2017 Budgetary Planning Report

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FOREWORD

The 2017 *Budgetary Planning Report* is devoted to analysing the 2017 Economic and Financial Document (EFD) and examines the substance of the parliamentary hearing of 19 April, developing and updating where appropriate, expanding on the analysis of the macroeconomic and public finance forecasts, the assessment of compliance with national and European fiscal rules and the sectoral analysis presented on that occasion.

The report is organised into four chapters. The first is devoted to an analysis of the EFD's macroeconomic forecasts for the period 2017-2020. The second analyses the trend and policy scenarios of the public finances, with particular attention being paid to the recent corrective budget measures for 2017, highlighting their possible impact on the revenue and expenditure account of general government. The third chapter discusses the public finance policy objectives in the light of current national and supranational fiscal rules. The fourth chapter offers a preliminary assessment of the inclusion, on an experimental basis, of a number of well-being indicators (fair and sustainable well-being) and a description of the state of progress on the National Reform Programme (NRP) for 2016 and the proposals in the NRP for 2017, accompanied by a number of thematic analyses.

The 2017-2020 policy macroeconomic scenario in the EFD is based on a structural correction of the public accounts for 2017 – now implemented with Decree Law 50/2017 – and the proposed budget for 2018-2020, which is discussed in very general terms in the EFD. According to those proposals, the measures would provide a stimulus compared with trend developments whose main impetus would derive from a reduction in indirect taxes and the fiscal burden on labour. These measures would be offset by corrective action to increase the efficiency of expenditure, measures to prevent tax evasion, increases in a number of revenue streams and action to reorganise tax expenditures. The net impact of the budget measures (including the correction for the current year) would be small reduction compared with trend in the deficit for 2017 (two-tenths of a point) and 2018 (one-tenth of a point) and a larger reduction in 2019 and 2020 (about four-tenths of a point in the first year and half a point in the second).

In the light of the available information and a very general reconstruction of the budget measures, the PBO endorsed the 2017-2020 policy scenario while underscoring the risks associated with the international environment (the emergence of US protectionist positions, the intensification of geopolitical tensions, the end of the decline in the euro, which has favoured Italian exports), with domestic conditions (an increase in Italian interest rates as a result of the widening of spreads on government securities) and with the high degree of uncertainty currently affecting the definition of the fiscal policy set out in the EFD.

The real GDP growth set out in EFD lies within the range of forecasts produced by the PBO panel (Car, Promethean and Ref.ricerche, in addition to the PBO itself), albeit at the upper bound of the interval, especially in 2018 and 2019, the year in which the contribution of domestic demand to GDP growth is largest.

Taken together, the results of the endorsement exercise point to an EFD estimate of the effects of the budget measures that falls within the impact assessments conducted in the panel forecasts (despite differences in the values of the fiscal multipliers used in the forecasting models adopted by the panel members). In view of the assumed composition of the budget measures, their overall impact, for both the PBO panel and the EFD, are virtually neutral over the forecasting period.

The PBO conducts an assessment of the risk factors threatening the Government's macroeconomic scenario, performing a number of simulations that incorporate less favourable developments, compared with the EFD, in exogenous international variables and a decline in investor confidence in Italian debt. More specifically, the simulation assumed: 1) slower growth (0.5 percentage points a year in 2017-2020) in world trade; 2) oil prices that were $10 a barrel higher in each year of 2018-2020; 3) a euro that was about 2 per cent stronger a year in 2018-2020; and 4) an increase of 100 basis points in Italian interest rates in each year of the 2018-2020 period (it is assumed that the increase involves the entire curve of domestic interest rates). These changes would have an adverse impact on real growth and domestic inflation (except in the case of an increase in oil prices), with proportionately worse consequences for growth in nominal GDP.

The public finance scenario in the EFD clearly maintains continuity with that presented in the Draft Budgetary Plan last October, which was then implemented with the subsequent Budget Act.

Compared with the forecast for net borrowing formulated in October, the policy forecast in the EFD diverges for 2017 only, since, following a request of the European Commission, the Government approved Decree Law 50/2017 correcting the deficit target from 2.3 to 2.1 per cent of GDP. In 2018-2019, the deficit as a proportion of GDP is unchanged on the earlier level (1.2 and 0.2 per cent respectively), with budget balance in effective terms forecast for 2020. The Government established that the improvement in the balance, equal to about 0.2 percentage points of GDP, forecast for 2018 and subsequent years thanks to the measures approved with Decree Law 50 shall be used to reduce part of the increase in indirect taxes triggered by the so-called "safeguard clauses".

Nevertheless, maintaining the same policy targets established last October and fully deactivating the safeguard clauses for indirect taxes would make it necessary to implement measures in the coming months with an impact of about 1 percentage point in GDP in 2018 and about 1.5 percentage points in the following two years, even without considering the need to finance additional measures announced by the Government to sustain growth and employment.

The EFD presents an undefined scenario for the corrective measures to be adopted to achieve these objectives. It refers generically to both expenditure and revenue measures, including, for the latter, additional action against tax evasion. On the expenditure side, a contribution should come from the new spending review, which is incorporated in the budget cycle as from this year and is based on a top-down approach to the definition of targets. The EFD set a goal of at least €1 billion a year in savings to be achieved by central government departments. At the moment, however, the application of the new procedure appears to lack a number of important steps if the targets are to be achieved in full, such as, for example, an indication in the EFD of the structure of policy revenue and expenditure broken down by subsector, especially those of the State.

With regard to the public debt, 2016 closed with a further - albeit slight - increase in the debt/GDP ratio (to 132.6 per cent). The policy scenario, even including possible support for the banking system, envisages a slight reduction in the ratio as soon as 2017 (-0.1 percentage points) and a subsequent sharper drop to 125.7 per cent in 2020.

There are a number of uncertainties weighing on this scenario, first and foremost the start of the normalisation of monetary policy in 2018: the ECB's reduction of its programme for purchasing sovereign debt could be accompanied by a notable increase in the cost of servicing the debt, perhaps greater than that already projected in the EFD policy scenario. Further doubts concern privatisation receipts (which have been reduced to 0.3 percentage points of GDP a year), for which insufficient information to assess credibility has far been provided so far, and nominal GDP growth that lies at the upper limit of the PBO panel's forecasts.

With regard to compliance with fiscal rules, the 2017 EFD confirms the objectives set out in earlier policy documents, notably the achievement of structural budget balance by 2019. The government document also leaves open the possibility of a less restrictive budget stance in 2018-2019 if EU institutions opt for a more flexible interpretation of the Stability and Growth Pact.

Some past choices, however, also affect assessment of compliance with fiscal rules in the present. The public investment plan linked to the request for flexibility in 2016 under the investment clause was only partially implemented, due in part to normal delays associated with the beginning of the new programming cycle for the Structural Funds. Although this did not affect the level of investment funded entirely by national funds, the slower-than-expected implementation of the programme in 2016 may have contributed to the fall in overall level of public investment compared with 2015 (-4.5 per cent), a violation of one of the conditions for granting the flexibility under the clause. A definitive conclusion by the European Commission will be issued after the publication of the Spring Forecasts, considering first the precondition for eligibility for the clause – which, as noted, requires that the overall expenditure aggregate not be lower in 2016 than in 2015 – and, second, the actual amount of expenditure to be considered for the purpose of the clause.

The decision to implement a fiscal policy for 2016-2017 that brings the budget close to the limit of a significant deviation from the fiscal rules in annual terms means that there is a risk of a significant deviation on a biennial basis in 2017. The inadvisability of an excessively restrictive fiscal stance appears to have been implicitly acknowledged by the European Commission itself, which – in calling for a structural adjustment of 0.2 percentage points of GDP – has in fact only requested that the deviation be rectified in annual terms.

On the other hand, the results of the monitoring of the expenditure benchmark, which are only partly affected by the challenges of measuring potential GDP and the output gap, appear to be more encouraging than those for the structural balance. This once again underscores the problems associated with a system of rules based mainly on variables that are exposed to significant measurement difficulties. In this regard, the recent agreement, approved by the EU Council (ECOFIN) at the end of last year, to formulate mid-year recommendations for countries such as Italy that have not yet achieved the medium-term objective (MTO) both in terms of changes in the structural balance and growth in the expenditure benchmark (net of discretionary revenue measures) is a welcome development.

In 2018-2020, the policy scenario for the structural balance appears fully compliant with European and national rules. Nevertheless, the debt/GDP ratio, although expected to decline, will not do so sufficiently to ensure compliance with the numerical rule within the policy horizon.

The inclusion for the first time of a number of well-being indicators (fair and sustainable well-being) in the EFD is another welcome development. Supplementing information on developments in the main macroeconomic variables with information on variables relevant for the quality of life and the environment provides a more complete picture of the information on which economic policy action is based. It permits an ex-post assessment of the results achieved and provides greater transparency on public decisions. However, a number of critical issues have emerged regarding the presentation of policy forecasts of indicators for the 2017-2020 period. Unlike the trend forecasts, these projections should reflect the effects of the measures contained in the budget package and the reforms outlined in the National Reform Programme (NRP). In April, with no information on the composition of the budget measures, it would be preferable for the EFD to report only a trend assessment of the indicators accompanied by the objectives that the Government intends to pursue (possibly consistent with the commitments taken at the European level with the Europe 2020 Strategy and internationally with Agenda 2030 for Sustainable Development), postponing the presentation of the policy developments in the indicators until after the approval of the Budget Act, for example in the Report to the competent parliamentary committees scheduled for 15 February each year.

With regard to the content of the NRP, the programme limits itself to confirming the reform plans outlined in earlier policy documents. This probably also reflects the fact that it was prepared at the end of the legislature. The chapter provides a brief description of the state of implementation of the provisions of the 2016 NRP for a number of specific areas (labour market, social policies, the tax system and tax evasion, public administration and education), of the European Commission's observations from last February and of the reform proposals contained in the 2017 NRP.

Among the labour market policies announced, particular importance is given to the commitment to reduce the tax wedge on lower incomes, and specifically on second wage earners in households, suggesting a form of taxation that fosters female employment. The chapter contains two in-depth analyses. The first shows that the differences between international tax systems do not seem sufficient on their own to explain the poor performance of female employment in Italy. Furthermore, the Italian tax system is not the most unfavourable in terms of the presence of factors that penalise female participation in the labour market, thanks in part to the fact that the basic tax unit is the individual and not the household. On the contrary, there is a robust positive correlation between the female employment rate and the supply of public services. The second in-depth study conducts a review of temporary and permanent incentive measures introduced in recent years to stimulate job creation and increase productivity. It emphasises in particular that new relief measures should only be implemented after an examination of the effectiveness of previous or existing measures in order to target the choice among different possible instruments more effectively and after a survey and reorganisation of those still in place to avoid fragmentation of the tax relief system and overlap and competition between measures (e.g. among those adopted at the regional or sub-regional level).

With regard to social policy, the "Inclusion Income" will be introduced in a system still characterised by multiple means-tested measures with different eligibility criteria focused on specific categories of beneficiaries that do not reduce the risk of poverty among the most vulnerable segments of the population. The extension of the new instrument to all households in a situation of absolute poverty will depend on the appropriation of additional resources and the possibility of the broader integration of the various existing measures into one instrument. Estimates performed in 2013 by the Minimum Income Working Group established by the Ministry of Labour and Social Policies put the cost of a measure that will completely bridge the existing gap between disposable income and the poverty level for all households in a situation of absolute poverty at between €5 and 7 billion.

Finally, with regard to taxation and, in particular, the Government's announcement that it would continue to reduce the fiscal burden to support growth and competitiveness, an in-depth analysis looks at developments in the tax burden in recent years. It finds that the decline mainly involved taxation of capital, through changes in the structure of corporate taxation and more contingent measures to facilitate and encourage investment. In particular, considering the sum of direct taxes and IRAP (the regional business tax), we find that between 2013 and 2015 (the last year for which information on individual taxes by general government body is available) revenue declined by half a percentage point of GDP, a drop that increased to nearly 1 point in 2016. However, this decrease appears to have been highly skewed towards corporate taxes. IRES (corporate income tax) and IRAP revenue in the last eight years has fallen by about 1.7 percentage points of GDP (from 5.4 per cent in 2007 to 3.6 per cent in 2015).

1. THE MACROECONOMIC ENVIRONMENT

1.1 The international economy

After the slowdown in the first half of 2016, the world economy posted a moderate acceleration, which has strengthened in the most recent period.

The general stability of the pace of expansion in the advanced countries was accompanied by an improvement in the emerging economies. More specifically, the United States experienced a slowdown in the last quarter of 2016 and an even sharper one in the first three months of 2017. Based on the available data for the second quarter, this should be a temporary phenomenon, partly amplified by the provisional nature of the data. The pace of growth at the end of 2016 was virtually unchanged in the euro area and in Japan. For the euro area, the signs for the first few months of 2017 remain positive. In the emerging economies, the recovery in commodity prices has favoured exporting countries, particularly Russia and Brazil, which could return to growth in the current year. According to leading indicators, global economic activity posted further gains in the first few months of 2017.

Along with the improvement in the overall outlook for growth, the turnaround in commodity prices has driven price dynamics in the major economies. The presence of unused capacity, especially in Europe, is still moderating pressure from the core components of inflation.

In this more positive scenario, widespread sources of risk remain. These are linked to uncertainty about the stance of US trade policy, the outcome of elections in several European countries and the direction of the negotiations over Brexit that have just begun. The intensification of geopolitical tensions over the last few weeks has fuelled risk in the global environment.

The improvement in economic conditions has been partially incorporated in the most recent forecasts of international bodies. In March, the OECD confirmed its forecast for world GDP growth in 2017 (3.3 per cent) and a moderate acceleration in 2018 (to 3.6 per cent; Table 1.1), interrupting the downward revisions that had marked the previous forecasting rounds. In April, the International Monetary Fund (IMF) marginally increased its forecast for world growth in 2017 (to 3.5 per cent), while maintaining its 2018 forecast (3.6 per cent). The forecasts for world growth in the Economic and Financial Document (EFD) for 2017 and 2018 (3.3 and 3.5 per cent respectively) are close to these projections, essentially confirming the forecasts in the Update to the EFD published last September. The EFD also forecasts a partial deceleration in global GDP growth in 2019 (to 3.3 per cent, in line with the Update) and stabilisation in 2020.

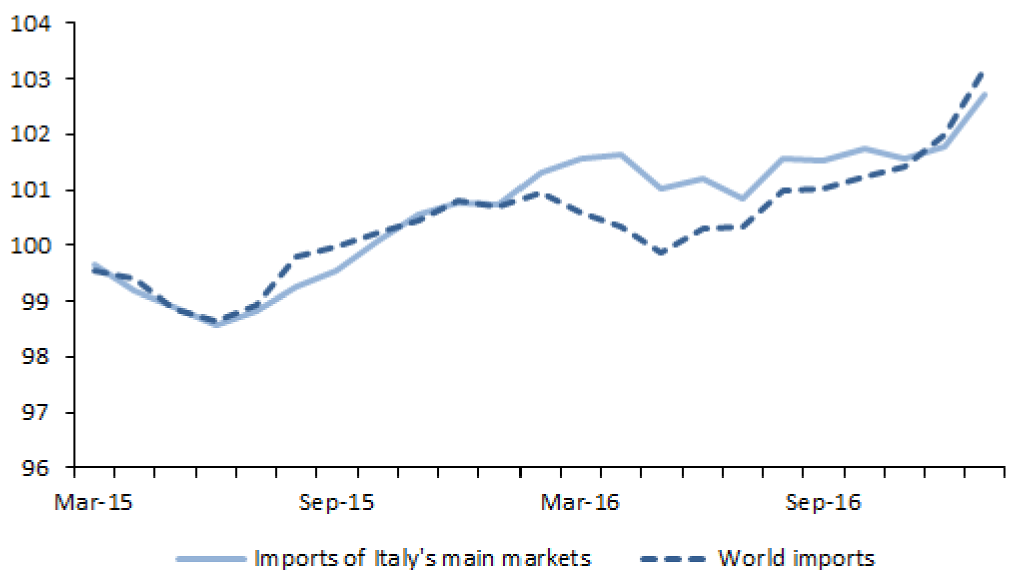
Table 1.1 – Growth in world GDP based on the most recent forecasts
(percentage growth rates)

	2016	2017	2018
OECD (March)	3.0	3.3 (+0.0 compared with the forecast in November)	3.6 (+0.0 compared with the forecast in November)
IMF (April)	3.1	3.5 (+0.1 compared with the forecast in October)	3.6 (+0.0 compared with the forecast in October)
EFD (April)	3.1	3.3 (-0.1 compared with the forecast in September)	3.5 (+0.0 compared with the forecast in September)

Sources: OECD (2017), *Interim Economic Outlook*, 7 March; IMF (2017), *World Economic Outlook*, 18 April; EFD, 11 April 2016

After several months of modest expansion, since the end of last summer international trade has grown more rapidly. The improvement, which has involved both the advanced and emerging countries, has translated into a more robust expansion in the most important markets for Italian exports (Figure 1.1). Looking ahead, the strengthening of world trade should continue, even though the elasticity of trade to global growth will remain below the long-term average. In its April forecast, the IMF projects trade growth of 3.8 per cent in the current year (unchanged compared with October), while for 2018 trade growth is expected to be 3.9 per cent (a reduction of 0.2 percentage points on the October forecast). The EFD forecasts for 2017-2018 (3.4 and 3.5 per cent) are slightly lower than these projections. Compared with the Update, the EFD forecast implies a significant upward correction for the current year and broad continuity in 2018 and 2019 (when international trade growth is put at 3.9 per cent). In 2020, the EFD forecasts a slightly slower pace of global trade growth (3.7 per cent) than the previous year.

Figure 1.1 – World imports and Italy's main destination markets
(3-month moving average; index, 2015=100)

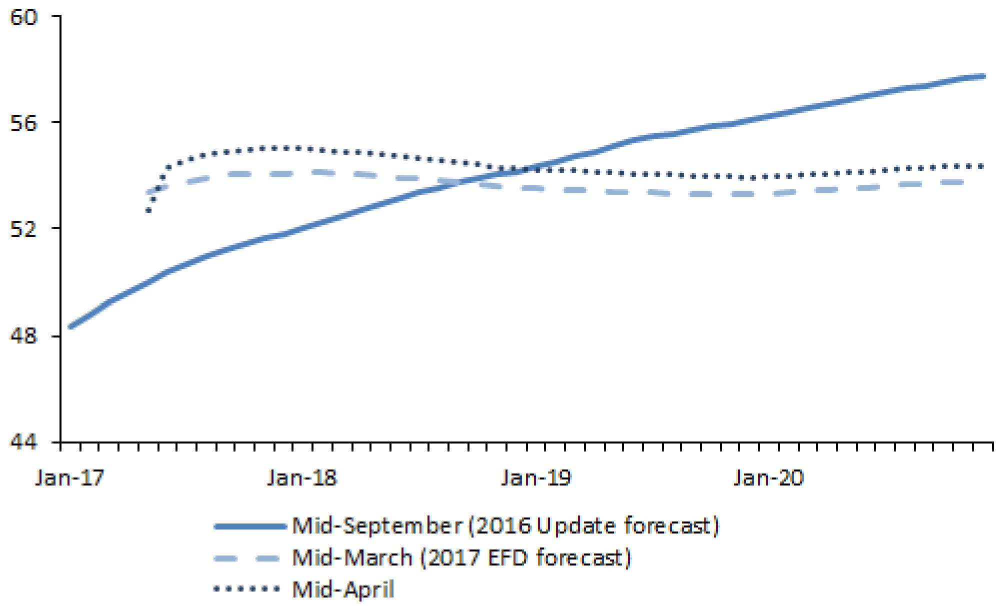


With regard to commodities, the November agreement between the OPEC countries to reduce production quotas impacted the price of oil, which in the space of a couple of weeks rose by about $12 per barrel, reaching $55 at the beginning of December. Subsequently, prices fluctuated around that level. The outlook for the coming years will be affected by a gradual increase in consumer demand, the supply-side uncertainties associated with the capacity of the OPEC countries to stick to their agreement and the expansion of unconventional production in the United States. On the basis of futures markets in mid-April, after the spike in 2017, oil prices should be broadly stable at around $53.5 per barrel (Figure 1.2). The EFD forecasts, which are based on forward prices recorded in the first ten days of March ($54.4 in 2017, $53.8 in 2018, $53.4 in 2019 and $53.6 in 2020), are essentially in line with these levels. Compared with the forecasts in the Update, the projection for the average price in 2017 is about $2 a barrel higher, while for those for 2018 and 2019 are $1.5 and $4 lower respectively.

Between the second week of November, in conjunction with the US presidential elections, and mid-December, the dollar appreciated considerably against the euro, rising almost 7 per cent in just over a month. The appreciation reflected the change in perspective about the economic policy stance announced by the new US president (fiscal stimulus and protectionist measures) and the expected monetary policy response. Subsequently, the dollar fluctuated against the euro without showing a clear trend, probably also affected by uncertainties about the actual policy choices of the US administration. Expectations reflected in forward exchange rates point to a progressive weakening of the dollar against the euro, on the order of just over 2 per cent annually. The EFD forecast is not in line with these expectations because it adopts a technical assumption of constant exchange rates, in accordance with the procedure recommended by the code of conduct of the European Commission.

On the monetary policy side, the Federal Reserve resumed interest rate increases after a protracted interruption (they were nudged upwards in December and March), announcing it would continue to do so in 2017. In the euro area, expectations are for a prolonged period of stable official interest rates, albeit with a gradual winding down of the asset purchase programme in 2018, which would result in higher market rates. This assumption is in fact incorporated in the EFD scenario, which forecasts larger increases in rates than those assumed in the Update of last September (short-term rates rise from marginally negative in 2017 to 0.5 per cent in 2018, 1.2 per cent in 2019 and to 1.8 per cent in 2020, registering a cumulative increase of two percentage points over the forecasting period).

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



Ultimately, the forecasts in the EFD appear to be substantially consistent with the latest projections produced by international bodies for world growth, trade and oil prices. However, they diverge from market expectations with regard to the technical assumption of exchange rate stability. Compared with the Update, the new exogenous scenario in the EFD provides a greater boost to growth (through exports) and inflation in the Italian economy in 2017 as a result of faster growth in world trade, the depreciation of the euro and the rise in oil prices. For the following years, the new values for exogenous international variables point to relatively weaker pressures on inflation, due to the assumption of virtually no change in oil prices, and the potential braking effect of rising interest rates on growth in domestic demand.

1.2 The Italian economy

In 2016, the Italian economy continued along the path of slow recovery that began in the central months of 2013. Correcting for calendar effects, GDP increased by 1 per cent on average in 2016. On an unadjusted basis, without taking account of the different number of working days, the increase was 0.9 per cent. GDP growth in the fourth quarter of 2016 (0.2 per cent) had a carry-over impact on 2017 of 0.3 per cent.

Final domestic demand (net of changes in inventories) made a positive contribution to GDP growth. Conversely, changes in inventories subtracted about 0.5 percentage points from 2016 growth, the result of a deceleration that mainly occurred in the first half of the year. The contribution of net exports was essentially nil on average for the year.

Private consumption slowed from its buoyant pace in early 2016, and was only marginally positive in the last three months of last year. The slowdown in household spending reflected the weakening of growth in household purchasing power (0.9 per cent in the fourth quarter, compared with 2.1 per cent in January-March 2016) and, for the fifth consecutive quarter, a decline in household confidence.

The quarterly national accounts data released by Istat last March shows a general improvement in total investment, with growth rates of more than a percentage point in all quarters with the exception of the second (which nevertheless registered growth of 0.4 per cent). The recovery in the rate of capital accumulation has been driven by the persistent strength of investment in transport equipment, accompanied by a recovery of investment in plant and machinery, fostered in part by tax relief measures. Investment in construction grew only slightly, largely fuelled by the residential component. The environment of gradual improvement is confirmed by the profitability indicators of firms, which continued to post gains.

After the slowdown in the third quarter, export growth recovered in the last three months of 2016, benefiting from the acceleration in world trade and the depreciation of the euro. Imports followed a similar trajectory, driven in part by the recovery in investment observed in the final part of 2016.

The more favourable economic environment improved bank credit quality indicators in the fourth quarter of 2016. Surveys of firms and banks show a moderate improvement in credit conditions in the early months of 2017. However, the terms of access to bank financing continued to differ by size class and business sector (being relatively more favourable for larger borrowers in manufacturing and services than for construction companies). Positive signals also emerge from household lending, which accelerated in February, driven by rising demand for mortgages for home purchases. The cost of credit, which was stable in February, remains at historically low levels.

The data available for the first months of 2017 point to continued economic growth, despite the recent decline in manufacturing output, which was impacted by statistical volatility associated with the number of working days.

According to PBO estimates, industrial production in the first quarter fell by 0.2 per cent compared with the first quarter of 2016. By contrast, qualitative indicators paint a positive picture: in March the Purchasing Managers' Index (PMI) for manufacturing reached its highest level in more than six years. Similar indications come from the confidence index for manufacturing firms, which has been improving progressively since last autumn and is well above its long-term average. In the construction industry, the production index remains volatile, contrasting with the clear expansionary trend visible in the sectoral confidence index. Positive signals also emerge from the real estate market, which continued to grow even in the latter part of 2016. In addition, the rise in sales has been accompanied by price stabilisation after some five consecutive years of decline. As far as other sectors are concerned, the rise in the sentiment of service companies and retailers suggests that the recovery phase may also involve these segments.

Overall, economic conditions suggest the possibility of continuing recovery. Based on the forecasts produced with the short-term PBO models, GDP is expected to grow by about 0.2 per cent in the first three months of 2017, and then accelerate in the next quarter.

According to Istat’s preliminary estimates, inflation rose to 1.8 per cent in April (from 1.4 per cent in March), mainly reflecting the rise in the prices of regulated energy products and transport services. Core inflation, which excludes the prices of energy products and unprocessed food, rose to 1 per cent (0.7 per cent in March). This reflected the transmission to final prices of past increases in commodity prices. However, internal inflationary pressures remain weak. Istat surveys of household and business expectations in April point to an attenuation of the pace of inflation.

National accounts data indicate a continuation of employment growth in the fourth quarter of 2016 (equivalent labour units on open-ended contracts) on both a quarter-on-quarter basis (0.3 per cent) and a year-on-year basis (1.2 per cent).

This performance is confirmed both on the supply side (labour force survey) and the demand side (an increase in jobs recorded in the mandatory reports of the Ministry of Labour and INPS administrative data). The growth in employment is entirely attributable to payroll employment in the manufacturing and services sectors. In February, the level of employment was unchanged on the previous month.

1.3 The macroeconomic forecasts in the EFD

After the GDP growth of 0.9 per cent in unadjusted terms in 2016 (compared with 0.8 per cent in the DBP), the EFD forecasts trend growth of 1.1 per cent in 2017, falling slightly to 1 per cent in 2018 (the year in which the increase in VAT under the safeguard clause is triggered), before returning to 1.1 per cent in 2019 and 2020. Compared with the DBP, these projections represent an upwards adjustment of one-tenth of a point for 2017 and a decrease of about one-tenth of a point for 2018 and 2019.[1] The slight improvement in the forecast for 2017 reflects more favourable assumptions about exogenous international variables. The decrease in the forecasts for 2018 and 2019 reflect slower growth in domestic demand than assumed last October, which is affected by less favourable developments in interest rates. Even with these adjustments, the trend growth in the EFD scenario continues to be driven, as in the DBP, by the expansion of domestic demand. With regard to inflation, the EFD increases the GDP deflator in 2017 by one-tenth of a point, reflecting the greater pressure engendered by the weakening of the euro and the increase in oil prices. In subsequent years, the deflator is reduced by one-tenth of a point compared with the DBP assumptions. Given the revisions of real growth and the GDP deflator, the growth in nominal GDP (2.2 per cent in 2017, 2.9 per cent in 2018 and 2019) rises by two-tenths of a point in 2017 compared with the DBP framework and decreases by about two-tenths of a point in the next two years. In 2020, which lies outside the DBP forecasting horizon, nominal GDP growth is essentially in line with that for the previous two years.

This trend scenario forms the basis of the EFD policy forecasts, which reflect the structural adjustment of the public accounts in 2017 and a budget package for 2018-

[1] The trend macroeconomic scenario in the EFD, which was prepared on the basis of the 2017 Budget Act, is compared with the policy scenario from last October's DBP, which was constructed on the basis of the proposed budget measures that were then incorporated in the Budget Act.

2020 characterised by a reduction in the weight of indirect taxes, measures to reduce the fiscal burden and compensatory measures to curb expenditure and counter tax evasion. The policy public finance scenario is relatively more restrictive than the trend scenario, with the deficit falling by two-tenths of a point in 2017, one tenth in 2018 and about four-tenths in 2019 and 2020. Nevertheless, given the composition of the budget measures set out in the EFD, the overall impact on growth is substantially neutral over the forecasting period. GDP growth in particular is in line with the trend projections for 2017 and 2018, a tenth of a point lower in 2019 and broadly in line with that for 2020. As regards the components of expenditure, in 2018 the budget measures shift the driver of growth slightly towards domestic demand, thanks to their favourable impact on consumption. By contrast, in 2019 and, partially, in 2020, net foreign demand is stronger, offsetting (but only partially in 2019) the weakening of domestic demand. The latter mainly reflects the easing of investment growth, which is more pronounced in 2019. The GDP deflator rises slightly in 2017 but declines in 2018 thanks to the reduction in indirect taxes before essentially aligning with developments in the trend scenario in last two years. As a result of developments in real growth and inflation, nominal GDP growth is marginally faster in 2017, slower in 2018 and in line with the trend scenario in 2019 and 2020. As a result of measures to lower social security contributions, employment tends to improve over the forecasting period, with the unemployment rate falling to 10 per cent by the end of the interval.

The output gap, which is estimated in the policy scenario at -2.7 per cent in 2016, declines to -1.8 per cent this year, -1.1 per cent in 2018 and -0.5 per cent in 2019 before disappearing in 2020. These estimates, based on the method agreed at the EU level, differ from those of the European Commission, which in the Winter Forecast in February assumed a smaller output gap for 2017 (-0.8 per cent) and 2018 (zero). These disparities reflect differences in the underlying macroeconomic forecasts and, above all, the time horizon of the estimates (four years in the EFD, compared with two for the Commission) and the procedure for identifying constraints on the initialization of variances for the calculation of structural unemployment and the so-called priors for estimating total factor productivity. As these differences demonstrate, the estimate of the output gap, which is crucial for the application of EU rules, has become especially uncertain in recent years, reflecting the difficulty of distinguishing the temporary and permanent components of the developments in economic activity. Different processes for extracting the trend in the same model can produce a very broad range of estimates (see Analysis 1.1 *Alternative Estimates of Potential Output and the Output Gap*).

1.4 Endorsement of the macroeconomic scenario

The PBO assessed the macroeconomic scenarios published in the EFD for the 2017-2020 forecasting period. Although European legislation only requires endorsement of policy forecasts, in agreement with the Ministry for the Economy and Finance (MEF), the PBO extends its endorsement process to comprise the macroeconomic forecasts in the trend scenario.

The PBO sent its letter endorsing the trend macroeconomic forecasts for 2017-2020 last March. This letter was then published on the PBO website, with a note explaining the endorsement exercise and discussing the risks inherent in the estimates (http://en.upbilancio.it/trend-macroeconomic-scenario-for-2017-2020-presented-in-2017-efd-endorsed/). The endorsement of the trend scenario occurred after the PBO had reported its findings on a provisional version of the government forecasts, which was followed by the preparation of a new trend macroeconomic scenario by the MEF, which was endorsed.

The PBO also endorsed the 2017-2020 policy macroeconomic framework published in EFD, sending the endorsement letter to the MEF today (19 April).

Briefly, the methodology adopted in the endorsement exercise involved the following aspects. It was based on a comprehensive analysis of the macroeconomic scenarios proposed by the MEF using: a) the PBO estimates for short-term developments in GDP and the main components of demand; b) the annual forecasts obtained by the PBO with the forecasting model of Istat, which was 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) that form part of the PBO forecasting panel. In addition, the PBO also monitored the 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 used by the MEF (world trade, oil prices, exchange rates, interest rates). In addition, for the policy scenario, the PBO panellists based their assessments on general hypotheses about the corrective measures for 2017 and the 2018-2020 budget measures developed by the PBO in accordance with the indications in the EFD and contacts with the MEF. To supplement the following analysis, Box 1.1 addresses the factors that contributed to determining the PBO forecasting error for 2016, which prompted the modification of the PBO's 2017 forecast .

Figures 1.3-1.5 set out the main results of the analysis. Overall, the trend macroeconomic scenario appears to lie within the acceptable range of forecasts, although it does approach the extreme values of that range. On the other hand, the panel forecasts are characterised by a relatively broad dispersion around the central values, denoting greater uncertainty than in the past.

More specifically, the EFD trend forecast for growth in 2017 lies within the forecast range (although it is above the median value). From 2018, is close to the maximum value of panel forecasts. In 2019, the MEF trend forecast for growth is slightly higher than the upper bound of the panel projections. Similar developments are found for nominal GDP growth, which in 2020 exceeds the upper limit of the panel forecasts. However, given the high degree of uncertainty involved, the PBO's endorsement of the overall trend scenario despite the presence of these isolated critical values takes account of the small size of the divergences (one-tenth of a point for both real and nominal GDP growth). Nevertheless, the fact that the MEF projections lie close to the upper limit of the panel forecasts for nearly the entire forecasting period (with the distance from the central values of the PBO panel projections widening in a number of years) prompted the PBO to underscore the risk factors in the trend scenario that could impact the policy scenario.

The proximity of the MEF trend forecasts to the upper bound of the panel forecasts as from 2018 appears to primarily reflect assumptions about certain components of final domestic demand. More specifically, the growth in investment in construction and in final domestic consumption appear higher than the upper bound of the panel range for most of the forecasting period.

For the inflation scenario, the trend developments in the deflator of private consumption envisaged in the EFD are within the range of the PBO panel forecasts, reflecting the effects of higher imported inflation in 2017 and the increase in VAT rates in 2018 and, in part, 2019. Differences in the assumptions about the evolution of the terms of trade bring the trend forecast for the GDP deflator close to the upper limit of the panel forecasts in 2020.

The analysis of the policy scenario covers the entire 2017-2020 period, which is affected by the structural correction of the public accounts in 2017 and the assumed budget measures for 2018-2020. A rough reconstruction of the budget measures was prepared by the PBO – and agreed with the panel forecasters – on the basis of the general indications contained in the EFD and the dialogue with the MEF on this issue. Thus, taking due account of the high level of uncertainty that characterises the definition of a budget policy framework, the measures would provide a stimulus compared with trend developments whose main impetus would derive from a reduction in indirect taxes and the fiscal burden on labour. These measures would be offset by corrective action to increase the efficiency of expenditure, measures to prevent tax evasion, increases in a number of revenue streams and action to reorganise tax expenditures. The net impact of the budget measures (including the correction for the current year) would be a small reduction compared with trend in the deficit for 2017 (two-tenths of a point) and 2018 (one-tenth of a point) and a larger reduction in 2019 and 2020 (about four-tenths of a point).

Based on these assumptions, real GDP growth in the policy scenario lies within the panel's forecasting interval (Figures 1.4 and 1.5). In this scenario, the slight divergence that characterised the trend scenario in 2019 is eliminated. However, real GDP growth is at the upper bound of the PBO panel forecasts, especially in 2018-2019. On the other hand, the distance from the central values of the panel forecasts, while persisting, decreases with respect to the trend scenario.

Taken together, the results point to an EFD estimate of the effects of the budget measures that falls within the impact assessments conducted in the panel forecasts. The dispersion observed for the latter in the trend scenario is essentially unchanged in the policy scenario, due in part to differences in the values of the multipliers associated with the various budget items used in the forecasting models adopted by the panel members (see Analysis 1.2). In general, in view of the assumed composition of the budget measures, their overall impact, for both the PBO panel and the EFD, are virtually neutral over the forecasting period.

Figure 1.3 – Comparison of the Government's trend scenario with the PBO panel forecasts

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

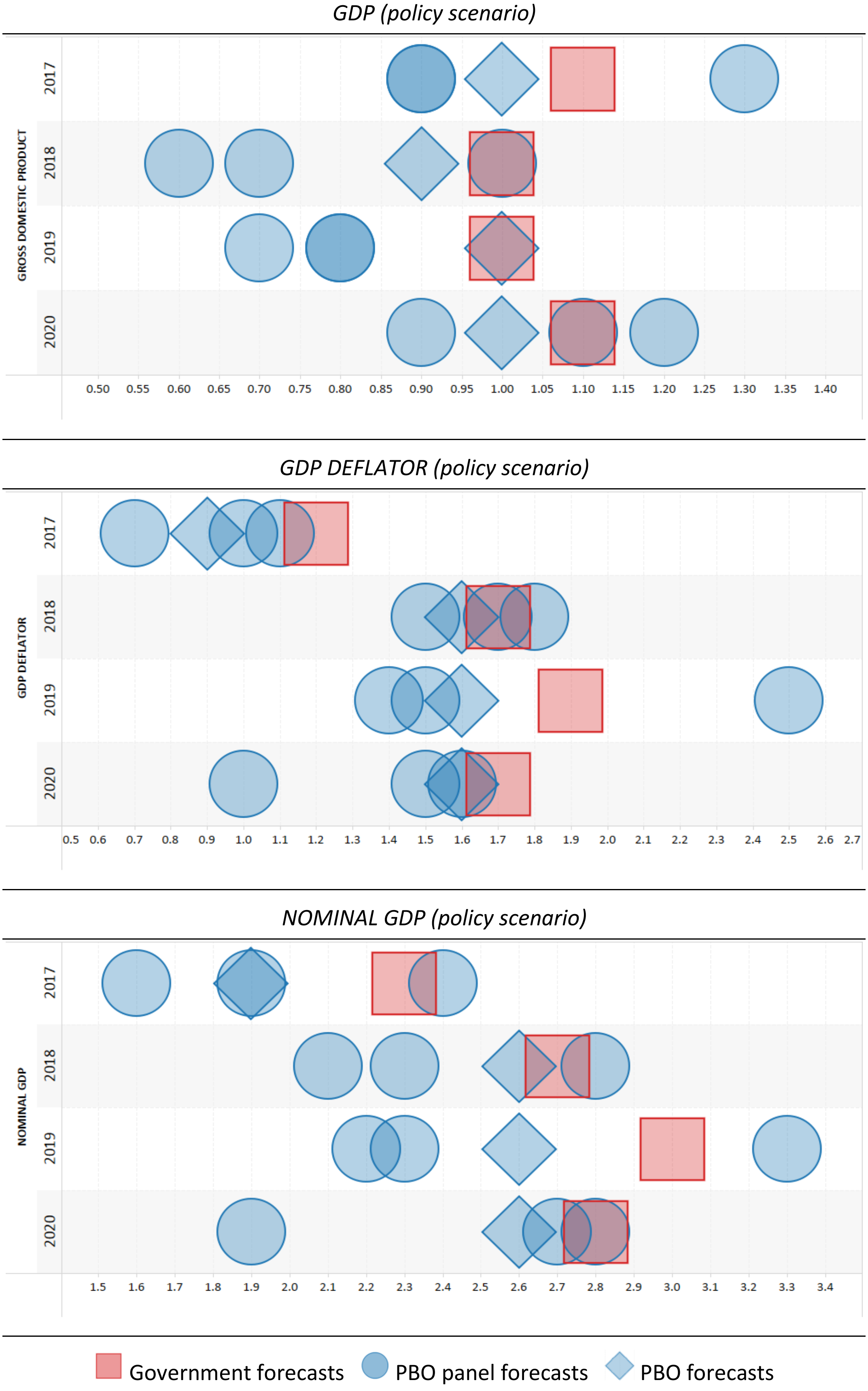
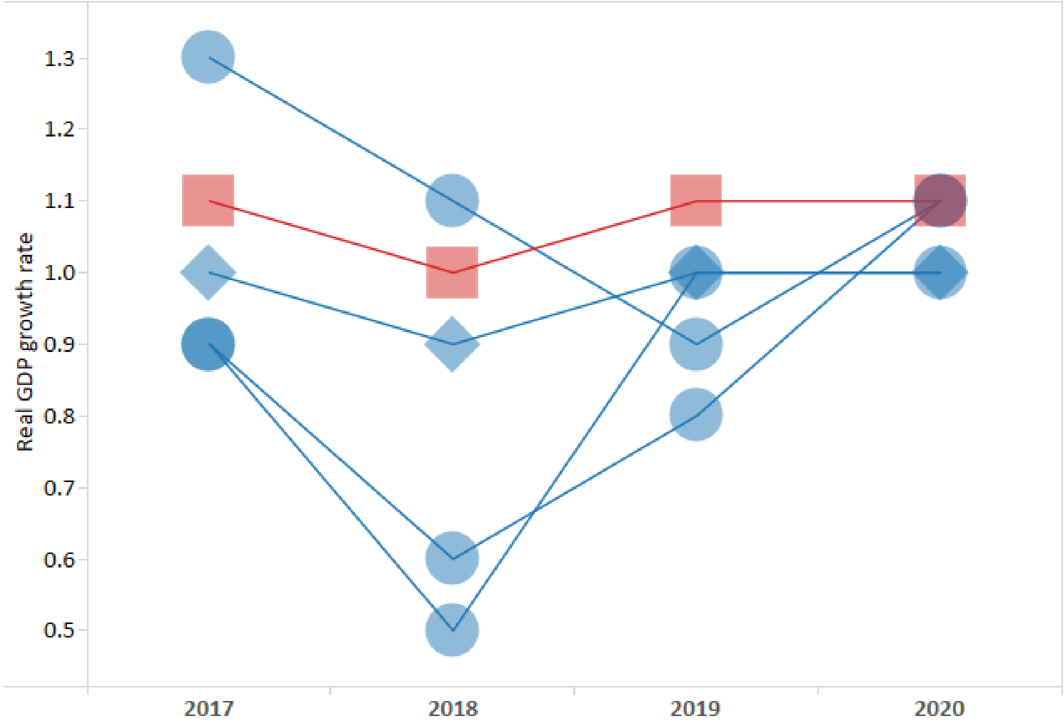
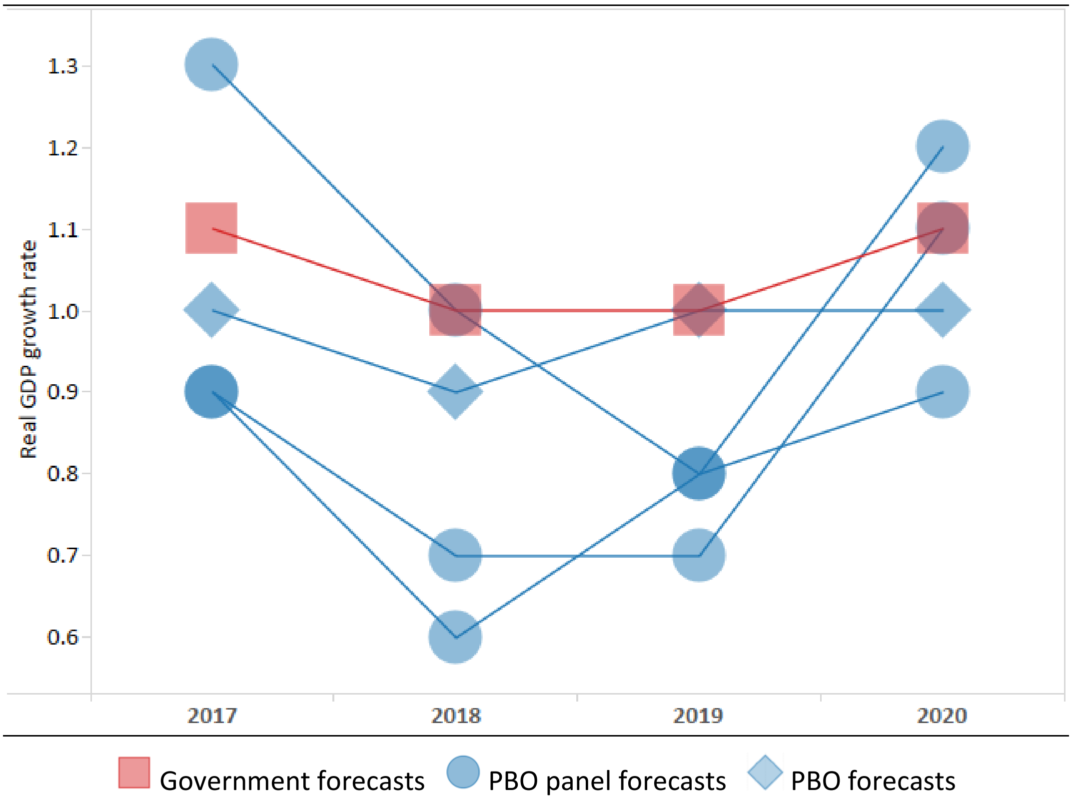


Figure 1.5 – Trend and policy developments in real GDP

Trend



Policy



In the policy scenario, the assumption of faster growth in domestic final consumption than the upper bound of the PBO panel forecasts, particularly in 2018 and 2019, remains. In the latter year, the contribution of domestic demand to GDP growth is also larger. These dynamics mainly reflect developments in household consumption, which in 2018 lie beyond the upper limit of the PBO forecasting range, and the assumption of more robust growth in public consumption in 2018 and 2019. This presumably reflects differences in the assumptions of the panel forecasters and the EFD about the price/quantity breakdown of the reduction (at current prices) in public consumption.

The growth in nominal GDP in the policy scenario also falls within the forecasting interval. As with real growth, the overshoot (in 2020) observed in the trend scenario with respect to the upper limit of the PBO panel is eliminated.

These comparisons place the policy forecasts in the EFD (with regard to both real GDP and nominal GDP) in compliance with the criteria for acceptability adopted by the PBO. However, even if attenuated, the element of risk threatening the trend scenario remains. The forecast for real growth lies, especially in 2018-2019, near the upper limit of the PBO panel forecasts. This constitutes a potential negative risk for the EFD forecast, especially in light of the diverse sources of uncertainty that shadow the global environment.

1.5 Threats to the forecasts

A number of factors of uncertainty involving both the external and internal situation loom over the macroeconomic scenario.

The international risk factors threatening the forecasts can essentially be summarised in three points: a) the effective materialisation of a protectionist stance in the United States and, in response, in other economic areas, thereby slowing international trade; b) the intensification of tensions on the world stage, with repercussions on commodity markets and, in particular, on oil prices; c) the end, as foreshadowed by expectations on forward markets, of the strengthening of the dollar and, symmetrically, the weakness of the euro that marked the arrival of the new US president.

With regard to factors of internal uncertainty, one element of risk is the possibility of an increase in domestic interest rates due to a fall in investor confidence and a persistent increase in the spreads on Italian government securities.

In addition to having different degrees of probability, these events could occur as alternatives or complements to each other. For example, a significant protectionist swing in the United States should not accompany a weakening of the dollar. On the other hand, a depreciation of the US currency is generally associated with a rise in oil prices. However, this correlation might not hold if the rise in international tensions underlying the increase in oil prices were to encourage precautionary movements of capital into the American economy. Finally, an increase in the sovereign debt risk could be triggered by external events that prompt international investors to favour more secure harbours for their money, but that could also occur independently of such shocks, specifically reflecting a decline in confidence.

Given the difficulty of identifying positive or negative correlations between shocks a priori, it is preferable to consider the assessment of the effects of each risk factor separately. For this purpose four simulations were conducted that modify the same number of exogenous variables in the EFD macroeconomic scenario. More specifically:

a) the protectionist risk is represented by a reduction of 0.5 percentage points per year in the growth in world trade compared with the EFD assumptions in 2017-2020;
b) geo-political risk is represented by an increase of $10 per barrel in oil prices compared with the EFD assumptions in each year of the 2018-2020 period;
c) foreign exchange risk is represented by a euro that is about 2 per cent stronger a year in 2018-2020, compared with the EFD assumption of invariance, reflecting prices on forward markets in the last few weeks;[2]
d) spread risk is represented by an increase of 100 basis points in Italian interest rates compared with the EFD assumptions in each year of the 2018-2020 period. It is assumed that the increase involves the entire curve of domestic interest rates (short-term and long-term rates on bank loans to firms and households).

The results of the simulations are given in Table 1.2. Very briefly, these exercises show that a less favourable international environment than the one assumed in the EFD (simulations 1, 2 and 3) would have generally negative effects on real GDP growth. In particular, the slower growth in world trade (simulation 1) and a stronger euro (simulation 2) would affect real growth by slowing exports. By contrast, higher oil prices would reduce the growth rate by curbing domestic demand. The unfavourable shocks on trade and the exchange rate would also depress inflation, slowing nominal GDP growth more than real GDP growth. The shock to the oil price (simulation 3), on the other hand, would an impulse effect on domestic inflation that would offset slower real growth, resulting in marginally faster nominal GDP growth than assumed in the baseline scenario.

As regards the shock of the higher domestic interest rates (simulation 4), the adverse impact would first and foremost involve real GDP as higher rates dampened the contribution of the components of domestic demand (over the 2018-2020 period, real GDP would decline by about three-tenths of a point compared with the baseline scenario). Nevertheless, the weaker growth of the economy would, with some lag, also affect inflation (the GDP deflator would decline by two-tenths of a point over the three-

[2] The EFD performs similar simulations to assess the sensitivity of the forecast to exogenous variables. The EFD exercise focuses exclusively on the impact on real growth. In addition to real growth, the PBO simulations also examine the impact on inflation and, therefore, on the nominal GDP of the Italian economy. They are conducted on the basis of a multi-country model (Oxford Economics) that takes account of relationships among the international variables.

year period). As a result, overall growth in nominal GDP in 2018-2020 would be substantially lower than the baseline hypothesis (by about five-tenths of a point). Note that this simulation does not consider any additional effects that could arise if the rise in domestic rates were accompanied by a significant decline in confidence among economic agents (households and businesses).

Table 1.2 – Impact of different assumptions for exogenous variables on real GDP, the GDP deflator and nominal GDP
(differences in percentage points in growth rates compared with baseline scenario)

	2017	2018	2019	2020	Total
Simulation 1					
Trade with key markets (0.5 p.p. lower as from 2017)					
Real GDP	-0.05	-0.15	-0.11	-0.10	-0.41
GDP deflator	0.00	-0.05	-0.14	-0.27	-0.46
Nominal GDP	-0.05	-0.20	-0.26	-0.37	-0.88
Simulation 2					
Exchange rate (about 2% appreciation of euro each year in nominal effective terms for Italy as from 2018)					
Real GDP	0.00	-0.64	-0.66	-0.68	-1.98
GDP deflator	0.00	-0.13	-0.69	-1.54	-2.36
Nominal GDP	0.00	-0.78	-1.36	-2.14	-4.28
Simulation 3					
Oil price ($10 a barrel higher as from 2018)					
Real GDP	0.00	0.01	-0.14	-0.07	-0.20
GDP deflator	0.00	0.04	0.23	0.26	0.53
Nominal GDP	0.00	0.05	0.09	0.18	0.32
Simulation 4					
Interest rates (100 basis points higher as from 2018)					
Real GDP	0.00	-0.12	-0.06	-0.09	-0.27
GDP deflator	0.00	-0.02	-0.07	-0.15	-0.24
Nominal GDP	0.00	-0.15	-0.14	-0.24	-0.53

Box 1.1 – Error in the PBO forecast for GDP in 2016 and revision of projection for 2017

When the macroeconomic scenario in the 2017 DBP was endorsed in October 2016, the PBO estimated GDP growth for 2016 at 0.7 per cent (0.75 per cent). In the light of the initial outturn for 2016, published by Istat in March this year, GDP growth was 0.9 per cent (0.88 per cent): the PBO's forecasting error was thus slightly more than 0.1 percentage points (0.13).

The main factors underlying the forecasting error can be identified as: a) variations in exogenous international variables (dollar/euro exchange rate, oil prices, world trade growth); b) changes in other exogenous factors underlying the forecast (interest rates, level of uncertainty, liquidity conditions at firms); and c) revisions of national accounts data. The contribution of these factors has been estimated using the PBO-Istat annual macroeconomic model, incorporating, for the variables corresponding to each single factor identified previously, the behaviour observed in the most recent period in place of the assumptions used in the forecasting scenario last October. The corresponding impact on GDP, as reported in the first column of Table R1.1.1, is therefore estimated by keeping the other information unchanged with respect to the values adopted in October 2016. The public finance forecasting scenario has also not been modified with respect to the endorsement of the 2017 DBP. The breakdown of the forecasting error should however be considered with caution, as the estimate of individual contributions does not take account of correlations between the various factors.

