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Country Report Italy 2019
Including an In-Depth Review on the prevention and correction of macroeconomic imbalances

Accompanying the document

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EXECUTIVE SUMMARY

In the face of a weakening macroeconomic outlook, tackling Italy's macroeconomic imbalances remains crucial. In particular, reducing the country's high public debt ratio requires stability-oriented macroeconomic and fiscal policies to go together with more and better targeted investments and ambitious structural reforms to lift its sluggish productivity and potential growth. These endeavours are also key to market confidence. As a matter of priority, reviving the momentum for reform is needed to ensure sound public finances, more effective public administration and justice, a more efficient education system and labour market, a friendlier business environment and a more resilient banking sector ([1]).

After solid real GDP growth of 1.6 % in 2017, economic activity slowed down. Exports growth, a main contributor to previous GDP expansion weakened, while household consumption was subdued. The investment recovery remains uneven but is losing momentum overall. This is also partly due to domestic policy uncertainty, negatively affecting business confidence and the real economy through higher risk premia. Real GDP grew by 1.0 % in 2018 and is expected to decelerate sizeably in 2019 amid high uncertainty about domestic policies and the global outlook before picking up in 2020.

The uneven and gradual improvement of the labour market continued in 2018. The number of people in employment reached a record high by mid-2018. However, the employment rate remained well below the EU average, particularly for women and young people. Regional employment gaps also remain substantial. Over the past two years, job growth has been driven by temporary contracts. The unemployment rate has been declining at a slow pace also due to rising participation in the labour market. However, youth and long-term unemployment remain very high.

Adequate investments are needed to strengthen administrative capacity, human capital and innovation, as well as to reduce regional disparities. Improved administrative capacity is a precondition for the effective delivery of public investment and better use of EU Funds including for active labour market policies (measures that can foster labour market participation) and infrastructures. Investment in human capital is a pre-requisite for boosting public and private investment. Investment in innovation would improve productivity and growth prospects in the medium and long term. These investments would increase productivity in southern Italy in particular and also allow to address smaller firms' weaknesses. Investment, including in climate change response, environmental sustainability and risk prevention, would also benefit from taking into account regional disparities. Annex D identifies key priorities for support by the European Regional Development Fund and the European Social Fund Plus over 2021-2027, building on the investment needs and challenges outlined in this report.

Italy has made limited progress in addressing the 2018 country-specific recommendations ([2]).

There has been some progress in:

- i) Fighting corruption thanks to a new anti-corruption law; ii) the banking sector where the reduction of the stock of non-performing loans has continued and the insolvency reform is being implemented; iii) implementing the reform of active labour market policies also thanks to additional resources allocated to public employment services.

There has been limited progress in:

- i) Tackling tax evasion where no action has been taken to encourage e-payments despite some progress in e-invoicing; ii) improving market-based access to finance where only measures of narrow scope have been adopted

([1]) This report assesses Italy's economy in light of the Commission's Annual Growth Survey published on 21 November 2018. The Commission calls on the Member States to implement reforms to make the EU economy more productive, resilient and inclusive. Member States should focus their efforts on the virtuous triangle of economic policy: delivering high-quality investment, focusing reforms efforts on productivity growth, inclusiveness and institutional quality and ensuring macroeconomic stability and sound public finance. The Commission also published the Alert Mechanism Report that initiated the eighth round of the macroeconomic imbalance procedure. It found that Italy warranted an in-depth review, which is presented in this report.

([2]) Information on the level of progress and actions taken to address the policy advice in each respective subpart of a country-specific recommendation is presented in Annex A.

and some past provisions reversed; iii) enforcing the framework for publicly-owned enterprises despite local bodies still being faced with operational difficulties; iv) encouraging women to work mainly due to the still inadequate provision of care facilities and the parental leave system; v) fostering research, innovation, digital skills and infrastructure and vocational-oriented tertiary education in particular because the funding for innovative investment has been reduced overall, despite some planned measures to strengthen administrative capacity.

There has been no progress in:

- i) Shifting taxation away from productive factors, revising tax expenditures and reforming 'cadastral values' used as a basis for calculating property tax; ii) reducing the share of old-age pensions in public spending, where there has even been some backtracking; iii) reducing trial length in civil justice; iv) addressing restrictions to competition.

Regarding progress towards its national targets under the Europe 2020 strategy, Italy has already achieved its targets on renewable energy, energy efficiency, early school leaving and higher education, and appears on track to reduce greenhouse gas emissions. Limited progress has been made in meeting the targets on employment rate, R&D investment and poverty and social exclusion.

Italy faces several challenges with regards to a number of indicators of the Social Scoreboard supporting the European Pillar of Social Rights. Although slowly on the rise, the employment rate remains lower than the EU average and the gender gap is among the highest in the EU. However, a comprehensive strategy to promote women's participation in the labour market is missing. Long-term and youth unemployment are serious concerns. The share of young people neither in employment nor in education and training is still the highest in the EU after a further increase in 2017. Income inequality and the risk of poverty are high, with wide regional disparities, and the impact of social transfers on poverty reduction is very low. The number of drop-outs from education and training programmes remains high. To tackle this issue, an anti-poverty scheme was introduced in 2018 and will be strengthened in 2019. Health outcomes are generally good and self-reported unmet needs for medical care are around the EU average, although with large regional disparities.

The main findings of the in-depth review and the related policy challenges are as follows:

- **Italy's high public debt remains a major vulnerability.** The government projections underlying the 2019 budget expect the debt-to-GDP ratio to have risen to 131.7% in 2018. The debt-to-GDP ratio may further increase in 2019 due to the weak macroeconomic outlook, underachievement of privatisation targets and a worsening primary balance. Overall Italy's structural deficit is estimated to have been 1.8 % of GDP in 2018. Government bond yields increased markedly in 2018, reflecting a higher risk premium and could increase further, as in the rest of the euro area. In the medium and long term, the high stock of public debt, its sensitivity to macroeconomic shocks and future ageing costs explain marked sustainability risks. Moreover, new measures that have introduced the possibility for early retirement, backtracking on earlier pension reforms, will raise pension expenditure and are expected to worsen debt sustainability going forward, also due to possible negative effects on growth potential.

- **Productivity growth has been sluggish over the past two decades**. The productivity gap between Italy and the EU continues to widen. In 2018 labour productivity is expected to have remained stable, while growth in total factor productivity (measuring how efficiently labour and capital are used in production) is expected to have grown by some 0.5 %, only half as fast as the EU average. This is largely due to low investment and innovation, barriers to competition, weaknesses in the public sector and a non-supportive business environment.

- **The unemployment rate remains high.** Slow economic growth, low average educational attainment levels, skill mismatches, and growing but still low activity rates limit employment growth. Participation rates, especially among women, remain low. Youth unemployment remains extremely high.

- **The cleaning-up of banks' balance sheets has continued despite renewed market pressure.** While Italian banks have continued to boost capital buffers and reduce legacy non-performing loans, they remain largely exposed to their own sovereign bonds. The raise in sovereign bond yields in 2018 adversely affects banks' capital positions, pushing up their funding costs and curtailing their access to unsecured wholesale funding. While the largest banks appear resilient, as confirmed by the recent EU-wide stress test, significant vulnerabilities remain, especially amongst medium and small banks. The reform of the insolvency framework still has to be implemented. Access to finance continues to be a challenge for many small Italian firms.

Other key structural issues analysed in this report, which point to particular challenges facing the Italian economy, are the following:

- **Taxation of production factors remains high and tax compliance low.** Italy's tax burden on labour and capital is still among the highest in the EU. While a broader 'flat-rate regime' slightly lowered taxation on the self-employed, the 2019 budget will raise the aggregate tax burden on firms. There has been no shift of the tax burden onto property and consumption and no revision of tax expenditures (like the number and scope of reduced VAT rates) or of outdated cadastral values (to bring them closer to market values). Tax evasion, especially due to omitted invoicing, remains high in Italy, which has one of the highest VAT gaps in the EU. Measures were enacted to encourage tax compliance through e-invoicing and the digital transmission of receipts, but also a new set of measures equivalent to a tax amnesty.

- **Labour market challenges persist.** Labour market rules have been tightened and hiring incentives extended to reduce the recourse to temporary contracts. Despite recent measures, active labour market policies remain weak and are poorly integrated with social policies. A new reform of public employment services is meant to support the integration in the labour market of the beneficiaries of the new citizenship income scheme. Despite the new labour inspectorate agency, operational since 2017, undeclared work remains widespread in Italy, especially in the south. Second-level (decentralised) bargaining continues to play only a limited role, also due to the high share of small firms.

- **Social policies remain poorly integrated.** The citizenship income scheme will replace the previous income support scheme, keeping an active inclusion approach subject to certain conditions. However, the scheme may prove difficult to implement and may put a considerable burden on the public administration. The actual impact on employment will depend on the effectiveness of activation policies and controls. Labour market conditions are improving but in-work poverty is high and rising, affecting in particular temporary workers and people with a migrant background. Access to affordable and adequate housing is also a challenge. Childcare and long-term care services remain underdeveloped. Measures to promote equal opportunities and a work-life balance are fragmented and limited in scope, negatively affecting women's participation in the labour market amid unfavourable demographic trends.

- **Education is a major challenge especially in southern Italy, hindering the quality of human capital.** There is a much higher number of early-school leavers and low achievers in the south. Attracting, selecting and motivating secondary education teachers remains a challenge. Following recent reforms, the apprenticeship system is gaining momentum. The percentage of people having completed higher education remains low, and the higher education system appears underfinanced and understaffed. Despite better employability rates, vocational-oriented higher education remains limited in scope. Measures to boost digital skills and adult learning lack a comprehensive approach.

- **Structural factors hold back investment and other key productivity drivers.** Weak human capital slows down Italy's transition to a knowledge-based economy. In the public sector, weak administrative capacity remains a barrier to public investment. Measures to boost private investment and innovation like the

'Impresa 4.0' plan generally had a positive effect, but the most efficient measures need to be made permanent following an in-depth assessment. Furthermore, micro and small firms face specific difficulties to adopt productivity-enhancing strategies. Measures to support knowledge (such as technological clusters) and cooperation among firms help smaller firms in particular to tackle these difficulties and increase their low productivity.

- **Significant barriers to competition remain**. Some sectors are still over-regulated, including business services and the retail sector. The lack of competitive processes to award public service contracts and concessions for public goods negatively affects the quality (and cost) of the service. Timely implementation of the 2015 competition law and the removal of remaining restrictions to competition would support productivity. However, recent announcements seem to go in the opposite direction by, for instance, restricting competition in the retail sector.

- **The regional divide remains acute**. In the south, productivity is particularly weak due to structural factors such as insufficient and ineffective investment. Territorial imbalances have risen since the crisis. In southern regions, investment and productivity are hampered by weak governance and low capacity to spend and implement policies. Moreover, lower levels of education and innovation limit the positive impact of measures adopted to support private investment. The south lags behind mainly in terms of intangible investment, as well as in transport infrastructure, waste management, water infrastructure and the prevention of risks from natural disasters. In rural areas the broadband network is also less advanced.

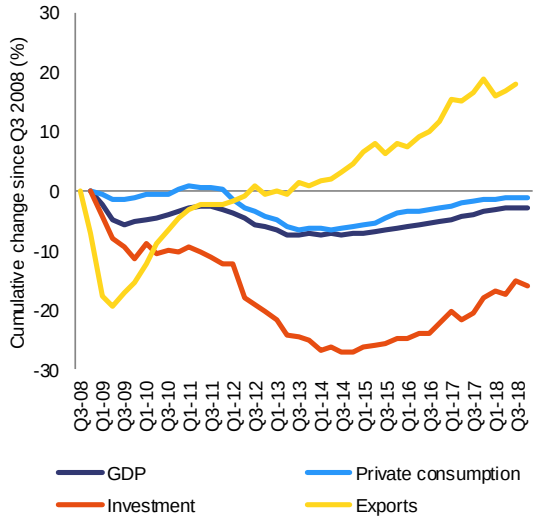
- **Efforts are needed to improve the public administration, the judicial system and the anti-corruption framework**. Despite recent reforms, the public administration and public-sector employment perform worse than in peer countries, not least in the area of digitisation and market surveillance. Challenges persist in managing publicly-owned enterprises and local public services, and uncertainty over the implementation of the public procurement code defers investment. Trial length in civil justice remains worrying, and a reform to streamline the civil procedure and limit the abuse of litigation is still pending. A new anti-corruption law and stronger prevention ensured by the national anti-corruption authority can improve the anti-corruption framework. However, the low efficiency of the criminal justice system is still preventing the prosecution of corruption, and a much-needed reform of the criminal trial and appeal system is at a very preliminary stage.

1. ECONOMIC SITUATION AND OUTLOOK

Real GDP growth, prospects and risks

Amid a slowdown in the euro area, the Italian economy slipped into a contraction. After solid real GDP growth in 2017 at 1.6 %, economic activity slowed down over 2018 (Graph 1.1). Exports and industrial production started weakening at the beginning of the year, amid concerns about global trade. Specific problems of the automotive industry added to the subdued picture. ([3]) In the second half of 2018, real GDP recorded a slight contraction, as the positive impact from re-strengthening exports was more than offset by faltering domestic demand. Helped by a relatively strong carryover from the previous year, real GDP grew by 1.0% in 2018 (European Commission, 2019a).

Graph 1.1: **Real GDP and components**



Source: Eurostat.

Household consumption downshifted sizeably in 2018. Despite rising disposable income and relatively high consumer confidence, consumer spending only grew moderately, as higher oil prices dented private consumption. Purchases of passenger cars and other durable consumption goods declined in the first nine months of 2018. ([4]) Moreover, financial market tensions and negative wealth effects associated with falls in asset prices appear to have curbed consumer spending and led households to increase savings.

The investment recovery is vulnerable to worsening financing conditions. Gross fixed capital formation, at 18.1 % of GDP in Q3-2018, is still markedly below both the latest peak of 2007 (22 %) and the EU average (20.6 %). While spending on equipment is almost back to 2007 levels, investment in construction has only recently bottomed out. The share of intangible assets, albeit still low by EU standards, increased to 2.9% of GDP by 2015 but has been stagnating since then. The recovery of private investment is forecast to slow down sizeably on the back of a more unsecure economic outlook. Furthermore, tailwinds such as an accommodative monetary policy stance and tax incentives wane, while some firms already face tighter financing conditions, also due to the worsening of sovereign funding conditions.

The adopted budget emphasises short-term demand stimulus over supply-side reforms. With the budget law adopted in December 2018, the government primarily intends to increase current expenditure (social transfers) and allocates only a relatively small amount of extra spending to public investment in 2019, even though the latter is assumed to be more effective in stimulating economic growth and supporting private investment (Ramey and Zubairy, 2018). The government revised its fiscal plans in December 2018 and reduced the deficit target for 2019, which eased uncertainty and helped stabilise financial markets. However, sovereign yields remain high compared to early 2018 and are expected to eventually translate into higher borrowing costs for firms and households. Hence, tighter financing conditions risk diluting or even offsetting the growth impact of budgetary measures (Blanchard and Zettelmeyer, 2018). Significant supply-side reforms that would be likely to have a sizeable impact on longer-term growth are mostly absent.

([3]) Car manufacturers had problems with the certification of cars under the new *Worldwide Harmonised Light Vehicle Test Procedure* (WLTP), compulsory as of 1 September 2018. In addition, car producers suffered from a drop in sales of diesel-powered cars, and Fiat Chrysler stopped the production of one of their models in August 2018.

([4]) Car registrations rose temporarily in July/August, as manufacturers offered high discounts for buying non-WLTP certified cars prior to the introduction of the new emission standard, but dropped sharply thereafter.

Growth prospects are subdued and subject to uncertainty and intensified downside risks. Real GDP growth is projected at 0.2 % in 2019 and at 0.8 % in 2020. Private consumption is expected to support growth, also helped by the introduction of the citizenship income scheme, while business investment is forecast to slow down sharply. High uncertainty about the economic outlook, the possible materialisation of external policy risks and a further rise in Italian sovereign yields could curtail both external and domestic demand. In particular, the planned rollback of structural reforms might have ramifications for medium-term growth prospects.

Potential growth is projected to rise moderately but continues to lag behind peer countries. On the back of low investment and weak productivity growth, potential output has been declining since the onset of the global financial crisis. Supported by structural reforms and the recovery of investment, growth in potential output is estimated to have turned positive in 2017 and to increase moderately in 2018-2020. Potential output is mainly driven by rising labour input, followed by capital accumulation. Trend TFP growth is estimated to have resumed in 2018 and to make a positive contribution to potential growth in 2019-2020 (Graph 1.2).

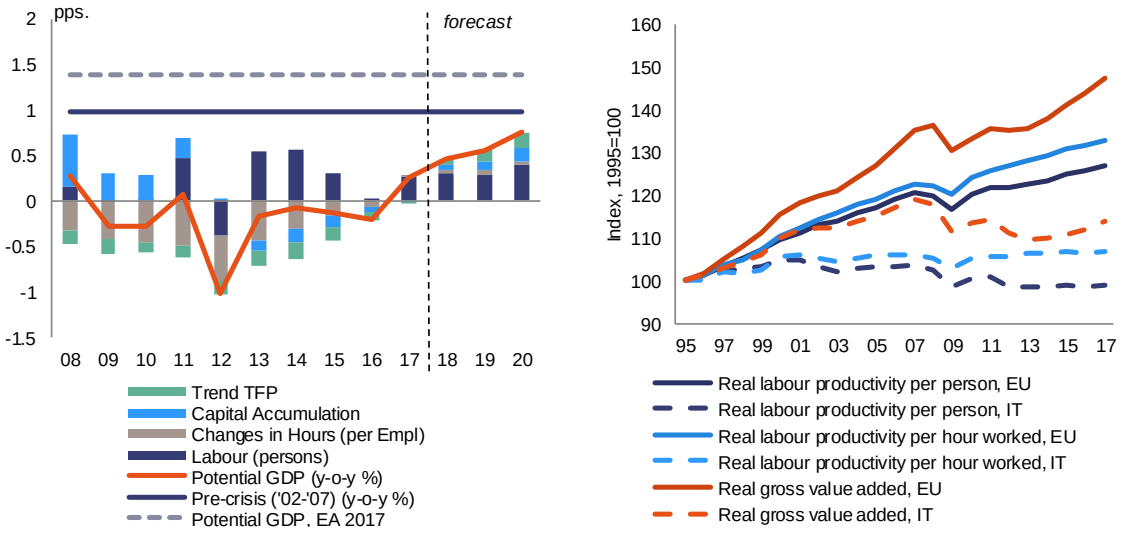
Weak productivity growth is a major constraint on economic expansion. The productivity gap between Italy and the rest of the EU remains substantial (Graph 1.2). Labour productivity (measured as real gross value added divided by hours worked) increased on average by 0.5 % per year between 2010 and 2017, compared with an EU average of 1.3 %. Labour productivity is projected to have remained unchanged in 2018.

Growth in total factor productivity (TFP) is lagging behind the EU average. In 2010-17, annual TFP growth rates averaged a mere 0.3 %, which is 0.5 pp. less than the EU average. In 2018, TFP is expected to have grown by 0.4 %, also. Despite the recent albeit moderate pick-up in TFP growth, helped by the cyclical recovery of business investment, structural obstacles remain. They hamper an efficient allocation of production factors across the economy and the diffusion of innovation and technological change (to use labour and capital more efficiently) has been insufficient.

Labour market

After hitting new records, job growth slowed amid weak economic activity. Headcount employment reached a historical record by mid-2018 but dropped slightly in Q3 2018, the first quarterly decline since 2013. Job growth has been driven by temporary contracts (Graph 1.3). The share of temporary employees has risen to 17.5 % in Q3 2018 and is above the EU average. The median duration of temporary contracts is less than 12 months. Gender and regional employment gaps

Graph 1.2: **Productivity and potential growth**

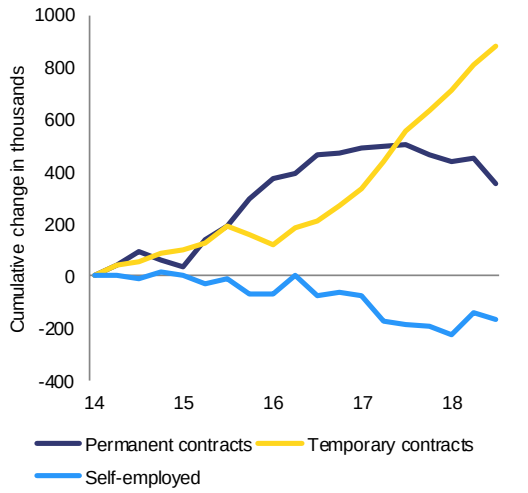


Source: European Commission.

remain substantial (section 4.3.1).

The unemployment rate fell to 10.3 % in the third quarter of 2018. As more people are joining the labour force, the unemployment rate is only slowly declining. As it is more difficult to find employment after an extended stint of unemployment, long-term unemployment is dropping more slowly than total unemployment. Youth unemployment (15-24) remains extremely high at 32.0 %. Moreover, the share of young people (15-24) neither in employment nor in education or training increased to 20.1 % in 2017 and remained the highest in the EU.

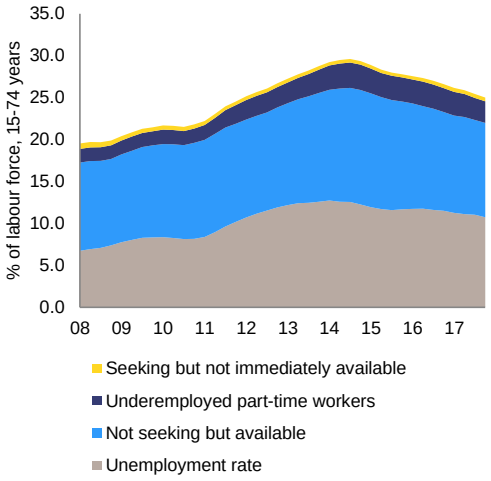
Graph 1.3: **Composition of employment growth**



Source: ISTAT.

Labour market conditions improved but the slack remains substantial. More people have started actively looking for a job, whereas the share of underemployed part-time workers has broadly stayed constant (Graph 1.4). Involuntary part time is widespread in Italy. In 2017, about 17 % of part-time workers declared their willingness to work more hours, with the highest incidence in Trentino, Veneto and Lazio. ([5]) The recent increase in hours worked was driven by the growth in positions filled rather than by hours worked per employee, which increased markedly only in the manufacturing sector. ([6])

Graph 1.4: **Unemployment and potential labour force**



(1) 4-quarter moving averages.
Source: Eurostat.

Prices, wages and costs

Weak wage growth reflects the labour market slack. In 2017, compensation per employee grew by 0.3 % in nominal terms, but dropped by 0.8 % when adjusted for inflation. Real compensation per employee remains well below the level in 2000, as people on average work fewer hours, while real hourly wages are stagnating. In addition to the labour market slack, the structural shift of jobs from sectors with relatively high productivity growth (industrial sector) to sectors with relatively low productivity growth (services) and the shift within the services sector from higher-paid jobs (e.g. in financial services) to lower-paid ones (e.g. in hotel and catering) is softening wage growth. ([7])

Due to subdued wage growth, the increase in unit labour costs remains contained. Nominal wage growth accelerated in 2018 on the back of wage increases in the public sector (which had

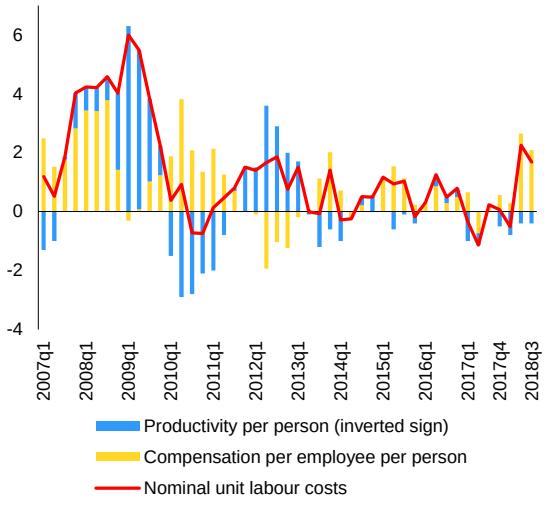
([5]) Around one third of involuntary part-timers are on a temporary contract, with ratios higher than 40 % in Val d'Aosta, Friuli Venezia Giulia, Campania, Sardegna, Molise. Only 3.3 % hold a second job, while around 32% are searching for a new one.

([6]) In Q3 2018, hours worked were still 5.1 % below the level of end-2007.

([7]) Between 2007 and 2017, real effective wages in the private sector, i.e. wages that have been actually paid compared to negotiated wages, increased by 0.4% on average per year. While wages in the industrial sector grew by 0.9 %, wages in the services sector stagnated, see also Istat (2018), p. 16. This might also explain the persistent negative wage drift despite favourable cyclical conditions.

been frozen since 2010) ([8]) but wage growth in the broader economy is expected to remain moderate. ([9]) The expected slow growth in productivity implies that wage moderation is likely to continue as it limits the scope for wage increases that do not impair price stability and competitiveness. Nominal unit labour costs fell in 2017 largely because of subdued wage growth (Graph 1.5).

Graph 1.5: **Compensation of employees, productivity and nominal unit labour costs**



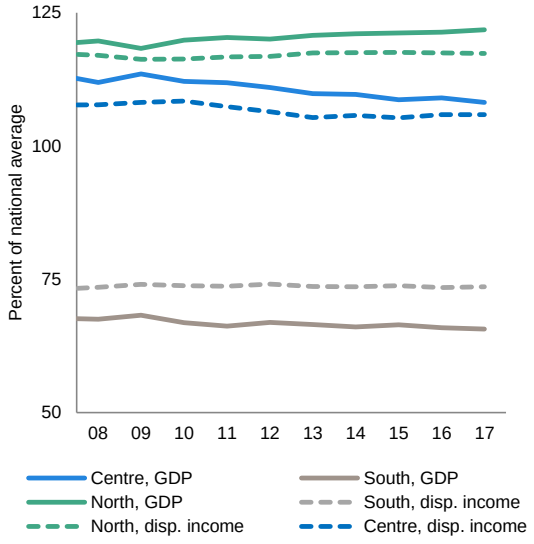
Source: European Commission.

Consumer prices are set to rise moderately. The headline harmonised index of consumer prices increased by 1.2 % in 2018, but is expected to rise by only 1.0% in 2019, before picking up again to 1.3% in 2020. Core inflation is set to rise gradually, in line with wage growth.

Income inequality, inter–regional disparity and social situation

Disposable incomes are lower than in 2008 and income inequality remains high. In 2017, real gross disposable income per capita was almost 9 % lower than in 2008 and income growth continues to lag behind the EU average. In 2017, the income of the 20 % of households with the highest income was almost six times the income of lowest income households (income quintile ratio (S80/S20 indicator). ([10]) Per-capita GDP in the South is only two thirds of the national average, while the northern regions exceeded the national average by more than 20 %. The ability of the tax-and-transfer system to mitigate interregional inequality via interregional income transfers appears limited (Graph 1.6).

Graph 1.6: **Regional dispersion of real GDP and disposable income per-capita**



(1) Disposable income deflated by private consumption deflator.
Source: ISTAT

The risk of poverty remains high. As highlighted by the Social Scoreboard, 28.9 % of the population were at risk of poverty or social exclusion in 2017. This rate, albeit lower than in the previous year, still exceeds both the pre-crisis level (25.5 % in 2008) and the 2017 EU average (22.4 %). The improving labour market situation provided some relief, but wage growth has so far remained subdued. Inter-regional income inequality remains persistent and social disparities loom large. Italy has a progressive personal income tax system, but social benefits for people at working age are generally low and are thus not effective in reducing poverty and inequality (section 4.3.3) By contrast, wealth is more evenly distributed, due to high home ownership rates.

([8]) The wage increase also included the payments of arrears.
([9]) In 2018, the first wave of permanent contracts agreed under the Jobs Act reform and supported by hiring incentives is losing the exemption from social contributions implying a rise in the compensation of employees.

([10]) The indicator is given by the ratio of the equivalised disposable income of the 20 % highest income households to the income of the 20 % lowest income households.

Financial developments

Sovereign bond yields came under severe pressure between May and December 2018. Market tensions owing to uncertainties about the economic and fiscal policy stance affected equity and sovereign debt markets. The ten-year sovereign bond yield rose from 1.8% at the beginning of May to 3.4 % by the end of October, and the spread vis-à-vis German bonds widened by 180 basis points over the same period. In December, financial tensions eased and market conditions progressively improved, although they remain worse than at the beginning of the year. Following the agreement on the budget, the ten-year sovereign bond yield declined to 3.0 % by early February 2019, with the spread vis-à-vis German bonds decreasing by 42 basis points.

Rating agencies downgraded Italy's credit rating or worsened the outlook. On 19 October 2018, Moody's downgraded Italy's rating to Baa3 (BBB-), one notch above investment grade, while Standard&Poor's left its rating unchanged at BBB but changed its outlook from 'stable' to 'negative' on 26 October 2018. Rating agencies stressed the increase in borrowing needs, the high debt-to-GDP ratio and the worsening economic outlook as main factors behind the negative rating action. Following the downgrade of sovereign debt, rating agencies also started downgrading the ratings of resident banks and firms (Bank of Italy, 2018).

Amid a global stock market slide and domestic policy uncertainty, equity prices fell sharply. The Milan benchmark stock exchange index lost almost 20 % of its value since early May, with the bank sub-index falling by more than 37%, as domestic banks are broadly exposed to Italian sovereign debt. Since mid-November 2018, bank credit default swap premia improved, but bank stocks hardly recovered and price-to-book ratios, a common metric for the valuation of banks, have dropped by over 25 % since the beginning of 2018 (BIS 2018).

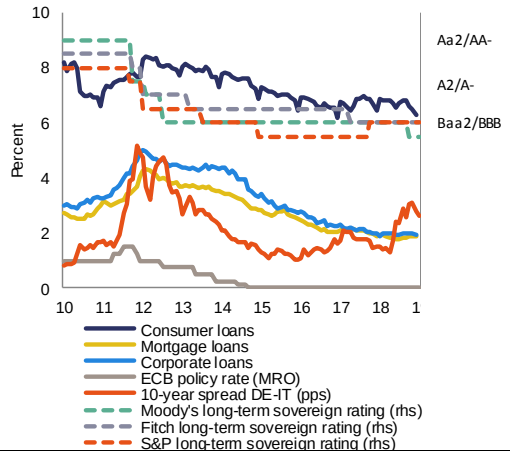
Non-domestic investors reduced their exposure to Italian assets. Between May and November 2018, non-resident investors reduced their holdings of government securities and bank bonds by EUR 77.3 billion and EUR 16 billion respectively. By contrast, deposits placed with Italian banks remained stable and private sector deposits rose by 3.3% in November, compared to the same month of the previous year. Since May 2018, deposits from domestic households and non-financial corporations have remained broadly stable, while foreign banks increased their deposits, as they appear to keep part of the proceeds from recent asset sales as deposits in Italy.

Lending conditions to the private sector face first signs of tightening. Interest rates on corporate loans and mortgages appear so far only marginally affected by recent market turbulences and rising sovereign yields (Graph 1.7). Bank lending surveys indicate a tightening of credit conditions, while the cost of new bond issuances has been increasing since May 2018. Moreover, the worsening of sovereign funding conditions tends to impact on banks' credit conditions with a time lag. Lending to firms is still growing at a moderate pace. Loans to households are driven by consumer credit, which is albeit weakening in line with the economy. However, increasing sovereign yields risk affecting banks' funding costs ([11]) and the deteriorating macroeconomic environment might worsen credit quality and undermine ongoing initiatives to reduce non-performing loan ratios. Consequently, a persistent fall in sovereign bond and other asset prices would entail higher borrowing costs for the private sector and weigh on household wealth. ([12])

([11]) The rise in the yields on government securities has also been associated in the past with a significant decline in the growth rate of business lending by Italian banks, see Bofondi et al., 2018 and Bocola, 2016.

([12]) According to the Bank of Italy, households' financial conditions remain solid, though the fall in security prices has already led to a decline in the value of their wealth.

Graph 1.7: **Ratings, sovereign spread, policy and lending rates**



(1) New business.
Source: Bank of Italy, ECB, Bloomberg.

