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Analysis of the 2016 Draft Budgetary Plan of ITALY

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COMMISSION OPINION

on the Draft Budgetary Plan of ITALY

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Analysis of the 2016 Draft Budgetary Plan of ITALY

1. INTRODUCTION

Italy submitted its Draft Budgetary Plan (DBP) for 2016 on 15 October 2015, 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 objective (MTO) of a balanced budgetary position in structural terms.

As the debt-to-GDP ratio was 123.2% in 2012 (the year in which Italy corrected its excessive deficit), exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit Italy is also subject to the transitional debt rule. In this period it should ensure sufficient progress towards compliance.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2015 autumn 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 2015 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2015-2016 (also taking into account the risks to their achievement) against the obligations stemming from the SGP. Section 5 provides an analysis of implementation of reforms in the area of fiscal governance in response to the latest Country-specific Recommendations (CSRs) adopted by the Council on 14 July 2015, including those to reduce the tax wedge. Section 6 concludes.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

Italy's 2016 DBP revised upward the 2015 real GDP outlook (see Box 1), with a 0.9% growth compared to the 0.7% projected in Italy's 2015 Stability Programme in spring, mainly because of a higher carry-over from 2014. As projected in the Stability Programme, increasing private domestic demand and exports are both set to contribute to growth in 2015. Imports are projected to accelerate markedly also driven by the recovery in equipment investment and restocking. After incorporating data up to and including the second quarter, the Commission 2015 autumn forecast projects the same real GDP growth in 2015 with the same contribution from domestic demand and similar export developments, but somewhat lower inventories and imports. On the other hand, the DBP significantly revises downward the 2015 GDP deflator, to 0.3% from 0.7% in the 2015 Stability Programme, as compared to 0.4% in the Commission 2015 autumn forecast.

For 2016, the DBP projects slightly higher real GDP growth than the 2015 Stability Programme (1.6% vs. 1.4%), mainly explained by the upward revision of private and public consumption. The Commission forecast expects similar real GDP growth, at 1.5%, with the same contribution from domestic demand as in the Government projections but envisages a negative contribution from net exports. In particular, the Commission expects a more limited rise in exports, as global demand is weaker than projected in the DBP, and stronger imports driven by higher investment. The net-lending vis-à-vis the rest of the world continues to be higher in the Commission forecast (2.3% vs. 1.9% of GDP in the DBP). Concerning price developments, both the Commission forecast and the DBP expect HICP inflation to rise in 2016 to around 1%, also in line with the 2015 Stability Programme. The DBP and the

Commission forecast both expect unemployment to decline further albeit remaining at high levels (just below 12%).

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 further loss of momentum in external demand.

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

Italy's 2016 DBP is based on the macroeconomic scenario already outlined in the update of Italy's Economic and Financial Document (DEF) of 18 September 2015. 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. These endorsements, mentioned in the DBP, took the form of two letters (dated 16 September 2015 and 29 September 2015, 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 are "*within an acceptable interval given the information currently available*". However, the PBO assessed the government growth projections for 2016 as closer to the upper bound of its forecast range, therefore subject to downside risks. The PBO also indicated that growth beyond 2016 is above the upper bound of its forecast range, and thus not prudent.

It is the second successive year that the government macroeconomic assumptions underlying a budgetary document are assessed by a national independent monitoring institution. The functional autonomy of the PBO is ensured by national provisions. Its encompassing mandate, defined in the Italian Law 243/2012, includes the assessment of macroeconomic and budgetary forecasts and of the compliance with numerical budgetary rules. The PBO was established by the Italian Constitutional Law 1/2012 and further detailed in Law 243/2012. Also in order to ensure 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 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 the course of 2015.

[1] See www.upbilancio.it/wp-content/uploads/2015/09/UPB_Lettera-validazione-QMT-NADEF-2015-con-allegato.pdf and www.upbilancio.it/wp-content/uploads/2015/09/lettera-validazione-MEF-prev.-programmatiche2015-2016-.pdf

Table 1. Comparison of macroeconomic developments and forecasts

	2014	2015			2016		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	-0.4	0.7	0.9	0.9	1.4	1.6	1.5
Private consumption (% change)	0.4	0.8	0.8	0.8	1.2	1.5	1.4
Gross fixed capital formation (% change)	-3.5	1.1	1.2	1.2	2.7	2.7	4.0
Exports of goods and services (% change)	3.1	3.8	4.3	4.4	4.0	3.8	3.3
Imports of goods and services (% change)	2.9	2.9	5.6	5.0	3.8	4.2	4.8
Contributions to real GDP growth:							
- Final domestic demand	-0.5	0.4	0.7	0.7	1.1	1.5	1.5
- Change in inventories	-0.1	0.0	0.4	0.2	0.1	0.1	0.2
- Net exports	0.1	0.4	-0.2	0.0	0.2	0.0	-0.3
Output gap[1]	-4.0	-3.4	-3.1	-2.9	-2.0	-1.5	-1.5
Employment (% change)	0.1	0.6	0.7	0.8	1.0	1.0	0.7
Unemployment rate (%)	12.7	12.3	12.2	12.2	11.7	11.7	11.8
Labour productivity (% change)	-0.7	0.1	0.2	-0.2	0.4	0.6	0.4
HICP inflation (%)	0.2	0.4	0.3	0.2	1.0	1.0	1.0
GDP deflator (% change)	0.9	0.7	0.4	0.4	1.2	1.0	1.0
Comp. of employees (per head, % change)	0.6	0.6	0.7	0.5	1.5	0.9	0.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.2	2.9	1.9	2.5	3.3	1.9	2.3

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 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 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 2.6% in 2015, from 3.0% of GDP in 2014 (see Table 2). This is in line with the deficit planned in the April 2015 Stability Programme. With respect to it, marginally higher primary surplus (1.7% of GDP vs. 1.6%), mainly due to better-than-expected economic developments (real growth at 0.9% vs. 0.7%), offsets the slightly higher interest expenditure (at 4.3% of GDP vs. 4.2%) due to the mild rise in yields compared to April. The Commission forecast also projects the 2015 deficit at 2.6% of GDP, based on the assumption of a strict budgetary execution in the final months of the year. For 2016, the DBP plans the government deficit to decline to 2.2% of GDP, which is substantially higher than in the Stability Programme (1.8% of GDP). This is mainly related to additional deficit-increasing measures foreseen in the DBP. The DBP was accompanied by a formal request by the government to avail itself of 0.4% of GDP additional flexibility in 2016, in addition to the 0.4% of GDP deviation from the required adjustment towards the MTO in 2016 already granted in spring 2015 for the structural reform clause (see also Section 4.2). After incorporating the DBP measures, the Commission forecast expects the headline deficit to stand at 2.3% of GDP in 2016, down from 2.6% in 2015, also due to 0.1 pp. of GDP lower interest expenditure compared to the DBP.

