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2016 Budgetary Planning Report

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Parliamentary Budget Office
Via del Seminario, 76
00186 Roma
segreteria@upbilancio.it

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FOREWORD

This *Budgetary Planning Report* is devoted to analysing the 2016 Economic and Financial Document (EFD) presented by the Government on 8 April this year.

The Report presents and examines the substance of the parliamentary hearing of 19 April, expanding on the analysis of the macroeconomic and public finance forecasts and the assessment of compliance with national and European fiscal rules presented on that occasion.

The report is organised into five chapters. The first is devoted to an analysis of the EFD's macroeconomic forecasts for the period 2016-2019, their validation and a discussion of the risks inherent in the economic scenario, underscored by the positioning of the Government forecasts with respect to the projections of the panel of independent forecasters (including the PBO). Additional risks associated with the expected developments in exchange rates are then analysed.

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. Specific attention is devoted to information available on derivatives transactions conducted by the Treasury and local governments and their impact of the evolution of the public debt.

The third chapter assesses the public finance policy objectives set out in the EFD in the light of national and supranational fiscal rules, focusing in particular on the adjustment path towards the medium-term objective delineated in the policy scenario and indicating the extent to which that scenario is consistent with the current interpretations of the European fiscal rules as transposed into domestic law.

The fourth chapter offers an initial evaluation of the status of implementation of the measures required by the activation of the two flexibility clauses envisaged under the Stability and Growth Pact invoked by the Government in the policy documents issued last year: the first section examines the programme of national public investments, including with regard to the Investment Plan for Europe, while the second assesses the progress of the structural reforms.

Finally, the fifth chapter is devoted to specific examinations of a number of areas of the structural policies set out in the NRP, providing an initial review of the issues and the actions taken, with a focus on the Jobs Act and the reforms of the education and justice systems.

1. THE MACROECONOMIC ENVIRONMENT

1.1 Characteristics of the current recovery

The global environment is characterized by widespread fragility. Financial and geo-political instability, mainly concentrated in the emerging economies, could slow world growth, which is already expanding at only a modest rate. The uncertainty is amplified by fears of terrorist attacks. International organizations believe that that balance of risk is already leaning more sharply towards the downside negative and they emphasize the need for policy measures that support growth and counter deflationary impulses. Those recommendations have also been advanced for preventive purposes. In the event of a possible deterioration in the global economic environment, the economic policy toolkit of the major economies could be find itself short of options, since interest rates are already at record lows, which is unusual during a recovery, and because fiscal policies are both constrained by debt restrictions and hindered by inadequate coordination among countries whose scope for action differs.

This is the situation facing the Italian economy, which last year had begun down the road to recovery. However, the resumption of growth seems to be abnormally slow, both compared with previous cyclical expansions and with respect to the steep decline from which the economy must recover. A statistical analysis shows how the probability of a low-intensity recovery (with quarterly rates of change in GDP close to zero or even negative) has risen in the most recent period compared with previous expansionary phases (see Appendix 1.1 “GDP expansion in Italy: evidence based on a comparison of empirical probability distributions”). At the same time, however, the gradual nature of the recovery must also be judged in relation to the two recessions that the Italian economy has experienced within the last seven years and that have driven the starting point of any recovery far down the slope. Adopting, for example, the growth rates projected in the policy scenario of the Economic and Financial Document (EFD), per capita GDP by volume (which fell by about 12 per cent between 2007 and 2014) would still be far from the pre-crisis level (by about 8 per cent) in 2019; the gap widens further (exceeding 20 per cent) if compared with the level that could have been reached in 2019 if per capita GDP growth had continued to follow the trend it had been on before the crisis. This deterioration presumably reflects the persistence, even in the long term, of the effects of cyclical downturns (see Appendix 1.2 “Estimates of hysteresis in the Italian economy”).

Cleary, these characteristics do mean the country is in an active recession, which is now past us, but they do point to an anomalous recovery, one that is exposed to the risk of deterioration in the international environment noted above and which reflects the difficulties facing stimulus policies, particularly in Europe.

1.2 The international economy

The signs of a slowdown in the world economy, which sharpened in late 2015 and early 2016, have stabilised somewhat more recently. Deflationary pressures persist globally, only somewhat attenuated by the recent recovery in oil prices. The deceleration in China seems to be continuing as expected, attenuating the fears of an abrupt slowdown that arose at the start of the year. Among the emerging economies, Brazil and Russia remain in deep recession. In the advanced economies, the United States, now in its seventh year of expansion, has experienced a slowdown in its rate of growth, but the resilience of consumption and the improvement in the labour market indicate that the expansion is continuing. In the euro area, the recovery continues at a moderate pace, although signs of a slowdown in Europe have emerged in the most recent leading and confidence indicators. In March the ECB stepped up its monetary stimulus in order to revive inflation expectations and support growth.

In their most recent forecasts, international organizations have once again revised downwards their forecasts for world growth in 2016 and 2017 (Table 1.1). According to both the Organisation for Economic Co-operation and Development (OECD) and the International Monetary Fund (IMF), global output should increase in 2016 at a pace similar to that in 2015 before accelerating slightly in 2017. The growth assumptions adopted in the EFD for 2016 and 2017 are essentially in line with these forecasts, reflecting a substantial downwards revision of the assumptions adopted in the Update to the EFD of last September. For subsequent years as well, the projections used in the EFD (3.6 per cent in both 2018 and 2019) were adjusted downward (by about half a percentage point) compared with the assumptions in the Update.

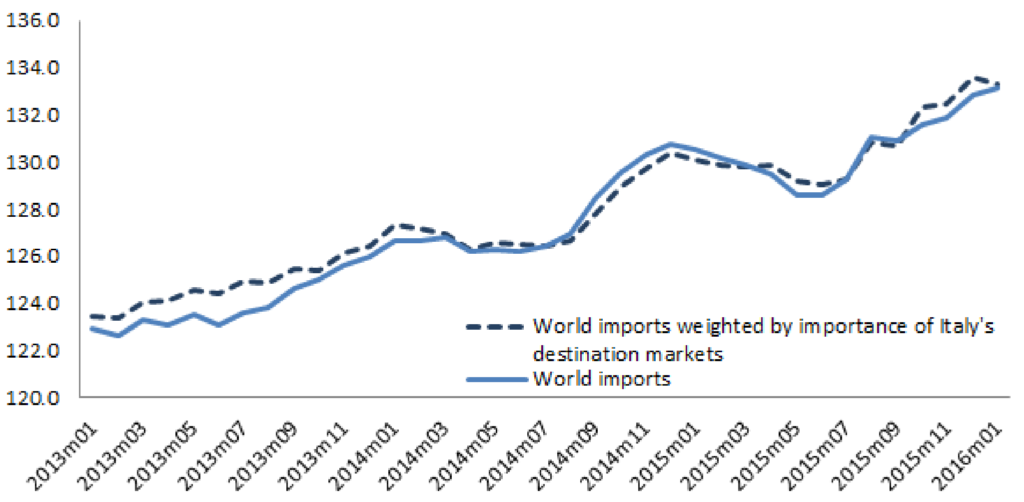
Following the decline registered in the first half of last year, international trade began to pick up gradually during the summer, expanding at a rate of 2 per cent over the course of the second half (Figure 1.1). Looking forward, trade should continue to expand moderately, reflecting both contained growth in international activity and the lower elasticity of trade to global output that has characterized the last few years. In its April forecasts, the IMF expects a moderate acceleration in world trade in 2016 and 2017 (3.1 and 3.8 per cent, with a downward correction in both years of 0.3 percentage points with respect to the forecasts made in January). The projections in the EFD for the 2016-2017 period (3 and 3.8 per cent) are very similar to these forecasts, entailing a significant reduction (about -1.5 points in 2016 and 2017) compared with the forecasts in the September Update. For the subsequent years as well, the EFD forecasts (4.6 per cent in 2018, 4.8 in 2019) revised the Update assumptions downwards (by about half a percentage point in 2018 and two-tenths of a point in 2019).

Table 1.1 – Growth in world GDP based on the most recent forecasts
(percentage growth rates)

	2015	2016		2017	
			difference in percentage points on previous forecast (1)		difference in percentage points on previous forecast (1)
OECD (February)	3.0	3.0	-0.3	3.3	-0.3
IMF (April)	3.1	3.2	-0.2	3.5	-0.1
EFD (April)	3.2	3.1	-0.7	3.5	-0.5

Sources: OECD (2016), *Interim Economic Outlook*, 18 February; IMF (2016), *World Economic Outlook*, 12 April, MEF (2016), *Documento di economia e finanza*, April.
(1) For the OECD November 2015, for the IMF January 2016 and for the EFD September 2015 (Update forecasts).

Figure 1.1 – World imports and Italy's main destination markets
(2010=100, quarterly moving averages)



Source: based on Central Plan Bureau data.

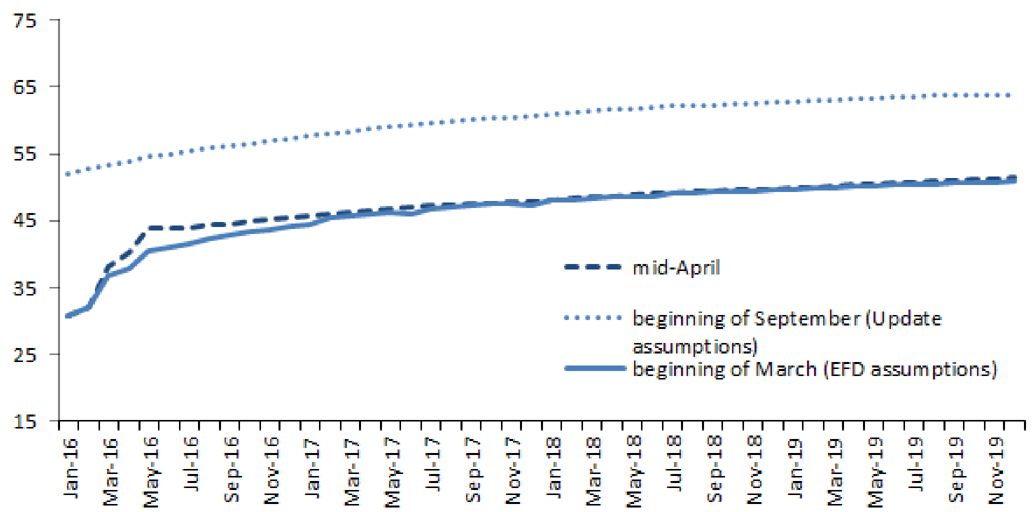
Expectations of an agreement between the major oil producers caused oil prices to rise above the lows reported in January/February. In the first two weeks of April the average price of Brent was close to $40 a barrel, an increase of 30 per cent over the start of 2016 (-30 per cent compared with a year earlier). The divisions between the major producers, however, make it unlikely that a binding agreement will be reached, as also demonstrated by the failure of the recent Doha summit. Oil prices will therefore continue to be affected by the underlying imbalance between weak demand and overabundant supply that characterizes the market, with little elasticity to changing prices. In line with these factors, the expectations of economic agents, as reflected in futures contracts at mid-April, do not incorporate the rebound at the start of 2016 and assume that prices will rise only gradually over the next few years (Figure 1.2). The assumptions in the EFD ($39 in 2016, $46 in 2017, $48 in 2018 and about $50 in 2019), determined on the basis of the price curve of forward contracts for the first weeks of

March, appear in line with these trends. They are significantly lower than the price assumptions that were incorporated in September in the Update scenario on the basis of market expectations during that period.

In conjunction with the rise in oil prices, the euro tended to appreciate against the US dollar and most other currencies. The strengthening of the single currency against the dollar was also affected by the changing outlook for US monetary policy, with interest rate increases likely to be more gradual than initially suggested by the Federal Reserve. The reinforcement of the monetary stimulus decided in March by the ECB (expansion of the scale of monthly securities purchases, a further reduction in official interest rates and new very favourable refinancing terms for banks) does not appear to have reversed this trend. The expectations reflected in forward rates indicate that the gradual appreciation of the euro will continue, at a rate of close to 2 per cent per year. The technical assumption of a constant exchange rate adopted in the EFD (agreed, for the 2016-2017 period, with the European Commission) appears to run counter to these expectations (Figure 1.3).

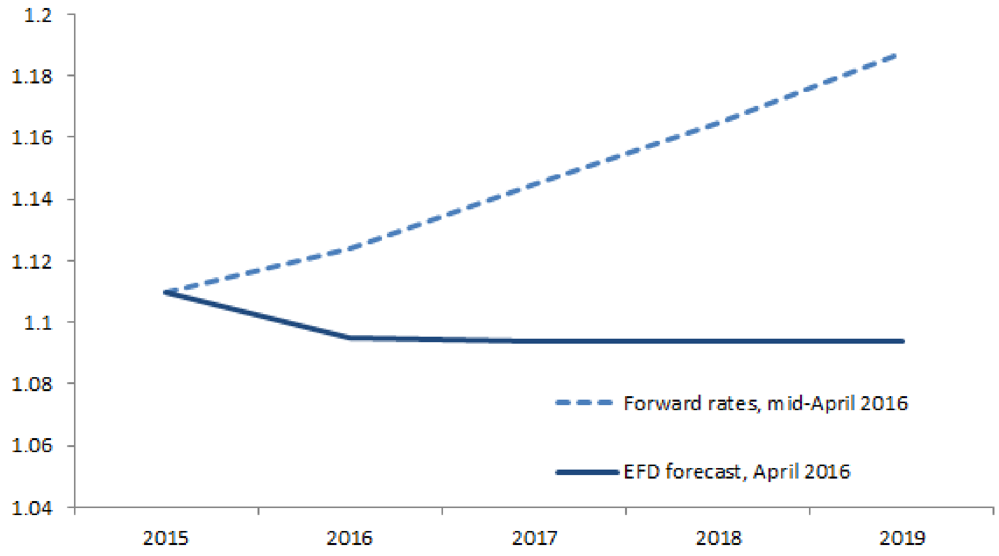
In short, the EFD's forecasts appear broadly aligned with the forecasts of international bodies with regard to global growth, international trade and oil prices. However, they diverge from market expectations with regard to the (technical) assumption that exchange rates will remain stationary.

Figure 1.2 – Brent oil prices in futures contracts
(dollars per barrel)



Source: Based on Barchart data.

Figure 1.3 **–** Dollar/euro exchange rate
(dollars per euro)



Source: Based on Barchart and MEF data.

1.3 The Italian economy

After three and half years of recession/stagnation, in 2015 the Italian economy returned to modest growth. However, the pace of growth fell progressively during the year: in the final quarter, GDP rose by 0.1 per cent, with a modest carry-over effect on 2016 (0.2 per cent). On average for 2015, the increase in GDP was 0.6 per cent, adjusting for calendar effects; in raw terms, i.e. gross of the working day effect, GDP rose by 0.8 per cent.

The slowdown at the end of 2015 reflected the deceleration in inventories (with a contribution of -0.4 percentage points to the change in GDP). By contrast, the contribution of final domestic demand to growth was positive (0.4 percentage points). Private consumption continued the recovery it began in mid-2013 (in the fourth quarter, it rose by 1.1 per cent year-on-year). The improvement in the labour market fostered a gradual rise in purchasing power (0.9 per cent in the fourth quarter of 2015 compared with a year earlier) and an improvement in household confidence. The easing of credit conditions helped buoy purchases of durable goods. Total investment also increased, accelerating in the final quarter of the year. Contributing factors included the growth in transport equipment and signs of recovery in construction. These developments more than offset the persistent weakness in investment in plant and machinery.

Driven by the growth of European markets, exports began to rise in the fourth quarter, expanding at a faster rate than imports. The contribution of net foreign demand to the change in GDP was slightly positive (+0.1 per cent).

After the slowdown in the final quarter of 2015, the available cyclical indicators for the first few months of 2016 point to a strengthening of economic activity. In particular, industrial output posted a marked increase, correcting the negative statistical effect of the holidays that most likely depressed performance in the final part of last year. In connection with this recovery, the spread of the recovery across manufacturing sectors also appears to have intensified compared with the modest figures for the preceding months. The confidence of industrial firms, as measured by the Istat sample survey, weakened at the start of 2016, although it remained relatively high. The Purchasing Managers' Index (PMI), however, continued to point to expansion.

As to the other sectors, construction showed signs of gradual recovery. In the real estate market, the drop in home prices in recent years came to a halt in 2015, while home sales began to rise. Business confidence, although affected by high volatility, appears to be on a significantly upward trend. The recovery is also expected to continue in the services sector, albeit at a moderate pace, fundamentally driven by rising consumption.

Taken as a whole, these clues signal the possibility of a rebound in economic activity at the start of 2016. Based on the short-term forecasting models of the Parliamentary Budget Office (PBO), GDP could grow by about 0.4 per cent in the first quarter, before registering a partial deceleration in the subsequent three months.

Inflation turned negative again at the start of the year, reaching -0.2 per cent in March. The decline was mainly driven by the fall in oil prices. Core inflation (excluding the prices of energy and fresh food products) remains extremely low (0.6 per cent in March), reflecting modest domestic inflationary pressures. Given the performance in the first three months of the year, the inflation rate that would be achieved if prices were to remain unchanged at their March levels for the rest of 2016 is -0.4 per cent. The expectations of households and firms, as measured in economic surveys, reflect an assumption that prices will remain weak over the coming months. Professional forecasters have been gradually revising their projections for 2016 downwards, and they are now in barely positive territory.

In the labour market, the considerable improvement in employment in 2015 (with an increase in standard labour units analogous to that in economic activity) seems to have been primarily affected by contribution relief measures to encourage the hiring of employees on open-ended contracts. This appears to be confirmed both by the acceleration during the year in the number of permanent employees as reported in the Istat labour force survey and by the increase in net registrations of open-ended employment relationships measured by the National Social Security Institute (INPS). The bringing forward of new hiring in response to the December deadline (as from 2016 the contribution relief was scheduled to be reduced) probably contributed to the contraction in employment in February 2016 (of 0.4 per cent, with a drop of 0.6 per cent in hiring on open-ended contracts). INPS data also showed a reduction in January, following the peak reached in previous months, in new registrations net of terminations.

The outlook for the job market for the rest of the year nevertheless remains moderately positive. The quarterly surveys indicate that firms' expectations for employment are essentially optimistic, especially in industry and trade.

1.4 The macroeconomic forecasts in the EFD

Based on the outturn for 2015, which as noted showed an increase in GDP (unadjusted) of 0.8 per cent (compared with a forecast of 0.9 per cent in the September Update), the EFD trend scenario forecasts growth of 1.2 per cent in 2016, 2017 and 2018, and 1.3 per cent in 2019. These projections represent a downwards revision, compared with the growth assumptions in the Update, of four-tenths of a point in 2016 and 2017 and three-tenths of a point in 2018; the forecast in the Update for 2019 was maintained in the EFD. The adjustment of the Government's projections mainly reflects the effects of a less favourable international environment than that incorporated in the September forecasts, which materialized in the final months of 2015. As in the Update, 2016-2019 growth is driven by final domestic demand, with only a weak contribution from net exports (negative in 2016 and 2018, and zero in 2019); inventories contribute essentially nothing (negative in 2017). Compared with the Update, the GDP deflator in 2016 is essentially unchanged, but the gap with the consumption deflator (which was, by contrast, adjusted downwards) has widened owing to the improvement in the terms of trade, which was not expected in the September forecasts. In the subsequent years of the forecasting horizon, the GDP deflator is lower than that used in the Update (three-tenths lower in 2017, two-tenths lower in 2018 and one-tenth lower in 2019). Given the revisions in real growth and, from 2017, in the GDP deflator, the increase in trend nominal GDP growth has been reduced by fourth-tenths of a point in 2016, seven-tenths in 2017, five-tenths in 2018 and one-tenth in 2019 compared with the forecast in the Update.

Box 1.1 – Output gap and forecasting period

The Government, in a letter from the Ministry for the Economy and Finance to the Vice-President of the European Commission and to the Commissioner for Economic Affairs and to seven other EU ministers (those of Latvia, Lithuania, Luxembourg, Portugal, Slovakia, Slovenia and Spain), recently raised the issue of the different forecasting horizon used by the Commission in the procedure for estimating potential GDP and the output gap (currently two years and, therefore, up to 2017 in the upcoming Spring Forecasts) compared with those that the Member States are required to use in their Stability and Convergence Programmes (four years, therefore until 2019 in the case of Italy's April EFD/Stability Programme).

The procedure agreed at the EU level provides for the variables used in calculating potential GDP (labour, capital and technological progress) to be projected over a medium-term horizon (currently defined as the three years subsequent to the end of the forecasting period) in order to obtain the convergence of potential levels compared with those observed, i.e. closing the respective gaps.

In the case of a longer forecasting period, for example until 2019 instead of 2017, the two years of additional forecasts will be based on economic assumptions and multivariate statistical models, while in the case of a shorter time horizon, they will be derived from a simple linear projection of the variables that are used to calculate potential output. As a result, the differences between the two scenarios will be larger the more the growth profile projected for the longer time horizon is characterized by accelerations/decelerations, i.e. it shifts away from the linear projections assumed in the short term. Therefore it is not possible to give in advance an assessment of the size of the impact of the different forecasting period used by the Government and that adopted by the European Commission since this is strictly dependent upon the phase of the cycle and the speed with which the gap between the observed and potential variables is closed. As reference one could however consider that the current procedure considers a medium-term convergence of three years, therefore a slower cycle in a longer forecasting period would lead to a closing of the gaps at a later point in time.

Comparing the recent forecasts of the output gap in the EFD with the European Commission's Winter 2016 Forecasts published in February (Table R1.1.1) we see that in this particular case the differences associated with the forecasting period only (i.e. obtained with the Government's macro scenario and shortening the period by two years) remain small (on the order of 2 percentage points), while the strongest impact is generated by the different macroeconomic scenarios underlying the projections of the Government and the Commission, which lead to output gap forecasts that are more optimistic by 0.5 points in the case of a shorter forecasting period. The two methodologies also employ different procedures for choosing the initialization parameters of the NAWRU (non-accelerating wage rate of unemployment) model, but in this case of the impact on the forecasts is close to negligible.

If, instead, we compare the September 2015 Update data with those of the Commission's Autumn 2015 Forecast published in November, the scenario changes (see Table R1.1.2).

Table R1.1.1 – Impact of the various factors on the output gap projections in a comparison of the EFD forecasts (policy) and the European Commission's Winter 2016 Forecasts

	Different horizon	Different macro scenario	Different selection procedure for parameters of NAWRU estimation model	All differences
2015	0.2	0.3	0.1	0.6
2016	0.2	0.5	0.1	0.7
2017	0.1	0.6	0.1	0.8

Table R1.1.2 – Impact of the various factors on the output gap projections in a comparison of the EFD forecasts (policy) and the European Commission's Autumn 2015 Forecasts

	Different horizon	Different macro scenario (1)	Different selection procedure for parameters of NAWRU estimation model	All differences (1)
2015	0.3	0.8	0.6	1.15
2016	0.4	0.7	0.7	1.06
2017	0.4	0.6	0.8	1.06

(1) Part of the difference is also attributable to the change in the production capacity index and consequently to the priors of the estimation model for TFP made between the publication of the Update and the Autumn Forecasts of November 2015.

In general, the impacts are stronger, in part as a consequence of the fact that between the publication of the Update and the Autumn Forecasts there was a further change to the procedure, not extrapolated here for simplicity, namely the production capacity index was modified and as a consequence so were the initialization parameters of the model for forecasting total factor productivity (TFP). More specifically, the effect of the different procedure for forecasting the initialization parameters is now significant due to the fact that by extending the time horizon by two years the values used by the Commission are no longer optimal.

In conclusion it is clear that it is not possible to quantify the effects of the differences between the two procedures a priori, either in terms of the forecasting horizon or the parameters and, therefore, for interpretive purposes it would be advisable to reduce the divergences to a minimum.

Beginning with this trend scenario, the EFD policy scenario demonstrates the effects of a fiscal policy characterized, as from 2017, by a lower indirect taxation burden, due to the deactivation of the safeguard clauses, and by corrective measures that only partly offset the effects of non-activation on the public finances. Compared with the assumptions made on a current legislation basis, the deficit will grow by 0.4 percentage points of GDP in 2017, 0.6 points in 2018 and 0.3 points in 2019 (see Chapter 2). The overall positive impact on economic activity is estimated at two-tenths of a point in 2017 and three-tenths in 2018; the effect is marginally favourable in 2019. Thus, the GDP growth rate under the policy scenario becomes 1.4, 1.5 and 1.4 per cent respectively in the three years (the forecast for 2016, which is not affected by the budget measures, remains at 1.2 per cent, as in the trend scenario). The higher growth is driven by increased growth in consumption and investment. Compared with the trend scenario, household spending is influenced by the rise in real disposable income due to lower indirect taxes (the consumption deflator falls by five-tenths of a point in 2017 and three-tenths in 2018) and by an improvement in employment. Investment reflects the more favourable general scenario for economic activity. The improvement in the components of final domestic demand more than offsets the weakening of the contribution of net foreign demand, the result of the acceleration in imports. The growth of nominal GDP reflects a lower inflation rate than that forecast in the trend scenario in 2017 (rising by two-tenths less). Nominal growth under the policy scenario is higher than that under the trend scenario for 2018, due to the increase in real GDP, which exceeds the reduction in the deflator, and in 2019, due to the emergence of inflationary pressures caused by the more dynamic economic scenario. As a result of the greater growth, employment under the policy scenario is higher starting from 2017 by one/two-tenths of a point each year, while the unemployment rate falls in the final year to 9.6 per cent (three-tenths lower than the trend forecast). The output gap, projected to be 3.6 per cent in 2015, would fall to 2.3 per cent this year and to 1.1 per cent in 2017, to then to almost zero in 2018, before turning positive in 2019 (0.7 per cent).

1.5 Validation of the macroeconomic scenario

The PBO has assessed the macroeconomic scenarios published in the EFD for the entire 2016-19 forecast period. European legislation requires the validation of macroeconomic policy projections only. In agreement with the Ministry for the Economy and Finance (MEF), the PBO has also extended the validation process to macroeconomic trend scenario projections.

On 1 April the PBO communicated its validation of the macroeconomic trend forecasts for 2016-19 in the 2016 EFD. The validation letter, with an attachment setting out the risks associated with the forecasts, has been published on the PBO website (http://www.upbilancio.it/wp-content/uploads/2016/04/Lettera-e-allegato-validazione-QMT-April-2016pdf.pdf). The PBO validated the trend scenario after having transmitted its observations on a preliminary version of the Government's forecasts, based on which the MEF prepared a new macroeconomic trend scenario, which was successfully validated.

On 18 April the PBO also validated the macroeconomic policy scenario for 2016-2019, published in the EFD, and sent the findings to the MEF.

The method adopted by the PBO for the validation exercise is briefly as follows. The validation exercise is conducted on the basis of a comprehensive analysis of the macroeconomic scenarios forecast by the MEF using: a) the PBO's own forecasts of short-term developments in GDP and the main demand components; b) the annual forecasts obtained by the PBO using Istat's forecasting model, which is used under the terms of the framework agreement signed with that institute; c) the annual forecasts produced separately and specifically by the independent forecasting institutes (CER, Prometeia and REF.ricerche). Furthermore, we monitored the most recent forecasts of other national and international institutions and conducted an analysis of the internal consistency of the scenarios developed by the MEF.

In order to ensure the consistency of the comparison with the MEF forecasts, the projections of the PBO panel of forecasters (including the PBO forecasts obtained using the Istat model) were formulated on the basis of the same assumptions for the exogenous international variables (international trade, exchange rates and oil prices) adopted by the MEF. In addition, for the macroeconomic policy forecasts, the PBO panel forecasters used the general assumptions about the 2017-2018 budget measures prepared by PBO consistent with the indications published in the EFD.

Figures 1.4 and 1.5 illustrate the main findings of the comparison of the macroeconomic trend and policy scenarios. The growth and inflation variables, which are essential for the public finances, under the macroeconomic trend scenario appear to be essentially in line with PBO panel forecasts. However, the scenario forecasts are generally close to the upper limit of the range of panel projections, indicating the emergence of risk factors in the trend scenario that then have repercussions on the policy scenario.

More specifically, the increase in real GDP in 2016 and 2018 lies at the upper limit of the forecasts of the PBO panel. In 2017 and 2019, the expected increase is below this limit. The main driver of these results is private consumption, which exceeds the highest of the PBO forecasts in 2016 and 2018. The faster pace of household expenditure in the MEF's scenario appears to reflect, as compared with the PBO forecast, the assumption of a higher propensity to consume in 2016 and more favourable developments in real disposable income, particularly in 2018.

Under the trend scenario for inflation there are no substantive divergences from the PBO panel forecast. However, in this case as well, the forecasts are close to the panel's upper limits. Specifically, the consumption deflator is near the uppermost limit of the PBO forecasts for the 2017-2019 period; the GDP deflator is at the uppermost bound for 2016-17.

The growth and inflation assumptions of the MEF's trend scenario combine to cause nominal GDP to be at the uppermost limit of the range of PBO panel forecasts over the entire forecasting period.

The policy scenario analysis covers the years 2017-2019, when the public finance measures are in effect (the 2016 policy scenario therefore coincides with the trend scenario). The very limited description in the EFD of the budget measures makes interpretation difficult. The stimulus, compared with the trend scenario developments, comes from the deactivation of the safeguard clauses, which is in part offset with corrective measures, mainly as part of the spending review, including tax relief measures. As noted, there is a net expansion of the deficit in 2017 and 2018 compared with the trend scenario, and a net reduction in 2019. There are no indications of the amount and composition of the overall measures.

Under the policy scenario, real GDP is still fall within the range of the PBO panel forecasts in 2017 and 2019, as in the trend scenario, and above this range (by one-tenth of a point) in 2018. This result reflects an estimate of the effects of the budget measures that falls within the impact assessments adopted by the forecasters in 2017 and 2019, and slightly above this range in 2018.

