cepInput

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Addressing the Italian malaise

Ways to revive economic growth and reduce public debt

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The future of the eurozone depends crucially on whether Italy can reduce its debt to GDP ratio. One way to do this is to increase GDP. This cepInput therefore looks at how to boost Italian GDP growth. The main findings are:

- Net exports – both before and after the crisis – have had a negative impact on Italian GDP growth. One reason for this is that labour productivity has only grown by 6% over the last two decades. In Germany it grew by 26% in the same period.
- The slow growth in labour productivity can be attributed to low investment and a drop in multifactor productivity. While the latter was a barrier to growth even before the crisis, low investment has only become a problem since the financial crisis. In 2018, gross investment was 20% below the 2007 level and net public investment was actually negative.
- To improve the conditions for productivity growth and improve GDP, the Italian government should shift expenditure away from consumption and towards investment.
- The Italian government should implement reforms that will foster innovation – particularly process innovation in companies – and strengthen education – particularly tertiary education, vocational training and the development of digital skills.

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1 Introduction

Italy faces major fiscal challenges due to its high level of public debt which stands at 135% of GDP.[1] In the EU, only Greek debt is higher at 181% of GDP. The Italian debt ratio rose sharply between 2008 and 2014, in particular, at an average rate of 4.2 percentage points per year.

The future design of the eurozone depends crucially on whether Italy succeeds in reducing its mountain of debt. Achieving budget surpluses is not absolutely necessary for this; the debt ratio will already fall if GDP growth exceeds the growth in public debt. Politicians tend to favour reducing debts by way of economic growth. Thus, it is not surprising that the Italian Prime Minister Giuseppe Conte said in a recent interview: “Our goal is debt reduction, I said that clearly. But we want to achieve that through economic growth and investments”.[2]

In fact, Italy did succeed in reducing its debt level through economic growth in the years before the financial crisis: between 1996 and 2007 the Italian debt ratio decreased by 1.4 percentage points per year, while total debt – measured in euro – increased on average by 0.1 percentage points per year in the same period. To get back on track, the Italian government must substantially increase GDP growth.

This cepInput will therefore provide recommendations on how to strengthen growth in Italian GDP. It is structured as follows: Section 2 traces the development of Italian GDP growth over recent decades and explains what was driving or hindering GDP growth between 1996 and 2007.1996 was chosen as the first year of the analysis due to data availability. 2007 was chosen as the final year of the first period as Italy was hit by the financial crisis in 2008 which led to a sharp decline in GDP in subsequent years. Only in 2015 did Italian GDP return to continuous growth. For this reason, 2015 was chosen as the first year of the second period. Section 3 discusses the contribution of net exports to GDP growth and looks at how the productivity of the Italian economy has developed, while Section 4 analyses the changes in the composition of domestic demand. Section 5 contains economic policy recommendations to revive Italian GDP growth.

2 Italian GDP growth

The growth rate of Italian GDP has been slowing down continuously over the last few decades: In the 1970s it grew on average by 3.8% per year; faster than in other countries, such as Belgium, France, Germany and the Netherlands, which will be used as basis for comparison in this Input (hereinafter: “EU-4”). During the 1980s, Italian GDP growth slowed to an average of 2.4% and was thus in line with that of the EU-4. In the 1990s Italian GDP growth slowed down even further to an average of 1.7% per year and was thus below average by comparison with the EU-4.[3]

