

Economic Survey of Italy, 2003

Summary

The traditional dynamism and flexibility of the Italian economy has faltered in recent years, in part because of the unfavourable developments in the international economy. Furthermore, structural reforms have not yet gone far enough to turn the tide. Despite supportive fiscal policies and monetary conditions, growth is sluggish, confidence is at a low ebb, inflation is above the euro-area average, and there are perceptions of a pervasive loss of competitiveness. As regards fiscal policy, room for manoeuvre has now been greatly reduced by tax cuts – desirable in themselves – and significant additional corrective measures will be required for some years to come, if medium-term targets are to be achieved and long-term fiscal sustainability is to be assured. Such corrective measures should be of a structural and permanent nature, with prime candidates being savings in public pensions and health care, and increased public sector efficiency. The pension system is very expensive, in large part because it still encourages early retirement, thus resulting in inefficient public spending and low employment rates. These perverse features need to be removed. Public health spending is not efficiently administered: recent agreements on standards and financing with regions are a step forward, and a more incisive control of costs could derive from the quarterly monitoring of spending that has already been implemented. In public administration, the retirement of large numbers of public employees creates opportunities for a more effective and less costly redeployment of human resources. Overall economic performance would be improved by policies that further strengthen competition in product markets, for example by not eroding the powers and independence of the sectoral regulators. Privatisations should be vigorously resumed and effective financial market monitoring of firms ensured. Speedier bankruptcy procedures should be introduced that give priority to efficient reallocation of resources. Together with less rigid employment protection legislation, this might encourage more small firms to expand to levels that would permit more investment in both human and R&D capital. Recent employment developments have been positive, and further improvements could be

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This Policy Brief presents the assessment and recommendations of the 2003 OECD Economic Survey of Italy. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

achieved by encouraging the social partners to allow wages of workers of all ages to more closely reflect their productivity and local conditions. Planned improvements in the social safety net and the functioning of employment services should also boost job creation by making employees willing to accept more flexible employment conditions. In the longer term, increasing the levels of output and living standards will also depend on raising the skills and qualifications of Italy's labour force. Proposed educational reforms could improve them both and thereby help to realise Italy's full economic potential. ■

What are the main policy challenges?

The Italian economy has not proved resilient to the global slowdown that started in 2001. The ambitious programme of structural reforms over the past decade allowed Italy to join the EMU and to improve macro-economic fundamentals, but has not been enough to spare the country from a disappointing performance in 2002, when the deceleration of growth was one of the sharpest among OECD countries. Discretionary fiscal support and low real interest rates temporarily revived both consumer and business spending in the second half of last year; however, it is unlikely that activity will pick up in Italy in advance of that of its trading partners, with Italian GDP rising this year broadly in line with the Euro-area average. A bright spot in the current downturn has been a strong employment performance, a clear result of the greater flexibility of the labour market following the reforms of the 1990s. It is worrying, though, that both inflation rates and unit labour costs are rising faster than the euro-area average, while Italian exporters appear to have lost competitiveness, and certainly have lost market shares. In addition, the convergence between North and South recorded in recent years needs to be maintained. This suggests that to derive the full benefits of reforms, existing ones need to be implemented fully, and others pursued with vigour.

Looking ahead, Italy's key challenges are to raise the potential rate of growth and increase resilience to future shocks, to address the issue of competitiveness by closing the inflation gap with the euro-area, and to safeguard the sustainability of public finances while also continuing to provide appropriate fiscal policy support to the growth process. Greater competition, reduced red tape, and more efficient public spending are critical elements of such a policy mix. Lower taxes, provided they are matched by a reduction in structural expenditure, are also important. Indeed, the present government came to power with a mandate – and sufficient parliamentary support – to carry out a major programme of growth-oriented economic reforms, some of which have already been implemented. Sev-

