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# REPORT FROM THE COMMISSION

## Italy

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

## 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 18 May 2016, the Commission issued a report under Article 126(3) TFEU[3], as Italy did not make sufficient progress towards compliance with the debt rule in 2015. The report concluded that, after the assessment of all relevant factors that might justify the *prima facie* lack of compliance, notably: (i) the unfavourable economic conditions, and in particular low inflation, which made the respect of the debt rule particularly demanding; (ii) the expectation that compliance with the required adjustment towards the Medium-Term budgetary Objective (MTO) was broadly ensured; and (iii) the expected implementation of ambitious growth-enhancing structural reforms in line with the authorities' commitment, which was expected to contribute to debt reduction in the medium/long term, the debt rule as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as complied with. In the report of May 2016, the Commission announced its intention to "revise its assessment of the relevant factors in a new report under Article 126(3) TFEU, as further information on the credibility and appropriateness of Italy's resumption of the adjustment path towards the MTO for 2017 becomes available", in particular in Italy's 2017 Draft Budgetary Plan. The latter was the condition explicitly stated in the Council Recommendations of July 2016[4] to grant to Italy the

[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 COM(2016) 305 final, 18.5.2016.

[4] See Council Recommendation (2016/C 299/01) of 12 July 2016 on the 2016 National Reform Programme of Italy and delivering a Council opinion on the 2016 Stability Programme of Italy.

maximum possible allowance in 2016 under the structural reform clause and the investment clause. This report follows up on that announcement of the Commission in May 2016.

Data notified by the authorities on 1 October 2016[5] and subsequently validated by Eurostat[6] show that Italy's general government deficit declined to 2.6 % of GDP in 2015 (from 3% in 2014), while the debt continued to rise to 132.3% of GDP (from 131.9 % in 2014), i.e. above the 60% of GDP reference value. For 2016, Italy's 2017 Draft Budgetary Plan[7] projects the debt-to-GDP ratio to peak at 132.8%, up by 0.5 percentage points from the 2015 level. In 2017, the Draft Budgetary Plan projects a small decline (of 0.2 percentage points) in the debt-to-GDP ratio to 132.6%.

Based on notified data and the Commission 2017 winter forecast, Italy did not make sufficient progress towards compliance with the debt reduction benchmark in 2015 (see Table 1), as the change in the structural balance[8] (0.2 percentage points of GDP) fell largely short of the required minimum linear structural adjustment (MLSA)[9] of 3.4 percentage points of GDP. The MLSA in 2015 is substantially higher than that required in 2013 (1 percentage point of GDP) due to the markedly lower-than-required structural adjustments in both 2013 and 2014 as well as to negative inflation surprises[10]. Based on the Commission 2017 winter forecast, Italy's debt-to-GDP ratio is projected to be considerably above the debt benchmark in both 2016 and 2017 (gaps to the debt benchmark of 7.4% and 7.1% of GDP, respectively). In addition, in the 2017 Draft Budgetary Plan the Italian authorities do not plan to comply with the debt rule (in its forward-looking dimension) either in 2016 or in 2017 (gaps of 4.6% and 1.9% of GDP, respectively), so that compliance is postponed compared to the 2016 Stability Programme. However, the (forward-looking) gap to the debt benchmark in 2017 based on the government plans is smaller than that based on the Commission forecast, as the authorities

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

[6] Eurostat news release No 04/2016 of 21 October 2016, available at: http://ec.europa.eu/eurostat/documents/2995521/7704449/2-21102016-AP-EN.pdf/f113daf6-9f48-4bb1-832d-e3a71e5ef009

[7] Available at: https://ec.europa.eu/info/files/draft-budgetary-plan-italy-2017_en

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

[9] Member States that were in EDP when the Six Pack amendments to the SGP were adopted (8 November 2011) are subject to transitional arrangements for the three years following the correction of their excessive deficit, to give them time to adapt their structural adjustments to the level needed to comply with the debt rule. During those three years, sufficient progress towards compliance is judged on the basis of a yearly minimum linear structural adjustment (MLSA) of the structural balance ensuring that – if followed – Member States will comply with the debt rule at the end of the transition period.

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

project sizeable structural adjustments as of 2018[11] (while the Commission expects a deterioration in 2018 under a no-policy change assumption).

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

The Commission has therefore prepared this report to comprehensively assess the departure from the debt rule in order to examine whether the launch of an excessive deficit procedure is warranted after all relevant factors have been considered. Section 2 of the report examines the deficit criterion. Section 3 examines the debt criterion. Section 4 deals with public investment and other relevant factors, including the assessment of compliance with the required adjustment path towards the MTO. The report takes into account the Commission 2017 winter forecast, released on 13 February 2017, and the Commission's evaluation of subsequent macroeconomic and fiscal developments. All conclusions for 2016 are currently still based on projections, awaiting the notification to Eurostat in April 2017.

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

| | | 2013 | 2014 | 2015 | 2016 | | 2017 | |
|---|---|---|---|---|---|---|---|---|
| | | | | | COM | DBP | COM | DBP |
| Deficit criterion | General government balance | -2.7 | -3.0 | -2.6 | -2.3 | -2.4 | -2.4 | -2.3 |
| Debt criterion | General government gross debt | 129.0 | 131.9 | 132.3 | 132.8 | 132.8 | 133.3 | 132.6 |
| | Gap to the debt reduction benchmark | n.r. | n.r. | n.r. | 7.4 | 4.6 | 7.1 | 1.9 |
| | Change in structural balance | 0.6 | -0.2 | 0.2 | -0.6 | -0.6 | -0.4 | -0.5 |
| | Required MLSA | 1.0 | 1.4 | 3.4 | 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 2016 DBP and Commission 2017 winter forecast*

## 2. DEFICIT CRITERION

*Italy conducted a sizeable fiscal adjustment between 2010 and 2013, which allowed the country to exit the excessive deficit procedure in 2013, by keeping headline deficits at a level not above 3% of GDP as of 2012 (down from more than 5% in 2009) and raising the primary surplus to over 2% of GDP. However, the fiscal stance eased in more recent years, mainly by cutting the tax burden and taking advantage of the fiscal space created by lower interest expenditure, which declined steadily from the peak of 5.2% of GDP in 2012 to 3.9% in 2016. As a result, the headline deficit stabilised at around 2.5% of GDP, while the primary surplus fell to 1.5% in 2015, without improving since then. The structural primary balance is estimated to have worsened by some 1.6 percentage points of GDP between 2013 and 2016 (from 3.9% to 2.3% of GDP) and is expected to shrink further in 2017-2018. That relaxation in the fiscal stance was partly used to support private investment and facilitate the*

[11] Namely, a structural effort of 0.9 percentage points of GDP in 2018, followed by one of 0.6 in 2019 based on the 2017 Draft Budgetary Plan.

*adoption/implementation of structural reforms (for instance through tax incentives)*[12]*, while reducing the risk of entering a low-inflation-low-growth trap. Debt refinancing risks are mitigated in the short term by the liquidity provided by the ECB and Italy's improved external position, which makes the country less reliant on external capital flows.*

Italy's general government deficit was reported at 2.6% of GDP in 2015. According to both the 2017 Draft Budgetary Plan and the Commission 2017 winter forecast, it is also projected to respect the Treaty reference value of 3% of GDP during the period 2016-2017. The deficit is projected by the Commission to further decline to 2.3% of GDP in 2016 and to slightly increase to 2.4% in 2017 after taking into account the measures legislated by the 2017 Budget, including, in particular, the full repeal with only minor compensation of a VAT hike legislated for 2017 through the 2016 Stability Law. It should be noted that, in previous public exchanges with the Commission, the government had committed to make that repeal conditional on implementing alternative deficit reduction measures to ensure the achievement of the planned 1.8% of GDP deficit target, which was eventually not the case. The budget also provided for higher pension expenditure, support to public investment, and a reduction in the overall tax burden, thanks to lower corporate income tax rates.

Furthermore, the government committed to take further measures worth 0.2% of GDP at the latest in April 2017, following the exchange of letters with the Commission on the relevant factors[13]. While the Commission took positive note of the government's public commitment to adopt additional fiscal measures, they will only be taken into account as soon as sufficient details are provided to assess the specific provisions to be enacted.

