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COMMISSION OPINION

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GENERAL CONSIDERATIONS

1. Regulation (EU) No 473/2013 sets out provisions for enhanced monitoring of budgetary policies in the euro area for ensuring that national budgets are consistent with the economic policy guidance issued in the context of the Stability and Growth Pact (SGP) and the European Semester for economic policy coordination.

2. Article 6 of Regulation (EU) No 473/2013 requires Member States to submit annually to the Commission and to the Eurogroup a Draft Budgetary Plan presenting by 15 October the main aspects of the budgetary situation of the general government and its subsectors for the forthcoming year.

CONSIDERATIONS CONCERNING ITALY

3. On the basis of the Draft Budgetary Plan for 2017 submitted on 18 October 2016 by Italy, the Commission has adopted the following opinion in accordance with Article 7 of Regulation (EU) No 473/2013.

4. The Commission opinion is to be seen in light of the latest economic and budgetary data. In this context, as indicated in the Commission recommendation for a Council Recommendation on the economic policy of the euro area as well as in the Commission Communication 'Towards a positive fiscal stance for the euro area', it is important that the aggregate fiscal stance of the euro area is positive and supports the ongoing recovery, while ensuring the long-term sustainability of national public finances.

5. Italy is subject to the preventive arm of the SGP and should ensure sufficient progress towards its minimum medium-term budgetary objective (MTO) of 0% of GDP. In 2016, it should limit the temporary deviation from the required 0.5% of GDP adjustment towards the MTO to the amount of 0.75% of GDP, which was provisionally allowed for investments and the implementation of structural reforms, subject to the condition of resuming the adjustment path towards the MTO in 2017. In 2017, it should achieve an annual fiscal adjustment of 0.6% of GDP or more towards the MTO. As the debt ratio amounted to 132.3% of GDP in 2015, Italy must comply with the debt rule.

6. Overall, the macroeconomic projections outlined in Italy’s 2017 Draft Budgetary Plan appear plausible. Compared to the 2016 Stability Programme, Italy’s 2017 Draft Budgetary Plan revised real GDP growth for 2016 downward (to 0.8%), with private domestic demand set to be its main driver, while the GDP deflator growth was confirmed at 1%. The Commission 2016 autumn forecast is broadly in line with these projections (real GDP growth at 0.7% and GDP deflator growth at 1%). For 2017, the Draft Budgetary Plan also projects lower real GDP growth (at 1%) and GDP deflator growth (at 1%) compared to the 2016 Stability Programme, broadly in line with the Commission forecast (growth at 0.9% and GDP deflator increasing by 0.9%). The Draft Budgetary Plan expects the unemployment rate to decline more than the Commission forecast, albeit remaining at high levels. Downside risks to

these projections are related to a long-lasting slowdown in external demand, political uncertainty and slow adjustment of the banking sector.

7. Italy complies with the requirement of Regulation (EU) No 473/2013 that the draft budget has to be based on independently endorsed or produced macroeconomic forecasts. The macroeconomic forecasts underlying the Draft Budgetary Plan have been endorsed by Parliamentary Budget Office, Italy's independent fiscal monitoring institution as being "within an acceptable interval given the information currently available". The Parliamentary Budget Office assessed the government growth projections beyond 2017 as being close to the upper limit of its forecast range, therefore subject to downside risks. Specific provisions in the Italian legislation are meant to ensure the independence of the Parliamentary Budget Office.

8. Italy's 2017 Draft Budgetary Plan projects the general government deficit to decrease to 2.4% in 2016, down from 2.6% of GDP in 2015 and slightly higher than the 2.3% planned in the Stability Programme. For 2017, the Draft Budgetary Plan expects the government deficit to slightly decline to 2.3% of GDP, i.e. significantly above the Stability Programme target of 1.8% of GDP. The difference results mainly from deficit increasing measures worth 0.7% of GDP, envisaged in the Draft Budgetary Plan. The planned (recalculated) deterioration in the structural balance for 2016 (0.6% of GDP) is in line with the Stability Programme. For 2017, the (recalculated) structural balance is set to deteriorate by around 0.5% of GDP compared to a (recalculated) zero structural adjustment in the Stability Programme. The Draft Budgetary Plan projects the debt-to-GDP ratio to peak at 132.8% in 2016 and to slightly decline to 132.6% of GDP in 2017.

9. The fall in interest expenditure, since the peak reached in 2012, has decisively contributed to improve the structural balance between 2012 and 2015 but also partly offset some deterioration in the structural primary balance. In 2016 and 2017, the projected deterioration of Italy's structural balance is accompanied by more than proportional deterioration in the structural primary balance.

