Italy: Staff Concluding Statement of the 2018 Article IV Consultation

November 13, 2018

1. **The key problems of the Italian economy are low growth and weak social outcomes.** Real personal incomes are at the level of two decades ago; unemployment has averaged close to 10 percent over this period; the living standards of middle-aged and younger generations have eroded; and emigration of Italian citizens is near a five-decade high. The authorities' emphasis on growth and social inclusion, therefore, is welcome.

2. **To raise growth and assist those left behind, we recommend a package of structural reforms, fiscal consolidation based on high-quality measures, and bank balance sheet strengthening.** Structural reforms to raise productivity and unlock Italy's potential is the overarching priority; without them, no strategy to lift incomes or secure stability can endure. The quality of fiscal policy needs to become more growth friendly and inclusive. Italy also needs to put to rest any concern about public debt sustainability, which recently has resurfaced. This requires credible consolidation to put the debt-to-GDP ratio, which is the second highest in the euro area, on a firm downward trajectory. Further strengthening banks' balance sheets would enhance their resilience and allow them to fully play their role in supporting the economy.

3. **Firm implementation of such a package would reduce risks, bolster investor confidence, and enhance resilience.** This is critical to safeguard growth in the near term, where uncertainty over the outlook is especially high given the still-unfolding adverse effects of higher sovereign spreads on private financing costs as well as emerging risks to the global outlook. It would also yield potentially sizable gains over the medium term by closing competitiveness gaps, boosting real incomes, and notably lowering public debt.

Structural reforms to boost productivity and growth

4. Faster potential growth is the only durable way to improve economic outcomes. The authorities are pursuing welcome measures in public administration and insolvency reform. They are also promoting fiscal incentives for investment. To have the desired impact and raise potential growth, however, it is critical that the authorities broaden their efforts to include significant labor and product market reforms:

a. *Labor markets*. The authorities' emphasis on gradually strengthening active labor market policies is welcome. However, decentralizing wage bargaining needs to be a priority—an essential measure to reduce structural unemployment and informality by facilitating the alignment of wages and productivity at the firm and regional levels. The recent constitutional court ruling and "Dignity Decree" have increased the uncertainty over, and the size of, dismissal costs. As the latter were already high in international comparison and would weigh on job creation, consideration should be given to lowering them.

b. *Product markets*. Steady progress in liberalizing product and service markets can raise productivity, investment and employment, but has largely been lacking for a number of years. The authorities are advised to lower barriers to competition that remain high in sectors such as local public services, professions, and retail. The weakening and delays in

implementing some of the legislated pro-competition measures that occurred over the past year also need to be addressed. Strengthening the Competition Authority's enforcement powers is recommended.

c. *Public administration*. The authorities plan welcome steps in tackling corruption, cutting red tape and simplifying administrative procedures, among others. Progress is also needed in rationalizing procurement and in streamlining, consolidating or privatizing local state-owned enterprises. Considering that past efforts in these areas have not been successful, the authorities may want to reinforce efforts to improve the managerial and administrative capacity to implement reforms and address weaknesses in coordination between the center and regions. Establishing ambitious targets or key performance indicators would allow the government to track and communicate progress.

d. *Insolvency*. The authorities are seeking to modernize the general insolvency regime. Given the lags involved in insolvency cases, such a modernization is timely. In developing the reform, they should continue to be guided by international best practice. Folding Italy's special regime for large enterprises, which is inefficient and costly, into the general regime is also recommended.

Fiscal policy to safeguard stability and support inclusive growth

5. **The authorities plan to enact a notable upfront fiscal stimulus to bolster demand.** The bulk of the stimulus is devoted to expanding social protection and pension benefits, though their design remains to be finalized. Additional resources are devoted to public investment and income tax cuts. The deficit target is 2.4 percent of GDP for 2019. For 2020-21, the deficit targets are 2.1 percent and 1.8 percent of GDP, respectively, underpinned by a VAT safeguard clause.

