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Country Report Italy 2016

Including an In-Depth Review on the prevention and correction of macroeconomic imbalances

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EXECUTIVE SUMMARY

This country report assesses Italy's economy in the light of the Commission's Annual Growth Survey published on 26 November 2015. The survey recommends three priorities for the EU's economic and social policy in 2016: re-launching investment, pursuing structural reforms to modernise Member States' economies, and responsible fiscal policies. At the same time, the Commission published the Alert Mechanism Report that initiated the fifth annual round of the macroeconomic imbalance procedure. The Alert Mechanism Report identified Italy as warranting a further in-depth review.

Italy entered the crisis with long-standing structural weaknesses. During the decade leading up to the crisis, deeply rooted structural weaknesses significantly constrained Italy's growth potential; Italy's annual real GDP growth averaged 1.5 %, around 2/3 percentage points below the euro area average, due primarily to sluggish total factor productivity. The high public debt ratio and the negative and worsening current account balance further limited the Italian economy's capacity to withstand the negative economic shock.

The legacy of the crisis constitutes a challenging starting point. Despite significant measures taken at the national and European level, the economy continued to contract until 2014. In 2015, Italy's real GDP had fallen back to the early 2000s levels, while the euro area GDP was more than 10 % higher. Investment fell sharply and more deeply than in the rest of the euro area on average. Unemployment and long-term unemployment increased substantially, while total factor productivity continued to decline and the participation rate remained among the lowest in the EU. As a result, Italy's gap in potential growth *vis-à-vis* the rest of the euro area widened. The public debt ratio increased to over 130 % of GDP in 2014 from around 100 % in 2007. Export market shares fell significantly until 2009 and competitiveness has not improved thereafter, also due to the slow responsiveness of wages and prices to the economic shock. While the financial sector proved to be relatively resilient during the global financial crisis, the prolonged recession led to the accumulation of a substantial stock of non-performing loans, weakening the banks' capacity to support the recovery.

A gradual recovery started in 2015 but risks persist. Economic activity expanded slightly in 2015 and is set to strengthen in 2016 and 2017. The positive outlook is backed by improving financing conditions and confidence, a supportive fiscal stance, better labour market prospects, and low oil prices. However, the recovery is weaker than in the euro area as a whole and subject to downside risks. In particular, the slowdown in emerging markets and the recent financial market turmoil weigh on the outlook. Employment, both in headcount and hours worked, started to increase already in mid-2014 and the unemployment rate has been declining since end-2014.

Structural weaknesses still hold back Italy's capacity to grow and adjust to economic shocks. Productivity growth remains sluggish, mainly due to the continued presence of structural obstacles to the efficient allocation of resources within the economy. The resulting low growth makes the reduction of the high public debt and the recovery of competitiveness more challenging. In turn, the high public indebtedness continues to weigh on Italy's economic performance and to expose the country to external shocks.

Overall, Italy has made some progress in addressing the 2015 country-specific recommendations. A comprehensive reform of the labour market was undertaken in 2015. 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. Furthermore, 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 reforms is still ongoing, these are 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. In some key areas there is scope for further action. 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, while key elements of

the country-specific recommendations, such as the revision of cadastral values and of tax expenditures have not been implemented. Social partners have not yet found an agreement on the delayed reform of collective bargaining. Regarding the statute of limitations, the legislative process on the long-awaited systematic revision is not completed.

Regarding the progress in reaching the national targets under the Europe 2020 Strategy, Italy has either reached or is making progress towards its targets on reducing greenhouse gas emissions, increasing the share of renewable energy, improving energy efficiency, reducing early school leaving and increasing the tertiary education attainment. More effort is needed regarding increasing the employment rate, investment in research and development and the fight against poverty and social exclusion.

The main findings of the in-depth review contained in this country report and the related policy challenges are:

- **Stronger productivity growth is the key factor for the correction of Italy's macroeconomic imbalances**. Important steps have been taken to improve the functioning of the economy. However, productivity developments remain sluggish, as total factor productivity is stagnant and investment has not yet recovered after the sharp fall experienced during the crisis. This hampers the recovery of competitiveness and makes the reduction of the high public debt ratio more difficult. Ongoing and scheduled structural reforms are expected to address barriers to investment and to have a positive impact on productivity and GDP growth over time.

- **Italy's high public debt ratio, coupled with deteriorated competitiveness and productivity growth, remains a source of vulnerability for the economy**. The debt ratio is set to peak at around 133 % of GDP in 2015 and to decline in 2016 and 2017 thanks to the expected recovery combined with a further decline in the interest rate paid on debt. However, the structural primary surplus is expected to worsen, slowing down the underlying pace of debt reduction. Furthermore, the privatisation plans might be delayed.

- **The low growth - low inflation environment slows down the recovery of cost competitiveness.** Since 2010, Italy has recorded a broad stabilisation in its export market shares, after large losses recorded in previous years. Wage growth has moderated but the current context of very low inflation and Italy's persistent sluggish labour productivity growth holds back the adjustment in unit labour costs relative to other euro area countries. Italy's product specialisation and the high share of small firms with a weak position on international markets further weigh on competitiveness.

- **Italy's labour market institutions have been deeply reformed and preliminary evidence indicates a positive impact on the economy, which would be amplified by a reform of collective bargaining.** The new legislation on open-ended contracts and the tax relief for new hires are having an initial positive impact on job creation and duality. Long-term unemployment and the risk of labour market exclusion for young people, as well as the low labour market participation of women, remain causes for concern. The reform of active labour market policies may prove challenging to implement. Furthermore, the progress in reforming the bargaining framework is slow and the diffusion of firm-level negotiations remains limited.

- **In the banking sector, important reforms are ongoing but pockets of vulnerability remain**. Long-standing weaknesses in banks' corporate governance are being tackled, supporting the capacity of the banking sector to allocate resources more efficiently. Measures have recently been announced to support the development of a private market for non-performing loan transactions, thereby helping to reduce their high stock over time and increasing the capacity of Italian banks to support the economy. The recent resolution of four small banks in Italy whereby subordinated bondholders incurred losses shows that some vulnerabilities persist.

- **Given its central position in the euro area, Italy is the source of potential spillovers to other Member States while external conditions affect its recovery.** Its modest recovery and structural weaknesses adversely impact the European recovery and growth potential. Italy's size and dense trade and financial links imply that the state of the Italian economy may have important consequences for the other EU economies. At the same time, external demand and the inflation environment are paramount to Italy's recovery, debt-to-GDP reduction efforts and to recovering competitiveness.

Other key economic issues analysed in this report that point to particular challenges for Italy are the following:

- **The taxation system hinders economic efficiency and growth.** Partly due to the costs of servicing the public debt, Italy's tax-to-GDP ratio in 2014 was among the highest in the EU. Relative to other Member States, the tax burden weighs more on the factors of production, which may have a negative impact on growth. The abolition of the property tax on primary residences further aggravates this problem. The long awaited revisions of tax expenditures and cadastral values have been further postponed and the frequent changes in tax policy increase uncertainty for economic operators. The tax system is complex and tax compliance is low, raising further the burden on compliant firms and households.

- **The public sector is being reformed to tackle its long standing inefficiencies**. Awaiting the implementation of the enabling law for the reform of public administration, its structural inefficiencies continue to slow implementation of reforms, deter investment, and open opportunities for rent-seeking, for instance in public procurement. In the justice system, lengthy court proceedings and a high number of pending civil and commercial cases remain major challenges, also after recent measures. Corruption is still a major problem and the statute of limitations remains an obstacle to the fight against it.

- **Remaining barriers to competition and the high administrative burden weigh on the business environment**. The parliament is expected to pass market-opening measures soon but significant barriers to competition will remain in important sectors, including in retail, professional services, local public services and the transport sectors. Doing business in Italy is significantly more difficult than in the other major EU economies and only modest progress has been achieved in recent years.

- **A reform of the school system is ongoing but investment in tertiary education, R&D and broadband communications remains relatively low**. The tertiary education attainment rate for 30-34 year-olds is one of the lowest in the EU as is basic skills proficiency in the adult population. The low rate of human capital reflects the low returns to education and skills in the labour market, particularly for the young. By improving school quality, the school reform aims at complementing the labour market reform in improving the chances for the educated young. Italy's spending in tertiary education as well as in research and innovation, particularly in the private sector, is low and collaboration between academia and business is suboptimal. Despite efforts in 2015, the coverage of new generation broadband communications infrastructure is among the lowest in the Union.

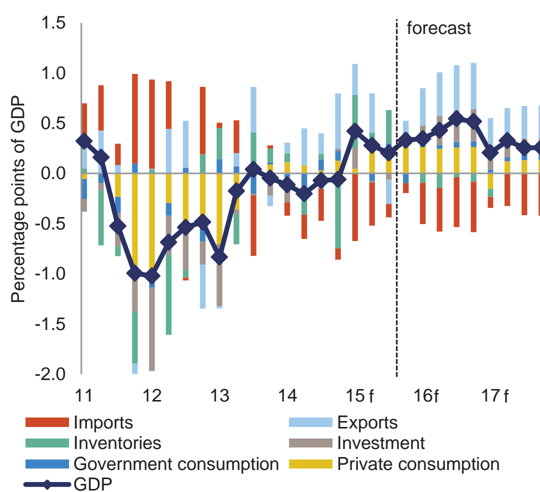
- **Social services are too fragmented to tackle effectively the social consequences of the crisis.** The share of persons at risk of poverty or social exclusion was 28.3 % in 2014, slightly down from 28.5 % in 2013. The rate is still higher than pre-crisis levels (25.5% in 2008) and showing no progress towards the Europe 2020 target on poverty reduction. The provision of social services is fragmented with deep regional disparities and there is no minimum income scheme. Some measures in the pipeline, such as the foreseen national antipoverty strategy, may set the basis for an integrated social policies framework.

1. SCENE-SETTER: ECONOMIC SITUATION AND OUTLOOK

Macroeconomic developments

After three years of recession, a slow recovery started in 2015 and is expected to strengthen in 2016 and 2017, with some downside risks. Economic activity is estimated to have expanded by 0.7 % in 2015, albeit at a diminishing pace over the course of the year. The recovery is set to strengthen in 2016, supported also by a deterioration in the structural budget balance, and 2017. The positive growth outlook is backed by improved confidence, better labour market prospects, low energy and oil prices and a gradual loosening of financial conditions. These factors are expected to continue to support growth in the short-to-medium term. However, the recovery is weaker than in the euro area as a whole and subject to some downside risks, in particular a slowdown in the growth of emerging markets and persistently low inflation.

Graph 1.1: **Real GDP growth and contributions**



"f" indicates that figures are based on the European Commission's 2016 winter forecast.
Source: European Commission (Eurostat)

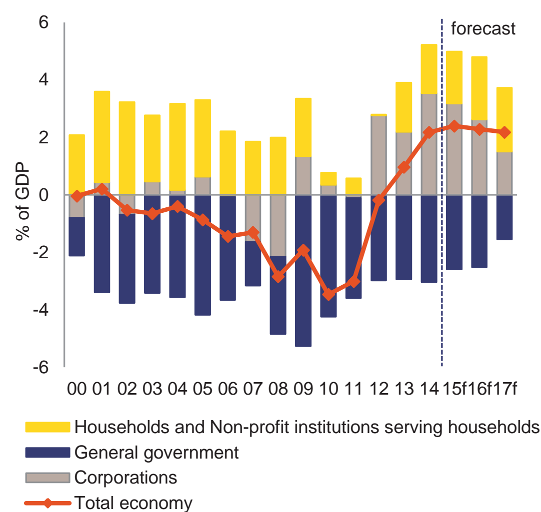
Growth is set to become increasingly self-sustained. Exports have supported economic activity in the first half of the year, but they declined in the third quarter as external demand faltered (Graph 1.1). Risks of a further slowdown in world demand, especially as emerging markets economies weaken further, would limit the extent to which exports support economic activity. Still, over the course of 2015, the contribution of private consumption increased gradually. This was underpinned by sustained job creation, low inflation and the consequent rise in real disposable income, notwithstanding the context of continued wage moderation. Looking forward, growth is set to be driven increasingly by domestic demand, also led by a recovery in investment. Some of the factors that have held back investment in recent years (weakness of private demand, financial fragmentation and uncertainty as to future prospects) are starting to recede. Sound non-financial corporations are in position to self-finance investments as they have been net lenders to the economy since 2012 and deleveraging needs are receding. In addition, policy measures to reduce labour costs and improve firms' profit margins are expected to boost investment further, mainly in machinery and equipment, while investment in construction is expected to resume only at a later stage and more gradually (Box 1.1).

Financing conditions for the private sector have started to loosen. The European Central Bank's Survey on Access to Finance of Enterprises (SAFE) for April-September 2015 pointed to improvements in access to financing for Italy's small and medium-sized enterprises. Similarly, the Bank Lending Survey conducted by Bank of Italy for the final quarter of 2015 reported a continued easing of credit standards on loans to firms and households as well as strengthening loan demand from both sectors. The stock of credit to households has started to expand since June, albeit modestly. The contraction of credit towards non-financial corporations slowed steadily over the course of 2015. The Bank of Italy projects credit towards non-financial corporations to start expanding in the first half of 2016 as the economic recovery strengthens and monetary policy remains accommodative.

The situation of Italian banks is improving but the market for impaired loans has yet to develop. The gradual improvement in the economy is being reflected in Italian banks' balance sheets. Though still weak, profitability is showing signs of recovery thanks to an increase in income from services and a slight reduction in value adjustments to loans. Banks' stock of non-performing loans is still increasing, but at a slowing pace. The slowdown in flows is not yet reflected in a reduction in the stock of non-

performing loans, because of the low work-out rate and the related difficulties in starting a secondary market. Recent reforms affecting credit recovery procedures, the tax deductibility of write-downs and losses on loans, and the setting up of a guarantee scheme could accelerate the closure of impaired loans. In June 2015, the ratio of non-performing loans in the Italian banking system stood at 17.5 % of total customer loans. The stock of bad debts – the worst category of non-performing loans – has risen to around EUR 200 billion (EUR 89 billion net of loan-loss provisions). However, recent increases in bad debts can mainly be ascribed to the reclassification of loans that were already non-performing and the rate of new bad debts is projected to decline gradually (see Section 2.5).

Graph 1.2: **Net lending/borrowing by sector**

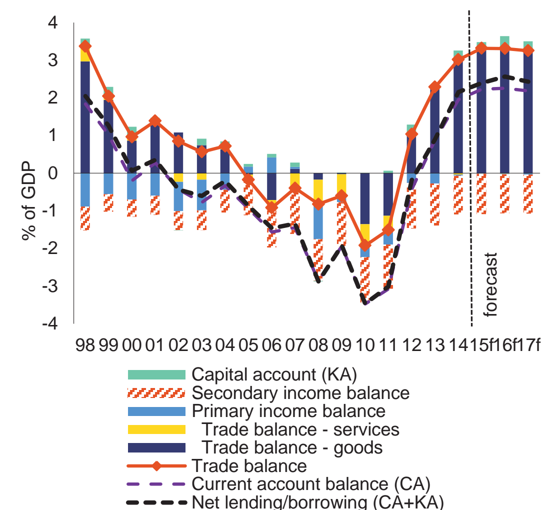


"f" indicates that figures are based on the European Commission's 2016 winter forecast.
Source: European Commission

Italy's private and public sectors are moving into passive deleveraging. The deleveraging process is set to shift slowly from being driven by negative net credit flows (i.e. active deleveraging) to being driven by nominal GDP growth outpacing net credit growth (i.e. passive deleveraging). Italy's corporate sector has turned into a net lender to the economy since 2012 mainly on the back of the sharp decline in investment, while the household sector has strengthened its net lender position by restoring savings. The general government borrowing position is slowly improving (Graph 1.2). These savings-investment dynamics have been mirrored in Italy's current account turning into surplus in 2013, after almost a decade of negative balances.

After a significant adjustment over the past few years, the current account surplus is expected to broadly stabilise in 2016-2017. The current account surplus stems from the rapid improvement in the trade balance and some decline in the primary income deficit while the other components have remained broadly stable (Graph 1.3). The current account surplus is expected to have reached 2.2 % of GDP in 2015, but it broadly stabilised over the course of the year: on the one hand, rising domestic demand fuelled imports, and on the other, the slowdown of world trade weighed on Italy's exports. As the economic recovery strengthens domestically and abroad, exports are forecast to regain momentum. However, imports are also expected to rise further, sustained not only by consumption but also by the long-awaited recovery in investments. This ultimately implies a broadly stable current account surplus in 2016 and 2017 (see Section 2.3).

Graph 1.3: **Breakdown of external position (current and capital accounts)**

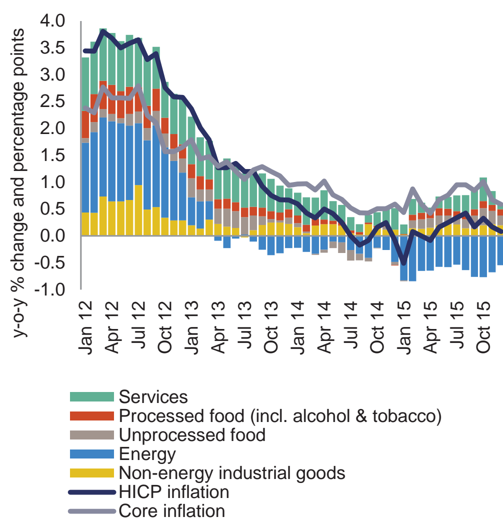


"f" indicates that figures are based on the European Commission's 2016 winter forecast.
Source: European Commission

Price developments have remained muted, mainly as a result of external factors. Inflation has gradually fallen since the mid- 2012 and it has been broadly stabilising over the course of 2015 at around 0.1 % (Graph 1.4). Headline inflation was

driven down by energy prices, while core inflation remained at around 0.7 % also on the back of contained labour cost pressures. The labour market slack, cuts to the labour tax wedge and inflation being lower than expected in previous bargaining rounds have been keeping labour cost pressures limited. Inflation is then projected to remain very low in 2016, as wage pressures remain limited and energy prices fall. The recent price developments are not likely to represent an immediate deflationary risk, especially in view of the action taken by the European Central Bank and strengthening growth. However, inflation expectations (measured in terms of inflation-linked swap rates) in Italy remain below the medium-term target of the European Central Bank. Persistently low inflation would make it more difficult to achieve the deleveraging necessary to ensure the sustainability of public and private finances.

Graph 1.4: **HICP inflation and the contributions of its components**

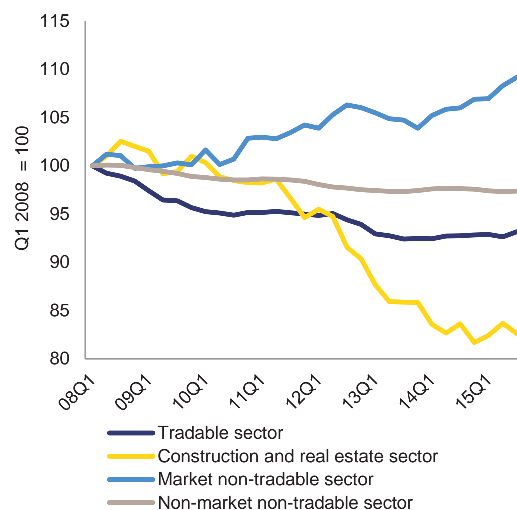


Source: European Commission

The labour market situation has been improving since mid-2014, despite the slow economic recovery. After the steep increase in the labour force recorded in 2012 following the pension reform, labour market participation has increased, albeit at a moderated pace. Employment, both in headcount and hours worked, has started to increase since mid-2014, even though the economy was still contracting. The pace of the recovery has strengthened over the course of 2015, supported also by a three-year social contribution exemption for new permanent hires made in 2015. While employment grew, the labour force remained broadly stable, resulting in a decline of the unemployment rate to 11.4 % in December 2015 (down from a post-crisis peak of 13.1 % in November 2014). As the economic recovery gathers pace and social contribution exemption remains in place, albeit only partially (40 %), employment is projected to grow further. The unemployment rate is expected to continue its gradual decline, but to remain at high levels since some of the many previously discouraged people are expected to join the labour force (see Section 2.4).

The crisis has changed the composition of employment. The change in the sectoral composition of the economy was driven mainly by a shrinking by nearly 20 % of the workforce in the construction and real-estate development sectors (Graph 1.5). However, the employment recovery registered since mid-2014 was driven mainly by services (i.e. market non-tradable sectors). The tradable sector, namely manufacturing, has shown some signs of stabilisation in headcount terms, while the drop in the number of hours of wage supplementation scheme (*cassa integrazione guadagni*) points to a gradual recovery in working hours.

Graph 1.5: **Headcount employment dynamics by sector**



Source: European Commission

Persistently high unemployment rates have negative consequences for employability and social conditions. The long-term unemployment

rate has been increasing steadily since 2008 for all age groups. Persistent joblessness poses significant risks to labour market participation which remain relatively low, especially for women and older workers. Against this background, social indicators have deteriorated in the aftermath of the crisis. The percentage of population at-risk-of poverty or social exclusion rose between 2008 and 2012 and declined only marginally in recent years. In Italy there were 17.1 million people at risk of poverty or social exclusion in 2014 (see Section 3.5).

Public finance developments

In 2015, the Italian general government deficit is projected at 2.6 % of GDP. Italy's deficit is expected to have declined from 3.0 % of GDP in 2014 to 2.6 % in 2015 supported by a further drop in interest expenditure and a marginally higher primary surplus stemming from positive economic growth. Primary expenditure is set to have continued to rise at a slow pace. More specifically, current primary expenditure is projected to have increased by less than 1 % year-on-year in nominal terms, thanks to the expenditure cuts legislated in the 2015 Stability Law and the ongoing freeze in public wages. However, this is partially offset by additional spending on the tax credit to low-wage employees, the extension of unemployment benefits, and new recruitment in the education system. The government estimates outlays related to the influx of refugees and migrants at around 0.2 % of GDP in 2015, marginally higher than in 2014 and twice as much as in 2011-2013. As regards capital expenditure, public investment is set to have bottomed out after five years of significant contraction. One-off outlays related to the Constitutional Court ruling about the full de-indexation of higher pensions over 2012 and 2013 affected capital transfer dynamics. On the revenue side, the improved economic outlook implies positive developments for personal and corporate income tax revenues. However, the reduction in the labour tax wedge is expected to have affected intakes from the regional tax on economic activities (IRAP) and social contributions. Overall, annual revenue increases are projected to have been in line with nominal GDP growth. In 2015, the structural balance is expected to have improved slightly relative to 2014 and the debt-to-GDP ratio to have peaked at close to 133 %.

The 2016 Stability Law is based on an expected marked worsening in the structural balance implying only a slight reduction in debt. For 2016, Italy asked for flexibility under the investment and structural reform clauses. Taking into account the expected impact of the 2016 Stability Law, Italy's deficit is projected to narrow only slightly in 2016, to 2.5 % of GDP, despite the positive growth outlook. This results in a deterioration of the structural balance of around 0.7 percentage points of GDP. The fall in interest expenditure from the 2012 peak (by around 1 percentage point of GDP by 2015) contributed decisively to keeping the structural balance broadly stable between 2012 and 2015 (at around 0.3 percentage points over the three years) despite the deterioration observed in the structural primary balance, by around 0.7 percentage point over the three years and set to continue in 2016, in a context of low nominal growth. On the revenue side, taxation is forecast to increase much less than nominal GDP as a result of a reduction in labour and property taxation. As a result, the tax burden is set to fall by nearly ¾ percentage points of GDP relative to 2015. In 2017, the headline deficit is projected to continue declining (to 1.5 % of GDP) based on a no-policy-change assumption. The government debt-to-GDP ratio is set to only slightly decrease to 132.4 % in 2016 and to 130.6 % in 2017, mainly due to higher nominal growth and primary surplus.

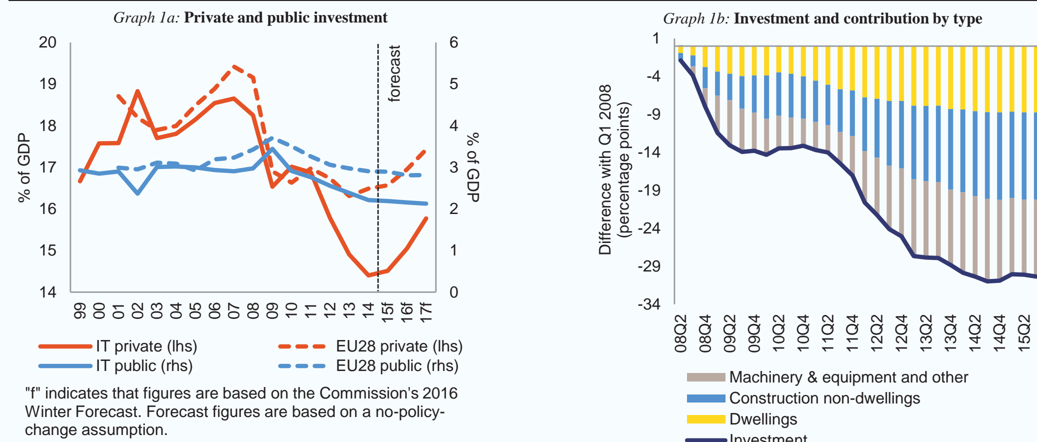
Box 1.1: Investment challenges

Macroeconomic perspective

Investment in Italy started to decline in 2008 and fell more sharply after the sovereign debt crisis. Before the crisis, Italy's investment as a share of GDP was broadly in line with that of the EU. As the crisis hit, the decline was sharper than the EU average and investment as a share of GDP fell to 16.6 % in 2014, from 21.6 % in 2007, nearly 3 percentage points below the EU average. In 2015 investment is expected to have marginally recovered, driven by machinery and equipment while construction is set to have broadly stabilised.

The investment decline concerned both the private and public sectors and both residential and non-residential types. Public investment in Italy fell from a peak of 3.4 % as a share of GDP in 2009 to 2.2 % in 2014 (Graph 1a). This was mainly a consequence of the fiscal adjustment pursued by the public sector in the aftermath of the sovereign debt crisis. Private investment declined from 18.7 % of GDP in 2007 to 14.4 % in 2014, around 2 percentage points below the EU average. The level of total investment was 30 % below the pre-crisis peak recorded in the first quarter of 2008. All types of investment contributed to this decline, with non-residential investment accounting for two thirds of the total drop (Graph 1b). The decline was driven by the fall in demand, the squeeze in firms' profits and tight financing conditions resulting from financial fragmentation and the banking sector which is impaired by rising non-performing loans. Since the beginning of 2015, credit conditions have started to ease, although primarily for exporting firms, while demand and profit margins began to rise, providing the conditions for a recovery in investment (Graph 2a). As demand strengthens further in 2016 and 2017, investment is expected to rebound.

Graph 1: **Investment developments**



Source: European Commission

Structural barriers to investment

The World Bank Doing Business Indicator for 2015 points to a less business- friendly environment in Italy than in the EU as a whole (Graph 2b). In particular, Italy performs worse than the EU average in the fields of access to finance, taxation and contract enforcement. So, despite recent progress ([1]), investment barriers in Italy remain in key areas ([2]):

([1]) The Government adopted relevant reforms in the field of labour market (Section 2.4) and education (Section 3.4).
([2]) European Commission (2015), *Member States Investment Challenges*, SWD(2015)400/2 final, available at http://ec.europa.eu/europe2020/pdf/2016/ags2016_challenges_ms_investment_environments_en.pdf.

(Continued on the next page)

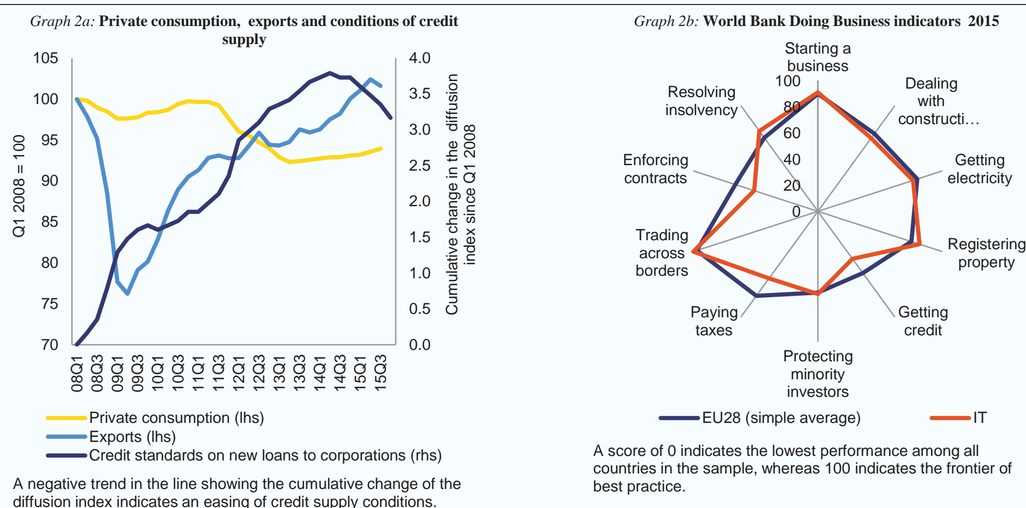
Box (continued)

Firms' access to finance remains heavily biased towards banks where some vulnerabilities persist (see Sections 2.5 and 3.3). Italian firms have relatively more debt than equity, which may restrict their access to credit. In addition, the high stock of non-performing loans weighs on banks' balance sheets constraining banks' capacity to support the economy. The ongoing and planned reform of the Italian insolvency system and the new securitisation scheme to be launched in March may help clean up banks' balance sheets. Capital markets remain underdeveloped, which represents a constraint particularly for innovative young firms. To improve firms' capitalisation and diversify access to finance, since 2011 the government has introduced an allowance for corporate equity to reduce the tax bias towards debt finance as well as a series of other measures (e.g. Central Guarantee Fund, mini-bonds).

The tax burden on productive factors remains high (see Section 3.1). Italy's taxes on capital as a share of GDP are relatively high (10.6 % vs. 8.2 % in the EU in 2014). Similarly, the implicit tax rate on labour stood at 44 % in 2014, 7.6 percentage points higher than the EU average. The government has started to take action to reduce the tax burden on labour and the 2016 Stability Law provides for a reduction in the corporate income tax from 2017. The law also provides for tax incentives on new investments for 2016. However, the fragmentation and uncertainty of R&D tax incentives are affecting private investment in innovation. In addition to the recent measures taken by the government, at end-2015 Italy's Cassa Depositi e Prestiti approved a business plan for 2016-2020 to boost investment by mobilising fresh resources especially for venture capital, innovation and development (see Section 3.1).

Public administration is inefficient, the regulatory burden remains high and the judicial system continues to be slow (see Section 3.2). Italy's public administration is characterised by significant bottlenecks and administrative weaknesses at local government level and, to a more limited extent, at national level. This also results in a low rate of absorption of EU structural funds. A comprehensive enabling law to reform Italy's public administration has been adopted and most of the implementing decrees will have to be adopted by August 2016. Insufficient coordination and overlapping responsibilities between levels of government increase uncertainty and make decision-making lengthy. A constitutional law to tackle this aspect is currently discussed in parliament. In addition, the low quality of Italian regulations, frequent changes to the legislation and slow enforcement due to lengthy proceedings weaken their effectiveness and overall legal certainty. Last but not least, most state-owned enterprises in local public services are sheltered from competition and this may result in underinvestment in important sectors of the economy.

Graph 2: **Private consumption, exports, conditions of credit supply and distance to the frontier of best performance**



A negative trend in the line showing the cumulative change of the diffusion index indicates an easing of credit supply conditions.

A score of 0 indicates the lowest performance among all countries in the sample, whereas 100 indicates the frontier of best practice.

Source: European Commission, World Bank

Box 1.2: **Contribution of the EU Budget to structural change**

Italy is a beneficiary of European Structural and Investment Funds (ESIF) and can receive up to EUR 43 billion for the period 2014-2020. This is equivalent to 0.4% of GDP (on an annual basis) and nearly 15% of the expected national public investment in areas supported by the ESI funds.

In the programming phase 2014-2020, the use of ESI funds is conditional to the delivery of reforms in a number of fields ("ex ante conditionalities"). The adoption of administrative capacity plans (PRA), that was a condition for the adoption of the 2014-2020 Operational Programmes and are an important step towards the improvement of administrative capacity in the use of ESI funds. Reforms in areas such as the fight against poverty, state aid, public procurement have started: the corresponding actions plans need to be completed at the latest by end-2016. The development of a national plan against poverty, for instance, will be carried out in this framework. Where ex-ante conditionalities are not fulfilled by end 2016, the Commission may suspend interim payment to the priorities of the programme concerned.

The programming of the Funds includes a focus on priorities and challenges identified in recent years in the context of the European Semester and under the Europe 2020 strategy. The ESI funds constitute a major resource in support of reforms indicated by the CSRs, for instance, in relation to the upgrading of port and logistic, the reform of public administration (including with respect to the use of ESI funds), the reinforcement of active labour market policies and services, the improvement of education and training and fight against early school leaving, the development of a Youth guarantee and the implementation of an anti-poverty scheme. Italy also benefits from EUR 567 million under the Youth Employment Initiative (matched by the same amount from the European Social Fund) to support young people to find their way to the labour market, get involved into traineeship projects or continue their education. Regular monitoring of implementation includes reporting in mid-2017 on the contribution of the funds to Europe 2020 objectives and progress in addressing relevant structural reforms to maximise the use of EU financing.

Financing under the new European Fund for Strategic Investments (EFSI), Horizon 2020, the Connecting Europe Facility and other directly managed EU funds would be additional to the ESI Funds. Following the first rounds of calls for projects under the Connecting Europe Facility, Italy has signed agreements for EUR 1 billion for transport projects. For more information on the use of ESIF in Italy, see: https://cohesiondata.ec.europa.eu/countries/IT.

Table 1.1: **Key economic, financial and social indicators - Italy**

									Forecast		
	2003-2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP (y-o-y)	1.2	-1.0	-5.5	1.7	0.6	-2.8	-1.7	-0.4	0.8	1.4	1.3
Private consumption (y-o-y)	1.3	-1.1	-1.6	1.2	0.0	-3.9	-2.7	0.4	0.9	1.5	0.6
Public consumption (y-o-y)	0.6	1.0	0.4	0.6	-1.8	-1.4	-0.3	-0.7	0.2	0.1	1.0
Gross fixed capital formation (y-o-y)	1.6	-3.1	-9.9	-0.5	-1.9	-9.3	-6.6	-3.5	1.0	3.8	4.8
Exports of goods and services (y-o-y)	4.5	-3.1	-18.1	11.8	5.2	2.3	0.8	3.1	4.3	3.1	4.4
Imports of goods and services (y-o-y)	4.5	-3.7	-12.9	12.4	0.5	-8.1	-2.5	2.9	5.3	4.9	4.9
Output gap	1.0	1.0	-4.2	-2.1	-1.6	-3.3	-4.2	-3.9	-2.9	-1.5	-0.3
Potential growth (y-o-y)	1.0	0.2	-0.4	-0.4	0.0	-1.1	-0.8	-0.8	-0.2	0.0	0.1
Contribution to GDP growth:											
Domestic demand (y-o-y)	1.1	-1.1	-3.0	0.8	-0.8	-4.5	-2.9	-0.5	0.8	1.6	1.4
Inventories (y-o-y)	0.1	-0.1	-1.2	1.2	0.2	-1.2	0.3	-0.1	0.2	0.2	0.0
Net exports (y-o-y)	0.0	0.2	-1.3	-0.2	1.2	2.9	0.9	0.1	-0.1	-0.4	0.0
Contribution to potential GDP growth:											
Total labour (hours) (y-o-y)	0.4	-0.2	-0.5	-0.5	0.0	-0.9	-0.4	-0.3	0.2	0.2	0.2
Capital accumulation (y-o-y)	0.7	0.6	0.3	0.3	0.2	0.0	-0.1	-0.2	-0.1	-0.1	0.0
Total factor productivity (y-o-y)	-0.1	-0.2	-0.2	-0.1	-0.2	-0.2	-0.3	-0.3	-0.3	-0.2	-0.1
Current account balance (% of GDP), balance of payments	-1.0	-2.9	-1.9	-3.5	-3.1	-0.4	0.9	1.9	-	-	-
Trade balance (% of GDP), balance of payments	-0.1	-0.8	-0.6	-1.9	-1.5	1.0	2.3	3.0	-	-	-
Terms of trade of goods and services (y-o-y)	-0.9	-2.1	6.3	-4.0	-2.6	-1.5	1.6	2.2	1.8	1.5	0.0
Capital account balance (% of GDP)	0.1	0.0	0.0	0.0	0.1	0.2	0.0	0.2	-	-	-
Net international investment position (% of GDP)	-18.2	-23.6	-24.9	-23.4	-21.9	-26.8	-29.1	-27.9	-	-	-
Net marketable external debt (% of GDP) (1)	-25.3	-32.4	-35.4	-40.6	-38.6	-43.8	-49.7	-52.4	-	-	-
Gross marketable external debt (% of GDP) (1)	89.4	97.2	104.2	105.8	103.5	109.2	109.2	115.7	-	-	-
Export performance vs. advanced countries (% change over 5 years)	-0.8	-6.4	-10.9	-12.4	-11.9	-16.7	-12.5	-8.26	-	-	-
Export market share, goods and services (y-o-y)	-1.8	-6.6	-4.9	-8.7	-3.0	-5.0	0.7	1.5	-	-	-
Net FDI flows (% of GDP)	0.7	3.2	0.0	1.0	0.8	0.3	0.0	0.3	-	-	-
Savings rate of households (net saving as % of net disposable income)	8.8	7.7	7.0	4.1	3.6	1.8	3.9	3.4	-	-	-
Private credit flow (consolidated, % of GDP)	9.3	6.6	0.9	5.0	3.2	-0.7	-2.7	-1.0	-	-	-
Private sector debt, consolidated (% of GDP)	96.7	113.8	120.7	121.5	121.0	123.4	120.8	119.3	-	-	-
of which household debt, consolidated (% of GDP)	32.8	39.1	42.5	43.6	43.8	43.9	43.5	42.9	-	-	-
of which non-financial corporate debt, consolidated (% of GDP)	63.9	74.7	78.2	77.9	77.2	79.5	77.3	76.4	-	-	-
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-0.1	-2.1	1.3	0.3	-0.1	2.8	2.2	3.5	3.2	2.6	1.5
Corporations, gross operating surplus (% of GDP)	23.0	22.4	20.9	21.0	21.0	20.1	20.2	20.0	20.2	20.6	20.4
Households, net lending (+) or net borrowing (-) (% of GDP)	2.4	2.0	2.0	0.4	0.6	0.0	1.7	1.7	1.8	2.2	2.2
Deflated house price index (y-o-y)	3.6	-0.4	-0.2	-2.2	-2.1	-5.3	-6.9	-4.6	-	-	-
Residential investment (% of GDP)	5.4	5.8	5.6	5.6	5.3	5.0	4.9	4.7	-	-	-
GDP deflator (y-o-y)	2.4	2.5	2.0	0.3	1.5	1.4	1.3	0.9	0.5	0.8	1.6
Harmonised index of consumer prices (HICP, y-o-y)	2.3	3.5	0.8	1.6	2.9	3.3	1.3	0.2	0.1	0.3	1.8
Nominal compensation per employee (y-o-y)	3.2	3.7	2.2	2.7	1.1	0.4	1.5	0.6	0.4	0.4	1.0
Labour productivity (real, person employed, y-o-y)	0.1	-1.3	-3.9	2.4	0.3	-2.5	0.0	-0.5	-	-	-
Unit labour costs (ULC, whole economy, y-o-y)	2.7	4.3	5.2	0.1	0.7	1.9	0.7	1.3	0.6	0.0	0.6
Real unit labour costs (y-o-y)	0.3	1.8	3.2	-0.2	-0.8	0.5	-0.6	0.4	0.1	-0.8	-0.9
Real effective exchange rate (ULC, y-o-y)	2.8	2.3	2.4	-2.8	0.4	-2.3	2.4	1.1	-4.1	-1.0	-
Real effective exchange rate (HICP, y-o-y)	1.4	1.4	1.3	-4.5	0.0	-1.9	1.9	0.3	-4.0	0.8	-0.4
Tax wedge on labour for a single person earning the average wage (%)	28.2	29.6	29.8	29.8	30.8	30.9	31.0	31.6	-	-	-
Taxe wedge on labour for a single person earning 50% of the average wage (%)	18.5*	20.6	21.0	21.2	22.5	22.7	22.9	18.4	-	-	-
Total financial sector liabilities, non-consolidated (y-o-y)	8.3	-8.9	5.5	3.5	-0.5	6.0	0.4	0.9	-	-	-
Tier 1 ratio (%) (2)	-	6.9	8.3	8.8	9.6	10.7	10.5	11.8	-	-	-
Return on equity (%) (3)	-	4.9	3.8	3.8	-14.3	-1.2	-12.8	-3.2	-	-	-
Gross non-performing debt (% of total debt instruments and total loans and advances) (4)	-	5.0	7.5	8.4	9.5	11.0	12.9	15.8	-	-	-
Unemployment rate	7.4	6.7	7.7	8.4	8.4	10.7	12.1	12.7	11.9	11.4	11.3
Long-term unemployment rate (% of active population)	3.8	3.1	3.5	4.1	4.3	5.7	6.9	7.8	-	-	-
Youth unemployment rate (% of active population in the same age group)	22.7	21.2	25.3	27.9	29.2	35.3	40.0	42.7	-	-	-
Activity rate (15-64 year-olds)	62.4	62.9	62.3	62.0	62.1	63.5	63.4	63.9	-	-	-
People at-risk poverty or social exclusion (% total population)	25.9	25.5	24.9	25.0	28.1	29.9	28.5	28.3	-	-	-
Persons living in households with very low work intensity (% of total population aged <60)	11.2	10.4	9.2	10.6	10.5	10.6	11.3	12.1	-	-	-
General government balance (% of GDP)	-3.3	-2.7	-5.3	-4.2	-3.5	-3.0	-2.9	-3.0	-2.6	-2.5	-1.5
Tax-to-GDP ratio (%)	40.1	41.5	42.0	41.7	41.7	43.7	43.6	43.7	43.6	42.9	42.9
Structural budget balance (% of GDP)	.	.	.	-3.3	-3.3	-1.3	-0.9	-1.1	-1.0	-1.7	-1.4
General government gross debt (% of GDP)	100.9	102.3	112.5	115.3	116.4	123.2	128.8	132.3	132.8	132.4	130.6

(1) Sum of portfolio debt instruments, other investments and reserve assets. (2, 3) Domestic banking groups and stand-alone banks. (4) Domestic banking groups and stand-alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches. (*) Indicates BPM5 and/or ESA95

Source: European Commission (2015 winter forecast), European Central Bank

2. IMBALANCES, RISKS, AND ADJUSTMENT ISSUES

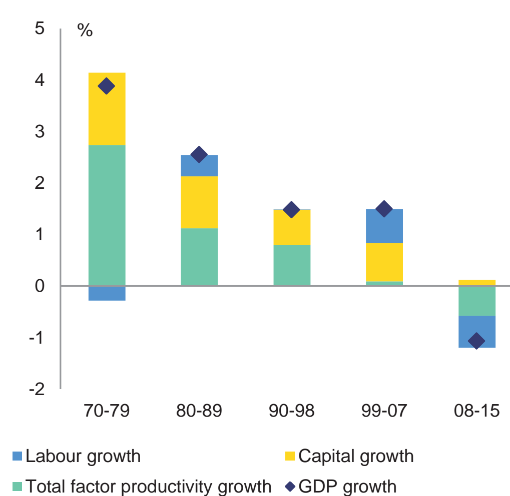
This section provides the in-depth review foreseen under the macroeconomic imbalances procedure (MIP). It focuses on the risks and vulnerabilities flagged in the Alert Mechanism Report 2016. The section analyses the reasons behind the sluggishness of productivity growth, discusses the implications of the high debt-to-GDP ratio, and assesses the competitive position of the Italian economy. It also analyses adjustment challenges in the labour market and in the banking sector and looks into how the important reforms in those policy areas may help to address the imbalances and restore productivity growth. Furthermore, it evaluates how the Italian economy affects and is affected by the rest of the euro area. The section concludes with the MIP assessment matrix which summarises the main findings.

