

ASSESSMENT AND RECOMMENDATIONS

Economic activity has decelerated, and prospects are more uncertain...

Following a short period of economic growth at around 3 per cent, the economic climate began to deteriorate in late 2000. This was primarily related to external factors — the sharp slowdown in world trade, and the negative impact of higher energy prices on household incomes. Underlying domestic economic conditions remained more conducive to growth, with the positive performance of the labour market, especially in service and construction sectors, sustaining consumer confidence and limiting the domestic demand downturn. Indeed, prior to the 11 September terrorist attacks in the United States, order books appeared to be improving. But a sharp near-term slowdown is now foreseen, as export markets stagnate, businesses delay investment plans in response to rising world uncertainty and households raise precautionary savings. The annual growth rate of the Italian economy in 2001 could fall to 1.8 per cent from the near 3 per cent registered last year.

... with a recovery taking root only in the second half of 2002

OECD projections are for an international recovery to become established from around the middle of 2002, and the Italian economy seems set to take part in such a recovery. Consumer price inflation is falling with the easing of oil prices, and this should sustain real incomes, permitting domestic spending to pick up as sentiment recovers. Monetary conditions in the euro area, which were already generally supportive in the Italian context, have eased further since September, taking real short-term interest rates down to around 1.4 per cent, which is historically low. Falling yields on ten-year government bonds have translated into lower costs of borrowing from banks for both corporations and households, and fiscal policy is likely to help support consumption and investment demand. Overall, real GDP is projected to slow further, to 1.2 per cent, on average, in 2002 and to pick up to 2¾ per cent in 2003. The main uncertainty facing the Italian economy would seem to be the timing and the momentum of the projected rebound of the world economy: export demand may decelerate more than expected or remain depressed for a longer period, with negative investment effects. Domestically, the evolution of consumer confidence is also quite uncertain but so far, it has held up better than initially expected.

Budget implementation has become difficult

Since achieving a budget deficit of just under 3 per cent of GDP in 1997, the process of further budget consolidation has been very gradual although the outturns up to 2000 have always been consistent with Italy's commitments under the *Stability Programme*. This year there is more of a problem complying with the *Programme*. Recognising the possibility of a sharp fiscal deficit slippage from its 0.8 per cent of GDP deficit target for 2001, the government announced in July a set of measures to contain public expenditure for goods and services, to reduce reimbursements for drug prescriptions and to accelerate the planned sale of real estate assets. The fiscal situation improved thereafter, assisted by better than expected tax revenues. However, the downward revision of the OECD growth

projection implies a larger deficit outcome in the Secretariat projections than the official ones, as automatic stabilisers come into operation. Moreover, for 2002, the official deficit projections may also be optimistic, given the likelihood that growth will be again slower than assumed in the official budget projections. The OECD is less optimistic than the Italian authorities concerning revenues from the planned sales of public real estate assets, although the mechanism recently devised by the authorities appears to provide for an adequate minimum percentage of the fair market value of such assets. Revenues arising from the creation of incentives for repatriation of financial assets illegally held abroad, or from the regularising of underground activities, are impossible to quantify accurately although the government seems to have estimated them prudently. The OECD projection thus sees the possibility of a substantial slippage from target in the absence of additional measures — hopefully structural in nature — to keep expenditure under control.

***Fiscal discipline
needs to be
maintained, with
some limited
scope for built-in
stabilisers***

In fashioning a response to the possibility of further slippage, a number of considerations come into play. In the first place, the medium-term plan retains the objective of arriving at approximate budget balance by 2003, *via* an average primary surplus of around 5 per cent of GDP. This objective needs to be maintained. The fact that Italy still has a debt/GDP ratio over forty percentage points above the Maastricht ceiling means that the room for fiscal manoeuvre is limited. However, subject to the constraint that the debt ratio should be seen to continue to fall, the situation demands some flexibility in allowing built-in stabilisers to operate on the revenue side (cyclical sensitivity of spending is low in Italy), even at the cost of some temporary slippage in the near-term annual targets. But it is vital that if they are allowed to operate at a time of economic slowing, they also be allowed to work fully in the upturn, generating better than targeted outcomes as growth rises above trend. In assessing the baseline against which revenues can be allowed to fluctuate cyclically, the most important strategic consideration is that the government's medium term plan be based on a cautious estimate of potential growth, and that public expenditures are kept on a secular downward path relative to potential growth. Pressure leading to excessive spending continues to be the most important allocational weakness in the Italian budget framework and could undermine the credibility of the medium-term objectives. Indeed, the government's plans to cut direct taxation of companies and individuals depend heavily on better control over spending.

