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ITALY

SELECTED ISSUES

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Executive Summary

Italian Productivity, Innovation, and Competitiveness
In Italy, as in many countries, price-based competitiveness measures have not always been an accurate guide to subsequent trade developments. This chapter offers a more comprehensive assessment of Italian export competitiveness, focusing in particular on the evolution of Italy's export market share.

Judicial System Reform—A Key to Growth
The inefficient Italian judicial system has contributed to a difficult business environment and lower investment. Improving the efficiency of the judicial system will require strengthening the mediation system, enhancing court management and accountability, and reforming the appeal system.

Reforming Capital Taxation in Italy
This chapter reviews capital taxation issues based on a comprehensive definition encompassing taxes on income, transactions, and ownership. It discusses options to enhance the neutrality of the capital income tax system, followed by a detailed analysis of the property tax, the inheritance tax, and various transaction taxes. The chapter also examines whether substituting a single net wealth tax for the set of existing taxes could be beneficial in the medium-term.

Reforming Tax Expenditures in Italy
The IMF has advised country authorities to roll back tax expenditures to support fiscal consolidation efforts. This chapter analyzes tax expenditures in Italy, considering the extent to which they can be considered part of an optimal tax system and, possible reforms.

Strategy for Fostering a Market for Distressed Debt in Italy
This chapter examines the framework for resolving NPLs and ways to accelerate write-offs, through tax policies, legal reforms, and regulatory policies, using lessons from other countries. It focuses on developing a private market for restructuring distressed assets that could support banks' efforts to clean their balance sheets and expand lending.

Reforming the Corporate Governance Framework of Italian Banks
Corporate governance is key for a well functioning banking system. The paper discusses the corporate governance of Italian banks, its regulatory framework, and specific challenges arising from dependence on foundations and cooperatives. It concludes with recommendations, in line with the FSAP, for strengthening corporate governance.

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ITALIAN PRODUCTIVITY, INNOVATION, AND COMPETITIVENESS[1]

In Italy, as in many countries, price-based competitiveness measures have not always been an accurate guide to subsequent trade developments. This chapter offers a more comprehensive assessment of Italian competitiveness, focusing in particular on the evolution of Italy's export market share. Overall, competitiveness is indeed a matter of concern; although perhaps not as critical as some assessments have claimed. Italy still maintains a high-quality export mix, and the adaptability of small-scale specialized firms is still a source of strength. But small firm size is now less of an asset, and even the most innovative sectors are being weighed down by the structural barriers that have depressed Italian productivity more broadly. Italy's future competitiveness will thus depend on successful implementation of the authorities' full structural- and institutional-reform agenda.

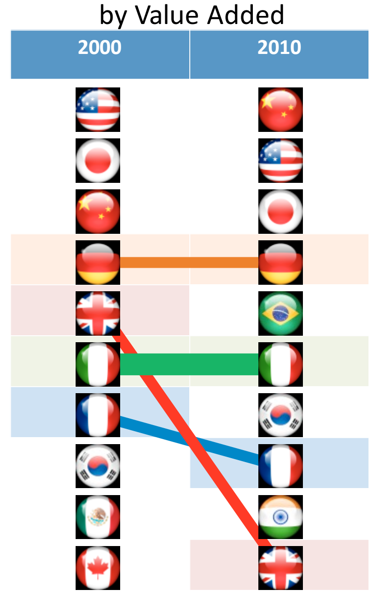
A. The Italian Competitiveness Puzzle

A loss in competitiveness without a collapse in exports

1. **Over the past two decades, discussion of the Italian economy has increasingly centered on the key themes of weak growth and competitiveness**. In this regard, a sustained drop in total factor productivity (TFP) growth, and the resulting increase in unit labor costs (ULC) relative to Italy's main EU competitors have raised repeated concerns about the competitiveness of Italy's exporters.

2. **Against this backdrop, however, Italian exports have held up relatively well.** In an era dominated by the dramatic expansion of emerging-market exporters, Italy's tradable sector continues to rank among the world's leaders—in contrast to many other European countries. And Italy's share of world exports has generally moved in parallel with its European peers (at least in value terms). Most recently, the buoyancy of exports in the face of depressed global demand underscores the continued adaptability and resilience of Italian trading firms. Indeed, according to the WTO/UNCTAD's Trade Performance Index, Italy remains the world's top-ranked exporter in textiles, clothing and leather goods; and is ranked second in the world (behind Germany) for non-electronic machinery and manufactures (basic and miscellaneous).

Top 10 Manufacturers by Value Added



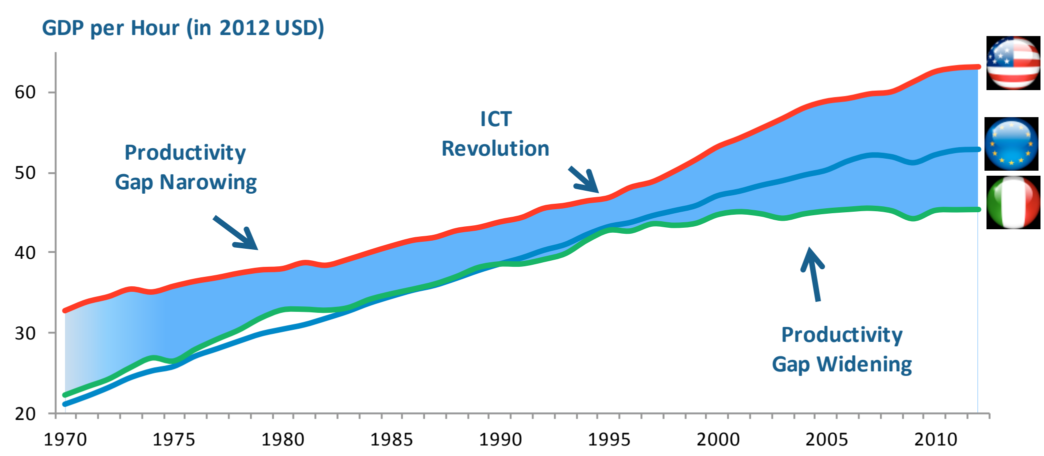
Source: UN Statistics

[1] Prepared by Andrew Tiffin (SPR).

Productivity, Innovation, and Exports

3. **Part of the key to this puzzle may lie in the nature of Italy's productivity challenge.** Although the underlying causes of Italy's poor productivity are still topics of active debate, part of the explanation most likely involves the changing nature of production, and the increased importance of innovation in maintaining sustained output growth (Aghion, 2011). As illustrated in the figure below, the Italian productivity experience is perhaps an amplified version of the (average) European experience; in which a process of trend convergence with the world leader ended in the mid 1990s, coinciding roughly with the information and communications technology (ICT) revolution (Bank of Italy, 2009). This latter development has often been described as a game-changing event—analogous to the introduction of steam or electricity—that has dramatically changed the nature of global production, and the requirements for firms and countries wishing to maintain their position at the global frontier (Crafts, 2012). In this regard, the ICT revolution has potentially expanded the scope for firms to distinguish between i) *technological competitiveness,* which is associated with the development of new products and requires substantial internal innovation (research, development, and design); and ii) *cost competitiveness*, which is associated instead with improved efficiency and lower labor costs (see Bogliacino & Pianta, 2010). For Italian firms facing increased cost-based competition from emerging-market exporters, the former is perhaps becoming more and more important.

4. **This chapter will explore the extent to which the performance of Italian exporters reflects their relative ability to innovate and adapt to a changing global environment.** Although the economy as a whole may have faced difficulty integrating and exploiting new technologies to boost performance—reflecting perhaps a broad range of structural and administrative impediments—it may be that Italian exporters have had better success. To this end, the chapter will separate Italy's exporting industries by their sources of innovation: extending the Pavitt (1984) Industrial Taxonomy, and separating each export industry into one of five separate



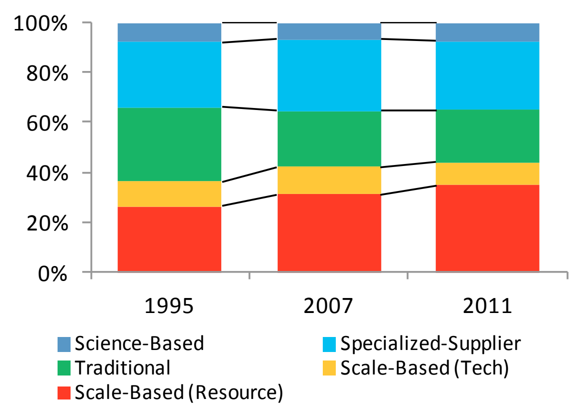
Source: The Conference Board, Total Economy Database groups[2]:

- *Science-based* industries, such as pharmaceuticals, high-end electronics, and aviation, are dominated by large firms, where innovation is typically internal to the firm and based on advances in science.
- *Specialized supplier* industries, which are often dominated by smaller firms that design, develop and produce equipment tailored specifically to a particular production process or need.
- *Traditional* industries, such as textiles, furniture, food, and basic manufactures, where internal innovation is less relevant, and new technology comes from external suppliers of equipment and material.
- *Scale-intensive* industries, where innovations are mainly derived from the exploitation of economies of scale. These can be further broken down into:
    - *Technology-based scale-intensive* industries, such as motor vehicles and other transport equipment.
    - *Resource-based scale-intensive* industries, such as industrial chemicals, refined petroleum products, basic metals, and processed foodstuffs.

5. **Italy's export mix has a substantial weight of traditional products, but also has a large proportion stemming from specialized-suppliers.** Indeed, although a key development over the past 15 years has been the shrinking importance of the traditional sector, and the growing importance of scale-intensive resource-based industries, a more singular feature of Italy's export mix is the large and stable share originating from specialized suppliers. In comparison to other countries, the share owing to these suppliers is more akin to that seen in Germany or the United States (Figure 1).

6. **It is this sector that has often been viewed as a key source of Italy's export prowess.** Firms in this sector tend to be small and medium in size, with a marked capacity for incremental innovation and a diversified range of high-quality, high-margin products with few substitutes (such as machine tools, precision instruments, and specialized machinery for industry and agriculture). Often organized within a flexible network of small firms or industrial districts, it is the inventiveness and agility of this sector that has been highlighted in the past as one of the main factors allowing Italy to maintain its relative world position.[3] This chapter will explore the extent to

Export Shares, by Industry Group



Source: COMTRADE, IMF staff calculations

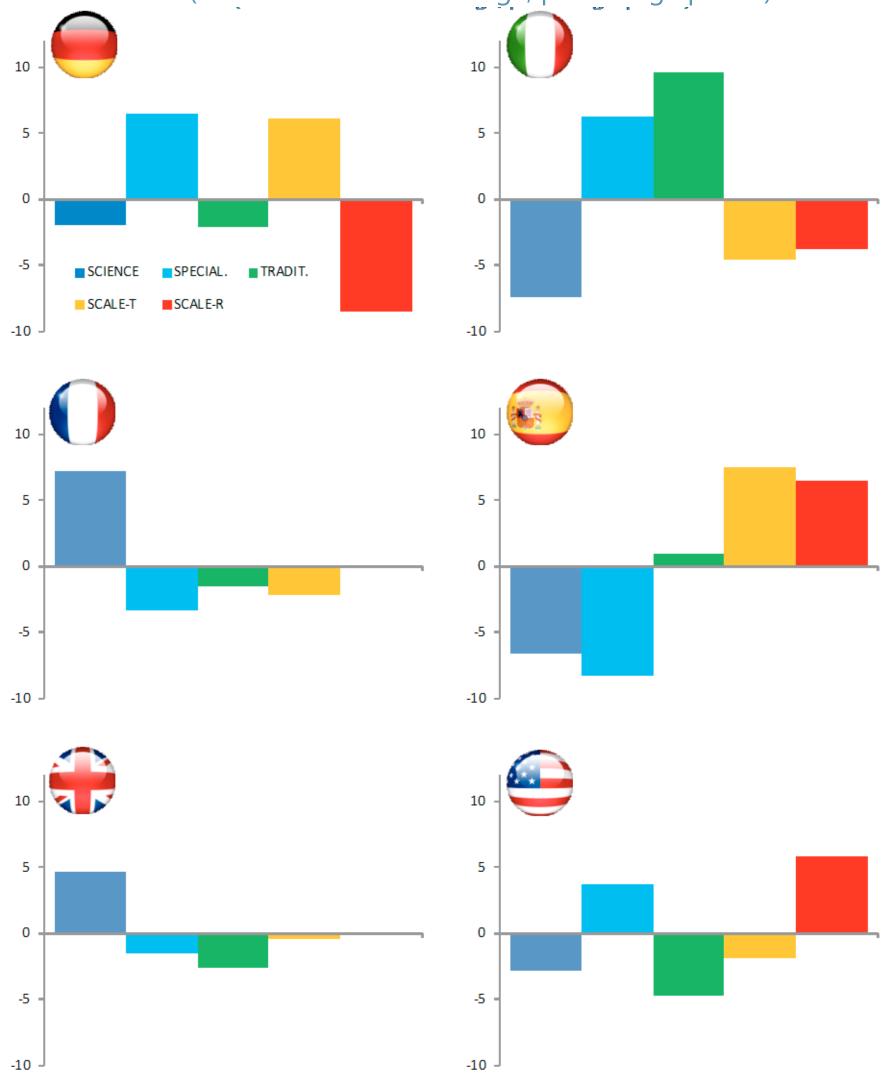
[2] See Kubielas (2007) for a Pavitt-based classification of each industry by ISIC rev.3

[3] See Porter (1990) and Ginsborg (2003).

which this sector has continued to remain competitive despite apparently adverse developments across Italy's price-based competitiveness indicators.

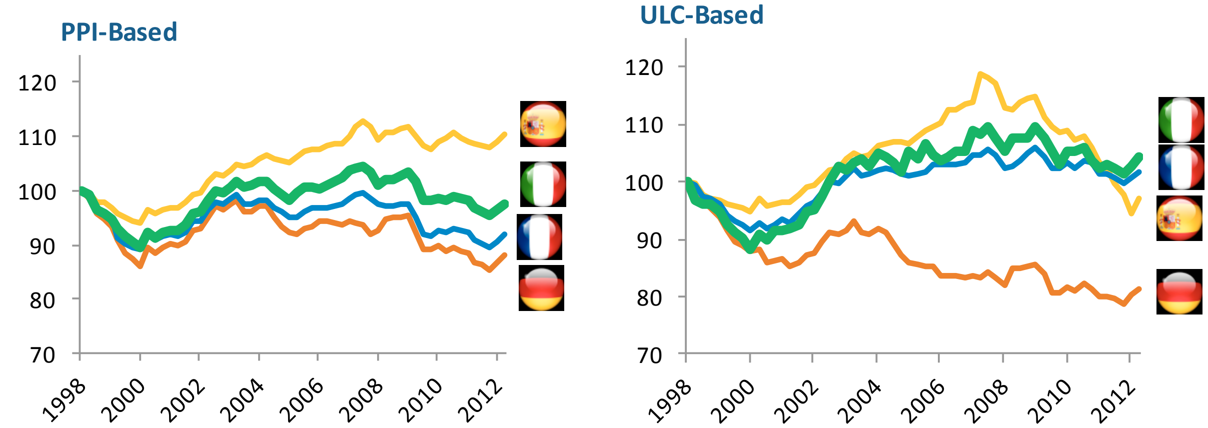
Figure 1. Export Shares, by Industry Group, 2011

(Deviation from EU average, percentage points)



Source: COMTRADE, IMF staff calculations.

Harmonized Competitiveness Indicators, 1999-2012
(Index, end 1998=100)



Source: Bank of Italy, ECB, IMF staff calculations

B. Price Competitiveness

Unit Labor Costs vs. Price-Based Measures

7. **Italy's standard price-competitiveness indicators present a mixed picture.** Although the dispersion of different competitiveness indexes is a feature in many European countries, it is particularly evident in Italy, where ULC-based indicators routinely suggest a substantially larger loss in competitiveness compared to other CPI- or PPI-based indicators (Bayoumi and others, 2011). Using a total-economy ULC-based measure, Italy's competitiveness appears to have deteriorated by up to 5 percent since adoption of the euro, compared to an improvement in Germany of nearly 20 percent. Using a PPI-based measure, on the other hand, the gap between the two countries is considerably narrower, and Italy is not materially less competitive than it was in 1999.

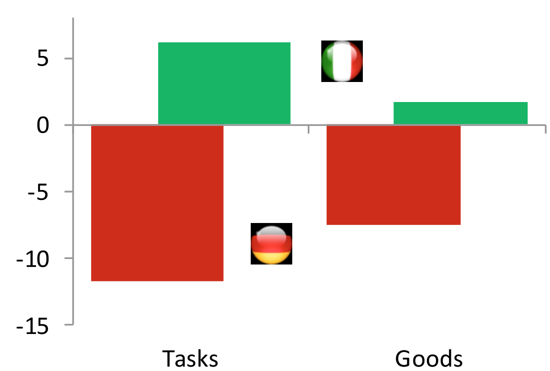
8. **Labor-cost measures may present an incomplete picture, and should perhaps be complemented.** Part of the discrepancy between the different types of measures may again reflect the changing nature of global production. In an era of globalization and international supply chains, the share of domestically employed labor in total production costs is decreasing, albeit to a different degree in different countries—indeed, wage shares in the manufacturing sector fell sharply in Germany between 1998 and 2007, but only marginally in Italy over the same period (Giordano & Zollino, 2013). Labor-cost-based indicators, therefore, may reflect a subset of costs that are perhaps becoming less and less representative, and so may not accurately represent Italy's overall price competitiveness. Arguably, then, price-based indicators may provide a better guide.

Supply-Chain Based Indicators

9. **IMF staff have developed alternative measures that address the implications of global supply chains on the assessment of price competitiveness.** Conventional measures are typically not well suited to instances when imports are used to produce exports, as they tend to assume that countries compete against each other to sell 'products' that they produce entirely at home, using only domestic inputs. A possible alternative, the "Value-added Real Effective Exchange Rate (VA-REER)," tackles this issue by adapting the usual REER framework to a world in which countries compete in the supply of value-added (or "tasks") rather than goods (Bems & Johnson, 2012). In this framework, to take the typical example, China is not competing with other countries in the supply of iPhones, but rather in the supply of final-assembly services, which form only a small portion of the iPhone's final price. Accounting for a country's supply-chain position, and improving on the (labor-focused) ULC indicator in the previous section,the VA-REER thus captures the overall *cost* competitiveness of the full range of a country's factors of production. A similar approach addresses the same issue by instead modifying the standard *price*-based REER approach, to include an additional term that reflects the role of outsourcing in offsetting the impact of domestic factor-price inflation (Bayoumi, Saito, & Turunen, 2013).This measure is therefore more focused on the actual price competitiveness of a country's gross exports, rather than its factors of production.

10. **For Italy, the differences between these alternative measures are illustrative.** Considering the cumulative Italian appreciation since adoption of the euro, the tasks-based VA-REER gives roughly the same assessment as the standard CPI-based REER. The modified price-based measure, on the other hand, suggests a substantially less-marked decline in competitiveness. This suggests that rising factor costs in Italy have not translated into an equivalent increase in the relative price of Italian goods, owing in part to role of low-cost imports from low inflation countries. Interestingly, Germany presents the opposite picture. The sharp increase in competitiveness implied by falling factor costs in Germany has not been fully matched by lower export prices, owing to the fact that Germany imports a large and increasing proportion of its inputs from countries with relatively high inflation. Looking at a wide range of indicators, therefore, the competitiveness challenge in Italy may not be as immediately dire as suggested by a focus solely on cost-based measures.

Supply-Chain Based Real Effective Exchange Rates
(Cumulative Appreciation, percent, 1999-2012)



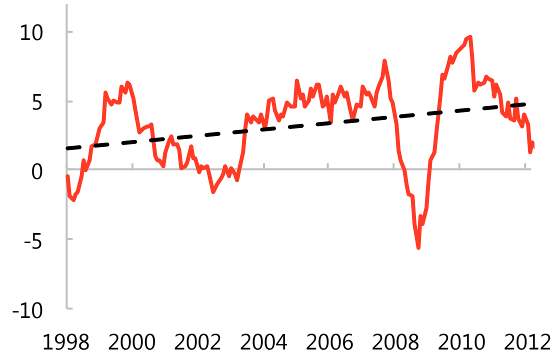
Source: Bayoumi, Saito & Turunen (2013)

C. Non-Price Competitiveness

Quality Indicators

11. **The relative strength of Italian exporters may also reflect their ongoing efforts to fend off competition by upgrading the quality of their products.** Past IMF staff research has emphasized the important role of non-price factors in supporting Italy's export performance (Lissovolik, 2008), and quality upgrades have featured prominently in this regard (Codogno, 2009). Export quality cannot be observed directly, but the clearest evidence of this trend is in the persistent upward movement of export unit values, which are generally taken as a key proxy for quality. Indeed, averaging across all export sectors, unit values in Italy are around 1½ times higher than the global mean.[4]

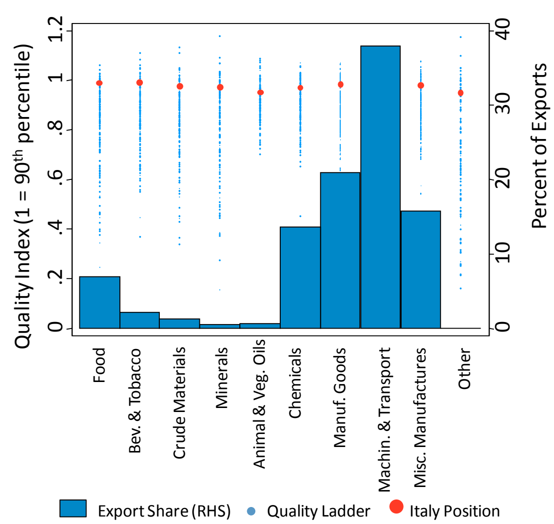
Export Unit Value
(percent change, y/y)



Source: ISTAT, IMF staff calculations

12. **Recent IMF staff research confirms Italy's continued success in maintaining the high quality of its export mix.** Although unit values are useful, they are a somewhat noisy indicator of quality, as they also reflect a range of other factors, including cost differences. Henn, Papageorgiou, & Spatafora (2013) calculate a more consistent, less noisy, set of quality indicators; based on unit values, but estimated within a sector-specific gravity-equation framework. The results suggest that Italy remains at the top of the global quality ladder across all its major exports, even those associated with more *traditional* industries.

Italy: Export Quality by Sector, 2009



Source: Henn, Papageorgiou & Spatafora (2013)

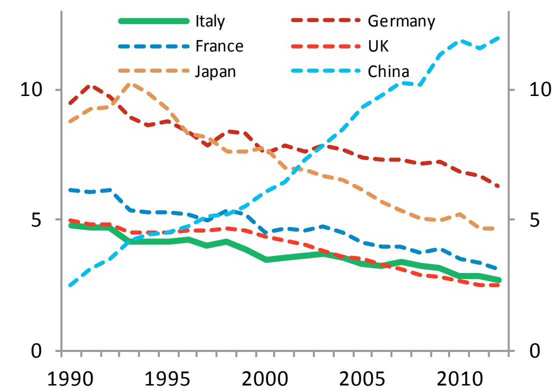
[4] WTO/UNCTAD relative unit-value data is available at http://www.intracen.org/country/italy/

D. Market-Share Dynamics

Shift-Share Analysis

13. **In light of the mixed picture presented above, perhaps a more telling indicator of Italian competitiveness is the actual evolution of its global market share.** But a simple investigation of markets shares raises the following issue: two countries with similarly competitive exporting firms may nonetheless display different performances over the short- to medium-term, if one has a more favorable mix of products (at the time), or if it exports to a particularly dynamic set of destinations. A more representative measure of a country's underlying competitiveness, therefore, will strip out such product and geographical effects.

Share of World Exports (percent)



Source: DOTS, IMF staff calculations

14. **The following analysis employs a shift-share approach to arrive at an "adjusted" measure of market-share growth.** Also known as constant market-share analysis (CMSA), shift-share analysis (SSA) is an econometric approach that allows the decomposition of changes in a country's market share over time. The key intuition is that a country's export growth does not occur in a vacuum, but is shaped instead by: the growth of world trade itself; the country's mix of trading partners; and the bundle of goods that it exports. Keeping all these factors constant, a country's market share should also remain constant—but if it decreases even after for controlling for its export/destination mix, then this adjusted market share serves as a key sign that the country's exporters are underperforming. In the following analysis, market shares are measured in value terms, and so incorporate the quality improvements outlined above.

15. **The approach is based on a fixed-effects regression of detailed bilateral trade flows.** Drawing on the methodology outlined by Cheptea (2005) and revised by Bricongne and others (2013), the methodology starts with the following equation:

$$\dot{X}_{ijkt} = \alpha_{it} + \beta_{jt} + \gamma_{kt} + \varepsilon_{ijkt}$$

Where α_{it}, β_{jt}, and γ_{kt} are exporter, importer, and product fixed effects that can vary across time. The dependent variable $\dot{X}_{ijkt}$ is disaggregated export growth; based on a mid-point measure so as to take into account the possibility of entry and exit from a particular export line (i.e. the extensive margin of trade). For any country, estimation of these fixed effects allows the decomposition of market-share growth into three separate components:

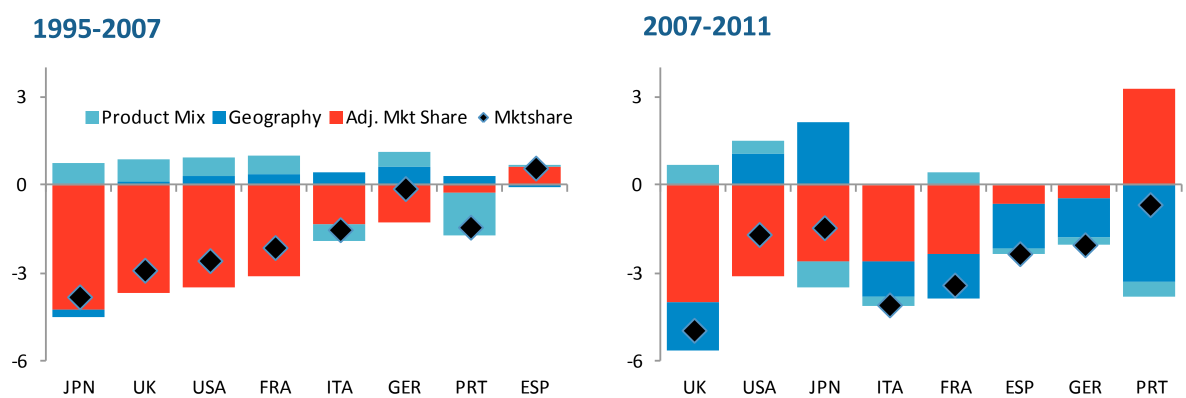
- A sectoral component measuring growth due to the mix of products exported
- A geographical component capturing changes due to the distribution of trading partners.
- An "adjusted" market share, or performance component that reflects growth due to a country's underlying price and non-price competitiveness.