The deficit projection for 2017 in the Draft Budgetary Plan (2.3% of GDP) only marginally differ from the Commission forecast, as the latter expects slightly weaker nominal GDP growth (1.9% vs. 2%) and features a more cautious assessment of some measures to increase tax compliance. In 2018, the Commission forecast projects that the deficit will rise again to 2.6% of GDP under a no-policy change assumption. The Draft Budgetary Plan projects instead that the deficit will further decrease to 1.2%, also because it includes a VAT hike worth EUR 19.6 billion (or 1.1% of GDP), which the Commission decided not to incorporate insofar as the government publicly declared its intention to repeal it.

## 3. DEBT CRITERION

*After increasing by around five percentage points per year on average during the double-dip recession of 2008-2013, Italy's government debt-to-GDP ratio continued to increase, but at a*

[12] For examples of these tax incentives, please refer to "*Country Report Italy 2017 - Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*", Sections 4.1 and 4.4.

[13] The consultation letter addressed by the Commission to the Italian authorities can be found at: www.mef.gov.it/inevidenza/documenti/Letter_17012017.pdf. The authorities' reply to the Commission, dated 1 February 2017 and including the commitment to adopt additional measures at the latest in April, can be found at: www.mef.gov.it/inevidenza/documenti/Letter_to_Dombrovskis_and_Moscovici_-_1_Feb._2017.pdf. Further details on those measures, including Italy's intention to ask the Commission to present a proposal for the extension of the existing derogation to the VAT Directive, whereby the Council authorized the split payment mechanism for all purchases by the Italian public administration until end-2017, can be found at: www.mef.gov.it/inevidenza/documenti/Letter_to_Dombrovskis_x_Moscovici_-_7_Feb._2017.pdf. A more detailed analysis of the government commitment has been made by the Parliamentary Budget Office in the following report: www.upbilancio.it/wp-content/uploads/2017/02/FLASH-1_2017.pdf. It includes a simulation of the impact of the measures on growth, which is found to be marginal and limited to 2017.

*slower pace (1.6 percentage points on average) in 2014-2015. In 2016-2018, the debt ratio is expected to hover around 133% of GDP. In this context, the accommodative monetary conditions are decisively contributing to reducing the differential between the average interest rate paid on debt and the GDP growth rate. Overall, the high public debt remains an important source of vulnerability for the Italian economy, but the low interest rate environment is playing a significant mitigating role also by underpinning a gradual economic recovery. On the other hand, the lower primary surplus, alongside with low real GDP growth and inflation, hinders the reduction of the high public debt ratio and privatisation proceeds are falling short of the government plan.*

In 2015, the government debt-to-GDP ratio reached 132.3%, i.e. 0.4 percentage points higher than in 2014. That increase is due to the fact that the real implicit interest rate on the debt[14], while gradually narrowing (to around 2.6%, from 2.7% in 2014), remained significantly above the positive real GDP growth (0.7%, i.e. 0.6 percentage points higher than in 2014), mainly due to low inflation (GDP deflator growth of 0.6%). In fact, real spot interest rates on new government securities issuances, which were close to zero in 2015 (and even slightly negative in 2016), were 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 (see also Box 1 and Graph 1). Because of the still large interest-growth rate differential (1.8 percentage points vs 2.6 in 2014), the "snowball" effect (see Table 2) continued entailing a large debt-increasing impact (at 2.4% of GDP, down from 3.3% in 2014). On the other hand, a broadly stable primary surplus (1.5% of GDP vs 1.6% in 2014) and a debt-decreasing stock-flow adjustment (0.4% of GDP) helped to curb debt dynamics in 2015. In particular, the stock-flow adjustment benefitted from the debt-decreasing impact of privatisation proceeds (0.4% of GDP) and the reduction of the liquidity buffer accumulated in previous years (0.7% of GDP) but was negatively affected by the debt-increasing impact of derivative contracts (0.4% of GDP) settled before the crisis, mainly in order to fix interest rates on part of the debt (at around 4.4% on average) and thus limit possible risks related to higher refinancing costs[15].

For 2016, the 2017 Draft Budgetary Plan projected that the debt-to-GDP ratio would peak at 132.8%, showing a further increase of 0.5 percentage points relative to 2015. That increase in the debt-to-GDP ratio is mainly driven by a shrinking but still sizeable debt-increasing "snowball" effect (1.7%) and stock-flow adjustment (0.5%), only partially offset by a marginally higher primary surplus (at 1.7%). The "snowball" effect is reduced by slightly higher real GDP growth and a lower debt-increasing impact of implicit real interest rates. The debt-increasing stock-flow adjustment in 2016 is due to low projected privatisation proceeds (0.1% of GDP), more than offset by debt-increasing "below-the-line" transactions (e.g. in swaps and swaptions, as well as changes in the liquidity buffer). Overall, the debt rule is not projected to be complied with by 2016 (in its forward-looking dimension) based on the Draft Budgetary Plan.

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

[15] Note that other minor transactions affecting the overall stock-flow adjustment (-0.4%) in 2015 are not reported. See also *Public Debt Report 2015*, Italian Ministry of the Economy and Finance, retrievable at www.dt.tesoro.it/export/sites/sitodt/modules/documenti_en/debito_pubblico/presentazioni_studi_relazioni/Public_Debt_Report_2015.pdf

For 2017, the Draft Budgetary Plan projected the debt ratio to slightly decline to 132.6% despite the dwindling primary surplus, mainly thanks to a shrinking (debt-increasing) "snowball" effect, as interest expenditure is set to decrease, nominal GDP growth to slightly accelerate, and ambitious privatisation proceeds (0.5% of GDP) to contribute to contain the debt-increasing stock-flow adjustment. Overall, the debt rule is not projected to be complied with by 2017 (in its forward-looking dimension) based on the Draft Budgetary Plan.

In the Commission 2017 winter forecast, debt developments in 2017 are somewhat less benign than in the Draft Budgetary Plan, as the debt ratio is set to peak at 133.3% in 2017, up from 132.8% in 2016, mainly due to lower nominal growth (and thus a larger "snowball" effect) and lower privatisation proceeds than in the government projections. Moreover, the forecast incorporates the government decision in December 2016 to earmark up to EUR 20 billion (or 1.2% of GDP) to support the banking sector and retail investors. Therefore, the Commission forecast also does not expect the debt rule to be complied with by 2017.

As shown in Graph 1, the expected slow recovery in real GDP growth (see solid blue line) and the only gradual decrease in implicit real debt-servicing costs (see dashed black line) as they start reflecting the lower real spot yields at issuance (see red line) both imply a shrinking "snowball" effect (see yellow shade) in 2016 and 2017. However, as real financing costs remain higher than real GDP growth, the overall impact of the "snowball" effect is still debt-increasing, projected at 1.1 percentage points in 2017 (down from 1.3 percentage points in 2016) –see Box 1. As that level is only slightly below the pre-crisis average of 1.2 percentage points over 1999-2007, the projected "snowball" effect no longer appears sufficient to explain Italy's lack of compliance with the debt rule in the coming years, as it was in the past. However, in the medium term, that improvement in the interest-growth rate differential might gradually reverse as monetary policy normalises.

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. In order to ensure continuous and effective progress towards compliance during the transition period, Member States should respect simultaneously the two conditions below:

a. First, the annual structural adjustment should not deviate by more than ¼% of GDP from the MLSA ensuring that the debt rule is met by the end of the transition period.

b. Second, at any time during the transition period, the remaining annual structural adjustment should not exceed ¾% of GDP (unless the first condition implies an annual effort above ¾% of GDP, which is the case for Italy).

Based on the Commission 2017 winter forecast, a surplus in the structural balance of around 2.2% of GDP, i.e. well above Italy's MTO of a balanced budget in structural terms, would have been needed to meet the debt reduction benchmark in 2015, given an annual MLSA of 3.4 percentage points in 2015. Instead, Italy's structural balance is estimated to have improved by 0.2 percentage points of GDP in 2015, to -1.0% of GDP, therefore falling substantially short of the requirements of the transition period for the debt reduction benchmark (see Table 1).

Following the end of the transition period, the standard debt rule became applicable in 2016. However, neither the 2017 Draft Budgetary Plan nor the Commission 2017 winter forecast expect compliance with the debt rule, given the large gap to the debt benchmark (in its forward-looking dimension) of 4.6% (based on the Draft Budgetary Plan) and 7.4% (based on

the Commission forecast) of GDP, respectively. The same applies to 2017. That 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 2017 Draft Budgetary Plan or the Commission 2017 winter forecast, before consideration is however given to all relevant factors as set out below.

