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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plans of Italy

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of Italy

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1. INTRODUCTION

Italy has submitted its 2017 Draft Budgetary Plan (DBP) on 18 October 2016, in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Italy is subject to the preventive arm of the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its medium term budgetary objective (MTO).

As public debt amounted to 132.3% of GDP in 2015, Italy is also required to comply with the debt rule.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2016 autumn forecast (Commission forecast). The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2016-2017 (also taking into account the risks to their achievement) against the obligations stemming from the SGP. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council on 12 July 2016, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Italy's 2017 DBP revised downward real GDP growth for 2016 (see Box 1) to 0.8%, compared to the 1.2% projected in Italy's 2016 Stability Programme (SP). This is mainly due to a lower-than-expected outturn for the first half of 2016. As projected in the SP, increasing private domestic demand is set to contribute the most, while lower stock building subtracts from output growth. After incorporating data for the first half of 2016, the Commission forecast for real GDP growth in 2016 (0.7%) is broadly aligned with that in the DBP, including in terms of contribution from GDP components but with somewhat higher imports. The forecast for the 2016 GDP deflator is confirmed at 1% in the DBP, in line with the SP and the Commission forecast.

For 2017, the DBP projects lower real GDP growth than the SP (1.0% vs. 1.4%), still supported by domestic demand, in particular private and public investment. The Commission forecast expects only marginally lower real GDP growth, at 0.9%, with a similar positive contribution from domestic demand and a negative one from net exports. However, the Commission expects a slightly lower rise in investment, as uncertainty and prevailing financing conditions weigh on the outlook, as well as stronger exports driven by more dynamic external demand. Concerning price developments, the DBP expects HICP headline inflation to rise in 2017 to 0.9% (from 0.1% in 2016), broadly in line with the 2016 SP, but less than in the Commission forecast (1.2%). The DBP expects the unemployment rate to decline more than the Commission forecast, albeit remaining at high levels (10.8% vs. 11.4%), also thanks to stronger employment growth.

Overall, the macroeconomic projections outlined in Italy's 2016 DBP appear plausible and broadly in line with those of the Commission. Downside risks to these projections are related to a further slowdown in external demand, political uncertainty and a slow adjustment of the banking sector.

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

Italy's 2016 DBP is based on the macroeconomic scenario outlined in the update of Italy's Economic and Financial Document (DEF) of 27 September 2016. The DEF presents a *trend scenario*, based on the hypothesis of unchanged legislation, and a *programme scenario*, including the impact of the measures proposed in the DBP. Both macroeconomic scenarios have been prepared by the government and endorsed by the Parliamentary Budget Office (PBO), Italy's independent fiscal monitoring institution. After the initial validation of the trend scenario, the PBO proceeded with endorsing also the programme one, after the government raised the DBP deficit target for 2017 to 2.3% of GDP from 2% in the updated DEF, without however modifying the projected real GDP growth of 1%. The programme scenario underlying the updated DEF had in fact been considered not plausible by the PBO.

The endorsements, mentioned in the DBP, took the form of two letters (dated 29 September and 18 October 2016, respectively)[1] addressed to the Italian Minister of Economy and Finance and publicly available on the PBO's website. The letters state that both the trend and the programme forecast scenarios for 2016-2017 are "*within an acceptable interval given the information currently available*". However, the PBO indicated that growth beyond 2017 is above the upper bound of its forecast range, and thus not prudent. In a parliamentary hearing on the 2017 Budget, the PBO noted that the expansionary policy planned in 2017 requires a stronger consolidation in the subsequent years to ensure achieving a balanced budget by 2019.

It is the third successive year that the government macroeconomic assumptions underlying a budgetary document are assessed by a national independent monitoring institution. The PBO's encompassing mandate, defined in Law 243/2012, includes the assessment of macroeconomic and budgetary forecasts and of the compliance with numerical budgetary rules. Regarding its independence, the law stipulates that the PBO: (i) shall operate with full autonomy and independence of judgement and assessment; (ii) is led by a Council of three members – one of whom acting as a president – with widely recognised independence, competence, and experience; (iii) shall be granted access to all relevant government databases; (iv) is mandated

[1] See http://www.upbilancio.it/wp-content/uploads/2016/09/Lettera-e-allegato-validazione-QMT-NADEF-2016_seguito-26_9.pdf and http://www.upbilancio.it/wp-content/uploads/2016/10/Lettera-validazione-QMP-DPB-2017.pdf

to communicate autonomously to the public on a standalone website; (v) is adequately funded; (vi) can employ up to 40 staff members. In practice, the Council members were appointed in May 2014 for a six-year non-renewable term, a memorandum of understanding with the Ministry of Economy and Finance on the exchange of information was signed in September 2014, and technical staff was recruited in 2015.

Table 1. Comparison of macroeconomic developments and forecasts

	2015	2016			2017		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	0.7	1.2	0.8	0.7	1.4	1.0	0.9
Private consumption (% change)	1.5	1.4	1.3	1.2	1.4	1.0	0.9
Gross fixed capital formation (% change)	1.3	2.2	2.0	2.1	3.0	2.9	2.6
Exports of goods and services (% change)	4.3	1.6	1.7	1.7	3.8	2.5	2.8
Imports of goods and services (% change)	6.0	2.5	2.1	2.4	3.8	3.6	3.8
Contributions to real GDP growth:							
- Final domestic demand	1.0	1.3	1.2	1.3	1.3	1.2	1.1
- Change in inventories	0.1	0.0	-0.4	-0.4	0.0	0.0	0.0
- Net exports	-0.4	-0.2	-0.1	-0.1	0.1	-0.3	-0.2
Output gap[1]	-2.6	-1.6	-1.6	-1.6	-0.4	-0.7	-0.8
Employment (% change)	0.6	0.9	1.2	1.2	1.0	0.9	0.4
Unemployment rate (%)	11.9	11.4	11.5	11.5	10.8	10.8	11.4
Labour productivity (% change)	-0.1	0.3	-0.5	-0.5	0.4	0.1	0.2
HICP inflation (%)	0.1	0.2	0.1	0.0	1.3	0.9	1.2
GDP deflator (% change)	0.6	1.0	1.0	1.0	1.1	1.0	0.9
Comp. of employees (per head, % change)	0.4	0.4	0.5	0.0	1.0	1.3	0.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.8	2.6	2.9	2.9	2.6	2.8	2.7