Furthermore, the Italian authorities indicate in the DBP that the budgetary impact of the migrants/refugees crisis 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 and in article 3 of the Fiscal compact". More specifically, this expenditure is estimated at EUR 2.5 bn (or 0.16% of GDP) in 2014 and at around EUR 3.2 bn in both 2015 and 2016 (or 0.2% of GDP), as compared to the average spending of EUR 1.2 bn (or 0.08% of GDP - net of EU contributions) over 2011-13. In relation to this, Italy requested to avail itself of additional flexibility in 2016 for the overall annual cost of the migrants/refugees crisis (i.e. 0.2 pp of GDP). This request should be considered separately from the abovementioned ones, since the DBP announces the intention to use the additional fiscal space, if it were to be granted, to increase the planned headline deficit to 2.4% of GDP in 2016 mainly through the earlier implementation of tax cuts currently planned for 2017. Moreover, the DBP also qualifies the additional migration outlays relative to the 2011-13 average as one-off measures as of 2014, although they do not meet the Commission criteria to be classified as one-offs and are thus included as permanent expenditure in the Commission 2015 autumn forecast.

The overall net deficit-increasing impact of the additional measures enshrined in the DBP accounts for close to 0.9 pp. of GDP. These expansionary measures are also expected to support real GDP growth in 2016 (up to 1.6% from 1.3% in the no-policy change scenario). On the revenue side, in 2016, total revenues (in nominal terms) are projected to increase considerably below nominal GDP growth (at 1.3% vs 2.6%), thus shrinking by 0.6 pp. as a share of GDP. In terms of composition, the projected decrease in current taxes on income and wealth, taxes on production and social contributions as a share of GDP is only partially compensated by higher one-off capital taxes as a result of the measures planned in the DBP (see Section 3.3 below for further details). On the expenditure side, in 2016 primary expenditure relative to GDP is projected to decrease by more than 0.9 pp. compared with 2015, as its increase in nominal terms (0.5% year-on-year) is significant lower than the projected nominal growth thanks to savings planned within the public administration (in this and previous Stability Laws). More specifically, current primary expenditure is projected to increase by 0.8% year-on-year driven by social transfer outlays (+1.9% y-o-y). Intermediate consumption is projected to decline in nominal terms due to the ongoing spending review. Compensation of employees is projected to increase slightly in 2016 mainly due to additional hiring in education enacted by the 2015 Stability Law as well as some resources (EUR 0.3 bn) allocated to the next bargaining round as the wage freeze in force since 2010 cannot be further prolonged following a recent Constitutional Court ruling on this issue[2]. As regards public

[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

investments, they are projected to increase by more than 2% y-o-y, in line with nominal GDP growth, and thus stabilise as a share of GDP[3] (see Section 3.3 below for further details).

Table 2. Composition of the budgetary adjustment

(% of GDP)	2014	2015			2016			Change: 2014-2016
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**48.2**	**48.0**	***48.2***	**48.2**	**48.5**	***47.6***	**47.3**	**-0.6**
of which:								
- Taxes on production and imports	15.3	15.1	*15.0*	15.1	15.8	*14.6*	14.5	-0.7
- Current taxes on income, wealth, etc.	14.7	15.1	*15.3*	14.9	15.3	*15.2*	14.7	0.5
- Capital taxes	0.1	0.1	*0.1*	0.1	0.1	*0.2*	0.2	0.1
- Social contributions	13.4	13.2	*13.3*	13.4	12.9	*13.1*	13.2	-0.3
- Other (residual)	4.6	4.5	*4.5*	4.7	4.4	*4.5*	4.6	-0.1
Expenditure	**51.2**	**50.5**	**50.8**	**50.8**	**49.9**	**49.8**	**49.6**	**-1.4**
of which:								
- Primary expenditure	46.6	46.3	46.5	46.5	45.7	45.6	45.5	-1.0
of which:								
Compensation of employees	10.2	10.1	10.1	10.0	9.9	9.9	9.9	-0.3
Intermediate consumption	5.6	5.3	7.9	5.5	5.2	7.6	5.3	2.0
Social payments	23.1	23.2	20.5	23.2	22.9	20.4	22.9	-2.7
Subsidies	1.8	1.6	1.7	1.7	1.6	1.5	1.6	-0.3
Gross fixed capital formation	2.2	2.2	2.3	2.2	2.3	2.3	2.2	0.1
Other (residual)	3.7	3.9	4.0	3.9	3.8	3.9	3.6	0.2
- Interest expenditure	4.6	4.2	4.3	4.3	4.2	4.2	4.1	-0.4
General government balance (GGB)	**-3.0**	**-2.6**	**-2.6**	**-2.6**	**-1.8**	**-2.2**	**-2.3**	**0.8**
Primary balance	**1.6**	**1.6**	**1.7**	**1.7**	**2.4**	**2.0**	**1.8**	**0.4**
One-off and other temporary measures	0.2	-0.1	-0.1	0.0	-0.1	-0.1	0.0	-0.3
GGB excl. one-offs	**-3.2**	**-2.5**	**-2.5**	**-2.6**	**-1.7**	**-2.1**	**-2.3**	**1.1**
Output gap[1]	-4.0	-3.4	-3.1	-2.9	-2.0	-1.5	-1.5	2.7
Cyclically-adjusted balance[1]	-0.9	-0.8	-0.9	-1.0	-0.7	-1.4	-1.5	-0.6
Structural balance (SB)[2]	**-1.1**	**-0.7**	**-0.8**	**-1.0**	**-0.6**	**-1.3**	**-1.5**	**-0.3**
Structural primary balance[2]	3.6	3.5	3.5	3.3	3.6	2.9	2.6	-0.7

Notes*:*

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

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

Source:

Stability Programme 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

[3] In the Commission forecast, the increase in public investment is milder in 2016, at 0.9% y-o-y, and the stabilisation expected to take place already in 2015 after five years of significant contraction. Moreover, capital transfers are forecast to contract in 2016 after the 2015 increase also due to one-off outlays (around EUR 2 bn) related to a Constitutional Court ruling about the de-indexation of higher pensions over 2012-2013.