eral of these have fiscal costs, at least in the short run, but the unexpectedly low economic growth since late 2001 has put strain on public finances. There is thus a pressing need at present for the government to find ways of continuing to finance its programme of necessary reforms in the areas of taxation, education and social policies, while also complying with Italy's obligations under the EC Treaty and the Stability and Growth Pact. The reforms themselves are likely to generate faster growth and thus eventually higher tax revenues, but the experience of other countries suggests that this will not come about in the short term. Meanwhile, recovery in Europe could quicken the pace of deficit reduction, although this would be partly offset insofar as higher interest rates would feed through into higher debt-servicing costs. Hence, an optimal policy would be early and permanent cuts in primary spending in those areas which do not directly improve competitiveness and growth performance, using the fiscal room created to finance reforms in other areas, including tax cuts. In this context, it is encouraging that the Italian authorities have refrained from attaching a specific timetable to their tax reform plans. In recent years, one-off measures have been taken to alleviate shortfalls in revenue, mostly due to weaker than expected economic growth, though some of them, such as the tax amnesty, could lead to some permanent enlargement of the tax base. In general, the government should avoid financing permanent tax cuts and/or permanently higher spending *via* one-off measures taken within an annual budgetary process. For the medium term, the adoption of a strategic multi-year framework, such as those implemented in some other OECD countries, could strengthen the implementation of fiscal policy, conducted in accordance with the Stability Programme. In coming years, Italy should run substantial primary surpluses in order to reduce public debt more rapidly. ■

What are the objectives for fiscal policy?

Although Italy's public debt has fallen substantially in the past decade, it still exceeds 100 per cent of GDP. Its average maturity structure is longer than in the past, lowering somewhat the sensitivity of the debt service burden to changes in interest rates. The net worth position of the public sector is believed to be more comfortable, as there is a large amount of public assets, mainly real estate earning low returns. A complete inventory of them is being compiled. If there is no reason to keep them in public hands, and the private sector can make more effective use of them, a long-term programme of gradual and orderly divestiture should be envisaged. While such real estate asset sales would allow the levels of the deficit and debt to fall, it is important that they not be used instead to substitute for structural spending reforms. In

the longer term, fiscal pressures from an ageing population will mount, and it is therefore doubly important that primary expenditures be reduced wherever possible, and the level of debt fall.

At the end of 2002, new legislation to strictly control and limit spending was introduced, and proved effective. The 2003 budget aimed at a deficit of 1.5 per cent of GDP. It included revenue-boosting measures, largely tax amnesties, equal to about 0.7 per cent of GDP. The deficit will also be reduced by continuation of the programme of real estate asset sales in the amount of 0.7 per cent of GDP. However, the deficit projection for 2003 has recently been revised to 2.3 per cent of GDP, mainly in the light of continuing weakness in activity. Under the 2002 update to the Stability Programme, the objective for 2004 is a deficit of 0.6 per cent of GDP, based on a GDP growth rate of 2.9 per cent.

Looking further ahead, the medium-term fiscal target is for a progressive reduction in the general government budget deficit, with a small surplus being registered by 2006. The medium-term plan projects primary surpluses of 4-5 per cent of GDP till 2006, although OECD projections indicate that the primary surplus (adjusted for the cycle and one-off measures) in 2003 will be around 3 per cent of GDP and will fall to under 2 per cent in 2004. According to these projections, additional measures will be required.

The tax reforms introduced in the 2003 budget aim at reducing the overall tax burden and simplifying the tax system. This first stage of a more ambitious tax-cutting programme primarily targets low-income families and should facilitate greater participation of marginal workers. The main feature of a new framework law, still to be implemented, is a move to a system of only two tax rates on personal incomes, with tax deductions on lower incomes. The tax reform also replaces the dual income tax by a single corporate tax rate, which however is still nearly 20 percentage points above the tax rate on financial income, thus favouring debt over equity finance. Narrowing this gap is desirable and could be achieved by broadening the corporate tax base while reducing the rate. The IRAP, a regional tax on productive activities, is to be phased out by the tax reform, but it would be unwise to implement this before alternative revenue sources are found for the regions.

The tax reform is also intended to lessen the size of the underground economy, *via* the introduction by the 2003 Budget Law of a large number of tax amnesties (*concordato* and *condoni*). They differ from traditional tax amnesties in that there are no penalties for unpaid tax in previous periods, simply requiring one-off payments by taxpayers. An additional goal of the tax amnesties is to clear the huge backlog of pending liti-

gation, allowing a more efficient assessment and collection of taxes in the future, and an enhanced capacity to fight tax evasion. This approach could lead to an increase in tax revenue, but there would be moral hazard problems if the amnesties were to become a regular feature of government policy. ■

Is product market competition sufficient?

