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Country Report Italy 2015 including an In-Depth Review on the prevention and correction of macroeconomic imbalances

{COM(2015) 85 final}

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EXECUTIVE SUMMARY

After a long contraction, growth is expected to turn positive in 2015 but remains well below the EU average and the public debt-to-GDP ratio is set to increase further. Inflation is projected to turn negative due to the fall in oil prices. Unemployment remains historically high and domestic demand is weak. Increasing global demand, a lower euro and falling oil prices could support economic growth in the future. Current account surplus is expected to strengthen slightly. The government deficit is set to reach 3 % of GDP in 2014 and to decrease in 2015 and 2016. Italy's public debt-to-GDP ratio is expected to peak in 2015 at 133 % of GDP based on the Commission 2015 winter forecast. The current low growth and inflation outlook pose a challenge to its reduction.

In March 2014, the Commission concluded that Italy was experiencing excessive macroeconomic imbalances requiring specific monitoring and strong policy action. This Country Report assesses Italy's economy against the background of the Commission's Annual Growth Survey which recommends three main pillars for the EU's economic and social policy in 2015: investment, structural reforms, and fiscal responsibility. In line with the Investment Plan for Europe, it also explores ways to maximise the impact of public resources and unlock private investment. Finally, it assesses Italy in the light of the findings of the Alert Mechanism Report published on 28 November 2014, in which the Commission found it useful to examine further the persistence of imbalances or their unwinding. The main findings of the in-depth review contained in this Country Report are:

- **Persistently low productivity growth continues to perpetuate Italy's macroeconomic imbalances, namely the very high level of public debt and the weak external competitiveness**. Italy's real GDP has fallen to the early 2000s levels, while the euro area GDP is more than 10 % higher. The poor performance of total factor productivity accounts for most of the difference and is at the root of Italy's declining competitiveness, while the low growth weighs on the sustainability of the public debt. Structural reforms — implemented and foreseen — should reduce public debt-to-GDP ratio and improve competitiveness through their positive impact on productivity and GDP. Strong commitment to these reforms is crucial, also in the light of Italy's past record marked by important implementation gaps.

- **The very high government debt remains a heavy burden for the Italian economy and a major source of vulnerability, especially in a context of protracted weak growth**. The fiscal adjustment and easing in market conditions have helped avert immediate sustainability risks. Past pension reforms should have a beneficial effect in the medium-to-long-term. However, public debt projections show that strong growth-friendly consolidation, sustained nominal growth and ambitious structural reforms are key to a substantial debt reduction.

- **Italy's competitiveness has not improved yet: sluggish productivity growth continues to push up unit labour costs, while non-cost factors remain unfavourable**. Italy's export competitiveness remains weak. Unit labour costs have been rising relative to trade partners, driven by the slow productivity growth. Italy's product specialisation and high share of small firms with a weak competitive position in international markets further hamper its competitiveness.

- **The protracted crisis has exposed the risks inherent in the Italian banking sector's close relationship with the domestic corporate sector and the sovereign**. Corporate non-performing loan ratio has increased to just over 27 %. Bank credit to corporates continues to contract, driven by weak demand and tight supply to SMEs with a high credit risk. Italy has taken several measures to reform the banking sector and diversify firms' funding sources. The banking sector's exposure to domestic government bonds is likely to remain high, and so its vulnerability to unfavourable market developments in the Italian sovereign debt market.

- **Investment was particularly hard hit during the crisis aggravating the long-run deterioration in its quality**. Since the crisis, productive investment in Italy has declined significantly and it is now 1.5% below the EU average as a share of GDP. The decline in the

amount of investment is compounded by a long-term deterioration in its quality.

- **The Italian economy's size makes it a potentially important source of spillovers to other Member States while its recovery depends on propitious external conditions**. The trade, financial and bank funding links harbour the potential to cause spillovers in other EU countries. At the same time, external demand and the inflation environment are paramount to Italy's export-led recovery, the debt-to-GDP reduction effort and to recovering competitiveness.

The Country Report also analyses other macroeconomic and structural issues and the main findings are:

- **Weaknesses in public administration and justice system hamper the quality of the business environment and reduce the capacity to implement reforms effectively.** Despite marginal improvements, inefficiencies in the public administration and justice remain. According to several national and international sources, corruption is high.

- **Lack of competition in product markets, infrastructure gaps and low spending on research on development, particularly in the business sector, are hampering productivity growth.** Restrictions on competition and infrastructure bottlenecks in important sectors of the economy remain present, while a very high number of inefficient companies owned by local authorities weigh on the country's public finances and economic performance. Investment in research and innovation is low.

- **Labour market participation remains low and active labour market policies are weak.** The participation of women, although growing, remains among the lowest in the EU. Youth unemployment has increased dramatically with the crisis. Employment services do not match the supply of labour to demand satisfactorily.

- **The Italian education system continues to suffer from long-standing problems.** The early school-leaving rate is well above the EU average and school education in Italy produces mixed results in terms of skills attainment.

- **The taxation system hinders economic efficiency.** The tax burden on labour has been reduced considerably in the past year but remains high. Tax compliance is low and time-consuming, posing risks to the level playing field in the market and to the fairness of burden sharing.

- **Social and regional disparities are growing wider**. Poverty and social exclusion have greatly increased while the social protection system is fragmented and fails to address these challenges properly. The southern regions have suffered a sharper fall in employment due to their long-standing structural weaknesses.

Overall, Italy has made some progress in addressing the 2014 recommendations. A significant shift of the tax burden away from labour has been undertaken. The ongoing reform of the labour market has a potential to address long-standing rigidities and improve the allocation of labour resources. Some progress has been made to improve the education system as well as the governance and resilience of the banking sector. Initial steps have been taken to streamline institutions and administration. A draft law for competition has been adopted by the government in February 2015. However, progress has been much more limited, and sometimes delayed, in several areas. The spending review is not yet part of regular budgeting procedures, and the privatisation programme also incurred delays in 2014. Only limited progress has been made in addressing corruption and infrastructure bottlenecks.

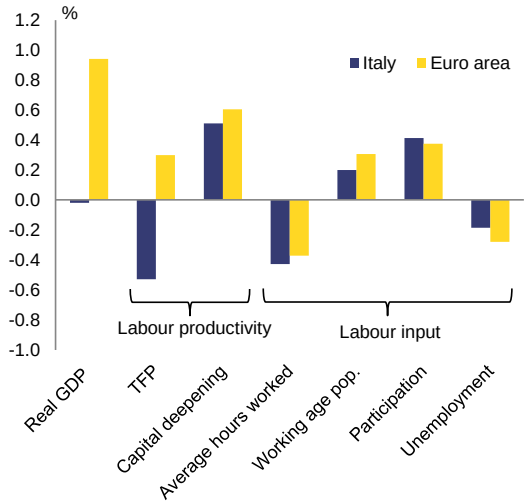
The Country Report shows the policy challenges stemming from the analysis of macroeconomic imbalances. Italy's main challenges regard growth-friendly fiscal consolidation and the implementation of structural reforms to improve productivity growth. Other challenges concern infrastructure bottlenecks, the efficiency of the tax system and the efficiency of the public administration, including justice.

1. SCENE SETTER: ECONOMIC SITUATION AND OUTLOOK

Macroeconomic developments

Italy's real GDP is back to levels seen at the start of this century, given also the sluggish productivity performance. This stands in sharp contrast with the euro area GDP, which is more than 10 % higher than its early 2000 levels. Breaking down Italy's GDP growth between 2001 and 2013, the poor performance of total factor productivity (TFP) accounts for most of the difference (Graph 1.1), whereas the contributions of the other components have been broadly in line with those in the euro area. As the crisis hit, not only did Italy's GDP contract significantly more than the euro area average, but Italy's potential output also declined. An ageing population and weak labour market participation have also contributed negatively to potential growth. In addition, the needed government's fiscal consolidation effort combined with private sector deleveraging has had a detrimental impact on capital accumulation.

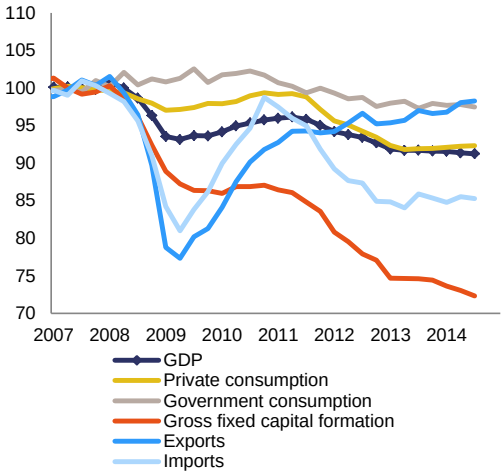
Graph 1.1: **Growth accounting, 2001-13**



Source: European Commission

The Italian economy is still struggling to come out of recession. In the first three quarters of 2014, the Italian economy underperformed the euro area and it contracted further by 0.4 % year-on-year. While private consumption has been stabilising since mid-2013, the saving rate has increased as waning inflation and new income support measures sustain real disposable income. Investment – both in equipment and construction – contracted substantially over the course of the first nine months of 2014, reflecting uncertain demand prospects as well as tight financing conditions. Exports have continued to sustain GDP growth, albeit only moderately (Graph 1.2).

Graph 1.2: **GDP and its components**



Source: ISTAT

Financing conditions remain tight, although they gradually loosened over the course of 2014. Following completion of the Single Supervisory Mechanism's comprehensive assessment of euro area banks, overall credit supply tightness has decreased. Bank lending to Italy's corporate sector, and small firms in particular, continued to contract by 2.3 % year-on-year in December 2014, but the contraction has slowed in recent months. However, small firms continue to face funding constraints due to high risk premiums. Credit demand remains weak due to subdued investment prospects related to economic uncertainty and spare capacity, firms' need to deleverage, and increased bond issuance by medium-sized and large firms (see Section 2.3). The cost of credit has been declining further for both households and firms, driven by lower policy rates. However, the very low inflation rate implies high real interest rates, and Italy's financing cost (both for the sovereign and the real economy) remains above the euro area average.

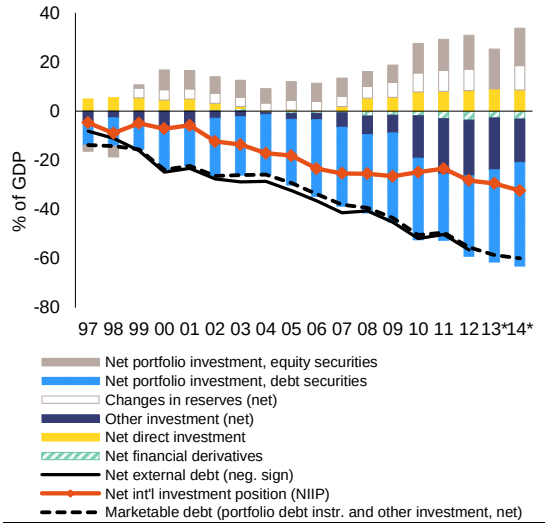
Looking ahead, external demand is expected to trigger a slow and gradual recovery. According to preliminary estimates, real GDP stabilised in the final quarter of 2014. While the value added in the

service sector increased, it decreased in manufacturing and agriculture. Overall, the Commission 2015 winter forecast projects a contraction of GDP by 0.5 % in 2014 and a gradual recovery in 2015 and 2016. Real GDP is forecast to expand by 0.6 % in 2015, supported by exports and only moderate improvements in domestic demand. The recovery is projected to strengthen in 2016 as financing conditions normalise and external demand reinforces triggering an increase in investments.

Italy's current account surplus has further increased, mirroring public and private sector deleveraging. On the external side, the 12-month cumulative balance recorded a surplus of EUR 29.6 billion (1.8 % of GDP) in December 2014, almost double the EUR 15.2 billion surplus recorded one year before. The ongoing correction in Italy's current account is driven by the further improvement of the trade balance (see Section 2.2), which in turn is caused by an expanding non-energy goods surplus ([1]) in combination with a shrinking energy goods deficit due also to falling oil prices. From a savings-investment point of view, the trend in Italy's current account is primarily due to a contraction in investment on account of deleveraging by the public and private sectors (the corporate sector turned into a net lender in 2012), while households are restoring their savings.

([1]) EU sanctions on Russia impacted negatively on Italy's trade: exports to Russia declined by 11.6 % in 2014 year-on-year. However, they account for less than 3 % of total exports.

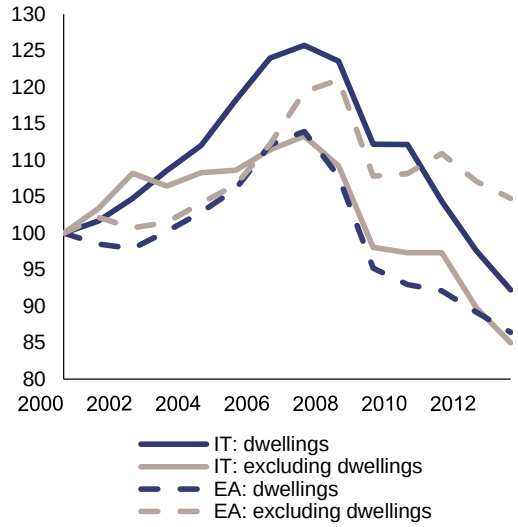
Graph 1.3: **Evolution and breakdown of Italy's net international investment position**



Source: European Commission

Italy has turned into a net lender to the rest of the world, but its net international investment position has slightly deteriorated. The recovery in foreign net portfolio investment in Italy seen since mid-2012 continued and was mirrored by a downward trend in foreign net other investment related to the gradual decline in reliance on Eurosystem liquidity. In the second half of 2014 however, this trend was interrupted by the reduced government bond issuance due to the Treasury's strong liquidity position, and by Italian banks' participation in the Eurosystem's targeted long-term refinancing operations. Although overall Italy has become a net lender to the rest of the world, its net international liabilities increased somewhat in 2014 as a result of net negative valuation adjustments related to the substantial decline in risk premiums on its own debt instruments. At around 30 % of GDP in 2014, Italy's negative net international investment position does not pose sustainability concerns, but the bias in its composition towards interest-bearing debt – reflected in the higher net external debt level – remains a vulnerability (Graph 1.3).

Graph 1.4: **Real gross fixed capital formation, index (2000=100)**

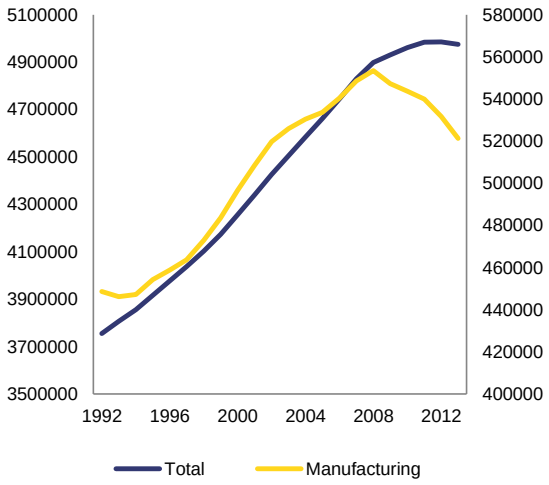


Source: European Commission

Since the crisis, productive investment in Italy has declined significantly and by more than the euro area average. As a share of GDP, investment fell from 21.6 % in 2007 to 17.8 % in 2013, 1.5 percentage points below the EU average (19.3 %). As shown in Graph 1.4, following a period of subdued growth, the non-residential component of investment was the hardest hit, reaching a level in 2013 that was 15 % below that in 2000 in real terms. Investment also continued to fall in the first nine months of 2014 (by 2.2 % in real terms year-on-year), particularly in construction (-3.4 %), but also in machinery and equipment (-1.7 %).

The fall was common to both public and privateinvestments. In nominal terms, investment by the government sector fell by 18 % over the 2008-13 period, with its share of GDP declining from 2.9 % in 2007 to 2.4 % in 2013. Investment by the corporate sector fell by nearly as much and accounted for 9.5 % of GDP in 2013, down from 11.3 % in 2007. Investment by the household sector and non-profit sector serving households was also affected, although to a lesser extent, with a share of GDP of 6 % in 2013 (-1.3 percentage point from 2007).

Graph 1.5: **Real net capital stock, million Euros**

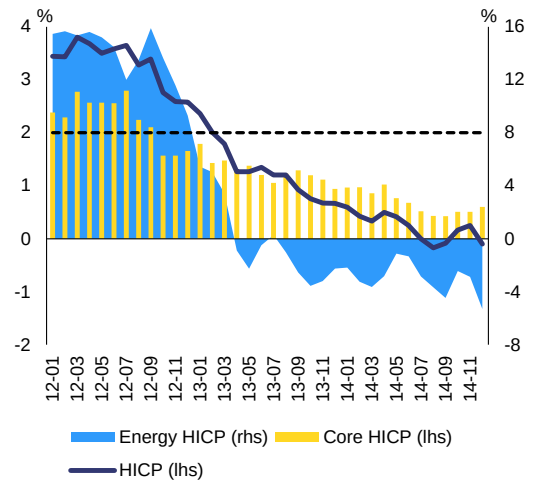


Source: European Commission

The persistent fall in investment is hindering Italy's future prospects The fall in investment was particularly marked in the manufacturing sector, leading to a significant depletion of net capital stock in this sector of the economy. The insufficient capital accumulation ultimately hampers Italy's potential output (Graph 1.5).

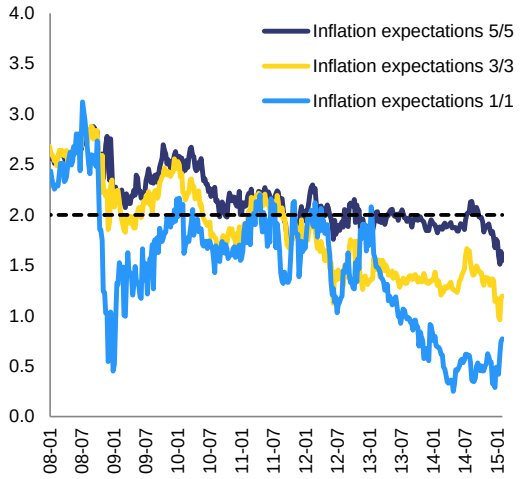
The decline in the amount of investment is compounded by a long-term deterioration in its quality. The marginal efficiency of capital – a proxy for the impact of investment on growth – has been dropping since the early 1990s and has been consistently below the euro area average. While capital deepening continued to have a positive impact on labour productivity, the observed accumulation pattern did not lead to rapid technological change and total factor productivity growth (Graph 1.1). This may reflect a limited ability of the economy to reallocate resources to more productive firms and sectors.

Graph 1.6: **HICP inflation and components**



Source: European Commission, ISTAT

Graph 1.7: **Italy's inflation-linked swap rates**



Source: European Commission

HICP inflation has been falling since mid-2012, driven by sluggish domestic demand and falling oil prices. HICP inflation averaged 0.2 % in 2014, less than in the euro area. The price adjustment has been substantial, particularly considering that inflation in Italy had been above the euro area average since the creation of the Economic and Monetary Union. In fact, since the end of 2012, inflation has been steadily declining driven down by the appreciation of the euro and lower import prices, in particular for energy products (Graph 1.6). The sluggish domestic demand contributed to the decline in core inflation. Towards the end of 2014, the significant slump in oil prices pushed down HICP inflation to extremely low levels which turned negative in December 2014 and January 2015.

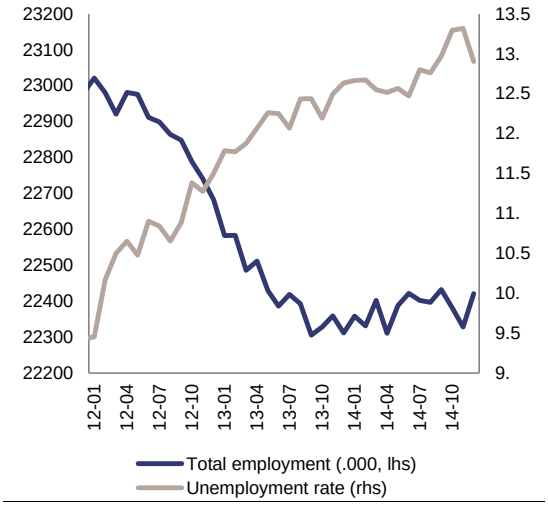
Inflation is expected to be slightly negative in 2015. According to the Commission 2015 winter forecast, the fall in oil prices is expected to feed quickly into the energy component of HICP inflation. This is projected to be negative on average over the year and to increase very gradually afterwards as economic prospects improve and oil price rise marginally. The increase in Italy's VAT rate by 2 percentage points as of January 2016, enshrined in the 2015 Stability Law, is set to increase HICP inflation in 2016 to 1.5 %.

The expansionary monetary stance reduces the risk of a deflationary spiral. Inflation expectations, measured in terms of inflation-linked swap rates, have been declining (Graph 1.7). The current context of i) the zero-lower bound on official interest rates in the euro area, ii) very low inflation and iii) high unemployment have heightened the risks of medium-term inflation expectations deviating substantially from the ECB target and of second round effects of the lower oil price on other prices and wages. However, the measures recently announced by the ECB (see footnote 44) are set to reduce substantially these risks and ultimately avoid a deflationary spiral.

Employment has broadly stabilised. Following significant labour shedding in 2012 and 2013, headcount employment has broadly stabilised over the course of 2014 (Graph 1.8). Another signal that most of the labour adjustment has already occurred comes from the slight reduction in the number of wage supplementation hours (*Cassa Integrazione Guadagni*) ([2]), as Graph 1.9 shows. Moreover, in the third quarter of 2014, the total number of hours worked returned to growth compared with the previous quarter driven by the manufacturing and private services sectors.

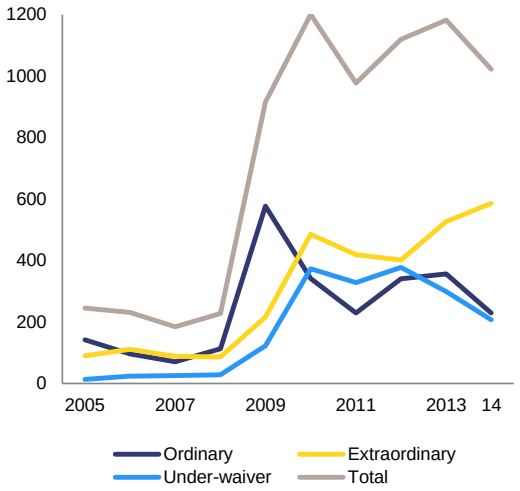
([2]) Cassa Integrazione Guadagni is a scheme whereby employees temporarily suspend or reduce their activity in exchange of an income support.

Graph 1.8: **Headcount employment and unemployment rate**



Source: European Commission, ISTAT

Graph 1.9: **Wage supplementation schemes, million of hours authorised**



(1) Ordinary wage supplementation scheme (CIGO) is a short-term working scheme granted to firms to avoid labour shedding during period of temporary shortfalls of sales. The special wage supplementation scheme (CIGS) is granted to restructuring firms or those initiating a bankruptcy procedure. The under-waiver component of CIG is for employees excluded from CIGO or CIGS.
Source: INPS

The unemployment rate has reached historically high levels as more people joined the labour force. The unemployment rate increased to the historically high level of 12.8 % in 2014 from 12.2 % in 2013, driven almost entirely by the growth in the participation rate (See also Section 3.3 and Section 3.5). Women contributed most to the increase in the labour force, possibly because household economic needs became more pressing. The Commission 2015 winter forecast projects the unemployment rate to remain above 12 % over 2015-16 due to the ample room for a recovery of hours worked and more people joining the labour force as economic prospects improve. As shown in Graph 1.9, the high use of the extraordinary wage supplementation scheme (CIGS) points to the risk of unemployment rising further, inasmuch as the 2012 and 2014 labour market reforms aim at limiting the use of this wage supplementation scheme to allow for labour reallocation (see Section 2.2). This would result in workers previously eligible for the scheme to become unemployed. Still, the recent measures taken to support job creation ([3]) may foster new hirings and therefore provide an upside risk to the forecast central scenario.

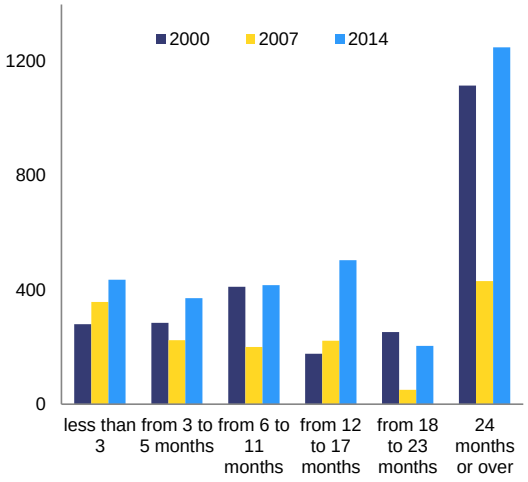
Long-term unemployment has been rising with potentially damaging effects on job finding rates and labour market matching. Persistently low job finding rates due to a weak demand for labour have resulted in rising long-term unemployment, which reached 63.1 % of unemployment in third quarter of 2014 (7.4 % of active population). In that quarter, almost 2 million people had been jobless for more than a year – most of them for between 18 and 47 months (Graph 1.10). Despite the increase in unemployment duration does not yet point clearly to a deterioration of matching efficiency ([4]), prolonged cyclical weakness and lingering unemployment may turn a temporary increase in unemployment into a structural problem, especially if the long-term unemployed get discouraged and reduce job search intensity. The proportion of the young population that has experienced spells of unemployment longer than 12 months increased from about 38 % in 2008 to

([3]) The reduction of the labour tax wedge as well as the fiscal incentives to support the new permanent contract.

([4]) Rosolia, A., 'The Italian labor market after the Great crisis' in 'Gli effetti della crisi sul potenziale produttivo e sulla spesa delle famiglie', *Bank of Italy – Workshops and Conferences*, No.18, 2014. The paper shows that matching efficiency temporarily deteriorated between 2011 and 2012. From late 2013, it returned toward its pre-crisis averages suggesting that the low job finding rate was related to weak labour demand rather than a mismatch between labour supply and demand.

60.6 % in third quarter of 2014. (See also Section 3.3).

Graph 1.10: **Unemployment by duration, (thousands)**



Source: Eurostat

Poverty and social exclusion continued to grow. Between 2008 and 2013, there has been an increase by 2 227 000 of people at risk of poverty and social exclusion (+14.7 percentage points). Children have been those characterised by the highest risk. Hence, Italy faces serious social challenges in this respect (see Section 3.3).

Public finance developments

The government deficit is expected to be 3 % of GDP in 2014 and 2.6 % in 2015, with overall no further improvement in the structural balance over these two years. The deficit is anticipated to have remained within the 3 % of GDP Treaty threshold in 2014, implying a marginal deterioration from the 2.8 % recorded in 2013. Overall, primary expenditure is expected to have increased by around 1 % in nominal terms year-on-year despite the significant increase of around 3 % in social spending due to the tax credit of 80 EUR per month since May 2014 to employees with low or medium income. Despite the flat nominal GDP, revenues increased slightly mainly thanks to higher VAT and property taxation intakes. Lower yields reduced the debt service bill by more than 0.1 percentage point of GDP. The 2015 Stability Law projects a reduction of the headline deficit to 2.6 % of GDP. The Commission Winter 2015 forecast is in line with this projection. Thanks to the planned savings (especially at local level) and the extension of the public sector wage freeze in force since 2010, nominal primary expenditure is forecast to record only a mild increase. Revenues are forecast to grow at broadly the same pace as nominal GDP, as the enacted cut in the labour tax wedge is largely compensated by measures to improve VAT collection (reverse charge and split payment for the public sector) and by the expected pick up in the corporate income tax after the fall recorded in 2014. The Commission forecast also factors in a further reduction in interest expenditure (-0.4 percentage point of GDP) thanks to the significant drop in yields over recent months. The structural balance is forecast to remain broadly stable over 2014-2015, with a small deterioration in 2014 followed by a similarly small improvement in 2015. Negative economic conditions, with an estimated negative potential growth and very low inflation, make more difficult the needed adjustment towards a balanced budgetary position in structural terms (i.e. Italy's Medium Term Objective).

The government debt-to-GDP ratio is still increasing. Negative economic conditions re also weighing on debt developments through their impact on the primary surplus and an unfavourable denominator effect, which are only partially compensated by lower interest expenditure (see Section 2.1). In 2014, the debt-to-GDP ratio is expected to have risen to around 132 % (from 127.9 % in 2013). This was also due to the ongoing settlement of trade debt arrears, further support to euro area programme countries, and a new increase in the Treasury's liquidity buffer. The debt-to-GDP ratio is projected to increase again in 2015, to around 133 % of GDP, despite some privatisation proceeds incorporated in the forecast (0.5 % of GDP) and the expected reduction in the Treasury's liquidity buffer. In 2016, the higher nominal GDP growth and primary surplus (forecast on a no-policy change basis) is expected to allow for a small reduction in the debt ratio.

Box 1.1: *Economic surveillance process*

The Commission's Annual Growth Survey, adopted in November 2014, started the 2015 European Semester, proposing that the EU pursue an integrated approach to economic policy built around three main pillars: boosting investment, accelerating structural reforms and pursuing responsible growth-friendly fiscal consolidation. The Annual Growth Survey also presented the process of streamlining the European Semester to increase the effectiveness of economic policy coordination at the EU level through greater accountability and by encouraging greater ownership by all actors.

In line with streamlining efforts this Country Report includes an In-Depth Review — as per Article 5 of Regulation no. 1176/2011 — to determine whether macroeconomic imbalances still exist, as announced in the Commission's Alert Mechanism Report published on November 2014.

Based on the 2014 In-Depth Review for Italy published in March 2014, the Commission concluded that Italy was experiencing excessive macroeconomic imbalances, requiring specific monitoring and strong policy action, in particular, the very high level of public debt and the weak external competitiveness, both ultimately rooted in the protracted sluggish productivity growth.

This Country Report includes an assessment of progress towards the implementation of the 2014 Country-Specific Recommendations adopted by the Council in July 2014. The Country-Specific Recommendations for Italy concerned public finances, taxation, public administration, access to finance, labour market, education, market opening and business environment, and infrastructure.

Table 1.1: **MIP scoreboard indicators**

			Thresholds	2008	2009	2010	2011	2012	2013
External imbalances and competitiveness	Current Account Balance (% of GDP)	3 year average	-4%/6%	-1.9	-2.1	-2.7	-2.8	-2.3	-0.9
		p.m.: level year	-	-2.8	-1.9	-3.5	-3.1	-0.5	1.0
	Net international investment position (% of GDP)		-35%	-24.7	-26.1	-24.7	-23.4	-28.6	-30.7
	Real effective exchange rate (REER) (42 industrial countries - HICP deflator)	% change (3 years)	±5% & ±11%	1.8	3.6	-1.9	-3.3	-6.2	0.0
		p.m.: % y-o-y change	-	1.4	1.2	-4.5	0.0	-1.9	1.9
	Export Market shares	% change (5 years)	-6%	-17.2	-18.5	-19.8	-19.6	-24.8	-18.4
		p.m.: % y-o-y change	-	-6.6	-4.2	-8.9	-2.9	-4.9	1.3
	Nominal unit labour costs (ULC)	% change (3 years)	9% & 12%	8.5	11.1	8.9	5.2	2.7	4.1
		p.m.: % y-o-y change	-	4.2	4.6	-0.1	0.7	2.1	1.3
Internal imbalances	Deflated House Prices (% y-o-y change)		6%	-0.5	-0.1	-2.2b	-2.1p	-5.4p	-6.9p
	Private Sector Credit Flow as % of GDP, consolidated		14%	6.5	1.5	4.4	2.8	-0.9	-3.0
	Private Sector Debt as % of GDP, consolidated		133%	113.7	120.1	121.2	120.4	120.8	118.8
	General Government Sector Debt as % of GDP		60%	102.3	112.5	115.3	116.4	122.2	127.9
	Unemployment Rate	3-year average	10%	6.5	6.9	7.6	8.2	9.2	10.4
		p.m.: level year	-	6.7	7.8	8.4	8.4	10.7	12.2
	Total Financial Sector Liabilities (% y-o-y change)		16.5%	-2.3	5.5	3.3	3.2	7.4	-0.7

Flags: b: break in time series. p: provisional.
Note: Figures highlighted are the ones falling outside the threshold established by EC Alert Mechanism Report. For REER and ULC, the first threshold concerns Euro Area Member States. (1) Figures in italic are according to the old standards (ESA95/BPM5). (2) Export market shares data: the total world export is based on the 5th edition of the Balance of Payments Manual (BPM5).
Source: European Commission

Table 1.2: **Key economic, financial and social indicators - Italy**

	2008	2009	2010	2011	2012	2013	Forecast 2014	2015	2016
Real GDP (y-o-y)	-1.0	-5.5	1.7	0.6	-2.3	-1.9	-0.5	0.6	1.3
Private consumption (y-o-y)	-1.1	-1.6	1.2	0.0	-4.0	-2.8	0.3	0.5	0.5
Public consumption (y-o-y)	1.0	0.4	0.6	-1.8	-1.5	-0.7	-0.7	-0.5	0.7
Gross fixed capital formation (y-o-y)	-3.1	-9.9	-0.5	-1.9	-7.4	-5.4	-2.6	1.0	4.1
Exports of goods and services (y-o-y)	-3.1	-18.1	11.8	5.2	2.0	0.6	1.3	3.4	4.2
Imports of goods and services (y-o-y)	-3.7	-12.9	12.4	0.5	-8.0	-2.7	0.3	2.6	4.6
Output gap	1.2	-4.0	-2.1	-1.7	-3.0	-4.3	-4.3	-3.5	-2.1
Contribution to GDP growth:									
Domestic demand (y-o-y)	-1.1	-3.0	0.8	-0.8	-4.2	-2.9	-0.4	0.4	1.1
Inventories (y-o-y)	-0.1	-1.2	1.2	0.2	-0.9	0.0	-0.4	-0.1	0.1
Net exports (y-o-y)	0.2	-1.3	-0.2	1.2	2.8	0.9	0.3	0.3	0.1
Current account balance (% of GDP), balance of payments	-2.8	-1.9	-3.5	-3.1	-0.5	1.0	.	.	.
Trade balance (% of GDP), balance of payments	-0.8	-0.6	-1.9	-1.5	0.9	2.4	.	.	.
Terms of trade of goods and services (y-o-y)	-2.1	6.3	-4.0	-2.6	-1.4	1.8	2.1	1.8	-0.5
Net international investment position (% of GDP)	-24.7	-26.1	-24.7	-23.4	-28.6	-30.7	.	.	.
Net external debt (% of GDP)	40.7*	45.3*	51.9*	50.3*	56.6*	.	.	.	.
Gross external debt (% of GDP)	103.58	112.86	114.05	111.4	118.3	118.0	.	.	.
Export performance vs advanced countries (% change over 5 years)	-6.4	-10.9	-12.4	-11.9	-16.9	-12.6	.	.	.
Export market share, goods and services (%)	3.3	3.1	2.8	2.8	2.6	2.7	.	.	.
Savings rate of households (net saving as percentage of net disposable income)	7.6	6.8	3.9	3.5	2.9	4.2	.	.	.
Private credit flow, consolidated, (% of GDP)	6.5	1.5	4.4	2.9	-0.9	-3.0	.	.	.
Private sector debt, consolidated (% of GDP)	113.8	120.1	121.2	120.4	120.8	118.8	.	.	.
Deflated house price index (y-o-y)	-0.4	-0.4	-2.2	-2.0	-5.4	-7.0	.	.	.
Residential investment (% of GDP)	5.8	5.6	5.6	5.3	5.1	4.8	.	.	.
Total financial sector liabilities, non-consolidated (y-o-y)	-9.2	5.5	3.5	-0.4	5.8	0.2	.	.	.
Tier 1 ratio[1]	.	.	.	.	.	.	.	.	.
Overall solvency ratio[2]	.	.	.	.	.	.	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances)[2]	.	.	.	.	.	.	.	.	.
Change in employment (number of people, y-o-y)	0.2	-1.8	-0.7	0.2	-0.2	-2.0	-0.3	0.3	0.5
Unemployment rate	6.7	7.8	8.4	8.4	10.7	12.2	12.8	12.8	12.6
Long-term unemployment rate (% of active population)	3.1	3.5	4.1	4.4	5.7	6.9	.	.	.
Youth unemployment rate (% of active population in the same age group)	21.3	25.4	27.8	29.1	35.3	40.0	.	.	.
Activity rate (15-64 year-olds)	63.0	62.4	62.2	62.2	63.7	63.5	.	.	.
Young people not in employment, education or training (%)	16.6	17.7	19.1	19.8	21.1	22.2	.	.	.
People at risk of poverty or social exclusion (% of total population)	25.3	24.7	24.5	28.2	29.9	28.4	.	.	.
At-risk-of-poverty rate (% of total population)	18.7	18.4	18.2	19.6	19.4	19.1	.	.	.
Severe material deprivation rate (% of total population)	7.5	7.0	6.9	11.2	14.5	12.4	11.4	.	.
Number of people living in households with very low work-intensity (% of total population aged below 60)	9.8	8.8	10.2	10.4	10.3	11.0	.	.	.
GDP deflator (y-o-y)	2.5	2.0	0.3	1.5	1.6	1.4	0.5	0.4	1.1
Harmonised index of consumer prices (HICP) (y-o-y)	3.5	0.8	1.6	2.9	3.3	1.3	0.2	-0.3	1.5
Nominal compensation per employee (y-o-y)	3.7	2.2	2.7	1.1	0.9	1.2	0.8	0.5	0.6
Labour productivity (real, person employed, y-o-y)	-1.3	-3.9	2.4	0.3	-2.1	0.0	.	.	.
Unit labour costs (ULC) (whole economy, y-o-y)	4.3	5.2	0.1	0.7	2.3	1.4	1.4	0.3	-0.1
Real unit labour costs (y-o-y)	1.8	3.2	-0.2	-0.8	0.6	0.0	0.9	-0.1	-1.2
REER[3] (ULC, y-o-y)	2.3	2.4	-2.8	0.4	-1.9	3.0	0.9	-3.2	-1.0
REER[3] (HICP, y-o-y)	0.4	1.1	-5.3	-0.6	-1.3	1.6	1.7	-0.3	-0.5
General government balance (% of GDP)	-2.7	-5.3	-4.2	-3.5	-3.0	-2.8	-3.0	-2.6	-2.0
Structural budget balance (% of GDP)	.	.	-3.3	-3.2	-1.5	-0.8	-0.9	-0.6	-0.8
General government gross debt (% of GDP)	102.3	112.5	115.3	116.4	122.2	127.9	131.9	133.0	131.9

1 Domestic banking groups and stand-alone banks.
2 Domestic banking groups and stand-alone banks, foreign-controlled (EU and non-EU) subsidiaries and branches.
3 Real effective exchange rate
* Indicates BPM5 and/or ESA95
Source: European Commission, 2015 winter forecast; ECB

2. IMBALANCES, RISKS, AND ADJUSTMENT

2.1. HIGH PUBLIC INDEBTEDNESS

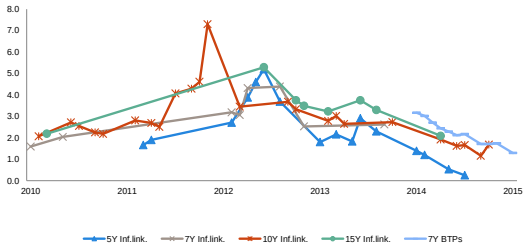
Overview and trends

High public debt is a major source of vulnerability for the Italian economy and, given its large size, it is considered of primary importance for world markets. Italy's public debt holds back growth through the high present and expected level of taxation needed to service it, the high interest bill limiting the room for productive public expenditure and the constrained ability to respond to economic shocks. Conversely, slow growth keeps the indebtedness level high. Furthermore, the large stock of public debt implies substantial refinancing risk and makes the country vulnerable to sudden rises in sovereign yields and financial market volatility in periods of increased risk aversion. Risks to the financial and economic stability of the euro area and beyond (spillovers) are considerable due to the variety of institutions and investors holding Italian sovereign securities across the world ([5]) (see Section 2.4 on spillovers).

