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REPORT FROM THE COMMISSION

Italy

Report prepared in accordance with Article 126(3) of the Treaty

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1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (TFEU) lays down the excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure¹, which is part of the Stability and Growth Pact (SGP). Specific provisions for euro area Member States under EDP are laid down in Regulation (EU) No 473/2013².

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3 % (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b) whether the ratio of government debt to GDP exceeds the reference value of 60 % (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 126(3) TFEU stipulates that, if a Member State does not fulfil the requirements under one or both of the above criteria, the Commission has to prepare a report. This report also has to “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

This report, which represents the first step in the EDP, analyses Italy's compliance with the debt criterion of the Treaty, with due regard to the economic background and other relevant factors.

Following the amendments to the SGP in 2011, the debt requirement has been put on an equal footing with the deficit requirement in order to ensure that, for countries with a debt-to-GDP ratio above the 60% reference value, the ratio is brought below (or sufficiently declining towards) that value. Article 2(1a) of Regulation (EC) No 1467/97 stipulates that Member States that were subject to an excessive deficit procedure on 8 November 2011 benefit from a three-year transition period, starting in the year following the correction of the excessive deficit, during which they are expected to make sufficient progress towards compliance with the debt reduction benchmark. In the case of Italy, the transition period

¹ OJ L 209, 2.8.1997, p. 6. The report also takes into account the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 3 September 2012, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/legal_texts/index_en.htm.

² Regulation (EU) No 473/2013 of the European Parliament and of the Council on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area (OJ L 140, 27.5.2013, p. 11).

covers the years 2013-2015 (i.e. 3 years after the correction of the excessive deficit³). The "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes" of 3 September 2012 spell out how the requirement for the structural balance is defined and assessed. In particular, they define a minimum linear structural adjustment of the structural balance (MLSA) ensuring that the debt reduction benchmark is met by the end of the transition period.

On 13 January 2015 the Commission adopted a Communication on Flexibility, providing new guidance on how to apply the existing rules of the Stability and Growth Pact, in order to strengthen the link between effective implementation of structural reforms, investment, and fiscal responsibility in support of jobs and growth. The Communication does not amend any provision of the Pact but aims to further reinforce the effectiveness and understanding of its rules and develop a more growth-friendly fiscal stance in the euro area by ensuring the best use of the flexibility enshrined within the Pact, while preserving its credibility and effectiveness in upholding fiscal responsibility. In particular, the Communication clarified that – in line with the provisions of Article 2(3) of Regulation (EC) No 1467/97 - the Commission – in the context of a report according to Article 126(3) TFEU - will analyse carefully all relevant medium-term developments regarding the economic, budgetary and debt positions. It has also clarified that the implementation of structural reforms in the context of the European Semester is to be considered among these relevant factors⁴.

On 27 February 2015, the Commission issued a Report under Article 126(3) TFEU, as Italy was not expected to make sufficient progress towards compliance with the debt rule in 2014, including the assessment of all relevant factors that might justify the *prima facie* lack of compliance, notably: (i) the unfavourable economic conditions, and in particular low inflation, which made the respect of the debt rule particularly demanding; (ii) the expectation that compliance with the required adjustment towards the Medium Term budgetary Objective (MTO) was broadly ensured; and (iii) the expected implementation of ambitious growth-enhancing structural reforms in line with the authorities' commitment, which was expected to contribute to debt reduction in the medium/long term. Data notified by the authorities on 1 April 2016⁵ and subsequently validated by Eurostat⁶ show that Italy's general government deficit declined to 2.6% of GDP in 2015 (from 3% in 2014), while the debt continued to rise, although marginally, to 132.7% of GDP (from 132.5% in 2014), i.e. above the 60% of GDP reference value. For 2016, Italy's 2016 Stability Programme plans a debt-to-GDP ratio start declining to 132.4%. In 2017, the debt-to-GDP ratio is planned to decrease further to 130.3%.

³ Council Decision 2013/314/EU of 21 June 2013 abrogating Decision 2010/286/EU on the existence of an excessive deficit in Italy. All EDP-related documents for Italy can be found at:

http://ec.europa.eu/economy_finance/economic_governance/sgp/corrective_arm/index_en.htm

⁴ Article 2 of Regulation (EC) No 1467/97 provides that "[...] The report shall reflect, as appropriate [...] the implementation of policies in the context of the prevention and correction of excessive macroeconomic imbalances, the implementation of policies in the context of the common growth strategy of the Union [...]".

⁵ According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Italy can be found at:

http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/excessive_deficit/edp_notification_tables.

⁶ Eurostat news release No 76/2016 of 21 April 2016, available at:

<http://ec.europa.eu/eurostat/documents/2995521/7235991/2-21042016-AP-EN.pdf/50171b56-3358-4df6-bb53-a23175d4e2de>

Based on the notified data and the Commission 2016 spring forecast, Italy did not make sufficient progress towards compliance with the debt reduction benchmark in 2015 (see Table 1), since the change in the structural balance⁷ falls short of the required MLSA by a large extent in 2015 (0.1 percentage points of GDP compared to the required MLSA of 2.6 percentage points of GDP). In the 2016 Stability Programme, the Italian authorities do not plan to fully comply with the debt rule in 2017 in its forward-looking dimension, although the gap is small in that year (i.e. 0.2 percentage points of GDP) also thanks to an ambitious privatisation plan. Projections based on the Commission 2016 spring forecast expect compliance with the debt rule only by 2020, under a no-policy-change assumption until 2017 and assuming thereafter an annual structural effort of 0.6% of GDP until the MTO is attained.

Table 1: General government deficit or/and debt (% of GDP)^a

		2013	2014	2015	2016		2017	
					COM	MS	COM	MS
Deficit criterion	General government balance	-2.9	-3.0	-2.6	-2.4	-2.3	-1.9	-1.8
Debt criterion	General government gross debt	129.0	132.5	132.7	132.7	132.4	131.8	130.3
	Gap to the debt reduction benchmark	n.r.	n.r.	n.r.	5.6	3.0	4.7	0.2
	Change in structural balance	0.4	-0.2	0.1	-0.7	-0.6	0.0	0.0
	Required MLSA	0.9	1.2	2.6	n.r.	n.r.	n.r.	n.r.

Notes:

^a In percent of GDP unless otherwise specified

Source: Commission services, Italy's 2016 SP and Commission 2016 spring forecast

Overall, Italy's insufficient progress towards compliance with the debt reduction benchmark in 2015 provides evidence of a *prima facie* existence of an excessive deficit in the sense of the Stability and Growth Pact before, however, considering all factors as set out below.

The Commission has therefore prepared the following report to comprehensively assess the departure from the debt rule, while considering all the relevant factors. Section 2 of the report examines the deficit criterion. Section 3 examines the debt criterion. Section 4 deals with public investment and other relevant factors, including the assessment of compliance with the required adjustment path towards the MTO. The report takes into account the Commission 2016 spring forecast, released on 3 May 2016, and the Commission's evaluation of subsequent developments.

2. DEFICIT CRITERION

Italy's general government deficit was reported at 2.6% of GDP in 2015. According to both the 2016 Stability Programme and the Commission 2016 spring forecast, it is also foreseen to respect the 3% of GDP Treaty reference value during the period 2016-2017. Namely, according to the Commission 2016 spring forecast, the deficit is expected to further decline to 2.4% of GDP in 2016 and to 1.9% in 2017, on a no-policy change basis and taking into

⁷ Throughout the document, all references to changes in the structural balance refer to the cyclically adjusted balance net of one-off and temporary measures, either forecast by the Commission or recalculated by the Commission on the basis of the information provided in the Stability Programme, using the commonly agreed methodology.

account the government commitment to repeal the VAT hike legislated for 2017 through the 2016 Stability Law, conditional however upon implementing deficit reduction measures to ensure the achievement of the planned 1.8% of GDP deficit target (from a trend of 1.4% that includes the full VAT hike).