Note:

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

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3. Recent and planned fiscal developments

3.1. Deficit developments

Italy's DBP projects the general government deficit to decrease to 2.4% in 2016, from 2.6% of GDP in 2015 (see Table 2). This is only slightly higher than the 2.3% of GDP deficit planned in the April 2016 Stability Programme (SP). This revision is explained by marginally lower primary surplus (1.6% of GDP vs. 1.7%), mainly due to worse-than-expected economic developments (real GDP growth at 0.8% vs. 1.2%). The Commission forecast also projects the 2016 deficit at 2.4% of GDP, following positive developments in the first three quarters and based on the assumption of a strict budgetary execution in the final months of the year.

For 2017, the DBP plans the government deficit to only marginally decline to 2.3% of GDP, which is substantially higher than in the SP (1.8% of GDP). This is the result of additional deficit-increasing measures envisaged in the DBP and of lower economic growth projections. After incorporating the DBP measures, the Commission forecast expects the headline deficit to stand at 2.4% of GDP in 2017, unchanged with respect to 2016. The small difference with the DBP is mainly explained by lower nominal GDP growth (1.8% vs. 2%) as well as a more cautious assessment of some financing measures aimed at increasing tax compliance.

The overall net deficit-increasing impact of the measures enshrined in the DBP accounts for close to 0.7 percentage points of GDP (namely, revenues would be 0.4 percentage points lower and expenditure 0.3 percentage points higher) compared to the "trend" scenario based on unchanged legislation. These expansionary measures are expected to support real GDP growth in 2017 (up to 1% in the programme scenario, from 0.6% in the trend scenario). In 2017, total revenues (in nominal terms) are projected to increase below nominal GDP growth (at 1.2% vs. 2%), thus shrinking by 0.3 percentage points as a share of GDP. In particular, in terms of composition, the projected decrease as a share of GDP in current taxes on income and wealth as well as in social contributions is due to the measures enacted in the 2016 Budget Law (such as the cut in the corporate income tax rate), which are only partially compensated by marginally higher taxes on production and imports as a result of measures planned in the DBP (see Section 3.3 below for further details). On the expenditure side, primary expenditure as a share of GDP is projected to decrease by 0.2 percentage points in 2017, as its increase in nominal terms (1.6% year-on-year) is lower than projected nominal growth. More specifically, current primary expenditure is projected to increase by 1.4% year-on-year driven by social transfers (+2.1% y-o-y) also due to measures planned in the DBP increasing pension outlays. Compensation of employees is also projected to increase slightly in 2017 in nominal terms, mainly due to resources allocated to the next bargaining round following the end of a wage freeze in force since 2010 also due to a Constitutional Court ruling on that issue[2]. As regards public investments, these are projected to increase by more than 9% y-o-y in nominal terms thanks to measures supporting investment in the DBP, and thus increases as a share of GDP[3] (see Section 3.3 below for further details).

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Italy standing at around 1.6%[4]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the DBP, interest expenditure in Italy is expected to fall from 4.2% of GDP in 2015 to 4.0% in 2016 and is projected to decrease further to 3.7% of GDP in 2017. This is well below the recent peak of 5.2% recorded in 2012 at the height of the euro area sovereign debt crisis. The picture based on the Member State's plans is broadly confirmed by the Commission forecast.

Against the background of falling interest expenditure, the projected deterioration of Italy's structural balance in 2016 (0.6 percentage points of GDP) and 2017 (0.5 percentage points of

[2] On 24 June 2015, the Italian Constitutional Court (ruling 178/2015) declared unconstitutional, starting from the publication date of the ruling (23 July 2015), and without retroactive effect, the freezing of collective bargaining for public wages introduced by the Decree Law 98/2011, specified by the DPR 122/2013, and extended by the 2014 and 2015 Stability Laws.

[3] In the Commission forecast, the increase in public investment is milder in 2017, at 4.7% y-o-y.

[4] 10-year bond yields as of October 2016.

GDP) in the Draft Budgetary Plan is accompanied by a more than proportional deterioration in the structural primary balance (0.7 percentage points of GDP in both 2016 and 2017). The Commission forecast points to similar conclusions.

Italy's DBP for 2016 and SP for 2016 were accompanied by a formal request to avail of the flexibility under the preventive arm for 2016 in view of the planned implementation of major structural reforms as well as of national expenditures on projects co-financed by the EU. Overall, Italy was provisionally assessed[5] to be eligible for the maximum allowance of 0.75% of GDP for 2016, of which 0.5% of GDP under the structural reform clause and 0.25% under the investment clause, under a number of conditions, which are discussed in Section 4.2.

The Italian authorities indicated in the DBP for 2016 and in the SP for 2016 that the budgetary impact of additional security costs related to the threat of terrorism and of the exceptional inflow of refugees is significant and should be considered as an unusual event and exceptional circumstance, 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 0.2% of GDP in 2016 in relation to exceptional security measures. Italy was provisionally assessed to be eligible for an allowance of 0.06% of GDP for the additional expenditure directly linked to security projected for 2016, which will be taken into account in the overall assessment of compliance with the preventive arm in 2016 to be made *ex-post* in 2017. As regards the impact of the exceptional inflow of refugees, Italy requested a temporary deviation from the adjustment path towards the MTO of 0.2% of GDP in 2016, corresponding to the overall annual cost (net of EU contributions) incurred in relation to the refugee crisis. Italy was provisionally assessed to be eligible for an allowance of 0.04% of GDP for 2016, corresponding to the additional refugee-related expenditure incurred in that year, to be taken into account in the overall assessment of compliance with the preventive arm in 2016 to be made *ex-post* in 2017.

