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REPORT FROM THE COMMISSION

Italy

Report prepared in accordance with Article 126(3) of the Treaty on the Functioning of the European Union

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1. INTRODUCTION

Article 126 of the Treaty on the Functioning of the European Union (TFEU) lays down the excessive deficit procedure (EDP). That procedure is further set out in Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[1], which is part of the Stability and Growth Pact (SGP). Specific provisions for euro area Member States under EDP are laid down in Regulation (EU) No 473/2013[2].

According to Article 126(2) TFEU, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3%; and (b) whether the ratio of government debt to GDP exceeds the reference value of 60%, unless it is sufficiently diminishing and approaching the reference value at a satisfactory pace.

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

This report, which represents the first step in the EDP, analyses Italy's compliance with the debt criterion of the Treaty, with due regard to the economic background and other relevant factors. On 22 November 2017, the Commission addressed a letter[3] to the Italian authorities announcing its intention to reassess Italy's compliance with the debt criterion in spring 2018, based on outturn data for 2017 and the final 2018 budget adopted by the Italian Parliament.

The data notified by the authorities in April 2018[4] and subsequently validated by Eurostat[5] show that Italy's general government deficit declined to 2.3% of GDP in 2017 (down from

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[1] OJ L 209, 2.8.1997, p. 6. This report also takes into account the "*Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes*", endorsed by the ECOFIN Council of 5 July 2016, available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

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

[3] See https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact/annual-draft-budgetary-plans-dbps-euro-area-countries/draft-budgetary-plans-2018_en

[4] According to Council Regulation (EC) No 479/2009, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Italy can be found at: http://ec.europa.eu/eurostat/web/government-finance-statistics/excessive-deficit-procedure/edp-notification-tables

2.5% in 2016), while the debt stabilised at 131.8% of GDP (from 132.0% in 2016), i.e. above the 60% of GDP reference value. For 2018, Italy's 2018 Stability Programme[6] (SP), as adopted by the government on 26 April 2018, projects the debt-to-GDP ratio to decrease by 1 percentage point to 130.8%. In 2019, the SP projects a further decline (of 2.8 percentage points) in the debt-to-GDP ratio to 128.0%. Based on notified data and the Commission 2018 spring forecast, Italy did not comply with the debt reduction benchmark in either 2016 (gap of 5.9% of GDP) or 2017 (gap of 5.1% of GDP) (see Table 1).

Overall, Italy's lack of compliance with the debt reduction benchmark in 2016 and 2017 provides evidence of a *prima facie* existence of an excessive deficit within the meaning of the SGP before, however, considering all factors as set out below. Moreover, based on the Commission 2018 spring forecast, Italy's debt-to-GDP ratio is projected to be above the debt reduction benchmark in both 2018 and 2019 (gap of 5.1% of GDP each year).

The Commission has therefore prepared this report to comprehensively assess the departure from the debt reduction benchmark and examine whether the launch of an excessive deficit procedure is warranted after all relevant factors have been considered. Section 2 of the report examines the deficit criterion. Section 3 examines the debt criterion. Section 4 deals with public investment and other relevant factors, including the assessment of compliance with the required adjustment path towards the Medium Term Objective (MTO). The report takes into account the Commission 2018 spring forecast, released on 3 May 2018.

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

		2015	2016	2017	2018		2019	
					COM	SP	COM	SP
Deficit criterion	General government balance	-2.6	-2.5	-2.3	-1.7	-1.6	-1.7	-0.8
Debt criterion	General government gross debt	131.5	132.0	131.8	130.7	130.8	129.7	128.0
	Gap to the debt reduction benchmark	n.r	5.9	5.1	5.1	1.3	5.1	0.8
	Change in structural balance	0.2	-0.8	-0.3	0.0	0.1	-0.3	0.7
	Required MLSA	3.4	n.r	n.r	n.r.	n.r.	n.r.	n.r.

Notes:

[a] In percent of GDP unless otherwise specified. "N.r." indicates "not relevant"

Source: *Commission services, Italy's 2018 SP and Commission 2018 spring forecast*

2. DEFICIT CRITERION

Italy made a sizeable fiscal effort between 2010 and 2013, raising the primary surplus to over 2% of GDP and exiting the excessive deficit procedure in 2013 by keeping its headline deficit at a level not above 3% of GDP as of 2012 (down from more than 5% in 2009). However, the fiscal stance eased in recent years. In 2017, the primary surplus decreased to 1.5% and the

[5] Eurostat news release No 69/2018 of 23 April 2018, available at: http://ec.europa.eu/eurostat/documents/2995521/8824490/2-23042018-AP-EN.pdf/6e5b346e-e302-4132-920a-854b00ac196d

[6] https://ec.europa.eu/info/2018-european-semester-national-reform-programmes-and-stability-convergence-programmes_en

headline deficit stabilised at around 2.3% of GDP. Yet, both are set to improve in 2018 on the back of higher inflation. Italy's structural primary balance is estimated to have halved between 2013 and 2017 (from 4.2% to 2.1% of GDP) and is set to shrink further in 2018-2019. Taking advantage also of lower interest expenditure, a fiscal loosening was partly used to lower the tax burden and facilitate the adoption/implementation of structural reforms.[7]

Italy's general government deficit was reported at 2.3% of GDP in 2017. According to both the 2018 SP and the Commission 2018 spring forecast, it is projected to respect the Treaty reference value of 3% of GDP during the period 2018-2019. The Commission projects the deficit to further decline to 1.7% of GDP in 2018 and remain stable in 2019, under a no-policy-change assumption. The SP deficit projections are broadly in line with the Commission forecast in 2018 (1.6% of GDP) but markedly lower in 2019 (0.8% compared to 1.7%) on the back of higher real GDP growth (1.4% compared to 1.2%) and a still legislated VAT hike for 2019 worth around EUR 12.5 billion (or 0.7% of GDP), which the Commission does not to incorporate in its no-policy-change forecast given the repeated repeals over the past years. In 2020, the SP projects the deficit to further decrease to around zero.

