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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. BACKGROUND

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 procedure"[1], 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 473/2013[2].

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. The Commission may also prepare a report if, notwithstanding the fulfilment of the requirements under the criteria, it is of the opinion that there is a risk of an excessive deficit, the latter understood as the situation defined in Article 126(2) TFEU. 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 the question of Italy's compliance with the debt criterion of the Treaty, with due regard to the economic background and other relevant factors before drawing a final conclusion on compliance.

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 Council 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

[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).

compliance with the debt reduction benchmark. In the case of Italy, the transition period covers the years 2013-2015 (i.e. 3 years after the correction of the excessive deficit[3]). 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 rule is met by the end of the transition period.

On 13 January 2015 the Commission presented 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 to 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 Council Regulation (EC) No 1467/97 - the Commission, when examining whether an EDP needs to be opened (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 factors[4].

Data notified by the authorities on 1 October 2014[5] and subsequently validated by Eurostat[6] show that the general government deficit in Italy reached 2.8% of GDP in 2013, while the debt was at 127.9% of GDP, above the 60% of GDP reference value. For 2014, both the mentioned notification and Italy's 2015 Draft Budgetary Plan (DBP) planned a debt-to-GDP ratio[7] of 131.6%. In 2015, the debt-to-GDP ratio is planned to further increase to 133.1%.

Overall, on the basis of the planned structural efforts and debt levels, Italy is not making sufficient progress towards compliance with the debt reduction benchmark in 2014 and 2015 (see Table 1), since the change in the structural balance falls short of the required MLSA by a large extent both in 2014 (-0.3 percentage points of GDP compared to the required MLSA of 0.9 percentage points of GDP) and in 2015 (0.3 percentage points of GDP compared to the required MLSA of 2.2 percentage points of GDP).

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[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 the following website: 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 158/2014 of 21 October 2014, available at: http://ec.europa.eu/eurostat/documents/2995521/5182258/2-21102014-AP-EN.PDF/497e3b55-dca0-482f-93e0-d82f81bc92d7?version=1.0

[7] Throughout the report, all figures are expressed in ESA2010.

Table 1. General government deficit or/and debt (% of GDP) [a]

		2011	2012	2013	2014		2015	
					COM	MS	COM	MS
Deficit criterion	General government balance	-3.5	-3.0	-2.8	-3.0	-3.0	-2.6	-2.6
Debt criterion	General government gross debt	116.4	122.2	127.9	131.9	131.6	133.0	133.1
	Change in structural balance	0.0	1.8	0.7	-0.2	-0.3	0.3	0.3
	Required MLSA	n.r.	n.r.	1.1	1.2	0.9	2.7	2.2

Notes:

[a] In percent of GDP unless otherwise specified

Source: *Commission services, Italy's 2015 DBP and Commission 2015 winter forecast*

The planned (recalculated) structural efforts[8] and debt levels for 2014 and 2015 in the Draft Budgetary Plan for 2015 and the projections in the Commission 2015 winter forecast provides evidence that there appears to be *prima facie* a risk of the existence of an excessive deficit in Italy 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 transitional debt rule in order to examine whether the launch of an Excessive Deficit Procedure is warranted after all relevant factors have been considered. 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 Medium Term budgetary Objective (MTO). The report takes into account the Commission 2015 winter forecast, released on 5 February 2015, and the Commission's evaluation of subsequent developments.

2. DEFICIT CRITERION

According to both the 2015 DBP and the Commission 2015 winter forecast, Italy`s general government deficit is foreseen to respect the Treaty reference value during the period 2014-2016. According to the Commission forecast, the deficit is expected to have reached 3.0% of GDP in 2014 and to decline thereafter to 2.6% of GDP in 2015. The forecast is in line with the planned deficit put forward in the 2015 DBP. The deficit is forecast to be 2.0% of GDP in 2016, on a no-policy change basis. However, it is worth noting that at the beginning of March 2015 the Italian Statistical Office (ISTAT) will publish a first release of 2014 outturn figures, and official notified figures will also be available at the beginning of April 2015. The forthcoming publication by Eurostat in April 2015 of notified and validated data on the 2014 outcome may entail a new assessment of the fulfilment of the deficit criterion.

3. DEBT CRITERION

In 2013, the government debt-to-GDP ratio reached 127.9%, the second-highest level in the Union, also due to insufficient pace of reduction in the years before the crisis. For 2014, in

[8] Throughout the document, all references to changes in the structural balance refer 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 DBP, using the commonly agreed methodology.

the 2015 DBP, the debt-to-GDP ratio is projected at 131.6%, showing an increase of 3.7 percentage points relative to 2013.

This increase is mainly due to the real GDP contraction and low inflation, both negatively affecting debt dynamics through a denominator effect and the budgetary outcome. The decrease in inflation leads in the short term to a higher real implicit interest rate on the debt[9] despite decreasing nominal interest rates. This is because, while the impact of lower inflation is immediate, the lower nominal yields only gradually pass through into the servicing cost of the outstanding debt stock, i.e. over a horizon of more than five years given the duration of the Italian debt and the roll-over period (see also Graph 1). More specifically, the debt-increasing impact of the implicit real cost of debt increased from 3.1% of GDP over 2011-2013 to 3.7% over 2014-2015.