10. In its Draft Budgetary Plan for 2016 and its 2016 Stability Programme, Italy indicated that the budgetary impact of the exceptional inflow of refugees and of additional security costs related to the threat of terrorism are significant and should be considered as unusual events outside the control of the government, as defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97. The provisions set out in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97 cater for this additional expenditure, in that the inflow of refugees and the threat of terrorism are exceptional events, their impact on the country`s public finances is significant and sustainability would not be compromised by allowing for a deviation from the adjustment path towards the MTO. Specifically, Italy requested a temporary deviation from the adjustment path towards the MTO of 0.2% of GDP in 2016 in relation to exceptional security measures. However, the Commission provisionally assessed Italy to be eligible for an allowance of 0.06% of GDP in relation to costs considered by the Commission to have a clear and direct link to security. As regards the impact of the exceptional inflow of refugees, Italy requested a temporary deviation from the adjustment path towards the MTO of 0.2% of GDP in 2016, corresponding to the estimated annual cost (net of EU contributions) incurred in relation to the refugee crisis. However, the Commission provisionally assessed Italy to be eligible for an allowance of 0.04% of GDP for 2016, corresponding to the additional refugee-related expenditure incurred in that year compared to 2015. Italy's 2017 Draft Budgetary Plan confirmed these amounts. The Commission will make a

final assessment, including on the eligible amounts, in spring 2017 on the basis of notified data as provided by the authorities.

11. The Draft Budgetary Plan indicates that the draft budget for 2017 comprises exceptional expenditures amounting to about 0.4% of GDP, in relation to the ongoing refugee crisis and to a preventive investment plan for the protection of the national territory against seismic risks. As regards the exceptional inflow of refugees, the Draft Budgetary Plan confirms its projected budgetary impact at 0.2% of GDP in 2016 and at 0.22% of GDP for 2017. Through the Draft Budgetary Plan, the Italian authorities make the case for a further temporary deviation from the adjustment path towards the MTO of 0.16% of GDP in 2017, corresponding to the difference between the overall costs projected for 2017 and the average expenditure over 2011-2013, before the refugee crisis intensified. The Commission has applied flexibility in the past for the financial costs incurred by several Member States as a result of the refugee crisis. The European Council in October 2016 recognised the "significant contribution, also of financial nature, made by frontline Member States in recent years". In the case of Italy, the Commission granted temporary deviations amounting to 0.07% of GDP in relation to the additional costs incurred in 2015 and 2016. The Commission stands ready to consider an additional deviation in 2017 in due course. As regards earthquake-related expenditures, the Commission acknowledges that Italy has been facing unprecedented seismic activity in the past months. The DBP sets out expenditures related to the emergency management and to the so-called "preventive investment plan for the protection of the national territory against seismic risks". Due to the integrated nature of these expenditures, which makes the link between emergency and prevention intervention less clear-cut, as well as the reoccurrence of intense earthquakes, the Commission is ready to consider a broader approach when it comes to the specific treatment of earthquake-related expenditures, and will continue to work with the Italian authorities accordingly. Thus, the 0.18% of GDP earmarked by the government for this purpose in 2017 according to the authorities could be considered eligible for the "unusual event clause". For the following years, only positive incremental changes in resources earmarked for this purpose would be considered eligible for possible further temporary deviations. In relation to both the earthquake and migration-related expenditures, the Commission's assessment will require the necessary ex-ante and ex-post data to be provided by the Italian authorities.

12. The measures underpinning Italy's Draft Budgetary Plan have a net negative impact on the 2017 headline deficit of 0.7% of GDP at face value. Deficit-increasing measures include the repeal of a previously legislated VAT increase, a preventive investment plan for the protection of the national territory against seismic risks, additional expenditure for assistance and reconstruction following the recent earthquake, measures increasing pension expenditure, the renewal of public sector wage contracts and resources to increase spending on education. Deficit-reducing measures include provisions to increase tax compliance and fight tax evasion, the extension to end-July 2017 of the deadline for the "voluntary disclosure" of assets held abroad, the sale of broadband licences, and, among those of a structural nature, the rationalisation of ministries' expenditure and the reduction in the notional return on new equity capital or reinvested earnings exempted from the payment of corporate income tax under the so-called "allowance for corporate equity". A sizeable increase in VAT as of 2018, which may be replaced by other measures having an equivalent budgetary impact, is maintained in the Draft Budgetary Plan in order to formally safeguard the planned budgetary targets. Significant incentives

have been introduced to private investments, many of which will however impact the government balance only as of 2018.

Overall, the Commission considers that many deficit-decreasing measures in the Draft Budgetary Plan, for instance to increase tax compliance, have very uncertain impact due to the behavioural component entailed, and that many expansionary measures, for instance further increasing pension expenditure, may lead to an increase in demand in the short term, but arguably will not contribute to boost potential growth.

