INTERNATIONAL MONETARY FUND

Italy—2000 Article IV Consultation

Preliminary Conclusions of the Mission

1. The economy is emerging with renewed strength from a decade of lackluster growth. The upswing reflects in part cyclical factors—helped by a recovery in Europe and global markets—but major improvements in the policy environment are also bearing fruit, following the persistent pursuit of macroeconomic stabilization as well as important structural reforms. The latter, while incomplete, have begun to fundamentally change the economy: among the many impressive examples are large-scale privatization and legal reforms that have strengthened competition and corporate governance; labor market liberalization, which is contributing to more rapid employment growth; and public sector reform, where a new framework (under the *Bassanini laws*) holds out the promise of far-reaching change.

2. Turning first to the near-term outlook, most indicators suggest a continuation of the recovery in 2000. External demand and business confidence have strengthened. And the stance of macroeconomic policies remains broadly supportive—with the impact of earlier interest rate declines, combined with the weakness of the euro, still outweighing the more recent tightening of interest rates by the European Central Bank, and the budgeted fiscal stance broadly neutral. In all, we expect GDP growth to accelerate to close to 2¾ percent in 2000 and 2001, still somewhat below the euro-area average. There are, however, some downside risks—even more so for 2001—related to repercussions from the oil price increase, the potential for disorderly adjustment of equity prices or the euro exchange rate, as well as

uncertainty about the robustness of consumption. These risks underscore the case for continuing reforms to strengthen the resilience and dynamism of the economy.

3. Headline inflation has accelerated since the summer of last year to 2½ percent. Even so, excluding energy and food, inflation has changed little over the past year. With the rise in headline inflation reflecting higher world market prices for oil, we see so far no signs of a serious general inflation risk, indicating no need for policy intervention. It will remain critical, however, that externally-induced inflation not feed through into higher wages. This principle is well recognized by the social pact that has been the cornerstone of Italy's remarkable convergence process; and, indeed, the continuing nominal wage moderation embedded in present contracts is needed to facilitate a reduction in the remaining inflation differential vis-à-vis the euro area. Competitiveness, nonetheless, remains a potential concern, especially if the euro realizes its appreciation potential.

4. Against current macroeconomic prospects, the fiscal deficit target for 2000 of 1.5 percent of GDP is an appropriate step on the path of further deficit reduction. Following the remarkable undershooting of the deficit objective in 1999 under considerably worse-than-expected growth conditions, and with tax revenues strengthening, the 2000 target should be well within reach. It will be critical that the nominal ceilings on noninterest expenditure are observed; at the same time, automatic stabilizers on the revenue side should be allowed to play fully. There are still some risks to meeting the deficit objective, not all under the state sector's control. These relate in part to deficit reductions at subnational levels where slippages occurred in 1999, to revenues from real estate sales, and to higher interest

payments—but they are broadly balanced by the expected impact of higher growth than assumed in the budget.

5. With respect to the medium term, we welcome the Stability Program's emphasis not only on further deficit and debt reduction, but also on lowering the high tax burden, which has hampered growth. It would be helpful if future medium-term plans (such as the *DPEF*) laid out a more detailed and transparent multi-year fiscal plan, specifying envisaged reform steps and detailing expenditure savings: this would help reduce uncertainty and strengthen domestic demand. Concerning quantitative medium-term objectives, fiscal vulnerabilities related to the very high public debt and population aging argue for keeping the fiscal balance, net of interest payments and adjusted for the budgetary impact of the cycle, at broadly the level expected for 2000, while proceeding with structural expenditure reforms. This would suggest maintaining the government balance net of interest payments at somewhat above 6 percent of GDP on average over the cycle,[1] allowing the general government balance to move into surplus by 2003. The design and implementation of policy would benefit from further improvements in the quality and timeliness of fiscal statistics for all levels of government; this will be particularly important as more responsibility is delegated to the subnational level.

