

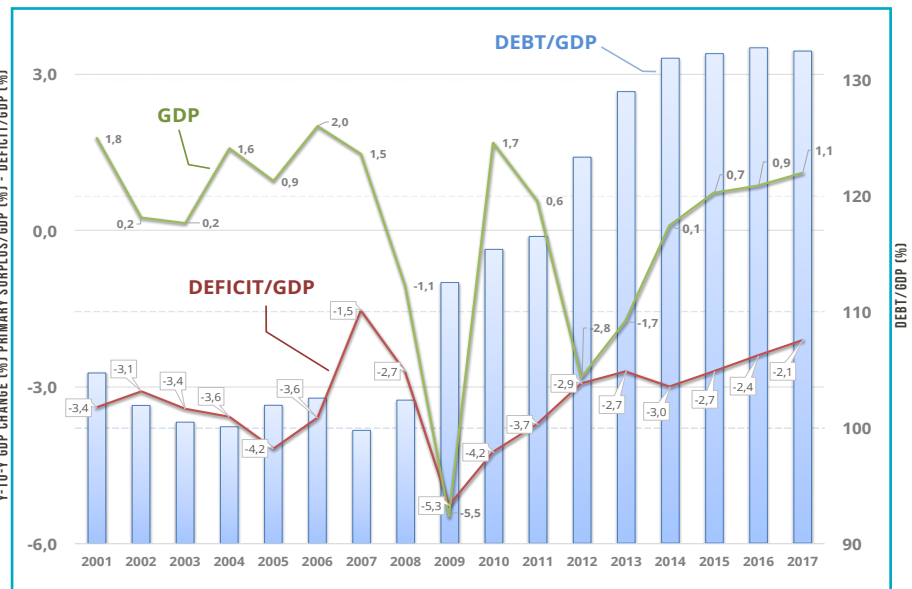
THE NARROW PATH

Growth in Italy is taking place more slowly than in other Eurozone countries. Public debate about this fact offers several explanations but rarely juxtaposes long-period trends with recent policies.

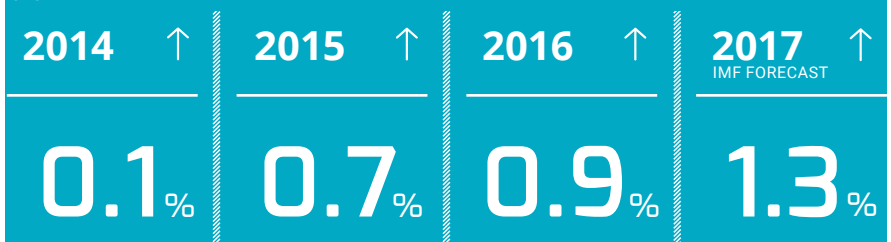
It is common knowledge that – among other things – low productivity is one of the main causes of the poor performance of the Italian economy. Red tape, the relatively limited openness to competitiveness of some professional services, the tax burden, the limited size of SMEs, and the need to improve secondary education and the efficiency of the judicial system are – among other factors – affecting our ability to grow the economy.

All such structural obstacles to stronger growth are targets of the ambitious reform program that has been under way since 2014. In the view of national authorities, structural reforms are re-shaping the economic potential of the country, while the combination of expansionary monetary policy undertaken by the ECB and appropriate fiscal policies adopted by the Government is allowing for conditions that enable the reform process. Let's focus on what "appropriate" means for fiscal policy in Italy at the present time.

The Government believes that a fiscal adjustment is definitely needed for a country with a debt as high as Italy's. However, the decision about the pace of the adjustment is crucial as it may potentially affect the prospects of the economy, including the private sector. While a slow pace of adjustment might not be effective for the purposes of debt reduction, an adjustment that is too fast may prove to be detrimental to the economy, and therefore to the debt-to-GDP ratio.



GROWTH



The situation in which the Italian authorities must move can be described as a "narrow path": on one side, high debt looms (implying exposure to external financial shocks) while on the other side an infant recovery needs to be nurtured in order to rid ourselves definitively of the double-dip recession. This picture may help in understanding the Government's search for a balance among such divergent needs. The search has apparently been successful in the latest four budgets. Since 2014 the Italian Government has managed to reduce the deficit-to-GDP ratio – and to stabilise the debt-to-GDP ratio by that means. At the same time, the composition of both revenue and spending has been

re-arranged to improve the business environment and to support internal demand.

