

Research Briefing | Italy

EU funds will help, but structural reforms are the key

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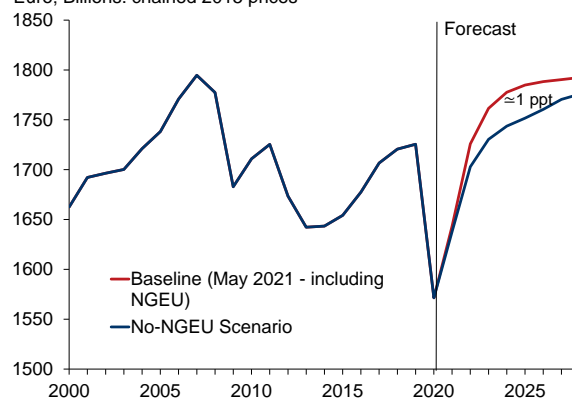
- **Italy's €235bn Resilience and Recovery Plan, which pairs funds from the EU with national commitments, has the potential to put its economy on a higher growth trajectory. But we still think it will be insufficient to raise Italy's per capita GDP to the eurozone average.**
- **The RRP entails additional spending worth 10% of GDP until 2026 alongside a package of ambitious structural reforms. The spending could directly add 1.5%-2% of GDP in the medium-term. And if the resources are allocated efficiently, targeting high-impact productivity measures and human capital, and the structural reforms are successful, it could boost GDP growth to 1.3% from 0.7% over the next 20 years.**
- **However, we have only incorporated the direct effects of the spending increase in our baseline. Italy has struggled to spend previous European funds due to a lack of institutional preparedness – public sector performance and institutional quality indicators remain poor.**
- **What's more, in our view, the reform agenda has a low probability of success. In Italy, ambitious reform agendas that need strong, sustained political support typically run up against enormous political hurdles.**

Italy presented its Resilience and Recovery Plan (RRP) to the European Commission at the end of April. The RRP makes full use of both the transfers and the loans earmarked under the Next Generation EU fund to aid recovery, as well as an additional national fund to finance further expenditures. Overall, the plan amounts to €235bn (14% of 2020 GDP), of which €85bn will be grants from the EU. Some funds will be used to finance existing spending plans, so we estimate the additional spending to be around €165bn (10% of 2020 GDP).

Figure 1: The Next Gen EU plan provides some support to Italian growth

Italy: GDP

Euro; Billions: chained 2015 prices



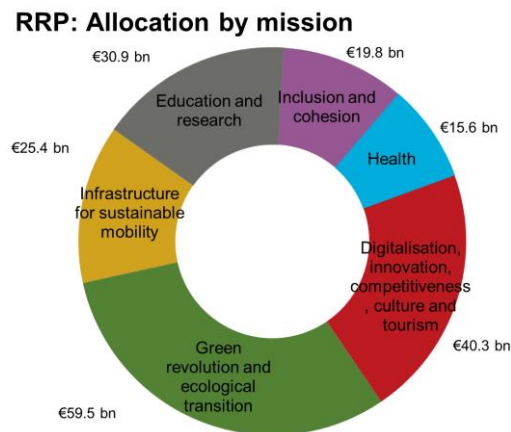
Source : Oxford Economics/Haver Analytics

According to our analysis, the additional funding from NGEU will boost growth over the coming years. The direct impact of this additional spending could amount to around 1.5%-2% of GDP in 2022-2026

The RRP allocates the resources from the NGEU and national fund to six missions (**Figure 2**), focusing particularly on the green revolution and energy transition, and digitalisation, which together account for more than half of the plan. This will be complemented by increased spending on education and research, infrastructure and sustainable mobility, social cohesion, and health. Italy is also the main beneficiary of another EU recovery programme (REACT EU), which will provide €13.5bn in grants out of a total envelope of around €50bn. REACT EU is targeted at sectors at the core of economic recovery, such as the labour market, and the green and digital transitions.

The new Draghi government has put significant emphasis on institutional reforms in the RRP. The plan groups the reforms into three main areas. The first, reform of the public administration and the justice system, is considered vital to underpin all the plan's objectives as it's a key to improving the efficiency of the Italy's public sector and its competitiveness. A second group of reforms is aimed at rationalising the administrative and legislative system while promoting competition. Third, within each mission, the plan introduces ad-hoc reforms aimed at innovating regulations and procedural regimes in specific sectors of the economy.

