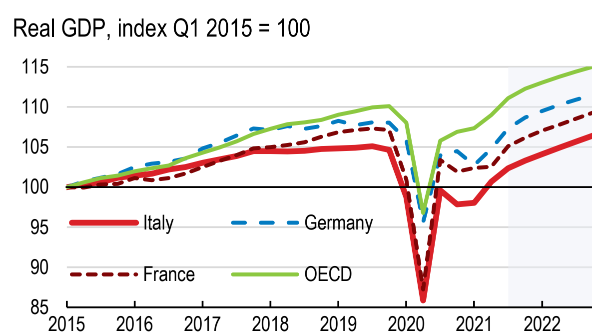
Executive summary

The economy is emerging from the COVID-19 pandemic

The pandemic's early onset and high fatality rates necessitated intensive lockdowns, resulting in a severe contraction in the Italian economy (Figure 1). Regionalised lockdowns and new modes of working have reduced the impact of restrictions on activity since then. The vaccine campaign, which first prioritised the most vulnerable to reduce pressure on hospitals, has been extended to all over 12.

Figure 1. The economic contraction was severe



Note: Shaded area indicates projections.
Source: OECD (2021), OECD Economic Outlook 109 (database) and provisional projections.

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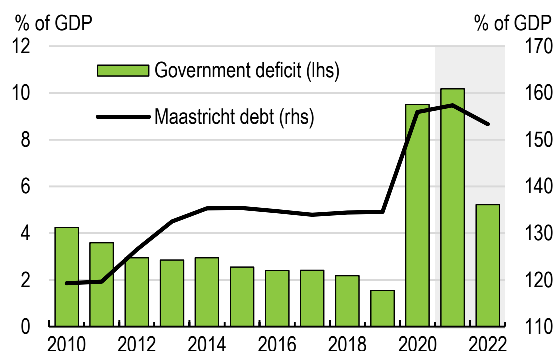
Generous government support mitigated job losses and hardship and preserved productive capacity (Figure 2). Loan guarantees and moratoria on debt repayments supported firm liquidity and limited bankruptcies. Short-time work schemes and a ban on firing were supplemented with income support for those falling out of existing safety nets, as well as tax payment deferrals. School attendance and educational outcomes worsened for the most disadvantaged, whilst the lockdown has been associated with higher domestic violence.

Significant fiscal support in 2021 will buoy the near-term recovery as vaccination rates accelerate and restrictions ease. Higher public investment, including from Next Generation EU funds, will support private sector investment, alongside higher confidence and demand (Table 1). GDP will reach 2019 levels by the first half of 2022. Consumption is expected to rise as households are able to consume part of their savings and employment recovers.

Figure 2. The government responded swiftly to the COVID-19 crisis



Source: OECD (2021), OECD Economic Outlook 109 (database) and provisional projections.

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Table 1. Exports and investment lead the recovery

(annual growth rates, unless specified)	2019	2020	2021	2022
Gross domestic product	0.3	-8.9	5.9	4.1
Private consumption	0.3	-10.7	4.7	4.5
Government consumption	-0.8	1.6	0.9	-0.6
Gross fixed capital formation	1.1	-9.2	15.9	8.7
Exports of goods & services	1.9	-14.5	12.0	7.1
Imports of goods & services	-0.5	-13.1	12.3	7.5
Unemployment rate (%)	10.0	9.3	10.4	10.1
Consumer price index	0.6	-0.1	1.5	1.3
Current account balance (% of GDP)	3.2	3.5	3.3	3.3
General government fiscal balance (% of GDP)	-1.6	-9.5	-10.6	-5.7
General government gross debt (% of GDP, Maastricht definition)	134.6	155.9	158.6	155.1

Source: OECD (2021), OECD Economic Outlook (database) and provisional projections.

Fiscal policy should continue to support households and firms until the recovery is firmly underway, and become increasingly targeted. Withdrawing liquidity support too early could force otherwise viable firms into bankruptcy. It would also raise unemployment and poverty, which were already high before COVID, affecting youth and women particularly. New labour market incentives seek to encourage hiring as the

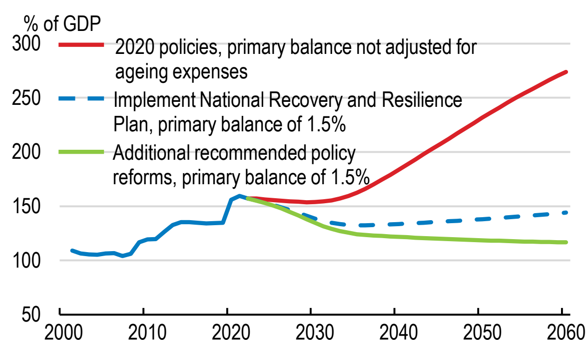
economy improves. Italy has a wide range of instruments to support firms in raising equity and loans as they emerge from the crisis.