In structural terms[4], the government plans imply an improvement in the structural balance by 0.2 pp. of GDP in 2015 and a deterioration of close to 0.5 pp. of GDP in 2016. As a result, the (recalculated) structural position reaches -1.3% of GDP in 2016. In the government plans (before recalculation), the achievement of the MTO of a balanced budget position in structural terms is postponed to 2018 from 2017 in the April 2015 Stability Programme. In the Commission forecast, the structural adjustment amounts to 0.1 pp. in 2015, followed by a deterioration of 0.5 pp. in 2016. The main differences with respect to the DBP are: (i) the lower structural adjustment in 2015 (despite the same headline deficit), due to the fact that the DBP treats as one-offs the increase in the outlays related to the migration crisis as compared to the 2011-2013 average (see above), while the Commission treats this expenditure as structural; (ii) the higher headline and structural deficit in 2016, due to the Commission's more cautious assessment of revenue developments and some specific measures enshrined in the DBP, namely additional revenues from gaming. This is partly compensated by lower interest expenditure in the Commission forecast. The fall in interest expenditure, since the peak reached in 2012 (of around 0.9 percentage points of GDP by 2015 – see also Box 2), has decisively contributed to maintain the structural balance broadly stable between 2012 and 2015 (around +0.3 percentage points over the three years) despite some deterioration in the structural primary balance (around -0.6 percentage points over the three years) in a context of low inflation and (up to 2014) economic contraction.

Overall downside risks to these budgetary projections are associated with possibly worse-than-expected macroeconomic outcomes, including persistently low inflation, as well as to partial or inadequate implementation of the measures in the DBP. In addition, risks in term of the quality of the budgetary execution stem from the lower transfers to local authorities as part of the planned savings, which could partially translate into either lower capital expenditure or tax increases at subnational level (see also Section 3.3).

Box 2: Impact of the current low interest rate environment on compliance with the SGP

Identifying an interest rate windfall for 2016

Sovereign bond yields have fallen sharply since end-2013 and nominal yields in Italy are well below their long-term average of around 4.9% (paid by the government over 2000-2010), with 10-year rates standing at around 1.5% at the end of October 2015 and average issuance yields at around 0.75% during the first seven months of 2015. As a result of lower rates, total interest expenditure of the general government has also been decreasing since 2013. Italy's 2016 DBP projects it to fall from the peak of 5.2% of GDP in 2012 to 4.3% in 2015 and to 4.2% in 2016. The Commission forecast, with a cut-off date of 22 October 2015 and thus taking into account a further reduction in yields on Italian sovereign securities (e.g. leading to 2-year zero coupon bonds CTZ issued for the first time with negative yield), shows somewhat lower interest expenditure in 2016 (at 4.1% of GDP).

Interest expenditure projected in the DBP entails an implicit average interest rate on the government debt of 3.3% in nominal terms in both 2015 and 2016, down from 3.6% in 2014. However, the implicit average interest rate in real terms (using the GDP deflator) is projected to increase to 2.9% in 2015 (from 2.7% recorded in 2014 and in 1999-2014 on average) and to fall to 2.3% in 2016, based on the assumption of higher inflation (GDP deflator increasing by1% y-o-y from 0.4% in 2015).

[4] Cyclically-adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

Prospects and vulnerability

The impact of lower yields on interest expenditure is substantial in the first year, as they positively affect the cost of short-term bonds as well as coupons on (interest and inflation) linked bonds. However, a large part (around 70%) of Italy's sovereign debt consists of fixed-rate bonds, thus it takes time (around 5 years) to have full pass-through of lower yields to interest expenditure (the average maturity of government debt securities is currently around 6 and a half years). Over the next twelve months, more than EUR 320 bn (or 19% of GDP) of state securities will mature, of which around half involving instruments already benefitting from currently low yields. That, together with the fact that nominal interest rates are not expected to decline significantly in 2016, explains why no major changes are expected in the implicit average interest rate in 2016 relative to 2015 (see above). A sudden and significant increase in yields would however imply a sizable impact on the interest bill because of the relatively large share of short-term and indexed debt instruments.

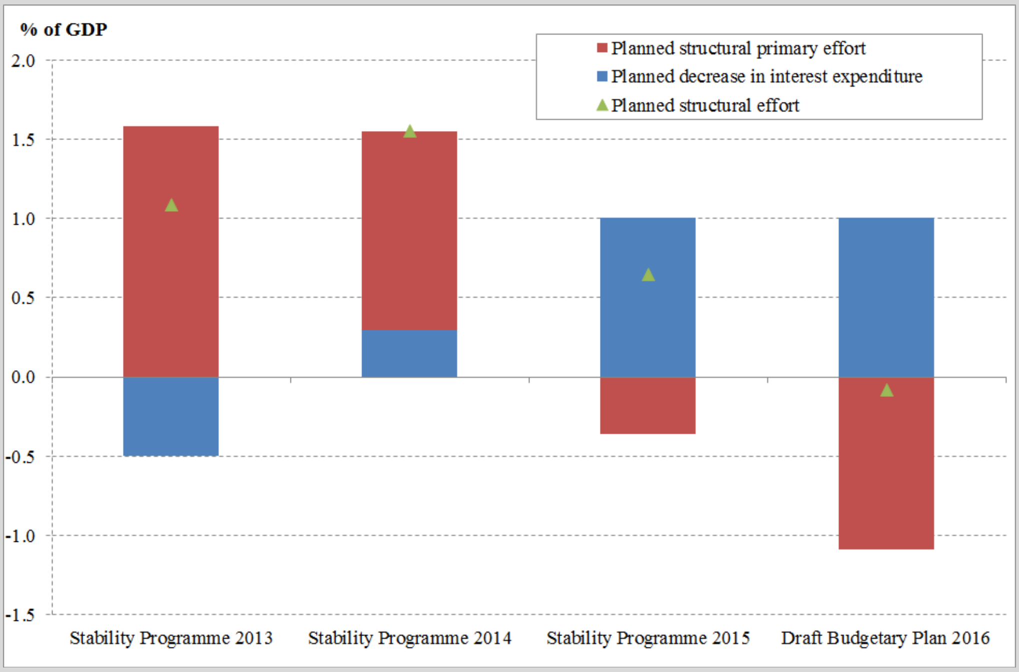
Consequences for public finances

While lower yields are having a positive impact on interest expenditure, the overall impact of low inflation on public finances appears to be less benign. In fact, a low inflation environment makes it more difficult to cut expenditure by limiting nominal expenditure growth (e.g. by freezing nominal wages or introducing nominal ceilings for other spending items such as healthcare). At the same time, low interest rates and inflation are often associated with weak domestic demand and subdued wage developments, which in turn entail a tax-poor growth composition. As a result, a low-inflation environment may be expected to exert negative effects on primary balances, thereby weighing on deficit and debt level dynamics. Furthermore, what matters for the debt-to-GDP ratio developments is also the differential between real GDP growth and the real implicit debt-servicing cost (through the so-called "snow-ball effect"). As mentioned, the latter is expected to decline below its long-term average only in 2016, while Italy's real GDP has started recovering only since the beginning of 2015 after a long and deep recession that negatively affected its potential growth. In this context, low real yields and increasing potential growth, alongside with large primary surpluses, will be essential to put the high debt-to-GDP ratio on a sustained declining path over the coming years.

