Italy - 2006 IMF Article IV Consultation
Preliminary Conclusions of the Mission

November 13, 2006

1. **The current economic recovery provides a window of opportunity for adjustment and reform that Italy cannot afford to miss.** The economy shows signs of emerging from an extended period of poor performance. The challenge for the government is to ensure that this recovery serves as the take-off for a sustained expansion, rather than just a short-lived cyclical rebound. Growth is picking up, some progress has already been achieved on the structural reform agenda, and buoyant revenues are helping the fiscal outturn. This is the most propitious economic environment in years to unshackle Italy's growth potential by putting the fiscal accounts in order, enhancing domestic competition, and improving the business environment. If not now, when?

2. **The ongoing cyclical recovery is notable for its breadth.** Export performance has improved in recent months, helped by solid global demand. In addition, investment has rebounded after several quarters of very weak outturns, while private consumption has strengthened. Overall, we see GDP growth of some 1¾ percent in 2006, declining modestly to about 1½ percent in 2007, still somewhat above Italy's current, low potential. Should these predictions prove correct, this would constitute the most robust two-year period of growth since the start of the current decade. In response to the improved environment we also expect continued employment growth and further declines in the unemployment rate. Inflation is forecast to remain close to current levels.

3. **Just as encouraging are the signs that Italian firms are beginning to profit from the opportunities offered by globalization.** The recent pickup in exports (especially in value terms), including in some traditional sectors and in highly competitive emerging markets, suggests that the initial stages of the necessary transformation to higher value-added, less labor-intensive goods may be underway. Increasingly, anecdotal evidence points in the same direction. This testifies to the fact that the problems that have plagued the Italian economy for years are not insoluble. At the same time, there can be no doubt that a decade of very low productivity growth has imposed a heavy burden on the economy that will take time to redress even with strong fiscal policies and substantial structural reforms. Perseverance on this front is essential to return to faster growth, while delays will only aggravate problems, making their eventual resolution even more difficult and costly.

Fiscal Developments and Prospects

4. **Remarkably strong revenues may push this year's deficit below its original target, but record spending shows that fundamental problems remain to be solved.** Based on current trends, the deficit may end the year below 3½ percent of GDP (net of court-ordered VAT refunds). While the factors underlying the strong revenue performance are not fully clear, they are at least partly structural. This could allow for better fiscal performance in the medium term, but only so long as spending pressures are contained. Unfortunately, expected sizable spending overruns relative to the 2006 budget—especially on wages and salaries and purchases of goods and services, largely for health—offer little cause for optimism. This overspending is especially disappointing as it will occur despite new expenditure control measures implemented during the year. The ratio of primary current spending to GDP will likely rise in 2006 for the sixth consecutive year (driven by real current primary spending growth of more than 2 percent

5. **This experience underscores that Italy's economic house cannot be put in order until spending trends are reversed.** Although some European countries spend more than Italy, these countries typically have far more extensive social welfare systems. Neither can it be argued that high levels of public spending are needed to support growth: how much growth have years of rising public expenditure brought to Italy? To the contrary, the legacy of Italy's

high spending is a massive debt load and a heavy tax burden that diverts resources from families and enterprises to the public sector, sapping growth. Experience around the world shows that to be successful and durable, fiscal adjustment needs to be based on curbing expenditure, not raising revenue, partly because of the confidence-dampening impact an increase in the tax burden can have. The priority for enhancing Italy's growth potential, then, is to address the factors that account for the persistent rise of public spending, in order to boost the primary surplus and drive down the public debt.

6. **The 2007 budget lives up to Italy's deficit commitments and contains some first steps to address medium-term spending pressures, but deficit reduction next year will come entirely from an increase in the revenue ratio.** While we expect the yield of some of the budget measures to fall short of estimates, we nevertheless project the deficit to decline below 3 percent of GDP next year, achieving the target agreed to under the Excessive Deficit Procedure. The budget should be approved undiluted and implemented rigorously to secure this important milestone. If spending targets are adhered to, the trend of rising primary current expenditure would be arrested, but only just: the budget projects the ratio of such spending to GDP to stabilize at broadly its 2006 level, as savings from some budget measures will be fully offset by new expenditure initiatives. In health care, and to a lesser extent in civil service and local government spending, the budget contains some initial measures that could, over time, contribute to containing expenditure pressures. Nevertheless, they fall short of fully realizing the commitment in the government's medium-term economic program (DPEF) to address comprehensively the structural determinants of spending in these areas, which have accounted for the bulk of recent expenditure growth. Without concerted action to address the priority spending areas highlighted in the DPEF there is a risk that Italy's exit from the Excessive Deficit Procedure's "red zone" could prove short-lived, with the higher revenue-to-GDP ratio simply providing additional fuel for Italy's relentless public spending machine.