Product market competition intensified in the 1990s thanks to liberalisation of network industries and local services, public administration reform, active enforcement of competition legislation and extensive privatisation. However, there is still considerable scope for improvement, and raising potential growth will be aided by removing obstacles to competition. The legacy of government intervention and the remnants of restrictive practices have hampered the development of competition in some sectors. Local governments should follow practices that strengthen competition in their dealings with the private sector. In general, the rents that are eroded by stronger competition are concentrated among entrenched incumbents, while the benefits are broadly distributed and thus less visible. This weakens support for further reforms.

The introduction of the one-stop shop to reduce the administrative burden on setting up enterprises has reduced waiting times for opening new businesses, but administrative burdens and red tape associated with running a business are still considered to be major problems by companies and may inhibit their growth. In public services, the introduction of competition through public procurement has been less than expected given commitments by the authorities as reflected in the 2001 *Regulatory Reform Review of Italy*. There has been little experience to date with outside bids, contracting out or tendering.

Entry barriers remain substantial in the professional services and retail distribution sectors despite regulatory reforms in the past few years. Recent reforms still allow for the involvement of professional associations in the tariff setting process. Their role should be reduced, to lessen the probability of regulatory capture. Decentralisation carries the risk that local regulations on urban planning prevent the opening of large retail outlets, thus hindering competition. Better co-ordination of competition policy objectives across different levels of government and a rethinking of devolution strategy as regards competition in local markets are required.

Regulatory reforms in network industries have been effective and, although incumbents retain dominant positions, competition is emerging. In particular, the liberalisation of telecommunications has been a success. Electricity prices are comparatively high, which is due mainly to high costs in generation. Privatisation of

network industries should be speeded up. The government has a controlling interest in electricity and gas and still retains a golden share in telecommunications. More recently, the powers of some sectoral regulators have been circumscribed. The authority to issue telecommunications licences has been transferred back to the Ministry for the time being. The introduction of an electricity pool has been delayed due to insufficient competition in generation, and the government has also intervened in recent tariff-setting by the energy regulator. The government now has the over-riding authority to approve tariffs, and future tariffs may have to be settled through a consensual process with the parliament. These actions risk a step backwards in earlier competition progress and should be reversed. In particular, the independence of the regulatory authorities should be reaffirmed, especially as the government is now planning a review of the regulatory authorities.

The international competitiveness of Italian industry is also influenced by its structure and governance. The enterprise sector is characterised by a large number of very small firms, and a small number of large ones, evidently with disincentives for small firms to grow. Although small firms have traditionally been a source of dynamism, their limited resources hamper their ability to invest in human capital. At the same time, foreign direct investment, an important potential source of technological know-how (and competition), is not attracted by Italy for many of the same reasons that hamper domestic businesses: red tape, an infrastructure gap in the South alongside bottlenecks in the North, and remaining product and labour market rigidities, issues that the authorities are trying to address. ■

How can financial markets be made more competitive and transparent?

The Italian system of corporate finance and governance features weak market scrutiny of firms and underdeveloped long-term risk finance. Equity market participation is limited to a small number of large firms, where insider (family group) control is consolidated by means of pyramidal shareholding schemes. Banks provide the bulk of financing to all firms, but play a limited role in monitoring them. Their role is by and large an arms-length one. Short-term financing is higher than in other EU countries, though the trend is downwards, while long-term lending is usually collateral-based. As in many countries, small firms find it hard to finance expansion. They may be reluctant to grow in any event, because of a higher burden of regulation and taxation at larger scales. But a key problem is an out-of-date bankruptcy law wherein bankrupt debtors can face criminal sanctions, creditors have no directive rights in a bankruptcy and can also face legal lia-

bility for pre-emptive actions, and there is scant regard for the goal of increasing firm value. A lengthy and costly judicial process greatly exacerbates these risks.

To address these shortcomings, Italy has over the 1990s implemented reforms of its financial system in tandem with real-side reforms, bringing its banking sector into line with EU norms and reforming the governance of listed firms. In this perspective, reforms continue. A new company law provides both listed and non-listed firms with greater autonomy to organise, finance, and govern themselves. The development of a private funded pension pillar could spur capital market development and create a new class of institutional investors to monitor firms. Banks are adapting to more stringent risk regulations in the context of Basle 2, which should improve their own incentives to monitor firms.