Figure 1.4 – Comparison of the Government's trend scenario with the PBO panel forecasts

GROSS DOMESTIC PRODUCT (trend scenario)

GDP DEFLATOR (trend scenario)

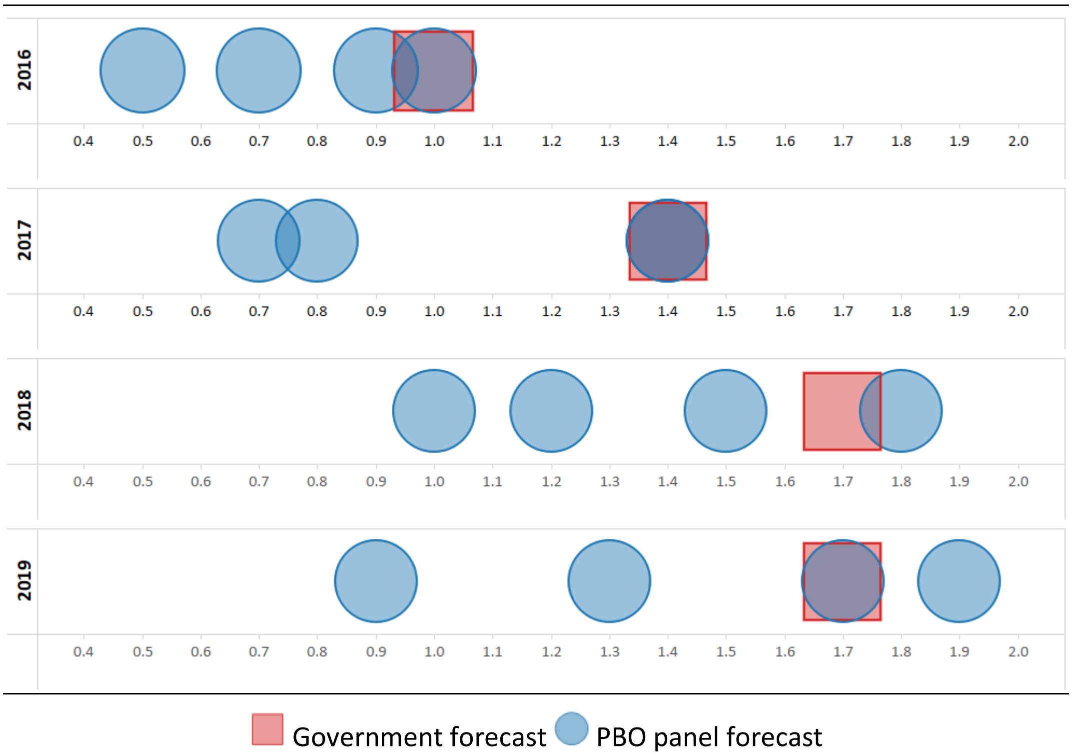
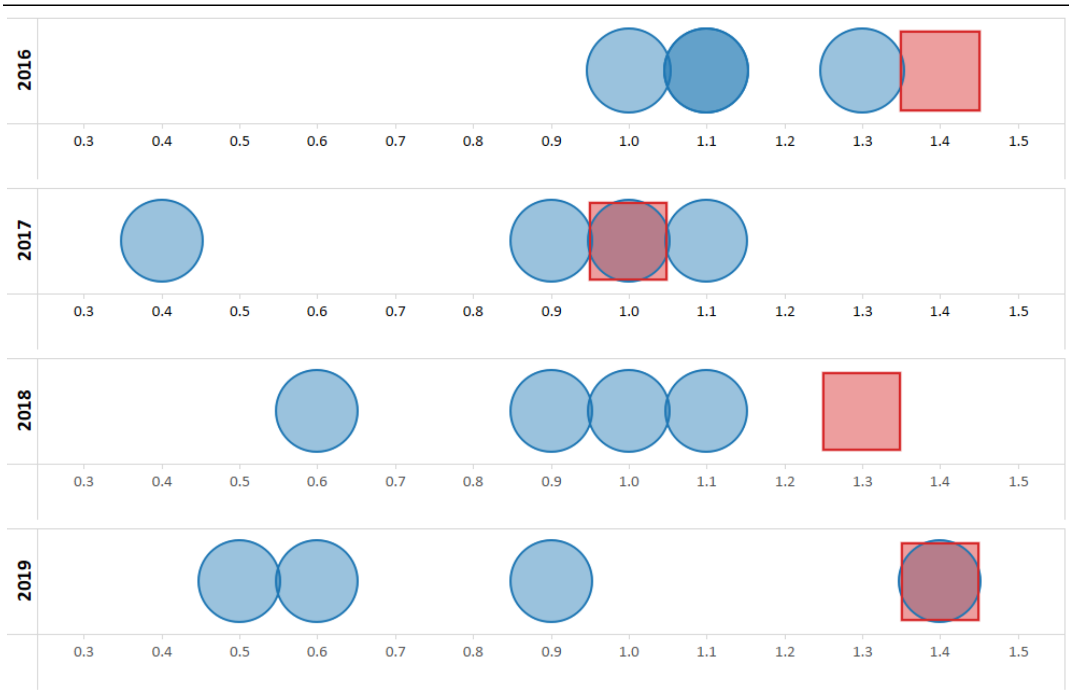


Figure 1.4 – *(cont.)* Comparison of the Government's trend scenario with the PBO panel forecasts

NOMINAL GDP (trend scenario)

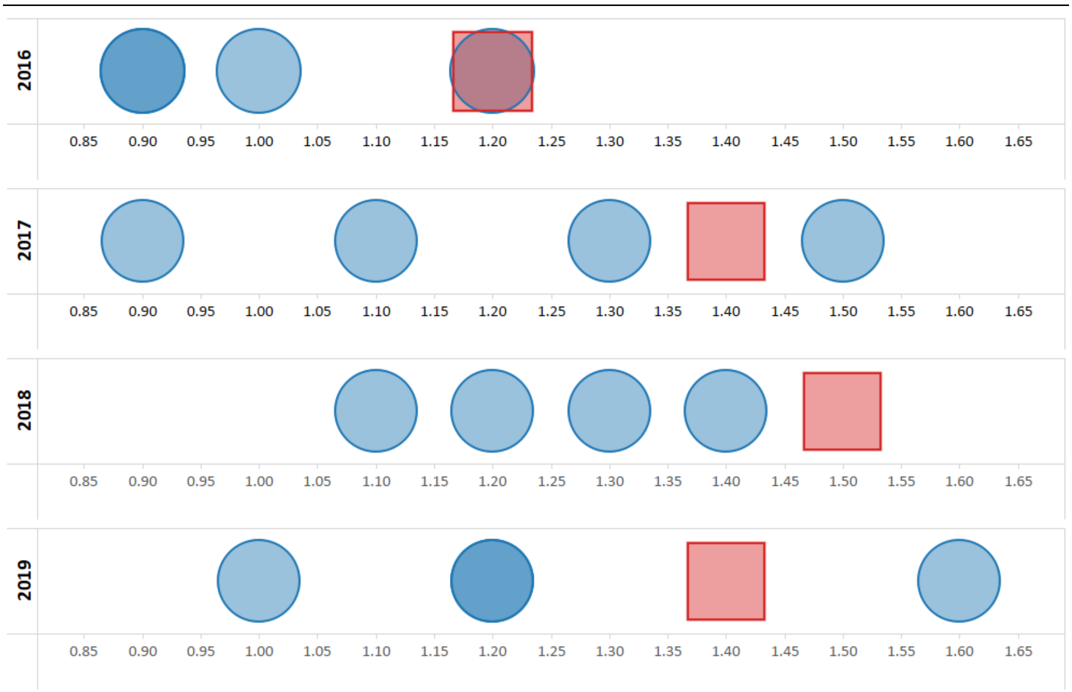
HOUSEHOLD CONSUMPTION (trend scenario)



Government forecast PBO panel forecast

Figure 1.5 – Comparison of the Government's policy scenario with the PBO panel forecasts

GROSS DOMESTIC PRODUCT (policy scenario)



GDP DEFLATOR (policy scenario)

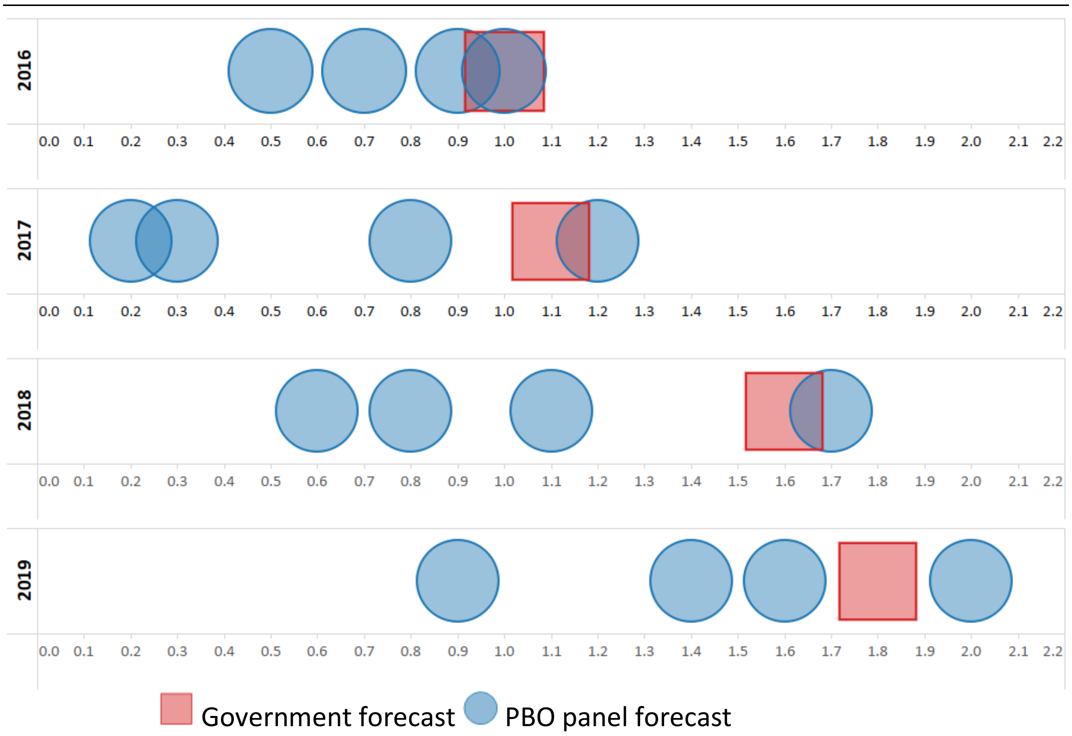
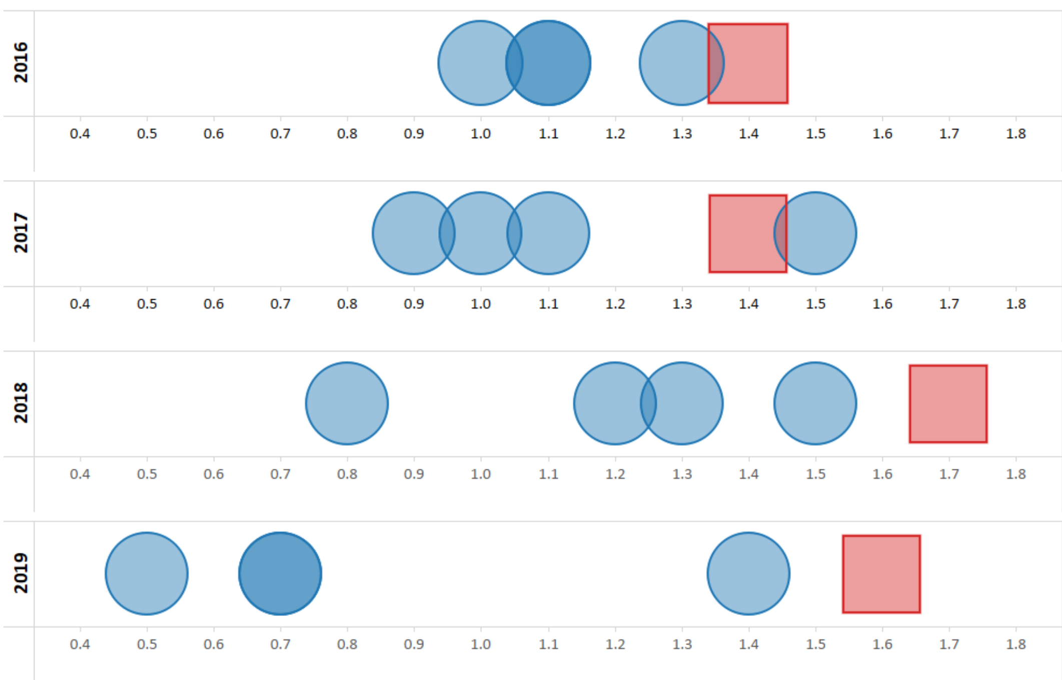


Figure 1.5 – *(cont.)* Comparison of the Government's policy scenario with the PBO panel forecasts

NOMINAL GDP (policy scenario)

HOUSEHOLD CONSUMPTION (policy scenario)



Government forecasts PBO panel forecasts

The policy scenario continues to assume that domestic demand will be more robust than contemplated by the PBO panel. This mainly reflects growth in household consumption, which is located in the uppermost part of the forecast range in 2017 and above this range in 2018 and 2019. The relatively more favourable assumptions on disposable income that characterize the trend scenario tend to be accentuated in the policy scenario, especially in 2018.

As in the trend scenario, nominal GDP growth lies close to the upper limit of the range of PBO forecasts in 2017 and 2019, and is above it in 2018. For the latter year, the EFD policy scenario, unlike the rest of the PBO panel forecasts, projects faster nominal GDP growth than in the trend scenario.

These comparisons ultimately lead to the emergence of a policy forecasting profile in the EFD within the range (real GDP) or at the limit (nominal GDP) of the acceptability criteria adopted by the PBO, with one divergent element (for both real and nominal GDP) in 2018. It appears that this divergence is mainly connected with the Government's relatively stronger assumption about the response of the volume variables (household consumption and GDP) to the deactivation of safeguard clauses, such as to induce a higher nominal GDP growth rate in the EFD policy scenario than in the trend scenario. From our dialogue with the MEF regarding this point, it was found that this effect essentially reflects the size and structure of the lags of the fiscal multipliers of the MEF's forecasting model (see also the Focus "*L'aggiornamento del modello ITEM e la verifica dei moltiplicatori fiscali*" ("Update of the ITEM model and verification of the fiscal multipliers", in *Documento di economia e finanza 2016*, p. 27). This appears to make the real growth for 2018 more elastic to the reduction in indirect taxes compared with the assumptions of the PBO's forecasters. Assessing this technical difference depends on the extent to which the models reflect the actual behaviour of the economy. There is obviously a great deal of inherent uncertainty, difficult to resolve through theoretical discussion of forecasting models.

Although it took due account of these critical issues, the PBO also decided to validate the EFD's macroeconomic policy scenario based on the following considerations:

- the location of the overall growth profile for 2017-2019 (with the exception of 2018) within the range of the PBO panel;
- the specific divergence from the upper limit of the forecasters in that year is small;
- the fact that the growth profile also depends upon overall budget measures that are not specified in the EFD, but whose the scale and composition could impact the PBO panel models in reducing the current divergence for 2018. For example, using the Istat-PBO model, we verified that the disparity of one-tenth of a point that characterizes 2018 could be eliminated if it is assumed that the gross impact of the budget is greater than the net impact of the measures, which

provide for an increase in investment grants, offset through the tax channel, of just over €1 billion.

However, it should be emphasized that the high degree of uncertainty that characterizes the current economic environment counsels a cautious approach. As indicated, the divergent performance of 2018 nominal GDP comes against the background a profile for that variable in all the other years that is constantly at the limit of the PBO panel projections. This positioning of the Government forecasts represents a risk factor for the scenario in general, and not just for 2018. Any adverse surprises on the growth and inflation front would threaten the expansion in nominal GDP and, with it, the reduction of the debt/GDP ratio (see section 3.2).

1.6 Risk: sensitivity to appreciation of the euro

The main source of risk is developments in the international economy. In section 1.1 we compared the most recent forecasts of international bodies and market operators with those of the EFD. We saw how the Government's assumptions are close to these forecasts for global growth, international demand and oil prices. However, there was a divergence on developments in the euro exchange rate, which is held constant in the technical assumptions of the EFD but and appreciates according to market expectations.

The technical assumption of a stable exchange rate is agreed by the MEF with the European Commission and is also adopted by other forecasters. Its theoretical foundation lies in the idea advanced in the literature[1] concerning the great difficulty in forecasting future exchange rate developments, to the point that no structural exchange rate model appears able to improve upon, on average, the forecast obtained from a random statistical relationship.[2] This approach leads to the assertion that the "best" forecast of the exchange rate is its current value.

However, this scenario becomes problematic when it is incorporated in the construction of macroeconomic scenarios in which aggregates intrinsically linked to the exchange rate are made to vary. In this case, incongruences can arise in the overall framework of international assumptions. More specifically, the assumption of a stable exchange rate

[1] See Meese R.A., Rogoff K. (1983), "*Empirical exchange rate models of the seventies: Do they fit out of sample?*", *Journal of International Economics* 14 (1-2), pp. 933-48.

[2] Technically, this statistical relationship is defined as a random walk.

violates the condition of interest rate parity[3] and may contradict the assumption of an oil price that varies on the basis of the prices of futures contracts.[4]

Using forward exchange rates would make it possible to remedy such potential incongruences. The exchange rates in futures markets would ensure consistency with market assumptions about interest rates (implying covered parity) and the price of oil, even though they are not necessarily a good predictor.

Table 1.2 reports the effects on growth, inflation and nominal GDP, substituting the forward dollar/euro exchange rate at mid-April for the technical assumption of rate invariance. As seen in section 1.2, this assumption results in an appreciation of the single currency as compared with rate curve assumed in the EFD.[5]

In brief, the strengthening of the euro would depress real growth by reducing competitiveness. As regards to price dynamics, a stronger currency would lower imported inflation, which would be reflected in a deceleration of the GDP deflator. The cumulative effect of slower growth and lower inflation could give rise to substantially lower nominal GDP growth than that assumed in the EFD for each forecast year.

Table 1.2 – Effects of the adoption of the forward exchange rate assumption (1)

	2016	2017	2018	2019
Real GDP	-0.1	-0.4	-0.2	-0.1
GDP deflator	0	-0.2	-0.5	-0.8
Nominal GDP	-0.2	-0.6	-0.7	-0.9

(1) Dollar/euro exchange rate equal to 1.124 in 2016 (+2.5 per cent compared with level assumed in the EFD scenario), 1.145 in 2017 (+4.5 per cent), 1.165 in 2018 (+6.5 per cent) and 1.187 in 2019 (+8.5 per cent).

3 Interest rate parity expresses the condition of equilibrium in the foreign exchange market for which the expected return on deposits denominated in different currencies must be equal when translated into the same currency. In the forward market, covered interest parity is achieved. This means that remuneration of a deposit in dollars is equal to the remuneration on a deposit in euros plus a forward premium/discount on the euro against the dollar.

4 The dollar prices of oil are correlated with the dollar exchange rate. It gives rise to a potential incongruence in assuming a stable exchange rate and a variable oil price in forecasts.

5 A similar sensitivity exercise is also conducted in the EFD. The difference with this simulation, other than the fact that they use different years to mark the start of the exchange rate shock (2016 for the PBO, 2017 for the MEF), is that the purpose of the PBO's exercise is to measure the effects not just on real growth (as is done in the EFD), but also on inflation (GDP deflator) and on nominal GDP.

Appendix 1.1

GDP expansion in Italy: evidence based on a comparison of empirical probability distributions

This appendix presents an exercise using empirical probability distributions constructed for the expansionary phases of the Italian economy starting from 1970. The latter, drawn from the ISCO/ISAE dating of the economic cycle and currently updated by Istat, were combined to form broader time periods of about 10 years each. More specifically, four periods were identified as "the 1970s" (1970q1-1979q4), "the 1980s" (1980q1-1989q4), "the 1990s" (1990q1-2003q4) and "the 2000s" (2004q1-2016q1). Figure A1.1 presents the probability distribution for periods of GDP expansion obtained using non-parametrical estimation from empirical observations. We are able to draw two main facts from Figure A1.1.

First, the intensity of the expansionary phases through which the Italian economy has passed has gradually diminished over time. The distribution for the 1970s is located to the right of Figure A1.1.1 and in correspondence with the highest quarterly GDP growth value. Starting the subsequent decade, expansions were characterised by increasingly slower growth rates. With the 1990s, the decline in the intensity of economic growth was joined by a reduction in the duration of the cyclical phases. The corresponding probability distributions therefore shifted to the left (Figure A1.1.1).

Secondly, the probability distribution for expansionary phases in the final period (2004q1-2016q1) is located to the left of those in the other periods and is centred around the slower rates of economic growth. It associates probability values other than zero even with negative variations in GDP. This corresponds to a higher probability that declines in GDP will also occur during the economic recovery/expansion phases. This evidence does not apply to the other distributions, which attribute a zero probability (or a very low probability, in the case of the expansion in the 1980s) to the occurrence of possible declines in GDP during expansions. This latter feature characterizes the cyclical phase of the 2000s and potentially distinguishes it from the other cyclical phases considered.

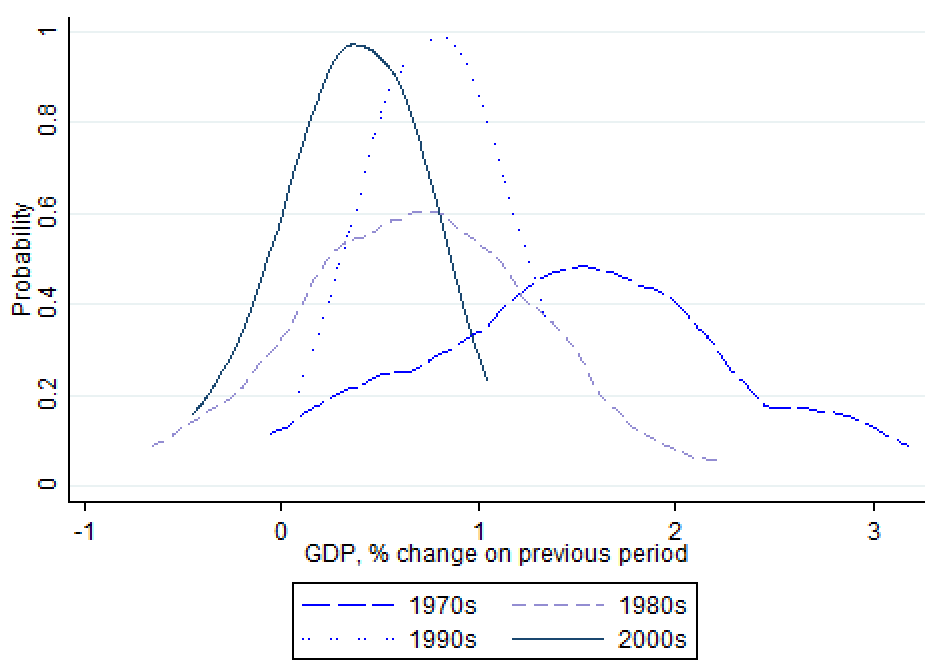
The comparison of the two empirical probability distributions can be tested to verify the statistical significance of one of their differences, i.e. to rule out the possibility that the observed differences are only due to chance. The results of a test of distribution dominance[6] indicate the existence of significant differences between the expansionary phases observed in the last decade, in particular between the probability distribution for the 1970s and those, respectively, for the 1980s and the 1990s (Table A1.1.1).

[6] A first order stochastic dominance test is used. The null hypothesis is that the two probability distributions are significantly different. It employs the assumption of different distributions for the p-values. See Linton, O., Maasoumi E., Whang Y. (2005), "*Consistent Testing for Stochastic Dominance under General Sampling Schemes*", *Review of Economic Studies* Vol. 72, pp.735–765.

Conversely, no difference emerges between the distributions of the cyclical phases for the 1980s and 1990s. Finally, we found a systematic difference between the frequency distribution for expansions in the 2000s (2004q1-2016q1) and the individual distributions corresponding to the previous periods.

Putting together all the cyclical recoveries observed in Italy up until the 1990s and isolating those in the 2000s, the differences of the final cyclical phase are even clearer, as shown in Figure A1.1.2. The atypical characteristics of the current recovery also seem to be confirmed by the statistical test of divergences between the distributions (last row of Table A1.1.1).

Figure A1.1.1 – Empirical probability distributions of expansionary phases (1)

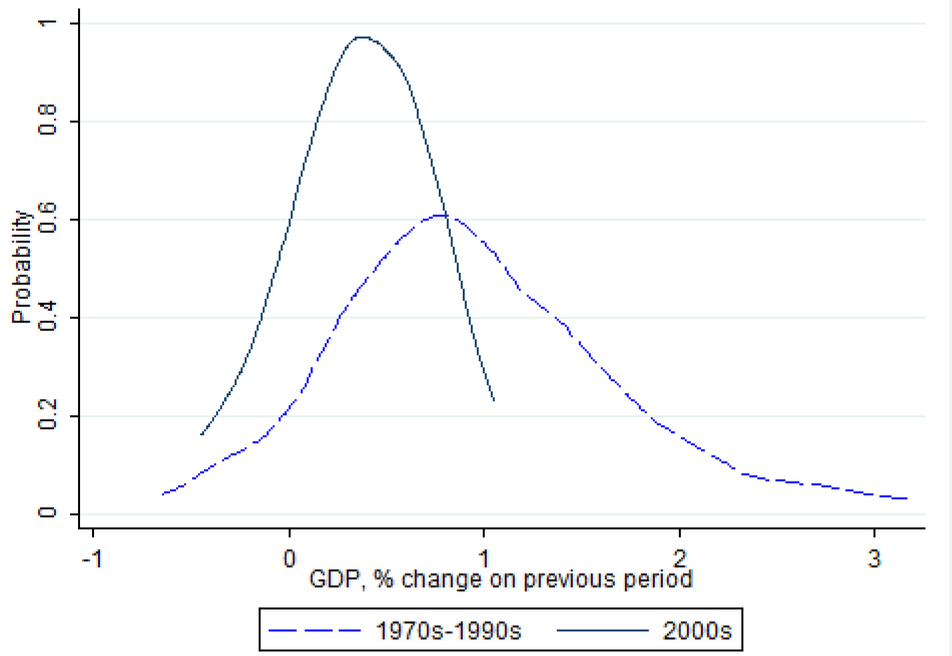


(1) GDP is expressed in chain-linked values, adjusted for seasonal and calendar effects; the x-axis reports quarterly growth rates.

Table A1.1.1 – Comparison between the empirical probability distributions of expansionary phases
(p-values of the distribution dominance test)

	1980s	1990s	2000s
1970s	0.994	0.177	0.997
1980s		0.006	0.842
1990s			0.997
1970s-1990s			0.948

Figure A1.1.2 – Probability distributions of expansionary phases in the 2000s and 1970s-1990s



Appendix 1.2

Estimates of hysteresis in the Italian economy

The term hysteresis refers to the phenomenon by which a recession, or a transitory event caused by a fall in demand, has persistent impacts on the long-term growth of GDP when economic growth tends to be driven by supply factors (availability and efficiency of the inputs of production). According to some observers, this is what many economies, including Italy, seem to have experienced during the recent crisis.[7] In effect, recovery from recessions has been slow, taking account of the depths of the contractions in production, while the estimates of the level and growth rate of potential GDP were generally revised downwards, shifting considerably and perhaps permanently away from pre-crisis trends.[8]

There are various reasons why a recession can have an impact on supply factors that affect long-term developments. They are systematized in endogenous growth models,[9] in which the decline in investment in a recession reduces the stock of capital, while cuts in spending on research and development permanently lower the total productivity of factors. In addition, recessions can diminish the intensity of the resource reallocation processes that underlie the growth in productivity without these being fully recovered subsequently in the expansion.[10] Finally another channel for hysteresis could be the labour market, where in prolonged recessions the fact that large groups of individuals remain unemployed for protracted periods of time causes their skills to deteriorate, transforming cyclical unemployment into structural unemployment, and, therefore reducing potential output.[11]

Despite the importance of the economic issue, statistical inference usually disregards the possibility of a relationship and a reciprocal influence between the short and the long term. Most empirical applications that break down economic growth into its cyclical (short-term) and trend (long-term) components assume, in fact, that they are

[7] See Blanchard O., Cerutti E., Summers L. (2015), "*Inflation and Activity: Two Explanations and their Monetary Policy Implications*", *IMF Working Paper*, no. 15, November, and Fatàs A., Summers L. (2015), "*The Permanent Effect of Fiscal Consolidations*", *CEPR Discussion Paper Series*, no. 10902, October.

[8] The correlation between short- and long-term GDP developments is not only applicable to recent experience. Blanchard et al. (2015) analyse 122 recessions over the last 50 years for 23 advanced countries and find that in two-thirds of cases, GDP in the subsequent recovery remains below pre-recession levels; in half of the cases, not only the levels, but also GDP growth rates fall. The persistent nature of cyclical fluctuations was noted as far back as the early 1980s with regard to the United States (Nelson C. R., Plosser C. R. (1982), "*Trends and Random Walks in Macroeconomic Time Series: Some Evidence and Implications*", *Journal of Monetary Economics*, 10, pp- 139-162).

[9] See Stadler G. W. (1990), "*Business Cycle Models with Endogenous Technology*", *American Economic Review*, pp. 763-778 and Fatàs A. (2000), "*Endogenous Growth and Stochastic Trend*", *Journal of Monetary Economics*, 5, pp- 147-162.

[10] See Comin D, Gertler M. (2006), "*Medium-term Business Cycles*", *American Economic Review*, pp. 523-551.

[11] Blanchard O., Summers L., "*Hysteresis and European Unemployment*", in Fischer S. (ed.), *NBER Macroeconomics Annual*, *MIT*, *Press*, September, pp. 15-77.

orthogonal. Although less well known, other models do envisage a possible correlation between the short and long term.

For the United States, Morley, Nelson and Zivot (2002)[12] estimate a model as follows:

$$\begin{aligned} y_t &= \mu_t + \psi_t & t = 1 \dots T \\ \mu_t &= \mu_{t-1} + \beta + \eta_t & \\ \psi_t &= \phi_1 \psi_{t-1} + \phi_2 \psi_{t-2} + k_t & \end{aligned}$$

$$\begin{pmatrix} \eta_t \\ k_t \end{pmatrix} \sim NID \left[\begin{pmatrix} 0 \\ 0 \end{pmatrix}, \begin{pmatrix} \sigma_\eta^2 & \sigma_{\eta\kappa} \\ \sigma_{\eta\kappa} & \sigma_k^2 \end{pmatrix} \right] \qquad \sigma_{\eta\kappa} = r\, \sigma_\eta \sigma_\kappa \tag{1}$$

where the GDP series, y_t, is decomposed into the trend, μt, represented with a random walk, the cycle, ψ_t, with a stationary autoregressive process, AR(2) or ARIMA(2.1), and the shocks of the two equations, η_t and k_t, are possibly correlated through the coefficient *r*.

The authors find a large and negative correlation (-0.83) between the statistically significant errors for the American GDP series. They interpret this result, which is associated with a high signal ratio ${\sigma_\eta}^2/{\sigma_\kappa}^2$, as the dominance of real shocks, η_t, over nominal ones, k_t. As, for example, a high and positive productivity shock, such as the introduction of the Internet, immediately increases the long-term output equilibrium, so that the level of actual GDP will be found in the short term under the trend component, up until the gap is eliminated. A positive shock in the trend scenario is therefore associated with a negative cycle shock. By contrast, a nominal shock, for example an accommodative monetary policy stance, will change the cycle without altering the trend.

Proietti (2002),[13] applying the same model to the Italian GDP series for the 1970-2001 period, finds a high and negative (-0.97) correlation between errors. The author demonstrates, however, that model (1) lends itself to multiple other interpretations, in addition to that of the trend dominating the cycle. For example, it corresponds to the decomposition of Beveridge-Nelson[14] into transitory and permanent components, or can be seen as a model that extracts the cycle on growth rates rather than on levels. Finally, it can also lead back to the concept of hysteresis as described at the beginning.

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[12] Morley, J.C., Nelson, C.R. and Zivot, E. (2002), "*Why are Beveridge-Nelson and Unobserved-Component Decomposition of GDP so Different?*", *Review of Economics and Statistics*, vol. 85, issue 2, pp. 235-243.
[13] Proietti, T., (2002), "*Some Reflections on Trend-Cycle Decompositions with Correlated Components*", *EUI working paper ECO No. 2002/23*.
[14] Beveridge, S., Nelson, C. R. (1981), "*A New Approach to Decomposition of Economic Time Series into Permanent and Transitory Components with Particular Attention to Measurement of the Business Cycle*", *Journal of Monetary Economics*, 7, pp. 151-174.

More specifically, Proietti (2002) demonstrates that it is possible to rewrite model (1) in terms of the hysteresis model introduced by Jaeger and Parkinson (1994)[15] in which the cycle permanently influences the trend:

$$\begin{aligned} y_t &= \mu_t + \psi_t^* && t = 1 \dots T \\ \mu_t &= \mu_{t-1} + (1+\theta)\psi_{t-1}^* + \eta_t^* && \eta_t^* \sim WN(0, \sigma_{\eta*}^2) \qquad (2) \\ \psi_t^* &= \phi_1\psi_t^* + \phi_2\psi_{t-1}^* + k_t^* && k_t^* \sim WN\left(0, \sigma_{k*}^2\right). \end{aligned}$$

The hysteresis parameter $(1+\theta)$ represents the portion of the cycle integrated into the trend. Where $\theta = -1$ we return to the classic model with orthogonal components. Using the 1970-2001 sample Proietti finds a value for θ of -0.37 for Italy, i.e. a hysteresis effect of 0.63.

We therefore applied the Proietti model (2002), extending the sample to 2015. The previous results are essentially confirmed. The estimation of model (1) with correlated errors shows a correlation between the cycle and the trend in the Italian GDP series of -0.98 and is statistically significant.[16] The ratio ${\sigma_\eta}^2/{\sigma_\kappa}^2$ is also greater than one. In parallel, the estimation of the parameter θ becomes -0.32, i.e. hysteresis $(1+\theta)$ of 0.68, indicating an increase compared with the value obtained for the 1970-2001 period.

Finally, performing a recursive estimation [17] of model (2) on the quarterly GDP series for Italy for the 1980-2015 period, we can observe that the hysteresis parameter undergoes fluctuations over time, tending to increase during the deepest recessionary phases (Figure A1.2.1).[18] Thus, for example, if at the start of the recession in the early 1990s, the estimation of the hysteresis parameter was equal to 0.3, in 1994 at the end of the recession it reached 0.5. A considerable increase in hysteresis is also observed with the recession of 2008, followed by, in the most recent period, relative stabilization around an estimation of about 0.7.

In conclusion, this signals the importance of assuming a correlation between the cycle and the trend for the Italian economy and the connected phenomenon of hysteresis. This is a development that must be taken into account in designing short- and long-term economic policies.

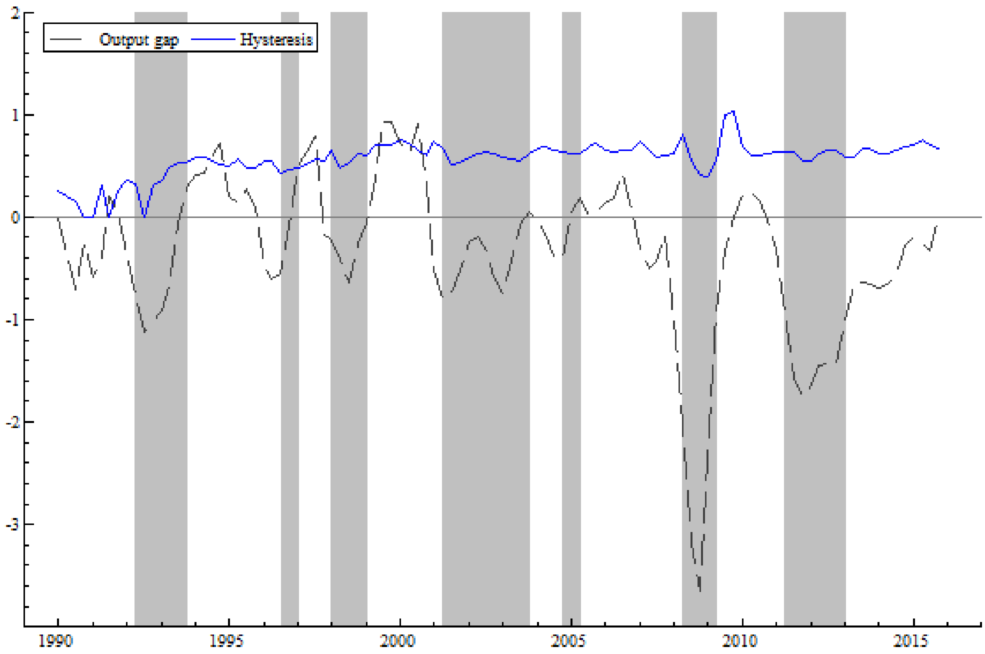
[15] Jaeger, A., Parkinson M (1994), "*Some Evidence on Hysteresis in Unemployment Rates*", *European Economic Review* 02/1994.

[16] The likelihood ratio test of the assumption of zero correlation of errors is rejected at 95 per cent (*p-value*=0.0006).

[17] Or leaving the initial point of the sample fixed and each time adding an observation until we arrive at the current period.

[18] In the graph, the ISCO/ISAE/Istat cycle dating bands inserted as reference are available at http://www.istat.it/it/files/2012/05/Rapporto-annuale-2012.pdf.

