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Assessment of the 2018 Stability Programme for

Italy

(Note prepared by DG ECFIN staff)

CONTENTS

1. INTRODUCTION.....	3
2. MACROECONOMIC DEVELOPMENTS	3
3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS.....	5
3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018.....	5
3.2. MEDIUM-TERM STRATEGY AND TARGETS	7
3.3. MEASURES UNDERPINNING THE PROGRAMME.....	9
3.4. DEBT DEVELOPMENTS.....	11
3.5. RISK ASSESSMENT	12
4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT	14
4.1. Compliance with the debt criterion	14
4.2. Compliance with the required adjustment path towards the MTO	16
5. FISCAL SUSTAINABILITY	19
6. FISCAL FRAMEWORK	21
7. SUMMARY	22
8. ANNEXES	23

1. INTRODUCTION

Italy submitted its 2018 Stability Programme (hereafter called Stability Programme), covering the period 2018-2021, on 16 May 2018. Given the caretaker nature of the government in place at that time, the budgetary projections of the Stability Programme are based on a trend scenario assuming unchanged legislation.

Italy is currently subject to the preventive arm of the stability and Growth Pact (SGP) and should ensure sufficient progress towards its MTO. As the debt ratio was 131.8 % of GDP in 2017, exceeding the 60 % of GDP reference value, Italy is also subject to the debt reduction benchmark.

Due to Italy's prima facie non-compliance with the debt reduction benchmark in 2016 and 2017, on 23 May 2018 the Commission issued 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 the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with, and that an EDP is thus not warranted at this stage. This conclusion followed an assessment of all the relevant factors, having regard in particular to Italy's ex-post compliance with the preventive arm in 2017. However, the adjustment in 2018 appears inadequate to ensure compliance with the adjustment path towards the MTO in 2018 based on the Commission 2018 spring forecast. The Commission will reassess compliance on the basis of the ex-post data for 2018 to be notified in Spring 2019.

This document complements the Country Report published on 7 March 2018 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 2018 spring forecast. The following section presents the recent and planned budgetary developments, according to the Stability Programme. In particular, it includes an overview of the medium term budgetary plans, an assessment of the measures underpinning the 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 of long term sustainability risks and Section 6 of recent developments and plans regarding the fiscal framework. Section 7 provides a summary.

2. MACROECONOMIC DEVELOPMENTS

The recovery of the Italian economy strengthened in 2017, with GDP growth driven both by domestic and external demand. Overall, Italy's real GDP expanded by 1.5 %, after 0.9 % in 2016. Investment continued to benefit from tax incentives and favourable financing conditions, while exports and imports both accelerated, mirroring global trade developments. In addition, consumption grew broadly in line with GDP growth on the back of solid job creation and rising labour force participation rates.

Given the ongoing consultations to form a government following the national elections on 4 March 2018, the Stability Programme submitted by the outgoing government only includes a baseline scenario assuming unchanged policies, i.e. already adopted/legislated fiscal measures and structural reforms as presented in the National Reform Programme. External assumptions are in line with those in the Commission 2018 spring forecast for 2018 and 2019.

Based on the Stability Programme, real GDP is expected to grow by 1.5 % in 2018, in line with the projections of the 2018 Draft Budgetary Plan (DBP) of October 2017. Compared to the DBP projections, a more favourable external environment and better financing conditions compensate for the negative impact resulting from the appreciation of the euro and higher oil prices. Stronger foreign demand translates into more dynamic export growth which implies a higher contribution to GDP growth as compared to the projections of the DBP. For 2019, the Stability Programme slightly revises real GDP growth downwards, to 1.4 % from 1.5 % in the DBP, as high uncertainty at the global level and heightened geopolitical risks warranted a more cautious approach. Real GDP is projected to grow by 1.3 % in 2020, confirming the DBP projections, and by 1.2 % in 2021, in line with the assumed trend.

Growth projections for 2018 are broadly aligned in the Stability Programme and the Commission 2018 spring forecast. The Stability Programme and the Commission 2018 spring forecast both expect domestic demand to maintain its key role due to strong investment growth, while private consumption is set to expand at similar rates as in 2017, supported by increasing employment and moderately rising wages. Exports are slightly more dynamic in the Stability Programme. However, the contribution to growth from net trade remains neutral in both cases. In 2019, real GDP growth is projected somewhat higher in the Stability Programme as compared to the Commission forecast, despite the inclusion of the VAT increase which is not considered in the Commission scenario. The Stability Programme projects private consumption to decelerate in 2019, while the Commission 2018 spring forecast expects consumer spending to grow at an unchanged rate. The key factor behind this divergence is the assumed higher fiscal burden due to the legislated VAT hike (0.7 % of GDP) related to the “safeguard clause” which is not included in the Commission forecast (see Section 3). The lower positive contribution from domestic demand is expected to be compensated by a positive contribution from net trade, as imports are set to decelerate significantly faster than exports. The no-policy change scenario for the outer years of the Stability Programme appears consistent with the external assumptions. The negative output gap (-1.2 % of potential output in 2017), as recalculated by the Commission based on the information in the programme following the commonly agreed methodology, is expected to close and turn positive in 2019. Potential real GDP growth is estimated to average ½ % over the programme period, i.e. below the 1 % average actual growth.

Concerning the labour market, the Stability Programme expects compensation of employees to increase significantly less in 2018 as compared to the Commission 2018 spring forecast (1.5 % as against 2.1 %), despite similar projections concerning employment and inflation dynamics. Part of the difference might be explained by a lower rebound in social contributions expected by the Stability Programme in connection with the three-year exemption for new hiring with open-ended contracts, which started in 2015. For 2019, projections of employment growth and compensation of employees in the Stability Programme are broadly aligned with those in the Commission 2018 spring forecast. Labour productivity (based on full-time equivalent employment) is expected to continue its positive trend and increase modestly over the programme period. The increase in unit labour costs is expected to remain below the rise in the GDP deflator from 2019, implying some improvement in profit margins over the programme period. The unemployment rate is expected to decline in line with the projected output expansion, decreasing to 10.2 % by 2019, somewhat below the Commission 2017 spring forecast, and to 9.1 % by 2021.

On balance, the macroeconomic scenario underpinning the Stability Programme appears to be somewhat optimistic, in particular the outlook for 2019. Main downside risks to the Stability Programme projections relate to a potentially less supportive external environment, inter alia associated with a rise in trade protectionism and high political uncertainty both at the global

and domestic level. On the upside, the investment-led recovery may spur productivity, and eventually GDP growth, more than expected. Furthermore, in 2019 the negative impact of the planned fiscal consolidation on growth might be stronger than assumed in the Stability Programme. The Parliamentary Budget Office (PBO), Italy's independent fiscal council, validated the baseline scenario in April 2018. However, the macroeconomic projections are positioned at the upper bound of the forecast range used for the assessment by the Office, in particular in 2019 and 2020, and thus subject to downside risks, inter alia because of the high degree of uncertainty affecting the current fiscal policy set-up.

Table 1: Comparison of macroeconomic developments and forecasts

	2017		2018		2019		2020	2021
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.5	1.5	1.5	1.5	1.2	1.4	1.3	1.2
Private consumption (% change)	1.4	1.4	1.2	1.4	1.2	1.0	0.9	1.2
Gross fixed capital formation (% change)	3.8	3.8	4.8	4.1	2.4	2.8	2.4	1.7
Exports of goods and services (% change)	5.4	5.4	4.5	5.2	4.2	4.2	3.9	3.2
Imports of goods and services (% change)	5.3	5.3	4.9	5.4	4.5	4.0	3.4	3.5
<i>Contributions to real GDP growth:</i>								
- Final domestic demand	1.5	1.5	1.6	1.5	1.2	1.1	1.1	1.2
- Change in inventories	-0.2	-0.2	-0.1	0.0	0.0	0.1	0.0	0.0
- Net exports	0.2	0.2	0.0	0.0	0.0	0.2	0.2	0.0
Output gap ¹	-1.2	-1.2	-0.1	-0.3	0.5	0.3	0.6	0.8
Employment (% change)	1.1	1.1	1.0	0.8	0.6	0.8	0.9	0.9
Unemployment rate (%)	11.2	11.2	10.8	10.7	10.6	10.2	9.7	9.1
Labour productivity (% change)	0.7	0.4	0.6	0.8	0.5	0.6	0.4	0.3
HICP inflation (%)	1.3	1.3	1.2	1.1	1.4	2.2	2.0	1.5
GDP deflator (% change)	0.6	0.6	1.4	1.3	1.3	1.8	1.7	1.5
Comp. of employees (per head, % change)	0.3	0.2	2.1	1.5	1.0	1.0	1.2	1.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.7	2.7	2.6	2.5	2.6	2.7	2.9	2.9
<i>Note:</i>								
¹ In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.								
<i>Source :</i>								
Commission 2018 spring forecast (COM); Stability Programme (SP).								

