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2015 Budgetary Planning Report

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CONTENTS

FOREWORD

This *Budgetary Planning Report* is devoted to analysing the 2015 Economic and Financial Document (EFD) presented by the Government on 10 April this year.

The report is organised into four chapters. The first is devoted to an analysis of the EFD's macroeconomic forecasts for the period 2015-2019, their validation and a discussion of the risks inherent in the economic scenario, especially as regards future developments in international variables.

The second chapter examines the trend and policy scenarios for the public finances, developments in the public debt and the threats to the sustainability of the public finances.

The third chapter discusses the most significant areas that could be impacted by the review of public spending and the reorganization of tax relief measures referred to in the EFD.

An assessment of the consistency of the EFD with the European fiscal rules (medium-term objective, expenditure, debt) is provided in the fourth chapter, together with a discussion of the structural reform clause invoked in the EFD.

Finally, the fifth chapter is devoted to an analysis of the impact that the recent ruling of the Italian Constitutional Court on the revaluation of pensions could have on compliance with the fiscal rules.

1. THE MACROECONOMIC ENVIRONMENT

1.1 International economic outlook

The world economy continues to expand, albeit at a relatively slow pace. Economic activity appears to be accelerating in the advanced countries and decelerating in the emerging economies. Specifically, growth in the United States has been faster than expected thanks above all to consumption, which has been buoyed by the more favourable outlook for employment, by lower oil prices and by greater household confidence. Conversely, growth in China is in line with expectations, but the relatively moderate expansion of investment could have an adverse impact on future growth. Together with the decline in the prices of raw materials, this could have a negative impact on the economies of the other export-oriented emerging economies and, more generally, on world growth, which has also been adversely affected by a resurgence of geopolitical tensions.

In the euro area, signals in the final part of 2014 point to a more robust recovery in economic activity. This reflects stronger growth in consumption and net exports, while the performance of investment remains below expectations owing to considerable spare capacity, policy uncertainty concerning the institutional architecture of the euro area – especially as consequence of the difficult negotiations in the Greek crisis – and persistently unfavourable (albeit improving) credit conditions. In the coming months, growth should receive a further boost from the depreciation of the euro, the sharp reduction in oil prices and the acceleration of world trade. Conversely, the continuing risk of a prolonged period of deflation, the necessary process of deleveraging in both the private and public sectors, the large stock of bad debts and high unemployment could all hold back growth.

Multiple initiatives have been launched to sustain economic activity in the euro area and the European Union in general. First, the European Central Bank (ECB) initiated a programme of financial asset purchases – including government securities – that is more ambitious than expected, with the primary objective of raising inflation expectations, which have been well below the ECB’s target for many months now. The programme has already improved financial conditions in the euro area and triggered a steep depreciation of the euro. In addition, credit markets have benefited from the completion of the “comprehensive assessment” of banks' balance sheets, which enhanced the transparency of the financial position of financial institutions, and from the start of the single supervisory mechanism, one of the pillars of the European banking union.

As regards budgetary policy, the European Commission has clarified the scope of the flexibility allowed in the Stability and Growth Pact for countries experiencing bad economic times, that implement major structural reforms or that intend to raise the level of public investment. At the same time, the fiscal stance of the Member States appears less restrictive than in the recent past. Finally, the Commission has prepared an Investment Plan for Europe (the Juncker Plan), which hinges on the establishment of a European Fund for Strategic Investments financed by the Commission itself and the European Investment Bank.

1.2 Domestic economic outlook

In 2014, Italy's real GDP contracted by -0.4 per cent, compared with a forecast of -0.3 per cent in the Update of the EFD 2014 (see Box 1.1).

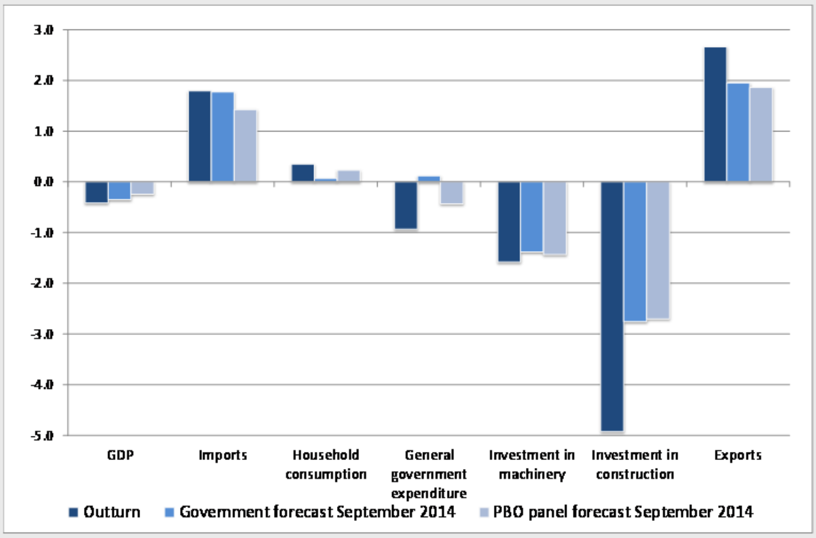
More recently, no clear signs of expansion have emerged from indicators of economic activity, although business and consumer confidence surveys point to a significant improvement in the outlook. Beginning in the second half of 2014, industrial production and turnover stabilized, while orders displayed a slightly stronger rising trend, driven in particular by orders from abroad. Other evidence of an acceleration in foreign demand is provided by export figures, especially for sales to non-EU countries thanks to the substantial depreciation of the euro in recent months. On the other hand, growth in consumption is less buoyant, with the retail sector essentially stable, probably because of the persistent uncertainty clouding the outlook for the labour market. Confidence indicators have improved considerably in recent months, however. The strongest increase in business confidence has been registered in the service sector and, to a lesser extent, in manufacturing. Initial signals of an improvement have also been seen in the retail trade and construction sectors, a development that appears confirmed by the increase in household demand for credit, comprising both consumer credit and loans for house purchases.

Although the labour market remains affected by the uncertainty engendered by developments in recent months, surveys of business and household confidence find clearer signs of optimism for the immediate future. Employment has held steady for a number of months, although the unemployment rate remains high. Nevertheless, the Ministry of Labour's data for the first months of the year reveal a trend among companies to transform fixed-term contracts into permanent jobs, probably the result of the fiscal incentives introduced by the Government. In the coming months, businesses and households expect employment to increase and unemployment to decline.

Box 1.1 – Forecast and actual macroeconomic conditions in 2014

The contraction in GDP in 2014 was slightly larger than forecast by the Government in September (-0.4 per cent, compared with the September forecast of -0.3 per cent. Figure 1.1). This was primarily attributable to worse than expected performance in the construction sector and, to a lesser extent, in investment in machinery.

Figure 1.1 – Comparison of forecasts and outturn for the sources and uses of income account in 2014
(percentage changes)



Source: based on Istat figures and MEF and PBO panel forecasts.

These factors were only partly offset by the better-than-expected performance of net exports, probably associated in part with the depreciation of the euro towards the close of the year, and of household consumption. The latter may have been sustained by an improvement in real disposable income due to very low or negative inflation rates – thanks in part to the milder-than-forecast impact of imported inflation – and the slight improvement in employment (expressed in terms of labour units).

Similar conclusions can be drawn from a comparison of Istat figures for actual growth and the average of the forecasts of the forecasting panel consulted by the PBO in September. In this case, the average forecast for GDP growth in September was even more favourable (-0.2 per cent), due above all to the larger expected contribution of net exports.

Developments in wages and prices are consistent with a modest recovery in economic activity. Wages have been rising at a stable and moderate pace since the middle of last year (about 1 per cent for contractual wages in March, due in part to the stability of wages in government jobs), and most public- and private-sector employees (about 60 per cent) are awaiting contract renewals. In the absence of internal pressures and with year-on-year import prices falling sharply, the rate of consumer price inflation is still negative or close to zero. Core inflation (i.e. net of the prices of unprocessed food and energy products) is positive but declining (0.4 per cent in March, down from 0.6 per cent in February).

The recovery in economic activity could be supported by the improving lending conditions in the credit market. The most recent surveys of bank lending conducted by the Bank of Italy point to an easing of terms and conditions for loans to both firms and households, albeit after a long period of substantial restrictions. In addition, lending rates continued to fall thanks to the transmission of the downward pressure of monetary-policy interest rates. Nevertheless, credit surveys point to stability in firms' investment demand, which likely reflects continuing scepticism about the opportunity of undertaking new investments in an environment of relatively low capacity utilization.

1.3 The macroeconomic scenario in 2015-19

As with the Update of the 2014 EFD, the 2015 EFD contains both a macroeconomic trend scenario, which considers the public finances on a current legislation basis, and a policy scenario, which reflects assumptions about possible budget measures that would be defined in the next budget session and the impact of the structural reforms established by the Government.

For 2015, the policy scenario of the 2015 EFD forecasts GDP growth at 0.7 per cent, the result of virtually identical contributions from net exports and domestic demand (Table 1.1). The current GDP growth projection is slightly higher than the previous policy forecast (0.6 per cent) owing to the considerably more favourable assumption about the exchange rate, which has produced an upward revision of the contribution of net exports. That revision was partly offset by a downward adjustment of domestic demand net of the change in inventories owing to less optimistic forecasts for consumption and investment in construction. On the inflation front, the current forecast for the increase in the growth rate of the consumption deflator (0.4 per cent) is broadly unchanged on that used in September, despite the substantial decline in the prices of imports associated with the decline in oil prices. The forecast for employment growth in terms of labour units (0.6 per cent) was revised significantly upwards, partly as a consequence of the stronger-than-expected performance registered in the final part of 2014.

The policy scenario of the EFD forecasts an acceleration in GDP in the years after 2015, when the rate of GDP growth is expected to rise to 1.4 per cent in 2016 and 1.5 per cent in 2017, before declining to 1.4 per cent in 2018 and 1.3 per cent in 2019. This performance reflects a significant increase the contribution of domestic demand net of the change in inventories, only partly offset by a decline in the contribution of net exports. More specifically, investment in machinery and equipment is expected to expand at rate of more than 4 per cent in 2016-17, before slowing to 3½ per cent in 2018 and about 3¼ per cent in 2019. Household consumption is also forecast to increase at a rapid clip, with growth averaging more than 1¼ per cent over the four years, with a peak of 1.4 per cent in 2017. Prices are also expected to accelerate to an annual average of just under 2 per cent in 2017. The unemployment rate would also decline steadily over the forecasting period, but would still be above 10 per cent in 2019.

Compared with the policy forecasts from last September, the projections in the EFD for 2016-17 have been revised upwards thanks to more favourable external conditions (lower oil prices and the depreciation of the euro), to lower interest rates and to a less restrictive fiscal stance due to the adjustment of the safeguard clauses provided for in the EFD. Conversely, despite the improvement in exogenous variables, the policy forecast for GDP growth in 2018 is unchanged, reflecting more prudent assumptions about the impact of the structural reforms on GDP growth, which is now estimated at zero until 2017, 0.1 percentage points in 2018 e and 0.2 points in 2019.

The EFD's policy scenario also envisages a gradual rise in the rate of potential GDP growth, from a negative 0.4 per cent in 2014 to a positive 0.5 per cent in 2019 (Table 1.2). The labour factor makes the largest contribution to the increase, but capital and total factor productivity (a proxy for technological progress) are also expected to make a positive contribution to the potential growth rate in the closing part of the forecasting period. With actual GDP growth rising more rapidly than potential growth, the output gap should therefore improve from its sharply negative level in 2014 (-4.6 per cent) to 0.5 per cent in 2019. These forecasts are similar to those published in the Update of the 2014 EFD.

Table 1.1 – Macroeconomic scenario
(percentages)

	2014		2015			2016			2017			2018			2019	
	Outturn	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend
EXOGENOUS INTERNATIONAL VARIABLES																
International trade	3.2	4.0	4.0	4.0	5.1	5.3	5.3	5.2	5.3	5.3	5.2	5.4	5.4	5.4	5.4	5.4
Oil price	99.0	104.7	56.7	56.7	98.5	57.4	57.4	98.5	57.4	57.4	98.5	57.4	57.4	98.5	57.4	57.4
Dollar/euro exchange rate	1.33	1.34	1.08	1.08	1.29	1.07	1.07	1.29	1.07	1.07	1.29	1.07	1.07	1.29	1.07	1.07
SOURCES AND USES ACCOUNT (VOLUMES)																
GDP	-0.4	-0.3	0.7	0.7	0.6	1.4	1.3	1.0	1.5	1.2	1.3	1.4	1.1	1.4	1.3	1.1
Imports	1.8	1.8	2.9	2.9	3.4	3.8	3.5	3.2	4.6	3.8	3.4	4.2	3.9	3.4	3.8	3.6
Final national consumption	0.0	0.1	0.3	0.3	0.6	0.8	0.7	0.7	1.0	0.7	1.0	1.0	0.8	1.0	1.0	0.8
- Household consumption	0.3	0.1	0.8	0.8	1.0	1.2	0.8	1.0	1.4	0.9	1.3	1.3	1.0	1.3	1.2	1.0
- General government expenditure	-0.9	0.1	-1.3	-1.3	-0.5	-0.5	0.4	-0.3	0.0	-0.1	0.0	0.0	0.0	0.2	0.3	0.3
Investment	-3.3	-2.1	1.1	1.1	1.5	2.7	2.1	2.1	3.0	2.3	2.0	2.8	2.2	1.8	2.4	2.1
- Investment in machinery and equipment	-1.7	-1.4	2.5	2.5	2.2	4.1	3.0	2.7	4.1	2.9	2.6	3.5	2.8	2.3	3.2	2.7
- Investment in construction	-4.9	-2.8	-0.3	-0.3	0.8	1.4	1.2	1.5	1.9	1.6	1.5	2.0	1.6	1.2	1.6	1.4
Exports	2.7	1.9	3.8	3.8	2.8	4.0	4.0	3.1	3.9	4.0	3.3	3.7	3.8	3.7	3.6	3.6
CONTRIBUTIONS TO GDP GROWTH																
Net exports	0.3	0.1	0.4	0.4	-0.1	0.2	0.3	0.1	0.0	0.2	0.1	0.0	0.1	0.0	0.1	0.1
Domestic demand net of changes in inventories	-0.6	-0.3	0.4	0.4	0.7	1.1	0.9	1.0	1.3	0.9	1.1	1.3	1.0	1.1	1.2	1.0
Changes in inventories	-0.1	-0.1	0.0	0.0	0.0	0.1	0.1	0.0	0.1	0.0	0.1	0.0	0.0	0.1	0.0	0.0
PRICES																
Import deflator	-2.5	-1.7	-1.6	-1.6	0.9	0.8	1.2	1.4	1.7	1.7	1.5	1.8	1.7	1.5	1.8	1.8
Export deflator	-0.3	-0.5	0.5	0.5	1.0	1.7	1.5	1.4	1.8	1.8	1.6	2.0	2.0	1.6	1.8	1.8
Consumption deflator	0.2	0.4	0.4	0.4	0.5	1.0	1.8	1.8	1.9	1.9	2.0	1.8	1.6	1.9	1.7	1.7
GDP deflator	0.8	0.8	0.7	0.7	0.6	1.2	1.7	1.6	1.8	1.8	1.8	1.9	1.8	1.8	1.8	1.8
LABOUR																
Unit labour costs (percentage of GDP)	1.2	0.3	0.4	0.4	0.3	1.1	1.0	0.6	0.8	0.8	0.7	1.2	1.2	0.8	1.0	0.9
Employment (labour units)	0.2	-0.9	0.6	0.6	0.1	1.0	0.9	0.5	0.8	0.6	0.6	0.7	0.5	0.7	0.7	0.5
Unemployment rate	12.7	12.6	12.3	12.3	12.5	11.7	11.8	12.1	11.2	11.4	11.6	10.9	11.1	11.2	10.5	10.9
Employment rate	55.4	55.6	55.8	55.8	55.8	56.3	56.2	56.1	56.7	56.5	56.3	57.1	56.8	56.7	57.4	57.0
Memorandum item: Nominal GDP	0.4	0.5	1.4	1.4	1.2	2.6	3.0	2.6	3.3	3.0	3.1	3.2	2.9	3.3	3.1	2.9

Table 1.2– Growth rates for potential GDP and the output gap
(as a percentage of GDP)

	2014			2015			2016			2017			2018			2019	
	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend	Update EFD 2014 policy	EFD 2015 policy	EFD 2015 trend
GDP growth rate (constant prices)	-0.4	-0.4	-0.3	0.7	0.7	0.6	1.4	1.3	1.0	1.5	1.2	1.3	1.4	1.1	1.4	1.3	1.1
Potential GDP growth rate	**-0.4**	**-0.5**	**-0.3**	**-0.1**	**-0.2**	**-0.2**	**0.0**	**0.0**	**0.0**	**0.2**	**0.1**	**0.2**	**0.3**	**0.2**	**0.3**	**0.5**	**0.4**
Contribution of factors to potential output																	
Labour	-0.1	-0.1	-0.2	0.1	0.1	-0.2	0.2	0.1	-0.1	0.2	0.2	-0.1	0.2	0.1	0.0	0.3	0.3
Capital	-0.2	-0.2	-0.3	-0.1	-0.1	-0.3	-0.1	-0.1	-0.2	0.0	-0.1	-0.2	0.0	0.0	-0.1	0.1	0.0
Total factor productivity	-0.2	-0.2	0.2	-0.1	-0.1	0.3	0.0	-0.1	0.3	0.0	0.0	0.4	0.1	0.0	0.4	0.1	0.1
Output gap	**-4.6**	**-4.5**	**-4.3**	**-3.8**	**-3.6**	**-3.5**	**-2.5**	**-2.3**	**-2.6**	**-1.3**	**-1.3**	**-1.4**	**-0.3**	**-0.4**	**-0.4**	**0.5**	**0.3**

1.4 *Validation of the policy scenarios*

The PBO has assessed the macroeconomic scenarios published in the 2015 EFD for the entire 2015-19 period. The validation was conducted on the basis of a comprehensive analysis of the macroeconomic scenarios published in the EFD. First, as with the validation exercise for the Update of the 2014 EFD, the PBO examined the forecasts developed independently by Istat and the three professional forecasting institutes on the PBO panel (CER, Prometeia and Ref.ricerche). We also monitored the forecasts for Italy of other national and international organizations (most recently the European Commission, the OECD, the IMF and the Bank of Italy) and analysed the internal consistency of the macroeconomic scenarios developed by the MEF.

To ensure that the forecasts were comparable, those of the PBO panel were formulated on the basis of the same international exogenous variables (international trade, exchange rates and oil prices) adopted by the MEF.

In addition, for the macroeconomic policy forecasts, the PBO panel forecasters were provided with general assumptions about the 2016-17 budget measures consistent with the indications published in the 2015 EFD (see also section 2.2 of this Report). More specifically, it was assumed that the increase in indirect taxes planned for 2016 as provided for in the safeguard clauses on a current legislation basis at 1 per cent of GDP would be cancelled (permanently). As from 2017, an additional cut in indirect taxes equal to 0.2 per cent of GDP was also assumed. Moreover, other assumptions regarded the adoption of deficit-containment measures (again, on a permanent basis) equal to 0.6 per cent of GDP as from 2016. As specified in the EFD (Section III), about three quarters of the measures would involve a reduction in expenditures through the spending review programme, while the remaining quarter would regard cuts in tax relief measures. Assessments based on the size of the fiscal multipliers used by the PBO panel forecasters lead to the conclusion that, considering the relatively small amounts involved, alternative assumptions about the composition of the budget measures would not have a substantial impact on the macroeconomic forecasts.

The main findings of the comparison of the policy scenario in the EFD with the forecasts of the PBO panel are provided in graphical form in Figure 1.1. The forecasts for GDP growth in the EFD policy scenario fall within the range of forecasts of the PBO panel. Nevertheless, in 2016-17 they are close to the upper limit. This is mainly attributable to forecasts for consumption and investment growth that lie outside the range. Conversely, the Government's projection for the contribution of net exports to GDP growth is near the lower limit. In short, despite the substantive convergence of the growth projections, the forecasts of the Government and the PBO panel reflect differing assessments of the role of domestic and foreign demand in driving growth. The EFD's forecast growth rate for employment (in terms of labour units) and for unit labour costs in 2016-17 appear relatively high, as is the growth rate in the GDP deflator for 2017.

All of the comparisons of the various forecasts were conducted on the basis of the specific forecasts produced by the forecasters. Naturally, each forecast has a specific degree of uncertainty, which can be measured on the basis of the errors committed by each forecaster in the past. Box 1.2 analyses the uncertainty in the forecasts of GDP growth provided by the PBO panel forecasters. Finally, as an additional component of the validation, we monitored the projections produced by other forecasters not included in the PBO panel (Table 1.3).

On the basis of our examination and close dialogue with the MEF, the PBO decided to validate the trend and policy scenarios in the EFD.

