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COMMISSION STAFF WORKING DOCUMENT

Analysis of the revised Draft Budgetary Plan of Italy

Accompanying the document

COMMISSION OPINION

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1. INTRODUCTION

Italy submitted its Draft Budgetary Plan for 2019 on 16 October 2018 in accordance with Regulation (EU) No 473/2013. On 23 October 2018, the Commission issued an Opinion on Italy's 2019 Draft Budgetary Plan, identifying a particularly serious non-compliance with the recommendation addressed to Italy by the Council on 13 July 2018 and requesting Italy to submit a revised Draft Budgetary Plan as soon as possible and in any event within three weeks of the date of that Opinion. Italy submitted a revised draft budgetary plan on 13 November 2018 ('revised DBP').

Italy is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium term budgetary objective (MTO). As the debt ratio was 131.2% of GDP in 2017, Italy also needs to comply with the debt reduction benchmark.

Section 2 of this document presents the macroeconomic outlook underlying the revised DBP and provides an assessment based on the Commission 2018 autumn forecast[1]. The following section presents the recent and planned fiscal developments, according to the revised DBP, including an analysis of risks to their achievement based on the Commission 2018 autumn forecast. In particular, it also includes an assessment of the measures underpinning the revised DBP. Section 4 assesses the recent and planned fiscal developments in 2018-2019 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2018, 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

The macroeconomic scenario underlying the revised 2019 DBP remains unchanged compared to the 2019 draft budgetary plan submitted on 16 October. Italy's revised 2019 DBP projects real GDP growth for 2018 at 1.2% (see Box 1), down from 1.5% forecast in the 2018 Stability Programme (SP). The slowdown in the manufacturing sector in combination with flagging

[1] Because the Commission autumn forecast was published on 8 November 2018, it is based on the 2019 draft budgetary plan and not on the revised 2019 draft budgetary plan. However, it should be considered that the macroeconomic projections and the fiscal targets are the same in both documents.

export growth as well as weak readings of short-term indicators related to the third quarter were key factors behind the downward revision. The output expansion is supported by domestic demand including inventories, while net exports are dragging down growth. The Commission forecast for real GDP growth of 1.1% in 2018 is close to the revised DBP's 1.2% which includes a higher estimate for the third quarter. In terms of growth contributions, the Commission forecast and the revised DBP are broadly aligned, but the revised DBP features a stronger impact from domestic demand and a negative contribution from net exports. The projected GDP deflator, at 1.3% for 2018, is in line with the Commission forecast.

For 2019, the revised DBP projects higher real GDP growth than the SP (1.5% vs. 1.4%), supported by a fiscal expansion, benefiting in particular private consumption and public investment. By contrast, the Commission forecast expects lower real GDP growth, at 1.2%, with a substantially lower positive contribution from domestic demand. Net exports are expected to be growth neutral, but the Commission projects a more moderate and delayed impact of budgetary measures. In addition, higher financing costs, also induced by a higher sovereign spread, are forecast to weigh on business investment. Concerning price developments, the revised DBP expects HICP headline inflation to rise in 2019 to 1.4% (from 1.3% in 2018), significantly lower than in the 2018 SP, and slightly lower than in the Commission forecast (1.5%). The revised DBP expects the unemployment rate to fall markedly more than the Commission forecast, albeit remaining at high levels (9.8% vs. 10.4%).

Overall, the revised DBP's macroeconomic assumptions for 2018 appear plausible, but are subject to increased downside risks in light of the ongoing deterioration of the economic situation. Growth projections for 2019 are markedly optimistic as regards both real and nominal GDP growth. The revised DBP's macroeconomic assumptions for 2019 are subject to high uncertainty and intensified downside risks. A prolonged rise in sovereign yields would worsen banks' funding conditions, further reduce credit supply and hamper private investment. Envisaged policy measures might prove less effective, having a lower impact on growth. Uncertainty about government policies might affect sentiment and domestic demand.