In this context, the projected debt-decreasing primary surplus in 2014 (1.7% of GDP) is more than offset by the “snowball” effect (see Table 2), which entails an overall debt-increasing impact (4.1% of GDP). Regarding 2015, the DBP projects a further increase in the debt-to-GDP ratio to 133.1%. The slightly higher primary surplus than in 2014 (1.9% of GDP) is set to be still insufficient to offset the still large “snowball" effect (3% of GDP). However, as of 2016, the debt ratio is planned to gradually decrease and reach 124.3% in 2018, thanks to higher real growth and inflation accelerating towards the ECB target, an increasing primary surplus and a privatisation plan projected to yield 0.7% of GDP per year.

In the Commission forecast, debt developments are similar to those projected in the DBP, with the debt-to-GDP ratio also peaking in 2015 at around the same level (133%), although lower inflation (GDP deflator) is expected in both 2014 (0.5% vs. 0.8%) and 2015 (0.4% vs. 0.6%) and privatisation proceeds slightly below those planned by the government (0.5% vs. 0.7% of GDP) are included in 2015. Graph 1 shows that the expected recovery in real GDP growth in 2015 leads to a lower “snowball” effect but is still insufficient to offset the still large implicit real cost of debt.

[9] 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).

Table 2: Debt dynamics [a]

	2011	2012	2013	2014		2015	
				COM	MS	COM	MS
Government gross debt ratio	116.4	122.2	127.9	131.9	131.6	133.0	133.1
Change in debt ratio [b] (1 = 2+3+4)	1.1	5.8	5.6	4.0	3.7	1.1	1.5
Contributions:							
• Primary balance (2)	-1.2	-2.2	-2.0	-1.6	-1.7	-1.7	-1.9
• “Snowball” effect (3)	2.3	5.9	5.5	4.7	4.1	3.0	3.0
of which:							
Interest expenditure	*4.7*	*5.2*	*4.8*	*4.7*	*4.7*	*4.3*	*4.5*
Real GDP growth	*-0.7*	*2.7*	*2.4*	*0.7*	*0.4*	*-0.7*	*-0.8*
Inflation (GDP deflator)	*-1.7*	*-1.9*	*-1.7*	*-0.7*	*-1.0*	*-0.6*	*-0.8*
• Stock-flow adjustment (4)	0.0	2.1	2.1	0.9	1.3	-0.2	0.4
of which:							
Cash/accruals difference	*0.4*	*0.1*	*0.8*	*0.5*	*1.5*	*1.2*	*0.8*
Net accumulation of financial as:	*-0.5*	*2.0*	*1.3*	*0.4*	*0.0*	*-1.4*	*-0.3*
of which privatisation proceeds	*-0.1*	*-0.5*	*-0.1*	*0.0*	*-0.3*	*-0.5*	*-0.7*
Valuation effect & residual	*0.0*	*0.0*	*0.0*	*0.0*	*-0.2*	*0.0*	*0.0*

Notes:

[a] In percent of GDP unless otherwise specified

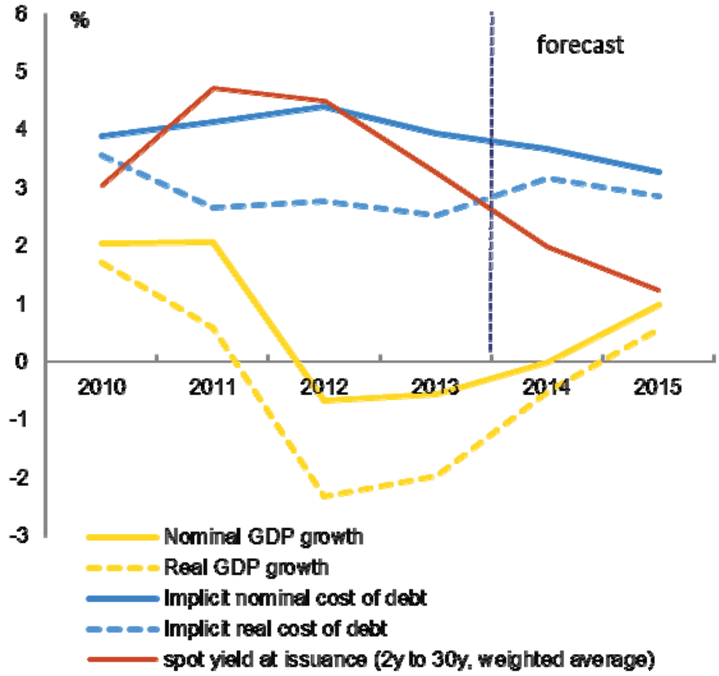
[b] The change in the gross debt ratio can be decomposed as follows:

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

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 2015 DBP and Commission 2015 winter forecast

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



Following the abrogation of the EDP in June 2013, Italy benefits from a three-year transition period to comply with the debt reduction benchmark, starting 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 ¼% 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 ¾% of GDP (unless the first condition implies an annual effort above ¾% of GDP). However, this condition does not apply to the case of Italy because the first condition implies an annual effort above ¾% of GDP.

