Italy's decline and the most urgent reforms to fight it

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«Italy's growth challenges»
Dipartimento del Tesoro-Bruegel Meeting
May 8, 2013

Idee per la Crescita: a Policy Forum on Italy's growth challenges


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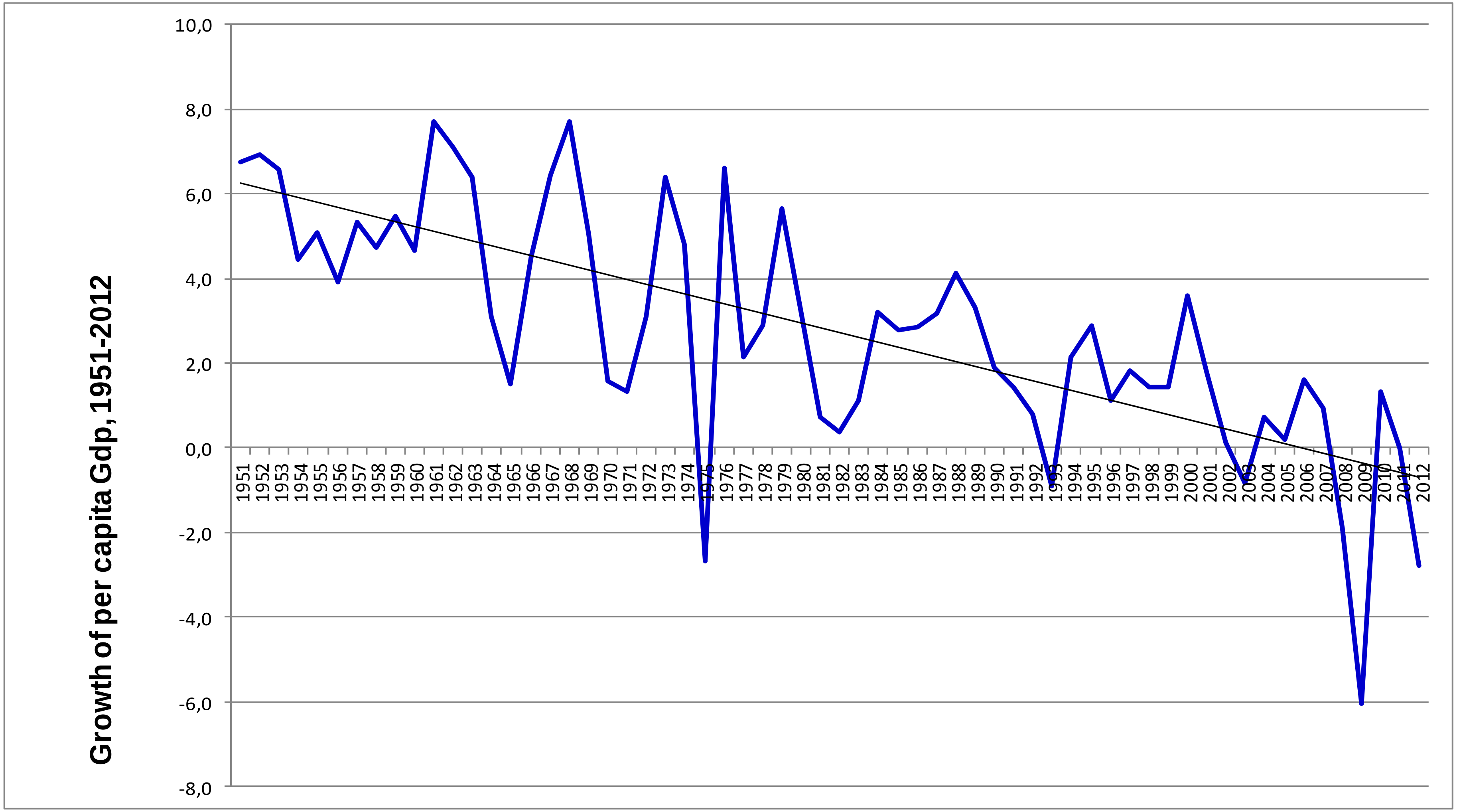
We have our First Report (three Rizzoli e-books to be released in mid May)

1. **Diagnosis**
2. **Proposals on how to make the credit system less bank-centered**
3. **Proposals on how to strengthen school autonomy**