Financial risks have increased but some factors mitigate the impact of financial stress in the short term. Relatively low private sector debt, ample trade surpluses and an almost balanced net international debt position are able to absorb a large part of the financial shock in the short term. Moreover, the high average residual maturity of the public debt slows down the transmission of an increase in government securities yields to the average cost of debt. However, a marked economic slowdown and higher interest rates in light of high public debt could expose financial vulnerabilities.

External position

Italy's current account surplus remained broadly stable in 2018. Amid a worsening external environment, the current account balance registered a surplus of 2.7 % in the 12-month period up to November 2018. The export performance deteriorated and Italian exports lost market shares, due to an appreciation of the euro in nominally effective terms, the slowdown in particular export markets and political uncertainty about global trade policy. By contrast, import growth remained relatively strong owing to the cyclical investment recovery and higher oil import prices. Consequently, the trade surplus declined by 0.2 pps. to 2.8 % of GDP over the same period. The 12-month primary income balance recorded a surplus of 0.8 % of GDP largely driven by improvements in the balance of investment income (which turned positive in September 2016).

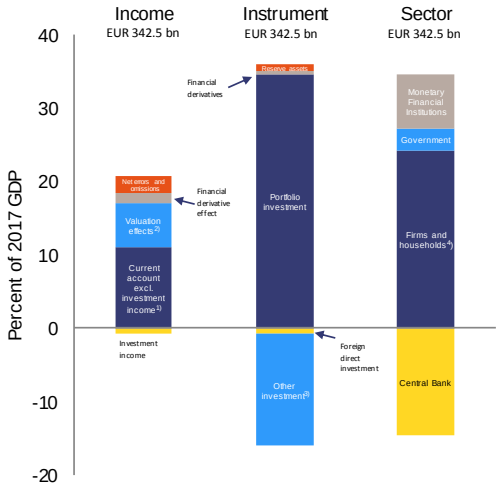
The current account surplus reflects saving and investment decisions by the different sectors of the economy. The corporate sector has assumed a net lending position since 2009, amounting to 1.1 % of GDP in 2017. Households increased net lending until 2014 and reduced residential investment in line with the slowing housing market but net lending fell to 0.9 % of GDP in 2017. In addition, the reduction of the government deficit supported the shift to a net lending position of the Italian economy.

The cyclically adjusted current account surplus is estimated at 2.3 % of GDP in 2018. The current account surplus remains somewhat above the level suggested by fundamentals, i.e. about 1.5 % of GDP. This surplus is estimated to be sufficient to keep Italy's net international investment position stable and bring it closer in line with fundamentals (in the absence of valuation effects). ([13])

The net international investment position (NIIP) has moved close to balance. Since the beginning of 2014 when net foreign liabilities peaked at almost EUR 400 billion (or 25 % of GDP), Italy's NIIP has improved by 342.5 billion (corresponding to 20 % of 2017 GDP). Net liabilities have fallen to 54.7 billion (or 3.1 % of GDP) by Q3 2018 (Graph 1.8) thanks to persistent current account surpluses and supported by valuation effects. The latter have been driven by the rate-of-return differential between Italian assets (mostly government bonds) held by non-residents and foreign assets (mostly equity and shares in investment funds) held by residents. ([14]) The sharp increase in government yields since May 2018 and the reciprocal fall in government bond prices imply a fall in the value of foreign liabilities and an improvement of the NIIP.

([13]) For details regarding the estimation of current accounts based on fundamentals, see Coutinho, L. et al. (2018).
([14]) For the methodological approach, see Schipper (2017).

Graph 1.8: **Change in net international investment position (NIIP), 2014Q1-2018Q3**



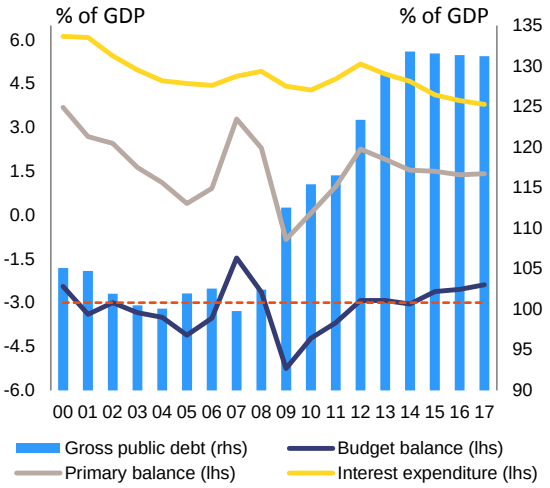
(1) Including capital account balance.
(2) Including conceptual and methodological deviations from the balance of payments, write-downs and statistical changes.
(3) Includes loans and trade credits, currency and deposits and other accounts receivable/payable.
(4) Includes financial corporations without monetary financial institutions, non-financial corporations and non-profit institutions serving households.
Source: Bank of Italy, Commission calculations.

The TARGET2 balance worsened in the second half of 2018. Since May 2018, the Bank of Italy's net debtor position in the TARGET2 European payment system deteriorated and net liabilities reached a new peak at EUR 492.5 billion in August 2018. By the end of the year, the balance had fallen to EUR 482 billion, largely thanks to inflows in December.

Public finance: public deficit and debt

Italy's headline and primary balance have broadly stabilised in recent years. After the sizable fiscal effort carried out over the period 2010-2013, which raised the primary surplus to above 2% of GDP, Italy's primary balance fell to 1.5% of GDP in 2014 and progressively deteriorated to 1.4% of GDP in 2017. The headline deficit fell from 3% of GDP in 2014 to 2.6% in 2015, and gradually narrowed to 2.4% of GDP in 2017, thanks to declining interest spending. The latter was also the result of historically low nominal interest rates on newly issued government securities, allowed by the ECB's accommodative policy stance.

Graph 1.9: **Public finances indicators**



Source: European Commission

Relatively weak economic growth and current fiscal plans are expected to put pressure on the government deficit in the coming years. Based on the government projections underlying the Budget Law approved in December 2018, the government headline deficit is expected to have declined to 1.9% of GDP in 2018, supported by economic growth and declining interest spending. For 2019, the government projects that the headline deficit will increase to 2.0% of GDP. However, the macroeconomic scenario underlying the 2019 deficit target is subject to downside risks, considering that the Commission 2019 winter forecast expects lower economic growth as compared to the government, both in real and nominal terms. In 2020, the government headline deficit is expected to decline to 1.8% of GDP based on the government projections, which assume additional revenues worth 1.2% of GDP from the automatic increase of VAT rates legislated as a safeguard clause. However, considering that in recent years such clauses were systematically repealed without implementing adequate alternative financing measures, there are high risks that the headline deficit will significantly increase in 2020 based on the government plans.

No reduction in government debt is expected over the coming years. The gross debt-to-GDP ratio increased steeply during the double-dip recession, from 102.4% in 2008 to 131.8% in 2014, before slightly declining to 131.2% in 2017.

In 2018, the government projections underlying the 2019 budget assume the debt-to-GDP ratio to have increased to 131.7% of GDP in 2018, mainly due to a large stock-flow adjustment partly related to fluctuations in the Treasury accounts. In 2019, the national authorities expect the government debt-to-GDP ratio to decline by 1 percentage point to 130.7%, by assuming privatisation proceeds amounting to 1% of GDP. However, this assumption appears unrealistic, considering that almost no privatisation proceeds were recorded over 2016-2018 despite the original targets of 0.5% of GDP per year (2016 Draft Budgetary Plan). Without considering the assumed privatisation proceeds, the government debt-to-GDP ratio is set to remain stable at close to 132% based on the government projections. Considering the downside risks to the government macroeconomic and deficit projections for 2019, it is likely that the government debt-to-GDP ratio will increase up to above 132% this year. In 2020, the government projections expect the debt-to-GDP ratio to decline by 1.5 percentage points to 129.2%, by assuming additional VAT revenues from the activation of the safeguard clauses amounting to 1.2% of GDP, as well as privatisation proceeds amounting to 0.3% of GDP. However, these projections are subject to significant risks, given that in recent years VAT safeguard clauses were systematically repealed and privatisation targets underachieved.

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

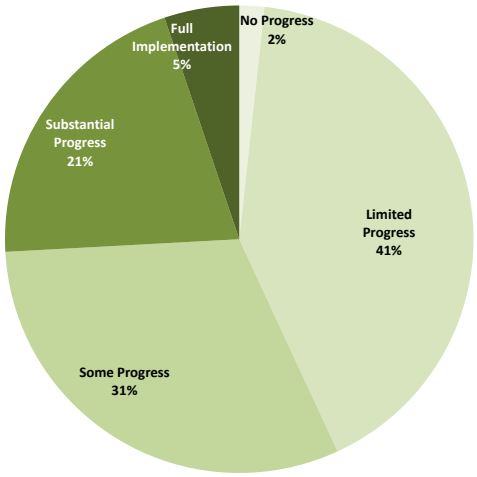
	2004-07	2008-12	2013-15	2016	2017	forecast 2018	forecast 2019	forecast 2020
Real GDP (y-o-y)	1.5	-1.5	-0.2	1.1	1.6	1.0	0.2	0.8
Potential growth (y-o-y)	0.9	-0.2	-0.1	-0.2	0.3	0.5	0.6	0.8
Private consumption (y-o-y)	1.2	-1.1	0.0	3.2	1.5	.	.	.
Public consumption (y-o-y)	0.4	-0.3	-0.5	0.3	-0.1	.	.	.
Gross fixed capital formation (y-o-y)	2.1	-5.0	-3.1	5.7	4.3	.	.	.
Exports of goods and services (y-o-y)	6.0	-0.9	3.5	6.6	5.7	.	.	.
Imports of goods and services (y-o-y)	5.2	-2.7	3.6	10.7	5.2	.	.	.
Contribution to GDP growth:								
Domestic demand (y-o-y)	1.2	-1.7	-0.6	1.4	1.6	.	.	.
Inventories (y-o-y)	0.1	-0.2	0.3	0.0	-0.4	.	.	.
Net exports (y-o-y)	0.2	0.5	0.1	-0.3	0.3	.	.	.
Contribution to potential GDP growth:								
Total Labour (hours) (y-o-y)	0.3	-0.4	0.2	0.0	0.3	0.3	0.3	0.4
Capital accumulation (y-o-y)	0.7	0.3	-0.1	-0.1	0.0	0.1	0.1	0.2
Total factor productivity (y-o-y)	-0.1	-0.1	-0.2	-0.1	0.0	0.0	0.1	0.2
Output gap	1.7	-1.8	-4.3	-2.3	-1.0	-0.3	0.3	0.8
Unemployment rate	7.2	8.4	12.2	11.7	11.2	10.7	10.4	10.0
GDP deflator (y-o-y)	2.2	1.5	1.4	2.1	0.5	1.3	1.3	1.4
Harmonised index of consumer prices (HICP, y-o-y)	2.2	2.4	0.5	-0.1	1.3	1.2	1.0	1.3
Nominal compensation per employee (y-o-y)	2.9	2.0	0.8	0.3	0.2	1.8	0.9	1.0
Labour productivity (real, person employed, y-o-y)	0.4	-1.0	0.1	-0.2	0.4	.	.	.
Unit labour costs (ULC, whole economy, y-o-y)	2.2	2.4	0.5	1.1	-0.4	1.6	0.8	0.6
Real unit labour costs (y-o-y)	0.0	0.9	-0.9	-0.9	-0.9	0.4	-0.5	-0.8
Real effective exchange rate (ULC, y-o-y)	1.4	-0.1	-0.6	-4.0	0.0	1.8	-1.9	-1.6
Real effective exchange rate (HICP, y-o-y)	0.1	-0.8	-0.7	-3.4	0.6	1.9	-1.6	-1.0
Savings rate of households (net saving as percentage of net disposable income)	8.8	5.0	3.6	3.2	2.3	.	.	.
Private credit flow, consolidated (% of GDP)	9.9	2.9	-1.6	-0.1	2.1	.	.	.
Private sector debt, consolidated (% of GDP)	99.4	121.5	118.6	111.8	110.5	.	.	.
of which household debt, consolidated (% of GDP)	34.2	42.6	42.7	41.3	41.1	.	.	.
of which non-financial corporate debt, consolidated (% of GDP)	65.2	78.9	75.9	70.5	69.3	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances) (2)	4.4	8.3	13.4	12.4	9.4	.	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-0.3	0.4	2.5	3.4	4.1	3.6	4.3	4.6
Corporations, gross operating surplus (% of GDP)	22.9	21.1	20.6	21.8	21.6	21.3	21.3	21.3
Households, net lending (+) or net borrowing (-) (% of GDP)	2.5	1.1	1.9	1.5	0.9	0.8	1.0	0.9
Deflated house price index (y-o-y)	3.7	-1.6	-7.1	-3.9	-2.3	.	.	.
Residential investment (% of GDP)	5.6	5.5	4.6	4.3	4.4	.	.	.
Current account balance (% of GDP), balance of payments	-1.0	-2.3	1.5	2.5	2.8	2.6	2.5	2.5
Trade balance (% of GDP), balance of payments	-0.2	-0.8	2.7	3.2	3.0	.	.	.
Terms of trade of goods and services (y-o-y)	-1.5	-0.9	2.2	2.7	-1.8	-0.4	-0.1	0.1
Capital account balance (% of GDP)	0.1	0.1	0.1	-0.2	-0.1	.	.	.
Net international investment position (% of GDP)	-17.9	-20.9	-21.1	-10.2	-6.3	.	.	.
NIIP excluding non-defaultable instruments (% of GDP) (1)	-9.5	-22.3	-20.6	-10.1	-4.6	.	.	.
IIP liabilities excluding non-defaultable instruments (% of GDP) (1)	94.7	114.2	123.6	122.7	121.2	.	.	.
Export performance vs. advanced countries (% change over 5 years)	0.5	-11.7	-10.8	-5.5	-2.6	.	.	.
Export market share, goods and services (y-o-y)	.	.	-0.3	3.0	-0.1	.	.	.
Net FDI flows (% of GDP)	0.8	1.1	0.1	-0.2	0.2	.	.	.
General government balance (% of GDP)	-3.1	-3.7	-2.9	-2.5	-2.4	-1.9	-2.9	-3.1
Structural budget balance (% of GDP)	-4.5	-3.1	-0.6	-1.5	-1.8	-1.8	-3.0	-3.5
General government gross debt (% of GDP)	101.1	114.0	130.8	131.4	131.2	131.1	131.0	131.1
Tax-to-GDP ratio (%) (3)	40.2	42.1	43.5	42.5	42.4	42.1	41.9	41.5
Tax rate for a single person earning the average wage (%)	28.4	30.2	31.1	31.1	.	.	.	.
Tax rate for a single person earning 50% of the average wage (%)	18.8	21.6	18.9	15.9	.	.	.	.

(1) NIIP excluding direct investment and portfolio equity shares
(2) domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.
(3)The tax-to-GDP indicator includes imputed social contributions and hence differs from the tax-to-GDP indicator used in the section on taxation
Source: Eurostat and ECB as of 31-1-2019, where available; European Commission for forecast figures (Winter forecast 2019 for real GDP and HICP, Autumn forecast 2018 otherwise)

2. PROGRESS WITH COUNTRY-SPECIFIC RECOMMENDATIONS

Since the start of the European Semester in 2011, 57 % of all country-specific recommendations addressed to Italy have recorded at least 'some progress". ([15]) 43 % of these CSRs recorded 'limited' or 'no progress' (Graph 2.1). The areas that registered the best performance in terms of progress are the measures to fight corruption and to reform the public administration and the labour market. Good performances have been registered also in the banking sector and in reducing restrictions to product and services markets.

Graph 2.1: **Overall multiannual implementation of 2011-2018 CSRs to date**



(1) The overall assessment of the country-specific recommendations related to fiscal policy excludes compliance with the Stability and Growth Pact
(2) The multiannual CSR assessment looks at the implementation until 2019 Country Report since the CSRs were first adopted.
Source: European Commission

Concerning public finances and taxation, limited progress was made to address the related CSRs. Efforts focused on containing public expenditure. Public wage bill growth has been moderate, with public wages rising in 2017 for the first time since 2011. Past pension reforms contributed to curb liabilities arising from ageing population and improve the long-term sustainability of public finances. However, this trend is being reversed: the share of old-age pension in total expenditure is expected to rise, mostly as a result of the implementation of the new early retirement scheme in 2019, backtracking on elements of past pension reforms. No privatisations have been undertaken to reduce public debt, so that recent targets have been systematically underachieved. Tax expenditures have been reviewed but not yet streamlined, Italy has not reviewed the outdated cadastral values, and taxation on labour has not been shifted to other tax bases. The first residence tax was repealed in 2015. The e-invoicing and e-transmission of receipts for commercial transactions, which are compulsory since January 2019, are expected to have a positive impact on tax compliance. However, the repeated tax amnesties may negatively impact tax compliance, while limited efforts were made to tackle tax evasion with consent, for instance by encouraging e-payments.

Some progress was registered in addressing CSRs concerning civil justice, the fight against corruption, public administration and the reduction of barriers to competition. Following the major reorganisation of civil courts in 2013, some civil justice reforms have been passed, increasing the specialisation and digitalisation of courts, reinforcing alternative dispute resolution and aiming to limit abuses of the trial through stricter admissibility rules for appeals. However, an all-encompassing reform of the civil trial is still pending. Overall, the length of civil trials has not been visibly reduced compared to past years. The fight against corruption was stepped up in 2012 through a comprehensive anti-corruption law, which also established the national anticorruption authority. In 2017, the statute of limitations was reformed and whistle-blowers' protection extended. A new anti-corruption law was adopted in December 2018, introducing better investigation techniques, stricter penalties and longer prescription terms for corruption offences. It also cancels prescription terms after a first instance conviction as of 2020. However, the effective sanctioning of corruption is hindered by the length of criminal proceedings, broadly unchanged since 2014 in the absence of a comprehensive reform of the criminal trial, including the appeal system. A comprehensive reform of public administration was adopted in 2015 and new draft bill was put forward in 2018. The measures simplify and clarify the decision-making process, encourage transparency and efficiency, and improve the management of public employment. Nevertheless,

([15]) For the assessment of other reforms implemented in the past, see in particular Section 4.

the operationalisation in specific areas, namely public employment and publicly-owned enterprises, may prove difficult while local public services will need a new legislative initiative to be reformed. In-depth market opening measures for product and services market were introduced in 2012 and 2017. Since 2011, several packages have been introduced to reduce the administrative burden for companies and citizens. In 2016, Italy has reformed the public procurement code. However, newly announced or adopted measures seem to go in the opposite direction, namely in the retail sector and in the collaborative transport sector.

In the financial sector, some progress was made. Banks' balance sheet repair including NPL disposals through outright sales and securitisations supported by the government guarantee scheme has substantially progressed. The corporate governance reform of the large cooperative banks has stalled and that of the small mutual banks was somewhat watered down and delayed, while the insolvency framework reform still has to be finalised. Some progress was achieved regarding market-based access to finance, with. policy measures adopted in recent years slowly bearing fruits, though bank credit remains the dominant source of financing for corporates. However, in the last year the reform efforts have lost momentum. The recent abrogation of the allowance for corporate equity appears at odds with the objective of strengthening firms' capital.

On the labour market, reform progress was limited. More than four years after its introduction, the jobs act reform remains incomplete, since important complements have not been fully implemented. Despite some recent efforts to make active labour market policies more effective, the placement capacity and overall efficiency of Public Employment Services remain weak, performance varies widely between regions and employment services are barely integrated and coordinated with other social and educational policies. The employment rate of women remains sizeably below the EU average. A comprehensive strategy combining a more efficient tax system with measures helping to reconcile career and family life, and subject to evaluation and monitoring, is still missing.

Overall, Italy made limited progress in addressing the 2018 country-specific recommendations. ([16]) No progress has been recorded in shifting the tax burden away from labour, despite a minor reduction of the tax burden for the self-employed, and in reducing the share of old pensions in public spending, which should actually increase. Limited progress has been made in tackling the shadow economy and strengthening the use of e-payments. While the progress was also limited concerning publicly-owned enterprises and local public services, some progress was achieved in improving the legal framework for fighting corruption, mainly thanks to a new anti-corruption law. However, no progress was recorded in reducing the length trial in civil justice and in addressing restrictions to competition. Some progress was also made in addressing non-performing loans in the banking sector and in implementing the insolvency reform while progress was limited in improving market based finance. Progress was also limited concerning women labour market participation and innovation, research, digital skills and infrastructure, and vocational oriented tertiary education. Some progress was recorded in implementing the reform of active labour market policies.

([16]) Information on the progress and action take to address the policy advice in each respective subpart of a country-specific recommendation is presented in the overview table in Annex A. This overall assessment does not include an assessment of Stability and Growth Pact compliance.

Table 2.1: **Assessment of 2018 CSR implementation**

Italy	**Overall assessment of progress with 2018 CSRs: XXX progress**
CSR 1: *Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio. Shift taxation away from labour, including by reducing tax expenditure and reforming the outdated cadastral values. Step up efforts to tackle the shadow economy, including by strengthening the compulsory use of e-payments through lower legal thresholds for cash payments. Reduce the share of old-age pensions in public spending to create space for other social spending.*(MIP relevant)	**No progress** • No progress in shifting taxation away from productive factors, in revising tax expenditure and in reforming the cadastral system • Limited progress in strengthening the compulsory use of electronic invoicing and payments • No progress in reducing the share of old pensions in public spending
CSR 2*: Reduce the length of civil trials at all instances by enforcing and streamlining procedural rules, including those under consideration by the legislator. Achieve more effective prevention and repression of corruption by reducing the length of criminal trials and implementing the new anti-corruption framework. Ensure enforcement of the new framework for publicly-owned enterprises and increase the efficiency and quality of local public services. Address restrictions to competition, including in services, also through a new annual competition law.* (MIP relevant)	**Limited progress** • No progress in reducing trial length in civil justice • Some progress in stepping up the fight against corruption • Limited Progress in addressing publicly-owned enterprises and local public services • No progress in addressing restrictions to competition
CSR 3: *Maintain the pace of reducing the high stock of non-performing loans and support further bank balance sheet restructuring and consolidation, including for small and medium-sized banks, and promptly implement the insolvency reform. Improve market-based access to finance for firms.* (MIP relevant)	**Some progress** • Some progress in addressing non-performing loans and bank restructuring • Limited progress in improving market-based access to finance
CSR 4*: Step up implementation of the reform of active labour market policies to ensure equal access to effective job-search assistance and training. Encourage labour market participation of women through a comprehensive strategy, rationalising family-support policies and increasing the coverage of childcare facilities. Foster research, innovation, digital skills and infrastructure through better-targeted investment and increase participation in vocational-oriented tertiary education.* (MIP relevant)	**Limited progress** • Some progress in implementing the reform of active labour market policies • Limited progress in encouraging labour market participation of women • Limited progress in addressing innovation, digital skills and infrastructures, and vocational-oriented tertiary education

(1)The overall assessment of CSR 1 does not include an assessment of compliance with the Stability and Growth Pact.
Source: European Commission

Box 2.1: **EU funds and programmes contribute to addressing structural challenges and to fostering growth and competitiveness in Italy**

Italy is one of the highest beneficiaries of ESI Funds. Financial allocation from programmes under the European Structural and Investment Funds (ESI Funds) aimed to support Italy in facing development challenges, amount to EUR 44.6 billion in the current multiannual financial framework (to which should be added EUR 30.5 billion from national contribution). The overall allocation is distributed between the ESI funds: 48.5% under the European Regional Development Fund (ERDF), 22.8% under the European Social Fund (ESF), 23.4% under the European Agricultural Fund for Rural Development (EARDF), 4.1% under the Youth Employment Initiative (YEI), and 1.2% under the European Maritime and Fisheries Fund (EMFF).
As of the end of 2018, Italy is lagging behind in the implementation of ESI funds if compared to the EU average. In terms of selection rate (% of the total allocation selected for the implementation of specific projects), the level recorded for Italy is 56% against 63% for the EU. Likewise, the payments rate for Italy (20%), remains below the EU average (27%), though it has allowed attaining the 2018's end-of-year targets.

EU funds are being used to address policy challenges identified in the 2018 CSRs. As regards **labour market participation**, the ESF supports the reform of active labour market policies, in particular by strengthening the public employment services, as well as the implementation of the youth Guarantee scheme. By November 2018, more than 1.4 million young people had registered in the programme and 1.1 million had been taken in charge; about 56% of them have benefited from an active policy measure. In the field of social inclusion, the ESF is contributing to support the national anti-poverty strategy (i.e. REI – Reddito di Inclusione), while actions financed under the Education programme contributes to implement the "Good School" reform.

In the field of **infrastructure**, EUR 2.45 billion of ESI funds are allocated to investments in transport networks, EUR 1.4 billion to sustainable urban transport infrastructures and EUR 889 million to fast internet networks, of which EUR 577 million for 100 Mbps and beyond. In these domains, projects should be finalised by the end of the programming period 2014-20. In particular, broadband infrastructure is expected to benefit 1 717 646 households, and railway projects are expected to modernise 270 km, located prevalently in the TEN-T core-network section of Southern Italy, such as along the Napoli-Bari and Messina-Catania-Palermo railways. The EU spending for infrastructure in Italy is reinforced by the Connecting Europe Facility (CEF). Under the 2014-2017 calls, Italian applicants submitted 164 eligible proposals. 59 projects were selected, with Italian beneficiaries receiving €1.5 billion of CEF Transport funding, and investing a total of €3.8 billion in these projects. This sum covers key cross-border rail projects such as the Brenner base tunnel or the new Lyon-Turin Rail link.

ESI funds are used also to improve the quality of areas, plants and equipment, mainly in Southern Italy, for the **provision of local public services** in the fields of risk prevention **(**EUR 2.3 billion), circular economy and water management (EUR 1.4 billion). ESI funds are expected to generate benefits related to water supply (1 373 786 persons should benefit from improved service by the end of the 2014/20 programming period), waste water treatment (4 014 540 population equivalent), waste recycling (877 800 Tonnes/year), flood protection (196 070 persons), forest fire protection (1 693 859 persons), habitats conserved (273 915 hectares).

EU programmes are also widely used in Italy to **foster research and innovation.** ESI funds allocate EUR 4.2 billion to research and development in the current multiannual financial framework. By the end of the programming period, programmes co-financed under ESI Funds should support 6 945 enterprises in building cooperation with research institutions and 4 528 enterprises in introducing new products in their markets. Programmes co-financed under ESI funds are also expected to support 3 750 full time equivalents new researchers and 4 962 full time equivalents researchers working in improved research infrastructure facilities. Furthermore,

private investment matching public support in innovation or R&D projects is expected to reach EUR 2.18 billion by the end of 2014/20. An additional boost to research and innovation comes from Horizon 2020, as participants from Italy received EUR 3.01 billion so far, with a projection to reach EUR 5.42 billion by the end of 2014/20, which would be 49.2% increase compared to 3.63 billion received in FP7. Applicants from Italy were awarded with 1812 Seals of Excellence, ranking Italy 2nd in the EU.

EU funding contributes to mobilisation of **private investment**. In particular, ESI Funds alone mobilise additional private capital by allocating about EUR 2.6 billion in the form of loans, guarantees and equity. This includes EUR 320 million for the SMEs Initiative, which provides securitisation of existing loans allowing enterprises to receive loans, with an expected leverage of 9.7. Altogether, 8.3% of the ESI Funds is allocated in a form of financial instruments.

The Commission can provide tailor-made technical support upon a Member State's request via the Structural Reform Support Programme to help Member States implement growth-sustaining reforms to address challenges identified in the European Semester process or other national reforms. Italy, for example, is receiving support to design a comprehensive accrual accounting system across Italy's public administration (according to International and European Public Sector Accounting Standards – IPSAS/EPSAS). The Commission is also continuing to assist the authorities in their efforts to fight tax evasion, notably by developing a methodology for estimating the excise tax gap. In addition, in 2018, work has started on enhancing the efficiency and effectiveness of the whistleblowing mechanism to fight corruption and on support for the implementation of the Italian National Digital Strategy.

In Italy, the overall volume of approved operations by the European Investment Bank (EIB) with the **European Fund for Strategic Investments (EFSI)** backing amounts to EUR 9.6 billion, which is set to trigger a total of EUR 57 billion in additional private and public investments (February 2019). Italy ranks 6th as to the overall volume of approved operations as a share of GDP. 81 projects involving Italy have so far been approved under the infrastructure and innovation window of EFSI. They amount to EUR 7 billion in total financing, which should, in turn, generate EUR 30.6 billion in investments. Under the SME component, 76 agreements with intermediary banks have been approved for a total of EUR 2.6 billion, which should mobilise around EUR 26.9 billion of total financing. 215 614 SMEs and mid-cap companies are expected to benefit from this support. "Acquedotto pugliese water services" is a notable example of such project in Italy. Acquedotto pugliese is the largest integrated water services operator in Southern Italy. The EIB is providing EUR 200 million in financing to upgrade the water network, and invest in water treatment facilities to increase the availability and quality of the drinking water distributed to the local population.

EU actions strengthen national, regional and local authorities and the civil society. Italy has allocated EUR 1.2 billion, the highest amount in the EU, for reinforcing the capacity of public administrations at different levels and prompting close cooperation with stakeholders. These resources focus on the improvement, simplification and modernisation of public administration's processes and organisation, with specific actions also aiming at strengthening the efficiency of anti-corruption measures and enhancing the justice system.

3. OVERALL FINDINGS REGARDING IMBALANCES, RISKS AND ADJUSTMENT ISSUES

The 2019 Alert Mechanism Report concluded that a new in-depth review should be undertaken for Italy to assess the persistence or unwinding of its imbalances. In spring 2018, Italy was identified as having excessive macroeconomic imbalances (European Commission, 2019d). The imbalances identified related, in particular, to high public debt, low productivity growth, high unemployment rate and the stock of non-performing loans. This section summarises the findings of the analyses in the context of the MIP in-depth review that is contained in various sections in this report.([17])

Imbalances and their gravity

Italy's high public debt is a major vulnerability for the economy. At 131.2 % of GDP in 2017, Italy's public debt translates into high servicing costs (3.8 % of GDP in 2017). The latter reduce the resources available for productivity-enhancing spending – already limited by the longstanding bias in public expenditure towards old-age pensions – and for implementing countercyclical policies in case of negative economic shocks. Furthermore, the sizeable rollover needs related to the high public debt expose Italy's public finances to sudden increases in financial market risk aversion. As observed since May 2018, fluctuations in market perceptions and preferences can result in high volatility and marked increases of sovereign yields, with potential negative spillovers to the banking sector and ultimately to financing conditions for firms and households.

The slow growth in productivity hampers the unwinding of macroeconomic imbalances. Stronger productivity dynamics would be a key driver to lift Italy's growth potential and strengthen its economic resilience. Despite the recent pick-up in labour productivity, overall productivity levels remain low, and the gap between Italy and the EU has continued to widen.

Labour market conditions are only slowly improving. In 2018 headcount employment exceeded pre-crisis levels. However, since hiring incentives expired at the end of 2016, jobs growth has almost exclusively been driven by temporary employment. Women's activity rates remain low and have dropped below 2016 levels in Q3 2018.

Despite the recent large reduction in NPLs, their legacy levels are still high. The gross NPL ratio declined from 11.5% at end-2017 to 10.2% in Q2-2018. Despite the progress made, the legacy stock of bad loans and unlikely-to-pay exposures remains still high in absolute terms and compared to EU peers. Due to the banks' high exposure to their own sovereign, higher sovereign yields have adversely affected banks' capital positions, pushing up their funding costs and curtailing their access to unsecured wholesale funding. Italian banks have recently tightened credit standards due to market uncertainty. As a consequence, bank credit to non-financial firms, especially smaller ones, is still subdued and is limiting overall investment growth in Italy.

Italy has strong trade and financial links to the Euro area and it accounts for 16 % of euro area GDP. Therefore, it remains a major source of trade and financial spillovers (tables 3.1 and 3.2). Exports of goods and services to the rest of the euro area correspond to 13 % of Italy's GDP. Italy is also an important export market for a number of euro area countries. Moreover, Italy's economy maintains strong financial linkages to other euro area countries.