6. Much of our discussion focussed on steps to extend the cyclical upswing into strong and sustained growth, shared more equitably across regions and different segments of the

[1] This recommendation corresponds to the cyclically-adjusted level of the primary surplus that is implied in the budget for 2000—which is some 6¼ percent of GDP, as against an actual primary surplus of about 5 percent of GDP.

population. We are particularly concerned about persistently low employment levels. These reflect both high unemployment, especially in the South and among women and the young, and low participation rates—which could jeopardize an extended upswing in some parts of the North and, indeed, the long-term viability of social security as the potential labor force declines.

7. The rise in the overall tax burden, as well as specific distortions of the tax system, slowed output and employment growth in the past: the government's strategy of lowering the tax burden in 2000, and over the medium-term, is thus most welcome. To target lower unemployment, particularly among the young and in the South, as well as an increase in labor force participation, steps should focus on reducing the high tax wedge on recorded labor income—as part of a broader approach, including stronger job training, that is discussed below. A first priority is to raise the tax credit for dependent labor income. In addition, a phased credit against employee social security contributions of the young should be considered, as a partial offset to lower entry-level wages. The recently announced plan to restructure tax credits for dependents by increasing the child tax credit is a welcome step—under a continuation of the present single-filer system—to encourage labor force participation by second income earners. In future years, additional room for cutting tax rates should partly come from a further broadening of the tax base. And—in a break from the past—temporary and ad hoc tax incentives on specific expenditure categories, which have distorted demand and complicated tax administration, should be discontinued. Together with a broadening of the tax base, this should pave the way for further cuts in personal income tax rates.

8. Of course, a reduction in taxes, together with a decisive cut in the debt ratio, is only feasible if expenditure is contained. This will entail difficult political choices. Among the areas for lowering expenditure is public sector employment, where some reduction has already been achieved, benefiting from attrition and redeployment. Advantage can also be taken of new technologies and a lower demand for some services (for example education, where the number of students is declining substantially). In addition, fiscal support for the railways, postal service, and local public transport could be curtailed by strengthening operational performance and, in some segments, privatization.

9. On social spending, Italy has achieved impressive progress over the past decade in altering an expenditure path that was clearly unsustainable. While overall social expenditures are not high relative to other EU countries, there is a need, as elsewhere, to redress efficiency ahead of the most adverse impact of population aging. Moreover, welfare programs targeted at the disadvantaged tend to be relatively underdeveloped, while pension system outlays—reflecting also a range of benefits unrelated to old age—remain among the highest in industrial countries as a percent of GDP. In our view, this calls for seeking a consensus on additional reforms that would meet the dual objectives of rebalancing expenditure away from (broadly-defined) pension benefits to other welfare objectives, and lowering future social expenditures—thus creating room for policies to strengthen growth and employment. Structural reforms that raise employment can help cushion the impact of population aging on the pension system, but the pension review scheduled for next year should also explore additional reform options. In rebalancing welfare expenditure, we welcome the discussion on expanding the unemployment system into a universal contribution-based insurance scheme

providing adequate support for the unemployed. In this reform, it will be crucial to redirect sufficient administrative capacity to foster retraining and job search, and to define time limits and other conditions for receiving benefits that would ensure adequate incentives to seek training and employment. This also applies to the *reddito minimo d'inserimento*: following a careful evaluation of the lessons from the pilot program, it could become an important pillar of general welfare support and integration into the labor force for the very poor.

10. An efficient public sector can play a critical role in strengthening Italy's growth prospects, and sweeping reforms are underway. Far-reaching legal changes have been enacted, covering, inter alia, mobility within the public sector, performance goals for managers, and the simplification of many administrative procedures (such as the so-called one-stop shop). The issue now is vigorous implementation, including at the local level. A second area of reform concerns the fiscal relationship between the state and subnational entities. The new system, enlarging the tax base of regional governments, represents an important step to improve transparency. As the system is implemented, a strengthening of administrative capacities at the subnational level will be a prerequisite for achieving greater efficiency. Moreover, present initiatives will need to be complemented by reforms that contain the impending rise in health care costs for an aging population. With this process of fiscal decentralization now being launched and increased scope for borrowing by local authorities, further steps will also be needed to improve coordination among the different entities of the public sector: this should include a strengthening of the incentives for compliance with the targets under the Internal Stability Pact. Moreover, tight cost control and a continued decline in the public sector payroll has to be assured.