Italy thus complies with the deficit criterion as defined in the Treaty and in Regulation (EC) No 1467/97.

3. DEBT CRITERION

After growing by some 5 percentage points per year on average during the double-dip recession of 2008-2013, Italy's government debt-to-GDP ratio continued to increase in 2014-2015 at a slower pace of 1 percentage point per year on average, before stabilising around 132% in 2016-2017. As of 2018, the debt ratio is set to decline mainly thanks to stronger nominal growth, falling below 130% of GDP by 2019. Favourable financing conditions are contributing to underpin the economic recovery and reduce the snowball effect. However, still low inflation, a limited increase in the primary surplus and below-target privatisation proceeds continue to limit the pace of debt reduction. While debt refinancing risks are limited in the short term, high public debt remains an important source of vulnerability for the Italian economy.

Following the abrogation of the EDP in June 2013, Italy was subject to a three-year transition period to comply with the debt reduction benchmark, which started in 2013 and ended in 2015. After the end of the transition period, the standard debt reduction benchmark became applicable in 2016. Based on notified data and the Commission forecast, the gap to the debt benchmark amounted to 5.9% of GDP in 2016 and to 5.1% in 2017. Moreover, based on both the SP for 2018 and the Commission forecast, Italy is not projected to comply with the debt reduction benchmark either in 2018 (gap to the debt benchmark of 1.3% and 5.1% of GDP, respectively) or in 2019 (gap to the debt benchmark of 0.8% and 5.1% of GDP, respectively).

More specifically, the debt-to-GDP ratio reached 131.8% in 2017, i.e. 0.2 percentage points lower than in 2016. The decrease was limited partly due to a still debt-increasing "snowball" effect, as the real implicit cost of debt,[8] while gradually shrinking (to 2.3%, from 2.7% in

[7] For instance, the *Jobs Act* labour market reform as well as innovative investment through tax incentives. For a review of those incentives, please refer to *Italy's 2018 Country Report*.

[8] The real implicit cost of debt at time *t* can be defined as the nominal yield paid by the government to service the outstanding debt at time *t-1*, net of the impact of inflation at time *t*. In Table 2, the yearly change in debt-

2013), remained above real GDP growth (1.5%). In fact, real spot interest rates on new government securities issuances, hovering around zero in 2015-2017, only gradually passed through into the real servicing cost of the outstanding debt stock, given the duration of the Italian debt and the roll-over period combined with low inflation (GDP deflator growth of 0.6%) – see also Box 1 and Graph 1. The positive interest rate-growth rate differential (0.8 percentage points, compared to 1.3 in 2015-2016) implied a still large debt-increasing impact from the "snowball" effect (1.1% of GDP, compared to 1.7% in 2015-2016 – see Table 2). On the other hand, a broadly stable primary surplus at 1.5% of GDP helped to curb debt dynamics in 2017. The stock-flow adjustment was slightly debt-increasing in 2017 (0.2%), mainly due to the impact of derivatives and of support to the banking sector,[9] partly offset by the reduction in the liquidity buffer, while there was no privatisation proceed.[10]

In 2018, the SP projects the debt-to-GDP ratio to decrease to 130.8%, down by 1 percentage point from the 2017 level. The projected favourable dynamics is mainly the result of a finally debt-decreasing "snowball" effect (-0.2% of GDP),[11] and a slight improvement in the primary surplus (to 1.9% of GDP) more than offsetting the debt-increasing stock-flow adjustment (1.1% of GDP). The Commission forecasts the debt ratio to decrease to 130.7% of GDP in 2018, broadly in line with the SP. The marginal difference is due to a slightly smaller stock-flow adjustment (0.9% of GDP compared to 1.1% in the SP) related to the smaller cash-accrual difference, while the net accumulation of financial assets is lower in the government projections also because they include 0.3% of GDP of privatisations proceeds that the Commission forecast does not incorporate, given the added uncertainty related to the formation of a new government and the recent track record of below-target privatisations.

For 2019, the SP projects a further significant decline in the debt-to-GDP ratio to 128.0%, mainly triggered by a large increase in the primary balance (to 2.7% of GDP) and a debt-decreasing "snowball effect" (-0.5% of GDP) explained by stronger nominal GDP growth compared to 2018, also due to the VAT hike and only partly offset by a debt-increasing stock-flow adjustment (0.6% of GDP). The Commission forecasts a more limited decline in the debt-to-GDP ratio in 2019, to 129.7%. The difference is also related to the lack of a VAT hike and lower real GDP growth, implying lower primary surplus (1.7% of GDP). Moreover, due to lower nominal GDP growth (2.5% compared to 3.2%), the "snowball" effect turns slightly debt-increasing again (0.3%) in the Commission forecast. Finally, the Commission incorporates only half of the 0.3% of GDP privatisation proceeds projected by the government for 2019. Risks to both the Commission and the SP debt projections are related to a worse-than-anticipated growth outlook, lower privatisation proceeds, and lower inflation.

As shown in Graph 1, the gradual decrease in real implicit debt-servicing cost (*dashed black line*) and the recovery in real GDP growth (*solid blue line*) implied already in 2017 a sizeable

to-GDP ratio due to the real implicit cost of debt can be obtained by adding the respective contributions from interest expenditure (debt-increasing) and GDP deflator (debt-decreasing).

[9] In fact, based on notified data, the bank rescue operations related to Banca Monte Paschi and the two Venetian Banks impacted the debt by close to 1% of GDP and the deficit by close to 0.4% of GDP.

