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Structural Reforms and the Potential Effects on the Italian Economy

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MINISTERO DELL'ECONOMIA E DELLE FINANZE

Motivation and Aim

- Since the second half of 2011 Italy has found itself at the center of a severe economic crisis.
- Concerns about the sustainability of its debt burden, along with gloomy growth prospects, have pushed up the cost of government borrowing.
- Two mounting challenges:
 - (i) achieve a rapid fiscal consolidation to restore financial market confidence;
 - (ii) implement structural reforms to strengthen medium-term growth prospects.
- An intensive reform agenda urges economic institutions to quantify the macroeconomic impact of complex reform scenarios.



Motivation and Aim

- A deep understanding of the functioning of the simulation tools available at the Department of the Treasury of the Italian Ministry of Economy and Finance is of utmost importance.
- National Reform Programmes (NRPs)
 - the elements necessary for monitoring progress towards the Europe 2020 national targets;
 - the assessment of the impact of the reforms through *simulation analysis*.
- Using the European Commission's model QUEST III with R&D, adapted to Italy, we quantify the *potential* effects of a set of interventions *inspired* to the reform packages currently being undertaken or under discussion.



Methodology

- We study alternative reform scenarios differing in both breadth and depth and evaluate the effects on the main macrovariables.
- For each scenario: joint versus disjoint implementation of the reforms in each area of policy intervention (explore the interlinkages of the model).
- The exercise provides a set of structural reforms, but all policy interventions and results are intended to be only exploratory.
- We also consider reform scenarios embedding a fiscal consolidation package equivalent to 6% of the GDP.



Policy Areas

- The first policy area of intervention, labeled *liberalization and simplification (product market)*, refers to all policies:
 - promoting competition in the product markets
 - reducing the administrative and regulatory burden
- The second area of policy interventions labeled *labor markets* includes a set of policies aimed at:
 - increasing employment and the participation rate
 - favoring social inclusion
- The *fiscal consolidation* package includes several provisions aimed at reducing the debt burden



Mapping the Policy Interventions onto the Model

Liberalization and Simplification (Product Market)

Policy variables / transmission channels in QUEST III	Examples of possible reform measures
Product markets markup	Policies to enhance competition and create a more friendly business environment.
Firms' administrative burden (overhead labour)	Reductions in administrative and regulatory burden; greater efficiency of e-government services; reduce administrative opacity.
Entry barriers in product markets (reducing fixed entry costs)	Cutting the cost and the time spent to start up a new firm



Mapping the Policy Interventions onto the Model

Labor market

Policy variables / transmission channels in QUEST III	Examples of possible reform measures
Wage markup	Fixing aggregate wage targets compatible with macro productivity trends, price stability and external competitiveness.
Tax shifts from labor to consumption	Tax reforms with the scope of reducing distortions in the labor market and providing more incentives to labor market participation.



Mapping the Policy Interventions onto the Model

Fiscal Consolidation (I part)

Policy variables / transmission channels in QUEST III	Examples of possible reform measures
Cut in transfers to households	To map social security reforms and pensions cuts.
Reduction of public consumption	To reproduce the cut in public spending
Increase in consumption tax rate	To reproduce the increase in the value added tax and in the fuel excise tax



Mapping the Policy Interventions onto the Model

Fiscal Consolidation (II part)

Policy variables / transmission channels in QUEST III	Examples of possible reform measures
Increase in labor income tax	To map the rise of the additional regional tax rate on labor income.
Increase in tax rates on tangible capital	To map the additional extraordinary tax for the repatriation/regularization of capital held abroad (i.e. the “tax shield” program), the introduction of the new municipal property tax and the increase in the <i>cadastral rental</i> value of the residential property
An <i>exogenous</i> improvement in the public sector balance budget	To reproduce the increased revenues from measures aimed at reducing tax evasion, widen the tax base and curtail the black economy.



Scenarios Description

- **Scenario A:** a *moderate* reform ex-ante budget-neutral scenario in which Italy closes the gap towards the EU best performers by 1/3 with a tax shift from labor to consumption of 0.05% of the GDP;
- **Scenario B:** a *substantial* reform ex-ante-budget-neutral scenario aimed at closing the gap by 1/2 with a tax shift of 0.1% of the GDP;
- **Scenario C:** a *radical* reform ex-ante-budget-neutral scenario in which it is assumed that Italy will completely close the gap and perform a tax shift equal to 0.2% of the GDP;
- **Scenario D:** *Scenario A* + *fiscal consolidation package* with a cumulative adjustment equivalent to 6% of the GDP;
- **Scenario E:** *Scenario B* + *fiscal consolidation package* with a cumulative adjustment equivalent to 6% of the GDP .



