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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of ITALY

Accompanying the document

COMMISSION OPINION

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1. INTRODUCTION

Italy submitted its Draft Budgetary Plan for 2015 on 16 October 2014, in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Italy is subject to the preventive arm of the Stability and Growth Pact (SGP) and should ensure sufficient progress towards its medium term objective (MTO) of a balanced budgetary position in structural terms. Since the Commission's preliminary analysis suggested that the submitted Draft Budgetary Plan (DBP) would envisage a significant deviation from the adjustment path towards the MTO, a letter was sent on 22 October 2014, consulting Italy on the reasons for the planned non-compliance with the requirements of the preventive arm of the SGP in 2015. In reply to the Commission letter, on 27 October 2014 the Italian authorities publicly announced further measures (worth EUR 4.53 bn or around 0.3% of GDP as indicated in Table 1 below) to improve the adjustment path towards the MTO and on 30 October 2014 sent updated tables incorporating them into the DBP (hereafter, "the updated DBP").

As the debt-to-GDP ratio was 122% in 2012 (the year in which Italy corrected its excessive deficit), exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit Italy is also subject to the transitional arrangements as regards compliance with the debt reduction benchmark. In this period it should ensure sufficient progress towards compliance.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission forecast. Section 3 presents the recent and planned fiscal developments, according to the updated DBP, i.e. including the measures announced by the Italian authorities on 27 October 2014, and an analysis of risks to their achievement based on the Commission forecast. In particular, it also assesses the measures underpinning the updated DBP. Section 4 assesses the recent and planned fiscal developments in 2014-2015 (also taking into account the risks to their achievement) against the obligations stemming from the SGP. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council on 8 July 2014, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

Table 1: additional measures announced by the government on 27 October 2014

Description of the measure	Estimated budgetary impact - ITALY (EUR bn)	Estimated budgetary impact – COM (EUR bn)
Allocation to deficit reduction of a Fund originally set to reduce the tax burden	+3.3	+3.3
Extension of the reverse charge mechanism (see Box 2) to the retail sector (EU authorisation needed). The expected resources are ensured through an increase of excise taxes as a safeguard clause.	+0.73	+0.73
Reduction of the share of domestic resources allocated to the co-financing of the EU cohesion funds that are exempted from the ceilings of the domestic stability pact applying to Regions.	+0.5	+0.5
Total	**+4.53**	**+4.53**
Total (% of GDP)	**+0.275**	**+0.275**

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The DBP significantly revised downward the 2014 real GDP outlook (see Box 1), with a 0.3% contraction compared to the 0.8% growth projected in Italy's 2014 Stability Programme in spring. Lower-than-expected export growth, given the slowdown in global trade in the first half of the year, together with persistently tight financing conditions (despite the repayment of trade debt arrears), has not triggered the expected recovery in investments, now projected to contract further in 2014. Weaker demand is in turn set to limit import growth relative to the Stability Programme expectations. After incorporating data up to the second quarter in ESA2010, the Commission forecast projects a slightly larger real GDP contraction in 2014 (0.4%), but with a similar composition. Moreover, Italy's DBP significantly revises downward 2014 HICP inflation to 0.4% from 0.9% in the 2014 Stability Programme (Commission's forecast: 0.2%).

For 2015, the DBP projects a much slower real GDP recovery than in the 2014 Stability Programme (0.6% vs. 1.3%), mainly explained by the downward revision of exports and investment. The Commission forecast expects the same real GDP growth as the DBP, but with a lower contribution from final domestic demand, compensated for by more dynamic exports. In particular, the Commission expects a more limited rise in private consumption and hence domestic demand, since employment is set to stabilise, whereas a lower exchange rate favours exports. Due to the expected weaker domestic demand, the Commission forecast for import growth is lower than in the DBP. In combination with stronger exports than in the DBP, the surplus vis-à-vis the rest of the world is higher in the Commission forecast (1.7% vs. 0.8% of GDP). Concerning price developments, both the Commission forecast and the DBP expect inflation to remain very low in 2015, around 0.5%, down from 1.2% in the 2014

Stability Programme. Unemployment is forecast to remain at very high levels by both the Commission and the Italian authorities.

The macroeconomic projections outlined in Italy's DBP appear realistic and broadly in line with the ones of the Commission, except for a slightly different composition of growth in 2015. Downside risks are related to further loss of momentum in the external demand revival. In addition, higher real interest rates would increase deleveraging pressures on the corporate and public sectors, in turn weighing on investment. On the positive side, growth prospects could benefit from a successful implementation of the reform process.

Box 1. The macroeconomic forecast underpinning the budget in Italy

The Draft Budgetary Plan (DBP) is based on a macroeconomic scenario already presented in the update of Italy's Economic and Financial Document (DEF) of 30 September 2014. The DEF presents a *trend scenario*, based on the hypothesis of unchanged legislation, and a *programme scenario* including the impact of the measures proposed in the DBP. Both macroeconomic scenarios have been prepared by the government and endorsed by the Parliamentary Budget Office (PBO), Italy's newly-established independent fiscal monitoring institution, in line with the July 2014 Council recommendation. These endorsements, mentioned in the DBP, took the form of two separate letters (dated 29 September 2014 and 10 October 2014, respectively) addressed to the Italian Minister of Economy and Finance and publicly available on the PBO's website. Both state that the respective forecast scenarios are "*within an acceptable interval given the information currently available*". It is also worth noting that, in a parliamentary hearing on 4 November 2014[1], the President of the PBO has confirmed the validity of the *programme scenario* underlying the DBP, even after the inclusion of the measures announced on 27 October 2014.