Since Italy joined the euro, lower interest rates and growth dividends have not been sufficiently earmarked to public debt reduction. Indebtedness decreased only by 11 percentage points from 111 % GDP in 1998 to 100 % in 2007 and then ballooned to 132 % in 2014 despite strong fiscal consolidation undertaken in response to sovereign debt market turmoil. Italy's general government debt-to-GDP ratio is now expected to peak at around 133 % in 2015, and decline slightly in 2016 thanks to the higher primary surplus and nominal GDP growth. In addition, pension reforms, once fully implemented will have a beneficial effect on the medium-to-long term sustainability of public finances.

More recently, negative growth and low inflation are key factors explaining the increase in the debt-to-GDP ratio, while the fiscal stance and the composition of the consolidation have kept the evolution of the nominal debt in check. The nominal debt level at the end of 2014 was lower than planned, thanks also to low interest expenditure and the fact that part of the resources earmarked for the settlement of trade debt arrears was not necessary. Indeed, financing costs hit an all-time low (see Graph 2.1.1).

Graph 2.1.1: **Italy — medium and long-term sovereign debt average yield at issuance (%)**



Source: European Commission

Despite the large decline in Italy's sovereign risk premium in recent months, low inflation raises the real implicit interest rate on outstanding government debt, thereby worsening debt dynamics. Indeed, despite decreasing nominal interest rates, the implicit cost of servicing debt increases in the short term because this lower cost of financing is reflected in the outstanding debt stock only gradually (given the maturity of the Italian debt and the roll-over period). This entails that the debt-increasing impact of the implicit real cost of debt (i.e. net of the impact of inflation) rises from around 3% of GDP over 2011-2013 to around 4 % foreseen over 2014-2015. This more than offsets the debt-reducing effect of the positive primary surplus (1.8% of GDP over 2011-2013). In addition, low inflation expectations would weigh on the real cost of financing for the economy, worsening growth prospects in turn. To illustrate the importance of the risk of deviation of medium-term inflation expectations from the 2 per cent target for price stability, it is worth noting that a 1 percentage point decrease in inflation per year over the 2014-17 baseline would mechanically increase debt-to-GDP ratio by about 5 percentage points at the end of the forecast period, other things being equal. ([6]) At the same time, price-competitiveness adjustment requires Italy to run inflation at below

([5]) See R. C. Merton, 'Measuring the Connectedness of the Financial System: Implications for Risk Management', *Asian Development Review* 31(1), Cambridge, MA: MIT Press, 2014, pp. 186–210.

([6]) This estimate only considers the 'mechanical' denominator impact of a higher/lower nominal GDP. In the short term, a higher/lower inflation would also translate in a lower/higher deficit, via tax revenue (the impact on expenditure being limited); in the medium term the overall impact may be close to zero as inflation will increasingly affect expenditure.

the euro area average. Counteracting the impact of possibly lower inflation on debt ratios would require even lower interest rates and further improving the primary balance in a growth-friendly manner (e.g. by focusing cuts on government consumption, limiting tax hikes and preserving productive investment, as well as spending on education and research and development). The debt-to-GDP ratio has also increased because of low or negative GDP growth (1.5 % of GDP over 2011-13). This trend should be reversed as growth becomes positive again, while the primary surplus also contributes to debt reduction. A fiscal framework supported by the on-going spending review, expenditure rationalisation programmes and the action of the newly-created Parliamentary Budget Office, should be conducive to an appropriate multiannual fiscal stance, and thus help put public debt on a downward path (see Section 3.1 for further details). Regarding the impact of monetary policy, the European Central Bank purchase programme of sovereign debt announced on 22 January 2015 will cover a wide range of medium to long-term maturities, thus supporting the lengthening of debt maturity, while reducing the risk deviation of medium-term inflation expectations from the 2 per cent target for price stability.

Against this challenging background, Italy's public debt management office continues to deliver in terms of risk management and anchoring of market expectations. The average maturity of public market debt currently stands at 6.4 years (against 7 years back in 2011) and given the currently large liquidity buffer and relatively smooth redemption profile, the refinancing risk remains rather low. Auctions are usually met with high demand, as the successful issuance in mid-January 2015 of EUR 6.5 billion 30-year bonds at an average yield of 3.29 % shows. The investor base is very stable, with about 60 % of government securities held domestically, a third of which by Italian banks (seesection 2.3). Demand is solid in a number of market segments and international investors are increasing their exposure. Market conditions allowing, some issuances are also planned in 2015 on the dollar market.

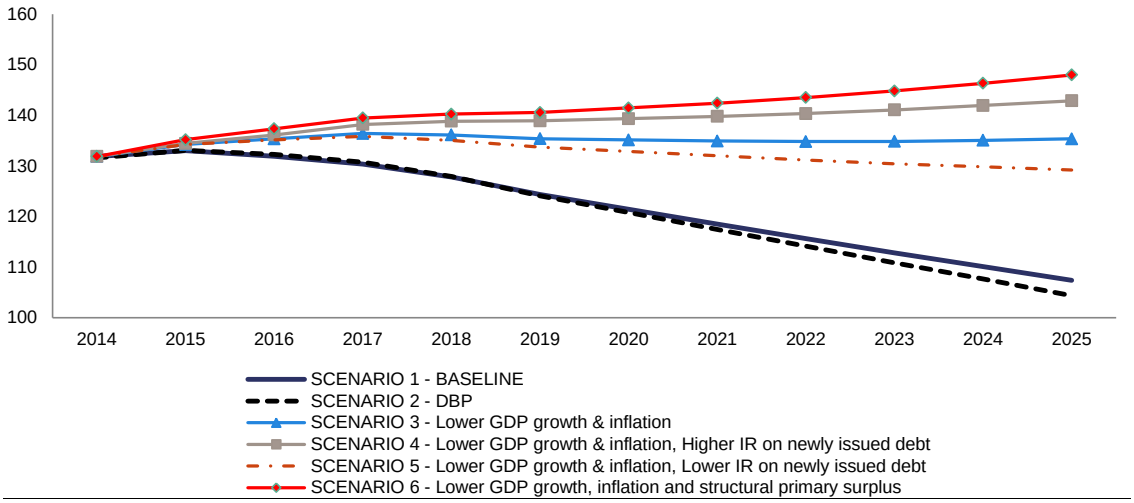
The privatisation programme of some state-owned enterprises and the sale of public real estate is set to contribute to the debt-reduction effort. While there have been some delays in implementation, the privatisation programme is set to accelerate in 2015 and to generate proceeds amounting to 0.7 % of GDP per year over the period 2015-17. More precisely, this year should see the privatisations of Poste Italiane (up to 40 %), ENAV (up to 49 %) and Ferrovie dello Stato, through initial public offerings as well as the sale of Grandi Stazioni. Administrative procedures for dismissals, privatisations and valorisation of public real estate have been accelerated. Invimit and Cassa Depositi e Prestiti, both state-owned, are involved in the valorisation and sale of unused public real-estate assets. Sale of local real-estate assets generated proceeds of some EUR 600 million in 2014. Until 2017, yearly proceeds of around EUR 1 billion from the sale of real estate assets of local governments and of the Ministry of Defence are to be expected. These funds can then be directed to the Sinking Fund for the Redemption of Debt Securities to buy back public debt, though with no significant impact expected, given current figures.

Assessing Italy's debt sustainability

Bearing in mind that there is no fixed threshold for debt sustainability, a number of criteria should be considered for its analysis. Italy's scoreboard on variables relevant for debt sustainability shows a mixed picture. The high level of indebtedness and the large financing needs of the country exert upward pressures on the refinancing costs and the roll-over risk. But on external debt, the current account and the net international investment position, which are also very relevant for investors, Italy has a relatively good record and stands out against south European countries with a negative net international investment position of only 30 % GDP as of end-2014. One should, however, bear in mind that this does not make Italy immune to a reversal of foreign capital inflows as experienced in mid-2011. From this perspective the larger share of domestic creditors (about 60 % for Treasury bonds) can also be seen as a shelter from volatility in international market sentiment.

There are three channels through which a decrease in public debt over GDP can be achieved: higher GDP growth, lower interest rates on government debt and a higher primary surplus. A country's public debt is generally considered sustainable if, as a percentage of GDP,

Graph 2.1.2: **Italy — Gross debt-to-GDP**



Source: European Commission

it declines over the medium term under plausible macroeconomic assumptions. A debt sustainability analysis for Italy is presented in what follows. ([7]) Debt projection results are presented under alternative scenarios, aimed at assessing the possible future evolution of debt under different macroeconomic conditions.

Baseline debt projections presented below are based on European Commission forecasts ([8]) and the assumption of no fiscal policy change beyond the forecast period (after 2016). Debt projections are additionally presented under an alternative scenario reflecting the macro-fiscal context reported in Italy's 2015 Draft Budgetary Plan. ([9]) The government structural primary balance is kept at 3.5 % - 3.7 % of GDP beyond 2016 for the two scenarios respectively. Under this condition, the Italian public debt is put on a decreasing path, as shown in Graph 2.1.2.

Additional scenarios provide an assessment of the impact that changes in the macro-fiscal context would have on projected public debt dynamics. Given the persistently disappointing growth performance of the Italian economy over the seven-year long crisis, a scenario (scenario 3 in Graph 2.1.2) is run to capture risks from lower GDP growth and inflation. Under this scenario, the indebtedness level would peak in 2017 at 136.4 % GDP and then stay broadly flat over the remaining projection period. Investor confidence is underpinned both by fiscal performance and macroeconomic prospects. In a protracted low-growth, low-inflation environment, an increase in sovereign yields, especially for countries with high indebtedness ratios, could take place. An alternative debt projection scenario (scenario 4) is therefore run in which lower growth and inflation are combined with an increase in sovereign bond yields (an increase by 2 percentage points phased in over 2015-17, followed by a gradual return to baseline assumptions on the interest rate). Under this scenario, the increased debt service would lead to a debt-to-GDP level that keeps increasing, reaching almost 143 % of GDP in 2025. Assuming a persistent accommodative monetary policy response to low growth and inflation, the interest rate on government debt would be brought down. This is represented in scenario 5 (where a gradual and permanent 1 percentage point decrease in the interest rate is assumed). In this case, public debt over GDP would again be slightly decreasing after 2017. Finally, in a context of low growth and low

([7]) The debt sustainability analysis presented here is based on the European Commission's Debt Sustainability Monitor model (for more details, see 'Assessing Public Debt Sustainability in EU Member States: A Guide', *European Economy* Occasional Paper No. 200, September 2014.).

([8]) Long-run convergence assumptions covering real interest rate, GDP growth rate and inflation are used, in line with what agreed with the Economic Policy Committee.

([9]) This Draft Budgetary Plan or DBP scenario is also based on the assumption of no fiscal policy change beyond the programme horizon.

inflation, it would be more difficult to pursue rapid fiscal consolidation. Scenario 6 shows the impact that this would have on debt dynamics. Fiscal fatigue in the form of a 1 percentage point decrease in the structural primary balance would lead the debt-to-GDP ratio to rise rapidly, reaching 148 % in 2025.

Box 2.1.1: **Impact of fiscal consolidation and structural reforms on public debt**

DSGE simulations (using QUEST) allow carrying out an impact assessment on debt of fiscal and structural policies, in a dynamic way ([1]). The interactions between policy and macroeconomic variables are indeed embedded into the model. Simulations combining and macroeconomic shocks with different fiscal-structural policies show the latter's potential impact on debt-to-GDP. The elements of the simulations are detailed individually below before assessing their combined effects.

Macroeconomic risks: below-target inflation and financial market pressures

Two macroeconomic risks are considered. First, the risk of very low inflation, decoupled from the euro-area average. This is modelled by a negative demand shock which confines inflation in Italy to 1 % for the first two years of the simulation period, the baseline level for the rest of the euro area being 2 %. The second risk is that of financial market turmoil that translates into a protracted period of higher sovereign spreads (meaning higher borrowing costs for the government). Currently the implicit interest rate on debt is 3.6 %, while the sovereign interest bill stands at some 5 % of GDP. This financial market risk is modelled by a shock that increases by 2 % the effective government interest rates and which is phased out once it has gone over the whole debt stock (assuming a 6-year average maturity).

Fiscal stance: increase or reduction of the primary surplus by 1 % of GDP

As fiscal consolidation is of primary importance to put public indebtedness on a downward path, the impact of an increase or reduction by 1 percentage point of the primary surplus is considered. In light of the recent tax cuts and spending review, consolidation is assumed to be implemented in a growth-friendly way ([2]), opting for expenditure cuts rather than tax increases.

Structural policies: tax shift, simplification, deregulation, and labour market reforms

Structural reforms affect economic activity and, through the related denominator and tax-base effects, debt dynamics. These policies usually generate negative (nominal) GDP effects in a first phase, as prices decline, before yielding positive growth benefits in the medium term. Some of the main reforms fully legislated in Italy in 2013-14 are considered here:

-Tax shift: while the VAT rate has already been raised in 2013, 2014 saw the enactment of three reforms to shift the tax burden away from productive factors: (i) the cut in IRAP (regional corporate income tax) through the deduction of labour component from the tax base, (ii) the IRPEF (labour income tax) reduction for low-income earners or € 80 bonus, (iii) the strengthening of ACE (aid to economic growth measures) leading to a deduction of notional cost of equity from the corporate income tax base. The quantification of the impact and financing of these measures are translated by negative shocks on the implicit tax rates on labour (-1.5 p.p.) and capital (-0.2 p.p.).

-Administrative simplification: several measures have been taken to simplify the administrative framework for citizens and business in 2012-14. To capture their effect, overhead labour costs are reduced by 3%. Reductions are phased in for a full effect within 3-4 years.

([1]) In the model, current debt is a function of debt in the previous period, related interest payments and the current primary budget deficit. Both the real GDP and the GDP deflator that make up the denominator in the deficit-to-GDP and debt-to-GDP ratios are endogenous variables, as are tax revenues and benefit payments for given tax and replacement rates. Hence, structural reforms affect economic activity, which then feeds back to budgetary variables and debt dynamics.

([2]) For an illustration of the effects of fiscal consolidations according to their composition see In't Veld, J., 'Fiscal consolidations and spillovers in the Euro area periphery and core', *European Economy*, Economic Papers **506**, October 2013, http://ec.europa.eu/economy_finance/publications/economic_paper/2013/ecp506_en.htm.

(Continued on the next page)

Box (continued)

-Product market reforms and deregulation: measures taken in 2012-13 aimed at deregulating and simplifying procedures for setting up a business. They have been quantified as leading to final goods mark-up reduction of 0.09 p.p.([3]) compared to an initial level of 13%([4]). In the model, these measures are captured by the respective mark-up reduction.

-Labour market reforms: the June 2012 labour market reform lightened the employment protection legislation (among others). This is modelled by a gradual increase in labour-augmenting productivity by 0.7 %.

Some reforms with a potential impact on GDP growth and, hence, the debt-to-GDP ratio are not included, either because of modelling limitations (justice reform described in Section 3.1, duration of work contracts reform described in 3.3), or because the final legal texts were still forthcoming at the time of writing (Jobs' Act, annual law on competition, education reform).

Privatisation programme

In May 2014, the Italian government re-launched a privatisation programme with increased receipts targets, namely €30 bn over 2014-2017 that should be allotted to reduce public debt.

None of the above-described measures is to be implemented on its own. Instead, a reforming government would rather adopt a combination of them. We develop five fiscal-structural policy combinations and show their respective impact in Graph 1. The simulation results for the debt-to-GDP level are displayed as percentage-point deviations from its baseline path. Hence, deviations indicate the additional effect of the measures considered (translated into shocks) and are in general combinable with different assumptions about the underlying baseline. In particular, the baseline could be the continuation of the status quo, or could already incorporate fiscal and structural measures other than the one analysed here (e.g. the baseline presented in the debt sustainability analysis). The simulations can hence also be seen as an assessment of positive and negative risks around a baseline projection for debt dynamics.

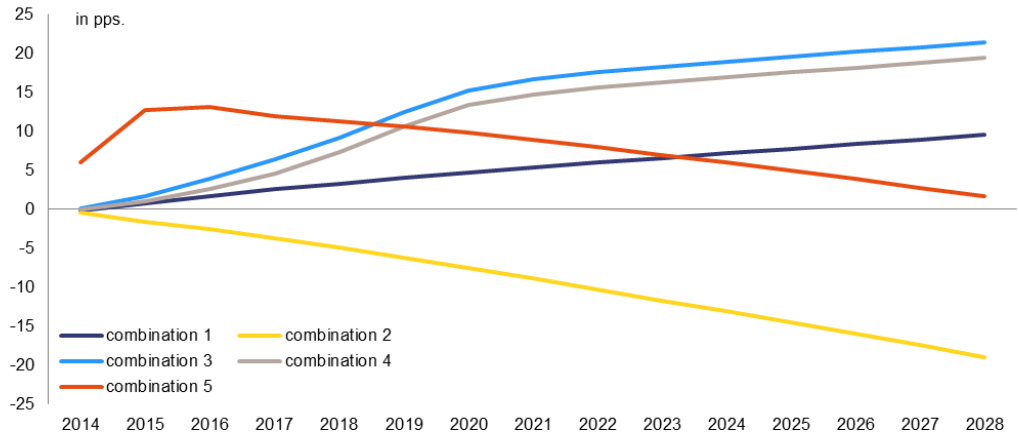
([3]) European Commission calculations based on Thum-Thysen, A., and Canton, E., 'Service sector mark-ups and product market regulation' (forthcoming)

([4]) ECFIN's methodology to estimate service sector mark-ups takes into account the level of product market regulation (PMR) as measured by the OECD's PMR indicators. With a 13% mark-up on the final goods sector, Italy is doing rather well, as the best euro area performers register a mark-up level in the final goods sector of 9.6 %.

(Continued on the next page)

Box (continued)

Graph 1: **Italy — Impact of fiscal-structural policy combinations on debt-to-GDP**



Source: European Commission, simulations carried out using QUEST.

- Combination 1: Primary surplus undershoot, tax shift, structural reforms

This policy combination includes a loosening of the fiscal consolidation stance by 1 % of GDP combined with the implementation of the tax shift, product market deregulation, administrative simplification, and labour market reform. In this combination, despite the structural effort, the fiscal relaxation leads to an increase of the debt level of +10 % of GDP by 2028 relative to the baseline. In other words, the measures undertaken on the structural side have, given their limited size and scope, a limited positive impact on public finances through the denominator and tax-revenue effects, which does not compensate the negative impact of less ambitious discretionary fiscal measures on public finances.

- Combination 2: Primary surplus overshoot, tax shift, structural reforms

The only difference to combination 1 is the tighter fiscal stance. The opposite debt evolution with this combination (-19 % of GDP relative to baseline by 2028) shows clearly the pre-eminence of the fiscal stance in curbing public indebtedness in the set of policy measures considered. The simulation results do not address the question of the political palatability of protracted fiscal consolidation given consolidation fatigue and the electoral cycle, however.

- Combination 3: Combination 1+ market confidence shock

The sovereign crisis has shown that in times of high policy scrutiny, sovereign spreads are usually dependent on key fiscal variables such as the deficit or gross debt. Therefore, it seems more likely that a country would face higher borrowing costs if its fiscal stance is looser than expected. The shock increasing sovereign yields is therefore implemented with combination 1 (as opposed to combination 2). The effect of such a shock to financing costs is very large. Indebtedness rises to 10 % of GDP above the level in combination 1 by 2020.

- Combination 4: Combination 3 + privatisation

Adding privatisation to combination 3 shows that privatisation alone is certainly not a solution to the Italian high indebtedness as the contribution to lowering debt-to-GDP is incremental.

- Combination 5: Combination 2 + negative demand shock leading to lower inflation

(Continued on the next page)

Box (continued)

The latest data has shown very low inflation in Italy, prompting fears of a debt-deflation spiral, and so a policy response combining strong fiscal consolidation and structural reforms to counter act this adverse effect would be most likely (combination 2). A negative demand shock that reduces inflation by 1 % below baseline implies an increase in the debt-to-GDP ratio relative to baseline: (i) nominal debt (numerator) increases given the reduction in tax revenues in response to lower domestic demand (deterioration of the primary balance), while (ii) nominal GDP (denominator) decreases because of lower growth and inflation. This results in a 13 % of GDP increase in public indebtedness within three years, before the effects of the shock are gradually phased out and debt is put back on a downward path through strong and protracted consolidation. Should similar negative demand shocks occur in the entire euro area and put downward pressure on prices in a low interest environment, the impact on Italian output and debt would be even more adverse, because falling prices in Italy would not (or less) translate into real depreciation and competitiveness gains. Thus, net trade would contribute less to supporting economic activity amid weak domestic demand ([5]).

([5]) In the model, Italy has a trade openness ratio (sum of export and imports over GDP) of 58% and a trade openness ratio towards the rest of the euro area of 25%.

The analyses presented in this section show that the first lever determining the pace of debt reduction is fiscal consolidation but that the condition for its success is a growing GDP. **To achieve a larger reduction of public indebtedness, the second and necessary policy lever is that of large-scope structural reforms.** The current structural fiscal position — if further improved and maintained — will reduce the public debt imbalance. Keeping the structural primary balance at 3.5 % (as a minimum) is key to bringing public debt over GDP below 110 % by 2025. A large primary surplus could help preserve market confidence (and keep the risk premium low) even if growth prospects and inflation remain weak in the short to medium term. However, past experience suggests that achieving and maintaining a high primary surplus is challenging. All the more when economic activity remains subdued and when there are deflationary pressures. Forceful consolidation to put debt on a downward path in a depressed macroeconomic context could indeed be self-defeating. Hence the only policy lever left is that of structural reforms large enough in scope and impact to push GDP significantly up in the medium-term (as the short-term effects of structural reforms are usually mixed and positive effects come in only with a few years' lag). In Box 2.1.1, these fiscal, structural and macroeconomic interactions are integrated in a dynamic model. Simulations show that some recently implemented reforms (on taxation, simplification, deregulation and labour market) bring about growth gains so that debt is also reduced thanks to the higher GDP and tax intake. Additional reforms, as those foreseen for instance on competition or on the labour market, would bring the debt-to-GDP ratio further down. (Privatisation can only be a complementary measure and would not suffice to bring public indebtedness significantly down in the medium term). Following previous announcements by the Ministry of Finance and endorsed by the Italian Government on 20 February 2015, Italy committed to adopt and implement an ambitious agenda of structural reforms.[10] If implemented, these reforms should increase Italian GDP by a few percentage points over the medium-term, thereby contributing to the long-term sustainability of Italy's public finances.

[10]
http://www.dt.mef.gov.it/it/analisi_programmazione_economico_finanziaria/strategia_crescita/

http://www.governo.it/Governo/ConsiglioMinistri/dettaglio.asp?d=77929

http://www.mef.gov.it/inevidenza/article_0079.html

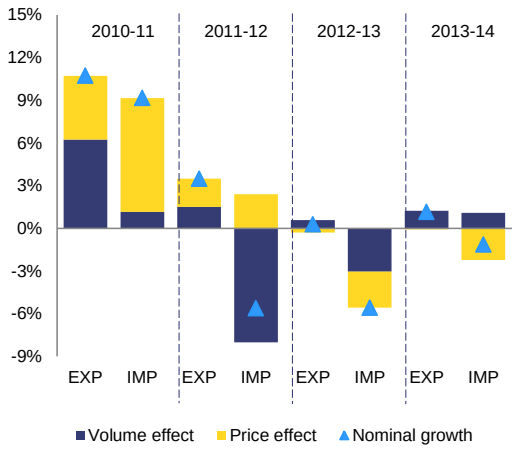
2.2. LOSS OF EXTERNAL COMPETITIVENESS

External position and export performance

The improvement in Italy's current account balance is mostly non-cyclical, reflecting the decline of potential growth and thus import demand. Having returned to surplus in 2013, Italy's current account is expected to have further increased to 1.8 % of GDP in 2014. The positive trend in the trade balance is primarily explained by shrinking nominal imports, whereas nominal exports have grown only moderately (Graph 2.2.1). In 2014, the gap between nominal growth of exports and imports is expected to have narrowed, but mainly owing to a smaller contraction of imports in the context of Italy's slow exit from economic recession. The improvement in its cyclically-adjusted current account ([11]) by 3.3 percentage points between 2008 and 2013 mainly reflects Italy's negative potential growth since the start of the crisis. The resulting decline in potential output constrains Italian domestic and thus import demand below pre-crisis levels. For export capacity to become the driver of significantly higher potential growth, Italy would need a reallocation of resources towards the tradable sectors but this shift does not seem to be happening so far.

([11]) The cyclically-adjusted current account balance is the current account balance which would prevail if the output gaps of a country and of its trade partners were at zero, and therefore both domestic demand (determining a country's imports) and external demand (determining a country's exports) were at their potential.

Graph 2.2.1: **Breakdown of the year-on-year change in goods components of Italy's trade balance**

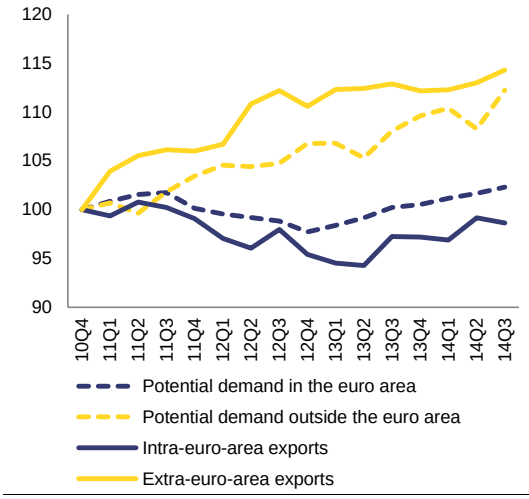


Source: European Commission

Italy's recent export performance has been largely driven by external demand developments. The contraction in demand from euro area trade partners over 2011-2012 was reflected in a similar fall in exports to those markets (Graph 2.2.2). In this period, falling demand from vulnerable euro area countries was in fact compounded by weak demand also from countries with no financial constraints in the euro area, like Germany. ([12]) With some lag, Italy's exporting firms have taken advantage of the very gradual recovery in demand from the euro area, which started at the beginning of 2013. The fall in the euro exchange rate and steady demand had instead supported exports to non-euro area markets in 2011 and 2012. However, in 2013 and 2014 demand from some emerging markets faltered, while the euro appreciated again until the first quarter of 2014. As a consequence, Italy's export performance towards non-euro area trade partners suffered. The depreciation of the euro boosted exports to outside the euro area again in the second half of 2014. Further favourable exchange rate developments, together with strengthening external demand, are expected to be the main engine to restart a gradual recovery in economic activity in 2015 and 2016.

([12]) See for instance in 't Veld, J., 'Fiscal consolidations and spillovers in the Euro area periphery and core', *European Commission – DG ECFIN Economic Papers*, No. 506, 2013

Graph 2.2.2: **Italy's export performance since mid-2010, intra and extra euro area breakdown**

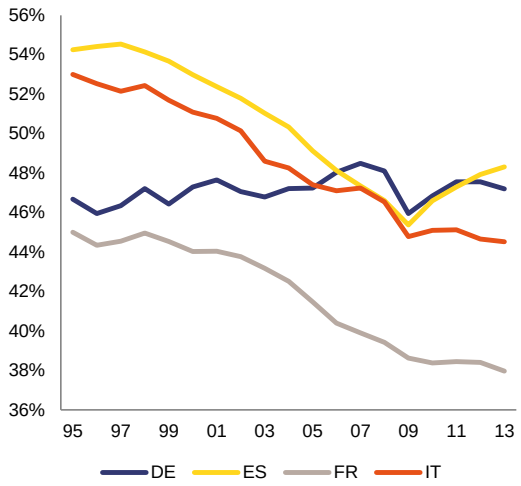


Source: Bank of Italy (based on national accounts ESA95-ESA2010)

The shares of tradable sectors in Italy's gross value added and employment have fallen significantly over the last two decades, mainly driven by the declining share of manufacturing industries. Between 1995 and 2013, the share of Italy's tradable sectors ([13]) in total gross value added declined from 53 % to 44.5 % (Graph 2.2.3). This decline has been common to most advanced economies, with the exception of Germany, and it reflects the reorientation of economic activity away from industry towards services. In Italy, the shift is mainly driven by the declining share of manufacturing industries, which in 1995 accounted for roughly 21 % of total gross value added and fell to 15 % in 2013. In particular, the evolution of the manufacturing sector's gross value added slowed down already after Italy's adoption of the euro in 1999 and turned strongly negative in 2008 when the crisis started (Graph 2.2.4). The declining importance of the tradable sectors is also visible in employment terms: over the period 1995-2013, the share of tradable sectors in Italy's (full-time-equivalent-based) employment decreased from 53.8 % to 48 %. Again, the bulk of the shift is explained by manufacturing sector's lower share of employment. Apart from manufacturing, gross value added and employment also declined in wholesale/retail trade and motor vehicle repair, as well as agriculture, forestry and fishing. Industries which somewhat offset the tradable sector's share decline are accommodation and food service activities, information and communication (mainly computer programming, consultancy and information service activities) and transportation and storage. The decreasing importance of manufacturing within the Italian economy has been driven mainly by those firms dependent on the domestic market alone and which were not able to re-orient their production towards foreign markets. In addition, domestic market developments may adversely affect export growth. ([14]) Overall, the erosion of Italy's manufacturing, accounting for 95% of Italy's goods exports, may have a negative impact on the country's export capacity. The subsequent analysis will therefore focus on the export performance of the manufacturing sector.

([13]) Following the NACE rev. 2 classification of economic activities, the tradable sectors are agriculture, industry excl. construction (A-E), and some selected services (G-J).

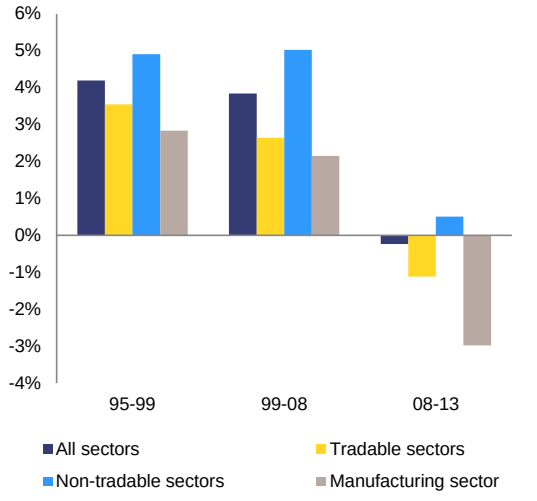
Graph 2.2.3: **Share of tradable sectors in gross value added**



Source: European Commission, ISTAT

([14]) Bugamelli, M., et al., 'Domestic and foreign sales: complements or substitutes?', *Bank of Italy Occasional Papers*, No. 248, 2014 This paper shows that over the 2008-12 period, there has been a positive correlation between domestic and foreign sales at the firm level, possibly explained by liquidity and credit constraints.

