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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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BASIC STATISTICS OF ITALY

THE LAND

Area (thousand sq. km)	301.3
Agricultural area (thousand sq. km, 1995)	165.2

Population of major cities (thousands, 1.1.2000)	
Rome	2 644
Milan	1 301
Naples	1 003
Turin	904

THE PEOPLE

Population, 31.12.99, thousands	57 680
Number of inhabitants per sq. km	191
Net natural increase, 1999, thousands	–34
Net rate per 1 000 inhabitants, 1999	–0.6

Labour force, 2000, thousands	23 573
Employment, 2000, thousands	21 080
In agriculture	1 120
In industry	6 767
Other	13 193

THE PRODUCTION

Gross domestic product in 2000 (trillions of lire)	2 257
GDP per head (2000, US$)	18 619
Gross fixed capital formation:	
Per cent of GDP in 2000	19.6
Per head in 2000 (US$)	3 657

Origin of gross domestic product in 2000 at market prices, per cent of total	
Agriculture	2.6
Industry	26.2
Construction	4.8
Other	66.5

THE PUBLIC SECTOR

Current expenditure in 2000 (percentage of GDP)	43.6
Current revenue in 2000 (percentage of GDP)	44.1

Gross financial liabilities in 2000 (percentage of GDP)	110.3
General government investment in 2000 (percentage of total investment)	12.2

THE FOREIGN TRADE

Exports of goods and services, as a percentage of GDP, 2000	28.4
Main export categories, as a percentage of total exports, 2000	
Manufactured goods	36.3
Fabric and textile goods	16.0
Chemical products	9.3
Transport equipment	11.6
Mineral fuels	2.2

Imports of goods and services as a percentage of GDP, 2000	27.2
Main import categories, as a percentage of total imports, 2000	
Foodstuffs	6.6
Manufactured goods	24.2
Metal, ores and scrap	10.2
Chemical products	12.9

THE CURRENCY

Irrevocable conversion rate (lira per euro)	1 936.27

Currency units of euro per US$, average of daily figures:	
Year 2000	1.0851
December 2001	1.1199

This Survey is based on the Secretariat's study prepared for the annual review of Italy by the Economic and Development Review Committee on 19 November 2001.

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After revisions in the light of discussions during the review, final approval of the Survey for publication was given by the Committee on 6 December 2001.

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The Secretariat's draft report was prepared for the Committee by Alexandra Bibbee, Alessandro Goglio and Chiara Bronchi under the supervision of Robert Price and Nicholas Vanston.

•

The previous Survey of Italy was issued in May 2000.

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 in the previous 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

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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 S*tability* P*rogramme*. This year there is more of a problem complying with the P*rogramme*. 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.

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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

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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…

Curtailing 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:

– M*anpower management*. Recent administrative reforms have begun to tackle the problem of inefficient staff allocations and inadequate skills, but further progress is needed;

– P*lanning 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 prerequisite, 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

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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

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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

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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;

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– 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.

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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

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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 from financial markets

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

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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.

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I. Macroeconomic performance

After slowing down through much of the decade, the Italian economy grew strongly in 2000. Employment rose and unemployment fell. Business and household confidence continued to be high for most of the year supported by fiscal reforms as well as progress in structural reforms in the product and labour markets. However, signs of weakness emerged towards the middle of the year and these were confirmed in 2001. The short-term outlook has been further clouded by the blow to confidence caused by the 11 September terrorist attacks in the United States (Table 1). The downturn is primarily attributable to external influences. Because of higher oil prices, consumer price inflation increased, peaking at 3 per cent in early 2001. This weakened consumer spending, and the slowdown of world demand led business to cut back investment. Improved conditions on the labour market, especially in the service and construction sectors, may have limited the setback to domestic demand growth, and the trend in inflation is now downwards. But protracted weakness abroad could undermine confidence and growth in the sectors where activity so far has held up well. Indeed, the main uncertainty facing the Italian economy would seem to be the timing and the momentum of the projected rebound of the world economy. The remainder of this chapter starts with a review of the recent macroeconomic developments and the short-term outlook. It then discusses the medium-term supply issues raised by Italian productivity.

Following robust growth in 2000, activity is slowing down

For much of 2000, the economic climate improved markedly and the growth gap between Italy and major trading partners narrowed (Figure 1). Real GDP growth accelerated to 2.9 per cent for the year, close to double the annual growth rate over the decade of the 1990s. The output gap fell to its lowest level since 1996. Domestic demand was robust, with private consumption expanding by about 3 per cent and fixed investment by double this amount (Figure 2). Various factors contributed to the expansion of investment: real interest rates remained relatively low, new tax incentives for reinvested profits were introduced and business confidence was strong (Figure 3). At the same time, net exports contributed 0.6 percentage points to GDP growth. With an estimated

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Table 1. **Demand and output**

Average annual growth rates and percentage changes at annual rates from previous period, 1995 prices[1]

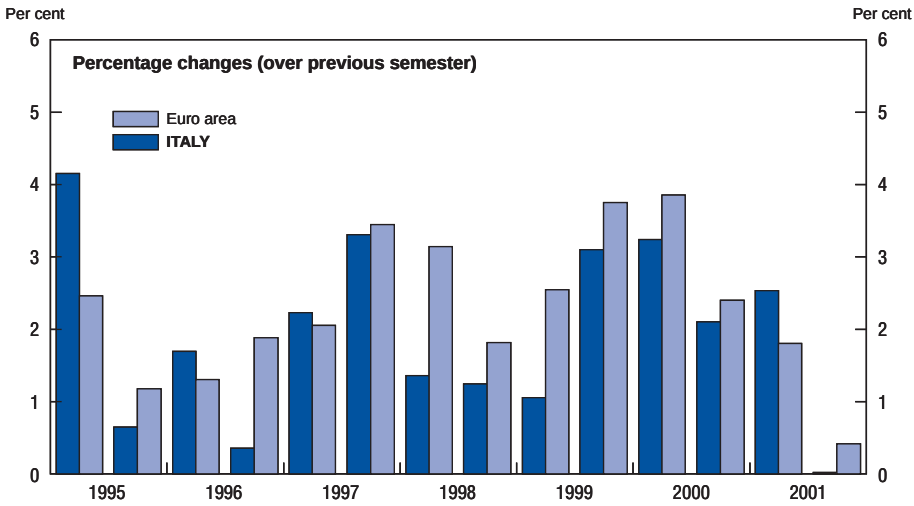
	1973-79	1979-89	1989-2000	1998	1999	2000	Q1 2001	Q2 2001	Q3 2001
Private consumption	4.3	3.4	1.9	3.1	2.3	2.9	–0.1	2.1	–0.1
Government consumption	2.7	2.7	0.5	0.3	1.5	1.6	0.9	0.1	0.6
Total fixed investment	1.3	2.3	2.0	4.3	4.6	6.1	3.2	–1.4	0.4
Construction	–0.8	0.4	0.4	–0.2	2.8	3.6	9.7	0.8	–0.7
Machinery and equipment	5.1	4.8	3.3	7.8	6.0	7.8	–0.9	–3.0	1.1
Stockbuilding[2]	0.2	0.1	–0.0	0.3	0.4	–1.0	0.7	–0.0	0.4
Total domestic demand	**3.5**	**3.1**	**1.6**	**3.1**	**3.0**	**2.3**	**3.7**	**1.0**	**2.0**
Net exports[2]	0.6	–0.3	0.2	–1.2	–1.3	0.6	0.0	–0.3	–0.3
Exports of goods and services	8.0	3.4	6.1	3.6	0.0	10.2	5.3	–7.5	–13.5
Imports of goods and services	4.8	5.7	5.8	9.0	5.1	8.3	5.7	–4.7	–10.4
GDP at market prices	**4.0**	**2.7**	**1.7**	**1.8**	**1.6**	**2.9**	**3.6**	**–0.1**	**0.6**
Memorandum items:									
Total employment	1.0	0.2	0.0	1.1	1.2	1.9	2.2	–1.3	2.1
Export market growth in manufacturing	. .	4.8	7.5	9.3	6.5	13.4	–4.8	–3.4	. .
GDP deflator	16.7	12.4	4.5	2.7	1.6	2.2	4.9	3.6	1.2
Private consumption deflator	16.3	11.9	4.6	2.1	2.1	2.9	2.2	4.0	1.9
Unemployment (in millions)	4.4	6.8	0.5	2.7	2.7	2.5	2.3	2.3	2.2
Unemployment (per cent of labour force)	4.9	8.2	10.6	11.9	11.5	10.7	9.9	9.6	9.5
Current account (per cent of GDP)	–0.4	–0.8	0.4	1.9	0.7	–0.4	0.7	–0.7	. .

1. Annual figures distributed over quarters.
2. Quarterly data show contributions to GDP growth.

Source: OECD.

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Figure 1. **Real GDP developments compared**[1]



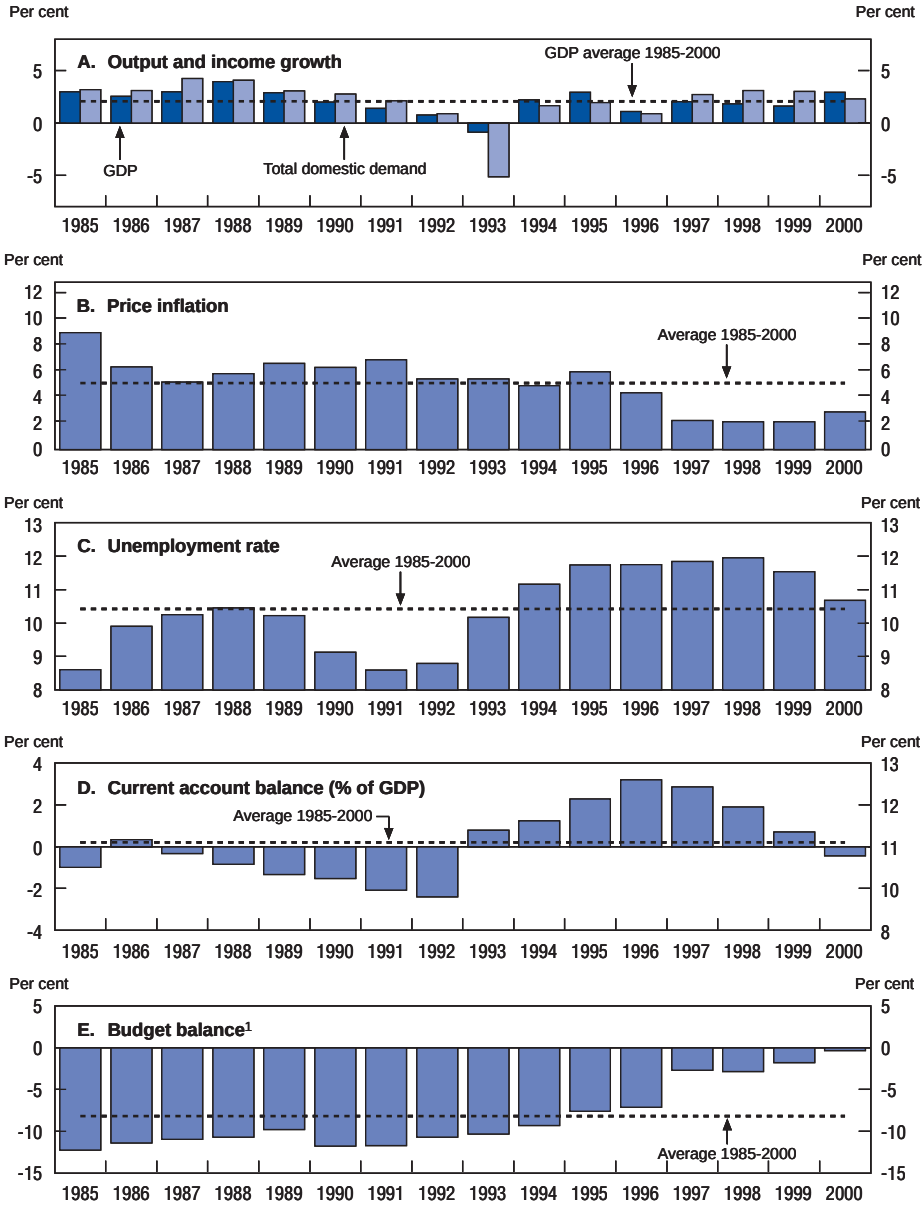
1. Data for second half of 2001 are projections.
Source: OECD.

real GDP growth rate at 2.5 per cent, the economy of southern Italy expanded well above its past trends (in 1996-99, the Mezzogiorno's annual growth rate was 1.9 per cent, against 1.5 per cent in the Centre-North). Fixed investment is estimated to have increased by 6.8 per cent, in part thanks to the new development programme for the South known as "*Programma di sviluppo del Mezzogiorno*" which covers the 2000-2006 period.[1]

Yet domestic demand growth slowed down significantly during 2000. Private consumption decelerated under the impact of the oil price rise, the stock market decline and weakening real disposable income growth (nominal wages are linked to "programmed" inflation, which was well below consumer price inflation). Domestic and foreign orders fell and business investment decelerated, mainly because exports were affected by the slackening of the US economy and other non-euro countries. After a brief rebound during the first quarter of 2001, the deceleration of activity continued in the second quarter of 2001, with GDP growth sinking to zero (Table 1). The business confidence climate continued to deteriorate, while consumer sentiment started to turn down from the 5-year peak reached in June. On the other hand, the labour market continued to show a rather high elasticity of employment with respect to output, reflecting ongoing structural and fiscal stimuli to labour demand, which in turn might have cushioned the fall in household demand.

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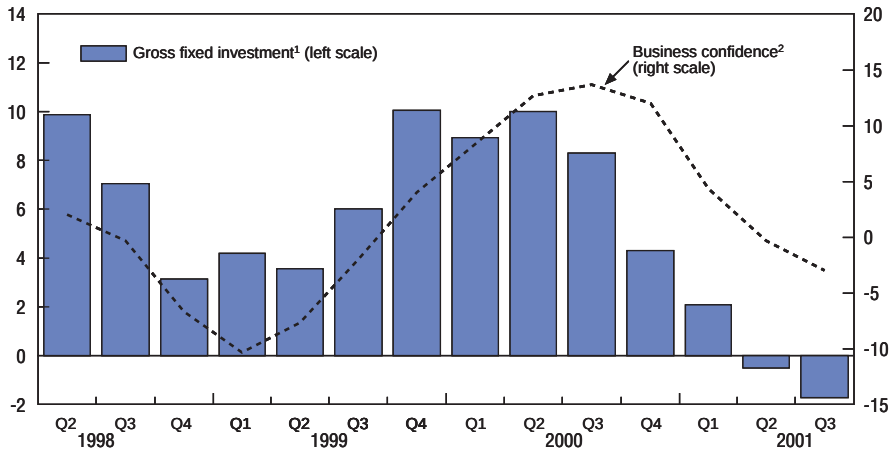
Figure 2. **Macroeconomic performance**



1. Budget balance is expressed as a percentage of GDP and includes the sale of UMTS licences in 2000.
Source: OECD.

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Figure 3. **Gross fixed investment and business confidence**



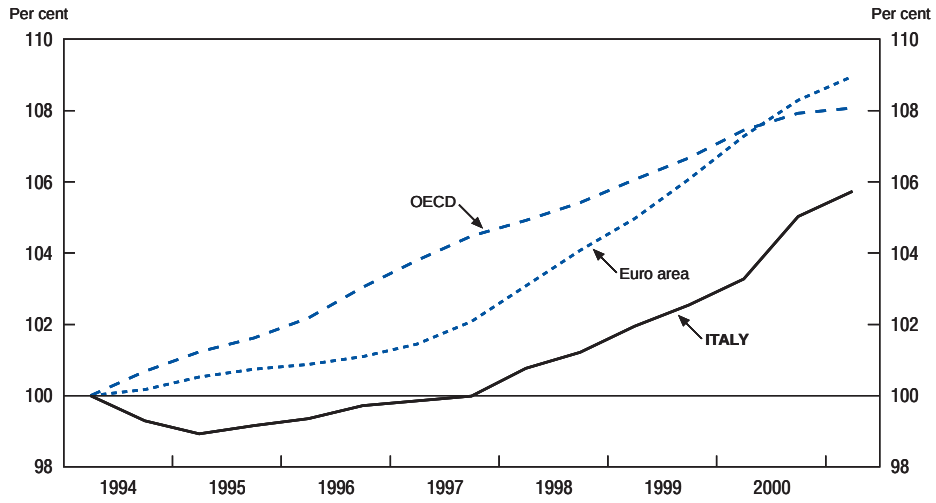
1. At 1995 prices year-on-year per cent changes, seasonally adjusted, excluding construction.
2. Business confidence indicator in the industry sector.
Source: OECD, EUROSTAT.

Labour market conditions remain favourable

In the course of 2000, employment growth in Italy was even stronger than in the other major euro-area countries. A new element was the rise in permanent full-time contracts, reflecting the buoyant economy (Figure 4). During the first half of 2001, employment continued to rise though at a slower pace, while permanent contracts continued to be favoured by the tax incentives introduced by the 2001 budget law. From October 2000 to the end of 2003 employers are entitled to a tax credit of up to L 800 000 (EUR 413.2), increased by 50 per cent in southern and disadvantaged regions, for each new permanent employee. While in 2000 the employment expansion was supported by a significant rise in the number of workers in the services sector (up 3 per cent), this trend was reversed in the first half of 2001; employment demand was mainly boosted by the buoyant construction sector. Between January 2000 and July 2001, more of the new jobs went to women rather than to men – the female employment rate rose by 3.3 percentage points (from 38.3 to 41.6 per cent), and that for men by 2.2 points (from 66.4 to 68.6 per cent). All regions registered the creation of new jobs, but especially in the South (Figure 5), while in the North, which normally enjoys one of the lowest unemployment rates in Europe, employment decelerated.

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Figure 4. **Aggregate employment patterns compared**
Indices (first semester of 1994 = 100)



Source: OECD.

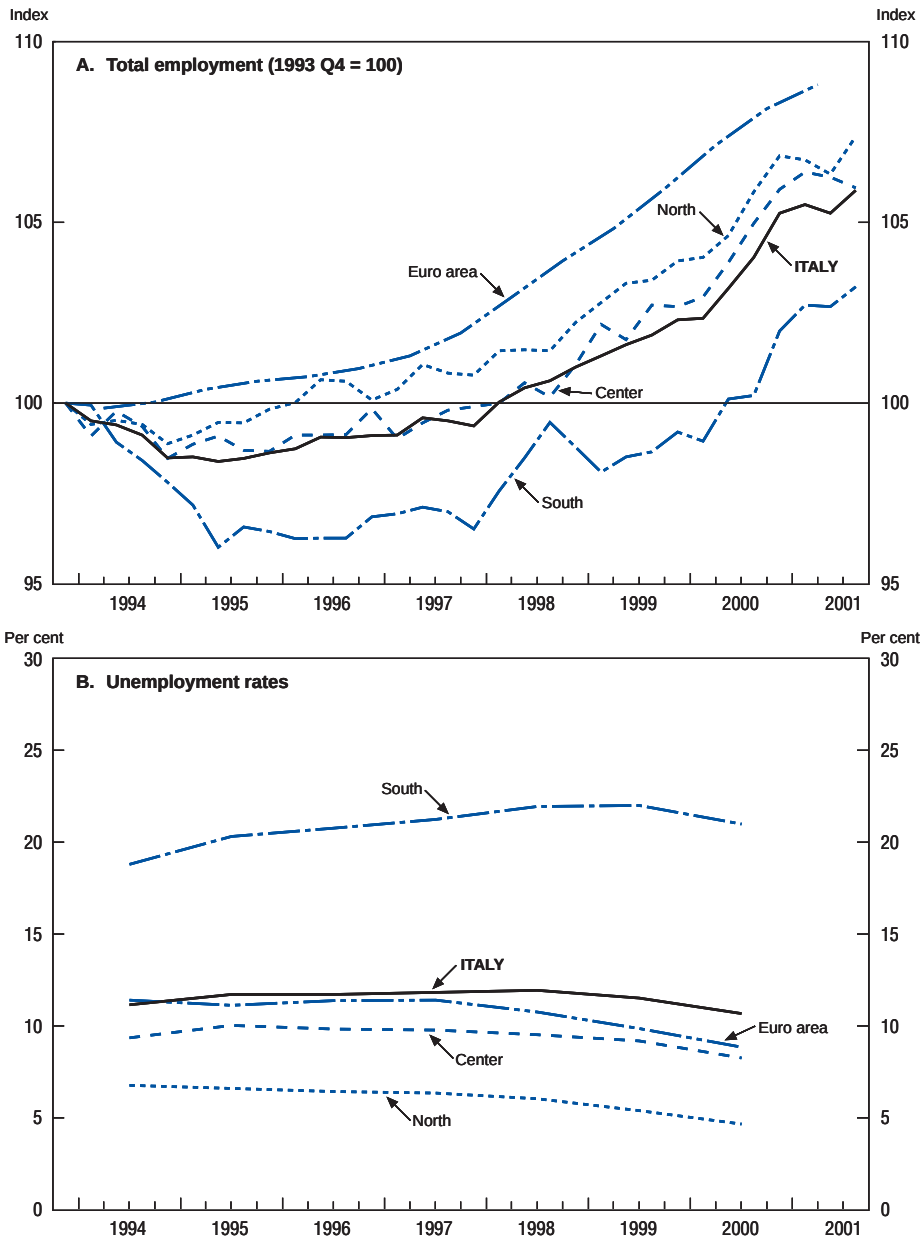
With the number of job seekers falling, the unemployment rate continued its gradual downward trend, reaching 9.2 per cent at the end of July 2001, 0.9 percentage point lower than a year earlier. The unemployment reduction was widespread, though the *Mezzogiorno* was still lagging behind the northern and central regions. The solid labour-demand growth thus more than absorbed the entire increase in labour supply. Despite the remarkable improvement, though, the rate of employment – the number of people employed as a percentage of the total population aged 15-64 – remained below the euro-area average.

Inflation is falling after an acceleration at the beginning of 2001

As in most euro-area countries, the inflation environment has become more favourable overall (Figure 6). After a brief surge early in 2001 as import price pass-through continued, the rate of increase in the harmonised consumer price index (HCPI) stabilised at around 2.5 per cent by October, because of lower energy prices, a flattening of domestic demand and the strengthening of the euro. Core inflation[2] was nevertheless still rising. The core inflation gap with the euro area, although substantially reduced from the peak reached at the end of 2000, remained positive while that with respect to the HCPI basically disappeared. The difference between the two gaps indicates the more benign reaction of the Italian economy towards external shocks (in part thanks to energy tax cuts implemented

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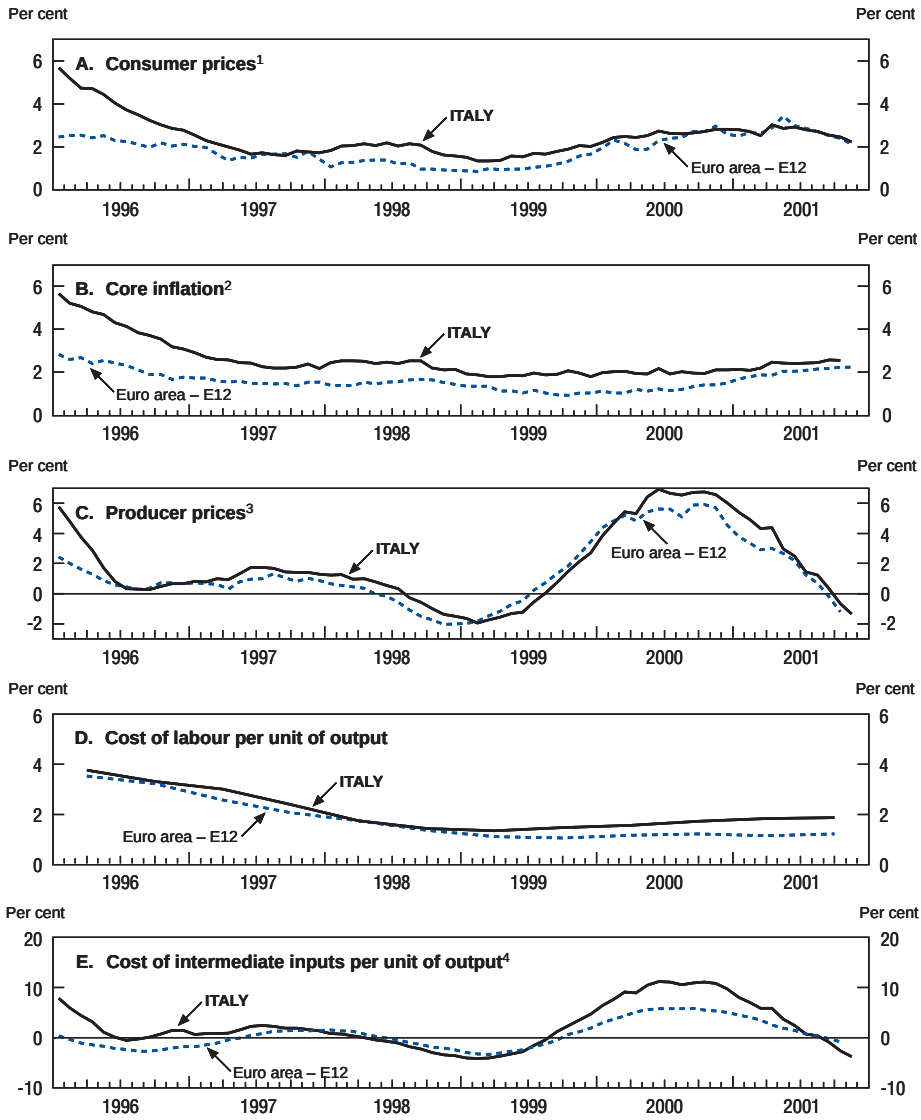
Figure 5. **Employment and unemployment by regions**



Source: OECD, ISTAT.

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Figure 6. **Inflation trends**
Year-on-year percentage changes, seasonally adjusted



1. Harmonised index.
2. Harmonised consumer price index less energy, food, alcohols and tobacco.
3. Producer price index in manufacturing.
4. Producer price index for intermediate goods.

Source: OECD.

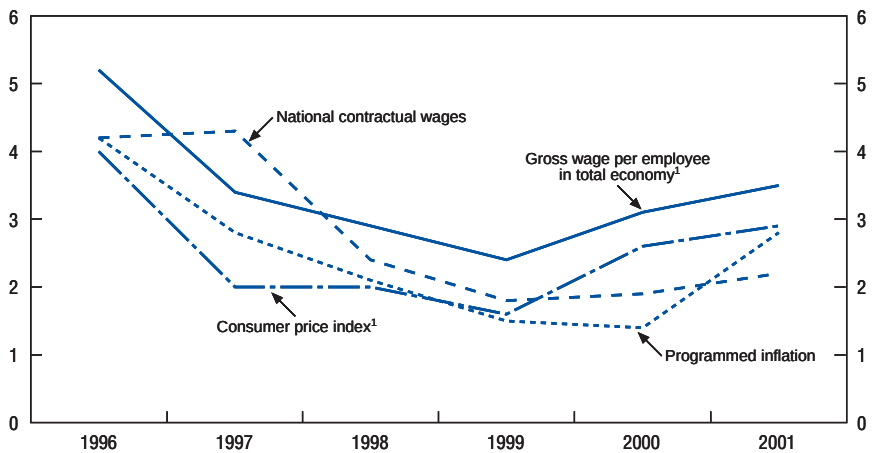
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in 1999 and 2000 and to the delay until 2002 in implementing some green taxes) but underlines persisting inflationary pressures especially in sheltered sectors such as services where competition is weaker (see Chapter IV). Since the beginning of 2001, producer prices have also been falling as the drop in imported inflation has released pressure on the price of intermediate production goods.

Moderate real wage growth and a cyclical expansion of productivity have also helped to contain factor input prices. For the near future, there is some possibility of a slight acceleration of unit labour costs due, in the presence of continuing wage moderation, to a slowdown of productivity. Indeed, unit labour costs may have been registering some rise in the business sector, a consequence of the reduction of output, accompanied by stationary employment. As for wages, several national contracts covering about 5.6 million workers were renewed between January and July 2001, with the biggest groups represented by employees in manufacturing and civil servants. The wage rise of these workers incorporated the unexpected acceleration of inflation in the first half of 2001 and the officially projected inflation for the second half of 2001 and year 2002 (Figure 7). All in all, the rise of the national contractual index for the period 2001-2002 is not likely to exceed the cumulative inflation rate of 4.5 per cent envisaged by the July 2001 medium-term plan (*Documento di Programmazione Economica e Finanziaria*, DPEF).[3] However, in 2001 alone the gross wage per employee in the entire economy is expected to rise by 3.5 percentage points (official projections), driven by the

Figure 7. **Wages, consumer price index and programmed inflation**

Year-on-year percentage changes



1. Data for 2001 are projections.
Source: ISTAT.

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second (enterprise) level of wage setting in the private sector and a steep wage rise in the public sector (4.2 per cent in 2001).[4]

Problems in export competitiveness…

Italian companies continued to lose market shares with respect to the euro-area and the rest of the world in 2000. This unfavourable trend may have reversed in 2001, when Italian export performance in world trade is estimated to have been positive. The reasons for the weak performance in the second half of the 1990s partly reflected a common trend regarding the major industrial countries, that is, "making space" for the growing exports of emerging markets. But it also appeared to be partly structural, as analysed in the previous OECD *Economic Survey of Italy*. *First*, the regional orientation of Italian trade exports appears to be disadvantageous, being focused on slower-growing markets (Table 2). *Second*, Italian exporters specialise in traditional products that have not been part of the ICT boom. This is working to Italy's advantage in 2001, however, with Italy making aggregate export share gains as faster-growing sectors shrink, but in the longer term Italian exports tend to suffer from a lack of specialisation in goods characterised by the highest rates of growth in demand, such as technology-intensive goods. This disadvantage is accentuated because it leaves Italy vulnerable to increasing competition from emerging markets with a similar specialisation but lower labour costs. On the positive side, Italian products are typically high-quality, up-market ones. But exporting firms have difficulties in permanently breaching fast-growing markets because of problems with commercialisation, logistics, distribution and marketing, for example.[5] Against this unfavourable background, the emergence of an adverse trend in relative unit labour costs, emanating from the wage and price rigidities noted above, can only serve to exacerbate market share losses once world trade returns to normal.

Table 2. **World trade and market shares**
Percentage changes

World trade[1]		Exports		Market shares[2]	
		Euro area	**Italy**	Euro area	**Italy**
1994	10.8	10.2	**11.7**	–0.1	**–0.5**
1995	9.3	8.8	**15.2**	1.0	**2.6**
1996	6.6	5.3	**1.2**	–0.6	**3.4**
1997	10.0	10.0	**3.8**	–1.5	**–8.2**
1998	5.5	7.1	**2.6**	2.1	**3.8**
1999	6.1	5.8	**1.8**	–1.3	**–7.7**
2000	12.6	12.4	**10.2**	–2.9	**–11.0**

1. Growth rates of the arithmetic average of world import volumes and world export volumes.
2. Market shares are the considered zone exports in percentage of world exports at current prices.
Source: OECD, IMF.

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... but the current account position improved in 2001

In 2000 Italy registered its first current-account deficit (of ½ per cent of GDP) in almost a decade. There was a marked adverse terms-of-trade effect from higher oil prices and the depreciation of the euro. The current account moved closer to balance over the period January-August 2001, and a surplus is expected to be registered for 2001 as a whole (Table 3). A rising surplus in the trade balance is more than compensating for the deterioration of the deficit on factor income account, because of the widening gap between the rates of return on domestic assets held by foreigners (mainly bonds) and those on foreign capital assets held by Italians (mostly foreign equities).

Monetary conditions have remained supportive of economic growth...

Monetary policy has remained supporting with real short-term interest rates around 1½ per cent in 2000, rising somewhat to 2 per cent in early 2001, as the ECB monetary policy tightened until spring. Between November 1999 and October 2000, the ECB raised policy interest rates by 225 basis points, leaving their structure unchanged (Figure 8, Panel A). Policy rates were lowered by 25 basis points in May 2001, by a further 25 points in August, by 50 basis points in response to a rise in economic uncertainty following the 11 September events in the US on 17 September, and by a further 50 basis points on 8 November. Based on a range of indicators, the current stance of monetary policy appears moderately loose and supportive of economic growth. Real short-term interest rates, at around 1.4 per cent below the euro-area average, remain historically low. Falling yields on government bonds have translated into lower costs of borrowing from banks for both corporations and households, with real long-term interest rates at around 2½ per cent (measured by current inflation).

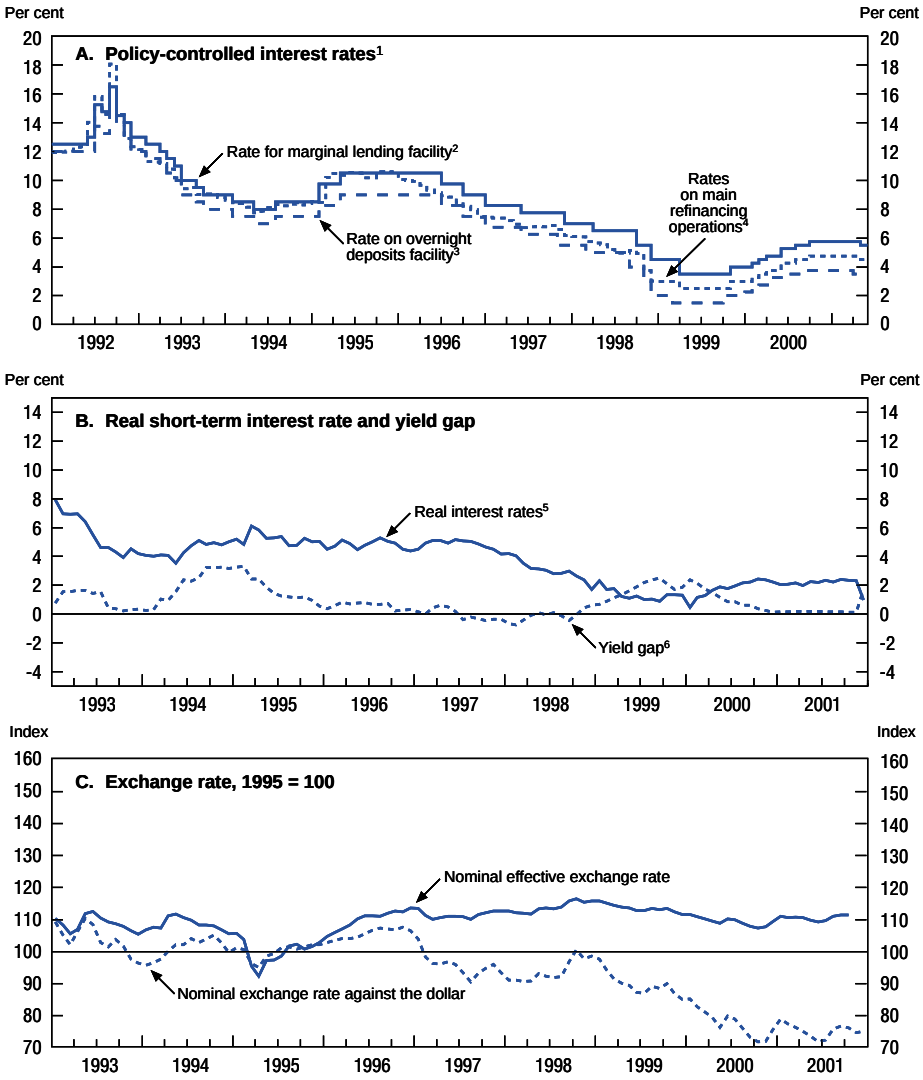
Table 3. **The current account of the balance of payments**
Billions of lire

	1999 Year	2000 Year	2000 Jan.-Sept.	2001[1] Jan.-Sept.
Current balance	**14 894**	**–11 794**	**–6 485**	**–4 450**
Exports	428 853	502 561	361 953	392 683
Imports	–386 170	–479 767	345 107	369 934
Trade balance	**42 683**	**22 794**	**16 846**	**22 749**
Services, net	2 178	64	1 843	2 436
Income, net	–20 122	–25 358	–19 212	–22 620
Current transfers, net	–9 846	–9 293	–5 962	–7 015
Invisibles balance	**–27 790**	**–34 587**	**–23 331**	**–27 199**

1. Provisional.
Source: Ufficio Italiano Cambi, *www.uic.it.*

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Figure 8. **Monetary conditions**



1. End of period.
2. Rate on fixed term advances from the Bank of Italy until December 1998.
3. Italian official discount rate until December 1998.
4. Rate on Bank of Italy repurchase operations until December 1998.
5. Three-month interbank rate deflated by CPI.
6. Long-term interest rate (yield on ten-year government bonds) minus short-term interest rate.

Source: OECD, Banca d'Italia, ECB.

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Table 4. **Money and credit aggregates**
Year-on-year percentage changes, end of period

	Contribution to the euro zone money aggregate M3[1]	Financial assets[2]		Credit[2]	
		Domestic	Total	Domestic	Total
1999					
December	3.4	0.4	20.7	4.7	8.4
2000					
December	4.2	3.7	5.5	5.4	6.5
2001					
October[3]	7.6	n.a	n.a	n.a	n.a

1. Figures refer to the liabilities of the Italian monetary financial institutions held by residents of all countries in the euro area. M3, which is the European Central Bank reference aggregate, consists of the following liabilities: currency in circulation and short-term deposits, repurchase agreements, debt securities with a maturity up to two years, money market fund shares and money market paper.
2. Figures refer to Italian residents.
3. Preliminary.

Source: Banca d'Italia, *Statistical Annex of Annual Report*, Tables aD4, aD5 and aD7, *www.bancaditalia.it*.

The volume of credit made available to the private sector has continued to expand, though at a slower pace than at the end of 2000, signalling that there has been no financial constraint on growth. The growth of the monetary aggregate M3 has continued to increase (Table 4) reaching an annual rate of 7.6 per cent in October. Financial factors rather than real ones could largely explain the acceleration of M3. In particular it could be an indication of the increased liquidity preference of investors because of uncertain market developments, but also may reflect diminishing inflationary pressures.

... as has fiscal policy

Fiscal policy has also been used, selectively, to support economic activity, against the background of a continuing consolidation effort. The fiscal stimulus provided by the 2001 budget (tax cuts for households and business, increased benefits for lower-income groups and a revival in public work projects) has been reinforced by the package of measures of the new government (the "100 days package", see Box 1). The coverage of the package is broad, ranging from tax measures to administrative simplification, and is based on the need for measures that offset the negative impact of slower world economic growth on business investment. It is difficult to assess the impact of these measures on growth, especially following the strong deterioration of business confidence with the 11th of September terrorist attack. Before this, the government foresaw an impact of 0.9 per cent (adding to a baseline growth of 2 per cent), while other estimates, such as those of ISAE (a main macroeconomic research institute) were lower. The latter more moderate assessments were mainly based on the computation of the effects of a provision

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Box 1. The "100-day package" and recent policy measures

On 2 July 2001, the Berlusconi government presented to Parliament its first economic programme, known as "the 100-day package", aimed at enhancing economic growth. The coverage of the package is broad and ambitious, ranging from tax measures to administrative simplification. The principal measures are listed below. The government was hoping to have the package approved before the end of July 2001 and to see the ensuing positive effects on economic activity becoming manifest from the autumn. However, the package was approved on 10 October with substantial delays in its implementation. The gains from the package are now likely to materialise beyond the beginning of 2002. The tax incentive package of the *Tremonti Law* II will have a retroactive effect, however, coming into force as of 1 July 2001.