For unviable firms, swift resolution processes should be put in place. Addressing lengthy court proceedings and ineffective case management will lower uncertainty and raise recovery rates. The planned bankruptcy code could facilitate earlier, more successful restructuring of firms. However, the expected rise in bankruptcies due to COVID will require procedural adaptations to prevent system overload. The non-performing loans market has developed rapidly. Reducing information asymmetries between banks and possible buyers of loan assets, which are higher in times of crisis, would help reduce the costs of bankruptcies.

After the pandemic subsides, fiscal policy must reorient to support higher growth and job creation. Prior to the COVID crisis, Italy ran consistent primary surpluses, but public debt to GDP did not fall due to weak growth. Ageing-related expenses crowd out investment in infrastructure, education and training. Reallocating public spending and tax can raise growth and improve the bias against the young, many of whom are out of employment and at risk of poverty. Faster trend growth can help reduce debt (Figure 3).

Figure 3. Faster growth is needed to improve the debt-to-GDP ratio

Debt-to-GDP ratio scenarios



Source: Ministry of Finance and Economy; OECD (2021), OECD Economic Outlook (database); Turner and Guillemette (2021) and OECD calculations.

https://stat.link/16ojgc

Supporting a greener, job-rich recovery is the priority

Addressing Italy's weak economic growth and ageing demographics requires tackling long-standing structural challenges. These include low levels of investment, productivity and employment, ineffective public administration, high regulatory burdens and sharp regional divides (Figure 4). Addressing these challenges would improve the economy's resilience to shocks and reverse the trend of stagnating GDP per capita.

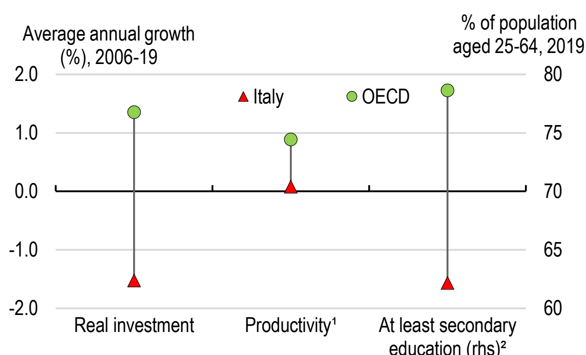
The National Recovery and Resilience Plan combines an ambitious structural reform agenda and large investments, offering a unique opportunity to transition to higher productivity and decarbonised growth. Structural reforms prioritise improving public administration effectiveness, civil justice and competition. These are complemented with EUR 235 billion in spending, utilising Next Generation EU grants and loans and increased national resources. Key priorities for investment are to support greener energy and transport and faster digitalisation. Human capital investment prioritises education, health and research and development. The South receives about 40% of resources to combat regional inequalities. The planned introduction of a longer term strategy to reform tax policy could further raise compliance, employment and firm dynamism.

Chances of successful implementation of structural reforms and public investment projects are greater than in the past. Clear milestones and targets have been set for the disbursement of Next Generation EU grants and loans. Governance innovations have been introduced to accelerate problem identification and spending, alongside enhanced monitoring for compliance. The legislative agenda to achieve the reforms will be challenging, but recently passed legislation to simplify green investments and support decision-making is a positive start. Public administration reforms will raise implementing capacity.

Significant green investment plans should be supported with lean regulations, green taxes and carbon pricing changes. A clear, long-term path for harmonising and gradually raising carbon pricing would guide decision-making. An explicit

strategy to manage the potential revenue gains and the costs of the transition, particularly for industries facing competitive pressures and lower income households, would provide certainty to investors and improve social buy-in. Well-designed regulations, standards and norms could further reinforce behaviour change.

Figure 4. More physical and social capital is key to raise growth



Note 1: USD per hour worked, constant 2015 prices and PPPs.
Note 2: Share of population aged 25-64 having attained at least upper secondary education.
Source: OECD (2021), OECD Economic Outlook 109 (database); OECD Productivity (database); and OECD Education at a Glance (database).

