INTERNATIONAL MONETARY FUND

Italy—2003 Article IV Consultation

Conclusions of the Mission

1. **The government's medium-term program rightly aims at relaunching economic growth**. Over the past decade, growth in Italy has been slower than in any euro-area country (except for Germany). Moreover, with the lowest employment rate in the euro area, per capita income remains below that of many advanced economies. These shortcomings are clearly recognized in the *Documento di Programmazione Economica e Finanziaria* (DPEF), which provides a broadly realistic assessment of Italy's economic prospects.

2. **Persistent slow growth has reflected deep-rooted structural weaknesses—fiscal imbalances and a high tax burden, labor market impediments, and a host of other factors stunting productivity. Reviving growth requires**:

- *Securing fiscal sustainability and reducing the tax burden*: in view of rising aging-related outlays, spending reforms will be the key to ensuring sustainability. But these reforms need to go further, freeing resources to both reduce the tax burden and shift spending to areas where it has its highest growth impact.

- *Raising employment*: ongoing reforms and wage moderation have yielded strong employment gains. Further steps should aim particularly at raising employment in the South and among women and the young.

- *Strengthening productivity and competitiveness*: raising productivity will require reforms to improve the quality and efficient use of all factors of production. This would also boost competitiveness. Indeed, low productivity growth, together with Italy's relatively high exposure to competition from emerging economies, has contributed to a loss of export market shares in recent years.

3. **While the benefits of these reforms are likely to accrue gradually, near-term growth prospects remain weak**. We welcome the more cautious medium-term growth projections adopted in the latest DPEF. In the short-term, as in most other euro-area countries, there are no firm signs yet of a robust recovery. In spite of historically low interest rates, we expect only a moderate rebound during the second half of the year, with GDP growth of 0.6 percent in 2003. In 2004, growth could rise to 1.8 percent. But risks remain sizable. These include a delayed pick-up of activity in partner countries, a renewed appreciation of the euro, and, if the domestic recovery were to falter, a reversal of recent employment gains. Continued wage restraint, together with steps to strengthen competition, particularly in services, are needed to lower inflation, thus preventing a further erosion of competitiveness. We expect consumer price inflation to fall to 1.8 percent in 2004, close to the government's projection.

Fiscal policies for stability and growth

4. **Italy is the only large euro-area country that has not breached the 3 percent deficit ceiling of the *Stability and Growth Pact* (SGP). However, the SGP goal of balancing the budget remains distant**. The DPEF projects a deficit of 2.3 percent of GDP in 2003. If this target is reached, the structural deficit, net of one off measures, would have

declined significantly since 2001, a considerable achievement, in a difficult macroeconomic environment. Such a result, however, would reflect entirely the fall in the interest burden, with no progress in lowering primary spending. Moreover, the reliance on one-off measures would remain sizable (close to 1½ percentage points of GDP in 2003), underscoring the need for significant progress to balance the budget. We also see risks to attaining the 2003 target. We estimate the SGP-based fiscal deficit at about 2¾ percent of GDP in 2003, unless revenues from the tax amnesties exceed our projections. Keeping the deficit close to the DPEF target may thus require additional efforts. The mechanisms introduced in September 2002 (with the *decreto taglia-spese*) are welcome, and could help in this respect.

5. **In this context, long-term fiscal trends remain a cause of concern**. Demographic trends will lead to a sizable increase in aging-related (health and pension) spending. The pension reforms of the 1990s will moderate this increase, and partially reverse it after 2040. But, according to our projections, current spending trends would be such that the public debt ratio—after declining slightly—would start rising rapidly after 2015.

6. **Early action is needed to prevent these developments**. This action can neither be limited to aging-related spending, nor can it exclude it. Our projections suggest that the public debt ratio could be maintained on a downward trend, converging to about 50 percent, with a three-pronged strategy:

- *Bringing the budget into a small surplus over the next few years*. In this respect, we support the DPEF's goal of reducing the structural deficit by ½ percentage point of GDP per year, as well as its 2004 deficit target (1.8 percent of GDP under current growth projections).

Around the implied path of structural fiscal targets, automatic stabilizers should operate fully and symmetrically, thus allowing fiscal policy to play a counter-cyclical role. We welcome the government's intention to phase out one-off measures by 2006. However, we estimate that one-off measures would decline only slightly in 2004 (taking into account those included in the *tendenziale*). While such measures have some role to play within a weak macroeconomic environment, their withdrawal should be more evenly distributed over time.