It is the first time that the government's macroeconomic assumptions underlying a budgetary document are assessed by a national independent monitoring institution. The functional autonomy of the PBO is secured by national provisions, in line with the requirements laid down in EU Regulation 473/2013. Its encompassing mandate, defined in the Italian Law 243/2012, includes the assessment of macroeconomic and budgetary forecasts and of the compliance with numerical budgetary rules.

The PBO was established by the Italian Constitutional Law 1/2012, as further detailed in Law 243/2012. The latter law also stipulates that the PBO: (i) shall operate with full autonomy and independence of judgement and assessment; (ii) is led by a Council of three members –one of which acts as President– with widely recognised independence, competence and experience; (iii) shall be granted access to all relevant government databases; (iv) is mandated to communicate autonomously to the public on a standalone website; (v) is adequately funded; (vi) can employ up to 40 staff members. In practice, the Council members were appointed in May 2014 for a six-year non-renewable term, a memorandum of understanding with the Ministry of Economy and Finance on the exchange of information was signed in September 2014, and staff recruitment is underway.

[1] See *Audizione preliminare nell'ambito dell'attività conoscitiva all'esame dei documenti di bilancio per il triennio 2015-17 del Presidente dell'Ufficio parlamentare di bilancio* at http://www.parlamento.it/application/xmanager/projects/parlamento/file/repository/ufficio_parlamentare_bilancio/Audizione_Presidente_UPB_04_11_2014.pdf

Table 2. Comparison of macroeconomic developments and forecasts

	2013	2014			2015		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	-1.9	0.8	-0.3	-0.4	1.3	0.6	0.6
Private consumption (% change)	-2.8	0.2	0.1	0.2	0.9	1.0	0.4
Gross fixed capital formation (% change)	-5.4	2.0	-2.1	-2.5	3.0	1.5	1.4
Exports of goods and services (% change)	0.6	4.0	1.9	1.5	4.4	2.8	3.4
Imports of goods and services (% change)	-2.7	2.8	1.8	1.3	4.4	3.4	2.7
Contributions to real GDP growth:							
- Final domestic demand	-2.9	0.5	-0.3	-0.5	1.1	0.7	0.4
- Change in inventories	0.0	-0.1	-0.1	0.1	0.0	0.0	0.0
- Net exports	0.9	0.5	0.1	0.1	0.2	-0.1	0.3
Output gap[1]	-4.2	-3.6	-4.1	-4.5	-2.7	-3.1	-3.4
Employment (% change)	-2.0	-0.6	-0.4	-0.5	0.8	0.3	0.1
Unemployment rate (%)	12.2	12.8	12.6	12.6	12.5	12.5	12.6
Labour productivity (% change)	-0.2	1.4	0.1	0.0	0.5	0.4	0.4
HICP inflation (%)	1.3	0.9	0.4	0.2	1.2	0.5	0.5
GDP deflator (% change)	1.4	1.0	0.8	0.4	1.2	0.6	0.5
Comp. of employees (per head, % change)	1.2	1.0	0.8	0.8	1.4	0.8	0.6
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	1.0	1.5	1.0	1.6	1.5	0.8	1.7

Note:

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

Source :

Stability programme 2014 (SP - ESA95); Draft Budgetary Plan 2015 (DBP - ESA2010); Commission 2014 autumn forecast (COM - ESA2010); Commission calculations.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The updated DBP projects the general government deficit to increase to 3.0% in 2014[2], from 2.8% of GDP in 2013 (ESA2010), whereas the 2014 deficit planned in the April Stability Programme was 2.6% of GDP, down from 3.0% in 2013 (ESA1995).

In 2014, the higher deficit reflects the downward revision of the projected primary surplus (to 1.7% of GDP vs. 2.6% in the Stability Programme), mainly explained by the worse-than-

[2] Neither the updated DBP nor the Commission forecast incorporated in the deficit figures the recent EU decision on additional own resources with which Italy is set to contribute to the EU budget due to the GNI revision under ESA2010 for the period 1995-2013. More specifically, the decision would imply an additional contribution of around 0.09% of GDP to be accrued in 2014, thereby increasing the risk of a deficit above 3% this year. By contrast, the lower resources called on to the EU budget would require a lower contribution of around 0.07% of GDP in 2014 or 2015. Overall, the decision will thus have a marginal net negative impact over 2014-2015.

expected economic developments. In addition, under ESA2010, the recognition of sizeable tax credits of banks related to past losses (Deferred Tax Assets) weighs more than anticipated on the deficit (by around 0.4% of GDP vs. 0.2%). However, interest expenditure in the updated DBP is lower than anticipated in the Stability Programme (4.7% of GDP vs. 5.2%), due to lower yields and the 0.2 pp. of GDP reduction implied by the netting out of swaps.

The Commission forecast also projects the 2014 deficit at 3.0% of GDP, based on a strict budgetary execution in the final months of the year.

For 2015, the updated DBP plans the government deficit to decline to 2.6% of GDP, which is substantially higher than in the Stability Programme (1.8% of GDP). Part of the difference (0.4 pp.) is explained by the worse starting position in 2014. An additional 0.4 pp. could be explained by the lower real GDP growth in 2015 (0.6% vs. 1.3%). The overall deficit-increasing impact entailed by the additional measures enshrined in the updated DBP accounts for around 0.4 pp. of GDP. All this is partially compensated by lower projected interest expenditure (0.5 pp.).