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT DEVELOPMENTS IN 2017 AND 2018

The 2017 government deficit was notified at 2.3 % of GDP, down from 2.5 % in 2016. The primary surplus remained stable at 1.5 % of GDP, while interest expenditure fell to 3.8 % of GDP (from 4.0 % in 2016). The outturn deficit was higher than the 2.1 % of GDP planned in the 2018 Draft Budgetary Plan, which did not include the cost of the liquidation of the two regional banks *Banca Popolare di Vicenza* and *Veneto Banca* (0.3% of GDP). Current

primary expenditure increased by 0.4 % y-o-y in nominal terms (i.e. well below nominal GDP growth). Compensation of employees increased only by 0.1 % y-o-y, as the increase in public wages agreed for 2017 in specific sectors will be recorded only as from 2018. Social transfers in cash, which at more than 20 % of GDP represented nearly half of current primary expenditure, increased by 1.7 % y-o-y also due to moderate pension expenditure dynamics (+1.2 % y-o-y). Other social transfers in cash increased more strongly (+3.4 % y-o-y). Healthcare expenditure continued to increase moderately (by 1.1 % y-o-y) and remained broadly stable as a share of GDP (6.6 % of GDP from 6.7 % in 2016). Other current expenditure declined sizably by (-11.8 % y-o-y, from 1.6 % to 1.4 % of GDP), mainly due to lower contributions to the EU (by EUR 2.8 billion, 0.2 % of GDP). Public investment declined by 5.6 % compared with 2016 (from 2.1 % to 2.0 % of GDP). Other capital expenditure increased significantly mainly due to the cost of the liquidation of the two Venetian banks and a higher impact from "deferred tax assets". On the revenue side, indirect taxes increased by 2.8 % y-o-y supported by measures aimed at collecting unsettled tax liabilities ("*rottamazione cartelle esattoriali*") and the extension of the "split payment" ⁽¹⁾ to all transactions involving public administrations. Direct taxes rose by 0.9 % y-o-y, i.e. less than nominal GDP, due to the reduction of the regional tax on the income of corporations (IRES), from 27.5 % to 24 %. Social contributions increased significantly (to +2.5 % y-o-y from +0.7 % in 2016), supported by employment growth and the settlement of past liabilities in the context of the "*rottamazione cartelle esattoriali*". Overall, the current tax burden slightly declined to 42.5 % of GDP in 2017 (from 42.7 % in 2016). Finally, capital taxes declined significantly (by around EUR 3 billion) due to a base effect related to the one-off intake in 2016 from the voluntary disclosure of assets held abroad.

In 2018, the Stability Programme projects the headline deficit at 1.6 % of GDP, i.e. above the 1.2 % of GDP targeted by the 2017 Stability Programme. The difference can be explained by the sizeable additional revenues related to the VAT hikes still incorporated in the previous targets, which were then postponed by one year to 2019 with the 2018 Draft Budgetary Plan. Such additional revenues more than offset the lower projected real GDP growth (1.0 % instead of 1.5 %). The deficit in the Stability Programme is however in line with the target of the 2018 Draft Budgetary Plan. Revenues as a share of GDP are projected to slightly decline in 2018 compared with 2017, mainly due to the additional impact of the reduced rates for the regional tax on corporations and declining expected revenues from the settlement of past tax liabilities. At the same time, social security contributions are expected to grow robustly, in line with positive labour market developments. The Stability Programme projects expenditure relative to GDP to fall by around 0.9 percentage points in 2018 compared with 2017, as several components are planned to increase less than the estimated 2.9 % nominal GDP growth. In particular, social transfers in cash are projected to increase by 2.5 %. Pension expenditure is projected to rise by 2.1 % and other transfers in cash by 3.9 %, also due to additional resources earmarked for reducing poverty and supporting families with newborn children. Healthcare expenditure is planned to increase by 2 %, mainly reflecting the new contracts for public employees, while the healthcare components of intermediate consumption and social transfers in kind are expected to increase only by 1.5 % and 0.7 % respectively, thanks to the measures aimed at containing pharmaceutical expenditure. Total compensation of employees is projected to increase more substantially, by 4.3 %, due to the renewal of contracts after a freeze in public wages since 2010. As the renewal of contracts concerns the

⁽¹⁾ Under the "split payment" system, payments by public administrations to private suppliers do not include VAT, and the latter is directly paid to the state budget.

period 2016-2018, the 2018 increase includes also arrears for the previous two years. Overall, current primary expenditure is expected to increase by 2.7 % y-o-y in nominal terms. Public investment is set to increase by 2.5 % also thanks to increased resources allocated by past budget laws, while other capital spending is projected to decrease by around 0.6 % of GDP due to a base effect following the high costs for "deferred tax assets" and the support to the banking sector in 2017.

3.2. MEDIUM-TERM STRATEGY AND TARGETS

The Stability Programme projects significant improvements in the headline and structural balances over the period 2019-2021. More specifically, the deficit is projected to decline to 0.8 % in 2019, while a headline balanced budget and a small budgetary surplus (0.2 % of GDP) are projected in 2020 and 2021. These projections are based on a trend scenario assuming unchanged legislation.

After worsening by 0.2 percentage points of GDP in 2017, the structural balance is projected to improve by 0.1 percentage points in 2018, 0.6 in 2019, 0.5 in 2020 and to broadly stabilise in 2021 according to the programme taken at face value. As a result, the MTO – i.e. a balanced budgetary position in structural terms – would be reached by 2020, one year later than planned in the 2017 Stability Programme, and maintained in 2021. The structural balance recalculated by the Commission on the basis of the information in the programme according to the commonly agreed methodology shows a similar improvement over the programme period. Nevertheless, also due to a different starting point estimate of the output gap in 2017 (-1.2 % of potential GDP as against -2.2 % in the programme at face value), the recalculated structural balance still points to a small structural deficit (0.2 % of GDP) in both 2020 and 2021. The MTO chosen by Italy, i.e. a balanced budget position in structural terms, reflects the objectives of the Pact.

The projected headline deficit for 2019 has been revised to 0.8 % of GDP, from 0.2 % in the 2017 Stability Programme, reflecting a worse 2018 base (1.6 % of GDP as against 1.2 % in the previous programme) and a reduced projected impact of the VAT hike (0.7 % of GDP as against 1.0 % of GDP). Detailed budgetary projections in the Stability Programme (Table 2) are based on unchanged legislation trends that incorporate sizeable additional revenues related to VAT hikes legislated as a "safeguard clause" to achieve the medium-term budgetary targets. Accounting for the partial sterilisation enacted with the 2018 budget, the positive budgetary impact of the VAT hike would be around 0.7 % of GDP in 2019 (from 1.0 % before). Nevertheless, due to the declining yields from past one-off measures and the additional impact of fiscal incentives for investment as well as a new tax regime for small enterprises (IRI), revenues are projected to remain broadly constant as a share of GDP. The projected budgetary adjustment is thus driven by government expenditure, which is expected to decline by 0.8 percentage point of GDP. Total compensation of employees is projected to decline by 0.4 percentage point of GDP, due to a base effect as the 2018 increase included also arrears for the previous two years. No further resources are expected to be allocated to the renewal of contractual wages in 2019, apart from the minimum anticipated increase in view of the following contractual agreement ("*vacanza contrattuale*"). Social transfers in cash are set to increase less than nominal GDP (at 2.3 %), leading to a decline as a share of GDP of 0.2 percentage point. Social transfers in kind and intermediate consumption are also projected to decrease by 0.2 percentage point of GDP (0.6 % increase y-o-y), partly due to lower resources allocated to healthcare by the 2017 Budget Law (0.1 % of GDP). In 2020 and 2021, revenues are expected to slightly decline by 0.1 percentage point of GDP on average, while primary expenditure is projected to decline substantially as a share of GDP, by 0.8 and 0.6

percentage point respectively. No further resources are considered for increases in public wages, with compensations of employees assumed to remain stable in nominal terms, while social transfers in cash are expected to continue increasing less than nominal GDP. Declines in other spending categories amount to 0.6 % of GDP over the two years.