The updating of the exogenous international variables to the actual values for 2016 led to a depreciation of the euro exchange rate, an improvement in international trade growth and lower oil prices than the values assumed in October. The more favourable international environment produced an improvement of about two-tenths of a point in the growth rate (0.17 percentage points). A slight reduction in the forecast (0.1 percentage points) was, however, caused by the revision of other exogenous factors (with, in particular, a rise in the uncertainty indicator). The revision of national accounts information, which improved the data for 2014 and, especially, 2015 helped to improve GDP growth slightly (0.1 percentage points).

An analogous exercise can be conducted to break down the factors that prompted the PBO to change the GDP forecast for 2017 in April compared with the projection (in the policy scenario) developed last October. The April forecast for GDP growth in 2017 (in the trend scenario) is 1 per cent (1.01) compared with the 0.9 per cent (0.94) policy forecast in the 2017 DBP macroeconomic scenario at the time of the endorsement exercise. The impacts of the factors considered above are given in the second column of Table R1.1.1. The revision of the 2017 forecast incorporated a positive contribution (equal to three-tenths of a point) from the more favourable scenario for exogenous international variables. By contrast, the new profile of other exogenous factors, characterised by a slight increase in uncertainty, made a negative contribution (about two-tenths of a point). This impact is almost entirely offset by the positive contribution from the revision of the national accounts. The residual component made a negative contribution, with a correction of about two-tenths of a percentage point: it reflected the signs of slight deceleration in growth drawn from the short-term forecasting models, which incorporate the adverse performance of a number of economic indicators available for the first few months of 2017. This factor may have also included the effects of slight deviations in the public finance policy scenario, updated in the light of the 2017 Stability Act, compared with the values considered in the endorsement of the 2017 DBP.

Table R.1.1.1 – GDP growth forecasts for 2016-2017: determinants of the forecasting error for 2016 and the revision for 2017

	Forecasting error	Revision of forecast
	2016	2017
PBO projections formulated in October 2016	**0.75**	**0.94**
International exogenous factors	0.17	0.32
Other exogenous factors	-0.13	-0.25
Revision of national accounts data	0.12	0.23
Residual component	-0.03	-0.23
Istat actual for 2016, PBO projections for 2017	**0.88**	**1.01**

Analysis 1.1

Alternative estimates of potential output and the output gap

In recent years, estimates of potential output and the output gap have become especially important within the context of the European fiscal rules. As we know, however, these variables are not observable and must be estimated with a high level of uncertainty, varying considerably depending on the model used. For example, the method used by the European Commission, which was agreed with the Member States, generates values for potential output and the output gap that can differ significantly from those used by other international organisations (OECD and IMF).

The recent economic crisis seems to have made the determination of such unobservables even more challenging. In particular, some scholars[3] have noted that the prolonged recession may have impaired the potential productive capacity of economies (with defined hysteresis effects), increasing the difficulty of distinguishing between the temporary (cyclical) and structural (trend) components of GDP growth. Other analysts demonstrate that, given the severe contraction in output, it may be necessary to select a functional form for the trend other than the one commonly used in the past to account for the possibility of a larger cyclical component than previously assumed. [4] Finally, some variables in economic surveys based on respondent assessments, once useful for extracting the signal of cyclical developments in the economy, may have become less informative, as the recent crisis may have changed the assessments and expectations of economic agents about what is considered a normal level of economic activity.

In order to assess the impact of these uncertainties in the case of Italy, a pending paper of the PBO (a preview of some of the results is provided) draws inspiration from a recent ECB study[5] to estimate a model (unobserved components), where the output gap is represented by a cyclical component that is common to a set of economic activity variables (GDP, unemployment rate and capacity).[6] Specific trends identify the structural component of each of these variables. The model is then completed by a relationship (the Phillips curve) in which inflation evolves as a function of the output gap, a trend component of consumer price inflation and the price of oil.

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[3] Blanchard, O., Cerutti, E. and Summers, L. (2015), "Inflation and Activity: Two Explanations and their Monetary Policy Implications", *IMF Working Paper*, no. 15, November; Fatàs, A. and Summers, L. (2015), "The Permanent Effect of Fiscal Consolidations", *CEPR Discussion Paper Series* no. 10902, October and, for Italy, Proietti, T. (2002), "Some Reflections on Trend-Cycle Decompositions with Correlated Components", *EUI Working Paper ECO* no. 23.

[4] Jarocinski, M. and Lenza, M. (2016), "An inflation-predicting measure of the output gap in the euro area", *ECB Working Paper Series* no. 1966, September.

[5] The set of models used is similar to that proposed by Jarocinski and Lenza (2016).

[6] The sample used to estimate the model covers the period 1985Q1 -2016Q4. For GDP, the quarterly seasonally adjusted series at constant prices was used. To measure core inflation, the consumer price index series excluding unprocessed food and energy products is used. The capacity utilisation series is the degree of use of plant as measured by Istat surveys. The oil price is the crude spot price denominated in euros.

The alternative estimates of the output gap used differ not only in the information set used (including or excluding the CP capacity utilisation series) but also in the types of trend, which vary according to the degree of influence of actual GDP. The specifications considered are as follows:

1. Local level model (LLT) with level $\mu_t = \mu_{t-1} + \beta_t + \eta_t$ and slope $\beta_t = \beta_{t-1} + \xi_t$ varying over time and uncorrelated errors $\eta_t \sim \mathrm{NID}(0, \sigma^2_\eta)$; $\xi_t \sim \mathrm{NID}(0, \sigma^2_\xi)$;
2. Random walk plus drift (RW), obtained by setting, in the LLT model equation, $\sigma^2_\xi = 0$; with constant drift β ;
3. Integrated random walk (IRW), obtained by setting, in the LLT model equation, $\sigma^2_\eta = 0$; with variable drift β_t.

In particular, we consider two specifications (LLT and IRW) in which the path of the trend declines in recent years with the deterioration in actual GDP, implying relatively greater hysteresis, and one specification (RW) in which the path of the trend is more stable over time, being less affected by hysteresis effects induced by the cycle.

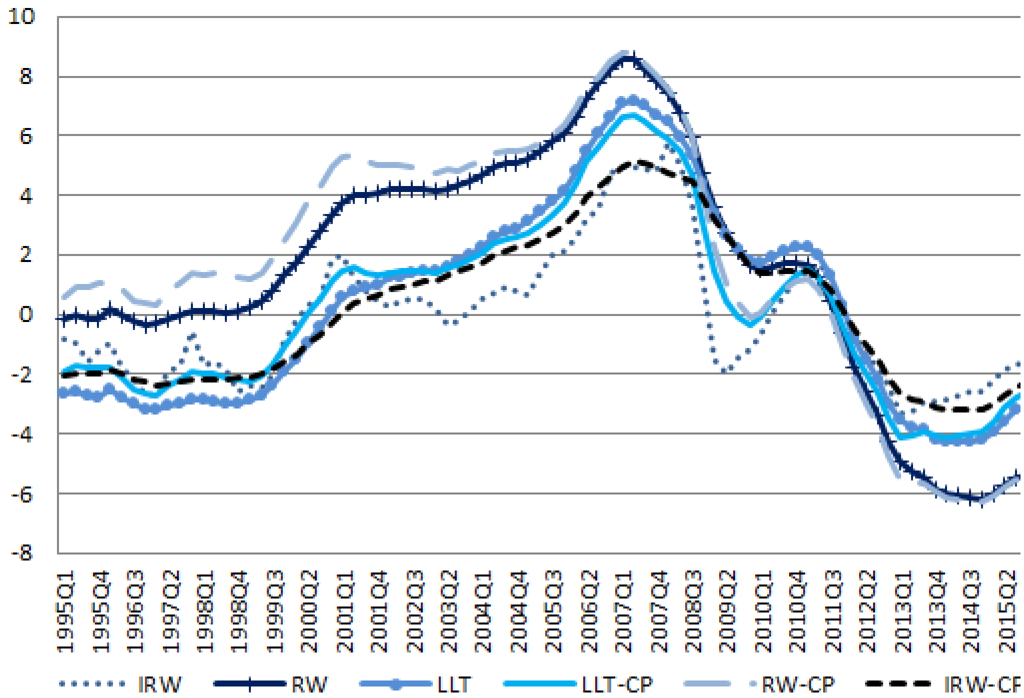
The results reported in the following table and charts show that with changes in the specification of the model, the estimates of the output gap and potential output vary over a very broad range. The greatest differences are found during expansions and, above all, in the recent crisis at the end of the sample period. More specifically, in the last period the most flexible models, IRW and LLT, generate a lower estimated of potential output and, therefore, an output gap that is closed more quickly that the RW model, which assumes more stable potential growth during the crisis (Figure A1.1.1). All of the models identify the double decline in the output gap in the recent recession, which is larger in 2012 than in 2008, but within a very broad estimated range, which in 2016 for example goes from -0.5 (IRW) to -5.3 (RW-CP). For the years in the forecasting period,[7] the negative output gap narrows relatively rapidly in the different models. In the IRW model, GDP returns to its potential in the current year. The official estimates of the European Commission, which were obtained using the method agreed with the Member States, are closest to those in the IRW model, forecasting the elimination of the output gap in 2018.

In view of the considerable variety in the results, it is necessary to adopt an assessment criterion to choose a model. For example, one could consider the matching of the model with the data, the stability of the estimated parameters and, when there is uncertainty concerning the appropriateness of the various models to identify the phase of the cycle, the capacity of alternative specifications to forecast inflation could be compared.

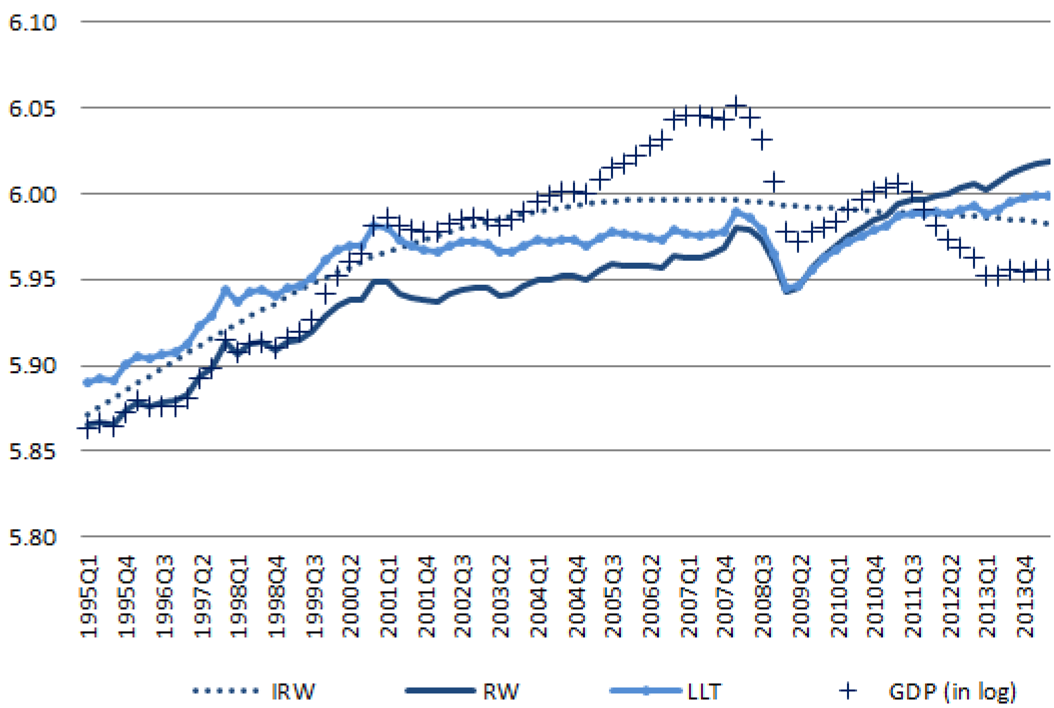
[7] The values for the variables are obtained on the basis of the parameters estimated with the application of the Kalman filter for future years.

Figure A1.1.1 – Output gap and potential output on the basis of different specifications of the estimation model

Output gap



Potential output



In purely statistical terms, the LLT-CP model appears to be the best (this is shown by the highest value for the statistic in the last row in Table A1.1.1). Substantially different results are obtained when considering the capacity to forecast inflation (Table A1.1.2).

- The goodness of the models in terms of their capacity to forecast inflation is not stable over time, but depends on the period under consideration. In general, inflation forecasting errors are larger in the last period (2012-16), when inflation falls to historically very low levels. Over the entire 2002-2016 sample, the IRW model is the best, on average and for all horizons. However, if the sample is segmented and, more specifically, the recent economic crisis is isolated, the result changes considerably. Until 2011, the LLT-CP model is the best. From 2012 onwards, i.e. in the final period of the last recession and the subsequent weak recovery, the model that produces the smallest error (on average and for each forecasting step except the first) is RW, which is that with the most stable trend growth.

- The LLT-CP model, which uses the Istat survey series on plant utilisation, generates a smaller average error than the other models until 2011, but becomes less accurate in more recent years. This may be related to the fact that the signal from the Istat surveys on capacity utilisation became partly inconsistent with actual economic developments. This could reflect a number of conditions consequent upon the recent economic crisis. The severity of the contraction in output may have changed the level considered "normal" for businesses, who now have lower expectations for production than in the past. Moreover, over the course of the crisis, the surviving businesses are the most efficient, which are likely to make the best use of the plant that they already have. This change of composition would render the assessment of capacity utilisation not perfectly comparable with the past. Finally, it should be noted that during the crisis, many companies postponed the renovation of plant to better times, so that the relatively rapid increase in capacity utilisation observed during the recovery would reflect the consequences of that postponement rather than a cyclical phenomenon.

In short, these initial results show that alternative specifications of the estimation model, in terms of trends and information sets, produce a wide range of values for the output gap. The evaluation of the goodness of the various models is subject to the choice of the criterion adopted, which does not necessarily lead to the identification of one model to be preferred to the others. The LLT model appears to be the best in statistical terms. However, considering their capacity to forecast inflation, other specifications (IRW and RW) are preferable for the more recent years. Specifically, in the final phase, after 2012, the RW model has the best predictive capacity.

Table A1.1.1 – Output gap in different specifications of the estimation model

	LLT	RW	IRW	LLT-CP	RW-CP	IRW-CP
2010	2.0	1.6	0.3	0.6	0.6	1.4
2011	1.5	0.7	1.2	0.8	0.3	0.9
2012	-1.9	-3.0	-1.6	-2.4	-3.4	-1.3
2013	-3.9	-5.4	-3.1	-4.0	-5.7	-2.9
2014	-4.2	-6.1	-2.7	-4.0	-6.2	-3.2
2015	-3.4	-5.7	-1.8	-3.0	-5.7	-2.6
2016	-2.7	-5.2	-0.5	-2.2	-5.3	-2.0
2017	-2.4	-5.0	0.1	-1.7	-5.0	-1.7
2018	-1.9	-4.3	0.1	-1.1	-4.1	-1.3
loglik (1)	*1252*	*1242*	*1239*	*1865*	*1859*	*1839*

(1) LogLik is likelihood (in log form). The higher this statistic is, the greater the likelihood of the model. However, comparisons are only possible of models with the same number of variables.

Table A1.1.2 – Forecasting error (MSE) of inflation annualized h quarters in advance on various samples (1)

		h=1	h=2	h=3	h=4	Average
LLT	2002-2016	0.09	0.24	0.44	0.64	0.36
	2008-2011	0.14	0.35	0.56	0.61	0.42
	2012-2016	0.09	0.22	0.43	0.71	0.36
RW	2002-2016	0.13	0.36	0.62	0.86	0.49
	2008-2011	0.29	0.81	1.35	1.68	1.03
	2012-2016	0.08	**0.17**	**0.28**	**0.44**	**0.24**
IRW	2002-2016	**0.05**	**0.14**	**0.30**	**0.49**	**0.25**
	2008-2011	**0.05**	**0.16**	0.31	0.40	0.23
	2012-2016	**0.06**	**0.17**	0.41	0.77	0.35
LLT-CP	2002-2016	0.12	0.23	0.37	0.52	0.31
	2008-2011	0.07	**0.16**	**0.24**	**0.27**	**0.18**
	2012-2016	0.27	0.48	0.76	1.08	0.65
RW-CP	2002-2016	0.15	0.28	0.45	0.65	0.38
	2008-2011	0.11	0.20	0.31	0.36	0.24
	2012-2016	0.33	0.58	0.93	1.35	0.80
IRW-CP	2002-2016	0.23	0.39	0.58	0.76	0.49
	2008-2011	0.28	0.47	0.65	0.74	0.54
	2012-2016	0.34	0.59	0.91	1.24	0.77

(1) The table reports the minimum error among models in boldface.

Analysis 1.2

The macroeconomic impact of fiscal policy and the multipliers of the PBO panel

The importance of precisely quantifying the effects of discretionary revenue and expenditure measures on the macroeconomic scenario has always been considerable. Nevertheless, such quantification is made particularly difficult by the uncertainty characterising the estimate of the so-called fiscal multiplier, i.e. the estimated change in real GDP induced by a given fiscal impulse.

Among the factors that determine the size of the multiplier, the composition of the budget package is certainly one of the most important. For this reason, a distinction is normally drawn between multipliers of the various revenue and expenditure measures. Generally, revenue multipliers are smaller than expenditure multipliers, at least in the first years after the introduction of budget measures. This difference is associated with the mechanism for the transmission of the fiscal impulse: a change in the amount of public consumption or public investment equates to an immediate and equivalent variation of a component of aggregate demand in real terms, whereas a measure that modifies the overall level of taxation first impacts the disposable income of households, part of which is saved and therefore does not go toward consumption, or business profits, which are generally only partially reinvested.

In turn, individual revenue and expenditure items impact economic activity differently. Expenditure measures based on transfers are generally associated with similar values for multipliers as revenue measures. Conversely, an increase in investment affects GDP through multiple channels, and the impact can be significant: in the short term, it has a direct impact on aggregate demand, possibly accompanied by an increase in complementary private investment; in the medium to long term, there may be an increase in production capacity and therefore of potential income. The response of GDP will depend in both cases on several factors: administrative effectiveness in the selection and management of investment projects is one of the main factors, influencing the speed with which resources are deployed and the quality of investments, and therefore the impact on potential output.

Likewise, different revenue measures can have different impacts on GDP. For example, reductions in social security contributions can reduce the cost of labour for firms and improve competitiveness, while also having a positive effect on the demand for labour.

Finally, many recent studies have found higher multipliers during and after the “great recession” of 2009, essentially due to a number of conjunctural factors that can amplify the expansionary or recessionary effects of fiscal policy.

Section A1.2.1 presents some recent findings in the literature, while section A1.2.2 provides a description of the multipliers in the macroeconomic models of the Italian economy of the PBO panel, with a comparison with those estimated by the econometric model of the MEF.

A1.2.1 Multipliers during and after the "great recession"

In recent years, the attention devoted to quantifying the value of fiscal multipliers has been greater than in previous decades given the increased role of fiscal policy as a tool for stimulating the cycle in a context of extremely low interest rates in which the limits of monetary policy have emerged quite clearly. This has engendered a proliferation of institutional and academic studies of the issue.

A recent study by the International Monetary Fund (IMF)[8] reviews the factors that determine the size of multipliers, of which we examine those of most importance to Italy during this period:

- *the cyclical position*: the value of the multipliers is higher in recessions than in periods in which the output gap is positive or nil. In fact, in periods with a negative output gap - especially if they follow shocks of a financial origin - a substantial part of the private sector (households and businesses) may be subject to financial constraints, such as little access to credit or the need to reduce their debt exposure (so-called deleveraging), which curb the growth in demand and output. In such circumstances, any increase in disposable income would likely increase demand, thereby increasing the values of fiscal multipliers. In addition, with a negative output gap, expansionary measures should help bring actual GDP to closer to potential GDP, with a relatively small impact on prices, maximizing the impact on real economic activity. Finally, when the level of output remains significantly below potential for long periods, hysteresis effects are triggered: the rise in long-term unemployment reduces the stock of human capital, while the shortage of investment reduces the stock of physical capital, with an adverse impact on potential growth. Budget measures that counter this type of risk (even if they stimulate activity only in the short term) tend to have significant multiplier effects.[9]

- *the role of monetary policy*: if monetary authorities implement accommodative policies, the value of the fiscal multiplier increases significantly. In addition, when monetary policy is constrained to the lower limit of policy rates (generally identified as the zero lower bound, ZLB), the traditional instruments available to

[8] Batini, N., Eyraud, L., Forni, L. and Weber, A. (2014), “Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections”, IMF *Technical Notes and Manuals*, no. 4.
[9] See also DeLong, B. J. and Summers, L. H. (2012), “Fiscal Policy in a Depressed Economy”, in *Brookings Papers on Economic Activity*, Spring.

the central bank have virtually no impact on real or nominal variables. In these cases, a reduction in the real interest rate, which would increase GDP growth, cannot be achieved by lowering nominal rates (which cannot fall below the ZLB) and therefore requires a (sufficiently long) increase in inflation, in which the role of fiscal policy is key.

- *the level of debt*: according to some studies,[10] in highly-indebted countries, an expansionary budget might, especially in times of financial crisis, have an adverse impact on confidence in a country's ability to discharge its financial obligations, thus triggering an increase in real interest rates and attenuating the beneficial effects of the budget measures on demand and GDP. A high level of debt relative to GDP could therefore reduce the value of the multiplier.[11]

The estimated values in the major institutional and academic models before the "great recession" generally indicated average expenditure multipliers ranging between 0.5 and 1 in the short term. That is, an expenditure impulse of one percentage point of GDP would correspond to an increase in GDP of between 0.5 and 1 percentage point. Revenue multipliers would be smaller, generally less than 0.5.

Unfortunately, with the exception of the United States, the available data are generally not sufficient to produce a reliable estimate for an individual country of the impact on the multiplier of crises like the recent recession, whose consequences are still discernible today (a negative output gap and monetary policy constrained by the ZLB). However, the use of theoretical models that can be used for policy simulations (including those used by major national and international institutions) and of empirical models that simultaneously consider multiple countries over time (so-called panel models) has confirmed a significant increase in the value of fiscal multipliers during and after the great recession.

For example, some models[12] quantify the expenditure multiplier at 1.6 in the first year, reaching maximum of 2.3 in subsequent periods where monetary policy is constrained by the ZLB for long periods, the fiscal impulse is lasting and occurs when nominal rates are constant. Similarly, the estimation of empirical models that envisage different mechanisms for the operation of economies in expansionary and recessionary periods has shown that the value of the fiscal multiplier is usually less than one in expansions and equal to about 2.5 in recessions.[13] IMF economists, examining the effects of the

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[10] Ilzezki, E., Mendoza, E.G. and Végh, C. A. (2013), "How big (small?) are fiscal multipliers?", in *Journal of Monetary Economics*, vol. 60, no. 2.
[11] Other factors noted in the IMF study include trade openness, the exchange rate regime, labour market rigidity, the size of automatic stabilisers and administrative effectiveness.
[12] See, for example, Christiano, L., Eichenbaum, M. and Rebelo, S. (2011), "When Is the Government Spending Multiplier Large?", in *Journal of Political Economy*, vol. 119, no. 1.
[13] See Auerbach, A. J. and Gorodnichenko, Y. (2013), "Fiscal Multipliers in Recession and Expansion", in *Fiscal Policy after the Financial Crisis*, Alesina, A. and Giavazzi, F. (eds), NBER.

fiscal consolidation policies implemented in recent years in various advanced countries, also quantify the aggregate fiscal multiplier at greater than 1.5 in recessions.[14]

The models in use at major international institutions confirm the increase in multipliers in recessions (and especially in the presence of the ZLB) and find that expenditure measures have a greater impact than revenue measures. For example, an OECD study finds an increase of about 40 per cent in the multiplier associated with government consumption expenditure if the nominal policy rate is bound for five years.[15] However, some of the technical characteristics of the models used by the OECD economists generally make the values of multipliers smaller in normal conditions. In Italy, a temporary government consumption shock would have an impact of just over 0.6. Any measure aimed at changing disposable income, such as a tax cut or an increase in transfers, would have a significantly smaller effect: the transfer multiplier is less than 0.2 and those associated with direct and indirect taxes are close to zero (0.12 and 0.07, respectively).

Continuing to look at Italy, a number of studies conducted by Bank of Italy economists[16] confirm a long-term consumption multiplier of close to 0.6 in standard conditions, in response to a permanent stimulus. Assuming stimulus measures implemented through revenue, the long-term multiplier associated with a permanent variation in taxation of labour income is 0.9, while that of a consumption tax is almost 0.4. Measures impacting capital income taxation would have a much greater overall effect (about 2.5). It should be pointed out that these multipliers are significantly lower on impact, systematically lower than those for expenditure, because the effects of the revenue shock tend to gradually modify agents' choices about the supply and demand for the factors of production, reducing its impact in the short term.

Revenue multipliers remain largely unchanged in a monetary policy scenario constrained by the ZLB for five years, while spending multipliers increase sharply. A fiscal stimulus of a corresponding duration through public consumption has a multiplier of more than 1.4 in the first year and about 1.2 in the second. However, if stimulus measures are associated with an increase in spreads due to a perception of heightened sovereign risk, the favourable effects on GDP and employment are reduced.[17]

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[14] See Blanchard, O. and Leigh, D. (2013), "Growth Forecast Errors and Fiscal Multipliers", in *American Economic Review*, vol. 103, no. 3.

[15] See Barrell, R., Holland, D. and Hurst, I. (2013), "Fiscal multipliers and prospects for consolidation", in *OECD Journal: Economic Studies*, vol. 2012, n. 1. In particular, the result reported in the study regards the United States, in which the multiplier goes from just over 0.6 to close to 1. The authors assume similar effects for other countries.

[16] See Locarno, A., Notarpietro, A. and Pisani, M. (2013), "Sovereign risk, monetary policy and fiscal multipliers: a structural model-based assessment", in Working Papers no. 943, Banca d'Italia.

[17] An analysis by ECB economists simulates similar scenarios using 15 different models in use at national central banks and produces similar results. For more details, see Kilponen, J., Pisani, M., Schmidt, S., Corbo, V., Hledik, T., Hollmayr, J., Hurtado, S., Júlio, P., Kulikov, D., Lemoine, M., Lozej, M., Lundvall, H., Maria, J.R., Micallef, B., Papageorgiou, D., Rysanek, J., Sideris, D., Thomas, C. and De Walque, G. (2015), "Comparing fiscal multipliers across models and countries in Europe", in *ECB Working Paper*, no. 1760.

In almost all cases, the results for the expenditure multipliers cited here regard measures involving current expenditure. Partly in the light of the steep decline since 2008, in more recent years the policy debate has in fact primarily focused on the possible use of fiscal policy to revive investment.

The IMF[18] recently published specific studies on estimating the public investment multiplier based on a sample of 17 OECD countries (not including Italy) from 1985 to 2013. The method adopted is similar to that proposed in some of the papers mentioned earlier[19] and seeks to highlight the role played by particular states of the economy, in particular with regard to the increase in the expansionary effects associated with particularly deep recessions and an accommodative monetary policy stance: in such situations, as mentioned earlier, the crowding out of private demand that would occur in normal cyclical conditions decreases considerably.

The results are essentially consistent with some of the other studies mentioned: in particular, under normal conditions, an increase in investment spending of 1 per cent of GDP increases output by 0.4 per cent in the same year and by 1.4 per cent four years later; over the same period, the debt/GDP ratio would decline by 4 points. In the case of long periods of slow growth (and a negative output gap), the value of the investment multiplier would be significantly higher: 1.5 in the year of intervention and about 3 in the fourth year, thanks in part, in the short term, to the "crowding in" effect of complementary private investment. This would result in a 10 per cent decline in the debt/GDP ratio over the four years. In periods with a positive output gap, however, investment would have a negative short-term impact on GDP and no impact in the long term, crowding out private investment and increasing the debt.

It is necessary to bear in mind the fact that other contextual conditions affect the impact of public investment expenditure on GDP. One key factor, for example, is the efficiency of the expenditure itself, construed as the cost/benefit ratio of the investment: with an adequate degree of efficiency, the multiplier effects are larger, comparable to those obtained in periods of negative output gap. Another key aspect concerns the financing of investment spending: the IMF's analysis suggests that borrowing to finance spending to increase the stock of capital produces larger multiplier effects (2.5 in the fourth year after the shock) than those created by a measure with a neutral impact on the public finances.

Overall, considering the reduction of the capital stock as a result of the crisis, the need to upgrade infrastructure even in the most advanced economies and the currently low level of debt refinancing costs, the IMF analysis recommends, in current conditions, public action to support investment, including debt funding.

[18] See IMF (2014), "World Economic Outlook", October, Chapter 3 and Abiad, A., Furceri, D. and Topalova, P. (2015), "The Macroeconomic Effects of Public Investment: Evidence from Advanced Economies", in *IMF Working Papers*, no. 95.
[19] See note 13.

Similar considerations have recently been proposed by the OECD, which - using different models based on the market access and the long-term sustainability of the public finances - estimates a non-negligible increase in the fiscal space available in advanced countries.[20] On the other hand, the European Commission, although referring to studies that attribute relatively high short-term multipliers to investment spending (between 1 and 1.3) that rise significantly in periods of particular weakness in the cycle, takes a more cautious position on the overall effectiveness of such intervention. [21]

A1.2.2 The multipliers in the PBO panel models

The evidence from the literature on fiscal multipliers provides a benchmark for framing the characteristics of some of the major macroeconomic models of the Italian economy. More specifically, the ITEM macroeconomic model of the MEF and the models of the PBO's panel of forecasters are considered. In addition to the PBO itself, the panel comprises the independent forecasting institutes CER, Prometeia and REF.ricerche. The PBO conducts its assessments using Istat's MeMo-It model under the framework agreement with that institute.

In considering the characteristics of these models, it is first necessary to emphasise that, by construction, they cannot generally capture differences in the response of the economy to fiscal policies depending on the position of the cycle. In other words, the multiplier effect on GDP of a change in a spending or revenue measure is the same regardless of the cyclical conditions in the baseline scenario, unless the forecaster takes external action to modify the models on the basis of judgements suggested by the literature. In this regard, the PBO estimates developed in a study now being completed, aimed at inferring the size of the multipliers in the MeMo-It model during the crisis period, shows significant increases in their value in the years following 2007.

Taking account of this limitation, the characteristics of the various models are summarized in Table A1.2.1. It assumes a permanent impulse from a fiscal measure, measured ex ante, of 1 per cent of nominal GDP for the first year of the baseline scenario. The table presents the responses (in percentage points of GDP) in terms of

[20] See OECD (2016), "OECD Economic Outlook", November, Chapter 2. According to the OECD, the short-term multiplier of a permanent increase in investment would be about 1, while the long-term multiplier would be 2 on average. The variability is primarily linked to the return on the investments and the resources used to finance the additional spending in the medium/long run. Under current conditions, if we consider the impact on potential GDP, the measure could be financed with deficit spending for a number of years without having an adverse impact on the debt/GDP ratio in the medium/long term. In addition, the presence of hysteresis effects would increase the multiplier by about 0.5 points in the longer term.

[21] The uncertainty is mainly attributable to the difficulty of assessing long-term impacts, which are strongly dependent on the sector in which the investment is made and the type of capital accumulated. These characteristics also affect the speed with which investment projects are implemented ("time to build") and their overall efficiency, meaning the extent to which an increase in investment actually translates into a corresponding increase in the capital stock. For more details, see European Commission (2016), "Report on Public Finances in EMU", *Institutional Paper* 045, chapter 3.

impact (i.e. in the first year) and maximum value (considered within a five-year horizon). These responses (which identify the size of the multipliers) are calculated in the case of deficit-financed positive fiscal shocks (i.e. higher expenditure and lower revenue), and therefore not associated with offsetting measures of the same magnitude implemented to ensure the neutrality of the measures' impact on the public finances.

In line with the foregoing, the impact multipliers associated with a permanent increase in public spending (for consumption or investment) tend to be higher for all models than those for revenue measures. Revenue multipliers are, however, more persistent and over time they tend to grow in size, such that the maximum values (which are reached at different times in the various models) reduce the disparity with spending multipliers.

With other conditions being equal, these characteristics would indicate that if the Government's sole objective is to stabilise the economic cycle in the short term (e.g. in the year following that in which budget decisions are taken), expenditure measures would be more effective than revenue measures. The size of the short-term multipliers shown in Table A1.2.1 also indicates that, in principle, the various models provide for the possibility that an increase in public expenditure financed with an equivalent increase in revenue (i.e. with a balanced budget) would have an expansionary impact on GDP.

However, in order to assess these implications, it must be recalled that certain conditions must hold. For public investment, as indicated in the findings of the literature discussed above, it is necessary to ensure administrative effectiveness and, in particular, that actual spending swiftly follows the spending decisions and is thus effectively implemented during the period in which the economic cycle is to be stabilised. Otherwise, the risk of involuntarily adopting pro-cyclical policies may arise. It is clear that this condition is especially pertinent to the Italian experience.

For public consumption, however, it is necessary to take account of the consistency of a short-term policy aimed at countering a weakening of the cycle with the medium/long-term spending reduction targets the Government intends to pursue. An interruption of the medium/long-term programme could be justified if the recession was especially severe. In this regard, however, we have to bear in mind the fact that the multiplier values in the various models shown in Table A1.2.1 refer to the case where the variation in this expenditure item translates into a corresponding volume change. If, however, the forecaster considers that the planned reduction in public consumption can be achieved primarily through a reduction in the prices (and to a lesser extent volumes) of government purchases, then the negative impact on GDP would be smaller than the values reported in the table. In this hypothesis, maintaining the medium/long-term objective (reduction of spending) might, in the model's assessment, not completely conflict (not to the extent implied by the values in Table A1.2.1) with the short-term need to not harm the economic cycle.

Table A.1.2.1 – Fiscal multipliers
(impact multipliers, maximum values within 5 years of the shock)

	MEF			PBO			CER			Prometeia			REF.ricerche		
	maximum	impact(1)		maximum	impact(1)		maximum	impact(1)		maximum	impact(1)		maximum	impact(1)	
Expenditure															
Public consumption	1.0	1.0	(I)	0.6	0.6	(III)	1.1	1.3	(IV)	1.0	1.0	(I)	1.1	1.1	(I)
Public investment	0.7	0.9	(II)	0.6	0.7	(III)	0.6	0.7	(II)	1.0	1.1	(IV)	1.1	1.1	(II)
Revenue															
IRPEF	0.2	0.7	(III)	0.2	0.6	(V)	0.5	0.6	(II)	0.3	0.8	(IV)	0.4	0.4	(I)
IRES	0.2	0.3	(III)	0.1	0.1	(IV)	0.1	0.1	(III)	0.1	0.1	(II)	0.1	0.2	(III)
VAT	0.2	0.9	(III)	0.1	0.4	(V)	0.3	1.0	(II)	0.2	0.6	(IV)	0.5	0.5	(I)
Social contributions	0.3	1.0	(III)	0.2	0.8	(V)	0.5	0.5	(I)	0.3	1.1	(IV)	0.6	0.6	(I)

Source: EFD April 2016, the PBO and information provided by individual institutes.
(1) The year of the maximum fiscal multiplier as measured to the second decimal place is given in parentheses, with the exception of the MEF.

Other considerations concern revenue multipliers. As can be seen in the table, the impact values (i.e. those most relevant to stabilisation policies) can differ, sometimes significantly, among the various items considered. For example, multipliers associated with VAT are, in general, lower than those associated with a variation in social contributions. This feature suggests, to a greater or lesser extent depending on the models considered, the possibility of another type of expansionary measure that can be implemented with a balanced budget, i.e. a so-called fiscal devaluation.

This expression refers a change in the overall structure of taxation, for a given level of revenue, in favour of the exporting sector of the economy. It consists in reducing social contribution rates, offsetting the loss of revenue with an increase in indirect taxation on consumption. This produces in a positive stimulus to GDP similar to the stimulus provided by a currency devaluation. A reduction in social contributions financed by VAT would benefit exporters, who enjoy the lower contribution burden without being subject to higher taxation. The latter is borne by firms that sell exclusively in the domestic market, mainly in the service sector. This results in an improvement in price competitiveness, which is reflected in a boost to foreign sales and an increase in the profitability of the exporting sector compared with the non-tradable sector. This manoeuvre also mimics the effects of a devaluation on imports, which lose competitiveness compared with domestic production. In fact, the increase in VAT raises the prices of goods and services sold on the domestic market, and therefore also those purchased from abroad, which do not, however, benefit from the reduction in social contributions. In addition, by stimulating national production to the detriment of imports, the reduction in the labour costs induced by the decrease in social contributions tends to increase overall labour demand in the economy. The positive effects on employment in certain models are also transmitted through the relative prices of the factors of production: with other conditions held equal, lower social contributions increase the attractiveness of labour inputs compared with other factors of production, favouring - within the limits of technological constraints - greater use of labour in production processes. It should be emphasised, however, that the effectiveness of a reduction in social contributions is obviously subordinate to the condition that it does not trigger tax competition with other economies.

Finally, the size of the impact multipliers of other items of direct taxation of factors of production (personal and corporate income tax) is generally small in the various models, confirming the evidence in the literature of a relatively limited short-term impact on GDP. However, this type of taxation affects the medium/long-term behaviour of economic agents (households and businesses), encouraging or discouraging the supply of labour (in the case of personal income tax) and the effort to accumulate capital (in the case of corporate income tax). These repercussions are partially captured in the models (especially in the case of personal income tax) by the emergence of an increasing multiplier effect over time. Recourse to cuts in direct taxation is therefore justified not so much by the pursuit of the objective of stabilising the economic cycle (for which they are relatively less effective) as by the objective of stimulating the medium/long-term supply of the factors of production and thereby increasing the potential growth of the economy.

2. THE PUBLIC FINANCES

2.1 The outturn for 2016

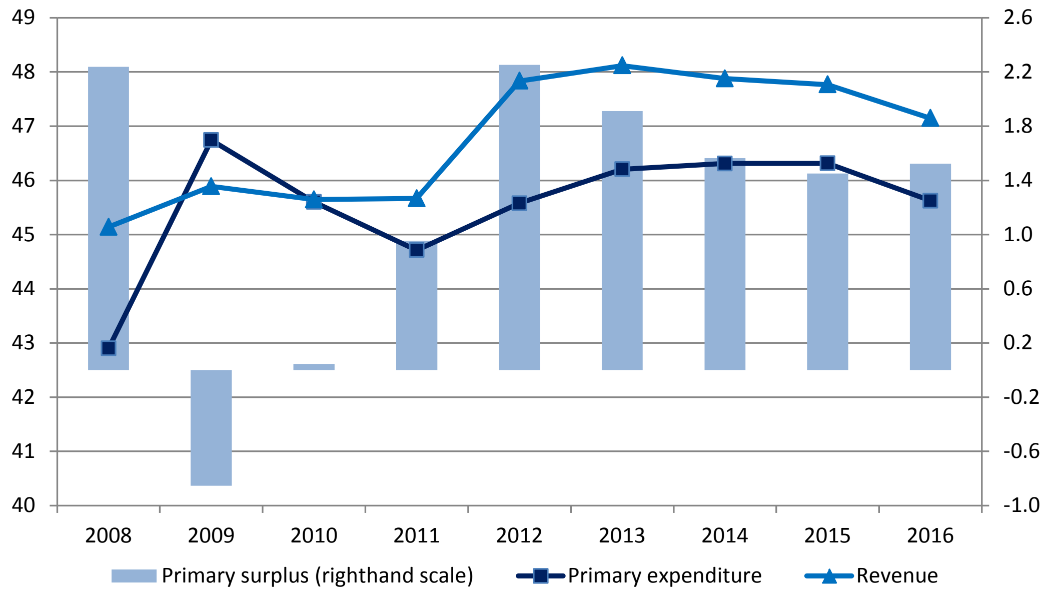
In 2016, the public deficit improved compared with the previous year, thanks to a decrease in interest expenditure and an increase in the primary surplus. Net general government borrowing fell in absolute value (from €44.2 billion to €40.8 billion) and as a percentage of GDP, from 2.7 per cent to 2.4 per cent (Table 2.1), reflecting a decline in spending for debt service (-€1.8 billion) to 4 per cent of GDP, and an increase in the primary surplus (+€1.6 billion), holding steady at 1.5 per cent of GDP. The reduction of 0.7 percentage points in primary expenditure as a proportion of GDP (to 45.6 per cent) – attributable to capital expenditure (which fell to 3.4 per cent), as primary current expenditure stabilised as a percentage of GDP (at 42.2 per cent) – was associated with a similar sized decline in revenue (to 47.1 per cent; Figure 2.1). The fiscal burden fell by almost half a percentage point of GDP, to 42.9 per cent of output, mainly due to developments in indirect taxes (Figure 2.2), which also declined in absolute value. Debt service charges declined for the fourth consecutive year and are now more than €17 billion lower than the peak recorded in 2012. The overall results for 2016 were affected by the inclusion of the Italian public broadcaster (RAI) in the general government sector, with both revenue effects, especially with regard to direct taxes and other current revenues, reflecting TV license fees and advertising revenue, and expenditure effects, notably compensation of employees and intermediate consumption, reflecting the company’s costs (Box 2.1).

Total revenue grew by 0.3 per cent in 2016, with a slightly smaller rise in current revenue (+0.2 per cent) – for which the reduction in indirect taxes noted earlier (-3.1 per cent) was just barely offset by an increase in other items - and an increase in capital revenue (+21.9 per cent), due entirely to the significant rise in capital taxes (+327.2 per cent). Against this background, current revenue contracted by seven-tenths of a point of GDP (to 46.7 per cent), while capital revenue posted a slight increase as a proportion of GDP, rising one-tenth of a point to 0.4 per cent.

Table 2.1 – General government consolidated revenue and expenditure accounts
(millions of euros)

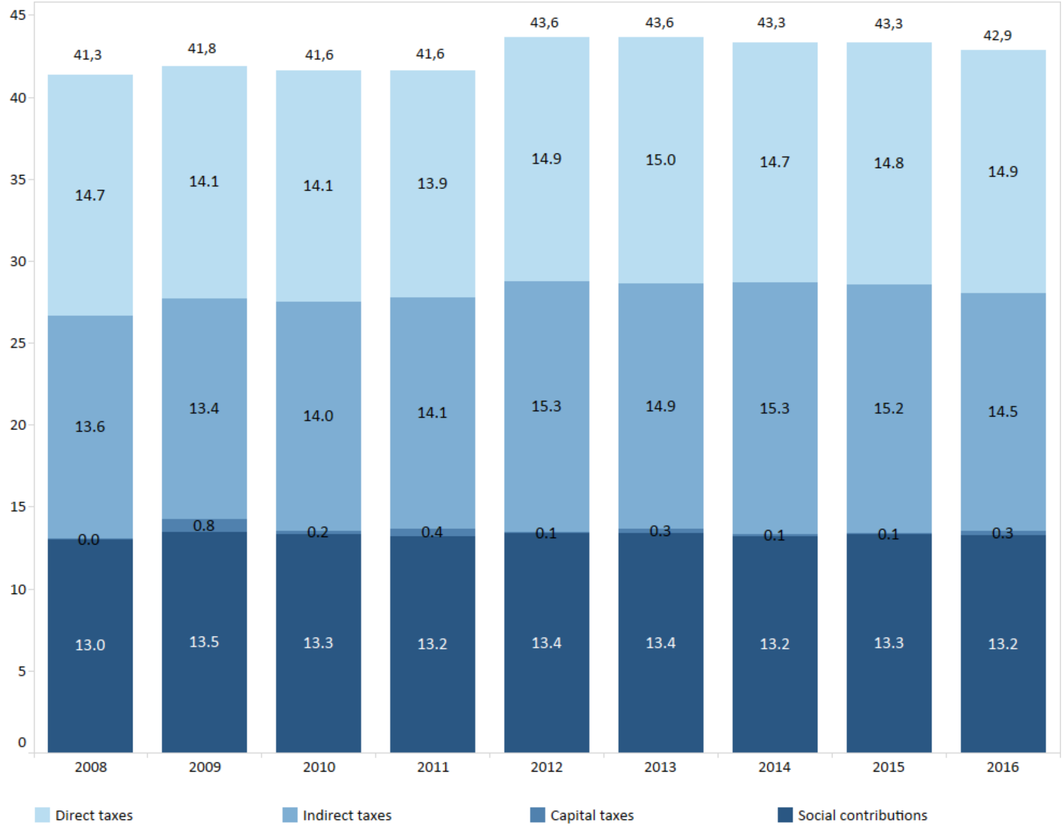
	2015 actual				Difference between 2015 actuals		2016 actual Apr. 2017		2016-2015	
	Oct. 2016	% of GDP	Apr. 2017	% of GDP	Abs. value	% of GDP	Abs. value	% of GDP	% change	Change as % of GDP
	(1)	(2)	(3)	(4)	(3) - (1)	(4) - (2)	(5)	(6)	(7)	(8)
Compensation of employees	161.453	9,8	161.998	9,8	545	0,0	164.084	9,8	1,3	0,0
Purchases of goods and services produced by market producers	44.145	2,7	43.770	2,7	-375	0,0	44.511	2,7	1,7	0,0
Intermediate consumption	89.248	5,4	90.092	5,5	844	0,0	91.066	5,4	1,1	0,0
Social benefits in cash	332.985	20,3	332.792	20,2	-193	0,0	337.514	20,2	1,4	0,0
Other current expenditure	63.777	3,9	65.169	4,0	1.392	0,1	68.526	4,1	5,2	0,1
TOTAL CURRENT PRIMARY EXPENDITURE	**691.608**	**42,1**	**693.821**	**42,2**	**2.213**	**0,1**	**705.701**	**42,2**	**1,7**	**0,0**
Interest expenditure	68.216	4,2	68.066	4,1	-150	0,0	66.272	4,0	-2,6	-0,2
TOTAL CURRENT EXPENDITURE	**759.824**	**46,3**	**761.887**	**46,3**	**2.063**	**0,0**	**771.973**	**46,2**	**1,3**	**-0,1**
Gross fixed capital formation	36.770	2,2	36.686	2,2	-84	0,0	35.048	2,1	-4,5	-0,1
Other capital expenditure	31.186	1,9	31.562	1,9	376	0,0	22.290	1,3	-29,4	-0,6
TOTAL CAPITAL EXPENDITURE	**67.956**	**4,1**	**68.248**	**4,1**	**292**	**0,0**	**57.338**	**3,4**	**-16,0**	**-0,7**
TOTAL PRIMARY EXPENDITURE	**759.564**	**46,2**	**762.069**	**46,3**	**2.505**	**0,1**	**763.039**	**45,6**	**0,1**	**-0,7**
TOTAL EXPENDITURE	**827.780**	**50,4**	**830.135**	**50,5**	**2.355**	**0,1**	**829.311**	**49,6**	**-0,1**	**-0,9**
Direct taxes	242.678	14,8	242.974	14,8	296	0,0	248.450	14,9	2,3	0,1
Indirect taxes	249.662	15,2	249.864	15,2	202	0,0	242.199	14,5	-3,1	-0,7
Social contributions	218.552	13,3	219.060	13,3	508	0,0	221.440	13,2	1,1	-0,1
Actual social contributions	*214.680*	*13,1*	*215.134*	*13,1*	*454*	*0,0*	*217.577*	*13,0*	*1,1*	*-0,1*
Imputed social contributions	*3.872*	*0,2*	*3.926*	*0,2*	*54*	*0,0*	*3.863*	*0,2*	*-1,6*	*0,0*
Other current revenue	68.460	4,2	68.592	4,2	132	0,0	69.773	4,2	1,7	0,0
TOTAL CURRENT REVENUE	**779.352**	**47,5**	**780.490**	**47,4**	**1.138**	**0,0**	**781.862**	**46,7**	**0,2**	**-0,7**
Capital taxes	1.217	0,1	1.217	0,1	0	0,0	5.199	0,3	327,2	0,2
Other capital revenue	4.280	0,3	4.231	0,3	-49	0,0	1.441	0,1	-65,9	-0,2
TOTAL CAPITAL REVENUE	**5.497**	**0,3**	**5.448**	**0,3**	**-49**	**0,0**	**6.640**	**0,4**	**21,9**	**0,1**
TOTAL REVENUE	**784.849**	**47,8**	**785.938**	**47,8**	**1.089**	**0,0**	**788.502**	**47,1**	**0,3**	**-0,6**
NET PRIMARY BORROWING (-) / LENDING (+)	**25.285**	**1,5**	**23.869**	**1,5**	**-1.416**	**-0,1**	**25.463**	**1,5**		**0,1**
NET BORROWING (-) / LENDING (+)	**-42.931**	**-2,6**	**-44.197**	**-2,7**	**-1.266**	**-0,1**	**-40.809**	**-2,4**		**0,2**
Nominal GDP	*1.642.444*		*1.645.439*		*2.995*		*1.672.438*			

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



Source: based on Istat data.

Figure 2.2 – Fiscal burden and its components *(percentage of GDP)*



Source: based on Istat data.

Direct taxes increased (+ 2.3 per cent), which in addition to the effects of RAI license fees mentioned above, mainly reflected to the expansion of IRPEF (personal income tax) and IRES (corporate income tax), while in lieu taxes contracted sharply owing to interest rate developments. The decrease in indirect taxes (-3.1 per cent) was a consequence of the fall in local taxation: IRAP (regional business tax) was significantly reduced by the effects on the balance payments and payments on account for 2016 of the measures introduced with the 2015 Stability Act concerning the elimination of labour costs from the calculation of the tax base, as well as the exemption of taxpayers in the farming, forestry and fisheries industries under the 2016 Stability Act. Municipal services tax (TASI) and municipal property tax (IMU) also fell as a result of the 2016 budget package, the former quite significantly due to the abolition of the tax for primary residences, while the latter decreased as a result of the exemption of agricultural land and the revision of tax rules governing certain industrial buildings and so-called "bolted" (fixed) plant and equipment. Excise taxes on mineral oils were essentially unchanged at the level of the previous year. By contrast, the year saw increases in VAT revenue, thanks in part to the effects of the split payment mechanism, and revenue from the gaming sector, which was affected by provisions in the budget measures. Social contributions increased (+1.1 per cent) by less than the wage bill due to the extension of contribution relief for employers who hired employees on open-ended contracts in 2016, although the magnitude and duration of the relief was smaller than in 2015. While other capital revenue contracted (-65.9 per cent), the strong expansion in capital taxes noted earlier (+327.2 per cent) was due to the impact of the voluntary disclosure programme for capital held abroad, which generated revenue of more than €4 billion.

Examining a longer time horizon, the fiscal burden – which stood at about 41 per cent in 2008-2011 – reached a peak of 43.6 per cent in 2012-2013, before falling a few tenths of a point to the 42.9 per cent mentioned earlier (Figure 2.2; for a brief analysis of recent developments in the tax burden, see section 4.2.3.1). These developments reflect fiscal policy choices and, in particular, the deficit reduction measures taken in 2012-2013 in connection with the economic and financial crisis and the sovereign debt crisis, as well as subsequent policies aimed at reconciling a further decline in the deficit with the reduction in taxation. Thus, the 2012-2013 period reflected the substantial impact of the measures taken in 2011 with Decree Laws 98, 138 and 201, aimed at containing the crisis of confidence in Italian debt by significantly increasing the size of the primary surplus, which essentially doubled compared with 2011. In this regard, the main corrective measures on the revenue side concerned not only indirect taxation - involving almost all components (VAT, excise taxes, gaming taxes and local property tax) - but also direct taxation (increases in regional surtaxes and tax on financial income). In 2014, direct taxes decline as a proportion of GDP and in absolute terms, as a result of the decrease in IRES and in lieu taxation of interest income, partly as a result of measures to support fiscal consolidation in 2013, thanks to advances of payments on account for the two categories. By contrast, indirect taxes increased, largely due to the introduction of the TASI and the increase in VAT, driven by the impact on 2014 of the increase in the ordinary rate as from October 2013. In 2015, the fiscal burden stabilised at 43.3 per cent since all of its components (direct and indirect taxes, social contributions and capital taxes) remained substantially unchanged as a proportion of GDP. However, the composition of the individual taxes change, with a sharp contraction in IRAP, reflecting the full deduction of labour costs from the tax base and a substantial increase in VAT, which partly reflected the introduction of the split payment mechanism. Finally, in 2016 the reduction in indirect taxation continued, while the share of direct taxes as a proportion of GDP increased due to the recognition of the RAI license fee as a result of the inclusion of that company in the general government sector, as mentioned earlier. The slight decline in social contributions as a proportion of GDP in recent years is associated with the contribution relief introduced to foster open-ended employment. Capital taxes have made an irregular contribution to the increase in the fiscal burden. In 2016, the impact of the voluntary disclosure programme was especially large, while in previous years the main factor was the erratic developments in capital taxes due to changes in accounting standards.