Based on the 2015 DBP, a surplus in the structural balance of more than 1% of GDP would be needed to meet the debt reduction benchmark in 2015, given an annual MLSA of 0.9 percentage points over 2014-2015. The structural effort planned by Italy for 2014 and 2015 is not sufficient to meet the requirements of the transition period for the debt reduction benchmark (see Table 1). First, Italy's structural balance[10] is planned to worsen by 0.3 percentage points of GDP in 2014, while the required improvement (MLSA) is 0.9 percentage points of GDP. Second, in 2015 the remaining annual MLSA would amount to 2.2 percentage points of GDP, while the planned structural adjustment is 0.3 percentage points of GDP. Based on the Commission forecast, which projects lower nominal growth (mainly due to lower inflation) and privatisation proceeds, these requirements would be even more stringent (MLSA of 1.2 percentage points in 2014, which becomes 2.7 percentage points in 2015 following the 2014 outcome, implying a needed structural surplus of more than 1.5% of GDP in 2015, i.e. well above Italy's MTO of a balanced budget in structural terms).

The overall analysis above thus suggests that *prima facie* the debt criterion in the sense of the Treaty and Council Regulation (EC) No 1467/97 appears not to be fulfilled based on the 2015 DBP as well as the Commission 2015 winter forecast before however consideration is given to all relevant factors as set out below.

4. RELEVANT FACTORS

Article 126(3) of the 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

[10] Throughout this document, all references to the structural balance refer to the cyclically adjusted balance net of one-off and temporary measures. The structural balance planned by the Member State is recalculated by the Commission services on the basis of the information provided in the Draft Budgetary Plan, using the commonly agreed methodology.

of the government to a larger extent than in case of the deficit. This is recognised in Article 2(4) of Council 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 to sustainability. 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 occurrence of extraordinary economic conditions**, which can hamper the reduction of the debt-to-GDP ratios and make compliance with the SGP provisions particularly demanding, needs to be taken into account. Specifically, the current environment of low inflation – on top of the protracted low growth – requires the concerned Member States to achieve very demanding structural adjustments to comply with the MLSA under the transitional debt rule. Moreover, negative inflation surprises have contributed to the upward revisions of the annual required MLSA, namely by around half of the difference in the requirement between spring and now[11]. 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 rule. 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 in the presence of nominal growth close to 3%[12].

In view of the above provisions, the following subsections consider in turn (1) the medium-term economic position; (2) the medium-term budgetary position, including an assessment of compliance with the required adjustment towards the MTO and the development of public investment; (3) the developments in the medium-term government debt position, its dynamics and sustainability; (4) other factors considered relevant by the Commission; and (5) other factors put forward by the Member State.

[11] This is based on a simulation exercise, looking at the difference between the current MLSA (based on the Commission 2015 winter forecast) and the one that would apply under the assumption of a level of inflation corresponding to the Commission 2014 spring forecast.

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

Based on the Commission 2014 spring forecast, on which the Council based its fiscal recommendation to Italy, the required MLSA was estimated at 0.7% of GDP in 2014 and 1.4% of GDP in 2015 (taking into account the 2014 outcome). The required MLSA became substantially higher, at 1.2% of GDP in 2014 and 2.7% of GDP in 2015, once recomputed on the basis of the Commission 2015 winter forecast, which forms the basis of the present assessment. This revision is partly driven by significantly lower inflation and potential growth estimates. These and other relevant factors will be discussed in greater detail in the following sections.

4.1. Medium-term economic position

Cyclical conditions, potential growth, and inflation

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 2014, Italy's GDP contracted by 1.3% on average, as compared to 0.1% in the euro area. Compared to its pre-crisis peak in 2007, GDP is expected in 2014 to have contracted by approximately 8.7%. Italy's 2015 DBP projects GDP to contract by 0.3% in 2014 and to recover in 2015 by 0.6%. The Commission forecast expects similar developments over 2014-2015. In particular, the 2015 recovery is still set to be very moderate (0.6%), while the negative estimate of potential growth (-0.3%) implies a significant reduction in Italy's negative output gap (from -4.3% to -3.5% of potential GDP). Thanks to some acceleration in 2016, this slow recovery would however exceed potential growth (still estimated to be marginally negative for that year), leading to a marked closure of the negative output gap (to -2.1% of potential GDP in 2016, based on the Commission 2015 winter forecast). Overall, over the last years, Italy has experienced negative potential growth (with the exception of 2011) and a negative output gap.