Short-term fiscal measures

- The package includes the *Tremonti Law* II that is based on the 1994 *Tremonti Law* that aimed at stimulating business investment *via* a tax reduction on new investment. According to this provision, 50 per cent of annual corporate profits will be tax exempt, over the period 2001-2002, if reinvested in investment assets that exceed in value the average investment made in the previous five years. The year with the highest level of investment must be subtracted from the average. The novelty of this measure with respect to the 1994 *Tremonti Law* is that the exemption (up to 20 per cent of the total employee compensation) will also be available for investment in human capital and for a wider range of business sectors including banks and insurance companies. A new reform of the corporate income tax will follow the expiration of the tax incentive. With respect to the application of the tax incentives of the "dual income tax" (DIT) introduced in 1997 by the previous government, taxpayers can choose between the DIT and the *Tremonti Law* II only for new capital investments approved prior to 30 June 2001. Conversely, new investments in human capital formation can benefit from the accumulation of the two incentives.
- The government has also passed a decree law providing temporary incentives for the repatriation of financial assets illegally held abroad by Italian citizens. Under the new norm, the legalisation of such assets is made conditional on the payment of a small fee (2.5 per cent of the value of the assets declared, or alternatively the investment of 12 per cent of this amount in government bonds).
- In order to finance part of the deficit, the government will sell a large stock of its real estates by the end of 2001.

Medium-term fiscal action

- With the aim of reducing the size of the underground economy, a three-year alternative tax regime will apply for firms and workers that regularise their position.

(See Chapter II for further details on the above measures).

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Box 1. **The "100-day package" and recent policy measures** (*cont.*)

Structural measures

Labour market initiatives

The EU labour market directive on temporary work has been transposed into Italian law, with the intention of granting a wider recourse to fixed term contracts and more labour market flexibility.

Investment in public infrastructure

A special measure, known as the *Strategic Infrastructure Law*, has been introduced to help rationalise and accelerate large-scale public works by simplifying the approval procedure. The legitimacy of any new public investment project will be justified on the basis of its strategic objective, and will be subject only to the EU, constitutional and criminal law principles. The principal role of the government will be to design the infrastructure projects according to needs, and to control their realisation. However the projects can be contracted-out to the private sector and financed with private capital.

Property rights

In order to stimulate R&D activity the new government has strengthened intellectual property rights by allowing, for the first time, researchers in universities and public research institutions to patent their inventions, entitling them to a portion of the profits thereby generated.

Simplification and the move towards a more business-friendly environment

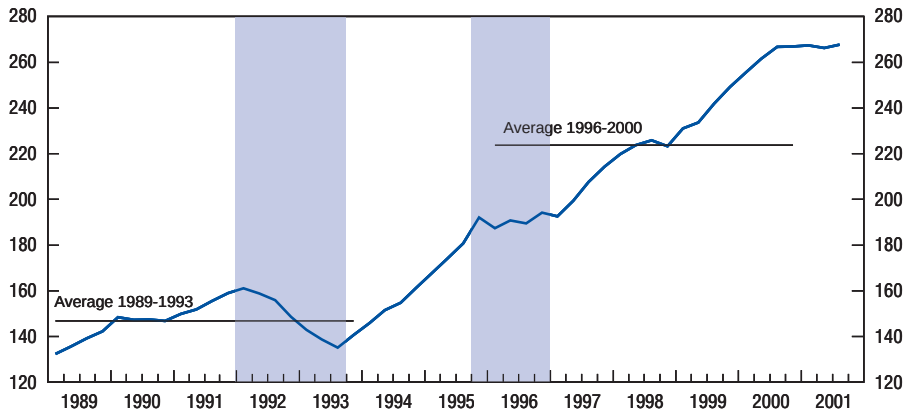
The package also intends to create a more business-friendly playing field in order to enhance entrepreneurial initiatives. Measures to reduce administrative costs and red tape have been finalised. Moreover, the approval processes in home internal refurbishing will be eliminated, to push the simplification process further.

(See Chapter IV for further details on the above measures).

that is likely to have an impact on investment demand in the short term, notably, what is known as the *Tremonti Law* II, aimed at facilitating the purchases of capital goods (Box 1). The new incentive provisions intervene at the crest of an expansionary phase of the investment cycle (Figure 9), and this might reduce the positive impact on investment activity: given the rising trend of investments in the former five-year period, there is the possibility that some businesses will even be able to lower investment below the 2000 levels and still benefit from the tax

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Figure 9. **The *Tremonti laws* and the gross fixed investment cycle**[1]
Trillions of lire



1. Seasonally adjusted data at current prices, excluding construction.
The first average applies to the 1994 *Tremonti Law*, the second average applies to the *Tremonti Law II*.
The grey zones represent recession periods.

Source: OECD.

incentives (although the cyclical fall in investment may be less than it otherwise would have been). Therefore the stimulus to fixed investment, while putting pressure on the fiscal deficit, might be limited. Import leakage could further reduce the growth impact.

Short-term prospects and risks

Prior to the 11 September terrorist attacks in the United States, there were signs that growth was beginning to strengthen again. Domestic and foreign orders had turned up, with the announcement of tax measures to encourage corporate investment assisting these demand gains. Though weakening somewhat from its spring peak, consumer confidence was supportive. With the economy operating below its potential and capacity utilisation still lower than the 1990 cyclical peak, the leading indicators pointed to the possibility of an imminent pick up in industrial production and continuing strong service activities. Overall, real GDP growth was expected in the range of 2 to 2¼ per cent in 2001, strengthening further in 2002.

The blow to business confidence caused by the 11 September events will push an already fragile demand for business investment into temporary stagnation.

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However, household consumption, which has held up better than initially expected, could be more resilient, with decelerating inflation assisting per-capita income. Domestic demand and exports of goods and services are expected to pick up strongly from the second semester of 2002 onward, the former assisted by the new tax breaks. With consumer sentiment improving, the precautionary savings built up by households during the period of uncertainty may unwind, thus spurring consumption. Further forces encouraging consumption are the expected improvement in labour-market performance and low real interest rates. Some export market losses are expected in 2002 and 2003, despite recovering tourism receipts, as Italy's trade specialisation becomes disadvantageous once again and as (with the level of the euro now higher) Italy's export prices continue to rise faster than those of its emerging-market competitors. Nonetheless, the current account surplus is projected to improve. Overall, real GDP is projected to slow to about 1.8 per cent this year and to 1¼ per cent in 2002, and to pick up to 2¾ per cent in 2003 (Table 5).

A further decline in inflation to below 2 per cent, year-on-year, continues to be in prospect for 2002. Price pressures eased in the second half of 2001, as a number of earlier inflationary pressures became less significant. These included the effects of the BSE crisis on meat prices, the weakness of the euro and a sharp increase in insurance premia following the lifting of a government price freeze. Moreover, the planned reduction in electricity and gas charges, slightly lower oil prices and the slowdown in global growth will contribute further to curbing inflation. Wage pressure should remain low, as noted above. At the same time, recent tax cuts and some progress in liberalising key service sectors may reinforce the downward inflation trend.

As a sequel to the 11 September events, significant uncertainties attach to the projections, principally on the external side. Export demand may decelerate more than expected or remain depressed for a longer period, with negative investment effects. Not all the uncertainty comes from abroad, however. Domestically, the main source of risk derives from the fiscal side, where the planned base-broadening measures may fail to increase revenues as much as expected. If accompanied by continuing spending overruns, this could prove damaging to budget outcomes and hence limit the room for tax cuts while also impinging on household and business confidence.

A medium-term challenge: rising multifactor productivity

The strong deceleration of the multifactor productivity (MFP) over the past decades that characterises the Italian economy continues to raise concerns for medium-term economic growth. Production in Italy, as in Germany and France, is very capital-intensive compared with other and more dynamic economies for

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Table 5. **Short-term outlook**

	1998	1999	2000	Projections		
				2001	2002	2003
	Current prices L. trillion	Percentage changes, volume (1995, prices)				
Private consumption[1]	1 232.9	2.3	2.9	1.2	1.4	2.7
Government consumption	372.8	1.5	1.6	0.6	0.6	0.6
Gross fixed investment	384.8	4.6	6.1	1.5	1.3	4.1
Machinery and equipment	223.1	6.0	7.8	0.7	1.3	4.1
Construction	161.6	2.8	3.6	2.7	1.1	4.0
Residential	89.5	1.8	2.5	1.2	1.2	4.0
Non-residential	72.1	4.1	5.1	4.4	1.0	4.0
Final domestic demand	1 990.5	2.6	3.3	1.2	1.3	2.6
Stockbuilding[2]	16.1	0.4	–1.0	–0.1	0.0	0.0
Total domestic demand	2 006.6	3.0	2.3	1.0	1.3	2.6
Exports of goods and services	548.1	0.0	10.2	5.9	2.2	6.9
Imports of goods and services	477.3	5.1	8.3	3.6	2.7	6.5
Net exports[2]	70.8	–1.3	0.6	0.8	–0.1	0.3
GDP at market prices	2 077.4	1.6	2.9	1.8	1.2	2.8
GDP at market prices in billion euros	1 072.9					
Memorandum items:						
GDP price deflator		1.6	2.2	3.0	2.8	1.9
GDP at current prices		3.3	5.2	4.8	4.0	4.8
Private consumption deflator		2.1	2.9	2.8	1.7	1.8
General government net lending, as a percentage of GDP		–1.8	–0.3	–1.4	–1.1	–1.1
Current balance, as a percentage of GDP		0.7	–0.4	0.1	0.6	0.7
Unemployment rate, per cent of labour force		11.5	10.7	10.0	10.2	10.0

1. Final consumption in the domestic market by households.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.
Source: OECD.

example the United States (Table 6).[6] This is especially surprising for an economy with a large number of small and medium size enterprises (SMEs) specialised in labour-intensive high-quality goods (the traditional *Made in Italy*). The high degree of capital deepening has been the likely answer to labour market rigidities. Companies have invested in *labour-saving* technology, substituting capital and imported intermediate goods for labour. This has increased average labour productivity, but at the expense of declining labour utilisation and MFP, although the labour intensity of growth has started to rise in the latter half of the 1990s with labour market reforms (see Chapter IV).

Although the deceleration of MFP can be the consequence of rigidities in the labour market that call for further structural reforms,[7] there is also a clear need to renew and optimise the stock of capital *via* product and financial market reforms

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Table 6. **Evolution of capital intensity and capital stock**
Average annual growth rate

		1980-90[1]	1990-98[2]	1995-98[3]
United States	Capital stock	3.0	2.6	3.3
	Capital/labour ratio	1.1	0.6	1.0
Japan	Capital stock	5.7	4.2	3.6
	Capital/labour ratio	4.9	4.7	4.4
Germany	Capital stock	2.6	2.6	2.3
	Capital/labour ratio	2.9	3.7	3.1
France	Capital stock	2.0	2.0	2.0
	Capital/labour ratio	2.3	2.3	2.3
Italy	**Capital stock**	**2.8**	**2.7**	**2.7**
	Capital/labour ratio	**2.7**	**3.5**	**3.4**
United Kingdom	Capital stock	1.8	1.6	1.6
	Capital/labour ratio	1.8	1.2	1.0
Canada	Capital stock	3.5	2.2	2.7
	Capital/labour ratio	1.8	0.9	1.4
Ireland	Capital stock	2.6	2.3	3.3
	Capital/labour ratio	2.4	–0.1	–0.4
Netherlands	Capital stock	1.7	2.3	2.8
	Capital/labour ratio	2.7	1.6	1.6

Note: Capital/labour ratio is adjusted for hours worked.
1. Data for Germany refer to 1981-90 and cover only western Germany.
2. 1990-1997 for Canada, Italy, Japan and the United States, 1990-96 for Ireland and the United Kingdom, 1991-98 for Germany.
3. 1995-1997 for Canada, Italy, Japan and the United States, 1995-96 for Ireland and the United Kingdom.
Source: Scarpetta *et al.* (2000).

(see Chapter IV). Production processes are characterised by excessive and in general old capital stock that hampers the efficiency and profitability of Italian firms. The recently approved *Tremonti Law* II (Box 1) grants tax incentives for new and replacement investments on a widespread basis. This will have a temporary positive impact on aggregate demand, but longer-lasting supply effects will to a large extent depend on the quality as well as quantity of new investments. Thus, time-limited tax incentives targeted to the scrapping of the old capital stock and investing in innovative and technologically advanced capital goods and related training of human capital might be a more useful tool to encourage the process of renovation of the capital stock and enhanced future productivity growth.

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II. Fiscal policy: reducing debt and the tax burden

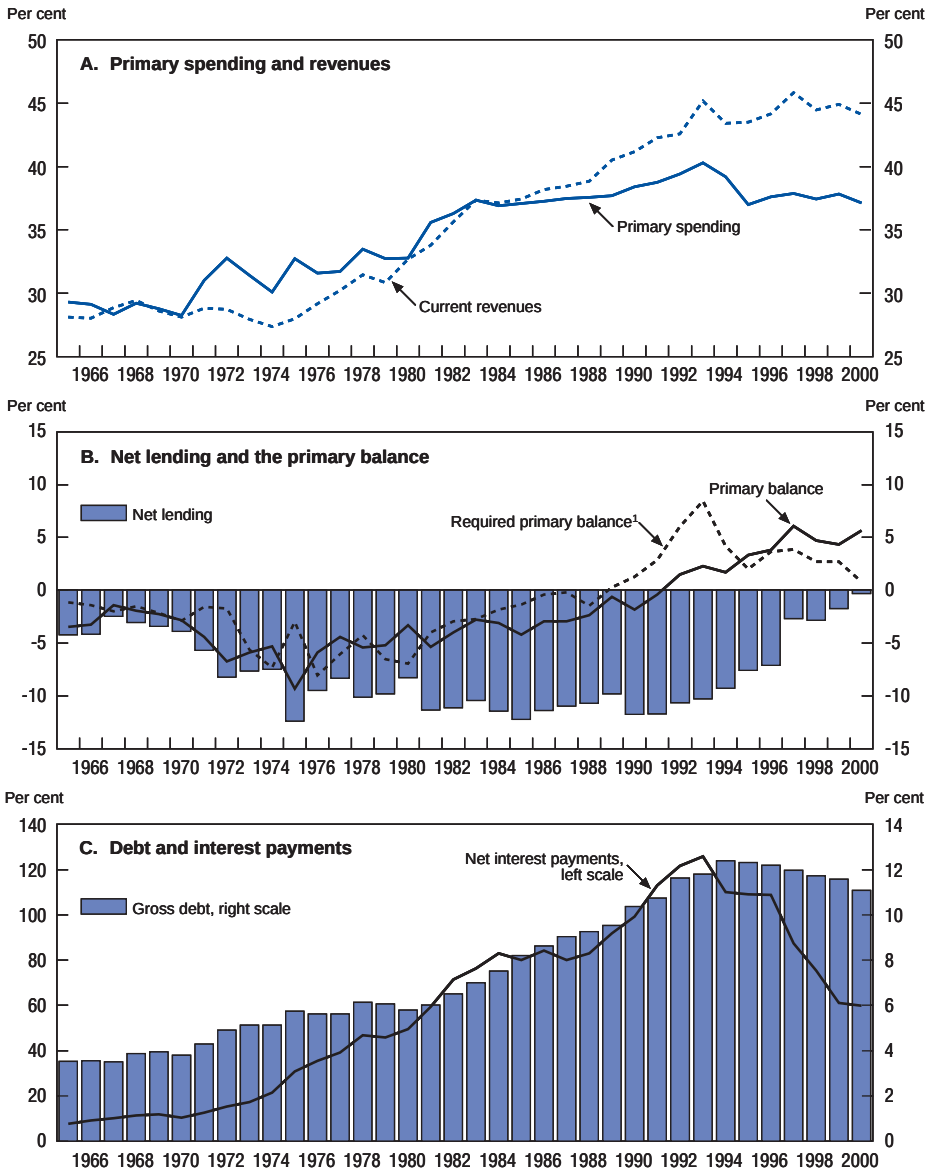
Overview

The 2000 budget deficit was the lowest for over thirty years, at 1.5 per cent of GDP, benefiting from the favourable trend in interest rates and better than expected revenue growth. Taking into account the "una-tantum" proceeds of the sale of mobile phone licences, the deficit was even significantly smaller than that, at 0.3 per cent of GDP (Figure 10). Over the five years to 1997, the consolidation process (by which the general government structural deficit was reduced by 7 percentage points of GDP) was materially assisted by tax increases (especially in 1992 and 1997) and reductions in transfers, subsidies and public investment spending, while substantially helped by interest rate declines. But progress towards budget balance – the objective for 2003 – could prove difficult to maintain. Since joining EMU, Italy has been able to exploit continued favourable movements in interest rates, but that leeway is now much reduced. More critically, the increase in effective tax rates involved in meeting the Maastricht criteria moved Italy above the average fiscal pressure ratio of EU countries and this has placed tax reform, and reduction, at the top of the agenda (Figure 10).

At the same time, as discussed in Chapter III, certain types of expenditure, including infrastructure investment, and non pension-related social expenditure may be underprovided for in Italy, calling for a rebalancing of primary spending as well as outright reduction if the budget objectives of tax and deficit reduction are to be reconciled. In this respect, continuing to meet the medium-term budget objectives specified in the *Stability and Growth Pact* will necessitate difficult decisions with respect to controls over health and pension spending. While there are strong arguments that a phase of cyclical weakening in activity may justify some slippage from deficit targets, as automatic stabilisers come into play, in Italy's case government debt remains around forty percentage points above the Maastricht ceiling, limiting the room for budgetary manoeuvre.

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Figure 10. **Fiscal indicators**
Per cent of GDP



1. Primary surplus needed to stabilise the net debt ratio.
Source: OECD.

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Recent budgetary developments

Progress towards consolidation became more difficult in 2000…

For 2000, the underlying budget deficit to GDP ratio was 1.5 per cent of GDP (excluding the receipts from the mobile phone sales amounting to 1.2 per cent of GDP, Table 7), an improvement of 0.3 percentage point from the previous year.[8] However, the structural primary surplus worsened slightly moving from 5.3 per cent to 5.1 per cent of GDP. Higher than expected revenues were offset by tax cuts implemented towards the end of the year. Confident that a deficit out-turn lower than targeted was in reach, during the summer of 2000 the government announced its intention of implementing a number of tax rebates before the end

Table 7. **General government income statement**[1]

Per cent of GDP

	1996	1997	1998	1999	2000
Receipts					
Direct taxes	15.3	16.0	14.3	14.9	14.5
of which:					
From households	11.9	12.2	10.5	11.0	10.6
From enterprises	3.4	3.8	3.9	3.9	3.9
Indirect taxes	11.8	12.4	15.3	15.2	15.1
Social security contributions	15.0	15.3	12.8	12.8	12.7
Other current transfers	1.4	1.4	1.4	1.3	1.2
Property and enterprises income	0.6	0.6	0.5	0.7	0.6
Total current receipts	44.2	45.8	44.5	44.9	44.1
Disbursements					
Government consumption	18.1	18.2	17.9	18.1	18.0
Subsidies	1.5	1.2	1.3	1.2	1.2
Social security outlays	16.9	17.3	17.0	17.2	16.7
Other current transfers	1.2	1.2	1.2	1.3	1.3
Interest on public debt	11.5	9.4	8.0	6.8	6.5
Total current disbursements	49.1	47.2	45.5	44.6	43.6
Saving	–4.9	–1.4	–1.0	0.4	0.5
Gross investment	2.2	2.2	2.4	2.5	2.4
Net capital transfers received	–1.2	–0.3	–0.7	–0.9	0.3
Consumption of fixed capital	1.2	1.2	1.2	1.3	1.3
Net capital outlays	2.2	1.3	1.8	2.1	0.8
Total disbursements	51.3	48.5	47.3	46.7	44.4
Net lending	–7.1	–2.7	–2.8	–1.8	–0.3
Primary balance	3.8	6.1	4.7	4.3	5.6
Memorandum items:					
Cyclically-adjusted primary balance	4.3	6.6	5.4	5.3	5.1
Cyclically-adjusted net lending	–6.5	–2.0	–2.0	–0.7	–0.8

1. OECD definitions. In particular, the primary balance is calculated taking into account both interest payments and interest receipts.

Source: OECD.

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of the year. In early October the figure was set at L 13.2 trillion (0.6 per cent of GDP), which was the amount needed to prevent the actual level of tax pressure from rising relative to the target expressed in percentage points of GDP. Such rebates were justified by the tax reforms of the previous years, which had led to a widening of the tax base and some expansion of the formal economy. They did not include the fiscal bonus (some L 12 trillion) arising from the windfall tax revenues from capital gains, a reflection of the good performance of the stock market.

As it turned out, the extent of the tax relief was too generous in the light of actual spending developments. While pension outlays in the year 2000 were lower than budgeted,[9] important tensions between the central government and the local authorities came to the surface. These mainly concerned the health care sector, for which regions have planning and co-ordination responsibilities while relying on central government transfers for financing. Under strong pressure from mounting prices of prescription drugs, decreasing co-payments by patients and rising consumption (new classes of drugs became reimbursable), pharmaceutical spending rose by 7¼ per cent in 2000 relative to the previous year. This was considerably faster than the rise in nominal GDP (5¼ per cent). Difficulties were compounded by the large wage concessions (over 8 per cent increases) needed to retain senior hospital staff following the proscription on physicians employed by the National Health Service to simultaneously engage in private practice. These tensions were interpreted as a sign that the Internal Stability Pact of 1999 (*Patto di Stabilità Interno*), which was designed to involve the local authorities in the attainment of the fiscal targets, had important defects (Chapter III). Excluding compulsory military service, public employment remained approximately unchanged, ending a sequence of significant reductions.

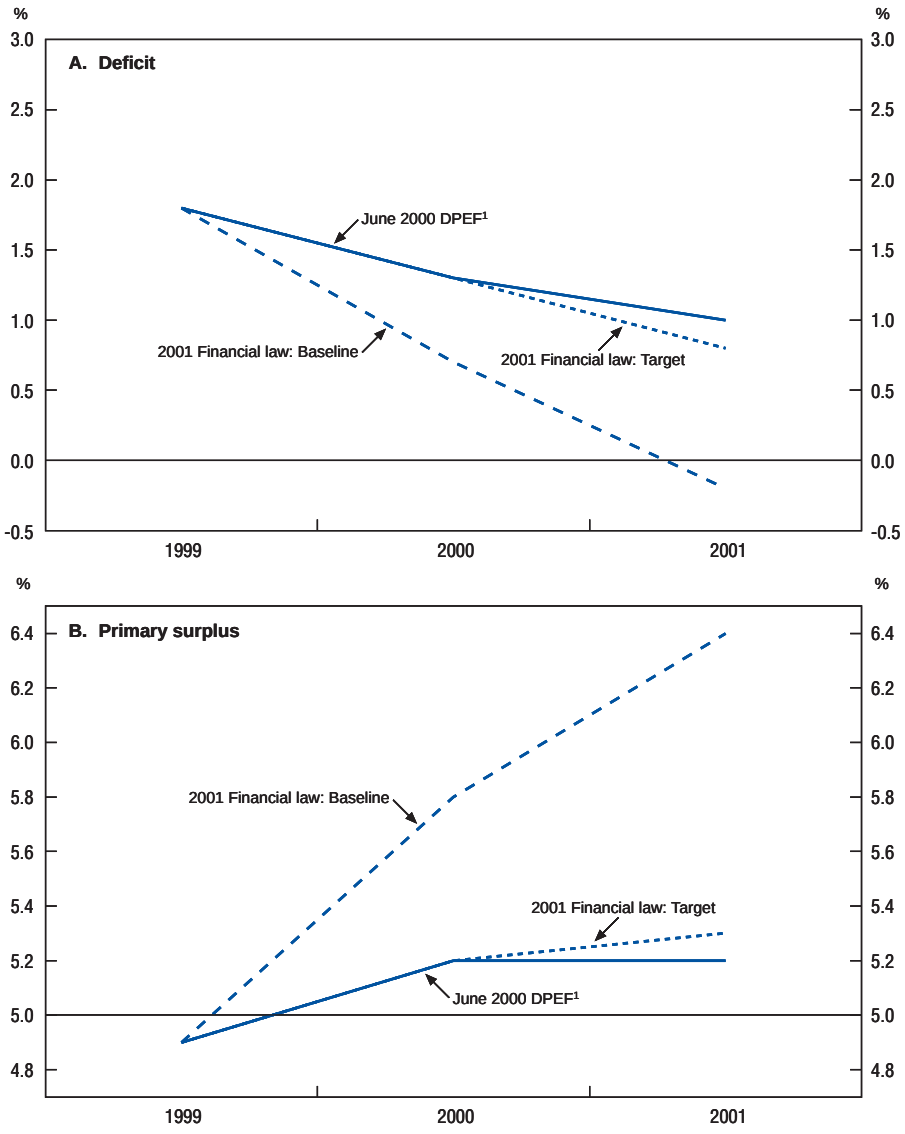
... and implementation problems intensified in the 2001 *budget*

The medium-term plan (*Documento di Programmazione Economica e Finanziaria*, DPEF) formulated in June 2000 projected a general government deficit on current policies of 1 per cent of GDP for 2001, a target which the new budget reduced to 0.8 per cent of GDP. A greater emphasis on tax reductions (for both households and companies) was counterbalanced by lower interest payments and measures to further restrict the expenditure of the local authorities. The resulting targeted level for the primary surplus of 5.3 per cent of GDP was slightly higher than the one foreseen in the DPEF. With such a background, reconciling a growth-oriented budget with the shift towards more ambitious fiscal targets meant that the underlying budget trend (assuming unchanged policies) had to be upgraded markedly (Figure 11), based on the expectation of tax receipts continuing to perform strongly as a consequence of structural reforms.

The implementation of the 2001 budget has been highly problematic, in part because of the spending problems inherited from the previous year. For

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Figure 11. **General government targets for 2001 and baseline changes**
Per cent of GDP



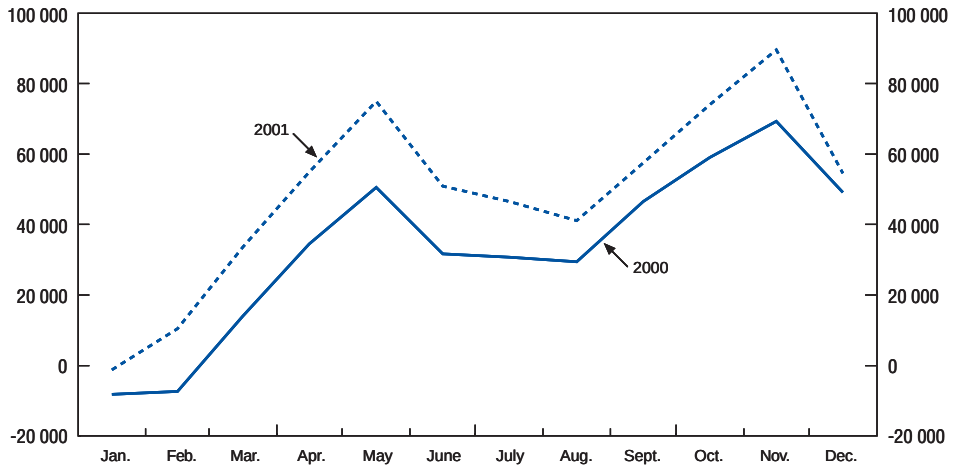
1. Under the June 2000 DPEF both baselines for the general government deficit and primary balance were set equal to the corresponding target levels.

Source: Ministero dell'Economia e delle Finanze (2000), Documento di Programmazione Economica e Finanziaria (June) and Nota di aggiornamento (November).

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example, though helping to contain expenses in 2000, the deferral of most of the costs attached to the two-year wage contract renewals running from 2000 have clearly contributed to surging compensation in 2001. With problems coming to a head quickly, the fiscal position deteriorated sharply during the first half of the year, raising expectations that the annual deficit target could be overshot by a large margin. Given the lack of up-to-date accrual figures for the general government – the relevant accounting methodology for the Maastricht evaluation criteria – the adverse dynamics of the deficit were signalled initially by the cash accounts of the state sector, a sub-entity of the general government (Figure 12). A rapid increase in the borrowing requirement was the counterpart of current expenditure rising faster than revenues (by as much as 10 per cent, compared with 6 per cent). Though influenced in part by special factors, most notably the refund of tax credit arrears,[10] this outcome was evaluated with alarm by both the Bank of Italy and the Audit Court (*Corte dei Conti*). The possible implications of these adverse developments for the net lending of the general government are illustrated in Table 8. Taking into account the fiscal data available in the Summer of 2001, a slippage of 1.2 percentage point of GDP from the annual deficit target seemed possible at that time, assuming no further intervention. This would have brought the level of the deficit in 2001 to 2 per cent of GDP.

Figure 12. **State sector borrowing requirement**
Trillions of lire



Source: Ministero dell'Economia e delle Finanze.

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Table 8. **Fiscal developments in the first half of 2001 and implications for the target deficit**

In trillions of lire

	1995	1996	1997	1998	1999	2000			2001[1]		
						Year	Jan.-June	July-Dec.	Year	Jan.-June	July-Dec.
General government overall borrowing requirement (*cash*, A)	126.6	128.9	52.6	58.5	31.6	49.1	31.7	17.5	61.8	50.9	10.9
General government net lending[2] (*accrual*, B)	135.7 (7.6)	135.0 (7.1)	53.7 (2.7)	58.7 (2.8)	37.7 (1.8)	34.3 (1.5)	–	–	47.0 (2.0)	–	–
A – B	–9.1	–6.1	–1.1	–0.5	–6.1	14.8	–	–	14.8		

1. The figures for 2001 illustrate a scenario which is based on the following underlying assumptions:
   a) a further deterioration of the overall cash borrowing requirement during the second half of 2001 of approximately 11 trillion, consistent with the April 2001 short term update (*Relazione sulla stima del fabbisogno di cassa per l'anno* 2001)
   b) no change in the overall *cash*/*accrual* difference for 2001 relative to 2000.
2. Figures as a percentage of GDP in parenthesis.

Source: OECD calculations using figures from Ministero dell'Economia e delle Finanze.

Measures to correct the slippage…

The need for further deficit-reducing steps was recognised in the new DPEF (for the period between 2002 and 2006) where the incoming government announced the intention of taking all possible steps to achieve the inherited 2001 fiscal deficit objectives.[11] To this end, the government expected 10 trillion from the planned sale of public real estate assets (which Eurostat has agreed to account "above the line"), corresponding to 0.5 per cent of GDP. To ensure a rapid execution of the sale programme, money is to be paid up-front by a pool of banks using the proceeds from bond issues (see Annex I). One initial offering at the beginning of December was oversubscribed.

More fundamentally, under a new central/regional pact, a fixed annual allocation of 6 per cent of GDP for overall public health care expenditure was established, by which the ceiling on pharmaceutical products – a major source of slippage already in 2000 – was set at 13 per cent of total health spending, making for a fairly ambitious target for some regions (prior to the abolition of the co-payment system the average share equalled 13½ per cent). The plan was backed by a new set of enforcement rules whereby non-performing regions have to raise their own funds, either *via* higher taxes or by re-imposing the co-payment system. Regions should now face an incentive for reducing their health care expenditure, in the form of criteria that they have actively helped to generate. On the other hand, the ability of the state to decide sanctions may be diluted, with the lack of transparent information on regional accounting making the pursuit of adequate monitoring less effective.

Overall, the fiscal situation has improved since the publication of the DPEF, assisted by better than expected tax revenues (Box 2). However, the downward revision of the OECD growth projection is stronger than the official one, implying a worse deficit outcome for 2001. A slippage of slightly more than half a percentage point of GDP relative to the initial deficit target seems likely, giving an eventual deficit outturn of 1.4 per cent of GDP. This would imply a marginal improvement over 2000.

… still leave outstanding uncertainties

The difficulties in stepping up the pace of fiscal consolidation should not be underestimated, however. In the absence of a complete and fully accountable set of reconciliation information between cash and accrual accounting systems, the concern was that, in a situation of re-accelerating spending and/or declining receipts, a stubborn gap between the two sets of accounts might mask the presence of structural sources of fiscal pressure that at a later stage will have to be taken into account on a commitment accounting basis.[12]

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Box 2. Evaluation of the possible out-turn for 2001

Assessment of the baseline deficit on unchanged policies. The short-run fiscal picture improved considerably after mid-year, partly reflecting better than expected revenues from the tax on the revaluation of business companies' real estate assets. The estimated extra revenues amount to 0.2 per cent of GDP relative to the amount planned in the original budget law for 2001, bringing the baseline deficit to 1.7 per cent of GDP.

Assessment of the impact of the new measures. Though below initial expectations, the sale of public real estate assets is expected to raise revenues by 0.2-0.3 per cent of GDP. Taking into account the effects of the new health measures and stronger cash management to contain the purchases of goods and services, the July measures appear to have reduced the deficit by 0.5 percentage point of GDP. With this and the unexpectedly high revenues described above, the expected deficit out-turn would decline to about 1.2 per cent of GDP.

Assessment of the impact of slower than initially expected real GDP *growth*. OECD calculations using the conventional elasticities of the budget deficit with respect to cyclical conditions, suggest a deterioration due to slower than anticipated GDP growth of about 0.2 percentage point. This leaves an expected final out-turn for 2001 of about 1.4 per cent of GDP, implying an overall slippage of 0.6 per cent of GDP relative to the original target but a small improvement from the 2000 out-turn (1.5 per cent of GDP).

Being the earliest fiscal indicators available, the cash financial balances of the general government provide indispensable guidelines for monitoring the intra-year performance of the public sector. However, fiscal commitments under the *Stability and Growth Pact* are established in accrual terms, hence the necessity for full reconciliation between cash and accrual accounting (discussed in Chapter III). In a country with a high public debt, such as Italy, deficient reconciliation information may increase short run fiscal vulnerability, insofar as financial markets could view an expanding discrepancy between cash and accrual deficits as evidence of a slowing pace of public debt reduction.

The new medium-term plan and the 2002 *budget*

The July 2001 DPEF tightened the deficit target for 2002 to ½ percentage point of GDP, envisaging further progress towards a position of broad balance by 2003 (Table 9). Both the new programme and its October update[13] reaffirm the targets set out in the 2000 DPEF, although the update foresees significantly weaker economic activity in 2002 than initially expected. From 2003, ambitious fiscal targets are maintained, assisted by a concomitant downward revision of interest payments.

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Table 9. **The medium-term budget plan**[1]

	2001			2002			2003			2004			2005		
	New	Update	Old	New	Update	Old	New	Update	Old	New	Update	Old	New	Update	Old
General government balance (% of GDP)	–0.8	–1.1	–1.0	–0.5	–0.5	–0.5	0.0	0.0	0.0	0.0	0.0	0.3	0.0	0.2	–
Interest payments (% of GDP)	6.2	6.2	6.2	6.0	5.8	6.0	5.9	5.6	5.6	5.8	5.4	5.2	5.6	5.2	–
Primary balance (% of GDP)	5.4	5.1	5.2	5.5	5.3	5.5	5.9	5.6	5.6	5.8	5.4	5.5	5.6	5.4	–
General government debt (% of GDP)	107.0	107.5	106.6	103.2	104.4	103.5	100.6	101.0	99.7	97.9	98.0	94.9	95.5	95.4	–
Macroeconomic assumptions															
Real GDP growth rate	2.4	2.0	2.9	3.1	2.3	3.1	3.2	3.0	3.1	3.1	3.0	3.1	3.1	3.1	–
Consumer price inflation	2.8	2.8	1.7	1.7	1.7	1.2	1.3	1.3	1.2	1.0	1.0	1.2	1.0	1.0	–
Unemployment rate	9.8	9.6	9.9	9.5	9.2	9.2	8.9	8.7	8.5	8.4	8.0	7.8	7.7	7.5	–
Employment (% of active population)	54.4	54.5	54.3	55.3	55.3	55.2	56.3	56.3	56.1	57.4	57.4	56.9	58.5	58.5	–

1. Old: DPEF 2001-2004 except for 2001 where latest official projections (April 2001) are reported.
New: DPEF 2002-2006 (first four years).
Update: *Nota di aggiornamento al* DPEF (October 2001) and *Italy's Stability Programme* (November 2001).

Source: Ministero dell'Economia e delle Finanze.

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Given the prospect of lower interest payments, the primary surplus has also been revised down somewhat. Deficit reduction and massive privatisation (totalling 1 per cent of GDP per year over the 5-year legislation period) will help debt reduction, the level of public debt declining to below 100 per cent of GDP in 2004.

At the same time, the government is determined to find resources to enhance infrastructure investment (particularly in the *Mezzogiorno*), and under the new programme these will be partially provided by faster real GDP growth. To help generate such stronger growth, new initiatives to streamline the approval and realisation of infrastructure projects are under study (*Legge obiettivo*, see Chapter III). Measures to reduce administrative costs and red tape have been finalised, although it is difficult to assess the extent to which such measures go beyond the "Bassanini reforms" which were introduced since 1997. Tax cuts large enough to entail a reduction of the tax burden have been temporary suspended, but will be implemented from 2003.

The broad objectives of the 2002 budget proposals that were presented to Parliament at the end of September 2001 are consistent with the DPEF. It appears that the government has allowed for an improvement of the baseline scenario for the 2002 deficit close to ½ percentage point of GDP, this being the estimate of the structural improvement expected for 2002 from the implementation of recent reforms, as well as from somewhat lower than initially expected interest payments (Table 10). In part, it will be given back in the form of tax relief and higher spending, consistent with the promise to support output growth. Given these expansionary measures, the resulting deficit at unchanged policies equals 1.7 per cent of GDP, so that achieving the target of 0.5 per cent of GDP in 2002 requires a fiscal adjustment of 1.2 per cent of GDP (32 trillion lira, or 17 billion euros). Overall, this would be the biggest fiscal adjustment planned since 1997, notwithstanding a much worse macroeconomic environment.

Given the prospect that real output growth will be slower than expected by the government, triggering the operation of built-in stabilisers, the official deficit projection may be optimistic. Moreover, while the bulk of the higher spending measures will be permanent (notably in the domain of pensions, as well as public wages), most corrective measures are one-off and difficult to quantify with precision. These include the revenues expected from the partial amnesty for tax evaders who repatriate financial assets illegally held abroad, for example, and from the sale of real estate assets. As concerns the latter (revenues from the sale of real estate), the envisaged list of real properties to be sold to the market could take longer than expected to prepare, which would in turn delay the execution of the overall programme, although the mechanisms recently devised appear to provide for an adequate minimum percentage of the "fair market value" of such assets (see Annex I). As concerns the former (revenues from repatriated financial assets illegally

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Table 10. **The 2002 general government budget**
Trillions of lire

Change in the trend deficit	–11.4
Lower interest payments	6.3
Structural improvements	5.1
Resulting trend deficit	30.2
Measures to support the economy	18.5
Higher expenditure	12.4
Wages	6.1
Minimum pension	4.2
Investment	1.7
Other	0.4
Lower revenues	6.1
Families	2.1
Business	2.3
Other	1.7
Expected revenue impact of the above measures	2.8
Resulting deficit prior to correction	45.9
Corrective measures	33.2
Lower spending	7.0
Health	3.0
Other current spending	4.0
Higher revenues	26.2
Sale of real estate assets	15.0
Reduction of the size of the underground economy	2.0
Repatriation of illegal financial assets	1.9
Other	7.3
Resulting deficit target	12.7

Source: Ministero dell'Economia e delle Finanze, Banca d'Italia and ISAE.

held abroad), the government seems to have estimated them prudently, as these calculations assume a capital reflow that is close to the lower end of private sector estimates.[14]

Debt dynamics and debt management

Sensitivity to interest-rate and output fluctuations…

A high debt-to-GDP ratio increases the vulnerability of the fiscal position to fluctuations in the financial markets – hence the necessity to control primary expenditures. Considering the commitments to the *Stability Programme*, it is of interest to assess the responsiveness of the general government deficit to unexpected shocks. Table 11 presents two scenarios, the first assuming a larger output gap, the second a lower effective interest rate on public debt. The calculations of the OECD Secretariat indicate that a 1 per cent point wider GDP output gap translates

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Table 11. **Response of the budget deficit to output and interest rate shocks**

	2001	2002	2003
The 2001 medium term plan[1]			
General government balance (per cent of GDP)	–1.1	–0.5	0.0
Interest payments (per cent of GDP)	6.2	5.8	5.6
Primary balance (per cent of GDP)	5.1	5.3	5.6
Assumptions:			
Real GDP growth rate	2.0	2.3	3.0
Estimated implicit output gap	–1.7	–1.5	–0.5
Consumer price inflation rate	2.8	1.7	1.3
Effective interest rate on public debt[2]	5.4	5.3	5.2
First scenario			
Hypothetical rise in output gap	1.0	1.0	1.0
Resulting output gap	–2.7	–2.5	–1.5
Implied rise in general government deficit (per cent of GDP)	0.4	0.5	0.5
Resulting general government balance (per cent of GDP)	–1.5	–1.0	–0.5
Resulting general government primary balance (per cent of GDP)	4.7	4.8	5.1
Second scenario			
Hypothetical fall in short-term interest rates	1.0	1.0	1.0
Implied fall in interest payments (per cent of GDP)	0.5	0.7	0.7
Resulting general government balance (per cent of GDP)	–0.6	0.2	0.7

1. Official projections (November 2001).
2. Defined as the percentage share of interest payments in one year relative to the stock of the general government debt in the previous year.