Scenarios Description

		Scenario A	Scenario B	Scenario C	Scenario D	Scenario E
Liberalization and Simplification	Reduce markup in the intermediate goods sectors ⁽¹⁾	0.3pp	0.5pp	1pp	0.3pp	0.5pp
	Reduce markup in the final goods sector ⁽¹⁾	1.43pp	2.15pp	4.3pp	1.43pp	2.15pp
	Reduce entry cost in the services ⁽¹⁾	4.4%	6.7%	13.3%	4.4%	6.7%
	Reduce entry cost in manufacturing ⁽¹⁾	12.6%	18.9%	37.8%	12.6%	18.9%
	Reduce administrative burden ⁽¹⁾	1%	1.7%	3.4%	1%	1.7%
Labor Market	Increase elasticity of subst. between labor inputs ⁽²⁾	10.7%	16.1%	32.2%	10.7%	16.1%
	Tax shift from labor to consumption	0.05% of GDP	0.1% of GDP	0.2% of GDP	0.05% of GDP	0.1% of GDP
Fiscal Consolidation	Reduce public consumption	...	...	...	1.6% of GDP	1.6% of GDP
	Reduce transfers to households	...	...	...	0.1% of GDP	0.1% of GDP
	Increase consumption tax	...	...	...	1.5% of GDP	1.5% of GDP
	Increase labour tax	...	...	...	1% of GDP	1% of GDP
	Extra revenues from fight against tax evasion	...	...	...	0.3% of GDP	0.3% of GDP
	Increase tax on capital	...	...	...	1.5% of GDP	1.5% of GDP

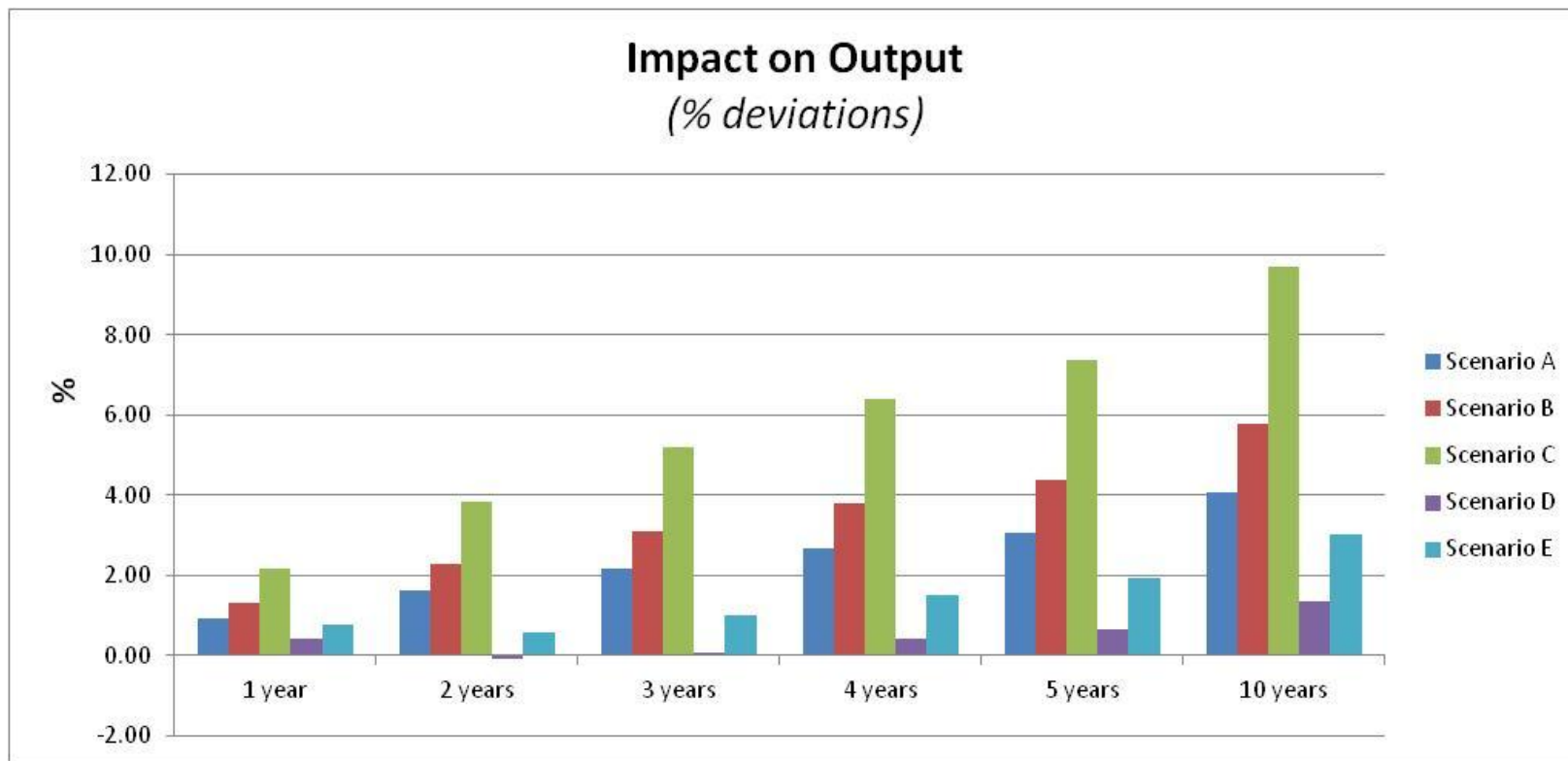
Note: degree of effort based on our elaboration of country variants of the QUEST III model: (1) gap reduction towards the EU15 best performers; (2) gap reduction towards the EU27 best performers.