In order to appreciate the results of the "narrow path" policy mix, we must look at the trends for debt, deficit and GDP over a lengthy period of time. Between the years 2000 and 2013, the Italian economy alternated 4 years of recession, 4 years of positive but low growth (below 1 percent), 5 years of higher growth (between 1 and 2 percent). Nothing exciting at all. After the double-dip, growth turned positive again in 2014 (a small improvement of 0.1%), then it slowly increased in the following years (+0.7% in 2015 and +0.9% in 2016). For 2017, both the IMF and the Bank of Italy forecast better

growth of 1.3%. Once again, a performance that nobody will consider at all satisfactory, but certainly it's a reversal of previous uncertain trends.

Now when we look at the trend of the deficit we can see that such growth is not the result of an expanding budget. On the contrary, it is based on a sound primary surplus and a constantly contracting deficit (which is decreasing from 3.0% of GDP in 2014 to the expected 2.1% in 2017 – and even lower according to latest forecasts). Which will allow the debt-to-GDP ratio to stabilise notwithstanding very low inflation.

The comparison with other major economies in Europe since 2009 shows that Spain, France and the UK associate growth rates higher than Italy with a negative primary balance, whereas Italian governments have managed to keep the primary balance in positive territory since 1993 (with the single exception of the year of the deepest crisis, 2009). The other large

country together with Italy that manages to combine positive primary balance and growth is Germany.

The road to recovering a higher growth potential is still long, but some of the reforms are beginning to bite. To mention some examples, the labour market is now more dynamic, thanks to the Jobs Act introduced early in 2015; cooperation between taxpayers and the tax administration is improving, as the principles of cooperative compliance and preventive assessment of tax planning are becoming common behaviour; the Italian customs rank #1 in the "Trading Across Borders" study (a component of the World Bank's Doing Business project) due to extensive digitalisation.

The fiscal stance adopted for the last four budgets has contributed to alleviating the upfront costs associated with the introduction of reforms, and therefore to create favourable conditions for reforms to be accepted by

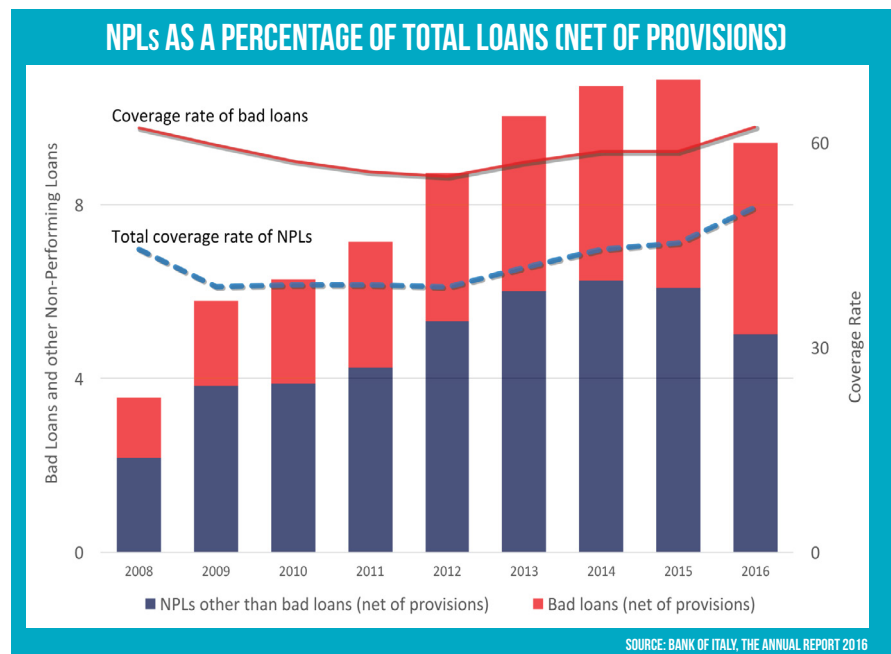
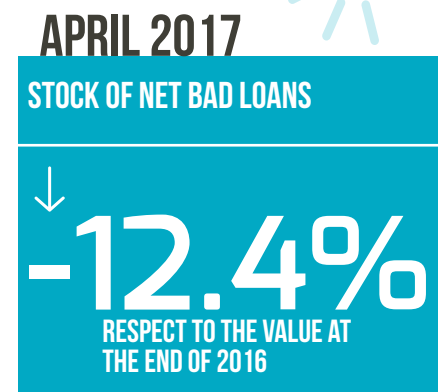
all stakeholders. Currently, public investment in strategic infrastructure is rising, the tax burden on both families and business has been cut, and selective tax breaks have stimulated private investment in innovation.