Source: Ministero dell'Economia e delle Finanze (2001), *Nota di aggiornamento al* DPEF (October) and *Italy's Stability Programme* (November); OECD estimates.

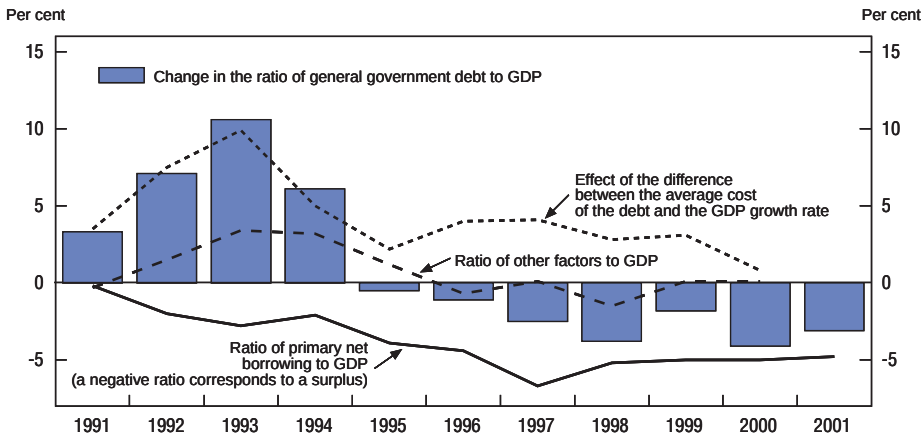
into a higher general government deficit of about 0.5 per cent of GDP per annum, with the implication that the deficit would come to 1 per cent in 2002, before falling in the following year. Achieving the objectives of the *Stability Programme* would be problematic as a result, though a partial offset would be provided by the likelihood of declining interest rates. A 1 percentage point lower interest rate paid on the debt would be accompanied by a decline in interest payments of about ½ percentage point of GDP.

... emphasise the importance of debt management

Italy is still one of the most indebted countries in the OECD measured in terms of the incidence of public debt relative to GDP. After reaching a peak of 124 per cent of GDP in 1994, the debt-to-GDP ratio has continued to decrease, reflecting the sequence of comparatively high primary surpluses. The deceleration in the debt ratio has gained momentum in recent years, even though for 2001 the OECD calculations foresee a slowdown in the pace of debt reduction, a consequence partly of less bullish privatisation revenues (Figure 13). Italy's public debt to GDP ratio still exceeds 110 per cent.

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Figure 13. **Change in the ratio of public debt to GDP and its components**[1]



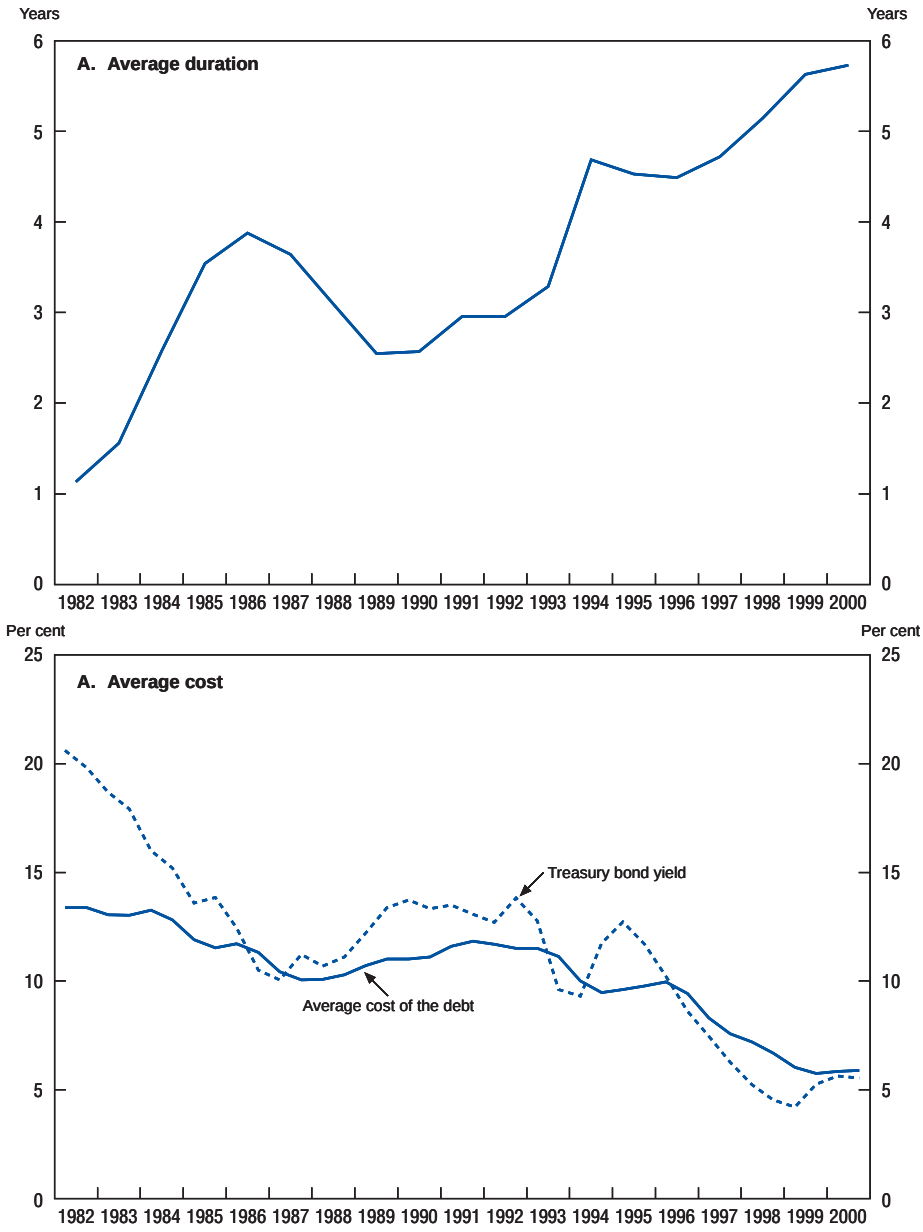
1. The change in the debt-to-GDP ratio (d) can be decomposed into three components on the basis of the following equality: $d(t) - d(t-1) = pr(t) + [r(t) - g(t)]d(t-1) + re(t)$, where pr = primary net borrowing in relation to GDP, r = the average cost of the debt, g = the rate increase in nominal GDP, and re = residual item, again expressed as a ratio to GDP. Data for 2001 are preliminary projections.

Source: Banca d'Italia.

Reflecting both a lengthening of the debt maturity structure and declining interest rates, the average cost of debt, *i.e.* the ratio of the interest payments to overall debt, declined sharply from 1997 (Figure 14). The Ministry of the Economy and Finance continues to emphasise the transparency, regularity and predictability of its operations *vis-à-vis* financial markets. Moreover, it diversifies instruments in order to reduce the sensitivity of the cost of debt to interest rate fluctuations. By the end of 2001, the average maturity of the debt continued to increase slightly reaching 5.7 years (compared with 5.5 years in 2000). The Ministry also maintains a composite basket which helps hedging against the exposure to interest rate risk. The share of fixed-rate bonds equals 70 per cent of the debt (Figure 15). In international issues, debt swaps have gained importance, with debt being immediately swapped after any international issuance in order to decrease the share of real foreign currency debt. In 2000, 90 per cent of the debt was swapped into euro and the component of foreign exchange declined in recent years. Thanks to this approach, debt payments in 2000 were largely insulated from the impact of the weakening of the euro. Treasury continued to use sinking funds, buy-backs and various types of instruments aimed at minimising the roll-over risks.

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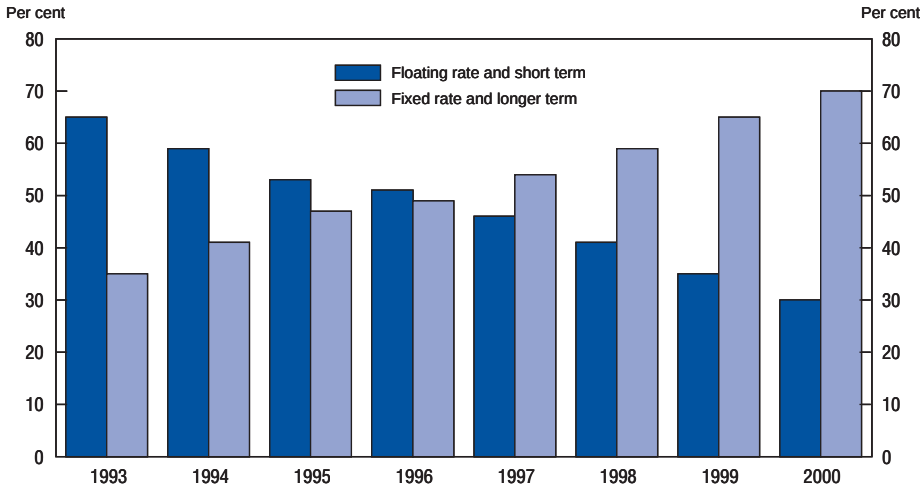
Figure 14. **Average duration and average cost of the debt**



Source: Ministero dell'Economia e delle Finanze.

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Figure 15. **Maturity breakdown of state sector domestic debt**
Per cent of total



Source: Banca d'Italia.

The tax reform programme

As noted, problems in meeting Italy's deficit targets have meant that the implementation of the platform of radical tax cuts upon which the government was elected have been deferred. However, on the revenue side, a major plank of the consolidation process has been the introduction of measures to broaden the tax base by regularising activities in the underground economy.

The tax system after the 1997-98 *reforms*

The 2000 *Economic Survey of Italy* reviewed the major issues involved in improving the tax system and the measures that had been taken since 1997, when a reform process was launched, reducing the numerous and wide-ranging forms of distortion introduced by the tax system in capital markets and business activity while aiming to broaden the tax base and lower statutory rates imposed on labour income. The 1997-98 tax reform eliminated some employers' compulsory health contributions, bringing the overall employers' contribution rate down to 34 per cent from 46½ per cent. However, with the introduction of the regional tax, IRAP, the tax base was broadened and the financing of part of social security expenditure was transferred from contributions to general taxation, so the tax wedge on labour remains among the highest in the OECD countries. Taxation of capital, on

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the other hand, was lowered and, as a result, the tax rates paid by individuals on dividends, capital gains and interest income are among the lowest in the OECD. Moreover, the implementation of the dual income tax (D*it*) reforms of 1998 reduced the cost of financing new investment *via* own-capital, thus contributing to making the corporate tax system more neutral with respect to debt sources of corporate financing (whether *via* equities or traditional banking credit). The pre-tax required rate of return on capital faced by companies operating in Italy, therefore, fell to close to the EU average.

In order to counteract the weak economic situation, and as a complement to the 1998 reforms, temporary incentives to new investments were introduced in the 1999 budget law applying to business activity in 1999 and 2000. This basically provided a subsidy to all new investment financed with own-capital (*i.e.* retained earnings or new shares). Furthermore, in the context of the 2000 budget law, the government decided to bring forward by one year the application of the D*it* to the whole business sector originally due in 2001, and to bring into force the S*uper*-D*it* for incorporated companies in 2000, while extending it to unincorporated companies in 2001. The S*uper*-D*it* progressively extends the tax advantage of the D*it* to the old capital stock, and thus makes the D*it* system more neutral with respect to already well-established and capitalised enterprises which could not take full advantage of the previous reform. The ultimate aim is to give a further incentive to the business sector to invest in new assets and to reduce leverage without reducing fiscal revenues.

As a result of tax-cutting measures, the tax burden of direct and indirect taxes declined by 0.4 and 0.1 per cent of GDP respectively in 2000, leading to an overall 1.9 per cent decline in the total tax burden relative to the year 1997, the qualifying year for EMU participation (Table 12). At 42.4 per cent of GDP, however, fiscal pressure remains 3 percentage points higher than in 1990. The impact of the tax cuts themselves were neutral: the tax concession did not change the out-turn for 2000 since it offset some unanticipated structural revenue shifts.

Table 12. **Trends in fiscal pressure**
As a percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Indirect taxes	10.7	11.1	11.3	12.0	11.8	12.1	11.8	12.4	15.3	15.2	15.1
Direct taxes	14.2	14.3	14.6	16.0	14.9	14.7	15.3	16.0	14.3	14.9	14.5
Social security contributions	14.4	14.9	15.1	15.3	15.1	14.7	15.0	15.3	12.9	12.8	12.7
Other tax receipts	0.1	0.2	2.0	0.7	0.1	0.6	0.3	0.7	0.4	0.1	0.1
Total fiscal pressure	39.4	40.5	43.0	44.0	41.8	42.2	42.5	44.5	42.9	43.0	42.4

Source: ISTAT.

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The new tax rules

Greater efficiency in tax administration and improved tax compliance are major factors underlying recent buoyant receipts. In carrying this further, the government wants to sharply curb the size of the underground economy. According to official estimates, the informal sector amounts to about 15 per cent of GDP, which is large by international standards The new rules are intended to allow important tax and social contribution rebates for business companies wishing to transit into the formal economy in the period between 2001 and 2003.[15] However, so far insufficient effort has been put into publicising the opportunities offered by the legal economy – easier access to financial markets, freedom of choice over suppliers and customers, for example – which firms operating in the hidden economy tend to neglect. The programme also needs to be backed by a credible penalty system.

A planned partial abolition of the (already small) inheritance tax and the tax on charitable donations are part of the move towards tax simplification, as well as the introduction of the tax incentives on business investment (Chapter I). Acting on the corporate income tax side, the government has replaced the D*it* with the T*remonti* L*aw* II, which grants generous incentives to new investment irrespective of the sources of financing (Chapter I).[16] Although apparently consistent with the goal of tax simplification, the former benefits imparted by the D*it* to the development of the equity markets have been lost. Moreover the government would like to reduce the rate of the corporate income tax and to gradually phase out the regional tax IRAP. Although the introduction of IRAP (in 1998) coincided with the elimination of a host of national and local taxes – itself a contribution to simplification – the calculation of the related tax liability is complex so that companies are subject to a considerably higher administrative burden.

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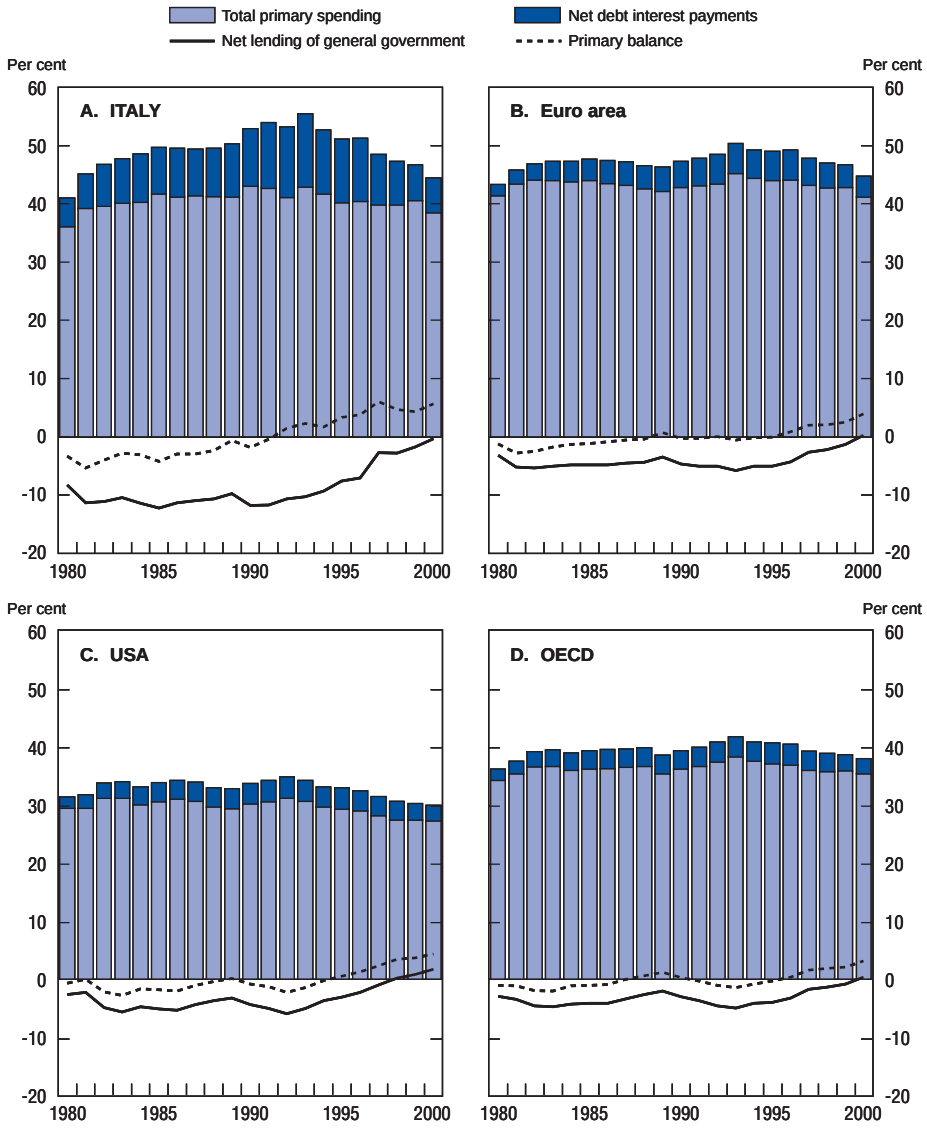
III. Public spending in Italy: policies to enhance its effectiveness

The control of public spending has been an essential element in bringing the general government deficit down to levels consistent with Italy's EMU obligations, which required one of the sharpest retrenchments in the OECD (Figure 16). However, though a significant proportion of the savings made were structural in nature, the consolidation process was assisted by a series of "one off" interventions – such as a freeze on wage contracts, *ad hoc* interventions in the health service and curbs on investment spending – which have created large compositional imbalances in public spending. Moreover, pressures from certain programmes – particularly those related to one of the fastest ageing populations in the OECD and to the *Mezzogiorno* – could intensify. At the same time, it is desirable on efficiency grounds to reduce the tax burden, but this is impossible without spending economies, on account of Italy's large public debt. Priorities in public spending will need to be reset and control mechanisms for their effective implementation put in place.

More fundamentally, there are wide margins for improvement in Italian public services and this chapter recommends new reform measures in the light of the policy actions taken so far. In a situation where political, social and economic objectives are intermixed, the analysis relies on indirect evidence and a degree of inference, using criteria related to international benchmarking, information on the efficiency of the planning and control processes (the presumption being that the nearer outcomes are to plan, the nearer they are to meeting social welfare objectives) and analysis of incentive structures built into the public institutions charged with implementing spending policies. Following this approach, the chapter identifies requirements for better public spending management at the central level. The issue of decentralisation is then taken up, since the realisation of a viable balance of responsibilities and incentives between central and local fiscal powers is an important element in determining the efficient allocation of resources and achieving better budget control. An overall assessment and agenda for policy action are presented in the final section of the chapter.

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Figure 16. **Trends in general government spending and the budget deficit**[1]
Per cent of GDP



1. For Italy and the other European countries concerned, the figures for 2000 take into account the revenues from the sale of third-generation mobile phone licences, UMTS.

Source: OECD.

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General government expenditure and forces shaping them

Effects of fiscal consolidation on spending

There have been two distinct general government spending trends since the 1960s (Table 13). Total public spending rose from less than 30 per cent of GDP in 1960 to a high of 55 per cent in 1993. As elsewhere, structural pressure on primary spending arose from the establishment and expansion of social programmes and services.[17] The revenue side did not adjust as quickly, and the primary balance of the general government rapidly fell into a structural deficit. Negative real interest rates and the associated "inflation tax" at first delayed the growth of public debt, but from the mid-1980s an inflation rate persistently higher than in the EU and OECD areas led to high nominal interest payments on government bonds.[18] As a result, by the early 1990s total public spending was significantly higher than the EU average, with the level of interest payments exceeding 10 per cent of GDP. Government debt continued rising until 1994 when it reached 124 per cent of GDP.

The second distinct phase covers the period of fiscal consolidation, prior to, during, and after Italy's entry into the Economic and Monetary Union in January 1998. From 1994, in particular, the Maastricht criteria spurred the Italian government to reassess its spending policy in the context of a longer term stabilisation strategy. Total public expenditure was reduced by 11 percentage points of GDP, to the current level of 44 per cent, a proportion not out of line with the rest of Europe (Figure 16). Primary expenditure restraint contributed some 30 per cent of the deficit improvement, most of which was accomplished *via* a combination of falling interest payments – as interest rates fell and privatisation receipts rose – and rising taxes (Table 14). Although the debt to GDP ratio fell, at about 110 per

Table 13. **Trends in public spending by economic category**
Per cent of GDP

	1960	1970	1980	1990	1993	1996	1999	2000
Government wages	8.6	9.9	11.0	12.6	12.3	11.5	10.7	10.5
Goods and services	5.2	5.1	5.7	6.9	7.3	6.6	7.4	7.5
Social security outlays	8.4	10.5	12.6	15.5	17.0	16.9	17.2	16.7
Subsidies	1.7	1.8	2.7	1.9	2.0	1.5	1.2	1.1
Other current transfers	0.8	0.9	0.7	0.9	1.3	1.2	1.3	1.3
Interest on public debt	1.4	1.6	5.2	9.6	12.3	11.5	6.8	6.5
Total current spending	26.0	29.7	37.9	48.1	52.5	49.1	44.6	43.6
Net capital outlays	1.9	2.3	3.2	4.3	2.8	2.2	2.1	0.8
Total expenditures	27.9	32.1	41.1	52.4	55.4	51.3	46.7	44.4
Total primary expenditures	26.5	30.5	35.9	42.8	43.1	39.8	39.9	37.9

Source: OECD.

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Table 14. **Sources of budget consolidation**
Changes in per cent of GDP

	1992-1997	1997- 2000	1992-2000
Total expenditures	–5.6	–3.4	–10.0
Final consumption	–1.9	–0.2	–2.0
Social security benefits	0.8	–0.6	–0.3
Transfers and subsidies	–0.5	0.1	–0.8
Current expenditure less interest payments	–1.6	–0.7	–3.1
Interest payments	–3.3	–2.9	–6.6
Total current expenditures	–4.8	–3.6	–9.7
Capital outlays[1]	–0.8	0.2	–0.3
Total receipts	4.2	–2.2	–2.1
Tax revenues[2]	2.8	–1.5	–1.0
Non-tax revenues	0.5	–0.2	–0.0
Total current receipts	3.3	–1.7	–1.0
Capital receipts	0.9	–0.5	–1.1
Primary balance	4.6	–0.4	3.3
Overall balance	8.0	2.4	10.0

1. The figure for 2000 does not take into account one-off revenues from the sale of third-generation mobile licences, UMTS, which should otherwise be quantified as a negative capital outlay, worth L 26 750 billion (1.2 per cent of GDP).
2. Direct and indirect taxes plus social security contributions.
Source: OECD.

cent of GDP it is still one of the highest in the OECD. Combined with a still high tax burden (jointly with the need to reduce it), it is an important reason for looking for greater effectiveness of public spending.

The composition of spending differs from that in other major OECD countries. F*irst*, debt interest payments, although declining, are still high internationally (6 per cent of GDP, about double the OECD average), a reflection of high public indebtedness. S*econd*, with a high hangover of debt interest payments, primary spending is low by continental European standards (by about 2½ percentage points of GDP), because of relatively low final consumption expenditure and much lower capital outlays (fixed investment and capital transfers). T*hird*, public pensions are significantly higher than the OECD average, totalling about 13.8 per cent of GDP in 2000 (inclusive of survivor and invalidity pensions).[19]

Low public investment

Cuts in public spending in the first half of the 1990s involved both service provision and, most markedly, capital spending. The fall in public investment also reflected the fight against corruption (*tangentopoli*) and the related problems of mismanagement in the use of public resources.[20] As a result, Italy currently

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has a relatively low public investment share in overall fixed capital spending (12 per cent for 2000, 1½ percentage points lower than the OECD average) (Figure 17). This implies a need to catch up with uncompleted construction works (for example, the road network) and urgent maintenance requirements (for other segments of the transport sector, especially the railways, along with energy and water). The backlog is particularly pronounced in the *Mezzogiorno*. The investment shortfall has exacerbated the inefficiencies characterising the supply of many public services, in turn reinforcing demands for improving and expanding the infrastructure endowment.[21]

Legislation governing public works – once highly fragmented and complex – started to be revised from 1994 in a sequence of attempts to make access to public works more open, transparent and efficient (*Merloni Laws*). With the programming capacity for public works improving, government investment has been recovering since 1996, even though the gap relative to the level of the early 1990s remains marked. This reflects the fact that new public investment programmes typically require long preparatory periods. It also appears that the Merloni Laws tend to be excessively prescriptive and this may pose problems, particularly in light of the need to increase the involvement of the private sector in public works.

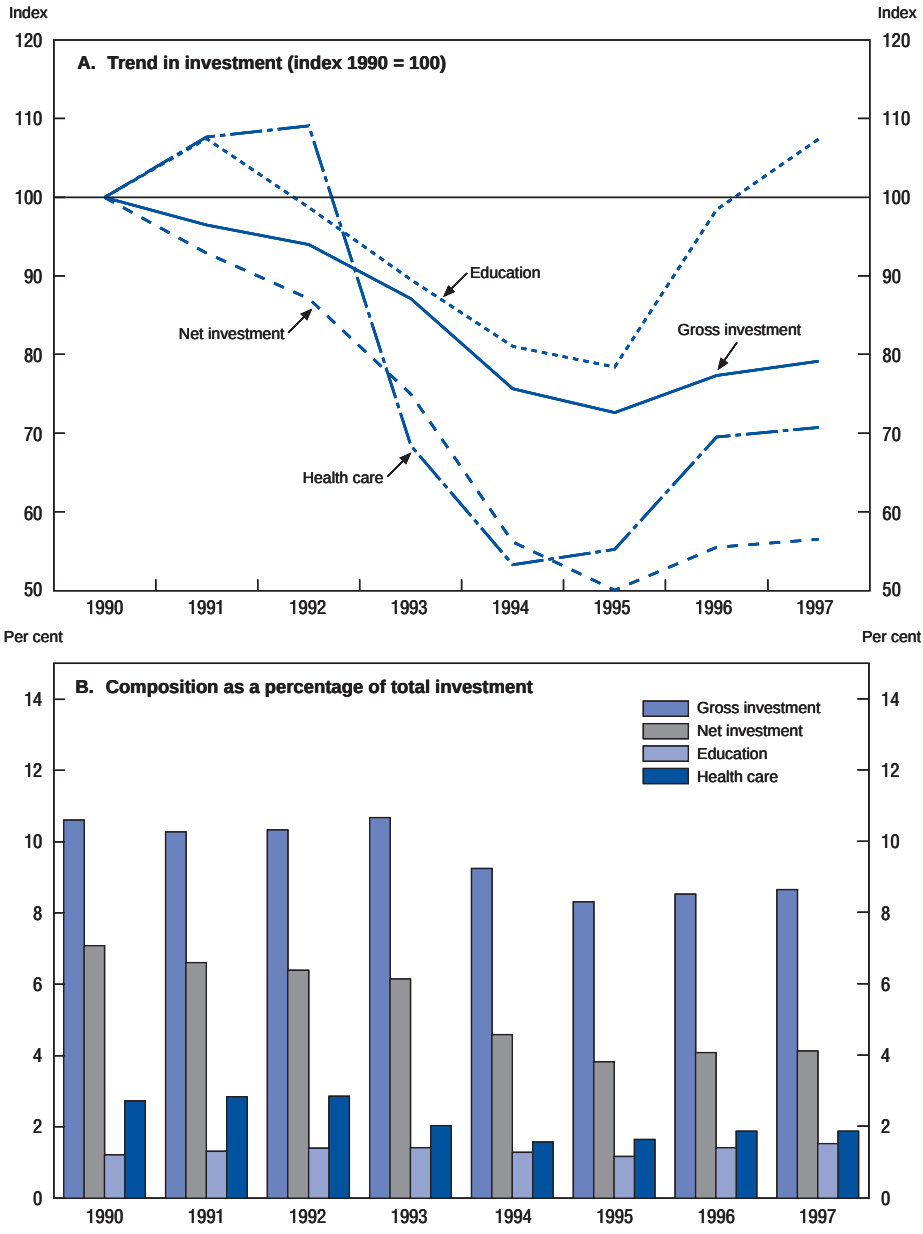
The fiscal dimension of population ageing

The 2000 *Economic Survey of Italy*, which covered the major fiscal issues arising from population ageing, recognised that the efforts made so far to contain the generosity of the system, to limit the trend towards early retirement, as well as to reform aspects of the social support system (other income transfers, health care and care for the frail elderly), have substantially reduced future fiscal pressures. After a transitional period, the new system implies a major improvement in incentives affecting the timing of retirement. However, the phase-in of the reforms is still rather slow and the *Survey* pointed out the risks of a further deterioration in the public sector primary balance, reflecting both direct pension spending and other old age-related spending, such as for health care.[22] Thus in setting medium- to longer-term budgetary targets, an extra safety margin would, in principle, need to be built in to take into account not only the full extent of the current debt problem, but also the future overhang associated with ageing.

OECD calculations in the context of the 2000 *Survey* suggested that maintaining a non-age-related primary surplus within the current levels while assuming a "no policy change" long-run GDP growth rate of just under 1 per cent would not suffice to let the debt to GDP ratio reach the 60 per cent threshold in the first half of this century, because of rising ageing costs.[23] Thus the Survey concluded that reaching this threshold would require a more up-front fiscal effort, as well structural policies to boost long-run growth.[24] This would lead to a faster decline of the debt-to-GDP ratio earlier on, which would be needed to offset the impact of ageing

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Figure 17. **The performance of government investment**



Source: ISTAT.

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through 2015 and 2030, within which period the impact of the demographic transition will be concentrated. This would allow resources which would otherwise be devoted to debt service in that period to be freed up for addressing ageing related needs.

Implications of high pension spending for other income transfer programmes

The counterpart of an income transfer system narrowly concentrated on pensions is a comparatively modest involvement of the state in other social transfers, in education and in health care (Table 15).[25] Largely as a consequence of social and cultural factors, under the Italian approach, an emphasis on the private provision of non-pension social services derives from the central role played by the family as a social safety net. In most other European countries, by contrast, such services are under the responsibility of the state. Given this, for Italy the overall extent of public outlays on social programmes is not overly large by international standards.[26]

The family plays a dual re-distributive role.[27] During periods of recessions, it acts counter-cyclically through the *pooling* of the resources made available by its various members. In addition, it permits favourable scale economies in consumption. In quantitative terms, the family is estimated to absorb between 70 and 90 per cent of the existing income inequalities among individuals, a remarkably high proportion by international standards.[28] Nevertheless, the available data suggest that the importance of the re-distributive function of the family has begun to decline since the end of the 1980s, both under the influence of changes in cultural and social habits and because of structural economic developments.[29] Hence, looking in prospective, falling pension benefits and further increases in female labour-market participation will mean that the ability of the family to care for its members will continue to decline, implying that pressures for state provision will increase.

The peculiar structure of Italy's welfare spending system has an impact on the distribution of income.[30] Although nearly three quarters of the EU citizens receive some kind of monetary transfer, in the case of Italy (and Greece) this share falls to a low of 50 per cent (Table 16). Moreover, in Italy (as in Greece and Spain) 80 per cent of transfer recipients are pensioners, which is significantly higher than the European average.[31]

A notable feature of Italy's welfare spending is its low cyclical sensitivity which also translates into a low overall cyclical sensitivity of public expenditure (Figure 18). In part, this reflects the low level of unemployment-related transfers. As it turns out, shocks in Italy have mainly been absorbed through revenue adjustments – since the built-in elasticity for corporate and indirect taxes is quite high – rather than through a combination of spending and revenues-side adjustments, as appears to be the case in many other OECD countries.[32] This situation may not be

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Table 15. **Functional distribution of social benefits**

1998

	Italy	France	Germany	Netherlands	United Kingdom	Spain	Sweden	European Union	United States	Japan	Canada
	Per cent of GDP										
Income transfers											
Invalidity	**1.5**	1.4	2.2	3.2	3.0	1.7	3.8	2.2	0.8	0.3	0.5
Old age pension[1]	**13.0**	11.0	11.4	9.6	10.4	8.8	12.2	10.8	5.1	5.8	4.3
Survivors	**2.6**	1.8	0.5	1.4	1.0	0.9	0.7	1.4	0.9	1.1	0.5
Family	**0.9**	2.8	2.8	1.2	2.2	0.4	3.5	2.2	0.6	0.5	0.7
Unemployment	**0.7**	2.2	2.5	1.9	0.9	2.8	3.1	1.9	0.3	0.6	1.0
Housing	**0.0**	0.9	0.2	0.4	1.6	0.1	0.8	0.6	0.2	. .	. .
Merit goods											
Health care	**5.7**	8.5	7.9	7.6	6.6	6.1	7.7	7.1	5.9	5.7	6.3
Education		6.2	5.5	4.6	4.9	5.3	6.8	5.6	6.4	4.7	6.2
Total of above	**29.4**	34.8	33.0	29.9	30.6	26.1	38.6	31.8	20.2	18.7	19.5
	Percentage distribution										
Income transfers											
Invalidity	**5.1**	4.0	6.7	10.7	9.8	6.5	9.8	6.9	4.0	1.6	2.6
Old age pension[1]	**44.2**	31.6	34.5	32.1	34.0	33.7	31.6	34.0	25.2	31.0	22.1
Survivors	**8.8**	5.2	1.5	4.7	3.3	3.4	1.8	4.4	4.5	5.9	2.6
Family	**3.1**	8.0	8.5	4.0	7.2	1.5	9.1	6.9	3.0	2.7	3.6
Unemployment	**2.4**	6.3	7.6	6.4	2.9	10.7	8.0	6.0	1.5	3.2	5.1
Housing	**0.0**	2.6	0.6	1.3	5.2	0.4	2.1	1.9	1.0	. .	. .
Merit goods											
Health care	**19.4**	24.4	23.9	25.4	21.6	23.4	19.9	22.3	29.2	30.5	32.3
Education	**17.0**	17.8	16.7	15.4	16.0	20.3	17.6	17.6	31.7	25.1	31.8
Total of above	**100.0**	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. For Italy, including TFR ("Trattamento di fine rapporto").

Source: Eurostat and OECD.

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Table 16. **Share of population receiving transfers**[1]
Percentage of total

	Pensions	Other social benefits	All social benefits together
Italy	**40**	**18**	**51**
Austria	34	69	86
Belgium	28	69	89
Denmark	19	75	85
France	25	62	79
Germany	29	57	78
Greece	39	19	50
Ireland	23	82	90
Luxembourg	29	66	86
Netherlands	19	66	81
Portugal	36	68	89
Spain	34	33	58
United Kingdom	28	71	85
European Union	30	52	73

1. The first line of the table reveals that 40 per cent of Italians live in households where at least one member draws a pension. For other social benefits, the figure is 18 per cent. For all social benefits together, the figure is smaller than 58 per cent (*i.e.* 40 per cent plus 18 per cent) since some households receive more than one type of social benefit.

Source: Eurostat.

desirable from the standpoint of the long-run effectiveness of spending programmes, partly in view of the likely further decline in the ability of the family to care for its members during spells of unemployment. This highlights the scope for creating some margin for increasing the size and impact of automatic fiscal stabilisers.

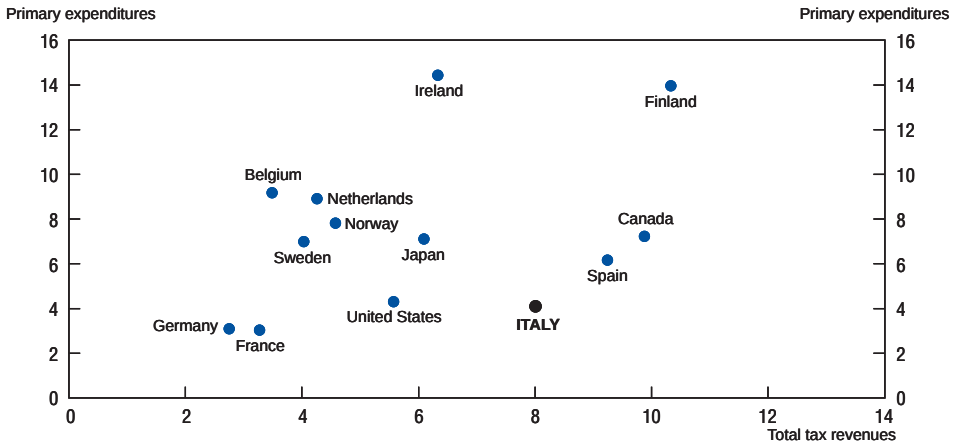
Public employment and the government wage bill

Recent employment trends

An important factor behind the sustained decline in primary spending has been the adoption of more binding employment policies at both the national and sub-national levels of government. Assisted by a freeze on new hiring and by better-designed measures to help the redeployment of public workers, general government employment declined from 1993 on. By 2000, the general government absorbed about 16 per cent of total employment, implying that it has shrunk by approximately 1 percentage point relative to the beginning of the 1990s (Table 17). Both the central and local governments have been reduced in size. Nevertheless, the international comparison suggests that the overall size of the general government sector is still larger in terms of overall employment than the euro-area average, albeit smaller than that of the G7 (Table 18).

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Figure 18. **Cyclical sensitivity of primary expenditures and tax revenues**[1]
Per cent of GDP



1. Cyclical sensitivity measured as coefficient of variation. The latter is defined as is the standard deviation divided by the average of the tax/GDP ratio (including social security contributions) and primary expenditures of general government in per cent of GDP. Sample period is 1980 to 2000.
Source: OECD.