Figure A1.2.1 – Recursive estimation of the hysteresis (1+ θ) of Italian GDP and the output gap



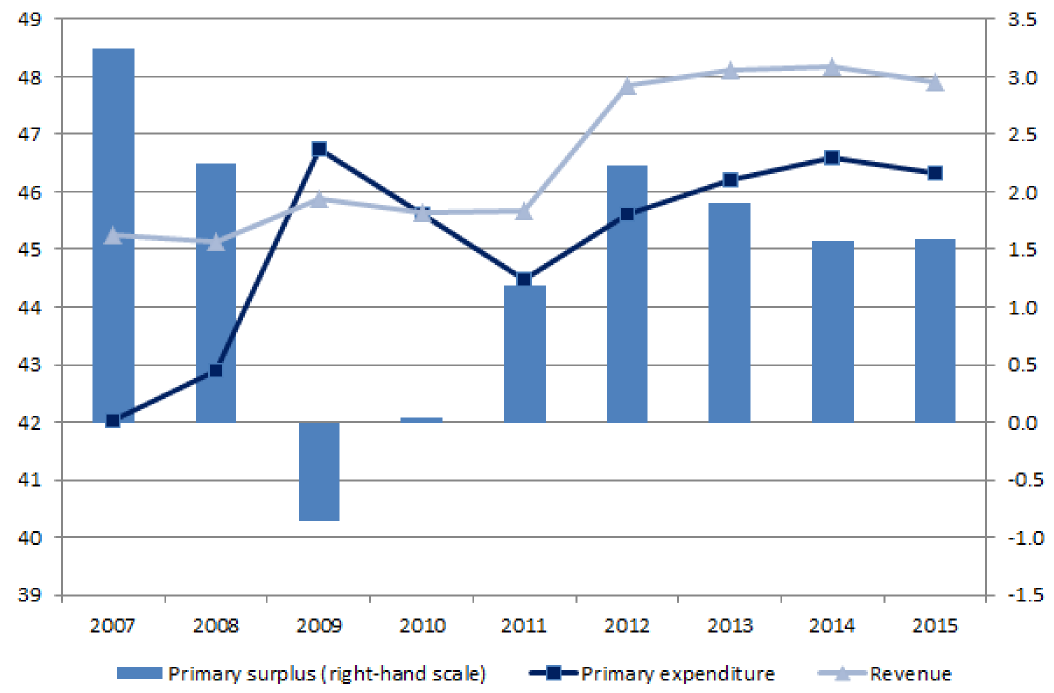
Source: Based on Istat and PBO data.

2. THE PUBLIC FINANCES

2.1 *The outturn for 2015*

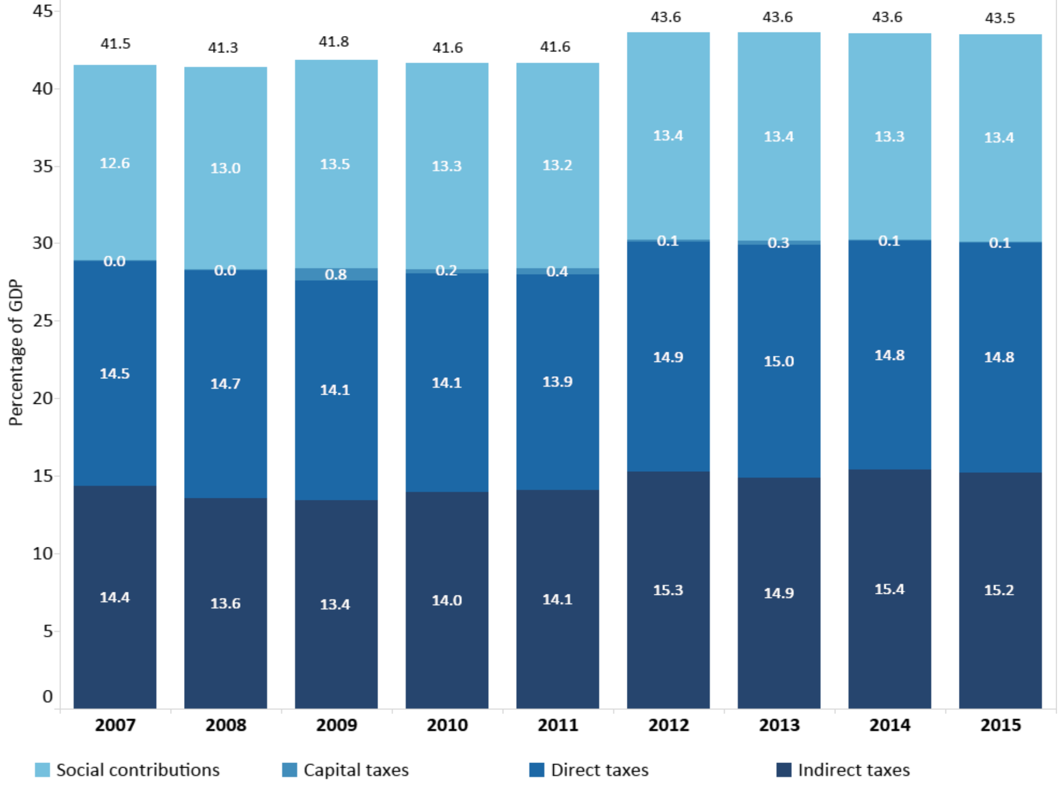
In 2015 the public finances improved thanks to favourable developments in interest expenditure. Net general government borrowing declined in absolute terms (from €48.9 billion to €42.4 billion) and as a percentage of GDP (from 3.0 to 2.6 per cent; Table 2.1a) as a result of the decline in debt service from 4.6 to 4.2 per cent of GDP. The latter reflected record-low yields on government securities, with placements at the end of October 2015 being issued at negative interest rates. The primary surplus remained stable at 1.6 per cent, reflecting identical declines of 0.3 per cent of GDP in primary expenditure (to 46.3 per cent) and overall revenue (to 47.9 per cent) (Figure 2.1). The fiscal burden edged downwards by one-tenth of a point of GDP to 43.5 per cent, reflecting developments in indirect taxes (Figure 2.2). The composition of primary expenditure changed as a proportion of GDP, with a decline in current outlays and an increase in spending on capital account. More specifically, primary current expenditure, which was virtually unchanged on 2014 in absolute terms, decreased as a proportion of GDP from 42.9 to 42.2 per cent, attributable to a decline in compensation of employees and other minor items, while outlays on capital account accelerated, especially those other than investment, with a consequent increase in their size in terms of GDP from 3.7 to 4.1 per cent (Figure 2.3).

Figure 2.1 – Primary surplus, general government primary revenue and expenditure – 2007-2015
(percentage of GDP)



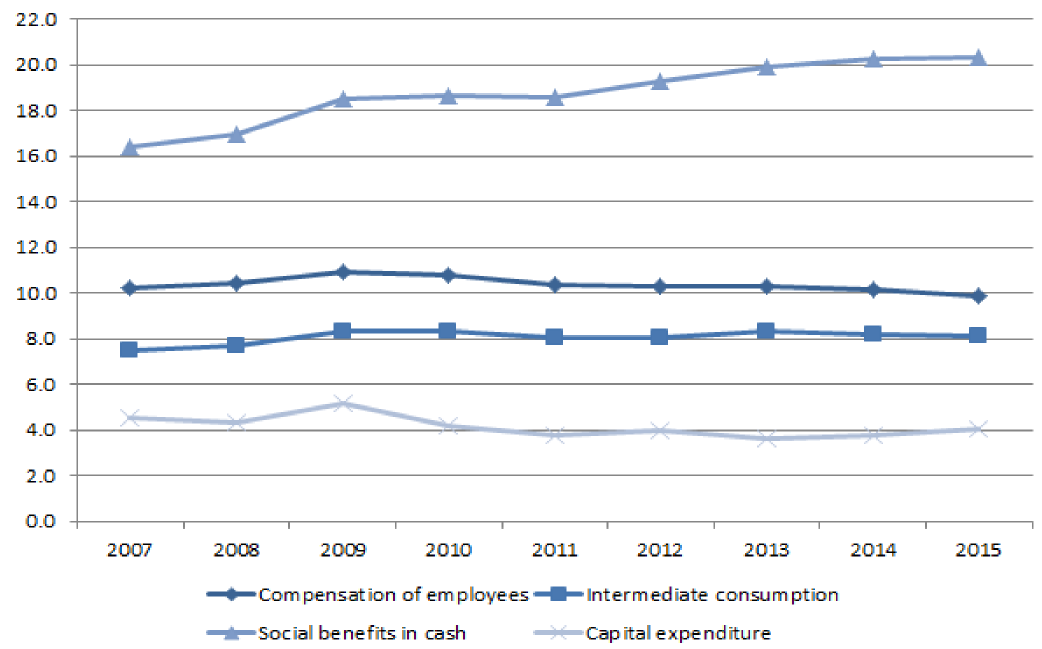
Source: Istat.

Figure 2.2 – Fiscal burden and its components – 2007-2015
(percentage of GDP)



Source: Istat.

Figure 2.3 – Main components of general government expenditure –2007-2015
(percentage of GDP)



Source: Istat.

The performance for 2015 reflected the revision, announced in early April on the occasion of the publication of data for the general government accounts for the fourth quarter, prompted by the impact of the operations connected with the resolution of crises at four banks,[19] which transferred resources (of which about €2.3 billion accounted for under indirect taxes from the Italian banking system to the National Resolution Fund (NRF) and from the latter to the banks under special administration to cover their losses (of which about €1.7 billion recorded under other capital expenditure). The impact of those transactions therefore improved net borrowing by about €600 million.

Compared with 2014, current expenditure declined by 0.7 per cent, thanks to the contraction in interest expenditure (-7.9 per cent), which fell for the third year in a row, and the stability of primary current expenditure noted earlier (+0.05 per cent). Compensation of employees contracted for the fifth consecutive year (-1.1 per cent) owning to a decline in employment (decreasing since 2007) – which involved all subsectors, especially local government and local health authorities – and the continuation of freezes on hiring and promotions. One factor was the freeze on hiring in segments impacted by the absorption of excess personnel from provincial governments. In addition. The impact of the "Good Education" (*Buona scuola*) plan was also smaller than expected, with fewer and slower hirings than planned. Intermediate consumption expanded slightly (+0.5 per cent), with a greater increase in social benefits in kind (+0.9 per cent), which reflected the increase in social assistance expenditure for foreigners. Intermediate consumption proper reflected the expansion of that aggregate by local health authorities – for which there was a delay in the agreement between the State and the Regions – during last summer. The increase in social benefits in cash (+1.9 per cent) reflected a moderate rise in expenditure for pensions and annuities, given the small increases in automatic pension adjustments and a larger rise in other benefits, reflecting in particular the full effects of the monthly €80 tax credit (the "bonus") for low-income employees, the refinancing of unemployment expenditure and an increase in termination benefits paid. A large contraction was registered in other current expenditure (-6.7 per cent), involving above all government grants for all sub-sectors, especially grants to generators of renewable energy, and expenditure for the EU budget. All components of capital expenditure (+10.7 per cent) increased: after five consecutive years of decline, both investments and investment grants began to expand again. The former rose moderately (+1.0 per cent), the net result of developments of the opposite sign in investment by central government departments (which declined) and local governments (which increased, partly in reflection of the lowering of the targets in the Internal Stability Pact of local authorities). By contrast, investment grants expanded more vigorously (+19.1 per cent), especially those to enterprises. Other capital transfers also increased sharply (+38.0 per cent). This is essentially attributable to two factors: the first was the one-off impact of pension arrears for 2012-2014 in respect of pension revaluations provided for in Decree Law 65/2015, which implemented the principles established in Constitutional Court ruling 70/2015 concerning the unconstitutionality of the freeze on pension adjustments introduced in 2011 for pensions greater than three times the minimum benefits. The second factor were the transfers to banks in special administration noted above.

[19] The Bank of Italy activated a procedure for the resolution of bank crises for a number of banks in extraordinary administration. The procedure involved the formation of four new corporations, with the adoption of their articles of association and the appointment of their officers by the Bank of Italy, with share capital subscribed by the National Resolution Fund (NRF). They are to operate as bridge banks to continue the essential operations previously carried out by the original banks with a view to their disposal. The NFR is an instrument of the Single Resolution Mechanism for banks, which is managed by the Resolution Committee and funded with contributions from banks in the European countries in order to finance resolution measures. Under European law, the Member States are required to provide bridge financing for the Fund if it does not have sufficient resources of its own.

Total revenue in 2015 (+1.0 per cent) reflected an increase in current revenue (+1.2 per cent) – in particular social contributions (+2.0 per cent) and indirect taxes (+1.9 per cent) – and a contraction in capital revenue (-24.6 per cent).

Indirect taxes, net of the NRF resources mentioned above, decreased, mainly owing to the contraction in IRAP (regional business tax), which was impacted by the measures concerning the full deduction of labour costs from taxable income, the decline in taxes on electricity, reflecting the reduction in system costs for renewables, the tax on natural gas, whose payment mechanism, which envisages an adjustment payment in March 2015, reflected actual consumption in 2014, which was considerably less than in 2013, and stamp duty. By contrast, revenue from VAT increased, thanks to the introduction of the split payment mechanism, as did those from taxes on gaming, which were also affected by budget measures, and taxes on tobacco products. The increase in direct taxes, which was attenuated by the elimination of the revenue from the tax on the revaluation of equity interests in the Bank of Italy, reflected the increase in personal income tax (IRPEF) and corporate income tax (IRES), partly due the dissipation of the effects of the temporary increase in payments on account in 2013, and in other taxes, which reflected changes in tax rates. The increase in social contributions reflected the rise in contributions paid by workers, especially the self-employed, as the increase in charges borne by employers was mitigated by the temporary social contribution relief for hiring on open-ended contracts. The contraction in capital revenue was essentially attributable to the reduction in the tax for the change in accounting standards (IAS) and investment grants from the rest of the world.

Compared with the Government estimates in the Technical Note to the 2016 Stability Act (Tables 2.1a, b and c), the outturn for 2015 met the forecast target of 2.6 per cent for net borrowing. The primary surplus was about one-tenth of a point of GDP lower than projected (1.6 instead of 1.7 per cent). Both total revenue and expenditure were lower than expected by the Government, at 47.9 and 50.5 per cent of GDP respectively, compared with forecasts of 48.2 and 50.8 per cent respectively. The composition of the budget items was different, however, also reflecting the effects of the revisions – which were not negligible in absolute terms – made by Istat to the general government accounts for 2014 at the time of the publication of the outturn for 2015 last March and April.[20]

Primary expenditure was lower than expected, owing to lower current primary outlays. Within the overall aggregate, outlays for compensation of employees and other minor expenditures contracted, more than offsetting the increase in intermediate consumption. The latter rose slightly, compared with official forecasts of a decrease, partly owing to the smaller-than-expected impact of the budget measures. Capital expenditure rose more rapidly than expected, especially outlays other than investments, which expanded by less than planned. Revenue was also lower than forecast, owing in particular to smaller direct tax revenue – due in part to the smaller-than-expected number of workers opting to receive an advance on termination benefits in their pay checks provided for in the 2015 Stability Act – and to lower capital revenue, reflecting among other things the recognition on a cash basis of voluntary disclosure revenue.

[20] For more information, please see Istat (2016), "*GDP and indebitamento netto AP – Anni 2013-2015*", 1 March, and Istat (2016), "*Conto economico trimestrale delle amministrazioni pubbliche – IV trimestre 2015*", 4 April.

2.2 The trend scenario

According to the EFD, net borrowing on a trend basis in 2016 is forecast to amount to 2.3 per cent of GDP, down 0.3 percentage points compared with 2015. The decline continues in the two subsequent years, going to 1.4 and 0.3 per cent, respectively, in 2017 and 2018; in 2019 the nominal budget balance is projected to show a surplus of 0.4 points of GDP (Tables 2.1a and 2.1b). This improvement is mainly driven by developments in the primary surplus, which will increase by just 0.1 percentage points of GDP in 2016 (from 1.6 to 1.7 per cent), but then rise at a rapid pace in the three subsequent years, reaching 3.9 per cent in 2009. These developments are the result of a reduction in expenditure net of interest spending, especially in current expenditure, over the entire forecasting period (from 46.3 per cent in 2015 to 43.2 per cent in 2019). The fiscal burden will have the opposite effect, declining from 43.5 per cent to 42.8 per cent between 2015 and 2016 and stabilizing in the following three years. At the same time, interest expenditure will continue to decline, falling by about two-tenths of a point of GDP each year until 2018 and by a further one-tenth of a point in 2019, going from 4.2 per cent in 2015 to 3.5 per cent at the end of the period (Table 2.2).

Compared with the public finance forecasts issued last autumn, the new projections reflect the outturn for the public finances in 2015, a generally less favourable macroeconomic environment and the financial effects of legislative measures approved through March 2016.

The forecast for net borrowing on a trend basis in 2016 was improved by 0.1 points, to 2.3 per cent. The projection had been revised upwards in the Technical Note from that set out in the September Update to the EFD (from 2.2 per cent to 2.4 per cent of GDP) to take account of measures for security and culture inserted with a Government amendment following the terrorist attacks in France. The improvement reported in the 2016 EFD reflected a reduction in outlays for interest on the public debt (from 4.3 per cent of GDP in November to 4.0 per cent), which offsets the deterioration in the trend primary surplus (from 2.0 to 1.7 per cent of GDP), reflecting a decrease of 0.4 points in revenue and one of 0.2 points in expenditure. The EFD notes that the forecast for the primary surplus in 2016 also reflects specific administrative measures that the Government had expected to implement during the year, including the actual spendibility of expenditure authorizations, the major administrative effort in revenue collection and the actions to expand real estate disposals moderately.

In the subsequent two years, the forecast for net borrowing is higher than the previous projection, by 0.3 points of GDP in 2017 and 0.1 points in 2018. In this case the larger expected decline in interest expenditure (about 0.3 points in each of the two years) does not offset the deterioration in the forecast for the trend primary surplus over the same period.

The ratio of revenue to GDP decreases both in 2016 and in 2017 (from 47.9 per cent in 2015 to 47.2 and 46.9 per cent respectively). This incorporates the effect of the measures adopted with the 2016 Stability Act and reflects both the deterioration registered in 2015 and the downward revision of the outlook for growth and developments in other exogenous variables (Table 2.1c).

The fiscal burden falls from 43.5 per cent in 2015 to 42.8 per cent in 2016. After a further decline of 0.1 points in 2017, it will stabilize at 42.9 per cent in the final two years of the forecasting period. The tax burden decreases by half a point of GDP in 2016, mainly due to the reduction in indirect taxes, primarily as a result of the measures in the Stability Acts for 2015 and 2016, including the full deductibility of labour costs from the IRAP tax base, the elimination of the municipal services tax (TASI) for primary residences and the partial exemption of agricultural land from municipal property tax. In the current year, net of capital taxes, the burden is distributed equally between direct and indirect taxes (14.7 points of GDP for both). As from 2017, the weight of indirect taxes starts rising again as a result of the effect of the safeguard clauses, which in the absence of compensatory measures will raise the reduced and ordinary VAT rates as from 2017 and excise taxes on mineral oils as from 2018 (€15.1 billion in 2017 and €19.6 billion in each of 2018 and 2019). At the same time, the gap with direct taxes increases owing to their gradual reduction, largely owing to tax relief for businesses and the reduction in the corporate income tax rate as from 2017.

In 2016 alone, capital taxes account for €4 billion in non-recurring revenue, of which €3.4 billion from the voluntary disclosure programme, without which the tax burden would have declined by a further 0.2 percentage points.

Social contributions decreased by 0.3 percentage points in relation to GDP in 2016 – owing to temporary contribution relief for hiring new employees on open-ended contracts, which ends in 2018 – but will return to their 2015 level in 2019.

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

	Technical Note					2016 EFD					
	2014 (10/2015)	2015	2016	2017	2018	2014 (04/2016)	2015 (04/2016)	2016	2017	2018	2019
Compensation of employees	163,814	164,868	166,453	165,822	165,561	163,622	0	163,942	162,692	162,321	162,656
Intermediate consumption	134,153	129,905	130,381	131,437	131,618	132,348	0	131,730	132,989	132,997	136,733
Social benefits in cash	328,304	335,500	342,779	349,846	358,448	326,863	0	339,960	345,280	353,780	361,960
Pensions	*256,902*	*258,950*	*261,954*	*267,866*	*275,137*	*256,645*	*258,804*	*261,650*	*264,920*	*272,230*	*279,370*
Other social benefits	*71,402*	*76,550*	*80,826*	*81,980*	*83,311*	*70,218*	*74,181*	*78,310*	*80,360*	*81,550*	*82,590*
Other current expenditure	66,922	66,916	66,763	63,426	62,826	68,071	0	65,795	63,588	63,228	63,987
TOTAL CURRENT PRIMARY EXPENDITURE	**693,193**	**697,189**	**706,376**	**710,531**	**718,453**	**690,904**	**0**	**701,427**	**704,549**	**712,326**	**725,336**
Interest expenditure	75,043	70,031	71,364	71,186	71,918	74,340	68,440	66,911	65,186	64,075	64,002
TOTAL CURRENT EXPENDITURE	**768,236**	**767,219**	**777,740**	**781,717**	**790,371**	**765,244**	**68,440**	**768,338**	**769,735**	**776,401**	**789,338**
Gross fixed capital formation	35,678	37,473	38,339	38,793	38,508	36,871	0	38,014	38,633	39,780	40,622
Investment grants	12,936	15,114	14,390	11,946	12,532	13,170	15,684	14,458	14,226	14,668	14,334
Other capital expenditure	9,776	11,712	9,594	6,887	6,672	10,249	13,805	7,903	7,468	6,926	4,618
TOTAL CAPITAL EXPENDITURE	**58,390**	**64,299**	**62,323**	**57,626**	**57,712**	**60,290**	**29,489**	**60,375**	**60,327**	**61,374**	**59,574**
TOTAL PRIMARY EXPENDITURE	**751,583**	**761,487**	**768,699**	**768,157**	**776,165**	**751,194**	**29,489**	**761,802**	**764,876**	**773,700**	**784,910**
TOTAL EXPENDITURE	**826,626**	**831,517**	**840,063**	**839,343**	**848,083**	**825,534**	**97,929**	**828,713**	**830,062**	**837,775**	**848,912**
Total tax revenue	486,567	496,553	503,969	522,098	536,470	487,719	492,754	495,196	510,241	525,259	537,714
Direct taxes	237,567	*248,986*	*254,285*	*252,985*	*256,963*	*237,931*	*242,356*	*245,699*	*244,778*	*248,480*	*254,221*
Indirect taxes	247,419	*245,588*	*246,616*	*268,157*	*278,543*	*248,207*	*249,324*	*245,333*	*264,691*	*275,999*	*282,704*
Capital taxes	1,581	*1,979*	*3,068*	*956*	*964*	*1,581*	*1,074*	*4,164*	*772*	*780*	*789*
Social contributions	216,404	217,901	220,724	224,482	232,873	214,340	218,535	219,456	222,319	231,726	241,703
Actual social contributions	*212,383*	*213,793*	*216,554*	*220,248*	*228,578*	*210,392*	*214,660*	*215,501*	*218,315*	*227,659*	*237,565*
Imputed social contributions	*4,021*	*4,108*	*4,170*	*4,234*	*4,295*	*3,948*	*3,875*	*3,955*	*4,004*	*4,067*	*4,138*
Other current revenue	69,173	69,063	69,224	69,776	71,168	0	0	69,832	68,772	70,195	71,582
TOTAL CURRENT REVENUE	**770,563**	**781,538**	**790,850**	**815,401**	**839,547**	**700,478**	**710,215**	**780,320**	**800,560**	**826,400**	**850,210**
OTHER CAPITAL REVENUE	**5,444**	**5,181**	**5,460**	**4,459**	**4,375**	**0**	**0**	**4,947**	**4,145**	**4,761**	**4,782**
TOTAL REVENUE	**777,588**	**788,698**	**799,378**	**820,816**	**844,886**	**702,059**	**711,289**	**789,431**	**805,477**	**831,941**	**855,781**
Tax burden	*43.6*	*43.7*	*43.2*	*43.0*	*42.9*	*43.6*	*43.5*	*42.8*	*42.7*	*42.9*	*42.9*
NET PRIMARY BORROWING (-) / LENDING (+)	**26,005**	**27,211**	**30,679**	**52,659**	**68,722**	**25,404**	**681,800**	**27,629**	**40,601**	**58,241**	**70,871**
% of GDP	1.6	1.7	1.8	3.0	3.8	1.6	41.7	1.7	2.4	3.3	3.9
NET BORROWING (-) / LENDING (+)	**-49,038**	**-42,819**	**-40,685**	**-18,527**	**-3,196**	**-48,936**	**-42,388**	**-39,282**	**-24,585**	**-5,834**	**6,869**
% of GDP	-3.0	-2.6	-2.4	-1.1	-0.2	-3.0	-2.6	-2.3	-1.4	-0.3	0.4
Nominal GDP	*1,613,859*	*1,635,384*	*1,678,566*	*1,734,508*	*1,792,769*	*1,611,884*	*1,636,372*	*1,671,584*	*1,715,832*	*1,764,755*	*1,818,439*

Source: PBO based on data in the Technical Note attached to the 2016 Stability Act, Table 3.2-5; 2016 Economic and Financial Document, Table II.2-1.

Table 2.1b – General government consolidated accounts: a comparison of trend forecasts
(percentage of GDP)

	Technical Note					2016 EFD					
	2014 (10/2015)	2015	2016	2017	2018	2014 (04/2016)	2015 (04/2016)	2016	2017	2018	2019
Compensation of employees	10.2	10.1	9.9	9.6	9.2	10.2	9.9	9.8	9.5	9.2	8.9
Intermediate consumption	8.3	7.9	7.8	7.6	7.3	8.2	8.1	7.9	7.8	7.5	7.5
Social benefits in cash	20.3	20.5	20.4	20.2	20.0	20.3	20.3	20.3	20.1	20.0	19.9
Pensions	*15.9*	*15.8*	*15.6*	*15.4*	*15.3*	*15.9*	*15.8*	*15.7*	*15.4*	*15.4*	*15.4*
Other social benefits	*4.4*	*4.7*	*4.8*	*4.7*	*4.6*	*4.4*	*4.5*	*4.7*	*4.7*	*4.6*	*4.5*
Other current expenditure	4.1	4.1	4.0	3.7	3.5	4.2	3.9	3.9	3.7	3.6	3.5
TOTAL CURRENT PRIMARY EXPENDITURE	**43.0**	**42.6**	**42.1**	**41.0**	**40.1**	**42.9**	**42.2**	**42.0**	**41.1**	**40.4**	**39.9**
Interest expenditure	4.6	4.3	4.3	4.1	4.0	4.6	4.2	4.0	3.8	3.6	3.5
TOTAL CURRENT EXPENDITURE	**47.6**	**46.9**	**46.3**	**45.1**	**44.1**	**47.5**	**46.4**	**46.0**	**44.9**	**44.0**	**43.4**
Gross fixed capital formation	2.2	2.3	2.3	2.2	2.1	2.3	2.3	2.3	2.3	2.3	2.2
Investment grants	0.8	0.9	0.9	0.7	0.7	0.8	1.0	0.9	0.8	0.8	0.8
Other capital expenditure	0.6	0.7	0.6	0.4	0.4	0.6	0.8	0.5	0.4	0.4	0.3
TOTAL CAPITAL EXPENDITURE	**3.6**	**3.9**	**3.7**	**3.3**	**3.2**	**3.7**	**4.1**	**3.6**	**3.5**	**3.5**	**3.3**
TOTAL PRIMARY EXPENDITURE	**46.6**	**46.6**	**45.8**	**44.3**	**43.3**	**46.6**	**46.3**	**45.6**	**44.6**	**43.8**	**43.2**
TOTAL EXPENDITURE	**51.2**	**50.8**	**50.0**	**48.4**	**47.3**	**51.2**	**50.5**	**49.6**	**48.4**	**47.5**	**46.7**
Total tax revenue	30.1	30.4	30.0	30.1	29.9	30.3	30.1	29.6	29.7	29.8	29.6
Direct taxes	*14.7*	*15.2*	*15.1*	*14.6*	*14.3*	*14.8*	*14.8*	*14.7*	*14.3*	*14.1*	*14.0*
Indirect taxes	*15.3*	*15.0*	*14.7*	*15.5*	*15.5*	*15.4*	*15.2*	*14.7*	*15.4*	*15.6*	*15.5*
Capital taxes	*0.1*	*0.1*	*0.2*	*0.1*	*0.1*	*0.1*	*0.1*	*0.2*	*0.0*	*0.0*	*0.0*
Social contributions	13.4	13.3	13.1	12.9	13.0	13.3	13.4	13.1	13.0	13.1	13.3
Actual social contributions	*13.2*	*13.1*	*12.9*	*12.7*	*12.7*	*13.1*	*13.1*	*12.9*	*12.7*	*12.9*	*13.1*
Imputed social contributions	*0.2*	*0.3*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*
Other current revenue	4.3	4.2	4.1	4.0	4.0	4.3	4.2	4.2	4.0	4.0	3.9
TOTAL CURRENT REVENUE	**47.7**	**47.8**	**47.1**	**47.0**	**46.8**	**47.7**	**47.6**	**46.7**	**46.7**	**46.8**	**46.8**
OTHER CAPITAL REVENUE	**0.3**	**0.3**	**0.3**	**0.3**	**0.2**	**0.3**	**0.3**	**0.3**	**0.2**	**0.3**	**0.3**
TOTAL REVENUE	**48.2**	**48.2**	**47.6**	**47.3**	**47.1**	**48.2**	**47.9**	**47.2**	**46.9**	**47.1**	**47.1**
NET PRIMARY BORROWING (-) / LENDING (+)	**1.6**	**1.7**	**1.8**	**3.0**	**3.8**	**1.6**	**1.6**	**1.7**	**2.4**	**3.3**	**3.9**
NET BORROWING (-) / LENDING (+)	**-3.0**	**-2.6**	**-2.4**	**-1.1**	**-0.2**	**-3.0**	**-2.6**	**-2.3**	**-1.4**	**-0.3**	**0.4**
Nominal GDP	*1,613,859*	*1,635,384*	*1,678,566*	*1,734,508*	*1,792,769*	*1,611,884*	*1,636,372*	*1,671,584*	*1,715,832*	*1,764,755*	*1,818,439*

Source: PBO based on data in the Technical Note attached to the 2016 Stability Act, Table 3.2-5; 2016 Economic and Financial Document, Table II.2-1.

Table 2.1c – General government consolidated accounts: a comparison of trend forecasts
(rates of changes)

	Technical Note				2016 EFD				
	2015	2016	2017	2018	2015	2016	2017	2018	2019
Compensation of employees	0.6	1.0	-0.4	-0.2	-1.1	1.4	-0.8	-0.2	0.2
Intermediate consumption	-3.2	0.4	0.8	0.1	0.5	-1.0	1.0	0.0	2.8
Social benefits in cash	2.2	2.2	2.1	2.5	1.9	2.1	1.6	2.5	2.3
Pensions	*0.8*	*1.2*	*2.3*	*2.7*	*0.8*	*1.1*	*1.2*	*2.8*	*2.6*
Other social benefits	*7.2*	*5.6*	*1.4*	*1.6*	*5.6*	*5.6*	*2.6*	*1.5*	*1.3*
Other current expenditure	0.0	-0.2	-5.0	-0.9	-6.7	3.6	-3.4	-0.6	1.2
TOTAL CURRENT PRIMARY EXPENDITURE	**0.6**	**1.3**	**0.6**	**1.1**	**0.0**	**1.5**	**0.4**	**1.1**	**1.8**
Interest expenditure	-6.7	1.9	-0.2	1.0	-7.9	-2.2	-2.6	-1.7	-0.1
TOTAL CURRENT EXPENDITURE	**-0.1**	**1.4**	**0.5**	**1.1**	**-0.7**	**1.1**	**0.2**	**0.9**	**1.7**
Gross fixed capital formation	5.0	2.3	1.2	-0.7	1.0	2.0	1.6	3.0	2.1
Investment grants	16.8	-4.8	-17.0	4.9	19.1	-7.8	-1.6	3.1	-2.3
Other capital expenditure	19.8	-18.1	-28.2	-3.1	34.7	-42.8	-5.5	-7.3	-33.3
TOTAL CAPITAL EXPENDITURE	**10.1**	**-3.1**	**-7.5**	**0.1**	**10.7**	**-9.5**	**-0.1**	**1.7**	**-2.9**
TOTAL PRIMARY EXPENDITURE	**1.3**	**0.9**	**-0.1**	**1.0**	**0.9**	**0.5**	**0.4**	**1.2**	**1.4**
TOTAL EXPENDITURE	**0.6**	**1.0**	**-0.1**	**1.0**	**0.1**	**0.3**	**0.2**	**0.9**	**1.3**
Total tax revenue	2.1	1.5	3.6	2.8	1.0	0.5	3.0	2.9	2.4
Direct taxes	*4.8*	*2.1*	*-0.5*	*1.6*	*1.9*	*1.4*	*-0.4*	*1.5*	*2.3*
Indirect taxes	*-0.7*	*0.4*	*8.7*	*3.9*	*0.5*	*-1.6*	*7.9*	*4.3*	*2.4*
Capital taxes	*25.2*	*55.0*	*-68.8*	*0.8*	*-32.1*	*287.7*	*-81.5*	*1.0*	*1.2*
Social contributions	0.7	1.3	1.7	3.7	2.0	0.4	1.3	4.2	4.3
Actual social contributions	*0.7*	*1.3*	*1.7*	*3.8*	*2.0*	*0.4*	*1.3*	*4.3*	*4.4*
Imputed social contributions	*2.2*	*1.5*	*1.5*	*1.4*	*-1.8*	*2.1*	*1.2*	*1.6*	*1.7*
Other current revenue	-0.2	0.2	0.8	2.0	-0.8	2.0	-1.5	2.1	2.0
TOTAL CURRENT REVENUE	**1.4**	**1.2**	**3.1**	**3.0**	**1.2**	**0.2**	**2.6**	**3.2**	**2.9**
OTHER CAPITAL REVENUE	**-4.8**	**5.4**	**-18.3**	**-1.9**	**-22.4**	**15.6**	**-16.2**	**14.9**	**0.4**
TOTAL REVENUE	**1.4**	**1.4**	**2.7**	**2.9**	**1.0**	**0.7**	**2.0**	**3.3**	**2.9**

Source: PBO based on data in the Technical Note attached to the 2016 Stability Act, Table 3.2-5; 2016 Economic and Financial Document, Table II.2-1.

