# Europe's make-or-break country:
## What is wrong with Italy's economy?

### By Ferdinando Giugliano and Christian Odendahl

After Matteo Renzi lost his referendum on constitutional reform and resigned, Italy returned to the European spotlight. Although Italy is a founding member of the EU, Italian public support for the European project is among the lowest in Europe; it is the eurozone's third largest economy, but its economy is the same size as it was in 2000; and it still has the third largest sovereign debt burden in the world, after the US and Japan. Italy could yet pull the eurozone apart – and indeed the EU.

Italy's dismal economic record has two causes: its membership of the euro, and successive governments' failure to reform the Italian economy.

Membership of the euro has not helped Italy. In the run-up to the crisis in 2008, imports and exports with its eurozone peers grew and inflation fell, but productivity growth slowed as low interest rates stimulated investment in unproductive sectors of the economy. And Italy's total exports – to countries inside and outside the eurozone – grew only slowly over the euro's first decade. Tight monetary and fiscal policies during the euro crisis made Italy's situation worse, as did the European Central Bank's failure to act as a lender of last resort to the Italian government until 2012. Italian banks, tied to the increasingly weak Italian economy and the highly indebted government, struggled to provide finance to more productive firms.

But Italy mostly has itself to blame. The abysmal productivity growth over two decades is also down to successive governments' failure to invest in infrastructure, research, education and skills; to make its public institutions and judicial system more efficient in order to help the most successful and productive businesses grow; to raise the employment rate of both men and women; and to promote the deployment of labour and capital to productive companies.

Solving Italy's economic problems will require further domestic reforms, including:

★ cuts to employers' social contributions to encourage hiring, and lower subsidies for unproductive jobs while giving more support to the unemployed, especially re-training;

★ more investment in schools and universities, especially in the quality of teachers and academics;

★ reduced bureaucracy to make it easier to start a business and pay taxes, and reform the justice system so that disputes are resolved more quickly;

★ a swift and thorough consolidation and recapitalisation of Italy's banking sector, preferably by raising capital on private markets; and

★ switching expenditure from public consumption, such as the pension system, towards public investment.

The eurozone should support such efforts by making reforms of its own:

★ keep monetary policy loose and ensure that the average fiscal stance of eurozone governments supports demand;

★ change fiscal rules to encourage governments to invest more and consume less, including in Italy; and

★ complete the banking union, which requires weaker states to reduce the amount of risk on their banks' books, and stronger states to share risk in the form of common European deposit insurance.

**Italy and its economy are back in the spotlight. The eurozone – and the EU – will continue to struggle unless the Italian economy recovers. It is the third largest eurozone economy, but output is still roughly where it was in 2000 and nearly 9 per cent lower than it was before the crisis in 2008, while unemployment is stuck at more than 11 per cent – half of which now comprises long-term unemployed (see Chart 1). Approval ratings for the EU are among the lowest in Italy.[1]**

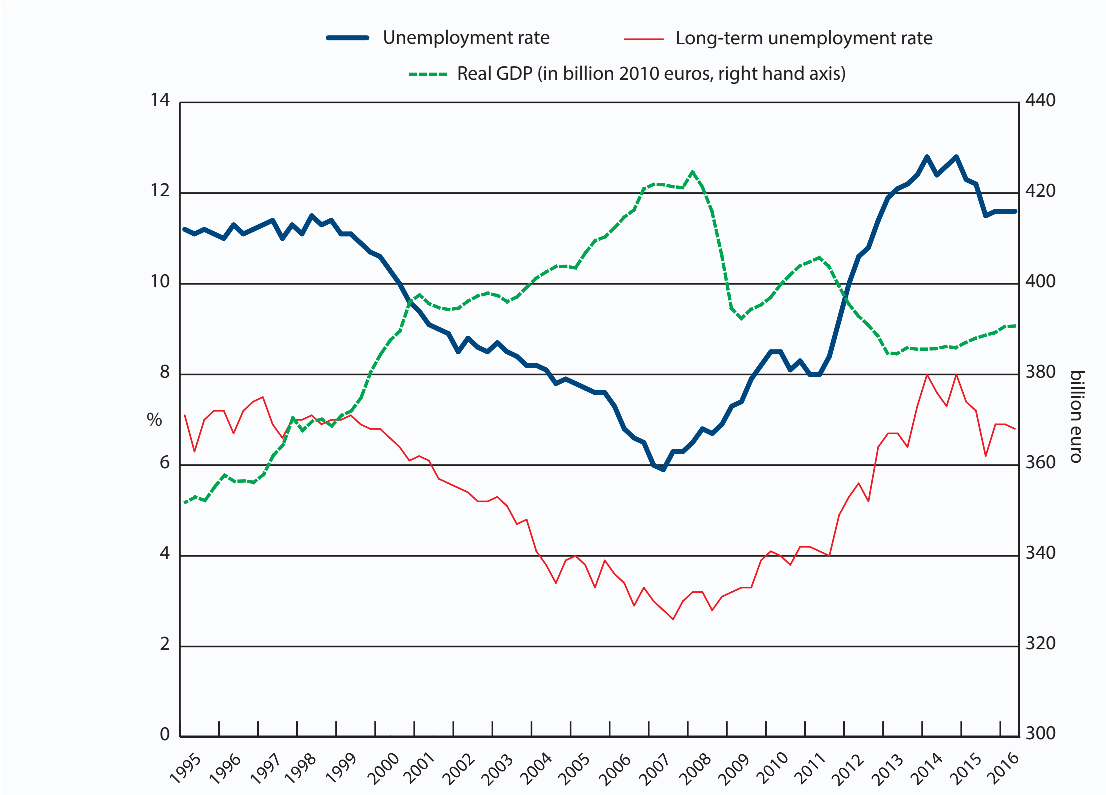
While Greece has dominated the headlines in recent years, the Greek economy is not large enough to pull the eurozone apart. And concerns about Greek 'contagion' to other economies were really about Italy, as it is too big to bail out. If Italy decided to leave the euro, a financial crisis would be unleashed across the currency union.

There are two competing explanations for the sorry state of Italy's economy. The first is that Italy entered the euro without being able to handle the consequences. The country gave up the freedom to devalue its currency to compensate for its relatively high inflation and wage growth; euro membership led to a steep fall in interest rates, which encouraged borrowing and investing in less productive parts of the economy; high public debt meant that Italy was unable to cushion the impact of the post-crisis slump; and its rigid labour and product markets made adjustment to economic shocks more difficult.

The second explanation is that, with or without the euro, Italy would have struggled economically. Its political and judicial institutions were inefficient; its businesses were too small and unable to meet the challenges of globalisation and the information technology revolution, in part because its markets were inflexible; and it faced a huge ageing problem – while failing to bring more women into employment to offset this problem.

Chart 1: Italy's unemployment and growth record show an economy in trouble

*Source: Haver.*




*1:* The EU average is 53 per cent. Only the Czech Republic and Greece have lower EU approval ratings than Italy. European Parliament, 'Parlemeter 2016: Analytical overview', November 2016.