Overall, the Stability Programme projects the reduction in the headline deficit towards a balanced budget position in 2020 as in the previous programme, although this corresponds to a postponement compared to previous years (Figure 1). Given the different starting point in 2018, the balanced budgetary position in 2020 is expected to be achieved thanks to a steeper reduction of government spending and a stronger projected real GDP growth as compared to the previous programme.

Table 2: Composition of the budgetary adjustment

(% of GDP)	2017	2018		2019		2020	2021	Change: 2017-2021
	COM	COM	SP	COM	SP	SP	SP	SP
Revenue	46.6	46.4	46.4	45.9	46.5	46.4	46.2	-0.4
<i>of which:</i>								
- Taxes on production and imports	14.6	14.4	14.5	14.4	15.0	15.3	15.2	0.6
- Current taxes on income, wealth, etc.	14.6	14.3	14.4	13.9	14.0	14.0	14.0	-0.6
- Social contributions	13.2	13.4	13.4	13.3	13.3	13.2	13.1	-0.1
- Other (residual)	4.3	4.2	4.1	4.2	4.2	3.9	3.9	-0.3
Expenditure	48.9	48.0	48.0	47.6	47.2	46.5	46.0	-2.9
<i>of which:</i>								
- Primary expenditure	45.1	44.5	44.5	44.1	43.7	43.0	42.5	-2.6
<i>of which:</i>								
Compensation of employees	9.6	9.7	9.7	9.4	9.3	9.0	8.8	-0.8
Intermediate consumption	5.5	5.4	5.4	5.4	5.3	5.2	5.2	-0.3
Social payments	22.6	22.4	22.5	22.4	22.2	22.1	22.0	-0.6
Subsidies	1.5	1.5	1.5	1.4	1.5	1.4	1.4	-0.1
Gross fixed capital formation	2.0	2.0	2.0	2.0	2.0	2.1	2.1	0.1
Other (residual)	3.9	3.5	3.4	3.6	3.5	3.2	3.0	-0.9
- Interest expenditure	3.8	3.6	3.5	3.5	3.5	3.5	3.5	-0.3
General government balance (GGB)	-2.3	-1.7	-1.6	-1.7	-0.8	0.0	0.2	2.5
Primary balance	1.5	1.9	1.9	1.7	2.7	3.4	3.7	2.2
One-off and other temporary	0.0	0.1	0.1	-0.1	-0.1	-0.1	0.0	0.0
GGB excl. one-offs	-2.3	-1.8	-1.7	-1.7	-0.7	0.1	0.2	2.5
Output gap ¹	-1.2	-0.1	-0.3	0.5	0.3	0.6	0.8	1.9
Cyclically-adjusted balance ¹	-1.7	-1.6	-1.4	-2.0	-0.9	-0.3	-0.2	1.5
Structural balance²	-1.7	-1.7	-1.5	-2.0	-0.8	-0.2	-0.2	1.5
Structural primary balance ²	2.1	1.9	2.0	1.5	2.7	3.3	3.3	1.1

Notes:

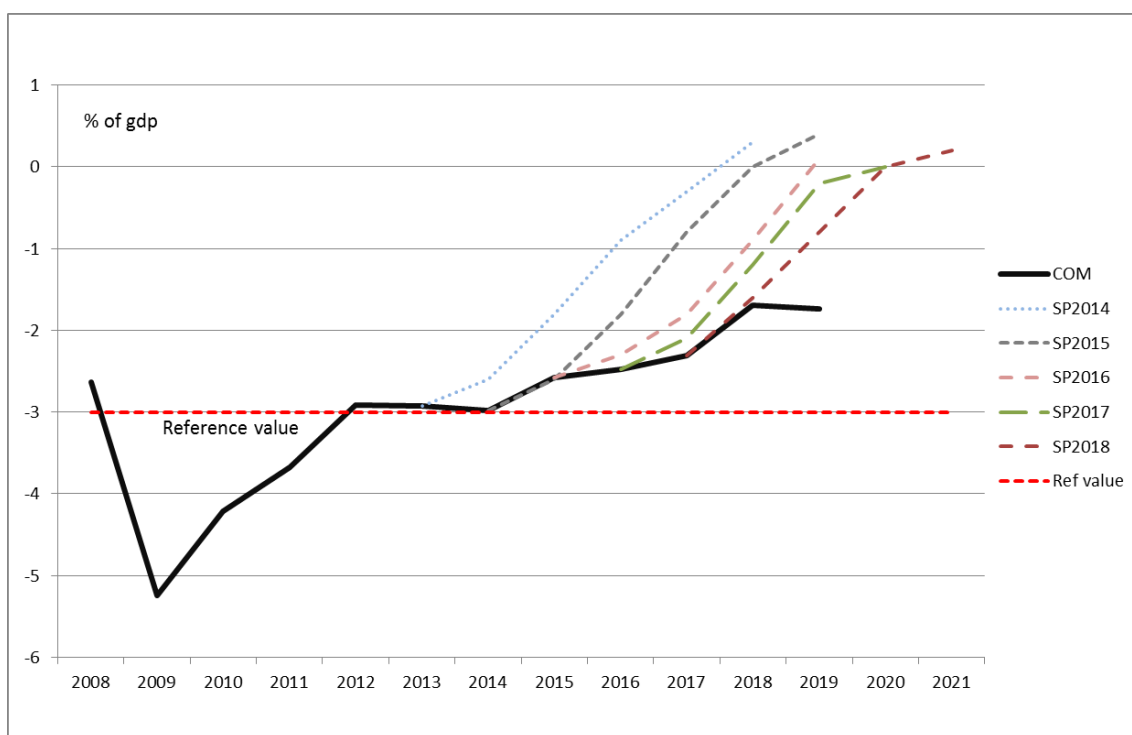
¹Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

²Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme (SP); Commission 2018 spring forecasts (COM); Commission calculations.

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



Source: Commission 2018 spring forecast; Stability Programmes

3.3. MEASURES UNDERPINNING THE PROGRAMME

The 2018 budget (Law 205/2017 and DL 148/2017) entails a worsening of Italy's headline balance (taken at face value) relative to the trend projections of EUR 10.8 billion (or 0.6 % of GDP) in 2018, EUR 11.4 billion (or 0.6 % of GDP) in 2019 and EUR 2.4 billion (or 0.1 % of GDP) in 2020. These amounts broadly confirm the estimates presented with the 2018 Draft Budgetary Plan (respectively EUR 11.0, 11.6 and 2.6 billion for the same years). As the Stability Programme is based on a trend scenario assuming unchanged legislation, no additional measures are included compared to the 2018 budget.