Box 1: The macroeconomic forecast underpinning the budget in Italy

Italy’s 2019 revised DBP is based on the macroeconomic scenario outlined in the update of the Economic and Financial Document (DEF) of 27 September 2018. The DEF update presents a trend scenario, based on the hypothesis of unchanged legislation, and a programme scenario, including the impact of the measures proposed in the revised DBP. Both macroeconomic scenarios have been prepared by the government. The Parliamentary Budget Office (PBO), Italy’s independent fiscal monitoring institution, endorsed the trend scenario but not the programme scenario observing that the estimates were outside the acceptable range given the information currently available. Compared to the trend scenario, the programme scenario presents a deficit target for 2019 of 2.4% of GDP (compared to 1.2%) and real GDP growth of 1.5% (compared to 0.9%).

The endorsement of the trend scenario and the non-endorsement of the programme scenario, mentioned in the revised DBP, took the form of two letters (dated 5 October and 14 October 2018, respectively) addressed to the Italian Minister of Economy and Finance and publicly available on the PBO’s website. In its parliamentary hearing on the DEF update, the PBO noted that the growth outlook for 2019 was overly optimistic and subject to high downside risks.

Table 1. Comparison of macroeconomic developments and forecasts

	2017	2018			2019		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	1.6	1.5	1.2	1.1	1.4	1.5	1.2
Private consumption (% change)	1.5	1.4	1.1	1.0	1.0	1.3	1.1
Gross fixed capital formation (% change)	4.3	4.1	4.4	3.7	2.8	3.7	2.0
Exports of goods and services (% change)	5.7	5.2	0.4	1.6	4.2	2.6	3.4
Imports of goods and services (% change)	5.2	5.4	1.7	2.6	4.0	3.0	3.7
Contributions to real GDP growth:							
- Final domestic demand	1.6	1.5	1.4	1.2	1.1	1.6	1.1
- Change in inventories	-0.4	0.0	0.1	0.1	0.1	-0.1	0.1
- Net exports	0.3	0.0	-0.3	-0.2	0.2	-0.1	0.0
Output gap[1]	-1.0	-0.3	-0.4	-0.3	0.3	0.4	0.3
Employment (% change)	1.2	0.8	0.9	1.0	0.8	1.0	0.8
Unemployment rate (%)	11.2	10.7	10.6	10.7	10.2	9.8	10.4
Labour productivity (% change)	0.6	0.8	0.3	0.1	0.6	0.5	0.2
HICP inflation (%)	1.3	1.1	1.3	1.3	2.2	1.4	1.5
GDP deflator (% change)	0.5	1.3	1.3	1.3	1.8	1.6	1.3
Comp. of employees (per head, % change)	0.2	1.5	1.7	1.8	1.0	1.5	0.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.7	2.5	2.6	2.5	2.7	2.5	2.4

Note:

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

Source:

Stability Programme 2018 (SP); revised Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The budgetary projections of the revised 2019 DBP remain unchanged compared to the 2019 draft budgetary plan submitted on 16 October, with the exception of slightly lower interest spending projected in 2019 by 0.1% of GDP, due to revised projections for government debt. As the budgetary target is kept unchanged, the primary balance projected in 2019 is also lower by 0.1% of GDP.

Italy's revised DBP projects that the general government deficit will decrease to 1.8% of GDP in 2018, from 2.4% of GDP in 2017. This is above the headline deficit projected by the

Stability Programme (1.6% of GDP), due to the revised macroeconomic outlook and increased sovereign interest rates. Based on the revised DBP, the structural balance[2] is projected to improve by 0.2% of GDP. The Commission 2018 autumn forecast projects the headline deficit at 1.9% of GDP in 2018, above the revised DBP due to more prudent assumptions on the size of public spending, including interests. Based on the Commission forecast, the structural balance is expected to remain stable at -1.8% of GDP in 2018.

The revised DBP projects the general government deficit to increase to 2.4% of GDP in 2019, up from 0.8% of GDP projected in the Stability Programme, notwithstanding similar economic growth projections. The upward revision from the Stability Programme largely results from the following factors: (i) the budgetary measures envisaged in the revised 2019 draft budgetary plan, with a net deficit-increasing impact of around 1.2% of GDP in the government projections; (ii) higher interest spending due to increased sovereign interest rates; (iii) a different macroeconomic trend scenario for 2019. Based on the revised DBP, the (recalculated) structural balance is expected to deteriorate by 0.9% of GDP in 2019. The Commission 2018 autumn forecast projects that Italy's general government deficit will rise to 2.9% in 2019. The difference with the revised DBP is mainly due to lower nominal GDP growth (2.5% compared to 3.1%), reflected in lower revenues in absolute terms, and higher projections for government spending, especially interest expenditure due to more conservative assumptions on sovereign interest rates. Based on the Commission 2018 autumn forecast, the structural balance is expected to deteriorate by 1.2% of GDP in 2019, to -3% of GDP.

