ITALIAN ECONOMIC OUTLOOK 2018-2019 AND THE ECONOMIC POLICY SCENARIO

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SUMMARY AND MAIN CONCLUSIONS

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Italian growth is slowing down The CSC, Confindustria Economic Research Department, forecasts the Italian real GDP growth at 1.1% in 2018 and at 0.9% in 2019, slowing down from 1.6% in 2017 (Table A).

This is the result, as already highlighted in June, of weakened internal and external **conditions** for growth: the uncertainty related to the US trade policy; the turbulence in some emerging countries that are target markets for Italian exports, such as Turkey and Argentina; the deceleration of several European economies; a progressive rise in interest rates associated to the end of the ECB's asset purchase programmes; the increase of Italian sovereign bonds yield; a weaker households' and firms' confidence. All of these factors are already negatively affecting the *performance* of the Italian economy.

Tabella A
CSC forecasts for Italy
(% change and diff. wrt CSC June 2018 forecasts)

	2017	2018		2019	
Gross domestic product	1,6	1,1	(-0,2)	0,9	(-0,2)
Exports of goods and services	5,7	0,7	(-2,0)	3,3	(-0,6)
Unemployment rate[1]	11,2	10,9	(0,0)	10,6	(0,0)
Consumer prices	1,2	1,4	(+0,4)	1,3	(0,0)
Government net lending[2]	2,4	1,8	(-0,1)	2,0	(+0,6)
Government Debt[2]	131,2	130,9	(-0,7)	130,7	(0,0)

[1] Percentage values; [2] as a percentage of GDP.
In June 2018 the outlook assumed the cancellation of the VAT safeguard clause by raising other taxes.
Source: CSC estimates.

Moreover, there are other factors that are difficult to predict and thus highly uncertain in their outcomes. Among the external factors, we signal:

the prospects for the US economy, which has been in the expansionary phase of the cycle for 9 years now, one of the longest growth period in history;

the results of the elections in Bavaria in mid-October, which could either strengthen or weaken Chancellor Merkel;

the US mid-term elections in November, which could lead to a change of majority in the House of Representatives, reducing the impact of the Trump administration's proposals;

the European Parliament elections in spring 2019, which will shape for the next five years the scope for action of the European Union on crucial issues such as single market integration.

Furthermore, we also signal some crucial internal factors:

the confidence of financial markets in the Italian budget law, in terms of its effectiveness in financing the expiring public debt (197 billion Euros in 2019): we have already seen signs of negative and worrisome reactions. Also, a higher public deficit now will result in larger government borrowing in the future;

the ability to deal with the unsolved bottlenecks of our economy, above all the need to reform the Public Administration (by simplifying and reducing administrative burdens), a much needed increase in small firms' productivity and growth of the infrastructure endowment;

the sustainability of the "government contract", with respect to its most burdensome items (flat tax, guaranteed minimum income scheme, pensions reform).

For this reason, what really matters is not the exact decimal of the Italian GDP growth forecast in 2018 and 2019, but rather to highlight the many risk factors, either tangible or hypothetical, that could lead to a downward revision of the forecast.

When looking at the main components of GDP, we notice that: exports, which have been the main driver of Italian growth in recent years, have ceased to play this role in 2018; private consumption is slowing down; public investment is still weak; private investment keeps growing at a high rate in 2018 but will slow down in 2019.

- **Exports**. Compared to CSC June estimates, Italy's exports growth is clearly revised downwards, especially for 2018, and for the first time since 2013 its dynamics will be worse than the one of global trade.

  A number of factors account for this disappointing performance. Some of them are common to all Eurozone countries, others are specific to Italy. First of all, **the strengthening of the euro** has decreased the competitiveness of Italian and European goods, curbing sales to non-EU countries. The acceleration of protectionist measures implemented during 2018 by the US administration clearly highlighted the new course in trade, and has slowed down Italian exports to the United States. The weakness of exports from other European countries (especially Germany) to non-EU destinations is then transferred, through global value chains, to intra-European trade, penalizing Italian sales.