The estimation draws from the bilateral dataset developed by Gaulier & Zingano (2010), which provides reconciled values of all international trade flows for about 5000 product headings from the 6-digit Harmonized System (HS) classification over the years 1995-2011 (See Appendix I for a more detailed treatment of the methodology and dataset).

Results

16. **Looking at exports as a whole, Italy's market share has historically been weighed down by an unfortunate export mix**. Like most other advanced-market countries, Italy's share of global exports has fallen with the introduction of emerging-market exporters into the global trading system. A detailed decomposition of growth rates for a number of countries is presented in Table 1, but for the pre-crisis period (1995-2007), the figure below suggests that Italy has generally managed to orient its exports to markets with a rapidly expanding demand for imports, while its product mix has been biased towards products where growth has been less dynamic.[5] Taking these two effects into account, it appears that Italy's adjusted market share measure, although disappointing, is not as critical as it might appear at first. Indeed, its underlying competitiveness compares favorably to countries such as France or the United Kingdom, and is broadly comparable to that of Germany. Looking at export-share developments over the post crisis period (2007-2011), most European countries suffered from a sudden downturn in demand from their main export partners. And again, Italy seems to have been additionally held back by a poor product mix, but the adjusted measure is nonetheless broadly in line with that of France or the United States, where price-competitiveness measures have typically been more favorable than those in Italy.

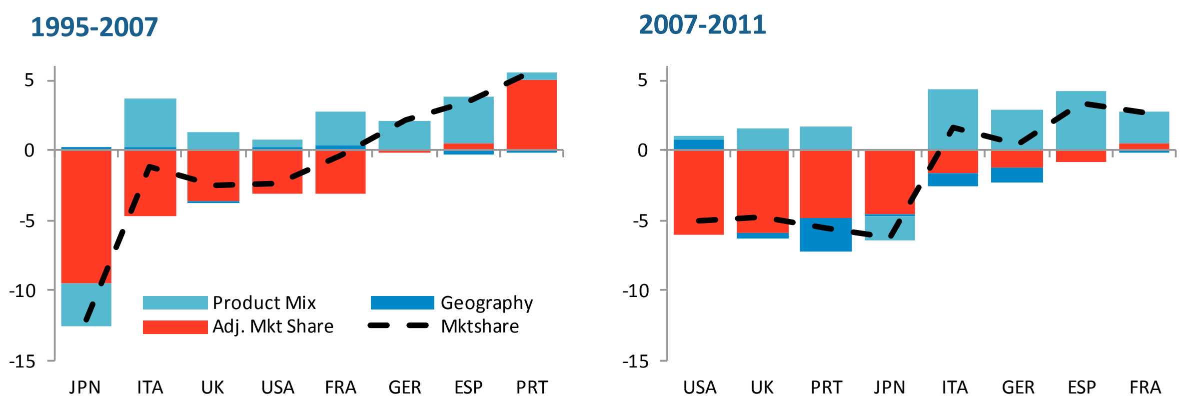
Decomposition of Market Share Growth, All Exports
(percent annualized)



[5] The sample length is chosen to take advantage of the full dataset, but it should be noted that his period includes the years previous the introduction of the euro, when Italian exports were still benefiting from the lira devaluation of the early-1990s. The devaluation may have created some room for the loss of competitiveness recorded in the subsequent years.

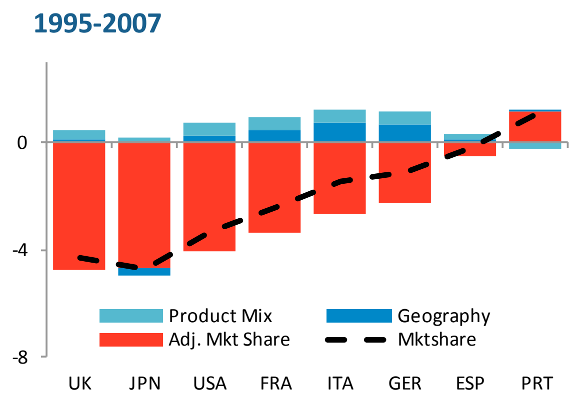
17. **Focusing on science-based industries, Italian exporters have generally been much more successful in targeting products with better prospects for growth.** Indeed, Italy has mostly managed to maintain or even increase its market share in this sector. But this represents only a small fraction of Italian exports, and the adjusted market-share measure paints an even less rosy picture; suggesting that exporters in this sector are still being held back by an underlying lack of competitiveness.

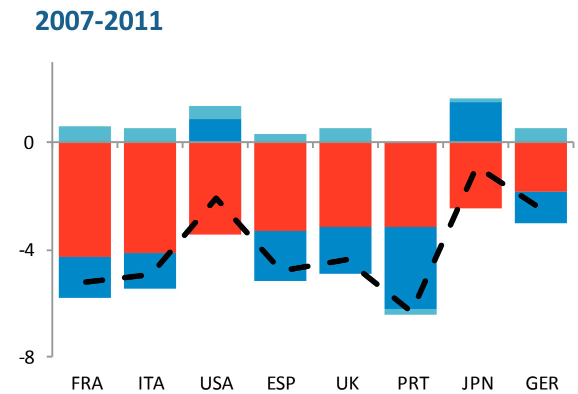
Decomposition of Market Share Growth, Science-Based Exporters
(percent annualized)



18. **Turning to specialized suppliers, Italy again seems to have had some success in focusing on high-growth products, but the underlying competitiveness measure is nonetheless worrisome.** In context, the competitiveness of the sector is perhaps not an issue of critical concern—as it still fares favorably compared to countries like France and the United Kingdom, and historically is not too far removed from Germany. But looking forward, the fact that weak competitiveness continues to erode Italy's global market share suggests that specialized-supplier exports may not be the source of strength that they once were. Partly, this may be the cumulative result of the distortions, rigidities, and administrative impediments that have helped stifle growth in the broader Italian economy; and which are now weighing even on this once-dynamic sector. Alternatively, it may also reflect the changing nature of global production; where larger scale firms tend to be more successful in generating worldwide brand recognition, securing access to finance, and integrating into global supply chains. And where small firm size—which once helped ensure the agility and resilience of the Italian export sector—is now less of an asset. Indeed, from a policy viewpoint, if firm size and global reach are now more important, there is perhaps a growing need for structural reforms that can remove the barriers to firm growth and encourage inward FDI. These reforms would also help the science-based sector described above, which appears relatively successful, but so far is only a small part of Italy's export base.

Decomposition of Market Share Growth, Specialized Product Exporters
(percent annualized)





E. Conclusion

19. **In Italy, as in many countries, price-based competitiveness measures have not always served as an accurate guide to subsequent trade developments.** These measures, such as relative unit labor costs, are simple to communicate and are often linked closely to the instruments available to policy makers. But globalization is reshaping the relationship between trade performance and price factors, with the latter providing less and less explanatory power for export growth (Di Mauro and others, 2008).

20. **This chapter has offered a more comprehensive assessment of Italy's competitiveness.** In light of the dispersion of Italy's price-based indicators, it is perhaps more instructive to look at the actual evolution of Italy's export market share; focusing in particular on the non-price factors—such as quality, innovation, and flexibility—that have underpinned Italy's success in the past. The overall appraisal is that Italian competitiveness is indeed a matter of concern; although perhaps not as critical as some assessments have claimed. Italy still maintains a high-quality export mix, and the adaptability of Italian firms is still a source of strength. But even the most innovative and flexible sectors are being weighed down by the structural impediments that have depressed Italian productivity more broadly. Italy's future competitiveness will thus depend on the institutional and macroeconomic conditions that allow productive firms to innovate, expand, and attract inward FDI; which in turn will require the successful implementation of the authorities' full structural- and institutional-reform agenda.

Table 1. Changes in World Market Share and Shift-Share Decomposition: Large Exporters, 1995.2011

(Annualized growth, percentage points)

		Market Share	Adjusted Mkt Share	Structural Effects	
				Geography	Product Mix
All Export Industries					
China	1995-2007	8.6	12.8	-1.8	-2.0
	2007-2011	5.1	6.6	0.0	-1.4
France	1995-2007	-2.1	-3.1	0.4	0.6
	2007-2011	-3.4	-2.4	-1.5	0.4
Germany	1995-2007	-0.1	-1.3	0.6	0.5
	2007-2011	-2.0	-0.5	-1.3	-0.3
Italy	1995-2007	-1.5	-1.4	0.4	-0.6
	2007-2011	-4.1	-2.6	-1.2	-0.3
Japan	1995-2007	-3.8	-4.3	-0.2	0.7
	2007-2011	-1.5	-2.6	2.1	-0.9
Portugal	1995-2007	-1.4	-0.3	0.3	-1.4
	2007-2011	-0.7	3.3	-3.3	-0.6
Spain	1995-2007	0.6	0.6	-0.1	0.1
	2007-2011	-2.3	-0.6	-1.5	-0.2
United Kingdom	1995-2007	-2.9	-3.7	0.1	0.8
	2007-2011	-5.0	-4.0	-1.7	0.7
USA	1995-2007	-2.6	-3.5	0.3	0.6
	2007-2011	-1.7	-3.1	1.1	0.4
Science-Based Industries					
China	1995-2007	15.7	21.1	-1.1	-3.4
	2007-2011	6.3	11.5	0.3	-5.0
France	1995-2007	-0.4	-3.1	0.3	2.4
	2007-2011	2.6	0.4	-0.1	2.3
Germany	1995-2007	2.1	0.0	0.1	2.0
	2007-2011	0.4	-1.3	-1.1	2.8
Italy	1995-2007	-1.2	-4.7	0.2	3.4
	2007-2011	1.6	-1.7	-0.9	4.3
Japan	1995-2007	-12.1	-9.5	0.3	-3.1
	2007-2011	-6.3	-4.6	-0.1	-1.6
Portugal	1995-2007	5.6	5.0	0.0	0.6
	2007-2011	-5.5	-4.9	-2.3	1.7
Spain	1995-2007	3.4	0.5	-0.4	3.3
	2007-2011	3.3	-0.9	0.0	4.3
United Kingdom	1995-2007	-2.6	-3.6	-0.2	1.2
	2007-2011	-4.7	-6.0	-0.3	1.6
USA	1995-2007	-2.4	-3.1	0.2	0.5
	2007-2011	-5.0	-6.0	0.7	0.3

Source: IMF Staff calculations using BACI database, developed by Gaulier & Zingano (2010)

Table 1 (cont.). Changes in World Market Share and Shift-Share Decomposition: Large Exporters, 1995.2011

(Annualized growth, percentage points)

		Market Share	Adjusted Mkt Share	Structural Effects	
				Geography	Product Mix
Specialized Supplier Industries					
China	1995-2007	13.0	15.2	-1.4	-0.5
	2007-2011	6.5	7.3	-0.2	-0.6
France	1995-2007	-2.5	-3.4	0.5	0.5
	2007-2011	-5.2	-4.3	-1.5	0.6
Germany	1995-2007	-1.1	-2.2	0.7	0.5
	2007-2011	-2.5	-1.8	-1.2	0.5
Italy	1995-2007	-1.5	-2.7	0.7	0.5
	2007-2011	-4.9	-4.1	-1.3	0.5
Japan	1995-2007	-4.7	-4.7	-0.3	0.2
	2007-2011	-0.9	-2.5	1.5	0.2
Portugal	1995-2007	1.0	1.1	0.1	-0.2
	2007-2011	-6.3	-3.2	-3.1	-0.2
Spain	1995-2007	-0.2	-0.5	0.1	0.2
	2007-2011	-4.8	-3.3	-1.9	0.3
United Kingdom	1995-2007	-4.3	-4.7	0.1	0.3
	2007-2011	-4.4	-3.2	-1.7	0.5
USA	1995-2007	-3.4	-4.0	0.2	0.5
	2007-2011	-2.1	-3.4	0.8	0.5
Traditional Industries					
China	1995-2007	5.4	8.6	-1.9	-1.0
	2007-2011	3.4	4.3	-0.4	-0.4
France	1995-2007	-1.9	-2.6	0.6	0.1
	2007-2011	-3.5	-3.0	-0.7	0.2
Germany	1995-2007	0.1	-2.0	1.4	0.8
	2007-2011	-3.1	-2.2	-0.2	-0.7
Italy	1995-2007	-2.2	-2.5	0.5	-0.3
	2007-2011	-5.1	-4.4	-0.6	-0.2
Japan	1995-2007	-4.2	-4.7	0.3	0.1
	2007-2011	0.4	-2.9	3.5	-0.1
Portugal	1995-2007	-3.7	-4.0	0.8	-0.4
	2007-2011	-1.5	1.6	-2.2	-0.9
Spain	1995-2007	0.7	0.4	0.6	-0.3
	2007-2011	-1.7	-0.7	-0.5	-0.6
United Kingdom	1995-2007	-2.9	-4.5	1.1	0.5
	2007-2011	-5.3	-4.7	-1.4	0.7
USA	1995-2007	-2.9	-5.6	1.8	1.1
	2007-2011	-0.5	-2.1	0.9	0.7

Source: IMF Staff calculations using BACI database, developed by Gaulier & Zingano (2010)

Table 1 (cont.). Changes in World Market Share and Shift-Share Decomposition: Large Exporters, 1995.2011

(Annualized growth, percentage points)

		Market Share	Adjusted Mkt Share	Structural Effects	
				Geography	Product Mix
Scale-Intensive Technology-Based Industries					
China	1995-2007	14.6	17.4	-2.4	0.0
	2007-2011	14.3	11.4	1.4	1.3
France	1995-2007	-2.3	-2.6	0.3	0.0
	2007-2011	-6.7	-3.8	-2.7	-0.2
Germany	1995-2007	0.8	0.4	0.4	0.0
	2007-2011	-0.5	1.1	-1.2	-0.4
Italy	1995-2007	-0.7	-0.1	-0.5	0.0
	2007-2011	-5.7	-4.3	-1.4	0.0
Japan	1995-2007	-3.1	-2.3	-0.8	0.1
	2007-2011	-2.3	-4.4	2.3	-0.1
Portugal	1995-2007	-0.2	0.3	-0.7	0.1
	2007-2011	3.9	8.9	-4.1	-0.4
Spain	1995-2007	-0.3	0.5	-0.9	0.0
	2007-2011	-4.0	-2.1	-1.7	-0.4
United Kingdom	1995-2007	-0.7	-0.3	-0.4	0.0
	2007-2011	-2.7	-1.2	-1.2	-0.3
USA	1995-2007	-2.0	-3.0	1.1	-0.1
	2007-2011	-0.3	-1.0	1.0	-0.2
Scale-Intensive Resource-Based Industries					
China	1995-2007	8.2	11.0	-2.2	-0.3
	2007-2011	3.1	4.3	0.6	-1.7
France	1995-2007	-2.7	-3.1	0.2	0.2
	2007-2011	-4.0	-2.1	-1.8	-0.1
Germany	1995-2007	-0.9	-1.4	0.5	-0.1
	2007-2011	-2.4	-0.3	-1.6	-0.5
Italy	1995-2007	-0.8	-1.0	0.2	0.0
	2007-2011	-3.3	-0.9	-1.7	-0.6
Japan	1995-2007	-1.8	-1.4	-0.7	0.3
	2007-2011	0.4	-1.2	2.9	-1.2
Portugal	1995-2007	0.6	1.0	0.7	-1.1
	2007-2011	0.9	3.9	-2.6	-0.3
Spain	1995-2007	1.0	1.5	-0.1	-0.4
	2007-2011	-1.3	1.1	-1.9	-0.6
United Kingdom	1995-2007	-3.1	-3.6	0.1	0.4
	2007-2011	-6.1	-4.7	-1.8	0.3
USA	1995-2007	-2.5	-2.4	0.0	-0.1
	2007-2011	-0.2	-1.9	1.1	0.6

Source: IMF Staff calculations using BACI database, developed by Gaulier & Zingano (2010)

Annex 1. Shift-Share Analysis and Competitiveness (from ECB, 2012)

The method envisages a decomposition of export growth based on a weighted variance analysis (ANOVA) of bilateral export data, disaggregated by product. The methodology is based on Cheptea and others (2005), and seeks to identify the export growth of each exporting country as if all exporters had the same geographical and sectoral specialization. This is important for export data, as export growth rates are affected by structural effects: exporters with strong positions in the most dynamic destination markets or specialized in high-growth sectors benefit, ceteris paribus, from stronger grch 1owth. With this methodology, "pure" exporter performance can be assessed separately from geographical and sectoral effects. The computation of the method consists of four main steps:

Step 1: Compute mid-point growth rates

For a country *i* exporting a value *x* to a country *c* of product *k* at time *t*, the mid-point growth rate is defined as follows:

$$g_{ickt} = \frac{x_{ickt} - x_{ick(t-1)}}{\frac{1}{2}\left(x_{ickt} + x_{ick(t-1)}\right)}$$

Similarly, the weight attributed to each flow g_{ickt} is given by the relative share of the flow in total exports, where total refers to the exports of the whole sample of countries:

$$s_{ickt} = \frac{x_{ickt} - x_{ick(t-1)}}{\left(\sum_c \sum_i \sum_k x_{ickt} + \sum_c \sum_i \sum_k x_{ick(t-1)}\right)}$$

The year-on-year growth rate of the total value of world exports is given by summing each individual flow g_{ickt} weighted by s_{ickt}.

Step 2: Fixed-effect regression

Starting from a dataset disaggregated by destination and sector (or product), the ANOVA methodology is used to decompose export growth into a sectoral effect, a geographical effect and a pure export competitiveness effect. Specifically, the mid-point growth rate is regressed on three sets of fixed effects, i.e. exporter, importer and sector/product fixed effects, here denoted with the letter *f* by means of a weighted OLS estimation. A separate regression is carried out for each year in the data. Hence, if α is the intercept, φ is the regression coefficient for exporter fixed effects, β the one for importer fixed effects, γ the one for product/sector fixed effects, and ε the error term, this can be written as：

$$g_{ickt} = \alpha + \sum_i \varphi_i f_i + \sum_c \beta_c f_c + \sum_k \gamma_k f_k + \varepsilon$$

The terms f_i , f_c and f_k are the exporter country, importer country and sector-specific fixed effects, respectively. In the regression, one exporter *i*, one importer *c* and one sector *k* is omitted to avoid perfect multicollinearity with the constant term α. The constant term α corresponds to the export growth of the reference country and the coefficients have to be interpreted as deviations from the performance of this country. In Step 3, however, the effects are normalized so as to quantify them as deviations from the average growth rate of exports for the overall sample in the dataset (in our case this roughly corresponds to world export growth).

Step 3: Computation of the indices from the estimated coefficients

From the estimated coefficients, growth is decomposed for each exporter (i.e. aggregating destination and product dimensions). First, however, the coefficients need to be normalized. Below, φ_i^t indicates the performance for exporter i relative to the omitted destination and sector. By contrast, $\hat{\varphi}_i^t$ is the marginal average for i's performance independent of the choice of omitted destination. It gives the export growth that country i would have if its geographical and sectoral specialization were equal to the average for the full sample. This is our measure of export performance (competitiveness). To obtain such a term, least-squares is needed which means computation. In other words, for each exporter i, a normalized coefficient is needed for the fixed effects, by summing them up to a constant term equal for all i's and to the weighted mean of the partner and product effects (weights are selected as above). This method generates identical results regardless of the choice of the omitted term in the estimation procedure, so that:

$$\hat{\varphi}_i^t = \alpha^t + \varphi_i^t + \sum_c s_{ic}^t \beta_c^t + \sum_k s_{ik}^t \gamma_k^t$$

This then allows the decomposition of a country's export growth into three components:

$$g_i^t = \sum_{c,k} g_{ick}^t s_{ick}^t = \hat{\varphi}_i^t + \sum_c s_{ic}^t \tilde{\beta}_c^t + \sum_k s_{ik}^t \tilde{\gamma}_k^t$$

Where $\tilde{\beta}_c^t = \beta_c^t - \sum_c s_c \beta_c^t$ and $\tilde{\gamma}_k^t = \gamma_k^t - \sum_k s_k \gamma_k^t$. The first component is the adjusted export growth rate, and the second and third components are the geographical and product-mix effects, respectively. The sum of annual growth rates provides the cumulative change over time so that:

$$g_i^{95-07} = \sum\nolimits_t \sum\nolimits_{c,k} g_i^t = \sum\nolimits_t \hat{\varphi}_i^t + \sum\nolimits_t \sum\nolimits_c s_{ic}^t \tilde{\beta}_c^t + \sum\nolimits_t \sum\nolimits_k s_{ik}^t \tilde{\gamma}_k^t$$

The change in export shares is then simply the country-specific growth rate, less the overall growth rate of world trade.

Data

The analysis draws from the BACI product-level database developed from COMTRADE data by Gaulier & Zingano (2010), which provides reconciled USD flow figures on more than 200 countries over roughly 5000 products of the Harmonized System (HS) classification. Following Cheptea and others (2012), flows below USD10,000 and those involving micro states are excluded, as are mineral, specific and non-classified products. For the regressions, 6-digit product data are aggregated down to the 2-digit level.[6]

[6] This implies that, for 2-digit categories containing a large set of products, any product-mix effect that happens within the 2-digit category will be captured by the residual component (adjusted market share) and not by the product-mix component. For a more complete discussion of the caveats associated with this methodology, please see Cheptea and others (2012).

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JUDICIAL SYSTEM REFORM—A KEY TO GROWTH[1]

The inefficiency of the Italian judicial system has contributed to reduced investments, slow growth and a difficult business environment. The enforcement of civil and commercial claims suffers from excessive delays in court proceedings, resulting in a very large number of pending cases. The Italian authorities have over the years taken steps to remove bottlenecks and speed up judicial proceedings. While these measures are generally steps in the right direction, shortcomings remain. To address these, consideration could be given to, inter alia, reviewing court fees, further improving the new mandatory mediation scheme, strengthening court management, and reforming the appeal system.

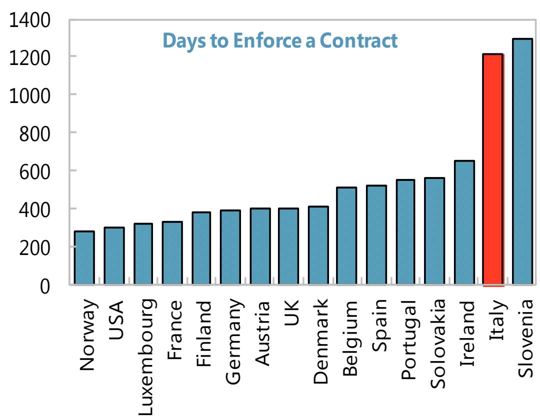
A. The Italian Justice System—A Contributor to a Difficult Business Environment

1. **An efficient justice system is essential for sustained economic growth.** A well-functioning, independent and efficient justice system is one where decisions are taken within a reasonable time, are predictable and effectively enforced, and where individual rights, including property rights, are properly protected.[2] As further elaborated below, improving the efficiencyof the judicial system can help improve the business climate, foster innovation, attract FDI, secure tax revenues and support economic growth. This paper focuses on the enforcement of civil and commercial claims in Italy as a key way to improve the environment for sustaining economic growth.

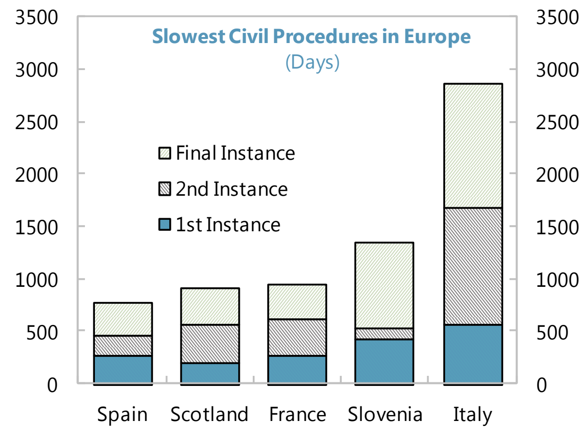
2. **The performance of the Italian justice system is well below European and OECD averages.** Of note, it takes an average of 1,200 days to enforce a contract in Italy, more than twice the OECD high-income country average (OECD, 2013, and Council of Europe's European Commission for the Efficiency of Justice (CEPEJ), 2012). Similar statistics from the 2013 EU Justice Scoreboard show that relative to its European peers, Italy scores poorly on the time needed to resolve administrative, civil and commercial cases. The OECD average to complete a civil case up to the Supreme Court level is 788 days, while it is almost 8 years in Italy (OECD, 2013). As a result,

[1] Prepared by Sergi Lanau (EUR), Gianluca Esposito (LEG), and Sebastian Pompe (LEG consultant). This paper has benefited from comments and inputs received from Kenneth Kang, Ross Leckow, Yan Liu, Justin Tyson, and David Velazquez-Romero. The authors would also like to thank the staffs of the Italian Ministry of Economy and Finance, the Ministry of Justice, and the Bank of Italy for helpful discussions and suggestions.

