

FRANCO-ITALIAN BUSINESS FORUM 2014 HOW TO REVIVE THE INDUSTRY AND ENHANCE COMPETITIVENESS



**Productivity must increase to
guarantee the international
competitiveness**

- Delors White Paper, 1993 -

Topic 1: Increase price competitiveness

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*The document has been prepared by Confindustria,
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TABLE OF CONTENT

- DEINDUSTRIALIZATION : A COMMON TREND IN FRANCE AND ITALY
- PROFIT MARGINS AND LABOR COST
- TAXES AND GOVERNMENT MEASURES

DEINDUSTRIALIZATION: A COMMON TREND IN FRANCE AND ITALY

Industry is the backbone of the economy. Due to its strong spillover effects over other sectors, manufacturing is significantly more important to the overall economy than it is often given credit for.

Industry features as an economic hub to the economy, because it offers an important market to suppliers from other sectors such as finance, construction, communication, utilities, public and private services, logistics and business services.

The function of industry as a hub for the economy is evidenced by the fact that the manufacturing sector accounts for 49% of intermediate input transaction in the EU economy, while its share of total value added and employment amounts to 15% and 14% respectively.

Business services as well as other non-industry sectors strongly benefit from industry's demand in the course of upstream and downstream value chains. In fact for every euro of manufacturing output in the EU, 34% of input comes from other supply sectors. This deep and mutually productive integration, particularly with the service sector, renders the traditional dichotomy between industry and services obsolete. If we combine the joint production of industry and services, the relevance of industry is considerably higher than it is often given credit for. In the EU, this joint production accounts for almost 25% of value added in the total economy compared to a world average of 20.8%. In Europe the manufacturing sector is also a major hub for the organization of value chains. Due to this interconnectedness, industry generates strong positive spillovers to other sectors.

For every unit of additional demand in the manufacturing sector this generates 1,68 units of additional output in the total economy.

As far as employment is concerned, while manufacturing directly provides 32 million jobs in the EU, more than 20 million jobs indirectly depend on industry in related supply sectors.

Therefore a vibrant and thriving industry in Italy and France will also benefit the economy overall.

Manufacturing
directly provides
32
million
jobs in the EU

Topic 1: Increase price competitiveness

Considering the relevance of industry for the above mentioned reasons, it comes as no surprise that a strong industrial base goes hand in hand with higher economic growth and technical progress.

However, despite this huge potential and the disproportion of relevance of industry for the total economy, the manufacturing sector, both in Italy and France, has come under pressure from various angles in recent years.

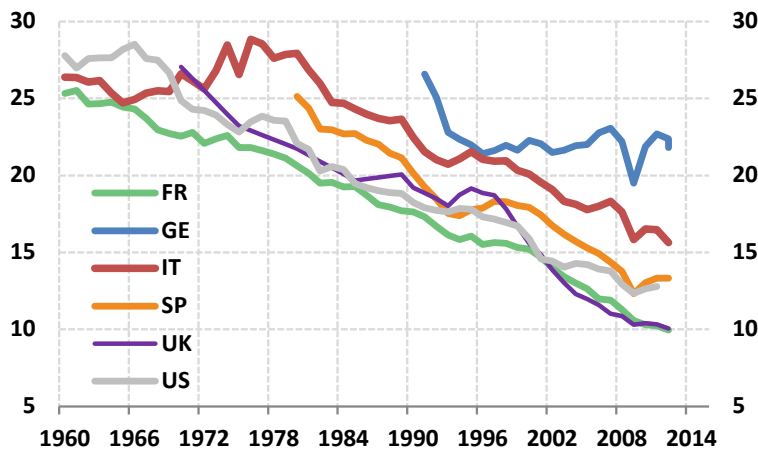
From an economic perspective, challenges have risen because of important mega trends: tertialization, globalization and knowledge intensification. They comprise, for example, a shift in global demand from goods to services, more intense competition from emerging markets, and challenges for low skilled jobs/sectors from technology-driven rationalization.

However, future global demand patterns will tend to favor manufacturing goods, in particular investment goods. Huge global trends, such as aging, urbanization and climate change, improve business prospects in fields like live sciences, transport infrastructure and environmental technologies.