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Investment rates are amongst the lowest in the OECD, held back by uncertainty, high leverage and a lack of access to equity finance. Higher public investment funded by Next Generation EU and generous fiscal incentives can crowd in private investment, provided leverage levels do not reduce firm risk-taking. Improving the quality of public administration and actions to reduce perceptions of corruption would lower the need for fiscal incentives and also support investment. Faster roll-out of broadband would support private sector digitisation and greater take-up of the expanding range of public services available online.

Stagnant productivity growth over the last two decades has been due to lagging services sector productivity. Productivity in the manufacturing sector has risen due to higher investment and the exit of less productive firms. Conversely, regulatory barriers, including those which conflict with recommendations from the competition authority, create high barriers to entry in retail sales as well as professional services. This in turn depresses competition and innovation.

Creating more and better jobs will require adjusting labour taxes. Short-time work and the ban on firing have limited redundancies. But youth and women, and those in the South, who tend to be hired on temporary and fixed term contracts, have been less protected. Temporary cuts in social security contributions will help as the economy recovers, but the high labour tax wedge remains a key obstacle. Female labour force participation remains very low, exacerbated by limited public support for childcare and high marginal effective tax rates for second income earners.

The quantity and quality of skills must rise to counteract low levels of digital literacy and ongoing adult learning. Support for employment is focused on hiring incentives. Despite the skills shortage, take up of existing worker training funds is low, especially for small businesses. Challenges remain in the delivery of public employment services, although the government is introducing a new approach to training the unemployed.

Tax reforms can improve growth and equity outcomes given Italy's high tax take and evasion rates. The number of tax expenditures is high and contributes to complexity. Labour taxes are a larger share of revenue, and consumption and inheritance taxes a smaller share than the OECD average. The low VAT share is partly due to poor compliance. The VAT exemption threshold is high. Greater use of technology and card payments should improve compliance and monitoring. Efforts to improve income tax equity should take into account the incidence of tax expenditures as well as property taxes, including on inheritance and immovable property.

Improving public sector effectiveness is key to sustaining the recovery

Raising the effectiveness of Italy's public sector is more urgent than ever. It will be key to achieving the planned boost to public investment, improving the business environment and ensuring quality public services can be accessed across Italy. The quality of public goods and services is variable, and a large stock of regulations and onerous and uncoordinated enforcement

processes drag firms' dynamism. Trust in public institutions is one of the lowest across OECD countries. In the coming years, Italy will have an unprecedented opportunity to improve the effectiveness of its public sector, through the Resilience and Recovery Plan's resources and policy goals, the renewal of the public service and the contributions from digitalisation and innovation.

There is scope to better prioritise public spending. Lack of fiscal space limits funding for the most growth-supporting public activities (Figure 5). Information about activities' performance or contribution to the government's priorities has limited influence on budget allocation decisions. Developing good indicators and analysis capacity in line ministries and further strengthening regular spending reviews would improve public spending allocations.

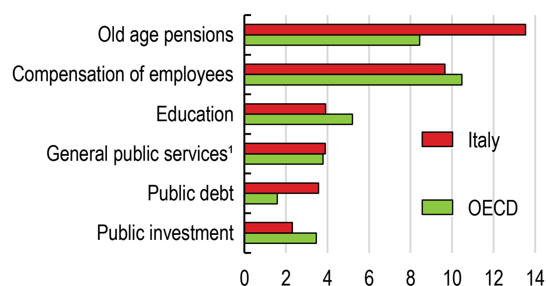
Regulatory burdens remain high, despite significant improvements in the process for preparing new regulations. A review of Italy's large stock of existing regulations, with a focus on reducing the number and improving the quality of regulations, would help simplify the regulatory environment. Improving coordination among agencies that implement regulations, and shifting their focus from enforcement to supporting compliance would support the business environment.

The public administration could become stronger and more agile. Staff with the necessary skills are lacking across the public administration. The accelerating retirement of public servants over the coming decade will allow renewal, if recruitment is more agile and anticipates skill needs and if retiring public servants can transmit their experience to new recruits. Stronger skills will also be essential to further leverage the benefits of digitalisation. Regulatory requirements and the threat of judicial sanctions lead decision makers to take defensive positions, rather than proactively supporting service delivery. Public servants' effectiveness could increase if performance was better recognised and rewarded.

Strengthening coordination, support and incentives across Italy's multi-layered government would improve its effectiveness. This is especially the case for public procurement, where many small agencies have thin capacity to design and implement projects effectively. The public sector also intervenes across the economy through thousands of public enterprises, mostly owned by subnational governments. The benefits and costs of this public ownership should be regularly assessed, the governance of public enterprises improved, and those that do not support core public service delivery divested once the economic situation stabilises.

