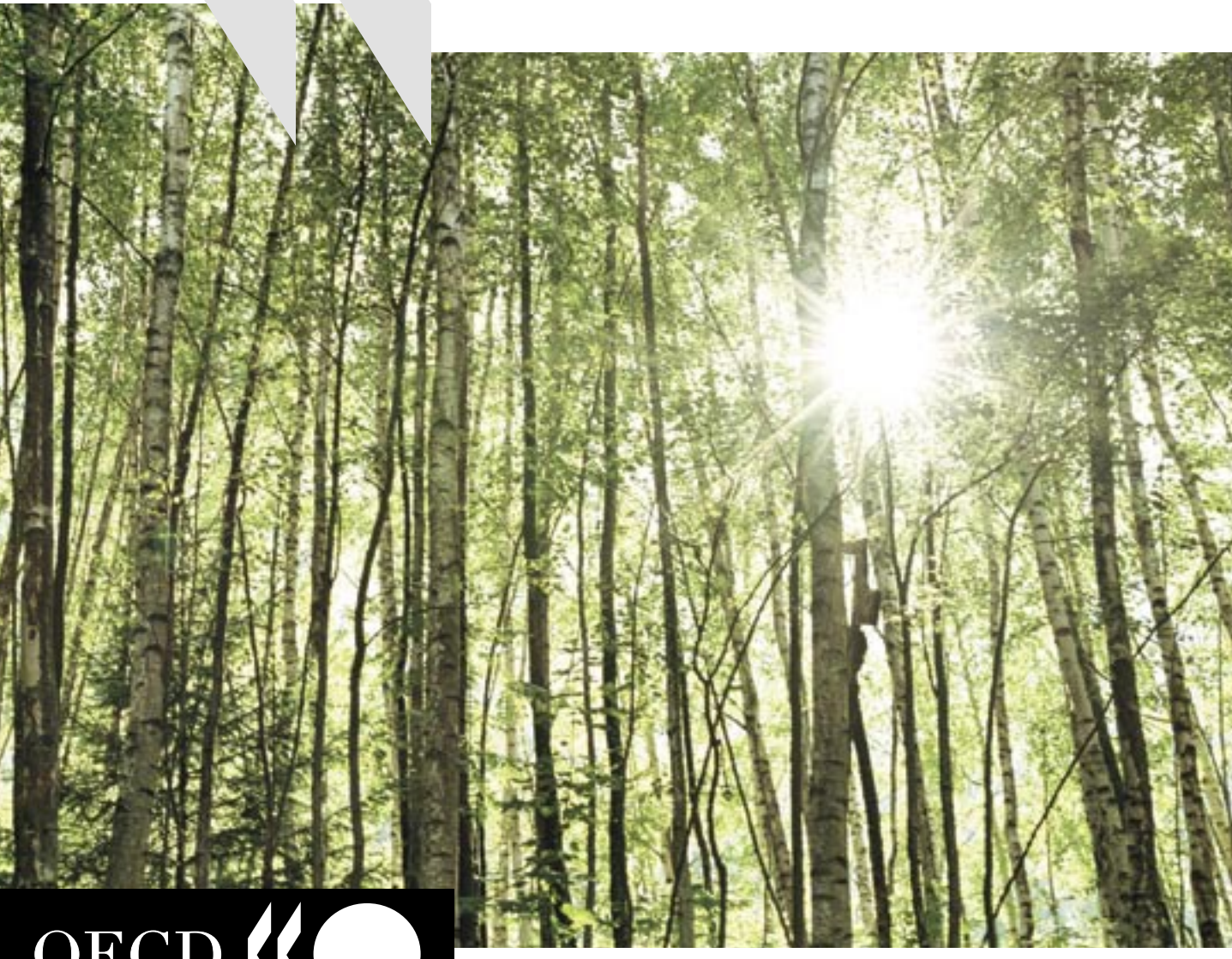
OECD Economic Surveys

Italy



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This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Italy were reviewed by the Committee on 16 December 2004. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 26 January 2005. Due to exceptional procedural delays in the publication process not all the information is up to date.

The Secretariat's draft report was prepared for the Committee by Alexandra Bibbee, Flavio Padrini, Paul O'Brien and Céline Baptista under the supervision of Nicholas Vanston.

The previous Survey of Italy was issued in March 2003.

This Economic Survey may not include an examination of certain policies that are relevant to the country but fall within the competence of the European Community. While some of these policies may be examined in the Survey of the Euro Area, other policies may not be examined by the EDRC, as the European Commission currently maintains that the Economic Surveys should be limited in their coverage. No limits apply to the policies that can be covered in the Economic Surveys of other OECD countries.

The Commission and the member States of the European Union are working actively on ways of reviewing EC and EU wide policies within the context of the EDRC.

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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, 20.10.2001)	
Rome	2 547
Milan	1 256
Naples	1 005
Turin	865

THE PEOPLE

Population , 31.12.02, thousands	57 321
Number of inhabitants per sq. km	190
Net natural increase, 2002, thousands	–19
Net rate per 1000 inhabitants, 2002	–0.4

Labour force, 2003, thousands	23 918
Employment, 2003, thousands	21 822
In agriculture	1 075
In industry	7 019
In services	13 728

THE PRODUCTION

Gross domestic product in 2003, billions of euros	1 302.0
GDP per head (2003, US$)	25 592
Gross fixed capital formation	
Per cent of GDP in 2003	19.1

Origin of gross domestic product in 2003 at market prices, per cent of total	
Agriculture	2.2
Industry	23.3
Construction	4.9
Other	69.6

THE PUBLIC SECTOR

Current expenditure in 2003 (percentage of GDP)	48.9
Current revenue in 2003 (percentage of GDP)	46.4

Gross financial liabilities in 2003 (percentage of GDP)	121.5
General government investment in 2003 (percentage of total investment)	16.3

THE FOREIGN TRADE

Exports of goods and services, as a percentage of GDP, 2003	25.4
Main export categories, as a percentage of total exports, 2003	
Manufactured goods	35.3
Fabric and textile goods	14.7
Chemical products	9.5
Transport equipment	10.7
Mineral fuels	2.1

Imports of goods and services, as a percentage of GDP, 2003	24.8
Main import categories, as a percentage of total imports, 2003	
Foodstuffs	7.1
Manufactured goods	25.4
Metal, ores and scrap	9.1
Chemical products	13.6

THE CURRENCY

Monetary unit: Euro

Currency units per US$, average of daily figures:	
Year 2004	0.8049
December 2004	0.7454

Executive summary

A modest recovery is under way. *A recovery has been under way since early 2004 and is expected to proceed at a moderate pace in 2005 and 2006, with domestic demand continuing to rise faster than GDP. Real growth is projected to remain somewhat slower than the EU average. The gap in consumer price inflation is expected to widen again in 2006. The current-account deficit has increased and export market share losses were substantial until recently. Employment growth has been impressive throughout the slowdown, but the growth of productivity, including that of total factor productivity, has been very weak.*

The public finances present a mixed picture. *Although declining, the debt level still exceeds 100% of GDP. The primary surplus has fallen significantly, and repeated resort to one-off measures has until now substituted for the implementation of deeper-seated reforms. The exceptional revenue measures have prevented the fiscal deficit from exceeding the 3% limit while limiting the negative impact on the economy. The Italian authorities are committed to pursue the phasing out of one-off measures by 2006. The OECD estimates that further structural measures may be needed to reach budget targets in 2005. Although the overall tax burden is not high, the tax system discourages entry in to the formal labour market: a € 6 billion income tax cut is planned for 2005. Devolution is making it more difficult in practice to control public spending. A series of recent pension reforms will contain future spending in that area and encourage workers to remain longer in the labour market. A sustained rise in the primary surplus is required to put public finances on a sound footing.*

Product-market competition needs strengthening. *Large parts of the service sector face competitive pressures that are too weak to encourage managerial or technological innovation, or to resist cost increases, which are then passed through to the traded sector. A stronger commitment to regulatory reform and liberalisation in product markets is required and remaining subsidies to industries should be based on social cost and benefit grounds. Once adequate competition is ensured in the electricity sector, and an adequate regulatory structure put in place, full privatisation should not be delayed. Other candidates for regulatory reform and other liberalisation efforts include the transport sector, road freight, professional services and retail trade. The latter often faces opposition from shopkeeper-captured local authorities and monitoring and benchmarking from central authorities would be crucial.*

Further corporate governance reforms should not be delayed. *Recent scandals have highlighted particular corporate governance problems and the policy reaction was swift, but incomplete. The ability of minority shareholders to play an appropriate role could be improved. The division of competencies among the supervisory authorities is in need of adjustment. It is regrettable that recent proposals to rectify these issues have not yet been implemented. Bankruptcy proceedings for smaller firms are prolonged and too close to criminal proceedings, potentially productive assets are dissipated, and entrepreneurs discouraged from continuing their activities. Speeding up of reforms in this area also is desirable.*

Labour market developments have been positive. *Reforms in the labour market have been far-reaching and have delivered higher employment and falling unemployment. Job security for those on temporary contracts is being improved. Job protection for insiders remains high, however, and there are major differences in labour market outcomes between the regions. Large-scale immigration, much of it clandestine in the past, is a recent phenomenon, and immigrants find work in areas where there are chronic labour shortages. Repeated regularisation exercises show that large numbers are willing to work in the formal sector. More could be done to extend legal immigration and aid immigrants to fit into the Italian society and economy.*

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Assessment and recommendations

Job creation has been strong, but growth weak, posing budgetary difficulties

In recent years, Italy's GDP growth has been below the euro-area average, and total factor productivity growth has been very weak, and even negative. The OECD estimates that the potential growth rate of GDP, possibly only temporarily, has fallen below 1½ per cent. Consumer price inflation has been faster than in the euro-area and relative unit labour costs in both the non-traded and traded sectors have been rising steeply. On the positive side Italy is one of the very few OECD countries to have enjoyed robust employment growth every year since the turn of the century, and its unemployment rate has fallen substantially. Italy managed to respect the 3% Stability and Growth Pact limit on public deficits despite slow growth thanks to sizeable one-off measures. The latest pension reforms will help reduce the growth of public pension spending in future decades by raising the effective retirement age. However, the structural deficit is still significant, gross debt remains well above 100% of GDP, decentralisation is complicating the task of maintaining fiscal discipline, and repeated tax amnesties carry the risk of encouraging tax avoidance and evasion in the expectation of further amnesties. Substantial efforts are needed in coming years, both to assure effective implementation of a fully-funded € 6 billion personal income tax cut that is planned for 2005, and to phase out completely by 2006 the one-off measures that reduced budget deficits in recent years. In sum, although Italy now seems to be recovering from the recessionary influences of the past 2-3 years, medium-term growth prospects seem poor, mainly because productivity growth and competitiveness remain weak. Italy's ageing population will act as a further drag on per capita income growth in later decades, making harder the task of reducing both public-sector deficits and debt while increasing the need to do so.

The key challenges are to raise potential growth while maintaining financial discipline

The challenges are thus to durably raise real per capita income growth rates and improve the public finances. Two main paths for policy are indicated:

- *Stimulate the supply side.* A series of growth-enhancing measures are needed which should aim to: implement more forcefully policies that will put the non-traded sector under stronger competitive pressure to seek cost-saving innovations; reform bankruptcy legislation that maintains high exit costs for both creditors and firm owners, and corporate governance structures that encourage financial opacity; continue policies that encourage employment creation in the formal sector, while taking stronger measures to raise human capital at all ages.
- *Make determined efforts to reduce public debt and deficits on a permanent basis.* Further savings can be made in public employment, government purchases and subsidies and it is

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especially important to ensure that decentralisation is implemented through efficiency-raising measures rather than duplication of posts. Continued forceful action is also required to prevent health spending from exceeding pre-agreed benchmarks. The tax base should be enlarged *via* simplification of the tax codes and more vigorous efforts to reduce evasion and avoidance. Tax rates should be reduced if and when they can be financed by permanent spending economies.

A gradual recovery is underway

The prolonged period of slow growth is ending. Exports are picking up and the erosion of market shares in volume terms has slowed. Private consumption growth is expected to continue to outpace that of GDP, and there are signs that private investment demand is recovering. Employment growth remains positive and private sector wage claims remain moderate, especially in real terms. The short-term outlook is for continued moderate growth, with the output gap narrowing in 2006. There are signs, though, of financial stress in the manufacturing sector, which has yet to emerge convincingly from a 4-year long recession, and worries that Italy's small enterprises in the traditional textile and footwear sectors are losing out to Asian and eastern European rivals, exacerbated by the strength of the euro and a domestic inflation rate that is higher than the euro-area average. And although Italy has a relatively low dependence on imported oil, a prolonged period of high oil prices would have a negative impact because of weaker demand in most trading partners and stronger domestic inflation pressures, and because Italy's exports to oil-producing countries are small relative to GDP.

Economic recovery will not by itself resolve the fiscal issues

As with many other EU countries, Italy's public finances deteriorated when growth slowed abruptly late in 2001, but the authorities continued to respect the 3% of GDP reference value of the Stability and Growth Pact, resorting to asset sales and one-off measures with limited demand impact, notably tax amnesties. The recovery will bring some fiscal improvement, but not enough by itself for Italy to remain under the 3% limit. In any case, there has been a trend deterioration in the underlying fiscal position since before the 2001-2003 slowdown, with the cyclically-adjusted primary surplus falling from around 6½ per cent, of GDP in 1997 to an estimated 2% by 2004 because of a strong upward dynamic in public spending. The OECD projects further falls in 2005 and 2006 on the basis of announced policy measures, with the public-sector deficit exceeding 3% of GDP in 2005, more so in 2006. This is despite the policy of capping current public spending growth (except on pensions) at 2% for 2005, together with revenue-enhancing measures. Sales of public assets, especially real-estate, are set to continue, and prior securitisations of such sales will continue to help net borrowing in 2005. *Reaching the official budget goal of a 2.7% deficit for 2005 may require additional consolidation measures as well as close monitoring of anti-evasion programmes and adherence to the spending caps.*

More determined action to reduce the deficit will be needed in the medium term

Given the high debt-to-GDP ratio, the priority for fiscal policy must be to reduce it substantially over the medium term. Much larger primary surpluses are necessary than those realised in recent years or projected by the OECD, and other debt-reducing measures should be undertaken. Although the latest medium-term fiscal plan (DPEF) postulates an improvement in the primary balance by some ½ per cent of GDP each year until 2008, it does not give precise indications as to how this is to be achieved, whereas Italy's underlying primary spending has been rising faster than the means of financing it for many years now. *A more detailed multi-year budgetary process is therefore desirable. One-off measures should be phased out completely by 2006 as planned, and be replaced by permanent cuts in structural spending programmes, preferably large enough to make room for subsequent growth-enhancing cuts in tax rates. When the output gap has been closed, Italy should further strengthen its consolidation efforts.*

Action should concentrate on spending cuts

Some spending cuts can be achieved by improving administrative efficiency: duplications of functions across different levels of government should be avoided while decentralising and the coming retirement of baby boomers should be used as an opportunity to achieve net reductions in staffing levels. Increases in public sector salaries should be limited to moderate rates, in order to be consistent with the new spending growth caps. Priority in spending should be given to improving infrastructure, especially in the south, and human capital. As in virtually all OECD countries, public spending on health is on an upward trend. Insofar as health services are a superior good and households are willing to spend more on them as their incomes rise, this need not be a problem in itself. But this should include a higher level of co-payments, continuing careful scrutiny of regional proposals and outturns, and more benchmarking across regions. Both spending control and efficient delivery are complicated by the fact that health spending is decentralised, yet financed essentially by the State, and wage levels are fixed at the central level. On the pension side, the recent reform is a major one though it is regrettable that it has been delayed to 2008. An updating of benefit coefficients to reflect increased longevity is due in 2005, and it should not be delayed. Further debt reduction measures should include stepped-up privatisations, including in network industries, to attain the € 100 billion target (about 7% of 2004 GDP) of the latest DPEF.

The tax system is being reformed

Although Italy's overall tax burden is not above average, including tax on personal incomes, the existence of a large-scale informal sector means that those who pay taxes face high average and marginal rates, which distort work effort and encourage informal working, exacerbated by the fact that the tax codes are complex, making compliance time-consuming. After a pause for most of the 1990s, amnesties were used extensively during the period of slow growth. These practices should be discontinued to avoid the risk of weakening tax compliance. The authorities have instituted a two-part cut in income tax rates, a first stage in 2003 for lower incomes and a second stage for mid to upper incomes,

accompanied by simplifications, in 2005. *On condition that the recent tax cut can be financed through permanent structural measures on the spending side,it is a welcome development. Moreover, it should be carefully designed so as to avoid excessive rises in marginal rates at low to medium income levels via tax allowance withdrawals. Tax amnesties should be definitively phased out and be replaced by more vigorous programmes to fight tax evasion across the economy.*

Italy's supply-side performance has weakened

Italy's per capita income is about average for the EU and a little higher than the OECD average. Its relative ranking has slipped somewhat, essentially because its growth performance has weakened not only relative to its own past performance but also relative to that of almost all other OECD countries. More worrying, recorded total factor productivity growth seems to have been negative lately. One consequence has been that although wages have grown very little in real terms as perceived by employees, (*i.e.* relative to the consumer price index), unit labour costs have risen quite significantly for their employers. For several years now, Italy has thus been losing price competitiveness within the euro-area, and recently even more sharply against non-euro-area countries as the euro has strengthened. Export volumes have fallen, and market shares in real terms have been eroded. Italian producers face heightened competition from eastern European and Asian countries on both the export and domestic markets. This process appears to be continuing: inflation in Italy is higher than the euro-area average, the output gap is closing, and although productivity performance is projected to pick up with the cyclical recovery, there are no early signs that it is going to do so rapidly. It is therefore important to understand the reasons for this poor productivity performance, and to find policies that will improve it.

Poor productivity and competitiveness reflect structural problems

An alternative (but less than fully convincing) interpretation of recent employment, output, and trade statistics is that there are measurement problems. For example, employment growth may be overstated as informal labour "emerges" into the formal sector. However, a reason why this interpretation is less than fully convincing is that national accounts data already include estimates of the informal economy, which therefore cannot represent a significant source of bias in the productivity statistics. Employment costs may be overstated as tax credits for contract conversion are registered as higher profits rather than lower labour costs and growing use of flexible labour contracts reduce non-wage rather than wage labour costs, while output may be understated because of quality improvements. Cyclical labour hoarding may have also played a role in the deceleration of productivity. However, persisting relatively high core inflation and relatively large current account deterioration suggest that there is a structural – rather than just a measurement or a cyclical – problem with productivity and competitiveness in Italy. *It would therefore be wise to base policy decisions in such an important area on the awareness that those structural problems are at the origin of the slowdown in economic performance. This is even more the case when the appropriate policy actions are ones that are desirable in themselves.*

Productivity in the non-tradeables sector needs to be boosted

OECD measures of competition and performance in product markets show that although Italy has made undeniable progress in reducing administrative burdens and strengthening competition, its recorded progress is not better on average than in other countries, and it therefore remains a relatively poor performer. *The service sector in particular lacks competitive pressure to resist cost increases and to innovate, in part because of remaining direct public-sector involvement in some sub-sectors, especially transport and energy. Pervasive price controls in freight transport are hard to justify, and political influence on road infrastructure is damaging and inefficient. Professional services mostly fall outside antitrust jurisdiction, and opening up of retail trade to supermarket chains is resisted by local authorities, often captured by local business interests. The retail sector issue needs to be discussed and resolved at the national level.* A consequence of protected high cost services is that input costs for the traded sector are higher than they need to be, and rise faster than in major trading partners. Although benefiting from a boost of recent reforms, there is a specific problem with the electricity sector, which remains dominated by the incumbent, while new generating capacity additions are hampered by local opposition and administrative barriers, as are interconnections with foreign producers. This and other structural factors result in electricity prices that are significantly higher than in surrounding EU countries, and overall generating capacity constraints could prove a bottleneck to growth in the near future. *Recently decided separation of the generation and transmission network as well as ways of augmenting generation capacity in response to market signals should not be delayed. This is an issue that, like retail trade, requires concerted action on a national scale.Consideration should also be given to fully privatising the electricity and gas transmission networks, subject to safeguards for third party access.*

Corporate governance needs further improvement

As noted in previous *Surveys*, the Italian corporate sector is characterised by a large number of small firms, often family-controlled, and a small number of very large firms, also often family-controlled even when publicly quoted. A recent series of bond defaults, including those of the Argentinian government, *Cirio* and *Parmalat* highlights the need for improvement in the system of corporate governance and oversight provided by the market. These episodes might have contributed to falling consumer confidence in the past few years, and underline the need to strengthen protection of minority shareholders as stressed by the OECD Principles of Corporate Governance, to establish more effective supervision of the market, and to update a bankruptcy legislation which does not ensure to either protect creditors or allow companies' owners to start a new business. Re-establishing confidence in the financial system will enhance the development of a private funded pension pillar with the diversion of worker severance fund flows into privately managed plans. This in turn would have further beneficial effects on domestic capital market development. A poorly performing financial sector represents a brake to an efficient allocation of capital with negative consequences on the growth of profitable firms, on R&D and innovation, and finally, on aggregate performance.

The first policy response has been prompt

The first policy response to serious corporate mismanagement was prompt, with a justifiable trade-off between the need to act swiftly to restore confidence and conserve assets, and the goal of creating optimal policies to deal with such situations, but a number of desirable measures have yet to be implemented. Originally, a bipartisan bill was submitted to the parliament in May 2004, concerning corporate governance and financial supervision. Some of the proposed measures progressively lost support and the bill was not approved. A new version of the bill under discussion in parliament still aims to strengthen minority shareholders' rights and improve the financial supervisory structure. *Approval of these measures should remain a priority in order to enhance confidence in the Italian financial market*. Bankruptcy law should also ideally encourage the maintenance of still-productive assets in order to help pay off creditors, and the reallocation or dissolution of unproductive assets. The new emergency bankruptcy procedures for large companies protect corporate assets more effectively than before, by speeding up the process. Under these procedures, a commission, appointed by the Ministry, supervises the restructuring exercise, while complying with normal judicial and market regulations. *Nevertheless, comprehensive bankruptcy reform remains an urgent matter.*

Employment creation has been remarkable

Statistically, the reason why per capita incomes have continued to rise a little in the past few years, despite apparently falling total factor productivity, is that employment creation has been vigorous. Indeed, more jobs were created in the recession years 2001-2004 than in the preceding 4 years of brisker GDP growth. The unemployment rate fell in each year of the recession, and is now below the estimated NAIRU. The labour market reforms of earlier years and more recently led to the increase in employment, although employment data may have been somewhat boosted by flows of previously under-recorded informal labour, especially newly regularised immigrant labour, into the formal force. The reforms have made it easier and cheaper to adjust enterprise labour forces *via* temporary contracts, and tax incentives have facilitated their conversion to permanent contracts. Thus employers have been more willing to take on low-skilled or inexperienced employees on flexible contracts, which have allowed them to gain work experience and build up skills, without them necessarily remaining indefinitely in a state of precariousness. The large increase in employment, particularly of the low-skilled, goes some way to explaining the weak growth of productivity. But the example of other countries, for example the United States before 2001, and especially Ireland, shows that it is possible to have strong growth in both employment and in total factor productivity for a prolonged period. *Competitive product markets seem to be needed as well as flexible labour markets.*

Nevertheless, the labour market remains segmented along regional lines while absorbing many immigrants

Unemployment rates in the more prosperous Northern and Central regions are under 5%. The southern regions continue to register rates at least three times higher, and the gap has diminished only marginally since 1998. The chronic problem of low mobility of

unemployed southern Italians towards the other regions perhaps influenced by the growing importance of equalisation transfers, is in contrast to the comparative success of immigrants in integrating themselves into the economy. Typically, immigrants, and especially illegal immigrants, arrive in the south of the country and head north to where the jobs are. Successive regularisation programmes have resulted in very large numbers of illegal immigrants joining the formal sector, thus widening the tax base and enhancing social security revenue.

Immigration policies should be more realistic and consistent

However, Italy's immigration policy is not well adapted to large scale inflows, perhaps a legacy from its past history of being an essentially emigration country. Official quotas for non-seasonal workers are relatively low and in practice linked to backward-looking labour-market assessments. *Given that Italy's immigrants appear to come looking for work, and finding it,a larger official quota for immigrants not tied to specific job offers might be appropriate. This will entail efforts in training and integration within the Italian labour market.* Illegal immigrants could then be dealt with more firmly.

Participation rates remain low

Although employment has risen substantially since the late 1990s, and unemployment rates have fallen, overall employment rates in Italy remain low, as do participation rates. The overall participation rate for those of working age is 63%, compared with an EU average of close to 70% (and a US figure of 75%). As in most countries, participation rates for prime-age males are well above 90%, but the figure drops to barely over 30% in Italy for males over 60 years old. Female participation rates are low by international comparison at all ages. Less than 50% of women are in the labour force compared with an EU average of 60%. And as in other southern European countries, part-time employment of women accounts for a relatively low proportion of their total employment. Participation rates of women and older males are lower than the EU average even in the prosperous Italian regions that experience chronic labour shortages. There is therefore considerable room for expanding output for some time to come by raising participation and employment rates of women and older males, including in the northern and central regions, towards international levels.

Policy efforts should focus on older workers and women of all ages

The pension reforms should help raise participation among the older workers in future years, though it is important that higher participation is accompanied by higher employment. *Adequate training for workers before they reach the vulnerable age will be important, and the public employment service should strengthen efforts to find jobs for the unemployed in this age group. The actual impact of the reforms on participation of older workers should be monitored.* As in other Mediterranean countries, there is a traditional culture of women staying at home to look after their children, and to care for their ageing parents. *Concerns about the low rates of female participation can be addressed by greater public investment in child-care facilities and care support for the elderly in order to help women stay in paid work. The high tax wedge on*

labour should be reduced, while the tax allowances for dependent spouses should be reformed in order to strengthen the financial incentives to work for second earners, especially those with low skills. Many immigrants are working as domestic help, potentially liberating their higher-skilled employers to join the labour force. *Liberalisation of immigrant flows could help facilitate this process.* Recent labour market reforms have increased the supply of part-time jobs, which may be particularly attractive to women. *Liberalisation of opening hours in the retail sector, and encouraging the spread of large retail outlets, as well as reforms in other product market areas, would further expand job opportunities for women along similar lines.*

Educational outcomes are unsatisfactory

Compared with other OECD countries, an above-average proportion of the Italian population has only lower-secondary education. This is especially true for older age-groups, but it is also true for younger ones. Forty per cent of 25-34 year-olds are in this category compared with an EU and OECD average close to 25%, and the results of the OECD Programme for International Student Assessment (PISA) show that Italian 15-year olds have attainments well below the average in particular in mathematical and problem-solving skills. There is a high proportion of youth which is in neither education nor the labour force, suggesting a difficult school-to-work transition. The risk of unemployment later in life is also considerably higher for those with only lower secondary education. The policy reaction to these features has been to raise the number of years of compulsory schooling from 10 to 12, and to reform the structure of primary and secondary education in major ways, including improving the school-to-work transition in the form of a vocational track, as detailed in the previous OECD *Survey*. *These reforms go very much in the right direction, and should be monitored to ensure that they are achieving their goals. Job-related training should be the next priority.*

Quality of the tertiary sector needs improvement

Furthermore, a smaller proportion than the OECD average has completed tertiary education, even though a relatively high proportion embarks on it. Years spent in obtaining an undergraduate degree are greater than the average, raising the opportunity cost of tertiary education and discouraging the formation of high level skills. The demand for high-skill workers may be hampered by the specialisation of Italian industries in low tech sectors and the small size of Italian firms, which reduce their R&D spending capability. At the tertiary level, a problem is an insufficient number of younger professors, for whom there are barriers to entry. Academic appointments lack transparency, promotion is not always linked to productivity, and Italy spends far less than the OECD or EU average on research and development, and significantly less on tertiary education. As a consequence Italy suffers from a pronounced net brain-drain. At the same time, administrative barriers to the recognition of foreign degrees and other professional qualifications mean that Italy misses out on the diffusion of high-level technical skills, experience and knowledge from abroad. *These shortcomings should be addressed with urgency. Policies here should concentrate on increasing the size of the teaching body, and making it easier for qualified persons, including foreigners, to occupy posts on merit and, eventually, with greater security of employment than is currently the case.*

Reforms should not be delayed

Although Italy does not face an immediate crisis, and politically difficult reforms (for example in the labour market and to pensions) have been launched, the economy is still experiencing a gradual erosion of its internal dynamism, its external competitiveness, and a still insufficient action to put public finances on a sustainable long-term footing. The slowness of the deterioration should not obscure the need to change these trends, nor to underestimate the time it will take to do so even after the necessary reforms are implemented. *This is all the more reason why such reforms should not be delayed.*

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Chapter 1

Economic performance and policy challenges

This chapter discusses recent macroeconomic performance in Italy and its linkages to structural policies. Unemployment dropped markedly as labour deepening occurred in response to labour market reforms. But despite strong employment growth, output growth has been weak because of a sharp drop in total factor productivity growth. The latter has also led to relatively high inflation and declining competitiveness, with strong recent losses of export market shares, in a context where nominal wage growth, although moderate, greatly surpasses productivity gains. OECD structural indicators suggest that low productivity growth can be traced to both weak domestic competition and insufficient human capital accumulation. Also, female and older worker labour force participation and employment rates remain among the weakest in the OECD. Fiscal performance has also deteriorated in the downturn. The main challenges facing policy makers are EMU membership, global competition and population ageing, requiring in turn structural reforms to boost productivity and employment and strengthen public finances.

Introduction: adjustment to EMU is not yet over

The Italian government has recently proclaimed three principal economic policy objectives: protection of households' purchasing power, a decline in the fiscal deficit, and improvement of competitiveness *via* structural reforms.[1] These will help achieve sustained non-inflationary growth, a goal which has eluded Italy for some time now but which is critical to dealing with population ageing and the quest for fiscal sustainability. From virtual stagnation during 2002-03, growth picked up in 2004, and is expected to remain moderate in line with the eurozone. The mid-1990s turnaround in the last cycle was considerably more dynamic. Sharply declining inflation and real interest rates in response to policy convergence with Europe, plus exchange rate depreciation in the context of EMS realignments, gave an extra boost to both domestic and foreign demand at that time.

The evidence suggests that potential growth in Italy was not boosted by EMU membership as much as domestic demand has been. Even though domestic demand has been growing only modestly, it has outpaced that of GDP. Losses of export market shares have persisted for about a decade, as has an inflation gap *vis-à-vis* other euro area countries. By contrast Germany, the only other major European economy that has been growing as slowly as Italy, appears to be suffering from insufficient domestic demand rather than supply and exhibits inflation well below that of its euro area partners as well as, more recently, better export performance. This may be because Germany entered EMU at a disadvantageously high (post-unification) exchange rate, whereas Italy entered at a favourably low (post-EMS crises) one – in both cases far from equilibrium and leading to a period of convergence in conformity to the "law of one price".

As far as Italy is concerned, convergence is in effect complete, in that the real exchange rate has risen back up to its 1992 level. The "excess" profit margins that were induced in the traded sector by the initial devaluations have by now been used up. But the real exchange rate is still rising, in part because of rising costs of inputs from the sheltered sector, where domestic competitive forces are weak. In the pre-euro world, the solution would have been a competitive devaluation, but a new type of transition is now required, based on a higher degree of structural flexibility and greater efficiency. Such a structural reform process has in fact been underway since Italy decided to seek EMU membership, but it remained incomplete and shallow, so long as the real exchange rate was undervalued. The current situation of below EU average growth, large export market share losses, and corporate distress may turn out to be a catalyst for more difficult adjustments, in particular those tackling entrenched vested interests.

Not co-incidentally, financial stress has mirrored that on the real side. Insufficient advantage was taken of the room for fiscal consolidation deriving from the real interest rate plunge upon EMU entry and the subsequent strong growth period. Instead, the structural primary surplus has fallen to a low level, debt levels have remained above 100% of GDP, and interest rate vulnerability of the budget remains high. The expansionary stance of fiscal policy has stimulated demand, while a good part of the supply weakness emanates

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from fiscal crowding out of productive investment – thus adding further to the pressures on the real exchange rate.[2] Hence, the primary surplus must be lifted again to a level that is consistent with a brisk and steady debt reduction at the same time that the real economy is pushed up into a higher permanent growth path.

This policy interdependence seems well specified in the government's new reform agenda. Signals are being given that fiscal policy must be put on sustainable long-term footing, while also orienting more of scarce public resources to tax reduction and human capital investments, and implementing "no cost" reforms to stimulate product market competition. A credible and prioritised fiscal policy can give a push to growth from both the demand and supply sides, by improving private agents' confidence and willingness to spend as well as their ability to satisfy these demands out of domestic production. In the past, too much of the consolidation came at the expense of pro-growth spending (R&D, infrastructure, education) while tax rates remained inefficiently high, and the complexity of the tax system (combined with occasional tax amnesties) encouraged tax avoidance and evasion.

This chapter takes the view that the opportunity to restructure after the advantageous conditions obtained at the time of EMU entry has been only partially seized, and that a deeper structural adjustment will be required for living standards to keep rising. The key economic policy challenges facing Italy are explored by looking more closely at the central problems of decelerating productivity, a still low employment rate, and a high public debt.

Macro-structural interactions

On the positive side, labour market reforms have advanced very far. The labour intensity of recent growth has been unusually high, especially after a period of "jobless growth", and unemployment has fallen to well under the euro area average. This is a remarkable and welcome achievement. But productivity growth has fallen as labour utilisation has risen and, despite an increase of the employment rate, per capita GDP growth in recent years has been among the lowest in Europe. Also, participation remains low by international comparison, even in the relatively prosperous and dynamic regions. Hence Italy's per capita GDP is only average by OECD standards, despite its high level of labour productivity (which is itself losing ground). Labour supply and demand in the formal sector continue to be hampered by high taxation and wage determination procedures that do not take local conditions sufficiently into account. Inflation is somewhat higher than the EU average, reflecting low productivity growth, and despite moderate nominal wage increases, and hardly any increase in real wages, traded goods market share losses have been significant.

Recent developments suggest a stagflation problem

Demand side developments

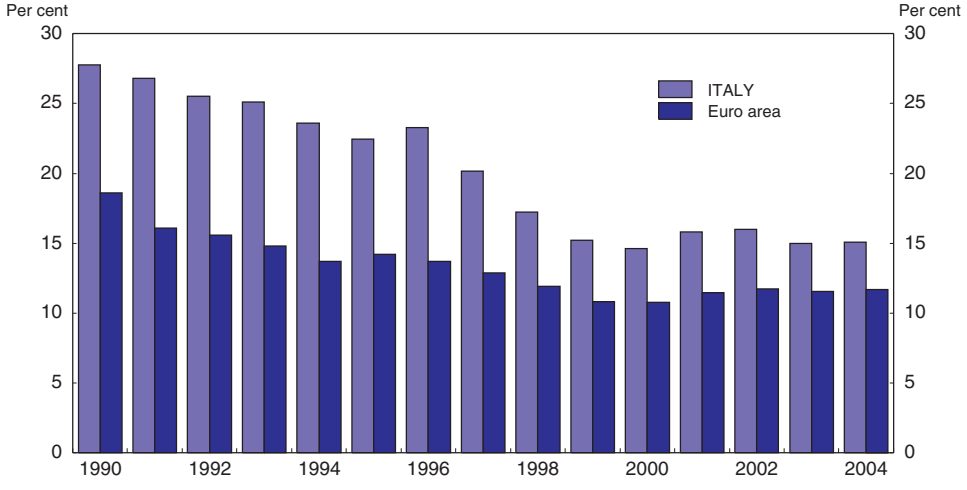
Italy was ultimately one of the countries hardest hit by the post-September 11 2001 economic downturn. Growth was less than ½ per cent in both 2002 and 2003, as exports and private fixed investment sagged. Private consumption was the mainstay of the economy, its rate of growth remaining well above that of GDP. A modest upturn began in mid-2003 but soon stalled in the wake of domestic financial instability stemming from several high-profile bond defaults (see Chapter 3). Consumer confidence plunged and growth stopped altogether in the fourth quarter. In the first half of 2004, a recovery of exports and fixed investment finally emerged, pulled along by the recovery in the rest of

the world. Industrial production nevertheless declined or stagnated until the autumn as imports boomed to satisfy a part of rising demand, and excess capacity remained high. Consumer confidence gradually improved throughout 2004 in response to healthy employment growth, a first prompt reaction to the bond defaults, and rising house prices. Henceforth, consumption is expected to take over as the main contributor to growth, though the anticipated full pass through of the oil price rise into consumer prices may restrain its growth for a while. Investment is expected to continue rising thanks to low real interest rates and cyclically improving profit margins. Exports are expected to benefit from sustained world demand growth, though subject to downside risks stemming from exchange rate turbulence and oil price impacts on foreign demands.[3]

The relative buoyancy of domestic demand reflects to some extent the fact that Italy is still benefiting from low real interest rates inherited from EMU entry, these being expected to continue throughout the projection period.[4] In the current cycle, *i.e.* since 2001, strong household credit growth has enabled a sustained pace of housing investment and a clear upturn in consumer durables purchases. Firms' borrowing, though, is not yet picking up despite recovering business confidence and investment, in part because non-performing loans have risen sharply and banks are scrutinising corporate borrowers more carefully. Fiscal policy has been supportive throughout the slow growth period 2002-04, notwithstanding the need to respect the Maastricht deficit limit, mainly thanks to extensive recourse to one-off measures with limited effects on demand, as well as cyclically declining interest payments, these factors even allowing room for a tax cut in 2003. The trend decline in household savings rates came to a halt in 2001, despite declining unemployment (Figure 1.1) perhaps as a result of the short term effect of the pension reform. The evidence suggests that much of the 2003 tax cut was saved.[5]

Although most other countries are growing faster than Italy, Italy's export market performance is hampered by an orientation to slow-growing markets: 14% of exports are destined for Germany and 60% for the internal European market, with comparatively little going to dynamic Asia, China or OPEC (Table 1.1).[6] More worryingly, the real exchange rate has been rising as a result of higher inflation than in the rest of the euro area, rising relative

Figure 1.1. **Household savings ratio**[1]



1. Data for 2004 are OECD estimations.

Source: OECD, Economic Outlook 76 database.

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Table 1.1. **Export by country**
(percentage changes from year ago)

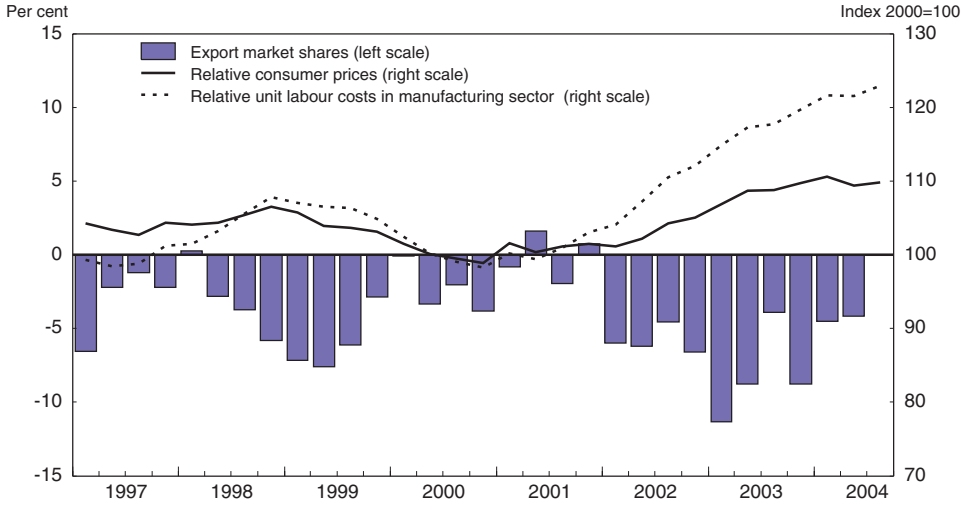
	Weight on total exports in 2003	1997	1998	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
Austria	2.3	–6.1	–0.5	1.4	–5.7	–1.2	6.2	21.7	–23.5	53.1
Belgium	2.7	–3.9	–0.8	–3.0	2.0	13.1	4.8	1.8	–11.0	–4.7
Finland	0.5	3.3	1.0	–7.3	–9.6	8.3	15.7	8.7	–20.2	58.4
France	12.2	–4.9	3.8	1.1	–4.3	–0.7	3.3	17.6	4.4	24.3
Germany	13.8	–8.2	–0.4	–0.7	–9.3	–1.8	–2.2	17.6	–8.0	19.1
Greece	2.1	1.6	0.1	3.5	–1.7	–3.2	11.5	20.5	–29.6	28.6
Ireland	0.5	–10.5	9.2	19.6	46.4	–17.8	–3.1	11.0	–37.8	69.1
Netherlands	2.4	–5.4	–0.4	–1.0	–7.6	1.3	0.5	7.6	2.3	16.9
Portugal	1.2	–1.9	4.5	5.6	–9.5	–1.7	–3.0	14.4	–28.0	11.0
United Kingdom	6.9	7.4	–0.1	–1.8	–4.0	–0.7	7.3	16.9	–18.0	30.8
Spain	6.9	1.6	10.3	9.0	–2.4	0.5	7.1	28.0	–22.4	42.4
EU15	53.3	–3.6	1.9	1.2	–5.2	–0.3	2.9	17.4	–11.5	25.7
Canada	0.9	3.9	3.3	2.8	8.1	6.9	1.2	16.9	–28.4	83.1
United States	8.5	3.8	10.3	4.2	12.3	–4.3	4.3	1.6	–27.5	50.0
Japan	1.7	–14.7	–16.5	–5.8	7.3	5.2	0.8	15.4	3.0	–41.7
Korea	0.8	–20.2	–57.9	32.8	33.9	8.1	13.1	11.8	–52.5	–26.4
Turkey	1.8	3.6	–9.2	–24.7	41.1	–17.4	9.9	38.9	–26.9	123.6
OECD	77.5	–3.0	1.2	0.7	–1.1	0.2	3.5	16.8	–19.6	30.5
China	1.5	–11.1	–20.7	–3.2	12.2	33.6	30.9	14.1	–34.8	121.3
Hong Kong, China	1.0	–7.8	–24.9	–10.1	11.0	–2.8	–0.3	4.6	–39.6	110.5
Singapore	0.5	–22.3	–33.1	12.8	23.0	2.0	–10.2	16.8	36.2	–44.1
Chinese Taipei	0.4	1.2	–10.1	–12.0	0.2	–14.6	1.0	8.4	–48.5	7.4
Russian Federation	1.5	4.6	–21.4	–39.9	26.7	36.9	13.5	21.3	–39.6	130.9
World	100.0	–3.0	–1.0	–1.8	0.7	1.9	4.1	16.5	–22.0	38.9

1. Quarterly percentage changes are calculated over the previous period at annual rate.

Source: OECD, *Monthly Statistics of International Trade*.

unit labour costs, and an appreciating euro (Figure 1.2). Furthermore, the types of products in which Italy specialises, notably clothing and footwear as well as capital equipment, tend to be highly price elastic, notwithstanding their reputation for quality. Export market

Figure 1.2. **Real exchange rates and export market shares**



Source: OECD Economic Outlook 76 database.

shares have substantially fallen in reaction to competition from low cost suppliers (though the rate of loss diminished in the first half of 2004), having declined by some 30% in cumulative terms over the past decade. More recently, import penetration has been strongly rising. Thus, though the economy is clearly emerging from its recession, external sector weakness is what keeps its growth rate well below that of Europe on average.

Despite weak growth and a negative output gap, inflation remained high at around a 2¾ per cent annual rate in 2003 and the first half of 2004. In the second half of 2004, however, it slowed sharply to less than 2%, where it remained in the first months of 2005. This reflected both decelerating food prices and administrative measures designed to keep inflation expectations in check in the wake of huge oil price rises. The government froze a series of controlled prices and tariffs and reached voluntary agreements with retailers to keep the prices of certain products frozen through end-year (Chapter 3). Inflation should remain at around 2% as cyclical productivity gains offset high energy prices. There is a risk of higher inflation if second round effects of the oil price rise materialise, *via* rising wage claims, especially as the output gap is projected to narrow by 2006.[7] Moreover, productivity is likely to recover only slowly as labour market reforms continue to foster employment growth.

Supply side considerations

The weak performance of Italian net exports is currently exacerbated by supply side constraints. Italian firms appear also unable to respond rapidly to foreign competition in both export and domestic markets by switching their product structure towards less price sensitive (higher value-added) segments.[8] The same factors responsible for poor price and non-price competitiveness probably lie behind weak total factor productivity growth (TFP), *i.e.*,the efficiency with which capital and labour resources are used, and a comparatively low potential rate of output growth. OECD estimates suggest a significant decline in trend in TFP growth, hence in trend labour productivity growth, over the past decade. The latter was largely offset by rising potential employment growth as the estimated non-accelerating inflation rate of unemployment (NAIRU) fell, a welcome result of labour market reforms. Thus, potential output growth held steady at around 1½ per cent (Table 1.2). At the same time, the cyclical unemployment and output "gaps" have contradicted each other, suggesting that tensions on the labour market have predominated in the formation of inflation, even though wages have appeared moderate (Box 1.1).

Table 1.3, based on actual output developments, indicates a sharp decline and virtual disappearance in overall TFP growth during the latter part of the 1990s and early 2000s, compared with the ½ to 1% average growth in the earlier periods. This decline was essentially offset by an acceleration of employment growth, with capital accumulation a bit faster than trend output growth. It seems that a very weak innovative capacity was offset by a rising recourse to labour, the cost of which had been reduced by various reforms. The sector decomposition of this same process delineates three distinct groups, however:

- A number of service sectors, namely construction, wholesale and retail trade, and restaurants and hotels, as well as the primary sectors of mining and agriculture, showed sharp declines in TFP growth – to inexplicably negative rates – combined with equally sharp rises in labour utilisation. These sectors also happen to be those employing larger shares of underground labour, and so may have been most sensitive to the new incentives implied by labour market reforms.