These two explanations are not mutually exclusive. Italy needs both eurozone and domestic reforms to prosper. The eurozone needs to complete the banking union, change its fiscal rules to allow governments to boost public investment, and use fiscal and monetary policies more aggressively to ensure sufficient demand for the bloc as a whole. Italy, in turn, needs to swiftly recapitalise its banks, preferably through raising private capital on markets; continue with labour market reforms to move workers into more productive companies; streamline its bureaucracy and byzantine judicial system; invest more in infrastructure, education and research; and help firms to grow and to take advantage of globalisation and technology.

This policy brief first takes stock of where the Italian economy stands, before analysing the reasons behind Italy's economic woes and whether recent reforms have eased constraints on growth. It concludes by laying out the challenges facing the future governments.

## Taking stock of the Italian economy

Italy's growth performance has been dismal. Between 2005 and 2015, GDP shrank by half a per cent a year on average. And between 1995 and 2015, Italy's performance was even worse than Greece's – despite the massive loss of economic activity suffered by Greece since the onset of its depression in 2009 (see Chart 2).

Despite running 2.5 per cent below potential, according to the International Monetary Fund (IMF), the Italian economy expanded by just 0.8 per cent in 2015. This year's figures are little better. Italy's economy is on course to grow by only 1 per cent in 2016, compared with 1.7 per cent for the eurozone as a whole and over 3 per cent for fellow crisis country Spain. Italy has not benefitted as much as its fellow eurozone member-states from a number of positive developments: the steep fall in the oil price; the European Central Bank's (ECB) programme of quantitative easing; the sharp fall in the value of the euro, which should help exporters; and less fiscal restraint in the eurozone, including in Italy.

The main reasons for this disappointing post-crisis performance are weak consumption and a collapse in investment. While exports have surpassed their previous peak in 2008, investment is still more than 30 per cent below its pre-crisis level (see Chart 3).

Chart 2:
Italy's long-term performance is dismal

*Source: Haver, author's calculation.*

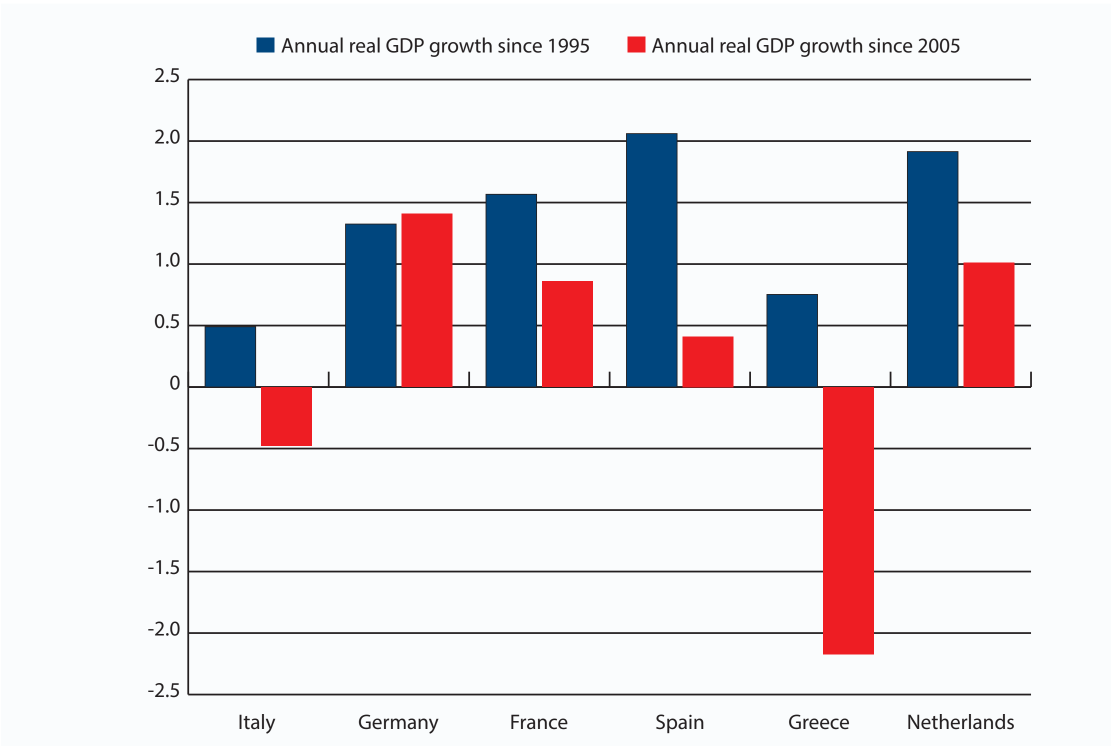
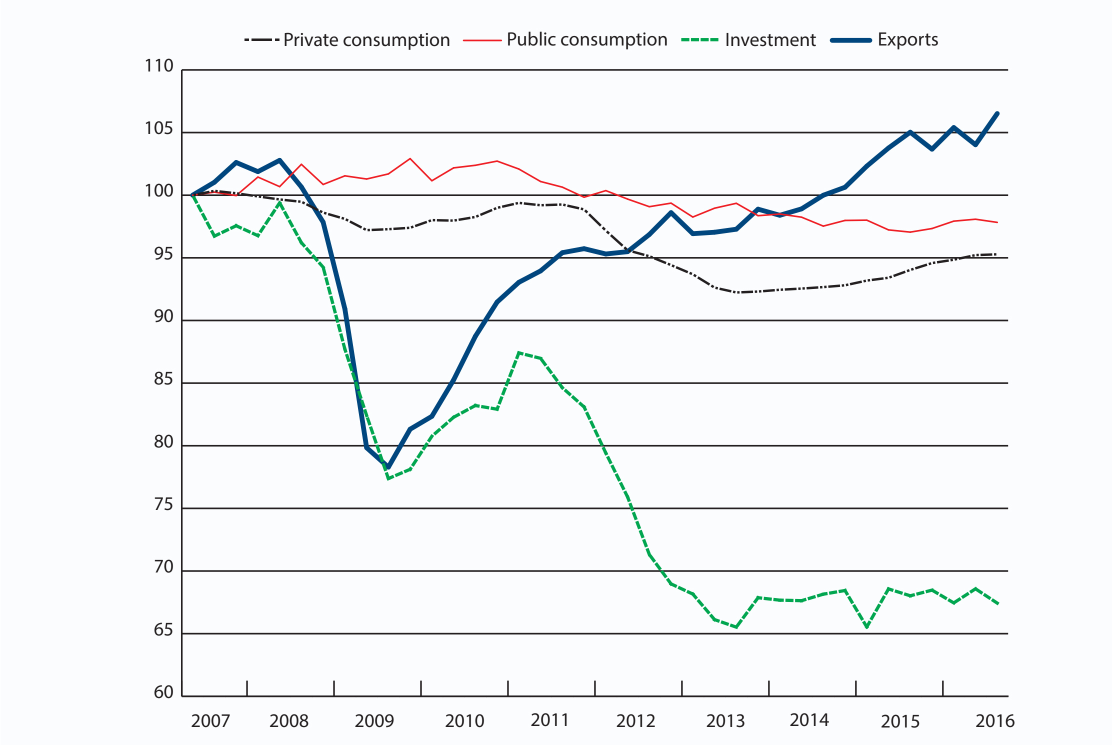