Primary expenditure grew by 0.1 per cent in 2016, the result of an increase of 1.7 per cent in current spending net of interest and a contraction of 16 per cent in capital expenditure. As a result, the latter declined by seven-tenths of a point as a proportion of GDP (to 3.4 per cent), while current primary expenditure stabilised as a ratio of GDP (at 42.2 per cent).

Among the components of current primary spending, compensation of employees began to increase again (+1.3 per cent) after five consecutive years of decline in absolute value due to various factors, including the inclusion of RAI personnel expenses, the implementation of the "Good Education" plan, the grant of a monthly tax credit of €80 euros to police, firefighter and armed forces personnel, including port authorities, who do not receive executive-level pay. Public employment grew after nine straight years of contraction. Total intermediate consumption accelerated (+1.3 per cent), reflecting a more rapid increase in social benefits in kind purchased directly from market producers (+1.7 per cent) and more moderate growth in intermediate consumption excluding purchases from market producers (+1.1 per cent). In addition, expenditure for the purchase of RAI goods and services was included in the latter. Benefits in kind were particularly affected by the increase in the assistance component due to social assistance spending for foreigners. Growth in social benefits in cash (+1.4 per cent) reflected a moderate expansion in pension spending (+0.9 per cent) and a larger rise in other spending (+3.3 per cent). More specifically, the latter reflected increases in outflows for termination benefits, maternity grants and unemployment benefits. Pension spending was limited by a negative inflation indexation adjustments. As for other current outlays, the substantial increase (+5.2 per cent) is also linked to the increase in production grants, in particular those distributed to renewable energy producers. The reduction in capital expenditure was due to the contraction in investment (-4.5 per cent) and, above all, other capital expenditure, which fell by more than half (-59.4 per cent). The latter was affected by the elimination of certain outlays registered in 2015, including the one-off payments of arrears for 2012-2014 for the revaluation of pension benefits – for pensions three times the minimum benefit - laid down by Decree Law 65/2015 and transfers from the National Resolution Fund to cover the losses of banks in receivership.[22] In addition, refundable tax credits for deferred tax assets (DTA) were considerably lower than in the previous year.[23] Investment declined for the seventh consecutive year, especially that by local government (-13.7 per cent), which had risen in 2015, since that was the last year resources from the 2007-2013 EU programming cycle could be spent without forfeiting funds. Another possible factor impacting the implementation of investments may have been the implementation of the new

[22] These regard amounts disbursed from the National Resolution Fund for the banking industry, which has been in operation since 2015 and is managed by the Bank of Italy on behalf of the Government (see section 2.2.2).

[23] This partly reflected the fact that owing to the change in the rules governing the deductibility of writedowns and losses on loans by credit and financial institutions, they can now be deducted in full in the year to which they are recognised, unlike the previous system in which they were deducted over a period of five years (with the consequent generation of deferred tax assets).

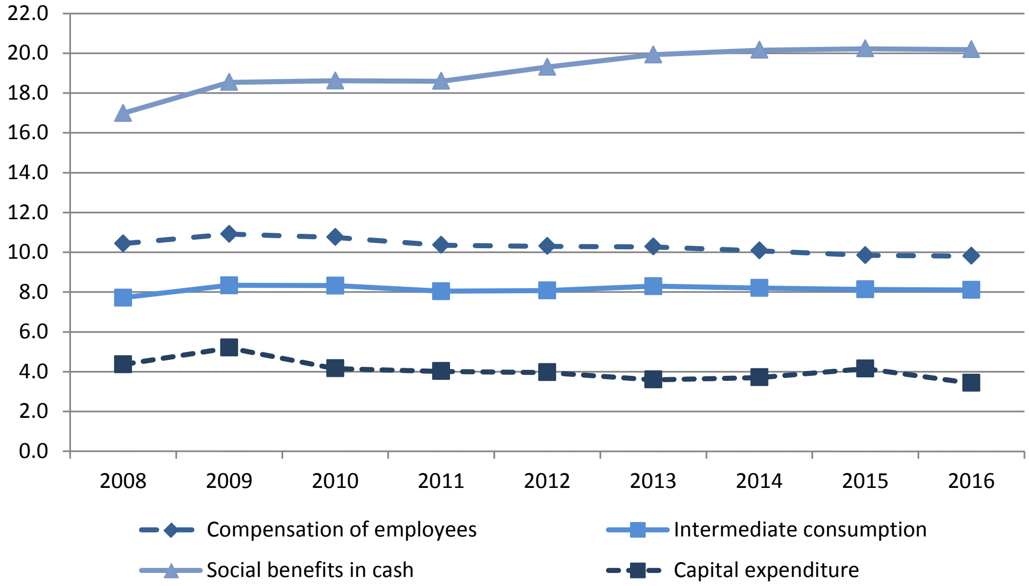
public procurement code owing to the changes it introduced (see Analysis 3.1.2). Grants for private investment rose moderately (+0.7 per cent).

Considering a longer-term horizon for expenditures as well, the underlying trends that have been under way for several years are continuing, showing a progressive decline in the main components of spending as a proportion of GDP, with the exception of social benefits in cash (Figure 2.3). This reflects small spending increases and in some cases reductions in absolute value. In particular, spending on compensation of employees declined in absolute value from 2011 to 2015. This reflected the various spending reduction measures associated with freezes on contract renewals and promotions and tight controls on turnover, with an uninterrupted decline in the number of public employees from 2007 to 2015. With regard to intermediate consumption,[24] various tools have contributed to limiting the operating costs of government departments, including: across-the-board cuts, expenditure limitations and ceilings for specific items and the programme for the rationalisation of purchases of goods and services. Outside of central government, the containment of expenditure was achieved through healthcare governance measures and deficit elimination plans, while other spending was controlled with the Internal Stability Pact. Capital expenditure reflects a fall in investment since 2010 and the erratic developments in other capital expenditure. In the past two years, social benefits have stabilised as a share of GDP after peaking in 2014 due to the monthly €80 tax credit granted to low-income employees. A particular contribution to curbing spending came from the effects of the latest pension reform and small indexation adjustments due to the moderation of inflation.

Figure 2.4 shows the growth rates of the main components of current primary spending, revealing the containment of expenditure since 2010, with negative rates for both compensation of employees from 2011 to 2015 and intermediate consumption in 2011-2012 business year. For 2016, the latter two components were affected by the statistical effect of the inclusion of RAI in the general government sector.

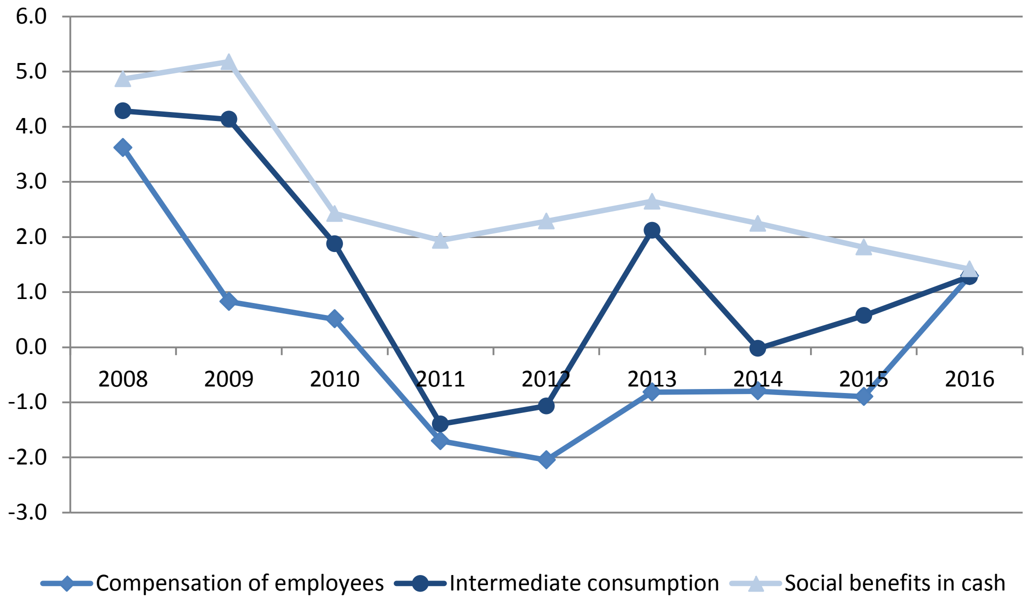
[24] For a more detailed analysis of intermediate consumption, see *Ufficio parlamentare di bilancio* (2017), "I consumi intermedi delle Amministrazioni pubbliche", Focus no. 3, March.

Figure 2.3 – Main components of primary expenditure
(percentage of GDP)



Source: based on Istat data.

Figure 2.4 – Main components of current primary expenditure
(percentage rate of change)



Source: based on Istat data.

Considering information since 1995, the year from which national accounts data compliant with ESA2010 is available, total general government expenditure, net of interest expenditure, rose by an annual average of 4.5 per cent over the period from 1996 to 2009 and by only 0.5 per cent between 2010 and 2016. In 2010 primary expenditure declined in absolute terms. However, this reflected differentiated trends: current primary spending grew at the same rate as total primary expenditure in the first period (+4.5 per cent) and 1.1 per cent in the second period, while capital expenditure, after an average increase of 5.4 per cent in the first period, then experienced an average reduction of 4.4 per cent between 2010 and 2016. Excluding social benefits in cash, current primary spending increased by an annual average of 4.4 per cent in 1996-2009 and only 0.3 per cent on average from 2010 to 2016.

The figures for the deficit and primary surplus for 2016 confirmed the projections in the Technical Note to the 2017-2019 Budget Act (Tables 2.2a, 2.2b and 2.2c). Adjusting the data for the effects of the inclusion of RAI in the general government sector, both revenue and expenditure were greater than indicated in the Technical Note, which did not include that impact. Even taking account of this change, the composition of the budget items still differs. On the expenditure side, current spending net of interest expenditure was higher than expected, especially intermediate consumption and other expenditure, while capital expenditure was lower, owing to the reduction in investments. On the revenue side, social contributions were greater than forecast, due the better-than-expected performance of employment, as were indirect taxes and capital taxes, with the latter reflecting the revenue associated with the greater-than-expected revenue from the voluntary disclosure programme.

Box 2.1 – Inclusion of RAI S.p.A. in the general government sector

The 2016 edition of the *Manual on Government Deficit and Debt* (MGDD)[25] devotes a specific section on classification of entities that provide public television and radio services. Their inclusion in the general government sector essentially depends on the nature of the payments requested of users for the public service provided. Where such payments are compulsory when certain general conditions are met (such as mere possession of a television), they must be considered a tax.[26] In this case, the payment cannot be considered revenue by the broadcaster, which has no power of taxation, but necessarily be associated with a public entity – the State – which then finances the broadcaster from that revenue stream. Consequently, for the purpose of classifying a broadcaster either within or outside general government, it is necessary to determine whether or not the company finances at least 50 per cent of its costs with funding from the market.

This condition is not met by RAI S.p.A.[27], which as from 2016 has therefore been included in the general government sector.

This inclusion does not in principle reflect the change as from 2016 in the procedures used to collect the license fee, as the compulsory nature of the payment has not changed. The change is instead attributable to the specification by Eurostat of the classification criteria for the license fee itself, which clarified the nature of the license as a tax.

Following that inclusion, as from 2016 the general government account has undergone a number of changes on the revenue and expenditure sides, a consequence, on the one hand, of the inclusion of license fee payments under general government revenue (previously, the item was sterilized within the corrective and offsetting items of State budget revenue, as it was considered revenue of RAI itself) and, on the other, of the inclusion of the company's financials in the public accounts:

- revenue shows an increase in direct and indirect taxes – in proportion to the license fees paid by households and firms, respectively[28] – and an increase in the sale of goods and services in relation to the advertising revenue of the company.The Tax Revenue Bulletin for 2016 reports overall revenue from RAI license fees of about €2 billion in 2016, an increase on the €1.7 billion registered in 2015.[29] Advertising and other revenue of RAI S.p.A. in 2015 is reported as about €700 million;
- expenditure shows an increase in respect of the costs recognised in the income statement of the company (personnel, intermediate consumption for the purchase of goods and services, interest).

The public accounts have therefore been increased on both the revenue and expenditure sides, while the net profit (or loss) of RAI contributes to reducing (or increasing) general government net borrowing.[30]

The public debt is also increased as a result of the inclusion of the debt of RAI.[31]

The accounting impact of the inclusion of RAI in the general government sector produces a number of changes in the macroeconomic aggregates of the private sector, which need to be

[25] This publication periodically updates the procedures for applying ESA2010.
[26] This circumstance was not considered significant when the public service represented the monopoly or majority form of television broadcasting and, accordingly, possession of a television could be assumed to be indicative of use of a public service. This can no longer be assumed in a situation in which private television services are common.
[27] In 2013-2015, license fees represented about 70 per cent of the total revenue of RAI S.p.A..
[28] The fee paid by households is classified under other current taxes (payment to obtain a license, item D.59(d) del ESA2010), while that paid by firms is included under other taxes on production (license for business and professional licenses, item D.29(e) of ESA2010).
[29] The RAI S.p.A. financial statements for 2015 report revenue for license fees of €1,637 million.
[30] For example, RAI S.p.A. posted a loss of €203 million in 2014 and about €46 million in 2015.
[31] For example, at December 31, 2015 the non-current financial liabilities of RAI S.p.A. (bonds and amounts due to banks) amounted to about €400 million.

accounted for in assessing developments in those aggregates in 2016 compared with 2015. On the demand side, the change caused a decrease in private consumption equal to the amount of the license fee. On the supply side, private sector employment and income decreased (with a corresponding increase in public employment).

2.2 The trend scenario

According to the EFD forecasts, general government net borrowing in 2017 should fall slightly from the previous year and then decline further in the next three years, with the largest declines coming in 2018 and 2019, mainly due to the increase in VAT rates connected with the activation of the VAT safeguard clauses and in excise taxes on mineral oils.

In the absence of changes, the deficit is projected at 2.3 per cent in 2017, falling to 1.3 per cent the next year, 0.6 per cent in 2019 and just below 0.5 per cent in 2020 (Tables 2.2a, 2.2b and 2.2c). The substantial reduction of the deficit is essentially due to favourable developments in the primary surplus, which, after holding at 1.5 per cent in 2017, will increase as from 2018, reaching 3.4 per cent at the end of the period due to the increase in VAT and the reduction in expenditure net of interest spending as a share of gross domestic product (45.6 per cent last year to 43.1 per cent in 2020), in particular, current expenditure, which declines as a percentage of GDP in in each year of the forecasting period (from 42.2 per cent in 2016 to 40.1 per cent in 2020). In 2017-2020, trend primary expenditure increases by an average of 1.3 per cent annually (after the annual average growth of 0.5 per cent between 2010 and 2016 noted earlier), reflecting an average increase of 1.4 per cent in current primary expenditure (+1.1 per cent in 2010-2016) and a decrease of 0.2 per cent in capital spending (-4.4 per cent in 2010-16). Net of social benefits in cash, current primary expenditure is expected to increase by an annual average of 0.7 per cent. Interest expense reflects the effects of the expected rise in rates and, after six years of decline registered through 2016 and expected for 2017-2018, it is forecast to begin rising again in absolute value as from 2019. As a percentage of GDP, such expenditure decreases from 4 per cent in 2016 to 3.8 per cent in 2020, after reaching a low of 3.7 per cent in 2018-2019.

Table 2.2a – General government consolidated revenue and expenditure account: a comparison of trend forecasts *(millions of euros)*

	Technical Note					2017 EFD					
	2015 (10/2016)	2016	2017	2018	2019	2015 (04/2017)	2016 (04/2017)	2017	2018	2019	2020
Compensation of employees	161,453	162,908	164,860	164,316	164,657	161,998	164,084	166,733	165,921	166,468	166,749
Intermediate consumption	133,393	133,433	134,914	133,402	134,850	133,862	135,577	136,530	136,079	136,987	139,502
Social benefits in cash	332,985	339,460	346,797	356,443	364,960	332,792	337,514	344,850	353,740	362,940	372,380
Pensions	*258,804*	*261,650*	*265,545*	*273,326*	*280,705*	*258,924*	*261,190*	*264,610*	*271,160*	*279,240*	*287,600*
Other social benefits	*74,181*	*77,810*	*81,252*	*83,118*	*84,254*	*73,868*	*76,324*	*80,240*	*82,580*	*83,700*	*84,780*
Other current expenditure	63,777	66,398	64,350	64,869	66,486	65,169	68,526	67,377	66,827	67,141	67,782
TOTAL CURRENT PRIMARY EXPENDITURE	**691,608**	**702,199**	**710,921**	**719,029**	**730,953**	**693,821**	**705,701**	**715,490**	**722,567**	**733,536**	**746,413**
Interest expenditure	68,216	66,478	63,442	62,394	61,770	68,066	66,272	65,979	65,531	67,422	71,089
TOTAL CURRENT EXPENDITURE	**759,824**	**768,677**	**774,363**	**781,423**	**792,723**	**761,887**	**771,973**	**781,469**	**788,098**	**800,958**	**817,502**
Gross fixed capital formation	36,770	37,112	39,555	41,359	42,507	36,686	35,048	36,038	38,389	38,903	36,502
Investment grants	15,627	15,115	12,826	17,182	14,327	15,766	15,874	16,195	16,372	16,193	16,088
Other capital expenditure (1)	15,559	6,053	7,353	7,225	5,367	15,796	6,416	5,443	6,452	5,251	4,125
TOTAL CAPITAL EXPENDITURE	**67,956**	**58,280**	**59,734**	**65,766**	**62,201**	**68,248**	**57,338**	**57,676**	**61,213**	**60,347**	**56,715**
TOTAL PRIMARY EXPENDITURE	**759,564**	**760,479**	**770,656**	**784,796**	**793,154**	**762,069**	**763,039**	**773,166**	**783,780**	**793,883**	**803,128**
TOTAL EXPENDITURE	**827,780**	**826,956**	**834,097**	**847,189**	**854,924**	**830,135**	**829,311**	**839,145**	**849,311**	**861,305**	**874,217**
Total tax revenue	493,557	493,081	498,405	522,593	535,815	494,055	495,848	499,102	519,550	533,305	541,921
Direct taxes	*242,678*	*248,248*	*248,891*	*247,551*	*252,036*	*242,974*	*248,450*	*249,050*	*245,691*	*251,238*	*255,026*
Indirect taxes	*249,662*	*240,968*	*246,292*	*274,212*	*282,938*	*249,864*	*242,199*	*247,146*	*272,945*	*281,145*	*285,964*
Capital taxes	*1,217*	*3,865*	*3,222*	*831*	*841*	*1,217*	*5,199*	*2,906*	*914*	*922*	*931*
Social contributions	218,552	219,669	222,906	230,224	240,036	219,060	221,440	224,565	232,861	241,740	247,417
Actual social contributions	*214,680*	*215,714*	*218,902*	*226,157*	*235,898*	*215,134*	*217,577*	*220,672*	*228,891*	*237,695*	*243,299*
Imputed social contributions	*3,872*	*3,955*	*4,004*	*4,067*	*4,138*	*3,926*	*3,863*	*3,893*	*3,970*	*4,045*	*4,118*
Other current revenue	68,460	69,755	69,689	70,466	71,736	68,592	69,773	70,559	70,706	71,912	72,892
TOTAL CURRENT REVENUE	**779,352**	**778,640**	**787,778**	**822,452**	**846,745**	**780,490**	**781,862**	**791,320**	**822,203**	**846,035**	**861,299**
Other capital revenue	4,280	3,697	3,265	3,561	3,932	4,231	1,441	5,365	3,393	3,666	3,598
TOTAL REVENUE	**784,849**	**786,202**	**794,265**	**826,844**	**851,518**	**785,938**	**788,502**	**799,591**	**826,510**	**850,623**	**865,828**
Tax burden	*43.4*	*42.6*	*42.3*	*42.8*	*42.8*	*43.34*	*42.89*	*42.3*	*42.8*	*42.8*	*42.4*
NET PRIMARY BORROWING (-) / LENDING (+)	**25,285**	**25,723**	**23,610**	**42,048**	**58,364**	**23,869**	**25,463**	**26,425**	**42,730**	**56,740**	**62,700**
% of GDP	1.5	1.5	1.4	2.4	3.2	1.5	1.5	1.5	2.4	3.1	3.4
NET BORROWING (-) / LENDING (+)	**-42,931**	**-40,754**	**-39,832**	**-20,345**	**-3,406**	**-44,197**	**-40,809**	**-39,554**	**-22,801**	**-10,682**	**-8,389**
% of GDP	-2.6	-2.4	-2.3	-1.2	-0.2	-2.7	-2.4	-2.3	-1.3	-0.6	-0.5
Nominal GDP	*1,642,444*	*1,672,026*	*1,705,841*	*1,758,962*	*1,812,933*	*1,645,439*	*1,672,438*	*1,709,547*	*1,758,562*	*1,810,380*	*1,861,903*

Source: based on data in the Technical Note to the 2017-2019 Budget Act, Table 3.2-5; 2017 EFD, Table II.2-1.

(1) In the 2017 EFD, the figure for this item differs from that of Istat as it takes account of the overall revision of the time series concerning frequency usage rights, which Istat performed for a shorter period of time. Under the new accounting treatment, the criterion for registering the sale of licenses has been changed. It is no longer registered in the year of the sale but in the years in which the licenses become available for use. Under the new accounting rules, registration is no longer carried out, as reported in the EFD, as a reduction in capital expenditure but rather under current revenue.

Table 2.2b – General government consolidated revenue and expenditure account: a comparison of trend forecasts *(percentage of GDP)*

	Technical Note					2017 EFD					
	2015 (10/2016)	2016	2017	2018	2019	2015 (04/2017)	2016 (04/2017)	2017	2018	2019	2020
Compensation of employees	9.8	9.7	9.7	9.3	9.1	9.8	9.8	9.8	9.4	9.2	9.0
Intermediate consumption	8.1	8.0	7.9	7.6	7.4	8.1	8.1	8.0	7.7	7.6	7.5
Social benefits in cash	20.3	20.3	20.3	20.3	20.1	20.2	20.2	20.2	20.1	20.0	20.0
Pensions	*15.8*	*15.6*	*15.6*	*15.5*	*15.5*	15.7	*15.6*	*15.5*	*15.4*	*15.4*	*15.4*
Other social benefits	*4.5*	*4.7*	*4.8*	*4.7*	*4.6*	4.5	*4.6*	*4.7*	*4.7*	*4.6*	*4.6*
Other current expenditure	3.9	4.0	3.8	3.7	3.7	4.0	4.1	3.9	3.8	3.7	3.6
TOTAL CURRENT PRIMARY EXPENDITURE	**42.1**	**42.0**	**41.7**	**40.9**	**40.3**	**42.2**	**42.2**	**41.9**	**41.1**	**40.5**	**40.1**
Interest expenditure	4.2	4.0	3.7	3.5	3.4	4.1	4.0	3.9	3.7	3.7	3.8
TOTAL CURRENT EXPENDITURE	**46.3**	**46.0**	**45.4**	**44.4**	**43.7**	**46.3**	**46.2**	**45.7**	**44.8**	**44.2**	**43.9**
Gross fixed capital formation	2.2	2.2	2.3	2.4	2.3	2.2	2.1	2.1	2.2	2.1	2.0
Investment grants	1.0	0.9	0.8	1.0	0.8	1.0	0.9	0.9	0.9	0.9	0.9
Other capital expenditure (1)	0.9	0.4	0.4	0.4	0.3	1.0	0.4	0.3	0.4	0.3	0.2
TOTAL CAPITAL EXPENDITURE	**4.1**	**3.5**	**3.5**	**3.7**	**3.4**	4.1	**3.4**	**3.4**	**3.5**	**3.3**	**3.0**
TOTAL PRIMARY EXPENDITURE	**46.2**	**45.5**	**45.2**	**44.6**	**43.7**	**46.3**	**45.6**	**45.2**	**44.6**	**43.9**	**43.1**
TOTAL EXPENDITURE	**50.4**	**49.5**	**48.9**	**48.2**	**47.2**	**50.5**	**49.6**	**49.1**	**48.3**	**47.6**	**47.0**
Total tax revenue	30.1	29.5	29.2	29.7	29.6	30.0	29.6	29.2	29.5	29.5	29.1
Direct taxes	*14.8*	*14.8*	*14.6*	*14.1*	*13.9*	14.8	*14.9*	*14.6*	*14.0*	*13.9*	*13.7*
Indirect taxes	*15.2*	*14.4*	*14.4*	*15.6*	*15.6*	15.2	*14.5*	*14.5*	*15.5*	*15.5*	*15.4*
Capital taxes	*0.1*	*0.2*	*0.2*	*0.05*	*0.05*	0.1	*0.31*	*0.17*	*0.05*	*0.05*	*0.05*
Social contributions	13.3	13.1	13.1	13.1	13.2	13.3	13.2	13.1	13.2	13.4	13.3
Actual social contributions	*13.1*	*12.9*	*12.8*	*12.9*	*13.0*	13.1	*13.0*	*12.9*	*13.0*	*13.1*	*13.1*
Imputed social contributions	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	0.2	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*
Other current revenue	4.2	4.2	4.1	4.0	4.0	4.2	4.2	4.1	4.0	4.0	3.9
TOTAL CURRENT REVENUE	**47.5**	**46.6**	**46.2**	**46.8**	**46.7**	**47.4**	**46.7**	**46.3**	**46.8**	**46.7**	**46.3**
Other capital revenue	0.3	0.2	0.2	0.2	0.2	0.3	0.1	0.3	0.2	0.2	0.2
TOTAL REVENUE	**47.8**	**47.0**	**46.6**	**47.0**	**47.0**	**47.8**	**47.1**	**46.8**	**47.0**	**47.0**	**46.5**
NET PRIMARY BORROWING (-) / LENDING (+)	**1.5**	**1.5**	**1.4**	**2.4**	**3.2**	**1.5**	**1.5**	**1.5**	**2.4**	**3.1**	**3.4**
NET BORROWING (-) / LENDING (+)	**-2.6**	**-2.4**	**-2.3**	**-1.2**	**-0.2**	**-2.7**	**-2.4**	**-2.3**	**-1.3**	**-0.6**	**-0.5**
Nominal GDP	*1,642,444*	*1,672,026*	*1,705,841*	*1,758,962*	*1,812,933*	*1,645,439*	*1,672,438*	*1,709,547*	*1,758,562*	*1,810,380*	*1,861,903*

Source: based on data in the Technical Note to the 2017-2019 Budget Act, Table 3.2-5; 2017 EFD, Table II.2-2.
(1) In the 2017 EFD, the figure for this item differs from that of Istat as it takes account of the overall revision of the time series concerning frequency usage rights, which Istat performed for a shorter period of time. Under the new accounting treatment, the criterion for registering the sale of licenses has been changed. It is no longer registered in the year of the sale but in the years in which the licenses become available for use. Under the new accounting rules, registration is no longer carried out, as reported in the EFD, as a reduction in capital expenditure but rather under current revenue.

Table 2.2c – General government consolidated revenue and expenditure account: a comparison of trend forecasts
(growth rates)

	Technical Note				2017 EFD				
	2016	2017	2018	2019	2016	2017	2018	2019	2020
Compensation of employees	0.9	1.2	-0.3	0.2	1.3	1.6	-0.5	0.3	0.2
Intermediate consumption	0.0	1.1	-1.1	1.1	1.3	0.7	-0.3	0.7	1.8
Social benefits in cash	1.9	2.2	2.8	2.4	1.4	2.2	2.6	2.6	2.6
Pensions	*1.1*	*1.5*	*2.9*	*2.7*	*0.9*	*1.3*	*2.5*	*3.0*	*3.0*
Other social benefits	*4.9*	*4.4*	*2.3*	*1.4*	*3.3*	*5.1*	*2.9*	*1.4*	*1.3*
Other current expenditure	4.1	-3.1	0.8	2.5	5.2	-1.7	-0.8	0.5	1.0
TOTAL CURRENT PRIMARY EXPENDITURE	**1.5**	**1.2**	**1.1**	**1.7**	**1.7**	**1.4**	**1.0**	**1.5**	**1.8**
Interest expenditure	-2.5	-4.6	-1.7	-1.0	-2.6	-0.4	-0.7	2.9	5.4
TOTAL CURRENT EXPENDITURE	**1.2**	**0.7**	**0.9**	**1.4**	**1.3**	**1.2**	**0.8**	**1.6**	**2.1**
Gross fixed capital formation	0.9	6.6	4.6	2.8	-4.5	2.8	6.5	1.3	-6.2
Investment grants	-3.3	-15.1	34.0	-16.6	0.7	2.0	1.1	-1.1	-0.6
Other capital expenditure (1)	-61.1	21.5	-1.7	-25.7	-59.4	-15.2	18.5	-18.6	-21.4
TOTAL CAPITAL EXPENDITURE	**-14.2**	**2.5**	**10.1**	**-5.4**	**-16.0**	**0.6**	**6.1**	**-1.4**	**-6.0**
TOTAL PRIMARY EXPENDITURE	**0.1**	**1.3**	**1.8**	**1.1**	**0.1**	**1.3**	**1.4**	**1.3**	**1.2**
TOTAL EXPENDITURE	**-0.1**	**0.9**	**1.6**	**0.9**	**-0.1**	**1.2**	**1.2**	**1.4**	**1.5**
Total tax revenue	-0.1	1.1	4.9	2.5	0.4	0.7	4.1	2.6	1.6
Direct taxes	*2.3*	*0.3*	*-0.5*	*1.8*	*2.3*	*0.2*	*-1.3*	*2.3*	*1.5*
Indirect taxes	*-3.5*	*2.2*	*11.3*	*3.2*	*-3.1*	*2.0*	*10.4*	*3.0*	*1.7*
Capital taxes	*217.6*	*-16.6*	*-74.2*	*1.2*	*327.2*	*-44.1*	*-68.5*	*0.9*	*1.0*
Social contributions	0.5	1.5	3.3	4.3	1.1	1.4	3.7	3.8	2.3
Actual social contributions	*0.5*	*1.5*	*3.3*	*4.3*	*1.1*	*1.4*	*3.7*	*3.8*	*2.4*
Imputed social contributions	*2.1*	*1.2*	*1.6*	*1.7*	*-1.6*	*0.8*	*2.0*	*1.9*	*1.8*
Other current revenue	1.9	-0.1	1.1	1.8	1.7	1.1	0.2	1.7	1.4
TOTAL CURRENT REVENUE	**-0.1**	**1.2**	**4.4**	**3.0**	**0.2**	**1.2**	**3.9**	**2.9**	**1.8**
Other capital revenue	-13.6	-11.7	9.1	10.4	-65.9	272.3	-36.8	8.0	-1.9
TOTAL REVENUE	**0.2**	**1.0**	**4.1**	**3.0**	**0.3**	**1.4**	**3.4**	**2.9**	**1.8**

Source: based on data in the Technical Note to the 2017-2019 Budget Act, Table 3.2-5; 2017 EFD, Table II.2-1.
(1) In the 2017 EFD, the figure for this item differs from that of Istat as it takes account of the overall revision of the time series concerning frequency usage rights, which Istat performed for a shorter period of time. Under the new accounting treatment, the criterion for registering the sale of licenses has been changed. It is no longer registered in the year of the sale but in the years in which the licenses become available for use. Under the new accounting rules, registration is no longer carried out, as reported in the EFD, as a reduction in capital expenditure but rather under current revenue.

Compared with the public finance scenario in the Technical Note, the new trend forecasts reflect the outturn data for 2016, a slightly more positive macroeconomic scenario in 2017 and a less favourable scenario in 2018-2019, as well as the financial impact of legislative measures approved up to March 2017, including those relating to the changes made during the ratification of Decree 193/2016, which were not included in the forecasts issued with the Technical Note.

Compared with the Technical Note, the deficit is confirmed at 2.3 per cent of GDP for 2017, while the trend figure has been revised upward by just one-tenth of a point for 2018 and more substantially, by four-tenths of a point, for 2019. The deterioration in the balances essentially reflects an increase in current primary expenditure and interest spending. The reductions in capital expenditure work in the opposite direction, falling as a result of the failure to implement expected investments in 2016 and, inter alia, a change in the recognition of amounts relating to frequency usage rights. Their treatment has changed in accordance with the periodic statistical and accounting revisions carried out at the European level, so they are no longer accounted for in the year of sale but rather in the various years in which the frequencies are used. In the 2017 EFD, the figure for this item differs from that reported by Istat in the notification made last October for 2012-15, as the EFD already incorporates the effects of the overall revision of the past time series. This brings forward an improvements in the public accounts, reflecting the positive effects of sales from previous years. Under the new accounting policies, however, they should not be recognised, as reported in the EFD, as a reduction in capital expenditure but rather under current revenue.

Revenue decreases as a proportion of GDP in the period under review, with the exception of 2018-2019, reflecting developments in the fiscal burden. The latter falls from 42.9 per cent last year to 42.4 per cent in 2020, although with a minimum of 42.3 per cent in 2017 - mainly associated with the effects of the various measures to reduce the weight of direct taxation introduced with the last two budget packages - followed by an increase to 42.8 per cent in 2018-2019 due to the expected increases in VAT and excise taxes.

Direct taxes reflect measures to help firms. More specifically, the estimation is impacted by the measure envisaged in the 2016 Stability Act to reduce the IRES rate from 27.5 per cent to 24 per cent as from 2017, as well as the measures provided for in the 2017 Budget Act regarding the increase in deductible depreciation (which expanded the provisions introduce the previous year) and the introduction of the optional flat tax on entrepreneurial income for the retained earnings of sole proprietorships and partnerships. Other measures to reduce direct taxation included provisions that exempted productivity bonuses from tax and extended the no-tax area for pensioners under the age of 75. By contrast, the share of GDP of indirect taxation and social security contributions increases over the years, beginning in 2018 for the former – reflecting the significant impact of the activation of the safeguard clauses - and in 2019 for the latter, in connection with the termination of extended contribution relief for open-ended hiring. Capital taxes reflect the revenue increases from the voluntary disclosure programme, which decreased from 2016 to 2017.

Primary expenditure is forecast to decline by about 2.5 percentage points of GDP over the forecasting period, reflecting – as noted above –- the decrease in nearly all the components of current expenditure. The evolution of primary spending on a current legislation basis, which is virtually stable in nominal terms net of social benefits, shows little scope for further significant spending cuts, unless it involves a reduction in the public services delivered. Of course, the spending review would in any case retain a role in improving the quality of public intervention and the efficiency of services.

The favourable trend in current primary spending depends on a number of factors. In addition to the decline in public employment forecast for each year of the current horizon, it also reflects substantial measures to curb intermediate consumption and, with regard to other current expenditure, the reduction in grants to renewable energy generators. However, this latter reduction is associated with a corresponding decrease on the revenue side, with a net impact of zero on the budget balance. With the next budget, some additional expenditure indicated in the EFD should be authorised to finance unchanged policies for the renewal of public employment contracts and peacekeeping missions, amounting to about €1.3 billion in 2018, €1.4 billion in 2019 and €1.5 billion in 2020.

Looking at the largest budget items, after the increase in 2016, reversing the downward trend seen in recent years, expenditure on compensation of employees was projected to rise again in 2017 then shrink in 2018, followed by a slight increase in the subsequent two years while nevertheless declining as a proportion of GDP (from 9.8 per cent to 9 per cent), owing to the forecast decrease in employment noted earlier.

These developments reflected in particular the appropriations for the public employment fund – whose allocation, as envisaged in the 2017 Budget Act, was recently specified - and the fund for school independence. In a recent decree of the President of the Council of Ministers, the former fund was allocated for three different purposes: for collective bargaining for 2016-18 for central government personnel; for the hiring of personnel on an open-ended basis (by the State, police forces, firefighters, sundry agencies); and for police forces, armed forces and firefighters for recruitment, career definitions, reorganisation of roles and the extension of the monthly €80 tax credit for the law enforcement and defence sector. The other fund for school independence increases the resources already provided for under the “Good Education” Act, whose first effects were already seen in 2015 and 2016. The effects of the indemnity for work under an expired bargaining agreement for 2019-2021 begin to emerge as from 2019.

Social benefits decrease slightly as a share of GDP, from 20.2 per cent to 20 per cent. In 2017, the pension component is affected by the provisions of the Budget Act concerning, among other things, the “fourteenth-month” additional pension payment for certain categories of pensioners, the retirement of workers in physically demanding occupations and measures for early career starters. It is also influenced by the effects of inflation, which impacts the revaluation of benefits. Other benefits rise substantially in 2017 due to the various measures provided for in the Budget Act for households, young people and poverty alleviation programmes.

Intermediate consumption is particularly affected by the developments in the healthcare component, with more rapid growth in 2020 as a result of the termination of corrective measures provided for in previous years.

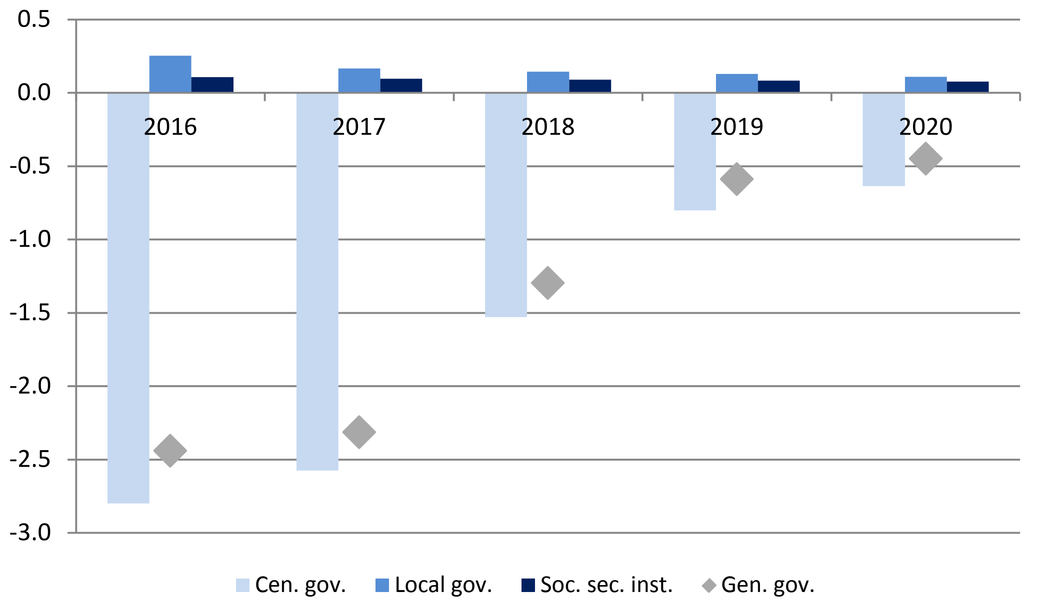
Capital expenditure, on the other hand, should be positively impacted by the significant expansionary measures provided for in the 2017 Budget Act, especially in 2018, notably through the use of the fund for reviving investment, the granting of financial authorisation for investment by local authorities, earthquake emergency measures and measures for public and private enterprises. However, such expenditure decreases in 2020, bringing capital expenditure below the level registered in 2016 even on a current legislation basis.

2.2.1 Trend developments by subsector

With regard to the trend balance by subsector, the forecasts for 2017-2020 show a net creditor position for both local governments (gradually declining 0.3 per cent of GDP in 2016 to 0.1 per cent in 2020) and social security institutions. These positive contributions partly offset central government net borrowing, although the latter is projected decline progressively, in line with the balance for the entire general government sector, from -2.6 per cent of GDP to -0.6 per cent in 2020 (Figure 2 5).

The presence of a net creditor position for local governments could, in part, be the result of assuming the adoption of a precautionary approach by those authorities in order to maintain a margin of safety with regard to the balanced-budget requirement (for example, with partial use of doubtful receivables).

Figure 2.5 – Trend developments in net borrowing by subsector
(percentage of GDP)



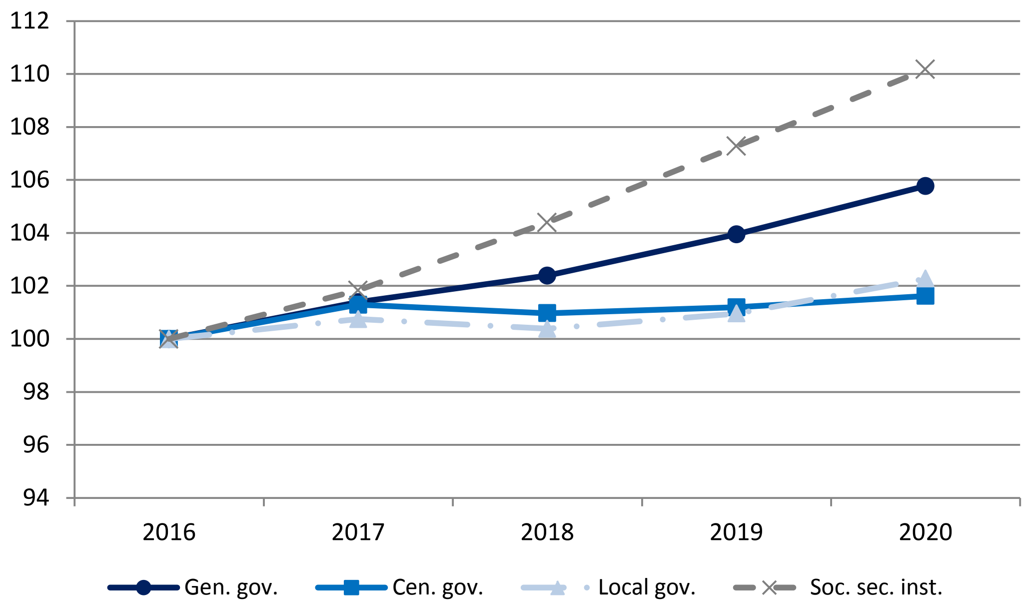
Source: based on 2017 EFD data.

With regard to the main components of primary spending, the trend forecasts reflect a substantial stabilisation of current expenditure by both central and local government, while the social security component continues to rise (Figure 2.6a).

For capital expenditure (Figure 2.6b), in the medium term, the forecasts reflect the presence of multiannual appropriations that the 2017 Budget Act provides for until 2032. Nevertheless, given the temporary nature of other expenditure authorisations capital expenditure by central government in 2020 is expected to decrease. This decline is partially offset by a moderate recovery in the local component until 2019, whose share of total general government capital spending rises from 43 per cent in 2016 to 48 per cent in 2020, although this remains below the average level registered in 2003-2012 (51 per cent).

Revenue net of transfers[32] (Figure 2.6c) display greater growth in 2016-2020 for central government (+9 per cent) and social security (+12 per cent), which reflects the end of contribution relief, and slower expansion for local governments (+6 per cent).

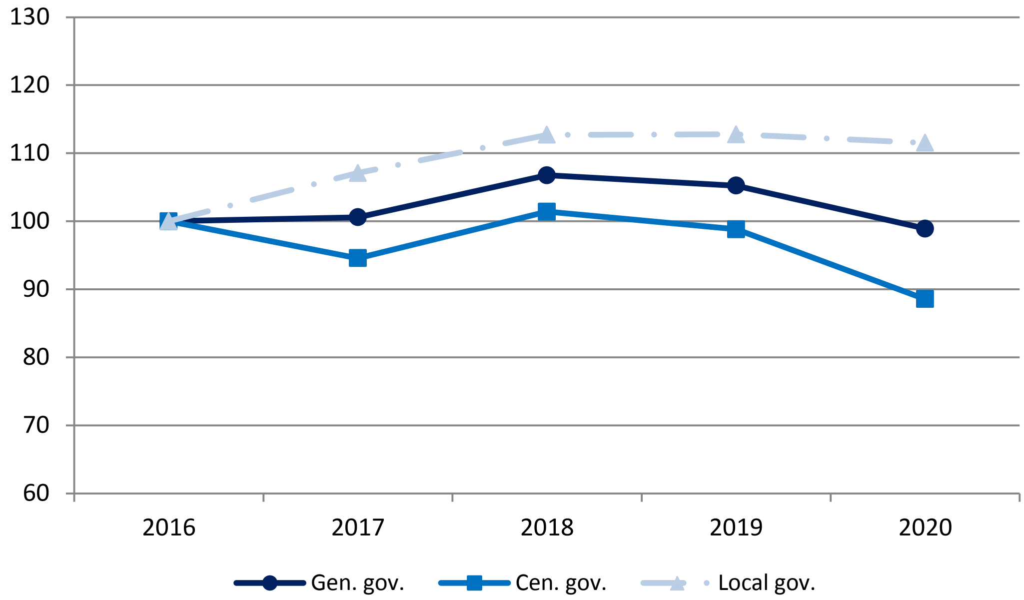
Figure 2.6a – Trend developments in current primary expenditure by subsector *(index; 2016=100)*



Source: based on 2017 EFD data.

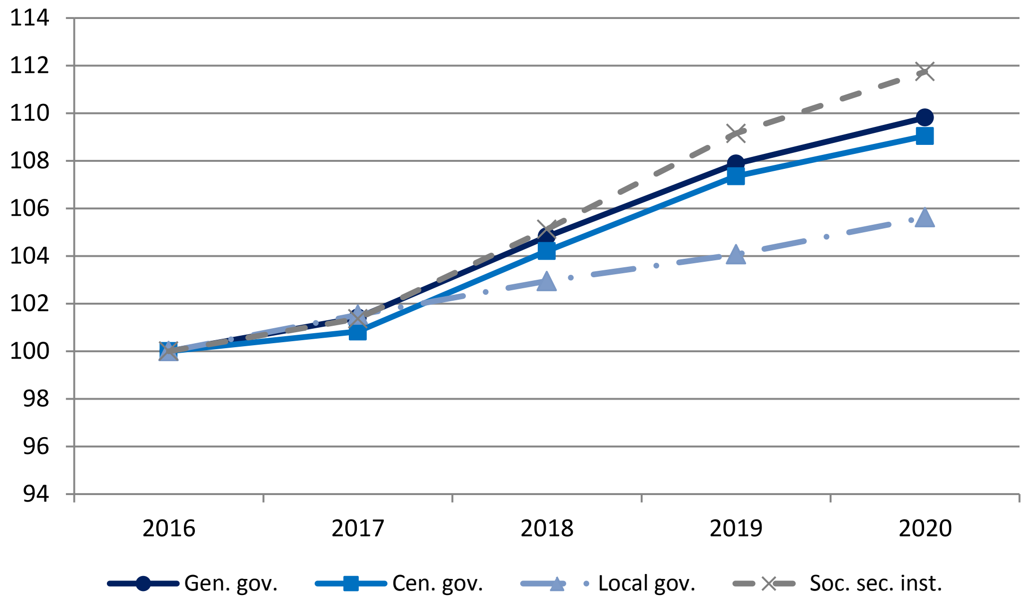
[32] The sum of this aggregate for subsectors is an approximation of total general government revenue but does not coincide perfectly with that aggregate owing to consolidation effects. The item "other current revenue" for the subsectors includes interest received by public entities belonging to other subsectors (for example, the State receives interest on loans to regions).

Figure 2.6b – Trend developments in capital expenditure by subsector
(index; 2016=100)



Source: based on 2017 EFD data.

Figure 2.6c – Trend developments in revenue net of transfers by subsector
(index; 2016=100)



Source: based on 2017 EFD data.

2.2.2 One-off measures

As provided for in current legislation, Section II of the EFD sets out a list highlighting the impact of one-off measures in the context of the trend forecasts for the general government sector, the quantification of which is necessary not only for calculating structural balances (which do not take account of such measures), but also for assessing compliance with the so-called expenditure benchmark.

The total value of the one-off revenue measures, estimated by the Government for 2017 at about €7.5 billion, decreases to €3 billion in the following year and tends toward nil the final two years of the forecasting horizon (Table 2.3). The related expenditure amounts to €2.5 billion in 2017 and gradually decreases over the next three years to stand at about €1 billion in 2020. The flows generated by sales of real estate assets, which are reported separately and whose representation in the national accounts is expressed in terms of the reduction in spending, are quantified at about €900 million annually. The net impact of one-off measures on the balance is therefore positive[33] overall in the first two years (€5.9 billion in 2017 and €2.2 billion in the following year, corresponding respectively to 0.3 and 0.1 points of GDP) and essentially nil in the final two.

Table 2.3 also gives a breakdown of the quantitatively most significant measures. An initial point to note is that temporary measures involving more expenditure currently envisaged by the Government are almost entirely attributable to managing the earthquake emergency. In the reconstruction of the policy amounts presented in the PBO's 2017 Budgetary Policy Report published last November,[34] the resources allocated to these items were considered one-off measures amounted to about €2.7 billion a year over the 2017-2019 period. The significant reduction currently envisaged is at least partially attributable to the alignment of one-off expenditure in the EFD in accordance with the restrictive position - in terms of time limits - adopted by the European Commission as from 2015.

According to this position,[35] outlays to respond to natural disasters can be considered temporary for up to two years from the occurrence of the event. For 2017, moreover, it should be borne in mind that the one-off expenditures are partly offset by the amount of incoming EU funds for the areas in Central Italy affected by the earthquakes of the autumn of 2016.

[33] The resources from temporary measures exceed outlays connected with other measures of the same nature, improving the nominal balance. In deriving the structural balances from the corresponding nominal balances, the elimination of the net impact of the one-off measures therefore contributes to worsening the structural balance compared with the nominal balance.
[34] Available at http://en.upbilancio.it/wp-content/uploads/2016/12/Rapporto-politica-di-bilancio-2017-_per-sito_EN.pdf, Section 3.2. In the Report, the value of one-off measures in the policy scenario were calculated on the basis of the trend values presented by the Government in the 2016 Update, summing those value with the amounts of measures likely to be considered one-off in all subsequent measures (including the 2017-19 Budget Bill).
[35] Referred to European Commission (2017), "Vade Mecum on the Stability and Growth Pact", Box 1.4, page. 27, and discussed more extensively in European Commission (2015),"Public finances in EMU", December.

Table 2.3 – One-off measures in the EFD
(millions of euros and percentage of GDP; a + sign = measures that improve the nominal balance)

	2017	2018	2019	2020
Trend balance of one-off measures as a % of GDP	**0.3**	**0.1**	**0.0**	**0.0**
Trend balance of one-off measures in absolute value(= a + b + c)	**5,886**	**2,171**	**-138**	**-5**
a) Revenue, of which:	7,519	3,016	482	115
Sundry in lieu taxes	*811*	*448*	*160*	*0*
Adjustment of budget values to IAS	*100*	*100*	*100*	*100*
EU solidarity fund for Amatrice earthquake	*750*	*0*	*0*	*0*
Special mandatory contribution to Resolution Fund for banks	*1,526*	*0*	*0*	*0*
Repatriation of capital held abroad (voluntary disclosure)	*2,000*	*0*	*0*	*0*
Settlement of tax arrears	*2,267*	*2,403*	*207*	*0*
b) Expenditure, of which:	-2,533	-1,695	-1,490	-990
Natural disaster response	*-2,513*	*-1,695*	*-1,490*	*-990*
c) Real estate disposals (decrease in expenditure)	900	850	870	870

Source: based on 2017 EFD data, Section II, Table II.2.9.

In this respect, it should be noted that there is an asymmetry in the time limits adopted by the Commission for the classification of one-offs on the expenditure side (restrictive) and on the revenue side (relatively indeterminate). For example, in the case of revenue deriving from alignment with international accounting standards, the amount continues to be considered temporary - therefore without structural impacts - at least until 2020, although the introduction of the in lieu tax came in 2009.

Again on the revenue side, one change is the classification of the revenue from the facilitated settlement of tax arrears as a one-off.[36]

In its November 2016 report, the PBO indicated that the quantification of one-offs in the 2017 DBP of October 2016 did not appear to account for such revenue. The 2017 EFD now explicitly includes that revenue under temporary revenue. The new accounting treatment in the EFD therefore brings the Government's position into compliance with the criteria adopted at the European level.

Finally, for the first time one-offs include the inflows and outflows of the National Resolution Fund (NRF) for banks.[37]

For 2015, payments made by the banks to the fund[38] (€2.3 billion) and drawings on the fund (€3.6 billion) are registered. The latter represent the sum of the initial partial coverage (€1.7 billion) of losses on non-performing loans recorded by the banks involved in the resolution procedure[39] and a subsequent capital injection (€1.8 billion) for the "bridge banks" created with

[36] See Article 6 of Decree Law 193/2016.
[37] This fund, which is not included in the general government sector as it is not considered an autonomous institutional entity, is managed by the Bank of Italy on behalf of the Government. In operation since 2015, it anticipates the activity of the Single Resolution Mechanism, which took effect as from 2016 and whose transactions are not registered in the general government account as they directly form part of the European Union's accounts.
[38] The option of requesting advance payment of fund dues was established in the 2016 Stability Act (Law 208/2015, Article 1, para. 848).
[39] Banca Marche, Banca popolare dell'Etruria e del Lazio, CariChieti and Cassa di risparmio di Ferrara.

the resolution procedure in order to facilitate their disposal. In accordance with the Manual on Government Deficit and Debt, this second intervention was reclassified as a capital transfer in the October 2016 notification, as the banks had not been divested within one year of their recapitalisation.

