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State and outlook of the Italian public finances

Introduction and summary

In recent years, given the unfavourable cyclical conditions, fiscal policy in Italy has been characterised by the need to sustain economic growth, bearing in mind the constraints on the public accounts needed to stabilise the debt as a ratio of GDP. The budgetary policies adopted have therefore sought to reconcile controlling deficits with measures to stimulate macroeconomic recovery, including the use of the budget flexibility provided for in European and national rules.

In the current environment and looking ahead to the next legislature, bearing in mind that the Italian economic recovery appears to be on more solid footing, attention has returned to focus above all on the high level of the debt in relation to GDP and on the need to reduce it.

A credible reduction in the debt/GDP ratio presupposes further consolidation of the public finances and the determination to address a number of critical issues that still characterise the public finance framework.

Taking up the reins of a number of analyses already conducted by the PBO, this Focus highlights recent and future trends in the public finance aggregates and draws attention, from a broad perspective, to the risks and problems still present in the current scenario. These risks and problems will shape the formulation of the policy objectives and, more generally, budgetary policy choices in the coming legislative term.

The picture of recent developments in the public finances and the outlook that emerges in the 2018 Draft Budgetary Plan (DBP) presented last October can be summarised as follows.

- The main weakness of the Italian public finances continues to be the high level of public debt and its ratio to GDP, which was equal to 132 per cent in 2016 (compared with a euro-area average excluding Italy of 81.4 per cent). Looking forward, the cumulative reduction in debt with respect to GDP forecast for 2018-2020 in the DBP (to

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123.9 per cent at the end of the period) is also attributable to an increase in primary budget surpluses, made possible in 2019-2020 primarily by the safeguard clauses providing for increases in indirect taxes.

- The large debt is accompanied by significant interest expenditure, which in 2016 was equal to 4 per cent of GDP, the highest in the EU after Portugal. The DBP expects this expenditure to decline as a ratio of GDP, assuming only a moderate increase in interest rates over the programming period.
- Partly to offset this considerable interest expenditure, the primary budget balance has almost always been in surplus over the past decade, and the DBP assumes that it will increase in 2018-2020, despite the expected reduction in the fiscal burden (including the impact of the safeguard clauses), which would be offset by a significant decline in primary expenditure in relation to GDP.

In this light, it is worth recalling a number of critical aspects of the public accounts, both in the current year and in the two subsequent years, which will have to be considered in the budgetary policy choices of the next parliamentary term. These critical elements are connected with two categories of considerations.

First, the policy scenario in the DBP presents some elements of uncertainty and indeterminacy.

I. On the revenue side, the DBP continues the gradual process of reducing the burden of taxation. However, this permanent reduction in revenue is, as in the past, partly financed with resources generated by initiatives to combat tax evasion and one-off measures. Although the revenue from these measures is difficult to estimate *ex ante*, it has often been used to fund measures whose future effects are certain. The uncertainty of these estimates is why the European Commission's forecasts, which are used in the context of the European surveillance mechanism, generally do not incorporate the impact of these measures *ex ante*.

II. As mentioned above, the ratio of interest expenditure to GDP in the DBP forecasts is expected to decline under the assumption of a limited increase in interest rates during the programming period, as is currently expected by the markets. However, rates are at risk of more significant increases, given the numerous factors of uncertainty currently in play, in particular related to the gradual tapering of quantitative easing (QE) and the outlook for the world economy.

III. Looking at the main components of expenditure, and in particular that for public employment, this year is affected by uncertainty about the actual resources available to local government entities to fund the renewal of the bargaining agreement for local authority personnel and employees in the healthcare sector. Furthermore, looking ahead it could be necessary to find additional resources for contract renewals, given that those currently being negotiated refer to the 2016-2018 period. Finally, it could also be necessary to ease the freeze on turnover, with more hiring than that envisaged in the 2018 Budget Act, given that the corrective budgets of the last decade have led to a substantial decrease in the number of personnel and considerable aging of the public workforce.

IV. The certainty of the resources available in the next few years from privatisations, which according to the DBP should contribute to reducing the debt by 0.3 per cent of GDP a year over the programming period, is undermined by the lack of detailed information on potential transactions. Nor does it seem likely that substantial resources for deficit reduction can be generated by property divestitures: on average over the last decade, such revenue has amounted to €1.2 billion a year and less than €1 billion in both 2015 and 2016. Moreover, the reduction in the debt/GDP ratio envisaged in the DBP for 2017 could be at risk if Eurostat should require that the guarantees issued by the State as part of the measures to safeguard the banking system be included in the debt.

Alongside these uncertainties, other critical issues are specifically linked to the possibility that in the coming years the safeguard clauses provided for in the DBP, as in the last two years, will be cancelled, in part or in full, and replaced with alternative funding. This would be especially challenging in the light of the progressive narrowing of the scope for cuts in many items in the public budget after the corrective measures implemented in the last decade and the reduced room for flexibility under the fiscal rules.

1) As mentioned earlier, in 2019-2020 most of the improvement in the public finances is attributable to the safeguard clauses for indirect taxes, which are expected to generate revenues of about €12.5 billion (0.7 per cent of GDP) in 2019 and around €19.2 billion (1 per cent of GDP) in 2020. Suspending them while retaining the targets for the budget balances will require raising alternative resources in the same amount.

2) The total deactivation of the safeguard clauses for 2018, with an impact of more than €15.7 billion, established in the recently approved budget package was largely financed in deficit, taking advantage of the flexibility available under the fiscal rules. As things currently stand, there does not appear to be any margin with European authorities for the granting of further flexibility in the coming years.

3) The proposal to recover resources through measures to reorganise and reduce tax expenditures has been the object of repeated analysis and policy commitments, which however have not yet been pursued. Measures in this area have major redistributive and sectoral effects that could have hindered their adoption.

4) Pension spending in Italy is much higher as a percentage of GDP than in other major European countries, and it is expected to accelerate over the three-year programming period. Nevertheless, thanks to the various

reforms implemented since the 1990s, such spending is more sustainable in the long term. It is unlikely that significant resources could be recouped from this sector. On the contrary, sustainability could be threatened in the event of unfunded revisions of the current pension system, in particular changes to the last significant reform implemented at the end of 2011, which will generate considerable savings looking forward.

5) On the capital expenditure side, the DBP forecasts an increase in public investment thanks to the considerable funding authorised in recent budget packages. It therefore seems improbable that this item will continue to contribute to the containment of the deficit as it has in past years if, as hoped, the problems associated with the application of the new legislation governing public procurement are solved. A recovery in investment would also be desirable from an economic and social point of view, given the existing shortcomings of infrastructure, including in the healthcare and educational sectors.

6) In some sectors, Italian public spending is lower than in other countries. For example, after numerous interventions healthcare spending is already among the lowest as percentage of GDP among the major European countries. Additional cuts would likely impact the quality of the services available or the scope of the public system.

7) In general, only selective measures could plausibly achieve further reductions in expenditure items that have already been declining as a percentage of GDP for some years now, such as those for intermediate consumption for example. Among other things, more than 50 per cent of this component of public expenditure consists of healthcare spending. The category also includes other items that would be difficult to cut further and in some cases have already been impacted by past budget measures, such as those for tax collection fees, commissions on securities paid to the Bank of Italy and spending on international missions.

8) Moreover, it should be borne in mind that recovering resources through expenditure cuts may have to be directed towards the qualitative recomposition of spending towards priority sectors. The savings obtained through rationalisation measures may also have to be reinvested in some sectors to address shortcomings in the quantity or quality of the services provided, deficiencies that have emerged in recent years.

The developments in the public finances in recent years and the outlook for the next three years must also be assessed in light of the obligations under national and European fiscal rules.

1) The achievement of the medium-term objective (MTO, which for Italy is a structural budget balance of zero) has been repeatedly postponed. The path towards the MTO has experienced successive deviations due to the substantial flexibility granted by the European Commission. Despite this flexibility, in 2017 the European

Commission's Opinion on DBP highlighted the risk of a significant deviation both for the structural balance rule and for the expenditure benchmark. At the national level, if a significant deviation is confirmed in the final data, it would be necessary to activate the automatic correction mechanism envisaged under current legislation.

2) As far as the outlook for the future is concerned, in 2018 the DBP provides for an adjustment of the structural balance of 0.3 percentage points, which would be consistent with the European rules thanks to the "margin of discretion" exercised by the European Commission. However, according to the Autumn Forecast of the Commission, the correction of the Italian structural deficit would be equal to only a tenth of a percentage point of GDP. Thus, compliance with the rules of the preventive arm is again at risk of a significant deviation. As was the case last year, the European surveillance process could lead to a request for corrective measures that would bring the balance back to a level consistent with compliance with the rules. This possibility would presumably be strengthened if the final 2017 accounts provide ex post confirmation of significant deviations for the structural balance and expenditure rules.

3) For 2019-2020, the DBP indicates structural adjustment targets of 4 tenths of a point in each year, with "substantial" achievement of structural balance (-0.2 per cent) in the final programming year. As noted previously, however, this path depends on the activation of significant increases in indirect taxes.