**Box 1: Impact of interest rate windfall on public finances**

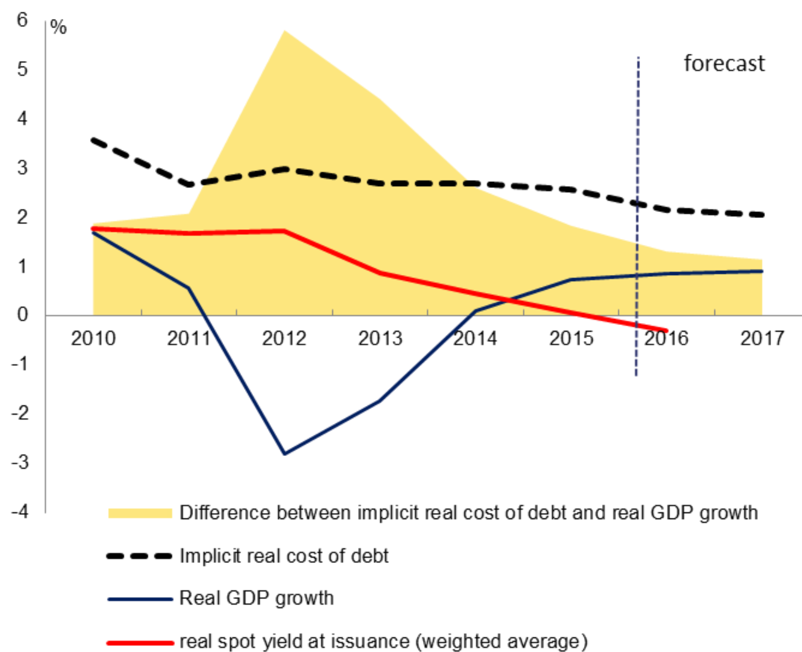
Sovereign bond yields have fallen sharply since end-2013 and nominal yields in Italy are well below their long-term average of around 4.9% (paid by the government over 2000-2010), with average issuance yields at around 0.55% in 2016 (ten-year bond yields stood at 2.4% at the end of January 2017). As a result of lower rates, the total interest expenditure of the general government decreased accordingly. Italy's 2017 Draft Budgetary Plan projects it to fall from the peak of 5.2% of GDP in 2012 to 4% in 2016 and to 3.7% in 2017. The Commission 2017 winter forecast expects it to remain stable at around 3.9% of GDP in 2016-2017. As a result of the only slightly higher inflation (GDP deflator increasing by 0.9% y-o-y up from 0.6% in 2015) and lower implicit nominal cost of debt (at 3.0%, down from 3.2% in 2015) expected in 2016-2017, the implicit average interest rate in real terms (using the GDP deflator) is projected to gradually decrease to 2.2% in 2016 and to 2.1% in 2017, down from 2.6% in 2015 (broadly in line with the average recorded over 2007-2014, i.e. 2.7%).

The impact of lower yields on interest expenditure is substantial in the first year, as they positively affect the cost of short-term bonds as well as coupons on (interest and inflation) linked bonds. However, as a large part (around 70%) of Italy's sovereign debt consists of fixed-rate bonds, it takes time (around five years) to have full pass-through of lower yields to interest expenditure (the average maturity of government debt securities is currently around six and a half years). This, together with the fact that nominal interest rates on new debt issuances are expected to be similar to those on expiring securities, explains why no major changes are expected in the implicit average interest rate over the forecast horizon.

While lower yields are having a positive impact on interest expenditure, the overall impact of low inflation on public finances is less benign. In fact, a low-inflation environment makes it more difficult to cut expenditure by limiting nominal expenditure growth (e.g. by freezing nominal wages or introducing nominal ceilings for other spending items such as healthcare). At the same time, low interest rates and inflation are often associated with weak domestic demand and subdued wage developments, which in turn entail a tax-poor growth composition. As a result, a low-inflation environment may be expected to exert negative effects on primary balances, thereby weighing on deficit and debt level dynamics. Furthermore, what matters for the debt-to-GDP ratio developments is the differential between real GDP growth and the real implicit debt-servicing cost (through the so-called "snowball" effect). As mentioned above, the latter is expected to only gradually decline below its long-term average as of 2016, while Italy's real GDP started recovering only since 2015 after a long and deep recession that negatively affected its potential growth.

In that context, low real yields and increasing potential growth alongside with large primary surpluses will be essential to put the high debt-to-GDP ratio on a sustained declining path over the next years.

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




## Table 2: Debt dynamics [a]

| | 2013 | 2014 | 2015 | 2016 | | 2017 | |
|---|---|---|---|---|---|---|---|
| | | | | COM | DBP | COM | DBP |
| Government gross debt ratio | 129.0 | 131.9 | 132.3 | 132.8 | 132.8 | 133.3 | 132.6 |
| Change in debt ratio [b] (1 = 2+3+4) | 5.7 | 2.9 | 0.4 | 0.5 | 0.5 | 0.5 | -0.2 |
| *Contributions:* | | | | | | | |
| • Primary balance (2) | -2.1 | -1.6 | -1.5 | -1.7 | -1.6 | -1.5 | -1.4 |
| • "Snowball" effect (3) | 5.5 | 3.3 | 2.4 | 1.7 | 1.6 | 1.5 | 1.1 |
| *of which:* | | | | | | | |
| *Interest expenditure* | *4.8* | *4.6* | *4.2* | *3.9* | *4.0* | *3.9* | *3.7* |
| *Real GDP growth* | *2.2* | *-0.1* | *-1.0* | *-1.1* | *-1.0* | *-1.2* | *-1.3* |
| *Inflation (GDP deflator)* | *-1.5* | *-1.1* | *-0.8* | *-1.1* | *-1.4* | *-1.2* | *-1.3* |
| • Stock-flow adjustment (4) | 2.3 | 1.1 | -0.4 | 0.5 | 0.5 | 0.5 | 0.1 |
| *of which:* | | | | | | | |
| *Cash/accruals difference* | *1.1* | *0.0* | *0.0* | *0.0* | *0.5* | *0.0* | *0.4* |
| *Net accumulation of financial assets* | *1.2* | *1.1* | *-0.5* | *0.5* | *0.2* | *0.5* | *-0.2* |
| *of which privatisation proceeds* | *-0.1* | *-0.2* | *-0.4* | *-0.1* | *-0.1* | *-0.2* | *-0.5* |
| *Valuation effect & residual* | *0.0* | *0.0* | *0.0* | *0.0* | *-0.3* | *0.0* | *-0.2* |

Notes:

[a] In percent of GDP unless otherwise specified

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

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

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

*Source: Commission services, Italy's 2016 DBP and Commission 2017 winter forecast*

## 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)[16] 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 requires a Member State to achieve more demanding structural adjustments to comply with the MLSA under the transitional debt rule, and negative inflation surprises may further contribute to the upward revisions of the required MLSA over time. In addition, the transitional debt rule assumes by construction that GDP deflator growth only returns to the long-term average value of 2% by 2021, which makes compliance with the forward-looking debt rule particularly demanding. 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.

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

In view of those provisions, the following subsections consider in turn: (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 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, while still unfavourable mainly due to low inflation, are expected to have improved as of 2016 and can no longer be considered a strong mitigating factor for Italy's lack of fiscal consolidation and the large gaps with the (forward-looking) debt rule forecast in the coming years. Moreover, structural weaknesses appear to be at the root of Italy's sluggish potential growth and, since the adoption of the 2016 country-specific recommendations, domestic developments have slowed down the adoption of new reforms in Italy. Pushing an ambitious structural reform agenda could have positively affected Italy's medium-term growth prospects and in turn enhanced the sustainability of the country's public finances.*

### Cyclical conditions, potential growth and inflation

Italy's real GDP growth was 0.7% in 2015 and the 2017 Draft Budgetary Plan projected it at 0.8% in 2016, slightly below the Commission 2017 winter forecast (0.9%)[17]. The negative estimate of potential growth in 2016 (-0.3%, stable from 2015) implies a significant closure in Italy's negative output gap, from -3.8% of potential GDP in 2014 to -2.8% in 2015 and -1.6% in 2016, based on the Commission forecast. Overall, in the 2013-2015 transition period for the debt rule, Italy experienced a negative output gap (around -3.6% of potential GDP on average) combined with negative potential growth (-0.4% of potential GDP on average). The somewhat higher real GDP growth forecast in 2017 (0.9%), above the estimated potential GDP growth (0.1%), would halve the negative output gap to -0.8% of potential GDP, based on the Commission forecast.