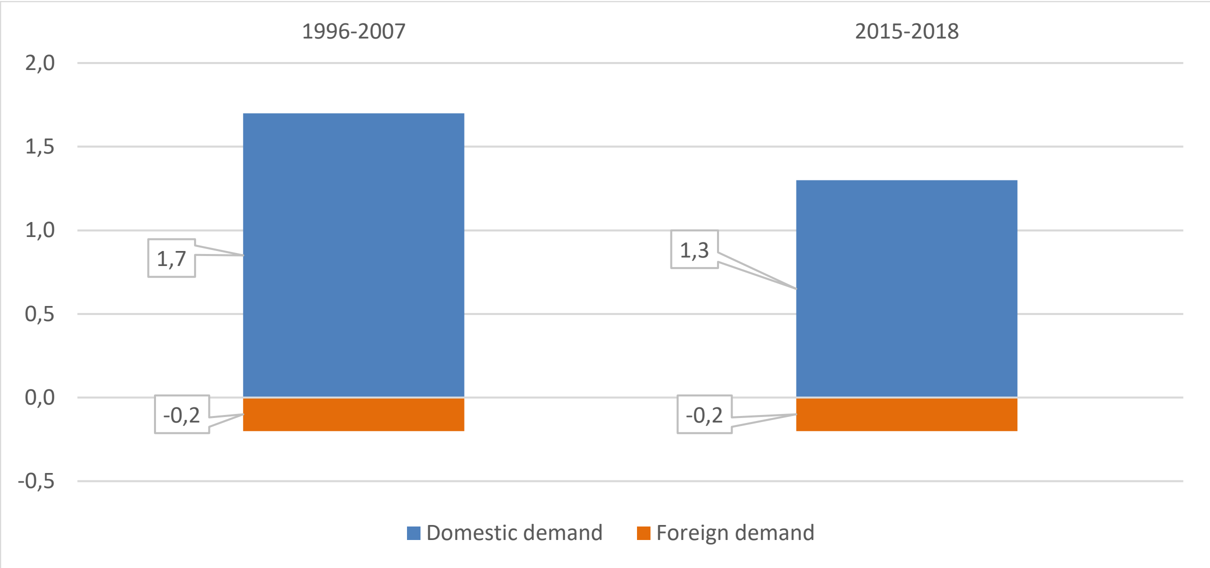
This trend of falling GDP growth continued through the 2000s. From 2000 to 2007 – the year before the financial crisis – GDP growth fell even further to just 1.5%. In the next seven years – 2008 to 2014 – Italian GDP contracted four times due to the financial crisis and the subsequent euro crisis. On average in this period Italian GDP contracted by 1.3% per year. Since 2015, Italy has again seen modest

[1] Source: Eurostat, general government consolidated debt data [gov_10dd_edpt1].
[2] Source: Reuters, “Italy wants to cut debt through growth, investments - Conte tells EU” by Francesco Guarascio. Published on 11/09/2019.
[3] Source: World Bank, GDP growth annual change in percentage [NY.GDP.MKTP.KD.ZG].

GDP growth. From 2015 to 2018, Italian GDP grew on average by 1.1% per year but GDP remains below its pre-crisis level. In 2018, Italian GDP[4] stood at 1,615 billion euros which is the same level as in 2004.

To find out what is driving or hindering the growth of Italian GDP, Figure 1 shows the extent to which domestic demand and net exports have contributed to economic growth in recent years. The increase in domestic demand reflects the growth of consumption and/or investment (Δ Consumption + Δ Investment), whereas net exports reflect the growth of exports minus the growth of imports (Δ Exports – Δ Imports). Both aspects – domestic demand and net exports – must be considered together as they are interdependent. Thus, a growth in domestic demand generally produces a rise in imports. Since a rise in imports has no direct effect on GDP growth, net exports will fall – ceteris paribus.

Fig. 1: Contribution of domestic demand and net exports to GDP growth (as a percentage)



Source: Eurostat, own calculation.

Figure 1 shows that, on average, in 1996 to 2007, domestic demand contributed 1.7 percentage points to GDP growth, while net exports had a negative average contribution of 0.2 percentage points per year. In 2015 to 2018, domestic demand contributed 1.3 percentage points to GDP growth while net exports maintained a negative contribution of 0.2 percentage points. The negative contribution to growth made by net exports is due to the fact that the growth rate of imports exceeded the growth rate of exports. In other words: Italian consumers and investors replaced domestic goods and services with imported ones. This is an indication that the Italian economy has a problem with its international competitiveness. Furthermore, Figure 1 shows that the reduction in GDP growth in 2015 to 2018 is due to a decline in the growth of domestic demand.