***Pension reforms
need to be phased
in more rapidly***

Creating the room for tax cuts will be all the more challenging given that spending pressures will intensify as a result of entitlement programmes already in place, especially with respect to pensions. Projections show that because of substantial reforms in recent years, spending on pensions may rise by less than 2 per cent of GDP up to 2040, significantly less than the EU average. Nevertheless, the current level of spending is high, and the phase-in of the reforms is slow. This calls for further reform initiatives, to extend the new system pro-rata to all workers, and to phase out 'seniority' pensions (*pensioni di anzianità*) before the announced date of 2008. Action has been taken to diminish incentives during the transition phase to retire early, but more could be done in this field. At the same time, the government needs to consider introducing a mandatory, fully-funded second tier. A decision on whether to use the private sector severance funds (TFR) for this purpose, as proposed, is overdue. Other more difficult decisions, particularly to extend the coverage of previous reforms, also need to be made without delay.

The Italian budget makes inefficient use of resources, because of weak budget control...

Curtailling spending on public pensions would allow a greater portion of national resources to be devoted to areas where social rates of return can be potentially high, such as non-pension social spending, infrastructure investment, research and education; but this also requires improvements in public sector efficiency. At the planning and control levels, inefficiencies are of two major kinds:

- *Manpower management.* Recent administrative reforms have begun to tackle the problem of inefficient staff allocations and inadequate skills, but further progress is needed;
- *Planning and control.* Deficiencies in the system too often prevent comparative costing of benefits of individual spending programmes, while involuntary overruns are commonplace, with *ex post* validation usually a routine matter.

There is no systematic way of ascertaining whether — or by how much — public spending exceeds the point of technical equalisation between social marginal costs and benefits, but the social rate of return is necessarily low or even negative where there is significant wastage of resources. Intensive retraining of civil servants, more effective hiring and higher mobility at all levels of government will be required, continuing the impetus from the Bassanini reforms. As a pre-requisite, the transition towards accrual accounting needs to be accelerated, in order to be able to monitor programme growth more effectively, while the amount of funds permitted to be “carried-over” from previous years should be more closely defined. As concerns audit activities, the 1994 reform gave the Audit Court the mandate to conduct audits focusing on results rather than only on compliance with legal procedures; its capacity in this field should be increased. An augmented role for Parliament in external audit should also be established, with less emphasis on detailed legislative specifications. The aim should be to create an accessible and accountable public administration, with a reformed managerial behaviour, based on the new “service charter” pledges, as opposed to legalistic notions of responsibility.

... and lack of clear local accountability

Decentralisation can help to make government more accountable and improve allocation of the economy’s resources by placing decision-making closer to the ultimate users and payers of public services at the regional and local levels. But the decentralisation process in Italy — which began in 1970 — has not yet reaped the expected efficiency gains from fiscal devolution. Incentive problems remain strong, because regional authorities know that their overruns will be covered *ex post* by the central government, without sanction. Fiscal accountability has been further weakened by the unclear division of spending and financing responsibilities across levels of government, as well as poor administrative capacity at local levels in some cases. The devolution of tax and spending power needs to be buttressed by better internal and external control mechanisms, improved information flows between levels of government, local civil service reforms, and enhanced local institutional capacities for monitoring and evaluating public investment projects. The new constitutional amendments have enlarged the scope for further devolution on the spending side, but have failed to clarify the corresponding financing responsibilities. It is essential that future implementing legislation give close attention to the hardening of lower level budget constraints.

The rising costs of health-related spending need to be contained

Public spending pressures have become more intense because of the rising cost of health care. Overall, the level of health-care spending is not high, but the authorities need to design policies which ensure that trend increases in costs are contained. Although the new agreement with the regions in August 2001 created a financial incentive for better spending control, notably on pharmaceuticals, a comprehensive reform of the health care system, giving local health care units stronger incentives to contain costs while ensuring consistent quality, is still urgently needed. This will require the attainment of full responsibility by regional authorities to determine what services can be provided, bearing the marginal costs of their actions and using their discretion to raise taxes if need be, or to adjust costs in line with sound management principles. The central government should set national standards in a very broad way, for example in terms of minimum service guarantees rather than mandatory specific services or detailed regulation of inputs. After that, it should occupy itself more with facilitating mechanisms through which best practice principles could be disseminated, for example creation of a database of nation wide benchmarks against which regional authorities can assess the performance of their own local health units.