Figure 2: allocation of the Italian NGEU plan by mission



Green revolution, ecological transition and digitalisation, together account for more than half of the plan.

Source : Oxford Economics

Economic impact of the NGEU

Using our global economic model ([GEM](#)), we have estimated the impact of Italy's RRP on the economy – the results are already included in our latest forecast update released [earlier this month](#). As the plan is not yet fully detailed, we have assumed that around 80% of the funds will be in the form of additional investment – mostly in government investment and the rest in incentives to enterprises. We then distributed the remaining 20% between government consumption (around 10%), household transfers, and tax cuts. We used some discretion on the timing for the disbursement of these funds – while we believe that all of the funding will be distributed eventually, we remain sceptical of the government's optimistic timelines and expect the uptake to be far [more gradual](#). In fact, we doubt that the government will be able to spend all the money within the official 2021-2026 timeframe – more likely, some of the expenditure will arrive after 2026.

Given the fact that most of the additional funds will be used as additional investment and our assumption of a limited impact on inflation, the scenario results show that the fiscal multiplier will be close to one in the short-to-medium term, before increasing above one in the longer term. This is due to the fact that stronger capital spending will impact capital accumulation and have a positive and permanent effect on the level of potential output.

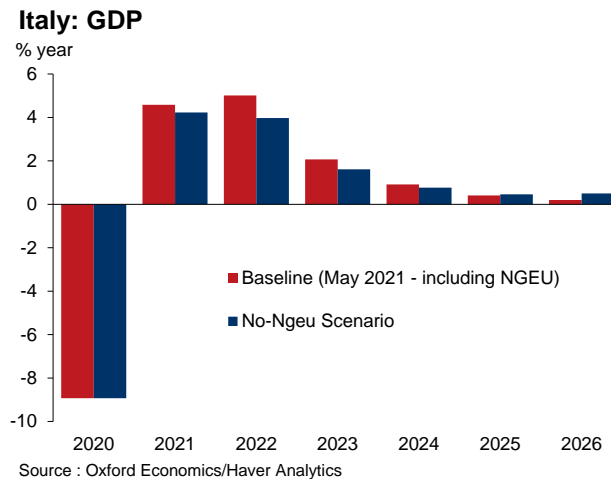
According to our modelling, the plan will add a significant spur to growth, with the direct impact of the additional spending contributing 1.5%-2% to GDP in 2022-2026 (**Figure 1**).

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For 2022, we estimate a growth rate of 5%, versus 4% of a no-NGEU scenario. For 2023, GDP growth would increase by around 0.5 ppts (**Figure 3**).

But despite providing some support to the overall Italian economy, the plan is not a game changer. Italy will still be a weak spot for the eurozone. In fact, as **Figure 6** shows, Italy's long-term adverse dynamics, in which GDP per capita lags the eurozone, won't be reversed.

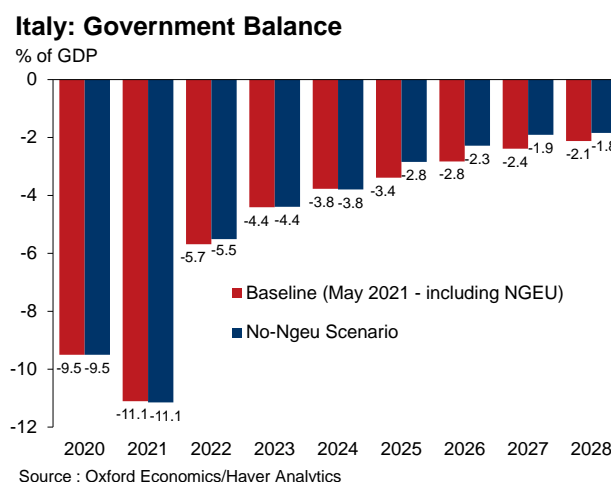
Figure 3: GDP growth will see a positive impact in the coming years



Growth in 2022 will also be supported by the fiscal stimulus coming from the NGEU, rising to 5% from 4% in a no-NGEU scenario.