Figure 1.2 **–** Comparison of Government's policy scenario with the PBO panel forecasts

GROSS DOMESTIC PRODUCT

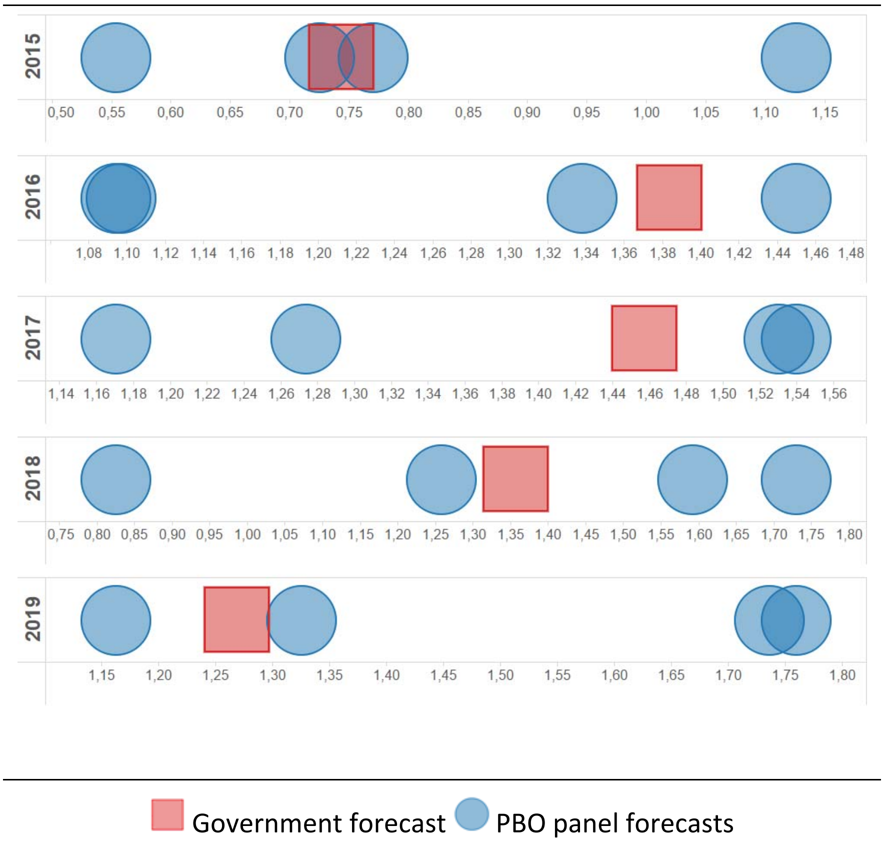


Figure 1.2 *(cont.)* – Comparison of Government's policy scenario with the PBO panel forecasts

GDP DEFLATOR

CONTRIBUTION TO GROWTH IN DOMESTIC DEMAND

Government forecast PBO panel forecasts

Figure 1.2 *(cont.)* – Comparison of Government's policy scenario with the PBO panel forecasts

CONTRIBUTION TO GROWTH IN NET EXPORTS

FINAL CONSUMPTION

Government forecast PBO panel forecasts

Figure 1.2 *(cont.)* – Comparison of Government's policy scenario with the PBO panel forecasts

GROSS FIXED INVESTMENT

IMPORTS

Government forecast PBO panel forecasts

Figure 1.2 *(cont.)* – Comparison of Government's policy scenario with the PBO panel forecasts

EXPORTS

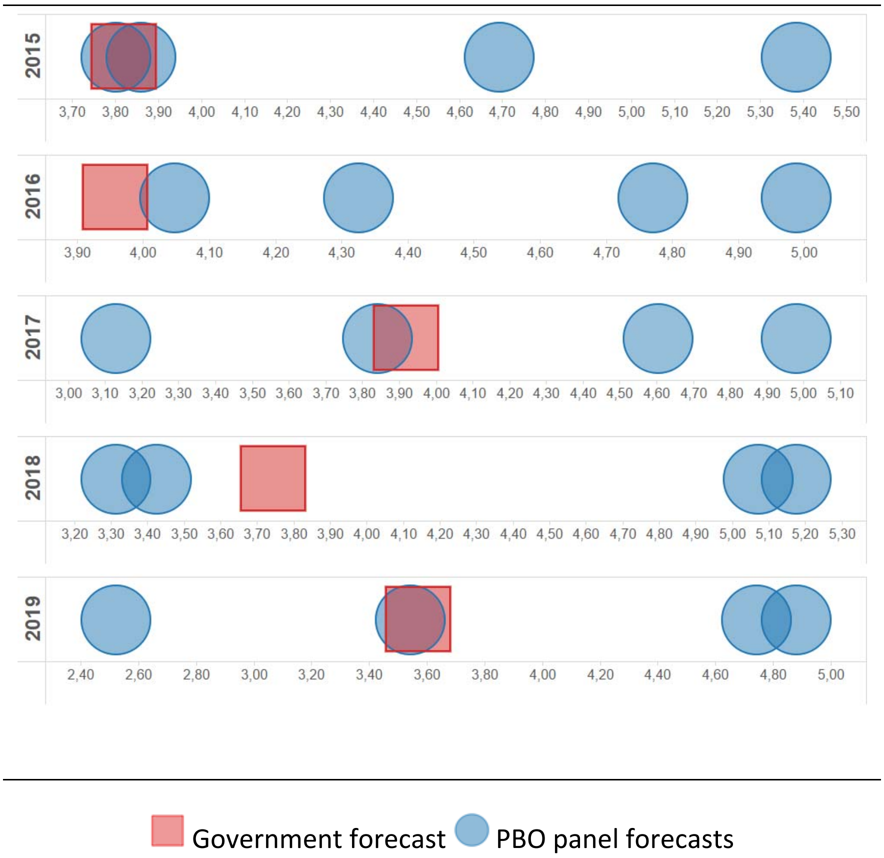


Table 1.3– Comparison of projections of non-PBO-panel forecasters *(percentage changes)*

	GDP		Private consumption		Total investment	
	2015	2016	2015	2016	2015	2016
Bank of Italy - 17 April 2015	> 0.5	1.5				
IMF - 14 April 2015	0.5	1.1	1.2	1.1	-0.3	0.4
EFD 2015 - 10 April 2015	**0.7**	**1.4**	**0.8**	**1.2**	**1.1**	**2.7**
Confcommercio - 27 March 2015	1.1	1.4				
Barclays - 26 March 2015	0.7	1.3				
Intesa San Paolo - 24 March 2015	0.4	1.0	0.8	1.1	0.2	2.1
OECD - 18 March 2015	0.6	1.3				
European Commission - 5 February 2015	0.6	1.3	0.5	0.5	1.0	4.1

Box 1.2 – Uncertainty of the forecasts

Macroeconomic forecasts are characterised by a degree of uncertainty. The scale of this uncertainty can be estimated on the basis of an analysis of past errors. In other words, we can probabilistically determine forecasting intervals within which, for a specific level of confidence, we can expect actual future values to fall.

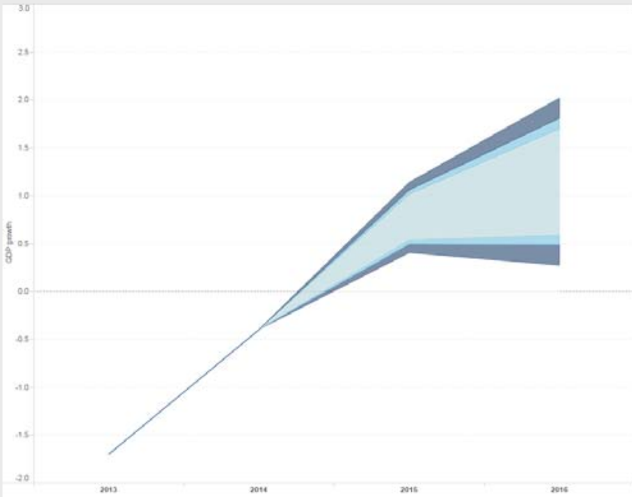
Three of the four forecasters on the PBO panel provided separate confidence intervals for their forecasts of gross domestic product, as obtained from forecasting errors from 1991 to 2014, which were assumed to have a normal distribution. Under this assumption, it was then possible to derive a single "combined" confidence interval calculated as the average of the forecasting intervals of the different forecasters.

We calculated the confidence intervals for the 2015 and 2016 forecasts, taking the distribution of past errors for the forecast for the current year and the following year.

Figure 1.3 depicts the margin of uncertainty of the GDP growth forecasts in the policy scenario for 2015 and 2016. The bands represent intervals corresponding to levels of confidence of 99 per cent (the exterior bands), 95 per cent (the intermediate bands) and 90 per cent (the internal band). At the 95 per cent confidence level, in 2015 the panel's forecast for GDP growth was between 0.5 per cent and 1.1 per cent, while for 2016 the interval runs from 0.5 per cent to 1.8 per cent.

Taking the specific GDP growth forecasts in the EFD for 2015 (0.7 per cent) and 2016 (1.4 per cent), both projections fall within the 90 per cent confidence interval. We can conclude that the Government forecasts are consistent with those produced by the forecasters on the PBO panel when we take account of the degree of uncertainty associated with the latter.

Figure 1.3 – Forecasting intervals for GDP growth in 2015 -16



1.5 Analysis of macroeconomic risks

Nevertheless, the risks to which the forecasts are exposed, especially for 2016-17, must be assessed. Above all, it is necessary to underscore uncertainties associated with international exogenous variables, as emphasised by the International Monetary Fund in its *World Economic Outlook* published in mid-April.

Under the guidelines agreed at the European Union level, the macroeconomic scenario in the EFD incorporates assumptions about growth in world trade in line with those used by the Commission for its own forecasts. This produces a growth rate for world trade of 4 per cent in 2015, about 5¼ per cent in 2016-17 and just under 5½ per cent in 2018-19. In addition, and again consistent with the guidelines agreed at the European Union level, the EFD adopts the technical assumption of no change in oil prices and the exchange rate of the euro over the course of the forecasting period from their average levels a few days before the forecasts were made. This means that for all of 2015-19, oil prices would remain at around $57 a barrel and the exchange rate of the euro against the dollar would be stable at around 1.07/1.08.

These assumptions are exposed to considerable risk of adverse revisions. In particular, oil prices could rise for a number of reasons, such as a stronger-than-expected negative response of supply to price, or in response to the geopolitical tensions affecting many of the oil producing countries. As emphasised by the IMF, account must be taken of the fact that the factors driving the recent decline in oil prices – the availability of alternative energy sources and OPEC pricing policy – seem likely to endure in the coming years. World trade could be adversely affected by the recent deterioration in the outlook for growth over the short and medium term in the emerging economies, especially China. In addition, geopolitical tensions could dampen world demand.

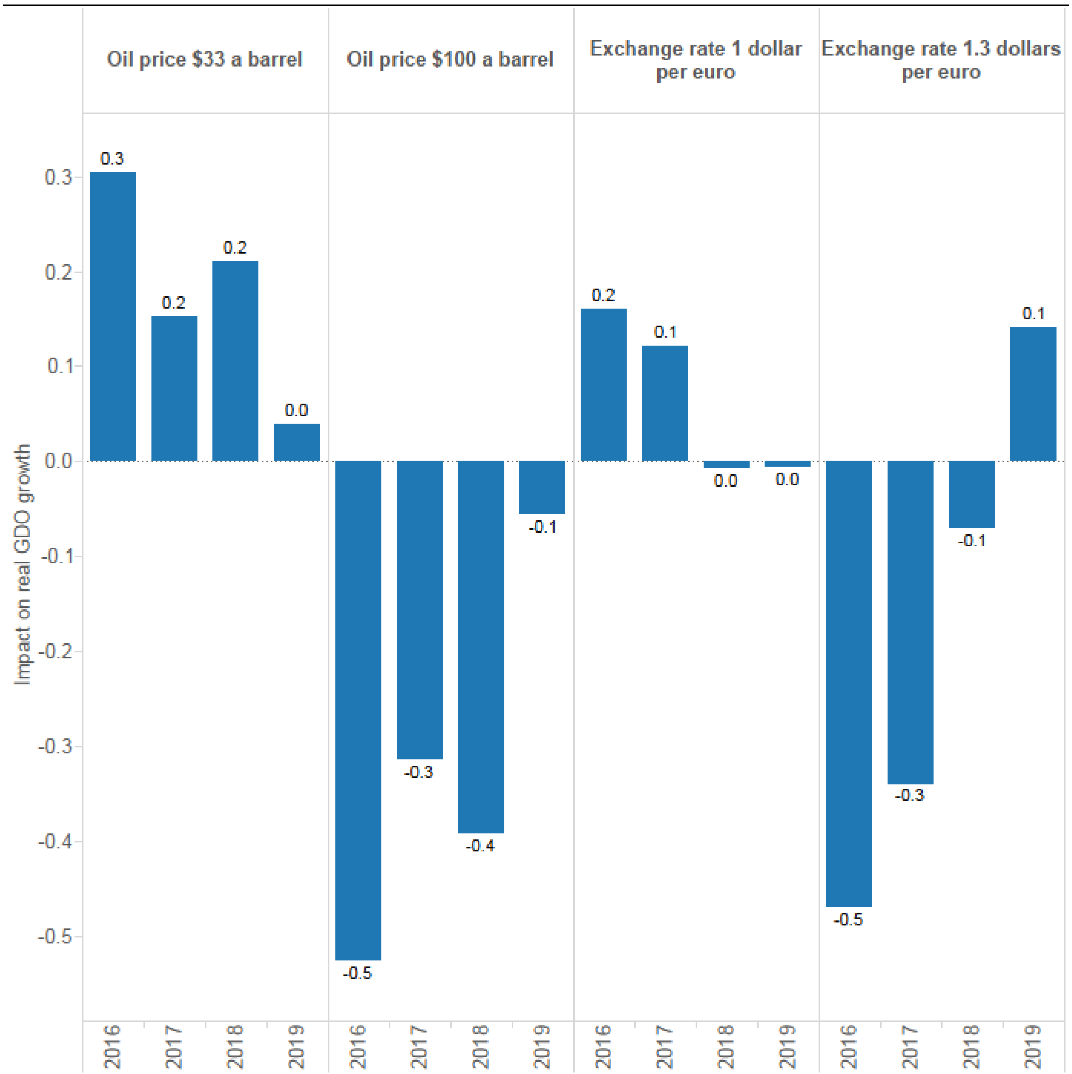
Uncertainty also clouds the size and duration of the impact on the exchange rate of the unconventional monetary policy instruments deployed by the ECB, taking account of possible monetary policy developments in other areas, especially the United States. Finally, possible tensions in financial markets due to developments in the situation in Greece cannot be ignored.

In order to assess the possible implications of the manifestation of these risk factors for the forecasts, a number of analyses of the sensitivity of economic growth to changes in the international exogenous variables were conducted on the basis of the forecasting models of the PBO panel forecasters. These simulations demonstrate that the GDP forecasts in the EFD are exposed to considerable downside risk in the event of an unfavourable turn in macroeconomic conditions. This could have an adverse impact on the public finance framework developed by the Government, as borne out by the sensitivity analyses of the growth scenarios contained in the EFD.

The simulations consisted in assuming different values for oil prices and the dollar/euro exchange rate from those used by the MEF. For oil prices, we considered a reduction to $33 per barrel and an increase to $100 per barrel, an interval that comprises about half of the official prices registered in the 2000-14 period. For the exchange rate, we considered a scenario with dollar/euro parity and another with a rate of $1.30 per euro. The latter was taken as the reference level for 2015 and 2016 in the forecasts contained in the Update of the 2014 EFD. In the simulation exercises, the values of the exogenous variables were reparameterized at the new levels as from 2016 and kept constant thereafter.

The results of the simulation, obtained as the average of the differential effects on the GDP growth rate estimated by the various forecasters on the PBO panel compared with the policy scenario are presented in Figure 1.4.

Figure 1.4 – Impact on real GDP growth of changes in oil prices and the dollar/euro exchange rate



Upside risks

The impact on real GDP growth of a further reduction in oil prices to $33 from the level currently assumed in the EFD ($57.4) would amount to about 0.3 percentage points in 2016, before diminishing to 0.2 points in 2017 and 2018 and nil in 2019.

The impact of dollar/euro parity as from 2016 would be slightly smaller. The additional growth would be about 0.2 percentage points in that year and 0.1 points the following year, before returning to the base scenario level.

Downside risks

By contrast, a return to the oil prices adopted in the Draft Budgetary Plan (about $100 per barrel) would cause growth the slow sharply, by about half a point of GDP in 2016. In the two subsequent years, the erosion of output would average about 0.35 points, before dissipating almost entirely in 2019.

An appreciation of the euro against the dollar to $1.30 would have an equally adverse impact: -0.5 points of GDP in 2016, -0.3 points in 2017, and virtually nil as from 2018.

2. THE PUBLIC FINANCES

2.1 The outturn for 2014

In 2014, general government net borrowing rose slightly, increasing to 3.0 per cent of GDP from 2.9 per cent in 2013 (Table 2.1a). The deterioration in the primary surplus (0.3 points of GDP, from 1.9 per cent in 2013 to 1.6 per cent in 2014) was only partly offset by the reduction in interest expenditure (0.1 points). The latter reflects the decline in yields at issue on government securities to their lowest level since the introduction of the euro. The decrease in the primary surplus, given the lack of any substantive change in the ratio of total revenue to GDP, reflects the rise in current primary expenditure (0.2 points) as a result of the increase in social benefits in cash (0.4 points) (Table 2.1b).

Compared with 2103, nominal current expenditure barely increased (0.7 per cent) in 2014, thanks to the substantial decline in interest expenditure (-3.5 per cent) (Table 2.1c). Compensation of employees decreased for the fourth year in a row (-0.6 per cent), reflecting a further decline in labour units (under way since 2007) and the continuing freeze on collective bargaining in the public sector and promotions. There was a modest rise in intermediate consumption (0.6 per cent), which, within social benefits in kind, was impacted by the decline in expenditure on pharmaceuticals and virtually no change in that on general medicine. Social benefits in cash rose by 2.7 per cent, reflecting a slight increase in pension benefits (+0.9 per cent) and a larger jump in other benefits (9.6 per cent). For the former, the rise reflects, among other things, the automatic pension revaluation of 1.2 per cent and the effects of the smaller revaluation of pensions more than three times the minimum pension, as provided for in the 2014 Stability Act. The growth in other social benefits reflected, in particular, the €80-per-month tax credit (the "bonus") for low-income employees established with Decree Law 66/2014 and the refinancing of *ad hoc* social safety net programmes. The increase in capital expenditure is associated with the recognition of tax credits claimed by firms for deferred tax assets, which offset the further decline in investment spending (-5.9 per cent), for a total contraction of one third in the last five years. Investment grants decreased even more sharply (-11.1 per cent), falling to their lowest levels since 1995, the first year for which data calculated in accordance with the new European system of accounts are available.

Total revenue for 2014 reflected an increase in indirect taxation as a proportion of GDP (0.5 points), which more than offset the contraction in direct taxes (-0.3 points) and capital taxes (-0.2 points). The fiscal burden was broadly unchanged for the third consecutive year at 43.5 per cent (Table 2.1a).

Overall, developments in 2014 continued the underlying trend of the past few years (Figure 2.1). Expenditure for compensation of employees and intermediate consumption was unchanged as a proportion of GDP at its 2011 levels (when it had decreased by almost one percentage point from 2010). Capital expenditure has declined compared with 2009 by about one and a half percentage points of GDP. Tax revenue remains at its 2012 levels (when it had risen by almost 2 points compared with 2011). Among the other major aggregates of the public finances, social benefits in cash have risen by about half a point of GDP per year since 2012, whereas revenue from social security contributions has been flat since 2009. These developments generated the primary surplus in 2011-12 and have kept it essentially unchanged in subsequent years, as confirmed by the figures for 2014.

Figure 2.1 – Main aggregates of general government accounts 2007-14
(percentage of GDP)

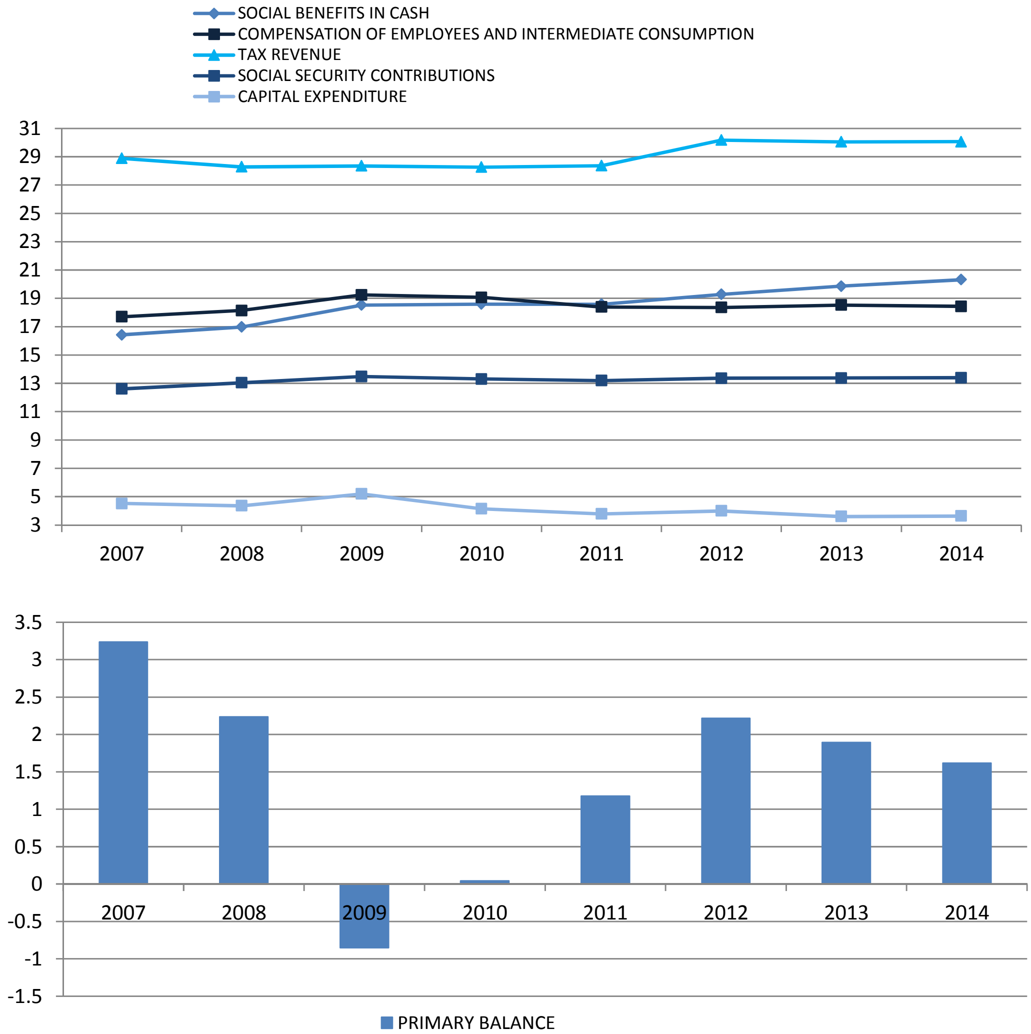


Table 2.1a – Consolidated general government accounts: a comparison of trend forecasts *(millions of euros)*