6. **The growth impact of the stimulus would be uncertain over the next two years and likely negative over the medium term, if elevated spreads were to persist.** The expected near-term positive impact of the stimulus—even with our relatively high fiscal multiplier assumptions—risks being countered by the negative effect from the persistent rise in sovereign spreads, as these pass through to higher private sector borrowing costs. The overall near-term effect on growth, thus, is ambiguous, whereas the medium-term impact would likely be negative. On balance, we project annual economic growth of around 1 percent in 2018-20, declining thereafter. The overall deficit for 2019 is projected at about 2⅔ percent of GDP. For 2020-21, deficits are projected at about 2.8-2.9 percent, unless there is broad political support to activate the VAT safeguard clause or find compensatory measures (in the amount of 0.7-0.8 percent of GDP), which however have proven very difficult to do in the past.

7. **The planned stimulus carries substantial downside risks as it would leave Italy very vulnerable.** Elevated yields affect the cost and availability of banks' funding and weaken their balance sheets. We project public debt to remain at around 130 percent of GDP over the next 3 years. Beyond that, additional fiscal adjustment will be needed just to stabilize debt, under our projections of rising interest rates during monetary policy normalization and increasing pension spending. Meanwhile, materialization of even modest adverse shocks, such as slowing growth or rising spreads, would increase debt, raising the risk that Italy could be forced into a large fiscal consolidation when the economy is weakening. This could transform a slowdown into a recession. International and Italy's previous experience suggest that the cost of a significant fiscal tightening when the economy is weak falls disproportionately on the poor and the vulnerable. Any

temporary gain in growth from the stimulus over the near term is thus likely to be outweighed by the substantial risk of a deterioration when modest adverse shocks materialize.

8. **Instead, we recommend undertaking a modest and gradual fiscal consolidation to help put public debt on a firm downward trajectory and reduce financing costs.** It would be prudent to consolidate public finances, while external conditions remain favorable and economic growth is above potential, thereby limiting the short-term output costs. A target of a small overall surplus in 4-5 years, achieved via a balanced adjustment, would ensure that debt declines firmly. It also means that, when adverse shocks materialize, Italy would not be forced into sharp consolidation than would otherwise be the case and, thus, shield the poor and the vulnerable.

9. **The recommended adjustment needs to be underpinned by a shift in the composition of policies to promote growth and social inclusion.** Italy's pension spending, the second highest in the euro zone, has crowded out resources for public investment and a modern safety net for the poor. The tax burden falls on a relatively narrow base, labor is taxed heavily, while wealth is not. These policies favor older generations at the expense of younger ones. Rebalancing to make policies more growth-friendly and inclusive requires reducing current spending, protecting the poor, raising public investment, broadening the tax base, and lowering tax rates on productive factors. In this regard:

a. *Alleviating poverty*. Italy needs a modern, guaranteed minimum income scheme targeted to the poor—one that avoids welfare dependence and disincentives to work and is not time bound. The authorities are designing a citizenship income program. While its design elements are yet to be finalized, we advise setting the benefits at levels that do not distort incentives to find regular work. International good practice suggests: (i) capping benefits at 40-70 percent of the relative poverty level; (ii) including gradual benefit phase-outs, income disregards, or conditional in-work benefits to incentivize regular work; and (iii) implementing adequate controls to prevent abuse and ensuring effective local administrative capacity. Consideration should be given to introducing this modernized scheme in the context of a comprehensive review of the social protection system, ideally by gradually scaling up the inclusion income program and rationalizing other income support programs.

b. *Pensions*. Italy implemented important reforms in the past, including in 2011, that have positioned it better than most countries in containing its high spending over the very long term. The authorities are considering changes, however, that would reduce the effective retirement age. Such changes would increase pension spending further, impose even more burdens on younger generations, leave less room for pro-growth policies, and lead to lower employment rates among older workers. Based on cross-country evidence, it is unlikely that the wave of retirements would create as many jobs for the young. The authorities should be mindful that, even under unchanged policies, Italy faces significant pension spending pressures over the next 2-3 decades that will strain the fiscal accounts. These point to the urgency of rationalizing the various excesses within the system, ensuring actuarial fairness, preserving the indexation of retirement age to life expectancy, and adjusting pension parameters to secure affordability.

