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COMMISSION OPINION

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on the Draft Budgetary Plan of Italy

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GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact (SGP) and the European Semester for economic policy coordination.
2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

CONSIDERATIONS CONCERNING ITALY

3. On the basis of the Draft Budgetary Plan for 2018 submitted on 17 October 2017 by Italy, as updated on 20 October 2017, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013. The Commission sent a letter to Italy on 27 October 2017 asking for further information and highlighted a number of preliminary observations related to the Draft Budgetary Plan. Italy replied to the Commission's letter on 30 October 2017. That information has been taken into account in the Commission's assessment of budgetary developments and risks.
4. Italy is subject to the preventive arm of the Stability and Growth Pact and should ensure sufficient progress towards its medium term budgetary objective of 0% of GDP. In 2017, it should achieve an annual fiscal adjustment of 0.6% of GDP or more towards the MTO. In 2018, it should pursue a substantial fiscal effort, taking into account the need to strengthen the ongoing recovery and to ensure the sustainability of Italy's public finances. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that translates into the requirement for a nominal rate of reduction of net primary government expenditure of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP. As its public debt exceeds the 60% of GDP reference value of the Treaty, Italy also needs to comply with the debt reduction benchmark.
5. Overall, the macroeconomic projections outlined in Italy's 2018 Draft Budgetary Plan appear plausible for 2017. However, the outlook for 2018 appears slightly optimistic as regards both real and nominal GDP growth. Compared to the 2017 Stability Programme, Italy's 2018 Draft Budgetary Plan revised real GDP growth for 2017 upward (from 1.0% to 1.5%), with private domestic demand set to be its main driver, while the GDP deflator growth was markedly revised downward (from 1.2% to 0.6%). The Commission 2017 autumn forecast is aligned with these projections. For 2018, the Draft Budgetary Plan also projects higher real GDP growth (at 1.5%), supported in particular by private and public investment, and broadly stable GDP deflator growth (at 1.6%) compared to the 2017 Stability Programme. By contrast, the Commission 2017 autumn forecast expects slightly lower real GDP growth (at

1.3%) and GDP deflator growth (at 1.3%). The Draft Budgetary Plan expects the unemployment rate to decline marginally more than the Commission forecast, albeit remaining at high levels also due to rising participation rates. Downside risks to these projections are related to the remaining fragilities of the Italian banking sector and a potential slowdown in external demand.

6. Italy complies with the requirement of Regulation EU No 473/2013 that the draft budget has to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecasts underlying the Draft Budgetary Plan have been endorsed by the Parliamentary Budget Office, Italy's independent fiscal monitoring institution. However, the Parliamentary Budget Office assessed the government growth projections beyond 2017 as being subject to significant downside risk, with growth in 2018 being above the upper bound of its forecast range.
7. Italy's 2018 Draft Budgetary Plan projects that the general government deficit will decrease to 2.1% in 2017, down from 2.5% of GDP in 2016 and in line with the Stability Programme. For 2018, the Draft Budgetary Plan expects the government deficit to decline further to 1.6% of GDP, i.e. considerably above the Stability Programme target of 1.2% of GDP, notwithstanding higher economic growth projections. The difference results mainly from deficit increasing measures worth 0.6% of GDP, envisaged in the Draft Budgetary Plan. The planned deterioration in the structural balance¹ for 2017 (0.4% of GDP) is slightly worse than in the Stability Programme (0.3% of GDP). For 2018, the structural balance is set to improve by around 0.2% of GDP, considerably below the structural adjustment of 0.8% of GDP planned in the Stability Programme. The Draft Budgetary Plan projects that the debt-to-GDP ratio will slightly decline to 131.6% in 2017 and to 130.0% in 2018. The fall in interest expenditure, since the peak reached in 2012, partly offsets some deterioration in the structural primary balance. As such, the projected deterioration of Italy's structural balance in 2017-2018 (0.2% of GDP, overall) is accompanied by a more pronounced deterioration in the structural primary balance (0.6% of GDP, overall).
8. In its Draft Budgetary Plan for 2017 and in the 2017 Stability Programme, Italy indicated that the budgetary impact of the exceptional inflow of refugees and exceptional seismic activity in 2017 is significant and should be considered as an unusual event outside the control of the government, as defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97. Specifically, Italy requested a temporary deviation from the adjustment path towards the MTO of 0.34% of GDP in 2017 in relation to the inflow of refugees and a preventive investment plan for the protection of the national territory against seismic risks. Italy's 2018 Draft Budgetary Plan confirms those amounts. The provisions set out in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 cater for that additional expenditure, in that the inflow of refugees and seismic activity are exceptional events, their impact on the country's public finances is significant and sustainability would not be compromised by allowing for a deviation from the adjustment path towards the MTO. In its assessment of Italy's 2017 Stability Programme, the Commission provisionally assessed Italy to be eligible for an allowance of 0.34% of GDP, in relation to costs considered by the Commission to have a clear and direct link to the exceptional inflow of refugees and to exceptional seismic activity. As regards costs in 2017, the Commission will make a final assessment, including on the eligible