Price indicators in Italy have been on a downward path since late-2012 with yearly HICP inflation at 0.2% in 2014 and at -0.4% in January 2015. Low aggregate demand and more recently the significant fall of energy prices are the main driving factors. The recent slump in oil prices is set to feed quickly into lower energy prices, and the Commission forecast expects yearly HICP inflation to be negative in 2015 (-0.3%). However, core inflation is expected to stabilise at low but positive levels. In 2016, inflation is forecast to return to 1.5% mainly because it factors in the VAT hike enshrined in the 2015 Stability Law to safeguard the achievement of the fiscal targets[13].

The debt-to-GDP ratio and the structural balance indicator are highly affected by the current moderate GDP deflator, expected to remain at around 0.5% over 2014-2015 before increasing in 2016. 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. In the case of Italy, the achievement of a structural adjustment of 1.2 percentage points of GDP per year in 2014 and 2015 (i.e. the MLSA based on the Commission forecast) with a nominal potential growth close to zero would require *ceteris paribus* a decrease in nominal primary expenditure of around 5% over the two years. As an alternative illustration, a mechanical exercise replicating an inflation

[13] This measure may still be replaced by others of an equivalent budgetary impact. In this case, the inflationary impact of budgetary measures could change accordingly.

environment consistent with ECB targets has been carried out by assuming an inflation stable at 2% and zero potential growth over 2014-2016, everything else being equal, in particular keeping the monetary level of headline deficit and debt unchanged relative to the Commission 2015 winter forecast. On this basis, the MLSA for Italy would have been met over the transition period 2013-2015. In summary, negative real growth developments together with low inflation affect the debt-to-GDP ratio through a larger "snowball" effect and more negative primary balances. Such unfavourable economic conditions critically curbed Italy's structural adjustments *ceteris paribus*, also because of the impact of actual growth on potential growth estimates.

Table 3: Macroeconomic and budgetary developments [a]

	2011	2012	2013	2014		2015	
				COM	MS	COM	MS
Real GDP (% change)	0.6	-2.3	-1.9	-0.5	-0.3	0.6	0.6
GDP deflator (% change)	1.5	1.6	1.4	0.5	0.8	0.4	0.6
Potential GDP (% change)	-0.1	-1.1	-0.4	-0.5	-0.3	-0.3	-0.2
Output gap (% of potential GDP)	-1.6	-2.7	-4.2	-4.3	-4.1	-3.5	-3.1
General government balance	-3.5	-3.0	-2.8	-3.0	-3.0	-2.6	-2.6
Primary balance	1.2	2.2	2.0	1.6	1.7	1.7	1.9
One-off and other temporary measures	0.7	0.1	0.2	0.2	0.3	-0.1	-0.1
Government gross fixed capital formation	2.8	2.5	2.4	2.2	2.2	2.2	2.3
Cyclically-adjusted balance	-2.6	-1.4	-0.5	-0.7	-0.8	-0.7	-0.9
Cyclically-adjusted primary balance	2.1	3.8	4.3	4.0	3.9	3.6	3.6
Structural balance [b]	-3.2	-1.5	-0.8	-0.9	-1.1	-0.6	-0.8
Structural primary balance	1.4	3.7	4.1	3.8	3.6	3.7	3.7

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 2015 Stability Law and Commission 2015 winter 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 context and following exchanges with the Ministry of Finance, the Italian government confirmed on 20 February 2015 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.[14]

In 2014, 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 2015 Country Report acknowledges that Italy is making some progress, although unevenly, in tackling the 2014 country specific recommendations

[14] http://www.governo.it/Governo/ConsiglioMinistri/dettaglio.asp?d=77929
http://www.mef.gov.it/inevidenza/article_0079.html
http://www.dt.mef.gov.it/it/analisi_programmazione_economico_finanziaria/strategia_crescita/

(CSRs)[15]. Overall, in light of remaining challenges in diverse reform areas and the fact that there has been no improvement in Italy's macroeconomic imbalances, continued commitment to swift adoption and full implementation of structural reform covering all country-specific recommendations is essential, which the Commission will keep on closely monitoring. Therefore, it has been concluded that Italy still has excessive imbalances which require specific monitoring and decisive policy action.[16]

Among the reforms with a potential positive impact on Italy's medium term growth prospects, the so-called 'Jobs Act' law, enabling the government to thoroughly reform the labour market, has been adopted. Two legislative decrees, regarding respectively the revision of dismissal rules for new hires and the new unemployment benefit system, were adopted on February 20 and will be implemented as of the beginning of March. Two legislative decrees (rationalisation of labour contracts, female participation) have been put forward by the government for non-binding Parliamentary consultation on 20 February. Additional legislative decrees are expected in the coming months.

On taxation, a sizeable reduction in the labour tax wedge has been secured in the 2015 Stability Law[17]. For the time being its financing is partly on the expenditure side, while an increase in indirect taxation as of 2016 safeguards the respect of fiscal targets in absence of further savings. Several long-pending legislative decrees under the February 2014 enabling law on taxation[18] are still expected to be adopted by end February 2015. An extension of the latter's deadline seems needed to allow for a completion of the process, particularly on the important revision of tax expenditure and environmental taxation which so far is still missing. Moreover, the measures enshrined in the 2015 Stability Law to improve the collection of VAT based on a reverse charge system and the cross-check of databases (*adempimento volontario / spesometro*) have the potential to address the recommendation to enhance tax compliance and fight evasion, if results are in line with expectations.