2.1. PRODUCTIVITY

Italy's productivity has been stagnant since the mid-1990s. Rapid post-war growth had brought Italy's GDP per capita above the OECD average by the 1980s. However, Italy's economic growth faltered from the mid-1990s onwards and GDP per capita deteriorated rapidly relative to the euro area and OECD countries. Graph 2.1.1 shows that the main driver of the growth turnaround was the declining contribution of total factor productivity, which measures the efficiency with which inputs are used in the economy. On the other hand, the quantity of capital input and to some extent labour input continued to contribute positively to growth, at least until the crisis. Graph 2.1.2 shows that total factor productivity has been declining in Italy while growing or remaining broadly stable in the other large euro area countries.

The productivity growth gap concerns almost all sectors of the economy, but it is larger in services. Internationally comparable data for total factor productivity are not available at sectoral level. Instead, Graph 2.1.3 shows labour productivity growth in 1999-2014 for key sectors of the economy. Labour productivity depends on total factor productivity and the amount of capital per unit of labour. In 1999-2014, Italy's labour productivity growth has been lower than the euro area average in all sectors except financial and insurance activities. Productivity grew less than in other euro area countries in the manufacturing sector and actually declined in trade, transport, communication and food services (sectors in which it increased in other large euro area countries) and in professional and other activities (by more than in other large euro area countries). Recent research shows that such within-sector decline of productivity growth is the main factor explaining the sluggishness of aggregate productivity over the last two decades. The reallocation of resources between sectors continued to contribute to aggregate productivity growth to a similar extent as in previous periods. ([1])

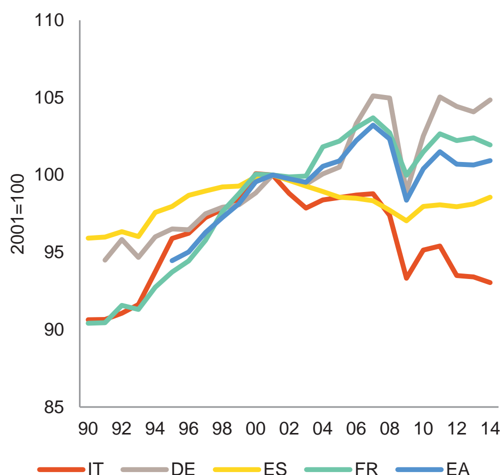
Graph 2.1.1: **Breakdown of GDP growth**



Source: European Commission (AMECO)

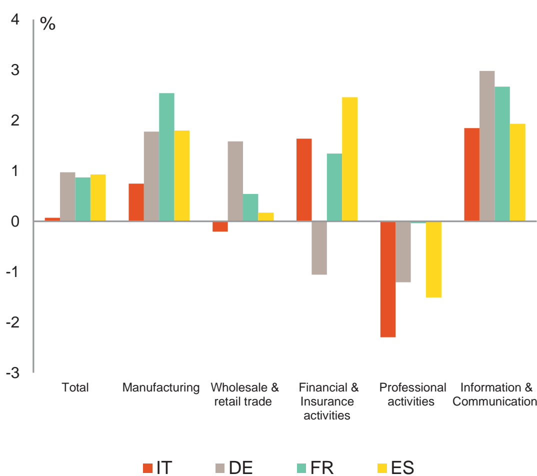
([1]) Daveri F. and Antonecchia G. (2015), *Productivity and reallocation in Italy during the Great Recession*, Istat seminar, January 2015, Rome.

Graph 2.1.2: **Total factor productivity growth**



Source: European Commission (AMECO)

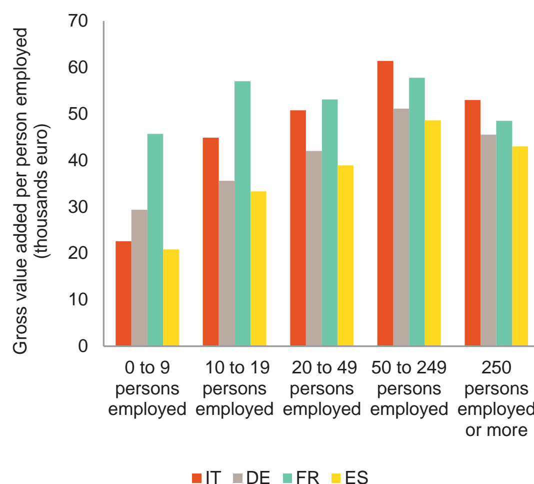
Graph 2.1.3: **Labour productivity growth in selected sectors, 1999-2014**



Source: European Commission

The high share of small firms in the economy and the very low productivity of small firms in the service sectors hold back aggregate productivity. Small firms tend to show lower productivity than large firms. Italy's large share of small firms therefore weighs on aggregated productivity. This is the main issue in manufacturing, where Italian firms show productivity levels similar to that of their peers of the same size in other euro area Member States In addition to this effect, Italy's micro- and small firms in the service sector exhibit lower productivity than their counterparts in Germany and France (Graph 2.1.4).

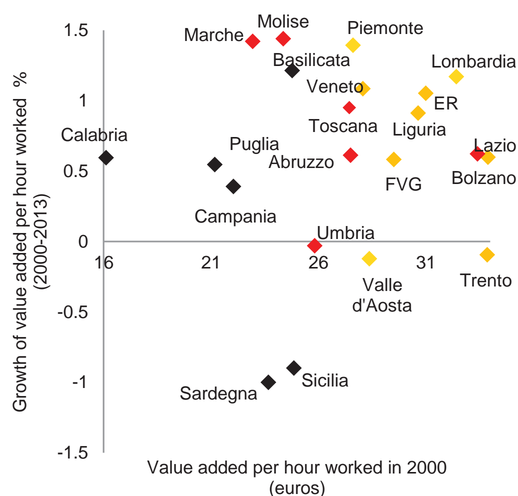
Graph 2.1.4: **Productivity by firm size in the trade sector, 2013**



Data shown are for the sector: wholesale and retail trade; repair of motor vehicles and motorcycles (G) in the Statistical classification of economic activities in the European Community (NACE)
Source: European Commission (Eurostat)

The wide regional productivity disparities are not closing. Graph 2.1.5 shows the very large regional disparities in labour productivity in manufacturing. It also shows that the productivity gap did not decrease in 1999-2013 (latest data available). As shown in the Commission's 2015 country report on Italy, the large productivity disparities have not been matched by wage dynamics, constraining the competitiveness of southern regions *vis-à-vis* the north. A very similar picture emerges if labour productivity in the whole economy is used.

Graph 2.1.5: **Labour productivity across Italian regions in manufacturing, 2000-2013**



In yellow: northern regions; red: centre regions; black: sourthern regions and islands. 'FVG' refers to Friuli-Venezia Giulia. 'ER' refers to Emilia-Romagna.
Source: European Commission (Eurostat)

Evidence of misallocation

There is evidence that misallocation has increased over time. Total factor productivity growth in the whole economy depends on firm-level dynamics in two respects. Firstly, given the share of input for each firm, aggregate productivity increases if firms use this input more efficiently (e.g. because of technological change). Italy's weaknesses in innovation and R&D are analysed in Section 3.4. Secondly, aggregate productivity increases if resources are reallocated from less productive to more productive firms. Economic research has recently started to measure the extent to which resources are misallocated in the economy using firm-level data. If input and output markets work efficiently, competition will force resource reallocation from the less productive to the more productive firms (for instance by driving the least productive out of the market), thereby reducing productivity differences. If markets do not work efficiently, firms with very different levels of productivity will be allowed to remain in the market. The research indicates that the dispersion of total factor productivity in revenue terms across firms gives therefore a measure of resource misallocation in the economy. Furthermore it shows to what extent such dispersion reduces the level of aggregate total factor productivity in the economy ([2]). A recent study calculates misallocation for the Italian economy using firm-level data ([3]). Graph 2.1.6 shows that misallocation in the manufacturing sector increased by more than 70 % over 1995-2013. The increase was very rapid in the period preceding the crisis, followed by some adjustment thereafter. The analysis also shows that the increase in misallocation is driven by the growing share of low productivity firms. In the service sector, misallocation increased even more rapidly. These results are in line with the analysis at the aggregate level, which shows a productivity slowdown around the mid-1990s.

The impact of the increase in misallocation on total factor productivity is sizeable. According to the study, if misallocation remained at the level of 1995, total factor productivity in 2013 would have been around 20 % higher. The literature is at a very early stage and few comparable studies are available. Evidence to date suggests that misallocation increased in Spain in 2000-2007 while it decreased in France in Germany in 2002-2008. These trends are broadly consistent with the trends in total factor productivity shown in Graph 2.1.2. ([4])

Resource misallocation seems to have increased more within geographical regions, firm size class and industrial sectors than across them. The study also shows that misallocation increased much more within categories than between them. This implies that reallocating resources to the most productive firms within these categories, would increase total factor productivity more than reallocating resources across categories, e.g. the aggregate productivity gains of moving workers and capital employed in the textile sector to the

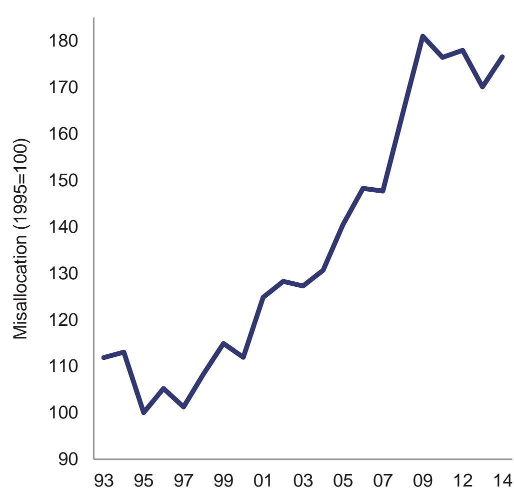
([2]) In practice, misallocation is measured as the variance of total factor productivity multiplied by the output price (revenue total factor productivity) across firms. Technical details in Chang-Tai H. and Klenow P.J. (2009), *Misallocation and Manufacturing TPF in China and India*, The Quarterly Journal of Economics, 124 (4): 1403-1448.

([3]) LSE Enterprise (2016), Study on capital and labour misallocation in Italy: the productivity conundrum, ECFIN contract 2014 017/H.

([4]) García-Santana M., Moral-Benito E., Pijoan-Mas J., Ramos R. (2015), *Growing like Spain*, mimeo, http://cadmus.eui.eu/bitstream/handle/1814/32232/MWP_WP_Crespo_Segura-Cayuela_2014_20.pdf; Crespo A. and Segura-Cayela R. (2014), *Understanding Competitiveness*, EUI Working papers 2014/20.

most productive firms in the textile sector itself are higher than moving them to the electronics sector. The analysis by geographical area shows, for instance, that while average revenue total factor productivity has been constantly lower in southern regions, resource misallocation tended to increase more in the other regions, and particularly in the industrialised northwest and centre.

Graph 2.1.6: **Misallocation in the manufacturing sector, 1993-2013**



Source: LSE Enterprise (2016), Study on capital and labour misallocation in Italy: the productivity conundrum, contract ECFIN 2014 017/H.

Mismatches between productivity and wages in the labour market and between productivity and loan growth in the capital market would support the misallocation hypothesis. The 2015 country report highlighted that earnings in Italy tend to increase continuously with age (unlike in other countries) and discussed the relevance of qualification and skill mismatches. Both indicate misalignments between wages, jobs, skills and productivity, and thus misallocation. ([5]) As regards capital, recent research uses firm-level data to analyse how the allocation of credit relates to firm-level total factor productivity growth. The results indicate that in Italy the allocation of credit does not respond to changes in productivity growth, as it is the case in other countries, particularly in France and Germany. ([6]) This confirms earlier finding of no correlation between loan growth (the main source of investment financing) and total factor productivity across sectors in 1999-2007. ([7]) Sections 2.4 and 2.5 discuss in more detail the functioning of labour and capital markets, respectively, and the ongoing reforms to change the regulatory framework and tackle the existing rigidities and inefficiencies that hinder the reallocation of resources.

The underlying causes of misallocation and sluggish total factor productivity growth are multi-layered and deep-rooted. Econometric analysis at the firm level confirms that certain characteristics of Italian firms, such as family ownership, the recourse to relational banking (i.e. the choice of a bank on the basis of personal relationships) and the low level of education among white-collar workers are associated with lower firm-level total factor productivity growth. ([8]) It also shows that state-ownership and the recourse to the wage supplementation schemes (see Section 2.3) are associated with higher misallocation. The broader literature highlights the role of the competition framework, as well as public administration and justice in fostering or hampering reallocation and productivity. ([9]) These factors are discussed in Sections 3.2, 3.3 and 3.6. Total factor productivity growth also crucially depends on human capital and innovation capacity. These factors are discussed in Section 3.4. Enhancing productivity through structural reforms in the above-mentioned policy areas is also one of the 2016 Council recommendations for the euro area.

([5]) European Commission (2015), *Macroeconomic Imbalances. Country Report – Italy 2015*, European Economy – Occasion Papers, no. 219.

([6]) Di Mauro F., Hassan F., Gianmarco I.P. Ottaviano (2015), poster session at the conference on 'Enhancing competitiveness and fostering sustainable growth', European Central Bank, Frankfurt am Main, June 2015.

([7]) Ottaviano G.I.P. and F. Hassan (2014), *Italy: the great unlearning*, VoxEu.org.

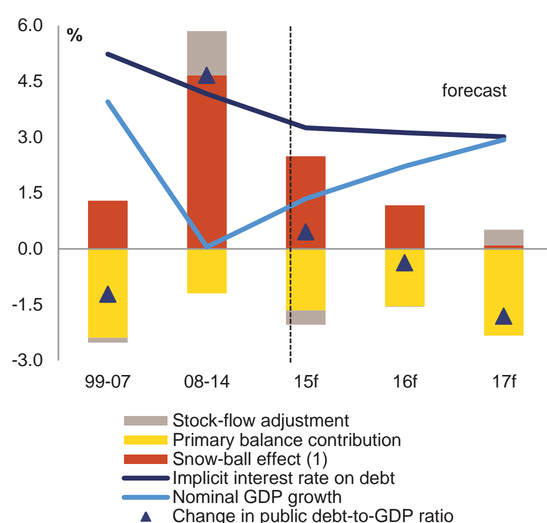
([8]) LSE Enterprise (2016), Study on capital and labour misallocation in Italy: the productivity conundrum, ECFIN contract 2014 017/H.

([9]) European Commission (2015), *Macroeconomic Imbalances. Country Report – Italy 2015*, European Economy – Occasional Papers, no. 219.

2.2. PUBLIC DEBT

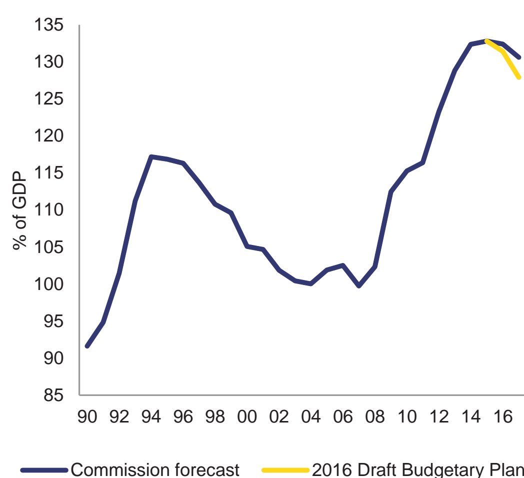
Italy's high public debt remains a source of vulnerability for the economy. The debt ratio increased on average by 4.7 percentage points of GDP per year over the 2008-2014 crisis period (Graph 2.2.1), bringing the debt-to-GDP ratio to 132.3 % in 2014 from the pre-crisis trough of around 100 % in 2007. The driver of this substantial increase was the large gap between rather high implicit interest rates paid on debt (4.2 % on average) and nearly zero average annual nominal GDP growth (-1.3 % real GDP growth and +1.4 % deflator), i.e. the 'snow-ball effect'. By contrast, the primary balance remained on average in surplus (1.2 % of GDP), therefore curbing debt dynamics. This was offset, however, by the large stock-flow adjustment mainly related to the financial support to euro area programme countries and the accumulation of liquidity buffers. According to the Commission's 2016 winter forecast, gross public debt is expected to have peaked at 132.8 % of GDP in 2015. The debt ratio is forecast to decline slightly in 2016 and somewhat more in 2017 (to 130.6 % of GDP) thanks to the expected recovery of real economic activity and inflation combined with a further decline in the implicit interest rate paid on debt.

Graph 2.2.1: **Drivers of annual % change in Italy's public debt-to-GDP ratio**



The snow-ball effect results from the difference between the implicit interest rate on debt and nominal GDP growth. The stock-flow adjustment includes to all transactions affecting public debt but not the government balance.
Source: European Commission

Graph 2.2.2: **Italy's public debt developments**

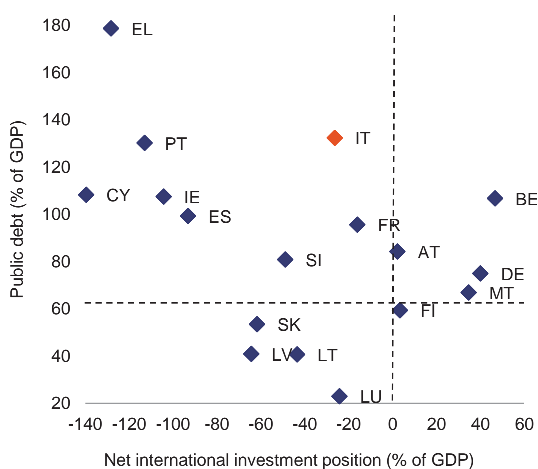


Source: European Commission

The sovereign-debt crisis shows that high (private and public) debt levels could lead to pro-cyclical fiscal policies. From mid-2011, Italy's economy was severely hit by increased risk aversion in financial markets because of its weakened fiscal and external positions following the global financial crisis. Italy displayed a negative and worsening current account balance (trough of -3.5 % of GDP in 2010) and a negative net international investment position. In this context, its sovereign securities and private debt instruments started to pay significant risk premia relative to core euro area countries and by end-2011 interest rates had reached unsustainable levels with spreads between Italian and German two-year sovereign bond yields above 700 basis points. This precarious situation forced the Italian government to adopt a strongly pro-cyclical restrictive fiscal stance in 2011-2013 in order to regain credibility *vis-à-vis* financial markets and other stakeholders. This resulted in an increase of around 3 percentage points in the structural primary surplus over the three years. However, this 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. The public debt-to-GDP ratio has further increased and the net international investment position has broadly stabilised at around -25/-30 % of GDP

(Graph 2.2.3), while the current account balance has significantly improved (2.2 % of GDP in 2015). As a result of the action undertaken at national and euro area level, the situation has now changed substantially as compared with that at the height of the crisis and, despite the recent turmoil in financial markets, spreads between Italian and German two-year sovereign bond yields are currently priced at around 50-70 basis points (and 130-160 bps for yields on ten-year bonds). Still, Italy has yet to address the vulnerability related to its high public debt and sluggish potential growth.

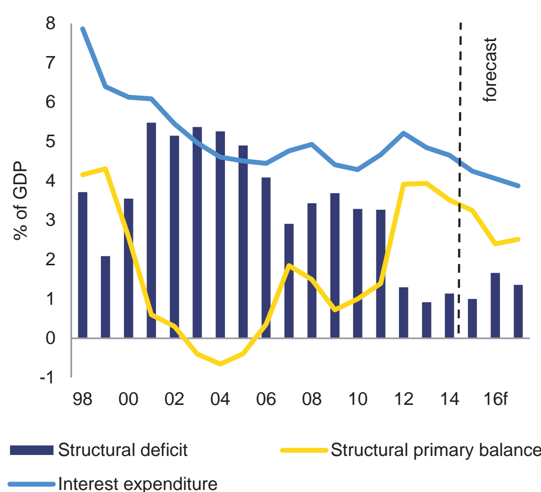
Graph 2.2.3: **Public debt and net international investment position, 2014**



Source: European Commission

Italy's banking sector remains exposed to the sovereign risk. The exposure of Italy's banking sector to Italian government securities has more than tripled since 2008 (from less than 8 % of GDP to around 25 % at end-2015). Since mid-2013, banks' exposure to sovereign securities has broadly stabilised, helped by decisive action by the ECB, including the 'outright monetary transactions' announced in summer 2012 and the launch of an expanded asset purchase programme started in January 2015. As foreign investors return and private investment opportunities resume, it is possible that Italian banks might significantly reduce their exposure to government securities in the coming years. However, for the time being, they remain vulnerable to possible abrupt changes in financial markets' perception of sovereign risk. In the medium to long term, the completion of the banking union, together with the proposed capital markets union, should deepen financial market integration in the euro area and thus make the Italian banking sector more resilient.

Graph 2.2.4: **General government structural balances**



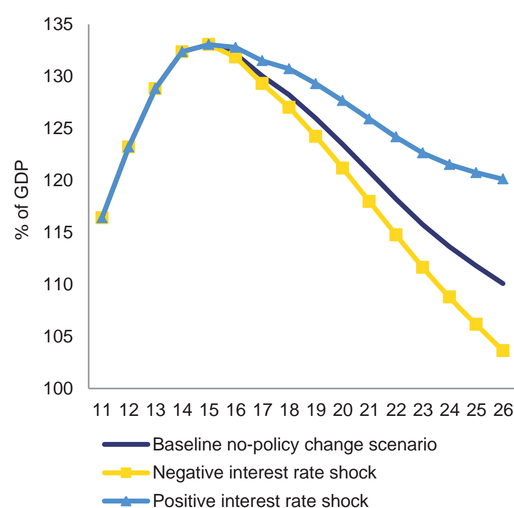
Source: European Commission

In 2016 the structural primary balance is forecast to worsen to a level not consistent with an adequate reduction in the debt-to-GDP ratio. The Commission's 2016 winter forecast expects an overall decline in Italy's structural primary surplus by around 1.5 percentage points of GDP, from the recent peak of around 4 % of GDP recorded in 2013 to 2.4 % in 2016 and 2.5 % in 2017, based on a no-policy change assumption (Graph 2.2.4). This would significantly slow down the pace of debt reduction. In a stylised baseline scenario in which the structural primary balance is kept constant at 2.5 % of GDP beyond the post-forecast horizon, the debt ratio would decrease only to below 125 % of GDP in 2020 and around 110 % in 2026. This still-high government debt ratio implies that, based on unchanged policies, the country would remain vulnerable to adverse shocks in the medium term. ([10]) Based on an alternative scenario, which assumes full compliance from 2017 with the fiscal effort required under the preventive arm of the Stability and Growth Pact, the debt ratio would decrease more substantially, to around 120 % of GDP in 2020. However, this scenario would require the structural primary surplus going back

([10]) European Commission (2015), *Fiscal Sustainability Report 2015*, European Economy – Institutional Paper, no. 018.

to around 4 % of GDP in the medium term, and is based on a rather favourable assumption of a differential between Italy's debt-servicing cost and economic growth averaging around 0.5 %.

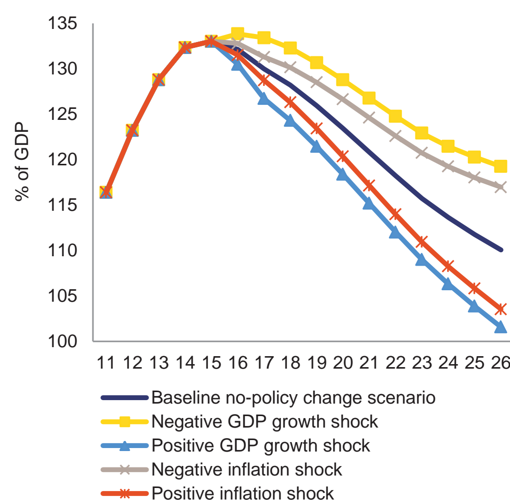
Graph 2.2.5: **Public debt under different interest rate assumptions**



The "negative interest rate shock" scenario assumes a standardised (permanent) negative shock of 1 percentage point to both short-term and long-term interest rates on newly issued and rolled over debt. The "positive interest rate shock" scenario assumes a standardised (permanent) positive shock of 2 percentage points to both short and long-term interest rates on newly issued and rolled over debt for the first 3 projection years followed by a 1 percentage point shock over the remaining of the projection horizon.
Source: European Commission - Fiscal Sustainability Report

Adverse shocks would further delay the reduction in the debt-to-GDP ratio. The weakened fiscal position expected for 2016 leaves the country exposed to adverse shocks in the medium term. Future debt-servicing costs might for instance be higher than assumed if significant risk aversion returned to financial markets and/or if the authorities' commitment to fiscal discipline were no longer deemed to be credible. Graph 2.2.5 shows public debt developments under alternative interest rates assumptions. Starting from the stylised baseline ('no-policy change') scenario incorporating implicit nominal interest rates paid on the debt at an average of 3.4 % over the 2016-2026 period, the assumed shock would imply implicit nominal interest rates averaging 4.1 % and a debt-to-GDP ratio still at around 120 % in 2026 (versus 110 % in the baseline scenario). A similar result would be obtained in the event of lower GDP growth or lower inflation, due for instance to an inefficient implementation of the ongoing reform agenda (Graph 2.2.6).

Graph 2.2.6: **Public debt under different growth and inflation assumptions**



The "negative GDP growth shock" scenario assumes an enhanced (permanent) negative shock to GDP growth of 0.5 percentage points. The "positive GDP growth shock" scenario assumes an enhanced (permanent) positive shock to GDP growth of 0.5 percentage points. The "negative inflation shock" scenario assumes a standardised (permanent) negative shock of 0.5 percentage points. The "positive inflation shock" scenario assumes a standardised (permanent) positive shock of 0.5 percentage points.
Source: European Commission, Fiscal Sustainability Report

Past pension reforms support the long-term sustainability of Italy's public debt. The full implementation of the pension reforms adopted in the past together with a prudent fiscal stance would help to ensure the sustainability of Italy's high public debt in the long run. Despite an ageing population, which will imply a significant rise in the dependency ratio, pension expenditure is expected to decline slightly as a share of GDP in the long term thanks to major reforms in the past. These savings are set to broadly compensate for the increasing spending outlays on healthcare and long-term care. ([11]) However, it must be borne in mind that these projections rely on the assumption of full implementation of recent pension reforms and positive developments in labour force participation and productivity.

([11]) European Commission (2015), The 2015 Ageing Report - Economic and budgetary projections for the 28 EU Member States (2013-2060), European Economy 3/2015.

Debt maturity is increasing again. Italy's public debt management office continues to pursue a strategy to increase the average maturity of state securities while limiting the issuance cost. The average maturity of sovereign securities reached a peak of over seven years in 2010. During the sovereign debt crisis the lack of demand for long-term maturity forced the debt management office to reduce the average debt maturity, which fell to 6.4 years by end 2014. However, the debt management office exploited favourable market conditions and the average debt maturity increased again slightly, to around 6.5 years at end-2015. Fixed-rate securities represented around 72.5 % of all government securities, inflation-linked securities 14 % and floating-rate securities (including short-term bills) 13.5 %. At the same time, the debt management office is taking advantage of historically low nominal interest rates and the average issuance yield in 2015 was 0.70 % (down from 3.11 % in 2012).

Privatisation proceeds and a reduction in the liquidity buffer help curb debt dynamics. The 2015 debt outcome benefited from privatisation proceeds amounting to around EUR 6.6 billion (or 0.4 % of GDP), including Banca Monte dei Paschi di Siena's reimbursement of Monti Bonds (EUR 1 billion), the sale of the Ministry of Economy and Finance's stake in ENEL (EUR 2.2 billion) and the initial public offering of Poste Italiane (EUR 3.2 billion). On the negative side, the 2015 debt was affected by the further settlement of trade debt arrears (around 0.4 % of GDP) and negative swap flows and swaptions (overall around 0.4 % of GDP) relating to past operations to hedge against the risk of increasing interest rates. Privatisations will support the debt reduction as the government plans to cash in 0.5 % of GDP each year in 2016-2018. However, the privatisation of up to 40 % of Ferrovie dello Stato (FS Group, the state railway company) has been postponed beyond 2016.

Fiscal framework

The national fiscal monitoring institution's analyses of the government's forecasts support transparency and accountability. The Parliamentary Budget Office became operational in 2014 and has gradually stepped up its work in the course of 2015. It is responsible for analysing and assessing macroeconomic and fiscal forecasts produced by the government and for verifying compliance with fiscal rules. Its reports and parliamentary hearings contribute to the transparency of the Italian budgetary process. For instance, in its recent assessment of the budget for 2016-2018, the Office considered that 2015-2016 growth forecasts underpinning the budget were acceptable, but found those for 2017 and 2018 excessively optimistic. While expecting the 3 % limit for the deficit to GDP ratio to be met in the coming years, the Office noted that the overall consistency of the budgetary strategy with the other rules of the Stability and Growth Pact appeared to be exposed to serious risks as regards both the preventive arm and the debt rule. However, it has to date commented only on the extent to which Italy has respected European fiscal rules and not on its compliance with country-specific rules. While this approach reflects to some extent the important cross-references to the EU provisions in the Italian fiscal framework, it does foster national ownership of the structural balanced budget rule enshrined in the Constitution.

Initiatives to reform Italy's fiscal framework are ongoing. As illustrated in Box 2.2.1, government expenditure as a share of potential GDP has been growing steadily since 1999, despite significant efforts to contain spending dynamics. Some spending review action has recently been taken, but savings targets tend to be lowered or underachieved. Spending reviews are expected to become a systematic feature thanks to a comprehensive reform of the budgetary process, which is being adopted. This reform could potentially bring Italy's budgetary process more in line with a performance-informed budgeting approach over the medium term. Balanced budget requirements for local governments are replacing the Domestic Stability Pact, but broad spending responsibilities continue not to be matched by autonomous fiscal capacity and this may contribute to spending overruns at local level. While it may be difficult to reduce Italy's primary expenditure significantly while leaving the current perimeter of state action unchanged, a systematic spending review process at all levels of government would allow for public expenditure to become more efficient and its composition more growth-friendly. Enforceable multi-annual expenditure ceilings supported by the full implementation of regular spending reviews could help to keep expenditure developments in line with revenues.

Box 2.2.1: Structure and evolution of public expenditure in Italy

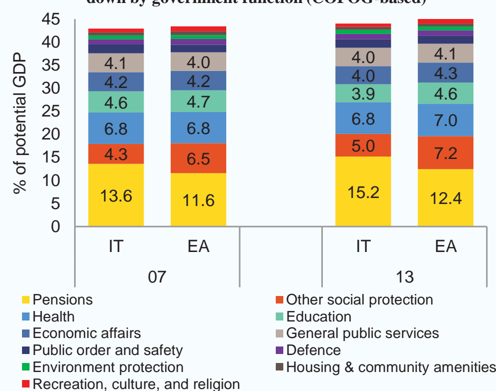
A recent analysis by the Commission ([1]) concludes that Italy's total public expenditure as a share of potential GDP has been steadily growing since 1999 due to both the insufficient containment of the country's current primary expenditure over the pre-crisis years and exceptionally sluggish potential growth since the global financial crisis. As a result, Italy's total public expenditure is now above the euro-area average despite slightly lower-than-average primary spending. In particular, Italy's debt-servicing costs continue to absorb considerably more resources than in the rest of the euro area, due to both a much more sizeable debt level and higher interest rates. Furthermore, large differentials between the implicit interest rate paid on it and sluggish nominal potential growth have implied adverse developments for the Italian public debt, especially after the 2010-2011 sovereign debt crisis.

Higher debt-servicing costs and a more demanding fiscal medium-term objective both imply that Italy should reduce its primary expenditure below the rest of the euro area, by around 2.5 percentage points, in order to avoid a relatively higher tax burden. At the same time, the debt sustainability challenge remains very relevant for the country, as a very high primary surplus, in the order of 4 % of GDP, would be needed to ensure compliance with the debt rule of the Stability and Growth Pact even under the assumption of a favourable trend reducing the differential between Italy's debt-servicing cost and potential growth to 0.5 percentage point in the medium term.

Italy's total public expenditure also appears increasingly biased towards the elderly, while growth-enhancing spending items have been severely restrained during the crisis. In particular, Italy's pension expenditure as a share of potential GDP is the second highest in the EU/OECD after Greece, while investment in infrastructure, education, and innovation has been particularly affected by the crisis (Graph 1). These developments, adding to long-standing inefficiencies, are likely to weigh on the country's anaemic potential growth. At the same time, past pension reforms, particularly the one in force since 2012 require full implementation to continue to contribute to the sustainability of the system, increase Italy's very low labour market participation, and underpin the adequacy of future entitlements.

Overall, it may be difficult to significantly compress Italy's primary expenditure in the future while leaving the current perimeter of State action unchanged. In this context, a systematic spending review would help at all government levels to increase the efficiency of public expenditure and make its composition more growth-friendly in order to support ongoing structural reform efforts and boost the country's potential growth. This is particularly true in a low-inflation environment, where containing public expenditure might not in itself suffice to keep its growth rate below the sluggish nominal potential GDP growth. The challenge is heightened by Italy's need to contain deflator dynamics below the rest of the euro area to restore price and cost competitiveness. In any case, a cautious approach is warranted by Italy in projecting future growth on which adjustments on the expenditure side are based, pending a long-needed step-change in the institutional setting, without which other reform efforts might not deliver their impact.

Graph 1: **Primary expenditure as share of potential GDP, broken down by government function (COFOG-based)**



Source: European Commission

([1]) Lorenzani D. and V. Reitano (2015), *Italy's Spending Maze Runner – an analysis of the structure and evolution of public expenditure in Italy*, European Economy – Discussion Paper, no. 023|2015.

Assessment of export performance

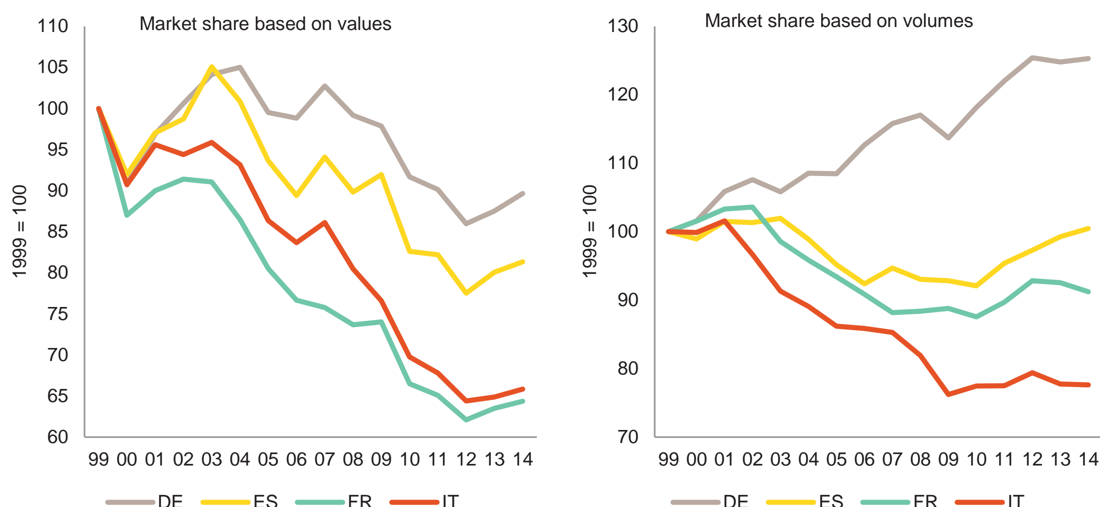
Export growth and market share

Italy is among the world's largest exporters. In terms of export value, it ranked fifth in the EU in 2014 (after Germany, the United Kingdom, France and the Netherlands). The country is also among the biggest exporters worldwide. As a share of domestic GDP, nominal exports of goods and services have in recent years gradually risen to around 30 % in Italy. This share is comparable to that of other large EU countries such as France (29 %) and Spain (33 %), but below that of Germany (46 %). In 2014, goods represented 82 % of Italian exports in value terms, whereas services accounted for only 18 %. Goods exports are dominated by manufacturing products which counted for 96 % of export value in 2014. The EU and the euro area absorbed 55 % and 40 % respectively of Italy's goods exports in 2014. In recent years, the country's goods exports have increasingly been oriented to non-EU countries. In 2014, around 80 % of goods exports originated in just five Italian regions, mainly in the north of the country (Piedmont, Lombardy, Emilia-Romagna, Veneto and Tuscany).

Italy's export market share loss since euro adoption worsened in the first phase of the crisis, while almost no recovery occurred thereafter. Since the adoption of the euro in 1999, Italy's export market share (goods and services) has declined significantly. This trend, which is due to the increasing participation of emerging markets in global trade, has affected other advanced economies, but the impact has been greater in Italy. During the first phase of the crisis, in which global trade collapsed (2008-2009), the erosion of large European countries' export market shares accelerated further, but Italy's nominal exports of goods and services were hit harder than those of its peers. As a result, the country's loss of export market share – in terms of both export volumes and values – has been significantly larger than that of Germany and Spain, and more similar to that of France (Graph 2.3.1). In 2010, Italian nominal export growth recovered, but less so than that of its European peers (except France). This stopped the

2.3. EXTERNAL COMPETITIVENESS

Graph 2.3.1: **Export market share of goods and services**

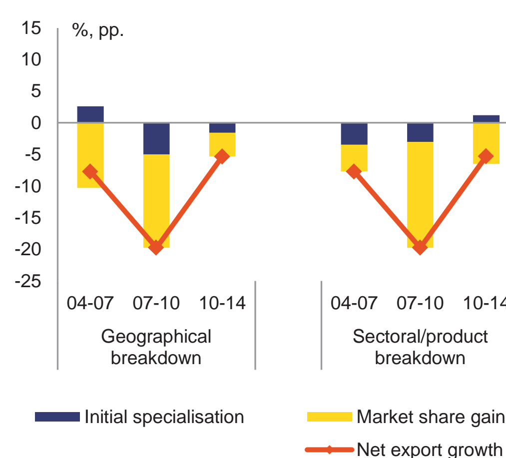


Export market shares based on values are with reference to all countries. Export market shares based on volumes are with reference to 36 industrial markets.
Source: European Commission (Eurostat, AMECO)

decline in Italy's volume-based export market share, but almost no recovery took place in the following years. As regards market share developments based on export values (which capture export quality, but tend to be biased by energy commodity price and exchange rate fluctuations), things did not stabilise until 2013, again followed by marginal recovery that lags behind that in peer countries. Somewhat more favourable cost and price competitiveness developments – driven by the depreciation of the euro and contained wage dynamics – may explain part of the increase (see "Cost and price competitiveness" in this Section). Furthermore, the modest rise may also partly be the mechanical effect of the slowdown of global trade in 2013-2014. It is therefore too early to assess whether the downward trend in Italy's export market share has been sustainably halted.

Italy's export market share losses over the last decade have stemmed mainly from erosion of competitiveness. A country's net nominal goods export growth (i.e. nominal goods export growth net of global nominal goods import demand) can be broken down into an exogenous component reflecting initial specialisation (fixed, at least in the short term) and an endogenous component reflecting competitive performance (related to the strategy on cost and non-cost factors and therefore under a country's control). The breakdown can be produced for both geographical and product markets. Italy's loss of export market share since 2004 can be ascribed mainly to competitiveness losses (Graph 2.3.2). Initial geographical and product specialisation patterns in its exports have also contributed negatively in selected periods, but in general these exogenous effects have been relatively limited and become smaller in recent years. In 2010-2014, Italy's export product specialisation was even slightly favourable. From a geographical point of view, the most recent years are characterised by a deteriorating goods export performance *vis-à-vis* euro area trade partners, but an improving performance versus non-euro area countries, also thanks to the depreciation of the euro. Notably, Italian goods exports to the United States, Turkey, China, Hong Kong, South Korea and Saudi Arabia – were particularly dynamic in 2009-2014. However, geopolitical tensions and slowing external demand from emerging markets represent downside risks. For instance, goods exports to Russia – accounting for 2.8 % of Italy's total goods exports in 2013 – declined by almost 12 % in 2014 and by another 27 % during the first ten months of 2015 compared to the same period in 2014. Furthermore, over the first ten months of 2015, goods exports to China have stagnated as compared with the same period in 2014. Conversely, goods exports to the United States rose by 22 % over the first ten months in 2015 compared to the same period in 2014.