Figure 5. Pension and debt costs leave little space for pro-growth and inclusive spending

Public expenditure in % of GDP, 2019 or latest



Note: Excludes public debt costs.
Source: OECD (2021), National Accounts Statistics (database).

MAIN FINDINGS	KEY RECOMMENDATIONS
Policies for a stronger and more resilient recovery from COVID-19	
The economy is expected to recover to 2019 levels by the first half of 2022. Withdrawing support for individuals and companies too early would lead to more bankruptcies, lower employment and higher poverty. Government debt rose to near 160% of GDP in 2021 and population ageing will put pressure on public finance.	Continue to provide fiscal support until the economic and employment recovery is well underway and make it increasingly targeted. Announce in advance a medium-term fiscal plan to be implemented once the recovery is self-sustained to reduce the public debt ratio, taking into account the effects of an ageing population.
Higher post-COVID insolvencies raise bank balance sheets risks. Although banking sector resilience has improved, non-performing loans remain high by OECD standards. The well-developed non-performing loans market can play a key role in reallocating credit in the post-COVID recovery. The court and early warning system risk being overwhelmed as the economy emerges from the crisis. Reforms to continue to improve the efficiency of the civil justice system are being considered by Parliament.	Introduce market-wide standards for valuing unlikely-to-pay loans. Increase resources for courts to better manage backlogs and improve speed and efficiency of civil justice court procedures.
Public finance reforms are needed to support faster growth and more and better jobs	
Despite relatively high public spending, spending that can best support growth and well-being is low and has been falling. Next Generation EU grant funds are significant at 13.5% of 2020 GDP. Slow historic absorption of EU funds is due to hurdles in designing, approving and implementing programmes. Procurement is slow, competition limited and capacity varies widely.	Improve the composition of public spending to promote growth and job creation. Consolidate smaller agencies' public procurement activities into higher capacity bodies.
Ageing- and interest-related expenditure pressures are high and set to rise in the longer term. The government has committed to returning to pre-COVID debt levels.	Contain pension spending by allowing the early retirement scheme (Quota 100) and the so-called women's option to expire in December 2021, and immediately re-establish the link between life expectancy and retirement age.
Tax revenue shares from labour are higher and VAT and inheritance lower than OECD peers. The tax wedge on labour is high, but has been lowered with income tax relief, family allowance reforms and temporary social security contribution cuts. The government intends to reform the tax system. Labour force participation fell sharply in 2020 and remains particularly low for women, especially those with children.	Implement a holistic tax reform that reduces complexity and tax expenditures and permanently lowers taxes on labour, financed through improved compliance and higher taxes on immovable property and inheritance. Improve access to quality childcare across all regions .
The recovery plan allocates 6.5% of GDP for green projects. Carbon tax pricing continues to favour diesel and industry.	Set a long-term plan to harmonise and gradually raise carbon prices, with policies and time to ease social and competitiveness transition costs.
SMEs do not access training funds enough. Current resources and structures will not reverse low adult learning rates and digital skills levels.	Increase access to adult skills attainment, with improved Training Fund application processes and better coordinated public employment services.
Raise investment and productivity	
Government incentives, including the recent temporary increase in the allowance for corporate equity, only partially offset regulatory obstacles to higher investment. Services productivity lags manufacturing, and firm growth levels lag OECD peers. Regulations are often anti-competitive.	Reduce regulatory barriers to entering professional services, including replacing licensing systems with less distortionary certification schemes
Penalties for engaging in corrupt activities increased in 2019.	Improve oversight and accountability of elected officials and magistrates to improve the quality of policies and build public trust.
Enhance public sector effectiveness	
Budget processes do not support reallocations to more effective spending.	Improve the allocation of resources and the effectiveness of spending through strengthened expenditure reviews also taking into account a succinct set of policy performance indicators.
Processes for preparing regulations have improved, but regulations and their enforcement remain burdensome.	Undertake stocktake reviews of regulations, starting with sectors that will be priorities for the post-COVID crisis recovery.
A shrinking and ageing workforce, shortages of relevant skills hold back the public sector's ability to deliver.	Rejuvenate the public sector workforce, through more agile recruiting, training and career management, with a particular focus on filling skill needs such as those for the digitalisation of the public sector.
Italy's hybrid decentralisation and overlapping policy competencies allows for innovation but can inhibit implementing policies or providing quality public goods and services.	Clarify competencies of different levels of government, supported by bodies that identify, disseminate and support effective practices.

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