With regard to 2017, the additional contribution required of the banks by the Bank of Italy at the end of 2016 was recognised as revenue – on a cash accounting basis - in order to enable the settlement of the residual liabilities acquired by the NRF in 2015 and to provide the funding necessary for its operations.

Amounts related to 2015 were not considered in the previous tables of one-off measures contained in the 2016 EFD and its Update, although the amounts had already been included in the general government account. [40] Their current inclusion appears to be the result of a correction.

2.3 Decree Law 50 of 2017

The provisions of Decree Law 50/2017[41] improve the general government balance by €3.1 billion in 2017, equal to 0.2 per cent of GDP, while in subsequent years the impact is virtually nil (see Table 2.4 for a summary view and Table 2.5 for more detail), as the permanent effects of the measures are used to fund the partial deactivation of the safeguard clauses in a similar or equal amount, totalling €3.8 billion in 2018, about €4.4 billion in 2019 and about €4.1 billion in 2020 (Table 2.6). The clauses still produce revenue of €15.7 billion in 2018, €18.9 billion in 2019 and €19.2 billion in 2020.[42]

If the one-off measures and the effects of the measures to support the earthquake-affected areas are considered to regard exceptional events (see Table 2.7), and if the total amount is recognised as such by the European Commission, the improvement in the balances amounts to €3.4 billion in 2017 (as requested from the European Commission), about €1 billion in each of 2018-2019 and essentially nil in 2020. As a proportion of GDP, the reduction in net borrowing is 0.2 percentage points in 2017 and 0.1 percentage points in the two subsequent years (Tables 2.4 and 2.5) (0.3 points excluding the effects of the safeguard clauses).

With resources of €4.5 billion in 2017, uses of €1.4 billion are envisaged. Resources and uses amount to about €9.1 billion in the subsequent year, €9.5 billion in 2019 and €6.6 billion in 2020.

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[40] Except for the recapitalisation of the bridge banks, which was reclassified under expenditure in the October 2016 notification.

[41] Decree Law 50 of 24 April 2017 with urgent measures concerning financial issues, initiatives for local governments, additional measures for areas affected by seismic events and measures for development (AC 4444).

[42] In 2018-2020, the amounts include, respectively: revenue of about €3.5 billion, €4.6 billion and €7.0 billion in respect of reduced-rate VAT; revenue of about €12.3 billion, €13.9 billion and €11.9 billion in respect of ordinary-rate VAT; and revenue of €350 million in 2019 and 2020 from excise taxes on mineral oils.

Net revenue, excluding the effects of their reduction due to the sterilisation of the safeguard clauses, progressively increases before shrinking in the last year. Revenue rises from €2.8 billion in 2017 to €5.3 billion in 2019, before falling to €4.2 billion in 2020 The trend reflects the partial impact of measures on the current year, due to the timing of the publication of the decree, and the fact that the split-payment provisions have been authorised by the European Commission until 30 June 2020.

Net expenditure is negative in 2017 in the amount of €0.3 billion, reflecting a reduction in current expenditure. It totals about €1 billion in each of 2018 and 2019 and then falls to about €0.2 billion in 2020, tracking the irregular developments in capital expenditure.

Table 2.4 – Summary of the effects of Decree Law 50/2017 on the general government revenue and expenditure account
(millions of euros)

	2017	2018	2019	2020
NET REVENUE	**2,833**	**1,155**	**966**	**152**
NET REVENUE EXCLUDING SAFEGUARD CLAUSES	**2,833**	**4,983**	**5,329**	**4,240**
Extension of split payment mechanism	1,046	1,555	1,555	504
Measures against unwarranted offsetting of tax receivables and liabilities	975	1,930	1,930	1,930
Reduction of tax litigation: pending disputes and increase in threshold for dispute mediation	320	152	72	72
Gaming taxes	238	413	413	413
Restructuring of ACE	219	325	816	600
Amendment of exercise of right to deduct VAT	100	100	100	100
Liens on comprehensive value of properties	85	226	282	282
Tobacco taxation (restructuring of excise taxes)	83	125	125	125
Taxation of short-term rentals	81	139	139	139
Extension of suspension and instalment payment of taxes suspended in areas hit by earthquakes	-118	118	0	0
Amendment of patent box system	0	67	38	38
Urban free zone in central Italy	-195	-168	-142	38
Other minor measures	-2	1	0	0
NET EXPENDITURE	**-268**	**1,140**	**966**	**152**
Provisions concerning the containment of public expenditure	-556	41	55	0
Additional measures in favour of earthquake areas	288	950	859	106
Measures in favour of local authorities	198	188	204	195
Investments for sporting events	69	10	10	10
Fund for urgent needs referred to in Article 1, paragraph 200 of Law 190/2014	-50	109	40	41
Increase in Fund for structural economic policy interventions referred to in Article 10, paragraph 5, of Decree Law 282/2004	0	40	13	75
Reduction in ANAS grant	-50	-50	0	0
Redetermination of regional allocation of Fund for local public transport	-70	-100	-100	-100
Reduction in Fund to be allocated for the revival of investment and the development of the country, referred to in Article 1, paragraph 140, of Law 232/2016	-24	-35	-103	-95
Reduction in Fund for the improvement and development of education	-64	0	0	0
Use of Fund for long-term transfers	0	0	0	-69
Fund for financing measures in favour of railway companies for modernisation of goods trains	0	20	0	0
Reduction in financing of State Railway investments - Grant for RFI programme contract referred to in Article 10, paragraph 1, of Decree Law 193/2016	0	-20	0	0
Other minor measures	-9	-13	-11	-10
Net borrowing excluding partial sterilisation of safeguard clauses (1)	**3,101**	**3,843**	**4,363**	**4,088**
% of GDP	*0.2*	*0.2*	*0.2*	*0.2*
Partial sterilisation of safeguard clauses: reduction of VAT rates and postponement of excise tax increases	0	-3,829	-4,363	-4,088
NET BORROWING (1)	**3,101**	**14**	**0**	**0**
NET BORROWING NET OF ONE-OFFS AND EXCEPTIONAL EVENTS (1)(2)	**3,382**	**934**	**1,000**	**69**

Source: based on data from the financial schedule attached to Decree Law 50/2017.
(1) A plus (minus) sign means an improvement (deterioration) in the balance. – (2) Impact on the balance net of one-off measures and those associated with exceptional events if the European Commission should allow those measures in their full amount.

Table 2.5 – Breakdown of the effects of Decree Law 50/2017 on the general government revenue and expenditure account
(millions of euros)

	2017	2018	2019	2020
USES	**1,376**	**9,144**	**9,460**	**6,644**
percentage of GDP	*0.1*	*0.5*	*0.5*	*0.4*
Increased expenditure	**555**	**1,372**	**1,179**	**426**
Increased current expenditure	***188***	***353***	***153***	***215***
Transfers to provinces	120	100	100	100
Increase in Fund for urgent needs referred to in Article 1, paragraph 200 of Law 190/2014	0	109	40	41
Increase in Fund for structural economic policy interventions referred to in Article 10, paragraph 5, of Decree Law 282/2004	0	40	13	75
Refinancing of Fund for needs associated with deferral of tax collection following natural disasters referred to in Article 1, paragraph 430, of Law 208/2015	0	101	0	0
School services: acquisition of cleaning services, minor maintenance and fittings	64	0	0	0
Other minor measures	4	3	1	0
Increased capital expenditure	***367***	***1,019***	***1,027***	***211***
Urgent measures for the public and private reconstruction of earthquake areas	150	0	0	0
Fund to be allocated to enable acceleration of reconstruction in areas hit by earthquakes in 2016 and 2017	92	739	712	80
Refinancing of Fund for reconstruction and assistance of the population in earthquake areas referred to in Article 4, paragraph 1, of Decree Law 189/2016	46	110	120	26
Restructuring of tax credit for purchase of capital equipment	0	55	55	0
Transfer to provinces in ordinary statute regions for extraordinary maintenance of road network	50	50	0	0
Allocation to provinces and metropolitan cities of Fund to finance school building and compliance with fire safety regulations	24	35	103	95
Project for finals of alpine skiing World Cup and championships in Cortina	5	10	10	10
Extension to 31/12/2019 of tax credit for investment in central Italian regions hit by earthquakes	0	0	27	0
Fund to finance measures for railroad companies to modernize goods trains	0	20	0	0
Decreased revenue	**-821**	**-7,772**	**-8,281**	**-6,218**
Partial sterilisation of safeguard clauses: reduction of VAT rates and postponement of increase in excise taxes	0	-3,829	-4,363	-4,088
Extension of *split payment* mechanism - reimbursements and offsetting	-502	-3,765	-3,765	-2,156
Urban free zone in central Italy - earthquake areas	-195	-168	-142	38
Extension of suspension and instalment payment of taxes suspended in areas hit by earthquakes	-118	0	0	0
Other minor measures	-6	-11	-11	-11
NET REVENUE	**2,833**	**1,155**	**966**	**152**
NET EXPENDITURE	**-268**	**1,140**	**966**	**152**
current	*-319*	*252*	*53*	*115*
capital	*51*	*889*	*913*	*37*
NET BORROWING (1)	**3,101**	**14**	**0**	**0**
percentage of GDP	*0.2*	*0.0*	*0.0*	*0.0*
NET BORROWING NET OF ONE-OFFS AND EXCEPTIONAL EVENTS (1)(2)	**3,382**	**934**	**1,000**	**69**
percentage of GDP	*0.2*	*0.1*	*0.1*	*0.0*

Source: based on data from the financial schedule attached to Decree Law 50/2017.
(1) A plus (minus) sign means an improvement (deterioration) in the balance. – (2) Impact on the balance net of one-off measures and those associated with exceptional events if the European Commission should allow those measures in their full amount.

Table 2.5 – *(cont.)* Breakdown of the effects of Decree Law 50/2017 on the general government revenue and expenditure account
(millions of euros)

	2017	2018	2019	2020
SOURCES	**4,477**	**9,158**	**9,460**	**6,644**
percentage of GDP	*0.3*	*0.5*	*0.5*	*0.4*
Increased revenue	**3,654**	**8,927**	**9,246**	**6,370**
Extension of split payment mechanism	1,548	5,320	5,320	2,660
Measures against unwarranted offsetting of tax receivables and liabilities	975	1,930	1,930	1,930
Reduction of tax litigation: pending disputes and increase in threshold for dispute mediation	320	152	72	72
Gaming taxes	238	413	413	413
Restructuring of ACE	219	325	816	600
Amendment of exercise of right to deduct VAT	100	100	100	100
Liens on comprehensive value of properties	85	226	282	282
Tobacco taxation (restructuring of excise taxes)	83	125	125	125
Taxation of short-term rentals	81	139	139	139
Extension of suspension and instalment payment of taxes suspended in areas hit by earthquakes	0	118	0	0
Amendment of patent box system	0	67	38	38
Other minor measures	4	12	11	11
Decreased expenditure	**-823**	**-232**	**-214**	**-274**
Decreased current expenditure	***-507***	***-101***	***-100***	***-100***
Reduction in appropriations for expenditure programmes of ministries	-320	0	0	0
Redetermination of regional allocation of Fund for local public transport	-70	-100	-100	-100
Reduction in Fund for the improvement and development of education	-64	0	0	0
Decrease in Fund for urgent needs referred to in Article 1, paragraph 200 of Law 190/2014	-50	0	0	0
Other minor measures	-3	-1	0	0
Decreased capital expenditure	***-316***	***-131***	***-114***	***-174***
Reduction in appropriations for expenditure programmes of ministries	-126	-14	0	0
Restructuring of tax credit for purchase of capital equipment	-110	0	0	0
Reduction in ANAS grant	-50	-50	0	0
Reduction in Fund to be allocated for the revival of investment and the development of the country, referred to in Article 1, paragraph 140 of Law 232/2016	-24	-35	-103	-95
Reduction in financing of State Railway investments - Grant for RFI programme contract referred to in Article 10, paragraph 1, of Decree Law 193/2016	0	-20	0	0
Use of Fund for long-term transfers	0	0	0	-69
Other minor measures	-6	-12	-11	-10

Source: based on data from the financial schedule attached to Decree Law 50/2017.

Table 2.6 – Decree Law 50/2017: previous safeguard clauses, partially deactivated safeguard clauses and safeguard clauses to be deactivated
(millions of euros)

Measure	2018	2019	2020
Safeguard clauses in 2017 Budget Act			
Increase in VAT rate from 10% to 13% as from 2018 (Article 1, paragraph 631, letter a)	6,957	6,957	6,957
Increase in VAT rate from 22% to 25% as from 2018 (Article 1, paragraph 631, letter b)	12,264	12,264	12,264
Increase in VAT rate from 25% to 25.9% as from 2019 (Article 1, paragraph 631, letter b)		3,679	3,679
Increase in excise tax on fuels as from 2018 (Article 1, paragraph 6, letter c), 2016 SA)	350	350	350
Total revenue increase projected from 2017 Budget Act	**19,571**	**23,250**	**23,250**
Partial deactivation of clauses provided for in Decree Law 50/2017			
Reduction in VAT rate from 13%to 11.5% in 2018 (Article 9, paragraph 1, letter a)	-3,478.5		
Reduction in VAT rate from 13% to 12% in 2019 (Article 9, paragraph 1, letter a)		-2,319	
Restoration of VAT rate to 13% as from 2020 (Article 9, paragraph 1, letter a)			0
VAT rate remains at 25% in 2018 (Article 9, paragraph 1, letter b)	0		
Reduction in VAT rate from 25.9% to 25.4% in 2019 (Article 9, paragraph 1, letter b)		-2,044	
Reduction in VAT rate from 25.9% to 24.9% in 2020 (Article 9, paragraph 1, letter b)			-4,088
Sterilisation of increase in excise tax of fuels for 2018 (Article 9, paragraph 1, letter c)	-350		
Total revenue reduction provided for in Decree Law 50/2017	**-3,829**	**-4,363**	**-4,088**
Safeguard clauses active post Decree Law 50/2017			
Increase in VAT rate from 10% to 11.5% as from 2018 (Article 9, paragraph 1, letter a)	3,478.5	3,478.5	3,478.5
Increase in VAT rate from11.5% to 12% as from 2019 (Article 9, paragraph 1, letter a)		1,160	1,160
Increase in VAT rate from 12% to 13% as from 2020 (Article 9, paragraph 1, letter a)			2,319
Increase in VAT rate from 22% to 25% as from 2018 (Article 9, paragraph 1, letter b)	12,264	12,264	12,264
Increase in VAT rate from 25% to 25.4% as from 2019 (Article 9, paragraph 1, letter b)		1,635.2	1,635.2
Reduction in VAT rate from 25.4% to 24.9% as from 2020 (Article 9, paragraph 1, letter b)			-2,044
Increase in excise tax on fuels as from 2019 (Article 9, paragraph 1, letter c)		350	350
Total increase in revenue expected if no alternative measures are found	**15,743**	**18,887**	**19,162**

Source: based on information in Decree Law 50/2017and data from the associated Technical Report.

On the uses side, the main measure makes the increases in VAT rates more gradual and postpones increases in excise taxes. Other major measures are intended to accelerate reconstruction in earthquake areas and provide assistance to the population following the end of the state of emergency. Other provisions provide for exemptions from the payment of taxes and social contributions charged to employers to agricultural enterprises in the areas affected by the recent earthquakes - within specified limits and under certain conditions related to the decrease in turnover caused by those events - as well as the extension of the suspension and instalment payment of suspended taxes for 2017. Further transfers are directed at provinces in the ordinary statute regions to fund basic functions and extraordinary maintenance of the road network. The latter measure is accompanied by a corresponding reduction in the expenditure authorisation for investment by ANAS (the National Road Agency). Regions, provinces and metropolitan cities are allocated resources for school building and compliance with fire safety regulations, with a concomitant reduction in the discretionary fund to be allocated, established with the 2017 Budget Act, for the revival of investment and the development of the country.

With regard to the regions, the decree implements one of the measures provided for in the State-Regions Agreement,[43] allocating them a share (equal to €400 million in terms of the net balance to be financed, equal to €132 million in terms of net borrowing) of the resources of the fund for investment established with the 2017 Budget Act (otherwise allocated to central government). However, under the terms of the agreement, these resources will be cut – in the same amount - in order to achieve the savings expected for 2017 in the 2015 Stability Act. The regions nevertheless undertake to implement additional investments of €132 million in 2017 funded out of their own budgets (or to achieve a surplus of equal amount).

Other smaller measures regard the transport and infrastructure sectors, for business productivity and investment, for investment in sporting events and for cleaning and maintenance services for schools.

On the funding side, the corrective measures essentially regard revenue. The main provisions comprise the extension of the split payment mechanism and measures to counter unwarranted offsetting of tax receivables and liabilities. The extension of the split payment mechanism should cover all general government departments, companies controlled directly or indirectly by the State and local governments, companies listed on the FTSE MIB index of Borsa Italiana and self-employed professionals.[44] As regards the measures to counter unwarranted offsetting of tax receivables and liabilities, the provisions establish an obligation for holders of VAT registration numbers to use the Revenue Agency's telematic services and extend the scope of the tax preparer certification: the amount above which tax receivables in respect of income taxes and related surtaxes, withholding tax, in lieu taxes and IRAP can only be used to offset liabilities if the associated tax return receives tax preparer certification is reduced from €15,000 to €5,000.

Greater revenue should be generated by the revision of the facilitated settlement of tax disputes, changes in the taxation of gaming (both the single gaming tax and lotto and other lotteries) and of tobacco products, as well as the redetermination of the reference base for the calculation of the allowance for corporate equity (ACE) and the taxation of short-term rentals (less than thirty days).

The rules on property liens are also revised, so that - without prejudice to the exemption of primary residences - all other properties owned by same debtor, regardless of their

[43] Agreement of 23 February 2017. The remaining measures in the agreement do not require ratification with primary legislation as the agreement itself is provided for in primary legislation.
[44] The overall net impact reflects an increase in revenue from greater VAT payments by purchasers and a decrease in revenue from offsetting and reimbursements of sellers.

individual value, can be attached if their total value exceeds €120,000 and the debt for which action is being taken exceeds that limit.

With regard to other funding measures, expenditure reductions (around €1 billion) are envisaged for 2017 only, of which more than half regard reductions in the appropriations for the spending programmes of ministries, as specified in a list attached to the decree. They mainly involve the Ministry for the Economy and Finance (in particular, the "accounting settlements, repayments and reimbursements of taxes" and "funds to be allocated" programmes). With regard to economic categories, over 45 per cent of the savings is generated by reductions in transfers or grants to other government entities or the private sector. As indicated in the technical report accompanying the decree, the measures do not represent an across-the-board cut but rather, for the majority of the savings, qualitatively and quantitatively differentiated choices, excluding reductions that would result in off-balance-sheet debt. In order to ensure adequate budget management in 2017, a specific administrative procedure is envisaged for possible reprogramming of the expenditure cuts if the department considers it necessary. Further savings are produced by the reallocation of the fund for the financing of local public transport in the ordinary statute regions.

One set of provisions, which according to the technical report accompanying the decree do not produce financial effects, concern local governments. These include measures concerning the allocation of different types of resources and contributions to the consolidation of the public accounts[45] and others that raise the percentages concerning turnover, for 2017-2018, in municipalities with a ratio of employees to the population below the average for their demographic class and with a population of over 1,000 inhabitants. In this case, according to the technical report, the provisions do not entail any increase in expenditure but rather represent a redistribution among the expenditure items in the budgets of the entities subject to the balanced-budget requirement. However, where there is room for manoeuvre between net credits to the municipal sector - which is likely to be contained in the EFD's trend forecasts based on the conduct and constraints of recent years - and the balance-budget goals, the overall general government deficit could increase because of a possible deterioration in municipal balances.

There are no budget effects for the healthcare measures as well. Some provisions are aimed at providing electronic invoice data to the Italian Medicines Agency (AIFA). The aim is to ensure that the information used by the Agency to assess potential overshoots of the ceiling on pharmaceutical expenditure for direct purchases by public healthcare units[46] and the consequent repayments due from the pharmaceutical industry (pay-

[45] The decree provides for the allocation of the resources of the municipal solidarity fund, the financial flexibility granted to the regions with the 2017 Budget Act in order to foster investment, and the transfers to the provinces and metropolitan cities of the ordinary statute regions to finance expenditure connected with roads and school building. It also reallocates the contribution to the public finances of provinces and metropolitan cities provided for in previous measures.
[46] See Parliamentary Budget Office (2016), "2017 Budgetary Policy Report", November.

back), after numerous appeals to the administrative courts by pharmaceutical companies and distributors, which have essentially stalled the repayment mechanism. In the pharmaceutical field, the role of the funds for innovative pharmaceuticals and innovative oncology pharmaceuticals is also clarified: they cannot be used to reimburse the cost of "conditionally innovative" products (for which no evidence of additional therapeutic benefit has yet been provided). Other provisions are mainly intended to enable the regular and timely payment of trade debts by the National Health Service, in part by speeding up procedures for allocating cash transfers.

The measures of a presumably one-off nature or related to exceptional events contained in the decree law include the simplified settlement of tax disputes (Article 11) and other measures to support the people affected by the earthquakes beginning in the summer of 2016 (Title III, Articles 41 to 46). Table 2.7 summarizes the expected impacts of the above measures.

The simplified settlement system for tax disputes in operation since the end of December 2016 – with full payment of the liability involved in the dispute without penalties or default interest – is expected to generate revenue gains in 2017-2018 (€320 million and €80 million respectively), which will only impact the nominal balance.

The situation with the measures related to natural disasters is more complex. Some of them qualify as one-off measures (such as support for reconstruction or seismic assessment of buildings in the areas hit by the recent earthquakes), while others are more difficult to classify (such as income support measures for the affected public through the suspension of tax payments, the establishment of free zones and tax credits for companies located in the affected territories) and yet others do not apparently qualify as one-off measures at all (such as prevention measures in areas other than those hit by the recent disaster or the purchase and maintenance of emergency vehicles). The European Commission will consider whether measures not classified as one-offs can be treated similarly to measures for which flexibility has already been granted to Italy for 2017 given the exceptional nature of the recent seismic emergency.[47]

[47] For the years after 2017, the authorisation of further deviations involving measures for seismic interventions may only be granted in the case of positive incremental changes in resources earmarked for this purpose (European Commission (2016),"Commission opinion of 16.11.2016 on the Draft Budgetary Plan of Italy").

Table 2.7 – Possible one-off measures or measures connected with exceptional events in Decree Law 50/2017
(millions of euros)

	2017	2018	2019	2020
Balance of measures	**-281**	**-920**	**-1000**	**-69**
a) Revenue	8	30	-142	38
of which: *facilitated settlement of tax disputes*	*320*	*80*		
urban free zone in central Italian areas hit by earthquakes	*-195*	*-168*	*-142*	*38*
extension of suspension and instalment payment of taxes in earthquake areas	*-118*	*118*		
b) Expenditure	-288	-950	-859	-106
of which: *measures for reconstruction of earthquake areas*	*-288*	*-849*	*-859*	*-106*
Fund for need deriving from deferral of tax collection		*-101*		

Source: based on data from the financial schedule attached to Decree Law 50/2017.

2.4 The policy scenario

The EFD seeks to improve the deficit by 0.2 percentage points of GDP in 2017 compared with the trend scenario, as required by the European Commission and implemented with Decree Law 50/2017, to continue reducing net borrowing – retaining the targets set in the DBP of last October for 2018 -2019 (equal to 1.2 per cent and 0.2 per cent of GDP) and achieving nominal budget balance in 2020 - and to achieve a small structural surplus in 2019 and to maintain structural balance, namely the MTO, the subsequent year (Tables 2.8 and 2.9).

It also explicitly states[48] that, in the event of changes at the European level in the rules of the preventive arm of the Stability Pact to foster greater growth and development, the scale of corrections of the public accounts for the coming years may be smaller than envisaged in the provisions of the EFD.

The Government plans to take further additional measures to be defined in the coming months and incorporated in the 2018 Budget Act.

The Government has also expressly indicated its intention to deactivate the safeguard clauses provided for in previous legislation.[49] The EFD states that the policy scenario reflects a lower level of indirect taxes than the trend scenario.[50] It also indicates that the clauses will be replaced by both expenditure and revenue measures, with the latter including further action against tax evasion. On the expenditure side, a new spending review will be conducted, with forecast savings of at least €1 billion a year for the State,

[48] See page 50, Section I of the EFD.
[49] See page III, Section I of the EFD. Note that the value of the clauses included in the trend forecasts is equal to €19.6 billion for 2018 and €23.3 billion as from 2019.
[50] See page 30, Section I of the EFD.

to be implemented in accordance with the provisions of the reform of the budget structure using a decree of the President of the Council of Ministers (see section 2.4.1).[51]

The overall objective is to retain the thrust of the economic policies adopted since 2014 to free the country's resources from an excessive fiscal burden and to revive investment and employment, while complying with fiscal consolidation requirements.[52] In addition to deactivating the safeguard clauses, scope will be found for measures – that are expansionary and that reduce the fiscal burden[53] - and resources for the renewal of public employment agreements that are compatible with the budget targets.[54]

In compliance with the requirements of the European Commission, 24 April 2017 saw the publication of Decree Law 50/2017 providing for a reduction in the 2017 deficit from 2.3 per cent to 2.1 per cent of GDP. In the subsequent years, the effect on net borrowing is virtually nil, as the higher revenue and the lower expenditure resulting from the provisions of the measure are essentially intended to offset a partial deactivation of the safeguard clauses - between 0.22 and 0.24 per cent of GDP over 2018-2020 – and measures to support the earthquake-affected areas as well as provinces and metropolitan cities.

Note that in its forecasts the European Commission does not include the expected revenue from the activation of the safeguard clauses, so the decree should yield a permanent improvement of 0.2 per cent in the public finance balances. Net of one-off measures and the effects of the provisions relating to the earthquakes considered to be exceptional, the improvement would be 0.2 per cent of GDP in 2017 and 0.3 per cent in the next two years as announced in EFD, should the Commission authorise the total amount of those measures (see section 2.3).

The policy scenario can be reconstructed for subsequent stages, beginning with the trend amounts, taking account of the financial impact of the new decree law, to produce a valuation - given the policy objectives - of the magnitude of the measures to be implemented in the 2018 Budget Act, both without further deactivation of the safeguard clauses and in the event of their total deactivation.

Given the EFD trend forecasts (Table 2.8, line a) and considering the effects of Decree Law 50/2017 (Table 2.8, line b), including the partial suspension of the safeguard clauses provided for in that decree, we obtain an updated trend forecast (Table 2.8, line c), which shows a reduction of two-tenths of a percentage point of GDP in 2017 and remains unchanged in 2018-2020.

[51] See page 5, Section I of the EFD.
[52] See page III, Section I of the EFD.
[53] See page 6, Section I of the EFD.
[54] See page 51, Section I of the EFD.

Given the policy objectives (Table 2.8, line d), taking the differences, the adjustment of the public accounts requires net corrective measures of 0.1 per cent in 2018, 0.4 per cent in 2019 and 0.5 per cent in 2020 (Table 2.8, line e).

In the event of the complete deactivation of the increase in VAT and excise taxes (in the amount specified in the decree law) alternative resources of the same amount would be necessary in 2018-2020 (respectively 0.9 per cent in 2018 and 1 per cent in each of the two following years; Table 2.8, line f). In order to achieve the targets, alternative net corrective measures would have to be included in the 2018 Budget Act in the amount of 1 per cent of GDP in 2018, increasing to 1.4 per cent in 2019 and 1.5 per cent in 2020 (Table 2.8, row g).

This reconstruction reveals the considerable scale of the measures that, even after the presentation of the decree, would have to be adopted in place of the full activation of the remaining clauses. Moreover, the gross package could be even larger if resources were needed for other purposes, as emerges from the EFD.

Table 2.8 – Objectives and corrective measures specified in the EFD and the effects of Decree Law 50/2017 (1)
(percentage of GDP)

	2016	2017	2018	2019	2020
Trend net borrowing (a)	**-2.4**	**-2.3**	**-1.3**	**-0.6**	**-0.5**
Change (+ = improvement)		0.1	1.0	0.7	0.1
of which: Revenue		*-0.3*	*0.2*	*0.0*	*-0.5*
Interest		*0.1*	*0.2*	*0.0*	*-0.1*
Primary expenditure		*0.4*	*0.6*	*0.8*	*0.7*
Measures in Decree Law 50/2017 (b)		**0.2**	**0.0**	**0.0**	**0.0**
of which: *Partial deactivation of clauses - Decree Law 50/2017*			*-0.2*	*-0.2*	*-0.2*
Trend net borrowing after Decree Law 50/2017 (c = a - b)		**-2.1**	**-1.3**	**-0.6**	**-0.5**
Policy net borrowing (d)	**-2.4**	**-2.1**	**-1.2**	**-0.2**	**0.0**
Change (+ = improvement)		*0.3*	*0.9*	*1.0*	*0.2*
Measures in 2018 Budget Act without further deactivation of clauses (e = d - c) (2)			**0.1**	**0.4**	**0.5**
Safeguard clauses after Decree Law 50/2017 (f)			*0.9*	*1.0*	*1.0*
Net corrective measures in 2018 Budget Act in event of total deactivation of safeguard clauses - maximum hypothesis (g = e + f)			**1.0**	**1.4**	**1.5**
Memorandum item					
Safeguard clauses 2017 BA (millions)			*19,571*	*23,250*	*23,250*
Partial deactivation of clauses - Decree Law 50/2017 (millions)			*3,829*	*4,363*	*4,088*
Safeguard clauses after Decree Law 50/2017 (millions) (3)			*15,743*	*18,887*	*19,162*

Source: based on the 2017 EFD and Decree Law 50/2017.
(1) Totals may not match due to rounding of decimals. – (2) A minus sign means that the policy balance is worse than the trend balance and that the measures are therefore expansionary. – (3) The safeguard clauses in force after Decree Law 50/2017 regard increases in VAT rates from 10 per cent to 11.5 per cent (€3,478.5 million) in 2018, a further increase from 11.5 per cent to 12 per cent in 2019 (€4,638 million) and a further increase from 12 per cent to 13 per cent as from 2020 (€6,957 million), as well as an increase from 22 per cent to 25 per cent (€12,264 million) in 2018 and a further increase from 25 per cent to 25.4 per cent (€13,899 million) in 2019, followed by a reduction from 25.4 per cent to 24.9 per cent in 2020 (a total of €11,855 million). These amounts would be accompanied by an increase in excise taxes of €350 million as from 2019. The sum of these changes would increase revenue by €15,742.5 million in 2018, €18,887 million in 2019 and €19,162 million in 2020, as reported in the table.

At the time of the presentation of the most important economic policy document, the policy scenario remains obscure. For the third consecutive year, no information has been provided on what could again be the most significant measure in the forthcoming budget package, i.e. complete or partial deactivation of the VAT increases provided for under existing legislation. Developments in current primary expenditure – as noted elsewhere - leave little room for additional cuts to offset any reduction in tax revenue.

The situation would be different if the possibility of "changes in the SGP's preventive arm directed at stimulating growth",[55] i.e. a larger policy deficit than that currently indicated in the EFD, should come to pass.

The safeguard clauses were deactivated for years in which Italy was granted ex-ante authorisation, for 2015-2016, to deviate from the path towards the MTO by about €19 billion, with the consequent partial suspension of the clauses financed through the deficit. Additional flexibility equal to 0.32 percentage points of GDP was also granted in 2017, of which 0.18 points for earthquake-related costs and 0.14 points for the migration emergency. Updated figures for the first quarter of 2017 reveal a surge in migration, and the EFD again stresses that spending undertaken to meet the exceptional costs associated with it should not be assessed only in terms of annual increments but also considering the fact that Italy supports that significant burden on behalf of the European Union.

In the EFD, the structural deficit is expected to rise in 2017, from 1.2 per cent the previous year to 1.5 per cent, before falling to 0.7 per cent in 2018 and turning into a surplus of 0.1 per cent in 2019 and balance in 2020. The new developments are generally more favourable than those set out in the DBP in October 2016 and reflect the performance of the components of the structural balance (Table 2.9).

In essence, on the one hand, the policy scenario plans a structural surplus in terms of GDP that will deteriorate in 2017 – partly reflecting the budgetary flexibility granted in that year for exceptional events related to the migration emergency and the earthquake emergency – and gradually improve in the next two years before stabilising at 3.8 per cent of GDP in 2020. On the other hand, interest expenditures as a proportion of GDP falls further in 2017-2018, and then stabilises in 2019 and rises again the next year in response to the gradual rise expected in interest rates.

The improvement in the nominal balance is even larger, with the progressive decline in the negative cyclical component of the budget, which disappears in the last year of the programming period, and the positive effect of one-off measures in 2017-2018, largely deriving from the revenue measures, in particular the mandatory special contribution to the National Resolution Fund provided for in the Bank of Italy's notice of 29 December 2016[56] and the revenue generated through the voluntary disclosure programme in 2017, as well as that produced by the facilitated settlement of tax arrears in 2017-2018 provided for in the Tax Decree (Decree Law 193/2016).

[55] See page 50, Section I of the EFD.
[56] Under the provisions of Article 1, paragraph 848, of Law 208/2015, that notice required two years of additional contributions to meet the financing needs of the fund.

Table 2.9 – Components of the policy budget balance (1)
(percentage of GDP. a + sign = improvement in the balance)

	2016	2017	2018	2019	2020
Structural primary surplus (a)	**2.8**	**2.4**	**3.0**	**3.8**	**3.8**
Change (a')	*-0.9*	*-0.4*	*0.6*	*0.8*	*0.0*
Interest (b)	**-4.0**	**-3.9**	**-3.7**	**-3.7**	**-3.8**
Change (b')	*0.2*	*0.1*	*0.2*	*0.0*	*-0.1*
Structural budget balance (c=a+b)	**-1.2**	**-1.5**	**-0.7**	**0.1**	**0.0**
Change (c'=a'+b')	*-0.7*	*-0.3*	*0.8*	*0.8*	*-0.1*
Cyclical component of budget balance (d)	**-1.5**	**-1.0**	**-0.6**	**-0.3**	**0.0**
Change (d')	*0.6*	*0.5*	*0.4*	*0.3*	*0.3*
One-off measures (e)	**0.2**	**0.3**	**0.1**	**0.0**	**0.0**
Change (e')	*0.4*	*0.1*	*-0.2*	*-0.1*	*0.0*
Overall balance (f=c+d+e)	**-2.4**	**-2.1**	**-1.2**	**-0.2**	**0.0**
Change (f'=c'+d'+e')	*0.3*	*0.3*	*0.9*	*1.0*	*0.2*

Source: based on the 2017 EFD.
(1) Totals may not match due to rounding of decimals.

2.4.1 Inclusion of the spending review process in the budget cycle

The first implementation of the innovations introduced last year in the budget formation process come in 2017. The Government's measures were intended to strengthen the top-down approach in budget preparation and, together with other changes (the introduction of "actions" as a budget unit, the strengthening of the budget on a cash basis, the merger of the Stability Bill and the Budget Bill), make it possible to conduct a more incisive spending review and improve the public allocation of resources.[57]

The new procedure envisages the issuance - by May -- of a decree of the President of the Council of Ministers that specifies, on a three-year basis, the spending targets for each ministry, consistent with the objectives for general government as a whole set out in the EFD. These objectives would constitute the benchmark for the formulation of proposals by the ministries for the preparation of the budget for the following year.

In general, in order to assess the consistency between the ministries' objectives and those for general government as a whole, the EFD should specify the target for the latter and break it down by policy revenue and expenditure and by subsector, and identify the expenditure component for the State within central government (from which the expenditure targets by ministry set out in the decree of the President of the Council of Ministers would be drawn). These quantitative elements should have an explicit political weight, as the expression of identified priorities and reflected in the allocation of resources.

[57] See the *"Audizione del Presidente dell'Ufficio parlamentare di bilancio nell'ambito dell'indagine conoscitiva sul contenuto della nuova legge di bilancio e sull'equilibrio di bilancio delle Regioni e degli Enti locali, di cui alla L. 243/2012",* before the joint session of the Budget Committees of the Chamber of Deputies (V – Budget, Treasury and Planning) and the Senate (5 – Economic Planning, Budget), 26 May 2016.

In addition to being consistent with that for general government as a whole (as clarified in the law), the ministries' goals should be credible, i.e. they should not be amended after the decree of the President of the Council of Ministers is issued. The early definition (compared with the practice of defining measures in the days immediately preceding the presentation of the budget) of priorities in public policies facilitates the operation of government departments: take for example the closure of the budgets of bodies other than the State or the implementation of spending-review measures. It should also be considered very helpful for economic agents (households and businesses), who can therefore stabilise their expectations and incorporate public policy changes into their behaviour. Last, it improves the quality of legislation by allocating adequate time for drafting the texts that translate decisions into legislation. These considerations have long been implicitly present (albeit neglected) in the Government Accounting Act, which since 1988 has required that the former Economic and Financial Planning Document (EFPD) and the current EFD specify the main revenue and expenditure measures.

The 2017 EFD should therefore be the starting point for the new procedure in 2017. As usual, the document indicates the targets as ratios of GDP for government departments and warns, in accordance with the need to prepare the decree of the President of the Council of Ministers, that central government departments will be required to come up with at least €1 billion in savings. Since the Government Accounting Act establishes that the objectives can be formulated in terms of resources to be employed or savings to be achieved, from a formal point of view the document fulfils the conditions for activating the procedure. However, the savings required of the State are just one element of the various other allocative decisions involved in fiscal policy. We are missing the intermediate part of the top-down process, i.e. how the balance for general government as a whole can be used to determine the State's contribution. The composition of the package in terms of spending cuts and revenue increases, and the allocation of the contribution on the expenditure side to subsectors and functions (in particular, social security and healthcare) is not delineated. In short, in the absence of a more precise macrofinancial framework incorporating the priorities announced by the Government, it is highly likely that the savings requested from the ministries can be subsequently altered, effectively limiting the added value of the new procedure .

The somewhat unsatisfactory characteristics of the initial application of the new top-down process seem to be attributable to certain aspects of the 2017 EFD, which as noted above features a certain degree of indeterminacy in its policy content. The possibility of variations in the target balance for general government linked to changes in the preventive arm of the Stability and Growth Pact to foster greater growth and development does not necessarily require indeterminacy of domestic policy. The current reference scenario could be broken down into revenue and expenditure, highlighting the associated priorities. This framework could be accompanied in the EFD with an indication of how any further flexibility would be allocated if the policy deficit were to be subsequently increased.

Early agreement on policy priorities would permit better allocation of contributions to consolidation, and - taking account of hopes for curbing expenditure – permit greater comprehensiveness in proposals from the ministries and other sectors, prompting a reconsideration of overall funding requests with respect to the functions to be performed. The strengthened programming component would increase the capacity to achieve the announced goals and, ultimately, improve understanding of budgetary policy and its credibility, a crucial aspect of sustaining the confidence of economic agents.

2.5 Policy developments in the debt

In 2016, the ratio of public debt to GDP rose, albeit slightly, from 132.1 per cent in 2015 to 132.6 per cent (Table 2.10). The increase in the debt stock (€45.1 billion) was the result of a general government borrowing requirement of €42.1 billion and an increase in the liquid assets of the Treasury (€7.4 billion),[58] partly offset by the overall net effect of issue/redemption discounts and premiums, the revaluation of inflation-linked securities and exchange-rate developments in the amount of €4.5 billion. Net of the increase in liquidity, the ratio was broadly unchanged (at 132.2 per cent of GDP). Privatisation receipts from ENAV amounted to €883 million (about 0.1 per cent of GDP), down from those registered in 2015 (€6.6 billion, or 0.4 per cent of GDP). The decline in the borrowing requirement reflected, in addition to the fall in net borrowing, the cash-accrual differences linked in particular to financial transactions with the European Union and the divergence between payments for military equipment and the related deliveries. For 2016, in the reconciliation[59] of general government net borrowing and the change in the debt, net purchases of financial assets include derivatives of about €4.3 billion, while, under debt adjustment items, changes in net liabilities in derivatives generated by special transactions (e.g. the repurchase of swaptions, cancellation of derivative contracts, restructuring of derivatives) amounted to about €4.1 billion.

Under the EFD's policy scenario, the debt/GDP ratio should begin to decline, albeit slightly, as from 2017 (around 0.1 per cent), despite the fact that the forecast contemplates possible intervention in support of the precautionary recapitalisation of banks, for which about half of the resources (€20 billion) made available with Decree Law 237/2016 (see Analysis 2.1) would be employed. In the subsequent years, the decline in the debt/GDP ratio would gradually accelerate to reach 125.7 per cent in 2020, about 7 percentage points of GDP less than in 2016 and 1.5 percentage points less than the trend scenario.

[58] €43.1 billion at year end.

[59] See Istat (2017), "*Notifica dell'indebitamento netto e del debito delle Amministrazioni pubbliche secondo il trattato di Maastricht*" of 24 April. In the breakdown of the stock-flow adjustment into its constituent components, we find a statistical discrepancy of €3.6 billion, which has an impact of about 0.2 per cent of GDP on the reduction in the debt. Nevertheless, that item could be revised in the next publication of the notification if additional information should become available.

Table 2.10 – Determinants of the change in the debt/GDP ratio (1)
(percentage of GDP and rates of change)

	2015	2016	2017	2018	2019	2020
Debt/GDP ratio	132.1	132.6	132.5	131.0	128.2	125.7
Change in debt/GDP ratio	**0.3**	**0.6**	**-0.2**	**-1.4**	**-2.9**	**-2.5**
Primary surplus (accrual accounting)	**-1.5**	**-1.5**	**-1.7**	**-2.5**	**-3.5**	**-3.8**
Snow-ball effect (2)	**2.2**	**1.8**	**0.9**	**0.2**	**-0.1**	**0.3**
of which: *Interest expenditure/Nominal GDP*	*4.1*	*4.0*	*3.9*	*3.7*	*3.7*	*3.8*
Contribution of growth in nominal GDP	*-1.9*	*-2.1*	*-3.0*	*-3.5*	*-3.8*	*-3.5*
memorandum item: Average cost of debt	*3.2*	*3.1*	*3.0*	*2.9*	*2.9*	*3.0*
Stock-flow adjustments	**-0.5**	**0.3**	**0.7**	**0.9**	**0.7**	**1.0**
Differences in cash and accrual accounting	*0.2*	*-0.2*	*0.4*	*0.3*	*0.5*	*0.7*
Net accumulation of financial assets (3)	*-0.1*	*0.4*	*0.7*	*0.3*	*0.1*	*0.0*
of which : privatisation receipts	*-0.4*	*-0.1*	*-0.3*	*-0.3*	*-0.3*	*-0.3*
Debt valuation effects	*-0.1*	*-0.2*	*0.4*	*0.4*	*0.3*	*0.4*
Other (4)	*-0.5*	*0.2*	*-0.7*	*-0.2*	*-0.2*	*-0.1*

Source: based on 2017 EFD.
(1) Totals may not match due to rounding of decimals. – (2) The snowball effect is calculated as the sum of interest as a proportion of nominal GDP and the contribution of growth in nominal GDP, given by $(d_{t-1}/PIL_{t-1})*(-g_t/(1+g_t))$, where d_{t-1} is the debt at time t-1 and g_t is the nominal rate of growth of GDP at time t. – (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.

Over the entire 2017-2020 period, the cumulative reduction in debt as a proportion of GDP is attributable entirely to the achievement of the planned primary surpluses, which would produce a decrease of more than 11 percentage points of GDP, as debt is expected to increase by more than 1 point of GDP due to the snowball effect (linked to the difference between interest expenditure and the contribution of nominal GDP growth) and an unfavourable impact of more than 3 percentage points of GDP from stock-flow adjustments in the four-year period (Table 2.10).

In the Government's forecasts, primary surpluses increase and return to high levels as from 2019. The adverse snowball 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 the contribution of nominal GDP growth of 3.8 per cent, which is offset by interest expenditure of around 3.7 per cent.

The forecast for interest expenditure in the policy document shows a fall to 3.9 per cent of GDP in 2017 and to 3.7 per cent in 2018 and 2019, before rising to 3.8 per cent of GDP in 2020. The upward revision of interest expenditure compared with previous forecasts reflects the expected increase in interest rates.

It should be noted that the trend scenario takes account of the deterioration in the borrowing requirement created by the termination in 2018 of the Single Treasury system.[60] However, the policy projections reflect the hypothesis of a gradual exit from the Single Treasury only from 2021.[61]

The contribution of the stock-flow adjustment to the change in the debt is constantly unfavourable over the 2017-2020 programming period. The effects of the various components only partially offset each other. The increase in debt due to transactions in financial derivatives, issues below par and the effect of rising inflation on indexed securities as from 2017 is greater than the decline in debt attributable to the reduction in the liquid assets of the MEF (overall, by about 1 per cent of GDP in 2017-2019) and privatisation receipts,[62] which are forecast to total 1.2 percentage points of GDP between 2017 and 2020.

The 2017 EFD reduces the planned privatisation receipts for 2017-2019 to 0.3 percentage points of GDP annually, down from their level in previous policy documents. The EFD does not contain enough information to assess whether the programme can be implemented with a sufficient level of probability. Overall, the disposal programme can thus be considered an element of risk within the policy scenario.

The decrease in the liquid assets of the MEF, projected at 0.7 per cent of GDP in 2017 (Table 2.10, "Other"), appears to be aimed at supporting the precautionary recapitalisation of banks (Table 2.10, in the line concerning the net accumulation of financial assets), including through the reduction in the stock of such assets formed at the end of 2016.

In accordance with the provisions of Law 196/2009,[63] the second section of the EFD contains detailed information on the results and the forecasts for interest expenditure in the State budget related to financial derivatives.

In the forecasts of the 2017 EFD, the interest expenditure generated by financial derivatives is expected to amount to about €4.6 billion, including the possible exercise of swaptions during the year. This change is attributable entirely to the absence of early termination clauses in 2017. The derivatives component also includes other financial items that in 2017 will generate a further outlay of about €1 billion. In 2018, swap interest expenditure rose to about €5 billion. The amount includes about €1.6 billion attributable to the likely early closure of some derivatives positions. In 2019 and 2020, however, total swap expenditure is projected to fall and is estimated at €3.2 billion and €2.3 billion, probably explained by the expected increase in interest rates, the reason the Government gave for obtaining the swaps.

[60] Decree Law 1/2012 Article 35, paragraph 8 and Law 190/2014 Article 1, paragraph 395.
[61] See page 4 of Section I of the EFD and page 65 of Section II of the EFD.
[62] Receipts from the disposal of holdings in public enterprises.
[63] Specifically by Article 10, paragraph 3, letter f), as amended by Article 1, paragraph 6, letter d) of Law 163 of 4 August 2016.

2.5.1 *The structure of the public debt: recent and future developments*

This section analyses the structure of the Italian public debt (composition by instrument, residual maturity analysis and composition by holder), developments in recent years and the effects of the Eurosystem's Public Sector Purchase Programme (PSPP) on the secondary market.

Looking at developments in the composition of debt instruments over the last few years, we find a certain stability in the components by maturity of the public debt (the medium/long-term portion on the one hand and the short-term and floating-rate portion on the other). At the end of December 2016, however, there was a slight decrease in the short-term/floating-rate component, while long-term debt increased (Figure 2.7).

Short-term debt refers to debt with an original maturity of less than one year. Floating-rate debt is defined as debt with an original maturity of more than one year with a floating- or inflation-linked rate. Medium/long-term debt is defined as fixed-rate debt with an original maturity of more than one year.

The average life of the debt shows a steady rise since 2014, after having declined in previous years, reaching 7.28 at the end of December 2016, up from a low of 6.83 at the end of 2014, with a consequent reduction in refinancing risk. This increase is explained by the increase in the share of the debt with a residual life of more than 5 years of about 2.4 percentage points between 2014 and the end of 2016, alongside a decrease in debt with a residual life of less than five years (Figure 2.8).

In 2016, the Italian Treasury introduced two new maturities in the long-term nominal fixed-term securities segment: a 20-year BTP and a 50-year BTP. These maturities contribute to lengthening the average life of the debt.

As far as an analysis of debt by subsector at the end of 2016 is concerned, local government debt is small and decreasing (by about €3.6 billion compared with the previous year), representing 4 per cent of the public debt, compared with 96 per cent for central government and the virtually nil volume of social security institutions.

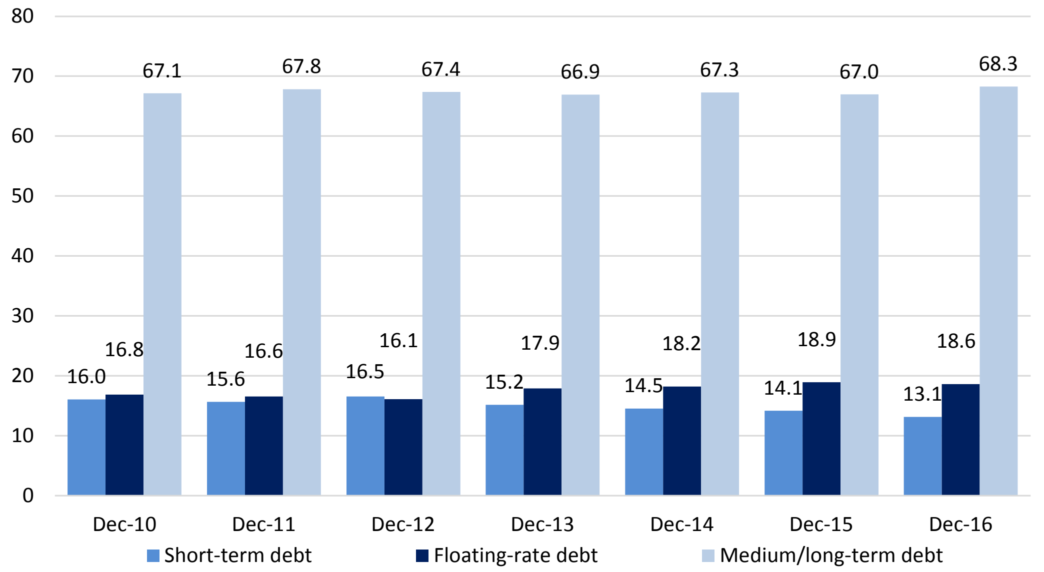
At the end of 2016, securities represented about 84 per cent of general government debt. Central government securities account for 99.2 per cent of total securities, while the residual share (0.8 per cent) is represented by the securities issued by local governments.

The main holders of government securities are monetary financial institutions with about 45 per cent of the total, followed by foreign investors with 36 per cent, the Bank of Italy with 14 per cent and the remaining domestic investors with 5 per cent (Figure 2.9).

Monetary financial institutions include banks, money market funds and other resident monetary financial institutions. Financial institutions include financial intermediaries (securities investment firms, SICAVs and mutual funds), financial auxiliaries, insurance corporations and pension funds.

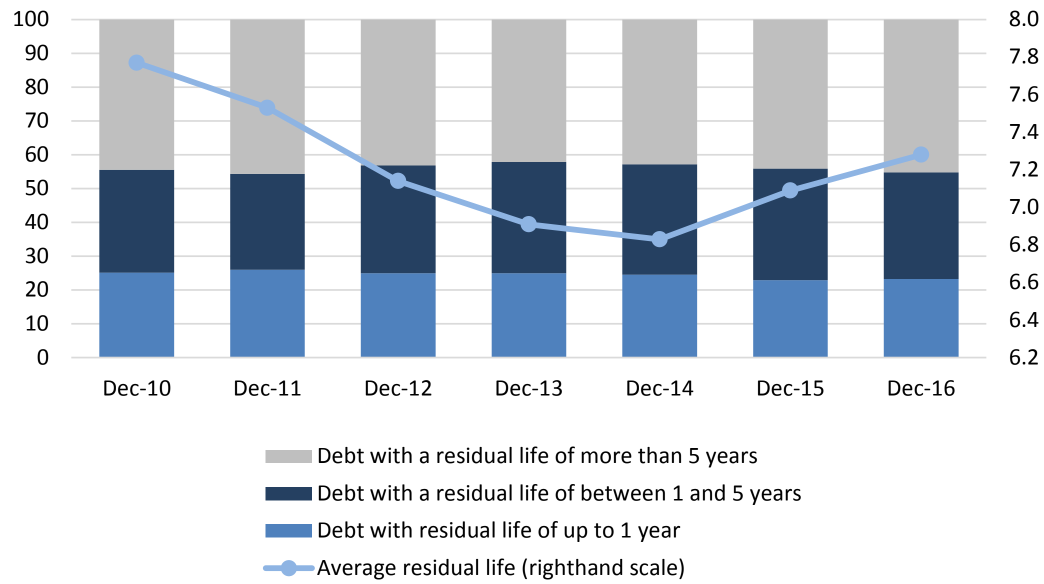
Other residents include households and non-profit institutions serving households, non-financial corporations and government departments.