11. There are signs that conditions in the formal economy of the South began to improve in the second half of 1999—including, for example, an increase in the start-up of new companies. And transparency and competition improved in the rising use of structural funds. But the challenges remain enormous, and call for far-reaching policy changes. The new development program for 2000-06 indeed includes important steps, such as the intended strengthening of local responsibility and accountability, and improvements in public services and infrastructure. We endorse the suggestions by labor representatives for improving job matching and upgrading job-related skills, including in new technology areas: involving local businesses and education institutions in these efforts holds out the promise of marked improvements, especially at the job-entry level. Tax reform measures—along the lines suggested above—would strengthen labor market performance in general, including in the South; and there is a growing recognition that, especially for the young, wage differentiation can help in achieving a needed skill catch-up by facilitating job market entry.

12. To be effective, the labor market impact of current policy initiatives for the South needs to be deepened by complementing them with a "partnership for skills," targeted particularly at strengthening open employment prospects for the young. This would seek agreement among the social partners at the national level on three mutually reinforcing elements: a commitment to improve job matching and job training, including a strengthened dialogue with the education sector; a temporary reduction of social security contributions for participants in the partnership; and wage differentials going well beyond those envisaged under current apprenticeship programs, as a quid pro quo for a stronger commitment by employers to training. More generally, overcoming the weakness of the southern labor

market ultimately requires that overall labor costs do not exceed the level consistent with gainful employment in the open economy, taking into account all costs of operating a business in the South. If this is achieved, past experience suggests social benefits that go beyond the direct employment effect: it would help bring into the open economy those currently working in the informal sector, where high wage differentials prevail but social protection is entirely absent.

13. With one of the most ambitious privatization programs among industrial countries, and major product market reforms, remarkable progress has been made in strengthening competition. Looking ahead, additional steps should focus on several areas: (i) in the energy sector—where prices, especially for enterprises, have remained high by international standards—competition should be strengthened through a rapid increase in the share of clients that are free to choose their suppliers, a temporary lowering of market share ceilings to eliminate the dominant market position of any single supplier, and a proprietary separation between the various entities of the vertically-integrated national companies; (ii) for the railways, the restructuring plan needs to be implemented vigorously, with a view to soon raise involvement of the private sector; and (iii) for large retail outlets, the approval process by regional public administrations should be accelerated. In an environment of increasing market consolidation, there is also a case for further measures to deter market abuse. Moreover, we urge implementing changes to the framework governing non-listed enterprises, as indicated in the *Mirone Commission* report. With the prevalence of small and medium-size unlisted companies, reforms that facilitate more dynamic growth of these enterprises could also have important macroeconomic effects.

14. In the past few years, serious problems in the banking sector have been successfully resolved, and the financial sector is now adjusting to fundamental changes in competitive conditions, arising in part from monetary union and global market integration. For the banking system, the sharp reduction in interest margins has so far been offset by a switch to nontraditional activities, including asset management. However, growing competitive pressures can be expected to erode the returns on some of these activities, and it will become increasingly important that operating costs are reduced, as recognized in the earlier labor agreement for the banking sector. On supervision, the distinction between bank and non-bank financial activities is likely to become increasingly blurred, and a continuation of close and well-coordinated financial sector supervision will be essential. Moreover, from a consumer protection perspective, it is important to ensure adequate disclosure of the yield and risk characteristics of retail financial products.

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15. In sum, past policies are beginning to bear fruit: the challenge for policymakers is to stay the course and, indeed, push the envelope of the economically feasible—using the window provided by a cyclical upswing, and ahead of the most severe impact of population aging. Reinvigorating a structural reform agenda along the lines outlined above should lay the groundwork for high-quality and more widely shared growth, allowing Italy to reap the full benefits of monetary union and global integration.

Rome
March 27, 2000