Chart 3: Consumption, investment and exports (March 2007 = 100)

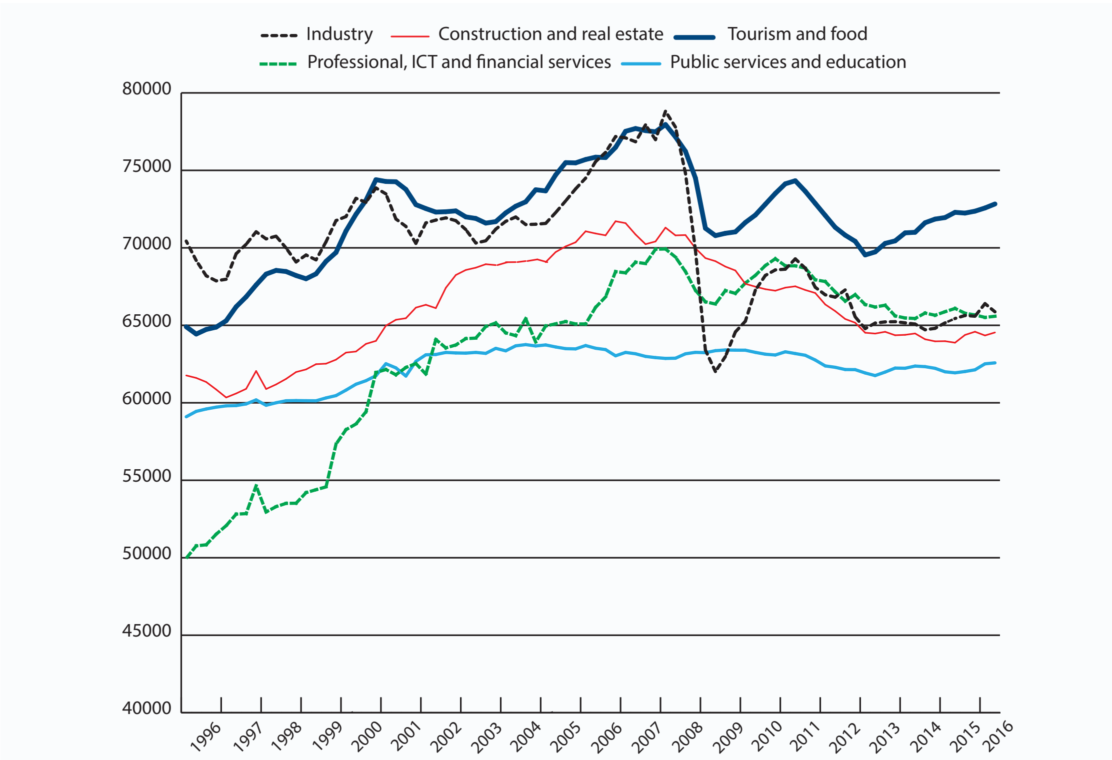
*Source: Haver.*




Italy has long prided itself on its industrial base, which still accounts for around 18 per cent of the Italian economy. However, the recession has had a devastating impact on this sector: in real terms the manufacturing sector is now producing less than in 1995. Other sectors, like construction and professional services, have also taken a hit, as has tourism, where activity is still below its 2000 level (see Chart 4).

Chart 4: Real gross value added has fallen throughout the economy (in million 2010 euros)

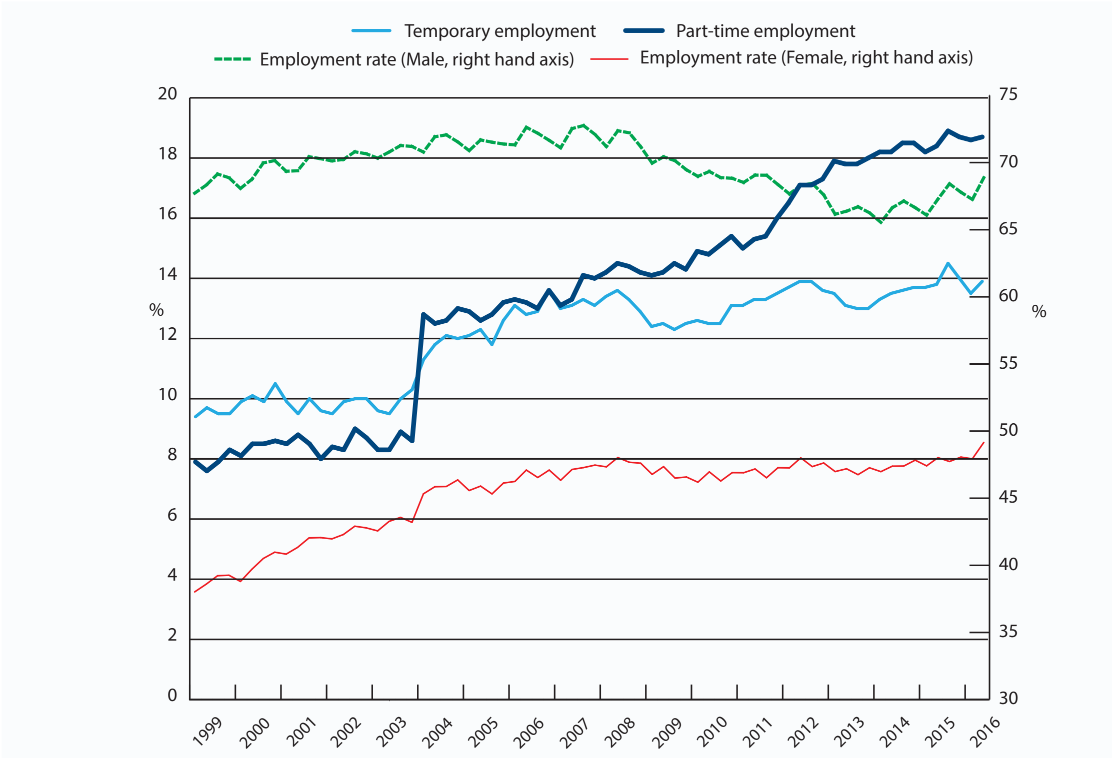
*Source: Haver.*




The mild recovery in recent years has helped the unemployment rate to fall from a peak of 13.1 per cent in November 2014 to 11.6 per cent in October 2016. But this is still nearly twice as high as the rate of around 6 per cent prevailing in the years before the crisis (see Chart 1), and temporary employment stands at 14 per cent of total employment (see Chart 5). Meanwhile, the employment rate – how many people of working age are in employment – stands at just 69 per cent for men and just 50 per cent for women.

Chart 5:
Low employment rates (per cent of working-age population) and high shares of temporary and part-time employment (per cent of total employment)

*Source: Haver, authors' calculation.*




Italy's biggest challenge is to improve its abysmal productivity performance. The country's labour productivity has not grown at all since 2000, having been roughly on a par with Germany, the US and other leading economies in the late 1980s. Total factor productivity, which measures the efficiency with which an economy uses its resources – principally, labour and capital – has been falling since the turn of the century (see Charts 6 and 7).