	Technical Note (1)					EFD 2015						
	2013 (10/2014)	2014	2015	2016	2017	2013 (03/2015)	2014	2015	2016	2017	2018	2019
Compensation of employees	164,747	163,051	164,217	165,869	165,181	164,910	163,874	164,752	166,428	165,742	165,771	166,270
Intermediate consumption	130,626	128,421	123,794	125,593	127,581	133,299	134,063	129,116	131,199	133,224	134,223	136,958
Social benefits in cash	319,690	332,140	342,923	348,968	357,535	319,688	328,304	338,050	342,630	350,990	359,960	367,450
Pensions	*254,564*	*258,870*	*263,006*	*268,086*	*275,061*	*254,564*	*256,902*	*259,500*	*262,480*	*269,350*	*277,180*	*283,920*
Other social benefits	*65,126*	*73,270*	*79,917*	*80,881*	*82,474*	*65,126*	*71,402*	*78,550*	*80,150*	*81,640*	*82,780*	*83,530*
Other current expenditure	66,640	65,201	64,897	65,615	65,538	66,134	66,090	65,651	66,953	65,463	65,837	66,330
TOTAL CURRENT PRIMARY EXPENDITURE	**681,703**	**688,813**	**695,831**	**706,045**	**715,835**	**684,031**	**692,331**	**697,569**	**707,210**	**715,419**	**725,791**	**737,008**
Interest expenditure	78,201	76,670	74,213	75,412	74,086	77,942	75,182	69,386	71,227	69,251	68,201	67,638
TOTAL CURRENT EXPENDITURE	**759,904**	**765,483**	**770,044**	**781,457**	**789,921**	**761,973**	**767,513**	**766,955**	**778,437**	**784,670**	**793,992**	**804,646**
Gross fixed investment	38,310	36,391	36,808	37,090	38,426	38,261	35,993	36,671	38,327	39,253	39,501	40,021
Investment grants	14,571	15,919	16,549	18,464	15,104	14,571	12,947	14,758	15,094	12,342	12,383	12,578
Other capital expenditure	4,724	7,819	5,871	7,494	7,791	5,129	9,809	8,762	10,314	8,372	8,532	6,874
TOTAL CAPITAL EXPENDITURE	**57,605**	**60,129**	**59,228**	**63,048**	**61,321**	**57,961**	**58,749**	**60,191**	**63,735**	**59,967**	**60,416**	**59,473**
TOTAL PRIMARY EXPENDITURE	**739,308**	**748,942**	**755,059**	**769,093**	**777,156**	**741,992**	**751,080**	**757,760**	**770,945**	**775,386**	**786,207**	**796,481**
TOTAL EXPENDITURE	**817,509**	**825,612**	**829,272**	**844,505**	**851,242**	**819,934**	**826,262**	**827,146**	**842,172**	**844,637**	**854,408**	**864,119**
Total tax revenue	485,309	487,585	497,785	522,256	540,003	483,706	485,837	496,531	525,861	542,768	554,312	565,313
Direct taxes	241,497	*238,241*	*245,471*	*254,588*	*258,918*	*240,908*	*237,539*	*247,285*	*258,647*	*263,308*	*266,758*	*271,825*
Indirect taxes	239,681	*247,997*	*250,244*	*266,513*	*280,147*	*238,644*	*246,991*	*247,267*	*266,147*	*278,505*	*286,592*	*292,519*
Capital taxes	4,131	*1,347*	*2,070*	*1,155*	*938*	*4,154*	*1,307*	*1,979*	*1,067*	*955*	*962*	*969*
Social security contributions	215,194	216,398	214,326	215,484	220,099	215,288	216,408	216,031	218,253	223,366	232,898	238,436
Actual social contributions	*211,057*	*212,224*	*210,096*	*211,202*	*215,759*	*211,200*	*212,383*	*211,923*	*214,083*	*219,132*	*228,603*	*234,084*
Imputed social contributions	*4,137*	*4,174*	*4,230*	*4,282*	*4,340*	*4,088*	*4,025*	*4,108*	*4,170*	*4,234*	*4,295*	*4,352*
Other current revenue	65,893	67,147	68,674	69,700	72,222	68,337	68,945	68,213	69,113	70,272	71,659	72,876
TOTAL CURRENT REVENUE	**762,265**	**769,783**	**778,715**	**806,285**	**831,386**	**763,177**	**769,883**	**778,796**	**812,160**	**835,451**	**857,907**	**875,656**
OTHER CAPITAL REVENUE	**5,155**	**5,269**	**5,884**	**6,824**	**5,883**	**5,148**	**6,016**	**5,182**	**5,459**	**4,459**	**4,375**	**4,593**
TOTAL REVENUE	**771,551**	**776,399**	**786,669**	**814,264**	**838,207**	**772,479**	**777,206**	**785,957**	**818,686**	**840,865**	**863,244**	**881,218**
Fiscal burden	*43.3*	*43.3*	*43.2*	*43.7*	*43.6*	*43.4*	*43.5*	*43.5*	*44.1*	*44.1*	*44.0*	*43.7*
NET PRIMARY BORROWING (-) / LENDING (+)	32,243	27,457	31,610	45,171	61,051	30,487	26,126	28,197	47,741	65,479	77,037	84,737
% of GDP	2.0	1.7	1.9	2.7	3.5	1.9	1.6	1.7	2.8	3.8	4.3	4.6
NET BORROWING (-) / LENDING (+)	**-45,958**	**-49,213**	**-42,603**	**-30,241**	**-13,035**	**-47,455**	**-49,056**	**-41,189**	**-23,486**	**-3,772**	**8,836**	**17,099**
% of GDP	-2.8	-3.0	-2.6	-1.8	-0.7	-2.9	-3.0	-2.5	-1.4	-0.2	0.5	0.9
Nominal GDP	*1,618,903*	*1,626,516*	*1,646,550*	*1,690,027*	*1,742,327*	*1,609,462*	*1,616,048*	*1,638,983*	*1,687,708*	*1,738,389*	*1,788,610*	*1,840,954*

Sources: for outturns, Istat, *Conti e aggregati economici delle AP*, December 2014 and *PIL e indebitamento AP*, 2012-14, 2 March 2015. For forecasts, Ministero dell'Economia e delle finanze, *Nota tecnico-illustrativa alla Legge di Stabilità 2015* and *Documento di economia e finanza*, April 2015.
(1) General government policy accounts (Table 3.2-5 of the NTI) in the format established under Regulation (EU) no. 549/2013 to ensure comparability with tables in the EFD.

Table 2.1b – Consolidated general government accounts: trend scenario
(percentage of GDP)

	Technical Note (1)					EFD 2015						
	2013 (10/2014)	2014	2015	2016	2017	2013 (03/2015)	2014	2015	2016	2017	2018	2019
Compensation of employees	10.2	10.0	10.0	9.8	9.5	10.2	10.1	10.1	9.9	9.5	9.3	9.0
Intermediate consumption	8.1	7.9	7.5	7.4	7.3	8.3	8.3	7.9	7.8	7.7	7.5	7.4
Social benefits in cash	19.7	20.4	20.8	20.6	20.5	19.9	20.3	20.6	20.3	20.2	20.1	20.0
Pensions	*15.7*	*15.9*	*16.0*	*15.9*	*15.8*	*15.8*	*15.9*	*15.8*	*15.6*	*15.5*	*15.5*	*15.4*
Other social benefits	*4.0*	*4.5*	*4.9*	*4.8*	*4.7*	*4.0*	*4.4*	*4.8*	*4.7*	*4.7*	*4.6*	*4.5*
Other current expenditure	4.1	4.0	3.9	3.9	3.8	4.1	4.1	4.0	4.0	3.8	3.7	3.6
TOTAL CURRENT PRIMARY EXPENDITURE	**42.1**	**42.3**	**42.3**	**41.8**	**41.1**	**42.5**	**42.8**	**42.6**	**41.9**	**41.2**	**40.6**	**40.0**
Interest expenditure	4.8	4.7	4.5	4.5	4.3	4.8	4.7	4.2	4.2	4.0	3.8	3.7
TOTAL CURRENT EXPENDITURE	**46.9**	**47.1**	**46.8**	**46.2**	**45.3**	**47.3**	**47.5**	**46.8**	**46.1**	**45.1**	**44.4**	**43.7**
Gross fixed investment	2.4	2.2	2.2	2.2	2.2	2.4	2.2	2.2	2.3	2.3	2.2	2.2
Investment grants	0.9	1.0	1.0	1.1	0.9	0.9	0.8	0.9	0.9	0.7	0.7	0.7
Other capital expenditure	0.3	0.5	0.4	0.4	0.4	0.3	0.6	0.5	0.6	0.5	0.5	0.4
TOTAL CAPITAL EXPENDITURE	**3.6**	**3.7**	**3.6**	**3.7**	**3.5**	**3.6**	**3.6**	**3.7**	**3.8**	**3.4**	**3.4**	**3.2**
TOTAL PRIMARY EXPENDITURE	**45.7**	**46.0**	**45.9**	**45.5**	**44.6**	**46.1**	**46.5**	**46.2**	**45.7**	**44.6**	**44.0**	**43.3**
TOTAL EXPENDITURE	**50.5**	**50.8**	**50.4**	**50.0**	**48.9**	**50.9**	**51.1**	**50.5**	**49.9**	**48.6**	**47.8**	**46.9**
Total tax revenue	30.0	30.0	30.2	30.9	31.0	30.1	30.1	30.3	31.2	31.2	31.0	30.7
Direct taxes	*14.9*	*14.6*	*14.9*	*15.1*	*14.9*	*15.0*	*14.7*	*15.1*	*15.3*	*15.1*	*14.9*	*14.8*
Indirect taxes	*14.8*	*15.2*	*15.2*	*15.8*	*16.1*	*14.8*	*15.3*	*15.1*	*15.8*	*16.0*	*16.0*	*15.9*
Capital taxes	*0.3*	*0.1*	*0.1*	*0.1*	*0.1*	*0.3*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Social security contributions	13.3	13.3	13.0	12.8	12.6	13.4	13.4	13.2	12.9	12.8	13.0	13.0
Actual social contributions	*13.0*	*13.0*	*12.8*	*12.5*	*12.4*	*13.1*	*13.1*	*12.9*	*12.7*	*12.6*	*12.8*	*12.7*
Imputed social contributions	*0.3*	*0.3*	*0.3*	*0.3*	*0.2*	*0.3*	*0.2*	*0.3*	*0.2*	*0.2*	*0.2*	*0.2*
Other current revenue	4.1	4.1	4.2	4.1	4.1	4.2	4.3	4.2	4.1	4.0	4.0	4.0
TOTAL CURRENT REVENUE	**47.1**	**47.3**	**47.3**	**47.7**	**47.7**	**47.4**	**47.6**	**47.5**	**48.1**	**48.1**	**48.0**	**47.6**
OTHER CAPITAL REVENUE	**0.3**	**0.3**	**0.4**	**0.4**	**0.3**	**0.3**	**0.4**	**0.3**	**0.3**	**0.3**	**0.2**	**0.2**
TOTAL REVENUE	**47.7**	**47.7**	**47.8**	**48.2**	**48.1**	**48.0**	**48.1**	**48.0**	**48.5**	**48.4**	**48.3**	**47.9**
NET PRIMARY BORROWING (-) / LENDING (+)	**2.0**	**1.7**	**1.9**	**2.7**	**3.5**	**1.9**	**1.6**	**1.7**	**2.8**	**3.8**	**4.3**	**4.6**
NET BORROWING (-) / LENDING (+)	**-2.8**	**-3.0**	**-2.6**	**-1.8**	**-0.7**	**-2.9**	**-3.0**	**-2.5**	**-1.4**	**-0.2**	**0.5**	**0.9**
Nominal GDP	*1,618,903*	*1,626,516*	*1,646,550*	*1,690,027*	*1,742,327*	*1,609,462*	*1,616,048*	*1,638,983*	*1,687,708*	*1,738,389*	*1,788,610*	*1,840,954*

Sources: for outturns, Istat, *Conti e aggregati economici delle AP*, December 2014 and *PIL e indebitamento AP*, 2012-14, 2 March 2015. For forecasts, Ministero dell'Economia e delle finanze, *Nota tecnico-illustrativa alla Legge di Stabilità 2015* and *Documento di economia e finanza*, April 2015.

(1) General government policy scenario (Table 3.2-5 of the NTI) in the format established under Regulation (EU) no. 549/2013 to ensure comparability with the tables in the EFD.

Table 2.1c – Consolidated general government accounts: trend scenario *(growth rates)*

	Technical Note (1)				EFD 2015					
	2014	2015	2016	2017	2014	2015	2016	2017	2018	2019
Compensation of employees	-1.0	0.7	1.0	-0.4	-0.6	0.5	1.0	-0.4	0.0	0.3
Intermediate consumption	-1.7	-3.6	1.5	1.6	0.6	-3.7	1.6	1.5	0.7	2.0
Social benefits in cash	3.9	3.2	1.8	2.5	2.7	3.0	1.4	2.4	2.6	2.1
Pensions	*1.7*	*1.6*	*1.9*	*2.6*	*0.9*	*1.0*	*1.1*	*2.6*	*2.9*	*2.4*
Other social benefits	*12.5*	*9.1*	*1.2*	*2.0*	*9.6*	*10.0*	*2.0*	*1.9*	*1.4*	*0.9*
Other current expenditure	-2.2	-0.5	1.1	-0.1	-0.1	-0.7	2.0	-2.2	0.6	0.7
TOTAL CURRENT PRIMARY EXPENDITURE	**1.0**	**1.0**	**1.5**	**1.4**	**1.2**	**0.8**	**1.4**	**1.2**	**1.4**	**1.5**
Interest expenditure	-2.0	-3.2	1.6	-1.8	-3.5	-7.7	2.7	-2.8	-1.5	-0.8
TOTAL CURRENT EXPENDITURE	**0.7**	**0.6**	**1.5**	**1.1**	**0.7**	**-0.1**	**1.5**	**0.8**	**1.2**	**1.3**
Gross fixed investment	-5.0	1.1	0.8	3.6	-5.9	1.9	4.5	2.4	0.6	1.3
Investment grants	9.3	4.0	11.6	-18.2	-11.1	14.0	2.3	-18.2	0.3	1.6
Other capital expenditure	65.5	-24.9	27.6	4.0	91.2	-10.7	17.7	-18.8	1.9	-19.4
TOTAL CAPITAL EXPENDITURE	**4.4**	**-1.5**	**6.4**	**-2.7**	**1.4**	**2.5**	**5.9**	**-5.9**	**0.7**	**-1.6**
TOTAL PRIMARY EXPENDITURE	**1.3**	**0.8**	**1.9**	**1.0**	**1.2**	**0.9**	**1.7**	**0.6**	**1.4**	**1.3**
TOTAL EXPENDITURE	**1.0**	**0.4**	**1.8**	**0.8**	**0.8**	**0.1**	**1.8**	**0.3**	**1.2**	**1.1**
Total tax revenue	0.5	2.1	4.9	3.4	0.4	2.2	5.9	3.2	2.1	2.0
Direct taxes	*-1.3*	*3.0*	*3.7*	*1.7*	*-1.4*	*4.1*	*4.6*	*1.8*	*1.3*	*1.9*
Indirect taxes	*3.5*	*0.9*	*6.5*	*5.1*	*3.5*	*0.1*	*7.6*	*4.6*	*2.9*	*2.1*
Capital taxes	*-67.4*	*53.7*	*-44.2*	*-18.8*	*-68.5*	*51.4*	*-46.1*	*-10.5*	*0.7*	*0.7*
Social security contributions	0.6	-1.0	0.5	2.1	0.5	-0.2	1.0	2.3	4.3	2.4
Actual social contributions	*0.6*	*-1.0*	*0.5*	*2.2*	*0.6*	*-0.2*	*1.0*	*2.4*	*4.3*	*2.4*
Imputed social contributions	*0.9*	*1.3*	*1.2*	*1.4*	*-1.5*	*2.1*	*1.5*	*1.5*	*1.4*	*1.3*
Other current revenue	1.9	2.3	1.5	3.6	0.9	-1.1	1.3	1.7	2.0	1.7
TOTAL CURRENT REVENUE	**1.0**	**1.2**	**3.5**	**3.1**	**0.9**	**1.2**	**4.3**	**2.9**	**2.7**	**2.1**
OTHER CAPITAL REVENUE	**2.2**	**11.7**	**16.0**	**-13.8**	**16.9**	**-13.9**	**5.3**	**-18.3**	**-1.9**	**5.0**
TOTAL REVENUE	**0.6**	**1.3**	**3.5**	**2.9**	**0.6**	**1.1**	**4.2**	**2.7**	**2.7**	**2.1**

Sources: for outturns, Istat, *Conti e aggregati economici delle AP*, December 2014 and *PIL e indebitamento AP*, 2012-14, 2 March 2015. For forecasts, Ministero dell'Economia e delle finanze, *Nota tecnico-illustrativa alla Legge di Stabilità 2015* and *Documento di economia e finanza*, April 2015.

(1) General government policy scenario (Table 3.2-5 of the NTI) in the format established under Regulation (EU) no. 549/2013 to ensure comparability with the tables in the EFD.

The transition from ESA 95 to ESA 2010 had an impact on revenue developments (see Box 2.1). Direct tax revenue declined (-1.4 per cent), mainly due to the impact of the decrease in corporate income taxes and the substitute tax on interest income. IRES (corporate income tax) reflected the decline in payments of the balance of tax liabilities and in payments on account in 2014, which in turn was a consequence of the temporary increase in the size of the payment on account for 2013. The substitute tax on interest income was affected by a decline in balance payments in February in respect of withholdings made by credit institutions the previous year in view of the increase of 10 percentage points in the second payment on account (due in October 2013) and by smaller payments due to a decline in interest accrued. IRPEF (personal income tax) was essentially unchanged at the level registered in 2013, while revenue increases were posted for withholding tax on distributed income of corporations and the tax on asset management products and on capital gains. A factor in both cases was the increase from 20 per cent to 26 per cent in the tax on investment income as from 1 July 2014. An additional contribution came from the one-off tax on the revaluation of shares in the Bank of Italy (€1.8 billion). In addition to the introduction of a tax on shared municipal services (TASI), the rise in indirect tax revenue (+3.5 per cent) was largely attributable to the rise in VAT, driven by the impact on 2014 of the increase in the ordinary VAT rate in October 2013, and the increase in energy taxes. Stamp duty and registration fees also made a positive contribution. The former were affected by the increase from 0.15 per cent to 0.20 per cent of the amount due on notices concerning financial instruments, while the latter were affected by the application the fee to transfers of finance leases on property used in business operations.

An examination of the estimate in the Technical Note to the 2015 Stability Act (TN) reveals that the actual results for 2014 essentially confirm the forecast balances. However, the composition of the aggregates is different. In part, this reflects the revision of the general government accounts for 2013 carried out by Istat on the occasion of the publication of the outturn for 2014. More specifically, with the revision, among other things, current primary expenditure for 2013 increased by 0.3 percentage points of GDP – owing to the change in the valuation of intermediate consumption[1] (totalling €2.7 billion) – and current revenue rose by 0.2 points (or €0.9 billion) – in reflection of the net impact of a reduction in estimated direct and indirect taxes and an increase in the value of production for market and for own use.[2] (Table 2.2).

Apart from these differences, which were connected with the 2013 revision of the accounts, the main divergences from the forecasts in the TN regarded expenditure on social security benefits and capital expenditure, which were lower than expected. Under

[1] The increase of €2.7 billion in intermediate consumption, with the revision having a permanent effect for subsequent years as well, involved the local government sector in particular, owing to two factors. The first regarded the internalisation of waste collection expenditure in the accounts of municipalities. Before 2013, municipalities in a number of large regions did not recognize that expenditure in their accounts, as the associated revenue from waste collection fees was not recognized either, because that revenue was collected directly by the municipally-owned companies that performed the service. With the entry into force of the municipal waste collection and services tax (TARES) as from 2013, introduced with Decree Law 201/2011, which replaced existing urban waste disposal levies, all municipalities began to report both revenue and expenditure in their accounts. As a result, this gave rise to a concomitant increase in expenditure for intermediate consumption, through payment of the municipally-owned companies for their services, and in revenue from the production of market services, under which TARES revenue was recognized. These effects had not been considered in the preliminary figures. The second factor concerns the adjustment of the cash flows associated with payments for intermediate consumption in 2013 in order to recognize them on an accrual basis. In doing so, an estimated item was subtracted in order to take account of the payment of past debts. This estimate was revised downwards in the light of the actual figures reported in the certified final accounts of local governments, which were received by Istat subsequently.

[2] See the previous note.

social benefits, pension expenditure reflected a decrease in payments for benefits under programmes exempt from general requirements[3] following a complex verification of compliance with the requirements, as well as the postponement of the gradual easing of the freeze on retirements. Other benefits were lower than forecast owing to a smaller impact of the €80 bonus (about €800 million), a slowdown in payments of benefits under *ad hoc* social safety net programmes owing to delays in making the resources available, and a decline in spending for termination benefits in the public sector. Capital expenditure reflected, among other items, lower-than-expected payments to Ferrovie dello Stato (State Railways).

[3] Including, among others, those for so-called "protected" beneficiaries and people employed in physically demanding jobs.

Table 2.2 – Consolidated general government accounts
(millions of euros)

	2013 actual				Difference with 2013 actual		2014 actual		Comparison 2014-2013	
	Oct. 2014	% of GDP	Mar. 2015	% of GDP	Total	% of GDP	Total	% of GDP	% change	Change as % of GDP
	(1)	(2)	(3)	(4)	(3) - (1)	(4) - (2)	(5)	(6)	(7)	(8)
Compensation of employees	164,747	10.2	164,910	10.2	163	0.1	163,874	10.1	-0.6	-0.1
Purchases of goods and services produced by market producers	43,375	2.7	43,458	2.7	83	0.0	43,738	2.7	0.6	0.0
Intermediate consumption	87,251	5.4	89,841	5.6	2,590	0.2	90,325	5.6	0.5	0.0
Social benefits in cash	319,690	19.7	319,688	19.9	-2	0.1	328,304	20.3	2.7	0.5
Other current expenditure	66,640	4.1	66,134	4.1	-506	0.0	66,090	4.1	-0.1	0.0
TOTAL CURRENT PRIMARY EXPENDITURE	**681,703**	**42.1**	**684,031**	**42.5**	**2,328**	**0.4**	**692,331**	**42.8**	**1.2**	**0.3**
Interest expenditure	78,201	4.8	77,942	4.8	-259	0.0	75,182	4.7	-3.5	-0.2
TOTAL CURRENT EXPENDITURE	**759,904**	**46.9**	**761,973**	**47.3**	**2,069**	**0.4**	**767,513**	**47.5**	**0.7**	**0.1**
Gross fixed investment	38,310	2.4	38,261	2.4	-49	0.0	35,981	2.2	-6.0	-0.2
Other capital expenditure	19,295	1.2	19,700	1.2	405	0.0	22,768	1.4	15.6	0.2
TOTAL CAPITAL EXPENDITURE	**57,605**	**3.6**	**57,961**	**3.6**	**356**	**0.0**	**58,749**	**3.6**	**1.4**	**0.0**
TOTAL PRIMARY EXPENDITURE	**739,308**	**45.7**	**741,992**	**46.1**	**2,684**	**0.4**	**751,080**	**46.5**	**1.2**	**0.4**
TOTAL EXPENDITURE	**817,509**	**50.5**	**819,934**	**50.9**	**2,425**	**0.4**	**826,262**	**51.1**	**0.8**	**0.2**
Direct taxes	241,497	14.9	240,908	15.0	-589	0.1	237,539	14.7	-1.4	-0.3
Indirect taxes	239,681	14.8	238,644	14.8	-1,037	0.0	246,991	15.3	3.5	0.5
Social security contributions	215,194	13.3	215,288	13.4	94	0.1	216,408	13.4	0.5	0.0
Actual social contributions	*211,057*	*13.0*	*211,200*	*13.1*	*143*	*0.1*	*212,383*	*13.1*	*0.6*	*0.0*
Imputed social contributions	*4,137*	*0.3*	*4,088*	*0.3*	*-49*	*0.0*	*4,025*	*0.2*	*-1.5*	*0.0*
Other current revenue	65,893	4.1	68,337	4.2	2,444	0.2	68,945	4.3	0.9	0.0
TOTAL CURRENT REVENUE	**762,265**	**47.1**	**763,177**	**47.4**	**912**	**0.3**	**769,883**	**47.6**	**0.9**	**0.2**
Capital taxes	4,131	0.3	4,154	0.3	23	0.0	1,307	0.1	-68.5	-0.2
Other capital revenue	5,155	0.3	5,148	0.3	-7	0.0	6,016	0.4	16.9	0.1
TOTAL CAPITAL REVENUE	**9,286**	**0.6**	**9,302**	**0.6**	**16**	**0.0**	**7,323**	**0.5**	**-21.3**	**-0.1**
TOTAL REVENUE	**771,551**	**47.7**	**772,479**	**48.0**	**928**	**0.3**	**777,206**	**48.1**	**0.6**	**0.1**
NET PRIMARY BORROWING (-) / LENDING (+)	**32,243**	**2.0**	**30,487**	**1.9**	**-1,756**	**-0.1**	**26,126**	**1.6**		**-0.3**
NET BORROWING (-) / LENDING (+)	**-45,958**	**-2.8**	**-47,455**	**-2.9**	**-1,497**	**-0.1**	**-49,056**	**-3.0**		**-0.1**
Nominal GDP	1,618,903		1,609,462		-9,441		1,616,048			

Source: Istat, *Conti e aggregati economici delle AP*, December 2014 and *PIL e indebitamento AP*, 2012-2014, 2 March 2015.