Graph 2.3.2: **Geographical and sectoral/product breakdown of Italy's net nominal export growth**

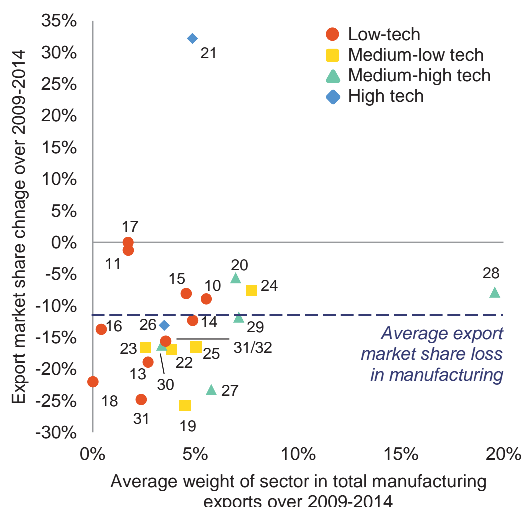


Net export growth is defined as nominal export growth net of global nominal import demand. Negative/positive net export growth is associated with export market share losses/gains. The initial specialisation component reflects the extent to which Italian exports were oriented towards dynamic geographical destination markets or product markets. A destination or product market is seen as dynamic if total imports in that market grow faster than total global imports. The market share gains component reflects Italy's competitive performance in destination or product markets. Only exports of goods are considered.
Source: European Commission

Recent export market share losses appear to be more contained in more technology-intensive sectors, although some traditional sectors have also performed relatively well. In 2009-2014, the Italian manufacturing sector as a whole recorded an export market share loss of around 11 %. Several high-tech and medium-high-tech sectors – some of which carry substantial weight in the country's industrial structure (e.g. machinery and equipment, pharmaceutical products, chemicals) are characterised by below-average losses or even gains (Graph 2.3.3). By contrast, many manufacturing products with lower technological

intensity (in particular coke and refined petroleum products, rubber and plastic products, fabricated metal products, non-metallic mineral products, textiles, furniture) seem to have performed worse. However, exports of some traditional low-tech 'made in Italy' (e.g. food products, beverages, leather and clothing) have held up relatively well. This success is most likely due to competitive strategies based on quality rather than price (see 'Non-cost competitiveness' in this Section). Consequently, the specialised and often small or medium-sized firms producing these goods have been able to appeal to specific tastes and maintain high margins. Finally, more recently Italian exports of transport equipment have been rising strongly: the sector has accounted for around 40 % of the growth in the value of goods exports since the beginning of 2015.

Graph 2.3.3: **Evolution of Italy's export market share in manufacturing sectors**

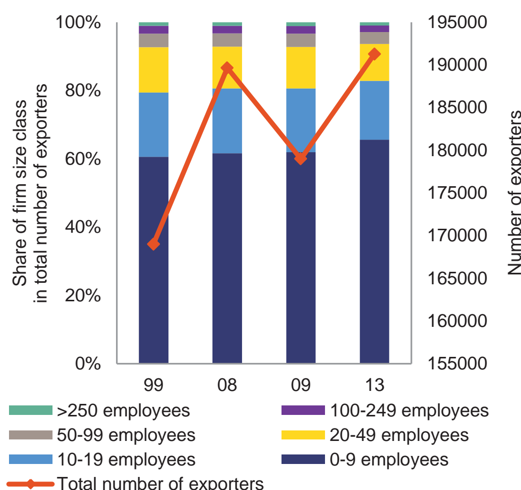


The numbers in the graph refer to the divisions in the NACE rev. 2 classification of manufacturing sectors: 10 = food products; 11 = beverages; 13 = textiles; 14 = wearing apparel; 15 = leather; 16 = wood products (excl. furniture); 17 = paper products; 18 = printing & recorded media; 19 = coke & refined petroleum products; 20 = chemicals; 21 = pharmaceutical products; 22 = rubber and plastic products; 23 = non-metallic mineral products; 24 = basic metals; 25 = fabricated metal products (excl. machinery & equipment); 26 = computer, electronic & optical products; 27 = electrical equipment; 28 = machinery & equipment; 29 = motor vehicles & (semi-)trailers; 30 = other transport equipment; 31 = furniture; 32 = other manufacturing. Tobacco products (12) have been omitted given the sector's negligible weight. Data for repair and installation of machinery & equipment (33) are not available.
Source: Istat, ICE Agenzia

Demography of exporting firms

The number of exporting firms in Italy has risen over the past 15 years. The number of Italian exporters rose from around 169 000 in 1999 to just over 191 000 in 2013. This compares with around 118 000 exporting firms in France, 250 000 in Germany and 95 000 in Spain in 2013. The number of Italian exporters fell sharply in 2009 when global trade collapsed, but it has fully recovered since then (Graph 2.3.4). The increase in the number of exporting firms is likely to have been driven by both structural factors (e.g. internationalisation of production chains, rise of digital technologies) and cyclical factors (e.g. attempts to shift sales abroad given weak domestic demand, opportunities created by the depreciation of the euro). The rise in the number of exporters in Italy has been driven exclusively by micro-firms (+13.2 % in 2009-2014), whereas there were declines in the numbers of small exporters (-2.7 %), medium-sized exporters and large exporters (both -6.3 %) over the same period. ([12])

Graph 2.3.4: **Number of Italian exporting firms and breakdown by firm size class**



Source: Istat

Almost half of Italy's exporting firms are active in industry, a considerably higher share than in other large EU countries. In 2013, around 46 % of Italian exporters were mainly active in industry

([12]) Micro-firms are companies with 0-9 employees; small firms are companies with 10-49 employees; medium-sized firms are companies with 50-249 employees; large firms are companies with at least 250 employees.

and 40 % mainly in wholesale and retail trade (the remainder being mainly active in other sectors). In Italy's peer countries, the share of industrial exporters amounts to only a quarter, whereas the weight of trade firms is similar to that of Italy. In terms of the value of Italy's exports, industry accounts for 84 % (ranging from 34 % among micro-exporters to over 90 % among large exporters). This compares with an industrial share in exports value of 78 % in Germany, 70 % in Spain and 61 % in France.

Exporters are present in all firm-size classes, but large firms are more likely to export. In the overall economy, the number of exporting firms as a share of all firms was around 5 % in 2013, in line with the percentage for France and Spain (both 4 %) but below that for Germany (11 %). In industry, however, the share was just over a fifth, still below that for Germany but considerably above the levels in France and Spain (Table 2.3.1). Exporters are present in all firm-size classes (not just large firms) but as expected, in all countries the share of exporters in the total population of firms increases with firm size, and this is broadly true across all sectors. For industry, whereas only 13 % of Italian micro-firms export, this share increases to 56 % for small firms and over 80 % for medium-sized and large firms. Micro- and small exporters are more concentrated in the trade sector, while there are relatively more medium-sized and large exporting firms in the industrial sector.

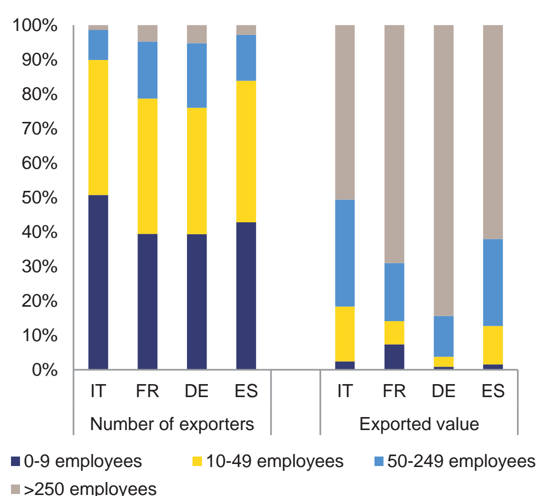
Table 2.3.1: **Share of exporting firms by sector, 2013**

Sector	IT	FR	DE	ES
Industry	21%	12%	31%	14%
Trade	7%	7%	20%	6%
Other sectors	1%	2%	5%	2%
Entire economy	**5%**	**4%**	**11%**	**4%**

Source: European Commission (Eurostat)

The high share of exporters in Italian industry is driven by the big share of micro-exporters in the total number of exporting firms. In 2013, the share of micro-firms in the total number of industrial exporters in Italy was 51 %, significantly higher than in France (39 %), Germany (39 %) and Spain (43 %). Furthermore, in Italy the share of exporters with more than 50 employees is one of the lowest. In terms of industrial exported value, Italian micro-exporters play a negligible role (they account for only 2.4 %, compared with 15.9 % for small firms, 31 % for medium-sized firms and 50.6 % for large firms). Small and medium-sized exporters play a more prominent role in Italy than in its peer economies, while in the other large EU countries – particularly Germany – large exporters take up higher shares of exports value than in Italy (Graph 2.3.5). The bias of Italian industrial exporters towards smaller firms limits the number of foreign markets served: the share of Italian exporting firms in industry that are active in more than 10 foreign markets is lower than in Germany and France, whereas the percentage is higher for those exporting to no more than five markets abroad.

Graph 2.3.5: **Breakdown of number of exporting firms and exported value by firm size class in industry, 2013**

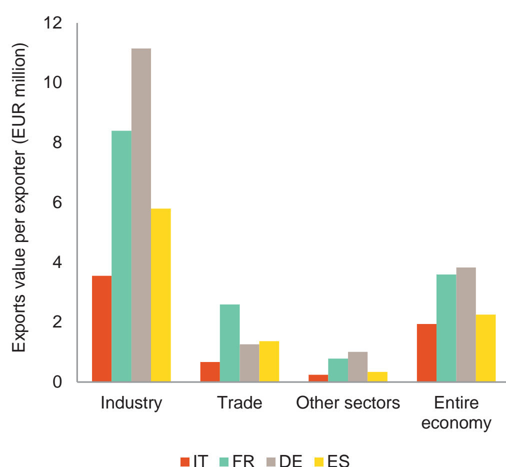


Figures for Germany may be biased due to the significant number of German exporting firms not assigned to a particular firm size class.
Source: European Commission (Eurostat)

The relatively high number of micro-exporters in Italy weighs on the average value of exports per exporting firm. Italian exporting firms export on average less value than exporters in other large EU countries: and this pattern applies to all macro-sectors considered (Graph 2.3.6). French and German exporters on average sell products abroad for roughly double the value of those sold by Italian exporting firms. The divide becomes even larger when considering only industry. In this macro-sector, the average Italian exporter in 2013 sold goods abroad for around EUR 3.5 million, as compared with EUR 5.8 million in Spain, EUR 8.4 million in France and EUR 11.1 million in

Germany. However, when comparing average exported value per industrial exporter by size class, the gap between Italy and its peers closes for small, medium-sized and large firms. This suggests that the overall low average exported value per industrial exporter in Italy is entirely driven by the high number of micro-exporters. Indeed, in 2013, Italy had almost as many industrial micro-exporters as Germany, France and Spain combined. In many cases, Italian micro-firms may show only occasional rather than well-established export activity.

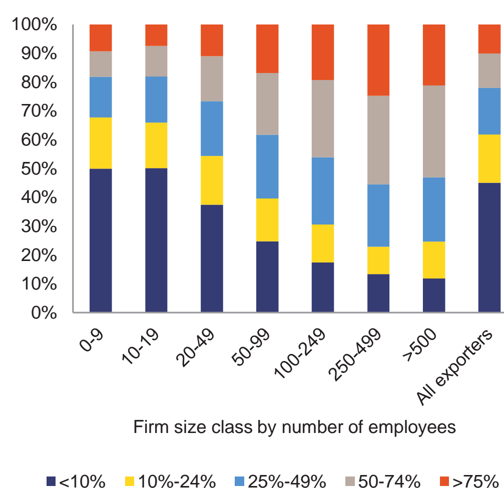
Graph 2.3.6: **Exports value per exporting firm by sector, 2013**



Source: European Commission (Eurostat)

On average, Italian manufacturing exporters still rely for a substantial proportion of their revenues on sales in the domestic market. In 2013, an average of 42 % of the turnover of Italian exporting firms in the manufacturing sector was made abroad. Hence, more than half of revenues still come from the domestic market. Only 22 % of manufacturing exporters collect at least half of their turnover abroad (yet these firms are responsible for almost 70 % of manufacturing exports in value terms). Export propensity varies by firm-size class: whereas micro-exporters gain on average only 25 % of their sales revenue abroad, this share rises to over 45 % for exporters with more than 100 employees. This is consistent with the distribution of Italian manufacturing exporters by export propensity class: the share of larger exporters increases as the ratio between export revenues and total revenues rises (Graph 2.3.7). Nevertheless, the still-significant share of domestic revenues in total sales limited the extent to which Italian manufacturing firms that export were able to mitigate the strong contraction of domestic demand in recent years. This may be reflected by the fact that the number of manufacturing exporters in Italy has declined by almost 4 500 firms (-5 %) since 2008.

Graph 2.3.7: **Distribution of manufacturing exporters by export propensity, 2013**



Export propensity is measured as the ratio between a firm's exported value and its turnover.
Source: Istat

Since 2009, the recovery of Italian manufacturing exports has been driven mainly by an increase in exports per firm rather than in the number of exporting firms. Average exports per exporting manufacturing firm have risen in Italy over the last decade. In 2005, Italian exporters in the manufacturing sector sold goods abroad for a value of EUR 2.7 million on average. This figure increased gradually up to 2009, when it fell back to its 2005 level due to the collapse of global trade. After 2009, however, average firm exports in manufacturing recovered again and reached EUR 3.5 million in 2013. By contrast, the number of manufacturing exporters has not recovered since 2009 and remains stable at around 87 000 units. The growth of Italy's manufacturing exports in recent years has thus been driven mainly by an increase in exports per firm and not in the

number of exporters. ([13]) The Italian authorities' plan (launched in March 2015) to promote products 'made in Italy' aims to increase the number of exporters by 20 000 firms. Unioncamere ([14]) (Italian association of chambers of commerce) estimates that an additional 112 000 Italian firms could become exporters.

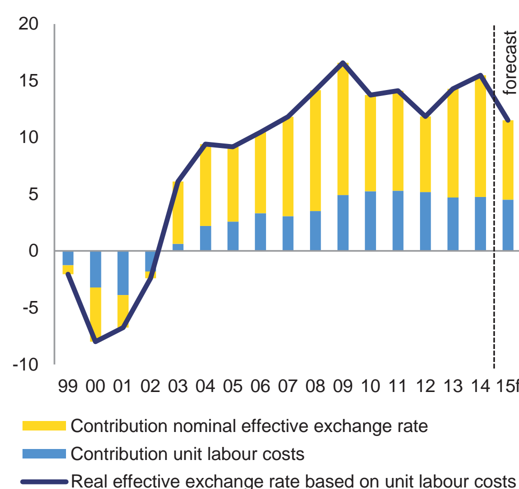
Cost and price competitiveness

Italy's loss of cost competitiveness since the early 2000s has been driven by the significant appreciation of Italy's nominal effective exchange rate and by the rapid rise in unit labour cost before the crisis. Graph 2.3.8 shows a breakdown of Italy's real effective exchange rate based on unit labour cost since 1998 into changes in the nominal effective exchange rate and in nominal unit labour cost relative to trade partners. The significant appreciation in the real effective exchange rate in the run-up to the crisis has been driven mainly by the appreciation of the nominal effective exchange rate. However, unlike that in Germany, unit labour cost in Italy has kept on growing, providing a further positive contribution to the real effective exchange rate dynamic. In the aftermath of the crisis, growth in unit labour cost has been more moderate, also thanks to wage growth gradually reflecting labour market weakness. This, together with the recent depreciation of the euro, has allowed for some gradual improvement in the real effective exchange rate.

([13]) See for instance: De Nardis S. (2015), *Manufacturing potential*, Scenario (11 February 2015), Nomisma.

([14]) Unioncamere (2015), Rapporto Unioncamere 2015. Alimentare il digitale. Il futuro del lavoro e della competitività dell'Italia.

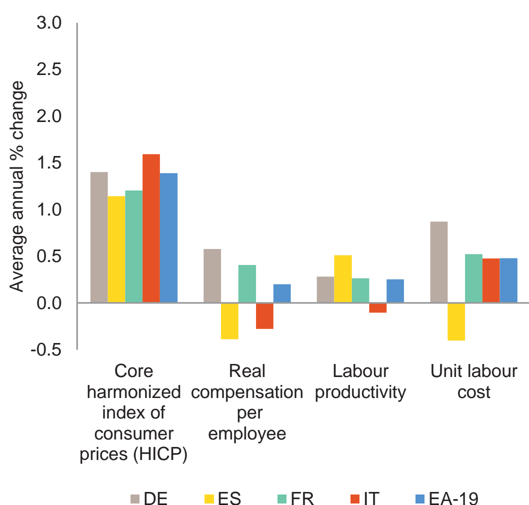
Graph 2.3.8: **Breakdown of the cumulative change in Italy's real effective exchange rate based on unit labour costs**



An increase of the real effective exchange rate reflects a loss of external cost competitiveness. "f" indicates that figures are based on the Commission's 2016 Winter Forecast.
Source: European Commission (AMECO)

The rise in unit labour cost is driven mainly by sluggish productivity growth. After the crisis, unit labour cost growth moderated significantly in Italy and France, but turned negative in Spain. Germany, on the other hand, saw faster growth on unit labour cost in 2010-2015 than before, which overall may point to some convergence and internal euro area adjustment. The adjustment process in Italy has been driven by a decline in real compensation per employee (see Section 2.4), albeit to a lesser extent than in Spain (Graph 2.3.9). However, labour productivity growth was negative on average in 2010-2015 and this has held back a greater adjustment. Recent labour market reforms aimed at increasing entry and exit flexibility and improving allocative efficiency in the economy are expected to contain Italy's unit labour cost growth (see Sections 2.1 and 2.4).

Graph 2.3.9: **Cost and price developments, 2010-2015**



Real compensation per employee is based on the private consumption deflator. Labour productivity is defined as real GDP per person employed.
Source: European Commission (AMECO)

Price-based real effective exchange rate indicators point to a slightly better competitiveness position for Italy than cost-based ones. Since the adoption of the euro, Italy has lost around 15 percentage points in competitiveness according to the real effective exchange rate indicator based on unit labour cost, against a broadly stable competitiveness according to the indicator based on producer price index. The loss of cost competitiveness may indicate a squeeze of profit margins for Italy's manufacturing firms which are compressing their mark-ups to remain competitive. However, Italy's participation in global value chains could also play a role. ([15]) Labour cost may have become less important as a component of total production costs in tradable sectors, so that cost-based indicators tell less about competitiveness dynamics.

Non-cost competitiveness

Italian manufacturing products are slowly becoming more technology-intensive. Between 1999 and 2014, manufacturing gross added value in Italy underwent a modest and very gradual shift away from low-tech and medium-low-tech products towards medium-high-tech and high-tech products. ([16]) However, in 2014, low-tech and medium-low-tech sectors still accounted for 61.3 % of manufacturing gross added value (3 percentage points less than in 1999), whereas high-tech sectors accounted for only 7.3 % (0.8 percentage points more than in 1999). Compared with the distribution of all manufacturing goods (i.e. including those not exported), as proxied by manufacturing gross value added, the distribution of exported manufacturing goods is more skewed towards medium-high-tech and high-tech products. Italy's manufacturing exports continue to be specialised in medium-high-tech and low-tech products, although there were modest shifts towards medium-low-tech and high-tech goods between 1999 and 2014.

Italy occupies a middle-ranking position in the EU for export quality, but has lost ground since 2009 in spite of divergent sectoral performance. Upgrading product quality may help Italian exporters to maintain export market share in sectors characterised by strong price competition or increasing product standardisation. Among EU-15 countries, Italy occupies a middle-ranking position in terms of average export quality. ([17]) However, between 2009 and 2014, its average quality ranking declined slightly *vis-à-vis* other

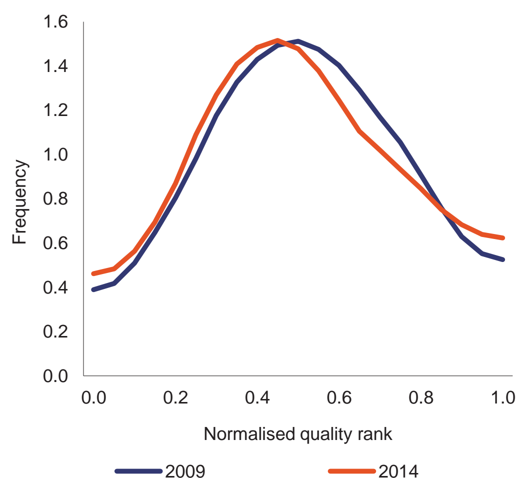
([15]) Giordano C., Zollino F. (2015), Exploring price and non-price determinants of trade flows in the largest euro-area countries, Bank of Italy – Occasional Papers, no. 233.

([16]) The classification of manufacturing sectors by technology intensity used here is based on the January 2014 Eurostat classification using two-digit level NACE Rev. 2 codes.

([17]) Export quality is measured here by average quality rank. For each type of product exported to the EU market (whereby product types are identified by its eight-digit code under the European Common Nomenclature (CN8)), a normalised quality rank can be calculated for each of 31 exporting countries included in the scope of the analysis (i.e. all EU Member States, the United States, Japan and China). The normalised quality rank of Italy for a specific product type is obtained by ordering all considered exporting countries from low quality to high quality with regard to the product type considered (with quality proxied by the difference between the price and production cost), then assigning a score of 0 and 1 respectively to the country exporting the lowest and highest quality of the specific product type considered, and finally determining the score of Italy within that range from 0 to 1 on the basis of the quality of Italy's exports of that product type relative to the other exporting countries considered. The average quality rank of a country is defined as the average of the normalised quality ranks of that country across all product types included in the scope of the analysis, weighed by each product type's export value. Finally, for each exporting country, a histogram or density function between 0 and 1 can be produced on the basis of the normalised quality ranks of all the product types that it exports.

EU-15 economies, i.e. the quality of Italian exports dropped as compared with that of other countries' exports. This relative decline in quality appears to have been driven by an increase in the number of products in the lowest quality classes (normalised quality rank between 0 and 0.4) at the expense of medium- and high-quality classes (normalised quality rank between 0.4 and 1). As regards the distribution of export value by quality class, a similar shift can be observed, but there is also an increase in the weight of top-quality products (Graph 2.3.10). This indicates that Italy's position in terms of export quality may be slightly polarising somewhat. As regards the performance of sectors, recorded quality increases in the pharmaceuticals sector, but also in some traditional sectors such as food products, textiles and clothing and leather products. However, the positive effect on the aggregate quality performance was offset by quality declines in some important exporting sectors such as basic metals, fabricated metal products, machinery and equipment, electrical equipment and motor vehicles and (semi-)trailers.

Graph 2.3.10: **Distribution of export value by normalised quality rank**



Source: European Commission

There appears to be significant scope to support the competitiveness of Italian export sectors by raising the efficiency of services to those sectors. As compared with other countries, market services [18] in Italy have strong domestic forward linkages to the rest of the economy. The total production generated in downstream sectors by one 'unit' of domestically supplied services is thus relatively high. This is particularly the case for business services [19], wholesale trade, inland transport and financial services. Market services are also essential specifically for Italian manufacturing exports: the value-added content of domestic market services in exported manufacturing goods is one of the highest in the EU. Highly productive market services could thus play a key role in the competitiveness of Italian export goods. However, market services seem relatively inefficient in Italy as compared with other countries. This is reflected in the high potential to improve the allocation of resources to their most productive uses ('allocative efficiency'), but also the decline in labour productivity in some key service sectors, such as business services and wholesale and retail trade. There thus appears to be significant scope to improve the efficiency of Italian market services, for instance through the removal of regulatory barriers and competition restrictions (see Section 3.4).

External sustainability analysis

The upward trend in Italy's current account balance has continued, driven by an increase of both exports and imports. From 2010, when Italy's current account deficit was 3.5 % of GDP, the balance improved by 5.4 percentage points of GDP to 2 % of GDP in 2014. The current account balance continued to record a surplus in 2015: in November 2015, the cumulative 12-month current account surplus amounted to almost EUR 35 billion (2.2 % of GDP), as compared with close to EUR 27 billion 1.7 % of GDP) over the same period one year earlier. The improvement since 2010 was driven mostly by the trade balance in goods which rose by 4.4 percentage points of GDP

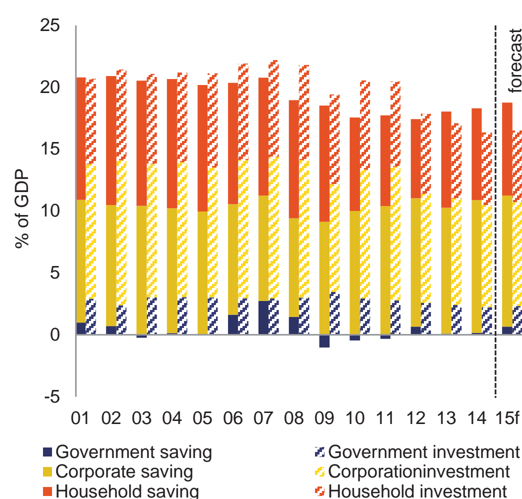
(18) Market services are defined as sections G-N in the NACE rev. 2 sectoral classification. They thus include wholesale and retail trade, transportation and storage, accommodation and food service activities, information and communication, financial and insurance activities, real estate services, professional, scientific and technical activities, and administrative and support service markets.

(19) Business services are defined as sections M-N in the NACE rev. 2 sectoral classification. They thus include professional, scientific and technical activities, and administrative and support service activities.

to 3 % of GDP in 2014. The EUR 80 billion increase in Italy's trade balance in 2010-2014 can be broken down into a rise of nominal exports by around EUR 73 billion and a fall in nominal imports by approximately EUR 7 billion. However, the relative contributions of export and import developments to the growth rate in the trade balance have changed over time. In particular, the contraction of imports played a significant role in 2012-2013. Conversely, in 2014-2015, imports have started to rise again, despite the sharp decline in the value of energy imports. The latter significantly reduced Italy's long-standing energy goods deficit in the context of a fall of energy prices and contributed to the improvement of its terms of trade. The most recent increase in imports appears to be driven mainly by capital and intermediate goods. This signals a gradual recovery of domestic demand, in particular in the form of equipment investment and stock-building. As a result of the rebound of imports, the positive contribution of net exports to real GDP growth observed in recent years is expected to disappear. Finally, the primary income balance registered an improvement of 0.3 percentage points of GDP between 2013 and 2014, driven by the improvement in investment income from foreign assets, while the strong decline in interest rates reduced payments of investment income on Italian assets held by foreigners.

The increase of the current account balance since 2010 has been driven mainly by the fall in investment. Of the 5.4 percentage points of GDP improvement in Italy's current account balance between 2010 and 2014, 4.2 percentage points are explained by a reduction in investment and 1.2 percentage points by an increase in savings (Graph 2.3.11). The fall in investment (from 20.5 % of GDP to 16.3 % of GDP) was broad-based – involving both the public and private sector – and was driven by fiscal consolidation, tight credit conditions and the uncertain economic outlook (Box 1.1). However, the decline in investment is expected to have reversed in 2015. The increase in saving since 2010 (from 17.1 % of GDP to 18.3 % of GDP) was mainly on the account of the general government and corporate sector (which has been a net lender since 2012).

Graph 2.3.11: **Savings and investment by sector**

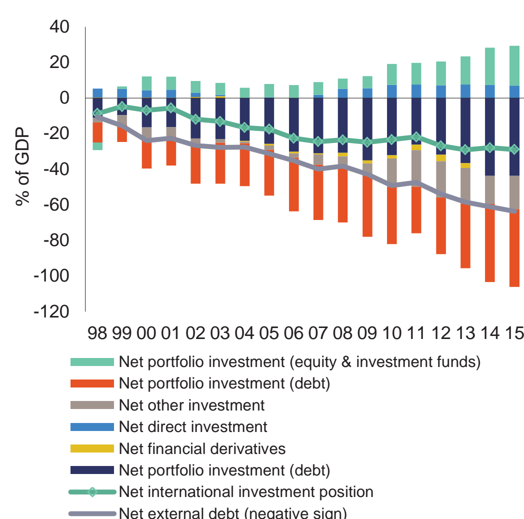


"f" indicates that figures are based on the Commission's 2016 Winter Forecast.
Source: European Commission (AMECO)

The correction of Italy's current account balance appears at least in part non-cyclical. Between 2010 and 2014, Italy's cyclically-adjusted current account balance (the current account balance adjusted for the domestic output gap and that of Italy's main trade partners) increased by 4.7 percentage points of GDP to 0.9 % of GDP, almost as much as the country's unadjusted current account balance. This means that when the Italian economy and those of its main trade partners return to their respective potential outputs, Italy's current account balance is expected to remain in surplus, suggesting that a significant part of the correction of the current account balance observed since 2010 has been non-cyclical. A non-cyclical decrease in domestic demand related to the decline of potential GDP in recent years appears to be a major driver of this. However, a modest increase in the ability to keep pace with growing external demand has also played a role. Alternative explanations for the high cyclically-adjusted current account balance may be obstacles to the financial system's capacity, which on the one hand may prevent investments taking place and on the other hand may force firms to save in order to be able to fund future projects with their own funds. It should be noted that estimates of cyclically adjusted current account balances are subject to a degree of uncertainty.

The net international investment position has stabilised. At the end of 2014, Italy's net international liabilities amounted to 27.9 % of GDP and have been rather stable in recent years (Graph 2.3.12). Italy's current account surpluses in recent years and the nascent economic recovery contribute positively to the decline of net external liabilities. However, valuation effects cause fluctuations around that general decline. In particular, the overall decrease of Italian sovereign yields and recovery of Italian equity prices increased the value of Italian assets held by foreigners, while the depreciation of the euro pushed up the value of Italian holdings of foreign-currency denominated assets which exceed corresponding liabilities. The modest level of Italy's net international liabilities and their decreasing trend do not imply immediate external sustainability concerns. However, gross external liabilities are large (about 171 % of GDP in the second quarter of 2015) and show a bias towards portfolio and other investment in interest-bearing debt instruments. In particular, gross external debt has risen in recent years (from 119.3 % of GDP at the end of 2012 to 128.5 % of GDP at the end of September 2015), also reflecting the higher amount of public debt in the hands of foreign investors. On the other hand, gross external assets show a bias towards portfolio investment in equity instruments and investment funds as well as direct investment. The asymmetric composition of the external position weighs on the income balance and exposes the country to interest rate risk and adverse changes in investor sentiment. These vulnerabilities would be reduced by a higher share of (typically more stable) inward foreign direct investment and/or equity portfolio investment, which would allow for better financial risk-sharing and could stimulate the economic recovery.

Graph 2.3.12: **Breakdown of Italy's net international investment position**



Source: European Commission

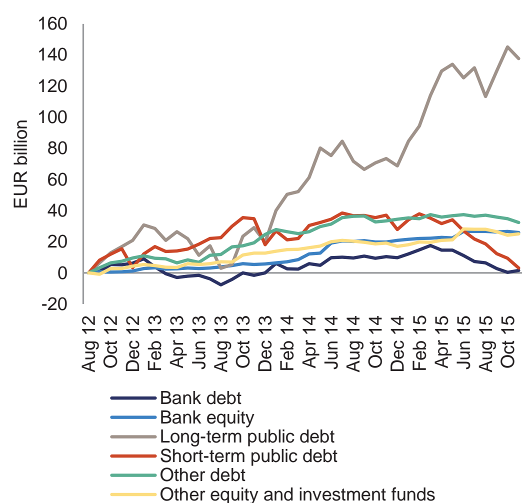
The recent rise in Italy's TARGET2 liabilities does not imply renewed difficulties in obtaining external financing. Between mid-2012 and mid-2014, Italy's TARGET2 liabilities ([20]) decreased from around EUR 290 billion to EUR 130 billion as private foreign portfolio investment in Italian assets gradually recovered. In the second half of 2014, the liabilities gradually rose again, subsequently fell in the first months of 2015 and finally started to increase once more as of June 2015. As a result, the liabilities amounted to EUR 249 billion again at the end of 2015. However, the overall increase since mid-2014 does not signal renewed distress, as witnessed during the euro area sovereign debt crisis when foreign capital flows to Italy and other vulnerable euro area countries dried up. In fact, foreign portfolio investment in Italian assets showed a recovery from mid-2012 (Graph 2.3.13), signalling renewed investor confidence. ([21]) The increase of Italy's TARGET2 liabilities is therefore explained by other factors.

([20]) A country's TARGET2 balance equals the difference between payments received and payments made by banks resident in that country and settled by the system via the national central bank. It is the accounting counterparty of all commercial and financial transactions between residents and non-residents.

([21]) Part of the growth of foreign portfolio investment in Italian assets – in particular long-term Italian sovereign bonds – is explained by the Eurosystem's purchase programmes, notably the public-sector purchase programme (PSPP) and the third covered bond purchase programme (CBPP3).

These include banks replacing international interbank funding by cheaper Eurosystem funding through targeted long-term refinancing operations ([22]), the Eurosystem's purchases of sovereign bonds since March 2015 under its expanded asset purchase programme (which allows banks to reduce their funding on the international interbank market), and, for particular months, the Treasury's net redemptions of sovereign debt (some of which was held by foreign investors) in the context of decreasing financing needs and its ample liquidity balances.

Graph 2.3.13: **Cumulative foreign portfolio investment in Italian securities**



Source: Bank of Italy

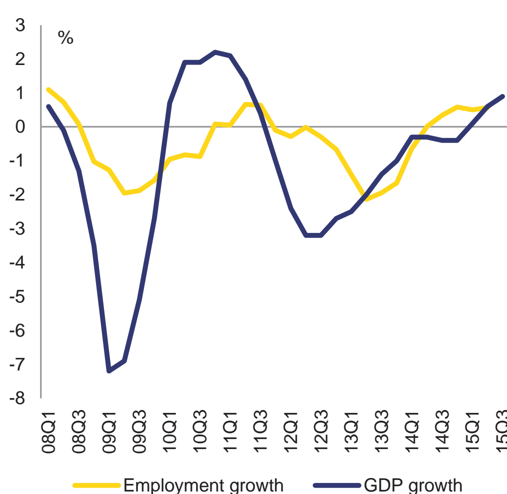
([22]) These refinancing operations are specifically designed to support lending to the real economy.

2.4. LABOUR MARKET

Labour market trends

The labour market is gradually emerging from the prolonged recession. In 2015 employment growth gained momentum (see Section 1). The rise in headcount employment outweighed the growth of the labour force, leading to a fall in the unemployment rate, in particular in the second half of 2015. In 2015, unemployment rate averaged 11.9 %, down from 13 % at the end of 2014. Labour productivity continued to decline on the back of the low GDP growth (Graph 2.4.1).

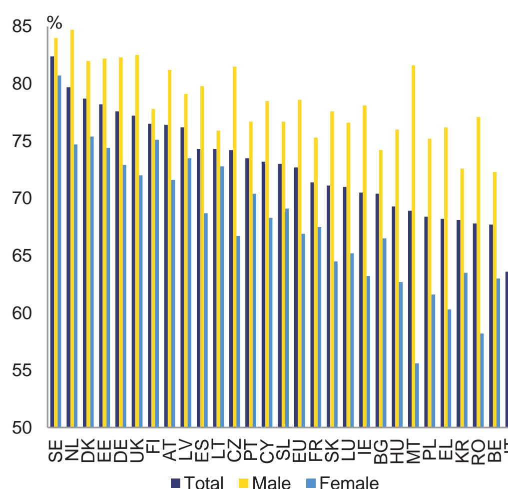
Graph 2.4.1: **Employment and GDP growth, year-on-year**



Source: European Commission (Eurostat)

Labour market participation has increased since the crisis, but it is one of the lowest in the EU. The effects of the crisis on household incomes and the extension of working life following the 2012 pension reform brought new participants onto the labour market. However, participation rates remain among the lowest in the EU (at 63.6 % as against an EU average of 72.7 % in the third quarter of 2015) (Graph 2.4.2). The gap is particularly large for women and the elderly. In particular, in the first half of 2015, the female participation rate remained at around 54.4 % of the working age population, below the EU average of 67 %. This has consequences for gender gaps in pensions. ([23]) Furthermore, participation rates are highly uneven across regions, partly because of the significant informal economy in the south (accounting for some 20 % of total employment there, as against about 10% in the rest of the country). ([24])

Graph 2.4.2: **Labour market participation (activity rate), Q3 2015**



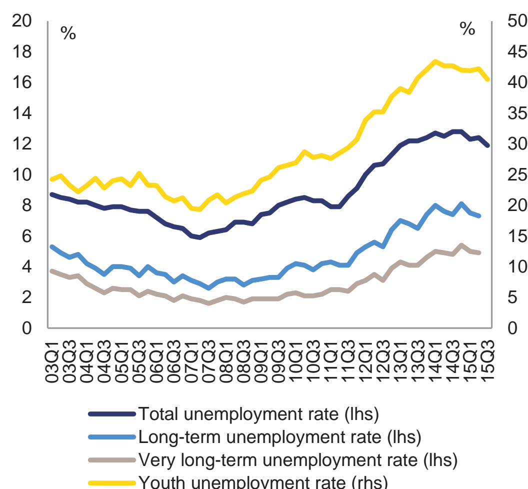
Source: European Commission

Long-term unemployment persists. The long-term unemployment rate has been increasing steadily since 2008 for all age groups, with very high regional variations, and it does not yet show a downward trend (Graphs 2.4.3). The probability of finding a job remains indeed low, as the drop in unemployment is mainly due to a decline in job destruction. In the first quarter of 2015, about 60 % of those looking for a job (corresponding to about 2.3 million people) had been searching for over a year. A majority of them had been jobless for more than two years.

([23]) The gender gap in pensions derives from low female employment rate and shorter working career for women (25 years against 40 for men). The gender dimension of pension adequacy is likely to remain a relevant issue in future, since women constitute the majority of non-standard workers (75 % of part-timers).

([24]) De Gregorio C. and A. Giordano (2015), The heterogeneity of irregular employment in Italy: some evidence from the Labour force survey integrated with administrative data, ISTAT working papers, no. 1.

Graph 2.4.3: **Unemployment, youth unemployment and long-term unemployment rates**



Source: European Commission (Eurostat)

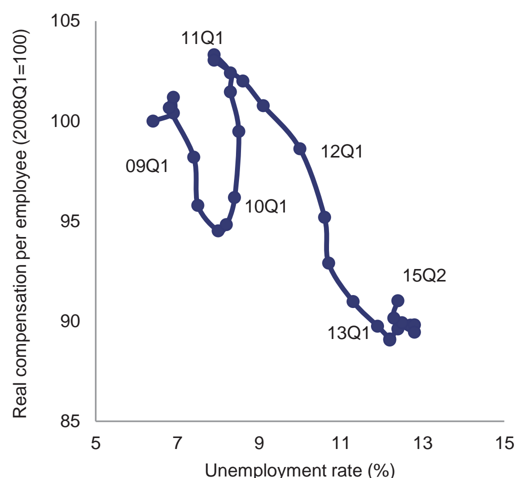
The risk of labour market exclusion is high, particularly for the young. Prolonged joblessness and high discouragement can have consequences for participation in the labour market and, ultimately, potential growth (Box 2.4.2). Italy registers one of the EU's highest rates of drop-out of the long-term unemployed from the workforce, with over 40 % giving up their job search and becoming inactive (2014). The situation is particularly worrying for young people. Youth unemployment has started to drop from very high levels down to 38.4 % in the final quarter of 2015, nearly 5 percentage points below the peak reached in the first quarter of 2014. The rate of young people not in education, employment or training is one of the highest in the EU, at about 22 % in 2014 for those aged 15-24. The rate increased more than 5 percentage points from 2008, as the growth in the number of inactive youth during the crisis was not accompanied by an increased enrolment in education. The large majority of the young people not in education, employment or training are low- and medium-skilled. However, also among those with high educational attainment, the rate of young people not in education, employment or training is more than double the EU average (24 % as against 11.4 % for the 15-24 age group).

Wage developments and collective bargaining

Wage growth has reflected with some lag labour market weakness and slowing inflation. Real wages still grow faster than productivity. Since the onset of the financial crisis, growth in negotiated wages has slowed gradually, but still remains above that in actual compensation per full-time equivalent employee. This difference is mainly due to a compression of the variable components of wages and a delayed response of negotiated wages due to the staggered nature of collective bargaining (contracts are negotiated in sequence and not all at the same time) and the duration of contracts for economic provisions (three years).([25]) In real terms, compensation per employee has started to respond to labour market slack. However, its growth rate remains above that of productivity, while the opposite is happening in the euro area as a whole (Graphs 2.4.4 and 2.4.5). Several factors can explain the slow response of real unit labour costs to the unemployment rate, including the difficulty of adjusting real wages to declining productivity in a low inflation environment and the frequency with which contracts are renegotiated.

([25]) See analysis in European Commission (2015), *Macroeconomic Imbalances. Country Report – Italy 2015*, European Economy – Occasional Papers, no. 219, pp. 29-32.

Graph 2.4.4: **Real compensation per employees to the unemployment rate**

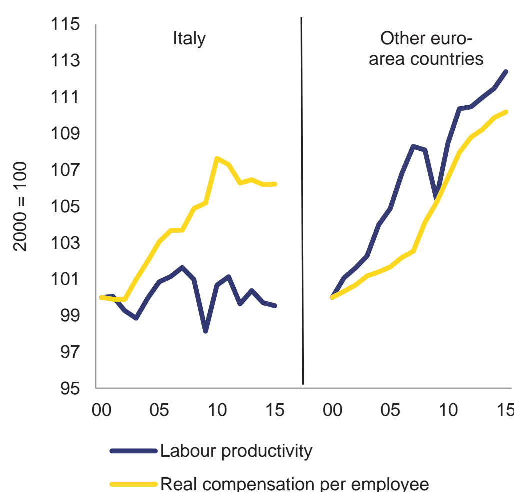


Source: European Commission (Eurostat)

Second-level bargaining is not sufficiently developed and the renewal of the bargaining framework has been delayed. The insufficient use of second level bargaining hampers the development of innovative solutions at firm level that could improve productivity and foster the response of wages to labour market conditions. Firm-level contracts on economic issues concern a minority of firms ([26]), also due to the specific features of the collective bargaining framework (Box 2.4.1). Under this framework, negotiated wages are set every three years on the basis of three-year inflation forecasts (HICP net of imported energy products). In a scenario of low and decreasing inflation, this delays the response of wages to labour market conditions. To support firm level bargaining, the Jobs Act contains a provision according to which companies can assign workers to tasks different from those for which they were recruited (*demansionamento*) via second-level bargaining. To incentivise it further, tax rebates on productivity-related wage increases have been established in the 2016 Stability Law. The effectiveness of the measures will depend on the conditions for granting the tax rebate (to be established by an administrative notice), in particular as regards the risk that the scheme is used to benefit from lower contributions and higher net salaries. The renewal of the collective bargaining framework, a prerogative of the social partners in the absence of a specific legislative framework, has been discussed, but no agreement has been found. The social partners disagree on the respective role of first- and second-level bargaining, in particular on which elements of bargaining should be covered by the second level.