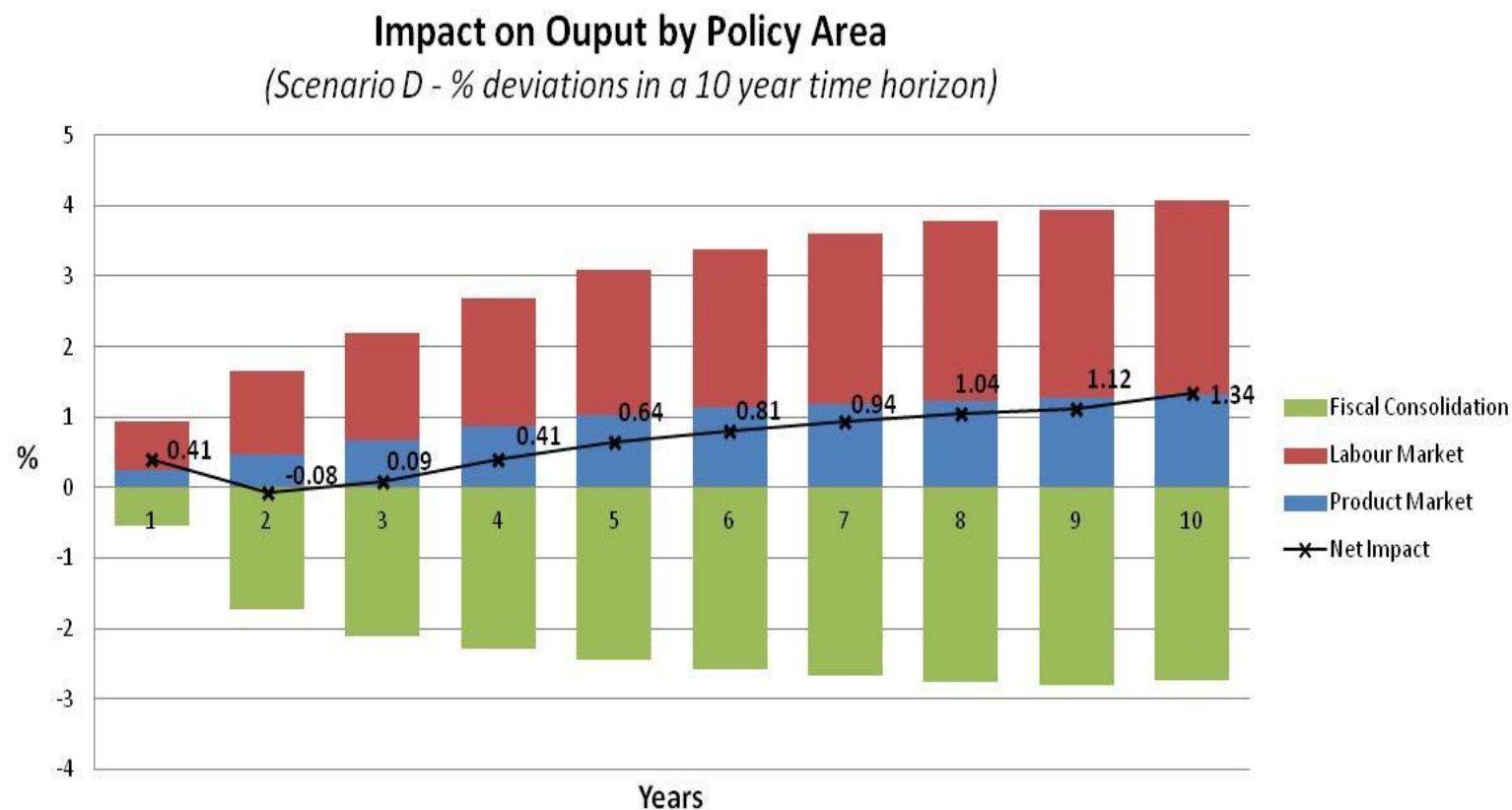
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Impact on Output under Different Scenarios