The main measures of the 2018 budget are described in Section 3.3 of the Staff Working Document assessing the 2018 Draft Budgetary Plan. The negative impact on revenues is expected to peak in 2018 and then to broadly stabilise over the rest of the programme period (0.5 % of GDP in 2018, 0.2 % in 2019 and 0.1 % in 2020), while spending measures increase substantially in 2019 and remains broadly stable thereafter (0.1 % of GDP, 0.4 % and 0.3 % over the same years respectively). The net impact is different based on the Commission forecast, because the "safeguard clauses" are not incorporated in the baseline. The main measures with a gross negative impact on the deficit are: (i) the abovementioned full repeal in 2018 and partial repeal in 2019 of a previously legislated increase in VAT and other taxes (the so-called "safeguard clauses") legislated for those years by the 2017 budget (worth 0.9 % of GDP in 2018 and 0.3 % of GDP in 2019); (ii) the permanent halving of social security contributions paid on new hires of young workers for the first three years of an open-ended contract, in order to support job creation (worth around 0.02 % of GDP in 2018 0.07 % of GDP in 2019); (iii) various measures to support investment, R&D and firm competitiveness, including through the extension of previously legislated fiscal incentives for investment

(worth 0.05 % of GDP in 2018 and 0.1 % of GDP in 2019); (iv) resources earmarked to increase public employees' wages (amounting to 0.1 % of GDP per year as of 2018) and to fight poverty and social exclusion (amounting to 0.02 % of GDP in 2018 and 0.04 % of GDP in 2019). On the financing side, the main components of the 2018 budget include: (i) a spending review, enacted partly through the rationalisation of ministries' expenditure but also through planned lower transfers to local public bodies (worth around 0.2 % of GDP in 2018 and 0.1 % of GDP in 2019); (ii) one-off measures aimed at collecting unsettled past tax liabilities, namely the extended possibility for taxpayers to avoid sanctions and fines by spontaneously regularising their past tax position (so-called "*rottamazione delle cartelle esattoriali*") and the possibility to increase the value of some assets in their balance sheet by paying a substitutive tax (0.07 % of GDP in 2018, overall); (iii) measures to increase tax compliance and fight tax evasion, including the progressive extension of compulsory electronic invoicing to all private sector transactions (worth 0.01 % of GDP in 2018 and 0.09 % of GDP in 2019) and other measures to reduce tax fraud, mainly of VAT (0.04 % of GDP in 2018 and 0.05 % of GDP in 2019). Moreover, additional resources of around 0.11 % of GDP in 2018 are related to the postponement to 2019 of a simplified tax regime (IRI) for small enterprises (previously legislated as of 2018 by the 2017 budget).

Main budgetary measures

Revenue	Expenditure
2018	
<ul style="list-style-type: none"> • Repeal of the "safeguard clauses" (-0.9 % of GDP) • Halving of social security contributions for new hires of young workers (-0.02 % of GDP) • Measures to settle past tax liabilities (0.07 % of GDP) • Measures to increase tax compliance (0.05 % of GDP) • Postponement of IRI (0.11% of GDP) 	<ul style="list-style-type: none"> • Support to investment, R&D and firm competitiveness (0.05 % of GDP) • Increase in public wages (0.1 % of GDP) • Fighting poverty and social exclusion (0.02 % of GDP) • Spending review (-0.2 % of GDP)
2019	
<ul style="list-style-type: none"> • Repeal of the "safeguard clauses" (-0.3 % of GDP) • Halving of social security contributions for new hires of young workers (-0.07 % of GDP) • Measures to increase tax compliance (0.14 % of GDP) 	<ul style="list-style-type: none"> • Support to investment, R&D and firm competitiveness (0.1 % of GDP) • Increase in public wages (0.1 % of GDP) • Fighting poverty and social exclusion (0.04 % of GDP) • Spending review (-0.1 % of GDP)
<p><u>Note:</u> The budgetary impact in the table is the impact reported in the programme, i.e. by the national authorities. A positive sign implies that revenue / expenditure increases as a consequence of this measure.</p>	

3.4. DEBT DEVELOPMENTS

After growing by some 5 percentage points per year on average during the double-dip recession of 2008-2013, Italy's government debt-to-GDP ratio continued to increase in 2014-2015 at a slower pace of 1 percentage point per year on average, before peaking at 132.0 % in 2016. In 2017 the debt-to-GDP declined only slightly to 131.8%. The decrease was limited partly due to a still debt-increasing "snowball" effect, as the real implicit cost of debt, while gradually shrinking (to 2.3 %, from 2.7 % in 2013), remained above real GDP growth (1.5 %). In fact, real spot interest rates on new government securities issuances, hovering around zero in 2015-2017, only gradually passed through into the real servicing cost of the outstanding debt stock, given the duration of the Italian debt and the roll-over period combined with low inflation (GDP deflator growth of 0.6 %). The positive interest rate-growth rate differential (0.8 percentage points, compared to 1.3 in 2015-2016) implied a still large debt-increasing impact from the "snowball" effect (1.1 % of GDP). On the other hand, a broadly stable primary surplus at 1.5 % of GDP helped to curb debt dynamics in 2017. The stock-flow adjustment was slightly debt-increasing in 2017 (0.2 %), mainly due to the impact of derivatives and of support to the banking sector, partly offset by the reduction in the liquidity buffer, while there were no privatisation proceeds.

In 2018, the Stability Programme projects the debt-to-GDP ratio to decrease to 130.8 %, down by 1 percentage point from the 2017 level. The projected favourable dynamics is mainly the result of a debt-decreasing "snowball" effect (-0.2 % of GDP), and a slight improvement in the primary surplus (to 1.9 % of GDP) more than offsetting the debt-increasing stock-flow adjustment (1.1 % of GDP). The Commission forecasts the debt ratio to decrease to 130.7 % of GDP in 2018, broadly in line with the Stability Programme. The marginal difference is due to a slightly smaller stock-flow adjustment (0.9 % of GDP compared to 1.1 % in the Stability Programme) related to the smaller cash-accrual difference, while the net accumulation of financial assets is lower in the government projections also because they include 0.3 % of GDP of privatisation proceeds that the Commission forecast does not incorporate, given the added uncertainty related to the formation of a new government and the recent track record of below-target privatisations.

For 2019, the Stability Programme projects a further significant decline in the debt-to-GDP ratio to 128.0 %, mainly triggered by a large increase in the primary balance (to 2.7 % of GDP) and a debt-decreasing "snowball effect" (-0.5 % of GDP) explained by stronger nominal GDP growth compared to 2018, only partly offset by a debt-increasing stock-flow adjustment (0.6 % of GDP). The Commission forecasts a more limited decline in the debt-to-GDP ratio in 2019, to 129.7 %. The difference is also related to the lack of a VAT hike and lower real GDP growth, implying lower primary surplus (1.7 % of GDP). Moreover, due to lower nominal GDP growth (2.5 % compared to 3.2 %), the "snowball" effect turns slightly debt-increasing again (0.3 %) in the Commission forecast. Finally, the Commission incorporates only half of the 0.3% of GDP privatisation proceeds projected by the government for 2019. Risks to both the Commission and the Stability Programme debt projections are related to a worse-than-anticipated growth outlook, lower privatisation proceeds, and lower inflation. The Stability Programme project the debt-to-GDP ratio to continue declining over the rest of the programme period, reaching 122.0 % in 2021, also thanks to (unspecified) privatisation proceeds projected at 0.3 % of GDP per year and increasing primary surplus.

Table 3: Debt developments

(% of GDP)	Average 2012-2016	2017	2018		2019		2020	2021
			COM	SP	COM	SP	SP	SP
Gross debt ratio¹	129.5	131.8	130.7	130.8	129.7	128.0	124.7	122.0
Change in the ratio	3.1	-0.2	-1.1	-1.0	-1.0	-2.8	-3.3	-2.7
<i>Contributions² :</i>								
1. Primary balance	-1.8	-1.5	-1.9	-1.9	-1.7	-2.7	-3.4	-3.7
2. "Snow-ball" effect	3.8	1.1	-0.1	-0.2	0.3	-0.5	-0.4	0.2
<i>Of which:</i>								
Interest expenditure	4.5	3.8	3.6	3.5	3.5	3.5	3.4	3.5
Growth effect	0.6	-1.9	-1.9	-1.9	-1.5	-1.8	-1.6	-1.5
Inflation effect	-1.3	-0.8	-1.8	-1.8	-1.6	-2.2	-2.2	-1.8
3. Stock-flow adjustment	1.1	0.2	0.9	1.1	0.4	0.5	0.5	0.8
<i>Of which:</i>								
Cash/accruals diff.				0.8		0.6	0.5	0.5
Acc. financial assets				0.2		0.1	0.1	0.3
<i>Privatisation</i>				-0.3		-0.3	-0.3	0.0
Val. effect & residual				0.0		0.0	0.1	0.0

Notes:

¹ End of period.