2.2 *The trend scenario*

On the basis of the Government's indications in the EFD, net borrowing on a trend basis is forecast to decline from 3.0 per cent of GDP in 2014 to 2.5 per cent in 2015. The decline continues in subsequent years, reaching budget balance in 2017 and a surplus of 0.5 and 0.9 points of GDP in 2018 and 2019 (Table 2.1b). The improvement in the balance between 2014 and 2019 is almost entirely attributable to the reduction in interest expenditure (from 4.7 per cent to 3.7 per cent of GDP) and in current primary expenditure (from 42.8 per cent to 40 per cent), partly due to the adoption of the current legislation criterion.

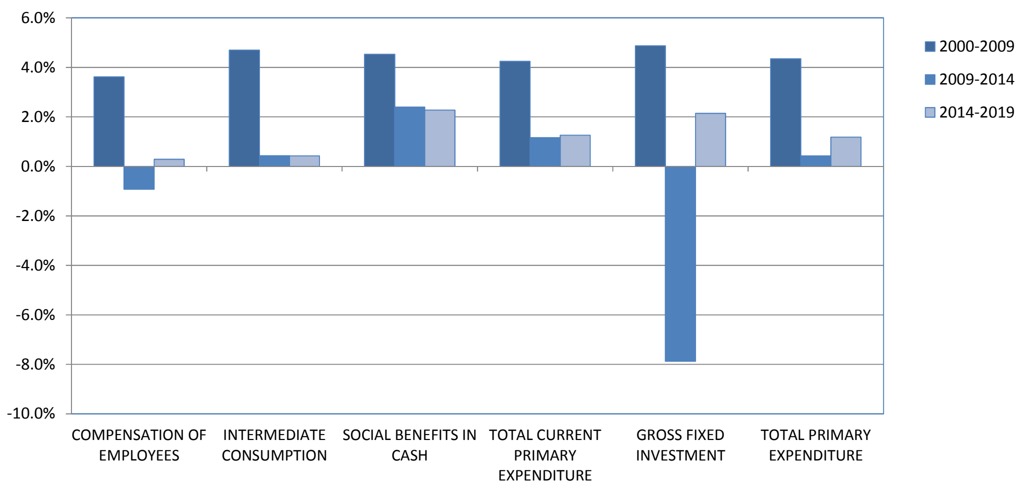
Compared with the forecasts issued last autumn, net borrowing on a trend basis falls by an increasing percentage each year: 0.1 percentage points of GDP in 2015, 0.4 points in 2016, 0.6 points in 2017 and 0.7 points in 2018. About half of the projected improvement is attributable to the expected decline in interest spending (0.2-0.3 points in each year of the 2015-18 period) connected with the January decision of the Governing Council of the ECB to expand quantitative easing to include government securities in its asset purchase programme. The remainder of the improvement is due to increases in social security contributions and direct taxes. While the increase in the former can be justified on the basis of expected increases in gross compensation of employees, the upwards revision of forecasts for revenue from direct taxes is not supported by any change in the associated tax base. Compared with last October, tax revenue, especially from the taxation of businesses, is expected to rise substantially in 2016 and 2017, the justification for which could be associated with an improved assessment (perhaps somewhat optimistic) of developments in the amount (the sum of payments on account and balance payments) to be paid in future years. This contributes to the increase in tax revenue by an average of 2.7 per cent per year between 2014 and the 2019 forecast in the EFD.

As regards the trend scenario for the balance, the reduction in net borrowing depends essentially on exogenous factors that are not linked to budgetary policy, which in addition to the assumptions concerning international variables include the reduction in interest rates as a result of greater market confidence and the expected success of quantitative easing, the stability of geopolitical conditions, and the continuation and successful conclusion of negotiations with Greece, as well as the achievement of the forecast impact of budget measures, especially on the spending side, and the sharp increases in tax revenue noted above.

It should be borne in mind that – compared with past efforts – much has been done in recent years to contain expenditure: in the last five years, current primary spending has risen in nominal terms by an average of 1.2 per cent per year, compared with 4.3 per cent in 2000-09 (Figure 2.2). The easiest expenditure items to cut (intermediate consumption and purchases of goods and services from market producers) have already been reduced. In the trend scenario presented in the EFD, current primary expenditure continues to rise, in line with its pace in the previous five years, by 1.3 per cent per year (Table 2.1c). Maintaining such a moderate rate of nominal increase until 2019, with an average forecast rise for pensions alone of 2.7 per cent per year over the final three years of the forecasting period, would require medium-term programs based on in-depth analysis.

Finally, additional threats to the trend scenario forecasts are represented by the composition of growth, which is slightly more tilted towards the components of domestic demand compared with the forecasts of other national and international forecasters. If net exports should play a larger role in GDP growth, the positive impact on revenue could be smaller, with obvious consequences for the budget balances.

Figure 2.2 – Average annual rates of growth in the main aggregates of government expenditure



Unchanged policies

The EFD contains forecasts on an unchanged policies basis for overall revenue and expenditure as well as for the main general government expenditure accounts,[4] offering some information on the methodology used. The latter is based on a comparison of developments in the last five years of the average growth rates of the main aggregates and their forecast behaviour under current legislation. As the latter produced faster growth, it was used to produce the unchanged policies scenario. A different approach was used only for compensation of employees, assuming contract renewals for 2016-18 and 2019-21.

The unchanged policy scenario contains smaller changes compared with current legislation than in the past, as the 2015 Stability Act already provided for permanent financing of a series of measures which under previous practice had been refinanced each year. Nevertheless, the Government explicitly retains the option of extending the measures, by sector and size, for which specific funding sources must be found, without prejudice to compatibility with policy objectives.

[4] The EFD specifies that it does not report detailed information on the components of expenditure for which the unchanged policy approach is not applicable, such as interest expenditure and that deriving from obligations under international treaties.

As regards the only component of additional expenditure considered, namely compensation of employees, the document does not clarify the "technical" hypothesis used. It reports expenditure increases[5] without specifying the procedures involved in the contract renewals or the timing of such renewals for the various segments of government employment.

Considering those renewals increases the size of the gross budget measures by considerable amounts, rising from €1.7 billion in 2016 to €8.8 billion in 2019: the EFD does not specify how the Government plans to raise the funds.

Consideration must also be given to the possibility of additional measures to finance other possible requirements.[6]

2.3 The policy scenario

Despite the improvement in the trend scenario for the public finances, the EFD retains the objectives in the Draft Budgetary Plan, which include a net borrowing ratio that declines from 3.0 per cent of GDP in 2014, 2.6 per cent in 2015 and further decreases to 0.8 per cent in 2017; in 2018 the budget is forecast in balance, while 2019 it is projected to register a surplus of 0.4 per cent (Table 2.3).

A comparison of the objectives with the corresponding trend values reveals the Government's desire to implement expansionary measures. More specifically, in 2015 the Government intends to use the 0.1 points of GDP of resources that emerged in the first part of the year to implement measures to strengthen the structural reforms it has already begun. From 2016, it is committed to using all of the room for manoeuvre created by the improvement in the accounts, within the limits of the policy objectives, to eliminate the effects of the safeguard clauses introduced with the 2014 and 2015 Stability Acts (increases in tax rates and elimination of deductions and tax relief measures, increases in rates of VAT and excise taxes).[7] In view of the differences between the trend balances and the policy targets (0.4 points of GDP in 2016 and about 0.6 points in each of the subsequent years) and bearing in mind that the Government intends to free up resources amounting to 0.6 points of GDP (0.45 points from a structural reduction in public spending and 0.15 points from permanent reductions in tax relief measures[8]), the measures envisaged in the safeguard clauses, i.e. equal to 1.0 points of GDP in 2016, could be eliminated completely in 2016 but by no more than 1.2 points in the subsequent years (Table 2.3).

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[5] Net of amounts to be paid to cover the period without a contract included in the trend scenario on a current legislation basis.

[6] In this regard, the 2015 Stability Act only provided for expenditure on peace missions for 2015-17.

[7] Under the provisions of the EFD, revenue generated by the safeguard clause in the 2014 Stability Act is estimated at €3.3 billion in 2016 and €6.3 billion from 2017, while that from the safeguard clause in the 2015 Stability Act is put at €12.8 billion in 2016, €19.2 billion in 2017 and €22.0 billion from 2018. Overall, the elimination of the measures in both clauses would give rise to an increase in net borrowing of 1.0, 1.5 and 1.6 percentage points of GDP respectively.

[8] See Section III of the EFD at page 113.

In the light of Italian and European fiscal rules, it is important to see how all of this impacts the change in the structural balance.

In 2015, the structural deficit would diminish by 0.2 percentage points of GDP, rather than the 0.3 points agreed with the European institutions at the end of 2014. In 2016, it would improve by 0.1 points, compared with the 0.5 points envisaged under the European rules. The smaller correction is connected with the Government's request to make use of the flexibility envisaged under the European fiscal rules – which is available to countries that implement major structural reforms which have positive effects on the long-term sustainability of the public finances – to temporarily deviate from the medium-term objective or from the adjustment path to the objective in the year following the publication of the Stability Programme.[9] The European Commission is responsible for verifying both the existence of the conditions for invoking flexibility and how much flexibility to grant. This will depend on the type of reforms and their actual feasibility (see Section 4.4).

Structural budget balance is achieved in 2017. In the two subsequent years, the budget would have surpluses of 0.1 and 0.2 points of GDP, respectively.

Figure 2.3 provides a graphical representation of the forecasts for net borrowing, structural borrowing and the change in structural borrowing in a comparison between the Draft Budgetary Plan and the trend and policy scenarios in the EFD.

[9] The deviation must be small, temporary and in any case keep net borrowing below 3 per cent of GDP. For more information, please see the PBO Focus "*Le nuove indicazioni della Commissione europea sulla flessibilità nel Patto di stabilità e crescita*" (http://www.upbilancio.it/wp-content/uploads/2015/01/Focus_1_Upb.pdf).

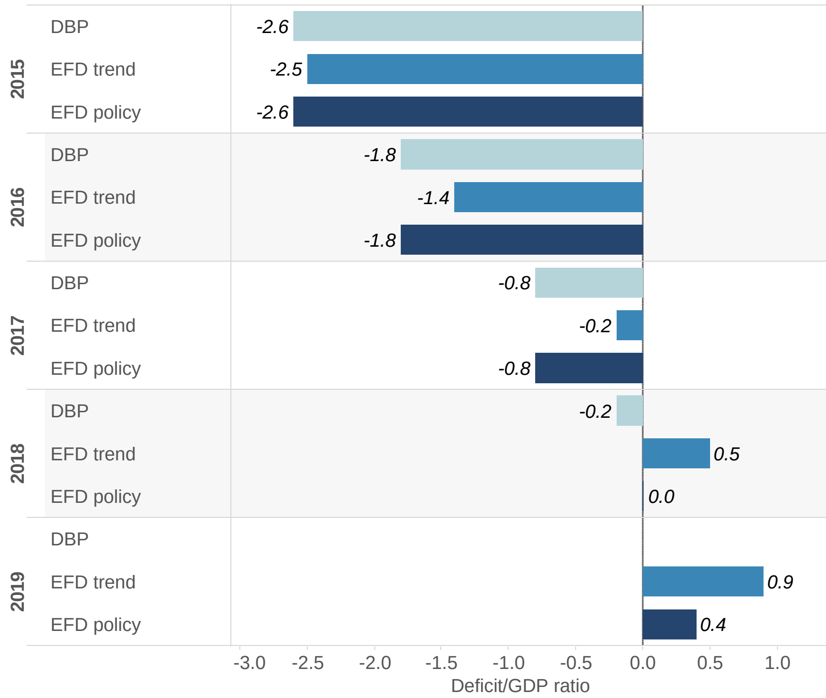
Table. 2.3 – Objectives and measures contained in the EFD (1)
(percentage of GDP)

	2014	2015	2016	2017	2018	2019
Trend net borrowing (a)	**-3.0**	**-2.5**	**-1.4**	**-0.2**	**0.5**	**0.9**
Change (+ = improvement)		0.5	1.1	1.2	0.7	0.4
of which: *Revenue*		*-0.1*	*0.6*	*-0.1*	*-0.1*	*-0.4*
Interest		*-0.4*	*0.0*	*-0.2*	*-0.2*	*-0.1*
Primary expenditure		*-0.2*	*-0.6*	*-1.1*	*-0.6*	*-0.7*
Trend structural net borrowing	-0.8	-0.5	0.0	0.5	0.8	0.8
Change (+ = improvement)	0.0	0.3	0.5	0.6	0.3	0.0
Policy net borrowing (b)	**-3.0**	**-2.6**	**-1.8**	**-0.8**	**0.0**	**0.4**
Change (+ = improvement)		0.4	0.8	1.0	0.8	0.4
Structural net borrowing	**-0.7**	**-0.5**	**-0.4**	**0.0**	**0.1**	**0.2**
Change (+ = improvement)	0.0	0.2	0.1	0.3	0.2	0.0
Measures (c = b - a) (2)		**-0.1**	**-0.4**	**-0.6**	**-0.5**	**-0.5**
Expansionary measures - Strengthening structural reforms		*-0.1*	-	-	-	-
Expenditure reductions		-	*0.6*	*0.6*	*0.6*	*0.6*
No activation of safeguard clauses in the 2014 and 2015 Stability Acts		-	*-1.0*	*-1.2*	*-1.2*	*-1.2*
Memorandum item:						
Safeguard clause 2014 Stability Act (3)			0.2	0.4	0.4	0.4
Safeguard clause 2015 Stability Act (4)			0.8	1.1	1.2	1.2

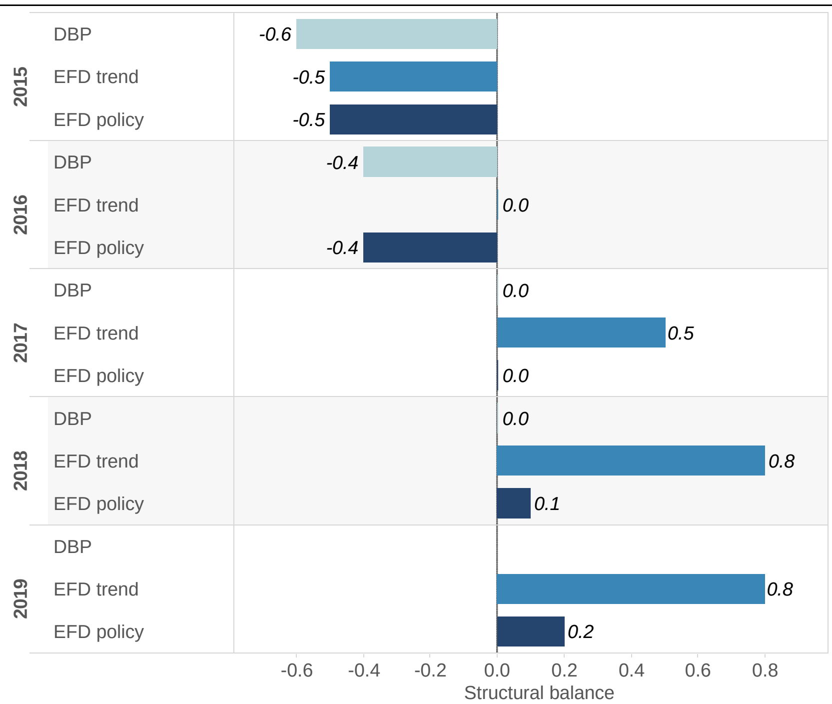
(1) Totals may not match due to rounding. – (2) A negative sign indicates that the policy balance is worse than the trend balance and, therefore, the measures are expansionary with respect to the trend scenario. – (3) The safeguard clause in the 2014 Stability Act envisaged revenue increases from changes in tax rates, the elimination of tax credits and of tax relief measures officially estimated at €3.3 billion in 2016 and €6.3 billion from 2017. – (4) Regards increases in VAT rates amounting to €12.8 billion in 2016, €19.2 billion in 2017 and €21.3 billion from 2018; these amounts would be accompanied by an increase in excise taxes of €0.7 billion from 2018.

Figure 2.3 – Public finance balances: comparison of the DBP, the trend EFD and the policy EFD

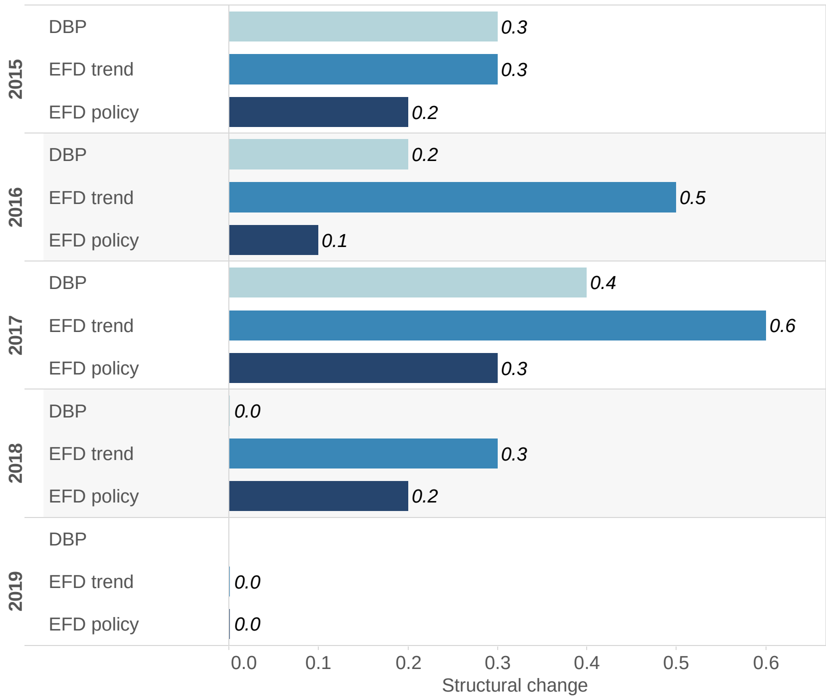
Net borrowing (percentages of GDP)



Structural net borrowing (percentages of GDP)



Change in structural net borrowing



2.4 Policy developments in the debt

In 2014 the ratio of the public debt to GDP rose by 3.6 percentage points, from 128.5 to 132.1 per cent. The change in the debt reflected the general government borrowing requirement (€69 billion), an increase in the liquid assets of the Treasury (€8.8 billion), exchange rate changes (€0.5 billion) and, with the opposite sign, issue premiums (-€8.7 billion) and privatization receipts (€3.3 billion), with the latter essentially consisting of the proceeds from the repayment of bonds acquired by the Treasury from Monte dei Paschi di Siena (€3 billion).

In the Government's plans, the ratio of debt to GDP is forecast to increase slightly in 2015, from 132.1 to 132.5 per cent, before declining by more than 12 points over the next four years to 120 per cent in 2019 (Table 2.4).

Factors in the decline include: a rising primary surplus; developments in macroeconomic conditions that would allow the pace of nominal GDP growth to gradually approach the average cost of debt and then exceed it as from 2017 (the snowball effect); the impact of stock-flow adjustments, which thanks to expected privatization proceeds are expected to be favourable over the entire forecasting period except for the last year.

Table 2.4– Determinants of the change in the debt/GDP ratio (1)
(percentage of GDP and rates of change)

	2014	2015	2016	2017	2018	2019
Debt/GDP ratio	132.1	132.5	130.9	127.4	123.4	120.0
Change in debt/GDP ratio	3.6	0.4	-1.6	-3.6	-3.9	-3.4
Primary surplus (accrual accounting)	-1.6	-1.6	-2.4	-3.2	-3.8	-4.0
Snowball effect (2), of which:	4.1	2.4	0.9	-0.2	-0.2	0.0
average cost of debt (accrual accounting)	*3.6*	*3.2*	*3.3*	*3.1*	*3.1*	*3.1*
nominal GDP growth rate	*0.4*	*1.4*	*2.6*	*3.3*	*3.2*	*3.1*
Stock-flow adjustments	1.1	-0.3	-0.1	-0.1	0.0	0.6
Differences in cash and accrual accounting	*0.8*	*0.6*	*-0.3*	*-0.2*	*-0.3*	*0.1*
Net accumulation of financial assets (3) *of which:*	*0.4*	*0.0*	*-0.2*	*-0.2*	*-0.1*	*0.2*
privatisation proceeds	*-0.2*	*-0.4*	*-0.5*	*-0.5*	*-0.3*	*0.0*
Debt valuation effects	*-0.5*	*-0.1*	*0.3*	*0.3*	*0.3*	*0.3*
Other (4)	*0.4*	*-0.8*	*0.1*	*-0.1*	*0.1*	*0.0*

Source: 2015 Economic and Financial Document.

(1) Totals may not match due to rounding. – (2) The snowball effect is calculated by multiplying the debt/GDP ratio for the previous year by (r -g)/(1 + g), where r is the average cost of debt and g is the rate of nominal GDP growth. – (3) Includes the effects of contributions to the ESM programme. – (4) Includes changes in liquid assets of the MEF, euro-area support contributions under the EFSF programme and statistical discrepancies.

Specifically, the primary surplus would rise by 2.4 percentage points of GDP, from 1.6 per cent in 2015 (equal to that of the previous year) to 4 per cent in 2019. Privatization proceeds would amount to 0.4 per cent of GDP for 2015 and 0.5 per cent in each of 2016 and 2017, before declining to 0.3 per cent in 2018 and nil in the final year of the planning period.