Table 2.2 – General government consolidated accounts
(millions of euros)

	2014 actual				Difference between 2014 actuals		2015 actual Apr. 2016		Comparison 2015-2014	
	Oct. 2015	% of GDP	Apr. 2016	% 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	163,814	10.2	163,622	10.2	-192	0.0	161,746	9.9	-1.1	-0.3
Purchases of goods and services from market producers	43,740	2.7	43,784	2.7	44	0.0	44,194	2.7	0.9	0.0
Intermediate consumption	90,413	5.6	88,564	5.5	-1,849	-0.1	88,831	5.4	0.3	-0.1
Social benefits in cash	328,304	20.3	326,863	20.3	-1,441	-0.1	332,985	20.3	1.9	0.1
Other current expenditure	66,922	4.1	68,071	4.2	1,149	0.1	63,488	3.9	-6.7	-0.3
TOTAL CURRENT PRIMARY EXPENDITURE	**693,193**	**43.0**	**690,904**	**42.9**	**-2,289**	**-0.1**	**691,244**	**42.2**	**0.0**	**-0.6**
Interest expenditure	75,043	4.6	74,340	4.6	-703	0.0	68,440	4.2	-7.9	-0.4
TOTAL CURRENT EXPENDITURE	**768,236**	**47.6**	**765,244**	**47.5**	**-2,992**	**-0.1**	**759,684**	**46.4**	**-0.7**	**-1.1**
Gross fixed capital formation	35,666	2.2	36,871	2.3	1,205	0.1	37,256	2.3	1.0	0.0
Other capital expenditure	22,724	1.4	23,419	1.5	695	0.0	29,489	1.8	25.9	0.3
TOTAL CAPITAL EXPENDITURE	**58,390**	**3.6**	**60,290**	**3.7**	**1,900**	**0.1**	**66,745**	**4.1**	**10.7**	**0.3**
TOTAL PRIMARY EXPENDITURE	**751,583**	**46.6**	**751,194**	**46.6**	**-389**	**0.0**	**757,989**	**46.3**	**0.9**	**-0.3**
TOTAL EXPENDITURE	**826,626**	**51.2**	**825,534**	**51.2**	**-1,092**	**0.0**	**826,429**	**50.5**	**0.1**	**-0.7**
										0.0
Direct taxes	237,567	14.7	237,931	14.8	364	0.0	242,356	14.8	1.9	0.0
Indirect taxes	247,419	15.3	248,207	15.4	788	0.1	249,324	15.2	0.5	-0.2
Social contributions	216,404	13.4	214,340	13.3	-2,064	-0.1	218,535	13.4	2.0	0.1
Actual social contributions	*212,383*	*13.2*	*210,392*	*13.1*	*-1,991*	*-0.1*	*214,660*	*13.1*	*2.0*	*0.1*
Imputed social contributions	*4,021*	*0.2*	*3,948*	*0.2*	*-73*	*0.0*	*3,875*	*0.2*	*-1.8*	*0.0*
Other current revenue	69,173	4.3	69,020	4.3	-153	0.0	68,471	4.2	-0.8	-0.1
TOTAL CURRENT REVENUE	**770,563**	**47.7**	**769,498**	**47.7**	**-1,065**	**0.0**	**778,686**	**47.6**	**1.2**	**-0.2**
Capital taxes	1,581	0.1	1,581	0.1	0	0.0	1,074	0.1	-32.1	0.0
Other capital revenue	5,444	0.3	5,519	0.3	75	0.0	4,281	0.3	-22.4	-0.1
TOTAL CAPITAL REVENUE	**7,025**	**0.4**	**7,100**	**0.4**	**75**	**0.0**	**5,355**	**0.3**	**-24.6**	**-0.1**
TOTAL REVENUE	**777,588**	**48.2**	**776,598**	**48.2**	**-990**	**0.0**	**784,041**	**47.9**	**1.0**	**-0.3**
NET PRIMARY BORROWING (-) / LENDING (+)	**26,005**	**1.6**	**25,404**	**1.6**	**-601**	**0.0**	**26,052**	**1.6**		**0.0**
NET BORROWING (-) / LENDING (+)	**-49,038**	**-3.0**	**-48,936**	**-3.0**	**102**	**0.0**	**-42,388**	**-2.6**		**0.4**
Nominal GDP	*1,613,859*		*1,611,884*		*-1,975*		*1,636,372*			

Source: Istat, *Conti and aggregati economici delle AP*, October 2015 and *Conto economico trimestrale delle AP*, April 2016.

Primary expenditure amounted to 46.3 per cent of GDP in 2015 (0.3 percentage points lower than the forecast in the Technical Note) and is expected to decline by almost 3 percentage points over the forecasting period, reaching 43.2 per cent in 2019.

All major components of current expenditure decrease in relation to GDP. The trend forecast confirms the downward trend in expenditure on compensation of employees in the current and subsequent years, which go from 9.9 per cent in 2015 to 8.9 per cent in 2019, despite the spending effects of the establishment of the "Good Education Fund", the resources appropriated for the 2016-18 contract renewal and the inclusion in 2019 of the new interim wage adjustment in the absence of contract renewal for 2019-2021. In 2017-2019, the reduction in employment is associated with the tightening of restrictions on turnover provided for in the last Stability Act. The forecasts on an unchanged policies basis reflect the technical assumption of the renewal of public employment contracts for 2019-2021, which would mean an increase in compensation of employees in 2019 of €600 million and an increase of €290 million in revenue from contributions, withholdings and other amounts charged to employers. Actual expenditure on intermediate consumption was higher than that envisaged in the most recent previous forecasts (0.2 percentage points of GDP), but their downward trend is confirmed, falling from 8.1 per cent in 2015 to 7.5 per cent in 2019 as a result of the spending restrictions. Social benefits in cash decline from 20.3 per cent in 2015 to 19.9 per cent in 2019 as a result of past reform measures. Spending on pensions falls by 0.4 percentage points of GDP in 2016 and in 2017 (to 15.4 per cent) before levelling off until 2019.

Overall, capital expenditure continues to decrease as percentage of GDP, but fixed capital formation is expected to revive with an acceleration associated with the activation of the investment clause: investment is expected to grow by 2 per cent in 2016, 1.6 per cent in 2017, 3 per cent in 2018 and 2.1 per cent in 2019.

2.3 The policy scenario

In view of the deterioration in the trend scenario for the public finances due to the downwards revision of growth projections for 2016-2018, and taking account of the continuing repercussions of a such a deep and protracted recession, the Government has planned a more gradual adjustment towards the medium-term objective (MTO) than that set out in last October's Draft Budgetary Plan (DBP). In the EFD, structural balance, and thus achievement of the MTO, is no longer reached in 2018, while a balance of -0.2 per cent of GDP is planned for 2019 (Table 2.3).

The EFD expresses the Government's intention to sterilise the safeguard clauses as restructured in the most recent Stability Act concerning VAT increases (as from 2017) and excise taxes (as from 2018), and to take corrective action that only partly offsets their effects.

Net borrowing, after having declined to 2.6 per cent of GDP in 2015 from the previous 3 per cent, is planned to continue decreasing, reaching 2.3 per cent in 2016, 1.8 per cent 2017 and 0.9 per cent in 2018, before becoming a small surplus, equal to 0.1 per cent, in 2019. Compared with the DBP, in the EFD a deficit of that size in 2016 is followed by policy deficits in 2017 and 2018 that are 0.7 per cent of GDP larger, while in 2019 the expected nominal surplus is 0.2 percentage points smaller than previously forecast.

The path of adjustment of the public accounts, given the update of the trend scenario and the new targets, reflects the adoption of measures that cause net borrowing to increase by 0.4 per cent of GDP in 2017, 0.6 per cent in 2018 and 0.3 per cent in 2019. The increase in the deficit is the result of the deactivation of the tax increases provided for in the safeguard clauses, by 0.9 points of GDP in 2017 and 1.1 points in each of the subsequent years, and of the concomitant implementation of corrective measures amounting to 0.5 per cent of GDP in each of 2017 and 2018 and 0.8 per cent in 2019 (Table 2.3).

With the policy developments in net borrowing, the structural balance, which remains negative throughout the forecasting period, deteriorates with respect to the projections in the DBP, while in 2016 and 2017, the adjustments towards the MTO are also worse.

In the EFD, the structural deficit increases in 2016 to 1.2 per cent of GDP from 0.6 per cent the previous year, before narrowing moderately in the two subsequent years (to 1.1 and 0.8 per cent respectively) and then more substantially at the end of the period, reaching 0.2 per cent of GDP.

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

	2015	2016	2017	2018	2019
Trend net borrowing (a)	**-2.6**	**-2.3**	**-1.4**	**-0.3**	**0.4**
Change (+ = improvement)		0.3	0.9	1.1	0.7
of which: *Revenue*		*-0.7*	*-0.3*	*0.2*	*0.0*
Interest		*0.2*	*0.2*	*0.2*	*0.1*
Primary expenditure		*0.8*	*1.0*	*0.7*	*0.7*
Trend structural net borrowing	-0.6	-1.3	-0.8	-0.1	0.1
Change (+ = improvement)	0.2	-0.7	0.5	0.7	0.2
Policy net borrowing (b)	**-2.6**	**-2.3**	**-1.8**	**-0.9**	**0.1**
Change (+ = improvement)		0.3	0.5	0.9	1.0
Policy structural net borrowing	**-0.6**	**-1.2**	**-1.1**	**-0.8**	**-0.2**
Change (+ = improvement)	0.2	-0.7	0.1	0.3	0.6
Measures (c = b - a) (2)		**0.0**	**-0.4**	**-0.6**	**-0.3**
Disactivation of safeguard clauses in the 2014 and 2015 Stability Acts			*-0.9*	*-1.1*	*-1.1*
Interventi correttivi netti			*0.5*	*0.5*	*0.8*
Memorandum item:					
Safeguard clause 2016 Stability Act (3)			15,133	19,571	19,571

Source: UPB based on the 2016 EFD.
(1) Totals may not match due to rounding of decimals. – (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 clauses in the 2016 Stability Act envisage increases in VAT rates in 2017 from 10 to 13 per cent (€6,957 billion) and from 22 to 24 per cent (€8,176 billion), which together produce the increase of €15,133 billion shown in the table, and in 2018 from 24 to 25 per cent (€4,088 billion, which together with the €15,133 for 2017 bring the total increase to €19,221 billion). These measures are accompanied increases in excise taxes generating €0.35 billion as from 2018 (which together with the €19,221 billion give a total increase €19,571 billion, which remains at that level in 2019 as well).

This behaviour reflects that of the components of the structural balance (Table 2.4):

- a structural primary surplus that deteriorates sharply in 2016, the consequence of the flexibility allowed for structural reforms and investment, and marginally in 2017, before gradually improving over the next two years;
- a constant improvement in interest expenditure over the entire forecasting period.

The nominal balance improves more substantially, primarily reflecting the gradual decrease in the negative cyclical component (which turns positive in 2019) and the positive impact of the one-off measures in 2016.[21]

More specifically:

- for 2016 the deterioration of 0.7 points in the structural balance is attributable to a decrease of about 0.8 points in the structural primary surplus (due to application of the flexibility clauses), partly offset by a reduction of about 0.2 points in interest expenditure.[22] The nominal balance does not reflect the developments in the structural balance, improving in 2016 by 0.3 points compared with the previous year. This is the result of a reduction of about 0.7 points in the cyclical component of the deficit and a positive impact of the one-off measures of 0.2 points (those measures increase the nominal deficit by 0.1 points of GDP in 2015 and decrease it by 0.1 points in 2016);

Table 2.4 – Components of the policy budget balance (1)
(percentage of GDP; + sign = improvement in balance)

	2015	2016	2017	2018	2019
Structural primary surplus (a)	**3.6**	**2.8**	**2.7**	**2.8**	**3.3**
Change (a')	*-0.2*	*-0.8*	*-0.1*	*0.1*	*0.5*
Interest (b)	**-4.2**	**-4.0**	**-3.8**	**-3.6**	**-3.5**
Change (b')	*0.4*	*0.2*	*0.2*	*0.2*	*0.1*
Structural budget balance (c=a+b)	**-0.6**	**-1.2**	**-1.1**	**-0.8**	**-0.2**
Change (c'=a'+b')	*0.2*	*-0.7*	*0.1*	*0.3*	*0.6*
Cyclical component of budget balance(d)	**-1.9**	**-1.2**	**-0.6**	**-0.1**	**0.4**
Change (d')	*0.5*	*0.7*	*0.6*	*0.5*	*0.5*
One-off measures (e)	**-0.1**	**0.1**	**0.0**	**0.0**	**0.0**
Change (e')	*-0.3*	*0.2*	*-0.1*	*0.0*	*0.0*
Overall balance (f=c+d+e)	**-2.6**	**-2.3**	**-1.8**	**-0.9**	**0.1**
Change (f'=c'+d'+e')	*0.4*	*0.3*	*0.5*	*0.9*	*1.0*

Source: UPB based on the 2016 EFD.
(1) Totals may not match due to rounding of decimals.

[21] Largely attributable to the revenue from the voluntary disclosure programme. The profile of the one-off measures has changed slightly from that considered in the DBP as a result of the exclusion and inclusion of a number of components and of the adjustment of estimates for certain items already envisaged last October. More specifically, expenditure reflects the exclusion of that for the migration emergency, the inclusion of arrears to be paid to the EU and the restructuring of expenditure for natural disasters. Revenue is affected by changes in the timing of the recognition of voluntary disclosure revenue and the upwards revision of proceeds from disposals.
[22] The differences are due to rounding of decimals.

- for 2017 the improvement of 0.1 points in the structural balance is the result of the decrease of 0.2 points in interest expenditure, which offsets the decline of 0.1 points in the structural primary surplus. While the structural balance only improves slightly, the nominal deficit decreases more substantially, with a contraction of 0.5 points compared with the previous year. This is the result of a further decline of 0.6 points in the cyclical component of the deficit, partially offset by the disappearance in 2017 of the positive effects of the one-off measures;
- in 2018-2019, the structural balance improves (by 0.3 and 0.6 points respectively), coming close to balance in 2019 (-0.2 points). These developments reflect the increase in the structural primary surplus (of 0.1 and 0.5 points) and the continuing decline in interest expenditure (of 0.2 and 0.1 points). The nominal balance also improves in both years, by about 1 point a year, achieving a small surplus in 2019 (+0.1), thanks in part to the improvement in the cyclical component.

Figure 2.4 summarizes the forecasts for net borrowing, structural borrowing and the change in structural borrowing in a comparison among the policy documents.

Figure 2.4 – Public finance balances: a comparison of EFD, NADEF and DBP forecasts published from 2014 to 2016
(2016-2018 forecasting period)

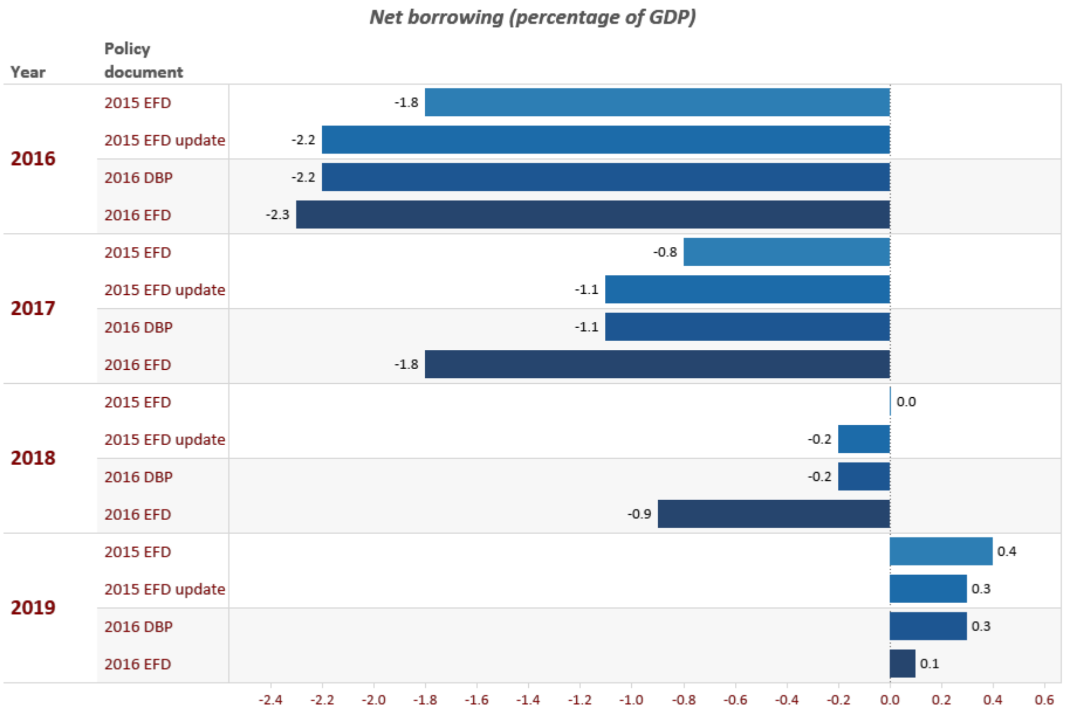
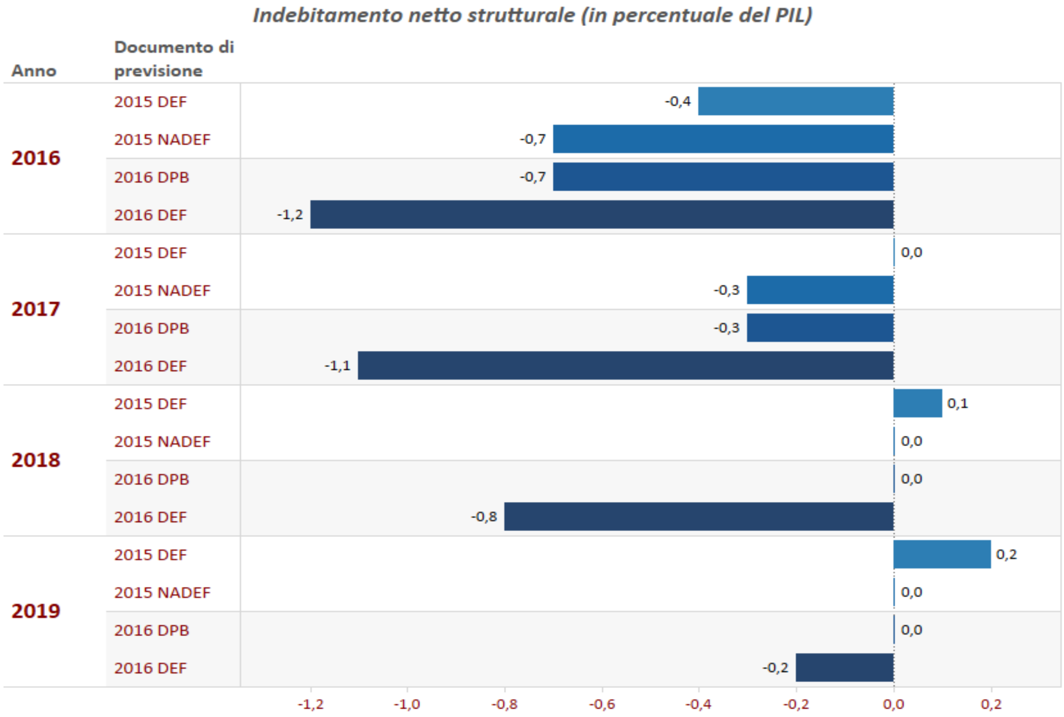
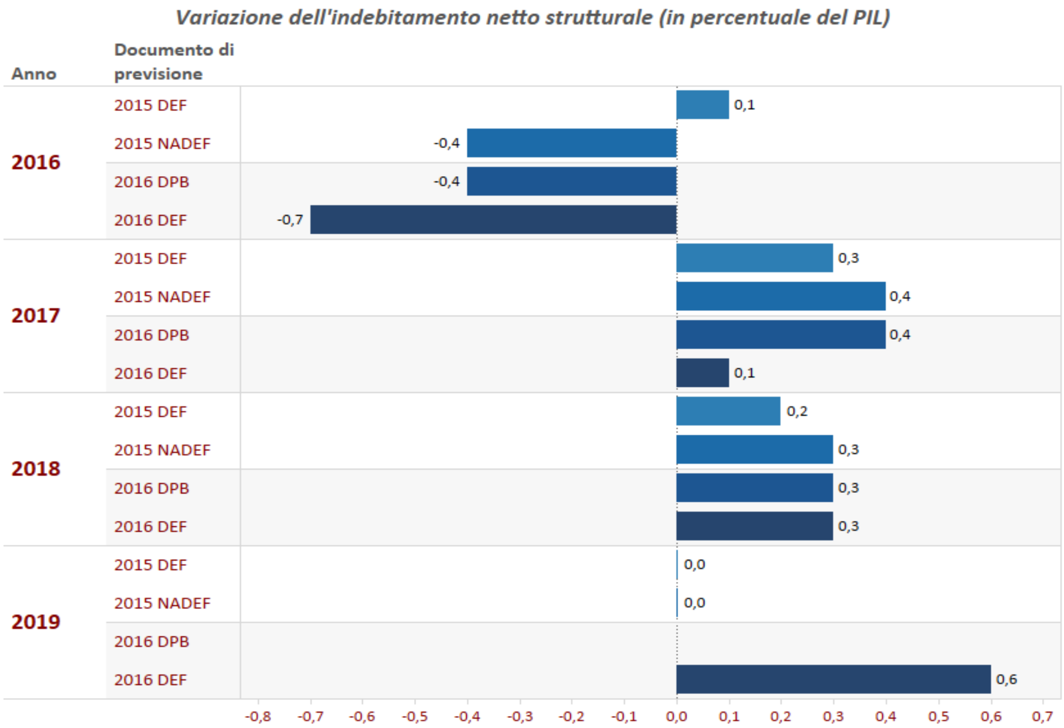


Figure 2.4 – *(cont.)* Public finance balances: a comparison of EFD, NADEF and DBP forecasts published from 2014 to 2016
(2016-2018 forecasting period)





The figures for 2016 for the 2016 DBP do not include the effects, equal to 0.2 percentage points of GDP, of Government amendment 1.1 ("Security package") to the 2016 Stability Act. For the DPBs, the change in structural net borrowing, which is not published, has been calculated by differences on the basis of the figures for structural net borrowing rounded to the first decimal place.

The budget measures, which according to the EFD will be defined in the coming months, are specified by areas of intervention, such as the spending review (increasingly stringent in 2018-2019), including tax expenditures, and the tools to increase tax compliance and reduce the scope for tax evasion and avoidance.

Thus, the most important policy document does not provide a general breakdown of the budget measures, postponing until October the assessment of their effectiveness in achieving the expected results.

The credibility of plans to reduce the deficit and the debt/GDP ratio depends significantly on the capacity to actually achieve the announced objectives for structural and budget policies.

To this end it would be advisable to specify the public finance policy scenario within the EFD – with a breakdown by revenue and expenditure aggregates – namely the decision about the overall resources and their uses, which represent the essential structure of the overall budget. If this was done in the early part of the year, it would leave room to specify the details of the proposals and initiatives subsequently. This would enhance the technical estimation component of econometric models, in which – as noted in the first chapter – the explication of the macro-measures that the Government intends to adopt to achieve the public finance objectives (or at least those actually used in the forecasting exercise) would make the macroeconomic scenario underlying the public accounts more credible. At the same time, however, bringing forward the specification of the policy scenario would not merely play a technical role, but would also contribute to consolidating expectations, stabilizing the climate of confidence, and facilitate the work of government officials, especially at the local level.

The circumstances surrounding the safeguard clauses providing for an increase in VAT and excise taxes underscore the potentially counterproductive effects of ambiguity about the consistency between the aggregate commitments for the budget balance and the announced budget measures. One source of uncertainty in this area is associated in particular with the Government's announced intention to sterilize the impact of the safeguard clauses without a sufficiently detailed indication of credible alternative measures to adjust the public finances.

Finally, the tenor of a number of institutional changes under discussion confirms the advisability of bringing forward the breakdown of policy objectives by subsector and the policy developments in the main general government aggregates in the EFD,[23] including the State sector. The lack of any specification of the resources allocated by the State does not seem consistent with the new procedure, which provides for expenditure targets to be specified by ministry.

[23] For more on this, see Table III.1 in the EFD, which only regards trend developments for general government.

The draft legislative decree concerning the reform of the structure of the budget[24] establishes that by May a decree of the Prime Minister shall specify the expenditure objectives for each ministry for a three-year period. The proposals of the ministries used in formulating budget and stability legislation, which in the future will be consolidated into a single instrument, must be consistent with these objectives.

2.4 Analysis of the fiscal stance

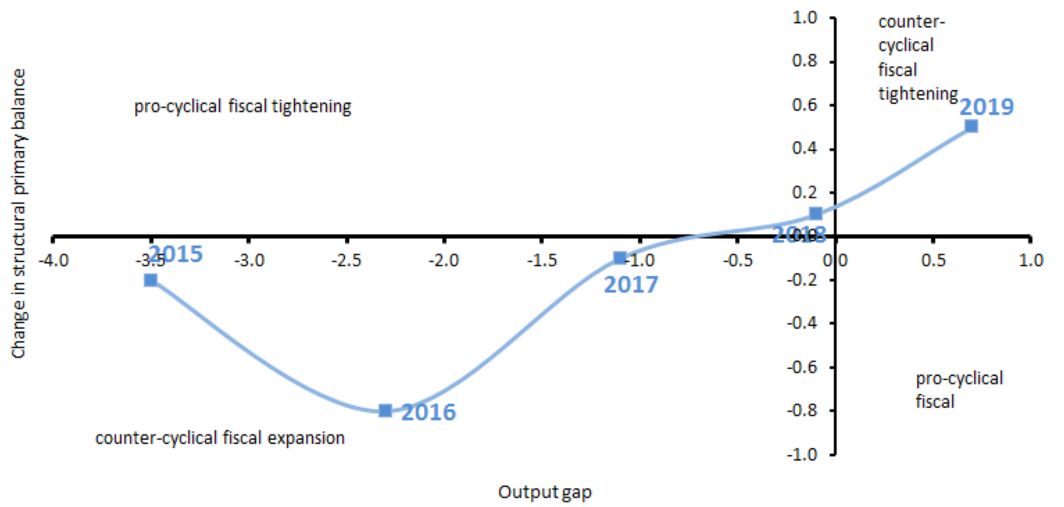
A comparison of the structural primary balance (the primary balance adjusted for cyclical effects and net of one-off measures) and the output gap (the divergence between actual GDP and potential GDP in percentage points) gives an immediate view of the fiscal stance (Figure 2.5), which measures the expansionary or restrictive orientation of economic policy against the background of the macroeconomic environment.

The change in the structural primary balance and the output gap between 2015 and 2019 shows that the adjustment path towards the MTO set out in the policy scenario allows fiscal policy to be counter-cyclical. The increases in the structural primary balance occur in years in which the output gap is positive, while in years in which the cycle is still negative the primary surplus, while still well above 2 per cent, is smaller. That reduction is equal to 0.8 points in 2016 and 0.1 points in 2017.

Comparing the fiscal stance of the EFD with that in previous policy documents, we can see that successive revisions of the adjustment path towards the MTO have progressively postponed achievement of structural balance, thereby reducing the pro-cyclical nature of the previously determined fiscal policy (Figure 2.6). Note that the European rules defining the path towards the MTO require that countries whose debt exceeds 60 per cent of GDP shall adopt corrective policies even if they are pro-cyclical: the obligation to implement a correction of the structural balance is waived only if the output gap is exceptionally large (greater than 4 per cent of GDP) or in the case of a contraction in output (Table R3.1.1).

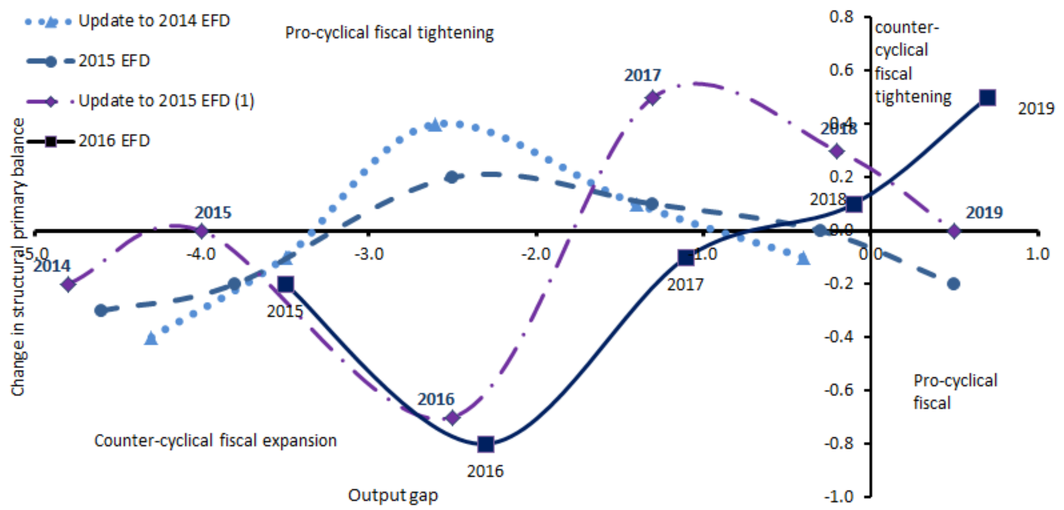
[24] Government instrument no. 264.

Figure 2.5 – Changes in the structural primary balance and the output gap *(percentage of GDP)*



Source: UPB based on data from the 2016 EFD.

Figure 2.6 – Changes in the structural primary balance and the output gap *(percentage of GDP)*



Source: Source: UPB based on data from the Update to the 2014 EFD, the 2015 EFD, the Update to the 2015 EFD and the 2016 EFD.

(1) The change in the primary balance in the Update to the 2015 EFD incorporates the effects of amendment 1.1 ("Security package") to the 2016 Stability Act, equal to -0.2 points of GDP.

2.5 *Policy developments in the debt*

In 2015 the ratio of the public debt to GDP rose, albeit slightly, from 132.5 to 132.7 per cent (Table 2.5). The increase in the debt was smaller than the general government borrowing requirement (€57.5 billion, a decrease on the €69.1 billion in 2014), largely owing to the reduction in the liquid assets of the Treasury (€10.7 billion), issue discounts and premiums (about €5 billion) and privatisation receipts (€6.6 billion). In addition, Italy's contribution to the financial support of the countries in the Economic and Monetary Union declined to €58.2 billion from the €60.3 billion registered in 2014. Conversely, factors increasing the debt included the impact of exchange rate developments (€0.3 billion), the reclassification in the NRF of credit institutions within general government (about 0.1 points of GDP) and the effects of financial derivatives, both as regards the net flow of interest (€3.2 billion) and the exercise by counterparties of swaptions entered into at the start of 2015 (about €3.6 billion).[25]

Under the policy scenario of the EFD, the ratio of debt to GDP should already begin to decline, albeit slightly, in 2016 before decreasing at a progressively faster pace to reach 123.8 per cent of GDP in 2019, about 9 points of GDP less than in 2015. The policy debt/GDP ratio in 2019 is expected to be at a similar level to that in the trend scenario.

The cumulative reduction in the debt over the entire 2016-2019 period is entirely attributable to achieving the policy primary surpluses (which would reduce the debt by 10 points of GDP), as the scenario envisages a small increase in the debt (about 1 point of GDP) due to the snow-ball effect (associated with the difference between the average interest rate on the debt and the rate of nominal GDP growth) and a neutral impact for stock-flow adjustments during the period (Table 2.5).

Table 2.5 – 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	132.5	132.7	132.4	130.9	128.0	123.8
Change in debt/GDP ratio	**3.5**	**0.2**	**-0.3**	**-1.5**	**-2.9**	**-4.2**
Primary surplus (accrual accounting)	**-1.6**	**-1.6**	**-1.7**	**-2.0**	**-2.7**	**-3.6**
Snowball effect (2), of which:	**4.0**	**2.2**	**1.2**	**0.6**	**-0.2**	**-0.5**
Average cost of debt (accrual accounting)	*3.6*	*3.2*	*3.1*	*2.9*	*2.8*	*2.8*
Nominal GDP growth rate	*0.5*	*1.5*	*2.2*	*2.5*	*3.1*	*3.2*
Stock-flow adjustments	**1.1**	**-0.4**	**0.2**	**-0.1**	**0.0**	**-0.1**
Differences in cash and accrual accounting)	*0.9*	*0.2*	*0.4*	*0.1*	*0.1*	*-0.1*
Net accumulation of financial assets (3) *of which:*	*0.2*	*-0.1*	*-0.2*	*-0.2*	*-0.1*	*-0.1*
privatisation proceeds	*-0.2*	*-0.4*	*-0.5*	*-0.5*	*-0.5*	*-0.3*
Debt valuation effects	*-0.4*	*-0.1*	*0.0*	*0.2*	*0.2*	*0.3*
Other (4)	*0.4*	*-0.4*	*-0.1*	*-0.3*	*-0.2*	*-0.2*

Source: 2016 EFD and UPB.
(1) Totals may not match due to rounding of decimals. – (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 Greek Loan Facility and the ESM programme. – (4) Includes changes in liquid assets of the MEF, euro-area support contributions under the EFSF programme, Eurostat reclassifications and statistical discrepancies.