[10] Other minor transactions affecting the stock-flow adjustment are not reported. See also the Italian Ministry of Economy and Finance's *Public Debt Report 2016*, at: www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/debito_pubblico/presentazioni_studi_relazioni/Rapporto_sul_Debito_Pubblico_2016.pdf

[11] In particular, the "snowball" effect is reduced thanks to much higher real GDP growth, despite slightly upward-trending real implicit cost of debt due to persistently low inflation in 2017.

shrinking of their differential (*yellow shade*), which is set to turn even slightly negative in 2018 for the first time since the onset of the global financial crisis. As a result, the debt-increasing "snowball" effect fell in 2017 to 1.1% of GDP, which compares with the pre-crisis average of 1.2% over 2000-2007. Hence, the "snowball" effect offers only a very partial explanation for Italy's lack of compliance with the debt reduction benchmark in 2017, and even less in the coming years.

Overall, this analysis thus suggests that *prima facie* the debt criterion for the purpose of the Treaty and Regulation (EC) No 1467/97 is not fulfilled, whether based on the 2018 SP or the Commission forecast, before consideration is given to all relevant factors as set out below.

Table 2: Debt dynamics [a]

	2015	2016	2017	2018		2019	
				COM	SP	COM	SP
Government gross debt ratio	131.5	132.0	131.8	130.7	130.8	129.7	128.0
Change in debt ratio [b] (1 = 2+3+4)	-0.3	0.5	-0.2	-1.1	-1.0	-1.0	-2.8
Contributions:							
• Primary balance (2)	-1.5	-1.5	-1.5	-1.9	-1.9	-1.7	-2.7
• "Snowball" effect (3)	1.7	1.7	1.1	-0.2	-0.2	0.3	-0.5
of which:							
Interest expenditure	*4.1*	*4.0*	*3.8*	*3.6*	*3.5*	*3.5*	*3.5*
Real GDP growth	*-1.2*	*-1.1*	*-2.0*	*-1.9*	*-1.9*	*-1.6*	*-1.8*
Inflation (GDP deflator)	*-1.2*	*-1.1*	*-0.8*	*-1.8*	*-1.8*	*-1.6*	*-2.2*
• Stock-flow adjustment (4)	-0.4	0.3	0.2	0.9	1.1	0.4	0.5
of which:							
Cash/accruals difference	*0.3*	*-0.7*	*-0.1*	*0.6*	*0.8*	*0.5*	*0.6*
Net accumulation of financial assets	*-0.7*	*0.9*	*0.4*	*0.3*	*0.2*	*-0.2*	*0.1*
of which privatisation proceeds	*-0.4*	*-0.1*	*0.0*	*0.0*	*-0.3*	*-0.2*	*-0.3*
Valuation effect & residual	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*

Notes:

[a] In percent of GDP unless otherwise specified

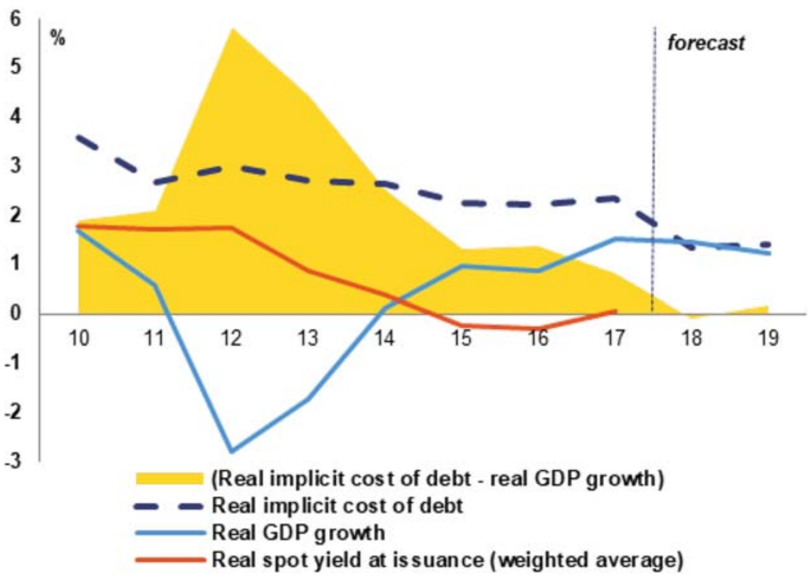
[b] The change in the gross debt ratio can be decomposed as follows:

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

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

Source: Commission services, Italy's 2018 SP and Commission 2018 spring forecast

Graph 1: Drivers of "snowball effect" on government debt



4. RELEVANT FACTORS

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

In case of apparent breach of the debt criterion, the analysis of the relevant factors is particularly warranted, given that debt dynamics are to a larger extent influenced by factors outside the control of the government than is the case for the deficit. This is recognised in Article 2(4) of Regulation (EC) No 1467/97, which provides that the relevant factors shall be taken into account when assessing compliance on the basis of the debt criterion irrespective of the size of the breach. In that respect, at least the following three main aspects need to be considered (and have been considered in the past)[12] when assessing compliance with the debt criterion given their impact on the debt dynamics and sustainability:

1. adherence to the MTO or the adjustment path towards it, which is supposed to ensure sustainability or rapid progress towards sustainability under normal macroeconomic circumstances. As by construction the country-specific MTO takes into account the debt level and implicit liabilities, compliance with the MTO or the adjustment path towards it should ensure convergence of the debt ratios towards prudent levels at least in the medium term;
2. structural reforms, already implemented or detailed in a structural reform plan, which are expected to enhance sustainability in the medium term through their impact on growth, thereby contributing to bring the debt-to-GDP ratio on a satisfactory downward path. Overall, adherence to the MTO (or the adjustment path towards it), alongside with the implementation of structural reforms (in the context of the European Semester), is expected under normal economic conditions to bring debt dynamics on a sustainable path through the combined impact on the debt level itself (through the achievement of a sound budgetary position at the MTO) and on economic growth (through the reforms);
3. unfavourable macroeconomic conditions and, in particular, low inflation, which can hamper the reduction of the debt-to-GDP ratio and make compliance with the SGP provisions particularly demanding. A low-inflation environment makes it more demanding for a Member State to comply with the debt reduction benchmark. Under such conditions, adherence to the MTO or the adjustment path towards it is a key relevant factor in assessing compliance with the debt criterion.