Chart 6:
Italy's labour productivity in comparison (real GDP per hour worked, in 2010 euros)

*Source: Haver, authors' calculation.*

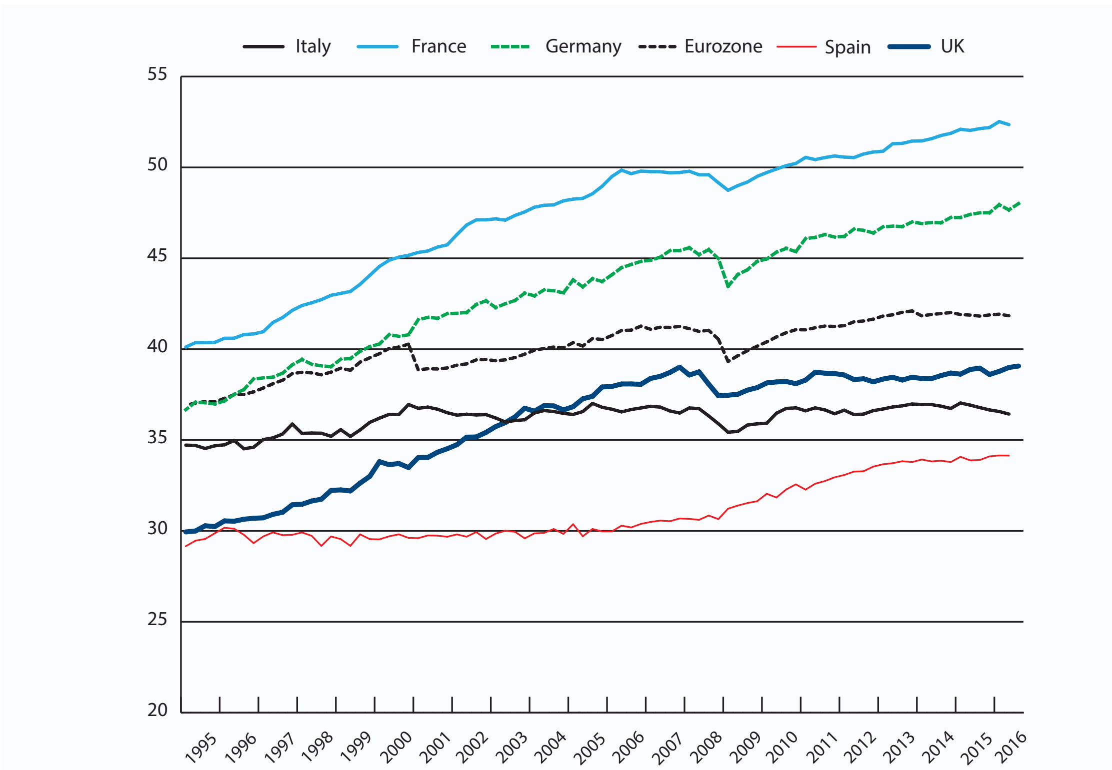
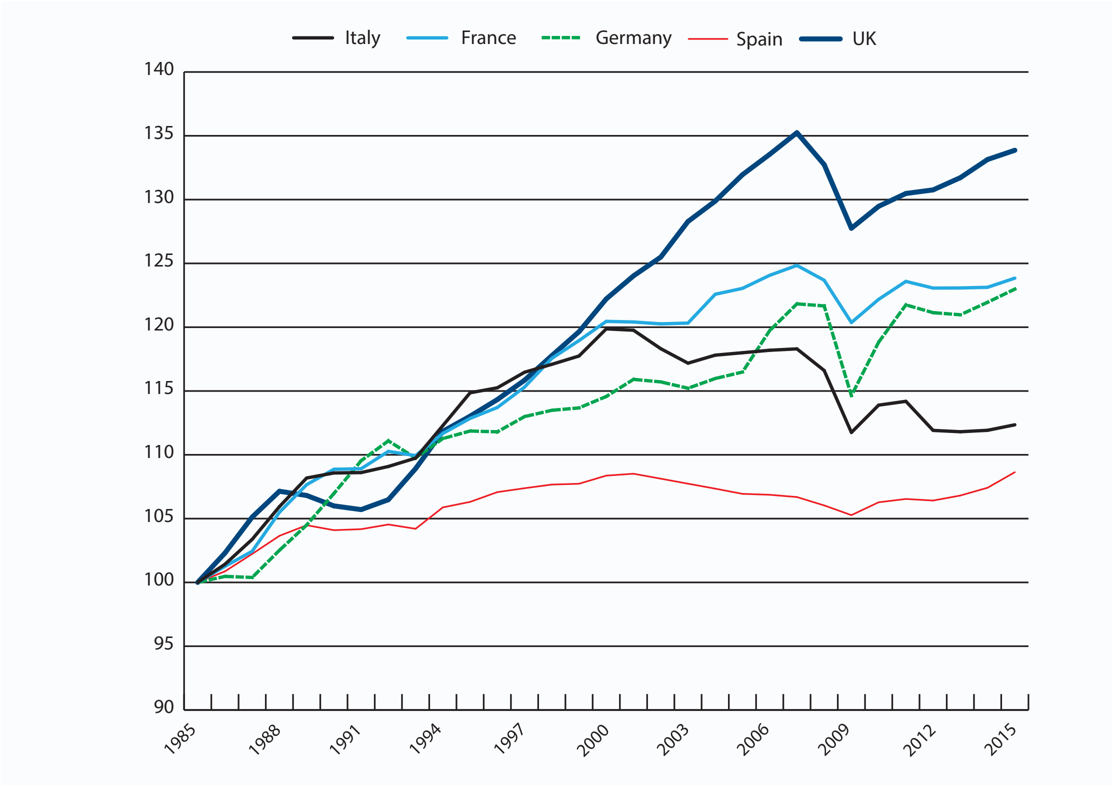


Chart 7: Italy's total factor productivity in decline since 1999 (1985 = 100)

*Source: Haver, authors' calculation.*




## Is the euro behind Italy's economic malaise?

Italy's pitiful economic performance over the last fifteen years or so coincides with its membership of the eurozone. Whether the euro is (part of) the cause is difficult to assess: in order to answer that question properly, one would have to construct a counterfactual world in which Italy did not join the euro, and compare the outcomes.

The best approximation is a recent paper in which the authors attempt to do just that.[2] They find that Italy's imports and exports with other eurozone member-states increased compared to the scenario under which Italy had not joined the euro. The study shows that inflation and interest rates were lower inside the euro than would have been the case without it. But the authors also find that productivity growth was significantly lower inside the euro, and growth in per capita incomes slightly lower.

It is not clear why Italy's productivity growth was so disappointing in the run-up to the crisis. One explanation is that lower interest rates and a more stable currency led to more investment in less productive sectors of the economy.[3] Another explanation is that Italy may have joined the common currency at an overvalued exchange rate. Contrary to the findings in the study above, one could argue that lower demand for Italian export goods – export sectors are often the sectors in which productivity growth is higher – hurt Italian producers.[4] And indeed, while Italy's total trade with the eurozone may have grown faster than under the non-euro scenario, its overall export performance has been disappointing, relative to other members of the currency union (see Chart 8).