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

Source:

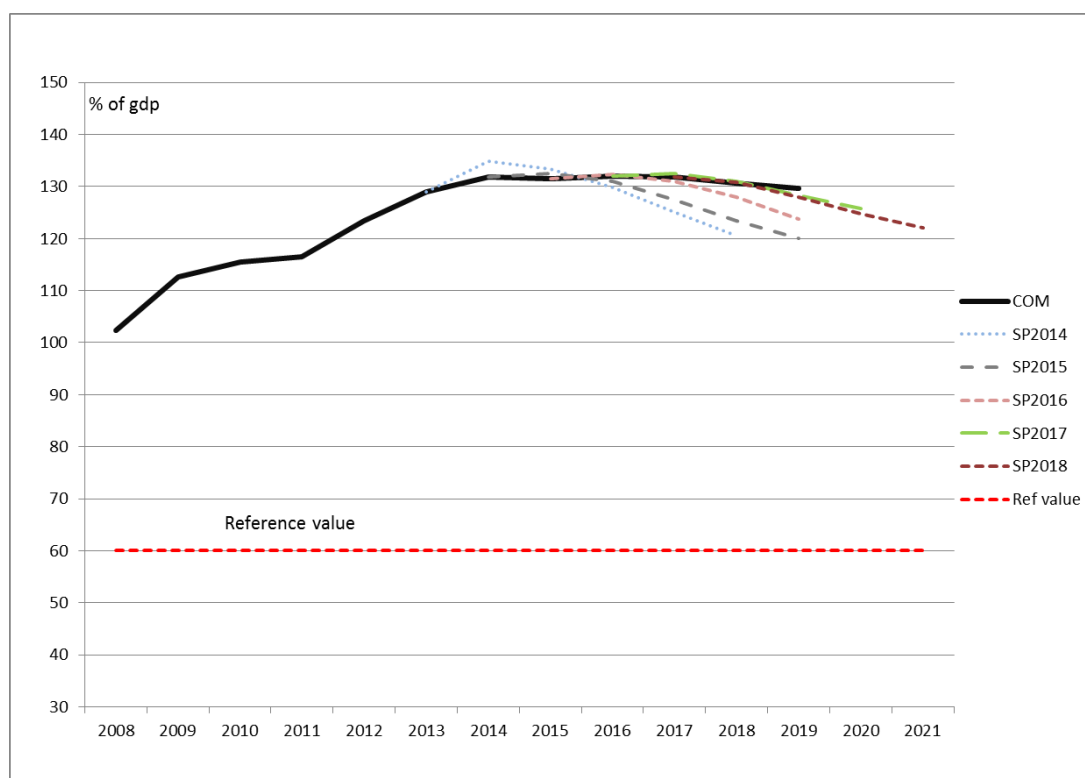
Commission 2018 spring forecast (COM); Stability Programme (SP), Commission calculations.

3.5. RISK ASSESSMENT

The Commission 2018 spring forecast, which incorporates the impact of the measures adopted with the 2018 budget, projects the headline deficit at 1.7 % of GDP in 2018. This is slightly higher than the 1.6 % of GDP deficit target of the programme, which is mainly explained by more dynamic primary expenditure expected in the Commission 2018 spring forecast (+1.6 % y-o-y against 1.5 % in the Stability Programme) and slightly more conservative revenue projections (+2.4 % y-o-y against 2.5 % in the Stability Programme).

In 2019, the Commission 2018 spring forecast points to a deficit of 1.7 % of GDP, markedly higher than the 0.8 % deficit projected by the government despite similar real GDP growth (1.3 % and 1.2 %, respectively). The projections of the Stability Programme assume the activation of the VAT hike legislated as a "safeguard clause", whose size was reduced by the 2018 budget to around 0.7 % of GDP in 2019, down from the previously legislated 1.0 %. As the activation of safeguard clauses has been systematically postponed in recent years and no details about possible alternative compensating measures are provided in the Stability Programme, their budgetary impact is not incorporated in the no-policy-change Commission 2018 spring forecast. Moreover, once social transfers in cash are excluded, current primary

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



Source: Commission 2018 spring forecast; Stability Programmes

expenditure projections for 2019 show a decline of 0.6 % y-o-y in nominal terms in the Stability Programme. These already ambitious trend developments seem to leave little room for additional sizeable savings. For 2020 and 2021, the continuous projected reduction in primary expenditure at 0.5 % percentage point of GDP per year on average appears optimistic, also given that it does not include additional resources for the renewal of public wages. In addition, the medium-term budgetary projections of the Stability Programme entail downside risks also for the growth projections. In particular, the Commission 2018 spring forecast expects a slightly lower real GDP growth for 2019 than the 2018 Stability Programme, despite a higher deficit. This suggests that the increase in VAT rates needed to ensure a lower headline deficit in the Programme could affect real GDP growth more than expected. These downside risks to the budgetary and nominal GDP growth projections in the Stability Programme are compounded by additional risks to the debt ratio, whose reduction partly rely on optimistic privatisation proceeds. Finally, uncertainty related to the new budgetary strategy of the upcoming government may imply a risk to the Stability Programme's projections. The Commission Opinion on the 2018 Draft Budgetary Plan for Italy pointed at downside risks concerning both the government and the Commission budgetary projections for 2017. The 2017 headline deficit turned out higher than expected both by the Commission 2017 autumn forecast and the 2018 Draft Budgetary Plan projections, at 2.3 % of GDP, instead of 2.1 %. The worse-than-expected outcome was due to additional costs for public support to the banking sector (0.3 % of GDP), while the headline deficit without such costs would have been 1.9 % of GDP, i.e. below the projections of the Draft Budgetary Plan. Still, an important factor to explain this outcome was the postponed recording of the increase of public wages from 2017 to 2018. Therefore, the better-than-expected outcome in 2017 does not point to excessively conservative forecasts in the autumn.

Overall, Italy's past stability programmes tended to delay the attainment of a balanced budget, and thus an adequate reduction of the debt-to-GDP ratio (see Figure 1 and Figure 2). While this was arguably related to the low growth and low inflation environment, the high public debt increases the vulnerability of the economy to financial risks associated with higher interest rates. On the contrary, a gradually improving fiscal position, in line with the Stability Programme projections, would help to maintain financial markets' confidence.

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

Box 1. Council Recommendations addressed to ITALY

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

The Council noted that "in 2018, in the light of its fiscal situation and in particular of its debt level, Italy is expected to further adjust towards its medium-term budgetary objective of a balanced budgetary position in structural terms. According to the commonly agreed adjustment matrix under the Stability and Growth Pact, that adjustment translates into a requirement of a nominal rate of reduction of net primary government expenditure of at least 0.2 % in 2018, corresponding to an annual structural adjustment of at least 0.6 % of GDP. Under unchanged policies, there is a risk of a significant deviation from the requirement in 2018. (...) As recalled in the Commission Communication accompanying these country-specific recommendations, the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal to achieve a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of Italy's public finances."

4.1. Compliance with the debt criterion

Italy's general government debt-to-GDP ratio only slightly decreased in 2017 to 131.8 % (from 132.0 % in 2016), remaining well above the Treaty reference value of 60 %, and based on the Commission 2018 spring forecast, Italy was found not to be compliant with the debt reduction benchmark in that year (with a gap to the debt benchmark of 5.1 % of GDP – see Table 5). Expected debt developments in both the Commission 2018 spring forecast and the Stability Programme show that Italy is not projected to comply with the debt reduction benchmark in 2018 and 2019 either. Gaps to compliance based on the Commission 2018 spring forecast are expected to remain large and stable at 5.1 % of GDP in both years. These gaps would be significantly lower (1.3 % and 0.8 % of GDP, respectively, based on the

forward-looking configuration of the benchmark), if the projections put forward in the Stability Programme for the period 2019-2021 were realised.