Figure 2.7 – General government debt: breakdown by instrument
(percentage points)



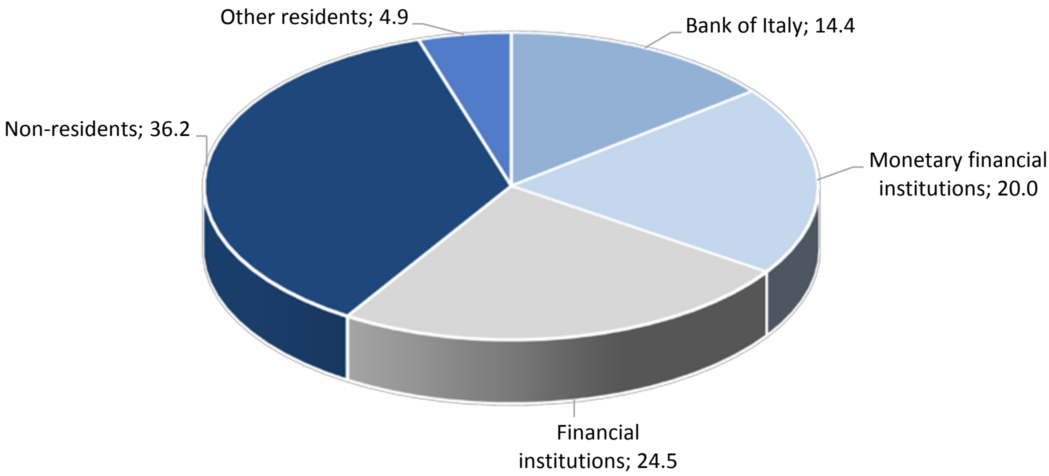
Source: based on Bank of Italy data.

Figure 2.8 – General government debt: breakdown by residual life
(left-hand scale in percentage points, right-hand scale in years)



Source: based on Bank of Italy data.

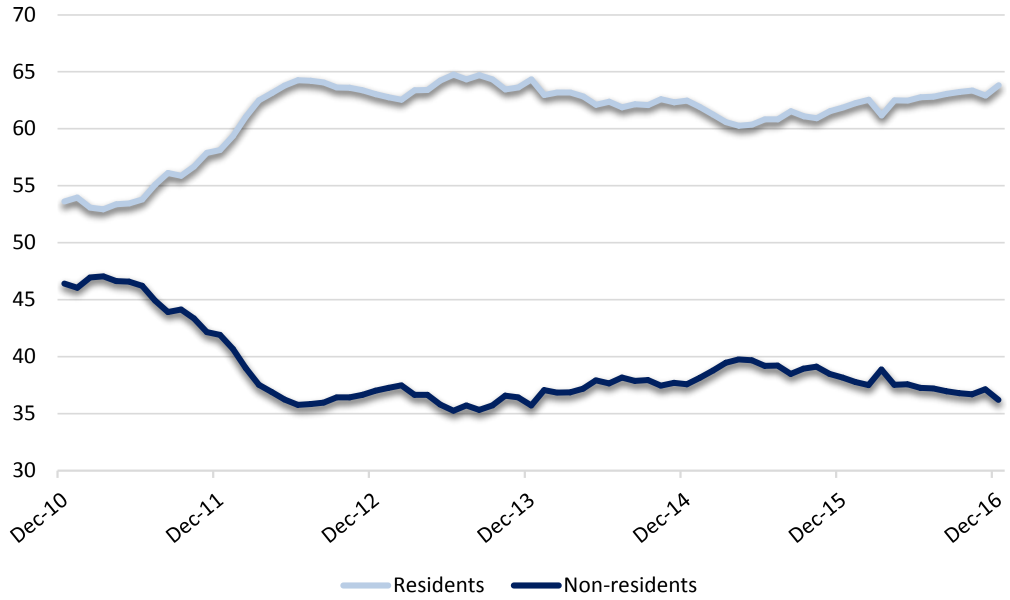
Figure 2.9 – General government securities: breakdown by holder
(percentage points)



Source: based on Bank of Italy data.

In particular, after the financial crisis, the share of foreign investors decreased, and since mid-2012 it has fluctuated at between 35 and 40 per cent. Last year, this proportion fell by about 2 per cent compared with the end of 2015 (Figure 2.10).

Figure 2,10 – General government securities: breakdown by resident/non-resident holder
(percentage points)



Source: based on Bank of Italy data.

The impact of the Public Sector Purchase Programme

From 9 March 2015 to the end of March 2017, the Eurosystem acquired €1,481 billion in government securities issued by euro-area countries through the PSPP,[64] of which about €246 billion in Italian securities (about 17 per cent of the total calculated at purchase prices). In order to estimate the corresponding face value, we assume that their share is about 90 per cent of the Italian securities purchased by the Eurosystem under the PSPP (which also includes bonds issued by decentralized entities, government agencies and international multilateral banks) and an average purchase price of 115. On the basis of these assumptions, it can be estimated that between March 2015 and March 2017 the Eurosystem purchased about €192 billion in Italian government securities at face value. Over the same period, net issuance of government securities (excluding BOTs) amounted to about €109 billion. This would mean that private investors divested securities worth about €83 billion.

If we analyse the change in the composition of holders of Italian government securities in the last two years (or since the start of the PSPP), those who have reduced their holdings of Italian government securities include banks, other residents (households) and foreign investors. By contrast, in addition to the Eurosystem, net purchasers have been other financial institutions, including insurance corporations and pension funds (Figure 2.11 and Table 2.11).

It is possible to conduct a qualitative assessment of the possible market effects of the termination of the programme by the Eurosystem (Table 2.12). Assuming a gradual winding down, it is possible to construct a scenario for net government security issues net of ECB purchases over the next few years. For 2017, secondary market purchases continued at a monthly rate of €80 billion until the end of March, before being reduced to €60 billion from April until the end of December 2017.[65]

For 2018, it is assumed that the ECB elects not to terminate the PSPP abruptly, but rather that it continues to ease the pace of its purchases gradually (the so-called "tapering"). Let us therefore assume a further 9-month period in 2018 in which the ECB decreases secondary market purchases to €40 billion from January to April and then to €20 billion until September 2018.[66]

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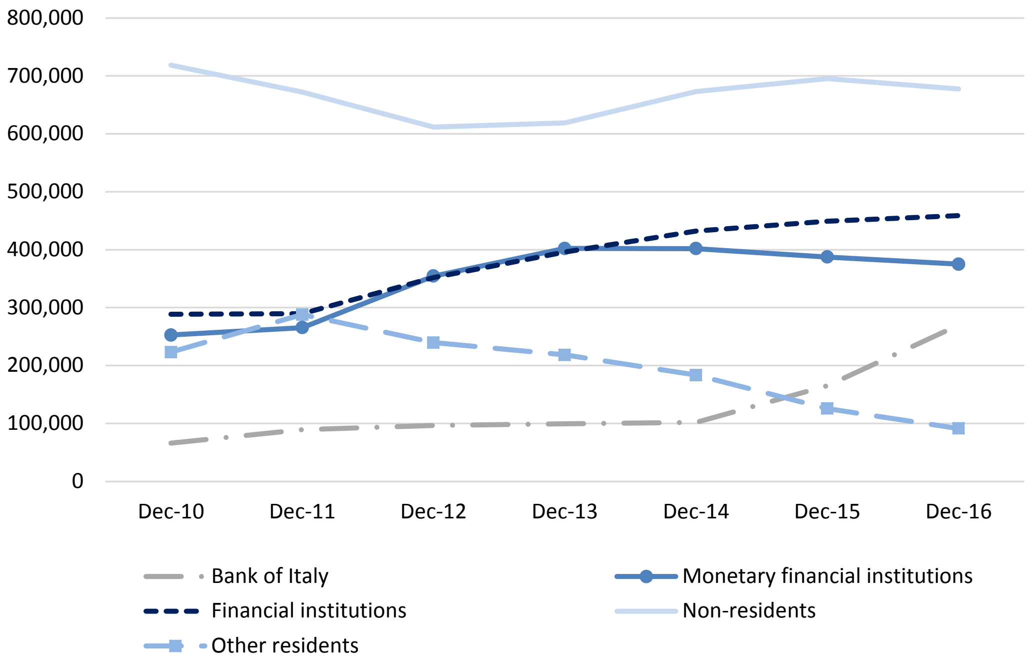
[64] See European Central Bank, https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html.

[65] See ECB press release of 8 December 2016.

[66] It is therefore assumed that the ECB gradually reduces the economic stimulus implemented using unconventional monetary policy measures in quantity and timing. The assumption is that the ECB extends the PSPP for another 9 months (as it did for this year in extending purchases from March until December 2017), but during that period gradually reduces the volume of purchases (using a constant reduction of €20 billion) before terminating the programme at the end of the additional extension.

Figure 2.11 – General government securities: breakdown by holder
(millions of euros)



Source: based on Bank of Italy data.

Table 2.11 – General government securities: breakdown by holder
(year-on-year change; billions of euros)

	Bank of Italy	Monetary financial institutions	Financial institutions	Non-residents	Other residents
31/12/2014	3	0	36	54	-35
31/12/2015	63	-15	17	22	-58
31/12/2016	104	-12	10	-18	-34

Source: based on Bank of Italy data.

Table 2.12 – Issues of Italian government securities net of BOTs under the assumption of tapering of the PSPP in 2017-2018
(billions of euros)

	2016	2017	2018
ECB purchases of government securities	102	95	33
Net issues of government securities	59	58	39
Net issues of government securities net of ECB purchases	-43	-37	6

For 2017, net issues of Italian government securities (excluding BOTs) are estimated at about €58 billion to fund the state-sector cash requirement.[67] Moreover, for 2017, under the assumptions noted above, it is assumed that the ECB purchases about €95 billion in Italian government securities under the PSPP. Consequently, with these assumptions, for this year, the flow of investment in the market for Italian government securities with a maturity of more than one year would be around a negative €37 billion.

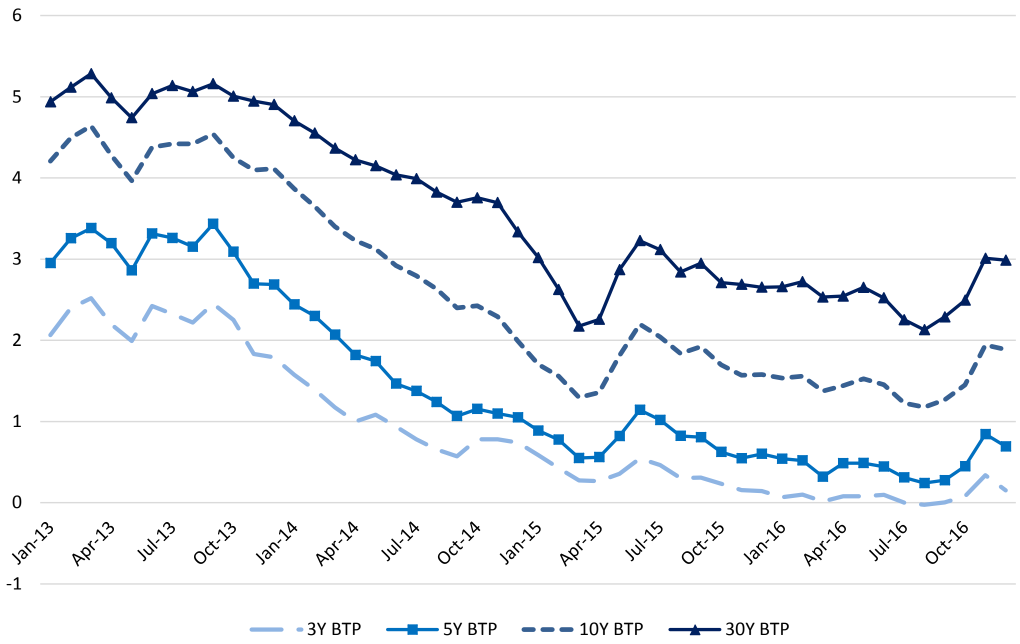
For 2018, we assume that the PSPP is terminated in September, so the ECB's purchases of Italian government securities on the secondary market should drop to €33 billion for the year. Net issues of government securities (excluding BOTs) decline by about €20 billion, both as a result of a reduction in maturing securities during the year and of the planned reduction of the state-sector borrowing requirement. The final effect, i.e. net issues of securities with a maturity of more than one year net of ECB purchases should return positive at around €6 billion. This scenario would therefore involve a change in the composition of debt holders and a gradual increase in interest rates, strengthened by the rise in inflation and the improvement in the outlook for growth.

The ECB's operation of the PSPP has presumably affected market interest rates for debt (Figure 2.12). Market rates continued to decline in 2016, although the year was characterised by periods of strong volatility. The weighted average cost of new issues dropped further, from 0.70 per cent in 2015 to 0.55 per cent in 2016, with a favourable impact on interest expenditure, which fell again over the last year, albeit at a slower pace than the previous year, going from 4.1 per cent to 4.0 per cent of GDP (Figure 2.13).

The 2017 EFD projections for interest expenditure incorporate a gradual rise in market interest rates, probably implicitly reflecting an assumption that the ECB will taper its purchases in the coming years. Figure 2.14 shows the variations in short-term rates (3-month) and long-term rates (10-year) for each year in the forecasting period as projected in the 2017 EFD and the 2016 EFD. More specifically, the 10-year rate implicit in the forward yield curves for 2018-2019 is now about 0.8 percentage points higher than last year.

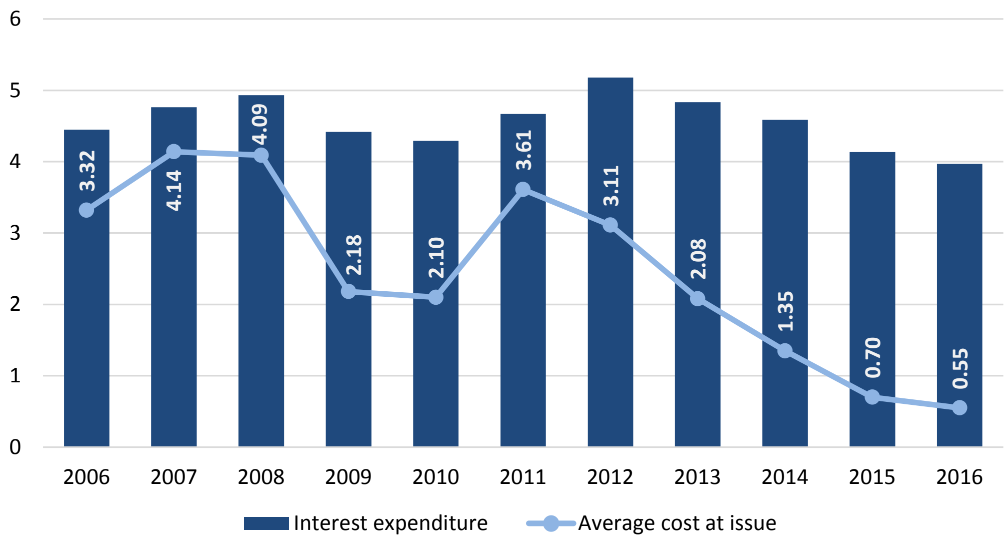
[67] This uses the forecasts for the state-sector cash balance in the 2017 EFD.

Figure 2.12 – Yields on government securities (3-year, 5-year, 10-year and 30-year BTPs)
(percentage points)



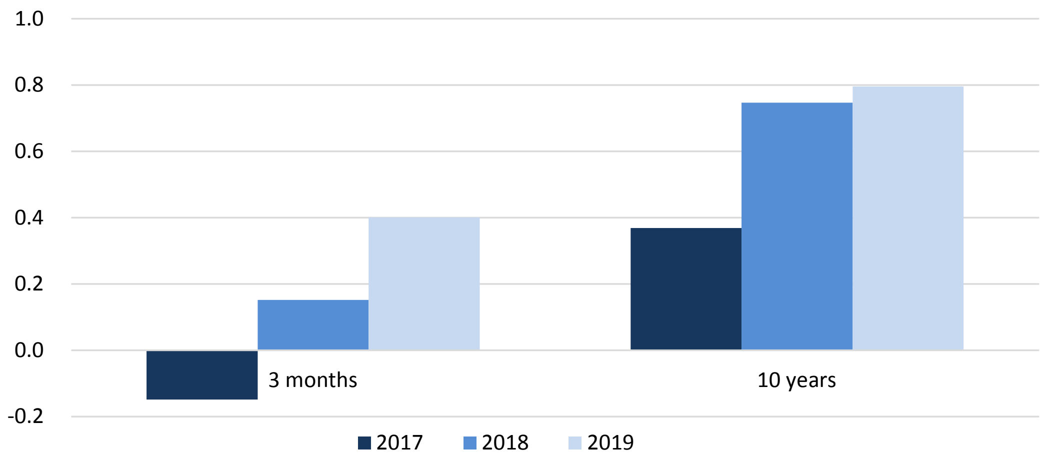
Source: based on Bank of Italy data.

Figure 2.13 – Interest expenditure as a percentage of GDP and weighted average cost at issue
(percentage points)



Source: based on Istat and MEF data.

Figure 2.14 – Change in forecasts for short- and long-term interest rates between the 2016 EFD 2016 and the 2017 EFD
(percentage points)



Source: based on MEF data.

2.5.2 Medium-term sustainability of the public finances and sensitivity analyses

The analysis of medium/long-term sustainability is divided into two parts: 1) a deterministic analysis with the formulation of a baseline scenario in which the policy path of the debt/GDP ratio presented in the EFD is extended until 2026 with ad hoc assumptions and undergoes sensitivity analysis; 2) a stochastic analysis in which variables affecting the debt/GDP ratio undergo temporary and permanent shocks with the aim of obtaining a large number of plausible scenarios for the ratio over the next decade and determining their probability ranges.

The ad hoc assumptions for the extension of the policy path for the EFD debt/GDP ratio from 2021 to 2026 are as follows: 1) the gradual convergence of the real growth rate to 1 per cent, an inflation rate of 2 per cent and short- and long-term interest rates at 3 and 4.5 per cent respectively; 2) a primary budget balance sufficient to ensure a structural deficit close to balance; 3) nil stock-flow adjustment. The extrapolation is carried out using a methodology similar to that used by the European Commission to analyse the sustainability of the public debt.[68]

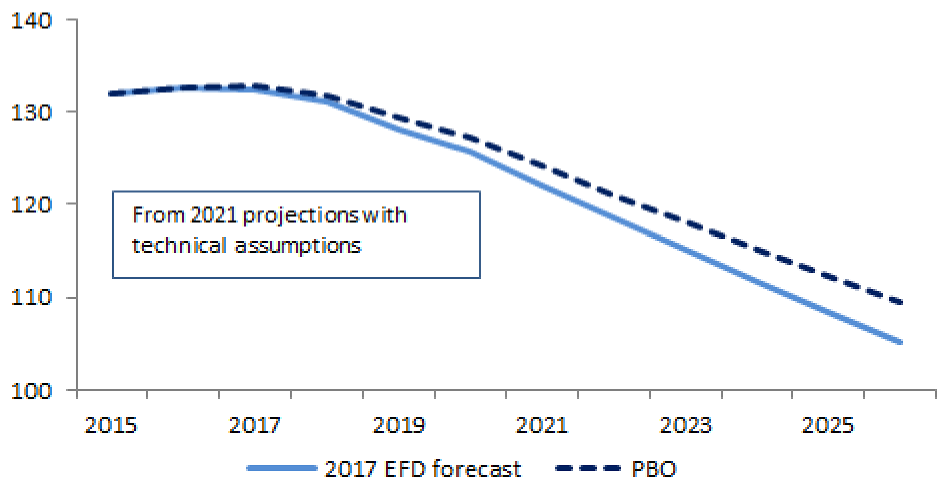
With these assumptions, the decline in the debt/GDP ratio continues after 2020 in the baseline scenario. However, at the end of the forecasting period, in 2026, it would still be above 100 per cent (Figure 2.15).

This evolution is compared with that in the debt/GDP ratio consistent with the PBO's growth forecasts for real GDP and the GDP deflator (Figure 2.15, panel A).

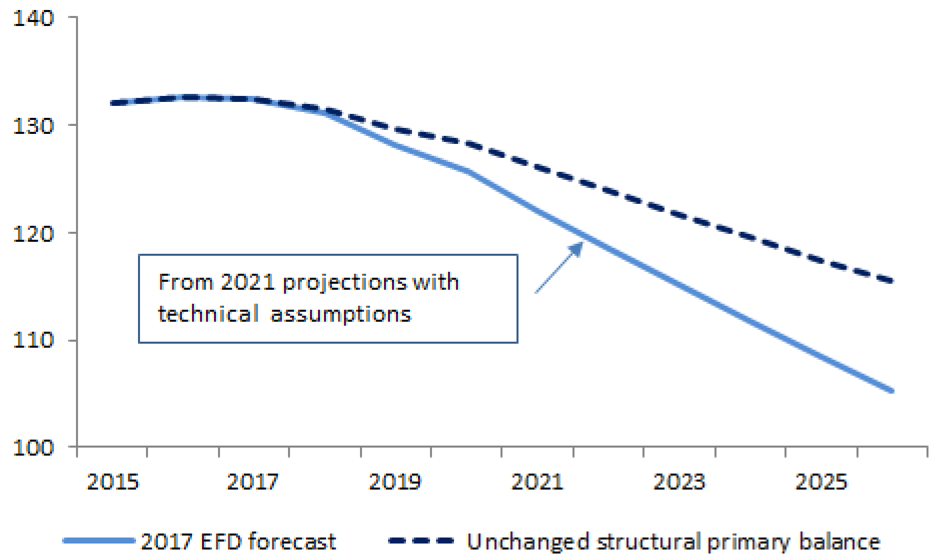
[68] See also Appendix 3.3 of the PBO's "2017 Budgetary Policy Report" at http://en.upbilancio.it/wp-content/uploads/2016/12/Rapporto-politica-di-bilancio-2017-_per-sito_EN.pdf.

Figure 2.15 – Developments in the debt/GDP ratio in selected macroeconomic scenarios
(percentage points)

Panel A: EFD and PBO forecasts



Panel B: EFD and unchanged structural primary balance



Source: based on 2017 EFD data.

We assume an elasticity of 0.539 for the primary surplus/GDP ratio to real GDP growth, in line with that estimated by the OECD and the European Commission. In addition, we assume that a change in the inflation rate is partially transmitted to interest rates. The stock-flow adjustment is unchanged with respect to that for the EFD policy scenario. After 2020, the assumptions used in the baseline scenario are retained.

In both scenarios, the debt/GDP ratio declines by the end of the EFD forecasting and continues to do so in subsequent years. However, in the PBO macroeconomic scenario, the decline is slower, creating a divergence between the two trajectories of about 1.6 percentage points of GDP in 2020, which grows to more than 4 points in 2026.

The importance of a policy choice that resumes the path of towards the medium-term objective in order to ensure debt sustainability is underscored by an analysis of the impact on the debt/GDP ratio of a structural primary balance unchanged on its 2017 value (Figure 2.15, panel B). The assumptions produce a smaller primary structural balance than the baseline for all years of the forecast. In this scenario, the debt/GDP ratio[69] displays a shallower decline, reaching 115 per cent of GDP at the end of the forecasting period, with a difference of around 10 percentage points with respect to the baseline scenario.

It is important to note that the developments in the debt/GDP ratio in the latter scenario are very similar to those that would be obtained by assuming the deactivation of the safeguard clauses for indirect taxes for 2018-2019 without offsetting budget measures.

The scenario consistent with the EFD policy scenario would comply with the backward-looking debt rule in 2022, while the PBO scenario would shows compliance coming later, in 2025. By contrast, the scenario with a structural primary balance unchanged on 2017 would not achieve compliance over the medium-term forecasting period.

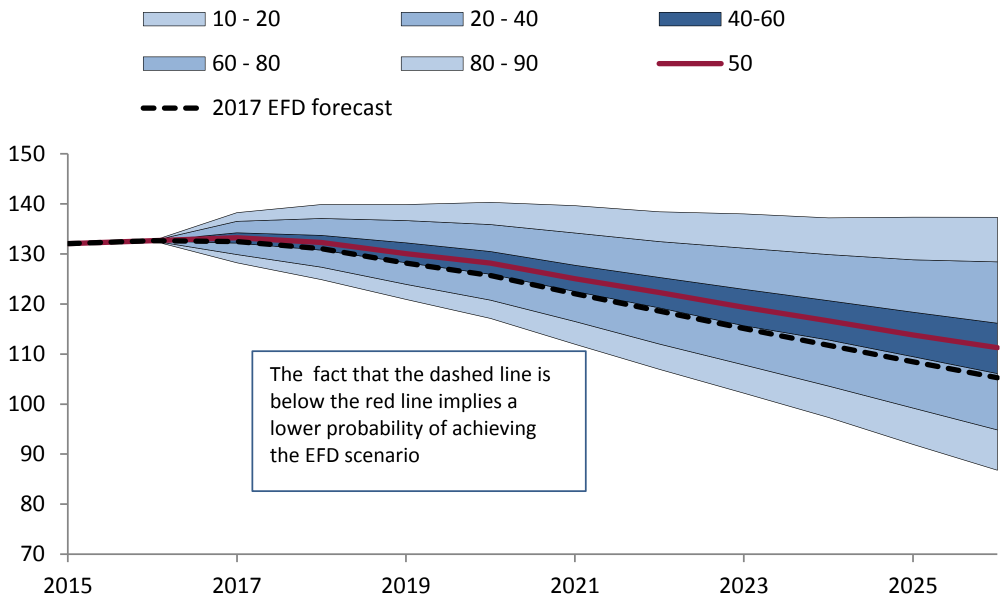
To take account of uncertainties in the estimates, the EFD's policy scenario is compared with probability intervals obtained using statistical techniques in line with those used by the European Commission and the International Monetary Fund.[70] More specifically, we have estimated 5,000 possible trajectories for the debt/GDP ratio, considering developments in the ratio that are consistent with the PBO macroeconomic forecasts discussed in the previous section. This enabled the construction of a probability fan chart under an assumption of temporary and permanent shocks to the variables that affect the behaviour of the debt (Figure 2.16).

[69] This sensitivity analysis uses the dynamic fiscal multipliers adopted in the Istat-UPB macroeconometric model, which were calculated by assuming a permanent change of one point of GDP in the budget balance. They are equal to about 0.23 in the first year and about 0.43 in the second, before gradually rising to about 0.55 in the fifth year. The simulations assume that that value is unchanged in subsequent years. If higher multipliers are used, the difference between the debt/GDP ratio in the alternative scenario and the baseline scenario would be smaller. This happens because the impact of a less restrictive fiscal policy on the denominator of the ratio (nominal GDP) would be more favourable. The opposite occurs for smaller multipliers.

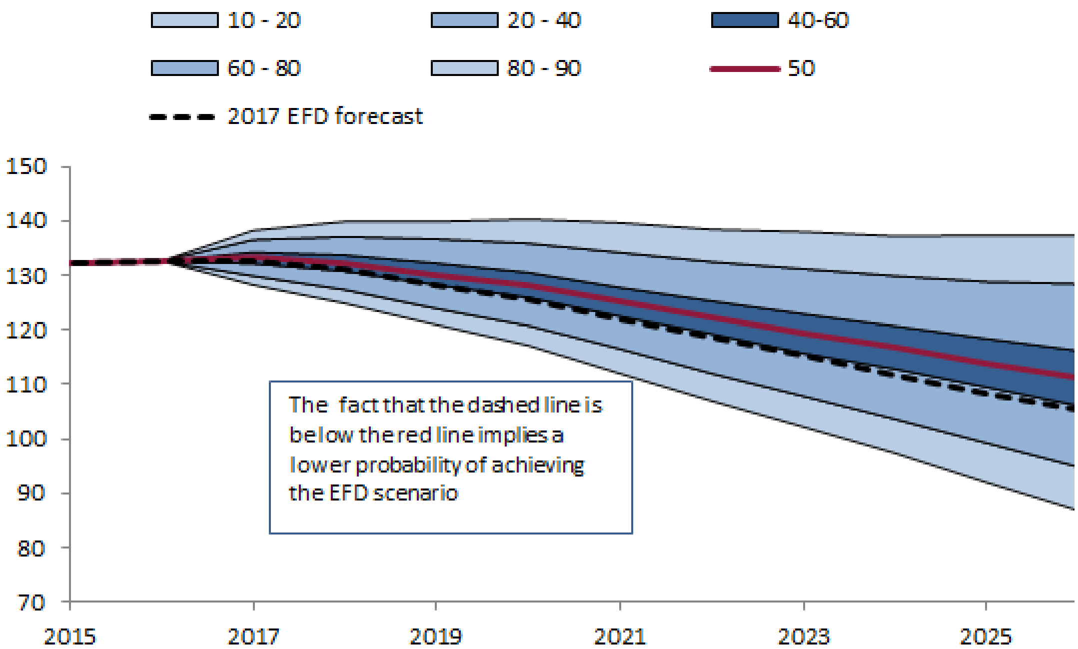
[70] See Berti K. (2013), "*Stochastic public debt projections using the historical variance-covariance matrix approach for EU countries*", European Commission, *Economic Papers 480*, April.

Figure 2.16 – Stochastic analysis of temporary shocks: EFD policy scenario compared with the PBO scenario
(percentage points)

Panel A: temporary shocks



Panel B: permanent shocks



Source: based on 2017 EFD data.

Using the equation describing debt dynamics, alternative debt/GDP ratio scenarios are obtained by shocking the variables that characterise the equation itself: the real GDP growth rate, the GDP deflator growth rate, the short-term interest rate and spreads between short- and long-term interest rates. [71]

With these assumptions, the EFD's policy debt/GDP ratio lies in the lower section or just below the central part of the probability interval under the assumption of temporary shocks. Given the PBO's macroeconomic forecasts, the likelihood that the debt would evolve in accordance with the EFD baseline scenario would be around or just under 40 per cent. The assumptions of a permanent shock produces a wider distribution of the values for the debt/GDP ratio, but with a lower median. This is attributable to developments in interest rates that in the case of persistent shocks are influenced by the recent decline in rates. This scenario therefore generates a slightly higher probability of achieving the EFD's policy forecast for the debt/GDP ratio.

Figure 2.17 reports the likelihood of a decline in the debt for each year compared with the previous year (panel A) and compliance with the debt rule on a backward-looking basis (panel B) under temporary and permanent shocks.

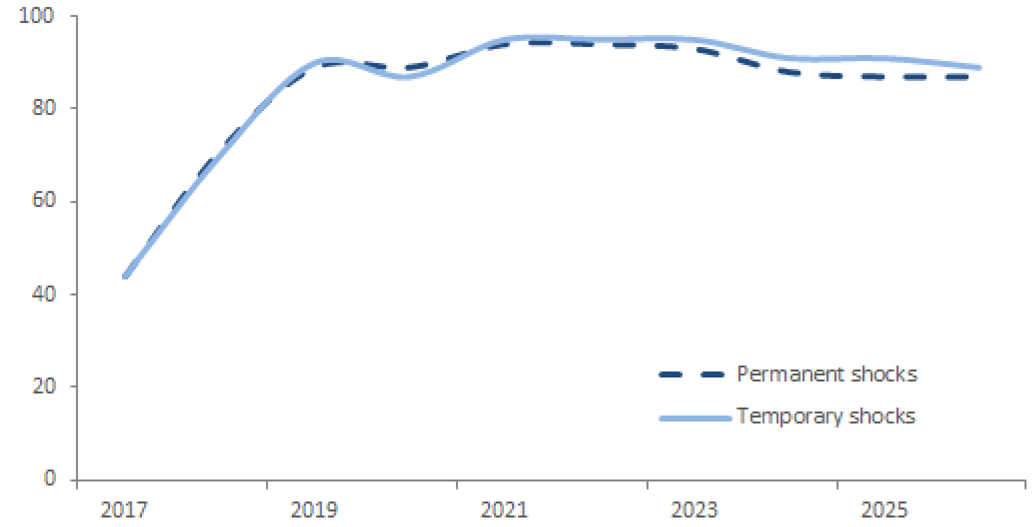
The analysis shows that in the case of temporary shocks, the probability of the debt/GDP ratio declining with respect to the previous year is 44 per cent in 2017, rising in the following years to stand at more than 90 per cent as from 2021. In the event of permanent shocks, the probability of reducing the ratio is essentially the same until 2022, and then stabilises at slightly below 90 per cent.

The analysis shows a very low probability for compliance with the backward-looking debt rule in the short-term, below 20 per cent. This increases in the subsequent years in both scenarios to stand at between 35 and 45 per cent in the medium term.

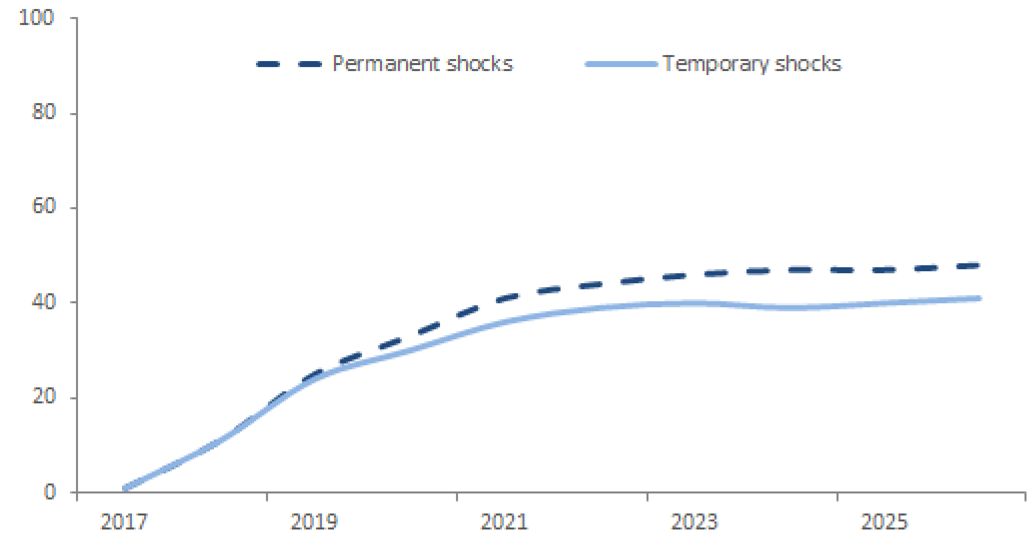
[71] The assumption of temporary shocks provides for changes in the variables that determine developments in the debt/GDP ratio whose effects are limited to the year of the shock. The assumption of permanent shocks provides for persistent shocks over time with regard to interest rates.

Figure 2.17 – Stochastic analysis of temporary and permanent shocks: implicit probabilities
(percentage points)

Panel A: Debt declines with respect to previous year



Panel B: Compliance with the debt rule



Source: based on 2017 EFD data.

Analysis 2.1

Support for the banking system

The new European banking rules,[72] introduced as from 2013 within the context of the European Banking Union, establish precise limits on admissible forms of public intervention to support the banking system. More specifically, the rules distinguish between cases in which there is evidence that a bank is failing, and cases in which the bank is still solvent. The aim of the European rules is to limit the moral hazard implicit in the assumption that an institution is "too big to fail", i.e. the implicit state guarantee for larger banks that cannot be allowed to fail in order to avoid a systemic crisis. The objective of the legislation, therefore, partly in response to the events that occurred during the years of the crisis, is to curb public intervention in support of the banking system to the greatest possible extent.

In the first case, namely when the failure of the credit institution facing a crisis, or at risk of entering a crisis, could engender serious consequences for the sustainability of the financial system, authorities may adopt the "resolution" procedure, i.e. a bank restructuring procedure managed by independent authorities (resolution authorities). A key element of the new European regime is that from 1 January 2016, shareholders and certain categories of creditors must bear part of the cost of a rescue (internal rescue or bail-in)[73] as a condition for the use of public resources (external rescue or bail-out). If the bail-in mechanism is applied (to shareholders and creditors) to cover at least 8 per cent of total liabilities, and part of the losses (up to 5 per cent) is absorbed by a Resolution Fund,[74] funded with resources provided by the banking system, public resources may be used to cover any further losses resulting from the resolution process.

In cases where the institution is still solvent, but only in order to avoid or respond to a serious economic disturbance and to preserve the financial stability of the country, Directive 59/2014 (BRRD) considers legitimate forms of extraordinary public financial support, without triggering a determination that the institution is failing and consequent

[72] Directive 2013/36 (CRD4) and the associated Regulation 575/2013 (CRR), Directive 59/2014 (BRRD) and "Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis" of 2013.

[73] The bail-in mechanism retains the hierarchy of creditors in an insolvency: consequently, losses are borne first by shareholders, then holders of other equity securities and subordinated debt, then unsecured creditors, including holders of ordinary bonds. Depositors with deposits of more than €100,000 may be involved in the bail-in only for the amount of their deposit that exceeds the €100,000 threshold and, if such a deposit is held by a person or an SME, only if all the other creditors involved in the bail-in are not sufficient to cover the losses. If the deposit is held by other counterparties, it is considered an unsecured debt and therefore placed on the same level in the hierarchy as ordinary bonds. Deposits of less than €100,000 are excluded from the bail-in.

[74] Each Member State must establish a Resolution Fund financed ex ante with contributions from the banking sector, which can be drawn upon in the case of bank failures. By 2025, each National Resolution Fund must have resources equal to at least 1 per cent of covered deposits of all credit institutions operating in the country. Banking Union also provides for the establishment of a Single Resolution Fund, which will begin full operation in 2024.

resolution, to include: (a) the granting of State guarantees of newly issued liabilities by banks or emergency liquidity assistance from the central bank; and b) precautionary recapitalisation, i.e. a strengthening of the bank's capital with public resources. The State may take such action under certain conditions, including compliance with state aid rules and being strictly temporary in nature. In addition, the guarantees a bank can receive are limited to the support strictly necessary to restore its medium/long-term financing capacity, while recapitalisation cannot be used to cover current or expected losses.

The procedure for implementing precautionary recapitalisation interventions is especially complex and articulated with regard to both the prerequisites for its use and the implementation procedures.[75] While the resolution of a failed bank triggers the bail-in mechanism, precautionary recapitalisations provide for so-called burden sharing, i.e. a penalty for the bank's shareholders and the holders of hybrid and subordinated financial instruments, again with the intention of reducing the burden on the public purse. Following the entry of the State in the capital of the bank, the interest of the existing shareholders is diluted, while hybrid and subordinated financial instruments are wholly or partially converted into shares, depending on the need. Unlike the bail-in procedure, in the case of burden sharing there are no costs for other bank creditors (mainly non-subordinated creditors and current account holders with deposits above €100,000).[76]

With regard to banks that are still solvent, Decree Law 237/2016 on the protection of savings in the credit sector provides for both forms of intervention permitted under Community rules, namely the granting of state guarantees and precautionary recapitalisations. The decree allows the State to grant its (unconditional, irrevocable, on first demand) guarantee on new bonds issued by banks with their registered office in Italy.[77] This option is temporary (until 30 June 2017, with possible renewal for another six months) and limited to the support strictly necessary to restore the medium/long-term financing capacity of the beneficiary banks. In accordance with the rules governing state aid, the guarantee shall be remunerated and the annual fee is determined on the basis of a formula that generally takes account of the creditworthiness of the beneficiary bank and the Italian Republic.[78]

Decree Law 237/2016 also provides for precautionary recapitalisations, in which there is also the possibility of restitution, i.e. an exchange of shares with ordinary bonds

[75] The starting point of the process is represented by the need to address a capital shortfall emerging from a stress test. The shortfall must be prospective and potential, i.e. conditional upon the occurrence of a hypothetical scenario. A bank experiencing such a capital shortfall must prepare a "market-based" recovery plan (which therefore does not envisage access to public financial support) for submission to the competent supervisory authorities. If the plan is considered insufficient – or its actual implementation is found to insufficient – to achieve the necessary recapitalisation, the bank may submit a request for State intervention.
[76] Recapitalisations may be undertaken only after the supervisory authority has quantified the capital shortfall and the European Commission has declared the intervention to be compatible with the regulations governing state aid and has approved the business reorganisation plan submitted by the bank.
[77] The guarantee may also be granted for emergency liquidity assistance.
[78] If the creditworthiness of Italy decreases, its guarantee is worth less and the cost for the bank declines as a result.

reserved for retail investors who receive new shares following the burden sharing as a result of a precautionary recapitalisation, under certain conditions.[79]

To finance with these measures, the decree provides for the establishment of a fund with resources of €20 billion for 2017 to cover the costs of share subscriptions and purchases to bolster capital and of the guarantees granted by the State. A decree of the Minister for the Economy and Finance, which has not yet been published in the *Gazetta Ufficiale*, provides for the allocation of the Fund between the two purposes. The 2017 EFD assumes that about half of the resources made available for the precautionary recapitalisation of banks under the decree will be utilised in 2017.

With regard to guarantees, the cost for the State, given the probability of default of banks, is estimated at €771 million in the technical report (TR) accompanying the decree, with the volume of bonds to be guaranteed forecast at €112 billion. This is a reasonable estimate, although the volume of bonds to be guaranteed may be larger, as acknowledged by the TR itself.

Since these transactions regard financial items (recapitalisation) and the granting of non-standard State guarantees,[80] the TR of the decree does not envisage any impact on net borrowing, except for the interest expense on the increase in issues of government securities, authorised by Parliament with the approval of the December 2016 Report.

As far as recapitalisation is concerned, there is a risk of non-compliance with the ESA2010 requirements for classifying such transactions as financial transactions, which have effects on gross public debt but not on net borrowing. In order to be classified as financial transactions, recapitalisation operations must be compatible with the state aid rules and a sufficient fixed rate of return must be paid to the State.[81] If the criteria set out in the ESA2010 Manual on Government Deficit and Debt and subsequent Eurostat decisions are not met, the transaction is reclassified as a capital transfer and, as such, also impacts net borrowing.

To date, three credit institutions have requested State guarantees, for a total of €20.6 billion in bonds (Table A2.1.1).

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[79] This seems justified not only on the macroprudential plane (with the need to avoid possible contagion that could propagate the instability of the recapitalised bank to other components of the banking system), but also from a microprudential point of view, as it frees the "rescued" entity from the risk of litigation associated with the sale of subordinated securities to investors without the necessary financial sophistication.

[80] That is, they have not been granted to an indistinct group of beneficiaries but rather only to beneficiaries meeting specific characteristics, including a different credit rating, on which the price of the guarantee depends.

[81] Eurostat (2013), "Decision of Eurostat on government deficit and debt. Clarification of the criteria to be taken into account for the recording of government capital injections into banks". The Manual specifies the rate on 10-year government securities as a proxy for "a sufficient rate of return" if the State is the sole shareholder of the bank and the average return on equity (ROE) for the sector if private shareholders are also involved. If there is no certain evidence of the existence of a sufficient rate of return, it is necessary to determine if there are private investors in the recapitalisation and if there are accumulated net losses.

Table A2.1.1 – Amount of guarantees requested
(billions of euros)

	Amount	Source
Banca Monte dei Paschi di Siena	11.0	Bank press releases of 25 January 2017 and 15 March 2017
Banca Popolare di Vicenza	5.2	Bank press releases of 3 February 2017 and 28 March 2017
Veneto Banca	4.4	Bank press releases of 2 February 2017 and 4 April 2017
Total	**20.6**	

The same institutions have also submitted a request for recapitalisation by the State in the amount of €13 billion, with the possibility that the cost to the State would be smaller a result of the application of burden-sharing arrangements (Table A2.1.2).

In general, the need for recapitalisation depends primarily on the management of the stock of non-performing loans (NPLs), which at the end of 2016 amounted to €349 billion on a gross basis for the Italian banking system, and to €173 billion net of writedowns recognised in bank financial statements.[82] Data show that both the flow of new NPLs[83] and the stock of NPLs[84] are declining. Nevertheless, it should be noted that in Italy the ratio of impaired positions to total loans (the NPL ratio) is about three times higher than the European average.[85]

Table A2.1.2 – Amount of recapitalisations requested
(billions of euros)

	Amount (3)	Source
Banca Monte dei Paschi di Siena	6,6(1)	Bank of Italy
Banca Popolare di Vicenza	3,3(2)	Bank press release of 4 April 2017
Veneto Banca	3,1(2)	Bank press release of 4 April 2017
Total	**13.0**	

(1) €4.6 billion for recapitalisation and €2 billion for restitution of retail investors. – (2) Amount of precautionary recapitalisation. – (3) The State's contribution may be less as a result of the burden sharing mechanism (also taking account of any settlements offered to private bondholders).

[82] Net bad debts, i.e. receivables due from insolvent counterparties – the most risky category of NPL – amounted to €81 billion, of which about €20 billion are held by banks in difficulty, with the rest being held by institutions whose financial condition do not require immediate sale on the market. The additional writedowns that the struggling banks may have to recognise, at current market prices, can be estimated, according to the Governor of the Bank of Italy, at about €10 billion. See Visco (2017), "The economic and financial situation of Italy and prospects for economic governance in the European Union", meeting with the Committee on Economic and Monetary Affairs of the European Parliament, 11 April 2017, https://www.bancaditalia.it/pubblicazioni/interventi-governatore/integov2017/Visco_20170411_en.pdf?language_id=1.

[83] The improvement in the outlook for the Italian economy has a favourable, albeit gradual, impact on the creditworthiness of the banks. In the fourth quarter of 2016 the flow of new NPLs as a proportion of total loans, corrected for seasonal factors and stated on an annual basis, fell from 2.6 per cent to 2.3 per cent. See Banca d'Italia (2017), "*Economic Bulletin*", no. 2, April.

[84] In 2015 gross bad debts amounted to €360 billion, while net bad debts totalled €197 billion. See Banca d'Italia (2016), "Financial Stability Report", no. 2.

[85] In the second quarter of 2016, the ratio for Italy was 16.4 per cent, compared with an EU average of 5.4 per cent. European Banking Authority (2016), "Risk assessment of the European banking system", December.

Note that with the guidance on the disposal of NPLs issued last March, the ECB partially revised its previous position, which favoured the rapid disposal of NPLs with the sale of portfolios on the market and consequent potential erosion of regulatory capital due to the large difference between the book value of the NPLs and the market price. The ECB does not prescribe quantitative targets for reducing NPLs in the guidance, but requires each bank, based on the specific features of its NPLs, to develop a strategy, including an operational plan, that includes a range of policy options, including in-house NPL workout and servicing (outsourcing of credit management and recovery), and not just the sale of portfolios on the market.[86] In addition, a Bank of Italy study has shown that in the Italian market between 2006 and 2015, the average recovery rate for bad debts was 43 per cent, with a large difference between the average recovery rate for positions sold, equal to 23 per cent, and the recovery rate for those worked out in house, equal to 47 per cent. In 2014-2015, however, the average recovery rate declined to 35 per cent, which reflected the increase in positions closed through market disposal.[87] Another Bank of Italy study finds that forcing banks to liquidate NPLs could be counterproductive in reviving the supply of credit if liquidation generates such large losses as to compromise the banks' capital ratios.[88]

Finally, the reduction of banks' NPLs requires progress in the reform of the Italian institutional and regulatory framework, with a reduction of the time required for loan recovery. In 2015-2016 a number of measures were adopted,[89] including the so-called Marciano Pact,[90] changes in bankruptcy rules and the creation of a public sales portal for all assets involved in bankruptcy and enforcement proceedings, for which an experimental phase was begun in January 2017. In order to develop the market for NPLs, the State guarantee on the securitization of bad debts was introduced. Other measures should work their way through Parliament in 2017, including the comprehensive reform of the rules governing corporate crises and insolvency procedures and the law on the extraordinary administration of large insolvent companies.

Greater efficiency in the civil justice system would also facilitate the disposal of bad debts. In 2016, the reduction in registered and pending proceedings, a reflection of the measures adopted in recent years, was accompanied by a decrease in the average

[86] European Central Bank (2017), "Guidance to banks on non-performing loans".
[87] Ciocchetta, F., Conti, F.M., De Luca, R., Guida, I., Rendina, A. and Santini, G. (2017), "Bad loan recovery rates", Banca d'Italia, Notes on Financial Stability and Supervision, no. 7.
[88] Accornero, M., Alessandri, P., Carpinelli, L. and Sorrentino, A.M. (2017), "Non-performing loans and the supply of bank credit: evidence from Italy", Banca d'Italia, Occasional Papers, no. 374. The study, which examines the Italian banking system in 2008-2016, finds that the supply of credit is not influenced by the stock of NPLs, but is affected by certain characteristics of banks, such as capital ratios and size. According to the study, the negative correlation between NPLs and the supply of credit found for Italy is caused by adverse cyclical factors that affected banks (increase in NPLs) and borrowers (loss of profitability and contraction in demand for credit).
[89] The measures are discussed in detail in the 2017 National Reform Programme.
[90] This involves the out-of-court transfer of real estate securing loans in the event of borrower default. The creditor is required to pay the borrower any difference between the amount of the loan and the value of the real estate.

length of litigation in the trial courts to 981 days.[91] This is a positive development, which should be strengthened in the coming years.

[91] See the 2017 National Reform Programme.

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

3.1 *The flexibility clause for investment*

The deviation from the adjustment path towards the MTO granted ex ante to Italy for 2016 equals a total of 0.86 per cent of GDP, of which 0.25 per cent for the investment clause. Ex-post acceptance by the European institutions is subject to three conditions: 1) the existence of credible plans for the resumption of the adjustment path towards the MTO as of 2017; 2) the effective use of the deviation from the adjustment path for the purpose of increasing investments compared with the previous year; 3) progress with the structural reform agenda, taking into account the Council Recommendations.

Although for the purposes of the first condition, the European Commission required an additional budget adjustment of 0.2 percentage points of GDP (see Section 2.4) and, for the third, the Government presented a plan for completing the reforms begun in recent years (see Section 4.2), complying with the second condition appears to be more challenging.

In 2016, investment did not rise on the previous year, as required by the condition of additionality, but contracted by 4.5 per cent (for a more thorough review see Analysis 3.1). The Government's assessment set out in the 2017 EFD indicates that the condition is nonetheless satisfied, despite the reduction in investment in the national accounts, considering a spending aggregate that includes, in addition to gross fixed capital formation (net of property sales), investment grants to firms, but excludes the share of these items financed by the European Union (Table A3.1.1).

Eliminating EU financing, which has been contracting sharply (from €3.1 billion in 2015 to €300 million in 2016) as a result of the normal delays that characterise the new planning cycle, we obtain an aggregate representing expenditure financed only from the national budget, which has been growing by around 1 per cent. The reduction in the share co-financed by the EU on the one hand seems to be attributable to the comparison with 2015, the closing year of the 2007-2013 programming cycle, and on the other, it confirms the low level of expenditure in 2016 as part of the new cycle.

This definition of the relevant expenditure aggregate for the purposes of the investment clause deserves a moment of attention. On the one hand, the inclusion of investment grants can be considered to be consistent with scope of application of the Juncker Plan, which supports private investment projects. On the other, excluding EU co-financing may not be entirely consistent with the definition of total investment specified in the clause condition.

In addition, since the amount of eligible expenditure actually carried out (according to the Government €3.5 billion, or 0.2 per cent of GDP; Table A3.1.2) seems to be less than the 0.25 per cent granted ex ante by the European Commission, the effective deviation that will be recognised in the ex post assessment for 2016 is an open question for now.[92]

The €3.5 billion in expenditure connected with projects that can be financed using European funds, while lower than expected, is still considerable considering the meagre amount of EU co-financing granted in 2016 (the €300 million for capital expenditure noted above). Based on the 2017 EFD it can be inferred that a portion of the projects, equal to €1.7 billion, for which application of the clause is requested did not receive EU co-financing, but that in any case the Government considered this portion to be eligible since it relates to the completion of projects begun under the previous programming cycle or approved but not co-financed due to the lack of resources in the EU budget.

In 2016 the Government adopted a series of measures to accelerate public investment in order to take full advantage of the flexibility allowed by the European Union. More specifically, measures were introduced to avoid delays owing to a scarcity of resources and problems at the regional level, and it was expected that the transition from the constraints of the domestic stability pact to the balanced-budget rule would mean fewer restrictions on the operations of local authorities. While a closer examination of the factors that might have restrained local authorities' capacity to make investments is provided in Analysis 3.1.2, here we note the delays in the establishment of the framework of fiscal rules for 2016, which seems to have affected the planning capability of local authorities in 2015, and the procedural changes made to the public tender process.

The European Commission's final conclusions will be prepared after the publication of the Spring Forecast, considering, first, the pre-condition for eligibility for the clause, which as noted requires that aggregate total expenditure not decrease in 2016 as compared with 2015, and, second, the actual amount of expenditure to be taken into account for the purposes of the clause.