Nevertheless for the reforms to be fully effective, several steps need to be taken. *First*, minority shareholder rights need strengthening, given the disproportionate degree of control exerted by holdings at the apex of pyramidal groups. The high cost of calling shareholders' meetings needs to be reduced. *Second*, conflicts of interest are not fully resolved. Because mutual funds are mainly owned by the banks, who also provide lucrative services to the firms, incentives by institutional investors to monitor firms in the interests of small shareholders are weak. Management of the new pension funds should be delinked from control by companies, and should be separated from the commercial banks' normal lending and savings management activities. Workers should be able to change funds without losing tax incentives. *Third*, market transparency and investor protections need strengthening, especially if private pension funds are to provide workers with genuine retirement security. Penalties for accounting fraud have been substantially weakened, especially for non-listed firms who are often at the top of pyramid holdings. *Fourth*, bank reform needs to go further. Basle 2 should be implemented while also striking a reasonable balance between the application of adequate risk-assessment mechanisms and their implications for small- and medium-size banks and firms. Bank governance should be strengthened by further divestiture and greater private-sector orientation of the banking foundations, but the government's most recent reform proposals (currently put on hold by the constitutional court) appear to go in the other direction. Competition for bank property rights should be enhanced also by a more open regulatory environment for takeovers. A bankruptcy reform currently in the drafting stages should pay greater attention to creditor rights and be completed and implemented without delay. ■

Would growth be boosted by labour market reforms?

Since the second half of the 1990s, labour market policies have been directed towards the liberalisation of employment contracts as well as fiscal incentives, and this has been followed by strong employment growth, albeit accompanied by a decelerating productivity. Although the gap is narrowing, the unemployment rate is still higher than the OECD and EU average. The employment ratio remains relatively low, especially for females and older workers in spite of recent increases. Moreover, despite aggregate wage moderation, wages still tend to be rigid at the micro level. Hence, Italy's external (and internal) competitiveness would be aided by further labour market reforms that enable firms to adjust their production techniques and levels in response to changing demand patterns.

To respond to these challenges, in 2002 the government and the social partners (with the exception of the largest trade union) agreed on a "Pact for Italy" (*Patto per l'Italia*). The Pact is directed at a better functioning labour market and more effective social policies. New types of contracts should help firms and workers to find better job/skill matches. The emphasis of the government on an efficient placement system is thus appropriate; priority attention should be given to the South, and incentives are required to ensure that the low-skilled receive adequate attention. A balanced approach in the reform is needed, as there is the risk of a dual labour market being created, if job protection for traditional contracts remains rigid. As stated in previous *Surveys*, too rigid rules on permanent contracts risk excessive recourse to increasingly precarious ones for new entrants. Conflicts should primarily be resolved through bilateral agreements or through multilateral committees rather than through the judicial system. Finally, to maximise the impact of flexible contracts on participation, the government should also promote higher and better provision of care for children and other dependents and develop policies which make work pay.

The Pact has announced measures – in part already implemented – to strengthen social inclusion and unemployment insurance, areas where public spending has traditionally been low in Italy. The main poverty-fighting weapon in the Pact is the introduction of tax cuts targeted at low income families. This strategy is welcome, as in the 1990s and early 2000s the share of people with relatively low income has increased considerably in Italy as compared with other OECD countries. Tax cuts for the low-paid and other making work pay policies can promote social inclusion through stronger incentives to work in the formal economy, while also allowing the implementation of a more differentiated and flexible wage structure including across regional lines. But an effective welfare

system also requires an adequate unemployment insurance and assistance system. There are currently many types of unemployment benefits of varying generosity. For ordinary beneficiaries, replacement rates are low, and advice, control and incentives to search for a job are limited. The new reforms provide for higher replacement rates for the ordinary unemployment benefits, while beneficiaries are required to attend specific training programmes and to accept a job offer, when available. This mix of improved incentives and strong sanctions is appropriate. Nevertheless, different categories of workers will still face very different levels of generosity in unemployment benefits. These should be streamlined, preferably by re-balancing the various levels of generosity. Furthermore, work incentives tied to eligibility conditions should be strengthened also in order to permit a wider sectoral coverage.