Table 17. **Size of general government employment**[1]

	General government	Central	Local	Social security
1990	**16.8**	9.7	6.8	0.3
1993	**17.4**	10.1	7.1	0.3
1996	**17.4**	9.6	7.5	0.3
1999	**16.6**	9.1	7.2	0.3
2000	**16.2**	9.2	6.8	0.3

1. As a percentage of total employment.
Source: ISTAT.

Privatisation and the wider public sector

As in other OECD countries, expenditure restraint in Italy occurred within the context of a broader programme of structural reforms, so that the general government accounts tell only part of the story.Privatisation also played a key role in reinforcing the credibility of the fiscal adjustment process. The public enterprise

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Table 18. **International comparisons of general government employment**
As a percentage of total employment

	1990	2000
Italy	**16.8**	**16.2**
Canada	21.5	20.2
France	23.1	24.2
Germany	15.1	11.4
Japan	8.1	8.5
United Kingdom	22.4	17.9
United States	15.4	15.3
Big seven	15.4	14.6
Euro area	16.9	15.7

Source: ISTAT and OECD.

sector has been significantly downsized since 1993, reflecting a strategy of disengagement from a large number of productive activities in order to refocus on essential functions.[33] Employment in public corporations was brought down to around 4 per cent of total employment in 1997, from 5½ per cent in 1990, corresponding to a cut of about 310 thousand employees (Figure 19, Panel A). Privatisation also responded to the pressure of the European Commission to cut public subsidies and transfers, along with the related need to adjust the finances of several major state groups. As a result, during the period between 1990 and 2000 the overall amount of (net) transfers accruing to the corporate sector declined from 3 per cent of GDP to less than 2 per cent (Figure 19, Panel B).[34]

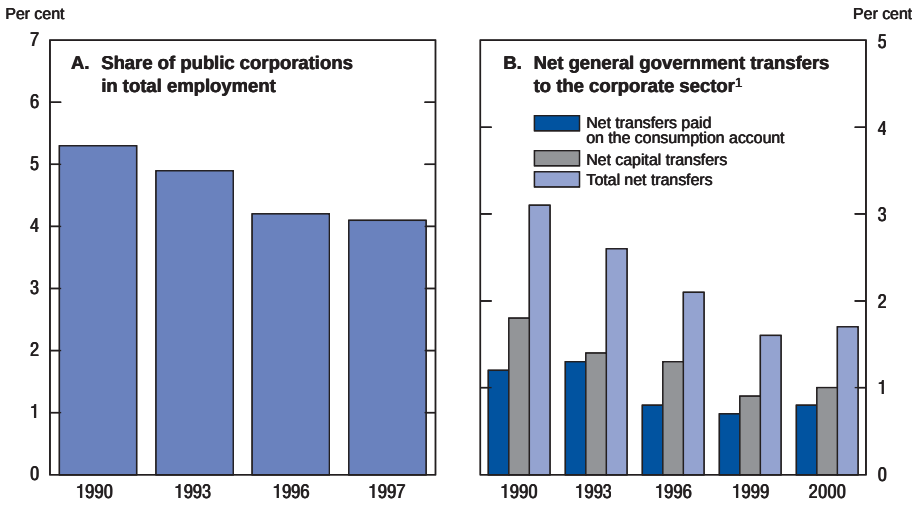
Public administration wages

Table 19 measures compensation per worker in the public administration against the private sector benchmark (private dependent employment). On this basis, the general government is characterised by high per-capita wages, although it is difficult to determine whether this reflects higher human capital in the public administration or other factors. Moreover, as discussed in Chapter II, public sector wages were allowed to increase quite substantially in 2001. Also, local governments have experienced sizeable wage gains over the 1990s, suggesting that wage moderation is needed at all levels of government.

There are regional asymmetries in the distribution of government jobs. Public employment is equivalent to 7.7 per cent of total population in both the Centre (excluding Rome and its surroundings) and the *Mezzogiorno*, compared with 7.0 per cent in the North (Table 20). Measured as a proportion of total employment, the concentration of public employment is particularly pronounced in the *Mezzogiorno*, also reflecting a lower employment rate. Given this background and

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Figure 19. **Impact of privatisation on public spending**



1. Including subsidies.
Source: ISTAT, Ministero dell'Economia e delle Finanze.

the context of relatively uniform per capita wages across regions, it is not surprising that the overall public workers' wage bill in the Centre-South of Italy is higher than in the North, as a percentage of regional GDP. It is much higher in the South alone, though the share of the *Mezzogiorno* in the total public wage bill has declined over recent years (from 39.8 to 36.1 per cent between 1996 and 1999).

Table 19. **Per capita public employment compensation**[1]

	General government	Central	Local	Social security
1990	132.5	139.2	120.9	185.7
1993	126.2	133.7	114.0	164.6
1996	129.2	136.3	118.3	175.3
1999	133.4	138.7	125.6	159.8
2000	133.2	134.5	130.1	167.7

1. Percentage points of the corresponding indicator for the rest of the economy including social security contributions using dependent employment figures.
Source: OECD calculations based on ISTAT figures.

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Table 20. **Regional public employment and compensation**
Percentage values, 1998

	All Italian regions excluding Lazio[1]	North West	North East	North	Centre excluding Lazio[1]	*Mezzogiorno*
Regional output	100.0	36.3	24.9	61.2	11.8	27.0
Regional population	100.0	28.8	20.1	48.9	11.1	40.0
General government employees as a percentage of:						
Total population	7.4	6.6	7.5	7.0	7.7	7.7
Total employment	18.6	14.7	15.7	15.1	17.6	25.2
Compensation per worker in the general government	100.0	98.6	99.8	99.1	101.3	101.0
General government compensation as a percentage of GDP	12.0	8.5	9.9	9.1	12.0	18.8

1. The Lazio region comprises Rome.
Sources: OECD calculations using ISTAT figures.

Correcting the deficiencies in public spending management and control

In some OECD countries, a strategic role for expenditure management is assumed by the executive authority, and within the government by the ministry in charge of the budget. In others, budgetary powers are shared between the executive and the legislature.[35] Neither model is intrinsically sounder from a spending control viewpoint, but the second requires well-adapted institutions or close constitutional constraints to ensure policy cohesion between economic and financial objectives and effective co-ordination between overlapping authorities. The public economy literature suggests that budgetary rules and the transparency of the budgetary system may affect the size of public expenditures and hence fiscal performance.[36] The 1997 *Survey* criticised the Italian system of expenditure management both for its emphasis on legal and procedural compliance rather than on the specification of objectives and assessment of performance, and for its fragmentation and complexity at all stages of the budgetary process (see Box 3). At the operational level, poor human resource management is a problem, because of lack of wage differentiation, labour mismatches and failure to devolve managerial competencies. Also, inflexible bureaucratic structures, complex administrative procedures and inefficient and non-competitive procurement processes give the system a reputation for poor quality of service provision.

A comprehensive reform strategy for the modernisation of administrative and budgetary procedures was launched during the early 1990s, gaining significant momentum in the last few years, and targeted at the efficiency of the public

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Box 3. Main weaknesses of the Italian budget

The Italian budget system has exhibited major structural problems in public spending management, because of *i*) an intricate and formalistic budget review and approval process; *ii*) complex accounting methods; *iii*) the absence of effective cash control mechanisms at the implementation stage; *iv*) the lack of incentives for agencies and line ministries to perform efficiently and *v*) weak auditing processes.

An intricate and formalistic budgetary process. Budgeting involves multiple Ministries and/or Departments and a proliferation of budget chapters and items. For historical reasons, budget preparation reflects a strong legalistic approach, where economic constraints come into play only at a later stage. A distinct feature of the Italian budget process lies in the need to comply with a broad range of legislative details, to the detriment of both clarity and scrutiny.

The budget process moreover is based on multiple budget concepts and documents which tend to differ in terms of timing, accounting basis and sectoral coverage. This complicates the organisation of the calendar for budgetary discussions and generally impedes parliamentary evaluation. The Parliamentary debate effectively centres on the size of policy measures (*manovra*) needed to bridge the gap between the trend deficit (*fabbisogno tendenziale*) and the deficit target (*fabbisogno programmatico*) of the general government. This encourages recourse to one-off revenue measures, the efficiency and durability of which are hard to predict, but which has probably tended to impede coherent structural adjustments to public spending and borrowing.[1]

Complex accounting methods. The existence of wide differences in out-turns between cash and accrual accounting methods complicates control and monitoring. While the underlying accounting method used by the State is in cash terms, the accounts of the general government, which is the relevant entity for the Maastricht evaluation criteria, are expressed in accrual terms. Reflecting the lack of a full set of reconciliation data, opportunities for transferring expenditures off budget are enhanced, which in turn means that the financial bill cannot effectively satisfy the key function of bridging the gap between the trend and the target deficit. In addition, the existence of wide and highly variable disparities between cash and accrual accounting methodologies, a major concern during the recent past (Chapter II), further compromises the effective control and monitoring of budget developments.

Absence of cash constraints. The responsibility for the management of the state cash resources falls upon the Ministry of Treasury (now the unified Ministry of the Economy and Finance, *Ministero dell'Economia e delle Finanze*) and specifically the Department of the *Ragioneria Generale dello Stato*. Although the local authorities and the other public agencies are required to deposit budgetary transfers and own resources (local taxes, charges or borrowing) in accounts held with the Treasury, the extent to which the executive can curtail spending is constrained. Neither are there effective cash limits at the state level because of the practice of allowing carry-overs from previous years. Thus, the budget law specifies line-item limits on a commitment basis (*autorizzazioni di competenza*) but allows unspent appropriations to be "carried over"' for two years (five years for capital spending). Annual cash resources (*autorizzazioni di cassa*) are determined as the sum of appropriations plus

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Box 3. **Main weaknesses of the Italian budget** (*cont.*)

carry-overs (*residui*). These are converted into cash figures by the application of standard, notional, "realisation coefficients" for each economic category. Moreover, at times, cash resources of one state agency have been used to meet needs of other institutions, leading to deferral of payments or additional general government borrowing.

Although the carryover phenomenon is common to many countries, an Italian peculiarity lies in the fact that the amount of carry-over is not accurately specified in the budget law. The cash figures on a programme-by-programme basis are not subject to Parliamentary approval and are usually available with long delays, creating uncertainty about the actual availability of cash resources. This makes resource allocation amongst sub-programmes and management of public services difficult. When Parliament approves a budget, this is based on a preliminary quantification of carry-overs, which, because it is drawn from a limited range of information, tends to be underestimated. This feature can exacerbate expenditure management problems, insofar as it creates uncertainties about the actual availability of cash resources.

The institutional and legal framework imposes stringent rules on budgetary decisions, with the Constitutional Law (Article 81) requiring that any additional spending must be covered by offsetting expenditure cuts or additional revenues (*copertura*). But the safeguard can be circumvented temporarily when external agencies, not covered by the Central State budget (*e.g.* social security funds) or local governments overspend with respect to initial targets. Thus, extra general government spending can arise even when the *copertura* requirement is formally met. Overestimation of offsetting measures has at times weakened fiscal discipline.[2]

Inadequate audit and evaluation. As concerns audit and evaluation, special emphasis has been given to legal compliance, at the expense of internal – *i.e.* agency or department specific – performance evaluation, and this has probably impeded the diffusion of cost-benefit and cost-efficiency practices in programme selection. Within this framework, control procedures mainly take the form of conventional *ex ante* and *ex post* review of conformity with existing legislation. The burden of performing these activities falls upon Parliament and the Audit Court (*Corte dei Conti*) – whose initiatives, according to its critics, are excessively focused on the strict interpretation of the financial regularity of accounts rather than value for money audit.

1. See Alesina *et al.* (1998).
2. Cassese (2000), pp. 195-218.

administration. It has involved the processes by which decisions are taken and the introduction of market mechanisms into the civil service sector, both addressed at producing better working methods and enhancing the quality of the services

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delivered. In addition, measures have been taken to improve the budget management framework.

Pathways to state budgeting reform

Streamlining budget administration

A principal area of reform has related to the streamlining of the activities of the central government, *via* ministerial consolidation. Until the mid-1990s, the Budget Ministry supplied the underlying macroeconomic assumptions, the Ministry of Finance was responsible for the revenue projections and the *Ragioneria Generale dello Stato*, itself a branch of the Ministry of Treasury, was involved in the quantification of expenditures in co-operation with various spending ministries. Since then, Budget and Treasury have been merged, and then Treasury and Finance unified in 2001, leading to the creation of the Ministry of the Economy and Finance (*Ministero dell'Economia e delle Finanze*). The reorganisation is too recent to draw a conclusion about the magnitude of the results achieved. While the original aim of the reform was to reduce the overall number of Ministries from above 20 to some 15, this has yet to occur.

In 1997 expenditures were reclassified, with a view to reducing the management and organisational problems arising from the fragmentation of the budget into many detailed items.[37] The number of budget chapters and items (some 5 000, initially) was drastically reduced. The 400 or so budget forecasting units (*unità previsionali*) were subsequently consolidated into homogeneous spending areas, which were placed under the responsibility of the various Ministries with spending authority. These changes have contributed to a simpler and more accountable public administration, creating a more transparent budget process, by drawing a clearer line of demarcation between political and managerial responsibilities at the implementation stage. However, the links between financial resources and policy targets are still quite vague, so that in many instances the activities of the forecasting units remain primarily focused on fulfilling bureaucratic obligations, rather than implementing a cost-benefit approach.

Further reforms were carried out in 1999 to speed the process of approval of the annual budget law (Legge Finanziaria).[38] This required making the calendar for presentation of the various documents involved in the budget process more efficient, while also separating the approval of the annual financial bill from the examination of the different instruments "connected" with the budget decision process (the so-called *provvedimenti collegati*). By shifting the discussion of such instruments to after the approval of the annual fiscal manoeuvre, risks of overlapping and delays have been considerably reduced.

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Better strategic fiscal control

Major institutional challenges were posed following EMU entry by the adherence of Italy to the convergence parameters of the Stability and Growth Pact (SGP), providing an opportunity to encompass within the medium-term plan (DPEF) a more rigorous analytical presentation of the underlying forces shaping the economy.[39] The disciplining role of the DPEF has been enforced by the introduction of a proviso establishing that net borrowing under the annual financial law is to be defined in a way consistent with the targets set by the DPEF. Any deviation from this rule (from unexpected cyclical economic developments, for example) has to be agreed by Parliament.

Clearer rules and more enforceable procedures and controls, together with the building of mutual trust, now assist the working relations between the government and the Parliament. The Parliamentary office in charge of the budget law can devote a greater proportion of its resources to evaluating fiscal targets and their adherence to the underlying macroeconomic assumptions. Less emphasis than previously is placed on compliance with detailed legal definitions of programme entitlements. On the other hand, prominent attention being given to the state net borrowing targets during the budget preparation stage may divert attention from effective Parliamentary scrutiny of current expenditures. The Audit Court's bureau which is responsible for preparing an annual *ex post* report to Parliament, remains under-staffed.

Accounting improvements

The quality of control is most closely linked to the issue of accounting. If the relationship between budget provision and resultant spending is relatively close, it is less likely that in financial auditing the need to "recalculate the sums" will take prominence over performance assessment at the agency level, which is key to ensuring value for money.[40] An important precondition is the move from cash-based to accrual accounting (as has been done in New Zealand and Australia, for example) and this is now being introduced in Italy in connection with the SGP. Implementation of a fully-fledged system of quarterly fiscal accounts on an accrual basis, though in the pipeline, may require several years. However, the adoption of the European accounting requirements has not been matched by a decline in emphasis on the cash-based side of the budget system, which still risks distorting the picture of the country's fiscal situation (Chapter II).

Improving human resource management

Recognising that a major source of waste and inefficiency relates to the lack of a proper controls and sanctions at the agency level, human resource management was finally implemented with the reforms launched in 1992. These

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attempted to introduce techniques of private sector management into the public administration and to de-politicise the status and career of civil servants. Changes in personnel management are critical for motivating public-sector workers and supporting staff morale. Incentives for enhanced performance have been built into management contracts, backed up by intensive training of managers. New performance evaluation and merit-based career systems have been established. Following these developments, the proportion of managers hired under fixed-term contracts at market-related salaries has increased. As yet, however, the reforms impose strict ceilings over the number of public jobs open to private sector applicants and focus virtually exclusively on higher-skilled civil servants.[41] Thus, they have largely failed, so far, to effect a change in the culture of mid- and lower-level civil servants, which is much needed to achieve a substantive modernisation of the public administration.

To address the lack of performance-related incentives for civil servants, human resource management was reorganised in 1999, focusing on the creation of internal (ministry-specific) evaluation and audit units, while the merit-based payment system was improved. Following these initiatives, the first labour contracts under the new provisions became effective from 2000. Jurisdiction for civil service sanctions and disputes has been moved from the administrative to the civil courts, while the criteria for controlling and sanctioning local government performance have been harmonised. Recent years have also seen the introduction of a pay determination system whereby new labour contracts for civil servants are to be bargained collectively. (Formerly, their pay was set by Parliament through an annual law thereby further complicating the budget approval process.) In parallel, a special agency was created to represent the state as the employer in negotiations with the unions. The law governing union representation was also reformed and part-time work was permitted in the public administration.

Simplifying public service delivery

The above changes have been complemented by the creation of the mandatory Citizens Charters (*Carte dei servizi*) for public services, including transport and health care. One year after their introduction in 1997, almost 7 000 agencies and local governments had adopted their own charter, specifying their standards. Innovations have included disclosure of public servants' salaries. As part of a widespread programme of regulatory simplification begun in 1996, successive initiatives have been launched to reduce duplication of functions among ministries and governmental departments. Since 1999, an Annual Simplification Law sets measurable short-term targets for eliminating and improving administrative procedures and for reorganising the functioning of governmental institutions, including the consolidation of ministries and/or their departments. Measures have also

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been introduced recently to secure the preparation of routine regulatory reviews of the quality of new laws and regulations.

The OECD report on regulatory reforms in Italy (OECD, 2001) stresses that reform of the regulatory state is a formidable and long-term task due to the legacy of decades of regulatory complexity, corruption and inefficiency. It goes on to say that, while the above reforms to streamline government are ambitious, they have not been very accountable with respects to results, so far – and there is still a tendency to estimate progress in terms of legal changes rather than concrete outcomes.[42] But the report also affirms that early results are now becoming concrete in other areas, such as declining administrative costs for citizens. Moreover, the broad regulatory quality strategy built over the past decade includes new procedures and institutions, most importantly new competition watchdogs. Since 1997, Italian simplification efforts have concentrated on two high profile projects aimed at easing the lives of citizens and businesses: self-certification and the one-stop shop (see Chapter IV).

More rational public procurement

Historically, the Italian public procurement system has been characterised by restricted tenders as opposed to open tenders, by a lack of clear specifications and award criteria, and a complex legal framework. This has translated into costly public contracts and a significant gap between planned and effective costs compared with other European countries.[43] However, public procurement procedures have become more transparent in recent years, partly as a response to the active role of the EU in ensuring a more open public procurement market.[44] Access to information has been assisted by the implementation of electronic procurement, with foreign trading partners recognising that access of their firms to Italian public contracts has become easier more recently. Measures have begun to be implemented to introduce a fully operational internet system of government purchases (Chapter II).

The planned reorganisation of the public purchasing network is based upon an initiative by the former government of December 2000, whereby purchases made by all central government entities are managed by a new central agency (C*onsip*) which stipulates purchasing conventions with private suppliers. The new initiative does not extend to the local governments, although they have been granted free access to the Consip's information network. While the fiscal benefits of a truly integrated purchasing system can be large, these may not be forthcoming unless proper mechanisms to preserve competition among potential suppliers of goods and services are established.

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Towards a more effective investment strategy

The OECD "growth project" suggests that public investment can have a significant effect on output growth.[45] Government investment does not seem to influence the rate of private capital accumulation, but it may affect growth by improving the framework conditions in which private agents operate. For example, high quality public investment in R&D, transport, communication and infrastructure, to the extent that it generates high economic and social returns, can help to create an environment conducive to entrepreneurship, innovation and private sector activity. Similarly, efficient government spending on education should improve the stock of human capital.

Recognising this, the former Italian government devised a new investment programme for the period 2000-2006 envisaging the use of 48 billion euro – approximately 4 per cent of 2000 GDP, almost equally split between European fund and national co-financing – for public investment in the M*ezzogiorno*. Following approval by the EU (August 2000), the plan was endorsed as the new Community Support Framework (CSF) for the Italian objective 1 regions. Under the new programme, regional governments are responsible for allocating 70 per cent of total funds of which most is destined to infrastructure projects (including transport, infrastructure and water). By 2003, when the programme will have become fully operational, the share of nationally financed public investment in total domestic investment will be around 13½ per cent, thus eliminating the current 1½ percentage points gap relative to the average of the OECD countries. The Ministry of the Economy and Finance has defined, in collaboration with the European Commission, the set of new rules underlying the allocation of the funds and has been entrusted with general supervisory and co-ordination tasks over the design and implementation of regional plans.

Among the recent reform initiatives included in the "100 days package", a major one has been the presentation to Parliament of a draft law designed to enhance public infrastructure investment (known as the L*egge obiettivo*, Strategic Infrastructure Law). The new regime will apply to strategic infrastructure, *i.e.* those projects considered to play a pivotal role in the growth and modernisation of the country. Strategic infrastructure is to be identified yearly by the central government in consultation with the local authorities. The government's intention is to introduce a fast track investment process, based on reduction of red tape and simpler procedures for administrative authorisations, and to create greater public accountability *via* a system of surveillance and support by the central government over the awarding authorities. The law also introduces a new institution, the general contractor, to speed up the building of infrastructure; in parallel, the government plans to dismantle the Authority for public works (A*utorità per la vigilanza sui lavori pubblici*, created by the Merloni laws but becoming operational only in 1999). Once the new law is approved, the government will enact implementing legislation

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to set out specific procedures for administrative approvals and concession contracts, in line with EC public procurement rules The law thus aims to provide the market with clear and simpler rules for the administrative approvals process, while signaling heightened political commitment. In this sense, it does not necessarily imply a drawback from the recent strategy to enhance the growth potential of the *Mezzogiorno*, which stresses the public-private sector partnership. On the other hand, a strongly centralised strategy for strategic public investment without independent oversight may not be consistent with the shift towards greater spending transparency. Enhanced surveillance is a key precondition for bringing the Italian public works system fully into line with international best practices.

Issues in fiscal federalism

As part of the strategy of public sector reform, Italy has been undergoing a process of decentralisation. As a result, the Italian governance system has characteristics both of a centralised state, with its close control over local spending, and a federal model, with its focus on local taxes as a means of financing a large part of local expenditure programmes. Currently, the local (*i.e.* regional, provincial and municipal) authorities account for some 40 per cent of total general government employment (Table 17). Local government consumption and investment spending total around 60 per cent of the general government total, equivalent to 12 per cent of GDP for 2000, a high proportion compared with other centralised states but low relative to federal states (Table 21). Neither the centralised model nor the federal

Table 21. **Shares of local governments in overall receipts and expenditure**[1]

	Italy	Canada	France	Germany	Japan	United Kingdom	United States
	In per cent of GDP						
Consumption spending	**9.6**	16.1	5.5	9.7	7.6	7.4	9.7
Capital spending	**2.3**	1.8	2.0	1.7	4.9	0.8	1.5
Total	**11.9**	17.9	7.5	11.4	12.5	8.2	11.2
Taxes	**5.9**	17.6	4.8	11.3	7.4	0.1	10.0
Transfers received from public entities	**5.1**	3.8	2.9	2.4	5.5	7.9	3.0
	In per cent of general government						
Consumption spending	**46.8**	73.1	30.6	70.1	47.6	33.3	55.5
Capital spending	**11.5**	8.3	11.0	12.2	30.6	3.7	8.5
Total	**58.3**	81.4	41.6	82.3	78.2	37.0	64.0
Taxes	**20.1**	53.9	19.2	49.9	41.3	0.1	42.6
Transfers received from public entities	**17.3**	11.6	11.6	10.6	30.7	79.0	12.8

1. In 2000 or nearest year available.
Source: OECD and Ministero dell'Economia e delle Finanze, *Relazione generale sulla situazione economica del paese*.

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one is intrinsically better from the point of view of expenditure control, although if the right conditions are present, the latter can impart important efficiency gains to the budget and the economy at large (Box 4). But based on the below analysis, the existing arrangements between central and local authorities have not enhanced spending discipline. Revenue and spending autonomy at the lower levels of government appear not to be closely matched, with accompanying incentive and co-ordination failures.

The objectives of decentralisation

In concept and design, reform has been motivated by both fiscal policy and regional development concerns. In the first stage, during the 1970s, decentralisation on the spending side began with the assignment of health care, local transport, manpower training, and environmental policies to the newly created "ordinary statute regions", according to constitutional mandate. (The spending responsibilities of provinces and municipalities had already been established in 1934, and those of the five "special statute regions" in 1948.) Expenditure devolution was coupled with an enhanced redistributive role for central government to reduce the regional disparities in the ability to finance and deliver a consistent quality of services. A curious feature was that, as the devolution of spending responsibilities to the regions began, taxing power was taken away from the municipalities and substituted by a system of grants from the national government, which extended to the new regions as well.

The second phase of decentralisation, during the 1990's and still ongoing, was a reaction to the evident failure by the initial devolution model to achieve its objectives. *First*, centralising taxation while decentralising spending led to a loss of general government spending discipline.[46] The corruption scandals at the beginning of the 1990s (*tangentopoli*) brought into sharp relief widespread waste of public funds due to years of poor co-ordination among procurement agencies and extensive collusion between suppliers and local administrations. *Second*, development in the poorer regions was obstructed by an over-dependence on transfers, while equalisation of per capita resources produced no convergence in service quality and gave no incentives for better governance. The decision was made to devolve a broader range of activities and powers to both the regions and municipalities, and the movement was termed "administrative federalism". The "Bassanini reforms" of the late 1990s then sought to increase the capacity of lower-level administrations to undertake their new functions.

In terms of actual amounts of spending devolved, the 1970-1985 phase was by far the more significant: subnational government spending doubled from 7 to 14 per cent of GDP. After remaining broadly constant, the administrative federalism phase accounted for a further increase of only about ½ per cent of GDP. In the past year, however, new "rules of government" have emerged and been locked

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Box 4. The attainment of efficiency gains from fiscal devolution

The arguments for fiscal devolution

The arguments in favour of fiscal devolution include the following:

- S*ubsidiarity*: with devolved government the diversity of preferences across jurisdictions would be better reflected in local spending patterns; this yields a welfare gain, *i.e.* better allocational efficiency.
- C*ompetition*: local jurisdictions would be able to compete with each other for tax bases, leading to lower tax rates, greater fiscal discipline and heightened operational efficiency of the public sector. Devolution brings the principal and agent together, promoting accountability of local administration on issues of a truly local nature.
- D*emocracy*: devolution would give a boost to local democracy by "empowering" citizens.

The theory underpinning this view (developed by Musgrave, Oates and Tiebout), in turn, rests on three basic assumptions:

i) Local public goods are by nature non-distributive – *i.e.*, the poor and wealthy equally benefit from public goods provided by local governments. Voting behaviour is therefore guided by efficiency rather than equity motives.

ii) The benefits from local public spending are fully internalised in local resident taxes. In other words, local jurisdictions are neither exporters nor importers of public goods. There are no inter-jurisdictional conflicts over "who should pay the bill".

iii) Voters are mobile, therefore the pressure on local governments to offer value for (tax-) money is strong.

Caveats

Clearly these conditions are only partially met in reality and central governments rely on the following mechanisms to tie the hands of local governments:

- Local governments have the possibility to raise user charges or property taxes to test voter's willingness to pay at the margin, but the bulk of local government funding is based on a formula sharing source taxes with the central government. That is, local tax autonomy is really undesirable, if social equity is a stronger priority.
- Formula-based block grants (untied grants) or horizontal transfers are further used to achieve equalisation of potential revenue and expenditure across local jurisdictions. Conditional grants may be justified where there is evidence of strong inter-regional spill-over effects, but strict limits are needed.
- Fiscal rules or borrowing controls are enforced to limit deficit spending. A co-operative approach may be a useful complement or even substitute for mechanical rules.

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Box 4. **The attainment of efficiency gains from fiscal devolution** (*cont.*)

However, such "solutions" have the potential to create new problems of their own which could ultimately undermine the rationale for devolution. In particular, excessive controls emanating from the centre may obscure local administrations' accountability to local citizens, while overly generous equalisation formulas weaken the incentive of tax competition (100 per cent equalisation eliminates it). The advantages of fiscal devolution may also cease to exist in cases where functions are inappropriately devolved to lower levels, *e.g.* not truly local goods or those benefiting from clear economies of scale, or where local governments suffer from a poor capacity to implement spending. According to the basic principles of fiscal federalism, the central government should have the responsibility for macroeconomic stabilisation and income redistribution, as well as other functions providing clear collective benefits or spillovers (national defence, R&D). Local governments are usually best placed to provide merit goods and services, where local preferences are likely to differ from any given set of uniform national standards.

Welfare could even be reduced if soft budget constraints were to arise as a consequence of devolution. In Italy's case, an unclear division of national and local competencies, *e.g.* in the area of health, and conditional grants taking on the character of entitlements, have prevented full fiscal responsibility in the receiving governments. For budget constraints to be binding, lower level governments should not be able to rely on transfers from above to bail them out of financial difficulties. But where arms-length relations with financial markets cannot be assured or local governments cannot be allowed to suffer the consequences of their own mismanagement, there is little alternative to maintaining tight central control over their spending and borrowing. Exercising strong central control, in turn, requires good provision of information and a strong reporting system, elements also missing in the case of Italy.

into the constitution by a set of amendments. These take Italy closer to a fiscal federalist model and enlarge the scope for future devolution.

Contradictions in the devolution of spending

The devolution of functions was from the outset financed almost totally by tied transfers, the intention being to assure adequate funding and standards of service in particular in the health and transportation areas (Table 22).[47] But this left central government in *de facto* control of many activities. To counter the risk that further decentralisation might exacerbate already large inter-regional discrepancies in service performance, the 1990 framework law reforming local administration reaffirmed the constitutional requirement that a standard level of service must be guaranteed to all citizens, and established the principle of the responsibility of

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Table 22. **Functional breakdown of regional government expenditures**

Percentage

	Ordinary statute		Special statute	
	1992	1999	1992	1999
General administration	4.8	5.7	8.1	10.5
Justice	0.0	0.0	0.0	0.0
Police	0.0	0.7	0.4	0.3
Education and culture	1.4	5.0	4.8	10.5
Housing[1]	1.1	0.0	3.5	0.0
Social affairs[2]	78.3	62.5	46.5	35.7
Transport	6.2	6.6	3.7	2.2
Economic development	5.9	10.7	16.8	14.8
Non attributable	2.0	6.1	12.0	7.3
Repayment loans	0.3	2.7	4.2	9.1
Total current expenditure	86.7	82.9	60.3	70.4
Total capital expenditure	13.3	17.1	39.7	29.6

1. For the provinces, expenditure on housing is included in social action.
2. Mainly health care for the regions, mainly social welcare and public health for the provinces and municipalities.

Source: Ministero dell'Economia e delle Finanze, *Relazione generale sulla situazione economica del paese*.

managers (managers of Local Health Units, public hospitals, university hospitals, etc.), ostensibly in support of this goal. In their practical application, however, the two principles have collided, as the powers of local managers are severely limited by overlapping responsibilities. For example, co-payment rates for drugs[48] and salaries of health workers, school equipment and teachers' salaries, transportation tariffs, and rules for hiring and firing are strictly controlled at the central level. To a large extent, central intervention has reflected its own (non-transparent) pursuit of social and employment policies. Efforts by regions to control expenditures or adapt them to local circumstances have in such ways been repeatedly frustrated, particularly in the area of health care. As a consequence, the constitutional court is constantly taking decisions on the proper boundary between national interest and regional autonomy. The imposition of specific "essential" standards in health care provision also creates moral hazard in that regions can come back to the central government and demand higher transfers in order to cover the extra cost to them of providing such levels of service.[49]

Regional autonomy has also been frequently challenged in the area of regional development, and this has stymied efforts to develop local initiative in the southern regions. The central authorities have long doubted the lower level administrations' ability to manage public investment projects properly. Access to central funding was conditional upon satisfying complex procedural requirements which often resulted in long delays in realisations and unfinished projects.[50] With the lack of autonomy tending to reinforce initial conditions of poor administrative

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capacity in the lagging areas, northern and central local governments have remained consistently better performers than their counterparts in the south despite roughly equalised per capita expenditure levels due to equalising transfers. To tackle these problems, recent policy action has thus been directed at improving local administrative capabilities for evaluation, through the promotion of a network of technical units in central and local administrations.

Incentive effects of financing arrangements

Conditional grants have been a main source of perverse incentives in regions, since they were set largely with reference to the previous year's expenditures and without any reference to objective performance criteria, and thus provided a constant incentive to overspend. These arrangements have further been perverted by the budget process (see Box 5). The central government had an incentive to underfund *ex ante*, under the pretence that regional expenditures could be thus controlled, or to limit the apparent deficit at the time of budget approval. The resulting local deficits were financed by arrears to suppliers and borrowing from banks, so as to bypass legal limits on borrowing by subnational governments.[51] The government periodically cleared the informal debts of the regions *via* capital transfers every two or three years for health and every three to five years for transport, thereby implicitly rewarding high or inefficient spenders. These off-budget operations amounted to about 6 per cent of budget appropriations in the health sector in 2000 (Table 23). An attempt was made in 1993 to limit grants in both sectors to a notion of "standard" per capita costs and own revenue capacity, with the intent of punishing any deviation in actual from standard costs (which would have to be covered by raising new regional taxes). However, the efforts failed due to the inability to define standard costs.

Reforms entered a new phase with the devolution of tax power and counterpart withdrawal of conditional grants since 1993. Tax devolution has taken two distinct forms:

- The assignment of some autonomy in determining tax rates as well as tax bases to lower level governments, notably the introduction of a regional health payroll tax in 1993, which was transformed in 1998 into a business value added tax, IRAP.[52]
- The sharing of some national tax revenues produced in the regional or municipal authority, notably the personal income tax.

Yields from the new tax sources were to be deducted one for one from transfers, giving no net gain in the short run. In the longer run, however, the possibility of higher revenue growth from own tax sources should have given subnational governments an incentive to encourage local growth, as well as to be more efficient in spending in line with the principles of tax competition.

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Box 5. Budget control and co-ordination problems at local levels

Inadequate co-ordination between central and local government

Many of the defects noted with respect to national budgeting are replicated at the local level, where a complex and legalistic budgeting system makes for a lack of budgetary control and oversight either internally, by citizens, or by the national government. Even though regional and local administrations are the major providers of public services, present accounting methods do not include assessment of the economic costs of such services, either in the project selection or evaluation phases of the budget process. Auditing is mainly internal, non-professional, and purely formal (to make sure no laws were broken).[1] The ability to make economic choices is limited by a lack of flexibility in the use of conditional grants. The inherent lack of accountability and flexibility, in turn, provides little incentive to innovate, especially in regions with low administrative capacity. Popular expectations of local and regional governments are low as dissatisfaction with the services rendered focuses on the central government, which is blamed for insufficient and delayed funding and for imposing inflexible rules on the use of funds and provision of services.[2]

Poor co-ordination with the central government exacerbates these problems. Deliberate *ex ante* underfunding by the Treasury has made for high budgetary uncertainty, which also entails direct economic costs. Delaying provision for local capital projects can increase their costs, while diverting borrowing to commercial banks may allow non-economic projects to proceed due to the implicit government guarantee on the loan. Allowing the local health units to go into arrears encourages suppliers to add a premium to their prices, in expectation of delayed payment. The central government does a poor job in collecting information on aggregate budgets or monitoring spending, and getting data with a long lag in large part because of the lower levels' financial dependence on central government itself.[3] Responsibility for distributing grants to and monitoring regional and local governments rests with Treasury and the Ministry of the Interior, respectively, but there has been little co-ordination on sub-national matters between the two.

The challenge of the Internal Stability Pact

In the context of the Stability and Growth Pact, the national government makes budgetary commitments to the EU on behalf of the general government, so that compliance concerns all levels. The 1999 financial law ushered in the so-called I*nternal* S*tability* P*act*, imposing deficit reduction *vis-à-vis* a no-policy-change baseline on subnational governments, with a co-operative mechanism, mainly in the context of the regional and mayors conferences, to deal with corrections of eventual overshoots. The global reduction was apportioned among the three subnational layers of government (regional, provincial and municipal) as well as single governments according to their levels of primary current expenditure. The deficit governed by the rule is on a cash basis, and excludes capital spending and interest payments on the expenditure side, and central government transfers on the revenue side. There is also a rule on debt, which however is poorly defined: given that pre-existing rules allow borrowing for capital expenditures up to the limit where debt service equals 25 per cent of own revenues, a large potential for borrowing and fiscal expansion seems to exist with the growing devolution of tax bases.[4]

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Box 5. **Budget control and co-ordination problems at local levels** (*cont.*)

Although the pact provided for the timely provision of data (by both regions and local governments above a certain size) on evolving budget positions, problems in monitoring have arisen because of continuing reporting and accounting difficulties (EU-level commitments are on an accruals basis and refer to a net lending definition of the deficit). The pact was continued under the financial laws for both 2000 and 2001. The latter included for the first time the obligation by regional and local governments to show, *ex ante*, that budgets submitted for approval to local and regional assemblies meet the targets assigned to them. Another provision of the same bill required regional governments to raise taxes if expenditure on health should be higher than target. The latter has been highly disputed, not enforced, and may be suspect on constitutional grounds.[5]

Overall, such co-ordination problems have led to a poor performance under the pact, particularly in the area of health spending. A more fundamental problem, perhaps, has been the lack of effective sanctions on non-compliance, apart from the sharing of sanctions which might be imposed at the European level on Italy. Indeed, the pact could even serve to perpetuate the soft budget constraint by encouraging free-riding. Even if recouped later on (itself doubtful), any budget overshoot at the sub-national government level must be compensated in the current year by the central government, given that it would be the one to bear most of the reputational costs of any breaching of the Maastricht ceiling.[6] The August 2001 health agreement with the regions featured an attempt at sanctions, by making full central funding conditional on the adoption of certain spending measures (Chapter II).

1. For local governments, the 1990 framework law provided for an external Board of Auditors consisting of professionals. All public entities were to use cost accounting, and while still retaining the cash reporting were also to use accrual accounting. However, these provisions have not been implemented. In the case of local governments, accounting is still regulated by a 1934 national law, so that additional national implementing legislation is required to establish accrual accounting. Also, local administrators have generally been unable to solve the technical difficulties in implementing a cost accounting system.
2. See Emiliani *et al.* (1997).
3. Regional budget formulation begins only when the central government budget is approved by parliament. Only when the regions know their tax rates and grant amounts, can their own budgeting begin. Then the regional budgets must be submitted to the national government, which has a 30-day statutory period to approve or comment (it cannot reject them). Meanwhile, the first quarter's operations are conducted on the basis of the appropriations for the first quarter of the previous fiscal year. Moreover, the Treasury is reluctant to release the grants, even those budgeted for – they require continuous prodding by the regional governments. See Emiliani *et al.* (1997).
4. Balassone and Franco (1999).
5. See Giarda (2000).
6. Balassone and Franco (1999) point out that apportioning the required effort across sub-national governments according to their levels of primary current expenditures is also unfair: not only does a government which is already running a surplus have to contribute to the effort, but if its level of current primary spending is high, it may be required a larger effort than a government running a large deficit. The pact also does not attempt to deal with the impact of the cycle on lower level budgets, just as devolution of taxation is making these budgets more cyclically sensitive than before.

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Table 23. **Public health care expenditure overruns**[1]

Trillions of lire

	1995	1996	1997	1998	1999	2000
Financing	92 502	97 849	99 993	105 416	112 958	124 586
IRAP[2]	47 089	50 550	51 442	55 037	50 288	55 920
State transfers	38 350	38 864	38 432	39 702	51 519	52 787
Other own revenues	3 933	4 163	4 645	4 947	5 269	9 055
Special statute regions	3 130	4 273	5 474	5 730	5 883	6 824
Spending	93 801	101 819	110 394	114 588	120 380	132 454
Deficit	–1 299	–3 970	–10 400	–9 172	–7 422	–7 868
As a percentage of spending	1.4	3.9	9.4	8.0	6.2	5.9

1. Figures refer to expenditure of the local health units.
2. From 1998 on, including regional income tax (addizionale IRPE). Prior to 1998, represents other taxes that were replaced by the IRAP in 1998.

Source: Ministero dell'Economia e delle Finanze, *Relazione generale sulla situazione economica del paese*.

However, conditional transfers continued to account for 55 per cent of regional revenues (Table 24), and the same moral hazard problems continued, with regions having no incentive to use their new tax powers to cover health and transport deficits, or alternatively to limit overruns *via* efficiency savings in order to reduce taxes. Furthermore, the central government continued to collect and set

Table 24. **Revenue sources of local governments**

	1992	1996	2000	1992	1996	2000
	Billions of lire			Shares in percentage		
Regions						
Taxes	11 680	23 999	81 499	9.4	17.1	44.2
Social contributions	. .	0	0	. .	0.0	0.0
Sales of goods and services	0	0	0	0.0	0.0	0.0
Transfers	111 990	115 344	100 156	89.6	82.2	54.3
Capital income	510	683	1 267	0.4	0.5	0.7
Others	780	261	1 358	0.6	0.2	0.7
Total	124 960	140 287	184 280	100.0	100.0	100.0
Provinces and municipalities						
Taxes	14 600	31 642	38 081	21.2	40.2	43.7
Social contributions	. .	0	0	. .	0.0	0.0
Sales of goods and services	6 850	8 765	11 441	10.0	11.1	13.1
Transfers	40 390	32 327	30 646	58.8	41.1	35.1
Capital income	1 420	2 340	3 714	2.1	3.0	4.3
Others	5 390	3 551	3 333	7.9	4.5	3.8
Total	68 650	78 625	87 215	100.0	100.0	100.0

Source: Ministero dell'Economia e delle Finanze, *Relazione sulla stima del fabbisogno di cassa*.