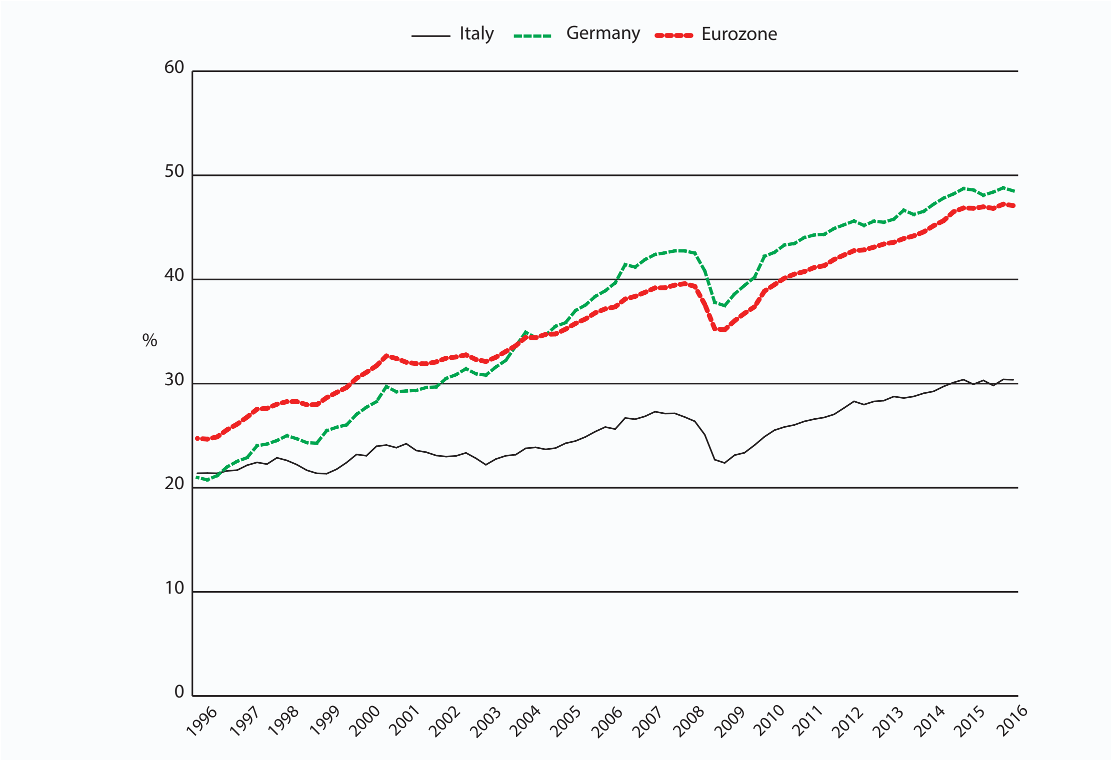
*2:* Paolo Manasse, Tommaso Nannicini, Alessandro Saia, 'Italy and the euro: Myths and realities', *VoxEu*, May 24th 2014.

*3:* Fadi Hassan and Gianmarco Ottaviano, 'Productivity in Italy: The great unlearning', *VoxEu*, November 30, 2013. There is also evidence from other southern European countries: Daniel Dias, Carlos Robalo Marques and Christine Richmond, 'Misallocation and productivity in the lead up to the eurozone crisis', Finance Discussion Papers, Federal Reserve, 2015.

*4:* Tommaso Monacelli, 'Euro, domanda e produttività: un viaggio nel mito', Noise From Amerika, August 2013.

Chart 8: Italy's disappointing export performance (exports as a share of GDP)

*Source: Haver, authors' calculation.*




Italy's large public debt burden became a serious problem during the euro crisis. The country had run up heavy debts before the introduction of the euro, mostly in the 1980s and early 1990s. Between 1994 and 2007, successive governments reduced the ratio of public debt to GDP from a peak of 122 per cent to 104 per cent of GDP. But as a result of the financial crisis, the debt level had risen back to 112 per cent by the end of 2009. When the euro crisis started in early 2010, Italy came under market pressure, with interest rates rising to unsustainable levels. Without recourse to a national central bank able to act as lender of last resort, Italy attempted to restore market confidence through austerity: in 2012 and 2013, the Italian authorities pushed through spending cuts and tax rises worth 3.1 and 4.7 per cent of GDP. Such austerity in the middle of an economic crisis was bound to make matters worse. In 2012, the government expected GDP to shrink by 1.2 per cent, before rising by 0.5 per cent and 1 per cent in 2013 and 2014. In fact, GDP shrank by 2.8 per cent, 1.7 per cent and 0.6 per cent respectively, only returning to growth last year.

Euro membership added to deflationary pressures in Italy: it had no recourse to currency devaluation or (even) lower interest rates as the ECB sets rates for the entire eurozone. Indeed, the ECB was slow to lower interest rates, even raising them in 2011, unnecessarily adding to Italy's problems. Italy's very low nominal growth makes it hard to reduce its debt-to-GDP ratio, which is projected to remain at 133 per cent next year.[5] That is despite the fact that Italy's 'primary' budget surplus (the budget balance before borrowing costs are taken into account) is forecast to be 1.2 per cent of GDP in 2016 – on a par with Germany and considerably above the primary deficits of France and Spain.

Yields on Italian bonds came down only after the ECB declared that it would henceforth be the eurozone's effective lender of last resort in the summer of 2012 (by announcing a programme of potentially unlimited government bond purchases known as Outright Monetary Transactions (OMT)). As a result, the counter-productive pressure to consolidate public finances during the crisis was eased considerably. If there was a role played by successive Italian governments' austerity programmes in restoring confidence, it was indirect: they helped Germany to agree to the unconventional steps that the ECB took to stem the crisis.

While Italy ran an exceedingly stringent fiscal policy from 2011 to 2014, its stance is broadly neutral now, with the government deficit forecast to be 2.4 per cent this year. Italy is making full use of the 'flexibility clauses' in the eurozone's fiscal rules to spend more, and benefits from the fact that low interest rates have shaved nearly €8 billion from the government's annual financing costs in the last two years.[6]

With public debt at a critically high level, it is unclear whether Italy would benefit from fiscal expansion. More public spending or tax cuts would help the economy in

*5:* Ministero dell'Economia e delle Finanze, 'Documento Programmatico di Bilancio 2017', 2016.

*6:* The eurozone's fiscal rules contain flexibility clauses that allow countries to spend more: on certain types of investment (if the economy is weak); on compensating for the economic pain of structural reforms; or on the fallout from a security crisis, such as the recent refugee crisis.

the short term, when interest rates are low and inflation below target: there would be no crowding out of private spending and investment. For example, research on Matteo Renzi's flagship income tax cut – aimed at giving those earning €8,000-26,000 a year a tax cut worth €80 per month – has shown that households spent the windfall, rather than saving it, thereby raising consumption.[7] And the former prime minister's property tax cut, enacted this year, should have a similar, although weaker, effect.[8] Higher economic growth and inflation would in turn lower the debt burden, relative to GDP.