For 2015, €2.2 billion have already been generated by the disposal of interests in ENEL in February and substantial stakes in Poste Italian and ENAV, originally slated for disposal last year, are expected to be sold this year. In addition, in 2015-17 €1.1 billion are expected to be raised from the repayment of bonds issued by Monte dei Paschi di Siena and purchased by the Treasury. Other disposals should include, among others, Ferrovie dello Stato.

Despite the downwards revision from the 0.7 percentage points of GDP a year indicated in the Update to the 2014 EFD, the disposal programme remains substantial.

In 2015, although smaller than the previous year thanks to growth (nominal GDP rises by 1.4 per cent after the 0.4 per cent of the previous year) and the decline in interest expenditure (the average cost of the debt declines from 3.6 per cent to 3.2 per cent), the snowball effect is still greater than the primary surplus. The debt increases from 132.1 to 132.5 per cent of GDP, although the rise is partly offset by the use of liquid assets accumulated in 2014 and the beneficial effect of large issue premiums.

The reduction in the debt/GDP ratio begins in 2016. It first declines to 130.9 per cent, thanks to a primary surplus that exceeds the snowball effect for the first time, which was further contained by nominal growth (2.6 per cent).

In 2017 and 2018, the ratio is forecast at 127.4 per cent and 123.4 per cent, respectively, thanks to a primary surplus of more than 3 per cent and, for the first time in 2017, a negative snowball effect (GDP growth of 3.3 per cent would exceed the average cost of debt, which again declines and comes to 3.1 per cent) that remains negative thereafter. A further modest decline in liquid assets (0.17 and 0.14 percentage points of GDP) reduces the volume of government securities.

In 2019, the debt is forecast to be equal to 120 per cent of GDP, with a primary surplus of 4 per cent and a zero snowball effect.

Throughout the forecasting period, the debt would benefit from the assumption of no additional financial support to the EMU Member States and the end of the contribution to the capital of the European Stability Mechanism (ESM).

Debt would be increased by, among other factors: the impact – in 2015 – of the depreciation of the euro on the euro value of liabilities denominated in foreign currencies; the impact – as from 2016 – of an increase in the Italian and European inflation rate on inflation-linked securities; the effect – in 2018-19 – of the gradual termination of the centralised management of local authority treasury balances as from 2018; and an increase in net flows associated with financial derivatives.

2.5 Analysis of the risks associated with the public finances

The resilience of the public finance scenario set out in the EFD depends on the combined occurrence of multiple conditions connected with developments in the public accounts themselves and in macroeconomic conditions.

With regard to the budget, the evolution of expenditure, especially current spending net of interest expense, depends on full achievement of the forecast savings from the planned measures. In addition, achievement of the objectives for the new expenditure containment measures appears even more challenging after years of consolidation, engendering, among other things, the risk that the benefits may be overestimated in part due to the overlapping of areas of intervention.

On the macroeconomic front, the sensitivity analyses of the EFD point to major consequences for the public finances if growth is not as fast as projected. The risks especially regard the assumptions concerning the international exogenous variables used in formulating the official forecasts. The simulations conducted by the PBO panel forecasters[10] to assess the effects on GDP growth of different assumptions for oil prices and exchange rates demonstrate that the impact could be significant.

[10] See the first chapter of this Report.

More specifically, the adverse scenario in the EFD considers a reduction in growth over the planning period of 0.5 percentage points of GDP in each year compared with the reference scenario and an increase of about 100 basis points in the yield curve caused by a deterioration in market perceptions concerning the sustainability of the public finances owing to slower growth. As underscored in the simulations in the EFD, this would have a substantial impact on the accounts:

- structural balance would not be achieved in the EFD planning period;
- the reduction in the ratio of debt to GDP would begin in 2017, a year later than in the base scenario, and debt would be about 7 percentage points of GDP larger;
- the general government balance would remain in deficit, with no surplus in 2019 as in the base scenario;
- owing to the smaller primary surplus, the debt/GDP ratio, while declining, would fall more slowly, resulting in non-compliance with the debt rule over the forecasting period;
- the primary surplus would still be greater than the snowball effect as from 2016, but that effect would not turn negative in the planning period, as the rate of growth in nominal GDP would not exceed the average cost of debt.

Box 2.1 – Accounting effects of ESA 2010 on the general government accounts

The adoption of ESA 2010 gave rise to changes in the criteria for allocating certain items of the national accounts. The main changes cause an increase in both the level and rate of change of revenue and expenditures, with limited effects on net borrowing.

On the revenue side, the main increases involved:

- indirect taxes, due to the inclusion of the rate component in electricity bills for renewable generation subsidies under that item. It had not previously been included in the public accounts under either revenue or expenditure. The considerable growth in that item in recent years (from €2.4 billion in 2008 to about €11 billion in 2013) explains the increase generated by the revision. Another change involved the inclusion in computing VAT of the share of VAT revenue allocated to financing the European Union;
- direct taxes, owing to the non-recognition of the decrease in cash payments due to the use of refundable tax credits (deferred tax assets); the latter are now accounted for under capital transfers to enterprises and recognized on an accrual basis rather than a cash basis;
- other current revenue, due to the inclusion in the gross operating surplus of depreciation (consumption of fixed capital) associated with expenditure previously classified as current and now included under capital expenditure (weapons, R&D).

On the expenditure side, the main changes regarded:

- current primary expenditure, which was increased by a number of the items already mentioned with regard to revenue, including the increase in transfers to the rest of the world due to the recognition under expenditure of the EU VAT transfers and production subsidies associated with renewable resource incentives. The item was reduced by the exclusion of expenditure on weapons and R&D, partly offset by the recognition of the associated depreciation under current expenditure;
- capital expenditure, which was impacted by expenditure on weapons and R&D and refundable tax credits (deferred tax assets);
- interest expenditure, which was reduced by the exclusion of interest in respect of derivatives contracts.

Revenue

The transition to ESA 2010 raised the growth rate for revenue due essentially to the recognition under indirect taxes of the rate component for renewable energy incentives and the recognition of deferred tax assets under direct taxes. With regard to the fiscal burden, in 2013 the denominator increased by €15.6 billion. On average over the 2011-13 period, just over 70 per cent of the increase was accounted for by the inclusion of the rate component for renewable energy incentives (Figure 2.4). Nevertheless, the fiscal burden declined after the transition to ESA 2010 owing to the upwards revision of GDP in the denominator (Figure 2.5).

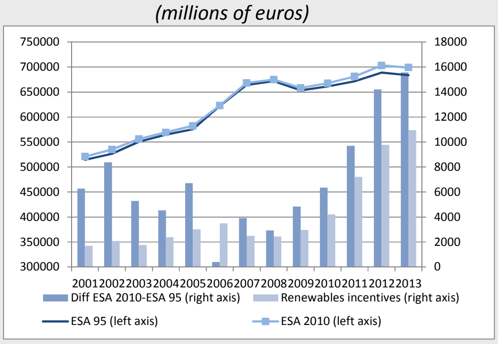
Expenditure

On the expenditure side, the transition to ESA 2010 accelerated growth primarily owing to subsidies to renewables generators, partly offset in the final years of the period by the reduction in interest expenditure due to the exclusion of swaps (Figure 2.6). More specifically, that exclusion initially increased overall expenditure, for the years in which those contracts gave rise to net receipts (until 2005), followed by a reduction for the years in which the derivatives produced an increasing net outward payment flow (from €260 million in 2006 to €3.2 billion in 2013).

The benchmark balance for the purpose of the European fiscal rules

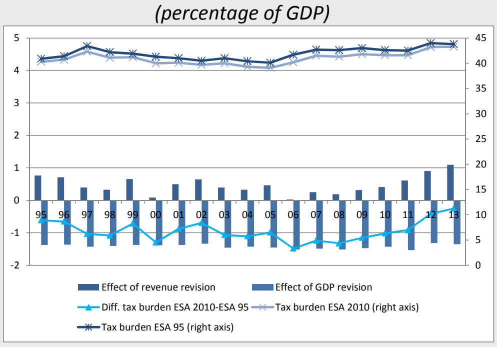
The reclassification engendered by ESA 2010 also impacted the benchmark balance used for the purpose of the European rules, i.e. net borrowing as a proportion of GDP. In addition to the changes to revenue and expenditures noted above, it was also affected in the denominator by the revision of the GDP time series. The latter effect generally predominated, especially at the end of the series, reducing the ratio in most years (Figure 2.7).

Figure 2.4 – Revenue impacting fiscal pressure under ESA 95 and ESA 2010
(millions of euros)



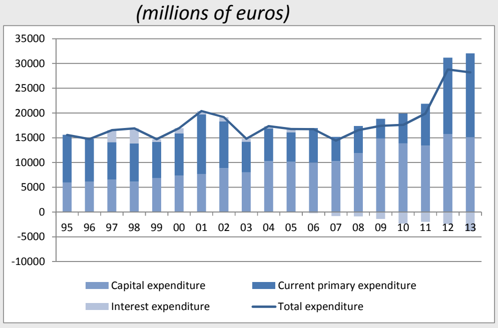
Source: for outturns, Istat, *Conti e aggregati economici delle AP*, December 2014 and *GDP e indebitamento AP*, 2012-2014, 2 March 2015; for incentives for renewable energy resources, Istat, "*Il passaggio al Sec 2010 e la revisione generale dei conti nazionali*", conference held in Rome, 16 December 2014.

Figure 2.5 – Reduction in fiscal burden as a result of ESA 2010 and its determinants
(percentage of GDP)



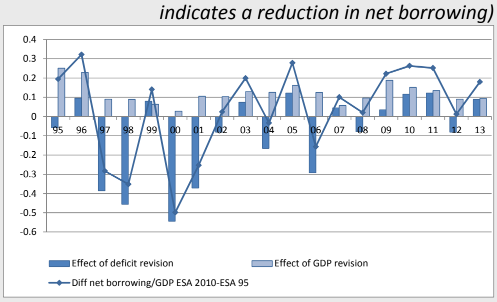
Source: based on Istat figures, *Conti e aggregati economici delle AP*, September and December 2014

Figure 2.6 – General government expenditure: composition of the difference between ESA 2010 and ESA 95
(millions of euros)



Source: based on Istat figures, *Conti e aggregati economici delle AP*, September and December 2014

Figure 2.7 – Change in net borrowing as a ratio of GDP as a result of ESA 2010
(percentage of GDP. A positive sign indicates a reduction in net borrowing)



Source: based on Istat figures, *Conti e aggregati economici delle AP*, September and December 2014

3. SECTORAL ANALYSIS

3.1 The spending review

The largest portion of the resources required to achieve the policy objectives set out in the EFD starting from 2016 would, as stated in the document itself, be raised through spending review measures (around 0.45 percentage points of GDP, or about €7 billion).

The EFD specifies numerous areas in which action should be taken to rationalise central and local government, placing systematic verification of spending programme priorities and enhancing the efficiency of government among the Government's priorities for action. The most important areas in which the spending review would be conducted are:

1) the concentration of local-level central government offices in single "federal buildings";
2) the rationalisation of public procurement;
3) the revision of the system of producer subsidies;
4) the rationalisation of government-controlled enterprises;
5) the use of standard needs/costs to determine expenditure targets for municipalities and provincial governments.

The following sections examine a number of aspects of the evaluation of the spending review measures that can be implemented in each of these areas. More specifically, note should be taken of:

the risk of double counting the expected savings among the different areas of correctives action identified in the National Reform Programme (NRP), which in this case include standard costs, transfer payments to enterprises and the rationalisation of government-controlled enterprises (in local and regional public transport). There is an analogous risk of overlap between measures to contain intermediate consumption expenditure or for rentals and, again, the use of standard needs;

the need to verify whether measures already adopted have been implemented in order to provide a realistic starting point for specifying new measures;

the need to bear in mind that the expenditure items referred to in the EFD are the easiest to tackle and therefore have been the most extensively trimmed under previous corrective measures, limiting the scope of future reductions;

the spending reviews require complex reorganisation processes that can be implemented gradually, over the medium term, contrasting with the need to find the resources from the first year that they appear in the EFD policy scenario.

3.1.1 Rationalisation of public procurement

Recent years have seen a proliferation of measures for containing the intermediate consumption expenditure of general government, mainly focusing on the procedures for determining purchase prices. As it is believed that this function would be best performed at the central level, a range of centrally managed instruments (legislative, organisational, contractual and control) has been introduced, seeking on the one hand to improve general government's negotiation capabilities in the procurement of goods and services, and on the other to establish benchmarks to be used by individual government departments in operations and to verify the results they have achieved.

Since 2010, the data on actual performance reveal a decline in the pace of growth in intermediate consumption expenditure and in some cases, even a reduction in absolute terms. Figure 3.1 shows developments in intermediate consumption expenditure in the sub-sectors of general government, while for the forecasting period only the estimate of total general government spending is available. Although the 2015 EFD has revised the intermediate consumption spending forecasts upwards by €5 billion per year compared with level set out in the Technical Note (due above all to the impact of the shift from ESA 95 to ESA 2010), for the current year spending has been reduced, followed by small increases as from the subsequent year.

This trend, and specifically the reduction in spending starting from this year, assumes full implementation of the spending review measures, including those envisaged in Decree Law 66/2014 and the 2015 Stability Act, which are focused, respectively, on enhancing the negotiating capabilities of the general government and on containing appropriations for the Ministries and local governments, with a reorganization of the budgeting rules for the latter.

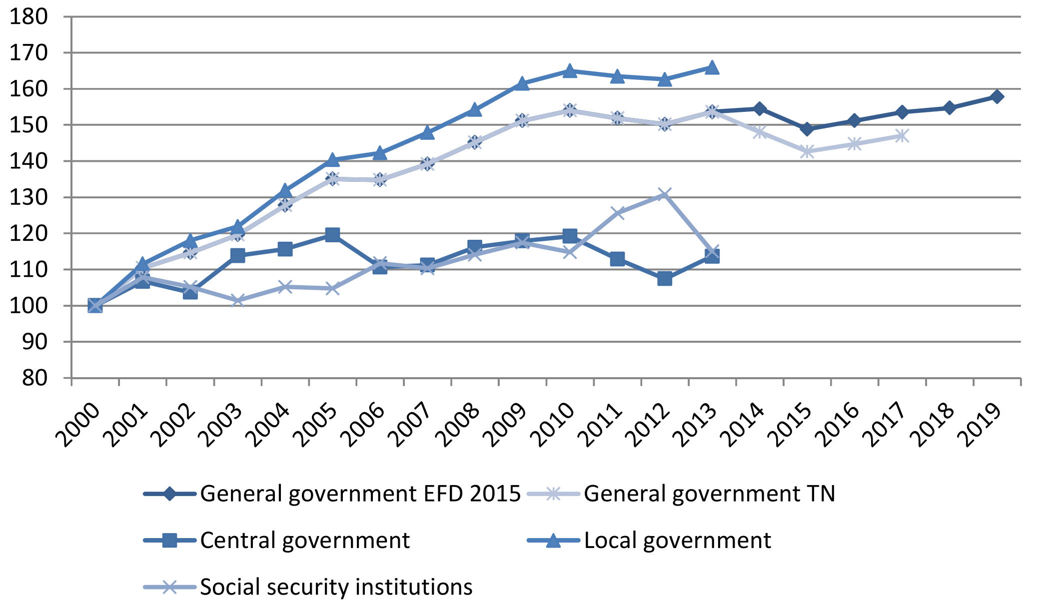
In order to implement additional measures for intermediate consumption as from 2016, the measures already envisaged in current legislation must generate all of their expected savings, with no delays in implementation.

The additional measures for intermediate consumption expenditure referred to in the EFD 2015 appear to regard measures concerning prices and limiting quantities. Some of the measures will therefore concern with additional actions to increase the efficiency of procurement. As the recently-introduced instruments are still being implemented, it is likely that the additional measures will involve extending the scope of application of these instruments, rather than a wholesale revision. Although large areas of expenditure have not been touched by the procurement rationalization process – thanks, for example, to the widespread use of serial extensions of existing contracts – past experience seems to indicate that additional savings could be achieved by incorporating these areas, albeit gradually.

Preliminary assessments of the economies attributable to price cuts obtained using the different instruments introduced by Consip (the government procurement agency), which build on the analysis set out in the annex to the EFD on general government's annual requirements for goods and services, show that savings in line with expectations could only be achieved if the use of existing instruments is significantly expanded.

Further savings could be generated by measures to reduce quantities purchased. In the medium term, this aspect will be affected by the reorganisation of planning and management policies, which could give rise to efficiency gains. The introduction of electronic invoicing, which will make it possible to monitor quantities procured more accurately, will have an impact in this area, as will the reorganisation of government departments. The completion of the reform of the Budget Act, with the comprehensive review of appropriations in the chapters of the Act, is necessary for assessing the efficiency of the use of public resources and for stabilising spending review processes in the context of the annual budget decision. In the short term, other instruments will presumably be identified, such as the review of existing procurement contracts, not only with a view to evaluating prices, as has been done so far, but also with regard to quantities purchased.

Figure 3.1 – Trend developments in intermediate consumption expenditure in the 2015 EFD
(*Indices: year 2000=100)*



Source: ISTAT until 2013, EFD 2015 from 2014. The dotted line refers to the data contained in the Technical Note (*Nota tecnico-illustrativa*) of the 2015 Stability Act.

3.1.2 Measures involving government buildings

The process of physically concentrating the currently highly fragmented "peripheral" government into a single location (the so-called "federal building" approach) is intended to pursue the objective of improving the efficiency of the general government's use and management of buildings, which is highly inefficient. This could translate into savings in spending on logistics and maintenance (in addition to improving the level of service for citizens by physically aggregating government offices). Under the NRP, the process will be overseen by the State Property Agency starting with plans to rationalise the premises occupied by individual departments already provided for under Decree Law 66/2014. However, no specific savings targets have been given.

The action outlined in the NRP, however, envisages additional measures to cut total spending, on which a series of legislative initiatives should have an impact, most recently those introduced with Decree Law 66/2014. The savings they should generate should theoretically be included in the trend scenario for intermediate consumption expenditure.

More specifically, Article 24 of Decree Law 66 envisages a series of measures to enhance the efficiency of spending by central government departments on leased property, strengthening the instruments previously introduced with the 2010 Finance Act (Law 191/2009)[11] and subsequently with Decree Law 95/2012.[12]

In particular, Decree Law 66/2014 calls for a new national plan for rationalising the use of premises to be drawn up by individual central government departments by 30 June 2015. Starting from 2016, the plan must cut spending on rentals by at least 50 per cent of the level of such expenditure in 2014 and must reduce the amount of space occupied in state-owned buildings by at least 30 per cent, again compared with the 2014 figure.

Other instruments introduced were:

- mandatory market studies to find the most attractive rentals, to be carried out primarily through a special IT application ("Paloma") established at the State Property Agency;
- specific reporting requirements for central government departments concerning the preparation of plans for optimising and rationalising the use of premises;[13]
- easier terms for government departments to withdraw from lease agreements;[14]
- an expansion of the State Property Agency's role as the principal agent with regard to maintenance (the "single maintainer");

[11] Article 2, paragraphs 222-224.
[12] Article 3 ("Rationalisation of public assets and reduction of rental costs").
[13] In the event of non-compliance, the State Property Agency shall report the failure to the State Audit Court.
[14] The time period in which to exercise the power to withdraw from the contact has been shortened, thereby allowing departments to provide notice of their intention to withdraw by 31 July 2014, rather than 1 December 2014, and this option has been extended to all government departments.

- a reduction of 15 per cent in rents for buildings leased for official use in contracts executed by central government departments.[15]

Significantly, Annex 3 to Decree Law 66 did not attribute saving to these measures. The Technical Report (TR) asserted that the regulations could have positive financial effects in terms of reporting on an accrual and cash basis. However, these were not quantified due to the fact that the basis for calculation will not be known until the accounts for the current year are closed and that they will actually be achieved in 2016. The measures originally contemplated in the 2010 Finance Act were also expected to have only a modest financial impact.[16] Similarly, the TR for Decree Law 95 explicitly argued that the savings on expenditure associated with a number of measures concerning rentals could not be quantified *ex-ante* or that only very limited estimates could be made. This approach appears to reflect a prudent assessment of the time necessary to implement the reorganisation processes that could lead to real savings such as to justify the reduction in specific appropriations made in the budgets of the individual government departments.

A number of quantitative guidelines concerning the amount of general government spending on rentals, one of the main expenditure items that the concentration process could reduce, are found in the so-called “Cottarelli Plan”. Currently, the central government uses buildings covering a gross total of around 79,290,000 m^2. Of this, 81 per cent (around 64,345,000 m^2) are state-owned premises and the remaining 19 per cent (approximately 14,945,000 m^2) is owned by private parties or public entities leased by the state. The state’s total spending on rentals is estimated at €1,215 million. Excluding the Ministry of Defence, which alone accounts for two-thirds of the space owned (about 42,564,000 m^2), we find that 60 per cent of the space used by the remaining departments is state-owned and 40 per cent is leased from third parties, an obvious increase in the percentage of leased property.

At present, the data collected by the Treasury Department provide no information on the property that government departments (other than central government) have leased from third parties. In 2012, the Special Commissioner for Expenditure Rationalization asked the Public Contracts Oversight Authority[17] to conduct a survey of rents paid by non-central government departments and government-controlled enterprises. The study found that spending under lease agreements totalled around €1,050 million per year. Spending on rent by central government departments and the others therefore totalled around €2,265 million, to which we must add the annual property management costs for these rentals.

[15] Decree Law 66 moved up this reduction from 1 July 2015 to 1 July 2014.
[16] Annex 7 of Law 191/2009 estimated an annual savings of €65 million generated by the regulations on rentals.
[17] Now incorporated into the National Anti-Corruption Authority.

Furthermore, it is necessary to consider the costs associated with the use of government-owned property by the central government departments, which include imputed rent (the reduction of which entails completely vacating the property and selling it) and the related annual management costs. There are no updated official estimates of the scale of these costs, but it is reasonable to assume that it is a multiple of the expenditure on leased property quantified above.

3.1.3 Review of producer subsidies

Another area identified in the NRP as a source of spending cuts is producer subsidies. The term seems to refer to a component of the broader aggregate of transfers to enterprises. The latter – in the various categories into which they are divided,[18] channel substantial resources to the productive sector,[19] although their amount has been falling in recent years as a result of corrective measures.

These transfers totalled around €41.7 billion in 2013, of which €24.3 billion disbursed by the central government and €16.9 billion by local governments. Local expenditure reflected, especially as from 2001, the full implementation of administrative federalism (under Legislative Decree 422 of 1997 "Transfer to the regions and other local governments of the functions and duties regarding local public transportation") and the transfer to the regions of central government responsibilities in the area of regional rail transportation. Expenditure by central government reflects the effect, of increasing size as from 2010, of the inclusion in the public accounts (under production grants, with a matching item under offset in revenue of the financing through indirect taxes on energy consumption) of the flows associated with incentives for renewable energy resources connected with the introduction of ESA 2010. In 2013, this produced an increase in expenditure by central government departments of around €11 billion. The value of transfers of general government corrected for that effect came to about €30.7 billion in 2013, while that of central government totalled around €13.3 billion.