3.2 Fiscal rules

3.2.1 The structural balance rule

After 2016-2017 period, in which Italy took advantage of the additional flexibility allowed under EU law mainly to implement policies to strengthen the economic cycle, the policy scenario in the 2017 EFD confirms the public finance objectives that envisage the resumption of the path of adjustment of the structural balance towards the MTO and reaching it in 2019.

[92] In the "2016 Budgetary Policy Report" (Section 2.3.1) the PBO reported the risk of not being able to take full advantage of the flexibility granted given the historical pattern of expenditure during the initial years of a programming cycle.

The assessment of compliance with the fiscal rules involves: ex post analysis, where compliance with the structural balance rule in 2016 is confirmed; in-year analysis for 2017; ex ante analysis for 2018 and the subsequent two-year period. The results for 2016 are strictly connected with the forecasts for 2017: the allowance of additional flexibility for the investment clause is dependent upon resuming the adjustment path. The additional adjustment of 0.2 percentage points of GDP (see Section 2.3) contributes to compliance for 2017 (on an annual basis) with the preventive arm of the Stability and Growth Pact; likewise, compliance in 2017 contributes to the positive assessment for 2016.

Table 3.1 sets out the information needed to assess compliance with the structural balance rule, illustrating the adjustment required (over one and two years) under the fiscal rules, the flexibility clauses granted by the EU institutions for each year and the adjustments made.[93] The difference shows whether compliance with the rules was achieved, indicating in the final line of each section the significance of any deviations.

According to the estimates contained in the EFD, in 2016 the structural adjustment was negative – indicating a departure from the MTO – equal to -0.7 percentage points. The ex-ante adjustment required by the rules was also negative, equal to about -0.4 percentage points. In this scenario, therefore, the result for 2016 would represent a deviation of around 0.3 percentage points, which is less than 0.5 and therefore is not considered significant. Over a two-year period, the deviation would be equal to around 0.13 percentage points, which is less than 0.25 and therefore is also deemed insignificant.[94]

It should, however, be noted that the adjustment required was determined on the basis of a number of components, one of which, as stated in Section 3.1, was represented by a margin of flexibility of 0.25 percentage points linked to the investment clause allowed by the EU institutions subject to certain conditions.

The European Commission is currently assessing whether these conditions have been met and should complete this work by the end of June. At present, there are three possible scenarios. The first is that – despite the reduction in investment in 2016 – the margin of flexibility of 0.25 is confirmed based on the reasoning put forth by the Government. Another scenario, which could be called a moderate risk scenario, is that the clause is instead allowed just for the amount of investment actually made, therefore reducing the flexibility margin to 0.2 points compared with the 0.25 permitted ex ante. The final scenario, the high risk scenario, is that the clause and associated 0.25 points of flexibility are both fully revoked.

[93] Consistent with the EFD, in Tables 3.1 and 3.2 the adjustment achieved in 2015 is recalculated based on updated data, therefore affecting the average two-year deviation for 2015-2016. It is important to note that the same calculation by the European Commission is based, for 2015, on the value “fixed” in the assessment made in the spring of 2016.

[94] Based on the value for 2015 “fixed” at the time of the European Commission’s assessment in the spring of 2016, there is an average two-year deviation of 0.2 percentage points, which leads to same conclusion of an insignificant deviation.

Table 3.1 – 2017 EFD objectives in light of the structural balance rule
(percentage points)

	2014	2015	2016	2017	2018	2019	2020
Structural budget balance - 2017 EFD forecasts	**-0.7**	**-0.5**	**-1.2**	**-1.5**	**-0.7**	**0.1**	**0.0**
Required adjustment excluding clauses (annual) (a)		0.25	0.5	0.6	0.6	0.6	-0.1
Deviation for structural reform clause and investment clause (b)		0.0	0.75	0.0	0.0	0.0	0.0
Deviation for exceptional events (security expenditure 2015-16, refugees 2015-17, terrorism 2017, earthquake 2017) (c)		0.03	0.11	0.32	0.0	0.0	0.0
Required adjustment including clauses and exceptional events (annual) (d=a-b-c)		0.2	-0.4	0.3	0.6	0.6	-0.1
Adjustment achieved (annual) (e)		0.3	-0.7	-0.3	0.8	0.8	-0.1
Difference between adjustment achieved and required (annual) (f=e-d)		0.1	-0.3	-0.6	0.2	0.2	0.0
Compliance with adjustment towards MTO (annual)			***Insig. dev.***	***Sig. dev.***	***Yes***	***Yes***	***Yes***
Required adjustment including clauses and exceptional events (biennial average) (g)			-0.1	0.0	0.4	0.6	0.3
Adjustment achieved (biennial average) (h)			-0.2	-0.5	0.2	0.8	0.4
Difference between adjustment achieved and required (biennial average) (i=h-g)			-0.13	-0.47	-0.22	0.18	0.09
Compliance with adjustment towards MTO (biennial average)			***Insig. dev.***	***Sig. dev.***	***Close to sig.***	***Yes***	***Yes***

Source: based on 2017 EFD data.

In the moderate risk scenario, there would still be a certain deviation, equal to around 0.4 percentage points, which would not be significant. There is a degree of deviation over the two-year period as well, but it is also not significant.

In the high risk scenario, the deviation would instead be equal to about 0.6 percentage points, which would be significant. Over the two-year period, the deviation would be around 0.26 percentage points, at the threshold of significance.

For 2017, the forecasts in the EFD continue to point towards a deterioration in the structural balance equal to about -0.3 percentage points. The improvement required ex ante by the European Union was initially equal to the 0.6 percentage points “or more” established in the country-specific recommendations published in July 2016. After the occurrence of a number of exceptional events (inflow of refugees, terrorism and extraordinary outlays for earthquake-prevention measures), the improvement required was reduced to about 0.3 percentage points. Despite the flexibility granted, there is therefore a deviation of 0.6 percentage points that, at least at first glance, would appear to be significant.

It should however be noted that this result could be at least in part attributable to purely statistical factors associated with the uncertainty of the estimate of potential GDP in 2016-2017. Indeed, the comparison between the 2017 EFD and the 2017 DPB from last October shows that, with effective net borrowing in the 2016-2017 period identical in the two documents prior to the recent budget package, the change in the structural balance between the two years was equal to -0.4 percentage points in the 2017 DPB, while under the trend scenario in the EFD it is equal to -0.5 percentage points. This means that the recently approved budget measures of 0.2 percentage points in 2017 give rise to a change as compared with 2016 of -0.3 percentage points instead of the previous -0.2 points.

Another aspect, hoped for in the 2017 EFD, is that the adjustment required in 2017 could be slightly lower than that indicated in July of last year if the European Commission should decide that it has overestimated the output gaps. The output gap estimates could be revised in the context of the EU's approval of a new methodology. This methodology assesses the plausibility of the output gap estimates obtained with the production function by comparing them with those obtained from regressions that include variables that are strongly correlated with the cycle. Specifically, as desired in the EFD, once these possible revisions to the output gap are made, Italy's economic situation might be judged "bad" rather than "normal" in 2017, which could lead to a reduction in the adjustment required based on the phase of the cycle.[95]

Therefore, in cases in which the deviation is at least in part attributable to problems associated with the estimate of potential GDP or the output gap, it could be deemed insignificant, or least at the threshold of significance. These assessments, however, underscore the risks of intentionally setting the planned adjustments of budgetary policy on the borderline between significant and insignificant deviation.

Again for 2017, the EFD's estimates present the risk of significant deviation on a biennial basis. In fact, during 2016-2017 the adjustment was on average negative and equal to about -0.5 percentage points, compared with a required adjustment of about zero. The risk is therefore a deviation of more than 0.25, which appears to be significant. It could be determined that, based on the EFD's estimates, a structural intervention of between 0.3 and 0.4 percentage points, beyond that recently adopted at the invitation of the European Commission, is needed in 2017 to avoid a significant deviation.

For 2018, the planned adjustment is equal to 0.8 percentage points while that required is at least 0.6 percentage points, if the cyclical conditions in Italy remain normal. In annual terms, this adjustment would be fully in line with the fiscal rules. Over two years, however, the average adjustment for 2017-2018 would be equal to about 0.2 percentage points, compared with an average required adjustment of about 0.4 percentage points. Therefore, the risk of deviation, amounting to about 0.2 percentage points, would be at the threshold of significance.

Finally, over the 2019-2020 period, the MTO would be achieved or exceeded in full compliance with the fiscal rules.

[95] Obviously, even if the European Commission decides to revise the output gap estimate, this does not automatically mean that the classification of the economic cycle actually changes since the associated threshold must be exceeded.

3.2.2 The expenditure benchmark

Table 3.2 reports the information needed to assess compliance with the expenditure benchmark for 2016 (ex-post evaluation) on an annual and biennial basis, demonstrating the growth in the expenditure aggregate, that required by the fiscal rules, any deviations and the final result of the analysis. Information is also provided on compliance with the rule for 2017-2018 on the basis of aggregate data provided by the MEF.[96]

The table shows that, using final data provided by Istat and the MEF, in real terms in 2016 the growth in the spending aggregate used for the rules net of discretionary revenue measures (DRMs) would be equal to 0.3 per cent. This growth is less than that allowed for that year by the fiscal rules, equal to 0.8 per cent, which is consistent with the required structural balance adjustment as discussed in Section 3.2.1.

We can therefore conclude that in that year there was compliance with the expenditure benchmark in annual terms. Furthermore the conclusions on the expenditure benchmark are more favourable than those on the structural balance rule, which presented a deviation, albeit not a significant one. EU legislation, which Italian law refers to, provides that, in the case of different outcomes between the two rules, a comprehensive assessment shall be performed to understand the reasons for the differences.

Table 3.2 – Compliance with the expenditure benchmark
(percentages)

	2015	2016	2017	2018
Adjusted net annual expenditure growth (real)	**0.8**	**0.3**	**-0.2**	**-1.8**
Adjusted net biennial expenditure growth (real)		**0.5**	**0.0**	**-1.0**
Target for annual expenditure benchmark growth including clauses and exceptional events (real)	-0.4	0.8	-0.7	-1.3
Deviation from annual target (% GDP) (1)	0.5	-0.2	0.2	-0.2
Compliance with expenditure benchmark (annual)		***Yes***	***Insig. dev.***	***Yes***
Target for average biennial expenditure benchmark growth including clauses and exceptional events (real)		0.2	0.1	-1.0
Deviation from biennial target (% GDP) (1)		0.16	-0.01	0.00
Compliance with expenditure benchmark (biennial average)		***Insig. dev.***	***Yes***	***Yes***

Source: based on Istat and MEF data.
(1) A positive sign indicates a negative contribution to the improvement of the structural balance.

[96] In Table 3,2, the growth rates are expressed in real terms in line with European Commission practice. However, as a result of the decision of the EU Council to provide recommendations on the aggregate spending benchmark (net of discretionary revenue measures) in nominal terms, starting in 2018 the assessment will also be made in nominal terms as indicated in European Commission (2017) "Vade Mecum on the Stability and Growth Pact – 2017 Edition". However, the results in terms of the deviation as a percentage of GDP do not change given that the same deflator is used to render the nominal variables real and vice-versa.

More specifically, an assessment must be made of whether the reason for the differences is due to one-off items that are eliminated from the structural balance, but not from the spending aggregate or from the DRMs. Taking the one-off expenditures and DRMs provided by the MEF and eliminating them from their respective items, the growth in the expenditure aggregate net of DRMs also shows a deviation, equal to about 0.1 percentage points of GDP and therefore is not significant. The deviation also remains below that observed for the structural balance.

Over two years, the average growth in the spending aggregate net of DRMs was equal to 0.5 per cent over the 2015-2016 period, greater than the permissible growth of 0.2 per cent. This means a deviation in terms of GDP of about 0.16 percentage points,[97] which is therefore not significant, a result similar to that under the structural balance rule.

It should be noted that, as for the structural balance rule, under the expenditure benchmark the permitted growth in 2016 also benefits from flexibility clauses, including the investment clause. However, if the clause were revoked, the permitted growth would be equal to 0.3 per cent, in line with that achieved, so there would be continued compliance with the expenditure benchmark. On a biennial basis, there would be a deviation, albeit at the threshold of significance. Netting the items from the one-off measures provided by the MEF, there would be a deviation, although not a significant difference on both an annual and biennial basis.

With regard to 2017, using the aggregate data from the MEF, the growth in the spending aggregate net of DRMs would be negative in real terms, equal to -0.2 per cent, above that permitted, equal to -0.7 per cent. The deviation in terms of GDP would be equal to 0.2 percentage points and so is not significant.

In this case as well, compliance with the expenditure benchmark is better than that for the structural balance rules described in the previous section. If one-offs are netting from expenditure and DRMs, the deviation would be larger, equal to around 0.4 percentage points of GDP, but would still not be significant.

On a biennial basis, Italy would comply with the expenditure benchmark thanks largely to the particularly positive result of 2016. However, netting the one-off measures from the aggregates would create a deviation, even if at the threshold of significance.

Finally, in 2018, the data provided by the MEF show full compliance with the rule in annual terms, consistent with the results for the structural balance rule. Compliance with the rules is also confirmed for the two-year perspective.

It is important to stress, however, that this check for 2018 was performed using aggregate data provided by the MEF, but details on the budget measures for 2018 are

[97] If instead of recalculating the spending aggregate for 2015, we take the value "fixed" at the time of the European Commission's spring 2016 assessment, the average biennial deviation would be -0.16 percentage points, slower than the objective and the therefore ensuring compliance with the rule.

not provided in the EFD. The assessment of compliance with the expenditure benchmark is therefore only partial and is subject to further verification when detailed information becomes available.

3.2.3 The debt rule

As to outturn for 2016, compliance with the numerical rule for debt reduction does not appear to have been achieved on the basis of some of the criteria provided for under EU legislation (backward-looking, forward-looking and adjusted for the cycle). In these cases the European Commission prepares a report on the debt that sets out the significant factors that contributed to the breach of the numerical rule in 2016 in order to decide whether or not to initiate an excessive deficit procedure tied to the debt benchmark.

Looking forward, the policy scenario for the debt-to-GDP ratio represented in the EFD is not consistent with compliance with the numerical rule for the entire 2017-2020 period using the backward-looking method. In 2020, the gap between the actual stock of debt and the benchmark level is still equal to 2 percentage points of GDP.

Breach of the backward-looking benchmark over the EFD's programming horizon also means that there is no compliance with the benchmark under the forward-looking method in 2017-2018.

In fact, as emphasised in preceding documents, compliance of the rule using the forward-looking method in a given year is the equivalent to compliance with the rule with the backward-looking approach two years after the benchmark year. For example, compliance with the rule under the backward-looking method in 2020 would imply compliance in 2018 using the forward-looking method. This also means that, given the data currently reported in the EFD, it is not possible to assess compliance with the rule using the forward-looking approach for 2019-2020, since this would require projections of the debt-to-GDP ratio for the 2021-2022 period.

As discussed in Section 2.5.2, a projection of the debt-to-GDP ratio beyond 2020 conducted using relatively neutral technical assumptions about the macroeconomic scenario and assuming compliance with the balanced-budget requirement would suggest that compliance with the rule using the backward-looking criterion can be achieved in 2022, with therefore compliance in 2020 under the forward-looking criterion.

Analysis 3.1

Additional factors to be considered in assessing the flexibility clause for investment

A3.1.1 Factors to be considered in assessing compliance with the clause

The deviation from adjustment path towards the MTO granted to Italy ex ante for 2016 was equal to a total of 0.86 per cent of GDP, divided between the flexibility clauses proper in the amount of 0.75 per cent (of which 0.5 per cent for structural reforms and 0.25 per cent for the investment clause) and a deviation for exceptional events of 0.11 per cent (of which 0.05 per cent for refugees and 0.06 per cent for security costs)[98].

Looking at the flexibility clauses proper, i.e. 0.75 per cent of GDP, in July 2015 the EU institutions recognised part – equal to 0.4 per cent – for the structural reforms, requested in connection with the 2015 EFD, while the remainder – equal to 0.35 per cent, divided in turn between 0.1 per cent for additional structural reforms and 0.25 per cent for the investment clause – requested in the 2016 DBP,[99] was granted one year later, in July 2016.[100] The additional flexibility of 0.35 per cent was allowed subject to three conditions: 1) the existence of credible plans for the resumption of the path of adjustment towards the MTO as from 2017; 2) the effective use of a deviation from the adjustment path for the purpose of increasing investment; 3) achieving progress with the structural reform agenda, taking Council recommendations into account.

For the purposes of the first condition, the European Commission required an additional budget adjustment of 0.2 percentage points of GDP, which the Government enacted with Decree Law 50/2017, while for the third, the Government presented a plan for completing the reforms begun in recent years (see Section 4.2). Compliance with the second condition appears to be more challenging.

More specifically, with regard to the first condition, i.e. resuming the path of adjustment towards the MTO in 2017 for the purposes of Italy's compliance with the preventive arm of the SGP, according to the Winter Forecasts of the European Commission published on 17 February, for 2017 there was a risk of significant deviation for both the expenditure benchmark and the structural balance, while considering flexibility of 0.32 per cent of GDP

[98] For a detailed description of the Italian Government's requests to the European Commission for temporary deviations from the adjustment path towards the MTO for 2015-2017, see Parliamentary Budget Office (2016), "2017 Budgetary Policy Report", Sec. 3.1, November.

[99] Italy initially requested a temporary deviation for the investment clause of 0.3 per cent, of which the EU granted only 0.25 per cent, since the Council of the EU had previously decided that the flexibility connected with structural reforms and with investments could exceed 0.75 overall.

[100] Report from the Commission of 22 February 2017 on the public debt, prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union (TFEU).

granted to Italy ex ante for exceptional events, of 0.18 per cent relating to the protection of national territory against seismic risks and of 0.14 per cent for refugee-related costs.[101]

Therefore, in order to ensure compliance with the preventive arm of the SGP for 2017 the European Commission, in its letter of 17 January, asked for additional structural budget measures of 0.2 per cent of GDP in 2017. Compliance can only be assessed by the Commission on the basis of the upcoming Spring Forecasts, taking account of the measures amounting to 0.2 per cent of GDP that the Italian authorities adopted with Decree Law 50/2017.

In summary, the events of 2016 and 2017 are closely connected with one another: an additional budget adjustment of 0.2 per cent of GDP makes it possible to assess whether the 2017 targets comply with the SGP. Compliance of the public finances in 2017 eases one of the conditions for assessing compliance in 2016 with regard to the investment clause and other structural reforms.

As to the second condition for granting additional flexibility, i.e. the actual use of the greater budget flexibility to increase investment, two particular issues arise: the first regards the additionality principle, for which total government investment must not fall in 2016 below the level of the previous year; the second concerns how much eligible investment was actually carried out for the purposes of determining the effective value of the flexibility granted under the clause for 2016.

As to the first issue, on the basis of the available information, the European Commission forecast – in its Winter Forecasts – a reduction in public investment in 2016 (-1.8 per cent), to be confirmed ex post. As a result, the condition for eligibility, i.e. that the level of public investment during the year in which the investment clause is granted must at least be maintained, was not satisfied in the Commission's forecasts. The most recent results in the general government revenue and expenditure accounts published by Istat on 4 April confirm that in 2016 the level of public investment decreased with respect to the previous year by even more than estimated by the European Commission (-4.5 per cent).[102] This is due to the decline in investment by local governments (-13.7 per cent),[103] especially by municipalities, as indicated by cash data in the General Government Payments Information System (SIOPE - *Sistema informativo sulle operazioni degli enti pubblici*) only partially offset by the increase in investment by central government (+9.5 per cent), thanks especially to military spending. However, the government forecasts for 2016 were gradually revised downwards in official documents, going from expected growth in investment of 2.4 per cent in September 2015 (2015 Update), to 2.0 per cent in the 2016 EFD, to growth of just 0.9 per cent in the 2016 Update.

Despite these developments, in the 2017 EFD the Government considers that the condition of additionality for investments (increase in 2016 over 2015) has been satisfied. This assessment was made on the basis of a spending aggregate:

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[101] Parliamentary Budget Office (2016), "2017 Budgetary Policy Report", Sec. 3.1, November.
[102] Istat (2017), "*Conto trimestrale delle pubbliche amministrazioni, reddito e risparmio delle famiglie e profitti delle società*", 4 April.
[103] See Table II.1-5 of Section II of the EFD.

- including investment net of real estate disposals – registered as a reduction in public investment – although, for 2016, this implies a slightly greater reduction in the aggregate compared with the previous year;[104]
- including investment grants to businesses, which in turn fell in 2016;
- excluding the share of the above items financed by the European Union.

Eliminating this last item for EU financing, which contracted sharply in 2016 (from €3.1 billion in 2015 to €300 million in 2016), we obtain an aggregate that represents just expenditure funded through the national budget, which grew by about 1 per cent (Table A3.1.1). The reduction in the share co-financed by the EU appears to be the result of comparing the figure with that of 2015, the closing year of the 2007-2013 programming cycle, but in any event confirms the paucity of spending in 2016 under the new cycle.

This definition of the spending aggregate relevant for the purposes of the investment clause raises two issues. On the one hand, the inclusion of investment grants can be deemed consistent with scope of application of the Juncker Plan, which supports private investment projects. On the other, excluding the EU co-financing component may not be entirely consistent with the definition of total investment specified in the clause condition.

Even considering the slight increase in the spending aggregate net of the EU share indicated in the EFD, a number of factors negatively affected government expenditure on investment as a whole. More specifically, there was the decline in EU co-financing in 2016 as a result of the conclusion of the 2007-2013 programming cycle (as 2015 was the last year for expenditure without forfeiting resources) and uncertainty about application associated with the entry into force of reforms having a significant impact on the public finances, such as the new Public Contracts Code, the balanced-budget rule for local authorities and the associated coordination with the accounting rules envisaged in Legislative Decree 118/2011, which came into force in 2015 (see the next section for more details).

The other issue concerning the granting of flexibility for investment directly relates to the value of eligible investments actually carried out.

Table A3.1.1 – General government expenditure on investments and investment grants net of the EU share
(millions of euros)

	2014	2015	2016	% change 2016/2015
Gross fixed capital accumulation net of real estate disposals (a)	38,046	37,629	35,831	-4.8
Investment grants to firms (b)	10,978	13,489	12,959	-3.9
EU share (c)	3,790	3,062	300	-90.2
Total (d=a+b-c)	45,234	48,056	48,490	0.9

Source: based on EFD data, Section I, Table R.1.

[104] The amount of real estate disposals is inferred as the difference between the aggregate of government investment in Table II.1.3 of Section II of the EFD and Table R.1 of Section I.

In this regard, the PBO[105] had emphasised that the spending projected in the 2016 DBP (€5.15 billion, 0.3 per cent of GDP – then reduced by the European Commission to 0.25 per cent, around €4.2 billion – which was, however, associated in the 2016 DBP with €6.15 billion in European co-financing) seemed to be considerable, especially when compared with the 2007-2013 EU programming experience, particularly in the early years of the programming cycle.

The results reported in the EFD show national expenditure of around €3.5 billion, equal to 0.2 per cent of GDP (Table A3.1.2), with an approximately 68 per cent ratio of achieving the spending targets.

Since the amount of eligible expenditure actually realized, as reported by the Government, appears to be less than the 0.25 per cent granted ex ante by the Commission, the amount of the actual deviation that will be recognised in the ex-post assessment for 2016 has yet to be determined.

This amount of expenditure connected with projects financeable with European funds, while lower than expected, is nonetheless considerable considering the meagre EU co-financing received in 2016 (€300 million on capital account).

However, as noted in the past by the PBO[106] and confirmed in the 2017 EFD, the funds indicated by the European Commission for the purposes of the eligibility of expenditure for the clause also involve current expenditure, such as production grants, current transfers to businesses and spending on education and training, as well as to promote youth employment.

Table A3.1.2 – National expenditure in 2016 as reported in the EFD for the purposes of application of the investment clause (1)
(millions of euros)

	ERDF	ESF	YEI	EAFRD	EMFF	CEF	EFSI	Total national expenditure	% of GDP
Flexibility requested (2016 DBP)	1,400	600	200	800	50	1,050	1,050	**5,150**	**0.3**
Expenditure implemented (2017 EFD)	1,497	263	115	587	15	1,021	0	**3,498**	**0.2**
Percentage implementation	*106.9*	*43.8*	*57.5*	*73.4*	*30.0*	*97.2*	*0.0*	*67.9*	

Source: based on 2017 EFD data.
(1) ERDF: European Regional Development Fund; ESF: European Social Fund; YEI: Young Employment Initiative; EAFRD: European Agricultural Fund for Rural Development; EMFF: European Maritime and Fisheries Fund; CEF: Connecting Europe Facility; EFSI: European Fund for Strategic Investments.

[105] Parliamentary Budget Office (2015), "2016 Budgetary Policy Report", Section 2.3.1, November.
[106] Parliamentary Budget Office (2015), op. cit..

From the 2017 EFD we can infer that not all the projects for which application of the clause is requested actually received EU co-financing: this regards measures totalling €1.7 billion, which the Government nevertheless deems eligible since they relate to the completion – with national resources – of projects begun in the previous 2007-2013 programming period (relative to the ERDF, for €1 billion) and to projects approved (CEF financing) but not co-financed due to lack of resources in the EU budget (€700 million).

The European Commission's final conclusions will be prepared on the basis of 2016 Eurostat data, reported in the course of the overall assessment of compliance with the preventive arm of the SGP, as indicated in the Report on debt. This assessment will address both of the issues examined above.

In any case it should be noted that, in 2016, the set of measures that the Government adopted to accelerate public investment in order to take advantage of the flexibility allowed was clearly not as effective as hoped. The Government, in fact, focused on a number of measures to avoid delays caused by the scarcity of resources and bottlenecks at the regional level: the 2016 Stability Act envisaged providing cash advances to the regions through the Revolving Fund for the implementation of community polices (as had already been done for central government departments), and simultaneously allowed those regions to establish entities for the exclusive purpose of managing European programmes under special accounting rules, with special treatment of the balanced-budget rules.

A3.1.2 Examination of investments by municipalities

As explained above, general government investment in 2016 fell by 4.5 per cent compared with the previous year. An examination of the factors underlying this development is essential to ascertaining whether any of the major reforms implemented during the year just ended facilitated the proper planning of investment spending or, possibly, created obstacles. It would also be useful to examine whether the factors that might affect developments in investment in 2015-2016 are temporary or whether there are also structural factors that could have a potentially negative impact on future investment as well.

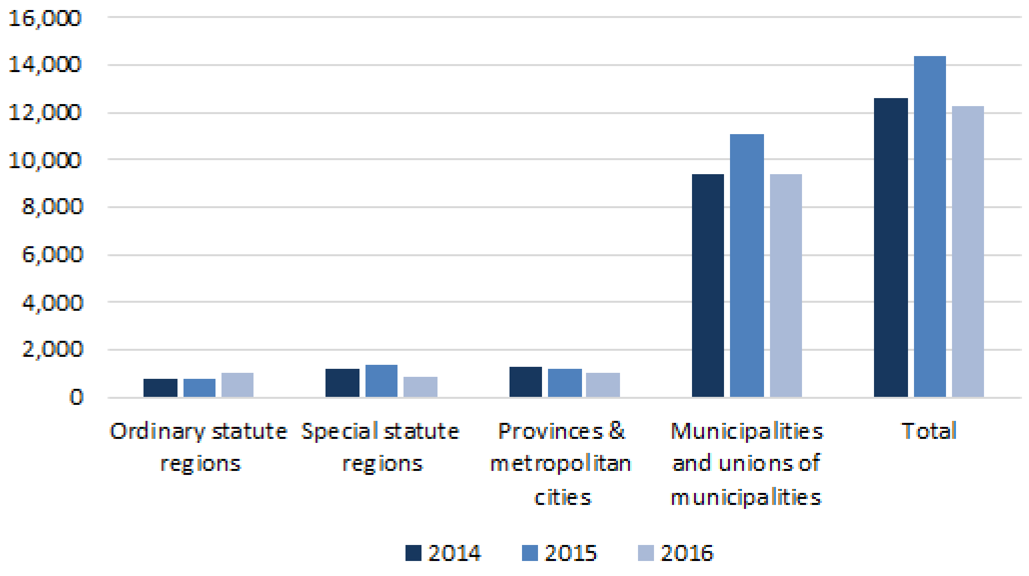
First, it should be noted that the uninterrupted decline in investment that characterised 2010-2014 came to a halt in 2015. A set of factors – some temporary – enabled the return to growth in 2015. This was made possible by the recovery in local government spending, particularly municipalities, and, to a marginal extent, social security institutions, which more than offset the decline, of around €2 billion, in investment spending by central government.

The growth in municipal investment in 2015 was mainly associated with the conclusion of the 2007-2013 programming cycle for EU funds, since 2015 was the last year in which recipients could avoid forfeiting resources (Figure A3.1.1). Specifically, increased capital spending was concentrated in the South, connected with the large number of projects co-financed by the EU in municipalities in that area.

Thanks in part to the exclusion of regional co-financing from the balanced-budget rules, in 2015 municipalities reported a significant increase in revenue from capital transfers from the regions to be used to pay for investment, which hit a peak in the last two months of the year (Figure A3.1.2) that could not be replicated the following year.

In addition to this key reason, investment expenditure by municipalities in 2015 may have been temporarily buoyed by a series of other factors, including the remaining funds from the final instalments of advances to pay commercial debts,[107] the process of easing the restrictions imposed by the Domestic Stability Pact, which made it possible to use a part of accumulated operating surpluses, extraordinary plans for investment for specific purposes (for example, reopening certain roadwork projects, investment in IT for improving local governments' accounting systems, investment in specific museums or archaeological sites, upgrading water supply and sanitation systems).

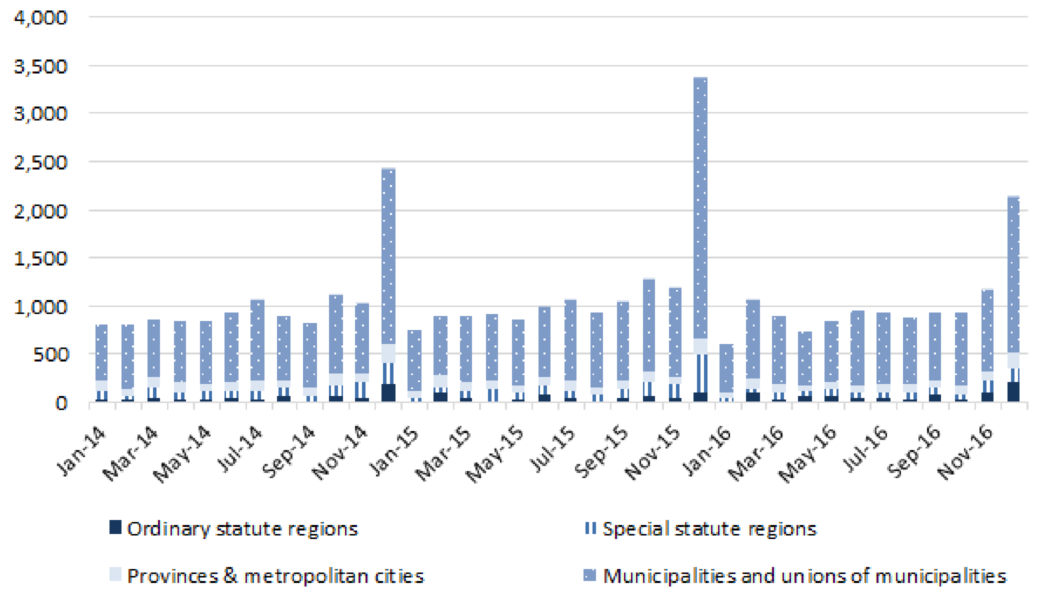
Figure A3.1.1 – Payments for local government investments – annual data
(millions of euros)



Source: based on SIOPE data.

[107] See the 2017 EFD, Section II, Table V.6-31 (p. 110), which shows remaining advances due to municipalities for commercial payables in the amount of €785 million. They were almost fully eliminated in 2016 (€86 million).

Figure A3.1.2 – Payments for local government investments – monthly data
(millions of euros)



Source: based on SIOPE data.

Likewise, a number of temporary factors presumably contributed to curbing investment spending in 2016. First and foremost, these include the uncertainty that characterised the planning in 2015 of investment for the subsequent year, since the legislation in force initially limited the option of including, for the purposes of the balanced-budget constraint, the restricted long-term fund (RLTF) for the share of the fund not created by debt to 2015 only. Given this fund's considerable resources (€8 billion on capital account in 2016), confirmation of its inclusion in the balanced-budget mechanism for subsequent years as well was a condition for appropriate long-term investment planning. This confirmation came with the 2016 Stability Act, too late for planning purposes.

Furthermore, in 2016 the process of initiating investment was slowed by uncertainty associated with the entry into force in April of the new Public Contracts Code. The National Builders Association (ANCE) asserts that the decrease in tendering last year was in part attributable to the need for bidders to familiarize themselves with the new rules and the difficulty in adjusting to the changes, which have already undergone – even though the implementing regulatory framework has yet to be finalised – corrections and further expansions as provided for by the law transposing for the European directives on tenders and concessions of 2014. More specifically, the restriction of tenders to works already in the approved executive design phase (and no longer on the basis of preliminary designs), although intended to improve the implementation of the projects financed, required a sudden improvement in local governments' planning skills. In the absence of this, in 2016 there was a decline of 2.1 per cent in the number of projects compared with 2015 and 16.6 per cent in the value of public contracts tendered, after growing during the preceding two years, with a more pronounced contraction for municipalities (-35 per cent for amount tendered) and in the South (-24.9 per cent in value).[108] The National Association of Italian Municipalities (ANCI) also emphasised the problems that local authorities are having due to their uncertainty concerning the new Public Contracts Code and new soft-law instruments, such as the guidelines of the National Anticorruption Authority (ANAC) and ministerial circulars and directives.[109]

These factors, linked to the innovative nature of some of the reforms and the consequent uncertainty as to their implementation, together with local authorities' inability to forecast the amount of resources effectively available,[110] presumably contributed to increasing the difficulty experienced by municipalities in planning expenditure in 2016. However we expect that, being temporary, these factors will have a positive impact once the reforms are in place and the volume of expected revenue becomes more stable (and local governments become more knowledgeable).

These temporary factors seem to have had an impact mainly on reaching the investment registration and payment phase, as suggested by the fact that municipalities' capital spending commitments increased, unlike payments, although only partial information on the scale of the problem is currently available.[111] A divergence between cash-based expenditure, decreasing in 2016, and commitments under modified commitment/cash accounting, which are likely to be rising, seems to indicate a time lag between registration of work progress reports and the associated payment. Furthermore, the figure representing payments in the first quarter of 2017 relating to capital expenditure has not yet increased, as would have been expected, given that the rising commitments should, sooner or later, translate into an increase in cash outlays.

There is an element of statistical uncertainty connected with the still provisional nature of the data available on local governments for 2016 and with the recent accounting reform under Legislative Decree 118/2011, which led to the adoption, starting in 2015, of the modified commitment/cash accounting. This approach, which calls for registration of commitments payable during the year, is deemed, theoretically, a better approximation of accrual-basis accounting than cash-basis accounting, but Istat will be able to verify this theoretical assumption only once it is ascertained that the local authorities' final accounts are in fact consistent with the new approach.[112] Another obstacle to the use of modified commitment/cash accounting data as a proxy for accrual basis accounting data is that the former are only available, in definitive form, after the general government accounts prepared on an accrual basis are released (1 March). However, the introduction of new forms of monitoring to supplement cash-based data (SIOPE) with electronic invoicing process (SIOPE Plus) information, could make the data available sooner.

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[108] See ANCE communication of 27 January 2017.

[109] See the interview with G. Rabaiotti, Commissioner of Public Works of the Municipality of Milan, ANCI representative for the Public Contracts Code, on Linkiesta, 31 January2017.

[110] The State Accounting General's monitoring data show a sizable difference between capital revenue recorded by municipalities during the budgeting phase (€27.5 billion) and that actually verified in the course of operations (€9.4 billion).

[111] The data on the monitoring performed by the State Accounting General on compliance with the balanced-budget constraint shows that the increase in investment expenditure commitments to be about 6 per cent (see ANCI Hearing on the 2017 EFD of 18 April 2017). The 2017 Report of the Court of Auditors, based on partial data, indicates an increase in commitments for capital expenditure by municipalities of up to 39 per cent.

[112] In light of the significant gap between commitments and payments, it needs to be checked whether the authorities properly recorded as commitments only spending on investment payable during the year.

If modified commitment/cash accounting is to play a greater role (in place of cash-basis accounting) in the construction of the national accounts, the investment expenditure of local authorities that is shown in the general government accounts – currently calculated on a cash basis – may have to be revised in 2016, probably upward.

Alongside these temporary factors, an assessment should be made of the effects on developments in capital spending of the accounting reform under Legislative Decree 118/2011 and the adoption of the balanced-budget rule, which were expected to limit investment expenditure to a lesser degree than past formulations of the Domestic Stability Pact.

The State Accountant General's monitoring revealed considerable overshooting by the municipalities segment (more than €6 billion) in complying with the balanced-budget constraint, indicating that they did not take full advantage of all the flexibility available to finance investment spending. This suggests that, in addition to the budget constraint, other factors contributed to slowing investment, including, in particular, the need for improved expertise at planning under the balanced-budget constraint.

In 2016, along with the temporary factors examined above, other circumstances connected with the application of the balanced-budget constraint could have contributed to keeping investment lower than expected, such as:

- over half of the overshooting is attributable to revenues that are at a high risk of being uncollectable. Indeed, the balanced-budget rule excludes from the reference balance – on the expenditure side – allocations to the provision for doubtful accounts,[113] equal to around €3 billion in 2015. This exclusion, while giving local administrators a degree of budgetary flexibility, nonetheless suggest a cautious approach to spending decisions;

- the inclusion of the restricted long-term fund (RLTF),[114] limited to the share of the fund not created by debt, in the reference balance means around €8 billion in capital revenue, arising from prior-year surpluses, can be included, enabling these surpluses to be used through 2019. Since these resources can therefore be used in subsequent years, by postponing their use through the RLTF (€5 billion), the works were performed as scheduled and the cash resources were available;

- the new balanced-budget rules have increased the need for effective planning, discouraging the generation of resources obtained through borrowing an amount exceeding the payments envisaged in the timetable for the works. SIOPE data demonstrate a decline of over €1 billion in revenue from borrowing. The use of borrowing may have been deterred in part by the new balanced-budget rules,

[113] The allocations to this provision offset the share of recognised revenue that is highly likely to be uncollected.
[114] This fund makes it possible to include in the balance the portion of resources received in past years that were utilized in the current year.

which though they allow local governments to postpone raising resources through self-financing to the subsequent year, require them – in the event they have unutilised borrowing reserves – to obtain new financial flexibility for their use in the subsequent year. Recourse to new borrowing may also have been discouraged by the high cost of servicing existing debt obtained in the past when interest rates were high;

- some of the overshooting is attributable to the temporary factors already discussed that had an impact on expenditure-planning capabilities, including uncertainty about the actual amount of resources available and the associated timing, delays in establishing the fiscal rules to apply in 2016, changes in tendering procedures, and the limitation on the availability of unrestricted surpluses[115] that can be allocated to investment.

The State Accountant General's monitoring found that few local authorities did not comply with the balanced-budget constraint and that the scale of their deficit is modest. It does not therefore seem that the elimination of incentivized vertical flexibility (not necessary given limited demand for additional financial resources) was a factor in checking investment expenditure. The poor application of regional agreements may have instead played a role. In light of the considerable total overshooting by the segment on the one hand and, on the other, the difficulty in coordinating expenditure planning by the various local authorities for the purpose of exchanging financial flexibility, it is necessary to consider instruments – even temporary ones – that enable, for smaller authorities at least, intertemporal flexibility mechanisms to be used.

[115] Not subject to numerous provisioning obligations (for example, for doubtful accounts, contract renewals, losses on equity investments, restoration of the advance fund pursuant to Decree Law 35/2013) or constraints (for example, repayment of loans or deficits relating to past years, such as those arising from the extraordinary reassessment of carryover amounts, or the restitution of flexibility enjoyed in the past).

4. WELL-BEING INDICATORS AND THE NATIONAL REFORM PROGRAMME

4.1 Indicators of fair and sustainable well-being

The indicators of fair and sustainable well-being (FSWs) developed and produced by Istat since 2010 seek to capture the multidimensionality of well-being, i.e. to measure the socio-economic and environmental phenomena that, along with more traditional GDP and other macroeconomic variables, enable us to assess the level of collective well-being and its sustainability over time.[116]

The Government Accounting Act, as amended in 2016,[117] provides for the systematic use of FSWs in policy documents, linking them directly to the economic and financial planning cycle and creating the basis for using them as a tool for assessing economic policy. More specifically, the indicators are included in budget programming on two occasions: in the EFD, in conjunction with the establishment of the general budget policy guidelines and in a report to the competent parliamentary committees by 15 February of the following year to evaluate developments in the indicators over the subsequent three years on the basis of the effects of the Budget Act approved in the final part of the previous year.

Initial experimental implementation of the new rule began with the 2017 EFD. In particular, the EFD incorporates an initial set of four indicators – selected from among the one hundred and thirty contained in the FSWs Report published regularly by Istat[118] - by a specifically established Technical Committee:[119] average adjusted per capita disposable income, an index of inequality in disposable income (the interquintile ratio), the rate of labour market non-participation and emissions of carbon dioxide and other greenhouse gases.[120] As provided for in the law, the Report provides information

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[116] For a short description of the evolution of the FSWs at the international level and in Italy, please see "*Audizione del Presidente dell'Ufficio parlamentare di bilancio nell'ambito dell'indagine conoscitiva sul contenuto della nuova legge di bilancio e sull'equilibrio di bilancio delle Regioni e degli Enti locali, di cui alla L. 243/2012*", before the joint session of the Budget Committees of the Chamber of Deputies (V – Budget, Treasury and Planning) and the Senate (5 – Economic Planning, Budget), 26 May 2016.

[117] Law 196/2009, Art. 10, paragraph 10 bis.

[118] Istat (2016), "*Il benessere equo e sostenibile in Italia*", December.

[119] This is the "Committee for fair and sustainable well-being indicators" chaired by the Minister for the Economy and Finance and made up of the President of Istat, the Governor of the Bank of Italy (or their delegates) and two sector experts.

[120] Average adjusted per capita disposable income is given by the value in euros per resident of household disposable income adjusted to take account of the value of in-kind services provided by public institutions and non-profit organisations. The index of inequality in disposable income is calculated as the ratio of the disposable income equivalent (i.e. divided by a scale of equivalence that takes account of the type and number of household members) received by the 20 per cent of the population with the highest income to that of the 20 per cent of the population with the lowest income. The rate of labour market non-participation is calculated as unemployed persons and the potential labour force (i.e. those who have not looked for a job in the previous four weeks but are available to work) aged 15-74 as a percentage of the total actual and potential labour force. Emissions of carbon dioxide and other greenhouse gases are calculated in terms of tonnes of CO_2 equivalent per inhabitant.

on developments in the last three years (2014-2016), calculated by Istat, and the future evolution on both a trend and policy basis for the next four years (2017-2020) in each indicator, taking account of the measures envisaged to achieve the goals set by the Government and the provisions of the National Reform Programme (NRP).

The introduction of the FSWs in the EFD is a welcome development. Accompanying developments in the main macroeconomic variables with information on variables relevant to the quality of life and the environment provides a more complete knowledge base on which economic policy action can be founded. It enables ex-post evaluation of the results achieved, ensures greater transparency of the decisions of policy-makers, and makes the country a leader at the international level. Nevertheless, an analysis of the Annex to the EFD devoted to the inclusion of the FSW indicators in the budget decision-making process reveals a number of concerns.

First, with regard to actual figures for the past three years, one of the indicators contained in the EFD and the equivalent indicator reported by Istat do not appear to be fully comparable,[121] thereby creating uncertainty and opacity in its interpretation. The index of inequality in disposable income reported in the EFD is 1.0 points higher in 2014 and 1.2 points higher in both 2015 and 2016. It would be desirable for the MEF to clarify in the EFD why it was necessary to adopt a different definition of the indicator, or to use different working assumptions from those underlying the equivalent statistic calculated by Istat, or any other reason that justifies the disparities. The comparability of indicators is essential for contextualizing them over a longer time span than the three-year period reported in the EFD.

Second, a number of comments are in order on the policy estimate of the indicators. Compared with the trend forecast, this estimate should reflect the effects of the measures contained in the budget package underlying the public finance targets set out in the first section of the EFD and those of in reform programme outlined in the NRP. However, the EFD generally does not provide information on the composition of the budget package but only its general outline, which makes it impossible to evaluate and verify the forecasting process that led the Government to determine the policy values of the well-being indicators. Thus, as highlighted in the hearing of the PBO of 26 May 2016,[122] it would be more appropriate to give only the trend estimate of the indicators in the EFD alongside the objectives to be achieved by government action, postponing the presentation of the policy version of the indicators to the Report of February 15, i.e. after the approval of the Budget Act for the subsequent three years. The choice of the

[121] The series for the inequality indicator was given by Istat in the 2016 FSW report (Istat (2016), "*Il benessere equo e sostenibile in Italia*") up to 2015. On 19 April 2017 Istat published on its website an update of the value for 2015 (which decreased from 5.8 per cent to 5.2 per cent) and that estimated for 2016 (5.2 per cent).

[122] "*Audizione del Presidente dell'Ufficio parlamentare di bilancio nell'ambito dell'indagine conoscitiva sul contenuto della nuova legge di bilancio e sull'equilibrio di bilancio delle Regioni e degli Enti locali, di cui alla L. 243/2012*", before the joint session of the Budget Committees of the Chamber of Deputies (V – Budget, Treasury and Planning) and the Senate (5 – Economic Planning, Budget), 26 May 2016.

map of indicators to be introduced in the EFD and the setting of the objectives should reflect and be consistent with the commitments undertaken at the European level with the Europe 2020 Strategy and at the international level with 2030 Agenda for Sustainable Development.

Third, other observations can be made concerning the selection of the indicators included on an experimental basis this year and on those that will be selected for permanent inclusion in the EFD. First, it should be noted that the interquintile ratio used as an indicator of inequality does not capture certain important aspects of the latter, especially for the lower income groups. More specifically, according to Istat, there was an increase in gross household disposable income in 2014-2015, which, as it involved most of the population groups, led to a reduction in inequality. However, these positive developments did not comprise those in a state of extreme financial hardship: the proportion of people at risk of poverty rose from 19.3 per cent in 2013 to 19.4 per cent in 2014 and 19.9 per cent in 2015.[123] It would therefore be desirable to at least include an indicator of the risk of falling into poverty or absolute poverty index in the indicators selected for inclusion in the EFD on a permanent basis. Furthermore, as experimentation with gender budgeting to assess the differing impact of fiscal policy on men and women has begun, pending completion of this process and the performance of a broader assessment than context analysis, it would have been a major step in the right direction to include other variables in addition to the rate of labour market non-participation among the indicators analysed in the EFD to enable assessment of the progress made in recent years in reducing the gender gap.

4.2 The state of implementation of the 2016 NRP and the proposals of the 2017 NRP

The 2017 NRP, coming at the end of the legislature, essentially does not envisage new reform programmes. It offers a comprehensive description of achievements in 2016 and early 2017 compared with the provisions of the 2016 NRP - also in response to the recommendation of the European Council in May 2016 and reaffirmed by the European Commission last February within the scope of the macroeconomic imbalance procedure[124] - and outlines the actions to be taken to complete the implementation of the announced reforms.

In its February report, the European Commission conducted an assessment of the progress made in 2016 with reference to the recommendations made to Italy by the European Council last year. In particular, it noted significant progress in the reform of the budgetary process - notably with

[123] Indicator calculated by Istat as the percentage of the total resident population composed of individuals with an income equivalent equal to or less than 60 per cent of the median income equivalent, reported in the 2016 FSW Report referred to earlier.

[124] European Commission (2017), "Country Report Italy 2017 Including an In-Depth Review on the prevention and correction of macroeconomic imbalances", SWD (2017) 77 final, Brussels 22.2.2017.

regard to the integration of the spending review in the budgetary process - and some progress in shifting the tax burden from production factors to consumption and property, implementing civil justice reform, banking reform and labour market reform. However, it found little progress and made renewed recommendations for intervention in six main areas: 1) public finances and taxation; 2) financial sector; 3) labour market and social policies; 4) investment; 5) sectoral policies (i.e. market reforms); 6) public administration and public employment.

With regard to the first area, the European Commission noted that without an increase in potential growth or a reduction in the scope of government action, it may be difficult to compress further real primary expenditure growth to fund a cut in the tax burden on the factors of production. It underscored the importance of reducing the tax and contribution burden on the factors of production, shifting taxation to property and consumption, while improving the effectiveness of the fight against tax evasion.

On the financial front, the Commission called for a definitive solution to problems related to non-performing loans and for completion of the reform of bank governance, with particular reference to cooperative banks, mutual banks and bank foundations.

As far as the labour market is concerned, the Commission highlighted three critical issues: 1) the implementation of active labour policies, with particular attention to services provided by public employment centres and authorised private agencies; 2) the strengthening of second-level (territorial- or company-level) bargaining; and 3) encouraging work by second earners in households. For social policies, the Commission recommended the development of a coherent national anti-poverty strategy, focusing on the new Inclusion Income scheme and the redesign of the various social expenditure programmes with a view to maximizing efficiency and effectiveness.

Particular importance was given to reviving public investment after years of contraction and stagnation, especially in the areas of education and the major infrastructure needed to modernise the country.

In further reference to modernisation and boosting productivity, the Commission called for the rapid adoption of the annual Competition Act (held up in Parliament for more than two years) to increase competition in the regulated professions and the transport, health and retail sectors and in the operation of the concession system.

Finally, the last observation regarded the completion of the reform of public administration and public employment, including measures concerning state-owned enterprises, local public services and, above all, civil justice, all of which have major impacts on productivity, enterprise and investment.

With regard to achievements in 2016, the 2017 NRP proposes a composite indicator of the progress made by the Government’s reform action, constructed as an average of the reform implementation percentages in eight policy areas weighted on the basis of the contribution as estimated by the MEF of each area to Italy’s potential growth in the medium term. Based on this indicator, as of the end of 2016, 76 per cent of the reform processes had been implemented (compared with 44 per cent at the end of 2015). This increase was largely attributable to the continuation of the reforms relating to public administration, education, the labour market, firms with Industry 4.0, banking and non-performing loans. It should be noted, however, that the indicator is constructed on the basis of monitoring the production of primary and secondary legislation, which does not necessarily mean that legislated and planned measures are actually operational.

The reform effort announced in the 2017 NRP is divided into a number of priority actions to be undertaken in the short term and others to be implemented later. The former include: revival of liberalisation with the approval of the 2015 Competition Bill; pursuit of the privatisation of state-controlled enterprises and public property; approval of the reform of criminal trials and the rules governing the period of limitations in addition to organizational changes to increase the efficiency of the judicial system; continuation of the process of shifting the tax burden to boost growth and productivity; and implementation of the anti-poverty strategy outlined in the enabling legislation approved last March.

Actions to be completed in the medium term include: the credible and permanent reduction of the debt/GDP ratio; the reduction of the tax burden on production factors; the rationalisation of tax expenditures; the fight against tax evasion; the spending review; the strengthening of active labour policies and measures to support the family; encouraging company-level collective bargaining; completing the legislative framework governing corporate insolvency; the implementation of reform measures already initiated in the justice system; the completion and implementation of the reform of the public administration; the acceleration of private and public investment and the fine-tuning and stabilisation of public procurement legislation; and reviving policies for territorial re-balancing and for Southern Italy.

The following sections briefly discuss the state of implementation of the provisions of the 2016 NRP, the European Commission’s comments of last February and the reform proposals contained in the 2017 NRP with regard to certain specific areas (labour market, social policies, tax system and tax evasion, public administration and education). Some comments on the reform proposals are also provided where possible.

4.2.1 The labour market

In May 2016, formulating its opinion on the 2016 NRP and the resulting recommendations, the European Council underscored the importance of active labour policies within the new framework established with the Jobs Act and, for the success of those policies, the need to enhance employment services. In the same document, the Council recalled the role of second-tier bargaining, which is still underdeveloped despite the measures taken, in order to better correlate remuneration with labour market conditions and thereby stimulate productivity and employability. It also pointed out the need to encourage female participation in the labour market (by building an adequate network of child and elderly care services in order to relieve women of informal care obligations). Finally, one of the Council's recommendations, with a broad scope and not merely referring to the labour market, concerned shifting the tax burden from the factors of production to consumption and property, including a reduction in the tax wedge.