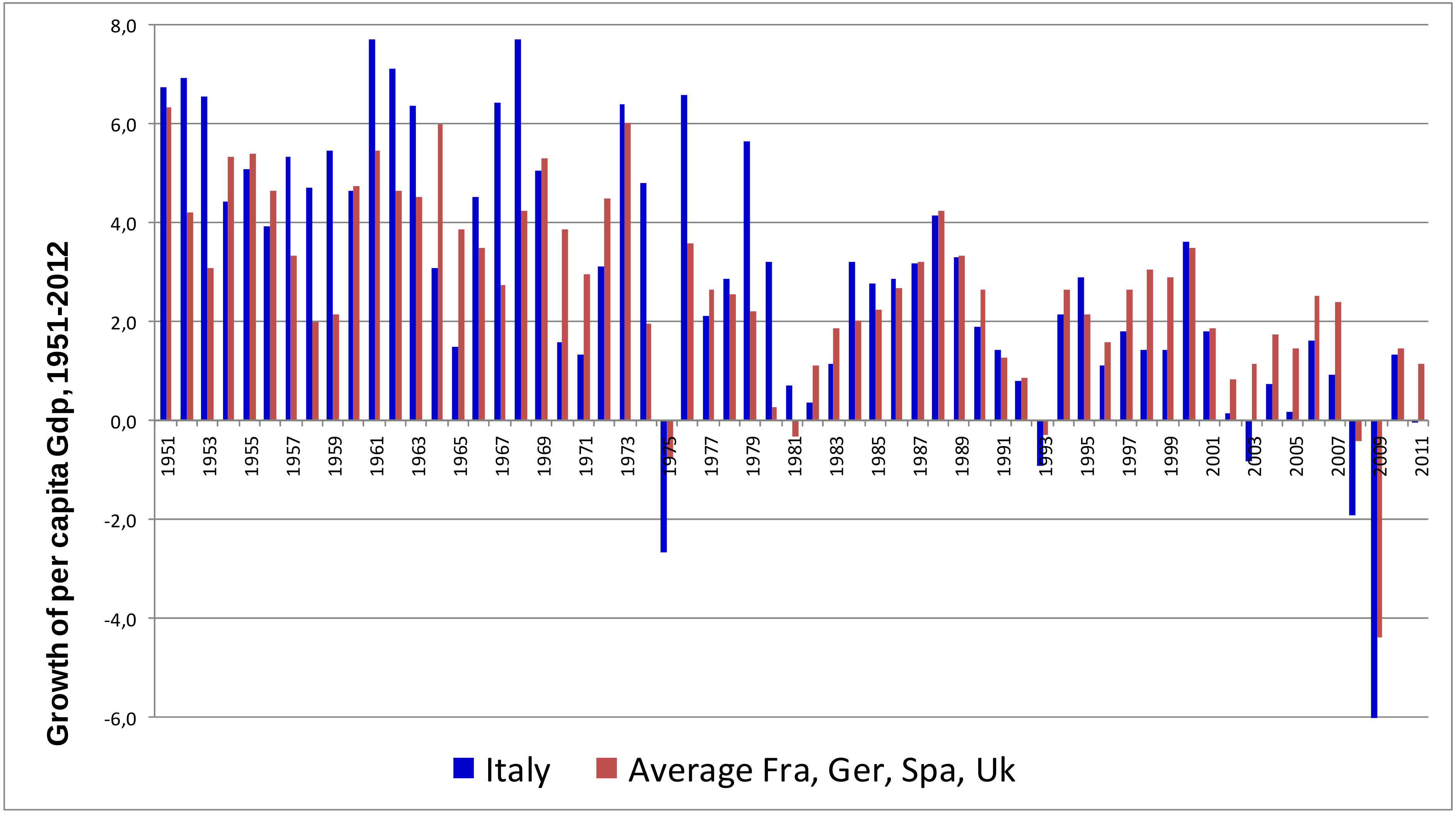
A summary of facts, first

Italy: a gradual growth slowdown …



Average yearly growth in the ‘50s: 5,5%. Down by some 1 ppt per decade, since then. Potential growth zeroed as of today.