Comparing interest expenditure projections across different vintages of Italy's Stability Programmes and the DBP sheds more light on the (unexpected) interest windfall related to the recent fall in interest rates (see Chart below)[5]. Namely, fiscal adjustment plans have changed in recent years also because of a less favourable economic environment, including negative growth up to 2014 as well as low inflation. In this context, the fall in interest expenditure by 2016 (around 1.5 pps. lower than projected in the 2013 Stability Programme) has contributed to maintaining the structural balance broadly stable since 2012.

[5] Note that, while it is likely that revisions in the interest expenditure projections across different vintages primarily reflect changes in interest rates, other factors such as debt dynamics, the maturity profile of debt and statistical reclassifications (e.g. the switchover to the ESA 2010 standard of national accounts) may also have played a role.

Overall structural effort and decrease in interest expenditures between 2012 and 2016 based on different government plans



Source: Stability programmes, Draft Budgetary Plan 2016, and AMECO

3.2. Debt developments

The DBP projects the debt-to-GDP ratio to peak in 2015 at 132.8% (see Table 3), up by 0.5 pp. from the 2014 level, similar to what was expected in the April 2015 Stability Programme.

Planned privatisation proceeds account for 0.4% of GDP in 2015, in line with the outcome already achieved in October after the successful IPO of the postal operator *Poste Italiane SPA*. The Commission forecast indicates a marginally higher debt ratio in 2015, explained by a somewhat smaller debt-reducing impact of the stock-flow adjustment[6].

[6] The debt-increasing stock-flow adjustment is also affected by the further settlement of trade debt arrears (estimated at around 0.3% of GDP in 2015) as well as the negative swap flows and swaptions (overall estimated at around 0.4% of GDP in 2015 and around 0.5% of GDP in 2016) related to operations carried out by the Treasury in the past to hedge the risk of increasing interest rates.

Table 3. Debt developments

(% of GDP)	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**132.3**	**132.5**	**132.8**	**133.0**	**130.9**	**131.4**	**132.2**
Change in the ratio	3.5	0.4	0.5	0.7	-1.6	-1.4	-0.9
Contributions[2] *:*							
1. Primary balance	**-1.6**	**-1.6**	**-1.7**	**-1.7**	**-2.4**	**-2.0**	**-1.8**
2. "Snow-ball" effect	**4.1**	**2.4**	**2.6**	**2.6**	**0.9**	**0.9**	**1.0**
Of which:							
Interest expenditure	4.6	4.2	4.3	4.3	4.2	4.2	4.1
Growth effect	0.6	-0.9	-1.2	-1.1	-1.8	-2.1	-1.9
Inflation effect	-1.1	-0.9	-0.5	-0.6	-1.5	-1.3	-1.2
3. Stock-flow adjustment	**1.1**	**-0.4**	**-0.4**	**-0.2**	**0.0**	**-0.2**	**-0.1**
Of which:							
Cash/accruals difference	-0.1	0.6	1.0	1.0	-0.3	0.0	0.0
Net accumulation of financial	1.2	0.0	-0.4	-1.2	-0.2	-0.5	-0.1
of which privatisation proceeds	-0.2	-0.4	-0.4	-0.4	-0.5	-0.5	-0.3
Valuation effect & residual	0.0	-0.9	-0.9	0.0	0.4	0.3	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 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

For 2016, the DBP projects a decline of 1.4 pps. in the debt-to-GDP ratio, to 131.4%, mainly triggered by positive nominal growth, which supports a marginal increase in the headline primary surplus (despite an increase in the structural deficit), as well as a fall in the debt-increasing impact of the snow-ball effect, given the broadly stable interest expenditure. Finally, an important debt-reducing effect is related to the projected privatisation proceeds (0.5% of GDP) mainly due to the announced privatisation of the state-owned railway company (*Ferrovie dello Stato*) and the air traffic control operator (*ENAV*). The 2015 Stability Programme projected a somewhat larger debt reduction in 2015, mainly thanks to higher primary surplus. The Commission forecast is less optimistic than the DBP on the pace of reduction of the debt-to-GDP ratio in 2016. The primary surplus is forecast to be 0.2 pp. of GDP lower (see Section 3.1) and the snow-ball effect marginally higher, in spite of lower interest expenditure. Regarding privatisation proceeds, the Commission forecast incorporates only 0.3% of GDP in 2016, because of the lack of details about the privatisation of the railway company.

Risks to both the Commission and the DBP debt projections for 2016 are mainly related to a worse-than-anticipated growth outlook, lower privatisation proceeds, as well as 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 0.9 pp. of GDP in 2015 compared to the authorities' trend scenario based on unchanged legislation, resulting in a deficit target of 2.2% of GDP (from 1.4%) after taking into account higher real GDP growth stemming from the DBP measures (1.6% up from 1.3% in the trend scenario). Overall, the DBP measures result in a decline of approximately EUR 18 bn (or 1.1% of GDP) in net revenues and in a decline in of EUR 3.5 bn (or 0.2% of GDP) in net expenditure.

Among the main measures included in the DBP with a gross negative impact on the 2016 deficit, amounting to 1.7% of GDP overall according to the government, are: (i) the repeal of a previously legislated increase in VAT and other taxes legislated for 2016 by the 2014 and 2015 Stability Laws (worth around EUR 16.8 billion or 1% of GDP); (ii) the abolition of recurrent property taxation on first residences (worth overall EUR 3.6 billion or 0.22% of GDP), with a full compensation to Municipalities of the related lost revenue; (iii) a cut of property tax on agricultural real estate and immovable machinery for productive use (amounting together to EUR 935 million or 0.06% of GDP); (iv) subsidies and other measures to fight poverty and social exclusion (amounting to EUR 600 million or 0.04% of GDP in 2016 and further EUR 400 million or 0.02% of GDP in 2017); (v) tax breaks on productivity premiums to promote second-level firm bargaining (worth around EUR 430 million or close to 0.03% of GDP in 2016); (vi) a reduction by 40%, for an overall duration of two years, on employers' social contributions paid on new permanent employees hired in the course of 2016 (with a negative impact on revenues of EUR 830 million or 0.05% of GDP in 2016 and further EUR 1.2 billion or 0.075% in 2017); (vii) the introduction of incentives for companies to invest through the possibility to deduct 140% of the spent amount instead of 100% (with a negative impact on revenues mainly in 2017, by EUR 934 million or 0.05% of GDP); (viii) other measures with smaller impact including a broader "no tax area" for pensioners, additional flexibility for women to opt for earlier retirement but with entitlement recomputed under the notional defined contribution system, as well as resources for local administrations to undertake investment and to renew public sector contractual wages. Should Italy receive additional fiscal space under the SGP in consideration of the "unusual event" of the refugee crisis, the DBP also foresees the possibility to advance to 2016 (from 2017) a reduction in corporate income tax ("IRES") by 3.5 pps. (to 24% from 27.5%, with a revenue loss of 0.17% of GDP).