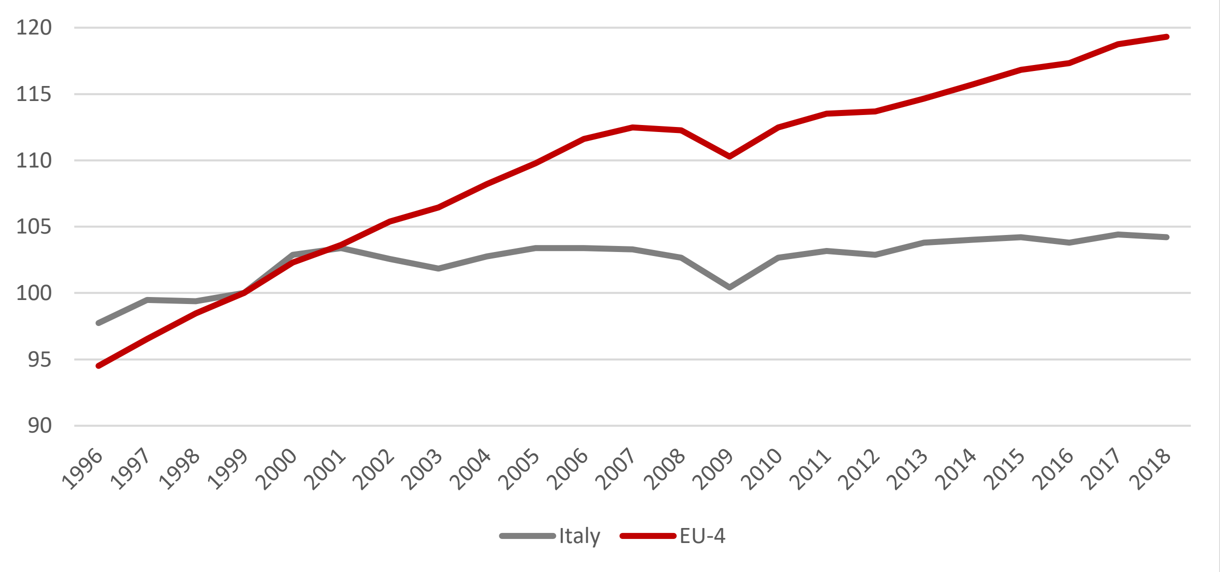
Section 3 will investigate why net exports have negative growth in both periods and show how net exports can be increased. The causes for the decline in the growth of domestic demand and how it can be stimulated will be discussed in Section 4.

4 Source: Eurostat, Gross domestic product – chained linked volumes (2010), million euro [nama_10_gdp].

3 Increasing Italian net exports

The negative contribution of net exports to the growth of GDP suggests that the Italian economy has a problem with international competitiveness. This finding is supported by the development of Italian labour productivity per hour worked. Figure 2 shows that this has stagnated over the past two decades, growing by only 6% between 1996 and 2018, i.e. 0.3% per year. The EU-4 saw an average increase in productivity of 25% over the same period, i.e. 1.1% per year.

Fig. 2: Growth in real labour productivity per hour worked 1996 – 2018 (1999*=100)