The DBP specifies that the planned budget for 2017 comprises exceptional expenditure amounting to about 0.4% of GDP, half of which in relation to the ongoing refugee crisis and the related need to set up a comprehensive policy of migration management, and the rest due to a preventive investment plan for the protection of the national territory against seismic risks, in particular by addressing hydrogeological risks and securing schools.

As regards the exceptional inflow of refugees, the DBP confirms the projected net budgetary impact of the exceptional inflow of refugees at 0.16% of GDP in 2015, 0.2% of GDP in 2016 and 0.22% of GDP for 2017. In relation to this, Italy's DBP requests a temporary deviation from the adjustment path towards the MTO of 0.16% of GDP in 2017, corresponding to the difference between the overall costs incurred in relation to the refugee crisis in 2017 and the average over 2011-2013 (0.06% of GDP), before the crisis intensified. The DBP argues that the spending on migrants cannot be evaluated only in terms of annual increased expenditure due to the recent emergency, but should take into account the overall effort made by Italy compared to the pre-emergency situation. The European Council conclusions[6] acknowledge "the significant contribution, including of financial nature, made by the frontline Member States in recent years". The Commission stands ready to consider an additional deviation for 2017 in due course. Given the structural nature of the migration-related costs and the need to avoid

[5] See "Assessment of the 2016 Stability Programme for Italy" (May 2016), available at the following link: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2016/12_it_scp_en.pdf

[6] European Council conclusions, 20-21 October 2016: http://www.consilium.europa.eu/en/press/press-releases/2016/10/21-european-council-conclusions/

double-counting, any allowance for the entire cost borne in 2017 (net of the allowance of 0.07% of GDP already granted in 2015 and 2016) could be granted only once.

As regards earthquake-related expenditures, the Commission acknowledges that Italy has been facing unprecedented seismic activity in the past months. The DBP sets out expenditures related to the emergency management and to the so-called "preventive investment plan for the protection of the national territory against seismic risks". Due to the integrated nature of these expenditures, which makes the link between emergency and prevention intervention less clear-cut, as well as the reoccurrence of intense earthquakes, the Commission is ready to consider a broader approach when it comes to the specific treatment of earthquake-related expenditures, and will continue to work with the Italian authorities accordingly.

Thus, the 0.18% of GDP earmarked by the Italian authorities[7] for the preventive investment plan in 2017 could be considered eligible for the "unusual event clause". This allowance should be confirmed *ex post* based on actual data for 2017. For the following years, only positive incremental changes in resources earmarked for this purpose would be considered eligible for possible further temporary deviations.

[7] See "Il Ministro Padoan risponde alla Commissione europea sul DPB 2017": http://www.tesoro.it/opencms754/opencms/inevidenza/documenti/Lettera_risposta_del_25_ottobre_2016_-_Dombrovskis_e_Moscovici.pdf

Table 2. Composition of the budgetary adjustment

(% of GDP)	2015	2016			2017			Change: 2015-2017
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue*	**47.8**	**47.2**	***47.0***	**47.4**	**46.9**	***46.7***	**46.9**	**-1.1**
of which:								
- Taxes on production and imports	15.2	14.7	*14.4*	14.6	15.4	*14.5*	14.6	-0.7
- Current taxes on income, wealth, etc.	14.8	14.7	*14.9*	15.0	14.3	*14.6*	14.8	-0.2
- Capital taxes	0.1	0.2	*0.2*	0.2	0.0	*0.2*	0.2	0.1
- Social contributions	13.3	13.1	*13.1*	13.2	13.0	*13.0*	13.0	-0.3
- Other (residual)	4.4	4.5	*4.4*	4.4	4.2	*4.4*	4.3	-0.1
Expenditure*	**50.4**	**49.6**	**49.5**	**49.7**	**48.4**	**49.0**	**49.3**	**-1.4**
of which:								
- Primary expenditure	46.2	45.6	45.5	45.8	44.6	45.3	45.5	-1.0
of which:								
Compensation of employees	9.8	9.8	9.7	9.8	9.5	9.7	9.7	-0.2
Intermediate consumption	5.4	5.3	5.4	5.5	5.2	5.4	5.5	-0.1
Social payments	23.0	22.9	22.9	22.9	22.7	22.9	23.0	-0.1
Subsidies	1.7	1.7	1.7	1.7	1.4	1.5	1.7	-0.2
Gross fixed capital formation	2.2	2.3	2.2	2.2	2.3	2.4	2.3	0.1
Other (residual)	4.1	3.6	3.6	3.6	3.5	3.4	3.4	-0.6
- Interest expenditure	4.2	4.0	4.0	4.0	3.8	3.7	3.8	-0.4
General government balance (GGB)	**-2.6**	**-2.3**	**-2.4**	**-2.4**	**-1.8**	**-2.3**	**-2.4**	**0.3**
Primary balance	**1.5**	**1.7**	**1.6**	**1.6**	**2.0**	**1.4**	**1.4**	**-0.2**
One-off and other temporary measures	-0.2	0.1	0.1	0.1	0.0	0.2	0.2	0.3
GGB excl. one-offs	**-2.5**	**-2.4**	**-2.5**	**-2.5**	**-1.8**	**-2.5**	**-2.6**	**0.0**
Output gap[1]	-2.6	-1.6	-1.6	-1.6	-0.4	-0.7	-0.8	1.9
Cyclically-adjusted balance[1]	-1.2	-1.5	-1.5	-1.5	-1.6	-1.9	-1.9	-0.7
Structural balance (SB)[2]	**-1.1**	**-1.6**	**-1.6**	**-1.6**	**-1.6**	**-2.1**	**-2.2**	**-1.0**
Structural primary balance[2]	3.1	2.4	2.4	2.4	2.2	1.6	1.6	-1.5

Notes:

* For 2017, revenues and expenditures in the Stability Programme are based on trends instead of targets.