¹ Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology.

amounts, in spring 2018 on the basis of observed data as provided by the authorities. In particular, given the need to verify implementation of the preventive investment plan for the protection of the national territory against seismic risks, the Commission should be provided with an *ex post* assessment by the authorities to be able to confirm the granted amount of flexibility.

9. The measures underpinning Italy's 2018 Draft Budgetary Plan have a net negative impact on the 2018 headline deficit of 0.6% of GDP at face value. The main deficit-increasing measures include the repeal in 2018 (and the partial repeal in 2019) of a VAT increase previously legislated as a "safeguard clause", the permanent halving of social security contributions paid on new young hires for the first three years of an open-ended contract, various measures to support investment, R&D and firm competitiveness, and further resources earmarked to increase public employees' wages and to fight poverty and social exclusion. Deficit-reducing measures include a spending review at both ministerial and local level, which represents the first implementation of the recent reform of the budgetary process. Deficit-reducing measures also include various provisions to increase tax compliance and fight tax evasion, including the extension of compulsory electronic invoicing to all private sector transactions, except those taxpayers subject to a simplified tax regime, as of 2019 and as of July 2018 for public procurement and fuels. The net impact of the measures underpinning the Draft Budgetary Plan is instead deficit decreasing by around 0.3% of GDP based on the Commission 2017 autumn forecast, since the "safeguard clauses" were not incorporated in its baseline. Moreover, "other expenditure measures" amounting to around 0.1% of GDP and "other revenue measures" amounting to around 0.1% of GDP in 2018 were not included in the Commission forecast due to lack of details in the Draft Budgetary Plan. Overall, the Commission considers that some deficit-decreasing measures of a structural nature included in the Draft Budgetary Plan, for instance to implement the spending review and increase tax compliance, are in line with previous country-specific recommendations, although the planned lower transfers to local public bodies might result in lower public investment.
10. The Commission projects that the headline deficit will be 2.1% of GDP in 2017 and 1.8% in 2018. The slightly higher headline deficit forecast by the Commission in 2018 compared to the Draft Budgetary Plan is due to lower nominal GDP growth and stronger expenditure dynamics in the Commission forecast. Based on the Commission forecast, the estimated increase in the structural deficit amounts to 0.4% of GDP in 2017, followed by a slight improvement of 0.1% of GDP in 2018. The Commission forecast projects a somewhat higher debt-to-GDP ratio than in the Draft Budgetary Plan, at 132.1% in 2017 and 130.8% in 2018. In 2017, the difference is mainly explained by the larger impact of the liquidation of two Italian regional lenders (Banca Popolare di Vicenza and Veneto Banca) and the precautionary recapitalisation of Banca Monte dei Paschi di Siena incorporated by the Commission in its debt forecast² (at around 0.9% of GDP compared to 0.6% of GDP in the Draft Budgetary Plan), as well as by a more cautious assessment by the Commission of the 0.2% of GDP privatisation proceeds projected by the government. In 2018, the difference is mainly related to lower nominal growth and the fact that the Commission incorporates only half of the 0.3% of GDP privatisation proceeds projected for 2018. Overall, downside risks to both the Commission and the

² The overall fiscal impact of the two operations is currently being investigated by the competent statistical authorities, EUROSTAT and ISTAT.

government budgetary projections are related to a larger-than-anticipated impact of the recent bank resolution cases, possibly worse than expected macroeconomic outcomes including persistently low inflation, lower privatisation proceeds and partial implementation of the deficit-reducing measures in the Draft Budgetary Plan.