Table 1.2. **Potential output and output gap**

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Output gap, total economy	–1.6	–1.0	–0.6	–0.3	1.3	1.4	0.4	–0.6	–0.7
Output gap, business sector	–1.8	–1.1	–0.7	–0.3	1.5	1.6	0.5	–0.7	–0.8
Hours gap	0.2	0.4	0.4	0.4	0.4	–0.2	–0.1	–0.4	–0.4
Unemployment gap	–1.9	–1.8	–1.7	–1.4	–0.8	0.0	0.4	0.6	1.1
Participation gap	–1.5	–1.3	–0.6	–0.2	0.1	0.3	0.4	0.2	0.7
Productivity gap	1.4	1.8	1.4	1.5	2.7	2.2	–0.3	–1.4	–2.2
ET/ETNIA gap	0.1	0.1	0.2	–0.2	0.0	–0.1	0.1	–0.1	–0.7
Potential output, total economy	1.4	1.4	1.4	1.3	1.5	1.5	1.4	1.4	1.3
Potential output, business economy	1.6	1.7	1.6	1.5	1.6	1.4	1.5	1.5	1.5
	Contribution to business potential output growth								
Trend total factor productivity	1.0	0.9	0.8	0.7	0.6	0.5	0.4	0.4	0.5
Capital stock	0.7	0.7	0.7	0.7	0.8	0.9	0.8	0.7	0.7
Trend hours worked	–0.1	–0.1	–0.1	–0.1	–0.1	–0.1	–0.1	–0.1	–0.1
Potential employment	0.0	0.2	0.2	0.2	0.4	0.2	0.4	0.5	0.4

Source: OECD Economic Outlook 76 database.

Box 1.1. **The paradox of opposing unemployment and output gaps**

Italian manufacturing industry is only now beginning to emerge from a prolonged recession and the government has had to resort to unusual measures to prevent the deficit from exceeding the SGP 3% limit. These signal an economy operating at well below potential, and indeed the OECD estimates that the output gap will close only slowly, even though potential growth is estimated to have fallen to around 1½ per cent. Yet inflation remains higher than the euro-area average and unemployment has fallen to well below the estimated NAIRU (which has itself fallen thanks to labour market reforms). These are more typical of an economy operating above potential and subject to inflationary pressures emerging form the labour market. But nominal wages have remained very moderate and real wages have barely risen for several years. Absent major data measurement problems, a fully satisfactory resolution of this stagflation paradox is not possible. The following reflections are relevant:

- although trend labour productivity slowed markedly in the past decade, actual productivity growth has slowed even more in the past few years. This is suggestive of a high degree of labour hoarding in response to what was expected to be a temporary recession;
- the very weak growth of productivity, even negative at times, has meant that unit labour costs and prices have risen faster than in trading partners despite wage moderation. The resulting erosion of competitiveness exacerbated the impact of the global slowdown on the traded sector, and likely added to pressure to keep wage increases low;
- labour market reforms have made it more attractive to hire and keep labour in the formal sector. This could help explain the strong growth of employment registered each year this century, the weak growth of productivity, and to some extent the nominal wage moderation.

- TFP growth in manufacturing fell to less than one-third of its rate over the previous two decades, and that in energy sectors fell significantly as well – though both remained

Table 1.3. **Contributions in real value added growth by industries**

	1982-2002	1982-1993	1993-1996	1996-2002
Total economy				
Real value added growth	2.1	2.1	2.0	1.9
Capital contribution to growth	1.5	1.6	1.2	1.4
Labour contribution to growth[1]	0.2	0.1	–0.1	0.6
TFP contribution to growth	0.5	0.4	1.0	–0.1
Agriculture, hunting, forestry and fishing				
Real value added growth	1.0	0.7	1.4	0.3
Capital contribution to growth	0.8	1.0	0.4	0.8
Labour contribution to growth[1]	–0.7	–0.6	–1.4	–0.2
TFP contribution to growth	0.8	0.3	2.4	–0.4
Total manufacturing[2]				
Real value added growth	2.0	1.7	3.0	1.9
Capital contribution to growth	1.2	1.3	0.8	1.0
Labour contribution to growth[1]	–0.5	–1.0	0.2	0.4
TFP contribution to growth	1.3	1.5	2.1	0.5
Mining and quarrying[2]				
Real value added growth	1.9	3.6	2.8	–3.4
Capital contribution to growth	1.9	1.7	2.3	1.9
Labour contribution to growth[1]	–0.6	–0.8	–1.2	0.2
TFP contribution to growth	0.7	2.7	1.7	–5.6
Electricity, gas and water supply[2]				
Real value added growth	1.7	1.1	4.0	1.7
Capital contribution to growth	1.5	1.9	1.2	0.9
Labour contribution to growth[1]	–0.0	0.5	–0.7	–0.9
TFP contribution to growth	0.2	–1.3	3.5	1.8
Construction				
Real value added growth	0.3	0.3	0.2	1.1
Capital contribution to growth	0.9	1.1	–0.2	1.6
Labour contribution to growth[1]	–0.6	–0.7	–1.7	1.0
TFP contribution to growth	0.1	–0.0	2.1	–1.5
Wholesale and retail trade; restaurants and hotels[2]				
Real value added growth	2.1	1.8	2.5	2.6
Capital contribution to growth	2.7	2.6	2.7	3.3
Labour contribution to growth[1]	0.6	0.5	0.1	1.1
TFP contribution to growth	–1.3	–1.3	–0.3	–1.8
Transport and storage communication[2]				
Real value added growth	3.4	3.6	2.6	3.5
Capital contribution to growth	2.1	2.2	1.8	2.2
Labour contribution to growth[1]	0.0	–0.1	–0.2	0.5
TFP contribution to growth	1.3	1.5	1.0	0.8
Financial intermediation[2]				
Real value added growth	3.7	4.0	2.4	3.7
Capital contribution to growth	1.4	1.8	1.0	0.6
Labour contribution to growth[1]	0.8	1.2	–0.4	0.4
TFP contribution to growth	1.5	1.0	1.7	2.7
Real estate, renting and business activities[2]				
Real value added growth	3.2	3.6	1.9	3.0
Capital contribution to growth	2.3	2.5	2.1	1.9
Labour contribution to growth[1]	1.0	1.3	0.1	0.9
TFP contribution to growth	–0.1	–0.1	–0.2	0.2
Community social and personal services				
Real value added growth	1.4	1.6	0.9	1.3
Capital contribution to growth	0.6	0.7	0.4	0.6
Labour contribution to growth[1]	0.8	1.1	0.2	0.5
TFP contribution to growth	–0.0	–0.2	0.2	0.2

Note: Classification of industries based on ISIC Rev 3.

1. Measured by full-time equivalent jobs (dependent employment).
2. Data available until 2000. Last column refers to 1996-2000 contributions.

Source: OECD STAN database.

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positive, with little accompanying rise in labour utilisation; output growth fell markedly in both sectors.

- The only sectors which experienced a rise in both TFP growth and labour utilisation were financial and business services, while transport and communications services raised total factor utilisation without sacrificing much TFP growth; these sectors thus showed large increases in average output growth.

Falling unemployment is a bright spot in the economy

In contrast to labour *productivity* performance, other aspects of labour *market* performance in Italy have been impressive. Job growth increased after the start of reforms in 1998, and was especially strong since 2001, although effective labour units have risen less markedly.[9] The unemployment rate has fallen from 12% in 1998 to under 8% today.[10] Another encouraging indicator is that per capita income has continued to grow as productivity has fallen somewhat (Figure 1.3). That is, labour productivity goes down, at least temporarily, as less efficient workers are bid into jobs, but per capita income (a better measure of national well-being) goes up as fewer slack labour resources exist in the economy. Hence, labour deepening has been economically beneficial for Italy.[11]

Wage moderation has helped

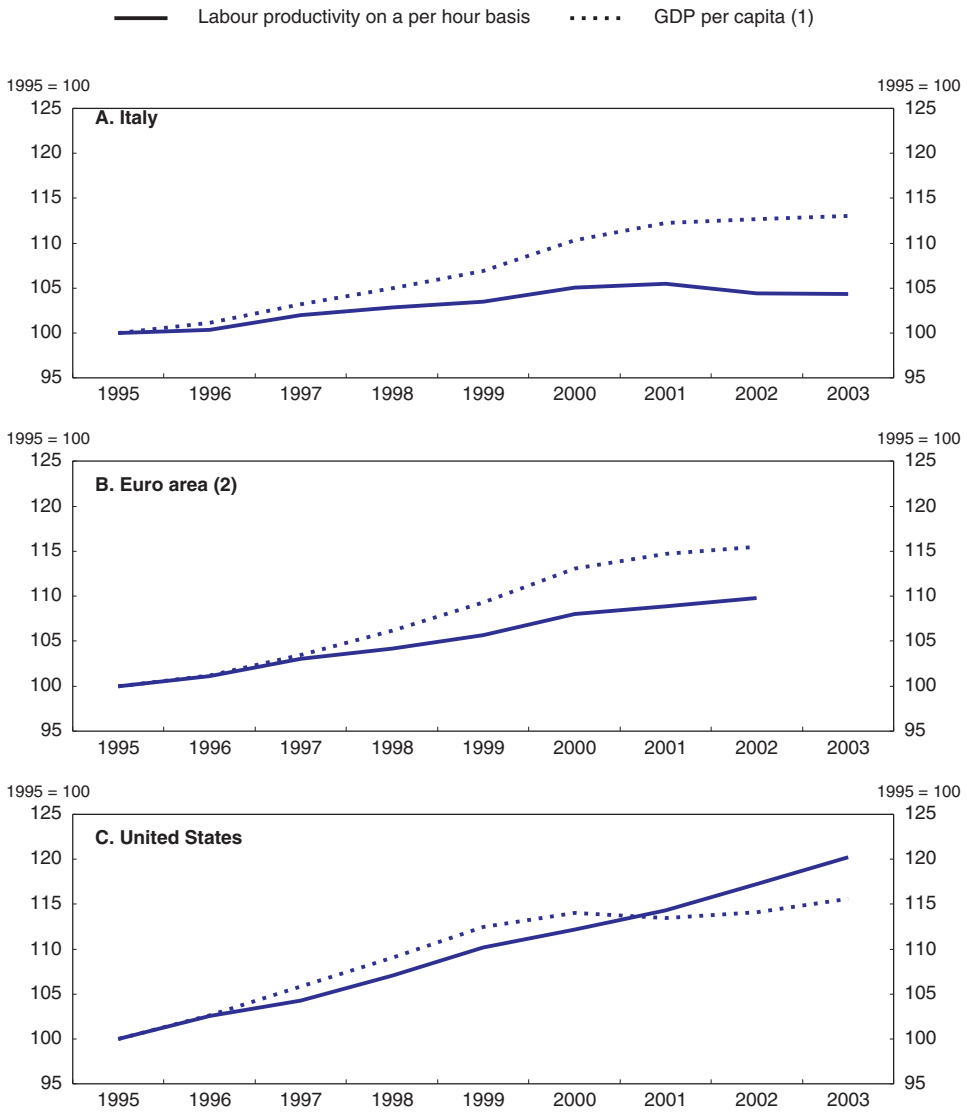
Despite rising employment, the growth of household incomes has been modest. Indeed, a policy since 1993 of "wage moderation" has been designed to underpin competitiveness and employment. Under this arrangement, a first level of wage bargaining at the national level fixes basic wage growth to the officially forecast inflation rate, and a second level allows for further productivity-related increases at the sector and firm levels. Clearly, then, low productivity growth has allowed scant room for real wage gains. And with productivity growth turning negative in the recent downturn, workers should in theory have accepted real wage cuts in order to keep unit labour costs (as perceived by employers) from rising. In practice, however, expected inflation has set a floor on nominal wage growth, so that unit labour costs instead have risen sharply. Where hiring and firing costs are high, as in Italy and continental Europe, the typical response of employers has been to "hoard" labour until the next upturn, but this begs the question of why Italian employers have actually continued to hire in the downturn (see Box 1.2 below).

Furthermore, the policy of forward indexation, which initially delivered strong disinflation benefits to households (by breaking the wage-price-devaluation cycle inherent in the old *scala mobile*), has more recently led to labour market strains. Following adoption of the euro in 2001, inflation rose to above the official *ex ante* forecasts, but "perceived" inflation rose much more,[12] contributing to a downturn in consumer confidence and rising wage claims (especially in the public sector), and even sparking debate on the continued relevance of the 1993 model. However, both inflation and inflation perceptions fell markedly in the autumn of 2004, suggesting that the prolonged phase of "euro changeover" may be finally over.

Labour market reforms have been intensive

The process of labour deepening is still going on. Recent labour market reforms have been along the lines of targeting flexibility of work contracts for new entrants, significantly reducing hiring and firing costs for marginal workers. Unchanged legislation on permanent contracts could have aggravated labour market duality, with a negative impact on

Figure 1.3. **GDP per capita and labour productivity**



1. GDP per capita is expressed in 2000 PPP constant prices, and has been calculated with population aged 15-64.
2. Euro area excludes Austria.

Source: OECD, Economic Department and Labour Force Statistics databases.

productivity, for two reasons: *i)* if firms cannot allocate workers optimally, they hiring too many new workers on fixed term contracts because those with tenure are hard to move to new tasks, and *ii)* workers on precarious contracts may engage in less on-the-job learning, while some of those with secure contracts may be less motivated to exert effort.[13] Yet Italy has so far managed to avoid any sizable increase in labour market segmentation. On top of the regulatory limits to repeatedly rolling over temporary contracts, generous fiscal incentives were given to hiring on a permanent basis starting in late 2000. These subsidies were first abruptly suspended because of their heavy budgetary cost and the lack of monitoring, though later on reduced in generosity and extended up to end 2006. Indeed,

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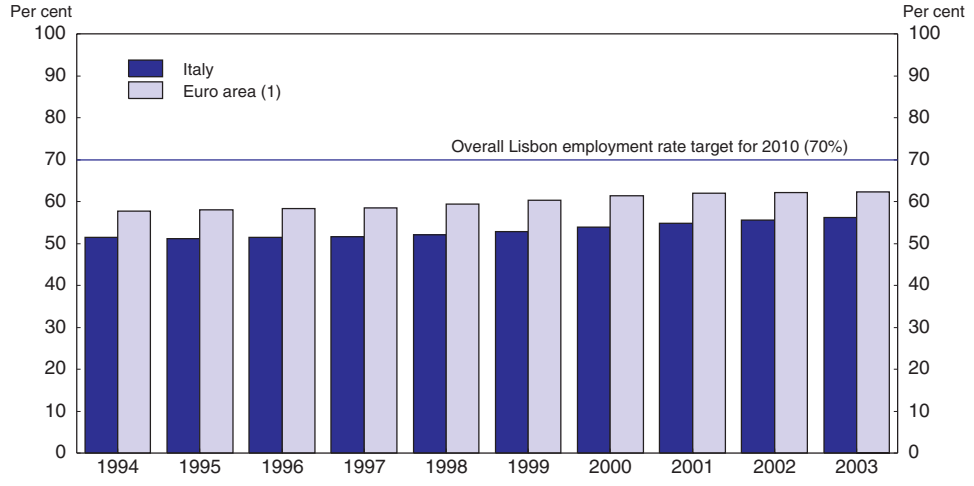
during these years the bulk of employment growth was in terms of permanent contract hires, though many of whom may have been already working in the underground economy, as firms took advantage of fiscal subsidies to convert them into regular employment.[14]

In 2003, a new law (Biagi Law) gave the government the possibility to reform further the functioning of the labour market, with the objective of increasing employment among youth, women, older workers and job-seekers, particularly in the Mezzogiorno. The new instruments include allowing private employment agencies to compete in the full range of services with public ones; promotion of life-long learning through apprenticeships; improved conditions for use by the firms of part-time work; and non-standard forms of employment (on-call, job sharing, "co-co-co"[15]). More time will be needed to evaluate their effectiveness, though rapid employment growth in the first half of 2004 is encouraging. Once the impacts of the current reforms are fully phased in, a period of slowing employment growth, back toward traditional relationships with output growth, may be associated with more "normal" productivity growth.[16] It is also possible that fiscal subsidies and the dual labour market imply inefficiently high labour intensity currently, in which case the slowing could be even sharper as subsidies are withdrawn and labour market insiders go into retirement.

Still low employment rates imply room for further improvement

Labour deepening, nevertheless, is clearly not finished. Italy still has the lowest employment rate in the euro area and falls far short of the ambitious Lisbon criteria (Figure 1.4). Italian female participation rates remain unusually low compared with other OECD countries, in all parts of the country, and their unemployment rates significantly higher than those of Italian men at all age groups and across regions (Chapter 5). The use of part-time work, which is often correlated with high female participation, also remains unusually low compared with other OECD countries (Figure 1.5), despite liberalisations of part-time contracts. Although the Biagi reforms seem to be paying more attention to this problem, the more constraining factor may be insufficient liberalisation in the retail sector, which is restricting working hours and the expansion of large retail outlets, and hence, the

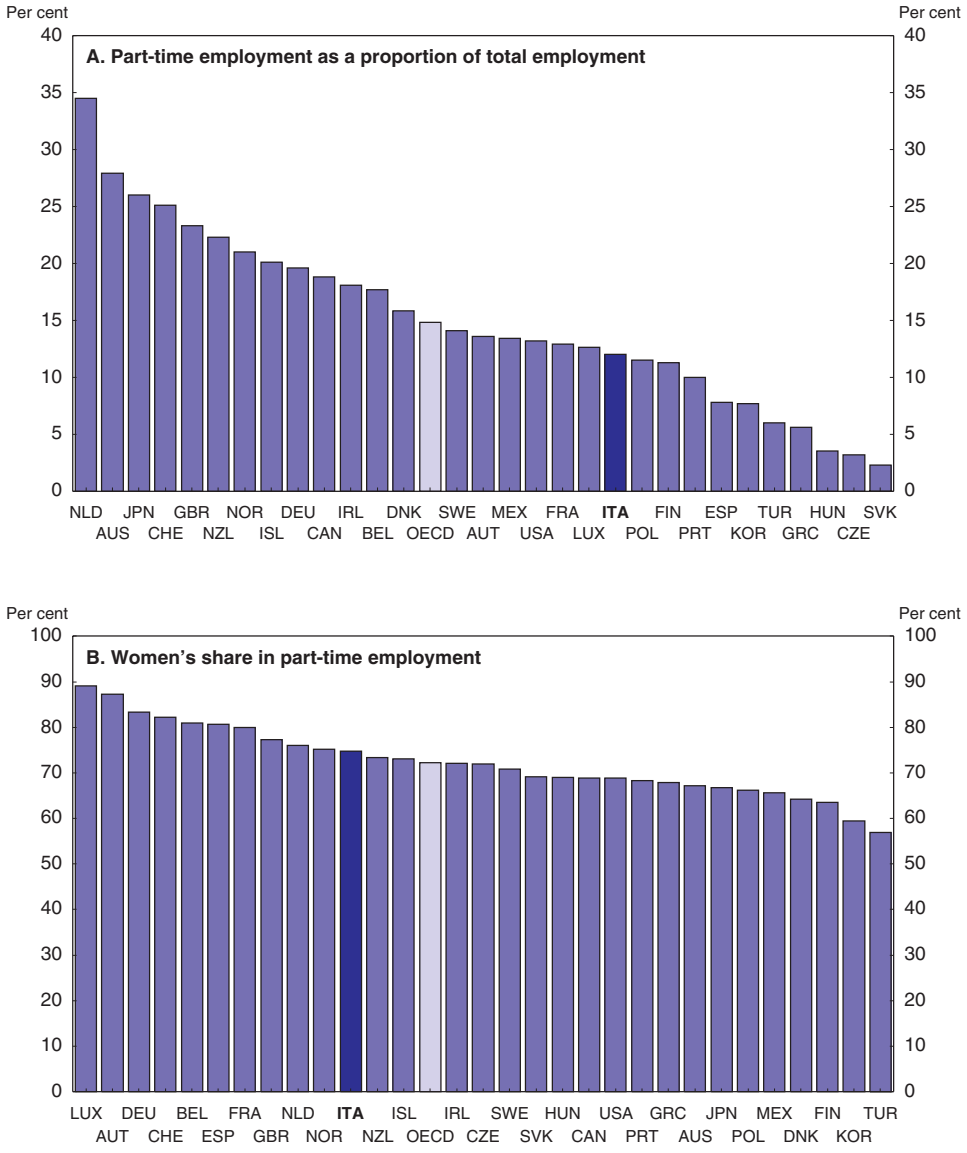
Figure 1.4. **Employment rates**



1. Excludes Luxembourg in 2003.

Source: Employment Outlook database.

Figure 1.5. **The use of part time**
2003, or latest year available



Source: OECD, *Employment Outlook* (2004).

supply of part-time jobs. The high tax wedge is clearly a disincentive to join the formal labour force,[17] particularly among low-skilled people, and reducing it is a major stated aim of the present government. Although Italy is free of many of the welfare benefit traps besetting other European countries with elaborate protections of working age people, generous tax deductions for dependent spouses create welfare-like traps at low incomes as they are withdrawn, discouraging participation of low-skill women. Also, the tradition of women staying at home to care for children and ageing parents has had its counterpart in few available public care facilities.

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Italy's older worker participation rate is around 60% of the OECD average (in the 55-64 age bracket). Though Italy lacks an explicit link between early retirement schemes and industry downsizing needs, the seniority pension system is very liberal: retirement at 57 year of age conditional on 35 years of contributions has long been the norm, with the implicit "tax" on working longer very high. Workers over 55 show very high voluntary and involuntary separation rates, despite that tenure rates tend be higher for them, in turn suggesting that demand for older works is also a problem.[18] The deterioration of skills with rising age is likely to be a main cause, combined with seniority-based pay scales. Life-long learning and worker training, indeed, are still underdeveloped in Italy.

Youth unemployment rates are among the highest in the OECD, and the very high proportion of youths who are neither in school nor in the labour market is worrisome. A shortage of skills, especially in the South where youth unemployment is particularly high, in conjunction with rigidities in wage setting, is a main cause. The share of the working-age population with at least upper secondary education is significantly lower than the OECD average, and the drop-out rate from tertiary education is especially high (Chapter 5). Present reforms are addressing the problems of high secondary school drop-out rates and inadequate school-to-work transition. But more efforts seem required in the area of tertiary education and in-job training programmes.

Deteriorating productivity reveals weak structural roots

With zero or negative productivity growth, and a floor on nominal wage growth, unit labour costs have risen significantly. The resulting inflation gap *vis-à-vis* other euro area partners of ½ per cent or more per year, though not overly alarming in any individual year, has resulted in a cost gap on a sustained basis which in cumulative terms is now quite large. If demand elasticity is high, market share losses could be substantial – as they indeed have been. The search for solutions to the persisting inflation gap therefore requires identifying the sources of low productivity growth, especially as it may not be realistic to expect trivial or negative nominal wage growth.

Box 1.2 presents various arguments as to why low or negative productivity growth may be a temporary phenomenon, arising from transitory effects of labour deepening reforms since the mid-1990s and/or cyclical behaviour in the downturn phase more recently, in either case requiring patience and time to be resolved. There could even be serious measurement problems, tending to explain the problem away. However, policy prudence would suggest paying attention to the possible fundamentals explaining unfavourable productivity dynamics. The following observations are relevant:

Weak service sector competition and innovative capacity

Both competitive pressure and innovative capacity spur TFP growth, the former providing a stimulus to seek efficiency gains *via* the adoption of technological or organisational best practices, and the latter the ability to achieve it. In a set of productivity-relevant structural indicators developed by the OECD, Italy tends to compare unfavourably with other countries in the following policy areas: extensive product market regulation, large scope of public ownership, excessive regulatory burden on business, barriers to FDI, over regulation of professional services, limited upper secondary and tertiary educational attainment and achievement (Figure 1.7).[19] In a number of these fields, Italy's performance has improved in recent years; however, other countries have also improved theirs. Most of these structural deficiencies concern barriers to competition in the service sectors,

Box 1.2. **The analytics of productivity decline in a context of labour deepening**

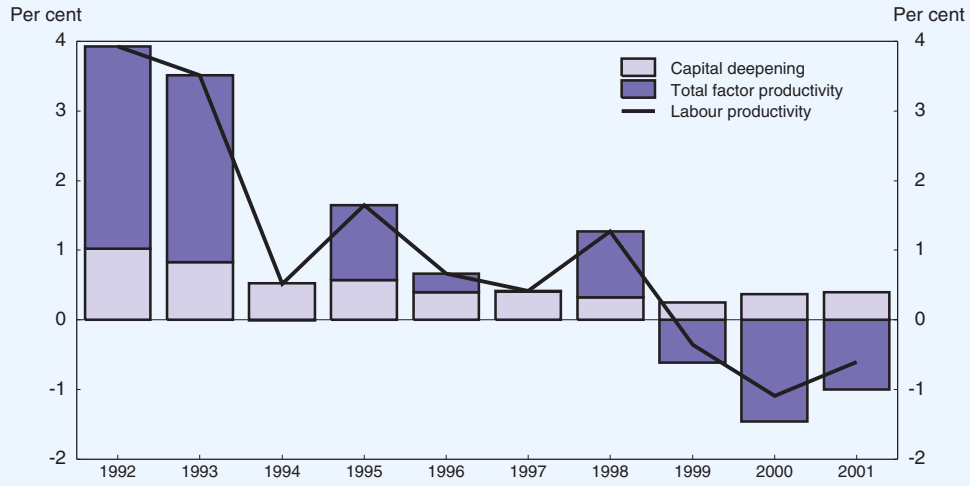
A sharp deceleration of labour productivity has taken place over the past decade in association with a strong deterioration of Italian cost competitiveness. It is important to distinguish whether this poor productivity performance is mainly an endogenous result of recent labour market reforms themselves – notably during a transition period in which there is a shift of production toward more labour intensive activities and also as underground workers not fully captured by the statistics are bid into formal jobs, or by adverse cyclical effects, or whether there is a more fundamental problem. While temporary shocks to productivity cannot be fully discounted, there are two cogent reasons why a negative structural shock is the stronger possibility and raises policy concerns:

i) The decline in productivity growth is more than explained by estimated TFP growth, which even turned negative in 2003-04 (Figure 1.6). Labour market reform by itself would be expected to rather reduce mainly the capital to labour ratio component;

ii) Two other disquieting developments present themselves as hard facts, namely relatively high core inflation and a large current account deterioration compared with European partners. Competitiveness cannot be all right if this is the case.

Figure 1.6. **Productivity decomposition**

Annual growth rates



Source: OECD (2004), *Economic Outlook* database No 76.

Productivity impacts of labour market reforms

Labour market reforms have reduced non-wage labour costs. Since 1995, the liberalisation of atypical labour contracts eased job protections. At the same time, generous fiscal incentives were given as generalised tax credits from October 2000 to December 2003, amounting to € 415 per month for each new worker hired (€ 620 in the South) under a permanent contract. It has been estimated that firms appraise the possibility of hiring 1% of new workers under temporary contracts as much as a 2-3% reduction in the wage paid to permanent jobs. Since the share of fixed-term contracts on all newly hired employees grew between 1995 and 2003 by 8 percentage points (from 34 to 42%), this inflow of flexibility into the Italian labour market was worth as much as a drop of about 16-21% in the wages of permanent workers (Cipollone and Guelfi, 2004).

Unusually, therefore, recent labour market reforms are not captured by declining unit labour costs, but rather by rising profitability *via* declining non-wage labour costs (severance and tax payments). Real wages would, if anything, have been expected to rise somewhat in response to an expansion of labour demand given lower non-wage costs, though in fact they remained stable.[1] Unit labour costs have nevertheless increased sharply because of the productivity slowdown, nullifying part of the initial profitability gain.

Box 1.2. **The analytics of productivity decline in a context of labour deepening** *(cont.)*

Decline in capital-to-labour ratio via sector recomposition effects. The decline in "effective" labour costs has led to a substitution of capital by labour,[2] mainly as production shifts toward labour intensive sectors in response to a rise in their relative profitability.[3] Another way of viewing this is that prior to labour market reforms, capital investments and capital intensity of production, and hence labour productivity, were inefficiently high and employment too low, reflecting a too-high relative price of labour as a result of union power. Therefore, lowering the relative price of labour *via* reforms should entail a period of adjustment to a lower level of labour productivity that is more compatible with full employment, an important social and economic goal. All in all, this period of labour deepening should by itself not impact on unit labour costs since the productivity slowdown is brought about *ab initio* by a decline in the price of labour. Once the transition is completed productivity can start to rise again normally.

Decline in TFP via skill and capital composition effects. If measured TFP incorporates labour quality, then labour deepening might have a depressive effect on the level of TFP as lower labour costs bid lower-skill workers into jobs. Once the new workers are trained TFP will recover, however, eventually surpassing its baseline levels insofar as a more flexible labour force makes it easier for employers to undertake organisational and technological changes in order to regain competitiveness. Moreover, if measured TFP incorporates capital quality then the slowdown in capital accumulation would also be reflected in slowdown of TFP. This effect might have been strong in recent years due to the diffusion of ICT. A rise in profitability (as TFP recovers *via* the human capital channel) would encourage renewed capital investment, counteracting this effect also.

Data mis-measurement and cyclical impacts

The data on productivity may be biased during the process of labour deepening, for example due to measurement errors related to the informal economy, so that the new flexible work contracts and fiscal incentives may have caused formerly undeclared workers to be declared, lowering the measured – but not true – productivity of labour.[1] This possibility should not exist however because Istat, the statistical agency, purports to measure the informal economy in terms of both output and employment. As a matter of fact, Istat estimates of illegal immigrants (about 660 000 people in 2001) has been confirmed by the number of illegal immigrants that regularised in 2002 (about 700 000 regularisation forms were filled).

There may be measurement problems also in assessing the price/output split. If quality improvements are poorly captured by volume changes, being instead reflected in a rising unit value or price, then Italy's inflation gap and export volume market share losses could conceivably reflect a steady value added upgrading of production and exports. The most straightforward argument to be made against spurious losses of export market shares masking quality improvements, however, is a marked deterioration over the past few years of the current account, *i.e.* by several percentage points of GDP compared with the rest of Europe. This suggests that the inflation gap and export volume share losses reflect genuinely poor productivity performance.

It is also tempting to say that the recent downturn has exaggerated the temporary slump in productivity even further due to cyclical labour hoarding which overlays the structural labour deepening process. Firms may even have engaged in some kind of "anticipatory hoarding", *i.e.* taking advantage of generous, and limited-in-time, fiscal incentives in order to hire now in anticipation of better times later on. On the other hand, the cyclical downturn should also evoke a countervailing positive impulse to TFP insofar as less efficient and less innovative firms exit the market, and on balance, the cyclical TFP effect should not be so significant.

Box 1.2. **The analytics of productivity decline in a context of labour deepening** *(cont.)*

Negative productivity shock and employment dynamics

Economic theory (*e.g.*, Layard *et al.*, 1991) suggests three distinct types of employment impacts arising from favourable total factor productivity dynamics: *i) technological impact*: an exogenous rise in productivity owing for example to better technology, initially reduces employment one for one; *ii) competitiveness impact*: an improvement in competitiveness which results from the same productivity increase reduces unit labour costs, in turn allowing firms to lower prices, expand production and thus overall employment; and *iii) investment impact*: declining unit labour costs will also raise profits and investment, further raising employment. The latter two positive effects usually offset the first negative effect (though this is an empirical question), so that on balance, a positive shock to productivity should boost employment. The current Italian situation presents itself as possibly the reverse case; *i.e.* a negative total factor productivity shock has in the first instance been associated with rising employment to maintain output (as in Table 1.4), but this has also reduced competitiveness and profitability, implying that eventually growth could falter and employment gains reverse. The problem is to identify the possible sources of the negative productivity shock.

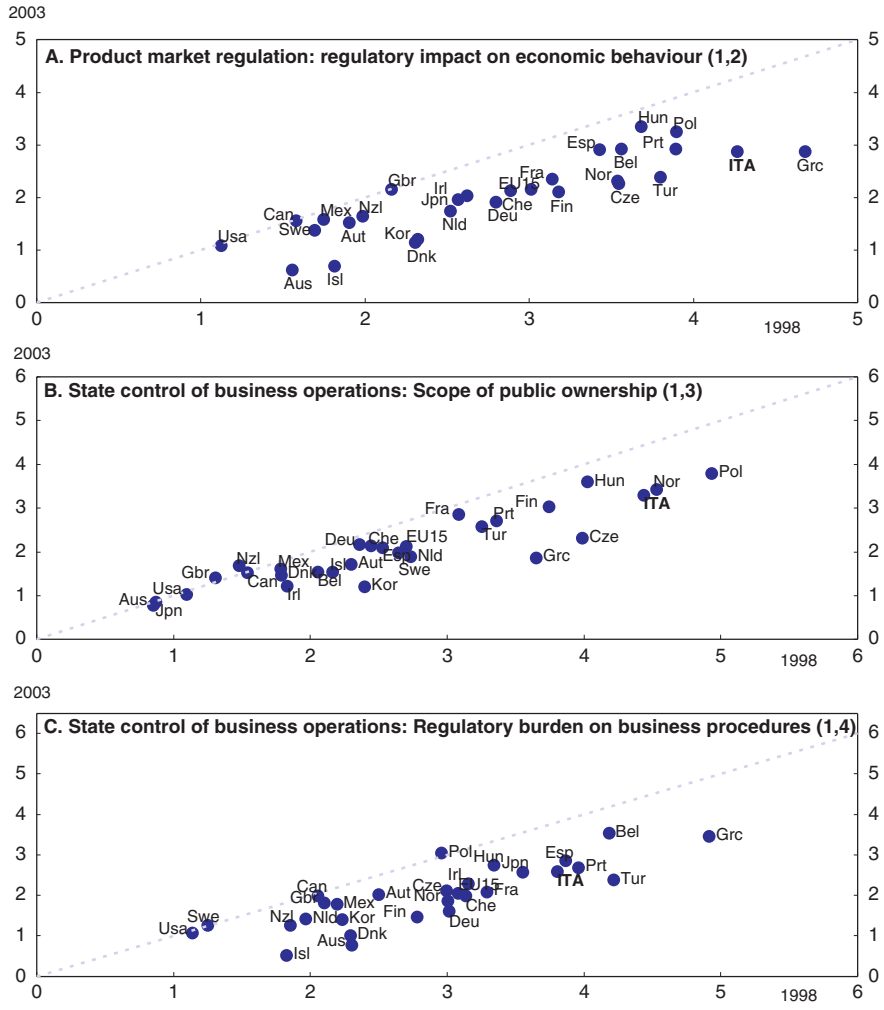
Demographics may have implied one such negative shock, as the former favourable dynamic in human capital stemming from the entry of the better-educated baby boomers into the labour market has by now run its course. A very small average firm size may also have interacted adversely with the growth slowdown, as well as with competitive pressures arising from intensified globalisation, as small firms are more likely cut research-related spending in order to maintain profitability in times of economic difficulty. Finally, rapid budget consolidation since the early 1990s entailed cuts to public spending on physical infrastructure and human capital.

Summing up

In conclusion, a number of alternative hypotheses could explain the unexpected observation of steeply declining cost competitiveness simultaneously with an intensive process of labour deepening. Any slowdown in productivity growth that is directly the result of sector, skill or capital composition effects of the labour deepening process itself, insofar as it occurred should be largely transitory, and eventually there should be important complementarities between employment and productivity – especially TFP – growth, and likewise between labour market reforms, real wages, and profitability. Data distortion hypotheses tending to whitewash the productivity problem should be given little weight, and indeed, some of these can be dismissed by valid, observable evidence such as the current account deficit. It is also unlikely that cyclical factors have been overriding since labour hoarding impacts are likely to have be offset by beneficial composition effects on TFP as weak firms tend to exit the market in periods of slowdown. This leaves the strong presumption that a negative structural shock to productivity has been operational during the process of labour deepening, but not because of it. It seems that to establish a favourable dynamic in productivity allowing sustained employment growth, measures to boost human capital and small firm growth and innovation are warranted.

1. The fact that most of the actual employment growth came out of declining unemployment, rather than significantly rising participation by marginal groups, suggests that demand was indeed the dominating factor.
2. Employment growth might also be the result of a lower outflow rate due to pension reforms that raised retirement age, *i.e.* as long as young and older workers are not perfect substitutes (Banca d'Italia, 2003).
3. The share of manufacturing in overall value added seems to have recently fallen slightly more in Italy than in the OECD (from 22.2 to 19.7% over 1995-2002 in Italy, against 19.7 to 18.6 over 1995-1999 in the OECD). However, in Italy this would also have been sped up by the rising real exchange rate. Also, it is difficult to compare sectoral shifts across countries because of different degrees of outsourcing of services formerly provided within the manufacturing firm.

Figure 1.7. **Structural indicators related to productivity**

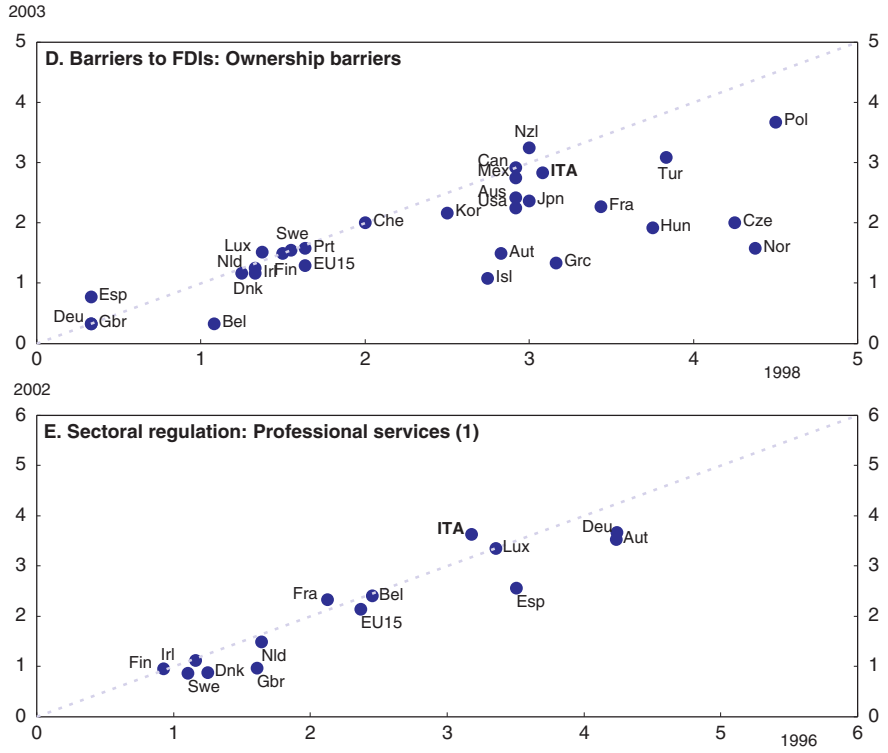


1. EU: EU15 excluding Luxembourg in 1998.
2. Economic regulation includes all domestic regulatory provisions affecting private governance and product market competition such as state control and legal barriers to entry in competitive market.
3. Covers scope and size of public enterprise as well as the direct state control over business enterprise (*via* voting rights or legislative bodies).
4. Concerns the involvement of the state in business operations *via* price controls or the use of command and control regulation.

including education, since the manufacturing sector is relatively open. Italy also tends to score poorly in terms of OECD innovation indicators, including low business R&D intensity, ICT diffusion and numbers of researchers (Chapter 5). Besides problems in domestic competition and human capital, it is possible that small firm scale, in part linked to labour market rigidities but also financial market constraints (see below), contributes to low diffusion of ICT and comparatively little research and development activity (see 2003 *Survey of Italy*).

To be sure, Italy also possesses notable competitive strengths, among which the flexibility of small firm industrial clusters (see 2003 *Survey*). Figure 1.8 shows that, as of 2002, even though productivity *levels* in the traded goods sector were comparatively low

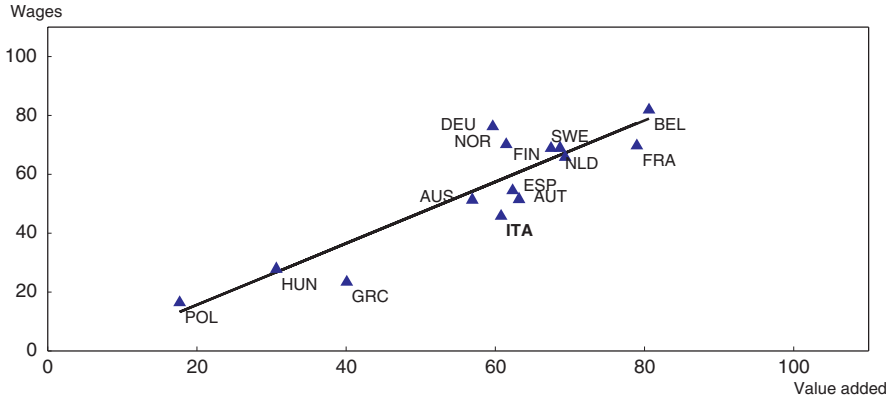
Figure 1.7. **Structural indicators related to productivity** *(cont.)*



1. Index of regulations in professional services (accounting, law, engineering and architecture).
Source: OECD (2005), *Economic Policy Reforms: Going for Growth*.

in the OECD context – pointing to a technology and TFP lag – workers in that sector were quite competitive since their wages were lower in relation to productivity than in most other OECD countries. Nevertheless, competitiveness of the traded goods sector suffered insofar as it was obliged to use inputs from the service sector, where unit labour costs have

Figure 1.8. **Productivity and wages in the traded sector**[1]
Per employee, in purchasing parities, USA = 100

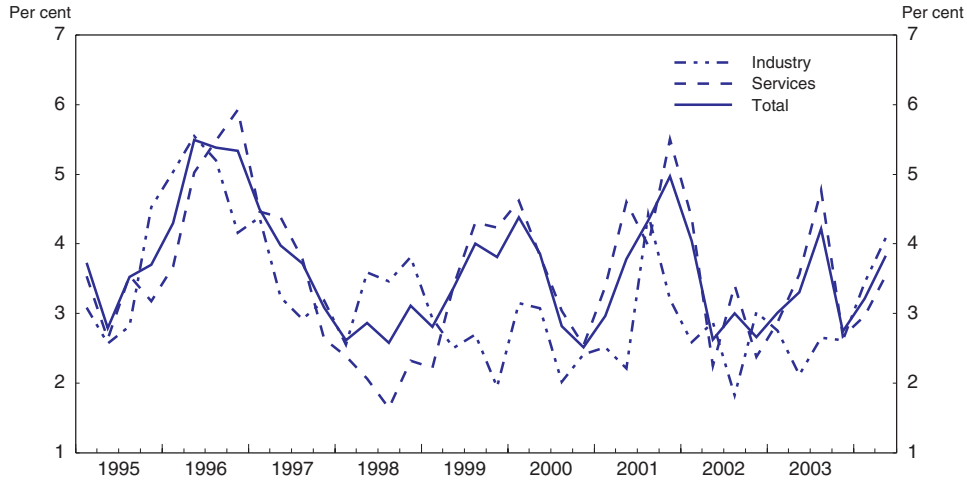


1. 2002, or latest year available, includes agriculture, mining and quarrying, manufacturing, electricity and construction.
Source: OECD, STAN Database.

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tended to increase much faster than in the traded goods sector (Figure 1.9). The above product market indicators suggest that the service sector has enjoyed relatively high rents allowing unit labour costs increases to be more easily passed through into prices. Relatively high service prices, including among the highest for energy and professional services in the EU, reduced profits margins in the traded goods sector. This highlights the scope for enhanced external competitiveness if service sector prices were to be lowered by increased exposure to forces of domestic competition (Chapter 3). There is also significant scope for Italy to move up the value added chain in traded goods, if current barriers to innovation were reduced.

Figure 1.9. **Unit labour costs by sectors**
Year on year percentage changes



Source: ISTAT, Conistat database.

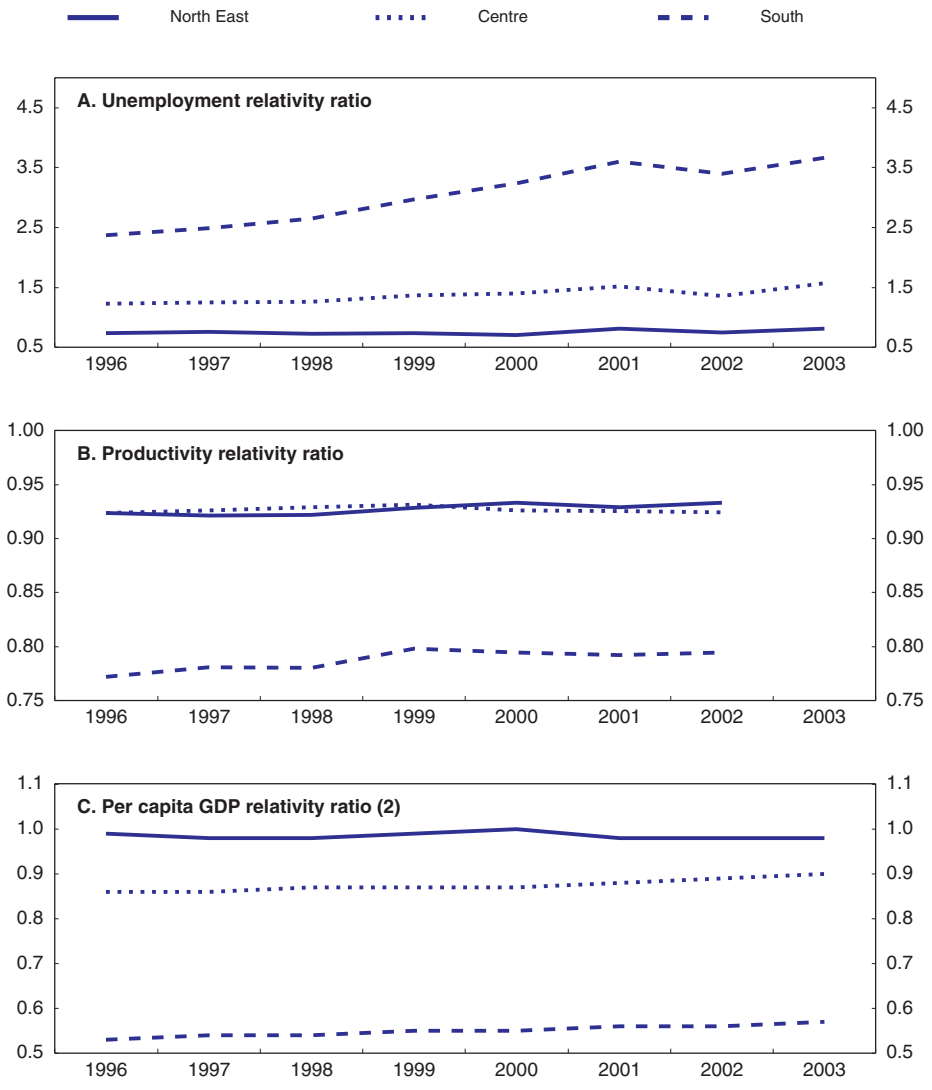
The role of financial markets

Although the banking sector shows healthy productivity growth, thanks to privatisation and restructuring, the financial system as a whole seems not to be conducive to enterprise creation, growth, and innovation. In case of bankruptcy, the law inflicts excessive penalties on defaulting debtors and neglects protections of creditor rights, mainly due to excessive judicial control allowing little scope for economic objectives. As a result, collateral-based lending is much more common than lending based on prospects, and a venture capital industry has yet to take off. As to capital markets, a lack of widespread share ownership, along with weak minority shareholder rights, creates a situation of weak contestability. Instead, a complex web of cross-ownership in industry (pyramidal structures) protects insider interests and mutes competitive pressures across firms. Also, problems of connected lending and tunnelling exist in relationships between banks and industry. Thus, capital may not be efficiently allocated and there is a lack of effective financial market oversight of management. These problems were highlighted in the recent financial scandals, which undermined confidence and provoked a policy response (Chapter 3).