  The slowdown in Italian exports, however, is more marked than the one of the main European partners. This can be due to the fragile *performance* in some specific sectors (motor vehicles, machinery, pharmaceutical items) and destination markets (China, Japan, Russia) in which Italian exports have performed well in the recent years. The price increase of Italian products sold outside the Eurozone, which is greater than, for example, that of German competitors, might have been played a major role in the loss of competitiveness.

  Risk factors on the international scenario remain unbalanced and downward: a further tightening of the spiral of protectionist measures, an increase in geopolitical tensions, a worsening of the turmoil in the financial markets of emerging countries, a lower support to the US economy coming from the expansive fiscal policy. In this context, the digital and organizational transformation of Italian firms is even more important, in order to seize opportunities and partially neutralize risks.

- **Private consumption.** Spending by Italian households is expected to slow down, with a significant downward revision of estimates compared to the CSC outlook published in June.

  In our forecasts for 2019 we assume that VAT and other taxes will not increase: this leads to a higher **disposable income** growth compared to our June forecast, and it avoids as well an impact on prices, which would have dragged on household expenditures. However, consumption will grow much less than income, because of a higher precautionary **saving rate**, starting this year. The increased uncertainty, generated both by internal political events and by the international scenario, leads to greater cautiousness in the management of family budgets, as already reflected in the most recent confidence indicators as well as some hard data.

  The growth of disposable income is also fueled by **employment** growth**,** which we forecast to continue, albeit at a lesser pace than GDP. The positive impact on disposable income, however, is dampened by low working hours and by the increase in fixed-term contracts, which nevertheless remain in line with European averages.

  The CSC forecasts do not incorporate the indications contained in the Update to the Stability programme (NaDEF, still not available at the time of publication of this report) on measures designed to stimulate consumption by running a public deficit. Regarding the impact for 2019, the timeliness in implementing

such measures is crucial. In the medium term, the effect will depend on expectations: if households anticipate future tax increases to finance higher government spending, it is likely that savings will increase for precautionary reasons and this would offset, at least partly, the positive effect on aggregate demand.

However, we could also imagine a positive confidence effect, and this could boost consumption and provide a significant contribution to growth.

- **Private investment.** Gross fixed capital formation is expected to grow in 2018 at similar rates than 2017, but it could slow down in 2019.

  It is reasonable to expect, in particular, a slowdown in purchases of **capital goods**, after the previous strong progress, which was driven by the need to modernize industrial plants after the crisis period, in which few investments were made, and was supported by public incentives. The decisions of the Government regarding measures to support the purchase of these assets will be very important: if they were reconfirmed, they would lead to a more robust trend than the one included in the CSC outlook.

  Business **credit** provides a weak support to economic activity. Credit supply has improved but it is still held back by the large amount of bad loans in banks' balance sheets, despite the recent decline, and by the uncertainty about the regulatory framework. Moreover, the increase in sovereign bond spreads in recent months has absorbed banks' capital. As a result, banks have squeezed even more credit supply. Credit demand, on the other hand, is already expanding above pre-crisis values, supported by an expected cost gradually increasing in the forecast horizon, compared to the current lows. Naturally, this scenario could significantly change if a sudden increase in financing cost took place as a consequence of an increased market's loss of confidence in Italy.