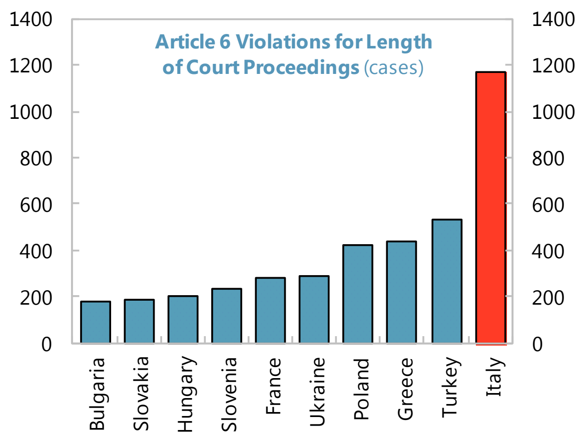
[2] See, for instance, Article 6 and Article 1 of Protocol No. 1 of the European Convention on Human Rights.



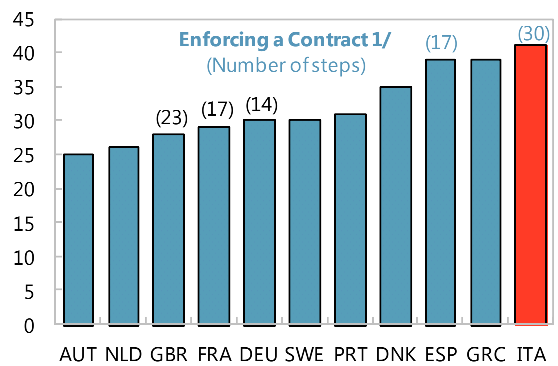
Source: Doing Business, 2013



Source: OECD (2013).



Source: ECtHR.



Source: Doing Business, 2012
1/ Cost of litigation, defined as the percent of dispute value shown in brackets where available.

Italy is the country with the highest number of violations of the “reasonable time” requirement enshrined in Article 6 of the European Convention on Human Rights (ECHR). The Fraser Institute ranks Italy 112th in terms of legal enforcement of contacts and the World Economic Forum (2013 Report) ranks it 139th in terms of the efficiency of the legal framework. While 2012 has witnessed a reduction in the number of pending cases in courts, these numbers remain high overall, with 9.7 million pending cases, including about 5 million pending civil cases (end 2012 figures).[3]

3. **The economic literature has established a positive link between the efficiency of the judicial system and growth.** Growth is projected to average 0.7 percent during 2013–18 and in the absence of deeper structural reforms potential growth is estimated at around ½ percent. A number

[3] For data on the number of pending civil and criminal cases in Italy, see Ministry of Justice data and the Report of the Italian Senate, *Dati statistici relative all-amministrazione della giustizia in Italia (*May 2013). By the end of 2011, there were also about 870,000 pending tax-related cases before the various organs of the “*giustizia tributaria*” (See the *“Relazione di monitoraggio sullo stato del contenzioso tributario e sull’attivita’ delle commissioni tributarie (2011)”*).

of factors unrelated to the judicial system are relevant to understand the dynamics of Italian growth (e.g., ageing population and public-administration inefficiencies), but a large body of literature suggests that weaknesses in the judicial system also adversely affect growth. The key channels linking the judicial system and growth are:

- **Foreign direct investment.** Inward FDI is positively correlated with the quality of legal institutions (Bénassy-Quéré et al., 2007). In turn, FDI has been linked to better growth outcomes (Lim, 2001). Inward FDI is indeed low in Italy and the judicial system may be one of the factors deterring foreigners from investing in the country. Annual FDI inflows over 2005-11 were about $^{1}/_{3}$ of the euro area average as a percent of GDP.

- **Development of credit markets and cost of credit.** Weak contract enforcement makes banks reluctant to lend, increases the cost of borrowing, and shortens maturities (Bae and Goyal, 2009; Laeven and Majnoni, 2003), with a detrimental impact on investment and GDP (Bianco et al., 2002; Laeven et al., 2003; Djankov et al., 2008).

- **Firm size.** There is a positive correlation between the quality of the judicial system and firm size (Kumar et al. 2001, Beck et al. 2006). Weak incentives to invest and hire workers under uncertain contract enforcement and costly dismissal procedures are two factors that could explain this correlation.[4] Italy certainly fits the pattern: SMEs account for nearly 70 percent of value added and, as discussed above, the judicial system is inefficient along many dimensions. Giacomelli and Menon (2012) use differences in court efficiency across Italian municipalities to establish a causal link and estimate that halving the length of civil proceedings could increase average firm size by 8–12 percent.

- **Weak enforcement reinforces vulnerabilities**. Weak enforcement leads to late payments, which triggers liquidity issues, bumps up insolvency and increases unemployment. The so-called "culture of late payments" is closely linked to a weak enforcement system (Intrum Justitia, 2013).

- **Entrepreneurship and innovation.** Ardagna and Lusardi (2008) establish a link between entrepreneurship rates and the efficiency of the judicial system using micro data for a sample of countries including Italy. Berkowitz et al. (2006) find that stronger contract-enforcement institutions are positively correlated with more complex exports and less sophisticated imports. The structure of exports suggests that entrepreneurship and innovation may suffer from judicial-system inefficiencies in Italy: high-technology products account for only 7 percent of manufactured exports, 9 percentage points below the OECD average.

[4] In the case of Italy, long judicial proceedings for worker dismissals result into higher firing costs for firms with more than 15 employees.

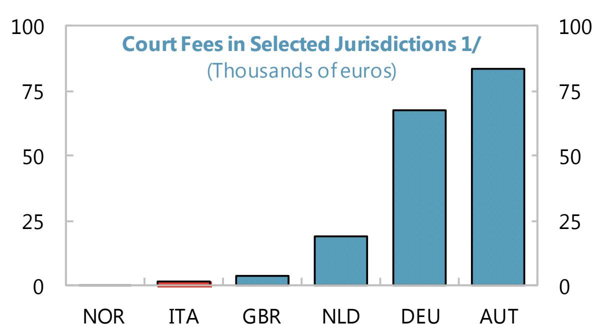
B. Diagnostic and Possible Remedies

4. **This section highlights the main reasons for the inefficiency of the Italian judicial system.** It then describes the measures taken by the authorities to address some of the shortcomings, and concludes by making recommendations for further reforms that the authorities could consider.

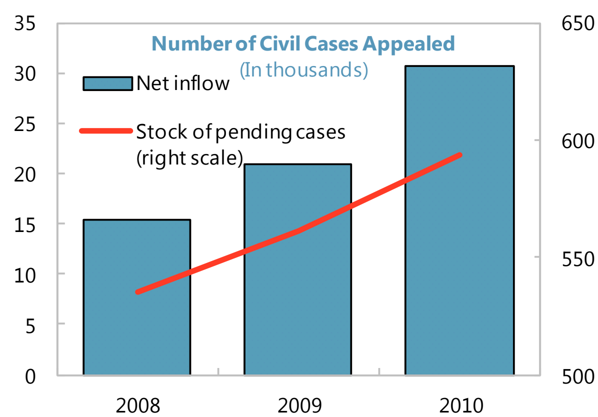
Main reasons for the inefficiency and bottlenecks

5. **A combination of large number of courts and low court fees has been a source of inefficiency.** Italy has the second highest number of courts in the EU (1,231 first instance courts of general jurisdiction (CEPEJ, 2012) and it has traditionally had low court fees.[5] Low court fees have a dual effect: they lead to larger inflow of cases and a higher appeal rate, and they increase public expenditure, since only a very small part of costs are passed on to the market. The issue of court fees is now being re-considered in Italy.

6. **Another source of inefficiency is the large number of pending cases in courts.** This is mainly due to the high inflow of cases, low clearance rates, and extended disposition time[6] (Checchi, 1975; Chiarloni, 1999). The inflow is very high both in first instance courts and in appellate courts. The latter results from the ease with which the parties can appeal first instance decisions or "jump" directly to the Court of Cassation.[7] Easy access to the Court of Cassation has increased its inflow of cases from 3,000 per year in the 1960s to nearly 30,000 in recent years (Chiarloni, 1999).



Sources: Faure and Moerland (2006),; Ministry of Justice.
1/ High value commercial claims (> €3mn). For the UK data cover England and Wales only. The amounts are indicative since they vary according to the type of cases, thresholds and degrees of jurisdiction.



Source: Dati statistici relativi all'amministrazione della giustizia in Italia, Servizio Studi del Senato.

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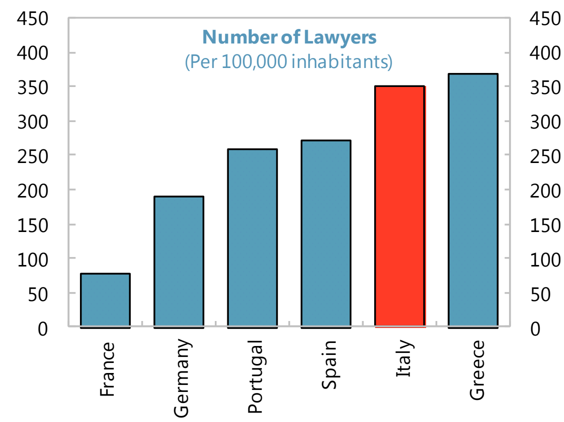
[5] The share of court fees in supporting court expenditure ranked Italy in the bottom 6 countries of Council of Europe states in 2012 (OECD 2013:110, MoJ 2012).

[6] Time needed to bring the case to an end.

7 The "Corte Suprema di Cassazione" or Court of Cassation is the highest court in the Italian judicial system. It ensures, among others, "the correct application of the law and its uniform interpretation, together with the unity of the national law and the respect of the boundaries among the various national jurisdictions."

7. **Also, the number of practicing lawyers in Italy is very high.** This is considered one of the factors behind the high number of incoming cases (Lupo, 2012).[8]



Source: CEPEJ.

8. **The workload of appeal courts is steadily increasing** with very limited scope to reduce the inflow in the near future, despite several legislative interventions.[9] Law 83/2012 introduced new measures aimed, *inter alia*, at rationalizing the appeal system. In particular, the law provides that, with a number of exceptions,[10] a case shall be excluded from appeal "*if it does not have a reasonable chance of being accepted*". The question, however, is how a court of appeal can determine, at first sight, whether an appeal has reasonable chances of being accepted, without actually re-litigating the case in full again or at least re-hearing the parties (even if in summary form) and thus determine whether it meets the test of inadmissibility. In addition, a dismissal may be appealed—again—before the Court of Cassation.

9. **An important factor which boosts litigation is the relatively unpredictable outcome of court cases.** Reports indicate that the high volume of cases at the Court of Cassation, in combination with frequent legislative changes, make it extremely hard for the Court of Cassation to deliver on its mandate of ensuring legal consistency. Also, the lengthy court process invites situations in which conflicting case law co-exists for a long time before an issue is finally settled before the Court of Cassation. This weakens respect for case-law, which in turn invites litigation and undermines confidence of both individual and businesses in the justice system as a whole (Muiznieks 2012).

10. **Complex and lengthy court procedures contribute to delays in court proceedings and in the enforcement process.[11]** The regime is characterized, on the one hand, by rigidity, and, on the

[8] See the statement by the President of the Court of Cassation of January 2013, on "The administration of justice in 2012", page 32.

[9] The measures have shifted the burden to the appeal courts (Szego, 2008) where Italy has a high reversal rate (i.e. the rate at which appeal court overturn lower court decisions) that is twice as high as France's (34.54 versus 11.74). A high reversal rate incentivizes appeals. The inflow of appeals cannot be solely tied to appeal grounds, but must be matched by improved quality of first instance courts. The proposed consolidation and specialization of the lower courts will help significantly in that respect.

[10] See Article 348 bis of the Code of Civil Procedure.

[11] The enforcement of courts decisions and other title documents in Italy is extremely complex and takes an exceedingly long time. Even the enforcement of a money claim, which as a fungible good should be simple, is a "maze of very detailed and complex rules". This is compounded by major difficulties in the identification of assets. This particularly affects financial institutions which must go through long and expensive searches of public records to find out whether a debtor has assets for garnishment. There is no obligation for the debtor to provide full disclosure

(continued)

Comparative Foreclosure Procedures in European Countries (2002)

	Global Compet. Index 2012	*Mortgage loans in % of GDP*	*Down payment ratio*	*Duration of mortgage foreclosure (months)*	*Legal expenses as % of mortgaged house price*
Sweden	5.53 (4)	56	15	--	--
NL	5.50 (5)	43	25	2-3	11
Germany	5.48 (6)	27	27	12-18	6
UK	5.45 (8)	52	9	12	5
Denmark	5.29 (12)	--	--	--	--
Austria	5.22 (16)	4	30	13	--
France	5.11 (21)	22	20	10-12	12-18
Spain	4.63 (36)	15	20	36	5-15
Italy	**4.46 (42)**	**5**	**42**	**36-60**	**18-20**

Source: Japelli et al. (2002)

other hand, by a great number of interim and interlocutory procedures. This allows for deferrals, and opens the door to a fragmentation of the actual dispute into a large number of sub-disputes, which are often subject to their own appeals. For example, the duration of foreclosure in Italy is amongst the highest in European countries, and with the highest costs. This increases overall transaction costs (a high down payment ratio, as well as interest rates), and the difficulty in accessing credit. The enforcement process itself (i.e. the execution of court decisions, orders or title documents) is highly problematic, with a low recovery rate and a lengthy time for collection (Chiarloni, 1999).

Measures taken by the authorities

11. **The Italian authorities have taken a number of measures to address the inefficiencies and bottlenecks in the functioning of their justice system.** These include measures to reduce case inflow (e.g., by increasing court fees, creating appeal barriers, and changing lawyers' fee structure), promote out-of-court settlements (including by further enhancing mandatory mediation), reduce the number of courts (creating economies of scale and fostering specialization), strengthen court management (e.g., by giving a greater management role to the Chief Judge of a court, creating case schedules, managing judges' workload), and speed case processing. The steps have had some

of their assets, and the access of bailiffs to public records, while expanded in 2005, is still restricted. The Code of Civil Procedure lacks a comprehensive regime of coercive orders, such as the French *astreintes*. The World Bank estimated the average length of a foreclosure procedure (attachment and auction of real estate) to take 90 months in Italy, which was seven times longer than similar procedures in most other European countries. See Silvestri (2010) for more details.

positive effect, such as the 43 percent decline in the inflow of small claims as a result of increased fees. However, other measures described below have had mixed results.

12. **The Pinto Law attempted to improve the situation in 2001 by giving litigants right to damages in case of excessively lengthy court proceedings.** The Pinto Law (Law No. 89/2001), however, did not have the intended effect of speeding up the court process because it failed to build in the necessary incentives for the judiciary to reform.[12] Instead, the law generated additional litigation and budgetary costs, and worsened the problems it meant to address,[13] by creating more litigation instead of reducing it (Fabbri 2009, Bossi,, 2012).[14]

13. **Funds used to compensate litigants for excessive delays in the judicial process could have been used to improve the efficiency of the justice system (Bossi, 2012).** The compensation awarded for actions filed under the Pinto Law was significant (€200 million by 2011).[15] Instead of being used to compensate litigants for the excessive length of the judicial process, these funds could have been invested more usefully in supporting institutional changes. In response to Council of Europe's Committee of Ministers Interim Resolution CM/Res DH (2010) 224, the Government enacted legislation in 2012 which aimed at clarifying the scope of the Pinto Law, but it did not address the underlying incentive problems.[16]

14. **The introduction of mandatory mediation in 2010 was another important corrective measure** (Decree-Law 28/2010)**.** While originally limited to specific disputes only, its scope was extended in 2011. The new system faced a number of challenges, both logistical and institutional. Despite the difficulties, reports indicate that the use of mediation increased following the enactment of the law,[17] and was successful in siphoning off cases from the courts for at least some procedures (Severino 2012, Bank of Italy communication, June 29, 2013). This legislation was however declared unconstitutional by the Constitutional Court in October 2012 (see below for recent developments in the area of mediation).

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[12] Thus, even though the Pinto law specifically gave the Italian Court of Auditors to right to impose on judges the obligation to contribute to the damages, this right was hardly exercised, if ever. The compensation for Pinto Law cases did not, in fact, cut into the budget for the courts since a special allocation was granted. The Pinto Law therefore failed to create individual and institutional incentives for change (see Dipartimento affari giuridici e legali (Presidenza del Consiglio dei Ministri), *Relazione al Parlamento anno 2010: l'esecuzione delle pronunce della Corte Europea dei Diritti dell'Uomo nei confronti dello Stato Italiano- legge 9 Gennaio 2006, n.12* (2010).).

[13] By 2011, about 50,000 Pinto Law cases were filed before the Italian Courts of Appeal, a fair number of which involved complaints of late payments of compensation awarded under Pinto Law actions.

[14] Not coincidentally, as of 2011, approximately, 5,000 of the 14,500 pending applications against Italy before the European Court of Human Rights (ECtHR) concerned "Pinto" proceedings, with more than 300 such applications arriving each month (Muiznieks 2012).

[15] Presidency of the Council of Ministers, *Misure per la crescita sostenibile* (2012), p.13.

[16] See Article 55 Decree-Law 83/2012 and conversion Law no.134 of August 7, 2012. ().

[17] According to the International Institute for Conflict Prevention & Resolution, the number of mediation procedures increased from 1,000 to 250,000 over 2009–10.

15. **Further changes included streamlined first-instance court proceedings and online civil case management in pilot courts**. Other measures like "backlog-reduction teams" in certain courts, and civil procedure reforms were also adopted. These measures proved successful in some pilot courts, with the Torino and Bolzano courts often presented as success stories. Some of the measures were supported by EU structural funds.[18]

16. More recently, the so-called "*Decreto del Fare*" (Law 98/2013, August 2013) includes, *inter alia*, the following additional measures:

- Law-clerk apprenticeships to work in courts and support judges;
- A task force of 400 magistrates to clear the backlog in the courts of appeal;
- Compulsory mediation (see below);
- New associate judges in the Court of Cassation;
- Concentrating in the Naples, Milan, and Rome Courts all disputes involving foreign investors; and
- First hearing to be mandatory scheduled within 30 days and settlement of litigations expected at the first hearing in most cases.

Key recommendations for further reforms

17. **Reforms so far are steps in the right direction but shortcomings remain, impeding swift claim enforcement.** To address these shortcomings, the judicial system should be further reformed to better support effective and efficient enforcement of civil and commercial claims. Consideration could be given to, *inter alia*, reviewing court fees, strengthening the new mandatory mediation scheme, improving court management and accountability, and reforming the appeal system. Reforms in these areas are key to reduce the overall number of incoming cases, while preserving access to justice, and to ensure a timely and effective resolution of the dispute when it enters the court system.

(i) Public finance and litigation incentives—court fees

[18] Since 2004, the EU supported a roll-out of the Torino and Bolzano courts' experience to the entire country (Program Title: *Diffusion of best practices in the Italian Judicial Offices*). This program made some progress (e.g. for the Milan Court). However, the program faced implementation constraints as well as jurisdictional issues between regional and central authorities. The central government has taken a stronger role in program management since 2010-2011, with the Ministry of Public Administration setting up an effective central monitoring system in 2011 and the Ministry of Justice putting in place professional management in 2012. This helped secure the EU structural funds. G. Vecchi, 'Systemic or incremental path of reform? The modernization of the judicial system in Italy', *International Journal for Court Administration* February 2013), and http://ec.europa.eu/esf/main.jsp?catId=46&langId=en&projectId=416

18. **A comprehensive review of the economic incentives underlying the justice system is critical to the development of an effective and efficient judicial process.** The objective should be to achieve a more reasonable and equitable distribution of the expenditure between the taxpayer and the market, while upholding basic principles of access to justice. A cost-redistribution is also likely to impact on the inflow of cases, by weeding out spurious and vexatious litigation. Recent cross-country developments in this area elsewhere in Europe could be useful guidance.

19. **Court fees have generally increased throughout Europe** (Faure, 2006; Hodges et al., 2010; CEPEJ, 2012). While no justice system is fully funded by court fees, a number of jurisdictions in Europe (e.g., the United Kingdom, the Netherlands, and Germany) have increased court fees significantly, notably for commercial procedures. Countries that did not have court fees, such as France, have now introduced them. Increasing or introducing court fees has three main beneficial effects: first, it helps prevent spurious litigation; second, it shifts the expenditure burden from taxpayers to litigants, and if carefully targeted, re-distributes the burden to those litigants most able to carry it; and third, it increases overall public revenue.

20. **Recent measures adopted by the Italian authorities consolidate court fees to a certain extent.**[19] Notwithstanding, court fees remain modest and capped (even for large commercial litigation). For both budgetary and legal purposes, the authorities are encouraged to carry out a comprehensive assessment (including both an impact and a policy assessment) of court fees for civil, commercial and tax cases, and explore increasing court fees, while upholding access to justice (e.g., through a properly developed legal aid system).

(ii) Strengthening out of court dispute settlement—mandatory mediation

21. **After being declared unconstitutional in 2012, compulsory mediation was reinstated in 2013.** This is a positive development. However, thus far, mediation has not been widely and consistently used in Italy following its introduction three years ago. The reasons range from a lack of strong incentives for all parties to a limited knowledge among the general public about the "mediation avenue." That said, the inefficiency of the justice system itself is a key obstacle. Cross country experience shows that mediation works well and is widespread in countries where the justice system also works well. Where the justice system is inefficient, parties (notably, a party that expects to lose the case) may not find it attractive to settle the disputes at an early stage through mediation and may prefer to take advantage of the lengthy judicial process. Notwithstanding, data provided by the authorities indicate that mediation is starting to pick up. It remains to be seen whether this trend will continue as a result of the adoption of the new mediation legislation.

22. **The compulsory presence of lawyers in mediation could be reconsidered.** The compulsory presence of lawyers in all mediation proceedings may create an unnecessary reserved area for lawyers, increase costs, hamper competition, and reduce the ability of other professionals

[19] See the "*Testo unico delle disposizioni legislative e regolamentari in materia di spese di giustizia*".

(who maybe more adequately trained to deal with the dispute at stake) to intervene in the mediation process. It is positive that the new legislation requires lawyers to be trained in mediation. This will however take time and pose complications since compulsory mediation has been introduced for an initial period of four years only.

23. **The authorities' efforts to actively promote out of court dispute settlement, including mediation, are steps in the right direction.** However, these efforts could be strengthened by**:**

- Allowing mediation to take place without the compulsory presence of lawyers;
- Developing standards for the selection, responsibilities, training and qualification of mediators;
- Informing market participants and the public at large about which procedures are subject to mediation (mandatory or otherwise) and about the time, process, and costs of mediation.

(iii) Improving court management - data systems and performance accountability

24. **Effective court organization and management could be strengthened with the objective of enabling the court to actively manage the case process and drive it forward.** This includes a broad range of elements such as the reorganization of courts (notably consolidation aiming for professionalization of management and specialization of judicial functions), simplification of administrative procedures, digitalizing processes, proactive case management, improved budgetary mechanisms, and performance accountability (van Dijk et al, 2013; European Network of Councils for the Judiciary, 2012).

25. **The authorities have already taken measures in this area.** These include a court retrenchment program, the development of a "data warehouse", and court work-plans based on individual caseload assessments. These are important steps since court management and accountability enable a cost-effective and rational use of court resources and maximize output, while preserving the quality of the justice system. Swift implementation of these measures would be key in terms of proper use of public funds and cost-effective use of judges' time.

26. **Court management and accountability require the development of performance indicators.** In this context, the ongoing work of the Italian authorities to set a "data warehouse" of litigation in all courts is welcomed. It aligns Italian practice with that of other countries and with recommendations by international institutions, such as the CEPEJ. The challenge lies in how those data are processed and translated into policy and institutional accountability. Initiatives such as the "Strasbourg Program" by the Turin Court (Fabbri et al. 2013)[20] could be used as examples, and consideration could be given to extend them to other courts. In this vein, the authorities are

[20] This is one of the first experiences of case management in Italy aiming at substantially reducing the backlog and the time within which civil disputes are resolved. This project was awarded the Crystal Scale of Justice prize in 2006 by the Council of Europe. For more details, see Fabri and Carboni (2013),

encouraged to set performance targets for judges, with the performance of (each chamber of) judges being tracked for internal monitoring and publication purposes. Such a system exists in various other European judiciaries (including at supreme courts' levels).

(iv) Strengthening and streamlining civil procedure and enforcement—the appeal system

27. **The efficiency and effectiveness of civil procedure could be strengthened**, with the objective to ensure a smooth process of cases in court. This includes (i) an effective regime of pre-trial disclosure and of interim measures; (ii) an enhanced role for judges in managing cases and an increased number of single judge processes; (iii) a simplification of the decision-format for lower courts; (iv) a review of the appeal system (in line with international recommendations), including to the Court of Cassation; (v) a stronger IT-based processing; and (vi) effective enforcement.

28. **Among these measures, priority could be given to a comprehensive review of the appeal system.** The authorities are taking measures to rationalize the appeal system and to tackle the large number of cases pending in the Court of Cassation. However, these reforms have not always led to the expected results. Various Supreme Courts in Europe have instituted filters to reduce the inflow of cases, including regimes of summary dismissals and pre-selection. For instance, some countries do not allow appeals to the Supreme Court if courts of appeal have upheld the first instance decision.[21] A comprehensive review of the appeal system (both at court of appeals and court of cassation levels) could therefore be undertaken, in light notably of Council of Europe Recommendation R(95)5 concerning the introduction and improvement of the functioning of appeal systems and procedures in civil and commercial cases, and of the recommendations by the European Judicial Network.

[21] European Network of Councils for the Judiciary, *Timeliness Report* (May 2011).