The forecast decrease in the deficit in 2016 mainly reflects positive GDP growth and declining interest expenditure, while low inflation still weighs on the primary surplus; it also takes into account the existence of some reserves in the budget (including a so-called “*fondo per le esigenze indifferibili*”, amounting to around EUR 0.7 bn), which the government should, however, not spend if it wants to achieve its deficit target. The 2016 Stability Programme projects the general government deficit-to-GDP ratio to decline to 2.3% in 2016 and to 1.8% in 2017. The small difference with the Commission 2016 spring forecast is mainly explained by lower tax revenues in 2016, also related to slightly weaker nominal GDP growth in the Commission 2016 spring forecast (1.9% vs. 2.2%).

3. DEBT CRITERION

In 2015, the government debt-to-GDP ratio peaked at 132.7%, 0.2 percentage points higher than in 2014. For 2016, in the Stability Programme, the debt-to-GDP ratio is projected at 132.4%, therefore showing a slight decrease of 0.3 percentage points relative to 2015.

The determinants of the slight increase in the debt-to-GDP ratio in 2015 were the following. Despite positive real GDP growth (0.8%) after three years of recession, low inflation (GDP deflator growth of 0.8%) led to a real implicit interest rate on the debt⁸ that, while gradually narrowing (to around 2.5%, from 2.8% in 2014), still remained significantly higher than real GDP growth. Real spot interest rates on new government securities issuances close to zero in 2015 are in fact only gradually passing through into the real servicing cost of the outstanding debt stock, given the duration of the Italian debt and the roll-over period (see also Graph 1). In this context, the “snowball” effect (see Table 2), continued entailing a large debt-increasing impact (at still 2.2% of GDP, down from 4% in 2014). On the other hand, a stable primary surplus (1.6% of GDP, the same as in 2014) and a debt-decreasing stock-flow adjustment (-0.4% of GDP) helped curb debt dynamics in 2015. In particular, the stock-flow adjustment benefitted from the debt-decreasing impact of privatisation proceeds (0.4% of GDP) and the reduction of the liquidity buffer accumulated in previous years (0.7% of GDP) but was negatively affected by the debt-increasing impact of derivative contracts (0.4% of GDP) settled before the crisis, mainly in order to fix interest rates on part of the debt (at around 4.4% on average) and thus limit possible risks related to higher refinancing costs.⁹

Regarding 2016, the Stability Programme projects a slight decrease in the debt-to-GDP ratio, to 132.4%. The decline would be mainly driven by a marginally higher primary surplus (at 1.7%) and a lower debt-increasing impact of the “snow-ball” effect (of 1.2 percentage

⁸ The implicit real cost of debt at time t can be defined as the nominal yield paid by the government to service the outstanding debt at time $t-1$, net of the impact of inflation at time t . In Table 2, the yearly change in debt-to-GDP ratio due to the implicit real cost of debt can be obtained by adding the respective contributions from interest expenditure (debt-increasing) and GDP deflator (debt-decreasing).

⁹ See also *Public Debt Report 2014*, Italian Ministry of the Economy and Finance, retrievable at www.dt.tesoro.it/export/sites/sitodt/modules/documenti_en/debito_pubblico/presentazioni_studi_relazioni/Public_Dept_Report_2014.pdf and *Indagine conoscitiva sugli strumenti finanziari derivati* (2015), retrievable at www.dt.tesoro.it/export/sites/sitodt/modules/documenti_it/debito_pubblico/presentazioni_studi_relazioni/Audizione_alla_Camera_dei_Deputati_-_febbraio_2015_-_Indagine_conoscitiva_sugli_strumenti_finanziari_derivati.pdf

points). This would, in particular, benefit from higher real GDP growth and a lower debt-increasing impact of implicit real interest rates (by 2.7 percentage points, as indicated by the difference between interest expenditure and inflation effect in Table 2). The stock-flow adjustment is projected by the Stability Programme to have a minor debt-increasing impact in 2016, as the planned privatisation proceeds (0.5% of GDP) are more than offset by debt-increasing “below-the-line” transactions, including in derivatives by around 0.4% of GDP. The debt ratio is projected to further decrease in the outer years of the programme and reach 123.8% of GDP in 2019 thanks to a steadily increasing primary surplus, a “snow-ball” effect becoming debt-decreasing as the GDP deflator accelerates towards the ECB inflation target, and further privatisation proceeds (0.5% of GDP per year over 2016-2018 and 0.3% in 2019). In the 2016 Stability Programme, the debt rule is projected not to be fully complied with in 2017 (in its forward-looking dimension), although with a small gap in that year.

In the Commission 2016 spring forecast, debt developments in 2016 and 2017 are slightly less benign than in the Stability Programme. The debt-to-GDP ratio is set to stabilise in 2016, mainly due to lower inflation (GDP deflator growth of 0.8%) than in the government projections. In 2017, the Commission 2016 spring forecast expects a smaller decrease in the debt-to-GDP ratio than the Stability Programme (of -1.0%, vs. -1.5%), due to a less favourable assessment of the stock-flow adjustment (0.4%, vs. -0.1%), also related to lower privatisation proceeds (at 0.3%, vs. 0.5%), whose details are not yet available. Overall, based on the Commission 2016 spring forecast, the debt rule is not expected to be complied with by 2017. Commission projections expect compliance with the debt rule only by 2020 in its forward-looking dimension (i.e. as of 2022), under a no-policy-change assumption until 2017 and assuming full compliance with the fiscal effort required under the preventive arm of the Stability and Growth Pact as of 2018 (i.e. an annual fiscal effort of 0.6% of GDP until the MTO is achieved).

Table 2: Debt dynamics ^a

	2013	2014	2015	2016		2017	
				COM	MS	COM	MS
Government gross debt ratio	129.0	132.5	132.7	132.7	132.4	131.8	130.9
Change in debt ratio ^b (1 = 2+3+4)	5.7	3.5	0.2	0.0	-0.3	-1.0	-1.5
<i>Contributions:</i>							
• Primary balance (2)	-1.9	-1.6	-1.6	-1.6	-1.7	-1.9	-2.0
• “Snowball” effect (3)	5.5	4.0	2.2	1.5	1.2	0.5	0.6
<i>of which:</i>							
Interest expenditure	4.8	4.6	4.2	4.0	4.0	3.8	3.8
Real GDP growth	2.2	0.4	-1.0	-1.4	-1.6	-1.7	-1.8
Inflation (GDP deflator)	-1.5	-1.0	-1.0	-1.1	-1.3	-1.6	-1.4
• Stock-flow adjustment (4)	2.1	1.1	-0.4	0.1	0.2	0.4	-0.1
<i>of which:</i>							
Cash/accruals difference	1.0	0.1	0.1	0.4	0.4	0.1	0.1
Net accumulation of financial assets	1.1	0.9	-0.5	-0.3	-0.2	0.3	-0.2
<i>of which privatisation proceeds</i>	-0.1	-0.2	-0.4	-0.2	-0.5	-0.3	-0.5
Valuation effect & residual	0.0	0.0	0.0	0.0	-0.1	0.0	-0.1

Notes:

^a In percent of GDP unless otherwise specified

^b The change in the gross debt ratio can be decomposed as follows:

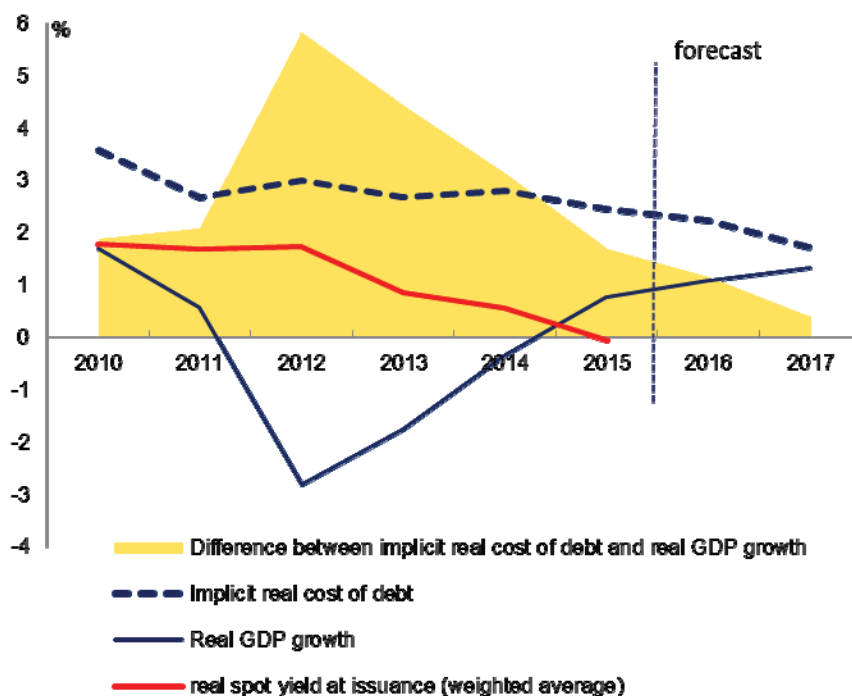
$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left(\frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the “snow-ball” effect, measuring the combined effect of interest expenditure and economic growth on the debt ratio.

Source: Commission services, Italy's 2016 SP and Commission 2016 spring forecast

As shown in Graph 1, the expected recovery in real GDP growth (see solid blue line) and the decrease in implicit real debt servicing costs (see dashed blue line), only gradually reflecting the lower real spot yields at issuance (see red line), imply a shrinking “snowball” effect (see yellow shade) in 2016 and 2017, compared to the previous years. However, as the real financing cost is still higher than the real GDP growth, the overall impact is still debt-increasing.

Graph 1: Drivers of “snowball effect” on government debt



Following the abrogation of the EDP in June 2013, Italy is subject to a three-year transition period to comply with the debt reduction benchmark, which started in 2013. In order to ensure continuous and effective progress towards compliance during the transition period, Member States should respect simultaneously the two conditions below:

- a. First, the annual structural adjustment should not deviate by more than $\frac{1}{4}\%$ of GDP from the minimum linear structural adjustment (MLSA) ensuring that the debt rule is met by the end of the transition period.
- b. Second, at any time during the transition period, the remaining annual structural adjustment should not exceed $\frac{3}{4}\%$ of GDP (unless the first condition implies an annual effort above $\frac{3}{4}\%$ of GDP, which is the case for Italy).

Based on the Commission 2016 spring forecast, a surplus in the structural balance of around 1.5% of GDP, i.e. well above Italy’s MTO of a balanced budget in structural terms, would have been needed to meet the debt reduction benchmark in 2015, given an annual MLSA of 2.6 percentage points in 2015¹⁰. Instead, Italy’s structural balance is estimated to have

¹⁰ As indicated in Section 4, based on the Commission 2014 spring forecast, on which the Council based its fiscal recommendation to Italy at that time, the required MLSA was set at 0.7% of GDP in 2014 and 1.4% of GDP in 2015 (taking into account the structural adjustment forecast for 2014). Once recomputed on the basis of the Commission 2016 spring forecast, the required MLSA becomes substantially higher: 1.2% of GDP in 2014 and, due to the 0.2 percentage point deterioration occurred in 2014, 2.6% of GDP in 2015.

improved by 0.1 percentage points of GDP in 2015, to -1% of GDP, therefore falling substantially short of the requirements of the transition period for the debt reduction benchmark (see Table 1). In 2016, neither the 2016 Stability Programme nor the Commission 2016 spring forecast expect compliance with the debt rule, given the large gap to the debt benchmark (in its forward-looking dimension) of, respectively 3% and 5.6% of GDP.

The overall analysis above thus suggests that *prima facie* the debt criterion in the sense of the Treaty and Regulation (EC) No 1467/97 appears not to be fulfilled based on the 2016 Stability Programme as well as the Commission 2016 spring forecast before, however, consideration is given to all relevant factors as set out below.

4. RELEVANT FACTORS

Article 126(3) TFEU provides that the Commission report “*shall also take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State*”. These factors are further clarified in Article 2(3) of Council Regulation (EC) No 1467/97, which also specifies that “*any other factors which, in the opinion of the Member State concerned, are relevant in order to comprehensively assess compliance with deficit and debt criteria and which the Member State has put forward to the Council and to the Commission*” need to be given due consideration.

In case of apparent breach of the debt criterion, the analysis of the relevant factors is particularly warranted given that debt dynamics are influenced by factors outside the control of the government to a larger extent than in case of the deficit. This is recognised in Article 2(4) of Regulation (EC) No 1467/97, which stipulates that the relevant factors shall be taken into account when assessing compliance on the basis of the debt criterion irrespective of the size of the breach.

In this respect, at least the following three main aspects need to be considered when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability.

1. Adherence to the MTO or the adjustment path towards it: the achievement of the MTO or the progress towards it is supposed, under normal macroeconomic circumstances, to ensure sustainability or rapid progress towards sustainability at least in the medium term. By construction, the country-specific MTO takes into account the debt level and implicit liabilities. Compliance with the MTO or the adjustment path towards it should ensure in the medium term convergence of the debt ratios towards prudent levels.
2. Structural reforms, already implemented or detailed in a structural reform plan: the rationale for taking into account these reforms is that through their impact on growth they are expected to enhance sustainability in the medium term, contributing to bring the debt-to-GDP ratio on a satisfactory downward path.

Adherence to the MTO (or the adjustment path towards it) along with implementation of structural reforms (in the context of the European Semester) is expected to bring debt dynamics on a sustainable path, through the combined impact on the debt level itself (through the achievement of a sound budgetary position at the MTO) and on economic growth (through the reforms).

3. Besides these two main factors, the still unfavourable macroeconomic conditions, and in particular very low inflation can hamper the reduction of the debt-to-GDP ratio and make compliance with the SGP provisions particularly demanding, and thus needs to be taken into account. In fact, the current low-inflation environment requires the concerned Member States to achieve more demanding structural adjustments to comply with the MLSA under the transitional debt rule and negative inflation surprises have contributed to the upward revisions of the required MLSA over time. In addition, the transitional debt rule assumes by construction that GDP deflator growth only returns to the long-term average value of 2% by 2020, which makes compliance with the forward-looking debt rule particularly demanding.

Under such conditions, adherence to the MTO or the adjustment path towards it (as spelled out in point 1) is a key relevant factor in assessing compliance with the debt criterion. It is worth noting that, while a structural balanced budgetary position ensures debt sustainability in principle, in the case of Italy attaining the MTO would ensure compliance with the debt reduction benchmark only in the presence of nominal growth of around 3%¹¹.

In view of the above provisions, the following subsections consider in turn: (1) the medium-term budgetary position, including an assessment of compliance with the required adjustment towards the MTO; (2) the medium-term economic position, including public investment and the state of play in terms of implementation of structural reforms; (3) other factors put forward by the Member State; (4) the developments in the medium-term government debt position, including its sustainability prospects, and other factors deemed relevant by the Commission.

4.1. Medium-term budgetary position

The assessment of Italy's compliance with the preventive arm in 2016 hinges crucially upon the Commission assessment on whether to allow a temporary deviation from the adjustment path towards the MTO. These considerations are reported in the first subsection. On this basis, the following subsection features the overall assessment of Italy's compliance with the required adjustment path towards the MTO. Namely, Italy appears to be broadly compliant with the required preventive arm adjustment in 2015 and 2016, once all the requested flexibility is granted.