At the same time, the stock of non-performing loans is now declining. The NPLs have been a consequence of the crisis, but also contributed to its worsening, as they have limited the flow of lending from banks to the economy. The increase in lending to the real economy, along with new financial instruments introduced by the Government in recent years (for instance mini-bonds and individual savings plans focusing on SMEs) will sustain the recovery, which will reinforce the soundness of public finances.

The outlook is for an increase in the real growth rate combined with higher inflation, a continuing primary surplus and modest implicit debt (thanks to past pension reforms), all leading to a decline in public debt.

NPLs: AN IMPROVING SCENARIO

The overall outlook regarding the Non-Performing Loans (NPLs) of Italian banking is improving. [The net bad loans](#) amount to €76.5 billion, representing a decrease of 13.5% (€10.3 billion) with respect to the value at the end of 2016. The rate of new NPLs for Italian banks [came back to pre-crisis level](#), while the coverage ratio for banking groups classified as significant is 52.8% (end of IQ 2017), about 8% higher than the average for the leading European bank. Considering that the main sources of systemic risk have now been addressed (the liquidation of two Venetian banks and the approval of MPS' precautionary recapitalization), the [Bank of Italy](#) forecasts a reduction of NPEs to less than 8% by 2018.



HOW DIGITALIZATION IS IMPROVING TAX LITIGATION AND CUSTOMS OPERATIONS

In Italy, a radical change is under way in the relationship between taxpayers and the Tax Administration. The essence of this change is a new and more cooperative approach throughout the process leading to tax compliance; in part, this is based on the progressive digitalisation and simplification of most procedures. This process includes the management of tax appeals.



COOPERATIVE COMPLIANCE

The most advanced form of this new model of communication and enhanced cooperation is certainly so-called Cooperative Compliance, which was introduced in 2016. This new regime operates at both ends: it offers large businesses less invasive tax assessments, disputes and fines, while giving the Italian Tax Office new insights into the businesses' taxable activities, reducing the scope for less collaborative attitudes.

Requirements for taking up the new scheme include: an effective tax framework that manages and controls the risk of breaching tax provisions or legislation; keeping the taxation authority informed of operations that might increase those risks; promoting a corporate culture of tax compliance. The scheme is aimed at resident and non-resident entities with a total turnover or operating revenues of at least €10 billion and in particular cases smaller entities.

The recent standard measures setting forth the operating procedures for the new form of enhanced cooperation in line with the 2013 OECD Framework are proving a remarkable step in the direction of preventing tax disputes and combating tax evasion. [Comment from www.pwc.com 7th July 2016]



CUSTOMS CLEARANCE IN PORTS

Now 92.6% of declared goods are cleared within five minutes. This result comes from the digitalisation of the process used for customs clearance. In the new process, Customs electronically receive documents pertaining to goods on ships even before they've reached the port, allowing them to proceed with customs clearance operations 24/7 by way of online controls.

It's notable that electronic filing is closing the gap between ports in Northern Italy (where the procedures were already very fast) and those in the South.

In 2016, Italy jumped from 37th position to 1st in the World Bank's Doing Business indicator regarding the time necessary for customs clearance in ports. Also the World Economic Forum's Enabling Trade Index 2016 ranked Italy in 3rd place worldwide for efficiency of customs procedures, behind Singapore and the UAE.



TAX CONTROVERSIES AND DISPUTE RESOLUTION

Last week [15th June] the Ministry of Finance released its latest report on tax controversies and dispute resolution, traditionally a critical area that has been demonstrating significant progress in recent years.