These various challenges have exerted significant pressure on industries and, as a result, the industrial share of total VA in the EU has declined to 15% average. However, the manufacturing sector is a growing market in global absolute terms and continues to offer opportunities.

Share of manufacturing in gross value added
10%
in France
15%
in Italy

Manufacturing share in gross value added, %



The financial crisis has evidenced that the benefits of a strong and stable manufacturing sector are essential to assure growth and employment in our continent. And no large economy, which is the case of France and Italy, can prosper without a relevant manufacturing base. Evidence has proved that only a revitalized industrial sector can ensure that we fully recover from the crisis and return to a sustainable growth path.

Italy and France are characterized by a strong manufacturing vocation and their economies strongly rely on the industrial sector. This is why we, as industrial

leaders, have to play a leading role in proposing what should be done in order to increase the competitiveness of European business.

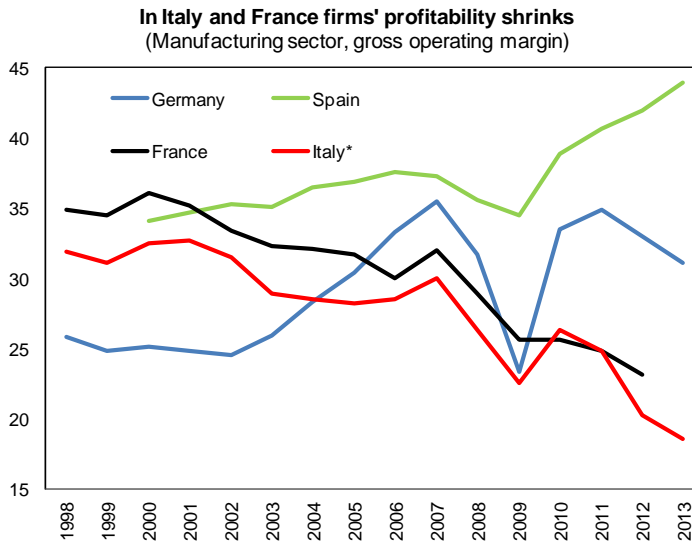
Despite some signs of recovery in the economic growth forecasts, we believe that urgent action is required to improve our competitiveness and to provide companies with a coherent set of policies conducting to a business-friendly environment, less burdensome and characterized by stable and clear rules.

In our respective countries, it is evidenced that public policies must aim at increasing the price competitiveness of our industries. The role of governments is to assure an equal level playing field as far as labor costs, taxation and government programs are concerned. Only in this way, with enhanced profit margins for industries, it will enable companies to undertake the necessary investments in technological innovation and internationalization.

Preventing deindustrialization implies to reduce the gap on unit labor costs by means of curbing the tax wedge and shifting taxes away from production factors.

PROFIT MARGINS AND LABOR COST

Profit margins have been dramatically declining



Gross operating margin = VA at base prices - Labor income.
Labor income = (compensation of employees/employees)*total employment.
* corrected for IRAP.
Source: CSC calculations on ISTAT and Eurostat data.

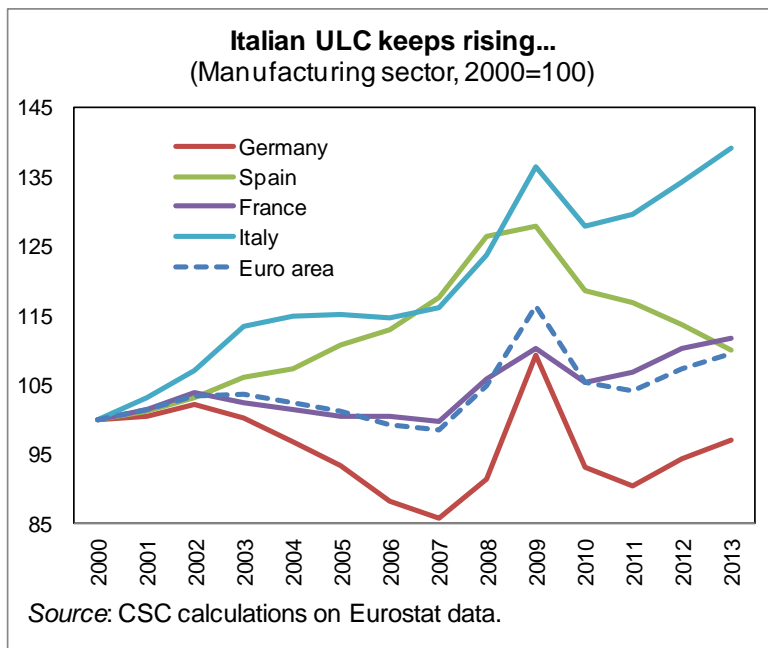
Profit margin rates have been negatively affected by the two economic recessions that hit the Euro area and Italy in particular.