4) As in previous years, there would be no compliance with the numerical rule for reduction of the debt/GDP ratio in the programming period, either with the backward-looking criterion, the cyclically adjusted criterion until 2020, or the forward-looking criterion until 2018. In the past, the consideration of relevant factors, such as unfavourable economic conditions and low inflation, prevented the opening of an excessive deficit procedure for non-compliance with the debt criterion. Looking ahead, and also considering the improved conditions in the Italian economy, it is uncertain how these factors will be evaluated by the European Commission.

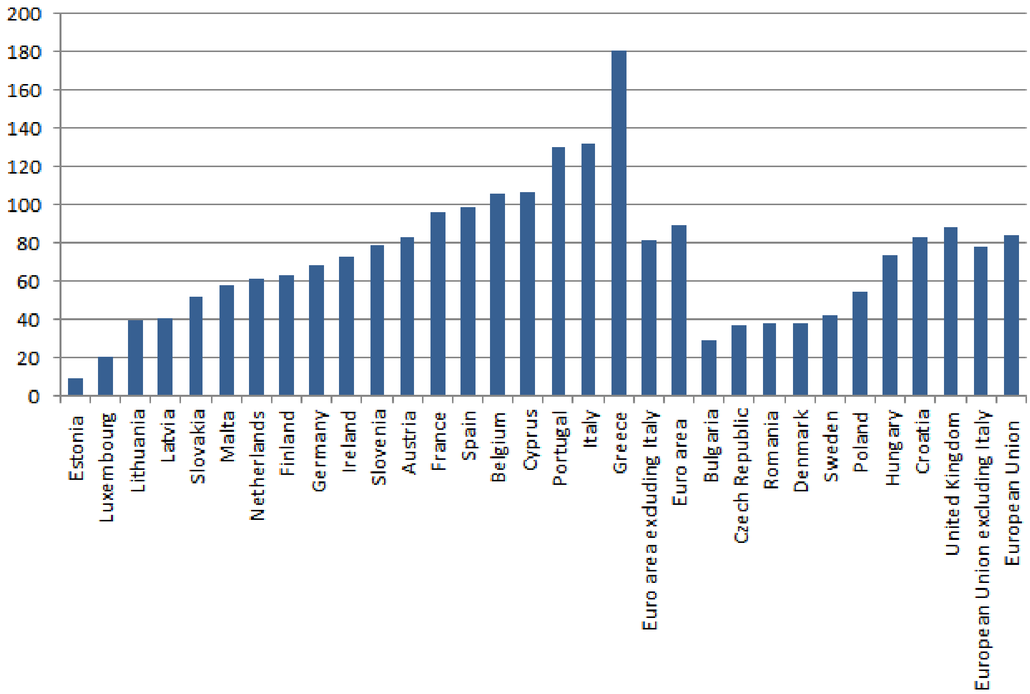
1. Debt, public finance balances and interest expenditure for general government

Italy has the highest ratio of public debt to GDP in the European Union, after Greece ...

The main weakness of the Italian public finances is the high level of public debt and its size as a proportion of gross domestic product. According to final figures for 2016, Italy's debt/GDP ratio was the highest in the EU after Greece (Figure 1).[1]

[1] For an analysis of the determinants of the increase in the debt/GDP ratio, see Ufficio parlamentare di bilancio (2017), "L'evoluzione del debito pubblico in rapporto al PIL in Italia e nei maggiori paesi", Flash no.2, May.

Figure 1 – General government debt in the European Union in 2016
(percentage of GDP)



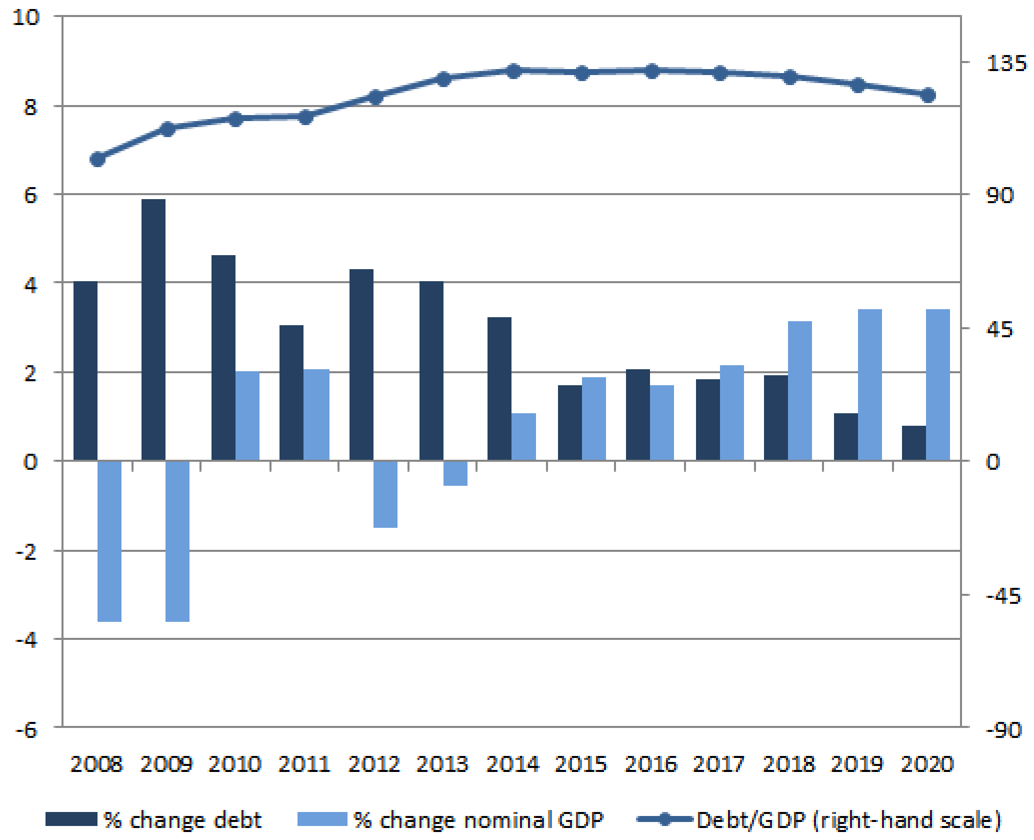
Source: based on Bank of Italy data.

At 132 per cent of GDP, it was more than twice the threshold of 60 per cent established under European rules and well above the average for the EU and the euro area (excluding Italy, equal to 78.1 and 81.4 per cent, respectively). It is also higher than that of other major European countries, with Spain and France at just under 100 per cent (99 and 96.5 per cent, respectively), the United Kingdom at 88.3 per cent and Germany at 68.1 per cent.

As a proportion of GDP, the debt grew continuously during the economic and financial crisis, rising from 102.4 per cent in 2008 to 131.8 per cent in 2014, before achieving an initial slight reduction in 2015, edging upwards in 2016 and then resuming its decline in the DBP estimates for 2017. Looking forward, the 2018 DBP envisages more pronounced decreases in 2018-2020, with the ratio reaching 123.9 per cent in the last year of the programming horizon (Figure 2).

A rising debt/GDP ratio has characterised other recent periods of the public finances in Italy, notably from the 1980s through the early 1990s, when – against the background of a monetary policy that no longer accommodated the public deficit - there were positive spreads between interest rates and GDP growth rates such as to trigger a snowball effect for the public debt. Subsequently, the 1992 financial crisis and the European commitments agreed following the signing of the Maastricht Treaty led to a breakthrough in budgetary policy, with the achievement of growing and substantial primary surpluses until 2000, which, together with significant privatisation proceeds, enabled a substantial reduction in the debt burden in relation to GDP. The smaller primary surpluses in the following years, despite favourable GDP growth, and the subsequent severe economic crisis led first to stabilisation and then growth in the debt/GDP ratio.

Figure 2 – Debt/GDP ratio and changes in the debt and GDP - 2008-2020
(percentage of GDP and percentage rate of change)



Source: based on data from Bank of Italy, Istat, 2017 Update of EFD and 2018 DBP.

The deterioration in economic conditions that began in 2007-2008 and continued over the following five years, due in part to the sovereign debt crisis, negatively impacted the Italian and European public accounts. The debt/GDP ratio was adversely affected by low, and on some occasions even negative, nominal GDP growth. Moreover, the increase in Italian debt reflected both the deterioration in the deficit – which in 2009-2011 rose above the ceiling of 3 per cent of GDP - and the impact of the financial support funds of the EMU countries, which registered especially large increases in 2011-2014 (Figure 2).

Note that in 2010 measures were taken - through bilateral loans, the European Financial Stabilization Mechanism (EFSM) and the European Financial Stability Facility(EFSF) – to provide financial support to the countries in difficulty (Ireland, Portugal and Greece). These instruments, together with the capital contribution to the European Stability Mechanism (ESM), affected the level of Italian debt in the amount of €3.9 billion in 2010, €13.1 billion in 2011, €42.7 billion in 2012, €55.6 billion in 2013, €60.3 billion in 2014, and €58.2 billion in 2015 and 2016.

Looking more closely at the change in the ratio of debt to GDP, we can distinguish the contribution of four components: 1) interest expenditure; 2) the primary balance of the revenue and expenditure account; 3) the stock-flow adjustment;[2]

[2] The stock-flow adjustment is the difference between the change in the debt, a cash-based financial concept, and net borrowing, i.e. the balance of the general government revenue and expenditure account. This difference therefore comprises cash inflows and outflows not included in the revenue and expenditure account. Especially significant examples of these include outlays or receipts for the acquisition or disposal of assets –

and 4) the change in nominal GDP (the denominator of the ratio).[3]

The rise of 33 points in the ratio in the period between 2008 and 2016[4] is equal to the algebraic sum of the four components just mentioned.