On the expenditure side, the targeted cuts foreseen by the 2015 Stability Law to central and local levels of government could be read in the context of the Council recommendation to pursue higher efficiency of public spending. However, there is a risk that some of the savings planned at local level could entail lower capital expenditure and/or higher local taxation, while additional sizeable savings and expenditure rationalisation are required in the following years to avoid (at least in part) the foreseen increases in indirect taxes. In the context of the spending review, a choice for more political ownership has been made but only some

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[15] For a more extensive overview, please refer to the second MIP specific monitoring report on Italy and the Country Report 2015, respectively at: http://ec.europa.eu/economy_finance/eu/countries/italy_en.htm and http://ec.europa.eu/europe2020/index_en.htm

[16] See Commission Communication COM(2015)85.

[17] These measures include: i) total deductibility of the labour component from the tax base of the regional tax on businesses (IRAP), with a net negative impact on revenues of 0.16% of GDP in 2015 and 0.27% in 2016; ii) a three-year waiver for social security contributions for private employers hiring new workers under open-ended contracts by end 2015, with net negative impact on revenues of 0.11% of GDP in 2015 and 0.22% in 2016; iii) a permanent tax credit (recorded as a social transfer) to low-wage employees, firstly enacted in April 2014 and financed only for that year, worth 0.6% of GDP as of 2015. An increase in VAT rates and excise duties (0.8% of GDP in 2016, 1.2% of GDP in 2017, and 1.35% of GDP in 2018) is foreseen to guarantee the achievement of planned fiscal targets, which may, however, be replaced by others having an equivalent budgetary impact.

[18] Three enacting decrees have been adopted: a reform of cadastral committees (a precondition for the reform of cadastral values to be completed by 2018), a simplification of the tax system, including through the introduction of pre-filled tax forms, and a revision of taxation on tobacco production and consumption.

instruments are already fully operational, and the integration in the yearly budgetary process lags behind. On privatisations, most of the envisaged sales are still under preparation.

The weak institutional and administrative efficiency weigh on the business environment and thus hamper growth prospects. In this context, the legislative process on institutional reform is ongoing and will continue over the period 2015-2016, while the enabling law on public administration reform has just started its parliamentary adoption process. The 2015-2017 Simplification Agenda was adopted and implementation is underway. Recent provisions to improve the judicial system's functioning have been converted into final law, while other measures are still pending. Also the legislative process on the long-awaited revision of the statute of limitations continues to be under preparation.

On 20 February 2015 the government adopted the long-awaited draft law on competition, which still has to be approved by the Parliament. Also announced for end-February 2015 is a decree law entailing a far-reaching school reform, for which additional funds have been earmarked. Furthermore, some additional measures to support access to finance and investment have been adopted. On banks, a promising step to tackle governance weaknesses in Italy's largest *banche popolari* was made.

In summary, since the adoption of the 2014 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.

The measures presented by the Italian authorities are expected to have a positive impact on growth and therefore on the sustainability of public finances. The Italian authorities estimate the overall impact of all reforms, regardless of their state of implementation, at 3.9%[19] of GDP by 2020 (+1.1% from product market reforms, +0.9% from the labour market reforms, +1.4% from the public administration reforms (of which +0.4% from the measures on justice), +0.3% from education reforms, +0.2% from tax reforms).

However, these results have not been endorsed by any national independent institution and seem to over-estimate the impact of the reforms. First, the estimates include also the quantified impact of legislation for which the content has not yet been fully defined or which has not yet been adopted. In those cases, reforms simulated are potentially larger in scope than those that will be effectively implemented. There is indeed a risk that the reforms may be adjusted during the legislative process, which might lead to a lower impact on GDP. This in particular holds for the yet-to-be-adopted law on competition (which is estimated to have a positive effect of GDP of 0.8% by 2020). In fact, delayed implementation already led the authorities to revise their estimates downwards on several occasions. Second, a number of methodological assumptions taken by the Italian authorities significantly affect the estimated size of the impact. The quantification of the shocks is in some cases not sufficiently specified and seems generous, as evidenced by the large magnitude of the shocks that would be necessary in the Commission model (QUEST) to produce comparable results, thereby leading to strong GDP impact. This for instance holds for the public administration reform (1% of GDP by 2020) and the competition reforms, including the annual law on competition (1.1% of GDP by 2020). Moreover, while the choice of the variable to translate the reform into a

[19] Italian authorities refer to comparable estimates presented in the *OECD Economic Surveys: Italy 2015* (www.oecd.org/italy/italy-institutional-changes-needed-to-ensure-success-of-reforms-to-boost-growth-and-jobs.htm), which the European Commission is not in a position to assess considering the absence of a description of the translation of reforms into quantified shocks.

shock is generally well-founded, a better justification of the choice of the variables would in some cases be needed for the Commission to adequately assess the authorities' estimates (e.g. for the translation of the justice reforms). Similarly, some simulations depend heavily on the model used, preventing the Commission to replicate and challenge the authorities' estimates on the basis of QUEST (for instance the simulations of labour market reforms with IGEM). Finally, some reforms are deemed to have an acceleration effect on the positive impact of previous ones. Notwithstanding possible positive confidence effects of a powerful reform momentum (which are by definition hardly quantifiable) as well as positive synergies between different measures, such an acceleration pattern is not supported by the existing literature and, therefore, usually not assumed in the quantification exercises made by the Commission. On the contrary, a gradual phasing in of shocks is arguably more realistic given implementation delays and that the materialisation of effects of structural reforms usually takes place with a lag.