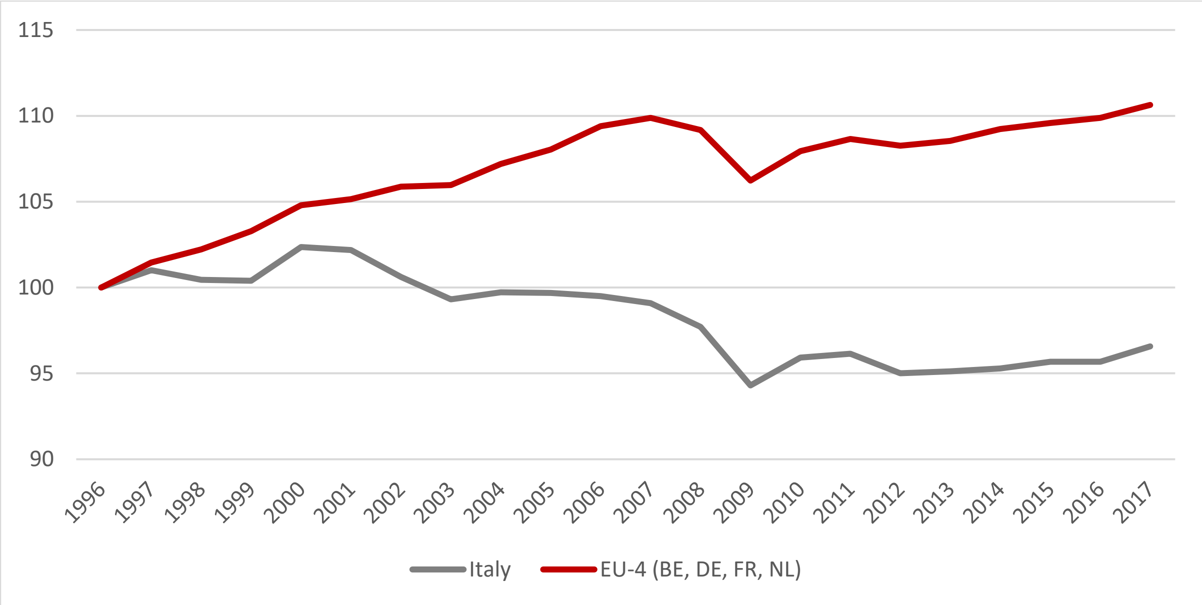


Source: Eurostat, own calculation. EU-4 is the average value for Belgium, Germany, France, and the Netherlands.
* Values are indexed at 1999 due to missing values for Belgium before 1999. The period 1996-1998 is therefore an average of France, Germany, and the Netherlands.

Two factors influence the development of labour productivity. The first factor is investment because the more capital that is available to support a worker's activities, the more productive that worker becomes. How investment can be stimulated will be discussed in Section 4. The second factor is multifactor productivity[5] (MFP). Multifactor productivity measures how efficiently factors of production – e.g. workers and capital – are combined. Thus a growth in MFP increases labour productivity. MFP is influenced by a large number of factors, the most important of which include education of the workforce, technological progress – e.g. process innovation –, political stability, lean judicial and public administration as well as the quality of infrastructure, design of the tax system and the presence of broad-band internet access.[6] Figure 3 shows the development of Italian MFP and compares it with that of the EU-4.

[5] MFP is also known as total factor productivity (TFP).
[6] For a more structured debate on the issue see for example: Cecilia Jona-Lasinio, Stefano Schiavo, Klaus Weyerstrass (2019). How to revive productivity growth?. EconPol Policy Report 13.

Fig. 3: Growth in multifactor productivity 1996 – 2017 (1996=100)



Source: OECD, own calculation. EU-4 is the average value for Belgium, Germany, France, and the Netherlands.

From 1996 until 2017, MFP increased on average by 10.6% in the EU-4. In the same period, Italian MFP fell by 3.4%. This trend suggests that there are structural weaknesses in the country.

In order to increase MFP, the Italian government should improve conditions for innovation – especially process innovation within companies – and strengthen education – especially tertiary education, vocational training and the development of digital skills.[7] The Italian government should also reduce bureaucracy. According to both the World Bank "Doing Business" project[8] and the European Regional Competitiveness Index[9], conditions for starting and operating a business in Italy are less favourable than in the EU-4. Moreover, the IMF stated in its consultation report[10] about Italy, that bankruptcy procedures take on average 6 years, thus discouraging entrepreneurs from setting up innovative companies.