The contribution of interest expenditure to the increase in the debt/GDP ratio was 41 points, plus the stock-flow adjustment of 8 points (almost half of which is attributable to Italy's contribution to providing financial support for euro-area countries). Conversely, the growth in the ratio was attenuated by the contribution of the primary surplus (-11.1 points; revenues were greater than primary spending and therefore reduced the debt) and that of growth, however weak, in nominal GDP (-5 points; Figure 3).

In an international comparison, the debt/GDP ratio has increased in the period following the Great Recession in all the countries considered. It rose by less than 5 points in Sweden and Germany, by around 20 points in Austria, Belgium the Netherlands, by around 30 points in Finland, France and Italy, by over 40 points in the United Kingdom and the United States, by over 50 points in Ireland, by over 60 points in Portugal, Japan and Spain, and by over 70 points in Greece. The recession obviously contributed by depressing the contribution of nominal GDP growth to reducing the ratio for some countries more than in others, including Italy.

But budgetary politics also played a role. In fact, almost all countries registered large primary deficits: for example, the cumulative deficit was greater than 20 points in France, 35 points in the United Kingdom and the United States, 40 points in Spain and Japan, and nearly 60 points in Ireland. There are three exceptions: Italy, Germany and Sweden, with primary surpluses of, respectively, 11 points and 12 points. For most countries, the primary deficits were attributable to outlays to support the banking system and to fiscal stimulus policies, especially in 2009-2010. By contrast, Italy constantly posted primary surpluses in 2008-2016, with the exception of a modest deficit in 2009 (0.9 per cent of GDP).

In the DBP, the cumulative reduction in the debt with respect to GDP in 2017-2020 is projected to be around 8 percentage points. This reduction mainly reflects the evolution of the planned primary budget surpluses, which would produce a 9 percentage point reduction in the debt in relation to GDP (Figure 4).

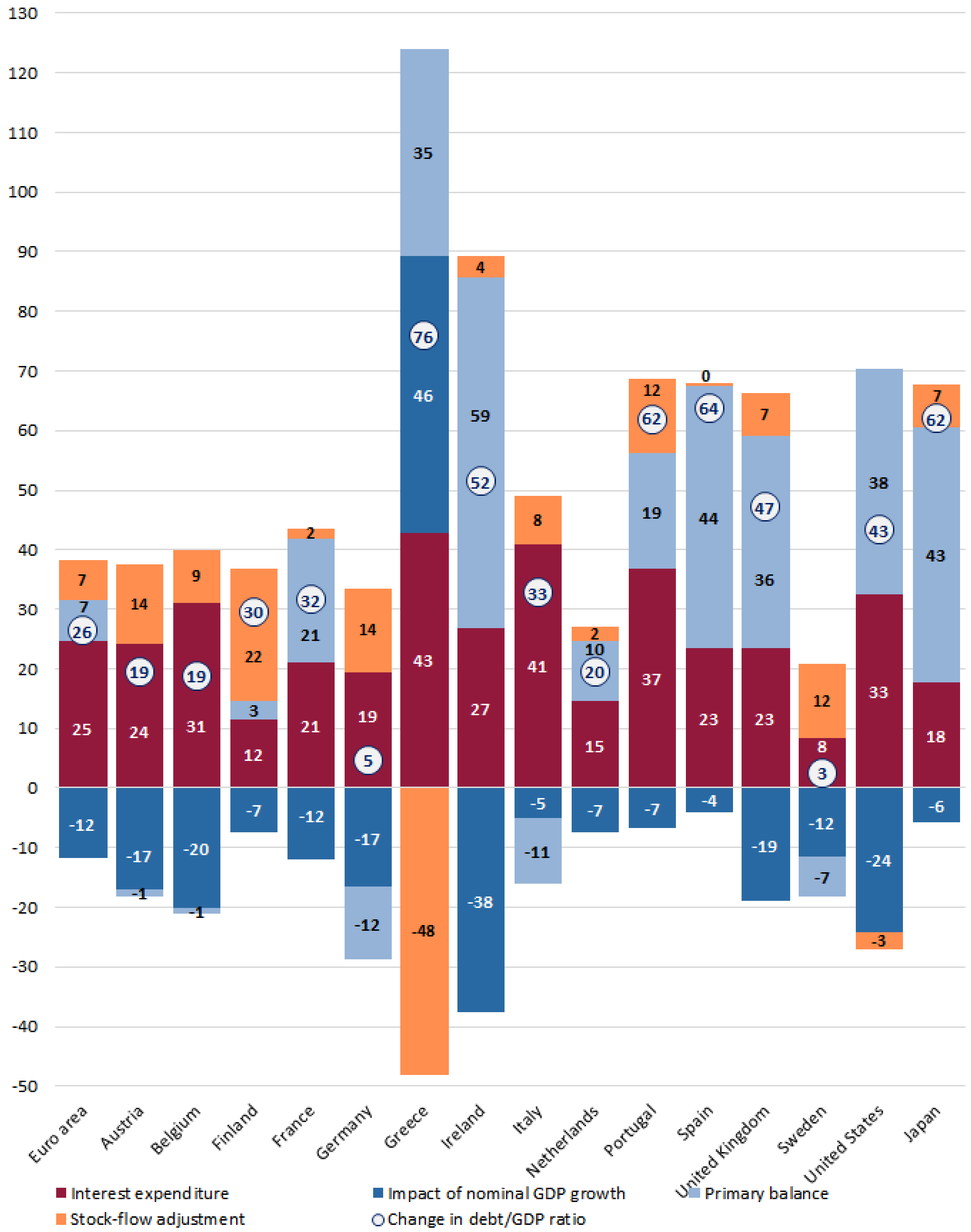
However, it is important to remember that such primary surpluses - and therefore the smaller increases in the debt - are possible in 2019-2020 thanks in part to the activation of safeguard clauses providing for increases in indirect taxes. The stock-flow adjustment produces an increase in the debt/GDP ratio of 2.3 percentage points. The lower weight is expected for 2017 despite the major interventions in favour of the banking industry, which in the DBP estimates were offset by a reduction in the Treasury's liquid assets.

such as, respectively, the contributions to the ESM and receipts from the privatisation of public companies – and the effects of financial derivatives.

[3] The algebraic sum of components 1) and 4) represents what is known in economic jargon as the snowball effect. The latter is equal to $\frac{I_t}{Y_t} + \left(\frac{D_{t-1}}{Y_t} - \frac{D_{t-1}}{Y_{t-1}}\right)$, where I is interest expenditure, D is the debt and Y is GDP. The term in parenthesis measures the impact of nominal GDP growth on the ratio: how many points the ratio would fall as a result of the change in GDP between t-1 and t if the debt was constant.

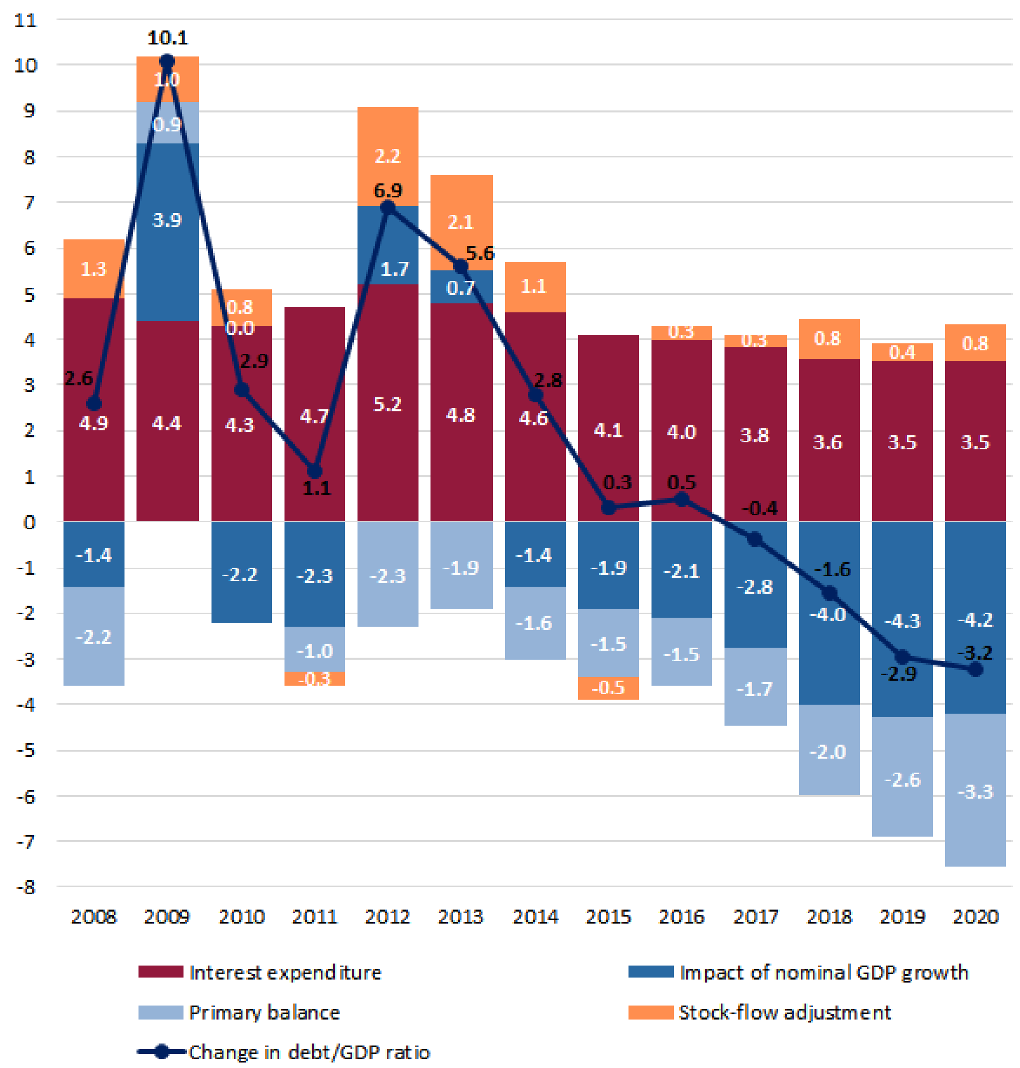
[4] This increase followed a decrease of about 17 points over the previous 12 years (1996-2007).