Evolution, prospects and policy responses

Italy's public debt is not expected to decrease substantially in the coming years. After a slow decline observed in recent years, the government debt-to-GDP ratio is set to have increased in 2018 to 131.7% based on the government projections. In 2019 and 2020, the public debt reduction projected by the government is subject to significant downward risks, as it assumes high privatisation proceeds in 2019 (1 % of GDP) and sizable revenues from the activation of VAT safeguard clauses in 2020 (1.2 % of GDP). Sovereign yields, which increased significantly in 2018 and declined only partially towards the end of the year, are expected to increase further from 2020 as in the

([17]) Analyses relevant for the in-depth review can be found in the following sections: Public finances (Section 4.1); Financial sector (Section 4.2), Labour market (Section 4.3); and Investment (Section 4.4).

Table 3.1: **Outward spill-over heat map for Italy**

	EU partner																										
	AT	BE	BG	HR	CY	CZ	DK	EE	FI	FR	DE	EL	HU	IE	IT	LV	LT	LU	MT	NL	PL	PT	RO	SK	SI	ES	SE	UK
Imports	3,1	4,7	6	4	1,1	4,1	1	0,8	0,7	1,8	2,2	2,3	4,6	3,1		0,8	2	11,8	6,1	3,3	2,4	1,2	4,6	4,8	8,8	2,1	1	0,8
Imports (in value added)	2,1	1,7	2,9	3,9	2,5	2,1	1,2	1,3	0,9	1,8	1,8	2,1	2,4	1,1		1,5	1,5	2,2	5,6	1,1	2,0	1,5	2,8	2,0	5,5	1,6	1,0	1,1
Financial liabilities	9,9	12,1	0,6	0,6	4,7	1,3	2,7	1,2	3,4	19,3	9,3	6,5	1,3	67,1		0,7	0,2	579,1	15,7	20,4	0,3	13,5	0,2	2,6	6,3	12,6	1,3	9,8
Financial assets	12,1	6,2	2,7	3,5	2,4	0,8	1,6	0,6	2,9	11,8	4,0	1,8	1,9	38,0		0,8	0,5	906,0	8,6	23,5	0,6	4,4	3,8	5,6	3,1	8,4	2,6	5,5
Liabilities (to banks)	1,1	0,9							0	11,3	2,3	0,5		0,4						3,6		2,5				4,9	0,1	1
Bank claims	17,5	1,2		44,5	4,6	13,1	0,7	0,6	0,8	2,2	5	1,5	9,5	3,1		1	0,7	44,8		2	1	1,5		20,3	10,2	4,6	0,3	1,7

(1) cross-border figures for Italy, expressed as a % of the GDP of the partner country. The darkest shade of red corresponds to percentile 95 and the darkest shade of green to percentile 5. The percentiles were calculated for each variable based on the full available sample of bilateral exposures among EU countries. The blank spaces represent missing data. Data refer to: Imports - 2016, Imports (in value added) - 2014, Financial liabilities - 2015, Financial assets - 2015, Liabilities (to banks) - 2018-Q2, Bank Claims - 2018-Q2.
Source: UN, OECD, WIOD, BIS and Commission services

rest of the euro area. In 2018, foreign investors decreased their holdings of Italian sovereign bonds, while Italian banks raised their exposure. However, despite episodes of scarce market liquidity observed at the end of May, which temporarily affected sovereign yields of other Member States, negative spillovers to the rest of the EU have been limited. In the medium and long term, Italy is expected to face marked fiscal sustainability challenges based on standard fiscal sustainability risks indicators and on the Commission debt sustainability analysis. Its high stock of debt, its sensitivity to macroeconomic-fiscal shocks and the future ageing costs contribute to that assessment. The new measures on pensions backtrack on pervious reforms and are expected to worsen fiscal sustainability, by increasing pension expenditure in the coming years and possibly hampering potential growth.

Productivity has recently risen, but reforms to strengthen productivity are still pending, insufficiently implemented or limited in scope. Over 2018-2020 a moderate increase in labour productivity is projected. Yet, the impact of recent reforms on productivity is only gradually building up and is sometimes hindered by inadequate implementation. The reform of active labour market policies aims to overcome labour market frictions and, in particular, to mitigate skill mismatches through adequate training and education. Yet, three years after its adoption, those measures are not yet fully implemented. Moreover, effective reforms to boost competition on product markets and thereby increase innovation and productivity suffer from a piecemeal approach.

Weakening economic activity in combination with lingering structural challenges puts employment growth at risk. The unemployment rate declined to 10.2% in Q3 2018, while youth unemployment remained high at about 32%. The economic slowdown, in combination with low levels of average educational attainment and persistent skill mismatches, is likely to weigh on employment growth. On the other hand, policy measures with the potential to boost employment dynamic once the economic activity recovers, such as increasing the degree of competition in product markets, remain ineffectual.

Banks have adopted several measures to reduce their NPLs and address sovereign risk. Besides having improved their internal work-out capacity, banks have also benefitted from public support for NPL disposal, such as aid-free State-guaranteed securitisations, and from a buoyant secondary market for impaired assets. Although so far market uncertainty has not significantly impaired NPL sales, including disposal price, downside risks for NPL disposals prevail in the current fragile market environment. In order to mitigate the impact of high sovereign yields on their capital base, several banks have adopted strategies to rebalance part of their sovereign bond portfolios to the held-to-collect category (not marked-to-market). However, especially smaller banks' capital buffers are likely to be further affected by wider sovereign spreads.

Overall assessment

Italy's remaining imbalances are not expected to unwind in the near term or could even deteriorate. Importantly, the public debt-to-GDP ratio remains very high, and its reduction going forward is hampered by current fiscal plans, weakening economic recovery as well as still higher borrowing costs. The high debt level is a potential source of negative spillovers for the euro area, though contagion from the higher market volatility has been limited so far. Labour market conditions are gradually improving, but the

unemployment rate remains high and is still far above pre-crisis levels, in particular for young people and the long-term unemployed. The economic outlook is subject to amplified downside risks, in the context of a policy-induced rise in sovereign yields and a very high public debt. This adds to Italy's structural weaknesses such as sluggish productivity growth, a still low investment ratio and a shrinking working age population, which are weighing on Italy's potential growth. Banks' balance sheet repair has progressed substantially, but significant vulnerabilities remain, in particular those related to banks' exposure to their own sovereign and to the weaknesses of small and medium banks. On the positive side, Italy's external position is relatively strong, with current account surpluses and a net international investment position moving closer to balance. Still, non-cost factors continue to weigh on export performance. Some structural reforms have been implemented to address the 2018 country-specific recommendations (Section 2), which in Italy's case are all related to its macroeconomic imbalances. However, the reform momentum has sizeably slowed down since 2018 and elements of backtracking are evident in some reform areas. Consistent implementation of those reforms, as well as a sufficient degree of ambition in the forthcoming reform effort are crucial to decisively tackle Italy's macroeconomic imbalances.

Box 3.1: Structural reforms and potential spillovers – the case of Italy

There is some debate about the size and direction of the cross-border spillovers of structural reforms. While the demand effect (higher demand for foreign products) leads unequivocally to positive spillovers, reforms typically also improve a country's competitiveness and this can go at the (relative) expense of other countries. Whether the net effect is positive or negative depends on the relative strength of these two opposing channels and is likely to be reform-specific. In a model simulation exercise ([1]) the impact of a comprehensive set of reforms is quantified for all EU Member States in a harmonised way (Varga and in 't Veld, 2014). For a large set of structural indicators the benchmark is defined as the average of the three best performing counties, and then in the simulation these gaps are closed by half for all indicators, for each country separately. An update of this exercise for Italy is shown in the table below, based on more recent indicators (but not capturing the most recently introduced reform measures). As the magnitude of the reform 'shocks' simulated here are based on a harmonized benchmarking exercise, they do not necessary correspond to past European Semester Country Specific recommendations, but they illustrate the potential impact structural reforms can theoretically have on Member States' economies.

The simulated reforms cover the following areas: product market regulation and entry, labour market participation, tax structure and R&D subsidies. For Italy the largest 'reform gaps' identified are in product market regulation (service sector markups and entry costs), the tax structure (as captured by the relative share of labour tax revenues compared to consumption tax revenues) and low labour force participation, in particular of low skilled and early retired. According to this theoretical exercise, this ambitious reform package, if adopted altogether and contemporaneously, could boost GDP by 7% after 10 years, and 14 ¾ % after 20 years. The reforms would raise competitiveness, boosting both exports and imports. As the terms of trade fall by about 3.5% after 10 years, the trade balance to GDP ratio actually falls slightly by 0.8 pps. The net spillover to the rest of the EA is very small but positive.

Table 1: **Spillover effects of structural reforms – Italy closing half of the structural reform gaps**

	Years										
Italy	1	2	3	4	5	6	7	8	9	**10**	**20**
GDP	1.37	1.56	1.88	2.41	3.08	3.83	4.67	5.52	6.36	**7.19**	**14.77**
REER	-2.20	-2.90	-2.53	-1.74	-0.75	0.22	1.07	1.84	2.57	**3.30**	**10.12**
Trade balance (% GDP)	-1.2	-1.8	-1.73	-1.50	-1.24	-1.03	-0.92	-0.85	-0.80	**-0.75**	**-0.33**
Rest of EA GDP	-0.08	-0.02	0.00	0.02	0.02	0.02	0.01	0.01	0.01	**0.01**	**0.00**
EA GDP	0.00	0.06	0.11	0.15	0.19	0.23	0.27	0.32	0.36	**0.41**	**0.82**

Note: increase in REER is a depreciation.
Reference: Varga, J, in 't Veld J. (2014), "The potential growth impact of structural reforms in the EU: a benchmarking exercise ", European Economy Economic Papers no. 541:
http://ec.europa.eu/economy_finance/publications/economic_paper/2014/pdf/ecp541_en.pdf

([1]) Quest is the global macroeconomic model DG ECGIN uses for macroeconomic policy analysis and research. It is a structural model in the New-Keynesian tradition with microeconomic foundations derived from utility and profit optimisation and including frictions in goods, labour and financial markets. Detailed information on the model and applications are available at: http://ec.europea.eu/economy_finance/research/macroeconomic_models_en.htm

Table 3.2: **MIP assessment matrix**

	Gravity of the challenge	**Evolution and prospects**	**Policy response**
	Imbalances (unsustainable trends, vulnerabilities and associated risks)		
Productivity and competitiveness	Italy's labour productivity growth has been sluggish for more than 20 years (0.3 % per year over 1995-2017 vs. 1.3 % in the EU). Weak productivity growth makes it difficult to restore and maintain competitiveness, limits the scope for wage rises and entails low GDP growth, which affects public debt ratio dynamics. Weak productivity growth is rooted in long-standing weaknesses in the functioning of labour, capital and product markets, compounded by inefficiencies in the public administration and justice system.	Since 2010, labour and total factor productivity have grown moderately but the gap to the EU average has remained substantial.. Labour productivity per hour worked grew moderately in 2017 (0.5 %) but is expected to have stagnated in 2018 and to remain subdued in 2019-20. Weak productivity growth implies either subdued wage growth or rising unit labour costs, hampering a sizable recovery of cost-competitiveness. It also reflects a relatively slow diffusion of technological progress, which limits competitiveness and potential growth.	Recently, structural reforms have been adopted in areas such as labour and product markets, banking, education, public administration and justice but are not yet fully implemented. Sound and full implementation of adopted reforms is key for overcoming structural weaknesses and boost productivity growth.
Public debt	In 2017 Italy's public debt-to-GDP ratio stood at 131.2 % of GDP, the second highest in the euro area. Italy's high public debt is a major source of vulnerability for the economy. The high debt servicing costs crowd out productive public expenditure, reduce the fiscal space to respond to economic shocks and may give rise to a harmful snowball effect if interest rates significantly exceed nominal GDP growth. The high rollover needs entail significant refinancing risks and expose Italy's public finances to any sudden increase in financial market risk aversion. Prolonged increases in sovereign yields may have adverse economic effects through the exposure of domestic financial institutions to public debt, with possible negative spillovers to the banking sector and to financing conditions for firms and households. Given its size, Italy's public debt ratio is a potential source of negative spillovers to the whole euro area.	After increasing from 102.4% in 2008 to 131.8% in 2014, the debt-to-GDP ratio slowly declined in recent years to 131.2% of GDP in 2017. The government debt-to-GDP ratio is set to have increased in 2018 to 131.7% based on the government projections. In 2019 and 2020, the public debt reduction projected by the government is subject to significant downward risks, as it assumes high privatisation proceeds in 2019 (1 % of GDP) and sizable revenues from the activation of VAT safeguard clauses in 2020 (1.2 % of GDP). Sovereign yields increased significantly in 2018 also due to uncertainties around the government's economic and fiscal stance, and declined only partially towards the end of the year. Negative spillovers to the rest of the EU were limited. Foreign investors decreased their holdings of Italy's sovereign bonds, while Italian banks increased their exposure. In 2019, sovereign yields are expected to increase further, as in the rest of the euro area. . Fiscal sustainability risks are high both in the medium and the long term, on the basis of the standard fiscal sustainability gap indicators and the Commission's debt sustainability analysis.	The planned fiscal strategy and the weak economic outlook are expected to prevent a substantial reduction of government debt over 2019-2021. Uncertainty related to the government economic and fiscal stance contributed to significantly raise sovereign yields, with a substantial increase in interest spending over the next years and the risk of negative spillovers to the banking sectors. The privatisation targets set for the coming years, particularly ambitious for 2019, are subject to significant downward risks, in light of the poor track record observed in recent years. The provisions broadening possibilities for early retirement will increase the longstanding bias of public spending towards old-age pensions and are expected to worsen fiscal sustainability, by increasing pension expenditure in the coming years and possibly hampering potential growth.
		Adjustment issues	
Labour market participation and unemployment	The unemployment rate doubled during the crisis, and the long-term unemployment rate steadily increased over the period for all age groups. The risk of labour market exclusion is particularly high for youngsters: the youth unemployment rate and the share of young people not in employment, education or training (NEET) are among the highest in the EU. The participation rate, particularly of women, is still very low despite recent increases.	The unemployment rate averaged 11.3 % in 2017 down from 12.8 % at the end of 2014, and it is expected to decline gradually in 2018 and 2019, partially helped by continuing employment growth. Long-term and youth unemployment are also slowly declining and the participation rate is increasing moderately.	The reform of active labour market policies and the strengthening of work-based learning could help to improve labour market matching and support the transition from education to work in the medium term. However, implementation is proving challenging. Measures to foster labour market participation are limited.

(Continued on the next page)

Table (continued)

Banks' asset quality	On the back of significant NPL sales and securitisations as well as persistent supervisory pressure, the gross NPL ratio declined from 11.5% at end-2017 to 10.2% in Q2-2018. In this regard, the net NPL ratio has halved since 2015 and stood at 5% in Q2 2018. Despite the substantial progress made, the legacy stock of bad loans (*sofferenze*) and of unlikely-to pay exposures still remains high in absolute terms and compared to EU peers. Any sudden economic downturn would adversely affect credit supply and NPL levels (see Section 4.2).	While Italian banks have continued to repair their balance sheets, headwinds include the impact from the higher sovereign yields on banks' funding costs and capital buffers. Further factors can slow the pace of NPL resolution: They include in particular weaknesses in the insolvency framework, the slow judicial system and constrains related to the servicing of unlikely-to-pay loans, where there are currently only few active market operators. Second-tier banks with their higher NPL ratios are also more challenged in resolving their NPLs and in continuing the balance sheet repair.	The NPL disposal has been facilitated by the development of the secondary market for impaired assets including number of players, besides public support for NPL disposal such as State-guaranteed securitisations. Banks have also worked towards improving their internal work-out capacity. The coming into force of the calendar provisioning rules for NPLs will likely compel Italian banks (and EU peers) to accelerate the NPL disposal and work-out for both unsecured and secured NPL exposures amid ongoing supervisory pressure.

Conclusions from the IDR analysis

- The public debt-to-GDP ratio remains very high, and current fiscal plans, a weakening recovery as well as higher borrowing costs hamper its reduction going forward. Still high long-term unemployment holds back future growth. Banks' balance sheet repair has substantially progressed, but bank credit to non-financial firms, especially smaller ones, is still subdued and is limiting overall investment growth. While the external position is relatively strong, with current account surpluses and a net international investment position moving closer to balance, non-cost factors continue to weigh on export performance.
- Remaining imbalances are not expected to unwind in the near term or could even deteriorate over the coming years. The government debt-to-GDP ratio is expected to have increased to close to 132% in 2018 and to remain stable in 2019 and 2020 based on the government projections, without considering the assumed privatisation proceeds and revenues expected from the activation of VAT safeguard clauses. Productivity dynamics are improving very slowly with a weak outlook. This holds back the relative adjustment in unit labour costs, despite wage moderation, while non-cost factors remain insufficiently supportive of external competitiveness. The legacy NPL stock has significantly declined, but vulnerabilities remain, which is in particular related to banks' exposure to the sovereign and to the state of medium and small banks.
- Overall, Italy's reform momentum has stalled in 2018. The fiscal expansion planned by the government does not include effective measures to lift Italy's sluggish potential growth and, in particular, to close the persistent productivity gap vis-à-vis the EU average. Some of the envisaged measures in the 2019 budget reverse elements of previous important reforms, in particular in the area of pensions, which can threaten the sustainability of public finances. While progress in reforming the cadastral system, tax expenditures and property taxation is limited, a new spending review has been planned for 2019. The government intends to replace the comprehensive anti-poverty scheme introduced in 2018 by a new income-support scheme with a close link to active labour market policies (ALMP). However, the implementation of the ALMP reform is slow and public employment services, a cornerstone of the new income-support scheme, do not seem adequately equipped. Though banks have come under market pressure from the entrenched sovereign-bank feedback loop and higher market volatility, progress on bank balance sheet repair has continued. The public administration reform has been implemented. Efficiency gains in civil justice remain limited, and a new reform streamlining civil trials is in progress, while a new anti-corruption bill is currently under discussion in parliament. Furthermore, the implementation of the 2015 annual competition law is delayed, with remaining restrictions to competition still to be removed.

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

Source: European Commission

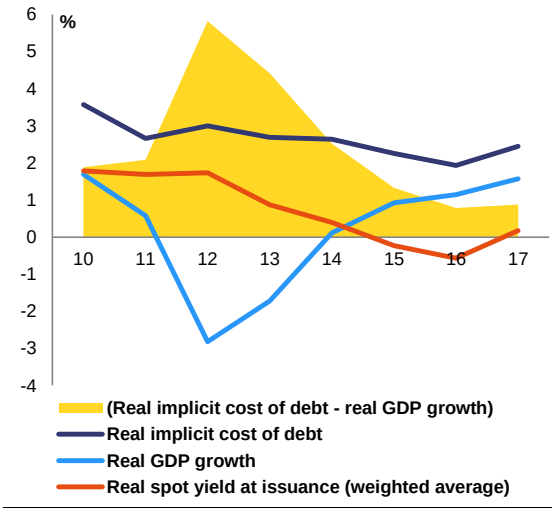
4. REFORM PRIORITIES

4.1. PUBLIC FINANCES AND TAXATION

4.1.1. PUBLIC DEBT*

A worsening primary surplus is expected to hinder the reduction of Italy's public debt over the coming years. In recent years, the difference between the real implicit cost of debt and real GDP growth, although remaining positive, progressively narrowed also thanks to the economic recovery and declining interest spending (Graph 4.1.1). As such, the snowball effect has shrunk, supporting the reduction of the debt-to-GDP ratio. However, the deterioration in the primary surplus and slightly debt-increasing stock-flow adjustments partly offset those developments. Overall, the debt-to-GDP ratio declined only slowly from 131.8% in 2014 to 131.2% in 2017. In 2019, the primary surplus is expected to slightly deteriorate based on the government projections underlying the 2019 budget. In 2020, the planned fiscal measures are set to entail a more marked deterioration, without considering the additional revenues expected from the activation of the VAT safeguard clauses.

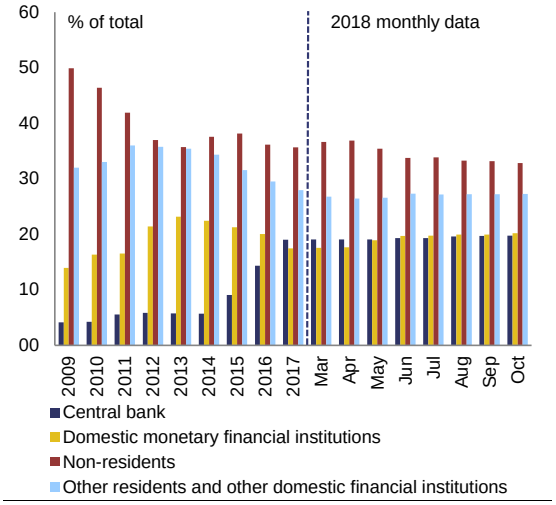
Graph 4.1.1: **Drivers of "snowball" effect on public debt**



Source: European Commission

Sovereign yields increased in 2018, leading to higher debt servicing costs. Yields on 10-year sovereign bonds increased by 1.6 pps between the beginning of May and the end of October 2018 (reaching 3.4%), before slightly declining to 2.6 at the end of January 2019 also as a result of Italy's revised fiscal targets in the 2019 budget. Yields on 2-year bonds increased by 1.4 pps. over the same period in 2018 (from -0.3% to 1.1%), before declining at the beginning of this year (to 0.3%). From 2020, sovereign yields are expected to further increase in line with the projected developments for the euro area. Even considering the relatively long average maturity of the stock of government securities (around 7 years at end of 2017), the implicit interest rate on government debt is set to progressively increase from 2020. Overall, the level shift observed in Italian sovereign yields contributes to reverse the declining trend in interest spending observed in recent years. Based on the government projections underlying the 2019 budget, interest spending is set to increase from 3.6 % of GDP in 2019 to 3.8 % in 2020.

Graph 4.1.2: **Government securities by holding sector**



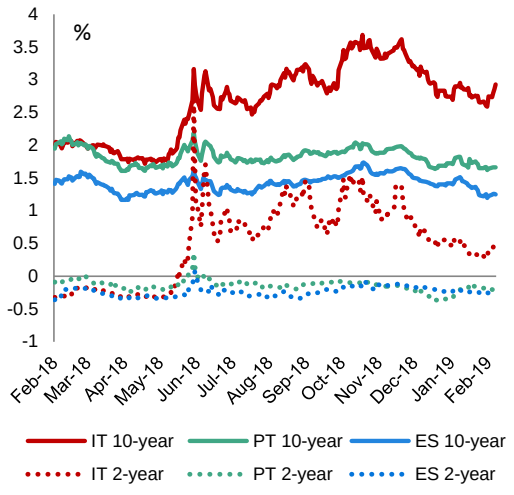
Source: Bank of Italy

Italian banks increased their holdings of Italy's sovereign bonds in 2018. After progressively decreasing in recent years, the amount of government securities held by Italian banks increased in the central months of 2018, by around EUR 55 billion between April and October (of which EUR 28 billion in May according to Bank of Italy data). The holdings of the central bank, which were already growing in recent years reflecting the quantitative easing programme, continued increasing in the course of 2018 at a moderate pace. Overall, the share of government securities held by private Italian banks, after

progressively declining from 23.2% in 2013 to 17.6% in April 2018, increased to 18.9% in May and reached 20.2% in October (Graph 4.1.2).

Foreign investors decreased their exposure to Italy's public debt. The share of government securities held by foreign investors declined from 36.9% in April to 35.4% in May and 32.8% in October. Those developments suggest a change in foreign investors' preferences, which might have led Italian banks to act as a buffer and limit losses on their portfolio of sovereign bonds. Italian households do not appear ready to compensate for the withdrawal of foreign investors as shown by the weak result of the November 2018 auction of the "BTP Italia" (EUR 2.1 billion raised against an average of around 7 billion per auction in recent years), which is a government security specifically designed for retail investors. However, the subscription for syndicated sovereign bonds in early 2019 suggests that foreign interest might have increased again following the revision of the government's fiscal plans in December 2018.

Graph 4.1.3: **Sovereign yields on the secondary market**



Source: Bloomberg

Despite episodes of scarce market liquidity, negative spillovers to other Member States have been limited. Overall, risks from the macroeconomic-financial context appear to be low, ensuring the possibility to refinance debt rollover needs at ease. However, the high level of debt increases investors' sensitivity to potential risks, possibly causing rapid changes in market sentiment and strong volatility on secondary markets. In particular, the peak in sovereign yields recorded at the end of May was marked by a substantial flattening of the yield curve (on the 29 May, yields increased by 0.5 basis points on 10-year bonds and 1.9 basis points on 2-year bonds, reaching 3.2% and 2.8% respectively), pointing to a large increase in perceived risk. Those developments temporarily affected other Member States' sovereign yields (for instance, Spanish and Portuguese 2-year yields rose, respectively, by 0.4 and 0.2 basis points between the 24th and the 30th of May). However, the yields on Italy's short-term bonds soon normalised while remaining at a relatively high level, and other Member States' sovereign yields quickly decoupled from Italy's ones, showing little correlation with the Italian sovereign bond market since then (Graph 4.1.3).

4.1.2. DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS*

Italy is expected to face marked sustainability challenges in both the medium and the long term. Both the Commission's debt sustainability analysis and the fiscal sustainability risk indicator S1([18]) point to high risk in the medium-term. The high and increasing stock of debt projected in 2029 in the baseline scenario and its sensitivity to macroeconomic-fiscal shocks contribute to that assessment (Annex B). In the long term, the assessment of fiscal sustainability takes into account the sizeable fiscal adjustment required to stabilise the debt-to-GDP ratio, especially in light of future ageing costs and the vulnerabilities linked to the high debt burden ([19]). The long-term fiscal sustainability risk indicator S2([20]) points to medium risks, also due to the projected increase in ageing costs. However, an overall analysis points to high risk in the long term, given the vulnerabilities linked to the high debt burden

([18]) The medium-term fiscal sustainability indicator S1 shows the additional effort required in terms of cumulated improvement in the structural primary balance over five years (starting from 2021), to reach a 60% debt-to-GDP ratio by 2033, taking into account future additional expenditure arising from an ageing population.

([19]) European Commission (2019c). For more explanations on the methodology, see also European Commission (2018e).

([20]) The long-term fiscal sustainability indicator S2 shows the upfront adjustment to the current structural primary balance (subsequently kept constant at the adjusted value forever) that is required to stabilise the debt-to-GDP ratio over the infinite horizon, taking into account future additional expenditure arising from an ageing population.

captured by the debt sustainability analysis risk assessment.

The new provisions on pensions are expected to worsen fiscal sustainability. As regards long-term fiscal sustainability, implicit liabilities arising from population ageing have been curbed by various pension reforms enacted in past years. However, a decree law of January 2019 reverses elements of those reforms by broadening the possibility of early retirement. In particular, the decree introduces the possibility to retire with 62 years of age and 38 years of contributions over the period 2019-2021. While no specific reduction in pension benefits is envisaged, shorter contribution periods for the beneficiaries of the scheme (either partially or totally covered by the Notional Defined Contribution system) will automatically imply lower pension benefits. Moreover, the indexation to life expectancy of the minimum contribution requirement needed to retire under the existing early retirement scheme ("pensione anticipata") has been removed up to 2026. In addition, the temporary early retirement scheme for women ("opzione donna") has been extended. Although the parliament may still amend details of that reform and the precise cost will also depend on the actual take-up, the new provisions will markedly increase pension expenditure over the coming years. The 2019 budget allocated a fund of 0.2 % of GDP in 2019, 0.4 % of GDP in 2020 and 0.5 % of GDP in 2021. However, the reform will pose a burden on public finances also after 2021. In fact, even if the new early retirement scheme is not prolonged, the number of pensioners will have increased during the three-year window, lifting pension expenditure for several years after 2021 compared to the pre-reform scenario. Moreover, the lack of indexation to life expectancy of the contribution period needed to retire under the existing early retirement scheme is set to increase pension expenditure in the medium term. Finally, those provisions, by broadening the possibility for early retirement, might negatively affect labour supply, thereby hampering potential growth.

4.1.3. COMPOSITION OF PUBLIC SPENDING*

While supporting public investment, the 2019 budget worsens the bias of Italy's public spending towards old-age pensions. After rising during the last double-dip recession, in recent years total public spending has progressively decreased as a share of GDP, reaching 54.2 % in 2017, also thanks to lower interest rates, the freeze of public wages and turnover limits for public employees. Public investments also dropped markedly as a share of GDP from 3.0 % in 2008 to 2.0 % in 2017 and are expected to have further declined in 2018 based on the government projections. Social transfers in cash, after rising significantly over 2013-2014, declined only marginally over the last years as a share of GDP, thereby increasing their share over total public spending. In particular, spending for old-age pensions, which already in 2008 represented a comparatively large share of public expenditure, has further increased in recent years and stood at around 15 % of GDP in 2016, among the highest in the EU. The 2019 budget is expected to increase total public spending as from 2019. In particular, it may support the recovery of public investment by allocating additional funds and strengthening administrative capacity (Section 4.4). However, such recovery is subject to downward risks, as the 2019 budget has also temporary reduced other investment funds and subsidies to investment. In addition,,administrative bottlenecks and implementation delays might further hamper the recovery. Social transfers, including spending for old-age pensions, are set to rise more markedly due to the introduction of a minimum income and an early retirement schemes, which have been allocated two funds worth in total 0.5 % of GDP in 2019 and 0.8 % of GDP in 2020-2021.

The assessment of the first spending review undertaken under the reformed budgetary process is still ongoing. With the 2018 budget, the government applied for the first time the reformed budgetary process that includes a systematic spending review across all levels of government. The assessment of that spending review is ongoing under specific agreements between the Ministry of Finance and each line Ministry. A similar spending review is planned for 2019, with expected savings of around 0.2 % of GDP. At the same time, the budgetary autonomy at the subnational level will be slightly increased as of January 2019, ([21]) by allowing local governments to spend their budgetary surpluses without prior authorisation.

([21]) The provision applies from January 2019 to municipalities, provinces and regions with a special statute, and from January 2021 to regions with an ordinary statute.

4.1.4. TAXATION*

Italy's tax system weighs heavily on labour and capital, while other sources of revenues are underused. Although decreasing for the fourth year in a row, the tax-to-GDP ratio, at 42.1 % in 2017, is still significantly above the EU average (39.0 %). Revenues from labour taxes are around the EU average as a share of total tax revenues but remain comparatively high as a share of GDP (20.7 % against an EU average of 19.4 %). In fact, the tax wedge on labour ([22]) is one of the highest in the EU, at 47.7 % in 2017 for a single at the average wage against an EU average of 42.8 %, and the implicit tax rate on labour stood at 42.4 % in 2017, against an EU average of 36.3 %. Similarly, the tax burden on capital was well above the EU average in 2017, as indicated by high revenues from capital taxes (24.1 % of total tax revenues compared to 21.9 %). At the same time, revenues from value-added tax (VAT) are relatively low, at 14.9 % of total tax revenues in 2017 compared to 18.1 % for the EU. In fact, although on a declining trend, Italy's VAT gap ([23]) remains among the highest in the EU, at 25.9 % in 2016 (EU average at 12.0 %). This is due, on the one hand, to relatively low tax compliance, especially related to omitted billing and invoicing (so-called tax evasion "with consent"); on the other hand, to the broad use of reduced VAT rates, while the standard one (22 %) is slightly above the EU average (21.5 %). The wide use of reduced rates resulted in a very high VAT rate gap of 14.9 % in 2016, well above the EU average of 10.3 % (CASE, 2018).

Efforts to shift the burden to tax bases less detrimental to growth and to reduce the complexity of the tax system remain limited. Despite the annual review of tax expenditures, there are still no plans to reduce their number and scope. The VAT hike legislated as a budgetary "safeguard clause", which included an increase of the 10 % reduced VAT rate, has been systematically postponed so far. Moreover, despite the ongoing efforts to set up and improve a digital platform for immovable properties, no concrete steps are planned to reform the outdated cadastral system or to reintroduce a recurrent property tax on first residences for high-income households. At the same time, the 2019 budget sligthly reduced the employers' contributions to the national insurance institute for accidents on the workplace (INAIL). Based on the latest Eurobarometer (Eurobarometer 2018), half of the companies surveyed consider the lack of stability and the complexity of the tax legislation as a major obstacle to investment (50 % and 54 %, respectively, against 28 % and 32 % in the EU).