However, there is a risk that tax cuts will merely lead to an import boom, and not to the domestic nominal growth needed to reduce – or at least not increase – the debt burden. Indeed, while nominal GDP grew by just 1.2 per cent in 2015, import growth accelerated to 6 per cent that year, outstripping export growth significantly – a sign that this worry may not be entirely misplaced.

A cut to employers' social contributions would be more effective, as this would make workers cheaper to hire. Public investment should also stimulate the domestic economy more than it raises imports. However, the next government should reverse Renzi's plan to cut corporate taxes in 2017. As it will also have to cut its budget deficit substantially to comply with eurozone fiscal rules, it is unlikely that it would be able to find the money to cut social contributions if it also cut corporate taxes.

## What the eurozone could do to help Italy

In order to help the Italian economy, there are three steps the eurozone could take. The first is to change its fiscal rules, to encourage countries, including Italy, to invest more. Fiscal rules should allow more investment in physical and digital infrastructure, as well as research, in return for curbs to public consumption. For example, Italy should find ways to reduce the amount of spending going to pensions, which is significantly above other rich countries. There is also a case for asking richer Italians to pay more for services such as healthcare or university education. In the current environment of low growth and inflation, switching public expenditure from consumption to investment has been found to raise growth.[9] As an additional incentive, the eurozone could agree that governments should be allowed to increase investment by more than they cut public consumption. (The eurozone should of course closely monitor whether public investment is in fact additional, rather than a rearrangement of existing expenditure under different labels.)

A more co-ordinated eurozone fiscal policy would also help. By forcing countries with high current account surpluses and low levels of public debt to boost their investment levels, the burden of increasing demand in the eurozone economy would no longer fall on the ECB's monetary policy alone. Germany, which is running a current account surplus of over 8 per cent of GDP, would be a prime candidate.[10] A fiscal expansion in Germany would not boost Italian GDP if the eurozone economy were running at full capacity: stronger German demand would push up inflation, forcing the ECB to raise rates and strengthen the euro. But since interest rates are now expected to be stuck at very low levels for a long time, the effect of a German stimulus on Italy would be sizable, according to research by the former chief economist of the International Monetary Fund (IMF), Olivier Blanchard, and others.[11]

The second eurozone policy that would help Italy is a speedy completion of the banking union. The decision to pool banking policies at the European level was a big step forward: it started a process of disentangling banks from sovereigns, and helped the ECB to support sovereign debt markets through the OMT programme. But after the ECB took over supervision of the eurozone's largest banks in 2014, progress slowed down. The eurozone still needs to agree on how to treat banks' holdings of sovereign debt, which banks can currently hold as 'risk free' assets. As a result, banks hold too many of them, in particular those of their own government. If governments decide to change the rules on sovereign debt to reflect the risks of holding these bonds, the eurozone needs another safe asset to underpin its financial markets. Moreover, the eurozone needs to make banks diversify their assets and liabilities across countries; agree on a backstop for the newly created common bank resolution fund; and set up common European deposit insurance. A shared deposit insurance scheme would establish a level playing field between banks: at the moment, German banks can attract depositors at lower prices since they benefit from the implicit guarantee of the Bundesrepublik, whose finances are in better shape than those of other governments. However, the European Commission's proposal for a European deposit insurance scheme (EDIS) faces stiff resistance from Germany, the Netherlands and others. These countries would like eurozone banks to reduce their level of risk first, before agreeing to share risks with other eurozone

*7:* Stefano Gagliarducci and Luigi Guiso, 'Gli 80 euro? Spesi al supermercato', *La Voce*, September 6th 2015.
*8:* Paolo Surico and Riccardo Trezzi, 'Meno IMU, più consumi', *La Voce*, July 20th 2015.
*9:* OECD, 'Economic outlook', Chapter 2, November 2016.
*10:* Simon Tilford, 'German rebalancing: Waiting for Godot?', CER policy brief, March 2015.
*11:* Olivier Blanchard, Christopher Erceg and Jesper Lindé, 'Jump starting the euro area recovery: would a rise in core fiscal spending help the periphery?', NBER Working Paper, July 2015.

governments. A grand bargain is probably feasible, but it will require political will on all sides.

Finally, the ECB needs to maintain its expansionary monetary policy. The ECB was slow to appreciate the severity of the euro crisis, and took too long to react. Currently, the ECB's approach is about right, since it includes a negative deposit rate, a substantial programme of private and public sector bond purchases, and a package of cheap loans to banks to help boost credit to the economy. But with the first signs of a recovery in the inflation rate, the calls on the ECB to curb its unconventional monetary policies are growing louder, threatening the success of these policies. The ECB should make it clearer that it will maintain its current stance until the eurozone has fully recovered. For example, the ECB could commit to allowing inflation to rise temporarily above target in the future.

But eurozone membership only partly explains Italy's woeful economic performance. The main reason is that the Italian economy was unable to face the challenges of globalisation and the information technology revolution. Here, there are two broad areas of economic reform that Italy must undertake: to the country's labour market and provision of education and skills, as well as to its banking system and its policies designed to promote private investment.

## How a lack of productive investment is holding Italy back

Productivity growth is driven by investment in machines and infrastructure, and in less tangible stuff, like research and development. Yet Italy's investment rates are now substantially lower than in other rich countries.

And the composition of Italian investment is also worrying. OECD data show that investment in information and communication technology (ICT) grew by slightly less than 7 per cent a year between 1995 and 2014, less than in Germany, France and the US. The gap grew during the crisis: Italy's investment in ICT has grown by less than 3 per cent per year since 2007, while the comparable rates for Germany, France and the US have all been higher. The Renzi government named a 'digital champion' in 2012, following a recommendation from the EU to put one prominent official in charge of digital matters, but Italy is still failing to provide digital infrastructure; the provision of broadband is low by European standards.

There are various explanations for Italy's weak use of ICT. Some link it to the poor quality of Italian managers, who tend to reward people equally, irrespective of their performance level, while managers themselves are not rewarded for attracting or developing talent.[12] Weak management has been found to hinder the adoption of ICT.[13]

Another reason is that small firms use ICT less than larger ones, and Italian firms are relatively small by international comparison.[14] If the best and most productive firms are able to invest and expand, this in turn drives up the economy's productivity. There are many barriers to company growth in Italy. For example, the country's strong tradition of family ownership may be a rational response to distrust in economic institutions, but it deters businesses from expanding. Another barrier is the low quality of public institutions such as the judiciary, which larger firms depend on to a greater extent than smaller ones.[15]

There is abundant evidence that the Italian economy has done a poor job at allocating resources to the sectors with the highest productivity growth, with a recent study showing that investment was higher in low productivity sectors.[16] Nor have sectors with stronger productivity growth seen higher loan growth.

In the aftermath of a financial crisis, there is an another reason why banks tend to lend to low productivity firms: rather than writing off a loan to a struggling firm, a bank can extend the loan and thus pretend that the firm is viable; that way, it does not need to realise losses on its loan book. Growing or more productive firms may find it hard to get new loans if banks' books are bogged down by loans to weak or failing companies. Such misallocation of capital has been a problem throughout the eurozone since the start of the euro crisis, but has received renewed attention since the extent of the Italian banking system's weakness was revealed at the end of 2015.