Graph 2.2.4: **Average annual growth rate of gross value added over selected periods**

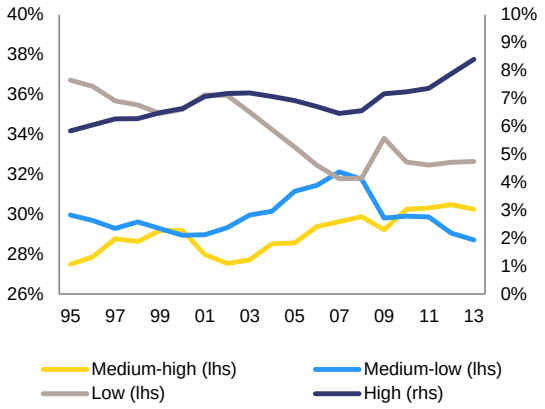


Source: European Commission, ISTAT

Italy is endowed with a diversified manufacturing base, which has undergone a very slow shift towards more technologically intensive activities since 1995. In 2013, Italy's largest manufacturing sectors (in terms of their share of manufacturing gross value added) were in basic metals (15.7 %), machinery and equipment (14 %), food products and beverages (11.9 %), textiles and leather (9.7 %), rubber and plastic products (8.7 %), and furniture and miscellaneous ([15]) (8.6 %). High-tech industries remain small in total manufacturing gross value added (8.4 % in 2013), while around 60 % of Italian manufacturing gross value added was still generated in low- or medium-low tech sectors, owing to the continued specialisation in 'traditional' sectors. Since 1995, however, a gradual shift away from low- and medium-low-tech sectors has taken place: the latter's share in total manufacturing gross value added decreased by 5.3 percentage points (Graph 2.2.5), mainly owing to the textiles and leather, wood and paper, and rubber and plastics industries. However, the food products and beverages, basic metals, and furniture and miscellaneous industries recorded a gross value added share increase, against the general trend. The increase in the gross value added share of medium-high- and high-tech industries took place mainly thanks to machinery and equipment, pharmaceutical products, electrical equipment, and computers and electronics sectors. The chemicals and motor vehicles and transport equipment industries went against the general upward trend.

([15]) Jewellery, musical instruments and toys; repair and installation of machinery and equipment

Graph 2.2.5: **Shares of gross value added in manufacturing by technology intensity**

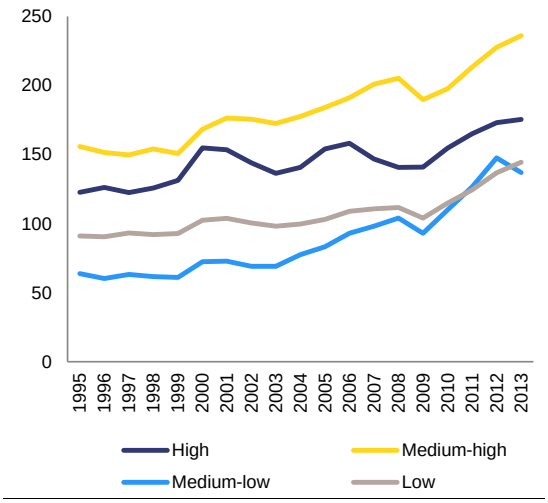


Source: European Commission, ISTAT

Exposure to external markets has increased in manufacturing sectors. Over the 1995-2013 period, all manufacturing sectors have increased their propensity to export ([16]), with the exception of the computer and electronic products sector. The increase has been more pronounced since the crisis in almost all sectors, as shown in Graph 2.2.6. Aggregating the sectors by technology intensity, export propensity is higher in medium-high and high technology-intensive sectors. This suggests that firms producing these types of products are more exposed to demand from abroad, which could also be due to higher integration of these products into global value chains.

([16]) Measured as the share of goods exports value out of total gross value added in each sector.

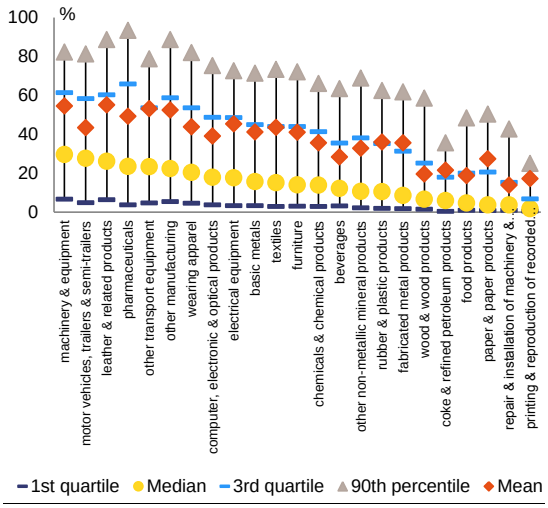
Graph 2.2.6: **Export propensity by technology intensity**



Source: European Commission, ISTAT

Italy's export propensity and performance is being held back by the bias in the country's firm demography towards small firms with low productivity. Aggregating firm-level data, Graph 2.2.7 shows that average export propensity ([17]) is close or above 50 % in five manufacturing sectors (i.e. leather and related products, machinery and equipment, other transport equipment, other manufacturing, and pharmaceutical), meaning that half or slightly more of the total output of these sectors is sold abroad. In addition, the graph shows that the distribution of firms' export propensity is wide in almost all sectors. In particular, the export propensity of the median is on average 30 percentage points lower than that of the third quartile. This suggests that there is room to increase exports at the intensive margins in all manufacturing sectors. **Italy's export propensity and performance is being held back by the bias in the country's firm demography towards small firms with low productivity.** Italy's firm demography is characterised by a high concentration of very small firms: in 2012, 99.9 % of Italian firms were small and medium-sized enterprises (up to 250 employees), whereas the share of micro-firms (up to nine employees) was 95.2 % of all companies. Micro-firms' labour productivity is however significantly below the firm average (Graph 2.2.8). The literature suggests a strong positive correlation between firm size, productivity and export capacity and performance, with a presence in geographically more distant markets requiring a higher level of efficiency. Consequently, the dominant presence in Italy of very small firms with low productivity is holding back an increase in the country's export propensity. This is reflected by the fact that Italian export propensity at firm level is clearly negatively correlated with firm's size (Graph 2.2.9).

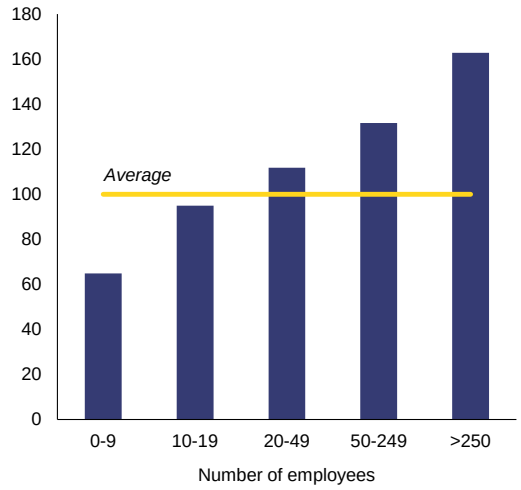
Graph 2.2.7: **Export propensity by manufacturing sector, 2012**



Source: ISTAT

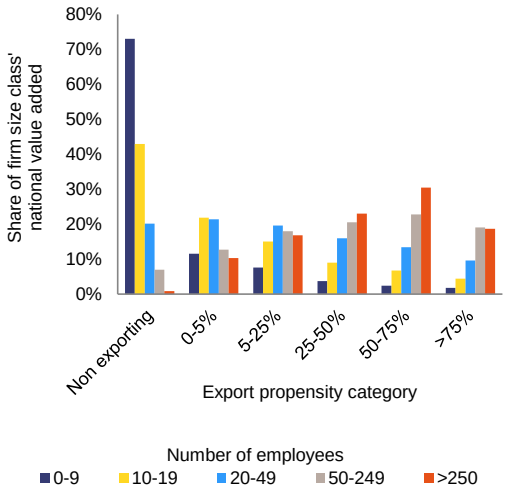
([17]) Measured as the ratio of turnover realised with foreign sales to total turnover.

Graph 2.2.8: **Labour productivity by firm size (100 = average over total firm population)**



(1) Labour productivity calculated as gross value added at factor cost divided by the number of persons employed
Source: ISTAT

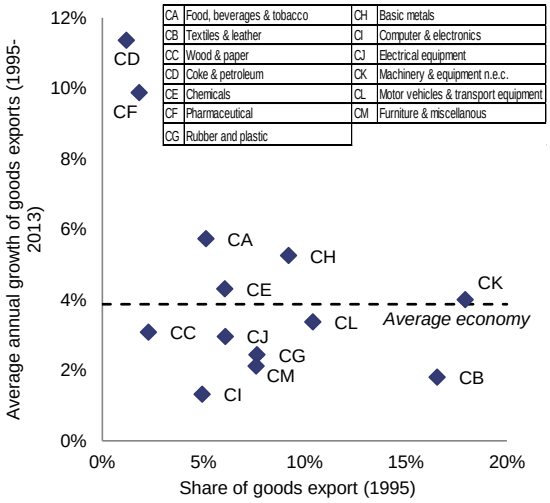
Graph 2.2.9: **Export propensity by firm size**



(1) The bars represent the ratio of the value added accounted for by firms which belong to a specific export propensity and firm size class and the total value added accounted for by all firms which belong to that firm size class (irrespective of their export propensity class). Hence bars with the same colour add up to 100 %.
Source: ISTAT

Export growth has varied quite significantly across sectors, the biggest exporting sectors being less dynamic. As shown in Graph 2.2.10, the sectors that experienced the fastest growth in exports over the 1995-2013 period were those producing coke and petroleum, and pharmaceutical products. However, these sectors accounted for a low share of total goods exports in 1995. The two sectors with the biggest shares were textiles and leather, and machinery and equipment, which together accounted for one third of total goods exports in 1995. However, their export dynamics have been respectively below the average and broadly in line with it. The different dynamics of exports by sector has brought some changes in the composition of Italy's goods exports.

Graph 2.2.10: **Goods exports of manufacturing sectors, by shares and dynamics**

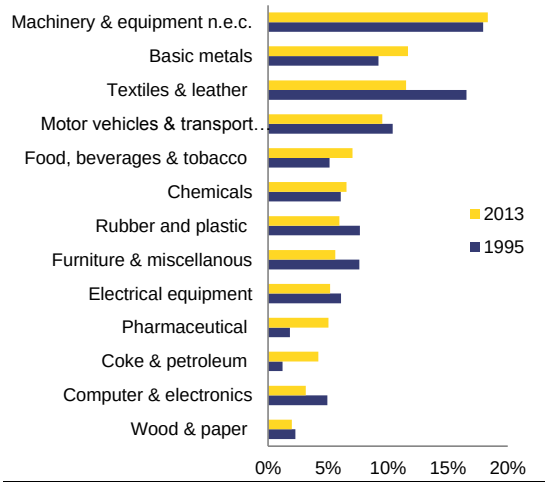


Source: European Commission, ISTAT

Some change in the sectoral composition of exports has taken place since the early 2000s. Exports of machinery and equipment account for one fifth of the total – broadly stable over the period 1995-2013 – and are the largest category of exported goods (Graph 2.2.11). Textiles and leather has dropped significantly (by around 5 percentage points) as have furniture and miscellaneous, rubber and plastics, and computer and electronic products (by 5.5 percentage points all together). The fall in their share of total exports has been compensated by an increase in metal, food and beverages, pharmaceutical, and coke and petroleum products (by an overall 10.6 percentage points). This change in sectoral composition reflects a shift from low to medium-low technology-intensive sectors (Graph 2.2.12), with the latter accounting for almost half of the total exports of manufactured goods in 2013. High-tech sectors, however, have broadly remained stable

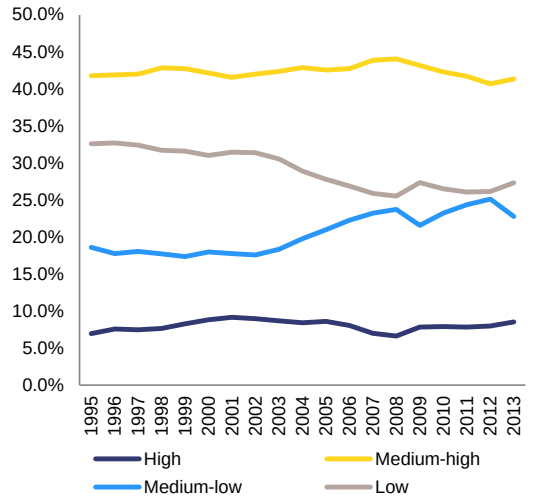
over the period and represent a small share of the total, around 8.5 percentage points.

Graph 2.2.11: **Shares of goods exports by manufacturing sector, 1995 and 2013**



Source: European Commission, ISTAT

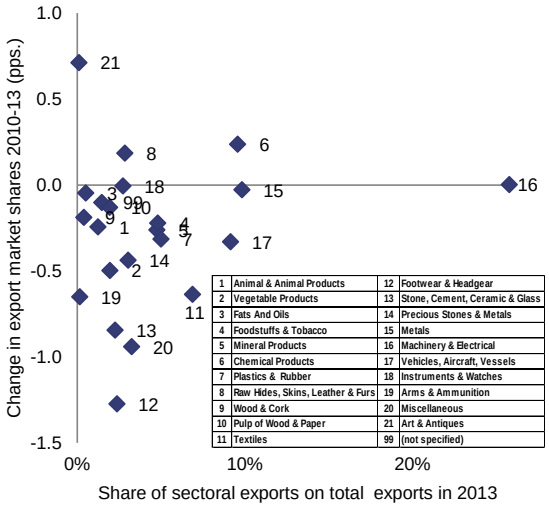
Graph 2.2.12: **Shares of manufacturing exports of goods, by technology intensity**



Source: European Commission, ISTAT

The marginal decline in Italy's export market shares between 2010 and 2013 conceals a heterogeneous performance across sectors. While the sectoral growth of exports in absolute terms explains the changes in the composition of Italy's goods exports, only the sectoral export market shares show which sectors have been exporting in line with or above total external demand. Over the 2010-13 period, export market share expressed in current prices and US dollars terms has declined only marginally (-0.2 percentage point). The performance by sectors ([18]) has been heterogeneous (Graph 2.2.13). Machinery and electrical products as well as metals, which accounted respectively for 26 % and 10 % of total goods exports in 2013, saw their export market shares stabilise over the period. The chemical products, leather and related products, and art and antiques sectors have been the only ones to experience some increase in their shares. However, these sectors together represented 12.5 % of total Italy's total exports of goods in 2013 and they have been more than offset by the rest, whose export market shares declined. In particular, transport equipment – which accounted for 9 % of total exports – have lost slightly more than the average (-0.3 percentage points vs. -0.2). Traditional sectors such as textiles and footwear have continued losing market shares in recent years, suggesting that competition from emerging markets has remained intense.

Graph 2.2.13: **Change in sectoral export market shares 2010-13, percentage points USD**



Source: European Commission

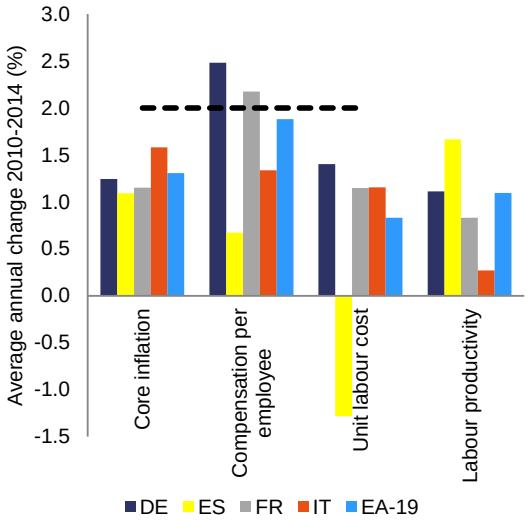
Cost/price and non-cost competitiveness

Cost-competitiveness has been deteriorating primarily due to sluggish productivity performance. After the financial crisis Italy's core

([18]) Sectors are classified by Harmonised System 1992.

inflation was on average well below 2 % (see Graph 2.2.14). The same applies to compensations per employee, which also reflected the freeze in public sector wages. Unit labour cost benefitted from those moderate developments. However, driven by the weak productivity dynamics, Italy's cost competitiveness relative to the rest of the euro area did not improve as in other countries - like Spain - that had to embark on an aggressive cost adjustment due to a deteriorated external position.

Graph 2.2.14: **Cost and price developments (2010-2014 average)**

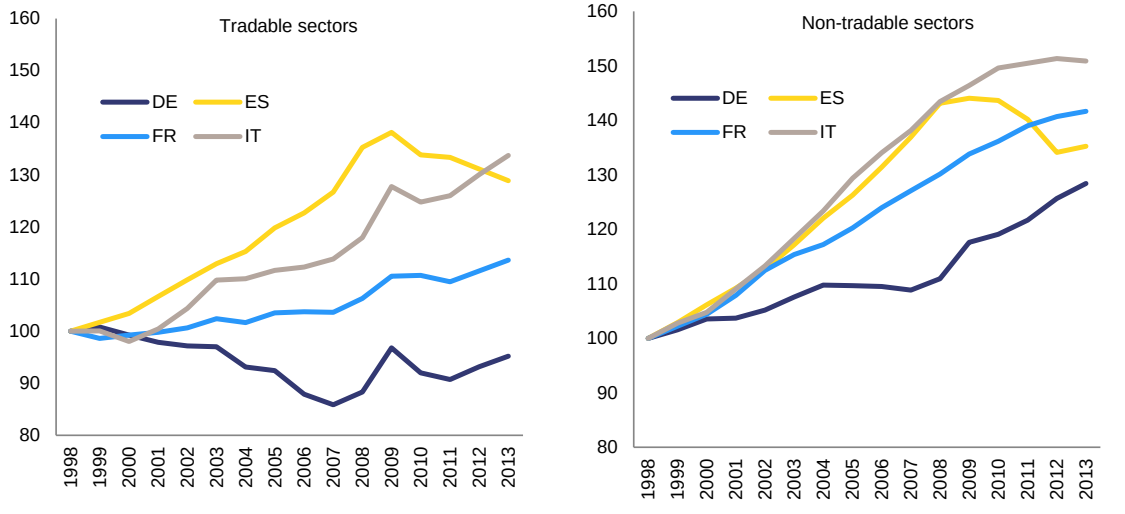


Source: European Commission

Recourse to labour hoarding has also played a significant role in the lack of adjustment in Italy's unit labour cost relative to the rest of the euro area, as it affected the country's already unfavourable productivity position.

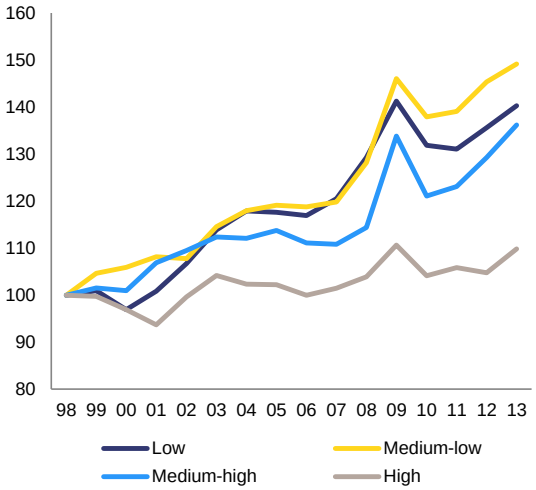
Unit labour cost in tradable sectors has grown less than in non-tradable ones; nevertheless its upward trend has been more sustained than in France, Germany and more recently Spain. In the pre-crisis period, the rise in Italy's unit labour cost was more sustained in non-tradable sectors as labour productivity declined on average (Graph 2.2.14). However, as the crisis hit, the non-tradable sectors limited the growth in unit labour costs thanks to a much slower pace of increase in compensation per full time equivalent, which can also be explained by the public sector wage freeze. However, from a cross-country perspective, the increase in unit labour costs in both tradable and non-tradable sectors since 1999 has been more sustained in Italy than in Germany and France. Looking at the tradable sectors in greater details and grouping them according to their technology intensity, Graph 2.2.16 shows that unit labour cost has held broadly stable in high-tech sectors, while increasing in the others. In fact, high-tech sectors have seen higher productivity growth than the others over the whole period.

Graph 2.2.15: **Unit labour cost index for selected countries, tradable vs. non-tradable sectors (1998=100, based on hours worked)**



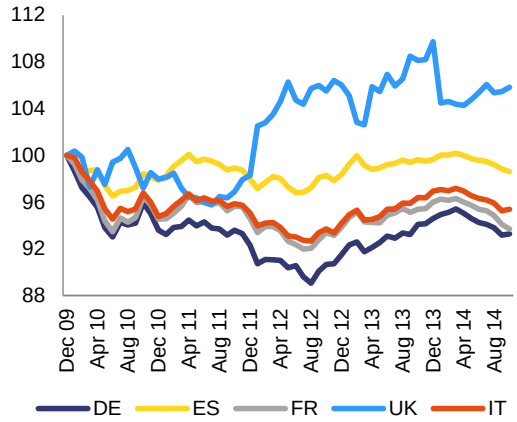
Source: European Commission, Eurostat

Graph 2.2.16: **Unit labour cost index (based on full-time equivalents) by technology intensity, 1998=100**



Source: European Commission, ISTAT

Graph 2.2.17: **Indicators of competitiveness: producer prices of manufactures (December 2010 =100)**



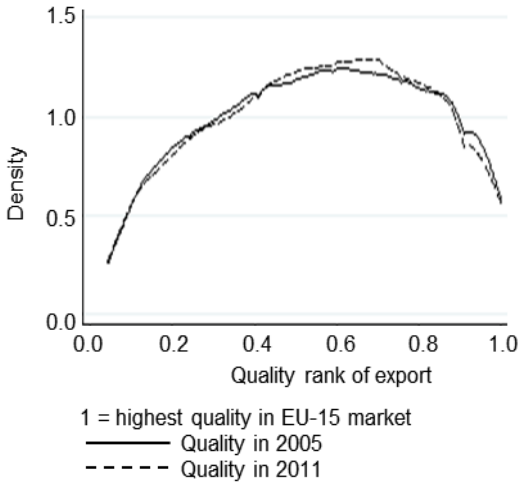
Source: Bank of Italy, European Commission

Most price-competitiveness indicators continue to show a better picture of Italy's competitive position than the real effective exchange rate based on unit labour cost. For instance, the Bank of Italy's competitiveness indicator based on producer prices of manufactured goods for a set of 62 countries indicates that since the financial crisis Italy's competitiveness position has improved more than for Spain's and by about the same as France and Germany (Graph 2.2.17). However the difference between labour cost and price indicators might also point to a squeeze in profit margins for Italian industrial firms, which are compressing their mark-ups in order to remain competitive in their markets. Both cost/price-competitiveness indicators will benefit from the recent euro depreciation.

Gains in non-cost competitiveness have not fully offset Italy's loss of cost competitiveness. One aspect of non-cost competitiveness is export quality which – if increasing over time – may shelter a country from cost competition from emerging markets or rising product standardisation. For Italy, a modest further specialisation in exporting goods of medium-high quality can be observed between 2005 and 2011 at the expense of exporting low- and high-quality goods (Graph 2.2.18). A second aspect of non-cost competitiveness is the quality of 'forward' or 'supply' linkages of services with the rest of the economy, i.e. efficient service industries supplying inputs to the production process of (exporting) sectors, thus supporting the latter's competitiveness. In Italy, forward linkages of services are rather strong, but their competitiveness-enhancing effect (as measured by labour productivity growth over the period 2007-11) on the rest of the Italian economy is negative (Graph 2.2.19). This is particularly the case for business services which are *de facto* still quite heavily regulated and protected from external competition. A third aspect of non-cost competitiveness is the degree of integration in global value chains. Compared with other large EU Member States like Germany and France, Italy participates to a similar extent in global value chains, as measured by the sum of backward and forward vertical specialisation shares. Within global value chains, Italian firms are mainly intermediate suppliers (i.e. occupying upstream

positions), but their position may be relatively weaker because of the firms' small size and low productivity (in spite of considerable firm heterogeneity). ([19])

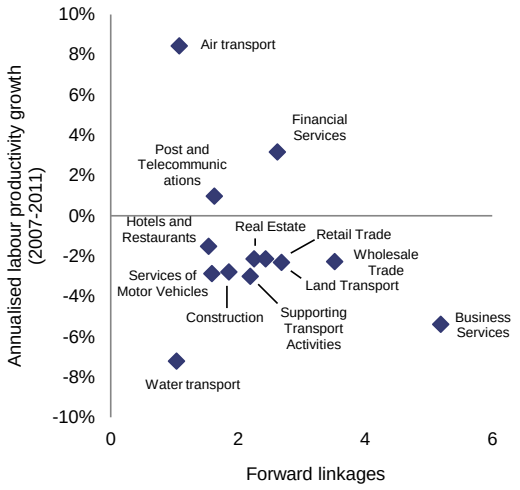
Graph 2.2.18: **Export quality**



(1) The evolution of the quality of a country's exports is shown here on the basis of the distribution of normalised quality ranks of individual manufacturing products exported to a specific destination market (here the EU-15 market) by a defined set of exporters. Shifts in the distribution of such ranks thus reflect changes in the quality dynamics of a country's exports over time.
Source: 'Quality in exports', European Economy – Economic Papers, no. 528, September 2014.

([19]) Accetturo, A., Giunta, A., 'Global value chains in the face of the Great Recession', Bank of Italy, mimeo, 2012

Graph 2.2.19: **The role of services in Italian non-cost competitiveness**



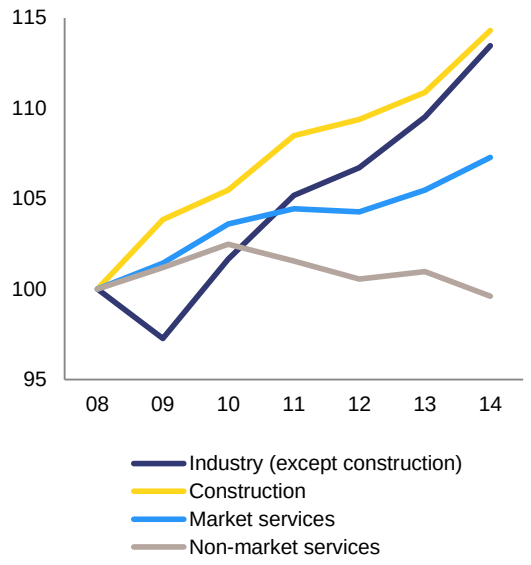
(1) The value of a services industry's forward linkages is an indication of how much of its production contributes to the production of other industries. The horizontal-axis figure shows the share of the various services sectors in the total value of intermediate inputs used in the economy.
Source: European Commission

Wages and productivity misalignments and the labour market reform

Nominal wage growth has slowed down. In 2014 (based on the first three available quarters) compensation per employee increased by 1.3 %, about the same rate as in the previous year (Graph 2.2.21). On an hourly basis, wage growth decelerated from 1.4 % in 2013 to 0.6 % in 2014. Aggregate wages conceal a different dynamic at the sectoral level (Graph 2.2.20). Wage growth is more moderate in market services and public administration than in manufacturing, which would support labour reallocation toward the tradable sector. The proportion of the labour force comprised by young people, by low-wage earners and by people with short tenure (probably on lower wages) in the private sector fell during the period, so that the adjustment of wages is likely to be stronger once these effects are taken into account. ([20])

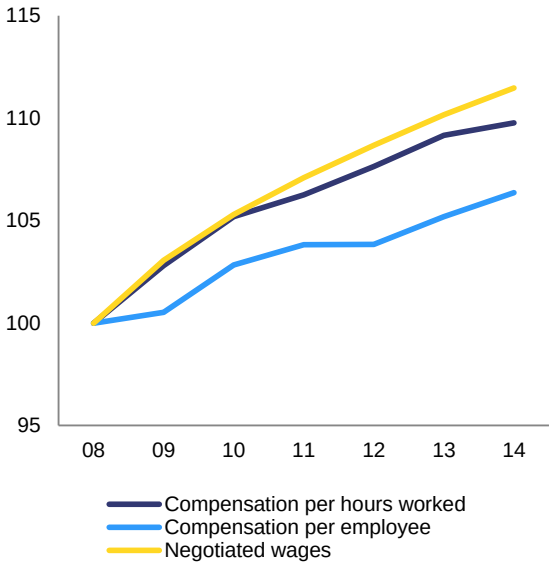
([20]) The proportion in employment of those aged 15-24 and 25-39 fell respectively from 6.5% in 2008 to 4.3% of 2014 and from 41% to 33%. Composition effects related to skill levels, age and tenure of employed in the private sector account for one fifth of the overall changes in wages over

Graph 2.2.20: **Compensation per employee by sector**



Source: European Commission, Eurostat

Graph 2.2.21: **Actual and negotiated wages**



Source: European Commission, Eurostat

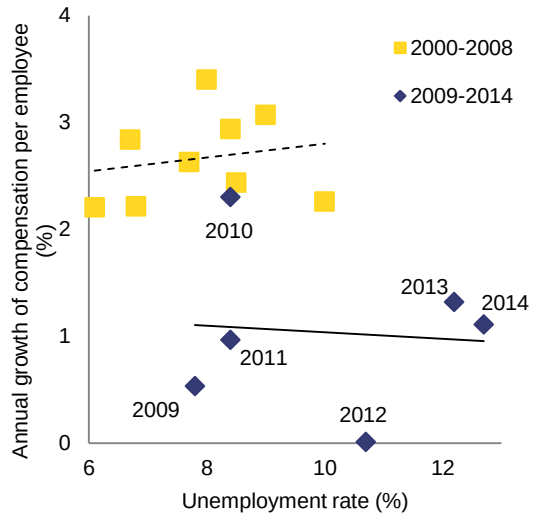
the period 2008-2013. Changes in the sectoral composition or the higher share of temporary and part-time contracts played a minor role (Relazione Annuale, Bank of Italy, 2014).

Negotiated wages have started to respond to the prolonged weakness in the labour market. The Phillips curve, i.e. the relationship between nominal wage growth and the unemployment rate, is the standard tool to assess the response of wages to labour market conditions. Graph 2.2.22 relates actual wages to the unemployment rate for the periods 2000-08 and 2009-13. In both periods, the correlation between the growth of actual wages and unemployment rate is weak (as shown by the flat curve). However, during the crisis, the average growth in actual wages drops (i.e. in the second period the curve shifts downward). Graph 2.2.23 reports for the period 2009-14 on the relationship between the growth in contractual wages and unemployment for Italy and the euro area. The graph shows that on average contractual wages in Italy respond to changes in the unemployment rate in a similar manner to those in the euro area as a whole (the two lines are parallel). The differences in the response of contractual versus actual wages reflect a number of factors. First, actual wages include variable components of pay that have been increasingly squeezed since the start of the crisis, which make them less responsive to unemployment. Second, a framework agreement signed in 2009 (the 'Productivity Pact') set the duration of collective contracts to three years, while until then contracts had lasted for two years for the economic provisions and four years for the normative ones. The agreement also established that wage increases were linked to three years inflation forecast based on the HICP net of imported energy products. ([21]) The increase in duration of contracts for the economic provisions together with their staggered nature (i.e. sectoral negotiations occur at different point in time) may have contributed to delaying wage adjustments. With HICP inflation slowing down, newly signed contracts will incorporate the lower inflation rate. However, delayed wage adjustment in a context of low inflation and sluggish labour productivity growth may make it challenging to align real wages with productivity. More frequent renegotiation of collective contracts and greater coordination at different bargaining levels might

([21]) Differences between actual and forecast inflation can be incorporated in wage increases ex-post, provided that the difference is significant, and subject to agreement among social partners.

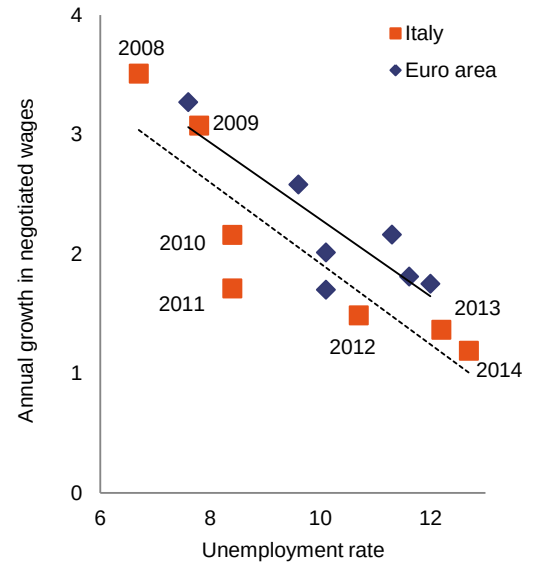
improve the response of wages to cyclical developments.

Graph 2.2.22: **Phillips curve for Italy: annual growth of compensation per employee**



Source: European Commission, Eurostat, ISTAT

Graph 2.2.23: **Phillips curve for Italy and euro area based on negotiated wages, 2008-2014**



Source: European Commission, ISTAT, Eurostat, European Central Bank

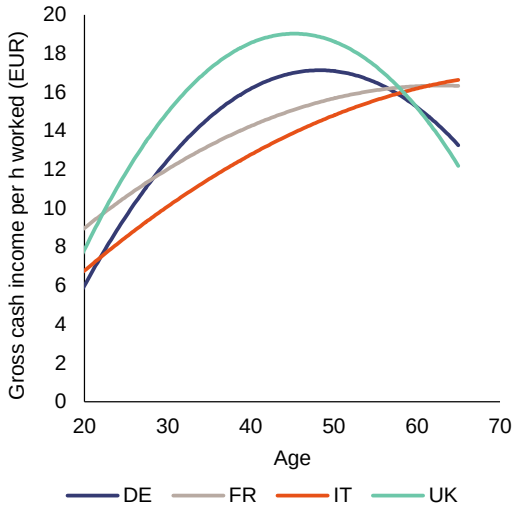
There are indications that the allocation and rewarding of labour does not reflect skills and productivity. First, differently from Germany and the United Kingdom, in Italy earnings increase continuously with age, indicating that wages may not reflect the productivity of workers. ([22]) Second, among the countries participating in the OECD Programme for the International Assessment of Adult Competencies (PIAAC), Italy has a lower-than-average share of workers that are over-qualified for their job (13 % compared with 21 %), but it has the highest share of under-qualified workers (22 %). Given the Italian economy's specialisation in low-to-medium technology products, one would expect the opposite. In terms of skill mismatches, Italy has rather high shares of both over-skilled and under-skilled workers. ([23]) Overall, these misalignments between wages, jobs, skills and productivity at the micro-level have both static and dynamic negative effects: they weigh on aggregated productivity, and reduce the returns to education for the young, and thus the rate of human capital accumulation. ([24])

([22]) See also 'In-depth review of the Italian economy', *European Economy Occasional Papers*, No. 182, 2014, p. 41, Graph 3.33. International comparisons are always difficult, as cross-country differences may depend on factors unrelated to pay scale, such as different turnover. In very flexible markets, such as in the UK, wages are supposed to follow productivity, which is therefore expected to peak and then decrease over time.

([23]) A worker is classified as (under-) over-qualified when the difference between his or her qualification level and the qualification level required in his or her job is (negative) positive. A worker is qualified as (under-) over-skilled when her/his proficiency is (below) above the (minimum) maximum required by her/his job. Full methodological details are at OECD (2013), 2013 Skills outlook, percentage point 170-173, http://www.oecd.org/site/piaac/.

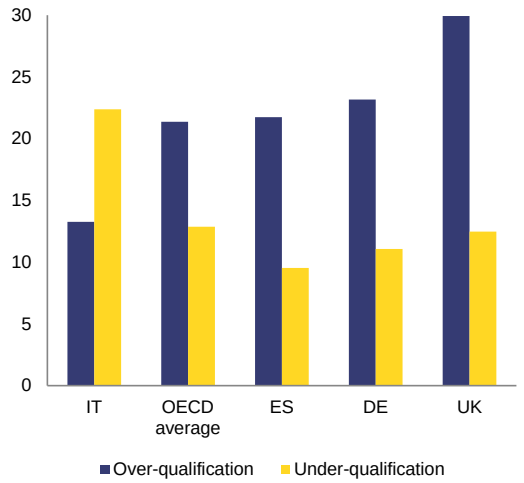
([24]) Hanushek E. A., Schwerdt G., Wiederhold S., Woessmann L. (2013), 'Returns to skills around the world: evidence from PIAAC', *OECD Education Working Papers*, No. 101. The paper finds that returns to skills are on average lower in Italy than in most of the other OECD countries, and that the differential between the return to skills for older workers (those aged 55-65) and that for young adults (aged 25-34) is higher than in the other OECD countries covered by the study.