Assessment of requests for deviating from SGP requirements

For 2015, Italy benefitted from a temporary allowance related to the enhanced consideration of relevant cyclical conditions introduced by the 2015 Flexibility Communication. In fact, Member States considered by the Commission to be in “very bad times” (i.e. with an output gap estimated to be between -4% and -3% of potential GDP), as it was the case for Italy based on the Commission 2015 spring forecast¹², and with a general government debt-to-GDP ratio above 60% are recommended to deliver a structural adjustment of 0.25% of GDP in order to make sufficient progress towards their MTO.

For 2016, Italy requested additional admissible temporary deviation pursuant to 2015 Flexibility Communication, in addition to the already granted allowance of 0.4 % of GDP

¹¹ For comparison, Italy's nominal GDP growth averaged around 4% over 1999-2007, i.e. before the crisis.

¹² See Commission Opinion C(2015) 8105 final.

from the preventive arm requirement under the structural reform clause¹³, whereby the country was recommended in July 2015 to deliver a structural effort of 0.1 percentage points of GDP in 2016, in lieu of the benchmark adjustment of 0.5 percentage points of GDP. Namely, Italy's 2016 Draft Budgetary Plan requested an additional allowance of 0.4% of GDP for 2016, of which 0.3% under the investment clause and additional 0.1% under the structural reform clause. Italy also invoked an allowance in relation to the government expenditure incurred to face the inflow of refugees over 2015-2016 and included in the 2016 Stability Law a package of extraordinary security-related expenditure, amounting to around EUR 3 bn or 0.2% of GDP.

The Commission opinion on Italy's 2016 Draft Budgetary Plan¹⁴ announced that it would assess Italy's possible eligibility for admissible temporary deviation under the SGP on the basis of: (i) the existence of credible plans for the resumption of the adjustment path towards the MTO; (ii) whether a deviation from the adjustment path is being effectively used for the purposes of increasing investments; and (iii) progress with the structural reform agenda, taking into account the Council recommendations. These conditions are discussed in order.

As regards condition (i), in a letter to the Commission¹⁵, the Italian government publicly declared its intention to resume its adjustment path towards the MTO beyond 2016, by committing to repeal the legislated VAT hike for 2017 "*conditional upon implementing deficit reduction measures to comply with the preventive arm of the SGP in 2017*" (see also Section 4.3). This public commitment was further confirmed by reassurances made by the Italian government to the Commission in a subsequent letter¹⁶. This notwithstanding, it appears difficult at this stage to fully assess Italy's plans to resume the adjustment path towards the MTO in 2017, for two reasons. First, the 2017 Stability Law will only be adopted in autumn 2016 and, in its absence, the Commission 2016 spring forecast for next year is based on a no-policy change assumption. Second, the 2016 Stability Programme highlights "*the criticalities affecting the current methodology for the calculation of the output gap, often leading to underestimations or results that are at odds with macroeconomic intuitions and provide a biased indication of Italy's actual compliance with the preventive arm of the SGP*" among the relevant factors that explain why "*the government deems it inappropriate and counterproductive to achieve the fiscal consolidation*" requested by the preventive arm rules, whereby the structural balance should improve in 2017 by more than 0.5 percentage points. Additional work will be carried out in the EPC-OGWG to analyse the issues raised by Italy and other Member States on the agreed methodology. On the basis of the Commission 2016 spring forecast, the Commission assessment of the planned fiscal effort for 2017 indicates a gap of between 0.15% and 0.2% of GDP – depending on the precise parameters used for the calculation of the output gap – to ensure broad compliance with the preventive arm of the SGP in 2017 based on the expenditure benchmark. However, given Italy's public

¹³ For the granting of the 0.4 percentage point allowance under the structural reform clause, please refer to European Commission (2015), "*Assessment of the 2015 Stability Programme for ITALY*" - http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2015/12_it_scp_en.pdf

¹⁴ See: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_en.pdf

¹⁵ See the cover letter accompanying the note "*Relevant Factors Influencing Debt Developments in Italy*" (9 May 2016) - http://www.tesoro.it/inevidenza/documenti/lettera_2840_del_09.05.2016_-_Min_Padoan_-_Mr_Dombrovskis_-_Moscovicix1x.pdf

¹⁶ An exchange of letters took place between the European Commission and the Italian government. The letters can be retrieved at: www.mef.gov.it/inevidenza/documenti/20160516Letter_to_Padoan.pdf (letter from the Commission to Italy) and www.mef.gov.it/inevidenza/documenti/Letter_to_Dombrovskis_x_Moscovici_-_17_May_2016.pdf (Italy's reply to the Commission).

commitment to comply with the preventive arm of the SGP in 2017, condition (i) can be considered to be complied with, albeit a full assessment of Italy's plans for 2017 will only be possible in autumn, when the draft budget is available. The Commission will reassess the relevant factors in a new report under Article 126(3) TFEU as further information on the credibility and appropriateness of Italy's resumption of the adjustment path towards the MTO for 2017 becomes available.

As regards condition (ii), Italy's government gross fixed capital formation is forecast by the Commission to increase further in nominal terms in 2016 and 2017 (by 0.9% and 0.6%, respectively). As a result, public investment is expected to remain broadly stable as a share of GDP (at around 2.3%). The 2016 Stability Programme projects similar developments for public investment over 2016-2017. In this context, the 2016 Stability Programme expects national expenditure in investment projects co-financed by the EU to reach around EUR 5 bn or 0.3% of GDP in 2016, which corresponds to the allowance invoked under the investment clause. While the information provided seems to confirm that Italy's deviation from the adjustment path towards the MTO is being effectively used for the purposes of increasing investments, it does not dispel any reasonable doubt on the feasibility of the reported amount of co-financed investment for 2016, which matters for the magnitude of the requested allowance. For instance, as regards the EUR 1 billion projects expected under the *Connecting Europe Facility* (CEF), only around EUR 0.35 billion appear feasible in the course of 2016, as some EUR 0.65 billion have not yet been successfully submitted to a CEF call to receive EU funding and are thus unlikely to be carried out in 2016. On this basis, it seems that an allowance of at most 0.25% of GDP could be granted under the investment clause for 2016, but with the *caveat* that significant downside risks exist and that the Commission will carry out an ex-post assessment in order to verify the actual amount of the national expenditure in co-financed investment projects and the related allowance to which Italy is eligible under the so-called "investment clause".

As regards condition (iii), the 2016 National Reform Programme broadly confirms the reform timetable put forward in the 2016 Draft Budgetary Plan, where the additional allowance under the clause was requested. The ambitious reform agenda includes a new competition law for 2016, the completion of the implementation of the labour market reform, as well as the long-awaited revision of the statute of limitations and measures concerning collective bargaining. It also encompasses measures to support access to finance, the implementation of the education and public administration reforms according to the respective timetables, and a systematic revision of tax expenditures. As regards the specific reforms for which the additional allowance was requested, i.e. measures to reduce the stock of non-performing loans and reform insolvency procedures, reasonable progress seems to be confirmed. Overall, given the extent of the structural reforms put forward by the government in the 2016 National Reform Programme, their state of legislative progress/implementation, as well as the methods used to simulate their effects, it seems that Italy could benefit in 2016 from the maximum amount of admissible temporary deviation allowed under the structural reform clause, i.e. 0.5% of GDP.

Overall, the abovementioned conditions for Italy to be allowed an additional temporary deviation from the adjustment path towards the MTO under the structural reform and investment clause in 2016 appear to be satisfied. The Commission will review its assessment of the relevant factors in a new report under Article 126(3) TFEU based on the Commission 2016 autumn forecast, as further information on the credibility and appropriateness of Italy's resumption of the adjustment path towards the MTO for 2017 becomes available.