On the revenue side, in 2015, total revenues (in nominal terms) are projected to increase in line with nominal GDP growth (i.e. by 1.2%), thus remaining stable as a share of GDP. In terms of composition, the projected increase in current taxes on income as a share of GDP is compensated by lower social contributions as a result of the measures planned in the DBP (see section 3.3 below for further details).

On the expenditure side, in 2015 primary expenditure is projected to increase in nominal terms by 0.7% year-on-year, with an overall change in composition towards social transfers, which are affected by the permanent tax credit to low-wage employees. The decrease in intermediate consumption, subsidies, and capital transfers is due to the planned savings within the public administration (including local levels of government). The prolonged wage freeze explains why compensation of employees is projected to increase slightly in 2015 (see section 3.3 below for further details).

In structural terms[3], the government plans as enshrined in the updated DBP imply a deterioration of the balance in 2014 (-0.3 pp. of GDP) and a marginal improvement in 2015 (+0.3 pp. of GDP), with a (recalculated) structural position still in deficit in 2015.

In the Commission forecast, after incorporating the measures in the updated DBP, the deficit is expected to be at 2.7% of GDP in 2015, down from 3% in 2014. The forecast structural adjustment amounts to 0.1 pp. in 2015, following a structural deterioration of -0.1 pp. in 2014. The differences with respect to the 2015 updated DBP are mainly due to a more cautious assessment of specific measures enshrined in the updated DBP (e.g. fight against tax evasion through *adempimento volontario/spesometro* and additional revenues from gaming), whose budgetary outcome is characterised by marked uncertainty, not least in light of the relevance of the behavioural component therein. Other minor differences relate to the slightly different composition of growth and inflation outcomes between the Commission forecast and the DBP macroeconomic scenario in 2014-15.

Overall downside risks to these budgetary projections are associated with possibly worse-than-expected macroeconomic outcomes, including persistently low inflation, as well as to partial or inadequate implementation of the measures enshrined in the updated DBP. In addition, risks in term of the quality of the budgetary execution stem from the fact that lower

[3] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission services on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

transfers from the central government as part of the planned savings could partially translate into either lower capital expenditure or tax increases at subnational level (see section 3.3 below for further details).

Table 3. Composition of the budgetary adjustment

(% of GDP)	2013	2014			2015			Change: 2013-2015
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**47.7**	**47.9**	***47.7***	**47.8**	**47.8**	***47.7***	**47.7**	**0.0**
of which:								
- Taxes on production and imports	14.8	15.0	*15.2*	15.3	15.1	*15.2*	15.1	0.4
- Current taxes on income, wealth, etc.	14.9	15.3	*14.6*	14.6	15.2	*14.9*	15.0	0.0
- Capital taxes	0.3	0.1	*0.1*	0.1	0.1	*0.1*	0.1	-0.2
- Social contributions	13.3	13.6	*13.3*	13.3	13.6	*13.0*	13.0	-0.3
- Other (residual)	4.4	3.9	*4.5*	4.5	3.8	*4.5*	4.5	0.1
Expenditure	**50.5**	**50.6**	**50.8**	**50.8**	**49.9**	**50.3**	**50.4**	**-0.2**
of which:								
- Primary expenditure	45.7	45.4	46.1	46.1	44.9	45.8	45.9	0.1
of which:								
Compensation of employees	10.2	10.3	10.0	10.1	10.0	10.0	10.0	-0.2
Intermediate consumption	5.4	5.4	5.2	5.2	5.3	4.7	5.0	-0.7
Social payments	22.4	23.5	23.1	23.2	23.4	23.6	23.6	1.2
Subsidies	1.7	1.1	1.7	1.8	1.0	1.5	1.6	-0.2
Gross fixed capital formation	2.4	1.6	2.2	2.2	1.5	2.3	2.0	-0.1
Other (residual)	3.6	3.5	3.9	3.7	3.7	3.7	3.6	0.1
- Interest expenditure	4.8	5.2	4.7	4.7	5.0	4.5	4.5	-0.3
General government balance (GGB)	**-2.8**	**-2.6**	**-3.0**	**-3.0**	**-1.8**	**-2.6**	**-2.7**	**0.2**
Primary balance	**2.0**	**2.6**	**1.7**	**1.7**	**3.3**	**1.9**	**1.8**	**-0.1**
One-off and other temporary	0.2	0.0	0.3	0.3	-0.1	-0.1	-0.1	-0.3
GGB excl. one-offs	**-3.1**	**-2.6**	**-3.3**	**-3.3**	**-1.7**	**-2.5**	**-2.6**	**0.6**
Output gap[1]	-4.2	-3.6	-4.1	-4.5	-2.7	-3.1	-3.4	1.1
Cyclically-adjusted balance[1]	-0.6	-0.6	-0.8	-0.6	-0.3	-0.9	-0.9	-0.3
Structural balance (SB)[2]	**-0.8**	**-0.6**	**-1.1**	**-0.9**	**-0.2**	**-0.8**	**-0.8**	**0.0**
Structural primary balance[2]	4.0	4.6	3.6	3.8	4.8	3.7	3.7	-0.3

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Stability programme 2014 (SP - ESA95); Draft Budgetary Plan 2015 (DBP - ESA2010); Commission 2014 autumn forecast (COM - ESA2010); Commission calculations.