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REFORMING CAPITAL TAXATION IN ITALY[1]

Recent tax reforms have improved capital taxation in Italy. Sustaining these recent reforms could significantly strengthen the design of the tax system. In particular, further progress towards a dual income tax system would enhance the coherence and effectiveness of the income tax structure. Unifying the tax treatment of retained earnings across different types of business could ease the distortions of business decisions. Updating cadastral values is essential for greater fairness in property taxation, and could finance a reduction in IMU rates—and more importantly a cut in property transaction taxes. Consideration could be given to an explicit wealth tax and/or a strengthening of inheritance taxes, which could create space to lower taxes on capital and labor income.

A. General Considerations

1. **This chapter reviews issues and options in capital taxation** based on a comprehensive definition encompassing taxes on: (i) capital income (business profit, dividends and interest received by individuals, capital gains, and rent); (ii) capital transfer (inheritance and transaction taxes); and (ii) capital ownership (property and net wealth taxes).[2]

2. **Italy's capital taxation is comparatively high.** According to Eurostat, capital taxes[3] in Italy yielded 10 percent of GDP, the fourth highest revenue in the EU-27 in 2011 (Figure 1). This result partly reflects the methodology used by Eurostat, which books all taxes and social contributions paid by the self-employed, a large group in Italy, as capital income taxes (instead of splitting them between capital and labor). Nonetheless, other capital taxes are also above average, with taxes on household income, capital stock and corporate income ranking respectively 5th, 6th, and 9th in the EU. The implicit tax rate on capital[4] is also very high at 33.6 percent, as well as the share of capital taxes in total taxes (23.5 percent). In terms of structure, Italy's reliance on transaction taxes stands out, with taxes on financial and capital transactions amounting to about half of total taxes on wealth

[1] Prepared by Luc Eyraud (FAD). This paper, which relies on and develops the findings of IMF (2012) has benefited from comments and inputs received from Ruud de Mooij, Kenneth Kang, Michael Keen, Thornton Matheson, John Norregaard, Justin Tyson, and Lawrence Walters. The author would also like to thank the staffs of the Italian Ministry of Economy and Finance and the Bank of Italy for helpful discussions and suggestions.

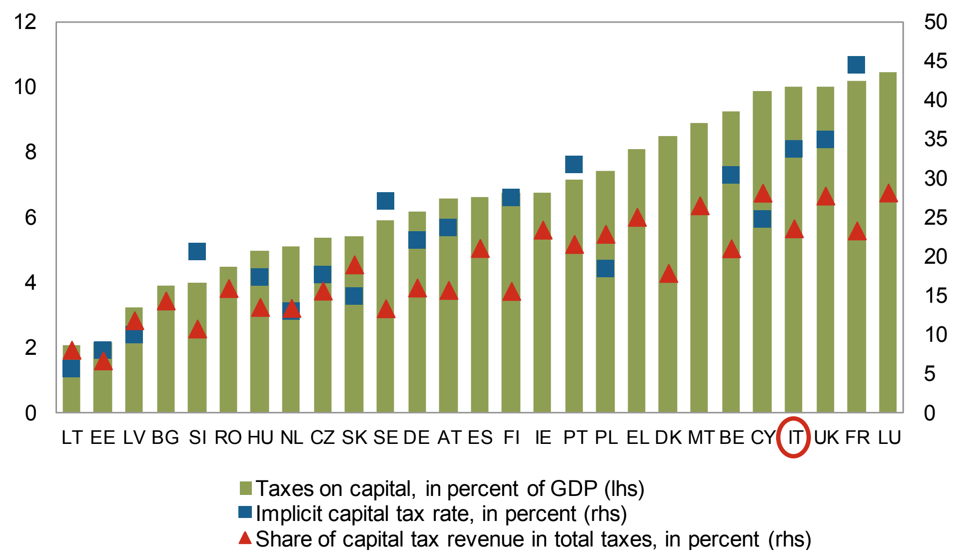
[2] In terms of their economic impact, the classification of various taxes considered in this chaoter is not always clear cut. For instance, the fixed charge on bank account introduced in December 2011 is not really a tax on a specific transaction nor, since it is unrelated to the balance of the account, is it a tax on wealth.

[3] Eurostat breaks down general government taxes by type of tax base—capital, labor and consumption. Some taxes (such as the Regional tax on Productive Activities, IRAP) are split between labor and capital. The "capital tax" category includes taxes on business income in a broad sense (not only taxes on profits but also taxes and levies that could be regarded as a prerequisite for earning profit) and taxes on capital stocks of households or their transaction.

[4] The implicit rate is the ratio of revenues to the potential tax base.

in 2011—compared to one fourth for the OECD average (Figure 2).[5] The reform of the real estate tax increased immovable property revenues from 0.7 percent of GDP in 2011 to 1.5 percent in 2012—above the OECD average (1.1 percent) but still significantly below taxes raised in Japan (2.2 percent of GDP), France (2.5 percent), the US (3.0 percent), and the UK (3.3 percent).

Figure 1. Capital Taxation in European Countries, 2011



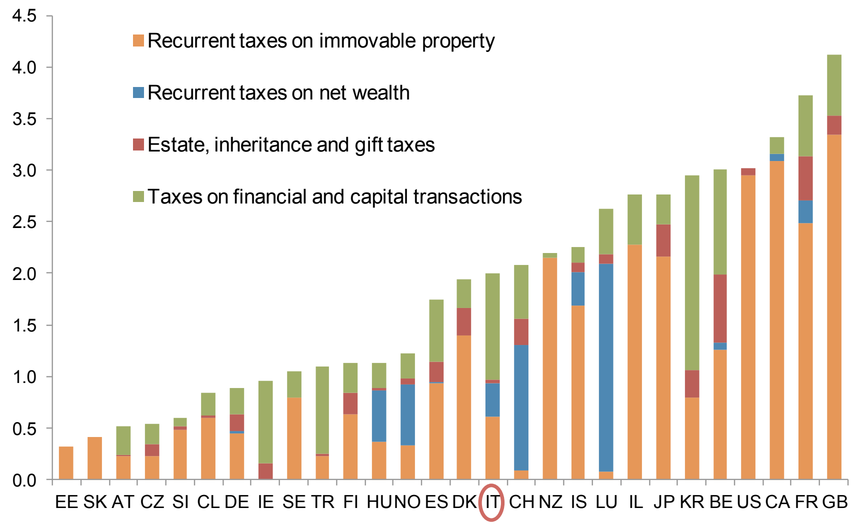
Source: Eurostat

3. **Reforming capital taxation is of considerable practical importance and current interest in Italy.** The 2011 consolidation packages relied largely on increased taxation of some transactions and items of capital income and of wealth. About one-fifth of the summer packages and half of the December package relied on capital taxation (Table 1), in particular the reintroduction of the primary residence tax in the December *manovra* of the Monti government. The capital tax structure was not significantly modified in 2012, although a financial transaction tax (FTT) was introduced at the end of the year, taking effect from March 2013.[6] In August 2013, the authorities announced that, as of 2014, property taxes (including those on non-primary residences) would be replaced with a local services tax; details of the new tax have yet to be designed.

[5] Data for 2012 are not available in the OECD revenue statistics database, but the increase in the property tax is likely to have mechanically reduced the reliance on transaction taxes.

[6] The FTT is expected to yield slightly above €1 billion per year.

Figure 2. Taxes on Wealth Stock and Transactions in the OECD, 2011 (percent of GDP)



Source: OECD Revenue Statistics

4. **The authorities have prepared a framework law setting out the strategic directions for a targeted tax reform.** This frame law is referred to as "Delega fiscale" (DF) as the government plans to use "delegated legislation" to conduct the tax reform—that is, Parliament passes a law outlining general principles, which also authorizes the government to proceed in legislating the actual details with decrees. The authorities' plan is to submit the DF to the new Parliament by the end of the year.

Table 1. Capital Tax Measures in the 2011 Fiscal Packages[1]

July-September Packages (in billions of Euros)		December Package (in billions of Euros)	
Stamp duty on securities accounts	1.3	First house property tax and base re-evaluation	10.7
Higher IRAP on banks [2]	1.0	Luxury good tax	0.4
Capital income taxation [3]	1.4	Stamp duty (including on financial instruments)	1.2
Income surtax for energy sector	1.8	Tax on asset held abroad	0.1
		IRAP deductibility [2, 4]	-1.5
		Allowance for corporate equity	-1.0
Total	5.5	Total	9.9
In percent of total 2012 package	19%	In percent of total 2012 package	49%

Source: Italian authorities' projections.
[1] Simulated impact on 2012 revenues.
[2] The IRAP bears on capital and labor; the two components cannot be separated.
[3] The withholding tax on interest (except government bonds) and dividends was unified at 20 percent.
[4] Deductibility of IRAP from CIT.

5. The chapter is organized as follows. Section B assesses the taxes on capital income through the prism of neutrality. Section C analyzes the real estate tax with an emphasis on properties' valuation. Taxes on wealth transfers are discussed in Section D (transaction taxes) and Section E (inheritance and gift taxes). Section F raises the broader question of whether a comprehensive wealth tax could be warranted as a substitute for existing taxes. Section G concludes. Thus, the chapter explores different dimensions of the capital taxation system in Italy. The analysis is not exhaustive, focusing instead on selected issues of current interest. Some important aspects beyond the scope of this SIP are deliberately omitted; in particular, the regional production tax, which is not specifically a tax on capital, is not considered here.

B. Enhancing the Neutrality of the Capital Income Tax System

6. **The essence of a dual income tax (DIT) is to tax capital income at a low single rate and labor income under a progressive schedule.** The DIT differs from a "comprehensive" income tax in distinguishing between capital and labor income (rather than subjecting the sum of the two to a single progressive scale) and from an "expenditure" tax in that it taxes the return to capital. Pioneered in Nordic countries, the DIT has several merits (Boadway, 2004). Perhaps most compelling, the increased international mobility of financial capital makes it increasingly difficult to tax capital income at rates as high as the marginal rates felt appropriate for labor taxation.[7]

7. **One essential benefit of the DIT is that it minimizes the distortions created by the multiplicity and diversity of capital income taxes.** Under the DIT, all forms of capital income are taxed at the proportional profit tax rate. By providing a level playing field for owners of different forms of capital income, there would be no tax incentive arbitrage among dividends, interest, rents, rental values, royalties, and capital gains. In addition, to avoid arbitrage opportunities and facilitate implementation, the textbook prescription is to set the corporate profit tax rate equal to the single rate on capital income.[8] Finally, the double taxation of distributed profits at the corporate level and the shareholder level is avoided, under a pure DIT, through a full imputation system.[9]

8. **The Italy tax system has evolved towards a DIT, providing a coherent and practicable framework for strengthening tax design**. Several features of the Italian tax system have DIT features, including the single and very similar rates applied to rental income (21 percent); interest income other than from government debt (20 percent); dividends not associated with a "qualified" (i.e., substantial) shareholding (20 percent or more); and capital gains on most financial instruments

[7] The DIT has also potential drawbacks, including the need to distinguish capital from labor income—when small businesses can readily shift between the two—and the perception of inequity in charging a lower tax rate on those, likely to be among the better off and more heavily dependent on capital income.

[8] If the corporate tax rate exceeds the flat tax on interest income, for instance, there is a tax gain from lending to corporations.

[9] This result is partly achieved by an allowance for corporate equity, which eliminates the double taxation of normal equity returns (but not that of normal profits). See discussion below.

(20 percent). The unification of withholding rates on interest income was one of the key measures of the August 2011 fiscal package.

9. **Adoption of the Allowance for Corporate Equity has also been an important step towards the DIT system in Italy.** Tax systems generally favor corporate debt over equity, because interest payments are deductible for corporate income tax purposes, while equity returns are not (De Mooij, 2011). The introduction in December 2011 of an Allowance for Corporate Equity (*Aiuto alla Crescita Economica*; ACE) has eased the tax bias toward debt finance and made equity injections more attractive, by providing a tax deduction to companies for a notional return on additional equity.[10] It thus neutralizes the preferential tax treatment of debt finance, which was present under the old system. These are very attractive properties: the importance of avoiding tax incentives to artificially high leverage, especially but not only for financial institutions, has emerged clearly since 2008. Given too the positive experience of several countries with ACE or similar systems, many now advocate widespread adoption of the ACE (IMF, 2010; Klemm, 2007; Mirrlees and others, 2011).

10. **There remain some differences from the textbook DIT in Italy**. These include the taxation of (half of) dividends under progressive personal income tax (*Imposta sul Reddito delle Persone Fisiche* IRPEF) rates for qualified shareholdings, the potential taxation of capital gains on real estate at the IRPEF rate[11], and the absence of any attempt to apply differential taxation of labor and capital income to unincorporated businesses. Notable too is that distributed corporate earnings (in excess of a normal rate of return) are taxed at effective rates that are close to the top marginal IRPEF rate (43 percent) rather than the rate on interest income (20 percent).[12] Finally, the IRES rate (27.5 percent) is also clearly above the interest income rate.

11. **Present tax arrangements are not neutral, however, between different organizational forms**. This may create distortions of business decisions regarding incorporation. A first concern is that retained profit of a corporation is subject to IRES, while business income of partnerships and sole proprietorships is liable for IRPEF, which is generally levied at a higher marginal tax rate, at least for high incomes (the range of IRPEF progressive rates is 23-43 percent, while the IRES flat rate is 27.5 percent). This may lead to tax-motivated incorporation. In addition, the profit of a corporation is

[10] For the first three fiscal years (2011-13), the notional interest rate is set at 3 percent. For subsequent years, it will be based on the Italian public debt securities' average return (adjusted for risk)—a proxy for the "normal" return to capital. Thus, with the ACE, normal equity returns are fully deductible and taxed only at a personal level, while returns above that are still taxed at both the corporate and the individual level.

[11] No taxation is applied if the property has been held for at least 5 years or if it has been used as primary residence.

[12] While distributions by non-corporate entities are simply taxed under the progressive IRPEF, corporate distributions are subject to two layers of taxation, at corporate and personal level. Specifically, the effective tax on distributed corporate earnings is a combination of (i) the corporate income tax (*Imposta sul Reddito delle Società*, IRES) levied at a 27.5 rate, and (ii) the dividend tax, which is either levied at 20 percent for non-qualified shareholdings or at progressive IRPEF rates on half of the dividends received for qualified shareholdings. Therefore, the effective tax rate is 42 percent ($= (0.275) + (0.2) \times (1 - 0.275)$) for non-qualified shareholdings; it is 43 percent ($= 0.275 + (0.43) \times (0.5) \times (1 - 0.275)$ for a qualified shareholder paying IRPEF at the top marginal rate of 43 percent.

liable for tax at personal level only if the profit is distributed; corporations can thus postpone personal tax payment by deferring realization. Partnerships and sole proprietorships do not have this option as their entire income is subject to IRPEF. On the other hand, to the extent that income is distributed, these groups are generally tax favored, since the progressive IRPEF rate is typically below the effective tax rate imposed on dividends distributed by corporations.[13] This creates a disincentive to incorporation for businesses with low incomes. Moreover, the ACE itself is particularly beneficial for partnerships and sole proprietorships, both because the notional return to equity is then deducted at a higher rate (at least for those with reasonably high incomes[14]) and because they enjoy the allowance with respect to all equity, whereas corporations receive it only in respect of equity built up since the introduction of the ACE.

12. **To address these issues, the authorities are considering unifying the tax treatment of retained earnings across different types of businesses.** The DF proposes to introduce a new business tax (irrespective of the legal form) dubbed *Imposta sul Reddito Imprenditoriale* (IRI). The IRI would be levied on retained earnings at the same rate as the IRES; all outflows to owners or managers would be deductible but fully taxable at personal level under the IRPEF. Firms liable to IRI would thus be taxed exactly like corporations with respect to their retained earnings; and the difference in respect of distributions would be quite small.[15] The reform would thus bring greater neutrality between corporations taxed under the IRES and other entities (including small businesses) taxed under the IRI. This would be an important move toward a business-neutral tax for entrepreneurs.

13. **Making the IRI optional, as envisioned by the DF, may complicate the tax system and run significant budgetary risk**. Optionality is obviously attractive for business: they could, and presumably would, all else equal, opt for whichever regime offers them the lowest tax liability. The converse is of course a risk to government's revenue. Moreover, options can tend to significantly complicate the tax administration, increasing both administration and compliance costs. If a compulsory regime would be too burdensome for some companies in the short term, optionality might be considered during a short transitional period. But ultimately, there should ideally be a single regime for all businesses other than the smallest enterprises. Determining the set of companies for which the IRI is to be mandatory would be a critical element in the final design of the reform.

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[13] More specifically, the top marginal rate of the progressive IRPEF (43 percent)—which is an upper limit to the average rate—is either exactly equal to (for qualified shareholdings) or one percentage point above (for non-qualified shareholdings) the effective average rate implied by the combination of the IRES and dividend taxation . See calculations in previous footnote.

[14] By definition, the higher the marginal tax rate, the higher the deduction.

[15] Indeed, as shown above, the gap between the IRPEF rate and the combined rates of IRES and dividend tax is small at higher income levels.

C. Implementing a Fairer and More Effective Property Tax

14. **Considerations of economic efficiency strongly underpin the case for exploiting property taxes to their full potential.** Property taxes in the form of recurrent taxes levied on land and buildings are generally considered to be more efficient than other types of taxes in that their impact on the allocation of resources in the economy is less adverse (Norregaard, 2013). The lower mobility of real property entails a limited impact of property taxes on decisions to supply labor, invest, and innovate. Furthermore, to the extent that increases in property taxes are fully capitalized in property prices, with resulting one-off wealth losses for present owners, the tax increase would not affect the rate of return for new owners and could therefore be considered neutral to investment behavior. This quality derives from the assumption that the property tax, if akin to a tax on accumulated wealth, does not alter future behavior. Some evidence suggests that immovable property taxation may also be more benign to economic growth than direct taxes, so that a revenue neutral growth-enhancing tax reform would shift part of the revenue base from income taxes to immovable property (and consumption). Its efficiency enhancing properties would be even further strengthened to the extent that the tax functions as a "benefit tax"[16] that finances local government services, by virtue of being borne mainly by residents with few spillovers: if a payment for services, the tax would be fully neutral with respect to labor supply and investment and savings decisions. Finally, property taxes are considered a relatively stable revenue source and—by requiring little in terms of international tax coordination—perhaps particularly attractive to economies that are otherwise exposed to tax competition for mobile tax bases.[17]

15. **While taxes on property in Italy are not low, they are not out of line with other advanced economies**. The introduction of the *Imposta Municipale* (IMU) at the start of 2012 fundamentally reformed, and increased, property taxation. In replacing the previous *Imposta Comunale sugli Immobili (*ICI), it brought primary residences back into the tax base and scaled up cadastral values by adjusting them with ad hoc factors. Property tax revenue more than doubled in 2012 to 1.5 percent of GDP.

16. **As part of the implementation of the IMU, cadastral values were adjusted by a common factor within each property type**. The current property valuation system is based on estimates of market rental values from 1988–89, and so is out of date. The basis for both the old ICI and the current IMU is the concept of cadastral rental value. This is an estimate of what the "normal" (i.e., average for similar properties in the same general location) rental value of the subject property would be as of 1988–89. It is based on location and building type, but very little else; there is, for instance, no information on type of construction, building condition or even age of building. As part of the IMU reform, an ad hoc increase in property values was implemented through the application

[16] The "benefit principle" of taxation taxes people in proportion to the marginal benefits they receive from government goods and services.

[17] A steep increase in property taxation may, nonetheless, affect negatively the real estate market and reduce liquidity (and consequently consumption) of landlords.

of multiplicative factors to the tax base. The revaluation coefficient for houses was 1.6; for other types of properties, reevaluation ranged from 1.2 to 1.6 percent. These factors resulted in a significant increase in taxable value by about 50 percent overall.

17. **However, the application of common factors has not fully addressed the issues of the property tax system**. First, despite the revaluation, the taxable values of many properties remain well below market value. The national average ratio of market to taxable value is still 2.2 for primary residences and 2.4 for other dwellings. Second, property values have increased markedly in the last 20 years, but not uniformly throughout the country. Changes in property values would not be problematic if all changes were proportionate and uniform across the country: tax rates could simply be adjusted or a common valuation adjustment factor be applied to all properties. Unfortunately, this is not the case in Italy. Since 1988-89, real estate prices have increased five-fold in some regions, and by only half that in others, and there are similar variations within every major city in Italy. This asymmetry and variability across the country makes the current cadastre unfair and inefficient. Simple adjustment factors cannot overcome disparities in assessed values and cannot address equity concerns.

18. **The update and reform of cadastral values are widely regarded as essential**. There are many ways to conduct the revaluation of properties. Policy options can be arranged along a continuum, with market-driven approaches based on capital market value on one end, and non-market approaches based on purely physical property characteristics on the other (Walters, 2011). In Italy, the Revenue Agency (which has recently incorporated the Land Agency) could implement a "comparable sales approach" for properties regularly exchanged in the market.[18] For more unique properties with a lack of comparative sales, individualized valuations are required, based either on a "cost-based approach" for owner-occupied properties or an "income approach" for income producing properties.[19]

19. **The substantial increase in taxable values could finance a large reduction in IMU rates—and perhaps even more beneficially in transactions taxes.** The taxable base for housing is still less than half the average market value nationally, so that comparable revenue at the national level could be raised after comprehensive revaluation with less than half the current tax rate. A strong case can be made for using some of this revenue increase to reduce distortionary taxes on transactions related to real property (see discussion in the following section).

20. **The crucial task of maintaining the cadastre and cadastral values will require resources.** Maintaining land and building records for over 83 million parcels and carrying out individualized

[18] The *comparable sales approach* consists in collecting data on recent sales of similar properties to estimate an average price per square meter for a given building type, based on building location and other characteristics.

[19] The *cost approach* estimates what it would cost to reproduce or replace the property by calculating the price of each component (including improvements) and adjusting for obsolescence. The *income approach* is based on capitalizing the expected income flows from a property.

appraisals for over one million specialized cadastral properties will strain the Revenue Agency. Some of the management tasks can be effectively shared with municipalities and other local agencies. But this too will require resources. And once updated, the cadastral values must be maintained and updated on a regular basis (for instance, every three years), otherwise the current valuation inaccuracies and inequities will quickly return. One approach that has proven effective in other countries is to dedicate a small portion of the property tax revenue for the maintenance of the assessment and collection system.

21. **One option for collecting additional required data is self-declaration by the taxpayer**. It has proven feasible in other countries to require the taxpayer to complete an objective description of their property as part of the tax collection process (Walters, 2011). For sure, not all taxpayers will complete the additional form and some will submit erroneous data. The Revenue Agency will need an audit staff and strategies as well as procedures to verify samples of submitted data, with well-publicized appeals procedures and penalties for those who deliberately falsify data. But many taxpayers will submit reasonably accurate data—and self-reporting would considerably reduce the cost of gathering additional information. Such an approach would not be perfect or costless, but might provide a fruitful way to accelerate progress.

22. **It is also important to review property tax exemptions, particularly those relating to agricultural land**. Roughly 60 percent of the land in Italy is currently exempted from the property tax.[20] Broadening the base of the property tax further could substantially reduce tax rates or enhance local revenues. This is not to say that all exemptions are unjustified. Rather, the argument is that all exemptions from the property tax merit careful review to assure that their objectives remain valid and that they are sufficiently effective, including relative to other policy instruments, in achieving them.

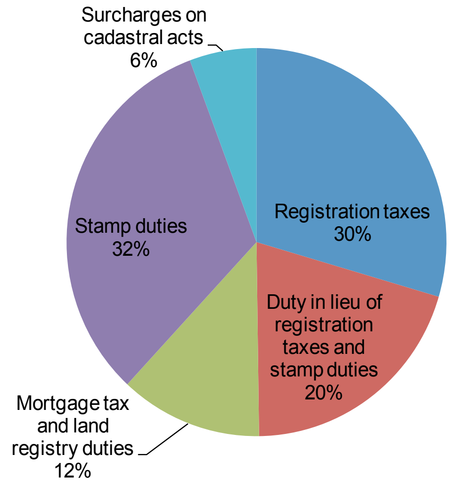
D. Reducing Distortionary Taxes on Transactions[21]

23. **Transaction taxes are relatively high in Italy**. Transaction taxes were estimated at 1.0 percent of GDP in 2011, twice the OECD average of 0.5 percent (Figure 2). Registration fees, levied on a wide range of transactions involving deeds, account for about half of all revenue from transactions taxes (Figure 3). Registration fees are levied on sales of real property, financial assets, and businesses, but also on other transactions, such as rents. Tax due is either fixed or proportional

[20] Agricultural land is exempted from property tax when there are hilly or mountainous. Under a law adopted in 1977, approximately two-thirds of Italy's municipalities qualify under the exemption provisions of this law. In addition, municipalities have the authority to grant specific exemptions for particular social groups such as the poor and aged. Finally, public facilities such as transport services, government property, places of public worship, cemeteries and family vaults, and clock towers are exempt. The result is that approximately 60 percent of Italy's property is exempted from the IMU.

[21] Here, "transaction taxes" refer to all taxes on asset transfers, excluding on gifts and inheritances. "Stamp duties", which refer to a duty levied on the issuance of official documents, are treated here as a subset of transaction taxes.

Figure 3. Revenues from Transaction Taxes, 2012[1]



Source: ISTAT
[1] Excluding inheritance/gift tax.

to the value of the asset, with rates ranging from 0.5 to 15 percent depending on the type of asset. Sales of shares of limited liability companies (SRLs), for instance, are subject to the fixed registration tax.

24. **Transaction taxes bear heavily on immovable property**. Transaction costs in the housing market are particularly high in Italy, about 25 percent above the OECD average (Andrews and others, 2011). Buyers must pay three taxes on their real estate purchase: the registration tax (*imposta di registro*), the mortgage tax (*imposta ipotecaria*), and the land registry tax (*imposta catastale*). The registration tax is levied on sales at rates ranging from 3–15 percent (depending on the type of property); for business assets, it is charged as a flat amount. The land registry tax is levied at 1 percent, while the mortgage tax rate is 2–3 percent.[22] VAT is, in general, charged on new housing, at a rate of 4–21 percent depending on the property. If the sale is subject to VAT, the registration tax and land registry tax are reduced to a small flat amount (except for business assets).