Special problems of the South

Decomposing competitiveness by region indicates a major problem in the South *vis-à-vis* the North. The wage level tends to be broadly similar nation wide (OECD indicators of labour market regulation show a relatively high level of administrative extension of collective agreements in Italy), notwithstanding firm-level negotiation as part of the wage setting mechanism, but productivity levels are much lower in the South (Figure 1.10). The South is relatively more specialised in services than the North, while the wage-productivity mismatch is concentrated in services rather than in manufacturing.[20] Also, a public infrastructure lag in areas like water and road transport impairs business sector

Figure 1.10. **Regional unemployment and productivity relativities**[1]



1. North West region is taken as benchmark.
2. Estimations based on Istat data, for 2002 and 2003.

Source: Istat (2003), Rilevazione continua sulle forze di lavoro; Istat (2004), Conti Economici regionali.

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productivity.[21] The quality of local administrations seems to have been improving in response to a policy strategy of rising regional responsibility, so far mainly on the spending side. As described in previous *Surveys*, current policies endeavour to increase the role of the market in the economy of the South. This involves winding down public subsidies, a process now being accelerated by the budgetary problems, and enhancing public administration and infrastructures also through results-based awarding of EU and national funds.

Largely in response to the policy shift, a higher average growth rate in the South than in the Centre-North has been sustained over the past eight years (a post-war record), with significant narrowing of the gap in per capita GDP. This growth moreover is driven by a relatively strong increase in fixed gross investment, the first time since the 1960s that capital accumulation – the essential basis for development – is favourable to the South of Italy.[22] The growth difference between the South and the average for Italy as a whole is not large, but compared with most of the rest of Europe, Italy is going in the right direction. In fact, most recent data from Eurostat show that regional disparities in both EU15 member states (with the exception of Italy, Austria, and Greece) and the 10 new member states are on the increase rather than on the decrease. Nevertheless, much faster growth rates in the South would be needed for a true catch-up process to occur and to close the still-substantial gap in living standards *vis-à-vis* the Centre North.

Rigid wage setting, especially in the public sector, and low skills in the South may also be factors contributing to low geographical mobility and consequent regional segmentation of labour markets, those in the North being very tight and short of skills. By contrast, many immigrants arrive in the South but rapidly leave to find jobs in the North (Chapter 4). Competitive pressures are likely to increase with new EU entrants from Eastern Europe, likely to be endowed with levels of education comparable to those in southern Italy but lower labour costs. There is also evidence that outsourcing is becoming more prevalent among Italian industry, with SMEs and even some industrial clusters relocating to Eastern Europe and the FSU, at the same time that private investment is needed to promote development in the South.

The fiscal structural effort was relaxed during the slowdown

The vanishing primary surplus

Extensive recourse to one-off measures has been a main means of fiscal adjustment in recent years.[23] One-off measures are by no means novel in the Italian (nor European) context, having been used in the crisis years of 1992-93, in the run-up to EMU in the mid-1990s (notably, the "solidarity tax") and again in 2000 with the sale of UMTS licenses (Table 1.4). They are an effective way of obtaining budget savings very quickly.[24] What is novel is their scale: they averaged over around 1½ per cent of GDP per year during 2002-04, compared with ¾ per cent during 1992-2001. The use of tax amnesties and real estate securitisations has been particularly intensive. The justification for stepped up use of temporary measures with largely neutral impacts on aggregate demand was the emergence of a negative output gap in 2003 (Table 1.2). This reasoning was generally accepted by the EU and by financial markets, but by the same token, Italy was cautioned to replace one-off measures by permanent ones as soon as growth recovered.[25]

But the end result was that by 2003, the trend primary surplus, *i.e.* adjusted for *both* the economic cycle and one-off measures, declined to about ½ per cent of GDP while the trend

Table 1.4. **Fiscal situation**

Per cent of GDP

	1997	1998	1999	2000	2001	2002	2003	2004
Total receipts	48.4	46.8	47.1	46.2	46.0	45.6	46.4	45.7
of which one-off measures[1]	. .	. .	. .	0.0	0.4	0.3	1.9	0.7
Total expenditures	51.1	49.9	48.9	46.9	48.7	48.0	48.9	48.7
of which one-off measures[2]	. .	. .	. .	1.3	0.2	0.9	0.2	0.7
Interest payments	9.4	8.3	6.8	6.5	6.6	5.9	5.4	5.3
Net balance	–2.7	–3.1	–1.8	–0.7	–2.7	–2.4	–2.5	–2.9
of which one-off measures	. .	. .	. .	1.3	0.6	1.2	2.1	1.4
Structural balance[3]	–2.2	–2.8	–1.6	–2.5	–3.3	–2.6	–2.2	–2.7
Net of all one -off measures	. .	. .	. .	–2.5	–3.9	–3.8	–4.3	–4.1
Primary structural balance[3]	6.4	4.9	4.5	3.6	2.7	2.7	2.5	2.0
Net of one-off measures	. .	. .	. .	3.6	2.1	1.6	0.4	0.6

Note: The data have still to be revised in light of ongoing assessments by Istat and Eurostat.

1. Measures aimed at increasing revenues are recorded as positive receipts.
2. Measures aimed at increasing revenues are recorded as negative expenditure.
3. Per cent of potential GDP.

Source: OECD, *Economic Outlook* 76 database; Italian Stability Programme, December 2004.

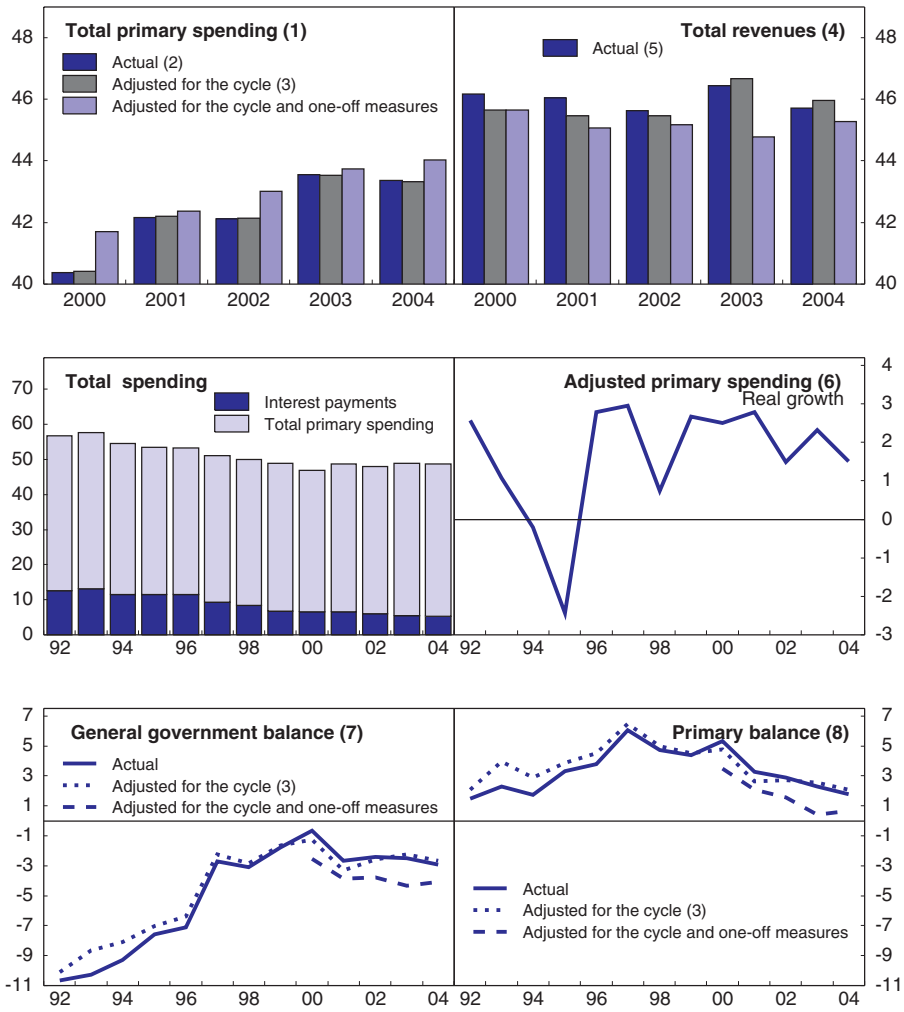
deficit jumped to 4½ per cent (Table 1.4 and Figure 1.11). By mid-2004, a sharp further worsening of the deficit necessitated a mid-year corrective package in order to keep that year's deficit under 3%. In other words, the build up in the structural primary surplus since the start of consolidation in 1992 has entirely been unwound. By contrast, Italy's Stability Programmes have consistently targeted medium-term primary surpluses in the range of 4-5% as necessary for fiscal sustainability. A substantial upward drift of primary spending was the main cause of the structural worsening (Figure 1.11).[26] A tax cut in 2003 also contributed, although (unlike spending drift) this had the merit of being part of the government's economic reform programme with high political priority.

By filling the fiscal gap at comparatively little political cost, one-off receipts may have eased pressure for more meaningful spending control. For example, public sector unions' demands for wage catch-up in 2003, following postponed wage contracts, were more easily met in a year when tax amnesties were hugely successful. But pressure from Brussels may also have been implicitly watered down by the decision by the Ecofin Council to hold in abeyance the excessive deficit procedures for countries which violated the deficit rule. This may have created expectations in Italy that the Stability and Growth Pact would before long be eased.

A sluggish decline in the debt

After 11 September 2001, euro-area interest rates dropped sharply following a series of cuts by the US Federal Reserve. Italy, with the highest debt ratio in the EU, was a major beneficiary, with the debt service burden falling from 6.5% of GDP in 2001 to 5.3% by 2004. Cyclical declines in interest rates largely offset the cyclical shortfall in revenues of around ½ per cent of GDP over 2002-2004, and to that extent the Italian budget situation was insulated from the cycle.[27] The earlier interest rate windfall associated with EMU convergence was even greater, as debt service plunged from a peak of over 12% of GDP in the early 1990s to around half that level by 2001. It is disappointing that in neither case was the windfall used to make faster reductions in the debt. Instead the structural primary surplus was allowed to decline.

Figure 1.11. **Fiscal balances**
Per cent of GDP

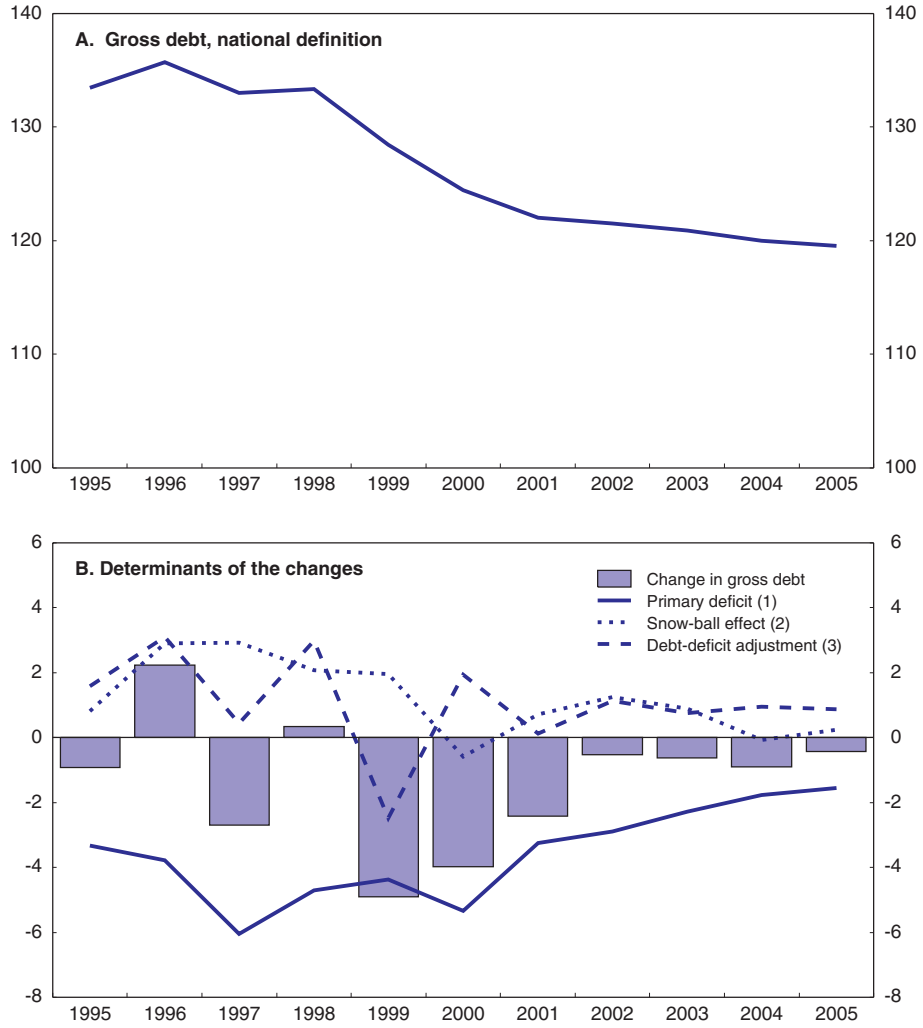


1. Current and capital spending, excluding interest payments.
2. Includes all one-off measures (recorded as negative outlays) aimed at reducing spending, like UMTS.
3. Excludes the cyclical effect.
4. Total tax and non-tax current revenues plus capital revenues.
5. Includes all on-off measures (recorded as positive receipts) aimed at increasing revenues.
6. Current primary spending adjusted for the cycle. Deflated by the GDP deflator.
7. Includes all one-off measures aimed at reducing the deficit.
8. Excludes net interest payments. Includes all one-off measures aimed at reducing the deficit.

Source: OECD, *Economic Outlook* 76 database; Ministry of the Economy and Finance.

The debt ratio (national accounts basis) fell by only around ¾ per cent per annum over 2002-04. By contrast, during 1998-2001 there had been an average yearly decline of 2¾ per cent points. There are several reasons for this drastic slowing (Figure 1.12). *First*, the last three years' decline in interest cost on the debt did not fully compensate for the decline in nominal GDP growth, so that the spread between the two, which matters for debt dynamics, worsened by ¼ per cent on average compared to the previous period.[28] *Second*, the level of the general government primary surplus was by now 2.2% of GDP lower on average than previously, subtracting that much less from the debt each year. *Third*, the

Figure 1.12. **General government debt**
Level and determinants of the changes
Per cent of GDP



1. Net borrowing excluding net interest payments. A minus position means a primary surplus.
2. The self-reinforcing effect of public debt accumulation or decumulation arising from a positive or negative differential between the interest paid on public debt and the growth rate of nominal GDP.
3. Includes the accumulation of financial assets, change in the value of debt denominated in foreign currency and remaining statistical adjustments.

Source: OECD, *Economic Outlook* 76 database.

deficit that actually matters for the debt is that on a cash basis (approximated by the public sector borrowing requirement) rather than on an accruals basis. The divergence between the two has been growing (1.6% of GDP in 2003, against 0.5% in 1998), this reduced the average "cash" level of the primary surplus to just about enough to stabilise the debt given the adverse yield-growth spread. However, the gap is expected to decline to 1% of GDP in 2004. A significant part of the modest debt reduction that occurred came from debt swaps and equity transfers to public bodies not in the general government. The appreciation of the euro also helped to reduce the value of the debt (the share of FX denominated debt fell from 3 to 2% between 2002 and 2003).

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Assessment

The government has, to its credit, managed to maintain the confidence of financial markets despite the high debt and it has respected EU rules on the public deficit under difficult economic circumstances, including a series of corporate bond defaults. But a policy of postponing structural adjustment – hoping for economic recovery to ignite and in the meantime using one-off measures to keep the deficit under 3% and prevent the debt from rising – was carried on until the 2004 budget. By end-2003, this policy of short-run remedies had reached its limits as without special operations, the debt would have gone up. In 2004, all the previous budgetary room for manoeuvre has been exhausted: interest rate windfalls have ended and easy one-off measures largely exhausted, the trend primary surplus has almost vanished and the trend deficit exceeded 3% by a large margin, mainly because of a strong underlying dynamic in the growth of public spending. Without structural reforms, therefore, the deficit and debt will start to rise again quickly.

Policy challenges

The macro tensions highlighted by the foregoing discussion imply the need for structural adjustments in Italy to boost competitiveness, raise potential growth, and secure fiscal sustainability. It is somewhat ironic that EMU membership, by allowing sharply lower real interest and exchange rates may, in effect, have relaxed the perceived need for structural adjustments on both supply and fiscal sides. However, irrevocable loss of the exchange rate instrument and the exigencies of the Stability and Growth Pact should have implied greater structural efforts and enhanced structural flexibility, made in face easier to achieve by the favourable macro conditions for EMU entry. It seems that market signals to enforce such "time consistent" behaviour may have not been strong enough, and policies too myopic. On top of the difficulty of competing within the confines of the single currency, global competition has been intensifying rapidly due to the rise of emerging market competitors, especially China, producing close substitutes for Italian traditional products but far more cheaply. The recent entry into EU of eastern European countries could pose a similar competitive challenge to Italy. Looking further ahead, population ageing is looming and will soon begin to exert a negative drag on both output growth and public finances by diminishing the size of the working age population as the retired one is growing. This section discusses the main challenges arising from the need to confront these multiple pressures by comprehensive policy actions.

Staying competitive within the constraints of EMU: the productivity challenge

Boosting competitiveness is mainly a matter of raising productivity growth in order to reduce cost and price inflation, *i.e.* to arrest the ongoing appreciation of the real exchange rate, while also competing more effectively in terms of higher quality (moving up the value-added chain). Raising labour productivity by capital deepening is subject to diminishing marginal returns. What is required is a boost to TFP growth *via* policies that encourage innovation, and efficiency in the use of existing resources. Only in this way can Italy withstand the challenge of a more integrated global environment now that resort to competitive devaluations is a thing of the past.

Allowing freer play of market forces

Vibrant market competition in heretofore sheltered sectors could provide the catalyst for such a structural change. The main competition policy challenges seem to arise in the

following areas. Despite divestitures, the state still holds controlling interest, or golden shares, in key network industries (energy, transport and telecommunications), and incumbents are often still 50% or more state-owned. Most local utilities remain under public ownership; professional fees and tariffs are self regulated; and entry into retail and wholesale distribution is often restricted under the guise of administrative permissions (Chapter 3). Public policies also need attention. Red tape still raises the costs of market entry, business operations, and product and process innovations. In some localities, a poor quality of public administration exacerbates the burden. It seems that a lack of fiscal competition (insufficient subnational fiscal autonomy with a large role for central government transfers) has weakened the incentives to attract businesses in order to expand the local tax base. Inadequate local infrastructure, reducing the returns to private investments, may reflect wrong priorities in public spending (Chapter 2).

Weak corporate governance and associated lack of transparency in the market for corporate control reinforce the more direct means of product market sheltering. Insufficient capital market development to mobilise funding for innovations *via* a more widespread diffusion of risks, in part reflecting the lack of a private pension pillar, and an outdated bankruptcy law that diminishes the appetite for risk, are other issues (Chapter 3). Obstacles to firm growth and stock market listing arising also from the demand side will need attention, notably still rigid employment protection for all but smallest firms,[29] the unwillingness to lose control by family owners, and incentives to tax evasion by many small firms.

The education sector seems to be another one where insiders are overly protected and policies too centralised, again leaving too little scope for competition to allocate resources. This has adverse impacts on education quantity and quality, and implies weak links between educational output and business needs. There also seems to be not enough priority setting in education spending to address the greater human capital needs in the south. However, a more serious problem may be the lack of innovation demand by entrepreneurs and of human skills demand by workers, that are embedded in the incentives in the productive system, notably weak stock market returns to innovative investments and significant opportunity costs for higher education (Chapter 3 and 5). The consequent "brain drain" of highly qualified researchers is also relatively large, while qualifications of immigrants are only with difficulty recognised (Chapter 4).

Political economy considerations

The nascent recovery may be a good time to undertake competition and corporate governance reforms. Even though implying little or no costs for the budget (unlike tax cuts), competition reforms could entail social costs of transitional economic dislocations, particularly "excess" labour hoarding and rent sharing in formerly protected industries. These would certainly be eased by faster growth. A stronger social safety net is also desirable, as budget conditions permit, but economic dynamism through comprehensive product, financial and labour market reforms must provide the main safety net. Reduction of labour market "dualism" by a gradual convergence of insider and outsider protections would also help, in addition to boosting productivity by allowing a better allocation of labour resources. Wage growth has been moderate and it would be important that it remain so in order to underpin the regaining of competitiveness. Nevertheless, productivity growth will eventually increase the scope for real wage gains.

Maintaining living standards in an ageing society: the employment challenge

Boosting productivity growth will be critical for continuing to raise per capita incomes as the population ages. That is, relatively declining numbers of working age people would have to be much more productive in order to support the growing numbers of retired elderly. But this will not be enough – unfavourable demographics make it imperative to raise the currently low employment rate. By 2050, the dependency ratio is expected to reach 67% (*i.e.*, only 3 persons of working age per every 2 of retirement age) – the highest in the OECD.[30] The optimal way to minimise inevitable shrinkage of the active labour force, and also to maximise the tax and contributions base in support of the retired, are to: *i)* increase currently low female and older worker participation rates; *ii)* reduce currently high unemployment rates for all population segments in the South; and *iii)* reduce barriers to legal immigration. The macro assumptions on which the Italian government's long run pension projections are based (Table 1.5) show that even if productivity growth converges to the euro area average of 1¾ per cent by around 2020 and rises further to 2% by 2026, maintaining long run growth rates around 1½ per cent will be a major challenge: very strong improvements in participation and structural unemployment (NAIRU) rates would still be needed to limit the adverse labour supply impacts of demographics. Thus preserving rising living standards would require ambitious employment targets much in line with those experienced over the last decade.

Table 1.5. **Long-run GDP calculations, at unchanged participation rates and NAIRU**[1]

Annual average growth rates

	Working-age population	Participation rate[2]	Unemployment rate[2]	Employment growth	Productivity growth	Real GDP growth
2004-2010	–0.2	67.7	7.2	0.5	1.3	1.8
2011-2020	–0.4	68.3	6.9	–0.3	1.6	1.4
2021-2030	–0.6	68.3	6.1	–0.6	1.9	1.4
2031-2040	–1.2	70.9	5.0	–0.7	2.0	1.3
2041-2050	–0.8	72.1	4.3	–0.6	2.0	1.4

1. The projection does not take into account the effects on labour force and GDP due to the pension reform recently passed (Law 243/2004)
2. End-period level.

Source: Ministry of Economy and Finance, Department of General Accounts (2004), "*Mid long term trends for the pension and health care systems*", National Baseline scenario.

Raising employment rates of women and older workers

Given that female and older worker employment rates fall far short of the OECD average, regardless of economic development of the various regions, these represent a large latent productive potential in Italy. Ongoing labour market reforms by their nature are oriented to bringing marginal workers, notably women, to jobs. A main challenge for future policies in this area may be to "make work pay", particularly among the low skilled and females in couples where a principal earner is already in the labour market. The high tax wedge is a major problem in this regard, and family benefits in the form of tax allowances can imply welfare-like traps at low incomes (Chapter 2). Further, child and old age care is not yet accessible or affordable. Using educated immigrant labour, such as that coming from Eastern Europe, as care workers has worked well in the past (Chapter 4). Another challenge will be to expand the supply of part time jobs – as attempted by the Biagi law by

easing the use of these contracts by firms – while maintaining their attractiveness to women, such an argument also suggesting important synergies with service sector liberalisation (Chapter 3).

Raising older worker participation rates is a prime policy concern of the OECD. Recent policy reforms are very much in line with OECD's recommendations in this area, holding out the prospect of substantial progress. The latest pension reform radically increases the minimum retirement age as of 2008, implying both fiscal savings and a major boost to older worker labour supply. The main problem may be on the side of demand, however. Indeed, unemployment and participation rates become much more sensitive to education level with advancing age (Chapter 5). The social partners should take a close look at these issues well before 2008. Relaxing employment protection legislation and making wage scales more flexible could help to boost demand for older workers. Life-long training to reach workers before they reach the vulnerable age must also be a strategic goal.

Liberalising immigration and improving labour market functioning

The scope for replacing retiring workers *via* immigration could be part of a solution to the rising dependency ratio. The immediate policy objective seems to be to optimise the quality of immigration within the constraint of low overall flows. On the other hand, illegal immigration is high, pointing to the failure of formal low immigration quotas. Chapter 4 develops the immigration theme in greater depth, and shows that illegal immigrant labour, helped by the underground economy, has been an important stabilising mechanism for the Italian labour market, helping to compensate for the low mobility and skills of Southern unemployed workers. On balance immigration increases competition in the labour market, relieves skill shortages, and (once legalised and properly inserted into the formal sector) is salutary for the budget. Better domestic skills formation, together with a significant increase in immigration quotas, could help to maximise such benefits.

Insufficient wage decentralisation in Italy has undermined regional convergence as well as worker mobility. Fiscal subsidies could in this sense be seen as distorting – it is rather institutional rigidities, the costs of bureaucracy, and skill shortages that cause firms to flee and avoid domestic restructuring, or alternatively, to stay at home while hiring immigrant labour rather than unemployed Southern workers. Furthermore, outsourcing could be seen as a way of stimulating competition in the sheltered sectors, in the end promoting rather than destroying Italian jobs.[31]

Putting fiscal policy on a sustainable footing: the public expenditure and tax enforcement challenges

A high debt ratio makes Italy vulnerable to changes in interest rates and market sentiment, increasing economic uncertainty and generally harmful for growth. It is not yet clear to what extent financial markets price underlying default risks into euro area country bond rates, however. So far, because of ample liquidity in the market, there has been little differentiation of risk premia despite widely differing degrees of national indebtedness, and a downgrading of Italy by one rating agency in the summer of 2004 had little effect on Italian government bond rates.[32] On the other hand, once world interest rates rise, there may be more room for differentiation of such risks. Italy should continue to follow a prudent course of action which assumes that default risk is indeed taken seriously by the markets. Even with no risk premium, the burden of debt service is 3 times the OECD average, sapping scarce resources every year.

Going forward, therefore, debt reduction must be a top priority, and Italy has no choice but to raise the primary surplus. This would be under any circumstances difficult, but even more so at a time of rising interest rates, ongoing fiscal decentralisation, and looming 2006 general elections.[33] The government has recognised the challenge and has identified the following multiple objectives for 2005-06: *i)* replace remaining one-off measures by permanent ones; *ii)* correct remaining structural slippage from deficit targets; and *iii)* make room for tax cuts. Hence, substantial structural savings must be found within the next two years, and this requires sharply reducing the trend growth of primary current spending, given the goal of reducing tax pressure. Even more efforts would be needed to attain levels of the primary surplus targeted by past Stability Programmes by 2008, also considered as being necessary for a satisfactory pace of debt reduction in previous OECD *Surveys*. The implied substantial slimming down of government will be highly beneficial for the supply side of the economy.

The large underground economy implies substantial scope for a tax base widening as a partial alternative to spending cuts.[34] Fighting tax evasion has long been a goal of governments but has proved to be very elusive, while repeated tax amnesties have implied moral hazards. Complexity of the tax code also implies that it may not be readily enforceable in any event. Privatisation provides another degree of freedom for reducing debt levels, which the government intends to exploit as the sum of public tangible assets is estimated to be very high. Chapter 2 looks at how Italy is responding to these daunting challenges in the new Budget and in spending, tax, and decentralisation areas.

Ensuring sustainable development: the pensions challenge

Population ageing will boost pension spending and, *ceteris paribus*, reduce growth potential. However, because of the pension reforms already approved, pension spending will show one of the lowest lowest rates increases in the OECD, albeit starting from a comparatively high current level. The latest pension reform provides budgetary savings after 2008 by extending further the effective retirement age and also contributes to contain the reduction of replacement rates brought about by the gradual introduction of the contribution-based system, but spending could be higher as from a couple of decades later, as the later retirements eventually imply higher pension amounts especially under actuarially fair rules. Health spending is also set to rise with an ageing population. Thus, the explicit debt must be reduced rapidly not only to create needed room for other budget priorities, such as tax cuts and public investments which will help to boost potential growth in the medium run, but also to help avert unacceptable old-age poverty in the longer run. A key challenge also will be to encourage private pension savings to maintain old age living standards as the replacement rates of reformed public pensions decline. This, in fact, is another main goal of the pension reform, all previous attempts at building a private pension pillar having achieved unsatisfactory results. Besides ensuring the political sustainability of pension reform, pension funds would spur capital market development and thus contribute to long run growth potential. Conversely, higher potential growth will be needed in order to raise savings capacity and the return to savings. These considerations point strongly to the importance of a comprehensive approach to structural reforms.

Notes

1. See, *e.g.*, Italian Government (2004).
2. High household savings, needed to fund the public debt, are often considered a brake on growth in the short run, but in the context of weak competitiveness and medium term supply constraints, may have prevented even higher inflation and balance of payments pressures.
3. Up-to-date projections for the Italian economy will be available with the publication of *Economic Outlook* 77 on 24 May 2005.
4. Monetary conditions for the euro area have nevertheless somewhat tightened because of euro appreciation against the dollar.
5. See Banca d'Italia (2004).
6. In the first three quarters of 2004, extra-EU exports grew at double digits, while EU exports at less than 5%.
7. There is a lagged adjustment mechanism for electricity and gas prices charged to customers. Furthermore, producer prices were already rising at the 4% rate in the early autumn of 2004.
8. The 1999 Survey of Italy also presented more direct empirical evidence that the product and market structure of Italian exports are concentrated in low-tech and slowly growing market segments.
9. The main exception is the second half of 2003, by which time the effects of previous reforms may have petered out, and both output and employment growth were weak. A new set of reforms (Biagi reforms) implemented late in the 2003 would have started to affect labour market outcomes only in 2004.
10. Istat also revised the labour force series for the past decade, based on more frequent surveys (formerly only at the beginning of the quarter), which raised the level of employment and reduced that of unemployment.
11. However since both higher productivity and higher employment are desirable, until productivity growth can be restored, the record on labour market reform remains mixed.
12. Taking advantage of consumers' confusion with the new price denominations, retailers raised prices. It seems that goods and services purchased on a routine basis were most affected by such price hikes, which biased consumers' perception of inflation upwards. Perceived inflation rose to around 10-12% during much of 2003 and early 2004.
13. A proposed bill to strengthen unemployment benefits and alleviate employment protection legislation for firms wishing to grow above the 15 worker threshold would address these problems, but has long been stuck in the parliament.
14. See Cipollone *et al*. (2004).
15. Collaboratori coordinati e continutivii.
16. The OECD's latest (EO76) medium term baseline shows a sharp slowdown of employment growth between 2007 and 2010, with the unemployment rate rising back up to the structural unemployment rate (NAIRU) of 8.4 per cent. It should be noted however, that the lack of endogeneity in the NAIRU estimate may present source of bias in the estimates.
17. The above-noted OECD stocktaking exercise identifies reduction of the tax wedge on labour as a key policy priority in improving labour market performance.
18. Average wages decline for such workers, as compared with younger workers, probably reflecting lower education levels of such cohorts rather than flexible wage arrangements. See OECD (2004).
19. International rankings of competitiveness (IMD, World Economic Forum) also tend to place Italy well below the median, and far below most other industrialised OECD countries.
20. See Ministry of Economics and Finance (2004), Figure 1.7, which shows that manufacturing sector productivity and wage per employee are both around 15% lower than the Italian average, whereas service sector productivity is 15% lower than on average in Italy but wages are only around 7% lower.
21. This reflects years of budget stringency as well as the 1990s fight against corruption (mani pulite), which put a stop to many projects in the north and south.
22. In the last years there was a slowdown of investments as a whole, but even in this context, the South was less affected, investments falling less than in the Centre-North.

23. Recent fiscal management has been broadly in line with previous trends. In 2000-01, output went above potential, and the cyclically-adjusted deficit nevertheless climbed to well over 3%. The year 2001 was an election year, and regrettably, fiscal stabilisers were not allowed to operate. The end of 2001 ushered in the world economic downturn and the new centre-right government inherited a budget deficit already close to 3% as it prepared its first budget (for 2002). Public finances were at first improved, as the adjusted primary surplus was stabilised and the deficit declined in line with falling interest payments, but in 2004, the actual deficit for the first time came perilously close to 3%. Deviation from Stability Programme targets to a large extent reflected operation of the fiscal stabilisers in the face of slow growth. Such slippage has been acknowledged by the European Commission as permissible, so long as the 3% upper limit remains the binding constraint.

24. However, in certain years of peak external pressure, as the recent one, intensity of use of one-offs may have been just as large, as there is no other way to make budget savings quickly. This would include the crisis years of 1992-93 and the year of qualifying for EMU, 1997.

25. Standard and Poors did downgrade Italian debt in July 2004, from AA to AA-. However, this seemed to be largely in reaction to the increased political tensions following the June European and regional elections, where the main party of the ruling coalition did poorly. As a consequence, Economics Minister Tremonti was forced to resign and the prospects for structural reform became more uncertain. The downgrading did not affect the risk premium on Italian debt, which had already risen modestly in the previous weeks.

26. A spending surge in 2001 reflected the elimination of the national "ticket" (patient copayment on prescription pharmaceuticals) by the former government, prior to national elections. In the following year, the next government succeeded in sharply reducing the rate of growth of pharmaceutical spending by allowing regions greater autonomy in seeking savings. While correcting for the spending excesses of the previous year, this did not fundamentally alter the long-run trend (see Chapter 2).

27. Indeed, combining the effect of the cycle on the primary balance (via taxes), and the opposing one of cyclically-induced interest rate changes on the debt service, Italy's overall budget balance is less sensitive to the cycle than is commonly thought. A rule of thumb is that each 1% decline in GDP growth worsens the primary balance by ½ per cent of GDP, all operating on the revenues side as spending is not cyclically responsive (given the lack of a universal unemployment insurance scheme). On the other hand, each 1 percentage point decline in interest rates reduces debt service by 0.5 percentage points of GDP. See Faini and Pisauro (2004).

28. The average interest rate on the debt fell from 5½ per cent in 2001 to 4½ per cent in 2004.

29. Nevertheless, evidence from micro studies suggests that employment protection legislation in the form of article 18 reduces only marginally firms' probability of growing. See *e.g.* Schivardi and Torrini (2004).

30. See Casey *et al*. (2003).

31. Recent survey results show that Italian companies investing abroad have achieved a 9% increase in turnover and 5% increase in productivity levels of plants remaining in Italy with no net loss of jobs. See Barba Navaretti and Castellani (2004).

32. See Guzzo (2004).

33. An empirical regularity seems to be that the budget worsens by ½ per cent of GDP in an election year owing to the political cycle. See Boeri and Tabellini (2004).

34. The officially estimated underground economy is some 16% of overall GDP. However, other estimates go up to the high 20s.

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Chapter 2

Fiscal reforms for credibility and growth

This chapter investigates the actions being taken by the Italian government to strengthen fiscal sustainability while supporting economic growth via fiscal policy. The key is to reduce structural spending and limit tax evasion, raising the primary surplus to levels targeted in Italy's Stability Programme, and making room for lower tax rates and enhanced spending on infrastructure and human capital. Privatisation of public enterprises and public real estate would further promote the objective of reducing debt toward the Maastricht criterion. A new pension reform, raising the effective retirement age as of 2008 and building a private funded pension pillar, a tougher 2005 Budget, and a phasing-out of one-off measures, including tax amnesties, are major first steps in this direction. Also needed are better control of public employment and wage growth, a reform of fiscal federalism, increased regional autonomy especially in health care, and continued reduction of tax distortions.

Fiscal policy: toward structural adjustment

Despite low growth, the public deficit has not exceeded 3% and the public debt ratio has fallen, but support has been provided to domestic demand, including a first stage of tax cuts in 2003. This outcome depended importantly on low interest rates and large-scale resort to one-off operations. In 2004, Italy presented a corrective package to keep that year's deficit below the Maastricht ceiling and avoid an early warning from the EU, and pledging to phase out one-off measures in favour of permanent ones and to implement structural reforms to improve long run fiscal sustainability. These commitments provide the main contours of the new medium term economic programme and the latest budget, and have also been reflected in passage of a major pension reform bill.

The new strategy

At the end of July 2004, the government introduced three significant fiscal policy initiatives: approval of a 2004 corrective mini-budget, presentation of the 2005-08 medium-term economic and financial programme, and passage of the pension reform bill designed to put fiscal accounts on a sustainable long-term basis. The strategy began to be implemented with the 2005 Financial Law and tax cut package.

The limits of the previous strategy had become increasingly evident by the first half of 2004, when the public sector borrowing requirement grew by 50% over the same period in the previous year and the public deficit widened to 3½ per cent of GDP. Spending was growing rapidly, the full impact of the 2003 tax cuts was being felt, and one-off measures were already declining in importance. In July, the government was therefore obliged to present a corrective package. The measures were of a structural nature insofar as: *i)* cuts in intermediate consumption were to be brought about by centralising many purchases and pharmaceutical companies were asked to share in the burden by lowering prices for prescription drugs; and *ii)* effective tax increases were imposed *via* cuts in tax credits for firms, elimination of special IRAP exemptions for the financial sector, and increased taxation of purchases and mortgages on second homes. However, the larger part of the package consisted of administrative squeezes on purchases of goods and services by ministries and social security institutions, implying the need for their continuation in order to also qualify as being of a structural nature:[1] when similar controls were applied in late 2002, using powers conferred on the Minister of Economy by the so-called *taglia spese* decree, the affected spending bounced back even more strongly in early 2003. The measures seemed to have been successful in containing the 2004 deficit to within the 2.9% of GDP target.[2] Indeed, the cash deficit declined with respect to 2003, which, along with the sale of a third tranche of ENEL for € 7.5 billion at end-2004 (the world's largest privatisation operation of the last four years), allowed the debt to fall more than expected (by 0.4% of GDP rather than 0.2%), to 105.8% of GDP on a Maastricht basis.

The new medium term budget plan for 2005-08 (DPEF) marks a departure toward a more structural approach. It reduces by half the volume of one-off measures in 2005 and in

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subsequent years eschews them altogether. Tax amnesties, in any event, seem to have reached practical limits. The plan asserts that tax cuts and other budget supports to growth cannot succeed if they impinge upon budget discipline, given likely adverse credibility effects. Hence, the primary surplus is to be increased toward sustainable levels of around 5% of GDP, which was negotiated by Italy upon EMU entry. This in turn will require reforms to alter the rigid dynamics of primary current spending.[3] An accelerated programme of privatisation and property sales, amounting to some € 100 billion, will assist in achieving debt reductions of 2% of GDP per year, given a large range of disposable public assets. The plan also stresses the complementary role of competition in boosting growth and offsetting the tightness of fiscal policy. Financial reforms are likewise considered necessary in order to restore the confidence of savers following recent financial scandals. Thus, tax cuts must occur within the logic of smaller government and a greater role for a well-regulated marketplace.

The DPEF provides a signal of transparency that in itself raises fiscal credibility. It is based on conservative macroeconomic assumptions and states unequivocally the magnitude of the structural fiscal adjustment that will be needed to cover the structural financing gap (Table 2.1). It also commits to fully finance planned further tax cuts. At the same time, few details are offered about the sources of the required primary current spending reductions, except to say that social and security areas will be fully exempted. While priority setting is commendable in any cutting exercise, giving blanket exemption to broad categories (with popular appeal) may nevertheless be too constraining. It is hard to envisage substantial spending cuts without touching the two biggest spending items: pensions and employment (Annex Table 2.A1.1). The latter are usually impossible to cut on a short-term basis, protected as they are by entitlements and contracts. These would require a more strategic approach.

Table 2.1. **DPEF 2005-2008**
General government, per cent of GDP

	2004	2005	2006	2007	2008
Primary deficit	2.4	2.4	3.3	4.0	4.7
Interest paid	5.3	5.1	5.3	5.4	5.6
Financial balance	–2.9	–2.7	–2.0	–1.4	–0.9
Cyclically-adjusted balance	–2.2	–2.2	–1.6	–1.2	–0.9
Cyclically-adjusted balance net of one-off measures	–3.1	–2.7	–1.6	–1.2	–0.9
Debt ratio	106.0[1]	104.1	101.9	99.2	98.0
Memorandum items:					
The medium-term budget trend :					
Primary deficit	2.4	0.8	1.1	1.5	1.9
Financial balance	–2.9	–4.4	–4.3	–4.2	–4.0
Fiscal effort (percentage points)					
Primary deficit	0.0	1.6	2.2	2.5	2.8
Financial balance	0.0	1.7	2.3	2.8	3.1

1. Actual outcome 105.8.

Source: Ministry of Economy and Finance, *Nota di aggiornamento al Documento di Programmazione Economico-Finanziaria 2005-2008* (September 2004), Italian Stability Programme (December 2004).

Indeed, the new pension reform is a significant structural reform that sharply raises the effective retirement age at which workers can access pension benefits without major abatements, generating medium term annual pension savings of around ¾ per cent of GDP.

It also improves growth prospects, both by expanding older worker labour supply and by encouraging capital market development *via* a new privately funded pension pillar. But the main part of the reform has been delayed to 2008, and the size of the spending challenge is likely to require budgetary action on pensions in the meantime. If the requisite spending cuts cannot be found, it would be better to delay the tax cuts than to allow the debt to mount, given the present fragility of public finances.

The 2005 Budget calls for € 24 billion (1.7% of GDP) in savings measures in order to counteract the trend deterioration of the deficit and reach the target of 2.7% of GDP (see Annex Table 2.A1.1). The savings measures fall into three main groups: *i)* a 2% cap on the growth of non-pension current spending, holding such spending roughly constant in real terms (€ 9 billion); *ii)* additional tax receipts from intensified scrutiny of small businesses, rental incomes, and value added tax invoices as well as selected tax increases (€ 7 billion); and *iii)* real estate asset and road toll securitisations, the sole remaining uses of one-off measures (€ 7 billion). To make these targets credible, the budget introduces a new model for the Internal Stability Pact (see below), and sector models to assess individual firm tax liabilities (*studi di settore*) will be updated.[4] However, pressures in health care and public sector wages may make it difficult to respect the 2% cap on non-pension current spending without cutting public employment, and close monitoring will be important, especially at the lower levels. The expected collections from intensified tax enforcement seem ambitious, as the updating of the *studi di settore* will take time. There is also political opposition to perceived "back-door" tax increases, which has stymied attempts to fight tax evasion in the past.

The Budget for 2005[5] furthermore implements the second phase of the personal income tax (IRE) reform and continues with alleviation of the labour cost component of the business value added tax (IRAP). The objectives are to reduce the labour tax wedge; to reduce average effective tax rates while avoiding sharp jumps in marginal effective tax rates at low-to-medium incomes; and to widen the labour and capital tax base in conjunction with strengthened tax enforcement policies. The tax cuts amount to around € 4 billion in 2005, rising to around € 7 billion in subsequent years, and accompanied by spending increases of around € 1 billion (see Annex Table 2.A1.2). There is to be full budget coverage for the tax reform package as follows. In 2005, almost half is financed through postponing the two last instalments of the one-off real estate amnesty introduced in 2004 (€ 2 billion). Expenditure cuts – mainly a further tightening of government purchases and a partial hiring freeze – will also contribute to financing (€ 2 billion). An increase of stamp duties and the estimated broadening of the tax base consequent to the reform represent the remaining financing component (€ 1 billion). In 2006, the real estate amnesty will be replaced by stronger expenditure cuts (totalling € 3.7 billion); an increase of stamp duties, excise taxes on cigarettes and of the self-financing effects (to € 4.5 billion); and one-off bringing forward of household and business taxes (€ 1.3 billion). This latter will be replaced in 2007 by a further strengthening of the hiring freeze. Thus, the tax reform becomes fully financed by structural measures only in 2007.

Tax reform

Fiscal pressure in Italy is above the OECD average but around the average for the EU25, reflecting the less extensive development of the welfare state – excluding pensions – in Italy. The tax wedge on labour income is, however, amongst the highest, notwithstanding the 1998 conversion of the health charge (*inter alia*) into a regional tax on business value

added, the IRAP. High labour taxation discourages employment and reflects the very expensive – and non-redistributive – pension system. Moreover, the tax burden on business is the second highest in the OECD, due in part to the wide base of the IRAP which includes all labour costs. With low taxes on financial income, labour is taxed more heavily than capital (Table 2.2), encouraging the substitution of regularised labour by capital and undeclared work. The effective taxation of capital has increased slightly since 1995, but much more so in other EU member states.[6] A related problem is a high level of tax evasion, which ratchets up tax rates on those who pay, reinforcing incentives to evade. The main tasks for reform should therefore be to reduce average and marginal tax rates on labour, and to widen both capital and labour income tax bases.

The government puts a high political and economic priority on fulfilling its electoral pledge to ease the direct tax burden on the Italian taxpayer. Thus far, an overhaul of

Table 2.2. **Tax burden and implicit tax rates**[1]

	1995	1998	1999	2000	2001	2002	Average 1995-2002	Change 1995-2002[4]	Difference 1995 to 2002[5]
A. Trend in Italian taxes									
Taxes as a percentage of GDP									
Labour employed[2]	16.7	18.8	18.4	18.0	18.3	18.2	18.2	0.5	1.5
Capital income	12.1	11.5	11.7	11.6	11.7	11.2	11.9	–1.5	–0.9
Capital and business income	8.0	8.0	8.6	8.8	9.1	8.3	8.6	0.6	0.4
Corporations	2.9	2.9	3.3	3.0	3.6	3.2	3.3	0.6	0.3
Total	28.8	30.3	30.1	29.6	30.0	29.4	29.7		0.6
Implicit tax rates									
Labour employed[2]	37.8	42.8	42.1	41.3	41.5	41.1	41.4	0.5	3.3
Capital[3]	26.3	27.4	29.1	28.5	28.1	28.1	28.0	0.8	1.7
Capital and business income	17.3	19.1	21.3	21.6	21.8	20.9	20.2	2.8	3.6
Corporations	14.0	14.0	16.4	14.6	17.0	15.8	15.8	0.7	1.8

	Italy	Germany	France	United Kingdom	Italy	Germany	France	United Kingdom
	In 2002				Difference 1995 to 2002[5]			
B. Italian taxes in comparison								
Taxes as a percentage of GDP								
Labour employed[2]	18.2	21.4	22.5	13.8	1.5	–0.5	0.1	0.0
Capital income	11.2	5.6	9.3	8.5	–0.9	–0.2	1.0	0.5
Capital and business income	8.3	4.5	5.0	5.7	0.4	–0.1	0.9	0.3
Corporations	3.2	1.7	3.4	2.7	0.3	–0.4	0.9	0.0
Total								
Implicit tax rates								
Labour employed[2]	41.1	39.9	41.8	24.6	3.3	0.4	–0.3	–1.1
Capital[3]	28.1	20.9	36.6	30.8	1.7	–0.2	5.6	3.0
Capital and business income	20.9	16.9	19.6	20.8	3.6	0.0	4.4	2.0
Corporations	15.8	n.a.	26.0	29.4	1.8	n.a.	9.7	11.9

1. Taxes are classified according to economic function as defined in the European System of Accounts 1995: consumption, labour and capital. Consumption taxes are not shown in the table. Implicit tax rates on labour and capital measure the effective average tax burden on different types of economic income or activity.
2. Taxes on employed labour comprise all taxes, directly linked to wages and mostly withheld at source, paid by employers and employees, including compulsory social contributions.
3. Capital is defined in a broad sense, including physical capital, intangible assets and financial investment ands savings. Corporation and household both pay taxes on capital.
4. Estimated annual average growth rate.
5. In percentage points.