7. **Structural reforms in priority spending areas should thus be initiated immediately after budget approval, making them effective before the next budget round.** In the public administration, planned discussions on civil service reform should begin promptly, with a view to reducing the relatively high wage bill and enhancing efficiency, including by rewarding merit and increasing mobility, without which the planned territorial reorganization is impracticable. Regarding local governments, the revisions to the Domestic Stability Pact that shift from spending to deficit limits are a step forward, but Italy is still far from a comprehensive system of fiscal federalism that reduces the bias to spend in existing arrangements. Such a system would also assist in the control of health care spending. In this latter area, it will be important to fully implement the proposed health pact, including corrective plans and the application of sanctions in noncompliant regions, "tickets" for selected services, and enhanced monitoring. Recent improvements in the oversight of state enterprises are a step forward, but several of them need restructuring to put them on a sounder financial footing, reducing another drain on public resources and improving the quality of capital spending in the budget.

8. **Although a greater emphasis on overall expenditure control in the 2007 budget would have been warranted, some revenue measures are well-founded.** Among these, containing evasion would help improve equity and eliminate distortions that reduce Italy's growth potential: widespread evasion contributes to high marginal tax rates, punishing those taxpayers who play by the rules; encourages activities where profits are easier to conceal; and discourages firms from expanding. The government's pledge to reduce tax rates in the future in step with gains from the fight against evasion is welcome. The commitment to abandon tax amnesties should also encourage better tax compliance; in this vein, the proposed amnesty for social security contributions on "submerged" employment should be reconsidered. The uniform withholding tax on financial income stands to enhance transparency and competition among financial instruments, and is consistent with international best practice, although the taxation of unrealized capital gains being considered may prove impractical. The planned cut in the tax wedge signals the government's appropriate commitment to reduce the competitive disadvantage imposed by high tax rates. However,

durable gains in competitiveness will require progress in reducing spending to create scope for further tax reductions and structural reforms to raise productivity growth.

9. **By contrast, the TFR flows accruing to the public sector do not represent structural adjustment, regardless of their accounting treatment.** The scheme takes advantage of an accounting rule that allows recording as revenue a flow that is more closely akin to borrowing (as it creates offsetting liabilities that will need to be repaid to workers in the future) and that will increase spending pressures in the medium term. These transactions may reduce the deficit in an accounting sense, but not in an economic one.

10. **Chronic budget overruns, and the habitual recourse to mid-year corrective packages, point to the need for significant improvements in the fiscal framework.** Budget procedures continue to focus almost exclusively on legal requirements and financial inputs, with insufficient attention paid to the results achieved. Experience in other countries has shown that a shift to a program orientation—with an explicit emphasis on establishing clear, up-front objectives for public spending and ex-post evaluation that focuses not just on amounts spent but also on results achieved—can generate greater efficiency and accountability in the use of public resources. While reforms of budgetary processes can take years to implement fully, the authorities should consider introducing pilot projects along these lines. The adoption of a multi-year spending framework with clear targets for outer years and a move away from the murky *tendenziale* would also facilitate planning by giving spending ministries greater certainty about the resources available to them in the future. An explicit commitment to use revenue overperformance solely for deficit reduction would also be useful. Greater institutional independence of budget assessments and projections is called for as well, either by reinforcing existing institutions or introducing a new, independent body.

Structural Reforms

11. **Despite welcome recent liberalizing steps, a pervasive lack of competition blunts incentives for firms to innovate and grow, and benefits the few while penalizing the many.** Protection results in high prices for consumers and reduced competitiveness for Italian firms. It is, in a very real sense, a tax imposed on the majority of the population for the benefit of the few. Measures to promote competition and improve the business environment are critical to generate a more dynamic, efficient and fundamentally fair economy. In this respect, we fully share the arguments expressed in July's DPEF about the benefits of greater competition to consumers and firms.

