

A SHORT REMINDER FOR THE NEXT ITALIAN MINISTER OF ECONOMIC DEVELOPMENT

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ITALY'S MAIN PROBLEM is not fiscal. Or, more accurately, it would not be fiscal if the economy were able to grow beyond its mediocre medium-term prospects. In the last 25 years, Italy has grown slower than any other European country, and there is no clear sign that this pattern is about to change. The main reason for this sluggishness is low productivity, a problem that has been mostly neglected. The Maastricht framework for European economic governance has been mainly focused on rigorous fiscal discipline. Microeconomic effects were expected to result from structural reforms aimed at improving the functioning of markets rather than directly improving productivity. However, identifying policies to promote innovation and thereby increase productivity is critical at this juncture. It is high time Europe returns to a sensible strategy aimed at increasing productivity and overall economic activity.

The reason why Italy's productivity gaps, like its fiscal instability, should be a matter of concern for the other countries is easily explained. Innovation and the effectiveness of private and public expenditures in research and development play a major role in determining productivity. R&D efficiency is often dependent on the starting point of investors. Historical gaps tend to remain sticky, making the return on R&D vary significantly between countries. The private rate of return on business R&D—i.e., a firm's extra income per dollar invested in R&D—is quite high, typically ranging between 20 and 30 percent. This return is higher than rates of return on physical capital, partly reflecting R&D's higher risk premiums. Investors in countries mired in a low growth and high debt environment are understandably reluctant to embrace new risks. Often, foreign or non-national investments are required to break the bad equilibrium in which weaker countries are stuck.

Public intervention at a European level is inescapable. Private R&D undertaken by one firm may increase productivity in other firms through knowledge spillovers. Spillovers can occur both within the same industry and to other industries. Thus, domestic social rates of return to private R&D are generally estimated to be two to three times the private return. These positive externalities imply that market forces will lead to an underinvestment in R&D relative to the socially efficient level. Fiscal policy is thus called on to help fill the gap using incentives or subsidies. Consequently, the size of the specific national fiscal margin of maneuver is relevant to public intervention fostering productivity growth, which ultimately

determines fiscal stability as well. Identifying policies that could augment productivity growth by promoting innovation is critical. Against this backdrop, fiscal policy should be judged in terms of its role in stimulating innovation through its effects on research and development, entrepreneurship, and technology transfer. A relevant guide has been provided in a recent publication by the International Monetary Fund (“Acting Now, Acting Together”, chapter 2 in the *Fiscal Monitor*, April 2016), which identifies areas in which fiscal policy would have a greater or lesser impact. What is true for the most advanced economies is even truer for Italy.

The key message of the IMF guide is that more should be done to encourage R&D. In advanced economies, private firms should invest 40 percent more in R&D, on average, to account for the positive knowledge spillovers they create to the wider economy. This investment in R&D could bolster GDP in the long term in those countries by 5 percent—and by even more globally as a result of international technology spillovers. Advanced economies can achieve this dividend through “well-designed policies that include fiscal R&D incentives and complementary public investments in basic research.”

Most of the findings confirm what was already intuited by many analysts. However, they call into question the current capacity to design proper fiscal stabilization policies critical to countering investment decline during recessions. This is particularly true for a country where the average size of firms is smaller, such as Italy. Adopting a simplified tax regime for small businesses can facilitate firm entry and reduce informality, which can raise productivity. But fiscal incentives for small and medium firms must be accurately designed in order to avoid incentivizing firms to remain small. In particular, fiscal measures should support the pooling of research or incentives for new firms.

Since the global financial crisis, Italy’s recovery has continued to be at best uneven, raising concerns that the country might be trapped in an era of mediocre growth. A lame recovery also casts a shadow on fiscal stability, which in turn hampers investments and consumption. The slow growth in total factor productivity (TFP) is particularly worrisome as it seems to result from an entrenched peculiarity that preceded the crisis and cuts through the economic cycles.

Unfortunately there is widespread uncertainty about how governments measure, let alone support, total factor productivity. Fiscal incentives for innovation are the standard answer. A more strategic thinking would be useful now that new breakthroughs in information technology could drive productivity increases in the coming decades. Brynjolfsson and McAfee quote anticipated technologies such as three-dimensional printing, big data, driverless cars, and artificial intelligence as potential triggers that might induce a dramatic growth spurt in the years to come. Gordon instead argues that the boost to TFP growth from these innovations is likely to be modest. As in other cases, it is highly likely that technological changes down the road will produce winners and losers, although the extent of the shifts between the two camps remains uncertain. For Italy, it is of paramount importance to remain in the winning side. For this reason, fiscal policy should be accurately targeted to create new and improved products and processes, as well as organizational change, improved marketing concepts, and new business models such as e-commerce or the sharing economy.

Italy experiences marked underinvestment and should address the problem through corrective fiscal instruments that provide incentives for private R&D. Fiscal incentives such as tax credits and direct subsidies can lower the private cost of R&D, making firms more inclined to invest, which is socially desirable because other firms will also benefit. If the external benefits from private R&D are as large as the private benefit, as the IMF’s *Fiscal Monitor*

suggests, then the “socially efficient correction should reduce the marginal cost of R&D by 50 percent”. In other words, the cost for a firm investing in extra R&D should be reduced by 50 cents per euro, which is probably a multiple of five of the current rates in Italy.

The European Union has an ambitious goal of raising private R&D from its current level of about 1.3 percent of GDP to 2 percent of GDP in 2020, an increase of more than 50 percent. Italy should coordinate with Brussels in order to design policies aimed at achieving these goals.