3.2. Debt developments

The 2013 debt-to-GDP ratio has been revised downward by 4.7 pps., to 127.9%, due to the switch to ESA2010. In the updated DBP, the government debt-to-GDP ratio (in ESA2010) is projected to be at 131.6% in 2014 (see Table 4), showing an increase of 3.7 pps. relative to 2013, compared to the 2.3 pps. rise projected in the Stability Programme, mainly because of lower nominal GDP growth. More specifically, the lower primary surplus projected in the DBP is insufficient to offset the significantly higher cost of debt service relative to growth (see snow-ball effect in Table 4), despite more favourable nominal interest rates.

In 2015, the debt-to-GDP ratio is projected to peak at 133.1%, with an increase of 1.5 pps. relative to the previous year. By contrast, the Stability Programme planned a decrease of 1.6 pps., mainly thanks to a significantly higher primary surplus and higher growth and inflation projected at that time, while interest expenditure was less benign for debt developments. According to the updated DBP, the debt ratio is projected to gradually decrease as of 2016, one year later than in the Stability Programme (to reach 124.3% in 2018).

In the Commission forecast, debt developments are broadly in line with those projected in the DBP, with the debt-to-GDP ratio also peaking in 2015, although at a slightly higher level of 133.8% of GDP, essentially due to lower inflation in both 2014 and 2015. In 2015, privatisation proceeds slightly below those planned by the government (0.5% vs. 0.7% of GDP) are included.

Table 4. Debt developments

(% of GDP)	2013	2014			2015		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**127.9**	**134.9**	**131.6**	**132.2**	**133.3**	**133.1**	**133.8**
Change in the ratio	5.6	2.3	3.7	4.3	-1.6	1.5	1.7
Contributions[2]*:*							
1. Primary balance	**-2.0**	**-2.6**	**-1.7**	**-1.7**	**-3.3**	**-1.9**	**-1.8**
2. "Snow-ball" effect	**5.5**	**3.0**	**4.1**	**4.6**	**1.8**	**3.0**	**3.1**
Of which:							
Interest expenditure	4.8	5.2	4.7	4.7	5.1	4.5	4.5
Growth effect	2.4	-1.0	0.4	0.5	-1.7	-0.8	-0.8
Inflation effect	-1.7	-1.2	-1.0	-0.6	-1.6	-0.8	-0.6
3. Stock-flow adjustment	**2.1**	**1.8**	**1.4**	**1.3**	**-0.1**	**0.5**	**0.4**
Of which:							
Cash/accruals difference	0.8	2.2	1.5	1.5	0.1	0.8	0.8
Net accumulation of financial assets	1.3	-0.2	0.0	-0.2	-0.4	-0.3	-0.4
of which privatisation proceeds	-0.1	-0.7	-0.3	0.0	-0.7	-0.7	-0.5
Valuation effect & residual	0.0	-0.2	-0.2	0.0	0.1	0.0	0.0

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source :

Stability programme 2014 (SP - ESA95); Draft Budgetary Plan 2015 (DBP - ESA2010); Commission 2014 autumn forecast (COM - ESA2010); Commission calculations.

3.3. Measures underpinning the DBP

Italy's updated DBP includes some expansionary provisions, such a reduction in the labour tax wedge, a revision of unemployment benefit system, as well as support to investments. Expenditure cuts and the increase in indirect taxes contribute to the partial financing of these measures. Overall, the foreseen policies imply a worsening in the headline budgetary position by around 0.4 pp. of GDP in 2015 compared to the authorities' trend scenario based on unchanged legislation, bringing it to the deficit target of 2.6% of GDP.

Among the main measures included in the updated DBP with a negative impact on the deficit are: (i) a reduction in the tax burden on labour due to the total deductibility of the labour component from the tax base of the regional tax on businesses (IRAP), with a net negative impact on revenues of 0.16% of GDP in 2015 and 0.27% in 2016; (ii) a three-year waiver for social security contributions payments for private employers hiring new workers under open-ended contracts by end 2015 (net negative impact on revenues of 0.11% of GDP in 2015 and 0.22% in 2016); (iii) a permanent tax credit recorded as social transfer ("monthly bonus of

EUR 80") to low-wage employees worth 0.6% of GDP as of 2015[4]; (iv) additional resources, worth altogether some 0.3% of GDP in 2015, destined to fund a revision of the unemployment benefit system also in light of the forthcoming *Jobs Act*, teachers' recruitment, the possibility for private sector employees so requesting to receive the severance pay instalments accruing each month in their pay packets, as well as a bonus to families with newly born children over 2015-2017.

On the financing side, among the measures enshrined in the updated DBP, more than 0.2% of GDP are projected to be raised mainly through the (permanent or temporary) extension of the *reverse charge* system for the payment of VAT (see Box 2) to four sectors foreseen in the EU legislation (construction, cleaning, green certificates, and gas) as well as to the retail sector and to the purchases made by the public administration (*split payment*). In the latter cases, however, since an EU authorisation is needed, a safeguard clause increasing excise duties on fuel as of 2015 is expected to ensure the planned resources (worth EUR 1.7 bn). Moreover, an increase in VAT rates and excise duties (0.8% of GDP in 2016, 1.2% of GDP in 2017, and 1.35% of GDP in 2018) is foreseen to guarantee the achievement of planned fiscal targets over the programme scenario. This measure may, however, be replaced by others having an equivalent budgetary impact.