On the financing side, the main component of the Italian budgetary strategy is related to the spending review, projected to entail additional gross expenditure savings of around 0.5% of GDP (gross) in 2016, with the involvement of all levels of government. More specifically, around half of these gross savings are related to the rationalisation of central government expenditure, while the rest is to be achieved through lower transfers to Provinces and Regions, in the latter case also related to the enforcement of the balanced budget rule, as well as through centralised public procurement for both central and local administrations. Overall, the net impact of expenditure savings legislated by the DBP, worth around EUR 3.5 billion (or 0.2% of GDP), are considerably below the EUR 10 billion (or 0.6% of GDP) targeted by the April 2015 Stability Programme, also due to a still pending rationalisation of tax expenditures. At the same time, there is a risk that at least part of the reduced resources to local administrations (including for healthcare) might lead to higher local taxes and/or lower capital expenditure. Among the other financing measures, around 0.13% of GDP is projected to be raised through the one-off impact of the extension throughout 2016 of the deadline for the "voluntary disclosure" of assets held abroad, and a further 0.07% of GDP from higher tax rates on gaming and from new selection procedures for providers acting in the field of betting on sport events. Finally, the DBP amended the increase in VAT rates and excise duties foreseen by the 2015 Stability Law as a safeguard clause (0.8% of GDP in 2016, 1.2% of GDP in 2017, and 1.35% of GDP in 2018), namely repealing it in 2016 (as already mentioned) and replacing it by a more marked increase as of 2017[7]. As a result, VAT rate increases equivalent to EUR 15.1 billion (0.9% of GDP) in 2017 and EUR 19.6 billion (1.2% of GDP) as of 2018, are introduced as a safeguard clause to guarantee the achievement of planned fiscal targets in the programme scenario. This measure may, however, be replaced in the future by other measures having an equivalent budgetary impact.

[7] For 2017, a 2 pps. increase is foreseen in the standard VAT rate together with a 3 pps. increase in the reduced rate (vs. a 1 pp. increase in both rates relative to 2016, as foreseen in the 2015 Stability Law).

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)		
	2015	**2016**	**2017**
Taxes on production and imports	0.0	-1.2	0.3
Current taxes on income, wealth, etc.	0.0	0.0	-0.3
Capital taxes	0.0	0.1	-0.1
Social contributions	0.0	0.0	0.0
Property Income	n.a.	n.a.	n.a.
Other	0.0	0.1	0.0
Total	n.a.	n.a.	n.a.

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 2016

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2015	**2016**	**2017**
Compensation of employees	0.0	0.0	0.0
Intermediate consumption	0.0	-0.1	-0.1
Social payments	0.0	0.0	0.0
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	n.a.	n.a.
Gross fixed capital formation	n.a.	n.a.	n.a.
Capital transfers	n.a.	n.a.	n.a.
Other	0.0	-0.1	0.2
Total	n.a.	n.a.	n.a.

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 2016

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 3 reports the latest country specific recommendations in the area of public finances. Italy is also subject to the transitional debt rule in 2015 and the debt rule in 2016.

Box 3. Council recommendations addressed to Italy

On 14 July 2015, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended to Italy to "*achieve a fiscal adjustment of at least 0.25 % of GDP towards the medium-term budgetary objective in 2015 and of 0.1 % of GDP in 2016 by taking the necessary structural measures in both 2015 and 2016, taking into account the allowed deviation for the implementation of major structural reforms. Ensure that the spending review is an integral part of the budgetary process. Swiftly and thoroughly implement the privatisation programme and use windfall gains to make further progress towards putting the general government debt ratio on an appropriate downward path. Implement the enabling law for tax reform by September 2015, in particular the revision of tax expenditures and cadastral values and the measures to enhance tax compliance*".

4.1. Compliance with the debt criterion

After correcting its excessive deficit in 2012, Italy is in a transition period as regards the debt criterion for the following three years. This implies that, during the transition period 2013-2015, Italy is required to make sufficient progress towards compliance with the debt criterion, as defined by the minimum linear structural adjustment (MLSA) in order to comply with the debt rule at the end of it.

In 2015, under unfavourable economic conditions including negative potential growth and low inflation, the required MLSA, based on the DBP, would be 1.3 pps. of GDP. Starting from a structural balance of -1% of GDP in 2014, this adjustment would have implied reaching a structural surplus of around 0.3% of GDP in 2015. Based on the Commission 2015 autumn forecast, which projects more subdued nominal growth as well as lower privatisation proceeds, the MLSA would be even more stringent, at 2 pps. in 2015, well above the forecast structural adjustments in this year and implying a needed structural surplus of more than 0.8% of GDP in 2015, i.e. above Italy's MTO[8].

As of 2016, when the transition period ends, Italy needs to comply with the debt reduction benchmark. For 2016, the DBP projects compliance with the debt reduction benchmark in its forward-looking configuration (gap of -0.1%. of GDP). However, the planned compliance is subject to considerable risks as it relies on: (i) the fiscal effort planned in order to achieve the MTO in 2018; (ii) a more ambitious privatisation plan than foreseen in the April 2015 Stability Programme; and (iii) nominal growth in the years from 2016 that might be difficult to achieve given the current low-inflation environment and the rather optimistic projection on real growth (as also flagged by the Parliamentary Budget Office - see Box 1). Based on the Commission forecast, Italy is projected not to comply with the debt rule after the end of the transition period, as its debt-to-GDP ratio will be considerably above the debt benchmark in both 2016 and 2017 (gaps of 3.7% and 3.1% of GDP, respectively), although for 2017 this conclusion is based on a no-policy change scenario. Based on an institutional scenario, which as of 2017 assumes full compliance with the fiscal effort required under the preventive arm of the SGP, Italy is expected to comply with the debt rule only by 2019[9], in its forward-looking configuration.