Figure 3 – Breakdown of the change in the debt/GDP ratio – Cumulative figures 2008-2016
(percentage of GDP)



Source: based on European Commission data, AMECO.

Figure 4 – Breakdown of change in debt/GDP ratio –2008-2020
(percentage of GDP)



Source: based on data from Bank of Italy, Istat, 2017 Update of EFD and 2018 DBP.

In the next three years, the forecasts put the effect of financial derivatives at €5 billion in 2018, and €3.2 billion and €2.3 billion in 2019 and 2020 respectively, with a decreasing impact as a result of the expected increase in interest rates. It should also be noted that an additional adverse contribution to the change in the debt/GDP ratio comes from other factors such as: an increase in the revaluation of debt through securities indexed to Italian and European inflation due to the expected acceleration in prices in both Italy and Europe; and a probable increase in the issue discounts for government securities issued below par, associated with the assumption of a rise in market interest rates in the coming years. In addition, the forecast reflects improvements in the debt due to privatisation proceeds of 0.3 per cent of GDP in each of the years in the 2018-2020 period, although information on the assets that would be sold is not yet available.

Finally, another factor is the expected improvement in the denominator of the ratio, i.e. the growth in nominal GDP, although uncertainty surrounds this element, especially as regards the growth in the deflator.

... resulting in the highest interest expenditure as a percentage of GDP in the EU after Portugal ...

Italy's debt situation generates very substantial interest expenditure – partly associated with the costs of having to refinance significant amounts of debt each year - which in 2016 was the highest in the EU as a percentage of GDP after that of Portugal (Figure 5).

In 2008-2010, the trend in interest expenditure – decreasing in 2009-2010 – essentially reflected the trend in global interest rates, with the effect heightened by the risk premium, as underscored by a spread between Italian BTPs and German Bunds that fluctuated between 100 and 200 basis points.

Subsequently, until 2012, expenditure grew by about one percentage point of GDP due to the widening of the risk premium (with the spread reaching over 500 basis points in the autumn of 2011), the growth in the debt and the contraction in GDP in 2012. With the start of QE by the European Central Bank, and the consequent decline in interest rates, interest expenditure fell again, both as a percentage of GDP and in absolute terms, going from 5.2 per cent of output in 2012 to 4 per cent in 2016.[5]

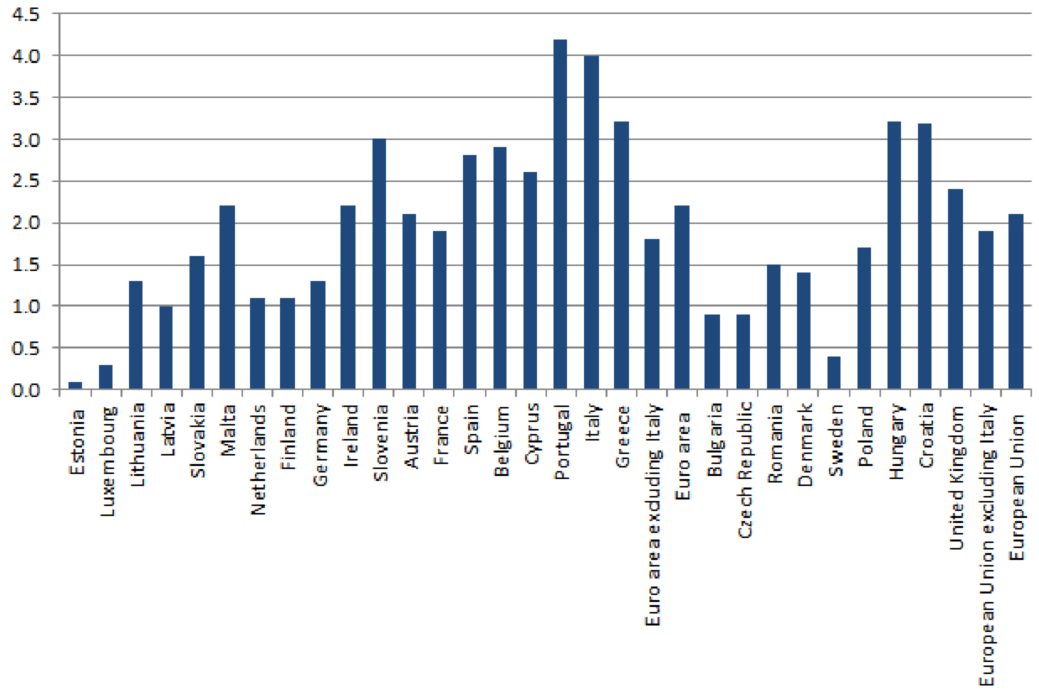
The DBP expects interest expenditure to decrease further in the coming years, reaching 3.5 per cent of GDP in 2020. The Government's planning document forecasts only a moderate increase in interest rates on the government securities market, as currently expected by the markets. However, this assumption is exposed to significant risks given the numerous factors of uncertainty currently connected with the tapering of QE and the global economic outlook.

... *and the need to maintain large primary surpluses over time* ...

After a 2009 when a primary deficit was registered (-0.9 per cent of GDP), essentially due to the operation of automatic stabilisers, a 2010 with a substantially zero primary balance and a 2011 with a primary surplus of just 1 per cent of GDP, in 2012 the surplus excluding interest spending returned to above 2 per cent of GDP in response to the need to reassure markets of the sustainability of the public finances and to reduce the budget deficit below the threshold established in European rules so as to exit the excessive deficit procedure opened for Italy – and many other countries - in 2009.

[5] For an analysis of developments in interest expenditure and the debt management policy adopted in recent years, see Ufficio parlamentare di bilancio (2017), "Il modello UPB di analisi e previsione della spesa per interessi", Nota di lavoro, October.

Figure 5 – General government interest expenditure in the EU in 2016
(percentage of GDP)



Source: based on Bank of Italy data.

Italy, Germany and Luxembourg are the only EU countries that have maintained a primary surplus without interruption throughout the 2011-2017 period. Over Italy's planning horizon, as indicated in the DBP, primary surpluses are gradually increasing: after 1.7 per cent of GDP expected for 2017, the surplus is projected to reach 3.3 per cent in 2020 (Figure 6).

2. General government revenue and expenditure

... thanks to a high ratio of revenue to GDP, although this has been decreasing since 2014 and ...

The fiscal burden, after fluctuating between 41 and 42 per cent in 2008-2011, reached a peak of 43.6 per cent in 2012-2013, mainly reflecting measures to contain the crisis of confidence in the Italian debt, considerably expanding the primary surplus, and partly due to the contraction in GDP in those years.

Subsequently, the tax burden fell by almost one point to 42.7 per cent in 2016, and it falls further to 42 per cent in 2020 in the policy scenario as a result of policies aimed at reconciling a further decrease in the deficit with the reduction of both taxation and the burden of social contributions associated with measures to combat tax evasion (Figures 7 and 8). [6]

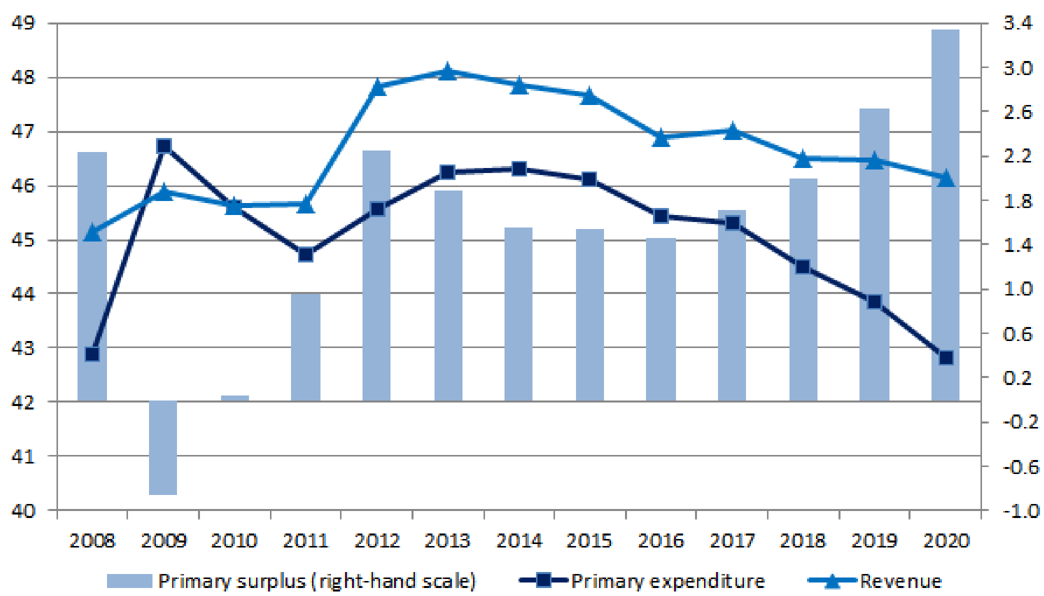
After fifty years of uninterrupted growth, in 2009, revenue decreased, due to a sharp contraction in GDP and despite the presence of substantial capital taxes – i.e. of an extraordinary nature - which buoyed revenue that year and in the following two years.