Notwithstanding recent improvements in regional disparities, employment rates and productivity levels remain low in the South where a third of the population lives. Policies that aim at reducing the large infrastructure gap of the South, at improving the quality of public services and at modernising local administrations can have a significant impact on output and employment growth, by improving the framework conditions in which private agents operate. The process initiated in 1998, and aimed at enhancing local governance systems, has produced positive outcomes (*i.e.* increased capacity of spending by regions). More needs to be done in terms of effectiveness (capacity of selecting and implementing high quality projects). The development of public-private partnerships (PPPs) could help fill the infrastructure gap, while minimising the impact on public finance, as long as partners are selected objectively, and cost-benefit calculations are performed rigorously. To stimulate private-sector involvement, the government has established *Infrastrutture S.p.A.*, which will act as a financial intermediary favouring the more rapid realisation of infrastructure projects thanks to a more thorough evaluation procedure. Private investment could also be encouraged *via* greater wage differentiation. To this end social partners should develop a more decentralised bargaining structure, for example by allowing the variable wage component in national agreements to adjust for productivity differentials both downward and upward, or by allowing individual firm opt-outs from the national contract. ■

Will education reforms raise the economy's competitiveness?

In the longer term, raising productivity levels and competitiveness will depend on improving the usable skills of the labour force. Despite significant improvements, the share of the population with at least upper-secondary education is much lower than

the OECD average. In 2003 the parliament approved a reform of the primary and secondary level education system to reduce drop out rates. A vocational education and training stream is proposed, alongside the current system, which is characterised by a broadly-based educational approach. Switching between the two streams at various points is provided for. The reforms should also facilitate the school-to-work transition, contributing to reduce mismatches in the labour market. In the process, the authorities should make sure that an early decision between high school and vocational training by pupils introduced by the reform is not driven by liquidity constraints on poorer families with negative consequences for their children's participation in tertiary education. Appropriate track counselling and the guidance instruments proposed by the reform should be quickly instituted. In any case, immediate and nation-wide implementation of such a major reform would be both impractical and very expensive. A programmed transition is indicated.

Teachers' wages grow only to a limited extent with tenure and are not linked to performance, sapping their incentive to provide high quality of teaching. Career systems and rewards for school teachers and managers that more clearly reflect individual efforts and results should be implemented also in relation to participation in training schemes as proposed by the government. Performance indicators for schools at the local or central level should be quickly implemented and extended in order to benchmark best practices and help households and students in their educational choices. Finally, the government should set broad objectives for educational standards and achievements, and permit the regions to experiment in the most effective ways of meeting them. ■

Is the public pension system too costly?

Although the reforms enacted in the mid 1990s were important steps toward ensuring the sustainability of the system in the long run, the level of public spending on pensions is still one of the highest among the OECD countries. Among other effects, this reduces available resources for other social programmes. Although the contribution rates financing the pay-as-you-go system are quite high and significantly impact on the tax wedge on labour, they are too low to finance current benefits. Topping-up from the central budget is and will be needed. Furthermore, the incentives built into the current pension regime encourage early retirement. Previous reforms will both reduce replacement rates and penalise early retirement, but they will not become fully effective for many years to come. The govern-

ment has presented to the parliament an enabling bill on pension reform, mainly aiming at encouraging the growth of a private funded pillar through the transfer of the firms' leaving payment funds (*Trattamento di fine rapporto*) to the pension funds. Older workers will be encouraged to remain in the labour force *via* tax incentives. Finally, contribution rates are being reduced in order to boost labour demand. However, the latter measure will further increase the deficit of the public system. Higher contribution rates for part of the self-employed can only partly compensate for this, and only in the short term.

In addition to promoting the development of a private funded pillar, a main priority of the pension reform should be to further increase the employment of older workers. This could strengthen the affordability of the pension system for the near future and increase the coverage of future pension entitlements at the individual level. This may require additional measures in the pension system and a reorientation of labour market policies. Concerning the reform of the pension system, several options, not necessarily mutually exclusive, are available, the main ones being: the immediate extension to all workers, on a pro-rated basis, of the 1995 shift to a defined-contribution system (workers with at least 18 years' seniority at the time of the reform were totally exempted); a further gradual increase in the minimum age for pension eligibility; and annual automatic revisions of the benefit formula to ensure actuarial neutrality. As for the reorientation of labour market policies, the authorities should discuss with the social partners ways of improving the "employability" of older workers, allowing wages to better match productivity. ■

Is health care spending an area of concern?