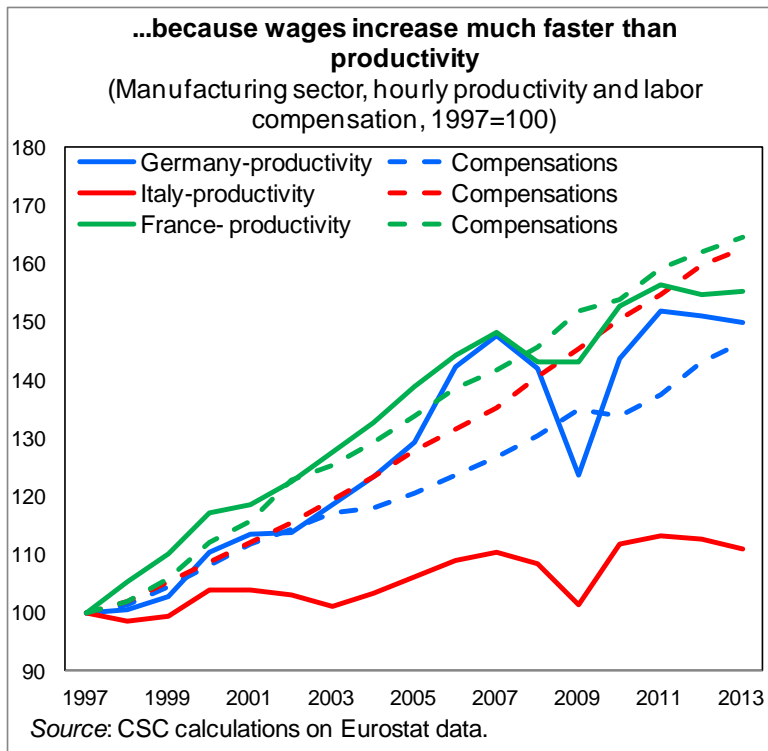
However, gross operating margins, a comparable measure across countries, had been already declining starting from 2000 in Italy and France. On the contrary, the dynamics of margins in the pre-crisis period was positive in Germany and Spain, where gross operating margins continued to grow also during the last recession.

In Italy and France, the main determinant of declining gross operating margins is the rise in Unit Labor Costs (ULC). On top of that, firms' markups have been negatively affected by the increasing cost of intermediate inputs, due in particular to higher price of raw materials.

A declining profitability lowers the firms' ability to finance investments with internal funding. In addition to constraints on the supply side, the weakness of credit demand also plays a major role, if not the main one in France, behind the slow growth of credit aggregates. On the positive side, Italian firms' financial resources have been increased by the payments of commercial debt arrears made by the Public Administration. This is also a particular concern in France and one of the government's commitments within the competitiveness pact is to reduce further late payments.