c. *Increasing public investment.* We welcome the authorities' intention to gradually increase public investment to support growth, with the aim of returning toward pre-crisis levels over time. To support this scaling up and improve the efficiency of investment

spending, it is all the more important that the government's plans to accelerate decision-making processes, improve public investment management, and strengthen implementation capacity are followed through fully. Offsetting budgetary measures are needed to ensure consistency with the recommended consolidation path.

d. *Improving the tax system*. The authorities are expanding the existing flat tax regime for the self-employed, introducing a permanent tax break on reinvested profits, and changing several other tax incentives. We are concerned that these add to a history of numerous marginal changes to the tax system, exacerbating uncertainty and damaging the business environment. Instead, we recommend a comprehensive reform to broaden the tax base, promote efficiency and ensure fairness by addressing large VAT compliance and policy gaps, rationalizing tax expenditures, taxing wealth through a modern property tax on primary residences (based on updated cadastral values), and emphasizing stricter enforcement. We welcome the expected phasing-in of the mandatory electronic transmission of receipts to the Revenue Agency together with the e-invoicing regime. Tax amnesties should be avoided; international experience confirms that any temporary benefits are offset by weaker tax compliance. Any consideration of flattening personal income tax rates needs to be consistent with the consolidation path recommended above, be evaluated together with the structure of benefits, maintain progressivity and neutrality, and reduce distortions.

Financial stability

10. **Important progress has been underway to improve the health of the banking system.** Capital levels have been increasing, problem assets reducing sharply, and profitability improving gradually. Gross nonperforming loans (NPLs) have declined from a peak of nearly 17 percent of loans in 2015 to around 10 percent in mid-2018, a substantial reduction in 3 years. This progress needs to continue on all fronts to restore the resilience of the banking system and enable it to fully support the real economy.

11. **A pre-requisite to financial sector stability is safeguarding the public finances.** Although tail risks to the banking system had been reduced by measures to improve balance sheets and tackling the large problem banks last year, vulnerabilities are re-emerging with the recent rise in sovereign yields. Sustained high yields would pose increasing challenges, especially for the weaker banks. This includes potential strains from capital losses on sovereign exposures, adverse effects on banks' funding and capital raising plans (including for the so-called MREL), pressures on still relatively weak profitability, and crowding out of credit to the private sector. In view of the downside risks, enhanced monitoring and planning are advisable.

12. **Further actions are needed to strengthen bank balance sheets.** Reducing NPLs further, enhancing banks' operational efficiency, improving bank governance, and tackling barriers to resolution remain important priorities:

a. *Reducing NPLs.* Close supervisory oversight of NPL reduction strategies of significant banks should be maintained. The guidance to less significant institutions is being complemented with a similar approach to oversight. The supervisor should ensure that their NPL reduction targets are also ambitious.

b. *Enhancing efficiency.* As with the larger banks that are making progress in reducing operational costs and diversifying income, the supervisor should ensure that less significant banks have realistic and coherent business model and cost reduction

assumptions. The consolidation of about 270 cooperative banks into three new banking groups should not be delayed; it can bring critically important improvements to governance, risk management, and efficiency. Issues identified in the planned asset quality review and business rationalization process should be followed up in the remaining smaller banks.

c. *Improving governance.* Legislative gaps in Italy's implementation of the EU fit and proper rules for bank management need to be closed.

d. *Tackling barriers to resolution.* Banking sector resilience would improve further when banks raise the necessary amounts of bail-in-able financing (MREL). Although most retail instruments eligible for bail-in are currently held by the wealthiest households, bail-in of subordinated debt held by retail investors has proven problematic in past bank resolutions. Thus, safeguards could be considered to limit the amount of bail-in-able debt held by retail investors to ensure MREL is effective.

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