After the very small increases recorded in 2014 and 2015 (0.2% and 0.1% respectively), headline Harmonised Index of Consumer Price (HICP) inflation was -0.1% in 2016. Core inflation also remained muted (at 0.5% in 2016 after 0.7% in both 2014 and 2015), due mainly to low aggregate demand, limited wage pressures and the significant fall of energy prices. However, headline HICP inflation is forecast in 2017 to climb to 1.4% mainly due to higher energy prices, while core inflation is set to increase to 0.8%. In addition, GDP deflator growth, which has been sluggish in the past years, is forecast to accelerate from 0.6% in 2015 to 0.9% in 2016 and 2017. Low inflation has so far made it more difficult to cut public expenditure as a share of GDP by freezing wages and pensions in nominal terms (in lieu of having them indexed to inflation): that policy was pursued by Italy in recent years and has led to a limited increase in primary expenditure in both nominal and real terms. On the revenue side, low inflation has implied lower tax revenues than in normal circumstances. Moreover, unfavourable macroeconomic conditions, including tight financing conditions in recent years, have also implied rather high fiscal multipliers heightened by the constrained monetary

[17] Preliminary national accounts data for the fourth quarter of 2016 point to real GDP growth of 0.9% for 2016 as a whole, in line with the Commission 2017 winter forecast.

policy due to the zero lower bound limit[18]. Therefore, it can be argued that Italy's possibility to carry out large fiscal adjustments has so far been somewhat hampered by macroeconomic conditions, because too restrictive fiscal policies could have been self-defeating, while the debt-to-GDP ratio and the primary balance have been negatively affected by moderate price developments. However, the improvement in macroeconomic conditions expected in the coming years, including higher inflation, means that they can no longer be regarded as a strong mitigating factor in explaining Italy's lack of fiscal effort in line with the Council recommendation for 2017, as well as its large gaps with the forward-looking debt rule (e.g. 7.1% of GDP in 2017 based on a no-policy change assumption).

Overall, long-standing structural weaknesses and the legacy of the crisis continue to weigh on Italy's economic recovery and are at the root of its sluggish potential growth[19]. Italy's GDP has not grown compared to 15 years ago, as against average annual growth of 1.2% in the rest of the euro area. It is largely explained by structural factors that hamper the efficient allocation of resources. At the current juncture, following the protracted crisis, banks are burdened by a large stock of non-performing loans and may not be able to fully support the recovery. Employment is growing, also thanks to the labour market reforms and hiring incentives, but long-term and youth unemployment remain high, which weigh on future economic growth prospects. Weak spots in public administration, very lengthy judicial proceedings and a difficult business environment, although gradually being addressed, continue to hinder investment. Last but not least, the limited development of capital markets in comparison with other advanced economies makes financing, particularly for smaller firms, largely dependent on bank lending. In that context, structural reforms addressing those weaknesses, which could in turn improve Italy's medium-term growth prospects, are crucial to enhance the sustainability of the country's public finances.

**Table 3: Macroeconomic and budgetary developments [a]**

| | 2013 | 2014 | 2015 | 2016 | | 2017 | |
|---|---|---|---|---|---|---|---|
| | | | | COM | MS | COM | MS |
| Real GDP (% change) | -1.7 | 0.1 | 0.7 | 0.9 | 0.8 | 0.9 | 1.0 |
| GDP deflator (% change) | 1.2 | 0.9 | 0.6 | 0.9 | 1.0 | 0.9 | 1.0 |
| Potential GDP (% change) | -0.4 | -0.3 | -0.3 | -0.3 | -0.3 | 0.1 | -0.1 |
| Output gap (% of potential GDP) | -4.2 | -3.8 | -2.8 | -1.6 | -1.6 | -0.8 | -0.7 |
| General government balance | -2.7 | -3.0 | -2.6 | -2.3 | -2.4 | -2.4 | -2.3 |
| Primary balance | 2.1 | 1.6 | 1.5 | 1.7 | 1.6 | 1.5 | 1.4 |
| One-off and other temporary measures | 0.5 | 0.2 | -0.2 | 0.2 | 0.1 | 0.1 | 0.2 |
| Government gross fixed capital formation | 2.4 | 2.3 | 2.2 | 2.2 | 2.2 | 2.2 | 2.4 |
| Cyclically-adjusted balance | -0.4 | -1.0 | -1.1 | -1.4 | -1.5 | -1.9 | -1.9 |
| Cyclically-adjusted primary balance | 4.4 | 3.6 | 3.0 | 2.6 | 2.5 | 2.0 | 1.8 |
| Structural balance [b] | -0.9 | -1.2 | -1.0 | -1.6 | -1.6 | -2.0 | -2.1 |
| Structural primary balance | 3.9 | 3.4 | 3.2 | 2.3 | 2.4 | 1.9 | 1.6 |

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 2017 DBP and Commission 2017 winter forecast*

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

[19] See "*Country Report Italy 2017 - Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*".

**Structural reforms**

In its Communication of 13 January 2015, the Commission strengthened the link between effective implementation of structural reforms, investment, and fiscal responsibility in support of jobs and growth, within the existing rules of the SGP. In both the 2016 National Reform Programme[20] and the revised "*Cronoprogramma*" of the "*Nota di Aggiornamento del DEF*"[21] the Italian government confirmed its commitment to keep momentum in the adoption and implementation of an ambitious structural reform plan covering a number of areas such as public administration and judicial system, competitiveness and product markets, labour market and education, as well as taxation.

In December 2016, the fourth specific monitoring report under the macroeconomic imbalance procedure (MIP)[22] reviewed the latest developments and policy initiatives relevant for correcting Italy's macroeconomic imbalances, i.e. high government debt and weak competitiveness in a context of subdued productivity growth, and for supporting adjustment processes (particularly in the labour market and banking system), in line with the 2016 country specific recommendations (CSRs).

The 2017 Country Report acknowledges that Italy has made some progress in tackling the 2016 CSRs but also that the reform momentum has markedly slowed down and that significant challenges persist in diverse reform areas. Overall, Italy's macroeconomic imbalances remain large and have not started to significantly correct[23]. As a result, the report concludes that Italy still displays excessive imbalances[24].

In detail, the report highlights that the adoption of new (sometimes long-awaited) reforms has significantly slowed down, although the implementation of those already adopted has broadly continued. Regarding public finances, the government adopted a comprehensive reform of the budgetary process that makes spending reviews a permanent feature of it, although its implementation was *de facto* postponed to the 2018 budget. Moreover, progress in the field of taxation is very limited, 2016 privatisation targets were not met and provisions in the 2017 budget partially reverse the 2012 pension reform.

Concerning the labour market, the implementation of the reform of active labour market policies has started but will have to overcome several obstacles, and the planned measures to foster female labour market participation appear insufficient. An important enabling law on the setup of a comprehensive anti-poverty scheme is under parliamentary discussion.

Regarding the banking sector, the implementation of the various corporate governance reforms is broadly on track. Some measures have also been taken to foster market-based mechanisms supported by private resources to reduce the non-performing loan burden, and some banks are preparing to use the new tools in the coming weeks. However, a more comprehensive and ambitious non-performing loans reduction strategy may be needed.

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[20] https://ec.europa.eu/info/files/2016-national-reform-programme-italy_en

[21] http://www.mef.gov.it/documenti-pubblicazioni/doc-finanza-pubblica/

[22] Forthcoming

[23] See "*Country Report Italy 2017 - Including an In-Depth Review on the prevention and correction of macroeconomic imbalances*".

[24] See Commission Communication "*2017 European Semester: Assessment of progress on structural reforms, prevention and correction of macroeconomic imbalances, and results of in-depth reviews under Regulation (EU) No 1176/2016*".

As regards the business environment and firms' competitiveness, the implementation of the 2015-2017 Simplification Agenda is on track and a range of measures has been taken to support firms' investment, innovation and internationalisation. However, the reduction in the allowance for corporate equity envisaged in the 2017 budget is not line with the goal of reducing firms' reliance on debt financing. No further progress has been made in the field of strengthening competition: the 2015 annual competition law still awaits final parliamentary ratification.