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

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

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

3.2. Debt developments

The DBP projects the debt-to-GDP ratio to peak in 2016 at 132.8% (see Table 3), up by 0.5 percentage points from the 2015 level. By contrast, the SP for 2016 targeted a reduction in the debt-to-GDP ratio of 0.3 percentage points already this year. [8] The difference is mainly due to lower nominal GDP growth and underachieved privatisation proceeds in the Draft Budgetary Plan (at 0.1% of GDP in 2016 vs. the planned 0.5%). Compared to the Draft Budgetary Plan, the Commission forecast expects a slightly higher debt ratio in 2016 due to somewhat lower nominal GDP growth

Table 3. Debt developments

(% of GDP)	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**132.3**	**132.4**	**132.8**	**133.0**	**130.9**	**132.6**	**133.1**
Change in the ratio	0.4	-0.3	0.5	0.7	-1.5	-0.2	0.1
Contributions[2] :							
1. Primary balance	**-1.5**	**-1.7**	**-1.6**	**-1.6**	**-2.0**	**-1.4**	**-1.4**
2. “Snow-ball” effect	**2.4**	**1.2**	**1.6**	**1.8**	**0.6**	**1.1**	**1.4**
Of which:							
Interest expenditure	4.2	4.0	4.0	4.0	3.8	3.7	3.8
Growth effect	-1.0	-1.6	-1.0	-0.9	-1.8	-1.3	-1.2
Inflation effect	-0.8	-1.3	-1.4	-1.2	-1.4	-1.3	-1.2
3. Stock-flow adjustment	**-0.4**	**0.2**	**0.5**	**0.5**	**-0.1**	**0.1**	**0.1**
Of which:							
Cash/accruals difference	0.0	0.4	0.5	0.5	0.1	0.4	0.4
Net accumulation of financial	-0.5	-0.2	0.2	0.0	-0.2	-0.2	-0.3
of which privatisation proceeds	-0.4	-0.5	-0.1	-0.1	-0.5	-0.5	-0.3
Valuation effect & residual	0.0	-0.1	-0.3	0.0	-0.1	-0.2	0.0

Notes:

[1] End of period.

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

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

For 2017, the DBP projects a small decline (of 0.2 percentage points) in the debt-to-GDP ratio to 132.6%, mainly triggered by stronger nominal GDP growth and lower interest expenditure, while the primary surplus is projected to decline compared to 2016. Additionally, the DBP plans a sizeable debt-reducing impact from projected privatisation proceeds (0.5% of GDP) mainly related to the planned IPO of the state-owned railway company (*Ferrovie dello Stato*) and the sale of a further stake in the postal service operator *Poste Italiane SPA*. The SP for 2016 projected a significantly larger debt reduction in 2017, mainly thanks to higher primary surplus and nominal GDP growth. The Commission forecast projects a further marginal

[8] From 132.7% in 2015 (though this was later revised downward by the statistical office to 132.3% of GDP) to 132.4%

increase in the debt-to-GDP ratio in 2017. The difference with the DBP is mainly explained by lower nominal GDP growth. Risks to both the Commission and the DBP debt projections for 2017 are mainly related to a worse-than-anticipated growth outlook, lower privatisation proceeds, and lower inflation.

3.3. Measures underpinning the draft budgetary plan

The measures in the DBP imply an overall worsening in the headline budgetary position of close to 0.7 percentage points of GDP in 2017 compared to the authorities' "trend" scenario based on unchanged legislation. This translates into a deficit target of 2.3% of GDP, from 1.6% in the trend scenario, after taking into account higher real GDP growth stemming from the DBP measures (at 1%, up from 0.6% in the trend scenario). Overall, the DBP measures result in a decline of approximately EUR 7.1 bn (or 0.4% of GDP) in revenues and in an increase of approximately EUR 5.3 bn (or 0.3% of GDP) in expenditure relative to the "trend" scenario based on unchanged legislation.

Among the main measures included in the DBP with a gross negative impact on the 2017 deficit are: (i) the repeal of a previously legislated increase in VAT and other taxes legislated for 2017 by the 2015 and 2016 Stability Laws (worth around EUR 15 billion or 0.9% of GDP)[9]; (ii) a preventive plan of public investments and subsidies (with budgetary allocations of around EUR 3 bn or 0.18% of GDP overall, according to the government) to increase the safety of buildings against seismic risks throughout the national territory also thanks to tax incentives; (iii) additional "emergency" expenditure for assistance and subsidies for reconstruction in central Italy following the recent earthquakes (EUR 1 bn or 0.06% of GDP including the use of a specific fund for emergencies); moreover, the 2017 Budget confirms the allocation of previously earmarked resources (EUR 1.7 bn or 0.1% of GDP) for reconstruction related to previous earthquakes in Abruzzi (2009) and Emilia Romagna (2012) as rebuilding activities in those areas take time because of cumbersome administrative procedures and the need to preserve the historical heritage of old buildings; (iv) measures (amounting to EUR 1.6 bn or 0.1% of GDP in 2017 and up to EUR 2.2 bn in 2018) further increasing the already high pension expenditure in Italy by allowing earlier retirement for specific categories of workers and by increasing minimum pensions; (v) the renewal of public sector wage contracts and resources to increase spending on education (EUR 1.7 bn or 0.1% of GDP); (vi) other spending measures include higher resources made available to local authorities (EUR 1 bn or 0.06% of GDP) and subsidies to investment, many of which will however impact on the government balance only as of 2018 (e.g. the extension beyond 2016 of the previously introduced incentive for companies to invest through the possibility to deduct 140% of the amount spent, as well as a new "hyper-amortisation" rate of 250% for digital investments); (vii) it should be recalled that the Budget Law for 2016 had provided for a reduction in corporate income tax ("IRES") rate from 27.5% to 24% as of 2017, with a negative impact on revenue of 0.17% of GDP. Many of these expansionary measures, for instance those increasing the already high pension expenditure in Italy, may lead to an increase in demand in the short term, but arguably will not contribute to boost potential growth.