[6] The description refers to and updates Ufficio parlamentare di bilancio (2017), "2017 Budgetary Planning Report", May, section 2.1.

Subsequently, the developments in the fiscal burden reflect fiscal policy choices. In particular, in 2012-2013 the effects of the measures (such as Decree Laws 98, 138 and 201 of 2011) to contain the deficit generated by the economic and financial crisis and the sovereign debt crisis, despite the reduction in municipal property tax (IMU) revenues due to the abolition of the levy on non-luxury primary residences in 2013.

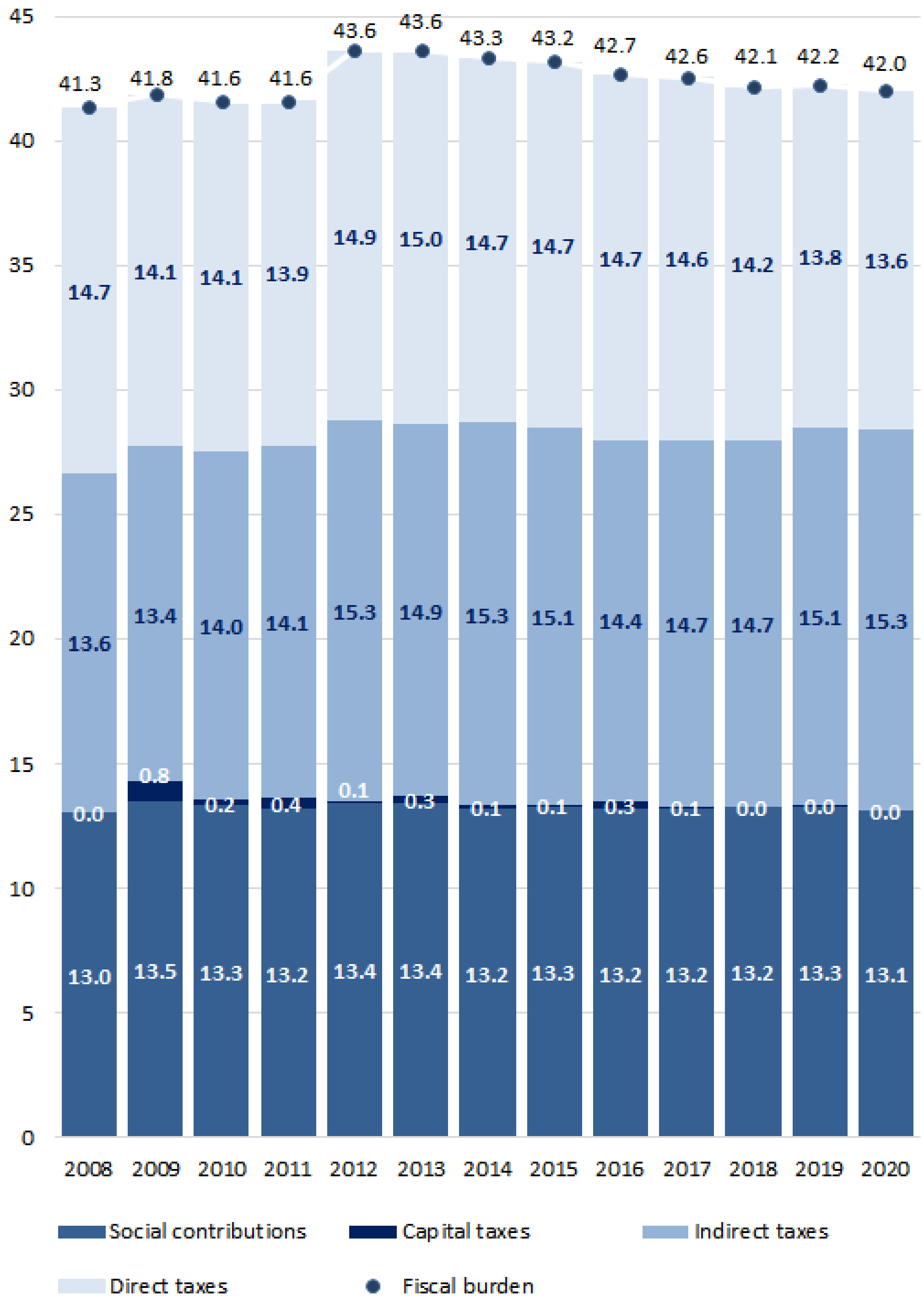
In 2014 the proportionate burden of direct taxes decreased, with an accompanying fall in absolute terms as well, due to the decline in IRES and the withholding tax on interest, also reflecting the bringing forward of payments on account to 2013. By contrast, revenue from indirect taxes increased, largely due to the introduction of the municipal services tax (TASI) and the increase in the ordinary VAT rate as from October 2013. In 2015, the fiscal burden barely edged down from 43.3 to 43.2 per cent. Its components were substantially unchanged as a proportion of GDP, but there was recomposition within indirect taxes: the sharp contraction in IRAP revenue – affected by the full deduction of labour costs from the tax base – was accompanied by a substantial increase in VAT, partly due to the introduction of the split payment mechanism. In 2016, the share of indirect taxation declined, while direct taxes increased as a proportion of GDP due to the allocation of RAI license fees to this item following the inclusion of the Italian broadcaster in the general government sector. The slight reduction of social contributions as a proportion of GDP in recent years is connected with total and partial contribution relief measures aimed at favouring open-ended hiring, introduced in 2015 and 2016 respectively. Capital taxes make an irregular contribution to developments in the fiscal burden: in 2016, in particular, they reflected the impact of the voluntary disclosure mechanism, while previous years the erratic developments in these taxes were attributable to changes in accounting standards. For 2017, a slight reduction in the fiscal burden is expected, due essentially to the reduction in capital tax revenue from the voluntary disclosure scheme compared with the previous year.

Figure 6 – Primary surplus, general government primary revenue and expenditure – 2008-2020
(percentage of GDP)



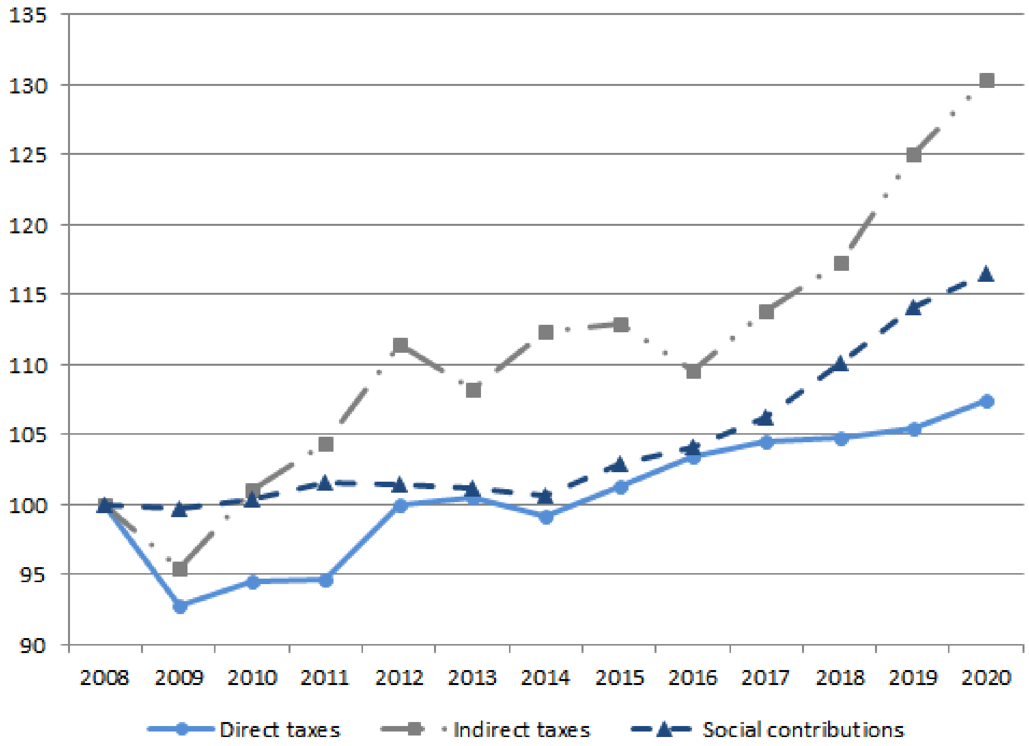
Source: based on data from Istat and the technical report accompanying the 2018-2020 Budget Act.