Finally, to strengthen institutional capacity, the government is implementing an ambitious public administration reform, which was however partly reversed by a recent Constitutional Court ruling, and an all-encompassing constitutional reform was rejected in a referendum held on 4 December 2016. Past reforms of civil justice, including with the aim to contain high abusive litigation, are only very timidly starting to show results, and the disposition time for civil and commercial litigious cases remains the longest in the Union at all instances. An important enabling law on the reform of civil proceedings is still under parliamentary discussion. Last but not least, the long-overdue reform of the statute of limitations to step up the fight against corruption is still pending, and the corruption prevention framework, including on whistle-blowers' protection, remain fragmented.

## 4.2. Medium-term budgetary position

*The assessment of Italy's compliance with the preventive arm in 2016 crucially hinges on the Commission decision to grant a temporary deviation of 0.75% of GDP from the adjustment towards the MTO for investment and structural reforms. However, one necessary condition to grant that allowance in full, i.e. the resumption of the adjustment path towards the MTO in 2017, does not appear to be fulfilled based on the Commission forecast. As a result, Italy is at risk of non-compliance with the required preventive arm adjustment in both 2016 and 2017.*

### Headline, structural balance and adjustment towards the MTO

Over the period 2015-2017, Italy benefitted from significant flexibility compared to the benchmark structural efforts required by the preventive arm of the SGP in light of the Communication "*Making the Best Use of the Flexibility within the Existing Rules of the Stability and Growth Pact*"[25]. Those elements of flexibility compared to the standard matrix of requirements are summarised in Table 4 below and are discussed in turn for each year.

**For 2015**, Italy was recommended to deliver a structural adjustment of at least 0.25% of GDP to make sufficient progress towards its MTO, in consideration of its cyclical conditions. Member States assessed to be in "very bad times" (as it was the case for Italy based on the Commission 2015 spring forecast[26]) and with a general government debt-to-GDP ratio above 60% are recommended to deliver a structural adjustment of 0.25% of GDP instead of 0.5%. Moreover, Italy was provisionally assessed to be eligible for an allowance of 0.03% of GDP for 2015, corresponding to the additional refugee-related expenditure incurred in that year compared to 2014[27]. That amount was confirmed by outturn data. Based on the Commission 2017 winter forecast and notified data in April 2016, Italy's structural balance is projected to have improved by 0.1 percentage points of GDP in 2015. Therefore, both for 2015 alone and

[25] See Commission Communication COM(2015) 12 final/2, 13.1.2015.
[26] See Commission Opinion C(2015) 8105 final.
[27] See "*Assessment of the 2016 Stability Programme for Italy (Note prepared by DG ECFIN staff)*" at http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2016/12_it_scp_en.pdf

for 2014 and 2015 taken together, the Commission forecast suggests some deviation from the structural balance pillar (a gap of 0.1 percentage points of GDP), while the expenditure benchmark points to compliance. Overall, Italy is forecast to have been broadly compliant with the preventive arm of the SGP in 2015, a conclusion that is further confirmed after considering the temporary allowance of 0.03% of GDP for refugee-related expenditure.

**For 2016**, Italy was recommended to limit its temporary deviation from the required structural adjustment of at least 0.5% of GDP to a maximum of 0.75% of GDP in light of the flexibility granted under the structural reform and investment clauses[28]. Specifically, Italy benefitted from:

(i) consideration of its cyclical conditions, as Member States assessed to be in “bad times" (as it was the case for Italy based on the Commission 2015 spring forecast[29]) and with a general government debt-to-GDP ratio above 60% are recommended to deliver a structural adjustment of 0.5% of GDP in lieu of an adjustment of 0.6% of GDP or more.

(ii) a temporary allowance requested by Italy’s 2015 Stability Programme and 2016 Draft Budgetary Plan in view of the planned implementation of major structural reforms and of national expenditures on projects co-financed by the Union. Overall, Italy was provisionally assessed[30] to be eligible for the maximum allowance of 0.75% of GDP for 2016, of which 0.5% of GDP under the structural reform clause and 0.25% under the investment clause. That allowance was granted in two steps: 0.4% of GDP was granted unconditionally under the structural reform clause in July 2015; and a further 0.35% of GDP (of which 0.1% of GDP under the structural reform clause and 0.25% of GDP under the investment clause) was granted in July 2016, conditionally on: (i) the existence of credible plans for the resumption of the adjustment path towards the MTO as of 2017; (ii) the effective use of a deviation from the adjustment path for the purpose of increasing investments; and (iii) progress with the structural reform agenda, taking into account the Council recommendations.

(iii) a temporary allowance related to the budgetary impact of additional security costs related to the threat of terrorism and of the exceptional inflow of refugees, which the authorities asked to consider as an "unusual event" as defined in Article 5(1) and Article 6(3) of Regulation (EC) No 1466/97. Specifically, Italy requested a temporary deviation from the adjustment path towards the MTO of 0.2% of GDP in 2016 in relation to exceptional security measures. Italy was provisionally assessed[31] to be eligible for an allowance of 0.06% of GDP for the additional expenditure directly linked to security projected for 2016, to be taken into account in the overall assessment of compliance with the preventive arm in 2016 to be made *ex-post* in 2017. As regards the impact of the exceptional inflow of refugees, Italy requested a temporary deviation from the adjustment path towards the MTO of 0.2% of GDP in 2016, corresponding to the overall annual cost (net of Union contributions) incurred in relation to the refugee crisis. Italy was provisionally assessed to be eligible for an allowance of 0.04% of GDP for 2016, corresponding to the additional refugee-related expenditure incurred in that

[28] For a full chronological account of the flexibility granted in 2016, please refer to "*Assessment of the 2016 Stability Programme for Italy (Note prepared by DG ECFIN staff)*" (pp. 6-7), at: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2016/12_it_scp_en.pdf

[29] See Commission Opinion C(2015) 8105 final.

[30] See " *Assessment of the 2016 Stability Programme for Italy (Note prepared by DG ECFIN staff)*", at: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/20_scps/2016/12_it_scp_en.pdf

[31] *Ibidem*

year, to be taken into account in the overall assessment of compliance with the preventive arm in 2016 to be made *ex-post* in 2017.

Based on the Commission 2017 winter forecast, Italy's structural balance is projected to have deteriorated by 0.6 percentage points of GDP in 2016. Therefore, with respect to the allowed structural deterioration of 0.25% of GDP (after correcting the preventive arm requirement for the entire 0.75% of GDP allowance under the flexibility clauses), the Commission forecast points to some deviation from the expenditure benchmark net of one-offs (a gap of -0.1 percentage points of GDP) and to a risk of some deviation (a gap of -0.4 percentage point of GDP) from the structural balance pillar over one year in 2016. Over 2015 and 2016 taken together, taking into account the corrected preventive arm requirement, the Commission forecast points to compliance with the expenditure benchmark net of one-offs and to some deviation (a gap of -0.2 percentage points of GDP) from the structural balance pillar. The discrepancy between the two indicators is mainly due to the fact that the expenditure benchmark benefits in 2016 from the use of a GDP deflator based also on the Commission 2015 spring forecast, which was inflated by a VAT hike already legislated as a safeguard clause but subsequently repealed. Following an overall assessment, there is a risk of some deviation from the adjustment path towards the MTO in 2016, provided that the previously described allowance of 0.75% of GDP is confirmed. That conclusion is confirmed after subtracting from the requirement in 2016 the additional budgetary impact of the exceptional inflow of refugees (0.05%) and of security costs (0.06%).

**For 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. That recommendation is the adjustment prescribed by the preventive arm matrix for Member States with a general government debt ratio above 60% of GDP, growth above potential, and experiencing "normal economic times".