([26]) Confindustria (2015), Nota dal Centro Studi Confindustria, no. 2.

Graph 2.4.5: **Real compensation per employee and productivity**



Nominal compensation per employment and labour productivity have been deflated by the GDP deflator
Source: European Commission (AMECO) 2015 Data from the autumn forecast

The Jobs Act

The Jobs Act has deeply reformed Italy's labour market institutions. In line with the 2016 Council recommendations to the euro area, the reform tackles major weaknesses in the Italian labour market such as duality, legal uncertainty in labour relations, and shortcomings in the design, inter-linkages and role of passive and active labour market policies. It has the potential to reduce duality, promote open-ended recruitment and favour labour reallocation. ([27]) All government

([27]) The adoption of the Jobs Act generated lively reactions from social partners who deemed that the usual tripartite consultation had not been followed and their opinion not been sufficiently considered. Still, Confindustria supported the Jobs Act and the government's attempt to tackle the misuse of 'atypical' jobs contracts, while the three main trade unions criticised the lack of protection of workers' rights and feared the creation of more precarious jobs.

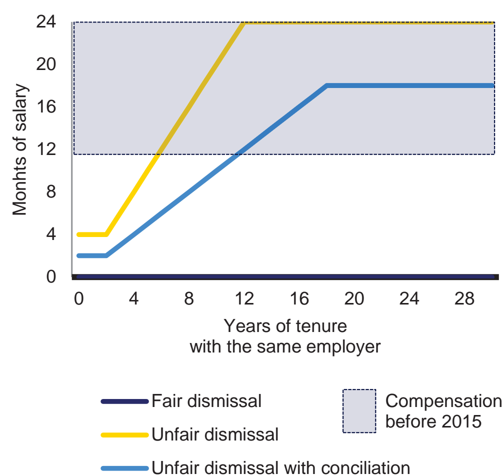
delegations were translated into implementing acts in 2015, with the exception of that concerning the introduction of a statutory minimum wage. The implementation of the Jobs Act signals an important achievement, particularly in the light of Italy's record on implementation. However, the full implementation and effectiveness of labour market policies may prove challenging, as discussed below. The Jobs Act confirmed the yearly monitoring report on the implementation and impact of the reform, as first introduced by the 2012 reform. A report is due in the first months of 2016.

Employment protection legislation

The revision of the rules for unfair dismissal increases exit flexibility and substantially increases legal certainty. Compared with the previous legislation, the reform substantially reduces the scope for reinstatement following unfair dismissals and adds to the cases where the sanction leads to monetary compensation, that increases with tenure. To limit court cases, the reform further facilitates the settlement of dismissal disputes through conciliation, supported by fiscal incentives. ([28]) Graph 2.4.6 shows the new schedule for monetary compensation with and without conciliation. Before the reform, the compensation could be agreed in any of the point covered by the grey area. By establishing clear rules, the reform substantially reduces this uncertainty. Also, for tenures up to 6 (without conciliation) or 12 years (with conciliation), the compensation is always lower than before, thus increasing exit flexibility at the early stage of the individual's career. Compensation for unfair dismissal remains much higher than for fair dismissals (virtually zero in Italy), which may increase both the incentive to go to court and the cost of litigation.

The reform was accompanied by substantial financial support for employers using open ended contracts. The government complemented the reform with permanent full deduction of the labour cost of employees under open-ended contracts from the regional tax on productive activities (IRAP) and a three-year exemption for private employers from paying social security contributions for new open-ended contracts signed in 2015 (up to a maximum of EUR 8 060 per year). These incentives were maintained by the 2016 Stability Law, but with reduced amounts (EUR 3 250 maximum contribution) and for two years only. Both measures were introduced with the aim of shifting employers' incentives towards open-ended contracts, thereby reducing labour market duality.

Graph 2.4.6: **Compensation in case of fair and unfair dismissal**



Source: European Commission

Preliminary evidence suggests that the new discipline for contracts and the accompanying tax relief are having an impact on job creation and duality. Some initial positive outcomes may be seen, in particular as regards the shift to open-ended hiring, although a proper assessment of its effectiveness will have to be made once the social security contribution relief expires in 2016. According to data released by the National Institute for Social Security (INPS), the number of new open-ended hires increased by 37 % in the first eleven months of 2015 compared to the same period of 2014, while new apprenticeship and collaboration contracts dropped by about 20 % and new fixed-term contracts increased only marginally, by about 1.5 %. Net of terminations, the increase in new contracts has been driven by open-ended hires while fixed-term and apprenticeships declined. As a result of these

([28]) For an in-depth description, see: European Commission (2015), *Macroeconomic Imbalances. Country Report – Italy 2015*, European Economy – Occasional Papers, no. 219, pp. 29-32.

trends, the share of open-ended contracts in total contracts activated/transformed has increased from 31.9 % in the first eleven months of 2014 to 38.6 % in the same period of 2015. In a survey carried out by Confindustria, 62 % of member firms declared that their recruiting decision had been influenced by the new provisions and that the tax relief for open-ended hiring was more important than the new rules for individual dismissals.([29]) According to research by Bank of Italy, the new rules for dismissal and the tax incentives together explain about a quarter of net job creation in the first half of 2015 (of which about two thirds are attributed to the tax relief and one third to the new rules on unfair dismissal) and the remaining is due to the cyclical improvements. ([30])

Passive labour market policies

The higher degree of flexibility in the labour market is complemented by more comprehensive unemployment benefits and assistance. In particular, the Jobs Act extended the coverage and duration of previous unemployment insurance and revised the conditionality and activation modalities. Unemployment benefits are now more inclusive, have a broader coverage and last longer. ([31]) The unemployment assistance scheme (ASDI), initially envisaged as temporary, has now been made permanent. The unemployment assistance scheme will provide six months' coverage for persons coming out of the unemployment benefit scheme, who are aged over 55 or have children, and whose household income is below a certain threshold. The unemployment benefits and assistance are to be complemented by social inclusion assistance that would tackle poverty. Overall, the new system appears well designed to cover those who are unemployed for up to 30 months, but less so for those with low work intensity or no work record.

The revision of the wage supplementation scheme (*cassa integrazione guadagni*) tackles existing distortions and could help labour reallocation. The reform has shortened the duration of the ordinary scheme from 36 to 24 months, strengthening its insurance component (firms using it more frequently are supposed to contribute more to its financing) and introduced conditions for workers working reduced hours. The scope of the scheme has also been extended. In the new framework, it will no longer be possible to be completely absent from work (*zero ore)* for the entire period covered by the scheme. Finally, sectors not covered must set up appropriate bilateral solidarity funds with the same objectives, to replace the under-waiver scheme (*cassa integrazione in deroga)* and free up resources to finance passive and active policies. Overall, the reform tackles long-standing weaknesses of passive labour market policies in Italy: the focus on job protection rather than the protection of the worker and the weak link with active labour market policies. It could thus promote workers mobility across jobs and facilitate the reallocation of labour with positive effects on total factor productivity growth.

The stronger focus on conditionality is positive, but effectiveness will depend on the efficiency of employment services. The provision of benefits is linked to the worker's availability to take up activation measures, including job offers that the employment services consider suitable. New measures have been introduced to support active job searches and return to the working environment. The effectiveness and enforcement of the job-search condition depends on a substantial upgrading and reorganisation of the employment services, including systematic and rigorous monitoring of their performance. To date, in fact, there is no evidence that the conditions that existed before the Jobs Act were ever enforced.

Active labour market policies

The governance of active labour market policies has been reformed. The Jobs Act establishes a new national agency for an active labour market (in place since January 2016) to coordinate a wide network of institutions and agencies (e.g. INPS,

([29]) In particular, 18 % of member firms have recruited new personnel, while 44 % have transformed other types of contracts into open-ended contracts. Confindustria (2015), *Scenari Economici n. 24,* pp. 25-26.

([30]) Bank of Italy (2015), *Bollettino Economico 4/2015*, pp. 31-32. The research was carried out on micro-data available for the Veneto region for the first four months of 2015.

([31]) For an in-depth description, see: European Commission (2015), *Macroeconomic Imbalances. Country Report – Italy 2015*, European Economy – Occasional Papers, no. 219, pp. 29-32. In 2014, before the latest reform, the coverage of short term unemployed by unemployment benefits was at 16 % in 2014, 21 percentage points lower than the EU average.

INAIL, employment services, chambers of commerce, schools) responsible for the management and monitoring of active labour market policies. The decree outlines a set of standards for provision (e.g minimum levels of services), which will have to be specified by a further decree. It also sets out the requirements for the certification of private entities allowed to provide such services and lays down the procedure to be followed by the unemployed when signing a personalised plan, with non-compliance leading to sanctions. A unified information system should gather information on job opportunities and active policies, beneficiaries of insurance benefits and contractual communications by firms.

The effective implementation of the measures planned has to overcome considerable challenges. For the time being, employment services are managed by the regions, which took over direct management from the provinces. The forthcoming constitutional reform would shift responsibility for the management and specific design of active labour market policies from the regions to the central administration, while regions will retain a substantial degree of control over budgets. This whole process will require a major coordination effort and stricter monitoring at various administrative levels. The success of the reform will rely largely on the extent of national/regional co-operation. The government and the regions are discussing a plan to manage the transition.

In many regions, enabling employment services to carry out the wide range of demanding tasks envisaged by the law will require significant upgrading. The placement capacity of Italian public employment services is extremely limited by European standards (only 4 % of jobseekers found employment through public employment services ([32]) in the period 2003-2011 and only 2.9 % of employers found suitable employees through the services in 2012). ([33]) A comparison with public employment services in other Member States indicates that the Italian public employment services are severely understaffed (in 2014, 8713 operators worked in Italy’s public employment services compared to 49407 in France and 77722 in the United Kingdom). The qualifications of the current staff hint at possible difficulties in the delivery of the ambitious range of services required by the law (in some regions, only 9 % of operators have a higher education qualification and in some almost half of the staff has only lower secondary education). In most cases, the services lack information infrastructure and capacity for data exchange. For example, a national job vacancy database exists only in theory: it should be based on the interconnection of regional databases, but only a few regions have operational databases and their interoperability is limited.

A key issue is the monitoring of service delivery and the performance of active labour market policies. The monitoring of service delivery remains irregular and fragmented, due to the absence of a common methodology for data collection and lack of a national database. The government has never carried out a systematic evaluation of active labour market policies. Interventions remain over-focused on training referrals, with limited evaluation of impact. Cooperation with employers is often weak and there is no coordination with education institutions and social services. The regions are responsible for planning active labour market policy provisions (such as training) and there is little evidence of the extent to which employers' are taken into account in the design of measures at local level. The lack of evaluation of the effectiveness of spending, and the below-EU-average expenditure on active labour market policies are key weaknesses in the provision of activation services for the unemployed (Graph 2.4.7).

The Youth Guarantee ([34]), a *de facto* pilot in the revision of active labour market policies, has improved support for young people, but its full implementation and the delivery of quality offers remain major challenges. The Youth Guarantee helped create new forms of cooperation between public and private services and provided an opportunity for employment services to reach out to young people. In 2015, implementation of the Youth Guarantee was stepped up. The use of standardised profiling methods was scaled up, individual support for young people was enhanced

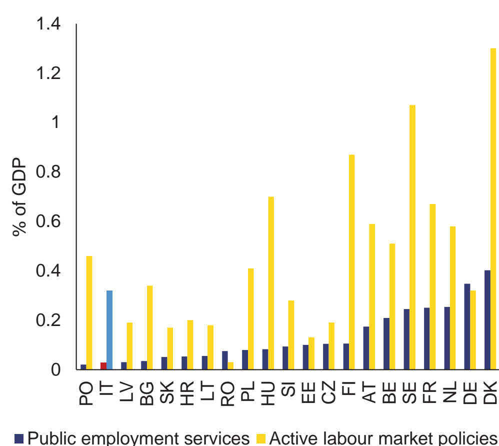
([32]) Mandrone E., D’Angelo D. (2014), Youth Guarantee and the Italian PES: insights from ISFOL Plus Survey data.

([33]) Unioncamere Excelsior informative system (2013).

([34]) Council Recommendation of 22 April 2013.

and the take-up of key measures (such as traineeships and specialised training) increased. However, while the number of young people registered has increased steadily (900 000 by end-2015), the number of offers remains limited: fewer than a third of registered young people received an offer. This issue could be addressed through stronger engagement on the part employers. Regional differences persist in the delivery of the Youth Guarantee scheme and information on the number and quality of the measures delivered at local level is not always available. In addition, the take-up of intra-mobility schemes remains low.

Graph 2.4.7: **Public expenditure for labour market services and active labour market policies**



Labour market services covers the costs of the public employment services plus any other publicly funded services for jobseekers
Source: European Commission (Eurostat)

Other measures

The measures to improve work-life balance and foster the women's participation in the labour market have limited potential. The relevant legislative decree amends part of the 2001 law on maternity and paternity leave, makes some changes to optional parental leave (e.g. extending the time in which the leave may be taken) and extends some rights to self-employed parents. The decree also facilitates access to part-time work for parents and introduces a specific leave of up to three months for participation in programmes tackling gender violence. These measures could have some positive impact on female employment in Italy, but probably not sufficient to increase substantially the very low participation rate among women. In particular, this may stem from the discouraging effects of the taxation system for second earners, especially for low-income families ([35]), the role of the female workforce in the informal economy or in atypical and precarious jobs, and the low availability of affordable care services, both for children and for the elderly, but these factors are not addressed. The government has made some efforts to improve supply of childcare, although with big differences among regions and towns. The 2015 school reform empowers the government to legislate on the creation of a single integrated system of early childhood education and care for children aged 0-6 by January 2017. As yet, it is unclear how this will be organised.

The Jobs Act introduces some initial measures to address Italy's large informal economy. According to ISTAT ([36]), undeclared work involves about 11.9 % of people in working age, with strong regional disparities and stronger incidence in some sectors such as other service activities (including home and personal care) (32.9 %); trade, transport, accommodation and restoration activities (26.2 %) and construction (23.4 %). It particularly affects women, migrants (in particular irregular migrants), younger and older workers, and people with low qualifications. The legislative decree on simplification of contracts amended the voucher contracts, which might facilitate the transition from undeclared to declared work especially in some sectors such as agriculture, tourism and home services. In addition, sanctions for undeclared work were strengthened ([37]) and the way they are applied changed as they now relate to the whole duration of undeclared employment. Finally, the legislative decree No 149/2015 rationalised the system of labour inspections through the creation of a national inspectorate incorporating three previously distinct institutions and changed the way inspections work. While these measures might have some effect, they remain piecemeal. A full strategy, analysing and addressing the root causes of the problem, is not yet in place.

([35]) Colonna F., Marcassa S. (2013), *Taxation and Labor Force Participation: The Case of Italy*, Banca d'Italia – Questioni di Economia e Finanza.
([36]) Istat (2015), Economia non osservata nei conti nazionali
([37]) Art. 22 of Legislative Decree 151/2015.

Box 2.4.1: **Collective bargaining in Italy and other European countries**

Collective bargaining consists of rules establishing the scope of collective agreements, the conditions for their renewals, and the hierarchy between different bargaining levels. These features can be regulated by law or by inter-sectoral framework agreements. Bargaining may take place at national, industry and/or firm level; at each level, there are rules on the bodies entitled to negotiate, on the subject of negotiations, and on requirements for the validity and duration of agreements.

Comparing collective bargaining in Italy vs. other European countries, the following issues stand out:

The rules are not clear and not well specified. Italy has a specific tradition of collective bargaining as the rules concerning negotiation and structure of contracts are not set by a specific legislation, but by framework agreements valid only for the signatories parties, which can be, but not necessarily are, signed by all trade unions. There is no minimum wage set by law.

Collective bargaining is more centralised than in most countries… In Italy, collective bargaining takes place primarily at national sectoral level. France, the definition of industrial sectors is narrower while in Germany and Spain sectoral contracts are signed at regional level. In both cases, contracts may better reflect the specific economic and labour market conditions. Industry level wage bargaining may be associated to different modes of horizontal coordination across sectors to better control aggregate wage dynamics. In Italy, coordination across sectors happens only informally, while it is achieved through pattern bargaining in Austria and Germany (i.e. one sector initiates negotiation and the others follow) and via guidelines set by peak associations in Spain.

…and the scope of firm-level bargaining is more limited. In most EU countries, vertical co-ordination (across bargaining levels) is ensured by the favourability principle, whereby lower levels of bargaining can only improve the conditions established at higher level. In Italy, inter-sectoral framework agreements set the bargaining rules, including the relationship between different levels of bargaining. Firm-level bargaining may only concern those issues that have been delegated from the national sectoral contract. Formally, the framework agreement of June 2011 allowed opting out from sectoral contracts, whenever necessary by local circumstances, i.e. in case of crisis or to promote investment and job creation, but only in non-wage issues. The government's decision to formalise into legislation the content of the June 2011 agreement was not seen with favour by social partners who committed not to use the possibility of derogation provided by the law. This is different from Spain where, following the 2012 reform, the employer is allowed to derogate, via firm level agreement with workers' representatives, from sectoral contracts for economic, technical or organisational reasons on a wide range of issues, including wages, hours, shift-work, workers' tasks. The economic reasons that warrant these changes occur when sales fall for at least two consecutive quarters. Moreover, firm-level collective contracts prevail on contracts of higher level (i.e. the conditions of the former can be less favourable to the worker). Also in France, company-level or sectoral agreement may deviate from all or part of a sectoral or inter-sectoral agreement even *in pejus* unless such derogation is expressly forbidden by higher level contracts. To facilitate company bargaining, the Fillon law of 2004 introduced the possibility for elected or mandated employees to sign agreements at company level. Nonetheless, the favourability principle remained valid with respect to minimum wages (Smic or sectoral), job classifications, supplementary social protection measures and multi-company and cross-sectoral vocational training funds. The inter-sectoral agreement of 2013 kept the validity of the favourability principle, allowing to adjust wages temporarily downward up to 1.2 Smic and/or modifying working time without authorisation of higher levels of bargaining. The only requirement being that these adjustments are made to avoid dismissals and are endorsed by the majority of the workers (accords de maintien de l'emploi). In Germany, collective bargaining is primarily conducted at industry-level between trade unions, which do not have direct representation within the firms, and employer's organisations. On the other hand, work councils can integrate what is foreseen by the law or intervene in non-regulated disciplines, but are not entitled to negotiate collective agreements.

In Italy the extension of collective agreements to non-signatory parties is automatic. Extension is a legal act through which a sector-level collective

(Continued on the next page)

Box (continued)

agreement becomes binding for employers not member of the association that has signed the agreement. In Italy, there is no formal rule on the extension of collective agreement, but these are de facto extended via judicial interpretation of the Constitutional principle (art 36) of fair wage. Extension is mainly automatic also in several other countries, including Austria, Belgium, France and Spain (in the latter only if the parts agree). In some countries, extension of a collective agreement can be requested by one (France) or both parties (Germany) that signed the agreement; in others, the ministry of labour can decide not to extend collective agreements (e.g. Netherlands, Portugal or Spain). In others countries, the extension is based on the representativeness of the parties that signed the original collective agreement (inter alia Belgium, Spain, France).

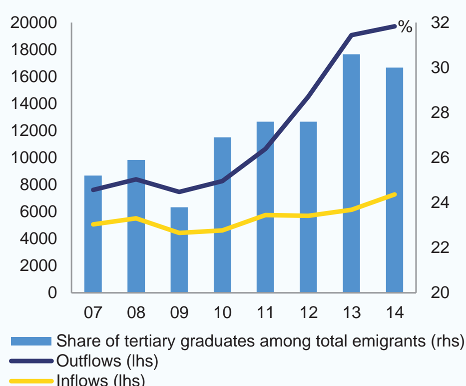
In Italy's private sector, criteria to measure trade union representativeness are de facto missing. With the exclusion of the public sector, in Italy there are no legal conditions setting criteria for unions' representativeness. In 2014, social partners and the employers' association in the manufacturing sector agreed on numerical criteria, which however have not yet been applied (similar agreements have been signed in other sectors, also waiting for their full operationalisation). Thus, the regulatory principle remains that of mutual acknowledgment of representativeness; the current structure does not exclude the coexistence of parallel collective agreements within the same firm or company. A similar principle exists in Germany, where, however, representativeness based on membership is a requirement for contracts' validity in case of disputes. In France, according to legislation passed in August 2008, national agreements are only valid if they have been signed by a confederation or confederations with at least 30% support nationally, and if they are not opposed by other confederations that together have majority support. However, in calculating levels of support and opposition, only the results of the five main national representative confederations are included. At industry level, clear rules define the organisations that have negotiating rights on the union side. Similarly, in Spain national representativeness is based on work councils' elections; representativeness is granted to unions that have at least 10% of delegates elected in work councils.

The duration of collective agreements and the rules setting the conditions of their validity are relatively long. The conditions that regulate the validity of an expired contract may influence the speed at which contracts are renewed and the scope of bargaining. In Italy, according to the 2009 collective bargaining framework agreement (expired, but still being applied in the absence of a new agreement), collective contracts are valid for three years. The most frequent duration of collective agreements across EU Member states is one year (as in France and Spain). The actual length of contracts is often protracted by the recurring delays in contracts' renewals (close to 20 and 35 months for the private and the public sector respectively). In addition, under the 2009 framework, negotiated wages are set every three years on the basis of three years inflation forecast. In a scenario of low and decreasing inflation, this delays the response of wages to labour market conditions. Recently signed contracts foresee however yearly revisions.

Box 2.4.2: Italy's brain drain

High-skilled young Italian residents are increasingly emigrating abroad. The emigration of highly qualified people increased during the crisis, causing a serious brain drain. The number of Italian citizens with a tertiary education degree leaving the country has been rapidly increasing since 2010 and has not been compensated by inflows of equally-qualified Italians returning to the country (Graph 1). Indeed, official statistics underestimate emigration flows because not all citizens leaving Italy register with the Italian consular authorities in the destination country.

Graph 1: **Migration flows of Italian citizens with a tertiary education degree (aged >25)**



Source: European Commission, ISTAT

The increasing emigration reflects better job opportunities and conditions abroad. Survey data show that, compared with their peers working in Italy, young Italian graduates working abroad earn higher and more rapidly increasing salaries. They also work more frequently under open-ended contracts and consider their formal qualification more appropriate for their job. ([1]) Focusing on Italians with a doctoral degree (PhDs), those working abroad report having both better job opportunities and significantly higher earnings. ([2]) This may explain why high-qualified Italian workers show a very low propensity to return to their home country. ([3]) Consequently, the emigration of highly qualified Italian workers does not qualify as 'brain circulation' (i.e. when people temporarily go abroad to study or work, but then go back to their home country).

The increasing emigration is not matched by an increasing inflow of high-skilled young foreigners. The emigration of qualified young Italians cannot be considered a 'brain exchange' either: many Italian workers leave the country, but few highly qualified individuals from other countries choose Italy as a destination. The proportion of foreign citizens living in Italy aged 25-64 with a tertiary education degree is much lower than that of Italian citizens (11.5 % compared with 17.5 % in 2014). In the EU as a whole the proportions of EU citizens and non-EU citizens with high qualifications are similar (29.4 % and 28.1 % respectively).

Risks to the quality of the labour supply and potential growth are mounting. The brain drain can thus result in a permanent net loss of highly qualified human capital, which would harm Italy's competitiveness. In the medium to long term, the brain drain may affect not only Italy's economic growth prospects, but also its public finances. The brain drain entails a dual financial cost: firstly, in terms of public expenditure on education for students who then permanently leave the country and secondly, in foregone future public revenue from taxes and social contributions that highly qualified emigrants would pay if they worked in Italy.

([1]) Consorzio Interuniversitario AlmaLaurea (2015), Condizione occupazionale dei laureati. XVII Indagine 2014, available at https://www.almalaurea.it/sites/almalaurea.it/files/docs/universita/occupazione/occupazione13/almalaurea_condizione_occupazionale_indagine-2014.pdf

([2]) Istat (2015), *L'inserimento professionale dei dottori di* ricerca. Anno 2014, available at http://www.istat.it/it/archivio/145861

([3]) Biondo A.E., Monteleone S., Skonieczny G., Torrisi B. (2012), *The propensity to return: Theory and evidence for the Italian brain drain*, Economics Letters, no. 115, pp. 359-62.

2.5. BANKING SECTOR

Table 2.5.1: **Key indicators on the Italian banking system**

Indicator	2008	2009	2010	2011	2012	2013	2014	Q2 2015
Total assets (EUR billion)	3,634.6	3,690.7	3,758.9	4,034.7	4,211.0	4,038.2	4,015.5	3,976.7
Stock of loans to firms (EUR billion)	869.4	849.0	867.1	893.6	864.7	813.9	808.0	810.4
Stock of loans to households (EUR billion)	468.6	496.4	592.6	618.5	610.1	602.2	596.6	608.6
Average interest rate on new corporate loans	4.52%	2.17%	2.79%	4.18%	3.64%	3.45%	2.56%	2.13%
Average interest rate on new household loans	5.09%	2.88%	2.97%	4.03%	3.69%	3.50%	2.84%	2.77%
Gross NPLs (EUR billion)	87.1	132.8	157.5	194.8	236.9	282.5	326.6	337.1
Gross bad loans (EUR billion)	42.8	60.2	78.6	107.9	125.1	155.4	183.6	195.3
Gross NPL ratio	5.1%	7.8%	8.9%	10.8%	13.3%	16.7%	17.1%	17.5%
Gross bad loan ratio	2.5%	3.6%	4.5%	6.0%	7.0%	9.2%	9.6%	10.1%
NPL coverage ratio	46.2%	40.2%	40.4%	40.3%	38.8%	41.8%	44.4%	44.7%
Bad loan coverage ratio	63.1%	60.4%	58.0%	56.3%	54.6%	56.9%	58.7%	58.7%
New NPL flow as % of NPL stock	4.2%	5.1%	3.9%	3.8%	5.4%	6.0%	5.5%	3.8%
New bad loan flow as % of bad loan stock	1.6%	2.0%	1.9%	1.9%	2.6%	2.8%	2.7%	2.9%
Loan value adjustments as % of operating profit	35.1%	47.8%	49.5%	59.8%	81.3%	107.4%	97.4%	55.0%
Funding gap	19.1%	14.1%	17.5%	17.8%	13.7%	11.0%	10.3%	10.1%
Eurosystem financing (EUR billion)	50.3	27.2	47.6	210.0	271.8	235.9	194.5	165.7
Domestic sovereign exposure (EUR billion)	174.9	205.3	252.6	265.4	354.5	402.1	401.8	405.1
Core tier 1 capital ratio (pre-Basel 3)	7.1%	8.2%	8.3%	9.3%	10.6%	10.5%	-	-
Total capital ratio (pre-Basel 3)	10.8%	12.0%	12.4%	13.0%	13.8%	13.9%	-	-
Common equity tier 1 capital ratio (Basel 3)	-	-	-	-	-	-	11.8%	12.1%
Total capital ratio (Basel 3)	-	-	-	-	-	-	14.5%	14.8%
Cost-to-income ratio	64.2%	63.0%	65.0%	67.6%	62.6%	61.7%	62.1%	-
Return on equity (net of goodwill impairments)	-	-	-	1.7%	1.0%	-0.9%	-0.2%	5.2%
Return on equity	4.5%	3.8%	3.4%	-9.3%	-0.1%	-7.8%	-1.5%	-
Net profit as % of capital and reserves	4.4%	2.8%	3.0%	-6.2%	-0.6%	-6.0%	-2.1%	-
Number of banks	799	788	760	740	706	684	664	654
Number of branches	34139	34,036	33,663	33,607	32,881	31,761	30,740	30,338
Number of employees	-	330,512	326,367	322,345	315,238	310,258	303,591	-

In general, figures are the latest available and are taken at the end of the indicated periods (i.e. December for full years, June for Q2), including average interest rates on new loans to firms and households. Average interest rates on new loans to households relate only to house loans. Funding gap figures show loans not covered by deposits as a share of total lending. Gross non-performing loans (NPL) are gross of loan-loss provisions. Bad loans are the worst category of non-performing loans. Domestic sovereign exposure figures only related to sovereign debt securities. The figure on loan value adjustments as % of operating profit in the last column only relates to the first half of 2015. The Q2 2015 funding gap figure in the last column relates to the situation at the end of Q3 2015. The return on equity (net of goodwill impairments) figure in the last column is annualised on the basis of the outcome of the first half of 2015. '-' indicates that a figure is not available.
Source: Bank of Italy

A recovering banking sector with pockets of vulnerability

The legacy of the deep and long recession in recent years, combined with long-standing structural weaknesses, has eroded the initial resilience of the Italian banking sector. Unlike some other euro area countries, before the crisis Italian banks were not exposed to a credit-fuelled asset bubble nor to complex financial instruments that led to large-scale public support to the banking sector. However, banks were strongly affected by the financial market fragmentation that followed the 2011-2012 euro area sovereign debt crisis. The strong link between investors' risk perception of the Italian sovereign and the Italian banking sector led to the drying up of international wholesale funding. Tighter lending standards mainly hit the corporate sector, in particular bank-dependent domestically-oriented small firms that were already weakened by the deep recession and moreover characterised by structurally low capitalisation. In addition, the protracted economic downturn has led to a rapid increase in the stock of non-performing loans. This has affected banks' profitability and is holding back the supply of credit to the gradually recovering economy (see 'Italian banks' asset quality' in this Section). The problems that emerged in the banking sector as a result of the crisis were exacerbated by long-standing structural issues, such as sectoral fragmentation, low cost efficiency and weaknesses in corporate governance (see 'Corporate governance in the Italian banking sector' in this

Section). More recently, the ECB's accommodative monetary policy and the improving macroeconomic conditions are helping Italian banks to regain resilience. At the same time, the sector has to adjust to the evolving regulatory landscape for banking at EU level, while some pockets of vulnerability remain.

Italy's banking system is slowly recovering from the long crisis period, but appears weaker than those of other EU countries. Banks' current liquidity situation is favourable with both the availability and cost of funding improving. Resident deposit growth has been solid while the withdrawal of non-resident deposits has stopped. Regarding retail funding, the switching from bank bonds to deposits has continued. Reliance on Eurosystem funding has further declined, in spite of banks' participation in the various targeted long-term refinancing operations to stimulate lending. Up until December 2015, Italian banks had participated for a cumulative amount of EUR 118 billion. At the end of 2015, the share of central bank funding in banks' liabilities fell to 5.1 % from 6.2 % at the end of 2014. The funding gap – the share of loans not covered by deposits – declined to 10.1 % in June 2015, mainly owing to the contraction of credit (Table 2.5.1). Profitability is showing signs of improvement but remains quite low. Over the first three quarters of 2015, return-on-equity (net of goodwill impairments) was 5.5 % on an annualised basis, compared to -0.2 % over 2014. In recent years, loan-loss provisions have absorbed large shares of banks' operating profit, and still represented 55 % of total operating profit in the first half of 2015. Meanwhile, net interest income is under pressure from the contraction of credit, the high stock of impaired loans and the low-interest-rate environment. However, non-lending income – in particular commissions and fees – has been on the rise. To support profitability, banks have continued their efforts to reduce operational expenses. Between 2008 and the third quarter of 2015, the number of bank branches – which is high per head in comparison to other EU countries – has declined by 12 %. In spite of the losses recorded in recent years, regulatory capital ratios have increased thanks to the raising of new capital and some reduction in risk-weighted assets. In September 2015, the common equity tier 1 and total capital ratios stood at 12.3 % and 15.1 % respectively (up by 0.5 and 0.6 percentage points compared to the end of 2014 respectively). Despite the positive developments mentioned above, the Italian banking system still compares unfavourably to the banking systems in other euro area countries, in particular in terms of regulatory capital, asset quality, profitability and cost efficiency (Table 2.5.2). However, it should be noted that public support of the banking sector during the crisis has been very limited compared to some other European countries. Furthermore, there has been no systemic effort to tackle the overhang of non-performing loans.

Table 2.5.2: **Cross-country comparison of key banking sector indicators, June 2015**

Country	CET1 ratio (%)	NPE ratio (%)	NPE coverage ratio (%)	Return on regulatory capital (%)	Cost-to-income ratio (%)
AT	11.2	7.9	56	11.6	57
BE	16.1	4.3	41	8.4	57
CY	14.2	49.6	32	3.4	32
DE	14.3	3.3	35	6.2	74
ES	12.2	7.1	46	12.8	47
FI	18.0	1.7	34	9.7	53
FR	12.5	4.2	51	9.3	67
IE	16.5	21.4	41	10.2	53
IT	**11.5**	**16.7**	**45**	**5.1**	**60**
LU	17.2	3.6	45	12.8	76
LV	10.5	4.8	28	35.3	42
MT	11.2	9.3	43	15.8	44
NL	13.6	2.9	37	8.9	53
PT	11.6	16.3	36	7.2	48
SI	17.7	28.3	61	7.2	59
EU	12.8	5.6	-	9.1	-
Median	13.6	7.1	41	9.3	53
Rank IT	12/15	12/15	5/15	14/15	12/15

Figures based on the banks in the selected countries that participated in the 2014 EU-wide stress test. For Italy, 14 banks are included in the sample, collectively representing 88% of total leverage exposures. Common equity tier 1 (CET1) ratio as % of risk-weighted assets. Non-performing exposure (NPE) ratio as % of total gross loans and advances. Non-performing exposure (NPE) coverage ratio equals loss provisions divided by gross total non-performing exposures. Return on regulatory capital is estimated as the proportion of net operating income compared to regulatory tier 1 capital. A lower rank in the last row indicates a worse performance compared to the other countries in the sample (consisting in total of 15 euro area countries).
Source: European Banking Authority (EBA) (2015), Report – 2015 EU-wide transparency exercise

Medium-sized and small banks may be more affected than larger ones by the current low interest rate environment and the slow disposal of non-performing loans. Given their traditional business model, these banks may have fewer opportunities to diversify their income and are more exposed to the low interest rate environment and flat yield curve. Compared to large banks, small and medium-sized banks are often also more exposed to small firms which are riskier and thus

Table 2.5.3: **Key indicators on the Italian banking system by segment, 2014**

Indicator	Banks / groups headed by public limited companies	Banks / groups headed by cooperative banks	Mutual banks	Total banking system
% of customer loans	72.5%	20.8%	6.6%	100.0%
% of NPL stock	70.1%	23.2%	6.7%	100.0%
Gross NPL ratio	17.1%	19.7%	18.0%	17.7%
NPL coverage ratio	48.0%	35.7%	36.6%	44.4%
% of bad loan stock	72.7%	21.3%	6.0%	100.0%
Gross bad loan ratio	10.0%	10.2%	9.1%	10.0%
Bad loan coverage ratio	62.0%	49.3%	52.0%	58.7%
Loan value adjustments as % of operating profit	91.1%	140.0%	81.3%	97.4%
Cost-to-income ratio	62.5%	63.6%	55.2%	62.1%
Common equity tier 1 capital ratio (Basel 3)	11.5%	11.5%	16.1%	11.8%
Total capital ratio (Basel 3)	14.6%	13.6%	16.5%	14.5%

'Banks / groups headed by public limited companies' roughly correspond to the segment of larger banks. 'Banks / groups headed by corporate banks' roughly correspond to the segment of medium-sized cooperative banks'. 'Mutual banks' ('banche di credito cooperativo') correspond to the segment of small banks.
Source: Bank of Italy

absorb more regulatory capital. Furthermore, the disposal of non-performing loans is likely to be more difficult for them as they may lack the required size and experience to attract specialised investors. It also tends to be more challenging for smaller banks to strengthen their capital position. This is due to the continuous pressure from loan-loss provisioning, new and more demanding regulatory requirements and – in many cases – rigid corporate governance arrangements based on diffuse retail shareholdings that make it unattractive or difficult for external investor to participate in those banks' equity. The weaker position of medium-sized and small banks is also visible in some key indicators, notably impaired loan ratios and coverage ratios (Table 2.5.3).

The recent resolution of four small Italian banks has entailed additional costs for the banking sector which weigh on banks' profitability. The four banks ([38]) had a combined market share of around 1 % and were under Bank of Italy's special administration. They were resolved using the resolution tools introduced by the EU's Bank Resolution and Recovery Directive which Italy had just transposed into its national law. Four temporary bridge banks were set up that took over the respective banks' good assets and liabilities, thereby preserving their regular business and employment. Conversely, EUR 8.5 billion in bad loans – accounting for almost 5 % of gross bad loans (the worst non-performing loan category) in the entire system – were transferred to a common 'bad bank' after applying a significant average haircut on their book value. In line with EU rules on state aid to the financial sector ([39]), part of the losses incurred during the four banks' resolution were borne by the banks' shareholders and subordinated bondholders (including retail investors), in line with EU rules on state aid to the financial sector. Subordinated bondholders contributed around EUR 800 million to cover the banks' losses. Italy's newly created national resolution fund provided EUR 3.6 billion to cover the remaining losses incurred and recapitalise the bridge banks and bad bank. As the resolution fund was still without paid-in funds, it borrowed from Italy's largest banks to finance the operation. Part of this loan has already been reimbursed thanks to the upfront payment of the sector's contributions to the resolution fund for the next three years. Should the resolution fund fail to repay the rest of the loan, a guarantee of Cassa Depositi e Prestiti would be activated. The 'extraordinary' contributions – albeit tax-deductible – represent a further burden on their 2015 financial results – especially for small banks – and also imply that the resolution fund is already drawing on its future financial capacity.

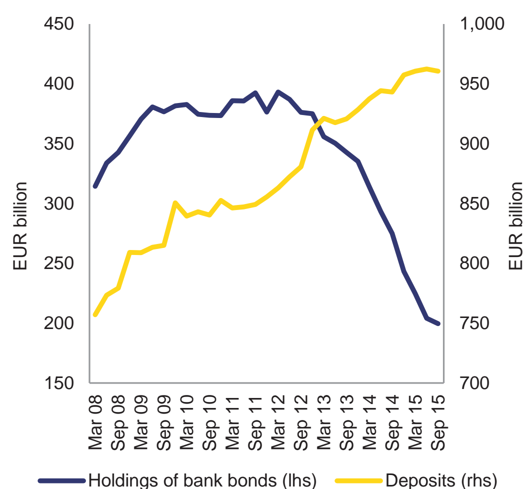
([38]) Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio della Provincia di Chieti, Cassa di Risparmio di Ferrara.

([39]) European Commission (2013), Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication'), Official Journal of the European Union (30 July 2013), C 216/1-15.

Following the losses suffered by retail subordinated bondholders of the resolved banks, the Italian authorities decided to set up a solidarity fund. The solidarity fund was set up under the 2016 Stability Law and would be endowed with maximum EUR 100 million. In parallel, an arbitration mechanism will be created to deal with the damages claimed by retail subordinated bondholders from banks that may have violated rules on consumer protection in investment services. In the past, retail customers purchased significant amounts of bonds issued by banks, not least thanks to the favourable tax treatment of their returns. Recently, the increase in the relatively favourable tax rate applied to bank bonds' returns from 12.5 % in 2012 to 26% in 2014 and potentially the mandatory contribution of subordinated creditors in banks' restructuring under the EU's state-aid rules (as applicable from August 2013) have contributed to a sharp decline in retail holdings of these bonds in favour of regular bank deposits (Graph 2.5.1). At the end of September 2015, the outstanding stock of bonds issued by banks resident in Italy amounted to EUR 664 billion, of which EUR 200 billion ([40]) were held by Italian households. An estimated 15 % - ca. EUR 31 billion – of the latter amount would relate to subordinated bonds. Since 2014, Italy's bank and financial-market supervisors have been active in raising awareness of the increased riskiness of bank bonds and have urged banks to comply with their diligence requirements towards retail investors. This is especially necessary given that from 2016 senior bonds (in addition to – with depositor preference in the ranking – deposits in excess of EUR 100 000) become eligible for bail-in to cover possible losses before the resolution fund could be accessed. This in line with the EU Bank Resolution and Recovery Directive.

([40]) According to Bank of Italy, households' holdings of Italian bank bonds would fall to around EUR 100 billion by the end of 2017 and roughly EUR 20 billion by 2020, in case no further acquisitions of bank bonds by households occur. Source: Bank of Italy (2016), *22° Congresso ASSIOM FOREX. Intervento del Governatore della Banca d'Italia Ignazio Visco*, 30 January 2016.

Graph 2.5.1: **Italian households' bank deposits and holdings of bonds issued by domestic monetary and financial institutions**



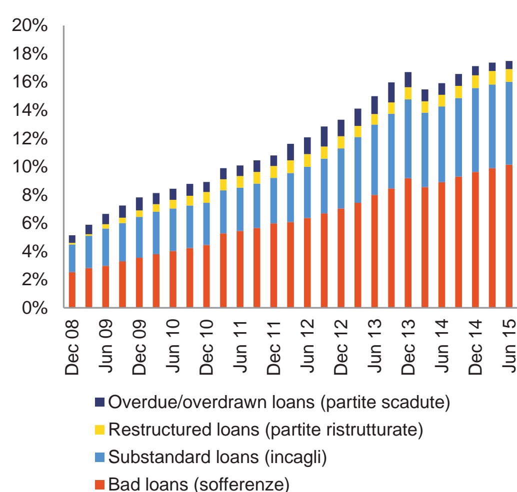
Figures relate both to senior and subordinated bond holdings.
Source: Bank of Italy

Recent asset quality developments

The growth in Italian banks' non-performing loan stock has declined in recent months, but impaired loans continue to put pressure on profitability and absorb resources. Following several years of economic downturn and a consequent decline in borrowers' capacity to service their debt, the asset quality of Italian banks has further deteriorated. In 2015, the stock of non-performing loans continued to increase, reaching EUR 337 billion in June 2015. This corresponds to a gross non-performing loan ratio of 17.5 %, 1.6 percentage points higher than a year before and 3.5 times higher than at the end of 2008 (Graph 2.5.2). Around two thirds of the gross non-performing loan stock is held by Italy's five largest banks. The non-performing loan ratio is significantly higher in southern Italy and on the islands than in the rest of the country. In recent months, the non-performing loan stock has grown more slowly. Gross bad loans (*sofferenze*) – the worst non-performing loan category – amounted to EUR 201 billion in December 2015. This equals 10.4 % of total customer loans, 1.5 percentage points higher than a year before and four times higher than at the end of 2008. Given the gradual recovery of the Italian economy, the growth in the stock of non-performing loans has started to slow down. Recent

further increases in the stock of bad loans are mainly the result of the reclassification of loans which were already non-performing. This explains why the declining trend of the quarterly new bad loan ratio was interrupted in the second quarter of 2015. The stock of overdue, restructured and substandard loans (the other non-performing loan categories) had stabilised or started to marginally decrease a few quarters earlier. In June 2015, they amounted to EUR 11 billion, EUR 18 billion and EUR 113 billion respectively.