Recommendation 1: The prerequisite for higher GDP growth is an increase in the international competitiveness of the Italian economy. This requires measures that support multifactor productivity, such as fostering innovation and increasing investment in human capital. Reducing bureaucracy and public sector inefficiency would also have a positive impact on GDP growth.

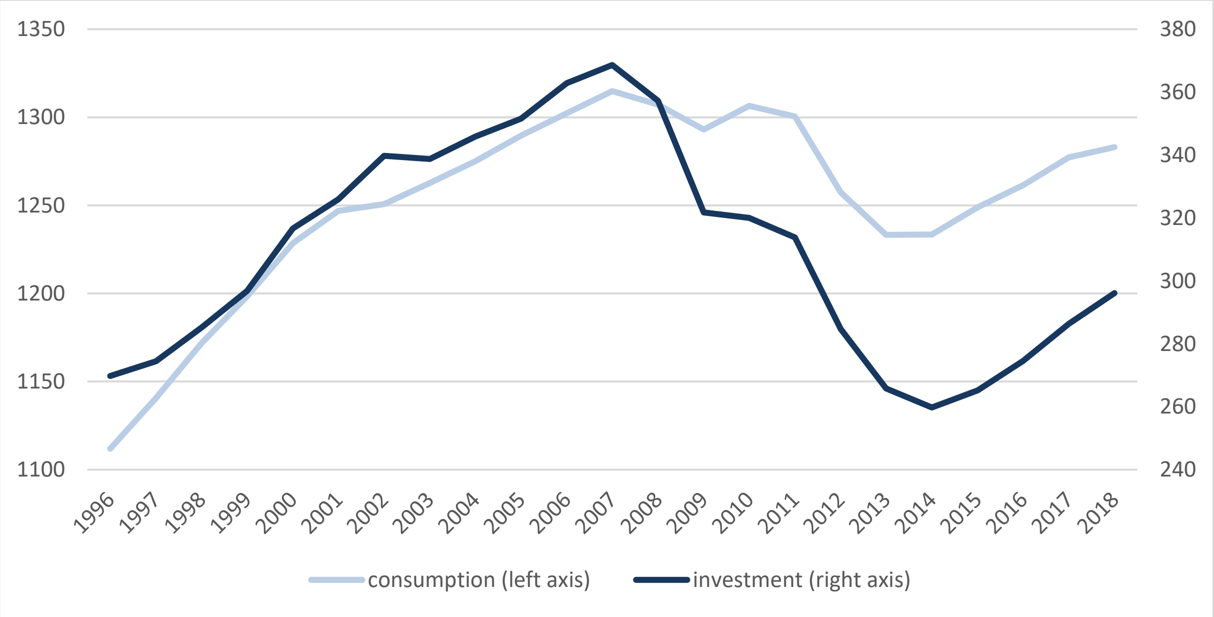
[7] These policies are also indicated by the European Commission, in the 2019 Country Specific Recommendation, as key to lifting Italian GDP growth.
[8] World Bank (2019). Doing Business 2019: Training for Reform. Washington, DC.
[9] European Commission (2019). European Regional Competitiveness Index.
[10] IMF (2019). Italy 2018 Article IV Consultation – Press release; Staff Report; and Statement by the Executive Director for Italy. IMF Country Report No. 19/40. Washington, DC.

4 How to stimulate Italian domestic demand

To explain the decline in growth of domestic demand between 2015 and 2018 as compared with 1996 to 2007 (see Fig. 1), this Section will analyse the extent to which the growth in gross investment and consumption contributed to domestic demand in both periods.