4.2. Medium-term budgetary position

Headline, structural balance and adjustment towards the MTO

The 2015 DBP projects the general government deficit to increase in 2014 to 3% of GDP, the Treaty reference value (compared to 2.8% in 2013). The higher deficit in 2014 mainly reflects further real GDP contraction and low inflation. By contrast, interest expenditure is projected to decline thanks to lower yields. The Commission forecast also projects the 2014 deficit at 3% of GDP, based on a strict budgetary execution in the final months of the year. For 2015, Italy's 2015 DBP plans the government deficit to decline to 2.6% of GDP, in line with the Commission forecast. In particular, further declining interest expenditure helps to achieve the deficit target. Overall downside risks are associated with possibly worse-than-expected macroeconomic outcomes, including persistently low inflation since revenues tend to decline much faster than primary expenditure and only new debt issuances benefit from lower nominal yields, as well as to a partial or inadequate implementation of the measures enshrined in the legislation.

In structural terms, the government plans enshrined in the 2015 DBP imply a deterioration of the balance in 2014 (-0.3 percentage points of GDP) followed by an equivalent improvement in 2015 (+0.3 percentage points of GDP), with a (recalculated) structural position still in deficit in 2015 (-0.8% of GDP). According to the Commission 2015 winter forecast, which takes into account the measures included in the 2015 Stability Law, a structural deterioration of 0.2 percentage points in 2014 is followed by a structural adjustment of 0.3 percentage points in 2015.

In accordance with the 2015 Flexibility Communication on the SGP, the Commission considers that no structural adjustment towards the MTO is required in 2014 due to exceptionally bad economic conditions experienced by Italy, namely a real GDP contraction and a largely negative output gap (below -4% of GDP). However, the Commission 2015 winter forecast projects a deterioration of the structural balance (by 0.2 percentage points of GDP) in 2014, suggesting some deviation from the requirement (a gap of 0.2 percentage points of GDP) based on the structural balance pillar over one year. The expenditure benchmark pillar is forecast to be met. Overall, this marginally negative outcome is markedly affected by the negative potential growth and low inflation, which play a crucial role in the estimation of the structural balance. Besides, both pillars are expected to be met over 2013-2014. Overall, Italy is projected to be compliant with the required adjustment towards the MTO in 2014.

As for 2015, the Commission 2015 winter forecast suggests that Italy is experiencing 'very bad times' (output gap is between -3 and -4% of GDP). Based on the new Flexibility Communication, Member States in very bad times with a general government debt ratio above 60% of GDP are expected to deliver a structural adjustment of 0.25% of GDP, so as to make sufficient progress towards their MTO. For Italy, the Commission 2015 winter forecast suggests a marginal deviation (a gap of -0.1% of GDP) from the expenditure benchmark in 2015, while the structural effort is set to be slightly higher than required, calling for an overall assessment. First, the marginal deviation measured on the basis of the expenditure pillar in 2015 is explained by the volatility of specific items within this indicator and by the negative effect of one-off transactions, which makes an assessment of compliance with the expenditure benchmark pillar based on a two-year horizon more suited to show whether the government is managing to control expenditure dynamics despite currently adverse economic conditions. Second, in 2014 and 2015 taken together, the expenditure benchmark is complied with according to the Commission 2015 winter forecast. Overall, Italy is projected to be compliant with the required adjustment towards the MTO in 2015.

In summary, based on both the government plans and the Commission 2015 winter forecast, Italy appears to be compliant with the above-mentioned requirements under the preventive arm regarding progress towards the MTO in 2014 and 2015, although rigorous implementation of the 2015 budget remains crucial in this respect.

Public investment

Over 1999-2007, gross fixed capital formation of the general government sector averaged around 3% of GDP and remained at those levels until 2011. The pressure on fiscal adjustment following the sovereign debt crisis led to a substantial reduction in public investment, as government institutions opted to cut capital rather than current expenditure under those pressing circumstances. In 2013, public investment fell to 2.4% of GDP and it is forecast to further decline to around 2.2% over 2014-15. The 2015 DBP projects slightly higher public investment in 2015 (at 2.3% of GDP – see Table 3), also thanks to additional resources earmarked to this aim.

In summary, developments in public investments, given their broad decline over time, do not seem the main relevant factor justifying Italy’s lack of compliance with the MLSA required under the debt rule over the 2013-2015 transition period.