For 2017, the authorities' budgetary projections comprise exceptional expenditure amounting to about 0.4% of GDP, half of which in relation to the ongoing refugee crisis and the related need to set up a comprehensive policy of migration management, and the rest due to a preventive investment plan for the protection of the national territory against seismic risks. As regards the exceptional inflow of refugees, its projected net budgetary impact is confirmed by the latest report on relevant factors[32] at 0.16% of GDP in 2015, 0.21% of GDP in 2016 and 0.22% of GDP for 2017. In relation to that element, Italy's 2017 Draft Budgetary Plan requested a temporary deviation from the adjustment path towards the MTO of 0.16% of GDP in 2017, corresponding to the difference between the overall costs incurred in relation to the refugee crisis in 2017 and the average over 2011-2013 (0.06% of GDP), before the crisis intensified. It in fact argued that the spending on migrants cannot be evaluated only in terms of annual increased expenditure due to the recent emergency but should take into account the overall effort made by Italy compared to the pre-emergency situation. The Commission Opinion on Italy's 2017 Draft Budgetary Plan[33] recalled the European Council conclusions[34] acknowledging "*the significant contribution, including of financial nature, made by the frontline Member States in recent years*" and indicated that the Commission would stand

[32] See "*Relevant Factors Influencing Debt Developments in Italy*", Ministry of Economy and Finance, February 2017: www.mef.gov.it/inevidenza/documenti/Italy_Relevant_Factors_February_2017.pdf

[33] See Commission Opinion C(2016) 8009 final.

[34] European Council conclusions, 20-21 October 2016, at: www.consilium.europa.eu/en/press/press-releases/2016/10/21-european-council-conclusions/

ready to consider an additional allowance for 2017 corresponding to the entire cost borne in 2017, net of the allowance already granted in 2015 and 2016. Given the structural nature of the migration-related costs and the need to avoid double-counting, that additional allowance could be granted only once. As regards earthquake-related expenditures, the Commission Opinion acknowledged that Italy has been facing unprecedented seismic activity in the recent months and that the integrated nature of emergency management and preventive investment measures for the protection of the national territory against seismic risks make the boundary between the two less clear-cut. The Opinion concluded that the Commission would stand ready to consider a broader approach for the treatment of earthquake-related expenditure and regard the 0.18% of GDP earmarked for the preventive plan in 2017, according to the Italian authorities[35], eligible for the "unusual event clause" once the necessary ex-ante and ex-post data are provided by the Italian authorities. In Italy's report on relevant factors (see section 4.5) the authorities indicate that the tax incentives for seismic proof prevention and rehabilitation measures, targeting mainly private housing, amount to EUR 2 billion[36]. Moreover, the authorities indicate that the 2017-2019 Budget established: (i) a special multiannual "investment fund", a share of which, estimated at EUR 0.5 billion, will be allocated in 2017 to securing schools and public offices and taking action to prevent anti-seismic risk and hydrogeological instability; and (ii) additional margins, estimated at EUR 0.5 billion, for regions and municipalities to invest, some of which are specifically earmarked for schools. Given the high uncertainty on the actual impact of the EUR 2 billion tax incentives on the anti-seismic properties of buildings, this should be monitored in view of the ex-post assessment to be provided to the Commission in order for the amount of provisionally granted flexibility to be confirmed.

Based on the Commission 2017 winter forecast, Italy's structural balance is projected to further deteriorate by 0.4 percentage points of GDP in 2017, reaching a level of -2.0% of GDP. Therefore, the Commission forecast points to a risk of a significant deviation from both the expenditure benchmark net of one-offs (a gap of -0.9 percentage point of GDP) and the structural balance pillar (a gap of -1.0 percentage point of GDP) over one year in 2017. Over 2016 and 2017 taken together, there is a risk of a significant deviation from both the expenditure benchmark net of one-offs (a gap of -0.5 percentage points of GDP per year, on average) and the structural balance pillar (a gap of -0.7 percentage points of GDP per year, on average). The reading of the fiscal effort based on the expenditure benchmark pillar benefits from a slightly higher GDP deflator (compared with that underlying the current estimate for the structural balance) also based on the Commission 2016 spring forecast, which included part of a later-repealed VAT hike. In turn, the reading of the fiscal effort based on the structural balance pillar is positively impacted by slightly higher potential GDP growth (compared with the medium-term potential GDP growth used in the expenditure benchmark pillar), but negatively impacted by a revenue shortfall (as revenue developments are estimated to have fallen short of what could be expected based on standard elasticities). Taking these factors into account, an overall assessment based on the Commission 2017

[35] See "*Il Ministro Padoan risponde alla Commissione europea sul DPB 2017*", at: www.tesoro.it/opencms754/opencms/inevidenza/documenti/Lettera_risposta_del_25_ottobre_2016_-_Dombrovskis_e_Moscovici.pdf

[36] They include a 50% deduction for maintenance costs aimed at securing buildings used for primary residence, secondary dwellings, condos and productive activities in seismic risk areas, which, if the interventions entail a reduction of seismic risk with the transition to a lower-risk class, could be raised up to 85%.

winter forecast points to a risk of a significant deviation from the recommended adjustment towards the MTO in 2017.

That conclusion is confirmed after considering the aforementioned temporary allowance of 0.32% of GDP[37] in relation to the projected budgetary impact of the inflow of refugees and of the preventive investment plan for the protection of the national territory against seismic risks in 2017. In that case, in fact, the Commission forecast would still point to a risk of a significant deviation from both the expenditure benchmark net of one-offs (a gap of -0.6 percentage points of GDP) and the structural balance pillar (a gap of -0.7 percentage points of GDP) over one year in 2017. Over 2016 and 2017 taken together, there is a risk of a significant deviation from both the expenditure benchmark pillar net of one-offs (a gap of -0.3 percentage points of GDP per year, on average) and the structural balance pillar (a gap of -0.5 percentage points of GDP per year, on average). Overall, there is a risk of a significant deviation from the adjustment path towards the MTO in 2017.

In light of the risk of significant deviation in 2017 based on the Commission forecast, Italy's compliance with the preventive arm in 2016 currently does not appear to be ensured, to the extent that only part of the allowance provisionally granted for 2016 can be considered at this stage. However, compliance with the SGP can only be definitively assessed in spring, on the basis of the follow-up to the commitments made by the Italian authorities to deliver at the latest in April further structural measures amounting to 0.2% of GDP for 2017 – since the assessment of these measures is likely to affect whether Italy can be deemed to have resumed the adjustment path towards the MTO in 2017. This was one of the key conditions for the 0.35% of GDP allowance that had been granted for 2016. Should this condition be deemed to be met, it would be necessary to also investigate whether the deviation from the adjustment path under the investment clause was effectively used for the purpose of increasing investment. In this regard, based on current information, the Commission forecasts a slight decrease in public investment in 2016, to be confirmed *ex post*. As a result, the eligibility condition – that the level of public investment in the year in which the investment clause is granted should at least be preserved – does not appear to be fulfilled at this stage. A final conclusion will be drawn based on notified data for 2016, as part of the overall assessment.

Without the 0.35% of GDP allowance, the required adjustment would be 0.1% of GDP in 2016[38]. Against this requirement, the Commission forecast would point to a risk of some deviation from the expenditure benchmark net of one-offs (a gap of -0.5 percentage points of GDP) and to a risk of a significant deviation (a gap of -0.7 percentage points of GDP) from the structural balance pillar over one year in 2016. Over 2015 and 2016 taken together, the Commission forecast would point to compliance with the expenditure benchmark net of one-offs and to a risk of a significant deviation (a gap of -0.4 percentage points of GDP per year, on average) from the structural balance pillar. Following an overall assessment along the same lines as above, there is a risk of significant deviation from the adjustment path towards the MTO in 2016. That conclusion would not change after subtracting from the requirement in 2016 the additional budgetary impact of the exceptional inflow of refugees (0.05%) and of security costs (0.06%). Italy is thus forecast to be at risk of significant deviation from the

[37] All the figures reported include also the additional 0.11% of GDP allowance provisionally granted for 2016.

[38] It includes only the allowance of 0.4% of GDP under the structural reform clause that was not made explicitly conditional on Italy's resumption of the adjustment path towards the MTO in 2017, unlike the residual 0.35% granted under the investment clause (0.25%) and structural reform clause (0.1%).

preventive arm requirements regarding progress towards the MTO in both 2016 and 2017, which puts at risk Italy's capacity to bring its debt dynamics on a sustainable path.

**Public investment**

As regards public investment, Italy's government gross fixed capital formation averaged at around 3% of GDP over 1999-2010 but the need to adjust quickly to respond to the sovereign debt crisis led to a substantial reduction in public investment to 2.3% of GDP over 2011-2014. In 2015, public investment bottomed out, reaching 2.2% of GDP (+0.2% year-on-year in nominal terms). The Commission expects it to have further decreased in nominal terms in 2016, by 1.8%, before marginally increasing again in 2017, by 1.7%. As a result, public investment is expected to remain stable as a share of GDP, at 2.2%, over 2015-2017. In summary, developments in public investments, given their broad decline over time, do not appear to represent a mitigating factor justifying Italy's lack of compliance with the debt rule.