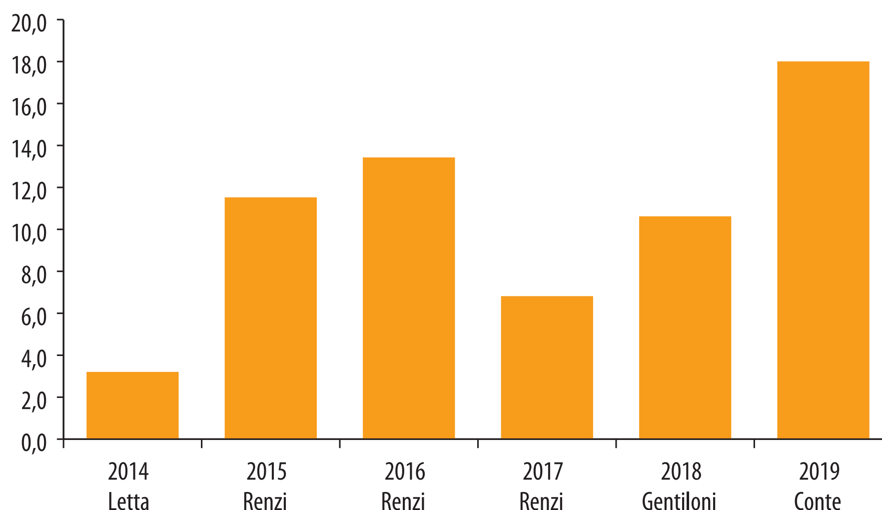
- **Public investment and public consumption**. The CSC forecasts a further reduction in public capital expenditure in 2018, with only a partial recover in 2019, unless the government will effectively allocate additional resources. On the other hand, public consumption will grow in 2018, supporting growth, and will remain substantially unchanged in 2019.

General government deficit will not improve According to the CSC outlook, the public deficit is estimated to fall to 1.8 percent of GDP in 2018, from 2.4 percent in 2017, which includes a *one-off* component linked to bank bailouts. This result is worse than envisaged by the outgoing Government in April, which estimated a deficit/GDP ratio at 1.6 percent this year. To a large extent, the difference between the two projections depends on the optimistic estimates of real and nominal GDP growth that had been formulated at the time and that the CSC had already highlighted; in part, the lesser reduction in interest expenditure due to the higher cost of financing that has been determined since May has its effect.

On an unchanged legislation basis, in 2019 the public deficit is expected to deteriorate at 2 percent of GDP. This estimate includes the non-increase in VAT. If the VAT increased, the deficit would be 1.4 percent of GDP.

According to the information available on the October 2nd, the Government, in the Update to the Economic and Financial Document (that should have been release within September 27th), fixes the target for deficit, for the next three years, at 2.4 percent of GDP. In 2019, this means that the Government is going to expand deficit approximately by one point of GDP, in nominal terms. This is the fourth Government in a row that plans a fiscal expansion, but the current Government has planned the largest one.

Chart A
Net fiscal plans: all expansionary in the last years
(Effects on public balance, Billions of Euro)



Amounts as planned in the NaDEF of September of the previous year.
Source: CSC calculations on data from the Italian Ministry of Economy and Finance.

For 2018, with data now largely defined, it is clear that Italy has not respected the rule on public deficit, not fully implementing the agreed structural correction by 0.3 percent of GDP.

In 2019, according to the European rules, the structural correction of the deficit should be 0.6 percentage points of GDP. But also for 2019, Italy is going to deviate from the adjustment path towards the Medium term budgetary objective.

Considering the available information about the measures that will be included in the next budget law, we can say:

- there is no correction deficit/GDP ratio, neither in nominal nor in structural terms; on the contrary nominal deficit is set to increase by 0.4 percent of GDP with respect to what was decided with the previous Economic and Financial Document;
- the deficit increase will be used to start some of the welfare measures included in the "government contract" which are very hard to eliminate afterwards unless in serious emergency situations. If economic agents are rational and anticipate this expenditure increases as permanent, they will expect a tax increase in the future and consequently will increase savings;
- there is a risk of discouraging dependent employment and increasing unreported employment. Nevertheless, it will be crucial how the guaranteed minimum income scheme and the tax reform for professionals ("Partite IVA") will be designed;
- the deficit increase is still small with respect to what the measures outlined by the Government would suggest. If appropriate resources to finance them are not found, there is a sensible risk of an even larger deficit/GDP ratio.