Impact on Output by Policy Area



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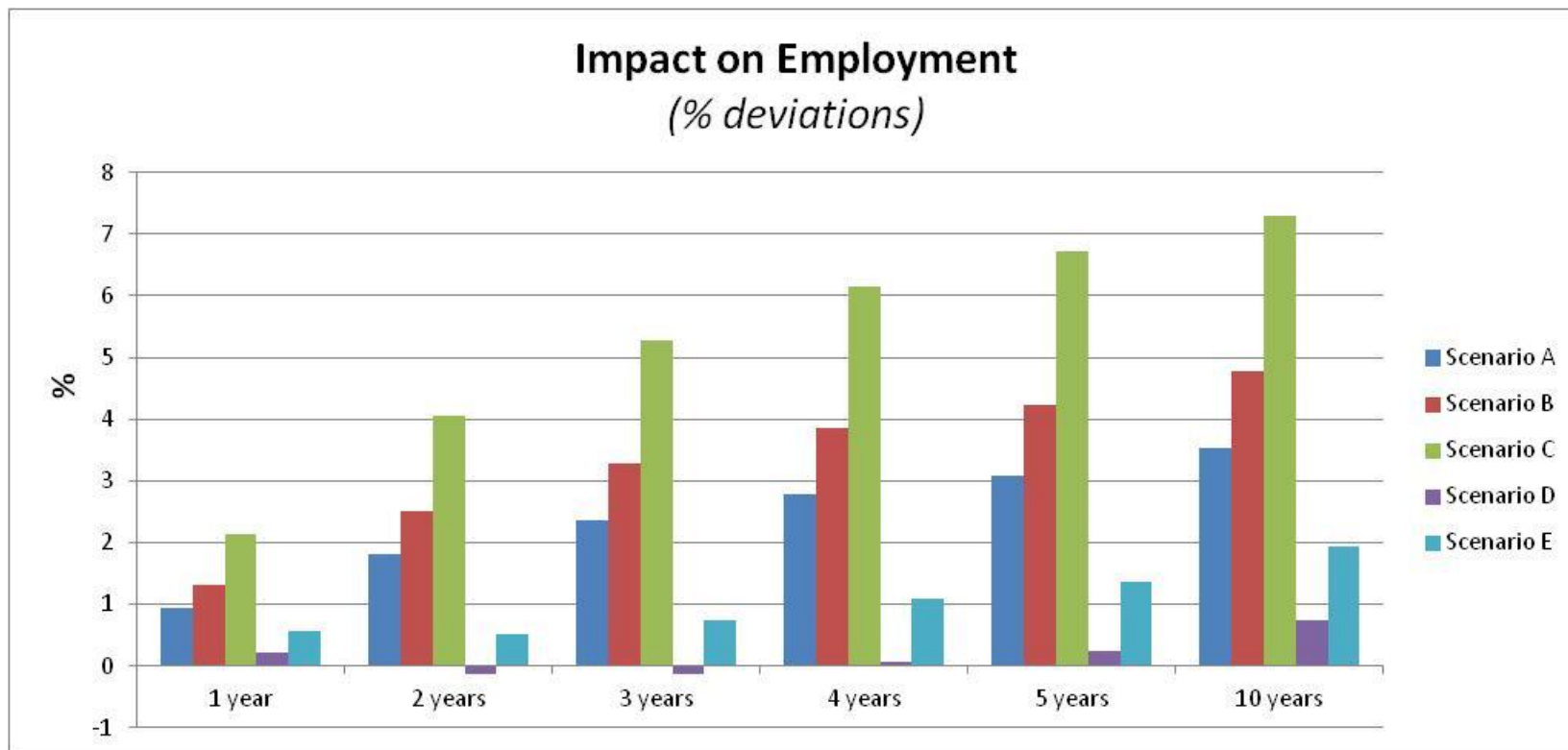
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Impact on Output: Taking Stock

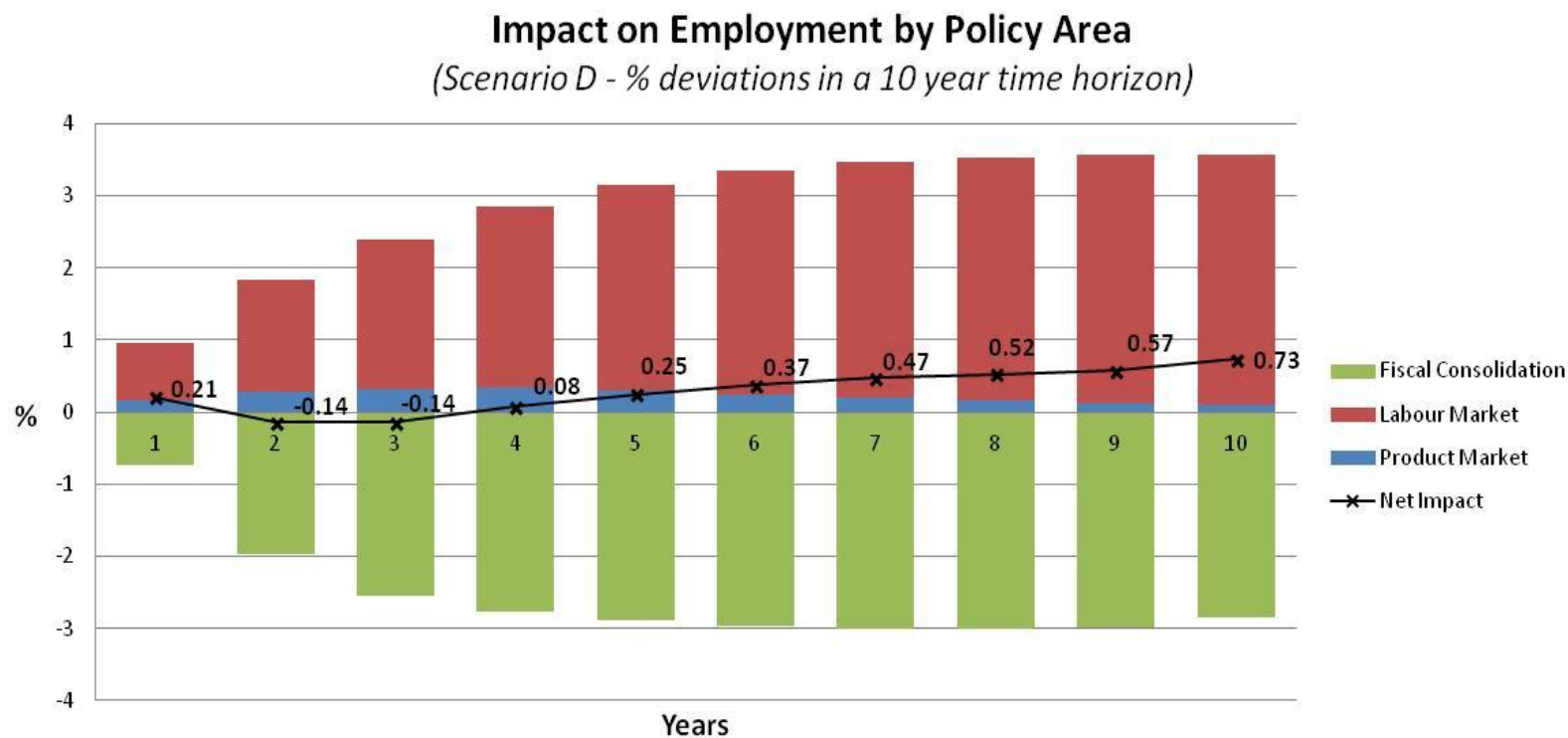
- After 10 years structural reforms may boost output with respect to the initial steady state from 4.06% in the moderate reform Scenario A, up to 5.77% in the substantial reform Scenario B.
- Scenario C shows that there's much scope for growth up to a cumulated increase in output of 9.69%.
- The major contribution is to be attributed to the policies intervening in the area of labor markets able to boost output up to 2.74% in scenario A and to 3.70% in scenario B.
- All reforms are likely to produce positive effects on output already in the short run.
- The fiscal austerity plan severely erodes the positive effects of the reforms and in the less ambitious scenario the economy undergoes a recession in the second year of intervention.
- As result of the vigorous fiscal consolidation package the average output growth rate gain in ten-year time horizon reduces from 0.6% to 0.3% in the substantial reform scenario and from 0.4% to 0.1% in the moderate reform scenario.