12. **We therefore strongly encourage accelerating the approval of reforms to boost domestic competition.** The liberalizing decrees introduced this summer contained important initiatives in the areas of professional services, retail distribution, transportation, banking, and insurance, and appropriately reinforced the Antitrust Authority's powers. Implementation of these reforms should be pursued vigorously and monitored carefully. In addition, initiatives to liberalize the energy sector, increase competition in public utilities, facilitate class action lawsuits, revise practices in the liberal professions, and simplify bureaucratic requirements should be appropriately ambitious and implemented without undue delay. Moving forward, it will be important that deregulation and the promotion of competition be pursued within a comprehensive and coordinated strategy, with a clear focus on eliminating those barriers that are most costly to society, and with explicit timeframes for reform implementation. Proceeding on a broad front, addressing rigidities in a variety of areas simultaneously, can help promote consensus and a balance across the interests of different stakeholders.

13. **Reforms to promote labor market flexibility have been critical to employment growth, and need to be safeguarded and supported by additional measures**. Improvements in Italy's labor market have been notable in recent years, with employment growing strongly and unemployment falling below the EU average. While fixed-term contracts have been an important path to traditional, open-ended employment for many, concerns have understandably been raised about the precariousness of employment under these schemes.

Rather than scale back these reforms—and with them much of the employment gain experienced in recent years—the response should be to develop an adequate employment safety net, offering better, and appropriately conditional, unemployment support in tandem with further reductions in employment protection. Italy's experience with the introduction of new, more flexible labor contracts has thus far been similar to that in other European countries. Simulations in those countries have found that employment growth from liberalizing contracts will eventually fade in the absence of reforms reducing the rigidity and cost of open-ended contracts. More generally, the focus of labor market policy should not be to construct roadblocks that seek to defend a worker's current position but rather to develop the pathways of opportunity that will allow the charting of a successful course over the length of an individual's career.

14. **Over time, reforms to the pension system can also make an important contribution to growth.** A series of pension reforms adopted over the years will—if implemented faithfully—significantly reduce the fiscal costs associated with an aging population. However, population aging will still have a dramatic effect on Italy's growth potential, particularly as participation rates for older individuals remain very low. Reforms to the social security system to establish a closer link between pension contributions and benefits, and the elimination of rules that bar retirees from working while receiving pensions, would enhance growth potential and allow a higher standard of living for the elderly. The recently-signed Memorandum of Understanding on pension reform options contains a number of positive commitments, including that of ensuring intergenerational equity within the pension system. The follow-up discussions scheduled for early next year will provide an opportunity to ensure that the system encourages greater participation in the labor force while preserving the financial impact of alreadyapproved reforms. The changes to the TFR system will give a welcome impulse to the development of private pension systems, which will have an important role to play in supporting the public system. In implementing the reform, the authorities should strive to create a level playing field across categories of funds. Draft rules governing the introduction of the new system are complex, and will need to be well-publicized and carefully explained, so that workers can make informed decisions.

Financial Sector

15. **Recent developments in the banking sector have been positive.** Financial soundness indicators have generally improved, and credit growth has remained robust. In addition, there has been significant progress in implementing recommendations of last year's IMF Financial Sector Stability Assessment: in particular, responsibility for regulating anticompetitive behavior has been transferred to the Antitrust Authority, and the Bank of Italy's statutes have been modified with a view to increasing transparency and accountability. To further this process and promote financial education, the Bank should consider regular publication of Financial Stability Reports, in line with practices at most leading central banks.

16. **The Bank of Italy's openly encouraging attitude toward bank consolidation is promoting changes that should bring appreciable increases in efficiency.** Signs of greater contestability in the system, including by cross-border players, are a most positive development. Greater transparency in banks' interactions with clients will also lead to increased competition in the sector, and the Antitrust Authority's commitment to monitor this carefully is welcome.

17. **To exercise fully its role in promoting growth, the financial sector needs, however, to move beyond its current relationship-based orientation.** The stock, insurance, and private bond markets remain undersized. Experience has shown that access to non-traditional sources of financing, in particular venture capital, is important for financing new firms, especially those engaged in high-tech activities. Measures to improve the legal framework can play an important role in this area. The new bankruptcy law and measures to accelerate legal processes should help, but many judicial procedures remain unnecessarily complex and time-consuming, and further steps are needed. The promotion of the private

pension pillar can also enhance the development of the financial system, providing a boost to growth and investment.