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the IRAP during a 2-year transition period, so that it has for the time being remained essentially a tax controlled by the central government.

A major reform of regional financing took place in March 2000, whereby a rules-based system of horizontal equalisation using a portion of national VAT receipts was introduced, abolishing almost all transfers to the regions, at least *ex ante*.The VAT fund is to equalise up to 90 per cent of the differences in standardised per capita revenues,[53] and also assign resources according to health related indicators (age structure or demographic indicators) in order to take into account the constitutional mandate that financing of regions' activities be "needs related". The more transparent footing of intergovernmental fiscal relations should help to stem regional spending overruns, while the fact that equalisation is less than 100 per cent leaves room for incentives to develop local tax bases. There are also potential problems. The "health needs" financing portion, in particular, could be subject to continual upward revisions as health costs rise due to population ageing, especially as the formula for calculating it is unclear.[54] This would tend to shift resources from the poorer toward the richer regions given the much older age structure of the latter, in turn putting upward pressure on the solidarity component and thus damaging incentives as well as credibility of the rule. The high share of own taxes in the form of the business value added tax (IRAP) may also provide little practical fiscal autonomy to the poorer regions, where the tax base is small; in the case of rapid future rises in health spending, they would have to raise tax rates much more than would the richer regions to balance budgets, which could distort business location decisions and further undermine their growth potential.[55] The new system may fail to harden budget constraints sufficiently insofar as bailouts have not been excluded and the phase-in period is rather long (fourteen years), given the time needed by the poorer regions to build up their administrative capacity and to improve their growth fundamentals in order to cope with it. Finally, repeated attempts to replace the (presently chaotic)[56] system for awarding grants at the municipal level by a more equitable, rules-based system have been so far unsuccessful.

Thus, the ongoing reform of financing at sub-national levels has yet to produce tangible results. The situation has been complicated, moreover, by recent constitutional changes which significantly widen the scope for further devolution, importantly including in the area of education, but also having unclear implications for fiscal accountability (Box 6). The new government, for its part, has targeted devolution as an important area of attention in its reform agenda. A major initiative has been the new health agreement with the regions (Chapter II), which by eliminating the harmful practice of *ex ante* underfunding should improve the budgeting process considerably. But despite a financial incentive for implementing specified spending economies, it may not eliminate moral hazard insofar as bailouts have not been explicitly excluded. More generally, the government plans to accord full local spending autonomy while centralising control over funding in

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Box 6. The 2001 constitutional amendments

A set of constitutional amendments in the area of fiscal federal relations was passed by the previous Parliament and ratified by popular referendum on 7 October 2001. The main changes are as follows (see Giarda, 2001):

- *More legislative power for regional governments and differentiated regional autonomy*. Legislative competence belonging exclusively to the central government in certain areas – most notably education – is transferred to a regime of shared responsibility with regions (*i.e.*, national government sets legislation defining "fundamental principles" and regions the implementing legislation). At the same time, concurrent competence in many more areas is transferred to exclusive regional competence. It is, however, up to the regions to ask for these transfers of power, which Parliament must approve. It is not clear how financing arrangements will reflect potentially very differing levels of regional autonomy.

- *More emphasis on regional taxes and sharing of national taxes according to the regional distribution of tax bases*. This is an important change relative to the present constitution, where shared national taxes accrue to a national fund to be divided among regions according to "needs" evaluation. "Needs" will continue to affect financing in areas of concurrent competence, however, probably in terms of a system of block grants (the new text is heavily worded against conditional grants). The reform is thus likely to generate greater interregional differences in service levels: uniformity is no longer an absolute constitutional value.

- *Constitutional recognition and power of execution for sub-regional governments* (*municipalities and provinces*). The power of execution, formerly strictly connected to legislative power, is to be transferred to sub-regional governments, which are also for the first time mentioned in the constitution and accorded equalisation principles formerly reserved only for regions. The reform provides something of an institutional revolution, as municipalities in future might be charged with responsibility in fields such as education, now entirely in the hands of central government agencies. What is not clear, however, is the degree of flexibility that will be allowed in the carrying out of their new functions, nor the accompanying mode of finance. Echoing past problems with devolution, rigid mandates would remove performance incentives and require categorical grants (with full pass through conditions); alternatively, autonomy not supported by tax effort is likely to produce fiscal irresponsibility.

Although deficit financing of subnational current expenditures is constitutionally excluded, past experience suggests that the implied hardening of the budget constraint could be counteracted by the possible loss of fiscal accountability associated with: *i*) the bigger share of public activities that will be managed under the regime of concurrent legislative power, and *ii*) the assignment of execution powers for regional and national competencies to sub-regional governments.

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the areas of health, education, and police. Whether this mix, which seems to be consistent with the new constitutional provisions, will serve to harden budget constraints is debatable and the new strategy awaits further clarification.

Implications for health care spending

Despite a relatively modest level of health spending, Italy does quite well in terms of health outcomes.[57] However, a number of indicators suggest serious micro-inefficiencies in health care supply. *First*, payments to suppliers are increasingly delayed (as seen, the predominant mode of financing spending overruns), and waiting times for medical procedures are long.[58] The premia charged for payment delays have also led to an excessive cost of medical supplies, including pharmaceuticals, equipment, and services. *Second*, there exist large differences across regions in utilisation rates. *Third*, Italy has almost twice the number of doctors per 1 000 inhabitants as the OECD average (4.7 *versus* 2.5), but only one-fourth the number of nurses per doctor (0.6 *versus* 2.4), while almost one-third of hospitals have fewer than the minimum number of beds considered necessary for efficiency and quality of care.[59]

At the macro level, conversely, health care expenditures have been squeezed, in particular in the first half of the 1990s (in the run-up to EMU), when public health spending fell by almost 2 per cent in real terms – unheard of in the OECD context. At present, the health care spending to GDP ratio remains relatively low, but the savings achieved earlier – administrative cuts in wages and input prices and capital spending freezes – were unsustainable. Indeed, health care spending has started to rise very fast since 1995, leading to the observed overruns, and such aggregate demand pressures may be driving this process independently of underlying micro efficiency problems or defective budget co-ordination observed under the internal stability pact. Population ageing implies an aggravation of such pressures in the future. In addition, the experience of other countries shows that the decentralisation of health spending has normally been associated with an increase in spending during a transition period.[60] This also means that it is very difficult to decentralise health care while constraining its spending, as was required for EMU entry and will continue to be required under the internal stability pact.

Assessment and agenda for further reform

Rebalancing public spending

The successive phases of fiscal expansion and consolidation have left the Italian budget with several major compositional and operational weaknesses. Spending in certain areas such as debt service and pensions is high, but in areas such as health, education, infrastructure investment and research, family and

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unemployment benefits, it is relatively low (Table 15). There are important needs to be met in human capital and in infrastructure development, and national resources for health, education and research may need to be increased. The social safety net is meagre, apart from pensions, and unemployment assistance, child and old age care will need to be reinforced in view of labour market needs (it would also enhance the performance of automatic fiscal stabilisers). The challenge is to find the resources to do these things while also facilitating tax cuts.

There are two ways of achieving this: a transfer of resources among programmes and a more efficient provision. In terms of resources allocated to it, Italian pension spending is almost alone in standing well above the OECD average. Indeed, there is substantial further scope for savings in the area of pensions. The 2000 E*conomic* S*urvey of* I*taly* showed that the reforms of the 1990s imply a major improvement in incentives affecting the timing of retirement and a major containment of benefit generosity, but that the phase-in of the reforms is rather slow. Urgent initiatives are needed to offset the increase of pension spending that can be expected when the baby-boom generation enters retirement. Namely: extend the pro-rata system for the calculation of benefits (which at present applies only to individuals with less than 18 years of contribution before 1995) to all workers; step-up the planned phase-out of the incentives to early retirement (*i.e.* retirement after 35 years of contributions and irrespective of the age of the individual); and remove the strong disincentive to working beyond age 64 in the present pension benefits formula. The findings of the Brambilla pension commission, created in the early days of the new government, would appear to strongly support these conclusions (see Annex II). In particular, the slow transition implies a further rise in the pension spending ratio of 0-4 per cent of GDP in coming decades, depending on the long-run rate of economic growth, and a 5 per cent of GDP widening of the deficit of the pension system. The implications are that measures to speed the transition and substantially cut pension spending further will be needed to avoid a severe crowding out of other expenditures in the years to come. Although actions have been taken to diminish incentives during the transition phase to retire early, more could be done in this field.

Achieving greater administrative and economic efficiency

A broad-based personnel reform needs to be further carried out, *via* a greater use of flexible labour forms and increased mobility, including a much needed shift towards a performance-based pay system. However, such a reform would need to be part of a general overhaul of the administrative system. Also, it is possible that initially the reform could lead to higher costs due to the political reality that losers would need to be compensated, though this should not be a reason not to undertake the reform since long-run savings (both directly in the wage bill and indirectly in greater public service efficiency) could be much higher.

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A conclusion of the above analysis is that the system of expenditure control has severe defects which have, in the past, led to involuntary overruns and inefficient resource use in the government sector. Exploiting existing scope for greater efficiencies, both in the specialised agencies and in the provision of general government services, could not only release resources for urgent priorities but also produce a more efficient and equitable economic policy. There are several areas calling out for policy action, and the adoption of cost-benefit accounting would allow for better prioritisation. On present accounting practices, there is no way of ascertaining whether, or by how much, public spending exceeds the point of technical equalisation between social marginal costs and benefits.

Recent reforms have been significant and have gone some way to improving the budget management and control weaknesses responsible for erratic budget outcomes. New methods of budgeting and reporting have helped control spending levels, reducing (until 2001) deficit overruns. Greater accountability and client-orientation are being built into the public administration apparatus. Better incentive structures have been built into civil-service management structures and regulatory reforms have improved the quality of government service provision. Overall, however, the effort is still far from complete if measured against the objectives of establishing an accessible public administration, a fundamentally changed managerial behaviour and a cost-saving organisational culture that is secure against undue influence from special interests. There is still excessive focus on the annual budget, and not enough attention paid to medium-term objectives. A strategic planning capability remains to be developed. Expenditure programmes will need to be designed in an explicitly medium-term context where goals and instruments are clearly identified.

As concerns budget management and control, the ongoing transition towards accrual accounting needs to be stepped up in order to be able to enforce budget ceilings at all levels of government. The amount of funds permitted to be "carried-over" from previous years should be expressly circumscribed over time in terms of the cumulated amounts, in the context of a medium budget framework. Whatever remaining obstacles prevent the budget from focusing on the wider, economic, definitions of the public sector should be removed.[61] As concerns audit activities, the mandate given to the Audit Court – focusing on results rather than mere compliance with legal procedures – needs to be fully implemented, while an expanded role for Parliament in external audit should also be established. A better-informed Parliament is important for it to make a constructive contribution to the budget at the preparatory stage. Both the Parliament's office in charge of evaluating the budget law and the Audit Court should be given the possibility to increase their staff accordingly, which may necessitate changes in the statutory ceilings on permitted personnel, preferably with compensatory reductions elsewhere.

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Making decentralisation more effective

Italy's process of decentralisation has by and large not succeeded in obtaining the expected efficiency gains from fiscal devolution. Very little progress has been achieved so far towards greater local transparency and moral hazard problems remain strong, because regional authorities know that their overruns will be covered *ex post* by the central government. The lack of credible sanctions implies that the balanced budget requirement is never met. To correct these deficiencies, the devolution of tax and spending power needs to be buttressed by better internal control mechanisms and institutional capacity in the receiving governments. A clear identification and allocation of spending and financing responsibilities across levels of government, with better co-ordination, is needed to make the development of local initiative and responsibility compatible with a hard budget constraint.

Imposing a harder budget constraint…

The recent reform of fiscal federal relations in Italy is a major step in hardening the lower tier government budget constraints, as it de-links the provision of grants from historical expenditures, which eliminates an important incentive to overspend, and strengthens the transparency of intergovernmental relationships. But devolving more tax power would be useless unless the moral hazard that perpetuates reliance on *ex post* bailouts is removed. One approach would be to introduce sanctions into the internal stability pact. Regions which build up large arrears might be subject to intervention of the Treasury, *via* the imposition of temporary tight controls over budgets and spending, implying reputational penalties for the politicians responsible.[62] The credibility of the new tax sharing rules needs to be strong at the outset.[63]

… will require greater spending autonomy…

Once the "no bail-out" threat can be made credible, regions will be in a position to assume greater responsibility for making good use of the money provided by (rule-based) transfers and local taxes. Accountability to the voters can help to bring about large potential benefits of decentralisation such as better allocative efficiency and public sector productivity. But this will also require devolving more real autonomy on the spending side. The recent phase of administrative federalism introduced new management and organisational tools to allow managers to set and pursue performance goals. Important as these are, without the basic freedom to prioritise activities in response to local preferences, or to set output prices and negotiate for input costs with respect to market-based criteria, they could remain superficial.

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… particularly in the health sector

These issues are paramount in the health care sector, where the resources needed to improve service provision can come only from more efficient management, given the tight spending ceilings of the internal stability pact. Otherwise, introduction of a hard budget constraint could exacerbate the problems of rationing and low service quality in the poorer areas. A process of implementing health sector reform, giving local health care units strong incentives to allocate resources effectively and to deliver services efficiently, is urgently needed and can only be designed and carried out at the regional level within a framework of national principles. This will require the attainment of full responsibility by regional authorities to determine what services can be provided and to negotiate contracts with health care providers,bearing the full costs of their actions and using their discretion to raise taxes if need be, or to adjust costs in line with sound management principles.[64]

At the same time, the inherent contradiction between enhanced regional policy autonomy and social equity as expressed in mandated "national standards" needs to be resolved. Under the new national tax sharing arrangements, nearly all (90 per cent) of regional differences in tax base capacity will be offset. This should provide the basis for social equity, with a possible top-up through a system of block grants. It also should be noted that the new amendments appear to remove the constitutional justification for mandated service uniformity, while affirming the right at all levels to share equitably in national tax resources (Box 6). To end the moral hazard that overlapping responsibilities imply, the central government should therefore end rigid mandates on essential services, co-payments, staff salaries, or hiring and firing rules, etc. Its more appropriate role might be to facilitate 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. National standards need to be defined in terms of a set of "bare minimum" levels of service, as opposed to the current set of entitlements, guaranteed to all residents in any area after appropriate negotiation between the regions and the center.[65]

Improving local institutional capacity…

Decentralisation will finally lead to improved public services only if subnational governments have the necessary administrative capacity to manage the transition to higher efficiency.[66] The initial situation in some of the regions and local administrations is greatly lacking in this respect, and radical measures to build such capacity are needed. A key feature of the Bassanini laws has been the reform of human resource management system discussed above; it is important that this be fully implemented. Inefficient staff allocations and poor skills, in particular in the southern regions, have not been addressed, and this calls for intensive retraining of civil servants so as to allow them to perform new tasks or

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become more productive in their current ones. Policies to allow staff dismissals may also be needed.

… will enhance service capability

In the process, real accountability to the public must be created (to fulfil the new "citizen charter" pledges), as opposed to legalistic notions of responsibility. This would include a "value for money" approach to local performance, including the evaluation of efficiency and effectiveness in service provision, and ability to cost services *ex ante*. Enhanced public scrutiny of sub-national budgets and outcomes could be encouraged by publication of such budgets. Modern accounting, budgeting, and auditing principles are an essential step towards the full transparency needed to monitor the performance of local health units and transportation companies.

Options for the use of market instruments

OECD experience has shown that the private sector can perform some of the functions traditionally carried out by government more efficiently. Technological developments are helping in this direction. Examples include refuse collection, running utilities, and road passenger transport. For a number of such domains, most notably transportation, electricity, and gas, the introduction of market mechanisms at the local level is instrumental to a successful liberalisation nation-wide. Privatisation could take the form of either outright sale of the underlying assets, as Italy has done to a large degree, or more contracting-out of the management of facilities and delivery of services. In the domain of asset sales, experience shows that market structure is at least as important as ownership. The goal is to deliver services in a competitive market framework, not to maximise privatisation receipts by creating private monopolies. Contracting-out can result in substantial savings if contracts are properly designed, while improving the quality of public services retained in-house via the "threat" of outside competition.[67]

In the area of infrastructure building and maintenance, where risks to private investors are high but financial and managerial know-how largely lacking in the public sector, private-public partnerships (PPPs) are a promising development. At the same time, the experience of other countries has borne out that local policy-makers should be careful to: *i*) contain project costs for example by use of standardised contracts; *ii*) ensure competition both in the tendering process and over the duration of the contract to avoid creation of monopoly positions; and *iii*) not initiate PPPs where traditional public investment might be more appropriate.[68] Similar principles would apply to the privatisation of government services in general.

Directly competing with the private sector is a related approach bringing market discipline into play in the carrying out of public sector activities. Examples are open public procurement and competitive recruitment, schemes which Italy has already adopted (see above). Italian cities have also formed partnerships with

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each other to improve supply efficiency, as in electricity, for example, while also allowing competing private entry into many areas of local service provision, under the impetus of the Bassanini reforms. The current government plans to step up this trend (Chapter IV), but it could be pushed farther, for example liberalising the labour markets in public administration to allow for more flexible wage setting and temporary contracts, depending on local conditions and budget constraints. Other OECD countries have been able to stimulate competition and efficiency in the education sector *via* the use of vouchers and decentralisation of education policy, the latter now being an official policy objective in Italy.[69] A greater use of market-based management principles should be made in both health and education (in particular higher education) sectors in Italy, especially as the problem of overlapping competencies with central government is removed, as recommended above. Also, a greater use of charges and copayments in areas such as health, education, and transport could help reduce budget pressures by shifting costs to the final user.

Italy has inaugurated elements of competition and partnership with the private sector in its promising new approach to infrastructure spending in the South. This plan has relied on a set of market-based incentives and private participation in local government infrastructure projects. It provides a model for reinforcing regional autonomy while building their administrative capacity in a context of mutual trust and co-operation between levels of government,[70] creative guidance and technical assistance from the centre, and competition-based local management. This experience also goes to show that the EU can impart a useful externality to reform efforts (as in public procurement; see above). However, the above caveats about PPPs need to be considered when deciding how far local governments should go into business activities. Also, the scope of the new Strategic Infrastructure Law should be strictly limited to strategic infrastructure where cross-regional interests are clear and paramount – *i.e.* where there is a national interest at stake – to avoid any undesirable reversal of the trend to greater local autonomy and openness to market forces. And consistent with the above suggestions, all projects targeted by the law should be subjected to careful cost-benefit analysis and a clear identification of the complementarities with private investment;[71] the apparently "fast-track" procedures facilitated by this law should not be allowed to skip this vital step. It remains true as well that general economic framework conditions need to be improved in order to maximise the ability of the private sector to participate, notably *via* more competition and better functioning financial and labour markets. These concerns form the focus of the next chapter. A summary of recommendations provided in this chapter is given in Box 7.

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Box 7. Recommendations for reforming public expenditure in Italy

Based on the analysis presented in the chapter, policy initiatives are needed to ensure more effective allocation and use of public resources. There are two ways of achieving this: a transfer of resources among programmes and a more efficient provision of services.

Complete the reform of the pension system

Despite reforms, expenditure on pensions, already very high, is expected to increase further. The authorities need to:

- Apply the pro-rata system for the calculations of benefits to all workers, regardless of the years of contributions (the new system applies only to those with less than 18 years of pension contributions before 1995).
- Phase out seniority pensions more rapidly (*pensioni di anzianità*).
- Raise the minimum retirement age to 60 years, and ensure a neutral pension system also as regards the decision to retire beyond 64.

Create a rational health care system

There will be growing expenditure pressure on health services for the elderly which may exacerbate pressure on public spending. The government should:

- Subject regional health spending to national standards in terms of a set of minimum levels of service, ensure that the regions are responsible for what services are provided, while assuming the full financial costs of their actions.
- Give health care units strong incentives to design and implement sound management practices, to match the requirement of fiscal responsibility with spending autonomy.

Strengthen other income transfers

To modernise the transfer system, the authorities need to:

- Re-examine income support schemes for the unemployed (following the recommendations of Chapter IV).
- Socialise part of child and old age care.
- Develop a well-targeted and carefully monitored social safety net.

Improve the budget process

A *sine qua non* of effective reform is a more accountable budget process. Reform is still far from complete if measured against the objective of abandoning excessive reliance on detailed legal requirements in favour of a more evaluative approach. The government needs to:

- Encourage budgeting by objectives at all levels of government.
- Reduce the extent to which budget appropriations can be "carried over" from previous years in the annual budget and not change budget allocations unless explicitly permitted by a supplementary appropriation process.

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Box 7. **Recommendations for reforming public expenditure in Italy** (*cont.*)

- Step-up the ongoing transition towards quarterly accrual accounting.
- Pay greater attention to medium-term objectives by designing expenditure programmes in an explicitly medium term context.
- As concerns audit activities: reinforce both external and internal audit systems; fully implement the 1994 mandate of the Audit Courtand of external Auditing Boards at the local level; strengthen *ex post* political oversight.

Harden budget constraints at lower level of government

The process of decentralisation needs to deliver greater efficiency gains, requiring:

- Action to correct the "moral hazard" problems arising from the fact that the regional authorities assume that their spending overruns will be covered *ex post* by the central government. Sanctions should be introduced into the internal stability pact.
- More local spending autonomy to make fiscal responsibility operational. This requires clarification of areas where there are overlapping responsibilities with central government. More monitoring and evaluation of development projects can enhance the learning process that comes with autonomy.
- Better institutional capacity at the local levels. Skills need to be raised via training and market-based personnel reforms. Negotiation and partnership with civil society and the central government are other elements of success.

Enhance the efficiency of the public administration

Action is needed to exploit existing scope for greater efficiencies at all levels of government:

- Measures should be taken to ensure that the planned shift towards a performance related pay system is fully implemented.
- Enhancing the efficiency of public employees also requires an effective competitive hiring, the use of mobility provisions, and more differentiated wages to eliminate labour mismatches.
- The process of establishing a more accessible and accountable public administration could be facilitated by the issue of a clear calendar of intermediate objectives, progress reports and press releases.
- Fully exploit the potential of information and communications technology for better government and deeper interaction with citizens.

Implement a transparent public investment strategy

The amount of public investment is low by international standards and new investment programmes have been devised to fill this gap. The government should:

- Allow infrastructure investment to be co-financed with private capital from both national and international sources, subject to allowing adequate competition in the market.

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Box 7. **Recommendations for reforming public expenditure in Italy** (*cont.*)

Use market instrument more widely

– Place the Strategic Infrastructure Law in the context of a comprehensive strategy involving all tiers of government as well as the private sector, and ensuring an adequate degree of surveillance;

The private sector can perform some of the functions traditionally carried by the government more efficiently. More attention should be paid to bringing market discipline into the carrying out of public sector activities:

– The provision of a broader range of local goods and services (*e.g.* bus services, waste collection and child care services) and the purchase of inputs for public sector agencies (*e.g.* maintenance and cleaning of public buildings and financial services) need to be increasingly contracted-out.

– User charges can be helpful in reducing excess demand for public services and improving their quality through the introduction of market signals, and they relieve the general taxpayer the cost of providing services.

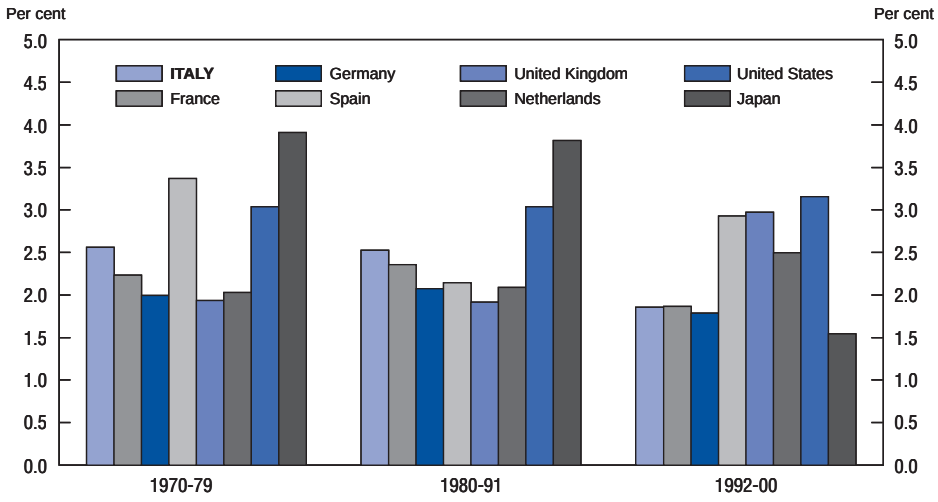
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IV. Structural reforms to raise potential growth

The policy implications of the 1990s growth slowdown

As measured by potential (full employment) GDP growth, Italy experienced the largest slowdown among the major European economies between the 1980s and 1990s (Figure 20). Much of this could represent the end of catch-up, as Italy reached GDP per capita levels similar to those of France, Germany and the UK by the end of the 1990s (Figure 21), having outperformed them in growth terms in earlier decades. Profound macroeconomic and structural reforms over the decade of the 1990s may have suppressed output growth, during a transition period, as well. Indeed, Chapter I described an acceleration of activity around the

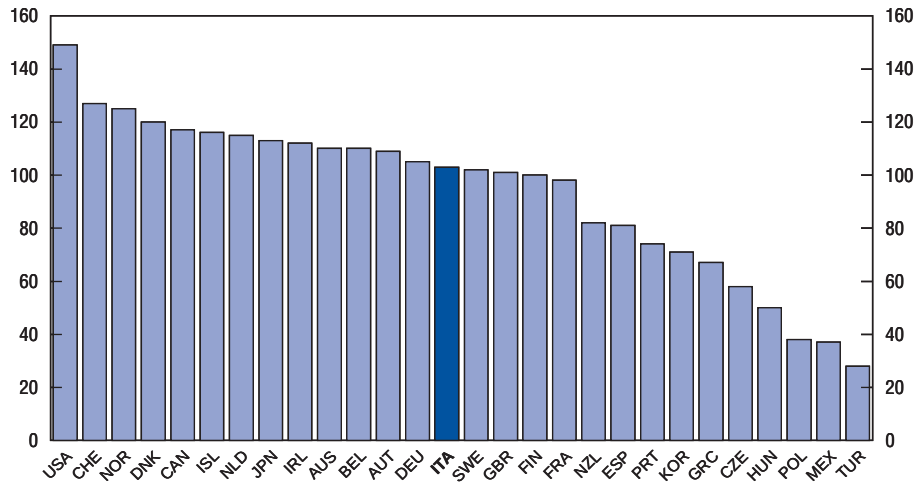
Figure 20. **Potential GDP growth**
Average annual growth over period



Source: OECD.

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Figure 21. **GDP per capita**
Volumes indices – Levels of PPP – year 1999



Source: OECD.

turn of the millenium. But it also noted that Italy's export performance has been, on balance, disappointing. And there remains a deep regional divide: the Centre-North has a per capita output level equal to 122 per cent of the EU average, whereas that of the *Mezzogiorno* is only 68 per cent. Thus, the need to continue and deepen the process of structural reform would appear to be strongly indicated.

A *growth accounting framework*

Relative to other larger OECD economies, Italy's per capita GDP growth performance in the 1990s was about in the middle, after having been near the top in the 1980s (Table 25). The countries that managed to raise their growth rates showed a more intensive use of labour (Netherlands, Spain,) and/or higher multi-factor productivity (MFP) growth (Netherlands, United States). Italy is characterised by a declining labour utilisation rate – mainly the result of a rising unemployment rate as slightly worsening demographics were just offset by higher labour force participation. Moreover, a sharp fall in participation (and hours worked) during the first half of the 1990s was only partly corrected by an upward dynamic in the second half (Table 26). Thus, participation rates of youths, women, and older workers remain much lower than in the comparison countries (apart from female

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Table 25. **Contributions to output growth: an international comparison**

Annual average growth rate

	Per capita real GDP	Working age population (a)	Labour force participation rate (b)	Unemployment rate (inverse) (c)	Hours worked (d)	Labour utilisation (a + b + c + d)	Multifactor productivity[1] (e)	Capital deepening (f)	Labour productivity (e + f)	*Memorandum item*: Multi-factor productivity corrected for hours worked + labour quality[2]
1990-1999										
Italy	**1.5**	**0.1**	**–0.1**	**–0.1**	**–0.3**	**–0.5**	**1.1**	**0.9**	**2.0**	**0.6**
Germany[3]	1.0	–0.1	0.0	–0.4	–0.6	–1.1	1.2	0.9	2.1	1.9
France	1.3	–0.1	0.3	–0.2	–0.6	–0.7	1.2	0.8	2.0	0.7
Netherlands	2.3	–0.2	1.3	0.4	–1.3	0.2	2.0	0.1	2.1	1.7
Spain	2.4	0.3	0.4	0.1	–0.5	0.3	1.1	1.0	2.1	. .
United Kingdom	1.6	–0.1	–0.1	0.0	–0.7	–0.8	1.6	0.7	2.4	0.5
United States	2.0	0.1	0.1	0.1	–1.1	–0.8	2.3	0.5	2.8	1.2
Japan	1.4	–0.2	0.7	–0.3	–1.3	–1.0	1.3	1.1	2.5	. .
1980-1989										
Italy	**2.1**	**0.5**	**–0.1**	**–0.5**	**–1.0**	**–1.1**	**2.4**	**0.8**	**3.2**	**1.4**
Germany	1.7	0.6	0.1	–0.4	–1.4	–1.1	1.9	0.9	2.8	1.6
France	1.7	0.4	–0.3	–0.4	–1.8	–2.1	2.8	1.0	3.8	1.9
Netherlands	1.3	0.5	–0.0	–0.3	–2.6	–2.5	3.5	0.3	3.9	2.2
Spain	2.3	0.8	–0.1	–1.0	–2.2	–2.6	3.8	1.0	4.8	. .
United Kingdom	2.2	0.3	0.3	–0.2	–0.6	–0.3	2.1	0.3	2.4	. .
United States	2.0	0.3	0.4	0.1	–1.4	–0.6	2.2	0.4	2.6	1.0
Japan	3.2	0.3	0.2	–0.0	–1.2	–0.7	2.3	1.5	3.8	. .

1. Corrected for hours worked.
2. The decade of the 1990s is represented by: 1990-98 for France and Netherlands, 1991-98 for Germany, 1990-97 for Italy and the United States, and 1990-96 for the United Kingdom.
3. 1991-1999.

Source: OECD, Bassanini *et al.* (2000).

Table 26. **Sources of Italian output growth over the decade of the 1990s**
Annual average growth rate

	1990-1994	1995-1999
Per capita real GDP	1.2	1.7
Working age population	0.3	–0.2
Labour force participation rate	–0.8	0.6
Unemployment rate (inverse)	–0.2	–0.1
Hours worked	–0.7	0.1
Labour utilisation	–1.4	0.4
Multifactor productivity	1.5	0.6
Capital deepening	1.1	0.7
Labour productivity	2.6	1.3

Source: OECD.

participation in Spain) (Table 27). Youth unemployment rates have been declining but are still higher than elsewhere. Differences within Italy are as great as those *vis-à-vis* other countries, with participation low mainly in the South although that of female and old-age workers is low in the Centre-North as well.

The slowdown in Italian MFP growth during the last decade is also striking, and may explain (along with insufficient product market competition) declining international competitiveness. Figure 22, based on the recent OECD (2001*e*) growth study, is suggestive of some of the factors involved:[72]

– MFP growth has tended to pick up more in countries that have made *greater use of information and communications technology* (ICT). But Italy (along with Spain) has made least use among OECD countries of such technology (Panel A). Moreover, the contributions of ICT-producing and ICT-using sectors to total economy labour productivity declined significantly in the second half of the 1990s.

– Increased MFP growth is associated with *increased business* R&D. In Italy, business R&D spending has been stagnant (Panel B), and along with government R&D spending is only half the EU average. Moreover, average annual growth in total R&D spending over the 1990s was negative.

– Countries with the lowest *administrative barriers to entrepreneurship* have also registered the largest increase in MFP growth. Administrative burdens on start-ups are key in this respect, and on this score Italy has displayed the highest level of red tape (Panel C).[73]

– Labour market rigidity in the form of *employment protection legislation* may also have played a role in lowering MFP growth. Italy features as an OECD country with one of the highest levels of employment protection (Panel D).

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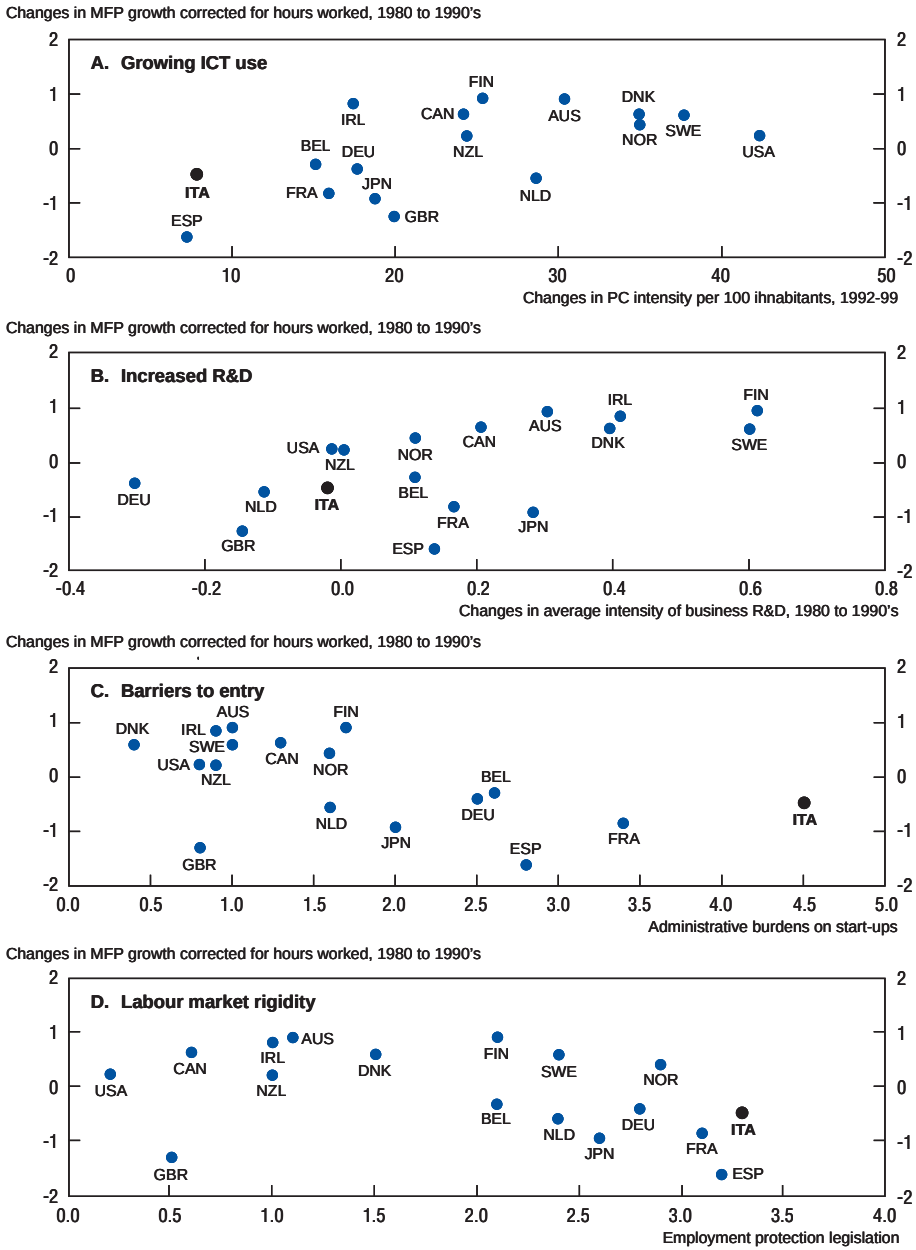
Table 27. **Participation and unemployment rates**

2000

	Italy	Center-North	*Mezzogiorno*	Germany	France	Netherlands	Spain	United Kingdom	United States	Japan
Participation rate (total)	**59.9**	63.6	53.3	72.2	68.0	73.9	65.3	76.6	77.2	72.5
Youths (15-24)	**37.7**	41.9	32.2	52.5	29.4	70.9	48.2	69.7	65.2	47.0
Men (25-54)	**90.4**	92.1	87.3	95.8	94.2	93.5	92.8	91.9	91.6	97.1
Women (25-54)	**57.9**	65.9	43.4	76.9	78.4	71.6	62.4	76.1	76.8	66.5
Older (55-64)	**29.0**	27.0	33.2	44.7	37.2	36.6	40.7	52.8	59.2	66.5
Trend participation rate	**60.6**	. .	. .	74.4	68.4	66.0	65.0	76.1	66.9	78.9
Unemployment rate (total)	**10.7**	5.8	21.3	8.1	10.1	3.5	14.1	5.6	4.0	5.0
Youths (15-24)	**31.1**	16.8	55.0	7.7	20.8	7.0	25.5	11.8	9.3	9.2
Men (25-54)	**6.3**	3.0	12.9	7.7	8.9	2.5	9.2	5.6	3.3	4.7
Women (25-54)	**12.1**	7.0	26.0	9.0	13.0	4.2	20.5	4.7	3.8	5.4
Older (55-64)	**4.4**	2.9	7.3	11.4	7.6	2.7	9.0	4.3	2.5	4.7

Source: OECD, ISTAT.

Figure 22. **Factors affecting changes in MFP growth**



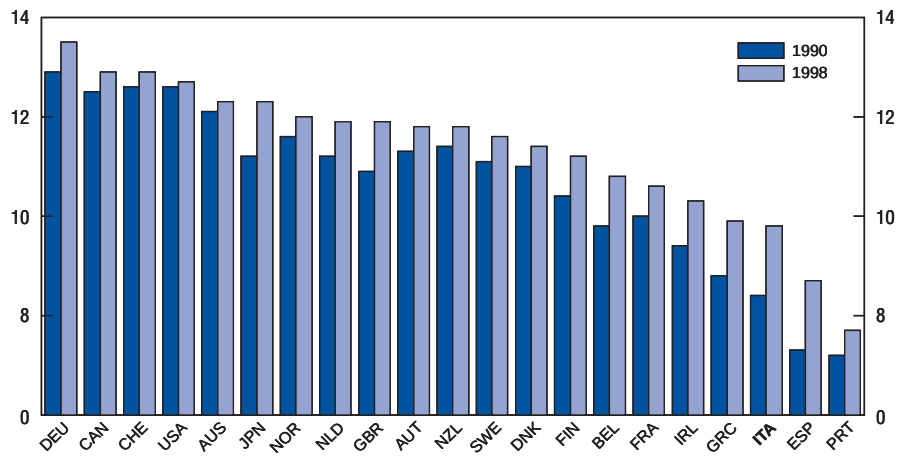
Source: OECD.

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H*uman capital development* in the form of education and training further raises multi-factor productivity by increasing the quality of the labour input.[74] Though Italy, like other OECD countries, has greatly increased the number of years of compulsory schooling, it remains one of the worst performers in terms of the level of education of the working age population (Figure 23), and worker training is also minimal. Shake-outs of lower-skill workers that accompanied capital deepening meant that human capital growth of employed workers was high through the compositional effect, although the purely generational dynamic (particularly strong in Italy) of retiring older workers and entering younger, better educated workers may also have played a role.[75] In fact, a sharp decrease in the MFP growth rate emerges in Italy after the quality of labour is taken into account (Table 25).