4.3. Medium-term government debt position

Over the period 1998-2007, the government debt only decreased by around 11% of GDP as a result of gradually eroding primary surpluses from the 6% of GDP peak recorded in 1997 and a deteriorating competitiveness position in the absence of sufficient structural reforms. At the end of 2007, Italy's general government debt was significantly higher than the euro-area average (at around 100% versus 65% of GDP). During the crisis, the debt-to-GDP ratio increased by around 32% to reach 132% at end-2014, which is broadly in line with the average increase in the euro-area (around 29%), as a primary surplus (2% of GDP in 2013) was progressively restored but coupled with large real GDP contractions. At this juncture, the reduction of Italy’s public debt imbalance is hampered by protracted negative growth and low inflation. On the back of unfavourable macroeconomic developments and after incorporating the measures enshrined in the 2015 Stability Law, the debt is now set to peak at 133% of GDP in 2015 in both the government projections and the Commission forecast (see Table 2) and to decline thereafter, mainly thanks to positive real GDP growth and higher inflation. In this respect, forceful implementation of structural reforms to foster potential growth in the medium/long term is crucial to achieve a satisfactory debt reduction path.

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 that Italy scores relatively well in terms of long-term sustainability risks despite the high current level of pension expenditure. Namely, 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 2.5 percentage points of GDP over 2017-2020).

The stock-flow adjustment increased the debt by around 2% and 1% in 2013 and 2014, respectively, mainly due to the ongoing repayment of trade debt arrears. The overall amount earmarked by the government to this end is around EUR 56 billion (or 3.5% of GDP) over 2013-15 and, as of end-January 2015, it is estimated that some EUR 36.5 billion (or 2.3% of GDP) of trade debt arrears accumulated up to end-2013 had been paid out to suppliers. For 2015, the Commission forecast points to a neutral impact of the stock-flow adjustment on debt developments, as further repayments of trade debt arrears are broadly compensated by a reduction in the cash buffer accumulated over the previous years, as well as by some privatisation proceeds (0.5% of GDP, i.e. slightly below the 0.7% government target).

In fact, Italy launched a privatisation plan also with the aim to earmark proceeds of 0.7% GDP per year to debt reduction over the period 2015-2017. In 2015, the government plans the privatisation of *Poste Italiane* and *ENAV*, as well as the sale of *Grandi Stazioni*, the company managing Italian large stations, plus a possible reduction in its stake of *ENEL*. Another operation expected in the short term is the sale by the Ministry of Economy and Finance (MEF) to Cassa Depositi e Prestiti –of which MEF holds 80.1% of shares– of its stake in the holding *STH*, which in turn controls *STMicroelectronics*. Looking forward, the national railway company *Ferrovie dello Stato* could also be privatised in 2016. Other proceeds could come from indirect privatisations through State-controlled enterprises. Over 2013-15, the government has also planned to sell real assets worth EUR 1.5 billion (or 0.1% of GDP), of which EUR 0.7 billion already realised, which are earmarked to debt reduction.

In summary, Italy's high public debt increased further during the crisis years, not only as a result of the above-mentioned macroeconomic conditions, but also because of other factors such as the ongoing repayment of government trade debt arrears. Over the coming years, enhanced growth prospects as well as a privatisation plan are set to put the debt-to-GDP ratio on a declining path as of 2016. Overall, 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 would enhance debt sustainability, provided that persistently high primary surpluses are ensured and growth prospect restored.

4.4. 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).

In assessing sufficient progress towards compliance with the debt reduction benchmark, financial assistance to euro area Member States with a debt or a deficit-increasing impact has been taken into account. According to the Commission 2015 winter forecast, the cumulative impact on debt of the Greek loan facility, EFSF disbursements, capital contributions to the ESM, and operations under Greek programme over the period 2010-2014 is around 3.7% of GDP, of which around 0.3% over 2014.When taking into account the impact of these operations, the required MLSA for 2014 is marginally lower, at 1.2 percentage points of GDP for 2014, which becomes 2.6 percentage points of GDP for 2015, but remains well above the structural effort projected by the government in 2014 and 2015.

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 5% of GDP at end-2013 (out of a total 6.1% of GDP[20]) but decreased significantly in 2014. The direct capital support to financial institutions (with an impact on the government debt) amounted to only EUR 4 billion (or 0.25% of GDP) at the end of 2013, out of which EUR 3 billion was paid back in the course of 2014.

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 2015 Stability Law, approved by the Italian Parliament on 22 December 2014, did not substantially modify the 2015 DBP presented by Italy in October 2014[21], on which the Commission Opinion[22] pointed to a risk of non-compliance with the provisions of the SGP for 2014-2015. The Commission thus invited the authorities to ensure full compliance with the SGP within the national budgetary process. In particular, the effectiveness of some budgetary measures, such as those to fight tax elusion/evasion, should still be ensured through adequate implementation. In addition, the implementation of the sizeable planned spending savings (around 0.25% of GDP) at regional level has been delayed. This, together with the need to find additional resources (around 0.05% of GDP) to offset the budgetary impact of a recent Constitutional Court ruling[23] declaring additional corporate income taxes imposed on energy sector companies unconstitutional, entails some risks to the achievement of the 2015 budgetary targets. Since the adoption of the Commission Opinion, the abovementioned Flexibility Communication has clarified that, in the view of the Commission, the required structural adjustment for Italy in order to progress towards the MTO is of 0.25% of GDP in 2015, rather than 0.5% as previously envisaged, in view of very bad economic conditions. Hence, as mentioned above, Italy is currently projected to be compliant with this requirement under the preventive arm of the SGP.