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

[9] Non-compliance in 2018 is borderline (gap of 0.2%).

Overall, Italy is not forecast either to comply with the MLSA in 2015, or to meet the debt reduction benchmark in 2016, while the DBP projects compliance with the debt rule as of 2016. Regarding past assessments, a report drafted under Art. 126(3) TFEU on 27 February 2015 concluded that overall, based on the analysis presented in the report "including the assessment of all the relevant factors and notably (i) the currently unfavourable economic conditions –with particularly low inflation– which make the respect of the debt rule particularly demanding; (ii) the expectation that compliance with the required adjustment towards the MTO was broadly ensured; and (iii) the expected implementation of ambitious growth-enhancing structural reforms in line with the authorities' commitment, expected to contribute to debt reduction in the medium/long term", the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as complied with at that time.

Table 6. Compliance with the debt criterion*

	2014	2015			2016		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	132.3	132.5	132.8	133.0	130.9	131.4	132.2
Gap to the debt benchmark [1,2]	-	-	-	-	0.0	-0.1	3.7
Structural adjustment [3]	-0.2	0.3	0.2	0.1	0.0	-0.5	-0.5
To be compared to:							
Required adjustment [4]	0.9	1.8	1.3	2.0	-	-	-

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 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 2015 (SP); Draft Budgetary Plan for 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations

* An ex-ante assessment of planned compliance with the debt criterion can be based on the DBP only for the concerned countries providing extended data series (i.e. covering years up to t+4) in the DPB on a voluntary basis, as agreed at the EFC-A on 22 September 2014 and reflected in the updated Code of Conduct of the two-pack.

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 and not yet at their MTO to deliver a structural adjustment so as to make sufficient progress towards it. The relevant Commission forecast vintages estimate Italy’s output gap in 2015 at between -4% and -3% of potential GDP, which, pursuant to the Commission communication on "Making the best use of the flexibility within the existing rules of the SGP" of 13 January 2015 (hereafter, "Flexibility Communication"), signals "very bad times", entailing – for Member States with a general government debt ratio above 60% of GDP – a required structural adjustment towards the MTO of 0.25% of GDP. The relevant Commission forecast vintages estimate Italy’s output gap in 2016 at between -3% and -1.5% of potential GDP, which, pursuant to the Flexibility Communication, signals "bad times", entailing – for Member States with a general government debt ratio above 60% of GDP and growth above potential – a required structural adjustment towards the MTO of 0.5% of GDP. Italy’s DBP projects a (recalculated) structural effort of 0.2 pp. of GDP in 2015, followed by a 0.5 pp. of GDP structural deterioration in 2016 (see also Section 3.1).

For 2015, the (recalculated) structural effort planned by the government shows some deviation (gap of -0.1 pp. of GDP) from the required 0.25 pp. of GDP adjustment towards the

MTO over one year. The expenditure benchmark also shows some deviation over one year (gap of -0.3 pp of GDP). Overall, Italy's DBP plans some deviation from the required adjustment towards the MTO in 2015.

For 2015, the Commission forecast expects only a 0.1 pp. of GDP improvement in the structural balance[10], pointing to some deviation from the required adjustment towards the MTO over one year (gap of -0.2 pp. of GDP). The expenditure benchmark also points to a similar deviation over one year (gap of -0.2 pp. of GDP). This calls for an overall assessment. While both indicators are negatively affected by some factors, namely one-off measures for the expenditure benchmark and a tax-poor growth composition affecting the structural balance, even after correcting for them they would still point to some deviation. Overall, there is a risk of some deviation from the required adjustment towards the MTO in 2015.

For 2016, Italy's DBP was accompanied by a formal request to avail itself of 0.4 pp. of GDP additional flexibility, in addition to the 0.4% of GDP already granted in spring 2015 under the structural reform clause (SRC)[11]. The request includes an additional 0.1 pp. of GDP deviation under the SRC, thus exploiting the full space of 0.5% of GDP available under it. It also includes 0.3 pp. of GDP under the investment clause (IC), based on EUR 5.1 bn of national expenditure on projects co-financed by the EU, but including also the national quota of co-financing (0.05% of GDP) for EU projects under the European Agricultural Fund for Rural Development (EAFRD) and European Maritime Fisheries Fund (EMFF), which are not explicitly mentioned by the Flexibility Communication albeit they fall under priority thematic areas selected at EU level. This request takes place outside the normal European Semester cycle and departs from the process envisaged in the Flexibility Communication.

The eligibility criteria for the IC, based on the Commission forecast, appear to be fulfilled in 2016, as: (i) the output gap estimation is slightly worse than the required threshold for eligibility of -1.5% of potential GDP; (ii) public investments are forecast to marginally increase in 2016 compared to 2015 (by 0.9% y-o-y); and (iii) Italy's structural deficit is forecast to be below the threshold ensuring a safety margin against the risk that the deficit-to-GDP ratio breaches the 3%. As regards the SRC, any further flexibility would need to be considered on the basis of progress made with the structural reform agenda, taking into account the Council recommendations[12].

The following assessment of compliance with the required adjustment towards the MTO in 2016 is however carried out on the basis of the preventive arm requirement enshrined in the fiscal CSR (see Box 3).

In 2016, the (recalculated) structural deterioration planned by the government points to a significant deviation from the required 0.1 pp. of GDP adjustment towards the MTO over both one year (gap of -0.6 pp. of GDP) and two years (average gap of -0.3 pp. of GDP). The same applies to the expenditure benchmark over both one year (gap of -0.7 pp. of GDP) and two years (average gap of -0.5 pp. of GDP) as, according to the information provided in the DBP, the growth rate of government expenditure, net of discretionary revenue measures, will

10 Compared to spring 2015, the government increased the amount of one-off measures to compensate for lower permanent revenues.

11 As a result, the required adjustment in 2016 –as enshrined in the fiscal CSR- had already been lowered to 0.1% of GDP from 0.5% of GDP

12 Namely, as said, the enabling law to make Italy's tax system more efficient and equitable was only partially implemented, leaving out the important reform of cadastral values and the revision of tax expenditures, which were the focus of the 2015 CSR, and the abrogation of the property tax on primary residences is at odds with a long-standing recommendation to shift taxation onto property and away from productive factors.

exceed the applicable expenditure benchmark rate (-0.2% y-o-y in real terms) in 2016. Overall, Italy's DBP plans a significant deviation from the required adjustment towards the MTO in 2016.