The 2016 Stability Programme also invokes an additional allowance in relation to two “unusual events”. On the one hand, the Italian government estimates that the net expenditure incurred to face the exceptional influx of refugee, particularly in terms of sea rescue operations and hospitality, healthcare and education costs, increased gradually since 2012 and amounted to EUR 2 billion (0.13% of GDP) in 2014, and EUR 2.6 billion (0.16% of GDP) in 2015. The refugee-related expenditure is projected at EUR 3.3 billion (0.2% of GDP) in 2016. The Commission clarified that, for the purposes of fiscal surveillance and on a temporary basis (i.e. solely for 2015 and 2016), additional refugee-related expenditure actually incurred by country based on observed data, would be taken into account when assessing Member States’ fiscal efforts. In fact, as fiscal efforts required under the SGP are set in terms of change in the structural balance, allowances for “unusual events”, including the refugee crisis, should only reflect elements that directly affect the change in the structural balance in a certain year. In the case of Italy, the refugee-related expenditure that can be taken into account *ex post* for 2015 is 0.03% of GDP. As for 2016, 0.04% of GDP is the amount that is currently expected by the Commission to affect Italy’s structural effort this year. A final assessment on the 2016 amount will be made on the basis of observed data provided by Italy in next year Stability Programme. Moreover, Italy’s 2016 Stability Law explicitly mentioned a package of exceptional security measures, adding up to 0.2% of GDP, to be taken into account by the Commission in assessing Italy’s compliance with the preventive arm. Overall, it appears that the link of some of the mentioned provisions to security may only be indirect, as in the case of EUR 1 bn earmarked for the requalification of urban areas and incentives to young people to attend cultural events. A preliminary assessment thus suggests that only 0.06% of GDP represents additional directly security-related expenditure affecting the structural effort in 2016, which could be taken into account in the overall assessment of compliance with the preventive arm in 2016 to be made *ex-post* in 2017.

In conclusion, the Commission has assessed Italy to be eligible, at this stage, for the following allowances: (i) 0.03% of GDP in 2015, due to the additional refugee-related expenditure incurred in that year, which leads to a corrected requirement of 0.22% of GDP for 2015 (instead of the 0.25% recommended in July 2015); (ii) 0.35% of GDP in 2016 under the structural reform and investment clause taken together, which leads to a corrected requirement of -0.25% of GDP for 2016. The actual additional spending related to the refugee crisis and to direct security measures (currently estimated at 0.04% and 0.06% of GDP respectively) will be taken into account *ex-post*.

Adjustment towards the MTO

The government plans enshrined in the 2016 Stability Programme imply an improvement in the recalculated structural balance¹⁷ by 0.2 percentage points of GDP in 2015, followed by a deterioration of 0.6 percentage points of GDP in 2016, with a structural position still in deficit in 2016 (at 1.6 % of GDP). This is only slightly better than the structural efforts estimated for 2015 (0.1 percentage points of GDP) and expected for 2016 (-0.7 percentage points of GDP) on the basis of the Commission 2016 spring forecast. For 2017, both the (recalculated) government plans and the Commission 2016 spring forecast expect a stable structural balance. However, the Italian government publicly declared its intention to comply

¹⁷ This refers to the cyclically adjusted balance net of one-off and temporary measures recalculated by the Commission on the basis of the information provided in the Stability Programme, using the commonly agreed methodology

with the preventive arm of the SGP beyond 2016, by committing (see above) to repeal a previously legislated VAT hike for 2017 “*conditional upon implementing deficit reduction measures to comply with the preventive arm of the SGP in 2017*”. Beyond 2017, the government plans confirm the medium-term objective of a balanced budgetary position in structural terms, which reflects the objectives of the Stability and Growth Pact, and the achievement of the MTO in 2019, i.e. one year later than projected in the 2015 Stability Programme. However, based on the recalculations by the Commission, Italy’s budgetary position would still indicate a structural deficit of ½% of GDP in 2019.

For 2015, Italy was recommended to deliver a structural adjustment of at least 0.25% of GDP, so as to make sufficient progress towards its MTO. Both for 2015 alone and for 2014 and 2015 taken together, the Commission 2016 spring forecast suggests some deviation from the structural balance pillar (a gap of 0.1 percentage points of GDP), while the expenditure benchmark points to compliance. Overall, Italy is thus projected to be broadly compliant with the required adjustment towards the MTO in 2015. The consideration of allowance under the so-called “refugee clause” (see above) would not change this conclusion.

For 2016, the corrected preventive arm requirement of -0.25% of GDP, i.e. discounting for the maximum flexibility that can be granted under the structural reform and investment clauses together, will be taken into account in the overall assessment that follows, together with the 0.1% of GDP further allowance related to the additional refugee related expenditure and exceptional security-related direct costs currently expected for this year. The Commission 2016 spring forecast expects Italy’s structural balance to deteriorate by 0.7 percentage points of GDP. Therefore, on the basis of both the government plans and the Commission 2016 spring forecast and taking into account the corrected preventive arm requirement, there is a risk of some deviation (a gap of -0.3 and -0.4 percentage points of GDP, respectively) from the structural balance pillar over one year in 2016, while the expenditure benchmark points to compliance based on the Commission 2016 spring forecast. Over 2015 and 2016 taken together, based on both the government plans and the Commission 2016 spring forecast and taking into account the corrected preventive arm requirement for 2015 and 2016, there is a risk of some deviation (a gap of -0.2 percentage points of GDP in both cases) from the structural balance pillar, while the expenditure benchmark points to compliance based on the Commission 2016 spring forecast. This calls for an overall assessment. The discrepancy between the two indicators is mainly due to the fact that the expenditure benchmark benefits in 2016 from both significant one-offs, as well as from the use of a higher GDP deflator frozen also on the basis of the 2015 Commission spring forecast, which incorporated a VAT hike enacted by the government as a safeguard clause but subsequently repealed. Following an overall assessment, Italy is expected to be at risk of some deviation from the required adjustment towards the MTO in 2016. This conclusion would not change should the budgetary impact (i.e. 0.1% of GDP) of the exceptional inflow of refugees as well as the security costs incurred in 2016 be excluded from the assessment.

In summary, based on both the government plans and the Commission 2016 spring forecast, Italy appears to be broadly compliant with the preventive arm requirements regarding progress towards the MTO in 2015 and 2016, although rigorous implementation of the 2016 budget remains crucial in this respect and this conclusion crucially hinges upon the allowance under the refugee clause in 2015 (which impacts on the two-year average) and the granting of the maximum allowance of 0.75% of GDP for the structural reform and investment clause in 2016. This allowance takes into account Italy’s public commitment to comply with the preventive arm of the SGP in 2017 (see above), as well as the actual and expected progress in

terms of structural reforms and co-financed investment. Given the uncertainties hindering the possibility at this stage to fully assess Italy's plans to resume of the adjustment path towards the MTO beyond 2016, the Commission will review its assessment of the relevant factors in a new report under Article 126(3) TFEU based on the Commission 2016 autumn forecast, as further information on Italy's compliance with the preventive arm of the SGP in 2017, in line with the government's public commitment, becomes available.

4.2. Medium-term economic position

Unfavourable macroeconomic conditions, particularly very low inflation, have hindered Italy's fiscal consolidation over the recent years by making it harder to maintain higher primary surpluses and by worsening debt dynamics through a large "snowball" effect. This notwithstanding, Italy has pursued some efforts, keeping its headline deficit within the 3 percent of GDP threshold since 2012, attaining one of the highest primary surplus in the EU over 2011-2015. Moreover, since the adoption of the 2015 CSRs, Italy has made progress with the implementation of an ambitious reform agenda, which should positively impact on Italy's medium term growth prospects and in turn enhance the sustainability of the country's public finances. However, strong commitment to their full implementation remains essential.