Within this aggregate, expenditure for the narrower category of producer subsidies is focused on aid disbursed to support the financing, development and formation of entrepreneurial activities, excluding subsidies classified under the general taxation system and resources for public services. There is vast number of such subsidy programmes, managed at various levels of government, aimed at beneficiaries differentiated by industrial policy objective. The Ministry for Economic Development

[18] Expenditure on "production grants", "sundry current transfers" and "investment grants" in the general government accounts.

[19] More specifically, resources are directed towards infrastructure (railways, roads and highways, subways), transportation (trucking, rail), defence (aeronautics, naval), aeronautics, communication (postal, telecommunications), agriculture, education (accredited private schools, private universities), and entertainment, other sectors and natural disaster response measures.

surveys 845 programmes, of which 45 national and 800 regional.[20] For just this subset, the assessment of expenditure open to cuts in 2012 came to €3.4 billion,[21] a development significantly affected by the budget measures undertaken in recent years.

The spending review set out in the NRP should therefore seek to rationalize this sector, characterised by the large number of instruments, substantial fragmentation of resources and the involvement of multiple government entities. Specifically, corrective action should seek to simplify national and regional legislation. For any review of regional spending, an agreement would have to be reached with the regions, since they exercise considerable autonomy in managing subsidies, with regard to both the type and the amount of funds made available to their local economies.

In order to achieve greater savings, the expenditure aggregate subject to reduction should be expanded beyond subsidies to incorporate other components of transfers to enterprises. At the same time, however, the scope for savings must take account of possible double counting with the other areas in which corrective action is to be taken under the NRP, in this case those connected with standard costs for local and regional public transportation and those relating to government-controlled enterprises. On the other hand, cuts in transfer payments could be associated with privatisations (Ferrovie dello Stato Italiane, Poste Italiane, ENAV).

3.1.4 The rationalisation of government-controlled enterprises

Government-controlled enterprises represent a diverse reality, with significant differences in terms of their owners, the size of shareholdings, the activities in which they are engaged and the characteristics of their operations (direct award of contracts or procurement through tenders).

The number of companies that can be identified using official databases may be an underestimate. In 2012, the MEF's databases[22] contained more than 8,000; ISTAT, which monitors and coordinates various sources of information, reported more than 11,000 in 2012.[23] The difficulty of specifying a definite number arises from the considerable fragmentation of the category (in MEF database, there is a less than 50 per cent rate of compliance with disclosure requirements) and the phenomenon of indirect

[20] These include capital and plant grants, operating grants, interest subsidies, mixed grants, tax credits, subsidised loans and equity investments.
[21] Measured in 2012 based on the most recent *Relazione sugli interventi di sostegno alle attività economiche e produttive 2013* by the Ministry for Economic Development.
[22] The Ministry for the Economy and Finance, *Rapporto sulle partecipazioni detenute dalle Amministrazioni Pubbliche* at 31 December 2012 http://www.dt.tesoro.it/export/sites/sitodt/modules/documenti_it/programmi_cartolarizzazione/patrimonio_pa/Rapporto_Partecipazioni_DatiAnno2012.pdf
[23] http://www.istat.it/it/archivio/143736.

shareholdings, often operating through a series of holding companies, with very weak lines of control.

In order to monitor the effectiveness of the measures, the primary goal is to obtain more timely and complete information. In 2014, an effort was made to standardize the procedures for collecting information on such companies, collating the information on the Treasury's website. Further effort should be made to develop information capabilities so as to improve integration of existing databases (using company taxpayer ID numbers).

Government-controlled enterprises engage in a wide variety of activities. Based on the definitions set out in the Rationalisation Programme of the Special Commissioner for the Spending Review, Carlo Cottarelli[24], these companies operate in four major areas:

- essential services, i.e. they supply goods and services almost exclusively to their government shareholder (mainly: property, asset or holding company management, IT services, sundry administrative services); these account for almost 13 per cent of the total in the MEF database;
- public services of no economic interest, providing services to the public in sectors with no revenue generation, mainly financed through general tax revenue; around 42 per cent of the companies in the MEF database fall into this category;
- public network services of economic interest, mainly in regulated sectors (electricity, water, gas, waste, local public transportation); accounting for about 23 per cent of the total;
- a residual category that encompasses companies that sell goods and services to the public in competitive markets; representing about 22 per cent of the total.

In recent years, numerous legislative measures have been adopted in an effort to reduce the number of such companies or to manage them more efficiently. Charts 4 and 5 in the Appendix to the NRP provide a summary of existing legislation, especially for local governments, but lack an assessment of its application and results. Since this is a diversified category with a variety of responsibilities, monitoring it would require developing instruments for coordinating and agreeing actions among various ministries and between central and local governments.

The 2015 Stability Act requires general government entities[25] to begin rationalising corporations and shareholdings held directly or indirectly so as to reduce their number, starting in 2015.

[24] http://revisionedellaspesa.gov.it/documenti/Programma_partecipate_locali_master_copy.pdf
[25] The regions, the autonomous provinces of Trento and Bolzano, local authorities, chambers of commerce, universities and public institutes of higher learning and port authorities.

The managers of the entities involved in the rationalisation process have until 31 March 2015 to draw up and approve a rationalisation plan, submitted to the regional audit section of the State Audit Court and published on their official website. A report on the results achieved will be prepared by 31 March 2016 (also to be sent to the State Audit Court and published on their website).

The measures in the 2015 Stability Act draw inspiration from the Rationalisation Programme of the Commissioner for the Spending Review, which sets out a strategy based upon: i) strictly limiting the field of action of the companies within the boundaries of the institutional mission of the entity that controls them; ii) placing direct restrictions on various forms of shareholding; iii) making extensive use of transparency and the pressure of adequately informed public opinion as instruments of control; iv) fostering the efficiency of the surviving companies, making extensive use of standard costs. The savings that can be achieved are estimated at a minimum of €2-3 billion.

The savings associated with the rationalisation of government-controlled enterprises are difficult to quantify, however, due both to a number of substantive issues and to issues connected with accounting for the activities performed.

As to the substantive issues, the immediate result of mergers or liquidations is the achievement of a reduction in costs, but one of limited scope (management bodies, offices, etc.). Broader reorganization actions would yield greater improvements in the structure of company accounts. However, these require time, as business plans must be prepared (and their measures implemented), and they frequently involve the problem of placing redundant personnel (who cannot simply be moved to another position within general government since they have not undergone a competitive selection process). The elimination of direct contracting could produce more efficient cost structures, but the transition would in certain cases have to be gradual so as to not squander the experience and skills possessed by the existing companies.

On the accounting front, reducing the number of companies or making them more efficient does not necessarily generate a corresponding reduction in expenditure for their public shareholders. While there are cases in which a company's improved efficiency helps lower the cost of procuring the services they provide (e.g. ancillary services undertakings), in other cases the efficiency-enhancement actions do not necessarily translate into lower current expenditure for the public shareholder, for a variety of reasons. The companies may be operating at a loss (even if not recurring), in which the thresholds set under the Italian Civil Code that require recapitalisation or liquidation have not been reached; or perhaps, if the threshold is reached, capital contributions (e.g. a building) restore the financial position so as to allow operations to continue. Or, in the case where operations are financed through rates or fees paid by users, certain activities carried out by government-controlled enterprises may not be reflected in any way in municipal accounts: greater efficiency in organising the factors of production would reduce the burden on the public, but – once again – would not result in lower spending by the government shareholders.

Other issues regard the feasibility of the plan for the rationalisation of government-controlled enterprises. For companies that can be sold since they provide market goods and services, local or systemic crisis situations may limit opportunities to sell the business to private-sector parties due to a lack of bids, and lowering the price is not always enough to change the outcome of an auction with no bidders. In these cases, a decision to place the businesses in liquidation (if operating at a loss) requires an assessment of the importance of that economic activity in the local area.

The governance of the rationalisation process is not made easier by the multiple responsibilities for the activities performed and by the complexity of corporate control among entities of different levels and types. A government entity that holds 100 per cent (or at least a majority) of a company has full control and can take effective reorganization actions more easily. More highly fragmented shareholdings, as is often the case at the local level, require that one of the shareholders be identified to spearhead the process and that the processes be defined more specifically. Even the ability to set policy at the central level seems difficult to coordinate, since the responsibilities for these areas are distributed across multiple ministries and would require close coordination among them. Finally, attention must also be paid to the risk of double counting any savings expected from measures addressing intermediate consumption and standard needs.

3.1.5 The utilisation of standard needs in local finance

The use of standard needs/costs in the spending review for local government should, in theory, make it possible to determine the level of efficient spending in the delivery of their services at any given level of service. It would thereby be possible to isolate the inefficient spending component that could be eliminated without compromising the services provided to the public.

The assessment of standard needs/costs in the spending review for local government was conducted under the Cottarelli Plan and has recently been applied, albeit partially, in the effort to allocate the cuts in funding to the provinces under the 2015 Stability Act.

According to the assessments made by the working group set up under the Cottarelli Plan,[26] spending attributable to inefficiency in municipalities and the ordinary regions for all of their key functions comes to around €3.6 billion. This represents considerable potential savings, although the actual amount must nevertheless be adequately specified.

[26] http://revisionedellaspesa.gov.it/documenti/Spending_comuni_rapporto_15settembre_x2x.pdf

First, it was found that the largest component of the €3.6 billion estimated total of inefficient expenditure was that for waste disposal services, which is financed, in large part, by user fees. As a result, a reduction in inefficient spending in this sector would benefit the public but would not translate into savings of public resources. Second, the inefficiency assessments are based on public expenditure data (and the corresponding amount of services provided in the various municipalities) gathered in 2010. Accordingly, the figures refer to expenditure amounts that have, at the segment and individual entity levels, experienced significant reductions since then. If, in principle, the municipalities had responded to these cuts in funding by making their spending more efficient, the additional cuts to be made in the coming years would at least in part impact the level of services provided to the public, with consequent implementation difficulties. In addition, the estimated savings achievable by eliminating inefficiencies in the local production of services indicated above may overlap with the potential savings resulting from other spending review measures (measures concerning property management, reduction in the use of external consultants, review of local government-controlled enterprises, etc.).

3.2 Tax relief measures

Alongside the spending review measures, another important component of the resources required to finance the neutralisation of the safeguard clauses starting from 2016 would be generated, as stated in the EFD, by measures to adjust tax relief mechanisms (around 0.15 percentage points of GDP, or €2.5 billion).

The need to rationalise the tax relief system has been one of the focal points of the tax reform agenda for some time. The goal is to verify the purposes and resources used to fund the vast assortment of tax relief measures that has accumulated over time in order to make them more efficient, while also contributing to consolidation of the public accounts.

The State budget has an annex listing measures containing exemptions and reductions in taxes provided for under tax legislation, accompanied by an estimate of the projected loss of revenue[27] over the three-year period. The annex to the State budget does not, however, provide systemic information on the purposes of each measure, something that would help future tax reformers to decide whether to maintain, eliminate or reduce individual tax relief mechanisms.

The Base Erosion Working Group formed in 2011 helped address this deficiency by establishing a classification of the purposes of tax relief measures and by assigning each

[27] The financial effects of each tax expenditure are generally estimated as the increase (or loss) in revenue resulting from the repeal (or introduction) of the expenditure involved, assuming that taxpayer behaviour remains unchanged.

measure to one or more categories.[28] The possible purposes identified by the Working Group range from the implementation of constitutional principles (such as tax progressivity), the achievement of territorial or social objectives, the simplification of the system, the recovery of unreported taxable income, making the tax system compatible with European Union law and international agreements, and eliminating double taxation. The Working Group recognized that many of the tax relief measures actually pursue more than one goal. Its study evaluated the financial impact of the various measures as at 2010 and has not been updated subsequently.

Finally, the monitoring and reorganisation of measures contributing to base erosion is one of the areas in which, under the tax reform enabling act, the Government is authorised to intervene by "eliminating or reforming tax expenditures that appear, in whole or in part, unjustified or obsolete in light of changes in social or economic needs or where they represent a duplication".

In order to provide policy-makers with updated financial assessments of tax relief measures containing a systematic and comprehensive indication of the purposes of each measure – useful for both finding the resources required by the EFD and, especially, to conduct a comprehensive review of the tax expenditure system – the PBO has integrated the two sources of information currently available: the table annexed to the 2015 State budget and the classification drawn up by the Base Erosion Working Group.

Table 1 illustrates the results for this year: the 282 tax relief mechanisms reported in the table annexed to the State budget, and the associated financial impact for 2015, have been assigned to the categories of purposes developed by the Base Erosion Working Group. For expository reasons, the table provides separate reporting only for measures whose financial exceeds €200 million.[29]

It should first be stressed that many of the larger relief programmes seek to achieve multiple objectives (such as measures concerning property renovation credits in personal income tax and value-added tax, which are classified as being of social and sectoral relevance and to recover unreported taxable income, or the partial deduction of personnel expenses for the purposes of IRAP (regional business tax), which is considered to have social and territorial relevance, provide support to enterprises and help protect the environment and artistic heritage), underscoring how complex and sensitive each revision in this area can be.

[28] The working group supplemented the measures reported in the table annexed to the State budget with the inclusion of additional measures and mechanisms under its broader mandate, which consists in considering the entire area of tax base erosion. In addition, the working group also analysed local tax relief measures. This different approach reflects the total number of items analysed, around 720 in the Report of the Working Group and about 280 in the table annexed to the State budget.

[29] The full list of tax relief measures, with indication of their objectives, will be published on the PBO site (www.upbilancio.it).

The table also shows that the tax relief measures with the largest financial impact are those designed to ensure compliance with constitutional principles (such as tax credits by source of income and for dependents, both in the personal income tax rules) or socially important goals (such as the reduced VAT rates of 4 per cent and 10 per cent,[30] the deduction for taxpayers' primary residence from personal income tax and the deduction of labour costs for IRAP purposes, the latter in relation to the support it provides employment). Even the measures in support of welfare (which includes tax credits for dependents, those for healthcare costs, those for contributions to supplementary pension schemes, and the exemption for disability pensions for veterans and the blind, all of which affect personal income tax) include measures with a substantial financial impact.

In general, these measures involve incentives that affect basic elements of a tax or that pursue redistributive objectives so explicit (tax progressivity, reductions for the lowest incomes or compensation of employees and equivalent workers) that it is very difficult to change them outside of a comprehensive reform of the entire tax relief system.

Lost revenue is more limited for measures aimed, among other things, at simplifying the tax system, which essentially includes a series of tax relief measures in the area of taxing investment income. Relief measures of sectoral relevance, which mainly regard excise taxes on energy products and IRAP, also have a smaller financial impact on average.

It is likely that these areas, where it is more difficult to find systemic objectives and the forms of implicit subsidies for specific sectors and interest groups are more evident, should be the focus of measures to achieve more immediate reductions in tax expenditures.

[30] On various occasions international organisations have reported greater erosion of VAT revenue in Italy compared with other European countries connected with a broader application of reduced rates.

Table 3.1– Tax relief measures identified in accordance with the classification of the Base Erosion Working Group
(2015, millions of euros)

	Tax	Tax relief measure	Base Erosion Working Group classification	Amount
1	IRPEF	Tax credits by source of income	Constitutional relevance	37,843
2	VAT	Reduced rate 4%	Social relevance	27,643
3	VAT	Reduced rate 10%	Social relevance	14,094
4	IRPEF	Deduction for mandatory pension and social assistance contributions and other amounts that do not form part of compensation of employees	Elimination of double taxation Constitutional relevance	12,261
5	IRPEF	Tax credits for dependents	Constitutional relevance Welfare measures	11,171
6	IRAP	Partial deduction of personnel costs	Social relevance Territorial relevance Protection of environment and artistic heritage Support for enterprises not limited to single industry	8,383
7	IRPEF	Separate taxation of termination benefits, arrears, etc.	Sectoral relevance	6,527
8	IRPEF	36% tax credit for property renovations	Social relevance Sectoral relevance Recovery of unreported taxable income	3,502
9	IRPEF	Deduction for primary residence	Social relevance	3,304
10	IRPEF	Tax credit for healthcare expenses	Welfare measures	2,904
11	IRPEF	Tax credit for supplementary pension contributions	Welfare measures	2,883
12	IRPEF	Exemption of disability payments to veterans and the blind, etc.	Welfare measures	2,441
13	Tax on insurance contracts	Exemption from tax on insurance contracts and annuities	No classifiable	2,272
14	Registration fees, mortgage-cadastral taxes, government concession fees	Substitute tax applied on medium/long-term loans	Simplification of system Social relevance Support for enterprises not limited to single industry	2,022
15	IRPEF	Exemption of child support payments to spouse following separation or divorce	Elimination of double taxation	1,943
16	Excise tax on energy products	Exemption from excise tax on energy products used as fuel for air transport	Compatibility with EU law and international agreements Competitiveness with other countries	1,539
17	IRPEF	Tax credit of 65% for energy efficiency upgrading of property	Social relevance Sectoral relevance Recovery of unreported taxable income	1,489
18	VAT	10% rate for property renovation work and home care services for the elderly and adult disabled	Social relevance Sectoral relevance Recovery of unreported taxable income	1,416
19	IRPEF	Tax credit for interest on loans for purchase of primary residence	Social relevance	1,257
20	Excise tax on energy products	Reduction of excise tax for truck drivers	Sectoral relevance Social relevance	1,148
21	Registration fees, mortgage-cadastral taxes	Purchase of primary residence	Social relevance	1,067
22	Excise tax on energy products	Reduced rate for agricultural uses	Sectoral relevance	969
23	IRPEF	€80 tax credit for low-income employees	Welfare measures	832

Table 3.1 *(cont.)* – Tax relief measures identified in accordance with classification of the Base Erosion Working Group
(2015, millions of euros)

	Tax	Tax relief measure	Base Erosion Working Group classification	Amount
24	IRES	Realignment of value of intangible assets for tax purposes with value for financial reporting purposes	Support for enterprises not limited to single industry	808
25	Tax on pension funds	Taxation of returns at fund level	Simplification of system Welfare measures	732
26	Excise tax on energy products	Exemption from excise tax on energy products used as fuel for marine transport	Compatibility with EU law and international agreements Sectoral relevance	598
27	Excise tax on electricity	Exemption for homes with very low consumption	Social relevance	597
28	IRPEF	5% deduction on property rental payments	Recovery of unreported taxable income	545
29	IRPEF	Tax credit for insurance premiums on pure life or long-term care policies	Social relevance	358
30	Registration fees	Exemption from registration fees for insurance and reinsurance contracts and receipts	Simplification of system Sectoral relevance	354
31	Tax on dividends	Reduction of rate to 1.375% on dividends paid to companies subject to corporate income tax in an EU Member State	Compatibility with EU law and international agreements	350
32	IRPEF	Tax credit for educational expenses	Welfare measures	348
33	IRAP	Reduced rate in agriculture	Sectoral relevance	324
34	IRPEF	50% tax credit for property renovations	Social relevance Sectoral relevance Recovery of unreported taxable income	292
35	IRPEF	Partial exemption from inclusion in taxable income for certain types of other income	Social relevance Protection of environment and artistic heritage	284
36	VAT	Special regime for farmers	Simplification of system Sectoral relevance	281
37	IRPEF	Return of workers and students abroad	Social relevance	251
38	IRPEF	Standard deductions on specific forms of income	Social relevance	247
39	IRPEF	Deduction of alimony payments to spouse following separation or divorce with the exclusion of child support payments	Elimination of double taxation	245
40	IRPEF	Tax credit for rental payments for primary residence	Social relevance Recovery of unreported taxable income	243
41		Reduction of price of diesel fuel and LPG in climatically vulnerable areas	Territorial relevance	231
42	IRPEF	Safeguard clause for termination benefits	Constitutional relevance	230
43	IRPEF	Tax credit on termination benefits	Constitutional relevance	227
44	IRPEF	Deduction of medical and assistance expenses for serious illness	Welfare measures	207
45	Other tax relief measures with value of less than €200 million			4,485
Total				**161,147**

4 COMPLIANCE WITH THE FISCAL RULES

The assessments in this chapter regard the trend forecasts and policy targets set out in the 2015 EFD. The impact of ruling no. 70/2015 of the Italian Constitutional Court on compliance with the fiscal rules is examined in Chapter 5. Regardless of the solution adopted by the Government, the effect of the ruling clearly strengthens the doubts about the room for manoeuvre in the 2015 budget, which we discuss below.

4.1 *Policy targets and MTO*

With an improvement in the trend forecasts for the public finances (the result of the improvement in macroeconomic conditions and the yield curve for government securities), which points to achievement of structural balance in 2016, the 2015 EFD retains the target established in last autumn's Draft Budgetary Plan (DBP) to achieve the medium-term objective in 2017 (Table 4.1).

The policy scenario outlined in the DBP provided for an improvement of 0.3 percentage points in the structural deficit in 2015 (with a negative output gap of -3.5 per cent) and 0.2 percentage points in 2016 (when the output gap was still projected to be negative at -2.6 per cent, with actual GDP growth exceeding potential growth). That scenario, in the light of the Communication of the European Commission "*Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*" of 13 January 2015, was consistent with the European rules for 2015 but not for 2016. Applying the terms used in the Communication to the macroeconomic forecasts in the EFD, conditions in 2015 would qualify as "very bad times", which would call for a structural adjustment of 0.25 percentage points. For 2016, conditions would qualify as "bad times", which, however, for a country with a large public debt requires a structural adjustment of 0.5 percentage points if – as in Italy's case – actual growth is greater than potential growth (Table 4.2).

The positive impact on the public finance scenario of the revision of forecasts for macroeconomic conditions and interest rates (see Chapter 2) showed an acceleration of progress along the adjustment path towards the medium-term objective (MTO). Under the trend scenario for the public finances, the structural balance would improve by 0.3 percentage points in 2015 and 0.5 percentage points in 2016, the year in which the MTO would be achieved.

Table 4.1– Policy targets and the MTO

	2014	2015	2016	2017	2018	2019
Output gap	-4.6	-3.8	-2.5	-1.3	-0.3	0.5
Real GDP growth	-0.4	0.7	1.4	1.5	1.4	1.3
Potential GDP growth	-0.4	-0.1	0.0	0.2	0.3	0.5
Balance - Medium-term objective	0	0	0	0	0	0
Adjustment objective	**0.0**	**0.25**	**0.0**	**0.4**	**0.0**	**0.0**
Structural balance	-0.7	-0.5	-0.4	0	0.1	0.2
Structural adjustment	**0**	**0.2**	**0.1**	**0.3**	**0.2**	**0**

The policy choice adopted in the 2015 EFD is different. The EFD invokes the structural reform clause for 2016, thereby reducing the structural adjustment of the balance in that year from 0.5 percentage points to 0.1 percentage points and confirming achievement of the MTO in 2017. In addition, borrowing would increase in 2015 compared with the trend forecast on a current legislation basis by 0.1 percentage points, reducing the structural adjustment from 0.3 percentage points to 0.2 percentage points.