In the government projections, the net deficit-increasing impact of the measures enshrined in the DBP is mainly on the spending side. On the revenue side, the main deficit-increasing measure is the abrogation of the increase in VAT rates previously legislated as a "safeguard clause" (around 0.7% of GDP) and included in the projections of the Stability Programme. Without considering the abrogation of the safeguard clause, the measures included in the revised DBP imply higher revenues in 2019. Overall, based on the government projections the measures included in the revised DBP are expected to have a significant impact on real GDP growth in 2019 (increasing to 1.5% in the programme scenario, up from 0.9% in the trend scenario). In comparison, based on the Commission forecast, where the "safeguard clauses" have not been included since autumn 2016, the overall net impact of the measures enshrined in the revised DBP is deficit-increasing by close to 0.6% of GDP, and the impact on growth is moderate.

Risks to both the revised DBP and the Commission deficit projections include: (i) worse-than-expected macroeconomic developments; (ii) lower-than-expected savings from the spending review; (iii) higher interest spending related to further increases in sovereign yields.

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

Table 2. Composition of the budgetary adjustment

(% of GDP)	2017	2018			2019			Change: 2017-2019
	COM	**SP**	**DBP**	**COM**	**SP**	**DBP**	**COM**	**DBP**
Revenue	**46.4**	**46.4**	**46.1**	**46.2**	**46.5**	**45.8**	**45.9**	**-0.5**
of which:								
- Taxes on production and imports	14.5	14.5	14.4	14.4	15.0	14.4	14.3	-0.1
- Current taxes on income, wealth, etc.	14.5	14.4	14.1	14.2	14.0	14.1	14.1	-0.4
- Capital taxes	0.1	0.0	0.1	0.1	0.0	0.1	0.1	-0.1
- Social contributions	13.1	13.4	13.3	13.3	13.3	13.3	13.2	0.2
- Other (residual)	4.2	4.1	4.2	4.3	4.2	3.9	4.2	-0.1
Expenditure	**48.7**	**48.0**	**48.0**	**48.1**	**47.2**	**48.3**	**48.8**	**-0.5**
of which:								
- Primary expenditure	44.9	44.5	44.3	44.5	43.7	44.6	45.0	-0.3
of which:								
Compensation of employees	9.5	9.7	9.6	9.7	9.3	9.4	9.5	-0.1
Intermediate consumption	5.5	5.4	5.5	5.5	5.3	5.4	5.3	-0.1
Social payments	22.4	22.5	22.4	22.4	22.2	22.9	23.1	0.5
Subsidies	1.5	1.5	1.5	1.5	1.5	1.5	1.5	-0.1
Gross fixed capital formation	2.0	2.0	1.8	1.9	2.0	2.1	1.9	0.1
Other (residual)	4.0	3.4	3.5	3.5	3.4	3.3	3.6	-0.6
- Interest expenditure	3.8	3.5	3.6	3.7	3.5	3.6	3.8	-0.2
General government balance (GGB)	**-2.4**	**-1.6**	**-1.8**	**-1.9**	**-0.8**	**-2.4**	**-2.9**	**0.0**
Primary balance	**1.4**	**1.9**	**1.8**	**1.7**	**2.7**	**1.2**	**1.0**	**-0.2**
One-off and other temporary measures	0.0	0.1	0.0	0.1	-0.1	-0.1	-0.1	-0.1
GGB excl. one-offs	**-2.4**	**-1.7**	**-1.9**	**-2.0**	**-0.7**	**-2.4**	**-2.8**	**0.0**
Output gap[1]	-1.0	-0.3	-0.4	-0.3	0.3	0.4	0.3	1.4
Cyclically-adjusted balance[1]	-1.9	-1.4	-1.6	-1.8	-0.9	-2.6	-3.0	-0.8
Structural balance (SB)[2]	**-1.8**	**-1.5**	**-1.6**	**-1.8**	**-0.8**	**-2.6**	**-3.0**	**-0.7**
Structural primary balance[2]	2.0	2.0	2.0	1.8	2.7	1.0	0.9	-0.9