After the completion of the implementation of the Jobs Act (Law 183/2014), the 2016 NRP's agenda for the labour market included the following points: 1) the implementation of the legislative decree on active labour policies (Legislative Decree 150/2015); 2) the adoption of measures for the transfer of resources from the Ministry of Labour and Isfol (institute for the analysis of social and labour policies) to the newly established National Agency for Active Labour Policy (Anpal); 3) the drafting of the Anpal bylaws; 4) the approval of the enabling legislation for the reform of the third sector and social enterprises and for the rules governing the Universal Social Civilian Service; 5) the implementation of the second phase of the "Youth Guarantee" programme; 6) the preparation of measures to strengthen second-level bargaining; 7) completion of the law for the reform of self-employment (the "Jobs Act for Non-Entrepreneur Self-Employed Workers") and to improve the work-life balance (so-called "agile working"); and 8) refinancing the development plan for socio-educational services for early childhood.

An initial assessment of the 2016 NRP and its compliance with the Council's recommendations came in February 2017 within the Report of the European Commission mentioned earlier. The Commission found some progress in the implementation of active labour policies and, in particular, the launch in November 2016 of testing of the redeployment allowance with a sample of 30,000 unemployed persons and the effective start of operations at Anpal in January 2017 (some functions had begun operations in November 2016). The Commission found limited progress in implementing the measures adopted in the 2017 Budget Act to encourage the work of second earners in households. Finally, some progress was made in easing the tax burden on labour and, in particular, strengthening tax incentives for productivity bonuses agreed in decentralised bargaining, reducing the pension contributions of self-employed workers registered in INPS's separate pension account and implementing a number of contribution relief measures for specific categories of newly hired employees.

In describing accomplishments in the past year, the 2017 NRP, also reflecting the European Commission's recommendations from last February, provides details on the introduction and/or implementation of a number of measures after February 2017 intended to meet those recommendations. More specifically, these include: the start of the work of the National Labour Inspectorate, with controls being conducted by three different entities (the Ministry of Labour and Social Policies, Inps and Inail); the approval of the bill for the reform of self-employment and to expand the scope for flexibility in payroll employment in order to improve the work-life balance ("agile working"); and the approval of the first decree implementing the reorganisation of the rules governing the International Civilian Service.

The 2017 NRP envisages both the rapid completion of measures already initiated and the implementation in 2017-2018 of new measures over and above ongoing reform processes. The first group includes: 1) implementation by June 2017 of Law 106/2016, with the preparation of three legislative decrees on the third sector and the International Civilian Service; 2) the approval by July 2017 of the bill on self-employment and work-life balance and the start of the reform of casual supplementary employment paid with the voucher system;[125] 3) the full operation by the end of May 2017 of the pension package contained in the 2017 Budget Act for early retirement.

The second group of new measures includes: 1) further strengthening of the effectiveness of active labour policies, starting with coordination between Anpal and local authorities, leveraging the results of the trial of the redeployment allowance; 2) support for female and youth employment with structural contribution relief measures for labour costs, targeted measures for households with the lowest incomes and the development of more appropriate welfare tools to facilitate the balancing of work with family responsibilities; 3) the reform of collective bargaining to give more space and greater certainty to second-tier contracts; 4) the preparation of measures on social contributions for workers with discontinuous careers to ensure adequate pension coverage while at the same time strengthening the second pillar of the supplementary pension system (pension funds and healthcare funds).

With regard to active labour policies, the importance of assessing the effectiveness of the network of employment service providers in the various local employment basins must be stressed. In particular, it is necessary to avoid situations in which, in the very circumstances for which their contribution is most important (in depressed areas with high unemployment rates), authorised private employment service operators do not have adequate economic motivation to implement active labour policies .

4.2.1.1 Comments on female employment support measures

The 2017 NRP sets out a major commitment to achieving a structural reduction in the cost of labour in order to boost female and youth employment. As noted by the European Commission in its February report, Italy has a low female employment rate, equal to 51.6 per cent of the population aged 20 to 64 in 2016, compared with averages for the countries in the euro area and the European Union, respectively, of 64.4 per cent and 65.3 per cent (Figure 4.1). This puts Italy next to last in the euro area and the European Union and affects achievement of the target of 75 per cent for the overall employment rate established under the Europe 2020 strategy.

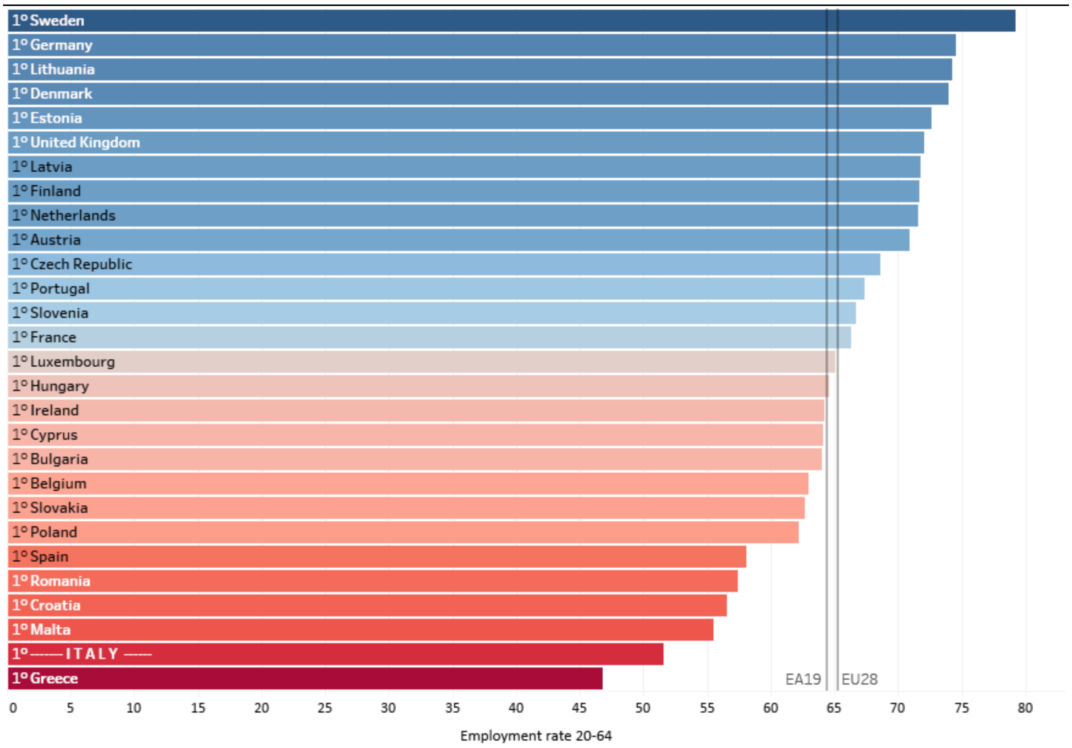
To help achieve the European target, the 2017 NRP makes it a priority to reduce, by the end of the legislature, the tax wedge on lower incomes and, specifically, on second earners, setting the stage for a system of taxation that fosters female employment. At the same time, the measures already under way such as measures to support parenthood (the baby bonus and day-care bonus), work-life balance (parental leave and work organization rules) and upgrading the structure of socio-educational services for

[125] On 17 March 2017, the voucher system was abolished, voiding the provisions concerning casual supplementary employment contained in the Jobs Act. See Ufficio parlamentare di bilancio (2017), "*La remunerazione del lavoro accessorio occasionale: l'esperienza dei voucher*", Focus tematico no. 4.

early childhood. Under the provisions of the 2017 NRP, the funds committed to the latter should make it possible to increase the average national level of coverage of demand for social-educational services to 13 per cent, and no less than 6 per cent in each region.[126]

There is widespread consensus in the literature about the possibility for tax changes to affect female participation in the labour market.[127] The most effective instruments are those that do not depend on the economic condition of the household as a whole but that directly impact the individual's net remuneration and are therefore conditional on finding and keeping a job (tax credits on labour income, especially when they are refundable, and subsidies for low income earners). A less incisive impact on the labour force participation of second earners is exercised by instruments that increase the disposable income of those in the lowest segment of the income distribution and that are conditional on household income (family allowances, tax credits for dependent children, etc.).

Figure 4.1 – Female employment rate for the 20-64 age group in the main European countries in 2016



Source: based on Eurostat data.

[126] In the 2013-2014 school year, the national coverage rate was 11,9 per cent, while four regions in Southern Italy had coverage rates of less than 6 per cent (4.9 per cent in Sicily, 4.3 per cent in Puglia, 2.2 per cent in Campania and 1.4 per cent in Calabria). See Istat (2016), "*Asili nido e altri servizi socio-educativi per la prima infanzia: censimento delle unità di offerta e spesa dei comuni*", November.

[127] See, among others,: European Commission (2017), op. cit.; Colonna, F. and Marcassa, S. (2013), "Taxation and labor force participation: the case of Italy", Occasional Papers no. 191, Banca d'Italia; Marino, M.R., Romanelli, M. and Tasso, M. (2016), "Women at work: the impact of welfare and fiscal policies in a dynamic labor supply model", Working Papers no. 1084, Banca d'Italia.

Nevertheless, differences between tax regimes at the international level do not in themselves seem sufficient to explain the poor performance of Italy with regard to female employment (Figure 4.1). For this reason, we must consider the significant influence of the cost of family care services and the role of institutional factors such as the availability of parenting support services and flexibility in the workplace (working hours, leave).[128]

On the taxation side, the disincentive for second earners to work can reflect both high taxation of low incomes and the presence of specific factors that penalize a spouse's work choices.

With regard to the first aspect, an international comparison of the taxation of low incomes can be made on the basis of the European Commission's[129] tax wedge estimates for 22 EU countries[130] (Figure 4.2). The overall tax wedge for an unmarried employee with no dependents with a salary equal to one-third of the average (€10,220 a year) in Italy does not appear to be especially large in an international comparison, ranking 10th best. The Italian tax wedge for a salary of two thirds of the average (about €20,530 euros a year) is larger (15th best). However, the countries with a larger tax wedge than Italy have higher female employment rates. This is particularly the case in France, Germany and Spain, which in 2016 had female employment rates for the 20-64 age group of 66.3, 74.5 and 58.1 per cent, respectively, compared with the Italian rate 51.6 per cent.

With regard to the existence of specific factors that penalize female participation in the labour market, two comments are in order. First, it should be noted that the structure of the Italian tax-benefit system is not the most unfavourable, partly because the tax unit is the individual rather than the household, making our system substantially neutral with respect to the work choices of spouses.[131] Nor are there any especially large

[128] See, among others: Del Boca , D. (2002), "The effect of child care and part time opportunities on participation and fertility decisions in Italy", in *Journal of Population Economics*, v. 15, no. 3, pages 549–573; Neri, A., Lo Conte, M. and Casadio, P. (2012), "Balancing work and family: New mothers' employment decisions during childbearing", in Addabbo, T. and Solinas, G. (eds), *Non-standard employment and quality of work: The case of Italy*, Physica-Verlag HD Heidelberg.

[129] European Commission (2016), "Tax and benefits indicators database", (https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/tax-and-benefits-indicators-database/methodology-tax-and-benefits-indicators-database_en).

[130] The tax wedge is represented by the taxes and social contributions charged to workers and employers as a proportion of labour costs. Taxes are considered net of benefits from the State. For Italy, no consideration is given to the impact of IRAP (regional business tax) on labour costs, which affects both the numerator and the denominator of the indicator. It should be borne in mind that the comparison of tax wedges among countries may be misleading in view of the fact that the indicator does not capture differences in the structure of the pension system, which can include differing proportions of private financing. A special case, for example, is represented by the United Kingdom. For an unmarried payroll employee with a salary of two thirds the average, the tax wedge in the United Kingdom is about 15 percentage points lower than the wedge in Italy (25.9 per cent of the cost of labour, compared with 40.9 per cent). This difference narrows drastically, to 1.4 percentage points, of net remuneration (11.0 per cent in the United Kingdom and 12.4 per cent in Italy) if we consider the tax component only, excluding social contributions from the calculation.

[131] From a strictly fiscal point of view, the gross tax is entirely independent of the income of the spouse, and the level of tax credits for dependent children is determined on the basis of individual income. A small

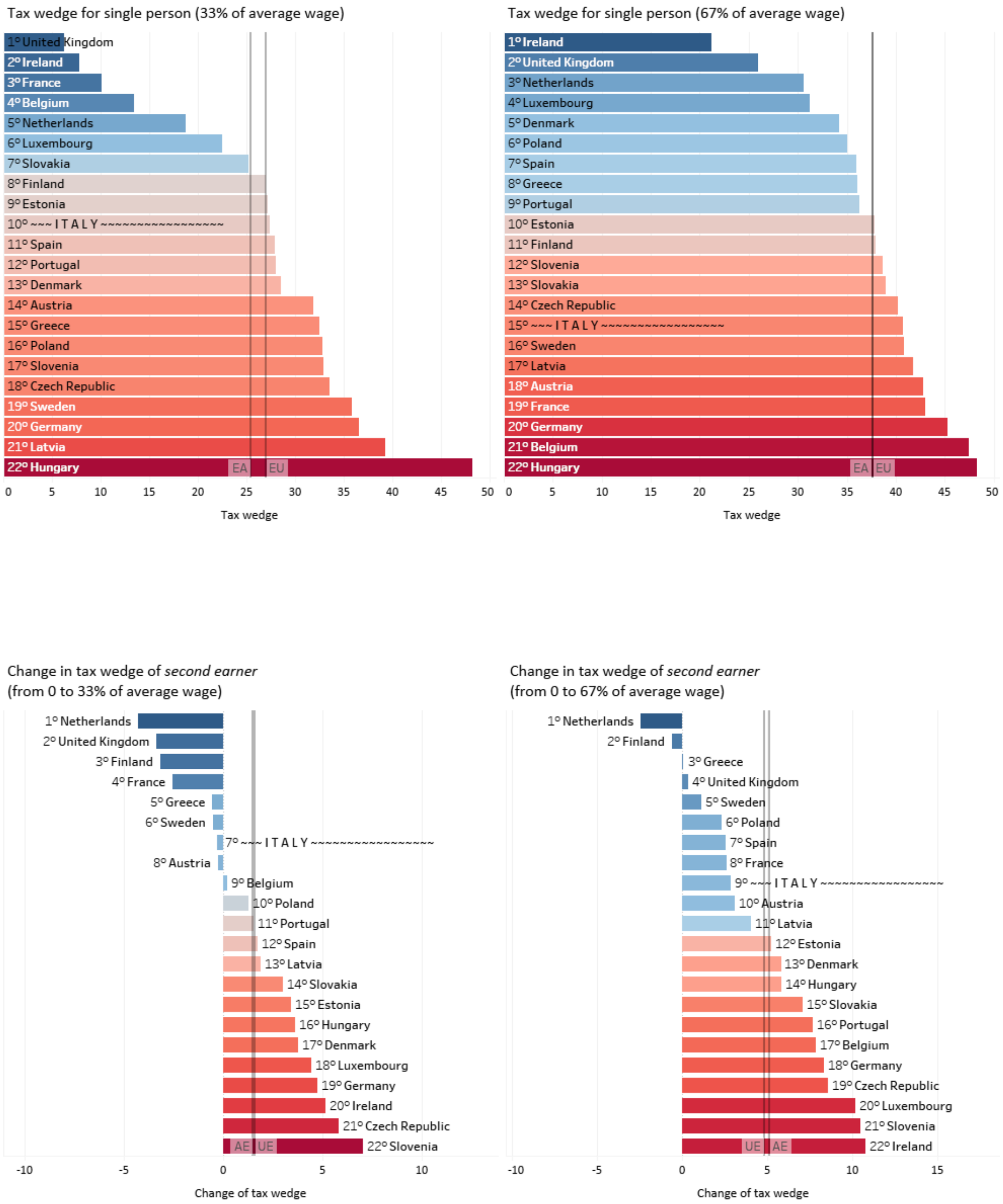
disincentives compared with international practice associated with the presence of family support benefits based on the economic condition of the entire household (e.g. family allowances and benefits conditional on possessing a given level of means as determined with the equivalent economic status indicator (ISEE)). More specifically, the estimates of the tax wedge show that for a household with two dependent children and two income earners in which one person receives the average wage and the other receives 33 per cent of the average, participation in labour market by the second earner produces a negative tax wedge in Italy (-0.3 percentage points), a figure that places Italy 7th best (among 22 European countries) in the ranking of countries with least disincentives for second earners. Italy's ranking is slightly worse (9th best) if we consider the change in the tax wedge caused by the second earner’s participation at a slightly higher salary (two-thirds of average pay) (Figure 4.2).

As regards the role of institutional factors, however, there is a strong correlation between the female employment rate and the supply of public services in Italy.[132] For example, Figure 4.3 shows how regional differences in female employment rates for 2004 to 2013 are strongly correlated with the indicators of the acceptance of 0-2 year olds in public nurseries.

disincentive to participation in the labour market by the second earner is represented by the tax credit for a dependent spouse, which is lost if the spouse has an income of more than €2,840.51.

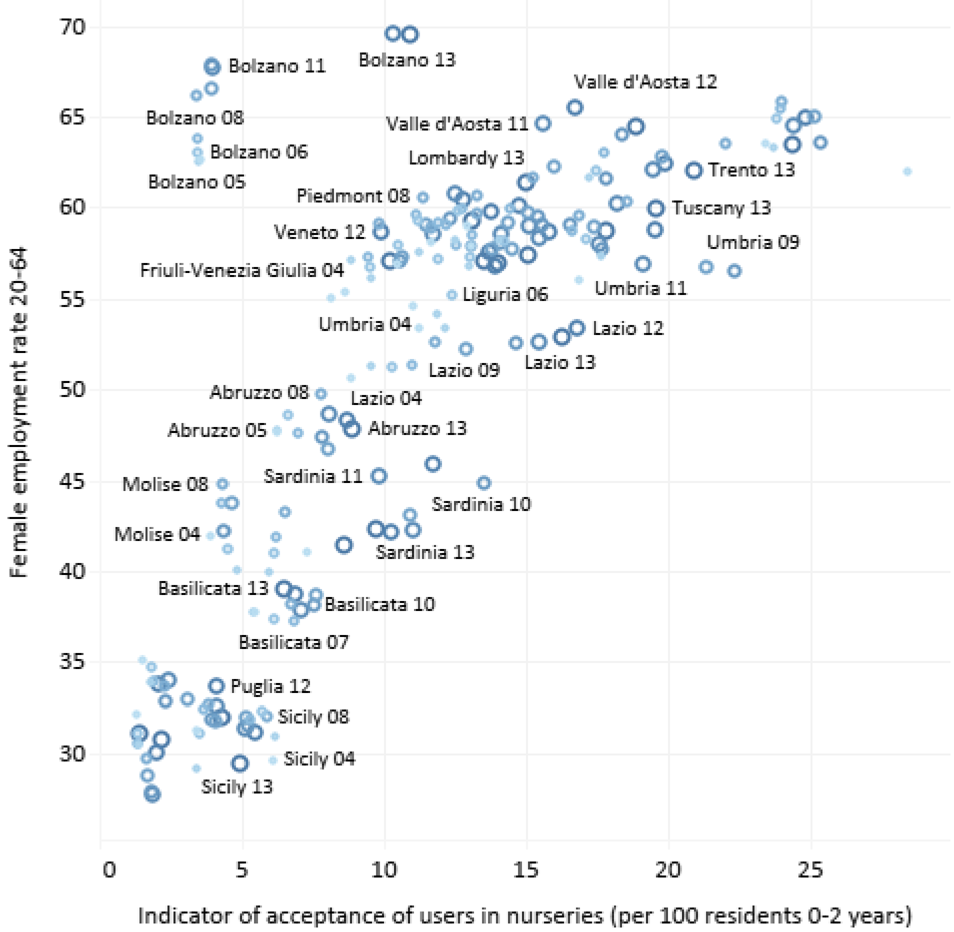
[132] Consider, for example, the regional distribution of acceptance rates in municipal nurseries (users served per 100 potential users).

Figure 4.2 – Comparison of tax wedges in the main European countries in 2016



Source: based on European Commission data in "Tax and benefits indicators database". The averages for the euro area (EA) and the European Union (EU) are obtained as a simple arithmetic average of the available countries excluding Italy. Data for Bulgaria, Cyprus, Croatia, Lithuania, Malta and Romania are not available.

Figure 4.3 – Female employment rate for the 20-64 age group and the indicator of acceptance of users in nurseries by region (2004-2013)



Source: based on Istat data in "*Rilevazione forze di Lavoro*" and "*Asili nido and altri servizi socio-educativi per la prima infanzia: censimento delle unità di offerta and spesa dei comuni*".

4.2.1.2 Survey of incentives to foster new hiring

In recent years, a number of temporary and permanent measures have been introduced to stimulate job creation and increase productivity. Any introduction of new subsidies should be preceded by an examination of the effectiveness of previously tested or existing mechanisms - to better guide the choice between different possible tools - and by a survey and reorganisation of those still in place to avoid fragmentation in the subsidy system, overlaps and competition between measures (e.g. between those adopted at the regional or sub-regional level).

In April 2017, Anpal published an updated edition of the "Guide to incentives for hiring and enterprise creation",[133] which provides a survey of current incentives. Until last year

[133] Anpal (2017), "*Guida agli incentivi all'assunzione e alla creazione di impresa*", available at http://anpal.gov.it/Pagine/default.aspx.

the publication was produced by the *Agenzia Italia Lavoro*, whose functions have been taken over by Anpal.

Five groups of benefits can be identified: 1) national measures aimed directly at boosting the labour market in the strict sense; 2) national measures that, through employment incentives, also pursue social policy functions; 3) national measures aimed at promoting enterprise creation, research and innovation; 4) programmes managed directly by Anpal Servizi; 5) incentives introduced by individual regions and autonomous provinces for the labour pools and industrial districts for which they are responsible.

There are twelve measures in the first group, i.e. national programmes aimed at the labour market in the strict sense, and they are summarized in Table 4.1 in chronological order of introduction. Compared with the survey conducted by Anpal, the contribution relief first introduced with the 2015 Stability Act (three years of full relief) and the 2016 Stability Act (two years of partial relief),[134] the deductibility of labour costs from the IRAP tax base and the specific multiannual contribution relief mechanisms for agricultural sector introduced with the 2017 Budget Act have been included for the sake of completeness.

In most cases the measures provide for a reduction in social contributions charged to employers. Most apply to new open-ended hiring or the transformation of fixed-term contracts into open-ended contracts. In some cases, they target specific categories of workers (young people, women, people who receive unemployment benefits (NASPI) or who are receiving special wage supplementation benefits (CIGS)). Temporary measures are more common than permanent mechanisms and more than half have no expenditure limits. These measures include the more specific programmes managed directly by Anpal and those that can be initiated by the regions and autonomous provinces within their sphere of autonomy (i.e. the measures in the fifth group).

[134] The Anpal survey excludes them because it is no longer possible to qualify for them. However, those that have already qualified will continue to receive benefits, depending on the case, as late as the end of 2018.

Table 4.1– National employment incentive measures

Year introduced	Type of measure	Main legislation	Beneficiaries	Segment/sector of application	Duration	Ceiling	Main benefits	Combination with other incentives and other aspects
1993	**WORKERS RECEIVING SPECIAL WAGE SUPPLEMENTATION BENEFITS** Contribution and financial benefits for re-employment with full-time open-ended contract	Law 223/1991, Law 236/1993 and INPS Circular no. 137/2012 .	New hiring on full-time open-ended contracts of workers that have received special wage supplementation benefits for at least 3 months, not necessarily continuously, and **are employees of firms benefitting from the special wage supplementation mechanism for at least 6 months**.	Scope of application of special wage supplementation mechanism	Structural for contribution benefits	None.	**Contribution benefits**: employer contributions reduced in the 12 months following hiring to the level established for ordinary apprenticeship contracts (10% of remuneration taxable for social security purposes, including Inail (workmen's compensation) contributions. The contribution rates for workers remain at their ordinary level. **Financial benefits**: for cases in which the worker is still receiving benefits under the "mobility" unemployment scheme, which was abolished as from 1 January 2017, the employer receives a monthly amount equal to 50% of the benefits that the worker would have received if he had not found employment. The number of monthly payments differs depending on the age of the worker (over or under 50) and where he resides (in depressed areas with high unemployment rates or other places).	With the repeal as from 1 January 2017 of the rules governing the "mobility" unemployment benefit scheme and enrolment in the mobility unemployment rolls, the monthly contribution of 50% of the mobility benefit that the worker would have received had he remained unemployed was eliminated. In addition, the scope of the special wage supplementation mechanism was significantly narrowed by the *Jobs Act*. Under EU rules, this benefit qualifies as aid for the hiring of disadvantaged workers (the "de minimis" rule does not apply). INPS Circular no. 137/2012 provided a number of clarifications concerning the requirements that employers must meet in order to qualify for the benefits.
2013	**WORKERS RECEIVING UNEMPLOYMENT BENEFITS (NASPI)** Financial benefits for re-employment with full-time open-ended contract	Law 92/2012 ("Fornero reform" of labour market), Law 99/2013, Legislative Decree 150/2015 and INPS Circulars nos. 175/2013 and 194/2015 , INPS Notice no. 4441/2015.	New hiring on full-time open-ended contracts of **workers receiving NASPI unemployment benefits** ("new social insurance for employment").	Scope of application of NASPI unemployment benefits mechanism (**private-sector segment**)	Structural.	None.	**Financial benefits**: the employer receives a monthly payment equal to 20% of the monthly NASPI benefit that the worker would have received if he had not found employment. The benefits terminate upon depletion of the NASPI resources.	Under EU regulations, the benefit is subject to the "de minimis" rule. The two INPS circulars provide clarifications on the requirements that employers must meet in order to qualify for the benefits (to prevent, for example, firing and subsequent rehirings under the benefit scheme by the employer or associates of the employer).
2013	**APPRENTICESHIP CONTRACT** Contribution, tax, financial and regulatory benefits for apprenticeship contracts	The main primary legislation governing the mechanism includes the 2012 Stability Act , Law 92/2012 ("Fornero reform" of labour market), Law 78/2014, the 2015 Stability Act, Legislative Decree 81/2015, Legislative Decree 150/2015 and Legislative Decree 185/2016 (with detailed rules in ministerial and INPS circulars).	New hires on apprenticeship contracts of **young people aged 15-29** (the age requirement changes depending on type of apprenticeship).	Only employment relationships in **private sector** (pending Decree of the Prime Minister extending application to public-sector employers)	Structural.	None.	**Contribution benefit**s: reduced contribution rates for the entire duration of the apprenticeship, for both the employer (11.31% including 1.31% additional contribution for unemployment insurance) and the worker (5.48%). The benefit can be extended for an additional 12 months following the end of the apprenticeship. For the two types of apprenticeship that form par of the "dual" system, the benefits are increased until 31 December 2017, but in this case the extension of benefits for an additional 12 months following the end of the apprenticeship no longer applies. **Tax benefits**: training costs for apprenticeships do not form part of the IRAP tax base. In addition, apprenticeship contracts signed after 1 January 2015 receive the same treatment as open-ended employment contracts (see line below on the exclusion of labour costs from the IRAP tax base). **Financial benefits**: worker may be placed in a lower job classification and remuneration may be more flexible that provided for in national collective bargaining agreements. In some cases, hours in training may not be paid or be paid at a lower rate. **Regulatory benefits**: apprentices are not included in calculating personnel thresholds set in collective bargaining agreements giving rise to commitments and obligations (e.g. obligation to hire disabled persons or hire apprentices on regular contracts).	The benefits may not be combined with those connected with the "Youth Guarantee" programme (see below), those targeted at firms headquartered in southern Italy (see below) or those connected with work-experience programmes (see below). Under EU rules, this benefit qualifies as aid for the hiring of disadvantaged workers (the "de minimis" rule does not apply).
2013	**WOMEN** Reduction of contributions charged to employers who hire women	Law 92/2012 ("Fornero reform" of labour market, Article 4, paragraphs 8-11), INPS Circular no. 111/2013 , Circular of the Ministry of Labour and Social Policies no. 34/2013, INPS Notices nos. 12212/2013 and 6319/2014	New hires of **women without regularly paid employment for at least 24 months (6 months if resident in disadvantaged areas or employable in professions or sectors with a large gender gap.** The person may be hired on either an open-ended contract or a fixed-term contract (in the latter case, staff leasing arrangements may also be used). The transformation of existing facilitated employment relationships into open-ended contracts is also permitted. The contracts may also be part-time.	Only employment relationships in **private sector.** Excludes intermittent domestic (on call) work contracts, as well as job sharing arrangements and casual supplementary employment (among other things, these contractual forms have been abolished).	Structural.	None.	**Contribution benefits**: reduction of 50% in contributions charged to the employer for 18 months in the case of people hired on open-ended contracts and 12 months for those hired on fixed-term contracts. If an existing facilitated contract is transformed into an open-ended contract, the benefits are extended to 18 months.	Under EU rules, this benefit qualifies as aid for the hiring of disadvantaged workers (the "de minimis" rule does not apply). Circular no. 111/2013 and the two INPS notices provide a number of clarifications on restrictions on eligibility for the benefit and its combination with other hiring incentives.

Table 4.1– *(cont.)* National employment incentive measures

Year introduced	Type of measure	Main legislation	Beneficiaries	Segment/sector of application	Duration	Ceiling	Main benefits	Combination with other incentives and other aspects
2013	**OVER 50s** Reduction of contributions charged to employers who hire over-50s	Law 92/2012 ("Fornero reform" of labour market, Article 4, paragraphs 8-11), with detailed rules in INPS Circular no. 111/2013 and Circular of the Ministry of Labour and Social Policies no. 34/2013.	New hires of **over-50 workers who have been unemployed for more than 12 months**. The person may be hired on either an open-ended contract or a fixed-term contract (in the latter case, staff leasing arrangements may also be used). The transformation of existing facilitated employment relationships into open-ended contracts is also permitted. The contracts may also be part-time.	Only employment relationships in **private sector.** Excludes intermittent (on call) domestic work contracts, as well as job sharing arrangements and casual supplementary employment (among other things, these contractual forms have been abolished).	Structural.	None.	**Contribution benefits**: reduction of 50% in contributions charged to the employer for 18 months in the case of people hired on open-ended contracts and 12 months for those hired on fixed-term contracts. If an existing facilitated contract is transformed into an open-ended contract, the benefits are extended to 18 months.	Under EU rules, this benefit qualifies as aid for the hiring of disadvantaged workers (the "de minimis" rule does not apply). Circular no. 111/2013 and Circular no. 34/2013 of the Ministry of Labour and Social Policies provide a number of clarifications on restrictions on eligibility for the benefit and its combination with other employment incentives.
2015 /2016	**IRAP MODIFICATION** Exclusion of labour costs from tax base of IRAP	2015 Stability Act and 2016 Stability Act, supplemented with Revenue Agency Circular no. 20/E16.	Open-ended employment **contracts** and seasonal work contracts **signed as from 1 January 2015**.	**All open-ended employment contracts.** The benefit also includes seasonal work contracts as long as they have a duration of at least 120 days per year for a minimum of two tax periods.	Structural.	None.	**Tax benefits**: the difference between the total cost of personnel on open-ended contracts and the existing itemized or standard deductions regarding the cost of labour may be deducted from the tax base for IRAP. This benefit may be applied at a rate of 70% to the cost of personnel hired on a seasonal basis.	This is not strictly speaking a benefit scheme, but rather a permanent modification of the characteristics of the tax.
2015	**FULL CONTRIBUTION RELIEF FOR THREE YEARS**	2015 Stability Act 2015 (Article 1, paragraphs 118-124) and INPS Circular no. 17/2015	**New hires on open-ended contracts**, including part-time positions, **carried out between 1 January and 31 December 2015**. The transformation of other types of contract into open-ended contracts is also permitted.	Only employment relationships in **private sector**. Employers may include **public economic enterprises** that compete with private-sector firms. Open-ended apprenticeships and domestic work contracts are excluded.	A maximum of **36 months** as from the hiring date.	There is a ceiling beyond which the benefits may no longer be granted. Access to the benefits is granted in the chronological order in which applications are submitted.	**Contribution benefits**: employers are exempt from payment of contributions, with the exception of Inail contributions. The reduction in pension contributions is offset from the State budget, sterilising the impact on future pensions. The benefits **may not exceed €8,060 per year per new employee on a full-time open-ended contract**. The benefit may not be combined with other contribution relief measures or other reductions in financing rates.	Restrictions are in place to prevent open-ended contracts being interrupted and reactivated only to gain access to the benefit mechanism. The agricultural sector is subject to specific restrictions. Workers who have already received the benefit are no longer eligible (the benefit applies only to the first activation of an open-ended contract for a given worker). If the worker is hired on a *part-time contract, the benefit is adjusted proportionately.*
2016	**PARTIAL CONTRIBUTION RELIEF FOR TWO YEARS**	2016 Stability Act 2016 (Article 1, paragraphs 178-180) and INPS Circular no. 57/2016	**New hires on open-ended contracts**, including part-time positions, **carried out between 1 January and 31 December 2016**. The transformation of other types of contract into open-ended contracts **is also permitted**.	Only employment relationships in **private sector**. Employers may include **public economic enterprises** that compete with private-sector firms. Open-ended apprenticeships and domestic work contracts are excluded.	A maximum of **24 months** as from the hiring date.	There is a ceiling beyond which the benefits may no longer be granted. Access to the benefits is granted in the chronological order in which applications are submitted.	Contribution benefits: employers are exempt from payment of 40% of contributions, with the exception of Inail contributions. The reduction in pension contributions is offset from the State budget, sterilising the impact on future pensions. The benefits **may not exceed €3,250 per year per new employee on a full-time open-ended contract**. The benefit may not be combined with other contribution relief measures or other reductions in financing rates.	Restrictions are in place to prevent open-ended contracts being interrupted and reactivated only to gain access to the benefit mechanism. The agricultural sector is subject to specific restrictions. Workers who have already received the benefit (including in the form introduced with the 2015 Stability Act) are no longer eligible (the benefit applies only to the first activation of an open-ended contract for a given worker). If the worker is hired on a part-time contract, the benefit is adjusted proportionately.
2017	**YOUTH GUARANTEE** Contribution relief connected with "Youth Guarantee" programme	Legislative Decree. 150/2015, Decree of the Ministry of Labour and Social Policies no. 394 of 2 December 2016 as amended, INPS Circular no. 40/2017 and Notice no. 1171/2017	New hires carried out **between 1 January and 31 December 2017, of young people between 16 and 29 enrolled in the "Youth Guarantee" programme** on open-ended contracts (including for staff leasing purposes), apprenticeship contracts directed at obtaining vocational qualification (including seasonal contracts if provided for in collective bargaining agreement) with a duration of at least 12 months, fixed-term contracts (including for staff leasing purposes) with a duration of at least 6 months. The contracts may also be part-time.	Only employment relationships in **private sector.** Domestic work contracts, apprenticeships other than those directed at obtaining a vocational qualification, intermittent (on call) contracts and casual supplementary employment contracts (among other things, this contractual form has been abolished).	A maximum of **12 months** as from the hiring date.	There is a ceiling beyond which the benefits may no longer be granted. Access to the benefits is granted in the chronological order in which applications are submitted.	Contribution benefits: employers are exempt from payment of contributions, with the exception of Inail contributions and other contributions listed in INPS Circular no. 40/2017. The reduction in pension contributions is offset from the State budget, sterilising the impact on future pensions. The benefits **may not exceed €8,060 per year per new employee on a full-time open-ended contract**. The benefit may not be combined with other employment incentives of a contribution or other nature.	If the worker is hired on a part-time contract, the benefit is adjusted proportionately. The benefit is also reduced if the worker is hired on a fixed-term contract or as an apprentice with a training period of less than 1 year. For a given worker, the benefit may be granted for one employment relationship only, with the exception of an extension of a fixed-term contract. No additional benefit is due in the case of the transformation of a fixed-term contract into an open-ended contract. The benefit may not be granted to employers who are legally required to hire a worker. The benefit is subject to the "de minimis" rule.

Table 4.1– *(cont.)* National employment incentive measures (1)

Year introduced	Type of measure	Main legislation	Beneficiaries	Segment/sector of application	Duration	Ceiling	Main benefits	Combination with other incentives and other aspects
2017	**DUAL SYSTEM Contribution relief for work experience programmes and trainee or advanced trainee apprenticeships**	2017 Budget Act (Article 1, paragraphs 308-310).	**New hires on open-ended contracts,** including part-time positions and apprenticeships, **carried out between 1 January 2017 and 31 December 2018,** of young students less than six months from receiving their diploma who have worked with that employer in a work experience arrangement or trainee apprenticeship.	Only employment relationships in **private sector**. Domestic work contracts and agricultural labourer contracts excluded.	A maximum of **36 months** as from the hiring date.	There is a ceiling beyond which the benefits may no longer be granted. Access to the benefits is granted in the chronological order in which applications are submitted.	**Contribution benefits**: employers are exempt from payment of contributions, with the exception of Inail contributions. The reduction in pension contributions is offset from the State budget, sterilising the impact on future pensions. The benefits **may not exceed €3,250 per year per new employee on a full-time open-ended contract**.	If the worker is hired on a part-time contract, the benefit is adjusted proportionately. The Government will assess the results obtained with the benefit mechanism by 31 December 2018 in order to decide whether it should be continued. The aspects concerning the "de minimis" rule are still being evaluated.
2017	**AGRICULTURE** Multi-year contribution relief for the agricultural sector	2017 Budget Act (Article 1, paragraphs 344 and 345).	**New smallholder farmers and new commercial farmers under the age of 40** who enrol in the agricultural pension system in 2017.	**Smallholder farmers and professional commercial farmers** referred to in Article 1 of Legislative Decree 99/2004.	Benefits decline over time: **36 months + 12 months + 12 months**	None.	**Contribution benefits**: disability, old age and survivor insurance (IVS) contributions are eliminated for a maximum of 36 months. A further exemption of 66% for a maximum of 12 months and one of 50% for an additional 12 months are also envisaged. The relief may not be combined with other exemptions or reductions in financing rates provided for in current legislation. The reduction in pension contributions is offset from the State budget, sterilising the impact on future pensions.	The benefit is subject to the "de minimis" rule.
2017	**SOUTHERN ITALY** Contribution relief for the regions of Southern Italy	2016 Stability Act (Article 1, paragraphs 109-110) with implementing provision in the Decree of the Ministry of Labour and Social Policies no. 367 of 16 November 2016, corrected with Decree no. 18719 of 15 December 2016. Detailed rules added with INPS Circular no. 41/2017 and Notice no. 1171/2017	**New hires on open-ended contracts**, including part-time positions, including for staff leasing purposes or apprenticeships directed at obtaining a vocational qualification (including seasonal contracts if provided for in collective bargaining agreement), **carried out between 1 January and 31 December 2017, by private-sector employers headquartered in Southern Italy, of young unemployed people aged 16-24 and people over 24 who have not had regularly paid employment in at least 6 months**. The transformation of other types of contract into open-ended contracts is also permitted.	Only employment relationships in **private sector**. Domestic work contracts, apprenticeships other than those directed at obtaining a vocational qualification, intermittent (on call) contracts and casual supplementary employment contracts (among other things, this contractual form has been abolished).	A maximum of **12 months as from the hiring date.**	There is a ceiling beyond which the benefits may no longer be granted. Access to the benefits is granted in the chronological order in which applications are submitted.	Contribution benefits: employers are exempt from payment of contributions, with the exception of Inail contributions and other contributions listed in INPS Circular no. 40/2017. The reduction in pension contributions is offset from the State budget, sterilising the impact on future pensions. The benefits **may not exceed €8,060 per year per new employee on a full-time open-ended contract**. The benefit may not be combined with other employment incentives of a contribution or other nature.	The benefit may also be granted for employment relationships established in implementation of association obligations as a member of a cooperative. If the worker is hired on a part-time contract, the benefit is adjusted proportionately. The benefit is also reduced if the apprenticeship directed at obtaining a vocational qualification provides for a training period of less than 1 year. Restrictions are in place to prevent open-ended contracts being interrupted and reactivated only to gain access to the benefit mechanism. The benefit may not be granted to employers who are legally required to hire a worker . The benefit is subject to the "de minimis" rule.

Source: Anpal (2017), "*Guida agli incentivi all'assunzione and alla creazione di impresa*" (http://anpal.gov.it/Pagine/default.aspx).

(1) Other incentives include: a) "minor" incentives to foster employment among disadvantages persons in social cooperatives, incarcerated people, the disabled, young parents, and to facilitate temporary replacements during maternity, paternity or family leave; b) incentives for the creation of enterprises at the national level; c) incentives for researchers and academics (return to Italy, reversing the "brain drain", research bonuses, etc.); d) the employment incentives provided for under the programmes managed by Anpal Servizi; and e) incentives for employment and the creation of enterprises provided for under regional legislation (normally in the form of calls for applications with the award of financial support).

The second group includes five national measures that also pursue social goals, targeting people facing disadvantages in access and remaining in the labour market. They include the following benefits: 1) for the hiring of disadvantaged people in social cooperatives[135] (with the elimination or near-elimination of disability, old age and survivor insurance (IVS) contributions and the addition of tax credits if the worker is incarcerated);[136] 2) for the hiring of incarcerated persons by private and public employers (with a 95 per cent reduction in IVS contribution rates and variable tax credits depending on the type of incarceration);[137] 3) for the hiring of disabled persons by private employers and public economic entities (with a reduction, for 36 or 60 months depending on circumstances, of the gross monthly salary subject to contributions);[138] 4) for the hiring of young parents (one-off bonus of €5,000 for each open-ended hiring or transformation into an open-ended position, including part-time positions, with a maximum of five bonuses per individual employer);[139] 5) to facilitate the temporary replacement of workers on maternity, paternity or family leave (with a 50 per cent reduction in IVS and Inail contributions charged to employers for a maximum of 12 months).

The third group, comprising national measures aimed at facilitating enterprise creation, research and innovation, includes an additional five incentive programmes aimed at: 1) encouraging the return of researchers and academics (with a reduction in taxable income for 2015-2018);[140] 2) reversing the "brain drain" (with a reduction in taxable income for 2016-2019);[141] 3) stimulating research (with tax credits for new R&D investments and hiring of highly qualified staff between 2015 and 2020); 4) supporting young people already included in the "Youth Guarantee" programme who decide to start their own business with the provision of interest-free financing[142] (the "SELFIEmployment" programme); 5) encouraging firms with young or female owners with interest-free financing.[143]

The fourth group, namely the programmes managed directly by Anpal Servizi, currently includes five measures, of which three belong to the category "training and innovation for employment, schools and universities" ("FIxOS&U"),[144] while a fourth provides

[135] The requirements are defined in the rules.
[136] The incentives were first introduced in 1991 (Law 381/1991).
[137] The contribution relief and the tax credits are available for 18 or 24 months (depending on the case) following the end of incarceration. The incentives were first introduced in 1991 (Law 381/1991).
[138] Can be added to other employment incentives. The provisions establishing the incentives are in Law 68/1999, as amended by Legislative Decree 151/2015.
[139] The bonus has been in place since 2010 and will remain until the appropriated resources are depleted.
[140] Only 10 per cent of income from teaching and research carried out in Italy is considered. Where the beneficiary is subject to IRAP, that income does not form part of the net production considered for IRAP purposes.
[141] Only 50 per cent of income produced in Italy is considered (the benefit applies to income from payroll employment and self-employment and entrepreneurial income).
[142] The financing is subject to maximum and minimum limits and eligible expenditures are specified. The loan must be repaid within seven years and award is subject to European "de minimis" rules.
[143] This can cover up to 75 per cent of eligible expenditure, with a maximum term of eight years. Award is subject to European "de minimis" rules.
[144] The programmes involve grants: to firms that hire young people on advanced training and research apprenticeship contracts (a minimum of 12 months); to firms that hire PhDs aged 30 to 35 on an open-

support for six-month internships for training in specialised skills for young people and the generational turnover in the craft professions (a grant for the intern) and the fifth provides funding for programmes not exceeding eight months for the social and employment integration of unaccompanied minors and young migrants (individual grants).[145]

Finally, with regard to the fifth group of programmes, several regions and the autonomous province of Trento have established employment incentives and entrepreneurial initiative incentives that provide for one-off or ongoing financial support, subsidized loans or financial guarantees.

4.2.2 Social policies

The 2016 NRP indicated that Italy's social policy priorities included: 1) the implementation of the legislation granting enabling authority to the Government for the rationalisation and reunification of family support programmes (the Consolidated Family Support Act); 2) the refinancing of the development plan for socio-educational services for early childhood; 3) the adoption of enabling legislation for the reorganisation of measures to combat poverty and social exclusion; and 4) the presentation of the bill on assistance for people with severe disabilities and no family support.

In May 2016, formulating its opinion on the 2016 NRP, the European Council stressed the need to counteract the process of gradual impoverishment of the population through a national strategy to combat poverty (focusing on the rationalisation of social spending and tax relief). In February 2017, the European Commission found that progress was limited, although it recognised how much had been accomplished to extend the Support for Active Inclusion programme (SIA) at the national level and the continuation of the approval process for the enabling legislation to reorganise anti-poverty measures into a unified system, incorporating and replacing the SIA and the Unemployment Allowance (ASDI).

The anti-poverty enabling legislation was approved last March (Law 33 of 15 March 2017). The National Plan for the Fight against Poverty and Social Exclusion provides for the introduction of the Inclusion Income (II) - a universal measure - and the launch of a reform to reorganise the system social assistance transfers. The reorganisation will involve the main direct anti-poverty programmes (SIA, ASDI, Purchase Cards). It will not

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ended or fixed-term contract (a minimum of 12 months); to cover the costs of company mentoring within a work-experience programme.

[145] All five programmes regard 2017 (some with interim deadlines for applications) and applications will be accepted as long as resources are available.

cover existing benefits for the elderly (often afflicted by targeting problems[146]) and those in support of parenthood and persons with disabilities.

The 2017 NRP envisages the approval of the enabling legislation for the reorganisation of measures and benefit programmes for families by the end of the year.[147]

4.2.2.1 Considerations on the Inclusion Income

The new anti-poverty programme finds itself incorporated in a system that is still characterised by a multitude of means-tested programmes, which have different eligibility criteria and are targeted at specific categories of beneficiary. It is a system that in the years of the crisis proved insufficient, especially for those who do not receive a pension, to reduce the risk of poverty among the more vulnerable segments the population.

Between 2008 to 2015, individuals at risk of falling into poverty[148] increased by 2.2 percentage points in Italy, rising from 6.8 to 9 per cent of the total population, a proportion exceeded only by Spain and Greece (Figure 4.4). The rise in the incidence of poverty in Italy, following the average trends observed in European countries (Table 4.2), mainly affected the population under 18 years of age (+4 percentage points to 13.3 per cent) and renters (+4.8 points, to 17 per cent). More specifically, the difference between the increase in poverty seen among people living in rented accommodation and homeowners in Italy is 3.4 percentage points in Italy, the highest in Europe after Portugal (9.1 points) and Denmark (4.6 points).

By contrast, Italy also experienced a decline in the incidence of relative poverty among over-65s (-0.9 points, to 3.4 per cent). This phenomenon involved all European countries with the exception of Poland (+0.9 percentage points, 2.4 per cent) and, to a lesser extent, France, Germany and the Czech Republic (+0.1 points each, to 1, 3.4 and 0.4 per cent respectively). During the crisis, the lack of exposure to the risk of unemployment and relatively low inflation were contributing factors.

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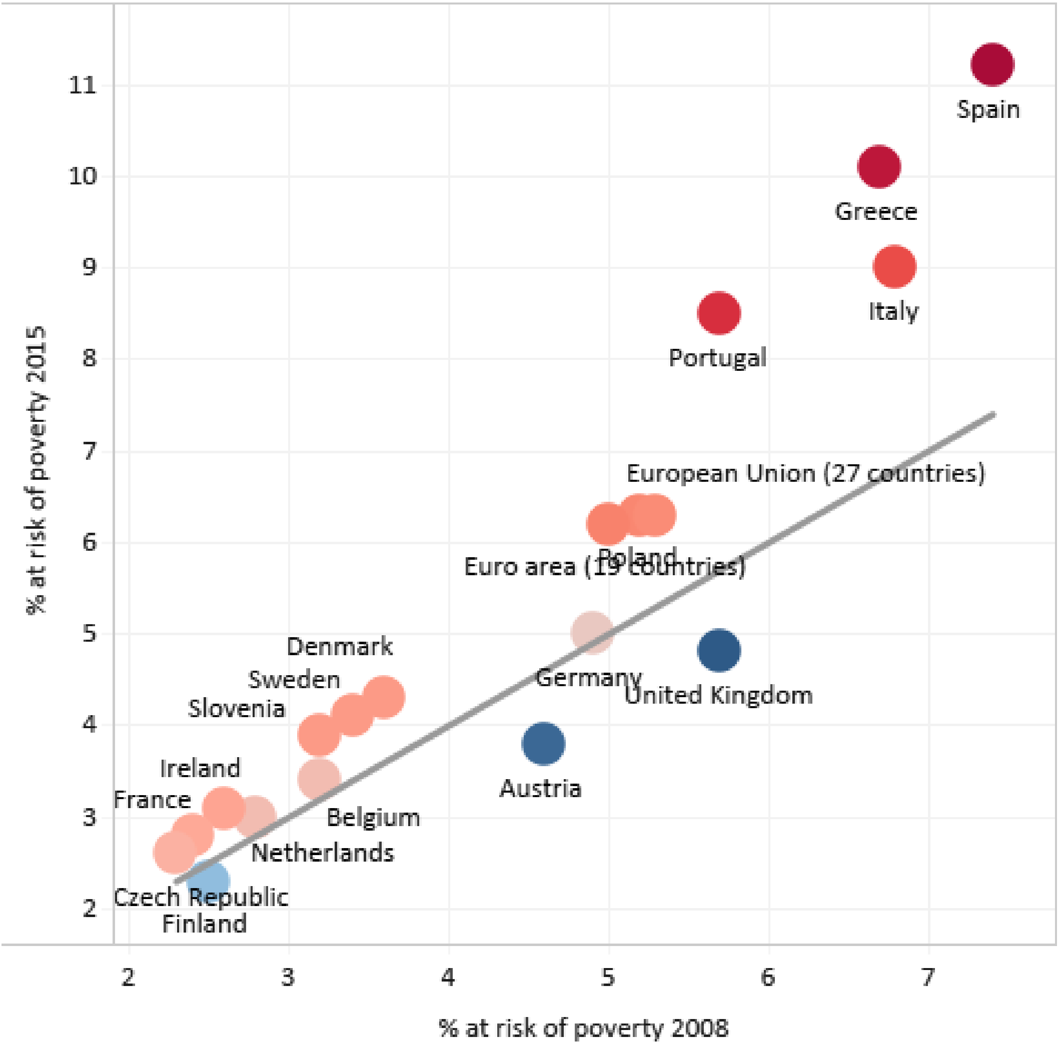
[146] The various assistance schemes in the pension system feature difference selection criteria, which in many cases do not take account of the overall resources and needs of households. See Boeri (2015), "*Non per cassa ma per equità*", Table 1 "*Distribuzione della spesa assistenziale destinata al contrasto della povertà della popolazione anziana per decili di ISEE*" (www.inps.it/docallegati/News/Documents/Proposta_INPS.pdf).

[147] For more information, see "*Audizione informale dell'Ufficio parlamentare di bilancio nell'ambito dell'esame del disegno di legge n. 1473 (Delega al Governo per riordinare e potenziare le misure a sostegno dei figli a carico) – Intervento del Consigliere dell'Ufficio parlamentare di bilancio Alberto Zanardi – Ufficio di Presidenza della Commissione 6ª del Senato della Repubblica (Finanze e tesoro)*", 12 October 2016.

[148] Those with an income below the poverty threshold, which is set at 40 per cent of the median equivalised income (Eurostat, appsso.eurostat.ec.europa.eu/nui/show.do?dataset=ilc_li08).

Although the anti-poverty enabling legislation provides for a gradual extension of the Inclusion Income to all households experiencing financial distress, in the initial phase of implementation it is restricted to families with minor children (consistent with the poverty data noted above), with members affected by severe disabilities or with unemployed members over 55 years of age (the pool of beneficiaries currently covered by the SIA and ASDI).

Figure 4.4 – Percentage of individuals at risk of poverty in the main European countries (2008–2015)



Source: based on Eurostat data. Poverty threshold set at 40 per cent of the median equivalised income.