On the financing side, the main components of the Italian budgetary strategy include measures aimed at increasing tax compliance and fighting against tax evasion, expected to

[9] It should be noted that a safeguard close worth close to EUR 20bn (or 1.2% of GDP) remains in force for the years 2018 and 2019 but the Italian authorities publicly committed to deactivate the clause also for those years.

deliver around EUR 4 bn or 0.25% of GDP. Namely, half of these resources refer to the expected one-off impact of the decision to forgo sanctions and fines related to unpaid taxes over the period 2000-2015 (so-called "*rottamazione delle cartelle esattoriali*") for taxpayers spontaneously regularising their past tax position; the remaining half is related to the increase in compliance expected from new transparency provisions on the communication of invoices and VAT data. However, these provisions have one-off and uncertain impact, as the projected resources will depend on the taxpayers' behaviour. Among the other financing measures of a one-off nature, around 0.1% of GDP is projected to be raised through the extension to end-July 2017 of the deadline for the "voluntary disclosure" of assets held abroad, and further 0.12% (or EUR 2 bn) from the one-off impact of the sale of broadband licences (recorded as lower capital expenditure). Among the deficit-reducing measures of a structural nature, the spending review is projected to entail additional gross expenditure savings of around EUR 2.7 bn (or 0.16% of GDP) in 2017, mostly related to reallocation of financial resources among public bodies but also from some rationalisation of ministries' expenditure, while additional savings achieved through lower transfers and compulsory centralised procurement for local administrations refer mainly to the years beyond 2017. Further receipts of EUR 1.7 bn (or 0.1% of GDP) are projected from the reduction from 4.75% to 2.3% in the notional return on new equity capital or reinvested earnings exempted from the payment of CIT under the so-called “allowance for corporate equity”.

Table 4. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	**2017**	**2018**
Taxes on production and	0	-0.6	0.9
Current taxes on income,	0	0.1	-0.3
Capital taxes	0	0.1	-0.1
Social contributions			
Property Income			
Other			
Total	0	-0.4	0.5

Note:

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

Source: Draft Budgetary Plan for 2017

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2016	**2017**	**2018**
Compensation of employees	0	0.1	0
Intermediate consumption	0	0.1	-0.1
Social payments	0	0.2	0.1
Interest Expenditure			
Subsidies			
Gross fixed capital formation	0	0.1	0.1
Capital transfers	0	0.0	0
Other	0	-0.1	0.1
Total	0	0.3	0.3

Note:

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

Source: Draft Budgetary Plan for 2017

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

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

Box 2: Council recommendations addressed to Italy

On 12 July 2016, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended to Italy, in 2016, to limit the temporary deviation from the required 0.5% of GDP adjustment towards the medium-term budgetary objective to the amount of 0.75% of GDP allowed for investments and the implementation of structural reforms, subject to the condition of resuming the adjustment path towards the medium-term budgetary objective in 2017; achieve an annual fiscal adjustment of 0.6% of GDP or more towards the medium-term budgetary objective in 2017; finalise the reform of the budgetary process in the course of 2016 and ensure that the spending review is an integral part of it; ensure the timely implementation of the privatisation programme and use the windfall gains to accelerate the reduction of the general government debt ratio; shift the tax burden from productive factors onto consumption and property; reduce the number and scope of tax expenditures and complete the reform of the cadastral system by mid-2017; take measures to improve tax compliance, including through electronic invoicing and payments.

4.1. Compliance with the debt rule

As the debt ratio amounted to 132.3% of GDP in 2015, Italy must comply with the debt rule.

For 2015, the minimum linear structural adjustment (MLSA) based on the Commission forecast is estimated at 2.6 percentage points of GDP, which would correspond to a sizeable structural surplus (1.5% of GDP), i.e. well above its MTO of a structural balanced budget[10]. Italy's estimated structural effort of 0.2 percentage points of GDP in 2015 based on the Commission forecast thus falls short of the MLSA to ensure sufficient progress towards compliance with the debt rule in 2015. On 18 May 2016, the Commission issued a report under article 126(3) TFEU, as Italy did not make sufficient progress towards compliance with the debt rule in 2015. The report concluded that, after the assessment of all relevant factors, the debt rule as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as complied with. The Commission also announced its intention to review its assessment of the relevant factors in a new report under Article 126(3) TFEU based on the Commission 2016 autumn forecast and on further information included in the DBP on Italy's resumption of the adjustment path towards the MTO in 2017, i.e. one of the conditions to grant to Italy the maximum possible allowance in 2016 under the structural reform clause and the investment clause (see also Section 4.2).

The DBP does not project compliance with the debt rule either in 2016 (gap of 4.6%. of GDP) or in 2017 (gap of 1.9% of GDP), which means that compliance is further postponed compared to the SP for 2016.

[10] By comparison, the respect of the debt rule at the MTO would require, ceteris paribus, nominal GDP growth of around 3% (vs. nominal potential growth estimated on average at 1% over 2015-2017).

Based on the Commission forecast, Italy is projected not to comply with the debt rule, as its debt-to-GDP ratio will be considerably above the debt benchmark in both 2016 and 2017 (gaps of 7.3% and 6.8% of GDP, respectively).

Overall, Italy neither plans nor is forecast to meet the debt rule by 2017.

