.0	8.1	7.5	7.2	7.1	7.3	7.3
<b>Rest of the world (% of GDP)</b>								
<b>Net lending (+) or net borrowing (-)</b>	<b>0.5</b>	<b>-0.9</b>	<b>-2.3</b>	<b>0.9</b>	<b>2.1</b>	<b>2.4</b>	<b>2.5</b>	<b>2.4</b>
<b>Net financial assets</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>	<b>n.a</b>
Net exports of goods and services	1.5	-0.1	-0.8	2.2	2.9	3.2	3.4	3.3
Net primary income from the rest of the world	-0.4	-0.1	-0.4	-0.2	-0.1	-0.1	-0.1	-0.1
Net capital transactions	0.2	0.1	0.1	0.0	0.2	0.2	0.2	0.2
Tradable sector	46.0	43.0	40.8	40.2	40.0	40.6	n.a	n.a
Non tradable sector	43.8	47.1	49.2	49.8	49.8	49.2	n.a	n.a
<i>of which: Building and construction sector</i>	4.4	5.2	5.1	4.6	4.5	4.4	n.a	n.a
Real effective exchange rate (index, 2010=100)	84.5	95.9	100.4	100.4	100.7	96.5	96.1	94.5
Terms of trade goods and services (index, 2010=100)	105.4	102.7	99.1	97.4	99.7	102.1	104.3	104.3
Market performance of exports (index, 2010=100)	130.8	113.0	101.3	100.2	100.0	99.4	97.6	96.9
<b>Notes:</b>								
<sup>1</sup> The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
<sup>2</sup> The indicator on domestic demand includes stocks.								
<sup>3</sup> 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.								
<b>Source:</b>								
AMECO data, Commission 2016 spring forecast								