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the revised DBP/programme as recalculated by Commission on the basis of the revised 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 2018 (SP); revised Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

Euro area sovereign bond yields remain at historically low levels, despite a rise observed in Italy in the course of 2018, with 10-year rates currently standing at 3.52[3]. Overall, total interest payments by the general government have continued to decrease as a share of GDP up to 2018. Based on the information included in the revised DBP, interest expenditure in Italy is expected to fall from 3.8% of GDP in 2017 to 3.6% in 2018 and to remain broadly stable next year, well below the 5.2% recorded in 2012 at the peak of the euro area sovereign debt crisis.

[3] 10-year bond yields as of 24 October 2018. Source: Bloomberg.

The Commission forecast projects slightly higher interest spending in 2018 compared to the revised DBP, and expects an increase in 2019. This is due to different projections as to the level of government debt and more conservative assumptions on sovereign yields next year, reflecting the high volatility observed in the Italian sovereign bond market in 2018.

The Italian authorities indicated in the draft budgetary plan submitted on 16 October that the budgetary impact of the extraordinary maintenance programme for the road network following the collapse of the Morandi bridge in Genoa is significant and should be considered as an unusual event outside the control of the government, for the purposes of Articles 5(1) and 6(3) of Regulation (EC) No 1466/97. More specifically, that expenditure is estimated at 0.05% of GDP in 2019. In the revised DBP, the Italian authorities indicated that the budgetary impact of a preventive plan to limit hydrogeological risks following adverse weather conditions is also significant and should be considered as an unusual event outside the control of the government, for the purposes of Articles 5(1) and 6(3) of Regulation (EC) No 1466/97. Overall, the expenditure related to the two events is estimated at 0.2% of GDP in 2019.

3.2. Debt developments

The debt-to-GDP ratio reached 131.2% in 2017, i.e. 0.2 percentage points lower than in 2016. The decrease was limited partly due to a still large debt-increasing “snowball” effect, related to a positive interest rate-growth rate differential. On the other hand, a broadly stable primary surplus at 1.4% of GDP helped to curb debt dynamics in 2017. The stock-flow adjustment was slightly debt-increasing in 2017 (0.2%), mainly due to the support to the banking sector, partly offset by the reduction in the liquidity buffer, while there were no privatisation proceeds.

Compared to the 2019 draft budgetary plan submitted on 16 October, the revised 2019 DBP projects a stronger reduction of the debt-to-GDP ratio from 2019, as the privatisation target for 2019 is increased to 1% of GDP from 0.3% of GDP.

In 2018, the revised DBP projects the debt-to-GDP ratio to decrease to 130.9%, down by 0.3 percentage point from the 2017 level. The projected dynamics is mainly the result of a declining although still debt-increasing “snowball” effect (0.5% of GDP), and a small improvement in the primary surplus (to 1.8% of GDP) more than offsetting the debt-increasing stock-flow adjustment (1.0% of GDP). For 2019, the revised DBP projects a decline in the debt-to-GDP ratio by 1.7 percentage points to 129.2%, mainly triggered by a debt-decreasing "snowball" effect, explained by a strong projected increase in nominal growth as compared to 2018. The projected acceleration in nominal growth is expected to offset a shrinking primary surplus (reaching 1.2% of GDP). The projected stock-flow adjustment is debt-decreasing due to the projected privatisation proceeds (1% of GDP).

The Commission 2018 autumn forecast projects the debt ratio to remain broadly stable at around 131% of GDP in 2018 and 2019. In 2018 the difference from the revised DBP is due to a slightly lower projected primary surplus and a higher "snowball" effect, related to marginally higher projections for the real implicit cost of debt. In 2019, the Commission projects significantly lower nominal growth and higher interest spending, reflected in a still sizable debt-increasing "snowball" effect. Furthermore, the Commission projects a lower primary surplus and assumes significantly lower privatisation proceeds in 2019, based on the track record in past years. Risks to both the Commission and the revised DBP debt projections are related to a worse-than-anticipated growth outlook, stronger deterioration of the primary balance, lower inflation or privatisation proceeds, and higher-than-expected interest spending.