Between 1996 and 2007, consumption contributed 1.1 percentage points while gross investment contributed 0.6 percentage points to the increase in domestic demand. From 2015 to 2018, consumption contributed only 0.8 percentage points to the increase in domestic demand. The contribution from investment remained the same as in 1996 to 2007. These figures seem to suggest that Italian growth in GDP should be stimulated by encouraging consumption. In fact, stimulating investment has more likelihood of success because an increase in investment will boost productivity thereby improving competitiveness. Stimulating consumption without first solving the problem of competitiveness would further increase imports. Thus, if exports remain constant, a substantial part of the increase in domestic demand would be outweighed by a drop in net exports. Figure 4 clearly shows that in Italy investment has fallen much more sharply than consumption. In 2018, investment was still 19.7% below its 2007 value – i.e. before the financial crisis. For comparison: consumption in 2018 was only 2.4% below the 2007 value.

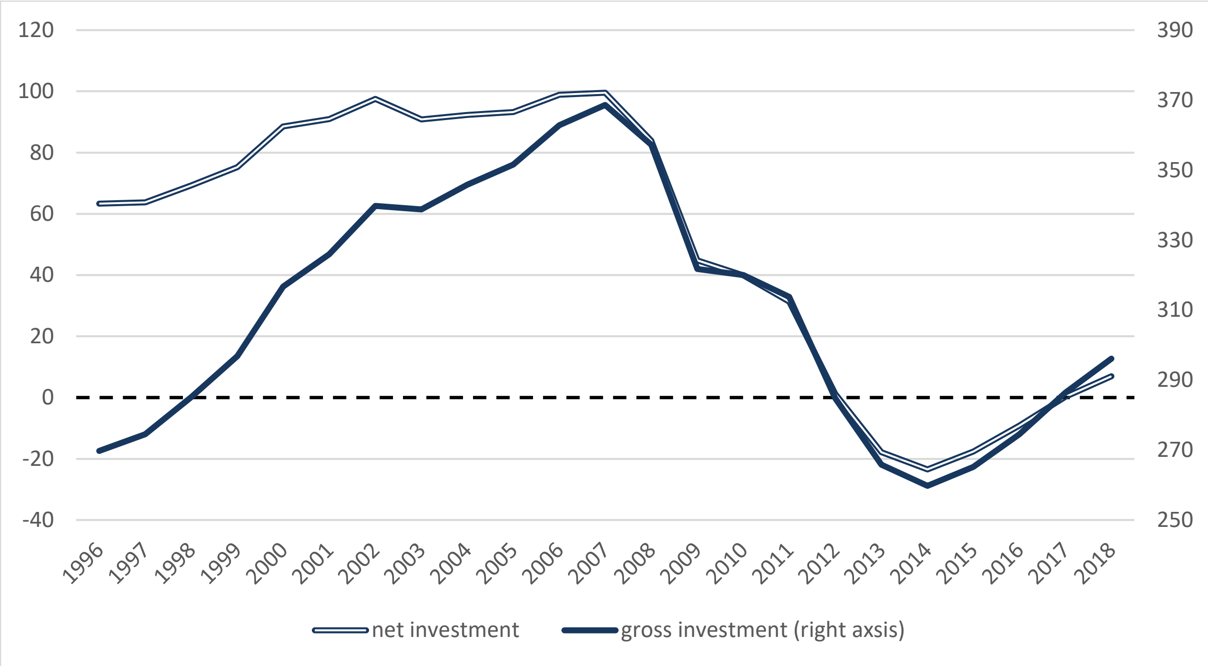
Fig. 4: Gross investment and consumption 1996 – 2018 (in billion euros)



Source: Eurostat, own calculation.

The fact that the rate of investment growth has been too slow since 2015 becomes even more apparent when we look at net investment, i.e. gross investment minus depreciation (see Figure 5). In the period 2015 to 2018, it was negative in the first two years and capital stock contracted. In 2017 it was at zero. Only since 2018 has it registered a slightly positive value, equal to 0.4% of GDP. Low investment was also responsible for the low growth in labour productivity (cf. Section 4).