Table 4.2 – Change in the share of individual at risk of poverty between 2008 and 2015 by age class and tenure status in the main European countries

Country	Total – Total	Total – Renter	Total – Owner	<18 – Total	<18 – Renter	<18 – Owner	18-64 – Total	18-64 – Renter	18-64 – Owner	>65 – Total	>65 – Renter	>65 – Owner
Spain	3,8 (11,2)	5,3 (26,4)	3,3 (8,4)	4,7 (16,7)	5,0 (36,8)	4,1 (11,9)	5,3 (11,9)	5,9 (24,9)	4,9 (9,3)	-2,7 (2,9)	-2,4 (7,0)	-2,6 (2,7)
Greece	3,4 (10,1)	3,3 (12,9)	3,3 (9,4)	5,3 (13,6)	4,8 (16,5)	5,2 (12,6)	4,4 (11,3)	3,1 (12,6)	4,7 (10,9)	-1,0 (3,6)	0,6 (5,6)	-1,2 (3,4)
Portugal	2,8 (8,5)	10,4 (16,5)	1,3 (6,9)	3,2 (11,6)	16,8 (27,0)	0,1 (8,1)	4,0 (9,2)	10,9 (16,6)	2,5 (7,6)	-0,7 (3,9)	2,5 (6,1)	-1,4 (3,5)
Italy	2,2 (9,0)	4,8 (17,0)	1,4 (7,1)	4,0 (13,3)	8,3 (25,2)	2,2 (9,5)	2,9 (9,8)	4,2 (16,4)	2,4 (8,1)	-0,9 (3,4)	0,2 (6,0)	-0,9 (3,1)
Euro area (19 countries)	1,2 (6,2)	1,4 (9,7)	1,1 (4,8)	1,7 (7,7)	2,7 (12,7)	1,2 (5,6)	1,7 (6,9)	1,4 (10,2)	1,8 (5,4)	-0,8 (2,7)	-0,1 (3,5)	-0,9 (2,5)
Poland	1,1 (6,3)	3,5 (11,3)	0,9 (6,0)	0,6 (8,2)	8,2 (14,3)	0,1 (7,8)	1,4 (6,6)	2,1 (10,8)	1,3 (6,4)	0,9 (2,4)	0,3 (5,4)	0,8 (2,3)
European Union (27 countries)	1,0 (6,3)	1,1 (9,3)	0,9 (5,2)	1,1 (7,8)	1,4 (11,3)	0,8 (6,5)	1,6 (6,8)	1,1 (9,9)	1,6 (5,7)	-0,9 (2,9)	-0,3 (3,2)	-1,1 (2,8)
Denmark	0,7 (4,3)	3,5 (8,6)	-1,1 (1,8)	0,5 (4,0)	8,5 (9,7)	-2,5 (1,7)	1,2 (5,5)	2,7 (10,1)	-0,4 (2,2)	-0,1 (1,1)	0,9 (1,4)	-0,8 (0,9)
Slovenia	0,7 (3,9)	1,4 (6,0)	0,6 (3,7)	1,4 (3,8)	1,0 (3,9)	1,5 (3,8)	1,1 (4,2)	1,6 (6,7)	0,9 (3,9)	-1,7 (2,8)	0,1 (5,3)	-1,7 (2,7)
Sweden	0,7 (4,1)	3,2 (10,2)	-0,2 (1,5)	1,0 (3,9)	6,4 (13,2)	-0,7 (0,9)	1,1 (5,1)	3,2 (11,6)	0,2 (2,0)	-0,5 (1,3)	0,2 (2,2)	-0,7 (1,0)
Ireland	0,5 (3,1)	1,4 (4,0)	0,1 (2,7)	0,0 (2,6)	1,2 (3,8)	-0,6 (2,0)	0,8 (3,2)	1,4 (4,0)	0,5 (2,9)	-0,6 (3,4)	3,3 (6,2)	-0,9 (3,2)
France	0,4 (2,8)	0,1 (5,0)	0,6 (1,7)	1,0 (3,4)	2,1 (6,5)	0,4 (1,6)	0,3 (3,2)	-0,3 (5,2)	0,7 (2,0)	0,1 (1,0)	-1,2 (0,6)	0,5 (1,1)
Czech Republic	0,3 (2,6)	1,5 (6,7)	0,2 (1,7)	0,9 (5,2)	3,4 (13,1)	0,2 (2,8)	0,3 (2,5)	1,0 (5,6)	0,3 (1,8)	0,1 (0,4)	0,0 (0,6)	0,1 (0,4)
Netherlands	0,2 (3,0)	2,5 (6,8)	-0,7 (1,3)	0,0 (2,4)	2,3 (7,4)	-0,5 (1,1)	0,6 (3,8)	3,4 (8,8)	-0,8 (1,4)	-0,4 (1,0)	0,1 (0,9)	-1,0 (1,1)
Belgium	0,2 (3,4)	0,5 (7,3)	-0,1 (1,9)	-0,2 (3,7)	-0,8 (7,8)	-0,2 (2,0)	0,5 (3,6)	1,5 (8,3)	0,1 (1,8)	-0,7 (2,1)	-2,2 (1,5)	-0,3 (2,3)
Germany	0,1 (5,0)	-0,2 (7,6)	0,2 (2,8)	-0,7 (3,8)	-1,4 (6,6)	-0,5 (1,8)	0,3 (5,8)	-0,3 (8,6)	0,5 (3,0)	0,1 (3,4)	0,9 (4,3)	-0,4 (2,9)
Finland	-0,2 (2,3)	-0,6 (4,9)	0,0 (1,4)	-0,8 (1,5)	-2,8 (2,0)	-0,2 (1,3)	0,2 (3,1)	-0,1 (6,2)	0,2 (1,7)	-0,5 (0,7)	-1,2 (0,9)	-0,4 (0,6)
Austria	-0,8 (3,8)	-0,5 (6,6)	-1,1 (2,0)	0,0 (4,7)	1,0 (8,1)	-1,0 (2,2)	-0,6 (3,8)	-0,7 (6,8)	-0,8 (1,7)	-2,1 (3,0)	-1,5 (3,4)	-2,2 (2,9)
United Kingdom	-0,9 (4,8)	-1,7 (7,1)	-1,1 (3,5)	-2,6 (4,2)	-4,3 (5,8)	-2,5 (2,8)	0,2 (5,4)	-0,8 (8,4)	-0,1 (3,7)	-3,0 (3,4)	-2,2 (2,2)	-3,3 (3,7)

Source: based on Eurostat data. Poverty threshold set at 40 per cent of the median equivalised income. The incidence of poverty by age class and tenure status in 2015 is given in parenthesis. The EU average does not include Croatia as data are not available.

The application of the Inclusion Income scheme is based on that used with the current SIA programme[149] with regard to the selection criteria for beneficiaries and the disbursement procedures, with greater funding (up from the current €750 million in benefits to about €1 billion for 2017-2018, in addition to unused resources from previous years and those included in the Inclusion National Operational Programme (NOP),[150] which continue to finance job support, activation and reintegration programmes). The range of social reintegration services activated with the SIA is

[149] The details of the application of the measure have not yet been announced. Some information on the Government's intentions can be inferred from the Memorandum of Understanding signed on 14 April 2017 with the *Alleanza Nazionale contro la Povertà*.

[150] Overall, the resources of the Inclusion NOP earmarked for those purposes amount to about €1 billion over seven years. See http://www.lavoro.gov.it/temi-e-priorita/europa-e-fondi-europei/focus-on/pon-Inclusione/Documents/Sintesi-Pon-Inclusione-ITA.pdf.

retained for the Inclusion Income programme, in accordance with the guidelines of the European Commission's Recommendation on Active Inclusion. [151] The Government has committed itself[152] to ensuring that appropriations for social inclusion and activation services do not fall below 25 per cent of spending, a crucial element, as highlighted in past experimentation,[153] in ensuring the uniformity of benefits throughout the country (the enabling legislation considers the Inclusion Income to represent an essential level of benefits).

The benefit will be determined by the difference between the disposable income of the household (defined by the Income Status Indicator (ISI) equivalent, i.e. the income component of the ISEE) [154] and a reference value (not less than €3,000) multiplied by the coefficients of the equivalence scale net of any increases. Other welfare benefits received by the household are deducted from that amount. [155] Eligibility for the benefit will be conditional on the ISEE level of the household (the access threshold will be at least €6,000 euros, double the level for the SIA) - to take into account household assets – and on a set of indicators of spending capacity and need. In order to avoid disincentives to work, at least part of the benefit will continue to be paid even after a possible increase in income due to the successful outcome of labour market reintegration policies, with the timing and conditions to be defined.

Given that the benefit will depend on the ISEE income component (ISI equivalent) and since rent is deducted from that amount, for any given level of income, a larger benefit will go to those living in rented accommodation, which as shown above is a segment of the population that is particularly at risk of poverty.

In view of the increase in the eligibility thresholds compared with the SIA, the pool of potential beneficiaries expected to increase (from the some 250,000 individuals under the SIA), but it should still be limited compared with the number of households in absolute poverty status (according to Istat estimates, equal to nearly 1.6 million in 2015). The extension of the plan to all households in a state of absolute poverty will depend on the appropriation of additional resources and the prospect of broader integration into a single mechanism of the various measures currently in force. Estimates performed in 2013 by the Minimum Income Working Group set up by the

[151] Commission Recommendation of 3 October 2008 on the active inclusion of people excluded from the labour market (2008/867/EC).
[152] Memorandum of Understanding of 14 April 2017.
[153] See "*Il reddito minimo di inserimento nel Rapporto della Commissione di indagine sull'esclusione sociale*"; Autonomie locali e servizi sociali, Fascicolo 3, December 2001.
[154] Upon initial application, at least 70 per cent of the difference must be covered and, in any case, the ceiling on the size of the benefit will be no less than the monthly social allowance (equal to €485 in 2017). The ISI includes all taxable income streams, comprising financial income and social assistance transfers, less 20 per cent of income equivalent to income from payroll employment (up to a maximum of €3,000 or €1,000 for payroll employees or pensioners, respectively), alimony and child support payments, certain expenditures and transfers for disability and non-self-sufficiency and rent paid for a primary residence (up to a maximum of €7,000, increased by €500 for each cohabiting child after the second).
[155] With the exception of assistance allowances and other benefits not subject to means testing, as well as benefits in kind (services) or monetary benefits in lieu of such benefits.

Ministry of Labour and Social Policies quantify the cost of a measure that would completely bridge the gap between disposable income and the poverty threshold for all households in absolute poverty at between €5 billion and €7 billion.[156]

4.2.3 The tax system and tax evasion

In May 2016, the European Council issued Recommendations concerning the tax system, which specifically addressed: (a) shifting the tax burden from factors of production to consumption and property; b) reducing the number and scope of tax expenditures; c) completing the land registry reform by the first half of 2017; d) implementing measures to improve tax compliance, including through electronic invoicing and payment systems.

In February 2017, the Commission's Country Report on Italy, in confirming these recommendations, acknowledged that some progress had been made in reducing the tax burden on the factors of production, but only limited progress was achieved in the reform of land registry values and the revision of tax expenditures, and measures to improve tax compliance.

Based on the composite indicator developed by the MEF concerning tax measures and the fight against evasion, the policies implemented in 2016 have enabled the implementation of 75 per cent of the reforms, up from 60 per cent through 2015. Until 2015, the Government's action focused mainly on implementing the enabling law on the reform of the tax system. In 2014-2016, some tax-related interventions also contributed to achieving the objectives of other policy areas, such as the labour market, with a number of measures to reduce the tax wedge (with the monthly €80 tax credit and deductibility of labour costs from the IRAP tax base) and competitiveness, with investment incentive measures.

Between November 2014 and September 2015, eleven legislative decrees were adopted to implement the enabling law on the reform of the tax system (Law 23/2014).[157] The Government redefined the abuse of right, strengthened the role of tax authorities in support of businesses with international activities (reducing constraints on cross-border transactions, improving the system of revenue rulings, dispute procedures and the efficiency of tax commissions) and revised

[156] See Baldini, P. and Pacifico, D. (2013), "*Stime del costo di programmi di contrasto alla povertà in recenti ricerche*", in "*Verso la costruzione di un istituto nazionale di contrasto alla povertà*", the report of the Minimum Income Working Group established by the Minster of Labour and Social Policies with a decree of 13 June 2013.

[157] The enabling law, whose deadlines expired in 2015, provided for: the reform of the land registry; rules for estimating and monitoring tax evasion and measures to limit base erosion; rules governing the abuse of right and tax avoidance; strengthened cooperation between tax authorities and business, with special regard to compliance assistance, tax simplification and a revision of the penalty system; strengthening of assessment and control activities; a revision of tax disputes and tax collection of local authorities; a revision of the taxation of entrepreneurial income and the establishment of flat-tax systems for smaller business taxpayers, as well as the rationalisation of the determination of entrepreneurial income and indirect taxation; rules governing public gaming; new forms of environmental taxation.

the system of tax disputes, penalties and collection. In addition, in order to limit the impact of assessments on taxpayers' economic activity, the Government has sought to strengthen and enhance preventive dialogue, improving voluntary compliance, compared with more traditional ex-post control and assessment activities, and enhancing the use of the information already contained in the databases available to tax authorities (cooperative compliance regime) in line with OECD guidelines (introduction of pre-filled tax returns, new procedures for identifying the degree of risk of taxpayers and spontaneous compliance encouraged with electronic invoicing, initially introduced only for suppliers of government departments).

Some parts of the enabling law were only partially implemented. With regard to the reorganisation of the public gaming sector, for example, the only measures implemented regarded taxation procedures, greater controllability of gaming equipment and advertising (regulated in accordance with European guidelines). In line with the actions of the Italian and European Digital Agendas, the electronic tax dispute proceeding has begun in the pilot regions of Tuscany and Umbria, prior to gradual extension to all other regions in the coming years.

The Government has only implemented some of the interventions set out in the 2016 NRP. More specifically, in conjunction with the 2016 EFD Update, the "Report on the Outcomes of Anti-Tax-Evasion Measures"[158] was presented, specifying future strategies for countering tax evasion. A process was initiated that involves the implementation of a stable and impartial methodology for the observation and calculation of tax evasion and the annual publication of the tax gap for major taxes and contributions. An Advisory Committee for Countering Tax Evasion, Avoidance and Fraud[159] was also set up with the task of overseeing and ensuring the coordination of activities carried out with the achievement of fiscal policy objectives. In addition, the "Annual Tax Expenditure Report 2016" was published as an annex to the 2017 Budget Act. It is produced by the Committee of Experts specifically set up by the Ministry for the Economy and Finance in preparation for the reorganisation of tax expenditures. By contrast, no measures were taken to reorganise and rationalise tax expenditures or change the personal income tax system. The reform of the land registry (see below) provided for in the enabling law on tax system reform was postponed again, as were measures concerning the overall reform of the tax court system.

Consistent with the actions provided for last year, the 2017 NRP indicates six strategic actions to be implemented by the end of 2018, which should complete the reform strategy defined for this legislature in 2014. The first three concern the structure of taxation, with a continuation of the reduction in the tax burden, the shifting of taxation from people to property and the review of tax expenditures. The remaining three actions concern the fight against tax evasion and consist in: ensuring coordination between tax authorities and the Advisory Committee for Countering Tax Evasion, Avoidance and Fraud; encouraging voluntary tax compliance, to be achieved in part by upgrading technological tools; and reducing disputes by reforming tax dispute proceedings and ensuring greater effectiveness in tax collection activities. No details are provided on the latter actions.

[158] Ministero dell'Economia (2016), "*Rapporto sui risultati conseguiti in materia di misure di contrasto all'evasione fiscale e contributiva*" (http://www.mef.gov.it/documenti-pubblicazioni/rapporti-relazioni/index.html#cont_7). The Report was prepared on the basis of the "*Relazione sull'economia non osservata e sull'evasione fiscale e contributiva*" drafted by the Committee established with a decree of the Minister for the Economy and Finance of 28 April 2016, chaired by Enrico Giovannini and composed of representatives of central and local government departments, academia and other institutions, in accordance with the provisions of Article 2, paragraph 2, of the above decree.

[159] The Committee met for the first time in March 2017, focusing on a survey of actions already taken to reduce the areas in which taxable income is being hidden from tax authorities.

With regard to the first action, namely the continuation of the reduction in the tax burden to support growth and competitiveness, the intention is to "ensure the continuity of the reduction in the tax burden on individuals and businesses begun with IRAP and IRES and continue the reduction in social contributions, starting with the most vulnerable segments (young people and women)".

In recent years, the reduction of the tax burden on the factors of production has mainly involved capital. The Government's actions in taxation have been significantly focused on the business sector, with changes to the tax structure and more contingent tax relief and investment incentive measures.

The 2016 Stability Act reduced the IRES rate from 27.5 per cent to 24 per cent, with effect from 2017. Other important measures were introduced with the 2017 Budget Act: 1) the introduction of the income tax for entrepreneurs (IRI), calculated by applying a flat rate equal to the IRES rate; and (2) reducing the contribution rate of self-employed persons registered in the separate INPS pension fund to 25 per cent. The same measure also introduced the principle of cash accounting in lieu of accrual accounting for the determination of taxable income for sole proprietorships and partnerships adopting simplified accounting. Another measure established a tax exemption for investments in long-term savings plans (PIRs), subject to specific conditions, and the establishment of the VAT group, as a single taxable entity, by entities that are legally independent, but closely linked at the financial, economic and organisational level. Under the rules for the latter, transactions within a VAT group are excluded from the scope of VAT.

At the same time, the tax treatment of financial and non-financial capital has been rebalanced, setting a single rate for tax on property income and other such income at 26 per cent.

With respect to labour, as from 2015 the cost of labour has been deductible from the IRAP tax base, while other measures are aimed at supporting disposable income, such as the monthly €80 tax credit as from 2014. The 2017 Budget Act also reduced tax rates on productivity bonuses agreed in decentralized bargaining, granted contribution relief for some types of new hiring and reduced social contributions for self-employed workers.

With regard to these measures, the Commission, in the Country Report for Italy, identified some significant progress in shifting the tax burden from the factors of production to consumption and property.

With regard to personal taxation, the 2016 NRP cautiously announced "an assessment of the possibility of modifying IRPEF [personal income tax] on the basis of available financial resources without prejudice to the public finance balances" in 2017-2018. No further action was taken to follow up on this announcement in 2016 and such modification was not retained in the 2017 NRP timetable.

The second action indicated by the Government regards the shifting of the tax burden from people to property and increasing the equity of taxation. This is entirely composed of interventions to revise land registry values.

The 2016 NRP provided for the revision of land registry values, following a complex effort to align databases, to accurately assess the revenue and distributive effects on taxpayers. In 2016, the only measures carried out regarded the determination of the imputed rent of productive and industrial facilities (so-called "bolted" (fixed) plant and equipment). The measure responded to the need to resolve significant technical and estimation issues in the process of determining the imputed rent of buildings used in production, but this is a limited step compared with the need for reform in this area.

The 2017 NRP merely provides for the updating of land registry information by 2018. This is intended to improve the quality of databases and their correlation with market data. In this regard, activities are under way to georeference real estate in land registry maps, the introduction of the size of the building and the determination of the land registry surface area for all real estate units in the ordinary categories with floor plans.

The third action envisages a review and rationalisation of tax expenditures, bearing in mind the need to continue in the direction of ensuring the sustainability of the public accounts and reducing the tax burden. At present, tax expenditures are being monitored, with the presentation of an annual report as an attachment to the Budget Act.

The total number of tax expenditures was found to be 610 (444 for state budget missions and 166 for local taxation). The "economic and financial policies and budget" mission contains the largest number of tax expenditures (111), followed by the "competitiveness and enterprise development" mission (59), the "social rights, social policies and family" mission (51) and the "employment policies" mission (49). The report provides a description and identifies the types of beneficiary for each measure (exemptions, exclusions, reductions in the taxable amount or the tax). Where possible, the financial effects are quantified on the basis of standard economic models of taxation, and the tax expenditures are classified on the basis of thirteen categories of expenditure comparable with spending programmes with the same purposes. Monitoring tax expenditures is a key element of budgetary transparency as well as an indispensable tool to ensure that the spending review as a whole forms an integral part of the budget process.

The 2017 NRP reaffirms the content of the enabling law on reform of the tax system, namely that the reorganisation of tax expenditures will seek to eliminate or revise those that are no longer justified on the basis of changing social and economic needs or those that duplicate public expenditure programmes. The law requires that this effort be conducted on an annual basis and should coincide with the Update to the EFD in the form of policy guidelines which, once approved by Parliament, will become binding on the Government for the purpose of drafting the budget package.

The remaining three actions dealing with the fight against tax evasion are barely sketched out in the NRP, which instead reviews what has been accomplished so far. However, some information is contained in the MEF's guidance for the achievement of fiscal policy goals for 2017-2019,[160] which should be implemented in agreements with the tax agencies. It incorporates and consolidates the strategic lines pursued heretofore

[160] Available on the website of the Ministry for the Economy and Finance: http://www.mef.gov.it/ministero/oiv/documenti/Atto_indirizzo_conseguimento_obiettivi_politica_fiscale_2017_2019.pdf.

and, in particular, encourages the computerized management of risk and the reduction of the invasiveness of administrative action with taxpayers considered to be low risk, providing for further improvement in the tax collection system and aiming to strengthen the fiduciary relationship with taxpayers with greater levels of tax compliance by simplifying tax formalities and increasing the quality of services provided by the tax authorities.

Finally, with regard to the objective of reducing the backlog of tax disputes and increasing the efficiency of tax collection, the NRP provides for a reform of the tax court process and bodies and the extension of the electronic tax dispute proceeding (which is not mandatory and is already operational is some regions) to the entire country in 2017. A dedicated portal will allow the electronic filing of dispute documentation already notified to the counterparty and on-line consultation of the proceeding file by all the parties involved.

4.2.3.1 Overview of recent developments in the tax burden

In 2016, the fiscal burden declined by nearly half a percentage point to 42.9 per cent (by 0.7 points, to 42.6, excluding receipts from the voluntary disclosure programme), reflecting the decline in indirect taxes. Nevertheless, Italy continues to have one of the highest fiscal burdens in the world: in 2015 it was 43.4 per cent, compared with an average of 41 per cent for the other euro-area countries (Table 4.3).

Between 2007 and 2015, the fiscal burden in Italy increased by 1.9 percentage points, in line with the average increase recorded by other euro-area countries (1.4 points). In Greece, the increase exceeded 6 percentage points, while Ireland recorded a 7.7 percentage point drop, making it the country with the lowest fiscal burden (24.3 per cent in 2015).

The incidence of direct and indirect taxes on GDP in Italy in 2016 was 29.4 per cent (with the two categories of tax having a virtually identical weight), down from 30 per cent in 2015 (when the average incidence of other euro area countries was 24.9 per cent). The prevalence of direct taxes over indirect taxes or vice-versa alternated in Italy between 2007 and 2015. On average in the other European countries, indirect taxes have accounted for a larger share of the tax burden, underscoring a significant difference in the functional breakdown of the tax burden (Figure 4.5).

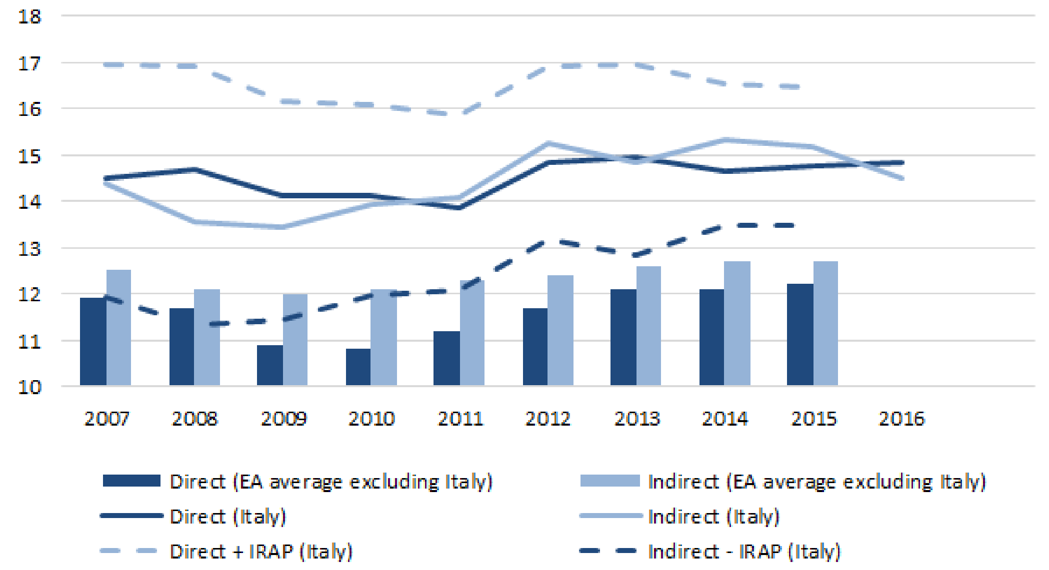
Considering the taxation of the factors of production in Italy, using the sum of direct taxes and IRAP, we find that between 2013 and 2015 (the last year for which data on the individual taxes for general government is available) revenue declined by half a point of GDP (Figure 4.5), rising to nearly one point in 2016. However, this fall was strongly concentrated on the side of corporate taxes in these years. IRES and IRAP revenue in the last eight years has contracted by about 1.7 percentage points of GDP (from 5.4 per cent in 2007 to 3.6 per cent in 2015; Table 4.4). Over the same period, IRPEF revenue grew by about one point of GDP (from 10.1 per cent in 2007 to 11.1 per cent in 2015), mainly due to the elasticity of the tax to nominal income. The same tendency is also seen if we consider the 0.6 per cent of GDP in respect of the €80 tax credit as a reduction in revenue rather than an increase in expenditure, as is the case in the national accounts. In the coming years, on a current legislation basis, the tax burden on households and that on businesses will diverge even further.

Table 4.3 – Developments in the fiscal burden in the main European countries

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2015-2007 (1)
Denmark	47.7	46.0	46.5	46.6	46.7	47.2	48.4	51.1	48.2	0.5
France	44.5	44.4	44.1	44.2	45.4	46.6	47.6	48.0	48.0	3.5
Belgium	44.5	45.1	44.5	44.8	45.5	46.7	47.7	47.4	46.8	2.3
Austria	41.7	42.5	42.1	42.0	42.1	42.7	43.5	43.7	44.3	2.6
Finland	41.5	41.2	41.0	40.8	42.1	42.7	43.7	43.9	44.1	2.6
Sweden	45.7	44.7	44.9	44.0	43.3	43.3	43.7	43.4	44.0	-1.7
Italy	**41.5**	**41.3**	**41.8**	**41.6**	**41.6**	**43.6**	**43.6**	**43.4**	**43.4**	**1.9**
EA (excluding Italy)	**39.6**	**39.1**	**38.8**	**38.7**	**39.3**	**40.2**	**40.9**	**41.1**	**41.0**	**1.4**
Germany	38.7	39.0	39.4	38.1	38.5	39.1	39.5	39.5	39.8	1.1
Greece	33.4	33.6	32.8	34.1	36.0	38.4	38.2	38.9	39.5	6.1
EU (excluding Italy)	**38.7**	**38.6**	**37.9**	**37.9**	**38.5**	**38.9**	**39.5**	**39.5**	**39.4**	**0.7**
Luxembourg	37.8	38.4	40.4	39.0	38.7	40.0	39.8	39.3	39.1	1.3
Hungary	39.4	39.4	39.0	37.4	36.7	38.4	38.0	38.2	39.0	-0.4
Netherlands	36.3	36.6	35.6	36.3	36.1	36.2	36.8	37.7	37.8	1.5
Croatia	37.1	36.8	36.4	36.2	35.3	35.9	36.6	36.6	37.5	0.4
Slovenia	37.2	36.7	36.6	37.3	36.9	37.3	37.2	36.9	37.0	-0.2
Portugal	34.9	34.8	33.4	33.6	35.4	34.4	37.1	37.0	36.9	2.0
Spain	37.4	33.3	31.3	32.7	32.7	33.7	34.5	34.8	34.9	-2.5
United Kingdom	34.9	36.5	34.0	35.0	35.6	34.8	34.7	34.2	34.8	-0.1
Malta	33.9	33.2	33.6	32.4	33.0	33.2	33.4	34.9	34.6	0.7
Czech Republic	34.2	32.9	32.0	32.4	33.6	34.1	34.7	33.7	34.2	0.0
Estonia	31.2	31.4	35.0	33.3	31.5	31.7	31.8	32.6	33.9	2.7
Poland	35.4	34.9	32.0	32.2	32.7	32.9	32.8	32.9	33.3	-2.1
Cyprus	35.7	34.4	31.5	31.7	31.7	31.4	31.4	33.1	32.9	-2.8
Slovakia	29.0	28.9	28.8	28.0	28.5	28.2	30.1	31.1	32.2	3.2
Latvia	28.3	28.0	27.5	28.0	27.9	28.7	28.7	29.1	29.3	1.0
Lithuania	30.1	30.7	30.6	28.6	27.4	27.2	27.2	27.7	29.2	-0.9
Bulgaria	31.4	30.5	27.0	25.8	25.2	26.6	28.1	28.3	28.9	-2.5
Romania	29.5	28.1	26.9	26.8	28.0	27.6	27.2	27.4	28.0	-1.5
Ireland	32.0	30.3	28.9	28.3	28.4	28.9	29.4	29.7	24.3	-7.7

Source: based on data from Banca d'Italia (2016), "*Statistiche di finanza pubblica nei paesi dell'Unione europea*", *Supplementi al Bollettino Statistico - Indicatori monetari and finanziari*, Year XXVI, 7 December.

Figure 4.5 – Developments in direct and indirect taxes
(percentage of GDP)



Source: based on Istat data for Italy and Bank of Italy data for the EU.

With regard to the incidence of taxes on the individual factors of production, in 2014 Italy's implicit tax rate on labour[161] was 8 percentage points higher than the average for EU countries and 5 percentage points higher than the average for the euro-area countries (Figure 4.6). The trend in the rate, as in most European countries, reversed course during the crisis (between 2007 and 2014) from the slight decline registered over the previous five years (Table 4.3). Denmark and Sweden are exceptions, posting a significant reduction in the rate during the crisis (2.4 and 4.2 percentage points respectively).

As noted elsewhere, recent fiscal policy measures in Italy have had a significant qualitative and quantitative impact on firms and have modified the tax structure consistent with the reform process that, as in other European countries, has characterised the last fifteen years.

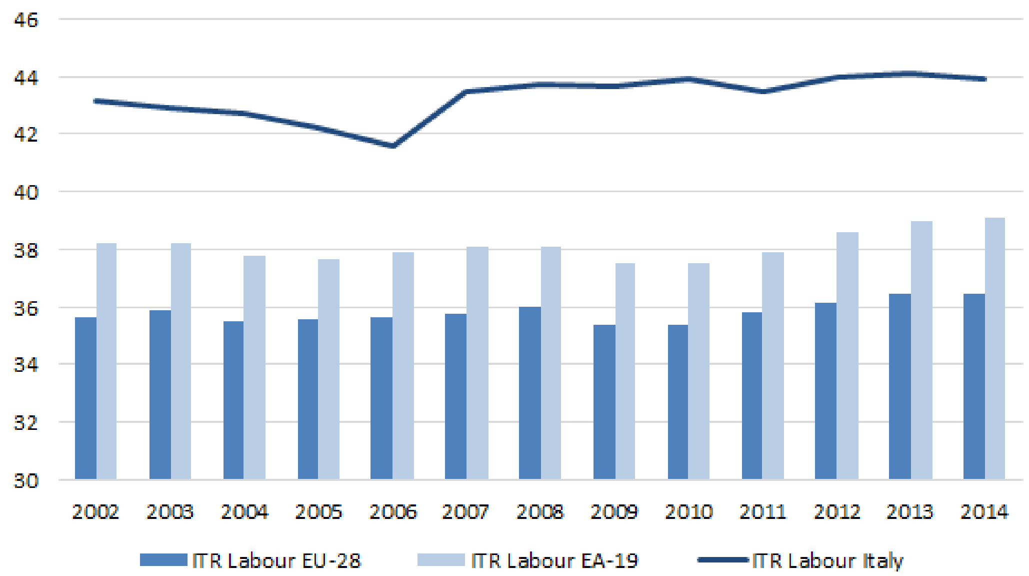
[161] The implicit tax rate is a metric of the average effective tax burden and is calculated by Eurostat for labour, consumption and capital. It is the ratio between tax revenue from each of these elements and the corresponding tax bases. The implicit rate on capital is an exception, as since 2012 it has been calculated using GDP in the denominator as a proxy of the tax base. The numerator of the implicit tax rate on labour includes taxes paid on labour and social contributions paid by workers and employers; the denominator is equal to total compensation of employees.

Table 4.4 – Revenue from the main taxes
(percentage of GDP)

	IRPEF	IRES	IRAP	VAT	Excise taxes	Municipal property tax
2007	10.1	2.9	2.5	5.9	2.2	0.8
2008	10.5	2.7	2.2	5.7	2.0	0.6
2009	10.6	2.1	2.0	5.5	2.2	0.6
2010	10.8	2.2	2.0	6.1	2.2	0.6
2011	10.6	2.1	2.0	6.0	2.5	0.6
2012	11.0	2.2	2.1	6.0	2.9	1.5
2013	10.9	2.4	2.0	5.8	2.8	1.3
2014	10.9	1.9	1.9	6.0	3.0	1.6
2015	11.1	1.9	1.7	6.2	2.8	1.5
2015-2007	**1.0**	**-1.0**	**-0.7**	**0.2**	**0.6**	**0.8**

Source: based on Istat data.

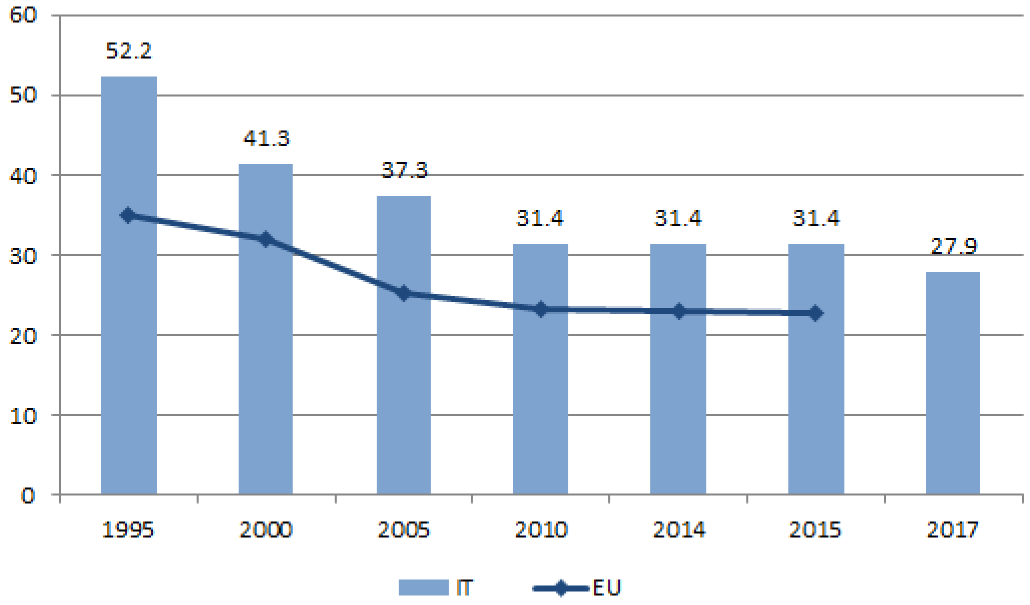
Figure 4.6 – Implicit tax rate on labour
(percentage of total compensation of employees)



Source: Eurostat (2015), "Taxation trends in the EU".

The tax rate is an initial element in assessing corporate tax policy. In Italy, the overall ordinary rate on profits has been declining steadily since the mid-1990s, going from 52.2 per cent in 1995 to 27.9 per cent in 2017. The trend at the European level over the same period is similar, with an average reduction of about 12 percentage points (Figure 4.7).

Figure 4.7 – Statutory rates of IRES and IRAP



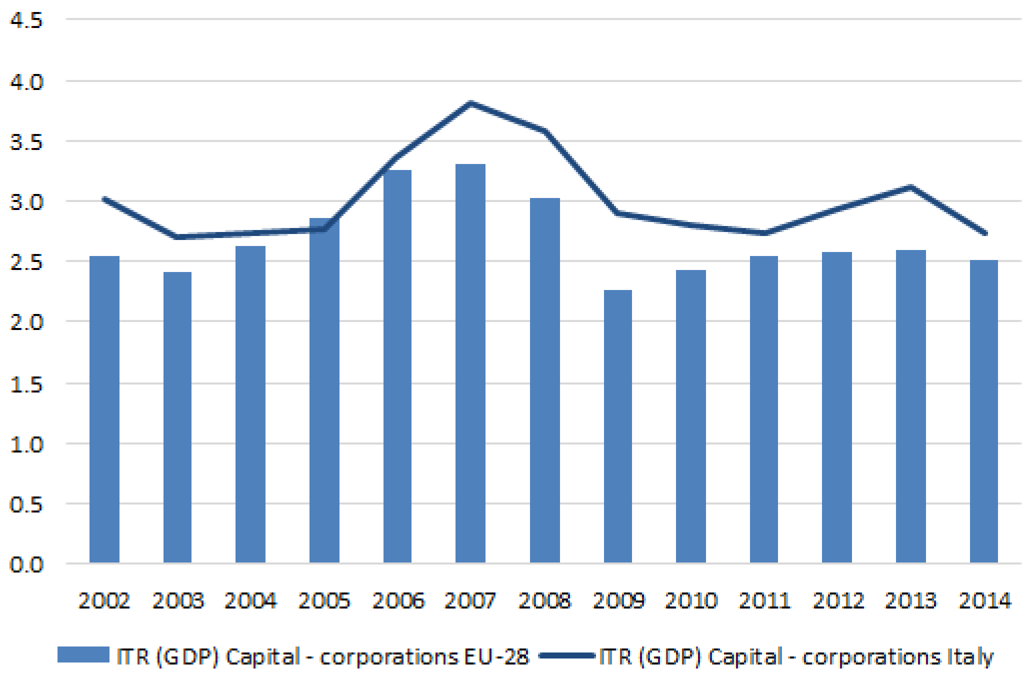
Source: Eurostat (2015), "Taxation trends in the EU".

Germany, which in the 1990s was, together with Italy, among the countries with the highest corporate tax rates, has reduced its legal rate by 26.6 percentage points. The same policy has also been adopted in countries with lower-than-average rates, such as Austria, the Netherlands and the United Kingdom. Ireland adopted an especially aggressive policy, reducing its rate by more than 27.5 points, from 40 per cent in 1995 to 12.5 per cent at the beginning of the 2000s.

However, a reduction in the legal rate does not necessarily correspond to a reduction in the implicit rate. The implicit VAT rate in Italy for corporations, while remaining above the European average, does not diverge significantly from it (Figure 4.8). Until 2007, taxes paid by corporations have been stable despite the reduction in legal rates, and in some cases have increased in terms of GDP. This has also occurred in other countries and, for Italy, can be explained as a consequence of the expansion of the taxpayer base and their profitability and, with regard to tax policy, of an extension of tax bases. More specifically, the measures have included, among others, the definitive abolition of the dual income tax, the modification of the deductibility of interest expense and the introduction of the participation exemption.

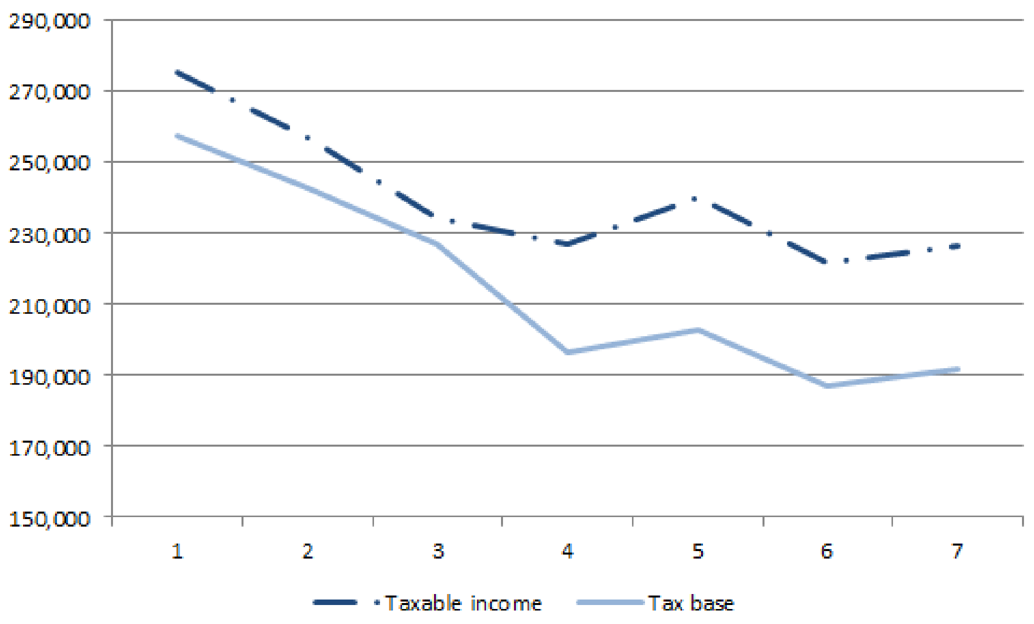
With the downturn, corporate profitability decreased (as from 2010 in particular) and as result revenue from corporate income tax contracted significantly. Once again, tax policy factors also contributed (in the opposite direction from past experience) to the erosion of tax base and accentuated the consequences of the economic recession on revenue generated from corporate income tax. These factors include the allowance for corporate equity (ACE) and the unlimited carry-forward of losses. Figure 4.9 shows progressive erosion of the tax base due to these two factors since 2008.

Figure 4.8 – Implicit tax rate on capital for corporations
(percentage of GDP)



Source: Eurostat (2015), "Taxation trends in the EU".

Figure 4.9 – Base erosion: divergence between taxable income of firms and actual IRES tax base
(euros; averages)



Source: based on MEF data – tax returns.

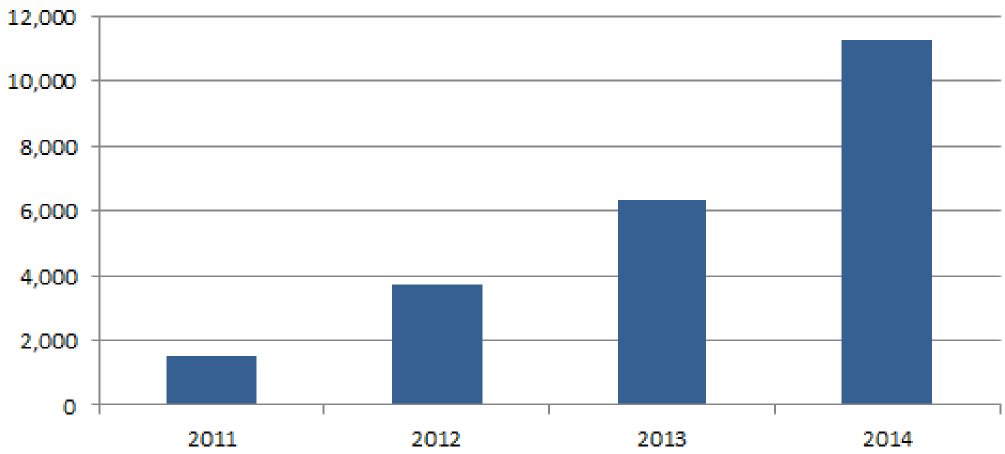
In particular, the effect of the ACE deduction on the taxable base, calculated annually as an ordinary return (applying a notional rate) on the increase in equity compared with that recorded in 2010, is increasing and over time tends to coincide with the return on the company's entire capital. Between 2011 and 2014, the potential deductibility of the ACE (i.e. not taking account of whether the company's tax base is sufficient to permit full deduction) went from just under €2 billion to almost €12 billion (Figure 4.10). Taking account of the non-deductibility of part of the ordinary return because the tax base is not sufficient to permit full deduction, the microsimulation model of the PBO was used to estimate a reduction in the effective tax rate in 2014 of 1.7 per cent for total non-financial corporations (Table 4.5), with a larger impact for agriculture (-2.1 points) and services (-1.9 points).

An international comparison shows that the implicit tax rate on consumption[162] appears to be lower in Italy than the average for the euro-area countries (about 18 per cent, compared with about 20; Figure 4.11). Evasion of VAT plays an important role in explaining this difference, despite the measures taken to rectify this in recent years. There appears to be, however, scope for an increase in VAT rates.

Finally, as regards the limited progress made in increasing the equity of property taxation, the linear revaluation, equal to 60 per cent of the imputed land registry rent on housing - implemented by replacing the ICI municipal property tax with the IMU municipal property tax in 2012 and the introduction of the TASI municipal services tax in 2014, parameterized to the revalued imputed rent - raised implicit tax rates on property, significantly increasing revenue, and amplified the significant distortions in the distribution of the levy, which is defined by the current structure of the land registry. Moreover, as underscored in the report of the European Commission, the abolition of property tax on primary residences, implemented in 2016, is inconsistent with the objective of widening the tax base and of transferring the tax burden from the factors of production factors to property and consumption.

[162] The implicit tax rate on consumption is calculated as the ratio of the sum of VAT revenue, excise taxes and other indirect consumption taxes to total household consumption expenditure.

Figure 4.10 – Developments in the potential deductibility of the ACE
(millions of euros)



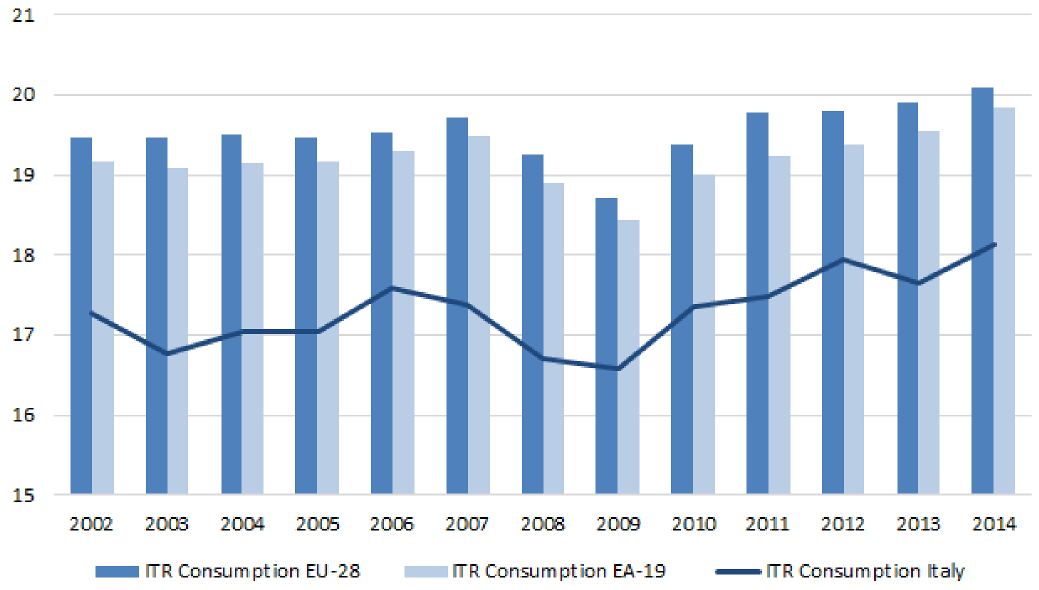
Source: based on MEF data – tax returns.

Table 4.5 – Impact of ACE by sector

	Share of value of production	Share of deduction used in 2014 (sufficiency of tax base)	Effective rate 2014	Statutory rate 2014	Reduction in rate
Agriculture, forestry and fishing	0.7%	18.8%	25.8%	27.5%	-1.7%
Industry	37.7%	67.0%	26.5%	27.5%	-1.0%
Construction	5.0%	48.8%	26.5%	27.5%	-1.0%
Services	46.0%	34.1%	26.3%	27.5%	-1.2%
Total	89.3%	42.9%	26.4%	27.5%	-1.1%

Source: based on the PBO microsimulation model. The total regards total non-financial corporations, which represent 89.3 per cent of all corporations.

Figure 4.11 – Implicit tax rate on consumption
(percentage of household consumption expenditure)



Source: Eurostat (2015), "Taxation trends in the EU".

4.2.4 The reform of the public administration

The reform, which was initiated in August 2015 with the enactment of Law 124/2015 concerning "enabling authority to Government for the reorganisation of government departments", is intended to increase Italy's competitiveness through the modernisation and simplification of relations between the public administration, the public and businesses.

In its recommendations issued last February, the European Commission found that progress in the implementation of the reform of the public administration was limited, stressing that Constitutional Court ruling no. 251/2016 (see below) has slowed or halted major parts of the reform. The Commission emphasised that inefficiencies in the public administration are hindering the implementation of structural reforms and the pace of investment.

Nevertheless, in 2016-2017 important steps have been taken in implementing the reform. In particular, as of the date of publication of the 2017 EFD, a presidential decree and somewhat over half (14 of 22) of the legislative decrees initially submitted by the Government had come into force. Another legislative decree entered force at the end of April.

In April 2016, when the previous EFD was published, only one of the implementing decrees, the so-called "law-trimmer" decree, had come into force, while 10 draft decrees an implementing regulation had been approved after preliminary analysis by the Council of Ministers. For these decrees, the schedule of reforms presented with the 2016 NRP provided for final approval by August 2016, and the Government's objectives were met. However, in November 2016, Constitutional Court ruling no. 251/2016 found that some of the articles of Law 124/2015 concerning the reform of the public administration were unconstitutional because they established that five legislative decrees should be adopted "after obtaining the opinion of the Unified Conference" rather than "subject to agreement with". In early 2017, the Council of Ministers approved preliminary corrective decrees for three of these five legislative decrees, while the other two, namely the "Legislative Decree containing consolidated provisions on local public services of general economic interest" and the "Legislative Decree containing rules governing public managers", which had not yet entered force, have been withdrawn and the deadline for the implementation of the enabling authority has expired. The schedule of reforms presented in the 2016 NRP also provided for the approval of further legislative decrees. At the end of April 2017, five had been definitively approved and in force. Five other draft legislative decrees have been approved on a preliminary basis.

The schedule of reforms presented with the 2017 NRP provides for the definitive approval by May 2017 of five draft legislative decrees and the three missing corrective decrees, mainly relating to the rules of public employment, the assessment of the public administration, state-controlled enterprises and disciplinary terminations. It is also provides for the drafting of the missing secondary legislation governing the implementation of the reform of the public administration and the re-presentation of the substance of the "Legislative Decree containing consolidated provisions on local public services of general economic interest", using unspecified procedures, by the end of 2017.

With regard to the reorganisation of state-controlled enterprises, the enabling legislation (Law 124/2015) was exercised with the approval of Legislative Decree 175/2016, which entered force in September 2016. The decree required that government departments conduct a survey of their holdings by March 2017 and implement the rationalisation in accordance with specific criteria over the next year. The process has slowed following the Constitutional Court's ruling on the unconstitutionality of the provisions of the enabling law, which provided for the adoption of legislative decrees "after obtaining the opinion of the Unified Conference" rather than "subject to agreement with". The subsequent corrective decree postponed the deadline for the survey of state-controlled enterprises to 30 September 2017, and as a result the start of the year granted for implementing the rationalisation process has also been postponed.

4.2.5 The education sector

School reform has repeatedly been urged in the recommendations of the Commission and the European Council to eliminate certain shortcomings compared with other European countries. In 2014 and 2015, in particular, it was emphasised that the early school leaving rate in Italy is higher than the EU average and urged Italy to approve a reform that, in order to tackle the problem, established a school evaluation system and strengthened vocationally-oriented education.

The 2016 NRP schedule has been implemented almost entirely, as acknowledged in the recent recommendations of the European Commission. It envisaged the adoption of nine legislative decrees to implement the enabling authority granted in Law 107/2015, the presentation of the National Teacher Training Plan and the Charter of rights and duties of students in work-experience programmes. As of the date of publication of the 2017 NRP, eight of the nine legislative decrees had been approved[163] and the National Teacher Training Plan had been presented. The Charter of rights and duties of students in work-experience programmes is expected shortly and an announcement of the Ministry of Education stated that the re-drafting of the consolidated education law has been postponed to future enabling legislation.

The NRP 2017 provides for the implementation and monitoring of school reform measures in the coming year, also drawing on the resources appropriated in the 2017 Budget Act. These include the National Teacher Training Plan, the National Digital School Plan and the National Plan for Inclusive Education.

Finally, the European Commission's 2017 report points out that although progress has been made with school reform, public spending on tertiary education as a proportion of GDP and Italy's tertiary education rate are among the lowest in Europe.

[163] The issues addressed by the eight legislative decrees include teacher recruitment, inclusion of disabled students, the revision of professional education programmes, education from 0 to 6 years, the right to an education, the promotion of a culture of humanism, Italian schools abroad and state examinations.

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