Italy: Staff Concluding Statement of the 2019 Article IV Mission

January 29, 2020

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

1. Fiscal policy implementation in 2019 was better than expected and contributed to improving market sentiment. Constructive engagement with the European Commission helped to avoid the launch of the EU's Excessive Deficit Procedure. Budget execution was prudent even as new social programs (the "Quota 100" early retirement rule and the citizenship income program) were launched. Revenue collection was also higher than expected. This, the new government's pro-EU stance, and the accommodative ECB policy helped reduce sovereign yields to near historical lows.

2. Nonetheless, the weakening external environment and domestic policy uncertainty have complicated an already difficult economic and social situation. Real GDP growth in 2019 is estimated at 0.2 percent, down from a 10-year high of 1.7 percent in 2017. Real personal incomes remain about 7 percent below the pre-crisis (2007) peak and continue to fall behind euro area peers. Despite record employment rates, unemployment is high at close to 10 percent, with much higher rates in the South and among the youth. Female workforce participation is the lowest in the EU.

3. The economic situation is projected to improve modestly but is subject to downside risks. Real GDP growth is forecast at ½ percent in 2020 and 0.6-0.7 percent thereafter. These forecasts are the lowest in the EU, reflecting weak potential growth. Materialization of adverse shocks, such as escalating trade tensions, a slowdown in key trading partners or geopolitical events, could lead to a much weaker outlook.

4. The overarching need, therefore, is for a comprehensive package of reforms to raise growth and enhance resilience. The current low interest rates provide a window of opportunity. (i) Structural reforms should tackle barriers to competition, rigid wage bargaining, and public sector and judicial inefficiencies. (ii) Credible medium-term fiscal consolidation is needed to lower public debt, underpinned by measures to support growth, protect the poor, and combat climate change. (iii) Continued strengthening of the stability of the banking system and its ability to support the economy requires bolstering capital in weak banks and improving profitability and asset quality.

Structural reforms to raise growth and create jobs

5. Steadfast implementation of structural reforms would unlock Italy's potential and durably improve outcomes. Reforms to liberalize markets and decentralize wage bargaining should be prioritized. They are estimated to yield real income gains of about 6-7 percent of GDP over a decade. Timely implementation of efforts underway to improve public sector efficiency and the insolvency and justice frameworks would add to these gains.

- *Product and service markets.* Lowering regulatory barriers to competition in sectors such as professional services, retail, and local services would have positive near- and medium-term effects. This would involve facilitating entry into sectors with high markups, removing exit barriers in sectors with many low-productivity firms, and generally lifting impediments to firm growth. Legislated pro-competition measures should be implemented, e.g., liberalization of energy tariffs. The competition authority's enforcement powers could be strengthened.

- *Labor markets.* Notwithstanding wage moderation in recent years, wages remain high relative to productivity. Realigning wages with productivity at the firm level would encourage investment and job creation. It requires modernizing wage bargaining, ideally giving primacy to firm-level contracts; in this context, a statutory minimum wage could be considered, accounting for varying productivity levels and living costs across regions. Well-designed reductions in the tax wedge on secondary earners, with increased supply of child- and elderly-care services, could raise female workforce participation and reduce gender gaps.

- *Complementary reforms.* Uncertainty over the procurement code and reforms to rationalize local state-owned enterprises should be addressed, while safeguarding efficiency and transparency. The adoption of the insolvency reform and planned streamlining of civil procedures are positive steps, requiring timely implementation. The special insolvency regime for large enterprises should be folded into the general insolvency framework. Improvements in higher education and skill acquisition would also help raise productivity.

Fiscal policies to safeguard sustainability and promote inclusive growth

6. The government's fiscal plan is modestly expansionary in 2020 and neutral thereafter. Key measures in this year's budget comprise postponing VAT hikes, a modestly lower labor tax wedge, combating tax evasion, incentives for private investment, and higher public investment including the Green New Deal. We project the overall deficit at around 2.4 percent of GDP in 2020, after which it declines marginally. This is based on lower nominal growth assumptions than the authorities and excludes future VAT safeguard clauses.

7. Italy needs credible medium-term consolidation as fiscal space remains at risk. Debt is projected to remain high at close to 135 percent of GDP over the medium term and to increase in the longer term owing to pension spending. If adverse shocks were to materialize, debt would rise sooner and faster. Therefore, it is strongly advisable to take advantage of the current low interest rates to implement credible medium-term consolidation, by legislating upfront high-quality measures. A gradual and balanced adjustment should aim to deliver an overall surplus of ½ percent of GDP by around 2025. Given current weak private demand, however, a neutral fiscal stance for this year could be considered, if a credible medium-term consolidation were in place.

8. Consolidation should be underpinned by inclusive and growth-friendly measures.

Spending: Current primary spending should be reduced over the medium term to meet deficit targets while improving protection of the poor and continuing to increase public investment.

- *Pension spending.* Italy has done more than most countries in reforming its pension system, generating savings over the very long term. But over the next few decades, spending pressures are projected to rise considerably. The experimental “Quota 100” early retirement rule increased spending further and created a discontinuity in the retirement age. It is important to preserve the indexation of retirement age to life expectancy, ensure actuarial fairness including for early retirement (i.e., closely linking lifetime benefits with lifetime contributions), and adjust pension parameters to secure affordability.