For 2016, the Commission forecast expects a structural deterioration of 0.5 pp. of GDP, which suggests a significant deviation based on the structural balance pillar over both one year (gap of -0.6 pp. of GDP) and two years (average gap of -0.4 pp. of GDP). The expenditure benchmark pillar points instead to some deviation over both one year (gap of -0.3 pp. of GDP) and two years (average gap of -0.2 pp. of GDP) since, based on Commission 2015 autumn forecast, the growth rate of government expenditure, net of discretionary revenue measures, in 2016 will exceed the applicable expenditure benchmark rate (-0.2% y-o-y in real terms). This calls for an overall assessment. The discrepancy between the two indicators is mainly due to a revenue shortfall in 2016, not reflected in the expenditure benchmark, which is foreseeable and cannot be considered as temporary, as it is related to the current low inflation environment and subdued wage increases, leading to lower-than-usual tax elasticity[13]. Therefore, the structural balance seems to be a better indicator of the government's fiscal stance at the current juncture. On balance, the overall assessment points to a risk of a significant deviation from the adjustment path towards the MTO in 2016.

Following an overall assessment of Italy's DBP, with the structural balance as a reference, including an analysis of expenditure net of discretionary revenue measures, some deviation from the adjustment path towards the MTO is to be expected in 2015 and a significant deviation from the adjustment path towards the MTO is to be expected in 2016.

Notwithstanding these findings, Italy's fulfilment of the eligibility criteria for the investment clause is a factor that could be taken into account in the context of future assessments of a possible deviation from the required adjustment path, to the extent that the deviation is used for the purpose of increasing investments and that credible plans are in place to resume as of 2017 the normal pace of structural adjustment, in accordance with the matrix of preventive arm requirements of the Flexibility Communication. The factors underpinning the overall assessment could thus be reviewed as additional information becomes available.

[13] Another difference is related to the fact that the expenditure benchmark uses the deflator from the two previous vintages of the Commission forecast, while the structural balance reflects the actual inflation, which turned out much lower than forecast in spring 2015. While this might at first glance suggest that the expenditure benchmark is a better indicator of the fiscal stance from this perspective, the lower inflation than previously forecast is mainly the result of the repeal by the DBP of an already legislated VAT hike in 2016.

Table 7: Compliance with the requirements of the preventive arm

(% of GDP)	2014	2015		2016	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	-1.1	-1.0		-1.5	
Structural balance based on freezing (COM)	-0.8	-0.7		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2014**	**2015**		**2016**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.3		0.5	
Required adjustment corrected[5]	0.0	0.3		0.1	
Change in structural balance[6]	-0.1	0.2	0.1	-0.5	-0.5
One-year deviation from the required adjustment [7]	-0.1	-0.1	-0.2	-0.6	-0.6
Two-year average deviation from the required adjustment [7]	0.3	-0.1	-0.1	-0.3	-0.4
Expenditure benchmark pillar					
Applicable reference rate[8]	0.0	-0.5		-0.2	
One-year deviation [9]	0.2	-0.3	-0.2	-0.7	-0.3
Two-year average deviation [9]	0.8	-0.1	0.0	-0.5	-0.2
Conclusion					
Conclusion over one year	Overall assessment	Overall assessment	Overall assessment	Significant deviation	Overall assessment
Conclusion over two years	Compliance	Overall assessment	Overall assessment	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 2016 (DBP); Commission 2015 autumn forecast (COM); Commission calculations.

4.3. Implementation of reforms in the area of fiscal governance

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 2015 CSR. The enabling law to make the system of taxation more efficient and equitable was only partially implemented by its expiration date of 26 September. Namely, several legislative decrees have been adopted (e.g. on simplification of the tax system with pre-compiled tax declaration forms, revision of cadastral committees, review of tobacco taxation, electronic invoicing and improvement of the traceability of payments, tax law certainty, tax support to the internationalisation of firms, reorganisation of tax agencies, review of penal and administrative sanctioning system, simplification of tax debt recovery procedures, monitoring of tax evasion, and revision of tax expenditures, tax disputes and inquiries). However, neither a reform of cadastral values nor concrete action to rationalise tax expenditures, which are the focus of the 2015 CSR, have been implemented under the enabling law or are expected in the near future. In addition, the abrogation of the property tax on primary residences is not in line with the goal of achieving a more efficient tax structure by shifting taxation onto property and away from productive factors.

On the expenditure side, further spending review actions have taken place during 2015, but savings targets for the future have been reduced, also because they were too ambitious without touching big spending items such as pensions or areas such as public transport. More specifically, whereas the 2015 Stability Programme still announced savings worth EUR 10 billion (0.6% of GDP, of which 0.15% of lower tax expenditures), the draft 2016 Stability Law (which is now under discussion in the parliament and is expected to be adopted by the end of 2015) foresees less than half of the originally planned expenditure cuts. The spending cuts refer to both the central and the local level. With regard to the former, ministers are once again directly involved in selecting areas within their own budgets eligible for targeted savings. In this context, the government is also empowered to complete by the end of 2015 a reform of the budgetary process that could be more in line with a performance-budgeting approach over the medium term and ensure that the spending review process becomes a permanent feature of the budgetary process. Spending review measures in the DBP extend centralised public procurement to the regional level as envisaged by the Public Spending Rationalisation Programme. To this end, a decree law is expected by the end of 2015 to specify the product categories covered and the spending thresholds above which central and local administrations should avail themselves of centralised procurement. A technical working group gathered for the first time on 23 July 2015 and already identified the first twelve product categories in the healthcare sector. Moreover, the draft 2016 Stability Law further reduces the scope for decentralised procurement by local authorities and other government bodies, particularly for specific categories of goods and services, with the exception of Municipalities' purchases below EUR 40 000.

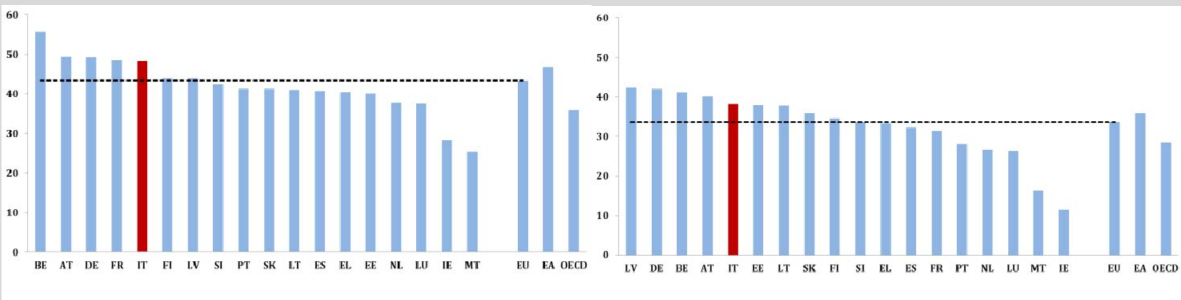
A comprehensive assessment of progress made with the implementation of the CSRs will be made in the 2016 Country Reports and in the context of the CSRs adopted by the Commission in May.