As we saw in Section 2, considering net borrowing as a proportion of GDP, the policy targets in the 2015 EFD are the same as those in the DBP. In other words, the Government proposes to use all of the room for manoeuvre created by the improvement in macroeconomic conditions and interest rates: in terms of GDP – comparing the policy targets with the trend forecast – this amounts to 0.1 percentage points in 2015, 0.4 percentage points in 2016, 0.6 percentage points in 2017, and 0.5 percentage points in 2018 and 2019.

Table 4.2– Matrix for determining the adjustment in the structural balance in relation to economic conditions

<table>
<tr><th rowspan="2">Economic conditions</th><th rowspan="2" colspan="2">Condition</th><th colspan="2">OBJECTIVE FOR ADJUSTMENT IN STRUCTURAL BALANCE</th></tr>
<tr><th>Debt below 60% and no sustainability risk</th><th>Debt above 60% or sustainability risk</th></tr>
<tr><td>Exceptionally bad times</td><td colspan="2">Real growth < 0 or output gap < -4</td><td colspan="2">No adjustment needed</td></tr>
<tr><td>Very bad times</td><td colspan="2">-4 < Output gap ≤-3</td><td>0</td><td>0.25</td></tr>
<tr><td rowspan="2">Bad times</td><td rowspan="2">-3 < Output gap ≤ -1.5</td><td>If growth below potential</td><td>0</td><td>0.25</td></tr>
<tr><td>If growth above potential</td><td>0.25</td><td>0.5</td></tr>
<tr><td>Normal times</td><td colspan="2">-1.5 < Output gap ≤ 1.5</td><td>0.5</td><td>> 0.5</td></tr>
<tr><td rowspan="2">Good times</td><td rowspan="2">Output gap > 1.5</td><td>If growth below potential</td><td>> 0.5</td><td>≥ 0.75</td></tr>
<tr><td>If growth above potential</td><td>0.75</td><td>≥ 1</td></tr>
</table>

As noted, for 2016 the Government assumes the application of the structural reform clause, which is discussed in Section 4.4. From an economic standpoint, this can be justified by the need to avoid compromising the nascent recovery with a restrictive fiscal stance when the effects of the structural reforms already enacted have not yet manifested themselves. For 2015, the proposal to use the margin of 0.1 percentage points of GDP (equal to about €1.6 billion) is a source of concern. This would produce a smaller improvement in the structural balance than that set out in the DBP and, strictly speaking, a smaller adjustment than that provided for under the rule on the adjustment path towards the MTO (0.2, as against 0.25). The issue is not so much that of a difference in the second decimal place of the adjustment of the structural balance as it is one of the uncertainty to which the small forecast improvement in the 2015 accounts is exposed. Even a modest deviation in the macroeconomic scenario or interest rates from the forecasts would eliminate that improvement and trigger a significant deviation from the adjustment path towards the MTO. It seem premature at this stage of the year – when developments in the balance payments and first payment on account of self-assessed taxation (the fulcrum of general government revenue) are not yet known – to use resources, however small, as though they had already been received. A decision taken in April to "spend" – this year – the effect of an improvement in macroeconomic conditions compared with the forecasts formulated the previous autumn without first waiting for that improvement to materialise appears to fly in the face of prudence.

4.2 The expenditure rule

The preventive arm of the Stability and Growth Pact requires controlling the growth of public expenditure (on an unchanged policies basis[31]) in order to ensure its sustainability consistent with the adjustment path towards structural balance.

The benchmark expenditure aggregate for the application of the rule only includes spending components most directly impacted by Government activity, excluding interest expenditure and the component linked to the economic cycle. The exclusion of these components allows the adoption of more accommodative policies during adverse economic times while at the same time prohibiting the "financing" of expenditure increases with savings generated by factors beyond the immediate control of the Government. Also excluded are expenditures funded entirely by EU programmes and short-term fluctuations in investment spending.[32]

[31] In the EFD forecasts, expenditure on an unchanged policies basis exceeds the trend forecast by €1.7 billion, €4.2 billion and €6.7 billion in 2016, 2017 and 2018, respectively. See Section 2.2.

[32] The spending aggregate for period *t* includes the average level of investment spending in years *t-3* to *t*, rather than current investment spending.

The rules requires that growth in the spending aggregate shall not exceed medium-term growth in the economy's potential output,[33] unless the changes are offset by revenue measures.

In order to ensure consistency with the adjustment path towards the MTO, the expenditure growth allowed under the rule is also determined in relation to the necessary adjustment of the structural balance, requiring a more stringent objective (applying a so-called "convergence margin") for countries that have not achieved the MTO. The Commission's new guidance on the size of the structural adjustment in relation to economic conditions (Table 4.2) also has an impact on the application of the expenditure rule.

The expenditure rule was complied with in 2014, while there is a deviation from the objective in the EFD forecasts for 2015 only (Figure 4.1).

In 2015, the benchmark spending aggregate expands by 1.2 per cent in nominal terms and 0.3 per cent in real terms, which exceeds the reduction target of -0.5 per cent[34]. The deviation, expressed as a proportion of GDP, amounts to 0.4 per cent, which is below the significance threshold defined by the Commission. That deviation does not *ex ante* trigger the opening of any formal proceeding. If the deviation should exceed the threshold of 0.5 points in the *ex post* assessment (to be conducted in 2016), the Commission could take account of that fact in its general assessment of whether to initiate an excessive deficit procedure.

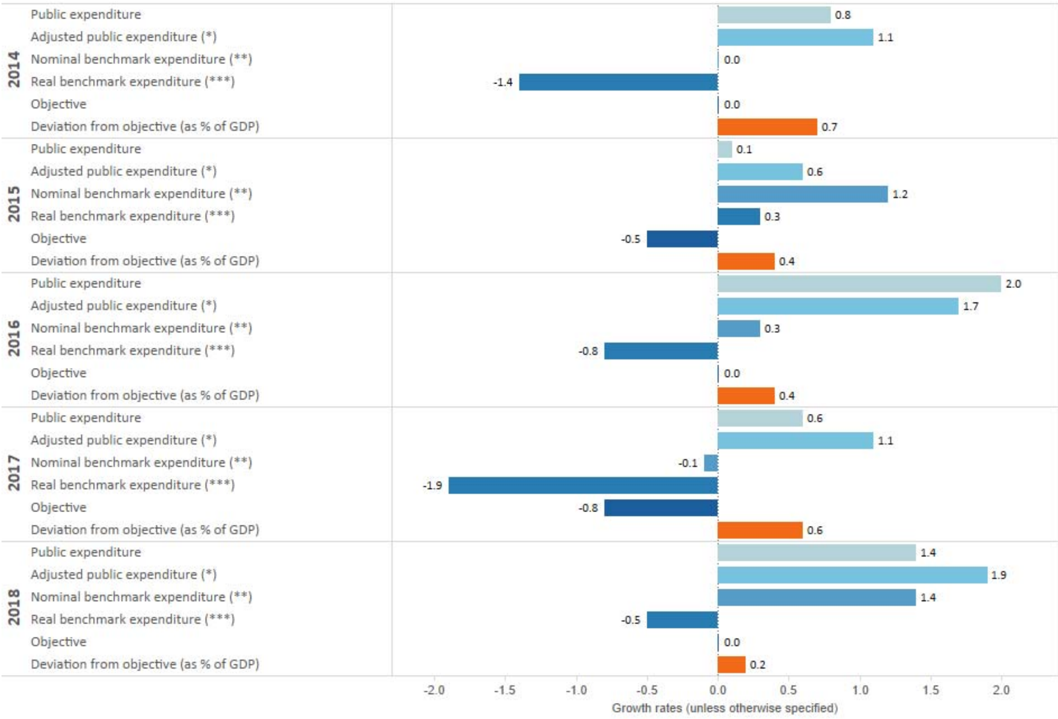
Although expenditure in 2015 is essentially unchanged compared with 2014 (the reduction in interest expenditure is partly offset by greater other spending[35]) and less than forecast in the subsequent years, certain features of the construction of the benchmark aggregate lead to violation of the objective:

1) benchmark expenditure does not include interest expenditure and so does not reflect the reduction in the latter achieved as from 2015, therefore increasing more than total expenditure;

2) in 2015 revenue reduction measures enter force. This produces an increase in benchmark expenditure, which is measured net of the effects of discretionary revenue measures. That increase with respect to 2014 is especially large.

[33] The estimate of medium-term potential growth used to apply this rule is calculated by the Commission as an average over a 10-tear time horizon running from *t-5* to *t+4*.
[34] The expenditure reduction target reflects the effects of the introduction of new criteria for determining the structural adjustment for 2015, which essentially halves the target.
[35] See Chapter 2.

Figure 4.1 – Rates of growth in public expenditure and application of the expenditure rule



(*) Adjusted expenditure: public expenditure excluding cyclical components, interest payments on the debt and spending entirely financed by EU programmes, adjusted for short-term fluctuations in investment spending.
(**) **Benchmark expenditure**: adjusted expenditure (see previous note) excluding changes in revenue due to discretionary measures
(***) The real change is calculated on the basis of the average value of the deflators calculated by the Commission in the Autumn and Spring Forecasts from the previous year. Where the information was not available, the forecast in the EFD was adopted.

Source: based on MEF data.

Recall that in the DBP forecasts, the rule was easily satisfied for 2015: expenditure grew by just 0.2 per cent, compared with the 1.2 per cent now forecast in the EFD. The difference is associated with a number of factors that, together, increase the expansion of benchmark spending by €7.4 billion (Table 4.3). These include:

- an increase in 2015 reference expenditure in the EFD compared with the DBP (+€3.9 billion) owing to:
    - about €2.3 billion in revisions of trend expenditure;
    - about €1.6 billion in budget measures;
- a reduction in discretionary revenue of €2.7 billion, attributable to:
    - downward revisions of social contribution revenue amounting to €3 billion, due to changes in the budget assumptions between the time the DBP was prepared and the definitive budget measures (a revision of the effects of social contribution relief measures);
    - an increase in tax revenue of +€0.3 billion (the net result of +0.6 billion compared with the quantification of the measures in the 2015 Stability Act and about -€0.3 billion in respect of the impact of measures approved after the Stability Act;[36]
- the downward revision of 2014 spending (€0.8 billion).

In 2016, compliance with the rule is restored. Although total expenditure rises by 2 per cent, the increase in discretionary revenue helps contain the increase in the benchmark expenditure aggregate (+0.3 per cent). This change, stated in real terms,[37] is a negative 0.8 per cent, and thus below the growth target, which has been set at zero as a result of the structural reform clause.[38]

In 2017, the objective should be recalculated on the basis of the new estimates of medium-term potential growth and the convergence margin, which the Commission has yet to prepare, and the required adjustment. Assuming no change in the growth of potential output and the convergence margin[39] and considering that the adjustment of the structural balance required in 2017 will be equal to the distance from the MTO (i.e. 0.4 percentage points), the growth target for the benchmark spending aggregate would be equal to -0.8 per cent.[40] Since the expenditure benchmark would decline by about 1.9 per cent in real terms, compliance with the rule would be achieved.

As regards the application of the rule in 2018, since the MTO for the structural balance would have been achieved the previous year, the convergence margin would no long be applied to the expenditure benchmark.[41] The benchmark would therefore require no change in expenditure (a growth target of zero), which is easily achieved in the forecasts (-0.5 per cent).

The expenditure rule also requires that the objectives be achieved over a two-year horizon,[42] which occurs in all of the years under consideration, as shown in Table 4.4. Over a two-year period, benchmark expenditure always increases less than the objective established under the rule.

[37] In 2016 the expenditure deflator is determined on the basis of the GDP deflator forecast by the Commission in its *Winter Forecast*. For subsequent years, the EFD forecasts are used.

[38] Since under the structural reform clause no structural adjustment is required in 2016, the convergence margin is not considered in the expenditure rule.

[39] Assumptions used in the EFD.

[40] This is obtained summing the medium-term rate of growth in potential output (equal to 0.04 in the assumptions used in the EFD) and the re-proportioned convergence margin ($-1.1 \cdot \frac{0.4}{0.5}$) taking account of the required structural adjustment.

[41] The expenditure growth target for 2018 reported in the EFD does not take account of this circumstance.

[42] The expenditure objectives and changes considered in applying the expenditure rule over a two-year horizon are determined as the average of the annual aggregates. Any deviation over the two-year period is considered significant if it exceeds 0.25 per cent of GDP.

Table 4.3– The expenditure rule for 2015 – Comparison of DBP and EFD forecasts for the absolute change in benchmark expenditure
(billions of euros)

2015 expenditure rule		DBP	EFD	EFD-DBP
Benchmark expenditure 2014	*a*	747.8	747.0	-0.8
Benchmark expenditure 2015	*b*	747.5	751.4	+3.9
Discretionary revenue measures	*c*	-1.6	-4.3	-2.7
Change in benchmark expenditure	***d=b-a+c***	**1.4**	**8.8**	**+7.4**

Source: based on MEF data.

Table 4.4– The expenditure rule for 2014-18 (two-year horizon)
Growth targets and forecast changes in expenditure

Change in benchmark expenditure	2014 / 2015	2015 / 2016	2016 / 2017	2017 / 2018
Objective	-0.3	-0.3	-0.4	-0.4
Actual	-0.6	-0.3	-1.4	-1.2

Source: based on MEF data.

4.3 The debt rule

In 2013-15 Italy was subject to transitional debt convergence arrangements, which called for achievement of a minimum structural adjustment that would enable compliance with the rule at the end of the period. The policy scenario set out in the EFD envisages a structural adjustment for 2015 that does not comply with the transitional provisions, as already prefigured in the DBP last year.

Nevertheless, in its report of February 2015 to assess whether to open an excessive deficit procedure for Italy, the Commission concluded that the debt criterion for the transition period should be considered satisfied despite the insufficient structural adjustment envisaged in the scenario. The report looked positively on the presence of major factors that impacted achievement of the objectives and the scale of the efforts already made and planned.

The Commission acknowledges the effectiveness of budgetary policies in the path towards the MTO, which in normal economic circumstances should in itself ensure the sustainability of the public finances. In addition, it also welcomes the adoption of structural reforms that in the medium term should spur growth and contribute to reducing the debt/GDP ratio. Finally, the report considered the exceptional nature of macroeconomic conditions, not only with regard to the slow pace of growth but also to the low level of inflation, which has required a very demanding adjustment effort. In the scenario delineated in the Commission's *Winter Forecast*, the improvement in the structural balance necessary to ensure compliance with the debt rule would have called for an additional cumulative structural correction of 2.5 points of GDP. The

Italian Government argued that such a large fiscal tightening would have caused a new recession and would have been self-defeating, producing a larger debt/GDP ratio than that set out in the DBP scenario.

As from 2016, the first year in which the ordinary debt rule would again apply, the EFD forecasts that the debt/GDP ratio will begin to decline, going from 132.5 per cent in 2015 to 130.9 per cent in 2016 and 120 per cent in 2019. This downward trend in the debt ratio would be consistent with the rule, which requires a reduction in the gap between the debt/GDP ratio and the 60 per cent target value at a pace of 5 per cent per year. More specifically, as from 2016 the forward-looking convergence criteria would be respected, i.e. the level of debt reached in 2018 (123.4 per cent of GDP) would be exactly equal to that necessary to have achieved an annual reduction of 5 per cent in the three previous years.

Achievement of the convergence objective is attributable to the gradual improvement in the deficit, which is forecast to decline from -2.6 per cent in 2015 to reach balance in 2018, and to the privatization programme, which is forecast to generated proceeds totalling 1.7 points of GDP (about €29 billion). The macroeconomic scenario depicted in the EFD also makes a decisive contribution to achievement of the objectives, as discussed in greater detail in Chapter 2. First, the forecast decline in interest rates,[43] together with a decline in refinancing requirements, is expected to reduce interest expenditure compared with the forecasts in the DBP from last year by about 0.3 per cent of GDP per year. Less favourable developments in interest rates could jeopardize the expected achievement of balance: the EFD calculates that a permanent increase of 100 basis points in the yield curve would raise interest expenditure by 0.15 per cent of GDP in the first year, 0.29 per cent in the second, 0.40 per cent in the third and 0.49 per cent in the fourth.

Other decisive factors in achieving the debt convergence objective are positive developments in GDP growth and the GDP deflator. An analysis of the sensitivity of debt developments to growth and inflation presented in the EFD shows that in a scenario of weaker growth (nominal GDP growth 1.2 per cent lower per year than the baseline) the forward-looking convergence criterion for the debt would not be satisfied. A deviation from the objectives would be even more sensitive if deflation should take hold.

4.4 The structural reform clause

As noted in the European Commission's Communication of 13 January 2015, Member States that implement structural reforms with a positive impact on the long-term

[43] The interest rates on the debt forecast in the EFD are based on market assessments incorporated in forward rates in recent weeks and make no specific assumptions concerning the impact of quantitative easing.

sustainability of public finances may ask to deviate temporarily from the MTO or from the adjustment path towards the MTO, invoking the so-called structural reform clause.

The rationale behind this element of flexibility is to allow temporary deviations from the objectives of fiscal discipline when a country undertakes structural reforms that may generate costs for the public finances in the short term but which, over a longer-term perspective, will have a positive impact on their sustainability.

The maximum allowable deviation is 0.5 per cent of GDP in the year following the publication of the Stability Programme. However, this deviation must be eliminated entirely within the time horizon of the Programme (i.e. within year *t+4* where *t* is the year of presentation of the Stability Programme).

The clause may be approved for the requesting country if a number of conditions are met, focusing primarily on the characteristics of the reforms:

1) the reforms must be structural, i.e. they must not be limited to adjusting ordinary taxes or public expenditure;
2) they must be major, i.e. they must have a significant financial impact on economic growth and the public finances;
3) they must have a net positive effect on the long-term sustainability of the public finances. These positive effects may be direct, in that they are connected with budgetary savings (even if they engender increased costs at short term, as might occur with measures impacting public-sector employment), or indirect, through increased revenue in the long term as a result of an increase in potential output (for example, as a result of a reduction in structural unemployment or a more efficient labour force) due to the implementation of the reforms;
4) they must be fully implemented. If they are not, the Government must provide the Commission – in the Stability Programme and the National Reform Programme – with detailed information on the characteristics of the proposed reforms and the timing of their future approval. If the structural reforms are not fully implemented, the temporary deviation from the MTO, or from the adjustment path, will no longer be warranted, which could lead to the opening of a procedure for significant deviation.

In addition, approval of the structural reform clause is subject to a number of conditions concerning the budgetary situation of the applicant:

a) application of the clause must not jeopardise compliance with the preventive arm of the Stability and Growth Pact. In other words, the country must maintain a safety margin to ensure that the deficit limit of 3.0 per cent of GDP is not breached;
b) following application of the clause, the budgetary position must return to the MTO within the time horizon of the Stability Programme. To this end, given that the maximum deviation is 0.5 per cent of GDP in the year following publication of the Stability Programme, the maximum distance of the structural balance form the MTO of the country invoking the clause may not exceed 1.5 per cent of GDP in the year in which the deviation is requested.

In the Stability Programme, the Government invokes the clause for major structural reforms, requesting a deviation from the adjustment path towards the MTO of 0.4 per cent of GDP. The deviation, as indicated in the new policy scenario presented in the EFD, will regard only one year, 2016, and will essentially involve shifting the adjustment path envisaged in the trend scenario ahead one year, thereby enabling compliance with the adjustment path presented in the DBP last October.

The scale of the net positive impact (direct and indirect) that the reforms envisaged by the Government will have on the long-term sustainability of the public finances and the other conditions referred to above will be assessed by the Commission – as indicated in the Commission document on "*The Operationalization of the Structural Reform Clause in the Preventive Arm of the SGP*" of last February – on the basis, naturally, of the information provided by the Government. Accordingly, it would be advisable to examine with attention that information as included in the EFD.

In particular, adopting the methodology proposed by the Commission for calculating the sustainability of the public finances produced by the structural reforms (see again "*The Operationalization of the Structural Reform Clause in the Preventive Arm of the SGP*"), the EFD lists the structural reforms relevant for the purposes of the flexibility clause and, for each group of reforms, assesses – using quantitative DSGE models – the effects on borrowing, broken down between direct impacts (lower expenditure and greater short-term costs) and indirect impacts through greater long-term growth (Table 4.5).

Two comments are in order. The first is that the set of reforms actually eligible under the structural reform clause might have to be reduced from the list set out in the table in the EFD. Considering as structural only those reforms that are not achieved through changes in taxes or public expenditure (condition 1) would lead to the exclusion measures concerning the reduction of the tax wedge (the €80 euro bonus and the deductibility of the labour component from IRAP), those concerning the VAT safeguard clause, those on the taxation of investment income, as well as various expenditure revision measures. Only the reforms in the areas of the public administration, competitiveness and the labour market, justice and education, i.e. the first two blocks of the table, could be properly defined as structural.

Even limiting consideration to this narrower selection of reforms, the total impact envisaged in the EFD on net borrowing remain positive and non-negligible. However, and this is the second comment, those effects are largely indirect, i.e. connected with the long-term increase in GDP and the associated expansion of the tax base. As underscored by the Commission, the valuation of the indirect effects of structural reforms on the public finances through quantitative models is a complex undertaking (because among other things it means translating often complex reforms into standard economic policy impulses to be incorporated in the models), therefore inserting considerable uncertainty into the outcomes. This uncertainty about the outcomes produced by the quantitative models counsels their use only to exclude the most implausible cases, especially in view of the Commission's statement that a final decision on the eligibility of the structural reform clause will essentially depend on qualitative assessments.