[25] For more information, see the notification of general government net borrowing and debt in accordance with the Maastricht Treaty of 21 April 2016.

In the Government's programme, the primary surpluses increase, reaching a high level at the end of the period: since 2000, su\ch levels have been achieved in only three years. The snow-ball effect, i.e. the effect of the accumulation of debt in previous years, declines over time and turns favourable in 2018, thanks above all to projections for nominal GDP growth in excess of 3 per cent, with a GDP deflator that is higher than expectations of a majority of forecasters and with a technical assumption of interest rates on government securities based instead on forward yield curves.

The contribution of stock-flow adjustments to the variation in the debt changes sign in the forecasting period and is nil over the 2016-2019 period, as the effects of the various components offset each other: on the one hand this includes the increase in debt attributable to financial derivatives, issues below par and the effect of the rise in inflation on indexed securities as from 2017, and, on the other, the decline in debt ascribable to the reduction in the liquidity holdings of the MEF and, especially, privatisation receipts, which are projected to amount to a total of 1.8 percentage points of GDP between 2016 and 2019: in short, large amounts with no indication of the assets to be sold.

In 2015, privatisation receipts amounted to €6.6 billion. The two main operations involved the sale of 5.74 per cent of Enel in February 2015, which generated proceeds of about €2.2 billion for the MEF. Subsequently, in October the public offering of ordinary shares in Poste Italiane (the Italian Post Office) in view of its listing on the stock exchange was completed. The receipts amounted to about €3.1 billion, including the impact of the exercise of the greenshoe option granted to institutional investors. The Government's target for proceeds from privatisations (or comparable transactions) was therefore achieved in 2015.[26]

In the Update to the 2015 EFD, privatisation receipts were forecast at 0.5 points of GDP in each of the years in the 2016-2018 period. As regards the details of the planned operations, the only information provided in the policy documents last year regarded 2016, specifying a commitment to carry out two main transactions: the sale of ENAV (listing and sale of up to 49 per cent of the agency) and the Ferrovie dello Stato Group (listing and sale of up to 40 per cent), once preliminary procedures are completed. No information is provided on privatisations to be carried out in 2017 and 2018.

The 2016 EFD reaffirms the objective of receipts equal to 0.5 points of GDP in each of the years between 2016 and 2018, in addition to 0.3 points in 2019. For 2016, this year's policy documents retain the objective of listing ENAV in 2016, while the disposal of the stake in Ferrovie dello Stato is included in the Government's medium-term plans, saying that alternative disposals will be carried out this year without specifying what these might be.[27] No information in provided on operations for 2017-2019.

[26] The other main operations included the repayment of Monti Bonds by Monte dei Paschi (€1.07 billion) and the capital reduction at ENAV (€180 million).

[27] Statements by Government officials indicate that the possibility of the disposal of an additional stake in Poste Italiane SpA is under consideration, without however ceding control by the MEF.

The magnitude of the forecast receipts is very ambitious, and at this time the information available is not sufficient to determine whether the Government’s privatisation programme, and thus the pace of debt reduction, is credible. This represents a risk factor within the policy scenario.

The EFD does not provide information on the expected effect of derivatives during the forecasting period: the amounts have been aggregated with other items included in the reconciliation of borrowing and the change in the debt. As such amounts have been very large in the past – equal on average in 2011-2015 to an increase in the debt of €4.7 billion a year (Table A2.1.1) – these effects should be broken out of the aggregate.

Appendix 2.1 briefly discusses the progress achieved in enhancing transparency on derivatives transactions in general government and the steps that remain to be taken.

Appendix 2.1

Disclosures on derivatives

About a year after the fact-finding enquiry conducted by the Finance Committee of the Chamber of Deputies concerning financial derivatives, it seems appropriate to assess what progress has been made on enhancing the transparency of transactions carried out by the Treasury and their impact on developments in the public debt.[28] During that enquiry, the Parliamentary Budget Office emphasised the advisability of increasing transparency and the accountability of the MEF to Parliament and the public through:

a) the adoption of specific guidelines and criteria for the use of derivatives;
b) the disclosure in policy documents of summary information on the impact of derivatives for the year involved and for the entire forecasting period;
c) an expansion of the information set, with the publication of periodic reports updated on the basis of changes in interest rates and new transactions.

As regards point a), the *Linee guida della gestione del debito pubblico 2016* (2016 guidelines for the management of the public debt)[29] specified the principles to be adopted by the State in conducting transactions in derivative instruments, which had in fact been used in recent years but had never been made public. In particular, they forbid new derivatives transactions with the exception of those hedging interest rate risk, leaving marginal scope[30] for active management of the existing portfolio to improve its performance.

The ban on new transactions appears to reflect the acknowledged riskiness of derivatives and, as a result of the new accounting criteria used for the national accounts, the elimination of their utility in controlling interest expenditure on an accruals basis. Among other things, the possibility allowed under the guidelines of renegotiating existing positions leaves room for considerable residual operations in derivatives[31] given the large size of the outstanding portfolio.[32]

By contrast, the guidance set out in the "framework decree"[33] is unchanged and allows transactions in derivatives in the broader category of debt restructuring operations. It is

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[28] For a definition of the basic concepts concerning derivatives and a description of the associated risks, see Focus no. 3/2015, the hearing of the Chairman of the Parliamentary Budget Office of 12 May 2015 and the speech to the Parliamentary Press Association of 19 June 2015, which are available on the website of the Parliamentary Budget Office.
[29] Published on the website of the Department of the Treasury.
[30] This clarification is contained in the guidelines.
[31] The accounting criteria established in SEC 2010 create a de facto incentive to renegotiate for the purposes of postponing the exercise of swaptions, which are not included in the debt until they are exercised, whereupon they are immediately registered in the debt on the basis of their mark-to-market (MTM) value, i.e. their market price, which is given by the present value of expected cash flows.
[32] The derivatives portfolio of the State at 31 December 2014 had a notional value of €163 billion and a MTM value of -€42 billion.
[33] Ministerial Decree of 23 December 2015, articles 3-5.

therefore necessary to coordinate the framework criteria and the guiding principles, and there remains a need for more detailed specification of the type of transactions allowed, in order to ensure that renegotiation transactions do not generate additional risks for the future.

As regards point b), no progress has been made on the transparency front with regard to disclosure of the derivatives component in the public accounts, especially as regards developments in the debt. As noted in section 2.5, in the EFD and in the policy documents in general, no information is provided on the expected impact of derivatives in the forecasting period.

It would be advisable to provide separate disclosure for the entire forecasting period on:

- the expected effect of the cash flow generated by derivatives, specifying any part of that flow generated by early termination clauses that are expected to be exercised;
- the expected effect on the debt of the exercise of other contractual clauses (swaptions) or of renegotiations.

Table A2.1.1 reports the corresponding figures for 2011-2015.

Finally, as regards point c), in 2015 the Treasury increased transparency, publishing certain information on contracts executed by the State and by local governments. In particular, the *Rapporto sul debito pubblico 2014* (2014 Report on the Public Debt) provides information on the derivatives of the Treasury, mainly regarding a qualitative description of the transactions carried out in 2014,[34] an indication of the purpose of the use of derivatives – such as to lengthen the duration – and a discussion of the extent to which the objectives were achieved (Table A2.1.2). As regards the existing stock of derivatives, the report does not contain any additional quantitative information beyond that already disclosed during the fact-finding enquiry. The annual updating on the occasion of subsequent editions of the report will be of interest, although it would be advisable to publish the document before the summer.

Table A2.1.1 – Effects of derivatives on the debt in 2011-2015
(millions of euros)

	2011	2012	2013	2014	2015
a) Cash flows from net acquisition of financial assets	2,193	3,876	2,714	3,621	3,190
b) Other effects of adjustment of debt: net liabilities (-) for financial derivatives	221	1,689	800	1,829	3,562
Total negative impact on debt	**2,414**	**5,565**	**3,514**	**5,450**	**6,753**

Source: Istat (2015 and 2016), "*Notifiche dell'indebitamento netto and del debito delle Amministrazioni pubbliche*", 21 April.

[34] In particular, the assignment of a new swaption to defer the effect on the debt of options that were about to be exercised by the counterparties.

Table A2.1.2 – Lengthening of duration (1) and average refixing period (ARP) (2) obtained using derivatives
(years)

		Duration			ARP		
		2012	2013	2014	2012	2013	2014
a) Before derivatives	Domestic securities	4.67	4.73	5.25	5.51	5.35	5.30
	Foreign securities	5.53	4.97	5.46	7.57	8.02	7.70
	Total	4.71	4.74	5.26	5.59	5.44	5.38
b) After derivatives	Domestic securities	5.32	5.18	5.77	6.22	5.95	5.89
	Foreign securities	5.94	5.36	5.86	8.54	8.93	8.55
	Total	5.34	5.18	5.77	6.30	6.05	5.97
c) Difference b-a	**Domestic securities**	**0.65**	**0.45**	**0.52**	**0.71**	**0.60**	**0.59**
	Foreign securities	**0.41**	**0.39**	**0.40**	**0.97**	**0.91**	**0.85**
	Total	**0.63**	**0.44**	**0.51**	**0.71**	**0.61**	**0.59**

Source: UPB based on MEF data (2015), "*Rapporto sul debito pubblico 2014*".
(1) Average maturity of liabilities weighted by the present value of the cash flows they generate. (2) Average time the debt structure takes to incorporate changes in rates.

As regard local governments, new information was made public during the fact-finding enquiry in 2015 and summarised in a series of tables published on the Treasury website (Table A2.1.3). The information provided concerns the notional value of outstanding contracts, which declined at the end of 2015 largely owing to the closure of derivatives positions associated with securities involved in a buyback coordinated by the Treasury. As regards the mark-to-market (MTM) value of the outstanding derivatives of local governments, no new information sources were published, leaving only partial disclosures available published by various institutions (Bank of Italy, Court of Auditors and the MEF) that have not been brought together in any reconciliation.

While representing important progress, the expansion of disclosures does not appear sufficient to clarify the degree and the timeframe in which the contingent liability represented by the negative MTM value of the derivatives could impact net borrowing and the debt in future years. There has been no response to the suggestion to provide a periodic update of expected payment flows or to disclose the structure of the exercise dates of the swaptions.[35] In addition, it would be advisable – as is done for other debt management operations – for transactions in derivatives to be reported in a timely manner on the MEF website, at least as regards their structural characteristics and their expected impact on borrowing and the debt, taking all due precautions connected with the private-law nature of the contracts.

[35] This information would not regard individual contracts – which confidentiality requirements would impede – but rather all expiring positions in each forecasting year.

Table A2.1.3 – Time series of derivatives contracts of local governments
(notional value in millions of euros)

	Stock of outstanding contracts			Closures	
	Notional	Number of entities	Number of contracts	Notional of extinguished or expired contracts	Number of extinguished or expired contracts
1997	413	1	1	0	0
1998	692	2	3	0	0
1999	942	3	5	0	0
2000	1,099	3	6	0	0
2001	2,205	43	61	279	2
2002	5,803	180	243	5	1
2003	11,761	383	521	66	3
2004	18,008	550	762	307	26
2005	18,768	607	871	2,698	109
2006	26,722	743	1,170	3,117	66
2007	37,044	796	1,331	2,372	90
2008	37,980	694	1,198	1,889	152
2009	36,687	549	1,004	1,680	198
2010	33,609	362	729	3,169	279
2011	30,425	298	619	3,326	122
2012	27,694	246	508	2,822	116
2013	25,691	223	462	1,904	47
2014	24,252	212	427	1,507	37
2015	19,896	192	384	2,727	43
Of which: notional outstanding at 31/12/2015 not yet amortised (1):					
Regions and Autonomous Provinces	6,835	17	66		
Provinces	1,617	29	74		
Provincial capitals	4,565	28	79		
Other municipalities	653	118	165		
Total	**13,670**	**192**	**384**		

Source: based on data from the "*Reportistica sui derivati delle Amministrazioni locali*" published on the MEF website.
(1) Report no. 3 published on the Treasury website contains the description "amortised amount", but clarifications provided to us indicate that that amount regards the residual notional value.

3. THE PUBLIC FINANCE OBJECTIVES IN THE LIGHT OF THE FISCAL RULES

3.1 The new structural adjustment objectives of the Government

With the policy scenario discussed above, the Government proposes a more gradual path towards the medium-term objective than that set out in previous policy documents. More specifically, the year in which budget balance is now expected to be essentially achieved has slipped from 2018 to 2019,[36] reducing the policy adjustment effort for 2017 by one-tenth of a point of GDP. That decision is justified by the Government in the light of the following factors:

- the risks of stagnation and deflation at the world level, in an environment of economic and geopolitical instability;
- insufficient coordination of fiscal policies in the euro area, with little fiscal expansion by the sounder countries and unsatisfactory progress in structural reforms in the other countries;
- the undesirable effects of excessive fiscal tightening, taking account of the increase in fiscal multipliers in the countries that have experienced prolonged severe recessions;
- the substantial costs connected with the major reform effort under way in Italy, which will have a positive impact on the investment climate and potential growth in the medium term but generates adverse effects for the public finances and the economy in the short term;
- the underestimation of the output gap underpinning the structural public finance balance in accordance with the methodology established at the EU level, which lends a pro-cyclical stance to budgetary policy.

These reasons, which are set out in the EFD, are essentially similar to those discussed in the report with which the Government submits the update of the plan for adjustment towards the MTO to Parliament for approval. In addition to the justifications contained in the EFD, the report to Parliament bases the request for postponement of budget balance on the impact[37] of a recession of unprecedented length and severity, which is not sufficiently reflected in the parameters used to measure the effects of the cycle at the EU level (the output gap), and exceptionally low inflation despite moderate real growth and an expansionary monetary policy stance at the euro-area level.

The request for a Parliamentary vote – like that previously approved at the time of the 2015 Update to the EFD[38] – was made pursuant to Article 6, paragraph 5, of Law

[36] In 2019, the budget will be close to balance (-0,2 points of GDP).
[37] As measured in terms of lost output compared with pre-crisis levels and with respect to the growth that would have been achieved if the pre-crisis growth trend had continued.
[38] At the time of the 2014 EFD and the 2014 Update, the same requests made generic reference to Article 6 of the law.

243/2012. Those provisions establish that the adjustment plan, previously approved on the occasion of an exceptional event, may be updated if exceptional events occur or if the Government intends to make changes in consideration of developments in the economic cycle.

More specifically, the law expressly refers to EU law in identifying exceptional events but expands its scope, specifying that such events may include severe economic recessions, including those involving the euro area or the European Union, or extraordinary events outside the control of the State, with a substantial impact on the general financial situation of the country, including serious financial crises or natural disasters.

It is therefore helpful to recall what EU law considers to be exceptional circumstances, focusing our attention on the preventive arm of the Stability and Growth Pact, which is now the relevant part for Italy.

3.2 Exceptional events in European law

EU law contains a general clause concerning exceptional events that permit divergence from the MTO or the path of adjustment towards it in the case that deviation does not endanger financial sustainability in the medium term. This clause concerns:

a) severe economic downturns for the entire euro area;
b) an unusual event outside the control of the Member State concerned which has a major impact on the financial position of the general government.

EU regulations and directives do not provide detailed guidance on the criteria for applying this general provision, especially as regards the definition of unusual event. According to official clarifications, considering the wide range of situations that could lead to application of the clause, the Commission and the Council have to assess each case individually.[39]

The clause has so far not been applied. According to the Commission, it is meant to remain limited to carefully circumscribed situations.

The clause could be applied shortly to accommodate the effects of the exceptional flow of refugees in certain Member States. The Commission will conduct an *ex post* assessment of the degree to which the extra costs of the refugee crisis could justify a temporary deviation from the adjustment path in 2015 and 2016.

[39] See *Report on Public Finances in EMU* published by the European Commission in December 2015 and Box 3.1.

Box 3.1 – Required adjustments in the structural balance in the preventive arm of the Stability and Growth Pact

Under the preventive arm of the Stability and Growth Pact (SGP), the possibility of economic downturns in a Member State are governed within the framework of the improvement in the structural balance in relation to economic conditions required of countries that have not achieved their MTO. That effort varies in accordance with the matrix shown in Table A3.1.

More specifically, the matrix contains a "waiver" of the obligation to improve the structural balance in the case of "exceptionally bad times", a situation defined as negative real growth or a negative output gap with an absolute value in excess of four points of GDP[40].

Table R3.1.1 – Annual adjustment towards the MTO required under the preventive arm of the SGP *(points of GDP)*

		Required annual fiscal adjustment	
	Condition	Debt below 60 per cent and no sustainability risk	Debt above 60 per cent or sustainability risk
Exceptionally bad times	Real growth < 0 or output gap < -4	No adjustment needed	
Very bad times	-4 ≤ output gap < -3	0	0.25
Bad times	-3 ≤ output gap < -1.5	0 if growth below potential, 0.25 if growth above potential	0.25 if growth below potential, 0.50 if growth above potential
Normal times	-1.5 ≤ output gap < 1.5	0.5	> 0,5
Good times	Output gap ≥ 1.5	> 0.5 if growth below potential, ≥ 0.75 if growth above potential	> 0.75 if growth below potential, ≥ 1 if growth above potential

Source: European Commission, *Communication from the Commission on making the best use of the flexibility within the existing rules of the Stability and Growth Pact,* January 2015.

In view of these conditions, the situation presented in the EFD, on the basis of current information, does not appear to qualify as an unusual event under the provisions of European law.

3.3 *Fiscal rules*

EU law, on which Italian law draws for the definition of the fiscal rules, establishes two rules in the preventive arm of the Stability and Growth Pact (SGP). The first rule concerns achievement of the MTO or maintaining the path of adjustment towards the MTO. The second rule is an expenditure rule that requires complying with a growth limit for a

[40] This has occurred twice for Finland (in 2012 and 2014) and once for Italy (in 2014).

structural expenditure aggregate, net of discretionary revenue, consistent with the MTO or the adjustment path towards the MTO.[41] Compliance with these two rules is assessed on an annual and biannual basis. In addition, as Italy's debt/GDP ratio is greater than 60 per cent in Italia, the corrective arm of the SGP requires that the difference between the ratio and 60 per cent be reduced by an average of one-twentieth per year.

Recall that EU surveillance regards results for the previous year (*ex post*), estimates for the current year (in-year) and forecasts for the subsequent year (*ex ante*). Finally, the European Commission also provides some guidance for the two years following that subsequent to the next budget act (2018-2019 for this year).

3.3.1 The adjustment path towards the medium-term objective

As regards 2015, the estimates in the EFD indicate that the adjustment of the structural budget balance was equal to about 0.2 percentage points, broadly in line with that required under EU rules (0.25 points) for Member States like Italy in very bad times with debt of more than 60 per cent of GDP.[42] For 2014-2015, the EFD estimates that the average adjustment was close to zero, diverging from the required correction (0.125), albeit not significantly.

Law 243/2012 establishes that divergences from the required adjustments are considered significant on the basis of the criteria established in EU law. This means that an annual divergence of more than 0.5 points would be significant, while a significant divergence over a two-year period is an average deviation of more than 0.25.

For 2016, with the presentation of the 2015 Stability Programme,[43] Italian authorities asked the EU to be able to use the flexibility clause for the structural reforms introduced in January 2015 in order to be able to deviate from the adjustment path towards the MTO by 0.4 points of GDP.[44] In the country-specific recommendations approved in mid-2015, the EU granted Italy permission to invoke this flexibility clause.[45]

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[41] The spending aggregate for the expenditure rule is obtained by subtracting cyclical expenditure related to unemployment, interest expenditure and expenditure financed entirely with EU funds from total public spending. In addition, annual expenditure on public investment is replaced by an average of spending in the current year and in the three previous years. The change in this aggregate is then reduced by the amount of discretionary revenue measures. The rate of growth with respect to the expenditure aggregate for the previous year is then considered in real terms.

[42] See Box 3.1.

[43] See Section I of the 2015 EFD. (http://www.dt.tesoro.it/modules/documenti_it/analisi_progammazione/documenti_programmatici/SEZIONE_I_-_Programma_di_Stabilitx_xdeliberatox_on-line.pdf).

[44] Law 243/2016 establishes that policy objectives can take account of the financial impact of structural reforms in accordance with EU regulations. At the EU level, for more on the structural reforms clause and the investment clause, see the Commission's Communication of January 13, 2015 and the document "*Commonly agreed position on flexibility in the Stability and Growth Pact*" of November 27, 2015 prepared by the Economic and Financial Committee and approved by ECOFIN at the end of 2015.

[45] See http://ec.europa.eu/europe2020/pdf/csr2015/csr2015_council_italy_it.pdf.

Subsequently, with the presentation of the 2016 DBP, the Italian authorities asked for an additional 0.4 points of flexibility, of which 0.1 points under the structural reforms clause and 0.3 points under the investment clause. In its opinion on the 2016 DBP, the Commission decided to postpone a decision on whether to grant Italy additional flexibility to the spring of this year on the basis of an examination of the 2016 Stability Programme.[46] In addition, the EU subsequently ruled that the maximum amount of flexibility that would be allowed to any country under all of the flexibility clauses would be 0.75 percentage points.[47]

For now, then, Italy has used 0.4 points of flexibility for 2016, pending the EU decision on the additional room for manoeuvre requested. Overall, the flexibility could reach the maximum of 0.75 points.

The adjustment required for 2016 (bad times and debt/GDP ratio of more than 60 per cent) would be 0.5 points of GDP. Taking account of 0.4 points of flexibility, the net adjustment would decline to 0.1 points. For that year, the EFD indicates a negative adjustment (i.e. a structural budget expansion) of about -0.7 points. The resulting divergence would therefore be significant (0.8 points, above the threshold of 0.5 points). The same result would be achieved even if the change in expenditure for refugees is eliminated from the structural adjustment and considering the 2015-2016 period.

With flexibility of 0.75 percentage points, the outcome would be different. The required adjustment would be equal to a -0.25 points. In this cast, the negative adjustment estimated in the EFD (-0.7 points) would still represent a divergence but it would no longer be significant on an annual or biannual basis.

Note that in its opinion on the 2016 DBP, the Commission had made its approval of additional flexibility for 2016 subject to three conditions: a) that any deviation from the adjustment path is being effectively used for the purposes of increasing investments (see section 4.1); b) the existence of credible plans for the resumption of the adjustment path towards the MTO; and c) the achievement of progress with the structural reform agenda (see section 4.2).[48]

As regards the implementation of the investments eligible for flexibility purposes, the Government has undertaken to achieve a target of €5.15 billion (0.3 points of GDP) so as to be able to invoke that clause. In order to achieve that target, the Government has taken action on a number of fronts: granting the Regions the authority to establish entities for the exclusive purpose of managing European interventions under special accounting rules, which a number of regional governments had already set up by the end of 2015; allowing the inclusion of undisbursed spending in the 2007-2013

[46] See http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_it.pdf.
[47] See the EFC document of November 27, 2015.
[48] See http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_it.pdf.

programming period in eligible expenditure; submitting information to the Commission to assist monitoring of interventions, indicating that procedures for some 85 per cent of planned expenditure had been launched and projects accounting for about 50 per cent were under way (see section 4.1).

Nevertheless, the possibility of sharply accelerating the full implementation of the investment plan remains exposed to considerable risk. This reflects the magnitude of the spending plans (€11.3 billion in combined national and European funds), which is quite large compared with that certified in the 2007-2013 programming cycle and, in particular, in the early years of the cycle, and with regard to the share of national co-financing, which in the past has been lower than that implied in the forecast values for 2016 (see section 4.1).

As regards the structural reforms, the Government's action generally appears to be in line with the mid-2015 country-specific recommendations of the Commission and the Council, with two exceptions, both noted by the Commission in the recently published Country Report 2016 (see section 4.2). One regards the shifting of the tax burden away from factors of production and onto property rents, consumption and environmental taxes, while the other concerns the prompt removal of barriers to competition. The abrogation of the municipal services tax (TASI) runs counter to the thrust of the former. The delay in enacting the competition law, now nearly six months behind schedule, threatens to undermine the credibility and impact of legislation that is intended to eliminate the problems afflicting many industries and markets.

The 2016 EFD contains estimates of the effects of the structural reforms on potential output growth and on the sustainability of the public finances in the medium term. The favourable impact of the structural reforms on the sustainability of the public finances is one of the conditions required for the flexibility under clause to be granted. The macroeconomic effects of the most recent reforms, i.e. those to be considered for the purposes of the clause, are specifically indicated only for the medium/long-term, when the consequences of the reforms will make themselves felt. Compared with the baseline scenario, GDP would be 2.2 per cent higher in 2020 (compared with the 1.8 per cent indicated in the 2015 EFD), 3.4 per cent higher in 2025 and 8.2 per cent higher over the longer term (cumulative impact). The impact on the primary balance also appears favourable in the long term.

Any assessment of the forecasts presented in the EFD is very challenging and difficult to base on solid foundations. One of the most sensitive aspects, as noted by the European Commission, is that the econometric models adopted only provide results for the key macroeconomic variables if certain assumptions are used, which should characterise the effects of the reform. However, the translation of the reforms into changes in the model parameters is a complex endeavour that requires ad hoc adjustments whose validity cannot generally be verified empirically.

Finally, as noted earlier, for the purposes of granting the flexibility under the clause for 2016, it is important to assess the adjustment path towards the MTO for 2017-2019 in the light of the European rules. Recall that the EFD specifies an adjustment of 0.1 percentage points for 2017, 0.3 points for 2018 and 0.6 points for 2019.

For 2017, the *ex-ante* assessment of compliance with the rules requires certain inputs that have yet to be defined. First, the EU rules establish that for countries like Italy, with a debt in excess of 60 per cent of GDP and in normal economic times (as estimated in the EFD and the winter forecast of the Commission), the required adjustment would be greater than 0.5 percentage points. What the actual adjustment will be will probably be known by mid-2016, with the approval of the country-specific recommendations by the Commission and the Council within the European semester.

With a required structural adjustment of more than 0.5 points, the policy adjustment in the EFD (0.1 points) would represent a divergence that risks being significant.

As regards the assessment of compliance with rule over a two-year period (2016-2017), it would be necessary to know how much flexibility will be granted for 2016. This appears to create a circular reference.

In any case, if the maximum flexibility were granted in 2016 (0.75 points), with a required adjustment for 2017 of more than 0.5 points, the average policy adjustment (negative) in 2016-2017, equal to -0.25 points, would represent a significant divergence from the required adjustment.[49]

The results for 2018 are similar to those for 2017, at least over the two-year horizon. In 2019, the policy adjustment is in line with the requirement and the MTO should essentially be achieved.

So, although the policy scenario presented in the EFD displays numerous divergences, compliance with the adjustment path towards the MTO appears confirmed in 2015 while in 2016 it will depend on the use of the maximum available flexibility (which has not been granted by the EU).

Conversely, in 2017 and 2018, a significant divergence from the required adjustment path appears to be a risk, especially when assessed in biannual terms. In 2019, the adjustment path is consistent with the fiscal rules.

In conclusion, the budget targets presented in the EFD for 2017 and 2018 do not represent an adjustment path towards the MTO that is consistent with the current interpretive framework of the European fiscal rules as transposed in Italian law.

The European Commission will conduct the assessment of the stability programmes on the basis of its own spring forecasts. Therefore, in order to estimate the structural budget balance it will presumably use an estimate of potential GDO and the output gap obtained with the method agreed at the EU level and applied to a forecasting period of two years, rather than four years as done in the EFD for the output gap.

[49] For example, if the required adjustment for 2017 was 0.6 points, that required for 2016-2017 would be 0.175.

As noted in a letter sent by Italy's Minister of finance to seven other EU ministers at the Commission, the choice of forecasting horizon impacts the estimation of potential output and the output gap. In general, a shorter forecasting period produces a lower estimate of potential GDP and, therefore, a smaller output gap, if negative. This results in a deterioration in the structural balance. However, it is more difficult to establish *ex ante* the impact on the change in the structural budget balance for a given year, because both the output gap and the level of the structural balance move in the same direction both in that year and in the previous year.[50] Accordingly, the variation could be virtually unchanged despite the difference in the forecasting horizon.

3.3.2 The expenditure rule

As regards the expenditure rule, in 2015 the growth in the spending aggregate considered by the rule was about 0.3 per cent, compared with benchmark growth of -0.5 per cent. This diverges from the objective but the deviation should not be significant as it amounts to about 0.4 per cent of GDP.[51] This holds even if we exclude the change in spending for refugees.

In 2016, if the flexibility granted for the deviation from the adjustment path towards the MTO remained at 0.4 percentage points, the growth in the expenditure aggregate (net of discretionary revenue) of 0.5 per cent would exceed the estimated benchmark of -0.2 per cent. Nevertheless, this does not represent a significant deviation from the objective, as it would be equal to 0.3 per cent of GDP. Over the 2016-2017 period, however, the divergence is significant.

If, however, the flexibility granted were the maximum amount available (0.75 points), using the EFD forecasts Italy would comply with the expenditure rule as the benchmark would be higher at around 0.6 per cent.

Thus, in 2016 the expenditure rule is more favourable than the adjustment path towards the MTO. In the event of a conflict between two rules, the Commission shall conduct an "overall assessment" to identify the causes of the difference. A preliminary analysis shows that the main cause is associated with slower growth in revenue net of one-off measures compared with GDP that would normally be expected (a "revenue shortfall"), which had an adverse impact on the MTO rule.

For subsequent years, the EFD reports that on an unchanged policies basis the expenditure aggregate considered under the rule, net of discretionary revenue measures, would contract by 1.3 per cent in 2017, 0.7 per cent in 2018 and 0.2 per cent

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[50] See also UPB (2016) "*Orizzonti temporali nella stima dell'*output gap" Flash n. 2 (http://www.upbilancio.it/flash-22016-orizzonti-temporali-nella-stima-delloutput-gap/).

[51] In EU law, similar to the rule on the adjustment path towards the MTO, the divergence in annual terms is significant if it exceeds 0.5 points, while in biannual terms it is significant if it exceeds 0.25 points on average.

in 2019. For 2017, the growth in the aggregate, net of discretionary revenue, would not diverge significantly as the objective is equal to -1.5 per cent. However, using the forecast growth in the GDP deflator used in the Commission's winter forecast (which is higher than that in the EFD), the expenditure aggregate would contract by 1.6 per cent, in compliance with the rule. The same conclusion holds for the 2016-2017 period.

Nevertheless, it is not possible to assess the policy objectives with respect to the expenditure rule since the EFD only reports public finance aggregates on an unchanged policies basis. It does this despite the provisions of Law 243/2012 that require policy documents to indicate the level of general government spending. The publication of the information necessary to assess the policy objectives in the light of the expenditure rule would be desirable.

3.3.3 The debt rule

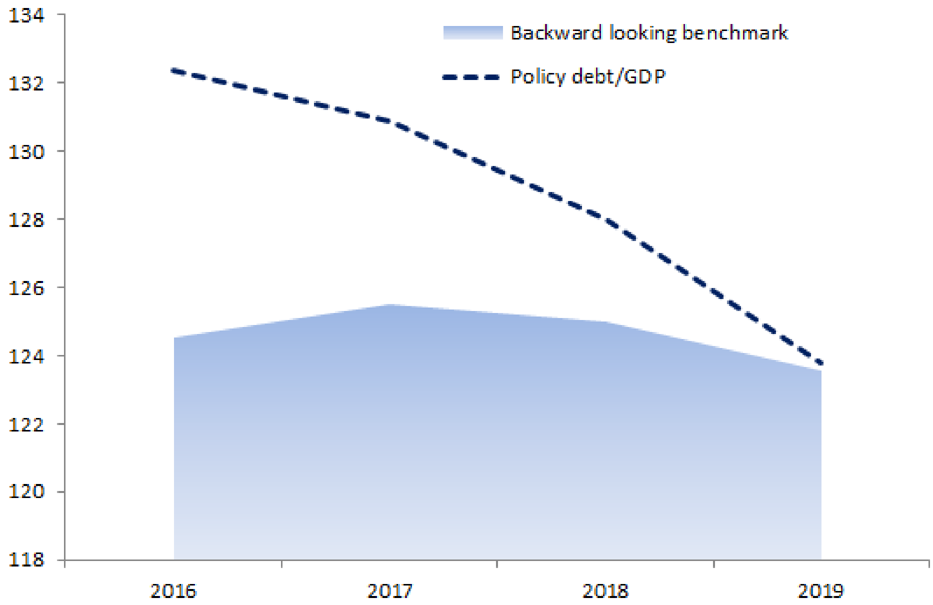
With regard to compliance with the debt reduction rule, in 2015 Italy was still subject to the transitional debt arrangements under EU regulations.[52] According to the EFD, compliance with the criteria in the transition period would require an additional cumulative structural adjustment of about 2 points of GDP in 2013-2015, well above what was actually achieved. The stability criteria for the transition period were therefore violated. At the EU level, this led to the preparation of a report by the Commission in which it examined whether it was necessary to open an excessive deficit procedure for Italy, considering the relevant factors that may have impacted the country's debt performance.

For 2016 (the first year in which the rule is in full effect) and subsequent years, the policy objectives contained in the EFD do not appear consistent with the debt rule using the backward-looking method (Figure 3.1). Nor does Italy comply with the rule in 2016-2017 using the forward-looking method.[53]This marks a major divergence from the scenario set out in the 2015 Update to the EFD, which had forecast compliance with the debt rule under the forward-looking method as from 2016. This is partly a consequence of the slower reduction in the initial years of the EFD forecasting horizon.

[52] Law 243/2012 establishes that the objectives for the debt/GDP ratio shall be consistent with the provisions of EU law. Regulation (EC) 1467/97 (the corrective arm of the SGP) establishes that countries involved in an excess deficit procedure in 2012, like Italy, shall be subject to the debt rule three years after they leave the procedure (2016). In the three transitional years, those countries shall make annual average structural adjustments sufficient to ensure compliance with the ordinary rule using the most favourable criterion. Italy exited the excessive deficit procedure in 2012; accordingly, the transitional period began in 2013 and ended 2015.