Source: Eurostat (2004), Structures of the taxation systems in the European Union, Data 1995-2002, Luxembourg.

corporate taxation and the first phase of personal income tax reform have been carried out, with a second phase of the latter now being planned. IRAP is also being eased by gradually exempting labour costs from the tax base. Altogether, the reforms will have decreased the tax burden by around 1½ percentage points of GDP. This is not among the largest tax cuts seen in the OECD, but the fiscal constraints owing to the high debt are perhaps greater than for any other tax cutting episode. According to OECD work, even a limited reduction in fiscal pressure could lead to higher growth if carried out in the context of a wider programme of reforms.[7]

Personal earned income tax

Reform measures and distributive impacts

A 2002 "delegate law" empowered the government to reform the personal income tax (formerly *IRPEF*, now *IRE*), on condition that no individual should be worse off as a result of the reform and that reform costs be fully covered in the yearly budgets. The main features of the government's proposal were to replace the former system of 5 tax rates by *i)* only two rates, 23% for incomes up to € 100 000 and 33% for incomes above that amount, *ii)* while also replacing the old new system of tax credits by deductions from the tax base aimed primarily at low and medium incomes to guarantee progressivity of the tax. Because of concerns about budget affordability and social equity, however, the reform is being implemented only on a step by step basis.

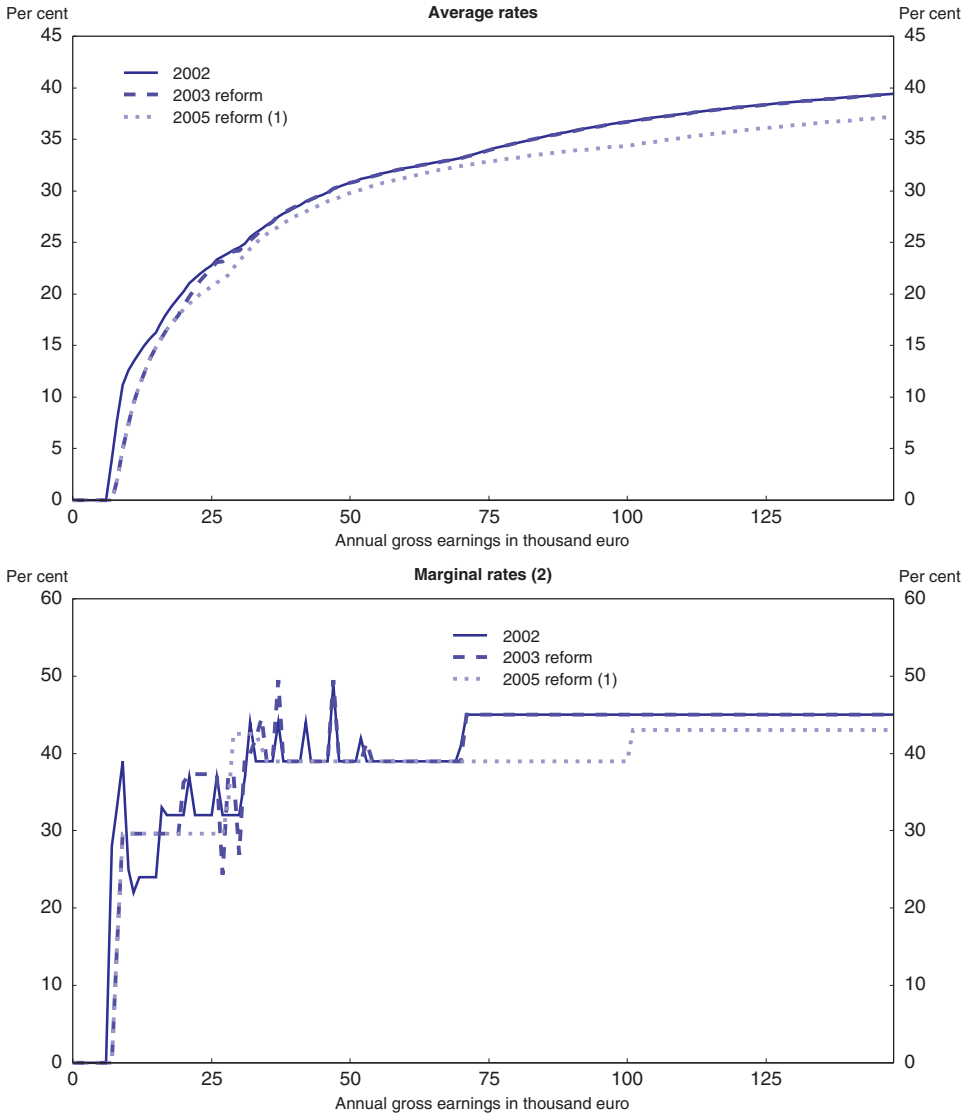
The first phase of the reform entered into force January 2003. It consisted of changes to the first three income tax brackets, raising tax rates for the first two (the lowest to 23%) and reducing it slightly for the third. A deduction was introduced that results in a minimum income below which no tax is payable ("no tax area"), and decreases linearly up to an upper income limit (€ 30 500 to € 33 500) close to the average wage. It depends on type of income and guarantees different degrees of progressivity.[8, 9] The budgetary cost of this first phase of the tax reform is estimated at 0.4% of GDP.

The next phase, entering into force January 2005, moves closer to the final 2-rate system. The previous system of 5 statutory tax rates – 23, 29, 31, 39 and 45% applying to income thresholds of € 15 000, € 29 000, € 32 500, and € 70 000, respectively – will be replaced by three basic statutory tax rates 23, 33, and 39% at income thresholds of € 26 000, € 33 500, and € 100 000. Additionally, there is a "solidarity contribution" of 4% for incomes above € 100 000, bringing the effective tax rate at these levels up to 43%.[10] The "no-tax area" defined by the first phase of the reform in 2003 remains intact but will now be phased out at a lower income threshold (€ 26 000 for all income types). Horizontal equity criteria will be introduced into a system of deductions, taking into account family situation and special factors such as disability and purchase of first home, while declining slowly with income.[11] A safeguard clause will give individuals the right to file their taxes under the old rules, if that is to their advantage. The cost of the second phase of the reform, in terms of foregone personal income tax compared to baseline, is estimated at € 4.3 billion in 2005, € 6.7 billion in 2006, and € 6 billion (0.4% of GDP) in 2007.[12]

Around 60% of all taxpayers will benefit from the second phase, with an average tax cut of around € 370, the other 40% having benefited mainly from the first phase. Taking the two phases together, the percentage tax cut for a single employee ranges from 0.8 to 2.3% for incomes above € 15 000, somewhat more for incomes between € 70 000 and € 100 000 and substantially more for incomes between € 7 000 and € 13 000. Thus, up to

€ 70 000 the overall tax reform is mildly progressive. The system of tax deductions has in particular allowed larger gains than with the previous system of tax credits at low to middle incomes for couples with dependent children. Nevertheless, in absolute terms the reductions will tend to be greater for upper income groups than for low incomes ones (Figure 2.1).[13] These differences are aggravated by the skewness of the Italian taxpayer distribution toward lower incomes: 93% of taxpayers earn less than € 32 500 per year and 98% earn less than € 70 000. The very poor gain nothing from the reform as they do not pay tax in any event.

Figure 2.1. **The reform of the personal income tax**
For a single worker



1. Includes 4% surcharge on income over 100 000 euros.
2. The marginal tax rate is the ratio of the increase in the tax liability corresponding to an increase of 1 000 euros.

Source: Marino, M.R., G. Messina and A. Staderini (2004), "L'attuale processo di riforma dell'imposta sul reddito: una stima degli effetti netti tra sgravi fiscali e mancato recupero del *fiscal drag*", paper delivered at conference *La questione tributaria in Italia*, Milano, 17-18 December.

Mainly for welfare reasons, the government is focusing income tax allowances on lower incomes, more so than with the prior system of income tax credits.[14] But in shifting progressively away from statutory rates toward income-related allowances, the reform has tended to increase marginal effective tax rates (METRs) at some ranges of lower incomes while reducing them quite sharply at the top (see Figure 2.1). As the first reform phase introduced a large deductible that is withdrawn as income rises, this acted as an effective tax on that income. In the second reform phase, the introduction of new allowances for various expenses and family situations amplifies the phasing-out of tax allowances as income rises, albeit much more gradually than with the no-tax area.[15] Given the desirability of keeping the tax system as simple as possible, to avoid distorting behaviour, it might be better to have income related benefits rather than income related allowances (even though the effective tax rate when taking account of benefits and taxes might end up being the same).

Macroeconomic impacts

The government has stated that the macroeconomic objectives of the reform are: *first*, to raise disposable incomes and hence consumption and output;[16] *second*, to boost potential growth for a period by encouraging higher employment; and *third*, to discourage fiscal evasion *via* more reasonable tax rates and a more effective tax administration.[17] For the first (consumption) channel to work, tax cuts need to be seen as sustainable and boosting permanent household income, because otherwise Ricardian effects might cause a part of the tax windfall to be saved. Indeed, empirical work suggests that the 2003 tax cuts were largely saved, as the accompanying deterioration in fiscal situation raised uncertainty.[18] This reinforces the need for corresponding primary spending cuts as sought by the DPEF, despite their depressive short term impact on demand, as consumer welfare and growth framework conditions are likely to improve.

Labour supply is likely to increase in response to tax cuts if "substitution effects" related to lower marginal effective tax rates (METRs) outweigh "income effects" related to lower average effective tax rates (AETRs).[19] But in the first phase of the reform, METRs tended to increase at low to middle levels of income (up to around € 33 000), where the vast majority of taxpayers lie and moreover where the greatest sensitivity to marginal rates is to be expected, even as their average rates fell; hence, income and substitution effects go in the same direction and the reform seems unlikely to stimulate significant additional work effort. In the second phase, the "peaks" seen in the marginal effective tax rates at low to medium incomes subsequent to the first phase of the reform have been smoothed, although some increases at incomes between € 28 000 and € 35 000 could not be avoided, given the overall budget constraint. Thus, it is still difficult to gage the labour supply impacts. On the other hand, part-time should be favoured, given almost consistently reduced METRs at incomes below € 28 000, as should the emersion of underground labour into the formal economy due to reductions in average tax rates at all income levels. Also, METRs will unequivocally fall at higher income levels, at which point the deduction has already been phased out, soliciting greater work effort among these groups. However, attenuating this effect are that: *a)* income effects are also high for these groups,[20] while substitution effects are thought to be low; and *b)* there are relatively few people in Italy at these (reported) income levels.

Nonetheless, there could be positive dynamic effects in the longer term since the large cuts in METRs at higher income levels have markedly increased the incentives to reach them *via* education and effort, over time. Raising both human capital accumulation and productivity would bring a double benefit to growth, as experience in the United States suggests. Hence the discussion about distributional and macroeconomic implications of the tax cuts should not focus on the static impacts alone. However, realising the full potential of this channel would also require a production structure that generates a greater demand for human capital, in turn bidding up the education premium in the wage structure, which is currently low in comparison with the EU15 average (Chapter 5). This suggests a symbiotic relationship among tax reform, competition policy and financial market reform, as pointed out by the DPEF.

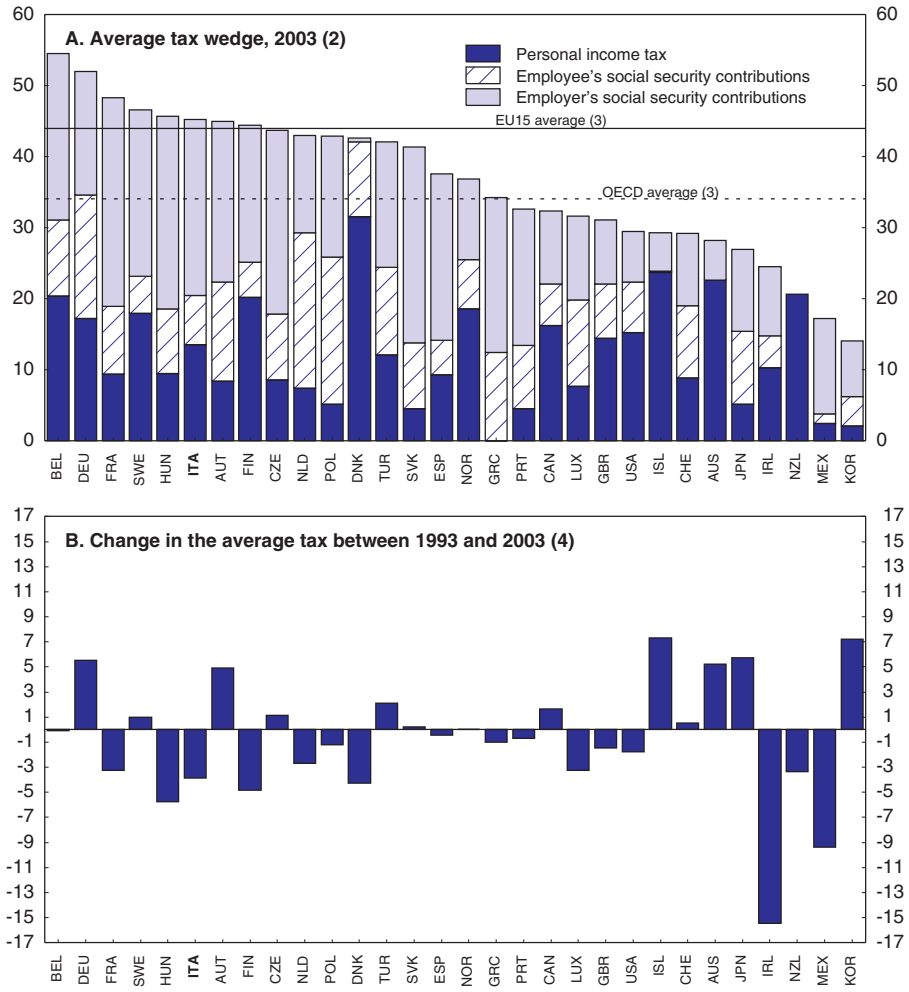
Income tax cuts could also stimulate higher labour demand by reducing the cost to employers of any given after-tax wage, which would be a function of the average rate tax alone, and which will have fallen for all workers. However, given the relative rigidity of wage setting in Italy, plus the fact that the tax cutting exercise does not form part of any incomes policy agreement, demand effects may be less significant. There may even be a perverse effect if labour unions increase their wage demands in response to perceived distributional unfairness of the tax cuts (as they have threatened to do).

The third macroeconomic channel of income tax cuts, reducing the underground economy, relies mainly on the average tax rate effect concerning individuals completely outside the formal economy. The fall in the AETRs, seen at all income levels in both phases of the reform, clearly decreases the attraction of working in the informal rather than in the formal economy, or indeed of going into retirement/benefits rather than continuing to work, insofar as this is not a marginal choice.[21] For the many self employed in Italy, however, there are likely to be several benefits for being in the formal sector, and so they are more likely evade taxes by not declaring all their income, in which case marginal rates would matter more, and here the effect is less unambiguous, depending on the level at which income stops being declared. However, pension contributions are the greater part of the tax wedge (Figure 2.2), and are not touched by the current reform. Any emergence from the underground economy should therefore be used to reduce pension contribution rates, allowing in turn a virtuous cycle to operate.[22] Insofar as tax rates are perceived to be more "fair", this would also increase respect for the law.[23] Strengthened tax administration should reinforce the incentive effects of lower tax rates. Reform of labour market regulations, in particular those punishing firms with more than 15 workers (making them subject to more stringent labour market regulation) would also reduce the incentive to not declare workers. Greater flexibility in wage bargaining might also make it easier for employers to declare and cover the social security charges for low productivity workers.

IRAP

The 2002 delegate law also expressed the government's intention to abolish IRAP, a regional tax on business value added introduced in 1998. It has turned out to be a highly unpopular tax, as it brought some firms formerly outside the tax net into it and is payable by loss-making and profitable firms alike.[24] Businesses claim that it is mainly a tax on labour, hurting employment.[25] It also seems to be almost unique in the international context.[26] On the other hand, it generates some € 30 billion in revenues annually, as much as the corporate income tax, but is less volatile and with a wider base allowing a lower rate.

Figure 2.2. **Tax wedges on labour**[1]
Per cent



1. For a single individual at the income of the average production worker. Tax wedges are calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll taxes as a percentage of labour costs (gross wage plus employers 'contributions).
2. Data for 2003 are based on estimated wage levels of the average production worker.
3. Weighted using 1995 GDP and purchasing power parities.
4. The first year refers to 1993 or the earliest year available.

Source: OECD, *Taxing Wages 2002-2003*.

Besides, it is a main revenue source for the regions. The government has decided to phase out the tax starting with the portion applying to labour costs.

The reduction process began in 2003, when 20% of labour costs were allowed to be exempted from the IRAP base for firms of up to 5 workers. The provision was maintained in the 2004 budget. In order to further reduce the overall tax wedge on labour, there are to be continued reductions in the labour cost component of IRAP in the new budget, the budgetary cost amounting to some 1% of GDP by 2007.[27] In particular, a deduction from the IRAP tax base will be introduced in 2005 for new hires on permanent contracts (compared

to the average employment level in 2004) up to a limit of € 20 000 for each new hire, and the deduction will be doubled for depressed (Objective 1 and 2) areas, and a new "competitiveness package proposes to extend such deductions further (Annex 2.A3). There is also a deduction for personnel costs related to research activities. This would seem to fulfil the mention in the DPEF of a targeted approach, namely to provide IRAP tax breaks for research and development, and (subject to EU negotiations) for particular regions and firm sizes, which would allow larger exemptions for labour costs in the selected firms. Nevertheless, it is also the case that the new IRAP deduction for new hires replaces a much more generous generalised tax break for the same purpose,[28] which was in force during 2001-03 but discontinued in 2004 because of excessive cost and inadequate monitoring (see Chapter 1).

Research suggests that progressively exempting a greater share of labour costs from the IRAP base could raise GDP by around 1%, perhaps more than equivalent personal income tax cuts would, as tax cuts to business impact more directly on the supply side of the economy, especially in the short-run due to wage rigidities, hence improving competitiveness.[29] Following also a broader development strategy that increases private financing of public investments while reducing current public spending to maintain budget equilibrium essentially doubles the growth impact. However, even if sufficient spending cuts are found, a constraint on the elimination of IRAP remains. This is the lack of a substitute revenue source for the regions, themselves faced with growing spending responsibilities under the recent constitutional reforms. This critical issue is taken up in the section on fiscal federalism below.

Taxes on capital income

The corporate tax reform was essentially completed in 2004, and was described in some detail in the 2003 *Survey*. The top marginal rate was reduced from 36 to 33%, to be in line with the planned top personal income tax rate, while the former special 19% rate on new investments funded by equity issue was eliminated.[30] There is a new treatment of groups, perhaps the main value added of the reform, allowing a world-wide consolidated tax filing and presenting many advantages.[31] The taxation of dividend payments was simplified, replacing the former imputation credit system by the rule that around half of dividends received are to be taxed as ordinary income at the personal level (as in Germany), though inter-company payments are essentially tax free. The tax treatment of capital gains on shareholdings is similar to those of dividend payments, though there is no longer any credit for losses.[32] A tax credit for research and innovation expenditures (Tecno-Tremonti) was also introduced. Regarding taxes on financial income (interest and capital gains), the government's proposal to unify these at a single rate of 12.5%, eliminating the previous higher rate of 27% on bank and postal savings accounts and certificates of deposit, has not yet been enacted.[33]

These changes could be seen as abolishing innovations of the 1998 reform that were designed to increase tax neutrality. This could also be seen as increasing tax uncertainty. Against this are the considerable advantages of simplicity and international consistency. Indeed, the theoretically elegant features of the 1998 reform may have had unintended effects. There is some evidence that the "dual income tax" (Dit), designed to reduce the tax bias against equity finance of investment, mainly benefited established capital-intensive firms rather than start ups with little impact on net equity issues.[34] The former imputation system to end double taxation of dividends gave major shareholders the option of paying final withholding at the financial income tax rate of 12.5%; but with a high tax on labour

(32.5% social charge plus two-thirds of IRAP), this gave an incentive to use undeclared labour to overstate profits, which could be distributed and taxed at a lower rate. Even though such potential abuses are less in the reformed system, a tax bias against equity finance has been reintroduced. There is still a need to encourage equity finance in order to develop the domestic capital market, especially as creation of a private pension pillar implied by the new pension reform could create a significant new source of demand for such instruments, given that pension funds normally require a high minimum share of domestic investments.

In addition, another distortion remains in the form of a wide gap (21 percentage points) between the rates of corporation and financial income tax on non-bank interest, dividends, stock market capital gains, and mutual fund income. This could give an incentive to hide profits as loan reimbursements, which effectively pay the lower tax rate. Correcting this situation would require raising the financial income tax rate to at least 23%, the planned new lower rate of personal income tax. However, the success of the 2002 "*scudo fiscale*" on repatriated capital, was based on the expectation of continuing low domestic tax rates on financial income, and indeed, the high international mobility of the capital tax base acts as a strong constraint on the ability to raise tax rates.

The government is attempting to address such issues of abusive fiscal arbitrage with a new provision against "thin capitalisation", meaning the practice of borrowing from shareholders or related parties in lieu of issuing stock, deducting the resulting interest payments from corporate income at a 33% tax rate with the shareholder or related party receiving the income paying a financial income tax rate of only 12.5%. However, the minimum threshold for non-deductibility of interest payments on such loans is quite high, equivalent to 5 times the receiving shareholder's participation, and it may be difficult to track related parties when the structure of shareholdings is non-transparent as in Italy.[35]

Tax amnesties

Besides reforms, the tax system has over the past three years been affected by numerous amnesties which generated substantial one-off fiscal receipts. Three in particular were considered successful in terms of their impact. The massive capital repatriation programme of 2002 may have been timed fortuitously, *i.e.* when securities returns abroad were collapsing anyway while the real estate market at home was heating up. The very popular immigrant regularization programme of the same year revealed the strong preference by such workers to join the formal economy, and could be seen as a way around formally restrictive, but essentially failed, immigration policies. The 2003 tax pardon (for irregularities committed in 2001) was so popular that virtually all major and medium sized firms applied, if only to buy insurance against the risk of future audits by the tax authority, one which was itself raised by the fact that so many other firms were signing up for the amnesty, in essence exposing the remaining ones to the attention of the tax administration. Other programmes were less successful, notably the 3-year-ahead preventive tax agreement of 2003 and the ongoing programme for emergence of the underground economy.

Some macroeconomic benefits may also have been conferred. The government hoped that the repatriation of capital would help finance domestic investment and growth, and to an extent this may have happened.[36] The large-scale regularization of illegal immigrants clearly expanded the social security tax base. At the same time it lifted future potential growth insofar as workers in the formal sector tend to be more productive and receive

better training than those in the informal sector. The option of *ex ante* tax settlements have the substantial benefit of being neutral to marginal effort as any revenues earned over and above the agreed amounts is tax free, though evidently the opposite risk of undershooting the agreed amount discouraged interest. Finally, as a means of fiscal adjustment, amnesties were relatively benign in terms of the economic cycle: even though penalties raised fiscal pressure, being recorded as capital transfers to government they did not, strictly speaking, enter into household current budget constraints (representing a drawdown of cash assets offset by cancellation of an outstanding liability).

As pointed out in previous *Surveys*, however, amnesties are unhelpful if they undermine the rule of law and principles of equal treatment upon which any effective tax system must rest.[37] If not backed up by credible penalties for repetition of irregular activity, and trust by those who do pay, amnesties could further shrink the tax base, undermining the tax reform. Taxpayers may take excessive risks in expectation of regular amnesties coupled with weak controls. Social solidarity could suffer from the belief that the system punishes only "honest" taxpayers who have not purchased immunity from fiscal harassment *via* tax shields and the like. Empirical analysis suggests that compliance consistently deteriorated in response to amnesties in the past.[38]

The DPEF itself suggests a multi-track approach to improving tax compliance. Tax cuts are to be balanced by a strengthened and more competent tax administration, with local level governments playing a critical role, as they are closer to the people. Nevertheless, many small firms might go out of business if suddenly forced to declare all their workers and sales revenues, so that real-side adjustments *via* enhanced competition and better functioning financial markets, also as envisioned by the DPEF, will need to accompany such a shift of strategy if it is to succeed. The more aggressive imposition of the rule of law could, in fact, put pressure on the social partners to make wage setting more flexible and decentralised, in lieu of firms' "opting out" of the formal sector in order to remain competitive. Indeed, the underground economy is more prevalent in the South where workers tend to be less productive (Chapter 5).

In conclusion, amnesties have a certain logic as an adjunct to tax reform, allowing taxpayers to settle outstanding obligations *vis-à-vis* the old tax regime while adapting to the new one, which should invite a higher degree of compliance by virtue of being simpler and more reasonable in terms of tax rates. The tax administration, for its part, clears its backlog of contested tax claims and is free to focus henceforth more sharply on enforcing compliance.[39] Some advantages of this sort may have been reaped in the latest amnesties. However, moral hazards were not altogether avoided, and tax amnesties should preferably not be included in any residual one-off measures planned for 2005. They must be substituted by strengthened enforcement which focuses scarce tax administration resources on "making its presence felt" everywhere, rather than on largely useless certifications of large firms and others who already comply.[40] A credible shift toward stronger and fairer enforcement could in fact provide more scope for tax rate cuts. Reducing the underground economy should be pursued as a major element of structural fiscal reform.

Expenditure reform

Recent expenditure trends

Primary expenditures have risen by 2 percentage points of GDP since 2000 (Table 2.A1.3). As the cyclical component of Italian public spending is very small (reflecting absence of a universal unemployment insurance with a high replacement rate), this implies a structural deterioration of the budget. If one-off negative expenditures (real estate operations), are excluded, then the rise is closer to 3%. Rises were especially large in health care costs, public wages, and public employment, and at all levels of government. This suggests that weak structural spending control may have been aggravated by the process of decentralisation. By contrast, over the period of intensive consolidation 1992 to 1999, public employment declined, public wage cost inflation was kept below that of the private sector, and health spending was under tight control. But it also seems that such discipline was external – mainly linked to EU constraints – merely keeping a lid on pressures rather than emanating from internalised incentives to make durable spending economies. This section takes a look at how Italy is responding to the challenge of achieving better control in key spending areas.

Pensions

The latest in a series of reforms

The Italian pension system was reformed in three steps during the 1990s: 1992 (Amato), 1995 (Dini), and 1998 (Prodi). These reforms sharply limited the projected rise in pension spending due to the process of demographic ageing, making this rise one of the mildest in the OECD albeit from an already high level.[41] Of particular importance to long run sustainability was the Dini reform, which put the system on a notional defined contribution (NDC) and actuarially fair basis. Nevertheless, all workers with at least 18 years' seniority were totally exempted from the reform, continuing to accumulate rights under pre-reform system rules until their retirements. This implied an excessively long and costly transition,[42] both by international standards,[43] and in relation to the present size of pension spending in Italy, which at one-third of total primary expenditures is the highest in the OECD. Moreover, post-reform the system is rather unfair across generational cohorts, a feature common to almost all pension reforms but aggravated in Italy's case by the above exclusion. Discontinuities will also arise with adjustment of benefits to growing life expectancy at only 10-year intervals. In 2004, the government passed a tough new reform (Maroni-Tremonti), aiming to address the transition issue and put fiscal policy on a more sustainable footing (Box 2.1).[44]

Raising the retirement age

The main part of the new reform aims at increasing the effective retirement age *via* tightened eligibility restrictions as of 2008, and generous fiscal incentives until then. Once the reform is fully phased in (by 2014), the actuarially adjusted "age window" for retirement under the NDC will no longer be 57-65 as intended by the original Dini reform, but rather 62-65 for men and 60-65 for women.[45] This will imply benefits for both growth, because of higher labour supply, and public finances, because of lower pension spending, albeit at some sacrifice of individual flexibility. The projected annual savings of around 0.7% of GDP (for about 20 years) could be used to finance a further tax cut, accelerated reduction of the debt, or other budget priorities. Although the high level of pensions in Italy are often rationalised as a substitute for a social safety net, they perform poorly in this regard, being non-distributive and even somewhat regressive. It would be appropriate to use a part of savings from pension reform to strengthen the safety net.[46]

Box 2.1. **The Maroni-Tremonti pension reform**

The Maroni-Tremonti pension reform became law in the summer of 2004 (Law 243/2004), after a lengthy public debate and despite lack of broad social support. Its main features are as follows:

- The eligibility conditions for seniority pensions (retiring before 65 for men, and 60 for women) under all regimes (earnings-related, mixed, and contribution-based) will tighten sharply as of 2008. In that year, the minimum age of retirement, with 35 years of contributions, rises from 57 to 60, then to 61 in 2010, and 62 in 2014 pending a review.[1] Women alone will retain, for the period 2008-2015, the option to retire at 57 with an actuarial adjustment. There is no age restriction with 40 contribution years. The statutory age for old-age pensions remains 65 for men and 60 for women, under the earnings-related and mixed regimes.
- Two of the four yearly exit "windows" for pensioners under the earnings-related and mixed regimes will be closed. Workers who become eligible for seniority pensions must wait until the next window opens, which will now happen only twice instead of four times per year. Furthermore, despite the previous legislation, the new "windows" regulation will be applied also to pensioners under the contribution-based regime. Such changes will produce a further delay for entry into pension, in this sense supplementing the age restrictions.
- Those who satisfy the requirements laid down in the previous legislation before 31st December 2007 are exempt from the considerations in the previous points and are entitled to a pension under the requirements previously in force (so-called "certezza dei diritti").
- Between now and 2008, a tax-free fiscal "super-bonus" will be given to private sector employees for postponing retirement, equal to the full amount of the social security payment, 32.7%.
- A private pension pillar will be constructed by diverting worker contributions (6.91% of wages) to company severance payment schemes (TFR, *Trattamento fine rapporto*). TFR payment will automatically flow into private pension funds as the default option unless the worker explicitly objects. Open, closed, or individual (PIP) funds, managed respectively by banks, banks as agents for firms or sectors, and insurance companies, may be chosen. Tax treatment is not yet specified, awaiting subsequent decrees.

The reform is a major step in the right direction. Yet, it could still be improved in the context of future budget laws. The sudden tightening of eligibility conditions for retirement as of 2008 does little to address the immediate fiscal challenge and adds to discontinuities in the system. It would be preferable to make the rise in the retirement age more gradual, and starting earlier.[47] Alternatively, the pension formula could be equalised for all workers immediately, *i.e.* putting them all on a pro-rata basis.[48] Moreover, fiscal incentives to postpone retirement tend to exacerbate the system's discontinuities as they apply only to people fulfilling the conditions for early retirement before 31 December 2007 and they carry deadweight losses due to payment of the incentive to people who would have postponed their retirement anyway – currently estimated at around 50% of the total private employees with age and contribution requirements equal or above those required for a seniority pension.[49]

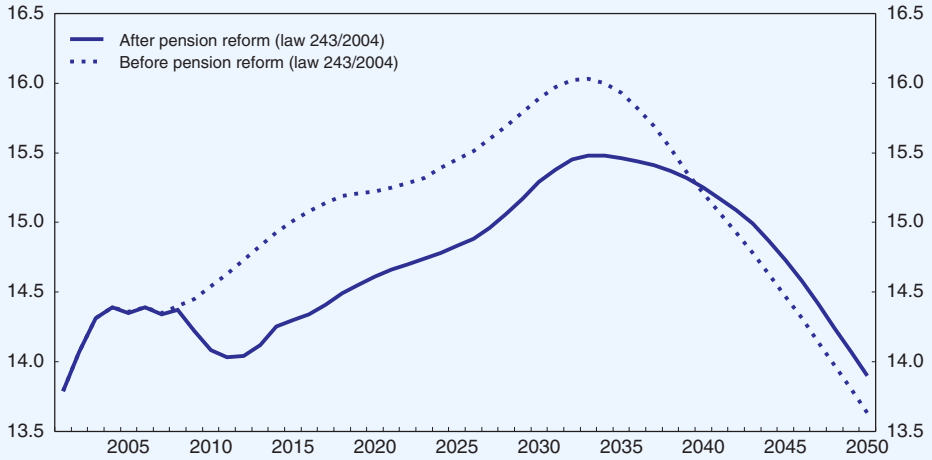
Also to be considered is that the sudden rise in older worker supply needs to elicit a matching rise in demand. The future shortage of labour force due to the well known

Box 2.1. **The Maroni-Tremonti pension reform** *(cont.)*

Delayed retirements due to the more stringent access rules (minimum age) would provide annual savings of some 0.7% of GDP between 2012 and 2020 and of some 0.6% in the period 2020-2035 (Figure 2.3). But after 2040, pension spending in terms of GDP is higher than in the base case on account of higher pensions being paid to retirement cohorts which had been subject to the tighter access conditions (*i.e.*, on the NDC part of the retirement benefit, which is subject to rules of actuarial fairness). Hence, the reform brings significant savings around the time that the baby boom will be retiring in large numbers. However, these dissipate and then reverse not long after the time of the peak in pension expenditures to GDP.

Figure 2.3. **Pension expenditure to GDP up to 2050**[1]

National baseline scenario



1. The forecasts were made by the Regioneria Generale dello Stato pension model updated to 2003.

Source: Ministry of Finance, Technical Report to the Pension Reform (Law 243/2004).

1. Deflation becoming entrenched in expectations was for a time, but seems to be no longer, a matter of concern to the Bank. See *Inflation Reports* in 2004.

demographic transition will undoubtedly create a more favourable context in this regard. However, this also may require more training directed at such workers along with more wage flexibility on their part. A problem here may be that firms do not see it in their interest to train older workers, as there is much less time to amortise their investments,[50] while the workers would resist wage flexibility as this could depress the amount of the final pension benefit they receive. Consequently, there could be pressure for government wage and training subsidies for older workers, especially since the unions did not support the reform. A more market-based solution would need to be found, however.[51]

In order to reduce downside risks in GDP growth rates underlying the official pension spending projections, structural reforms to boost labour productivity all around, notably those targeting education and competition, are very important. As labour supply would also need to be raised, the statutory retirement age for women should be brought up to that

of men, while retaining the greater flexibility, with actuarial adjustment, that women as the principal caregivers are likely to require. Some of the resources freed up by pension reform should be devoted to better child and old age care facilities, targeting the workplace needs of younger as well as older women.

Despite these outstanding issues, the important feature is that a major new parametric reform of the pension system was passed, one which creates much-needed budget room to reduce debt and pursue other fiscal priorities. This should help to reduce consumer and investor uncertainty after a long debate and thereby help to support economic stability and growth. It should also raise potential growth in the longer term by boosting participation of older workers.

Building a private pension pillar

The steps to construct a private pillar by diverting future company severance (TFR) flows are perhaps the main value added of the Maroni-Tremonti reform, if they succeed. Previous attempts to build a private funded pillar have failed, even though this was a main ambition of the Dini reform. As the new scheme is voluntary, it is important that workers see it in their interests to participate. Experience in other OECD countries suggests that voluntary schemes with attractive tax incentives work best to encourage individual pension savings. With sharply declining in-work income replacement rates on PAYG pensions, tax subsidies to supplementary private pension plans may be justified by the need to avert a high recourse to public assistance in the future, or else to make pension reforms more politically acceptable, even if somewhat costly to the present budget. Such aids are typically deferred taxes which are repaid upon withdrawal of savings during retirement. On the other hand, there is empirical evidence that savings diversion in order to take advantage of tax breaks is substantial. The resulting deadweight losses may not be justifiable in the current budget situation.[52]

The Italian case presents other complications. The TFR currently serves as a source of low-cost financing to firms, paying the worker a yearly return of 1.5% plus ¾ of the inflation rate. There is some evidence that when workers withdraw their TFR savings prematurely, they face a heightened risk of being fired, as the firm has less "invested" in that worker.[53] Workers may value job security more than expected return differentials on market-based investments, especially considering the attending financial risk plus the general present lack of confidence in Italian financial market. In that case, many might choose to opt out of the plan. The government has indicated that firms will be compensated for the loss of TFR funds, which could help address this issue, and this has been partly specified in a "competitiveness package" prepared in early 2005 (Annex 2.A3). It will also be vital that workers' faith in the safety of their savings be secured by an adequate financial market reform which might be aided by passage of the new financial market supervisory model (see Chapter 3).

Besides increasing retirement income security, the private funded pillar would also help to develop the domestic capital markets. The sums at stake are considerable: the entire annual TFR flow amounts to € 13 billion (1% of GDP). This would give a significant boost to volumes intermediated by the markets, while improving the allocation of capital. Here the worker choice of savings vehicle may be relevant. Closed funds, managed by employers and workers within individual firms or sectors, are typically very risk-averse with low intermediation margins, but favoured by unions and currently the most popular form of placement. This may bring little value added to the intermediation industry or to

the allocation of capital. Open funds, not tied to individual firms or sectors and independently managed by banks, and individual plans, usually managed by insurance companies, would serve better, though higher management fees, especially on the latter, might be dissuasive.[54]

A further issue pertains to TFR contributions of workers who opt out of the private funded system. There have been proposals to put these on the books of INPS, the social security institution for private sector workers, who would then manage these funds and pay the workers the same low return as currently. Government might benefit, in a bookkeeping sense at least, if the inflows into INPS were to count as government receipts (if Eurostat rules permit), providing a large fiscal windfall. On the other hand, political risks are imaginable. Such a windfall could reduce the pressure to find spending economies, undermining the sorely needed structural fiscal adjustment. As INPS has no experience in fund management, it would require much new expertise, expanding public employment. Also, nationalising workers' remaining TFR contributions could be considered as increasing the tax wedge, and economically harmful. Hence, on balance it is better to keep these funds in private hands.

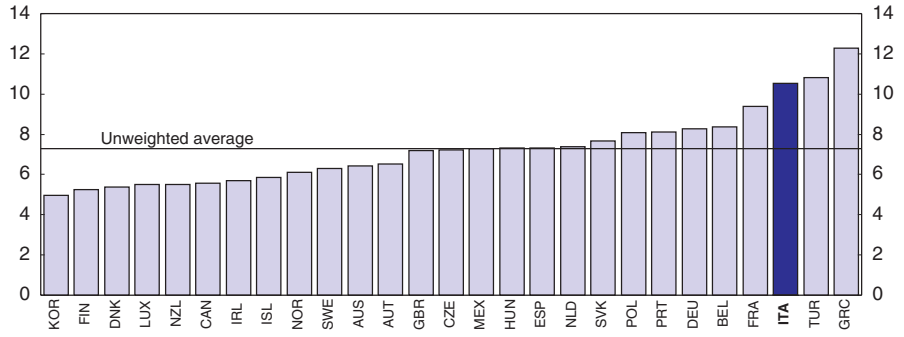
Public employment and wages

After pensions, personnel costs are the major item of government spending (Annex Table 2.A1.1). The performance and numbers of public personnel determine the quality and quantity of services to citizens and the efficiency with which their taxes are put to use. The government has been continuing the reform of the public administration begun in 1998.[55] Given the fiscal challenge, the emphasis may need to shift more decisively toward cost control, in particular streamlining public employment and moderating wage growth, while stepping up the quality to cost ratio *via* accelerated structural reforms.

Italy displays one of the highest ratios of public administration to total employment in the OECD (Figure 2.4).[56] Public employment in the domain of social services is relatively modest, however, reflecting the low participation rate of women (Figure 2.5), as well as a

Figure 2.4. **Public administration employees**[1]

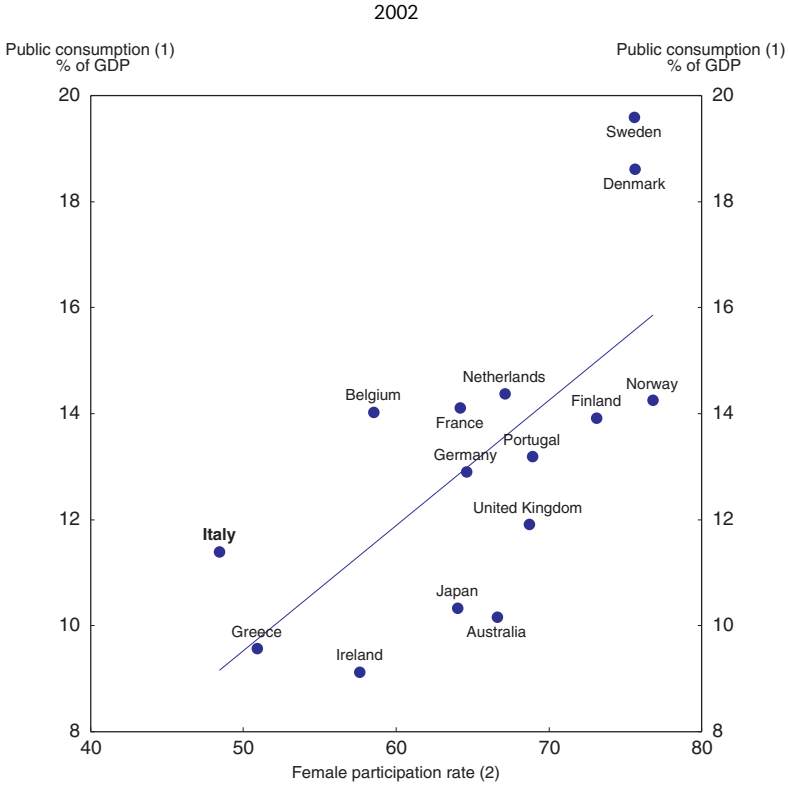
As a percentage of total employees in 2002 [2]



1. Corresponds to the national accounts industry branch NACE L. It includes such activities as defence, judicial services and police, foreign and economic affairs, administration of tax and social systems, regulatory and general public service activities. Public employees working in other industry branches (especially health and education) are not included. For Turkey the figure may be distorted by the very low total employment number appearing in the denominator, as an estimate for informal employment is not included in this figure, as it is in Italy.
2. 1999 for Belgium. No data for Japan, Switzerland or the United States.

Source: OECD Annual Labour Force database.

Figure 2.5. **Public consumption of market services and female participation rate**



1. General government consumption on education, health and social protection.
2. Female labour force as a percentage of female population aged 15 to 64.

Source: OECD Annual National Accounts database; OECD Annual Labour Force Statistics database.

high rate of volunteer work among the retired. As female and older worker participation and employment rates rise (toward the Lisbon criteria), demand for the latter category of public worker will likely increase, making it especially important that the issue of excessive employment at the bureaucratic level be tackled. It is worrisome that general government employment has been rising since 1999, contrasting with a steady decline from 1992 to 1999.

The budget laws for both 2003 and 2004 imposed a freeze on the organisational charts of all public administrations (except the smaller local ones), requiring that they be adapted to the reform process, decentralisation of public functions, and privatisation within the limit of the posts filled at end September 2002. General restrictions on recruitment of new personnel were also imposed. New recruitments at the national level are tightly controlled, subject to slim financial quotas and allowed only in certain sectors.[57] At lower levels, recruitment limits are set in accordance with political agreements among the central, regional, and local governments. There are also restrictions applying to all levels on the use of fixed term contracts (expenditure must be kept under 90% of that of the previous year), as public administrations often use short-term contracts to get around limitations on taking on open-ended personnel.

Public sector wages, relative to the private sector, are high compared with other OECD countries (Table 2.3). They seem more than adequate to attract and keep qualified workers in government, so that wage moderation in line with budget needs is possible – and

Table 2.3. **General government employment and compensation**

As a percentage of total economy counterparts

	General government employment[1]		Public employment compensation[2]	
	1993	2003	1993	2003
Italy	15.6	14.6	127.0	138.2
Canada	22.8	20.9	105.4	90.6
France	24.0	23.0	94.7	108.2
Germany	13.4	11.1	113.3	122.8
Japan	8.2	8.8	111.7	118.1
United Kingdom	21.6	18.8	67.9	58.9
United States	15.4	15.2	111.1	104.4
Big seven	15.1	14.6	104.3	104.0
Euro area	16.3	15.4	122.9	130.8

1. Per cent of total employment.
2. Per capita. Percentage points of the corresponding indicator for the rest of the economy including social security contributions using dependent employment figures.

Source: OECD, *Economic Outlook* 76 database.

desirable. Recent budgets have in fact allocated amounts for wage increases reflecting projected inflation plus ¼ per cent productivity increase. However, public sector wages are set by collective negotiation, and tend to be more uniform than in the private sector. The government has in some years postponed the renegotiation of wage agreements, citing budget discipline. In 2003, however, a number of contracts were renewed, so that including both strong wage drift and contract catch-up, public wages rose by 5½ per cent, following 4% in the previous year (versus 2¼ per cent both years in the private sector). More contracts are due to be renewed in 2004, and the public sector unions have been demanding 8%, based in part on a more "realistic" inflation assumption of 4%. Thus, significant further wage pressure is likely, though not accounted for in the DPEF's assessment of financing needs, which are based on "current legislation".

Incomplete personnel reforms in government seem to have further boosted wage costs. A budget allocation is now made each year for performance bonuses to managers, but it is not clear how transparent the criteria have been for awarding such allowances. The *Ragioneria Generale dello Stato* (Government Accounting Office) has suggested that abuses of the bonus system are giving rise to spending pressure.