This could create **two risks**:

i) a reaction from financial markets causing a further increase in the sovereign spread. The 10-year BTP yield increased up to 3.25 percent two days after the Cabinet meeting of September27th; if the increase lasts, credit conditions for households and firms will deteriorate, and the financing cost for public finances will raise;

ii) the EU opens an infringement procedure. In November the European Commission has to evaluate the Draft Budgetary Plan for 2019. Given that the European Parliament elections will take place at the end of May 2019, an infringement procedure could have political connotations; this puts the European Commission in a tough spot.

On the other hand, increasing the government balance objective to 2.4 percent of GDP, does not guarantee that there will be fiscal capacity for implementing the economic measures outlined by the Government without identifying **adequate resources.** The gross fiscal plan, instead, which includes a rescheduling of expenses and income, can be quite large. To be credible, however, it is necessary that the measures of deficit increase and measures to finance it have the same time span. If the Parliament approves the objectives described in the NaDEF, the gross fiscal plan will be massive.

The long election campaign in Italy and the long genesis of the Government have blocked any economic policy action for at least the first six months of 2018. This has **fueled the uncertainty** on the lines of economic policy, not least because the government contract and the statements by political leaders have not highlighted a one and only direction, giving rise to different interpretations. This has eroded the confidence of consumers and Italian firms.

The forecast scenario, characterized by low and slow growth, very high public debt and rising interest rates, however, makes it **necessary and urgent to take action,** in the next Budget Law, adopting economic policy measures able to improve in a structural way such trends and to provide certainty on the lines of action.

Above all, Italy needs to accelerate the reduction of **public debt,** after having lost four years, through measures that significantly affect the dynamics of GDP and employment. This is the only way to increase public debt sustainability. Unfortunately, the direction of the Government seems to be different.

This is crucial to **reassure investors** who buy Italian sovereign bonds, preventing capital outflows (which have already been observed) from turning into a dangerous trend.

On the other hand, a loss of confidence would trigger a further increase in the sovereign spread and the financing cost for the public sector, firms and households. The increase could be accentuated by a possible ratings downgrade, as the decision by Moody's is expected shortly.

A higher cost and a lower availability of credit to households and firms would slow down the economy, both penalizing households' consumption dynamics and resources for firms, reducing their competitiveness.

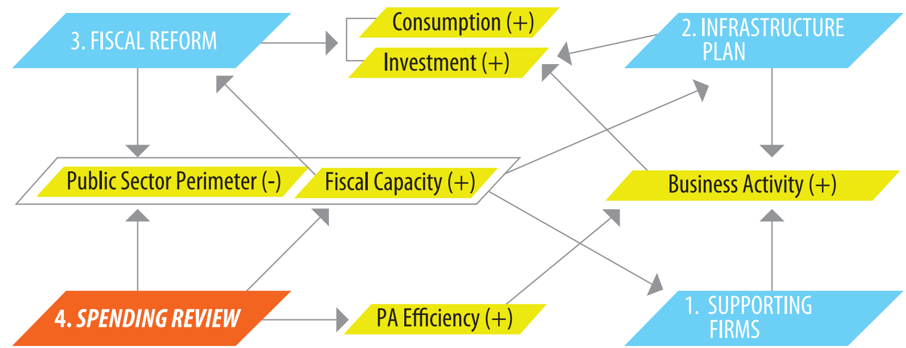
Effective policy actions are needed The described outlook can be improved, and uncertainty can be reduced, with appropriate policy actions. The Confindustria Research Department identifies **four directions for economic policy** that can positively affect investors' choices, with positive effects on the Italian GDP:

1. strengthen the measures to support firms;
2. implement a major plan for infrastructure;
3. launch a tax reform for firms and households;
4. conduct an effective analysis and review of public spending.

The identified actions, taken together, are meant to **stimulate investment**, both public and private. Such measures can indeed improve the outlook of growth in the medium term and significantly contribute to increase the sustainability of public accounts.