[53] Compliance with the rule under the forward-looking method in a given year is effectively equivalent to compliance with the rule using the backward-looking method two years after the reference year. Current information is therefore not sufficient to assess compliance with the rule under the forward-looking method in 2018 and 2019.

Figure 3.1 – Policy objectives for the debt within the context of the debt rule



Source: 2016 EFD and UPB.

On the other hand, the rule is somewhat pro-cyclical, making compliance more difficult in periods of negative output gaps and low inflation, i.e. when fiscal tightenings could have a relatively undesirable impact on the level of economic activity. The EFD points out a number of relevant factors that justify the deviation of the debt/GDP ratio from a path consistent with the rule, such as, for example, the risks of deflation and stagnation and the undesired effects of excessive fiscal consolidation measures.

3.4 Possible developments in the fiscal rules

The Government feels that the economic and institutional environment is such as to advise against a fiscal tightening of 0.5 points of GDP in 2017. In addition, other factors make the technical parameters used in the European surveillance mechanism especially uncertain. In these circumstances, the interpretive framework could evolve to address some of the issues that have emerged in European surveillance activities, although at the moment there is no evidence that such developments might bring the policy objectives of the EFD into compliance with the fiscal rules.

More specifically, the sensitivity to the forecasting horizon noted earlier is not the only problem characterising the estimates of potential output and the output gap. The estimate is also highly sensitive to revisions of the forecasts themselves and actual outturns. The estimate also depends significantly on assumptions adopted for the parameters of the filters used to measure structural unemployment and the variables to approximate capacity usage. Changes in the underlying model can also lead to significant divergences in outputs, as demonstrated by the differences in the output gaps estimated by the European Commission and the OECD.[54]

In addition, the use of structural balances can produce counterintuitive results. For example, the EFD shows an improvement of 0.3 points of GDP in 2016 as against a deterioration of no less than 0.7 points in structural terms. Such a large discrepancy is due to the difference between the effective rate of change in GDP estimated in the EFD (1.2 per cent) and that for the corresponding potential GDP, which is projected to fall by 0.2 per cent.

The uncertainty and variability of estimates of the structural balance have prompted a reflection on the advisability of using these indicators in budget programming. In this regard, the invitation of the Dutch Presidency of the EU Council to discuss the possibility of using an alternative indicator for the EU fiscal rules is a welcome step.[55] In particular, the proposal envisages the use of an observable and less volatile indicator than the structural balance in EU fiscal surveillance. The European fiscal framework would provide for European approval of medium-term plans based on variables such as the structural budget balance and, at the same time, would conduct annual monitoring on the basis of more controllable variables such as expenditure. According to the Dutch proposal, such a framework would help increase the simplicity, credibility and predictability of fiscal policy coordination. However, it is less clear how it would ensure adequate flexibility, a characteristic that the proposal itself acknowledges is a desirable feature in fiscal planning. The trade-off between flexibility and predictability was also underscored in a recent document published by the European Commission (DG ECOFIN). The Commission has declared its willingness to perform technical analyses to strengthen the use of the expenditure rule within the SGP.[56] The PBO is already studying these issues in collaboration with the EU's other independent fiscal institutions.

Finally, the definition of national budget planning should not neglect an assessment of the European stance. The issue of coordinating fiscal policies returns us to the Five Presidents' Report and the discussion of the establishment of a European Finance Minister. Pending these developments, each country should be able to look for areas in which to apply the existing scope for flexibility so as to make the public finances more sustainable in the medium term.

[54] For more information, see Working Paper no. 1/2015 of the PBO (http://www.upbilancio.it/wp-content/uploads/2015/02/Nota-di-lavoro_-n_1.pdf).

[55] See https://www.rijksoverheid.nl/binaries/rijksoverheid/documenten/kamerstukken/2016/04/14/bijlage-7-presidency-paper-simplification-sgp/bijlage-7-presidency-paper-%E2%80%93-simplification-sgp.pdf.

[56] See https://www.rijksoverheid.nl/documenten/kamerstukken/2016/04/14/bijlage-13-note-informal-ecofin-stability-and-growth-pact. See also Flash no.3/2016 of the PBO.

3.5 Medium-term sustainability of the public finances and sensitivity analysis

The ultimate objective of the fiscal rules is to ensure the medium-term sustainability of the public finances. These rules should take account both of the direct impact on the public finance balances and the indirect effects associated with their impact on the macroeconomic scenario. The rules should therefore permit the modulation of actions in relation to the need to implement counter-cyclical fiscal policies. However, Italy's very large public debt significantly reduces the room for manoeuvre in implementing counter-cyclical fiscal measures.

It is therefore necessary to assess the medium-term sustainability of the debt in relation to GDP. In addition, having considering the relevant risk factors in the macroeconomic scenario identified earlier, we must assess the sensitivity of the debt to the main assumptions that drive its behaviour.

First, we conduct an initial exercise in which the policy path of the debt/GDP ratio in the 2016 EFD is extended beyond 2019 until 2025 using a number of ad hoc assumptions (the baseline scenario). More specifically, we assume a primary balance sufficient to ensure that the overall budget is close to balance, zero stock-flow adjustments, the gradual convergence of real growth towards 1 per cent, the inflation rate towards 2 per cent and short and long-term interest rates towards 3 and 4.5 per cent, respectively. The extrapolation uses a method similar to that adopted by the European Commission in analysing the sustainability of the public debt.[57]

With these assumptions, the baseline scenario shows the continuation of the decline in the debt /GDP ratio after 2019; in 2025 it would still be above 100 per cent (Figure 3.2).

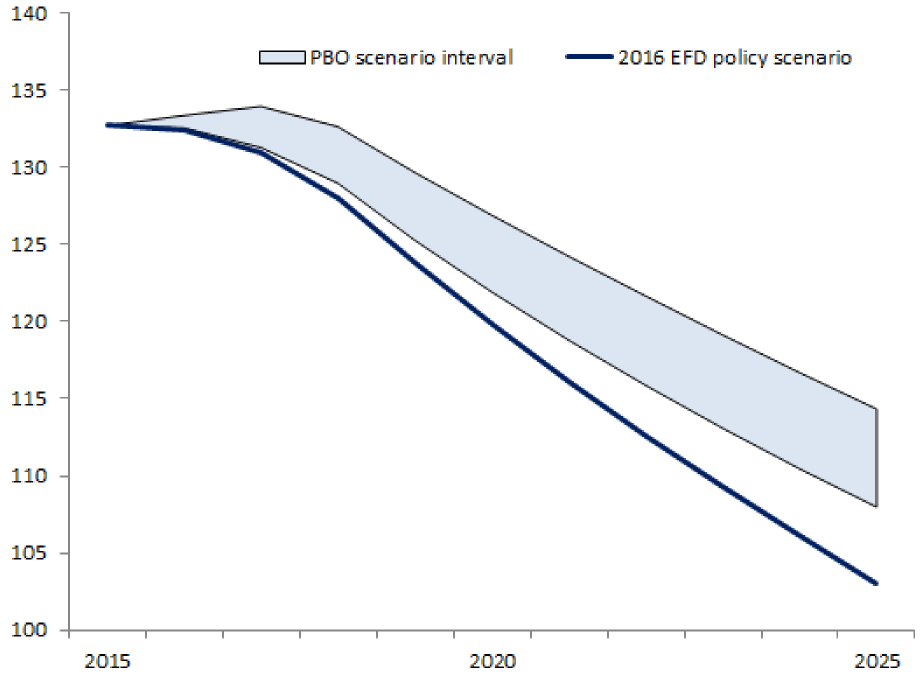
This scenario is compared against alternative scenarios that use the most and least favourable forecasts for nominal GDP from among those developed by the PBO panel of forecasters for 2016-2019.[58]

We assume an elasticity of 0.539 for the primary surplus/GDP ratio with respect to real GDP growth. In addition, the exercise assumes that inflation partly feeds through to interest rates. The stock-flow adjustment is unchanged on that in the policy scenario in the EFD. After 2019 the scenarios use the same assumptions as those in the baseline scenario.

[57] See also "2016 Budgetary Policy Report" of the PBO.

[58] More specifically, in the most favourable scenario, we use the nominal GDP growth rate of the forecaster for which the sensitivity analysis produces the lowest debt/GDP ratio in 2019. In the least favourable scenario, we use the nominal GDP growth rate of the forecaster for which the sensitivity analysis produces the highest debt/GDP ratio in 2019.

Figure 3.2 – Developments in the debt/GDP ratio in different macroeconomic scenarios



Source: UPB based on figures from the 2016 EFD and the panel of forecasters.

In both scenarios the debt/GDP ratio begins to decline by the end of the EFD forecasting horizon and continues to fall in the subsequent years. However, in the least favourable scenario, the debt/GDP ratio only begins to descend in 2018. The policy scenario in the 2016 EFD diverges slightly from PBO interval in 2016 and more significantly as from 2017. In 2019, the EFD scenario reports a debt/GDP ratio that is 1.5 percentage points lower than the scenario using the most optimistic assumptions of the panel and 5.9 points lower than that adopting the least optimistic.

In order to take account of the uncertainty of the estimates, the EFD scenario is also compared with intervals obtained using statistical techniques in line with those used by the European Commission and the International Monetary Fund. In particular, 2,000 possible trajectories of the debt/GDP ratio are estimated using the alternative scenarios described above. This enables the construction of a probability range around the scenarios obtained using the assumptions of the most and least optimistic forecasters[59] (Figures 3.3).

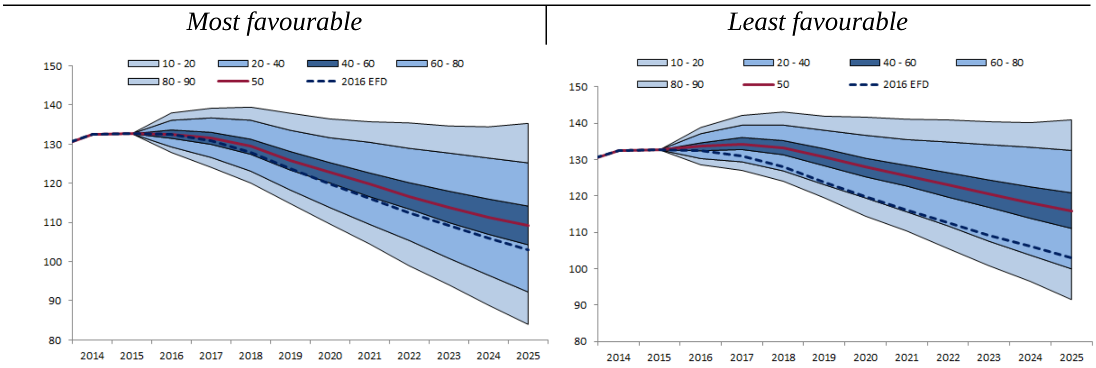
[59] Using the equation that describes the debt dynamics, the alternative scenarios for the debt/GDP ratio are subjected to temporary shocks. The shocks are applied to the real growth rate, the rate of change in the GDP deflator, the short-term interest rate and the long-term interest rate using an approach similar to that proposed by the European Commission in Berti K. (2013), "*Stochastic public debt projections using the historical variance-covariance matrix approach for EU countries*", *European Commission, Economic Papers 480, April*.

Compared with the most favourable PBO scenario, until 2019 the EFD policy scenario moves along the lower portion of the centre of the probability interval (between the 40th and 50th percentiles), suggesting that the two scenarios are substantially similar.

Conversely, compared with the least favourable PBO scenario, the EFD scenario remains in a relatively less likely interval (between the 20th and 40th percentiles). In 2019, the debt/GDP ratio in the EFD would be close to the lower limit of that interval, representing a relatively low probability of actual occurrence.

These sensitivity exercises therefore suggest that even with less favourable macroeconomic hypotheses, the public finance objectives of the EFD should still ensure a decrease in the debt/GDP ratio over the medium term. Nevertheless, there is a substantial risk that in the short term the reduction objective will not be achieved. Moreover, it is highly likely that, for given structural public finance objectives, the debt reduction scenario will diverge significantly from the EFD scenario if less favourable, but still realistic, macroeconomic conditions should prevail. Stochastic analysis confirms the high upside risks where a potential deterioration in the economic situation compared with the EFD scenario would make the planned pace of debt reduction quite difficult to achieve.

Figure 3.3 – Stochastic analysis: 2016 EFD policy scenario compared with UPB scenarios



Source: UPB based on figures from the 2016 EFD and the panel of forecasters.

4. THE REQUEST FOR FLEXIBILITY UNDER THE STABILITY AND GROWTH PACT: INITIAL ASSESSMENTS ON THE STATUS OF THE IMPLEMENTATION OF THE STRUCTURAL REFORMS AND INVESTMENTS

As mentioned in Chapter 3, in the 2015 EFD, and subsequently with the DBP in the autumn of 2015, the Government requested the application of the flexibility clauses for 2016 under the preventive arm of the Stability and Growth Pact (SGP). The request set out in the 2015 EFD for a deviation from adjustment path towards the MTO of 0.4 percentage points of GDP, in connection with the implementation of structural reforms, was accepted by the European Commission and the EU Council. Subsequently, upon the occasion of the presentation of the 2016 DBP, the Italian authorities asked to be able to apply an additional 0.1 percentage points of flexibility under the structural reform clause and another 0.3 percentage points under the investment clause.

The flexibility for implementation the reforms initially regarded the following areas: public administration, competition, the justice system, education, the labour market, shifting the tax burden away from employment and profits, and strengthening the spending review. As a result of progress made with regard to non-performing loans and bankruptcy proceedings, a further request of 0.1 percentage points was made.

If the reforms are not undertaken, or the investments are not made, deviations from the path towards the MTO observed *ex post* will be considered unauthorized. This chapter therefore explores the status of the investments and the structural reforms.

4.1 The investment clause

As stated, in last October's DBP the Government asked for additional flexibility – equal to 0.3 per cent of GDP – in the adjustment path towards the MTO, invoking the public investment clause.[60]

In the "*Commonly agreed position on flexibility within the Stability and Growth Pact*" approved by the ECOFIN Council on 12 February 2016, [61] explicit reference is made to the investment clause, according to which certain investments aiming at, ancillary to or economically equivalent to the implementation of major structural reforms, under

[60] Provided for in the Commission document of 13 January 2015 "*Making the best use of the flexibility within the existing rules of the Stability and Growth Pact*" (http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/2015-01-13_communication_sgp_flexibility_guidelines_en.pdf).

[61] See Note of the EU Economic and Financial Committee of 30 November 2015.

certain conditions, may justify a temporary deviation from the MTO or from the adjustment path towards it.[62]

An investment may be considered economically equivalent to the implementation of structural reforms only if it can be demonstrated that it has a major net positive impact (direct and indirect) on potential growth and on the sustainability of public finances.

Investments than can be eligible for a temporary deviation are national expenditure projects that are funded with co-financing from the European structural and investment funds[63] (ERDF, ESF, EAFRD, EMFF and YEI[64] provided for by Regulation (EU) No. 1303/2013[65]), expenditures for the Trans-European Networks (TEN) and for the Connecting Europe Facility (CEF), as well as national projects co-financed by the EFSI. For eligible investments, the Member States may benefit under the preventive arm of the Pact from a temporary deviation of up to 0.5 per cent of GDP (considering the initial deviation and any additional deviation in subsequent years for the national portion of the eligible co-financed expenditure) from the MTO or from the adjustment path towards the MTO if certain requirements are met (see Box 4.1).

Ex-ante, that is to say during the course of this year, receiving the flexibility will depend on commitments of structural funds for Italy and the level of national co-financing planned for 2016. *Ex-post*, the permissible deviation will depend on the effective payment of the structural funds and the corresponding national co-financing.

As mentioned in Chapter 3, in the context of its opinion on the DBP from last November,[66] the European Commission recognized – in light of its forecasts – that Italy satisfies the criteria for granting the investment clause, but it has deferred the final decision until the assessment of the 2016 Stability Programme. In making a decision, the Commission will take account of the monitoring of the investment plan, the use of the deviation to effectively increase investment and the progress made in the reform agenda, including with regard to the EU Council's specific recommendations for Italy from last July.

[62] In this regard see also *"Vade Mecum on the Stability and Growth Pact"* 2016 edition.
[63] On the use of the European structural and investment funds under the Junker plan, see l'*Audizione dell'Ufficio parlamentare di bilancio nell'ambito dell'Indagine conoscitiva sul Piano di investimenti per l'Europa* of 25 February 2015.
[64] ERDF: European Regional Development Fund; ESF: European Social Fund; EAFRD: European Agricultural Fund for Rural Development; EMFF: European Maritime and Fisheries Fund; YEI: Young Employment Initiative; it should be noted that Italy does not participate in the Cohesion Fund, since this is targeted at the economic convergence of the less developed regions.
[65] See Regulation (EU) No. 1303/2013. It was then clarified that the European Commission, in addition to the CEF, TEN-T and EFSI, will consider the totality of the four structural funds and not just the ERDF and ESF, which are the only European funds envisaged for territorial cohesion under Regulation (EC) No. 1083/2006, in force at the time of the first version of the investment clause, to which the Commission Communication on flexibility of 13 January 2015 refers.
[66] For the European Commission's opinion see: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_en.pdf; for the working document accompanying the opinion see: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/lv_2015-11-16_swd_en.pdf.

Box 4.1 – Requirements of the investment clause

The Member State must satisfy the following requirements to benefit from the investment clause.

1. Its GDP growth is negative or its output gap is negative and is greater than -1.5 per cent of GDP in absolute terms in the year the clause is activated. Italy meets this condition in 2016, as indicated in the European Commission's opinion on the 2016 DBP.
2. The permitted deviation does not lead to a breach of the threshold of 3 per cent for the effective deficit in terms of GDP and an appropriate safety margin is preserved. According to the European Commission's forecasts this condition has been met.
3. Projects eligible for the funds and expenditures mentioned above must have a long-term positive and verifiable budgetary effect. In the 2016 DBP, in requesting of activation of the investment clause for Italy, information was provided on simulations performed using the Treasury's models showing the effects on potential GDP of investment in relation to share attributable to national funds and EU co-financing. In addition, the MEF evaluated the effect of the expected medium and long-term benefits for the primary surplus of investments in co-financed projects, assessing a specific indicator provided for in the methodology suggested by the Commission in "*The Operationalization of the Structural Reform Clause in the Preventive Arm of the SGP*". The results of this simulation show that this condition would be met.
4. The cumulative temporary deviation under the investment clause and the structural reform clause must not exceed 0.75 per cent of GDP.[67] In this regard, it should be specified that Italy requested total flexibility equal to 0.8 per cent (0.5 per cent for the reforms and 0.3 per cent for investments), taking into account both the request set out in the 2015 EFD and that in the 2016 DBP. The total limit of 0.75 points was established subsequent to Italy's request for greater flexibility on the occasion of the 2016 DBP.
5. Co-financed expenditure must not substitute other nationally financed investments, so that total public investment is not decreased in 2016 compared with the previous year. According to the European Commission's forecasts this requirement has been met. The developments in expected public investment for the current year are also impacted by a series of measures included in the 2016 Stability Act, such as allowing regional governments to receive advances of funds (available through the Revolving Fund for the implementation of EU policies) to help in the financing of investments and allowing the Regions to establish entities for the exclusive purpose of managing European interventions under special accounting rules in order to accelerate the spending of funds. Some regions, such as Lombardy and Lazio had approved laws establishing such institutions as early as late December 2015. In addition, municipalities may increase their investments thanks to new spending options owing to the introduction of the nominal balanced budget rule, which is less stringent than the previous constraints under the preceding DSP, which required budget surpluses, and the inclusion of the restricted long-term fund (RLTF) in the balance subject to the constraint. The information[68] concerning the sharp increase reported in municipal tenders related to such investments over the first two months of the year can be interpreted in this light.
6. The temporary deviation must be offset within the adjustment path towards the MTO, which must be achieved within the time horizon of the Stability Programme.
7. The temporary deviation for the entire amount of national co-financing is granted for the first year only. For subsequent years, only positive incremental variations in co-financing can be added to the original temporary deviation. Once the clause is utilized it cannot be requested again until the MTO is achieved.

[67] See note 45.

[68] As reported by Osservatorio Cresme-Sole 24 Ore, see *Sole 24 Ore*, 29 March 2016.

The Commission will perform a plausibility assessment based on detailed information that the Government must provide on the main categories of projects, the quantification of the expenditure involved, the key features and the objectives of the investment projects.

As to the monitoring of the investments in 2016, the Government is in the process of sending information to the Commission. In mid-February, the Government submitted a document containing detailed information on the composition of €5.15 billion in expenditure based upon the request for activation of the flexibility clause equal to 0.3 per cent of GDP, which will be matched by €6.15 billion in EU co-financing (Table 4.1). This is an initial set of non-exhaustive information that will be progressively updated that details what has already been outlined in the DBP of October 2015.

More specifically, the document specified the amounts involved in the procedures initiated and the projects in progress. The former regard to public calls to select the entities that will execute the projects, while projects in progress are those that have already secured financing or are being carried out with payments being made. Of the target of around €5.2 billion in expenditure indicated by the Government in the 2016 DBP, procedures have been initiated for about €4.4 billion, of which €2.6 billion for projects and works in progress. These latter account for about 50 per cent of the target. The most advanced projects, accounting for some 92 per cent of the planned expenditure, relate to the Connecting Europe Facility (CEF), partly for projects (approximately €663 million) considered eligible but that have not yet received co-financing due to lack of EU resources.

Table 4.1 – National expenditure for projects co-financed by the European Union under the investment clause - 2016 (1)
(millions of euros and percentage of expenditure targets)

	ERDF		ESF		YEI		EAFRD		EMFF		CEF		EFSI		Total national expenditure (2)	
	mn	%	mn	%	mn	%	mn	%	mn	%	mn	%	mn	%	mn	%
Expenditure target	**1,400**		**600**		**200**		**800**		**50**		**1,050**		**1,050**		**5,150**	
Procedures begun	788	56.3	314	52.4	88	44.1	1,264	158.1	0	0	964	91.8	946	90.1	**4,366**	84.8
of which projects under way	*362*	*25.8*	*151*	*25.2*	*87*	*43.3*	*495*	*61.9*	*0*	*0*	*964*	*91.8*	*546*	*52.0*	***2,605***	*50.6*

Source: based on 2016 EFD data.
(1) ERDF: European Regional Development Fund; ESF: European Social Fund; YEI: Young Employment Initiative; EAFRD: European Agricultural Fund for Rural Development; CEF: Connecting Europe Facility; EFSI: European Fund for Strategic Development. – (2) National expenditure of €5,150 million is added to the spending co-financed by the EU in the amount of €6,150 million, for total co-financed investment in 2016 of €11,300 million.

With regard to projects in process, 75 main projects were identified, classified into nine categories of expenditure,[69] involving ministries and regional governments, largely in southern Italy.

It lists the projects financed through the Investment Plan for Europe, with guarantees under the EFSI, for which procedures are under way for the Digital Agenda (around €950 million in expenditure, of which €400 million for ultra-broadband) and transportation infrastructure (Pedemontana Veneta highway, €303 million; Pedemontana Lombarda highway, €150 million; highways in Veneto, €93.5 million). As a whole the projects in progress account for more than 50 per cent of the target for the EFSI. However, only one of these projects (the Veneto highways) has already been approved by the EIB (see Box 4.2).

It should be emphasized that the expenditure for investments eligible under the clause also includes a number of projects co-financed by the EU under the 2007-2013 programming cycle that are to be completed using national resources and are to be operational by 31 March 2017. These are investments that have not been completed and accounted for by the end of 2015 that are to be inserted in the new 2014-2020 programming cycle.

The list submitted by the Government contains information ranging from small-scale projects to strategic infrastructure, already indicated in the attachment to the 2015 EFD.

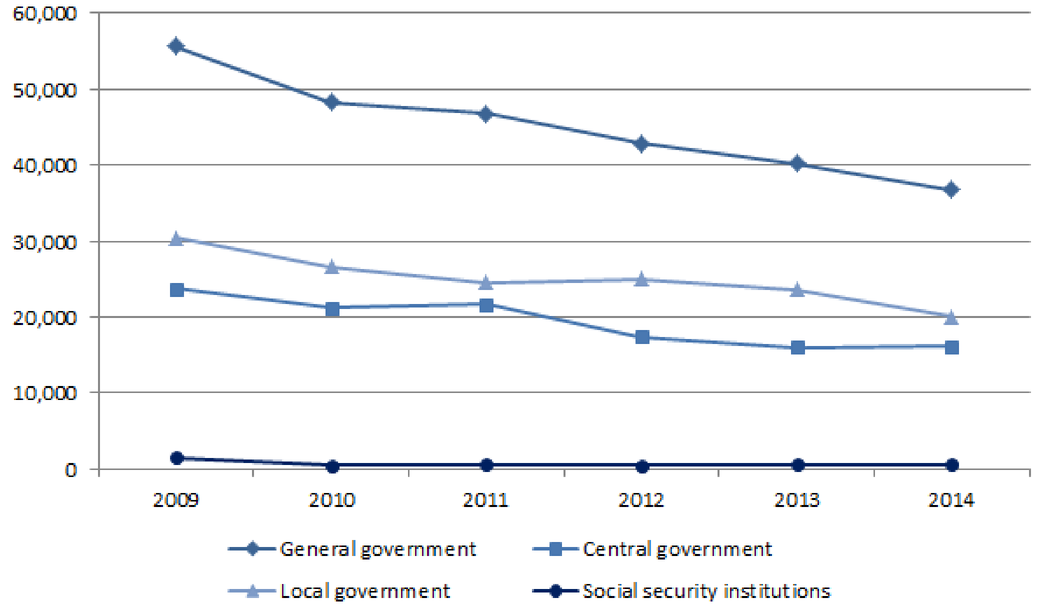
These projects should reverse the downward trend in public investment (down about 34 per cent) during the 2010-2014 period (Figure 4.1), interrupted only by a slight increase in 2015. More specifically, investment in roadworks in 2014 was about 23 per cent lower than in 2009 and that in other civil works (including ports, pipelines, soil protection works, railway lines) dropped by about 44 per cent (Figure 4.2).

The recent disclosure of information by the Government and the updates to follow on specific investment projects will be used in making an initial assessment of how many are ready to start work in 2016.

The presence in the detailed tables of many projects sponsored by the regions shows that among the instruments utilized to overcome the project-readiness problem are agreements stipulated with such institutions. This is an important aspect of the governance process for implementing investments. One of the causes of the delays in carrying out projects is the existence of multiple decision-making institutions, at different levels of government.

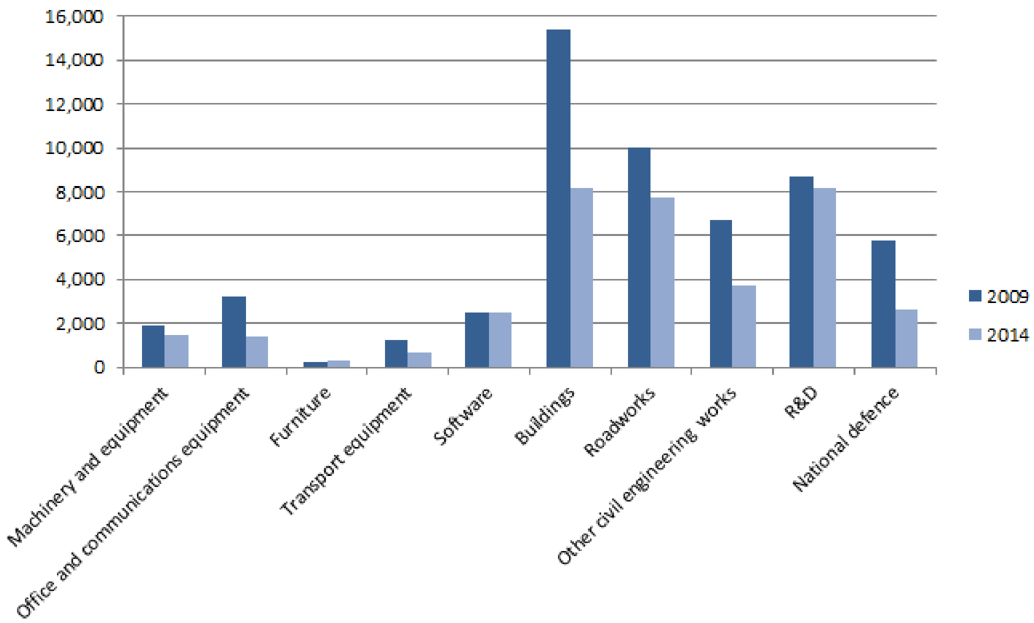
[69] Transport and network infrastructure, tourism and culture, research and innovation, environmental protection and risk prevention, enhancing public institutional capacities, employment and labour mobility, Digital Agenda, education, competitiveness of SMEs.

Figure 4.1 – Investments net of disposals by sub-sector – 2009-2014
(millions of euros)



Source: Istat.

Figure 4.2 – Investments net of disposals by type of asset – 2009 and 2014
(millions of euros)



Source: Istat.

Box 4.2 – Implementation of the Investment Plan for Europe in Italy

The Investment Plan for Europe was launched at the end of 2014 by the European Commission in partnership with the EIB Group, with the objective of mobilising resources for investment in the EU in the amount of €315 billion for the 2016-2018 period.[70] The main instrument for achieving this objective was the use of a portion of the EU's structural funds to create a European Fund for Strategic Investments (EFSI) that will provide first-loss guarantees for financing of eligible investments.

Although the Plan is only just getting started, it is already possible to make an initial assessment of its progress. In fact, the EIB Group was able to accelerate many procedures for financing a series of projects to as early as the first half of 2015.

As of mid-March 2016, the EIB and EIF had approved more than 200 projects across the entire EU, for a volume equal to about €10.5 billion. The total expected investments linked to these projects are equal to approximately €76 billion, 24 per cent of the Plan's total objective.

With regard to Italy, the Plan has already led to the financing of a considerable number of operational projects (Table R4.2.1). As of the end of March of this year, the EIB and EIF had approved 33 financing operations, supported by EFSI guarantees, worth almost €1.8 billion, corresponding to a total investment of about €12.6 billion (0.8 per cent of the GDP forecast for this year).

The sector benefitting the most from the Plan in Italy is that of investments by SMEs thanks to the guarantees that the EIF provides for the portfolio of loans granted by banks to SMEs (Table R4.2.1). The total value of investments by SMEs account for almost half of the Plan total, followed by the transportation infrastructure sector (18 per cent) financed by the EIB. Relatively innovative sectors, such as telecommunications infrastructure (14 per cent) financed by the EIB, and equity and venture capital funds (10 per cent) account for a considerable share.

However, these significant results refer almost exclusively to private investments; the impact on public investments is, at present, rather limited. In fact, of the 33 operational projects backed by the EFSI just one, in the transportation infrastructure sector, has received support from the State budget. The total amount of the contribution is equal to €93 million, well below the total target of €1.05 billion indicated by the Government in the 2016 DBP.

The Government's plan includes three additional projects (two in the transportation infrastructure sector and one in telecommunications infrastructure) that could bring the total contribution from the State budget to €946 million, about €100 million less than the original objective. However, the procedures for implementing the three additional projects are still being carried out. This component of the Government's plan with regard to the investment clause could suffer from the difficulties usually encountered in carrying out infrastructure projects that involve the public administration.[71]

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[70] The EIB Group is composed of the European Investment Bank (EIB) and the European Investment Fund (EIF). For more information on the Plan, visit the dedicated portals of the European Commission (http://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en#documents), the EIB (http://www.eib.org/efsi/) and the EIF (http://www.eif.org/what_we_do/efsi/index.htm). For an analysis of the criteria, see the report of the parliamentary testimony of the UPB from February 2015: http://www.upbilancio.it/piano-di-investimenti-per-leuropa/.

[71] For more on the issues associated with implementing public infrastructure programmes in Italy, see UPB (2015), *"Il piano di investimento europeo. Una opportunità per una migliore* governance *delle infrastrutture pubbliche in Italia?"* October: http://www.upbilancio.it/focus-tematico-n-5-26-ottobre-2015/.

Table R4.2.1 – EIB and EIF projects with EFSI guarantees in Italy at 31 March 2016

Sector	Number of operations	Value of EIB/EIF financing (millions of euros)	Total value of operations (millions of euros)	% of total value
Transportation infrastructure	3	620	2,318	18
Telecommunications infrastructure	1	500	1,800	14
Energy infrastructure	1	200	415	3
Industrial investment	3	145	568	5
Guarantees of portfolios of loans to SMEs	21	223	6,143	49
Participation in equity and venture capital funds	4	105	1,315	10
Total (1)	**33**	**1,792**	**12,559**	**100**

Source: Based on EIB Group data.
(1) Totals may not match due to the rounding of decimals.

However there continue to be considerable threats to any sharp acceleration of full implementation of the investment programme. The first thing to take into account is the sheer volume of projected spending (€11.3 billion when considering both national and EU funds), particularly when compared with that certified for the 2007-2013 programming cycle (in 2011-2014 it amounted to about €8.4 billion on average) and especially in the early stages of the cycle, such as this year. In addition, the national share of co-financing in the past was smaller than that implied by the amounts projected for 2016. In fact, taking account of the administrative and technical delays that have often characterized structural fund use in the past, specifically for capital expenditure, given the existence, for example, of complex projects that sometimes extend beyond the programming period,[72] the launch of procedures covering 85 per cent of planned expenditure (as reported by the Government) may not translate into effective cash outlays by the end of the year. For this purpose, it would therefore be beneficial to perform additional analysis of the status of individual projects, including a survey of work remaining for full implementation in terms of cash outlays by the end of this year.