Graph 2.5.2: **Non-performing loan ratio**



In 2014, a structural break occurs owing to the inclusion of Cassa Depositi e Prestiti.
Source: Bank of Italy

The deterioration in the quality of corporate loans has been the main driver behind the increase in non-performing loans in Italy. Over 80 % of non-performing loans relate to firms (here defined as non-financial corporations and producer households), while most of the remainder is attributable to (consumer) households. In June 2015, the gross non-performing loan ratio for firms amounted to 28.6 %. Considering only bad loans related to firms, the stock related to firms amounted to EUR 159 billion in December 2015, almost five times the corresponding stock at the end of 2008. In December 2015, the sectors with the highest bad loan stocks were construction, wholesale & retail trade and real estate activities. The manufacturing sector accounted for almost a quarter of all bad loans related to firms. Relative to total loans, the construction sector, wholesale & retail trade and several manufacturing subsectors registered above-average gross bad loan ratios. Contrary to corporate exposures, on which the protracted downturn in Italy had a significant impact, loans to (consumer) households are of significantly better quality, with a gross non-performing loan ratio of only 10.4 % in June 2015. The total stock of bad loans relating to (consumer) households amounted to EUR 37 billion in December 2015, up from EUR 9.1 billion at the end of 2008.

The coverage of non-performing loans by loss provisions has not changed significantly in recent months. In June 2015, the non-performing loan coverage ratio – defined as the ratio between loan loss provisions and gross non-performing loans – was 44.7 % for the entire banking sector, still 1.5 percentage points less than at the end of 2008 (Table 2.5.1). Compared to the end of 2012 when the coverage ratio was at its lowest, the non-performing loan coverage increased by almost 6 percentage points. This was partly thanks to the Bank of Italy's asset quality review in 2012-2013 and the ECB's comprehensive assessment of the euro area banking sector. However, the non-performing loan coverage ratio continues to vary across banks (Table 2.5.3), only partially in function of the degree of loan portfolio collateralisation. The coverage ratio of bad loans stood at 58.7 % in June 2015, unchanged compared to the end of 2014 but up by around 4 percentage points since the end of 2012. Although coverage ratios have been increasing in recent years, they are still below the levels recorded at the end of 2008.

Notwithstanding investors' increasing appetite for Italian distressed assets, the disposal of non-performing loans by banks remains slow. In recent years, several banks have changed their impaired asset management strategies to reduce direct and indirect costs associated with the high stock of non-performing loans. Recent evidence also suggests an increase in the volume of impaired asset sales in Italy, but the number of transactions has remained relatively low and mainly involved larger banks. Smaller banks continue to have only limited opportunities to become active players on the private non-performing loan market. In 2014, Italian banks sold non-performing loans amounting to EUR 7.5 billion, and in the first three quarters of 2015, they sold another EUR 11.5 billion (with EUR 9.5

billion in non-performing loan transactions still in progress). ([41]) So far, sales have mainly involved non-performing retail loan portfolios, but more recently the disposal of corporate loans has also gained some momentum. The development of Italy's private non-performing loan market has lagged relative to that in other euro area countries. The main reason for this is the still diverging expectations of the price of non-performing loans by banks and by investors ('non-performing loan pricing gap'). Although the gap narrowed in recent months, it is still estimated at around 20 percentage points. It is driven by several factors, such as information asymmetries and extra discounting by investors in anticipation of lengthy collateral recovery procedures. Hence, the August 2015 reform of Italy's insolvency and foreclosure framework is expected to help to reduce the non-performing loan pricing gap for impaired assets. Finally, the expectation of a further economic recovery as well as the current accommodative monetary policy stance should contribute to the work-out of impaired loans. The reduction of banks' non-performing loans and the improvement of the insolvency framework is one of the 2016 Council recommendations to the euro area.

Policy initiatives to improve asset quality

The Italian authorities have announced the establishment of a securitisation scheme backed by state guarantees to foster the clean-up of banks' balance sheets. To address the issue of the very limited size and slow development of a private distressed debt market in Italy, in February 2016 the Italian government presented a decree law for the creation of a securitisation framework. Open to all banks, but based on voluntary participation, this framework aims to encourage banks to set up special-purpose vehicles that would acquire (part of) their non-performing loan portfolios. The vehicles' impaired loan purchases would be funded by the issuance of senior- and junior-ranked notes (in addition to an optional mezzanine tranche). A bank setting up a vehicle would initially hold the junior tranche, but it would have to sell a significant share of it to private investors at market price. These investors would be directly exposed to the gains (or losses) from the recovery process, and would therefore have the right to appoint the non-performing loan servicing company that would be in charge of the work-out process. The requirement of selling a large part of the vehicle's junior tranche is both a condition for the bank to achieve balance-sheet derecognition for the non-performing loans it transferred to the vehicle, as well as for the Italian state to issue a guarantee on the vehicles' senior notes. The senior notes would have an investment-grade rating (before taking the state guarantee into account). In exchange for providing a guarantee on vehicles' senior tranche, the state would receive a market-conform fee that increases over time to encourage a speedy work-out. Because of the market-based guarantee fees, the Commission considers the scheme free of state aid. It will monitor the implementation of the scheme through a monitoring trustee. If the scheme is successful in significantly reducing the stock of impaired loans held by banks, there would be major benefits for the Italian banking system and the economy as a whole. It would help banks' profitability and internal capital generation, releasing resources currently allocated to the management and work-out of non-performing loans. It would also increase banking sector competition and remove a major brake on the supply of new loans to support Italy's economic recovery.

The tax treatment of loan losses has been reformed to give banks incentives to set aside more provisions. In August 2015, the parliament adopted a law allowing banks to deduct loan losses from their taxable income within the year that the losses are made, as is the norm in most other European countries. This replaces the previous arrangement under which losses were deducted in equal instalments over a period of five years which was the regime before (a so-called deferred deductibility regime). This creates a greater incentive for banks to set aside loan-loss provisions and thus increase coverage ratios. This in turn brings banks' expectations of the realisable value of non-performing loans closer to those of investors, thereby facilitating private non-performing loan transactions. In addition, the new tax treatment of loan losses prevents the creation of new state-guaranteed deferred tax assets ([42]) on

([41]) PWC (2015), Portfolio Advisory Group, Market update Q3 2015.

([42]) Deferred tax assets (DTAs) are potential claims of firms – in this case banks – against the government, as they may be

banks' balance sheets. This implies a weakening of the link between Italian banks and the sovereign and should over time lead to an improvement in the quality of banks' capital. For the stock of deferred tax assets that was already present on banks' balance sheets before the reform, a transition period is envisaged during which the legacy stock will gradually be phased out.

The role of the insolvency and foreclosure framework

The surge of non-performing loans in the Italian banking sector has coincided with an increase in the number of bankruptcy and insolvency procedures. The number of new petitions for bankruptcy (*fallimento*) rose from 11 808 in 2011 to 15 354 in 2014. The number of newly initiated reorganisation procedures (*concordato preventivo*) also increased to 3 615 in 2014 from 1 203 in 2011, after having peaked at 4 712 in 2013. Ministry of Justice data suggest that, by 2014, the number of pending cases (including the above-mentioned procedures, forced liquidations and extraordinary administrations), had grown by around 22.5 % from 2011 to reach 93 239. However, since the beginning of 2015, the number of bankruptcies appears to have started declining: in the first nine months of 2015, there were around 10 600 bankruptcies, ca. 530 less than in the corresponding period the year before. The decline has involved all macro-sectors of the economy. There has also been a significant drop in other insolvency procedures ([43]), which in the nine months of 2015 fell by 19.4 % year-on-year. ([44]) However, apart from a gradual recovery in the economy, changes in these figures may reflect changes in the framework applied. For instance, the decline in the number of applications for reorganisations *in bianco* ([45]) in the second half of 2013 and onwards was linked to a change in the law that ordered the appointment of a judicial commissioner to oversee a debtor's conduct and thus to prevent abuse of that tool.

Italy's insolvency system and individual debt collection remedies appear to be weak. Well-designed (pre-)insolvency and foreclosure frameworks and their efficient application play an important role in fostering the early restructuring and rescue of financially distressed but viable firms and the swift liquidation of non-viable ones. As such, they contribute to the prevention and work-out of impaired assets on banks' balance sheets, while raising recovery values, fostering the reallocation of productive resources and promoting a culture of second chance and entrepreneurship. Although Italy ranks 23rd (out of 189 countries) on resolving insolvency according to the World Bank's 2016 Doing Business indicators, various official data suggest significant weaknesses in insolvency and foreclosure practices in the country. In 2014, the average length of bankruptcy procedures was 2 709 days, against 2 635 days in 2013, and it varied widely across Italy, ranging from 765 days in Campobasso to 5 876 days in Potenza. The ability of the first instance courts to cope with the flow of new cases has been weakening: the clearance rate fell from 94.7 % in 2012 to 71.5 % in 2014, thereby increasing the backlog of pending cases. ([46]) Furthermore, creditors fail to act proactively or promptly, so a debtor's financial problems may be recognised too late: out of 15 354 new bankruptcy procedures in 2014, only 2 had been initiated by creditors. The rest originated from failed reorganisation

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used to reduce taxes to be paid on firms' future profits. In the case of banks, they arose *inter alia* as a result of the deferred tax deductibility of losses recorded on non-performing loans which created a temporary difference between banks' accounting profit (which included the loan losses of the year in full) and taxable profit (which reflected only part of the loan losses of the year, deferring the deduction of the rest of the loan losses to future years). In principle, banks can only use DTAs if they record taxable profits in the future. The dependence on future profitability is however eliminated if the state decides to guarantee DTAs, even in years in which losses are made. In that case, the EU's Capital Requirements Regulation clarifies the regulatory treatment of such 'state-guaranteed DTAs' in banks' regulatory capital. The large build-up of non-performing loans in Italy in recent years has thus led to a large stock of DTAs on Italian banks' balance sheets.

([43]) These include debt restructuring agreements, receivership, extraordinary administration, voluntary arrangements with creditors, forced liquidations and other procedures with insolvency status.

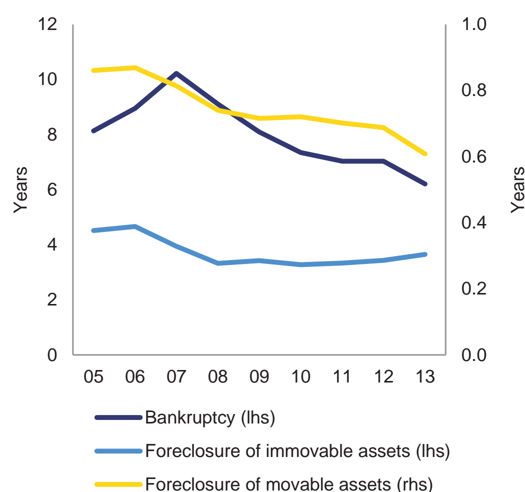
([44]) Cerved (2015), Monitor of Bankruptcies, Insolvency Proceedings and Business Closures, September 2015 # 24.

([45]) *Concordati preventivi in bianco* differ from *concordati preventivi* in that fact that a fully-fledged restructuring agreement must not yet be in place when the application is filed with the court.

([46]) Council of Europe, The European Commission for the Efficiency of Justice

procedures introduced at the debtors' initiative. Reorganisation efforts very often end up in liquidation or bankruptcy: only 10 % of companies that submitted a restructuring plan between 2008 and 2011 were still in business in September 2015. Big variations in these percentages from one court to another may suggest a non-uniform approach in the way the relevant provisions are interpreted and applied. In general, the outcomes achieved show a sub-optimal use of the various tools available: 2014 data indicate that only 14.4 % of reorganisation proceedings follow the proposed restructuring agreement, while around 45 % of bankruptcy proceedings close with no distribution of proceeds. Furthermore, foreclosures through the enforcement of claims on movable and immovable property respectively took 1 326 and 216 days in 2014 (Graph 2.5.3). Such delays, combined with weaknesses in the overall functioning of the justice system (see Section 3.2) have a considerable impact on financial workout.

Graph 2.5.3: **Length of procedures**



Source: Ministry of Justice

In 2015, a further reform of the insolvency and foreclosure frameworks was adopted. Since 2004, Italian policymakers have repeatedly reformed the country's insolvency and foreclosure frameworks. The most recent change was adopted in August 2015 and it affected both insolvency rules and property foreclosures. The reform aimed at fixing the failures of previous legislative interventions and further improving existing tools. For instance, to address the rather limited use of out-of-court restructuring agreements, a new instrument is now available (the new instrument is similar to the 'scheme of arrangement' in the United Kingdom) which enables the effective restructuring of financial liabilities with a binding effect also over dissenting creditors, under specific conditions. Furthermore, the possibility for interim financing has been reinforced, creditors can now submit alternative restructuring plans, the disposal of debtors' assets is opened to competition, shareholders' assemblies of debtor firms can be circumvented if a capital increase is envisaged, and deadlines on bankruptcy procedures have been tightened. On foreclosures, the reform tries among other things to tackle the phenomenon of multiple auction attempts. It also shortens deadlines and envisages a single electronic portal to advertise forced sales of seized assets country-wide. Finally, in February 2016, the government proposed a further measure to facilitate the sale of properties following enforcement proceedings, namely by reducing the registration tax to be paid, under certain conditions.

The effects of the latest insolvency and foreclosure reform are still to be seen, while a functional restructuring regime is still missing for a share of non-performing loans. One of the main purposes of the recent reform was to mitigate the negative effect of (unpredictably) long insolvency and foreclosure procedures on private investors' valuation of banks' impaired assets. This effect has held back the development of a private non-performing loan market in Italy. A survey of market participants estimates that the reform could reduce the average duration of proceedings on bad loans by about 20 %. ([47]) According to a preliminary assessment by the Bank of Italy, the reform could shorten the length of bankruptcy proceedings from more than six years now to between three and five years and that of foreclosures from more than four years to around three years. ([48]) On the other hand, the over-indebtedness (*sovraindebitamento*) procedure for debtors falling outside the insolvency legislation and for consumers, though introduced in 2012, is reportedly implemented only in few

([47]) Cerved (2015), 2015 Cerved SMEs Report.
([48]) Marcucci M., Pischedda A., Profeta V. (2015), *The changes of the Italian insolvency and foreclosure regulation adopted in 2015*, Bank of Italy – Notes on Financial Stability and Supervision, no. 2.

cases and with large discrepancies among courts. Furthermore, end-of-2014 figures indicate that in more than one quarter of bad loans, recovery is conducted outside the realm of the insolvency framework, either due to the debtor's non-eligibility for the insolvency proceedings or for other reasons. ([49]) In the meantime, the government has commissioned a proposal for an organic overhaul of the insolvency system and possibly the collateral framework ('Rordorf Commission'). Furthermore, in February 2016 a draft enabling law was presented that – once approved by the parliament – would give the government a mandate to enact an organic reform of the insolvency framework. Regarding these additional reform initiatives, it is important to ensure that all relevant parameters – e.g. the capacity of the court system, the role of practitioners, stakeholders' skills and behavioural aspects of debtors and creditors – are taken into account to achieve speedier debt restructuring.

Corporate governance reforms in the Italian banking sector

Since the beginning of 2015, the government has taken several important initiatives to tackle weaknesses in Italian banks' corporate governance and make the sector more robust. The reforms affect three traditional banking models: larger cooperative banks (*banche popolari*), banks with foundations as shareholders, and small (cooperative) mutual banks (*banche di credito cooperativo*). Whereas the former two reforms are already being implemented, the latter has been included in a February 2016 decree law which still needs to be approved by the parliament. The common goals of these reforms are to strengthen banks' corporate governance, facilitate shareholder oversight and ease access to banks' capital. Given the increasing complexity of banking and its stricter regulation, it is essential that banks' shareholders as well as creditors become fully aware of the possible risks, are in a position to assume those risks and take on full responsibility. They can do so in particular by exercising the necessary control over banks' management and requiring the strict adherence to sound risk management and credit granting policies in order to safeguard banks' capital in the long run.

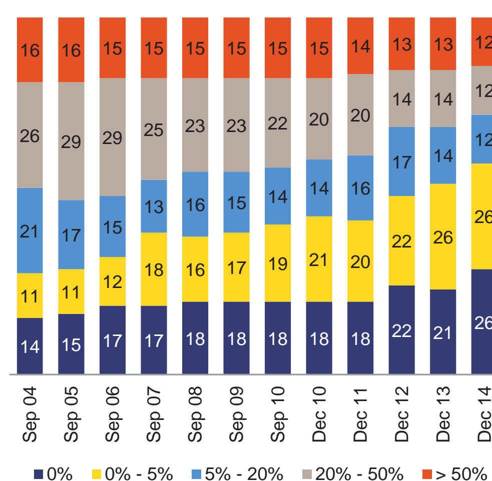
The mandatory transformation of Italy's largest cooperative banks into joint-stock companies aligns the banks' corporate governance with their size. *Banche popolari* collectively hold around a quarter of the market. Although several of them expanded considerably over the past two decades and now rank among Italy's largest banks, they maintained their cooperative status. However, over time most of the banks *de facto* loosened the application of some rigid corporate governance features by creating complex organisational arrangements which allowed them to attract institutional investors and ensured that they had a stronger role in decision-making. To increase transparency and address remaining asymmetries, the March 2015 reform requires all *banche popolari* with assets over EUR 8 billion (currently 11 entities) to transform themselves into joint-stock companies. This implies the end of the 'one-head-one-vote' principle which gave every shareholder only one vote irrespective of their stake. It also puts a stop to the 1 % ceiling on the stake of individual shareholders (though, as a transitional measure, banks may choose to maintain a 5 % ceiling for a period of two years). These changes will make it easier for large cooperative banks to raise capital, but it would also make them contestable. As such, the reform is expected to foster consolidation within the segment. Furthermore, the reform also contains provisions applying to all *popolari* irrespective of their size: relaxed voting rules for mergers and acquisitions and decisions on legal form, as well as a reorganisation of the number of proxy votes.

([49]) Cerved (2015), *2015 Cerved SMEs Report*. To fall within the scope of insolvency proceedings under the Italian bankruptcy law (Royal Decree 267/1942 and subsequent amendments), a firm needs to meet at least one of the following minimum thresholds: (i) assets worth EUR 300 000 in at least one of the three preceding years; (ii) annual revenues of EUR 200 000 in at least one of the three preceding years; (iii) debts amounting to at least EUR 500 000. Other reasons for falling outside insolvency proceedings may be that the debtors concerned have a single lender only (which by definition excludes the application of insolvency laws as they are meant to regulate conflicts among multiple creditors) or that creditors may pursue their claims by enforcing personal guarantees and securities provided by the firm's shareholders or managers, thereby lacking any motivation to engage in insolvency proceedings.

The implementation of the *banche popolari* reform should be completed by the end of 2016. The reform stipulates that the transformation of the largest cooperative banks must be adopted by the banks' shareholders' meetings by the end of 2016 applying relaxed majority rules. So far, a couple of banks have already completed their transformation. The other banks concerned are still preparing theirs, while some are also exploring merger and acquisition opportunities. Some banks may be waiting for the outcome of legal challenges brought by various consumer and shareholder groups which is expected in February 2016.

Another recent reform which reduces the influence of foundations over their reference banks is currently being implemented. Bank foundations are private non-profit bodies which played an important role in the privatisation of Italian banks in the 1990s and since then have acted as banks' long-term shareholders. Although they were supposed to diversify their investment over time, many maintained a big stake in their reference banks (Graph 2.5.4). However, the negative performance of the banking sector in recent years has weakened the foundations' financial soundness, preventing them from fully participating in some banks' capital increases or forcing them to sell part of their stakes. In April 2015 the foundations' representative body (ACRI) and the Italian Ministry of Economy and Finance, as their supervisor, signed a memorandum of understanding that clarifies the interpretation of the 1998 Ciampi law on the role and governance of bank foundations. The memorandum therefore represents a binding contract and gives the ministry the power to enforce it. Its main provisions prohibit foundations from investing more than a third of their total assets in a single entity so that they diversify sufficiently, thereby protecting their capital and also strengthening their independence. As a result, on the basis of 2014 data, around 30 foundations will have to reduce their stake in their reference banks, either within three years in the case of listed banks or within five years in the case of non-listed banks. Furthermore, the memorandum contains provisions to strengthen foundations' corporate governance and protect their financial soundness. All but one of the 88 foundations have signed the memorandum or already comply with its main provisions. At the end of 2015, more than 30 foundations had already aligned their statutes with the memorandum's provisions or had established contacts with the ministry. The others should ensure compliance by April 2016. Furthermore, some foundations have already made divestments from their reference banks. Foundations could potentially invest in other banks than their reference bank within the conditions set by the memorandum.

Graph 2.5.4: **Number of foundations according to their stake in their reference bank**



Source: Associazione di Fondazioni e di Casse di Risparmio (ACRI)

A reform has just been presented to strengthen the important segment of small mutual banks. Despite their 7.5% market share, small mutual banks (*banche di credito cooperativo* (BCCs)) play an important role in lending at local level. In February 2016, the government presented a decree law to reform the segment of small mutual banks, taking into account some guiding principles put forward by the small mutual banks themselves. The decree law, which may still be amended by the parliament and to be followed by implementing provisions, includes strong incentives for small mutual banks to join a cooperative banking group. The latter holding would need to have at least EUR 1 billion in capital and would have an institutional protection scheme. Small mutual banks not willing to join the group would have to give up their status of small mutual banks. Furthermore, the group would be majority-owned by the member small mutual banks, while the remainder of its capital would be open to external investors. The role of the holding would be to manage and coordinate the

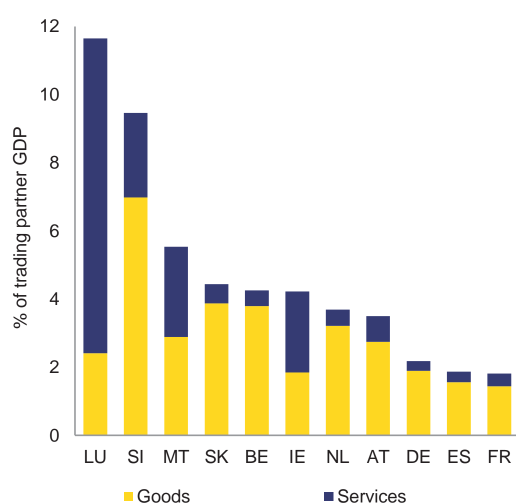
member small mutual banks, based on so-called cohesion contracts of which the strictness would *inter alia* be based on a bank's risk profile. In turn, individual small mutual banks would maintain their mutualistic and cooperative nature, including the 'one-head-one-vote' principle. Finally, some measures are foreseen to strengthen the capital of individual small mutual banks. The implementation of the reform of the segment of small mutual banks will be a complex and gradual process, both from a technical and cultural point of view.

2.6. EURO AREA SPILLOVERS

Italy's economy is the third largest in the euro area, accounting for around 16 % of the area's overall GDP. This implies that Italy is a major source of economic and financial spillovers for the rest of the euro area**.** There are in fact large direct and indirect trade and financial links.

Direct trade links with Italy are sizeable for some euro area Member States. Regarding goods trade within the euro area, Italy is a particularly important export market for Slovenia, Slovakia, Belgium and the Netherlands, all of whose goods exports to Italy are above 3 % of their respective GDP (around 7 % for Slovenia). For Luxembourg, it is services that dominate exports to Italy (accounting for more than 9 % of its GDP). For other countries such as Malta and Ireland, both exports of goods and services to Italy are relevant in terms of their respective GDP (Graph 2.6.1).

Graph 2.6.1: **Italian imports by euro area country of origin, 2013**



Source: European Commission, United Nations

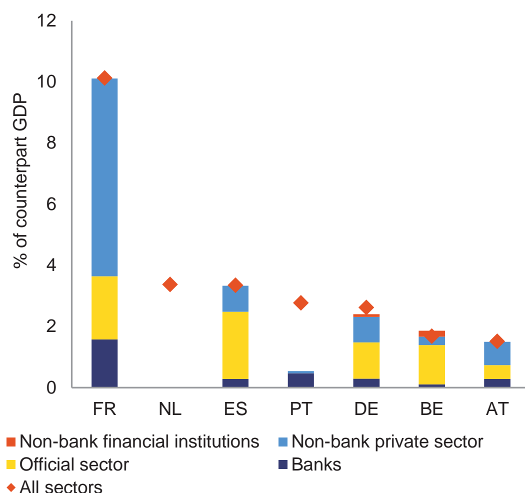
Exports to the rest of the euro area represent around 12 % of Italy's GDP. Total exports of goods and services represent approximately 29 % of Italian GDP, of which more than one third goes to the rest of the euro area. Italy's economy is therefore subject to large spillovers from demand developments in other euro area countries. This is particularly true for demand from Germany and France and, to a lesser extent, from Spain, Belgium, the Netherlands and Austria.

Sluggish demand from the rest of the euro area has slowed down the recovery of the Italian economy. Following the sovereign-debt crisis, in a period of significant domestic demand restraint, the overall deleveraging stance in the euro area implied that the trade channel could not be used as an effective growth driver of the Italian economy between 2001 and 2014. Furthermore, large and increasing current account surpluses in some euro area trade partners seemed to point to long-lasting weakness in their levels of investment and consumption. Subdued demand from these economies in turn put a strain on Italy's exports.

The low inflation environment makes further competitiveness gains more difficult while structural reforms could help to sustain demand in the short term. The low inflation in the euro area reduces Italy's room for price adjustment to recover competitiveness, particularly given its high public debt-to-GDP ratio and persistently low potential growth. At the same time, the structural reform efforts in Italy and the rest of the euro area, if appropriately sequenced, could improve short-term demand prospects, particularly given the accommodative euro area monetary policy. This would be helped by removing barriers to investment (Box 1.1), making budgets more growth-friendly (Box 2.2.1) and better aligning wages to productivity in Italy and other euro area countries. These measures would also help to reduce the high unemployment rates in most euro area countries.

The banking union has so far not increased the exposure of banks in other euro area countries to the Italian economy. The French banking sector remains the most directly exposed to Italy. French banks' exposure to the Italian economy amounted to approximately 10 % of French GDP in the second quarter of 2015 (against around 13 % a year before). A large part of this exposure takes the form of claims on the non-bank private sector (6.5 %). For banks located in other euro area countries, however, exposure to the Italian economy is mainly related to the official sector, with a direct exposure in the order of 1-2 % of the respective GDP (Graph 2.6.2).

Graph 2.6.2: **Euro area banks' claims on Italy by sector, Q2 2015**



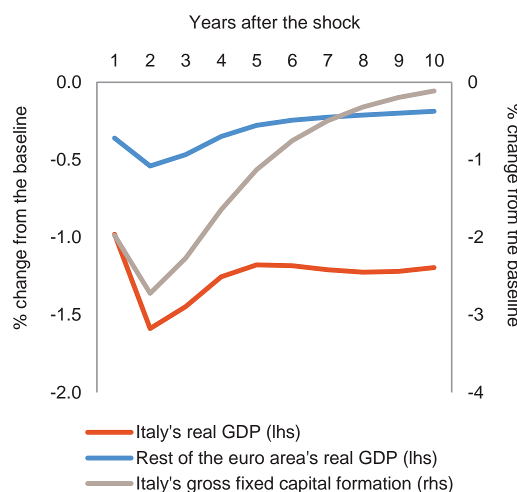
Based on a EU sample of 11 countries. The sum of sectors may not add up to the total due to unallocated claims. Figures are on an ultimate-risk basis.
Source: Bank of International Settlements, International Monetary Fund

Italian banks remain directly exposed to the German and Austrian economies. In the second quarter of 2015, the Italian banking sector was significantly exposed to Germany and Austria, with claims amounting to around 9 % and 4 % of Italy's GDP respectively. These claims are mainly towards the non-bank private sector. The direct exposure of Italian banks to other euro area countries' official sectors appears to be relevant only for Germany, and to a lesser extent Spain.

Italy's high public debt remains a source of possible adverse spillovers for the rest of the euro area. Italy's public debt-to-GDP ratio is expected to have peaked in 2015. However, it is projected to remain very high in the coming years and the pace of its decline is subject to possible adverse shocks, particularly if the structural primary surplus were to worsen further and/or reform action comes to a halt. The current accommodative monetary policy in the euro area has helped reduce the spreads between yields of sovereign bonds issued in different jurisdictions and is reassuring financial markets about future nominal growth prospects. Still, a sudden change in the currently favourable risk perception cannot be ruled out, particularly if policies at country level were to depart from the differentiated adjustment needed for a sustained euro area recovery. In this context, it is worth recalling that general risk perception is one of the main determinants of sovereign spreads in the euro area.

Model simulations show the potentially large spillovers from the Italian economy on the rest of the euro area. One simulation assumes a temporary confidence shock hitting productive investment in Italy that reduces real GDP by 1 % in the first year and by a further 0.6 % in the second year. The negative impact on the rest of the euro area's real GDP would be in the order of 0.4 % in the first year and a further 0.2 % in the second year (Graph 2.6.3). This large impact on the rest of the euro area is explained by the size of the Italian economy and by the fact that Italian investment has a large import component. The results of this simulation are largely driven by the 'zero lower bound' constraint that euro area monetary policy is currently facing. In the absence of this constraint, spillovers would become minor because in the model the potential negative impact would be offset by a more accommodative monetary stance. The cause of this hypothetical confidence shock could be a sudden halt to the ongoing structural reform process in Italy, which could increase the risk premium paid by Italian firms on their financing needs. This increase would lead to a decline in firms' expected profitability and thus a significant fall in their investment.

Graph 2.6.3: **Impact of a simulated temporary confidence shock on the Italian economy and spillovers to the rest of euro area**



Source: European Commission (QUEST model)

Box 2.6.1: **Specific monitoring of Italy's policy implementation under the macroeconomic imbalances procedure**

In the 2015 European Semester cycle, Italy was found to be experiencing excessive macroeconomic imbalances which require specific monitoring. To this end, the Commission presented a first specific monitoring report in December 2015. ([1]) This box concludes the specific monitoring cycle by summarising the findings on progress in implementing reforms (see annex A) that relate to country-specific recommendations relevant for Italy's macroeconomic imbalances.

For Italy, all 2015 country-specific recommendations were considered relevant under the macroeconomic imbalances procedure. The policies help to meet the following overarching objectives:

- **Reducing public indebtedness:** The government has approved an expansionary draft budget for 2016. Action to review spending was undertaken in 2015, but savings targets for the future have again been lowered. Implementation of the privatisation programme is proceeding, with a major operation completed at the end of 2015.

- **Raising productivity and external competitiveness:** The reform of the labour market has been completed but challenges to implementing active labour market policies remain and there are significant delays in the reform of collective bargaining. The enabling law to reform the tax system has only been partially implemented. In particular, the revision of tax expenditures and of cadastral values was not carried out. Furthermore, the cuts in property taxation under the 2016 Stability Law do not follow the long-standing Council recommendation to shift taxation away from productive factors. The draft 2015 annual law on competition has not been adopted yet and further market opening measures are needed. To reduce the administrative burden for firms and households, the government has agreed with the regions the 2015-2017 Simplification Agenda. Its implementation is on schedule. The schools reform has been adopted by the parliament and implementation is now ongoing. Italy has taken significant steps to address long-standing governance weaknesses in the banking sector. Furthermore, to facilitate the disposal of banks' non-performing loans, a new securitisation scheme backed by state guarantees has been announced and important measures have been taken on the tax treatment of loan losses and to improve the insolvency and foreclosure framework.

- **Strengthening institutional capacity to implement reforms:** The legislative process for the draft constitutional reform bill is on track and the new electoral law has been adopted by the parliament. An enabling law to reform the public administration was adopted by the parliament in August 2015 and the government has adopted a first set of implementing legislative decrees in January 2016. In the field of civil justice, efforts are currently focusing on implementing reforms from previous years, albeit with mixed success. While recent measures have been taken to step up the fight against corruption, the long-recommended systematic revision of the statute of limitations is still on hold. The operationalisation of the Agency for Territorial Cohesion should play a key role in improving the management of EU funds, but staffing concerns remain.

Italy has made some progress in the policy areas above. These findings are broadly consistent with those of the first specific monitoring report of December 2015.

([1]) European Commission (2015), *Italy – Review of progress on policy measures relevant for the correction of macroeconomic imbalances*. Available at: http://ec.europa.eu/economy_finance/economic_governance/macroeconomic_imbalance_procedure/mip_reports/index_en.htm

2.7. MIP ASSESSMENT MATRIX

This MIP Assessment Matrix summarises the main findings of the in-depth review in the Country Report. It focuses on imbalances and adjustment issues relevant for the MIP.

Table 2.7.1: **MIP Assessment Matrix - Italy**

	Gravity of the challenge	Evolution and prospects	Policy response
Imbalances (unsustainable trends, vulnerabilities and associated risks			
Productivity (see Section 2.1)	Italy's labour productivity growth has been sluggish for almost 20 years, due primarily to total factor productivity dynamics. Over 1994-2014, Italy's total factor productivity declined by 0.5 % while increasing by around 17 % in both France and Germany. Weak productivity dynamics hamper competitiveness and entail low GDP growth, which affects public debt ratio dynamics. Weak productivity growth is rooted in long-standing weaknesses in the functioning of labour, capital and product markets, compounded by inefficiencies in the public administration and justice system.	The crisis has aggravated productivity dynamics. Over 2008-2014, labour productivity declined by 4.3 % and total factor productivity by around 5.5 %. Labour productivity is expected to decline further in 2015 by -0.2 % and to grow only moderately in 2016 and 2017, well below the growth rate forecast for the euro area as a whole.	Major ongoing and planned reforms of the labour and product markets, banking, education, public administration and justice could help address the bottlenecks that hold back productivity growth. In particular, the comprehensive reform of the labour market to improve entry and exit flexibility, promote open-ended hiring, and reduce segmentation could improve the allocation of labour and provide incentives to invest in training and education. This would raise productivity. Similarly, ongoing policy action in the banking sector – in particular on banks' corporate governance – could improve the allocation of capital.
Public debt (see Section 2.2)	In 2015, Italy's public debt-to-GDP ratio stood at just below 133 %, up from a pre-crisis level in 2007 of around 100 %. Italy's high public indebtedness is a major source of vulnerability for the Italian economy. It holds back growth, crowds out productive public expenditure, reduces the fiscal space to respond to shocks, entails significant refinancing risk and may give rise to a harmful snowball effect if interest rates significantly exceed real growth rates. It may also have adverse effects and feedback loops through the exposure of domestic financial institutions to public debt, and may induce vulnerability in case of shocks to interest rates spreads. Furthermore, given its size, Italy's public debt is a potential source of negative spillovers to the euro area.	Negative growth and low inflation have pushed up the public debt-to-GDP ratio in recent years, while the primary balance remained on average in surplus. The public debt-to-GDP ratio is expected to decline in 2016 and 2017. However, the structural primary surplus is forecast to worsen to in 2016. This would not be consistent with an adequate reduction of the debt ratio. Adverse shocks could further delay the reduction of the debt ratio. Past pension reforms, if fully implemented, should support the long-term sustainability of Italy's public debt.	Measures taken include a review of public expenditure (0.2 % of spending cuts are planned for 2016, considerably less than the 0.6 % of GDP envisaged in April 2015), and a privatisation programme (0.4 % of GDP in 2015 and 0.5 % planned for 2016-2018). The structural reforms to foster productivity growth would make public debt more sustainable. Policy gaps include the failure to build regular spending reviews into the budgetary process across all government levels.
External competitiveness (see Section 2.3)	Over the past decades, Italy has been losing export market share, although losses have stopped since 2013. Deteriorating cost competitiveness has been one of the main factors driving the loss of export market share. Non-cost competitiveness factors, including product specialisation and the high share of small firms with a weak competitive position in international markets, remain insufficiently supportive. The current account balance – significantly improved over the last years – is expected to have reached 2.2 % of GDP in 2015, driven by a decline in imports and some growth in exports. Italy's net international investment position, at -27.9 % of GDP in 2014, does not pose sustainability concerns, even though the level of net marketable debt is relatively high.	Italy has recorded very small gains in export market share since 2013, but it is too early to assess whether the downward trend of the past has been stopped. Moreover, the gains are small compared to losses in preceding years and could be partly explained by the mechanical effect of the slowdown of global trade in 2013-2014. Moderate wage growth, reflecting the labour market weakness, and the euro's depreciation have allowed a gradual improvement in the real effective exchange rate based on unit labour cost, but not sufficiently to restore previous competitiveness losses.	Structural reforms to foster productivity growth would help to improve cost and non-cost competitiveness. Policy gaps include the lack of steps to better align wages with productivity, and of measures to promote firm growth. In particular, the reform of the framework for collective bargaining has incurred a delay.

(Continued on the next page)

Table (continued)

	Adjustment issues		
Labour market participation and unemployment (see Section 2.4)	The unemployment rate more than doubled during the crisis, from 6.1 % in 2007 to 12.7 % in 2014, and the long-term unemployment rate steadily increased over the period for all age groups. The risk of labour market exclusion is particularly high for youngsters: youth unemployment reached 40.5 % in the third quarter of 2015 and the share of young people not in employment, education or training (NEET) is the highest in the EU (about 22 % among those aged 15-24).	In 2015, the unemployment rate averaged 11.9%, down from 13% at the end of 2014, but long-term unemployment is not yet decreasing. Youth unemployment has started to decline, but remains very high. The participation rate grew moderately during the crisis but remains the lowest in the EU (63.6 % versus an EU average of 72.7 % in the third quarter of 2015).	The reform of active labour market policies and the strengthening of work-based learning could help to improve labour market matching and aid the transition from education to work in the medium term. However, implementation is likely to be challenging. Measures to foster labour market participation are limited.
Banks' asset quality (see Section 2.5)	The crisis has worsened Italian banks' asset quality, leading to significant loan-loss provisions that are undermining profitability, and holding back the growth of credit to the real economy. The stock of non-performing loans amounted to EUR 337 billion in June 2015 (18 % of total customer loans), while the average coverage ratio is still below its 2008 level. Tackling the non-performing loan problem would become even more urgent if monetary policy became less favourable.	While the inflow of new non-performing loans has slowed down since last year in parallel with the nascent economic recovery, the resolution of problem loans is progressing very slowly. The Italian non-performing loan market has lagged more buoyant distressed debts markets in the euro area, such as those in Spain or Ireland.	In August 2015, the Italian authorities reformed the insolvency and foreclosure framework and allowed the immediate full tax deductibility of losses on loans. Italy has announced the creation of a state-guarantee scheme for the securitisation of banks' non-performing loans to encourage the removal of such loans from banks' balance sheets.
	Conclusions from the IDR analysis		

- Very high government debt represents a major economic burden and vulnerability. The competitive position remains weak. Both imbalances are underpinned by protracted weak growth and productivity dynamics. The high stock of non-performing loans weighs on banks' balance sheets and high long-term unemployment holds back future growth.
- The crisis has aggravated productivity dynamics and the outlook remains weak. The public debt ratio is expected to peak in 2015 and to then decline only very gradually. Wage growth has moderated, but weak labour productivity growth holds back the relative adjustment in unit labour costs, while non-cost aspects remain insufficiently supportive of external competitiveness. The resolution of non-performing loans remains slow and long-term unemployment is not declining yet.
- An important reform of labour market institutions has been implemented, but progress in revising collective bargaining framework is slow. To foster the disposal of non-performing loans, reforms of taxation, insolvency and foreclosure rules have been enacted and a state-guarantee scheme has been announced. Measures with regard to the education system, public administration and justice are also being taken. The public expenditure review, not fully integrated yet in the budgetary process, and the privatisation plan would improve public debt sustainability. Market opening measures are being delayed and policy gaps remain notably with regard to taxation and the fight against corruption.

The first column summarises "gravity" issues which aim at providing an order of magnitude of the level of imbalances. The second column reports findings concerning the "evolution and prospects" of imbalances. The third column reports recent and planned relevant measures. Findings are reported for each source of imbalance and adjustment issue. The final three paragraphs of the matrix summarise the overall challenges, in terms of their gravity, developments and prospects, policy response.
Source: European Commission

3. ADDITIONAL STRUCTURAL ISSUES

In addition to the imbalances and adjustment issues addressed in Section 2, this section provides an analysis of other structural economic and social challenges for Italy. Focusing on the policy areas covered in the 2015 country-specific recommendations, this section analyses issues related to taxation, public administration and institutional efficiency, competition and business environment, education and R&D policy, social policy as well network industries, energy, climate and environment.

3.1. TAXATION

Italy's tax burden is among the highest in the EU but it is forecast to decrease. In 2014, Italy's tax-to-GDP ratio was 43.4 % of GDP, considerably above the EU average of 38.8 % of GDP. According to the Commission's 2016 winter forecast, Italy's tax-to-GDP ratio is expected to decrease in 2016 and 2017 on the back of the economic recovery. However, considering the high cost of servicing debt and the medium-term objective, Italy would need to decrease primary expenditure substantially to create fiscal room to reduce the tax burden further ([50]). Italy's tax structure is based on an equal proportion of indirect taxes, direct taxes and social security contributions. There are a number of challenges affecting Italian taxation, among which some of the most urgent are the very low tax compliance, a still missing all-compassing reforms of tax expenditures, in particular with respect to the value-added tax reduced rates, and of the old system of cadastral values in the context of the implementation of the 2014 enabling law on taxation; as well as the need to alleviate the tax burden on labour and to reform environmental taxation. A recent analysis by the Commission ([51]) identified housing taxation as an additional challenge as regards structural shift and debt bias.

The tax burden on labour is very high in Italy compared with the EU average, despite recent efforts to reduce it. Italy's implicit tax rate on labour, ([52]) at 44 % in 2014, was among the highest in the EU and well above the euro area average of 39 % (Graph 3.1.1). In the same year, the tax wedge for the average-wage single worker stood at 48.2 %, clearly above the EU average of around 41 %, and the level of labour taxation amounted to 21.6 % of GDP, as compared to 21.3 % in the euro area. Net social security contributions paid by employers and employees together accounted for 13.4 % of GDP in 2014, as compared to around 15.6 % in the euro area. In 2014, the inactivity trap ([53]), at 23.9 %, was below the EU average of 54.5 %, largely explained by lower social assistance expenditure for the working age population in Italy. The unemployment trap ([54]), at 79.6 % in 2014, was slightly above the EU average level of 74.2 %. A reduction in the labour tax burden could decisively contribute to increasing Italy's below-average employment levels ([55]) by stimulating labour demand and supply in the medium to long term. In line with the 2016 Council recommendations to the euro area, Italy enacted a series of measures aimed at reducing its tax wedge over the period 2015-2016. These measures were mostly enacted through the

([50]) Lorenzani D., V. Reitano (2015), Italy Spending Maze Runner. An analysis of the structure and evolution of public expenditure in Italy, European Economy – Discussion Paper, no. 023/2015.