Increasing labor cost is one fair explanation of declining margins





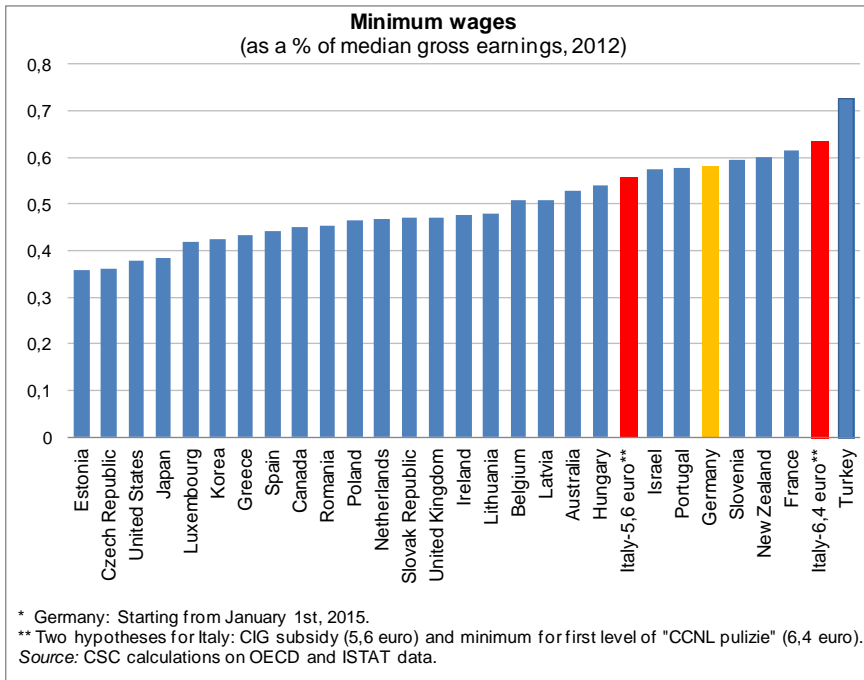
Nominal unit Labor cost in Italy
+40%
between 2000 and 2013
+30%
in France

In manufacturing sector Italian ULC has increased by 39.2% from 2000 to 2013, much more than on average in the Euro area (+9.4%). The dynamics in France is broadly in line with the one in the Euro area. Spanish ULC moved in line with the Italian one up to 2009 but has been reducing since then, filling the gap with respect to the EA average. German ULC, on the contrary, has decreased by 3.0% since 2000, despite a rise in the last two years.

Thus, the Italian manufacturing sector faces a cumulated competitiveness gap of 42.2 percentage points relative to the German one.

The Italian loss in ULC competitiveness is driven by its dismal productivity performance relative to the one in Germany and in France, while the compensation of Italian employees (per hour worked) has increased at a similar pace than the one of French workers, but at a pace totally disanchored from any kind of competitive relationship. Compared to Italy, France mainly suffers from the rapid rise in wages and less so from weak productivity gains. Wages' moderation is therefore becoming more pressing. However, this is a necessary condition but not a sufficient one to restore competitiveness and control costs: productivity gains have also to be increased.