Finally, a crucial component of the Italian budgetary strategy is related to the so-called *spending review*, projected to entail additional significant savings on the expenditure side, worth more than 0.5% of GDP in 2015, with the involvement of all levels of government. More specifically, around half of these savings is related to lower transfers to Regions and Provinces, while the rest of the savings is to be achieved through the rationalisation of central government expenditure. However, there is a risk that at least part of the reduced transfer from the central government might lead to higher local taxes and/or lower capital expenditure.

Box 2. The reverse charge mechanism

Italy's updated DBP includes a series of provisions, worth overall some 0.16% of GDP in 2015, aimed to increase revenues from value added tax (VAT), mainly through the (permanent or temporary) extension of the "reverse charge system" for the payment of VAT to four sectors foreseen in the EU VAT legislation (construction, cleaning, green certificates, and gas) as well as to the retail sector and to the purchases made by the public administration. In the latter cases, however, since an EU authorisation is needed, a safeguard clause increasing excise duties on fuel as of 2015 is expected to ensure the planned resources (worth EUR 1.7 bn).

The "reverse charge mechanism" for the payment of VAT (hereafter, *the reverse charge*) is applied as derogation to the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax ("the VAT Directive"), and consists in a shift of the liability to pay VAT from the supplier of the goods or services to the recipient of the supply.

In fact, the VAT Directive specifies that value added tax shall be payable by any taxable person carrying out transactions involving the taxable supply of goods or services (i.e. the supplier). However, in the case of cross-border transactions and for certain domestic sectors characterised by high risk of fraud, it explicitly allows for a shift of the obligation to pay VAT to the person to whom the supply is made (i.e. the recipient of the goods or services).

[4] Part of the financing of this measure (0.16% of GDP) had been earmarked to this end in the Decree Law 66/2014 and thus is already included in the trend scenario based on unchanged legislation.

The most important advantage of the reverse charge mechanism is that it makes the so called 'carousel fraud' impossible at any stage of the supply chain, except the retail level. In particular, VAT cannot be embezzled, to the extent that no VAT is charged and paid in Business to Business transactions.

On the other hand, amongst the shortcoming of the reverse charge are the following: i) it significantly moves away from the principle of 'fractioned payment' of VAT, whereby each taxable person in the chain pays a part of the total VAT amount; ii) the potential for fraud remains at the retail level in the presence of reverse charge, and the amount of the tax that can be defrauded increases because of the breach of the 'self-policing' principle of fractioned payment, which makes fraud potentially more profitable at the retail level; iii) when the reverse charge mechanism only applies to a limited range of goods and services, the carousel fraudsters are still able to carry out their activities by trading in other goods.

Finally, the introduction of a more generalised reverse charge mechanism could be expected to entail other types of fraud, which explains also why the Commission refused the request submitted by Austria and Germany for a general application of the reverse charge.

Amongst the situation in which Member States applied the reverse charge to specific sectors, positive experiences can be recorded in the construction sector, in business to business transactions (e.g. in Austria and Germany), as well as in the trade of mobile phones (e.g. in the UK). However, it is not possible to establish *ex ante* to what extent the reverse charge represents the most appropriate and efficient instrument to tackle VAT fraud also in different sectors.

Table 5. Main discretionary measures reported in the DBP

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2014	**2015**	**2016**
Taxes on production and	0	-0.13	0.55
Current taxes on income, wealth,	0	0.07	0.14
Capital taxes	n.a.	n.a.	n.a.
Social contributions	0	-0.11	-0.18
Property Income	n.a.	n.a.	n.a.
Other	0	0.12	-0.09
Total	0	-0.05	0.42

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan 2015

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2014	**2015**	**2016**
Compensation of employees	0	0.06	0.12
Intermediate consumption	0	-0.17	0
Social payments	0	0.54	-0.11
Interest Expenditure	n.a.	n.a.	n.a.
Subsidies	n.a.	n.a.	n.a.
Gross fixed capital formation	0	-0.06	0
Capital transfers	n.a.	n.a.	n.a.
Other	0	-0.07	0.06
Total	0	0.30	0.07

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan 2015

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Box 3. Council recommendations addressed to Italy

On 8 July 2014, the Council addressed recommendations to Italy in the context of the European Semester. In particular, in the area of public finances the Council recommended to Italy to:

(1) Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission 2014 spring forecast. In 2015, significantly strengthen the budgetary strategy to ensure compliance with the debt reduction requirement. Thereafter, ensure that the general government debt is on a sufficiently downward path; carry out the ambitious privatisation plan; implement a growth-friendly fiscal adjustment based on the announced significant savings coming from a durable improvement of the efficiency and quality of public expenditure at all levels of government, while preserving growth-enhancing spending like R&D, innovation, education and essential infrastructure projects. Guarantee the independence and full operationalisation of the fiscal council as soon as possible and no later than in September 2014, in time for the assessment of the 2015 Draft Budgetary Plan".

(2) Further shift the tax burden from productive factors to consumption, property and the environment, in compliance with the budgetary targets. To this end, evaluate the effectiveness of the recent reduction in the labour tax wedge and ensure its financing for 2015, review the scope of direct tax expenditures and broaden the tax base, notably on consumption. Consider the alignment of excise duties on diesel to those on petrol and their indexation on inflation, and remove environmentally harmful subsidies. Implement the enabling law for tax reform by March 2015, including by adopting the decrees leading to the reform of the cadastral system to ensure the effectiveness of the reform of immovable property taxation. Further improve tax compliance by enhancing the predictability of the tax system, simplifying procedures, improving tax debt recovery and modernising tax administration. Pursue the fight against tax evasion and take additional steps against the shadow economy and undeclared work.