Table 5. Compliance with the debt rule

	2015	2016			2017		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	132.3	132.4	132.8	133.0	130.9	132.6	133.1
Gap to the debt benchmark [1,2]	n.r.	3.0	4.6	7.3	0.2	1.9	6.8
Structural adjustment [3]	0.2	-0.6	-0.6	-0.5	0.0	-0.5	-0.5
To be compared to:							
Required adjustment [4]	2.6						

Notes:

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

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

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

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

Source:

Stability Programme 2016 (SP); Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations

4.2. Adjustment towards the MTO

The preventive arm of the SGP requires Member States with a general government debt ratio above 60% of GDP, not yet at their MTO, and experiencing "bad times" (i.e. an estimated output gap between -3% and -1.5% of potential GDP based on the relevant Commission forecast vintages), as is the case for Italy in 2016, to deliver a structural adjustment towards the MTO of 0.5% of GDP. For 2016, Italy was allowed to deviate by a maximum of 0.75% of GDP in consideration of the allowance granted for the structural reform and investment clauses (see Section 3.1 for further details). This allowance for 2016 was granted in two steps: 0.4% of GDP under the structural reform clause in autumn 2015 and a further 0.35% of GDP, of which additional 0.1% of GDP under the structural reform clause and 0.25% of GDP under the investment clause in spring 2016, conditional however on: (i) the existence of credible plans for the resumption of the adjustment path towards the MTO as of 2017; (ii) the effective use of a deviation from the adjustment path for the purpose of increasing investments; and (iii) progress with the structural reform agenda, taking into account the Council recommendations.

The preventive arm of the SGP requires Member States with a general government debt ratio above 60% of GDP, growth above potential, and experiencing "normal times" (i.e. an estimated output gap between -1.5% and 1.5% of potential GDP), as is the case for Italy in 2017, to deliver a structural adjustment towards the MTO of 0.6% of GDP or more. Italy's DBP projects a (recalculated) structural deterioration of 0.6 percentage points of GDP in 2016 and a further deterioration of 0.5 percentage points of GDP in 2017 (see also Section 3.1).

For 2016, the (recalculated) structural effort planned by the government points to some deviation from the required adjustment towards the MTO (see Table 7) both over one year (gap of -0.3 percentage points of GDP) and over 2015 and 2016 taken together (gap of -0.2 percentage points of GDP per year, on average). The expenditure benchmark points instead to compliance. This calls for an overall assessment. The discrepancy between the two indicators is mainly due to the fact that the expenditure benchmark benefits in 2016 from significant one-offs and the use of a GDP deflator based also on the Commission 2015 spring forecast, which was inflated by a VAT hike already legislated as a safeguard clause but subsequently repealed. The overall conclusion is that, if the abovementioned allowance of 0.75% of GDP is confirmed, Italy's DBP plans some deviation from the required adjustment towards the MTO in 2016.

For 2016, the Commission forecast expect Italy's structural balance to deteriorate by 0.5 percentage points of GDP. Therefore, taking into account the preventive arm requirement of -0.25% of GDP, after correcting for the entire 0.75% of GDP allowance, the Commission forecast points to a risk of some deviation (a gap of -0.3 percentage points of GDP) from the structural balance pillar over one year in 2016. The expenditure benchmark points instead to compliance, as the growth rate of government expenditure, net of discretionary revenue measures, will not exceed the applicable expenditure benchmark rate (0.6% y-o-y in real terms) in 2016. Over 2015 and 2016 taken together, based on the Commission forecast and taking into account the corrected preventive arm requirement, there is a risk of some deviation (a gap of -0.2 percentage points of GDP) from the structural balance pillar. The expenditure benchmark points instead to compliance. Following an overall assessment along the abovementioned lines, a risk of some deviation from the adjustment path towards the MTO is to be expected in 2016. Provided that the abovementioned allowance of 0.75% of GDP is confirmed, this conclusion does not change when the additional budgetary impact (0.1% of GDP overall) of the exceptional inflow of refugees (0.04%) as well as of security costs (0.06%) expected in 2016 is subtracted from the preventive arm requirement.

In 2017, the (recalculated) structural deterioration planned by the government points to a significant deviation from the required 0.6 percentage points of GDP adjustment towards the MTO (see Table 7) over both one year (gap of -1.1 percentage points of GDP) and two years (gap of -0.7 percentage points of GDP per year, on average). The same applies to the expenditure benchmark over both one year (gap of -0.7 percentage points of GDP) and two years (gap of -0.3 percentage points of GDP per year, on average) as, according to the information provided in the DBP, the growth rate of government expenditure, net of discretionary revenue measures, will exceed the applicable expenditure benchmark rate (-1.4% y-o-y in real terms) in 2017. Overall, Italy's DBP plans a significant deviation from the required adjustment towards the MTO in 2017.

For 2017, the Commission forecast expects Italy's structural balance to further deteriorate by 0.5 percentage points of GDP, reaching -2.2% of GDP (i.e. below Italy's minimum benchmark of -1.5% of GDP). The Commission forecast points to a risk of a significant deviation (a gap of -1.1 percentage points of GDP) from the structural balance pillar over one year in 2017. The expenditure benchmark points to the same conclusion (gap of -1.1

percentage points of GDP), as the growth rate of government expenditure, net of discretionary revenue measures, will significantly exceed the applicable expenditure benchmark rate (-1.4% y-o-y in real terms) in 2017. Over 2016 and 2017 taken together, based on the Commission forecast, there is a risk of a significant deviation (a gap of -0.7 percentage points of GDP per year, on average) from the structural balance pillar. The expenditure benchmark also points to the same conclusion (a gap of -0.5 percentage points of GDP per year, on average).