- *Poverty alleviation.* The citizenship income program targets the most vulnerable. However, benefits are well above international benchmarks; they decline too quickly with family size, penalizing larger and poorer families; and they fall sharply if a job offer is accepted, especially at low wages. These design features should be aligned with international best practice to avoid disincentives to work and welfare dependence.

- *Supporting investment.* A better quality of public investment management—improved feasibility studies, prioritization, and implementation—would support investment plans and enhance efficiency. Limiting uncertainty in tax matters would improve the investment climate.

Revenue: The design of the tax system should be improved to promote growth and labor force participation, while benefiting low- and middle-income households.

- *Lowering the labor tax wedge.* Italy’s average labor tax wedge is about 48 percent, compared to the EU average of about 42 percent. The authorities’ plan reduces the wedge modestly by 0.2-0.3 percent of GDP in 2020-21. A more ambitious reduction to the EU average could cost 2 percent of GDP that should be offset by significant base broadening.
- *Broadening tax base.* There is considerable scope to: (i) rationalize tax credits and deductions in the personal income tax system, especially those that are not well targeted or disincentivize labor supply; (ii) streamline the use of VAT reduced rates, with attention to distributional consequences by raising rates on goods consumed largely by the well-off; and (iii) update the property valuation system that imposes a disproportionate burden on poorer households to address equity concerns and increase tax collection at significantly lower statutory rates.
- *Tackling tax evasion.* The authorities are emphasizing reducing compliance gaps (6 percent of GDP). They have mandated electronic invoicing and transmission. Among other measures, they envisage improved monitoring and risk analysis by accessing financial data, which requires addressing privacy concerns. Strengthening the institutional and governance arrangements of the tax agency, including to address staffing gaps, and removing legal obstacles to tax debt collection would further support their efforts.

9. Italy’s commitment to reduce carbon emissions requires strong policy action. Carbon taxation is the most effective tool. While carbon taxes in Italy are high in some sectors, the bulk of emissions (mostly in electricity) is taxed at low rates. A uniform carbon tax of €70 per ton of CO_2, above which excises should be added to correct for other externalities, would reduce emissions by 20 percent by 2030. It could be phased in gradually (Fiscal Monitor, October 2019). The revenues generated could be used to compensate impacted households or offset distortionary taxes. Well-targeted public investment and incentives, energy price liberalization, and regulatory standards could help promote development of clean technology.

Financial sector measures to increase resilience and support the economy

10. Substantial progress has been made in strengthening the health of banks' balance sheets. The European and Italian authorities raised prudential requirements and implemented measures to facilitate capitalization, lower non-performing loans (NPLs), improve governance, and encourage consolidation of mutual banks. They took action to restructure or recapitalize several weak banks. As a result, the capitalization and asset quality of the banking sector have improved considerably. For instance, the NPL ratio has more than halved in three years, falling from 16 percent of loans in 2016 to 7.3 percent in September 2019, with NPL sales at or above targets even considering the market strains in 2018-19.

11. However, important challenges remain. The capital ratio (fully loaded Common Equity Tier 1) is about 1.5 percentage points below, and the NPL ratio is over twice, the EU average. Although improving recently, the profitability of Italian banks remains low, like many EU peers. This is particularly the case for small- and mid-sized banks, reflecting limited potential to increase revenue, structurally high operating costs, challenges to business models, and governance weaknesses. Exposures to the Italian sovereign are relatively large. Many banks continue to be heavy users of the ECB's Targeted Longer-Term Refinancing Operations.

12. These challenges highlight the need for further enhancing banking sector resilience. Key recommendations of the IMF's financial sector assessment program include:

- *Capital and asset quality*. Further boosting capital buffers is needed to enhance resilience in weaker banks. NPL reduction plans should continue to be robustly challenged, with further attention given to unlikely-to-pay loans. The SSM's approach to setting bank-specific expectations for the gradual path to full provisioning of the existing NPL stock could be extended to less significant institutions with high NPLs. Prudential policies to moderate the sovereign-bank nexus could also be considered and phased-in to avoid possible market disruptions.

- *Profitability and governance*. Many banks need to reduce costs further and invest in technology. Strong supervisory focus on the viability of business models and cost reduction plans must, therefore, continue and intensify. Further bank consolidation is needed, given the limited scope to grow revenues. Long-standing legislative gaps in the implementation of the EU fit and proper rules for banks' management should be closed quickly.

- *Supervision and c risis management*. In tackling weak banks, the efforts of the Italian authorities have focused on market solutions. Escalation of corrective measures has generally taken time as consideration has been given to systemic implications and contagion risk. While this approach may have merit, weaknesses could persist or even be exacerbated if not dealt with in a timely manner. Going forward, consideration should be given to more escalated corrective measures, using all available tools. As a general principle, care needs to be taken that the use of special administration does not delay decisive action when needed. Building additional loss absorbing capacity over an appropriate transition period would facilitate orderly resolution or liquidation for less significant institutions, in particular those for which a resolution strategy is foreseen. The use of the deposit guarantee scheme for preventive measures should be avoided as much as possible. Enhancements of the crisis management framework at the EU level, including through the introduction of an orderly liquidation regime for non-systemic banks, would further facilitate resolution and liquidation.

The mission is grateful to the authorities and other interlocutors for their time, helpful discussions, and warm hospitality. The views in this statement also reflect the findings of the 2019 Financial Sector Assessment Program (FSAP), which was conducted by the IMF over the period November 2018-March 2019. Countries with financial sectors that are considered systemically important, such as Italy, undertake a mandatory stability assessment every five years.