As in most Member countries, public spending on health is on an upward trend, with expenditures often exceeding projections and demand for health services rising faster than incomes. A fundamental issue is the blurred division of responsibilities between the central government, which takes most of the financing responsibility, and the regions, for whom health care accounts for the lion's share of total spending in their – much smaller – budgets. To address these issues, the central government and the regions have reached agreement on resources to be devoted to the sector, minimum standards of services, and reduction of waiting times for medical services. But in the case of recurrent deficits, the current penalty to overspending regions is the reduction of state transfers to their lower levels before the 2001 agreement. However, the actual implementation of this penalty is still to be tested, and there may be a risk that health administrators would seek to avoid penalties by running hospital arrears.

Bailing out should be explicitly excluded in the case that a region overshoots *ex post*. An important role for the central government should also be to provide adequate information among regional administrations and hospitals on best practices and to develop a system of benchmarking. In the longer term, demand for health services is likely to expand faster than GDP, because of ageing, and decisions need to be taken as to whether all, or only a well-defined part, of the higher demand is financed out of public budgets. ■

Should human resource management in the public administration be tightened?

Spending on public administration is high in Italy, and value for money could be improved. The previous *Survey* of Italy addressed this topic in the chapter on public expenditure. As in many Member countries, job protection legislation is both stricter and more strictly implemented in the public sector than in the private sector. There are large numbers of public employees performing – quite adequately – tasks which are nevertheless comparatively undemanding, and of doubtful utility. It is very difficult and costly to suppress occupied posts, easier to create new ones, and there are barriers to mobility both within levels of government and between them. Given that the size of the labour force is set to shrink in coming years, the way forward would be to make global assessments of minimum human resource needs in public administration, and to ensure that as older employees in unproductive tasks retire, they are not replaced by new recruits performing the same tasks. ■

How can policies achieve sustainable development?

Policies for achieving sustainable development need to make more use of market forces. In the water sector, pollution discharges from urban wastewater are still a cause for concern. Investment has been hampered by pricing policies that keep water charges at a fraction of those in other OECD countries. Moreover, consumers face marginal rates that increase with the volume of

consumption, even though marginal costs are unlikely to show this pattern, reflecting a desire to redistribute income through water policy – an inefficient choice of instruments. Agricultural nutrient run-offs are also a problem but priority needs to be given to ensuring that urban water systems meet water quality goals, by putting in place prices that reflect the costs of meeting these goals and transferring social elements of water pricing to the overall budget.

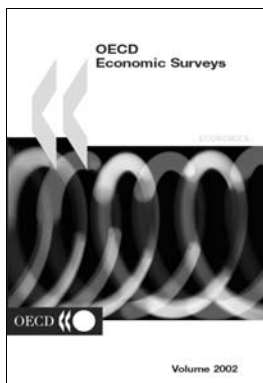
Greater use of market forces is also needed to achieve the goal of reducing greenhouse gas emissions, an orientation that would reduce the need for detailed government intervention in this area. A liberalised electricity industry is likely to reduce greenhouse gas emission intensity as the currently most economic fuel in this sector produces low emissions. In addition, a low carbon tax has been introduced, and there are announced intentions to change the tax into a more efficient levy on emissions. However, considerable effort will be required to ensure that an adequate infrastructure is available for implementing this levy and, later, introducing a trading system. Moreover, the market will deliver the most efficient solution only if incentives to abatement are similar in all sectors. Two sectors where prices may be generating inefficient results stand out. One is transport, where high taxes may result in much higher abatement costs than elsewhere and hence in over-investment in fuel-saving technology, the other is renewable energy. In this sector, the price of green electricity permits are much higher than elsewhere in Europe and the United States, suggesting that there could be significant gains from trade in these permits. ■

For further information

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- **Economic Outlook No. 73**, June 2003. More information about this publication can be found on the OECD's Web site at www.oecd.org/eco/Economic_Outlook.

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They are published under the responsibility of the Secretary-General.

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