Capital deepening, the final source of productivity growth, has been greater in Europe, including in Italy, than in the United States (Table 25). While the exact reasons for this remain controversial, one factor that clearly has been important is the higher relative cost of labour, in turn reflecting high relative taxation of labour plus slow adjustment in the market-clearing wage because of labour market rigidities.[76] Capital deepening can have negligible effects on growth while creating high unemployment, if (low productivity) workers are replaced by capital equipment and labour markets do not clear. By the same token, labour market reforms

Figure 23. **The level of education of the population**
Average number of years of education of the working-age population



Source: OECD.

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during the latter half of the 1990s caused capital deepening to decline in Italy, as growth became more labour intensive. The counterpart was a marked slowing of productivity, although the within-decade fall in innovative activity (denoted in Panels A and B of Figure 22) also contributed to a strong deceleration in MFP (Table 26).

Implications

From the above, it emerges that despite a decade of reforms, most of the per capita growth that has occurred is due to capital deepening and its counterpart in the rising average skills of employed workers (*cum* high structural unemployment). Labour utilisation is still very low, while the part of MFP growth stemming from technological innovation (as opposed to growth of human capital) is weak. Even though past reforms have not fully borne their fruits, much more reform would, on these trends, appear to be needed in order to attain the targeted medium term growth rate of 3 per cent (Chapter II). Easing the burden on future working generations of the ageing challenge facing Italy also requires sustained high growth in the long-run.The government has stressed the importance it attaches to the raising of potential growth and has accordingly presented a list of "supply side" measures in the 100 days' plan (see Box 1) and the Stability Programme. The remainder of this chapter will look at such measures and suggest further steps in terms of a 3-pronged policy focus to boost growth in Italy:

- Policies directed at raising employment *via* higher labour force participation and lower unemployment are key. Lower labour taxes and more flexible labour markets are important imperatives .
- A rise in growth *via* the MFP channel. This seems feasible, given high catch-up potential in the South and the encouraging example of the United States. The more growth can be lifted *via* this channel, the more will rising real wages accompany rising labour utilisation operating *via* the first channel.
- Policies to boost competitiveness, a major channel through which investment, hence employment, becomes attractive. Well-functioning product and financial markets are critical in this respect.

Policies to boost employment

Regulatory reform and changing labour market structure

Italy has gone a long way to increasing the flexibility of its labour market *via* steady deregulation throughout the last decade. This process has been both spontaneous and policy-driven. In 1997, a series of reforms by Labour Minister

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Treu ("Pacchetto Treu") formalised evolving flexibility arrangements in Italian industry.[77] The reforms enlarged the scope for apprenticeship schemes, part-time employment, and temporary contracts. Moreover they permitted the opening of temporary work agencies, which even if rather limited in scope, introduced modern job matching services in an environment dominated by an inefficient public employment service. The use of fixed-term (interim) work arrangements, albeit subject to conditions such as restricting their application for low-skilled workers, boomed in subsequent years. In 1999, the rules concerning the use of interim contracts for unskilled jobs were eased (this condition having been largely ignored in any event). Finally in mid-2001, as one of its first structural economic measures, the new government extended the possibility and terms for use of temporary contracts, aligning Italy with EU directives.

As the labour market became more flexible, its performance improved markedly. During the 1995-2000 period, participation and employment rates rose by 2½ and 3 percentage points, respectively, partially reversing the trends earlier in the decade, while three-quarters of the total employment growth was registered in 1998-2000. A strong initial expansion of "atypical" work contracts, *i.e.* part-time and fixed-term (Table 28), tended to favour women and youths. The rise in female participation and employment rates (by 4 percentage points each) was particularly steep, and occurred mainly in the Centre-North. Also the number of permanent contracts started to rise in 1998, partly reflecting economic recovery and the tightening of labour markets in the Centre-North, where skill shortages became acute. Participation rates of older workers and those in the South benefited as well, and the former stabilised after 1998, having sharply declined over the earlier

Table 28. **The growth of different types of labour contracts**

	1995-97	1998-99	2000	1995-2000	End-2000[1] levels
Total employment variation[2]	1.9	2.3	3.2	7.6	100.0
Contribution to the variation					
Self-employed workers	0.2	0.1	0.8	1.1	27.9
Full-time workers	0.3	–0.1	0.7	0.9	25.9
Part-time workers	–0.1	0.2	0.1	0.2	2.0
Workers in dependent employment	1.7	2.3	2.4	6.5	72.1
Full-time permanent workers	0.0	0.1	1.8	2.0	61.1
"Atypical workers"	1.6	2.2	0.6	4.5	11.0
of which:					
Part-time permanent workers	0.6	0.7	0.4	1.8	4.2
Part-time temporary workers	0.4	0.4	0.2	1.0	2.2
Full-time temporary workers	0.6	1.1	0.0	1.7	4.6

1. Percentage total employment structure as at January 2001.
2. Annual percentage growth rates.
Source: Labour Force Survey.

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part of the decade. Overall, abstracting from the cycle, the entire five-year period as well as the first half of 2001 (see Chapter I), was characterised by a higher employment intensity of GDP growth than in the past. The apparent structural change reflected both the greater incidence of part-time work and a lower mean growth in productivity in terms of effective labour units (lower capital intensity), as flexibility allowed the recourse to labour resources that would otherwise have been unused.[78]

Fiscal incentives also helped to stimulate employment growth, once EMU-entry had been secured and fiscal stringency could be somewhat relaxed (Table 29). The 1997 labour reform reduced employer social security contribution rates for some categories of "atypical" workers by around two-thirds, implying the lowering of total labour costs for such contracts by more than 15 per cent. These incentives, later extended to end-2001, were particularly important for the employment gains registered in the South.[79] The more recent growth of permanent contracts was furthermore related to company tax incentives tied to the extension of such contracts, granted in the 2001 budget law and extended to end-2003. The new government has added new tax breaks tied to the declaration of underground employment and has confirmed social security rebates for new hires in the South (Chapter II).

Table 29. **Employment incentives**
Number of positions covered by incentives, in thousands

	1996	1997	1998	1999	2000
Work/training contracts	374	390	403	369	310
Apprenticeships	284	273	341	419	458
Tax credits (flows)	–	10	52	10	8
Reductions in social security contributions	273	325	375	434	487
Total (excluding tax credits)	773	831	955	1 066	1 115
Memorandum item:					
Growth in total economy dependent employment	100	76	215	250	382

Source: Ministero del Lavoro e delle Politiche Sociali (2001*a*).

Given the impacts of labour market reform thus far, an important question is how much more reform, and what kind, may be needed in order to attain the government's implicit employment objectives. Annex III examines this issue in terms of scenarios, superimposing on negative demographic trends various projections of recent favourable employment trends into the future. These show that to achieve EU benchmark employment objectives, the very buoyant employment growth of the last two years would need to be sustained for another 10 years. However, because the Centre-North is already so close to full employment, most of

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the effort would need to be shifted to the South, and it would have to include comprehensive structural reforms to boost investment and MFP as well as employment. Due to the growing weight of the older age classes, more reforms will be needed in order to raise the employment rate of older workers, mainly in the Centre-North, to EU-desired levels. And while the continuation of encouraging female participation trends over the past 5 years would be sufficient to attain EU goals in this respect, further policy action might be needed to sustain such trends. Another issue (not directly addressed by the simple simulations) is that of a growing "duality" in labour markets due to emphasis on atypical contracts and social security derogations in the reforms pursued thus far, which may impact negatively in the longer term on skill development and pension rights. Both the overall quantitative goals and the need to counteract the risk of dualism have been stressed in the recent government White Paper mapping out the labour market strategy for the 2001-06 Parliament.[80]

Decentralised wage setting to reduce regional disparities

The analysis above shows how important the South is to the better utilisation of labour resources in Italy. The data clearly show the existence of regionally segmented labour markets, in other words a lack of adjustment mechanisms within and across regions. An analysis by the OECD (2000*b*) shows that Italy (along with Germany) has the largest regional labour market differences among OECD countries, which have worsened through time. Although the existence of differential employment and unemployment rates are not necessarily signs of fundamental disequilibria – people in one region may have a higher preference for leisure, or the amenities of life there may discourage migration to areas of lower unemployment – Italy stands out as the country where wages are little affected by local employment conditions. Italy also has one of the lowest rates of inter-regional migration flows, which have been on a secular decline as regional disparities have intensified, although more recently starting to rise again.

The previous chapter showed how attempts to solve these "market failures" *via* high levels of inter-regional transfers have not been successful. Policies to boost employment through social security tax rebates heavily targeted to southern workers have become less and less relevant as the European Union has increasingly questioned them. As fiscal subsidies are withdrawn, mechanisms to make wage costs more sensitive to labour market conditions will have to be developed. The White Paper calls on the social partners to establish a more flexible wage bargaining system, envisaging at the same time a better targeting of employment incentives to disadvantaged groups, for example by concentrating fiscal and social security tax cuts among low-paid workers.

Currently, wage setting in Italy occurs on first the central level, which basically links the national reference wage to officially targeted inflation, and second,

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the firm-level, whereby wage premia are linked to individual firm ability to pay, as to a large extent proxied by firm size. Aggregate wage moderation has thus been favoured and some elements of wage flexibility and differentiation introduced. The national reference wage set at the first level serves as the national *de facto* minimum wage, but in conjunction with a high labour tax wedge, this pushes labour costs far above market-clearing levels in the South where productivity levels are much lower.[81] The second level, while perhaps giving an impression of wage flexibility, in actuality has meant only flexibility in the upward direction. It has also had the effects of reducing wage differentials among workers inside a given firm, enlarging wage differentials among similar qualification jobs but in different firms, and slightly widening wage differentials across firms in north and south.[82] While perhaps benefiting work effort, tying workers' fortunes too closely to firm profitability rather than to individual performance arguably creates a new constituency against greater product market competition.

The social partners might consider adapting their model of *concertazione*, set in 1993, to more contemporary circumstances: inflation is pretty much under control (but product market competition needs further strengthening), while flexible wage setting can be an important instrument to raise potential growth. A new model of bargaining could be more decentralised at the outset, *i.e.* to allow a wage level that better reflects local labour market conditions, while also incorporating elements of both firm and individual performance.[83] An alternative solution might be to maintain the national level (especially if this were considered still necessary from the perspective of aggregate wage moderation), while allowing deviations in the downward as well as in the upward direction at the regional and company-levels.[84]

The new approach would have two main impacts in the South. F*irst*, lower-skill workers, in particular youth workers, could be "priced into" the market. This would raise employment but (initially) reduce average productivity levels *via* possible composition effects, and depress average real wages, while probably raising real incomes. Better human capital development might be encouraged by greater wage differentiation, the latter improving the rewards to education and self-betterment. S*econd*, greater North-South wage differentiation would augment the incentives for firms to locate in the South and for workers to migrate, both channels acting as regional balancing mechanisms for the labour market – the US being the prime example of this in the OECD. The growing use of ICT, in addition, eases restrictions on where enterprises set up (since they obtain agglomeration and information advantages more easily through the net). Workers' flows could be reinforced by a relaxation of housing policies which restrain mobility, *e.g.* high house purchase taxes.

Increasing internal migration and enlarging regional wage differentials may not be uncontroversial policies. As for the latter, targeting tax and social security rebates to low-paid workers, as planned, might provide a partial offset to

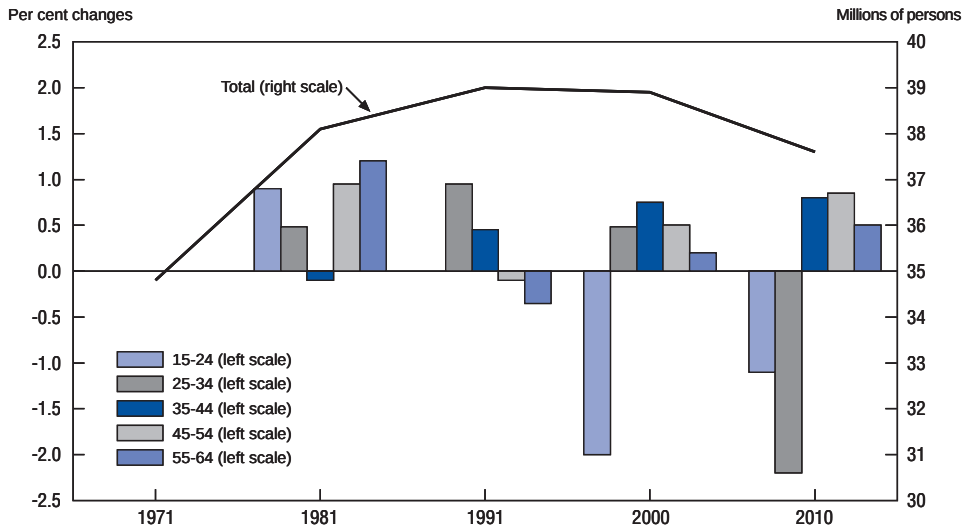
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lower pre-tax wages while providing for the necessary labour supply incentives, both in the South and for some demographic groups in the North as well. As for the former, it is possible that the first to migrate would be those with better skills. Internal migration as an adjustment tool could be opposed precisely because the South – already poor in human capital – could be further deprived of its talent base. However, preserving a system of rigid wage setting is the wrong answer to such a concern. Once again, it calls for complementing wage flexibility with a policy focus to develop worker skills and firm innovation. In any event, if low skill wages were to fall far enough in the South, there could be substantial net emigration by these workers and not the higher-skill workers as in the past.

Increasing older worker and female participation

Over the past five years, the contribution of demographic factors to aggregate employment has been substantially positive, thanks to the growth of the central age groups and drop in the younger age cohorts characterised by lower employment levels (Figure 24).[85] Over the coming decade, however, this contribution could turn more negative as the growing weight of older workers reduces

Figure 24. **Working-age population dynamics**



Source: Ministero del Lavoro e delle Politiche Sociali (2001).

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labour force participation merely through the compositional effect. In the second half of this decade, there will be an actual drop in the working age population as these older baby boomers start to retire.[86] Hence the urgency of reversing the tendency to declining labour force participation of older age groups in Italy (and elsewhere). Though measures to facilitate working beyond retirement age have been introduced recently (Box 11), reform of the pension system must be the main vehicle for improved incentives to work longer. The current re-opening of the pension debate provides the opportunity. The access to seniority pensions and the implicit tax on working past age 64 need to be reduced by measures recommended in the 2000 S*urvey* (see also Annex II). The resulting fiscal savings could be used, in large part, to reduce onerous social security in particular on low wages, thus raising the employability of younger workers as well (a "double dividend").

The efforts to raise female employment and participation have thus far succeeded in large part because of the growth of more flexible work contracts that are more consistent with women's *de facto* heavier family responsibilities – especially so in Italy, where the burden of elderly care still falls almost entirely on women and where a dearth of child-care facilities prevents mothers from working.[87] But there is still far to go in convergence toward international levels, and this will require a better reconciliation of family and work life. Incentives might be developed in the context of an eventual overhaul of the social welfare system – *i.e.*, with less emphasis on pensions and more on family and social assistance benefits (Chapter III) – for example by the partial socialisation of child and old age care. A greater emphasis on voluntary, as opposed to compulsory, maternity leave may also help to achieve higher female employment and participation, according to a cross-country analysis (ISAE 2001) wherein Italy is shown to have the opposite mix, *i.e.* a long compulsory leave period with relatively limited further voluntary leave possibilities. The government could also help to improve female employment prospects by taking a more active lead in providing equal employment opportunities. A role might also be played by further reductions in the rigidities attached to the use of part-time contracts, which may ease barriers to labour market participation by youths and elderly workers as well as females.

Policies to boost productivity

Shifting from in-job to in-market forms of worker protection

Another dimension of labour market rigidity that is receiving wide attention in Italy today is that of employment protection legislation (EPL), specifically Article 18 of the Labour Law against individual dismissals for "unjust cause", the latter being a matter of interpretation by the courts who have the right to reinstate workers in their old jobs.[88] It may be argued that the lack of flexibility to dismiss or reassign workers has negative effects on growth, as it retards the adaptation of the economy to shocks and to the opportunities offered by technical progress

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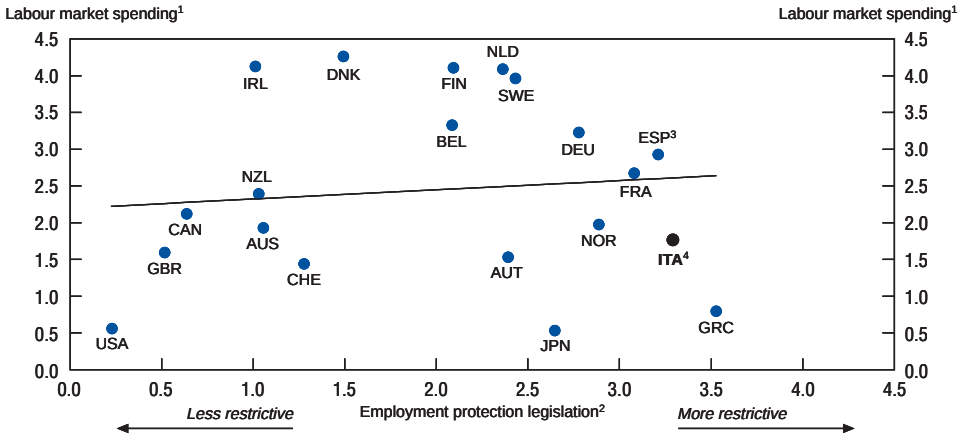
(Figure 22 above suggests this also). The argument could be nuanced, however, by taking into account the system of industrial relations. The compression of wages that typically accompanies highly co-ordinated systems (such as in Italy) should make employers more willing to train existing employees in order to meet firms' skill needs – *i.e.*, because they can thus reap the difference between the marginal productivity of skilled workers and their earnings, as the typically rigid wage structures under such systems also make it difficult for firms to poach each others' skilled workers – in turn weakening the putative negative effect of hiring and firing restrictions on innovation. While research by the OECD provides indirect empirical evidence for this hypothesis on a cross-country basis,[89] it may be weaker in the case of Italy where little training is observed, the training wage premium is surprisingly large, and inter-firm mobility among labour market insiders is actually quite high (see below). As EPL kicks in only once a firm reaches 15 employees, it may also be a factor keeping firm size in Italy sub-optimally small (95 per cent of firms are clustered in the 1-10 worker range),[90] and it may also discourage foreign direct investment. In the South, in particular, the combination of EPL and wage rigidity make it difficult for firms to be competitive and to grow to optimal size.

The same problems can be seen from the vantage point of workers. The above arguments imply that the only way to attain a given employment level faced with high EPL is *via* aggregate wage moderation; conversely with flexibility, real wages would be higher on average for any given level of employment *via* the productivity channel.[91] In that sense, the 1993 *concertazione* could be considered, at least in part, a trade-off for insider protection. Furthermore, the growing coexistence of strict employment protection for permanent workers and minimal protection for temporary workers results in a "dual" labour market that may not improve the functioning of the labour market in the long run. Productivity is reduced among those with excessive protection as much as those whose conditions of work are precarious, the former because of a lack of discipline and the latter because of a lack of reasonable job prospects to elicit effort and commitment. There is an equity issue insofar as worker protection ends up penalising the weakest population brackets,[92] as flexibility is created only at the periphery of the labour market. Creating more flexibility by continued fiscal derogations accentuates this duality *inter alia* because a whole class of workers is being created with very minimal pension rights,[93] setting up a future liability for the social assistance system.[94] Excessive and unreasonable protection in the public sector once again sets up a negative demonstration effect for the private sector.

Labour and product market performance would be enhanced if job protection rules were relaxed, say by allowing legitimate disputes to be settled through an efficient arbitration system rather than through the courts. Firms would be more willing to offer permanent contracts in the knowledge that dismissals would be easier in the case of non-performance or structural change.[95] While fixed term contracts should continue to be liberalised (though without fiscal derogations,

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Figure 25. **In-job protection *vs* in-market security**



1. Public expenditure on unemployment compensation and active labour market policies (excluding early retirement schemes) as a percentage of GDP. Annual average over the decade of the 1990s.
2. OECD (1998) composite indicator of employment protection of legislation.
3. Early retirement for labour market reasons are included.
4. The Italian Labour Market Program database is currently being revised. The data shown in the figure refer to the former concept.

Source: OECD.

which seem unwarranted), the result would be more broadly flexible and equitable labour markets, with higher productivity. Nevertheless, insiders will lose security, in a context where in-market worker protections are minimal (Figure 25).[96] Thus, strengthening the social consensus for reform, as well as improving labour market functioning, will require a more adequate unemployment benefit system and better policies to help the school-to-work transition and to place workers in jobs. At the same time, however, such in-market protection should not be too open -ended and must be monitored and enforced carefully; otherwise it could lead to new forms of labour market rigidity, by increasing the "reservation wage" even as wage decentralisation reduces it in areas of high unemployment.[97]

The new government has recently specified its position on job protection rules, intending to move away from a rigid system of reinstatement to a more flexible one of compensation. A new delegated law (decree) identifies three groups for which current job protection rules will no longer apply during a transition phase to the new system: firms emerging from the underground economy, workers shifting from a fixed term to a permanent contract, and firms that because of new hires overtake the size threshold for which EPL applies. Consistent with the shift toward

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reduced labour market dualism, the government has liberalised fixed term contracts (see above) and identified a strategy to improve labour market protections. The latter includes: *i*) the recovery of full legality of worker-firm relations (with tax incentives as the main instrument, see Chapter II; *ii*) a better matching of labour supply and demand through an expanded role for private job placement services (mainly by simplifying controls); *iii*) reinforcement of the private pension pillar to offset declining future generosity of the public pensions system (perhaps using current worker contributions to severance funds, TFR).[98] These are important objectives, especially that with respect to the underground economy, which is still very large in Italy and prevents any access to training or security.[99] There is also a need, however, to refocus and better monitor public training services, which suffer from a fundamental lack of mission and competition, and they will need particular strengthening in the South (with a greater emphasis given to traineeships and other insertion mechanisms). The same could be said for public job placement services, although these should benefit from the exposure to competitive forces due to the planned liberalisation of private services.

Worker security can be enhanced by other policies, for instance pro-competition reform of the product markets, which by increasing the number of firms and employment (in the longer run) also increases the chances of finding a new job by displaced workers.[100] But the best job protection is of course enhanced and continuing skill development. Part of the debate about EPL may reflect a generational conflict between workers with out-of-date skills (or public workers originally hired under non-competitive conditions) and newly trained, more highly educated workers who can command permanent contracts as a fringe benefit rather than needing it as a protection against competition. The next section considers ways that policies can help to increase basic worker competencies in a cost-effective way *via* worker training, and especially, public education.

Improving human capital

Among OECD countries, Italy has a notably poor performance as regards human capital formation. The proportion of working-age males having upper secondary or higher education is the fifth lowest in the area after Portugal, Turkey, Spain, and Mexico, while educational attainment levels are significantly lower in the South than in the Centre-North. The compulsory schooling age was raised to 15 years as recently as 1999. Nor is this relatively low level of compulsory education compensated for by additional training in the workplace. Perhaps because of these features, expenditure on R&D and innovative activities are well below the OECD average.

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Education

Compulsory schooling remains at the lower end of the OECD spectrum (Figure 23). On top of this, post-compulsory educational qualifications are achieved only two-thirds as frequently, per capita, as in the OECD on average (Table 30). The high-school drop-out rate is particularly high in the South, where youth and long-term unemployment are concentrated. There is thus substantial scope for increasing the human capital of the working age population *via* education reform, especially at the upper-secondary level. Studies show that failure to complete upper-secondary education tends to lead to tenuous attachment to the labour market and low-skill, low-paid and insecure jobs. Skills learned at the

Table 30. **Educational attainment**

	Per cent of population that has attained in 1999:									
	At least upper secondary education					Tertiary education: type A and advanced research programmes				
	25-64	25-34	34-44	45-54	55-64	25-64	25-34	34-44	45-54	55-64
Australia	57	65	59	55	44	18	20	19	18	10
Austria	74	83	78	69	59	6	7	7	6	4
Belgium	57	73	61	50	36	12	16	13	11	7
Canada	79	87	83	78	62	19	23	18	20	14
Czech Republic	86	93	89	85	75	11	11	13	10	9
Denmark	80	87	80	79	70	7	10	6	5	4
Finland	72	86	82	67	46	14	16	15	14	9
France	62	76	65	56	42	11	15	10	10	7
Germany	81	85	85	81	73	13	13	15	14	10
Greece	50	71	58	42	24	12	17	14	11	6
Hungary	67	80	76	70	36	14	14	14	14	11
Iceland	56	64	59	53	40	18	22	20	15	9
Ireland	51	67	56	41	31	11	16	11	7	5
Italy	**42**	**55**	**50**	**37**	**21**	**9**	**10**	**11**	**10**	**5**
Japan	81	93	92	79	60	18	23	25	16	9
Korea	66	93	72	47	28	17	23	19	11	8
Luxembourg	56	61	57	52	41	12	13	11	15	7
Mexico	20	25	22	16	9	12	14	14	9	5
Netherlands	..	..	..	..	..	20	23	22	19	15
New Zealand	74	79	77	71	60	13	16	14	13	7
Norway	85	94	89	79	68	25	31	26	23	18
Poland	54	62	59	53	37	11	12	10	11	10
Portugal	21	30	21	15	11	7	9	7	6	4
Spain	35	55	41	25	13	15	22	16	12	7
Sweden	77	87	81	74	61	13	11	14	16	12
Switzerland	82	89	84	79	72	15	17	16	14	11
Turkey	22	26	23	18	12	7	8	7	8	5
United Kingdom	62	66	63	60	53	17	19	17	16	12
United States	87	88	88	88	81	27	29	27	30	23
Country mean	62	72	66	58	45	14	16	15	13	9

Source: OECD, *Education at a Glance*, OECD Indicators (2001).

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tertiary level are critical in providing the basis for technology development, good management, and entrepreneurship. However, the gap with other leading industrial countries in university training is wide (Table 30). While many enter into university studies, the drop-out rate is high. Brain drain is another problem reflecting on the quality of education services.[101]

The planned devolution of education (Chapter III) presents significant new opportunities for reform. Financing powers of the central government should be used as a lever to impose conditions for competition and accountability in education management, much as is being done in the health sector. The regional authorities should use future devolved policy powers to modernise the high-school and university curricula in line with local labour market needs. Extending compulsory education to the upper-secondary level may be an important medium-term objective, but specialised vocational and technical schools would need to be expanded as compulsory schooling is increased. Until that time, participation in training recently made mandatory for school-leavers until age 18 (*obbligo formativo*), needs to be fully implemented with an adequate quality of services assured.[102]

Reforms should also be geared to achieving economies in current education spending, releasing resources to fill more serious gaps in human capital formation. Two possibilities can be suggested. In Italy as elsewhere, it is the upper strata of society that benefit the most from public subsidies to post-compulsory education.[103] Modest subsidies could be justified by the fact that private returns to schooling are so high that the demand for schooling is not likely to be very sensitive to subsidy levels (Table 31). This argues for means-tested co-payments at the tertiary level, accompanied by a programme of generous government loans to ease students' likely liquidity constraints, in addition to needs-based merit scholarships. Greater wage flexibility, as recommended above, could complement such a reform by increasing the private return to tertiary education, which is lower than in other OECD countries.

Table 31. **Private and public returns to post-compulsory schooling**

Men; per cent

	Private internal rate of return		Social rate of return	
	Upper secondary	Tertiary	Upper secondary	Tertiary
Italy	**11.2**	**6.5**	**8.4**	**7.0**
United States	16.4	14.9	13.2	13.7
Japan	6.4	7.5	5.0	6.7
Germany	10.8	9.0	10.2	6.5
France	14.8	12.2	9.6	13.2
United Kingdom	15.1	17.3	12.9	15.2
Netherlands	7.9	12.0	6.2	10.0

Source: OECD (2001*f*).

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The cost-effectiveness of public spending at the compulsory level may also be questioned. Italian spending per pupil in elementary school is half as high again as the OECD average, and the pupil-to-teacher ratio is also one of the lowest (Table 32). In principle, devoting abundant resources to the most formative years of instruction should produce relatively high levels of motivation and position children well for further educational attainment. Indeed, the percentage of the cohort (both male and female) reaching grade 5 is 100 per cent. At the secondary level, spending per pupil is also above the OECD average, but outcomes are poorer as suggested by the large number of pupils who fail to continue beyond compulsory schooling, though enrolments have been rising.[104] The government plans to increase non-teaching resources, with no apparent plans to reduce those for teaching,[105] yet it may be questioned whether the amount of resources devoted to schooling are not already high. Market-based reform of the teaching profession may be called for. At the same time, the adequacy of the elementary school system in meeting the needs of disadvantaged children needs to be re-examined.

Worker training

A recent OECD (2001*f*) study finds evidence (mainly for the US and UK) that worker training raises productivity by an amount that more than compensates for the higher wages paid to trained workers. However, Italian firms by and large have not found it in their interest to pursue worker training and the "training wage premium" (the gap in wages between trained and untrained workers) is particularly large especially for those with upper-secondary – but not tertiary – education. Free-riding is a possible explanation in the Italian context where across-firm mobility by labour market "insiders" is quite high,[106] and so employers may not be able to appropriate the gains from training. The new government has attempted to improve incentives for firms to supply training by extending the scope of investment tax breaks to include worker training costs (see Box 1). 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. In line with common practice in other countries, these costs can be deducted as an expense instead of being gradually amortised over the period in which the investment is being used. This instantaneous depreciation allowance is equivalent to a subsidy.[107]

The OECD study also shows that worker training programmes are disproportionately utilised by the more highly educated and skilled workers and that workers in larger enterprises have a higher access rate than those in small-to-medium enterprises. This must be because from the firm's point of view, such workers are expected to provide the greatest returns to training investments. From a social point of view, however, it may be more important to enlarge training access to underachievers and upgrade technical and vocational training for those with inadequate skills to find admission to the job market, or to a steady job.[108]

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Table 32. **Expenditure on education**[1]

	A. Expenditure per student, by level of education,[2] US dollars			B. Expenditure on educational institutions as a percentage of GDP			C. Pupil to teacher ratio
	Primary	All secondary	Tertiary	Public[5]	Private[6]	Total	Primary
Australia	3 981	5 830	11 539	4.34	1.13	5.46	17.3
Austria[3, 7]	6 065	8 163	11 279	5.98	0.38	6.36	14.5
Belgium[4, 8]	3 743	5 970	6 508	4.74	n.a.	4.74	13.9
Canada	n.a.	n.a.	14 579	5.48	0.68	6.16	18.7
Czech Republic	1 645	3 182	5 584	4.07	0.60	4.67	23.4
Denmark	6 713	7 200	9 562	6.81	0.36	7.17	10.6
Finland	4 641	5 111	7 327	5.75	n.a.	5.72	17.4
France	3 752	6 605	7 226	5.88	0.36	6.24	19.6
Germany	3 531	6 209	9 481	4.35	1.20	5.55	21.0
Greece[4, 7]	2 368	3 287	4 157	3.44	1.32	4.76	13.5
Hungary	2 028	2 140	5 073	4.46	0.59	5.04	10.9
Iceland	n.a.	n.a.	n.a.	6.55	0.32	6.87	13.3
Ireland	2 745	3 934	8 522	4.31	0.40	4.71	21.6
Italy[3]	**5 653**	**6 458**	**6 295**	**4.82**	**0.19**	**5.01**	**11.3**
Japan	5 075	5 890	9 871	3.55	1.17	4.72	21.2
Korea	2 838	3 544	6 356	4.07	2.96	7.03	32.2
Mexico	863	1 586	3 800	4.10	0.65	4.75	27.2
Netherlands	3 795	5 304	10 757	4.49	0.12	4.61	16.6
New Zealand[7]	n.a.	n.a.	n.a.	6.05	n.a.	n.a.	20.5
Norway[3, 7]	5 761	7 343	10 918	6.77	0.13	6.90	12.6
Poland[7]	1 496	1 438	4 262	5.35	n.a.	n.a.	n.a.
Portugal	3 121	4 636	n.a.	5.57	0.08	5.65	n.a.
Spain	3 267	4 274	5 038	4.44	0.85	5.30	15.4
Sweden	5 579	5 648	13 224	6.59	0.18	6.77	13.3
Switzerland[3]	6 470	9 348	16 563	5.38	0.47	5.86	16.1
United Kingdom[4]	3 329	5 230	9 699	2.94	0.54	3.48	22.5
United States	6 043	7 764	19 802	4.82	1.61	6.43	16.3
Country mean	3 940	5 294	9 063	5.00	0.66	5.66	18.0
OECD total	3 915	5 625	11 720	4.64	1.11	5.75	

1. For sources and methods see OECD, *Education at a glance* (2001), Annex 3.
2. Expenditure per student in US dollars, converted using PPPs on public and private education based on full-time equivalent.
3. Public institutions.
4. Public and government-dependent private institutions only.
5. Including public subsidies to households attributable for educational institutions. Including direct expenditure on educational institutions from international sources.
6. Net of public subsidies attributable for educational institutions.
7. Public subsidies to households not included in public expenditure, but in private expenditure.
8. Flemish.

Source: OECD, *Education at a Glance*, OECD *Indicators* (2001).

Blanket subsidies for in-firm worker training may in this sense not be the best use of scarce public funds. It should be noted, moreover, that human capital of employed workers in Italy is already quite high, because of past shake-out of lower skill workers. But their skills may be ill-adapted to recent technological developments in the ICT sector, and tax breaks targeted to this particular training need may once again be more cost-effective than blanket subsidies.

A related problem left unsolved by the current approach is that of older workers with deteriorating or redundant skills. The OECD data show that people over 40 are offered very little training because of the relatively short time left in their working lives over which to profit from it. This may subsequently accelerate their exit from the labour force, as firms are anxious to get rid of such workers *via* early retirement schemes or outright firing (especially insofar as pay rises with seniority). This points to a need to encourage people to remain longer in the workforce, by strengthening lifelong learning possibilities. Such a policy would boost labour force participation as well, as the propensity to work beyond age 64 is closely related to the amount of human capital embodied in a worker, which has been shown to be a more powerful force than the pension system "tax" on working longer (*i.e.*, for such workers, work may be said to be enjoyable).[109]

Stimulating MFP *growth*

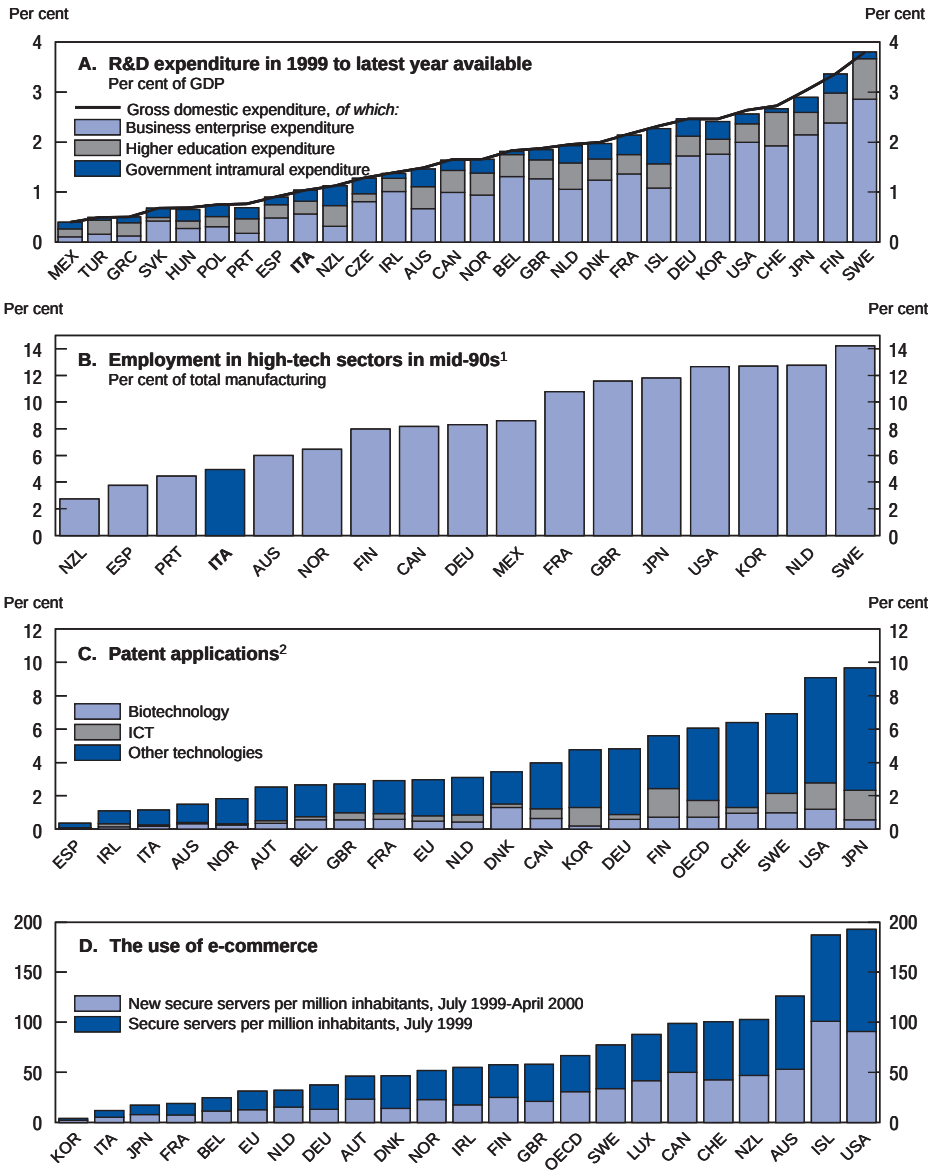
In the longer term, the key to rising living standards is higher MFP growth, which be helped by a higher level of enterprise innovation. In Italy, however, the share of GDP accounted for by private and public spending on R&D is about half the OECD average; the relative size of its high tech sectors is low; and it is toward the bottom of the rankings for patent applications in both the US and Europe (Figure 26, Panels A-C). The amount of e-commerce transactions is still very small compared to most other OECD countries (Panel D). Surveys by the Bank of Italy show that whereas Italian firms have made heavy investments in ICT equipment, the skills needed to make use of such equipment are often lacking, so that expected productivity benefits have largely failed to materialise.

E*nterprise innovation and* R&D

Firm size appears to be a key factor in innovation, with small firms less likely to innovate than larger ones.[110] Since almost half of total employment is to be found in firms with less than 10 employees (below), the implications for the aggregate innovative capacity of Italian industry seem quite negative. However, it would be a mistake to infer that the Italian industrial model is obsolete. The data show that the traditional sector has significantly accelerated its tangible innovative activity, with such investments being highly productive in the case of small firms operating in industrial districts.[111] Therefore a significant chunk of innovation, not directly captured by formal indicators, is the result of spillovers of knowledge deriving from an

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Figure 26. **Innovation indicators**



1. According to ISIC rev. 2, the following are classified as high-technology industries: aircraft (3845), office and computing equipment (3825), drugs and medicines (3522), and radio,TV and communication equipment (3822). For Mexico not including aircraft.
2. Patents granted at the US Patents and Trademark Office relative to GDP, by country of inventor, 1999.

Source: OECD, *Main Science and Technology Indicators*; OECD, STAN database.

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agglomeration of firms within districts. However, these traditional sectors face a higher price elasticity than R&D-intensive sectors, exposing them to intense competition from low-cost developing countries (exports are even less technology-intensive than overall industrial production). This makes the need for innovation, through accelerated application of advanced services and information technology to clusters of small units, all the greater. But firms should also be able to grow if they want to, reacting to the incentives of competition, without policy distortions (notably EPL legislation and financial market constraints) biasing their choice in either direction.

Also hidden among the aggregate indicators are a few bright spots in Italy's education and research system: despite the small number of graduates, its university sector has a relatively strong specialisation in science and technology, with the share of science and engineering graduates on a par with that of Sweden (around 25 per cent).[112] There is also strong specialisation in the health field. While the share of researchers in the labour force is only about half the OECD average (33 *versus* 59 per 10 000), Italy ranks just below Canada in terms of its share of total scientific publications in the OECD area (4 per cent in 1997). However, human resources in science and technology remain concentrated in the public research sector, with few researchers working in industry. There are weak links between scientific research and industrial applications (only 10 per cent of innovative enterprises collaborate in research, against 25 per cent in the EU). Without an increase in business spending on R&D, the contribution of human resources in science and technology to Italy's economy will be limited as will the scope for attracting the return immigration of Italian PhD's working abroad in science and engineering.