Table 3. Debt developments

(% of GDP)	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**131.2**	**130.8**	**130.9**	**131.1**	**128.0**	**129.2**	**131.0**
Change in the ratio	-0.1	-0.4	-0.3	-0.1	-2.8	-1.7	-0.1
Contributions[2] *:*							
1. Primary balance	**-1.4**	**-1.9**	**-1.8**	**-1.7**	**-2.7**	**-1.2**	**-1.0**
2. "Snow-ball" effect	**1.1**	**-0.2**	**0.5**	**0.6**	**-0.5**	**-0.3**	**0.7**
Of which:							
Interest expenditure	3.8	3.5	3.6	3.7	3.5	3.6	3.8
Growth effect	-2.0	-1.9	-1.5	-1.5	-1.8	-1.9	-1.5
Inflation effect	-0.6	-1.8	-1.6	-1.6	-2.2	-2.0	-1.7
3. Stock-flow adjustment	**0.2**	**1.7**	**1.0**	**1.1**	**0.5**	**-0.1**	**0.2**
Of which:							
Cash/accruals difference		0.8	0.5		0.6	0.5	
Net accumulation of financial		0.2	0.0		0.1	-0.7	
of which privatisation proceeds		-0.3	-0.3		-0.3	-1.0	
Valuation effect & residual		0.0	0.5		0.0	0.1	

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 2018 (SP); revised Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The main provisions included in the revised 2019 DBP remain broadly the same as those envisaged by the 2019 draft budgetary plan previously submitted on 16 October. These provisions were further specified in two legislative proposals: the "fiscal decree"[4], and the draft budget law, submitted to the Parliament on 31 October and currently under discussion.

The main deficit-increasing measures for 2019 include: the abrogation of the increase in VAT rates previously legislated as a "safeguard clause" (around 0.7% of GDP); the allocation of a fund of around 0.4% of GDP to strengthen public employment services and introduce a citizenship income for inactive or unemployed adults, with the exact amount of the allowance and access conditions to be legislated at a later stage; the allocation of a fund of around 0.4% of GDP to introduce higher flexibility for early retirement, with the exact conditions and minimum threshold to be legislated at a later stage; measures (around 0.2% of GDP) to support public investment, including by creating two funds for investments planned at the

[4] Decreto Legge, 23 ottobre 2018, n. 119, *Disposizioni urgenti in materia fiscale e finanziaria*.

central and at the local level and setting up new bodies in charge of streamlining administrative procedures and supporting implementation; a tax reform extending the scope of the simplified tax regime for the self-employed, by widening access conditions to a forfeit 15% tax rate on yearly turnover paid as a substitute of the personal income tax, and reducing to 15% the corporate income tax rate on firms' profits used to increase investment or to hire new employees, under specific conditions.

The main deficit-reducing measures for 2019 include: the abrogation of previously-legislated favourable tax regimes for firms (around 0.3% of GDP), including a simplified personal income tax regime for entrepreneurial activities ("*Imposta sul Reddito Imprenditoriale*"), existing tax incentives for firms' capital uplifts ("*Aiuto alla Crescita Economica*"), and the tax deductibility of specific costs and budgetary losses for some categories of firms, especially banks;[5] a spending review at different levels of government (around 0.2% of GDP); and various tax amnesty provisions aimed at collecting past unpaid tax liabilities and settling pending tax-related litigation, while encouraging tax compliance through the extension of the compulsory electronic transmission of invoices also to transactions with final consumers.

The abrogation of previously legislated favourable tax regimes for firms will increase revenues already in 2019, while the tax cuts – although being implemented as of 2019 – will produce their main budgetary impact from 2020. Therefore, the overall impact of the change in the tax regime will be revenue-increasing in 2019 and broadly neutral from 2020. Similarly, the strengthened provisions for the electronic transmission of invoices and the tax amnesty provisions will produce their main budgetary impact as of 2020.

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. As the debt ratio was 131.2% of GDP in 2017, above the 60% Treaty threshold, Italy is also subject to the debt reduction benchmark.