([51]) European Commission (2015), *Tax reforms in EU Member States 2015*, European Economy – Institutional Paper, no. 008/2015.

([52]) The implicit tax rate on employed labour is defined as the sum of all direct and indirect taxes and employees' and employers' social contributions levied on employed labour income divided by the total compensation of employees working in the economic territory increased by taxes on wage bill and payroll. An analogous definition applies to capital (total taxes over theoretical base).

([53]) The inactivity trap measures the financial incentive for an inactive person not entitled to unemployment benefits (but potentially receiving other benefits like social assistance) to move from inactivity to paid employment. It is defined as the rate at which the additional gross income of such a transition is taxed. These figures refer to the inactivity trap at 67 % of the average wage and for a single individual.

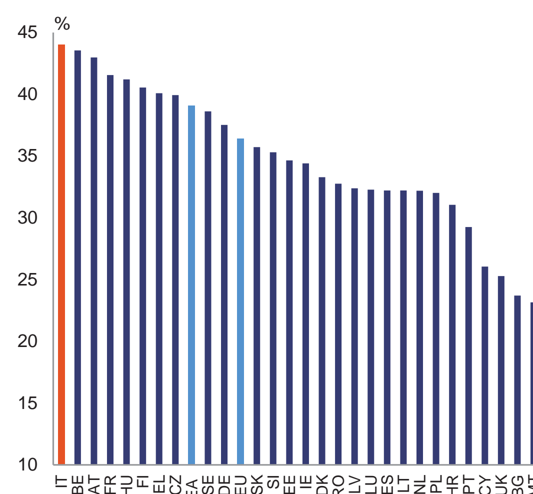
([54]) The unemployment trap measures the financial incentive for an unemployed entitled to unemployment benefits to move from inactivity to paid employment. It is defined as the rate at which the additional gross income of this transition is taxed. Here, the unemployment trap reflects the situation of workers receiving 67 % of the average wage both when working and when going back to work.

([55]) As indicated in the part on labour market, Italy's employment rate (referred to the age bracket 20-64) was at 59.9 % in 2014, well below the EU average of 69.2 %.

2015 and 2016 Stability Laws. ([56]) Overall, in 2014 the tax wedge on low-income earners ([57]) decreased to 38.2 %, from 41.8 % in 2013, but was still considerably above the EU average of 33.7 %. The Bank of Italy estimated ([58]), as a result of these measures, a permanent reduction in the labour tax wedge of 4.6 percentage points of the total labour costs (of which 1.3 percentage points for employers and 3.3 percentage points for employees) for employees with a gross wage one third below the national average (EUR 19 707).

Italy's tax burden on capital is also higher than the EU average but set to decrease. Revenues from capital taxation in Italy, at 10.6 % of GDP in 2014, were also considerably higher than the EU average of 8.2 %. Measures to reduce the tax burden on corporate income are included in the 2016 Stability Law. This envisages an incentive in 2016 for companies to invest through the possibility to deduct 140 % of the amounts spent, as well as a reduction in 2017 of the corporate income tax (IRES) rate by 3.5 percentage points, from 27.5 % to 24 %. In the short term, the potential growth impact of these provisions aimed to reduce the tax burden on factors of production could be at least partially offset by the measures needed to finance them. The long-term impact will depend on the quality of these financing measures (e.g. preserving growth-enhancing spending).

Graph 3.1.1: **Implicit tax rate on labour, 2014**



Source: European Commission

Significant challenges remain as regards Italy's property tax regime, heightened by recent policy actions. In 2014, Italy redesigned its property tax regime introducing a new tax on indivisible services (TASI), intended to meet the expenses for public electricity, upkeep of parks and public spaces, street cleaning, and all services provided to the public. This was part of a single municipal tax together with other property taxes (so-called IMU and TARI). In that year, revenues from Italy's recurrent property taxation, amounting to 1.6 % of GDP, were fully in line with the EU average. The 2016 Stability Law envisages a reform of local taxation including the repeal of the TASI on first residences as of 2016, together with the property tax on agricultural real estate and immovable machinery for productive use. Overall, the abolition of the primary residence tax appears to be a step back in the process of achieving a more efficient tax structure by shifting taxation onto property and away from factors of production. Uncertainties also remain as regards the revision of the cadastral system, a prerequisite for equitable and efficient property taxation, which the government had been empowered to reform in 2014. The census committees' composition, powers, and functioning have been disciplined, but a systematic revision of cadastral values to bring them more in line with the market value of the property, has been postponed to 2016. The

([56]) For a full description of these measures, see the Commission's 2015 country report on Italy. The 2016 Stability Law mostly extended the measures previously enacted except for the reduction by 40 %, for two years, of employers' social contributions paid on new permanent employees hired over 2016, which prolongs the previously enacted full exemption.
([57]) A single person earning 50% of the average wage.
([58]) *Audizione preliminare all'esame dei documenti di bilancio per il triennio 2015-2017*, Testimonianza del Vice Direttore Generale della Banca d'Italia, November 2014.

Revenue Agency ([59]) had in fact simulated that reformed cadastral values might increase by up to six times on the current ones. As a result, a major opportunity to tackle a long-standing problem swiftly has been missed.

The '80 euro bonus' is expected to have a positive impact on social and labour tax-wedge outcomes. The outcome of abolishing the tax on indivisible services is more debatable, particularly if assessed against alternative uses of the same resources. Recent simulations by the Commission ([60]) on the impact of the '80 euro bonus' on social and employment outcomes suggests that the tax credit reduces the tax wedge on labour ([61]) by 2.3 percentage points on average, with female, young, and low skilled workers mostly benefiting from it, as they tend to have lower incomes. The tax credit is found to increase the employment income of affected individuals by 7 % on average. On average, household disposable income ([62]) has increased by around 1.1 % (the EUROMOD-based simulation estimates the overall annual budgetary impact at around EUR 8.5 billion versus the EUR 9.5 billion reported in the government estimate). The highest percentage increases in disposable income are recorded in the second and third decile (1.8 % and 1.9 % respectively), while all deciles but the last two benefit from gains above the average. Income of the lowest decile increases by 1.3 % (i.e. only slightly more than the 1.1 % average), as this group also includes low-income pensioners and unemployed not affected by the tax credit. The introduction of the tax credit reduced inequality and poverty especially among children, as households with more members benefited from the bonus relatively more. On the other hand, the poverty rate among the elderly (with threshold fixed before the introduction of the bonus) does not improve as pensioners are not affected by the bonus (Table 3.1.1). The simulations indicate a reduction in the Gini coefficient of inequality ([63]) by 0.25 percentage points. A similar exercise conducted for the abolition of the first-residence tax TASI suggests a more modest increase in household disposable income (by 0.38 % on average due to estimated budgetary impact of around EUR 3.5 billion). The percentage increase is significantly larger for the bottom income decile (+1 %) than for the top income decile (+0.3 %), as TASI represents a larger share of lower-income households' budgets. However, the number of affected taxpayers is significantly higher in the top income decile (around 3.3 million versus 2 million in the bottom income decile), suggesting that in absolute terms the wealthiest will enjoy a bigger share of the budgetary resources needed for this tax relief measure. The top five deciles would in fact benefit from around two thirds of the total budgetary resources earmarked for this tax relief. EUROMOD-based simulation also suggests that the abolition of TASI will marginally reduce the Gini coefficient of inequality (by around 0.06 percentage points when the cadastral return is also included). Regarding the reduction in the poverty rate, the elderly would benefit the most from the TASI abolition (-0.4 % when including the cadastral return and with the threshold fixed before the introduction of the bonus) (Table 3.1.1). On the other hand, working age people would benefit the least (around -0.2 %). A counterfactual hypothetical exercise shows that, had the resources earmarked for abolishing the TASI been used instead to reduce employers' social security contributions for low-income workers (defined as workers with employment income below EUR 29 000 per year to be consistent with the '80 euro bonus' target), this would have entailed a reduction in the labour tax wedge of 1.4 percentage points,

([59]) See also UIL – Servizio Politiche Territoriali (2015).

([60]) European Commission (Joint Research Centre), based on the EUROMOD model, 2016. This exercise does not consider the impact of alternative measures to reduce poverty and inequality (e.g. minimum income schemes).

([61]) For the purpose of the simulation, the labour tax wedge is defined as the sum of the ratio of simulated personal income taxes that can be attributed to labour and employer and employee social security contribution to employment income plus employer social security contributions. The tax wedge on labour is calculated on all individuals with employment income, benefiting or not from the tax credit.

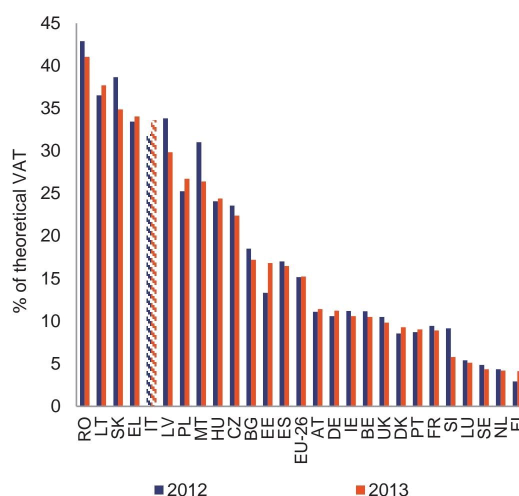
([62]) Equivalised household disposable income corresponds to total household income adjusted by household composition. The adjustment for household composition is made using the OECD-modified scale, assigning a weight of 1 to the household head, 0.5 to other adults in the household and 0.3 to children, and dividing total household income by the sum of the weighting factors.

([63]) The 'Gini coefficient' is a measure of statistical dispersion of the income distribution of a country's residents and is a commonly used measure of inequality. Given the frequency distribution of the residents' levels of income, a zero coefficient indicates perfect equality, as everyone has the same income, while a unit coefficient indicates maximum inequality (for example, where only one resident has all income and all others have none).

corresponding to a saving for the average employer of EUR 247 per low-income employee. In a behavioural framework, a discount in employer social security contributions may increase labour demand.

Despite some progress, tax compliance remains low in Italy, also due to poor tax design. Italy's relatively low tax compliance takes different forms, including tax under-declaration and evasion, VAT frauds, as well as a significant weight of the shadow economy. According to the national statistical office ([64]), the informal economy, worth EUR 190 billion (or 11.9 % of GDP) in 2013, was the only sector growing during the crisis. This has adverse effects in both macroeconomic and microeconomic terms, as it decreases tax revenues, hinders the financing of social protection, and threatens market competition and social equality. A substantial share of Italy's potential tax revenue vanishes in tax evasion and avoidance. A recent report on tax evasion ([65]) estimated this phenomenon at EUR 122.2 billion (or around 7.5 % of GDP) in 2015. This is larger than the average tax gap estimated by the Italian government over the period 2007-2012 at EUR 91 billion (5.6 % of GDP). ([66]) The study estimates that halving the amount of tax evasion would increase Italy's GDP by 3.1 % and employment by 335 000 jobs.

Graph 3.1.2: **Value added tax gap, 2012-2013**



Source: CPB (2015), Study to quantify and analyse the VAT gap in the EU Member States – 2015 report

Italy's VAT gap is among the highest in the EU. In 2013, Italy's VAT gap stood at 33.6 % of the total VAT theoretically collectable, thereby being more than twice the EU average (Graph 3.1.2). The difference between the VAT actually collected and theoretically collectable amounted to EUR 47.5 billion in 2013, EUR 2 billion more than in the previous year. Some measures have been enacted in 2015 to improve VAT collection based on the (permanent or temporary) extension of a reverse charge system to four sectors provided for in EU legislation (construction, cleaning, green certificates, and gas), as well as to the purchases made by the public administration (the so-called split payment). Other provisions aimed at fostering tax compliance are based on the cross-check of databases pushing taxpayers to voluntarily revise their tax returns before litigation (the so-called *adempimento volontario*), but results have so far been less promising than in the former case. Moreover, in 2015 Italy adopted eight legislative decrees implementing the 2014 enabling law on taxation, including electronic invoicing and traceability of payments for transactions subject to VAT, certainty of law, incentives for international businesses, revision of rulings and tax disputes, reorganisation of tax agencies, simplification of the collection procedures, estimation and monitoring of tax evasion, and the revision of the system of sanctions for tax-related offences. The latter measure encompassed overall milder administrative sanctions, including for omitted or

([64]) www.istat.it/it/archivio/175791
([65]) Centro Studi Confindustria (2015), *L'evasione blocca lo sviluppo*, no. 25.
([66]) Ministero Economia e Finanze (2014), Rapporto sulla realizzazione delle strategie di contrasto all'evasione fiscale, sui risultati conseguiti nel 2013 e nell'anno in corso, nonché su quelli attesi, con riferimento sia al recupero di gettito derivante da accertamento all'evasione che a quello attribuibile alla maggiore propensione all'adempimento da parte dei contribuenti. The estimated tax gap included EUR 44 billion of direct taxes, EUR 7 billion of the regional tax on productive activities, and EUR 40 billion of VAT.

Table 3.1.1: **Impact of the EUR 80 tax credit and the abolition of the property tax on first residences (TASI) on the poverty rates and on the Gini coefficient for inequality**

	(a) Without tax credit	(b) With tax credit	(c) Change	(d) With TASI	(e) Without TASI	(f) Change
Poverty rate (with fixed threshold)						
All	18.3%	17.7%	**-0.6%**	17.9%	17.6%	**-0.3%**
Male	17.1%	16.5%	**-0.6%**	16.8%	16.5%	**-0.3%**
Female	19.4%	18.8%	**-0.6%**	18.9%	18.6%	**-0.3%**
Child	24.8%	23.7%	**-1.1%**	23.5%	23.2%	**-0.3%**
Working age	17.8%	17.1%	**-0.7%**	17.2%	17.0%	**-0.2%**
Elderly	14.2%	14.2%	**0.0%**	14.9%	14.5%	**-0.4%**

In columns (a) to (c) the poverty threshold is fixed at 60% of the median equivalised disposable income before the introduction of the bonus. In columns (d) to (f) the poverty threshold is fixed at 60% of the median equivalised disposable income after the introduction of the bonus.
Source: European Commission, Joint Research Centre, based on the EUROMOD model

unfaithful self-declaration, increased thresholds for the criminal relevance of different tax evasion offences (immediately applicable, also with retroactive effect) and stricter sanctions for fraudulent behaviour or for omitted declaration by taxpayer substitutes. It is to be seen in practice whether this revised sanctioning system will strike the right balance between proportionality and effectiveness and thus lead to stronger deterrence for tax avoidance and evasion. In this context, the 2016 Stability Law also envisages an increase in the legal threshold for the use of cash from EUR 1 000 to EUR 3 000 which may represent an obstacle to fighting tax avoidance and money laundering.

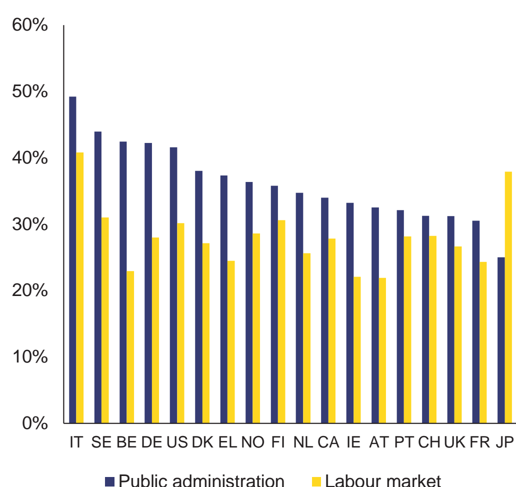
Administrative aspects and tax design appear to be contributing to Italy's low tax compliance. Italy's administrative costs of tax collection slightly increased in 2013 to 1.1 % of net revenues (up from 1 % in 2011), above the EU average of 0.97 %. In 2014, the total time spent on filing and paying taxes by a sample mid-sized company was 269 hours compared to 178 in the EU on average. Of these, 39 hours were spent complying with corporate income taxes, 198 for labour taxes and 32 for consumption taxes. ([67]) As regards tax simplification, in April 2015 the Italian Revenue Agency launched a website where all taxpayer allowed to fill the *Modello 730* can access their individual income tax returns. The pre-filled tax forms are based on the information the Agency stored in its database from previous years and on information provided by various other institutions.

([67]) PWC, Paying Taxes 2016.

3.2. PUBLIC ADMINISTRATION AND INSTITUTIONAL EFFICIENCY, JUSTICE AND ANTI-CORRUPTION

Public administration

Graph 3.2.1: **Percentage of employees aged 50 or older, 2013**



Source: ARAN elaboration on OECD data, Strategic Human Resources Management in Government Survey, labour force statistics database

Available international comparisons indicate that the efficiency and effectiveness of the Italian public sector is below the EU average. According to the World Bank 2015 Worldwide Governance Indicators, Italy scores well below the EU average on the government effectiveness indicator, which captures the perceptions of the quality of public services, the capacity of the civil service and its independence from political pressures, and the quality of policy formulation. Data also reveal a negative trend. Italy's score for government effectiveness has gradually decreased from 0.67 in 2004 to 0.42 in 2009 and to 0.38 in 2014. The EU also displays a downward trend albeit at a slower pace. ([68]) Similarly, the regulatory quality index, which captures perceptions of the ability of the government to provide sound policies and regulations, is below EU average and deteriorating faster. The 2013 European Quality of Government Index gives a similar picture with Italy well below the EU average, ranking 25th out of the 27 EU states considered. Moreover, Italy shows the widest variation across EU regions in terms of quality and impartiality of public services. The variation nationally is almost as great as the variation within the EU: 3.29 in Italy against 3.31 in the whole EU. This represents an additional challenge for Italy: to improve the overall level of efficiency of its national public administration and simultaneously reduce the variation between regions.

Several factors underlie the weak performance of Italian public administrations. The excessive length of bureaucratic procedures reduces the effectiveness of administrative actions. Competences are unclearly shared among central and local administrations, generating overlapping and intra institutional conflicts. These make administrative processes uncertain both in terms of duration and outcome. This lack of transparency reduces the accountability of the public administration. There is also a problem of age and quality of public employment. Almost 50 % of central and local public administration employees are aged 50 or older ([69]) while only 10 % are aged 35 or younger (Graph 3.2.1). Moreover, in 2013 only 18 % of public administration employees were graduates while 34 % did not finish the secondary education. The representative agency for public administration (ARAN) compared the education requirements of all the positions within the public administration to the actual educational qualifications of current employees. The representative agency for public administration found that in 33 % of positions there is a skills mismatch (rising to 49 % if only positions requiring a university degree are considered) (Graph 3.2.2). ([70]) If the public administration is broken down into sub-categories, the skills mismatch is even more apparent. Some 53 % of employees of non-economic agencies are underqualified while 6 % are overqualified; for ministries the percentages are 34 % and 9 %; among university staff 25 % are underqualified while 18 % is overqualified. Positions that required a university degree can be covered through internal career progression or through external recruitment.

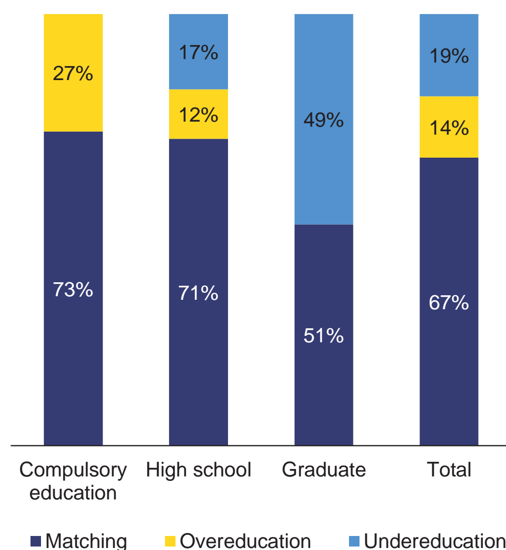
([68]) World Bank's Worldwide Governance Indicators 2015. The governance score denotes the estimate of governance measured on a scale from approximately -2.5 to 2.5. Higher values correspond to better governance. The percentile ranks of Italy among all 215 countries covered by the Worldwide Governance Indicators are 75.12 (2004), 66.51 (2009) and 66.83 (2014) respectively.

([69]) Mastrogiuseppe P., Vignocchi C. (2013), *Anzianità ed età del personale pubblico*, ARAN Occasional Paper 3.

([70]) Mastrogiuseppe P. (2013), Organizzazione e capitale umano: due questioni chiave per il rilancio del pubblico impiego, ARAN Occasional Paper 4.

In the latter case, mismatching is minimised by the current mandatory educational requirements. However, in the former case positions could be covered by employees recruited before the introduction of educational requirements, which is the majority of cases considering the age pyramid of staff. Italy ranks among the lowest in the OECD countries in use of the internet for dealing with public administrations.

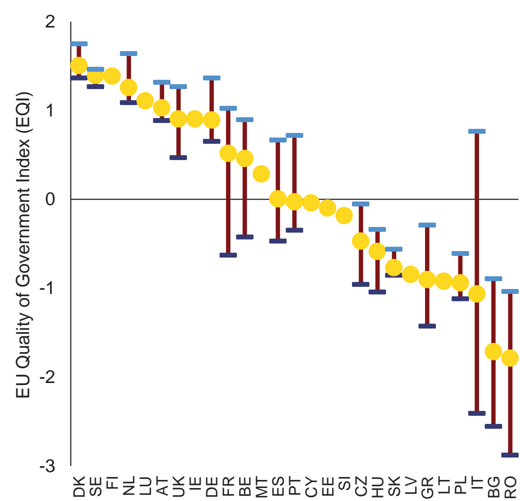
Graph 3.2.2: **Matching and mismatching distribution according to skills level required, 2013**



Source: ARAN elaboration on RGS-IGOS data

The low efficiency of the Italian public administration negatively affects the business environment and productivity. In the 2015-2016 World Economic Forum's Global Competitiveness Report, the inefficiency of government bureaucracy is identified as the most problematic factor for doing business in Italy.([71]) The negative impact is channelled directly or indirectly to the whole economy. The negative impact is direct in terms of additional costs or loss of resources, through for instance a more burdensome business environment (see Section 3.3). The inefficiency of the Italian public administration also impacts the economy indirectly by holding back firms' growth and foreign direct investment or delaying the implementation and enforcement of reforms, even when well designed. Referring to the large variation in efficiency among Italian provinces (Graph 3.2.3), the International Monetary Fund ([72]) estimated that if public sector efficiency rose to the level of the best provinces of the country, the productivity of the average firm would increase by 5-10 % and GDP would rise overall by 2 %.

Graph 3.2.3: **EU quality of government index and within-country variation at regional level**



Source: European Commission

In August 2015 a comprehensive enabling law to reform public administration was adopted. The reform aims to tackle most of the sources of inefficiency highlighted above by improving access to documents and data for the public, improving the recruitment, management and mobility of staff, streamlining and speeding up decision-making processes. The implementing legislative decrees have to be adopted before August 2016 with the exception of the decree for simplification and transparency measures (deadline February 2016), and the decree regarding public employment (deadline February 2017).

In January 2016, a series of legislative decrees were proposed by the government. Two important decrees cover the transparency and simplification measures envisaged in the enabling law. Key provisions concern the simplification of the procedure for acquiring a certified announcement on the commencement of activity

([71]) World Economic Forum (2015), Global Competitiveness Report 2015-2016.

([72]) IMF (2015), IMF Country Report no. 15/166.

(SCIA) and the functioning of the *Conferenza dei Servizi* ([73]). A simplified conference is introduced, covering most regular projects. For more sensitive projects, traditional conferences remain in place but clear and binding time constraints are introduced to complete them. A special procedure, cutting up to 50 % of the time required by regular procedures and managed directly by the Prime Minister's office, is legislated for national or regional strategic projects, with only general criteria for eligibility. The application of the silence-means-consent principle is extended. The other seven decrees cover a number of provisions: public administration disciplinary dismissal, port authorities' reorganisation (see Section 3.6), state forestry corps, national health system senior manager selection, reorganisation and rationalisation of state-owned enterprises and local public services.

Public procurement

Italy's public procurement system still features a number of structural weaknesses. The legal and institutional framework is complex and unstable. The e-procurement landscape is fragmented, with advanced buyers at central level and in some regions while others have yet to start the transition to e-submission. A comprehensive e-procurement plan has been drawn up. In terms of e-invoicing, Italy has completed the transition, achieving a take-up close to 100 %. There is a significant discrepancy between the tenders registered at national level and those published in the European tenders electronic daily (in terms of value and number of operations). Italy has one of the highest rates in the EU of negotiated procedures without publication of a notice (9 % of all procedures) and one of the highest rates of single-bid contracts (29 %), one of the lowest publication rates of contract notices in the EU Official journal (19.5 % of total public procurement expenditure). Lack of administrative capacity and significant barriers to competition in key economic sectors translate into burdensome procedures and inefficiencies. The average length of a tendering procedure is 210 days (compared to an EU average of 77.4 days). 340 decisions on remedies in this field were registered in 2013. Finally, there is a high perception of corruption as a widespread phenomenon in public procurement: 70 % of respondents in a 2014 Eurobarometer survey stated this.

The Italian government plans to adopt a comprehensive national strategy for public procurement in 2016. This should contribute to better compliance with new EU rules on public contracts and concessions and identifying concrete measures to overcome the country's systemic problems. The provisions are expected to focus on improving the institutional framework and modernising the central and local administrations.

Local state owned enterprises

Nearly 8 000 local state-owned enterprises in Italy weigh on the efficiency of the economy and public finances. Local state-owned enterprises have proliferated in Italy during the last two to three decades. An extensive analysis on the demography and economic variables of state-owned enterprises is included in the Commission's 2015 country report on Italy. The roots of state-owned enterprises' inefficiencies are manifold. Although local state-owned enterprises are in principle subject to private law, several derogations to this principle and a number of special provisions have created a complicated framework for operating and organising state-owned enterprises. Diverging and inconsistent approaches have been adopted by the courts in implementing laws, depending on the special features of separate categories of state-owned enterprises. This gives rise to legal uncertainty and burdensome procedures. ([74]) Besides, the vast majority of local state-owned enterprises are awarded service contracts directly, with no open tender, which further reduces incentives for seeking efficiency gains. ([75]) Finally, political intervention is found to be very frequent and to have a negative impact on local state-owned

([73]) Every public administration affected by a project takes part to this unified conference to deliver its opinion and to reach a common position over the project, eventually approving or blocking it.

([74]) See for instance Corte di Cassazione, cases no. 22209/2013 and 28495/2012.

([75]) Corte dei Conti (2014), Gli organismi partecipati dagli enti territoriali.

enterprises' economic performance, namely their return on investment and return on equity. ([76])

New initiatives were taken under the public administration reform in January 2016 to tackle the root causes of inefficiency in state-owned enterprises and local public services. The new framework aims to regulate systematically state-owned enterprises in line with the principles of efficient management, protection of competition and the need to reduce public expenditure. New state-owned enterprises need to be justified against other alternatives and fall within the institutional goals of the public authority, subject to prior control by the Court of Auditors. The latter shall also be responsible to review annual rationalisation reports. The role of participating public authorities is aligned to the position of regular shareholders. Performance criteria for the directors are introduced and state-owned enterprises are required to prepare corporate governance reports on a yearly basis. The new provisions clarify that state-owned enterprises are subject to the bankruptcy legislation. Compensation for public service obligations is to be documented separately. The articles of association of the state-owned enterprises need to be adjusted to the new rules by end-2016. Given that similar measures, though in a fragmented way, were taken in the past with no concrete result, the actual implementation of the reform represents an important challenge. Important measures are also proposed to revise the legal framework for local public services in order to strengthen competition and improve efficiency.

Institutional capacity

Important measures are being taken to strengthen the institutional capacity to adopt and implement reforms. The new electoral law aims at producing more stable majorities in the Italian parliament, ultimately allowing government to pursue a five years reform programme. The new electoral law was fully adopted in May 2015 and will be operational as from July 2016. The constitutional bill aims at reducing the Senate's legislative power overhauling the current perfect bicameral system. The legislative process will be more prompt and streamlined. In addition, in line with the public administration reform, the division of powers between the centre and the regions will be clarified and the provincial level of government phased out. Both chambers of the parliament completed their first reading of the constitutional bill in March and October 2015. Final adoption is envisaged for the first half of 2016. Therefore, taking into consideration the public administration reform, the new electoral law and the constitutional bill, from August 2016, Italy should have a completely new institutional design. In the meantime, the current government is accelerating the adoption and implementation of past measures. In November 2015, the share of implementing measures passed by the Monti and Letta governments that have been adopted amounts to 76.3 %. The Renzi government has adopted 265 bills ([77]) up to mid-November 2015. It is however not clear how many of these implementing measures have already been adopted nor how many face a delay in their adoption.

European structural and investment funds

Inefficiency in public administration impedes Italy's ability to use EU funds effectively. Italy's use of EU funds remains substantially lower than the EU average. In 2015 - the last available year for reporting on funds use - the absorption rate of all structural funds was still at 80 % of total planned expenditure, with just a 10 % increase over the previous year. Italy continues to be a 'two speeds' country in terms of using EU funds. North-central regions and a couple of southern regions perform in line with the EU average both in qualitative and quantitative terms, but a limited number of southern regions are well below the average in terms of absorption, quality of expenditure and project completion. ([78]) The latter regions are also the main recipients of the cohesion policy, accounting for approximately 70 % of the resources.

Medium and long term measures to address Italy's long-standing weaknesses in using EU

([76]) Menozzi et al. (2011), Board composition, political connections, and performance in state-owned enterprises, Industrial and Corporate Change; Garrone et al. (2011), Utility municipali: influenza politica o discrezionalità del management, L'Industria, a. XXXII, n. 1.

([77]) Including decree laws, draft laws and legislative decrees.

([78]) As of 1 December 2015, absorption levels for Competitiveness regions stand at 90 %, while Convergence regions stand at around 76 % with four regions barely reaching 68 %.

funds have been adopted. The Agency for Territorial Cohesion is now operational. The department for Cohesion policy has been reformed and is now part of the Prime Minister's office. The adoption of the national and regional programmes was conditional upon the adoption of plans for administrative reinforcement (PRA). These were introduced to ensure that the administrations responsible for the use of cohesion policy funds have the structure and the competences to manage the resources they are entrusted to. The coordination of the process is overseen by a high level steering committee, chaired by the prime minister's secretary general and the main stakeholders. ([79])

Justice system

Lengthy proceedings and a large number of pending civil and commercial cases remain major challenges. In Italy, the time needed to resolve all types of civil and commercial cases in first instance remained relatively stable at around 380 days over 2010-2014. ([80]) While the time needed to resolve litigious civil and commercial cases in first instance has decreased to 532 days in 2014 as compared to 608 days in 2013, it remains among the longest in the EU. Moreover, litigious civil and commercial proceedings are particularly long in second instance as well as at the Supreme Court. ([81]) Since 2009, the total number of cases pending in courts has fallen consistently thanks to high clearance rates in both first and second instance courts, in particular regarding civil and commercial litigious cases. ([82]) This shows courts' potential to reduce the backlogs accumulated. This notwithstanding, no further progress was made over 2014 to reduce the backlog of 4.5 million cases pending in first instance civil courts. In administrative courts, the backlog in first instance per capita has halved since 2010 with very high clearance rate over the years, but the disposition time ([83]) in first instance remains very high at 983 days in 2014.

Despite the improvements in terms of reducing the backlog, the percentage of cases pending for more than three years in first and second instance civil courts increased in 2014. Cases pending for more than three years in civil first and second instance courts increased from 24 % of all cases in 2013 to 32 % in 2014. ([84]) The fact that one third of all civil cases have been pending in courts for more than three years has serious repercussions on the functioning of the justice system, as it affects the trust of the users and is therefore detrimental to the business and investment environment. A large number of court cases exceeding the reasonable length of proceedings also puts a strain on the public budget. ([85])

There is scope for improving the quality of the justice system in several aspects. While surveys of court users and legal professionals are the main method of measuring 'customer satisfaction', they are very rarely used in Italy. No surveys were carried out in 2014. ([86]) Information and communication technology tools remain underused particularly in administrative and tax-related courts, where the 'digital administrative trial' is not yet fully applicable. Wider publication of judgments of first and second instance civil courts and better communication policies between courts and the public could improve the transparency of court activities.

Compared to judicial reforms undertaken in previous years, fewer legislative initiatives were

([79]) Representatives from the Labour Ministry, the Agency for Territorial Cohesion, the Department for territorial cohesion, the Public administration, the European Commission and regions representatives.

([80]) The disposition time amounted to 376 days in 2014, compared to 395 days in 2010, 391 days in 2012 and 369 days in 2013. Source: European Commission, *2016 EU Justice Scoreboard*.

([81]) The disposition time for litigious civil and commercial cases was 959 days in second instance and 1 316 days at the Supreme Court in 2014. Source: CEPEJ, *Study on the functioning of judicial systems in the EU Member States*.

([82]) The clearance rate for civil and commercial litigious cases was 119 % in 2014 both in first and second instance courts, the highest in the EU. Source: CEPEJ, *Study on the functioning of judicial systems in the EU Member States*.

([83]) Disposition time is an estimated indicator of average trial length, comparing the number of resolved cases during the observed period and the number of unresolved cases at its end. For more information and an empirical analysis: Lorenzani D., Lucidi F. (2014), *The Economic Impact of Civil Justice Reforms*, European Economy – Economic Papers, no. 530/2014.

([84]) Ministry of Justice, Progetto Strasburgo 2, September 2015

([85]) The Ministry of Justice estimates that since 2001 over EUR 750 million have been paid in compensations (with over 450 million still pending as of August 2015).

([86]) European Commission, *2016 EU Justice Scoreboard*.

set in motion in 2015. Two enabling laws were proposed in the first half of 2015, but their adoption is still pending. The first concerns the reform of the honorary magistracy and justices of peace. The second envisages amendments to civil procedural rules seeking to streamline certain aspects of proceedings and strengthens the courts' specialisation by extending the competences of business courts and creating sections specialised in family-law disputes. The measures provided for have the potential to address some of the weaknesses of the Italian justice system and are strongly supported by the business community, but the timeline for adoption and implementation remains uncertain. A further step towards the 'digital civil trial' was taken by introducing the possibility of electronic filing of the first exchange of statements between the parties in all first and second instance courts. This complements the obligatory electronic transmission of documents in ongoing proceedings, fully applicable as of 30 June 2015. The Italian government estimates that the savings already generated from the use of the 'digital civil trial' between October 2014 and September 2015 amounted to EUR 53 million. ([87]) The effects of the digitalisation of proceedings on their efficiency cannot yet be measured, but the first results on the payment orders issued by electronic means are promising. ([88])

The Italian government continued to monitor the reforms already adopted. Regularly published data on the functioning of compulsory mediation in specific civil and commercial matters suggests that there is a positive trend of parties' entering mediation, ([89]) but the percentage of cases where agreements were found remains low. ([90]) A recent stakeholder survey showed that two thirds of companies with experience in mediation had a negative assessment and almost half thought that it was less attractive than courts in terms of costs incurred. ([91]) The limited success of the mediation scheme introduced in 2013 for a four-year trial period may call into question the compulsory approach to mediation. Reliable data on the measures adopted in 2014 on the transfer of pending cases to arbitration and the introduction of mandatory assisted negotiation is not yet available. An assessment is foreseen for 2016.

The government announced new organisational measures seeking to address courts' backlog, particularly for cases pending for more than three years. The Italian Ministry of Justice has developed a multiannual project ([92]) aimed at reducing courts' backlog in several phases, the first one targeted at cases which started before 2000. It also developed a number of principles to be applied by courts in the management of their backlog, such as the application of the 'first-in-first-out' rule and continuous monitoring of the duration of pending cases. If successfully applied, these measures could have positive effects by addressing one of the most critical challenges in the justice system. It must be noted, however, that focusing on the relatively more complex older cases is likely to have a temporary negative impact on the overall number of pending cases as well as lower the clearance rates in courts.

Corruption

Corruption is still a major problem in Italy and the statute of limitations remains an obstacle to fighting it. Most of the challenges highlighted for Italy by the 2014 EU anti-corruption report persist, including high-level corruption and links with organised crime, conflicts of interest and asset disclosure, infrastructure and other large public works, and corruption in the private sector. In a recent Eurobarometer survey ([93]), Italy is consistently among the EU countries with the highest percentage of firms believing that the following are a widespread problem in their country: corruption (98 %); bribes (36 %); abuse of power for personal gain among politicians, party representatives or senior officials at national level (88 %); as well as reporting that favouritism and corruption hampers business competition (89 %); that corruption affects public procurement

([87]) http://pst.giustizia.it/PST/

([88]) The time to adopt a payment order by courts decreased in most districts, up to 45 %, since the application of the 'digital civil trial' rules (as of June 2015).

([89]) 45 % participated in the first mediation meeting in the first half of 2015 as compared with 39 % in 2014.

([90]) Around 22 % of mediations where both parties participate in at least one meeting end in agreement. The rate increases to 40.5 % if parties participate in more mediation meetings.

([91]) Survey carried out by the ABI-Confindustria, May 2015.

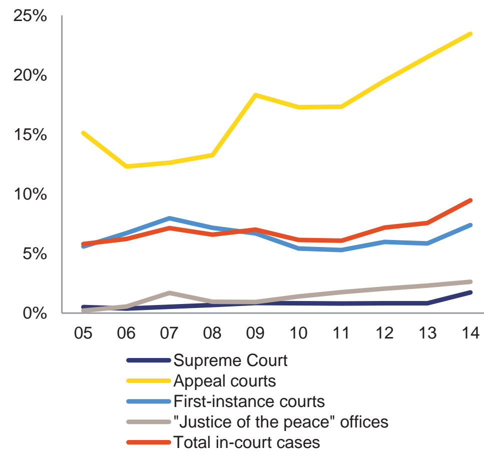
([92]) Ministry of Justice, Progetto organizzativo Arretrato civile ultratriennale - Programma Strasburgo 2.

([93]) Flash Eurobarometer 428, *Businesses' attitudes towards corruption in the EU*, September-October 2015.

managed by regional or local authorities (77 %); and in general that corruption is a major hindrance to doing business (60 %). This survey is confirmed by several international indicators: according to Transparency International 2016, Italy had one of the worst scores in the EU in terms of corruption perception in 2015. The World Economic Forum Global Competitiveness Report 2014-2015 ranked Italy 102nd out of 144 countries on indicators related to ethics and corruption. The World Bank governance indicators ranked Italy 25th in the EU for control of corruption in 2014 data. The national anti-corruption authority ANAC analysed a sample of the corruption prevention plans that all administrative bodies and state-owned companies must have and found their quality 'generally unsatisfactory', ([94]) characterised by a formalistic approach to compliance and limited involvement of managers. This adds to Italy's lack of a uniform and systematic verification of public officials' assets and conflicts of interest. Overall, it is estimated that ineffective anti-corruption measures have so far deterred inward investment and economic growth. Transparency International and the Council of Europe Group of States against Corruption have pointed to the statute of limitations as a major weakness in Italy's system for preventing corruption and called for a thorough assessment of the reasons behind the large number of time-barred corruption cases and for a comprehensive plan to tackle them. As discussed in the 2015 Italy country report, the current system provides incentives for delaying tactics. Indeed, the trend over time in the ratio of time-barred criminal cases to the total number of resolved cases reported in Graph 3.2.4 shows that, while prescription rates in the first instance remained quite stable over time but rapidly rose to 7.4 % in 2014, prescriptions in appeal courts increased steadily and visibly from 15 % to 23.5 % over 2005-2014. As for the Supreme Court, while prescription rates are obviously much lower, the same increasing trend can be noticed, rapidly accelerating over the last year. The available evidence confirms the significant number of cases that are time-barred after first instance convictions.

([94]) ANAC (2015), Aggiornamento 2015 al Piano Nazionale Anticorruzione, Determinazione no. 12/2015.

Graph 3.2.4: **Ratio of statute-barred criminal cases over total resolved cases**



The total number of resolved cases per relevant instance in 2014 is as follows: Supreme Court: 53 350; appeal courts: 103 577; first-instance courts: 320 551; "Justice of the peace" offices: 54 763; total in-court cases: 532 441
Source: Ministry of Justice, European Commission

There are delays in the reform of the statute of limitations. A draft bill for a systematic revision of Italy's statute of limitations is still under discussion in the parliament after two votes in the relevant chambers. However, some laws were approved in the course of 2015. These raise penalties and thus also prescription terms for specific corruption offences, introduce new offences in the criminal code such as self-laundering of money and accounting fraud, and strengthen the competences of the national anti-corruption authority ANAC, particularly in public procurement. Legislative initiatives are also under way to encourage whistle-blowers, who currently enjoy limited and fragmented protection. Proper implementation of these rules, together with the swift approval of a systematic revision of the statute of limitations, could represent a step change in the fight against corruption.

The application of Italy's statute of limitations for certain criminal offences may raise issues under EU law. Following a referral for a preliminary ruling by the District Court of Cuneo, the Court of Justice of the EU ruled in September 2015 ([95]) that the Italian Court should *inter alia* disapply national statute of limitations rules, if

([95]) Case C-105/14. See press release no. 95/15.

they prevent Italy from imposing effective and dissuasive penalties for criminal offences involving value added tax (VAT) fraud. The application of Italy's statute of limitations lead the country to infringe its obligations under Article 325 TFEU to counter fraud that affects the EU's financial interests. Although the case concerned fraudulent 'VAT carousel' arrangements, this judgment is relevant for the fight against corruption for two reasons. First, it echoes the national court's affirmation that in criminal proceedings on offences (e.g. tax evasion), entailing complex investigations, offenders' *de facto* impunity is the norm rather than the exception in Italy due to the expiration of the limitation period. ([96]) Most importantly, the Court of Justice calls on the national court to ensure that EU law is given full effect by not applying those provisions of domestic law that have an opposite effect, i.e. the statute of limitations in that case. Therefore, without prejudice to the final outcome of this case in Italy, ([97]) a revision of the statute of limitations is also relevant in the light of this development, given the obligation for Member States to fight corruption under EU law.

([96]) Judgment of the Court of September 2015, Case C-105/14.
([97]) Concerning this case, a ruling of the Italian Constitutional Court is currently pending following a referral by the Court of Appeal of Milan with regard to the possible limitations that the fundamental principles stemming from the Italian constitution may bring to the implementation of the court's judgment in this case in the Italian legal order.