Graph 2.2.24: **Age-earning profile, 2012**



(1) Wages are calculated from EU SILC data on yearly gross employee cash or near cash income, which includes salaries and other benefits (e.g. holiday and overtime payments). The yearly income is divided by the average hours worked to approximate an hourly wage. The lines are polynomial interpolation of actual data.
Source: European Commission, EU-SILC

Graph 2.2.25: **Incidence of over- and under-qualification (% of workers), 2012**



Source: OECD, PIAAC

Aligning wages with productivity and promoting the adoption of innovative solutions at firm level remain challenges for Italy. Decentralised bargaining can play an important role in strengthening the responsiveness of wages to productivity as well as to labour market conditions. Firm-level contracts on economic issues still concern a minority of firms, with the share being lower in southern regions. ([25]) In January 2014, the social partners signed a further agreement for the manufacturing sector, laying down the procedures for measuring trade union membership in line with the criteria for certification of trade unions' representation defined by a previous 2011 agreement. The 2014 agreement is however not operational yet due to administrative and institutional issues, while a large majority of collective contracts in the manufacturing sector are coming to an end in 2015. Pending the implementation of the agreement, a number of obstacles continue to prevent firms and workers from engaging in firm-level negotiation. If properly implemented, the agreement could also make effective the possibility of derogating from national collective contracts, which was formally introduced by the 2011 intersectoral agreement but rarely implemented.

Building on earlier reforms, the current government has initiated a comprehensive reform to improve labour market functioning, while reducing segmentation. In December 2014, the parliament approved an enabling law, the 'Jobs Act' for the reform of the labour market. The act follows the pattern and direction of previous reforms. It makes decisive changes in employment protection legislation, the unemployment benefits system and wage supplementation schemes, and the governance and functioning of active and passive labour market policies. It also envisages action to reduce the administrative burden on firms, improve the effectiveness of the labour inspectorate and promote reconciliation between family and working life (see Section 3). Implementing legislative decrees have to be enacted within six months. Swift implementation of the 'Jobs act' should improve entry and exit flexibility, enhance labour reallocation and promote stable open-ended employment, most notably for the young.

The first legislative decree revises dismissal rules for new hires under open-ended contracts. The decree de facto revises for new hires the article of the Worker Statute (i.e. Article 18) that regulates unfair dismissals. The decree has

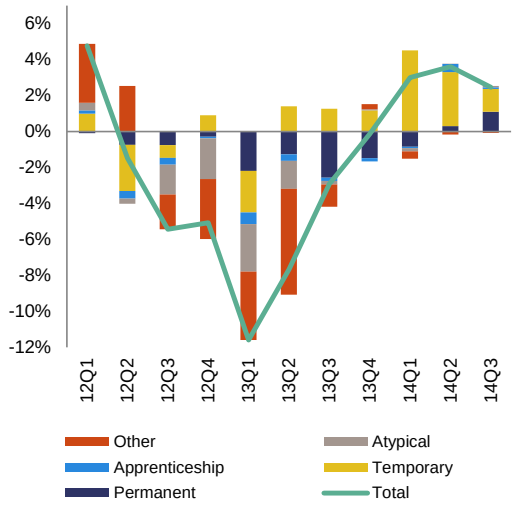
([25]) 'Nota dal Centro Studi Confindustria', *Confindustria*, No. 2, 2015

completed the legislative process and will enter into force in March 2015. In particular, it substantially reduces the scope for reinstatement following unfair dismissals and expands the number of cases where the sanction leads to a monetary compensation, which rises with tenure. Reinstatement can be ordered only in case of discriminatory dismissal or if the disciplinary reason put forward by the employer is false. It cannot longer be ordered in case a dismissal motivated by economic reason is judged unfair. Compensation is also foreseen in case of collective dismissal procedures, thereby extending the scope of the new rules in case of restructuring. Compensation for unfair dismissal remains much higher than for fair dismissals (which is virtually zero in Italy), which may increase both the incentive to go to court and the cost of the litigation. To limit court cases, the decree further facilitates the settlement of dismissal disputes through conciliation, supported by fiscal incentives. For workers laid off, the decree introduces, the "*contratto di ricollocazione*", i.e. a voucher for laid-off workers. The government is accompanying the reform with hiring incentives for permanent contract (see Section 3.4).

A complementary decree revises labour contracts and allows a more flexible use of labour within the firm. With a view to reducing duality, the enabling law foresees that the revision of dismissal rules is accompanied by a revision of labour contracts. The respective legislative decree has been tabled in February, and is now subject to the non-binding opinion of the Parliament. The decree provides a clear definition of dependent employment, under which all existing atypical contracts have to be brought back as from January 2016, with the exception of well-defined circumstances. This is an important step to reduce duality. The 2012 reform has already reduced the use of atypical contracts (Graph 2.2.26) and this was accompanied by an increase in the use of temporary contracts, especially of young people, also driven by further measures to liberalise temporary contracts introduced in 2013 and 2014. The decree also clarifies certain provisions for temporary contracts, seasonal work, part-time, agency work and job-on-call. It also reviews apprenticeship contracts, by reducing the costs for the employers and enhancing the scope of formal education, in the attempt of encouraging its uptake – so far very limited – and moving closer to a dual system. Finally, the decree enhances flexibility in the allocation of labour within the firm, by allowing workers to be assigned to different tasks during restructuring periods.

The new rules have several benefits for the labour market functioning and the potential for reducing duality. Overall, the new provisions reduce the uncertainty and costs associated with the dismissal procedure, including by further fostering pre-trial negotiation, and reduce the scope of atypical contracts. In the medium- to long-term, as the number of workers under the new regime increases, this could improve reallocation across sectors, promote stable employment prospects, not least for young people and encourage job-specific training. Its effects on total factor productivity growth are therefore likely to be positive. However, the labour judges' interpretation of the new legislation will be important for the reform to have a rapid impact. Its effect on labour market duality will depend on the scale of the take-up of open-ended contracts, which will be influenced also by the effectiveness of rebates on social security contributions introduced by the 2015 Stability Law and available for three years for contracts signed in 2015.

Graph 2.2.26: **Growth of new contracts signed and contributions by contractual forms, y-o-y % change**



Source: European Commission, Ministry of Labour Comunicazioni Obbligatorie

A more integrated unemployment benefit system is being developed, based on unemployment insurance with broader coverage and stronger conditionality, and on a newly introduced unemployment assistance for long-term unemployed. A second legislative decree will enter into force in March 2015. The decree introduces a new unemployment benefit *(Nuovo Assegno per l'Impiego – NASPI)* targeting all employees in the private sector who become unemployed from May 2015 onwards. Compared to the previous system, NASPI provides for a longer duration of benefits (from 18 to 24 months) while broadly maintaining their level and reduces the contribution periods. Furthermore, it strengthens the conditionality with regard to job-search or training activities. In an experimental manner for 2015, two additional schemes are introduced. The first provides an unemployment insurance scheme (*Indennita' di disoccupazione per i lavoratori con rapporto di collaborazione coordinate e continuative e a progetto – DIS-COLL*) to workers in atypical (collaboration) contracts who become unemployed in 2015. The second (*Assegno di disoccupazione*, ASDI) is an unemployment assistance scheme, means-tested and linked to activation measures, which provides an extra six months' cover to unemployed workers with children or close to retirement who have exhausted their right to the NASPI. It is non-contributory and it may imply a positive step in providing some income support and activation measures to the long-term unemployed (see Section 3.3).

The new unemployment benefit system represents a substantial change supporting workers' in transition from unemployment to employment, in particular in light of the envisaged revision of wage supplementation schemes. The measures introduced address the rigidities of dismissal procedure while securing workers' transition between different jobs. Flexibility for workers to move between different occupations and location is combined with more secure transitions between different employment statuses. The risks of unemployment traps, in particular at low level of incomes, stemming from more generous unemployment benefits need to be addressed with cost-effective activation policies, for which new implementing legislation is needed. An additional important complementary provision is the revision of the wage supplementation schemes (*Cassa Integrazione Guadagni*), also due under the enabling law. Wage supplementation schemes provide an effective way to avoid wasteful labour shedding during recessions, but also delay economic restructuring and labour reallocation, with negative effects on productivity growth and workers' employability. The government intends to review and substantially streamline these schemes, among other things by reducing their duration and the cases where they can be used and by improving the insurance dimension (firms using more frequently the scheme will contribute more to its financing).

2.3. SPECIAL TOPIC: ITALY'S BANKING SECTOR IN A PROTRACTED LOW-GROWTH ENVIRONMENT

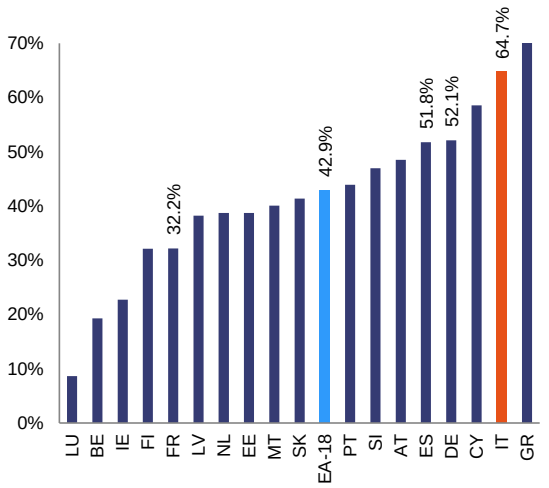
Bank-corporate nexus

The protracted crisis has exposed the vulnerability inherent in the close intertwining between Italian banks and corporates. This mutual vulnerability is rooted in the significant presence of overleveraged bank-dependent companies, firms' weaker financial health and creditworthiness due to the protracted crisis, the high stock of non-performing loans on banks' balance sheets, and contracting bank credit to the non-financial corporate sector.

Italian banks are relatively more exposed to corporates through lending than banks in other euro area countries, while Italian firms are more reliant on external debt financing (bank loans) than their European peers. The former fact is due to Italian banks' business models which are strongly focused on traditional intermediation through deposit-taking and lending. Regarding the latter fact, in 2013, bank loans represented 64.7 % of Italian firms' total financial debt, more than 20 percentage points higher than the euro area average (Graph 2.3.1).

The demography of the Italian non-financial corporate sector is skewed towards very small businesses which explains the high incidence of bank loans in firms' external funding. SMEs are the backbone of the Italian economy. In 2012, 99.9 % of Italian businesses employed fewer than 50 employees, generated almost 70 % of value added and accounted for just over 80 % of people employed. Micro-firms (with up to nine employees) — of which a substantial share are 'artisanal' firms — accounted for 95.2 % of all companies and were good for around 30.8 % of value added and close to 50 % of persons employed. As small firms — and especially micro-firms — tend to have only limited access to capital market funding, their high share in the total number of Italian firms helps to explain the high incidence of bank loans in corporates' external funding. Other relevant factors include the strong presence of banks focused on traditional deposit-taking and lending, underdeveloped capital markets, the high incidence of family ownership of firms (implying reluctance to give up control) and a long-standing bias in taxation towards debt financing.

Graph 2.3.1: **Share of domestic bank loans in total financial debt of the non-financial corporate sector at end-2013**

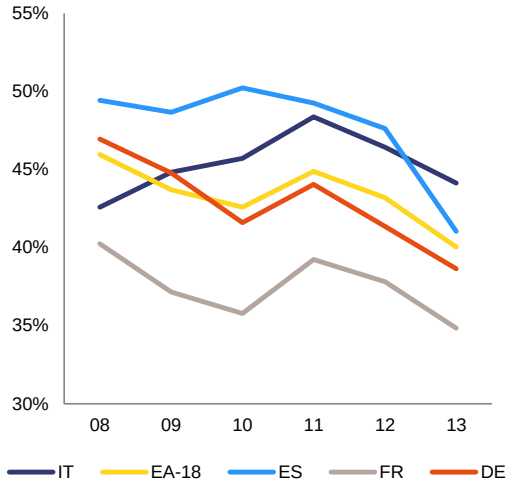


Source: European Commission, European Central Bank

The financial structure of Italy's non-financial corporate sector is characterised by relatively high financial leverage, where the latter is inversely proportional to firm size. In 2013, the average financial leverage ([26]) of the Italian corporate sector was 44.1 %, around 4 percentage points higher than the euro area average. This implies that Italian firms on average are less well capitalised than businesses in other euro area countries and thus less resilient to financial shocks. After 2011, the contraction of bank lending to firms and the increased recourse of medium-sized and large firms to capital markets caused financial leverage to start falling, a trend which began earlier in other large euro area economies (Graph 2.3.2).

([26]) Financial leverage is defined as the ratio between financial debt and the sum of financial debt and equity. Financial debt consists of loans and debt securities. This concept should be distinguished from indebtedness, which is measured by the corporate debt-to-GDP ratio.

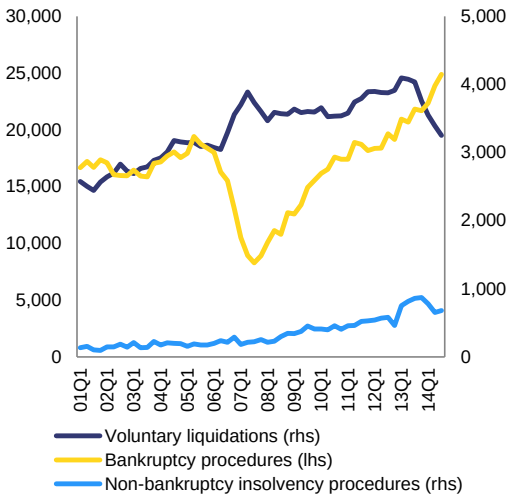
Graph 2.3.2: **Financial leverage of the non-financial corporate sector**



Source: European Commission

The deep and protracted recession in Italy has severely affected the creditworthiness of Italian firms and has widened the gap between small and large companies. Over the period 2008-2013, the gross operating surplus of the Italian non-financial corporate sector has decreased by more than 10 %. Compared to before the crisis, the share of firms making a profit has declined by around 10 percentage points to around 55 %. The negative effect of the decline in sales and profits on firms' financial health and creditworthiness is exacerbated by the high financial leverage of many Italian firms. A recent study by the Bank of Italy has found that a 10 percentage points increase in financial leverage implies a 1 percentage point higher probability of default, and that the adverse impact of a drop in sales on a firm's solvency is almost four times greater for businesses in the highest quartile of the financial leverage distribution than for companies in the lowest quartile. ([27]) At the end of June 2014, the average interest expense coverage ratio of Italian firms ([28]) — a measure of debt-service capacity — reached a new peak of close to 22 %. A third of Italian companies are estimated to be financially fragile as their interest expense coverage ratio is above 50 %. The deterioration in Italian firms' creditworthiness is also clearly visible in the number of bankruptcies which has increased steeply since 2008. In addition, recourse to non-bankruptcy insolvency procedures and voluntary liquidations has gone up (Graph 2.3.3). Furthermore, the long crisis has led to a polarisation of financial health by firm size. The turnover and gross operating margin of small firms — on average characterised by lower productivity, higher financial leverage and higher dependence on domestic demand — have been affected more severely than those of medium-sized and large businesses (Graph 2.3.4). The future financial situation of Italy's corporates crucially depends on how soon the economy will return to growth.

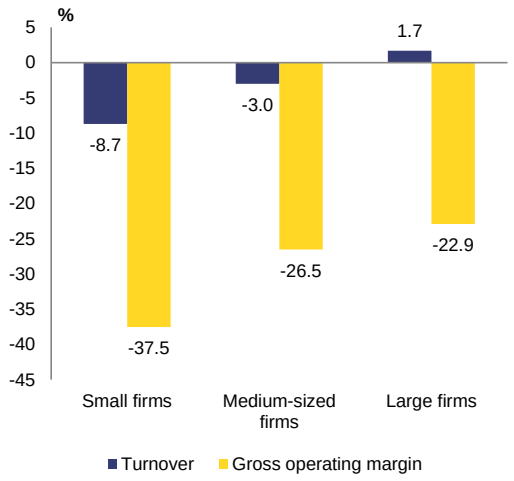
Graph 2.3.3: **Number of bankruptcy and non-bankruptcy insolvency procedures and voluntary liquidations in Italy**



(1) Seasonally-adjusted data
Source: Cerved Group, Rapporto Cerved PMI 2014, 2014

([27]) 'The role of leverage in firm solvency: evidence from bank loans', *Bank of Italy Occasional Papers*, no. 244, 2014.
([28]) The interest expense coverage ratio is calculated as the ratio of net interest expense to gross operating profit.

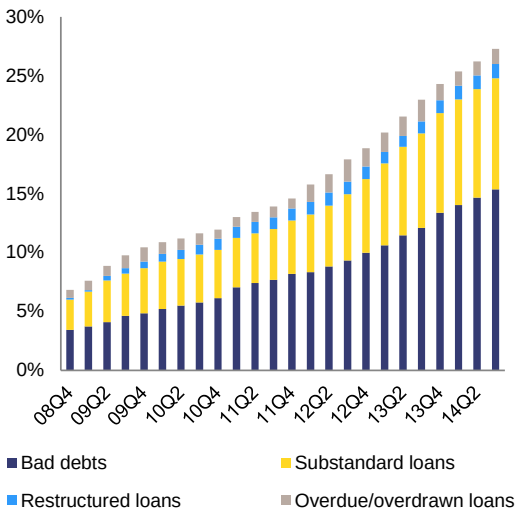
Graph 2.3.4: **Change in turnover and gross operating margin between 2007 and 2013 by firm size**



Source: Cerved Group, Rapporto Cerved PMI 2014, 2014

The deterioration in the quality of loans to firms has led to a sharp increase of non-performing loans and a substantial erosion of banks' profitability. Since the end of 2008, the non-performing loan ratio (as a share of total customer loans) of the Italian banking sector as a whole has more than tripled and stood at 16.6 % in the third quarter of 2014. Bad debts — the worst category of impaired loans in Italy ([29]) — amounted to EUR 177 billion (i.e. 9.3 % of total customer loans). The increase in the non-performing loan ratio is mainly due to banks' corporate exposures. Considering only non-financial corporations and producer households, Italian banks' non-performing loan ratio has risen from 6.8 % in the fourth quarter of 2008 to 27.3 % in the third quarter of 2014 of which more than half (i.e. 15.4 % or EUR 141 billion) was bad debt (Graph 2.3.5). The corporate non-performing loan ratio is significantly higher in southern Italy. Part of the increase in the non-performing loan ratio is denominator-driven (i.e. the contraction of outstanding credit to firms). In the course of 2014, the inflow of new corporate non-performing loans and of bad debts stabilised at around 7 % and 4 % of the stock of loans to firms respectively. The inflow is higher for small firms and those that are more dependent on bank loans. Despite this stabilisation, a further increase in the corporate non-performing loan ratio is likely as the transition dynamics of impaired loans to the corporate sector are still very much biased towards further deterioration. The dramatic increase in non-performing loans has significantly undermined Italian banks' already weak profitability: in 2013, almost half of banks' total operating income was absorbed by loan impairments (Graph 2.3.6). The recognition of loan losses by banks has been accelerated in recent years by the strict loan portfolio reviews conducted by the Bank of Italy and as part of the European Central Bank's comprehensive assessment of euro area banks as well as the increased tax deductibility of loan-loss provisions and loan write-offs (albeit the Italian regime still represents a disincentive compared to the regime in some other Member States). This is reflected in the coverage ratio for non-performing loans ([30]) which increased from 37.7 % in June 2012 to 42.4 % in June 2014, and for bad debts, which rose from 54.7 % to 57.1 %. Medium-sized banks seem less well covered than the largest banks, while small banks compensate for their lower coverage ratio with more collateral.

Graph 2.3.5: **Corporate non-performing loan ratio of Italian banks**

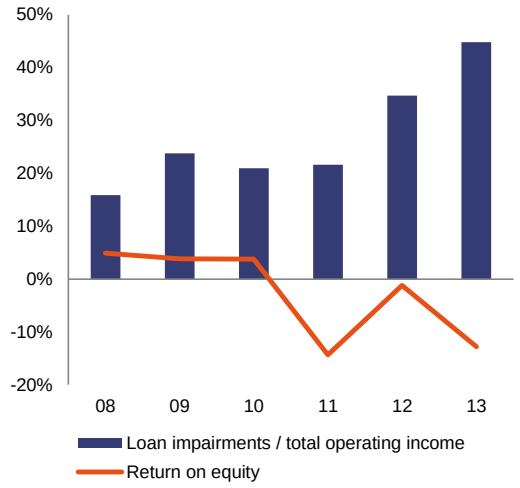


Source: Bank of Italy

([29]) In Italy, impaired loans are classified into four categories: bad debts (*sofferenze*), substandard loans (*incagli*), restructured loans (*partite ristrutturate*) and overdue/overdrawn loans (*partite scadute*).

([30]) The non-performing loan coverage ratio is the ratio of the stock of loan-loss provisions to the stock of non-performing loans.

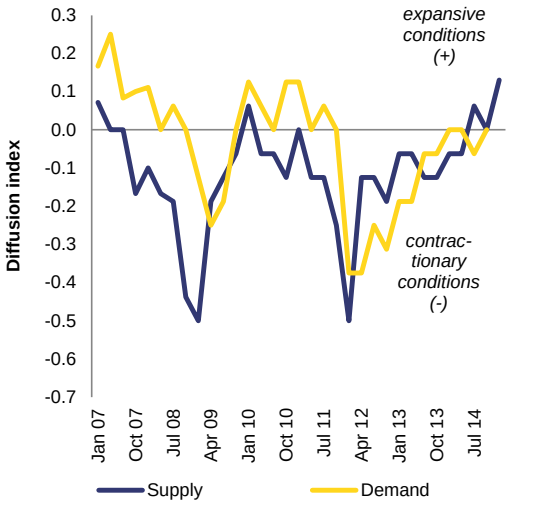
Graph 2.3.6: **Ratio of loan impairments to total operating income and return on equity of Italian banks**



Source: European Central Bank

Banks' credit to Italian firms has contracted strongly in response to higher credit risk and other supply constraints, but weak credit demand has increasingly become the main driver of the downward trend of credit contractions to firm. On the supply side, the contraction is mainly explained by increased credit risk which has made banks much more selective in granting credit and looking for opportunities with better risk-return profiles such as securities investment. Temporary uncertainty over the evolving regulatory framework and the conclusion of the European Central Bank's comprehensive assessment of euro area banks may also have played a role. On the demand side, the main drivers are subdued investment due to the uncertain economic outlook and high spare capacity, the increased recourse of large corporates to alternative funding channels such as bond issuance (this explains why bank credit contracted more for large than for small firms), and to some extent deleveraging needs among highly-indebted corporates. Over the past two years, the gradual withdrawal of credit supply conditions from contractionary territory has preceded that of credit demand conditions, which are now considered the main determinant of observed lending trends (Graph 2.3.7). Since mid-2014, credit supply conditions have been close to neutral, but access to finance for small firms with weaker balance sheets remains precarious. Given the uncertain economic outlook and continued high credit risk, lending volumes are not expected to recover quickly.

Graph 2.3.7: **Credit supply and demand conditions for Italian non-financial corporates**



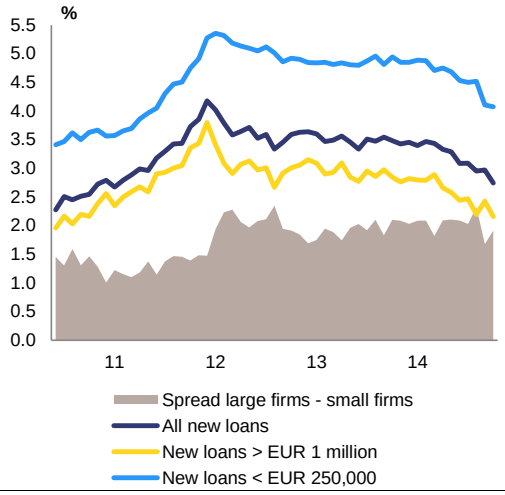
Source: Bank of Italy

Small Italian firms have become the main victim of banks' tight credit conditions in recent years due to their strong dependence on bank funding and high financial leverage. This is reflected in the increase in lending rates which banks have been charging on new loans to Italian SMEs, adding further to their financial difficulties by undermining their debt service capacity and profitability. Although since mid-2011 the cost of new bank loans to Italian companies has risen for all firm sizes, the spread between the average interest rate charged to small firms (proxied by loans below EUR 250,000) and large firms (proxied by loans above EUR 1 million) has widened (Graph 2.3.8). Since mid-2014, nominal lending rates have started declining (in part thanks to the European Central Bank's further monetary easing), but the beneficial effect has been offset by the fall in inflation which has pushed real interest rates up. The asymmetric impact of tighter bank lending conditions on small firms is also reflected by the inverse relationship between firm size on the one hand and the share of discouraged borrowers ([31]), the share of firms of which the loan

([31]) Discouraged borrowers are borrowers deciding not to apply for a loan out of fear of rejection.

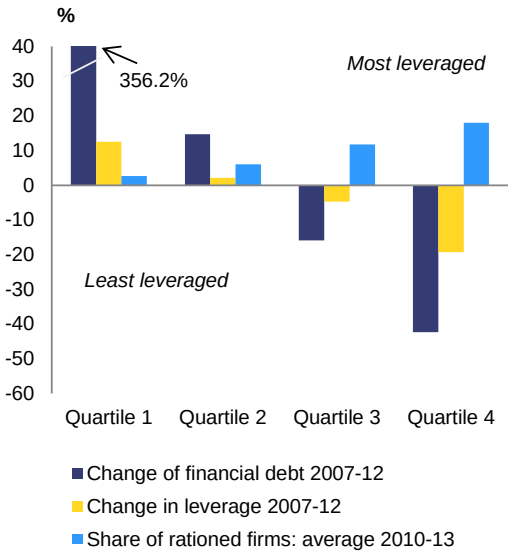
application was rejected, and the share of firms declaring their liquidity situation as insufficient on the other hand. Similarly, the deleveraging of the Italian non-financial corporate sector — in part due to the strong credit contraction — has mainly involved those firms with the highest leverage before the recession, in particular small firms (Graph 2.3.9). Looking ahead, firms' lower leverage should in principle have a beneficial effect on their financing conditions given improved creditworthiness.

Graph 2.3.8: **Bank interest rates on new loans to Italian firms**



Source: Bank of Italy

Graph 2.3.9: **Deleveraging and credit rationing of Italian firms per leverage quartile**



Source: Bank of Italy, Financial Stability Report, no. 2/2014, November 2014

Over the past year, the Italian authorities have enacted several structural measures targeted at diversifying firms' funding sources, decreasing dependence on banks and fostering more resilient financial structures. In the course of 2014, several important measures were taken which could contribute to weakening the bank-corporate nexus in Italy. Recent survey evidence suggests, however, that SMEs' awareness of the measures remains rather limited which may in part be due to increasing policy fragmentation. ([32]) First, to give Italian firms an incentive to make their equity base more robust, the Italian government has further strengthened the so-called 'allowance for corporate equity' (ACE) framework ([33]). It has done so in particular by extending the benefit to firms without income tax liabilities

([32]) Ministero dello Sviluppo Economico (MISE), *Indagine sulle micro, piccole e medie imprese: sintesi dei principali resultati*, July 2014. In this survey, high shares of respondents claiming that they did not know the allowance for corporate equity (ACE) and mini-bond frameworks (76.2 % and 75.2 % respectively). The most well-known initiatives are the Central Guarantee Fund for SMEs (50 % of respondents knows it) and the 'Nuova Sabatini' framework to support specific types of SME investment (60.8 % of respondents knows it).

([33]) Since 2012, this framework allows Italian firms to deduct a notional return on new equity capital or reinvested earnings in computing taxable profits.

through the provision of a regional tax (IRAP) credit instead (to be split into five equal yearly amounts), and by allowing firms that have decided to list themselves on a stock exchange to benefit from a 40 % increase in the amount of equity capital raised to determine the allowance during the first three years of being quoted (*super-ACE*) (the latter measure is, however, still under approval by the European Commission). According to a Bank of Italy survey of firms ([34]), only around 10 % of firms that have increased or expect to increase net equity do so because of the allowance for corporate equity framework. This situation may have changed since the recent measures strengthening the allowance for corporate equity, but lack of data prevents a further assessment at this stage. Second, measures were introduced to encourage the stock-market listing by SMEs. Third, the so-called 'mini-bond' framework ([35]) has been further strengthened to support a decrease in bank dependence of Italian firms. In particular, the favourable withholding tax regime already applicable to interest paid by listed bonds has been extended to interest paid by unlisted (mini-)bonds, and mini-bonds as well as portfolios thereof have become eligible for guarantees by the Central Guarantee Fund for SMEs. Since November 2012, there have been around 70 mini-bond placements for a total value of almost EUR 8 billion (ca. 10 % of total bond issuance over the period). Initially, issuance was dominated by larger corporates with strong balance sheets which replaced bank debt with mini-bonds, but the recent decrease in average issuance size suggests a growing presence of medium-sized firms, many of which are first-time issuers. For small firms however, mini-bond issuance seems realistic only in combination with securitisation given the low liquidity and higher risk of individual placements, and assuming small firms are willing to bear the costs of higher transparency requirements. A fourth measure is the exemption of institutional investors and foreign investors from the withholding tax regime applicable to their medium- and long-term financing to the Italian economy, as such fostering their development as alternative lenders to the economy. Fifth, insurance companies (in addition to securitisation firms and collective investment funds) have been allowed to provide lending to firms, either directly or together with banks, and subject to prudential rules and monitoring from the insurance supervisor IVASS. A similar mandate is being granted to export insurance agency SACE. Although the long-term nature of insurers' liabilities makes them suitable alternative lenders and corporate lending may currently offer better returns than insurers' traditional investment policies, it remains to be seen whether this measure will be successful in reducing Italian SMEs' credit constraints. In particular, the current economic climate and high corporate credit risk, the high cost of setting up a credit monitoring capacity, preparations for the introduction of the Solvency II framework and the improved opportunities to acquire exposure to the corporate sector by investing in (loan) securitisations may make insurance companies reluctant to embark on direct lending. Sixth, Cassa Depositi e Prestiti has decided to invest EUR 350 million in a private-debt and venture-capital funds, thus supporting the further development of capital markets in Italy. Finally, the Italian government has decided to create a service company to capitalise and restructure of promising Italian industrial firms in temporary financial difficulties. However, further details are still lacking.

Other policy measures have been targeted more at overcoming firms' more immediate access-to-finance obstacles in the context of the current protracted crisis. Overcoming access to finance and the liquidity problems of SMEs — the backbone of the Italian economy — is essential to keeping viable firms in business and supporting Italy's economic recovery, in particular through investment. In terms of mitigating credit risk, the most significant measure has been the progressive strengthening of the Central Guarantee Fund for SMEs in various ways. During the crisis, reliance on the Central Guarantee Fund has increased strongly, and the Fund has played an important role in supporting the observed increase in the share of secured bank loans. During the first 10 months of 2014, EUR 6.5 billion of guarantees were granted in relation to a loan volume of EUR 10.2 billion. More than 80 % of the loans concerned were contracted by micro- and small firms. However, only a small share of the volume of guaranteed loans (ca. 20 %) was meant to

([34]) 'Indagine sulle imprese industriali e dei servizi – Anno di riferimento 2013', *Banca d'Italia - Supplementi al Bollettino Statistico*, no. 40, July 2014.

([35]) Mini-bonds are unlisted corporate bonds, a funding instrument which was introduced in 2012 to diversify the debt financing of medium-sized and small enterprises.

finance investment, whereas 80 % was granted for supporting firms' working capital. This suggests that Italian SMEs continue to face challenges in expanding investment. A recent impact study ([36]) of the Central Guarantee Fund's activities suggests that firms which access the Fund have mainly benefitted from increased loan size rather than a lower interest rate. Further crisis-inspired initiatives to ease access to finance for firms and SMEs include in particular the increased involvement of Cassa Depositi e Prestiti which in cooperation with the Italian Banking Association (ABI) has been supporting investment by SMEs (for example in new machinery and equipment through the EUR 5 billion *Nuova Sabatini* programme), as well as several debt moratoriums. Finally, also the repayment by the public administration of trade debt arrears (EUR 35.3 billion reimbursed at the end of January 2015) has also helped to alleviate credit constraints on firms, but most of the reimbursed funds have been used to reduce debt towards suppliers, employees and banks rather than to finance new investment.

The very large stock of impaired loans that built up during the crisis represents a crucial challenge for Italy in the years to come. In the third quarter of 2014, Italian banks' balance sheets were burdened with a non-performing loan stock of around EUR 315 billion, of which EUR 250 billion related to corporates. In addition to being a drag on new loan generation in favour of the real economy, undermining banks' profitability and capital adequacy, this large impaired loan stock may put strain on the capacity of many Italian banks — especially medium-sized and small ones — to appropriately manage arrears. Now that the inflow of new non-performing loans is stabilising, banks have started to concentrate their efforts on raising the rate at which impaired loans are cleared from their balance sheets. Italy's two largest banks have taken the lead by preparing to set up a common private vehicle dedicated to the proactive management of restructured loans, also leveraging the knowledge and expertise of external partners. Smaller banks with limited or insufficient in-house capacity to service impaired assets are increasingly outsourcing this activity to non-performing loan servicing companies. Another way to dispose of non-performing loans is their sale on the distressed-debt market. Banks' incentives to do this include the removal of overhead expenses related to non-performing loan management, the reduction of risk-weighted assets and consequent freeing up of regulatory capital, and the recovery of profitability. In Italy however, the size of the distressed-debt market is very small compared to the impaired loan stock, despite the recent gradual increase in transactions (Graph 2.3.10). On the back of the still uncertain economic outlook, the reasons for this include: (i) the lack of sectoral coordination which would especially benefit smaller banks (further exacerbated by the fragmentation of the Italian banking sector); (ii) banks' reluctance to sell in anticipation of a recovery in collateral values or given their preference to preserve long-standing customer relationships; (iii) Italy's very slow and inefficient judicial processes which undermine the recovery value of collateral; (iv) a thin capital buffer to absorb losses in the case of some individual banks ([37]). Nevertheless, a number of obstacles to the development of a distressed-debt market in Italy have recently been removed. First, the improved tax deductibility of loan-loss provisions and write-offs enacted in 2013 has somewhat reduced banks' fiscal disincentives to recognise losses and has— in combination with a lower haircut required by potential sellers due to the slowly improving economic outlook — somewhat narrowed the spread between the bid and ask price of impaired assets. Second, the conclusion of the European Central Bank's comprehensive assessment of euro area banks has increased transparency on the quality of asset portfolios of the banks covered by the exercise. ([38]) Third, anecdotal evidence suggests that in recent months foreign investors

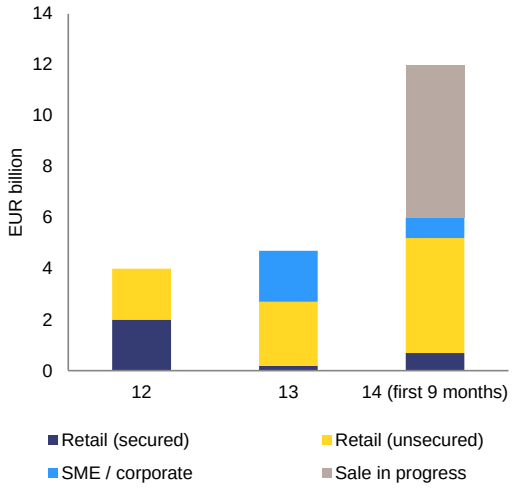
([36]) Promuov Italia, Rapporto di Approfondimento sul Fondo di Garanzia, 2014.

([37]) See for instance: 'A strategy for developing a market for non-performing loans in Italy', *IMF Working Papers*, WP/15/24, 2014.