Impact on Employment under Different Scenarios



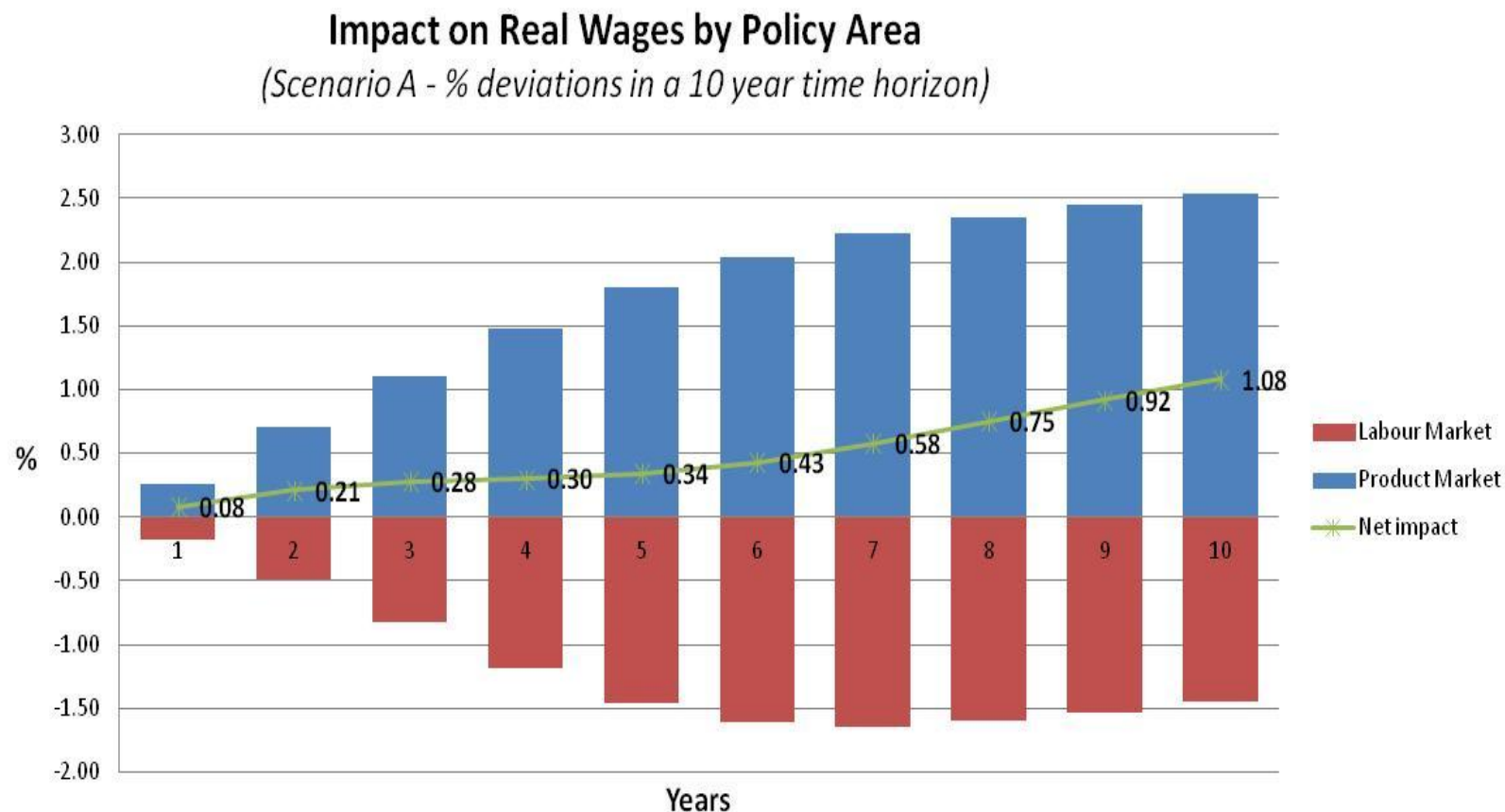
Impact on Employment by Policy Area



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Impact on Real Wages by Policy Area

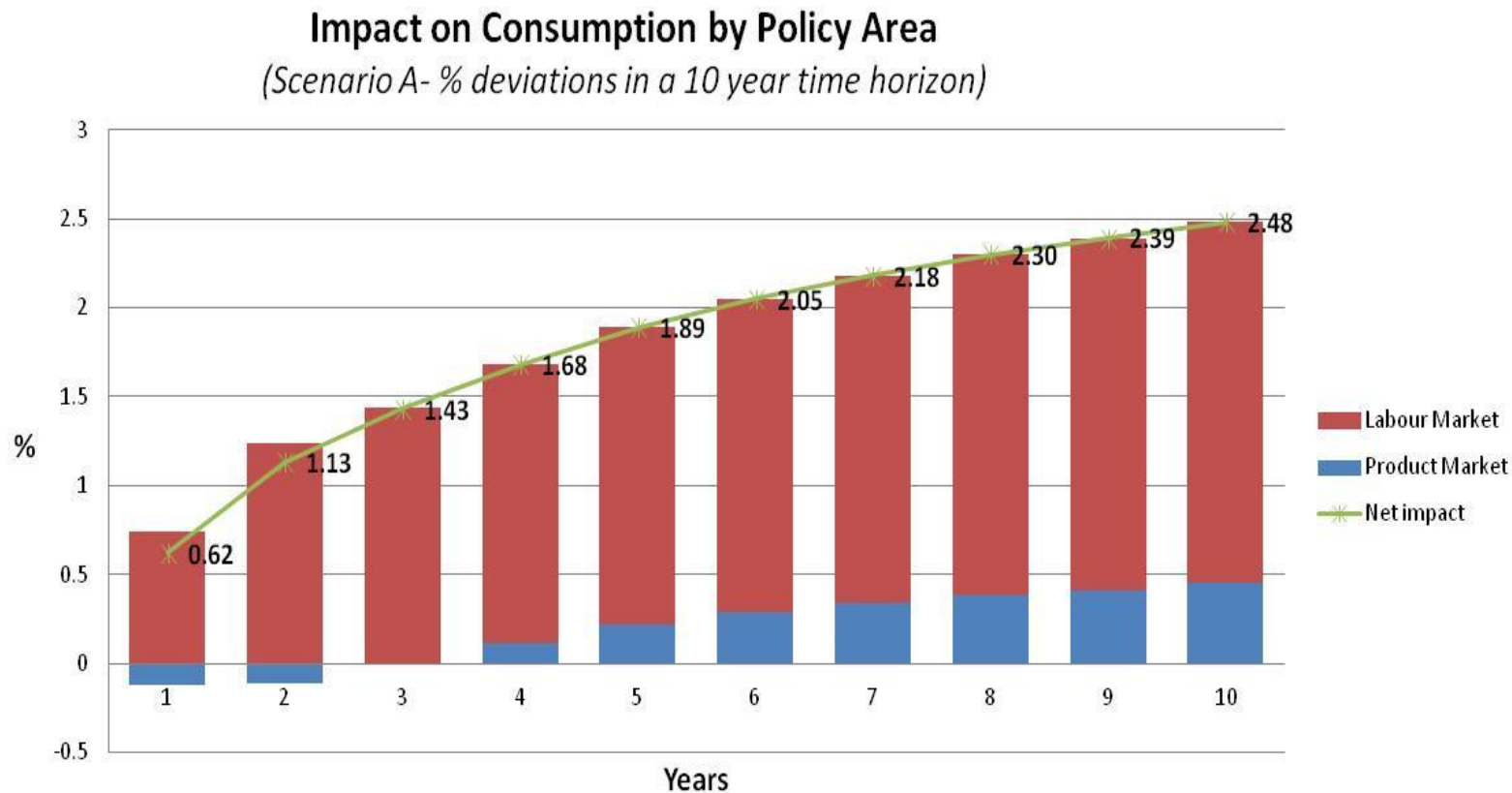


Impact on Employment: Taking Stock

- After 10 years the moderate reform Scenario A would imply an increase of 3.54% , while the substantial reform Scenario B an increase of 4.78%.
- Employment is strongly affected by all the labor market interventions which have a direct impact on labor and supply schedules.
- Wage moderation pushes toward an alignment of wages to productivity trends and, at the same time, fiscal reforms aimed at narrowing the labor tax wedge, reduce fiscal distortions and deadweight losses due to the strong fiscal pressure on labor income.
- Product market measures produce very small effects on employment, since in QUEST the labor market is characterized by strong rigidities (adjustment costs) which are responsible for the slow and costly adjustment of employment in response to shocks.