**Table 4: Summary of flexibility**

| **Flexibility granted to Italy under the SGP (% of GDP)** | **2015** | **2016** | **2017** |
|---|---|---|---|
| Cyclical conditions | "very bad times" | "bad times" | "normal times" |
| Benchmark matrix requirement (taking into account cyclical conditions and debt level) | 0.25% | 0.5% | 0.6% |
| Flexibility granted "ex-ante" | 0.03% | 0.86% | 0.32% |
| *of which for flexibility clauses:* | - | • 0.5% for the structural reform clause<br>• 0.25% for the investment clause | - |
| *of which for unusual events:* | • 0.03% for the refugee clause **(confirmed ex-post)** | • 0.05% for the refugee clause<br>• 0.06% for the security costs | • 0.18% for earthquake-related costs<br>• 0.14% for the refugee clause |
| "Corrected" matrix requirement after flexibility clauses as per CSR1 | 0.25% | -0.25% | 0.60% |
| Required structural adjustment after flexibility and unusual event clauses | 0.22% | -0.36% | 0.28% |
| Structural adjustment carried out by Italy (2017 winter forecast) | 0.2% | -0.6% | -0.4% |

## 4.3. Medium-term government debt position

*The Italian debt remains a major source of vulnerability over the medium term, and recently adopted measures are not in line with the full implementation of past pensions reforms that would be needed, together with the other structural reforms fostering potential growth in the medium/long term and further fiscal adjustment, to enhance debt sustainability.*

After reaching the already very high level of 132.3% of GDP in 2015 and despite a projected gradual recovery, Italy's debt ratio is set in the Commission 2017 winter forecast to have kept on increasing in 2016 (to 132.8%) and to peak at 133.3% in 2017, before stabilising in 2018. This is mainly due to the expansionary fiscal policy pursued by the government in 2016 and 2017, as a result of which Italy's structural balance is projected to deteriorate from -1.0% of potential GDP in 2015 to -2.5% in 2018 (under a no-policy change assumption), i.e. well below the minimum benchmark that should ensure a safety margin against the risk that Italy breaches the 3% deficit threshold. The government projections are slightly more optimistic, as the 2017 Draft Budgetary Plan projects the debt-to-GDP ratio to start declining from 2017, to 132.6%. That declining path is expected to accelerate over the programme period thanks to

ambitious fiscal consolidation targets as of 2018 as well as real growth at 1.2% and inflation progressively increasing towards 2%.

In the short-term, Italy remains vulnerable to any sudden increase in financial market risk aversion due to its high level of government debt and low potential growth. Moreover, Italy's structural primary surplus of 1.3% of GDP forecast by the Commission for 2018 (down from 3.2% in 2015) could increase sustainability risks in the medium term, as a weak fiscal position might raise risk premia in the future.

Italy's pension expenditure as a share of GDP has experienced a marked upward level shift as a result of the crisis and the related fall in nominal GDP[39] and is now the second highest in the EU/OECD after Greece. On the positive side, however, implicit liabilities arising from population ageing have been curbed thanks in part to the 2012 Fornero Reform, so that Italy scores relatively well in terms of long-term sustainability risks despite the high current level of pension expenditure. Specifically, based on the Commission 2017 winter forecast, Italy's structural primary surplus forecast for 2018 (based on a no-policy change assumption) should improve by around 0.4 percentage points[40] to keep the debt-to-GDP ratio stable over the long term, including the cost of ageing. However, it should be noted that the 2017 Budget contains measures that partially reverse the 2012 Fornero Reform, slightly increasing pension expenditure over the medium term, which the mentioned long-term sustainability indicator did not yet include. Moreover, achieving a debt ratio of 60% of GDP by 2031 would require a significant fiscal adjustment (in the order of 6.6 percentage points of GDP over 2019-2023[41]). In that context, further fiscal adjustment and forceful implementation of structural reforms to foster potential growth in the medium/long term remains crucial to achieve a satisfactory debt reduction path.

The 2017 Draft Budgetary Plan confirms an underachievement of the ambitious privatisation plan of the government. In fact, after the 0.4% of GDP privatisation proceeds recorded in 2015, only 0.1% of GDP is projected for 2016 in lieu of the 0.5% planned in the 2016 Stability Programme. That state of affairs is mainly due to delays in important privatisation projects, such as the one involving the State-owned railway company *Ferrovie dello Stato* originally planned for 2016. The main transaction carried out in 2016 regarded the air traffic control company ENAV (for EUR 836 million or 0.05% of GDP). For 2017, the target of 0.5% of GDP is confirmed as the government intends to sell a further stake (around 30%) in the postal operator (*Poste Italiane*) and launch an initial public offering for *Ferrovie dello Stato*. The government is also committed to extract more value form the management of real estate assets and continue with their sale: in 2015, the sale of general government real assets generated proceeds of around EUR 1 billion and similar amounts are expected in 2016 and 2017. However, there are clear downside risks affecting all those projections.

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[39] The upward level shift was close to 2 percentage points in 2015 between the projections for public pension spending reported, respectively in the *2009 Ageing Report* and the *2015 Ageing Report* of the European Commission.

[40] Source: "*2016 Fiscal Sustainability Report*". An S2 indicator at 0.4 denotes "low risk".

[41] *Ibidem*. An S1 indicator at 6.6 denotes "high risk".

### 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 0.4% of GDP at end-2015 (out of a total of 2.2% of GDP), significantly down from 1.4% of GDP at end-2014. Direct capital support to financial institutions (with an impact on the government debt) was around 0.1% of GDP at the end of 2015. An additional risk for public finances is related to the possible cost borne by the government for the recapitalisation of weak Italian banks and compensation of retail junior bondholders, as well as the issuance of guarantees for non-performing loans securitisation vehicles. For instance, in 2017, both the deficit and debt figures could be revised upwards following the EUR 20 billion (or 1.2 % of GDP) banking support package earmarked by the government in December 2016.

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 2016 Draft Budgetary Plan[42] and 2017 Draft Budgetary Plan[43] pointed to a risk of non-compliance with the provisions of the SGP in 2016-2017 and invited the authorities to take the necessary measures within the national budgetary process to ensure that the 2016 and 2017 Budgets would be compliant with the SGP. However, despite the flagged risk of non-compliance with the SGP in 2016 and 2017, the 2017 Budget was passed on 7 December 2016 without major changes compared to the Draft Budgetary Plan.

### 4.5. Other factors put forward by the Member State

On 1 February 2017, the Italian authorities transmitted documents concerning relevant factors in accordance with Article 2(3) of Regulation (EC) No 1467/97[44]. The analysis presented in the other sections of this report covers most of the factors put forward by the authorities.

The first relevant factor discussed in the report is the persistence of deflationary pressures and weak nominal GDP growth, likely to extend in the short to medium-term, thereby hindering a significant reduction in the public debt ratio. Looking forward, according to the Italian authorities, worldwide excess capacity and strong competitive pressures are set to still bear down on prices. Oil and commodity prices have recovered some ground, but euro area growth remains low by historical standards, the impact of euro exchange rate depreciation is tapering off, and protectionist risks for European exports are looming. In that economic environment, restrictive fiscal policy stance may be self-defeating, if conducted through cuts in growth-enhancing productive investment expenditure, which is further aggravated by still unsatisfactory coordination of fiscal policies among euro area Member States. This applies in particular to the case of Italy, where unprecedented negative cyclical conditions over 2008-

[42] Commission Opinion C(2015) 8105 final, 16.11.2015, on the Draft Budgetary Plan of Italy.
[43] Commission Opinion C(2016) 8009 final, 16.11.2016, on the Draft Budgetary Plan of Italy.
[44] See "*Relevant Factors Influencing Debt Developments in Italy*", Ministry of Economy and Finance, February 2017, at: www.mef.gov.it/inevidenza/documenti/Italy_Relevant_Factors_February_2017.pdf

2009 and 2011-2014 significantly increased fiscal multipliers, made the necessary adjustment to comply with the debt rule particularly demanding, and aggravated the Italian debt imbalance through a largely negative "snowball" effect, amplified by low inflation. Given that outlook, the government considered appropriate to aim for gradual deficit reduction in 2017 while targeting faster consolidation in 2018-2020.