- *Introducing reforms to reduce long-term pension and health spending*. These reforms would not yield large immediate savings, but are critical for long-term fiscal sustainability. Our calculations show that sustainability requires reforms to moderate the long-run rise in aging-related spending by about 1½ percentage points of GDP with respect to our baseline projections (as long as a small budget surplus is achieved through cuts in other spending).

- *Bringing down the public debt-to-GDP ratio faster than implied by the deficit path*. This calls for: (i) continuing the sale of public assets; in this respect, an important role could be played by *Patrimonio S.p.A.*, which started its operations this year; (ii) bringing the borrowing requirement (*Fabbisogno di cassa*, the most immediate determinant of the change in the debt stock) close to the deficit. There is an urgent need to break the trend of recent years, when the borrowing requirement has substantially exceeded the deficit.

7. **Raising potential growth requires not only ensuring fiscal solvency, but also lowering the tax burden**. In this respect, a useful benchmark could be to reduce the burden to the EU average (excluding the Nordic countries) during the current legislature, i.e., by about ½ percent of GDP on average per year. We note the DPEF's intention for further tax

reform, but its timing is left open. Of course, these cuts will require spending to be cut in excess of what is needed to complete the fiscal consolidation process. This should be achievable in 2004, a year when the targeted decline in the structural deficit will be facilitated by the projected fall in interest payments (by almost as much as the deficit) and by a likely shift of some investment spending outside the budget (through *Infrastrutture S.p.A.* and the *European Action Plan for Growth*).

8. **Cuts in primary spending should not be postponed further**. Reducing **public employment** has proved, so far, an elusive goal and more decisive steps are needed. **Public sector wages** have risen faster than those in the private sector in recent years, and the preliminary wage agreement of early 2002 is difficult to reconcile with fiscal consolidation goals. More progress can be made in lowering **subsidies to enterprises**, a stated goal of the government's first DPEF. **Means-tested user fees** should also be used more broadly in the provision of public services. As to **expenditures for goods and services**, recent reform steps are promising, but room remains for taking full advantage of competition in the procurement of public services. Regarding **pensions**, the current draft framework law would commendably strengthen the second, fully-funded component of the pension system. But it would not be sufficient to significantly moderate pension spending trends (*inter alia*, because it would imply an unfunded cut in contribution rates for new employees). More needs to be done to raise the effective retirement age and accelerate the shift to the contribution-based system. In the area of **health spending**, regions should be given sufficient tools and incentives to meet spending and financing targets, in line with national objectives. In

particular, increased recourse to co-payments should be encouraged; only half of the regions currently have co-payments for pharmaceuticals.

9. **Public-private sector partnerships could provide an important vehicle to support needed improvements in infrastructure**. However, the viability of each project must be closely and transparently assessed, ensuring, for those projects that are not fully self-financing, that future government liabilities are clearly defined and strictly limited. Any contingent liabilities should also be spelled out in budgetary documents.

10. **Reconciling decentralization with overall fiscal discipline remains a key challenge**. The persistent overruns in health spending of recent years, the perpetual need for the central government to settle debt accumulated by subnational governments, the problem of lowering public employment at the local level, and the limited progress in privatizing local public enterprises underscore the severe difficulties in this area. The decision in the 2003 budget to reduce the flexibility of regions in managing their tax level, while consistent with the overall goal of reducing tax pressure, further highlights the difficult trade-offs that need to be faced. We look forward to the rapid conclusion of the work of the *Alta Commissione* charged with proposing a financing model for fiscal devolution. It will also be critical to introduce stronger incentives and constraints to maintain financial discipline for all territorial authorities. Building on recent steps that have strengthened centralized expenditure monitoring, it will be essential to ensure that the central government has sufficient information to monitor fiscal developments on a cash and accrual basis at sub-national levels. This would be helped considerably by the introduction of uniform accounting and timely reporting standards for all general government components.

Labor market and initiatives for stronger regional growth

11. **The improvement in labor market performance has been impressive**. An extended period of wage moderation and substantial liberalization since the mid-1990s have led to strong broad-based employment gains, even during the present period of weak growth. The fact that some of the increase in employment may be due to the emergence of workers already employed does not detract from the importance of these achievements.