Macroeconomic conditions and public investment

Real GDP growth in Italy has been below the euro area average since the 1990s. More specifically, Italy's average GDP growth amounted to 1.5% on average between 1999 and 2007, as compared to 2.3% in the euro area, while between 2008 and 2015, Italy's GDP contracted by 1.1% on average, as compared to a 0.1% expansion in the euro area. Compared to its pre-crisis peak in 2007, real GDP had contracted in 2015 by more than 8%. Italy's real GDP growth was 0.8% in 2015 and the 2016 Stability Programme projects real GDP to grow by 1.2% in 2016, slightly above the Commission 2016 spring forecast (1.1%). The negative estimate of potential growth -0.2% in 2016, after -0.3% in 2015, implies a significant closure in Italy's negative output gap, from -3.9% of potential GDP in 2014 to -2.9% in 2015 and -1.6% in 2016, based on the Commission 2016 spring forecast (a similar closure is projected in the Stability Programme). The acceleration in real GDP growth in 2017, well above the still sluggish potential growth (estimated to be around 0.1% that year), would lead to an almost complete closure of the negative output gap (to -0.4% of potential GDP in 2017, based on the Commission 2016 spring forecast). Overall, since 2009, Italy has experienced a negative output gap combined with negative potential growth (with the exception of a slightly positive one in 2011).

Price indicators in Italy have been on a downward path since late-2012: yearly HICP inflation stood at 0.1% in 2015 and at -0.3% in April 2016. Low aggregate demand, limited wage pressures and the significant fall of energy prices are the main driving factors. The slump in oil prices is set to lead to negative annual energy prices also in 2016. Overall, the Commission 2016 spring forecast expects yearly HICP inflation to remain broadly stable in 2016 (0.2%), and core inflation is expected to stabilise at low levels (0.5% after 0.7% in 2015). In 2017, HICP inflation is forecast to accelerate to 1.4% mainly because it factors in around half of the 0.9% of GDP VAT hike enshrined in the 2016 Stability Law. In fact, in a letter to the Commission (see Section 4.1), the government publicly committed to repeal it and to make the repeal "*conditional upon implementing deficit reduction measures to comply with the preventive arm of the SGP in 2017*" through the next Stability Law.

The debt-to-GDP ratio and the structural primary balance are highly affected by the moderate GDP deflator growth (0.8% in 2015), forecast to remain stable in 2016 before increasing, to 1.2% in 2017. In fact, as explained in Section 3, the current cyclical conditions negatively affect debt dynamics through their impact on the “snowball” effect and by making it harder to achieve and maintain higher primary surpluses. It is worth noting that, based on the Commission 2014 spring forecast, on which the Council based its fiscal recommendation to Italy at that time, the required MLSA was estimated at 0.7% of GDP in 2014 and 1.4% of GDP in 2015 (taking into account the structural adjustment forecast for 2014). Once recomputed on the basis of the Commission 2016 spring forecast, which forms the basis of the present assessment, the required MLSA becomes substantially higher: 1.2% of GDP in 2014 and, due to the 0.2% deterioration occurred in 2014, 2.6% of GDP in 2015. The upward revision in the MLSA since 2014 has been driven by significantly lower inflation and potential growth estimates. The achievement of a structural adjustment of around 2.6 percentage points of GDP in 2015 (i.e. the MLSA based on the Commission 2016 spring forecast) with nominal potential growth at around 0.4% would have required *ceteris paribus* a decrease in nominal primary expenditure of around 5.5% year-on-year in that year.

In addition, persistently low inflation is making it more difficult to cut public expenditure as a share of GDP by freezing wages and pensions in nominal terms (instead of having them indexed to inflation). This policy was pursued by Italy in recent years and led to a limited increase in primary expenditure in both nominal and real terms. On the revenue side, persistently low inflation implies lower tax revenues than in normal circumstances (including inflation around 2%) at the medium-term standard semi-elasticity. Therefore, it can be argued that Italy’s possibility to carry out fiscal adjustments is being hampered by macroeconomic conditions at this juncture; in turn, as the country seems to be facing a “double-trap” of low inflation and low productivity growth hindering wage and labour market adjustments, too restrictive fiscal policies could worsen the low-inflation problem.

Lastly, but not the least, unfavourable macroeconomic conditions, particularly low inflation and tight financing conditions, have further hindered Italy’s fiscal consolidation over the recent years through their impact on fiscal multipliers heightened by the limited possibility to use economic stabilisers. On the one hand, it could be argued that, in a period of constrained monetary policy stimulus due to the zero lower bound limit and ongoing banking sector adjustment hampering its full transmission, Italy’s fiscal multipliers are higher than in normal conditions. That is why the use of the flexibility embedded in the SGP could at this stage help avoid the risk of persistently low inflation (as highlighted by negative HICP inflation since February 2016), which would in turn make the necessary deleveraging of Italy’s public sector more difficult to be achieved in an orderly fashion. On the other hand, the possibility to use economic stabilisers has been hampered by Italy’s precarious situation in the financial markets following the 2011 sovereign debt crisis, whereby Italy had to adopt a strongly procyclical restrictive fiscal stance in 2011-2013 in order to regain credibility vis-à-vis financial markets and other stakeholders. While this resulted in an increase of around 3 percentage points in the structural primary surplus over the three years, the large fiscal effort in a period of negative output gap, overall weak demand, and impaired monetary policy transmission affected Italy’s short-term economic prospects and at the same time exacerbated the impact of the crisis on the labour market and on the resilience of the banking sector.

Despite all these difficulties, Italy succeeded in achieving and maintaining primary surpluses of 1.7% of GDP on average over 2011-2015, the second highest in the EU after Germany,

although a clear deterioration in structural primary surpluses from close to 4% of potential GDP over 2012-2013 to around 3.2% in 2015 can be observed.

As regards public investment, Italy's government gross fixed capital formation averaged at around 3% of GDP over 1999-2010 but the need to adjust quickly to respond to the sovereign debt crisis led to a substantial reduction in public investment to 2.3% of GDP over 2011-2014. In 2015, public investment bottomed out, reaching 2.3% of GDP (+1% year-on-year in nominal terms), and is forecast by the Commission to increase further in nominal terms in 2016 and 2017 (by 0.9% and 0.6%, respectively). As a result, public investment is expected to remain broadly stable as a share of GDP (at around 2.3%). The 2016 Stability Programme projects similar developments for public investment over 2016-2017. In summary, developments in public investments, given their broad decline over time, do not appear to be the main relevant factor justifying Italy's lack of compliance with the MLSA required under the debt rule over the 2013-2015 transition period.

Table 3: Macroeconomic and budgetary developments ^a

	2013	2014	2015	2016		2017	
				COM	MS	COM	MS
Real GDP (% change)	-1.7	-0.3	0.8	1.1	1.2	1.3	1.4
GDP deflator (% change)	1.2	0.8	0.8	0.8	1.0	1.2	1.1
Potential GDP (% change)	-0.8	-0.7	-0.3	-0.2	-0.1	0.1	0.2
Output gap (% of potential GDP)	-4.3	-3.9	-2.9	-1.6	-1.6	-0.4	-0.4
General government balance	-2.9	-3.0	-2.6	-2.5	-2.4	-1.9	-1.8
Primary balance	1.9	1.6	1.6	1.6	1.7	1.9	2.0
One-off and other temporary measures	0.3	0.2	-0.1	0.1	0.1	0.0	0.0
Government gross fixed capital formation	2.4	2.3	2.3	2.3	2.3	2.2	2.3
Cyclically-adjusted balance	-0.6	-0.9	-1.1	-1.6	-1.5	-1.7	-1.6
Cyclically-adjusted primary balance	4.2	3.7	3.1	2.4	2.5	2.1	2.2
Structural balance ^b	-0.9	-1.1	-1.0	-1.7	-1.6	-1.7	-1.6
Structural primary balance	4.0	3.5	3.2	2.3	2.4	2.1	2.2

Notes:

^a In percent of GDP unless otherwise specified

^b Cyclically adjusted balance excluding one-offs and other temporary measures

Source: Commission services, Italy's 2016 SP and Commission 2016 spring forecast

Structural reforms

In its Communication of 13 January 2015, the Commission strengthened the link between effective implementation of structural reforms, investment, and fiscal responsibility in support of jobs and growth, within the existing rules of the SGP. In this 2016 National Reform Programme (NRP), the Italian government confirmed its commitment to keep momentum in the adoption and implementation of an ambitious structural reform plan covering a number of areas such as public administration and judicial system, competitiveness and product markets, labour market and education, as well as taxation.