4.1. Compliance with the debt criterion

Over 2013-2015, Italy is in a transition period for the assessment of compliance with the debt criterion. Under the projected unfavourable economic conditions (negative potential growth and low inflation), the required minimum linear structural adjustment (MLSA), based on the updated DBP would be 0.9 pp. and 2.2 pp. of GDP for 2014 and 2015 respectively. Starting from a structural balance of -0.8% of GDP in 2013, this adjustment would have implied reaching a structural surplus around 1% of GDP in 2015. Based on the Commission 2014 autumn forecast, which projects more subdued nominal growth and lower privatisation proceeds, the MLSA would have been even more stringent, at 1.2 pps. in 2014 and 2.5 pps. in 2015, well above the forecast structural adjustments in these years and implying a needed structural surplus of more than 1.5% of GDP in 2015, i.e. well above Italy's MTO[5]. By comparison, the respect of the debt rule at the MTO would require, *ceteris paribus*, a nominal GDP growth of around 3% (vs. a nominal potential growth estimated on average at 0.5% over 2014-2016).

[5] The achievement of a structural adjustment of 1.2 pps. of GDP in both 2014 and 2015 (i.e. the MLSA based on the Commission forecast), with a potential growth in nominal terms close to zero, would require ceteris paribus a decrease in nominal primary expenditure of around 5% over the two years.

In this context, policies fostering growth prospects, keeping current primary expenditure under strict control while increasing the overall efficiency of public spending, as well as the planned privatisations, would contribute to bring the debt-to-GDP ratio on a declining path consistent with the debt rule over the coming years.

Table 6. Compliance with the debt criterion*

	2013	2014		2015	
		DBP	COM	DBP	COM
Gap to the debt benchmark [1,2]	n.r.	n.r.	n.r.	n.r.	n.r.
Structural adjustment [3]	0.8	-0.3	-0.1	0.3	0.1
To be compared to:					
Required adjustment [4]	1.1	0.9	1.2	2.2	2.5

Notes:

[1] Not relevant for Member Sates that were subject to an EDP procedure in November 2011 and for a period of three years following the correction of the excessive deficit.

[2] Shows the difference between the debt-to-GDP ratio and the debt benchmark. If positive, projected gross debt-to-GDP ratio does not comply with the debt reduction benchmark.

[3] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[4] Defines the remaining annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (DBP) budgetary projections for the previous years are achieved and that GDP growth follows COM (DBP) forecast.

Source :

Stability programme 2014 (SP - ESA95); Draft Budgetary Plan 2015 (DBP - ESA2010); Commission 2014 autumn forecast (COM - ESA2010); Commission calculations.

* An ex-ante assessment of planned compliance with the debt criterion can be assessed based on the DBP only for the concerned countries providing extended data series in the DPB on a voluntary basis, as agreed at the EFC-A on 22 September.

4.2. Adjustment towards the MTO

The preventive arm of the SGP requires Member States with a general government debt ratio above 60% of GDP and experiencing 'bad times' that are not yet at their MTO to deliver a structural adjustment so as to make sufficient progress towards it. The updated DBP projects a (recalculated) structural deterioration of 0.3 pp. of GDP in 2014, followed by a 0.3 pp. of GDP improvement in 2015.

In 2014, exceptionally severe economic conditions, namely a real GDP contraction and a largely negative output gap larger than 4% of GDP, justified in the Commission's view that Italy is not required to fulfil the requirement of a structural adjustment towards the MTO. It is worth noting that, since 2008, Italy's economy has been in recession in five out of seven years, implying a historically unprecedented economic downturn, also significantly affecting the already slow potential growth[6].

[6] Compared to its pre-crisis peak in 2007, Italy's real GDP is expected in 2014 to have contracted by 8.6%. Besides, potential growth is now estimated to have been negative since 2009, and to remain so until 2016.

For 2015, the planned change in the structural balance highlights some deviation (gap below the -0.5 pp. threshold for significance) from the required adjustment towards the MTO over one year. The Commission 2014 autumn forecast points to the same conclusion, given the expected marginal improvement in the structural balance (0.1 pp.). In 2015, the expenditure benchmark points to a possible significant deviation of -0.7 pp. over one year, based on the Commission forecast, while only some deviation (-0.2 pp.) is projected by the updated DBP.

Over two years (2014-2015), both the Commission forecast and the updated DBP indicate a possible significant deviation (larger than the 0.25 pp. of GDP margin) as regards the structural balance pillar. The Commission forecast also points to some deviation (-0.2 pp.) as regards the expenditure benchmark pillar over these two years, while the updated DBP suggests that the net expenditure growth rate is in line with the benchmark.

Therefore, an overall assessment needs to be carried out as for Italy's compliance in 2015 with the preventive arm over both one and two years. Against this background, Italy might be at risk of a significant deviation from the required adjustment path towards the MTO.