Figure 7 – The fiscal burden and its components –2008-2020
(percentage of GDP)



Source: based on data from Istat and the technical report accompanying the 2018-2020 Budget Act.

Figure 8 – Main components of the fiscal burden –2008-2020
(index; 2008=100)



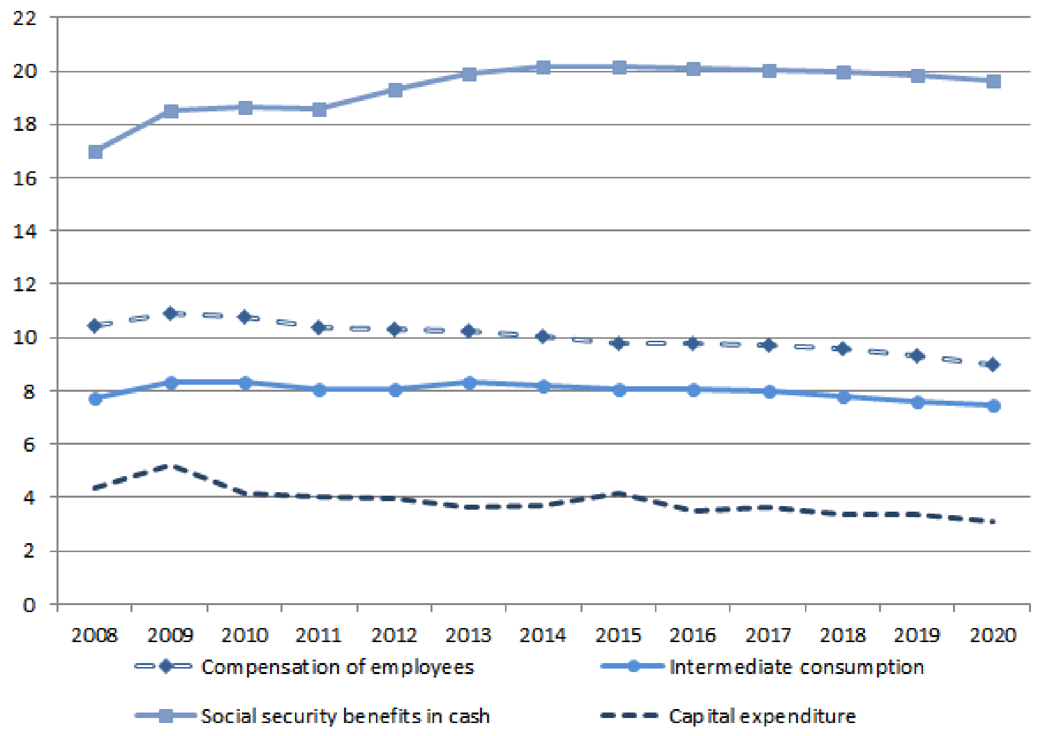
Source: based on data from Istat and the technical report accompanying the 2018-2020 Budget Act.

In the policy scenario for 2018-2020, the fiscal burden is forecast to decline by about half a percentage point of GDP - from 42.6 per cent in 2017 to 42 per cent of 2020 as noted earlier - due to the gradual decrease in direct taxes as a proportion of output (from 14.6 to 13.6 per cent of GDP), while social contributions will remain virtually unchanged (at just over 13 per cent) and indirect taxes will rise (from 14.7 to 15.3 per cent), with the latter increase reflecting the implementation of the safeguard clauses in 2019-2020. The reduction in direct taxes as a share of GDP is connected with the revenue-reduction effects of the cut in the IRES rate, the entry into force of the IRI system (the income tax on entrepreneurial income) and the extension of a number of existing tax relief measures (for example, tax credits for building renovations and energy upgrading) and the introduction of new relief measures.

... a reduction in primary expenditure as a share of GDP since 2015, with falling growth rates or decreases in absolute terms in certain years but ...

With regard to primary expenditure, the underlying trends under way for several years are continuing, indicating a progressive decline in the main components of expenditure as proportion of GDP, with the exclusion of social security benefits in cash (Figure 9).

Figure 9 – Main components of primary expenditure – 2008-2020
(percentage of GDP)



Source: based on data from Istat and the technical report accompanying the 2018-2020 Budget Act.

This was due to small expenditure increases in nominal terms and, in some cases, reductions in absolute terms.[7]

In particular, spending on compensation of employees decreased in absolute terms in 2011-2015. This reflected the various measures freezing contract renewals and career advancement and tightly restricting turnover, which led to an uninterrupted decline in the number of public employees from 2007 to 2015.

In the intermediate consumption segment, various instruments[8] were used to limit government operating costs, including across-the-board cuts, limitations and spending ceilings for specific items, and the rationalisation of purchases of goods and services. At the decentralised level, expenditure savings were achieved through changes to healthcare governance and the introduction of deficit consolidation plans as well as through the internal stability pact rules.

In recent years, social benefits have stabilised in terms of GDP after peaking in 2014 due to the monthly €80 tax credit for low-income employees. In a challenging demographic context, the effects of pension reforms, in particular the most recent one implemented in 2011, and the limited impact of indexation adjustments, associated with low inflation, have contributed to the containment of expenditure.

The volume of capital expenditure reflects the drastic reduction in investments as from 2010 and the erratic developments in other capital expenditure.

[7] The description refers to Ufficio parlamentare di bilancio (2017), "2017 Budgetary Planning Report", May, section 2.1.
[8] For an extensive analysis of intermediate consumption, see Ufficio parlamentare di bilancio (2017), "I consumi intermedi delle Amministrazioni pubbliche", Focus no. 3, March.

Figure 10, which shows the growth rates of the main components of primary current expenditure, reveals the containment in spending since 2010, with negative rates both for compensation of employees, from 2011 to 2015, and for intermediate consumption, in 2011-2012. For the latter, the rate of change was close to zero in 2014-2015 as well.[9] In 2016, these two expenditure categories reflected the accounting effect of the inclusion of the RAI in the general government sector.

From 2016, growth rates turn positive again for all components of current spending, although the pace of increase is slower than the expansion of nominal GDP, thereby reducing these components as a percentage of GDP.

In the DBP policy scenario for 2018-2020, primary expenditure is expected to fall by 2.5 percentage points of GDP - from the 45.3 per cent estimated for 2017 to the 42.8 per cent forecast for 2020 - reflecting decreases in all the major components. Over the three-year planning period, all the main current expenditure items are expected to continue to grow at a slower average rate than nominal GDP. Moreover, the average growth in capital expenditure should be negative.

More specifically, compensation of employees is expected to decrease in absolute terms in 2020, incorporating the impact of the contract renewal for 2016-2018 only, in line with the current legislation criterion.

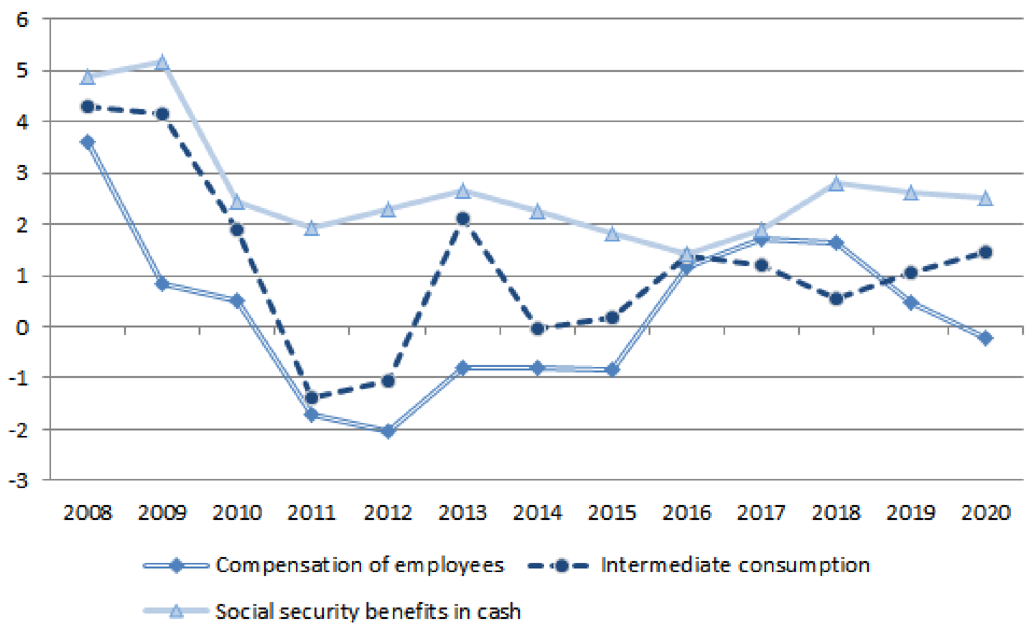
The growth in intermediate consumption is contained both by the effects of past redeterminations of the financing of the national healthcare system and the various budget packages decided at the central government level - with cuts in the budgets of ministries, which are also a feature of the latest Budget Act - and at the local level. On the capital expenditure front, developments essentially reflect the reductions in 2018 and 2020 in investment grants due to the reprogramming of transfers to the Italian State Railways as well as the ongoing decline in other capital expenditure related to the decrease in refundable tax credits for the deferred tax assets of the banking system.