([38]) Nine out of the 15 Italian banks participating in the European Central Bank's comprehensive assessment registered capital shortfalls based on 2013 balance-sheet data. All banks passed the asset quality review when considering the capital increases made in the first nine months of 2014, whereas the stress test revealed capital shortfalls amounting to EUR 3.3 billion for four banks. By taking into account other mitigating measures adopted in the course of 2014 (e.g. one-off asset divestments, finalization of ongoing authorization procedures to use internal models), the theoretical capital shortfalls were reduced to EUR 2.9 billion. These shortfalls are currently concentrated in two banks, namely in Banca Monte dei Paschi di Siena and Banca Carige.

have become increasingly interested in investing in Italy. For the time being however, the non-performing loan work-out rate in Italy remains currently too low to achieve a significant reduction in the non-performing loan stock over a reasonable time period. If the write-off rate does not increase significantly, the stock of non-performing loans is likely to remain a drag on Italian banks' activity for a protracted period of time, also contributing to the holding back of the Italian economy's recovery.

Graph 2.3.10: **Sales of impaired assets by Italian banks**



Source: PriceWaterhouseCoopers (PWC), European Portfolio Advisory Group - Market update, November 2014

Although Italy's insolvency framework has been modernised in recent years to facilitate corporate restructuring and rescue, the beneficial effects are being held back by Italy's inefficient and overburdened court system (see Section 3.1). Efficient (pre-)insolvency frameworks play an important role in fostering the early restructuring and rescue of financially distressed but viable firms and the speedy liquidation of non-viable ones. As such, these frameworks speed up the deleveraging process of the corporate sector, support the resolution of impaired assets on banks' balance sheets, support recovery values and contribute to a culture of second chance and entrepreneurship. Since 2005, Italy's general insolvency law (*legge fallimentare)* has been subject to several modernisation efforts, which have mainly promoted the rescue of viable firms. A diverse set of tools — including out-of-court ones — is now available, such as the restructuring-driven preventive composition (*concordato preventivo*) for companies in financial crisis, which is similar to the 'Chapter 11' process in the United States. Further innovations include the super-seniority status of interim financing and the immunity of out-of-court certified rescue plans (*piani di risanamento*) from claw-back actions in case of subsequent insolvency. Small enterprises are eligible for the personal insolvency framework (*procedura liquidatoria per sovraindebitamento*) following an amendment in 2012 and the recent creation of a special body to facilitate the preparation of restructuring plans and support the overall process. The recent reforms have done much to bring Italy's insolvency framework into line with international best practices. However, their effectiveness is being significantly weakened by the insufficient capacity of the country's court system, which has come under additional pressure from the high inflow of new cases due to the protracted recession. This is *inter alia* reflected in the very long average duration of bankruptcy procedures, which still averaged 7.9 years for cases closed in 2013, albeit one year less than in 2011. ([39]) Although their impact is not yet known, measures have been taken to address the shortcomings of the court system (e.g. the arbitral transfer) which are to apply also to disputes emerging in the context of bankruptcy. On the other hand, the steadily increasing number of bankruptcies indicates that there is room for improvement in the timely use of the pre-insolvency instruments. A detailed analysis of the effectiveness of the various new tools in Italy's insolvency framework — also taking into account the diluting impact of the crisis — is needed to determine whether further policy intervention is required. In this context, the Italian Ministry of Justice decided in January 2015 to establish a commission of experts which is expected to make proposals for the reform and streamlining of the Italian insolvency and collateral framework by end-2015. In addition, soft-law guidelines (such as best practices among banks, including those for promoting early-warning systems) may help to encourage stakeholders to take timely steps towards restructuring.

Excessively long judicial proceedings are an important obstacle to the proper functioning of the legal framework on collaterals in Italy,

([39]) Cerved Group, *Rapporto Cerved PMI 2014*, 2014.

further reform of which is under discussion. In general, speedy, cheap and simple collateral enforcement procedures facilitate the work-out of secured impaired loans, maximise the recovery value of pledged assets, thereby foster the development of a private distressed-debt market, and have beneficial effects on the availability and cost of credit to firms. Although Italy's collateral seizure framework has in recent years undergone some reforms aimed at simplifying the enforcement procedure, there seems to exist scope for further intervention. Important proposals have been tabled to tackle remaining framework-related and existing practice-related obstacles, but they have not been pursued on so far to their full extent. Innovations put forward include fine-tuned non-possessory liens, also enabling automatic collateral appropriation by the creditor if the debtor fails to comply with his obligations, and tools such as an electronic database allowing the traceability of movable-asset collaterals. In addition, some proposals based on the experience of other jurisdictions have been floated, such as the fiduciary loan contract. ([40]) Discussions would need to produce a result that fits the Italian context and legal system. Last but not least, in the interest of efficient enforcement, it is essential that the bottleneck of Italy's underperforming court system, which has come under further strain from the long crisis is tackled: on average, it still takes around three years to foreclose and collect collateral through court procedures in Italy.

The reform of the governance of Italy's largest cooperative banks (*banche popolari*), recently adopted by the government, may kick-start a process of consolidation, which could strengthen the banking sector's capacity to work out non-performing loans. In January 2015, the Italian government adopted a decree law requiring Italy's 10 largest cooperative banks (*banche popolari*) to abolish the so-called 'one-head-one-vote' principle ([41]) and the 1 % ceiling on the stake of individual shareholders and to transform themselves into joint-stock companies. Furthermore, the decree law relaxes the voting rules applicable to mergers and acquisitions and decisions on a change of legal form, while also relaxing rules on proxy votes. As such, the decree law addresses long-standing concerns regarding the weaknesses of Italy's largest *banche popolari*. In addition to improving effective oversight and shareholder control over the banks' management and making the banks more attractive to new investors, the reform — if fully adopted by parliament — is expected to trigger consolidation within the market segment. This may in turn strengthen banks' impaired-loan work-out capacities, apart from creating scope for cost synergies. Contrary to the governance reform of the *banche popolari*, there has not yet been a specific intervention reviewing the role of foundations in the Italian banking sector.

Bank-sovereign nexus

The Italian banking sector traditionally holds a large amount of domestic government bonds which are generally considered highly liquid. Since the beginning of 2012, domestic banks have significantly increased their domestic sovereign exposure, to a large extent absorbing volumes shed by foreign investors and thereby sustaining bond prices and expanding their collateral pool. By relying on cheap Eurosystem funding through participation in the two three-year long-term refinancing operations (LTROs), several Italian banks were able to support their profit through carry trade. ([42]) In June 2013, domestic banks' sovereign exposure reached a peak of EUR 426 billion (corresponding to 10.2 % of total bank assets). Since then, banks' holdings have been broadly stable, fluctuating around EUR 400 billion (Graph 2.3.11).

In spite of some new disincentives, Italian banks are expected to remain closely intertwined with the sovereign. In the medium term, Italian banks' holdings of domestic sovereign debt securities are likely to remain high due to the substantial financing needs of the Italian sovereign and the attractiveness of sovereign security investment compared to alternatives such as lending in the current weak economic environment ([43]).

([40]) IMF, *Article IV Consultation – Italy*, 2014. See also the 2013 Belgian act on security interests on movable assets.

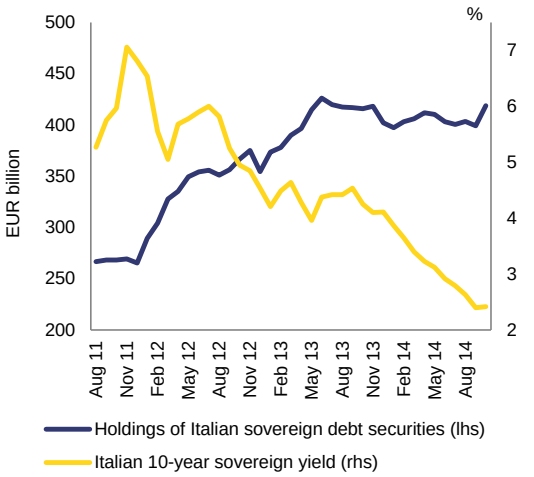
([41]) Every shareholder holds one vote irrespective of the size of his shareholding.

([42]) Carry trade exploits the positive spread between the (high) yield on (domestic) sovereign bonds and the (low) refinancing rate offered on Eurosystem liquidity facilities.

([43]) According to the Bank of Italy, lending – when adjusted for the cost of provisioning – currently produces a return

However, there are other developments, which are likely to lower incentives for banks to invest in sovereign debt. One of these is the gradual phase-out of prudential filters which neutralised the valuation effects of changes in bond prices on banks' capital under the EU's new legal framework on capital requirements. Others include the lower relative attractiveness of Italian sovereign securities due to the substantial fall in the return they offer, and the Eurosystem's replacement of long-term refinancing operations with targeted long-term refinancing operations (T-LTROs) ([44]) of which the use by participating banks is more constrained. The continued high exposure of Italian banks to domestic sovereign debt implies risks for both the banks and the sovereign. First, in spite of the current favourable market conditions, the banking sector remains vulnerable to adverse yield and credit rating developments in the Italian sovereign debt market. In combination with the planned phase-out of prudential filters, these would result in more volatile capital ratios, depending on the accounting classification applicable to sovereign bonds' holding. Second, given the historically high share of Italian government bond holdings in banks' total assets, the willingness of banks to sustain demand for sovereign debt may be limited. Should Italian banks start reducing their exposure significantly, sovereign yields may rise with potentially negative effects on the rest of the economy (for example through higher lending rates). This risk is, however, mitigated by the gradual decline in the Italian government's borrowing requirement if the path of fiscal consolidation is maintained, and the expansion of the European Central Bank's asset purchase programme, which will also involve euro area sovereign bonds ([45]). The latter creates the opportunity for Italian banks with the highest domestic sovereign exposures to reduce their holdings, and allows potential sellers to realise capital gains following the strong decline in secondary-market yields in recent months.

Graph 2.3.11: **Italian banks' domestic sovereign exposure and Italian 10-year sovereign yield**



Source: Bank of Italy, European Central Bank

Combined monthly asset purchases will amount to EUR 60 billion, and this at least until September 2016. Purchases of securities under the expanded asset purchase programme that are not covered by the asset-backed securities and covered bonds purchase programmes will be allocated across issuers from the various euro-area countries on the basis of the European Central Bank's capital key.

which is clearly lower than investment in securities. See Bank of Italy, *Financial Stability Report*, no. 2/2014, November 2014.

([44]) These refinancing operations are specifically designed to support lending to the real economy. The first two operations took place in September and December 2014, and the participation of Italian banks is estimated at EUR 23 billion and EUR 26 billion respectively.

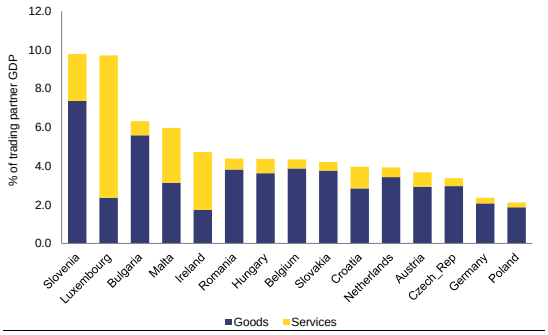
([45]) On 22 January 2015, the European Central Bank announced an expansion of its assets purchase programme by adding the purchase of sovereign bonds to the already existing private-sector purchase programmes (i.e. for asset-backed securities (ABSPP) and covered bonds (CBPP3)) to address the risks of a too prolonged period of low inflation.

2.4. EURO-AREA SPILLOVERS

The large size of the Italian economy makes it a potentially important source of spillovers in other euro area Member States. Conversely, the Italian economy's recovery is dependent on propitious external conditions. Though geographically diverse, the links between trade, finance and bank funding have the potential to cause spillovers in other large EU Member States, neighbouring countries and central and east European Member States. Italy is also susceptible to spillovers from outside: external demand, from both EU and non-EU countries, is paramount as Italy's GDP growth is largely export-led. The inflation environment in the euro area is also crucial to the debt-to-GDP reduction effort and competitiveness recovery.

Italy accounts for around 16.5 % of overall euro area output and is tightly bound to other euro area countries through trade and financial links. Concerning trade, it is among the most important export markets for other large euro area economies such as Germany, Spain and France, as well as for neighbouring Slovenia. For Slovenia and Luxembourg, Italy-bound exports account for almost 10 % of their GDP. For nine other Member States, the weight of their trade linkages with Italy varies between 3 % and 5 % of GDP (see Graph 2.4.1).

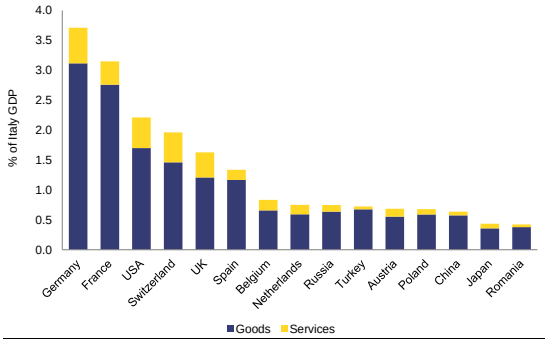
Graph 2.4.1: **Italy — Imports by county of origin (top 15 EU countries)**



Source: European Commission calculations based on UN (2012 data)

Total exports of goods and services represent approximately 29 % of Italian GDP. Italian exporters depend to a large extent on the German and French markets, whose imports correspond to 3.7 % and 3.1 % of Italy's GDP, respectively. However, the inability to contain existing surpluses in the euro area has put a strain on aggregate demand. As Italy's growth hinges crucially on its export performance, those asymmetric adjustment patterns between debtor and creditor countries within the euro area weigh down on Italy's recovery. With a combined export weight of 3 % of Italian GDP, the United Kingdom and Spain are also significant trade partners. Outside the EU, the United States and Switzerland are sizeable export markets (approximately 2 % of GDP each) (see Graph 2.4.2).

Graph 2.4.2: **Italy — Exports by destination (top 15 countries)**

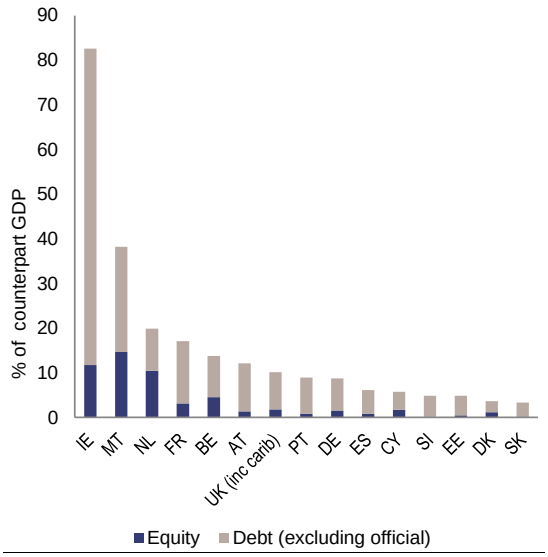


Source: European Commission calculations based on UN (2012 data)

Regarding financial links, most euro area countries' financial exposures to Italy via equity and debt instruments is relatively moderate ([46]) with the exception of Ireland and Malta. Ireland's total exposure to Italy represented 83 % of Irish GDP in 2012 while for Malta the figure was 38 %. Five other Member States had exposure of more than 10 % of their GDP, including France and the UK. EU Member States' financial exposure to Italy mostly takes the form of debt instruments, rather than foreign direct investment or portfolio investment in equity (see Graph 2.4.3). Conversely, Italy is significantly exposed to equity investments in Luxembourg (approximately 15 % of Italian GDP in 2012). Relevant though more modest gross financial investments (ranging between 7 % and 10 % of Italian GDP in 2012) are in the UK (essentially via debt instruments), France, the Netherlands, Ireland and Germany.

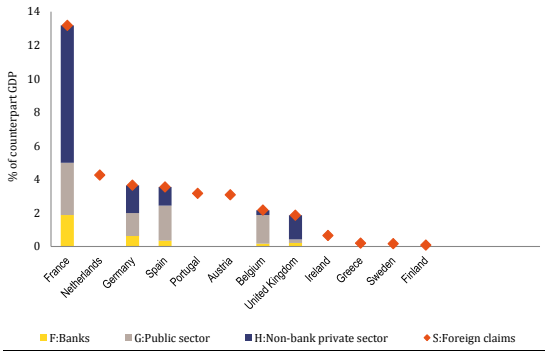
([46]) Luxembourg, an outlier country not included in the analysis, registered exposures equivalent to almost 4 times its GDP. Also, Italian financial investments in Luxembourg amount to six times the latter's GDP.

Graph 2.4.3: **Italy — Partner's exposure to liabilities (top EU 15, excl. LU)**



Source: European Commission calculations based on Hobza, A., Zeugner, S., 'Current accounts and financial flows in the euro area', Journal of International Money and Finance, 2014.
Debt excluding official equals other investment (e.g. loans) plus portfolio investment in debt securities, minus official amounts linked to TARGET2, the European Central Bank's Securities Markets Programme and euro area financial assistance programmes. 2012 data.

Graph 2.4.4: **Italy — EU bank claims, by sector**



(1) Based on a EU sample of 12 countries; sum of sectors may not add to total due to unallocated claims
Source: BIS consolidated banking statistics (ultimate risk basis, 2014Q2), IMF, own calculations

Data on banks' cross-border exposure show Italy's crucial importance for the French banking sector. French banks' exposure to the Italian economy ([47]) amounted to approximately 13 % of French GDP in the second quarter of 2014, essentially concentrated in the non-bank private sector (8 %). Seven other Member States had exposures to Italy of roughly 2 % to 4 % of their GDP, with Germany showing the second highest total exposure in absolute values (see Graph 2.4.4). As for Italy's exposure to other countries, in the second quarter of 2014, the Italian banking sector was significantly exposed to Germany, with claims worth approximately 12 % of Italian GDP, mainly in the German non-bank private sector. Italy's claims on other countries are more moderate, with the UK, France, the US and Croatia coming next in line with figures between 1.5 % and 2.5 % of Italy's GDP. Non-EU countries account for only about one quarter of Italian banks' foreign claims. Exposure to Russia was 1.3 % Italy's GDP in the second quarter of 2014.

Italy's high public indebtedness could have adverse effects on other euro-area countries. The transmission channel here is financial markets' sentiment and risk perception. The high debt level and the challenge the government faces in getting it onto a downward path in a context of low growth could create market uncertainty if fiscal adjustment fatigue set in and/or reform action was further delayed. Recent analyses of determinants of sovereign spreads in the euro area ([48]) ascribe an important role to the increase in general risk perception, which particularly affected vulnerable euro-area economies, including Italy. Furthermore, changes in Italian sovereign CDS spreads appear to carry a significant potential to

([47]) Data on bank claims differs from data on gross financial exposures as the latter covers the claims of the entire economy, whereas the former covers the banking sector specifically. Furthermore, the two data sources may not be entirely consistent as i) gross financial exposures are based on 2012 data while bank claims are based on data for the second quarter of 2014, ii) the countries in sample differ across datasets and iii) data on bank claims is based on the country of ultimate risk (the country where the guarantor of a claim resides) and includes claims of banks' own foreign affiliates, while gross financial exposures are based on a locational notion of counterpart that is consistent with balance of payments statistics.

([48]) See for instance Giordano, L., et al., 'Sovereign risk premia in the Euro Area and the role of contagion', *Journal of Financial Management, Markets and Institutions*, 1/2013, January-June 2013.

negatively impact on spreads of periphery and southern member states ([49]).

Modest growth, prolonged low inflation and insufficient policy coordination make the adjustment in Italy more challenging. Sluggish demand in Italy's main trade partners, driven by simultaneous fiscal consolidation in several other euro area countries and adjustment of excessive private indebtedness, makes it more difficult for Italy to turn its export performance around. This is further exacerbated by zero-lower-bound constraints on euro-area monetary policy to counter deflationary pressures and to prop up economic activity. Low inflation, much below the 2 per cent target for price stability, makes reducing Italy's debt-to-GDP ratio more challenging (see Section 3.1). It also reduces the room for using price adjustment to recover competitiveness and makes the realignment in relative prices within the euro area difficult. The European Central Bank recently announced measures of quantitative easing, that should help anchor positive inflation expectations while keeping the cost of sovereign financing low. The right policy-mix balance would thus include strong fiscal consolidation and forceful structural reforms. In fact, Italy could take advantage of the accommodative monetary policy to forcefully implement structural reforms to cushion the economy against potential short-term negative effects on growth and consumption. Given the potential beneficial effect of those reforms (in particular on competition) on the functioning of Single Market, they could contribute to growth and rebalancing in other euro-area partners. There is also a case for coordinating the structural reforms, at the euro-area level, as there seem to be positive, even if small, spillover effects of structural reforms. (See footnote 48 page 46) Indeed, QUEST simulations show that the output gain of coordinated structural reforms is about 10 % higher than in a scenario where each country acts alone.

([49]) 'Cross-border spill-overs in the euro area', *Quarterly Report on the Euro Area* Vol 13 No 4, 2014.

3. OTHER STRUCTURAL ISSUES

3.1. PUBLIC ADMINISTRATION AND BUSINESS ENVIRONMENT

It is hard to quantify the extent to which weaknesses in public administration affect Italy's productivity performance, yet evidence confirms that they weigh on the business environment and the country's capacity to reform. There are numerous and diverse transmission channels by which inefficiencies in public administration affect productivity performance, not least through the broader business environment in which firms invest and operate. These include market regulation, effective contract enforcement and justice systems, and the productivity of the public sector. This makes it hard to conclusively estimate how far the long-standing underlying weaknesses in the public administration might have contributed to Italy's sluggish productivity dynamics over the last two decades. Weaknesses in Italy's public administration have included skills mismatch, lack of transparency, and cronyism. ([50]) The World Bank 2014 Worldwide Governance Indicators show that Italy's performance is well below the European average in each of the six dimensions covered by the index, including government effectiveness, control of corruption, and rule of law. The 2013 European Quality of Government Index showed Italy has the widest variation across EU regions among others in public service quality and impartiality (see also Section 3.5). According to the World Bank's *Doing Business* indicators the excessive regulatory burden is a major cause of competitive disadvantage for Italy: starting a company remains costly while tax compliance and contract enforcement are cumbersome. In Italy it takes over 1 000 days to enforce a contract, more than twice the OECD average, and the still high backlog of civil cases — 5.2 million — points to difficulties in absorbing pending cases and coping with incoming ones. Several gaps also remain in the uptake of online public services, with Italy third from bottom among OECD countries in use of the Internet for dealing with public administrations. In addition to the direct costs on businesses that weigh on cost-competitiveness, the weaknesses mentioned are shown in the literature ([51]) to have sizeable negative effects on the economy, by hindering foreign direct investment and company growth, constraining labour participation, and hampering reallocation.

A major effort is underway to improve Italy's institutional capacity to adopt and implement legislation. Italy's broad structural reforms programme over recent years contained measures that were only partially implemented or even abandoned, thus depriving the economy of the full benefits of reforms. At mid-February 2015, 348 implementing measures (32.3%) stemming from legislation adopted under the Monti and Letta administrations still need to be adopted. Furthermore, 401 implementing measures stemming from legislation under the Renzi administration (which has already been published in the Italian Official Journal) still await adoption. Insufficient coordination and overlapping responsibilities between different layers of government are a major factor hampering the effective implementation of the measures adopted. Changes in the institutional framework to remove bottlenecks holding back the adoption and implementation of reforms are currently being discussed. In particular, a constitutional reform expected by end-2015 reviews the structure of law-making process and the allocation of responsibilities between central and sub-national governments. On the first point, the Senate would retain legislative powers on only a narrow range of issues, a change that is likely to speed up the legislative process. On the second point, some devolved functions (e.g. energy and infrastructure) would be centralised again, the division of responsibility between the centre and the regions clarified, the provincial level of government phased out, and most concurrent competences (e.g. for retail regulation) abolished, which could contribute to more uniform regulation and more effective implementation.

([50]) See, among others, 'Il Fenomeno della Corruzione in Italia. Prima Mappa dell'Alto Commissario Anticorruzione', *Department of Public Administration - Commission against corruption*, 2008, and 'La Corruzione in Italia. Per una Politica di Prevenzione', *Commission on corruption in public administration*, 2012.

([51]) Lorenzani, D. and F., Lucidi, 'The Economic Impact of Civil Justice Reforms', *European Economy Economic Papers*, No 530, September 2014, show that halving the backlog is associated with an increase in FDI net inflows by 0.5 percentage points. In Giacomelli, S., and C., Menon, 'Firm size and judicial efficiency: evidence from the neighbour's Court', *Bank of Italy Working Papers*, No 898, January 2012, halving the length of civil proceedings would increase the average firm size by 8 to 12 %.

Despite recent progress, a comprehensive reform of the public administration is still pending. A recently enacted reform to modernise the public administration aims to facilitate staff turnover, thereby reducing average age, improve voluntary and compulsory mobility, limit the compensation of state attorneys and top officials in local administrations, and streamline public bodies and procurement. In addition, a 'Simplification Agenda for 2015-17' was adopted in December 2014 to foster cooperation between central and regional governments in establishing a more coherent simplification framework. However, swift and effective operationalisation is proving challenging: a decree defining the modalities of staff mobility in the public administration is still missing, and a draft law enabling the government to reorganise the public administration — including local public services, state administration, the evaluation of managers' performance, the business friendliness of administrative procedures, and corruption prevention — is pending in the Senate. This reform could be an important step forward.

Regular evaluation of the impact of spending is not yet an integral part of the budgetary process across all government levels. Building on past experiences of spending reviews, a number of initiatives have recently been launched to improve the efficiency of public spending in Italy. At central level, ministers were directly involved in selecting areas within their own budgets eligible for targeted savings without recourse to linear expenditure cuts as in the past. However, the need to preserve growth-enhancing expenditure items and improve the economic efficiency of the public administration would still require top-down coordination and monitoring. In this context, the government is also empowered to complete by 2015 a reform of the budgetary process that could be more in line with a performance budgeting approach over the medium term. This overall process could be supported by a fiscal framework strengthened by the newly-established Parliamentary Budget Office, the national fiscal monitoring institution that has been operational since September 2014. At local level, the 2015 Stability Law envisaged additional savings from regions (EUR 4 billion), combined with the application of the balanced budget rule in 2015, i.e. one year earlier than initially planned. If properly implemented, this may address some of the problems experienced under the previous Internal Stability Pact, such as the strong influence of historical spending on central transfers to sub-national governments. However, since sound coordination of budgetary responsibilities across government levels is not yet in place, the outcome of the legislated cuts in terms of capital and current expenditure as well as local taxation remains uncertain. Moreover, the needed agreement between the state and the regions to decide on the distribution of expenditure cuts has been delayed, which entails some risks to the achievement of the 2015 budgetary targets. Among the initiatives to improve efficiency in public spending and achieve the planned savings at all government levels, wider use of centralised public procurement envisaged by the Public Spending Rationalisation Programme was partly implemented as of January 2015, by establishing a restricted list of 'procurement aggregator bodies' — including CONSIP, the national central purchasing body, and a territorial procurement aggregator per region — together with a technical working table coordinated by the Ministry of Economy and Finance. To become fully operational, a further governmental decree is needed specifying the product categories covered and the spending thresholds above which central and local administrations must use centralised procurement.

Some relevant reforms have been enacted to improve the efficiency of the justice system. In the past few years, Italy's judicial system has undergone several reforms. In September 2013, Italy completed a broad reorganisation of judicial geography, decreasing the number of first instance civil courts by around 50 %, as well as creating specialised courts for businesses aimed at achieving economies of scale and promoting professional specialisation. Other reforms include the 2013 reintroduction of compulsory mediation in specific civil and commercial matters, although with mixed success in terms of uptake ([52]),

([52]) Between January and June 2014, the parties appeared before the mediator in 39.1 % of cases, and agreements were found in only 35.9 % of those. Source: Ministry of Justice. Beyond the economic dimension, the respect of fundamental rights, in particular the right to access to justice, and principles such as judicial independence should be the basis of any justice reform. In this context, a general obligation to use alternative dispute resolutions might be against the right to an effective remedy before a tribunal, as per Article 47 of the EU Charter of Fundamental Rights.

measures to limit excessive recourse to appeals through an eligibility filter, and an increase in court fees. In the course of 2014, a law introduced further digitalisation measures in civil, administrative, and tax-related trials. It also established 'proceedings offices' supporting the judges, and provided for accelerated administrative proceedings concerning public procurement. A second reform sought to reduce the backlog of civil cases by allowing the transfer of pending cases to arbitration and introducing a new form of out-of-court settlement, on top of new measures to improve the enforcement of judicial decisions. In this context, crucial aspects are the adequate operationalisation of these measures, including in terms of incentives to the uptake of new alternative dispute resolution mechanisms, as well as the regular government monitoring of their success in tackling long-standing inefficiencies. In particular, it is important that the new measures to favour out-of-court settlements would not end up increasing the overall length and costs of civil proceedings. November 2014 data on the uptake in five judicial districts of the 'digital civil trial', now compulsory in first instance, indicate a reduction between 19 % and 60 % in the time to deal with a specific type of case and savings estimated at around EUR 43 million. In early 2015, two draft enabling laws forming part of justice reform package, announced by the government at the end of August 2014, were presented to parliament. The first concerns honorary magistrates and 'judges of peace'. The second aims to reform the civil proceedings in order to reduce their length, extend the competences of business courts specialised in company-law cases, and create courts specialised in family-law disputes and human rights.

Despite some progress in terms of judicial efficiency, lengthy trials remain a major factor behind Italy's poor business environment. Beneficial impacts on the functioning of the justice system and on the economy at large may be expected from the judicial reforms enacted by Italy over the recent years. In fact, predictable, timely, and effective enforcement of obligations and rights in fields such as property (including intellectual property rights), insolvency, and labour law help create a trustworthy and business-friendly environment conducive to investment and entrepreneurial activity. However, the latest available evidence for Italy does not reflect the expected efficiency gains yet. Namely, according to the latest data , a decrease by around 5% in the number of pending litigious civil and commercial cases can be observed between 2012 and 2013, essentially due to relatively high clearance rates ([53]). However, the absolute backlog per 100 inhabitants, at around 5.3, was still the third-highest in the EU in 2013([54]). On the other hand, while the disposition time decreased for civil and commercial cases (litigious and non-litigious) in both first and second instance ([55]), it increased for litigious cases by some 3 %from 2012 to 2013, remaining the third highest in the EU. Although first instance courts account for the largest part of pending cases, recent evidence shows that their capacity to reduce them is much greater than in higher instances ([56]). Between 2012 and 2014, the percentage of Italian consumers finding it easy to resolve disputes with businesses through either courts or out-of-court bodies increased from 24 % to 30 % and from 30 % to 43 %, respectively, but remained well below the EU average (36 % and 46 %). ([57]) Overall, only real and perceivable progress in terms of efficiency of the justice system, ensured by adequate follow-up on the reform momentum, could contribute to make the business environment more conducive to foreign direct investment.

([53]) Source: 'Study of the European Commission for the Efficiency of Justice' (CEPEJ) prepared in view of the 2015 EU Justice Scoreboard (to be published in early March 2015). The clearance rate was 106.6 % in first instance courts and 127.2 % in appeal courts in 2013. Pending cases in first instance administrative courts have also been relatively high but decreasing by around 12 % per year from 349 149 at the end of 2012 to 262 775 at the end of 2014. Source: Consiglio di Stato.

([54]) The total number of pending civil cases in all instances was 5 159 466 at the end of 2013, against 5 385 781 at the end of 2012 and 5 922 673 in 2009. Source: Ministry of Justice.

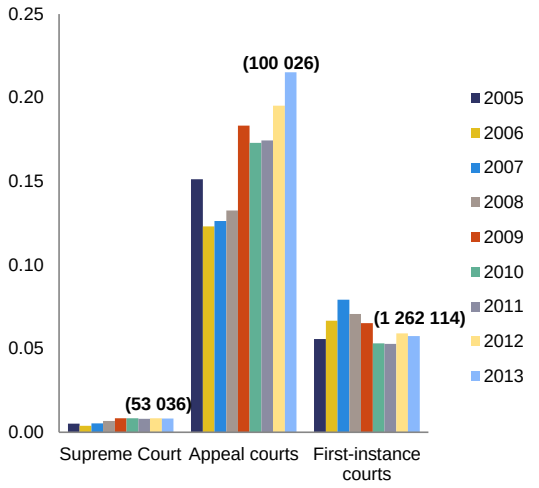
([55]) The disposition time is an estimated indicator of average trial length, comparing the number of resolved cases during the observed period and the number of unresolved cases at its end. It provides a measure of the average number of days necessary for a pending case to be solved in court. The disposition time for civil and commercial cases decreased from 395 days in 2010 to 369 days in 2013 in first instance courts and from 1 242 days in 2010 to 842 days in 2013 in second instance courts. Sources: 'Study of the European Commission for the Efficiency of Justice' (CEPEJ) prepared in view of the 2015 EU Justice Scoreboard (to be published in early March 2015)

([56]) 'Giustizia civile: Censimento speciale sulle pendenze uffici giudiziari', 2014. Source: Ministry of Justice.

([57]) 'Consumer attitudes towards cross-border trade and consumer protection', Flash Eurobarometer No 397, 2014.

Corruption in Italy is still a major problem and the statute of limitations remains an obstacle to the fight against it. The 2014 EU anti-corruption report highlights the persistence of challenges such as high-level corruption and links with organised crime, conflicts of interest and asset disclosure, infrastructure and other large public works, and corruption in the private sector. This is confirmed by several international indicators: the World Economic Forum Global Competitiveness Report 2014-15 ranks Italy 102nd out of 144 countries on indicators related to ethics and corruption. The World Bank governance indicators ranked Italy 25th in the EU for control of corruption in 2013 data. It is estimated that ineffective anti-corruption measures have so far deterred inward investment and economic growth. ([58]) Transparency International and the Council of Europe Group of States against Corruption have pointed to the statute of limitations as a major weakness in Italy's system for preventing corruption and called for a thorough assessment of the reasons behind the large number of time-barred corruption cases and for a comprehensive plan to tackle them. ([59]) In the Italian system, a first-instance conviction does not affect the possibility that a case is dismissed as time-barred because the legal prescription term expires. This, especially in the presence of lengthy investigations and appeal procedures, creates high incentives for delaying tactics by the defendants and low incentives to resort to optional expedited procedures. ([60]) Indeed, as reported in the Graph 3.1.1, the evolution over time in the ratio of time-barred criminal cases to the total number of resolved cases shows that, while prescription rates in first instance remained quite stable over time, prescriptions in appeal courts significantly increased from 15 % to 22 % over 2005-13. This confirms the significant number of cases that are time-barred after first instance convictions. While since 2013 the Council has addressed a country-specific recommendation to Italy requesting a revision of the statute of limitations, this process is still in the initial phase. Namely, draft laws are under discussion in the Parliament to suspend prescription terms for two years after first-instance convictions and for a further year after conviction on appeal, to raise penalties and thus also prescription terms for corruption offences, to introduce new offences such as accounting fraud and step up the fight against mafia. Swift and joint approval and operationalisation of these norms could represent a step change in the fight against corruption.

Graph 3.1.1: **Ratio of time-barred criminal cases to total resolved criminal cases per instance**



(1) Total resolved criminal cases in 2013 are reported in parenthesis per relevant instance
Source: Ministry of Justice, European Commission

Some efforts have been made in enhancing the prevention and repression of corruption, but operationalisation is often challenging. Some progress in preventing corruption has been made by broadening rules on transparency and conflict of interest for independent authorities and public administrations contracting out studies and consulting activities, as well as the powers of the national anti-corruption authority. This was merged with the former procurement supervisory body. It was also given powers to oversee the awarding of public contracts and to recommend stopping tenders deemed at risk of mafia infiltration, bribery or other corruptive phenomena. Over 2014, the authority intervened in several high-profile procurement cases by making recommendations to local prefects. Following this reform, the authority is being reorganised

([58]) 'Corruzione freno allo sviluppo. Il rebus della ripresa', Centro Studi Confindustria, December 2014.
([59]) 'Exporting Corruption, Progress Report 2014, Assessing Enforcement of the OECD Convention on Combating Foreign Bribery', *Transparency International*, 2014 and 'Third Evaluation Round. Evaluation Report on Italy Incriminations (ETS 173 and 191, GPC 2)', *GRECO*, 2012.
([60]) For instance, the possibility to ask for '*pattegiamento*' in front of the preliminary hearing judge. See also the '2014 EU anti-corruption report', European Commission, 2014.

internally on the basis of a plan presented by its president at the end of 2014 but yet to be endorsed by the government. However, the authority has no fully enforced powers to penalise violations, its opinions are non-binding, and its capacity remains to be proved in the proactive monitoring of the corruption prevention plans due by all administrative bodies and state-owned companies. In early 2015, the offence of self-laundering — i.e. the re-employment or transfer of resources stemming from an assumed illegal activity like tax evasion — was introduced in the Italian criminal code in order to prevent the use of resources from tax evasion or slush funds. This could benefit the new rules on voluntary disclosure aiming to collect more tax revenues from the repatriation of Italian capitals that had been deposited abroad by September 2015. However, it is too early to assess the effectiveness of this provision. The deal with Switzerland signed in February 2015 to abolish bank secrecy and introduce the principle of cooperation in identifying dubious cash flows could also impact.