More specifically, based on the Commission forecast, the expenditure benchmark shows a possible significant deviation over one year in 2015. However, this indicator is affected by the large volatility of specific items like taxation on banks, changes in one-offs, and the first year impact of cuts to the labour tax wedge. More in particular: i) corporate income tax revenues are expected to be particularly low in 2014 mainly due to the cleaning up of banks' balance sheets, while some recovery is expected in 2015. These developments negatively affect the expenditure benchmark in 2015, as additional revenues are not discretionary and thus treated as windfall taxes; ii) the policy stance underpinning the 2015 updated DBP, with a significant cut to the labour tax burden in line with the July 2014 Council recommendation, implies in the first year (i.e. 2015) a sizeable negative impact on discretionary revenue measures; iii) the same applies to the cut to the personal income tax to low-wage workers made permanent in 2015 (which is statistically recorded in social transfers, thus implying higher expenditure in that year). It is worth noting that this measure could translate into lower wage claims over the medium/long run, thus contributing to the country's competitiveness position; and iv) the change in one-offs relative to 2014, as lower one-off revenues (around 0.2% of GDP) negatively impact on discretionary revenue measures in 2015, while around 0.2% of GDP of one-off capital expenditure is set to finance works related to natural calamities (i.e. Abruzzi and Emilia earthquakes).

In terms of the structural balance pillar, the assessment over two years (2014-2015), based on the Commission 2014 autumn forecast, points to a significant deviation, even if at margin. It is worth noting that the estimated negative potential growth and low inflation play a crucial role in determining such a marginally negative outcome[7].

[7] It is worth noting that both the expenditure benchmark and the structural balance indicators are affected by the current unfavourable estimate of potential growth (-0.5% for the structural balance and 0% for the expenditure benchmark, computed using the 10-year average rate of potential growth) and a GDP deflator below 1%. In comparison, the average real GDP growth before the crisis was low but positive (1.5% on average between 1999 and 2007), while the GDP deflator averaged at around 2.4%. More specifically, the Commission forecast estimate of a flat nominal potential output growth in 2015 (-0.5% real and +0.5% GDP deflator) implies that, *ceteris paribus*, nominal primary expenditure should fall by more than 1% year-on-year in order to achieve a structural improvement of 0.5 pp. of GDP in 2015. By comparison, the Commission 2014 Spring forecast expected nominal potential growth of around 1.4% in 2015 (+0.1% real and +1.3% GDP deflator), which allowed a 0.5 pp. of GDP structural adjustment to be achieved even with a slight year-on-year increase (0.3%) in nominal expenditure.

After an overall assessment that takes into account adverse macroeconomic conditions and the implementation of fiscal structural reforms broadly consistent with the July 2014 Council recommendations, it appears that Italy's Draft Budgetary Plan would not meet the required structural adjustment towards the MTO and might thus be at risk of a significant deviation.

Table 7: Assessment of compliance with the preventive arm of the SGP

(% of GDP)	2013	2014		2015	
Initial position[1]					
Medium-term objective (MTO)	0.0	0.0		0.0	
Structural balance[2] (COM)	-0.8	-0.9		-0.8	
Structural balance based on freezing (COM)	-0.5	-0.8		-	
Position vis-a -vis the MTO[3]	Not at MTO	Not at MTO		Not at MTO	
(% of GDP)	**2013**	**2014**		**2015**	
	COM	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar					
Required adjustment[4]	0.0	0.0		0.5	
Change in structural balance[5]	0.6	-0.3	-0.1	0.3	0.1
One-year deviation from the required adjustment after considering the relevant factors[6]	0.6	-0.3	-0.1	-0.2	-0.4
Two-year average change in structural balance[5]	1.4	0.2	0.3	0.0	0.0
Two-year average deviation from the required adjustment after considering the relevant factors[6]	1.4	0.2	0.3	-0.25	-0.25
Expenditure benchmark pillar					
Applicable reference rate[7]	0.3	0.0		-1.1	
One-year deviation[8]	1.3	0.4	0.4	-0.1	-0.7
Two-year average deviation[8]		0.9	0.9	0.2	-0.2
Conclusion					
Conclusion over one year	Compliance	Overall assessment	Overall assessment	Overall assessment	Overall assessment
Conclusion over two years		Compliance	Compliance	Overall assessment	Overall assessment

Notes

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

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

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

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact, page 28.).

[5] Change in the structural balance compared to year t-1. Ex post assessment (for 2013) is carried out on the basis of Commission 2014 spring forecast.

[6] The difference of the change in the structural balance and the required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[7] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A lower rate applies as long as the country is adjusting towards its MTO, including in year t. The reference rates applicable to 2014 onwards have been updated in 2013.

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

Source :

Draft Budgetary Plan 2015 (DBP), Commission 2014 autumn forecast (COM), Commission calculations

5. IMPLEMENTATION OF FISCAL-STRUCTURAL REFORMS

Italy's progress in addressing all Country Specific Recommendations, including those recommending the implementation of fiscal structural reforms, is being assessed in the context of the Macroeconomic Imbalance Procedure, of which an update will be published shortly.

Beyond the establishment of an independent fiscal monitoring institution (see Box 1), Italy has taken some steps to reform the taxation system and reduce the tax wedge (see Box 4). The further reduction in the tax wedge on labour, on top of that already adopted in 2014 (see Box 4), is a step towards implementing the country-specific recommendation issued in July 2014 under the European Semester (see Box 3) to shift the tax burden away from the productive factors onto consumption and property. However, the recommended revision of tax expenditure and environmental taxation could finance a further reduction in labour taxes. The implementation of the enabling law on taxation – adopted by Parliament in February 2014 and which is a right step towards improving the efficiency in taxation – is progressing. Three enacting decrees have been adopted: a reform of cadastral committees (as a precondition for the reform of cadastral values to be completed by 2018), a simplification of the tax system, including through the introduction of pre-filled tax forms, and a revision of taxation on tobacco production and consumption. Two further enacting decrees, related to fiscal tutoring and cooperative compliance for large firms, as well as reduction in tax-related red tape for SMEs, are expected to be adopted before the expiry of the enabling law in March 2015.