11. On 22 February 2017, the Commission issued a report under Article 126(3) TFEU as Italy had not made sufficient progress towards compliance with the debt criterion in 2015. The report concluded that the debt reduction benchmark should be considered as not complied with at that stage, unless additional measures worth 0.2% of GDP were delivered. Following the enactment of those measures, the Commission indicated that no further assessment of compliance with the debt criterion in 2015 would be needed, and a new assessment of compliance with the debt criterion in 2016 based on the Commission 2017 autumn forecast was announced.
12. Based on the Draft Budgetary Plan, Italy is not projected to comply with the debt reduction benchmark either in 2017 or in 2018. Based on the Commission 2017 autumn forecast, the debt reduction benchmark is not projected to be met in 2017 and 2018 either.
13. In 2017, Italy was recommended to deliver a structural adjustment towards the MTO of 0.6% of GDP or more. Based on the Draft Budgetary Plan, the expenditure benchmark points to a risk of significant deviation in 2017 both over one year (gap of 1.2% of GDP) and over two years (gap of 0.6% of GDP per year, on average). The same conclusion can be reached on the basis of the structural balance pillar both over one year (gap of 1.0% of GDP) and over two years (gap of 0.7% of GDP per year, on average). Compliance with the expenditure benchmark is positively affected by a slightly higher GDP deflator that included a later repealed VAT hike. Taking it into account, the conclusion of a risk of significant deviation is confirmed. The structural balance, in turn, is affected negatively by revenue shortfalls and positively by a decline in interest expenditure and in nationally-financed public investments, leaving the conclusion unchanged. Overall, Italy's Draft Budgetary Plan plans a significant deviation from the required adjustment towards the MTO in 2017. Subtracting from the preventive arm requirement the projected budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks would not change that conclusion. Based on the Commission 2017 autumn forecast, the expenditure benchmark points to a risk of significant deviation in 2017 both over one year (gap of 0.9% of GDP) and over two years (gap of 0.4% of GDP per year, on average). The same conclusion can be reached on the basis of the structural balance pillar both over one year (gap of 1.0% of GDP) and over two years (gap of 0.7% of GDP per year, on average). Taking into account the factors indicated above, the overall assessment points to a risk of significant deviation in 2017 based on the Commission 2017 autumn forecast. Again, subtracting from the preventive arm requirement the projected budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks would not change that conclusion.
14. In 2018, Italy was recommended to ensure a nominal rate of reduction of net primary government expenditure of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP. Based on the Draft Budgetary Plan, the expenditure benchmark points to a risk of some deviation over one year (gap of 0.1% of GDP) and to a risk of significant deviation over two years (gap of 0.6% of GDP per year, on average). The same conclusion can be reached on the basis of the

structural balance pillar both over one year (gap of 0.4% of GDP) and over two years (gap of 0.7% of GDP per year, on average). The structural balance is negatively affected by revenue shortfalls, which are offset by the impact of a decline in interest expenditure and a slightly higher (point) estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark. The expenditure benchmark is thus considered to appropriately reflect the underlying fiscal effort of Italy. Overall, Italy's Draft Budgetary Plan plans a significant deviation from the required adjustment towards the MTO in 2018. Based on the Commission 2017 autumn forecast, the expenditure benchmark points to a risk of significant deviation in 2018 both over one year (gap of 0.5% of GDP) and over two years (gap of 0.7% of GDP per year, on average). The structural balance pillar points to a risk of some deviation over one year (gap of 0.5% of GDP) and to a risk of significant deviation over two years (gap of 0.8% of GDP per year, on average). Taking into account the factors indicated above, the overall assessment points to a risk of significant deviation in 2018 based on the Commission 2017 autumn forecast.