In view of those provisions, the following subsections consider: (1) the medium-term economic position, including the state of play in terms of implementation of structural reforms; (2) the medium-term budgetary position, including an assessment of compliance with the required adjustment towards the MTO and of public investment; (3) the developments in the medium-term government debt position, including its sustainability

[12] See the 126(3) Reports COM(2015) 113 final, 27.2.2015, and COM(2016) 305 final, 18.5.2016.

prospects; (4) other factors deemed relevant by the Commission; and (5) other factors put forward by the Member State.

4.1. Medium-term economic position

Macroeconomic conditions are improving and can no longer be argued to be a strong mitigating factor in explaining Italy's large gaps to compliance with the forward-looking debt reduction benchmark. On the other hand, low productivity growth still constrains Italy's potential growth and hampers a faster reduction of the debt ratio. Italy made some progress in addressing the 2017 CSRs, but the positive growth impact of these reforms will depend on their effective implementation in the medium-term, while in the short term it remains hard to disentangle it from the ongoing cyclical recovery.

Cyclical conditions, potential growth and inflation

Italy's real GDP growth reached 1.5% in 2017. Both the 2018 SP and the Commission forecast expected it at the same level in 2018, before softening in 2019. Potential growth is estimated to have finally turned positive in 2017, at 0.3%, (up from -0.2% in 2016) and to further pick up in 2018-2019, while remaining at a very low level. As a result, Italy's negative output gap is estimated by the Commission to have closed quickly, from -3.4% of potential GDP in 2015 to -0.1% in 2018, before turning positive in 2019 (at 0.5%).

Despite the progress achieved in important reform areas (e.g. labour market and public administration reforms, fight against tax evasion, banks' balance sheet repair), the legacy of the crisis and remaining structural weaknesses continue to weigh on Italy's potential growth.[13] Italy's GDP is still below the pre-crisis level and has not grown compared to 15 years ago, while annual growth has averaged 1.2% in the rest of the euro area. This is also explained by structural factors that hamper the efficient allocation of resources and constitute a drag on productivity. A still large share of old-age pensions and debt-servicing costs in Italy's overall public spending restrain growth-enhancing spending items like education and infrastructure. The high tax burden on production factors and still low tax compliance continue to hold back economic growth. Employment is growing also thanks to labour market reforms and hiring incentives, but largely driven by temporary contracts and with still high levels of long-term and youth unemployment weighing on future economic growth prospects. The business environment continues to hinder entrepreneurship, including due to weak spots in the public administration and very lengthy civil and criminal justice proceedings. Investment, in particular in intangible assets, is still low. In that context, Italy's ongoing recovery offers an important window of opportunity to pursue the reform effort in order to improve medium-term growth prospects and enhance the sustainability of the country's public finances.

After remaining very muted in 2015 and 2016 (0.1% and -0.1% respectively), mainly due to low aggregate demand, limited wage pressures and a fall in energy prices, headline Harmonised Index of Consumer Price (HICP) inflation increased in 2017, at 1.3%, mainly driven by higher energy prices. However, it is expected to slightly recede to 1.2% in 2018, largely due to negative base effects related to unprocessed food, and to rise again to 1.4% in 2019, on the back of the steady rise of prices for non-energy industrial goods and services.

[13] See Commission Staff Working Document SWD(2018) 210 final, 7.3.2018, "*Country Report Italy 2018. Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*".

Core inflation is also set to pick up gradually over the forecast period – in line with moderate wage growth – and reach 1.4% in 2019.

Until recently, low inflation has made it more difficult for Italy to cut its public expenditure as a share of GDP by freezing wages and pensions in nominal terms, while implying lower-than-normal tax revenues. Moreover, unfavourable macroeconomic conditions, including tight financing conditions, have implied higher-than-average fiscal multipliers, amplified by the constrained monetary policy due to the zero lower bound.[14] Overall, Italy's possibility to carry out large fiscal adjustments and bring down its debt ratio was somewhat hampered by macroeconomic conditions and the risk that fiscal policies could turn self-defeating, with the debt ratio and the primary balance being negatively impacted by subdued price developments. While too large fiscal adjustments could still have a significant impact on growth, the recent acceleration of GDP growth in both real and nominal terms as of 2017 suggest that macroeconomic conditions are improving and can no longer be argued to be a strong mitigating factor in explaining Italy's large gaps to compliance with the forward-looking debt reduction benchmark. In fact, both the Commission and the SP expect nominal growth to approach 3% in 2018, and the SP projects it at above 3% in 2019-2020.

Table 3: Macroeconomic and budgetary developments [a]

	2015	2016	2017	2018		2019	
				COM	SP	COM	SP
Real GDP (% change)	1.0	0.9	1.5	1.5	1.5	1.2	1.4
GDP deflator (% change)	0.9	0.8	0.6	1.4	1.3	1.3	1.8
Potential GDP (% change)	-0.2	-0.2	0.3	0.4	0.6	0.5	0.8
Output gap (% of potential GDP)	-3.4	-2.4	-1.2	-0.1	-0.3	0.5	0.3
General government balance	-2.6	-2.5	-2.3	-1.7	-1.6	-1.7	-0.8
Primary balance	1.5	1.5	1.5	1.9	1.9	1.7	2.7
One-off and other temporary measures	-0.2	0.2	0.0	0.1	0.1	-0.1	-0.1
Government gross fixed capital formation	2.3	2.1	2.0	2.0	2.0	2.0	2.0
Cyclically-adjusted balance	-0.7	-1.2	-1.7	-1.6	-1.4	-2.0	-0.9
Cyclically-adjusted primary balance	3.4	2.7	2.1	1.9	2.1	1.4	2.6
Structural balance [b]	-0.6	-1.4	-1.7	-1.7	-1.5	-2.0	-0.8
Structural primary balance	3.5	2.5	2.1	1.9	2.0	1.5	2.7

Notes:

[a] In percent of GDP unless otherwise specified

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

Source: Commission services, Italy's 2018 SP and Commission 2018 spring forecast

Structural reforms

Given the ongoing discussion to form a new government following the general elections of March 4th, the current caretaker government adopted in April 2018 a National Reform Programme[15] which does not propose any new legislative initiative. However, it considers the already adopted reforms –covering a number of areas such as public administration and judicial system, competition, labour market, education and competitiveness. The impact of these reforms is estimated at 2.9% of GDP over 5 years and 4.7% over 10 years compared to the baseline. The long-term impact is projected at as much as 10% of GDP.