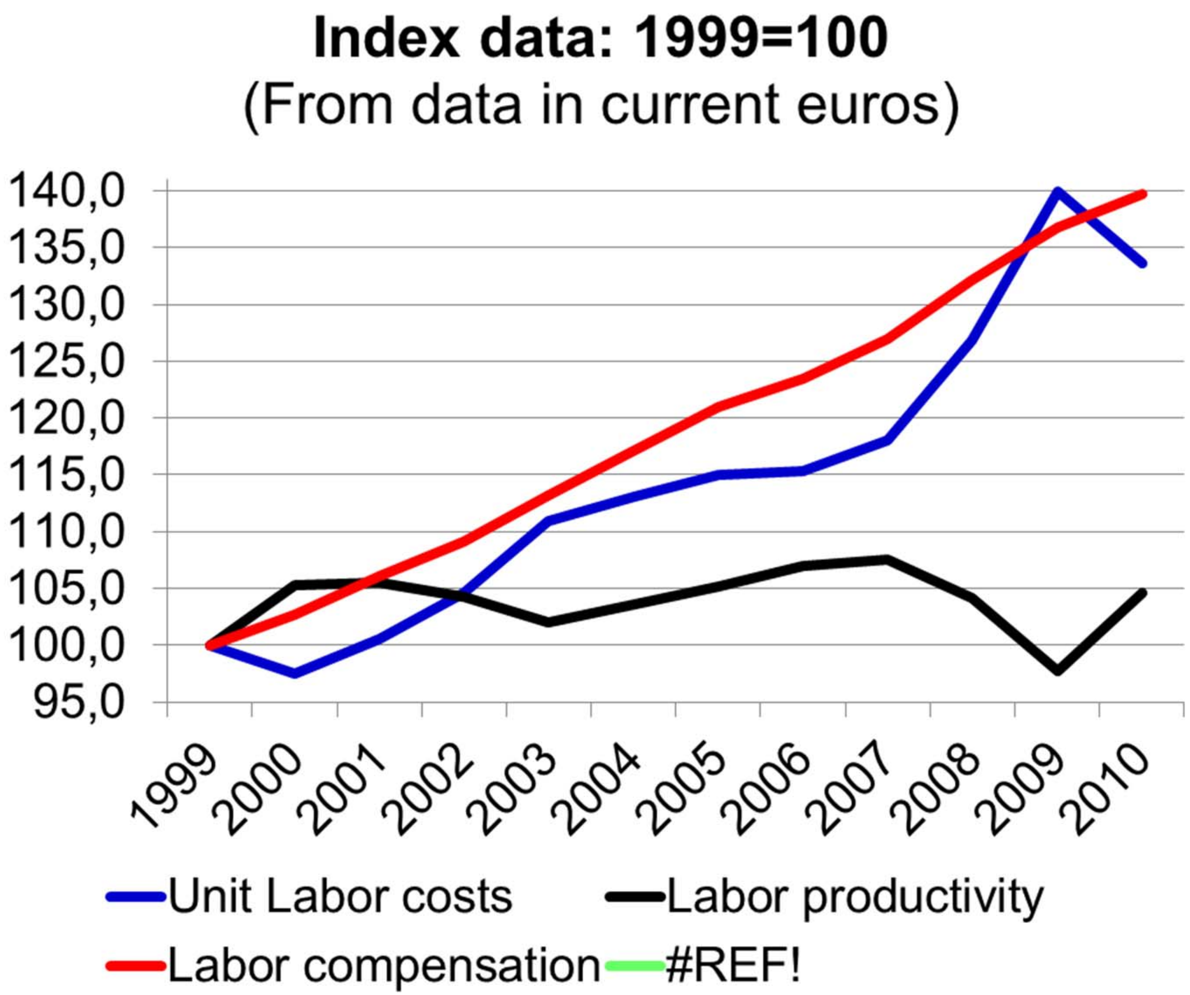
.. More pronounced for Italy than for other large EU countries. End of grace period: ≈ early 1990s



Mostly a question of productivity growth disappearance. Demography hasn't helped either

Growth rates	Per capita Gdp	Gdp per hour worked	Hours per potential worker	Potential workers per capita
1971-80	+3.2	+2.9	+0.3	+0.0
1981-90	+2.3	+1.7	+0.0	+0.6
1991-00	+1.5	+1.5	+0.2	-0.1
2001-10	-0.2	+0.1	+0.0	-0.3

Stagnating productivity + rising wages = loss of competitiveness



Italy's manufacturing unit labor costs rising very fast with the euro

- 1999-2010: +33.6

Why so fast?