As in the initial stage of the plan, the government is expected to make more use of the EU grants, which will limit the impact on the fiscal deficit initially. But the take-up in loans from the EU, which we expect to be used from around 2025, will increase the public deficit later (**Figure 4**). We expect the government deficit to rise above 3% in 2025 and the primary deficit to shift into surplus only in 2026. Due to the positive combination of stronger growth and the limited impact on the deficit, government debt is likely to be slightly lower than in the no-NGEU scenario up until 2026. But in the following years, government debt will likely be marginally higher, at 152% of GDP in 2030.

Figure 4: Government balance will see small impacts in 2021-2024



The fiscal deficit is broadly similar in both scenarios in the initial years, as the NGEU plan will make more use of the transfers. But from 2025, the impact diverges, as the NGEU is expected to mobilize around €80bn of additional loans.

Upside scenario: economic and structural reforms in Italy

The trajectory for growth could change radically if Draghi is able to set Italy on a path of structural reform (along the lines outlined in the RRP) that subsequent governments continue to pursue. In line with our previous [research](#), we have developed an illustrative upside scenario for Italy. The main assumptions are summarised in **Figure 5**.

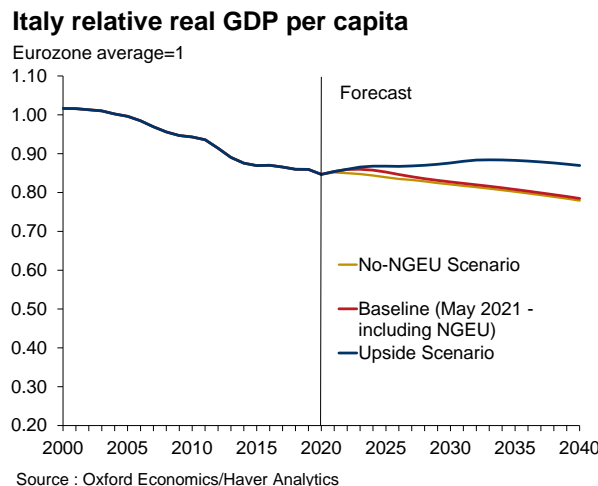
Figure 5: upside scenario assumptions

	Assumption	Transmission	Calibration
Near to Medium Term	Investor sentiment improves	Lower government rates help with the interest payments and reduces private rates.	Italian 10-year government bond yield spread increases only marginally from current level and stabilizes at around 100bps after 2021, in line with the 10-year government bond yield of Spain.
	Gender gap is reduced	Potential output is stronger over the longer term, in line with increased capital accumulation, strengthening labour supply and faster productivity growth.	Implied gender gap participation rate diminishes by 10ppt, with the overall participation rate gradually increasing over the next 10 years.
Quality of institutions is improved	Quality of institutions in Italy improves over the next 10 years, in line with the historical improvements seen in the the best eurozone countries.		
Better educational quality	Average years of education increases at a quicker rate than in baseline and reaches 15 at the end of the scenario simulation (2050).		
Long Term	Additional fiscal easing as debt burden issues soften	Stronger government investment and government consumption help with both demand and potential output.	Additional fiscal easing in government consumption and government investment, from mid-2020 with targeting a primary surplus of around 2.5-3% of GDP.

Under these assumptions, the annual pace of growth in Italy would almost double over 2021-2040 – rising from 0.7% to 1.3%. The level of GDP would be around 13% higher than in the baseline in 2040. One of the most important takeaways under this optimistic scenario is that Italy’s debt sustainability would drop down the list of Europe’s key worries, with public debt dropping to 120% of GDP in 2040.

Our upside scenario is, by definition, a simplification of what could happen in the Italian economy. Still, it is a useful guide to quantify the potential benefits of Draghi-style structural reforms. Moreover, it shows that the critical issue for Italy continues to be solving its structural issues, independently of the funding injection from the NGEU plan. Tackling the structural hurdles would not only be hugely beneficial for the country itself, but it would also help to put an end to Italy’s reputation as the eurozone’s biggest liability. In particular, the gap between Italy’s GDP per capita and the eurozone’s (**Figure 6**) would remain stable, in contrast to the further decline we calculate in the current baseline.

Figure 6: Structural reforms are critical for Italy to prevent the gap with its peers from widening further



In our upside scenario we show that Italy’s lacklustre growth and questionable debt sustainability would drop off the list of Europe’s key worries.