[14] See, for instance, Blanchard O. and D. Leigh (2013), at www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf

[15] http://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/analisi_progammazione/documenti_programmatici/def_2018/DEF_2018_-_Sez.3_-_PNR.pdf

In its 2018 Country Report, the Commission assessed that Italy has made some progress in addressing the 2017 CSRs but also that the reform momentum has slowed down and that significant challenges persist in diverse reform areas. More specifically, Italy has made substantial progress in adopting measures to increase tax compliance and fight corruption. Some progress was made in reforming the public administration, addressing restrictions to competition, repairing the banking system and rationalising social spending. Only limited progress was made in shifting the tax burden, reducing trial length in civil justice and reforming the insolvency framework. Gaps also remain in reforming collective bargaining, active labour market policies, and in enhancing access to work for second earners. Italy's macroeconomic imbalances -mainly related to a very high public debt and sluggish productivity growth- have stopped deteriorating but remain elevated.[16] As a result, the Commission concluded that Italy still displays excessive macroeconomic imbalances.[17]

More specifically, in the field of public finances, the government adopted a comprehensive reform of the budgetary process, which was implemented for the first time with the 2018 budget. It also introduced important measures to fight tax evasion like compulsory electronic invoicing. However, progress in shifting the tax burden from production factors to property and consumption as well as in incentivising compulsory electronic payments was limited, past privatisation targets were not met, and provisions in the 2017 and 2018 budgets partially reversed past pension reforms aggravating the existing bias of public spending towards old-age pensions.

As regards the business environment, Italy made efforts in 2017 to reform the public administration, judicial system and anti-corruption framework, and finally adopted the 2015 annual competition law. However, the efficiency of the public administration remains lower than in peer countries. Challenges persist in the management and rationalisation of publicly-owned enterprises. Moreover, the length of civil justice trials remains very high especially at higher instances, also due to lack of adequate enforcement of procedural rules against the misuse of litigation in the context of wide access to lawyers. While the revision of the statute of limitations strengthened Italy's anti-corruption framework, persistent inefficiencies in the functioning of criminal justice and implementation challenges hinder the prevention and repression of corruption. Finally, significant barriers to competition remain, and some sectors are still over-regulated, including professional services, local public services.

Regarding the banking sector, efforts to tackle acute banking problems and address the high level of non-performing loans (NPLs) are bearing fruit. Namely, the total gross stock of NPLs declined from its peak of EUR 360 bn (or 18.2% of total customer loans) in 2015 to EUR 285 bn (or 14.5% of total customer loans) at the end of Q4 2017. Despite this marked decline, the stock of NPLs remains high compared to EU peers. The reform of the insolvency framework is yet to be finalised. Concerning the labour market, ‘second-level’ wage bargaining is not widespread and the implementation of the reform of active labour market policies is delayed. Moreover, the planned measures to foster female labour market participation appear insufficient. On the positive side, the setup of a comprehensive anti-poverty scheme was a major step forward although Italy still displays a high risk of poverty and social exclusion.

[16] See “*Country Report Italy 2018*”. Ibidem.

[17] See Commission Communication COM(2018) 120 final, " *2018 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2011".*

4.2. Medium-term budgetary position

The ex-post assessment of Italy's compliance with the preventive arm points to some deviation from the adjustment path towards the MTO in both 2016 and 2017, once taken into account the allowances granted under the flexibility clauses and/or for unusual events. Instead, as regards 2018, the fiscal adjustment is not expected to be adequate in light of the sustainability challenges that Italy faces. The latter takes into account the 2018 Budget Law and assumes no further change in policies thereafter.

Headline, structural balance and adjustment towards the MTO

As regards **2016**, the Commission concluded in May 2017[18] that Italy's adjustment path towards the MTO was broadly compliant with the requirements of the preventive arm of the SGP. In fact, the 0.7% of GDP deterioration in its structural balance based on the Commission 2017 spring forecast was assessed to point to some deviation from the required 0.5% of GDP adjustment towards the MTO in 2016, once taking into account the following allowances: (i) 0.5% of GDP under the structural reform clause; (ii) 0.21% of GDP under the investment clause; (iii) 0.06% of GDP due to the additional expenditure for the exceptional inflow of refugees; and (iv) 0.06% of GDP for security-related expenditure related to the terrorist threat. However, part of the abovementioned allowance, namely 0.1% of GDP under the structural reform clause and 0.25% of GDP under the investment clause, was granted in July 2016 conditionally, among others, on the existence of credible plans for the resumption of the adjustment path towards the MTO as of 2017.

As regards **2017**, Italy was recommended to deliver a structural adjustment of 0.6% of GDP or more, so as to make sufficient progress towards its MTO. However, the 2018 SP confirms that the outturn budgetary impact of the exceptional inflow of refugees and of a preventive investment plan for the protection of the national territory against seismic risks was significant in 2017, at around 0.35% of GDP, only slightly higher than the ex-ante estimate. On that basis, the Commission considers that the allowance preliminarily granted under the under the unusual event clause[19] can be confirmed. Therefore, the required adjustment towards the MTO for 2017 has been reduced to take into account these costs.