Italy's management of EU funds remains poor but recent reforms may deliver improvements. The use of EU funds over the 2007-13 programming period continued to rank low with an absorption rate for all structural funds of 70.7 % of total planned resources at end-2014, still substantially below the EU average. Part of the gap is due to delays, bottlenecks, and administrative weaknesses, particularly in the south of Italy. However, some steps are being taken to improve the situation at all levels. The 2014-20 Partnership Agreement, approved by the Commission in October 2014, envisages that all EU co-funded operational programmes will have to be accompanied by plans of administrative reinforcement. These plans are designed to guarantee that administrations have the basic level of structure and competence necessary to manage the resources entrusted to them. They also include measures to strengthen public administration in general in fields that are crucial for proper and effective management of EU funds, such as public procurement, state aid and corruption prevention. Furthermore, after long delays, Italy's agency for territorial cohesion is about to become operational: the director has been named, part of the personnel from the existing Department for development and social cohesion is being transferred to it, and open competitions to recruit further staff are under way. The agency will focus its attention and the bulk of its resources on Italy's less developed southern regions. The prime minister has been given direct monitoring and intervention powers to ensure the timely use of funds, which should particularly help regions with a lower absorption rate.

3.2. COMPETITION, INFRASTRUCTURES AND INNOVATION

Market opening

Barriers to competition remain, thus hampering productivity and investment. Service and product market reforms facilitate resource reallocation and investment, and are thus a necessary complement of labour market reforms. Italy has made some progress in the last two decades. On the OECD synthetic index for product market regulation Italy is now in line with the OECD average, while it was among the most restrictive countries in 1998. After a wave of reforms in 2012, the pace had stalled, however, and barriers to competition remain in many sectors of the economy.

In February 2015, the government has adopted a draft law on competition addressing barriers to competition in several sectors of the economy, but with measures of various depth and scope. In February 2015, the government adopted a draft law on competition, abiding for the first time by the 2009 legislation that requires the government to present such draft law every year on the basis of the National Competition Authority's proposal. This is an important step and may set in motion a positive mechanism, whereby regulatory barriers to competition are regularly reviewed and tackled. The draft law covers most of the sectors identified by the Competition Authority and in the 2014 country-specific recommendations, although with differentiated scope and ambition. Measures are particularly incisive in the insurance sector, aimed at fighting fraud, broadening the scope for discounted policies under specific conditions, and enhancing transparency and the possibility of comparing across offers. In the telecommunication sector, positive measures are taken to ease switch also through increased transparency on the conditions and penalties. The draft law almost completes the liberalisation of fuel distribution, removing remaining restrictions to new entries, as limits to fully automatised stations had been already removed in October 2014. Measures of more limited scope are taken for the legal professions. For notaries, the draft law removes the compulsory notarial deed for some specific acts, the minimum reference turnover, allows active promotion, and enlarges the geographical scope of activity to the whole administrative region. However, the reference maximum number of notaries per number of inhabitants remains. For lawyers, the draft law allows non-professional shareholders but maintains the scope of activities reserved to lawyers and the parameters set by the Ministry of Justice in the event of litigation (which could translate into de facto minimum tariffs). The scope of activity for limited liability companies is also enlarged for the engineering profession. In the context of the mutual evaluation exercise of regulated professions conducted at European level, Italy has still to complete for all its regulated professions the analysis to see whether the existing regulatory approaches are justified by general interest and proportionate, and explore the use of alternative forms of regulation. With regard to the distribution of pharmaceutical products, the draft law removes the limit to own more than four pharmacies and allows corporate bodies to own pharmacies. However, it does not remove the quota regime, does not open the market for drugs with compulsory prescription but no state reimbursement and does not address the bottlenecks to the uptake of non-patented drugs, as identified by the Competition Authority. Market opening measures had been already taken in the banking sector with respect to the portability of check accounts and in the rental market for large buildings.

Other important sectors are however not covered by the draft competition law. Some important sectors identified by the Competition Authority are not covered by the draft law, namely the allocation of radio spectrum frequencies, health sector, taxis, ports and airports, and local public services (see below). ([61]) Competition in the maritime and hydroelectric sectors is severely hindered by authorisation schemes under which service providers are given the right to use public infrastructure for long periods without competitive procedures. Evidence shows that the award of hydroelectric and beach authorisations through competitive and transparent procedures reduces costs for consumers and increases the payments by concession holders to the State. Furthermore, a measure introduced in 2014 allows the incumbent motorway concession holders to propose changes to the concession contracts that could result in

([61]) For more extensive analyses, see European Commission, 'Assessment of the 2014 national reform programme and stability programme for Italy', SWD (2014)413, 2014. See also: Autorità garante per la concorrenza e il mercato, 'Proposte di riforma concorrenziale ai fini della legge annuale per il mercato e la concorrenza - Anno 2014', 2014.

lengthy extensions, which may foreclose the market and raise possible issues of compatibility with EU law. Finally, Italy remains characterised by a fragmented and stratified system of laws and regulations emanating from different levels of government. This is the case for instance in the retail sector, where competition is often constrained due to differences in the way national legislation is interpreted and implemented at the regional and local level. ([62]) A thoroughly scrutiny of the legislation was foreseen by article 1 of Law 27/2012 but never implemented.

Local public enterprises and local public services

Italy's more than 8 000 local state-owned enterprises weigh on the efficiency of the economy and public finances. The report of the Commissioner for the spending review records 7 726 local State-owned enterprises, which are active in all sectors of the economy. ([63]) Around 35 % of the 3 152 companies surveyed by the Court of Auditors in 2012 reported losses in at least one year from 2010 to 2012. According to the study conducted under the spending review, around 438 local state-owned enterprises (598 including those in liquidation) had recorded yearly losses over 2010-12, which questions their viability. The share of aggregate losses borne by the public administration is estimated at EUR 1.2 billion per year, of which around 25 % are borne by local state-owned enterprises that do not provide local public services or other services of general interest. There are important signs of inefficiencies: (i) at least 3000 local state-owned enterprises have fewer than six employees and in about half of local state-owned enterprises the number of directors is higher than the number of employees; (ii) 44 % of municipal state-owned enterprises are co-owned by municipalities with fewer than 30 000 inhabitants, indicating there are important potential economies of scale to be made through consolidation; (iii) in a large number of local state-owned enterprises, the public shareholder's stake is very low — below 5 % for some 1 400 local state-owned enterprises, below 10 % for about 1 900 and below 20 % for 2 500 — which appears too low if participation served the general interest.

The regulatory framework for state-owned enterprises is unclear. Although state-owned enterprises are in principle subject to private law, special provisions or features of public law add to the legal framework. This complicated framework is the result of developments over the years, which have seen the introduction of several legal tools reflecting the contemporary trends and addressing the needs of the moment. This gives rise to inconsistencies and uncertainties which result in cumbersome court proceedings in order to be resolved.

The vast majority of state-owned enterprises are sheltered from competition. The Court of Auditors reports data by contract award procedure for 2012, summarised in Table 4.2.1 below. Open tendering is used for a very small proportion of contract awards, while the vast majority of contracts is done either through 'in-house' awards (with no open tender) or similar procedures. According to the Competition Authority, some of the in-house contracts refer to services that could be provided by different operators through open competition, as they entail potentially profitable and therefore attractive business (e.g. car and bike-sharing schemes, tourist transportation). Furthermore, several in-house awards do not comply with the conditions of the EU and national framework.

Table 3.2.1: **Type of award**

	In-house	Other procedures	Total without open tender	Open tender	Total awards
Local public services	6910	5955	12865	269	13134
Strumentali	2080	9276	11356	88	11444
Total	8990	15231	24221	357	24578
% of total awards					
Local public services	53	45	98	2	100
Strumentali	18	81	99	1	100
Total	37	62	99	1	100

Source: Corte dei Conti, Gli organismi partecipati degli enti territoriali, 2014.

The need for a comprehensive reform is acknowledged by the government but action is weak as it derives from the extension granted

([62]) Since 2012, the national competition authority can issue an opinion requesting public local entities or administration to repeal any administrative act that, in the view of the authority, is contrary to competition law and principles. In case of non-compliance to its opinion, the authority may challenge the act before the Administrative Tribunal. Nearly ¼ of the 45 of the opinion issued concern the retail sector.

([63]) Commissario alla spesa, 'Programma di razionalizzazione delle participate locali', 2014, p. 4, Tavola II.1.

for rectifying non-compliant in-house contracts. The enabling law for the reform of public administration would delegate to the government the power to enact legislative decrees for a comprehensive reform of local state-owned enterprises and local public services. This would include making the involvement of local authorities in state-owned enterprises more transparent; promoting the consolidation of local state-owned enterprises across municipalities; defining optimal territorial areas in the context of providing local public services; strengthening competition and protecting consumers' interests in local public services; introducing mechanisms to reward local administrations that use open tendering; and streamlining the overall regulatory framework on state-owned enterprises to prevent overlaps and contradictions. Pending such reform, the 2015 Stability Law includes measures to improve transparency and foresees a rationalisation process based on rationalisation plans to be submitted by local and regional authorities by end-March 2015.. However, the rectification of contracts not complying with the EU and national requirements on in-house awards has been de facto postponed to 31 December 2015 despite the end-2014 deadline set in Italy's 2014 country-specific recommendation. Nor has there been yet any official assessment on the number and economic features of such contracts.

Public procurement

Italy's public procurement system faces a significant number of important problems: complexity, fragmentation and instability of the legal and institutional framework; administrative burden; excessive length of procedures; high litigation rate; fragmentation of e-procurement solutions; contracting authorities' lack of administrative capacity; significant barriers to competition in key economic sectors; and inefficiency of the system of supervision and control. The government has announced a reform of the code of public contracts aimed at transposing the new directives on EU public procurement and concessions and at simplifying the currently fragmented legal framework. A national strategy for public procurement is also being developed. It is to identify measures to overcome the country's systemic public procurement problems. It could also include e-procurement, which is currently done at national, regional and local level, increasing complexity and the risk of duplication or redundancy.

Network industries and infrastructures

The competition framework and infrastructure are still major weaknesses in the transport sector. Inefficiency is particularly critical in local and regional transport services**,** which account for around 28 % of companies in local public services described above. In road transport, recent research shows ample evidence of inefficiencies, in terms of substantial oversupply, high ticket evasion, fragmentation (the largest operator in Italy employs 12 000, against 120 000 in the UK) and under-investment in the fleet. Italian companies have lower revenues per km than their counterparts in the UK, Germany, France, Sweden, Belgium and the Netherlands (EUR 1.08 per km against an average of EUR 1.34) and receive higher public subsidies (EUR 2.2 per km against an average of EUR 1.4). ([64]) In railways, the majority of the public service contracts between the incumbent operator (i.e. Trenitalia) and the regions expired at the end of 2014 and the absence of a structured framework for competitive tendering procedures precludes a real improvement in competition in the sector. The amount paid by the state as a compensation for the obligation of public services is however relatively low at 12 EUR per 1 000 passenger/km against an EU average of around 60 EUR per 1 000 passenger/km. In addition, public aid for railway infrastructure development more than halved between 2009 and 2012, from over EUR 8 billion to less than EUR 4 billion. Italy's trade would also greatly benefit from better port infrastructure. The lack of intermodal connections with the hinterland remains one of the major causes of inefficiency. The situation is particularly difficult in the southern regions. For instance, only 8 % of ship berths are connected to the inland railway network in the south against 48 % in the north. Furthermore, lengthy and costly administrative and customs procedures, insufficient coordination and lack of strategic planning of port development also affect the way they function.

The Transport Authority is operational and is consolidating its work and activities. The

([64]) Fondazione Caracciolo, 'Il trasporto pubblico in Italia. Stato, prospettive e confronti internazionali', 2012.

Transport Authority, legally established in 2011, was set up in September 2013 and became operational in January 2014. Full staff enrolment is still pending, but the authority has already started taking some regulatory actions, for example on access to railway infrastructure, passenger rights, airport tariffs and tender criteria for highways and local public transport. This could help to address some of the major barriers to competition. The national reform programme also envisaged the adoption of specific measures to improve the sector's efficiency, such as increasing the use of open tendering procedures and standard costs in public procurement and the use of intelligent transport systems by December 2014. However, no significant progress has been made in this respect. Italy did not provide the Intelligent Transport System progress report that was due in 2014.

No significant progress has been made to improve the management of ports and their connections with the hinterland. Decree law 'Sblocca Italia' mentions the adoption of a National Strategic Plan for Ports and Logistics which will mainly focus on reorganising existing port authorities and promoting intermodal transport by strengthening certain connections (e.g. crucial port/airport links). However, so far concrete steps have not been taken and political discussions to determine the details are expected in 2015. On interconnections only limited improvements have been made, among them the new Venice-Mestre access to the North Sea-Baltic and Mediterranean Corridora and rail and road access to the port of Civitavecchia from the Scandinavian-Mediterranean Corridor. Works to improve the accessibility of the other Trans-European Transport Network core network ports to the Trans-European Transport Network core network corridors are lagging behind. A national airport plan was approved by the Council of Ministers in September 2014 and final adoption should follow soon.

Next generation broadband networks, digital skills and the use of information technology by firms, households and government are not adequate for the needs of a modern knowledge-based society. ([65]) Italy features the lowest share of fast and ultra-fast broadband subscriptions relative to total broadband subscriptions in the EU. In 2014 only 2.2 % of subscriptions had a speed above 30Mbps, considerably lower than the EU average (22.5 %), and next generation networks were available to only 21 % of households, the lowest value in the EU. Only 47 % of the Italian population has at least basic digital skills (vs an EU average of 60 %), while the share of the workforce with sufficient digital skills is also well below the EU average (38 % vs 54 %). These figures partly reflect little use of the internet: in 2014, 31 % of the population had still never used the internet, significantly higher than the EU average of 18 %. Furthermore, in 2014 only 23 % of people dealt with public authorities online, half the EU average of 47 %. In addition, only a fifth (22 %) of Italian consumers bought goods or services online in 2014 (the third lowest percentage in the EU), with very little increase (2 percentage points) since 2013. ([66]) Consumer confidence in buying online domestically is the fifth lowest in the EU. ([67]) On the business side, companies in Italy are still lagging behind in their use of digital technology to sell products and services. In 2014 only 18 % of large companies were selling on-line, almost half the EU average of 35 %. Small and medium-sized companies were even less active with only 5.1 % of them selling online — the worst performance in the EU, and far less than the EU average of 15 %. Italian firms' low use of digital technology is particularly critical in the textile sector where Italy is strongly specialised. They risk losing out to competitors investing more in digital technologies to make innovations in their business processes.

The government has set out some plans to address these bottlenecks but progress remains limited. Italy's plans for a digital growth strategy and next generation networks remain vague in terms of implementation details and targets. They also do not provide enough support to public and

([65]) As regards the five main drivers of the digital economy, Italy ranks 14th out of 28 Member States on digital public services, 20th on integration of digital technologies by business, 24th on human capital, 27th on both connectivity and on use of internet services. Source: Digital Economy and Society Index, DG CNECT.

([66]) Eurostat, 'Community Survey on ICT usage in households and by individuals', 2014.

([67]) 'Consumer attitudes towards cross-border trade and consumer protection', *Flash Eurobarometer* 397, 2014.

private investment to reach the EU Digital Agenda targets by 2020. In the context of the grand coalition for digital jobs, Italy has set up a national coalition for digital jobs to address the digital skills gaps at national level. In 2013 the Italian government started working on a national plan for digital culture, education and competencies but to date this has produced very few concrete initiatives. In the context of the digital agenda strategy the government has set up three priority initiatives: e-invoicing (for public administrations), e-identity and a unified population registry. Compulsory e-invoicing of public administrations has been operational for central administrations since June 2014 and its extension to local administrations is planned for March 2015. E-identity and the unified population registry are supposed to be gradually introduced starting from 2015. Other initiatives described in the digital agenda strategy include provisions of e-payments, e-justice and e-health. The main concerns about Italy's strategy are the long deadlines set for full implementation (prone to additional delays), local administrations' compliance and issues with interoperability standards across public administrations for some public services (health in particular). A detailed national strategy on e-procurement with specific objectives, targets and indicators in line with EU e-procurement objectives is also missing from the digital growth strategy.

Insufficient grid capacity hampers the smooth functioning of the electricity market and contributes to higher wholesale prices, while security of supply in the gas sector is sometimes at risk from insufficient storage capacity. The national electric power grid is not sufficient to meet demand and this creates bottlenecks across the country. This is reflected in regional price variations between different price zones. The situation is currently improving, except in Sicily where electricity prices are significantly higher than in the rest of Italy. Depressed internal energy demand and the marked slowdown in the Italian electricity market represent the main obstacles to a significant upgrade of infrastructure capacity. In particular, several gas projects have been delayed or cancelled (Galsi, Tauern, perhaps IGI-Poseidon, while TAP has not secured a final landing site). Complex and regionally inconsistent procedures for building plants and strengthening the grid are also hampering the full deployment of renewables.

The policy response to these challenges has been mixed. Some Italian projects have been included in the first Projects of Common Interest list. These projects could further develop much-needed infrastructure in particular in the northern part of the country where they will improve interconnectivity with the European market (e.g. France, Austria and Slovenia). Some other projects of common interest involving Italy will strengthen the southern electricity internal line and reduce bottlenecks inside the country. The issue of 'price zones' and north-south disparities may decrease through the new Sorgente-Rizziconi electricity cable connecting Sicily with the mainland. Italy has identified the categories of infrastructures to be considered as 'strategic' but not the specific projects, a step that was foreseen in the 2013 National Energy Strategy.

Energy efficiency, renewable energy, climate and the environment

Italy has made some progresses towards achieving its renewables and energy efficiency 2020 targets. In 2012 renewable energy in Italy accounted for 13.5 % of gross final energy consumption, showing that there is some progress towards meeting its 2020 target of 17 %. To alleviate cost pressures on Italian firms, in line with the national reform programme, in October 2014 the government cut feed-in tariffs for photovoltaic and other renewables energy plants. Experience elsewhere in Europe shows that such retroactive changes can undermine investor confidence and may increase the cost of capital for future investments. On energy efficiency, Italy appears to have achieved its 2020 targets for primary and final energy consumption in 2012, which could be partly explained by the lower than expected economic growth. Italy has indicated to be on track with the implementation of the EU acquis but red tape and a fragmented regulation at the regional and local level may hold back investment, particularly in the building sector.

Waste and water management is inefficient and a strategy for the adaptation to climate change is lagging. Environmental problems such as inadequate waste management and lacking or non-functioning water infrastructure are a persistent concern, particularly in southern Italy. In the centre and northern regions poor land management, flooding and air pollution are the

main challenges with a significant impact on the national budget. ([68]) It is estimated that air pollution causes almost 67 000 premature deaths and over 16 million workdays lost per year (2010) and that flooding cost the economy €11 billion between 2002-13. As recognised by Italian Authorities ([69]), infrastructures and economy could be seriously affected by climate change, in particular in areas including tourism and agriculture. The Italian government has prepared a National Adaptation Strategy to take appropriate action to prevent or minimise the damage caused by climate change, which has been discussed with the regions. However the strategy has not yet been adopted despite the strong encouragements made in the EU's Adaptation Strategy.

Research and innovation

Research and development intensity and innovation are low in Italy and public-private collaboration remains weak. Business research and development intensity in Italy was 0.67 % in 2013, against an EU average of 1.29 %. Public sector research and development intensity is also at a significantly lower level than the EU average (0.54 % instead of 0.72 % in 2013. This is also because Italy has been cutting its public research and development budget at a higher rate than the overall public budget (the share of research and development in government expenditure fell to 1.02 % from 1.32 % in 2007). At the same time, Italy's weak innovation performance is not able to contribute to the renewal of the economic fabric, in particular in terms of fast-growing innovative firms and employment in knowledge-intensive activities. Italy also has an only modest level of public-private cooperation in research and development and public-private scientific co-publications are well below EU average (33.4 co-publication for million population in Italy vs. 52.8 for the EU). ([70]) Public research and development financed by business represents only 0.014 % of GDP (EU: 0.051 %). In Italy, public-private cooperation occurs on an ad-hoc and sporadic basis in the absence of well-developed networks and formal structures. The low research and development activity is both a consequence and a factor of Italy's relative specialisation in low-to-medium technology products and weigh on the non-price competitiveness of the economy (see Section 2.2.3).

Limited steps were taken in 2014. First, Italian authorities launched a new research and development tax credit for all types of businesses investing in research and development and released all secondary regulations needed to make the measures included in the start-up law operational. The tax credit is however temporary (2015-19) in continuity with past experiences, whose effectiveness was weakened by their frequent changes, temporal character and low predictability. Second, a growing share of public research and innovation funding was distributed on the basis of performance indicators and some barriers to the recruitment of full and associate professors were removed. Finally, measures to facilitate innovative firms' access to the credit market and to innovative financial instruments, such as equity crowd-funding (see Section 2.2.4) will also help. While these measures are likely to improve efficiency in resource allocation and might to some extent help leverage private research and innovation investment, the overall underfinancing of research and innovation activities, the weak public-private collaboration, and the continued lack of effective and timely policy implementation remain problematic.

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

([69]) 'The Sixth National Communication under the UN Framework Convention on Climate Change', Italy, 2013

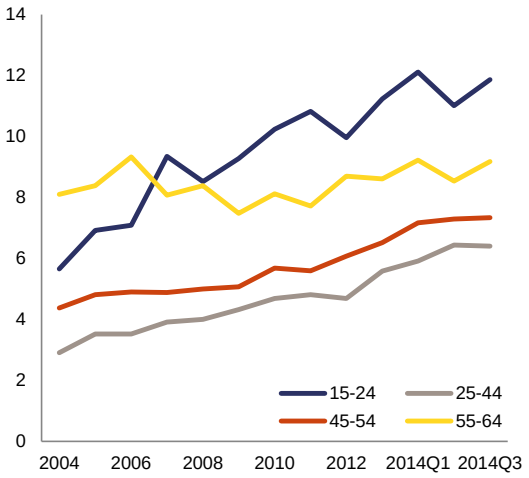
([70]) European Commission, 'Innovation Union Scoreboard 2014', 2014.

3.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

Labour market

While no progress has been achieved towards meeting the 2020 employment targets, activity rates have remained resilient, reflecting rising participation in the labour force by the elderly and women. However, falling labour market participation among young people shows their increasing discouragement. Between 2007 and 2014 the proportion of the population in the labour force increased from 62.5 % to 63.7 %, an unusual development given the increase of long-term unemployment and the protracted slack of the labour utilisation (see Section 1). The increase of labour supply was particularly strong during the recession triggered by the 2011 sovereign debt crisis. In single-earner households, more stringent economic needs resulting from uncertain or lacking labour income had a positive effect on the activity rate (the so-called *added* worker effect) that compensated for the *discouraged* worker effect typical of recessions. The added worker effect led to a significant increase of female activity rates, from 50.7 % in 2007 to 54 % in 2014 ([71]), while tax incentives for women adopted in 2012 might have also played a role. This increase is particularly large for prime age workers (age group 25-54), in particular women aged over 40, whose activity rate increased to 75 %, 5 percentage points higher than in 2007. For this age group, female employment kept rising throughout the period; this increase was matched by an increase in unemployment as a result of expanding activity rates. Yet, female activity and employment rates remain very low compared to the EU average. ([72]) In the case of older workers (age group 55-64), the activity rate increased from about 35 % in 2007 to 48.4 % in the first three quarters of 2014. A number of factors contributed to these developments, including the pension reform in late 2011 which raised the retirement age and led to changes in the attitudes towards female employment. These positive developments contrast with falling participation among younger cohorts aged below 35. Furthermore, the discouraged worker effect is becoming stronger in light of the persistently low job-finding rates and prolonged labour market slack. The number of those willing to work but not seeking a job because they believe no work is available increased from 5 % of the potential labour force in 2005 to 7.5 % in 2013. ([73]) The increase was stronger among young people than for other cohorts (Graph 3.3.1). The number of residents moving abroad also increased, of which more than 30 % had a university degree. ([74])

Graph 3.3.1: **Discouraged workers by age groups**



The graph shows the number of persons willing to work but not seeking because they think that no work is available, as a percentage of the sum of those plus the labour force.
Source: European Commission, ISTAT

Persistently high rates of youth unemployment and of young people not in employment, education or training point again to the risk of discouragement from entering the labour market. This may have potentially severe consequences on Italy's human capital

([71]) Franceschi, F., 'The Added Worker Effect for Married Women in Italy' in 'Gli effetti della crisi sul potenziale produttivo e sulla spesa delle famiglie in Italia', *Bank of Italy – Workshops and Conferences*, No.18, 2014. The paper shows that the added worker effect accounts for 8 % of the higher labour supply of married women during the 2011 crisis.

([72]) The gender gaps in employment and hours worked translate into lower pension entitlements for women: the current average gender pension gap in Italy is 31 % (still below the EU average of 39 %). See European Network of Experts on Gender Equality, '*The gender gap in pensions in the EU'*, p. 37, 2013

([73]) The potential labour force is calculated here as the sum of labour force plus those willing to work but not seeking because they think that no work is available (data from Labour force survey, Istat).

([74]) In 2013 the number of residents officially leaving the country increased by about 20 % over 2012. Most of the people who left have Italian citizenship (+ 21 %, from 68 000 in 2012 to 82 000 in 2013), ISTAT 2014.

accumulation. Youth unemployment has almost doubled over the past decade to reach almost 43 % in third quarter of 2014. It is also characterised by marked regional variations. The proportion of young people aged between 15 and 24 not in employment, education or training rose from 16.2% in 2007 to 22.2 % in 2013 (32.9 % for those aged 25-29) and is now the highest in the EU. Among these the big majority (77.5 %) is willing to work but 56.3 % are economically inactive. Furthermore, contrary to the pattern seen in some other Member States (e.g. Spain), the fall in youth activity rates has not been associated with longer time spent in education and training. The big gap between young graduates' competencies and labour market needs has made the transition from education to work increasingly difficult. Only 54.6 % of those aged 15-34 who graduated from the first and second stages of tertiary education within the previous three years were employed, against the EU average of 78.6 %. In addition, having a foothold in the labour market is often not sufficient to ensure lasting involvement and the Italian labour market remains segmented.

Active labour market policies are not sufficiently developed to address the foregoing shortcomings, not least because of the fragmentation of employment services across the country. Expenditure on active labour market policies is below the EU average and is biased against job-search assistance. Furthermore, there is no effective coordination between activation policies and the unemployment benefit system. Also, the evaluation of active labour market policies is occasional and not based on systematic monitoring. A crucial element holding back effective active labour market policies is the poor performance of employment services, which show limited capacity to provide transparent information to job-seekers and to address the needs of employers. Furthermore, there are enduring regional disparities in the quality of services provided by public employment services and in the quality of cooperation between public and private employment services.

The 'Jobs Act' includes promising measures to reform the governance of active labour market policies and their interplay with passive policies. The establishment of a national coordination agency envisaged by the 'Jobs Act' is a promising step to improve the governance of the system as well as the link between passive and active policies. The creation of the agency is also expected to entail planning and implementing a comprehensive national strategy on employment services, including a better integration between public and private services. The related legislative decree is foreseen for spring 2015, only then a full assessment of the measure will be possible. The definition of the basic levels of provision of public services, which was already envisaged by the 2012 labour market reform, remains pending.

Limited progress has been made in promoting female employment. Some measures to foster female employment have been initiated, but their operationalisation and effectiveness needs to be monitored. In 2013, financial incentives for hiring unemployed women were introduced. To be effective, these incentives would benefit from the provision of childcare facilities. Measures have been tabled to counter regional disparities in the availability of childcare facilities through structural funds and the Cohesion Action Plan, and additional funding for early childcare have been envisaged by the 2015 Stability Law. However, the percentage of children in the age range 0-3 who were in any kind of formal childcare in 2012 (21 %) was still largely below the EU average (28 %). No measures have been enacted to date to remove the financial disincentives deterring married women in particular from entering the labour market. Long-term care remains expensive and this reduces the labour supply of women aged over 50 (see below). An additional 'baby bonus' of EUR 80 per month (see section on social policy) has been established by the 2015 Stability Law but its impact on the participation of women is likely to be limited. A scheme to favour the reintegration of women into work after maternity, by providing a benefit in return for curtailing parental leave, had a very low uptake and was reformulated in 2014. The 'Jobs Act' includes some promising elements, such as the extension of maternity allocations to all categories of female workers, tax credit for working mothers, revision of existing tax credits for family members, incentives for reconciliation arrangements included in collective contracts, and improvement of child-care services. Some of these elements have been included in the related implementing legislative decree, presented on 20 February 2015.

Measures taken to tackle youth unemployment have not been sufficient; supporting young people in their transition from school to work remains a major challenge. Several positive developments took place within the framework of the Youth Guarantee Implementation Plan. To promote job creation, incentives have been introduced to hire young people between 18 and 29 years old and out of work for at least 6 months on permanent contracts; the conditions for hiring on apprenticeship contracts have been simplified to make them more attractive for employers; profiling methods were adopted to identify young job-seekers according to the type of intervention required; a national website has been launched to foster outreach. To improve the efficiency of support measures, services delivered to young people such as training, apprenticeships, assistance for employment search, etc. were standardised in terms of costs, modalities and duration, and an increased use was made of private placement agencies. However, and in spite of EU funds being mobilised rapidly, youth employment prospects remain a major challenge. Young people registered for the Youth Guarantee account for about one fifth of the total potential clients (1.7 million young people not in education, employment or training) and those with low education and further away from the education and labour systems have been less involved so far. ([75]) Interventions from public employment services towards young people are still weak, especially in southern regions. Targeted approaches for differentiated needs (such as 'second-chance' pathways in education), specific training focusing on the skills required by the labour market, and work-based experiences leading to qualifications remain underdeveloped. Despite recent agreements between the Ministry of Labour and employers' associations, more concrete collaboration with stakeholders to provide for offers of sufficient number and quality that respond to the needs of both demand and supply of labour, in line with the objective of the Youth Guarantee, is still missing. The apprenticeship contract does not yet represent a key port of entry in the labour market.

([75]) Youth Guarantee Monitoring, 23 January 2015. http://www.garanziagiovani.gov.it/Monitoraggio/Pagine/default.aspx.

Progress in combating undeclared work is limited. In 2014, no additional legislative steps against the shadow economy and undeclared work were taken. The most prominent aspect of the fight against irregular work and evasion of social security contributions was the increase and indexing of fines for violations of regulations on safety and security at the workplace and irregular work (in particular, administrative sanctions for undeclared work were increased by 30 %). However, the foreseen hiring of 250 inspectors and technical experts within the Ministry of Labour and Social Policies was not confirmed by the 2015 Stability Law. The 'Jobs Act' announces the creation of a dedicated agency that should incorporate and better coordinate the different bodies involved in labour inspection. The relevant implementing decree is planned for spring 2015.

Education

School outcomes and adult skills are below the EU average and entry into the labour market is difficult for the high-skilled. The early school-leaving rate remains well above the EU average (17 % compared to 12 % in 2013), although it is approaching the 2020 national target of 16 %. School education in Italy produces rather mixed results in terms of basic skills attainment, with very large regional differences between the centre-north and the south**.** Italy's tertiary education attainment rate is the lowest in the EU (22.4 % in 2013 for 30-34 year-olds), remaining well below its 2020 national target of 26-27 %. While the school-to-university transition rate is close to the EU average, the drop-out rate is very high (45 % in 2012). ([76]) Entering the labour market is also difficult for the high-skilled: for the 25-29 age group, the employment rate of tertiary graduates is 50.1 % compared to the EU average of 78.5 % in 2013. Italy has a very low share of young people in work-based learning and a very high and increasing share of young people not in education, employment or training (26 % of 15-29 year-olds in 2013).

Italy does still not have a comprehensive career guidance system at all education levels. Recent surveys show that many students made an ineffective choice of their educational paths. At

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

upper secondary level, 46 % of 2014 graduates would not choose the same programme/school again. ([77]) At tertiary educational level, 66 % of recent first-cycle graduates and 61 % of second-cycle graduates make no or limited use in their job of the competences acquired during tertiary studies. ([78]) Starting with the 2013-14 school year, career and counselling activities became compulsory during the penultimate year of upper secondary education and the last year of lower secondary education, but with limited additional resources allocated (EUR 6.6 million in 2013-14). The national guidelines for career guidance issued by the Ministry of Education in February 2014 acknowledge the need for extending and improving career guidance activities in schools at all education levels. This would help increase the labour market relevance of education and reduce early school leaving.

Italy's adult population has one of the lowest levels of numeracy and literacy skills among EU countries and lifelong learning is not sufficiently developed. According to the OECD Programme for the International Assessment of Adult Competencies, close to 30 % of adults (aged 16-65) have low literacy and numeracy skills, compared to an EU average of 19 % for literacy and 24 % for numeracy. The youngest generation (aged 16-24) scores better than the overall population; however, recent tertiary graduates (aged up to 29) do not score better than upper secondary graduates in the best performing European countries. Adult participation in lifelong learning remains low compared to the EU average (6.2 % compared to 10.5 %, in 2013) and has broadly stagnated over the last few years. Compared to the EU average, it appears that the widest gaps concern groups in the active population aged between 35 and 54, with low (ISCED 0-2) and high (ISCED 5-6) educational attainments, and residing in the south. Italian expenditure on training activities has fallen slightly over time (from 0.18 % in 2007 to 0.14 % in 2011) whereas it slightly increased in the EU (from 0.18 % to 0.20 % over the same period). Expenditure on general publicly financed lifelong learning activities amounted to EUR 1.2 billion in 2012. Compared to the period before the economic crisis, these measures were significantly reduced as their funding was redirected to shoring up wage supplementation schemes.

The government is prioritising expenditure on school education after several years of cuts. The government held a public consultation on a reform of the school system, to be financed by EUR 1 billion in 2015 and EUR 3 billion from 2016 through a fund created by the 2015 Stability Law. The public consultation ended on 15 November 2014 and a legislative follow-up is expected by end-February 2015. The government also intends to provide broadband and wireless connections in all educational institutions. This is linked to more general plans to improve school infrastructure: EUR 1 billion has been earmarked in 2014-15 for actions on safety measures, energy efficiency and anti-seismic regulations, as well as to renovate schools.

Measures to improve school outcomes are promising. The implementation of the first three-year cycle of the National System for Evaluation of schools has started in the 2014-15 school year. Properly involving all relevant actors and stakeholders will be key for making it a success. One of the main measures of the planned reform consists in replacing the current purely seniority-based teacher career system with a system that includes also merit-based elements. This would be a major innovation for Italy's education system. Meanwhile, the government also proposes to recruit on a permanent basis as of September 2015 almost 150 000 teachers who have so far worked under short-term contracts; from 2016 onwards access to the profession would be possible only through open competitions.