Table 4.5 – Impact of structural reforms on net borrowing
(percentages)

		2016	2020	2025	Long term
Structural reforms operational since 2015	Indirect impact	0.3	0.8	1.3	2.4
	Direct impact	-0.1	-0.1	-0.1	-0.1
	Total impact	0.2	0.7	1.2	2.3
Structural reforms introduced in 2015	Indirect impact	0.1	0.1	0.3	1.3
	Direct impact	-0.2	-0.2	-0.2	-0.2
	Total impact	-0.1	-0.1	0.1	1.1
Spending reductions operational since 2015	Indirect impact	0.0	-0.1	-0.1	0.0
	Direct impact	0.4	0.5	0.5	0.5
	Total impact	0.4	0.4	0.4	0.5
Spending reductions introduced in 2015	Indirect impact	-0.1	-0.1	-0.1	0.0
	Direct impact	0.6	0.6	0.6	0.6
	Total impact	0.5	0.5	0.5	0.6
Reduction in tax wedge	Indirect impact	0.1	0.2	0.2	0.2
	Direct impact	-0.9	-0.9	-0.9	-0.9
	Total impact	-0.8	-0.7	-0.7	-0.7
Increase in taxation of investment income	Indirect impact	-0.1	-0.1	-0.1	-0.1
	Direct impact	0.2	0.2	0.2	0.2
	Total impact	0.1	0.1	0.0	0.0
VAT clauses 2015 decision	Indirect impact	0.0	-0.2	-0.2	-0.2
	Direct impact	0.8	1.3	1.3	1.3
	Total impact	0.8	1.1	1.1	1.1
Measures to reduce VAT increase	Indirect impact	0.1	0.1	0.2	0.2
	Direct impact	-1.0	-1.2	-1.2	-1.2
	Total impact	-0.9	-1.1	-1.0	-1.0

Note: a positive (negative) sign indicates an improvement (deterioration) in net borrowing.

5 IMPLICATIONS OF THE CONSTITUTIONAL COURT'S RULING ON PENSION REVALUATIONS

5.1 The effects of the ruling

In its ruling no. 70/2015, the Constitutional Court found the first part of Article 24, paragraph 25, of Decree Law 201/2011 to be unconstitutional. That article suspended the inflation adjustment of pensions for 2012-13, excluding pensions that were less than three times the minimum pension paid by the national social security institute (INPS), for which full revaluation was allowed.

Decree Law 201/2011 amended the system established under Decree Law 98/2011, which had already limited pension revaluations for 2012-13.[44] It is not clear whether the decision means that the system under Decree Law 98/2011 should apply to the 2012-13 period, or whether the system set out under the previous rules would apply.

The following analysis is based on the "worst-case" scenario for the public finances, i.e. the case in which, as a result of the decision, the automatic adjustment mechanism applicable to the 2012-13 period is that governed by the legislation in force prior to Decree Law 98/2011. Such legislation requires that the revaluation be made based upon the aggregation of the pensions payable to each individual beneficiary (Article 34, paragraph 1, of Law 448/1998) and uses a bracket mechanism (Article 69, paragraph 1, of Law 388/2000) that provides for indexing of:

a) 100 per cent for the bracket equal to up to three times the minimum pension paid by INPS;
b) 90 per cent for the bracket equal to between three and five times the minimum pension paid by INPS;
c) 75 per cent for the bracket equal to more than five times the minimum pension paid by INPS.

The pension adjustment method set out in Article 1, paragraph 483, of Law 147/2013 would apply to the 2014-16 period only, since it was not modified by the Constitutional Court's decision. This temporary provision also requires that the adjustment be made to the aggregate of the pensions, but uses a category-based mechanism of categories that envisages the indexing of cumulative total pension payments to a single beneficiary at a rate of:

a) 100 per cent for pension payments amounting to or less than three times the minimum INPS pension;

[44] Article 18, paragraph 3, of Decree Law 98/2011 provided that persons whose pension payments were more than five times the minimum amount would receive a revaluation equal to just 70 per cent of that for the pensions with a value of to up to three time the minimum.

b) 95 per cent for pension payments amounting to between three and four times the INPS minimum;
c) 75 per cent for pension payments amounting to between four and five times the INPS minimum;
d) 50 per cent for pension payments amounting to between five and six times the INPS minimum;
e) 40 per cent in 2014 and 45 per cent in each of 2015 and 2016 for pensions amounting to more than six times the INPS minimum. For 2014 only, The 40 per cent revaluation is not applicable to the bracket of more than six times greater than the INPS minimum. This suspension does not apply to the 2015-16 period, for which the revaluation rate is 45 per cent.

As governed by Law 147/2013, following the end of the 2014-16 period, the revaluation rates previously set out, applicable to 2011 (Article 34, paragraph 1 of Law 448/1998 and Article 69, paragraph 1, of Law 388/2000), will once again apply.

Table 5.1 summarizes this scenario, with separate columns showing the system prior to the decision and the situation subsequent to it in the absence of corrective action by the Government. It order to explain the effects that the decision could have, Figure 5.1 shows examples that, for certain types of pension, would pay less per year due to the failure to index them under the provisions of the law now repealed.

To better understand the potential effects of the decision – if no corrective actions are undertaken – it should be pointed out that, when using an indexing mechanism, the lack of revaluation in even one period (the “direct” effect) is not subsequently recouped, which also results in a smaller base upon which revaluations in subsequent years are calculated (the “lagged” effect). These effects can be grasped better if we take several model pensioners and calculate the reduction in their annual pension payments due to lack of indexing (Figure 5.1). The calculations focused on hypothetical pensioners whose benefits are equal to the mid-point value for the pension classes affected by the ruling, respectively 3.5, 4.5 and 5.5 times the minimum pension (MP) and the average value of the category of greater than 6 times the MP (equal to 9.3 times the MP).

In this case, the suspension would have applied for two years (2012 and 2013) for persons with total pensions in excess of three times the minimum. As shown in Figure 5.1, the annual loss due to de-indexing accumulates during the two-year period, before stabilising in subsequent years, in which only the lagged effect is seen. For example, a pensioner who receives a monthly pension payment equal to 3.5 times the MP (€1,639 in 2011) receives €567 less in pension payments in 2012; in 2013 the effect rises to a total of €1,214 (€567 of direct effect for 2012, €630 of direct effect for 2013 and €17 of lagged effect). The lagged effect is €29 in 2014 and €32 in 2015.

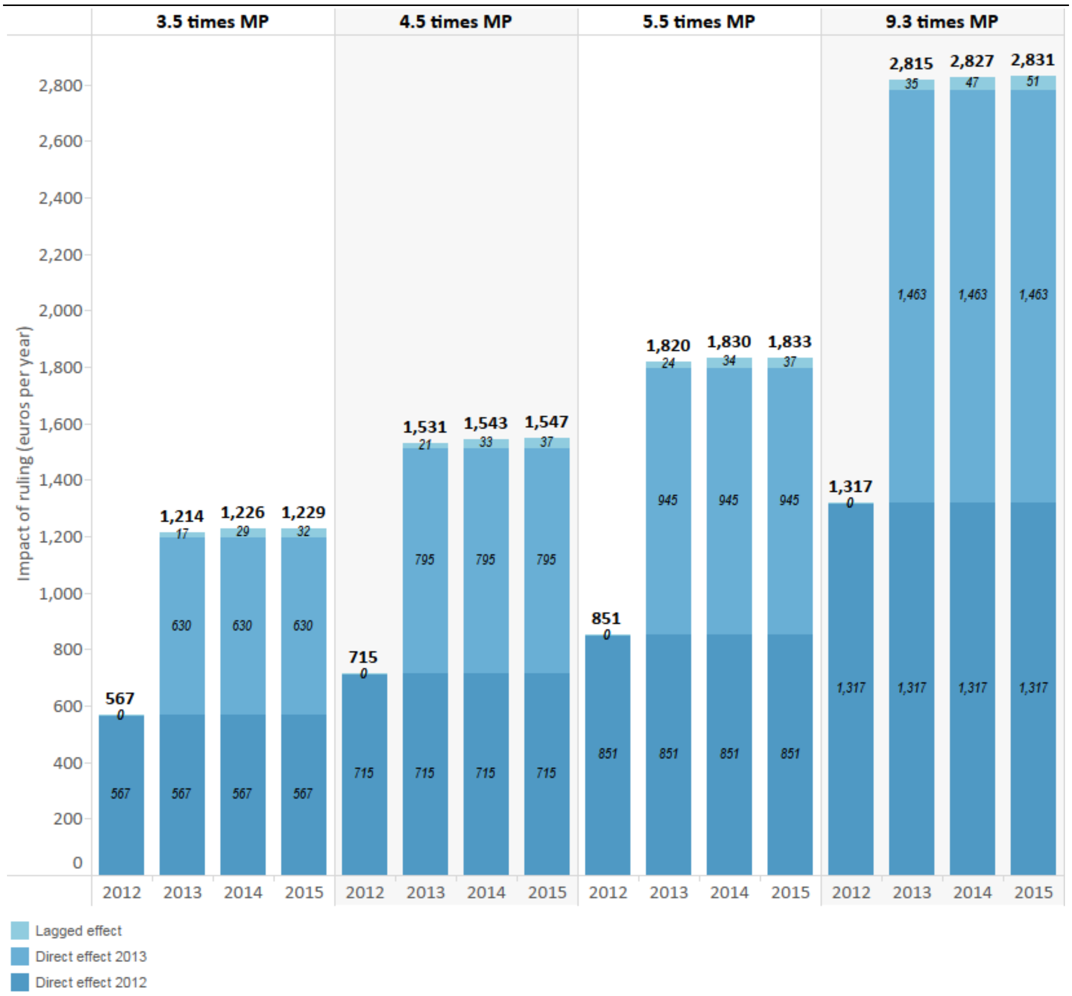
Table 5.1 – Pension revaluation system prior to and following ruling no. 70/2015 – 2011-15

<table>
<tr><th></th><th>System prior to ruling</th><th>System after ruling</th></tr>
<tr><th colspan="3">2011</th></tr>
<tr><th>Cumulative pension brackets</th><th>L 448/1998</th><th>L 448/1998</th></tr>
<tr><td>Up to 2 MP</td><td rowspan="2">100%</td><td rowspan="2">100%</td></tr>
<tr><td>From 2 to 3 MP</td></tr>
<tr><td>From 3 to 4 MP</td><td rowspan="2">90%</td><td rowspan="2">90%</td></tr>
<tr><td>From 4 to 5 MP</td></tr>
<tr><td>From 5 to 6 MP</td><td rowspan="2">75%</td><td rowspan="2">75%</td></tr>
<tr><td>More than 6 MP</td></tr>
<tr><th colspan="3">2012 (definitive revaluation 2.7%)</th></tr>
<tr><th>Cumulative pension brackets</th><th>DL 201/2011</th><th>L 448/1998</th></tr>
<tr><td>Up to 2 MP</td><td rowspan="2">100%</td><td rowspan="2">100%</td></tr>
<tr><td>From 2 to 3 MP</td></tr>
<tr><td>From 3 to 4 MP</td><td rowspan="2">0%</td><td rowspan="2">90%</td></tr>
<tr><td>From 4 to 5 MP</td></tr>
<tr><td>From 5 to 6 MP</td><td rowspan="2">0%</td><td rowspan="2">75%</td></tr>
<tr><td>More than 6 MP</td></tr>
<tr><th colspan="3">2013 (definitive revaluation 3.0%)</th></tr>
<tr><th>Cumulative pension brackets</th><th>DL 201/2011</th><th>L 448/1998</th></tr>
<tr><td>Up to 2 MP</td><td rowspan="2">100%</td><td rowspan="2">100%</td></tr>
<tr><td>From 2 to 3 MP</td></tr>
<tr><td>From 3 to 4 MP</td><td rowspan="2">0%</td><td rowspan="2">90%</td></tr>
<tr><td>From 4 to 5 MP</td></tr>
<tr><td>From 5 to 6 MP</td><td rowspan="2">0%</td><td rowspan="2">75%</td></tr>
<tr><td>More than 6 MP</td></tr>
<tr><th colspan="3">2014 (definitive revaluation 1.1%)</th></tr>
<tr><th>Cumulative pension categories</th><th>L 147 2013</th><th>L 147 2013</th></tr>
<tr><td>Up to 2 MP</td><td rowspan="2">100%</td><td rowspan="2">100%</td></tr>
<tr><td>From 2 to 3 MP</td></tr>
<tr><td>From 3 to 4 MP</td><td>95%</td><td>95%</td></tr>
<tr><td>From 4 to 5 MP</td><td>75%</td><td>75%</td></tr>
<tr><td>From 5 to 6 MP</td><td>50%</td><td>50%</td></tr>
<tr><td>More than 6 MP</td><td>40% (*)</td><td>40% (*)</td></tr>
<tr><th colspan="3">2015 -2016 (provisional revaluation 0.3%)</th></tr>
<tr><th>Cumulative pension categories</th><th>L 147 2013</th><th>L 147 2013</th></tr>
<tr><td>Up to 2 MP</td><td rowspan="2">100%</td><td rowspan="2">100%</td></tr>
<tr><td>From 2 to 3 MP</td></tr>
<tr><td>From 3 to 4 MP</td><td>95%</td><td>95%</td></tr>
<tr><td>From 4 to 5 MP</td><td>75%</td><td>75%</td></tr>
<tr><td>From 5 to 6 MP</td><td>50%</td><td>50%</td></tr>
<tr><td>More than 6 MP</td><td>45%</td><td>45%</td></tr>
<tr><th colspan="3">2017 and subsequent years</th></tr>
<tr><th>Cumulative pension brackets</th><th>L 448/1998</th><th>L 448/1998</th></tr>
<tr><td>Up to 2 MP</td><td rowspan="2">100%</td><td rowspan="2">100%</td></tr>
<tr><td>From 2 to 3 MP</td></tr>
<tr><td>From 3 to 4 MP</td><td rowspan="2">90%</td><td rowspan="2">90%</td></tr>
<tr><td>From 4 to 5 MP</td></tr>
<tr><td>From 5 to 6 MP</td><td rowspan="2">75%</td><td rowspan="2">75%</td></tr>
<tr><td>More than 6 MP</td></tr>
</table>

Key: MP= minimum INPS pension.

(*) In 2014 the pensions for the bracket of more than 6 times the MP were not revalued.

Figure 5.1 – Effects of ruling no. 70/2015 by class of model pensioner
(Effects by class of model pensioner)



Source: PBO calculations.

Full repayment of the arrears would be equal to the sum of the pension payments not received by pensioners during the 2012-14 period. For example, for a pensioner who receives 3.5 times the MP, the arrears amount to around €3,000. Starting from 2015, the pension would be around €1,230 per year higher.

However, any such repayment of arrears would actually over-compensate the pensioner for the loss. While the amounts not received in past years would have been taxed at the marginal personal income tax rates, amounts received as payment of arrears are taxed separately at the average rate, a considerably less burdensome tax treatment.

For a pensioner receiving a monthly pension equal to 3.5 times the MP, the pension payments not received due to de-indexing (€3,000) would have been taxed at the marginal rate of around 30 per cent if they had been paid year by year, whereas the amount would be taxed at an average rate of around 19 per cent in the event of full restitution. Accordingly, the pensioner in this case lost €2,100 worth of purchasing power and, if reimbursed the full amount of the arrears today, the recovered purchasing power would be around €2,400, more than the amount lost.

5.2 The statistical recording of the effects of the ruling

To assess the impact of Constitutional Court ruling no. 70/2015 on the public accounts, we must first examine the recognition criteria for the various items in order to develop the reference parameters for national and European fiscal rules.

With regard to the accrued balance (net borrowing), the ESA 2010 rules[45] and the associated implementation manual[46] establish that payments of arrears shall be recorded when the claimants have an automatic and incontrovertible right for a given amount that can be individually determined, and when it is unlikely that the claimants will fail to request their due.

When a decision merely sets a principle of compensation, or when the claims must be reviewed for eligibility and in relation to determination of the amount by administrative services, expenditure or revenue is recorded as soon as the value of the obligation is reliably determined.

Therefore, the year in which the revaluation of the pension to which the arrears relate accrues would not apply. It also appears that if the arrears are paid in instalments they can be recorded on a cash basis.[47] Payment of the arrears over several years would instead have an impact on recordation in the general government debt.

With regard to the structural balance, we need to determine whether the amounts paid as arrears can be treated as one-off payments. The classification of a budget item as a one-off amount must be justified by the Member State and accepted by the Commission. This category – not subject under European regulations and under codes of conduct to specific listing, but merely a listing of examples – includes measures with temporary effects arising from unforeseen factors or from measures intended to achieve temporary positive effects. Although there does not appear to be an explicit rule as such, there are precedents as to the effects of payments treated as a one-off items.[48]

In assessing whether the arrears can be viewed as lump-sum amounts, we must also verify the classification of the amounts pertaining to the first four months of 2015, i.e. the period prior to the date of publication of the decision. For national accounting

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[45] Regulation (EU) No. 549/2013 of the European Parliament and of the Council of 21 May 2013, on the European System of National and Regional Accounts in the European Union, section “Court decisions”.
[46] See Eurostat, *Manual on Government Deficit and Debt – Implementation of ESA 2010*, 2014.
[47] The Manual specifies that the arrears must be recorded as capital transfers, in that they relate to amounts accrued in past years. In the case of deferred payment, a financial item is recognised (“other assets and liabilities”) to record the existence of amounts accrued but not yet paid.
[48] Specifically, the reimbursements owed as a result of the European Court of Justice decision finding the non-deductibility of VAT on corporate vehicles provided for by Community legislation to be illegal were treated at lump-sum payments (C-228/05 of 4 September 2006).

purposes, the amounts paid in 2015 and referring to benefits accruing during that period are considered to have accrued in the year. Following this line of reasoning, the amounts accrued in 2012-14 should be treated as a lump-sum amount, while the entire sum for 2015 should be treated as structural. However, we must also bear in mind that the amount regarding the first four months of 2015 reflects an expenditure item that redresses a past situation, distinct from the amounts that form a structural part of the 2015 budget as a result of the ruling. Based upon this reconstruction, the structural component would not comprise all of 2015, but only the amount for the last eight months of the year.

Beginning in 2016, the full impact of the adjustment accruing for each year is treated structurally.

To aid understanding, Table 5.2 summarises the recognition criteria we have just discussed with reference to the various fiscal rules.

Table 5.2– Criteria for the recognition of the effects of the decision for fiscal rule purposes

Rule	Recognition criterion	Impacts
Net borrowing (rule 3%)	Arrears accruing in 2012-14 and amounts accruing in 2015 should be recognised entirely in 2015, regardless of actual time of payment	Net borrowing worsens in 2015 by the entire amount accruing in 2012-15. In 2016 and subsequent years, borrowing increases by the amount accruing in each year.
Structural balance	Arrears accruing in 2012-14 (and perhaps those for the first 4 months of 2015) could be treated as one-off payments and therefore excluding from the calculation (subject to approval of the Commission)	The structural balance for 2015 worsens in an amount equal to the amount accruing in 2015 (to be determined whether this regards the entire year or only 8 months). In 2016 and subsequent years, the balance worsens by the amount accruing in each year.
Debt	The amounts are recognized on a cash basis	Debt increases in line with actual payments.
Expenditure	Arrears accruing in 2012-14 and amount accruing in 2015 should be recognized entirely in 2015, regardless of actual time of payment. The increase in expenditure should be considered gross of the increase in personal income tax generated by the increase in pensions.	Expenditure increases in 2015 by the entire amount accruing in 2012-15. In 2016 and subsequent years, expenditure increases by the amount accruing in each year.

5.3 The impact on compliance with fiscal rules

Taking the statistical-recording criteria described above as a starting point, the Constitutional Court's decision must also be assessed with regard to its implications for Italy's compliance with the rules of the Stability and Growth Pact.

The implications for the pubic accounts will depend on the scale of the amounts to be paid, taking account of any compensatory or corrective measures that the Government should decide to adopt.

As already noted in Section 5.2, a distinction must be made between the "ongoing" effects that impact the structural balances, and those associated with the payment of arrears that should be treated as a one-off payment. For the latter, taking account of the accounting rules under ESA 2010, an unfavourable impact on general government net borrowing can be expected only in 2015. There would then be a permanent component that would have an unfavourable impact on the deficit in 2015 and in subsequent years.

For 2015, if the total amounts to be paid during the year (permanent and arrears) exceeds 0.5 points of GDP,[49] the impact of the decision would be net borrowing above the 3 per cent threshold envisaged by the corrective arm of the Stability and Growth Pact. This would require the EU Commission to prepare a report to determine if Italy's has an excessive deficit under the EU Treaty, even if the exceptional nature, the temporary nature and the size of the breach will have to be assessed.

Exceeding the 3 per cent limit could jeopardise the use of the structural reform clause, which, based on European policy indications, can only be invoked in the context of the preventive arm of the Stability Pact.

With regard to the preventive arm of the Pact, in 2015, again in the absence of compensatory measures, the payment of the amounts that affect the structural balance could lead to a smaller improvement in the structural deficit on the previous year than the 0.25 percentage points envisaged in the EFD and required under the European rules. If the increase in ongoing pensions following the ruling is large, the structural balance could remain unchanged or deteriorate compared with the previous year.

In subsequent years, the inclusion of the ongoing extra cost in the public finance trend scenario would produce, under the EFD scenario, a reduction in the leeway for suspending the increase in VAT rates and the other safeguard clauses. Implementing the ruling would therefore appear to require – with no change in policy objectives – the reformulation of the announced measures.

[49] Amount given by the difference between net borrowing under the trend scenario set out in the EFD (2.5 per cent) and the 3 per cent limit under the European rules.

Maintaining the EFD’s policy balances as from 2016 could enable confirmation – for the purposes of the debt rule under the corrective arm of the Stability and Growth Pact – of the scenario set out in the EFD, with compliance with the rule on a forward-looking basis in 2016. This scenario depends on the timing of the payment of the arrears in 2015, bearing in mind that the aggregate would be recorded at the time of the cash payment of the arrears. In this case, the increase in the stock of debt in 2015 – and the lagged impact in subsequent years – would be included in the calculation of the benchmark established by the rule, effectively increasing it. This would facilitate compliance with the rule. At the same time, the payment of the arrears in 2015 would not alter the declining debt scenario in subsequent years. On the contrary, if payments are deferred to subsequent years, the increase in the benchmark would be less pronounced and, at the same time, the debt would fall at a slower rate.

In any event, the post-ruling scenario is exposed to greater risk, taking account of the fact that the EFD itself already required that a budget surplus be maintained during the final years of the forecasting period to ensure compliance with the debt rule.

With regard to the expenditure rule, the implications of the Court’s ruling for 2015 could have a significant negative impact on the EFD scenario. Bearing in mind that the full impact of the decision (arrears and permanent) would be incorporated into the formula, benchmark expenditure – again in the absence of compensating measures – would deviate significantly from the objective envisaged by the European rules for 2015; starting from 2016, compliance with the rule would resume. There could also be deviations in compliance with the two-year rule, although not necessarily significant, in both 2014-15 and 2015-16.

It should however be noted that in its current formulation the expenditure rule does not take account of either the temporary nature of the payment of arrears or of the “automatic” increase in revenue generated by higher pension benefits. These two factors make compliance with the expenditure rule more challenging.

Finally, it should be stressed that these considerations were made on the basis of the macroeconomic forecasts underlying the EFD. The macroeconomic scenario could change, however, as a result of higher payments associated with the Court’s ruling, especially those relating to the arrears in 2015. Thanks to the positive feedback effect of higher growth on the public finances, the final impact on compliance with the fiscal rules might therefore be less challenging than indicated above.

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