As the government debt to GDP ratio breached the reference value of 60% in 2017 based on notified data, there appears to be prima facie a risk of the existence of an excessive deficit in Italy in the sense of the Treaty and the Stability and Growth Pact. The Commission has therefore prepared a report under Article 126(3) TFEU to assess Italy's compliance with the debt criterion of the Treaty.

This report was adopted on 23 May 2018 and includes an assessment of all the relevant factors, notably: (i) the improving macroeconomic conditions, no longer explaining Italy's large gaps with the debt reduction benchmark; (ii) the ex-post compliance with the required adjustment towards the MTO in 2017 but the risk of significant deviation in 2018 based on the Commission 2018 spring forecast; and (iii) some progress in adopting and implementing growth-enhancing structural reforms. Based on this assessment, the report came to the conclusion that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with, and that an EDP is thus not warranted at this stage, having regard in particular to Italy's ex-post compliance with the preventive arm in 2017. However, the adjustment in 2018 appears inadequate to ensure compliance with the adjustment path towards the MTO in 2018 based on the Commission 2018 spring forecast. The Commission will reassess compliance on the basis of the ex-post data for 2018 to be notified in Spring 2019.

Table 4. Compliance with the debt criterion

	2017	2018		2019	
		SP	COM	SP	COM
Gross debt ratio	132	130.8	130.7	128.0	129.7
Gap to the debt benchmark ^{1,2}	5.1	1.4	5.1	0.8	5.1
Structural adjustment ³	-0.3	0.1	0.0	0.7	-0.3
<i>To be compared to:</i>					
Required adjustment ⁴					

Notes:

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

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

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

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

Source :

Commission 2018 spring forecast (COM); Stability Programme (SP), Commission calculations.

4.2. Compliance with the required adjustment path towards the MTO

Assessment of requests for deviating from SGP requirements

In the 2017 Draft Budgetary Plan and the following budgetary documents (2017 Stability Programme and 2018 Draft Budgetary Plan), the Italian authorities pointed to exceptional expenditures in 2017 related to (i) the ongoing refugee crisis and the need to set up a comprehensive policy of migration management, and (ii) a preventive investment plan for the protection of the national territory against seismic risks, in particular by addressing hydrogeological risks and securing schools. The 2018 Stability Programme confirmed that exceptional expenditure in 2017 related to migration and protection against seismic risks was significant and provided adequate evidence of the scope and nature of these additional budgetary costs. More specifically, as regards migration this expenditure amounted to 0.22% of GDP in 2016 and was estimated in the 2017 Stability Programme at 0.25% of GDP in 2017. The Commission quantified the additional allowance to be granted ex ante for the refugee-related expenditure in 2017 at 0.16% of GDP, corresponding to the overall cost projected for 2017, net of the 0.09% of GDP deviation already granted in 2015 and 2016, so as to avoid double-counting. Based on outturn data, the 2018 Stability Programme confirms that the expenditure (excluding EU contributions) incurred in 2017 to face the exceptional influx of refugees, particularly in terms of sea rescue operations and hospitality, healthcare and education costs, amounted to EUR 4.3 billion or 0.25 % of GDP. As regards seismic activity, the Draft Budgetary Plan for 2017 requested an additional allowance of 0.18% of GDP consisting of earthquake-related expenditures, which was confirmed by the 2017 Stability Programme and the 2018 Draft Budgetary Plan. The 2018 Stability Programme revised slightly upwards the expenditure in 2017 to 0.19 % of GDP, consisting of fiscal incentives for building recovery (0.12 % of GDP), direct interventions to reduce risks (0.03 % of GDP) and specific interventions to reduce vulnerabilities of school facilities (0.04 % of GDP).

Overall, as regards 2017, the Commission assesses that Italy can benefit from an overall temporary deviation of 0.35 % of GDP, of which: (i) 0.16 % of GDP is due to the exceptional inflow of refugees/migrants; and (ii) 0.19 % of GDP is for the preventive investment plan for the protection of the national territory against seismic risks.

Adjustment towards the MTO

In 2017, Italy's structural balance is expected to have deteriorated by 0.3 % of GDP based on the Commission 2018 spring forecast, reaching -1.7 % of GDP. The expenditure benchmark points to some deviation both over one year (gap of 0.3 % of GDP) and over 2016 and 2017 taken together (gap of 0.1 % of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, has exceeded the applicable expenditure benchmark rate (-0.6 % in real terms). The structural balance pillar points to some deviation over one year (gap of 0.5 % of GDP) and to a significant deviation over 2016 and 2017 taken together (gap of 0.4 % of GDP per year, on average). Both in 2016 and 2017, the structural balance is negatively affected by significant revenue shortfalls and a lower GDP deflator than that underlying the expenditure benchmark, which are only partly compensated by the decline in interest spending. Taking into account those factors, the overall assessment points to some deviation in 2017.

As regards 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. The Commission 2018 spring forecast expects Italy's structural balance to remain stable at 1.7 % of GDP, while the government plans in the Stability Programme project a small structural effort of 0.1 % of GDP.

Based on the Commission 2018 spring forecast, the expenditure benchmark points to a risk of significant deviation in 2018 both over one year (gap of 1 % of GDP) and over 2017 and 2018 taken together (gap of 0.7 % of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate (0.2 % in nominal terms). The same conclusion can be reached on the basis of the structural balance pillar, which points to a risk of significant deviation both over one year (gap of 0.6 % of GDP) and over 2017 and 2018 taken together (gap of 0.6 % of GDP per year, on average). The structural balance is negatively impacted by revenue shortfalls (0.1 % of GDP), which are offset by the positive impact of a decline in interest expenditure (0.2 % of GDP), and a slightly higher GDP deflator and point estimate for potential GDP growth compared to those underlying the expenditure benchmark (0.3 % of GDP). Taking into account those factors, the overall assessment points to a risk of significant deviation from the preventive arm requirement in 2018 based on the Commission forecast.

However, the country-specific recommendations adopted by the Council on 11 July 2017 mentioned that the assessment of the 2018 Draft Budgetary Plan and subsequent assessment of 2018 budget outcomes will need to take due account of the goal of achieving a fiscal stance that contributes to both strengthening the ongoing recovery and ensuring the sustainability of public finances. Following the Commission's assessment of the strength of the recovery in Italy while giving due consideration to its sustainability challenges, carried out in the context of its opinion on Italy's Draft Budgetary Plan, the Commission considered that a fiscal structural effort of at least 0.3 % of GDP would be adequate in 2018, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary expenditure not exceeding 0.5 %. Even taking that into account in the overall assessment, there is a risk of a significant deviation from the recommended adjustment path towards the MTO in 2018 based on the Commission 2018 spring forecast.

For 2019, Italy is recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1 %, corresponding to an annual structural adjustment of 0.6 % of GDP. The Commission 2018 spring forecast expects Italy's structural balance to deteriorate by 0.3 % of GDP in 2019, reaching -2.0 % of GDP under a no-policy-change assumption. The expenditure benchmark points to a risk of significant deviation both over one year (gap of 1 % of GDP) and over 2018 and 2019 taken together (gap of 0.8 % of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate (0.1% in nominal terms) in 2019. The same conclusion can be reached on the basis of the structural balance pillar, which points to a risk of significant deviation both over one year (gap of 0.9 % of GDP) and over 2018 and 2019 taken together (gap of 0.6 % of GDP per year, on average). The structural balance is positively impacted by a slightly higher point estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark (0.2 % of GDP). Taking into account those factors, the overall assessment points to a risk of significant deviation in 2019.

In summary, based on the Commission 2018 spring forecast, Italy appears to be broadly compliant with the preventive arm requirements regarding progress towards the MTO in 2017. A risk of a significant deviation from the adjustment path towards the MTO is to be expected both in 2018 and 2019.