15. The country-specific recommendations adopted by the Council on 11 July 2017³ mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. The Commission has carried out a qualitative assessment of the strength of the recovery in Italy while giving due consideration to its sustainability challenges. Italy does not face short-term sustainability challenges, although in the medium term the overall risks to fiscal sustainability are assessed as high. At the same time, the recovery in Italy appears fragile. In particular, real GDP and investment remain below their pre-crisis levels, while unemployment rate is still much higher than before the crisis, which, together with persistently weak productivity, undermines Italy's growth prospects. Moreover, the estimated output gap is subject to uncertainty as flagged by the plausibility tool. In order to balance the current stabilisation needs with the existing sustainability challenges, according to the Commission, a fiscal structural effort of at least 0.3% of GDP is required, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary government expenditure not exceeding 0.5%. Taking that into account in the overall assessment, Italy's fiscal adjustment cannot be considered adequate, in light of the sustainability challenges that Italy faces, on the basis of the Commission 2017 autumn forecast.
16. Italy has taken some steps to reduce the labour tax wedge and, more generally, to reform the taxation system and increase tax compliance. As regards the former, Italy's 2018 Draft Budgetary Plan envisages the permanent halving of social security contributions paid by private employers on new hires below the age of 30 (and below the age of 35 for new contracts starting in 2018) for the first three years of an open-ended contract, and for the first year of an apprenticeship contract; private employers are fully exempted if they hire students who had previously taken part in traineeship programmes with them. As regards the latter, the extension of existing compulsory electronic invoicing for transactions with the public administration to private sector transactions is in line with the country-specific recommendation asking Italy to broaden the compulsory use of electronic invoicing and payments. However, the recommended reform of the cadastral system, concrete actions to reduce the number

³ Council Recommendation of 11 July 2017 on the 2017 National Reform Programme of Italy and delivering a Council opinion on the 2017 Stability Programme of Italy, OJ C 261, 9.9.2017, p. 46.

and scope of tax expenditures, and measures to increase property taxation on high-income households have not been implemented. On the expenditure side, the government has implemented for the first time the reformed budgetary process that aims at performance-budgeting over the medium term and ensuring that the spending review becomes a more permanent feature of the budgetary process across all levels of government. Over 2011-2017, Italy's fiscal effort has been mostly on the revenue side and helped by downward trending interest expenditure, while primary expenditure has increased slightly, relative to Italy's sluggish potential output. Italy's public expenditure appears to be increasingly biased towards the elderly, while growth-enhancing spending items have been markedly restrained during the crisis. This has contributed to the increase in the weight of social spending in total expenditure at the expense of investment and public wages.

17. Overall, and after considering the need to balance the two objectives of strengthening the ongoing recovery and ensuring fiscal sustainability, the Commission is of the opinion that the Draft Budgetary Plan of Italy, which is currently under the preventive arm and subject to the debt reduction benchmark, is at risk of non-compliance with the provisions of the Stability and Growth Pact. The fiscal adjustment projected in the Commission 2017 autumn forecast for 2018 is not adequate in light of the sustainability challenges that Italy faces. Therefore, the Commission invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2018 budget will be compliant with the SGP and to use windfall gains to accelerate the reduction of the government debt-to-GDP ratio. Compliance with the preventive arm requirements is a key relevant factor when assessing compliance with the debt criterion.

The Commission is also of the opinion that Italy has made some progress with regard to the structural part of the fiscal recommendations contained in the Council Recommendation of 11 July 2017 in the context of the 2017 European Semester and invites the authorities to make further progress. A comprehensive assessment of progress made with the implementation of the country-specific recommendations will be undertaken in the 2018 Country Reports and in the context of the country-specific recommendations to be proposed by the Commission in May 2018.

Done at Brussels, 22.11.2017

For the Commission
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