The measures should be jointly designed, taking into account the impact that each one can have on the others and, therefore, on the Italian economy (Graph B). In the current situation, **coordinated actions** send better signals and help identify the policy direction more clearly.

Chart B
Policy Measures



Improving the revenue and the spending side in the public budget are actions that need to proceed together. An effective spending review can create fiscal capacity, which can be used for investment. Improving infrastructures can facilitate the activity of firms, which would also be sustained by the other support measures.

A **gradual approach** is the preferred option to jointly implement the aforementioned measures. This would facilitate the adoption of potential corrective measures, and would avoid a too negative impact on public accounts in the early stages of the implementation.

1. Measures to support firms.

Economic policy should accompany the processes of transformation of firms, in a virtuous way, simultaneously taking action on three levers: loosening the financial constraints for investments; loosening the constraint of internal skills; strengthening the systemic logic.

Some measures should have a transversal impact on the productive system: the reduction of the general tax burden on firms; the struggle against the uncertainty and the slowness of bureaucratic procedures; the better functioning of financial markets; a support for credit, strengthening the Guarantee Fund for SMEs; the increase in productivity, with a greater tax exemption of second-level premiums.

We need a strong commitment to the **professional training** of workers and the alignment between demand and supply of skills. It is essential that the skills and resources within the Italian industry, which is fragmented among a multitude of companies that are largely small, are exploited by means of policies that encourage **coordination** around common investment projects.

Policy should continue to support **technological innovation** and **internationalization**. The strong interest of companies towards the *National Plan for Industry 4.0* and the *Plan for the extraordinary promotion of Made in Italy* is an important signal in view of the next Budget Law, which will have to provide answers on the pursuance and strengthening of these tools, on a multiannual horizon.

Both the digital challenge and the one of internationalization require - also for the future - a commitment to support firms. In particular, it is important to continue the support for the investment in the renewal of machinery and the development of new products, also including expenses for staff training and technical and managerial consultancy, so as to strengthen the **absorption capacity** of new technologies.

Continuity should be given to the reduction of social contributions paid by firms, in order to lower **labor costs** and improve the competitiveness of Italian firms. The measures taken in recent years have only scratched the surface of the problem. More incisive actions are needed to lower and reshape social contributions, with the aim of closing the gap with other European countries and align the burden on manufacturing firms with the one prevailing in other sectors. There are three areas for action: given limited resources, focus the reduction of contributions on new hires on permanent contracts; reduce the contribution burden for

those social programmes for which industrial companies pay more than other sectors; do not dismantle past pension reforms, because this would make it necessary, sooner or later, to increase the contribution burden on current workers. This would be exactly the case if the so called "quota 100", a mechanism that allows for earlier retirement, were to be introduced.

2. A plan for investment in infrastructure.

Italy has accumulated a worrying investment gap, both public and private. Since the beginning of the crisis in 2008, public investment in infrastructure have fallen to just 16 billion Euros in 2017 from 29 billion Euros in 2009, a much more marked decline than that in GDP. This has contributed to widen the gap with other countries in the infrastructural endowment and in logistics.

The lack of investment not only hampers the GDP dynamics in the short term, but also hinders the economic **growth potential** in the medium term, worsening competitiveness and compromising efficiency and quality of services for citizens and firms.

Italy should immediately launch a significant plan for investment in tangible and intangible infrastructures, both green-field and brown-field, as well as in human capital and research. A big plan of investment would be particularly timely in this period of low interest rates. A plan with **well-defined projects and resources** could be welcomed by the international markets and the EU, helping to curb the sovereign spread and, therefore, the cost of the investment.

We need to focus on the creation of transport, telecommunications and energy networks, carefully selecting projects based on effectiveness and economic returns. Priority should be assigned to: improving the railway connections of ports and airports; completing ultra-broadband and 5G mobile communications; completing large projects such as "TAV" and "TAP".