Table 5: Compliance with the requirements under the preventive arm

(% of GDP)	2017	2018		2019	
Initial position¹					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance ² (COM)	-1.7	-1.7		-2.0	
Structural balance based on freezing (COM)	-2.0	-1.7		-	
Position vis-a-vis the MTO³	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	2017	2018		2019	
	COM	SP	COM	SP	COM
Structural balance pillar					
Required adjustment ⁴	0.6	0.6		0.6	
Required adjustment corrected ⁵	0.2	0.6		0.6	
Change in structural balance ⁶	-0.3	0.1	0.0	0.7	-0.3
<i>One-year deviation from the required adjustment⁷</i>	-0.5	-0.5	-0.6	0.1	-0.9
<i>Two-year average deviation from the required adjustment⁷</i>	-0.4	-0.5	-0.6	-0.2	-0.8
Expenditure benchmark pillar					
Applicable reference rate ⁸	-0.6	-0.2		0.1	
One-year deviation adjusted for one-offs ⁹	-0.3	-0.7	-1.0	0.0	-1.0
Two-year deviation adjusted for one-offs ⁹	-0.1	-0.5	-0.7	-0.3	-1.0
<i>PER MEMORIAM: One-year deviation¹⁰</i>	-0.5	-0.6	-0.9	-0.1	-1.1
<i>PER MEMORIAM: Two-year average deviation¹⁰</i>	0.0	-0.6	-0.7	-0.3	-1.0
Notes					
¹ The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.					
² Structural balance = cyclically-adjusted government balance excluding one-off measures.					
³ Based on the relevant structural balance at year t-1.					
⁴ Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).					
⁵ Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.					
⁶ Change in the structural balance compared to year t-1. Ex post assessment (for 2017) is carried out on the basis of Commission 2018 spring forecast.					
⁷ The difference of the change in the structural balance and the corrected required adjustment.					
⁸ Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.					
⁹ Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
¹⁰ Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.					
<i>Source:</i>					
<i>Stability Programme (SP); Commission 2018 spring forecast (COM); Commission calculations.</i>					

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, mainly related to a high debt-to-GDP ratio.²

Based on Commission 2018 spring forecasts and a no-fiscal policy change scenario beyond the forecast horizon, government debt, at 131.8 % of GDP in 2017, is expected to broadly stabilise by 2028, thus remaining above the 60 % of GDP Treaty threshold. Over this horizon, government debt is projected to decline by 2024 to 127.7 % of GDP and then to increase by 2028 to more than 132 % of GDP. Sensitivity analysis shows similar risks.³ Overall, this highlights high risks for the country from debt sustainability analysis in the medium term. The full implementation of the Stability Programme would put debt on a decreasing path by 2028, although remaining above the 60% of GDP reference value in 2028.

The medium-term fiscal sustainability risk indicator S1⁴ is at 7.5 percentage points of GDP, primarily related to the high level of government debt contributing with 4.9 percentage points of GDP, thus indicating high risks in the medium term. The full implementation of the Stability Programme would put the sustainability risk indicator S1 at 6.3 percentage points of GDP, leading to a similar medium-term risk. Overall, risks to fiscal sustainability over the medium term are, therefore, high. Fully implementing the fiscal plans in the Stability Programme would decrease those risks.

The long-term fiscal sustainability risk indicator S2 is at 1.8 % of GDP. In the long term, Italy therefore appears to face low fiscal sustainability risks, primarily related to the projected ageing costs contributing 1.1 percentage points of GDP. Full implementation of the programme would put the S2 indicator at -0.2 percentage points of GDP, leading to a similar long-term risk, but making the S2 indicator more resilient to possible upward revision of ageing costs.⁵ However, the long-term sustainability ensured by past pensions reforms, by curbing implicit liabilities arising from population ageing, is slowly deteriorating. This is due to worsening demographic trends projected by Eurostat and the fact that the 2017 and 2018 budgets contained measures that partially reversed past pension reforms and slightly increased Italy's old-age pension expenditure over the medium term. The latter, at around 15 % of potential GDP in 2016, is already one of the highest in the EU/OECD. Overall, any further backtracking on the implementation of past healthcare and pension reforms, in particular the adjustment of the retirement age, could further worsen Italy's long-term sustainability risks.

² This conclusion is based on the short-term fiscal sustainability risk indicator S0. See the note to Table 5 for a definition of the indicator.

³ Sensitivity analysis includes several deterministic debt projections, as well as stochastic projections (see Debt Sustainability Monitor 2017 for more details).

⁴ See the note to Table 5 for a definition of the indicator.

⁵ The projected costs of ageing used to compute the debt projections and the fiscal sustainability indicators S1 and S2 are based on the updated projections, endorsed by the EPC on 30 January 2018, and to be published in the forthcoming Ageing Report 2018.

Table 6: Sustainability indicators

<i>Time horizon</i>	No-policy Change Scenario		Stability / Convergence Programme Scenario	
Short Term	LOW risk			
S0 indicator ^[1]	0.4			
Fiscal subindex	0.5	HIGH risk		
Financial & competitiveness subindex	0.3	LOW risk		
Medium Term	HIGH risk			
DSA ^[2]	HIGH risk			
S1 indicator ^[3]	7.5	HIGH risk	6.3	HIGH risk
<i>of which</i>				
Initial Budgetary Position	1.9		0.4	
Debt Requirement	4.9		5.1	
Cost of Ageing	0.8		0.8	
<i>of which</i>				
Pensions	0.8		0.8	
Health-care	0.3		0.2	
Long-term care	0.1		0.1	
Other	-0.4		-0.3	
Long Term	LOW risk		LOW risk	
S2 indicator ^[4]	1.8		-0.2	
<i>of which</i>				
Initial Budgetary Position	0.7		-1.2	
Cost of Ageing	1.1		1.0	
<i>of which</i>				
Pensions	-0.1		-0.2	
Health-care	0.8		0.7	
Long-term care	0.9		0.9	
Other	-0.4		-0.4	
Source: Commission services; 2018 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 2018 forecast covering until 2019 included. The 'stability/convergence programme' scenario depicts the sustainability gap under the assumption that the budgetary plans in the programme are fully implemented over the period covered by the programme. Age-related expenditure as given in the 2018 Ageing Report.				
[1] The S0 indicator of short term fiscal challenges informs the early detection of fiscal stress associated to fiscal risks within a one-year horizon. To estimate these risks S0 uses a set of fiscal, financial and competitiveness indicators selected and weighted according to their signalling power. S0 is therefore a composite indicator whose methodology is fundamentally different from the S1 and S2 indicators, which quantify fiscal adjustment efforts. The critical threshold for the overall S0 indicator is 0.46. For the fiscal and the financial-competitiveness sub-indexes, thresholds are respectively at 0.36 and 0.49*.				
[2] Debt Sustainability Analysis (DSA) is performed around the no fiscal policy change scenario in a manner that tests the response of this scenario to different shocks presented as sensitivity tests and stochastic projections*.				
[3] The S1 indicator is a medium-term sustainability gap; it measures the upfront fiscal adjustment effort required to bring the debt-to-GDP ratio to 60 % by 2032. This adjustment effort corresponds to a cumulated improvement in the structural primary balance over the 5 years following the forecast horizon (i.e. from 2020 for No-policy Change scenario and from last available year for the SCP scenario); it must be then sustained, including financing for any additional expenditure until the target date, arising from an ageing population. The critical thresholds for S1 are 0 and 2.5, between which S1 indicates medium risk. If S1 is below 0 or above 2.5, it indicates low or high risk, respectively*.				
[4] The S2 indicator is a long-term sustainability gap; it shows the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical thresholds for S2 are 2 and 6, between which S2 indicates medium risk. If S2 is below 2 or above 6, it indicates low or high risk, respectively*.				
* For more information see Fiscal Sustainability Report 2015 and Debt Sustainability Monitor 2017.				

6. FISCAL FRAMEWORK

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

In 2016, two remaining enacting decrees of Law 196/2009 were adopted together with a reform of the structure of budget itself.⁶ Therefore, the reform of the budgetary process in Italy can be considered formally concluded. In 2017, the administrative steps needed to implement such actuating decrees progressed, namely concerning innovations on the accounting systems. In addition, some corrections to the 93/2016 enacting decree were introduced with the DL 29/2017, in order to improve the accounting and budgetary framework. With the 2018 budget, the spending review was for the first time implemented as a systematic feature of the budget process. The 2018 budget also encouraged investment at the local level by introducing earmarked quotas within the national budgetary framework.

