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FIRMS' GROWTH SHOULD INSPIRE BRUSSELS' REMARKS ON ITALY'S POLITICAL ECONOMY

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FOR THE FIRST TIME, in the upcoming days, the Eurogroup and the European Council will take account of the Commission's communication on flexibility when they are called to give opinions on the 2015 update to its stability and convergence program, which Italy had to submit to the Council and the European Commission in mid-April.

The Italian government is very interested in the application of new margins of flexibility that would allow for a less stringent fiscal policy. Prime Minister Matteo Renzi is already envisioning an expanded interpretation of flexibility, one including not only the already agreed-upon €10bn, but an additional €3bn. Overall, Italy's fiscal position will be less aligned with the rules prescribing a sizable reduction in structural deficit and public debt. The mitigating factors that should justify more flexibility have their fundamental reasoning in creating the premises for higher economic growth. An accelerated increase in economic activity is *per se* a factor that allows for a reduction in the ratio of deficit and debt to GDP.

Ultimately, the premises for faster growth should be redirected to structural reforms and, in particular, to those leading to a higher level of Total Factor Productivity. Broadly speaking, TFP is what ultimately determines economic grwoth. It is generally defined as a function of within-firm and across-firm efficiency. The former is linked to investments in human capital, innovation, management quality, and technology. The latter relates to the efficiency of labour and capital reallocation. In the Italian case, there seems to be a clear relationship between low levels of TFP and the size of firms. Under this light, we question the character of Italy's political economy and highlight a fundamental intervention that seems to be lacking: significant incentives for increasing the size of Italian firms.

On 25-26 June, the European Council endorsed country-specific recommendations for economic and fiscal policies for 26 non-program EU member states. These recommendations were adopted by the economic and finance ministers on 14 July to formally conclude the 2015 European Semester. The Council's fiscal policy recommendations aim to ensure that countries comply with the EU's Stability and Growth Pact (SGP). To this end, these opinions take account of the Commission's communication on flexibility within the SGP, which was released in January this year. The country-specific recommendations for fiscal policies issued under the 2015 European Semester will need to be reflected in the draft budgetary plans for 2016, which countries have to submit to the Eurogroup and the Council by mid-October.

The latest country-specific recommendations issued by the European Council identify risks of non-compliance with the structural effort requirements of the SGP in 12 of the 17 euro area countries under review. Overall, as the European Central Bank highlighted in its September Economic Bulletin, 12 euro area countries under the SGP's preventive arm are required to progress toward their medium-term budgetary objectives, with structural efforts amounting to 0.2% of GDP on aggregate over 2015-16, though the figures for this period are expected to be slightly negative. Therefore, the recommendations ask Italy, as well as seven other member states (Belgium, Estonia, Latvia, Lithuania, Malta, Austria, and Finland), to make structural efforts commensurate with the preventive arm of the SGP.

Italy, together with Belgium, also face large consolidation gaps with respect to the debt rule. The required improvement in the structural balance under the debt rule in 2015 is equivalent to 2.1% of GDP for Italy (a result of cumulated consolidation shortfalls since 2013)[1],which compares with a forecast for structural efforts amounting to 0.3% of GDP. These requirements are not reflected in the 2015 country-specific recommendations for Italy, as the Commission has concluded that the deviation from the debt rule can be explained by relevant factors, such as unfavorable economic conditions and the implementation of structural reforms.

The Italian draft budgetary plan for 2016 should therefore clarify how a government, one whose structural efforts fall short of their commitments under the SGP, intends to follow up on the country-specific recommendations in order to ensure compliance with the EU's fiscal rules and increase the rate of deficit reduction. The nature of the structural reforms that need to be undertaken becomes a critical factor for evaluating compliance with the SGP in its broader definition.

In terms of structural reforms, it is widely acknowledged that many countries have adopted measures such as increasing wage decentralization, strengthening competition via reduction of barriers to entry for professional services, enhancing economic efficiency by improving the judicial system, and increasing flexibility with respect to working arrangements. Similar reforms have also been implemented in Italy. However, further reforms will be needed to decisively shift expectations, particularly in the priority area of raising total factor productivity (TFP), which ultimately is what drives long-term growth.

Of particular interest for Italy is the nexus between firm growth, technology adoption, and resource allocation in the euro area, and how they all affect productivity growth. While small and young firms create the most new jobs, that value diminishes if they do not grow over time. According to an example recently made by the ECB chief economist, the average size of a manufacturing sector start-up in the US and Italy is roughly the same within its first two years (5-10 employees). After ten years, however, the average US firm would have grown to around 75 employees, while the average Italian one would still have less than 15 employees. This static pattern of firm growth hinders both within-firm and across-firm channels of TFP growth. Firms that stay small tend to be less likely to invest in new technologies, particularly in ICT investments that are crucial to succeeding in the digital economy. Small firms face relatively higher fixed costs when adopting ICT, while exhibiting higher risk aversion and encountering greater difficulties when collecting resources to finance more innovative projects. As Peter Praet recently remarked: if firms do not grow, it also weakens the potential

[1] *ECB Monthly Bulletin*, September 2015

for productivity growth through the across-firm channel. The more resources are concentrated in the most productive firms in each sector, the faster aggregate TFP grows.

According to the IMF, firm size is strongly and positively correlated with TFP in certain countries, with micro firms being about a third less productive than large firms. Creating the conditions for a more dynamic distribution of firm growth could thus make a decisive difference to TFP developments in the euro area. Therefore, structural reforms should be designed to change the set of incentives that motivate Italian firms to remain small. Regulations that encourage firms to stay below certain size thresholds should be removed. In Italy, for example, some studies argue that labour regulations that kick-in at the 15-employee threshold may have encouraged firms to stay small in the past, although these are now *de facto* no longer in force. A possible reason is that firms are afraid of overcoming the "large taxpayer" threshold and prefer to remain small for fiscal reasons. Fiscal and legal reforms such as reducing overall investment taxation or enhancing the efficiency of civil justice can lead to higher rates of market entry by firms and attract greater foreign direct investment. A new ECB study finds, for example, that the probability of obtaining credit is up to 40% higher in countries with a better legal system. Human capital should also be increased, especially in the area of digital skills. Firms will find it easier to invest in ICT if workers do not lack the necessary skills.

Discussion within the Eurogroup on Italy's implementation of its country-specific recommendations on fiscal policy should be inspired by these assessments of Italy's political economy, encouraging firms to grow in both size and technology. Fiscal interventions along this line justify the application of margins of flexibility in the assessment of Italy's fiscal policy.