25. **Transactions taxes can be relatively easy to administer**. Changes in ownership happen relatively infrequently and can be fairly easy for tax administrations to keep track of—especially when the purchaser has clear interest in ensuring that the necessary legal requirements reflecting the ownership change are completed (Thuronyi, 1996).

26. **But they can also impose large efficiency costs**. It might be argued that these taxes are user charges to finance the costs to the state of maintaining ownership records, and regulating transactions and asset markets. The revenue raised, however, may outweigh these costs. Most fundamentally they distort behavior, impeding mutually beneficial transactions and so hindering the

[22] The base is in each case market value, not cadastral value, except for houses bought by individuals.

efficient allocation of assets (including by discouraging otherwise profitable investments that would increase the asset value).

27. **Transaction taxes on real property may be particularly damaging.** By discouraging transactions on the real estate market, they have far-reaching consequences.[23] First, the reduced market liquidity may increase price volatility, although both theory and empirical evidence are mixed (transaction costs may also reduce volatility by curbing speculative transactions; Andrews, 2010). Second, transaction costs are likely to raise the elasticity of demand with respect to pre-tax prices, which may inflate housing prices and mitigate their response to supply shocks.[24] Third, transaction costs create incentives for buyers and sellers to collude and partly evade the tax by arranging a lower price for the property and a corresponding separate payment, either informal or formal (for the fixtures and fittings)—this eases the distortions but undermines habits of tax compliance. Fourth—and perhaps most important—theoretical and empirical studies show that transaction costs create lock-in effects in the housing market and have negative effects on residential and job mobility, so impeding labor market matching and increasing structural unemployment (Oswald 1996, 1999; Van Ommeren and Van Leuvensteijn 2005; and Caldera Sánchez and Andrews 2011). Italy's residential mobility is indeed significantly below the OECD average—no doubt this reflects more than transactions taxes, but these clearly do not help (Figure 4).

28. **There is a strong case for reducing transaction taxes on real property in Italy—perhaps using part of the revenue gains from an improved IMU to this end.** In the context of the fiscal federalism reform, the authorities plan to substitute a single rate for most transaction taxes on immovable property from 2014. The Legislative Decree 23/2011 establishes the rates of this new tax at 2 percent for primary residences, and 9 percent on other properties, compared to the current rates which range between 3 and 18 percent.[25] This effort to streamline transaction taxes should continue, and the order of magnitude of the rate cuts seems reasonable (although the reduction may still be on the low side for properties not used as primary residences).[26] Further reform of the IMU including a review of the cadastre may provide an opportunity to do just this, by offsetting the increase in the IMU base by a cut in registration taxes.

29. **Italy has also recently adopted a FTT, ahead of the plan to introduce of a similar tax at the European level**. With the financial crisis, FTTs have come under widespread scrutiny as a means to curb financial market excesses and raise revenue to meet the direct fiscal costs of future support to the financial sector (Matheson, 2012). In Italy, the FTT in effect since March 2013 targets three

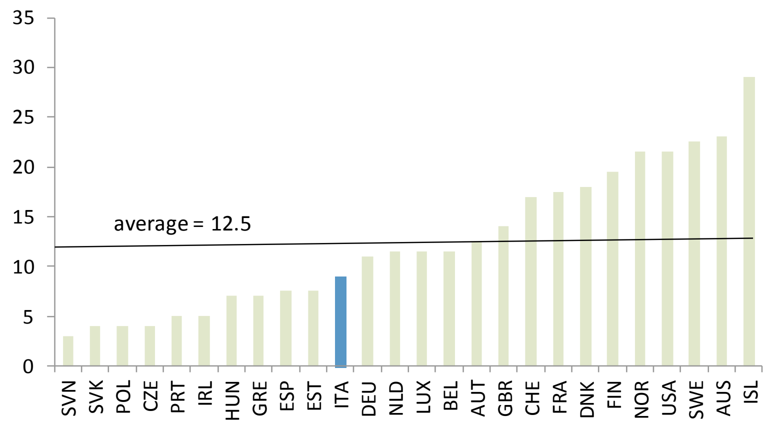
[23] These effects are likely to be significant in Italy, since real estate transactions are also subject to relatively high notary fees (Andrews and others, 2011).

[24] This result holds under the assumption that supply and demand functions are linear and the tax is ad valorem.

[25] The exact coverage of the tax still needs to be specified and these provisions may be revised given that significant changes have been introduced to property taxation since the decree was adopted in March 2011.

[26] Under the assumption that half of transaction taxes bear on real property, the tax rates on real property transfers should be divided by four to reduce total transaction revenues to the OECD average.

Figure 4. Residential Mobility in OECD Countries
(Percentage of Households that Changed Residence within the Last Two Years)



Source: Caldera Sanchez and Andrews (2011).

categories of transactions: transfers of equity instruments, equity derivative trades and high-frequency trading. Tax rates vary depending on the transaction type and whether it is executed on a regulated market or not. The FTT carries risks, as it may reduce trading volume and liquidity, and lower asset prices.[27] In addition, it is unclear whether leverage will be discouraged, given the lower tax rate on derivatives, which are typically highly-leveraged transactions. There is also a risk of displacement of trading activities, as it may be difficult to enforce the tax outside of Italy. Finally, to the extent that the FTT taxes transactions between businesses, it can distort business decisions and reduce total output, so that more revenue could be raised by taxing that output directly. After reviewing several options, IMF (2010) has expressed a preference for a "Financial Activities Tax," levied on the sum of profits and remuneration of financial institutions, which would be broadly equivalent to a VAT for the financial sector. Overall, given the recent introduction of the Italian FTT, it would be wise to carefully monitor the effects of the tax on the stock markets, in order to evaluate its merits and drawbacks.

E. Strengthening the Taxation of Inheritance and Gifts

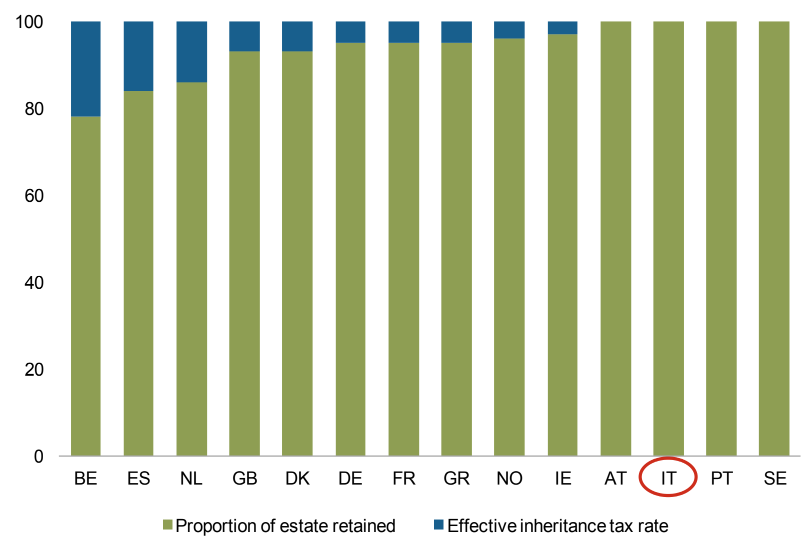
30. **Italy taxes lifetime gifts and inheritances**. Allowances are specified as lifetime amounts from a specific donor, and a running total must be kept if an individual receives more than one gift, or a gift and an inheritance from the same donor. Transfers are net of financial liabilities, and

[27] A recent analysis carried out on the French FTT found volume reduction for most of taxed stocks but no liquidity fall (Becchetti and others, 2013).

different rates and allowances apply according to the degree of kinship of the beneficiary.[28] Transaction taxes are also due at death in some cases.[29]

31. **The inheritance and gift tax currently raises little revenue**. In 2012, it yielded €520 million, equivalent to 0.03 percent of GDP or 0.1 percent of total tax revenue. The main reason for this low yield is that the rates and allowances are quite generous (Figure 5). In France, allowances are significantly lower (each child benefit from a €100,000 allowance for instance), and marginal rates range from 5 to 60 percent. In Germany, the range of marginal rates is 7–50 percent, while the child allowance is €400,000. In the U.K., the tax threshold for the whole estate is £325,000, and the tax rate is 40 percent. In Spain, marginal rates are between 7 and 34 percent, while the child allowance is up to €47,859. The asset valuation is another explanatory factor for the low yield of the tax: for real property gifts or bequests, the assessment base is the cadastral not the market value.

Figure 5. Effective Inheritance Tax Rates in Europe



Source: AGN International (2013).

Note: Tax paid on married individuals who died on 01/01/2013, leaving a spouse and two children. Assets owned at death are a house of €600,000; cash of €1,000,000; quoted company shares of €300,000; and unquoted company shares of €700,000 (total asset value €2,600,000).

[28] The share of the estate received by the donee is taxed at 4 percent if the transfer is to a spouse or direct descendent or ancestor, with a tax allowance of €1 million; 6 percent if the transfer is to siblings, with an allowance of €100,000; 6 percent if the transfer is to other relatives, without any tax deduction; and 8 percent in all other cases.

[29] In the case of a real property transfer (by inheritance or gift), the donee has also to pay the mortgage tax and the land register tax (3 percent of the cadastral value of the property). If the property is registered as the donee's principal residence, both taxes are reduced to a small flat fee.

32. **Structurally, the Italian inheritance and gift tax is well designed**. It is close to a pure "donee-based" (or "accession") tax: each donee pays tax to the extent that wealth transfers received, whether by gift or inheritance, exceed a lifetime limit (Ireland being another example). This equalizes treatment between those who prefer to make lifetime gifts and those who keep their wealth until death, and eliminates some common gift-based avoidance schemes (where gifts, if made long enough before death, are taxed less heavily than inheritances). One weakness of current arrangements, however, from the perspective of equalizing treatment of beneficiaries, is that transfers from different donors are treated separately: so a donee is less heavily taxed if he or she receives a transfer from two different donors than if the transfer is made by only one donor (as allowances cumulate in the first case). The alternative—as for instance in Ireland—is to apply allowances to the sum of all prior gifts and inheritances received by a donee from different donors. Another practical weakness is that allowances thresholds are not automatically updated, but require a new ministerial decree. This has created problems of equity, liquidity, and public acceptability in other countries, as rising house prices have brought more and more of the middle classes into the inheritance tax. Some automatic adjustment for inflation could partly address this issue.

33. **The tax is likely to have little impact**. The purpose of the inheritance tax is to equalize opportunities and mitigate potential adverse effect of wealth transmission on effort and saving of the donee. The current system likely has little effect of this kind, simply because of the combination of high allowances and low flat rates. First, the allowance for the closest relatives seems particularly high: up to €2 million can be transferred tax-free, if the estate is owned in equal shares by the parents and is given to their only child.[30] Only 1 percent of households have net wealth above €2 million (according to the Bank of Italy 2010 *Survey on Household Income and Wealth*). Second, the flat rates are low, in particular compared with the PIT rate schedule. From an economic point of view, there is little rationale for taxing far less someone who gets revenue unrelated to work or saving than someone who gets income from his own effort. A progressive banding structure may be fairer, and not much more detrimental to work incentives. This could involve a lower rate equal to the lowest PIT rate (23 percent), and a top marginal rate close to the highest rate (43 percent).

34. **The merits of some exemptions are questionable**. First, transfers of enterprises or controlling stakes in enterprises to descendants or spouses are exempt from the inheritance and gift tax, so long as the beneficiary continues the business activity for the next 5 years. This protects against the risk that a family business must be sold on death to pay the tax. But there is some evidence that such retention of SMEs may entrench inefficient management (Bloom, 2006). A better option may be to eliminate this exemption, but allow the tax to be paid in installments, over 5 or 10 years for instance. Second, family homes benefit from a significant reduction of transaction taxes if the donee uses the property as his or her main residence. This may reflect concern that joint occupiers should not have to sell the house on the first death, but can create an incentive to over-

[30] On average, there is only one child per family in Italy.

invest in homes.[31] A solution would be to eliminate this relief but allow deferring the tax payment until the subsequent sale of the home (with some lock-in effects as potential drawback). Third, the rationale for exempting government bonds from the inheritance tax but not from the gift tax is unclear.

35. **Capital gains on inheritances are not taxed in many cases**.[32] This relief is sometimes claimed to be warranted on the grounds that taxing capital gains on death is double taxation if the asset is also subject to an inheritance tax. But there are good reasons to tax both (Boadway, and others, 2010). First, the two taxes have different roles. The aim of capital gains tax is to ensure that capital gains are treated like other forms of income; transfer taxes have a different goal. Second, exempting capital gains at death may distort behavior: individuals are encouraged to hold onto assets that have risen in value, and/or buy high yield assets, and convert income into capital gains.[33] Third, the capital gain exemption comes on top of other reliefs granted to owner-occupied homes. As a result, increases in their value are very lightly taxed in Italy: they are exempt from capital gains tax at sale (as the sale of a primary residence, and that of a secondary home held for more than five years are also exempt from capital gain taxes), and partly at death (due to the capital gain exemption, but also to the fact that the transaction taxes are reduced to a small lump sum fee if the donee uses the property as its primary residence). Only the inheritance tax would capture capital gains, although imperfectly and at a relatively low rate. Fourth, capital gains on securities other than government bonds are taxed only on the share accrued by the heir in the case of inheritance, and on the full amount in the case of a gift.

F. Towards a More Comprehensive Taxation of Wealth?

36. **Like many others, Italy does not levy a comprehensive tax on net wealth.** Until recently, NWTs have been in decline: several European countries repealed an NWT in the last 20 years, including Austria, Denmark, Finland, Germany, the Netherlands, and Sweden. Within Europe, only France, Iceland, Norway, Spain, and Switzerland still have a recurrent NWT. Interestingly counter to this trend, however, both Iceland and Spain recently reintroduced wealth taxes as a temporary measure for fiscal consolidation purposes. The top marginal rate of current NWTs is in general less

[31] In addition, there is no obligation for the donee to maintain the primary residence for some minimum period: he or she could declare the house as its primary residence to benefit from the tax relief, and sell it a few days later.

[32] The general rule is that capital gains on assets acquired by inheritance are taxed only on the share accrued by the donee, while capital gains on gifts are taxed on the full amount. In practice, there are numerous exceptions to this rule: (1) Buildings and agricultural land acquired by inheritance are fully exempt, that is to say: no tax is paid on the gains accrued by the donor prior to the transfer, and on those accrued by the donee between the transfer and the property sale; (2) For building land acquired by inheritance, only the capital gain accrued by the donee is taxable (3) For gifts of buildings and agricultural land, there is full exemption if more than five years have passed between the purchase of the property by the donor and its sale by the donee; otherwise the capital gains accrued by both the donor and the donee are taxed; (4) In any case, if the donee uses an inherited building as their primary residence, no capital gain tax is due.

[33] This effect is partly mitigated in Italy by the exemption of capital gains on the sale of the primary residence.

than 2 percent, while revenues are below 1 percent of GDP (except for Luxembourg, where the wealth tax yields 1.5 to 2 percent of GDP per year).

37. **Italy, however, does tax various financial and real assets owned by households and businesses** (Table 2 and Box). The December 2011 fiscal package brought important changes, particularly the inclusion of primary residences in the property tax and new taxes on luxury goods and on assets held abroad. These taxes on selected forms of wealth yielded about 1.6 percent of GDP in 2012, slightly above the OECD average (1.4 percent of GDP in 2011).

Table 2. Revenues from Taxes on the Wealth Stock in 2012

	In billion	In percent of GDP
Real estate held domestically	23.80	1.51
Real estate held abroad	0.01	0.00
Financial assets held domestically [1]	0.00	0.00
Financial assets held abroad [1]	0.01	0.00
Financial assets (tax shield)	0.88	0.06
Luxury goods	0.13	0.01

Source: Italian authorities' projections.

[1] Including bank accounts. Negligible in 2012 as banks used tax credits from previous years.

Box 1. Taxes on Asset Holding in Italy

Individual and businesses are taxed on financial and real assets held domestically. Real estate is taxed at 0.4 percent for the primary residence and 0.76 percent for other properties. Bank accounts are subject to an annual flat fee of €34 for individuals, and €100 for businesses. Financial assets (excluding bank accounts) are taxed at 0.15 percent; the financial sector does not pay this tax. Some luxury goods are subject to specific taxes.

Taxes on assets held abroad are only paid by individuals. Real properties held abroad are subject to the basic IMU rates; financial assets held abroad are taxed at 0.15 percent annually, excluding bank accounts held in EU countries or EEA member states that allow information exchange, which are subject to the €34.2 lump sum fee.

A special tax applies to financial assets (held aboard and domestically) covered by the 'tax shield' program. Amounts repatriated under the 2001 and 2009 foreign asset disclosure schemes and still not disclosed to the tax administration are taxed at 1.35 percent in 2013, and 0.4 percent from 2014.

38. **There has been considerable interest in the possibility of introducing a comprehensive wealth tax in Italy**, reflecting the public resistance to spending-only austerity; the search for new resources to quickly reduce public debt; an aim of spreading the burden of fiscal adjustment more equally; the difficulty to draw a clear line between capital and labor income; and the significant concentration of wealth in Italy. Net household wealth amounted to €8.6 trillion at end-2011, about 4.5 times the public debt, and Italy has one of the highest wealth-to-income ratios in advanced economies (about 770 percent of household disposable income in 2011). The richest 10 percent households hold about half of total net wealth, while income inequality in Italy is above the OECD average.

39. **The current set of wealth taxes is likely to have a modest redistributive impact**. Excluding the property tax (which serves a different purpose), these taxes raise relatively little revenue: only 0.1 percent of GDP in 2012. In addition, wealth taxes bear essentially on real property, which constitutes the main asset of the middle class (Table 3). By contrast, the top 10 percent wealthiest households keep almost one-fifth of their gross wealth in financial securities and business equity, which are subject to a lower taxation.[34]

Table 3. Composition of Italian Household Wealth per Net Wealth Decile[1]

	Real Assets			Financial Assets			
Decile	Real Estate	Business Equity	Valuables	Deposits	Government Securities	Other Securities	Trade Credit [2]
1	3	2	60	33	0	0	1
2	2	1	37	59	0	0	0
3	32	7	14	40	3	4	1
4	79	3	4	11	1	2	0
5	87	3	2	6	0	1	0
6	90	2	1	5	1	1	0
7	89	2	2	5	1	1	0
8	87	3	1	5	1	3	0
9	87	3	1	5	1	3	0
10	78	10	1	4	1	5	1

Source: 2010 Survey on Household Income and Wealth (BOI), and staff estimates.
Reading: Real estate accounts for 78 percent of net wealth of the top 10 percent richest households.
[1] As a share of total (real+financial) assets. Averages over the weighted sample of households.
[2] Or credit extended to other households.

[34] Looking at Table 3, it is striking and perhaps surprising that the highest decile hold such a large share of their wealth in non-financial assets. While the data in principle include assets held abroad, it is possible that these are understated; the survey also mentions the possibility that increased risk aversion has led to reduced holding of financial assets since 2000. There are few internationally comparable data, but the top decile in the U.S. held around 70 percent of their wealth in non-financial assets—not entirely dissimilar to the estimates for Italy (Board of Governors of the Federal Reserve System, 2012).

40. **There may be efficiency advantages in a piecemeal approach to wealth taxation, but this also creates distortions**. Real property is much less mobile internationally than financial capital, so that efficiency consideration points to taxing it at a higher rate—as is now the case. But such differential treatment raises other concerns. For instance, the steep increase in property taxation may adversely affect the real estate market. And exemptions or preferential tax treatments open up opportunities for avoidance. For instance, the flat fee on bank accounts may encourage some households to divest low-yield assets and keep their savings in bank accounts. Another issue is that wealth taxes are currently levied on gross assets, generating a bias against leveraging. This may amplify the traditionally high propensity of Italian households to save (although their savings rate has declined significantly since the onset of the financial crisis). To mitigate this bias, financial liabilities should be deducted from the taxpayer's gross wealth.

41. **A comprehensive NWT has relatively high compliance and administrative costs.** In principle, a NWT could replace the set of existing taxes, applying a single tax rate to all assets (net of liabilities) with a high allowance (possibly with a progressive rate schedule). This would be in addition to the IMU, as their objectives are not similar: the property tax is a benefit tax financing local government services, while the NWT aims at equalizing opportunities, and should be assigned to the central government. A NWT could also complement the capital income tax, if the latter is constrained by policy design—for example, by the commitment to a low flat rate under the DIT system. But there would also be difficulties. It is often argued that a NWT has a higher cost of administration and a higher compliance cost; cost and complexity were important factors behind the repeal of the NWT in several European countries. This argument has, however, somewhat less force in Italy, where taxes on financial and real assets already exist: the shift to a NWT would probably not require a dramatic change in revenue administration, apart from the need to collect information on financial liabilities. Another difficulty is the need to define the appropriate taxable unit of the NWT.[35] Boadway and others (2010) discuss this issue in the context of the tax reform in England, where husband and wife are also treated as separate units. The system should be designed to minimize incentives to split wealth among family members, for instance by giving households the option to file a joint declaration with specific rates and allowances.

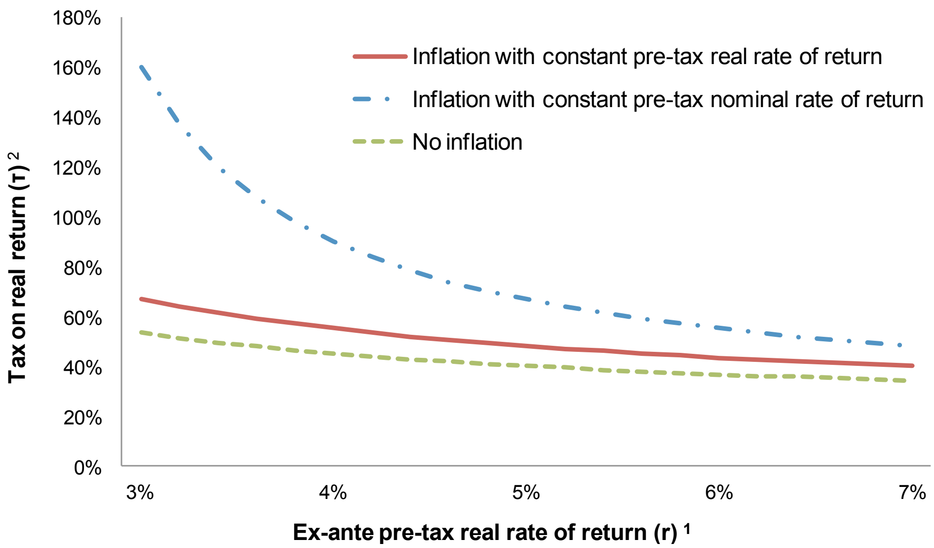
42. **Probably most important, a NWT could significantly discourage capital accumulation.** Capital taxation is already very high in Italy by European standards (Figure 1). The layering of the NWT on top of the existing capital income tax could indeed result in high effective marginal rates, particularly at lower real rates of return and at higher inflation rates (Figure 6).[36] For instance, for an investor earning a 5 percent real return on assets, a 1 percent NWT effectively doubles the current 20 percent capital income tax to 40 percent; in the presence of 2 percent inflation, the tax on the real

[35] Currently, the taxable unit is the individual in Italy.

[36] Suppose that an asset of value A is subject to a wealth tax at rate T and generates a nominal rate of return of $i = r + \pi$ (where r is the real rate of return and π the inflation rate) that is taxed at rate t. Total tax paid is then $TA + t(r + \pi)A = \left[t + \left(\frac{T}{r}\right) + \left(\frac{t\pi}{r}\right)\right] rA$, so that the effective tax rate on real returns is, on the horizontal axis in Figure 5: $\tau \equiv t + (T/r) + (t\pi/r)$. With zero inflation, $\tau \equiv t + (T/i)$.

return would rise to 67 percent in the short term (if inflation is not anticipated, and the pre-tax real rate of return declines) and 48 percent in the medium term (once nominal pre-tax rates of return have adjusted). Facing lower returns, investors may shift from savings to consumption, which would negatively affect domestic investment and growth. They may also look for opportunities abroad and expatriate.[37]

Figure 6. Impact of a 1 Percent Wealth Tax on the Taxation of Real Returns of Investors



Source: IMF staff estimates.
[1] Ex-ante = before negative effect of unanticipated inflation on the real rate of return.
[2] Tax on real return combines the capital income tax (t = 20 percent) and the wealth tax (T = 1 percent). Inflation assumption is 2 percent per year.

G. Conclusions

43. **Considerable progress has been made towards a more neutral capital income tax system but challenges remain.** Neutrality in the treatment of capital income has been significantly improved by recent reforms, especially by the introduction of the ACE. This eliminates the tax on the normal return to equity at the level of the business, neutralizing the preferential tax treatment of debt finance. Present tax arrangements, however, are not neutral between different organizational forms. To address this issue, the authorities have proposed to introduce a new business tax unifying the treatment of retained earnings across different types of business. This is a further step toward easing distortions of business decisions on organizational form and investment levels.

[37] In any case, these decisions are driven by multiple factors and not only by taxation.

44. **Cadastral values should be brought closer to market values**. Property tax assessments are more than 20 years out of date, and relative property prices have diverged widely since then: in some regions, they have increased by 500 percent; in others, by half that. While effective in increasing revenues, recent uniform adjustments to cadastral values and rate increases have increased awareness of the system's inequities, even though taxable values remain well below market values. Alignment of cadastral prices with market prices will be an important step to improve fairness in property taxation, and so pave the way for more effective use of this instrument. Tax rate cuts could partially offset increases in taxable value resulting from revaluation, but some of the revenue gains should also be used to reduce transaction taxes tied to immovable property.