Significant discrepancies in wages



Minimum wage as a percentage of median wage

61%

in France

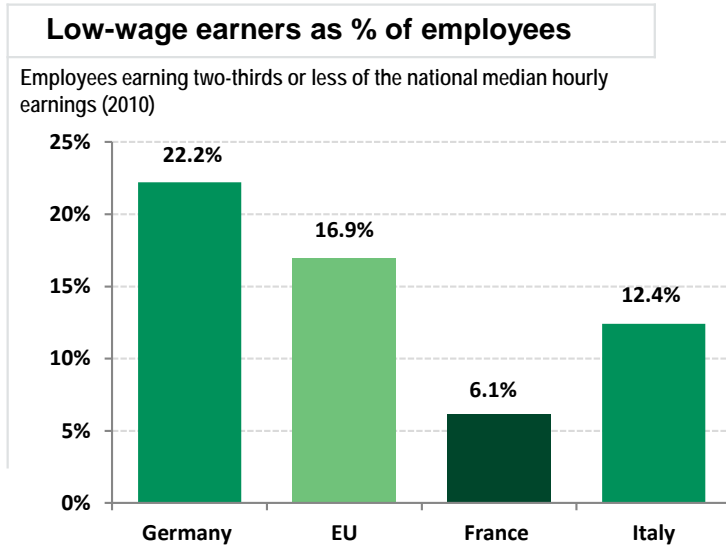
62%

in Italy

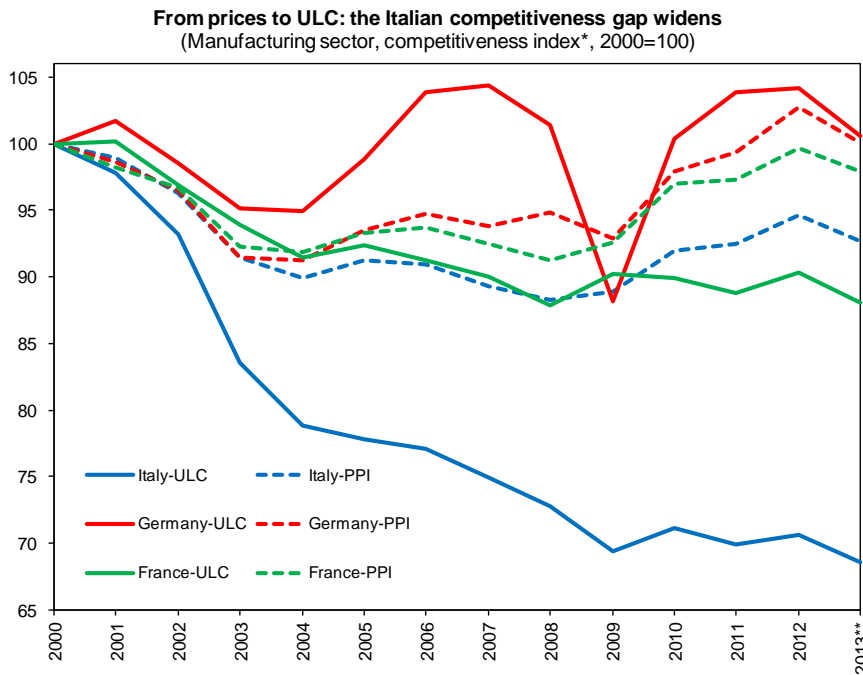
Minimum wages are set by law in many countries. Minimum-wage levels differ markedly across countries: for example, they are equal to 37.8% of the median wage in the United States and to 61.5% in France. In Germany a minimum wage of 8.5 euro per hour (equal to 58% of the median wage) will be introduced in 2015.

In Italy, there is no statutory country-wide minimum wage. However, negotiated minimum wages set by sectorial collective agreements are binding not only for employers and employees that are members of the signing parties but also for the entire industry that falls under the scope of the agreement. In fact, the Italian Constitution (Art. 39) declares collective agreements generally binding on all employee categories covered by the agreement. On this basis, the minimum wage level set by collective bargaining in a particular sector is often taken as a reference by courts when determining whether specific wages conform to constitutional requirements. The Renzi government is currently evaluating the option of introducing a statutory minimum wage. Based on CSC calculations, a minimum wage equal to the maximum CIG subsidy (a work time reduction scheme) would represent 55.7% of the median wage, while a minimum wage equal to the lowest level set by the collective agreement in the cleaning activities sector would represent 63.5% of the median wage. These are both quite high levels as compared to other countries.

A relatively high minimum wage reduces the inequality of the wage distribution. However, it may have a negative effect on employment and it may put pressure on wage growth. In France, this is an acute concern, hotly debated on whether and how to address it.



A loss of price and cost competitiveness



* Inverse of the effective real exchange rate deflated with production prices with respect to 61 competitor countries and deflated with ULC with respect to 36 competitor countries.
 ** 2013: average of the first 11 months for the PPI index and average of the first three quarters for the ULC index.
 Source: CSC calculations on Bank of Italy and European Commission data.

The real effective exchange rate (REER) measures the country's competitiveness with respect to a group of competitors. Different dynamics between the Euro area countries are driven by the price-cost component of REER, while the nominal exchange rate component is almost the same (but for different weights applied to each country's competitors).

Topic 1: Increase price competitiveness

An increase in the competitiveness indicator, defined as the inverse of the REER, is associated with lower price-cost of the country's goods relative to foreign goods.

According to the measure based on the producer price index (PPI), Italian goods competitiveness remained roughly constant from 2003 to 2013, losing some ground with respect to French goods (5.2 pp from 2000) and to German ones (7.3 pp).

However, the Italian gap widens dramatically when the index is measured with the ULC: Italian goods competitiveness have lost 31.4 pp from 2000 with respect to the average of competitor countries.

Thus, the two indicators offer a very different picture of the competitiveness of Italian goods. Which one is the more accurate? According to a CSC analysis based on a group of nine Euro area countries, the dynamics of exports is more sensitive to the ULC index: for the Italian case, the loss in ULC competitiveness had a negative impact of 0.95 pp yearly on export growth.