Public resources are crucial. In addition to the fiscal space that can be created in the public budget with a spending review, two possibilities are identified for funding: an extraordinary and temporary European golden rule, which can be immediately operational; the issue of Eurobonds for growth, which could be a more long-term project. Beyond that, resources could be found from the European budget, reallocating part of the cohesion fund to investment which would enhance competitiveness.

We should also **mobilize private resources**, even in partnership with the public sector. High competence is needed in the public sector when defining contracts with private firms, ensuring the pursuit of the collective interest. It is deemed as priority to: reduce litigation, enhance contractual standardization, introduce public planning.

Finally, the problems of the Italian **public administration** should be addressed, to foster spillovers of infrastructural investment on growth: the veto power of regional administrations should be reduced especially when it comes to large projects of national interest; administrative procedures should be improved, continuing on the path laid down by the "Madia reform"; a commission for the monitoring and evaluation of the investment should be established.

3. Launching the tax reform.

The Italian tax system has many critical issues: high tax pressure; high tax burden on labor and low on consumption; high tax and contributory evasion; complexity of the tax system.

The **personal income tax (IRPEF),** which is the main source of government revenues and shows significant progressivity, especially in the middle-low income brackets, is yet also the one that shows the most critical issues. In particular, the irrationality of its tax system. But what reform can solve the problems of the IRPEF?

The hypothesis at the center of the debate is the introduction of a **flat tax** on personal income, associated with a system of deductions and other tax allowances that ensures progressivity. Flat tax rates, moreover, are not new in the Italian tax system.

In the countries where it was introduced, the flat tax showed **advantages and disadvantages.** It could simplify the income tax, reduce costs and compliance time, increase tax compliance and it could be more rational than the current tax system. However, in addition to the need to preserve progressivity, an excessive reduction in revenues should be avoided.

One way to recover the loss in revenue would be to make some tariffs paid by citizens for public services progressive: wealthier households would pay higher tariffs than low-income ones.

The decisive element to determine the advantages of a tax cut through the adoption of a form of "flat tax" is to verify if it is able to generate **positive effects on growth**, boosting consumption and increasing incentives to work, in order to compensate for the loss in revenues. This depends on how this type of tax is designed and how gradually it comes into force.

A micro-founded **simulation** exercise, carried out by the CSC, illustrates the possible effects in Italy, in terms of GDP growth and public deficit, over a medium-term horizon, of the adoption of two alternative quasi-flat tax schemes, that could be implemented either immediately or gradually.

The **results** show that:

- it is very unlikely that the transition from the current system to a quasi-flat tax would finance itself with the proceeds of the induced higher growth;
- such a tax reform should be well defined and announced from the beginning, but necessarily implemented gradually;
- to finance the loss in revenue it is necessary to raise resources through a serious spending review and a reduction in tax evasion.

4. Spending review.

A thoughtful process of public spending analysis and review is a priority, given the many objectives of economic policy and the scarce resources.

Previous revisions had important limits. A true public spending revision should have two objectives: to make public services more efficient and to reduce the number of services offered by the public sector, if they can be supplied effectively by the market.

Making **public services more efficient** unleashes resources, which can be reinvested to improve their quality and boost economic growth, by increasing the competitiveness of firms.

The redefinition of the **perimeter of public services** makes structural resources available in order to finance policies to promote growth.

Timing is crucial to success, since a serious spending review needs time to give results. Therefore, it is necessary to start immediately with a multi-annual spending review, that could contribute to support the other identified policy measures.

Politics plays a fundamental role, since it should support the spending review process, involving all central and local institutional actors, and assuming a role of leadership and lasting commitment.

The **roadmap to success** in the spending review process is the following: set clear political objectives; establish an ex-ante methodology; involve strongly the institutions with spending capacity; set up a system of incentives and penalties to align interests; ensure transparency, so that citizens and firms can evaluate actions and results.