45. **There is scope to strengthen the taxation of wealth in Italy**. Doing so could enhance social solidarity, and share more equitably the burden of fiscal consolidation. A first step toward wealth taxation reform could be to reduce significantly taxes on asset transactions. These are quite large in Italy, but have little justification beyond administrative simplicity: they distort behavior and hinder the efficient allocation of assets. The inheritance tax is quite well designed, but currently has little redistributive impact because of its relatively low rates and high allowances. Adopting a progressive rate schedule may allow Italy to achieve a more ambitious equalization of opportunities. In the medium term, a move toward a more comprehensive taxation of wealth would mean substituting a single NWT for the set of existing taxes. A piecemeal approach allows differentiating rates across assets according to their degree of mobility, which has efficiency advantages; but this comes at some price in terms of equity, and can create its own distortions across types of asset (and difficulty in netting out liabilities).

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REFORMING TAX EXPENDITURES IN ITALY[1]

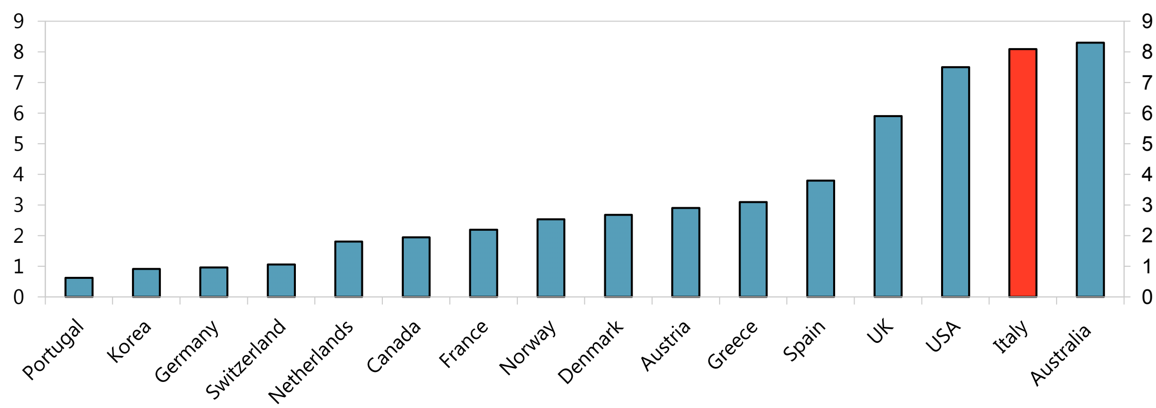
The IMF has advised country authorities to roll back tax expenditures as a way to support fiscal consolidation efforts—urging them to evaluate tax expenditures according to clear criteria, and assessing their impact on public finances, economic efficiency, equity, and administrative and compliance costs.[2] This chapter analyzes tax expenditures in Italy, considering the extent to which tax expenditures can be considered part of an optimal tax system and possible reforms.

A. What Are Tax Expenditures?

1. Tax expenditures are government revenues foregone as a result of differential, or preferential, treatment of specific sectors, activities, regions, or agents. They can take many forms, including allowances (deductions from the base), exemptions (exclusions from the base), rate relief (lower rates), credits (reductions in liability) and tax deferrals (postponing payments). International comparisons are complicated by different methodologies and assessments as to what constitute a tax expenditure, but the practice is pervasive, and tax expenditures in Italy are clearly elevated.

Tax Expenditures in Selected Advanced Economies

(Percent of GDP)



Sources: OECD (2010); United States, National Commission on Fiscal Responsibility and Reform (2010).
Note: Higher values may arise from more comprehensve reporting (recent estimates for Italy are higher due to change in benchmark).

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[1] Prepared by Justin Tyson (EUR). This chapter, which builds on the findings of IMF (2012), has benefited from suggestions from Luc Eyraud, Ruud de Mooij, Kenneth Kang, and Michael Keen. The author would also like to thank the staffs of the Italian Ministry of Economy and Finance and the Bank of Italy for helpful discussions, suggestions and inputs.

[2] See April 2011 Fiscal Monitor.

B. Why Should Tax Expenditures Be Reformed?

2. Tax expenditures can have major consequences for the fairness, complexity, efficiency and effectiveness of not only the tax system itself but, since they often serve purposes that might be (or are also) pursued through public spending, of the wider fiscal system.

Tax expenditures can compromise fairness. Tax expenditures can be a poor way of pursuing equity objectives: in a progressive tax system, for instance, any policy that reduces taxable income will benefit most those in the highest marginal tax bracket and convey no benefit to those out of the tax system, a potential reason for using tax credits (or spending measures) instead. The tax expenditures associated with the reduced VAT rates in Italy, for instance, in themselves increase progressivity—but much of the benefit will go to the better off, so that the same equity objectives could likely be pursued at less cost through social spending.

Tax expenditures can be inefficient and poorly targeted. Tax expenditures can create unintended or unwelcome distortions: the current deduction of mortgage interest, for instance, may have been appropriate when imputed income from owner-occupation was effectively taxable, but now simply encourages leveraged housing finance.

Tax expenditures are vulnerable to lobbying. Special interest groups may find it easier to argue for tax breaks than for explicit spending support. Tax expenditures often bypass the scrutiny accorded to spending in the regular budget and may not require annual renewal in the budgetary process—this lack of transparency may explain some of the appeal they hold for policy makers.

C. Are All Tax Expenditures Bad?

3. Not all tax expenditures are necessarily bad. For example, tax expenditures could benefit from administrative economies of scale—as they usually deliver their "rewards" through a reduction in taxes that would have been paid anyway, spending ministries do not need to allocate resources to administering substitute programs in either cash or kind. Tax expenditures can also be a way of achieving fair and efficient taxation: the largest single tax expenditure in Italy is a tax credit that serves the same purpose as basic tax-free thresholds serve elsewhere. The table below provides a comparison of tax expenditures and direct spending, summarizing the main costs and benefits.

Table 1. Comparison of Tax Expenditures and Direct Spending

	Tax Expenditures	Direct Spending
Accessibility for beneficiaries	Simple, because of their automatic nature.	More complex, requiring selection.
Administrative and compliance costs	High, if exemptions are properly monitored.	Medium, due to necessity of a selection and allocation system.
Possible abuses	Evasion, avoidance, and rent seeking.	Arbitrariness, inefficiency, and capture of the allocating body.
Flexibility	Work with permanent laws, thereby generating stability but also inertia.	Work with budgets, evaluations, and regular reallocations. 1/
Transparency and accountability	Their automatic nature does not contemplate control mechanisms or accountability.	Must be approved by the legislature, as with all government expenditure.
Expenditure control	Expenditure determined ex-post; uncertain and unlimited, which can cause fiscal imbalances.	Programmed and controlled spending, limited by budget law.
Equity	Only potential taxpayers benefit, and those with the highest income often benefit the most.	Discretion can provide more equitable access, enhancing targeting of beneficiaries.

Source: Villela, Lemgruber, and Jorratt (2010) in April 2011 Fiscal Monitor.

1/ This has not been the case in Italy, where the budget contains many legal rigidities.

D. How Can Tax Expenditures Be Identified and Quantified?

4. Identifying and quantifying tax expenditures is critical for a complete understanding, and informed public discussion, of the overall impact of the tax system. The first step is the definition of a benchmark tax system. It is this norm that allows identification of provisions in the tax system that are part of this tax norm and those that are not. However, there is no consensus on how to define a tax norm.

5. The main distinction is between approaches that use a norm based on theoretical concepts of income, consumption, or value-added taxes and those that use a country's own tax laws as a basis to define the benchmark, isolating differential or preferential treatment judged as tax expenditures (e.g. targeted provisions to address specific policy objectives). The former will classify as tax expenditures elements which might otherwise be considered part of tax design.

6. Once tax expenditures have been identified, the second step is to quantify the budgetary cost of the individual tax expenditure "policies." Most countries estimate the loss in government revenue due to the tax expenditure, based on the actual uptake of the differential treatment. Substantial work has already been undertaken on the identification and quantification of tax expenditures in Italy. A report, commissioned by the Ministry of Economy and Finance (MEF), identifies and costs 720 tax expenditures amounting to about 16 percent of GDP.[3] The MEF, by

[3] MEF (2011).

choosing the conceptual approach to identifying the benchmark, provides very extensive coverage by international standards; however, it would be neither feasible nor desirable to eliminate all the tax expenditures identified.[4]

E. Once Identified, How Should Tax Expenditures Be Evaluated?

7. Clear and frequent evaluation of the identified tax expenditure is necessary for scaling back those not generating benefits commensurate to their cost. This is not always straightforward, in that the impact of tax expenditures on behavior is often hard to identify; but even in such cases, some sense can be given of whether it is plausible that the response is large enough to warrant the costs incurred. As a start, tax expenditures should be evaluated within the framework used to analyze the tax system as a whole:

1. Does the tax expenditure promote or hinder economic efficiency? To what extent does it influence taxpayer behavior in desirable ways or distort behavior in undesirable ways?

2. Is the tax expenditure fair? Are similar individuals treated similarly? Does the tax expenditure account for individuals' different capacities to bear the burden of taxation?

3. Is the tax expenditure simple and easily administered? This includes calculating tax liability, filing taxes, government administration, enforcement and ease of evasion.

4. Is the tax expenditure vulnerable to lobbying? Does the tax expenditure benefit very specific interests groups and how frequently are costs and benefits scrutinized?

8. It is also important to compare tax expenditures with alternative spending measures and, more generally, to assess them in the light of what can be achieved on the spending side. For example, some of the tax expenditures with social objectives, such as the dependent relative tax credit, potentially overlap with the objectives of social assistance programs run through the social security system—the relative costs and merits of both delivery options need to be considered.

F. What Types of Tax Expenditures Are There in Italy?

Personal Income Tax (PIT)

9. Establishing the relevant benchmark for the personal income tax is not easy, as it is a prime tax instrument for redistribution. While the literature offers some guidance on what is optimal (i.e. a natural benchmark), it requires a subjective assessment of the equity-efficiency trade-off. Some targeted allowances can be desirable, but in practice many are often not effective. In Italy, tax expenditures were measured both against a measure of comprehensive economic income

[4] Since 2010, annual State Budget documents have included a list of all tax expenditures, but only at the level of central government and measured against current legislation—a narrower benchmark than used in the MEF report.

(consumption plus change in net worth) and also against a dual income tax (DIT) system, which taxes labor income at progressive rates but capital income at a low single rate.[5]

10. Many of the largest identified PIT tax expenditures are arguably desirable parts of a normal tax system. Table 2 summarizes the largest PIT tax expenditures, collectively worth over 5 percent of GDP.

Table 2. Summary of Largest PIT Tax Expenditures

Description	Value (billions)	Percent GDP	Comment
Tax credit for wage income from employment, pensions, self-employment and similar income.	37.73	2.41	This regime is a substititue for the fact that Italy has no lower personal income tax threshold.
Various financial subsitute taxes (lower rates) on interests, dividends, capital gains and other forms of return.	13.17	0.84	Substitute tax regime by-passes the requirement to tax capital income according to the progressive PIT schedule by mimicking a Dual Income tax regime.
Tax credit for dependent relatives.	10.50	0.67	This benefit is sometimes considered a measure of ability to pay and part of the benchmark system rather than a tax expenditture.
Tax exemption (excluded from base) for contributions to welfare and pension schemes for employees.	10.10	0.64	Pension contributions are excluded and pension income is taxed. Avoids double taxation.
Lower PIT rates for payment of separation allowances and "golden handshakes"	5.10	0.33	Unwinds tax progressivity that would come from what is effectively receipt of multi-year income in one period.
Tax exemption (excluded from base) for compulsory contributions to welfare and pension schemes for self-employed.	4.31	0.28	Pension contributions are excluded and pension income is taxed. Avoids double taxation.
Tax credit for medical expenses and health assistance services.	2.36	0.15	Considered to have welfare objective.
Sum of largest PIT tax expenditures.	**83.26**	**5.32**	

Sources: MEF, 2011; and IMF staff estimates.

11. The largest single item is a universal tax credit that compensates for the lack of an income tax threshold, which Italy does not have but many other countries do. Consequently, it can be seen as a key component of a progressive income tax system. Similarly, the 2nd largest tax expenditure in this category allows capital income to be taxed at a low and (almost) uniform rate. As such, it is an intrinsic part of the DIT system. The third largest item is a tax credit for dependent relatives, which in many countries is considered a measure of ability to pay and hence contributes to the fairness of the tax system. Arguably, of the largest PIT tax expenditures, the tax credit for medical expenses and health services is one that most likely could be replaced by a better targeted expenditure program.

[5] A DIT differs from a 'comprehensive' income tax in distinguishing between capital and labor income (rather than subjecting the sum of the two to a single progressive scale). To avoid arbitrage opportunities and facilitate implementation, the textbook prescription is to set the corporate income tax rate equal to the single rate on capital income. See IMF(2012) for a fuller discussion.

Corporate Income Tax (CIT)

12. To measures CIT tax expenditures a concept of net business profit was applied. The largest CIT tax expenditure is a measure to avoid double taxation of foreign sourced dividends. Other measures, although less a feature of a normal CIT system, could have their merits in the current environment, such as the deductibility of social security costs from the regional business value added tax (IRAP). This measure was introduced to reduce the labor tax wedge and incentivize hiring by firms. Other CIT tax expenditures, such as those to incentivize restructuring and mergers, should be weighed against other policy options for achieving this objective, such as a streamlining of court processes (see chapter 2).

13. An important element of corporate/business taxation in Italy is the Allowance for Corporate Equity (ACE). It is an important example of a provision that looks like a tax expenditure, but can also be considered a key element of tax design. By providing a tax deduction for a notional return on additional equity injected into companies, this system reduces the cost of such finance and eases the tax incentive to use debt rather than equity finance. It constitutes an important step toward greater neutrality for business investment and financing decisions, taking Italy closer to a form of "dual income tax".

Table 3. Summary of Largest Tax Expenditures

Description	Value (billions)	Percent GDP	Comment
Foreign-source dividends received by a resident corporate taxpayer are 95% exempt from CIT.	8.38	0.54	Measure to avoid double taxation.
Subsitute tax (16 percent) for capital gains from goodwill, trademarks and other intangible assets resulting from extraordinary operations, such as restructuring and mergers.	7.43	0.47	Tax provision to promote firm dynamism and incentivize new activity.
Full deduction from IRAP tax base of SSC costs related to permanent workers; full deduction from PIT and CIT tax base of IRAP on labour costs (plus partial deductability of interests costs). 1/	6.69	0.43	Provision mainly to reduce labor tax wedge.
Substitute tax for capital gains arising from "extraordinary" operations, suchs as mergers, divisions, and transfers of companies.	6.40	0.41	Measure to favor restructuring, which brings higher depreciation charges (lower taxes) from corporates in the future.
Subsitute tax on capital gains (lower rate) from revaluation of assets held on the balance sheet at historical cost.	4.18	0.27	Generates current revenue for the authorities in exchange for higher depreciation charges (lower taxes) from corporates in the future.
Sum of largest CIT tax expenditures.	**33.08**	**2.11**	

1/ Full deducution of IRAP labor costs from PIT and CIT was introduced in Law 214/2011 and is not explicitly costed in the table, which instead based on earlier lump-sum deductions per employee.

Sources: MEF, 2011; and IMF staff estimates.

Value Added Tax (VAT)

14. A uniform rate with a broad base is a good benchmark (e.g. the VAT is not a good instrument either to address externalities, or to deal with redistribution). Consequently, the top-down policy gap outlined below is a useful concept, as it measures a deviation from a benchmark that is deemed optimal.

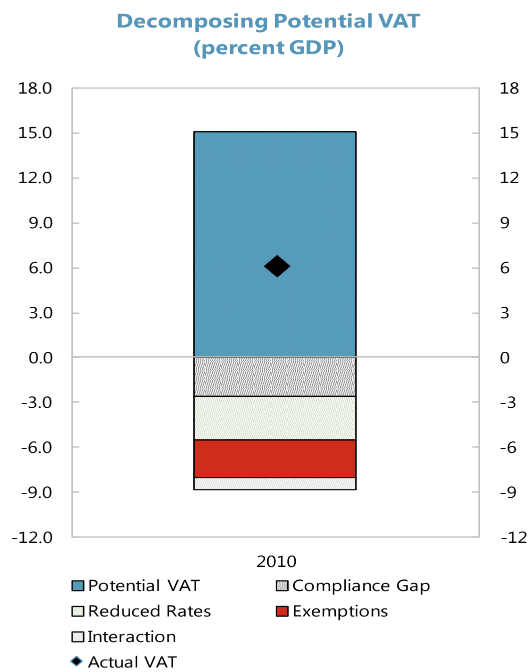
15. For the VAT, the shortfall of C-efficiency[6] from 100 percent can in principle be decomposed into terms relating to both the compliance gap and a "policy gap," reflecting the extent to which consumption is not actually taxed at the standard rate. For Italy, C-efficiency is estimated at around 41 percent in 2010—revenue was 41 percent of what it would have been had the then-standard rate been applied to actual taxable consumption. Combining this with a compliance gap of around 30 percent, as the studies of the Revenue Agency suggest, implies a policy gap also of around 41 percent. These calculations are illustrative, in that they derive from distinct data sources that are not fully comparable. Nonetheless, they give some sense of the relative potential of design and compliance improvements: halving the compliance gap, maintaining all tax rates unchanged, would thus raise about 1.3 percent of GDP; halving the policy gap, keeping the standard rate unchanged, would raise about 2.7 percent of GDP. (The policy gap can in turn be decomposed into elements reflecting rate differentiation and the operation of exemptions: Box 1 illustrates for Italy).[7]

Box 1. Decomposing the IVA Policy Gap

De Mooij and Keen (2012) show that the policy gap can be further decomposed down as:

(1-policy gap) = (1-exemptions)×(1-rate dispersion)

where the first term captures the impact of exemptions (sectors, activities), and the second measures the effect of non-standard VAT rates on collections (usually lower rates). The recent report of the MEF on tax expenditures in Italy implies rate dispersion at about 0.25 percent; combined with a policy gap of 41 percent, this implies an "exemptions" gap of 0.22 percent in 2010. In percent of GDP (2010), this means lost revenue of 2.5 due to exemptions (including those mandatory under EU rules, which of course Italy cannot unilaterally remove), 2.9 due to lower rates, and 2.6 due to non-compliance. This leads to actual revenue collection of just over 6 percent of GDP—as opposed to potential revenue, at an unchanged standard rate, of 15 percent of GDP.



[6] C-efficiency is the ratio of VAT revenues to the product of the standard VAT rate and consumption.

[7] Box developed from IMF (2012).

16. The largest VAT tax expenditures in the MEF report are the reduced rates (2.5 percent of GDP), consistent with a top-down decomposition of the VAT policy gap.[8] However, the estimated cost of exempt regimes from the decomposition of the policy gap (2.5 percent of GDP) is much larger than that found by the MEF (0.06 percent of GDP)—this is likely due to the unquantified miscellaneous exempt regimes, both national and EC-mandated. Both groups of exempt regimes should be scrutinized. The MEF report also quantifies the cost of VAT reduced rates and some of the exempt regimes; these are summarized in Table 4.

Table 4. Summary of Largest VAT Tax Expenditures

Description	Value (billions)	Percent GDP	Comment
VAT reduced rate (10 percent).	24.60	1.57	Including food items, restaurants and hotels, pharmaceutical and medical products, energy products and recreational services.
VAT reduced rate (4 percent).	14.60	0.93	Including food items, books and newspapers, and school and company canteens.
VAT Exemptions			
Italy Specific			
Special regime/s for agricultural producers	0.29	0.02	
Special regime for publishing sector	0.24	0.02	
Special regime for tobacco and match producers			
Supplies of goods to (solely) charitable, educational or research bodies	0.17	0.01	
Exemption for funeral services	0.12	0.01	
Miscellaneous other regimes			
EC regulations			Including financial sector, travel agencies, used cars, secondhand goods, antiques, sales by auction etc.
Sum of largest VAT tax expenditures.	**40.02**	**2.56**	

Sources: MEF, 2011; and IMF staff estimates.

Excise Tax (VAT)

17. The benchmark used in the MEF study is the legal tax system, although in principle, as excise taxes are designed to address externalities, one could assess the extent to which taxes fall short of the Pigouvian rate. Most excise tax expenditures are designed to provide some degree of competitive advantage to sectors that could be better achieved through other reforms—for example, structural reforms to reduce the cost of energy (see Table 5).

[8] The MEF estimate of the cost of reduced rates (2.5 percent of GDP) differs slightly from the estimate in Box 1 (2.9 percent of GDP) due to differences in the estimated base of taxable consumption.

Table 5. Summary of Largest Excise Tax Expenditures

Description	Value (billions)	Percent GDP	Comment
Reduced excise tax for public transport companies.	1.67	0.11	Sectoral benefits.
Reduced excise tax for agricultural sector.	0.96	0.06	Sectoral benefits.
Tax exemption for houses with monthly energy consumption between 3 and 120 KWH.	0.55	0.04	
Sum of largest Excise tax expenditures.	**3.17**	**0.20**	

Sources: MEF, 2011; and IMF staff estimates.

Other taxes

18. Some very large tax expenditures have already been removed with recent reforms. For example, the proposed revaluation of property cadastral values will eliminate previously identified tax expenditures related to property and transfers taxes (see chapter 3).

G. Which Tax Expenditures Should Be Reformed and How?

19. Italy has a strong foundation to build on in terms of reforming tax expenditures. As mentioned, substantial work has already been undertaken on the identification and quantification of tax expenditures by the MEF. In addition, the draft tax reform law (*Delega Fiscale*) provides for the annual publication of a list of tax expenditures according to criteria and a methodology that will be supported by an external review body. This goes beyond the standards set out in the IMF Code of Good Practices on Fiscal Transparency and the OECD Best Practices for Budget Transparency.[9]

20. Several other steps should be considered.

Selected Support for Agricultural Sector

Description	Value (billions)	Percent GDP
Tax Expenditures		
Reduced excise tax for agricultural sector.	0.96	0.06
Special VAT regime for agriculture.	0.31	0.02
Reduced IRAP rate for agricultural sector.	0.23	0.01
CIT exemption for certain agricultural cooperatives.	0.17	0.01
Reduced transaction taxes for rural property.	0.16	0.01
Budget Support		
National funds for rural development	1.5	0.10
EC Comon Agricultural Policy (mainly single payment)	5.9	0.38

Source: MEF (2011), Ministero delle Politiche Agricole e Forestali.

- *Ideally, all tax expenditures should be regularly and systematically reviewed, just like regular government expenditures*. Indeed, in Italy tax expenditures reviews should be combined with spending reviews to allow policy makers to analyze holistically government support to particular sectors, activities, regions, or agents. Otherwise there is a risk of overlapping objectives and expenditures between different programs. The text table provides an illustrative estimate of agricultural sector support, but the transport sector and social welfare programs are other areas where potential duplication should be evaluated.

- *Tax expenditures often don't require annual scrutiny and renewal by Parliament*. To incentivize proper consideration of costs and benefits, the authorities could consider legislating expiry

[9] IMF (2007) Article 3.1.3 and OECD (2002).

clauses for all tax expenditures (especially those benefiting particular groups). In addition, any extension of existing tax expenditures, or granting of new ones, should only be possible as part of the annual budget process.

- *Particular caution is needed in aggregating tax expenditures*, because the aggregate revenue gain from eliminating two tax advantages may differ from the sum of the gains from eliminating each in isolation.

21. It is hard to identify up front how much could be saved from a thorough review. However, using the study already done, policy makers should consider priority reviews for tax expenditures that are not fully quantified (e.g. VAT exempt regimes); are poorly targeted (e.g. VAT reduced rates); are better covered by expenditure programs (e.g. for medical services); benefit only certain groups that also receive spending support (e.g. reduced VAT and excise tax for public transport companies and agriculture); and are distortionary (e.g. preferential treatment for government bonds). Table 6 provides an illustrative guide for priority review (it should be noted that savings will not equal the total estimate of the tax expenditure cost if it is to be replaced by a better targeted spending program or if the reduction is partial).

Table 6. Illustrative Table of Tax Expenditures for Priority Review

Description	Value (billions)	Percent GDP	Comment
VAT Reduced Rates	39.20	2.50	Not all of this can be saved, but some reduced rates could be eliminated and others harmonized. Expenditure programs may be needed to offset some redistributive impact.
VAT Exempt Regimes	…	2.52	Top-down estimate. Some are EC requirements.
Fuel excise tax exemptions and reduced rates	3.17	0.20	Accelerated structural reforms could provide alternative support to productivity.
Income tax credit for medical expenses and health assistance services.	2.36	0.15	Objectives potentially better achieved by spending progam.
Income tax credit for interest paid on mortgage for principal residence (or construction of principle residence).	1.34	0.09	A complete repeal could create budget difficulties for some households, so a review should proceed with caution focusing first on new mortgages.
Reduced income tax rates on the interest and bonuses from government securities and other forms of public debt e.g. postal bonds.	1.38	0.09	Supports government bond market over other forms of investment.
CIT: substitute taxes to encourage restructuring, mergers and transfers.	13.83	0.88	Objectives potentially better achieved through structural reforms. Estimates should be treated with caution as some may be one-off.
Total (illustrative)	**61.28**	**6.44**	

Sources: MEF, 2011; and IMF staff estimates.