The data released show an overall drop of 11.6% in pending proceedings in 2016 compared with 2015. This is the result of a more effective management of old controversies coupled with a significant drop in new disputes. In fact, in 2016 new controversies for businesses and households

WORLD BANK'S DOING BUSINESS

"TRADING ACROSS BORDERS" RANKING



2016

WORLD ECONOMIC FORUM

"EFFICIENCY OF CUSTOMS PROCEDURES" RANKING



2016

dropped by almost 10% (9,8%) i.e. there were 25,322 fewer than in 2015. The most significant part of this drop was recorded in proceedings of the "first instance" (lowest level) where the reform introduced the possibility of arbitration.

The length of proceedings also dropped by 19% (first instances), from 2 years and 8 months in 2014 to 2 years and 3 months in 2016, with a uniformly distributed improvement across northern and southern regions.

Last but not least, a significant process of digitalisation is being implemented in the field of tax justice as well. Since mid-2016, the digital submission of tax appeals represents an option everywhere in Italy (some regions were early adopters of the new system). Despite the quite recent introduction of the online platform, almost 7,000 digital submissions of appeals were registered in 2016. The program foresees that from the end of 2018 digital submission will be the only option, as paper appeals will be phased out.

INDIVIDUAL SAVING PLANS (PIR) FROM SAVINGS TO INVESTMENT FOR COMPANIES' GROWTH

The 2017 Italian Budget introduced a new class of tax-exempt investment plans for individual retail investors called "piani individuali di risparmio" (PIR). Returns from PIRs are exempt from both capital gains (26%) and inheritance tax as long as the investment meets a few criteria, among which are a minimum holding period of 5 years and a maximum contribution of €30,000 per year.

These plans were created to channel private savings towards equity and debt instruments issued by Italian corporates, and especially by small and medium enterprises (SMEs). They have been modelled on the French "Plan d'épargne en actions" and UK "Individual Savings Account" and are part of the "Finance for Growth" program, the Government initiative to stimulate growth by facilitating the matching of demand and supply in credit and capital.

Individual saving plans are a step forward for the evolution of Italian capital markets in two directions. On the one hand, they assist in the capitalisation of small and medium enterprises, which suffer of a chronic lack of capital. On the other hand, they reduce the excessive dependence of those companies on bank credit, thus tempering the long-standing fragility of a market with few financial operators.

Being an instrument dedicated to Italian investors, the PIR might substantially reinforce the share of domestic players in the stock market, thus reducing its volatility and uncertainty. This will gradually rebalance the presence of national and international investors and improve the structure of the stock market. As a side effect this might induce big corporates to con-

sider having an Italian affiliate if it can subsequently issue equity or debt securities that are eligible for inclusion in PIRs.

Market reaction so far has substantially exceeded expectations. In the first few months funding was over €1.1bn ([source: Assogestioni, as of end March 2017](#)), almost reaching the Government's initial target of €1.8bn and expected funding for 2017 is now set at €10bn according to market studies. The market today includes over 40 products offered by asset managers, but many more are expected for the second half of the year.

This provides evidence of a dynamic underlying savings industry, while it highlights a pool of investors willing to seize this opportunity. This product line can have a disruptive effect on both the Italian corporate bond market, bringing significant new flows of equity, with limited volatility in the asset class since the funds are "locked in" for 5 years.

This could stimulate the transition of SMEs to the stock market, leading to a modernization of governance and company management. Individual saving plans can potentially support the changing attitude of Italian households, who are gradually becoming more inclined to invest their resources. Faced with declining yields on government securities and bank bonds, they are now moving to mutual funds, life insurance policies and pension products. These now account for around 27% of household portfolios ([source: Prometeia](#)), which is the highest level in 20 years.

INNOVATING THE CORPORATE BOND MARKET

NEW OFFER FROM ASSET MANAGERS

40+
NEW PRODUCTS

EXPECTED FUNDING FOR 2017

€ 10
BILLION

SOURCE: MARKET STUDIES

FTSE MID CAP INDEX 6 MONTHS PERFORMANCE

+26%
AS OF 22 JUNE 2017

SOURCE: ITALIAN STOCK EXCHANGE

FTSE ITALIA STAR INDEX 6 MONTHS PERFORMANCE

+32%
AS OF 22 JUNE 2017

SOURCE: ITALIAN STOCK EXCHANGE



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The Narrow Path is a newsletter about Italy's economy and public finances. It is released periodically to update a professional audience about major facts related to reforms and improvements of the economic activity.