In the autumn of that year, the government rescued four small banks (Banca Etruria, CaRiFe, CaRiChieti and Banca Marche). In the process, the government had to wipe out their shareholders and impose losses on ('bail in') junior bondholders, many of whom were retail investors. There were widespread protests, despite a fund to compensate retail investors who had bought these bonds without being properly informed about the risks.

*12:* Fadi Hassan and Gianmarco Ottaviano, 'Productivity in Italy: The great unlearning', *VoxEu*, November 30, 2013.
*13:* Nicholas Bloom, Raffaella Sadun and John Van Reenen, 'Americans do IT better: US multinationals and the productivity miracle', *American Economic Review*, February 2012.
*14:* Franco Amatori, Matteo Bugamelli and Andrea Colli, 'Italian firms in history: Size, technology and entrepreneurship', Bank of Italy Economic History Working Paper, October 2011.
*15:* Silvia Giacomelli and Carlo Menon, 'Firm size and judicial efficiency in Italy: Evidence from the neighbour's tribunal', SERC Discussion Paper, May 2012.
*16:* Fadi Hassan and Gianmarco Ottaviano, 'Productivity in Italy: The great unlearning', *VoxEu*, November 30th, 2013.

The four small banks were just the tip of an iceberg, however. Italian banks currently carry over €350 billion in non-performing loans (NPLs). Even though the value of NPLs seems to have stabilised and Italian banks have set aside funds to cover losses, NPLs weigh on banks' ability to lend for three reasons. First, provisioning for losses and managing NPLs reduces profits. Second, regulation forces banks to fund NPLs with more of their own funds, leaving less capital to fund new lending. Some banks, including Intesa Sanpaolo, the country's largest, have a strong capital position, but others, such as Carige or Monte dei Paschi di Siena (MPS), are substantially weaker. Third, banks with large holdings of NPLs are perceived as riskier, increasing their funding costs.[17]

The government has adopted a three-pronged approach to help unclog Italy's banking system:

★ First, it has introduced various reforms to the judicial system to speed up the repossession of collateral – such as houses or commercial assets. If collateral is easier to recover, non-performing loans are more valuable, which makes it more profitable for banks to sell them to specialised asset managers;

★ Secondly, the government has encouraged Italian banks to set up a private bank rescue fund, called Atlante. This fund is intended to help troubled banks to sell NPLs to investors and to raise capital on markets. Atlante has intervened in two banks, Veneto Banca and Banca Popolare di Vicenza, which were struggling to raise capital;

★ Third, the government has used its equity stake in MPS to promote a change of management followed by a recapitalisation plan. This ambitious plan would see MPS offload its worst NPLs into a private vehicle backed by Atlante. Stakes in that new vehicle would then be sold to investors. The losses on the sale of these NPLs would create a hole in MPS's balance sheet, to be filled by private investors through a €5 billion share issue.

But these steps are not enough. Italy's byzantine court system continues to weigh on the valuation of NPLs, making it impossible for banks to sell them without facing severe losses. The Atlante fund is running out of money just when the banks it has rescued need more capital. And MPS is struggling to find investors because of the bank's high costs and low profitability. Renzi's referendum defeat may deter private investors in Italy's most troubled banks, though markets have so far reacted calmly.

The Italian government may therefore be forced to step in and recapitalise at least some of the country's banks. According to new EU rules on banking resolution and state aid, a government recapitalisation would require some bondholders to be bailed in. How much new capital Italian banks need is uncertain. Some analysts estimate that €40 billion is needed to shore up the weakest banks – 3 per cent of Italian GDP. This is less than other countries had to inject into their banking systems during the financial crisis, but it would add to Italy's critically high debt burden.

Key to solving Italy's banking problems is therefore further restructuring of the banking sector; a swift recapitalisation, ideally via raising funds on private markets, of all those banks with weak capital; an orderly resolution of smaller banks that are not able to strengthen their capital; further reforms to the civil justice system to increase the value of NPLs; and a thorough investigation of the widespread mis-selling of bonds, together with a selective compensation scheme for those who were truly misled about the risks.

## Italy's labour market – the wealth of humans

Italy's labour market and its education and training systems also need reform. One often heard explanation for the country's economic malaise is labour market regulation. Here, the argument goes, overly strict labour laws prevent firms from hiring, leading to long spells of unemployment, which undermine workers' skills and productivity. The international evidence on whether more flexible labour markets drive productivity growth is mixed, but Italy's labour code did, until recently, impose very severe restrictions on dismissals and severance pay, deterring firms from hiring workers when economic prospects were uncertain.

Renzi's 2014 labour market reform, the 'jobs act', has introduced an open-ended contract for new hires. Under the contract, workers who have not long been at a company receive less severance pay, lowering the cost of firing. The government also made a temporary cut to employers' social contributions when they hire someone on a permanent contract, to encourage them to take on new workers on more stable terms. That cut eliminated employers' social contributions for three years for those hired in 2015, and reduced the contributions for those hired in 2016 by 40 per cent for two years. From 2017, this measure will be replaced with an incentive targeted at younger workers, especially in southern Italy.

Data from the Italian social security agency show that Italian companies offered around 2.6 million new permanent contracts in 2015, while terminating around

*17:* For more details, see European Parliament, 'Non-performing loans in the Banking Union: stocktaking and challenges', Briefing, March 2016.

1.7 million. This net increase of 913,000 jobs is a significant improvement on the net loss of 52,000 permanent jobs in 2014. Recent research based on data from the Veneto region in northern Italy suggests that these new hires were largely thanks to the cut in social contributions.[18] And the latest labour market data shows that as the fiscal incentive was reduced, the growth in new permanent jobs slowed: just 47,000 over the first nine months of 2016.

Another labour market indicator is how well the market matches firms and workers. A functioning market ideally sends workers to firms where they can be most productive. That requires geographic mobility, as well as the redeployment of workers to high-productivity sectors. In Italy, however, employment and wages have grown in sectors with lower productivity growth, as a study from 2014 has shown.[19] Such misallocation of labour stifles the growth of productivity and living standards. The authors of the study argue that this is partly down to the existing model of wage bargaining, which is too restrictive and slow to react to changing economic fortunes.

Renzi was planning to reform Italy's highly centralised wage bargaining structure. But his government left it to the trades unions and the employers' confederation to decide how best to do this; so far there has been little progress. However, the government did push through a law to reduce income taxes on the bonuses workers receive for strong performance. Since these bonuses are decided on at company-level and not centrally, the law is an indirect attempt by the government to strengthen decentralised wage bargaining.