Aggregate data on profits and costs hinder the heterogeneity of firms' performance. Disaggregated data are particularly informative during the crisis, as firms' indicators diverged: exporting firms performed significantly better than non-exporting ones. More generally, larger and more internationalized firms display better performances.

In Italy, exporting firms were able to decrease ULC and increase profits between 2008 and 2011, unlike non-exporting firms.

Italian firms' performance by internationalization

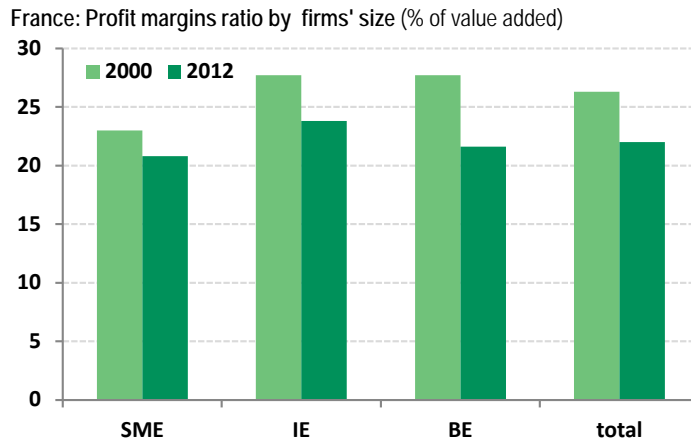
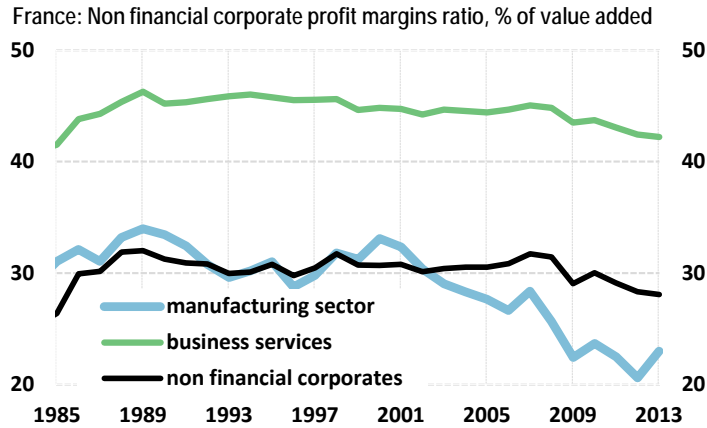
| Economic indicators of manufacturing firms, by destination markets | | | | | | |
|---|--------------------------------------|--|-------------|--------------------------------------|-----------------------|--|
| <i>(% cumulated variations)</i> | | | | | | |
| | Labor cost per employee (nominal) | Value added per worker (constant prices*) | ULC | <i>Profits (as % of value added)</i> | | |
| | Var. % 2002-2007 | | | <i>2002</i> | <i>Var. 2002-2007</i> | |
| Non-exporting firms | 19,4 | 1,8 | 17,4 | 28,1 | 0,0 | |
| Exporting firms | 18,1 | 5,8 | 11,6 | 35,7 | 0,6 | |
| Totale | 18,6 | 5,5 | 12,4 | 33,2 | 0,5 | |
| | Var. % 2008-2011 | | | <i>2008</i> | <i>Var. 2008-2011</i> | |
| Non-exporting firms | 7,2 | 1,5 | 5,6 | 12,6 | -2,5 | |
| Exporting firms | 8,8 | 10,1 | -1,2 | 31,6 | 2,6 | |
| Total | 7,4 | 6,4 | 1,0 | 27,5 | 1,4 | |

* Value added deflated by production prices (of goods sold in the domestic market for non-exporting firms; average of goods sold in the domestic and in foreign markets for exporting firms, weighted by the share of sales abroad).

Source: CSC calculations on ISTAT data, Struttura e competitività delle imprese.