The extension of flat-rate regimes will lower taxes on the self-employed and individual entrepreneurs. Two provisions included in the 2019 budget will lower taxes on self-employed workers and individual entrepreneurs. First, the scope of the existing simplified tax regime will be extended. The current regime consists in an optional forfeit 15 % tax rate for self-employed workers and individual entrepreneurs with yearly turnover below sector-specific thresholds up to a maximum of EUR 55 000. With the new provisions, among other changes to the eligibility conditions, the income threshold is raised to EUR 65 000 irrespective of the sector of activity. Second, a new 20 % forfeit tax rate will be available as of 2020 for the same category of taxpayers with yearly turnover between EUR 65 000 and EUR 100 000. Based on the government estimates, the two provisions will correspond, respectively, to a net revenue loss of around EUR 1.4 and 1.1 billion as of 2021. While the two measures are relatively small in scope and affect a limited number of taxpayers, the use of flat-rate regimes reduces the redistributive power of the tax system. Based on a simulation by the European Commission Joint Research Centre using EUROMOD ([24]), the first reform would

([22]) The tax wedge on labour is the proportional difference between the total cost of employing a worker and the employee's net earnings. Data are taken from the European Commission Tax and Benefit Indicator database (based on OECD data and model).

([23]) The VAT gap is the difference between theoretical and actually collected VAT revenues. It has several components: the VAT rate gap is one of them and measures the specific VAT revenues losses linked to reduced VAT rates, in comparison to a situation where all products and services would be taxed at the standard rate.

([24]) EUROMOD is the tax-benefit microsimulation model for the EU. It simulates individuals' and households' benefit entitlements and tax liabilities according to the rules in place in each Member State. Simulations are based on representative survey data from the European Statistics on Income and Living Conditions (EU-SILC) and cover the main elements of direct taxation, social contributions and non-contributory benefits. The variable for yearly turnover is constructed by matching IT-SILC 2013 data with

potentially benefit mostly the new eligible self-employed in the upper half of the household income distribution [25].

Measures on corporate taxation have temporarily increased the tax burden on firms at an aggregate level. After being postponed by the 2018 budget, the previously legislated tax regime for personal income from entrepreneurial activities ("Imposta sul Reddito Imprenditoriale"), aimed at harmonising the tax treatment of small firms and corporations, has been abrogated. Only a few of the tax expenditures to support private investment and innovation, expiring in 2018, have been extended, while also being reduced in scope (Section 4.4). At the same time, the tax deductibility of specific costs for some categories of firms, especially banks, will be limited, with a temporary positive effect on revenues in 2019. The 2019 budget also introduced a tax on digital services and on money transfers. Furthermore, the "allowance for corporate equity" (ACE), introduced in 2011 to reduce the corporate debt bias, has been replaced by a new tax rebate on firms' profits used to increase investment or hire new employees, with an overall positive impact on tax revenues in the short run. The tax rebate consists in a reduction of the standard corporate income tax (IRES) rate from 24 % to 15 %. As the main beneficiaries of ACE have been *de facto* financial institutions, this reform shifts the tax burden from non-financial to financial corporations. Although the new tax rebate directly targets productive investments, its implementation may prove complex. Furthermore, the abolition of ACE will reduce firms' incentives to use equity financing, worsening the debt bias in corporate taxation (Section 4.4).

The compulsory e-transmission of receipts is expected to encourage tax compliance and improve revenue collection. In recent years, Italy's budgetary strategy strongly relied on measures to combat tax fraud, especially for indirect taxes ([26]), which contributed to raise VAT revenues. Electronic invoicing has become mandatory for all companies as of January 2019, which might help reducing tax evasion "without consent", i.e. omitted declaration (MEF, 2018). However, its implementation should ensure simplification and a low administrative burden on taxpayers in order not to encourage tax evasion "with consent" in the form of omitted invoicing. The decree law 119/2018 ("fiscal decree"), converted into law in December 2018, has complemented the electronic invoicing by making the electronic transmission of receipts compulsory for all commercial transactions with final consumers.([27]) This provision is expected to provide the tax agency with more timely and accurate information, allowing targeted inspections. The related deterrent effect might help reducing tax evasion "with consent", particularly in the form of omitted billing and invoicing.

The new possibility to settle past tax liabilities without fines and at advantageous interest rates could have a negative impact on tax compliance. This provision represents the third initiative of this kind in recent years, and is more advantageous for taxpayers compared to past editions, to the extent that payments can be made in instalments over several years. The "fiscal decree" also includes several smaller provisions curtailing old pending tax liabilities of limited size and reducing incentives for taxpayers to prolong the duration of tax litigations. Overall, the new provisions equivalent to a tax amnesty are expected to discourage tax compliance in the future, by implicitly rewarding non-compliant behaviour (Luitel et al. 2007, Jensen and Woehlbier, 2012).

administrative data, based on the joint distribution of income and turnover by classes.

[25] According to the simulations, most of the new eligible taxpayers and most of those who could potentially benefit from lower tax liabilities are in the bottom half of the income distribution. However, among taxpayers becoming eligible for the flat-rate regime thanks to the reform, the share of those who would pay less taxes under that regime increases across the distribution of equivalised disposable income. Such share is particularly low in the first decile (26%), increases steadily from 42% in the second decile up to 71% in the ninth decile, and declines in the tenth decile to 54%.

([26]) The main measures implemented in recent years to fight VAT fraud are authorised derogations from the EU VAT rules. These include: (i) the mandatory e-invoicing for transactions among companies, (ii) the electronic accounting system, and (iii) the split payment (under this regime public administration payments to private suppliers of goods and services do not include VAT, which is directly paid to the government budget).

([27]) The e-transmission of receipts will be mandatory from July 2019 for all subjects with a yearly turnover above EUR 400 000, and from January 2020 for all taxpayers.

4.2. FINANCIAL SECTOR

Italian banks have made significant progress on balance sheet restructuring despite renewed market pressure. However due to the high bank exposure to the sovereign, higher sovereign yields (though recently come down) have adversely affected banks' capital positions, pushing up their funding costs and curtailing access to unsecured wholesale funding. Nevertheless, banks have continued to boost capital buffers and reduce legacy non-performing loans (NPLs) to 10.2 % in Q2-2018 amid positive profitability since 2017. The recent European Banking Authority stress test has shown the resilience of the involved Italian banks in the assumed adverse scenario. Smaller banks though are often perceived as more vulnerable. Further balance sheet restructuring and consolidation, as well as improving banks' capital and earnings capacity should be fostered. While access to finance has improved, it continues to be a challenge for many small Italian firms.

Recent developments*

Since the market uncertainty in late spring 2018, Italian banks had increased their exposure to their sovereign. According to Bank of Italy data, Italian banks' holdings of Italian sovereign bonds have increased from EUR 298 billion in April 2018 to EUR 328 billion in November, partly compensating for the withdrawal of foreign investors since spring. Sovereign debt as a share of total banking sector assets remains elevated at 10.5 % in November 2018 (higher than many EU peers), reflecting the close sovereign-bank feedback loop in Italy, with smaller banks often being more exposed than larger ones. The common equity Tier 1 capital for the largest Italian banks has declined by up to 80bp in Q2-2018 (less so in Q3) due to the sovereign yield widening. According to Bank of Italy (2018), a 100bps upward shift in the government yield curve (as of end-June level) would reduce the common equity Tier 1 ratio of banks by 50bps (40bps for significant banks and 90bps for less significant banks). Assuming no substantial changes in the cost of funding, most banks can withstand in the short term a further increase in sovereign spreads. Several banks adopted strategies to rebalance part of their sovereign bond portfolios to the held-to-collect category (valued at amortised cost) to avoid a negative impact on the capital base from the rising sovereign yields. ([28])

Any persistently high sovereign yields are likely to negatively impact banks' cost of funding, their market access, and hence credit provision. Banks could be adversely impacted by the higher sovereign risk through a number of reinforcing channels, such as capital losses from their sovereign exposures, higher funding costs, limited market access, lower collateral valuation and credit ratings or reduced funding benefits from government guarantees. However, the liquidity position of Italian banks has remained adequate, mainly supported by the increase in domestic deposits and the reliance on ECB refinancing operations. Since May, many banks were precluded from issuing unsecured senior or subordinated debt securities. A worsening of the market situation risks increasing banks' funding costs (whilst impairing credit supply) and making it more difficult for banks to meet the subordinated part of the minimum requirements for own funds and eligible liabilities (so-called MREL) targets as well as to adjust from the phase out from the ECB targeted longer-term refinancing operations starting in 2020.

Notwithstanding recent improvements, the subdued profitability continues to be a major challenge for the banking sector. Despite the market volatility, banks continued to increase their capital buffers in 2018 with the common equity Tier 1 increasing to 13.2 % in June 2018, compared to 12.5 % in June 2017. Despite some narrowing, a gap remains between the capital buffers of Italian banks and the average of EU peers. On the back of cost reductions and lower loan-loss provisions, profitability improved further in the first half of 2018 for both large groups and smaller banks, but remains very low, partly due to the low interest rate environment. In spite of efforts to further increase efficiency, some Italian banks are still struggling with high cost-to-income ratios. Furthermore, Italian banks have continued to also lag behind in terms of rationalising staff and branches since the beginning of the crisis. The below-average profitability, with some

([28]) The impact of an increase in sovereign yields varies from bank to bank depending on the total sovereign exposure, where the bonds are recorded (i.e. trading and fair value vs banking book) and the duration of the portfolio.

heterogeneity against EU peers, jeopardises the capital strengthening process of Italian banks, making their generation of capital more difficult.

Italian banks have made significant progress in reducing legacy NPLs via disposals and continuing balance sheet repair. In 2017 and in the first half of 2018, banks disposed of a significant amount of bad loans (roughly EUR 40 billion), nearly two thirds of which came through securitisations. ([29]) Italian significant institutions are expected to dispose some EUR 40 billion in NPL transactions from their balance sheets by end-2020. The secondary NPL market has further developed with NPL pricing improving, supported by better NPL data quality, and more NPL servicing firms have entered the market. Banks have also improved their internal work-out capacity. Looking ahead, due to the significant volume of unlikely-to-pay loans in bank balance sheets, the secondary market offers the potential for further development. Banks will have to decide whether to invest in the active management of these loans or to de-recognise them through outright sales to specialised operators and securitisation. Market operators focusing on unlikely-to-pay loans, which are currently few on the Italian market, require specific skills, strategies and logistics (i.e. proactive management of borrowers, early warning indicators, advanced IT platforms), and appropriate financial resources to support borrowers.

However, many banks still exhibit high NPL levels, especially when compared with EU peers. While market uncertainty has so far not significantly negatively impacted NPL sales including prices, downside risks for NPL disposals prevail in the current market environment, as the State sponsored securitisation scheme is also becoming more costly due to higher fees on State guarantees. Commission estimates show that NPL ratios would be sizeably impacted by any sudden economic downturn, while banks' credit growth is adversely affected by NPLs (especially for smaller banks). ([30])

Some progress has been made on State-aided banks, though significant vulnerabilities remain. Banca Monte dei Paschi di Siena has continued to implement its restructuring plan, inter alia, on NPL disposals, mainly through a large securitisation transaction, and cost-cutting measures. ([31]) However, recent efforts to further increase its subordinated debt (after an issuance in early 2018) have been curtailed by the unfavourable market conditions, while the bank's NPL ratio is still above domestic peers. Regarding the 2015 resolution of four small banks and the 2017 liquidation of two Venetian banks, no significant public contingent liabilities related to these cases have so far materialised.

Adding to previous schemes, which have led to substantial compensation payment to retail investors for misselling, the government has set up a compensation scheme for retail shareholders and subordinated bondholders of gone-concern banks. As part of the 2019 budget law, the government has set up a savers compensation fund (*Fondo indennizzo risparimiatori*) with an initial envelope of EUR 1.6 billion for the period 2019-2021. Beneficiaries should be bank shareholders and holders of subordinated bonds with a retail client profile, individual entrepreneurs and some micro-enterprises, which suffered losses during the compulsory administrative liquidation of banks liquidated between 16 November 2015 and end-2017. However, to what extent the existence of the conditions of mis-selling will be assessed by an independent body are still to be seen. The compensation would equal 30 % of the acquisition cost, up to a maximum of EUR 100 000 per shareholder and 95 % of the recognised amount, up to a maximum of 100 000 per bondholder.

([29]) NPL disposal has been also supported by the transitional arrangements related to the implementation of IFRS 9, which allowed spreading over time the impact on capital of additional loan-loss provisions on NPLs. Moreover, the aid-free State guarantee framework for bad loan securitisations (GACS) was recently extended by another 6 months from September 2018 onwards. The 14 transactions completed with the support of this scheme between February 2016 and September 2018, involved a total gross NPL volume of EUR 59 billion.

([30]) The estimates are based on panel regressions, comprising 400 Italian banks, for 2006-2017 and data from SNL S&P. For instance, a 1% increase in the unemployment rate, ceteris paribus, would lead to 1.4% rise in the NPL ratio of Italian banks. In addition, Italian banks with higher capital buffers, NPL coverage and deposit growth are able to sustain higher credit extension, with the economic cycle also playing a significant role in banks' credit growth.

([31]) In the first half of 2018, the bank completed with the support of the State sponsored securitisation scheme and the Italian Recovery Fund the securitisation of EUR 24.6 billion of bad loans.

Compensations under this scheme will be granted net of any previously received compensation, reimbursement or refund. Previous mis-selling compensation schemes covered only holders of subordinated debt subject to burden-sharing and compensation were granted only after a court or an independent panel confirmed an instance of misselling in the specific case, in line with EU legislation.

Second-tier banks*

Second tier banks have also progressed on their balance sheet de-risking and strengthening. Notwithstanding this progress, some mid-cap banks are still perceived as more vulnerable by the market. In early January 2019, the ECB put Banca Carige under temporary administration, following the rejection by a shareholders' meeting of a capital increase of EUR 400 million and the subsequent resignation of the majority of the board members. ([32]) Subsequently, the government notified aid in the form of a State guarantee on newly-issued liabilities and emergency liquidity assistance, which the Commission authorised. Second-tier banks have been very active on the secondary market for distressed assets and have improved their arrears management capacities, also due to supervisory pressure. The ongoing balance sheet repair will prepare the second-tier banks for the new NPL calendar provisioning rules. Despite progress with balance sheet de-risking, these banks still have above-system average NPL ratios and need further efforts to strengthen their capital buffers and resilience to shocks, including from higher sovereign spreads. In addition, whereas their liquidity position has remained adequate, ECB funding constitutes a significant contribution to the total funding of these banks, as it exceeds 10% of their total assets. Most of these banks though have only a limited track-record of accessing wholesale markets, which could make funding after the phasing out of the targeted longer-term refinancing operations more expensive and difficult.

([32]) In November 2018, Banca Carige benefitted from the support of the voluntary scheme of the interbank deposit guarantee fund, which invested EUR 320 million into subordinated convertible bonds.

Corporate governance and insolvency reforms*

The final part of the 2015 reform of the large cooperative banks has been recently suspended. All large cooperative banks (banche popolari) with assets above EUR 8 billion have already transformed themselves into joint-stock companies by the end-2016 deadline, with the exception of Banca Popolare di Bari and Banca Popolare di Sondrio. Some provisions of the 2015 reform were subject to a Constitutional Court challenge with the implementation of the reform being suspended in the meantime. The March 2018 ruling of the Constitutional Court confirmed that the reform did not infringe any constitutional provisions. However, the full implementation of the reform was postponed again in July 2018 until end-year (Mille-Proroghe decree law). Importantly, a recent decision of the Italian State Council referred several questions related to this reform to the Court of Justice of the European Union while suspending in the meantime the transformation of Banca Popolare di Bari and Banco Popolare di Sondrio into joint stock companies, with the government intending to delay the completion of the reform until end-2019.

The almost completed reform of small mutual banks was recently further amended. The 2016 reform of small mutual banks (*banche di credito cooperativo*) was not completed by July 2018 (as originally planned), but was subject to a 3 months delay. In December 2018, the Parliament approved an amendment to the Decree 119/2018 (Fiscal Decree), which allows the small mutual banks operating in the Bolzano and Trento provinces to participate in institutional protection schemes, as an alternative to setting up a cooperative banking group. In the view of the authorities, this would reinforce the cooperative features of the small mutual banks and maintain regional links. Following these amendments, the reform will lead to the emergence of only two groups with national coverage, ICCREA and Cassa Centrale Banca, which will be subject to a comprehensive assessment by the Single Supervisory Mechanism in 2019.

The Government plans to complete the reform of the insolvency framework in the near future. In October 2017, the parliament passed an enabling law of the insolvency framework,

authorising the government to overhaul its bankruptcy legislation which dates back to 1942. The reform, inter alia, promotes out-of-court agreements between debtors and creditors, simplifies bankruptcy procedures and introduces a pre-emptive mechanism for corporate insolvencies. A legislative decree to adopt the insolvency code has been recently approved by the Council of Ministers. A timely implementation of the decrees is important to accelerate the slow judiciary system for foreclosure procedures and collateral enforcement and to further boost the resilience of the banking sector.

Measures to accelerate out-of-court collateral enforcement have not progressed so far. The *Patto Marciano*, which is a private enforcement clause in credit agreements (adopted in 2016), has not been de facto used so far by banks neither in loan contracts with firms nor with households. The application of the *Patto Marciano* with firms has been further facilitated and promoted in a Memorandum of Understanding between the Italian Banking Association and Confindustria in February 2018. It will be important to monitor the impact of this memorandum in practice and remove any remaining legal uncertainty and take appropriate corrective action, where needed.

Access to finance*

Access to finance remains a barrier to investment in Italy. Firms' financing in Italy remains predominantly bank-based, while the capital market is still underdeveloped if compared to EU peers. The large share of NPLs (although significantly decreasing) and the traditional over-reliance of Italian firms on bank credit represented a drag on investment during the crisis. Though access to bank credit has improved in recent years on the back of declining interest rates and improved credit conditions, it remains subdued amid downside risks (see Section 1). At the same time, since the financial crisis, firms have reduced leverage, boosted equity and self-financing capacity, lowering overall credit demand. Having a more diversified financial system with deep and developed capital markets, an objective of the capital markets union, would complement bank financing and make Italy's financial system more resilient to shocks, especially in periods when the credit channel becomes impaired. Overall, while non-bank financing has been substantially boosted in recent years, it is still small relative to bank credit to firms (around EUR 700 billion in September 2018). Section 4.4.1 provides further details on the relationship between access to finance and investment.

Both demand and supply factors help to explain the low reliance on market-based financing. Demand factors include information asymmetries such as SMEs with often a low level of financial education (e.g. EIB, 2018), fear of losing control, or issuance costs and burdensome administrative requirements. Supply factors also play a role, as (innovative) SMEs tend to be smaller or riskier and often lack collateral when accessing credit markets (see e.g. Thum-Thysen et al., 2017, EIB, 2018). In addition, institutional investors, especially pension funds, but also insurance undertakings, tend to have low expertise in evaluating riskier firms (or those in their early stages) or have future commitments to their clients (for instance, on guaranteed products and their rates of return).

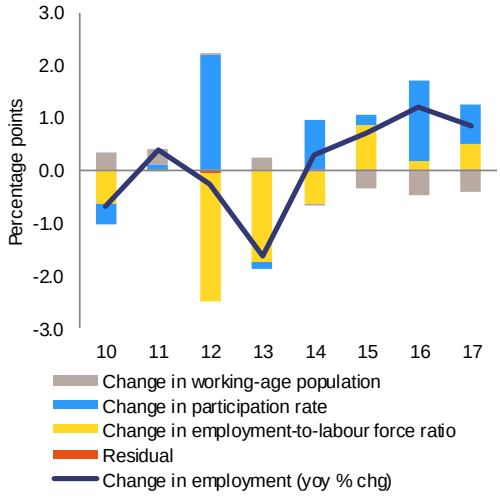
Several policy measures adopted in recent years are slowly bearing fruits. The SME Guarantee Fund, by facilitating SME access to credit, has overall guaranteed EUR 49 billion of loans during 2015-17. Related, the National Promotional Institute Cassa Depositi e Prestiti, through its diverse set of instruments, including securitisation of loans, has supported access to SME credit for EUR 7 billion during 2015-17. In terms of access to market financing, Minibonds (issued by unlisted companies) have been successful in raising EUR 15.6 billion for 200 companies during January 2012 - April 2018. Meanwhile, the alternative investment market, simplifying the Initial Public Offering process for SMEs, has garnered a market capitalisation of around EUR 7 billion by end-2017. Furthermore, long-term individual savings plans, introduced in 2016 to encourage SME investments, have raised EUR 16 billion by June 2018, although SMEs listed on the Milano benchmark stock market index account only for 40 % of total funds. The allowance for corporate equity has been abolished as part of the 2019 budget (see section 4.1). Private equity, including venture capital, plays only a marginal role The 2019 budget law introduced a fund for venture capital.

4.3. LABOUR MARKET, EDUCATION AND SOCIAL POLICIES

4.3.1. LABOUR MARKET*

Employment growth has been associated with a rising labour force. Past reforms that raised the effective retirement age increased labour supply, which was partly dampened by a shrinking working-age population (Graph 4.3.1). Activity rates have also been supported by rising labour demand due to the cyclical upswing, in particular following fiscal incentives for hiring and reforms that eased labour market regulations. The labour force increased by almost one million persons between 2008 and 2017, reflecting in particular higher participation rates of older workers and women. Notwithstanding recent improvements, the employment rate gap of the South to the national average was 14 pps. in Q3 2018. ([33]) Inactivity remains pervasive among women, the low-skilled and the young. ([34]) As a result of more people entering the labour market, the unemployment rate has fallen only slowly from its peak of 12.8 % in Q4 2014 to 10.3 % in Q3 2018.

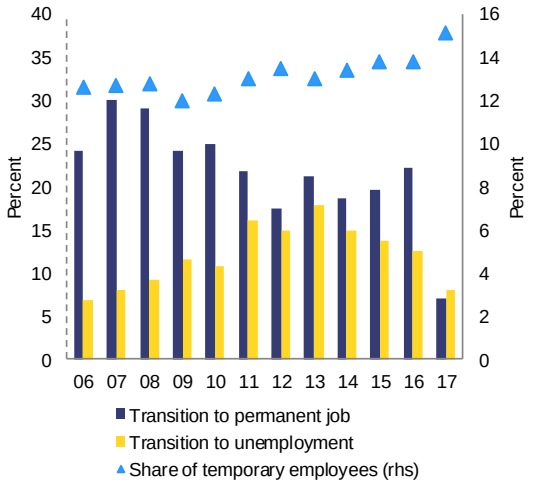
Graph 4.3.1: **Composition of the change of employment**



(1) The participation rate is defined as labour force divided by working age population (20-64 years).
Source: Eurostat.

Since 2017, employment growth has been based on temporary contracts. After the expiry of the hiring incentives at end-2016, temporary contracts have become the only driver of jobs growth. Between Q3 2017 and Q3 2018, temporary contracts grew by 11.6 %, while permanent jobs declined by 1.0 %. The median duration of temporary contracts is less than 12 months and the probability of a transition to a permanent post dropped substantially in 2017 after the end of the hiring incentives (Graph 4.3.2). Since 2008, the share of temporary employees (as percentage of the total number of employees, 20-64 years) has risen to 15.1 % in 2017, only briefly interrupted by the recession in 2012 and the hiring incentives for permanent jobs provided as part of the Jobs Act reform. The rise in temporary contracts and the associated higher job turnover reduces firms' incentive to invest in job specific training and the scope for workers' specialisation. Moreover, involuntary part-time remains widespread and around one third of involuntary part-timers are on a temporary contract.

Graph 4.3.2: **Transition rates of temporary employees**



Source: Eurostat.

In recent years, jobs growth appears to have become more responsive to output growth. This may be the result of recent labour market reforms, accompanied by generous fiscal incentives (Gorg et al, 2018) Employment is set to rise, once economic growth exceeds productivity growth. However, the employment rate at 63.1 % in Q3 2018 remains substantially below the EU average (73.2 %). Looking ahead, further improvements largely depend on the reduction of (structural) unemployment and rising activity rates. However, structural unemployment, measured by

([33]) Activity rates (age group 15-64) range from 75.3% in the Province of Bolzano to 52.0% in Sicily (Q1 2018).
([34]) Boeri at al. (2016) find evidence that the unanticipated increase of the retirement age at the end of 2011 (Fornero reform) has temporarily curbed youth hirings due to a lock-in effect of older workers.

the non-accelerating wage rate of unemployment, is projected to remain high, due to the prevailing mismatch between average workers' skills and the skills demanded by employers. The skill mismatch is exacerbated by the high youth unemployment, among the highest in the EU, which has a long-term negative impact on skills formation and future employability of young people.

The gender employment gap in Italy remains one of the highest in the EU. The employment rate of women (20-64) was substantially lower than the EU average (52.5 % against 66.4 %) in 2017. A high tax wedge for second earners reduces the financial incentive for women to take up work (the marginal tax rate for a second earner earning two thirds of the average wage is at 29.5 % in 2016). In addition, the lack of adequate measures to reconcile professional and private life such as care facilities tends to hamper employment, especially for women with dependent children or other family members in need of care. Only 28.6 % of children under three years of age is in formal early childhood education, well below the EU average. This situation is exacerbated by an inadequate system of parental leave. For example, parents on parental leave are only paid 30 % of their salary. However, the government extended the compulsory paternity leave from 4 to 5 days, increased the voucher amount for public childcare facilities and introduced priority to requests for flexible working hours by women and workers with children with disabilities.

The employment rate for non-EU born is around the EU average. The employment gap with respect to natives is very small. However, highly educated migrants are less likely to be employed than Italian peers (the employment rate is 17.6 pps lower) and almost three quarters of non-EU nationals (but less than 20 % of Italians) are formally overqualified for their job.

The government tightened labour market rules to curb the use of temporary contracts. The Law 96/2018 ("Decreto Dignità"), adopted in August 2018, has introduced regulatory changes in the Jobs Act. The law reduces the maximum duration of temporary contracts from 36 months to 24 months and requires employers to provide formal reasons to extend contracts beyond 12 months. ([35]) Otherwise, the contract is automatically converted into an open-ended one. ([36]) The new rules apply both to fixed-term and agency-work contracts. ([37]) The law also increases workers' compensation in case of unfair dismissals for open-ended contracts. ([38]) For the period 2019-20, existing incentives for hiring people under 30 are extended to persons aged 35 or less. Furthermore, on September 2018 the Constitutional Court abrogated any automatic link between the job tenure and the indemnity for unfair dismissal, giving more leeway to the assessment by judges.

Collective bargaining at firm or local level continues to play only a limited role. This is also due to the prevalence of small firms in Italy. In the period 2010-2016, the share of firms (with at least 20 employees) that adopted firm-level bargaining was stable at around 20 %. Incentives provided in the 2017 and 2018 Budget Laws were estimated to have a very small impact on net labour income and may be regressive in nature (Sestito, 2017). A stronger framework for collective bargaining at the firm or local level could support the efficient allocation of resources within and across firms, strengthen the link between wages and local economic conditions, and facilitate the adoption of innovative work practices at firm level (e.g. flexible working-time arrangements to support work-life balance or vocational training).

In February 2018, the main social partners signed a new framework agreement. This so-called *Patto per la Fabbrica* is intended to reform the collective bargaining framework, in particular by better measuring representativeness, also on the employers' side, and avoid uncoordinated decentralisation. ([39]) Over the last years, a rising

([35]) For example, significant and unexpected demand increases or seasonal peaks.

([36]) Additional provisions include the reduction of contract extensions from 5 to 4, the increase of the additional social security contribution paid by employers for the renewal of temporary contracts from 1.4% to 1.9%, and the re-reintroduction of voucher-based work in the agriculture and tourism sectors.

([37]) The latter are now considered in the quota of employees under temporary contracts per firm, while the threshold has been increased from 20% to 30% of total employees.

([38]) The law raises the maximum indemnity in case of unfair dismissal from 24 to 36 monthly salaries.

([39]) Agreements on rules and criteria to measure trade union representativeness, a prerequisite for fostering second-level bargaining, have been signed in recent years, but are not

number of firms and workers have signed contracts with recently formed associations. In June 2018, there were 871 registered contracts – representing an increase of 50 % since 2013 – of which more than 500 are considered "irregular" (i.e. including economic and working conditions below the standards set by the most common contracts). According to recent estimates in the services sector, those minor contracts entail a wage "penalty" compared to the most common wage contracts between 8 % and 20 % (D'Amuri and Nizzi, 2017). However, the criteria for representativeness still need to be defined and might require legislative action. The agreement also stresses the importance of developing collective bargaining on non-wage issues (including welfare benefits, training and skills, occupational safety, workers` involvement in firms' management). ([40]) The new framework agreement offers the possibility to deviate from the national or sectorial agreement only to the upside.

Undeclared work remains widespread in Italy. According to ISTAT estimates, the unobserved economy was worth about EUR 210 billion (12.4 % of GDP) in 2016. Around 37.2 % of it is attributable to undeclared work. The estimated share of undeclared work (as the percentage of total labour input) was 15.6 % in 2016. This mainly involves more vulnerable groups such as migrants, women and minors. The National Inspectorate Agency, operational since 2017 and created to avoid overlaps and increase effectiveness, registered an increase of 36 % in undeclared work in 2017 (253 000, up from 187 000). Housing and food services, construction, commerce and agriculture are particularly affected. In line with the previous year, almost 65 % of the inspected firms were found to be involved in irregular employment practices. The inspected firms were selected among those with the highest risk of irregularity. The Agency focused particularly on the phenomenon of "caporalato" in the agriculture sector, characterised by a high incidence of irregularity and by a risk of labour exploitation, especially for irregular migrants. ([41]) With the establishment of an institutional group in October 2018, the actions against this phenomenon were extended to the entire national territory. From a regional perspective, the Agency imposed most of the fines in Campania, Puglia and Lazio. Exchanging data between different agencies ([42]) and investment in human resources would improve the overall performance of the new Agency. The 2019 budget law envisages a recruitment plan of almost 1 000 inspectors for 2019-2021.

The implementation of reforms of active labour market policies is proceeding only slowly. Despite new steps to strengthen public employment services and reduce regional disparities, active labour market policies are barely integrated and coordinated with related policies (e.g. social protection, social services, adult learning, and vocational training). Major competences lie with regional authorities, which received new resources in 2018 to reinforce public employment services. However, the recruitment of new staff has not yet started. A further comprehensive reform of the system is also envisaged to implement the activation component of the citizenship income scheme, with a maximum of EUR 1 billion for each year in 2019 and 2020 allocated by the 2019 Budget Law.

Investment in staff is crucial to improve the quality of the public employment services. Monitoring indicators and minimum standards were set at the national level by Decree in January 2018, but strengthening coordination between the national agency (ANPAL) and regions remains a major challenge. Following the 2019 budget law and the Decree on the Citizen Income, public employment services are being linked through a newly developed national IT system. Beneficiaries of the citizenship income scheme will be supported in their job search by specialised staff ("navigator"). Beneficiaries will also receive the re-placement voucher, with the aim of increasing its take up that has been very limited so far. The

operational yet. For more information, see European Commission (2018b).

([40]) The notion of "second-level agreement" refers to agreements signed either at firm- or territorial level (i.e., by a firms located in the same territory) hierarchically subordinated to a certain nationwide sectoral agreement (which represents the "first level" of bargaining).

([41]) According to INPS data, in the agriculture sector one third of workers hired in 2016 were immigrants and 70% of them were employed less than 51 working days (the minimum number to claim access to social security benefits).

([42]) INPS, INAIL - Istituto Nazionale per l'Assicurazione contro gli Infortuni sul Lavoro e le malattie professionali, and Ministry of Labour.

information provided to nonregistered people has been improved, as well as the on-line registration of jobseekers and the set-up of single points of contact for the long-term unemployed. For the latter, a national strategy for their integration into the labour market has been adopted in December 2018. Further efforts are needed to improve the case management and the provision of individual assessment plans based on effective cooperation among relevant services (including social, health and training). The development of a qualitative profiling tool, which will complement the existing statistical profiling methodology, is a good step in this direction. Unioncamere plans to conduct surveys and share the results with ANPAL, to provide users and operators with information on the forecast of companies' vacancies and training needs. But the envisaged cooperation with employers has not yet started.