Box 2. Council recommendations addressed to Italy

On 13 July 2018, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended that Italy take action in 2018 and 2019 to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1% in 2019, corresponding to an annual structural adjustment of 0.6% of GDP, and to use windfall gains to accelerate the reduction of the general government debt ratio.

5 More specifically, the tax deductibility of the goodwill and other intangible assets related to past operations is lowered by spreading it over eleven years; the tax deductibility of credit losses incurred in 2018 is postponed to 2026; the tax deductibility of losses due to the implementation of new accounting principles is lowered by spreading it over ten years; and the advance payment of the tax on insurances is increased.

4.1. Compliance with the debt criterion

As the debt ratio was 131.2% of GDP in 2017, Italy needs to comply with the debt reduction benchmark.

In 2017, based on notified data and the Commission forecast, Italy did not comply with the debt reduction benchmark (gap to the debt benchmark of 6.6% in 2017). On 23 May 2018, in view of Italy's prima facie non-compliance with the debt reduction benchmark in 2016 and 2017, the Commission adopted a report under Article 126(3) of the Treaty on the Functioning of the European Union, analysing whether Italy was compliant with the debt criterion of the Treaty. After considering all the relevant factors and in particular Italy's compliance with the preventive arm, the report concluded that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as complied with at that stage. Italy's particularly serious non-compliance identified by the Commission with the recommendation addressed to it by the Council on 13 July 2018 represents a material change in the relevant factors analysed by the Commission on 23 May 2018. That calls for revisiting the Commission's assessment.

Based on the revised DBP, Italy is not projected to comply with the debt reduction benchmark either in 2018 (gap to the debt benchmark of 3.7% of GDP) or in 2019 (gap to the debt benchmark of 3.6% of GDP). This conclusion is confirmed based on the Commission forecast (gap to the debt benchmark of 6.6% and 6.7% of GDP in 2018 and 2019 respectively).

Based on an overall assessment of the revised DBP, the debt reduction benchmark is expected not to be met either in 2018 or in 2019.

Table 4. Compliance with the debt criterion*

	2017	2018			2019		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	131.2	130.8	130.9	131.1	128.0	129.2	131.0
Gap to the debt benchmark [1,2]	6.6	1.3	3.7	6.6	0.8	3.6	6.7
Structural adjustment [3]	-0.3	0.1	0.2	0.0	0.7	-0.9	-1.2
To be compared to:							
Required adjustment [4]							

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 2018 (SP); revised Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations

4.2. Adjustment towards the MTO

Italy is subject to the preventive arm of the SGP and has to ensure compliance with the required adjustment towards the MTO. As regards **2018**, Italy was recommended to ensure a nominal rate of reduction of net primary government expenditure of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP. However, the Commission Communication on the 2017 European Semester of May 2017[6] stated that the Commission would stand ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment could be particularly significant. Following the Commission's assessment of the strength of the recovery in Italy while giving due consideration to its sustainability challenges, carried out in the context of its opinion on Italy's 2018 Draft Budgetary Plan, a fiscal structural effort of at least 0.3% of GDP is required for 2018, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary government expenditure not exceeding 0.5%.

Based on the revised DBP, the expenditure benchmark points to an inadequate fiscal adjustment in 2018, because the growth rate of Italy's government expenditure, net of discretionary revenue measures and one-offs, is expected to exceed that recommended by the Council. In addition, the improvement in the (recalculated) structural balance planned by the government for 2018 (0.2% of GDP) is less than the adequate structural adjustment of 0.3% of GDP. An overall assessment based on the government plans points to a risk of significant deviation from the adjustment path towards the medium-term budgetary objective recommended by the Council for 2018. Based on the Commission 2018 autumn forecast, the overall assessment based on the government plans is confirmed, because the expenditure benchmark points to an inadequate fiscal adjustment in 2018, and the same indication is provided by the structural balance pillar.

For **2019**, Italy is recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1%, corresponding to an annual structural adjustment of 0.6% of GDP.