Overall, based on the information provided in the Stability Programme, the past and planned fiscal performance in Italy appears to broadly comply with the requirements of the applicable national numerical fiscal rules, according to the Parliamentary Budget Office (PBO). The recorded 2016-17 deviation from the structural target and the expected slight deviation in 2018 would not affect compliance with the MTO in the medium-term based on the national legislation, provided that the structural adjustments planned in the Stability Programme for 2019 and 2020 are complied with.⁷

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

The PBO has endorsed the trend macroeconomic scenario presented in the Stability Programme. The endorsement took the form of a letter sent to the Minister of Finance on the 5th of April 2018. The Office indicated that the growth projections in the trend scenario are positioned in the higher part of the forecast range used for its assessment, in particular in 2019 and 2020.

⁶ Enacting Decrees 90/2016 and 93/2016 and Law 163/2016

⁷ PBO's Parliamentary audition on the 2018 "*Documento di Economia e Finanza*", the comprehensive budgetary document which includes the 2018 Stability Programme.

7. SUMMARY

In 2017, Italy's structural balance deteriorated by 0.3 % of GDP based on the Commission 2018 spring forecast, which points to some deviation from the required adjustment towards the MTO once taking into account an allowance of 0.35 % of GDP related to the migration inflow and the need for protection against seismic risk. 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 2017 and over 2016 and 2017 taken together.

The debt-to-GDP ratio slightly declined in 2017 to 131.8 % of GDP, i.e. well above the Treaty reference value of 60 % and, based on the Commission 2018 spring forecast, Italy was not compliant with the debt reduction benchmark in that year and is not expected to comply in 2018 and 2019 either. Due to Italy's *prima facie* non-compliance with the debt reduction benchmark in 2016 and 2017, the Commission has 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 the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with, and that an EDP is thus not warranted at this stage. This conclusion followed an assessment of all the relevant factors, having regard in particular to Italy's ex-post compliance with the preventive arm in 2017. However, the adjustment in 2018 appears inadequate to ensure compliance with the adjustment path towards the MTO in 2018 based on the Commission 2018 spring forecast. The Commission will reassess compliance on the basis of the ex-post data for 2018 to be notified in Spring 2019.

As regards 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. The Commission 2018 spring forecast expects Italy's structural balance to remain stable at 1.7 % of GDP in 2018, while the projections of the 2018 Stability Programme point to a small structural effort of 0.1 % of GDP. Based on the Commission 2018 spring forecast, there is a risk of significant deviation from the preventive arm requirement both in 2018 and over 2017 and 2018 taken together. However, in order to balance Italy's current stabilisation needs and existing sustainability challenges, in its 2018 DBP Opinion, the Commission considered that a fiscal structural effort of at least 0.3 % of GDP would be adequate in 2018, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary expenditure not exceeding 0.5 %. Even taking that into account in the overall assessment, there is a risk of significant deviation from the recommended adjustment path towards the MTO in 2018 based on the Commission 2018 spring forecast.

For 2019, Italy is recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1%, corresponding to an annual structural adjustment of 0.6 % of GDP. The Stability Programme plans a structural improvement of 0.7 % of GDP, while the Commission expects Italy's structural balance to further deteriorate by 0.3 % of GDP, reaching -2.0 % of GDP. The difference is mainly due to the fact that the Commission 2018 spring forecast does not include a VAT hike (amounting to around EUR 12.5 billion or 0.7 % of GDP) legislated for 2019 as a "safeguard clause" to ensure the achievement of the budgetary targets, as such increase was systematically repealed in recent years. Taking into account the preventive arm requirement, an overall assessment based on the Commission 2018 spring forecast points to a risk of a significant deviation from the recommended adjustment path towards the MTO in 2019 and over 2018 and 2019 taken together.

8. ANNEXES

Table I. Macroeconomic indicators

	2000-2004	2005-2009	2010-2014	2015	2016	2017	2018	2019
Core indicators								
GDP growth rate	1.5	-0.4	-0.4	1.0	0.9	1.5	1.5	1.2
Output gap ¹	1.3	0.6	-3.2	-3.4	-2.4	-1.2	-0.1	0.5
HICP (annual % change)	2.5	2.1	1.9	0.1	-0.1	1.3	1.2	1.4
Domestic demand (annual % change) ²	1.6	-0.3	-1.4	1.5	1.1	1.3	1.5	1.2
Unemployment rate (% of labour force) ³	8.8	7.0	10.5	11.9	11.7	11.2	10.8	10.6
Gross fixed capital formation (% of GDP)	20.7	21.1	18.4	16.9	17.1	17.5	18.0	18.4
Gross national saving (% of GDP)	20.6	19.6	17.8	18.8	19.6	20.0	20.3	20.6
General Government (% of GDP)								
Net lending (+) or net borrowing (-)	-3.1	-3.4	-3.3	-2.6	-2.5	-2.3	-1.7	-1.7
Gross debt	102.5	103.8	123.2	131.5	132.0	131.8	130.7	129.7
Net financial assets	-95.5	-94.4	-111.6	-132.0	-130.0	n.a	n.a	n.a
Total revenue	43.9	44.7	47.1	47.7	46.9	46.6	46.4	45.9
Total expenditure	47.0	48.1	50.4	50.3	49.3	48.9	48.0	47.6
<i>of which: Interest</i>	5.4	4.6	4.7	4.1	4.0	3.8	3.6	3.5
Corporations (% of GDP)								
Net lending (+) or net borrowing (-)	0.1	-0.4	1.6	2.3	3.5	4.0	3.5	3.5
Net financial assets; non-financial corporations	-98.9	-126.9	-118.7	-122.8	-117.5	n.a	n.a	n.a
Net financial assets; financial corporations	-11.4	4.6	31.2	38.5	42.9	n.a	n.a	n.a
Gross capital formation	11.0	10.6	9.5	9.5	9.3	9.6	9.8	10.0
Gross operating surplus	24.0	22.3	20.6	20.8	21.3	20.9	20.8	20.8
Households and NPISH (% of GDP)								
Net lending (+) or net borrowing (-)	2.8	2.2	1.0	1.9	1.3	1.0	0.8	0.8
Net financial assets	199.2	199.9	179.2	196.0	192.8	n.a	n.a	n.a
Gross wages and salaries	27.0	28.4	29.1	29.2	29.4	29.5	29.7	29.6
Net property income	15.1	13.9	11.0	10.4	9.8	9.6	9.1	9.0
Current transfers received	20.6	21.6	24.1	24.6	24.5	24.3	24.3	24.3
Gross saving	10.0	9.8	7.4	7.2	7.1	6.6	6.5	6.7
Rest of the world (% of GDP)								
Net lending (+) or net borrowing (-)	-0.3	-1.6	-0.7	1.7	2.3	2.7	2.6	2.6
Net financial assets	8.5	19.6	25.1	25.0	16.9	n.a	n.a	n.a
Net exports of goods and services	0.8	-0.6	0.5	2.9	3.3	3.1	3.1	3.1
Net primary income from the rest of the world	-0.4	-0.1	-0.2	-0.5	0.2	0.5	0.5	0.5
Net capital transactions	0.1	0.1	0.1	0.2	-0.2	-0.1	0.0	0.0
Tradable sector	44.9	42.0	40.3	40.6	41.0	41.3	n.a	n.a
Non tradable sector	45.3	48.1	49.5	49.2	48.7	48.3	n.a	n.a
<i>of which: Building and construction sector</i>	4.7	5.4	4.8	4.3	4.3	4.2	n.a	n.a
Real effective exchange rate (index, 2000=100)	88.0	99.1	99.7	96.2	96.4	96.4	98.7	97.6
Terms of trade goods and services (index, 2000=100)	104.4	100.7	98.1	102.3	104.7	103.3	103.5	103.6
Market performance of exports (index, 2000=100)	123.6	107.2	100.2	98.1	96.6	97.3	96.6	96.3
Notes:								
¹ The output gap constitutes the gap between the actual and potential gross domestic product at 2005 market prices.								
² The indicator on domestic demand includes stocks.								
³ Unemployed persons are all persons who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.								
Source: AMECO data, Commission 2018 spring forecast								