The Youth Guarantee scheme is supporting an increasing number of young people. Since its launch in 2014, 1.4 million young people have registered, out of which 53% have received support through activation measures. However, large discrepancies persist across regions, with 45 % of the young covered by the scheme in the South compared to 71.1 % in the North-West. Traineeships are by far the most common provided measure. Their potential substitution effects and their impact on labour market segmentation should be further monitored. The share of young people neither in employment, education or training covered is still low (14.1 %), but new outreach measures are being rolled out, including a better linkage with social assistance beneficiaries, e.g. people with disabilities. The share of young people in the programme who have not received any offer for more than 4 months remains high (83 %). The European Social Fund supports the roll-out of new measures addressed to young people, with a particular emphasis on southern regions. ([43])

4.3.2. EDUCATION AND SKILLS*

Investment in education and skills formation are crucial to promote a smart, inclusive and sustainable growth. Italy's sluggish productivity trend is partly due to the ineffective skills' formation system and the related weak demand for high skills. The early school leaving rate remains above EU average (14 % vs 10.6 % in 2017). Despite some timid improvements, Italian students and adults are still amongst the worst performer in the EU in key competences and basic skills (see European Commission 2018b). Italy has also one of the lowest tertiary educational attainment rates for 30- to 34-year-olds in the EU (26.9 % compared to 39.9 % EU average in 2017). This couples with one of the lowest general government expenditure in the EU as a proportion of GDP (3.9 % for Italy and 4.7 % for the EU in 2016).

Primary and secondary education

Despite recent improvements in the quality of schooling, wide and persisting regional gaps in learning outcomes remain a major concern. According to 2018 national test results, the number of low achievers is significantly higher in the South than the North (in grade 8: 45 % vs 28 % in Italian, 67 % vs 27-30 % in English, 54-56 % vs 28-32 % in mathematics). Especially in the South, the significant differences in results between and within schools may indicate a tendency to group students according to their ability. The South and the Islands register also the highest early school leaving rates (17.3 % and 21 % respectively, compared to a national data: 14 % and the EU average: 10.6 %). The early school leaving rate for people with disabilities is higher than the EU average (30.2 % vs 23.6 %).

The educational attainment of non-Italian students' lags significantly behind that of Italians. Non-Italian students made up 9.4 % of the school population in the school year 2016/17. The majority (61 %) was born in Italy. Compared to Italian students, foreign students are at higher risk of grade repetition (31.3 % vs 10 %) and early school leaving (30.1 % vs 12 %). They also show lower enrolment rates of boys compared to girls, especially after grade 10 (MIUR 2018). So far, no policy action has been adopted or discussed to reduce differences of attainment with Italian students.

Attracting, effectively recruiting and motivating teachers is key but challenging. While the share of funding allocated to primary and secondary

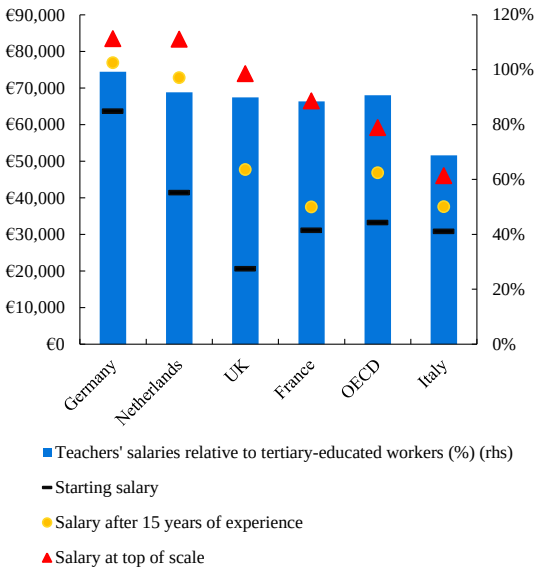
([43]) Axis 1bis of the National Operational Programme for the implementation of the Youth Employment Initiative (YEI) in Italy is only funded with ESF resources and it is addressed to young people other than NEETs in less developed and in transition regions.

education is broadly in line with the EU average, learning outcomes could be negatively affected by the management of teachers and their working conditions. Italian teachers' salaries remain low compared to international standards and relative to tertiary-educated workers. Salary progressions are also significantly slower than international peers (maximum salary achieved after 35 years in Italy, with 25 years being the OECD average). This combines with limited career prospects, based on a single career pathway, and is exclusively based on seniority rather than merit (Graph 4.3.3). In addition, surveys show that both the general public and teachers themselves have a low opinion of the status of the teaching profession. ([44]) The new government announced a revision of the recruitment and training system introduced by the 2015 school reform (European Commission 2017a). The new system would return to knowledge-based open competitions, with the training component reduced from three to one-year on-the-job training. This might pose additional challenges in selecting motivated and skilled teachers. The backtracking of the reform would also limit the possibility for school principals to reward teachers based on merit. The dedicated fund *(Fondo per la valorizzazione del merito*) will be merged into a single fund (*Fondo per il miglioramento dell'offerta formativa*) to be disbursed uniformly through negotiations with trade union.

Following reforms adopted over recent years, the apprenticeship system is gaining momentum. However, the recently adopted system of work-based learning was significantly scaled down, both in terms of mandatory number of hours and of funding (cut by almost 60 %). The employability of recent Vocational Educational Training graduates is slowly increasing, to 50.8 % in 2017 (below the EU average of 76.6 %). Employers' involvement in work-based learning has been strengthened through agreements between public authorities and businesses and fiscal incentives. Social Partners remain important for shaping occupational apprenticeships in manufacturing by collectively agreeing on the definition of occupational profiles.

([44]) OECD 2014 - TALIS 2013 Results: An International Perspective on Teaching and Learning, Paris: OECD Publishing

Graph 4.3.3: **Motivating Teachers - salary and career progression indicators, 2017**



Source: Education at a Glance 2018, OECD

Tertiary education

Tertiary educational attainment rates remain low and the educational outcomes are poor. The share of university graduates is slowly but steadily increasing, a trend confirmed by the increase of 4.3 % in enrolments in 2017. Tertiary educational attainment of people with disabilities is also very low (23 % vs. the EU average of 30.3 %). Moreover, even when graduated, adults have among the lowest average literacy and numeracy scores compared with peer countries (ranking 26th out of 29 countries in both dimensions) (OECD, 2016). As a consequence skills shortage and mismatches are pervasive. The employment rate of recent graduates is increasing but remains well below the EU average (in 2017, 54.5 % compared to the EU average of 81.5 % for the age group 25-29). The low demand for tertiary graduates from the productive sector contributes to poor employment prospects, as companies tend to privilege candidates with previous work experience. Moreover, on average, the wage premium for graduated students is lower than in peer countries (41.2 % in Italy vs 66.3 % in Germany and 54.4 % in France). ([45]) This might suggest a low return on education and may discourage tertiary educational attainment.

([45]) Almalaurea 2018 and OECD data

Despite better employability rates, the non-academic tertiary education remains limited in scope. The Employment rate of graduates from tertiary vocational education institutes (*Istituti Tecnici Superiori*) is above 80 % (INDIRE 2018) after one year. However, they account for less than 1 % of all students in tertiary education (OECD average of 18 % (OECD 2017b) and are concentrated in the most industrialised regions of Italy. Moreover, according to INDIRE 2018, female participation is very low (under 25 %).

The higher education system is under-financed and under-staffed, especially in Southern regions. Total funding for higher education remains one of the lowest in the EU at just 0.3 % of GDP in 2016 (EU average 0.7 %). It was increased by 5 % in 2018 (from EUR 6.981 billion in 2017 to EUR 7.327 billion in 2018). However, most of the increase was devoted to specific initiatives (e.g. "excellent departments"). The proportion of performance-related funding (*quota premiale*) rose to 24 % of available resources, but it was compensated by a decrease in the allocations based on standard costs (22 %), while the fund designed to compensate universities with fewer resources remained unchanged at 2 %. Overall, the average amount of resources at the disposal of universities remained substantially unchanged and subdued. Consequently, the financial burden on students and their families has increased. Enrolment in university remains relatively low. Tuition fees have steadily increased and are now among the highest in the EU (OECD, 2017c), while student support has remained limited (only 11.6 % of students received grants in 2017). Limited funding also impacts directly on the quality and quantity of the faculties.

Funding measures are limited and discontinuous. Special recruitment initiatives ("*cattedre Natta") and dedicated funds* ("*Fondo di finanziamento attività base di ricerca*") have been abolished or discontinuously activated. However, the 2019 budget law provides funding for 1 600 additional tenure tracks for assistant professors (*ricercatore a tempo determinato di tipo B*) and 900 medical specialisation places. Moreover, the Impresa 4.0 plan includes the objective of the strengthening of tertiary vocational education institutes (ITS), but results are still to come. As of 2018, new university-track tertiary professional education pathways (*Lauree Professionalizzanti*) have been introduced alongside the ITS.

Adult learning and digital skills

Adult participation in learning is very limited. In 2017 the participation rate in any form of training for both adults and low-skilled adults decreased compared to 2016, respectively from 8.3 % to 7.9 % and from 2.3 % to 2 % (Eurostat). The employment gap between high- and low-skilled is among the highest in the EU and employment prospects for low-skilled workers are deteriorating further. Upskilling is particularly needed for digital skills: only 44 % of the Italian population possessed at least basic digital skills in 2016 (56 % in the EU). The role of firms in increasing training participation and digital skills is pivotal but still limited. The social partners' agreement of March 2018 may contribute to tackle this challenge.

Measures to boost adult learning and digital skills are discontinuous and not comprehensive. There are currently 19 joint inter-professional funds to support the development of continuous training. The 2019 Budget Law extended the tax credit introduced in 2017 for companies investing in training. ([46]) The *'Percorsi di Garanzia delle Competenze'* (Skills Guarantee pathways) for low skilled adults need enhanced capacity building, particularly in guidance and validation, to increase low-skilled adults take up. On digital skills, the National Plan for Digital Education was launched in 2015 with modest results. ([47]) However, these measures do not target categories at risk of social exclusion such as elderly and inactive people.

4.3.3. SOCIAL POLICIES AND DEMOGRAPHY

Poverty risk and income inequality remain high. In 2017, the share of people at risk of poverty or social exclusion (AROPE) declined to 28.9 % from 30.0 % in 2016. However, it remains well above both pre-crisis levels (25.5 % in 2008)

([46]) This amounts between 30 % and 50 % (depending on firms' size) of the cost of employees for the period of training activities. Eligible training activities are those targeted in the Impresa 4.0 Plan.

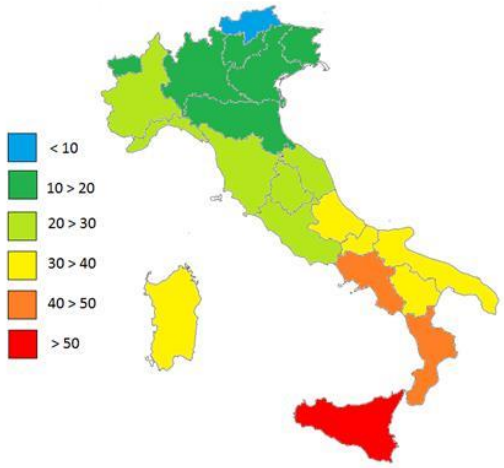
([47]) Only 20 % of teachers has ever followed training on digital literacy and still 24 % of schools have not started yet any coding courses.

and the EU average (22.4 %). Children, especially with a migrant background, are particularly at risk of poverty or social exclusion (32.1 % in 2017 down from 33.2 % in 2016). Moreover, poverty in urban areas is increasing. Income inequality in Italy is above the EU average (see section 1). **([48])** While the Italian income tax system is among the most progressive in the EU, the redistributive role of social transfers is weak. The impact of social transfers (excluding pensions) on poverty and inequality reduction was one of the lowest in the EU in 2017. Social spending is strongly biased towards old-age pensions, which largely depend on income. The distribution of wealth remains relatively even in Italy, due to high rates of home ownership.

Within the EU, Italy shows the biggest regional differences in poverty and social exclusion. The social situation mirrors the divergence in per-capita income across regions. Both the EU regions with the lowest and highest rates of AROPE are in Italy (Bolzano at 8.5 % and Sicily at 52.1 %). While the main divide is between the North and the South, central regions have seen their AROPE rates constantly rising from 18.6 % in 2008 to 25.3 % in 2017. By contrast, southern regions have only seen some minor improvements (from 44.7 % to 42.3 %).

High average pension replacement rates mask large differences at individual level. Adequacy measured by pensions' capacity to replace earned income before retirement is generally high, but their ability to prevent and mitigate the risk of poverty is low. In 2016, the ratio between the median disposable income of people older than 65 and those younger than 65 years was 100 percent, against 92 percent for the EU average. However, despite the overall high pension expenditure (corresponding to 16.2 % of GDP (EU: 12.6 %) and one third of primary public expenditure in 2016) ([49]), the provision for old age is uneven. The pension system performs the income maintenance function while protection against poverty is inadequate, and tight eligibility conditions include regressive clauses. The 2016 pension reform aimed to facilitate early retirement for some worker categories through so-called APE (Anticipo finanziario a garanzia pensionistica) and raising lower pension incomes (European Commission 2018c).

Graph 4.3.4: **Percentage at risk of poverty or social exclusion by NUTS 2 Region (2017)**



Source: Eurostat.

Despite improvements in the labour market, in-work poverty is rising. In 2017, the number of employed persons facing the risk of poverty rose to 12.2 %. The share of the working poor on temporary contracts is relatively high and increasing (22.5% against EU average of 16.3%). Moreover, the rate of in-work poverty for non-EU born workers is extremely high (32 % in 2017).

Access to social protection for self-employed workers is limited. Italy has the second highest rate of self-employment in the EU (20.8 % in 2017 against 13.7 % EU average). Yet, self-employed are not formally entitled to unemployment benefits and in some cases are not formally coverage by sickness benefits. Overall, the self-employed are generally less protected against social risks than employees. Moreover, self-employed cannot opt for voluntary schemes for unemployment benefits. Additionally, a regulatory framework for working conditions and social protection for platform workers is still missing. ([50])

([48]) Income quintile share ratio (S80/S20), stood at 5.9 in 2017, against the EU average of 5.1. The Gini index stood at 32.7 in 2017 against 30.3 on average in the EU. The higher the coefficient is, the less equal is the income distribution.

([49]) See Centro Studi e Ricerche di Itinerari Previdenziali (2018).

([50]) Platform work is an employment form in which organisations or individuals use an online platform to provide specific services in exchange for payment.

The government has introduced a reformed minimum income scheme, starting from April 2019. The 'Citizenship Income' (*Reddito di cittadinanza*) will replace the REI (*Reddito d'inclusione*). According to the decree law, the new scheme, provided for 18 months with the possibility of renewal, will target households (including pensioners) with an *Indicator of the Equivalent Economic Situation* lower than EUR 9 360 and residing in Italy for at least 10 years. The Citizenship Income will be one of the most generous income-support schemes in the EU. ([51]) The scheme will keep the previous system's active inclusion approach, complemented by conditionality rules. ([52]) According to the budget law, a new fund (Fund for the citizenship income), with a yearly budget of EUR 7.1 billion for 2019 and about 8 billion as of 2020, will finance the scheme, partly strengthen public employment services and implementation of the activation component of the reform. However, the scheme may prove difficult to implement and may put a considerable burden on the public administration. Two digital platforms will support the National Social Security Institute, public employment services and municipalities' social services to better coordinate and deliver personalised services. The actual impact on employment will depend on the effectiveness of activation policies and controls.

Access to affordable and adequate housing remains challenging. While only 4 % of the population have access to housing with a subsidised rent, 28.2 % of tenants who pay rents at market prices were overburdened by housing costs in 2017 (EU average: 25.2 %). The severe housing deprivation rate, albeit on a declining trend, stood at 11.1 % in 2016, compared with a EU average of 5.6 %. ([53]) The public and social housing stock in Italy is among the lowest in the EU (only 4 % of the housing stock is owned by the public sector). Dwellings are often in a precarious condition and declared unfit for habitation. Housing needs were exacerbated by the economic crisis. Since 2015, following the depletion of the National Fund to support low-income tenants, new funds were introduced, targeted to indebted households. ([54])

The provision and coordination of social services remains underdeveloped. Besides efforts to improve early childhood education and childcare, Italian authorities embraced an active inclusion approach, when the REI was introduced in 2018 (i.e. linking employment services with income support). According to the 2019 budget law, funds for dependent persons, persons with severe disabilities without family support and for family caregivers will be increased. However, people with disabilities and other disadvantaged groups in many cases do not receive adequate support as home and community-based care as well as long-term care services face challenges in terms of funding, access and quality (European Commission 2018b, p. 40).

The outcome of the health system is overall good, despite below-EU average spending. ([55]) In 2017 Italy spent only 8.9 % of GDP on overall health care, of which relatively more on prevention and less on administrative costs than the EU average (9.6 %). Government spending is slightly declining and remains biased towards hospital spending, at the expense of primary care. Self-reported unmet needs for medical care decreased markedly from 7.2 % in 2015 to 1.8 % in 2017. However, out-of-pocket expenditure on health care (23.1 % of total health expenditure) is above the EU average and increasing. Expenditure on retail pharmaceuticals per capita is above the EU

([51]) Based on a comparison with the level of benefits across the EU as a share of the poverty threshold, as used in the Minimum income benchmarking framework. For details, see European Commission (2018d).

([52]) The beneficiary has to sign an agreement with the public employment services (Patto per il lavoro) including training obligations and the acceptance of one of the first two suitable job offers not far away from the worker's place of residence, while the third offer could be anywhere in the national territory. In case the needs of the households are more complex and multidimensional, the beneficiaries of the measure subscribe a social inclusion agreement (Patto per l'Inclusione Sociale) involving territorial and social services.

([53]) The severe housing deprivation rate is defined as the percentage of the population living in a dwelling which is considered as overcrowded, while also exhibiting at least one of the housing deprivation measures such as a leaking roof, no bath/shower and no indoor toilet, or a dwelling considered too dark.

([54]) Additional resources are also dedicated to support homeless people within the PON Inclusione under the ESF (EUR 25 million) as well as under the FEAD (EUR 25 million; nevertheless, the social housing system is characterised by limited investment and lack of coordination between government levels.

([55]) Life expectancy at birth is the second highest and the preventable death rate is the lowest in the EU.

average but the market share of generics remains one of the lowest in EU, with no effective policy action taken in recent years. The number of doctors is slightly above the EU average but their age is increasing, pointing to potential shortages in the medium-term. The nurse-to-doctor ratio remains below the EU average. Over recent years, there has been a slight move away from institutional long-term care towards home care.

The uneven provision of healthcare across regions can affect access, equity and efficiency. The number of individuals in the South declaring unmet healthcare needs is almost twice as high as in the North. In principle, the central government sets a list of standard health care goods and services available to the population through public funding, which is allocated according to demographic factors, while regions are free to provide additional services. However, the relative costs of this extra provision must be covered through the regions' own financial resources. Co-payments are commonly applied to citizens for some health care services and they may vary across regions. ([56]) Waiting lists and travel distances are also higher in Southern regions. Patients are allowed to obtain hospital care (specialist consultation and hospital surgery) in other regions and there is a system of interregional expenditure compensation. The interregional mobility is intended to promote the right to choose health care treatments and thus improve access. However, the mobility from less to more efficient regions may potentially entrench and aggravate disparities.

Demographic trends and migration

Demographic trends point to a decline of working-age population in the medium term. Current policies to sustain demographic trends are mainly based on bonus transfers and tax credits and no evaluation or impact assessment has been carried out or is envisaged. Investment in care services, generally more effective in supporting natality rates and labour market participation of women, remain subdued. Similarly, measures to promote equal opportunities and adequate work-life balance policies are fragmented and limited in scope (see 2018 Country Report).

The migration balance, although positive, is not compensating the natural balance loss. In 2018, inflows amounted to around 349 000 (+1.7 % compared to 2017), while the number of residents leaving the country further increased from very high levels (around 160 000. 3.1 % more than in 2017). The latter includes a large number of high-skilled young Italians moving to other EU countries. In 2016, the number of Italian graduates leaving the country increased by 9 % compared to 2015. The draft budget Law 2019 focuses on re-attracting emigrated highly skilled students to Italy [to be updated/integrated on brain drain]. However, the structural challenges pushing graduates to emigrate remain unaddressed. Finally, the integration of migrants, especially refugees, remains challenging. Asylum applications decreased in 2018 but no significant progress has been made in implementing the first National Plan for the Integration of Beneficiaries of International Protection adopted in 2017 and the budget allocation for reception facilities of asylum seekers has been reduced. Additionally, the social impact of the recent Law on immigration and security (*Decreto Sicurezza*) ([57]) needs to be monitored.

Investment needs

Increasing investment to foster labour market participation and skills is vital for raising productivity and long-term inclusive growth. Further investment in active labour market policies could promote labour market participation which remains very low, especially for women and young people. Increasing investment in child and long term care is also crucial, paying attention to geographical disparities in the availability of services. Investing in active inclusion would support the reach out to people at risk of poverty or social exclusion, including children and working poor. The education and training system is characterised by wide regional differences in terms of infrastructures and outcomes. Adequate investment to foster quality, inclusiveness and labour market relevance of education and training, as well as upskilling and reskilling for adults, is crucial to promote equality of opportunities and foster long-term growth.

([56]) Co-payments are commonly applied to citizens for outpatient specialist visits with general practitioner (GP) referral diagnostic services, reimbursed medicines and unwarranted use of emergency services, whereas primary care and hospital inpatient care are free at the point of use.

([57]) Law n.132/2018

Box 4.3.1: Monitoring performance in the light of the European Pillar of Social Rights

The European Pillar of Social Rights is designed as a compass for a renewed process of upward convergence towards better working and living conditions in the European Union.[1] It sets out twenty essential principles and rights in the areas of equal opportunities and access to the labour market; fair working conditions; and social protection and inclusion. The analysis in the Country Report has been carried out in light of the Pillar principles.

SOCIAL SCOREBOARD FOR ITALY		
Equal opportunities and access to the labour market	Early leavers from education and training (% of population aged 18-24)	Critical situation
	Gender employment gap	Critical situation
	Income quintile ratio (S80/S20)	Weak but improving
	At risk of poverty or social exclusion (in %)	To watch
	Youth NEET (% of total population aged 15-24)	Critical situation
Dynamic labour markets and fair working conditions	Employment rate (% population aged 20-64)	Critical situation
	Unemployment rate (% population aged 15-74)	To watch
	Long-term unemployment rate (% population aged 15-74)	Critical situation
	GDHI per capita growth	To watch
	Net earnings of a full-time average single worker earning AW	On average
Social protection and inclusion	Impact of social transfers (other than pensions) on poverty reduction	Critical situation
	Children aged less than 3 years in formal childcare	On average
	Self-reported unmet need for medical care	Better than average
	Individuals' level of digital skills	N/A

Members States are classified according to a statistical methodology agreed with the EMCO and SPC Committees. The methodology looks jointly at levels and changes of the indicators in comparison with the respective EU averages and classifies Member States in seven categories (from "best performers" to "critical situations"). For instance, a country can be flagged as "better than average" if the level of the indicator is close to EU average, but it is improving fast. For methodological details, please consult the draft Joint Employment Report 2019, COM(2018)761 final.
NEET: neither in employment nor in education or training; GDHI: gross disposable household income.

Italy faces challenges on many indicators of the Social Scoreboard supporting the European Pillar of Social Rights. Labour market conditions are only slowly improving and the persistently high unemployment had a strong impact on the social situation. Youth unemployment, as well as the NEET rate, remain among the highest in the EU. The gender gap is extremely high, but a comprehensive strategy to promote participation of women in the labour market is still missing. The impact of social transfers on poverty reduction is limited and the share of people at risk of poverty or social exclusion remains very high. To tackle this issue, an anti-poverty scheme was introduced in 2018 and will be strengthened in 2019.

In addition to these challenges, access to social housing is extremely limited. The social housing system is affected by limited funding, difficult coordination between different government levels and lack of strategic overview. Italy has one of the lowest stocks of social and public housing in Europe, in a context of growing housing needs. Only 4% of the population has access to subsidised rent and all available indicators reveal high and increasing housing related hardship. Access to social housing is almost precluded to younger generations, since occupants tend to remain in social housing for their entire lives. The situation is also worrying for children (9.4% live in a household with a housing cost overburden). Chronic homelessness is also on the rise.

Setting clear rules on the representativeness of social partners is key to put in place a fair and transparent second level bargaining framework. The *Patto per la Fabbrica* (March 2018) is a first but important step in that direction (see chapter 4.3.1). In recent months, important collective agreements were signed for the chemical and construction sectors, including innovations in line with the principles set in this Agreement. Furthermore, in June 2018 INPS and CNEL agreed to create a joint repository of all collective contracts signed in Italy. This is another positive step, which could help tackling the phenomenon of minor contracts setting wages and working conditions below the standards set by the major contracts.

[1] The European Pillar of Social Rights was proclaimed on 17 November 2017 by the European Parliament, the Council and the European Commission: https://ec.europa.eu/commission/priorities/deeper-and-fairer-economic-and-monetary-union/european-pillar-social-rights/european-pillar-social-rights-20-principles_en

4.4. COMPETITIVENESS AND INVESTMENT

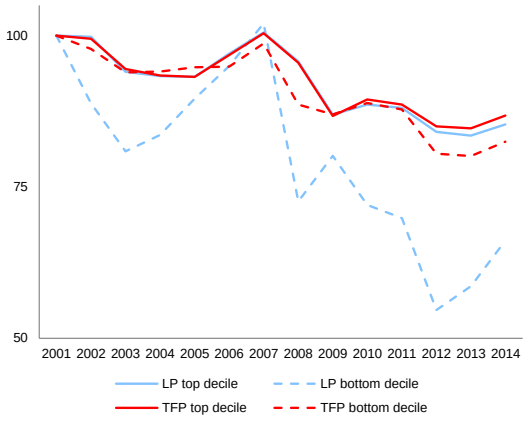
4.4.1. INVESTMENT AND PRODUCTIVITY*

Structural factors continue to hold back Italy's productivity dynamics, limiting the potential to improve non-price competitiveness and GDP growth. The productivity growth gap between Italy and the rest of the EU remains large (Section 1), especially when comparing the South (Section 4.4.3). The underperformance of Italy's aggregate productivity hides a considerable heterogeneity across firms. It is linked to low levels of investment and innovation, as well as weak competition in several sectors (Section 4.4.2), weaknesses in the institutional and administrative framework and a challenging business environment (Section 4.4.4). Following the 2016 Council Recommendation, Italy is planning on appointing a National Productivity Board. ([58])

Aggregate productivity growth is limited by the greater importance of smaller firms and their lower productivity compared to peer countries. In Italy, the lower productivity of micro firms with respect to larger ones (Costa *et al*., *forthcoming*; Bugamelli *et al*, 2018) is amplified by their larger contribution to value added (29 % with respect to 20.7 % in the EU) and jobs (46 % with respect to 29.4 %) (European Commission 2018f). Italian micro and small firms are less productive than in peer countries, even accounting for the specialisation in traditional sectors. This is also due to the quantitative and qualitative shortage of human capital, a vulnerable financial structure and the large weight of firms mostly family-managed, where the recruitment of external managers is limited (Bugamelli *et al*., 2018). The productivity of medium and large firms is in line with peer countries, but their weight is smaller (respectively, 0.5% and less than 0.1 % compared to 0.9% and 0.2 % in the EU).

The adoption of productivity enhancing strategies by smaller firms is limited in Italy. About one out of two Italian firms does not innovate ([59]), with only 20% of strong innovators in manufacturing and 12% in services. This despite the fact that process and organisational innovation, particularly relevant for smaller firms and traditional sectors (Istat, 2018b), as well as product innovation, enhance productivity, even of small firms. The ability of smaller firms to benefit from synergies along the value chain, following innovative investment, is limited by the high degree of vertical fragmentation of the Italian production chain and the low degree of formal cooperation among firms (Istat, 2018b; Bugamelli *et al*. 2018; Confindustria, 2018a; Del Gatto *et al.*, *forthcoming*). This results in a polarization between many micro and small firms with limited resources, skills, propensity to export to foreign markets and innovation and few larger, highly innovative, productive firms active in international markets (Bugamelli *et al.*, 2018). Low innovation also implies slower transition to a green economy ([60]). These features makes smaller firms particularly vulnerable to external shocks and contributes to explaining the widening of productivity heterogeneity across firms during the crisis (Graph 4.4.1).

Graph 4.4.1: **Heterogeneity in firm-level productivity in Italy (2001=100)**



Source: CompNET

The weak dynamics of knowledge intensive sectors limit productivity prospects in the medium-long term. The share of value added in knowledge intensive sectors is low. Moreover, this share is stagnant in high-tech and medium-high tech manufacturing (the latter going back to pre-crisis level only in 2017) and even declining in high-tech knowledge intensive services (from 4.6% in 2007 to 4.2% in 2016). Labour

([58]) National Productivity Boards are objective, neutral and independent institutions that can investigate the productivity challenges, contributing to evidence-based policy making, boosting domestic ownership of structural reforms.

([59]) Based on the 2014 Community Innovation Survey.

([60]) Only 16% of Italian firms offer green products or services compared to 25% in the EU.

productivity in market services decreased by 5% since 2000, while their contribution to added value increased (by 2.5 pps). Labour productivity growth remains concentrated in manufacturing (+20%), whose contribution to added value, instead, declined.

Weak productivity growth is also linked to low private and public investments. The investment gap between Italy and the euro area has almost doubled since the crisis. The composition remains skewed towards investments by households and manufacturing at the expense of businesses and professional services. Private investment represented 15.7 % of GDP in 2017, still 3 pps. below its pre-crisis level and 2.5 pps. below the euro area average. However, the slight acceleration of private investment in 2017 reduced the gap *vis-à-vis* the euro area. Public investment has steadily decreased from 3 % of GDP in 2008 to 2 % in 2017. ([61])

The improvement of structural factors is key to increase investment and productivity. Long-term barriers to investment are more significant in Italy than in peer countries (EIB, 2018; Barbku et al., 2015). Beyond and interlinked with the importance of smaller firms and the low specialisation of the Italian economy in knowledge-intensive sectors, other factors hinder investments. Econometric analyses (Briguglio *et al*, *forthcoming*) show that restricted bank credit, tax burden on corporations and under-education are major barriers to investment, while increasing corporate self-financing and equity, an improved business environment (Section 4.4.4) and higher education represent a driver of investment. While public investment might indirectly worsen financing conditions, it can crowd-in private investment (Graph 4.4.2), by creating favourable conditions, for instance through the promotion of relevant infrastructure (e.g. research, transport, energy). However, a proper design and effective delivery of public investment are essential to this aim.

While market-based access to finance is a key driver of investment, policy support is partially waning. The capitalisation of non-financial business remains low and the abolition of the Allowance for Corporate Equity may reduce firms' incentives to use equity financing (Section 4.1). The over-reliance of Italian firms on banks coupled with restricted credit due to the large share of NPLs (Section 4.2), represents a drag on investment, while non-bank access to finance is a key driver, especially for intangibles (Graph 4.4.2). Demand side factors also play a role in explaining restricted credit (Angelini, 2018). Although less than 20 % of small firms declared that the SME Guarantee Fund has been effective in stimulating investment in 2017 (Istat, 2018b), the impact of measures supporting both bank and market-based finance has been generally positive (Section 4.2).

Tax incentives lowering the corporate tax burden have been conducive to investment. During the crisis, the effective corporate tax burden contributed to slow private investments (Graph 4.4.2). The super-depreciation (*Superammortamento*) on physical capital investment of the Impresa 4.0 Plan, instead, contributed to the recovery of investment in machinery and other equipment recorded in 2017. This temporary measure will not be extended, but a new structural tax rebate on reinvested profits have been introduced as of 2019 (Section 4.1).

Public schemes supporting innovative investment remain temporary and still lack an in-depth assessment of their efficiency. R&D tax incentives generally have a positive but modest effect on investment in intangibles (Graph 4.4.2). While an evaluation of the Impresa 4.0 package is not available yet, provisional data suggest it has been effective in stimulating investment decisions in 2017. The deduction of 250 % of investment in innovative technologies (*Iperammortamento*), including ICT, and the R&D tax credit were considered rather effective in stimulating investment decisions in 2017 by almost 50 % of firms, especially by larger ones (Istat, 2018b). According to Italian authorities, the R&D tax credit was largely taken up by firms in industrial sectors and only marginally by firms in the service sector, where productivity is especially lagging behind. Both *Iperammortamento* and the R&D tax credit are extended to 2019, but will be reduced on average, particularly for larger investment. Most of these measures remain temporary and unstable in a context in which 84% of Italian firms consider

([61]) Peer countries like Spain and Germany have a similar level (2% of GDP and 2.2%, respectively), while in France public investment is considerably higher (3.4%). The euro area average is 2.6% of GDP.

uncertainty about the future as an obstacle to investment decisions (EIB, 2018). Making permanent some of these measures based on an in-depth assessment would enhance their impact, including by easing firms' investment planning. Targeting investment in specific research areas can be more effectively achieved through direct public support (Nascia *et al*., 2018).