3.3. COMPETITION AND BUSINESS ENVIRONMENT

Competition

Barriers to competition remain significant in Italy. Service and product reforms facilitate resource reallocation and investment, allowing more productive companies to enter new markets and to grow faster, thus raising the average competitiveness of the national economy, as also recognised in the 2016 Council recommendations to the euro area. Through a wave of reform up to 2012, Italy competition framework in product and service markets was brought broadly in line with the OECD average, according to the OECD index for product market regulation. However, in recent years, no major measures have been adopted to further open up the Italian economy. Furthermore, Section 2.1 shows that productivity growth in important service sectors underperformed the EU average in recent years, weighing on the competitiveness of the economy.

In 2015 the Italian government started an annual exercise to tackle remaining barriers to competition. In February 2015, the government adopted a draft law on competition, for the first time complying with the 2009 legislation that requires the government to present such a draft law every year on the basis of a proposal from the national Competition Authority. This is an important step and it may set in motion a positive annual mechanism. The law was passed in first reading by the Chamber of Deputies and it is now being discussed in the Senate. Final adoption is envisaged for the beginning of 2016. Many provisions of the draft law have been weakened during the parliamentary discussions. The draft law, as voted by the Chamber, envisages competition-enhancing interventions in a number of sectors. The measures appear particularly structured for the insurance sector where anti-frauds instruments, transparency and offer comparability have been strengthened. In other sectors, provisions are more targeted to remove or lower specific barriers to competition. In the telecommunication industry, clients' migration is expected to be made easier. In 2017, Poste Italiane is set to lose the monopoly over judicial and administrative notifications. In the electricity and gas sectors, the switch to a completely free market is to be boosted. Other minor measures are present for the banking and the fuel distribution sectors.

The draft text could have been more ambitious on some regulated professions such as notaries, lawyers and pharmacists. According to an in-depth assessment of the regulation of business services by the Commission ([98]) and the OECD's indicators of regulation in non-manufacturing sectors, many aspects of the Italian regulated professions are still too regulated. In particular, there are restrictions in the authorisation and insurance requirements, shareholding requirements and voting rights. Given the weakening which occurred during the parliamentary procedure, the adopted provisions only partially address these bottlenecks. Less stringent criteria have been introduced for the geographical distribution of notaries but the profession remains heavily regulated and barriers for newcomers remain strong. Unjustified exclusive rights are still in place, which the competition law would only partially reduce by allowing specific corporate acts through digitalised procedures, without a mandatory notarial deed. Furthermore, the government's proposal to allow also lawyers to certify property transactions (with maximum value of EUR 100 000) has been discarded by the parliament. With regard to lawyers, law firms have been only partially liberalised with non-professionals allowed to own shares only up to one third of law firms' capital. In the pharmacy sector, the law relaxes or removes a number of limitations concerning partners' mandatory requirements and incompatibilities, companies' legal status and geographical and numerical distribution. Overall, these sectors still remain substantially regulated. Furthermore, no actions for reducing the differences in rules between regions have been taken, in particularly for training requirements. These differences can weaken the free movement of professionals within the national territory. The government is planning to nationally harmonize the rules and to reduce these differences but there are delays in the implementation.

The competition law does not cover many relevant sectors still over-protected or regulated. Compared with proposals of the Italian competition authority's proposals, some sectors have not been covered or covered only in part. In particular, pro-competition measures are still needed in the allocation of radio spectrum

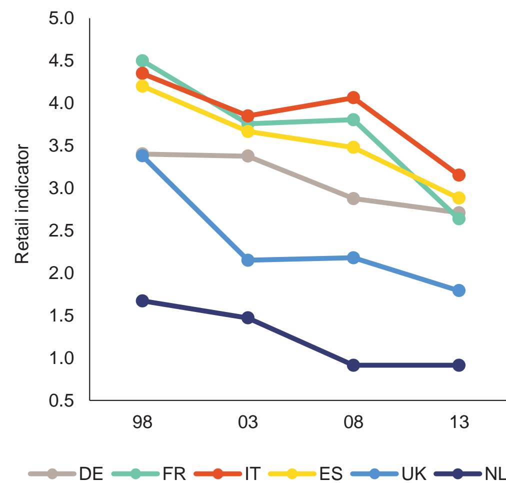
([98]) http://ec.europa.eu/growth/single-market/index_en.htm

frequencies, in the health sector, in hydroelectric power plants, in local public transport and taxis, ports and airports (see Section 3.6). Following the positive exercise in 2015, the Italian government is due to present a new annual competition law in 2016 following the new recommendations from the Italian competition authority.

The public process of granting rights on public domain for economic activities is still inefficient and does not promote competition. Competition in a number of sectors is severely hindered by permit schemes: service providers are given the right to use public infrastructure for long periods with no competitive procedures. Evidences from the hydroelectric power plants and maritime touristic sectors show that awarding permits through competitive and transparent procedures reduces costs for consumers and increases the payments by concession holders to the State. The Competition Authority has already intervened several times and, as mentioned, a suggestion to change the legislation on hydroelectric permits was included in the competition authority's proposal for the 2015 competition law.

The retail sector show signs of inefficiency. Starting from 1998 Italy has been worst performer among major EU economies in terms of strictness of market regulation (Graph 3.3.1), according to the OECD relevant index. The index indicates the following shortcomings: large-surfaces retail outlets are still subject to special rules, especially concerning new openings; incumbents are excessively protected from new entrants; restrictions on promotions, discounts and below-cost sales are still severe. As expected, the mark-up of the retail sector is higher than the other European main economies (Graph 3.3.2). Even disregarding the two best performing countries, Italian mark-up is still 24 % and 20 % higher than France and Germany respectively. In addition, consumers' assessment of the performance of the Italian retail sector is also below the EU average. [99] Furthermore, productivity growth in the retail sector has been very low in Italy (see Section 2.1) and, correspondingly, nominal unit labour costs were among the fastest growing in the EU in recent years. It is important to note that productivity in the retail sector is shown to be crucial to aggregate productivity trends. According to the literature, almost half of the productivity gap, cumulated from 1995, between the EU and the United States is due to the weak European performance in three sectors: retail, wholesale trade and securities. [100]

Graph 3.3.1: **Retail: market regulation index**

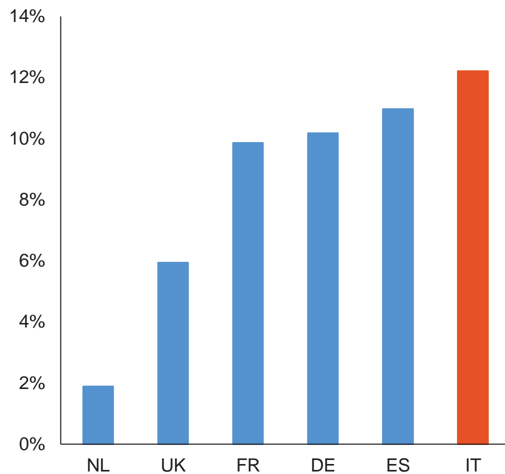


Source: OECD - Indicators of sectoral regulation (NMR) 2013, European Commission

[99] Consumer Markets Scoreboard 2016.

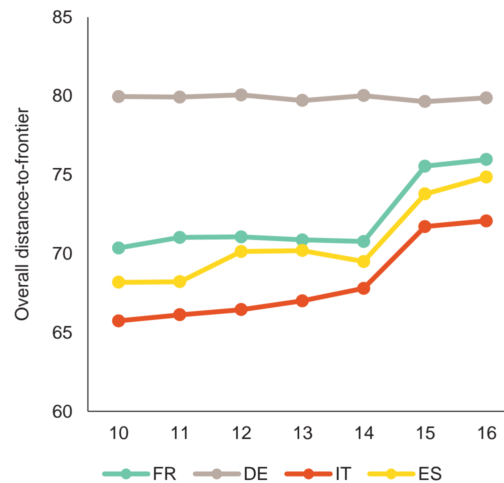
[100] Van Ark et al, 'Changing Gear, Productivity, ICT and Services Industries: Europe and the United States', 2002" and "R. J. Gordon, 'Why was Europe left at the station when America's productivity locomotive departed?', 2004.

Graph 3.3.2: **Retail: sectoral mark-up**



Source: European Commission

Graph 3.3.3: **Relative performance in doing business compared to the best performer**



There were some breaks in the series in 2015 and 2016. The 2015 report broadened the scope of some indicators: Getting credit, Protecting minority investors, resolving insolvency. The 2016 report broadened the scope of: Registering property, Dealing with construction permits, Getting electricity, Enforcing contracts. The 2016 report also increased the relevance of the indicator sets on Trading across borders.
Source: World Bank - Doing Business Indicators 2016

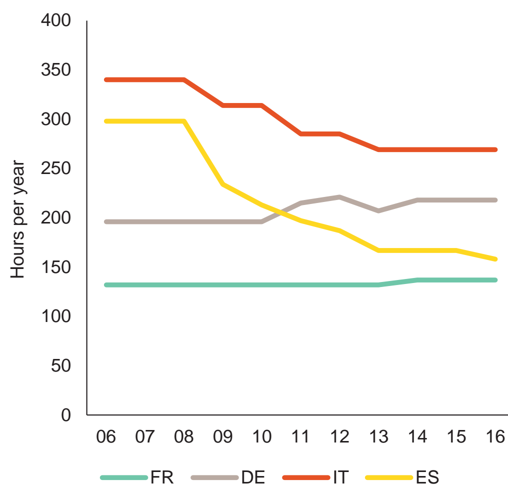
Business environment

Market opening measures need to be supported by a more business friendly environment. Pro-competition measures and provisions adopted in a non-business-friendly environment cannot fully benefit the economy. The Italian business environment is still not sufficiently conducive to growth. Italy remains characterised by a fragmented and stratified system of laws and regulations emanating from different levels of government. A thoroughly examination of the legislation was envisaged by Article 1 of Law 27/2012 but was never implemented. Doing business in Italy is significantly more difficult than in the other major EU economies. The World Bank doing business indicator ranks Italy 45th out of 189 economies in the ease of doing business ranking. Italy is still behind the other major EU economies and the modest progress made in recent years has not allowed the country to fully catch up with its peers (Graph 3.3.3).

Some aspects of Italy's business environment remain very unfavourable. Italy only ranks 86th in dealing with building permits, 97th in getting credit, 111th in contract enforcement and 137th in tax payment. Since 2013, the average time needed to pay taxes is 269 hours per year compared to 189 hours in the EU (Graph 3.3.4). The number of payments due per year is 14, compared to the 8 required in France and 9 due in Germany and Spain. Companies operating in Italy are even more disadvantaged when contracts need to be enforced. According to the doing business indicator 2016, it takes 1 120 days to enforce a contract in Italy, compared to the 395 days in France, 429 in Germany and 510 days in Spain. The excessive length of the procedure is not counterbalanced by the cost of enforcing a contract. Italian companies bear costs equivalent to 23.1 % of the claim value, while in Germany, France and Spain, the corresponding cost is 14.4 %, 17.4 % and 18.5 % respectively. Only in a limited number of sub-indicators Italy shows some progress and scores above the EU average. The time needed to start up a company has considerably decreased as well as the time to complete insolvency proceedings. However, the cost of opening a new

business is still extremely high, equal to 13.8 % of the per-person income, while the same cost is 0.8 % in France, 1.8 % in Germany and 5.2 % in Spain (Graph 3.3.5). The difficult business environment is closely linked to the weaknesses and inefficiencies in Italy's public administration (see Section 3.2).

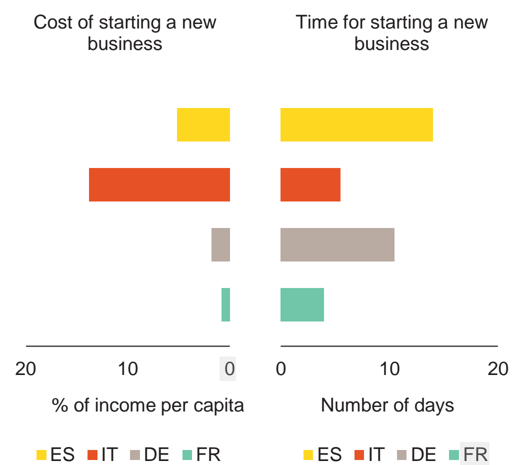
Graph 3.3.4: **Time required for tax payment for companies**



Source: World Bank - Doing Business Indicators 2016

The 2015-2017 Simplification Agenda and the 2015 public administration reform are on track. Business environment problems arise not only from restrictive or outdated regulations, but also from past piecemeal measures and regional level implementation. However, the current government is attempting to adopt a more organic approach to address the problem. The Simplification Agenda, by allowing an easier and more streamlined cooperation between central and regional governments, aims at establishing a more coherent simplification framework. The government regularly monitors the implementation of the Simplification Agenda. Measures already implemented include: electronic invoicing for all the public administration entities which is fully operational; the social security compliance certificate (DURC) which is on line starting from July 2015. Some other measures, which have already been launched, are experiencing some delays: digital citizenship, which includes the digital trial (see Section 3.2), the digitalisation of the population registry and a digital identity. In addition, the public administration reform, by increasing efficiency and effectiveness of the central and local administrations, represents an opportunity to significantly improve the business environment of the country: reducing procedure lengths and increasing certainty of bureaucratic processes translate into a reduction of direct and indirect costs borne by Italian companies (see Section 3.2).

Graph 3.3.5: **Time required and associated cost to start a business, 2015**

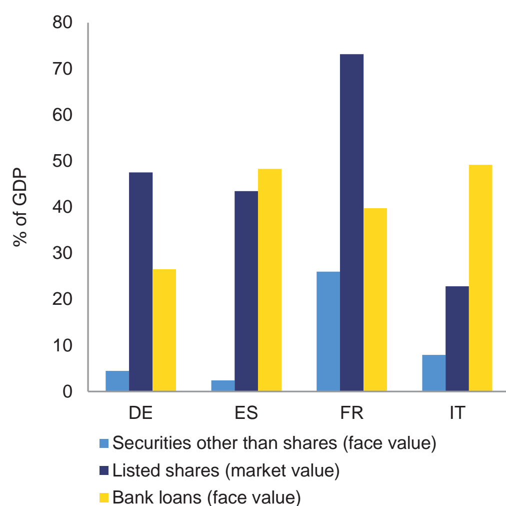


Source: World Bank – Doing Business Indicators 2016

Capital markets in Italy continue to be less developed than in other advanced economies, limiting the alternatives to bank loans. Italian companies' external financing continues to be strongly bank-centred: in November 2015, total bank loans to firms amounted to 49.2 % of GDP, compared to 26.5 % in Germany and 39.8 % in France. Conversely, market-based funding through equity and debt instruments appears to be less developed in Italy: listed shares represented just 22.8 % of GDP in November 2015 (much less than in Germany and France), whereas debt instruments totalled 8 % of GDP (more than in Germany, but significantly less than in France) (Graph 3.3.6). More specialised sources of external financing appear even more limited: in 2014, private equity investment in Italy amounted to 0.113 % of GDP (less than half and less than a third of the shares in Germany and France respectively), while venture capital investment was just 0.002 % of GDP (less

than a tenth of the German and French share). ([101]) Strong reliance on bank loans and the relative thinness of domestic capital markets can be associated with firms' high financial leverage ([102]), lack of alternative funding sources when banks' capacity to provide credit is constrained, and funding gaps for young and small innovative firms (see Section 3.4). In the recent past, the Italian authorities have adopted several measures aimed at diversifying firms' funding sources, including an allowance for corporate equity, regulatory frameworks for equity crowdfunding and the issuance of mini-bonds, and incentives for the stock-market listing of SMEs. In addition, several initiatives have been launched in recent years to mitigate firms' liquidity constraints in the context of the crisis, notably through the Guarantee Fund for SMEs and the *Nuova Sabatini* programme to stimulate investment in machinery and equipment. A comprehensive overview of the main measures can be found in the Commission's 2015 country report on Italy.

Graph 3.3.6: **Funding sources for non-financial corporations, November 2015**



Securities other than shares mainly consist of debt securities.
Source: European Central Bank, European Commission

([101]) European Private Equity and Venture Capital Association (EVCA), 2014 European Private Equity Activity. Statistics on Fundraising, Investments & Divestments.
([102]) Financial leverage is defined as the ratio between financial debt and the sum of financial debt and equity. Financial debt consists of loans and debt securities. Higher financial leverage is associated with lower creditworthiness.

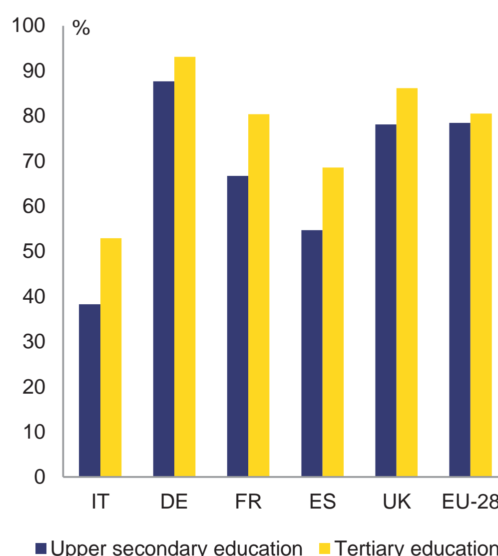
3.4. EDUCATION, R&D AND INNOVATION

Education

Education attainment rates and the skills level of the adult population in Italy are below the EU average. The tertiary education attainment rate for 30-34 year-olds is one of the lowest in the EU (23.9 % in 2014) and remains below the Europe 2020 national target of 26-27 %. The early school leaving rate remains well above the EU average (15 % in 2014 compared with 11.2 %), although it is on a declining trend and below the Europe 2020 national target of 16 %. There are marked regional differences in basic skills proficiency, as measured by the 2012 OECD Programme for International Student Assessment (PISA) and the annual standardised student tests by the National Agency for School Evaluation (INVALSI). Work-based learning is not sufficiently well-developed: only 10.4 % of upper secondary students participated in traineeships (*alternanza scuola-lavoro*) in 2014-2015, although this figure has been on an upward trend in the last few years. ([103]) Entry into the labour market is difficult for young people, including the high-skilled (Graph 3.4.1). ([104])

Teachers have limited career prospects. The teaching career system offers only a single career pathway with fixed salary increases based solely on seniority. Italian teachers' statutory salary levels are lower than the OECD average at every career stage and, owing to the seniority-based career system, the maximum salary can only be reached after 35 years of service, while the OECD average is 24 years. ([105]) Teachers' salaries relative to other workers with tertiary education are also low. Limited career prospects, coupled with relatively low salaries compared with other high-skilled professions, may make it difficult to attract the best-qualified graduates into the teaching profession. ([106]) According to recent surveys, the status of the teaching profession is perceived as rather low, both by the general public ([107]) and teachers themselves. ([108])

Graph 3.4.1: **Employment rate of recent graduates, 2014**



Recent graduates are defined as people aged 20-34 who left education between 2011 and 2013.
Source: European Commission (Eurostat)

Italy has made substantial progress in adopting and implementing the school reform. A major school reform was approved by the parliament in July 2015, and it could improve school outcomes. The reform gives more autonomy to schools and introduces limited merit-based elements in teachers' salaries (up to EUR 200 million per year). Furthermore, around 85 000 teachers are recruited (around 45 % of which filling existing position). These are positive steps, provided that the school autonomy is accompanied by stronger accountability of heads ([109]) and future recruiting takes place only via open competition, as the government has committed to do. The implementation of the National System for

([103]) Italian Ministry of Education and Research (2015), *Focus del 30 Novembre 2015: Alternanza Scuola Lavoro*.
([104]) Montanari M., Pinelli D., Torre R. (2015), *From tertiary education to work in Italy: a difficult transition*, ECFIN Country Focus, Vol. 12, Issue 5, European Commission, Directorate-General for Economic and Financial Affairs.
([105]) OECD (2015), *Education at a Glance 2015*. OECD Indicators. All figures are in purchasing power parity.
([106]) European Commission (2012), *Supporting the Teaching Professions for Better Learning Outcomes*, http://ec.europa.eu/education/policy/school/doc/teachercomp_en.pdf
([107]) Dolton, P., Marcenaro-Gutierrez O. (2013), *2013 Global Teacher Status Index*.
([108]) OECD (2014), TALIS 2013 Results: An International Perspective on Teaching and Learning.
([109]) Hanushek E. A., Woessmann L. (2011), *The economics of international differences in educational achievement*. In Hanushek E. A., Machin S., Woessmann, L., *Handbook of the Economics of Education*, Vol. 3, Amsterdam: North Holland, pp. 89-200; Bloom N., Lemos R., Sadun R., Van Reenen J. (2015), *Does Management Matter in Schools?*, The Economic Journal, Vol. 125, Issue 584, pp. 647-674.

Evaluation of schools will support the reform by increasing school accountability. Self-assessment reports were published in November 2015. Evaluation by external teams, coordinated by an inspector, will start during the 2015-2016 school year. The key to the success of this system is ensuring that all relevant players and stakeholders are involved.

The school reform also strengthens work-based learning in upper secondary schools and vocationally-oriented tertiary education. Traineeships have become compulsory for students in the last three years of upper secondary education. This measure is a step in the right direction as it could help education and training to better meet the labour market needs. The school reform also includes several measures to boost the Higher Technical Institutes for vocational training at tertiary level. The Higher Technical Institutes remain a niche provider of education. Only around 6 000 students studied there in 2014. Data on the employability of recent graduates are however encouraging: in 2015 80 % were in employment one year after graduating.

Italy faces a challenge of integrating different levels of lifelong learning systems into a coherent national qualification system. ([110]) In 2014, only 2.2 % of the low skilled had participated in training or education in the previous four weeks (EU average: 4.4 %). Also for the rest of the population, participation in education and training is lower than the EU average (8 % in Italy versus 10.7 % in the EU), with no evidence of an increase in the recent years. Despite the adoption in 2012 and 2013 of several packages laying down a national strategy for adult learning, implementation is slow. Decree 13/2013 established the National Repository of education, training and professional qualifications. A first release of the National Qualification Framework should be implemented by mid-2016 and draft National Guidelines for validation of non-formal and informal learning and certification of competence should be produced by end-2016.

([110]) Cedefop (2015), Analysis and overview of NQF developments in European countries.

The Italian apprenticeships system has been reviewed recently but concerns remain about the quality of provisions. Apprenticeships leading to a professional certificate or a diploma will be integrated in regional Vocational Education and Training systems of three and four years duration as a dual system involving both schools and companies. With an additional year of apprenticeship, they will give access to vocationally oriented tertiary education. Professional apprenticeships which previously targeted only young people (aged 18-29) are extended to include adult workers who have been made redundant. The reform is a good step towards a more integrated and attractive apprenticeships system, but no specific quality criteria are set for the companies offering apprenticeships.

Underfunding weighs on the higher education system. Public expenditure in education in Italy is lower than the EU average. The gap is particularly large in tertiary education. General government expenditure in tertiary education was one of the lowest in the EU at only 0.4 % of GDP and 0.7 % of total general government expenditure in 2013. Major cuts to overall public funding for higher education took place between 2009 and 2013. This went in parallel with a freeze of public salaries and staff cuts (the number of permanent teaching staff decreased by 17 % over 2008-2014), implying a reduction of approximately 20 % in real terms. Funding cuts compounded the issue of ageing teaching staff. The average age is 52 and around 17 % of 2013 staff (i.e. almost 9 300 people) could retire between 2014 and 2018. ([111]) Moreover, Italy has one of the lowest shares in the EU of teaching staff aged under 40 (16 % in 2013). Support for students is also low. Only 8 % of first-cycle students receive a public grant, one of the lowest proportions in the EU and a quarter of eligible students do not receive a grant due to lack of available funding. ([112])

The quality of higher education is receiving more attention, but attracting young researchers remains a challenge. More attention

([111]) ANVUR (2014), Rapporto sullo stato del sistema universitario e della ricerca 2013.

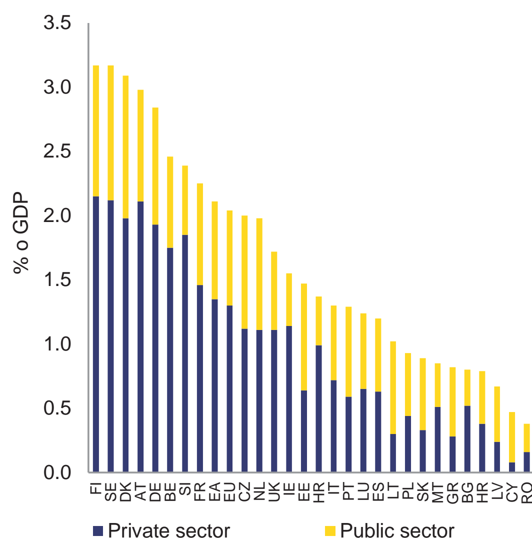
([112]) European Commission (2015), National Student Fee and Support Systems in European Higher Education 2015/16.

is being paid to the quality of higher education and to the framework for allocating public funding. In 2015, the share of performance-related funding to tertiary education institutions rose to 20 % of total funding and is set to gradually increase to 30 %. Standard costs were established and are being rolled out gradually until 2018 as a criterion for allocating the remaining share of public funding. The ministry also started the third round of evaluation of research results (*valutazione della qualità dei prodotti della ricerca*) for the period 2011-2014 to monitor the results achieved by universities and public research institutes under the control of the Ministry of Education since 2011. The 2016 Stability Law provides funding for hiring up to 650 new full and associate professors through a simplified procedure, as well as 850 young researchers on 'tenure-track' positions; it also makes it easier to hire young researchers on fixed-term contracts, not leading to a tenure track. These one-off measures are a first positive step, although rather limited in scope and not sufficient to address the issue of the ageing teaching staff.

R&D and innovation

Italy is still characterised by low R&D investment compared to other EU countries. In 2014, Italy's overall R&D intensity – defined as total R&D expenditure as a share of GDP – amounted to 1.29 %, compared to an EU average of 2.03 %. The gap with the EU average is higher for R&D expenditure by private businesses (0.72 % of GDP in Italy compared to an EU average of 1.3 %) than by the public sector (0.53 % of GDP in Italy compared to an EU average of 0.72 %) (Graph 3.4.2). As in many other countries, growth in Italy's R&D intensity has slowed down since the start of the protracted crisis in 2009. The fiscal consolidation strategy of the last few years did not protect R&D: the share of research and innovation in government expenditure decreased from 1.32 % in 2007 to 0.99 % in 2014.

Graph 3.4.2: **R&D intensity, 2014**

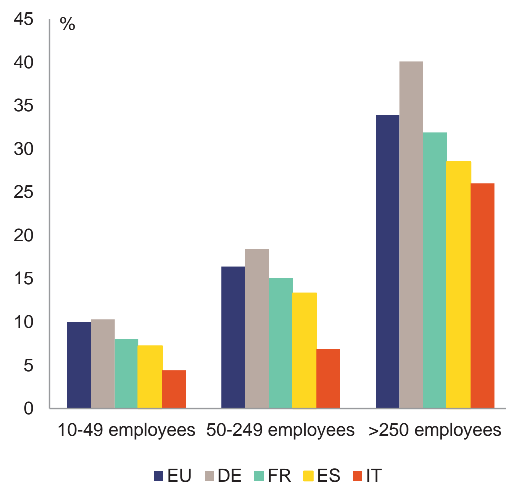


Source: European Commission (Eurostat)

Structural weaknesses affect Italy's R&D system. Italy scores low on several specific aspects relevant to foster R&D and innovative activity. First, R&D funding gaps continue to exist, especially for young and small innovative firms which do not have sufficient internal resources to fund their projects. While bank lending tends to be a less suitable source of external funding for R&D projects, more appropriate funding channels tend to be underdeveloped in Italy (see Section 3.3). Second, the relative scarcity of highly-skilled human resources in Italy holds back Italy's innovative performance. Moreover, many Italian researchers have left the country in recent years owing to lack of career prospects and competitive salaries (Box 2.4.1). Third, Italy's research and innovation system is characterised by weak cooperation between academia and business (Graph 3.4.3). In 2012, the share of public R&D financed by businesses was only 0.014 % of GDP, well below the EU average of 0.051 %. This holds back the transfer of knowledge from universities and other public research to firms and the spreading of the risks related to R&D activities. Fourth, the low share of high-tech knowledge-intensive services and of high-tech manufacturing activities, and the significant share of low-tech and medium-low-tech manufacturing activities (see Section 2.3) is both a cause and a consequence of Italy's weak innovative performance. Finally, Italy's unfavourable general business environment,

its many small and family-owned firms and relatively low inward foreign direct investment also explain why Italy exhibits less innovative activity than its peers (see Sections 2.3 and 3.3).

Graph 3.4.3: **Share of innovative firms cooperating with higher education institutions, by number of employees, 2012**

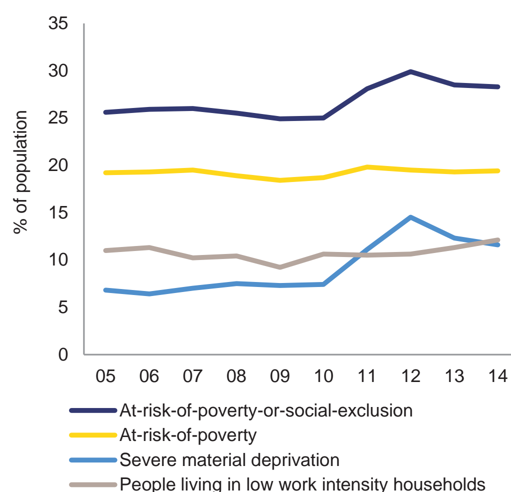


Source: European Commission (Eurostat)

Italy has taken a number of policy initiatives to support its research and innovation system, but their fragmentation remains a concern. First, the renewal of the tax credit for firms' R&D activity for the period 2015-2019 took effect. The tax credit amounts to 25 % of incremental R&D investment, subject to a ceiling of EUR 5 million per beneficiary, and it rises to 50 % for research carried out with public research centres and universities. However, its effectiveness may be limited by its temporary nature and lack of predictability given frequent changes in the past. Second, in the beginning of 2015, the privileges that were already in place for so-called 'innovative start-ups' were extended to 'innovative SMEs'. These privileges include *inter alia* simplified access to the Central Guarantee Fund for SMEs, tax incentives for investment in young innovative SMEs, flexible remuneration schemes and deferred deduction of losses from capital and other waivers. Third, implementing rules for the so-called 'patent box' regime that allows for the partial exclusion (up to 50 % in 2017) of revenues from intangible assets (e.g. patents, trademarks, industrial designs and models) were adopted in July 2015. Fourth, a revision of the regulatory framework on equity crowdfunding has taken place and further public consultations have been organised to support the development of this financing channel. Fifth, the government set up a EUR 50 million fund managed by Invitalia for privately co-financed venture capital investments. Sixth, the 2016 Stability Law sets aside funds for the hiring of new professors and researchers (see "Education" in this Section). Seventh, Italy has decided to join the enhanced cooperation at EU level on unitary patent protection. Once in place, the unitary patent will make it easier, faster and cheaper for Italian innovative firms to obtain patent protection in all 26 participating Member States. Finally, several measures have been taken in recent years to foster non-bank funding channels for firms (see Section 3.3). In spite of these initiatives, the effectiveness of the above-mentioned measures may be limited due to the lack of an overarching innovation strategy. At the same time, the National Research Programme 2014-2020, which was presented for the first time in February 2014, has not been approved yet and is therefore still not operational.

3.5. SOCIAL POLICY

Graph 3.5.1: **At-risk-of-poverty-or-social-exclusion rate and its components**



Source: Istat

More than a quarter of Italians are at risk of poverty or social exclusion. The share of persons at risk of poverty of social exclusion was 28.3 % in 2014, slightly down from 28.5 % in 2013 (Graph 3.5.1). The rate is still higher than pre-crisis levels (25.5 % in 2008) and is showing no progress towards the Europe 2020 target on poverty reduction. The overall evolution of the rate is explained by developments in the proportion of people with severe material deprivation, slightly falling from the peaks of 2012, or living in low work intensity households. In addition, inequality in income distribution has increased since 2008 and it was well above the EU average in 2014.

The increase in poverty or social exclusion has been significant for vulnerable groups (such as women, children, immigrants and minority communities), with substantial regional disparities. Children (aged less than 18) are the age-group with the highest risk of poverty and social exclusion, a risk that also affects the subsequent age group (18-24 years). The share of persons at risk of poverty of social exclusion increased significantly for foreign citizens between 2008 (34 %) and 2014 (48.2 %), more than twice as much as in the rest of the EU. Disparities between the south and the rest of Italy are also significant. In Sicily (55.3 %), Campania (49 %) and Calabria (43.5 %), the share of persons at risk of poverty of social exclusion is more than 20 percentage points higher than the national average. The weak safety net limits the impact of social transfers on the reduction of poverty. Calculations on the rate of people at risk of poverty before and after social transfers show that social benefits in Italy reduce poverty in Italy by 5.5 percentage points, less than in the EU as a whole (-8.9 percentage points).

The economic crisis and the stagnation of the Italian economy has put the Italian social welfare system under pressure and exposed its structural weaknesses. The legislative framework on social policies adopted in 2000 envisaged setting up a system of integrated social policies, including the introduction of a minimum income scheme with attention to those most in need. ([113]) The framework has never become fully operational. The social policies framework has remained fragmented (apart from healthcare), with limited redistributive capacity, low selectivity, low quality of service provision, limited enabling and activation measures and significant regional disparities.

The difficult coordination between different layers of government has hampered an efficient implementation of the existing normative framework. National Standards (*livelli essenziali di prestazione*) for the provision of social services have not yet been defined in most fields, nor coherently implemented throughout Italy. One issue is that the central level defines standards but cannot earmark financial resources to support them, as this would limit the autonomy of regional and local authorities in social policy fields. The forthcoming constitutional reform is expected to re-centralise the overall policy design in the social field. This might in principle make it possible to reduce at least in part the existing stark regional disparities. For instance the average expenditure in social services per inhabitant varies between EUR 264 in the province of Bolzano and EUR 25 in Calabria.

The quality and efficiency of services is also extremely variable across and within regions. Only a few regions have put in place structured and differentiated systems according to needs. In others, low levels of expenditure are combined with low capacity to provide adequate services.

([113]) Law 328/2000.

Monitoring is also weak in many cases, with several local services not even having a digital database of users and expenditure. Systematic collaboration between social services and employment services exists only in few regions.

Social protection expenditure is mainly absorbed by pensions. In 2013 Italy spent more than any other large Member State on pensions as a share of potential GDP. This pattern worsened significantly over the crisis, with pension-related expenditure increasing by 1.5 percentage points of potential GDP over 2007-2013. As opposed to pension expenditure, in 2013 other social transfers (e.g. unemployment benefits, disability and sickness benefits) still represented a significantly lower share of Italy's potential GDP (below 5 %) than in any other big Member State except Spain, despite the increase (by 0.6 percentage points) registered over the crisis years. ([114])

Funding of social services is fragmented and was reduced. At the national level, the main funding instrument for social services is the National Fund for Social Policies, managed (around 90 %) by regional authorities. Resources allocated to the National Fund for Social Policies decreased by over half between 2008 (EUR 712 million) and 2015 (EUR 313 million). Social services are therefore funded in large part through municipalities' own resources (62.5 %), through regional funds for social policies (17.1 %), the national fund for social policies (12.4 %) or other sources (8 %) ([115]). Budget cuts for municipalities have put social services under pressure.

Italy does not have a universal minimum income scheme. Several pilot income schemes have been trialled in the past, following the adoption of the 2000 framework, but were never transformed into permanent instrument to fight poverty. In 2013-2014, a new trial (*Sostegno per l'Inclusione Attiva (SIA)*) was launched, in 12 large cities, funded with EUR 50 million for 18 months. This experiment, whose extension had been recommended by the 2014 country specific recommendations, was discontinued during 2015.

At the national level, the allocation of funding to social policies has kept shifting, often without a clear strategic policy framework. In 2015, the overall amount of national spending on social services and assistance was brought back to 2008 levels, after being halved between 2008 and 2013. Yet, the composition of expenditure has changed. While the National Fund for Social Policies has been halved since 2008, a large part of the budget for social policies has been dedicated to a measure to support fertility rates (the so-called "baby bonus"). An allowance of EUR 80 per month for three years is granted to households with babies born or adopted in 2015-2017. The measure has limited targeting and was introduced with no fully-fledged impact assessment. The resources earmarked in the 2015 Stability Law for this measure are not negligible. The peak will be reached in 2017 and 2018 with over EUR 1 billion per year.

The childcare and long term care systems have important weaknesses. The long term care system is characterised by a very strong emphasis on cash benefits programmes over services. The main cash programme is the 'Companion Allowance' (*indennità di accompagnamento*), characterised by the absence of any accountability requirements for beneficiaries; no differentiation according to the severity of the disability; and no means testing. The relatively modest amount given to each beneficiary (EUR 500 per month) may make it insufficient to cater for the needs of people with severe disabilities in low-income households. The lack of accountability and the limited amounts mean that the benefit is mostly used to pay a salary to a migrant care-worker, often undeclared, but only if household incomes are sufficient. Therefore, the provision of cash transfer instead of services may translate in an insufficient access to quality care by people in need and in an incentive to undeclared work.

Availability of childcare services remains a challenge. Availability of childcare facilities is lower than the EU average, especially for the age group 0-3 (21 % versus 27 %), and it is very far from the Barcelona target of 33 % by 2010. Even though in recent years substantial investments in

([114]) Figures are for primary expenditure according to the so-called 'functional classification' (COFOG). This classifies general government expenditure by the purpose for which public funds are used. First-level COFOG splits public expenditure into ten functional groups (including, among others, social protection, health care, education, and defence).

([115]) Istat figures for 2011.

childcare were made, in the school year 2012/2013 as a national average, only 13.5 % of children 0-3 years old had access to crèches managed or financially supported by local authorities (i.e. municipalities). In addition to the low formal childcare coverage for young children, there is an income inequality issue in access to childcare. Childcare use is twice as high among families in the fifth income quintile as compared to the first quintile (for children below the age of two). ([116]) Regional disparities are noteworthy.

The limited provision of childcare and long term care also has a negative impact on carers' participation in the labour market. A recent study ([117]) shows that around 14 % of mid-life working women in Italy, with care responsibilities, have reduced or given-up labour-market participation due to reasons related to coping with informal care for their parents. The share of grandmothers providing intensive care for their grandchildren in Italy is among the highest (22 %) in the EU, which is a factor behind the low employment rates among women aged 55 and above.

There might be scope for ensuring a better use of resources by analysing the impact of the different tools. Some savings could be made by analysing the impact of different tools and by streamlining some existing instruments (such as some smaller funds that might overlap and be combined), also in the view of financing a nationwide minimum income scheme. Also, some evidence hints at a possible excessive use of disability allowances as a substitution for other forms of income support. ([118]).

Nonetheless, in 2015, some positive signals and opportunities for a reinforcement of the system have emerged. The government has worked in close partnership with regional and local authorities and the not-for-profit sector to develop tools and measures that may ensure a better governance of the welfare system. This also includes a strategic and coordinated use of EU funds, which offer substantial opportunities to support social investment in the 2014-2020 programming phase.

Two key new tools aim at a more accurate identification of needs and monitoring of provisions. One is the reform of means-testing mechanisms (ISEE, the index of equivalised economic situation, created by Law 109/1998), which might provide useful parameters for laying down the basic levels of social services. ([119]) By revising weightings attributed to property income and capital income, the 'new ISEE' contributes to a more equitable (progressive) consideration of wealth to access social benefits. The system seems more accurate than in the past: for instance, the number of households reporting no capital income decreased sharply compared with the old system (from 73 % to 24 %). The other is a national database on social assistance (*casellario dell'assistenza*) ([120]), still at an early stage of implementation. It will be managed by INPS and collect information on all social assistance provisions, gathered by several agencies (including regional and local authorities). The system, associated with monitoring and evaluation methods, should allow for better targeting of measures, also by avoiding overlapping and fragmentation and permitting better monitoring. As a further step, in end-January the government proposed an enabling law which foresees the reorganisation of means-tested welfare instruments in order to rationalise their provisions while maximising their impact.

([116]) Eurydice (2009), *Tackling Social and Cultural Inequalities through Early Childhood Education and Care in Europe*, European Commission - Education, Audiovisual & Culture Executive Agency (EACEA).
([117]) Naldini M., Pavolini E., Solera C. (2014), *Does caring for the elderly affect mid-life women's employment?,* Carlo Alberto Notebooks.
([118]) Negri N. and Saraceno C. (1996), Le politiche contro la povertà in Italia; Sacchi S. (2005), Reddito minimo e politiche di contrasto alla povertà in Italia, Urge Working Paper no. 1; Rossi E. and Masala P. (2008), Lotta alla povertà: le politiche pubbliche per la tutela dei diritti della persona, in Rinaldi W. (2008), Giustizia e povertà. Even though no conclusive evidence exists on this topic, the observation of an unbalanced distribution of disability benefits across the country points to the need for further analysis. Based on Istat data of 2013, 44 % of civil disability pensions were in the South, 35 % in the North and 20 % in the Centre, which respectively represent 35 %, 46 % and 20 % of the Italian population.
([119]) Law 214/2011; Prime Ministerial Decree 159/2013.
([120]) Interministerial Decree 206/2014.

The 2016 Stability Law sets aside resources for an anti-poverty measure, building on the Active Social Inclusion (SIA) scheme discontinued in 2015. Compared with this scheme, the key change is the withdrawal of the requirement to have been previously employed, which makes the new scheme complementary to the unemployment insurance (ASDI). The measure is targeted to families with children and ISEE below EUR 3 000, plus some other criteria to further select the most needy among them, still to be defined. Households would receive between EUR 160 and EUR 400 per month according to the number of family members, for a maximum of one year. The Stability Law earmarks EUR 600 million for 2016 and 1 billion for 2017 and 2018 in a Fund to fight poverty and social exclusion. Additional funding could come in 2016 from other scattered funds. It is an important step, above all because the measure is conceived as a structural one, instead of a trial as in the past. Nonetheless, its funding, while substantial ([121]), is still largely insufficient to meet the needs of the restricted target group and therefore it is not possible to consider this measure as a universal minimum income scheme. It is estimated that an amount of EUR 2.4 billion would be necessary if all people in the target group were to be catered for. A measure to bring all persons out of absolute material deprivation would cost around EUR 7 billion, according to available estimations. ([122])

The anti-poverty measure will be accompanied by a reinforcement of activation measures. The allocation of benefits is dependent on signing up for an 'active inclusion' contract. Implementing this system will require a substantial upgrading of social services, which will be carried out with the support of the European Social Fund. The adoption of a national plan against poverty, announced for 2016, will in principle offer a basis for outlining the different components of the measure and constitute a key step in actually implementing the integrated framework for social policies established by law in 2000.