[20] http://ec.europa.eu/eurostat/documents/2995521/6616449/2-10022015-AP-EN.pdf/d75df6fe-100b-4ae7-a09e-00400edb183a

[21] The Italian DBP submitted on 16 October 2014 planned a structural effort falling short of the SGP requirements (preventive and corrective arms). Following exchanges with the Commission, on 27 October 2014 the Italian authorities publicly announced further measures (worth EUR 4.53 billion or around 0.3% of GDP) to improve the adjustment path towards the MTO. This "updated DBP" targets a 2015 deficit of 2.6% of GDP (instead of 2.9% in the original DBP), with a (recalculated) structural adjustment of 0.3% of GDP. At that point, the fiscal effort taken at face value was thus considered sufficient to avoid a DBP rejection.

[22] Commission Opinion C(2014)8806 final, 28.11.2014, on the Draft Budgetary Plan of Italy. Available at http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/dbp/2014/it_2014-11-28_co_en.pdf

[23] “Sentenza No. 10/2015”, published on 11 February 2015.

4.5. Other factors put forward by the Member State

On 13 February 2015, the Italian authorities transmitted documents concerning relevant factors in accordance with Article 2(3) of Council Regulation (EC) No 1467/97[24]. The analysis presented in the other sections of this report already covers most of the factors put forward by the authorities.

According to the Italian authorities unprecedented negative cyclical conditions have made the necessary adjustment to comply with the debt rule over 2013-15 particularly demanding and likely self-defeating. The Italian authorities also point to the largely negative "snowball effect" driven by negative real GDP growth and amplified by low inflation. Moreover, they point out that, excluding the debt-increasing impact of contributions to financial assistance to euro-area programme countries as well as the settlement of trade debt arrears, the increase in the debt-to-GDP ratio would have been more modest (from 123.2% in 2013 to 126.6% in 2015).

Furthermore, the Italian authorities highlight the ongoing wide-ranging programme of structural reforms aiming to "address deeply rooted structural weaknesses and increase growth potential". The authorities confirm their reform commitments as well as the quantifications. These reforms, which are expected to have a positive impact on economic growth and, therefore, the sustainability of public finances, are discussed in more detail in Section 4.1 of this report.

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. In addition, the primary surplus averaged 1.9% of GDP over 2012-2014, also thanks to a significant reduction in public spending, while the fiscal consolidation strategy aims at preserving growth-enhancing expenditure such as infrastructure, R&D, innovation and education. The government claims that further fiscal tightening would reduce the positive impact of reforms.

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 maturity structure among the highest in the Union also contributes to these results.

Finally, the relatively low indebtedness of the private sector, in particular the household sector, is argued to be one of the main strengths of the Italian economy and to bring its total debt in line with the euro-area average. In addition, contingent liabilities of the government are below those recorded in the large majority of Member States.

[24] http://www.mef.gov.it/inevidenza/article_0079.html

5. CONCLUSIONS

The general government gross debt in Italy reached 127.9% of GDP in 2013, i.e. well above the 60% of GDP reference value, and is forecast to further increase to 131.9% in 2014 and 133% in 2015, before declining as of 2016. Over the 2013-15 transition period, Italy does not plan to achieve the MLSA required to comply with the debt reduction benchmark. This suggests that *prima facie* the debt criterion as defined in the Treaty appeared to be not fulfilled before consideration was given to all relevant factors, whereas the 3% 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 at around 0.5%, respecting over 2014-2015 the MLSA required by the debt rule would imply a cumulated structural adjustment around 2.5 percentage points of GDP based on the Commission 2015 winter forecast, i.e. achieving a structural surplus more than 1.5% of GDP in 2015, well above Italy's MTO. In the current economic circumstances, the required additional structural effort would be expected to have negative implications for growth and further aggravate the deflationary trends of the economy, and thereby would not contribute towards bringing debt on an appropriate downward path. Moreover, Italy is expected to comply with the required adjustment path towards the MTO in 2014-2015.

Following previous announcements by the Ministry of Finance, endorsed by the Italian Government on 20 February, Italy committed to adopt/implement an ambitious structural reform agenda. The swift implementation of this ongoing agenda is key to enhance Italy's growth prospects in the medium term, and thus to contribute bringing the debt-to-GDP ratio on a satisfactory reduction path.

Overall, the analysis presented in this report including the assessment of all the relevant factors and notably (i) the currently unfavourable economic conditions - with particularly 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, 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, suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with.