There is a need for adequate investments in human capital, innovation and strengthened administrative capacity and to reduce regional disparities across sectors. Investment in higher education and skills (Section 4.3) is pre-requisite for boosting public and private investment. Investing in innovation and supporting small firms' efficiency would enhance productivity. Improving the administrative capacity is a pre-condition for the effective delivery of public investment and use of EU funds. This could strengthen the impact of investments in broadband, transport, water management and in the circular economy, where the South is particularly lagging behind. Addressing the drivers of lower productivity of laggard regions and integrating environmental considerations in sectoral investments would contribute to long-run growth in an inclusive and sustainable economy.

Investment in human capital is needed also to counter Italy's slows transition to a knowledge-based economy. While the availability of human capital is significantly and positively correlated with the number of innovative start-ups (UPM, 2018), the expenditure for tertiary graduates is low (Section 4.3), hampering innovation and productivity growth. The situation is worse in those fields relevant for innovation, as shown by the lower share of graduates with respect to the EU in fields such as computing (0.6% against 2.5% in 2016), science and engineering (12.2% against 15.5%). There is a need to boost studies in these fields and to strengthen specific skills, such as financial skills, including through on-the-job training.

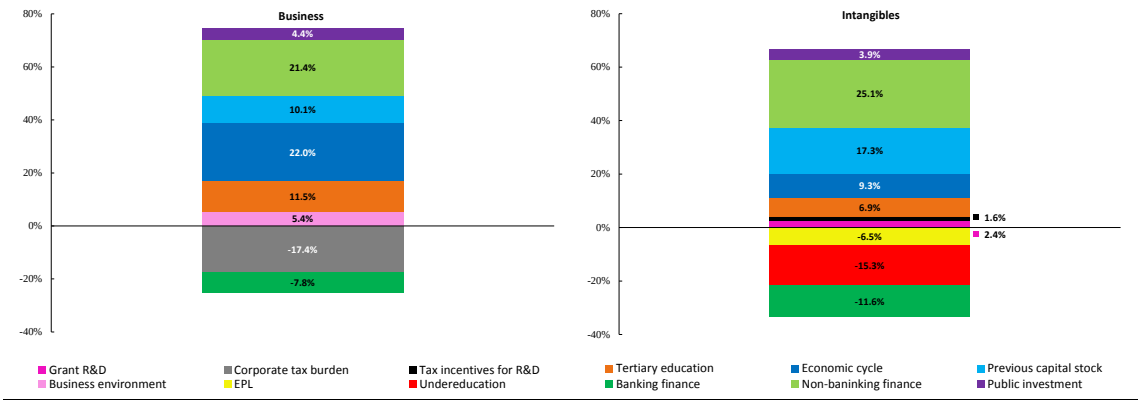
A comprehensive support of digital skills in the digital transformation process is necessary to have an impact on productivity. The development of ICT skills, including of managers, is necessary to complement investment in broadband technology. The fragmentation of the productive system into small firms slows down digitalisation, as isolated investment of small firms cannot benefit from economies of scale or a coordinated approach (Istat, 2018b; Confindustria 2018b).

Policies supporting knowledge and cooperation among smaller firms go in the right direction. Measures such as technological clusters and network contracts, which support cooperation among firms and the exploitation of economies of scale, improved the performance of participating firms (Confindustria, 2017; Istat, 2018c). The Competence Centres, yet to be activated, are meant to provide technological transfer to SMEs on industry 4.0 technologies and related ICT training. The Digital Innovation Hubs, 21 of which are already operational, accompany SMEs' digital transformation and networking in larger digital value-chains.

There is a need to raise the low level of investment in intangibles. Investment in intangibles and, more specifically, in R&D (respectively 2.9 % and 1.4 % of GDP in 2017) has been considerably below the euro area average (respectively, 4.1 % and 2.2 % in 2017) since the early 2000s. R&D expenditure is also below Italy's EU2020 target of 1.5 % of GDP. Business R&D expenditure is particularly low compared to the euro area average (0.8 % of GDP against 1.4 % in 2017). Nevertheless, among SMEs it increased from 0.13 % of GDP in 2007 to 0.22 % in 2015, although it is still below the EU average of 0.3 %. Public support to business expenditure remains low but increased from 0.05 % of GDP in 2008 to 0.12 % in 2016, with an increasing share due to tax incentives (0.08 % from 0.02 % in 2008) (OECD, 2018). Public expenditure in R&D is also below the euro area average (0.5 % of GDP with respect to 0.7 %) and is declining since 2012, mostly due to the declining trend in the higher education sector, despite its potential to crowd-in private investment in intangibles (Briguglio *et al.*, *forthcoming*).

There is a need to further invest in the administrative capacity of the public sector, especially at local level. Inadequate human capital in the public sector constrains the capacity to assess, select and manage investment projects, including EU funded. Italy's weak public sector's administrative capacity at both national and local level (Section 4.4.3) represents an investment

Graph 4.4.2: **Estimated contributions to (business and intangibles) investment**



(1) Estimated contributions correspond to the independent impact of each explanatory variables (see legend) to the investment trend based on estimated coefficients from an augmented acceletor model.
(2) Data refer to time series for Italy covering 1999-2018Q1 (business) and 1996-2018Q1 (intangibles). Investment and macroeconomic data are from national accounts.
(3) Banking finance corresponds to the share of NPLs. Non-banking finance corresponds to firms' self-financing and equity
(4) Education refers to tertiary education (including the impact over-education)
(5) Business environment is proxied by the world bank doing business index
(6) Public investment for intangibles refer to R&D
(7) Economic cycle corresponds to previous GDP
(8) EPL stands for employment protection legislation (OECD) for temporary employment
Source: D. Briguglio et al. (forthcoming)

barrier across sectors and prevents effective delivery of investment projects. This also undermines the implementation of EU funds, where Italy lags behind compared to the EU average (Box 2.1). There is a general need to provide technical support to central and local administrations in the planning, evaluation and monitoring of investment projects, while guaranteeing operational support to identifying and addressing possible bottlenecks. The two centralised institutional bodies (*Centrale per la progettazione delle opera pubbliche* and *InvestItalia*) planned to be activated in 2019 are a positive step in this direction, as well as similar initiatives of the Environment Ministry. The government's intention of creating a task force for public investment would go in the same direction. Implementing the reform on the professionalization of public buyers (Section 4.4.4) would also contribute to this goal.

Specific challenges

Italy is lagging behind in promoting access to ultrafast (100 Mbps) internet for all. Despite this objective of the 2020 Digital Agenda, in 2017 15.5 % of Italian firms did not have access to an adequately fast broadband connection (10.6 % on average in EU) and only 23.9 % of households are covered by ultra-fast broadband in 2018 (60.0 % on average in the EU). In some areas ("white areas") ultrafast broadband infrastructure is not yet available and no operator has plans to invest in next-generation networks (30 Mbps or faster) in the coming years (Section 4.4.3), while in others only one infrastructure is present ("grey areas"). Private investment plans amount to only 43 % of the investment needs for meeting the 2020 Digital Agenda objectives (MISE, 2015).

I**nvestments in broadband are undergoing implementation delays.** Two out of the three public tenders launched by the government to guaranteeing next-generation networks to all "white areas", as the first phase of the Ultra-Fast Broadband strategy, co-financed by EU funds, have been awarded only in the second half of 2017 and the third are only at the beginning of 2019, all after some lengthy law suits.. This late start, combined with delays in operational planning of works and in the granting of local permits (involving more than 6 700 municipalities), could delay the absorption of EU funds and could put at risk the timely achievement of the 2020 Digital Agenda objectives. Moreover, the second phase of the strategy, meant to support ultrafast connectivity in "grey areas", is stalling as well, pending the Italian government's submission of the

plan to the European Commission for State Aid scrutiny.

The achievement of the ambitious 2030 EU energy and climate targets calls for sustained green investments. While Italy is currently on track to achieve the 2020 binding targets on greenhouse gas emissions and renewable (with a 20% decrease of emissions, with respect to a target of 11% for 2017), progress has been stagnating in the last few years. In 2016, final energy consumption increased, signalling a downward risk in achieving of the 2020 energy efficiency target. Italy has the second largest renewable sector in Europe after Germany in terms of direct and indirect jobs (179.000 in 2016), further policies in line with new 2030 objectives can boost growth and create up to 115.000 new jobs per year. ([62])

Investments are needed to improve the energy infrastructure. This can contribute to a more resilient, secure and flexible energy system, while enhancing market integration and reducing price gaps. The Italian electricity grid is not yet sufficiently equipped to cope with increased exchanges across borders and to cope with the magnitude of variable renewables as projected for 2030. It is estimated that EUR 10 billion will be needed in the next 10 years to modernise the electricity transmission grid ([63]). A diversified and flexible gas grid, including import routes, can more easily accommodate the integration of different demand sectors as well as a fuel switch. The Italian gas Transmission System Operator foresees EUR 5.7 billion of additional investments in the period 2018-2022. ([64])

The integrated National Energy and Climate Plan (NECP) is the key guidance to establish investment needs in the area of decarbonisation and energy. The objectives of the 2017 National Energy Strategy are being currently revised, also in light of the new EU energy targets for 2030. In its draft National Energy and Climate Plan adopted on 31 December 2018 ([65]), Italy provided an overview of the investment needs until 2030 for the different dimensions of the Energy Union: those amount to 13,2 billion per year. The information provided will further contribute to the identification and assessment of energy and climate-related investment needs for Italy.

There is a need to integrate climate change mitigation and adaptation policies across all sectors, including transport. Emissions in sectors not covered by the EU ETS are expected to decrease by 21% between 2005 and 2020 (with respect to a target of 13%) and by 25% between 2005 and 2030 (with respect to a target of 33%). While prioritising the low-carbon transition for long-term investments is cost efficient, delayed action will increase the costs to meet the obligations under the Effort Sharing Regulation and provide disincentives to a private sector increasingly keen to make green investments. Structural and cohesion funds have already been used to support the implementation of adaptation-related actions, ([66]) including in the water sector. Yet, further efforts are needed in order to finalise and implement the National Adaptation Plan in a coordinated manner across sectors and governance levels, also supporting the cities signatories of the Covenant of Mayors. Investing in sustainable transport and infrastructure allows to tackling not only environmental but also mobility challenges, considered by firms as a major obstacle to investment activities, as well as investment gaps by 50% of municipalities (EIB, 2018).

In the transport sector, Italy has not delivered on its infrastructure investment strategy (*Connettere l'Italia*). Very limited progress has been made in implementing the planned investments in rail, road and sustainable urban mobility. This is due to administrative delays, spending inefficiencies, a lengthy transposition of the new directives on procurement and concessions and litigation, although litigation for smaller projects has been curbed by the introduction of a dissuasive fee for initiating administrative appeals. The government intends to reorient investments towards smaller projects, for example in urban mobility, which are easier to implement.

([62]) Proposta di Piano Nazionale Integrato per l'Energia e il Clima, 31/12/2018, p.224.
([63]) TERNA, Piano di Sviluppo 2018.
([64]) SNAM, Piano Strategico 2018-2022
([65]) In line with the EU Regulation 2018/1999 on the Governance of the Energy Union and Climate Action.

([66]) Under the Partnership Agreement for Italy, 2014-2020, EUR 2 743 million have been allocated to the thematic objective "Promoting climate change adaptation, risk prevention and management", including EUR 989 million from the European Regional Development Fund and EUR 1 753 million from the European Agricultural Fund for Rural Development.

Investments are needed in order to raise the quality of transport infrastructures toward the EU average. The EU transport scoreboard shows a below EU average quality of infrastructure, especially for ports. The state of repair is a clear source of concern, as shown by the collapse of the Morandi bridge in Genoa. The government has prioritised maintenance and safety with a plan to monitor the maintenance status of all infrastructures and the set-up of a new agency in charge of infrastructure safety for rail and road. In this respect, for 2019 Italy was granted an allowance of EUR 1 billion with respect to the EU fiscal rules in relation to an investment plan to secure road infrastructure similar to the Morandi Bridge.

Italy is not yet playing its key role in the European Transport strategy. Italy is crossed by 4 TEN-T core network corridors covering major transport flows in Europe. These transport axes are of vital importance for Italy's export economy and especially for its ports. However, the government is currently reconsidering the socio-economic rationale of its engagement in major projects of European significance, such as the Brenner Base tunnel and Lyon-Turin Base tunnel. After launching a new cost-benefit analysis for four major infrastructure projects, in December 2018 the government announced that it would further delay tenders for the Lyon-Turin Base tunnel project. Long-term political and financial commitment at national and regional level is key to fulfil Italy's obligations under the TEN-T regulation to complete the core network by 2030.

4.4.2. COMPETITION AND SINGLE MARKET INTEGRATION*

Services represent a high and growing part of the Italian economy. In 2017 market services contributed to 48.1 % of gross added value, up from 45.6 % in 2000. Thus, these sectors' efficiency and competition level have an increasing impact on the whole economy productivity both directly (Section 4.4.1) and as an input to other business activities. According to some studies (UPM, 2018), a reduction in regulatory restrictions in professional services and retail trade has a positive impact on their total factor productivity. A similar positive impact also concerns the manufacturing sectors. Banca d'Italia suggests that a reduction of the regulatory restrictions in non-manufacturing sectors would lead to a 25-29 % productivity gain in Italy (Bugamelli et al, 2018).

Business services remain highly regulated. According to the Commission, the overall level of restrictiveness in Italy is higher than the EU weighted average for six out of seven professions analysed. ([67]) Also, the new intra-EEA OECD STRI ([68]) index for business services, computer services, construction and trade services is higher than average in Italy. The low dynamism and competition within these sectors is also confirmed by the low business churn rate (15.5 % in Italy against 18.1 % in the EU in 2015). ([69]) Also, as from 2018, a range of new professional orders in the health sector, for example for physiotherapists, has been set up with new reserved activities.

The retail sector is highly regulated and new restrictions have been announced. Despite the effective 2012 liberalisations, over-regulation still burdens the retail sector. According to the Commission's restrictiveness indicator for retail, in 2018, Italy is among the most restrictive Member States and performs worse than peer economies (Graph 4.4.3). Restrictions concentrate especially in the establishment of retail shops. According to the Commission, strict conditions apply to the authorisation process when opening a new outlet. Italy also scores among the highest in the EU on the number of permits required in the procedure. ([70]) By discouraging new entrants, these regulations tend to affect market dynamics, protecting the incumbents and negatively impacting the already low productivity of the retail sector (European Commission, 2016a). As to the regulation of retailers' daily operations, while shops' opening hours are fully liberalised, restrictions remain on sales promotions and the distribution for some products, including non-prescription drugs. The situation could worsen if Italy backtracked on earlier reforms by re-

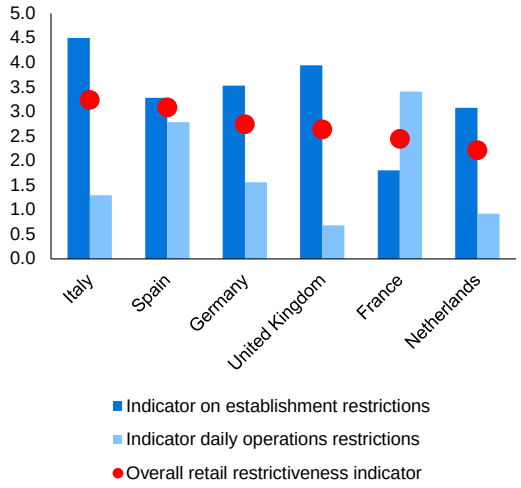
([67]) The European commission developed a composite indicato based Member States's data and complemented by Commission research (European Commission,2017)
([68]) Service Restrictiveness index, OECD, 2017a
([69]) The business churn rate is calculated as the ratio of the sum of newly founded and closed enterprises to the total number of enterprises in year *t*.
([70]) Requirements include the provision of economic data, a number of different impact assessments and specific requirements linked to the location.

regulating shop opening hours, as announced. Finally, the percentage of consumers reporting unfair commercial practices and other illicit practices from retailers is now well above the EU average (European Commission, 2019b).

The regime for the assignment of limited authorisations remains unclear and broadly discretionary. The actual grant of concessions of use of public areas for the provision of a wide range of services, related to trade, tourism, energy and industrial activities do not follow competition and transparency principles. Furthermore, reassignments are often subject to repeated ex-lege prorogations. This negatively affects entry and investment in these sectors as well as the management of scarce resources. For example, in the street trade sector at the end of 2017 the legislator extended again 'old' authorisations until December 2020. ([71]) Recently, it also set the automatic general extensions of beach concessions. The recent identification at administrative level of transparency principles to be applied to assign the rights to use public domain areas within ports ([72]) might be a step in the right direction, provided it is effectively applied.

Collaborative economy has a strong growth potential in Italy. According to 2018 Eurobarometer, 18 % of respondents in Italy have used a service offered via collaborative platforms. While only 5 % of respondents have offered services, 24 % of respondents claimed they would consider it as private individuals. Despite this potential, a comprehensive regulative approach, involving sector-specific elements, is still missing. Excessive regulations threaten the proper functioning of some sectors (for example in collaborative transport). In others, levelling the playing field would reduce the disadvantages with the traditional players (for example in the accommodation/hotel sector). Moreover, some features of the 2017 obligations on platforms to collect taxes on behalf on non-professional stakeholders raise legal challenges and, thus, uncertainty, slowing down further the sector development. The lack of a clear strategy, along with fragmented and often very restrictive local regulations, is a burden especially on the traditional tourism sector. This is a concern as tourism represents 5% of GDP (2017), is anticyclical and geographically homogeneous (Bugamelli *et al.*, 2018).

Graph 4.4.3: **Restrictiveness in the retail sector, 2018**



Source: European Commission, 2018

Despite liberalisations, energy prices remain high. According to the Commission, at wholesale level, energy market concentration in Italy has decreased and is below the EU average. ([73]) This allowed wholesale prices to decrease by 14.3 % and 28.4 % respectively for the electricity and gas sector between 2005 and 2015. However, due to the energy mix, the network structure, and the charges and taxation component, they are still among the highest in the EU. At retail level, high market concentration, taxes and levies contribute to keep prices among the highest in the EU for both markets. However, retail electricity prices for households significantly decreased between 2016 and 2017 (-11.2 %) (ACER/CEER, 2018). Such a trend has to be read in conjunction with the rise in the annual switching rate among household consumers (8 % for electricity household consumers in 2015, against an EU average of 6.3 %. The 2017 national strategy – currently under revision – proposes to narrow the price gap between Italy and European peers through, among other measures, the full liberalisation of final markets and the progressive reduction of system charges.

([71]) Law 205/2017 and Resolution n. 87935 of 7 march 2018 by Minister for Economic Development.
([72]) ART delibera n. 57/2018

([73]) Herfindahl-Hirschmann Index, European Commission on Platts PowerVision data on installed capacity.

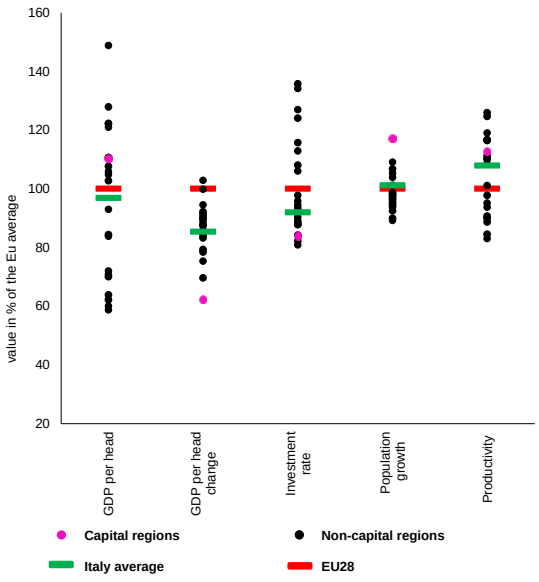
Efforts to lift regulatory barriers stalled after the adoption of the 2015 annual competition law in 2017, while new restrictions might be introduced. New restrictions, as the introduction of *equo compenso* ([74]) for regulated professions, were introduced shortly after the adoption of the law. Moreover, half of the 2015 competition law implementing decrees are still to be adopted, while the phasing out of the regulated tariffs in the energy sector has been postponed from 2019 to mid-2020. Implementing measures on the re-organisation of taxi and private hire transport were not adopted within the timeframe of the delegation granted. While the Competition law increased the number and geographical scope of activities of notaries, subsequent amendments to the Notary law suggest the possibility that local orders may have room to limit the competition among providers. ([75]) A new competition law has been announced by the government but details on content and timeline have not been provided yet. Restrictions might rise with the announced measures on the retail sector, which aim to backtrack from the 2012 liberalisation of the opening hours (especially during Sunday).

4.4.3. REGIONAL DIMENSION

The GDP and productivity gap with respect to the EU average is widening for all Italian regions, especially in the South. In 2016, around a third of the country's NUTS 2 regions, all located in Southern Italy, remain largely underdeveloped with a GDP per head lower than 75 % of the EU average (lower than 59 % in the poorest regions). Disparities among Italian regions remain high. Whereas labour productivity has decreased since 2010 in all Italian regions with respect to the EU average, it is lower than 80 % of the EU average in some Southern regions. In 2016, apparent labour productivity ([76]) in the South ranged from 76 % (Calabria) to 89 % (Abruzzo) of the national average. Between 2010 and 2016 productivity shrunk on average by 0.5 % per year, i.e. more than in the whole country.

Southern regions suffer from structural weaknesses and a decreasing inflow of public expenditure. Competitiveness of Southern regions remains below the country average. ([77]) The industrial base in the South remains dominated by micro-firms, lower internationalisation, lower integration into the value chain, a more limited access to finance (Svimez 2017 and 2018). Furthermore, public expenditure per inhabitant is systematically lower in Southern regions since the economic and financial crisis (Confindustria and SRM, 2018).

Graph 4.4.4: **Regional dispersion in Italy in selected macroeconomic variables**



Source: Eurostat

Territorial imbalances have increased since the crisis, but private investment has recently improved in the South. While investment was already higher in the North before the crisis, since then it has declined more in the South (-32 % versus -20 % in the Centre-North) (Svimez 2018; Briguglio *et al*, forthcoming). Since 2015, private investment started to recover in the South of Italy and the value added generated by the southern manufacturing sector has grown cumulatively by more than 12.4 % over 2015-2017, with a trend

([74]) Fairness assessment of tariff. This system may entail the re-introduction of minimum tariff thresholds for services provided to business, thus potentially restricting competition on prices

([75]) Art. 93-ter, para 1-bis, law 89/1913.

([76]) Apparent labour productivity is defined as value added at factor costs divided by the number of persons employed.

([77]) Regional Competitiveness Index 2016, European Commission

more than double that recorded in the rest of the country (5.4 %). However, recovery is expected to slow down and both consumption and investment gaps remain large (Svimez, 2018).

The divergence in investment between the North and the South is particularly marked for intangibles and innovation. The number of employees employed in high-tech industries is almost twice as big in the North (3.7 % versus 2 %) and R&D expenditure is 1.5 times bigger (1.4 % of regional GDP, compared to 0.9 % of regional GDP in the South). The number of patents per inhabitant is 10 times higher in the North than in the South (106.8 versus 10.1 per 1 million people) (Nascia *et al.*, 2018).

Weaknesses in the innovation ecosystem in the South constraint the impact of measures to support private investment. The Southern manufacturing industry has benefited from the fiscal incentives of the Impresa 4.0 plan. However, its weaker pre-existing conditions, such as the local level of education and innovation, limited their impact. According to data of Italian authorities, the R&D tax credit was mostly absorbed by firms in the North (70 % of the total costs with respect to only 10 % for Southern firms in 2017), while 54 % of firms benefitting from the Start-ups Act are located in Lombardia, Emilia Romagna, Lazio e Veneto (UPM, 2018).

The South is lagging behind in transport infrastructure. The South is lagging behind particularly in terms of connections and public transport services to TEN-T airports, last-mile rail freight links with the TEN-T ports and inland terminals, and basic standards on regional railways. Projects for realizing key rail projects along the TEN-T core network (Napoli - Bari and Messina - Catania - Palermo) are delayed and were still under preparation in 2018. The South is lagging behind also in terms of urban and sustainable transport. Targeted investments are needed, but need to be complemented by improved governance of public services.

The development of advanced broadband networks in rural Southern Italy is limited by insufficient investment and digital skills. These areas are projected to have a lower coverage, by 2020, of broadband at 100 Mbps or higher speeds than in the rest of Italy (36 % of buildings vs. 56 %, also due to delays on ongoing "next generation access" projects. Even after completion of the ongoing projects, there will still be unmet investment needs in order to achieve the European Gigabit Society strategic objectives for 2025, especially in rural areas. Moreover, only 68 % of southern households had a broadband subscription in 2018 compared to 76 % in Northern Italy and ultra-fast broadband subscriptions are among the lowest in Europe (8.9 % of households in 2018). This low rate is due to costs and, more importantly, to insufficient digital skills, which need to be supported in parallel (Section 4.4.1).

Progress on waste management is uneven with insufficient effective investment in the South. The South performs worse than the North in most sustainable development goals. High recycling rates are common and improving in the North, but only partially in the Centre and South. The performance of Southern regions for waste management need to be raised up to the level of the North, while putting in place a structural mechanism to ensure that all landfills are adequately monitored.

Insufficient effective investment is being made in water infrastructure in the South, while scarcity and drought risks continue. The fragmentation of the sector, together with the weak credit profile of smaller operators (Section 4.2), remains a barrier to investment. Despite the efforts and the appointment of a special commissioner, there has been only limited progress in reducing the number of agglomerations non-compliant with the Urban Waste Water Directive ([78]), corresponding to a population of over 28 million people still affected, mainly located in the South. Between 2012 and 2018, there has been an overall improvement in compliance of around 15 % nationally, but in the Southern regions the rate varies from 25 % in Puglia to 3 % in Calabria ([79]).

Investing in more sustainable modes of transport is necessary to limit the negative spillovers to economic activity. In 2017, limit values for EU air quality were exceeded in areas inhabited by about 25 million people, mostly

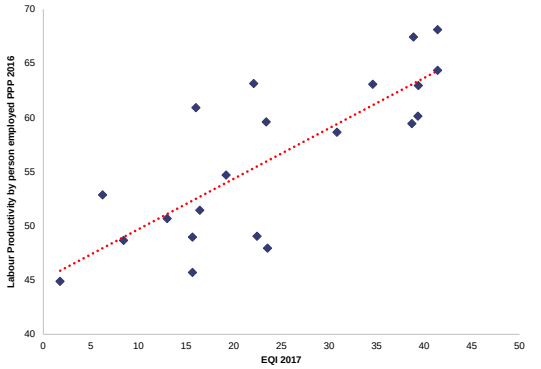
([78]) Council Directive 91/271/EEC.
([79]) Figures based on information received in the context of cases 2004/2034, 2009/2034, 2014/2059 and 2017/2181.

corresponding to the Po Valley and larger cities. This is due to the high level of road traffic, with over 80 % of trips made by private car, as well as inefficient domestic combustion. Effective planning measures (such as low emission zones), emergency bans on certain types of vehicles and parity between petrol and diesel fuel prices represent other ways to deal with air pollution.

Investment in prevention for hydrogeological and seismic risks is needed to reduce emergency expenditures. In 2016, there were 31 flood incidents registered all over the national territory. According to data collected by ISPRA the damages caused by floods (and landslides) were at least EUR 1.96 billion in 2016 and EUR 1.31 billion in 2017. In November 2018, Italy was hit again by floods and landslides with EUR 6 million made available from all sources. Following these events, for 2019 Italy was granted an allowance of EUR 2.1 billion with respect to the EU fiscal rules to ensure prevention against major hydrogeological risks. The series of earthquakes that hit Italy in 2016 had a direct physical cost alone of around EUR 22 billion on infrastructure, businesses, public and residential buildings. The EU's Solidarity Fund provided EUR 1.2 billion, the highest amount ever paid out for an application. However, vulnerability checks were performed for only one in three schools, with negative peaks in regions with high seismic activity such as Calabria (2 %), Campania (4 %) and, especially recently, Sicily (7 %) (Cittadinanzattiva, 2018).

The lower quality of governance in the South seriously limits these regions' spending and policy making capacity. According to the EQI indicators institutional quality in Southern regions is below the national and EU average (Section 4.4.4). Institutional quality is highly correlated to the level of regional productivity (Graph 4.4.5). Institutional weaknesses in Southern regions, together with other factors, remain important bottlenecks for an effective delivery of policies. For instance, they prevent Italian regions from grasping the full benefits of Smart Specialisation strategies in terms of innovation and competitiveness ([80]). Institutional weaknesses also negatively impact the ability of less developed regions to use the EU funds, which are precisely intended to reduce the gap with respect to the rest of the country.

Graph 4.4.5: **EQI index and labour productivity, Italy 2016-2017**



Source: European Commission

4.4.4. INSTITUTIONAL QUALITY*

Public administration

Quality of governance indicators confirm the weaknesses of the Italian Public Administration. The average performance level is among the lowest in the EU with negative impacts on both business and citizens' activities. Complex procedures, the overlapping of responsibilities and poor management of public employment contribute to this result (European Commission 2017a, 2018b).

The business environment remains complex despite important ongoing progress. According to the 2018 Doing Business Report, despite an improvement in 2017 (ranking 46 compared to 50 in 2016), Italy still performs below the EU average. This is confirmed by several indicators monitored by the Commission ([81]) (European Commission 2018b). This contributes to further slow down business investment (graph 4.4.2). However, a preliminary assessment of the 2012 Start-up Act is positive. According to Italian authorities, in April 2018 it had facilitated the birth

([80]) Focused investment on research, development and innovation on selected priorities.

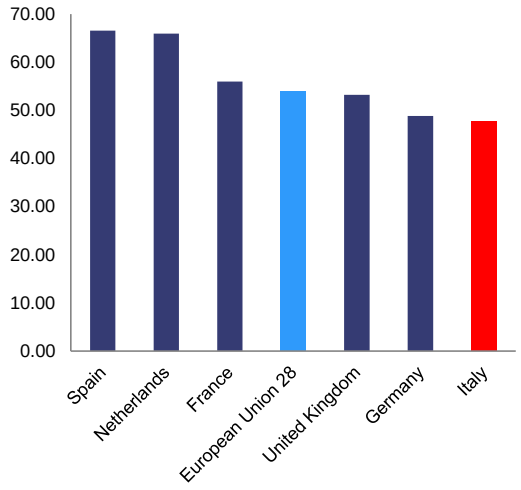
([81]) Paying taxes (IT: 238 hours, EU: 171.39); The complexity of administrative procedures (considered as a significant problem by 84% of respondents in IT and by 60% in the EU); Cost to start-up a company (around EUR 2000 in Italy, EUR 311 in the EU); The cost of procedure for resolving insolvency (costs of recovering debt as % of debtors' estate in 2018: 22% in Italy, 10.25% in the EU).

of more than 9 000 innovative start-ups and supported SME's in the integration in a green economy. Moreover, a number of other policy measures were adopted: more than 30 standardised and simplified authorisations templates between 2017 and 2018, and a simpler and faster decision-making process to grant authorisations (*conferenza servizi*). However, the impact of the measures is still very limited. Further measures (e.g. the creation of special economic zones) are still at an early stage of implementation.

The provision of digital public services is an additional challenge. Digitisation of processes and services could lead to sizable cost and time savings, and services quality improvements for both citizens and businesses. However, Italy performs worse than the EU average, scoring 47.7 against 53.87 (Graph 4.4.6). In Italy, the implementation of advanced eGovernment solutions, particularly the 'digital by default' and the 'once only' ([82]) strategies, is expected to produce annual relevant benefits of around EUR 1.3 billion (European Commission, 2014). However, inconsistent planning, scarce financial resources and insufficient coordination, are delaying key initiatives like the digital population registry, the online payment system, the rationalisation of public administrations' databases or the single sign-on based on an EIDAS compliant eID (SPID). ([83]) The high average age of public employees (European Commission 2018b) and average low digital skills (ISTAT 2017) further slow the process down. However, when clear political priorities and effective enforcement are combined, results are evident as for the rapid development of the electronic market for public administrations and e-invoicing.