In addition, all of the expenditure contemplated in the plan approved by the Government might not be considered eligible by the European Commission. In addition to capital expenditure for both investments and investment grants, the lists include current expenditure, such as production grants and current transfers to firms. It is important to expressly break out the various types of expenditure involved.

[72] As shown in an analysis conducted by the Bank of Italy based on Open Coesione data, Bank of Italy (2014) "*Economie regionali*" no. 43, December.

4.2 *The structural reform clause*

The National Reform Programme (NRP) set out in the 2016 EFD mainly focuses on the implementation of reform measures that have already been announced, with the objective of ensuring consistency with the European Commission's *Annual Growth Survey* of last December and the more recent EU Council Recommendations. According to the 2016 EFD, the structural reforms aim to support medium and long-term economic policy, raising potential growth, and improving the context in which investment decisions are made (to that end projects programmed for future years would also contribute). However, these involve costs for the public finances and may also have unfavourable consequences on the economy over the short term: therefore, the need to make them is invoked as one of the reasons for which a restrictive fiscal policy should not be undertaken.

The structural reform clause[73] permits a temporary deviation from the MTO or the adjustment path towards the MTO it where comprehensive projects are carried out that, while generating costs for the public budget in the short term: 1) are major; 2) are fully implemented (through binding measures and, given the possibility of postponements and delays in carrying out the overarching reforms, provide for monitoring during the execution phase);[74] 3) have a positive, verifiable impact on the medium- and long-term sustainability of the public finances. This impact may consist of direct budgetary effects or indirect effects channelled through higher potential GDP and, therefore, higher future revenue. The Member States must provide detailed information on the impact of the reforms on the public finances and growth in the Stability Programme and in the NRP.

If the structural reforms are not fully implemented, it is necessary to provide a detailed plan, under the NRP,[75] specifying the timeline and quantifying the costs and impact on potential GDP. Should the project not be implemented, the justification for deviating from the MTO would be forfeit, creating the risk of a procedure for significant deviation.

The structural reform clause is granted during the assessment of the Stability Programme, in particular as part of the country-specific recommendations.

In its opinion on the DBP of 17 November 2015, the Commission reiterated that in assessing the request for additional flexibility the progress made in implementing the reforms will be monitored, including in light of the Council recommendations of July 2015. In the following section we devote further attention to these recommendations and those from 2014 (referred to in last year's EFD in envisaging a series of projects the status of which now needs to be verified), before examining the NRP, which contains detailed information on the work performed over the last two years with regard to the measures implemented or in the process of being implemented and reports the Government's estimation of the effects of the reforms, which we also consider.

[73] See European Commission (2016), "*Vademecum on the Stability and Growth Pact – 2016 edition*", *European Economy, Institutional Paper* 21, March; UPB (2015), *"2016 Budgetary Policy Report*", November.
[74] The EU Commission and Council follow the progress made, assess the difficulties and imbalances in the context of the European semester and the excessive deficit procedure (EDP), which provides the legal framework for conducting this process.
[75] For Member States subject to the EDP, it is in the corrective action plan.

4.2.1 *The EU Council recommendations*

In its recommendations of July 2015 the EU Council emphasized six points it recommended by incorporated into the 2015-2016 *agenda*.

The first was general and embraced three areas: the inclusion of the spending review as an integral part of the annual budgetary process; the implementation of the enabling law for tax reform (by September 2015), with specific mention of the adjustment of cadastral values and the enhancement of tax compliance; and the implementation of the privatisation programme.

The second point encouraged the adoption of the national strategic plan for ports and logistics (to promote intermodal transport) and making the Agency for Territorial Cohesion fully operational (to improve the management of EU funds).

The third point recommended completing the implementation of laws aimed at improving the institutional framework and modernising the public administration, revising the statute of limitations (by mid- 2015) and improving civil justice to reduce the length of proceedings.

The fourth point asked that steps be taken to tackle (by the end of 2015) the weaknesses in the corporate governance of banks, to implement the reform of bank foundations, and to take measures to accelerate the reduction of non-performing loans.

The fifth point addressed the labour market and the education system, with the request that the legislative decrees for implementing the Jobs Act be enacted, second-level contractual bargaining be promoted, and school and vocationally-oriented tertiary education reform be implemented.

Finally, the sixth point contained the request that Italy implement the simplification agenda for 2015-2017, promote competition-enhancement measures in all sectors covered by competition law, and rectify (by the end of 2015) cases in which local public services contracts have been awarded in violation of in-house rules.

4.2.2 *The status of the structural reforms*

The main features of the timeline attached to the 2016 EFD can be read in parallel with the Council's July 2015 recommendations.

In response to the first point of the recommendations, measures are being enacted to integrate the spending review process into the budgetary cycle and to bolster financial programming.[76] Other items on the agenda include the revision of the cadastral values (by the end of 2018) and the reduction of personal income taxes (2017-2018), both suggested in the 2014 recommendations. Implementation of the fiscal equity enabling law (Law 23/2014) continued. Finally, shares of Poste Italiane SpA and ENEL SpA have been sold on the market, the procedures for selling up to 49 per cent of ENAV have been prepared and the preliminary steps for privatizing Ferrovie dello Stato have been taken.

The European Commission already indicated that last year the decision to eliminate the municipal services tax on primary residences and postpone the updating of imputed property income are at odds with the rebalancing the tax burden.[77]

As to the second point of the recommendations, the National Strategic Plan for Ports and Logistics (*Gazzetta Ufficiale* no. 250 of 27 October 2015) was approved. The Agency for Territorial Cohesion completed the organizational processes, specifically developing the organizational chart, but is still a long way from becoming fully operational.[78]

On the third point, the actions taken to implement Law 23/2014 (fiscal equity enabling law) and Law 124/2015 (enabling act for reform of the public administration) involved simplification and rationalization measures. In the wake of the reform of the institutional framework, the electoral reform for the Chamber of Deputies (Law 52/2015) was approved and Parliament gave its final approval to the constitutional reform to eliminate perfect bicameralism (pending the outcome of the referendum for its confirmation). There are also two new points added to the agenda: implementation of the White Paper on Defence by the end of 2016[79] and, by February 2017, approval of one or more legislative decrees for reorganizing the labour practices applicable to government entities (the so-called Jobs Act for the public administration).

If we also take account of the legislative degrees implementing Law 107/2015 (education reform), expected by the end of July 2016, and the completion of the decrees relating to Law 124/2015, by the end of summer 2016, we find a concentration of deadlines whose achievement depends upon clear and efficient scheduling of parliamentary work.

The third point of the recommendations regarded the issue of justice. In 2015 efforts continued to reform the civil justice system.[80] The Council's recommendations have influenced the 2016 agenda, which in the civil justice area involves the comprehensive reform of civil trials (A.S. no. 2284) and bankruptcy proceedings (A.C. no. 3671), and in the criminal arena, reform of the statute of limitations (A.S. no. 1844) and addressing

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[76] See the schedules to the legislative decree revising the structure of the budget and strengthening the function of the cash-based budget (Government instruments nos. 264 and 265, already submitted for parliamentary review).
[77] See "*Country Report Italy 2016*", Commission Staff Working Document SWD(2016) 81 final.
[78] See the institutional website: http://www.agenziacoesione.gov.it/it/.
[79] Internal reconfiguration and rationalization of the Ministry of Defence.
[80] On the demand side, the introduction of the new forms of out-of-court dispute resolution; on the supply side, entry into practice of electronic civil trial procedures and the hiring of public employees in redundancy to relieve shortages of administrative personnel.

compliance with the reasonable length of trials (A.S. no. 2067). By the end of 2016, the draft of the enabling law reforming the system for honorary judges should be approved (A.C. no. 3672).

With regard to the banking sector – addressed in the fourth point of the recommendations – in the second half of 2015 and in the early months of 2016 significant progress was made in reducing the risk associated with non-performing loans (Law 132/2015),[81] in reforming the mutual banks (Law 33/2015), cooperative banks (Decree Law 18/2016), and in implementing two European directives on the recovery of credit institutions (Legislative Decree 180/2015) and on deposit guarantee schemes (Legislative Decree 30/2016).[82] In addition, over the 2015-2016 period, the process for the self-reform of banking foundations should be completed.

The reform agenda contains the self-reform of bank foundations. This is a project that has been pursued for some time and about which numerous requests have already been made at the European level, for which the regulatory autonomy left to the industry must be monitored in order to ensure that it is effectively and promptly implemented.

In response to the fifth point of the recommendations, between mid-2015 and early 2016, the eight enabling legislative decrees implementing the Jobs Act (for a description of the decrees see page 89) were approved and the second phase of the "Youth Guarantee" project, with the so-called "super bonus" for employers that hire young people as apprentices under open-ended contracts, was launched. In addition, the timeline indicates that progress in being made on the decrees for the National Active Labour Policies Agency (by the end of 2016) to become fully operational and on the bill (A.S. no. 2233) for the reform of the rules for the self-employed and work-life balance (by the end of September 2016). Also among those actions urged by the Council, Italy has announced a plan to broaden the scope of second-level collective bargaining.[83]

Implementation of the Jobs Act does not end with the eight legislative decrees completed in 2015. It will be necessary to complete the lower-level enabling measures without delay.

Finally, with regard to competition and competitiveness – the sixth point of the recommendations – the Simplification Agenda was launched and the 2016 programme

[81] To address the issue of impaired loans, specific measures were adopted in compliance with the strict restrictions imposed by EU legislation on State aid (revising of the tax treatment of losses on banks' loans, introduction of a system for issuing state guarantees for securitization transactions that have non-performing loans as the underlying assets. The framework of instruments available to deconsolidate non-performing loans should be completed with the formation of the Atlante Fund by the end of April 2016.

[82] To promote the recovery of bank and non-bank receivables, amendments were made to the Cod of Civil Procedure, simplifying and speeding up the judicial forced sale process, and to bankruptcy law, as regards resolution instruments for businesses in crisis (composition with creditors and debt restructurings).

[83] In *Country Report 2016* on Italy (pp. 39-40), the Commission emphasized that second-level collective bargaining, which helps to better align wages to productivity and encourages the adoption of innovative contracting solutions, is still the prerogative of a minority of firms: "*Collective bargaining [in Italy] is more centralised than in most countries. […] [In France, Germany and Spain] contracts may better reflect the specific economic and labour market conditions*".

contemplates measures for incentivizing investment and innovative start-ups, also confirming the extraordinary "Made in Italy" plan. However, the initiatives adopted to date are only moderately consistent with the 2014 and 2015 recommendations, in which the Council requested that actions be taken to encourage competition on a broader scale (including in the provision of local public services), while the annual law on competition for 2015, the most appropriate regulatory instrument for driving market reforms, has not yet been approved. The delay in the adoption of the requested initiatives is implicitly recognized in the EFD, where the timeline lays out, in sequence, the bills for the law on competition for 2015, to be approved by the end of June 2016, and that for 2016 to be approved just six months later, by the end of December 2016.[84]

4.2.3 The assessment of the effects of the structural reforms

As emphasised in the *Vade Mecum* mentioned earlier, the examination by the European Commission must involve a qualitative plausibility assessment of the estimates of the effects of the reforms in order to determine whether it meets the sustainability-enhancing condition.[85] This requires a certain prudence given the uncertainty and risks that characterize impact assessments, especially the indirect effects.

The most controversial aspect involves the incorporation of the individual reforms in general economic equilibrium models, which provide information on the effect on potential GDP and on other macroeconomic variables. The simulation is generally conducted using dynamic stochastic general equilibrium models (DSGE), in which the reforms are treated as "policy shocks" by modifying a number of the key parameters.[86] Although we are not focusing on the limitations of these models,[87] we should mention that the translation of the reforms into changes to the parameters involves judgements, to be made before the model is used, on the nature of the measures adopted, their

[84] There has been a delay in approving the annual law on competition for 2015 which has caused a de facto postponement of that for 2016 as well. *Country Report Italy 2016* states that, even considering the draft of the annual law on competition for 2015, *"[…] significant barriers to competition will remain in important sectors, including in retail, professional services, local public services and transport sector. Doing business in Italy is significantly more difficult than in other major EU economies and only modest progress has been achieved in recent years*".

[85] The *Vademecum* attempts to formalize the criterion, expressing it as a requirement for significant sustainability benefits in net present value terms, taking into account both the direct positive and negative impacts and the indirect budgetary impacts.

[86] For example, the mark-up, the cost of capital, bureaucratic costs for firms, and certain fiscal policy tools (for example, shifting the tax burden from one tax to another). In some cases preliminary estimations are made of the effects of the reforms on certain intermediate indicators (such as, for example, those of the OECD for market regulation and labour protection), that are then translated into modifications of the model parameters (respectively, the mark-up and labour productivity).

[87] The theoretical framework and the assumptions on which these models are generally based (micro-founded models that are strictly dependent upon the theoretical constraints, i.e. intertemporal utility maximisation, rational expectations, representative agents) can lead, for example neglect of the demand side, the consequences that the latter can have through the hysteresis effects on potential GDP, the effects of any changes in the system of consumer preferences as a consequence of the reforms, of diversity in behaviour and distributive phenomena.

effectiveness and adherence to the announced objectives (for example, improved efficiency of the public administration, increase in the share of qualified workers, increase in market competition). Little is known of this phase and moreover it frequently involves highly controversial assessments. If it is uncertain whether the projects, in the environmental context in which they are inserted, are effective, the effects remain undetermined. In fact, the model only yields results for some variables (for example, GDP, investment, employment) for the assumptions inserted.

The European Commission also considers this step to be difficult and uncertain, requiring caution in interpreting results. However, to obtain an assessment of the possible effects of the reforms to at least a first order of magnitude, the Commission itself conducted a number of simulations. One of these consisted in imposing standard shocks using the QUEST (DSGE) model for the entire European Union, which would represent the effects of stylized economic reforms. It is nonetheless recognized that standard policy shocks are not fully comparable across different types of reforms and that the estimates could vary from country to country (in part because they depend on the starting-point values of the indicators and on macroeconomic conditions). Moreover, the Commission estimates the reaction of the budget balance to changes in output (indirect effect of the reforms), based on the methodology to compute the cyclically-adjusted budget balance and a series of assumptions. For Italy, a 1 per cent increase in GDP would change the balance (in percentage of GDP) by 0.53 points after five years and 0.5 points after 10 years or more.

Another simulation is presented in a recent European Commission study[88] evaluating the macroeconomic impact of a number of structural reforms in Italy, Spain, Portugal and France, again using the QUEST model, while stressing that the results are not directly comparable with those conducted by national authorities (given the differences in the range of reforms considered and in the assumptions made). The document explains that it was not possible to quantify the results for many measures given the insufficient information available or the lack of a method capable of representing the actions through specific shocks. For Italy, the effect on GDP of a group of actions provided for in the NRPs presented in 2013, in 2014 and in 2015[89] would translate into a difference of 1.29 percentage points compared with the baseline scenario in 2020, 2.07 points in 2025 and 2.84 in 2035, while the budget balance would improve by 0.45 points of GDP in 2020, 0.69 in 2025 and 1.16 in 2035.

The EFD presents separately the direct effects on the public finances (during the short term period of 2015-2019),[90] for only the most recent reforms, and classified into ten grids,[91] and indirect effects. The former are reported with reference to the State budget

[88] European Commission (2016) *"The Economic Impact of Selected Structural Reform Measures in Italy, France, Spain and Portugal"*, European Economy, Institutional Paper no. 23, April.

[89] The privatization package of 2012 and the annual competition law 2015, the measures for the public administration approved in 2012-13 and in 2014, the labour market reforms of 2012-13 and 2014-15, those on taxation approved in 2013, 2014 and 2015, and the education reform of 2015. Not all of the specific measures that make up these projects were considered.

[90] In some cases it is difficult to identify the boundary between the sphere of fiscal policy and that of structural policies (UPB (2015), "*2015 Budgetary Planning Report*").

[91] This is the update of the measures already enacted and new interventions that came to light during the review of the measures approved in the interim between the 2015 EFD and the more recent policy document. In proposing a description of the reforms in a classification by intervention area, which translates into ten "grids", the EFD indicates that, of the 430 measures included, 20 are new and 240 were updated over the past year (about 55 per cent of the total).

(since it is deemed that the reforms essentially impact this aggregate),[92] with results that are, as expected, unfavourable. In fact, in the five years considered, increased expenditure totalled an estimated €86.1 billion, compared with €31.9 billion in lower expenditure, and decreased revenue of €85.5 billion, compared with increased revenue of €22.3 billion.

The estimation of the impacts on the macroeconomic variables and the corresponding indirect effects on the public finances are reported in the 2016 EFD with reference to the most recent reforms only, to be considered for the purposes of the flexibility clause, including measures concerning non-performing loans and bankruptcy procedures and those for financing growth, and are classified in nine programme areas[93] (Table 4.3).[94]

The impacts are specifically illustrated for the medium and long term only, when the effects of the reforms will be fully developed. GDP would be 2.2 per cent higher, compared with the baseline scenario, in 2020,[95] 3.4 per cent in 2025 and 8.2 per cent over the long term (cumulative effects). The impact on the budget balance also appears to be favourable. The relationship between the impact on GDP and the change in the primary balance seems to be more stable over time if the reforms introduced in the models through the assumption of changes in fiscal variables (taxes, contributions or expenses) are excluded.

Table 4.3 – Macroeconomic effects of the reforms

	2020	2025	Long term
GDP	2.2	3.4	8.2
GDP (1)	2.2	3.5	8
Consumption	2.7	4.2	6.3
Investment	3.3	4.8	11.5
Employment	1.5	2.1	3.7
Primary balance	1.1	1.7	2.8
Primary balance (1)	0.9	1.6	3.6

Source: Based on 2016 EFD data.
(1) Net the reforms introduced in the models through assumptions of modifications to fiscal variables (taxes, contributions or expenditures).

[92] However, the effects of the switch to a balanced budget for local authorities are included. Not all of the changes in Tables C and D have been inserted. In addition, the resources for action and cohesion plans and funds for European projects are excluded.
[93] The multiplicity of the classifications presented in the NRP (by recommendation, by grid, by policy area, by Europe 2020 objective) does not aid comprehension, although this is in part due to the complexity and overlapping of the rules and requirements to follow.
[94] The table reports the overall effects indicated in the EFD. The estimated effects of the individual reforms were summed to calculate the primary balance.
[95] The 2015 EFD estimated the overall effect on GDP of the reform package then under consideration to be 1.8 percentage points.

In the 2016 EFD, in order to assess the effects of the reforms on potential GDP, the endogenous growth version of the QUEST III model with research and development calibrated for Italy, the micro-founded IGEM dynamic general equilibrium model for the Italian economy and in some cases, the ITEM econometric forecasting and simulation model for the Italian economy, which has been recently revised and re-estimated.

Ultimately, the estimations of the results of the structural reforms are subject to a higher level of uncertainty than normally affects the forecasts. It is very challenging to provide an opinion on the assessments presented in the EFD since it is difficult to base them on a sound foundation.

5. THE STRUCTURAL REFORMS: AN EXAMINATION OF THE JOBS ACT, EDUCATION AND JUSTICE

The assessment of the effects of complex reforms like those set out in the National Reform Programme (NRP) cannot simply consist in the quantities generated by econometric models, however refined. It requires a comprehensive analysis of the issues concerning the sector, the priority objectives to identify, the possible actions to be taken and the obstacles that may arise. In the remainder of this chapter, we examine a number of areas of action of structural policies, focusing on an initial review of the problems and the actions taken.

The following sections concentrate on labour market policies, the reform of the education system and the status of the justice system.

5.1 *The Jobs Act and the complexity of assessing its effects*

Labour legislation has undergone far-reaching reform since 2014. The first step in the process came with the enactment of Decree Law 34 of 20 March 2014 (known as the "Poletti Decree")[96] which, anticipating the reform introduced with the Jobs Act, adopted urgent measures to counter the weakness of employment caused by the economic crisis. More specifically, it made it easier for firms to use fixed-term contracts[97] and expanded the scope for apprenticeships.[98] The objective was to encourage firms to hire workers thanks to a less stringent form of contract and to strengthen the most appropriate channel for ushering young people from education to the working world.

A few months later, the enabling law for a comprehensive reform of the labour market was enacted (Law 183/2014), introducing a very broad range of actions incorporated in eight legislative decrees, the last of which were approved at the end of 2015 .

The enabling law for the reform of the labour market was implemented with eight legislative decrees. Legislative Decree 22/2015 reorganised the system of social shock absorbers in the case of involuntary unemployment, introducing the New Social Insurance for Employment (NASPI) and the Unemployment Allowance (ASDI). Compared with earlier social insurance schemes, the NASPI has expanded the population of eligible workers,[99] eased access requirements and increased the initial value of the benefits. Alongside this expansion of coverage, benefits now decline more rapidly and the imputed pension contributions covering periods of unemployment have been

[96] Ratified with Law 78/2014.

[97] With the first contract, it was no longer necessary to specify the motive for the fixed-term contract, which could now be renewed five times within a maximum period of 36 months. The number of fixed-term contracts at a single firm could not exceed 20 per cent of total employees.

[98] It was no longer necessary to specify the training content of the apprenticeship contract, the limit on the hiring of new apprentices was eased (at least 20 per cent of apprentices had to be transformed into permanent employees within three years, compared with the previous requirement of 50 percent) and employers were free to use public or private training services.

[99] All private-sector employees excluding those in agriculture.

reduced.[100] Disbursement of NASPI benefits is subject to participation in initiatives organised as part of active labour policies. Those who use up their NASPI benefits but are still in a state of hardship could qualify for ASDI benefits, which are less generous (75 per cent of the last NASPI payment[101]) and are paid out for no more than six months.[102]

Legislative Decree 23/2015 introduced the open-ended contract with increasing protection. The new system applies to workers who have been newly hired on permanent contracts and to conversions – following the entry into force of the decree – of fixed-term contracts or apprenticeships into open-ended contracts. In the event of an individual dismissal, workers may obtain reinstatement only when the dismissal is found to be discriminatory or for disciplinary reasons later proved to be unfounded. In all other cases, reinstatement is no longer possible and, in the absence of an (objective or subjective) justification or good cause,[103] the employer shall pay the worker an indemnity of two months' pay for each year of employment with the firm.[104] Under the new system, the rules for collective dismissals (more than five employees) are the same as those for individual dismissals. Compared with the previous system, termination of an open-ended employment relationship, subject to payment of the indemnity, has become easier and less exposed to the uncertainty of the speed and outcomes of labour litigation.

Legislative Decree 80/2015 reforms measures to improve the work-life balance. The range of possible cases of maternity and paternity leave has been broadened. It is now possible to take parental leave in the form of part-time work. Specific precautions have been introduced governing night-time work for working mothers and to support women who have been victims of gender-motivated violence (with the possibility of reducing workloads). With regard to flexibility mechanisms to improve the work-life balance, regardless of parental issues, the new measures do not consider telecommuting workers in calculating the employment thresholds that give rise to legal obligations or requirements for the application of certain work rules for employers.

Legislative Decree 81/2015 reorganises all other forms of contract with increasing protection, for which the provisions of Article 18 of the *Statuto dei lavoratori* (Workers' Charter) apply in full.[105] The rules governing apprenticeships were revised significantly.[106] From now on, such employment relationships are included in the so-called "work experience system", in which studies to obtain secondary and tertiary qualifications also include periods spent working in a company.[107] Another major innovation regards the flexible working arrangements that can be used in employment relationships. Even in the absence of specific provisions in a collective bargaining agreement, employers and employees can agree on supplementary work, the structure of the working day (without changing the total number of working hours) and increases in the number of working hours under part-time contracts (overtime), as long as these do not involve violations of the collective bargaining agreement. The decree also addresses the rules governing job duties, allowing individual agreements reached under the auspices of organisations

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[100] For a summary examination of the characteristics of the NASPI, see the INPS circular no. 46 of 3 March 2016.

[101] The ASDI benefits, which are tax free and may not exceed the amount of the social allowance, may be increased depending on the number of dependents.

[102] The Ministerial Decree of 29 October 2015 implements certain provisions of Legislative Decree 22/2015.

[103] If an objective justification is demonstrated, the worker is not entitled to an indemnity.

[104] The indemnity ranges from a minimum of four and a maximum of six months for companies with fewer than 15 employees and a minimum of 12 and a maximum of 24 months for companies with more than 15 employees. If the employer and the employee opt for the rapid conciliation procedure (avoiding the labour courts), the indemnity amounts to one month's pay for each year of service up to a maximum of 18 month's pay. Indemnities are reduced for small companies and non-profit organisations.

[105] The new decree replaced, with supplemental provisions, the Poletti Decree of 2014.

[106] While continuing along the lines set out with Legislative Decree 167/2011 and Law 183/2011.

[107] Students working towards advanced degrees (a doctorate, for example) may also use the apprenticeship contract with a company.

specified under Article 2113 of the Civil Code (so-called “secure environments” for workers) to modify duties, job placement and pay, and company unit to which they are assigned.[108]

Legislative Decree 148/2015 reorganised the system of social shock absorbers for employed workers.[109] The new ordinary wage supplementation mechanism (CIGO) has been extended to all firms with more than five employees[110] and is now conditional on the real possibility of resuming and continuing employment.[111] The new extraordinary wage supplementation mechanism (CIGS) is now deployed for situations of severe overmanning that could lead to collective dismissals with economic and social repercussions. As with shock absorbers for the unemployed, the expansion of eligible workers for the wage supplementation mechanisms has been balanced by changes in the duration of the benefits and changes in the contribution rates for employers.[112] In addition, the scope for using CIGO/CIGS at zero hours (total suspension from work) has been tightly restricted and use of the solidarity contract is now one of the preliminary conditions for gaining access to the CIGS mechanism.

Legislative Decree 149/2015 established the National Labour Inspectorate, which has taken over the control activities concerning labour and social legislation issues previously performed by the Ministry of Labour, INPS (National Social Security Institute) and INAIL (National Workplace Accident Insurance Institute). In order to ensure operational parity among all personnel involved in the supervision of labour issues, the legislation gives all INPS and INAIL officials the same powers as those exercised by the inspectors of the Ministry of Labour, including the status of judiciary police officers.

Legislative Decree 150/2015 reorganized the operation of active labour policies. A new National Active Labour Policies Agency (ANPAL) was created to provide unified coordination of the previous employment centres and other regional and national bodies with various responsibilities in this area.[113] The National Employment Services Network – coordinated by ANPAL – also includes private sector entities authorised to provide labour market services[114], ISFOL (National Vocational Education Institute), the chambers of commerce, universities and advanced educational institutions. Using the Unified Labour Policy Information System – an integrated dataset established with the decree – employment centres verify that beneficiaries of the social shock absorbers (those under Legislative Decree 22/2015 and Legislative Decree 148/2015) are participating, on pain of losing those benefits, in initiatives for human capital maintenance, skill boosting and job placement. The employment centre and the unemployed enter into a customised service agreement that fits the personal and professional characteristics of the person as closely as possible. If unemployment persists, the unemployed person may apply for a job placement allowance, which can be spent with the participants in the National Employment

[108] Although they represent real steps towards greater decentralisation of the negotiation of contractual terms and conditions, these reforms do not yet appear sufficient to fully implement the recommendations of the European Commission and the EU Council, which call for greater second-level bargaining over the financial aspects of contracts in order to foster a stable link between pay and productivity. A similar consideration was advanced by the Budget Department of the Senate in *Nota breve* no. 12 of May 2015.

[109] For an overview of the decree, see Circular no. of 5 October 2015 of the Ministry of Labour and Social Policy and Circular no. 197 of 2 December 2015 of INPS.

[110] It covers employees, including apprentices with apprenticeship contracts leading to professional qualifications.

[111] The intention is to prevent improper use of the mechanism as a sort of income of last resort or welfare benefits.

[112] With a reduction in basic rates (which employers pay regularly as a component of labour costs) and the introduction of additional rates to be paid in the case of actual use of wage supplementation. This mechanism increases accountability, demanding greater contributions from those who use the system, and at the same time reduces the tax and contribution burden in periods of normal economic activity and employment conditions.

[113] The decree revises the functions and organisation of the employment centres.

[114] For example, temp agencies, or associations of worker or company representatives.

Services Network to gain access to additional intensive job search services and targeted professional retraining programmes.[115]

The final implementing decree was Legislative Decree 151/2015 concerning various rationalisation and simplification measures, including employment. These include an amendment of Article 4 of the Workers' Charter that permits the use of certain systems to monitor workers remotely (with the use of cameras, computers, tablet, and company telephones) for disciplinary purposes. The decree also made it possible to transfer leave and vacation time. Workers may transfer accrued leave and vacation time free of charge to other employees of the same employer for the purposes and to the extent established in collective bargaining agreements.[116]

The appendix to the 2016 NRP reports the estimated effects of selected measures in the Jobs Act on a number of macroeconomic and public finance variables (GDP, gross investment, employment, consumption and the budget deficit). The estimates do not cover the entire package of approved reforms, but they do specifically regard open-ended contracts with increasing protection (Legislative Decree 23/2015), the new rules for other employment contracts and changes in job duties (Legislative Decree 81/2015) and work-life balance measures (Legislative Decree 80/2015). The quantification of the effects uses the DGE-QUEST III model of the MEF, whose features were described and discussed in section 4.2.3.[117] Measured at 2020, the effects of the legislative changes produce increases (compared with the baseline scenario of no labour market reforms) of 0.6 points in GDP, 0.4 points in investment, 1.0 point in employment and 0.6 points in consumption and a reduction of 0.2 points of GDP in the deficit. These effects strengthen gradually over time, rising in the long run (beyond 2030) to increases of 1.3 points in GDP, 1.0 point in investment, 2.0 points in employment and 1.4 points in consumption and a reduction of 0.6 points in the deficit.

Another assessment is contained in a recent study by the European Commission.[118] The quantification exercise also used a QUEST-type model whose structure differed partly from that developed by Italy and did not necessarily use the same micro-and macro-economic assumptions. Moreover, the Commission only considered the entry into force of open-ended contracts with increasing protection, which by facilitating dismissals is assumed to have a positive impact on the rate of growth in labour productivity (+0.04 per cent per year), increasing GDP in 2020 by 0.1 percentage points, a gradual rise from the 0.04 points achieved in 2016, and reducing the budget deficit by 0.01 points of GDP (compared with a baseline scenario of no labour market reforms). These effects gather pace slowly with time and in the long run, beyond 2030, amount to +0.49 and -0.02 points respectively. The impacts are much smaller than those included in the 2016 EFD,

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[115] The network participants only receive the funds if the job search is successful.

[116] For a more detailed discussion of the content of the decree, which rationalises and simplifies many aspects regarding procedures and requirements connected with employment relationships, please see the INAIL circulars no. 10 of 21 March 2016 and no. 92 of 23 December 2015.

[117] More specifically, the effects of the Jobs Act are incorporated in the model in the form of a reduction in the remuneration of workers on open-ended contracts and an increase in the proportion of atypical contracts (page 20 of the appendix to the 2016 NRP).

[118] See European Commission (2016), "*The Economic Impact of Selected Structural Reform Measures in Italy, France, Spain and Portugal*", *Institutional Paper* n. 23.

partly of which could be explained by the narrower range of reforms considered.[119] At the same time, however, it is more challenging to explain the divergence in the assessment of the impact on employment. For the Commission, the effect in 2020 was a negative 0.02 percentage points and it remains at that level for quite some time, before disappearing after 2030. By contrast, the impact in the EFD is positive and significantly larger. The same discrepancy appears in the assessment of the impact on the deficit, which for the Commission is negligible (albeit slowly increasing) but more significant for the EFD.

Even taking account of the differences in the underlying assumptions, the comparison of the estimates in the EFD and those of the European Commission counsels prudence in assessing the impact of the Jobs Act on growth and employment, at least in the initial years, for which no direct evidence is available yet. Among other things, a number of other recent studies examining the effects of the Jobs Act also suggest caution. They sought to separate out the effects from those of other measures that have affected the labour market in recent years, notably the contribution relief for new hires on open-ended contracts in 2015 and 2016.[120]

The Competitiveness Report published by Istat in 2016[121] contains a section devoted to an analysis of the perception of businesses of the regulatory and tax factors that had the greatest impact on their hiring decisions. The period examined by the report was January-November 2015, and the data was gathered from a sample survey of manufacturing and services companies. In the manufacturing sector, 50.2 per cent of those interview said that full contribution relief had an important or fairly important impact on their decision to increase hiring.[122] The percentage of those with these views of the new rules governing contracts with increasing protection declines to 35.1 per cent, while the IRAP relief measures were considered important or fairly important by 19.6 per cent of respondents. In the services sector, 61.1 per cent said that full contribution relief had an important or fairly important impact, while 49.5 per cent held the same opinion of the new rules governing contracts with increasing protection and 39.0 per cent felt that way about the IRAP relief. The figures reveal the substantially larger impact of contribution relief compared with the reform of the employment contract. The same pattern emerges from the replies concerning the factors that played the largest role in hindering new hiring. In manufacturing, the most frequent response was the insufficient level of demand, followed by high labour costs. Among services

[119] It should be noted, however, that of the three legislative changes considered by Italy's QUEST III model, the introduction of the contract with increasing protection appears to be the most significant and, consequently, the difference with the reforms examined by the European Commission could be smaller than it might appear at first glance.
[120] The 2015 Stability Act granted three years of full contribution relief for new hires on open-ended contracts (including contract conversions). The 2016 Stability Act extended the relief for new hires in 2016 but reduces the amount and duration (to two years).
[121] See http://www.istat.it/it/competitivita.
[122] The respondents were asked to assign a judgement to each measure from among the following categories: very important, fairly important, not very important, unimportant.

firms, the greatest obstacles were the same, but in reverse order (first high labour costs, then low demand).

Results comparable to those found by ISTAT emerged in a study by Confindustria at the end of 2015. The study[123] used data gathered as part of the annual labour market survey in order to determine whether contribution relief or the new rules on open-ended contracts played the greatest role in hiring decisions. The latter were very or fairly important for 55.6 per cent of respondents,[124] while the figure rises to more than 95 per cent for full contribution relief in 2015. The percentage of respondents who considered the contribution relief unimportant was virtually nil, while those considering the new contract with increasing protection unimportant accounted for about 20 per cent of respondents.