13. The Commission expects the headline deficit to be at 2.4% of GDP in both 2016 and 2017. The slightly higher headline deficit forecast by the Commission in 2017 compared to the Draft Budgetary Plan is due to lower nominal GDP growth and a more cautious assessment of some financing measures aimed at increasing tax compliance. The projected structural deterioration amounts to 0.5% of GDP in 2016, followed by a further deterioration of 0.5% in 2017. Overall, downside risks to both the Commission and the government budgetary projections are related to possibly worse than expected macroeconomic outcomes, including persistently low inflation, as well as to partial or inadequate implementation of the deficit-reducing measures in the Draft Budgetary Plan. The Commission forecast expects a somewhat higher debt-to-GDP ratio than in the Draft Budgetary Plan, at 133% in 2016 and 133.1% in 2017, mainly due to lower nominal GDP growth. Risks to the debt projections for 2017 are mainly related to a worse than anticipated growth outlook, lower privatisation intake, as well as lower inflation.

14. On 18 May 2016, the Commission issued a report under Article 126(3) TFEU, as Italy did not make sufficient progress towards compliance with the debt rule in 2015. The report concluded that, after the assessment of all relevant factors, the debt rule should be considered as complied with. Based on both the Draft Budgetary Plan and the Commission forecast, the debt rule is not expected to be respected in 2016 and 2017.

15. In 2016, the planned (recalculated) structural deterioration of 0.6% of GDP in the Draft Budgetary Plan points to some deviation from the required adjustment towards the MTO, after the full provisional allowance granted under the structural reform and investment clause is taken into account. The expenditure benchmark points instead to compliance. The discrepancy between the two indicators is mainly due to the fact that the expenditure benchmark benefits in 2016 from significant one-offs and the use of a GDP deflator based also on the Commission 2015 spring forecast, which was inflated by a legislated increase in VAT that was subsequently repealed. Overall, if the allowance of 0.75% of GDP is confirmed, Italy plans some deviation from the required adjustment towards the MTO in 2016. The same conclusion is reached on the basis of the Commission 2016 autumn forecast. However, a necessary condition to grant that allowance was Italy's resumption of the adjustment path towards the MTO in 2017, which does not appear to be fulfilled on the basis of both the Draft Budgetary Plan and Commission forecast. Moreover, while a final assessment will be possible only in spring 2017, preliminary information points to co-financed investment likely to be below the granted allowance of 0.25% of GDP in 2016. An overall assessment that excludes the additional 0.35% of GDP allowance granted in spring 2016 would indicate a risk of significant deviation from the adjustment path towards the MTO in 2016. This conclusion does not change when the additional budgetary impact of the exceptional inflow of refugees and of security costs related

to the threat of terrorism (overall 0.1% of GDP to be confirmed ex-post) is subtracted from the preventive arm requirement.

The Draft Budgetary Plan envisages a (recalculated) structural deterioration of 0.5% of GDP in 2017, which, compared to the improvement of 0.6% of GDP or more recommended by the Council country-specific recommendation, points to a risk of significant deviation from the adjustment path towards the MTO. This is also confirmed by the expenditure benchmark. The Commission forecast also points to a risk of significant deviation from the adjustment path towards the MTO in 2017. This conclusion does not change if the budgetary impact of the exceptional inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks (to be confirmed ex post) is subtracted from the preventive arm requirement.

16. Italy has taken steps to reduce the labour tax wedge and reform the taxation system at large. As regards the former, Italy's 2017 Draft Budgetary Plan envisages lower tax rates on productivity premia to incentivise decentralised bargaining; the exemption from the payment of social security contributions for employers hiring students who previously took part in traineeship programmes in the same firm, and for farmers below the age of 40; and the reduction of the rate of social security contributions for the self-employed. However, the recommended reform of cadastral values and all-encompassing revision of tax expenditures have not been implemented. A reform of the budgetary process has been recently adopted to make the spending review an integral part of it across all levels of government, as recommended, but full implementation will be needed to this aim.

17. Overall, the Commission is of the opinion that the Draft Budgetary Plan of Italy, which is currently under the preventive arm and subject to the debt rule, is at risk of non-compliance with the provisions of the SGP. In particular, according to the Commission 2016 autumn forecast there is a risk of significant deviation from the required adjustment path towards the MTO in 2017. Moreover, without the full allowance of 0.75% of GDP granted under the structural reform and investment clause, the Commission 2016 autumn forecast would point to a risk of significant deviation from the required adjustment path towards the MTO also in 2016. In line with the Commission Communication 'Towards a positive fiscal stance for the euro area', the Commission therefore invites the authorities to take the necessary measures within the national budgetary process to ensure that the 2017 budget will be compliant with the SGP.

The Commission is also of the opinion that Italy has made some progress with regard to the structural part of the fiscal country-specific recommendation issued by the Council in the context of the 2016 European Semester and thus invites the authorities to make further progress. A comprehensive assessment of progress made in the implementation of the country-specific recommendations will be made in the 2017 Country Reports and in the context of the country-specific recommendations to be adopted by the Council in 2017.

Done at Brussels, 16.11.2016

For the Commission
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