Fig. 5: Net investment 1996 – 2018 (in billion euros)



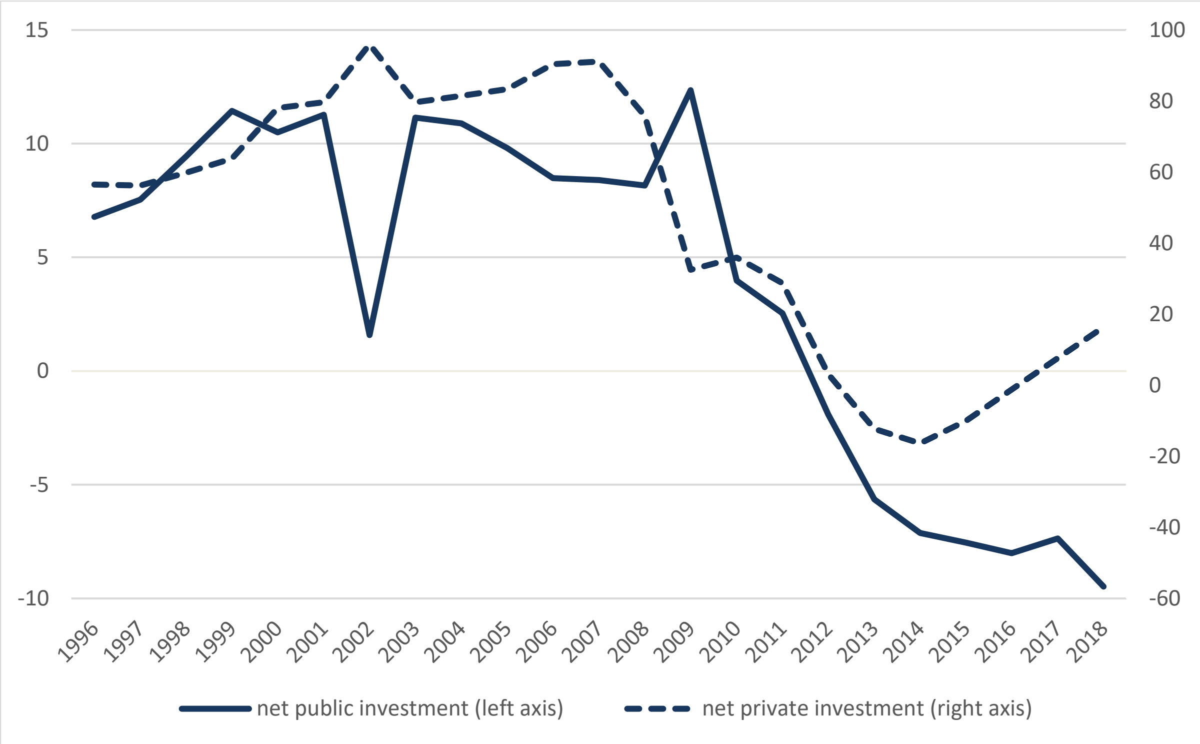
Source: Ameco, own calculation.

The Italian government should therefore create whatever conditions it can to bring about higher net investment. This would help to improve competitiveness as it would lead to higher productivity per worker and thus to an increase in GDP. Furthermore, higher economic growth may increase demand for labour and thus reduce unemployment.[11]

A comparison of net private and public investment since 2007 shows that public investment contracted up to 2018, whereas net private investment has been growing since 2015, becoming slightly positive in 2017 and 2018 (see Figure 6).

[11] In 2018, the unemployment rate was at 10,6% of the active population, i.e. 4,5 percentage points above the pre-crisis level. Source: Eurostat, total unemployment as percentage of the active population [une_rt_a].

Fig. 6: Public and private net investment 1996 – 2018 (in billion euros)



Source: Eurostat, own calculation.

The Italian government should therefore increase public investment by reducing spending on consumption. However, given that, in Italy, private investment is on average 6.2 times higher than public investment, it is crucial to ensure that private investment regains its pre-crisis level as soon as possible.