This conclusion does not change if the total projected budgetary impact of the inflow of refugees in 2017 (estimated at 0.15% after excluding the 0.07% of GDP deviation granted in 2015 and 2016) and the 0.18% of GDP earmarked by the government for a preventive investment plan for the protection of the national territory against seismic risks are subtracted from the preventive arm requirement. In fact, also after considering this potential allowance of 0.33% of GDP, the Commission forecast points to a risk of a significant deviation (a gap of -0.8 percentage points of GDP) from the structural balance pillar over one year in 2017. The expenditure benchmark points to the same conclusion (gap of -0.7 percentage points of GDP), as the growth rate of government expenditure, net of discretionary revenue measures, will significantly exceed the applicable expenditure benchmark rate (-0.7% y-o-y in real terms) in 2017. Over 2016 and 2017 taken together, based on the Commission forecast, there is a risk of a significant deviation (a gap of -0.5 percentage points of GDP per year, on average) from the structural balance pillar. The expenditure benchmark points instead to some deviation (a gap of -0.2 percentage points of GDP per year, on average). This calls for an overall assessment. The discrepancy between the two indicators is mainly due to the fact that the expenditure benchmark benefits in 2016 and 2017 from the use of a GDP deflator based also on the Commission 2015 and 2016 spring forecasts, which were inflated by VAT hikes legislated as safeguard clauses but subsequently repealed. Overall, a risk of a significant deviation from the adjustment path towards the MTO is to be expected in 2017, putting at risk the compliance with the requirements of the preventive arm of the Pact.

In summary, based on the Commission forecast, Italy appears to be at risk of some deviation from the preventive arm requirements regarding progress towards the MTO in 2016 and at risk of significant deviation in 2017. The conclusion for 2016 crucially hinges upon the consideration of the allowed temporary deviation from the adjustment path towards the MTO of 0.75% of GDP under the structural reform and investment clauses. However, a necessary condition to grant part of that allowance was Italy's resumption of the adjustment towards the MTO in 2017, which does not appear to be fulfilled on the basis of the Commission forecast. Moreover, while a final assessment will be possible only on the basis of outturn data in 2017, preliminary information on co-financed investment in 2016 points to amounts below the 0.25% of GDP for which flexibility was granted under the investment clause. All in all, assuming a required adjustment of 0.1% of GDP[11], the overall assessment would indicate a risk of significant deviation from the adjustment path towards the MTO in 2016 as well.

[11] This includes only the allowance of 0.4% of GDP under the structural reform clause that was not made explicitly conditional on Italy's resumption of the adjustment path towards the MTO in 2017, unlike the residual 0.35% granted under the investment clause (0.25%) and structural reform clause (0.1%).

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2015	2016			2017		
Initial position[1]							
Medium-term objective (MTO)	0.0	0.0			0.0		
Structural balance[2] (COM)	-1.1	-1.6			-2.2		
Structural balance based on freezing (COM)	-0.7	-1.6			-		
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO			Not at MTO		
(% of GDP)	**2015**	**2016**			**2017**		
	COM	**DBP**	**COM**		**DBP**	**COM**	
		Vis-à-vis the CSR	**Vis-à-vis the CSR**	**Including additional clauses**	**Vis-à-vis the CSR**	**Vis-à-vis the CSR**	**Including additional clauses**
Structural balance pillar							
Required adjustment[4]	0.3	0.5			0.6		
Required adjustment corrected[5]	0.2	-0.25		-0.35	0.6		0.3
Change in structural balance[6]	0.1	-0.6	-0.5	-0.5	-0.5	-0.5	-0.5
One-year deviation from the required adjustment [7]	-0.1	-0.3	-0.3	-0.2	-1.1	-1.1	-0.8
Two-year average deviation from the required adjustment [7]	-0.1	-0.2	-0.2	-0.1	-0.7	-0.7	-0.5
Expenditure benchmark pillar							
Applicable reference rate[8]	-0.5	0.6			-1.4		-0.7
One-year deviation [9]	0.2	0.2	0.1	0.3	-0.7	-1.1	-0.7
Two-year average deviation [9]	0.2	0.2	0.2	0.2	-0.3	-0.5	-0.2
Conclusion							
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Significant deviation	Significant deviation	Significant deviation
Conclusion over two years	Overall assessment	Overall assessment	Overall assessment	Overall assessment	Significant deviation	Significant deviation	Overall assessment

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 27.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2014) was carried out on the basis of Commission 2015 spring forecast.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures and revenue increases mandated by law from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2017 (DBP); Commission 2016 autumn forecast (COM); Commission calculations.

Box 3: Implementation of the "constrained judgement" approach and its impact in the context of the fiscal surveillance

The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response to this mandate from the Council, two concrete decisions were taken in agreement with the Member States in October 2016. First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment (NAWRU) would be introduced in the commonly agreed methodology. This change has already been implemented in the Commission 2016 autumn forecast. Second, in line with the renewed mandate provided by the ECOFIN Council on 11 October, the Economic Policy Committee – Output Gap Working Group has worked on a "constrained judgement" approach for cases where the common method is shown to produce counterintuitive output gap results for individual Member States.

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gaps for individual Member States estimated on the basis of the common method. To this end, the Commission developed in cooperation with the Member States an objective screening tool to assess if the common methodology produces plausible output gap estimates for all Member States. Where this "plausibility" tool identifies counter-intuitive results, the Commission has carried out an "in depth" analysis.

In the case of Italy, the plausibility tool provided some indications that the output gap estimated on the basis of the commonly agreed methodology for 2016 (i.e. -1.6% of potential GDP) may be counterintuitive. In fact, this falls just outside the confidence interval indicated by the “plausibility” tool, although at a rather low level of confidence (68%), so that overall the indication coming from the tool may be regarded as borderline.

The value for Italy’s output gap obtained by the plausibility tool would be -2.1% of potential GDP in 2016, i.e. some 0.5 percentage points of GDP wider than that based on the commonly agreed methodology. Applying this difference also to the output gap estimate for 2017 based on the commonly agreed methodology, i.e. -0.8% of potential GDP, the tool would point for analogy to a "plausible" estimate of -1.3%.