Topic 1: Increase price competitiveness

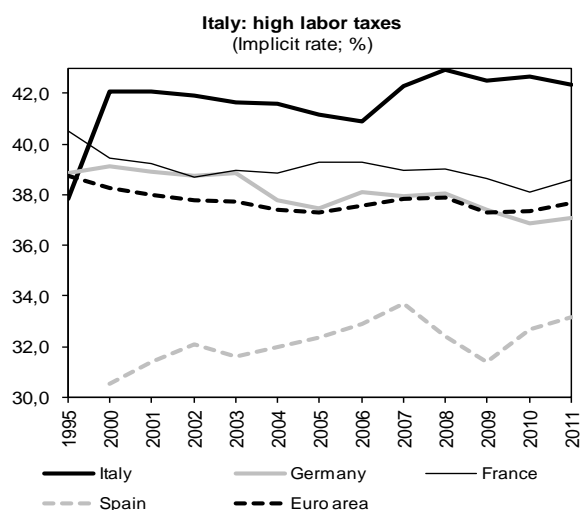
In France, if we have a look at the corporate profit margins ratio by sectors, the conclusion is sobering as profit margins have significantly fallen in the manufacturing sector, which is much more exports-oriented than the services sector, where profit margins are much higher and have declined much less. The observation of profit margins ratio by firms' size also leads to a concerning conclusion as the bigger the firm, the more pronounced the decline of profit margins between 2000 and 2012.



SME = small & medium-sized enterprises
 IE = intermediate-sized enterprises
 BE = big enterprises

TAXES AND GOVERNMENT MEASURES

A significant tax burden in comparison to other countries



Implicit rates are given by the ratio between tax and social security revenues and income of employees (in %).

Source: CSC calculations on Eurostat data.

Italy: corporate income tax is above average

| | <i>Corporate income tax</i> | | <i>Implicit tax rate</i> | |
|-----------------------|-----------------------------|----------------------|--------------------------|----------------------|
| | (Revenue as % of GDP) | | (%) | |
| | 2011 | Difference 1995-2011 | 2011 | Difference 1995-2011 |
| Cyprus | 6,8 | 2,6 | 26,9 | 2,6 |
| Malta | 6,0 | 3,3 | | |
| Luxembourg | 5,0 | -1,5 | | |
| Portugal ¹ | 3,2 | 0,9 | 36,1 | |
| Belgium | 3,0 | 0,6 | 17,0 | -3,3 |
| Italy | 2,8 | 0,0 | 24,8 | 5,9 |
| Finland | 2,7 | 0,4 | 16,9 | -1,5 |
| Slovakia | 2,6 | -4,1 | 17,5 | -33,7 |
| Germany | 2,6 | 0,6 | | |
| Ireland | 2,4 | -0,3 | | |
| Austria | 2,3 | 0,7 | 22,0 | -2,9 |
| France | 2,3 | 0,5 | 26,9 | 4,3 |
| Netherlands | 2,2 | -1,1 | 7,1 | -12,7 |
| Greece | 2,1 | -0,2 | | |
| Spain ² | 1,9 | 0,0 | 21,8 | |
| Slovenia | 1,7 | 1,2 | 19,7 | 3,1 |
| Estonia | 1,3 | -1,2 | 5,8 | |
| Euro area | 2,5 | 0,3 | 20,8 | -0,3 |
| United Kingdom | 3,1 | 0,4 | 18,8 | -2,4 |
| EU27 | 2,6 | 0,3 | | |

¹ Data refer to 2008; ² data refer to 2009.

Corporate income tax doesn't include tax on self-employment but do include eventual indirect tax on corporate income. For the Italian case the data refer to IRES and the share of (private) IRAP applied to value added net of labor cost, excluding the part paid by the self-employed. The implicit tax is given by the ratio between the tax revenues and the gross operating margin (in %).

Source: CSC calculations on Eurostat data.

High taxes and the complexity of the taxation system are major obstacles for doing business in Italy and in France, with an additional problem here, that is the instability of the taxation system. This is true for all taxes that apply to business activity, but especially so for labor taxation.

For corporate income, the Italian implicit tax rate, that measures the effective burden on taxpayers, was equal to 24,8% of gross operating margins in 2011, versus 20,8% on average in the Euro area. For labor income, the Italian implicit tax rate was equal to 42,3% of employees' income, while in the EA it was 37,7%.