Public investment should prioritise innovation and education, as described in Section 3. This would increase human capital in the country and facilitate the spread of innovative solutions within both private firms and public administration.

Recommendation 2: As an increase in investment may boost productivity, and thereby improve competitiveness, the Italian government should create the necessary conditions for higher investment. Given that the growth in net investment since 2018 has been fuelled solely by private investment, it should increase public investment whilst reducing spending on consumption. Public investment should be channelled into innovation and education policies.

Recommendation 3: In order to increase labour productivity and create incentives for private investment, the Italian government should improve the business environment, particularly by reducing bureaucracy and increasing the efficiency of the public administration.

5 Policy recommendations

In order to increase GDP growth, Italy must carry out extensive reforms. These include reforms to increase labour productivity and international competitiveness. More specifically, the Italian government should implement reforms that will foster innovation – particularly process innovation in companies – and strengthen education – particularly tertiary education, vocational training and the development of digital skills.

The European Commission[12] recommends inter alia the following reforms for Italy:

- Shift taxation away from labour and capital and onto property and consumption. This could promote both employment and investment whilst remaining budget neutral.
- Focus on education as the key factor for economic growth. The education system and vocational training should be improved with cooperation from employers. In addition, more incentives should be provided to improve schoolteacher performance, such as salary increases, and promotion should be based on performance rather than years of service. Digital skills should play a stronger role in school curricula. Investment in tertiary education should be expanded and the number of university graduates increased as there are currently too few graduates, particularly in STEM subjects.
- Increase administrative capacity at all levels of government. This can be achieved by training more public employees and improving the distribution of work between the various administrative levels. An effective administration is a prerequisite for the provision of public investment and an efficient use of EU funds. In addition, it would increase legal certainty.
- Cut the length of civil proceedings. Appropriate implementation of more simple procedural rules could help to speed up civil proceedings. Reform aimed at streamlining civil proceedings could also reduce the time needed to resolve a case. In no other state in the EU do civil proceedings take so long.
- Focus on the quality of infrastructure, particularly as regards maintenance and safety. In addition, broadband coverage should be expanded as it is currently well below the EU average.

These are just a few of the areas that the Italian government could prioritise in order to increase GDP growth. In addition, labour reforms envisaged by earlier governments should be revived.

6 Conclusion

Italy faces the major challenge of reducing its debt ratio.. To do this, the country must increase its GDP growth.

This will be a difficult task for the Italian government. Italy's GDP growth rates have fallen since the 1980s. While this trend is common to other EU founding members, in Italy the slowdown is more acute. In addition, the financial and subsequent euro crisis between 2008 and 2014 led to a sharp fall in Italy's GDP.

This cepInput looked at how the growth in domestic demand and net exports affected GDP growth in Italy, both before the financial crisis and in the years thereafter.

[12] European Commission (2019). Country specific recommendation to Italy.

In both periods, net exports had a negative impact on GDP growth. This indicates that the Italian economy has a problem with its international competitiveness. This is supported by the fact that productivity per hour worked has not changed since 1999 whereas in the EU-4 it has grown.

There are two reasons for this stagnation. Firstly, multi-factor productivity is low; its value was lower in 2018 than in 1996. Secondly, investment is low. It fell sharply between 2008 and 2014 and has not yet recovered from this collapse. Between 2013 and 2016, net investment was actually negative, i.e. capital stock shrank because gross investment was too low to make up for depreciation. The slight recovery in net investment is solely due to an increase in net private investment; net public investment remains negative. Overall, however, the increase in net investment is still low and this has negative consequences for the long-term potential growth of the Italian economy.

If the Italian government is serious about wanting to to reduce public debt, it is important to implement growth enhancing reforms. Productivity growth, in particular, must be strengthened for which it is essential to improve education and boost the Italian economy’s capacity for innovation. Since the current sluggish recovery in investment is being driven by the private sector, the Italian government should optimise conditions for private investment whilst also boosting public investment. By contrast, public spending on consumption should be reduced.

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