To conclude, the rationalisation of staff is evidently taking a long time and the recruitment freeze has not been successful in preventing a renewed rise in general government employment, while public sector wages are rising much faster than those in the private sector. According to the government, the main difficulties in controlling personnel costs are: the autonomy given to regional and local administrations and consequent lack of central control over their hiring levels; the necessity to provide exceptions to recruitment restrictions in priority areas such as public safety, national defence and civil protection; wage progressions with career as determined by collective agreements; and lack of timely collection of data and information from the fragmented and decentralising public administrations.[58] However, more efforts could be made to find savings in the public wage bill, with some suggestions being as follows:

- Hiring restrictions at the central level appear tight but should be replaced by net reductions in force, an even tighter requirement, as a counterpart to the shift of

functions to lower levels of government. The lack of central control over lower level hiring, which is in any event consistent with federalism, seems a lesser problem than the unwillingness by the central level itself to relinquish staff no longer needed for performing the devolved tasks.[59] A temporary freeze on all net hiring could also be envisaged. The forthcoming retirement of the baby boom cohorts should be taken as an opportunity to shrink public sector payrolls. Since the labour force is expected to shrink in future years, even stable public sector employment would entail disproportionate falls in private sector employment.

- Government will need to adopt a tougher posture toward pay negotiations with public sector unions. There may be no good reason for higher rates of wage increase in the public than in the private sector, given the typically higher level of security enjoyed there and the more generous benefits. Cost of living and productivity differences should be taken into account in determining pay schedules (as in the United States), while wage negotiations should be decentralised in line with growing regional autonomy. The application of performance bonuses for managers should be carefully scrutinised, and the relevant criteria clarified.

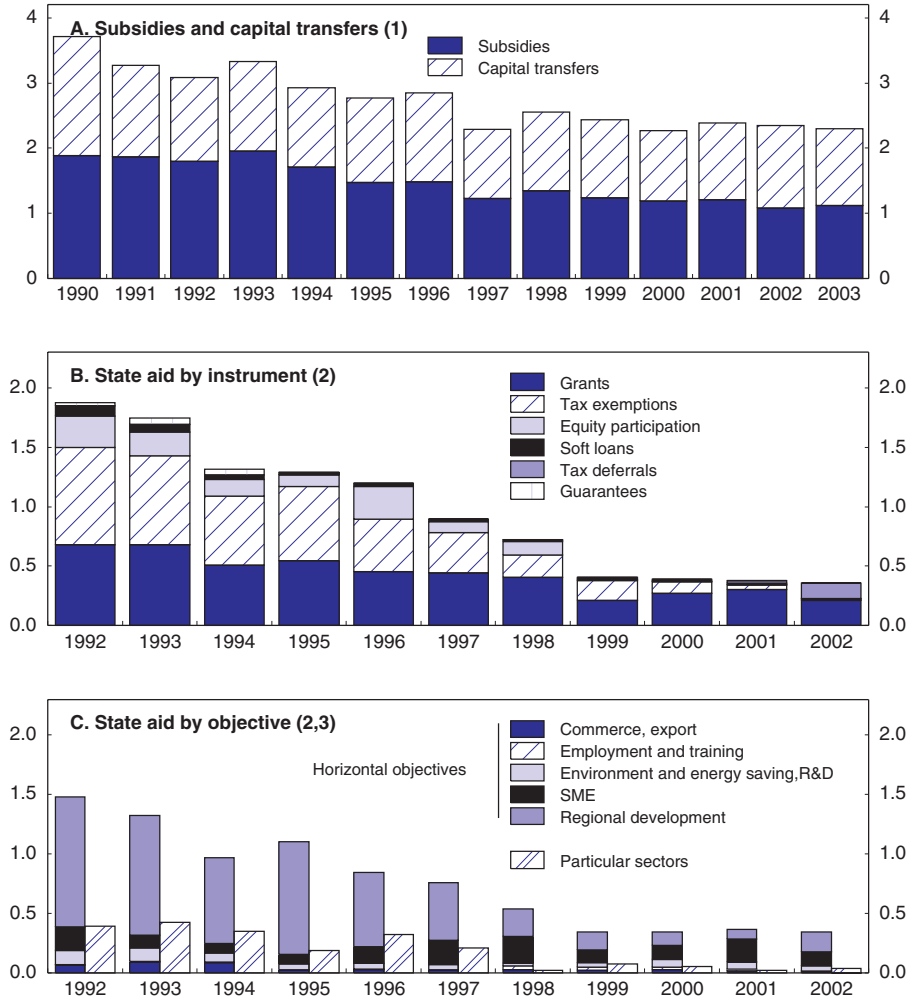
Corporate welfare

The government has proposed significant cuts in "corporate welfare" – a range of government transfers to the corporate sector – to help cover the projected financing gap, and tax cuts in particular.[60] Such spending has already been slashed as a per cent of GDP in the past decade (Figure 2.6). Of the amount remaining (€ 30 billion), roughly half is extended by central government and hence amenable to direct policy control. Of that amount, only around half is directed to private enterprises, mainly in the form of capital transfers for new hires or for investment in disadvantaged areas. In 2004 as an emergency measure, transfers to post and railways were reduced, as well as to the private sector. The latter, eventually all, will be converted into long-term soft loans, *via* a new investment fund (*fondo rotativo*), with only the credit subsidy element appearing in the budget instead of the full principal amount as before. This process was started with the corrective package of 2004 and will eventually be expanded to cover all subsidies to private firms.

The larger part of corporate subsidies goes to the South, mainly to small firms. Their conversion into loans may be expected to improve incentives to use the money wisely, by enhancing the financial responsibility of both firms and banks. The allocation of resources will therefore be improved. Also, small firms' debt loads will increase at the same time that they face the loss of TFR low cost credits because of the pension reform, and the switch by banks to Basle 2, which entails greater scrutiny of credit risks. Hence it may be important, once again, to stimulate capital markets as the grant system is wound down. The transformation of *Cassa depositi e prestiti* into a financial institution (see Chapter 3) may involve both subsidised and market based banking functions that perhaps could be used to good effect to address financing issues in the depressed areas and for small firms more generally. The *Cassa* will also be charged with management of the new investment fund. Once the transformation of grants to private firms into loans is completed, only about 0.4 percentage points of GDP of the financing gap would have been covered in this way, however. A more substantial contribution would involve reducing subsidies to Post, Railways, and State Road Agency (Anas); their progressive privatisations, as discussed in Chapter 3, would entail a reduction or elimination of their subsidies. There will also be a

Figure 2.6. **General government subsidies and capital transfers to non-financial corporations**

Per cent of GDP



1. National Accounts basis.
2. European Commission definition. Includes aid for particular manufacturing sectors, aid for general government development and aid for horizontal objectives including general regional development schemes for which the specific sector is not known.
3. State aid for horizontal objectives is aid that is not granted to specific sectors. Particular sectors include manufacturing sectors, non-manufacturing sectors, transport, financial and other services.

Source: OECD, National Accounts database; European Commission, State Aid Scoreboard, Spring 2004 update.

need to make room in the budget for a share of these soft credits as provisions for companies going bankrupt.

Privatisation

Privatisation of public enterprises or public services can alleviate spending pressure *via* reduced debt and debt service or public employment. It is also usually conducive to an enhanced role for market forces, therefore growth-friendly (see Chapter 3). Privatisation of economic enterprises was significant during the period 1993-2000, bringing nearly

€ 100 billion in receipts that accelerated debt reduction, while also allowing significant market liberalisation (Table 2.A1.2). The privatisation of public services has not been active yet, but decentralisation should be an opportunity to do so, even though local governments have in general responded slowly so far (see below).

In recent years, more innovative types of privatisation have been used to reduce both debt and deficits. An active element of budget policy during 2000-04 was securitisation of real estate assets and financial credits, allowing in all some € 35 billion in deficit reduction, insofar as resulting receipts were counted as negative investment spending. However, these savings were all one-off while real estate securitisations created a public obligation that must be serviced by other means, usually even more securitisations, if the securitised assets cannot be sold off quickly; this, in fact happened in 2004, and subsequently the bonds were downgraded. Debt-for-equity swaps with the transformed *Cassa depositi e prestiti*, now outside the general government, reduced the public debt in 2003, when it would otherwise have increased, even though the Treasury was still the owner of the *Cassa*. Another innovation has been the growing use of public-private partnerships to partly finance and privatise investments, which could serve to raise their transparency, and this has been a European-wide phenomenon (Table 2.4). However, as stressed in the 2003 *Survey*, this suggests that a policy of full transparency regarding possible contingent liabilities for the government be followed and that a broader definition of government might be useful.

The DPEF sets high ambitions for privatisation in the next four years, which at € 100 billion is equivalent to the intensive pace set during the late 1990s. It remains to be seen whether the target can be achieved. Ideally, this would involve partial or full divestiture

Table 2.4. **Public private partnerships in selected OECD countries**

	Central accommo-dation	Airports	Defence	Housing	Health and hospitals	IT	Ports	Prisons	Heavy railway	Light railway	Roads	Schools	Sports and leisure	Water and waste
Austria	○	○			◔	○		○	◔		◔	○		○
Belgium		◔	○	◔					○	○	◔	○		◔
Denmark	○						◔	○	◔		◔	◔	◔	
Finland			○		◔						◔	◔		○
France	◔	◔	○		◔		◔	◔	◔	●	●	○		●
Germany	◔	○	◑		○	◔		◔	◑	◑	◑	◑		◕
Greece	◔	●									◑		◑	
Ireland	○			◔	◔					◔	◕	◑		◕
Italy	○	◔		○	◑		◔	○		◑	◕		◔	◔
Netherlands	○		○	○	○		○	○	◑		◑	◔		◑
Norway	○		○		◔			○	○		◑	◔		
Portugal		○		○	◔	◔	○	○	○	◑	●	○		◑
Spain	○	○			◔		●			◔	●	○	○	◑
Sweden			○		○				○	◑	○			
UK	●	●	●	●	●	●		●		●	●	●	●	●
Czech Republic		○	◔	○	○				○	○	◔	○	○	◑
Hungary				○	◔	○		◔		○	◑	◑	◔	◑
Poland	○	○		○			◔		○	○	◔			◑
Slovakia		○									○			○
Turkey	◑								○	○	○			◑

Legend:
○ Discussions ongoing. ◔ Projects in procurement. ◑ Many procured projects, some projects closed.
◕ Substantial number of closed projects. ● Substantial number of closed projects, majority of them in operation.

Source: Source: PricewaterhouseCoopers, "Developing Public Private Partnerships in New Europe, 2004".

of still major government holdings in network and other industries, starting with the energy sector and extending to the many enterprises still owned by local authorities, which could also serve the competition goal (see Chapter 3). However, most of the emphasis will apparently be put on sales of government real estate, including office buildings which would then be leased back.[61] The identified and audited public sector assets amount to 138% of GDP, the majority in tangible fixed assets (Table 2.5). Though selling real estate can be efficiency-enhancing insofar as the private sector may better manage these properties, especially commercial and residential buildings which comprise the greater part of the asset stock,[62] in cases of historical buildings or monuments, cultural or local sensitivities may have to be taken into account. The government is also planning to sell part of the road network in 2005, which would require the state to make payments to the purchaser in subsequent years. The future budgetary burden of lease-back for properties and fees for road management should be carefully assessed against the immediate benefits of asset sales.

Table 2.5. **Public sector assets: 2002**[1]

	Central government	Local government	Public sector	Public sector
	Adjusted value	Adjusted value	Adjusted value	Adjusted value
	Millions of euros			% of GDP
Liquid funds	187 031	44 981	232 011	18.4
Receivables	42 799	45 306	88 105	7.0
Advances	45 693	–	45 693	3.6
Other account receivable	1 180	975	2 155	0.2
Equity investments	103 416	77 300	180 716	14.3
Intangible fixed assets	5	57 817	57 822	4.6
Tangible fixed assets	586 136	545 911	1 132 047	89.8
of which: Infrastructures	–	180 000	–	
Other	–	56 000	–	
Total assets	966 259	772 289	1 738 548	137.9

1. Data included in this table are preliminary estimates and are subject to revisions.

Source: Ministry of Finance, Italy's Stability Programme, Update November 2003.

Fiscal federalism

The institutional framework

The constitutional reforms of October 2001 (Box 2.2) substantially advance on paper the process of decentralisation that has been underway since the regional level was created in the mid-1970s. These reforms have not been fully implemented, however, given a lack of either agreement or clarity regarding the new amendments (the law was rather hurriedly designed by the previous legislature and later approved by national referendum). The Constitutional Court has, in effect, been setting policy in this area *via* its rulings on matters of dispute between the regions and the state. A new consensus is clearly needed in order to end the judicial disputes and pass to the stage of implementing legislation. To this end, a number of proposals to modify the proposed constitutional reforms are before parliament or under discussion. Perhaps the most contentious issue is the separation of legislative powers defined in Article 117. A law proposal by one of the parties in the governing coalition (law "La Loggia") grants exclusive competence to the regions in health, education, and police – areas to which the constitution attributes shared competencies. There is also a proposal to transfer areas such as energy, the professions, and large

Box 2.2. **The new Title V of the Constitution**

The new Title V of the constitution, which came into effect by constitutional law on October 2001, significantly expands the powers and autonomy of regional governments, bringing Italy closer to a true federal state. It articulates legislative, spending, and taxation powers across the different levels of government as follows:

- *Article 117*. Legislative powers of the regions are greatly expanded. In areas of "exclusive competence" of the state[1] and regions,[2] each has full legislative powers in its respective areas. In areas of "shared competence",[3] the state is responsible only for legislation of fundamental principles and the regions for all implementing legislation.
- *Article 118*. There is a general decentralisation of administrative functions. These are by default attributed to the cities, unless the uniform delivery of services requires that they be performed by the provinces, metropolitan cities, regions, or state according to the principles of subsidiarity, differentiation, and adequacy. Regions may choose the extent to which they wish to assume functional responsibilities in areas of shared competencies.
- *Article 119*. The principle of financial autonomy for lower levels of government is established, though in broad terms. Their assigned functions should be completely financed by own taxes and revenues, sharing of national taxes collected on their territory, and equalising transfers from the state which are not earmarked to specific uses. Investments may be financed by recourse to debt financing by lower level entities, not guaranteed by the state.

1. The state has exclusive competence in matters of foreign policy and relations, immigration, state-church relations, defense and national security, money and exchange rate, guardianship of financial markets and competition, taxation, organs of the state, citizenship, public order and safety (except local police), judicial and penal system, determination of essential levels of services as a right for all citizens, general education norms, public pensions, organisation of lower levels of government, customs, standards, statistical information, protection of environment and cultural assets.
2. Everything not explicitly mentioned as belonging to exclusive or shared competence with the state belongs to the exclusive competence of the regions.
3. Areas of shared competence with the regions are: external relations at the regional level, foreign trade, labour market, education (except for professional instruction), the professions, R&D, health, food, sport, civil protection, territorial administration, ports and airports, large transport and navigation networks, communication, energy generation/ transmission/ distribution, private pensions, co-ordination of fiscal policy and tax system, maintenance of environment and cultural assets, savings banks and local-type savings institutions.

transport networks back to the exclusive competence of the state, rather than to be shared with the regions as the constitution requires. There are further proposals to transform the Senate into a Chamber of Regions akin to the German Bundesrat, to improve co-ordination of state-regional legislation and budget planning. This could be a step in the right direction, replacing the current less binding mechanism of the state-regional conference. Most such proposals would necessitate new constitutional amendments and thus two-thirds approval by the parliament, which helps explains why resolution of these matters is a long and difficult process. Annex 2.A2 provides further details on legislative developments in this area.

Devolution of spending

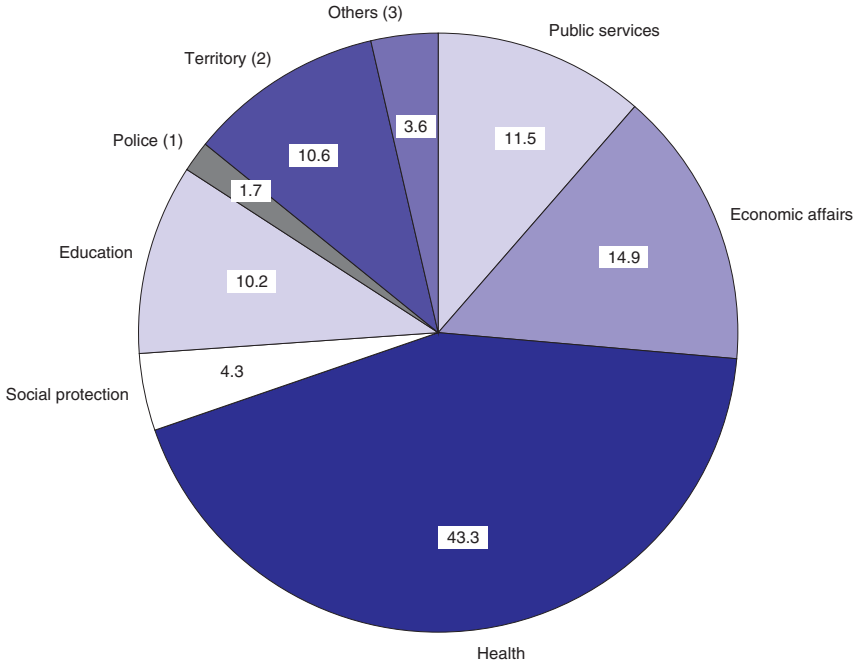
The new constitutional amendments expand the transfer of administrative functions from the centre to the regions, and are likely to boost the latter's spending by up to one-third.[63] This would result in a roughly equal sharing of total government expenditure between central and regional levels (53 and 47%, respectively). As the lion's share (70%) of

central government spending is accounted for by the pension system, the central level will remain mainly responsible for social security and other income transfers, while virtually all citizen services will pass to the regional level. This seems to fit in well with the principle of subsidiarity, *i.e.* that the provision of services should be at the level that is closest to the ultimate user, allowing greater transparency and accountability regarding the use of public money (that is, if citizens perceive a link between taxes they pay and services they receive). Health and education will be the two biggest items of regional spending, with respective shares of one-third and one-quarter (see Figure 2.7 for current shares). The net budgetary cost of the reform will not be trivial, as earlier hoped for. Experience to date and in other OECD Countries (*e.g.* Spain) has shown that territorial transfer of personnel is difficult, while there are also unavoidable learning and transition costs. Estimates of the cost of devolution are significant (see Annex 2.A2), which would add to the financing burden foreseen in the DPEF and increase the need for spending economies elsewhere.

Decentralisation should be seen as a major opportunity to privatise public services and, in general, to increase efficiency of provision through better incentives. Almost all the services that are being devolved to the lower levels are ones that can also be provided by the market: health, education, transport, security, labour market services, energy, communications, transport, etc. This means that allowing competition with private suppliers of such services, or even outright privatisation, could spur efficiencies, including the use of cost-benefit analysis for investment projects, while also reducing public employment. These services are also supplied at the individual level rather than for the common good. This in turn means that co-

Figure 2.7. **Local government expenditure by function**

As a percentage of total expenditure in 2002



1. Defence, public order and safety.
2. Environment protection, housing and community amenities.
3. Recreation, culture and religion.

Source: OECD Annual National Accounts database.

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payments, tariffs, vouchers and similar market mechanisms could be levied to assist in their financing, restrain demand, and further stimulate competition. To complement these actions, the simplification of regulations and "red tape" should be fully implemented in all regions (Box 2.3). It will be important that sub-national authorities take advantage of such opportunities, rather than to seek shelter from competition for themselves or influential

Box 2.3. **The simplification process**

The simplification process in Italy is geared to making the public administration more accountable and efficient. Its main objectives are to: 1) reduce times and costs of administrative activities; 2) eliminate public intervention and useless administrative burdens. The one-stop shops for productive activities, introduced in 1998, and the initiatives for widespread use of self-certifications, instead of public certifications, are among the range of instruments introduced to realize such objectives. Procedural simplification has been carried out through the so-called de-legification tool, replacing numerous laws by streamlined regulations. Regions and municipalities adopted in some cases these procedures (so called Administrative Federalism), for example the latter were given the power of licence issuing. Another tool, annual simplification laws, continuously updated the simplification process and its results.

The 2003 Simplification Law aims at making easily accessible the regulations concerning single subject matters through a unique tool, the Code. For the issuing of codes, regulatory recasting is the new adopted technique. Parliament annually intervenes in the subjects that the government points out as priorities. Following the principles and criteria contained in the simplification law, the government issues legislative decrees and, if necessary, government regulations (secondary rules). The so-called codes collect all the rules regulating single sectors, eliminate the obsolete ones, gathering a single regulatory framework the discipline in force, as well as innovating it, according to general and specific principles and criteria.

The 2003 Simplification law also states that administrative interventions should be eliminated or substituted with the notification of beginning of an activity, or silence-is-consent (self regulation), in a broader range of cases. The government has recently presented to the Parliament the fourth annual simplification law (bill of Law on simplification and normative recasting for the year 2005). In the bill, it is provided that the government will adopt a broad deregulation of business activities, determining the cases in which such activities are still subject to authorisations, license permits, etc., as well as continue the codification process. Regulatory impact assessments have also become important aspects of the regulatory reform agenda.

The regulatory reform framework is now being profoundly reshaped with the new allocation of powers between state, regions, and local entities, following the constitutional reform of 2001. Indeed, the transfer of concurrent and exclusive legislative as well as regulatory powers and the devolution of administrative functions to local entities urge the need for a widespread awareness of simplification policies and tools among regional and local decision-makers and administrators.

The implementation of e-government Action Plan is also having an impact on simplification policies, enabling the administration to work more efficiently in particular in the areas of e-procurement, tax filing, and one-stop shops. One-stop shops have been created at the local level, responding to the needs of business and citizens to interact with a single administration and to receive a single answer through a single procedure, lower costs and shortened times, as well as favoured territorial development. However, it seems that thus far the one-stop shops have been used for individual rather than company purposes, though one-stop shops for foreign investors are now being developed.

The implementation phase has faced difficulties in some cases. For example, the regulatory assessments have been carried out at an experimental stage only, and more training as well as cultural change in regulatory and administrative decision making are needed for a full use of its potential. The one stop shops have radically cut waiting times for investment approvals where they have been introduced; however 45% of the regions still do not have them. The recasting and codification is expected to radically cut and improve the accessibility of the legal system; however the issuing of codes is falling behind schedule in some cases.

constituencies as some have in the past. Assuming greater responsibility for their own financing could go a long way to stimulate such incentives.[64]

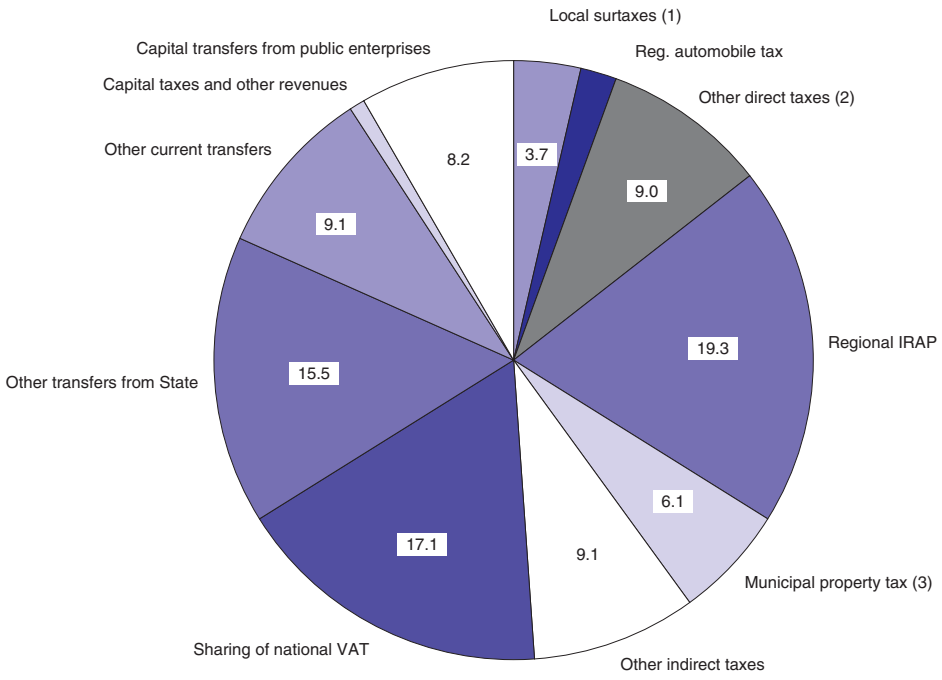
Devolution of revenue-raising powers

Regional accountability is a necessary condition for delivering the benefits of subsidiarity and requires a degree of tax autonomy that bears some correlation to services provided at the regional level. If citizens perceive that a higher quality of local services than they receive would be warranted by the amount of local taxes they pay, then democratic pressures would build on the local authorities to improve their services or else be ejected from power in the next elections. If the low level of services is tied to too-low taxes, then citizens could agree to pay more. If, on the other hand, a large part of local spending is funded from national transfers, then a poor quality of spending could be blamed on insufficient transfers and there is little local accountability to citizens, with possible "free riding" on the national government. In other words, there is no necessary contradiction between lower level tax autonomy and fiscal policy discipline. To procure such discipline, it is important that the revenues which finance sub-national authority spending be traced back to the choices of the same sub-national authorities. Fiscal centralisation combined with spending decentralisation may nullify the expected benefits of federalism in terms of a more efficient allocation of resources.

At present, around 40% of local government revenue sources come from "own" taxes (Figure 2.8), even though tax rate autonomy is circumscribed. In 2002, the central

Figure 2.8. **Local government revenues by type**

As a percentage of total revenues in 2002



1. Regional and municipal surtaxes on national income tax.
2. Environment protection, housing and community amenities.
3. Recreation, culture and religion.

Source: Bank of Italy.

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government decided to suspend the little leeway that regions already had to alter their rates of IRAP and their surcharge on the national personal income tax. This step effectively removed regions' tax autonomy, at odds with the philosophy and intent of federalism,[65] but could be seen as an attempt to enforce better spending control and keep tax pressure from rising. Some regions had started to increase tax rates as their deficits widened in response to tightened access to *ex post* grants to cover regional health deficits, in exchange for more realistic *ex ante* budgeted grant levels along with bonuses for virtuous regions, under the August 2001 Health Agreement.[66] An important outstanding task for Italy is to decide what taxes could be given back to regions, fully controlled by them and correlated with their spending responsibilities, in order to fulfil the intent of the constitutional reforms. The 2005 Budget has reinstated the power of regions to raise their IRAP tax rates and personal income tax surcharges, a welcome step in this regard.[67] To form a social and political consensus, a high commission on fiscal federalism has been set up, though its work is behind schedule and its mandate was recently extended. Finding an effective replacement for IRAP as a regional tax will be one of the key issues to be resolved (Box 2.4).

Because inter-regional per capita income disparities are so wide in Italy, revenue transfers (equalization) from rich to poor regions are an important feature of the financing system. However, the method of determining such transfers has been in the past unclear and haphazard. A law promulgated in 2000 (law 56/2000) was meant to provide clarity and objectivity. It specified a new formula for regional sharing of national VAT revenues which took as the reference point regions' potential rather than actual tax revenues, mainly IRAP, as well as spending needs based on demographic characteristics and the like. With less than full equalization (90%), this would have preserved regions' incentives to maximise their own tax take. However, the law was never fully applied and an inefficient bargaining mechanism remained the rule, albeit much improved after the August 2001 Health Agreement. More generally, transfers do not seem to have served the purpose of closing the regional income gap and may have even prolonged it by creating a "dependency culture", only now beginning to unwind. In the mid-1990s, 4% of GDP was annually transferred from the regions in the North-Centre to those in the South, down from 5% a decade earlier but still about the same proportionate amount as in Germany (from old to new Länder), where this is considered a major problem.[68] It will be important to preserve the best features of law 56/2000 in the design of equalisation mechanisms for the new fiscal federalist arrangements.[69]

The DPEF specifies that the lower levels of government are fully expected to contribute to the required fiscal adjustment. This reinforces the need for increasing regions' accountability by giving them autonomous means of finance. But it may be necessary to go one step further *via* self-legislated limits on local deficits and debt, partly enforced by the financial markets, which is a successful feature of some federalist systems. The Internal Stability Pact was an attempt to "decentralise" the external budget constraint binding Italy, by imposing limits on regional spending increases and deficits (see previous *Surveys*). However, sanctions were weak and deficits in health (often implicit *via* payment lags to suppliers) continued. The exigencies of federal reform and the fiscal challenge call for a new mechanism. The 2005 Budget takes a step in this direction by defining a disciplined Internal Stability Pact for 2005-07. In 2005, it subjects all sub-national expenditures (current and capital)[70] to a spending growth cap over the average expenditure sustained in 2003, also imposing quarterly (or semester) spending targets and reporting requirements. As of 2006, tough sanctions will be applied for failure to obey the previous

Box 2.4. **Issues in replacing the IRAP by an alternative regional tax**

The IRAP suffers from several shortcomings as a sub-national tax (see Buglione and Marè, 2003), in contrast with its efficiency characteristic noted above (*i.e.*, easy to collect on a wide base). Being a tax on the remuneration to the factors of production, it is both procyclical and comparatively unevenly distributed across regions, requiring compensating transfers in periods of economic downturn and to the less developed regions. Furthermore, it may only weakly satisfy the benefit principle, *i.e.* those who pay are also those who benefit most from public services provided, since it is levied in the first instance on subjects conducting productive activity on the territory rather than its citizens and voters. Nationwide operations by many companies make their value added hard to allocate to individual regions.

The high commission is reportedly considering the use of a regional sales tax top-up to the national value added tax, as a substitute for IRAP. Property taxes, which remain underdeveloped, could also play a role in municipal level finance. Both of these taxes would seem to satisfy better the benefit principle, as revenues are closely connected to the territorial consumption profile; furthermore all citizens would be obliged to pay and the tax bases are highly visible. The sales tax itself would be very transparent, because unlike value added taxes such taxes are direct add-ons to retail list prices rather than being already included in posted retail prices. This should in turn strengthen local level accountability. However, cross-border shopping to take advantage of varying regional sales taxes could be a complicating factor, more so perhaps than in the United States where there is a much wider geographical dispersion, though it is also true that in Italy people are not highly mobile across regions. A more serious problem is that current EU rules prohibit use of the sales tax instrument (VAT being the first source of finance of the European budget, member states are not allowed to introduce within their national borders additional taxes or surcharges on the same tax base). The European Court is also about to issue a ruling on the admissibility even of IRAP as a regional tax.*

The other main regional tax is the surcharge on the national income tax, though allowing more substantial discretion to vary the surcharge might disturb progressive profile of the national tax, whereas redistribution policy is a state prerogative. Other possibilities for regional taxes might include the devolution to regions of the central tobacco tax, of the excise tax on energy, and of real estate transactions taxes; also increases in regional education and environment taxes might be considered, consistent with greater regional legislative competence in these areas.

* An initial report by the court's counsel has found that IRAP is not admissible under EU rules on harmonisation of VAT regimes.

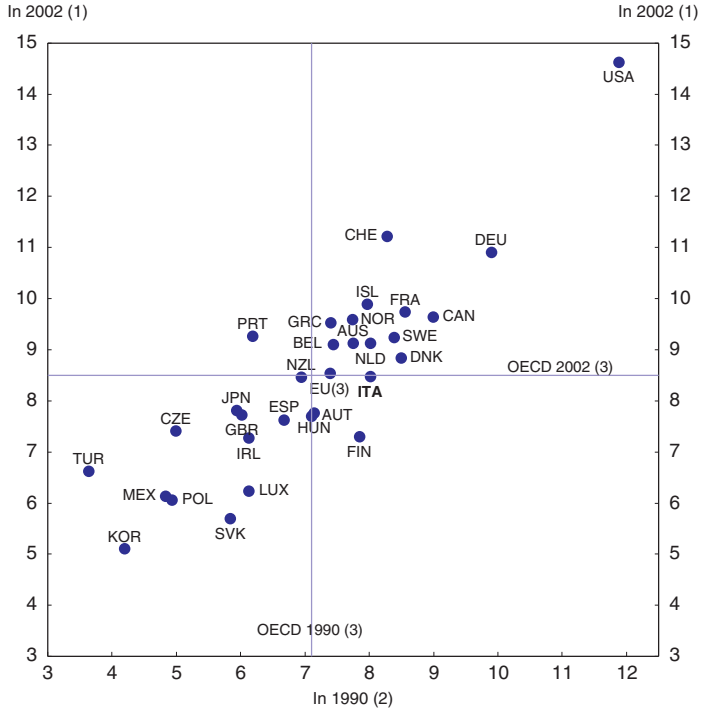
year's limits, including an obligation by the local entity to reduce spending by 10% relative to the penultimate year, prohibition of all hiring, and prohibition of any borrowing to finance investments.

The case of health care

Health care costs in Italy are around the OECD average (Figure 2.9), but as elsewhere pressures for increases are strong. The major area of health cost pressure has been pharmaceuticals, where supply-driven demand and innovation-induced price inflation form part of an OECD-wide phenomenon. But costs rose particularly strongly in 2001 when the national ticket (patient co-payment) on prescription drugs was abolished. The policy

Figure 2.9. **Total expenditure on health care**

As a percentage of GDP



1. Data refer to 1997 for the Netherlands; 2000 for Turkey; 2001 for Australia and Japan.
2. Data refer to 1991 for Hungary; 1992 for Germany; 1995 for Belgium; 1997 for the Slovak Republic.
3. Unweighted average; includes all available countries at the relevant point of time.

Source: OECD Health Data, 2004.

implemented in the following year gave regions broad autonomy to curtail pharmaceuticals costs, and it was quite successful. Regions differed in their approaches, some applying tickets and others purchasing pharmaceutical products directly by their local health units at lower prices, according to what seemed to work best in each particular context.[71] Pressures in pharmaceutical spending have re-emerged more recently, however, and the 2004 corrective package has introduced a system of centralised pharmaceutical control with the requirement that pharmaceutical companies lower their prices as a contribution to the fiscal effort (for this purpose a new agency called "agenzia italiana del farmaco" has been set up). This policy should be effective, insofar as the national government has greater monopsony power than uncoordinated regions, but it also reflects the growing tendency to centralise health policy and its financing.

The largest problem in health care is that of inefficiency. In spite of the large differences in regional income, per capita expenditure in health services is virtually equalised across regions.[72] In southern regions, where per capita GDP is well below the national mean, the share of resources absorbed by the health sector was greater than the national mean, damaging other sectors (Table 2.6). Funding is also largely equalised, with own resources topped up by equalising federal transfers, though the regions which generate the biggest per capita deficits are located in the centre and south of Italy. However, the quality of services is quite uneven, with northern regions providing better services than those in the south (Table 2.7).[73] This syndrome could actually be exacerbated

Table 2.6. **Regional public health spending**

	Per capita health expenditure in euros			Health expenditure In % of GDP			Per capita health deficit in euros			
	2000	2001	2002	2000	2001	2002	2000	2001	2002	2003
North	1 248	1 343	1 416	5.1	5.2	5.4	31	34	26	19
Center	1 254	1 351	1 401	5.8	5.9	5.9	60	89	55	57
South	1 124	1 244	1 257	8.2	8.7	8.5	84	80	68	33
Italy	1 206	1 309	1 363	6.0	6.2	6.3	56	68	46	31

Source: Ministry of Economy and Finance, Relazione Generale sulla Situazione Economica del Paese, 2003.

by the exclusive right of the state to determine the "essential" services that must be provided across the country. Regions can claim that high and rigid national standards leave them with little room for manoeuvre in controlling costs (and that therefore extra funding must be provided by the state). Centralised wage bargaining is another problem infringing on local autonomy. There is a large imbalance between nationally negotiated wages and the productivity of health care workers in less developed regions, itself usually reflecting poor quality of local public administrations and unfinished health sector investments.[74] Thus, resources may be squandered on excessive labour costs without ever attaining the desired level of national standards.

In conclusion, the case of the health care sector highlights the key question regarding the new constitutional arrangements (and their further amendments): what do they do to address the longstanding problem of local service provision and public personnel policies, which are far more opaque and distorting than (means-tested) cash transfers at the national level as a main tool of regional redistribution? Distorted incentives imply that despite equal per capita resources, health service quality is significantly lower in less developed regions. There is a grave risk that recentralising much of regional financing with a major role for equalising transfers as has been the case, while imposing common national standards on local service delivery as required by the constitution, on top of uniform wages as is longstanding policy, will only weaken incentives to close this gap as moral hazards would be particularly high.[75]

A more efficient allocation of resources would emerge if regions were to be fully responsible for *both* provision and financing of health care services on their territory, given an efficient system of regional equalisation based on objective criteria. Political competition to win local votes, national recognition, and even central government grants *via* a satisfactory level of services would provide the necessary incentives. This approach

Table 2.7. **Regional health supply indicators**

Indicators	North	Center	South	Italy
In-patient beds per 1 000 population	4.7	4.8	4.0	4.5
Average in-patient beds for each health care establishment per 10 000 population	46.1	37.3	34.6	41.6
Employment-to-beds ratio	77.9	80.1	75.0	77.4
General practitioners per 10 000 population	8.1	8.7	8.0	8.2
National health system staff per 10 000 population	123.8	115.5	100.5	113.8
Resident population for each general practitioner	1 242	1 143	1 245	1 223
Number of Local Health Care Units	88	41	68	197
Resident population over 65, per cent of resident population	19.4	19.6	15.7	18.1

Source: ISTAT, Health for all, 2003.

Box 2.5. **Recommendations in fiscal policy**

Budget and debt

Reduce debt on a sustained basis, in line with commitments undertaken in DPEF: over the medium term, raise primary surplus by ½ per cent per year, toward the 5% mark, allowing a moderate budget surplus which should be maintained at least until the Maastricht debt criterion is reached; Phase out one-off measures by 2006; Accelerate privatization of economic enterprises, including in network industries and at local levels, making this a primary means of attaining the € 100 billion privatization target of the DPEF.

Reach 2005 budget goals: increase consolidation measures in 2005 in order to counter risks of slower growth and likely continued inclusion of Anas in the general government; revise studi di settori early in 2005 in order to reach end-year targets for counter-evasion collections; monitor closely current spending at all levels of government to stay within 2% budgeted growth caps.

Set budget priorities while consolidating: make room for pro-growth tax cuts and greater infrastructure, education, and security spending by reducing other primary spending sufficiently; prioritise also within the primary current spending envelope to meet demands from population ageing, rising female participation, and growing labour market insecurity.

Increase budget transparency: ascertain future budget costs of lease-back and bond service obligations before selling or securitizing government real estate, and of contingent government liabilities on PPPs before approving them; Continue to investigate reasons for growing difference between government net borrowing requirement and net lending, in order to better manage debt dynamics; As noted in previous Surveys, introduce economic rather than accounting concepts in budgeting, switch to multi-year budget framework, and common accounting methodology across different government levels.

Taxes

Reduce tax wedge to increase incentives to formal work: implement second phase of personal income tax reform, subject to the budget constraint, while limiting sharp increases in marginal tax rates at lower to middle incomes *via* tax allowances; Expand the deduction for labour costs in IRAP, likewise subject to budget constraint; Use widening of tax base (thanks to lower tax rates and better compliance) to provide fiscal alleviations of employer social charges for low-skilled workers.

Make tax enforcement more effective: credibly commit to no more tax amnesties; do random rather than systematic audits of largely compliant large firms, releasing scarce resources of the tax authority for "making its presence felt" everywhere throughout the economy; apply fair and equal treatment in enforcement; tighten rules for "thin capitalisation".

Expenditures

Pursue more near-term pension savings, complementing recent pension reforms: start raising retirement age earlier than 2008, and more gradually, or alternatively; subject all workers previously exempted from the Dini reform to the pro-rata system immediately (2005); Update pension parameters (for life expectancy and real growth) in 2005, as required by law.

Build a private funded pension pillar to ensure sustainability of pension reform: provide clear information to workers on expected income replacement rates on public pensions, and require transparency in private pension fund management fees; Strengthen perceived safety of private pensions by passing the financial supervision reform; Weigh potential deadweight losses due to savings diversion when considering tax incentives; More generally, pursue pro-growth policies to enhance the capacity for, and returns to, private savings.

Box 2.5. **Recommendations in fiscal policy** *(cont.)*

Contain public employment and wage growth: require net reductions in central government employment as the counterpart to devolution of functions to lower levels, including revision of labour contracts to allow reassignment and reclassification of personnel; in coming years, use retirement of baby boomers as opportunity to substantially shrink public sector payrolls; Impose a hard 2% annual ceiling on wage growth, including wage drift, over 2005-07, allowing no subsequent "catch-up"; review criteria and practices for awarding performance bonuses to managers.

Rationalise corporate subsidies: convert subsidies into soft loans for private firms in depressed areas as planned; reduce subsidies to railways, post, and Anas, by progressively privatisating these entities; enforce transparent administration of credit subsidies by banks and make on-budget provisions for bad loans.

Make greater use of market mechanisms in devolved government services: privatise local government services where appropriate and otherwise introduce fees, copayments, and income-contingent loans to restrain and better allocate demand, notably in health care and education; make greater use of outsourcing and exposure to competition *via* market opening to enforce greater efficiency of provision.

Federalism

Expand lower level fiscal and spending autonomy: replace shrinking IRAP tax base by alternative own new taxes for regions, according to principles of correlation (with spending responsibilities) and tax efficiency; finalise work by High Commission on Fiscal Federalism; make national standards in health care and other areas both minimal and general to allow sufficient regional autonomy; allow decentralized wage bargaining in public sector taking into account regional cost-of-living and productivity differences.

Harden lower level budget constraint: implement Law 56/2000 on cross-regional equalization of resources (using national VAT receipts) based on regional tax capacity, with less than 100% equalization, replacing discretionary central government grants; allow golden rule to operate at lower levels in line with new constitutional arrangements while limiting guarantees of lower level debts; credibly enforce new budget monitoring procedures and sanctions for overshooting 2% spending growth caps at lower levels.

already seems to working in the area of territorial investment policy, where a national programme linked to EU transfers and emphasising the responsibility of local authorities, and competition among them, has vastly increased their capacity to develop (and finish) projects and absorb EU structural funds. The sharp reduction of corporate subsidies, going mainly to the South, goes further in the direction of reducing the "dependency culture" and stimulating a market culture. The same logic should apply to health, education and other local services. At the same time, however, it would be essential that a proper social safety net, based on transparent cash transfers to individuals, should be instituted at the national level as the primary mechanism to deal with regional income disparities.

Notes

1. The package also included € 2 billion in unspecified savings, revealed at end-year to consist of anticipations of future tax receipts. The tax amnesty was also extended back to the tax year 2002. These increased the uses of one-off measures (to € 20 billion, or 1½ per cent of GDP) above what had been originally planned.

2. According to preliminary Istat estimates, the full year deficit came in at 3% of GDP. This included the effects of a reclassification of capital injections into the state railroads as agreed with Eurostat, *i.e.* from a financing to a capital transfer item, which added 0.3% to the annual deficits since 2001. Thus, on the basis of unchanged accounting, the 2004 deficit was 2.7% of GDP, below the original target of 2.9%.

3. Chapter 1 has argued that prime reasons for slow growth may have been the persisting high debt, fiscal pressure and reform uncertainty on the one side, and weak domestic competition on the other.

4. Further details unveiled in 2005 include enhanced access by the fiscal authority to bank records, not only of firms as formerly but also of self-employed professionals. See Il Sole 24 Ore, 6 January 2005, p. 15.

5. A revised 2005 Budget including the tax package (and other more minor changes) was submitted by the government at end-November in the form of a "maxi-amendment" to its original budget proposal, and at end-year it was passed by Parliament by means of a confidence vote.

6. The 1998 tax reform resulted in a significant reduction in the tax burden on capital income and capital stocks (wealth). Also, the self-employed paid substantially less social security contributions as a result of the 1998 reform, although the availability of collaborazioni coordinate e continuative (similar to self-employment) may have been more instrumental in reducing undeclared work.

7. OECD (2001). The latest DPEF presents a graph clearly suggesting a negative correlation between growth and tax pressure in large advanced countries. Adding smaller countries (*e.g.*, Scandinavian) gives no clear relationship, however (see Sella, 2004). Hence, an econometric approach which can control for other factors is required.

8. A deduction of € 7 500 is granted for dependent workers (formerly the tax-exempt income level for employees was around € 6 000); € 7 000 for pensioners; € 4 500 for self-employed; and € 3 000 for all others. The deduction decreases linearly up to € 33 500 for employed income; € 33 000 for pension income; € 30 500 for self-employment income; and € 29 000 for all other types of income.

9. Though the reform was targeted to lower income earners, it may have benefited wealthier taxpayers insofar as the expansion of the no-tax area may have increased the after tax return for second earners, including spouses and children of high-income individuals. Another criticism made in response to the 2003 tax cuts was that corresponding cuts in social services hit the poor harder than the rich (see various statements by CGIL trade union). It is partly because of such political economy implications that welfare spending cuts have been declared off-limits in 2005-06 by the DPEF.

10. The fiscal authority considers the 43% effective rate on incomes above € 100 000 as a fourth statutory rate for all practical purposes (see Il Sole 24 Ore, 4 January 2005, p. 21), although the updated Tax Law (Testo Unico) states that there are only three statutory personal income rates. The latter may reflect that the government intends to abolish the high-income surcharge once budget conditions permit.

11. The previous system of tax credits will be replaced by a schedule of tax deductions as follows: € 3 200 for dependent spouse; € 2900 for each dependent child; € 3200 for each dependent child of single-parent families; € 3700 for each handicapped child; € 550 additional amount for children under 3 years of age; € 1820 for personal care expenditures for "non-auto-sufficient" persons. The allowable combined deduction declines with income net of deductible expenses up to € 78 000, according to the following transformation coefficient: Coeff = (78 000 + Deduction – Net Income)/ 78 000. If this coefficient is equal to or greater than one, then the full amount of the deduction applies; if it is zero or less, there is no deduction; at intermediate ranges taxpayers receive a partial deduction as determined by the size of the coefficient.

12. This includes a small impact on TFR tax payments and on lower level government surcharges on the personal income tax.

13. According to an analysis by Cer-Spi (2004), one half of the total fiscal benefits go to the upper two income deciles and two-thirds to the upper four. The cost of the tax allowances for lower incomes are around € 1 billion whereas that of the tax cuts themselves are € 6.4 billion, giving a total fiscal cost of € 7.4 billion.

14. The credits were available to all income groups and constant within each tax bracket. Besides credits for spouse, children, and type of income (dependent worker, pensioner or professional), a credit with a tax rate of 19% and subject to maxima was granted among others for expenditures on health, education, mortgage interest on first home, and life insurance.

15. While a tax credits and a tax allowance are of equal value for a given tax rate, they may have different effects in progressive systems.

16. Higher consumption could then translate into improved incentives to invest *via* typical accelerator effects, thus raising growth not only in the short term but also in the medium term.

17. See Italian Government (2004a).

18. See Banca d'Italia (2004). Furthermore, a recent survey conducted by www.lavoce.info suggests that only around one-third of the proposed next phase of tax cuts would translate into higher consumer spending (see Pisauro and Monti, 2004).