In a more recent work of greater analytical and econometric depth,[125] Sestito and Viviano (2016) use microdata for the Region of Veneto to determine what part of the improvements in employment achieved in 2015 was attributable to the temporary contribution relief and what part to the introduction of the contract with increasing protection. Both measures were found to be effective in fostering the use of open-ended contracts and increasing employment, but the dominant effect was attributable to the full contribution relief, while the new contract rules helped reinforce the propensity of firms to hire new permanent employees. These results regard the first contribution relief measure, which applied to 2015. It will be very helpful to repeat the analysis for 2016, when on the one hand the contribution relief will be reduced substantially (to 40 per cent and for two rather than three years) and, on the other, the implementation of the Jobs Act will have moved ahead with the introduction of new incentives for hiring (for example, the new rules on the flexibility of workloads and changes in job duties under the provisions of Legislative Decree 81/2015).

A more general reference can be found in the recent literature with the work of Dosi *et al.* (2016).[126] Within a theoretical model of the "Keynes meets Schumpeter" sort,[127] they demonstrate that the causal relationship between the simple deregulation of the labour market and employment and growth is debatable, and could even be reversed. Equally critical is the work of Fana *et al.* (2016),[128] which, using seasonally adjusted data and isolating the months in 2015 when only the contribution relief was in effect (before the

[123] Confindustria (2015), "*Scenari economici*", no. 24, September.

[124] The respondents were asked to assess each measure on a scale similar to that used by ISTAT: very, fairly, little, none.

[125] Sestito, P. and Viviano, E. (2016), "*Hiring incentives and/or firing cost reduction? Evaluating the impact of the 2015 policies on the Italian labour market*", *mimeo*. The two authors develop a probability model using a difference-in-difference technique.

[126] Dosi G., Pereira M. C., Roventini A., Virgillito M. E. (2016), "*When more flexibility yields more fragility: the microfoundations of Keynesian aggregate unemployment*", ISIGrowth WP no. 5/2016.

[127] This sort of modelling describes the dynamics of the economy by grafting the effects of process of scientific-technological progress in the mode of Schumpeter onto a Keynesian approach in which aggregate demand is the main driver of growth.

[128] Fana M., D. Guarascio, V. Cirillo (2016), "*Did Italy need more labour flexibility?*", *Review of European Economic Policy*, publication pending.

entry into force of the rules governing the contract with increasing protection), significantly reduces the impact of the Jobs Act on the activation of new open-ended contracts last year. It also perceives a risk that many of the conversions of other types of contract into open-ended contracts will not survive the end of the three-year contribution relief. *Mutatis mutandis*, the same observation can also be extended the second, reduced, contribution relief for new hires on open-ended contracts (or contract conversions) in 2016.

In conclusion, although it must be acknowledged that the labour market reform introduced with the Jobs Act is one of the reforms that Italy has introduced most rapidly and vigorously, responding to the modernization and simplification recommendations of the EU Council of 2014 and 2015 (all of the eight complex legislative decrees were approved just over a year after the enactment of the enabling legislation), it is advisable to use caution in assessing how the new rules will translate into higher productivity, employment and economic growth in the coming years. The three-year contribution relief granted in 2015 created a strong incentive for employers to hire, in some cases postponing hiring plans for 2014 and bringing forward new hires planned for 2016. In a stagnant economy, the entry into force of the contract with increasing protection may have worked to encourage hiring in order to benefit from the contribution relief rather than as an independent factor around which employment relationships and production could be organised.

5.2 European recommendations for the school system and educational reform

The "Good Education" reform (*La buona scuola*, from the title of the report presented by the Government in September 2014) was implemented with Law 107/2015 and represents the primary instrument of an effort to reform – partly in response to European recommendations – the education and training sector.

In this field, the NRP of April 2015 was intended to respond to a specific request contained in the recommendations of the Council of July 2014, which urged Italy to implement the National System for Evaluation of Schools to improve school outcomes and reduce rates of early school leaving, to increase the use of work-based learning in upper secondary vocational education and training and strengthen vocationally-oriented tertiary education, to create a national register of qualifications to ensure wide recognition of skills, and to ensure that public funding better rewards the quality of higher education and research. In a subsequent recommendation of July 2015, the Council continued to focus on the implementation of educational reform and the expansion of professionally-oriented tertiary education, identifying the education system as one of the causes of high youth unemployment and the large proportion (the largest in the Union) of young people between 15 and 24 who are neither in education or in work.[129] Italy's performance in terms of school leaving and the percentage of the population with a university education is

[129] See the Council Recommendations of 8 July 2014 and 14 July 2015 on the National Reform Programmes of 2014 and 2015 of Italy and formulate an opinion of the Council on Italy's 2014 and 2015 Stability Programmes, 2014/C 247/11 and 2015/C 272/16.

significantly worse than the European average (see Table 5.1). The improvement of the education system, including the training of adults in life-long learning programmes, and the reduction of school leaving were indicated as some of the ex-ante conditions that would be considered in the programming of structural funds within the 2014-2020 framework programme. However, we must not overlook, among the reason prompting the reform, the need to address the infraction proceeding initiated by the European Commission against Italy for failing to correctly implement Directive 1999/70/EEC concerning fixed-term work[130] and the ruling of 26 November 2014 of the European Court of Justice finding that Italian law was inconsistent with the directive.

Law 107/2015 addresses many aspects of the education system, delegating nine areas of intervention to the Government.[131] In the initial months of implementation, attention was focused on the emergency hiring plan, intended in part to deal with the issue of job insecurity among teachers. The enhancement of school independence, increasing the accountability of school heads, the evaluation of schools and greater flexibility in the school curriculum and teaching hours represent some of the most significant changes. In addition, a more concerted effort has begun to promote work experience programmes, including apprenticeships for 15 year olds, and an effort is being made to strengthen vocational education. The recent effort in school building has also been significant.[132]

Table 5.1 – The path to the Europe 2020 objectives

	2009	2013	2014	2015	2020 target
Early school leaving (1)					
Italy	19.1%	16.8%	15.0%	14.7%	16.0%
EU28	14.2%	11.9%	11.2%	10.9%	10.0%
University education (2)					
Italy	19.0%	22.5%	23.9%	25.3%	26.0/27.0%
EU 28	32.3%	37.1%	37.9%	38.5%	40.0%

Source: Eurostat and 2016 EFD. There is a discontinuity in the time series in 2014.
(1) Young people between 18 and 24 who have at most a lower middle school diploma and do not attend educational or training courses. – (2) Population aged between 30 and 34 with a university diploma.

[130] The issues regarded the periodic renewal of fixed-term contracts to fill vacancies in the absence of criteria for determining the real need for requesting the renewal, the certainty of the date of completion of competitions for permanent positions, and measures to prevent and punish the illegal use of a succession of fixed-term contracts.

[131] The delegated legislation, to be implemented within eight months, regard: the reorganisation of the legislation governing the educational and training system (consolidated law); the training and recruitment of teachers in secondary school; the inclusion of students with disabilities and the recognition of different modes of communication; the revision of professional education; the establishment of the integrated education system up to the age of six; the effectiveness of the right to study; the promotion of humanist culture, the leveraging of cultural resources and supporting creativity; the reorganization of Italian educational institutions and initiatives abroad; and the assessment and certification of student skills. The timetable of the reforms presented in the 2016 EFD schedules implementation for July 2016.

[132] Including the three-year planning system, the implementation of a register of school buildings (as from September 2015), the exclusion of investments in school building from budget constraints for local governments.

The reform law specifies many educational objectives, including the improvement of certain skills, especially digital literacy,[133] as well as measures to deal with a number of ethical issues (countering bullying, active and democratic citizenship, the rule of law and environmental sustainability) and a series of specific targets, such as reducing early school leaving, relations with local communities (including the voluntary sector and the business community), afternoon school openings, increasing work experience programmes, customized educational programmes,[134] awards and rewarding student merit, and reducing class sizes.

Last February, the European Commission,[135] in its staff country report on Italy, reviewed the status of the reforms. In addition to drawing attention to the problems noted above, it also acknowledged some improvement in the level of early school leaving and the development of traineeships. While it stigmatises the limited career prospects for teachers, based primarily on seniority, the low pay and the low status of teachers, it also welcomes the progress made in implementing the school reform, especially the increase in school autonomy, the introduction of limited merit-based pay elements, the recruitment of about 85,000 teachers (45 per cent of whom filling existing positions), the introduction of stronger accountability of school heads, the commitment to ensure that future recruiting takes place only through open competition, the introduction of school evaluation system, the introduction of mandatory traineeships and the review of apprenticeships (although concerns remain about the lack of quality criteria for the companies offering apprenticeships).

The following sections address a selection of the main issues involved in the reform programme.

5.2.1 Teacher recruitment, training and merit

The "Good Education" report envisages the exceptional recruitment of about 148,100 teachers, including teachers on fixed-term contracts entered in long-term waiting lists and the winners and those found qualified in the last competitive selection procedure, held in 2012 (including planned ordinary turnover and previously authorized positions for special needs teachers).[136] However, Law 107/2016 reduced the number of positions, quantified in the technical report at about 102,700,[137] with budgeted expenditure of €544 million for 2015, €1.8 billion for 2016 and €2.2 billion for 2025.[138]

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[133] In October 2015, the Ministry of Education adopted the National Digital Schools Plan, appropriating €1.1 billion in resources, according to the 2016 EFD.

[134] Elective courses are introduced in the final three years of secondary school, which will be incorporated in the final diploma exam (*maturità*).

[135] European Commission (2016), Commission Staff Working Document, Country Report Italy 2016, SWD(2016) 81 final, Brussels, 26 February.

[136] According to the report, the new teachers would mainly be used to: fill open positions, thereby avoiding year-long substitute teachers, strengthen teaching in certain subjects and introduce electives, increase the extended and full-time places available in primary school and the use of laboratories, increase functional staff in schools, to be used for short-term substitute assignments, complementary and extracurricular activities and contributing to innovation in the schools.

[137] The difference is in part attributable to the exclusion of those found qualified in the 2012 selection competition and the postponement of those entered in the waiting lists for nursery schools (about 23,000), pending implementation of the delegated legislation on education for the 0-6 age group.

[138] Law 107/2016 limits the duration of fixed-term contracts to three years and provides for the establishment of a fund for court-ordered indemnities (€10 million for 2015-2016). Nevertheless, Circular

The reform created the so-called “unified area teaching staff”, composed of “ordinary” positions, “special needs” positions and “special subjects” positions (who can also be used for temporary substitute teaching for periods of up to 10 days), which as from the 2016/2017 will be determined on a regional basis with an interministerial decree, having consulted the Unified Conference of central and local government, before being allotted among the “territorial zones” by the Regional Education Offices (REO).

The main development, from the point of view of managing schools, would appear to be the registration as from 2016-2017 of the staff hired under the extraordinary plan in the “territorial zones”, from which school heads can draw teachers for three-year positions in the schools. For the 2016-2017 school year, a major mobility plan is also in place, which will involve, upon application, teachers already in permanent position and then those hired under the extraordinary plan and assigned to temporary posts in 2015-2016.

After the 2015 round of hiring, Law 107/2015 establishes that recruitment shall be conducted through national competitive selection procedures on the basis of qualifications and tests held on a regional basis (but a dual channel will continue to operate, with half of the new hires to be taken from the waiting lists until these are drawn down) and sets an imminent deadline for the organising the first selection competition. The new teachers hired on open-ended contracts will enter permanent positions only after a probationary period of one year, at the end of which the school head will conduct an evaluation of their performance on the basis of criteria established by the Ministry of Education and a proceeding conducted by a “tutor” instructor, after also consulting with other teachers on a specifically formed committee (chaired by the school head). Candidate that do not pass the evaluation may serve just one additional probationary year. Delegated legislation will determine a three-year teacher training process for secondary school teachers, with a fixed-term trainee contract and the award of a teacher qualification diploma (which will also be necessary for recognized private schools) after the first year.

The schools will have to indicate their staffing needs and the tools they feel are necessary to implement the three-year educational plan, which will comprise plans for school improvement and the planning of teacher training activities. Account will be taken of the degree of curricular autonomy and the scope for flexibility (including, for example, expanding instruction in selected areas or multi-week planning of schedules). The plan will be assessed by the REO, with the results being transmitted to the Ministry of Education, in relation to the limits of the assigned teaching staff.

The reform appropriated €40 million per year for implementation of the National Education Plan and for training activities, while the kitty of €500 for each teacher in a permanent position for culture related expenses (books, theatre programmes, courses) will cost €381 million.

School heads will be given resources to award bonuses to high-performing teachers on the basis of criteria defined by the teacher evaluation committee (€200 million in 2016).

The hiring of teachers under the extraordinary plan was carried out in a number of phases in 2015, first filling “authorised” positions and then the new expanded positions. Nevertheless, the number of teachers recruited only totalled about 86,300 (including 48,800 in the expanded positions), essentially due to mismatching between teacher qualifications and the jobs available (a shortage of special needs, mathematics and

no. 3/2015 of the Minister for Public Administration established that the rules governing fixed-term work (Legislative Decree 81/2015), with the associated limits, do not apply to teachers or the administrative, technical and auxiliary staff in municipal schools.

science teachers).[139] A less important factor might have been the fact that some teachers did not apply for fear of being hired in a province far from their homes (the distribution of open positions was skewed towards the Centre and North of the country compared with the distribution of teachers).[140]

The reduction in the number of teachers hired, and the delays with which some were taken on (about 56,000 slipped from September to November), made it impossible, at least for the current school year, to drastically reduce the number of substitutes,[141] and created a pool of unused funding for hiring of about €375 million. Accordingly, with a decree of the Ministry of Education and the Ministry for the Economy and Finance of 23 December 2015, part of the savings on the hirings was allocated to funds for substitute teachers, and between December and January some contracts were paid late.[142] The instability experienced by teachers remains high, even during the year (recruitment continued after the start of the school year), creating problems for teaching continuity.

The new selection procedure (authorised with a Prime Minister's Order of 24 December 2015) envisages the hiring of 63,712 teachers on open-ended contracts in 2016-2018. According to the 2016 EFD, this would offer a solution to the problem of subjects for which there is a shortage of permanent teachers (especially mathematics). Additional hirings will be made from the waiting lists (where some 45,000 teachers are still registered, of which about a third are nursery school teachers), thereby covering teacher requirements for the three years, for a total of more than 90,000 teachers and drawing down all the secondary school teachers on waiting lists.[143] The selection procedure is running late;[144] the goal is to complete selection by August, so as to have the new teachers ready for September.

With regard to the evaluation of teacher merit, the ministerial decree establishing the allotment criteria for the bonus fund was issued (about €23,000 per school on average), based on the number of teachers and other indicators. The €500 kitty was made available, while the National

[139] The problem had been noted: see, for example, Gavosto A. (2014), "*La buona scuola tra azzardi and scarse risorse*", in *La Stampa*, 23 November.
[140] In addition, teachers who were offered annual substitute positions for 2015-2016 (perhaps close to home) were allowed to accept them in order to ensure course continuity without losing their right to a permanent position, postponing their hiring until September 2016.
[141] With nearly 99,800 substitutes on fixed-term contracts as of June in non-vacant positions (those whose regular teacher is in service elsewhere or on leave, or positions that are not included in the "authorised" staffing level but rather are only "de facto" positions) compared with 103,800 the previous year and a substantial increase in substitute teachers in temporary special needs positions (assigned, for example, following an appeal), while annual substitute assignments for vacant positions fell significantly, going from 14,405 to 5,627 (see the response of the undersecretary Davide Faraone to the urgent question no. 2-01249, 5 February 2016).
[142] MEF (2015), Press Release No. 261 of 23 December 2015, http://www.mef.gov.it/ufficio-stampa/comunicati/2015/comunicato_0263.html .
[143] See the reply to the question cited in note 13.
[144] The reasons for the delays include the preliminary revision of the selection classes (Presidential Decree no. 19 of 14 February 2016) and other factors, including difficulties in finding people to serve on the selection committees.

Education Plan is expected to be issued by the end of May. The EFD notes that thanks in part to the 2014-2020 NOP, the resources available for life-long learning amount to €400 million.

5.2.2 Evaluating schools and heads

Law 107/2015 also seeks to strengthen the National System for Evaluation of Schools (Presidential Decree no. 80 of 2013), in order to improve the quality and the assessment of school heads.[145]

The evaluation process begins with a self-assessment of the schools, based in part on the data in the Ministry of Education and INVALSI knowledge base – a sort of shared comparative "dashboard" (results of skills tests and assessments of "value added", i.e. progress achieved) – that is incorporated into the self-assessment report and the improvement plan, which are to be submitted to the director general of the REO, together with results achieved. The second stage consists of an external evaluation, with the identification of schools to be audited and visits by an external team, composed of an inspector and two experts,[146] which are followed by amendment of the improvement plans by the schools. This is followed by the implementation of the improvement initiatives, as well as reporting of the results and their dissemination on the new Ministry of Education portal (together with all other information on the schools).

The EFD emphasises that the self-assessment report has been published by 95 per cent of the schools, and in 80 per cent of cases they have complied with the standards for consistency and reliability. The visits by the external teams will be limited by the ongoing shortage of trained inspectors: initially, it seems that only 390 schools will be involved (including 20 recognized private schools), just over 4 per cent of the total.[147]

School heads are responsible for managing their financial[148] and instrumental resources and for results and the development of human resources. The heads will be assessed on the basis of the improvement in the school's results and a range of other criteria. Given the shortage of school heads, Law 107/2015 also includes provisions that are intended to resolve pending litigation over previous selection procedures. The 2016 Stability Act modified the recruitment procedure, giving the Ministry of Education, rather than the National Civil Service School, responsibility for organizing the joint training course and selection procedure for vacancies over the three-year period.

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[145] €8 million a year have been appropriated for 2016-2019 for INVALSI (National Agency for School Evaluation), for national skills tests, for participation in international testing initiative, for school self-assessments and for the evaluation visits.

[146] Some have alleged that the presence of external experts exceeds the remit specified in the enabling legislation, given that Law 10/2011 assigned that duty to inspectors only (see Falanga (2014), *"La valutazione del personale docente, delle Istituzioni scolastiche e l´autovalutazione: considerazioni di carattere giuridico"*, FGA WP no. 53.

[147] Tucci C. (2016), *"Valutazione esterna per un campione ridotto di scuole"*, *Il Sole 24 ore*, 1 March.

[148] With a decree of the Ministry of Education, in November 2015, the parameters for the allotment of the operating fund to the schools, which was increased by about €125 million a year from 2016 to 2021 by Law 107/2015. The amount per student was increased (for primary schools, from €8 to €20, for technical institutes from €24 to €36), a number of incentives were introduced and the criteria for the allotment of the new resources for work-study programmes were established (see the press release of the Ministry of education of 18 November 2015).

Law 107/2015, reprising the previous legislation (Legislative Decree 165/2001), establishes that the evaluation of school heads shall be conducted by a special team, led by a school head and composed of experts, including persons who do not belong to the regional education system, shall be connected with the three-year assignment and with performance pay. Funding for the pay of school heads was recently increased in order to reward the improvement in skills. The 2016 EFD confirms that the implementing measures are being prepared.

5.2.3 Work experience programmes

The reform also seeks to promote school programmes involving the alternation of periods of study with periods of workplace experience, to be implemented in secondary schools after the first two years of school, establishing a minimum of 400 hours of work experience per year for technical and vocational schools and 200 hours for high schools (where, individually, they are now mandatory) and appropriating €100 million per year for this purpose as from 2016 (including technical assistance and monitoring).

The scope for internships has been expanded (they are permitted when school is out of session and can be implemented through simulated firms, in non-traditional settings, such as for example museums, and even abroad). A charter of the rights and duties of students in workplace experience programmes must be prepared and the schools will have to organize training courses on workplace health and safety (by next June according to the EFD). A register of firms willing to take on students has been established with the chambers of commerce.

Young people between the ages of 15 and 25 can be hired on first-level apprenticeship contracts, which mergers workplace training with vocational education and training provided by regional institutions (Legislative Decree 81/2015, implementing Law 183/2014, the Jobs Act).

Law 183/2010 allowed the mandatory education requirement to be met with apprenticeship programmes, partly evading the increase in the legal working age to 16, which had been established, albeit after many other countries of a comparable level of development, with Law 296/06.[149] Legislative Decree 81/2015 establishes that apprenticeships of the first and third levels (advanced training and research) integrate training and work in a dual system. Another implementing decree of the Jobs Act (Legislative Decree 150/2015), in granting certain contribution relief for first-level apprenticeship contracts on an experimental basis, gives the Ministry of Labour and the Ministry of Education, in agreement with the regions, the tasks of promoting experimentation with the dual system (apprenticeships and workplace experience programmes).

According to the EFD, workplace experience programmes and apprenticeships should help counter early school leaving. Last October, the interministerial decree establishing training standards and the criteria for apprenticeship programmes was issued. The EFD explains that numerous memorandums of understanding had been reached between

[149] In most European countries education is compulsory up to the age of 16. Mandatory instruction began to be extended in the 1980s in order to reduce early school leaving and ensure that everyone received a basic educational qualification (see Eurydice Italia (2012), "*Bollettino di informazione internazionale, Sistemi scolastici europei 2012*", monograph, March.

the labour undersecretariat and regional government education counsellors for experimentation with the "dual system", while Italia Lavoro is selecting 300 vocational training centres. The Ministry of Education and Confindustria have signed a protocol of understanding for workplace experience programmes in order to develop skills relevant to the labour market. A decree of the Ministry of Education has allocated €45 million for new local employability laboratories.

5.2.4 Effects of the education reform

The 2016 EFD puts the net cost to the State budget of the measures for innovation and human capital at about €1 billion in 2015, €3.4 billion in 2016, €3.2 billion in 2017 and 2018, and €3 billion in 2019. The resources needed to finance the education reform amount to about €0.7 billion in 2015 and around €2 billion in subsequent, net of the increase in tax revenue.

The EFD puts the impact on GDP at 0.3 per cent in 2020, 0.6 per cent in 2025 and 2.4 per cent over the long term, while the impact on the budget balance is only given as from 2025, with a reduction of 0.1 points of GDP, which rises to 1 point in the long term. The lag in the emergence of the positive effects of the reform can be explained by the time necessary for the age cohorts affected by the school reforms to enter the labour market. The European Commission, in the institutional paper cited earlier, sees the education reform – within which it estimates only the impact of the increase in public spending for hiring new teachers – gradually increasing the proportion of medium and high skilled workers, as is normal in such works. The percentage increase in GDP is greater than that envisaged in the 2016 EFD in 2020 and in 2025 (equal to 0.46 and 1.04 points respectively), but only 1.4 points in 2035. The impact in terms of the budget balance as a percentage of GDP is similar (0.11 points in 2020, 0.27 in 2025 and 0.55 in 2035).

The reform is based on the principle of school autonomy and the "corporatization" of schools. While on the one hand the balanced recognition of merit could enhance the quality of instruction,[150] on the other, the introduction of competitive mechanisms (above all the selection of teachers by school heads) in a sector that bears little resemblance to competitive markets – especially due to the difficulty of measuring and evaluating output – might not ensure achievement of the hoped-for efficiency gains and could have an adverse impact on equity within the education system. The extent of this risk would depend, among other things, on the differing ability of families to gather and assess information relevant to making choices about

[150] However, note that the decision to give school heads responsibility for decisions concerning merit pay also depended on the fact that no uniform national teacher evaluation system receiving sufficient consensus from the parties involved has been developed – nor is it easy to develop such a system. Even the method for evaluating school heads and schools is still being constructed.

the education of young people,[151] and could be increased by opportunistic conduct on the part of schools (cream-skimming of more promising students) in a country that is already characterised by the strong intergenerational persistence of levels of educational attainment and social rigidity.[152]

5.3 Measures to increase the efficiency of the civil justice system

The EFD conducts a review of measures to improve the operation of the civil justice system, which form part of the reform process undertaken by recent Governments. The starting point is given by the average length of civil proceedings, which are not at the level of European standards. This translates into a very large number of pending cases. More specifically, enforcement and bankruptcy proceedings, which are essential to debt recovery (whether bank debt or otherwise), are especially long. According to Ministry of Justice data, at the end of 2014, the average effective [153] duration of a real estate enforcement proceeding in ordinary courts was 1,340 days, with a considerable degree of variability, ranging from 2,630 days in District of Catania to 515 days in the District of Trieste.[154] The average effective duration of a moveable property enforcement proceeding in the court of first instance at the national level was 210 days (368 days in the District of Reggio Calabria, 155 days in the District of Trento). The average effective length of bankruptcy proceedings was 2,894 days (7.9 years), ranging from 5,937 days (District of Messina) to 695 days (District of Campobasso).

Since a reduction in the time needed to obtain justice increases the market value of impaired receivables, measures to improve the civil justice system are of key importance. Among the measures to facilitate debt collection, the amendments to the Code of Civil Procedure simplify proceedings for forced sales and reduce the time necessary to complete them, while the changes to bankruptcy law impact company crisis resolution tools, such as composition with creditors and restructuring agreements.[155]

The rules governing composition with creditors were amended with the introduction of incentives to encourage debt restructuring as an alternative to liquidation of the debtor's assets and, at the same time, increase the rate of recovery for creditors. A new model agreement for companies whose debts to banks and other financial intermediaries are equal to at least 50 per cent of total liabilities was also introduced. An agreement reached with creditors representing at

[151] See, for example, OECD (2014) "*When is competition between schools beneficial*".

[152] The influence of schoolmates on the performance of a student (the peer effect) is considered a major factor in improving learning.

[153] The effective duration differs from that calculated with statistical indicators, which are normally used in international comparisons. Calculating the effective duration of proceedings requires the electronic "tagging" of individual cases. This was done in 2014 by the Ministry, with the special civil justice census.

[154] The figures, as do the following, regard courts belonging to the appellate court district mentioned in the text. The data were provided by the Ministry of Justice, Statistics Directorate General.

[155] Last February, the Government presented a draft enabling bill for the comprehensive reform of insolvency proceedings.

least 75 per cent of a company's financial debt is binding for all other banks or financial intermediaries.

More generally, the measures to reform civil justice sought to encourage alternative dispute resolution approaches, with the introduction of assisted negotiation and arbitration for pending suits (encouraging out-of-court solutions – Decree Law 132/2014), and tax incentives to encourage the use of civil mediation procedures.[156]

These measures to meet the demand for justice were accompanied by others impacting the supply of justice, including the gradual introduction of the electronic civil proceeding, originally conceived in legislation introduced in 2001, the establishment of innovative organizational arrangements to support judges (so-called trial offices in individual courts and courts of appeal), the hiring of public-sector employees eligible for transfer from entities with excess personnel, in order to make up the shortage of administrative personnel. In other supply measures, after the reform of the structure of the court system of 2012-2013 involving the trial courts, a second initiative involving the territorial organisation of appeals courts is being assessed, and could involve further reorganisation of the ordinary courts and justices of the peace.

Since the length of dispute resolution proceedings is not solely a question of supply and demand factors, as it also involves institutional issues, such as existing trial rules, in February 2015 the Government presented a draft enabling bill to reform the rules of civil procedure to achieve greater efficiency and specialisation, making trials more linear, faster and understandable.[157]

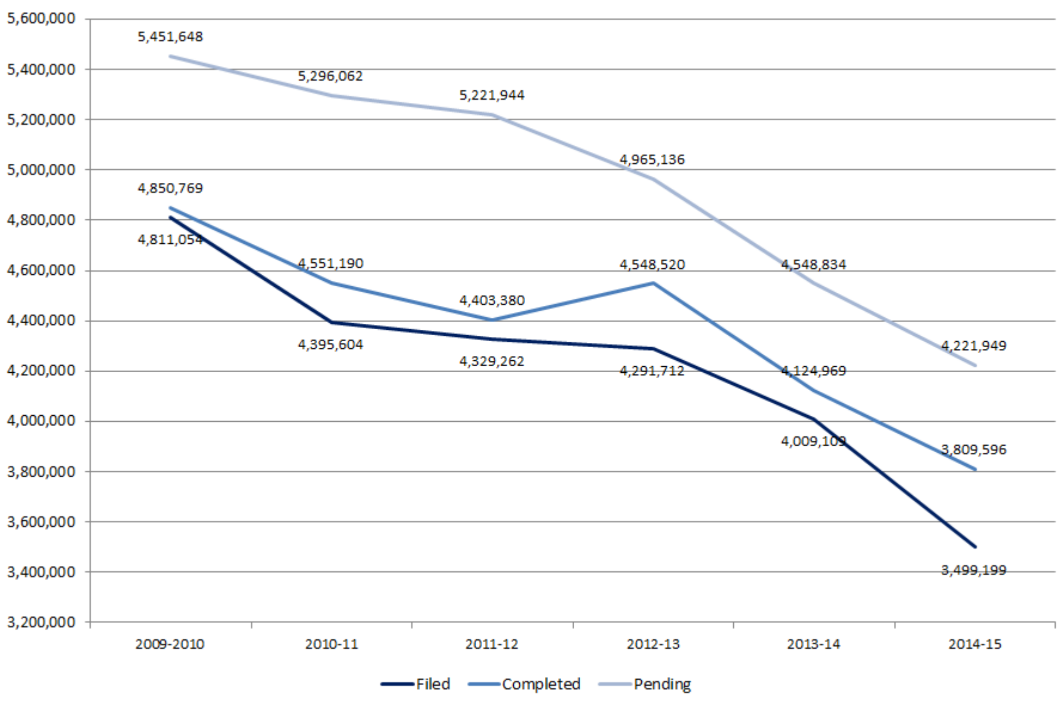
In terms of assessing the effects of the reform measures, the special census of the civil justice system of 2014 and the start of operation of the civil justice data warehouse enable us to draw some initial conclusions. In the final years of the national plan, a major reduction in overall civil litigation has begun (comprising justices of the peace, ordinary courts, juvenile courts, appeals courts and the Court of Cassation). The number of pending proceedings displays a continuous decline, from about 4.8 million at the end of the 2009-2010 judicial year to about 3.5 million at the end of 2014-2015 (Figure 5.1). In addition to the joint effects of the legislative reforms adopted by recent Governments (mediation, filtering of appeals), the reduction in the number of cases filed could be attributable to the increased cost of turning to the justice system (Decree Law 83/2012). At the moment, there is not enough information to assess the effects of increasing recourse to out-of-court solutions on the reduction in filings of new ordinary suits.[158]

[156] Civil mediation was introduced in the Italian legal system with Legislative Decree 28/2010, in implementation of Directive 52/2008/EU.

[157] The bill provides for the rationalisation of trial deadlines and the simplification of procedures. It also provides for strengthening business courts, with an extension of their competencies, and the creation of a family and personal rights court.

[158] Canzio G. (2016), "*Relazione sull'amministrazione della giustizia nell'anno 2015*".

Figure 5.1 – Flow of civil proceedings in the judicial years from 1 July 2009 to 30 June 2015 – Total court system (Court of Cassation, courts of appeal, trial courts, justices of the peace, juvenile courts)



Source: UPB based on Ministry of Justice data.

The number of pending cases before the civil courts at every level is also steadily decreasing, going from about 5.5 million at the end of the 2009-2010 judicial year to about 4.2 million at the end of 2014-15.[159] The substantial reduction in the backlog is due not only to the decline in new filings, but also to the courts' adoption of virtuous practices and reorganisation programmes with a focus on resource specialisation and efficiency enhancement.[160] Figure 5.1 shows the curve of proceedings completed is always above the curve of new filings during the year: since in each year the number of completed cases is greater than new filings, the stock of pending cases is declining.

[159]The Ministry of Justice has adopted the convention of excluding from pending civil cases any cases involving guardianship, custodianship and similar situations, cases not adjudicable by a judge and under the jurisdiction of only the ordinary courts. In practice these comprises cases that can only be closed with the death of the person involved, or with the revocation of an order of disqualification or similar measure. In short, completion of the cases does not depend on action by the court. Such cases numbered about 361,000 at the end of the 2014-2015 judicial year (30 June 2015).

[160]Canzio, G. (2016), "*Relazione sull'amministrazione della giustizia nell'anno 2015*". In order to address the backlog, in 2014 the Ministry launched the so-called "Project Strasbourg 2", which represented an attempt to replicate at the national level the successful experience of the Court of Turin. The goal is to gradually remove the origins of the backlog. The project is based on the FIFO principle (first in – first out) used by companies in managing and valuing inventories. As applied to the courts, the principle means the first suit filed is also the first to exit the court.

This positive trend is, however, accompanied by a number of critical issues. First, the Court of Cassation and the courts of appeal have been reducing the stock of pending cases at a slower pace than that provided for in the Pinto Act on the reasonable length of trials (one and two years, respectively). Second, although the number of pending cases is declining, as noted earlier, the age of proceedings is increasing, therefore increasing the number of cases in which the government could be cited for damages under the Pinto Act. The proceedings before the courts and the courts of appeal at risk of violating the Pinto Act I numbered about 1.12 million at 31 December 2014, compared with 1.05 million at 31 December 2013.[161]

[161] Barbuto, M. (2015), "*Aggiornamento del Progetto Strasburgo 2*", 30 September, Ministry of Justice. Two pieces of legislation (Decree Law 83/2012 and the 2016 Stability Act) have attempted to rationalise the rules governing indemnities, impacting both the question of the validity of claims and the amount. According to Ministry of Justice data, since the introduction of the Pinto Act (Law 89/2001), damages of €313 million have been paid, while the value of damages awarded but not yet paid amounted to about €450 million (at the end of the 2014 calendar year). See Barbuto, M. (2015), "*Aggiornamento del Censimento speciale della giustizia civile*", Ministry of Justice.

Parliamentary Budget Office
Via del Seminario, 76
00186 Roma Italy
www.upbilancio.it