In 2015, under the Macroeconomic Imbalances Procedure (MIP), Italy was subject to a specific monitoring by the Commission as a Member State displaying excessive imbalances. The specific monitoring assesses the implementation progress for reforms contributing to the unwinding of such imbalances. The 2016 Country Report acknowledges that Italy has made

some progress in tackling the 2015 country specific recommendations (CSRs)¹⁸. However, in light of remaining challenges in diverse reform areas and the fact that there macroeconomic imbalances remain large and have not started to significantly correct, it has been concluded that Italy still displays excessive imbalances¹⁹. Continued commitment to swift adoption and full implementation of structural reform covering all country-specific recommendations is essential, which the Commission will keep on monitoring closely.

Among the reforms with a potential positive impact on Italy's medium term growth prospects, a comprehensive reform of the labour market was undertaken in 2015 and important measures were adopted to reform the governance of the banking sector and to address the stock of non-performing loans; the education sector was reformed with a view to better rewarding merit and strengthening work-based learning and vocational training; measures to reduce the administrative burden for citizens and businesses were taken; moreover, the parliament is discussing a law on competition and has passed an enabling law for the reform of the public administration. While implementation of some of these reforms is still ongoing, they represent important steps to address Italy's long-standing weaknesses. The full impact of these reforms may materialise only over time but early signs are positive.

On the other hand, there is scope for further action in some key areas. Targets for spending review savings have been further reduced; the cut to property taxes on first residences from 2016 is not consistent with repeated Council recommendations to shift taxation away from productive factors onto property and consumption and key elements of the respective country-specific recommendations have not been implemented (see below for more details); social partners have not yet found an agreement on the delayed reform of collective bargaining; the legislative process on the long-awaited systematic revision of the statute of limitations is not completed.

In summary, since the adoption of the 2015 CSRs, Italy has made progress with the implementation of an extensive reform agenda aiming at the transformation of the economy's productive structure in a still unfavourable economic environment. Strong commitment and full implementation of structural reforms remains essential.

In view of the planned implementation of major structural reforms with a positive impact on the long-term sustainability of public finances, Italy requested an overall temporary deviation of 0.5% of GDP from the required adjustment path towards the medium-term objective in 2016, of which 0.4% in its 2015 Stability Programme and additional 0.1% in its 2016 DBP. The details underpinning these reforms have been laid out in the 2015 and 2016 National Reform Programmes, both broadly confirming the planned reform agenda. The measures presented by the Italian authorities are expected to have a positive impact on growth and therefore on the sustainability of public finances²⁰. The areas of reform put forward in the

¹⁸ For a more extensive overview, please refer to the Commission Staff Working Document “*Country Report Italy 2016 - Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*” - http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_italy_en.pdf.

¹⁹ See Commission Communication COM(2016) 95 final/2 “2016 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011” - http://ec.europa.eu/europe2020/pdf/csr2016/cr2016_comm_en.pdf.

²⁰ See in particular Section 4.2 of the “*Assessment of the 2015 Stability Programme for ITALY*” (...*the positive impact on the sustainability of public finances is two-fold: on the one hand an increase in GDP leads to an automatic decrease in the debt ratio everything else being equal; on the other, higher GDP growth usually leads to a larger tax intake and to a decrease in nominal deficit and debt (respectively by 0.8 and 2 percentage*

programme as having an impact on public finance sustainability and being relevant to Italy's application for the structural reform clause include: (i) public administration and simplification; (ii) product and service markets; (iii) labour market; (iv) civil justice; (v) education; (vi) a tax shift; (vii) measures to reduce the stock of non-performing loans and reform insolvency procedures; (viii) access to finance; and (ix) spending review as financing measure. The overall impact of the reforms on real GDP levels is estimated by the authorities, regardless of their state of implementation, at +2.2% by 2020 (+0.4% from public administration and simplification; +0.4% from the product market reforms, +0.6% from labour market reforms, +0.1% from the measures on justice, +0.3 % from education reforms, +0.2% from tax reforms, +0.2% from measures to address non-performing loans and insolvency; +0.2% from the new measures for access to finance; -0.2% from spending review).

4.3. Other factors put forward by the Member State

On 9 May 2016, the Italian authorities transmitted documents concerning relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97²¹. The analysis presented in the other sections of this report covers most of the factors put forward by the authorities.

According to the Italian authorities, Europe is currently facing a risk of persistently low inflation and stagnation, which is also incorporated in the Commission 2016 spring forecast. In this economic environment, restrictive fiscal policy stance may be self-defeating, leading among others to cut growth-enhancing productive investment expenditure, which is further aggravated by still unsatisfactory coordination of fiscal policies among euro area Member States. This applies in particular to the case of Italy, where unprecedented negative cyclical conditions over 2008-2009 and 2011-2014 have significantly increased fiscal multipliers, made the necessary adjustment to comply with the debt rule particularly demanding, and aggravated the Italian debt imbalance through a largely negative "snowball effect", amplified by low inflation. In this spirit, the Italian authorities report a simulation showing that the MLSA under "*higher real growth and a normal times deflator*" would have implied much lower and realistic structural adjustments to be implemented. Namely, assuming higher GDP deflator growth of 2% as of 2014 and zero real GDP growth in 2014 (instead of a contraction) would have almost halved the structural effort needed for Italy to comply with the debt rule over the period 2013-2015. In this case, the structural adjustment achieved by Italy in 2013 would have been in line with the MLSA "adjusted for low inflation and growth", while for 2014 and 2015 the actual adjustment would have still fallen short of the requirements. Moreover, factoring in also the alternative estimation methodology for potential output put forward by the 2016 Stability Programme, the Italian authorities argue that the gap to the debt benchmark based on the Commission 2016 spring forecast would markedly shrink in 2016 and that the debt rule would be complied with already in 2016, if one assumed in addition a normal GDP deflator growth at 2 percent per year since 2014.

The Italian authorities also stress the ongoing wide-ranging programme of structural reforms aiming to address deeply rooted structural weaknesses and increase growth potential at least

points of GDP by 2020 for the whole reform package with respect to the baseline). The improvement in the Z indicator associated with the reforms is estimated at 1.1 percentage points of GDP by 2025...") -

http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2015/12_it_scp_en.pdf

²¹ "Relevant Factors Influencing Debt Developments in Italy", May 2016 -

http://www.tesoro.it/inevidenza/documenti/Relevant_Factor_Influencing_Debt_Developments_in_Italy.pdf

in the medium term. The authorities confirm their commitment to carry out an ambitious reform agenda, expected to have a positive impact on economic growth and, therefore, the sustainability of public finances, as discussed also in Section 4.1 of this report. Italy also highlights the need to take into account the short-term costs imposed on the Member States of Euro-area reform initiatives, as in the case of the Banking Union.

Furthermore, the Italian authorities point out a series of shortcomings of the commonly agreed methodology for the estimation of the output-gap followed by the Commission to compute the structural efforts relevant for the fiscal surveillance. Among these shortcomings, the inconsistency of the estimates with macroeconomic intuition is reportedly evidenced by the rapid closure of Italy's output gap over 2016-2017. In this context, alternative estimation methods are put forward as a basis to argue that Italy started its latest reform effort from a position of balanced budget in structural terms in 2015 and should thus not be requested to carry out any adjustment towards its MTO in 2017. However, in an accompanying letter, the Italian government publicly declared its intention to comply with the preventive arm of the SGP beyond 2016 (see also Section 4.1).