12. **Ongoing reforms need to be complemented by additional steps with contributions from social partners**. The government, with the support of most social partners, has rightly chosen to move forward with further reforms. We welcome the rapid implementation of the first part of the *Biagi* reform. The second part should also proceed without delay, with expanded unemployment assistance particularly appropriate, provided that eligibility criteria are, as planned, well targeted and imply strong job search incentives. Notwithstanding these reforms, we continue to see a critical need for progress in two areas:

- *Wage differentiation*: We encourage the social partners to ensure that wages more adequately reflect productivity differences across regions and groups of workers. Importantly, this would secure open employment and thus social protection for some that are currently employed in the underground economy. The public sector should lead by example with regional cost of living allowances—which could be assessed once ISTAT completes its welcome initiative on the publication of regional price level data.

- *Active labor market policies*: An expansion and greater targeting of these policies is needed to improve job matching, for labor market entrants and older workers.

13. **Together with labor market reforms, other ongoing initiatives detailed in the DPEF hold out the promise of more durable convergence in living standards for the South**. Employment, export, and private investment growth, as well as the creation of new firms and some administrative improvements, are all positive signs. But we share the widespread view that progress needs to be nurtured carefully, including with further attention to strengthening local administrations and law enforcement. Complementing these steps, there is a role for well-planned and executed public infrastructure, an area where needs are sizable in the South and in other parts of the country.

Strengthening productivity growth

14. **Structural policies aimed at raising productivity are an integral part of a growth-oriented policy strategy**. Strong employment gains in recent years have been accompanied by low labor (and total factor) productivity growth. This calls for: (i) raising human capital—the previously mentioned active labor market policies and broader educational reforms are needed to overcome Italy's relatively low standing in this area; and (ii) reforms aimed at strengthening competition and dynamism in the business sector.

15. **Increasing competition would benefit both productivity growth and inflation developments**. An extensive privatization program and product market liberalization have contributed to stronger competition in many sectors over the past decade. However, as noted in a recent OECD report, the task is far from complete, and recent progress has been uneven. We welcome the resumption of the privatization process at the central level, in spite of difficult market conditions, but further efforts are needed, including at the local level. State interference into the autonomy of regulatory authorities—notably, late last year, into the

pricing rules in the electricity market—has introduced some uncertainty into the roles of these authorities and is regrettable. In the electricity sector, we welcome the prospect of overcoming local impediments to building new and more efficient generation capacity, a critical area in light of current capacity constraints and the high cost of energy in Italy. More competition is needed in the retail sector, where local authorities have oftentimes blocked the establishment of larger outlets. Here, as in the case of professional services, there is also a clear case for reducing regulations and strengthening the role of the anti-trust authority.

16. **Growth is also hindered by low FDI in Italy and by the slow growth of firms—both features that are symptomatic of deeper structural weaknesses**. This calls foremost for tackling directly the impediments to FDI and enterprise expansion, including by ensuring equal effective tax treatment for all firms—especially through more vigorous tax law enforcement—and by further reducing bureaucratic obstacles. Recent corporate law reforms are welcome and afford the potential for an enhanced role of minority shareholders.

17. **An efficient and stable financial system is an important ingredient for economic growth**. Italy has made significant progress over recent years in this regard, helped by consolidation in the banking sector. Gains are evident in the resiliency of the system to the recent slowdown and to adverse external shocks. Financial conditions do not appear to be constraining economic activity, and credit growth remains robust, especially for mortgages. The recent rise in bank capital ratios is welcome, in particular, in view of the still relatively high level of nonperforming loans.

18. **Nevertheless, further progress is needed**:

- Bank profitability remains low by international standards. This will require further efforts to control costs—and there appears to be room for this in many banks. This is being addressed, in part, by voluntary staff redundancies (whose benefits take time to be realized) and the lagged impact of earlier consolidation. Securing future efficiency gains while maintaining competitive pressures is likely to eventually require further consolidation and greater cross-border penetration by financial institutions (in Italy, as elsewhere in Europe).

- In key areas, market discipline should be strengthened through increased transparency and disclosure. Consumer protection for financial investments needs to be improved, as highlighted, for example, by the recent controversies related to the sale by financial intermediaries of Cirio bonds to retail customers. This is best addressed by strengthening and enforcing clear disclosure requirements concerning the risks and prices of financial products.

- The outdated bankruptcy law for non-financial firms increases the costs of finance, by lengthening court proceedings, reducing the value of collateral, and failing to adequately protect the value of firms in temporary distress. A modern and effective bankruptcy law needs to be approved swiftly.

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19. The visit comes at a time when Italy holds the EU presidency—and implementing the structural growth agenda outlined above could provide a strong, timely signal of Italy's leadership. This would require overcoming vested interests, but would offer far-reaching benefits, with positive repercussions also for Italy's global trading partners.

Rome, July 22, 2003