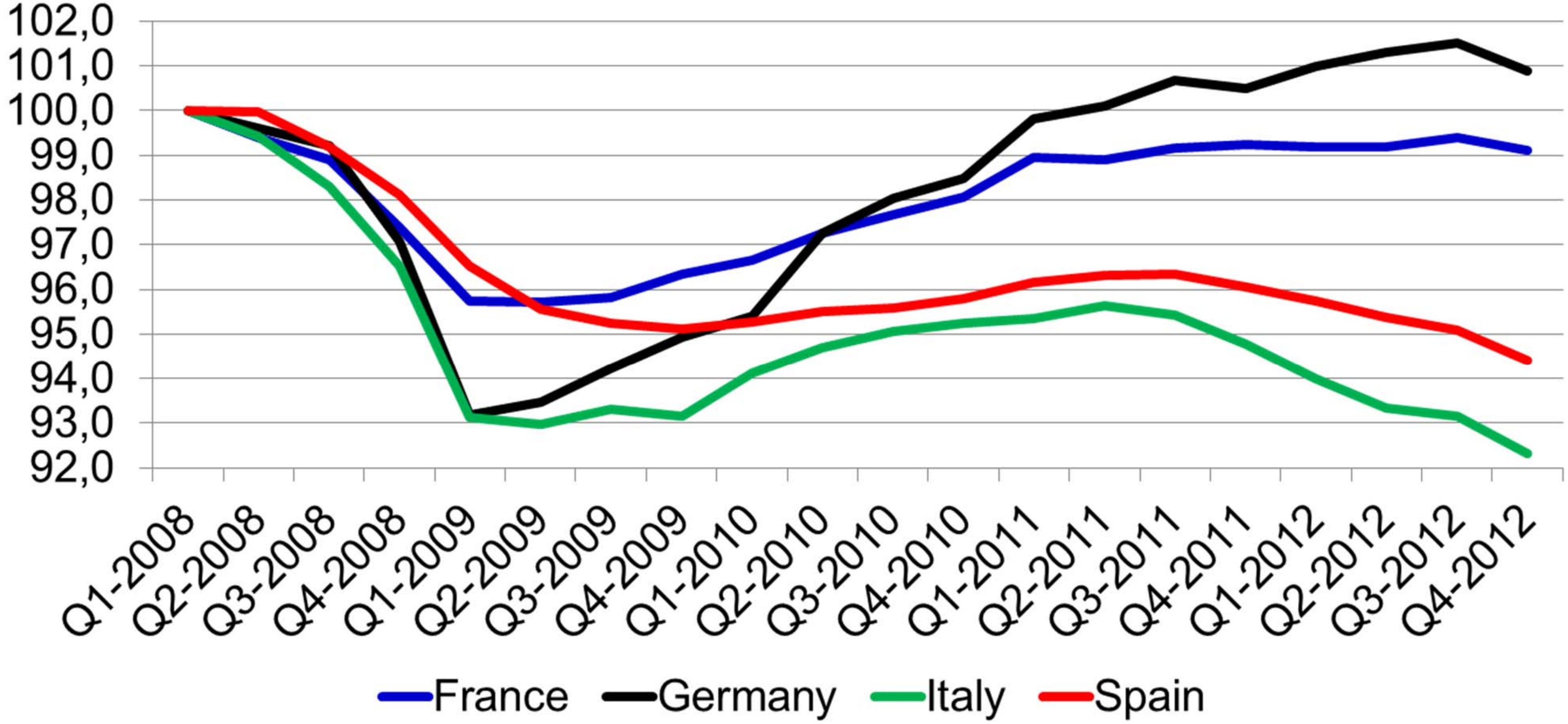
- Wages up by 39%
- Labor productivity up by a mere 5% (0% since 2000)

E.g. Germany:
unit labor costs stayed constant, productivity <u>and</u> wages up by 28%

So Italy's growth stopped
long before
the current crisis.

Then the Great Recession came
through, in two halves.

First half of the crisis (2008-09): common shock Second half (2011-12): for Italy and Spain only