The Commission 2018 spring forecast expects Italy's structural balance to have deteriorated by 0.3% of GDP in 2017,[20] reaching -1.7% of GDP. This new estimate of structural deterioration compares to the 0.4% of GDP expected on the basis of the Commission 2017 autumn forecast. The main reason for the difference is that wage increases already agreed for 2017 in specific sectors will have a budgetary impact only as from 2018, while other lower-than-expected expenditure was offset by lower revenues (see also Box 1).

Based on the Commission 2018 spring forecast, the expenditure benchmark points to some deviation both over one year (gap of 0.3% of GDP) and over 2016 and 2017 taken together (gap of 0.1% of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, has exceeded the applicable expenditure

[18] See COM(2017) 511 final of 22.5.2017, available at: https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-italy.pdf

[19] Namely, the eligible expenditure in 2017 amounts to 0.16% of GDP for the exceptional inflow of refugees and 0.18% of GDP concerning protection against seismic risks.

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

benchmark rate (-0.6% in real terms) in 2017. The structural balance pillar points to some deviation over one year (gap of 0.5% of GDP) and to a significant deviation over 2016 and 2017 taken together (gap of 0.4% of GDP per year, on average). Both in 2016 and 2017, the structural balance is negatively affected by significant revenue shortfalls and a lower GDP deflator than that underlying the expenditure benchmark, which are only partly compensated by the decline in interest spending. Taking into account those factors, the overall assessment points to some deviation in 2017.

Box 1: The improvement in Italy's expenditure benchmark in 2017

The Commission 2017 autumn forecast expected Italy’s structural balance to deteriorate by 0.4% of GDP in 2017. On that basis, the expenditure benchmark pointed to a risk of significant deviation both over one year (gap of 0.9% of GDP) and over 2016 and 2017 taken together (gap of 0.4% of GDP per year, on average). The same conclusion could be reached on the basis of the structural balance pillar both over one year (gap of 1.0% of GDP) and over 2016 and 2017 taken together (gap of 0.7% of GDP per year, on average).

Based on outturn data for 2017 and the Commission 2018 spring forecast, Italy’s structural balance is expected to have deteriorated by 0.3% of GDP in 2017. As mentioned, after taking into account the 0.35% of GDP allowance for unusual events ex post, the expenditure benchmark points now to some deviation both in 2017 (gap of 0.3% of GDP) and over 2016 and 2017 taken together (gap of 0.1% of GDP per year, on average).

The main reason for the mentioned improvement compared to the Commission 2017 autumn forecast is that the increase in nominal government expenditure net of discretionary revenue measures and one-offs in 2017 turned out lower than expected in autumn by around EUR 1.7 bn (or 0.1% of GDP), mostly due to lower compensation of employees, as wage increases agreed already for 2017 in specific sectors will have a budgetary impact only as of 2018.

More in detail, on the one hand the increase in the corrected (primary) expenditure aggregate was lower by around 0.05% of GDP, mainly due to lower-than-expected compensation of employees and green energy production incentives. This deceleration in structural expenditure was partly compensated by an acceleration in one-off expenditure (by around 0.5% of GDP), largely due to the budgetary impact of bank rescue operations. On the other hand, the change in total discretionary revenue measures net of one-offs worsened by around 0.45% of GDP, largely due to lower tax receipts to compensate photovoltaic incentives and a higher share of discretionary revenues of one-off nature.

As regards **2018**, Italy was recommended to ensure a nominal rate of reduction of net primary government expenditure of at least 0.2% in 2018, corresponding to an annual structural adjustment of at least 0.6% of GDP. However, the Commission Communication on the 2017 European Semester of May 2017[21] stated that the Commission would stand ready to use its margin of appreciation in cases where the impact of a large fiscal adjustment on growth and employment could be particularly significant. Overall, in order to balance Italy's current stabilisation needs and existing sustainability challenges, the Commission considered that a fiscal structural effort of at least 0.3% of GDP would be adequate in 2018, without any additional margin of deviation over one year. This corresponds to a nominal rate of growth of net primary expenditure not exceeding 0.5%.

[21] https://ec.europa.eu/info/sites/info/files/2017-european-semester-country-specific-recommendations-commission-recommendations-communication.pdf

The Commission 2018 spring forecast expects Italy’s structural balance to remain stable at -1.7% of GDP, while the government plans in the 2018 SP[22] project a small structural effort of 0.1% of GDP. Based on the Commission 2018 spring forecast, and taking into account the adjusted requirement for 2018, the expenditure benchmark points to an inadequate fiscal adjustment (gap of 0.7% of GDP) in 2018. The same conclusion can be reached on the basis of the structural balance pillar (gap of 0.3% of GDP). The structural balance is negatively impacted by revenue shortfalls (0.1% of GDP), which are offset by the positive impact of a decline in interest expenditure (0.2% of GDP), and a slightly higher GDP deflator and point estimate for potential GDP growth compared to those underlying the expenditure benchmark (0.3% of GDP). Overall, Italy's fiscal adjustment cannot be considered adequate, in light of the sustainability challenges that Italy faces, based on the Commission 2018 spring forecast.

For **2019**, Italy is recommended to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1%, corresponding to an annual structural adjustment of 0.6% of GDP. The Commission 2018 spring forecast expects Italy’s structural balance to deteriorate by 0.3% of GDP in 2019, reaching -2.0% of GDP under a no-policy-change assumption. The expenditure benchmark points to a risk of significant deviation both over one year (gap of 1% of GDP) and over 2018 and 2019 taken together (gap of 0.8% of GDP per year, on average), as the growth rate of government expenditure, net of discretionary revenue measures and one-offs, will exceed the applicable expenditure benchmark rate (0.1% in nominal terms) in 2019. The same conclusion can be reached on the basis of the structural balance pillar, which points to a risk of significant deviation both over one year (gap of 0.9% of GDP) and over 2018 and 2019 taken together (gap of 0.6% of GDP per year, on average). The structural balance is positively impacted by a slightly higher point estimate for potential GDP growth compared to the medium-term average underlying the expenditure benchmark (0.2% of GDP). Taking into account those factors, the overall assessment points to a risk of significant deviation in 2019.