Impact on Consumption by Policy Area



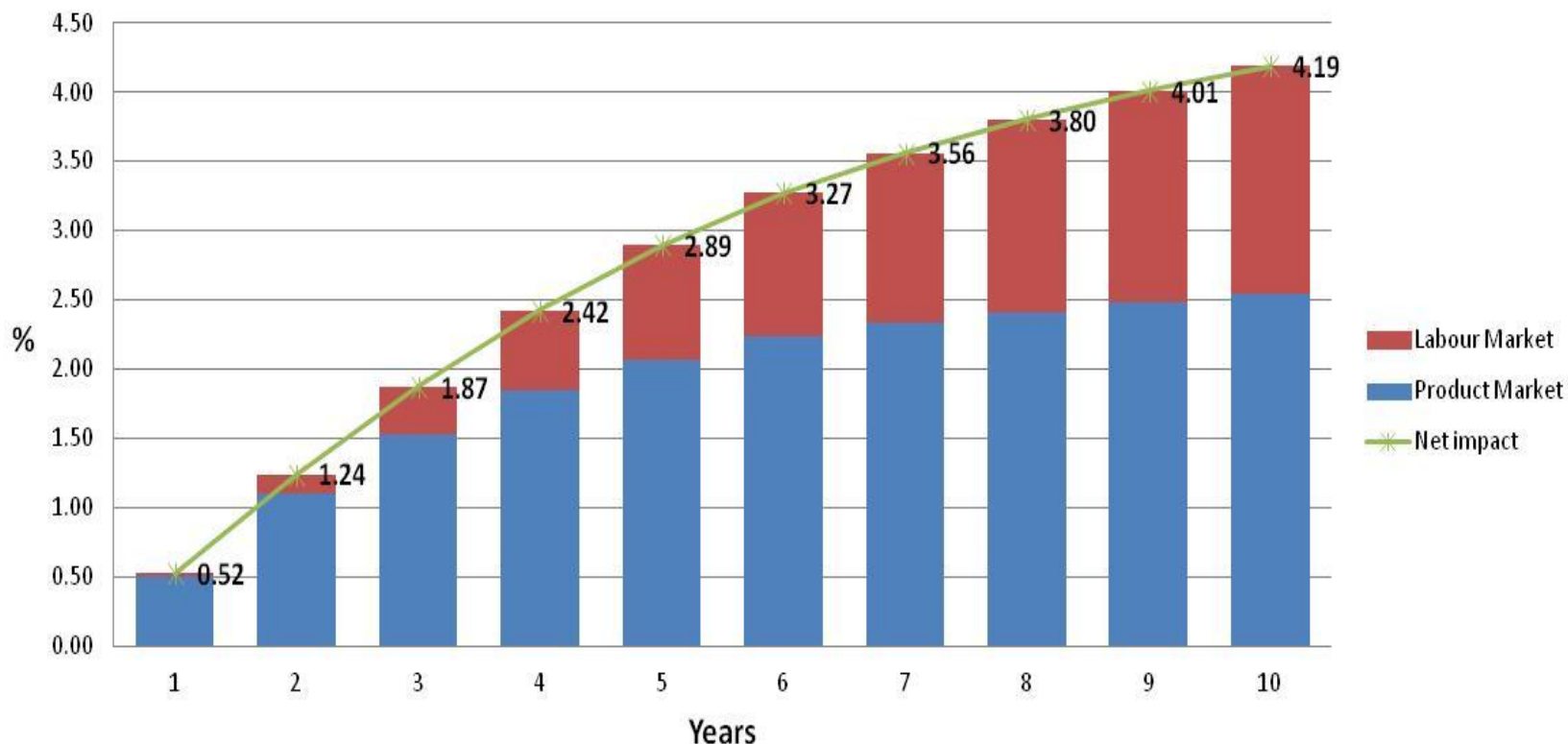
Impact on Consumption: Taking Stock

- Aggregate consumption would increase up to 2.44% and 3.35% (with a potential 5.25%) after 10 years.
- Forward looking non liquidity constraint consumers postpone their consumption decisions during the early phases of the reform process.
- The fiscal austerity plan is likely to severely mitigate the positive effects of the interventions, especially during the earlier phases of the reform process.
- Most of these losses accrue to liquidity-constraint households who would experience a drop in consumption.