19. Marginal tax rates are likely to be more important for eliciting effort of persons already in the workforce (*i.e.*, the number of hours worked) while the decision of whether or not to join the workforce, and the decision of whether to retire/go on benefits or work, is more related to average tax rates. Furthermore, most empirical studies seem to indicate that substitution effects are rather low for medium/high incomes and higher for low income and married women. In addition, the effects of taxes might be stronger on the decision of whether to work or not than on the number of hours worked for those already employed. And for the decision on whether to work or not, it is the average tax rate that matters; hence, lower METRs and lower AETRs work in the same, positive direction for this group.

20. At high income levels, average and marginal tax rates tend to equalise.

21. According to Keen (2002, p.55), "The effects of a decision of whether or not to participate in the formal sector could plausibly be more powerful than on the effort supplied by those already in the formal sector".

22. However, in this way the contribution method for pension benefit calculations would be broken. Thus, fiscal contributions to the charges on lower skill workers could be envisioned.

23. Indeed, the taxpayer income distribution depicted in Figure 2.1 may be heavily skewed toward the left by the prevalence of undeclared income, which exposes more people to the tax benefit traps at low incomes.

24. The Italian employers' association has brought a suit before the European Court claiming the inadmissibility of IRAP. However, as Keen (2002) points out, IRAP is an origin-based VAT, and it is interesting that there is no similar opposition to the VAT.

25. This however, is also true of the regular value added tax, which is levied at the consumer rather than firm level, and even more so of the old health care charge which was replaced by the IRAP.

26. The German Länder have imposed two types of business taxes, one on capital which has been phased out and another on profits about which reforms are being discussed.

27. In the last months of 2004, there was a policy debate about the desirability of putting more of the emphasis of the tax reform on IRAP than on IRE, giving the urgent need to improve national competitiveness. However, in the end the main focus was put on IRE, *i.e.* the personal income tax.

28. The former tax credit amounted to € 440 per worker per month in the Centre-North, and € 660 in the South. The new IRAP deduction provides a maximum tax benefit of around € 70 per worker per month in the Centre-North (IRAP tax rate of 4.25% applied to maximum annual eligible wage of € 20 000) and € 140 in the South.

29. See Confindustria (2003).

30. The DIT applied a reduced rate of 19%, as opposed to the standard rate of 36%, to new investments funded by equity issue, subject to the constraint that the average tax rate cannot fall below 27%.

31. This allows tax credits for taxes paid by subsidiaries abroad and for dividend payments and disposals of shares within domestic and international groups.

32. An elegant method of taxing capital gains on an accruals basis, the "equaliser", was also scrapped.

33. Capital gains from the sale of participations by "qualified" shareholders (*i.e.*, those holding more than 5% of listed company stocks or 25% of non-listed company stocks) are subject to ordinary taxation of 40%.

34. See 2002 Survey. Also, according to ISAE (2003a), the main beneficiaries of the Dit were in the utilities, metals, means of transport, rubber, wood, and food processing sectors. The latter study suggests that the benefits of "Tecno-Tremonti" are also not likely to be widely distributed, mainly favouring companies between 250 and 500 employees (comprising only 0.15% of the firms in the

database) and those belonging to the sectors of mechanics, means of transport, and information technology.

35. See ISAE (2003a).

36. This assumes that financial investors increase at the same time their "home bias" regarding the geographical allocation of their funds.

37. In the popular view, including that of the trade unions, the tax-evaders cover many employers, self-employed and investors of funds abroad, and so they were the main beneficiaries while honest people (mainly covering formal dependent workers) were implicitly penalised, as penalties fell substantially short of the amount of back taxes due.

38. See Zangari and Federi (2003). Also, the fact that the deadline for the 2003-06 tax agreements was extended well into the first tax year covered by the agreement could have had especially large moral hazard effects, though in the end the programme was not largely subscribed.

39. There also may be efficiency gains from information collected in the course of the amnesties.

40. See Il Sole 24 Ore, 12 August 2004.

41. See Burniaux *et al.* (2003).

42. The last of these fully exempted workers will retire around 2012-2017, putting a heavy burden on the system. Younger workers looking forward to far less generous public pensions must continue to pay for the pensions of these more fortunate older workers for some time to come. The system will be fully under the Dini rules around 2030-2035, when the last of the workers with less than 18 years' service in 1995, who were put onto the new system on a pro-rata basis, will have retired. Spending thus peaks around these later years, and thereafter declines.

43. Sweden, the only other OECD country having introduced a virtual defined contribution system, put all workers on the new system on a pro-rata basis immediately. The transition to the new system is 16 years, compared with 37 years in Italy, at far less cost. See Boeri (2004).

44. Under the Patto per l'Italia, a 2002 agreement mainly to reform the labour market, it was agreed that a review of the pension system would have to be undertaken by the social partners later on. The idea at that time was to use the savings from any further pension reform to finance a strengthening of the social safety net, notably a badly needed universal unemployment insurance scheme. This was to be distinguished from the regular 10-yearly review of the pension benefit parameters, the first of which in 2005, in order to update them mainly in line with new information about life expectancy but also growth.

45. This refers to employees. For self-employed, the age window will be 63-65 for men and 60-65 for women.

46. See Boeri (*op. cit.*).

47. Boeri (2004), for example, recommends starting in 2005 rather than 2008, gradually moving the retirement window from 57-65 currently to 59-67 (say by 3 months per year), while introducing automatic adjustments for life expectancy within the window.

48. Workers exempted from the Dini reform had at least 18 years of contribution in 1995. Thus, they now have have at most 7 years to go before retirement (as 35 years of contributions are the required minimum for retirement). Hence, putting such workers on a pro-rata basis along with the others yields less savings each year that this step is delayed, though at present these savings are still are non-negligible

49. Boeri, *op. cit.*

50. However, tenure among older workers tends to exceed that of younger ones.

51. See OECD (2004a) and Marano and Sestito (2004), both stressing the need for more policy attention to the sizeable human capital gap related to age. The latter authors also note that pension schemes are used in Italy at relatively young ages to solve redundancy problems, as unemployment benefits and targeted labour market policies are underdeveloped.

52. Yoo and de Serres (2004), show that despite significant variations in the size of pension tax subsidy across OECD countries, most incur a sizeable positive net tax cost. However in countries such as Sweden and Italy who partly tax accrued return on investment, the cost is on the low end.

53. See Garibaldi and Pacelli (2004).

54. See Guzzo (2004), United States, United Kingdom, and Netherlands pension funds are highly developed and could serve as good models. They (nominally) put worker contributions in equities

while the workers are young, then gradually put them into fixed-interest securities in order to safeguard capital as workers approach retirement age.

55. As noted in previous Surveys, its main lines are: *i)* making public sector managers more accountable to the democratically elected political level, using a results-oriented approach based on fixed term contracts and performance related pay; *ii)* "privatising" the civil service by way of competitive hiring, performance reviews and performance related pay; *iii)* regulatory simplification; *iv)* decentralising functions.

56. The figure for Turkey may be biased upward by the very low total employment number appearing in the denominator, as an estimate for informal employment is not included in this figure, as it is in Italy. The size of the informal sector in Turkey is estimated at 50% of the total economy.

57. The cost of new hires for all state administrations and national public bodies cannot all together exceed € 70 million for 2004 and € 280 million for the next years. Within this amount, recruitment of new personnel is allowed only in public safety, international affairs, national defence, urgent rescue and civil protection for calamities, protection of the environment, justice, consumer protection, agricultural protection, cultural protection, internal affairs ministry competences and successful candidates from past public competitions. According to the law, all new hires must be authorised with a Governmental decree.

58. *Source:* Ministry of Public Administration.

59. For example, agricultural policy has been decentralised but there are now reportedly twice as many people employed in this area as before devolution. Other examples of this sort are numerous, as the bureaucrats in question were unwilling to move and were protected from lay-offs by rigid contracts and regulations.

60. In earlier discussions, the government proposed using corporate welfare cuts to pay for the tax cuts, on the theory that tax relief would help compensate firms for loss of subsidies.

61. At end 2004, a public real estate Fund (Fondo Immobili Publici) was set up, to which 396 government properties were transferred and will later be sold, with a combined value of € 3.3 billion (net of a 10% discount), helping to meet the budget deficit target in 2004 and implying permanent savings of about 1% per year (see next footnote). The properties will then be rented back to the government.

62. Average maintenance costs in the public sector are 3.5% of asset value, against 0.5-2% in the private sector. Also, spare office capacity in the public sector is higher than in the private sector, suggesting rationalisation gains. See Ministero dell'Economia e delle Finanze, Ufficio Stampa, 29 December 2004.

63. Estimates range from around € 40 billion to € 55 billion, compared with 2001 regional spending of € 165 billion, and usually assume that the "Bossi" reform will pass. See ISAE (2003b), Reforme Associazione (2004) and Assonime (2004).

64. See Vitaletti (2004).

65. This decision was defended by the Constitutional Court, which ruled that the IRAP was a national, not regional, tax.

66. The regions were originally given the right to decide variations of +/–1% on the rate of IRAP around its central level of 4¼ per cent, as well as to provide tax reliefs to selected firms.

67. Though the initial budget draft had this provision, it was withdrawn with the revised budget incorporating the tax cut package, but then in the end reinstated in the process of the parliamentary discussions.

68. See Confindustria (2002).

69. See Bordignon and Giarda (2004)

70. Note that the constitution allows borrowing for local government investments, without any specified limit, and without guarantees by the state.

71. See Cer (2003). Spain has also implemented a range of reforms in pharmaceutical spending (OECD, 2004b).

72. Bordignon *et al.* (2002).

73. Bordignon *et al.* (2002) provides measures of health care outcomes (such as infant mortality) that perform much more poorly in the South.

74. A national Senate hospital inspection commission has uncovered widespread failures in the southern regions, including abandoned unfinished hospitals and large stocks of unused pharmaceuticals, implying large-scale waste of public resources. There are also major problems of hygiene and lacking facilities in the functioning public hospitals, and public psychiatric facilities show especially severe problems. Alongside these are modern, clean, and efficient private hospitals. See Il Sole 24 Ore 31 August 2004.

75. Boldrin (2002) states that the Italian political equilibrium for the last 50 years has been based on the central government transferring substantial resources from one set of regions to the other. Any reform that makes such transfers hard to achieve would destroy the existing political equilibrium, which would be "suicidal" for politicians, and quite naturally resisted. Thus, the major problem for this author seems to be "coalition-based" regional redistribution, rather than merely a soft budget constraint most often cited in the literature.

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ANNEX 2.A1

Statistical background

Table 2.A1.1. **Budget measures for 2005 and their impacts in 2005-07**

€ millions, changes relative to baseline

	2005	2006	2007
Corrective measures (– A + B + C – D)	**23 959**	**14 200**	**15 400**
(% of GDP)	1.7	1.0	1.0
A) Expenditures	**–9 715**	**–8 829**	**–9 602**
Application of the 2% growth ceiling	**–9 137**	**–8 702**	**–9 674**
Intermediate consumption	–4 800	–5 417	–6 324
Other current expenditure	–2 257	–2 250	–2 395
Capital expenditure	–2 080	–1 035	–955
Other (net)	**–578**	**–127**	**72**
Lower spending (includes Demanio[1])	–1 570	–577	–318
Higher spending	992	450	390
B) Revenues	**5 744**	**3 871**	**4 298**
Revenue-raising measures	**7 204**	**4 058**	**4 377**
Property rental income evasion	316	432	503
VAT evasion	190	190	190
Sector studies	3 804	1 957	2 166
Special regimes and misc.	1 664	396	402
Local taxes	778	736	767
Non-tax receipts	348	348	348
Demanio[1]	105	0	0
Extension of tax reliefs	**–1 460**	**–187**	**–79**
C) Disposals of public assets	**7 000**	**0**	**0**
D) Debt restructuring	**–1 500**	**–1 500**	**–1 500**
Primary balance	**33 809**	**28 570**	**36 300**
(% of GDP)	2.4	1.9	2.4
Interest payments	**72 500**	**74 500**	**80 200**
(% of GDP)	5.1	5.0	5.2
Net lending	**–38 691**	**–45 930**	**–43 900**
(% of GDP)	–2.7	–3.1	–2.8
Further measures required	**0**	**16 380**	**22 301**
(% of GDP)		1.1	1.4
Programmed net lending	**–38 691**	**–29 550**	**–21 600**
(% of GDP)	–2.7	–2.0	–1.4

1. Demanio is the agency for evaluation of public assets.

Source: Ragioneria Generale dello Stato (2004), *L'economia italiana nel 2005*, *Relazione Previsionale e Programmatic Sezione II*.

Table 2.A1.2. **The 2005 tax reform package**

In € million

	2005	2006	2007	2008
Budget costs	**4 978**	**8 209**	**7 637**	**7 908**
Business value added tax (IRAP)	0	496	582	753
Credits for new hires	0	315	484	655
Credits for research activity	0	181	98	98
Personal income tax (IRE)[1]	4 261	6 690	5 982	5 982
Spending increases[2]	717	1 023	1 073	1 173
Budget coverage	**5 230**	**8 295**	**8 103**	**8 350**
Spending cuts	4 051	3 758	4 404	4 621
Real estate amnesty	2 000	0	0	0
Partial hiring freeze	418	1 084	1 695	1 912
Purchases of goods and services	1 100	1 900	1 900	1 900
Education	47	198	273	273
Corporate subsidies	260	330	260	260
Others[3]	226	246	276	276
Widening of tax base	562	822	771	801
Tax increases	618	3 714	2 928	2 928
Cigarette excise	0	1 000	1 000	1 000
Sport and games	48	304	608	608
Stamp duties	570	1 120	1 320	1 320
Acceleration of tax instalments	0	1 290	0	0

1. Includes second round impacts on TFR (€ 125 million per year) and regional surcharges (€ 28 million as of 2007).
2. University fund (€ 417 million in 2005 and € 653 thereafter), wage increases 2004-2005 (0.54%), interest subsidies for enterprise rotating fund, and other fund costs.
3. Selected benefits (€ 106 million per year), Sogin (€ 100 million per year), and miscellaneous (€ 20, 40, 70 and 70 million in 2005-2008 respectively).

Source: Italian Government, 2005 Financial Law.

Table 2.A1.3. **Trends in public spending by economic category**

Per cent of GDP

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004[1]
Government wages	11.2	11.5	11.6	10.7	10.7	10.6	10.8	10.8	11.0	11.3
Goods and services	6.6	6.6	6.6	7.3	7.4	7.7	8.1	8.1	8.4	8.2
Social security outlays	16.7	16.9	17.3	17.0	17.2	16.7	16.6	17.0	17.2	17.3
Subsidies	1.5	1.5	1.2	1.3	1.2	1.2	1.2	1.1	1.1	1.1
Other current transfers	2.4	2.7	2.7	2.8	3.0	2.9	2.9	3.0	3.0	3.0
Interest on public debt	11.5	11.5	9.4	8.3	6.8	6.5	6.6	5.9	5.4	5.3
Total current spending	49.9	50.6	48.8	47.3	46.2	45.6	46.1	45.9	46.2	46.2
Net capital outlays	3.4	2.6	2.3	2.6	2.7	1.3	2.6	2.1	2.8	2.5
Total expenditures	53.4	53.2	51.1	49.9	48.9	46.9	48.7	48.0	48.9	48.7
Memorandum items:										
Total expenditures for										
OECD[2]	42.4	42.0	40.8	40.4	40.2	39.4	40.4	40.9	41.2	40.8
Euro area[2]	51.4	51.4	50.0	49.2	48.8	47.1	48.2	48.5	49.1	48.8
Total expenditures excluding interest on public debt and real estate sell-offs[3]	41.8	41.7	41.7	41.6	42.1	41.5	42.3	43.0	43.7	44.1

1. OECD estimates.
2. Weighted using 1995 GDP and purchasing power parities. Average of available data.
3. Real estate sell-offs are counted as negative capital outlays and include 2001-2004 securisation operations, sell-off of real estate to Fintecna and others in 2002, and sell-off of public owner occupied real estate in 2004.

Source: OECD, Economic Outlook 76 database.

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Table 2.A1.4. **Privatisation programme for public enterprises**

	Ministry of Treasury							IRI[1] and ENI groups					Total cumulative proceeds (billion euros)
	Company	Phase	Sector	Date	% share		Proceeds (billion euros)	Company	Sector	Date	% share	Proceeds (billion euros)	
1992								Various	Various			0.6	
													0.6
1993								Finanziaria Italgel	Food	Aug.	62.1	0.2	
								Finanziaria CBD	Food	Oct.	62.4	0.2	
								Credito Italiano	Bank	Dec.	54.9	0.9	
								Various	Various			1.3	
													3.2
1994								Banca commerciale					
	IMI	1st	Bank	Feb.	27.5	Minority share	0.9	italiana	Bank	Feb.	51.3	1.5	
	INA	1st	Insurance	June	47.3	Minority share	2.3	Acciai Speciali Terni	Iron and steel	July	100.0	0.3	
								SME 1	Food	Dec.	32.0	0.4	
								Various	Various			2.1	
							3.3						10.8
1995								ILVA Laminati					
	IMI	2nd	Bank	July	14.5	Minority share	0.5	Piani	Iron and steel	Mar.	100.0	1.3	
	INA	2nd	Insurance	Oct.	18.4	Minority share	0.9	SME 2	Food	Aug.	14.9	0.2	
	ENI	1st	Petroleum	Nov.	15.0	Minority share	3.3	Various	Various			2.4	
							7.9						19.2
1996													
	INA	3rd	Insurance	June	31.1	Residual shares	1.7	Various	various			1.8	
						Residual		*of which:* GS/					
	IMI	3rd	Bank	July	6.9	shares	0.3	Autogrill	Food	May	15.2	0.1	
	ENI	2nd	Petroleum	Nov.	15.8	Minority share	4.6						
							14.4						28.7
1997	San Paolo di Torino		Bank	June	3.4	Residual shares	0.2	Various	Various			1.4	
	Banco di Napoli		Bank	June	60.0	Controlling shares	0.0	*of which:* Banca di Roma	Bank	Dec.	14.4	0.3	
	ENI	3rd	Petroleum	July	17.6	Minority share	6.8						
	Telecom Italia		Telecom-munica-tions	Nov.	28.0	Controlling shares	11.8						
	SEAT		Publishing	Nov.	44.7	Controlling shares	0.9						
							34.1						50.3
1998	ENI	4th	Petroleum	July	14.2	Minority shares	6.7	Various	Various			2.2	
	Banca Nazionale del Lavoro (BNL)	1st	Bank	Sept.	25.0	Controlling shares	1.3	*Of which:*					
	Banca Nazionale del Lavoro (BNL)	2nd	Bank	Dec.	42.1	Controlling shares	2.1	Alitalia	Transport	May	18.4	0.4	
								Banca di Roma	Bank	Dec.		0.12	
							44.3						63.23

Table 2.A1.4. **Privatisation programme for public enterprises** *(cont.)*

	Ministry of Treasury							IRI[1] and ENI groups					Total cumulative proceeds (billion euros)
	Company	Phase	Sector	Date	% share		Proceeds (billion euros)	Company	Sector	Date	% share	Proceeds (billion euros)	
1999	ENEL	1st	Energy	Nov.	31.7	Minority shares	16.6	Various	Various			5.7	
	Mediocredito Centrale	1st	Bank	Dec.	100.0	Controlling shares	2.0	Of which					
	UNIM		Property	Dec.	7.5	Residual shares	0.03	Autostrade	Motorways		57.0	4.2	
							62.9						87.6
2000	Credito Industriale Sardo		Bank	May	53.2	Controlling shares	0.02	Various	Various			10.3	
	Meliorbanca		Bank	July	7.2	Residual shares	0.03	Of which					
	Mediocredito Lombardo		Bank	July	3.4	Residual shares	0.04	Autostrade	Motorways	Mar.	30.0	2.5	
	Banco di Napoli		Bank	Nov.	16.2	Residual shares	0.5	Finmeccanica	Aerospatial/ Defence	June	43.7	5.5	
								Aeroporti di Roma	Airport	Aug.	54.2	1.3	
							63.5						98.4
2001	ENI 5		Petroleum	Feb.	5.0		2.7	Various	Various				
	Beni Stabili S.p.a.			June	0.3	Residual shares	0.0	Of which					
	San Paolo IMI			June	0.4	Residual shares	0.8	Cofiri		Feb.	100.0	0.5	
	Mediocredito Centrale 2		Bank	July	0.3	Residual shares	0.0						
	BNL		Bank	Dec.	1.3	Residual shares	0.1						
	Mediocredito dell'Umbria		Bank	Dec.	6.9	Residual shares	0.01						
							67.1						102.6
2002	Cariverona			Jan.	0.01	Residual shares	0.0	Various	Various			0.01	
	Mediovenezie			Jan.	0.2	Residual shares	0.0						
	Mediocredito Toscano		Bank	Feb.	6.5	Residual shares	0.02						
	INA		Insurance	April	0.01	Residual shares	0.0						
	Generali			April	0.2		0.07						
	MedioCredito Fondiario CentroItalia		Bank	May	3.4	Residual shares	0.01						
	Telecom Italia	2nd	Telecom-munica-tions	Dec.	4.1	Residual shares	1.4						
							1.5						
							68.6						104.1

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Table 2.A1.4. **Privatisation programme for public enterprises** *(cont.)*

	Ministry of Treasury							IRI[1] and ENI groups					Total cumulative proceeds (billion euros)
	Company	Phase	Sector	Date	% share		Proceeds (billion euros)	Company	Sector	Date	% share	Proceeds (billion euros)	
2003	Mediocredito Friuli Venezia Giula		Bank	Oct.	34.0	Residual shares	0.1	Various	Various			0.03	
	ENEL	2nd	Energy	Nov.	6.6	Minority shares	2.2						
	ETI		Tobacco	Dec.	100.0	Residual shares	2.3						
	Cassa Depositi e Prestiti			Dec.	30.0		1.1						
							74.2						109.7
2004	Coopercredito			April	14.4	Residual shares	0.02						
	ENEL	3rd		Oct.	19.0	Minority shares	7.6						
							81.8						117.3

1. Fincantieri since December 2002.

Source: Ministry of Finance, Treasury department, *La relazione sulle privatizzazioni*, various issues.

ANNEX 2.A2

Legislative developments in Italian federalism

The push to federalism during the 1990s and 2000

The constitutional reform implemented in 2001 has changed the Italian institutional framework defining the fiscal relations across the different levels of governments towards a more federalist structure. However changes in the direction of a higher degree of autonomy for the Italian sub-central governments have been introduced since the early 90's. The principal innovations could be briefly summarised as follows:

- the legislative decree No. 77/1995 which reforms the accounting system of local authorities;
- the legislative decrees No. 504/1992 and No. 244/1997 which change respectively the transfer schemes from the central government to local authorities (provinces and municipalities) and to regions;
- the law decree No. 41/1995 and the law No. 133/1999, implemented by the legislative decree no.56/2000, which abolishes transfers to regions and substitutes them with tax sharing schemes;
- the law No. 662/1996 and the implementation decree No. 446/1997 which establishes IRAP, a new regional tax on productive activities which incorporates some of the existing local taxes;
- the transformation of specific grants into general grants and the abolition of the national fund for health care.

The Bassanini laws (laws No. 59/1997 and No. 127/1997 and successive implementation decrees[1]) were introduced to strengthen the responsibility of local governments towards their residents, rationalising public administration. The first Bassanini law allocated to Regions competences and controls on issues related to agriculture, transport and trade, industrial and energy sectors, public investment, community amenities, cultural and historic heritage, education and professional training. The Bassanini reform represented an important step towards administrative decentralisation, still within the context of an unchanged Constitution: it introduced important principles in the definition of the fiscal relations across levels of government such as the principles of subsidiarity, efficiency, cost-effectiveness, responsibility, adequacy and differentiation, and it was to be implemented at zero additional costs for the general government.

Another important step towards a higher degree of financial regional autonomy, and which partially anticipates some of the issues of the constitutional reform, is represented

by the legislative decree No. 56/2000. This decree substitutes the central transfers and the national fund for financing both current and capital health spending with tax sharing schemes. In particular, it establishes the regional share to the national VAT and it indicates the range of increase of the tax rate (from 0.5 to 0.9%) of the surcharge on Irpef, the national personal income tax, and of the regional share on the excises on gasoline. Moreover, the decree introduces a mechanism for the allotment of the sharing on VAT, which is based on the equalisation of the spending needs and the fiscal capacity of regions.

All these new changes allowed the move from a top-down financing model to a more decentralised system which culminated with the 2001 reform of the Constitution.

The 2001 reform of the Constitution

Changes have been introduced with the constitutional law No. 3 of 2001. They relate to Title V of the Constitution, with particular reference to the following articles:

- Title V – article 117 : the new amendments modify the allocation of legislative powers between the central government and regions: on one side, there are competences under the exclusive responsibility of the central government (exclusive State competences); on the other, there are concurrent competences between the central government and regions; all those not listed as exclusive State competences or concurrent competences are attributed to the exclusive legislative power of regions;
- Title V – article 118: the new amendments introduce the subsidiarity principle, according to which all functions are exerted by municipalities, being preserved the possibility to confer them to higher levels of governments (metropolitan cities, provinces, regions, central state), so to guarantee the uniform implementation of spending functions across the country;
- Title V – article 119: the new amendments relate to the financing of sub-central governments and introduce the possibility for lower levels of government to establish and levy own taxes and other own revenues in accordance with the Constitution and in co-ordination with the national public finance and tax system. In addition, sub-national governments must be ensured with a sufficient amount of unconditional revenues such as own taxes or transfers – either in the form of tax sharing arrangements on national revenues or of equalisation transfers – to finance the newly decentralized spending functions. Specific grants can still be designed and allocated by the central government but only in favour of specific sub-central authorities and for specific objectives, which are explicitly mentioned in the same article of the Constitution.

The first implementation law was introduced in 2003 with the so called law *La Loggia* (law No. 131/2003). It does not intervene however in the implementation of the financial autonomy of the sub-central governments as formulated in article 119 of the Constitution. The law introduces a gradual transfer of exclusive as well as concurrent legislative competences to regions by delegating the central government to emanate legislative decrees on the general principles on the concurrent competences as indicated in the current legislative framework. Moreover the law states the procedures for the devolution of administrative functions to municipalities as indicated in article 118 of the new Constitution. In order to limit the possible occurrence of contentious proceedings between the state and the regions, the same law introduces: *i)* a procedure of compulsory, but not binding, positions of the two legislative parties; *ii)* the emanation of legislative decrees by

the central government to define the fundamental functions of provinces and municipalities.

The budget law for 2003 established (art. 3) the High Commission on Fiscal Federalism with the specific aim to define the general principles relating to the co-ordination of the national public finance and the tax system, following the headings on the structural schemes[2] provided by the Conferenza Unificata. The Commission was expected to conclude its works by autumn 2004 (as stated in the budget law for 2004), but its mandate was further extended with the budget law for 2005.

The proposed constitutional amendment

A major constitutional innovation (the so-called Bossi law) envisages the devolution to regions of exclusive legislative competence on issues related to:

- Health (health care and management), currently in the concurrent competences under the more general heading of "tutela della salute".
- Education: the Bossi proposal also introduces the possibility for regions to define school programmes which are strictly related to regional issues. In the current constitutional text, education lies within the concurrent competences which leaves the central government to emanate laws defining the general principles.
- Administrative police (*vigili urbani*): in the current version of the Constitution it is classified within the residual regional competences.

The Bossi proposal has been incorporated in the draft constitutional law *La Loggia*, which has been approved by the Parliament (Senate Act 2544-B on 23 March 2005). Since this law aims at changing the Italian Constitution, it should be approved a second time by both houses of Parliament later in 2005, and then confirmed by national referendum which is to be held in 2006. This law limits within more defined boundaries both regional and central legislative competences,[3] aiming also to reduce institutional conflicts generated by the increasing ambiguities in the interpretation of the current article 117. In particular, the proposal advocates the total elimination of concurrent competences and their subsequent allocation between regions and the central government on the basis of proportionality and adequacy criteria; it reintroduces the principle of the national interest and defines a transitory period during which, for the newly allocated competences, the current laws are still to be considered operating until the new Constitution is implemented.

Such a constitutional amendment furthermore aims to change the overall institutional framework of the Italian Republic (the so called "riforma dei saggi"). The government's constitutional proposal indicates the establishment in the Parliament of a Regional Chamber, which will substitute the current Senate and whose legislative competence will relate to regional issues. Only the lower House will still be subject to the political control of the government. In addition, the riforma dei saggi changes[4] the composition of the Constitutional Court by introducing the designation of four of its fifteen members by the Federal Senate and the Presidents of regions. Such institutional innovations should reinforce the autonomy of regions in the light of their increased legislative power: the aim is to incorporate in the legislative institutional procedures those co-operative decisional mechanisms already working within the *Conferenza Unificata*.

These new proposals do not change however article 119 of the Constitution. Hence no changes are made to the financing scheme of the sub-central governments (own tax

revenues, equalisation schemes) as designed in the current title V of the Constitution. Still, the financing mechanism of the federal system remains the fundamental aspect to be defined for the effective implementation of the constitutional reform.

The financing scheme in article 119 of the Constitution

According to article 119 of the Constitution, there are three main aspects that define the structure of the new financing system of the sub-central governments:[5]

- ordinary resources.
- additional resources.
- borrowing to finance investment outlays.

As to ordinary resources, the financing structure relies on the fundamental principle of fiscal autonomy. Sub central governments thus have the power to introduce own taxes within their boundaries (for regions it is a legislative power, while for other local authorities this power reduces to laws and rules relating to the implementation of regional or central laws). A second aspect is represented by the equalisation transfers, which should be determined by a central law and which should be allocated to regions according to their fiscal capacity (as stated in article 119). In addition, the use of the equalisation grants is not constrained by specific purposes of spending.

According to the current article 119 of the Constitution, the equalisation scheme should be based only on the fiscal capacity of decentralised governments, where no explicit mention to factors strictly connected to the authority's territory or spending needs is made. Hence the main objective relies on the equalisation of tax bases across the country. The new law proposals do not present however any implementation of the equalisation scheme that should be applied. Basically, there are two main problems that should be addressed when designing an equalisation transfer: *i*) the model to apply, whether of a horizontal or vertical type; *ii*) the level of solidarity, whether the equalisation should compensate for the divergences across governments fully or only partially.

The legislative decree No. 56/2000, noted above, indicates an equalisation scheme which is defined mainly on the basis of the tax capacity, rather than actual tax collections, which is important for incentives to maximise local tax collections, as well as on spending needs. It is also designed so as to reduce up to 90% of the divergences in terms of revenues across regions, also benefiting incentives. However, there is to be a transitional period wherein assessment of needs is based on historical spending. This decree is still operating until the central government emanates a new law to implement the reformed article 119 of the Constitution.

ISAE estimates[6] the spending needs of exclusive and concurrent regional competences at € 102 billion (almost half of which is already decentralised). These should be financed in three main ways:

- As to the equalisation transfers, the estimates indicate that they should amount to € 18 billion if the funding is based on past expenditure (spesa storica), at least in the first years of implementation so to avoid breaks in the funding arrangements. According to these estimates, the equalisation scheme should help finance 57% of the decentralised expenditure in Calabria, 55% in Campania and 42% in Puglia.
- The second point relates to additional resources and special contributions. They represent two important instruments for economic and social redistribution policies.

Such transfers are determined by central laws and explicitly refer to the following areas of intervention: *a)* to promote economic development, social cohesion and solidarity; *b)* to eliminate social and economic disparities; *c)* to enhance the effective exercise of individual rights; *d)* to provide for purposes other than those referring to the ordinary implementation of the decentralised functions. These additional contributions are thus addressed to specific sub-central governments with well defined needs. In this case the central government intervention relates to the specific needs of the local territory, and no mention to tax or income effort is made.

- The last point relates to borrowing: sub central governments are allowed to finance investment expenditure through borrowing (*i.e.* by loan-raising), while such financial instrument is not allowed to finance current expenditure. The law sets a limitation to the level of local borrowing, up to 25%. Moreover, no state guarantee is made on the debt issued at the local level.

Notes

1. Legislative decrees: no. 112/98 on economic development, productive activities, community amenities, environment and infrastructure, services for individual and collective care; No. 143/97 on agriculture; No. 469/97 on labour market; No. 422/97 on local public transport.
2. The structural mechanisms on fiscal federalism relate to the equalisation schemes and the definition and destination of special contributions.
3. Briefly, it has to be noted that some items currently in the concurrent competences, such as infrastructure and energy, are brought back in the exclusive state competence, while others, such as items related to productive activities, are transferred again from the exclusive regional competence to the exclusive central one.
4. This amendment has been already introduced in La Loggia draft law.
5. See Busillo, F. (2003), "Alcuni indirizzi per l'attuazione delle disposizioni in material di Federalismo Fiscale previste dal nuovo Titolo V della Costituzione", Centro ricerche e documentazione economica e finanziaria (Ce.R.D.F.), *www.ssef.it*, Ministry of the Economy and Finance, January.
6. ISAE Audition at the Senate of the Republic, 6 November 2002.

ANNEX 2.A3

Measures to enhance competitiveness

The government has recently proposed measures aiming at boosting competitiveness and fostering business activity. They are included in two different pieces of legislation:

1. *Draft Law No. 5736* has been submitted to Parliament and is imminent approval is expected.

- The new bankruptcy law streamlines the procedures, provides greater protection from creditors and makes it easier to preserve the assets of the firm in order to restructure itself and re-start business as an ongoing concern.
- Streamline the legal procedures and accelerate the time for ruling on litigation.
- The Technological Innovation Fund provides cash-advances (to reduce interest charges) for R&D expenditures.

2. *Decree Law No. 35/2005* was approved by the Senate on 4 May 2005 and its final approval is expected by 15 May 2005.

- New legislation increases the power of Arbitrators (*Giudice di Pace*) to settle litigations.
- De-regulation: procedures for starting new business activities have been reduced. Authorities must reply within 90 days, otherwise the authorisation is implicitly granted.
- Fiscal incentives are provided to encourage mergers among small and medium size firms.
- The IRAP on labour costs is reduced as follows: 100 000 euros per new employee in the Mezzogiorno and 60 000 euros for other under-utilised areas.
- The maximum length of unemployment compensation is increased by 1 month to 7 months for workers under 50 and to 10 months for workers over 50.
- Accelerate the financing (including the EU funds) for public works projects for the Mezzogiorno.
- Provide fiscal incentives for R&D and research grants to universities.
- Provide fiscal incentives for the agri-business sector.

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Chapter 3

Corporate governance and market liberalisation: the scope for improvement

The functioning of Italy's financial and product markets has undergone major changes since the 1990s. Households have shifted their savings to the equity and corporate bond markets. However, they have been hurt by a series of bond defaults that have highlighted the urgency of improving bankruptcy procedures, corporate governance and financial market supervision. Despite this, the bill reforming the financial sector is still under discussion by the parliament. In the product market, the liberalisation process is moving ahead in many sectors, notably energy. Nonetheless, public ownership is still widespread relative to most OECD countries. The role of independent authorities has been sometimes questioned. Professional services are still mostly exempted from antitrust jurisdiction. Devolution of powers at decentralised level has often preserved rents for retail trade and local public services. Greater commitment to reforms is needed to enhance the functioning of the Italian financial and product markets.

The structures and functioning of Italy's financial and product markets have undergone major changes during the 1990s and the beginning of the current decade. Thanks to privatisation, liberalisation and better regulation, the weight of the state in the economy has substantially decreased. Business and households have been adapting to a different environment, where competition, transparency and informed assessment of risks are crucial determinants for increased prosperity. This process has brought benefits. But in several areas, Italy lags behind best practice, in some cases because of slowness in the approval and implementation of proposed reforms.

This chapter describes recent developments in these markets. It focuses on the main issues that have arisen or have become more evident in the past two years. Since the second half of the 1990s, the fall in the real return on government bonds has induced many households to shift their savings to the equity and corporate bond markets. However, households have been performing risky operations often lacking an adequate expertise and in an environment where misbehaviour in providing information has been observed in a number of cases. Thus, although the share of household financial assets invested in corporate bonds issued by non-financial companies is still very low, households have been particularly hurt by a series of recent corporate bond defaults, those of the food-processing companies *Cirio* and *Parmalat* being the most relevant.[1] These defaults have sometimes been the result of outright fraud but they have also highlighted the urgency of improving corporate governance of both financial and non-financial institutions, financial market supervision, and bankruptcy procedures. The first policy response by the government and the parliament has been prompt and appropriate overall. However, the proposed measures to enhance corporate governance and financial market supervision are still under parliamentary scrutiny and this could hurt the restoration of confidence in the Italian financial market.

In the product market, the liberalisation process is moving ahead. The policy response to the electricity interruptions and complete black-out during the summer of 2003 has been mainly a market-oriented one, underscoring the commitment of the Italian government to reforms. The ongoing liberalisation of the railway sector is another step in the right direction. Nonetheless, the reform programme has often appeared to lack continuity over time and consistency across sectors. Despite past and recent divestitures, public ownership and direct intervention is still widespread relative to most OECD countries. The role of independent sectoral authorities has been questioned and their responsibilities have sometimes been clawed back by the government. Sectors like professional services are still mostly exempted from antitrust jurisdiction while for others, like retail trade or local public services, devolution of powers at decentralised level has often meant the preservation of previous rents.

Further efforts are needed to enhance the functioning of the Italian financial and product markets. Lifting privatisation, liberalisation and competition to the levels of the OECD best performers entails facing new challenges. Commitment to legislation and implementation of reforms is the key for long-lasting prosperity.

Enhancing corporate governance and the functioning of financial markets

Developments in allocation of savings and corporate financing and governance

Since the mid-1990s, the allocation of Italian household savings has been changing considerably as a result of public finance consolidation. The reduction of the government borrowing requirement, the consequent fall in real interest rates on public bonds as well as the privatisation of publicly-owned companies contributed significantly to saving reallocation away from public debt and towards private securities. The share of households' savings allocated in private equities and bonds increased substantially and is at levels comparable to, or above, those of other OECD countries (Table 3.1). This period also witnessed a decreasing share of saving allocated to bank deposits and an increasing one directed to mutual funds. The latter remains low compared with the United States but it is in line with Germany and higher than in France.

As in other OECD countries, a proportion of private bonds and equities are bought by households directly through financial intermediaries because of expected higher returns compared with mutual funds, despite this practice being much riskier. Financial intermediaries have the obligation to make clients aware of the risks characterising the financial instruments, to evaluate the suitability of the investment for the client and to provide copies of the information related to each single issue. This information is not always available, however. Indeed, there is no information sheet obligation in the case of securities issued by companies to institutional investors in the primary market and then traded to individual investors in the secondary market.[2] Furthermore and more importantly, although

Table 3.1. **Households' financial assets**

As a share of the total

	Currency and deposits		Securities other than shares		*Of which* government		Shares and other equity[1]		*Of which* mutual funds		Insurance technical reserves		Other accounts receivable[2]	
	1995	2002/03[3]	1995	2002/03[3]	1995	2002/03[3]	1995	2002/03[3]	1995	2002/03[3]	1995	2002/03[3]	1995	2002/03[3]
Belgium	28.5	30.5	28.9	24.1	2.1	1.8	26.8	28.3	8.5	15.1	9.7	17.3	6.0	–0.1
Denmark	26.7	27.4	14.9	8.9	. .	. .	23.0	18.7	. .	. .	33.9	43.6	1.5	1.4
Finland	72.1	33.5	5.8	1.2	. .	. .	5.3	39.3	1.0	5.0	14.8	21.4	2.0	4.6
France	36.0	31.1	5.1	2.1	. .	. .	34.1	33.3	11.6	9.4	20.8	29.5	3.9	4.0
Germany	41.8	35.9	12.9	11.3	. .	. .	18.4	21.0	7.0	11.4	25.8	30.2	1.1	1.6
Italy	**40.2**	**27.0**	**30.8**	**22.1**	**16.6**	**6.6**	**18.8**	**34.3**	**4.0**	**12.3**	**9.2**	**16.1**	**1.0**	**0.5**
Japan[4]	49.3	54.9	10.3	6.0	. .	. .	11.1	8.3	. .	. .	25.3	27.4	4.0	3.4
Netherlands	22.6	24.1	3.4	3.9	. .	. .	19.3	11.8	4.3	. .	52.4	57.4	2.3	2.8
Norway	40.0	36.6	1.2	1.6	. .	. .	12.2	15.4	3.2	4.3	35.8	35.1	10.8	11.3
Portugal	48.9	44.1	0.9	9.3	. .	. .	36.6	28.1	6.1	8.0	10.3	16.6	3.3	1.8
Spain	50.1	42.2	3.1	1.8	1.4	0.3	30.9	36.8	10.1	11.7	9.9	15.5	6.1	3.7
Sweden	24.7	17.5	7.8	2.6	. .	1.4	26.2	30.4	5.9	9.3	26.7	40.1	14.6	9.3
United Kingdom[4]	24.0	27.1	2.1	1.3	. .	. .	19.4	14.9	3.7	4.0	50.8	53.3	3.7	3.3
United States	13.2	12.5	9.6	7.7	. .	. .	45.7	46.7	8.7	13.7	30.3	31.3	1.2	1.8
Memorandum item:														
Average of euro area countries[5]	38.6	32.9	13.9	10.9	. .	. .	23.9	27.0	7.5	10.4	21.1	26.9	2.5	2.2

1. Includes mutual funds.
2. Includes loans.
3. 2003 for Italy and the United States.
4. Balance sheet not consolidated.
5. Belgium, Finland, France, Germany, Italy, the Netherlands, Portugal and Spain. The average for mutual funds does not include the Netherlands for 2002.

Source: OECD National Accounts database; Bank of Italy.

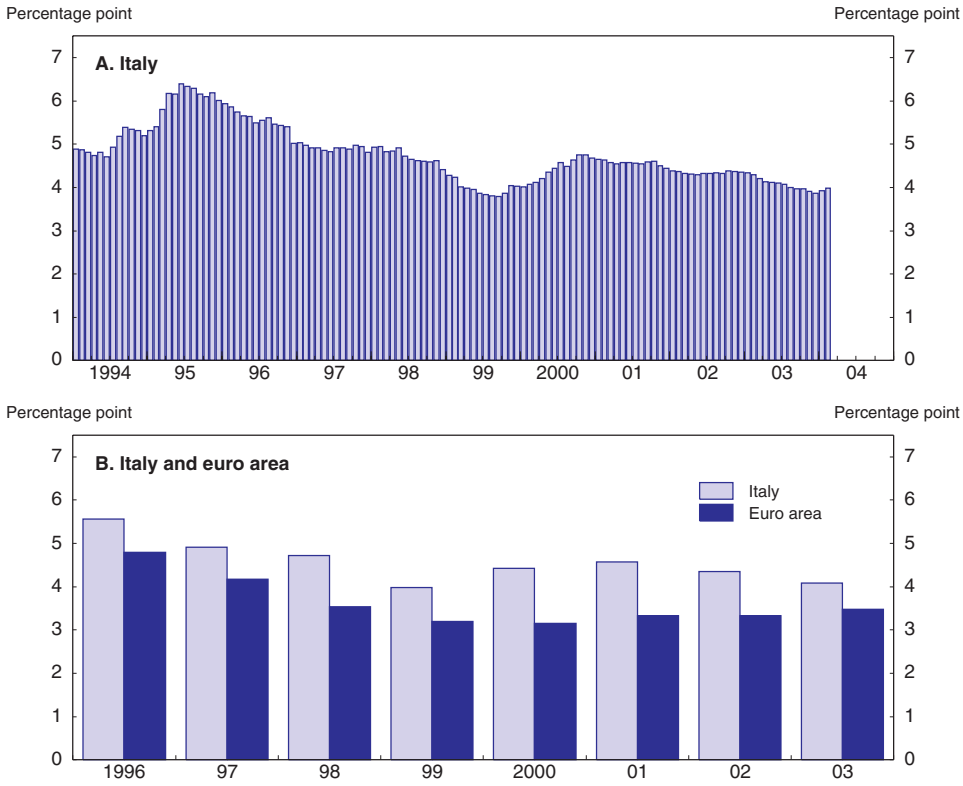
financial intermediaries are required by law to act with transparency and in the interest of clients, monitoring their behaviour on the ground is difficult and *ex ante* enforceability of this rule is problematic. *Ex-post* enforceability is, however, usually fulfilled.[3] Therefore, households have been performing risky operations without being provided with adequate information. Moreover, according to Fazio (2004), professional skills in Italian banks have not kept up with the need of adequately advising an increasing number of savers that have been shifting from government bonds towards riskier financial instruments. Although the share of household financial assets invested in corporate bonds issued by non-financial companies was still less than 2% in 2003, the successive corporate bond defaults that erupted in the last two years – the most notable case being the one of *Parmalat* (see Annex 3.A1) – were quite unexpected to households and this might have contributed to the low and declining consumer confidence observed since 2002.[4]

The demand by households for higher-return instruments induced a corresponding shift in financing from companies. During the 1990s, companies started to rely less on self-financing and bank credits and more on equity and bond issuances. They also exploited more often bond issuances in international markets through their foreign affiliates, including in countries where information requirements are more limited than in Italy (Tremonti, 2004). To a degree, this also reflected limits on bond issuing imposed by the civil law– now partly removed by the new company law (Bresciamorra, 2004).[5]

Bond and equity financing still nevertheless represents a relatively low share of companies' total liabilities while an important financing source for companies is represented by loans. In 2002, around 32% of non-financial companies' total liabilities were represented by loans higher than the 16% in the United States and 24% in France, but in line with the 31% in the United Kingdom and lower than the 43% in Germany (Bank of Italy, 2004b). Companies' share of bonds and equities over total liabilities is below that in other G7 countries, equalling around 52% in Italy compared with 64% in the United Kingdom, 60½ per cent in France and the United States, but it is higher than in Germany (43%). One of the main reasons for the relatively low recourse to equity and bond financing has been the reluctance of companies' majority shareholders to open their establishments to third parties (Merloni and Micossi, 2004, and *2003 Survey*). This has resulted, *inter alia*, in a significant use of own funds to avoid dilution of ownership structure, the creation of pyramidal groups with a family holding at the top and, currently to a limited extent, issues of shares with no voting rights.