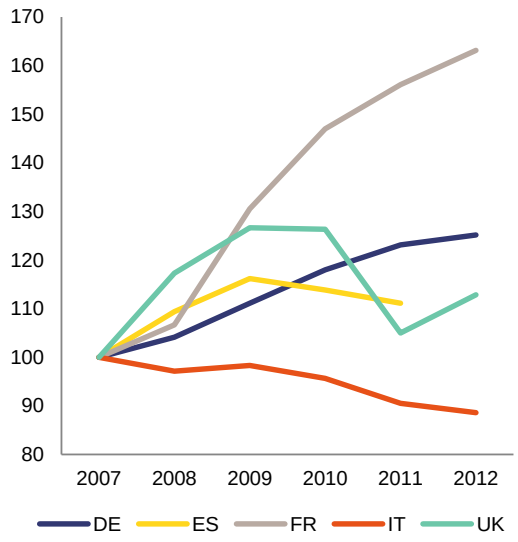
Spending in tertiary education as a share of GDP is well below the EU average but quality of higher education is receiving more attention. Between 2009 and 2013, overall public funding to tertiary education was cut by approximately 20 % in real terms and general government expenditure on tertiary education as a share of GDP is the lowest in the EU (0.4 % in 2012) (Graph 3.3.2). According to the principles of the 2010 reform, an increasing proportion of public funding for universities should be allocated on the basis of

([77]) AlmaDiploma, 'XII Rapporto sul profilo dei diplomati', 2014,

([78]) AlmaLaurea, '*Condizione occupazionale dei laureati. XVI Indagine 2013'*, 2014 Recent graduates are people that completed their studies one year before the survey was conducted.

research and teaching performance. However, until 2013 this has been difficult to implement in practice due to cuts in higher education funding and restrictive rules that limited the annual changes in the amount of funds each university could receive. In 2014, the share of performance-related public funding to universities has increased from 13.5 % to 18 % (with less restrictive implementing rules compared to 2013) and standard costs were defined and are gradually being introduced by 2018 as criteria for allocating the remaining share of public funding. In the medium- to long-term, adequate funding will be key to improve the performance of Italy's tertiary education sector.

Graph 3.3.2: **General government expenditure on tertiary education (index 2007=100)**



Source: European Commission, Eurostat

The labour market relevance of education is still limited. In the area of work-based learning, the government plans to make traineeships of at least 200 hours per year compulsory for pupils in the last three years of upper secondary vocational education. As of September 2014, a pilot project allows students in the last two years of upper secondary education to participate in on-the-job training periods in companies, using apprenticeship contracts. However, it started on a very small scale. The national register of qualifications is planned to be ready with some delay in the first half of 2015 and will consist of a single database containing existing regional skill qualification systems. Concerning vocationally-oriented tertiary education, a quality-rewarding financing model for the Higher Technical Institutes will be introduced in 2015, with 10 % of funding allocated according to performance indicators. This is a welcome step, although the Higher Technical Institutes remain a small education niche: only about 5 000 students were attending them at end-2013, although data on graduate employability are encouraging. ([79])

Social policies

Italy faces serious social challenges with poverty and social exclusion is continuing to grow, affecting children in particular. Progress towards the Europe 2020 national target for poverty reduction has not occurred; on the contrary, the number of people at risk of poverty and social exclusion increased by 2.3 million between 2008 and 2013 (+14.7 percentage points). This accounted for nearly half (46 %) of the total increase in Europe during the same period. In 2013, 28.4 % of people in Italy were at risk of poverty or social exclusion (EU average: 24.5 %). Despite severe material deprivation dropped to 12.4 % in 2013 from 14.5 % in 2012, it remained above the EU average and the significant increase recorded during the crisis was unusual compared to other Member States. Children remained the age group at highest risk of poverty and social exclusion and the presence of children remained a discriminating factor in Italian households, with higher poverty and social exclusion in households with children. Among households with children, the in-work poverty rate was particularly high for single parent households (24.7 %, among the highest in the EU). The in-work poverty rate for all employed persons remained high at 10.6 %, which may be linked to the high level of atypical contracts. People over 18 born outside Italy are also increasingly at risk of poverty, with an increase of 8.3 percentage points between 2008 (34%) and 2013 (42.3 %). Income inequality continued to increase, with the ratio of total income of the top 20 % to the income of the bottom 20 % rising to 5.7 in 2013 (the EU28 average ratio was equal to 5). Structural disparities between the south and the other regional areas in

([79]) Ministero dell'Istruzione, dell'Università e della Ricerca, 'Presentazione del sistema di Monitoraggio e valutazione degli Istituti Tecnici superiori', 2014.

terms of poverty and social exclusion indicators remained significant.

The social protection system is fragmented and not well equipped to address the challenges of poverty and social exclusion. Social expenditure in Italy is largely oriented towards the elderly and dominated by pension expenditure, which represented 16.6 % of GDP in 2012, the second highest share in the EU. This leaves little scope for the other functions of social protection, namely to support families and children and address the risk of social exclusion and poverty. Social assistance expenditure is fragmented and there is no nationwide minimum income scheme or framework in place. As a result, Italy has the third highest share of people living in poor or jobless households that are not covered by social transfers, and a larger share of the working age population is dependent on the pension income of a family member. ([80]) Given the absence of an overarching long-term strategy to reduce poverty and promote social inclusion, funding priorities tend to shift from year to year. There are many different schemes and actors in the provision of social services and it is difficult for recipients and operators alike to have a complete picture of the support available. A nationwide database of social benefit recipients and services is not yet in place and this strongly limits the efficiency and consistency of services. No standards for basic levels of provision of services have been developed at the national level, allowing deep territorial differences and a fundamental inequality in the support to people in need to persist. ([81])

Some positive initiatives to address poverty and social exclusion have been experimented, but it is unclear how they coordinate. The launch of the pilot scheme on the support for active inclusion represented a significant step towards the development of an efficient minimum income scheme combining cash benefits with compulsory activation and social services programmes (a large part of it funded by the European Social Fund). Its implementation required putting in place adequate control systems and reached 6 517 households (corresponding to 26 863 persons) in September 2014. However, dedicated resources were allocated to the scheme in 2014 but no additional resources are envisaged by the 2015 Stability Law. It is unclear whether and how the support for active inclusion will evolve after the introduction of new unemployment assistance scheme (*Assegno di disoccupazione* - ASDI) foreseen by the draft legislative decree adopted in December 2014 under the 'Jobs Act', as the main aims and beneficiaries of the two measures largely overlap. Whether these tools will complement each other as a broader safety net against poverty will depend on the level and stability of funding to be found within the budgetary constraints, on the proper identification and coverage of relevant target groups, and on the quality of accompanying support provided by employment and social services across different regions, pending the long-awaited reform.

Progress in improving the effectiveness of family support schemes and quality services favouring low-income households with children has been limited. In relation to family support schemes, the 2015 Stability Law introduced a 'baby bonus', providing a benefit of EUR 80 per month to families below a certain income level, for each child below the age of three. The measure does not seem to be based on an impact assessment analysis, and its funding may risk competing with other more structural investments (such as the pilot social assistance scheme for low-income households with children and investments in childcare facilities). In 2014, the scheme covering expenses for childcare or babysitting for working mothers who decide to curtail parental leave and to return to work was reformulated in light of its very low uptake. The revised measure addresses a wider group (including private sector workers) and provides for a more generous contribution.

Serious weaknesses continue to affect the availability and access to child care. While childcare places increased by 22 % between December 2008 (234 703 places) and December 2012 (287 149 places), their availability, particularly for low-income families, remains an issue. In 2012, 79 % of children aged 0-3 were not in any formal childcare against the EU average of 72 %. Territorial differences are very marked: in the regions of the south, only 22.5 % of municipalities run nurseries and crèches (with extreme situations such as in Calabria, where they

([80]) European Commission, 'Employment and Social Developments in Europe report 2013'.

([81]) ISTAT, 'Tendenze demografiche e trasformazioni sociali. Nuove sfide per il sistema di welfare. 2014 Annual Report', 2014.

exist in 9 % of municipalities) while these services exist in 76.3 % of municipalities in northern Italy. In the future, municipalities, responsible for most of the expenditure, will have to cope with a substantial reduction in national support to finance these services.

No significant progress has been seen on long-term care, a particularly important topic in a country with a significantly ageing population. Resources dedicated to the National Fund for Not-self-sufficient Persons were slightly increased in the 2015 Stability Law. Overall, the long-term care system is characterised by a high degree of fragmentation between institutions, sources of financing and governance, and by significant variation between regions. In the past few years, money transfers from the social services to the non-self-sufficient elderly and disabled have greatly increased while the services provided directly by the social services have decreased: state funds for 2013 were in fact significantly lower than the funding a few years ago (60 % less than in 2008). ([82]) The system thus has a very strong prevalence of cash benefit programmes over services (45 % of the overall long-term care expenditure is dedicated to cash benefits, mostly on companion allowance). This cash benefit is provided as a lump sum payment with no differentiation regarding the severity of the disability. At the same time, Italy has a relatively low coverage of institutional care (the lowest capacity of all OECD countries) although in the number of long-term care beds increased by 5.2 % over 2000-2011. Therefore, support for the elderly and not-self-sufficient people continues to rely mainly on informal care provided by relatives over 50 (mostly women) and, when affordable, by migrant care workers, often with irregular contracts. The care frequency is relatively high with 74 % of informal carers providing care on a daily basis.

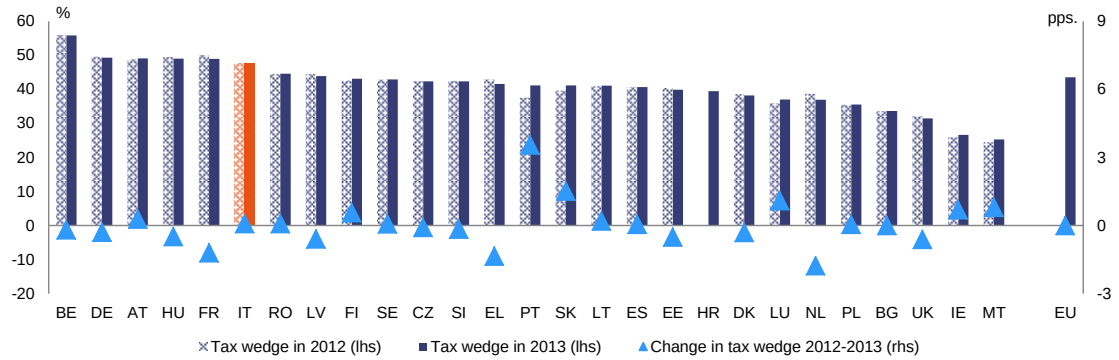
The Italian government has committed to developing a framework strategy for social inclusion by mid-2016. The work will be based on a broad consultation of stakeholders that will start by March 2015. This may represent an opportunity to ensure a better integration and consistency of measures and programmes and longer term planning, thus overcoming the current fragmentation and instability of instruments and programmes that reduces effectiveness and efficiency.

European Structural and Investment Funds (European Social Fund, National Operational Programme on Social Inclusion) will provide the framework for developing and testing basic levels of services (*livelli essenziali di prestazione*) in different fields. The same funds will also support the development of a national database on services and benefit recipients, so as to improve access to and comparability of resources and thus the overall efficiency of the system. The first step in this rationalisation was the in-depth revision of means-testing mechanisms (ISEE), which was implemented in late 2014. This is expected to provide parameters for the harmonised delivery of social services, with better targeting of benefits and assistance.

([82]) Network Non Autosufficienza, 'L'assistenza agli anziani non autosufficienti in Italia - Rapporto promosso dall'IRCCS - INCRA per l'Agenzia nazionale per l'invecchiamento', 2013.

3.4. TAXATION

Graph 3.4.1: **Tax wedge and recent changes for 100% average production wage (APW) earner**



(1) Tax wedge of single earner without children at 100 % of the average wage. No recent data are available for Cyprus. Data for Croatia are only available for 2013. EU average does not include Cyprus and Croatia. The tax wedge for Italy does not include the labour-related part of the regional tax on businesses, which is however included in the implicit tax rate on labour.
Source: Commission services

The very high tax burden on labour and capital in Italy compared to other Member States hinders the efficient allocation of productive factors. The implicit tax rate ([83]) on labour was 42.8 % in 2012, the highest in the EU and well above the EU (GDP-weighted) average of 36.1 %. Also the tax wedge (Graph 3.4.1) in 2013 was among the highest in the EU and at a similar level to 2012 (47.8 % versus the EU average of 43.6 %). The implicit tax rate on corporate income was 25.9 %, the third highest in the EU. The implicit tax rate on capital (which includes taxation on immovable property) increased from 32 % in 2011 to 37 % in 2012. Conversely, the implicit tax rate on consumption was 17.7 %, significantly lower than the EU average of 19.9 %.

Action to lower the taxation of labour is being taken. The 2015 Stability Law introduced several measures to reduce the tax burden on labour. First, the law provides for a full deduction of the labour costs of employees under open-ended contracts from the regional tax on productive activities (IRAP) in a permanent way. At the same time however, it envisages the abrogation of the previous generalised reduction in IRAP rates, enacted in April 2014. In net terms, the measure should lead to a permanent reduction in the implicit tax rate on labour of around 1 percentage point. Second, the 2015 Stability Law makes permanent the tax credit to low-wage employees (also known as the monthly bonus of EUR 80), which was first enacted in 2014 and financed only for 2014 (worth 0.6 % of GDP per year). This measure intends primarily to support private consumption but could also have a positive impact on labour demand and competitiveness in the medium-to-long term to the extent that it translates into lower wage claims. This single measure should bring about a permanent reduction in the implicit tax rate on labour of 0.4 percentage points. Cumulatively, the two permanent measures would reduce the implicit tax rate on labour by some 1.5 percentage points, closing about one fourth of the gap to the EU average. According to Bank of Italy, the tax wedge for employees with a gross wage which is one third below the national average (EUR 19 707) would be reduced by 4.6 percentage points of the total labour cost (1.3 percentage points for employers and 3.3 percentage points for employees). ([84]) Finally, the law exempts private employers (with the exception of the agricultural sector and household services) from paying social security contributions for three years for new personnel hired in 2015 under open-ended contracts (with a ceiling of EUR 8 060 per year). In the short term, this temporary measure could help labour demand and thus job. The three

([83]) The 'implicit tax rate' is a measure of the effective average burden on different types of economic income or activity, e.g. labour, consumption or capital. It is calculated as the ratio of the revenue from the type of tax in question to its (maximum possible) base.

([84]) 'Audizione preliminare all'esame dei documenti di bilancio per il triennio 2015-2017', Banca d'Italia, November 2014.

measures are financed by spending cuts and an increase in VAT rates and excise duties equivalent to 0.8 % of GDP in 2016, 1.2 % in 2017 and 1.4 % in 2018, as such ensuring the achievement of fiscal targets over the period. Such increases may however be replaced by spending cuts or other saving measures with an equivalent budgetary impact. In the short term, these measures' potentially positive impact on growth could be at least partially offset by the expenditure savings and/or the higher taxation on consumption which are needed to finance them. However, long-term growth could be positively affected to the extent that the spending cuts effectively tackle the inefficiencies in Italy's public expenditure at all levels of government and preserve growth-enhancing spending like research and development, innovation, education, and essential infrastructure projects.

Improving the design of environmental and property taxation could help achieve the Europe 2020 national climate and energy targets and improve the equity and efficiency of the tax system. Environmental taxation reached 3 % of GDP in 2012, compared with around 2.4 % for the EU. Most of this comes from energy (2.3 % of GDP) and transport taxation (0.7 % of GDP) which are relatively high compared with the EU average. However, revising energy and transport taxation could help Italy to reach the agreed Europe 2020 climate targets in a cost-effective way (according to the latest national projections submitted to the Commission in 2013 and taking into account existing measures, Italy is set to miss these targets). The pollution/resources component (0.03 % of GDP) still plays a marginal role in taxation. In 2012, Italy's taxation of property – at 2.5 % of GDP – was above the EU average, but a growth-friendly shift from taxes on property transactions to recurrent taxes on immovable property (considered the least harmful to growth) is taking place following reforms in 2012 and 2014. However, the planned revision of the outdated cadastral values is progressing slowly (see below). Revenues from inheritance and gift taxation are low compared with other Member States.

The numerous tax expenditures weigh on the efficiency of the tax system. The annex to the 2015 Stability Law reports 282 provisions that prescribe exemptions or reductions with respect to benchmark tax levels. Such provisions are estimated to account for EUR 161 billion of foregone revenues in 2015 (about 10 % of GDP). ([85]) International comparisons are difficult because of differences in the way tax expenditures are defined and identified. There is some evidence, however, that the number and scope of tax expenditures in Italy are overly high. According to the OECD (2010), in Italy foregone revenues from tax expenditures as a share of GDP were among the highest in OECD countries covered and Tyler (2014) reports similar results for a wider set of countries. ([86]) While several of the tax expenditures in place can be justified, there is for example a general consensus that reduced VAT rates are an inefficient instrument to improve the equity of the tax system — as the same welfare objectives could be pursued at less cost through social spending — and that direct taxation is better suited for distributional purposes. In Italy, reduced VAT rates and exemptions are estimated to account for 45 % of potential revenues in 2012, the sixth highest value in the EU (EU average: 36 %), although there are no significant VAT exemptions that deviate from the common regime. ([87])

Tax compliance remains low and time-consuming, which could harm the level playing field and social equality. Different sources indicate the presence of a large shadow economy and concerning levels of tax under-declaration and VAT fraud. This could adversely affect the Italian

([85]) Another analysis carried out by the Ministry of Economy and Finance in 2011 counted 720 such provisions. The difference between the two exercises is mostly due to the diverging definitions of the benchmark compared to which a certain provision is considered a deviation. The first exercise takes the tax laws as a benchmark, whereas the second estimate considers theoretical concepts of income, consumption or value-added taxes. The second exercise may classify as tax expenditures elements which may be considered part of tax design under the first one.

([86]) OECD, Tax expenditures in OECD countries, 2010; Tyler J., Reforming tax expenditures in Italy: what, why and how?, IMF Working Papers, WP/14/7, 2014.

([87]) CPB/CASE, *Study to quantify and analyse the VAT gap in the EU27 Member States*, commissioned by the European Commission, 2014. The VAT (policy) gap is defined as the difference between the expected VAT receipts if all the VAT was charged at standard rates and the VAT expected according to applicable rules. It is a measure of foregone revenues due to reduced VAT rates and exemptions. The caveats related to international comparisons of the tax gaps should however be taken into account. Some VAT exemptions are set under EU law and are mandatory for Member States.

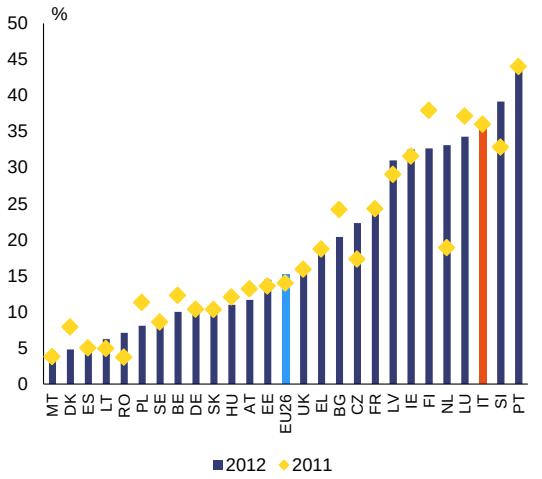
economy by undermining tax revenues, distorting competition, and hindering the financing of social protection. For instance, the Italian statistical office reports that tax evasion/elusion is larger in sectors with very low productivity growth and large shares of micro-enterprises, hinting at it as a de facto disincentive to grow. ([88]) A report on tax evasion published by the Italian government in October 2014 ([89]) estimated an average total tax gap of EUR 91 billion (5.6 % of GDP) over the period 2007-12, of which around EUR 44 billion concerned direct taxes (2.7 % of GDP), EUR 7 billion the regional tax on productive activities (IRAP) (0.4 % of GDP), and EUR 40 billion VAT (2.5 % of GDP). Italy's VAT compliance gap ([90]) was estimated to be among the highest in the EU (32 %) in 2012 and to have slightly increased compared to 2011 (Graph 3.4.2). In addition, the administrative burden created by the Italian tax system for a medium-sized company is much higher compared to the EU average (filing and paying taxes was estimated to take 269 hours in 2014. against the EU average of 179), mainly due to labour taxation. Finally, frequent changes to tax regulations undermine the stability and predictability of the business environment which may affect firms' investment decisions.

([88]) Istat, Rapporto Annuale. La situazione del paese, 2012.

([89]) Ministero Economia e Finanze, Rapporto sulla realizzazione delle strategie di contrasto all'evasione fiscale, sui risultati conseguiti nel 2013 e nell'anno in corso, nonché su quelli attesi, con riferimento sia al recupero di gettito derivante da accertamento all'evasione che a quello attribuibile alla maggiore propensione all'adempimento da parte dei contribuenti (art. 6 del decreto legge 24 aprile 2014 n. 66), October 2014.

([90]) CPB/CASE, *Study to quantify and analyse the VAT gap in the EU27 Member States*, commissioned by the European Commission, 2014. The VAT (compliance) gap is the difference between the amount of actually collected VAT and the VAT total tax liability (i.e. the VAT that should in theory be collected based on VAT legislation). It can be seen as an indicator of the effectiveness of VAT enforcement and compliance measures. The caveats related to international comparisons of the tax gaps should however be taken into account.

Graph 3.4.2: **VAT gaps in the EU (2014)**



(1) EU-26 excludes Cyprus and Croatia
Source: CBP/CASE, Study to quantify and analyse the VAT gap in the EU27 Member States, commissioned by the European Commission, 2014.

Some measures have been taken to improve tax compliance as part of the fiscal strategy in 2015. In October 2014, a legislative decree introduced pre-filled tax declarations for employees and pensioners and several simplifications concerning the declarations of individuals, companies and tax refunds. The 2015 Stability Law included two main provisions aimed at fighting tax fraud and evasion. The first aims at reducing VAT evasion through a permanent or temporary extension of the 'reverse charge system' for VAT payments to four sectors foreseen in EU VAT legislation — services related to immovable property, cleaning, green certificates and gas supplies — plus the retail sector and a 'split payment system' for goods and services supplied to Italian public bodies. The reverse charge is applied as a derogation under the EU VAT Directive and has the advantage of making 'carousel fraud' impossible in all supply chain stages, except at the retail level (in particular, VAT cannot be embezzled to the extent that no VAT is charged and paid in business-to-business transactions). However, this mechanism is not devoid of shortcomings ([91]) and should be

([91]) First, it moves away from the principle of 'fractioned payment' of VAT whereby each taxable person in the chain pays a part of the total amount. Second, the potential for fraud remains and even increases at the retail level because of the breach of the 'self-policing' principle of fractioned payment which makes it more profitable. Third, when the

considered carefully. Should the reverse charge not be applied to the retail sector, the 2015 Stability Law foresees a safeguard clause increasing excise duties on fuel as of 2015 which would anyhow ensure the expected resources. The second provision ('adempimento volontario') aims to foster tax compliance based on the cross-check of existing databases ('spesometro') and subsequent communications between the tax office and taxpayers who could thereby induced to autonomously revise their previous declarations. The 2015 Stability Law also modifies the simplified tax regime for the self-employed and two sets of rules have been adopted to improve voluntary disclosure by taxpayers, one for activities and assets held abroad and another to ease the regularisation of taxpayers' tax position. Finally, Italy has signed the Foreign Account Tax Compliance Act with the United States and a multilateral agreement to automatically exchange financial information based on OECD global standards (as of early 2017). Furthermore, Italy and Switzerland have recently reached an agreement on cooperation in tax matters. As of early March 2015, this should facilitate the regularisation of capital held abroad through the newly-introduced voluntary disclosure, as well as end double taxation between the two countries. Other stated objectives include the switch to automatic exchange of information on capital held abroad and an adaptation of the Swiss tax regime.

The implementation of the enabling law on taxation is progressing slowly. An enabling law for the reform of the tax system was passed by the Italian Parliament in March 2014. Implementing legislative decrees have to be adopted by the government by March 2015. To date, three legislative decrees have been enacted, i.e. on the revision of cadastral committees, the simplification of the tax system and the revision of taxation on tobacco production and consumption. A large package of legislative decrees is expected to be adopted by the government by end-February 2015, which are subject only to the non-binding opinion of the parliament. These include: (i) the reform of cadastral values (to be finalised within five years); (ii) increasing the certainty of tax law; (iii) the revision of taxation of individual entrepreneurs; (iv) the reduction of tax evasion and elusion and its monitoring; (v) VAT e-invoicing and other ways to improve the traceability of payments; (vi) the revision of tax collection procedures; (vii) the simplification of taxation of international businesses; and (viii) the revision of taxation of the gambling sector. Given that the parliament needs 30 days to issue its non-binding opinion, the expiry date of the enabling law may have to be extended. Anticipating this extension, the government now foresees the adoption of the legislative decree on the revision of tax expenditures by September 2015. In particular, it envisages the establishment of a specific parliamentary session review tax expenditures during the annual budget session. On the revision of environmental taxation, there is no legislative decree so far. The revision of tax expenditures and of environmental taxation could help prevent the legislated increase in the standard VAT rate from setting in fully and eventually further finance the reduction in the labour tax wedge.

reverse charge mechanism only applies to a limited range of products and services, carousel fraudsters are still able to carry out their activities by trading in other products.

3.5. SPECIAL TOPIC: REGIONAL DISPARITIES

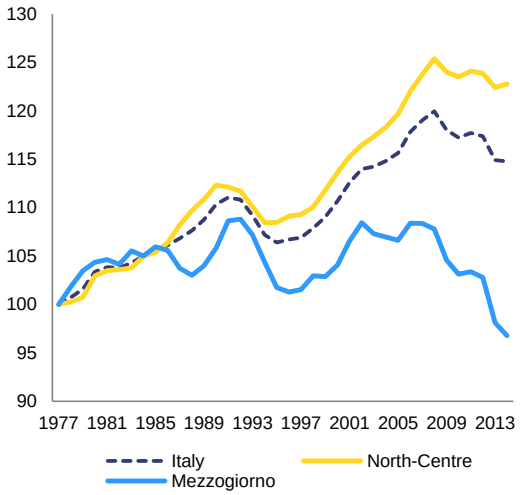
The crisis has exacerbated the long-standing socio-economic divide between the north-centre and the Mezzogiorno. ([92]) Since the reunification of Italy in 1860s, the country has been characterised by a significant and enduring divide between the north-centre and the Mezzogiorno regions. The last six years of the crisis have helped accelerate this divide, which had already started to widen in the 1990s. Between 2008 and 2013, real GDP in the Mezzogiorno dropped by almost twice as much as it did in the north-centre (about 13 % versus 7 %, respectively). Particularly after 2010, the economy of Mezzogiorno, more domestically oriented and more dependent on public spending, was particularly hit by the fall in domestic demand (partly compensated in the north-centre by the recovery of export).

The impact of the crisis on the labour market and productivity

Most of the gap in GDP per capita is explained by the lower employment rate in the Mezzogiorno. Differences in employment rates can explain two thirds of the GDP per capita gap between the Mezzogiorno and the north-centre. Labour market disparities between the north-centre and the Mezzogiorno increased to very high levels (Graphs 3.5.1 and 3.5.2) during the crisis and regional variations in employment are among the highest in the EU (Graph 3.5.2A). Most of Italy's downturn in employment was borne by the Mezzogiorno, which accounted for approximately 65 % of Italy's loss of head-count employment during the crisis (2007-12), even though it provides only one third of Italy's population. Unemployment in the Mezzogiorno increased from 11 % in 2007 to 19.7 % in 2013 and is now more than 10 percentage points higher than the one in the north-centre.

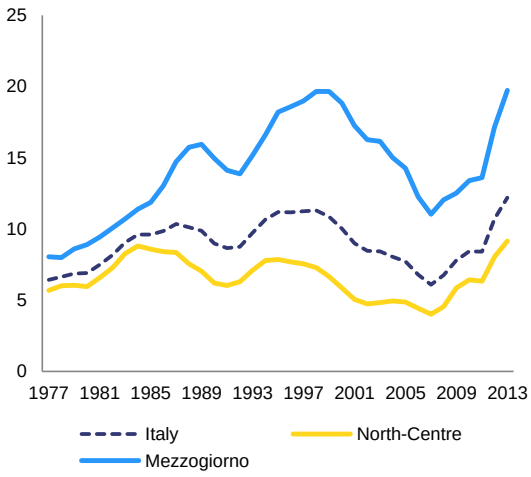
([92]) Mezzogiorno includes Abruzzo, Molise, Campania, Puglia, Basilicata, Calabria and the two islands Sardegna and Sicilia.

Graph 3.5.1: **Regional employment (1977=100)**



Source: ISTAT

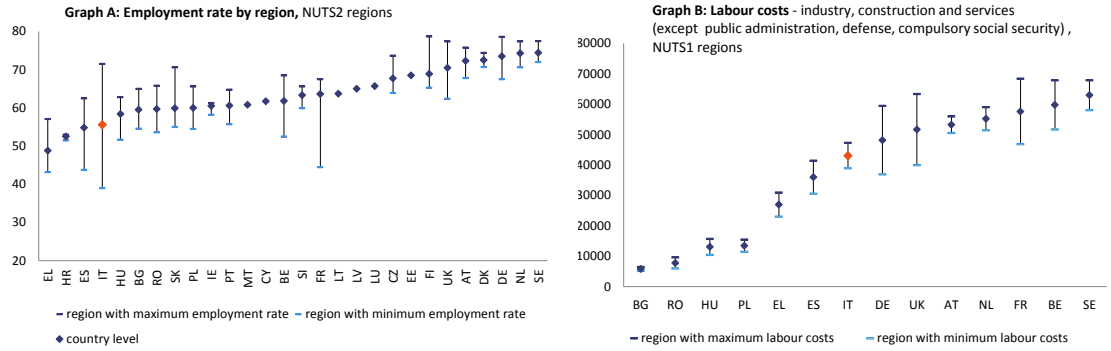
Graph 3.5.2: **Regional unemployment rate**



Source: ISTAT

Women and young people are the most disadvantaged categories in the Mezzogiorno. Out of all 272 NUTS2 EU regions, eight Mezzogiorno regions are among the 10 European regions with the lowest participation of women in the labour market. While the female employment rate in the north-centre is at 60 %, close to the euro-area average of 62 %, the Mezzogiorno rate is only about half this level (30 %). During the crisis, male employment fell more significantly than female employment. Unemployment among young people aged 15-24 skyrocketed during the crisis. In

Graph 3.5.3: **Regional employment rate and labour costs**



Source: European Commission, Eurostat

2013, the employment rates of young people in Italy and Mezzogiorno are respectively only about half and a third of that in the euro area. In some southern regions (such as Calabria, Basilicata and Sicily) youth unemployment rate reaches 55 %, more than double that in the north-east regions. Over the 2001-13 period, net emigration totalled around 710 000 persons, primarily young people with a high level of education. The departure from the Mezzogiorno has been growing in recent years: from approximately 47 800 a year in 2001-11 it peaked at circa 92 100 per year in 2012-13.

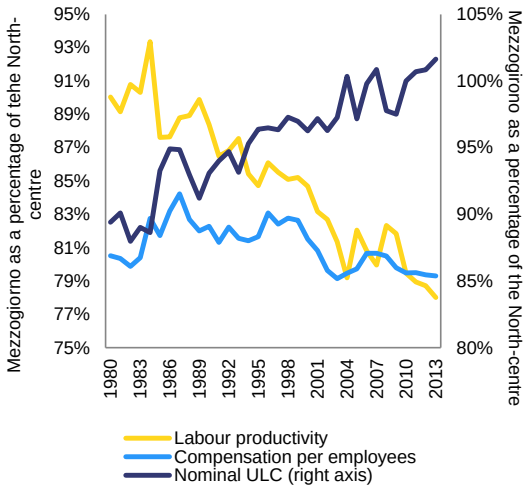
During the crisis, labour productivity in the Mezzogiorno also fell faster than in the north-centre, reversing the catching-up of the previous decade. In relative terms, productivity in the Mezzogiorno fell between 2009 and 2013 from 85 % to 83 % of that in the north-centre, accelerating the previous trend (it was about 80% in mid-90s). Particularly in the manufacturing sector, Mezzogiorno's relative productivity (compared to north-centre) has been on a long-term downward trend since the early 1970s (from 99 % of that in the north-centre to about 78 % now), while there was some catch up in the services sector (both market and non-market).

Wage developments are misaligned from productivity, particularly in the tradable sector. Italy shows low variation in regional wages with high regional variation in employment, suggesting that some of the workers may be priced-out of employment (Graph 3.5.2). Graph 3.5.4 shows that, particularly in the tradable sector, the long-term relative productivity decline was not matched by wages adjustments. The current system of wage bargaining centred on national sectorial contracts seems to limit the scope for adjusting wages to the locally differentiated productivity levels and to affect employability, particularly of the most disadvantaged, in terms of skills, gender, age or regions ([93]). Moreover, empirical evidence suggests that in the context of centralised wage bargaining and wages determined predominantly by leading regions, negative economic shocks, such as the current crisis, have a bigger impact on lagging regions. ([94]) In Italy indeed since the late 1970s, north-centre was more resilient during the shocks.

([93]) Italy – Selected issues, *IMF Country Report* No.11/76, July 2011

([94]) Pench, L., Sestito, P., Frontini, E., 'Some Unpleasant Arithmetics of Regional Unemployment in the EU: Are there any lessons for the EMU?', European Economy. No. 134, 1999, and Vamvakidis, A., 'Regional wage differentiation and wage bargaining system in the EU', IMF Working paper No.43, 2008.

Graph 3.5.4: **Labour productivity, labour costs and unit labour costs in Mezzogiorno relative to the North-centre, manufacturing sector**



Source: European Commission

Structural differences holding back productivity growth in the Mezzogiorno

Productivity differentialsare responsible for the remaining one third of the GDP per capita gap. Productivity differentials reflect structural differences in many areas, including quality of governance, the education system, and the business environment. Other disparities, for instance in infrastructures, are covered in the relevant sections.

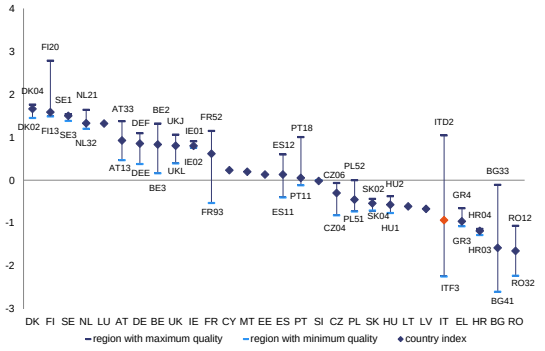
The quality of governance is very low and an major barrier to economic development. A simple, transparent and efficient regulatory system with legal certainty and reliable public services, devoid of corruption, are crucial for the effectiveness of public spending, a well-functioning business environment in general and the attractiveness of foreign investment. The European Quality of Governance Index (2013) ([95]) (Graph 3.5.5) ranks Italy as the fifth least-performing country in terms of quality of governance in the EU, while at the same time showing the largest variation between its best and worst performing regions (Graph 5). While the Trento and Bolzano provinces rank among the best 10 % of performers, the regions in the south (and Lazio, the region which includes Rome) are among the worst performers in the EU. A study by the European Commission ([96]) shows that the index is highly correlated with the level of trust and socio-economic development indicators, such as income levels, educational attainment or technology. It also finds evidence of a clear positive correlation between the index and absorption of EU funds, which is below the EU average for Italy. Part of the poor performance in absorption of structural funds is due to delays, bottlenecks and administrative weaknesses, particularly in the Mezzogiorno (see Section 2.1). The quality of regional governance and legal certainty is not only a key driver of productivity in the long-term ([97]) but also crucial for the successful use of the EU funds and the implementation of the Investment Plan for Europe in the short term. Improving the Mezzogiorno's administrative capacity is also important as its economy is much more heavily dependent on the public sector. Public services account for about 30 % of value added in the Mezzogiorno against about 17 % in north-centre.

([95]) *The European Quality of Government Index (EQI)* is a composite index created by the European Commission (DG REGIO) that enables the measurement of institutional quality on a regional level. It combines country-level data from the World Bank's Worldwide Governance Indicators (WGI) and adjusts using regional-level survey data (based on answers form 85000 respondents across Europe) to include regional variation as perceived by local inhabitants. It looks at categories such as control of corruption, rule of law and government effectiveness.