The new government has expressed a commitment to developing the new economy in Italy.[113] Besides simplifying financial rules for the creation of innovative business start-ups, it plans to strengthen intellectual property rights by allowing, for the first time, researchers in universities and public research institutions to patent their inventions, entitling them to a portion of the profits thereby generated. While this may help increase the commercial applicability of basic research, more needs to be done. Increasing the share of business spending for R&D should be a priority. Tax relief is a common policy instrument used to stimulate business R&D (given the problems of non-appropriability, indivisibility and risk), and the elasticity of R&D spending with respect to cost is usually high (about 0.4 in Italy). In Italy, however, such aid is exclusively targeted to SMEs where the tax subsidy for R&D is 45 per cent – the highest in the OECD area.[114] Given the low growth of business R&D in the 1990s, there may be scope for a thorough assessment of the impact of tax relief. There may also be a need to eventually increase government R&D spending, which is itself quite low in OECD terms.

Productivity take-off in the South

The main scope for productivity growth is in the South. (The government's medium term GDP growth assumption of 3 per cent requires a rate of at least 4 per

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cent in the South, given resource constraints in the North-Centre). With abundant unused natural, cultural, and human resources, the *Mezzogiorno* has a large growth potential. If such growth were to occur in the high-tech sector, such as ICT-intensive business services, computer programming, e-commerce, and telecommunications,[115] the rise in MFP could be considerable. More regional wage differentiation (as recommended above) could provide a decisive boost to the take-off of such industries,[116] provided that an intensive programme of higher technical education is encouraged by public policies.

Notwithstanding promising initial conditions, a dramatic turnaround requires an equally dramatic change in development policies for the South. The New Competitiveness policies for the Mezzogiorno designed under the previous administration, described extensively in last year's *Survey* and briefly summarised in Chapter III, was just such an attempt to reorient policies toward a more market-based approach anchored in local initiative. Nonetheless, the infrastructure gap and low quality of public services are still major factors hampering productivity growth. The new Strategic Infrastructure Law is meant to fill this gap more quickly. However, as stated in Chapter III, the scope and operation of the law should be made complementary with the needs of the private sector so as not to interfere with the market-based approach. Infrastructure development thus needs to be firmly embedded in a comprehensive strategy that includes cost-benefit analysis of public projects, promoting product market competition especially in local services (below), decentralising wages, and allowing more flexible labour market mechanisms. The issue of social capital is also critical. A high degree of trust between citizens, adequate personal security and administration of justice must be secured before investments, innovation, or growth can be contemplated.[117]

Product and financial market reform to improve competitiveness

Increasing product market competition

The OECD (2001) *Review of Regulatory Reform in Italy* acknowledged the vast distance that has been covered since Italy began liberalising product markets at the start of the 1990s. This required a sustained programme of privatisation, market opening, and deregulation followed by appropriate re-regulation, and institution building. But, as the *Review* stressed, there is considerable scope for further improvement, and raising growth will depend critically on removing the distortions to competition. Without the elimination of entrenched monopoly positions and an easing of barriers to entry, innovation is unlikely to thrive in Italy. The competitiveness of Italian firms depends to a significant degree on improving the quality and reducing the cost of services, notably transport, communications, energy, water and professional services. Reducing regulatory complexity and high costs would moreover lift major impediments to foreign direct investment inflows,

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Table 33. **Foreign direct investment inflows**
As a percentage of GDP

	1995	1996	1997	1998	1999	2000[1]
Austria	0.81	1.91	1.29	2.15	1.42	4.97
Finland	0.82	0.87	1.73	9.41	3.59	7.28
France	1.52	1.41	1.65	2.13	3.27	3.40
Germany	0.56	0.24	0.58	1.13	2.66	9.43
Ireland	0.57	0.79	0.73	10.28	19.50	24.18
Italy	**0.44**	**0.29**	**0.43**	**0.36**	**0.59**	**1.25**
Netherlands	2.96	4.04	2.95	9.40	10.38	14.34
Portugal	0.61	1.32	2.33	2.82	0.99	5.95
Spain	1.08	1.12	1.14	2.01	2.62	6.53
Sweden	6.02	1.94	4.59	8.17	25.20	9.99
United Kingdom	1.92	2.30	2.81	5.24	6.01	9.40

1. Data for 2000 are projections.
Source: OECD.

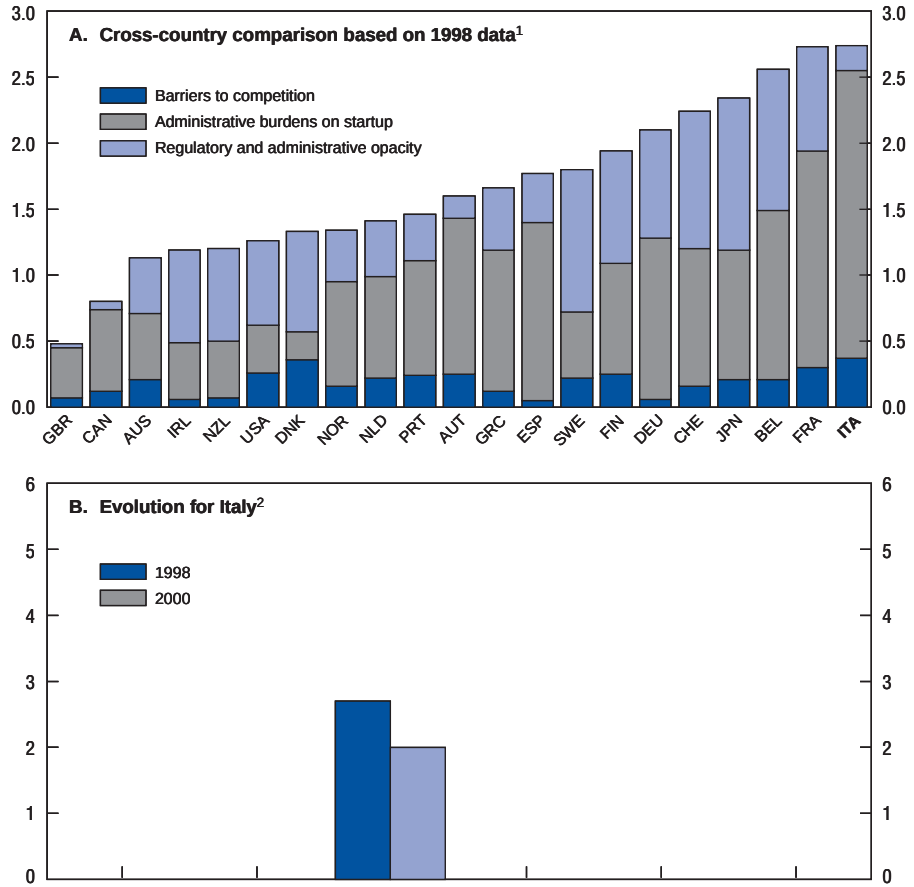
an important potential source of technological diffusion but which are presently very low in Italy (Table 33).

Competition is still weak in many service areas. For example, concessions, licenses and other rules impair competition in local public services, liberal professions, and services to households. The past devolution of regulatory powers to the regional levels has sometimes been problematic for the liberalisation process, for example in retail distribution, in that local governments proved even more susceptible than national government to blocking pressure by the main vested interests. A related form of protection for incumbents in Italy has been that of administrative obstacles to start-ups and product innovations, including lengthy procedures and complex regulations. An important start was made in the direction of simplification by the previous government (*e.g.*, *sportello unico*): it now takes 10 weeks to establish a new firm, down from 22 weeks a few years ago, and other barriers have been reduced, but there are still too many obstacles to enterprise innovation and growth (Figure 27). The insurance sector is another area where competition has failed to take root, and tariffs remain very high (despite a recent 1-year freeze to help control inflation in the wake of oil price rises). There is also a need to boost competition in the privatising network industries (Box 8).

More generally, the history of competition policy in Italy is very recent. EU principles and directives have guided progress in the competition policy area, but a more pro-active approach is needed. The Antitrust Authority, the independent competition watchdog created in 1990, has been the main competition advocate domestically. However, it lacks some of the enforcement powers and flexibility of antitrust regulators in other countries, and thus may be finding it more difficult to prove the existence of secret agreements. It needs to be given a

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Figure 27. **Barriers to entrepreneurship**



Note: In most OECD countries for which data are available, administrative barriers are the biggest single barrier to setting up new business. Barriers to competition, which include price controls and antitrust exemptions played less of a role in all countries.

1. Year 1998 indicators are based on available comparative information and on information provided by Member countries though a survey conducted in March 1998. The scale of indicators is 0-6, from least to most restrictive. The components are weighted to show their relative importance in the overall indicator. Since 1998, many countries have implemented reforms. For some individual countries, more information on recent progress in regulatory reform (including an update of the indicators) can be found in the OECD reviews of regulatory reform.
2. Year 2000 indicator is based on information provided by Italy, using the 1998 OECD methodology with assistance from OECD secretariat.

Source: Nicoletti *et al.* (1999) and OECD (2001*b*).

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Box 8. Competition in network industries

In the newly privatising network industries, namely telecoms, electricity, gas, railways, road and air transport, competition has been more difficult to establish in some sectors than others. The Italian regulatory regime in *telecommunications* has been one of the most pro-competitive in OECD countries and tougher competition has resulted in important benefits for consumers in fixed and mobile telephony and for business in value-added services. However, there is considerable room to bring down voice telephony prices further and to improve access to leased lines, while the regulator needs to remain vigilant so as to ensure competition in the local loop. The golden share regulation on the incumbent should be removed. It would also be desirable to return responsibility for mobile licensing to the communications regulator. In *electricity*, there has been divestiture of some of the dominant firm's (ENEL) generation plant and access to import transmission capacity, and likewise in *gas*, there has been an initial separation of the dominant firm's (ENI) vertically-integrated structure. However, more restructuring of the dominant firms and reductions of their market share is needed. Two important steps in this respect were the recent privatisation of the gas network and the streamlining of procedures to build a new electricity generation plant, thereby facilitating access to the market. In addition, close regulatory attention to creating a level playing field, monitoring charges and promoting consumer choice will be necessary in order to reduce high prices, particularly when compared with the EU, and regional disparities in the quality of services in the energy sector. Consideration should also be given to strengthening the sectoral regulator. Recently intensive merger activity has given further rise to competition concerns in connection with the creation of multi-utilities. The demarcation of regulatory authority in such cases may be unclear, and cross-subsidisation and other anti-competitive practices may be easier to hide. In *transport*, the railways have been liberalised in terms of company separation of the network and the granting of licences to potential competitors of the public sector incumbent, but more reforms are needed to establish the incentives and institutions for market governance, which will however require a rise in tariffs to reflect the withdrawal of subsidies.

A general problem is the way in which concessions have been granted. It is not clear that this was done in a competitive way in the transport sector. The problem is paramount in the local provision of public services, and may have been relevant for railway, *Autostrada* and *Aeroporti di Roma*. For example, in the recent privatisations of *Autostrada* and *Aeroporti di Roma*, 40 to 45 year exclusive concessions to operate were extended to the (pre-selected) purchasers of the privatising firms. The argument was that long concessions are required for such long-lived infrastructure in order to give the operator adequate incentives to invest not only in new and improved capacity, but also in organisational and managerial know-how. Normally, competition "for the market" (*i.e.*, competitive bidding for the licenses of concessions) is used when the nature of the industry precludes competition in the market. The government's argument has been that the existence of huge subsidies in areas such as railways may make bidding as a way of allocating such concessions inefficient. However, it is not clear that the length of the concession or the degree of subsidy cannot

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Box 8. **Competition in network industries** (*cont.*)

be one element of the asset that the government is selling and that should therefore affect its price, making some kind of efficient allocation system via auctioning feasible. But regardless of how it is done, a strong sectoral regulator will be required in order to respond to technology and relative price changes that are impossible to foresee for a 40-50-year asset. It may also be possible to limit the spatial scope of the concession. This may be done by breaking out the competitive parts of the business (*e.g.*, provision of auxiliary services such as baggage handling in the case of airports) and subjecting them to competitive rules. Breaking up the natural monopoly into as many pieces as possible (*e.g.*, privatising the two Rome airports separately) would furthermore allow, if not actual competition (as collusion among a small number of players is likely), then benchmarking (cost comparisons) by the regulator.

wider range of sanctions with strong legal powers. It also should be given a greater say in the shape of the privatisation process, to allow greater weight to be given to competition principles, as opposed to the maximisation of budget revenues. A guiding principle should be that "in the market competition", *i.e.* privatising within a liberalised market structure with no administrative constraints on entry, should take precedence over "for the market" competition, *i.e.* a process of bidding for protected market positions among the potential buyers, and that where the nature of the industry precludes market competition (see Box 8), and strong post-privatisation regulation will be required. Otherwise in the long run, the cost to consumer welfare, competitiveness and growth may well outweigh short term benefits to the budget and to taxpayers.

The DPEF and Stability Programme include very ambitious targets for further privatisation, as well as actions in support of further administrative simplification (Box 11). These documents also recognise an explicit linkage between privatisation and competition policy, given that the major rationale given for privatisation is to improve the supply side of the economy. However, it is essential that it not be taken for granted that competition will increase as government withdraws from the market. Greater attention must be given to maximising the contestibility of market positions created at the outset of the privatisation process. The government has also stated its intention to increase the market content of local public services, to deregulate the liberal professions, and to liberalise retail distribution, regarding these as critical to its policy to boost international competitiveness. These are major areas in need of action, and are likely to require institutional reforms to better co-ordinate competition policy across the different levels

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of government. The 2002 financing law will begin to tackle these issues by providing clear guidance to local authorities with respect to both the obligation to split network ownership and the provision of public services, and to rely on competitive procedures to grant operating licenses. There is also an intention to open the energy sector, although perhaps more active support to the energy regulator may be needed to reduce still very high energy prices in Italy (Box 8).

Improving allocation of capital

Growth will depend finally upon improving the allocation of capital *via* the financial system. Many of the problems referred to above find their counterpart in the financial system. In particular, the polarity of the Italian industrial structure (a host of small firms and a handful of large ones) reflects in part the inability of the system of finance to allow firms to grow, *i.e.* small firms tend to stay small. Insufficient innovation may be partly related to the lack of firms' access to risk capital and of effective market mechanisms for enterprise management control.

Enterprise finance and governance issues

Small enterprises dominate the Italian structure of production: 45 per cent of total employment, more than twice the European average, is in firms with fewer than 10 employees. Reflecting the large weight of small firms, around one-third of all workers in Italy are self-employed, far above the OECD average. There are relatively few large companies, and the gap with other EU countries is also wide for medium-sized enterprises. While the main reason for fragmentation has been high taxes and rigid labour laws, financial factors have also been relevant.[118] Small firms bear a heavy burden in terms of financial costs (absorbing one-third of operating profits, against 17 per cent for large firms), reflecting their substantial recourse to debt capital (Table 34), in turn mainly short-term bank credit, although a large part of investment is family-financed. A structure of liabilities skewed toward debt capital makes for greater financial fragility in adverse phases of the economic cycle. It

Table 34. **Leverage by firm size**[1]

	1996	1997	1998	1999
Employees				
1-14	67.1	67.6	66.6	67.2
15-49	61.2	61.4	61.1	60.4
50-199	56.2	57.2	57.3	56.3
200-499	53.8	52.6	55.4	54.4
≥ 500	49.6	47.7	46.2	43.0

1. Leverage defined as ratio of financial liabilities to total assets.
Source: Banca d'Italia.

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may also prevent firms from grasping good investment opportunities thereby diminishing their growth potential. Moreover, in Italy the practice of borrowing from multiple banks is prevalent, which weakens customer relationships and exacerbates the lack of outside long-term finance and enterprise monitoring.

For larger firms, family finance remains important while listed firms are characterised by a high degree of "insider" control.[119] Indeed, where old patterns of "insider" control have been disrupted by changes in financial regulation (as in the case of privatisations), new mechanisms to prevent an overly active market in corporate control have emerged.[120] Cross-shareholdings have thus (until recently) expanded and take the form of pyramidal structures, enabling control by the use of relatively small direct equity stakes (Table 35). The use of shareholder agreements (informal but tightly exercised coalitions) reinforces insider control. Minority shareholder rights have suffered as a result, a factor preventing more widespread demand for share ownership (Table 36).[121] The stock market has failed to grow in terms of the share of companies listed, which number only about 275 firms despite rather modest thresholds on firm size for entry (although listed firms tend to use the market intensively and a fledgling market for venture capital firms includes 45 firms). Companies seem reluctant to list because they are unwilling to "open their books" to allow new shareholders to participate in their capital, reflecting tax and regulatory, but also cultural, factors. This is also related to the relative lack of medium and large-size firms in Italy. Moreover, few Italian firms are listed on other European exchanges.

Financial market reforms

Reform of the banking system since 1990 has produced a more efficient and market-based allocation of credit (Box 9 and Table 37). In the process, there may have been temporary disruptions in small firm credit supplies especially in the South, where bank restructuring contributed to the severe downturn in the mid-1990s.

Table 35. **Separation between ownership and control**
In the top 10 private-sector groups

	1990	2000
Average number of listed companies per group	6.9	3.3
Group leverage[1]	2.4	1.8
Proportion of non-voting shares[2]	19	8
Average level of control[3]	49.5	54.5

1. Ratio of capital controlled to capital invested.
2. In the company's total market value.
3. Average percentage of shares with voting rights in ordinary shareholders' meetings controlled by the group holding company, weighted by market value.

Source: *www.consob.it.*

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Table 36. **Major shareholders in listed companies**[1]

	1990	1996	1997	1998	1999	2000
Foreign investors	5.0	4.5	5.0	5.9	6.2	6.5
Financial institutions	7.5	10.0	10.4	11.4	11.3	14.1
of which:						
Insurance companies	2.5	1.9	2.2	2.5	1.5	3.2
Banks	2.9	4.3	5.1	4.8	5.3	5.9
Foundations	2.1	3.8	3.1	5.1	4.5	5.0
Companies	22.0	8.2	14.4	12.6	19.4	17.2
State and local authorities	18.1	32.5	12.1	8.8	10.6	10.2
Individuals	5.6	5.5	4.8	3.8	4.5	4.9
Total market capitalisation of major shareholders[2]	58.2	60.7	46.7	43.5	52.0	52.8
Total market capitalisation of the Italian stock market[3]	. .	20.3	30.2	45.1	64.5	67.8

1. Percentage ratio of holdings above 2 per cent with reference to market capitalisation of ordinary share capital of all companies listed on the Italian stock exchange.
2. As a percentage of total market capitalisation.
3. As a percentage of GDP.

Source: *www.consob.it.*

Though no such credit shortages can now be observed, the large bank privatisations of the early 1990s have left a void in terms of development and innovation-oriented finance. Privatisation is itself not complete, as the *fondazioni* (non-profit foundations) continue to hold a significant portion of bank listed capital despite ongoing divestiture of their majority holdings as required by law;[122] as the *fondazioni* are not subject to market forces, this raises concerns about their ability to contribute to effective capital allocation by the banking system.[123] Banks, moreover, have by and large failed to channel savings toward more innovative forms of financing of smaller firms (as for example, intermediaries in commercial paper and bond markets, or investment banking), designed to bring them to capital markets.[124]

Thus, a financing gap for small firms persists – notably in the scarcity of long-term finance based on prospects rather than collateral. Given the importance of local knowledge for small-firm finance, it may be necessary to remove obstacles to the further development of domestic securities markets in order to fill this gap. A venture capital market may also be ideally suited to small enterprise finance. Policy changes of the 1990s have in fact laid the groundwork for capital market development. The return to monetary stability has reduced the cost of capital providing an incentive for firms to rebalance their financial structures away from debt toward equity capital, and for households to lengthen the maturity of their portfolios, including shares. The 1998 tax reform also provided an incentive, in particular the dual income tax (D*it*) which reduced the bias in the tax system against equity financing[125] (albeit Tremonti-bis has discontinued the D*it*, thereby reinstating the former degree of bias in favour of debt finance).

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Box 9. Banking reform

The 1990 Amato Law on bank privatisation and the 1993 Banking Law transposing the EU directives played a major role in fostering a more market-oriented system (although the reform process had already started in the 1980s). Three main trends have been established subsequent to these reforms:

- *Extensive bank privatisation*. The share of total assets held by banks controlled by the state or other public institutions has greatly decreased, from 68 per cent in 1992 to 12 per cent in 2000. The remaining publicly held banks are owned by the *fondazioni* (non-profit entities with close ties to local government), who also continue to hold minority shares in banks more widely (Table 36).[1]
- *Merger and acquisition activities have achieved major consolidation in the sector*. The consolidation process was stimulated by deregulation, the opening up to foreign competition, the growth in asset management business and the introduction of the single currency. It has taken place through the formation of banking groups, of which there are now 74, and has allowed economies of scale in production and distribution of new services, and increased risk diversification. The ratio of bad debts to total loans has declined substantially (Table 37). Reorganisation plans led to a lowering of costs and improved quality of services, especially for small business and individuals. The share of unit labour costs over gross income fell from 7 percentage points above the EU average in the mid-1990s to one of the lowest values in continental Europe. The profitability gap between Italy and the euro area has almost closed. Banks in southern Italy have been major beneficiaries of consolidation, and credit markets are no longer regionally segmented. This has improved the supply of credit in the South.
- *An increase in bank competition due to the easing of entry rules, regulatory action and antitrust enforcement*. The supervisory authority has acted to ensure that the process of consolidation is accompanied by increasing efficiency in the sector and to guarantee competition at local level.[2] The secondary legislation in the field of prudential supervision in the last few years aimed at encouraging banks and banking groups to develop new means of distribution for financial products, to decrease the existing territorial segmentations and to widen customers' choices. The entry into the market of new players, both Italian and foreign, provided an important counterweight to increasing concentration. During the last decade 191 new banks were constituted. The number of foreign bank subsidiaries and branches rose from 41 to 71. Foreign players are especially active in the household mortgage market. The increase in competition has resulted in the reduction of the spread between short-term loans and deposit rates. It has further eliminated regional disparities. Deposit rates are roughly equal across geographic areas, and lending rates differ only by a margin reflecting greater riskiness of loans in the South. Asset management services are supplied on equal terms throughout the country.

1. As financial institutions mainly hold the shares of other financial institutions, notably banks, Table 36 implies that share holdings of the *fondazioni* could amount to as much as one-third of banks' listed capital.
2. The Bank of Italy, in its capacity as antitrust authority in the banking sector, has carried out 38 formal proceedings (consisting in thorough investigations on situations – merger, collusive agreement, abuse of dominant position – that substantially lessen competition in the market), a high number in an international comparison. In more than half of the 18 proceedings regarding concentrations, measures were taken in order to avoid that a dominant position in local markets could arise.

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Table 37. **Banking statistics**

	1990	1995	1998	1999	2000
Net interest income (as per cent of total assets)	3.40	2.78	2.15	1.95	1.92
Non-interest income (as per cent of total assets)	1.02	0.86	1.40	1.60	1.76
Operating expenses (as per cent of total assets)	2.72	2.45	2.16	2.15	2.05
of which: Banking staff costs	1.77	1.55	1.30	1.26	1.15
Net profit as per cent of capital and reserves (ROE)	10.2	1.6	7.5	9.7	11.5
Total assets (per cent of GDP)	120.7	142.0	146.6	147.4	153.3
Total number of employees (thousands)	337	359	346	343	343
Banking staff costs per employee (thousands euros, constant prices)	54.3	57.0	54.4	53.7	53.4
Non performing loans (as per cent of total loans)	5.0	9.2	8.7	7.4	5.7
Number of banks	1 156	970	921	876	841

Source: Banca d'Italia.

The 1998 D*raghi reform* of rules regarding listed companies was a major step forward in changing regulations in support of stock market development, notably by shoring up minority shareholder rights. Its restrictions on cross-shareholdings have reduced pyramiding somewhat, but leverage is still high (Table 35) and share holdings remain highly concentrated (Table 36). The recently-passed reform of company law provides needed technical corrections to the D*raghi reforms*, notably extending their reach to non-listed firms. However, it does not fill all the gaps in protection of minority rights and in transparency (Box 10). The law also provides for the consistent application of rigorous accounting standards to small as well as larger firms (having applied only to the latter in the past), which could remove a major hurdle to stock market listing. However, it will be important that the accompanying alleviation of criminal penalties on (minor) accounting fraud does not create a weakening of standards by the back door.

All in all, efforts to develop the capital market and curtail use of pyramid structures have not borne the anticipated fruits. Perhaps the only answer is growth of more dispersed ownership. The development of private pension funds would provide a major stimulus in this regard. As noted above, the government intends to build a private pension pillar. It should mandate that current TFR contributions be diverted for this purpose, in line with intentions, but tax relief related to further voluntary contributions is likely to be needed to fuel sufficient growth to provide security for workers and to contribute to development of capital markets.[126] And as recommended in last year's S*urvey*, as well as in the recent Brambilla report (Annex II), the funds should remain "open", with full market competition for management and without restrictions on portfolio choices apart from those related to

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Box 10. Reform of financial framework conditions

The OECD growth study has shown that the quality of the rules that govern business has a significant impact on an economy's ability to grow, innovate, and compete. Numerous measures have been adopted recently or are forthcoming in the fields of company law, bankruptcy law, civil justice and regulatory simplification. Their objective is to improve the legal framework in which companies operate.

Company law. A wide ranging reform of the rules governing listed companies was enacted with the Consolidated Law on Financial Intermediation (the so-called Draghi reform) of 1998. Reflecting the view that corporate governance in Italy had been tilted excessively in favour of assuring control by insiders at the expense of shareholder protection, the new provisions marked an advance in the protection of minority shareholders, strengthening their means of protection and enhancing the effectiveness of oversight by the board of auditors. In addition, innovations concerning cross-shareholdings, solicitation to invest, proxy votes, shareholder agreements and take-over bids helped to promote competition and efficiency of the securities market and to increase the contestibility of ownership. In many ways, the reforms took Italy beyond the rest of continental Europe in moving toward the (more transparent) Anglo-Saxon model of shareholder capitalism. However, several neglected issues weakened the impact of the other reforms on shareholder protection, principally the rules on shareholder meetings which still make it costly for investors to call meetings and make proposals to management. Soon afterwards, the government recognised the need for a general reform of company law, and a draft bill was drawn up and still pending in the last Parliament. The new government took up the bill, and it was approved with substantial amendments by the new Parliament in autumn 2001. The new law allows for more diversified provisions on corporate models (reflecting the predominance of small firms and other non-listed companies in the productive structure), simplification of company law, greater autonomy in drafting company by-laws, a broader range of possibilities for corporate finance, more effective measures for protection of investors, and improvement in the quality of financial statements – notably a requirement by small as well as larger firms to adopt transparent accounting standards (in the past, this applied only above a certain firm size). At the same time, the standards and penalties for accounting fraud have been lowered in the criminal part of the law, ostensibly to alleviate the cost to small firms to complying with the new more rigorous accounting standards.

Bankruptcy law. Italian bankruptcy law dates back to 1942 and the need for its reform is widely acknowledged. Italian rules do not pay sufficient attention to maximising the company's value.* And the severe sanctions that they impose on the debtor-entrepreneur, though intended to protect creditors, reduce the incentive to have recourse to bankruptcy procedures, diminishing the prospects of a turnaround and hence a recovery of claims. A reform bill was presented during the last legislature, and was resubmitted in the current legislature, but the new government has stated that intends to present a new proposal. The intention is to simplify procedures, reduce sanctions on the entrepreneur, foster agreements with creditors, and lessen the scope for actions of revocation that are harmful to creditors.

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Box 10. **Reform of financial framework conditions** (*cont.*)

Civil justice. The malfunctioning of the civil justice system is a cause of inefficiency in the economy, undermining competition and generating distortions. The crux of the problem has been the slowness of civil proceedings. In the 1990s, a series of measures was introduced to rectify both the demand for civil justice and the system's ability to supply a remedy. Alongside these measures are the provisions of the reform of company law concerning recourse to the courts. Additional measures regarding the resolution of company disputes are currently under study.

Regulatory and tax simplification. In the 1990s, Italy like most other OECD countries embarked upon a regulatory reform with a view to reducing the direct and indirect costs imposed by regulations on administrations, individuals, and companies. It has aimed at administrative streamlining, ensuring a higher standard for the new rules and the rationalisation of existing ones. Regulatory reform by the new government has continued on the path of administrative simplification while beginning to eliminate the size threshold for the application of rigid job protection rules. A tax reform launched in 1998 aimed at simplification of the tax system, and improving compliance. Such reforms should contribute to a more dynamic enterprise sector, as growth was held back in the past by the increasing regulatory burden associated with larger firm size. Reforms to reduce the underground economy should help address the current reluctance of firms to enter capital markets due to an unwillingness to "open their books". Fiscal transparency could be improved further by allowing limited liability partnerships, which do not tax the company but only the partners, and Italy's lack of such arrangements is an anomaly among OECD countries.

* Well-designed procedures should maximise the economic value of the troubled enterprise (*ex post* efficiency) while furnishing guarantees to its creditors (*ex ante* efficiency).

investor protection. Pension funds could also lead to the emergence of institutional investors with a long-term view, that in turn could come to exercise a role in corporate control as in some other OECD countries. However, it is still necessary to change the rules on shareholders' meetings to reduce the cost for institutional investors to make shareholder proposals and to exercise their vote.[127] Finally, attention is needed to the reform of bankruptcy law, judicial procedures, and tax and regulatory simplification, to eliminate major obstacles to risk-taking and innovation (Box 10).

Conclusions

The new government in Italy, having both a supply-side orientation and large parliamentary majority, is well positioned to deepen the structural reform

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process. If the further dismantling of various forms of protection against competition – in labour, product and financial markets alike – is to proceed against a background of continued social consensus, it is vital that the population be educated on the benefits of reforms. More flexible labour markets will allow reduced social exclusion and higher real wages, albeit greater wage differences and less security for some workers. Thus, strengthening the social safety net is the critical counterpart. The government has rightly stressed the need to eliminate the underground economy in order to increase worker security. However its position on the reform of unemployment benefits (an objective of the last government) is still at an early stage,[128] as is the outcome of the debate on EPL. The new delegated law is an important step toward easing existing EPL. Further pension reform is needed both to improve incentives to participate in the labour market and to raise labour demand *via* cuts in social security tax rates, in particular for low-skill workers. The government's position on pension reform should be fully articulated before the end of 2001, in a way that follows the key recommendations of the Brambilla report.[129] Proceeding with reforms to make the wage setting mechanism more responsive to local labour market conditions is a key element in raising employment and potential output in all Italian regions. The government should therefore further encourage the social partners to come up with a creative new design for the social pact.

Italy's lag *vis-à-vis* other advanced OECD countries in innovation and new forms of international competition is evident. The government has made many promises to facilitate the new economy, but actions so far have been scarce. Years of budget tightness have short-changed human capital development in Italy. But even within tight budget constraints, progress is possible. More regulatory simplification, going beyond the few steps taken thus far, could help to promote domestic innovative activities thus keeping scientists at home. Educational reforms could raise the level of human capital while releasing resources for research and training, if these reforms are sufficiently market-based. Product and financial market competition would also need to be much higher than can be observed in Italy today, and EPL eased, to reduce the constraints on firms to grow and innovate. Thus, standing up to the vested interests that have in a number of cases have blocked the expansion of competition is perhaps the best service that the central government could provide. The combination of greater wage and employment flexibility, better human capital development, and stronger product market competition building upon improved public services, could furthermore help to unleash the long-awaited growth take-off in the South.

A summary of recommendations for structural reform is provided in Box 11.

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Box 11. A review of progress in structural reform

Proposal	Recent action taken	Recommendations
1. Labour market reform		
A. Increase wage and labour cost flexibility		
Lower taxes on labour		Use savings from further pension reform to reduce social security contribution rates especially on low wages; further progress in the fight against tax evasion can also contribute
Reduce obstacles to atypical work contracts	Conditions on use of temporary contracts eased in line with EU directives	Continue to liberalise terms for use of temporary and part-time contracts; eliminate selective fiscal derogations for labour contracts
Links wages to productivity	White Paper invites social partners to develop more flexible wage bargaining	Decentralise wage bargaining to allow for regional differences in productivity levels (without excluding national co-ordination); make wages more responsive to individuals' performance and skill levels; reduce house purchase taxes to spur geographical mobility
Ease employment protection legislation	Government issues delegated law easing EPL at the margin	Replace judicial procedures with arbitration to solve job termination disputes
B. Improve labour market security		
Expand and unify income support schemes for the unemployed	In 2001 Finance Law, unemployment benefits for workers over 50 increased; use of early retirement schemes reduced	Unify replacement rates across sectors and firms and raise toward international norms (making this conditional on easing of EPL); establish strict time limits on receipt of benefits, conditional on a active job search with monitoring
Modernise job-placement services	Procedures for labour placement services and temporary work companies streamlined (single form approvals)	Implement plans to expand private employment agencies and establish competition in the sector; enhance focus of public

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Box 11. **A review of progress in structural reform** (*cont.*)

Proposal	Recent action taken	Recommendations
		employment agencies on weakest subjects; allow all agencies to engage in training activities
Improve job training services	Tax incentives declining due to EU restrictions on their use in the South (releasing resources for training)	Increase training content of youth apprenticeship contracts; refocus and monitor national public training services and improve co-ordination with decentralised job placement services; devote more resources to training
Reduce the underground economy	Tax incentives to declaration of clandestine employees	Strengthen enforcement and monitoring of tax, social security, and work safety laws; reduce tax burden on labour, particularly for low-skill workers
Build a private pension leg	Brambilla Commission presents reform options, government presents draft delegated law on pension reform	Divert TFR to mandatory contributions for private pension fund; allow tax credits for voluntary contributions; open pension funds
C. Raise labour force participation		
Raise older workers participation	Finance Law of 2001 eliminates social security contributions for workers eligible for retirement, and expands possibilities for cumulating pension with employment income	Further pension reform to reduce implicit tax on working longer in the transition phase to the new system and for people over 64; phase-out seniority pensions more quickly
Raise female participation	Finance Law of 2002 expands family tax credits	Socialise part of child and old-age care, using part of pension savings, *via* tax credits for home care or specialised institutions (*e.g.*, day care centres); further ease part-time work

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Box 11. **A review of progress in structural reform** (*cont.*)

Proposal	Recent action taken	Recommendations
II.Human capital development and fostering innovation		
A. Human capital		
Raise educational attainment of the population	Compulsory schooling raised to 15 in 1999	Raise school-leaving age to upper secondary level; in the meantime provide for effective training services mandatory for school leavers until age 18
Improve links between school and labour market		More specialised and vocational schools at upper secondary level needed to reduce high drop-out rates; non-university post-secondary degrees (or short university courses) in technical training; provide for traineeships and other insertion mechanisms
Improve quality of tertiary education	Decentralisation of university administration in 1999; university curricula restructured and modernised	Market-based management reforms in universities; continue to monitor decentralisation reforms
B. Innovation		
Raise effectiveness of education spending	National Education Plan presented, including 10 billion euro extra spending over next 5 years	Make "quality teaching" a priority in compulsory schooling; consider use of vouchers; allow more local autonomy in negotiating with teachers' unions; use means-tested copayments, scholarships, and government student loans to finance tertiary sector
Improve job training	Tremonti-bis applies to worker training as part of investment	Target subsidies to weaker labour market elements and to technological training of employed workers

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Box 11. **A review of progress in structural reform** (*cont.*)

Proposal	Recent action taken	Recommendations
Increase R&D spending and rebalance toward business	Patents for university researchers allowed; public funding for R&D frozen in 2002 at 2001 level, in contrast to earlier intentions (a negative action)	Review tax relief schemes for R&D to SMEs and potentially apply them to larger firms; encourage research collaboration between universities and enterprises; increase public R&D spending to OECD norm
Reduce barriers to business start-ups	Financial rules (on initial capital subscriptions) for establishing a new firm eased	Foster venture capital market; allow limited liability partnerships; reform bankruptcy law and related judicial processes
Reduce administrative burden on business	Elimination of official approvals for house refurbishing and of mid-year VAT instalment	Further reduce red tape including approvals for new products; further simplify the tax system
III. Competition and allocation of resources		
A. Increase product market competition		
Continue privatisations	DPEF and Stability Programme include ambitious further privatisation targets, amounting to 1 per cent of GDP per year for 5 years, with new fast-track procedures	Implement plans while liberalising sectors before privatisation; ensure competitive bidding and coherence of the privatisation process with competition policy (to maximise market contestibility of the privatised entity); better monitoring of the competitive impact over time of the process
Deregulate local public services, liberal professions and retail trade	Plans to liberalise these sectors in DPEF (22-point plan)	Implement plans; allow better co-ordination in competition policy between national and local levels; more forceful insistence by the insurance authority on compliance with the rules of competition

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Box 11. **A review of progress in structural reform** (*cont.*)

Proposal	Recent action taken	Recommendations
Create competition in network industries	Transport sector starting liberalisation; separation of vertical structure of ENI; partial divestiture of ENEL generation plant and access to import transmission capacity; plan to open energy sector in DPEF	In energy, more restructuring of the dominant firms and reduction of their market share (going beyond administrative actions, and involving more active regulation); ensure market incentives in rail and air transport and more competition in road transport; in telecommunications, implement the unbundling of the local loop
Persevere with market-led strategy for the South	2001-06 cofinancing plan with EU structural funds announced	Strengthen the role of cost-benefit analysis at all tiers of government; strengthen local competition and make labour markets more flexible; strengthen rule of law
Foster a "competition culture"		Strengthen powers of Antitrust and sectoral regulators; educate the public on the benefits of competition
B. More efficient financial markets		
Deepen capital markets	New Company Law passed	Develop private pension funds; further strengthen minority shareholder rights (*e.g.*, make calling shareholder meetings less costly) to reduce prevalence of pyramid schemes; strengthen accounting standards; continue regulatory simplification
Improve bank governance	The 2002 Finance Law introduces radical reform of *fondazioni* by 2006, requiring complete divestitures of bank holdings and full non-profit status	Review policies regulating hostile take-overs of banks by banks; implement reform of *fondazioni*

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Notes

1. See OECD (2000*a*) for further details.
2. Harmonised consumer price index less energy, food, alcohols and tobacco.
3. The July 2001 DPEF envisages an inflation rate of 2.8 per cent in 2001 and 1.7 per cent in 2002.
4. Currently, wage setting in Italy occurs on two distinct levels – the first is the central level, which defines the national industry reference wage, taking into account the officially projected inflation and past unexpected price rises; the second is the firm-level, whereby wage premia are linked to individual firm productivity performance (see Chapter IV).
5. See OECD (2000*a*) and ISTAT (2001).
6. The accurate measurement of capital input is inherently difficult and comparisons across countries maybe particularly so. For a discussion of the different empirical assumptions see Scarpetta *et al.* (2000).
7. According to recent estimates by Scarpetta *et al.* (2000), the growth rate of capital-intensity, measured as the capital/labour ratio, increased in the 1990s compared to the 1980s, but this was mainly driven by losses in employment rather than an acceleration of investment.
8. Consistent with the medium term fiscal plan of June 1999, the December 1999 Stability Programme set a target for the general government budget deficit in 2000 of 1.5 per cent of GDP, associated with a primary surplus of 5 per cent of GDP. However, given a better than expected economic performance, the June 2000 DPEF set new targets for the year, at 1.3 per cent of GDP for the budget deficit and 5.2 per cent for the primary surplus. In the event, the outturn equalled the old target.
9. This was due mainly to transitory factors, since such benefits were indexed to the previous year's lower inflation rate. There was also a fall in the number of new pensions as the higher age of entitlement to the old-age pension scheme was fully phased in.
10. The obligation to refund such arrears results in a temporary increase of the cash borrowing requirement without any accrual counterpart.
11. By that time, the official projection of real output growth in 2001 was lowered slightly (to 2.4 per cent), while the projected size of the deficit was increased by almost a full percentage point of GDP (to 1.9 per cent). As a result, the overall magnitude of the annual revision equalled 1.1 per cent of GDP, with roughly three quarters of this amount being contributed by the fiscal slippage, and the remaining quarter by slower output growth.
12. Banca d'Italia (2001*a*, *b*), Corte dei Conti (2001).