On the contrary, consumption taxes are lower in Italy than in other European countries. A rebalancing between these two forms of taxation would be useful, in order to transfer part of the tax burden on imported goods and services. In France, there is exactly the same issue of rebalancing and the government is acting in this way (the competitiveness tax credit is indeed partly financed by a VAT increase).

Moreover, other revenues should come from a serious program against tax evasion.

The measures that the Renzi government is currently adopting to enhance competitiveness move in the right direction. Still, much more needs to be done and there is plenty of room for improvement. This is exactly the same thing in France, where numerous measures are being implemented to restore price and non-price competitiveness but with limited expected positive results.

The decrease in the tax wedge is an important step. However, only a small part of the decrease applies to IRAP (700 million euros in 2014; but it is going to triple in 2015), while most funds go to IRPEF (6,7 billion euros). Moreover, cuts to IRAP are linear, while it would be more efficient to tailor them specifically to labor cost.

The additional funds available for public administration payment of arrears (9,6 billion euros in 2014) are also good news for firms.

Government programmes - Measure taken in France ...

| Measure | Amount & Characteristics |
|---|---|
| Competitiveness & jobs tax credit (CICE), first level of the Competitiveness pact | <p>EUR 20 bn annually by 2015 (incl. EUR 12 bn in 2014)</p> <p>Calculated in proportion to the company's gross payroll costs excluding salaries higher than 2.5 times the minimum wage (proportion fixed at 4% in 2013 and 6% thereafter)</p> <p>All firms eligible</p> <p>Free use of the funds and ex post monitoring</p> |
| Payrolls tax cuts (Responsibility pact, in addition to the CICE) | <p>EUR 10 bn:</p> <ul style="list-style-type: none"> - EUR 4.5 bn of cuts to employer payroll taxes targeted on wages between 1 and 1.6 times the minimum wage (2015) - EUR 1 bn of reduction in the family benefit contributions of freelancers and craftspeople (2015) - EUR 4.5 bn of cuts in family benefit contribution paid by employers for all salaries up to 3.5 times the minimum wage (2016) <p>Strings attached: jobs creation and social dialogue enhancement</p> |
| Tax cuts | <ul style="list-style-type: none"> - Removal of the surcharge on corporate income tax (2016, EUR 2.5 bn) - Removal by 2017 of the corporate social security levy (C3S) (EUR 5.5 bn, incl. EUR 1 bn in 2015) - Scrapping of several dozen complicated and low-yielding small taxes - Reduction in the corporate tax rate from the current 33.33% to 28% by 2020 (first step in 2017) |

... and in Italy

| Measure | Amount & Characteristics |
|--|---|
| Corporate tax cut (IRAP regional tax) | <p>EUR 3bn by 2015</p> <p>A 10% cut of the local tax on value added (IRAP, EUR 30bn annual collection) by May 2014, with a EUR 3bn full impact in 2015.</p> <p>According to some estimates, this measure represents less than 10% of the total tax cut required to close the unit labour cost gap between Italy and Germany.</p> |
| Personal income tax cut (IRPEF) | <p>EUR 10 bn</p> <p>Reduction of taxes for low earners (annual gross income between EUR 8,000 and EUR 25,000).</p> <p>According to some estimates, this measure should result in EUR 1,000 annual net saving for roughly 10m taxpayers, with a monthly salary below EUR 1,500.</p> |
| Payment of Public administration arrears | <p>EUR 20 bn by 2015 already allocated and EUR 13 bn to be defined</p> <p>Acceleration of the payment of public commercial arrears, which could be factored by banks and other financial players.</p> <p>EUR 47 bn have been allocated, with EUR 24 bn already paid and more than EUR 20 bn planned to be paid by the end of 2015. Government has recently decided to increase funds available to pay commercial debt by EUR 13 bn.</p> |
| Cutting SMEs' energy cost | <p>EUR 1.5 bn</p> <p>10% reduction in the electricity price paid by Italian SMEs (SMEs' total energy bill is estimated to be EUR 15 bn).</p> |
| Lower taxes on the work of young people | <p>For employers, who decide to hire a young person who has either been without remunerated employment for at least 6 months, or who does not have a secondary school diploma, a tax incentive has been introduced equal to a one-third reduction of the gross taxable income subject to social welfare costs for a period of 18 months and for a sum of not more than 650 euros per employee.</p> |