([96]) Charron, N., Lapuente, V. and Dijkstraet, L., 'Regional Governance Matters: A Study on Regional Variation in Quality of Government within the EU', DG REGIO Working Papers 01, 2012.

([97]) Tabellini, G., '*Culture and institutions: economic development in the regions of Europe*, Journal of the European Economic Association, European Economic Association, 8(4):677–716, 2010.

Graph 3.5.5: **European Quality of Government Index 2013 (EQI) and the regional country variation**



Source: European Commission

There are also important regional differences in the performance of the education system, which produces rather mixed results in terms of basic skills attainment across regions. As in previous rounds, the 2012 OECD Programme for International Student Assessment (PISA) shows that the performance of Italy's education system is in line with or above the EU average in the northern regions but significantly worse in the south. Similar regional differences can be seen also in the 2011 Trends in International Mathematics and Science Study & Progress in International Reading Literacy Study on 10 year-olds, conducted by the International Association for the Evaluation of Educational Achievement.

The business environment is much worse in the Mezzogiorno than in the north-centre. The World Bank's Doing Business Indicator reveals particularly high regional variation in Italy, with the Mezzogiorno clearly lagging behind in terms of the quality, timing and costs of the administrative procedures relevant for businesses. For example, obtaining the construction permits for a warehouse requires 164 days in Bologna (Emilia-Romagna) at a cost equivalent to 177 % of income per head, while in Potenza (Basilicata) it takes 208 days at a cost of 725 % of income per head. Enforcing a contract takes an average of 855 days and costs 22 % of the claim in Turin (Piedmont) as compared with 2 022 days and a cost of 34 % of the claim in Bari (Puglia). Starting a business takes from 6 days in Padua (Veneto) to 16 days in Naples (Campania), while registering a property takes 13 days in Bologna and 24 days in Rome. ([98])

([98]) As reported in 'Investment for jobs and growth', *Sixth report on economic, social and territorial cohesion*, DG REGIO, July 2014.

ANNEX A
Overview Table

Commitments	Summary assessment ([99])
CSR 1: Reinforce the budgetary measures for 2014 in the light of the emerging gap relative to the Stability and Growth Pact requirements, namely the debt reduction rule, based on the Commission services 2014 spring forecast and ensure progress towards the MTO. In 2015, significantly strengthen the budgetary strategy to ensure compliance with the debt reduction requirement and thus reaching the MTO. Thereafter, ensure that the general government debt is on a sufficiently downward path; carry out the ambitious privatisation plan; implement a growth-friendly fiscal adjustment based on the announced significant savings coming from a durable improvement of the efficiency and quality of public expenditure at all levels of government, while preserving growth-enhancing spending like R&D, innovation, education and essential infrastructure projects. Guarantee the independence and full operationalisation of the fiscal council as soon as possible and no later than September 2014, in time for the assessment of the 2015 Draft Budgetary Plan.	Italy has made **limited progres**s in addressing CSR 1 (this overall assessment excludes an assessment of compliance with the Stability and Growth Pact): • Limited progress was made to improve the efficiency and quality of public spending. Ministers were directly involved in selecting areas within their own budgets eligible for targeted savings without recourse to linear expenditure cuts as in the past. However, the need to preserve growth-enhancing expenditure items and improve the economic efficiency of the public administration would still require top-down coordination and monitoring. The identification of additional savings at regional level (EUR 4 billion in 2015) has been delayed. • Limited progress was made with regard to privatisation. Privatisation proceeds in 2014 amounted to 0.5% of GDP (mainly related to the reimbursement of Monti bonds by Banca Monte dei Paschi), short of the target of 0.7% per year. • Substantial progress was made with regard to the Italy's Fiscal Council, which has been operational since September 2014.
CSR 2: Further shift the tax burden from productive factors to consumption, property and the environment, in compliance with the budgetary targets. To this end, evaluate the effectiveness of the recent reduction in the	Italy has made **some progress** in addressing CSR 2: • Some progress was made in shifting taxation away from labour. A tax credit (of EUR 10

([99]) The following categories are used to assess progress in implementing the 2014 country-specific recommendations of the Council Recommendation: No progress: The Member State has neither announced nor adopted any measures to address the country-specific recommendation. This category also applies if a Member State has commissioned a study group to evaluate possible measures. Limited progress: The Member State has announced some measures to address the country-specific recommendation, but these measures appear insufficient and/or their adoption/implementation is at risk. Some progress: The Member State has announced or adopted measures to address the country specific recommendation. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases. Substantial progress: The Member State has adopted measures, most of which have been implemented. These measures go a long way in addressing the country-specific recommendation. Fully addressed: The Member State has adopted and implemented measures that address the country-specific recommendation appropriately.

labour tax wedge and ensure its financing for 2015, review the scope of direct tax expenditures and broaden the tax base, in particular on consumption. Ensure more effective environmental taxation, including in the area of excise duties, and remove environmentally harmful subsidies. Implement the enabling law for tax reform by March 2015, including by adopting the decrees leading to the reform of the cadastral system to ensure the effectiveness of the reform of immovable property taxation. Further improve tax compliance by enhancing the predictability of the tax system, simplifying procedures, improving tax debt recovery and modernising tax administration. Pursue the fight against tax evasion and take additional steps against the shadow economy and undeclared work.	billion or 0.6% of GDP per year) was introduced for low-income earners in April 2014 and the labour component was excluded from the calculation of the regional business tax (IRAP) from Jan 2015. For new hires under open-ended contracts in 2015, private sector employers will not pay social security contributions for three years. • Limited progress was made on tax expenditures, environmental taxation, and removal of environmentally harmful subsidies. • Some progress was made to simplify procedures (including pre-filled tax returns) and improve compliance (including measures to prevent carousel fraud in VAT and facilitate voluntary disclosure). A report on tax evasion was published in October 2014, which assesses the tax gap (EUR 91 billion).
CSR 3: As part of a wider effort to improve the efficiency of public administration, clarify competences at all levels of Government. Ensure better management of EU funds by taking decisive action to improve administrative capacity, transparency, evaluation and quality control both at national and regional level, especially in southern regions. Further enhance the effectiveness of anti-corruption measures, including by revising the statute of limitations by the end of 2014, and strengthening the powers of the national anti-corruption authority. Monitor in a timely manner the impact of the reforms adopted to increase the efficiency of civil justice with a view to securing their effectiveness and adopting complementary action if needed.	Italy has made **limited progress** in addressing CSR 3: • Limited progress was made to improve the efficiency of public administration, although some effort is under way. The Senate completed its first reading of the draft constitutional bill clarifying the competences of different levels of government. A draft enabling law envisaging a comprehensive reform of the public administration is currently being considered by the Senate. The agency for territorial cohesion is about to become operational. • Limited progress was made in the fight against corruption. In particular, the process to revise the Italian stature of limitations is still in the initial phase. However, the powers of anti-corruption authority ANAC were enhanced and the new offence of self-laundering was introduced into the Italian criminal code.. • Some progress was made towards improving the functioning of civil justice. Electronic filing in civil, administrative and tax-related trials became obligatory and the ‘office of proceedings’ was established. The possibility to transfer pending cases to arbitration and a new pre-trial procedure of 'assisted negotiation' (negoziazione assistita),

	mandatory in certain cases, was introduced. Simplification measures were also introduced. Further reforms are under way.
CSR 4: Reinforce the resilience of the banking sector and ensure its capacity to manage and dispose of impaired assets to revive lending to the real economy. Foster non-bank access to finance for firms, especially small and medium-sized businesses. Continue to promote and monitor efficient corporate governance practices in the whole banking sector, with particular attention to large cooperative banks ('banche popolari') and the role of foundations, with a view to improving the effectiveness of financial intermediation	Italy has made **some progress** in addressing CSR 4: • Some progress was made on the disposal of impaired assets, but the efforts were concentrated only in the largest banks, especially in the context of the European Central Bank's comprehensive assessment of the euro-area banking sector. • Some progress was made on addressing the corporate governance weaknesses in the banking sector. The Bank of Italy has strengthened the corporate governance of banks by requiring *inter alia* a clear distinction of responsibilities and powers of corporate governance bodies, the effectiveness of controls and a composition of governing bodies which is consistent with the size and the complexity of banks. Italy's largest cooperative banks (*banche popolari*) – i.e. those with more than EUR 8 billion assets – are required to transform themselves into joint-stock companies, thus abolishing the 'one head-one vote' rule. No specific initiative was taken yet on the role of foundations in Italy's banking sector. • Substantial progress was made towards facilitating and diversifying firms' access to finance. Measures include the strengthening of the allowance for corporate equity (ACE) framework, tax incentives for investment in mini-bonds by institutional and foreign investors, the further enhancing of the Central Guarantee Fund for SMEs, the introduction of direct lending by insurance firms, incentives for SMEs to list themselves on the stock market, investment support programmes by Cassa Depositi e Prestiti (e.g. *Nuova Sabatini*), the extending of the existing research and development tax credit framework and the introduction of a favourable tax regime ('Patent Box') for revenues from the use or sale of patents and trademarks.

CSR 5: Evaluate, by the end of 2014, the impact of the labour market and wage-setting reforms on job creation, dismissals' procedures, labour market duality and cost competitiveness, and assess the need for additional action. Work towards a more comprehensive social protection for the unemployed, while limiting the use of wage supplementation schemes to facilitate labour re-allocation. Strengthen the link between active and passive labour market policies, starting with a detailed roadmap for action by December 2014, and reinforce the coordination and performance of public employment services across the country. Adopt effective action to promote female employment, by adopting measures to reduce fiscal disincentives for second earners by March 2015 and providing adequate care services. Provide adequate services across the country to non-registered young people and ensure stronger private sector commitment to offering quality apprenticeships and traineeships by the end of 2014, in line with the objectives of a youth guarantee. To address exposure to poverty and social exclusion, scale-up the new pilot social assistance scheme, in compliance with budgetary targets, guaranteeing appropriate targeting, strict conditionality and territorial uniformity, and strengthening the link with activation measures. Improve the effectiveness of family support schemes and quality services favouring low-income households with children.	Italy has made **some progress** in addressing CSR 5: • Some progress was made to reduce segmentation, increase exit flexibility, reform passive and active labour market policies and foster participation. A broad-ranging enabling law for reforming the labour market was passed in December 2014, with two important legislative implementing decrees on employment protection and the revision of unemployment benefits being already adopted and two, respectively on labour contracts and work-life balance, subject to the non-binding opinion of the Parliament. Other implementing legislative decrees (on active labour market policies, review of wage-supplementation schemes and inspections) are expected to follow in Spring 2015. • Limited progress was made on youth unemployment. The implementation of the Youth Guarantee started in May 2014 but the take-up is limited. • Limited progress was made to address exposure to poverty. A pilot project on the social inclusion scheme (SIA) has been carried out in 12 metropolitan cities. Under the labour market reform, an unemployment assistance scheme (ASDI) is being established.
CSR 6: Implement the National System for Evaluation of Schools to improve school outcomes in turn and reduce rates of early school leaving. Increase the use of work-based learning in upper secondary vocational education and training and strengthen vocationally-oriented tertiary education. Create a national register of qualifications to ensure wide recognition of skills. Ensure that public funding better rewards the quality of higher education and research.	Italy has made **some progress** in addressing CSR 6: • Some progress was made in implementing the National System for Evaluation of schools, which is being phased in, and the government has prioritised expenditure on school education. A public consultation on the reform of the education system was closed in November 2014 and legislative follow up is expected in early 2015. • Some progress was made towards increasing the share of performance-related public

	funding for universities (from 13.5% in 2013 to 18% in 2014). Standard costs will gradually be introduced over 2014-18 as criteria for allocating the remaining share of public funding. • Limited progress was made on vocational training. The national register of qualifications is due to be ready by early 2015. More action is expected under the forthcoming broader reform.
CSR 7: Approve the pending legislation or other equivalent measures aimed at simplifying the regulatory environment for businesses and citizens and address implementation gaps in existing legislation. Foster market opening and remove remaining barriers to, and restrictions on, competition in the professional and local public services, insurance, fuel distribution, retail and postal services sectors. Enhance the efficiency of public procurement, especially by streamlining procedures including through the better use of e-procurement, rationalising the central purchasing bodies and securing the proper application of pre- and post-award rules. In local public services, rigorously implement the legislation providing for the rectification of contracts that do not comply with the requirements on in-house awards by 31 December 2014.	Italy has made **limited progress** in addressing CSR 7: • Some progress was made simplify the regulatory environment for business and citizens. The government has adopted the 'Simplification Agenda for 2015-17' to foster cooperation between central and regional governments in establishing a more coherent simplification framework and measures have been taken to simplify authorisation procedures in environmental and construction matters. • Limited progress was made in improving public procurement. Measures to rationalise public procurement have taken and a draft enabling law for the reform of the public procurement code was tabled government. • No progress was made to reform local public services. The deadline of end-2014 for rectifying contracts that do not comply with EU law has been postponed to end-2015. The observatory that is supposed to oversee the implementation of relevant legislation is not yet operational. The draft enabling law for the reform of the public administration includes measures to reform local public services. • Limited progress was made to address restrictions on competition in other sectors. A draft 'law for competition' was adopted in February 2015 and covers a number of sectors. In the banking sector, the regulation concerning the portability of bank accounts was improved. The rental market for non-residential large buildings was opened. Italy is actively participating in the mutual evaluation exercise provided for in the Directive

	amending the Professional Qualifications Directive but has yet to complete its review.
CSR 8: Ensure swift and full operationalisation of the Transport Authority by September 2014. Approve the list of strategic infrastructure in the energy sector and enhance port management and connections with the hinterland.	Italy has made **limited progress** in addressing CSR 8: • Substantial progress was made on the Transport Authority, which is now operational, although understaffed. • Limited progress was made with regard to strategic infrastructures in energy and ports. Decree-law 90/2014 sets out criteria for selecting strategic infrastructures and envisages a strategic plan for Italian ports but no concrete steps to implement it have been taken yet

Europe 2020 (national targets and progress)	
Employment rate target: 67-69 %	The employment rate was 61.2 % in 2011, 61 % in 2012 and 59.8 % in 2013. No progress has been achieved towards meeting the target.
Research and development target: 1.53 % of GDP	Gross domestic expenditure on research and development was 1.21 % in 2011, 1.26 % in 2012 and 1.25% in 2013 (provisional). No progress has been achieved towards meeting the target.
Greenhouse gas emissions target -13 % (compared with 2005 emissions); ETS emissions are not covered by this national target.	According to the latest national projections submitted to the Commission in 2013 and taking into account existing measures, it is expected that the target will be missed: -9.5 % in 2020 as compared with 2005 (i.e. a projected shortfall of 3.5 percentage points). However, according to approximated data for 2012, emissions are lower than expected as they decreased by 18% between 2005 and 2012.
Renewable energy target: 17 %	Renewables' share of gross final energy consumption was 12.3 % in 2011 and 13.5 % in 2012. Despite recent changes to support schemes, Italy is on track to reach its 17% target in 2020.
Energy efficiency: absolute level of primary energy consumption of 158 Mtoe	Progress needs to be sustained over time. In 2012, primary energy consumption in Italy stood at 155.2 Mtoe, below the 2020 target but this evolution is also

	related to economic recession.
Early school leaving target: 16 %	Some progress has been made towards meeting this target. The early school leaving rate (the percentage of the population aged 18-24 with at most lower secondary education and not in further education or training) fell from 18.2 % in 2011 to 17.6 % in 2012 and 17.0 % in 2013.
Tertiary education target: 26-27 %	Some progress has been made towards meeting this target. The tertiary educational attainment rate rose from 20.3 % in 2011 to 21.7 % in 2012 and 22.4 % in 2013.
Target on the reduction of population at risk of poverty or social exclusion in number of persons: -2 200 000 (compared to 2008, thus corresponding to 12 899 0000 people at risk of poverty or social exclusion in 2020)	Limited progress has been made in meeting this target. The number of people at risk of poverty or social exclusion fell from 18 194 million in 2012 to 17 326 million in 2013.

ANNEX B
Standard Tables

Table AB.1: **Macroeconomic indicators**

	1996-2000	2001-2005	2006-2010	2011	2012	2013	2014	2015	2016
Core indicators									
GDP growth rate	2.0	0.9	-0.3	0.6	-2.3	-1.9	-0.5	0.6	1.3
Output gap [1]	0.4	0.8	-0.1	-1.7	-3.0	-4.3	-4.3	-3.5	-2.1
HICP (annual % change)	2.4	2.4	2.0	2.9	3.3	1.3	0.2	-0.3	1.5
Domestic demand (annual % change) [2]	2.5	1.1	0.0	-0.6	-5.0	-2.9	-0.8	0.3	1.3
Unemployment rate (% of labour force) [3]	10.9	8.3	7.2	8.4	10.7	12.2	12.8	12.8	12.6
Gross fixed capital formation (% of GDP)	19.4	20.9	20.8	19.6	18.6	17.8	17.3	17.6	18.2
Gross national saving (% of GDP)	21.2	20.5	18.9	17.4	18.1	18.7	18.7	19.6	20.3
General government (% of GDP)									
Net lending (+) or net borrowing (-)	-3.2	-3.5	-3.5	-3.5	-3.0	-2.8	-3.0	-2.6	-2.0
Gross debt	111.1	101.8	106.5	116.4	122.2	127.9	131.9	133.0	131.9
Net financial assets	-99.0	-91.2	-94.0	-94.3	-109.0	n.a.	n.a.	n.a.	n.a.
Total revenue	45.3	43.6	45.2	45.6	47.4	47.7	47.7	47.6	47.7
Total expenditure	48.5	47.1	48.6	49.1	50.4	50.5	50.7	50.1	49.6
of which: Interest	8.1	5.1	4.6	4.7	5.2	4.8	4.7	4.3	4.3
Corporations (% of GDP)									
Net lending (+) or net borrowing (-)	-0.3	-0.1	-0.7	-0.3	1.9	1.9	2.4	2.1	1.5
Net financial assets; non-financial corporations	-86.6	-105.5	-122.0	-111.6	-114.8	n.a.	n.a.	n.a.	n.a.
Net financial assets; financial corporations	-7.4	-9.8	9.5	29.8	29.8	n.a.	n.a.	n.a.	n.a.
Gross capital formation	10.5	11.3	10.9	11.1	9.6	9.3	8.8	9.0	9.6
Gross operating surplus	24.0	23.7	21.9	21.0	20.2	20.1	19.6	19.7	19.7
Households and NPISH (% of GDP)									
Net lending (+) or net borrowing (-)	5.2	3.2	2.0	0.8	0.8	1.9	2.6	3.2	3.1
Net financial assets	190.6	196.1	183.6	160.0	171.2	n.a.	n.a.	n.a.	n.a.
Gross wages and salaries	26.8	27.3	28.7	29.1	29.3	29.3	29.6	29.7	29.5
Net property income	17.9	14.6	13.2	11.4	11.0	10.2	10.3	10.0	10.0
Current transfers received	20.5	20.7	22.2	23.5	24.0	24.6	25.3	25.8	25.6
Gross saving	11.7	10.2	9.1	7.3	7.1	8.0	8.5	9.1	9.1
Rest of the world (% of GDP)									
Net lending (+) or net borrowing (-)	1.7	-0.5	-2.2	-3.0	-0.3	0.9	1.9	2.7	2.7
Net financial assets	4.4	12.4	26.5	22.3	29.4	n.a.	n.a.	n.a.	n.a.
Net exports of goods and services	2.8	0.6	-0.9	-1.6	0.9	2.3	3.1	3.9	3.8
Net primary income from the rest of the world	-0.5	-0.3	-0.2	-0.3	-0.2	-0.2	-0.1	-0.1	-0.1
Net capital transactions	0.2	0.1	0.0	0.1	0.2	0.0	0.1	0.1	0.1
Tradable sector	46.7	44.3	41.5	40.5	40.1	40.1	n.a.	n.a.	n.a.
Non-tradable sector	43.2	46.0	48.5	49.3	49.7	49.9	n.a.	n.a.	n.a.
of which: Building and construction sector	4.4	4.9	5.3	5.0	4.9	4.7	n.a.	n.a.	n.a.

1 The output gap constitutes the gap between the actual and potential gross domestic product at 2010 market prices.
2 The indicator of domestic demand includes stocks.
3 Unemployed persons are all those who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.
Source: European Commission 2015 winter forecast; Commission calculations

Table AB.2: **Financial market indicators**

	2009	2010	2011	2012	2013	2014
Total assets of the banking sector (% of GDP)[1)]	246.5	244.8	257.1	269.4	259.5	254.1
Share of assets of the five largest banks (% of total assets)	31.0	39.8	39.5	39.7	39.6	n.a.
Foreign ownership of banking system (% of total assets)	12.1	13.2	13.4	13.4	12.4	n.a.
Financial soundness indicators:						
- non-performing loans (% of total loans)[2)]	9.4	10.0	11.7	13.7	16.5	17.3
- capital adequacy ratio (%)[2)]	11.7	12.1	12.7	13.4	13.7	15.0
- return on equity (%)[2)]	4.0	3.7	-13.0	-0.9	-11.5	1.2
Bank loans to the private sector (year-on-year % change)[1)]	2.4	4.0	0.9	1.7	-3.5	-1.8
Lending for house purchase (year-on-year % change)[1)]	5.9	7.5	4.4	-0.5	-1.1	-0.8
Loan to deposit ratio[1)]	131.2	118.3	125.1	117.3	111.0	107.6
Central Bank liquidity as % of liabilities[3)]	0.9	1.6	6.5	8.0	7.4	5.7
Private debt (% of GDP)	120.1	121.2	120.4	120.8	118.8	n.a.
Gross external debt (% of GDP)[4)] - public	52.2	52.1	42.5	45.7	44.4	50.7
- private	25.0	25.6	25.0	27.3	31.8	31.2
Long-term interest rate spread versus Bund (basis points)*	109.1	129.3	281.6	399.8	274.7	172.9
Credit default swap spreads for sovereign securities (5-year)*	98.6	135.9	242.6	323.2	199.7	101.6

1) Latest data November 2014.
2) Latest data Q2 2014.
3) Latest data September 2014.
4) Latest data June 2014. Monetary authorities, monetary and financial institutions are not included.
* Measured in basis points.
Source: IMF (financial soundness indicators), European Commission (long-term interest rates), World Bank (gross external debt) and ECB (all other indicators).

Table AB.3: **Taxation indicators**

	2002	2006	2008	2010	2011	2012
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	40.5	41.7	42.7	42.5	42.4	44.0
Breakdown by economic function (% of GDP)[1]						
Consumption	10.6	10.8	10.2	10.8	10.8	10.9
of which:						
- VAT	6.2	6.2	5.9	6.3	6.2	6.1
- excise duties on tobacco and alcohol	0.7	0.8	0.8	0.8	0.8	0.8
- energy	2.3	2.2	1.9	2.0	2.1	2.3
- other (residual)	1.5	1.6	1.6	1.7	1.7	1.6
Labour employed	18.0	18.1	19.3	19.4	19.2	19.6
Labour non-employed	2.2	2.3	2.5	2.8	2.8	2.9
Capital and business income	7.3	8.2	8.6	7.4	7.2	7.6
Stocks of capital/wealth	2.4	2.3	2.0	2.2	2.4	3.0
p.m. Environmental taxes[2]	2.9	2.8	2.5	2.6	2.7	3.0
VAT efficiency[3]						
Actual VAT revenues as % of theoretical revenues at standard rate	43.1	42.8	40.6	41.6	41.3	38.8

1. Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2014), Taxation trends in the European Union, for a more detailed explanation.
2. This category comprises taxes on energy, transport and pollution and resources included in taxes on consumption and capital.
3. VAT efficiency is measured via the VAT revenue ratio. It is defined as the ratio between the actual VAT revenue collected and the revenue that would be raised if VAT was applied at the standard rate to all final (domestic) consumption expenditures, which is an imperfect measure of the theoretical pure VAT base. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services ('policy gap') or a failure to collect all tax due to e.g. fraud ('collection gap'). It should be noted that the relative scale of cross-border shopping (including trade in financial services) compared to domestic consumption also influences the value of the ratio, notably for smaller economies. For a more detailed discussion, see European Commission (2012), Tax Reforms in EU Member States, and OECD (2014), Consumption tax trends.
Source: European Commission

Table AB.4: **Labour market and social indicators**

	2008	2009	2010	2011	2012	2013	2014
Employment rate (% of population aged 20-64)	63.0	61.7	61.1	61.2	61.0	59.8	59.8
Employment growth (% change from previous year)	0.2	-1.7	-0.6	0.3	-0.2	-2.0	-0.4
Employment rate of women (% of female population aged 20-64)	50.6	49.7	49.5	49.9	50.5	49.9	50.0
Employment rate of men (% of male population aged 20-64)	75.4	73.8	72.8	72.6	71.6	69.8	69.7
Employment rate of older workers (% of population aged 55-64)	34.4	35.7	36.6	37.9	40.4	42.7	45.9
Part-time employment (% of total employment, age 15 years and over)	14.3	14.3	15.0	15.5	17.1	17.9	18.3
Part-time employment of women (% of women employment, age 15 years and over)	27.9	27.9	29.0	29.3	31.1	31.9	32.2
Part-time employment of men (% of men employment, age 15 years and over)	5.3	5.1	5.5	5.9	7.2	7.9	8.3
Fixed term employment (% of employees with a fixed term contract, age 15 years and over)	13.3	12.5	12.8	13.4	13.8	13.2	13.6
Transitions from temporary to permanent employment	29.1	24.2	25.0	21.7	17.5	21.2	n.a.
Unemployment rate[1] (% of labour force, age group 15-74)	6.7	7.8	8.4	8.4	10.7	12.2	12.6
Long-term unemployment rate[2] (% of labour force)	3.1	3.5	4.1	4.4	5.7	6.9	7.7
Youth unemployment rate (% of youth labour force aged 15-24)	21.3	25.4	27.8	29.1	35.3	40.0	42.3
Youth NEET rate (% of population aged 15-24)	16.6	17.7	19.1	19.8	21.1	22.2	n.a.
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	19.7	19.2	18.8	18.2	17.6	17.0	n.a.
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	19.2	19.0	19.8	20.3	21.7	22.4	n.a.
Formal childcare (from 1 to 29 hours; % over the population aged less than 3 years)	12.0	9.0	6.0	9.0	10.0	n.a.	n.a.
Formal childcare (30 hours or over; % over the population aged less than 3 years)	16.0	16.0	16.0	17.0	11.0	n.a.	n.a.
Labour productivity per person employed (annual % change)	-0.6	-2.8	2.6	0.5	-1.4	-0.2	-0.5
Hours worked per person employed (annual % change)	-0.6	-1.7	0.1	-0.2	-1.3	0.0	0.3
Labour productivity per hour worked (annual % change; constant prices)	-0.7	-2.2	2.3	0.5	-0.8	0.1	-0.5
Compensation per employee (annual % change; constant prices)	1.1	0.3	2.3	-0.3	-0.8	-0.2	0.3
Nominal unit labour cost growth (annual % change)	4.5	4.0	-0.2	1.0	2.2	1.2	n.a.
Real unit labour cost growth (annual % change)	2.0	1.9	-0.6	-0.3	0.6	-0.2	n.a.

1 Unemployed persons are all those who were not employed, but had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. Data on the unemployment rate of 2014 includes the last release by Eurostat in early February 2015.
2 Long-term unemployed are persons who have been unemployed for at least 12 months.
Source: European Commission (EU Labour Force Survey and European National Accounts)

Table AB.5: **Expenditure on social protection benefits (% of GDP)**

	2007	2008	2009	2010	2011	2012
Sickness/healthcare	6.6	6.9	7.3	7.3	7.0	7.0
Invalidity	1.5	1.6	1.7	1.7	1.6	1.7
Old age and survivors	15.5	16.1	17.1	17.4	17.5	17.9
Family/children	1.2	1.3	1.4	1.3	1.4	1.4
Unemployment	0.4	0.5	0.8	0.8	0.8	0.9
Housing and social exclusion n.e.c.	0.0	0.0	0.0	0.0	0.0	0.0
Total	25.4	26.4	28.5	28.6	28.4	29.0
of which: means-tested benefits	1.7	1.8	2.0	1.8	1.8	1.8
Social inclusion indicators	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
People at risk of poverty or social exclusion[1] (% of total population)	25.3	24.7	24.5	28.2	29.9	28.4
Children at risk of poverty or social exclusion (% of people aged 0-17)	29.1	28.8	28.9	32.2	33.8	31.9
Elderly at risk of poverty or social exclusion (% of people aged 65+)	24.4	22.8	20.3	24.1	25.2	22.6
At-risk-of-poverty rate[2] (% of total population)	18.7	18.4	18.2	19.6	19.4	19.1
Severe material deprivation rate[3] (% of total population)	7.5	7.0	6.9	11.2	14.5	12.4
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	9.8	8.8	10.2	10.4	10.3	11.0
In-work at-risk-of-poverty rate (% of persons employed)	8.9	10.2	9.4	10.7	11.0	10.6
Impact of social transfers (excluding pensions) on reducing poverty	20.1	20.7	21.9	19.7	20.5	22.4
Poverty thresholds, expressed in national currency at constant prices[5]	9194.1	8878.2	8982.0	8855.2	8636.7	8210.8
Gross disposable income (households)	1095209.0	1065582.0	1073937.0	1096845.0	1077446.0	1079032.0
Relative median poverty risk gap (60% of median equivalised income, age: total)	23.0	22.6	24.5	26.0	25.4	28.0
Inequality of income distribution (S80/S20 income quintile share ratio)	5.1	5.2	5.2	5.6	5.5	5.7

1 People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).
2 At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
3 Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.
4 People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.
5 For EE, CY, MT, SI and SK, thresholds in nominal values in euros; harmonised index of consumer prices (HICP) = 100 in 2006 (2007 survey refers to 2006 incomes).
6 2014 data refer to the average of the first three quarters.
Source: For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table AB.6: **Product market performance and policy indicators**

	2004-08	2009	2010	2011	2012	2013	2014
Labour productivity1 in total economy (annual growth in %)	0.1	-3.9	2.4	0.3	-1.7	0.2	n.a.
Labour productivity[1] in manufacturing (annual growth in %)	1.6	-13.4	13.1	2.8	-2.3	-1.0	n.a.
Labour productivity[1] in electricity, gas (annual growth in %)	4.4	-4.0	-6.5	-5.3	1.4	-8.7	n.a.
Labour productivity[1] in the construction sector (annual growth in %)	-2.0	-6.9	-2.0	-3.0	-0.3	3.5	n.a.
Labour productivity[1] in the wholesale and retail sector (annual growth in %)	0.8	-9.0	4.0	2.9	-4.8	-0.3	n.a.
Labour productivity[1] in the information and communication sector (annual growth in %)	2.5	0.6	3.4	0.4	-1.4	-3.6	n.a.
Patent intensity in manufacturing[2] (EPO patent applications divided by gross value added of the sector)	0.0	0.0	0.0	0.0	n.a.	n.a.	n.a.
Policy indicators	**2004-08**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Enforcing contracts[3] (days)	1282	1210	1210	1210	1185	1185	1185
Time to start a business[3] (days)	12.4	10	6	6	6	6	5
R&D expenditure (% of GDP)	1.1	1.2	1.2	1.2	1.3	1.3	n.a.
Total public expenditure on education (% of GDP)	4.5	4.7	4.5	4.3	n.a.	n.a.	n.a.
(Index: 0=not regulated; 6=most regulated)	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Product market regulation[4], overall	1.49	n.a.	n.a.	n.a.	n.a.	1.26	n.a.
Product market regulation[4], retail	4.06	n.a.	n.a.	n.a.	n.a.	3.15	n.a.
Product market regulation[4], professional services	3.02	n.a.	n.a.	n.a.	n.a.	2.10	n.a.
Product market regulation[4], network industries[5]	2.45	2.23	2.15	2.01	2.01	2.01	n.a.

1 Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.
2 Patent data refer to applications to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.
3 The methodologies, including the assumptions, for this indicator are presented in detail here: http://www.doingbusiness.org/methodology.
4 Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are presented in detail here: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm
5 Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).
Source: European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators)

Table AB.7: **Green Growth**

Green growth performance		2003-2007	2008	2009	2010	2011	2012
Macroeconomic							
Energy intensity	kgoe / €	0.13	0.12	0.12	0.12	0.12	0.12
Carbon intensity	kg / €	0.39	0.37	0.35	0.35	0.34	0.33
Resource intensity (reciprocal of resource productivity)	kg / €	0.56	0.52	0.49	0.46	0.45	n.a.
Waste intensity	kg / €	n.a.	0.12	n.a.	0.11	n.a.	0.12
Energy balance of trade	% GDP	-1.7	-2.2	-2.7	-3.3	-3.8	-3.9
Energy weight in HICP	%	6.7	8.2	7.8	7.5	8.4	9.6
Difference between energy price change and inflation	%	2.3	7.4	-5.8	-3.3	5.0	9.2
Ratio of environmental taxes to labour taxes	ratio	13.7%	11.5%	12.1%	11.8%	12.2%	13.4%
Ratio of environmental taxes to total taxes	ratio	6.8%	5.9%	6.2%	6.2%	6.3%	6.9%
Sectoral							
Industry energy intensity	kgoe / €	0.15	0.13	0.13	0.13	0.12	0.12
Share of energy-intensive industries in the economy	% GDP	9.5	9.3	8.4	8.7	8.8	8.7
Electricity prices for medium-sized industrial users**	€ / kWh	n.a.	n.a.	n.a.	0.14	0.16	0.17
Gas prices for medium-sized industrial users***	€ / kWh	n.a.	0.04	0.03	0.03	0.03	0.04
Public R&D for energy	% GDP	n.a.	0.04	0.03	0.02	0.02	0.02
Public R&D for the environment	% GDP	n.a.	0.03	0.02	0.02	0.02	0.02
Recycling rate of municipal waste	ratio	31.0%	37.1%	44.4%	48.2%	54.4%	58.0%
Share of GHG emissions covered by ETS*	%	n.a.	40.8	37.7	38.3	39.0	38.9
Transport energy intensity	kgoe / €	0.66	0.64	0.65	0.64	0.65	0.64
Transport carbon intensity	kg / €	1.87	1.81	1.84	1.81	1.82	1.73
Security of energy supply							
Energy import dependency	%	85.1	85.7	83.3	84.3	81.8	80.8
Diversification of oil import sources	HHI	0.12	0.12	0.12	0.10	0.07	0.09
Diversification of energy mix	HHI	n.a.	0.34	0.34	0.33	0.31	0.30
Renewable energy share of energy mix	%	6.3	7.4	9.4	10.4	11.6	12.8

Country-specific notes:
2013 is not included in the table due to lack of data.
General explanation of the table items:
All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 prices)
Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)
Carbon intensity: Greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
Resource intensity: Domestic material consumption (in kg) divided by GDP (in EUR)
Waste intensity: waste (in kg) divided by GDP (in EUR)
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Energy weight in HICP: the proportion of "energy" items in the consumption basket used for the construction of the HICP
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)
Environmental taxes over labour or total taxes: from DG TAXUD's database 'Taxation trends in the European Union'
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices for medium-sized industrial users: consumption band 500–2000MWh and 10000–100000 GJ; figures excl. VAT.
Recycling rate of municipal waste: ratio of recycled municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP
Proportion of GHG emissions covered by ETS: based on greenhouse gas emissions (excl LULUCF) as reported by Member States to the European Environment Agency
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR)
Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector
Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels
Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin
Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
Renewable energy share of energy mix: %-share of gross inland energy consumption, expressed in tonne oil equivalents
* European Commission and European Environment Agency
** For 2007 average of S1 & S2 for DE, HR, LU, NL, FI, SE & UK. Other countries only have S2.
*** For 2007 average of S1 & S2 for HR, IT, NL, FI, SE & UK. Other countries only have S2.
Source: European Commission, unless indicated otherwise; European Commission elaborations indicated below