The second key factor highlighted by the Italian authorities is the gross underestimation of Italy’s output gap based on the "commonly agreed methodology". In their view, the Commission's estimates that Italy’s output gap will shrink to a mere 0.8 percentage points of GDP in 2017 and virtually close in 2018 are not in line with economic intuition, given Italy's sharp output loss compared to 2008, the unemployment rate of 11.6 percent and virtual stability in wages and prices. In that context, the report of the Italian authorities presents alternative output gap estimates, suggesting values hovering around 3 percentage points of GDP in 2017 and, crucially, closing more gradually than suggested by the Commission over the coming years, thereby affecting the required fiscal effort. A more realistic estimate of Italy's output gap is argued to entail Italy's compliance with the preventive arm of the SGP. However, in relation to that issue, improvements have already been made to the commonly agreed methodology, in response to a mandate of the ECOFIN Council[45].

The Italian authorities also stress the ongoing wide-ranging programme of structural reforms aiming to address deeply rooted structural weaknesses and increase growth potential at least in the medium term. The authorities confirm their commitment to carry out an ambitious reform agenda, expected to have a positive impact on economic growth and, therefore, the sustainability of public finances, as discussed also in section 4.1 of this report. The effect of recent reforms 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.

Other mitigating relevant factors reported by the authorities include Italy’s track record of fiscal discipline and the budgetary impact of the exceptional inflow of refugees and of earthquakes. Specifically, the authorities recall that in 2012 Italy managed to exit the excessive deficit procedure as recommended and that, despite the economic contraction, the headline deficit remained within the 3% of GDP Treaty threshold since then. The largest primary surplus in the Union over 2012-2015 is attributed to an ambitious plan of growth-friendly fiscal consolidation, complementing significant reduction in the tax wedge on labour with durable improvements in the efficiency and quality of public expenditure at all levels of government. The authorities also stress that, since 2012, risks related to debt sustainability receded in the short term and remained limited over the medium term, while pension reforms

[45] The April 2016 Amsterdam Informal ECOFIN Council requested that improvements be made to the commonly agreed methodology for the estimation of potential growth and the output gap. In response to that mandate, two concrete decisions were taken in agreement with the Member States in October 2016. First, it was agreed that a revised methodology for the estimation of the non-accelerating wage rate of unemployment would be introduced in the commonly agreed methodology, which was already implemented in the Commission 2016 autumn forecast. Second, in line with the renewed mandate provided by the ECOFIN Council on 11 October 2016, the Economic Policy Committee – Output Gap Working Group worked on a "constrained judgement" approach for cases where the common method was shown to produce counterintuitive output gap results for individual Member States. The Commission staff working document "*Analysis of the draft budgetary plans of Italy*" (SWD(2016) 509 final, 16.11.2016) shows that, in the case of Italy, its compliance status under the SGP is not affected by the use of an alternative “constrained judgement” approach to estimating the output gap. See: https://ec.europa.eu/info/files/staff-working-document-analysis-2017-draft-budgetary-plan-italy_en

adopted over the past 20 years make Italy's debt one of the most sustainable in the Union over the long term. A debt maturity structure among the soundest in the Union also contributes to that.

As regards relevant factor of "unusual events", the Italian authorities' report highlights that, since 2014, Italy has faced an extraordinary influx of refugees and migrants, entailing substantial costs projected at EUR 3.8 billion (or 0.22% of GDP) for 2017. However, if the influx were to sustain the same growth rate as in recent months, expenditure would reach EUR 4.2 billion (or 0.24% of GDP). The difference between the expenditure estimated for 2017 (net of Union contributions) and the one incurred on average in the years 2011-2013, which preceded the current acute phase, is worth up to EUR 3.2 billion (or 0.19% of GDP). Moreover, Italy suffered particularly acute seismic activity in recent months, raising the awareness that systematic risk-mitigation policy is necessary given the human and economic cost of recurrent earthquakes. That situation requires not only appropriate regulations and enforcement but also an additional public expenditure. In addition to one-off expenditures for rescue, assistance and reconstruction amounting to around EUR 3 billion in 2017, the 2017 Budget raised tax incentives for seismic-risk mitigation investments and structural works, targeting mainly private housing. The mechanism envisages a tax allowance that is an increasing function of the seismic risk mitigation category. Additional resources are envisaged for public investment in anti-seismic infrastructure by establishing a special fund targeting schools, public offices and transport infrastructure. Taken together, increased anti-seismic tax incentives and public investment measures are estimated to entail budgetary costs of close to 0.2% of GDP, in addition to the direct costs related to earthquakes, usually classified as *one-offs*.

## 5. CONCLUSIONS

Italy's general government gross debt reached 132.3% of GDP in 2015, well above the 60% of GDP reference value, and Italy did not make sufficient progress towards compliance with the debt reduction benchmark in 2015. Moreover, the Commission forecast does not expect Italy to comply with the debt rule either in 2016 or in 2017, and the gap is particularly large also due to the significant deterioration of Italy's structural balance from -1.0% of potential GDP in 2015 to -2.5% expected in 2018 based 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 also examined the relevant factors.

Macroeconomic conditions, while still unfavourable especially due to low inflation, are projected to have slightly improved as of 2016 and cannot be considered as a mitigating factor in explaining Italy’s lack of fiscal consolidation in 2016 and 2017 and its large gaps with the debt rule, notably in its forward-looking dimension, expected in the coming years.

The assessment of Italy’s compliance with the preventive arm in 2016 crucially hinges upon allowing a temporary deviation from the adjustment path towards the MTO under the investment and structural reforms clause. However, a necessary condition for that assessment, i.e. the resumption of the adjustment path towards the MTO in 2017, does not appear to be fulfilled based on the Commission 2017 winter forecast. On 17 January 2017 the Commission sent a letter informing the Italian government that an additional structural effort of at least 0.2% of GDP would be needed to reduce the gap to broad compliance with the preventive

arm in 2017. Letters submitted and made public by the Italian government on 1 and 7 February 2017 contain a series of commitments to be adopted at the latest in April 2017 in order to achieve an additional structural effort of at least 0.2% of GDP in 2017. The Commission takes positive note of those political commitments. However, the first letter did not provide sufficient details about the actual measures that the government intends to adopt to allow their incorporation in the Commission 2017 winter forecast, so that they will be taken into account as soon as the commitments made in the aforementioned letters are enacted. As a result, based on the Commission 2017 winter forecast Italy is at risk of non-compliance with the required preventive arm adjustment in both 2016 and 2017.

Moreover, since the adoption of the 2016 Country Specific Recommendations, domestic developments have slowed down the adoption of new reforms in Italy. Pushing an ambitious structural reforms agenda could have positively impacted on Italy's medium-term growth prospects and in turn enhance the sustainability of the country's public finances.

Finally, the Italian debt remains a major source of vulnerability over the medium term, and recently adopted measures are not in line with the full and forceful implementation of past pensions reforms that would be needed, together with the other structural reforms fostering potential growth in the medium/long term and further fiscal adjustment, to enhance debt sustainability. An additional risk for public finances is related to the possible cost borne by the government for the recapitalisation of weak Italian banks and compensation of retail junior bondholders, as well as the issuance of guarantees for non-performing loans securitisation vehicles.

Overall, the analysis presented in this report includes the assessment of all relevant factors and notably: (i) the currently unfavourable but gradually improving macroeconomic conditions, including low inflation; (ii) the risk of non-compliance with the required adjustment towards the MTO in both 2016 and 2017 based on the Commission 2017 winter forecast; and (iii) the observed marked slowdown in the implementation of growth-enhancing structural reforms in line with the authorities' commitment. Unless the additional structural measures, worth at least 0.2% of GDP, that the government committed to adopt at the latest in April 2017 are credibly enacted by that time in order to reduce the gap to broad compliance with the preventive arm in 2017 (and thus in 2016), the current analysis suggests that the debt criterion as defined in the Treaty and in Regulation (EC) No 1467/1997 should be considered as currently not complied with. However, a decision on whether to recommend opening an EDP would only be taken on the basis of the Commission 2017 spring forecast, taking into account outturn data for 2016 and the implementation of the fiscal commitments made by the Italian authorities in February 2017.