Use of market instruments should be expanded in the public sector

OECD experience has shown that the private sector can perform some functions traditionally carried out by the public sector better and more cheaply. Consideration should thus be given to what parts of activities already with sub-national governments could be outsourced or privatised. Technological developments are helping in this direction. Examples include refuse collection, local transportation, water and tax collection. Private provision could take the form of either outright sale of the underlying assets, as Italy has done in a number of areas, or more contracting-out of the management of facilities and delivery of services. Directly competing with the private sector is a related approach bringing market discipline into play in the carrying out of public sector activities and relieving the burden on public finances. Examples are open public procurement and competitive recruitment —schemes which Italy has already adopted in some cases. Italian cities are also allowing competing private entry into many areas of local service provision. This trend could be pushed further.

More rapid economic growth is key

Achieving stronger trend growth of the economy is a central objective of the Italian government, and this requires a more rapid pace of structural reform. Some of the benefits of structural reforms implemented during the 1990's are visible in the recent expansion: labour and product markets are operating more efficiently; wage inflation has been under much better control; the employment content of growth has picked up recently; and the gap between Italian and euro-area growth narrowed substantially in 2000. But a number of structural weaknesses persist. Despite its recent fall, the structural unemployment rate remains high and participation rates low by EU standards. Although the growth of multi-factor productivity (MFP) in Italy had typically been significantly higher than the EU average in earlier decades, it dropped to the modest rates of other large EU countries in the 1990s. Export performance has been weakening, due partly to an orientation towards slower-growth areas of trade. Regional imbalances remain acute. The need is to ensure that the next upturn is underpinned by even stronger employment growth than in the recent expansion, and founded on higher potential growth. The effort to raise growth potential is being supported by an ambitious medium-term growth strategy, initiated by the "100 days programme", which

encompasses initiatives across a wide range of areas, aimed at creating a more business-friendly environment. The programme includes tax measures designed to encourage business investment, together with labour-, product- and financial-market initiatives and steps to improve human capital acquisition and innovation potential. It is too early to assess the impact of the programme but the extent of the structural problems still requiring attention in these areas is illustrated below.

A better functioning labour market could raise employment

Labour market reforms introduced since the mid-1990s have helped spur employment growth. But employment and participation rates are low, particularly in the South, and among young people, women, and people above the age of 55. A more intensive mobilisation of labour resources is needed, based on the policy needs of these “outside” groups:

- To avoid risks of developing a dual labour market, as fixed-term and part-time contracts are expanded for new entrants and re-entrants, a relaxation of currently strict employment protection rules would seem essential;
- Unemployment insurance should be expanded while taking care to minimise disincentive effects;
- To boost female participation, provision of child and old-age care should be enhanced;
- The high tax wedge should be reduced, especially to raise employment of lower-wage labour.

Action on the pension front could help finance these reforms, while also helping to stimulate the continued employment of older workers. Maintaining efforts against tax evasion would contribute to lower tax rates for legal workers. A further rigidity needing attention is the predominance of centralised wage bargaining, since regional productivity differentials remain large.

Skill deficiencies need to be corrected

Though youths have more education than adults on average, they nevertheless experience a difficult school-to-work transition and relatively high unemployment rates. Among adults, by contrast, the likelihood of unemployment, and weak attachment to the labour force, is concentrated on the least educated. This suggests the need for better-targeted active labour market policies, and also to give priority to better human capital development.

- Although per-pupil spending in primary and secondary schooling is relatively high by OECD standards, educational attainment at the secondary level is substantially below average. Also, despite reforms, the system of tertiary education has far to go in terms of stimulating competition to improve the quality of service;
- Full implementation of the obligation for school leavers to participate in training up until the age of 18 is desirable because of the close link between upper secondary education and labour market attachment; at the same time students need to be better motivated *via* quality teaching and expanded vocational and technical training services;
- Despite recent increases in university fees, regressive subsidies to higher education should be phased down, and replaced by a system of student loans and needs-based scholarships. OECD studies suggest that this can strengthen

the resource base for improved tertiary education without compromising participation rates or access to higher education by disadvantaged groups.

Another area where Italy stands out is the low level of worker training, and the government has allowed company tax credits for worker training expenses in an attempt to fill this gap. Such a move would be useful in order to strengthen the role of market mechanisms in a field traditionally dominated by not very transparent public procurement mechanisms. But OECD experience shows that worker training by firms tends to benefit the already best skilled and educated workers. This suggests that public resources, including those spent on financial incentives, would be better spent on training of marginal workers and labour force outsiders, with public training services restructured accordingly.