Based on the revised DBP, the expenditure benchmark points to a risk of significant deviation both in 2019 (gap of 1.3% of GDP) and over 2018 and 2019 taken together (gap of 0.9% of GDP per year, on average, taking into account the adjustment for both years recommended by the Council), because the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed that recommended by the Council. The same indication is provided by the structural balance pillar, which points to a risk of significant deviation both over one year (gap of 1.5% of GDP in 2019) and over 2018 and 2019 taken together (gap of 1.0% per year, on average, taking into account the adjustment for both years recommended by the Council). That finding would not change after considering the reduced requirement in 2018 following the application of the margin of discretion. An overall assessment based on the government plans points to a particularly serious non-compliance with the adjustment path towards the medium-term budgetary objective recommended by the Council for 2019. That conclusion would not change even if the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were considered an unusual event outside the control of the Member State concerned for the purposes of Article 5(1) and Article 6(3) of Regulation (EC)

[6] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

No 1466/97 and subtracted from the requirement of the preventive arm of the Stability and Growth Pact.

Based on the Commission 2018 autumn forecast, the overall assessment based on the government's plans is confirmed, because the expenditure benchmark also points to a risk of significant deviation both in 2019 (gap of 1.5% of GDP) and over 2018 and 2019 taken together (gap of 1.3% of GDP per year, on average, taking into account the adjustment for both years recommended by the Council). The same indication is provided by the structural balance pillar, which points to a risk of significant deviation both over one year (gap of 1.8% of GDP in 2019) and over 2018 and 2019 taken together (gap of 1.2% per year, on average, taking into account the adjustment for both years recommended by the Council). That finding would not change after considering the reduced requirement in 2018 following the application of the margin of discretion.

An overall assessment based on the revised DBP and the Commission 2018 autumn forecast points to a risk of significant deviation from the adjustment path towards the MTO in 2018 and to a particularly serious non-compliance in 2019. That conclusion would not change even if the budgetary impact (around 0.2% of GDP) of the extraordinary maintenance programme for the road network and connections following the collapse of the Morandi bridge in Genoa and of a preventive plan to limit hydrogeological risks following adverse weather conditions were considered as unusual events outside the control of the Member State concerned for the purposes of Articles 5(1) and 6(3) of Regulation (EC) No 1466/97 and subtracted from the requirement of the preventive arm of the Stability and Growth Pact.

Table 5: Compliance with the requirements of the preventive arm

(% of GDP)	2017	2018		2019	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	-1.8	-1.8		-3.0	
Structural balance based on freezing (COM)	-2.0	-1.7		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2017**	**2018**		**2019**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.6	0.6		0.6	
Required adjustment corrected[5]	0.2	0.6		0.6	
Change in structural balance[6]	-0.3	0.2	0.0	-0.9	-1.2
One-year deviation from the required adjustment [7]	-0.5	-0.4	-0.6	-1.5	-1.8
Two-year average deviation from the required adjustment [7]	-0.4	-0.4	-0.5	-1.0	-1.2
Expenditure benchmark pillar					
Applicable reference rate[8]	-0.6	-0.2		0.1	
One-year deviation adjusted for one-offs [9]	-0.3	-0.6	-1.1	-1.3	-1.5
Two-year average deviation adjusted for one-offs [9]	-0.1	-0.4	-0.7	-0.9	-1.3

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points (p.p.) is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance = cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 38.).

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

[6] Change in the structural balance compared to year t-1. Ex post assessment (for 2017) was carried out on the basis of Commission 2018 spring forecast.

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

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

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

Source :

Revised Draft Budgetary Plan for 2019 (DBP); Commission 2018 autumn forecast (COM); Commission calculations.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

The adjustment planned by the revised DBP entails an increase in overall government expenditure as a share of GDP by 0.3 percentage point in 2019. In particular, social payments will substantially increase, from 22.4% of GDP in 2018 to 22.9% of GDP in 2019, mainly as an effect of the funds allocated for the minimum income and the early retirement scheme. Public investment, which is expected to decline from 2% of GDP in 2017 to 1.9% of GDP in 2018, is projected by the revised DBP to increase to 2.1% of GDP in 2019 as a result of the additional funds allocated and the measures taken to support administrative procedures. Conversely, government revenues are expected to decline as a share of GDP by 0.3 percentage point.