Italy also needs to improve support for the unemployed. Italian governments have long prioritised protecting the job rather than supporting workers through unemployment benefits and active labour market policies to help them find new work. Companies in trouble can apply for a government subsidy – the so-called wage supplementation scheme ('Cassa Integrazione Guadagni') – that pays a portion of a worker's salary and social contributions. However, as a recent paper has shown, the scheme has been predominantly used by low-productivity companies, and not temporarily, as was originally intended. As a result, workers have not migrated to more productive firms.[20] The Renzi government introduced a new universal unemployment benefit scheme ('Nuova Assicurazione Sociale per l'Impiego'). While a step in the right direction, this new measure has not been matched by a meaningful reform of the wage supplementation scheme, which remains a source of inefficiency.

Italian workers are also relatively unproductive because they are poorly skilled by international standards. Only 17 per cent of Italian adults have tertiary education, half the OECD average of 34 per cent (see Chart 9). At university level, the government is planning to attract more talented young researchers, by increasing research funding to €2.4 billion in 2017 and by funding 500 new professors who will be chosen by independent commissions. The additional funding, while welcome, is not enough to boost Italian tertiary education and research. The university sector lacks the autonomy and competition needed to improve teaching and research.

Italian workers also have weak ICT skills. A survey conducted by the OECD found that in 2012, 50 per cent of workers in Italy said that they did not use a computer as part of their job. In the UK the proportion was below 30 per cent. Fewer than 30 per cent of Italians thought their computer skills were sufficient to apply for a new job within a year – in Germany the proportion was over 50 per cent.[21]

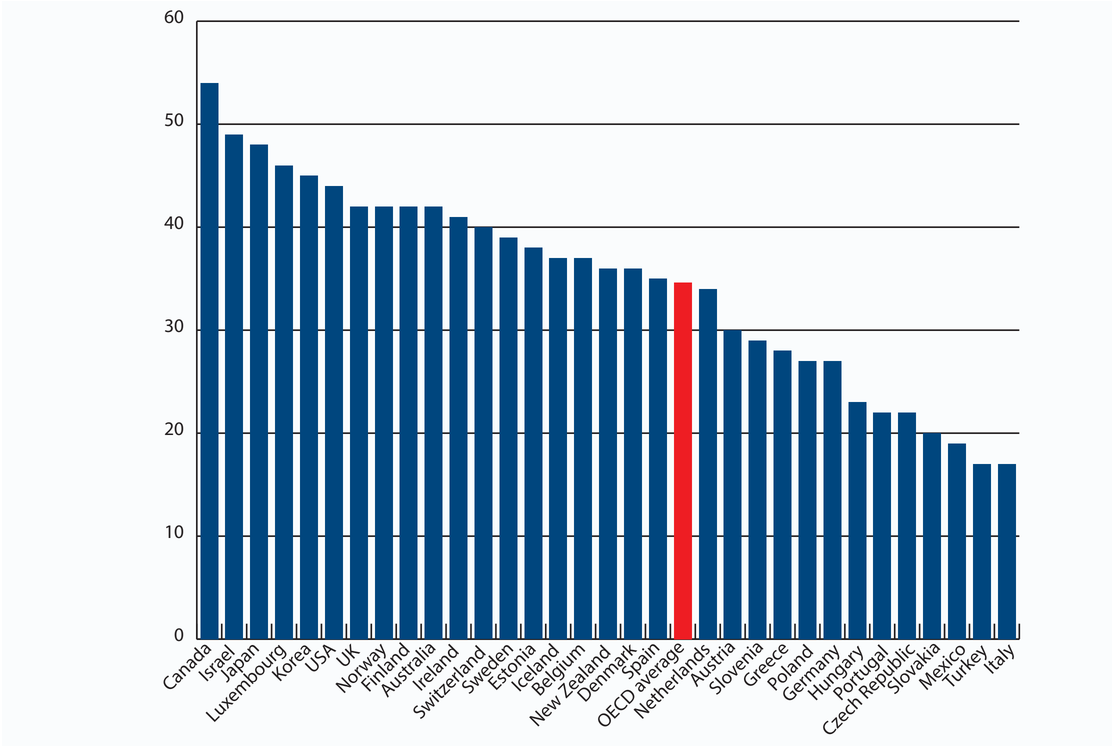
The recently published update of the OECD PISA school study among 15 year olds shows that Italy is the worst overall performer in sciences, mathematics and reading in western Europe.[22]

Renzi introduced a school reform called 'the good school'. In its original incarnation, this reform would have allowed head teachers to hire directly from a pool of 'qualified teachers'. However, the reform was watered down, and the government's 90,000 new recruits were not properly selected based on the subject they teach. As a result, these new teachers will do little to improve the quality of the Italian schooling system.

*18:* Paolo Sestito and Elena Viviano, 'Hiring incentives and/or firing costs reduction?', Bank of Italy Occasional Paper, March 2016.
*19:* Paolo Manasse and Thomas Manfredi, 'Wages, productivity and employment in Italy: Tales from a distorted labour market', *VoxEu*, April 19th 2014.
*20:* Sara Calligaris, Massimo Del Gatto, Fadi Hassan, Gianmarco Ottaviano and Fabiano Schivardi, 'Italy's productivity conundrum', EU Commission Discussion Paper, May 2016.
*21:* OECD, 'Measuring the digital economy: a new perspective', 2014.
*22:* OECD, 'PISA: Results in focus', December 2016.

Chart 9: Share of 25-64 years old with tertiary education

*Source: OECD.*




## The future of the Italian economy

Italy's economic malaise has many fathers. Membership of the euro has not helped the Italian economy: while it boosted imports and exports with other eurozone countries and lowered inflation before the crisis, it also slowed down productivity growth, as economic activity moved into less productive sectors. Overall Italian export growth was relatively weak in Italy under the euro. The crisis exposed the eurozone's institutional flaws and eurozone macroeconomic policies were insufficient to stabilise Italy. In particular, the ECB's failure to act as a lender of last resort until 2012 had a pernicious effect on Italy's borrowing costs, which shot up unnecessarily and forced austerity on Italy at the worst possible time.

But Italy mostly has itself to blame for its economic woes. Abysmal productivity growth – over the course of two decades – is down to successive governments' failure to invest in both physical and human capital; to reform its political and judicial institutions to help the most successful and productive businesses grow; to raise the employment rate of both men and women; and to promote the deployment of labour and capital where they can be most productive.

There is no silver bullet that could solve Italy's economic problems, but a long and painful reform process over many years is needed, which Renzi had started. Italy needs much higher public investment, which could be funded by taking the axe to current spending. It needs new measures to boost innovation, and its banks need more capital so they can increase lending to more productive companies. Labour market reforms need to continue. For example, employer social contributions and the wage supplementation schemes need to be cut further, to encourage more hiring of workers by the most productive firms on permanent contracts. Moreover, the unemployed need more support, especially through re-training. Italy's schools and universities need more funding and more autonomy to compete internationally.

The eurozone also needs to play its part: by creating sufficient demand across the currency union as a whole through more effective monetary and fiscal policies; by completing the banking union in a grand bargain between weak and strong states; and by changing fiscal rules to encourage governments to invest more and consume less.

Italy could pull the eurozone apart – and indeed the EU. Labouring under a barely sustainable debt burden, Italy needs faster growth to counter growing anti-European sentiment and defuse political tensions. Unless future Italian governments, together with the eurozone, manage to turn Italy around, Europe could face another existential crisis.

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