In addition, the authorities recall that in 2012 Italy managed to exit the excessive deficit procedure as recommended and that, despite the economic contraction, the headline deficit has remained within the 3% of GDP Treaty threshold since then. The largest primary surplus in the EU over 2012-2015 is attributed to an ambitious plan of growth-friendly fiscal consolidation, complementing significant reduction in the tax wedge on labour with durable improvements in the efficiency and quality of public expenditure at all levels of government.

The authorities also stress that since 2012 risks related to debt sustainability have diminished in the short term and remained limited over the medium term, while pension reforms adopted over the past 20 years make Italy's debt the most sustainable in the Union over the long term. A debt maturity structure among the soundest in the Union also contributes to these results.

4.4. Medium-term government debt position

Despite Italy's projected gradual recovery, the reduction of its public debt imbalance is still markedly hampered by low inflation, as mentioned in Section 3. As a result, based on the Commission 2016 spring forecast, Italy's debt-to-GDP ratio is set to start declining only in 2017, after the peak of 132.7% reached in 2015-2016, mainly thanks to higher real GDP growth and inflation. The government projections are slightly more optimistic and the 2016 Stability Programme projects the debt-to-GDP ratio to start declining already from 2016, to 132.4%. This declining path is expected to accelerate over the 2017-2019 programme period thanks to real growth at 1.4-1.5% and inflation progressively increasing towards 2%.

In the short-term, Italy remains vulnerable to any sudden increase in financial market risk aversion due to its high level of government debt and low potential growth. On the positive side, implicit liabilities arising from population ageing have been curbed also thanks to the 2012 pension reform (so-called "*Fornero reform*"), so that Italy scores relatively well in terms of long-term sustainability risks despite the high current level of pension expenditure. Namely, based on the Commission 2016 spring forecast, the structural primary surplus expected for 2016 would be more than sufficient to keep the debt-to-GDP ratio stable over the long term. However, achieving a debt ratio of 60% of GDP by 2030 would require further fiscal adjustment (in the order of 4.8 percentage points of GDP over 2017-2021). In this context, further fiscal adjustment and forceful implementation of structural reforms to foster

potential growth in the medium/long term remains crucial to achieve a satisfactory debt reduction path.

The 2016 Stability Programme confirms the ambitious privatisation plan launched by the government. In fact, after the 0.4% of GDP privatisation proceeds recorded in 2015, further 0.5% of GDP per year over 2016-2018, and 0.3% of GDP in 2019 are targeted in the 2016 Stability Programme, but details are not provided. There are clear downside risks affecting these projections, as important privatisation projects, such as the one involving the national railway company *Ferrovie dello Stato* originally planned for 2016, have been postponed.

In summary, while Italian debt appears to be a source of vulnerability, the full and forceful implementation of pensions reforms adopted in the past, together with the other announced structural reforms to foster potential growth in the medium/long term and further fiscal adjustment, would crucially help enhance debt sustainability, provided that persistently high primary surpluses are ensured and growth prospect restored.

4.5. Other factors considered relevant by the Commission

Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances (Article 2(3) of Regulation (EC) No 1467/97).

Regarding government support to the financial sector in the course of the financial crisis, contingent liabilities to support liquidity provisions of financial institutions amounted to around 0.4% of GDP at end-2015 (out of a total of 2.3% of GDP), significantly down from around 1.4% of GDP at end-2014. The direct capital support to financial institutions (with an impact on the government debt) was close to zero at the end of 2015, as around EUR 1 billion was paid back in the course of 2015.

Article 12(1) of Regulation (EU) No 473/2013 requires that this report considers also "the extent to which the Member State concerned has taken into account the Commission's opinion" on the country's DBP, as referred in Article 7(1) of the same Regulation.

The Commission Opinion on Italy's 2016 Draft Budgetary Plan²² pointed to a risk of non-compliance with the provisions of the SGP for 2015-2016 and invites the Italian authorities to take the necessary measures within the national budgetary process to ensure that the 2016 budget would be compliant with the SGP. Since the adoption of the Commission Opinion, the Commission has positively assessed Italy's request to be allowed an additional admissible deviation of 0.35% of GDP for 2016 under the structural reform and investment clause, in addition to the 0.4% of GDP already allowed in spring 2015. Moreover, 0.03% outturn refugee related additional expenditure has been discounted from the preventive arm requirement in 2015. Hence, as mentioned above, Italy is currently projected to be broadly compliant with the requirement under the preventive arm of the SGP in 2015 and 2016.

²² Commission Opinion C(2015) 8105 final, 16.11.2015, on the Draft Budgetary Plan of Italy - http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2015/it_2015-11-16_co_en.pdf

CONCLUSIONS

The general government gross debt in Italy reached 132.7% of GDP in 2015, i.e. above the 60% of GDP reference value, and is forecast to remain stable in 2016, before declining to 131.8 % in 2017. Over the 2013-2015 transition period, Italy's structural efforts have fallen short of minimum linear structural adjustment (MLSA) required to comply with the debt rule. As a result, the Commission 2016 spring forecast does not expect Italy to comply with the debt rule either in 2015 or in 2016. This suggests that *prima facie* the debt criterion as defined in the Treaty appeared to be not fulfilled, before consideration is given to all relevant factors, whereas the 3% of GDP deficit criterion appears to be fulfilled. In line with the Treaty, this report also examined the relevant factors.

Due to currently negative economic developments, including negative potential growth and a GDP deflator well below 2%, respecting the MLSA required by the debt rule would have implied a structural adjustment of more than 2.5 percentage points of GDP in 2015 based on the Commission 2016 spring forecast, i.e. achieving a structural surplus of around 1.5% of GDP, well above Italy's MTO. In the current economic circumstances, the required additional structural effort could be expected to have negative implications for growth and further aggravate the current low-inflation environment, thereby not contributing towards bringing debt on an appropriate downward path. Moreover, Italy is estimated to have broadly complied with the required adjustment path towards the MTO in 2015. Broad compliance is also expected in 2016, once an overall allowance of 0.75% of GDP for 2016 is granted to Italy, taking into account its progress with the structural reform agenda, the planned investments, as well as the Italian government's commitment to comply with the preventive arm of the SGP in 2017, which was publicly confirmed by the authorities. However, the Commission will be able to better assess this commitment only on the basis of Italy's 2017 Draft Budgetary Plan and its 2016 autumn forecast.

Furthermore, in the 2016 Stability Programme, Italy plans to fully comply with the debt rule (in its forward-looking dimension) beyond 2017, although with a small gap in that year (i.e. 0.2 percentage points of GDP) also thanks to an ambitious privatisation plan. The 2016 National Reform Programme confirms Italy's commitment to adopt/implement an ambitious structural reform agenda, in addition to the progress already acknowledged by the 2016 Country Report for Italy in line with the 2015 Country Specific Recommendations. In this context, Italy requested to avail itself of an overall temporary deviation by 0.5 percentage points of GDP from the required preventive arm adjustment towards the MTO under the so-called structural reform clause. The Commission has positively assessed this request, in view of the plausible positive impact on Italy's growth prospects, and thus public finance sustainability, related to the ambitious structural reforms put forward by the government, if fully and timely implemented.

The analysis presented in this report includes the assessment of all the relevant factors, notably: (i) the currently unfavourable macroeconomic conditions and in particular still very low inflation – which make the respect of the debt rule particularly demanding, (ii) the expectation that compliance with the required adjustment towards the MTO is broadly ensured once the fiscal flexibility requested by Italy for this year is granted; and (iii) the expected implementation of ambitious growth-enhancing structural reforms in line with the authorities' commitment, which is expected to contribute to debt reduction in the medium/long term. This suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with. The

Commission will revise its assessment of the relevant factors in a new report under Article 126(3) TFEU, as further information on the credibility and appropriateness of Italy's resumption of the adjustment path towards the MTO for 2017 becomes available.