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

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

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

5. IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

Italy has taken some steps to reduce the labour tax wedge (see Box 4) and, more broadly, to reform the taxation system. However, as regards the broader reform of tax policy, there seem to be considerable delays with respect to the 2016 CSR. Neither a reform of cadastral values nor concrete action to rationalise tax expenditures, which are the focus of the 2016 CSR, have been enacted or are expected in the near future. Some provisions in the DBP go in the right direction to spur private investment. However, despite the reduction in interest rates on new banks' loans and corporate bonds, the decision to reduce the notional rate for the "allowance on corporate equity" (see Section 3.3) could be premature in consideration of the fact that banks' financing conditions remain difficult, in particular for SMEs, and additional equity is needed to allow sizeable investment in innovation by firms. Moreover, the measures envisaged in the DBP to enhance tax compliance do not include further use of electronic invoicing and payments, as recommended by the Council, and are expected to generate additional revenues largely of one-off nature.

On the expenditure side, further action to rationalise public spending has been taken during 2016. Namely, the government has completed a reform of the budgetary process, which, by unifying the Stability Law and the Budget, could be, over the medium term, more in line with a performance-budgeting approach and could ensure that the spending review process becomes a permanent feature of the budgetary process. However, given the late adoption of these new provisions, a systematic implementation of the spending review targets set at the central level for each Ministry is *de facto* postponed to next year. Moreover, savings targets for the future have been reduced, also because they turned out to be too ambitious without actions to rationalise large spending items like pensions or public transport. Ministers are once again directly involved in selecting areas within their own budgets liable to be subject to targeted savings. Moreover, centralised public procurement is being progressively extended to the regional level, as envisaged by the Public Spending Rationalisation Programme. Namely, the government passed a decree law specifying product categories and spending thresholds above which central and local administrations should opt for centralised procurement. A technical working group is envisaging additional product categories to be included in the programme.

Finally, the government decision to repeal the already legislated VAT hike combined with additional spending (including on pensions) in the 2017 DBP cast serious doubts on the credibility of Italy's budgetary strategy to reach its MTO. More specifically, the three-year budget envisaged since the 2009 reform of the budgetary process was meant to give more certainty about the measures that the government wanted to implement in order to achieve its medium-term targets. However, the practice of including large tax increases to fill the gap between trends and targets in the three-year budget and of repealing them later on has made the budget unreliable in the outer years.

Last spring, Italy was granted an allowance of 0.5% of GDP under the structural reform clause in 2016. The reform timetable included in the update of Italy's DEF broadly confirms that in the 2016 National Reform Programme.

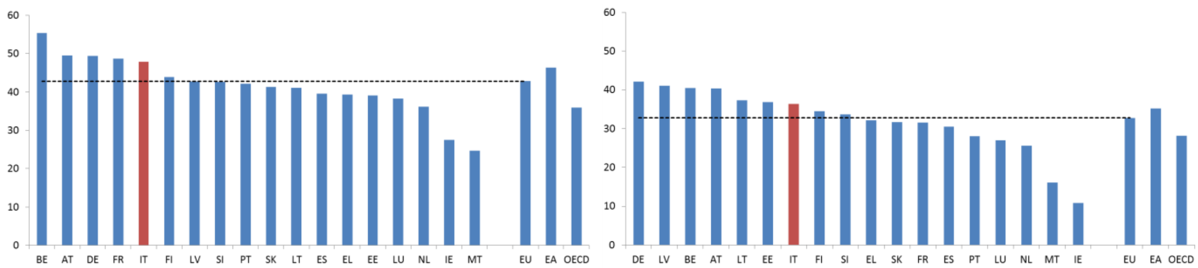
A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2017 Country Reports and in the context of the CSRs adopted by the Commission in May.

Box 4: Addressing the tax burden on labour in the euro area

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

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

The tax burden on labour in Italy at the average wage and a low wage (2015)



Notes: Data for Latvia, Lithuania and Malta is for 2014. No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

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

In the context of the 2016 European Semester, Italy received recommendations to "(…) Shift the tax burden from productive factors onto consumption and property. Reduce the number and scope of tax expenditures and complete the reform of the cadastral system by mid-2017. Take measures to improve tax compliance, including through electronic invoicing and payments."

Italy’s Draft Budgetary Plan contains the following measures affecting the tax wedge on labour: (i) lower tax rates on productivity premia in order to incentivise decentralised bargaining; (ii) the exemption from the payment of social security contributions for employers hiring students who previously took part in traineeship programmes in the same firm, and for farmers below the age of 40; and (iii) the reduction of the social security contributions rate for the self-employed to 25% from 29% in 2017.

These measures aim at increasing competitiveness and supporting employment growth by targeting specific groups of workers. Their budgetary impact is limited to less than EUR 500 million in 2017. However, these measures follow more substantial ones adopted through recent Budget Laws, e.g. the abolition from the tax base of the regional tax on economic activities (IRAP) of the labour costs on permanent employment (impact of more than 0.3% of GDP as from 2016), the monthly EUR 80 tax credit to low income workers (impact of more than 0.5% of GDP as from 2015 – recorded as additional social spending), and the three-year exemption of social contribution for new permanent hires in 2015/2016 (budgetary impact of around 0.4% of GDP in 2017).

6. OVERALL CONCLUSION

Based on both the DBP and the Commission 2016 autumn forecast, Italy is not expected to comply with the debt rule in 2016 and 2017.

The planned and forecast structural deteriorations based on both the DBP and the Commission forecast point to a risk of some deviation from the required adjustment path towards the MTO in 2016 once the full allowance of 0.75% of GDP granted in spring under the structural reform and investment clause is taken into account. Should this no longer be the case in consideration of Italy's lack of resumption of the adjustment path towards the MTO in 2017, the planned and forecast structural deterioration in 2016 would point to a risk of significant deviation from the required adjustment path towards the MTO in 2016. This conclusion does not change when the additional budgetary impact of the exceptional inflow of refugees and of security costs related to the threat of terrorism (overall 0.1% of GDP to be confirmed ex-post) is subtracted from the preventive arm requirement.

Regarding 2017, the assessment based on the (recalculated) DBP points to a significant deviation, in line with the conclusion of the overall assessment based on the Commission forecast. This conclusion does not change when the budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks (overall 0.33% of GDP to be confirmed ex post) is subtracted from the preventive arm requirement.