3. Critical aspects of the public finance scenario still to be addressed and solved

Given the current scenario, it is worth highlighting a number of critical elements in the state of the public accounts, both for the current year and for the two following years, that will have to be taken into account in the budgetary policy decisions in the coming parliamentary term, also in the light of national and European fiscal rules.

[9] The increase in intermediate consumption in 2013, as shown in Figure 8, reflects the impact of the inclusion of the State Monopolies Agency in the general government sector, which involved the recognition under that item of fees for gaming concessions, in the amount of about €2.5 billion as from 2013.

***Figure 10**–* Main components of primary current expenditure – 2008-2020
(rate of change)



Source: based on data from Istat and the technical report accompanying the 2018-2020 Budget Act.

- The stock of public debt could be higher in 2017 than the level indicated in the DBP, due to the impact of the guarantees of €5.4 billion granted by the State to Banca Intesa in the purchase of Veneto banks (Banca Popolare di Vicenza and Veneto Banca). Those amounts could be included in the debt if Eurostat decides to include the liquidator in the general government sector, as the Banca Intesa claim on the liquidator is secured against any negative balance between assets (performing loans) and liabilities acquired (deposits).[10] It is likely that Eurostat will decide on this issue by next spring. The European Commission's Autumn Forecast incorporate the impact of these guarantees on the debt.
- Looking ahead to 2019-2020, the improvement in the public finances is largely associated with the implementation of the safeguard clauses providing for increases in indirect taxes of about €12.5 billion (0.7 per cent of GDP) in 2019 and about €19.2 billion (1 per cent of GDP) the following year. Cancellation of the increases with no change to the public finance balances would require finding substantial alternative resources to fund the shortfall. It is important to bear in mind that, precisely because the VAT increases introduced to support the consolidation of accounts have been systematically suspended in recent years, the European Commission does not consider the associated revenue increases in its forecasts and

[10] For more information, see Box 2.2 "State guarantees to the banking sector" in Ufficio parlamentare di bilancio (2017), "2018 Budgetary Policy Report", December. The risks in this situation were discussed in the hearing of the PBO on the Update of the 2017 Economic and Financial Document on 3 October 2017.

therefore in its *ex ante* assessment of compliance with the fiscal rules.

- With the recently approved budget, the full deactivation of the clauses in 2018, worth more than €15.7 billion, was largely financed in deficit, taking advantage of the flexibility granted under the fiscal rules. For 2019, the sterilisation was only partial (€6.4 billion). To help cover the revenue shortfall, the introduction of the income tax on entrepreneurial income (IRI) provided for in the previous Budget Act was deferred.
- As for the resources raised through the fight against tax evasion, the revenue increases are generally limited in time or can only be recognized ex post, making it difficult to incorporate them in the Commission's forecasts, which are those used in the European surveillance mechanism.
- Increasing resources through the rationalisation of tax expenditures has been the object of policy commitments and analysis in recent years. However, recent budget packages have included no measures to reduce such expenditures, presumably due to the redistributive and sectoral effects that their elimination would entail. Conversely, tax relief measures have been expanded.
- No detailed information is available on the privatization plan, which official policy documents expect to reduce the debt by 0.3 per cent of GDP in each year of the programming period. Nor does it seem likely that substantial resources for deficit reduction can be generated by property divestitures: on average over the last decade, such revenue has amounted to €1.2 billion a year and less than €1 billion in both 2015 and 2016.
- Looking at public employment, in the next few years it could be necessary to find additional resources for contract renewals, given that those currently being negotiated refer to the 2016-2018 period. For 2018 itself, problems could arise in finding resources for the renewal of the public employment contract for local entities and the healthcare sector. Finally, it could be necessary to ease the freeze on turnover in public employment, with more hiring than that envisaged in the recently approved Budget Act. The corrective budgets of the last decade have led to a substantial decrease in the number of personnel and considerable aging of the public workforce, with consequences for the overall efficiency of government operations and the deployment of technological innovation within the public system.
- The reduction in public investments under way since 2010 has in fact helped contain the deficit in the recent past. If, as hoped, the problems associated with the application of the new legislation governing public procurement are solved and in the presence of the considerable funding authorised by in latest budget packages, pressure on the public finances could increase, which would require greater control over other expenditure items. The recovery of an adequate volume of investment would also be desirable from an economic and social point of view, given the existing infrastructure shortcomings, including in the healthcare and educational

sectors, which have emerged in Italy, especially in certain regions.

- As we know, pension spending in Italy is much higher as a percentage of GDP than in other major European countries,[11] although, thanks to the various reforms implemented since the 1990s, such spending is more sustainable in the long term, as European indicators have shown. The sustainability of that spending would be threatened in the event of unfunded revisions of the current pension system, in particular changes to the last significant reform implemented at the end of 2011, which will also generate considerable savings looking forward.
- After numerous interventions public healthcare spending is already the lowest as percentage of GDP among the major European countries except for Spain.[12] Additional cuts would likely impact the quality of the services available or the scope of the public system.
- In general, it would be a challenge to implement further reductions in expenditure items that have already been declining as a percentage of GDP for some time now, such as those for intermediate consumption for example. Among other things, more than 50 per cent of this component of general government expenditure consists of items included in healthcare spending. The category also includes other items that would be difficult to cut further and in some cases have already been impacted by past budget measures, such as those for tax collection fees, commissions on securities paid to the Bank of Italy and spending on international missions.
- Recovering resources through expenditure cuts may have to be directed towards the enhancement of spending in priority sectors. The savings obtained through rationalisation measures may also have to be used to improve the quality of the public services provided, especially in sectors in which deficiencies have emerged in recent years

4. Fiscal rules

Italy has complied with the structural balance rule and the expenditure benchmark above all thanks to the flexibility granted under the fiscal ....

The performance of the public finances in recent years and the outlook for the next three years must also be assessed in the light of the obligations arising from the European fiscal rules (Stability and Growth Pact, or SGP) and national rules (the budget-balance requirement provided for under the Constitution).

First, the recent experience of Italy in the application of the fiscal rules has been marked by the repeated granting of flexibility and postponements of achievement of the medium-term objective

[11] In 2015, it was equal to 16 per cent of GDP, compared with 14 per cent in France, 11 per cent in Spain, 10.3 per cent in Germany and 7.6 per cent in the United Kingdom.

[12] In 2015, that expenditure was equal to 7.1 per cent of GDP, compared with 8.2 per cent in France, 7.6 per cent in the United Kingdom, 7.2 per cent in Germany and 6.2 per cent in Spain.

(a structural balance of zero).[13] These deviations from the path towards the MTO have been approved by Parliament with a qualified majority, as provided for by law.

First, it is important to recall that in July 2013, the European Council recommended that Italy achieve the MTO by 2014, but in the 2014 Stability Program (SP), achievement of the objective was postponed to 2016, based on considerations concerning the severity of the economic crisis and the need to achieve ambitious structural reforms. In the following years, achievement was postponed again. The path towards the MTO has experienced successive deviations thanks to the scope for flexibility granted by the European Commission.

In 2015, the Commission introduced the so-called "matrix" to specify the adjustment effort that countries that have not achieved their MTO must make depending on cyclical conditions and the debt/GDP ratio. This attenuated the adjustment effort for all countries, including Italy, struggling with severe recessions or exceptionally adverse cyclical conditions. In addition, the Commission, in interpreting the SGP rules, granted flexibility in the event of ambitious structural reforms that could strengthen the long-term sustainability of the public finances and in the case of specific categories of public investment.[14] Finally, over the past few years the Commission has granted a number of countries additional flexibility for so-called unusual events.

In 2015, Italy was able to reduce its structural adjustment by 0.25 percentage points of GDP compared with the "benchmark" (i.e. in normal times) as a consequence of the application of the new matrix, and by 0.03 points of GDP as a consequence of the additional expenditure necessary to cope with the increase in migration.

For 2016, Italy requested and obtained flexibility equal to 0.71 points of GDP (0.5 points for the implementation of structural reforms and 0.21 for investments[15]). Italy then benefited, again in 2016, from further flexibility due to unusual events linked to the migration emergency equal to 0.06 percentage points of GDP and 0.06 percentage points of GDP in relation to exceptional security needs due to terrorism. Overall, in 2016 Italy benefited from flexibility totalling 0.83 percentage points of GDP.

For 2017, the Commission initially allowed eligible expenditure of 0.34 percentage points of GDP under the unusual events clause, broken down as follows: 0.16 points for the migrant emergency and 0.18 points for costs related to earthquakes. As usual, a final evaluation will be conducted next spring by the Commission on the basis of final accounts, based on data provided by Italy.[16]

For 2018 only, the Commission has also decided to apply a "margin of discretion" in determining the structural adjustment effort for those countries, such as Italy, that would be required to implement a significant adjustment of their public finances (0.5 percentage points of GDP or more) under the preventive arm, with significant effects on growth and employment.[17] In the Italian

[13] For a detailed analysis of the budget flexibility granted to Italy, see Ufficio parlamentare di bilancio (2016), "2016 Budgetary Planning Report", April, section 4; Ufficio parlamentare di bilancio (2016), "2017 Budgetary Policy Report", November, section 3.1; and Ufficio parlamentare di bilancio (2017), "2017 Budgetary Planning Report", May, section 3.1.