The Commission forecast for 2018-2019 is based on the assumption of no further changes in policies after the 2018 Budget, given the ongoing formation of a government following the national elections of March 4th and the caretaker government's adoption on April 26th of a Stability Programme including only a trend scenario based on unchanged legislation.

Public investment

As regards public investment, Italy’s government gross fixed capital formation averaged around 3% of GDP over 1999-2010, but the need to adjust quickly to respond to the sovereign debt crisis led to a substantial reduction in public investment to around 2.4% of GDP on average over 2011-2016. In 2017, public investment-to-GDP ratio reached a new low, at 2% of GDP (-5.6% year-on-year in nominal terms). The ratio is forecast by the Commission to remain roughly constant at 2% of GDP in 2018-2019, as investment recover broadly in line with nominal GDP growth. In summary, given its broad decline over time, public investment does not appear to represent a mitigating factor justifying Italy’s lack of compliance with the debt reduction benchmark.

[22] Recalculated based on the commonly agreed methodology.

4.3. Medium-term government debt position

Italy's public debt remains a major source of vulnerability for the economy. Recently-adopted measures, together with adverse demographic trends, risk reversing the positive trend achieved by past pensions reforms and weaken long-term fiscal sustainability, even more so if real interest rates increased more than currently expected.

After reaching 131.8% in 2017, Italy’s debt-to-GDP ratio is set to decrease to 130.7% in 2018 and 129.7% in 2019 in the Commission 2018 spring forecast. This is also due to stronger nominal GDP growth over the forecast horizon. Yet, a limited increase in the primary surplus, still muted inflation dynamics and systematically below-target privatisation proceeds continue to hinder the pace of debt reduction.

According to the European Commission's short-term fiscal sustainability risk indicator "S0", Italy does not appear to face short-term sustainability challenges, although vulnerabilities appear on the fiscal side.[23] While Italy is exposed to sudden increases in financial market risk aversion due to improving but still large roll-over needs (around 20% of GDP in 2017) related to its public debt, risks from the macro-financial context remain in fact limited, also thanks to the ECB's accommodative monetary policy.

In the medium term, Italy faces marked sustainability challenges. Its structural primary surplus is forecast to further deteriorate to 1.5% of GDP in 2019 under a no-policy-change assumption, down from 3.5% in 2015. This could heighten sustainability risks in the medium term, as a weak fiscal position might raise risk premia. This is captured by the Commission's medium-term fiscal sustainability risk indicator S1, which points to 'high risk'. Achieving a debt ratio of 60% of GDP by 2032 would in fact require Italy to make a large cumulative fiscal effort of 7.5% of GDP over 2020-2024.

The long-term fiscal sustainability risk indicator S2 still points to 'low risk', as a permanent increase in the structural primary surplus of around 1.8 percentage points of GDP would be needed to keep the debt-to-GDP ratio stable over the long term, including the cost of ageing. However, the long-term sustainability ensured by past pensions reforms, by curbing implicit liabilities arising from population ageing, is slowly deteriorating. This is due to worsening demographic trends projected by Eurostat and the fact that the 2017 and 2018 budgets contained measures that partially reversed past pension reforms and slightly increased Italy's old-age pension expenditure over the medium term. The latter, at around 15% of potential GDP in 2016, is already one of the highest in the EU/OECD. Overall, further backtracking on the implementation of past healthcare and pension reforms, in particular the adjustment of the retirement age, could further worsen Italy's long-term sustainability risks.

Privatisation proceeds underachieved the 0.5% of GDP target projected by the government in both 2016 and 2017, when they amounted to 0.05% of GDP and below 0.01% of GDP, respectively. Going forward, the SP still projects 0.3% of GDP privatisation proceeds per year over 2018-2020. As regards 2018, the Commission does not incorporate any privatisation proceed *ex ante* given added uncertainty related to the formation of a new government and the track record of privatisations until now. As regard 2019, only half of the projected proceeds are included in the forecast for prudential reasons.

[23] S0 is set to be below the 'high-risk' threshold in 2017 but, at 0.4, remains among the highest in the EU, mainly due to Italy's very high public debt. Furthermore, the fiscal sub-index is above its critical threshold.

Against this background, further fiscal adjustment and the pursuit of the reform effort to foster potential growth in the medium/long term remains crucial to achieve a satisfactory debt reduction path going forward.

4.4. Other factors considered relevant by the Commission

Among the other factors considered relevant by the Commission, particular consideration is given to financial contributions to fostering international solidarity and achieving the policy goals of the Union, the debt incurred in the form of bilateral and multilateral support between Member States in the context of safeguarding financial stability, and the debt related to financial stabilisation operations during major financial disturbances (Article 2(3) of Regulation (EC) No 1467/97). Regarding government support to the financial sector in the course of the financial crisis, contingent liabilities to support liquidity provisions of financial institutions amounted to around 1.5% of GDP at end-2017 (out of a total amount of contingent liabilities of 3.7% of GDP), up from 0.5% of GDP at end-2016.

Support to financial institutions with an impact on the government debt amounted to close to 1% of GDP in 2017 (up from 0.2% at end-2016). This was mainly related to the liquidation of two Italian regional lenders (*Banca Popolare di Vicenza and Veneto Banca*) and the precautionary recapitalisation of *Banca Monte dei Paschi di Siena*. The related impact on deficit was close to 0.4% of GDP. An additional risk for public finances is related to the possible (one-off) impact from the support to financial institutions also on the 2018 deficit, as well as from the considerable stock of trade debt arrears of the public administration.