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 screen 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. Furthermore, the Eurogroup expressed its intention to take stock of the state of play in the reduction of the tax burden on labour when discussing the DBPs of euro area Member States.

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 (2014)



Notes: Data for Latvia, Lithuania and Malta is for 2013. 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.

This screening 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 2014 European Semester, Italy was issued the recommendation to "further shift the tax burden from productive factors to consumption, property, and the environment, in compliance with the budgetary targets" and "to this end, evaluate the effectiveness of the recent reduction in the labour tax wedge and ensure its financing for 2015, review the scope of direct tax expenditures, and broaden the tax base, in particular on consumption". Italy's 2015 DBP foresaw several provisions aimed at reducing the tax wedge on labour, including: (i) a permanent full deduction of the labour costs of employees under open-ended contracts from the taxable base of the regional tax on businesses (IRAP); (ii) the exemption of private employers (with the exception of the agricultural sector and household services) from social security contributions for three years for the new personnel hired under open-ended contracts during 2015; (iii) making permanent the tax credit to low-wage employees ("monthly bonus of EUR 80") first enacted in April 2014 and financed only for that year. Recognising the positive steps undertaken by Italy to reduce the tax wedge, no further recommendation was made in this sense to Italy in the context of the 2015 European Semester. It is worth noting that these measures were (and are still) expected to have a much higher impact on 2016 than in 2015, due to their phasing in.

Italy’s 2016 DBP still contains the following measure that affects the tax wedge on labour: namely, a reduction by 40%, for an overall duration of two years, on employers’ social contributions paid on new permanent employees hired in the course of 2016 (with a negative impact on revenues by 0.05% in 2016 and further 0.04% in 2017). This prolongs the previously enacted full exemption for three years for new personnel hired under open-ended contracts during 2015. This measure, among those that contribute to increasing the target deficit as compared to the trend scenario based on unchanged legislation, could help labour demand and thus job creation in the short term. This prolongs the previously enacted full exemption for three years for new personnel hired under open-ended contracts during 2015.

The measure is intended to support the broader reform of the labour market under Law 183/2014 (“Jobs Act”), which has revised dismissal rules for new hires under open-ended contracts and reduced the scope for atypical fixed-term contracts with the objective of tackling labour market duality. There is some preliminary evidence that the combination of incentives and new regulation are having an impact. According to data released by the Ministry of Labour[14], the number of new open-ended contracts increased by about 39% in the first seven months of 2015 compared to the first seven months of 2014, while new atypical fixed-term contracts (“*contratti di collaborazione*”) declined[15] by 23% over the same period. The share of all fixed-terms contracts on the total number of new contracts decreased by 4.7 pps from 76.3% to 72.6%[16]. In addition, the number of contract conversions from fixed-term to open-ended during the first seven months of 2015 increased by around 40% compared to the same period in 2014.

In its April 2015 Stability Programme, Italy requested a temporary deviation of 0.4% of GDP from the required adjustment path towards the MTO in 2016 in view of the planned implementation of major structural reforms with a positive impact on the long-term sustainability of public finances. The content, state of implementation and latest impact assessment of these structural reforms had been detailed in Italy’s 2015 NRP and summarised in the Stability Programme. The reform areas having an impact on public finance sustainability put forward in the Stability Programme included: (i) public administration and simplification; (ii) product and service markets; (iii) labour market; (iv) civil justice; (v) education; (vi) a tax shift; and (vii) spending review as financing measure. The overall impact of the reforms was estimated by the authorities at 1.8% of GDP by 2020 in the April 2015 Stability Programme and no updates are available at this stage. Since, based on the relevant vintage of the Commission forecast, Italy was expected to be within the maximum allowed distance of 1.5% of GDP from its MTO, which means that the structural balance was

14 www.cliclavoro.gov.it/Barometro-Del-Lavoro/Pagine/Andamento-Mercato-Lavoro.aspx.

15 Nonetheless, the decline partly reflects the effects of policy measures concerning apprenticeship contracts included in the 2014 Stability Law (Law 190/2014 of 23 December 2014).

16 Fixed-term contracts refer in this case to all contracts that are not open-ended.

expected to return to the MTO within the programme period, and taking into account that both the 3% reference value for the headline deficit and an appropriate safety margin with respect to the deficit reference value would be preserved after granting the requested deviation, Italy was assessed eligible to benefit from the requested structural reform clause, provided that the agreed reforms would be adequately implemented.

Overall, the implementation of the country-specific recommendations is progressing well in the labour market, education and banking policy areas. The enabling law for the reform of public administration was also adopted by the Parliament in summer 2015. The competition law and the reform of constitutional settings have advanced in the Parliament. Further progress is due in the reform of local public services and local public enterprises, in promoting second-level collective bargaining, and with regard to the long-awaited systematic revision of the statute of limitations. These reforms could raise Italy’s potential growth, also by removing bottlenecks to effective policy implementation, and thus enhance debt sustainability.

5. OVERALL CONCLUSION

Based on the DBP and the Commission 2015 autumn forecast, the structural improvement in 2015 falls short of the minimum linear structural adjustment to ensure sufficient progress towards compliance with the debt criterion. While the DBP plans compliance with the debt rule in 2016, the Commission forecast points to a risk of non-compliance.

The planned and forecast structural adjustment based on the DBP and the Commission forecast point to a risk of some deviation from the required adjustment path towards the MTO in 2015. Regarding 2016, based on the required adjustment path towards the MTO enshrined in the fiscal CSR, the assessment based on the DBP points to a significant deviation, in line with the conclusion of the overall assessment based on the Commission forecast. This conclusion would not change in case the budgetary impact of the exceptional inflow of refugees was excluded from the assessment.

In the context of the 'overall assessment' of a possible deviation from the adjustment path towards the MTO, Italy's possible eligibility for flexibility under the SGP can be taken into account. Particular attention will be paid to whether a deviation from the adjustment path is being effectively used for the purposes of increasing investments, to progress made with the structural reform agenda, taking into account the Council recommendations, and to the existence of credible plans for the resumption of the adjustment path towards the MTO.