[14] European Commission (2015), "*Making the best use of the flexibility within the existing rules of the stability and growth pact*", COM (2015) 12 final.

[15] The flexibility for investments was initially granted in the maximum amount allowed, i.e. 0.25 percentage points, in the presence of an additional request for the implementation of structural reforms. *Ex post*, however, since not all the investments planned and notified *ex ante* to the Commission were carried out, the flexibility was reduced to 0.21 points.

[16] European Commission (2017), "*Recommendation for a Council Recommendation on the 2017 National Reform Programme of Italy and delivering a Council opinion on the 2017 Stability Programme of Italy", COM (2017) 511 final.*

[17] European Commission (2017), "*2017 European Semester: Country-specific recommendations*", COM (2017) 500 final and European Commission (2017), "*Communication from the Commission, 2018 Draft Budgetary Plans: Overall Assessment*", COM (2017) 800 final.

case, the Commission felt that the conditions for reducing the adjustment required for 2018 from 0.6 to 0.3 percentage points of GDP had been met. The effective achievement of this reduced adjustment is however mandatory.

The flexibility granted since 2015 has made it possible to restructure the path of adjustment towards the MTO in compliance with the rules. Overall, the flexibility envisaged and granted in 2015-2018 has been considerable and can be estimated at around €29.7 billion (Table 1).

As for 2017, the DBP envisages a structural deficit of 1.3 per cent, with a risk of significant deviation both for the structural balance rule and for the expenditure benchmark. These risks are also highlighted in the European Commission's Opinion on the DBP. If the 2017 outturn provides *ex post* confirmation of significant deviations from the numerical rules on the structural balance or the growth of expenditure, the Commission will conduct an assessment to verify compliance with the preventive arm of the SGP. In the case of non-compliance, a procedure for significant deviation could be opened. Moreover, in the assessment of the relevant factors concerning compliance with the debt rule, violation of the rules of the preventive arm constitutes an adverse finding, which may prompt the opening of an excessive deficit procedure on the basis of the debt criterion. At the national level, if a significant deviation is confirmed by the final accounts, it would be necessary to activate the automatic correction mechanism envisaged under applicable law.

... flexibility that is not currently available for future years ...

Looking forward, the path towards the MTO in the 2018 DBP envisages a structural deficit of 1 per cent in 2018, an improvement of 0.3 percentage points compared with the previous year.

Table 1 – Deviations from the path of adjustment towards the MTO due to flexibility granted to Italy – 2015- 2018

	% GDP				Absolute values (billions of euros)				
	2015	2016	2017	2018	2015	2016	2017	2018	Total 2015-18
a) Economic cycle [(1)]	0.25				4.1				4.1
a) Structural reforms		0.50				8.4			8.4
a) Investment		0.21				3.5			3.5
b) Migrant flows	0.03	0.06	0.16		0.5	1.0	2.7		4.3
b) Security		0.06				1.0			1.0
b) Seismic activity			0.18				3.1		3.1
c) Margin of discretion				0.30				5.3	5.3
Total	**0.28**	**0.83**	**0.34**	**0.30**	**4.6**	**13.9**	**5.8**	**5.3**	**29.7**
Nominal GDP (DBP 2018)					*1,652.2*	*1,680.5*	*1,716.5*	*1,770.3*	

Source: based on European and national documentation.
(1) The deviation associated with economic conditions is calculated on the basis of the path of adjustment towards the MTO required before the European Commission Communication on flexibility.

As the PBO has pointed out in recent reports,[18] the Opinion of the European Commission on the DBP[19] issued last November found that, based on its own Autumn Forecast, the correction of the Italian structural deficit would be equal to only a tenth of a percentage point of GDP, lower than the three-tenths forecast in the DBP and below the mandatory effort required. Thus, compliance with the rules of the preventive arm is at risk of significant deviation in 2018 as well, both as regards the structural balance and the expenditure rule. As was the case last year, the European surveillance process could lead to a request for corrective measures that return the balance to a level consistent with compliance with the rules. For 2019-2020, the DBP indicates a structural deficit targets of -0.6 in 2019 and -0.2 in 2020, with structural adjustments of four-tenths of a point for each year. As underscored above, however, "substantial" achievement of structural balance is entrusted to the large safeguard clauses for VAT increases (0.7 per cent of GDP in 2019, 1 per cent in 2020), whose deactivation would require finding a large volume of alternative resources .

Recall, again, that the suspension of the safeguard clauses, i.e. the decision not to increase tax rates, in the recent past was made possible above all by the restructuring of the path of adjustment towards the MTO based on the considerable flexibility granted by the European institutions.

However, at EU level no margins are currently foreseen for additional flexibility in the coming years. It is important to remember that, under the rules established by the Commission, flexibility for carrying out structural reforms and public investment can only be requested again after the MTO has been achieved.[20] Furthermore, the Commission has repeatedly emphasised that the "margin of discretion" will be applied for 2018 only and not for the following years. In any case, if the macroeconomic forecasts of the DBP or the European Commission in November 2017 should be realized, Italy's cyclical conditions would probably be too favourable to be able to take advantage of this margin in 2019, as occurred for France this year. For example, the European Commission's forecasts point to a positive output gap for Italy of just below one in 2019, compared with an output gap of close to zero for France in both 2018 and 2019.

... at the same time, complying with the numerical rule for reducing the debt/GDP ratio has been and remains a challenge

The policy scenarios for the public finances delineated in recent years have not generally been sufficient to enable compliance with the debt rule by Italy since 2013, due in part to the presence of relevant factors recognised by the European Commission.

The numerical debt/GDP reduction rule, envisaged in the Six Pack of 2011, was applied

[18] See Ufficio parlamentare di bilancio, (2017) "2018 Budgetary Policy Report", December.
[19] European Commission (2017), "*Commission Opinion on the draft budgetary plan of Italy*", COM (2017) 8019 final.

[20] European Commission (2015), "*Making the best use of the flexibility within the existing rules of the stability and growth pact*", COM (2015) 12 final.

to Italy from 2013 to 2015 in the transitional formulation envisaged for Member States after the closure of an excessive deficit procedure.[21] Since 2016, the rule has been applied in its definitive form, as the three-year transition period has expired.

Compliance with the numerical rule in the transitional phase was achieved only in 2013. In 2014 the adjustment achieved was smaller than required. Accordingly, in February 2015 the Commission prepared a report pursuant to Article 126(3) of the TFEU, which concluded - after considering the relevant factors, including the unfavourable economic situation, low inflation, the expected implementation of ambitious structural reforms and compliance with the preventive arm of the SGP - that the debt criterion had nevertheless been respected despite the failure to comply with the numerical rule.

Overall, in the 2013-2015 period, Italy, on the basis of the transitory debt criterion, should have implemented a cumulative structural adjustment of 2.7 percentage points (0.9 points each year). In 2013-2014, the adjustment achieved was 0.1 percentage points, instead of 1.8 points.

In 2015, the correction was again smaller than that provided for in the transitional phase, i.e. 0.1, rather than the missing 2.6 percentage points for the three-year period. Therefore, in May 2016 the Commission prepared a new report pursuant to Article 126(3) of the TFEU, and, on the basis of the relevant factors, it again concluded that the debt criterion had been met, despite the failure to comply with the numerical rule.[22]

In the 2016 report, the Commission announced its intention to review its assessment concerning the debt rule in the light of the information available for 2016 (definitive accounts) and 2017. As a result, in February 2017 the Commission prepared a new report under Article 126(3) of the Treaty in which it requested the implementation of additional structural budgetary measures in 2017, equal to at least 0.2 percentage points of GDP, bearing in mind the fact that in 2016 the adjustment required to comply with the debt criterion is not been fully achieved either. Since the measures were effectively adopted by Italy in April 2017 with Decree Law 50/2017, in July 2017 the European Council, as part of its Recommendations to Italy, said that no further measures were necessary.

Looking ahead, despite the decline in the debt/GDP ratio forecast in the DBP, the reduction in the numerical rule for that ratio is never achieved in the period considered, either with the backward-looking criterion, the cyclically adjusted criterion until 2020 or the forward-looking criterion until 2018.[23] For an assessment, it is necessary to consider the evolution of the relevant factors (unfavourable economic times, low inflation, compliance with the preventive arm of the SGP), which in the past enabled the Commission to avoid opening a procedure for breach of the debt rule.

[21] The excessive deficit procedure for Italy was closed in 2013, after the deficit fell below the 3 per cent threshold in 2012.

[22] The relevant factors considered were the following: the adverse economic situation, the low rate of inflation, compliance with the preventive arm of the SGP and the expected implementation of structural reforms that would reduce the debt in the medium/long-term.

[23] Compliance with the rule using the forward-looking method in a given year is the equivalent of complying with the rule using the backward-looking approach two years after the reference year. For example, complying with the rule using the backward-looking approach in 2020 implies compliance with the rule in 2018 using the forward-looking criterion. This also means that given the current state of information it is not possible to assess compliance with the rule using the forward-looking approach for 2019-2020, because that would require projections for the debt/GDP ratio for 2021-2022.