Banks have also increased their recourse to equity financing – partly as a result of their privatisation – and now around 60% of total bank capital is listed. During the 1990s the banking sector went through a process of asset consolidation as well as improvements in risk management that raised productivity and profitability (Fazio, 2004, and IMF, 2003). Despite this, profitability remains low by international standards mainly because of high costs (IMF, 2004a). Competition in the banking sector has also increased as suggested by the declining differential between lending and borrowing rates (Figure 3.1), which nevertheless remains higher than the euro area average.[6] The stability of the banking system has improved since the mid-1990s with bad loans as a percentage of supervisory capital (*patrimonio di vigilanza*) decreasing from 40% in 1996 to around 11% in 2003. Banks' balance sheets have also been improved by securitisations of their loans – around 45% of which concerning bad loans – carried out especially in the 1999-2002 period, also being helped by some tax incentives introduced in 1999 and withdrawn in 2003. A significant amount of risk linked to bad loans has remained within banks themselves, however, as they have retained the riskiest portions of these financial instruments (so called junior securities).[7]

Figure 3.1. **Differential between lending and borrowing rates**[1]



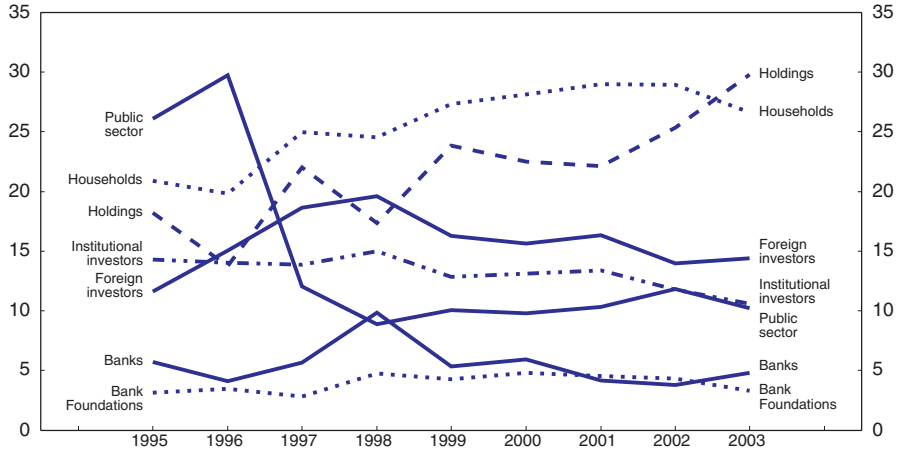
1. Lending rates: interests on loans up to 18 months, all customers; borrowing rates: average rate on deposits.
Source: International Monetary Fund, International Financial Statistics database.

These structural changes in financial and saving behaviour were relatively fast, and more flexible regulation was needed to keep up with them. Important legislation like the Banking Act (*Testo Unico Bancario)* in 1993 and the Financial Market Act (*Testo Unico della Finanza*) in 1998 reformed the banking and financial regulation framework towards greater transparency of security issuing by companies, more correct behaviour of financial intermediaries and more comprehensive information provided to the public (Fazio, 2004). However, some loopholes and drawbacks in the regulatory and institutional framework persisted, notably in the transparency of transactions between companies and their subsidiaries in off-shore centres or in the adequacy of sanctions, sometimes coupled with inadequate enforcement.

Outstanding issues – general

Indeed, corporate governance issues have remained a problem. As stressed in the *2003 Survey*, Italian entrepreneurship is characterised by the high value attached to family insider control. This helps to explain both the high share of small unlisted firms and the complicated ownership structures of many large listed ones. These structures allow high control leverage for a small number of investors, *i.e.* their control rights exceed their cash flow ones. In fact, listed companies' share ownership is increasingly dominated by holdings (Figure 3.2) that, despite stricter regulation and supervision by the securities market watchdog (*Commissione Nazionale per le Societá e la Borsa*, CONSOB), sometimes represent groups controlled by an individual or a family and used to build pyramidal

Figure 3.2. **Share ownership of listed companies**
Per cent of total market capitalisation, end of year



Source: Borsa Italiana.

structures. As in other OECD countries, information on these complex shareholder structures could be hard to obtain (OECD, 2004a).

Other features contribute to the persistence of corporate governance problems. Even if independent directors are present in around 90% of Italian listed companies in line with recommendations of the Italian Stock Exchange corporate governance code of conduct (see below), they are often chosen by controlling shareholders so that their effective independence is questionable.[8] Only one third of the 30 largest listed companies have chosen to introduce slate voting procedures allowing minority shareholders to submit their candidates. Most of the companies choosing to involve minority shareholders in directors' appointment include Treasury participation in their capital and therefore have the obligation to do so. The accountability of directors is further limited by the scarce opportunity of shareholders to put items on the general meeting agenda.[9] In this context, minority shareholders' rights can hardly be protected.[10]

In principle, companies' financial operations and balance sheets have to pass a number of controls:[11] *i)* internal auditing; *ii)* a board of auditors (*collegio sindacale*); *iii)* an audit committee for those listed companies agreeing to the code of conduct of the Italian Stock Exchange (see below); and *iv)* external audit firms. In particular, the *collegio sindacale* has the obligation of checking whether management and administrative operations are consistent with laws and by-laws through a number of instruments including inspections. In the case of listed companies, the *collegio* should also communicate management's irregularities to CONSOB. In the past few years, these communications have increased as a response to recent provisions increasing sanctions against members of *collegio sindacale* not reporting irregularities, implying that effective application of the *collegio sindacale*'s powers is probably incomplete in the absence of proper incentives. In fact, despite current legislation requiring the presence of at least one independent member in the *collegio sindacale* elected by minority shareholders, only a quarter of listed companies fulfil this requirement because of high minimum shareholder thresholds established in companies' by-laws[12] and because participation of shareholders and institutional investors at general meetings is rare (Tables 3.2 and 3.3). Furthermore, for non-listed companies only majority

Table 3.2. **Members of boards of auditors (*sindaci*) elected by minority shareholders**

End -May 2003

Sectors	Number of companies	In % of total members in the sector
Insurance	2	22.2
Banking	11	28.9
Non-financial sector	54	25.4
Total	67	25.8

Source: CONSOB (2004).

Table 3.3. **Institutional investors in listed companies**

Per cent, 2003

	Sectors				
	Insurance	Banking	Financial	Industrial	Services
A. Share of voting rights in the general shareholding meetings[1]					
Italian asset management companies	0.2	0.1	0.4	0.2	0.2
Italian pension funds	0.2	–	–	0.4	0.2
Italian banks and insurance companies	0.8	0.9	–	0.3	0.4
Foreign funds	0.7	1.1	0.4	1.6	1.1
Foreign banks and insurance companies	0.3	0.3	–	–	0.1
Total	2.2	2.4	0.8	2.5	2.0
B. Share of listed companies' capital owned by Italian mutual funds[2]					
In % of total of the sector	4.0	3.1	–	3.6	–

1. Voting rights held by institutional investors, average values of meetings in 2003, for companies included in the Mib30 and Midex indexes and in the Star segment.
2. At end-December 2003. The share in the total economy amounts to 3.5%.

Source: CONSOB (2004).

shareholders are entitled to nominate internal auditors and members of *collegiosindacale*. Finally, in some companies (for example in the pre-default *Parmalat*), the chief financial officer was also a member of the internal control committee (Micossi, 2004).

External audit firms are listed in an *ad hoc* register and monitored by CONSOB. CONSOB's legal instruments to perform this monitoring activity are extensive and sanctions can even imply the removal of the audit firm from the register. External audit firms have the obligation to report to CONSOB any negative opinion on companies' balance sheets as well as the impossibility to issue an opinion because of the lack of exhaustive information. However, the choice and remuneration of the external auditing firm are decided on the basis of a proposal of directors.

Outstanding issues – financial sector

A rising matter of concern regarding corporate governance has been the increasing participation of non-banking companies in the capital of banks of which the companies are important clients, which could raise conflict of interests (Giavazzi, 2004).[13] Current legislation forbids participation of non-financial companies in banks above 15%. Moreover, participations above 5% in banks have to be authorised by the Bank of Italy. However, non-financial companies are allowed to agree to shareholders' pacts and be represented in the

banks' board of directors. Therefore, companies might well have an interest to receive easy credit from banks in which they hold an interest (connected lending).[14] In fact, no comprehensive regulation exists on connected lending or lending to related parties (IMF, 2004b).

Governance of financial institutions should indeed be strengthened as much as that of non-financial companies. The presence of institutional investors in the banks' capital– a factor that could boost bank management's accountability towards minority shareholders – is limited. Moreover, as in most OECD countries, banks have been increasingly involved in intertwined activities like investment banking, intermediation in retail financial markets, credit supply and periodic reports on companies for investors. This could allow banks to exploit economies of scope. Nonetheless, these activities can also raise conflicts of interest, although existing regulation requires full disclosure of the conflicts and partial barriers among the different activities of the banks ("Chinese walls").[15]

Another potential conflict of interest can arise in the management of the Italian Stock Exchange (*Borsa Italiana*). The Italian Stock exchange was privatised in 1997 and it is now controlled by a number of banks – each allowed to hold a maximum 5% share – that as a result have the responsibility of companies' listing while collecting fees from trading activities. Incentives to apply stringent listing criteria could thus be weakened. To limit conflicts of interest, listing is decided by a separate committee composed of the Stock Exchange's chief executive officer (CEO) and other managers who are prevented from having any relationship with stock market participants. But the CEO is elected by the board of directors.[16] One possible solution for reducing conflicts of interest could be the listing of the Stock Exchange itself while strengthening supervision by CONSOB as envisaged by the bill presented in the parliament (see below). Another solution is through increasing competition in this sector and indeed a new stock exchange (TLX) has been introduced by the *Unicredito* bank. However, the likely presence of network externalities might prevent the existence of more than one profitable stock exchange in Italy.

The self-discipline option

Self-imposed corporate governance rules can be a workable substitute for tight legislation if appropriate incentives are introduced for their actual implementation. In 1999, a Committee at the Italian Stock Exchange published a number of corporate governance recommendations for listed companies (so-called *Codice Preda*).[17] These recommendations were revised in July 2002. The code covers many aspects of companies' governance, notably the role and composition of the board of directors, appointment and remuneration of directors, internal control, relationship with institutional investors, insider dealing and rules of the shareholders' meetings. Stock exchange rules oblige listed companies to inform the market on the application of these recommendations and, eventually, on the reasons why they were not applied ("comply or explain"). An increasing number of companies report information on their corporate structure and for the most part they declare they are following most of the recommendations (ASSONIME, 2004). However, the rules are implemented on a voluntary basis and only patchy implementation of the recommendations does not seem to result in significantly higher cost of capital for opaque companies so far (Merloni and Micossi, 2004). Therefore, self-discipline may currently lack proper incentives.

Supervisory responsibilities in financial markets

Supervision of financial markets is organised as a mix between the model "by objectives" and the model "by sectors". According to the supervisory model by objectives, distinct and independent agencies pursue their assigned objectives– stability, transparency and competition – across different institutions (Di Giorgio *et al*., 2000). In contrast, according to the supervision model by sectors, each supervisory agency has full responsibility over a specific sector.

The Bank of Italy has both a wide cross-sectoral responsibility over financial market stability and responsibility over stability, efficiency and competitiveness of the banking sector. According to the IMF (2004b), the Bank of Italy's system for monitoring financial market stability is sophisticated, as it involves a comprehensive reporting system by intermediaries allowing the calculation of a wide range of financial stability indicators. The Bank of Italy also has a role in ensuring efficiency and stability of securities markets as it can postpone or prevent the issue of securities deemed too large to be absorbed or unsuitable for the market, as for example when securities' characteristics are deemed difficult to understand and the yield hard to calculate for the public. In this case, Bank of Italy activity can have an impact on the transparency of the market.

CONSOB has wide supervisory authority – including inspections – over companies issuing securities, financial firms and banks when providing investment services, institutions managing financial markets and, as noted earlier, external auditors. For example, it has the authority over controlling whether listed companies or companies issuing bonds directly to the public are providing correct and proper information to the market. In case of illegal behaviour, CONSOB can even propose to the Ministry of the Economy to make provision for sanctions on directors and members of *collegio sindacale* although the company itself can not be liable to penalties.[18] Nevertheless, because of a shortage of human resources CONSOB might perform a less-then-desirable number of inspections (Cardia, 2004). Moreover, the inspection activity generally reacts only after the publication of information by companies. Finally, the sanctions that CONSOB can impose are probably insufficient to credibly deter companies' misbehaviour.[19]

According to Fazio (2004), CONSOB and the Bank of Italy operate in a co-ordinated fashion to avoid a double burden on companies and other market participants, and exchange of information between the two institutions is regularly performed.

The Bank of Italy has responsibility of enforcing the competition law in the banking sector. The Antitrust Authority provides non-binding opinions to the Bank of Italy about its competition enforcement matters. The antitrust legislation provides that in exceptional cases the Bank of Italy, in agreement with the Antitrust Authority, may permit restrictions of competition among banks that is deemed necessary to preserve monetary stability (Tesauro, 2004, Annex 1). This provision has never been applied. To ensure financial market stability, the Bank of Italy retains the power not only of supervising the adequacy of financial intermediaries' prudential capital but, as required by EU law, also of authorising any acquisition operation of significant shareholdings in banks on the basis of sound and prudent management considerations, where the latter are subject to interpretation by the Bank of Italy.[20]

The Minister of the Economy chairs the Credit and Saving Inter-ministerial Committee (CICR) – including five additional Ministers and attended by the Governor of Bank of Italy – with the power of issuing broad guidelines regarding supervision of the credit market on

the basis of proposals by the Bank of Italy.[21] Moreover, the Ministry of the Economy supervises on the stability of private pension funds together with the Ministry of Labour while the agency responsible for these instruments is the Pension Fund Supervisory Commission (COVIP). Finally, insurance companies are supervised by the Private Insurance Supervisory Institute (ISVAP).

With such a mixed institutional structure, in some cases the same regulatory agency could face conflicting goals as for example in the case of the acquisition, participation or concentration of financial intermediaries that could facilitate stability but dampen competition or the reverse.[22]

The policy response to restore confidence in financial markets

The above weaknesses characterising Italian corporate governance and financial markets represent a brake to an efficient allocation of capital with negative consequences on the growth of profitable firms, R&D and innovation, and more in general aggregate performance (Box 3.1). Recently, the government has undertaken a series of actions to tackle these problems. At the end of 2003, new emergency procedures for restructuring large and insolvent companies were approved. At the beginning of 2004, after one year of discussions and reviews a more modern company law was implemented. A major bulk of much-needed measures is still under discussion, though. In fact, during the first part of 2004 a number of bills on corporate governance and financial market supervision –

Box 3.1. **Some evidence on the impact of the financial sector on economic performance in Italy**

Carpenter and Rondi (2004) find that proceeds from initial public offerings (IPOs) in the stock market positively affect the growth and performance of Italian small firms when the latter are independent from larger industrial conglomerates. In contrast, IPOs have no impact on the performance of affiliated or large firms. They identify a different behaviour between "new style" firms, *i.e.* firms using equity to finance their growth, and "old style" firms which use IPOs to separate ownership from control. They also observe that the equity financing of Italian "new style" firms' is much lower than in the US putting in doubt the effectiveness of policies to provide easier access to equity finance in Italy. They rather recommend any reform aimed at dismantling pyramidal business groups. Existing separation of ownership and control in many "old-style" firms would require the establishment of monitoring devices for minority shareholders, the tightening of corporate governance rules and the strengthening of investors' legal protection.

Hall and Oriani (2004) show that on aggregate the stock market seems not to provide a positive premium to R&D investments in Italy, in contrast to what happens in other G7 countries. However, by controlling for share ownership structure, they find that R&D investment in Italy is indeed valued by the market for those companies where a major shareholder is absent. These results suggest that major shareholders in Italy do not respond to market pressure. They also suggest that policies favouring a widespread share ownership structure – like a better protection of minority shareholders – would result in a premium for profitable R&D investments giving incentives for firms to innovate.

Finally, Fabbri (2002) shows that external financing, aggregate capital stock and output levels are higher in Italian regions with greater efficiency of the judicial system dealing with corporate credit misbehaviour. These results imply that aggregate performance is crucially influenced by an effective legal enforcement of corporate law.

including one proposed by the government – were being discussed by the parliament. In May 2004, a bipartisan bill was finally presented incorporating many reform proposals already included in other bills as well as new proposals arising in the context of a comprehensive enquiry carried out by the parliament. However, during the following summer the bipartisan agreement broke apart and after a long discussion, a revised bill was approved by the Chamber of Deputies and is now before the Senate. This section provides a description of the main recent measures – some already implemented and some only proposed – to reform the Italian financial sector.

New restructuring procedures

In late December 2003, in the wake of the *Parmalat* bond default the government approved a decree law accelerating and expanding the scope of emergency procedures already available for the restructuring of insolvent companies. As revised at the end of November 2004, the new measures apply to all companies with more than 500 employees and debts of more than 300 million euros. As a result of this decree law, special bankruptcy procedures for a big insolvent company have been modified and the following initiatives can be undertaken: *i)* the Minister of Productive Activities nominates a "special manager" (*commissario straordinario*) to handle the emergency procedures; *ii)* the *commissario straordinario* has to submit a restructuring plan to the Minister of Productive Activities within 6 months for approval; *iii)* the restructuring of the company has to be carried out within two years and can include divestiture of non-core activities; *iv)* the divestiture procedures of non-core activities can start immediately even before the submission of the restructuring plan, although approval of the Minister is still needed; *v)* the restructuring plan can also include an action of revocation (*azione revocatoria*), *i.e.* the recovery of payments affecting the balance sheet undertaken by the company just before the implementation of the emergency procedures; *vi)* the special manager may propose a composition plan to be accepted by a majority of creditors; *vii)* if the restructuring plan or the composition are not approved, then the special manager, after the Minister's approval, has the option to sell any industrial assets of the insolvent company within one year (while the industrial activities are allowed to keep running) or, if the selling is not feasible, to ask the judiciary to apply the ordinary bankruptcy procedures.[23]

The acceleration of the emergency procedures and the reinforcement of the restructuring option for troubled companies represent a strengthening of creditors' protection and are thus consistent with the recommendations of the *2003 Survey*. But the support for troubled companies seems to go beyond the need to protect creditors' rights. For example, revocation is usually an instrument used in ordinary bankruptcy procedures in order to protect creditors' rights rather than a means of financing restructuring plans of troubled companies. More importantly, the new prerogative of the government – and in particular of the Ministry of Productive Activities – to approve the restructuring plan and to supervise the "special administration" procedures might jeopardize the level playing field among market participants.

More generally, the approval of this decree law highlights the need for implementing a new bankruptcy law valid for both small and big companies as stressed in the *2003 Survey*. In fact, more efficient ordinary bankruptcy procedures would diminish the need for emergency measures with the direct involvement of the state such as the one currently carried out for restructuring *Parmalat*. In July 2003, an *ad hoc* Committee finalised a number of reform proposals and presented them to the government. The proposals aim at

favouring the composition with creditors or the acceleration of the liquidation procedures of insolvent companies. The reform would also allow the insolvent debtor to start a new activity. However, the proposals are still under examination by the government. Speeding up the reform of bankruptcy procedures would contribute to restoring confidence more rapidly among investors. The new "competitiveness package" (Annex 2.A3) anticipates some of these reform proposals and gives to the government the powers to implement the whole reform within 6 months.

New company law

The new company law entered into force in January 2004 as foreseen.[24] It encompasses regulations for all non-listed companies and partly also listed companies for those aspects missing in previous legislation.[25] Thanks to this, the tasks of the board of directors and of its managing committees have been better defined; executive boards have to report on their activities to the board of directors and to *collegio sindacale* at regular intervals and they have to be ready to provide the board with adequate information at any moment; directors have to disclose to other directors as well as to *collegio sindacale* any interest arising from companies' operations, including those on behalf of third parties.[26] Moreover, directors of subsidiaries are now required to disclose inter-group relations and to justify any action influenced by the controlling company. Shareholders and creditors can also sue the controlling company in case its influence causes losses that are not offset by benefits occuring to the subsidiary by belonging to a group. These measures could mitigate the problems connected to pyramidal structures. The new law should also facilitate bond financing as the previous ceilings on bond issuing have been relaxed. As a result, the advantages of bond issuing through off-shore subsidiaries should also be reduced somewhat. On the other hand, lower criminal penalties in case of accounting fraud of non-listed companies are inconsistent both with efforts to improve transparency and with the main thrust of the new law (see also OECD, 2004b).

The government approved at the end of 2004 further modifications of the new company law in order to cope with demands coming out from the first practical implementation of the reform and related corporate governance issues.[27] These provide for a discipline of related party transactions, requiring the board of directors to put in place, on the basis of a regulation enacted by Consob, adequate procedures to ensure transparency and fairness of transactions with related parties performed by the company directly or indirectly through subsidiaries. Moreover, they impose an information obligation on professional investors intending to circulate in the secondary market in Italy bonds issued to them abroad by companies controlling or controlled by Italian companies.

Enhancing corporate governance and financial market oversight

In May 2004, a bipartisan bill reforming supervisory authorities and tackling corporate governance issues was presented. The bill incorporates many of the proposals previously submitted by the government to the parliament (Box 3.2), other measures included in a number of bills already under discussion as well as new proposals arising in the context of a comprehensive enquiry carried out by the parliament. After the bipartisan agreement broke apart during the summer, the parliamentary majority presented a revised bill in November 2004, which was eventually approved with some further modifications by the Chambers of Deputies and is now before the Senate.

Box 3.2. **The government bill on saving protection**

In February 2004, the government presented a bill to reform the system of saving protection. The bill has two main objectives: *a)* streamlining the institutional system of financial market supervision towards a model "by objectives"; *b)* strengthening the sanction system against corporate and financial crimes.

The bill replaces CONSOB with a new "Authority on saving" which would be mainly responsible for the transparency and adequate information in financial markets, including in the banking sector. Transparency of insurance products and pension funds would remain under the responsibility of ISVAP and COVIP, respectively, but subject to the new Authority's opinions. The Authority on saving would be an independent institution but would have to submit an annual plan of future activities to the parliament. The Authority would also have to periodically report the most relevant financial market developments to CICR and could propose to the same committee any resolution needed to ensure the fulfilment of the saving protection objective. The Bank of Italy would retain the main task of supervising financial market stability while the Antitrust Authority would have to ensure competition in the banking sector. To fulfil their respective goals, the Bank of Italy and the Antitrust Authority would have the joint responsibility of authorising mergers and acquisitions in the banking sector, and objection by one of the two institutions – which must be publicly justified – would be sufficient to stop the transaction. The Authority on saving and the Bank of Italy could also turn to the finance police (*Guardia di Finanza*) to collect proof of actions against financial markets' transparency and stability. A contact Committee would be set up comprising the new Authority on saving, Bank of Italy, the Antitrust Authority, ISVAP and COVIP that would meet every month to share information – including confidential one – and enhance co-operation. Finally, the government would retain considerable direct influence on financial markets through the CICR that would exercise "high supervision" on banking activities and on saving protection, and would establish general principles on supervision activity.

Penalties against corporate or financial crime would be strengthened. Emphasis has been placed on the identification of two new crimes, "harm against saving" (*nocumento al risparmio*) and withholding of information about conflicts of interests. The first would apply to individuals intentionally acting against the existing rules on financial intermediation and causing harm to at least 1 per thousand of the population or leading to the destruction or reduction of the value of financial instruments equal to at least 1 per thousand of GDP. The second would apply to members of companies' board of directors that fail to communicate possible conflicts of interest deriving from their holding of securities listed in domestic or European markets. Moreover, the bill introduces or reinforces sanctions for a series of corporate and financial offences as well as for illegal behaviour by companies' accountants and internal auditors.

The bill also introduces the obligation for companies to report within their consolidated budget the balance sheets of their branches in off-shore centres compiled according to the Italian accounting rules. A public insurance fund will be established covering investors' losses caused by illegal behaviour of companies or financial intermediaries. A series of measures will also involve audit firms. Rules will be introduced for the duration of contracts with audit firms and their renewal. Limits are also envisaged on ancillary services that audit firms can provide to audited firms. The new Authority is given the responsibility of monitoring companies' compliance with these rules.

In the run up to the final bill, the Minister of Economy and Finance held four hearings before the parliamentary commissions in charge with the scrutiny of the bill, in an attempt to speed up the legislative process. The Minister favourably considered the proposed measures on corporate governance and in particular supported the election of a member of the board by minority shareholders. Moreover, the Minister considered that the law should provide companies' obligation to disclose to the market compliance with the code of corporate governance and the reason of non compliance, a system of internal and external controls to verify the accuracy of such information and adequate sanctions for directors omitting information or revealing untrue one. Regarding conflicts of interest, the Minister took the view that very stringent disclosure obligations would be more effective than further prohibitions and limits. CONSOB should be entrusted with full responsibility on transparency of all financial products. CONSOB should however ask the opinion of the Authority in charge of a specific sector (Bank of Italy, ISVAP or COVIP). On the other hand, the Minister deemed it preferable, for the time being, not to modify the distribution of competencies between the Bank of Italy and the Antitrust Authority concerning competition in the banking sector.[28]

The bill strengthens the responsibility of CONSOB in the domain of transparency in securities market. Indeed, CONSOB will be given the responsibility for the transparency of bank bonds as well as of insurance products and pension funds. Moreover, among its responsibilities, CONSOB will retain the final decision on listing (including the listing of the companies managing financial markets like *Borsa Italiana*), carry out settlement and arbitration procedures in case of disputes between savers and financial intermediaries, and verify the accuracy of information to the market on compliance with the code of corporate governance of the Italian Stock Exchange. A contact committee will be set-up comprising the Authorities supervising financial markets that will meet on a monthly basis to share information and enhance co-operation. The Minister of the Economy can convene the contact committee to provide the Authorities with "relevant notifications" for their activity.[29]

Regarding corporate governance and conflicts of interests, the bill envisages that in listed companies a member of the board of directors has to be elected by minority shareholders. Moreover, at least one member of the board has to be independent. The new bill will also enforce the requirement that at least one member of *collegio sindacale* be chosen by minority shareholders.[30] Both chief financial officers and chief executive officers will have to certify the companies' financial reports. Both directors and members of *collegio sindacale* will have to disclose all their activities in other companies before accepting their mandates. CONSOB is given more responsibilities regarding the supervision of transparency requirements for off-shore subsidiaries of Italian firms. On this issue, CONSOB will be in charge of adopting implementing regulations.

False accounting is to be prosecuted more strictly. Finally, financial intermediaries are allowed to re-sell in the secondary market, within a period of one year, bonds previously issued to professional investors only on condition of providing a guarantee. An information sheet on these bonds is also to be supplied in line with all the other securities issued in Italy.[31] Credit restrictions are introduced for connected lending but credit societies and mutual savings banks would be exempted from these restrictions. Ceilings will be introduced on the portfolio investments that mutual funds can place on companies belonging to the same group of the mutual funds.

Finally, in the context of a bill implementing a number of European directives ("*legge comunitaria*"), the parliament has recently approved the implementation of the European Community directive on "market abuse", originally included in the bipartisan bill.[32] The directive aims at tackling financial market rigging and the use of insider information. Thanks to these measures, CONSOB inspection and sanction powers would be strengthened and penalties on market abuse raised. The *legge comunitaria* also foresees an increase by one third of the CONSOB personnel in the context of its future strengthened responsibilities in this domain.

Recommendations

The above proposals are important steps in the right direction of improving the financial market's supervisory model, enhancing corporate governance and deterring illegal behaviour. However, the proposals have not been approved yet and the discussion is still ongoing. The Minister of the Economy's support for the reform could accelerate the approval of the bill. Its endorsement by the parliament and its implementation should indeed remain a priority. The new measures would fit in a legislative framework – including the Banking Law and the Finance Law of the 1990s and the more recent Company Law – that for most aspects is already adequate but needs improvements, as highlighted by the previous discussion.

A primary role should also be given to corporate self-regulation with its effective application a *sine qua non*. The obligation on companies to implement the corporate governance recommendations of the Italian Stock Exchange should be strengthened, for example by subjecting all companies' listing to the implementation of the recommendations as in other stock exchanges in OECD countries and as is already the case for some rules of the code in smaller segments of *Borsa Italiana*. Their effective enforcement could be supervised by CONSOB as envisaged by the bill under discussion in the parliament. If this is not deemed sufficient, more stringent regulation and sanctions could be introduced. For example, to enhance transparency of complex shareholdings *Borsa Italiana* could be required to establish an *ad hoc* market segment of listed companies representing groups used to build pyramidal structures. Financial intermediaries should be required to provide information to their customers on whether or not bond issues include companies' ratings and, if the rating is included, on the default risk linked to each rating level. Specialised judiciary courts' sections could be established dealing exclusively with company and financial legal cases. The possibility for shareholders and creditors to launch class-action-type lawsuits could be considered. Consideration could be given to introducing monetary incentives for individuals denouncing companies' illegal behaviour ("whistleblowers").

The establishment of an insurance fund to reimburse corporate bond investors in case of default arising from illegal behaviour – as proposed by the government – could boost public confidence in these financial instruments, especially after the series of defaults recently experienced. Nevertheless, it could also result in moral hazard problems with the consequent inadequate investors' supervision of companies' behaviour and corporate governance. Re-examination should thus be given to the establishment of the insurance fund. As a minimum, a ceiling should be introduced on the amount of saving reimbursed.

A streamlining of financial market supervisory responsibilities is appropriate as currently discussed in the parliament because it improves the implementation of the legislative framework. A greater accountability of the supervisory authorities towards the

parliament, as envisaged by the original bipartisan bill, would also be welcome. On the other hand, the purpose of CICR could be re-examined and, eventually, the committee could be abolished.

Moreover, it is important that the regulatory model does not lead to a proliferation of controls on intermediaries and an increased administrative burden upon them. Cooperation among the three authorities – as envisaged by the bill – is therefore crucial to avoid this and also to guarantee the rapid and smooth operation of supervisory tasks. A smooth functioning of the Authorities' coordination would also be important for sharing information and methods, and for ensuring appropriate balance between their different objectives.

Finally, according to the bill CONSOB would strengthen its responsibilities. To be able to effectively exercise them, its human and financial resources should be increased over and above what is already foreseen by the *legge communitaria*. To this end, monetary sanctions on companies committing financial crimes could be collected in an *ad hoc* fund to be used to finance its activities.

Strengthening competition in product markets

The 2003 Survey has stressed that insufficient competition in product markets could be one of the main reasons for the poor performance of the Italian economy in the past decade compared with most of the other OECD countries. Insufficient competition could indeed represent a brake to higher R&D activities and a more widespread diffusion of new technologies, and hence to higher productivity growth. Moreover, inadequate liberalisation of sectors more protected from international competition, typically services, could translate not only in higher prices for consumers but also in higher costs for companies in tradable sectors, typically manufacturing, thus contributing to the ongoing loss of competitiveness of Italian firms.[33]

In this section, we focus on recent liberalisation and privatisation policies (or lack of them) in some important service sectors of the Italian economy: energy, transport, telecommunication, professional services and retail trade. In total, these sectors represent around 30% of the Italian total value added and 57% of the private service one, and embody a relevant share of inputs to the manufacturing sector.[34]

The electricity and gas sectors

During 2003, an accelerating energy demand – especially electricity – has shown more clearly the weaknesses characterising the Italian energy sector. Energy intensity rose by more than 2½ per cent compared with the previous year after having declined by an average annual ½ per cent during the previous decade (Ministry of the Economy and Finance, 2004a). Electricity intensity in 2003 recorded an identical increase while the average annual growth in the previous decade was around ¾ per cent. The reasons for the unusual 2003 increases of gas and electricity consumption are, respectively, a particularly cold winter and the heat wave hitting the country during the summer.

Until recently, Italy was one of the few European OECD countries lacking any measure to encourage peak capacity (European Commission, 2004a, Annex A, Table 6). With generation and import capacity lower than peak demand,[35] at the end of June 2003 the electricity supply was interrupted in some areas of Italy. At the end of August, in order to increase production the government was forced to raise limits of air emissions and of

temperatures of wastewater by power stations. Concerns on the security of supply erupted at the end of September when Italy experienced a general blackout because of disruptions to the imported electricity transmission grid with Switzerland (UCTE, 2004).

Some steps have recently been taken to further liberalise the energy market and improve the security of supply. Since the beginning of 2003, all consumers have been free to choose their gas supplier. Since April 2003, the same is true for electricity consumers with an annual demand of more than 100 000 kWh.[36] Since July 2004, free electricity choice has been expanded to the whole business sector. Demand liberalisation will be finalised in July 2007 when all households will be free to choose their electricity supplier thanks to a recently approved law.[37] Concessionary electricity prices are still available for low-income and low-consuming households, although efforts to tackle poverty could be rather directed towards reinforcing more general social assistance schemes.

Electricity

On the supply side, electricity generation is now fully liberalised. Despite pro-competitive measures like the obligation for the incumbent ENEL to divest part of its power stations, its share over the total is still around 50% (Ministry of the Economy and Finance, 2003). This high share allows the incumbent to exert significant market power. A greater degree of competition is still hampered by administrative barriers – especially at local level – burdening the set up of new power plants, which would increase new entrants' market share. While barriers were significantly reduced by a 2002 decree law leading to new authorisations and new expected capacity of about 20 000 MW already by end-2004, local governments retain some power to oppose or block the construction of new power plants in their jurisdictions.[38] Moreover, a better functioning of the market is hindered by the so-called "CIP6 incentives" introduced in 1992, currently subsidising more than 15% of national generation for a cost to the public of around 1¼ per cent of GDP (Electricity and Gas Authority, 2004).[39] These incentives were initially intended to promote renewable energy production but they have actually been granted also to polluting and inefficient types of electricity generation, especially if compared with today's available technologies.[40] The share of renewable energy is currently only around 19% of total CIP6 energy generation. These incentives are accordingly being phased out while generation from renewable energy is more adequately promoted by "green certificates" (see the *2003 Survey*). Still, because of past decisions the volume subsidised by CIP6 incentives will be unchanged until 2007 and will decrease only slowly afterwards.

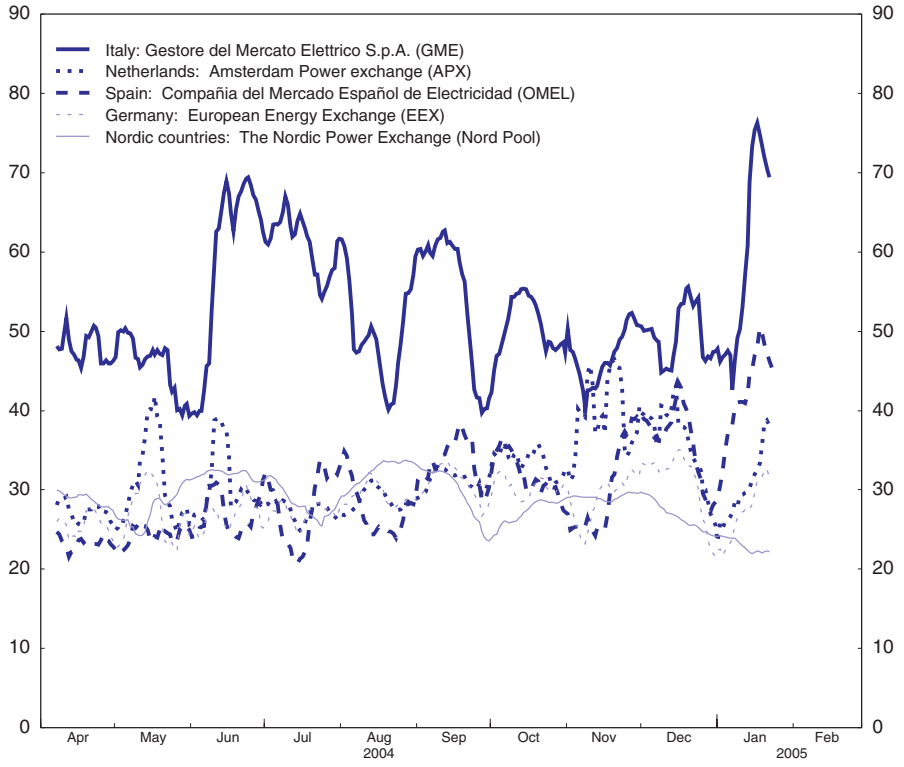
The management of the electricity transmission network is responsibility of GRTN, a joint-stock public company entirely owned by the Ministry of the Economy. However, the network is still physically under the control of the incumbent and state-controlled ENEL through the subsidiary *Terna* and, for a minor part, of some smaller private or local-government-controlled electricity companies. This set-up might discourage the incumbent from adequately investing in transmission infrastructure because it would facilitate access of new entrants in the market (Antitrust Authority, 2004a). Moreover, it could also represent an obstacle to higher electricity imports from abroad, which are crucial to meet increasing demand. Another drawback is that, while the Electricity and Gas Authority is responsible for setting access prices to the transmission and distribution networks, legal provisions approved in October 2003 give the government the power of imposing strict guidelines on the Authority in this respect.

In May 2004, the government decided on the unification of *Terna* with GRTN by October 2005. Companies operating in the electricity market will not be allowed to hold more than 20% in *Terna*-GRTN after July 2007. Thus, ENEL is obliged to reduce its participation in the company by then and in June 2004 it already started to divest 50%. The limit on voting rights of any shareholder in the new merged company will be 5%. The Electricity and Gas Authority will also have to devise incentives in order for owners of the remaining part of the network (around 6% of the total) to join the new company. Furthermore, the Authority will be responsible for regulating the access to the network while a yet-to-be-specified group of public shareholders (probably *Cassa Depositi e Prestiti*; see section on the divestiture programme) will be given the responsibility of maintaining ownership control of the network.

To improve security and quality of the service, the Electricity and Gas Authority recently introduced a price system for electricity transmission ensuring a higher remuneration for new infrastructure investments. Moreover, quality objectives regarding electricity interruptions have been tightened. In April 2004, the government requested GRTN to build a new transmission line between Italy and Switzerland that would allow an increase of electricity import capacity of around 1,300 MW, *i.e.* slightly below 20% of current import capacity during winter.[41] More controversially, the energy law recently approved allows companies investing in interconnection capacities to be exempted from the third party access requirement for a limited period of time (European Commission, 2004b). This measure risks limiting access to the market and should be substituted by appropriate regulation allowing both access to the network and an adequate return on new investment. To increase the price elasticity of demand, electronic meters are being installed monitoring hourly consumption for those consumers choosing contracts with hourly prices. ENEL has already started to offer such contracts even if the installation of these meters to the whole population will be completed only in 2005. Finally, the government has approved provisions for the introduction of capacity payments. The capacity payment scheme foresees remuneration for electricity producers investing in new generation capacity so as to reach a target established by the authorities (Fraser and Lo Passo, 2003). The objective is to attain a desired level of system "reliability", *i.e.* an adequately low probability of electricity interruptions. A transitory remuneration regime has already been implemented benefiting producers that make their generation capacity available during "critical" periods of the year, *i.e.* during the summer and in December (Electricity and Gas Authority, 2004).

In April 2004, the Italian electricity trading system (*Borsa Elettrica*) started its operations. The number of companies allowed to supply electricity in the system is 34 while there is a single purchaser (*Acquirente Unico*) that is responsible for delivering electricity through GRTN to lower-demand consumers, who are still constrained in the choice of the electricity supplier.[42] Access to the *Borsa* for all wholesale purchasers will start in January 2005. Electricity produced with CIP6 subsidies and imported electricity can not be exchanged in the *Borsa*.[43] The electricity exchange market should enhance transparency of price setting in the electricity market. In the first five months of operations, the electricity price quoted in *Borsa Elettrica* (around EUR 52¾ per MWh on average) has been around double the ones in the electricity trading market of other European countries (Figure 3.3). This high price level can mainly be explained by an unfavourable energy mix, the still significant market power of the incumbent, and the capacity constraints of electricity generation and imports.

Figure 3.3. **Prices in electricity trading markets**
Euro per MWh
Moving average over 7 days



Source: Association of European Power Exchanges (EuroPEX); Gestore Mercato Elettrico database.

This first phase of *Borsa Elettrica* is still experimental as its transactions have covered on average only about 28% of total electricity demand. The government considers that a fuller evaluation of the outcomes of the *Borsa* transactions can be made only at the end of 2005.

The electricity exchange system can promote not only price transparency but also a greater security of service. First, since the bids are closed one day in advance, GRTN is now in a position to better predict available supply for the following day. Moreover, some sections of the market are devoted to ancillary services for a better matching of supply and demand, including bids for reserves.

Gas

In the gas sector, transport activities are already formally separated from the others. However, transport in international transmission networks is still prioritised to the gas delivered by virtue of long-term contracts signed by the incumbent and state-controlled ENI with gas extraction companies abroad.[44] Moreover, ENI often owns or controls companies abroad managing the foreign parts of the transmission network transporting gas to Italy, half of the capital of the main national transmission operator *SNAM Rete Gas*, and almost all available storage facilities. Therefore, *de facto* access of new entrants to the transmission network is difficult. To increase entry, a "network code" has been introduced specifying rules for the management of gas transport services and the access to the national and regional networks. More importantly, no energy or gas-related company will

be allowed to hold, either directly or indirectly, more than 20% of *SNAM Rete Gas* by July 2007. Accordingly, ENI will have to divest its exceeding share by then.

In the meanwhile, a number of welcome initiatives are being undertaken to increase gas transport infrastructure. Currently, gas is imported to Italy through four major pipelines: *i)* TRANSMED, linking Algeria to Italy, *via* Tunisia; *ii)* TAG, through Austria, transporting Russian gas *via* Ukraine and Slovakia; *iii)* TENP and TRANSITGAS, through Switzerland, transporting Dutch gas *via* Germany and Norwegian gas *via* France. Very recently, a new pipeline has been established connecting Libya to Italy. An expansion of the TRANSMED and TAG pipelines is foreseen. New pipeline projects are also ready to connect Algeria and Italy *via* Sardinia, and to link Turkey and Greece for transportation of Caspian Sea gas. Moreover, there are seven projects for new liquefied gas terminals. Two have recently received central and regional government approvals and should start operations by 2008 (one in Apulia and one in Veneto). The other liquefied gas projects are undergoing the review process for authorization. The government is also foreseeing new incentives for the construction of gas infrastructures, as well as measures to avoid bureaucratic delays hampering new investments in gas pipelines.

Recommendations

The recent measures regarding the energy market are steps in the right direction towards greater competition in the sector and enhanced security and quality of supply. To further advance the reform, ENI should give up its control of the national transmission operator while making sure that *de facto* gas import barriers for new entrants are reduced. Consideration could be given to fully privatising the electricity and gas transmission network as well as vertically separating the gas storage facilities. These measures should be carried out while continuing to ensure third party access rights and to provide enough market-based incentives to the private operators for adequately investing in new transmission and storage infrastructure. Once adequate competition in the sector is ensured, the government should also proceed with the full privatisation of ENEL and ENI (see section on the divestiture programme).

The transport sector

Recent developments

During the 1990s, transport volumes have increased more rapidly than GDP (ISTAT, 2003 and Fontana and Zatti, 2003). In 2001, road transport had a considerably higher share for both passenger and freight, although at comparable levels with those of other European countries (Table 3.4). Rail transport has a relatively small share of the total, especially for passengers. After the reform of port management in 1994,[45] sea freight transport has registered a marked increase. Nevertheless, sea transport maintains an expansion potential considering the peninsular configuration of the country. Recently, the government has tried to increase the share of rail and sea transport by introducing financial incentives for road freight transport companies to carry their trucks either by railways or by ferries during long-distance transfers. Moreover, the government has provided € 2 billion to port authorities to adapt ports also to short-distance shipment and has succeeded in including longer-distance sea transport development projects (so-called "sea motorways") in the Trans European Network (TEN) programme. A public joint-stock company (*Rete Autostrade Mediterranée*) has been established to manage the development of short-distance shipment and the "sea motorways" projects funded by the TEN programme.

Table 3.4. **Passenger and freight transport**

	Italy		France		Germany		Spain		United Kingdom	
	2001	1991-2001 annual change	2001	1991-2001 annual change	2001	1991-2001 annual change	2001	1991-2001 annual change	2001	1991-2001 annual change
Passenger transport										
A. Passenger cars (p-km)	773.7	3.7	727.6	2.1	736.9	0.5	308.0	5.4	624.0	0.7
% of total	77.8	–	83.9	–	n.d.	–	n.d.	–	86.2	–
B. Buses and coaches (p-km)	95.8	1.2	41.3	–0.4	68.7	0.2	51.7	3.8	48.0	0.9
% of total	9.6	–	4.8	–	n.d.	–	n.d.	–	6.6	–
C. Powered two-wheelers (p-km)[1]	68.4	2.2	12.3	–0.1	17.0	4.8	14.3	0.7	5.0	2.5
% of total	6.9	–	1.4	–	n.d.	–	n.d.	–	0.7	–
D. Railways (p-km)	46.8	0.4	71.6	1.4	75.3	3.1	20.8	2.4	39.1	1.9
% of total	4.7	–	8.3	–	n.d.	–	n.d.	–	5.4	–
E. Air traffic (p-km) (domestic flight)	10.0	5.9	14.5	2.2	n.d.	n.d.	n.d.	n.d.	7.7	4.5
% of total	1.0	–	1.7	–	n.d.	–	n.d.	–	1.1	–
F. Total (p-km)[2]										
(A + B + C + D + E)	994.7	3.4	867.3	2.2	897.9	0.4	394.8	5.8	723.8	1.0
Freight transport										
A. Road (t-km)[3]	154.8	1.6	189.0	4.9	289.0	3.6	161.0	6.1	152.1	1.8
% of total	68.0	–	74.5	–	67.4	–	76.0	–	66.4	–
B. Railways (t-km)	24.4	1.2	50.3	0.2	74.3	0.6	12.3	1.3	19.4	2.4
% of total	10.7	–	19.8	–	17.3	–	5.8	–	8.5	–
C. Inland Waterways (t-km)	0.1	1.1	8.3	0.1	64.8	1.5	0.0	–	0.2	0.0
% of total	0.0	–	3.3	–	15.1	–	0.0	–	0.1	–
D Sea[4] (t-km)	48.5	2.7	6.2	0.5	0.8	1.2	38.4	1.0	57.4	n.d.
% of total	21.3	–	2.4	–	0.2	–	18.1	–	25.1	–
E. Total (t-km)										
(A + B + C + D)	227.7	0.6	253.9	3.4	428.8	2.4	211.8	4.6	229.1	1.5

Note: p-km = passenger-kilometer: 1 passenger transported a distance of 1 kilometer; t-km = ton-kilometer: 1 ton transported for a distance of 1 kilometer.

1. Data are based on national statistics and Eurostat statistics. Annual change over 1995-2001.
2. Excludes air traffic for Germany and Spain.
3. National haulage by vehicles registered in the country.
4. Domestic coastal transport. Intra-EU transport excluded. Due to structural breaks changes are not shown for the United Kingdom.

Source: European Conference of Ministers of Transport; Eurostat, *Energy and Transport in Figures*, 2003.