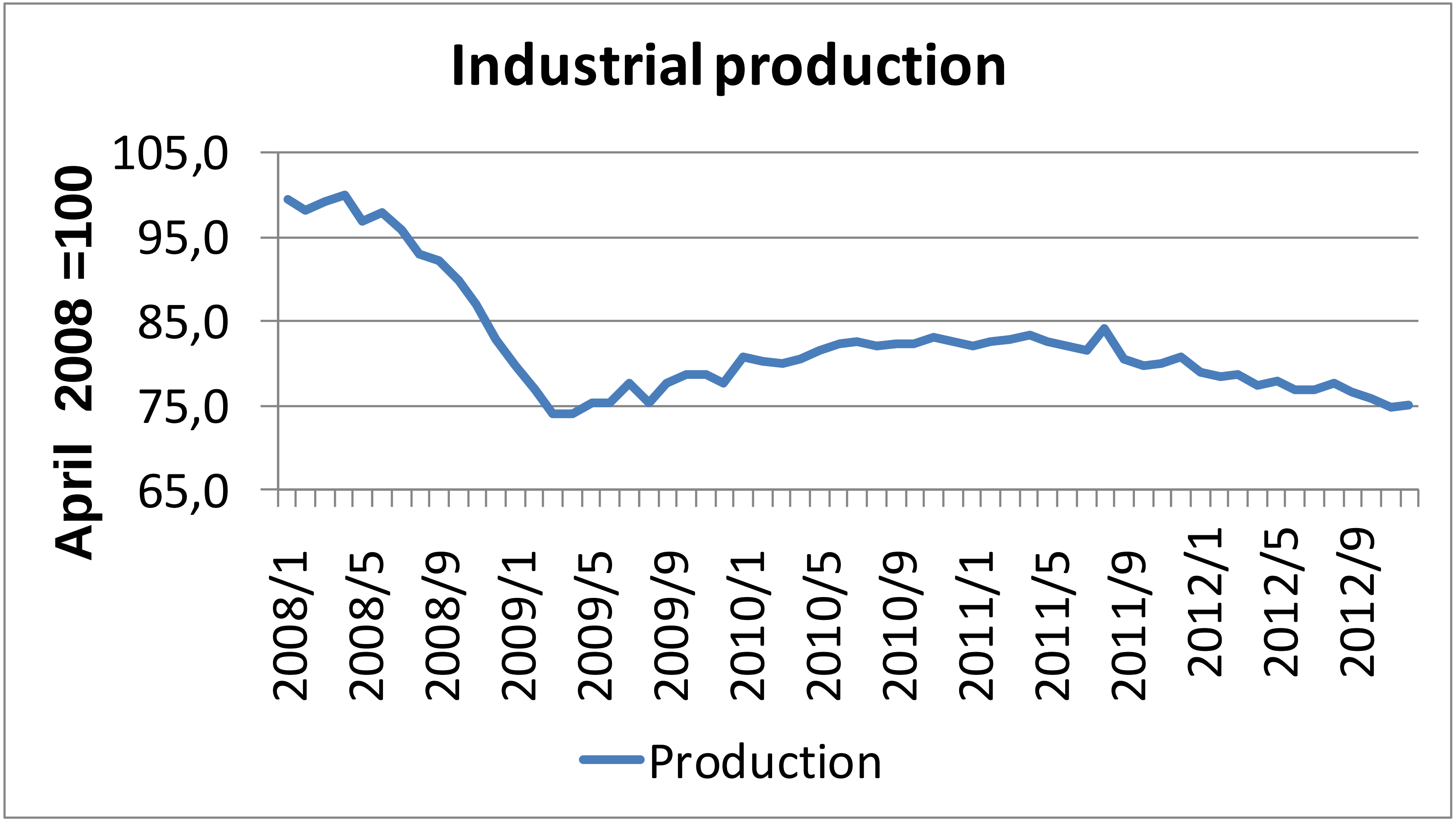


(Gdp 2008, q1=100)

Germany recovering fast, Italy and Spain lagging quite behind, France in between.

Italy's industry very hardly hit during today's crisis

One fourth of Italy's industrial production left on the ground. In two waves.



Yet domestic and external markets, two worlds apart

Italy, Industrial turnover	Total	National	Abroad
April 2008	100.0	100.0	100.0
April 2009	78.0	80.8	71.6
April 2011	92.5	91.2	95.7
April 2012	89.3	85.4	98.1

- Turnover from abroad is at -2 ppts from before the crisis
- Turnover from domestic markets stuck at -15 ppts from before the crisis

This is where the positive data on trade balances come from

Source: Istat

Italy's domestic market depressed for four main reasons:

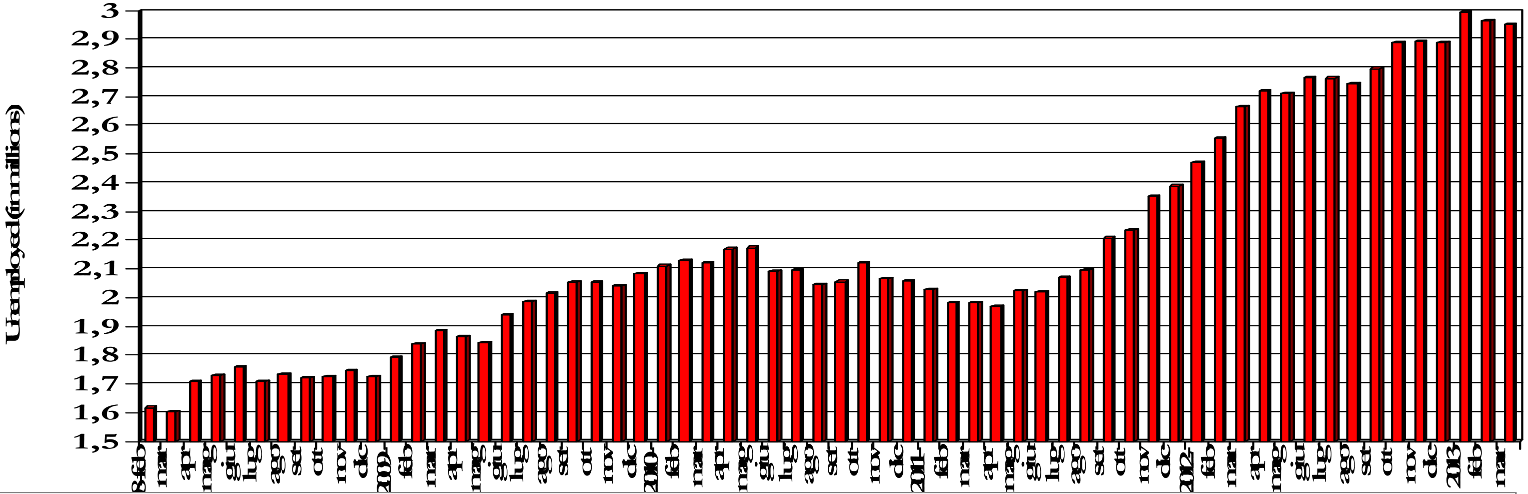
1) rise in unemployment

2) fall in real wages

3) rising taxes

4) fall in savings and drying up of credit

Rising unemployment and falling real wages, more so in 2011-12 ..



.. With taxes trending up to almost ½ of Gdp as a result of fiscal adjustment ..

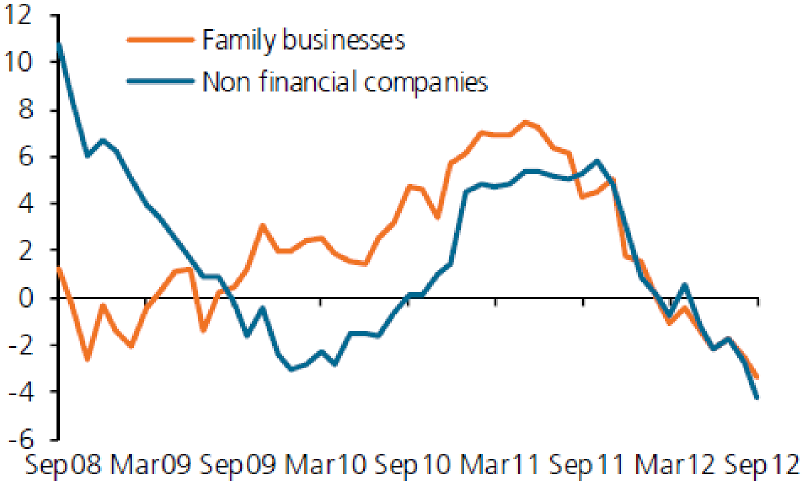
Official data in % ppts **As of April 2013 (unless stated)**	**2011**	**2012**	**2013**	**2014**
Deficit / Gdp (as of Dec 2011)	3,9	1,5	0,2	-0,1
Deficit / Gdp	3,9	3,0	2,9	1,8
Total Gov revenue / Gdp (with ↑vat July 2013)	46,6	48,1	48,6	48,4
Gov spending / Gdp (net of interest debt payments)	45,6	45,6	46,2	44,6
Interest debt payments / Gdp	4,9	5,5	5,3	5,6
Scenario: Gdp growth	+0,4	-2,4	-1,3	+1,3