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13. Designated with the name of N*ota di aggiornamento al* DPEF.

14. Applying the penalty of 2.5 per cent of the value of the assets declared (see Box 1), the latter would need to be 76 trillion lira in order to produce the 1.9 trillion lira in budgeted revenues (Table 10). However, to the extent that taxpayers choose the option of buying government bonds in the amount of 12 per cent of the repatriated capital, in lieu of paying the penalty, the capital reflow would need to be greater than 76 trillion. Italian banks have reported larger than anticipated capital reflows in the early months of the amnesty, and their estimates of the total final amount range from 50 to 100 billion euros, *i.e.* about 100 to 200 trillion lira (see "Sotto lo scudo più capitali del previsto", *Il Sole* 24 *Ore*, 28 November 2001, p. 2).

15. An alternative corporate income tax rate of 10 per cent, in 2001, 15 per cent in 2002 and 20 per cent in 2003 (instead of the standard 36 per cent rate). A lower flat rate of 8 per cent in 2001 (rising to 10 and 12 per cent in 2002 and 2003, respectively) will replace the standard employer social security contribution rates. Similarly, employees will pay a flat-rate income tax of 6 per cent (8 per cent in 2002 and 10 per cent in 2003), while being fully exempt from paying social security contributions. As concerns past years, firms and employees concerned are entitled to benefit from a partial amnesty on past taxable incomes and social security contributions. Consequently, the ordinary penalty is replaced by the payment of an alternative flat tax rate of 8 per cent on the declared income.

16. For investment after June 2001, the government has substituted the tax incentives allowed by the D*it* with those envisaged under the T*remonti* L*aw* II.

17. The leaving age for compulsory schooling was raised to fourteen years in 1962, while both a social pension system and a universal national health care programme were introduced in the 1970s.

18. See for a wider discussion of these developments Signorini and Visco (1999).

19. See EC (2001).

20. In part this reflected a fall in prices as bribes were substantially reduced.

21. See ISTAT (2001), pp. 231-283. From the supply viewpoint, several factors contributed to the decline in public works, including reductions in commitments for investment projects in the annual financial law, postponements in the execution of several multi-year projects and administrative cash management by the Ministry of the Economy and Finance.

22. This is a problem common to many OECD countries. For a general discussion see OECD (2001*a*), pp. 145-167, and Dang *et al.* (2001).

23. OECD (2000*a*), p. 65.

24. The calculations show that raising the long-term growth rate to nearer to 1½ per cent would allow the 60 per cent threshold to be eventually reached at the current level of the primary surplus despite the expected rise in ageing costs. However, also raising the primary surplus to above 6 per cent would allow the debt target to be reached much more quickly, creating room for tax cuts and an easing of the primary surplus requirement relatively early on.

25. In a number of areas, including education, for example, the Italian public sector spends even less than is the case in the United States and Canada, which are known for their stronger reliance on the private sector for the provision of social services. See Atkinson and van den Noord (2001).

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26. The functional breakdown is less comprehensive than that by economic categories, a reflection of differing systems of classification and data constraints, while there is also a lack of sufficiently up-to-date figures. See Adema (2001).
27. D'Alessio and Signorini (2000). See also Brandolini and D'Alessio (2000).
28. A number of recent studies on the personal distribution of incomes show that the pattern of income inequalities has tended to worsen for Italy. See, for example, Brandolini (1999).
29. Included in the latter are major labour market changes and the related increase in female participation rates, which have been accompanied by a declining average family size.
30. Marlier and Cohen-Solal (2000).
31. Furthermore, with this share decreasing quite slowly with income, the third, fourth and the top fifth quintiles combined together still total 36 per cent of overall non-pension benefits, a much higher proportion than the corresponding EU average.
32. Van den Noord (2000).
33. For a general discussion see OECD (2001*b*) and Goglio (2001).
34. The fiscal dimension of privatisation is also important, with massive sales of state assets aimed at debt redemption having been needed to assist the beneficial effects of a high level of the primary surplus. Since 1995 privatisation sales acted to reduce the debt ratio by about 7½ percentage points of GDP.
35. See Tanzi (1994), p. 306 and Commissione Tecnica per la Spesa Pubblica (1998), p. 15.
36. See Von Hagen and Harden (1996) and Koutopoulos and Perotti (1999).
37. Perez (1997).
38. Perez (1999).
39. From the strategic viewpoint, the role of the DPEF in overall economic programming has been increased *via* the incorporation of an annual review of structural reforms, in both product and labour markets, an illustration of privatisation objectives and an assessment of policy initiatives targeted on enhancing the growth potential of the *Mezzogiorno* (such as in the domain of infrastructure investment, for example).
40. Tanzi (1994).
41. ISAE (2001).
42. OECD (2001*b*), p. 52.
43. OECD (2001*b*), p. 74.
44. Commissione Tecnica per la Spesa Pubblica (2001*a*).
45. OECD (2001*b*), p. 65.
46. On the other hand, centralisation of tax *administration* was probably warranted insofar as a myriad of local taxes and fees had complicated the system and fragmented tax collection had been inefficient. This probably contributed to the substantial increase in real tax revenues in the late 1970s and early 1980s.
47. The National Health Fund and the National Transport Fund are the two main earmarked funds. Health and transportation services are not provided directly by the regions but rather by the local health units and public (and private) enterprises in the transport sector, and although these entities in principle can charge fees and tariffs, these are kept low for reasons of social policy.

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48. In early 2001, prior to national elections, the central government prohibited imposition of the "ticket", a copayment on pharmaceuticals, by local health units. This denied regions an important tool for meeting commitments under the internal stability pact, which were still expected by central government.

49. In a recent case, the constitutional court has sided with the regions in this matter and ordered the central government to provide grants to cover the extra cost of providing nationally mandated "essential" services.

50. See Giarda (2000). To some extent, of course, the corruption scandals justified these doubts.

51. Regions are permitted to borrow only for the capital budget and for share participation in public enterprises, with the proviso that capital charges (interest plus principal repayment) not exceed 25 per cent of regional own revenue, net of health contributions. Local Health Units and transportation companies (accounting for about 80 per cent of regional expenditure), on the other hand, can borrow from commercial banks to pay suppliers' bills.

52. Prior to 1992, lower level governments could not levy taxes or modify tax rates, which were set by the central government.

53. The "solidarity coefficient" of 90 per cent was a compromise solution after a fierce debate – the poorer regions had wanted 100 per cent, and the government 80 per cent. The use of standardised (potential) rather than actual revenues in the formula is meant to sanction the lack of fiscal effort.

54. The concept of eligible health care expenditures is used to determine the average eligible cost and thus the distance from the average. Under the existing law on the national health service, this should be based on a uniform level of services to be provided across the country and an estimate for each region of the per capita cost of providing these services. The previous system for allocating grants was based on the same mechanism. However, it was extremely difficult to come to an agreement, and the allocation formula between 1980 and 1997 changed practically every year. See Annunziata and Szekely (2000).

55. Simulations in Annunziata and Szekely (2000) show that annual increases in health care costs 1 percentage point higher than the real GDP growth rate would create a sizeable imbalance in the system within a decade. While the affluent northern regions could raise their required extra revenue by raising their IRAP and regional personal income tax rates, none of the southern regions would be able to do so. This might lead to a continuous reform of the tax assignment and equalisation mechanism, reducing its credibility.

56. While the overall system of transfers succeeded in more or less equalising per capita nominal expenditure across regions, sharp differences arose among local per-capita expenditure levels *within* regions in response to different abilities to negotiate with central government officials and/or to differences in political affiliations at the regional level. See Giarda (2000).

57. In the advanced OECD countries in general, there seems to be little relation between the level of health spending and health outcomes such as life expectancy.

58. For example, waiting times in Italy average 23 days for a liver sonogram, 74 days for an endoscopy. The average payment-to-supplier delay for the purchase of hospital supplies was 251 days in 1998, an increase of 30 per cent from the previous year, while in regions such as Emilia-Romagna and Lazio, the delays were 343 and 449 days, respectively. See Reviglio (2000).

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59. Reviglio, *op. cit.*
60. ISAE (2001).
61. Pisauro (2001), Tanzi (1994).
62. Some authors have suggested that it may not be wise to eliminate vertical financial imbalances altogether, since some level of grants from the central government is needed in order to give it a lever over subnational governments (see, *e.g.*, Pisauro 2001).
63. See Commissione Tecnica per la Spesa Pubblica (2001*b*).
64. See Reviglio (2000), p. 24.
65. See Lorenzini and Petretto (2000).
66. See Tanzi (1996).
67. See Atkinson and van den Noord (2001).
68. See 2001 OECD *Survey of United Kingdom*.
69. Recent studies of major voucher schemes experiments in the United States (Ohio and Wisconsin) show that school systems making use of vouchers showed much better educational performance outcomes than schools that did not make use of vouchers (see Hoxby, 2001). Competition is likely to be needed in the education sector in order to counteract the strength of treachers unions (in virtually all OECD countries).
70. A cross-country analysis by ISAE (2001) shows that the most critical element of success in the decentralisation process seems to be the creation of such an atmosphere of mutual trust.
71. Wurzel (2001) shows that the German government's failure to adopt such practices led to massive waste in infrastructure spending in the Eastern Länder.
72. The first two panels of Figure 22 present correlations between changes in MFP growth and *changes* in various indicators of innovative activity, whereas the latter two present correlations between changes in MFP growth and *levels* of various "state variables" that make possible improvements in trend MFP growth.
73. Figure 27 below shows that Italy performs significantly better with respect to the two other types of barriers to entrepreneurship, namely regulatory transparency and barriers competition. It also shows that when Italy's composite indicator is updated to 2000, it falls by about 25 per cent, reflecting the impact of the administrative simplification ("Bassanini") reforms pursued in the late 1990s. However, these changes would have come too late to materially affect the growth of MFP during the 1990s, so that the level of administrative barriers observed in 1998 would still be the more appropriate ones to use for the correlations reported in Panel C of Figure 22. Also, Italy's position at the upper end of the spectrum for administrative burdens on start-ups would remain unaffected even assuming that no improvements have taken place elsewhere.
74. OECD estimates show that the long-run effect on output of one additional year of schooling in the population at large is about 6 per cent.
75. The educational attainment of workers declines quite sharply with age in Italy (see OECD, 2001*f*). The two factors reinforced each other to the extent that labour shedding was often applied to older workers in the form of early retirement.
76. See Leibfritz *et al.* (1997) for a discussion of taxes and employment.
77. Until then, labour input had been regulated mainly by changes in per capita working hours, absenteeism, and overtime. Labour and capital underutilisation resulted from

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this inefficiency, and labour intensive production was discouraged. See Casadio and D'Aurizio (2001). The *Cassa Integrazione* (CIG), a public income support scheme for collective but temporary suspensions of activity, or else for permanent dismissals owing to restructurings, was also used to adjust labour input, but it applied mainly to larger firms and covered only 20 per cent of the workforce, and benefits were very uneven across firms.

78. The structural improvement was also reflected in a decline in the OECD's measure of "non-accelerating inflation rate of unemployment" (NAIRU), from 10.2 per cent in 1997 to 9.3 per cent in 2001.

79. Conversely, much of the sharp decline in employment in the South in the mid-1990s had reflected the scaling down of government employment and the phase-out of social security rebates, as well as the drop in construction activity following the discovery of widespread abuse of public funds, *tangentopoli*.

80. See Ministero del Lavoro e delle Politiche Sociali (2001*b*).

81. See OECD (2000*a*), Figure 32.

82. The first effect is due to the predominance of undifferentiated wage premia. The second and third effects are due to the partial diffusion of firm-level contracts and flexible wage premia (it is estimated that about half of workers are not covered by firm-level flexible premia). Thus, the only partial distribution of productivity gains favours the registered tendency toward the reduction of the labour share in Italy. See Casadio and D'Aurizio (2001).

83. Sestito (2002) recommends that the role of the national level be changed from one of the "pivot" of the system to one of the definition of certain minimum guarantees to workers (in this sense, wage decentralisation takes on some of the aspects of fiscal decentralisation seen in the discussion of health care or education in the previous chapter).

84. This is the *de facto* solution that has been adopted by Germany to improve the wage competitiveness of the Eastern Länder.

85. Major favourable revisions to the labour force statistics in 1992 incorporated such a demographic change. A more accurate method of estimating the population age structure revealed a much smaller share of young people in the population and a correspondingly higher share of adults and middle-age groups.

86. As last year's *Survey* pointed out, demographic factors will imply a relatively sharp decline in working age population over the next two to three decades, with a resulting rise in old-age dependency ratio that has necessitated reforms to reduce benefit generosity for future retirees under the PAYG pension system.

87. OECD (2000*b* and 2001*d*) show that Italy scores very low in terms of young children using formal child-care arrangements, while female participation is very low not only for mothers but also for non-mothers. Among mothers, moreover, there is a huge difference between the employment rate of the highly educated (69.4 per cent) and the low educated (26.1 per cent).

88. The EPL indicator, shown in Figures 22 and 25, is a weighted average of indicators for regular contracts, temporary contracts, and collective dismissals – Italy scores quite high on all three and therefore Article 18 is not the only determinant of the country's position in the overall ranking.

89. See OECD (2001*g*). It should be noted that in this study, the dependent variable responding to EPL in the cross-country regressions is not worker training by firms, but

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R&D spending by high-technology industries (of which there are relatively few in Italy), and the strength of the response tends to be inversely related to the degree of co-ordination in industrial relations. The link with the propensity to offer worker training is, rather, an inference.

90. The unions claim that Article 18 is not a factor relevant to small firm size, because so few firms can be observed in the 11 to 15 employee range. This, however, may not be sufficient argument as tax and other regulatory factors also come into play.

91. See Galli (2000).

92. ISAE (2001).

93. Unlike in France, reduced social security contributions acting as labour market incentives have a full counterpart in reduced future pension benefits, consistent with actuarial fairness of the new system.

94. There may be an implicit presumption among policy makers that since the uptake of such contracts is primarily by women and young people, social security concerns are less pressing: the former normally provide only a second income, with their security deriving from the primary earner, and the latter still have many years ahead in which to build up pension rights. What may be important is to get these people into the job market, to avoid a deterioration of skills that could otherwise develop.

95. The unions argue that the Article 18 provisions are rarely used in any event, because of the long and costly delays for the worker. It may be argued, however, it is the *threat* of such costs that would arise for the employer as well in the case of a court action, that may inhibit recourse to this provision.

96. As noted in Chapter III, unemployment benefits are structurally low compared to other European countries.

97. See OECD (1994) for a discussion.

98. See Ministero dell'Economia e delle Finanze (2001).

99. ISTAT estimates that irregular employment amounted to 3.5 million workers in 1998, implying an underground economy equivalent to 15 per cent of GDP. A new study by Censis (2001), however, estimates such workers at 5 million (a large part of which in the South), bringing the size of the underground economy to 20 per cent of GDP. The report claims that the differences with the Istat estimates are due to a more complete accounting for immigrant labour and women working from their homes.

100. See OECD (2001*g*).

101. An education reform in the late 1990s which gave more administrative powers to the local levels initially attracted a repatriation of professorial talent, but it largely backfired insofar as university administrators tended to abuse their new rights in exercising even heavier favouritism in hiring decisions than before.

102. The Bertagna Commission on education reform presented its report in late November. It calls for a reform of the school cycle featuring the main following elements: 3 years of pre-school remain optional; elementary and middle school, 5 and 3 years, respectively, both remaining compulsory; at age 14, upon completion of middle school, students choose one of three routes: *i*) lycée (high-school) for 4 years instead of the current 5; *ii*) professional institute offering technical training for 3 or 4 years, the latter resulting in a diploma giving the right to university entry or further technical training; or *iii*) secondary-level training alternating with work experience (*i.e.* for school-leavers). This plan, to be subject to national debate in late December, would align Italy with most other OECD countries in terms of the age at which secondary studies are

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completed (18), while improving the school-to-work transition *via* a greater focus on technical training.

103. See Checchi (2000). The study stresses that students from better off families persevere with their studies not only because their families provide more encouragement (as might be expected), but also because their professional job prospects tend to be much brighter thanks to family connections.

104. For 18 year olds, enrolment in the school system increased from 70 to 74 per cent between 1995 and 2000. See Sestito (2002).

105. In the new 5-year National Education Plan, 10 billion euro in new "investment" spending for schooling is allocated to the following areas: educational reform, technological innovations, teacher training and continuing education of teachers; *obbligo formativo* and adult education, professionalisation of school managers, school buildings, and financing for private schools at the compulsory schooling level.

106. An ISAE (2001) study of firm-level data notes that job turnover is higher among insiders (defined as including both permanent workers and young workers repeatedly hired on fixed-term contracts), as in the presence of high hiring costs and even higher firing costs, firms prefer to turn to "tested" workers.

107. This depends on the economic depreciation rate of the new skill, the corporate tax rate and the real interest rate. For example, for values of straight-line depreciation over 10 years, 25 per cent, and 4 per cent respectively for these variables, the rate of subsidy is 4 per cent. See OECD (2001*f*).

108. Other countries' experience shows that trying to training subsidies to such groups tends not to work well.

109. See OECD (2000*a*), Chapter III.

110. An EU survey (EUROSTAT – CIS2) shows that the proportion of firms introducing innovations rises from 44 per cent for firms with 20-49 employees to 79 per cent for those with more than 500 employees. An analysis carried out by ISTAT and the Italian Research Council (2000) gives similar results, and also shows that firms located in southern Italy are much less likely to innovate than those in the North-East.

111. The ISTAT (2001) study finds that "traditional" industries have performed much more effectively than other sectors in terms of achieving greater reductions in labour costs from process and product innovations, with gains particularly high for smaller firms (defined as 20-49 employees), and that being in an industrial district enhances performance even further. Studies for the United States also show that the innovation rate, defined as number of innovations per employee, is higher for SMEs than for larger firms.

112. See OECD, *Education at a Glance*, 2000.

113. See Ministero dell'Economia et delle Finanze (2001).

114. See STI Scoreboard 2001, Figure A.6.6.

115. The growth of e-commerce could bring particularly large reductions in transactions costs for all firms in Italy. It depends on several factors: payments systems are secure, reliable and widely accepted; safeguards for the security and certainty of transactions; adequate regulation of on-line transactions; rules to protect privacy; and the achievement of a critical mass of transactions. See Coppel (2001).

116. Germany's experience in integration of the New Länder may be instructive in this regard. Substantial differences in productivity have co-existed with official policies to

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equalise wages. The resulting loss of competitiveness required massive fiscal transfers and ill-conceived infrastructure projects, keeping taxes high and creating a dependency culture. Training and work provision schemes of idle labour largely failed with respect to improving employment prospects, and even served as a negative signalling device. Worker training in firms suffered because of the lack of viable productive activities. This set up a vicious cycle whereby productivity levels have failed to converge with wage rates. See Wurzel (2001).

117. Fazio (1999).

118. A survey conducted in 2001 by the Abacus Institute indicates that labour market rigidities, in particular the difficulty of reducing personnel, are the prime reason for small firms' failure to grow, cited by over 30 per cent of respondents. In second place is the high tax burden (29 per cent), and thirdly, financial constraints (20 per cent). Inadequate public infrastructure was only cited by 6 per cent of firms. See Ministero dell'Economia e delle Finanze (2001).

119. A notable exception is Mediobanca, which established a unique and powerful position as an investment bank with long-term lending and equity stakes in many firms.

120. See Deeg and Perez (2000).

121. On average, the top 5 largest shareholders of large companies hold 87 per cent of its shares; more than half of listed firms are controlled by a single owner.

122. Divestiture of majority holdings was often brought about by the merger of a *fondazioni*-owned small bank (*Cassa di Risparmio*) with a larger private bank, reducing their share holdings to minority status in the merged entity. The new government has introduced, within the 2002 financial law, a radical reform of the *fondazioni*, which calls for a complete withdrawal from the banking business and redesign along the lines of the model of the US Foundations, non-profit institutions which leave the management of their investment portfolios to independent trusts. The reform is to be completed by 2006.

123. See OECD (2001*b*).

124. The 1993 Banking Law (Box 9) included measures to stimulate long-term relations between universal banks and firms, patterned on Germany, for example by allowing banks to issue bonds and medium-to-long term credit (previously reserved for specialised credit institutions) and to hold equity stakes in non financial firms. It also permitted non financial firms to issue commercial paper and long-term investment certificates in an effort to increase long term funding to firms. See Deeg and Perez (2000).

125. See the OECD (2000*a*), Chapter II.

126. Ministero dell'Economia e delle Finanze (2001), Box on *Il secondo pilastro previdenziale*, which suggests that tax relief on income from pension savings, rather than on principal, is likely to be sufficient to allow for pension fund growth while not being too costly for the budget.

127. Bianchi and Enriques (2001) argue that mutual funds, which have emerged as significant items on the liabilities side of bank balance sheets, could also come to exercise a role in corporate control, if minority rights are further strengthened.

128. See Ministero del Lavoro e delle Politiche Sociali (2001*b*).

129. A draft delegated law was presented to the Social Partners in early December, envisaging incentives to postpone retirement age, use of TFR for private pension insurance, and reduction of pension contribution by firms for newly hired workers.

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Annex I
The sale of public real estate assets

Background

Concerning the sale of public real properties, the Italian authorities have put at the top of their agenda residential buildings and other properties which are suitable for business use (retail and office space). Later on, they will decide on the feasibility of selling assets which because of their state of preservation and/or location are less attractive to the market (abandoned and remote railways stations and military quarters, for example). Historic buildings which are protected by special environment and artistic preservation norms (palaces, museums and monuments, for example) will not be sold. Based on the most recent announcements, the revenues officially expected from the realisation of the sales programme are equal to 60 trillion lira (between 2½ and 3 percentage points of GDP), still a prudent estimate according to the government.

Previous attempts to sell public properties have given largely disappointing results. An amount of 6 trillion lira (about a quarter of a point of GDP) had been included in the budget for 2000 but never realised. For 2001, the government expects between 4 and 6 trillion, which is less than the 8 trillion originally set in the 2001 budget. A major stumbling block has been the need to update the inventory of properties, partly because ownership is split across various entities of the general government, *i.e.* central government, the local authorities and the social security institutions. Even more critically, the decision to sell properties individually has magnified the veto power of the authorities at lower levels of government which own most of the properties and feel concerned about the prospect of lower rental income. Such difficulties have been compounded by the existence of a large number of tenants in arrears on their rent payments, given the reluctance of the state to face lengthy dispute settlement procedures which would need to be entered into on a case by case basis.

The new approach

Securitisation

This background has called for the definition of a selling strategy that can generate rapid results, while also ensuring procedures which are as transparent as possible. The first requisite, *rapidity*, is to be achieved via the method of securitisation, according to which a given bloc of properties is sold by the state to an independent private company which will be allowed to raise funds through selling collateralised bonds to the general public. Each bloc of properties will be defined according to predetermined criteria, so as to ensure that properties characterised by a similar usage (whether private, or business), quality and value are grouped together. Each purchasing company is to be created *ad hoc*, most likely encompassing a consortium of investment banks. Later on, the company will be free to resell

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the properties to the market on an individual basis. Because of its role as an intermediary between the state and the market the purchasing company has been designated, as in past securitisation operations, with the name of Special Purpose Vehicle (SPV).

The second requirement, *transparency*, is a key precondition in order to build the trust between bond issuers and purchasers which will be needed to realise a successful securitisation programme. Under the new approach, the properties will be used as collateral for the bonds with the state committed, at this stage, to a below-market price. The prospect that the SPV will resell the collateral at a higher price is equivalent to an insurance to the bond holder against the risk of default, thus enhancing both the attractiveness of the operation to the purchasers and the likelihood that the bonds will receive a high rating. Moreover, bond holders will be able to resell their bonds on the secondary market for state securities.

Sale of individual properties

As noted, each SPV can resell its portfolio of properties to the market on a case by case basis and one of its statutory missions will be to do this under the best possible conditions. The surplus so created will be paid back to the state having taken into account transaction costs and brokerage fees.

Treatment of receipts and budgetary impacts

The treatment of the receipts resulting from public asset sales may take various forms, according to Eurostat. For example, the receipts accruing to a public holding company which sells shares or other equity it owns in a third enterprise have to be fully recorded in the financial accounts of both the holding and the general government. As such, the sale has no consequences for the net lending of the general government. Similar treatment is reserved for receipts of a company in which the government has a holding which sells real assets it owns. By contrast, the direct sale of real assets by the state (fixed assets, inventories, valuable, land or other non-produced non-financial assets) is treated as a capital receipt item in the national accounts and as such it has a positive impact on the net lending of the general government.

The sale of properties can thus be used for the purpose of meeting the deficit targets agreed with the EU under the *Stability Programme*. However, while the revenues from the securitisation can be fully used for deficit reduction – in which case they will be recorded when the change of ownership takes place – the criteria underlying the treatment in the budget account of the surplus attached to the resale of individual properties are still to be determined.

At the time of writing, one SPV, comprising both domestic and international partners, has been mandated to proceed to the securitisation of the first bloc of properties. The government expects this operation to be fully realised before the end of 2001 so as to assist the achievement of the fiscal targets for the year.

Other incentives

Past experience suggests that the execution of the programme would be highly problematic in the absence of carefully designed incentives, in part because of the important vested interests it will affect. On top of the usual purchasing pre-emption right, current tenants of public properties will be entitled to purchase these properties from the SPV at a 30 per cent discount on the market value. Special safeguard guarantees will protect low-income tenants from the risk of being turned out of their apartments. Also critical to the success of the programme will be the co-operation of the lower entities of the general

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government. One of the reasons why the government would like to ensure a maximum degree of procedural standardisation is precisely to avoid disparities of treatment across entities, which is much needed to have them involved in the strategy. More fundamentally, lower level government owners will benefit to the full extent from the revenues accruing from the sale (the initial price plus the resale surplus). Such revenues will be credited in a remunerated account held at the Ministry of Economy and Finance.

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Annex II

Main conclusions of the Brambilla pension commission

The "*Commissione ministeriale per la valutazione degli effetti della legge* 335/95 *e successivi provvedimenti*" (Brambilla Commission) was established in order to assess the financial effects of the 1995 pension reform over the period 1996-2000. The Commission was also in charge of updating the estimates of the financial effects of the 1995 reform for the period 2001-2006 and for the projected path of pension expenditure over the next decades. The Commission's final report[1] does not so much offer specific recommendations for further pension reform (except in the areas of private pension provision and steady state properties), as to point out the tensions inherent in the present pension system. By implication, it is then up to the government to issue new legislation that addresses these concerns. The analysis adopts the optic of the objectives of the original reform law (No. 335/95), the new obligations under membership in the European Monetary Union, and the need to stimulate competitiveness and growth.

Main conclusions of the audit

- The 1995 pension reform has substantially achieved the financial targets that were set for *the period* 1996-2000. The overall effect consists of an improvement in the public finance balance of around 28.3 billion euro, in line with the expected results. Of these, savings and higher revenues account for 31.7 billion euro. Costs of implementing the reform were lower than expected (3.4 billion euro instead of the projected 5.5 billion euro), almost exclusively because of the slow development of the second pillar.
- The updating of the estimates for *the period* 2001-2005 shows that the cumulative financial effect is expected to be 5.3 billion euro higher than what was estimated in 1995, with an improvement in the public finances balance of around 52 billion euro.

Problems in the transition

The slow transition to the new steady state system continues to cause serious problems in the fiscal, social equity, and economic domains for at least two decades to come. They are as follows:

– *Pension spending*, already high in EU terms, is set to rise further, crowding out other spending. However, the ultimate ratio to GDP (now around 14 per cent) depends very much on the growth rate of real GDP that is assumed. For example, 1 per cent long-run real annual growth implies a peaking of such spending at over 18 per cent of GDP, 2 per cent avoids any major increase, while 3 per cent allows a decline. The official projections shown in the special chapter of last year's *Survey* assumed long run annual growth of 1½ per cent, and pension spending peaked at close to 16 per cent in 2035. The only reliable constant in the calculations is the demographic tendency projected

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by ISTAT, which shows a sharp rise in the dependency ratio (in the absence of massive immigration).

- At current contribution rates, moreover, the *financial disequilibrium of the pension system* is set to widen markedly over the next two decades. The "equilibrium" contribution rate is projected to rise by 4.7 percentage points by 2032.[2] In order to cover the gap, the effective contribution rate should have the same increase. However, such an increase would be unacceptable from an economic viewpoint, while issuing more debt is unacceptable from the point of view of obligations under the Stability and Growth Pact. Thus, a further reduction in pension or other public spending will be necessary. After having reached the peak, the "equilibrium" contribution rate is expected to decline to 39 per cent in 2050 following the demographic path.

– *Generational and worker inequalities*, as calculated by pension rates of return (or alternatively effective replacement rates) for the different groups, are severe. This is because of strong preference given to workers with more seniority during the transition. Also, differential contribution rates exist for different categories of workers, with private dependent workers being particularly disadvantaged relative to other groups. Social inequalities in the future are also aggravated by the recent growth of *parasubordinati*, *i.e.* workers on atypical contracts benefiting from social security tax breaks but at the cost of inadequate pension coverage in retirement, given the lack of supplementary coverage (below).

- Pension system parameters *distort the labour market*, as evidenced in a low and falling (over the past 20 years) employment rate and a large underground economy. The strong recent growth of *parasubordinati* shows the large impact that cuts in social security taxes can have on labour supply and demand. The most affected groups are women and workers aged 51-65. Italy stands out similarly for its low median retirement age, especially for women, the discrepancy with other countries being even larger when taking into account life expectancy. The implication is that the goal of reaching the Lisbon/Stockholm criteria, discussed in Annex III, reinforces the need for further pension reform.

- The high tax wedge furthermore *impairs competitiveness* in the context of the single currency.

- The Commission notes a *slow development of complementary pension provisions*. The following main reasons are given:

- Scarcity of resources at the disposal of potential adherents (again, a problem of too high a labour tax wedge), requiring the usage of other set-aside funds such as TFR.

4. There is little competition between various types of pension funds due to excessive restrictions on open and individual pension funds, while negotiated funds are excessively favoured; thus deregulation followed by re-regulation to assure better prudential supervision is needed.

- Obstacles to participation in pension funds by public sector workers, which must be removed even though there is no TFR in this case to access.

5. Continuing legislative interventions in recent years have created a climate of instability and uncertainty; greater regulatory stability is needed in order to stimulate both supply and demand in the market for pension funds.

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Issues in the long run

Finally the report points out some structural features of the system (once it reaches the steady state) that leave room to improve its effectiveness in reaching the target of economic and social sustainability. Two of them are particularly relevant. *First*, the difference allowed in the law between the financing contribution rate (actually paid into the system) and the calculated contribution rate (used in the calculation of pension benefits) carries costs, whether for social equity or for financial equilibrium. Unless a good reason can be given for such differences, they should be eliminated. *Second*, the modalities for updating the "transformation coefficients" of the benefit formula every ten years *via* a political process,[3] carry high risks and could generate strong discontinuities in the treatment of different cohorts. A possible solution could be to update at shorter intervals and to adopt an "automatic" method of calculation.

Notes

1. Commissione ministeriale per la valutazione degli effetti della legge No. 335/95 e successivi provvedimenti (2001), *Verifica del sistema previdenziale ai sensi della legge* 335/95 *e successivi provvedimenti, nell'ottica della competitività, dello sviluppo e dell'equità*, September.
2. The equilibrium contribution rate in 2000 was 2.1 per cent. It is projected to reach a peak of 46.8 per cent in 2032.
3. See last year's *Survey* for a discussion.

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Annex III

Future directions for labour market reform

The Lisbon summit in March 2000 laid down as the general objective of EU labour market policies to raise the overall employment rate from an average of 61 per cent at present to as close as possible to 70 per cent by 2010, and that of women from 51 to more than 60 per cent. The Stockholm summit of March 2001 further specified intermediate targets for employment rates of 67 per cent overall and 57 per cent for women by January 2005, while also agreeing on a 2010 target of 50 per cent for older workers (55-64). The Italian Ministry of Labour and Social Policies[1] has tried to determine likely national employment objectives from the perspective of these EU targets, basing its calculations on a set of scenarios until 2005 and then 2010 that project the positive trends having surfaced in the labour market during the 1995-2000 period,[2] superimposing these on the underlying negative demographic trends projected by ISTAT. The resulting projections of potential employment would then imply a range of potential GDP growth rates, given different assumptions about future labour productivity growth (1¾ per cent per year "high", and ½ per cent "low"). Conversely, the resulting intervals of GDP growth rates may also be interpreted as the economic growth "needed" to attain a specific reference employment scenario. Six different scenarios have been envisaged, as follows:

- The first scenario *i*) takes on board only the negative demographic effects (participation and employment rates are assumed unchanged from 2000). The labour force is unchanged until 2005 and then declines substantially by 2010. GDP growth is barely positive, even under the "high productivity" case. The message is that much more growth of the employment rate is needed to offset the negative demographic effects.

- The second through fifth scenarios project successively more ambitious assumptions about average employment growth as follows *ii*) that reported over the 1995-2000 period (negative demographic effects still dominate); *iii*) the previous assumption but the employment rates of older male workers remain unchanged from 2000, as they already had from 1998 (demographic effects neutralised); *iv*) the higher average employment growth experienced over the 1998-2000 period (the Centre-North comes close to its maximum potential); and *v*) the previous assumption plus the hypothesis of a recovery of older male workers' participation to their 1993 level as of 2005 (this substantially eases labour market tightness in the Centre-North though unemployment there is still 2.2 per cent by 2010 compared with 17 per cent in the South).

- The sixth scenario *vi*) adds onto the assumptions of *vii*) a closing of the gap between the Centre-North and the South by 2020 (*i.e.*, the Centre-North reaches its employment targets by 2010 and stays there while the South catches up 10 years later). The employment rate would reach 65 per cent and the unemployment rate would drop to 4 per cent by 2010. The likely range of the GDP growth rate would be 2¾-4 in the first

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5-year period and then 1¾-3 in the subsequent one, with clearly higher values in the South.[3]

It is clear that only the final very ambitious scenario allows Italy to approach the full-employment situation outlined in the European Union, with, of course, no indications of what sorts of policies would be needed to translate it into reality. The previous scenarios (2nd to 5th) demonstrated that should the trends observed in 1995 (or 1998) to 2000 be long-lasting, the North-South polarisation would be unsustainable. The Centre-North regions would quickly hit most of the European objectives. However, the resulting bottlenecks (which already appeared in 2000) imply aggregate inflation risks that would jeopardise Italian competitiveness and growth. Even in the (5th and 6th) scenarios incorporating optimistic assumptions for older worker participation (based on past pension reform impacts), their employment rate by 2010 is only 36 per cent – far from the 50 per cent objective set by the Stockholm summit.

Notes

1. See Ministero del Lavoro e delle Politiche Sociali (2001*a*).
2. An assumption inherent in such a procedure is that the elements of flexibility introduced in the labour market brought about structural changes and that, should these elements of flexibility be consolidated, the said changes are going to be replicable, therefore moving beyond the mere preservation of the current levels. Alternatively, it may be assumed that the structural changes underway, leading toward greater flexibility, are part of a process that is still in progress, so that a 5 or 10 year horizon would allow a realisation of the overall effects of the process currently underway.
3. The compositional effect of a growing weight of the southern economy during the catch-up period would be negative, as productivity levels are lower there. This would apply all the more if one of the mechanisms of higher employment growth were to include decentralised wage determination, hence more "low wage" production. On the other hand, the rate of growth of productivity would be higher, due to the catch-up effect.

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Annex IV

Chronology of main economic events

2000

April

The government allows social contribution reductions to employers who hire unemployed people on full-time or part-time basis.

June

The government submits to Parliament the medium term economic plan, which envisages a general government deficit target of 1 per cent of GDP in 2001.

August

The definition of budget balance of regional and local authorities is redefined according the "internal stability pact". The budget balance of the regions must be at least 1 per cent higher than 1999 current primary expenditure, while for local authorities it must be 1.1 per cent higher. A side-agreement on health requires that regional taxes should be increased if expenditure should be higher than target.

September

In the wake of rising oil prices, the excise tax on oil and some of its derivatives is further reduced from the 1999 cuts. This new reduction is time-limited, but is subsequently renewed two times.

November

With Law 354, the government extends the exemption base for the personal income tax and reduces the tax rate for the second bracket of the personal income tax rate from 26.5 to 25.5 per cent (fiscal "bonus").

December

The Budget Law for 2001 is approved.

Parliament passes a law to reduce the number of civil servants by 0.5 per cent from the end-1997 level in each year over 2002–2003.

The wage contracts for employees in public transports are revised and renewed.

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The Stability Programme for 2001-04 is approved by the European Commission.

2001

January

The wage contracts for employees in postal services are revised and renewed.

February

The wage contracts for teachers in public education are renewed.

March

Poste Spa is entitled to carry out financial activities like any other bank or financial intermediary. Consequently, the monitoring of its financial activities is shifted from the Ministry of Communication to Banca d'Italia and Consob.

Parliament approves a set of Constitutional amendments in the area of fiscal federal relations, subject to subsequent ratification by popular referendum.

The one-year freeze on auto insurance premia is lifted.

May

The new right-of-centre coalition wins the general political elections, with a large Parliamentary majority.

The companies that opt for the re-evaluation of their physical and capital assets can pay a lower corporate income tax rate.

June

The Berlusconi government is sworn in.

The former Ministries of Finance and Treasury merge into a single Ministry of the Economy and Finance.

The new government announces the continued commitment of Italy to the Stability and Growth Pact.

July

The government presents the "100-day package" and submits to Parliament the medium-term economic plan (DPEF) for 2002-2006, which tightens the deficit target for 2002 to ½ per cent of GDP.

The wage contracts are renewed for the metal-workers, which are highly representative of the majority of workers in the industry and service sectors.

The government is delegated by Parliament to issue decrees over the course of one year in the area of labour market regulations, including: job placement services, work incentives, welfare to work, working hours, part-time, atypical work contracts, and Article 18. These decrees (so-called "delegated laws") are subject to Parliamentary approval within 60 days.

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August

The rules on temporary contracts are further eased by a "delegated law", the government interpreting this to be in line with EU directives. One of the three main trade unions contests these changes.

The Brambilla Commission is formed to study options on further pension reform.

The minimum pension is increased.

A new agreement on health is reached with the regions, which establishes a fixed annual allocation of 6 per cent of GDP for *ex ante* federal grants, with a sub-ceiling on pharmaceutical purchases. Regions are again made responsible for funding their own *ex post* overshoots, *via* taxes or user charges.

September

The government presents the budget proposal for 2002.

The Brambilla Commission presents its final report.

October

The "100-day package" is approved. All measures become law, except those pertaining to pension reform which await the approval of the social partners.

A new Company Law is passed, based on a draft by the previous government with major amendments.

The new Constitutional amendments in the area of federal fiscal relations are approved by national referendum.

A "White Paper" spelling out the government's medium-term strategy for labour market reforms is issued.

November

The oil excise tax is finally restored to its former level.

The government promulgates a "delegated law" providing for a marginal easing of employment protection legislation in addition to other labour market reforms. The unions are unanimous in their opposition to the new draft law.

The Stability Programme for 2002-05 is presented.

The Minister of Education and Research presents the new 5-year National Education Plan.

The Bertagna Commission on education reform issues its report.

December

The government receives a delegation from Parliament to undertake further pension and tax reforms by means of decree laws.

The government issues, as an amendment to the Finance Law for 2002, a radical medium-term reform plan for the *fondazioni*.

The government passes to Parliament "delegated laws" on pension and tax reform. The pension reform includes: incentives to postpone retirement age ; the use of TFR for private retirement insurance; and reduction of the pension contribution to be paid by firms (by 3 to

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5 per cent points) for newly hired workers. The fiscal reform sets the medium-term objective of reducing the number of income tax brackets for individuals to two: 23 per cent up to an income of 100 000 euros and 33 per cent thereafter. Union opposition, in particular to the pension reforms, is strong.

2002

January

The state cash borrowing requirement for the full year 2001 comes in at 28 billion euro (54.4 trillion lira).

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