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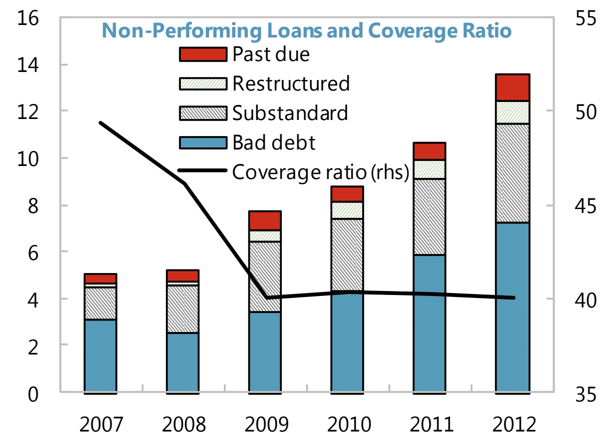
STRATEGY FOR FOSTERING A MARKET FOR DISTRESSED DEBT IN ITALY[1]

Addressing the buildup of nonperforming loans (NPLs) since the crisis will remain a challenge for Italian banks well after the recession. The high stock of NPLs is due both to the increase in flows and the slow pace of write-offs. The paper examines the framework for resolving NPLs and ways to accelerate write-offs, through tax policies, legal reforms, and regulatory policies, using lessons from other countries where banks have accelerated NPL disposals. The paper focuses on developing a private market for restructuring distressed assets that could support banks' efforts to clean their balance sheets and rehabilitate problem borrowers.

A. Current Situation with NPLs in Italy

1. **The definition and coverage of NPLs in Italy is generally more conservative than in other European countries**. Italy's NPL definition covers four categories and includes not only "bad debt" (loans in a state of insolvency), but also "substandard," "past due" (beyond 90 days), and "restructured" loans (loans whose initial terms have been altered). Italy has been following the international financial reporting standards (IFRS) since 2005, but has adopted a more conservative definition of "incurred losses" that is closer to the prudential definition.[2] The existence of collateral or guarantees in Italy also does not affect loan classification and is not included in the reported coverage rate, which is not always the case in other countries following the IFRS. For these reasons, the lack of a common definition across Europe makes it difficult to compare NPLs and their provisioning coverage across countries.



Source: Bank of Italy.

2. **The lengthy recession has severely eroded the asset quality of Italian banks.** Since 2007, the ratio of nonperforming loans (bad, substandard, restructured and past-due) has nearly tripled to 14 percent. While much of the increase has been in the worst category of defaulted "bad debt," substandard loans (that demonstrate temporary financial weakness) have also expanded

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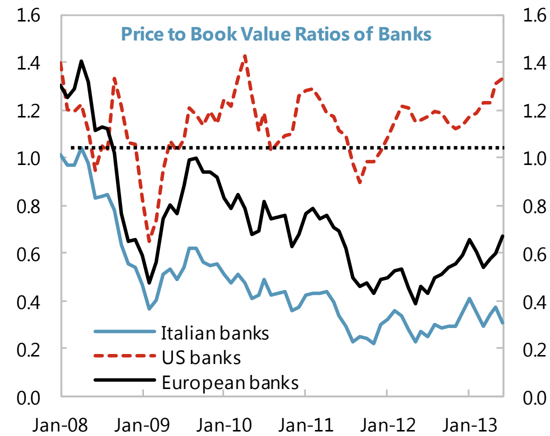
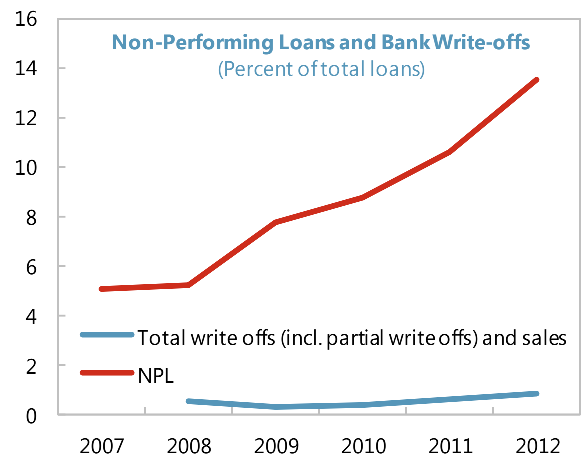
[1] Prepared by Bergljot Barkbu (EUR), Nadege Jassaud (MCM), and Kenneth Kang (EUR).

[2] Under the IFRS, a loss is considered as "incurred" if there is objective evidence of impairment. Expected losses linked to future events and forward looking considerations are not recognized. To address this weakness and upon a special request of the G20, international accounting setters, IFRS and US Gaap are currently discussing changes in bank provisioning accounting. However, full reconciliation of the two approaches appears unlikely at this stage.

significantly. Loan loss provisioning has not kept pace with the rise in NPLs, with the coverage ratio (loan loss provisions to non performing loans) having fallen from 45 percent to 39 percent. Provisioning also varies across banks, with smaller banks in general featuring a lower coverage rate. Provisioning coverage does not include collateral backing (real estate and guarantees) which in Italy covers nearly two-thirds of all loans.

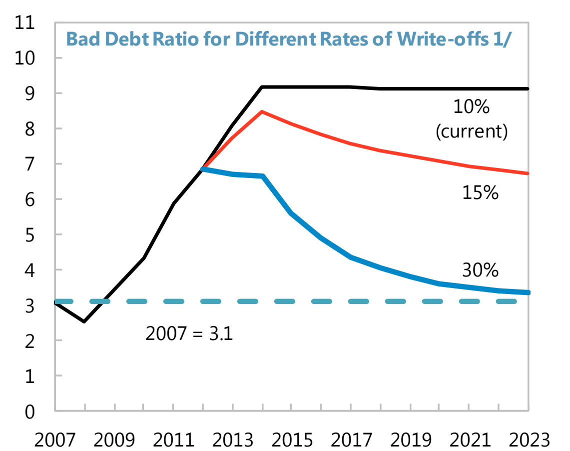


3. **The pace of write-offs has slowed since the crisis**. The high stock of NPLs is due both to an increase in flows and the slow pace of write-offs which has increased to over 6 years, from just under 4 years before the crisis. Over the last five years, NPL write-off rates have not kept pace with the flow of new NPLs.[3] Although practices vary across countries, the pace of write-offs in Italy is low and contributing factor to the high steady state of NPLs in Italy.



Source: Bank of Italy.

4. **Without a significant pickup in write-offs, NPLs could remain high well after the recession.** Staff simulations suggest that at current write-off rates, under the baseline scenario of a modest recovery, the bad debt ratio would peak in 2015 and decline only gradually. In the absence of a stronger recovery, it would take a substantial increase in write-offs—nearly a tripling compared to the historical average—to bring down the bad debt ratio to pre-crisis levels within ten years.



Sources: IMF staff estimates; and Bank of Italy.
1/ The simulation assumes a 2 percent default rate, reduced to 1 percent from 2015 and a 1 percent loan growth. Write-off rates are expressed as a percentage of bad debt.

5. **High NPLs are a major drag on bank profitability**. High NPLs undermine bank profitability in several ways. As NPLs do not generate an interest return but require funding at positive market rates, they create a negative carry, which reduces banks' net interest margins.[4] High NPLs also raise the scope for additional provisioning, as market values decline and growth slows. In 2012, rising loan losses absorbed

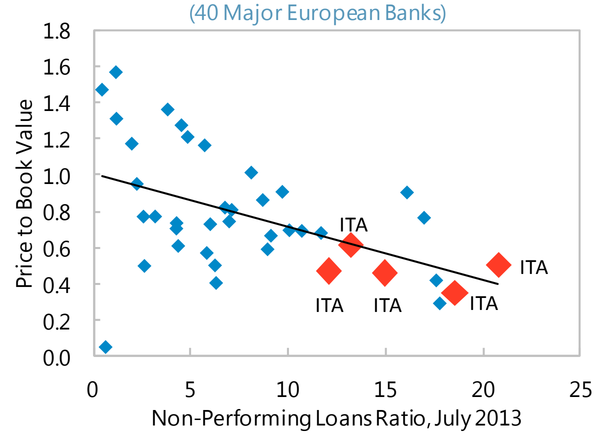
[3] See the Bank of Italy's April 2013 *Financial Stability Report*.

[4] In addition, since Italian banks are allowed to accrue interests on NPLs that are not classified as bad debt (roughly half of NPLs), this accrued interest overstates net interest income and the resulting tax burden.

nearly all of operating profits of the large banks. NPLs also incur a cost in terms of regulatory capital. For banks using standardized methods, a higher risk weight (up to 150 percent) is required for the portion of NPLs that are not provisioned or collateralized. Banks using internal models under Basel 2 calculate the expected losses on NPLs and are required to deduct from core capital, the part that is not covered by specific provisions ("expected IRB shortfall"). Finally, a large NPL portfolio ties up human and operational resources which the bank could use instead to support more profitable lending.

6. **There is also evidence that high NPLs lower bank valuations and have increased the cost of funding.** Worsening asset quality may be a factor in explaining Italian banks' higher CDS spreads and lower market share valuations compared to banks in the rest of Europe and the United States. There is also empirical evidence that banks with worse asset quality are more sensitive to sovereign distress, passing on higher sovereign risk premia to the real economy. This leads to a higher cost of funding for Italian banks and tighter credit conditions for the real economy.[5] Accelerating the disposal of NPLs would reduce this vulnerability and strengthen banks' capacity to extend new lending.

NPL Ratio versus Price to Book Value, July 2013
(40 Major European Banks)



Source: Bloomberg.

B. Reasons behind the Slow Pace of Write-Offs

7. The slow pace of write-offs reflects both push factors that lower the incentives for banks to write-off and pull factors that limit the effectiveness of available options to dispose of NPLs efficiently and quickly.

Push Factors: Limited Incentives for Banks

8. **Lower provisioning limits the incentive for banks to write off more aggressively.** By writing off, banks remove the bad loans from their balance sheets. As a result, they need to book a loss, up to the difference between the value in their book and the amount they provisioned. Hence, lower provisions imply a high cost in writing off (Box 1). Italian banks' heavy reliance on collateral, covering some 48 percent of total loans, may also encourage banks to wait till the end of a lengthy foreclosure procedure to collect rather than to dispose quickly. This creates some uncertainty in estimating loan recoveries as collateral values are difficult to assess given their sensitivity to real estate developments and collection delays through the legal system.

[5] See E. Zoli, "Italian Sovereign Spreads: Their Determinants and Pass-through to Bank Funding Costs and Lending Conditions," IMF WP/13/84, April 2013.

9. **Lower provisioning may also hamper sales to third parties.** An alternative to write offs are direct sales which are usually the most efficient and quick solution to relieve banks from vulnerable assets and collection costs. However, selling also implies some discount compared to the valuation in bank books. This "pricing gap" with the market is currently about 10-25 percent. It varies by loan category and also reflects different perceptions on the prospects for recovery, provisioning rates, or the value of the underlying collateral. It is reported to have narrowed recently, partly in response to the increased provisioning under the BoI special inspections, but still remains too large for banks to sell.

Box 1. International Practices for Write-offs of NPLs

Write-off practices vary widely across countries. While European banks tend not to write-off until the debt is considered uncollectible, U.S banks write off more promptly, due to more stringent regulatory guidance. In past banking crisis, supervisors also used time limits on NPLs to accelerate the cleanup of banks' balance sheets.

In the United States, regulators have overlaid the accounting standard with detailed regulatory guidance that harmonizes the treatment of write-offs. The regulators acknowledge that management will have discretion in judging write-offs under U.S generally accepted accounting principles (US-GAAP). But to guide management, regulators have added detailed regulatory guidance that harmonizes the treatment of write-offs. Compliance with the guidance, in turn, is validated through onsite inspections.

U.S. regulatory guidance has introduced time-limits on writing off NPLs that are independent from the time to foreclose. For example, after 180 days past due, a mortgage loan is valued exclusively based on the underlying collateral (at market price with no adjustment for possible increase in value over time). Any loan balance that exceeds the value of the collateral, less the cost to sell, should be written off. This requirement is regardless of how long it takes to foreclose.

Guidance on write-offs was also been introduced in other countries to help clean bank books from legacy assets. For instance, in Japan, the emergency economic measures of 2001 further accelerated the disposal of distressed collateral. A guideline was requiring major banks to remove near-bankruptcy and lower quality loans ("bad debt") within three years after their recognition. This helped remove book value of old loans worth 270 billion USD from bank balance sheets from 2001 to 2004. In Brazil, distressed loans (so called "H" loans) must be written-off after 6 months. They continue to be accounted for off-balance sheet, provisioned at 100 percent.

Sources: The US mortgage crisis - are there lessons for policymakers? Michael Fratantoni and Michael Moore, February 2013; FDIC risk management manual; IMF Working Paper/04/86, Basel Core Principles for Effective Banking Supervision—Detailed Assessment of Compliance for Brazil and Japan, 2012

[1] This temporary measure was withdrawn in 2005 after the stock of NPLs had declined substantially and the banking system was officially regarded as "normalized". Instead, a new guidance was issued to continue to encourage early identification and disposal of bad debt.

10. **The tax regime also penalizes banks that aggressively provision and write-off bad loans**. Unlike in most other countries, write-offs in Italy are not tax deductible without a court declaration of insolvency, which can take several years. Up to that point, banks are allowed to deduct loan-loss provisions from taxable income only up to 0.3 percent of outstanding loans. The remaining provisions are treated as a deferred tax asset (DTA) that can be deducted from taxes in

equal installments over 18 years but at a lower net present value.[6] By reducing the tax benefits of provisioning, the cap on tax deductibility provides a disincentive for banks to write off more aggressively their bad loans.

Pull Factors: Limited Options for Restructuring Bad Loans

11. **The lengthy and inefficient judicial process hinders write-offs, as it raises the cost to collect collateral and dispose of non-performing loans.** The bankruptcy law has been amended several times since 2006 to facilitate restructuring and business continuation. These included introducing super-priority status for interim financing, a moratorium on creditors' action, and no claw-back actions. Nevertheless, it still takes on average 3 years to foreclose and collect real estate collateral through the courts, while completing a bankruptcy procedure takes on average more than 7 years. According to the World Bank Doing Business surveys, Italy ranks low in resolving insolvency (#20 out of 31 OECD countries) and in enforcing contracts (#30 out of 31). The inefficient bankruptcy and foreclosure procedures lengthen the write-off process, delaying the resolution of bad loans and undermining their recovery values.

12. **A market for restructuring distressed debt exists but is small and not well developed.** Italian banks, especially in the 1990s, unloaded some bad loans to the market, including through direct sales and securitization. NPL sales have recently picked up, but they remain low at around €2 billion annually compared to €122 billion stock of bad loans. Despite the rapid buildup in NPLs, the market for distressed debt remains small, consisting of only a few domestic investors specializing mainly in collection. This is in contrast with some other advanced economies, where an active market for distressed debt expanded rapidly in response to banks' growing needs to unload their NPLs.

C. A Strategy for Developing a Distressed Debt Market

13. **Fostering a distressed debt market would have benefits not only for the banking sector but also for financial markets and the economy.** For the banks, having an active market for NPL disposal would relieve the burden of collection and restructuring and free up resources to support new lending. It may also boost loan recovery values and provide a more cost effective alternative to lengthy court procedures. Having a liquid market to dispose of NPLs or real estate collateral when needed would also assist banks in managing their portfolio risk. For financial markets, an active market for distressed debt would improve secondary market liquidity for loans, support new lines of businesses, such as NPL securitization, and draw in more outside investors, including from overseas. For the broader economy, developing another nonbanking channel would diversify the sources of financing, allow for earlier and faster resolution of bad loans during a

[6] In NPV terms, this results in a 25 percent reduction in tax benefits. Any possible subsequent write-off of NPLs does not interfere with this above-mentioned 18 years DTA process

downturn, and possibly enhance corporate productivity by supporting needed restructuring and reallocation.

14. **The distressed debt market in Europe is still in the early stages but has shown signs of growing**. Since 2010, NPL sales in Europe have risen from €11 billion to over €30 billion in 2012.[7] Most of the activity has taken place in Germany, Ireland, Spain and the United Kingdom and focused mainly on commercial real estate and consumer loans. The majority of investors represent private equity funds from both Europe and the United States. There is little cross border activity in the distressed debt market.

15. **Past approaches to resolving NPLs varies across countries depending on the size of the problem and its systemic nature**. NPL resolution ranged from large-scale, centralized intervention to address a systemic crisis, such as in Japan (early 2000s), Korea (late 1990s), and to a lesser extent in Sweden (1990s) and the United States (1980s/1990s), to a purely private-led market for disposing of NPLs. Some countries, such as Korea, Malaysia, and Sweden, relied on a publicly owned bad bank to help transfer and dispose of distressed loans from weak banks. Over time, these approaches also evolved into a hybrid one where public intervention was supported by private-led restructuring that led to important reforms to improve the insolvency system, promote out-of-court workouts, and strengthen the market infrastructure. Post crisis, financial institutions utilized these new institutions to actively manage their bad loan portfolios through the business cycle.

16. **A strategy for fostering a distressed debt market in Italy would need to address the legal, prudential and tax impediments to faster write-offs.** Here, the main areas are:

- *Judicial reform*. Reforms should look to improve the efficiency of the legal system, including by expanding the use of specialized bankruptcy courts beyond Milan. Foreclosures could be accelerated by introducing more standardized procedures for collateral assessments and allowing for online court application and decisions. Out-of-court workouts could also be encouraged by issuing best practice guidelines and providing similar tax and regulatory treatment as under court-led insolvency.

- *Prudential policies*. Strengthening provisioning coverage, including through forward-looking, comprehensive asset quality reviews and conservative valuation of real estate collateral, would ensure that banks face the proper incentive to write-off or dispose of bad loans. As noted by the FSAP, ensuring a minimum level of harmonization and strengthening prudential guidelines on write-off practices could also accelerate NPL disposals.

[7] See Ernst & Young, "European Non-Performing Loan Report 2011" and "Flocking to Europe: Ernst & Young 2013 Non-Performing Loan Report."

- *Tax policy*. Aligning the tax deductibility of loan loss provisioning and write-offs to international levels could accelerate disposals. Staff estimates that allowing for full deductibility of new loan loss provision would cost around 3 billion (0.2 percent of GDP) in tax revenue.

17. **Corporate restructuring vehicles (CRVs) could also be used to assist banks in working more with the markets to rehabilitate distressed borrowers**. A CRV is a private special purpose vehicle (SPV) where banks partner with an outside investor to collect or resolve problem loans. They have been used in other countries, such as in Korea after its financial crisis (see Box 2), to accelerate NPL disposal and corporate restructuring. CRVs have the benefit of tapping outside financing and expertise to assist in restructuring. They also help bridge the gap in pricing distressed loans by allowing banks and investors to share in the gains from credit recovery. The key though is to ensure that for the transfer of bad assets or conversion of debt to equity be done at fair market value in order to prevent banks from hiding or "warehousing" bad assets off their balance sheets.

D. Conclusion

18. **Accelerating the write-off of bad loans would strengthen confidence in Italian banks and ensure they play a supportive role in the recovery.** Steps to strengthen provisioning practices, remove the fiscal disincentives for write-offs, and expand the market distressed assets could accelerate NPL disposals. While the market for distressed debt is small, it is expanding with the rise in NPLs and could serve as a useful instrument for banks' to reduce their NPL holdings.

Box 2. Korea's Experience with Corporate Restructuring

Korea after its financial crisis in the late 1990s undertook major bank and corporate restructuring. With NPLs reaching nearly 30 percent of GDP, banks had neither the resources nor the expertise to undertake large-scale restructuring and needed other sources of financing and tools to resolve the crisis. The Korean government played a leading role in restructuring the banking system, through changes in the legal and regulatory framework, the use of public funds, and the creation of new crisis management institutions. One such institution was the Korea Asset Management Company (KAMCO) which purchased distressed assets from banks and other financial institutions and disposed of them quickly through various channels. While KAMCO played an important role in removing bad assets from banks' balance sheets, banks also relied heavily on private market solutions to facilitate NPL disposal.

One initiative that proved useful was the creation of "corporate restructuring vehicles" (CRVs) to assist banks in the market-based restructuring of viable, but distressed firms. CRVs were one option in a menu of approaches to facilitate NPL disposal. Here corporate restructuring was similar to distressed debt disposal, but rather than simply removing the bad asset from banks' balance sheet, the aim was also to rehabilitate the borrower itself. The CRVs took over distressed assets from creditor banks and restructured them using an asset management company with turnaround experience. To encourage their use, the government provided CRVs with special regulatory treatment and tax benefits. In Korea, several types of CRVs were created:

- *Corporate restructuring funds (CRFs)*: Funds which issued securities, invested in distressed firms, and received regular dividends.
- *Corporate restructuring vehicles (CRCs)*: Restructuring companies which took majority stakes in firms, reshuffled management, restructured operations, and sold back to market.
- *Corporate restructuring vehicles (CRVs)*: SPVs set up by banks to pool distressed assets and transfer to AMC for specialized management with help of outside experts.
- *C-REITs*: Real estate investment trust investing in properties from distressed firms.

CRVs allowed banks to partner with outside investors, both domestic and overseas, to rehabilitate distressed companies. They gave banks more options to manage their NPLs and raise their recovery value. To operative effectively, they require a supportive regulatory, tax and market environment. In addition, to ensure the proper incentives for disposal and avoid the risk of hiding bad assets, it would be important that the transfer of assets be done at fair market value and in a transparent manner.

Sources: A. Chopra et. al., "From Crisis to Recovery in Korea: Strategy, Achievements, and Lessons," IMF WP/01/154, October 2001; Dong He, "The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea," IMF WP/04/172, September 2004.

REFORMING THE CORPORATE GOVERNANCE OF ITALIAN BANKS[1]

Corporate governance is key for a well functioning banking system. It determines the systems, principles, and processes by which banks are governed and has important implications for the banks' behavior towards their employees, clients, and shareholders. Effective corporate governance is also important for the integrity of financial markets, as the recent financial crisis has revealed. More recently, corporate governance has been added to the formal list of Basel Core Principles for Effective Banking Supervision. The paper discusses the corporate governance of Italian banks, its regulatory framework, and specific challenges arising from the dependence on foundations and cooperatives. The paper concludes with recommendations, in line with the FSAP, for strengthening corporate governance.

A. Concentrated Ownership and Foundation Influenced Banks

1. **Bank ownership in Italy is heavily concentrated.** Banks in Italy are private entities. Their ownership structures can be broadly divided into three main categories: joint stock companies[2], banks under cooperative status (cooperatives and mutuals) and branches of foreign banks, accounting respectively for 80, 15 and 5 percent of the total assets. In joint stock companies, ownership remains concentrated (Bianchi-Bianco, 2006) even if less than in other industrial sectors. In 2011 for instance, the largest shareholder in listed banks held on average 45 percent of the capital (18 percent, when weighted by market capitalizations).

2. **Concentrated ownership has its benefits but also raises governance challenges.** Concentrated ownership can facilitate smooth decision making and provide strong incentives for controlling shareholders to monitor the bank. In Italy, however, controlling shareholders are sometimes minority shareholders that exercise control beyond their ownership through legal devices such as joint lists, coalitions with other shareholders (formalized or not[3]), voting rights ceilings and cross-holdings. These shareholders are also often linked to non-profit foundations, whose governance differs from a standard corporation.

[1] Prepared by Nadege Jassaud (MCM).

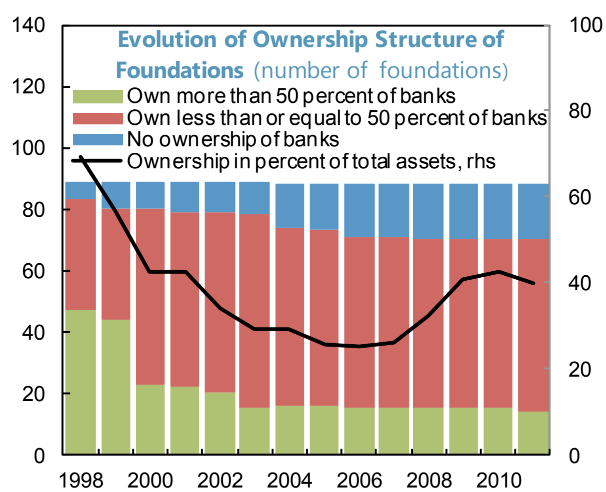
[2] In July 2013, 318 companies were listed, accounting for 24 percent of GDP in terms of market capitalization (7 percent of GDP for listed financials)

[3] Bianca and Bianci define a company as controlled by an informal coalition when one cannot identify one controlling shareholder and the 3 largest shareholders together own more than 20%.

Foundations continue to be major shareholders in Italian banks

3. **Italian Foundations have played a critical role in the privatization of state-owned banks.** In the early 1990's, the Italian government decided to privatize the state-owned banks (saving banks) and transform them into joint stock companies. To address the limited availability of domestic capital, the government created 88 foundations to serve as temporary trustees for the capital of the privatized banks.

4. **Although the foundations were mandated to relinquish control in banks in 1999, many continue to be major shareholders in banks.**[4] From holding all of the privatized banks in 1998, the foundations have seen their ownership share in their original banks drop sharply to 40 percent by 2012. Nearly one in five foundations has entirely disinvested from their original bank. Despite the divestment, foundations still remain major shareholders in four of the top 10 joint stock banking groups: Banca Monte dei Paschi di Siena (MPS), Banca Carige, Intesa[5] (ISP) and Unicredit (UCG) as well as in other medium size banks (Banca della Marche, Banco di Sardegna, Cassa di Risparmio di Parma e Piacenza). In many cases, a significant influence (here defined as a share of at least 20 percent) is often enough to ensure the foundation remains as controlling shareholders, despite lacking a majority of shares.



Sources: ACRI; and Ministry of Finance.

Shareholder Structure of Major Italian Banks and Presence of Foundation

Bank name	Foundations	Percent ownership
Banca delle Marche	4	59.1
Banca Carige s.p.a.	1	49.4
Banco di Sardegna Spa	1	49.0
Banca Monte dei Paschi di Siena s.p.a.	1	34.2
Intesa Sanpaolo s.p.a.	5	24.7
Cassa di Risparmio di Parma e Piacenza	1	15.0
Credito Bergamasco Spa	1	11.6
Unicredit Banca s.p.a.	3	9.0
Mediobanca	2	4.6
Unione di Banche Italiane s.c.p.a.	2	4.5

Sources: BoI; Bloomberg; CONSOB; and company documents.