Side remarks

- Net of interest spending up in 2013 for extraordinary outlays from Emilia earthquake + accelerated arrears payment
- 2014 growth data are <u>optimistic</u> numbers

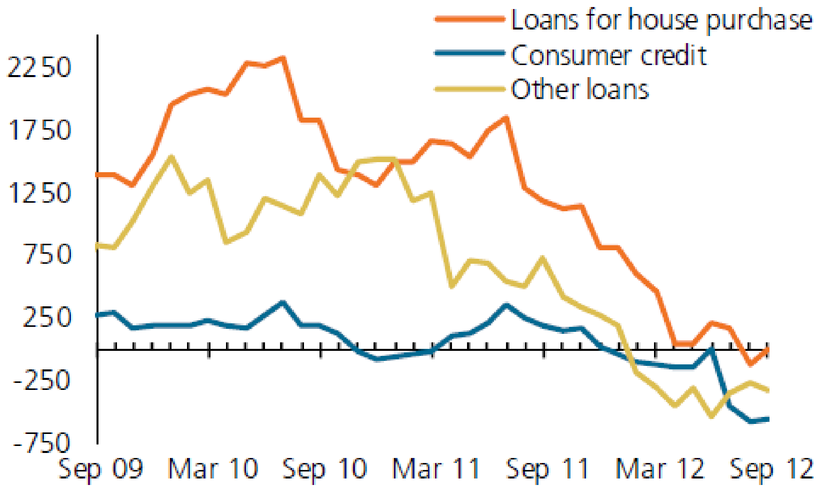
.. And credit disappeared ..

Loans to family businesses and non-financial corporations
(y/y % change)



Note: from June 2010 to May 2011, data adjusted to take account of the statistical discontinuity, due to re-recognition in bank financial statements of assets sold or securitised. Our estimate of adjustment for family businesses.

Monthly flows of loans to households, data referred to Eurozone residents
(millions of euro, 5-term moving avg.



Note: Monthly flows calculated as differences between stocks, adjusted to eliminate the effects of reclassifications, exchange rate variations, and other changes in value not tied to transactions.

Source: Intesa Sanpaolo calculations, Bank of Italy and ECB data.

Why Italy doesn't grow, in a nutshell

Diagnosis - Italy is:

- a <u>rich</u> country (Still below Eu average, yet twice richer than in 1970)
- a <u>demographically old</u> country (1/5 of total population above 64; like Germany and Japan)
- a <u>densely populated</u> country (206 inhabitants per km^2; high-Gdp Oecd countries =30)

Implication

- In a rich and densely populated country, opportunities of "extensive growth" <u>already exploited in the past</u>
- In a demographically old country, <u>resistance to innovation</u> hampers reform and adoption of growth-enhancing policies

Conclusion

Under these circumstances, <u>normal</u> that Italy doesn't grow.

Yet it <u>could</u> grow: rich, old, densely populated Germany & Israel do grow.

How to revive Italy’s growth?

1. Service market liberalization would gradually speed up growth (not in Idee per la Crescita yet)

	(1) mark-ups μ	(2) Total Factor Productivity
Barrier to entry-Retail$_{t-1}$	0.0422***	
	(0.0118)	
Barrier to entry$_{t-1}$	0.0241***	
	(0.00503)	
Mark-up-Retail		-0.021
		(0.136)
Mark-up		-0.210***
		(0.0818)
Total Factor Productivity $_{t-1}$		0.312***
		(0.0151)
Δ. Turnover (Demand shifter)	0.0587***	0.267***
	(0.0141)	(0.0150)

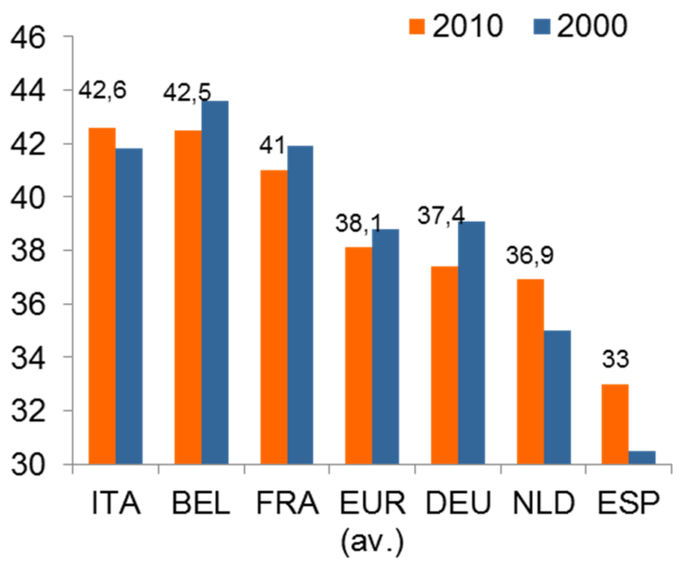
Daveri, Lecat & Parisi, WP Treasury Dept, March 2013