Furthermore, the measures to improve the collection of VAT based on a *reverse charge* system, if results are in line with expectations, are consistent with the recommendation to enhance tax compliance and fight evasion. The new provision fostering tax compliance based on the cross-check of databases (*adempimento volontario/spesometro*) is potentially very promising, but its final outcome remains conditional on swift and effective implementation.

On the expenditure side, targeted cuts are made to central and local levels of government expenditure, potentially in line with the Council recommendation to pursue higher efficiency of public spending, which should eventually aim at making spending reviews a permanent feature of the budgetary process. As a result, large expenditure savings are planned as of 2015. However, additional sizeable savings and expenditure rationalisation are required in the following years to avoid at least in part the foreseen increases in indirect taxes.

The planned consolidation strategy tends to safeguard productive expenditure, as specific measures in the updated DBP also aim at supporting investment growth, for instance through tax deductions for R&D expenditure and the so-called *patent box*. However, as mentioned above, some of the savings at local level could entail lower capital expenditure.

Further structural reforms with a potential impact on the sustainability of public finances are also progressing, namely regarding labour market ('Jobs Act'), public administration, education, and the judicial system. Although ambitious in scope, the effectiveness of these reforms will depend on the outcome of the legislative process and implementation.

Box 4. Addressing the tax wedge

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed its commitment to effectively reduce the tax burden on labour. It will take stock of Member States' plans for reductions of the tax burden when discussing the Draft Budgetary Plans.

In the context of the European Semester, Italy was recommended to "further shift the tax burden from productive factors to consumption, property, and the environment, in compliance with the budgetary targets" and "to this end, evaluate the effectiveness of the recent reduction in the labour tax wedge and ensure its financing for 2015, review the scope of direct tax expenditures, and broaden the tax base, in particular on consumption".

The tax wedge in Italy is well above the EU average. For a single person without children earning 50% of the average wage, it was 41.6% compared to an EU average of 34% in 2013; at 67% of the average wage it was 44.7% (EU average: 37.7%) and for the average wage it was 47.8% (EU average: 41.1%). The Italian employment rate in 2013 was 59.8% against a 68.4% EU average.

The updated DBP foresees different provisions aimed to reduce the tax wedge on labour. First, it provides for a full deduction of the labour costs of employees under open-ended contracts from the taxable base of the regional tax on businesses (IRAP) in a permanent way. At the same time, however, it envisages the abrogation of the previous generalised reduction in IRAP rates, legislated in April 2014. The net impact, decreasing revenues by some 0.16% of GDP in 2015, would still be a reduction in labour costs for businesses, which could improve Italy's cost competitiveness in the short term. It is worth noting that, while IRAP is sometimes excluded from the computation of the tax wedge on labour *stricto sensu*, in so far as it is considered an indirect tax, it is included in other measurements of the overall tax burden on labour, including the implicit tax rate on labour (defined as the sum of all direct and indirect taxes and social contribution levied on employed labour income, as a percentage of total compensation of employees from national accounts).

Second, the updated DBP exempts private employers (with the exception of the agricultural sector and household services) from social security contributions for three years for the new personnel hired under open-ended contracts during 2015. The measure could help labour demand and thus job creation in the short term.

On top of these measures, the updated DBP plans to make permanent the tax credit recorded as social transfer ("monthly bonus of EUR 80"), worth some 0.6% of GDP per year, to low-wage employees, first enacted in April 2014 and financed only for that year. This is intended primarily to support private consumption, but, in the medium to long term, it could also have a positive impact on labour demand and competitiveness, to the extent that it translates into lower wage claims.

The Bank of Italy[8] estimates that the impact of the three aforementioned DBP measures would be, for employees with a gross wage one third below the national average (EUR 19,707), a permanent reduction in the total labour tax wedge by 4.6 pps of total labour cost

[8] See parliamentary hearing on 3 November 2014: *Audizione preliminare all'esame dei documenti di bilancio per il triennio 2015-2017. Testimonianza del Vice Direttore Generale della Banca d'Italia Luigi Federico Signorini*). https://www.bancaditalia.it/interventi/intaltri_mdir/signorini-031114/signorini-03112014.pdf

(1.3 pps. for employers and 3.3 pps. for employees). In case of newly-hired personnel with open-ended contracts, the new measures would imply a total exemption of private employers from any labour-related tax burden for three years. In the short term, the potential positive impact on growth of these measures could be at least partially offset by the spending savings and/or higher taxation on consumption needed to finance them. However, to the extent that the spending cuts effectively tackle the inefficiencies of Italy's public expenditure at all levels of government, preserving growth-enhancing spending like R&D, innovation, education, and essential infrastructure projects, long-term growth could be positively affected.

6. OVERALL CONCLUSION

After an overall assessment that takes into account adverse macroeconomic conditions and the implementation of fiscal structural reforms broadly consistent with the July 2014 Council recommendations, it appears that Italy's Draft Budgetary Plan would not meet the required structural adjustment towards the MTO and might thus be at risk of a significant deviation.

Based on the Commission forecast the transitional debt rule over the 2013-2015 would require an even more stringent structural effort, which is not met.

In this context, policies fostering growth prospects, keeping current primary expenditure under strict control while increasing the overall efficiency of public spending, as well as the planned privatisations, would contribute to bring the debt-to-GDP ratio on a declining path consistent with the debt rule over the coming years.