The implementation of the 2015 Public Administration reform is complete but needs to be properly operationalised. Preliminary results by Italian authorities suggest that the new faster procedures (*Conferenza dei Servizi*) and the enhanced transparency are bearing fruits. However, being the collection of information provided on a voluntary basis, a self-selecting effect might bias the results. Also, local bodies need support to apply the new provisions. In this regards, the announced draft bill "*concretezza*" establishes a support group to help administrations with the actual enforcement of the reforms.

Graph 4.4.6: **eGovernment Indicator, 2019**



(1) The composite index captures the level of development of a country's eGovernment services by looking at availability, user-friendliness, burden reduction, usage and open data policies implementation
Source: European Commission, Digital Scoreboard, 2019

The effects of the reform on public employment might take longer to be visible. The implementing decrees concerning the recruitment procedures, planning of competences needs, skills and performance evaluation have been adopted and the operationalisation is ongoing. However, modifying long-standing administrative practice, especially with low generational turnover and high number of temporary agents, might prove difficult. The *Concretezza* draft bill also envisages again a complete turnover of public employment (allowing the replacement of every civil servant leaving the administration). If coupled with a proper enforcement of the new rules for recruitment (European Commission 2018b), this could be beneficial in terms of average age of the public employment and skills (especially digital) level. However, no legislative initiatives have been put forward to reform the public management, which is key for the efficiency of the public administration.

([82]) 'Digital by default' strategies: the electronic channel becomes the standard one in delivering services (other channels are exceptional). 'Once only' strategies: users' data are asked once and shared at all administrative levels.

([83]) EIDAS is the EU interoperable standard for Electronic IDentification, Authentication and trust Services. SPID is the acronym for Sistema Pubblico d'Identità Digitale (digital identity public system)

The enforcement of the 2016 publicly owned enterprises' single framework and reforming local public services are crucial. The new framework integrates and streamlines previous fragmented legislation to better manage and rationalise publicly owned enterprises (European Commission 2016a). Overall, the set of monitoring and sanctioning tools seems effective. Still, given the difficulties of past reform attempts, the operationalisation and the enforcement are expected to be challenging. By September 2018, local public administrations had to complete the divestment procedure for non-strategic shareholdings identified in their 'extraordinary' rationalisation plan. By end-2018, local bodies are expected to review all their shareholdings owned at end-2017 and present their first 'periodic' rationalization plan. The authorities are currently drafting a monitoring report to assess the actual effectiveness of the framework. Preliminary information suggests some challenges concerning local administrations' ability to effectively and timely dismiss the non-strategic shares. Finally, the quality and efficiency of local public services would benefit from a reform initiative to increase competition also by favouring public open bids over in-house assignments.

The implementation of the public procurement code is ongoing, but delays create uncertainty. According to Anti-corruption authority, between 2015 and 2017, the sought-after increasing centralisation and professionalization of contracts is taking place. However, crucial implementing measures are still missing, creating uncertainty in the application and effective use of the new code. This is particularly true for the qualification of contracting authorities, preventing substantial improvements in their administrative capacity and ability to use public procurement efficiently. The prolonged inactivity of the government's *Cabina di regia* has translated into lack of coordination in the implementation of the reform, further slowing down progress and hampering the adoption of a more coherent and more widespread plan for digitalization of tender procedures. The new government announced amendments to the code without providing further details, further raising uncertainty on the overall framework.

A streamlined administrative organisation would increase the effectiveness of market surveillance and prevent unfair competition from non-compliant businesses. The responsibility for market surveillance of non-food products is spread over various ministries, creating frequent overlaps (e.g. the toys sector) and difficulties in identifying common priorities. Local bodies perform inspections, but cannot take enforcement decisions and do have market surveillance as their core mission. The Ministry of Economic Development is responsible for coordination, but the overall system lacks clear guidelines to enable an efficient coordination and effective cooperation and does not allow for direct contacts between the all relevant other actors involved. The complex organisation couples with a scarcity of financial resources. This limits significantly the number of inspections and tests.

Payment delays from the public administration are slowly improving. According to Banca d'Italia, at the end of 2017, commercial arrears in the public sector accounted for 3.3 % of GDP, down from 3.8 % in 2016 (from EUR 64 billion to EUR 57 billion). However, over the same period, the estimated average payment time registered only a slight improvement (from 100 to 95). The ongoing development of Siope+, the information system for public transactions, should further help in limiting the problem. However, the limitations to the use of factoring in public contracts is penalising particularly SMEs. This is particularly true for many local authorities, still paying with delays of more 200 days with instances of up 340 days. Moreover, despite consumers' trust in redress mechanisms is now in line with the EU average, retailers' awareness of Alternative Dispute Resolution is the lowest in the EU (European Commission, 2019b).

Civil justice

The low efficiency of Italy's civil justice system remains a source of concern. In 2017, the time needed to resolve civil and commercial litigious cases in Italy was still the highest in the EU at all instances (European Commission, 2019e). Between 2016 and 2017 it decreased by around 10 % in second and third instance (to around 2.5 and 3.5 years, respectively), but rose in first instance by around 6 % (up to 1.5 years), thus offsetting past efficiency gains. The latter trend

reflects *inter alia* lower clearance rates ([84]) at first instance (by around 6 %) (European Commission, 2019e). The Court of Cassation, despite a 2% increase of incoming cases, managed to increase its clearance rate from 92% to 100%. However, a high number of incoming cases at the Supreme Court of Cassation, coupled with lower clearance rates of its tax section, ([85]) negatively affects the overall efficiency of the Court and raises concerns about the quality of Italy's tax justice system at first and second instance. Overall, past reforms are helping to reduce the backlog of pending civil cases – still the highest in the EU (European Commission, 2019e) – and are starting to have a positive impact on trial length at higher instances (GRECO, 2018). Despite those small efficiency gains, however, there is still room to limit abuses of the trial and ensure a more efficient functioning of courts to reduce the overall length of civil proceedings (European Commission, 2018b). In the absence, Italy's lengthy civil proceedings will keep hindering entrepreneurial activity and foreign direct investment (Lorenzani and Lucidi, 2014).

A reform of the civil procedure is still pending. An important enabling law streamlining certain aspects of the civil procedure and introducing stronger deterrence against abusive litigation, submitted to parliament in 2015, failed to pass within the parliamentary term. The new government, however, announced another reform proposal to extend the scope of a simplified procedure for civil trials. The draft law (still to be published) will make the latter the default, with the exception of the most complex cases. It also extends the range of cases in which a single judge is competent in first instance courts, streamlines mandatory deadlines during the procedure, and extends the scope of the "*assisted negotiation*" to reduce litigation. Overall, adequate enforcement of simpler procedural rules could contribute to decisively speeding up civil trials. Other lingering challenges for Italy's civil justice system are: (i) the still limited and inconsistent use of the inadmissibility filter for appeals in second instance courts (only 1.6 % of appeals were declared inadmissible in 2017 (European Commission, 2018b), with large variation across courts); (ii) the numerous vacancies for administrative staff (around 8 000); and (iii) the large remaining differences across courts in the effectiveness of case management despite the adoption of the *Strasbourg II* best practices.

([84]) The clearance rate, defined as the ratio of resolved cases to incoming cases, is a commonly-used indicator to monitor the case flow and assess the ability of a judicial system to handle the inflow of judicial cases.

([85]) In 2017 the tax section of the Supreme Court of Cassation received over one third of all of its incoming cases but attained a clearance rate of only 81% (Corte di Cassazione, 2018), below the average of 100% for all civil sections of the Court. Tax cases thus represent an increasing percentage of the backlog of the Court, from 44% in 2014 to 52% in 2017 and 56% in Q3-2018.

Fight against corruption

Progress with improving Italy's anti-corruption framework is ongoing, but gaps remain. While remaining low, Italy's score has slightly improved compared to 2017 in the World Bank's 2018 "control of corruption" index and in the "incidence of corruption" index of the 2018 *Global Competitiveness Report*. That partly reflects recent improvements in the anti-corruption system, such as a new framework to protect whistleblowers and the stronger role of the National Anti-corruption Authority in implementing it. However, some criminal offences like the embezzlement of public money are still characterised in Italy by too mild penalties, which prevents the use of effective investigation techniques (e.g. tape recording), and by exceptions to international standards, such as the impossibility to seize the embezzler's property. A new anti-corruption law of January 2019 tackles some of those gaps. To boost the detection and repression of corruption, the law introduces stricter minimum and maximum penalties, and thus longer prescription terms, for corruption cases, extends to them special investigation techniques like the "*operations under cover*", and sets a leniency scheme for those who first denounce corruption. It also strengthens deterrence through a permanent ban on parties of a corruptive act from holding public offices or doing business with the public administration, and it introduces a stop to prescription terms after a first-instance conviction as of 2020. A single framework to regulate lobbying activities for all elected and appointed officials is still missing in Italy, but a draft bill currently under discussion establishes an official registry of lobbyists to better regulate lobbying activities for members of the Senate. ([86])

([86]) Draft Law No. 484, 14 June 2018.

The low efficiency of criminal justice seriously hinders the prosecution of corruption. The disposition time for criminal cases, around 4 years overall in 2017 (Ministry of Justice), is broadly unchanged since 2014 and remains one of the longest in the EU at all instances (CEPEJ, 2018). At the appeal level, in particular, long disposition time (2.5 years) is explained mainly by the high number of cases pending for over 2 years (48 % of all pending cases in 2016) and by the increasing trend in litigation since 2014 also due to rising appeal rates (from 40 % to 45 % over 2014-2017). Those factors remain a source of concern. Moreover, as recent reforms of the statute of limitations do not apply to ongoing trials, the ratio of time-barred over resolved criminal cases rose in 2017 both during the investigation and during the trial, with a worrying peak of 26 % in appeal courts. As for corruption cases specifically, 5 % got time-barred while being investigated and 15 % during the trial, with peaks for embezzlement of public money (23 %), corruption by breach of official duties (24 %) and active corruption (25 %).

A much-needed reform of the criminal trial, including the appeal system, is in the pipeline. In 2017, the Council of Europe ([87]) invited the Italian authorities to pursue a "*reform of the appeal system and of the statute of limitations*". Some initial progress in that direction with a positive impact on disposition time at first instance has been acknowledged (GRECO, 2018), in light of the decriminalisation of minor offences, first steps to reform the appellate system and the broadening of the competences of the judges of the peace. However, a comprehensive reform of the criminal trial and the appeal system, announced by the government, is still under discussion by an expert group of the Ministry of Justice. Among the proposals officially submitted to the Ministry ([88]), the following in particular could reduce incentives to delaying tactics and speed up criminal trials: (i) a reform of the current prohibition of *reformatio in peius* ([89]) of appealed rulings, in order to allow the latter in more cases; (ii) the possibility for lawyers to validly receive judicial notifications at their domicile on behalf of their defendants, which prevents the courts from having to look for defendants who cannot be found; and (iii) the broadening of the cases where the witnessess do not have to be haeard again (so-called "*rinnovazione degli atti*") if a judge changes, unless specific circumanstances require it.

Italy's National Anti-corruption Authority improved its prevention role, especially in the field of public procurement. The authority is almost fully staffed (with 320 posts filled out of 350) and was given a stronger role to implement the revised anti-corruption framework. In February 2018, it established an online platform to report illicit activities and misconduct (ANAC, 2018a). As such, an increase in whistleblowing was recorded in June 2018 (ANAC, 2018b), mainly in the public sector and on part of public employees. In September 2018, the authority adopted a regulation clarifying its powers to impose fines for failure to protect whistleblowers (ANAC, 2018c). However, the new framework to protect whistleblowers has a limited impact on private sector companies, whose adherence to it remains voluntary and subject to the signature of a compliance programme. The authority has also clarified its supervisory role (ANAC, 2018d), which in the first half of 2018 resulted in 102 investigations and 16 proceedings against public administrations for failure to adopt their three-year corruption prevention plans (ANAC, 2018e). As regards public procurement, ANAC carried out 133 preventive and administrative checks over 2015-2018 through a special section of Italy's financial police (*Nucleo Speciale Anticorruzione Guardia di Finanza*). Moreover, since its new powers were introduced in 2017, it issued 471 non-binding pre-dispute opinions to solve procurement controversies before they are brought to the attention of the administrative judge. Last, a regulation (ANAC, 2018f) has clarified the authority's power to appeal the judicial system in case of serious violations of the public procurement code, but that power has rarely been used so far.

([87]) The Group of States against Corruption (GRECO) is the Council of Europe's anti-corruption monitoring body.

([88]) For instance, proposal 3711 of 23 November 2018 for a reform of criminal trials by the National Judges Association (Italy's representative organisation of judges): "*Proposte di riforma dell'Associazione Nazionale Magistrati in materia di diritto e processo penale*" – p 23.

([89]) The *reformatio in peius* indicates the possibility that, following an appeal, the appellants find themselves in a worse position than if they had not appealed. In Italy, if the appeal is filed only by the appellant (as opposed to appeals filed by the public prosecutor), a "*reformatio in peius*" of the first-instance ruling is not allowed.

Box 4.4.1: **Investment challenges and reforms in Italy**

Section 1. Macroeconomic perspective

The economic recovery in Italy after the crisis has been weaker than in peer countries. The investment rate has been picking up since 2015, mostly for what concerns equipment investment, but remains substantially below the pre-crisis average. The persisting weakness of investment is mostly related to structural factors. Finally, the high stock of general government debt continues to weigh on public investment.

Section 2. Assessment of barriers to investment and ongoing reforms

Public administration/ Business environment	Regulatory/ administrative burden	
	Public administration	CSR
	Public procurement /PPPs	
	Judicial system	CSR
	Insolvency framework	CSR
	Competition and regulatory framework	CSR
Labour market/ Education	EPL & framework for labour contracts	
	Wages & wage setting	
	Education, skills, lifelong learning	

Financial Sector / Taxation	Taxation	CSR
	Access to finance	CSR
R&D&I	Cooperation btw academia, research and business	
	Financing of R&D&I	
Sector specific regulation	Business services / Regulated professions	CSR
	Retail	
	Construction	
	Digital Economy / Telecom	
	Energy	
	Transport	

Legend:

	No barrier to investment identified
CSR	Investment barriers that are also subject to a CSR
	No progress
	Limited progress
	Some progress
	Substantial progress
	Fully addressed
	Not assessed yet

Italy presents a number of challenges, including regional disparities (section 4.4). The public institutions are often perceived as inefficient, ineffective and not enough supportive of business activities (section 4.4). Moreover, firms are affected by financial constraints and a high tax burden on labour inputs (sections 4.1 and 4.2) while product and service market regulation and skills match can be improved to boost investment and productivity (sections 4.3 and 4.4).

Selected barriers to investment and priority actions underway

1. Firms' access to finance remains heavily biased towards banks where pockets of vulnerabilities persist (despite recent actions by the authorities), while capital markets remain underdeveloped (section 4.2). SME and innovative firms are usually constrained in obtaining bank loans by the lack of collaterals and by their undercapitalisation, while access to the stock market is generally limited to the few larger companies. Impresa 4.0 plan addresses this issue with a number of measures (section 4.4), including a strengthened public venture capital, crowdfunding for SMEs and start-up, an allowance for corporate equity and mini-bonds.

2. The Italian public procurement system is inefficient because of the fragmentation of the legal framework (section 4.4), the low level of administrative capacity and the lack of coordination among institutions make**.** A Public procurement and concessions code has been adopted. However, the implementation of the code is still not complete causing uncertainty and slowing down investment.

ANNEX A: OVERVIEW TABLE

Commitments	**Summary assessment**
2018 country-specific recommendations (CSRs)	
CSR 1: Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio. Shift taxation away from labour, including by reducing tax expenditure and reforming the outdated cadastral values. Step up efforts to tackle the shadow economy, including by strengthening the compulsory use of e-payments through lower legal thresholds for cash payments. Reduce the share of old-age pensions in public spending to create space for other social spending.	Italy has made **No Progress** in addressing CSR 1
Ensure that the nominal growth rate of net primary government expenditure does not exceed 0.1 % in 2019, corresponding to an annual structural adjustment of 0.6 % of GDP. Use windfall gains to accelerate the reduction of the general government debt ratio.	**The compliance assessment with the Stability and Growth Pact will be included in Spring when final data for 2018 will be available.**
Shift taxation away from labour, including by reducing tax expenditure and reforming the outdated cadastral values.	**No Progress** No progress was achieved in these areas, because: (i) tax expenditures have been reviewed but not streamlined; (ii) cadastral values have not been reformed; and (iii) taxation on labour has not been reduced nor shifted to other tax base but only a very marginal reduction of taxation on capital has been enacted (namely self-employed through the extension of the so-called "flat tax regime").
Step up efforts to tackle the shadow economy, including by strengthening the compulsory use of e-payments through lower legal thresholds for cash payments.	**Limited Progress** E-invoicing has become compulsory for the private sector as of 2019 pursuant to the 2018 budget law of December 2017. Moreover, electronic transmission of receipts has been introduced. Nevertheless, a new tax amnesty could offset the positive impact of those measures on tax compliance; no action was taken to encourage e-payments for instance through lower legal thresholds for cash payments.
Reduce the share of old-age pensions in public spending to create space for other social spending.	**No Progress** Old-age pension expenditure has actually been increased through the introduction of a new early-retirement scheme.
CSR 2: Reduce the length of civil trials at all instances by enforcing and streamlining procedural rules, including those under consideration by the legislator. Achieve more effective prevention and	Italy has made **Limited Progress** in addressing CSR 2

repression of corruption by reducing the length of criminal trials and implementing the new anti-corruption framework. Ensure enforcement of the new framework for publicly-owned enterprises and increase the efficiency and quality of local public services. Address restrictions to competition, including in services, also through a new annual competition law.	
Reduce the length of civil trials at all instances by enforcing and streamlining procedural rules, including those under consideration by the legislator.	**No Progress** No new measures have been introduced to enforce and streamline procedural rules, including those against the misuse of litigation.
Achieve more effective prevention and repression of corruption by reducing the length of criminal trials and implementing the new anti-corruption framework.	**Some Progress** A new anti-corruption law was passed by the Parliament in December 2018. It introduced stricter penalties and longer prescription terms for corruption offences. It even stops prescription terms after a first instance conviction (as requested by GRECO) but only as of 2020. However, despite the recent reform of the statute of limitations, prosecution of corruption remains ineffective due to long trials and the still unmet need of a reform of the appeal system to avoid misuse of litigation.
Ensure enforcement of the new framework for publicly-owned enterprises and increase the efficiency and quality of local public services.	**Limited Progress** The enforcement of the the new SOEs framework is ongoing, although with some delays. The limited ability of local bodies to effectively dismiss non-core shares is delaying the enforcement. No initiatives have been taken on local public services.
Address restrictions to competition, including in services, also through a new annual competition law.	**No Progress** No progress is registered in reducing barriers to competition.
CSR 3: Maintain the pace of reducing the high stock of non-performing loans and support further bank balance sheet restructuring and consolidation, including for small and medium-sized banks, and promptly implement the insolvency reform. Improve market-based access to finance for firms.	Italy has made **Some Progress** in addressing CSR 3
Maintain the pace of reducing the high stock of non-performing loans and support further bank balance sheet restructuring and consolidation, including for small and medium-sized banks, and promptly implement the insolvency reform.	**Some Progress** Banks' balance sheet repair including non-performing loans disposals through outright sales and securitisations with the government guarantee scheme (GACS) has substantially progressed. Despite a number of important banking reforms adopted in recent years, the corporate governance reform of the large cooperative banks has stalled and that of the small mutual banks somewhat watered down, while the insolvency framework reform still has to be finalised. Having said this, a recovering banking system, in

	particular small and mid-sized banks, is now suffering contagion from the increase in sovereign yields, which has already negatively impacted banks' capital positions and jeopardised access to unsecured wholesale funding.
Improve market-based access to finance for firms.	**Limited Progress** In addition to past policy measures (the SME Guarantee Fund, instruments through the state lender Cassa Depositi e Prestiti (CDP), Minibonds, the alternative investment market (AIM), and long-term individual saving plans (PIR)), a new fund for venture capital has been set and PIR will be extended to unlisted companies. However, the allowance for corporate equity (ACE), conducive in lowering leveraging and boosting firm equity has been abolished as part of the 2019 Budget law. Although these measures go in the right direction, there is a backtracking on increasing firms' capitalisation by the abrogation of ACE (which was largely used by corporations).
CSR 4: Step up implementation of the reform of active labour market policies to ensure equal access to effective job-search assistance and training. Encourage labour market participation of women through a comprehensive strategy, rationalising family-support policies and increasing the coverage of childcare facilities. Foster research, innovation, digital skills and infrastructure through better-targeted investment and increase participation in vocational-oriented tertiary education.	Italy has made **Limited Progress** in addressing CSR 4
Step up implementation of the reform of active labour market policies to ensure equal access to effective job-search assistance and training.	**Some Progress** Monitoring indicators and minimum standards for Public Employment Services (PES) staff were set at the national level by Decree in January 2018, but strengthening coordination between the national agency (ANPAL) and regions remains a major challenge. PES are being linked through a newly developed national IT system. The information provided to non-registered people has also been improved, as well as the on-line registration of jobseekers and the set-up of single points of contact for the long-term unemployed. But active labour market policies (ALMP) are barely integrated and coordinated with related policies (e.g. social protection, social services, adult learning, and vocational training). Major competences lie with regional authorities, which received new resources in 2018 to reinforce public employment services (PES). However, recruitments of new staff has not yet started.

Encourage labour market participation of women through a comprehensive strategy, rationalising family-support policies and increasing the coverage of childcare facilities.	**Limited Progress** Female labour participation remains one of the lowest in the EU. The employment rate of women (20-64) is substantially lower than the EU average ([52.5% vs 66.4%]) in 2017. A high tax wedge for second earners reduces the financial incentive for women to take up work (the marginal tax rate for a second earner earning two thirds of the average wage is at [30.5%] in 20XX). In addition, the lack of adequate measures to reconcile professional and private life such as care facilities tends to hamper employment, especially for women with dependent children or other family members in need of care. The share of children under three years of age in formal early childhood education at 27.3% is well below the EU average. This situation is exacerbated by an inadequate system of parental leave.
Foster research, innovation, digital skills and infrastructure through better-targeted investment and increase participation in vocational-oriented tertiary education.	**Limited Progress** A fully fledged assessment of the R&D incentives contained in Impresa 4.0 is lacking. From preliminary information available, tax incentives would have had a positive impact on private investment. However, the incentives - which remain of temporary nature - have been substantially reduced by the last budget law. The latter introduced a new (supposedly structural) system of tax reduction on reinvested profit, which however does not seem to concern also investment in R&D. The new budget law confirms the tax credit on training in skills linked to 4.0 technologies for 2019 (with 250 million EUR budget, the same amount budgeted the previous year); however a comprehensive strategy for digital skills is still missing; the funding for the National Plan for Digital School is still insufficient for reaching the Plan's objectives and competence centers for the Industry 4.0 strategy are having a slow start. The funding of public research is stagnating (0.50% GDP in 2017, the lowest value since 2005). Public investment in infrastructure remains low, although the government intends to address the issue of lack of project management skills within public administrations that hampers ability to carry out investment. Despite the interesting initiatives on ITS and 'lauree professionalizzanti', vocational-oriented tertiary education concern only a few thousand students. The 2019 Budget Law sets two institutional bodies to strengthen investment capacity of national and local authorities (Centrale per la progettazione delle opere pubbliche e Investitalia). Moreover, funds to promote innovative technologies such as Artificial Intelligence, Blockchain and Internet of Things were

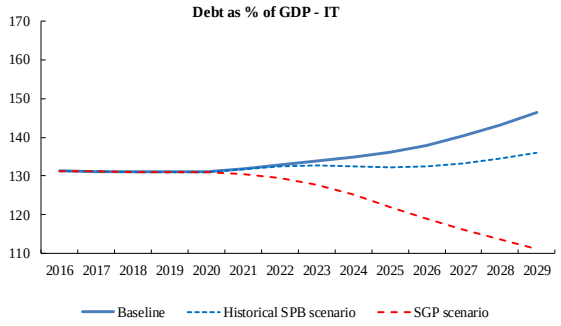
	created. The drafting of a standard contract for Public-Private Partnership is ongoing. The PPP for the creation of Competence centres were selected. Finally, the 2019 Budget Law provides incentives for private employers who hire young graduates or PHD holders through a permanent contract (EUR 50 mn in 2019 and 20 in 2020). No progress is registered on education, particularly on vocational-oriented tertiary education.
Europe 2020 (national targets and progress)	
Employment rate target set in the NRP: 67-69 %.	The employment rate has increased to 63.3 % in Q3-2018, still lower than the national target and substantially below the EU average (73.2 %).
R&D target set in the NRP: 1.53 % of GDP	Italy is not on track to meet its EU2020 target, as, R&D intensity would need to grow at more than double the growth rate of the current trend. In 2017, R&D intensity in Italy was 1.35 % of GDP composed of 61 % private investment (0.83 % of GDP) and 37 % public investment (0.50 % of GDP).
National greenhouse gas (GHG) emissions target: -13 % in 2020 compared with 2005 (in sectors not included in the EU emissions trading scheme)	According to the projections submitted in 2017, Italy is on track to meet its 2020 greenhouse gas (GHG) emission target, with a 8 percentage points margin (i.e. a reduction of 21%). In 2017, according to preliminary data, emissions were reduced by 20 % from 2005. The interim target of 11 % reduction was thereby overachieved by 9 percentage points.
2020 renewable energy target: 17 %	With a renewable energy share of 18.3 % in 2017, Italy is well above the trajectory to reach its 2020 renewable energy target. However compared to last year, the share of renewable electricity generation stalled, remaining at 34%, while the share of renewables in transport decreased of about 13% (from 7,4% in 2016 to 6,5 % in 2017). Only the share of renewables in heating and cooling increased substantially over this period (from 18.9 % to 20.1%). Further efforts are therefore needed across all three sectors in view of ensuring a steady growth of renewables and the achievement of the 2020 and 2030 objectives.

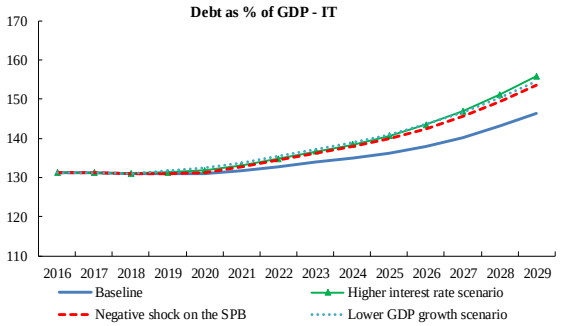
Energy efficiency, 2020 energy consumption targets: Italy's 2020 energy efficiency target is 158 Mtoe expressed in primary energy consumption (124 Mtoe expressed in final energy consumption)	The target was set at a level that would allow energy consumption to grow in the coming years. After the growth of both primary and final energy consumption in the period 2013-2014, energy consumption in the country decreased between 2015 and 2016. However primary energy consumption registered again a small increase, moving from 148.0 Mtoe in 2016 to 148,94 Mtoe in 2017. Final energy consumption decreased slightly from 115.9 Mtoe in 2016 to 115.2 Mtoe in 2017. In light of the possible economic recovery in Italy and of the recent upward trend in primary energy consumption, further efforts are however needed both to remain within the levels set for the 2020 energy efficiency target and in view of the new 2030 objectives.
Early leavers from education and training target: 16 % (EU target: <10 %)	Italy reached its national target in 2014 (15 %). The figure for 2017 was 14 %, slightly up from the previous year (13.8 %), and still one of the highest in the EU.
Tertiary education attainment (% of population aged 30-34) target: 26-27 % (EU target: >40 %)	The national target was reached in 2016 (26.2 %and the figure further increased in 2017 (to 26.9 %) – but is still one of the lowest in the EU and nowhere near the EU target of at least 40 %.
Target for reducing the number of people at risk of poverty or social exclusion, expressed as an absolute number of people: -2.2 million (base year 2010: 15.1 million).	With an increase of more than 2 million people at risk of poverty or social exclusion (AROPE) compared to 2008, Italy has not met this target. In 2017, the AROPE rate declined to 28.9 %, down from 30.0 % in 2016. However, it remains well above both pre-crisis levels (25.5 % in 2008) and the EU average (22 %).

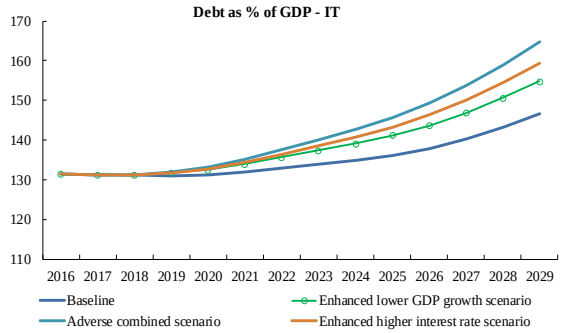
ANNEX B: COMMISSION DEBT SUSTAINABILITY ANALYSIS AND FISCAL RISKS

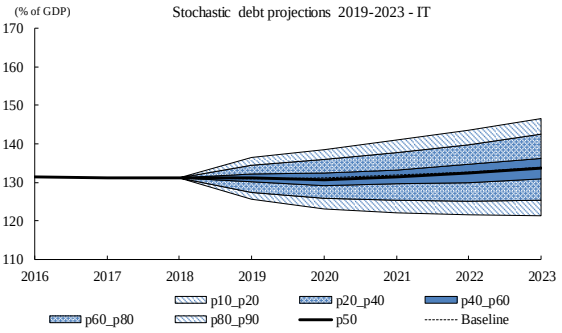
General Government debt projections under baseline, alternative scenarios and sensitivity tests

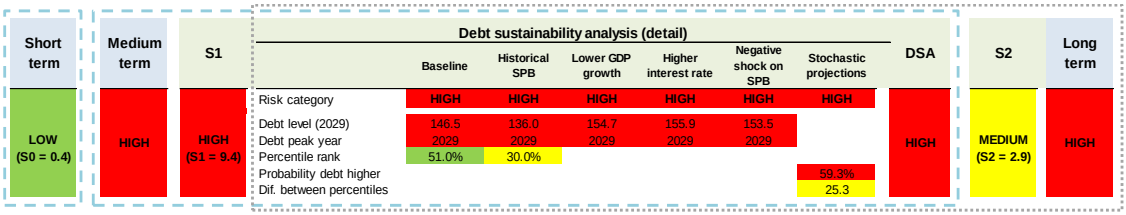
IT - Debt projections baseline scenario	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029
Gross debt ratio	**131.2**	**131.1**	**131.0**	**131.1**	**131.9**	**132.8**	**133.9**	**134.9**	**136.2**	**137.9**	**140.3**	**143.2**	**146.5**
Changes in the ratio (-1+2+3)	*-0.1*	*-0.1*	*-0.1*	*0.1*	*0.7*	*1.0*	*1.1*	*1.0*	*1.3*	*1.8*	*2.3*	*2.9*	*3.3*
of which													
(1) Primary balance (1.1+1.2+1.3)	**1.4**	**1.7**	**1.0**	**0.8**	**0.6**	**0.3**	**0.1**	**-0.1**	**-0.2**	**-0.3**	**-0.4**	**-0.6**	**-0.7**
(1.1) Structural primary balance *(1.1.1-1.1.2+1.1.3)*	***2.0***	***1.8***	***0.9***	***0.4***	***0.3***	***0.2***	***0.1***	***-0.1***	***-0.2***	***-0.3***	***-0.4***	***-0.6***	***-0.7***
(1.1.1) Structural primary balance (bef. CoA)	*2.0*	*1.8*	*0.9*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*
(1.1.2) Cost of ageing					*0.1*	*0.3*	*0.4*	*0.6*	*0.7*	*0.9*	*1.0*	*1.2*	*1.4*
(1.1.3) Others (taxes and property incomes)					*0.0*	*0.1*	*0.1*	*0.1*	*0.2*	*0.2*	*0.2*	*0.2*	*0.3*
(1.2) Cyclical component	***-0.5***	***-0.2***	***0.2***	***0.5***	***0.3***	***0.2***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(1.3) One-off and other temporary measures	***0.0***	***0.1***	***-0.1***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***	***0.0***
(2) Snowball effect (2.1+2.2+2.3)	**1.1**	**0.5**	**0.7**	**0.4**	**1.4**	**1.3**	**1.1**	**0.9**	**1.1**	**1.5**	**1.9**	**2.3**	**2.6**
(2.1) Interest expenditure	*3.8*	*3.7*	*3.8*	*3.9*	*4.0*	*4.1*	*4.2*	*4.3*	*4.6*	*4.8*	*5.2*	*5.5*	*5.8*
(2.2) Growth effect	*-2.0*	*-1.5*	*-1.5*	*-1.7*	*-0.5*	*-0.4*	*-0.4*	*-0.9*	*-0.8*	*-0.7*	*-0.5*	*-0.5*	*-0.5*
(2.3) Inflation effect	*-0.7*	*-1.6*	*-1.7*	*-1.8*	*-2.1*	*-2.3*	*-2.6*	*-2.6*	*-2.6*	*-2.7*	*-2.7*	*-2.8*	*-2.8*
(3) Stock-flow adjustments	**0.2**	**1.1**	**0.2**	**0.5**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**











Note: For further information, see the European Commission Fiscal Sustainability Report (FSR) 2018.