- Reducing barriers of entry brings down mark-ups mostly in retail
- And reducing rents would speed up productivity
- Gradually over time

2. Benchmarking shows room for cutting labor taxes

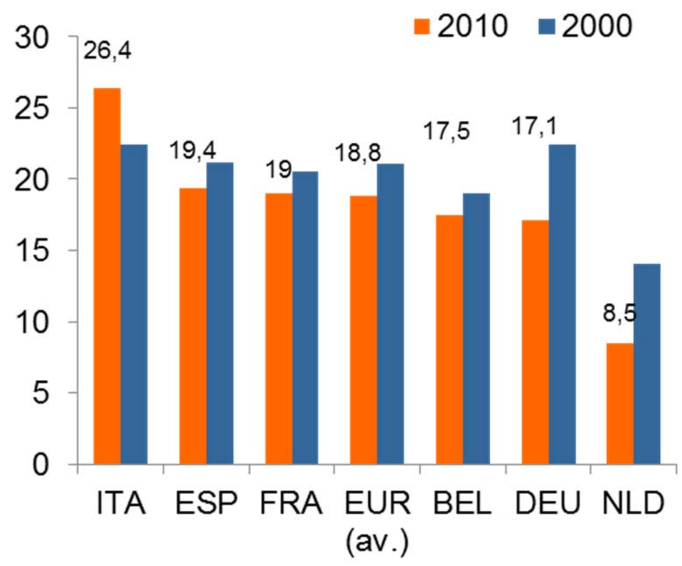
Fiscal pressure on labor and business income will have to be cut, as part of an overhaul of the tax system

Implicit tax rate on labour (%)



Source: Eurostat, Trend in Taxation in the EU 2012, Table 78.

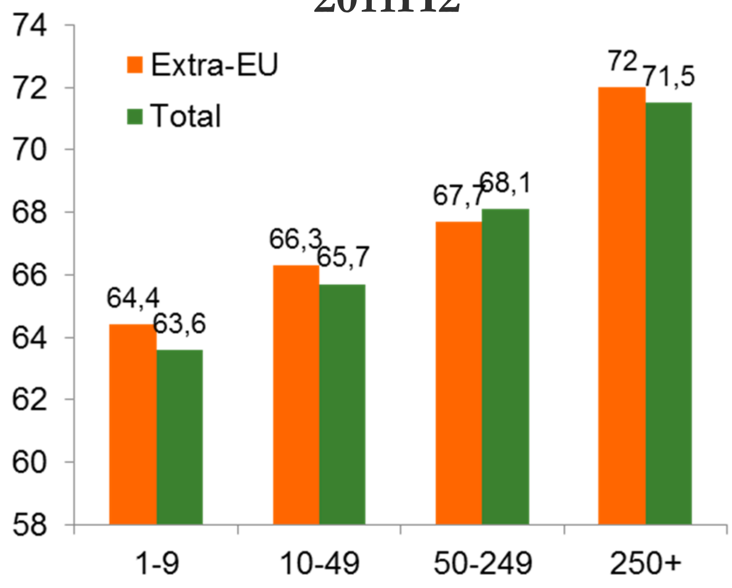
Implicit tax rate on capital and business income (%)



Source: Eurostat, Trend in Taxation in the EU 2012, Table 80.

Also: small size, less of a strength than in the past. Credit and finance for firms' internal growth

Percentage of firms growing in foreign markets, by size, 2009H1-2011H2



Source: Istat, Rapporto Annuale 2012, Table 3.1.

- **Some factors favoring a small size**: more flexible management of labor force, fiscal incentives for debt financing vs equity financing, easier to hide sales and profits.

- **Recent actions**:
  - "Contratto di rete" (L. 30,7/2010 n. 122), to favor cooperation agreements among SMEs; >300 contracts signed.
  - L. 26/12/2011 n 214 "Salva Italia": tax allowance for reinvested profits, deducibility of the regional tax on employment

and here comes Mr Schivardi