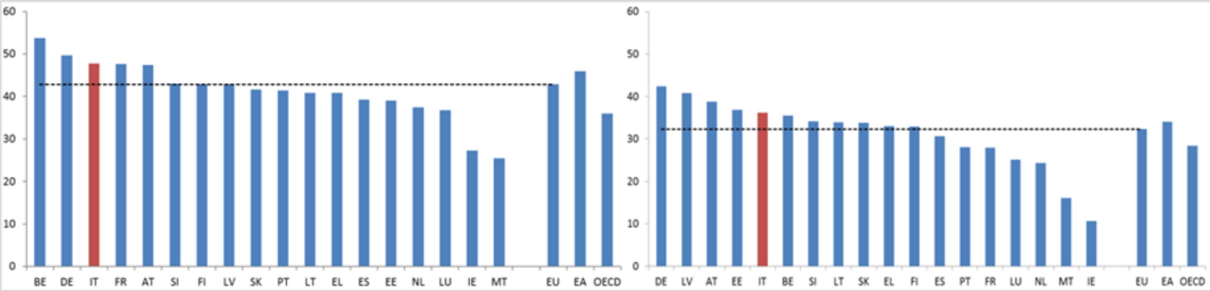
The measures included in the revised DBP indicate a risk of backtracking on reforms that Italy had adopted in line with past Country-Specific Recommendations, as well as with regard to the structural fiscal aspects of the recommendations addressed to Italy by the Council on 13 July 2018. In particular, while the Council recommended that Italy should reduce the share of old-age pensions in its public spending to create space for other social spending, the newly introduced possibility for early retirement backtracks on earlier pension reforms that underpin the long-term sustainability of Italy's sizeable public debt. It may also have a negative impact on the labour supply, in a context where Italy is already lagging behind the EU average for the participation of its older workers (55-64) in employment. Moreover, the introduction of a tax amnesty could discourage tax compliance, thereby largely offsetting the potential positive effect of strengthened electronic invoicing. Furthermore, while the revised DBP includes provisions lowering the tax burden on firms hiring or reinvesting their earnings in capital goods, the impact of those provisions is largely offset in 2019 by the abrogation of existing favourable tax regimes on firms and on reinvested earnings. Last, the newly introduced measures increasing taxation on banks, together with the impact of higher sovereign yields, could hinder the supply of credit. Taken together, the growth impact of the policy measures underlying the 2019 draft budgetary plan may be smaller than projected by the government even in the short term. Overall, the revised 2019 DBP does not envisage effective measures to tackle Italy's sluggish potential growth and, in particular, its long-lasting stagnation in productivity.

Box 3 – 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 (2017)



Notes: 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 2018 European Semester, Italy received the recommendation to "(...) Shift taxation away from labour, including by reducing tax expenditure and reforming the outdated cadastral values (...)". Italy's revised DBP contains one measure that affects the tax wedge on labour, namely the extension of the simplified tax regime for self-employed workers, by loosening access conditions. Currently, self-employed workers with yearly turnovers below sector-specific thresholds have the option to pay, as a substitute of the personal income tax, a forfeit 15% tax rate on their yearly turnover adjusted for specific "profitability coefficients". With the new regime, all thresholds for yearly turnover, which currently vary across sectors of activity and range up to EUR 55 000, are harmonised and raised to EUR 65 000. In addition, several other access conditions, such as maximum yearly thresholds for specific kinds of expenditures incurred, are removed. The measure is expected to reduce personal income taxes paid by self-employed workers who did not qualify for the simplified regime so far, with an overall structural negative impact on revenues of 0.1% of GDP.

6. OVERALL CONCLUSION

Based on the revised DBP and the Commission 2018 autumn forecast, Italy is not projected to comply with the debt reduction benchmark in 2018 and 2019. In 2018, both the revised DBP and the Commission forecast point to a risk of significant deviation from the fiscal structural effort considered adequate by the Commission in order to balance Italy's stabilisation needs and sustainability challenges. In 2019, the large structural deterioration projected by the revised DBP (0.9% of GDP) and the Commission forecast (1.2% of GDP) indicate a particularly serious non-compliance from the recommended adjustment path towards the MTO. That conclusion would not change even if the budgetary impact of the extraordinary maintenance programme for the road network and the prevention plan to secure the national territory against hydrogeological risks were considered an unusual event outside the control of the Member State concerned for the purposes of Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 and subtracted from the requirement of the preventive arm of the Stability and Growth Pact.