[1] The first table presents the baseline no-fiscal policy change scenario projections. It shows the projected government debt dynamics and its decomposition between the primary balance, snowball effects and stock-flow adjustments. Snowball effects measure the net impact of the counteracting effects of interest rates, inflation, real GDP growth (and exchange rates in some countries). Stock-flow adjustments include differences in cash and accrual accounting, net accumulation of assets, as well as valuation and other residual effects.

[2] The charts present a series of sensitivity tests around the baseline scenario, as well as alternative policy scenarios, in particular: the historical structural primary balance (SPB) scenario (where the SPB is set at its historical average), the Stability and Growth Pact (SGP) scenario (where fiscal policy is assumed to evolve in line with the main provisions of the SGP), a higher interest rate scenario (+1 pp. compared to the baseline), a lower GDP growth scenario (-0.5 pp. compared to the baseline) and a negative shock on the SPB (calibrated on the basis of the forecasted change). An adverse combined scenario and enhanced sensitivity tests (on the interest rate and growth) are also included, as well as stochastic projections. Detailed information on the design of these projections can be found in the FSR 2018.

[3] The second table presents the overall fiscal risk classification over the short, medium and long-term.

a. For the short-term, the risk category (low/high) is based on the S0 indicator. S0 is an early-detection indicator of fiscal stress in the upcoming year, based on 25 fiscal and financial-competitiveness variables that have proven in the past to be leading indicators of fiscal stress. The critical threshold beyond which fiscal distress is signalled is 0.46.

b. For the medium-term, the risk category (low/medium/high) is based on the joint use of the S1 indicator and of the DSA results. The S1 indicator measures the fiscal adjustment required (cumulated over the 5 years following the forecast horizon and sustained thereafter) to bring the debt-to-GDP ratio to 60 % by 2033. The critical values used are 0 and 2.5 pps. of GDP. The DSA classification is based on the results of 5 deterministic scenarios (baseline, historical SPB, higher interest rate, lower GDP growth and negative shock on the SPB scenarios) and the stochastic projections. Different criteria are used such as the projected debt level, the debt path, the realism of fiscal assumptions, the probability of debt stabilisation, and the size of uncertainties.

c. For the long-term, the risk category (low/medium/high) is based on the joint use of the S2 indicator and the DSA results. The S2 indicator measures the upfront and permanent fiscal adjustment required to stabilise the debt-to-GDP ratio over the infinite horizon, including the costs of ageing. The critical values used are 2 and 6 pps. of GDP. The DSA results are used to further qualify the long-term risk classification, in particular in cases when debt vulnerabilities are identified (a medium / high DSA risk category).

ANNEX C: STANDARD TABLES

Table C.1: **Financial Market Indicators**

	2013	2014	2015	2016	2017	2018
Total assets of the banking sector (% of GDP)[1)]	252.3	248.0	237.2	232.3	215.5	211.9
Share of assets of the five largest banks (% of total assets)	39.6	41.0	41.0	43.0	43.4	-
Foreign ownership of banking system (% of total assets)[2)]	8.6	8.3	7.8	8.6	8.0	8.3
Financial soundness indicators:[2)]						
- non-performing loans (% of total loans)	-	16.5	16.5	15.0	11.2	10.0
- capital adequacy ratio (%)	13.7	14.2	14.8	13.9	16.8	16.0
- return on equity (%)[3)]	-11.5	-2.8	3.1	-7.7	7.1	7.4
Bank loans to the private sector (year-on-year % change)[1)]	-3.5	-0.8	-0.6	-0.2	-1.6	0.0
Lending for house purchase (year-on-year % change)[1)]	-1.1	-0.9	0.4	1.7	2.1	1.9
Loan to deposit ratio[2)]	-	109.2	105.8	101.2	102.1	95.8
Central Bank liquidity as % of liabilities[1)]	-	6.2	5.1	6.5	8.4	7.9
Private debt (% of GDP)	121.6	119.0	115.1	111.8	110.5	-
Gross external debt (% of GDP)[2)] - public	43.2	50.3	50.9	47.3	45.6	42.0
- private	31.2	30.7	29.5	27.2	25.3	26.5
Long-term interest rate spread versus Bund (basis points)*	274.7	172.9	121.8	139.8	179.4	216.5
Credit default swap spreads for sovereign securities (5-year)*	199.7	101.6	92.2	107.8	86.8	87.1

(1) Latest data Q3 2018. Includes not only banks but all monetary financial institutions excluding central banks.
(2) Latest data Q2 2018.
(3) Quarterly values are annualised.
* Measured in basis points.
Source: European Commission (long-term interest rates); World Bank (gross external debt); Eurostat (private debt); ECB (all other indicators).

Table C.2: **Headline Social Scoreboard indicators**

	2013	2014	2015	2016	2017	2018 [6]
Equal opportunities and access to the labour market						
Early leavers from education and training (% of population aged 18-24)	16.8	15.0	14.7	13.8	14.0	:
Gender employment gap (pps)	19.8	19.4	20.0	20.1	19.8	19.9
Income inequality, measured as quintile share ratio (S80/S20)	5.8	5.8	5.8	6.3	5.9	:
At-risk-of-poverty or social exclusion rate[1] (AROPE)	28.5	28.3	28.7	30.0	28.9	:
Young people neither in employment nor in education and training (% of population aged 15-24)	22.2	22.1	21.4	19.9	20.1	:
Dynamic labour markets and fair working conditions[†]						
Employment rate (20-64 years)	59.7	59.9	60.5	61.6	62.3	62.9
Unemployment rate[2] (15-74 years)	12.1	12.7	11.9	11.7	11.2	10.6
Long-term unemployment rate[3] (as % of active population)	6.9	7.7	6.9	6.7	6.5	6.2
Gross disposable income of households in real terms per capita[4] (Index 2008=100)	88.4	88.5	89.6	90.7	91.3	:
Annual net earnings of a full-time single worker without children earning an average wage (levels in PPS, three-year average)	20408	20597	20762	21070	:	:
Annual net earnings of a full-time single worker without children earning an average wage (percentage change, real terms, three-year average)	-1.3	-0.7	0.1	0.7	:	:
Public support / Social protection and inclusion						
Impact of social transfers (excluding pensions) on poverty reduction[5]	21.5	21.5	21.7	21.4	19.4	:
Children aged less than 3 years in formal childcare	22.0	22.9	27.3	34.4	28.6	:
Self-reported unmet need for medical care	7.0	7.0	7.2	5.5	1.8	:
Individuals who have basic or above basic overall digital skills (% of population aged 16-74)	:	:	43.0	44.0	:	:

(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) 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.
(3) Long-term unemployed are people who have been unemployed for at least 12 months.
(4) Gross disposable household income is defined in unadjusted terms, according to the draft Joint Employment Report 2019.
(5) Reduction in percentage of the risk of poverty rate, due to social transfers (calculated comparing at-risk-of poverty rates before social transfers with those after transfers; pensions are not considered as social transfers in the calculation).
(6) Average of first three quarters of 2018 for the employment rate, long-term unemployment rate and gender employment gap. Data for unemployment rate is seasonally adjusted (annual series, for EE, EL, HU, IT and UK data based on first three quarters of 2018).
Source: Eurostat

Table C.3: **Labour market and education indicators**

Labour market indicators	**2013**	**2014**	**2015**	**2016**	**2017**	**2018** [4]
Activity rate (15-64)	63.4	63.9	64.0	64.9	65.4	:
Employment in current job by duration						
From 0 to 11 months	8.9	9.3	10.0	10.3	10.5	:
From 12 to 23 months	5.9	5.6	6.1	7.0	7.0	:
From 24 to 59 months	13.8	13.3	12.4	12.4	12.6	:
60 months or over	71.4	71.8	71.5	70.3	69.8	:
Employment growth* (% change from previous year)	-1.8	0.1	0.7	1.3	1.2	0.6
Employment rate of women (% of female population aged 20-64)	49.9	50.3	50.6	51.6	52.5	53.1
Employment rate of men (% of male population aged 20-64)	69.7	69.7	70.6	71.7	72.3	73.0
Employment rate of older workers* (% of population aged 55-64)	42.7	46.2	48.2	50.3	52.2	53.7
Part-time employment* (% of total employment, aged 15-64)	17.6	18.1	18.3	18.5	18.5	18.3
Fixed-term employment* (% of employees with a fixed term contract, aged 15-64)	13.2	13.6	14.1	14.0	15.5	17.1
Participation in activation labour market policies (per 100 persons wanting to work)	16.7	15.1	:	:	:	:
Transition rate from temporary to permanent employment (3-year average)	20.1	19.1	19.8	20.1	16.3	:
Youth unemployment rate (% active population aged 15-24)	40.0	42.7	40.3	37.8	34.7	32.2
Gender gap in part-time employment	24.3	24.3	24.4	24.5	24.2	24.3
Gender pay gap[1] (in undadjusted form)	7.0	6.1	5.5	5.3	:	:
Education and training indicators	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**
Adult participation in learning (% of people aged 25-64 participating in education and training)	6.2	8.1	7.3	8.3	7.9	:
Underachievement in education[2]	:	:	23.3	:	:	:
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	22.5	23.9	25.3	26.2	26.9	:
Variation in performance explained by students' socio-economic status[3]	:	:	9.6	:	:	:

* Non-scoreboard indicator

(1) Difference between the average gross hourly earnings of male paid employees and of female paid employees as a percentage of average gross hourly earnings of male paid employees. It is defined as "unadjusted", as it does not correct for the distribution of individual characteristics (and thus gives an overall picture of gender inequalities in terms of pay). All employees working in firms with ten or more employees, without restrictions for age and hours worked, are included.

(2) PISA (OECD) results for low achievement in mathematics for 15 year-olds.

(3) Impact of socio-economic and cultural status on PISA (OECD) scores. Values for 2012 and 2015 refer respectively to mathematics and science.

(4) Average of first three quarters of 2018. Data for youth unemployment rate is seasonally adjusted (annual series, for EE, EL, HU, IT and UK data based on first three quarters of 2018).

Source: Eurostat, OECD

Table C.4: **Social inclusion and health indicators**

	2012	2013	2014	2015	2016	2017
Expenditure on social protection benefits* (% of GDP)						
Sickness/healthcare	6.8	6.8	6.8	6.6	6.6	:
Disability	1.6	1.7	1.7	1.7	1.7	:
Old age and survivors	16.7	17.0	16.8	16.8	16.5	:
Family/children	1.2	1.2	1.6	1.7	1.8	:
Unemployment	1.6	1.8	1.7	1.7	1.7	:
Housing	0.0	0.0	0.0	0.0	0.0	:
Social exclusion n.e.c.	0.2	0.2	0.2	0.2	0.3	:
Total	28.1	28.6	28.8	28.8	28.6	:
of which: means-tested benefits	1.6	1.6	2.1	2.2	2.3	:
General government expenditure by function (% of GDP, COFOG)						
Social protection	20.5	21.0	21.2	21.3	21.1	:
Health	7.2	7.2	7.2	7.0	7.0	:
Education	4.1	4.1	4.0	4.0	3.9	:
Out-of-pocket expenditure on healthcare (% of total health expenditure)	21.7	21.8	22.1	23.1	23.1	:
Children at risk of poverty or social exclusion (% of people aged 0-17)*	34.1	32.0	32.1	33.5	33.2	32.1
At-risk-of-poverty rate[1] (% of total population)	19.5	19.3	19.4	19.9	20.6	20.3
In-work at-risk-of-poverty rate (% of persons employed)	11.0	11.0	11.0	11.5	11.7	12.2
Severe material deprivation rate[2] (% of total population)	14.5	12.3	11.6	11.5	12.1	10.1
Severe housing deprivation rate[3], by tenure status						
Owner, with mortgage or loan	8.3	9.1	8.4	9.7	6.5	5.2
Tenant, rent at market price	16.8	16.2	19.1	18.6	14.8	11.1
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	10.6	11.3	12.1	11.7	12.8	11.8
Poverty thresholds, expressed in national currency at constant prices*	8611	8212	8118	8147	8344	8504
Healthy life years (at the age of 65)						
Females	7.1	7.1	7.3	7.5	10.1	:
Males	7.7	7.7	7.8	7.8	10.4	:
Aggregate replacement ratio for pensions[5] (at the age of 65)	0.6	0.6	0.6	0.7	0.7	0.7
Connectivity dimension of the Digital Economy and Society Inedex (DESI)[6]	:	:	35.6	40.2	43.5	53.8
GINI coefficient before taxes and transfers*	51.0	51.6	51.7	51.3	52.5	51.8
GINI coefficient after taxes and transfers*	32.4	32.8	32.4	32.4	33.1	32.7

* Non-scoreboard indicator
(1) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
(2) 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.
(3) Percentage of total population living in overcrowded dwellings and exhibiting housing deprivation.
(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) Ratio of the median individual gross pensions of people aged 65-74 relative to the median individual gross earnings of people aged 50-59.
(6) Fixed broadband take up (33%), mobile broadband take up (22%), speed (33%) and affordability (11%), from the Digital Scoreboard.

Source: Eurostat, OECD

Table C.5: **Product market performance and policy indicators**

Performance indicators	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Labour productivity per person[1] growth (t/t-1) in %						
Labour productivity growth in industry	-1.02	0.48	1.43	1.86	1.21	3.01
Labour productivity growth in construction	-2.26	2.75	-1.76	0.35	0.53	0.73
Labour productivity growth in market services	-2.83	-0.09	0.44	-0.23	-0.88	-0.14
Unit Labour Cost (ULC) index[2] growth (t/t-1) in %						
ULC growth in industry	1.38	1.85	0.68	1.17	-0.01	-1.10
ULC growth in construction	-0.35	-4.35	0.68	2.74	0.97	0.17
ULC growth in market services	1.51	0.72	0.24	2.31	2.84	1.50
Business environment	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Time needed to enforce contracts[3] (days)	1185	1185	1185	1120	1120	1120
Time needed to start a business[3] (days)	7.5	7.5	6.5	6.0	6.0	6.0
Outcome of applications by SMEs for bank loans[4]	1.08	0.95	1.06	0.58	0.51	0.33
Research and innovation	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
R&D intensity	1.27	1.31	1.34	1.34	1.37	1.35
General government expenditure on education as % of GDP	4.10	4.10	4.00	4.00	3.90	:
Employed people with tertiary education and/or people employed in science and technology as % of total employment	33	33	33	34	34	35
Population having completed tertiary education[5]	14	14	15	16	16	17
Young people with upper secondary education[6]	78	78	80	80	81	82
Trade balance of high technology products as % of GDP	-0.61	-0.43	-0.41	-0.56	-0.49	-0.41
Product and service markets and competition				**2003**	**2008**	**2013**
OECD product market regulation (PMR)[7], overall				1.80	1.49	1.26
OECD PMR[7], retail				3.85	4.06	3.15
OECD PMR[7], professional services				3.55	3.02	2.10
OECD PMR[7], network industries[8]				2.97	2.45	2.01

(1) Value added in constant prices divided by the number of persons employed.
(2) Compensation of employees in current prices divided by value added in constant prices.
(3) The methodologies, including the assumptions, for this indicator are shown in detail here: http://www.doingbusiness.org/methodology .
(4) Average of the answer to question Q7B_a. "[Bank loan]: If you applied and tried to negotiate for this type of financing over the past six months, what was the outcome?". Answers were codified as follows: zero if received everything, one if received 75% and above, two if received below 75%, three if refused or rejected and treated as missing values if the application is still pending or don't know.
(5) Percentage population aged 15-64 having completed tertiary education.
(6) Percentage population aged 20-24 having attained at least upper secondary education.
(7) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are shown in detail here: http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm
(8) 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); SAFE (for outcome of SMEs' applications for bank loans)."

Table C.6: **Green growth**

Green growth performance		2012	2013	2014	2015	2016	2017
Macroeconomic							
Energy intensity	kgoe / €	0.11	0.10	0.10	0.10	0.10	-
Carbon intensity	kg / €	0.30	0.29	0.28	0.28	0.27	-
Resource intensity (reciprocal of resource productivity)	kg / €	0.36	0.32	0.31	0.32	0.32	0.32
Waste intensity	kg / €	0.10	-	0.10	-	0.10	-
Energy balance of trade	% GDP	-3.8	-3.3	-2.6	-2.0	-1.6	-1.9
Weighting of energy in HICP	%	9.57	10.02	9.11	9.96	9.55	8.98
Difference between energy price change and inflation	%	9.2	0.1	-3.7	-2.8	-4.7	1.4
Real unit of energy cost	% of value added	14.7	14.0	12.6	13.1	13.8	-
Ratio of environmental taxes to labour taxes	ratio	0.16	0.16	0.17	0.16	0.17	-
Environmental taxes	% GDP	3.5	3.5	3.6	3.4	3.5	-
Sectoral							
Industry energy intensity	kgoe / €	0.11	0.10	0.10	0.10	0.10	-
Real unit energy cost for manufacturing industry excl. refining	% of value added	18.2	17.5	16.0	17.3	19.0	-
Share of energy-intensive industries in the economy	% GDP	8.09	7.97	7.88	7.75	7.83	8.01
Electricity prices for medium-sized industrial users	€ / kWh	0.17	0.17	0.17	0.16	0.15	0.15
Gas prices for medium-sized industrial users	€ / kWh	0.04	0.04	0.04	0.03	0.03	0.03
Public R&D for energy	% GDP	0.02	0.02	0.02	0.02	0.02	0.02
Public R&D for environmental protection	% GDP	0.02	0.01	0.02	0.01	0.01	0.01
Municipal waste recycling rate	%	38.4	39.4	41.6	43.5	45.1	-
Share of GHG emissions covered by ETS*	%	39.9	37.6	36.6	36.3	36.4	-
Transport energy intensity	kgoe / €	0.53	0.54	0.56	0.57	0.55	-
Transport carbon intensity	kg / €	1.44	1.44	1.53	1.54	1.47	-
Security of energy supply							
Energy import dependency	%	56.4	55.9	40.6	51.2	47.2	-
Aggregated supplier concentration index	HHI	13.8	16.0	13.3	14.9	16.1	-
Diversification of energy mix	HHI	0.30	0.29	0.29	0.29	0.30	-

(1) All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2010 prices)
Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)
Carbon intensity: greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
Resource intensity: domestic material consumption (in kg) divided by GDP (in EUR)
Waste intensity: waste (in kg) divided by GDP (in EUR)
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Weighting of energy in HICP: the proportion of 'energy' items in the consumption basket used for the construction of the HICP
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)
Real unit energy cost: real energy costs as % of total value added for the economy
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2010 EUR)
Real unit energy costs for manufacturing industry excluding refining : real costs as % of value added for manufacturing sectors
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices for medium-sized industrial users: consumption band 500–20 00MWh and 10 000–100 000 GJ; figures excl. VAT.
Recycling rate of municipal waste: ratio of recycled and composted municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D for these categories as % of GDP
Proportion of GHG emissions covered by EU emissions trading system (ETS) (excluding aviation): based on GHG emissions (excl land use, land use change and forestry) as reported by Member States to the European Environment Agency.
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2010 EUR)
Transport carbon intensity: GHG emissions in transport activity divided by gross value added of the transport industry
Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels
Aggregated supplier concentration index: covers oil, gas and coal. Smaller values indicate larger diversification and hence lower risk.
Diversification of the energy mix: Herfindahl index covering natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
* European Commission and European Environment Agency
Source: European Commission and European Environment Agency (Share of GHG emissions covered by ETS); European Commission (Environmental taxes over labour taxes and GDP); Eurostat (all other indicators)

ANNEX D: INVESTMENT GUIDANCE ON COHESION POLICY FUNDING 2021-2027 FOR ITALY

Building on the Commission proposal for the next Multi-Annual Financial Framework for the period 2021-2027 of 2 May 2018 (COM (2018) 321), this Annex D presents the preliminary Commission services views on priority investment areas and framework conditions for effective delivery for the 2021-2027 Cohesion Policy. These priority investment areas are derived from the broader context of investment bottlenecks, investment needs and regional disparities assessed in the report. This Annex provides the basis for a dialogue between Italy and the Commission services in view of the programming of the cohesion policy funds (European Regional Development Fund and European Social Fund Plus).

Policy Objective 1: A Smarter Europe – Innovative and smart industrial transformation
Expenditure on research and innovation in Italy is significantly below EU average and the country is considered a moderate innovator. Italy has room to foster productivity growth by **enhancing research and innovation capacities and the uptake of advanced technologies**, in line with national and regional smart specialisation strategies. High priority investment needs([90]) are identified to address the technological, economic and societal challenges, while tackling strong regional divergences, in particular to: increase the number and the scale-up of innovative firms in knowledge-intensive sectors with the highest growth potential; foster knowledge exchanges between research organisations and businesses, especially innovative small and medium sized enterprises, in particular through collaborative partnerships and training. support innovative services for research organisations and companies that cooperate with the aim of transforming new ideas into commercially viable innovative enterprises.
Given the lack of integration of digital technologies in the economy and the low level of digital skills, investment needs have therefore been identified **to promote digitisation for citizens, companies and governments**, and in particular to: increase digital skills in small and medium sized enterprises and their uptake of digital technology solutions, including e-commerce, e-payments, cloud-computing services, and also internet of things, cybersecurity and artificial intelligence; improve the deployment of digital public services for both citizens and businesses, and e-procurement, to support the efficiency and transparency of public administrations.

([90]) The intensity of needs is classified in three categories in a descending order – high priority needs, priority needs, needs.

Italian small and medium sized enterprises perform below EU average in terms of productivity and growth. Investment needs have therefore been identified to **enhance growth and competitiveness of** small and medium sized enterprises, and in particular to:

foster growth and productivity-enhancing strategies through promotion of entrepreneurship, managerial and financial skills, skills related to industrial transition (e.g. energy efficiency and circular economy), and value chains integration;

support internationalisation of small and medium sized enterprises to move up in the global value chains, including by joining cooperation networks and inter-regional clusters;

facilitate access to finance and address regional disparities through a balanced use of grants and financial instruments in less-developed regions and a wider use of financial instruments in more-developed ones.

Policy Objective 2: A low carbon and greener Europe – Clean and fair energy transition, green and blue investment, circular economy, climate adaptation and risk prevention

Italy scores well with respect to the 2020 Climate and Energy targets. However, the decoupling between economic growth and energy consumption is still weak, and recent progress in both renewable energy and energy efficiency is modest. High priority investment needs have therefore been identified to **promote energy efficiency measures,** as well as **priority investments for renewable energy**, and in particular to:

promote energy efficiency through renovation of social housing and public buildings, giving priority to deep renovations, innovative technologies and most advanced standards and practices;

promote innovative and less mature renewable technologies, particularly for heating and cooling, in public buildings, social housing and industrial processes in small and medium sized enterprises;

promote technologies, such as energy storage, to integrate more renewable energy in the system and increase flexibility and smartening of the grid, also increasing the coupling of energy sectors.

Due to its geography, Italy is particularly vulnerable to threats arising from climate change, hydrogeological events and seismic activity. High-priority investment needs have therefore been identified to **promote climate change adaptation, risk prevention and disaster resilience**, and in particular to:

strengthen prevention and preparedness measures increasing hydrogeological resilience based on an integrated basin and eco-system restoration approach, in line with regional floods management plans;

promote seismic resilience, focusing on public buildings, such as schools and hospitals;

deploy green infrastructure aimed at ecosystem restoration and climate adaptation in urban

areas more vulnerable to climate change, biodiversity loss and air pollution.

The quality of local water and waste management is greatly uneven across regions. The level of infringements with EU water legislation is relatively high in the less developed regions. On waste management, despite some improvements, more efforts are needed to comply with the post-2020 recycling targets, especially in less developed regions. Investment needs have therefore been identified to **promote sustainable water and waste management, and circular economy**, and in particular to:

address water access, reuse, treatment, drinking water and leakage in the less developed regions;

support waste prevention, reuse and recycling with adequate infrastructure, and target upper stages of the waste hierarchy, such as separate waste collection systems, in the less developed regions;

supporting small and medium sized enterprises in implementing innovative circular economy and other green economy solutions.

Policy Objective 3: A more connected Europe – Mobility and regional information and communication technology connectivity

On ultrafast internet connectivity (100 Mbps and above), Italy still lags behind EU average. In order to enhance **digital connectivity**, high-priority investment needs have therefore been identified:

build very-high capacity broadband networks, starting from the deployment of infrastructure networks for ultrafast internet access (100 Mbps or more) in white areas, also with the aim of tackling the urban-rural broadband coverage gap.

The Italian transportation system relies heavily on roads. The sector could contribute more to climate change objectives. Moreover, the Italian section of the Scandinavian-Mediterranean corridor, eligible for ERDF funding in the less developed regions, is still incomplete. In order to develop a **sustainable, climate resilient, intelligent, secure and intermodal Trans European transport network**, investment needs have therefore been identified in the following areas:

completion of the rail Trans European transport network , also bringing national sections of the network in line with EU standards (including European Railway Traffic Management System, interoperability. accessibility for users with reduced mobility);

multimodality: i) rail-sea connections to Trans European transport network core ports for freight transport; ii) rail/public transport links to Trans European transport network airports for passengers.

As for regional railways, which connect inner areas with urban centres and Trans European transport network nodes, there is a persistent infrastructure gap between the more and the less developed regions, in terms of electrification, single vs. double tracks, traffic

management systems and intermodality stations. In order to **develop sustainable, climate resilient, intelligent and intermodal regional mobility,** investment needs have therefore been identified in the following areas: electrification of regional railways; improvement of traffic management systems, elimination of uncontrolled and non-automated level crossings, and enhanced access for persons with reduced mobility to railways; better accessibility and improved access to urban centres and Trans European transport network, through intermodal platforms (bikes, car-sharing, etc.) nearby regional rail stations.
The efficiency and quality of local public transport is generally lagging behind in the less developed regions, while some Centre-Northern Italy's urban centres which are affected by traffic congestion. In order to promote actions included **in sustainable urban mobility** plans and enable the shift from private cars towards cleaner forms of mobility, high priority investment needs have therefore been identified in order to: support intermodal platforms, and promote active and innovative forms of mobility (such as bikes); support clean transport infrastructure (e.g. metro, tram, light rail); promote the expansion of infrastructure for electro-mobility; intelligent transport systems solutions for improved infrastructure use and service quality.
Policy Objective 4: A more social Europe – Implementing the European Pillar of Social Rights
Italy faces important **labour market** challenges, notably the labour market participation of women and youth, with a wide territorial divide. High priority investment needs have therefore been therefore identified **to improve access to employment, modernise labour market institutions and promote women's labour market participation**, taking into account regional disparities, and in particular to: improve access to the labour market, in particular for women, youth, third country nationals, long-term unemployed and inactive people; improve the capacity of labour market institutions and services, and enhance cooperation with employers and education institutes and between service providers; promote work-life balance policies, including access to affordable care services, greater involvement of men in caring duties and support to innovative ways of work organisation; fight undeclared work and labour exploitation (e.g. migrants in the agriculture sector).

The **education and training system** is characterised by wide regional differences in terms of learning outcomes, school infrastructure and equipment. High priority investment needs have therefore been therefore identified **to improve the quality, accessibility, effectiveness and labour market relevance of education and training and promote lifelong learning**, and in particular to:

fight early school leaving and improve basic skills levels, with particular attention to the areas with the highest drop-out rates;

widen access to tertiary education, in particular for students from low socio-economic backgrounds, including by increasing the offer of student accommodation, and expand the tertiary non-academic sector to increase tertiary educational attainment;

ensure the quality, accessibility, inclusiveness, effectiveness and labour market relevance of education and training, in particular for persons with disabilities and disadvantaged groups, to support acquisition of key competences, including digital skills;

modernise vocational education and training systems, including by strengthening work-based learning;

ensure lifelong learning, upskilling and reskilling for all, including low skilled adults, taking into account digital skills as well as other specific sectoral needs (e.g. green industrial transformation), through validation of prior learning, better anticipation of new skills requirements;

upgrade education equipment and infrastructure in all levels of education, in particular in less developed regions.

The rate of people at risk of **poverty and social exclusion** and income inequality remain among the highest in the EU. High priority investment needs have therefore been therefore identified **to foster active inclusion, promote the socio-economic integration of people at risk of poverty or social exclusion**, **address material deprivation**, **improve accessibility, effectiveness and resilience of healthcare and long-term care with a view to reducing health inequalities,** and in particular to:

foster integrated and personalised active inclusion measures to outreach people at risk of poverty or social exclusion, including children and working poor;

enhance high quality, accessible and affordable social services and their infrastructure, including housing, childcare, healthcare and long-term care, taking into account regional disparities and the rural/urban divide, also in access to innovative technologies and new care models;

improve accessibility and adequacy of social protection systems as well as independent living for all, including persons with disabilities, through the development of community-based services and the integration of health, social and long-term care services;

ensure the re-skilling and upskilling of healthcare, long-term care and social service

workforce;

promote socio-economic integration of third-country nationals, while also ensuring their protection from violence and exploitation, and of marginalised communities, also through housing infrastructure;

address material deprivation through food and basic material assistance to the most deprived.

Policy Objective 5 – A Europe closer to citizens by fostering the sustainable and integrated development of urban, rural and coastal areas and local initiatives

Italy has a large geographical diversity of "territories" (urban, metropolitan, rural but also coastal, islands, mountains) with a high degree of complexity, potential and challenges. Territorial strategies need to be implemented in synergy with the other policy objectives with the primary aim of fostering economic and social development in areas most affected by poverty. Investment needs have therefore been identified at territorial level, in terms of functional areas:

metropolitan functional areas need to address poverty challenges, caused also by agglomeration effect and population trends;

medium urban areas need to develop innovative ways of cooperation in order to enhance their economic, social and environmental potential, taking vulnerable groups into account;

inner areas confronted with demographic challenges and poverty need to improve the quality of services of general interests.

In the context of territorial strategies, investments needs are also identified to promote cultural heritage and support to enterprises in the culture and creative sectors, with a focus on local production systems and locally rooted jobs, including through territorial cooperation.

Factors for effective delivery of Cohesion policy

Italy is confronted with weak administrative capacity for the management of European Structural and Investment Funds. This is reflected in below-average absorption of European Structural and Investment funds in some regions and for some national programmes. To improve the administration and implementation of the European Structural and Investment Funds, there is a need to:

ensure proper implementation of administrative strengthening plans (Piani di Rafforzamento Amministrativo) based on the experience of the 2014-20 period;

reinforce partnership and bottom-up policy setting with greater involvement of cities, other local bodies, and economic and social partners to ensure a timely and efficient implementation of territorial and urban integrated strategies;

enhance capacity and participation of social partners in the delivery of the policy objectives;

increase administrative capacity of beneficiaries, in particular at local level, to prepare and implement projects;

improve, both in terms of quality and timing, the preparation of key infrastructural projects, in particular rail projects on the national network in less developed regions;

take into account the lessons learnt in Piemonte during the implementation of the Commission pilot project on industrial transition, in particular about the impact of new technologies, decarbonisation and the promotion of inclusive growth;

strengthen measures to prevent and combat conflict of interests, fraud and corruption;

improve public procurement performance, in particular with regard to the number of contracting authorities, their professional capacity, their ability to integrate sustainability and innovation aspects in procurement, single bidding, simplification of procedures, decision speed, small and medium sized enterprises contractors, and capacity of the authorities to carry out effective verifications;

broader use of financial instruments and contribution to a compartment for Italy under InvestEU for all revenue-generating and cost-saving activities.

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