Article 12(1) of Regulation (EU) No 473/2013 requires that this report considers also "the extent to which the Member State concerned has taken into account the Commission opinion" on the country's Draft Budgetary Plan, as referred in Article 7(1) of the same Regulation. The Commission Opinion on Italy’s 2017 Draft Budgetary Plan[24] and 2018 Draft Budgetary Plan[25] both pointed to a risk of non-compliance with the provisions of the SGP and invited the authorities to take the necessary measures within the national budgetary process to ensure compliance. However, despite the flagged risks of non-compliance with the SGP, both 2017 and 2018 Budgets passed without major changes compared to the Draft Budgetary Plans.

4.5. Other factors put forward by the Member State

On 14 May 2018, the Italian authorities transmitted documents concerning relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97.[26] The analysis presented in the other sections of this report already covers most of the factors put forward by the authorities.

The first relevant factor discussed in the report is Italy’s track record of fiscal discipline, witnessed by the sizable primary surpluses and the moderation in nominal current primary expenditure dynamics in recent years. The second relevant factor raised by the authorities is that, after taking into account the significant flexibility granted by the Commission over 2015-2017, Italy complied with the adjustment path towards the MTO, based in particular on the expenditure benchmark in 2017.

[24] Commission Opinion C(2016) 8009 final, 16.11.2016, on the Draft Budgetary Plan of Italy.
[25] Commission Opinion C(2017) 8019 final, 22.11.2017, on the Draft Budgetary Plan of Italy.
[26] See "*Relevant Factors Influencing Debt Developments in Italy*", Ministry of Economy and Finance, May 2018, at: www.mef.gov.it/inevidenza/documenti/Italy_Report_Relevant_Factors_May_2018.pdf

The third relevant factor highlighted by the authorities is the persistence of deflationary pressures, hindering Italy's efforts both to reduce the public debt ratio and to regain wage and price competitiveness in a context of slow wage growth in Europe and other advanced economies.

The fourth key factor is the underestimation of the slack in Italy's economy even after the revision in the "commonly agreed methodology" to measure the output gap in line with some technical changes proposed by the Italian delegation to the Output Gap Working Group. While the latter implied a widening of Italy's output gap for 2017 to -1.2% of potential GDP (from -0.6% based on the Commission 2017 autumn forecast), the revised estimates of the Commission still suggest that the country's economic activity should reach its potential in 2018. According to the authorities, this estimate is not in line with economic intuition, given Italy's sharp output loss compared to 2008, the still high unemployment rate of 11% and the virtual stability in wages and prices. The report thus presents alternative estimates, suggesting an output gap still close to -3% of potential GDP in 2018 based on the government projections, whereby Italy would have been at its MTO in recent years and would satisfy the debt reduction benchmark in its "cyclical-adjusted configuration" and under the additional assumption of a "normal" inflation rate (based on the GDP deflator) of 2%.

Other relevant factors put forward by the authorities in relation to Italy's public debt include its sustainability, as the country still displays low long-term sustainability risks despite the worsened demographic projections; its affordability, given the downward-trending interest expenditure; and the very low level of contingent liabilities and of private sector debt.

The report also stresses Italy’s structural reform effort in 2017, including on healing and restructuring the banking system, improving tax collection and enhancing competition in services. The positive impact on real GDP growth of structural reforms carried out in the 2014-2017 period is estimated by the Italian authorities at 2.2 percentage points of GDP by 2020, 3.4 percentage points by 2025 and 8.2 percentage points in the long run.

5. CONCLUSIONS

Italy's general government gross debt reached 131.8% of GDP in 2017, well above the 60% of GDP reference value, and Italy did not comply with the debt reduction benchmark either in 2016 or in 2017. Moreover, the Commission forecast does not expect Italy to comply with the debt reduction benchmark in 2018-2019, the gap remaining large also due to the significant deterioration of the structural balance from -0.6% of potential GDP in 2015 to -2.0% forecast in 2019 under a no-policy-change assumption. This suggests that, before consideration is given to all relevant factors, the debt criterion as defined in the Treaty does not appear to be fulfilled *prima facie*. In line with the Treaty, this report examines the relevant factors.

Macroeconomic conditions improved in 2017 and nominal GDP growth is forecast to further pick up to 2.9% in 2018, before slightly receding to 2.5% in 2019. Thus, the macroeconomic outlook can no longer be considered as a mitigating factor explaining Italy’s large gaps with the debt reduction benchmark, notably in its forward-looking dimension, over 2017-2019.

The *ex-post* assessment of Italy’s compliance with the preventive arm in 2017 indicates broad compliance with the adjustment path towards the MTO, once taken into account the granted allowance for unusual events. As regards 2018, instead, Italy's fiscal adjustment is currently inadequate in light of the sustainability challenges that Italy faces. Hence, the necessary measures should be taken as of 2018 to comply with the provisions of the Stability and

Growth Pact. The use of any windfall gains to further reduce the general government debt ratio would be prudent.

Moreover, Italy has made some progress in addressing the 2017 Country Specific Recommendations, but the impact of structural reforms on growth will crucially depend on implementation and remains difficult to disentangle from the ongoing cyclical recovery.

Finally, the large public debt remains a major source of vulnerability for the Italian economy, and a careful balance between growth-enhancing reforms and fiscal responsibility remains key. Instead, recently-adopted measures, together with adverse demographic trends, risk to reverse the positive trend achieved by past pensions reforms and weaken long-term fiscal sustainability, even more so if real interest rates increased more than currently expected.

The analysis presented in this report includes the assessment of all relevant factors and notably: (i) the improving macroeconomic conditions, no longer explaining Italy's large gaps with the debt reduction benchmark; (ii) the ex-post compliance with the required adjustment towards the MTO in 2017; and (iii) some progress in adopting and implementing growth-enhancing structural reforms. Overall, the analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently complied with, and that an EDP is thus not warranted at this stage, having regard in particular to Italy's ex-post compliance with the preventive arm in 2017. However, the adjustment in 2018 appears inadequate to ensure compliance with the adjustment path towards the MTO in 2018 based on the Commission 2018 spring forecast. The Commission will reassess compliance on the basis of the ex-post data for 2018 to be notified in Spring 2019.