Impact on Investments by Policy Area

Impact on Investments by Policy Area
(Scenario A- % deviations in a 10 year time horizon)

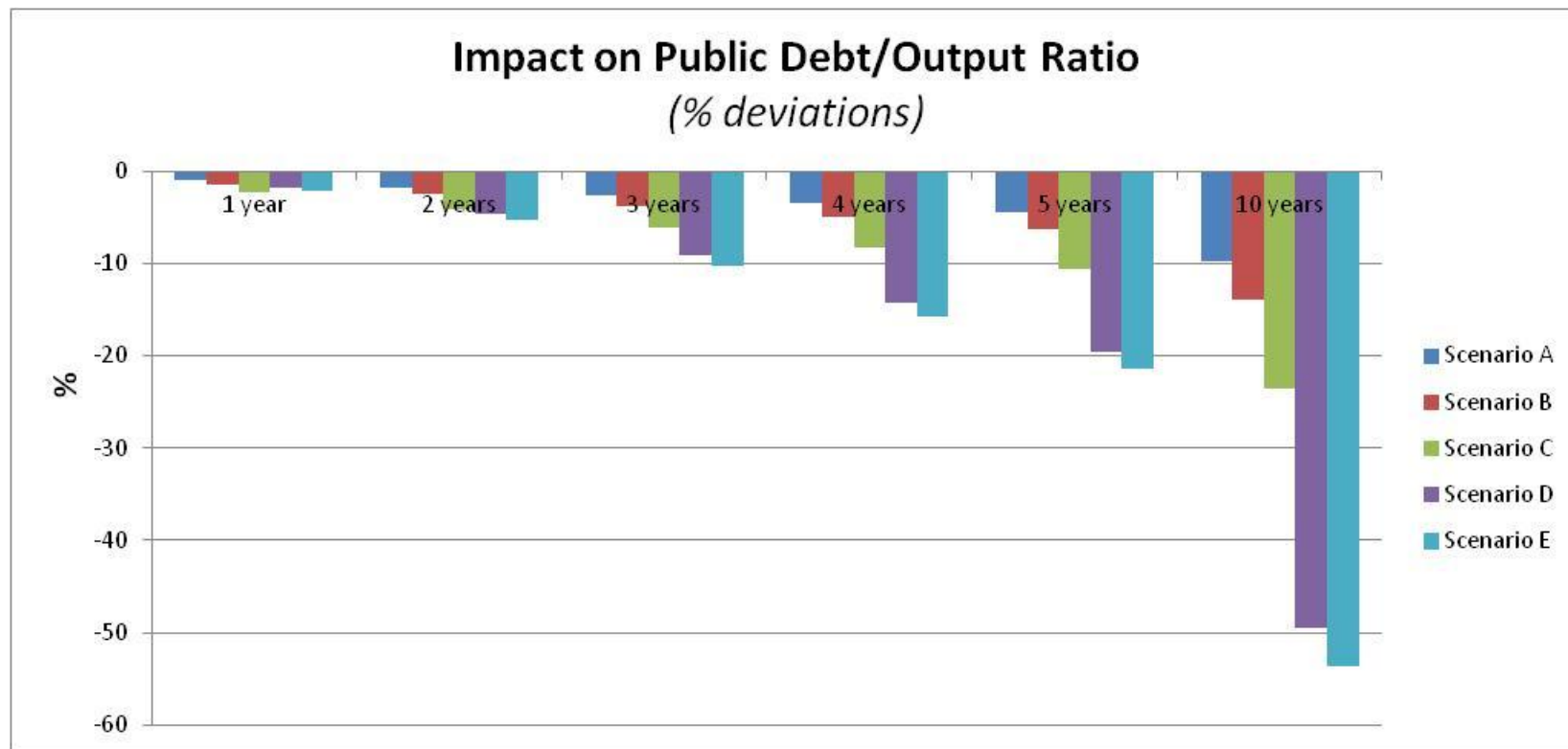


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Impact on Public Debt under Different Scenarios



Conclusions

- After a prolonged period of slow growth and a severe confidence crisis, Italy has embarked on an ambitious reform package aimed at increasing supply potential, improving competitiveness, ensure fiscal sustainability and enhance confidence in government ability to service its debt.
- This paper takes stock of the recent provisions undertaken or still on the table and quantifies the potential effects on the Italian economy of different reform scenarios including a broad range of policy interventions and differing in the progress made in two policy areas: *liberalization-simplification* and *labor markets*.
- Policies aimed to enhance competition in goods market, simplify bureaucracy, increase labor supply and align wages to productivity trends are likely to generate sizable gains in output, consumption and employment and net foreign assets position already during the earlier phases of the implementation, and that most of these gains derive from labor market reforms.



Conclusions

- The positive effects on output and the improvement in employment are able to support fiscal consolidation also in the ex-ante budget neutral scenarios.
- As regards to the external imbalances, the external asset position improves as a result of the reforms which boost domestic competitiveness and increase exports.
- However, the fiscal austerity plan is likely to severely reduce the positive effects of the interventions, especially during the first years of reform process.
- In particular, liquidity-constraint households may incur transitional losses in consumption.
- Overall, our results clearly show that a stronger progress in implementing structural reforms is crucial to rein in the slowdown in the economic activity and the fall in consumption due to the fiscal consolidation package.