Privatisation and liberalisation need to lead to greater competition

Higher potential growth requires competitive and efficient product and financial markets. Innovation as well as competitiveness are still blocked by barriers to entry, high service prices, and lack of contestability of markets despite progress over the last decade. The local dimension of the regulatory reform process is potentially a problem owing to the greater influence of vested interests at these levels. The 2002 financing law will, however, begin to tackle these issues by providing clear guidance to local authorities with respect both to the obligation to split network ownership and the provision of public services, and to rely on competitive procedures to grant operating licences. Regarding privatisations at the national level, in a number of cases there appears to have been excessive emphasis on budget revenues as opposed to competition. In particular, the granting of exclusive concessions, absence of competitive bidding, and the continuing dominance of the previous incumbent have sometimes been a problem. In the last years, though progress in structural reform has been substantial, further tackling remaining problems is made more urgent because the government intends to privatise many more public enterprises. Indeed the government is committed in the Stability Programme to assuring an explicit and transparent link between privatisation and competition policy.

Firms need a business-friendly environment, especially in the South,...

The main source of higher MFP growth is innovation by firms and the government has taken some actions to strengthen intellectual property rights and reduce red tape. It is important that these and subsequent measures strengthen linkages between business and universities and lead to higher business and government R&D, both of which are low by OECD standards. At the same time, policies are needed to address the disincentives for Italian enterprises to grow, which may include *inter alia* the application of employment protection legislation to firms with over fifteen employees. Perhaps the greatest scope for MFP growth is in the South, which has abundant unused natural, cultural and human resources to feed the growth of new activities. In this respect, accelerated large-scale public investment projects could fill a major infrastructure gap in the area and help to attract private capital. It is important to conduct careful cost-benefit analysis of these projects, and that they remain part of a comprehensive strategy involving all tiers of government and the private sector. The strategy should also aim at the liberalisation of local service provision, and enhancing involvement and trust in public institutions.

... assisted by better support

Potential growth would also be enhanced by deeper financial markets and ones which would provide opportunities for small firms to grow. Banking

from financial markets

privatisation and reform since 1990 have improved bank efficiency and reduced regional segmentation. However, the ongoing divestiture of majority holdings by the quasi-public *fondazioni*, who still own a substantial share of total bank market capitalisation, needs to be completed to resolve a remaining issue of bank governance. In the allocation of capital, the role of the securities market and of intermediaries bringing firms to the stock market remains weak. Although public equity ownership has increased significantly, it remains highly concentrated while insiders use pyramid structures to exercise a disproportionate influence over publicly-listed companies. An important corporate governance reform in 1998 addressed the problem of insufficient minority shareholder rights, but it will need to be further strengthened. This would help develop widespread share ownership, and the development of a private pension pillar would further provide a significant boost to equity markets. The government has passed a new company law, which broadens the scope of reforms to include non-listed firms. This law is designed to subject all firms to transparent accounting standards, while at the same time reducing penalties for minor accounting irregularities. This could remove a major hurdle to stock market listing, but it is essential that accounting standards should not be unintentionally weakened by a watering down of the criminal part of the law in the case of accounting fraud. Bankruptcy reform is also still urgently needed to promote risk-taking and entrepreneurship, as is judicial reform.

Summing up

The economy having slowed in response to exogenous events and uncertainties, the timing and strength of any upswing will depend mainly on external forces. Monetary policy is cushioning the impact on domestic demand, but in line with the medium-term objective, the room for fiscal manoeuvre is restricted to the partial operation of automatic stabilisers, which must, however, be seen to apply fully in reverse in the forthcoming upturn. High government indebtedness demands that the consolidation process itself be reinvigorated, while wide-ranging public spending economies of a structural nature and a more efficient budget process are needed if the government is to accomplish its objective of implementing tax cuts, its major supply-side tool. This is only one element of a broad structural reform agenda. While progress in regulatory reform has been substantial, sluggish growth in recent years and signs of worsening competitiveness show that much remains to be done to improve the supply side of the economy. Lower labour taxes particularly for the less-skilled groups and more flexible wage setting are needed to help raise labour utilisation and increase growth potential. In this area, the added flexibility given by labour contract innovation needs to be supplemented by reform of job-protection rules, accompanied by an expanded and well-designed unemployment insurance system and efforts to strengthen skills. The final challenge is to raise the currently unsatisfactory rate of multi-factor productivity growth, on which rising living standards ultimately depend. In this respect, it is vital that the formation and growth of new and innovative firms be encouraged in a competitive environment. This will require further dismantling of barriers to entry and growth, together with the continued modernisation of Italy's capital markets. In the South, recent experience shows that a joint public and market-based approach is the way forward. Although much progress has been made in recent years, the process of reform required to make the Italian economy more balanced and dynamic has far to go.