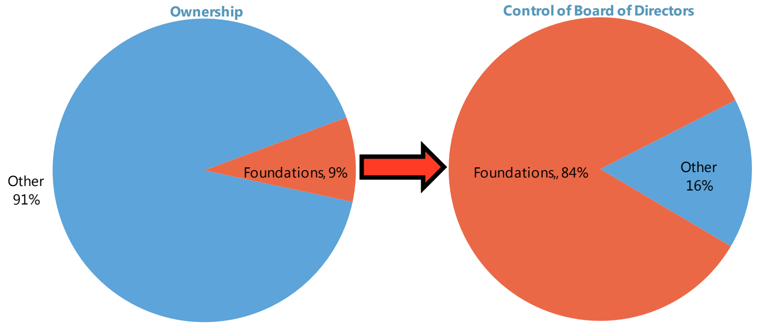
5. **Some foundations have maintained their control through joint lists, shareholder agreements and voting rights ceilings.** In the two largest Italian banks, foundations nominate

[4] The Ciampi law (Law no. 461/98, together with decree, no. 153/99). This obligation remains in force today except for Foundations which have net assets with a book value under €200 million in 2002 or are located in special statute regions.

[5] According to Mediobanca research, 12 foundations control 30 percent of Intesa's shares, against 25 percent in reported numbers (that fall under the 2 percent threshold).

Unicredit: Bank Ownership and Control of Board of Directors

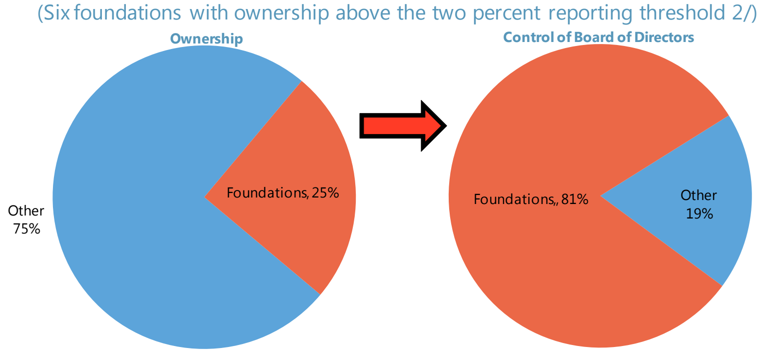
(Three foundations with ownership above the two percent reporting threshold 1/)



Sources: Company reports; IMF staff estimates.
1/ Carimonte Holding (jointly controlled by Fondazione Cassa di Risparmio di Modena and Fondazione del Monte di Bologna e Ravenna); Fondazione Cassa di Risparmio Verona, Vicenza, Belluno e Ancona; and Fondazione Cassa di Risparmio di Torino).

Intesa: Bank Ownership and Control of Board of Directors

(Six foundations with ownership above the two percent reporting threshold 2/)



Sources: Company reports; IMF staff estimates.
2/ Compagnia di San Paolo; Fondazione Cariplo; Fondazione Cassa di Risparmio di Padova; Cassa di Risparmio di Firenze; and Fondazione Casa di Risparmio in Bologna.

the majority of the board's members, despite lacking a controlling share. For instance, at Banca Intesa, the five foundations owning 25 percent of the shares nominate nearly 80 percent of the Board. At Unicredit, the three largest foundations owning a minority share nominate a similarly high share of Board members. In the third largest bank (MPS), the foundation was able to maintain an absolute control through the combined effect of its 50 percent ownership share and a voting rights ceiling on other shareholders. Indeed, MPS had a 4 percent voting cap on outside shareholders till July 2013[6], allowing the Foundation MPS to exercise control well beyond its actual ownership.

Foundations have played an important role supporting Italian banks

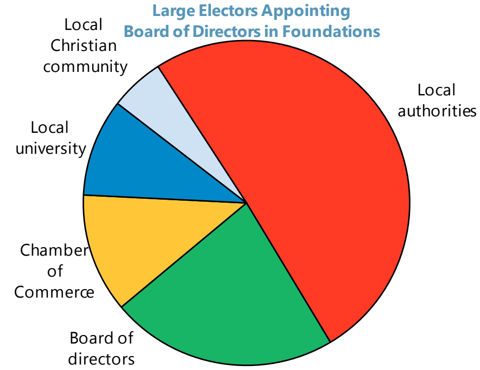
6. **Foundations have in many cases spurred Italian banks to expand and modernize.** Since privatization, foundations have supported two large consolidations of the banking sector: a national consolidation in the late 1990s when several domestic banks merged to gain scale; followed by a

[6] This cap was removed in July 2013, upon a special request from the EU Commission for fulfilling State Aid criteria

wave of international acquisitions and capital raising in the mid 2000s. This latter consolidation gave birth to three large international banking groups (UCG, ISP, MPS) and diluted the ownership role of the foundations.

7. **Foundations have also served as stable long-term shareholders of banks, and in the recent crisis, supported the bank recapitalization efforts.** In December 2012, the book value of their assets amounted to €51 billion, making the foundations one of the largest domestic long term investors after the public pension funds (total assets of € 232 billion) and the Cassa Depositi e Prestiti (CDP, with total assets of €274 billion). Foundations have also supported the recapitalization effort of Italian banks, providing one-fifth of the €27 billion capital raised by their largest banks since 2008. They were also able to retain their shares, despite sharp declines in their values.

Large Electors Appointing Board of Directors in Foundations



Source: Mediobanca.

Foundation ownership also raises specific governance challenges

8. **Foundations are subject to strong political influence**. The foundations are strongly influenced by the stakeholders they serve, which varies depending on each foundation's own statutes. According to Mediobanca research[7], 47 percent of foundations' boards are elected by local authorities (the Region, the Province or the City mayor), while another 21 percent are appointed directly by the elected board directors. Therefore, in practice, local politicians dominate the boards of several foundations[8], with for example, 60 percent of the seats at the Fondazione MPS, and 55 percent at Fondazione Cariplo (Intesa). As a consequence, the foundations' decisions are heavily influenced by local interests and political cycles.

9. **Foundations have a limited internal accountability and little oversight**. Even though foundations are governed under law 461/98 which includes some general corporate governance principles, they do not follow basic corporate governance practices. For example, the appointment of governing bodies is often non-transparent and foundations do not follow uniform accounting and disclosure rules. In addition, there has been little oversight of the foundations, despite the law. In 2003, the Constitutional Court curtailed the supervisory powers of the Ministry of Economy and Finance (MEF) vis-à-vis foundations.

10. **Risk management at the foundations is also weak**. Despite provisions in law 461/98 that require diversification of obligations, some large foundations still have portfolios heavily

[7] Mediobanca research analyzed the Board of Director composition of six of the largest Italian Foundations.

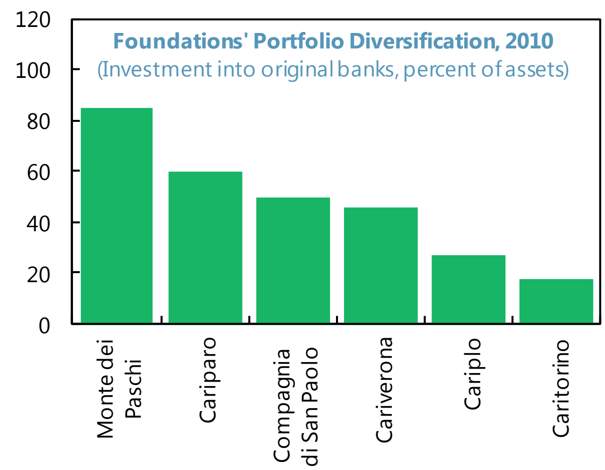
[8] I politici ai vertici delle fondazioni bancarieThe politicians at the top of the banking foundations. 27.01.13 27/01/13 Tito Boeri.

concentrated in their "original" bank, with stakes varying from 30 to 90 percent. Some foundations have also made use of bank credit (mortgages, credit lines) to fund miscellaneous expenditures, such as capital increases, real estate acquisitions or restructuring. Others have invested in risky derivative products. These activities increased the riskiness of their portfolio and raised pressure on banks to generate dividends to support the weak financial position of the shareholder foundation.

Largest Italian Foundations by Total Assets
(Billion euros)

Name	Size
Fondazione C.R. Provincie Lombarde	6.6
Compagnia di San Paolo di Torino	5.6
Fondazione C.R. Verona Vicenza B.A.	2.7
Fondazione C.R. Torino	1.9
Fondazione C.R. Padova e Rovigo	1.7
Fondazione Roma	1.4
Fondazione C.R. Cuneo	1.3
Ente C.R. Firenze	1.3
Fondazione C.R. Lucca	1.2
Fondazione C.R. Genova e Imperia	1.0

Source: ACRI.



Source: Mediobanca.

Foundation-owned banks are less resilient

11. **Stress test results show that banks influenced by foundations are one of the weakest links in the Italian banking sector.** The IMF's FSAP stress tests included a baseline[9] and two downside scenarios[10]. It finds that banks influenced by foundations[11] are particularly vulnerable to slow growth or adverse macroeconomic conditions.[12] In the "adverse" scenario which simulates a double dip with growth of -5.6 percent till 2015, their Tier 1 ratio would plummet from 8.8 percent in December 2012 to 2.5 percent in 2015 (i.e. below the Basel 3 minima). The CET1 and Tier 1 capital shortfalls of this category of banks would be respectively, €3.2 and €5.4 billion (0.2 and 0.3 percent of GDP), accounting for 40–50 percent of the shortfall of all Italian banks in the test.

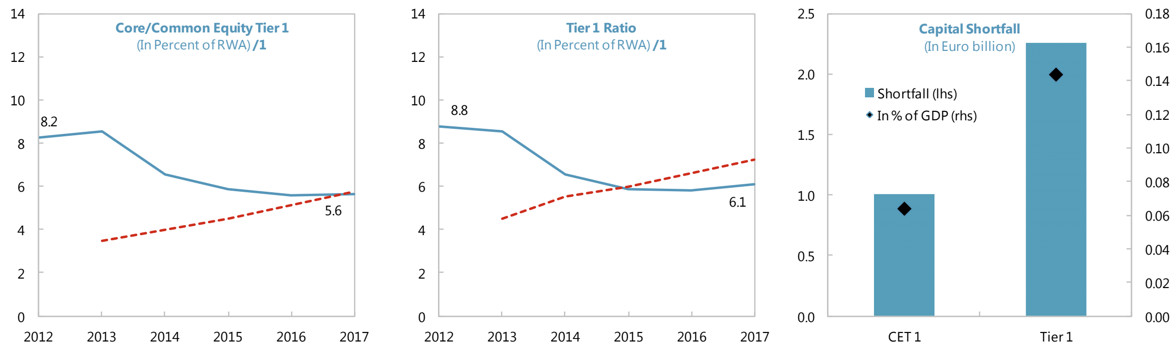
[9] Based on the April 2013 WEO.

[10] In the "slow growth" scenario, domestic growth is lower than in the baseline by 0.7 percentage points each year during 2013–17, leaving the five-year cumulative growth rate at -0.1 percent. The "adverse" scenario incorporates a 1¼ standard deviation shock (-4.2 percentage points compared to baseline) on a two-year cumulative real GDP growth rate during 2013–14, with a cutoff date in 2015. See the accompanying FSSA for more detail.

[11] The stress test defined banks influenced by foundations as banks in which one single foundation controls at least 20 percent of shares. This subcategory accounts for 11 percent of the Italian banking assets and excludes Banca Intesa or Unicredit.

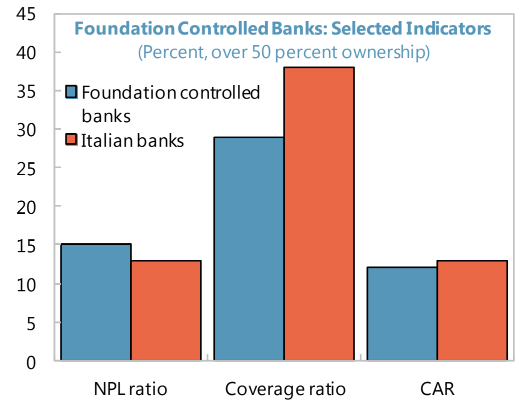
[12] FSSA report for Italy, paragraph 29.

Banks Under the Influence of Banking Foundations: Stress Test, 2012-17



Source: Bank of Italy.

12. **These results are explained by the weak asset quality of foundation-influenced banks.** Banks that have the highest proportion of foundation ownership (14 banks with 50 percent and above shares owned by foundations) display higher NPL ratios (2 percentage points above system averages), lower NPL provision coverage (9 percentage points below average) and lower capital ratios (2 percentage points below average). This is confirmed by a BoI study[13] that indicates that bank performance has been negatively correlated to the proportion of foundation ownership.



Sources: Bank of Italy.

B. Cooperative Banks

13. **Unlike the Italian foundations, cooperative banks are common internationally, but certain governance aspects can be problematic, especially for larger and listed cooperatives.** Cooperatives (*Banche Popolari*) are part of the eco-diversity of bank ownership that contributes to the resilience of the financial system. They typically provide loans to local firms. However, restrictions on ownership may hamper effective governance once the bank grows beyond a certain size, as well as thwart potential outside investors. They also suffer from weak asset quality and profitability.

Cooperative banks serve a useful function for the local economy

14. **Cooperatives engage in less risky, traditional bank lending to the local economy.** Due to their legal status, smaller size and geographical remit, cooperatives tend to avoid exposure to financial markets and the international economy and focus on servicing local borrowers. For example, *Banche Popolari* (BPs) lend up to two-thirds of their funds to small and medium-size companies (SMEs) and account for three quarters of new SME loans since 2008.

15. **Cooperatives have raised their capital ratios, despite difficult economic conditions.** According to their association, BPs have increased their capital by 24 percent, against 13 percent for

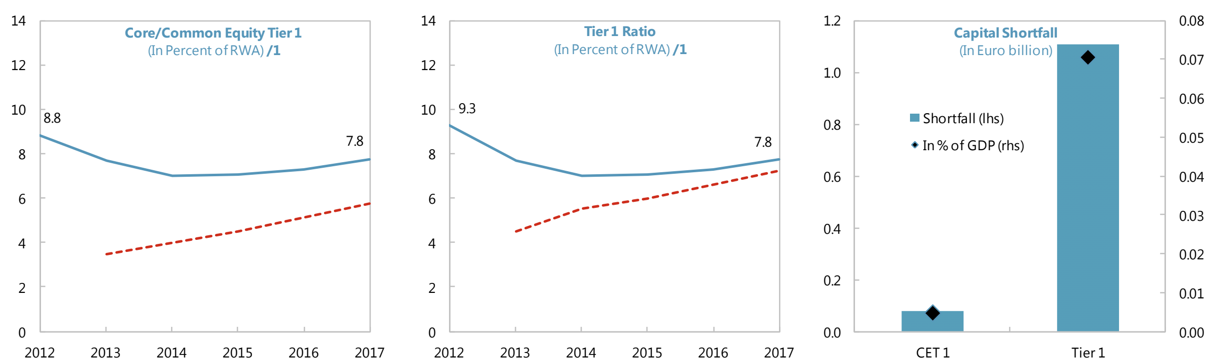
[13] Speech from Fabrizio Saccomanni, Bank of Italy, at the 22nd Annual Congress of the Banking Foundations and Saving Banks in Palermo, Italy, June 7, 2012.

other Italian banks, through retained earnings (cooperatives have legal restrictions in terms of dividend payments) as well as new capital placed throughout their large retail networks. The rest of the capital increase was due to large cooperatives moving to more sophisticated Basel 2 risk calculations whose risk weights generated savings. For example, between December 2011 and June 2012, the risk weighted assets of Banca Popolare fell by almost a half, from €90 billion to €50 billion, when the bank moved to IRB modeling.

Certain governance aspects can be problematic, especially for larger, listed cooperatives

16. **Restrictions on ownership may hamper effective shareholder control once cooperatives grow beyond a certain size.** By their nature, cooperatives impose restrictions on ownership, with the ownership limit set at 0.5 percent of their capital and higher limits when capital is subscribed by institutional investors. Cooperatives also include caps on voting rights, with a "one person one vote" rule and limits to vote proxies.[14] Cooperatives include membership requirements and any transfers of shares need to be approved by the board. In large cooperatives, these restrictions make it difficult for any shareholder, even with a larger capital stake, to change the governance structure. This reduces members' incentives to exert effective oversight over management, replace poorly performing management or stand in the way of directors nominating their successors. It can also give incentives for insiders with special interests to control the bank, such as employees, relatives or former employees.

Cooperative Banks (Banche Popolari): Stress Test, 2012-17



Source: Bank of Italy.

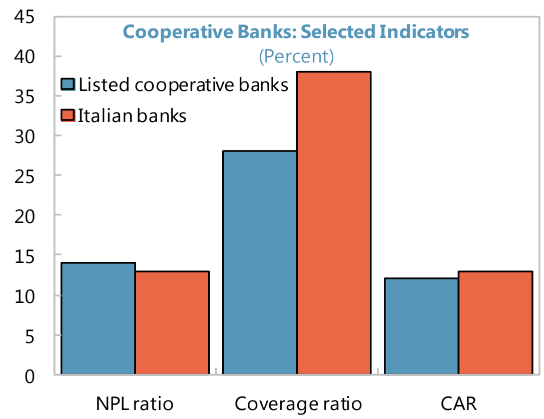
17. **Restrictions on ownership also make it difficult to raise private capital.** By hindering the emergence of large shareholders, ownership restrictions reduce the attractiveness of investing in BPs, making takeovers virtual impossible. As a result, BPs rely mostly on internal capital generation or tapping their retail base investors to raise needed funds. This is in contrast to joint stock companies where, provided there is a prospect of future profits, they can issue new shares and sell

[14] A recent reform starting in 2008 and passed in 2012 reaffirmed the status of cooperatives, while adapting it to the international environment. The reform consisted of the following: amendment of the ownership ceiling to 0.5 to 1 percent of the share capital, establishment of a maximum of proxies up to a maximum of 10

those at market price when the need to shore up equity arises. Cooperatives, on the other hand, can only raise new capital by increasing their membership. These systems were originally designed for small institutions functioning within close communities, but are now being applied with little fundamental change to large, complex banking groups.

Cooperatives are more vulnerable

18. **Like foundation-influenced banks, cooperative banks suffer from poor asset quality and profitability.** In the FSAP stress test, cooperative banks perform worse than other banks in the adverse scenario. They account for around half of the capital shortfall of Italian banks (€2.4 and 6.8 billion in terms of CET 1 and Tier 1 respectively), with their Tier 1 ratio dropping from 9.3 percent in 2012 to 4.2 percent in 2015. These results can be attributed to relatively low profitability and a weaker solvency position. Indeed, compared to the average for the system, large cooperatives feature weaker asset quality, with NPL ratios approaching nearly 14 percent and much lower provisioning (10 percentage points below average). Despite being listed banks, their capitalization remains below the market average, at 12 percent of total capital.



Sources: Bank of Italy.

C. Governance Regulatory Framework

19. **Italy has taken steps to strengthen its bank governance regulatory framework.** Since the early 2000's, Italy has implemented the EU directives and recommendations on corporate governance. However, as the recent financial crisis revealed a couple of corporate governance failures in Italy, including at Banca Popolare di Milano (2011) and Monte dei Paschi (2012), financial regulations were further enhanced, with new standards and regulations for listed and unlisted companies.

Italian regulations on corporate governance

20. **Italy has implemented successive EU directives and recommendations on corporate governance and developed a specific regime to protect minority shareholder**s. Since approaches to corporate governance are deeply rooted in national traditions, the corporate governance regulation in the EU is made of a mix of directives and recommendations. Italy has implemented: the 2003 EU Action Plan on corporate governance; recommendations on board structures (2003 and 2005); and, directives on disclosure (2005) and shareholder rights (2004 and 2007) in its banking, security and corporate laws. Italy has also added a specific regime to protect the minority shareholders, with at least one member at the board of directors (BoD) to be appointed

by minority shareholders ("slate voting"). This member also chairs the internal control body *(collegio sindacale)*[15].

Recent additions

21. **For listed companies, a revised code of conduct has been issued, aligning Italy with EU best practices**. Initially introduced in 1999, the Code was updated in December 2011. Based on a "comply or explain" mechanism, the code aims at promoting diversity within the BoD in terms of gender, experience and functions. It also stresses the importance of independence for BoD, requiring that issuers belonging to the FTSE-Mib Index have "at least one third" of independent directors on their boards and, in any case, at least two independent directors should sit in the BoD (against one in the non listed companies). It also includes a definition of independence more stringent than in the current Italian law.[16]

22. **A Decree law bans cross-appointments at the boards of financial institutions with significant cross-shareholdings.** The Italian Legislator introduced a new set of laws to ban interlocking directorates[17] in the financial sector, in force since December 2011. It has established a new eligibility requirement for corporate governance bodies of financial institutions, to ensure that "no member of BoD or supervisory boards, boards of auditors, as well no executive officer of a financial entity shall, at the same time, serve in "corresponding" positions in competing [entities]." The new requirement affected 10 percent of financial institutions which had to change their governance accordingly.

23. **A BoI Circular calls for Board of Directors to be appropriately skilled at all times and reinforces the role of non-executive directors.** According to a BoI circular issued in January 2012, the BoD members shall be appropriately skilled to perform their tasks (risk management and control tasks included). It also calls for a sufficient number of non-executive directors, with well-defined

[15] Members of the BoD are appointed on the basis of slates (list of candidates) presented by the shareholders owning a minimum of capital. The thresholds are defined annually by Consob, taking into account the company's capitalization, free float and ownership structure (ranging from 0.5 percent for blue chips to 4.5 percent for very small companies). However, bank by-laws establish the mechanisms according to which board seats are distributed among the slates presented. Most of the time, the slate receiving the highest number of votes takes all board seats, but the quota reserved for minority shareholders (one seat). A few companies adopt a proportional multi-winner system where any slate takes a number of board seats proportional to the vote it receives.

[16] Independence is regulated both by the Italian banking law and the code of conduct. The law enforces a minimum definition, while the code of conduct follows broader criteria, in line with EU recommendations. It includes, for instance, the remuneration criteria to determine independence (when a Board member receives substantial amounts from the companies or related parties), and a time limit (after 9 years, the Board member is considered as non independent). MPS was, for instance, not compliant with the Code of conduct, with regard to these independence criteria.

[17] Section 36 (1) of the so-called "Rescue-Italy Law Decree" (Law Decree 6/2011, ratified with amendments by Law 214/2011, in force as from 28 December 2011).

roles and duties, who should actively contribute to the BoD discussions. Those criteria should be subject to periodic self-assessment.

24. **To mitigate conflicts of interest, a related party lending regulation has been introduced in the banking regulation**. Italy's framework for related party lending was deficient before the amendments to the Banking Law of 2006 and to Circular 263 in 2011. The new provisions governing related-parties transactions[18] entered into force end-2012 and completes the framework already in place for listed companies. The BoI issued its draft implementing regulation on reporting duties for public consultation, asking banks to submit to the BoI information on exposures to each related party and connected persons, on a nominative basis.

D. Enhancing the Governance Framework in Italian Banks

25. **Further reforms to the corporate governance framework would strengthen oversight and management of the banks and contribute to financial stability.** Reforms, in line with the FSAP's recommendations, should focus on strengthening banking regulations with stricter fit and proper rules for directors and major shareholders, implementing the new related party lending regulation, setting up a credible oversight for foundations when they are influential shareholders in banks and facilitating the transformation of large cooperatives into joint stock companies.

26. **Strengthening the fit and proper rules for Directors and major shareholders would improve bank discipline**. The "fit and proper test" of board members performed by supervisors currently refers to integrity (criminal proceedings) and professional experience. The FSAP recommended expanding the definition of fit and proper criteria to adverse regulatory judgments for directors, and financial soundness—including the capacity to provide additional capital, if needed—for shareholders. In addition, the supervisor should have the power (which it currently does not) to change the composition of the bank's Board if the supervisor believes that any individuals are not fulfilling their duties related to the fit and proper rules.

27. **The new regulation on related party lending would safeguard against potential abuse, if well implemented.** The regulation on related party lending entered into force only in 2013. The BoI should use its supervisory discretion to tighten the definition of connected parties, when appropriate, including economic influence as is the case for the large exposure regulation. Further, to be in line with best standard practices, the regulation should be amended to ensure that the related party transactions do not carry more favorable terms relative to those with unrelated parties, and that board members with conflicts of interest are excluded from the decision.

28. **Foundations that are major shareholders of banks should apply a cap on leverage, strict disinvestment procedures and governance rules.** Foundations should move towards a more balanced portfolio and follow prudent investment policies (diversification policies, minimum reserves

[18] BoI circular 263 "New regulations for the prudential supervision of banks" (Title V, Chapter 5, Section II).

invested in safe assets, etc.). A leverage cap should prevent them from excessively leveraged acquisitions and investments in risky assets. In addition, they should follow stronger corporate governance arrangements and introduce terms limits for foundation board members and a cooling-off period between a political office and the appointment to a foundation (or vice-versa)—a provision currently left to the "Code of Ethics." Foundations should also be subject to strict oversight with prompt corrective actions by the MEF (or another supervisor).

29. **The largest cooperative banks should also be encouraged to convert to joint stock companies.** Cooperative banks were designed as intermediaries whose business was restricted to a limited geographical area. Today they may be inadequate as large intermediaries operating at national and even international level, listed on the stock exchange. Listed cooperative banks should look to turn themselves into companies limited by shares. At a minimum, reforms should increase shareholders rights, including raising limits on proxy voting, facilitating the transfer of shares and the addition of new items at the agenda of shareholders' meetings .

E. Conclusion

30. **Effective corporate governance is important for a well functioning banking system and the integrity of financial markets**. Even though corporate governance varies according to the degree of ownership and control and the identity of the controlling shareholders, the regulation and supervision need to ensure that those differences do not impede bank performance and resilience. More effective corporate governance will ensure that banks can play a supportive role to the economy and contribute to broader financial stability. It will also help make those banks attractive to private capital, which will help shore up defenses of Italian banks.

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