([121]) The measure will be funded with about EUR 800 million in 2016 (partly earmarked in the 2016 Stability Law, partly coming from savings on other measures). Slightly lower amounts are foreseen for 2017 and 2018.

([122]) In recent years, several studies and political proposals provided estimations of the costs of minimum income scheme. A recent analysis for Italy estimates the funding required by a minimum income scheme by applying EUROMOD and considering two alternatives. Depending on the scenario, the gross budgetary impact ranges between 0.4 % and 0.5 % of GDP, but the net budgetary impact would be lower since this does not account for the different minimum benefits provided at regional or local level. These estimates are broadly in line with administrative estimates from the Ministry of Labour and Social Policies (Ministry of Labour and Social Policies (2013), *Verso la costruzione di un istituto nazionale di contrasto alla povertà*). See also: Madama et al. (2014), *Minimum income: the Italian trajectory – One, no one and one hundred thousand minimum income schemes*; Ravagli, L. (2014), *A minimum income in Italy*, preliminary draft paper presented at SIEP XXVI Conference (25-26 September 2014), Pavia 25 and 26 September 2014; Alleanza contro la Povertà (2014), *Reddito d'Inclusione Sociale*, from http://www.redditoinclusione.it/cose-il-reis/ (estimate of EUR 7.1 billion); Tridico R. (2015), *Reddito di cittadinanza e opportunità economica: Un confronto tra italia e resto d'Europa*, Working Paper no. 18/2015, Universita' Roma Tre (estimate of about EUR 10 billion).

3.6. NETWORK INDUSTRIES, ENERGY, CLIMATE & ENVIRONMENT

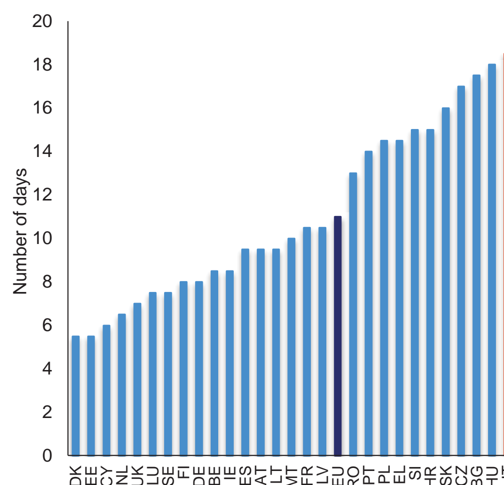
Transport

Italy's infrastructure endowment is close to the EU average. According to available international comparisons, Italy has one of the highest index among the major European economies ([123]). However, Italy transport infrastructures investments fell rapidly from the peak of 1.6 % of the GDP in 2006 to 0.5 % in 2013.

The quality of Italian transport infrastructures is still low despite some improvement. According to the World Economic Forum Global Competitiveness report, Italy performs below the EU average in all the main infrastructures quality indicators, ranking 16th for railroad quality, 20th for ports and roads, 21st for air transport infrastructure quality. The poor performance has negative effects on Italy's economic activities. It takes more than 18 days to import or export in Italy, against an EU average of 11 days and the 8, 9.5 and 10.5 days needed respectively in Germany, Spain and France (Graph 3.6.1). People in Italy spend more than 38 hours per year in traffic congestions, the fourth worst result in the EU and well above the EU average of 30.96 hours (Graph 3.6.2). As a result, population and economic operators satisfaction with national infrastructures is extremely low. According to the forthcoming Consumer Markets Scoreboard, Italy is the fourth worst Member State when it comes to consumers' evaluation of the performance of trains services (Italy: 68.5 against 76.2 for the EU), despite a big improvement since 2013. The country performs even worse when it comes to consumers' assessment of urban transport which was ranked worst in the EU in 2015. Airlines services - despite an improvement since 2013 - were ranked seventh worst in the EU.

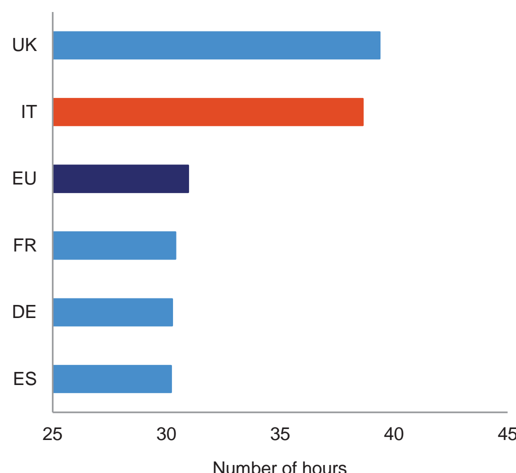
([123]) Santangelo, E., 'Gli investimenti in infrastrutture di trasporto, ritorni e ritardi', Deloitte-Luiss, 2015. The endowment index is the result of the combination of a number of sub-indicators like the number of km of railroads, highways, number of ports, etc.

Graph 3.6.1: **Number of days to import/export through port infrastructures**



Source: Deloitte – Luiss Report, World Bank – Doing Business Indicators 2016

Graph 3.6.2: **Hours spent in traffic congestion annually**



Source: European Commission (Joint Research Centre), Tom Tom

A weak competition framework and underinvestment affect railroads and ports. In railways, most of the public service contracts between the incumbent operator (Trenitalia) and the regions expired at the end of 2014. However, the lack of a structured framework for competitive tenders still prevents a real improvement in competition in the sector. Public investments in railway infrastructures more than halved between 2009 and 2012, from over EUR 8 billion to less

than EUR 4 billion. As a result, the infrastructure gap between the northern and southern regions persists. Electrified railways represent 56 % of total railways in southern regions while 75 % in the northern ones. Double tracks are also underdeveloped, being only 28 % of the total network in the less developed regions as against 48 % in more developed ones. The gap persists also for European railway traffic management system (ERTMS). [124] For ports, the lack of intermodal connections with the hinterland remains one of the major causes of inefficiency. The situation is particularly difficult in the southern regions where only 8 % of ship berths are connected to the inland railway network against 48 % in the north. The Italian competition authority highlighted the following weaknesses in the competition framework: i) port authorities regulate, monitor and plan ports activities while also operating the same activities, and are thus easily subject to conflicts of interest; ii) the duration of concession is excessive. It should be proportionate to the nature of the concession's activities; iii) competition in technical-nautical services is insufficient. In July 2015, the government adopted the long-awaited National Strategic Plan for Ports and Logistics. However, in December 2015, the Constitutional Court accepted Campania region's plea of unconstitutionality for the methodology followed to draw up the national plan. [125] The actual implementation of the plan is therefore extremely uncertain. In addition, Italy could substantially cut the red tape in ports with the deployment of the maritime logistic window (due by 2015), notably if merged with the custom single window, as successfully done in other Member States. Under the public administration reform, a legislative decree concerning port authorities was issued in January 2016: the number of ports' authorities is reduced from 24 to 15, a single customs office, a single administrative office and a single control office were introduced.

The draft National Airport Plan has been elaborated. It takes into account the airports of national interest as defined by the Ministry of Infrastructure and Transport, as defined by Decree 201 of 17 September 2015, following a consultation of the "State-Regions Conference" body. Its final version is expected to be adopted after a Strategic Environmental Assessment procedure has been finished. [126] A key element of the plan is to improve the airports' multimodal access with the long-awaited high speed links to the three major Italian airports (Milan Malpensa, Rome Fiumicino, Venice) and improvements in all the main airports (e.g. metro connection to Milan Linate).

Weaknesses are particularly evident in local public transportation. The situation is critical in local and regional transport services**,** mainly operated by in-house/publicly-owned companies. These often result not efficient and with low quality standards (see Section 3.3 and the 2015 country report). A reform of the sector has been announced for 2016 in the 2015 national reform programme.

The Italian transportation authority has further consolidated its activities. The Authority was established in 2011 and became operational in January 2014. During 2015 it has started to pursue fully is mandate by releasing important regulatory measures, including on rail access charges, while staff recruitment is ongoing.

Communication

Coverage of next generation broadband networks improved noticeably but Italy remains among the worst performers. In 2015, the number of households covered increased from 36 % to 44 % of total. However, all EU countries experienced the same trend, so that Italy's ranking did not change (27th). Similarly, the share of subscriptions above 30 mbps of total broadband subscriptions increased (from 3.81 % in 2014 to 5.4 % in 2015) marginally improving the Italian ranking, from 26th to 25th in the EU.

The ambitious Digital Agenda target for the next generation network coverage is not guaranteed but efforts are ongoing. The next generation networks (NGN) coverage is supposed

[124] Indicatori territoriali per le politiche di sviluppo (Istat).
[125] The Campania region claimed that, according to the constitution, regional authorities should have been consulted in elaborating any national plan regarding ports and related infrastructures.
[126] http://www.va.minambiente.it/it-IT/Oggetti/Info/1584

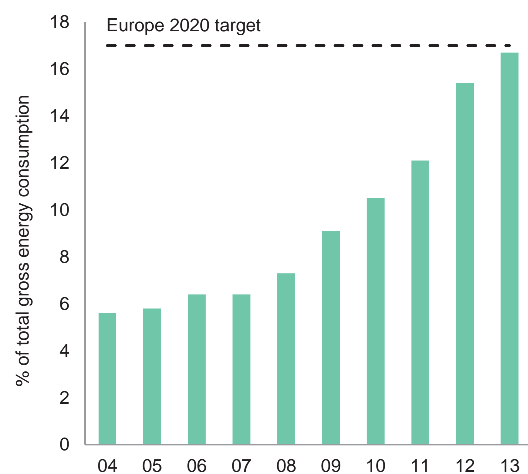
to reach 60 % of the population in 2018. ([127]) Private investment will focus mostly in densely populated areas, while EU structural funds will play a major role for southern regions. Nonetheless Italy's goal is still lower than the 2015 average next generation networks coverage in the EU (71 % of households). To improve the performance and raise the target, the government allocated additional resources for EUR 2.2 billion to the national next generation networks plan. The additional effort will not necessarily guarantee reaching the ambitious Digital Agenda targets: 100 % broadband coverage at 30 Mbps or more by 2020.

E-commerce shows a largely untapped potential. The country has among the lowest EU percentage of small and medium enterprises selling online (7 % in Italy compared to 16 % on average in the EU) and among the lowest percentage of consumers buying online (26 % in Italy compared to 53 % in the EU). ([128]) In addition, some communication sub-sectors, like internet provision or fixed telephone services, are assessed by consumers as among the worst-performing in the EU ([129]). A series of bottom-up projects, created by different stakeholders, are being promoted to increase the digital skills of citizens, civil servants, workers, jobseekers and entrepreneurs. However, this kind of project is likely to be created in digitally well-developed clusters, thus exacerbating geographical inequality and digital exclusion.

Energy

Competition in the power generation and gas supply markets continues to improve and it is already stronger than EU average. Italy has fully unbundled both the electricity and gas transmission system operators. Furthermore, despite rather low market liquidity, the level of competition on gas markets was improved by the introduction of congestion management rules. Competition in the electricity market has been strengthened by the development of the electricity network. In terms of installed capacity, the market incumbent has 31 % of the market share. This is one of the lowest incumbent market shares in the EU ([130]). In order to maintain sufficient system adequacy in the electricity sector, Italy is planning to introduce a capacity mechanism. The decision is currently under examination by the Commission to ensure that it complies with the EU state aid rules.

Graph 3.6.3: **Share of renewable energy in gross energy consumption**



Source: European Commission (Eurostat)

Despite the high number of retailers, domestic retail prices are higher than the EU average and the associated quality lower. Italy has among the highest number of retailers in the EU in both electricity and natural gas markets. The cumulative market shares of the main retailers (with at least 5 % of the market) are among the lowest in the Union. However, the 2015 market monitoring survey highlights that consumers' evaluation of the gas services market is the third worst in the EU and of the electricity market is the seventh worst in the union. Average retail electricity prices are higher than in the EU, with electricity network, policy measures ([131]) and taxes accounting, respectively, for 17 %, 23 % and 13 % of the final

([127]) Forecasts made by the Ministry of Economic Development after the latest new-generation-network (NGN) implementation monitoring: http://www.infratelitalia.it/wp-content/uploads/2015/10/Esito-Consultazione-BUL-21102015.pdf

([128]) Community Survey on ICT usage in households and by individuals (Eurostat).

([129]) . Consumer Markets Scoreboard 2016

([130]) Market share of the largest generator in the electricity market in 2013 (Eurostat).

([131]) Including support to renewables and energy efficiency policies, nuclear decommissioning, support to energy-intensive industries and other minor policy measures.

price paid by consumers. Italy has recently adopted some measures to reduce the burden of renewable energy support schemes on consumers and industry and the planned phasing out of the standard offer market (*mercato di maggior tutela*) will further encourage competition among retailers. As regards smart meters for gas, the current target is at 60 % by 2018 for smaller gas customers. In March 2015, the government confirmed the existing financial commitment for the development of smart grids and renewables technologies.

Italy's has reached the 2020 target for renewable energy and energy efficiency. Feed-in tariffs and tradable renewable energy certificates (green certificates) have led to significant results. In 2014 overall investment costs were equal to EUR 13.4 billion, with the photovoltaic sector accounting for more than 45 % of the total. The share of renewable energy in Italy was approximately 17.1 % in 2013 ([132]), already above the 2020 target of 17 % (Graph 3.6.3). A stable regulatory framework would contribute to consolidating these results although lengthy and costly administrative barriers, particularly for small scale projects, remain. With regard to energy efficiency, primary energy intensity is about 17% below the EU average. The tradable white certificate system (*certificati bianchi* or *titoli di efficienza energetica*) was one of the first market mechanisms for energy efficiency in Europe. The Energy Efficiency Tax Rebate Programme (55 % tax reduction up to 2013, increased to 65 % in 2014) has proved to be an effective scheme for scaling up energy efficiency investments: between 2007 and 2014, almost 1.9 million applications were received, and about EUR 22 billion of investments were leveraged by households, at a cost of about EUR 12 billion in tax revenues. The tax rebate has been confirmed in the budget law for 2016.

Italy is on track to achieve the 2020 target for greenhouse gases emissions. Under the Europe 2020 strategy, Italy has to reduce its greenhouse gas (GHG) emissions not covered by the EU Emission Trading System (ETS) by 13 % in 2020 compared to 2005. According to the most recent national projections dated 2015 based on existing measures, Italy is on track to achieve the 2020 target, with non-ETS emissions decreasing by 18 % between 2005 and 2020. According to the latest approximated estimate for 2014, emissions have already decreased by 22 % compared to 2005. The recently adopted *Collegato Ambientale* includes a national plan on sustainable consumption and production. ([133])

Italy has one of the highest levels of environmental taxation in the EU. The environmental taxation-to-GDP ratio increased from 2010, reaching a 3.42 % value in 2013. The energy taxation-to-GDP ratio is also among the highest in the EU, with a value of 2.78 % in 2013. However the tax rates do not completely count for environmental and climate change externalities. ([134]) The committee on environmental taxation mentioned in the 2015 national reform programme has yet to become operational.

Waste and water management remains inefficient. Environmental problems such as inadequate waste management and lacking or poorly performing water infrastructures are a persistent concern, particularly in southern Italy. In the central and northern regions poor land management, flooding and air pollution are the main challenges with a significant impact on the national budget. ([135]) Flooding cost the economy EUR 11 billion between 2002 and 2013. In 2012, the European Environment Agency estimated almost 85 000 premature deaths due to particulate matter concentrations, nitrogen dioxide and ozone concentration.

([132]) http://ec.europa.eu/eurostat/web/energy/data/shares

([133]) http://www.minambiente.it/comunicati/presentazione-del-programma-nazionale-di-prevenzione-dei-rifiut

([134]) OECD, Environmental performance Review, 2013

([135]) For floods: Risk and Policy Analysts, Study on Economic and Social Benefits of Environmental Protection and Resource Efficiency related to the European Semester, 2014. For air pollution: European Commission, Impact Assessment of the Commission Integrated Clean Air Package, 2013. For land management: Italian Partnership Agreement 29.10.14, section 'Analysis of Disparities', section 1A, pp. 55-63.

ANNEX A

Overview Table

Commitments	Summary assessment ([136])
2015 country-specific recommendations (CSRs)	
CSR 1: Achieve a fiscal adjustment of at least 0.25 % of GDP towards the medium-term budgetary objective in 2015 and of 0.1 % of GDP in 2016 by taking the necessary structural measures in both 2015 and 2016, taking into account the allowed deviation for the implementation of major structural reforms. Ensure that the spending review is an integral part of the budgetary process. Swiftly and thoroughly implement the privatisation programme and use windfall gains to make further progress towards putting the general government debt ratio on an appropriate downward path. Implement the enabling law for tax reform by September 2015, in particular the revision of tax expenditures and cadastral values and the measures to enhance tax compliance.	Italy has made **limited progress** in addressing CSR 1 (this overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact): • **Limited progress** has been made regarding the spending review. Some positive spending review actions have been recently implemented in Italy, yet saving targets tend to be systematically lowered or underachieved. An encompassing intervention on tax expenditures and local public enterprises, as well as the implementation of the extension of centralised public procurement to the regional level are still pending. The deadline for the central government to reform the budgetary process towards a more performance-informed budgeting approach has been postponed. • **Some progress** has been made regarding privatisations. Privatisation proceeds accounted for around 0.4 % of GDP in 2015, thanks to the operation related to ENEL and the successful initial public offering of the postal operator *Poste Italiane*. For 2016, projected privatisation proceeds earmarked to debt reduction amount to 0.5 % of GDP but details are not yet available and significant downside risks remain (given also the recent postponement of the privatisation of *Ferrovie dello Stato* beyond 2016). • **Limited progress** has been made regarding the taxation reform. The enabling law for the reform of the tax system has been implemented by the foreseen deadline, featuring eight legislative decrees. Nevertheless, crucial aspects such as the reform of the outdated cadastral values and the systematic revision of tax expenditures were left out of its scope. Moreover, some of the implementing provisions, such as the higher threshold for cash

([136]) The following categories are used to assess progress in implementing the 2015 country-specific recommendations (CSRs): 'No progress': the Member State has neither announced nor adopted measures to address the CSR – this category also applies if the Member State has commissioned a study group to evaluate possible measures; 'Limited progress': the Member State has announced some measures to address the CSR, but these appear insufficient and/or their adoption/implementation is at risk; 'Some progress': the Member State has announced or adopted measures to address the CSR - these are promising, but not all of them have been implemented and it is not certain that all will be; 'Substantial progress': the Member State has adopted measures, most of which have been implemented – they go a long way towards addressing the CSR; 'Fully implemented': the Member State has adopted and implemented measures that address the CSR appropriately.

	payments and the revised sanctions system for tax-related offences raise doubts concerning their impact on tax evasion and avoidance. Last, but not least, simultaneously adopted tax reforms, such as the recent abolition of the property tax on first residences, appear at odds with the objective to broaden the tax base and shift the tax burden away from productive factors and onto property and consumption.
CSR 2: Adopt the planned national strategic plan for ports and logistics, particularly to help promote intermodal transport through better connections. Ensure that the Agency for Territorial Cohesion is made fully operational so that the management of EU funds markedly improves.	Italy has made **some progress** in addressing CSR 2: • **Limited progress** has been made regarding ports. The national strategic plan for port and logistics has been adopted, but the Constitutional Court accepted the Campania region's plea for unconstitutionality as regions were not directly involved. After this problem has been overcome, the plan needs to be operationalised. • **Some progress** has been made regarding the management of EU funds. The Agency for Territorial Cohesion is now operational. Furthermore, The department for cohesion policy has been reformed and is now part of the Prime Minister's office, but uncertainties remain in terms of staffing.
CSR 3: Adopt and implement the pending laws aimed at improving the institutional framework and modernising the public administration. Revise the statute of limitations by mid-2015. Ensure that the reforms adopted to improve the efficiency of civil justice help reduce the length of proceedings.	Italy has made **some progress** in addressing CSR 3: • **Some progress** has been made regarding the reform of the institutional framework and public administration. The enabling law to reform the public administration has been adopted in August 2015. In January 2016, a first set of implementing decrees (*inter alia* dealing with state-owned enterprises, local public services, the simplification of the *Conferenza dei Servizi*, and the simplification and speeding up of administrative procedures) has been proposed by the government. The parliamentary discussion on the constitutional reform – allowing more stable parliamentary majorities, changing the role of the Senate and clarifying the division of competences between the various government levels – is still ongoing but progressing according to schedule: the final vote by the Chamber of Deputies is expected in April 2016. A new electoral law has been

	adopted in May 2015 and will enter into force as of July 2016. • **Limited progress** has been made regarding the fight against corruption. Maximum penalties for corruption were raised, which in turn extended prescription terms, but the underlying structural problems relating to the statute of limitations remain. A draft law containing provisions to this end is still under parliamentary discussion. • **Some progress** has been made regarding the improvement of civil justice efficiency. The 2014 laws to reform the civil justice system are being implemented with some positive results. The digitalisation of civil trials has been mandatory at first instance since December 2014 and the possibility of electronic filing of the first exchange of statements between the parties in all first and second instance courts was introduced. The digitalisation of tax-related trials is still ongoing. The Ministry of Justice is continuing to pursue the so-called 'Barbuto Plan' and is implementing a multi-year project to reduce the backlog. Two enabling laws (on reforming the honorary magistracy and judges of peace, and streamlining civil procedural rules and reinforcing the specialisation of courts) are still under parliamentary discussion. Although these reforms can improve the functioning of the justice system, the latest evidence does not yet show positive results, in particular concerning the length of court proceedings.
CSR 4: By end-2015, introduce binding measures to tackle remaining weaknesses in the corporate governance of banks, implement the agreed reform of foundations, and take measures to accelerate the broad-based reduction of non-performing loans.	Italy has made **substantial progress** in addressing CSR 4: • **Substantial progress** has been made regarding the improvement of banks' corporate governance. Two important governance reforms relating to large cooperative banks and bank foundations are under implementation, and a third one on small mutual banks has just been presented by the government. • **Some progress** has been made regarding the improvement of asset quality in the banking sector. Italy has passed a law intervening on the tax treatment of loan loss provisions and on the insolvency and foreclosure framework, which should contribute to the development of a private non-performing loan market. The

	authorities have also announced a state-aid-free guarantee scheme for NPL securitisations to achieve to significantly reduce the stock of impaired loans on banks' balance sheets. Although the growth of the NPL stock in the banking system has started to stabilise, it remains at a record high.
CSR 5: Adopt the legislative decrees on the design and use of wage supplementation schemes, the revision of contractual arrangements, work-life balance and the strengthening of active labour market policies. Promote, in consultation with the social partners and in accordance with national practices, an effective framework for second-level contractual bargaining. As part of efforts to tackle youth unemployment, adopt and implement the planned school reform and expand vocationally-oriented tertiary education.	Italy has made **substantial progress** in addressing CSR 5: • **Full implementation** has been achieved regarding the revision of wage supplementation schemes and contractual arrangements. The relevant legislative decrees following the Jobs Act have been adopted in June and September 2015. • **Substantial progress** has been made regarding work-life balance and active labour market policies. The relevant legislative decrees following the Jobs Act have been adopted in June and September 2015. However, considerable administrative, political and resource challenges have to be overcome for the implementation of the measures related to active labour market policies which starts in the beginning of 2016. • **Limited progress** has been made regarding the decentralisation of wage bargaining. In January 2016, the three main trade unions agreed on a proposal for a new bargaining framework. However, an agreement with the employers' associations still needs to be found. The 2016 Stability Law introduced tax incentives on productivity-related premiums agreed at decentralised level with the intention of fostering decentralised bargaining. • **Substantial progress** has been made regarding the reform of education. The school reform adopted in July 2015, and implementing decrees are to be adopted by January 2017.
CSR 6: Implement the simplification agenda for 2015-2017 to ease the administrative and regulatory burden. Adopt competition-enhancing measures in all the sectors covered by the competition law, and take decisive action to remove remaining barriers. Ensure that local public services contracts not complying with the	Italy has made **limited progress** in addressing CSR 6: • **Some progress** has been made regarding business environment simplification. The measures under the 2015-2017 simplification agenda are being implemented according to the

requirements on in-house awards are rectified by no later than end-2015.	timeline set. Progress reports are available on a dedicated website. • **Limited progress** has been made regarding the fostering of competition in services. The 2015 annual competition law presented by the government in early 2015 has been voted in first reading by the Chamber of Deputies, but it is currently still under discussion in the Senate. Moreover, some provisions have been watered down during the parliamentary process. • **No progress** has been made regarding the rectification of local public service contracts. At the end of 2015, no information was available on the number and extent of non-compliant contracts and their rectification. However, important provisions to reform the sector have been included in the 2015 enabling law to reform the public administration.

Europe 2020 (national targets and progress)	
Employment rate target: 67 %-69 %	The employment rate has shown some signs of recovery, increasing to 56.7 % in the third quarter of 2015 (compared to 55.7 % in 2014), but it is still far from the target.
Research and development (R&D) target: 1.53 % of GDP	Italy's R&D investment stood at 1.29 % of GDP in 2014. Therefore, there is only limited progress towards the target. In recent years, Italy has been cutting its public budget for R&D and innovation at a higher rate than the overall public budget. This trend keeps Italy's public sector R&D intensity at a significantly lower level than the EU average (0.53 % of GDP compared to an EU average of 0.72 % of GDP in 2014), while business R&D intensity has slightly increased, reaching 0.72 % of GDP in 2014 (compared to an EU average of 1.3 % of GDP).
Greenhouse gas emissions target: -13 % in non-ETS sectors (compared with emissions in 2005)	According to the latest national projections submitted to the European Commission in 2015 and taking into account existing measures, emissions are projected to decrease by 18 % by 2020 with respect to 2005. Therefore, Italy is on track to reach its 2020 greenhouse gas emission reduction target, with a 5 % margin. According to approximated data for 2014,

	emissions decreased by 22 % between 2005 and 2014.
Renewable energy target: 17 %	With a renewable energy share of 17.1 % in 2014, Italy has already achieved its target for 2020. Uncertainty on future renewable support schemes could nonetheless imply some challenges for the development of the sector. With a 4.5 % share of renewable energy sources in transport in 2014, Italy is less than half-way towards achieving the binding 10 % target in transport by 2020.
Energy efficiency target: 158 Mtoe (absolute level of primary energy consumption)	Even if Italy's current primary energy consumption is below its 2020 target, additional efforts are still needed to confirm the decoupling from the expected GDP increase during the next five years, as the observed decrease in primary and final energy consumption could be partially attributed to recent low economic growth.
Early school leaving target: 16 %	Italy has met this target. The early school leaving rate (the percentage of the population aged 18-24 with at most lower secondary education and not in further education or training) fell from 17.3 % in 2012 to 16.8 % in 2013 and 15 % in 2014.
Tertiary education target: 26 %-27 %	Italy has made some progress towards achieving this target. The tertiary educational attainment rate rose from 21.9 % in 2012 to 22.5 % in 2013 and 23.9 % in 2014.
Risk of poverty or social exclusion target: -2.2 million people at risk of poverty or social exclusion (compared to the number of people in 2008, thus corresponding to a target of 12.9 million people at risk of poverty or social exclusion in 2020)	Not only there is no progress towards achieving this target, but the situation has also further deteriorated. The share of person at risk of poverty of social exclusion was 28.3 % in 2014 (slightly down from 28.5 % in 2013, but still much higher than in 2008 when it was 25.5 %).

ANNEX B

MIP scoreboard

Table B.1: **MIP scoreboard - Italy**

Italy			Thresholds	2009	2010	2011	2012	2013	2014
External imbalances and competitiveness	Current account balance (% of GDP)	3-year average	-4% / 6%	-2.1	-2.8	-2.8	-2.3	-0.9	0.8
	Net international investment position (% of GDP)		-35%	-24.9	-23.4	-21.9	-26.6	-28.8	-27.9
	Real effective exchange rate - 42 trading partners, HICP deflator	3-years % change	±5% & ±11%	3.6	-1.9	-3.3	-6.2	0.0	0.2
	Export market share - % of world exports	5-years % change	-6%	-17.9	-19.1	-19.0	-25.3	-19.4	-14.0
	Nominal unit labour cost index (2010=100)	3-years % change	9% & 12%	11.1	8.9	5.2	2.1	3.0	3.6
Internal imbalances	Deflated house prices (% y-o-y change)		6%	-0.1	-2.2b	-2.1p	-5.4p	-6.9p	-4.6p
	Private sector credit flow as % of GDP, consolidated		14%	0.8	5.0	3.1	-0.8	-2.7	-0.9
	Private sector debt as % of GDP, consolidated		133%	120.7	121.5	121.0	123.4	120.8	119.3
	General government gross debt as % of GDP		60%	112.5	115.3	116.4	123.2	128.8	132.3
	Unemployment rate	3-year average	10%	6.8	7.6	8.2	9.2	10.4	11.8
	Total financial sector liabilities (% y-o-y change)		16.5%	5.5	3.4	3.2	7.5	-0.8	-0.7
New employment indicators	Activity rate - % of total population aged 15-64 (3-years change in p.p.)		-0.2%	-0.3	-0.4	-0.8	1.2	1.4	1.8
	Long-term unemployment rate - % of active population aged 15-74 (3-years change in percentage points)		0.5%	0.1	1.2	1.2	2.2	2.8	3.5
	Youth unemployment rate - % of active population aged 15-24 (3-years change in percentage points)		2%	3.5	7.5	8.0	10.0	12.1	13.5

The flags "p" and "b" respectively indicate provisional data and a break in the time series. Figures highlighted are those falling outside the threshold established by the European Commission's Alert Mechanism Report. For the real effective exchange rate (REER) and unit labour cost (ULC), the first threshold applies to euro area Member States.
Source: European Commission

ANNEX C
Standard Tables

Table C.1: **Financial market indicators**

	2010	2011	2012	2013	2014	2015
Total assets of the banking sector (% of GDP)	236.6	247.9	261.4	251.9	249.2	239.7
Share of assets of the five largest banks (% of total assets)	39.8	39.5	39.7	39.6	40.7	-
Foreign ownership of banking system (% of total assets)	13.2	13.4	13.4	12.4	12.7	-
Financial soundness indicators:						
- non-performing loans (% of total loans) (1)	10.0	11.7	13.7	16.5	18.0	18.0
- capital adequacy ratio (%) (1)	12.1	12.7	13.4	13.7	14.3	14.5
- return on equity (%) (1)	3.7	-13.0	-0.9	-11.5	-2.8	2.5
Bank loans to the private sector (year-on-year % change)	4.0	0.9	1.7	-3.5	-0.8	-0.6
Lending for house purchases (year-on-year % change)	7.5	4.4	-0.5	-1.1	-0.9	0.4
Loan to deposit ratio	118.3	125.1	117.3	111.0	108.2	102.8
Central Bank liquidity as % of liabilities (1)	1.9	6.8	8.4	7.7	6.2	5.1
Private debt (% of GDP)	121.5	121.0	123.4	120.8	119.3	-
Gross external debt (% of GDP) (2) - public	45.5	38.1	41.0	43.1	50.5	52.7
- private	29.6	27.1	30.6	31.2	31.2	32.1
Long-term interest rate spread versus Bund (basis points) (*)	129.3	281.6	399.8	274.7	172.9	121.8
Credit default swap spreads for sovereign securities (5-year) (*)	135.9	242.6	323.2	199.7	101.6	92.2

(1) Latest data of Q2 2015. (2) Latest data of September 2015. Monetary authorities and monetary and financial institutions are not included. (*) Measured in basis points.
Source: International Monetary Fund (IMF) (financial soundness indicators), European Commission (Eurostat) (long-term interest rates & private debt), World Bank (gross external debt), European Central Bank (all other indicators)

Table C.2: **Labour market and social indicators**

	2010	2011	2012	2013	2014	2015 (4)
Employment rate (% of population aged 20-64)	61.0	61.0	60.9	59.7	59.9	60.4
Employment growth (% change from previous year)	-0.6	0.3	-0.3	-1.8	0.1	0.7
Employment rate of women (% of female population aged 20-64)	49.5	49.9	50.5	49.9	50.3	50.5
Employment rate of men (% of male population aged 20-64)	72.7	72.5	71.5	69.7	69.7	70.5
Employment rate of older workers (% of population aged 55-64)	36.5	37.8	40.3	42.7	46.2	48.2
Part-time employment (% of total employment, aged 15 years and over)	15.0	15.4	17.0	17.9	18.4	18.5
Fixed term employment (% of employees with a fixed term contract, aged 15 years and over)	12.7	13.3	13.8	13.2	13.6	14.0
Transitions from temporary to permanent employment	25.0	21.7	17.5	21.2	18.6	-
Unemployment rate(1) (% active population, age group 15-74)	8.4	8.4	10.7	12.1	12.7	12.1
Long-term unemployment rate (2) (% of labour force)	4.1	4.3	5.7	6.9	7.8	7.0
Youth unemployment rate (% active population aged 15-24)	27.9	29.2	35.3	40.0	42.7	40.9
Youth NEET (3) rate (% of population aged 15-24)	19.0	19.7	21.0	22.2	22.1	-
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	18.6	17.8	17.3	16.8	15.0	-
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	19.9	20.4	21.9	22.5	23.9	-
Formal childcare (30 hours or over; % of population aged less than 3 years)	16.0	16.0	11.0	13.0	-	-

(1) Unemployed persons are all those who were not employed but had actively sought work and were ready to begin working immediately or within two weeks. (2) Long-term unemployed are peoples who have been unemployed for at least 12 months. (3) Not in education, employment or training. (4) Average of first three quarters of 2015. Data for total unemployment and youth unemployment rates are seasonally adjusted.
Source: European Commission (EU Labour Force Survey)

Table C.3: **Labour market and social indicators (continued)**

Expenditure on social protection benefits (% of GDP)	2009	2010	2011	2012	2013	2014
Sickness/healthcare	7.0	7.0	6.8	6.8	6.8	-
Invalidity	1.6	1.6	1.5	1.5	1.6	-
Old age and survivors	15.9	16.2	16.2	16.7	17.2	-
Family/children	1.3	1.1	1.2	1.2	1.2	-
Unemployment	1.5	1.5	1.5	1.6	1.7	-
Housing and social exclusion n.e.c.	0.0	0.0	0.0	0.0	0.0	-
Total	27.5	27.6	27.3	28.0	28.6	-
of which: means-tested benefits	1.8	1.6	1.6	1.6	1.6	-
Social inclusion indicators	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
People at risk of poverty or social exclusion [1] (% of total population)	24.9	25.0	28.1	29.9	28.5	28.3
Children at risk of poverty or social exclusion (% of people aged 0-17)	28.7	29.5	31.5	34.1	32.0	32.1
At-risk-of-poverty rate [2] (% of total population)	18.4	18.7	19.8	19.5	19.3	19.4
Severe material deprivation rate [3] (% of total population)	7.3	7.4	11.1	14.5	12.3	11.6
Proportion of people living in low work intensity households [4] (% of people aged 0-59)	9.2	10.6	10.5	10.6	11.3	12.1
In-work at-risk-of-poverty rate (% of persons employed)	10.2	9.5	11.0	11.0	11.0	11.0
Impact of social transfers (excluding pensions) on reducing poverty	21.0	21.1	19.5	20.4	21.5	21.5
Poverty thresholds, expressed in national currency at constant prices [5]	8 860	8 997	8 854	8 610	8 211	8 120
Gross disposable income (households) (% change)	-2.3	-0.1	2.6	-2.7	0.6	0.0
Inequality of income distribution (S80/S20 income quintile share ratio)	5.3	5.4	5.7	5.6	5.8	5.8

(1) People at risk of poverty or social exclusion (AROPE) are individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI). (2) At-risk-of-poverty rate (AROP) is the proportion of people with an equivalised disposable income below 60 % of the national equivalised median income. (3) Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone. (4) People living in households with very low work intensity refers to the proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20% of their total work-time potential in the previous 12 months. (5) For EE, CY, MT, SI and SK, thresholds in nominal values in EUR; harmonised index of consumer prices (HICP) in 2006 = 100 (2007 survey refers to 2006 incomes). (6) Expressed in millions of national currency (EUR).
Source: EU-SILC (social inclusion indicators), ESSPROS (indicators on expenditure for social protection benefits)

Table C.4: **Structural policy and business environment indicators**

Performance indicators	2009	2010	2011	2012	2013	2014
Labour productivity (real, per person employed, y-o-y)						
Labour productivity in industry	-5.89	8.62	1.13	1.62	0.60	-2.18
Labour productivity in construction	-6.59	-1.49	-3.34	2.75	4.86	1.76
Labour productivity in market services	-2.22	2.12	0.09	-1.54	0.89	-1.04
Unit labour costs (ULC) (whole economy, y-o-y)						
ULC in industry	10.21	-5.78	1.68	1.37	1.96	3.48
ULC in construction	9.13	2.34	4.93	-0.35	-3.28	-3.49
ULC in market services	5.86	-0.40	1.44	2.02	1.14	2.27
Business environment	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Time needed to enforce contracts [(1)] (days)	1210	1210	1210	1210	1185	1185
Time needed to start a business [(1)] (days)	10.0	10.0	6.0	6.0	7.0	7.0
Outcome of applications by SMEs for bank loans [(2)]	0.73	0.74	0.80	1.08	0.95	1.06
Research and innovation	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
R&D intensity (% of GDP)	1.22	1.22	1.21	1.27	1.30	1.29
Total public expenditure on education (% of GDP, for all levels of education combined)	4.70	4.50	4.29	-	-	-
Number of science & technology people employed (% of total employment	32	31	32	33	33	33
Population having completed tertiary education [(3)]	13	13	13	14	14	15
Young people with upper secondary level education [(4)]	76	77	77	78	78	80
Trade balance of high technology products (% of GDP)	-0.59	-1.15	-0.91	-0.61	-0.43	-0.38
Product and service markets and competition				**2003**	**2008**	**2013**
OECD product market regulation (PMR) [(5)], overall				1.80	1.49	1.26
OECD PMR [(5)], retail				3.85	4.06	3.15
OECD PMR [(5)], professional services				3.55	3.02	2.10
OECD PMR [(5)], network industries [(6)]				2.97	2.45	2.01

(1) The methodologies, including the assumptions, for this indicator are shown in detail here: http://www.doingbusiness.org/methodology. (2) Average of the answer to question Q7B_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received most of it, two if only received a limited part of it, three if refused or rejected, and treated as missing values if the application is still pending or respondent does not know. (3) Percentage population aged 15-64 having completed tertiary education. (4) Percentage population aged 20-24 having attained at least upper secondary education. (5) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm. (6) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).
Source: European Commission, World Bank Doing Business (indicators on enforcing contracts and time to start a business), OECD (product market regulation indicators), European Central Bank - Survey on the Access to Finance of Enterprises (SAFE) (indicator on outcome of SMEs' applications for bank loans)

Table C.5: **Green growth performance indicators**

Green growth performance		2009	2010	2011	2012	2013	2014
Macroeconomic							
Energy intensity	kgoe / €	0.12	0.12	0.12	0.12	0.12	-
Carbon intensity	kg / €	0.34	0.35	0.33	0.33	0.31	-
Resource intensity (reciprocal of resource productivity)	kg / €	0.50	0.46	0.45	0.39	0.38	0.38
Waste intensity	kg / €	-	0.11	-	0.11	-	-
Energy balance of trade	% of GDP	-2.6	-3.2	-3.6	-3.8	-3.3	-2.6
Weighting of energy in HICP	%	7.78	7.54	8.37	9.57	10.02	9.11
Difference between energy price change and inflation	%	-5.8	-3.3	5.0	9.2	0.0	-3.7
Real unit of energy cost	% of value added	12.5	14.0	14.4	-	-	-
Ratio of labour taxes to environmental taxes	ratio	7.7	7.7	7.0	6.2	6.3	6.0
Environmental taxes	% of GDP	2.8	2.8	3.0	3.5	3.4	3.6
Sectoral							
Industry energy intensity	kgoe / €	0.13	0.13	0.12	0.12	0.12	-
Real unit energy cost for manufacturing industry	% of value added	30.2	35.7	37.7	-	-	-
Share of energy-intensive industries in the economy	% of GDP	8.37	8.62	8.64	8.75	8.58	8.46
Electricity prices for medium-sized industrial users	€ / kWh	0.15	0.14	0.16	0.17	0.17	0.17
Gas prices for medium-sized industrial users	€ / kWh	0.03	0.03	0.03	0.04	0.04	0.04
Public R&D for energy	% of GDP	0.03	0.02	0.02	0.02	0.02	0.02
Public R&D for environment	% of GDP	0.02	0.02	0.02	0.02	0.01	0.01
Municipal waste recycling rate	%	44.5	47.6	53.1	56.8	59.6	-
Share of GHG emissions covered by ETS*	%	37.7	38.3	39.0	38.9	37.6	36.6
Transport energy intensity	kgoe / €	0.62	0.61	0.62	0.61	0.61	-
Transport carbon intensity	kg / €	1.78	1.75	1.76	1.64	1.62	-
Security of energy supply							
Energy import dependency	%	83.3	84.3	81.8	79.3	76.9	-
Aggregated supplier concentration index	HHI	15.8	15.1	13.4	13.9	16.2	-
Diversification of energy mix	HHI	0.34	0.33	0.31	0.30	0.29	-

All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2005 prices). Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR). Carbon intensity: greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR). Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR). Waste intensity: waste (in kg) divided by GDP (in EUR). Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP. Weighting of energy in HICP: the proportion of "energy" items in the consumption basket used for the construction of the HICP. Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change). Real unit energy cost: real energy costs as a percentage of total value added for the economy. Environmental taxes over labour taxes and GDP: from European Commission's database, "Taxation trends in the European Union". Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR). Real unit energy costs for manufacturing industry: real costs as a percentage of value added for manufacturing sectors. Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP. Electricity and gas prices for medium-sized industrial users: consumption band 500 – 2 000MWh and 10 000 – 100 000 GJ; figures excl. VAT. Municipal waste recycling rate: ratio of recycled municipal waste to total municipal waste. Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP. Proportion of greenhouse gas (GHG) emissions covered by EU Emission Trading System (ETS): based on greenhouse gas emissions (excl. land use, land use change and forestry) as reported by Member States to the European Environment Agency). Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR). Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector. Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels. Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk. Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels. (*) European Commission and European Environment Agency
Source: European Commission (Eurostat), unless indicated otherwise