Current issues

The railway sector has been undergoing a noteworthy reform (IBM Business Consulting Services and Kirchner, 2004). Legal provisions since July 2001 provide for the separation of the railway transportation service company *Trenitalia* from the main infrastructure management company *Rete Ferroviaria Italiana* (RFI), which is burdened by debts and is benefiting from state subsidies. Nevertheless, both companies still belong to the incumbent and state-owned holding *Ferrovie dello Stato* (FS). According to the authorities, even this partial separation should prevent cross-subsidies between different segments of the market. Neither formal separation nor divestiture of *Trenitalia* is considered a priority at the moment but actions in this direction are not excluded by the government. The approval of new legislation by the parliament in October 2003 provides for open access of both international and domestic companies to the network for freight and passenger international transport. National companies can also access the network for domestic freight and long-distance passenger transport services. On the other hand, international companies are allowed only if their country of origin allows access to Italian

companies according to the reciprocity principle. Regional administrations are responsible for tendering contracts for short-distance passenger transport. Nevertheless, no tender has been organised so far, although some of them are now planned in northern Italy.

There are currently 35 companies licensed for activities in the national railway network. However, only slightly more than a third of them have started operating in the RFI network. Some pre-existing regional companies operate in their own smaller networks, whereas others have not started operations. Despite reforms, the dominant position of the incumbent FS is still significant in both freight and short-distance passenger transport service[46] and full in the long-distance passenger transport service.

A regulatory entity on railway services is being established acting as regulator and appeal body of the railway sector. However, the entity reports directly to the Minister of Transport. At the moment, its human resources are minimal but the restructuring plan of the Ministry envisages increasing them soon. Notification of licences for starting operations is responsibility of the Ministry of Transport that has to fulfil administrative procedures within three months from the request. Prices for rail transport services are established by Inter-ministerial Economic Planning Committee (CIPE). Moreover, RFI has still the responsibility of conducting tests and issuing opinions on safety and technical characteristics of new entrants' rolling stocks. Obtaining safety certification is considered by railway undertakings as a long and costly requirement compared with other European countries. Nevertheless, the Ministry of Transport does not plan to tender this service because of the difficulties of finding companies with the same technical knowledge as RFI.[47] On the other hand, service facilities are also under the responsibility of RFI and access to them is judged by new entrants to be relatively easy.

In air transport, national as well as European continental routes have been liberalised.[48] The liberalisation has led to the entry of low-cost carriers with a beneficial impact for consumers. Nonetheless, inter-continental flights – regulated by bilateral air service agreements – as well as the most remunerative airport slots are still under exclusive concession to *Alitalia* (Ponti, 2004), although the government is trying to finalise agreements with non-EU countries to open routes for new entrants. An adequate system for fulfilling universal service obligations has not been put in place. Therefore, *Alitalia* has the obligation of serving non-profitable routes linking remote areas with the rest of the country without receiving direct payment for this public service (Scarpa, 2004 and Sebastiani, 2004). *Alitalia* has been suffering severe financial strains because of increasing competition, lower total demand for air transport services, and high wage and administrative costs.

After commitment by the government to help restructuring *Alitalia*, the 2005 budget bill encompassed € 750 million for a capital injection into the national flag carrier. In October 2004 a state guarantee was issued for bank loans to the company. In addition, the government extended special unemployment benefits already in force in some industries (*cassa integrazione guadagni straordinaria* and *trattamento di mobilitá*) to the airline sector.[49] Around 3,700 workers dismissed from *Alitalia* are expected to enter these schemes or the regular pension scheme in the next few years. Moreover, the State-owned *Fintecna*, which in 2002 replaced the winding-up public holding IRI, has committed to purchase around half of the capital of *AZ Service*, a subsidiary that will be established during *Alitalia*'s business re-organisation and that will be responsible for maintenance, handling and ICT. The state is expected to reduce its share ownership in *Alitalia* below 50% by the end of 2005.

More transparent procedures for the management of airports have been introduced at the end of the 1990s. Nevertheless, their implementation has been slow and partial (Antitrust Authority, 2004b). The maximum length of the airport management exclusive concession (40 years) is still very long and hampers competition for the market. This results in high costs of airport services for airline companies as well as in the intrusion of airport managing companies in potentially competitive markets like handling services and commercial activities inside airports. A recently approved law by the parliament supports these negative developments, as it allows current airport managing companies' contracts to be renewed without competitive tendering.

In road freight transport, owners of companies are still required to register in a professional board. Despite this, the sector is characterised by a large number of small firms, which have been often allowed to run old and highly polluting trucks (Fontana and Zatti, 2003). Minimum and maximum prices for road freight transport services are set by law. A reform of the sector is being implemented. Entry in this market will be liberalised by the end of 2004. Moreover, in October 2003 the government presented a bill eliminating price control in the sector. The same bill also simplifies entry in the long-distance road passenger transport sector. However, the bill is still under discussion in the parliament. In the meanwhile, the liberalisation of local road passenger transport through competitive tendering by regional and local administrations – started in 1997 – is being implemented only slowly and the contract is often awarded to the local incumbent (Ministry of the Economy and Finance, 2003, Boitani and Cambini, 2004). Moreover, prices are set below-cost at the decentralised political level so that the sector still needs to be heavily subsided (Boitani, 2004).[50] The Ministry of Transport (2004) has accordingly proposed to create a permanent committee with representatives from central and local administrations to exchange information on best practice experiences as well as to exert moral suasion towards more decisive liberalisation efforts.

Highway infrastructures – as well all national roads – are publicly owned. The public company ANAS is responsible for authorising and monitoring management of roads as well as for directly managing some of them without setting tolls. Although management of most highways has been tendered, the formerly public company *Autostrade per l'Italia* maintains a dominant position in this sector. Furthermore, local administrations still hold a share – often a controlling share – of a relevant number of highway managing companies. Tolls are established by contracts between ANAS and the highway infrastructure companies on the basis of criteria decided at the political level by CIPE and under approval of the Ministry of Transport and the Ministry of the Economy. No independent regulatory authority exists and the level of tolls is politically-driven. This could enhance the risk of regulatory capture with detrimental effects on consumers. Moreover, the profitability of the highway managing companies could excessively depend on political decisions rather than on their performance.[51]

At the beginning of 2003, ANAS was transformed into a joint-stock company. The financial objective of the company is to collect at least half of its revenues through private sources, which would also permit to the exclusion of the company from the general government aggregate of the national accounts (National Audit Office, 2003).[52] To this end, ANAS plans *inter alia* to introduce tolls for new highways and national roads or in some of the existing ones. The double role of ANAS as both supervisor and manager of highways and national roads could potentially hamper the establishment of a level playing field in

the road infrastructure management sector. Despite this potential conflict of interest, at the moment there is no plan to separate the two functions.

The 2005 budget bill included measures for the transfer of a number of national roads (totalling around 1 500 km) to companies directly or indirectly controlled by the state. The state would then pay an annual fee ("shadow toll") to these companies for maintenance of the roads and for remunerating the initial investment of the managing company. The shadow toll mechanism would represent a step towards more transparency in the financing of road maintenance. To improve the management of national roads, the government should choose an auction procedure open to private companies for assigning the management of national roads and should introduce performance-related financial incentives for road managing companies.

Recommendations

A number of measures are needed to accelerate the liberalisation of the transport sector. As a first important step, road freight should be completely liberalised. Tendering of contracts for local transport services should be accelerated. More in general, a straightforward division should be established between the owners of the networks that are deemed non-contestable, and the providers of the services that are potentially competitive. Thus, RFI and *Trenitalia* should be detached from the FS holding. Moreover, the government should terminate ANAS responsibility as supervisor of the highway managing companies. An independent transport authority should be established provided with adequate human and financial resources. The authority should be charged *inter alia* with the setting of prices for access to the transport networks and service facilities as well as with regulating on transport safety responsibilities especially where these are crucial and more difficult to identify, like in the rail passenger transport sector.[53] The authority could also regulate on prices for the provision of transport services where adequate competition has not yet arisen. Non-discriminatory mechanisms to assign universal service obligations should be introduced. The government should then privatise *Alitalia*, FS and, if adequate private revenue objectives are reached, ANAS.

Reforms in other sectors

In the *telecommunication* sector, consumers are benefiting from falling prices also thanks to ongoing liberalisation (Ministry of the Economy and Finance, 2003).[54] As the incumbent *Telecom Italia* retains a dominant position in network access provision, cross-subsidisation is countered by imposing balance sheet separation of the incumbent's network management activities from the other services. However, this might not be sufficient to ensure a level playing field between *Telecom Italia* and its competitors. Indeed, in November 2004 the Antitrust Authority has found that *Telecom Italia* abuses its dominant position in the business fixed telephony sector by setting higher network access prices to its competitors than to its own integrated retail segment.[55] In the meantime, some operators – notably *Fastweb* – have also chosen to build their own network, although at the moment covering only some bigger cities. Stronger competition should be further boosted by a decrease in the incumbent's interconnection and line rental charges decided by the Communication Authority during 2003. Nonetheless, there is still scope for strengthening competition in the telecommunication market where *Telecom Italia* still retains a dominant position. Moreover, progress towards more competition in mobile telephony is hampered

by the need for establishing new telecommunication infrastructure for third generation devices, which has been slowed down by some local administrations.[56]

In the past, Italy has been slow to develop broadband technology because of insufficient competition in analogical telephone network and the lack of platform competition – cable TV facilities being almost completely absent. However, since 2002 the expansion of broadband technology has accelerated[57] and fixed and mobile broadband lines have increased at a rate higher than in other European countries. This performance is explained by both a more articulated supply of broadband services by private providers and by public intervention like: *a)* financial aid to business for activating broadband connections; *b)* implementation of e-government projects; *c)* introduction of a programme for the development of broadband network in the South carried out by two companies controlled by the State-owned *Sviluppo Italia*.

In August 2003, the government approved the new code of laws on electronic communications. On the basis of this new legislation, the Communication Authority has to periodically monitor the degree of competition in different segments of the telecommunication market. If competition is deemed adequate, then regulation initially introduced to boost contestability should be dropped. Moreover, licences are to be substituted by automatic general authorisations. Mobile telephony's available frequencies can now be freely bought and sold among operators. Measures have also been introduced to limit local administrations' barriers (for example local taxes or fees) to the establishment of new telecommunication infrastructures.

On the other hand, the government has been limiting the responsibilities of the Communication Authority. In 2001, the power to issue licences was transferred from the Authority to the Ministry of Communication (see the *2003 Survey*). Moreover, the above mentioned code of laws on electronic communications has formally recognised as regulatory institutions in telecommunications both the Authority and the Ministry without clearly specifying the division of responsibilities. Finally, at the end of 2003 the Ministry claimed the responsibility for market control, monitoring of companies' adherence to regulation and enforcement of sanctions. A new formal cooperation protocol between the Ministry and the Authority clearly identifying responsibilities has nevertheless been defined and approved in June 2004. Since the state participates– indirectly through ENEL – in a company operating in the sector (*Wind*) and has a golden share in the incumbent, these steps risk tilting the playing field in the market.

To make further progress in the liberalisation of telecommunications, the independence and responsibilities of the Communication Authority should be re-instated. Moreover, the government should abandon its participation in the sector, notably by accelerating the divestiture of *Wind* by ENEL. Finally, the golden share in the incumbent should be substituted by appropriate regulation, if strategic objectives are deemed to be protected.

A major reform of the *media* sector was approved in May 2004. The law identifies a new "communication integrated system" (*sistema integrato delle comunicazioni*, SIC) aggregating many media activities and imposes a 20% ownership ceiling, which should be monitored by the Communication Authority. However, apart from some exceptions[58] no ceiling is imposed on individual segments of the media market, which in any case are still subject to antitrust legislation.[59] For analogue terrestrial television , *i.e.* the most popular system in Italy, the new ceiling on SIC implies looser constraints than previously existing ones, thus

upholding the current duopoly by the State-owned *Radiotelevisione Italiana* (RAI) and *Mediaset*.

On the other hand, this new legislation could be considered more forward-looking as it includes in the SIC – among other media – digital terrestrial television. This broadcasting system allows for a higher number of national channels than the analogue one and therefore has the potential to boost competition. Digital television is now scarcely widespread but the law itself expects this new system to replace analogue television by end-2006 also thanks to public incentives for households to switch.[60] It should be noted, however, that in the meanwhile current exclusive concessions for the use of the analogue frequencies are automatically renewed, while both RAI and *Mediaset* are allowed to duplicate their existing channels also in the new system. Moreover, despite the possible overuse of frequencies per channel, the Antitrust Authority recently agreed on the purchase of additional frequencies by RAI, which claims to need additional frequencies for improving quality. These measures could put the current dominant companies in a favourable position also in the emerging digital television sector. Therefore, the existing duopoly in national broadcasting by state-owned RAI and *Mediaset* is likely to persist in the medium term. The Communication Authority and the Antitrust Authority will have the challenging task of preventing this scenario from arising and of establishing adequate conditions for new entrants to participate in the broadcasting market.

The law also provides for a partial divestiture of RAI that will, however, remain under public control with a maximum threshold of 1% for individual participations by private investors. The government plans to divest at least 20% of the company in 2005. RAI will continue to broadcast programs of public interest for an additional twelve years and the parliament will continue being in charge of choosing the public representatives of its executive board, which however will be formally appointed by the Ministry of the Economy. The company will provide for accounting separation of its activities of public interest – financed through a public fee – from commercial ones.

In some other areas, measures are needed to strengthen competition. Regarding *professional services*, associations (*ordini*) and minimum fees are still considered by the government to be important instruments to guarantee quality and protect the interests of consumers. Therefore, professional services mostly fall outside antitrust jurisdiction. Proposals currently under consideration by the parliament could make the problems even worse. In fact, a bipartisan bill is being discussed introducing several new professional associations in the health sector. Another bipartisan bill proposes to introduce a reference price for professional services which would substitute the current price ranges.[61] But the reference price would still be determined by law on the basis of associations' proposals. On the other hand, restrictions on advertising would be relaxed and more freedom for professionals' choice of their business configuration (including partnerships) would be introduced, which could improve efficiency in this sector still characterised by an atomistic structure.[62] In the meanwhile, following the devolution process introduced by the 2001 changes to the Constitution, legislation was implemented in some regions giving a greater political consultative role to professional associations.[63] As a response, the central government recently approved a decree to establish more clearly the division of responsibilities regarding professional services between central and regional administrations. The reform of professional services should be stepped up. A review of the exclusion of professional services from antitrust jurisdiction should be carried out with the objective of removing the exclusions that are unnecessary.

In the *retail sector*, several regional administrations are slowing down the liberalisation process (see the *2003 Survey*). While for small outlets licensing is no longer required, large-scale retailers need authorisation by local authorities. Regulations on large-scale outlets often aim at promoting non-economic objectives, such as urban planning and small shopkeepers in cities' historical centres. However, in many cases local governments have implemented a restrictive policy.[64] As a result, the share of smaller shops has increased significantly since 1999 when the reform of the sector was introduced. Although big retailers have been adapting to these developments through purchasing or opening smaller shops, these limits to the expansion of bigger retail chains may have prevented downward pressure on aggregate prices, especially on widely-used goods (Figure 3.4). Despite these developments at the local level, the central government still imposes very strict time limits on price discounts on most items, as well as a specific administrative burden attached to these discounts, to avoid small shopkeepers being displaced from the market. At the same time, however, responding to mounting consumers' disappointment with price rises that also led to a "shopping strike" in September 2003, in the 2004 budget law the government introduced provisions for more intense price monitoring by the financial police and for funding initiatives at the local level to promote sale offers of widely-used goods. More recently in September 2004, the Ministry of Productive Activities signed an agreement with large-scale retailers freezing the prices of some of their products until end-year. These latest initiatives seem to be successful in slowing down price increases of widely-used goods so far (Figure 3.4).

The effectiveness (and desirability) of these measures should be re-assessed. On one hand, barring price reductions has clearly limited benefits accruing to consumers from the liberalisation of retail trade to the advantage of smaller shopkeepers. Any risk of predatory price strategy should be assessed on a case-by-case basis by the Antitrust Authority. On the other hand, a constant monitoring of price increases is difficult to implement and in any case should not prevent the provision of market signals to both business and consumers regarding the adequate choice of their suppliers. Finally, voluntary price restraints through moral suasion could only have a short-run decelerating effect on inflation but risk having the opposite one once the voluntary restraint is over unless the structural problems of the retail sector are tackled. Accordingly, moral suasion by the central government could be helpful for an effective implementation of the retail trade liberalisation at local level.

The divestiture programme

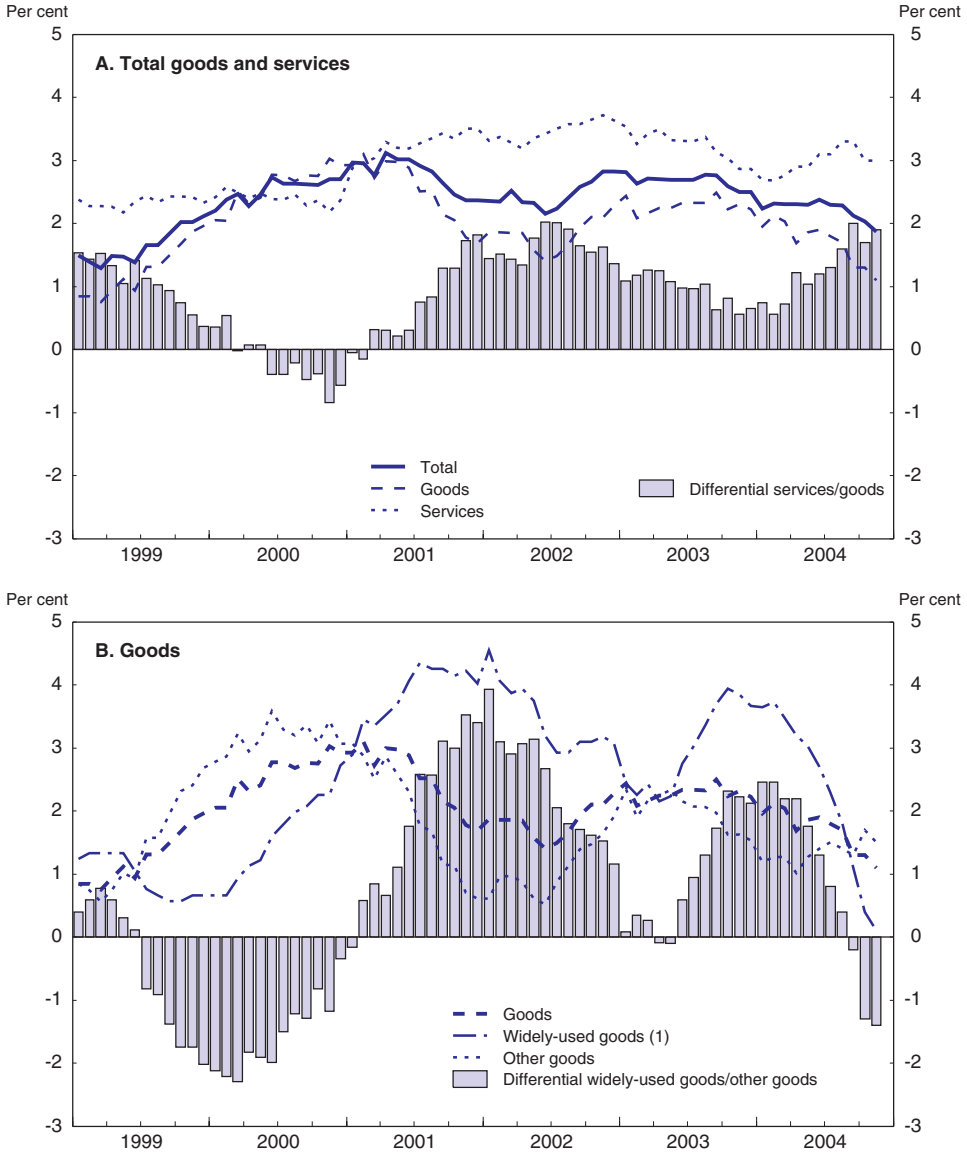
Since the beginning of the 1990s, the government has carried out a major divestiture programme of public companies (see Chapter 2). However, the government still holds majority or control shares in a sizeable number of companies, notably in energy and transport (Figure 3.5). Moreover, a "golden share" was introduced in the by-laws of some divested companies allowing government vetoes in some of their strategic choices.

After some years of slowdown, recently the divestiture programme has been resumed more forcefully. In 2003, the government privatised ETI (tobacco manufacturing company) and sold shares of ENEL (6.6 percent) and of the financial institution *Mediocredito Friuli Venezia Giulia* (34%).[65] In October 2004, the Ministry of Finance further divested around 19% of its directly-held assets in ENEL. This sell-off still leaves the public sector with a control share of the company, which the government intends to retain.

Moreover, at end-2003 the financial institution *Cassa Depositi e Prestiti* (CDP) – charged with financing local administrations' investments – was split from the general government

Figure 3.4. **The inflation rate: a breakdown**

Year-on-year percentage changes of consumer price index



1. Includes food, detergent goods for housing and personal care goods.

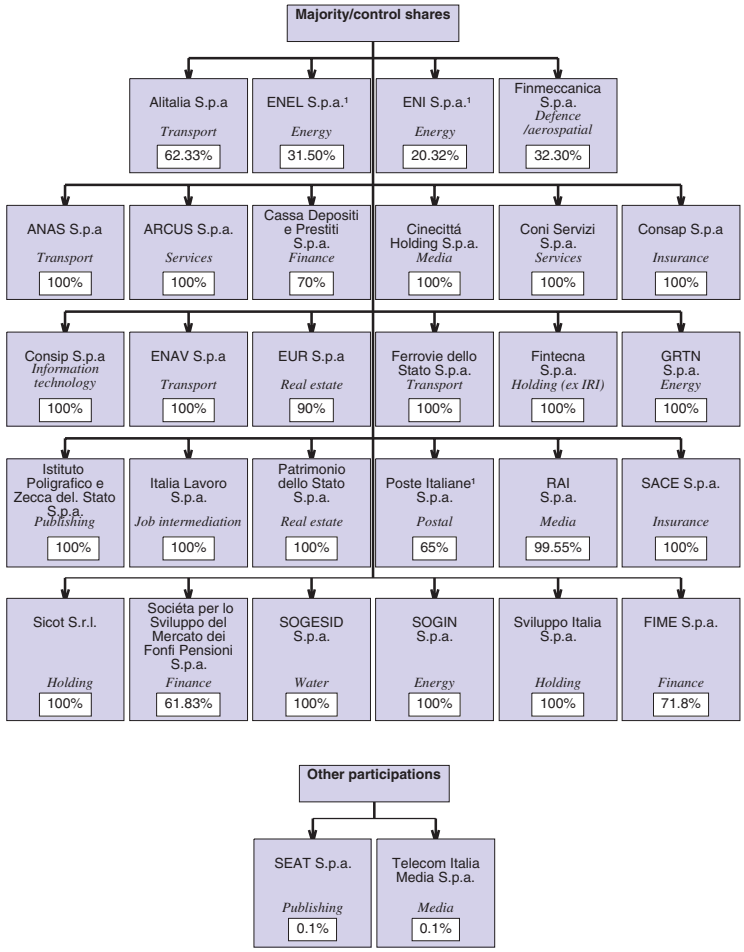
Source: ISTAT.

and transformed into a joint-stock company, of which 30% was purchased by bank foundations while the rest remained under direct public control. At the same time, the Ministry of the Economy transferred shares of ENEL (10.35%), ENI (10%) and the public postal company *Poste Italiane* (35%) to CDP. CDP is also considering purchasing shares of *Terna* and of *STMicroelectronics*, a microchip producer currently controlled by *Finmeccanica* and by the French *Areva* and *France Télécom*.

These industrial participations contribute to the asset position of the CDP's *gestione separata*, *i.e.* the segment of activities aimed at providing direct lending at favourable conditions to local authorities for public services not subject to competition.[66] As *gestione*

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Figure 3.5. **The government direct ownership**
As of November 2004



1. An additional 10.35% of ENEL, 10% of ENI and 35% of *Poste Italiane* is indirectly controlled through *Cassa Depositi e Prestiti*.

Source: Ministry of the Economy and Finance, Dipartimento del Tesoro.

separata is required by law to remain in financial equilibrium, it is unlikely that its assets in ENI and ENEL – providing substantial dividends – will be divested any time soon. At the same time, *Poste Italiane* will have the important task of distributing existing and new postal saving products on behalf of CDP, which will represent the main source of funding for *gestione separata*. Therefore, CDP considers the 35% ownership of *Poste* as crucial for the success of its funding activities so that its divestiture seems unlikely at the moment.

Meanwhile, *Fintecna* is closing or selling a number of public companies – for example the sea transport company *Tirrenia* – and will finance new infrastructure projects like the

Box 3.3. **Recommendations in financial and product markets**

Financial markets

1. *Reform bankruptcy legislation*: Make sure that government intervention and use of revocation in the restructuring of distressed large companies do not jeopardize the level playing field among firms; approve and implement a new general bankruptcy law which adequately encourages private settlements with creditors, speeds up the liquidation procedures of insolvent companies and allows insolvent debtor to start a new business.
2. *Enhance corporate governance and transparency of financial instruments*: Approve and implement the bill presented in the parliament, in particular the measures to protect minority shareholders, to improve transparency of financial instruments, to disclose conflicts of interests and limit their negative effects, to strengthen sanctions in case of corporate misconduct to require *Borsa Italiana* to establish an *ad-hoc* market segment of listed companies representing groups used to build pyramidal structures; require financial intermediaries to provide information to their customers on whether or not bond issues include companies' ratings and, if the rating is included, on the default risk linked to each rating level; establish specialised judiciary courts' sections dealing exclusively with corporate and financial crimes; consider introducing the possibility for shareholders and creditors to launch class-action-type lawsuits as well as monetary incentives for individuals denouncing companies' illegal behaviour ("whistleblowers").
3. *Strengthen financial market supervision*: Streamline financial market supervision with a view of enhancing supervisory authorities' accountability; improve cooperation among the supervisory Authorities with a view to share information and methods, guarantee a rapid and smooth proceeding of supervisory tasks and ensure appropriate balance between their different objectives, re-examine the purpose of CICR and, eventually, abolish it; increase human and financial resources to CONSOB.
4. *Reinforce corporate self-discipline*: Subject companies' listing in the stock exchange to the implementation of the corporate Code of Conduct; require CONSOB to supervise the effective enforcement of the recommendations.
5. *Improve governance of the Italian Stock Exchange*: Consider listing of the Stock Exchange; strengthen supervision by CONSOB as envisaged by the bipartisan bill presented in the parliament;

Product markets

6. *Continue liberalisation and privatisation in electricity and gas*: Terminate ENI's control on the national gas transmission operator; reduce *de facto* gas import barriers for new entrants; provide for vertical separation of the gas storage facilities; consider fully privatising the electricity and gas transmission network while continuing to ensure third party access rights; provide enough market-based incentives to the private operators for adequately investing in new transmission and storage infrastructure; proceed with the full privatisation of ENEL and ENI once enough competition in the sector is ensured; make sure that the ongoing devolution process does not imply a slowing down of liberalisation and privatisation at the decentralised level.
7. *Speed up liberalisation in transport:* Liberalise completely road freight transport, especially prices; accelerate tendering of contracts for local transport services, both for road and railway; terminate ANAS responsibility as supervisor of the highway managing companies; introduce tendering for the management of national roads as well as performance-related financial incentives for road managing companies; introduce obligation of tendering for the management of airport facilities; detach RFI and *Trenitalia* from the FS holding; establish an independent transport authority provided with adequate human and financial resources and charged *inter alia* with the setting of prices for access to the transport networks and service facilities as well as with regulating on prices for the provision of transport services where adequate competition has not yet arisen and on transport safety responsibilities; introduce non-discriminatory mechanisms to assign universal service obligations; privatise *Alitalia*, FS once enough competition in railway is ensured, and ANAS if adequate private revenue objectives are reached.

Box 3.3. **Recommendations in financial and product markets** *(cont.)*

Product markets

8. *Keep up competition in telecommunications:* Abandon government participation in the sector, notably by accelerating the divestiture of *Wind* by ENEL; substitute the golden share in the incumbent by appropriate regulation if strategic objectives are deemed to be protected; re-instate the independence and responsibilities of the Communication Authority.
9. *Reduce rents in inherently competitive sectors:* Perform an overall review of the exclusion of professional services from antitrust jurisdiction with the objective of eliminating any unnecessary restriction to competition; reconsider measures barring price reductions and monitoring of price increases in the retail sector; make sure that voluntary price restraints through moral suasion do not result in price bouncing back once control is lifted; exert a stronger moral suasion for the implementation of the retail trade liberalisation at local level.

Messina Strait bridge. *Fintecna* is expected to shut down once its divestiture programme is finished.

Moreover, the 2004 budget requested the government to streamline procedures and purposes of its golden shares currently enforced in the by-laws of *Telecom Italia*, ENEL, ENI and the aerospace and defence-related company *Finmeccanica*. The reasons for exerting vetoes through golden shares will be limited to national security and defence issues. Vetoes can be exercised in case of mergers, relocations abroad and share acquisitions over a certain threshold. The government will substitute its current members of the executive boards with "observers" without voting rights in charge of verifying whether companies' operations could require the government veto. To accelerate the veto decision procedures, the silence-is-consent method has been introduced. In addition, the government's decisions can be challenged in administrative courts. However, for the moment the government will maintain all the existing golden shares and could introduce a new one in *Alitalia*'s by-law.

Finally, the privatisation of *local public services* is proceeding slowly. While many former public utility agencies were transformed into joint-stock companies, they mostly remained under public control (Confservizi, 2004). A major reason for the delay of local public service liberalisation is the uncertainty over the division of regulatory responsibilities between local and central authorities.[67] In many cases local administrations still mandate the provision of public services to the publicly-owned incumbents without competitive tendering.[68] National legislation passed in the context of the 2004 budget has validated the persistence of this practice at least until the end of 2006.[69] These steps contribute to slowing down the liberalisation process in the provision of local public services.[70]

Overall, while the regulatory reform has further progressed in a number of sectors, the government both at the central and local level still maintains a significant direct control over the economy. This pervasive presence could prevent the establishment of a level playing field and may discourage foreign investment. The government should thus speed up the privatisation programme while making sure that the ongoing devolution process does not imply a slowing down of liberalisations at the decentralised level.

Notes

1. Cirio and Parmalat bonds accounted for approximately 10% of total corporate bonds held by Italian households and 0.2% of their financial assets.
2. However, a prospectus must be published when a public offer is made in the secondary market.
3. For example, in the case of the Cirio bond default CONSOB proposed to the Minister of the Economy to impose fines for more than 400 bank employees.
4. Some major banks have started to implement plans of partial or complete reimbursement of the defaulted bonds placed to some segments of retail customers. These initiatives could represent an implicit admission of opaque behaviour towards some segments of private investors or inadequate capacity of banks' operators to assess the risk of sophisticated financial instruments.
5. According to the civil law, bond financing in the domestic market could not be higher than companies' paid-up capital.
6. The difference with the euro area average is explained by two reasons. First, a relatively high proportion of Italian banks' liabilities consist of bonds. Including interests on bonds in the computation would partly reduce the margin because this form of fundraising is more costly than deposits. The second reason is the different structure of the Italian productive sector. The Italian business system is mainly composed of small firms, to which banks lend with a risk premium. According to ECB harmonized statistics, at the end of 2003 in Italy the interest rate on new loans up to 1 million euro, which proxies credit standards for small firms, was equal to 4.1% whereas that on new loans over 1 million euro was 3.2%, identical to the euro area as a whole.
7. Some concern has been raised as to whether these securitisation operations have transferred banks' risks to private investors. However, most securities were bought by institutional investors while only a small part is held by mutual funds, hence indirectly by private investors.
8. For example, in Parmalat the independent directors were close friends of the company's president.
9. In a symbolic move, the Association grouping mutual funds (ASSOGESTIONI) has bought a number of shares in each listed company and through this participates in general meetings. However, participation of individual mutual funds to companies' general meetings is rare.
10. For example, "tunnelling", *i.e.* the transfer of assets or profits out of firm for the benefit of the controlling shareholder has been observed in the Parmalat case. The problem could be more severe in the context of a group of companies where the controlling company can more easily shift assets away from the controlled one.
11. The traditional governance model for listed companies is characterised by a board of directors (consiglio di amministrazione) and a board of auditors (collegio sindacale). The recent changes to the company law introduced other two governance models: *a)* the dualistic (two-tier) model characterised by an executive council and a supervisory council; *b)* the monistic (one-tier) model with a board of directors which nominates the internal auditing council. See the 2003 OECD Economic Survey of Italy for more details. In what follows, for convenience we will refer mainly to the traditional model as it still represents the dominant governance model in Italy. However, the same analysis broadly extends also to the other two models.
12. The minimum threshold was 1.9% on average for 26 large listed companies in 2004 according to ASSONIME, the association grouping the Italian joint-stock companies.
13. A further conflict of interest could derive from the widespread ownership of mutual funds by banks. This issue will gain increasing importance given the likely involvement of mutual funds in the expansion of the private pension pillar. See the 2003 OECD *Economic Survey of Italy* for a discussion.
14. The current credit ceiling to participating companies and their subsidiaries is 20% of banks' supervised capital, which is quite high. Moreover, this limit is valid for each participating company. Therefore, if two companies participate in the bank's capital, then the total limit is 40% (20% for each participating company). However, additional restrictions are in place: Bank of Italy can require companies to sign a memo declaring not to influence decisions of the board; if credit is provided to companies that participate in the bank's board of directors, then all members of the board have to agree to the operation. The adequacy of current credit ceilings is being reviewed and the ceilings could be eventually reinforced.
15. Other governance issues could arise from the relationship between banks and banks' foundations. In a welcome step, the foundations' regulation has been recently changed establishing their private status. However, a more controversial rule allows individuals holding top positions in the

foundations to take high level posts in the banks of which foundations have a "non-relevant" participation (*i.e.* a participation of less than 20% for non-listed banks and of 10% for listed ones). This could delay the separation of foundations from banks, an issue that has been analysed in the 2003 OECD Economic Survey of Italy. Moreover, in August 2003 a decree law allowed foundations to postpone the disposal of their controlling stakes in banks until the end of 2005. Furthermore, foundations with net worth less than EUR 200 million as well as foundations located in special-status regions (Regioni a statuto speciale) are excluded from the obligation of disposing of their controlling stake.

16. Another conflict of interest could derive from banks' share ownership in listed companies as well as from the listing of banks themselves that could result in a more lenient application of market rules for financial institutions or for companies where financial institutions are shareholders. Similarly to listing, this conflict is tackled by giving direct responsibility for sanctions to the CEO.

17. Around 40 codes of conduct have also been issued by business associations aimed at adopting governance models preventing briberies. This is in response to a 2001 legal provision recognising company responsibility when employees engage in briberies.

18. However, if the company fails to establish adequate internal auditing institutions, it can be liable of the crimes committed by its directors (Fazio, 2004).

19. For example, the maximum sanction for misbehaviour is EUR 25 800 for intermediaries and double that amount for companies issuing bonds. See Cardia (2004).

20. The priority of stability over competition objectives in Italy is probably a heritage of the pre-1990s legislation, which was established after the banking crisis of the 1930's, and of the fact that for a long time the banking sector was under public ownership. See Tesauro (2004).

21. For example, in August 2004 the CICR issued guidelines regarding the corporate governance of banks and provided the Bank of Italy with the responsibility for their implementation.

22. For example, the acquisition of a distressed bank by a profitable one could enhance stability but dampen competition. On the other hand, the relevant participation in a bank by a non-financial company could raise stability issues but be irrelevant for competition.

23. In April 2004, the government approved additional measures to ease the composition with creditors (concordato) for large companies.

24. For a fuller discussion of the new company law see the 2003 *OECD Economic Survey of Italy* and Ministry of the Economy and Finance (2003).

25. Together with the company law, the government has also introduced simplified judiciary procedures concerning corporate issues.

26. In October 2004, a decree fine-tuning the company law introduced the obligation for sole managing directors to disclose their conflicts of interest also during shareholders' meetings.

27. Decreto legislativo No. 310 was approved on 28 December 2004.

28. An earlier version of the bill had stated that the Antitrust Authority would have to ensure competition in the banking sector; that a joint authorisation by the Antitrust Authority (concerning competition) and the Bank of Italy (concerning stability) would be foreseen for mergers and acquisitions in the banking sector; and that a new Bank of Italy by-law would contain a maximum length for the office of the Governor. These measures were eliminated from the final version of the bill.

29. The original bipartisan bill differs from the bill currently under discussion mainly as regards the supervisory model. According to the bipartisan bill, CONSOB would be replaced by a new "Authority on financial markets". COVIP and ISVAP would be abolished and supervision of insurances and pension funds would be allocated to the other supervisory institutions according to their assigned objectives. A new parliamentary committee on saving would be created, which would issue a binding opinion regarding the appointment of the Bank of Italy's governor and of the president of the new Authority of financial markets. The committee would also examine the opinions and the annual reports of the supervisory authorities.

30. An earlier version of the bill stated that presidents of companies will not be allowed to have executive roles. This is no longer in the final version.

31. Some more specific measures have also been introduced by a Decree of the Ministry of the Economy regarding the administration of government bills and bonds bought by financial intermediaries on behalf of their clients. The Decree aims at enlarging and improving the minimum information that intermediaries have to provide to their clients regarding the

government bonds' auctions, the tax treatment and the fees applied by the intermediaries. The Decree also introduces a ceiling on the intermediation and administration fees. The information requirements are welcome as they could reduce the information asymmetries existing between financial intermediaries and clients. However, the setting of intermediation fees should be left to the market rather than distorted by the imposition of ceilings.

32. The legge comunitaria has been approved by the Chamber of Deputies and is currently under discussion by the Senate.

33. See Allegra *et al*. (2004).

34. See Allegra *et al*. *op. cit*. for an estimation of dependence of the tradable sector on the non tradable one in the Italian economy.

35. In June 2003, available capacity was 48 000 MW while demand was 53 000 MW. It should be noticed that net operative capacity was higher than demand (63 000 MW) but that almost ¼ of the capacity was unavailable because of maintenance and network problems.

36. This corresponds to a market opening of 66% (European Commission, 2004a).

37. The law has been approved by the parliament in July 2004 after two years since its presentation by the government. However, parts of the original bill had already been approved through separate laws. See the 2003 OECD Survey of Italy for a fuller description of the original bill.

38. The changes to the Italian Constitution approved in 2001 have given regional administrations legislative power over energy production, transport and distribution. Nevertheless, the state establishes the general principles over which regional legislation should be based.

39. The name CIP6 derives from the deliberation number 6 of the now winded down Comitato Interministeriale Prezzi that introduced such incentives in 1992.

40. Starting from April 2004, the Electricity and Gas Authority has intensified inspections at subsidised plants to verify that they still satisfy the conditions for receiving subsidies set by the 1992 deliberation.

41. Because of higher temperatures, during the summer import capacity is reduced by around 15%. See SFOE (2003).

42. Transactions are supervised by Gestore del Mercato Elettrico (Electric Market Managing Company).

43. GRTN is required by law to purchase electricity produced by CIP6 generators at a pre-determined above-the-market price. This capacity is then assigned outside the Borsa to all interested consumers at below-the-market price. GRTN is reimbursed for the difference between purchasing and selling price through an ad-hoc item in the final consumers' electricity bill. Also import capacity – significantly cheaper than domestic generation – is assigned by GRTN outside the Borsa to all interested consumers. For both CIP6 generation and imports, the rules for their allocation are established by the Electricity and Gas Authority in such a way that a large number of final consumers – including the Acquirente Unico – can get a "fair" share of these capacities, *i.e.* a share proportional to the consumers' request. Market mechanisms like the Borsa would not guarantee the distribution of a "fair" share of this capacity.

44. See the interview of the then-president of the Electricity and Gas Authority Pippo Ranci in Michele Polo: "Parola di Authority", 23-09-2003, *www.lavoce.info*.

45. The 1994 reform assigns the responsibility of individual ports' regulation and planning to independent authorities. These authorities allocate the use or management of port terminals to private companies through competitive tendering. See Musso (2002).

46. For the rail freight transport sector the market share of the incumbent was around 98% of total tonne-kms in 2003. For the short distance passenger transport the market share was approximately 99% of total passenger-kms. See IBM Business Consulting Services and Kirchner, 2004.

47. A recent EC Directive requires EU member states to establish an independent safety certification authority by 2006. Therefore, Italy will have to comply by that date.

48. The Antitrust Authority has recently blocked a coach-sharing agreement between the national flag carrier Alitalia and Volare concerning domestic routes.

49. The schemes will be financed by *ad hoc* social security contributions from airline companies and by the state.

50. During the recent bargaining claims in the public transport sector in Milan, to avoid further strikes also the central government agreed to grant subsidies to finance previously agreed wage rises.

51. During 2003 and the beginning of 2004, there has been a long discussion on criteria for the new tolls for the highway network managed by Autostrade per l'Italia. Tolls established by the contract between ANAS and Austostrade had to be changed because in the meanwhile CIPE had modified the criteria for their calculation. In particular, CIPE – which in this occasion also requested the approval of its decision by the parliament – established that the costs of new investments had to be recovered in 10 rather than 5 years thus allowing a reduction of the proposed tolls. During this discussion, the profitability of Autostrade was highly uncertain and its share price fluctuated considerably.

52. In 2002, ANAS financing sources were almost completely public.

53. Safety in rail transport depends on the maintenance of both the railway and of the rolling stocks, which in a vertically separated network should belong to different companies. Hold-up problems could emerge if division of responsibilities is left unclear.

54. For a review of telecommunication liberalisation in EU Member states see European Commission (2003).

55. The Antitrust Authority had previously intervened to block the acquisition of a wireless-fidelity interconnection company by Telecom Italia for fear that it could establish a dominant position in wireless interconnection in addition to the one retained in fixed-line interconnection.

56. A segment of the telecommunication sector that is still characterised by a dominant position is the production and distribution of business phone directories. This is probably explained by the presence of network externalities (Buzzacchi and Cambini, 2004). The solution envisaged by the Communication Authority is to grant exclusive concessions on this activity in local areas through competitive tendering. An alternative is to introduce a cap on the price charged by the current quasi-monopolist (Pagine Gialle) to the companies listed in the directories.

57. In June 2004 over 45% of the enterprises with access to the internet used broadband technology, with a peak of 95% among enterprises with over 250 employees. At the same time, nearly 6 million households had a broadband connection (with broadband referring to a speed connection over 128 Kbps), *i.e.* 38% of all households using internet. This percentage has more than doubled since October 2003. More information is available in the 2004 report by the Permanent Observatory on the Information Society: *www.innovazione.gov.it*.

58. Some new less binding limits are imposed on ownership of local televisions. Limits will also characterise cross-ownerships of national televisions and newspapers until end-2010.

59. According to the European Commission normal procedure, concerns on dominant position usually arise with a market share of over 40% although at times dominant positions could also arise with lower market shares. See the 2002 European Commission guidelines for market analysis and evaluation of significant market power on electronic communication services (Official Gazette No. 2002/C, 165/03).

60. In 2004, the incentive was EUR 150 for the purchase of the device allowing TV sets to broadcast digital programmes. A recent survey from the Communication Authority has pointed out that the current status of the infrastructure is consistent with the attainment of this objective but that it is uncertain whether households will be prepared to switch by end-2006.

61. In the meanwhile, in the context of generalised increases of prices for legal services, new minimum and maximum prices have been introduced for services provided electronically, *e.g.* e-mail.

62. An *ad hoc* government commission has finalised proposals for reforming the professions. However, the proposals have not been endorsed by the government yet.

63. Incentives have also been introduced for using services from professionals that are members of *ad hoc* rolls. For example, the Lazio regional administration provides contributions for building renovations to co-owners choosing condominium managers from the ad-hoc professional roll.

64. Other subtle instruments are sometimes used to slow down liberalisation of retail trade at local level. For example, exploiting a loophole in national legislation a number of regions do not allow coffee bars or food retailers to sell both daily newspapers and all the other periodicals at the same time but only one of the two categories. In so doing, newsstands can continue exploiting the exclusive right of selling all kinds of periodicals.

65. See Ministry of the Economy and Finance (2004b).

66. The other segment of CDP's activities is called gestione ordinaria and will finance public infrastructure considered remunerative. CDP will fund these activities by issuing financial instruments without state guarantee.

67. In July 2004, the Constitutional Court has established that the state has responsibility over ensuring competition in the provision of the services. Nevertheless, the state can only identify the general principles on competition whereas the local authorities implement more specific rules in accordance with these general principles. It remains to be seen whether this clarification of the Constitutional Court will accelerate local public service liberalisation.

68. As an example, current legislation for local public transport foresaw the awarding of services through competitive tendering from 2003. Local authorities in Lombardy are considered the most advanced in this area. Nevertheless, they have awarded only 10 of the 22 planned tenders. Other two tenders are about to be awarded and six tenders are in progress. Three local authorities have still to start the administrative procedures needed for tendering.

69. The tender obligation can be overcome in the case of the so-called "in-house" services. These services are defined as those not involving any explicit contractual relationship between the public institution (*e.g.* a municipality) and the entity performing the services. Moreover, this entity is required to perform the bulk of its activities with the public institution.

70. In the absence of adequate public administration capability at local level competitive tendering of public services could result in the establishment of local monopolies not appropriately regulated or monitored. This could be a problem especially in many regions of the South. Accordingly, the government considers building an adequate administrative capacity at local level as a crucial pre-requisite for the successful privatisation of public services.

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ANNEX 3.A1

The Parmalat case[1]

Parmalat started its activities in the 1960s and is now one of the biggest agro food enterprises in Europe. Its operations have gradually assumed an international dimension and now the group owns companies in 50 different countries. *Parmalat* increasingly used international bond issuing as a source of finance. Since 1997, 32 bond issues were carried out. More than 80% of the group's bond issues were underwritten by leading international banks. Three quarters of the outstanding bonds are held by foreign investors.

Despite its international expansion, governance of the company did not improve. In fact, it progressively developed into a complex and opaque corporate structure that allowed close control by founding family members.[2] Many financial operations were carried out through its subsidiary companies abroad, often located in off-shore centres. Some of these operations were illegal. In particular, some acquisitions and investments were financed by using funds at some of its subsidiaries, funds that later on have been discovered to be non-existent.

In March 2003, the securities market watchdog (*Commissione Nazionale per le Societá e la Borsa*, CONSOB) started to question the asset composition of *Parmalat*'s 2002 balance sheet, in particular its high levels of both debt and liquid assets. The company justified the high level of liquid assets with its strategy of readily exploiting expansion opportunities. At this stage, neither the internal board of auditors (*collegio sindacale*) nor the main external auditor pointed out critical areas in *Parmalat*'s balance sheet. During the summer, CONSOB reiterated its requests for clarifications on the existence and use of the company's liquid assets to the *collegio sindacale*, the main external auditor and the secondary external auditor. In response, the *collegio sindacale* and the external auditors provided information to CONSOB on a subsidiary, the *Bonlat Financing Corporation*, based in the Cayman Islands. According to this information, the subsidiary held most of *Parmalat*'s liquid assets in a bank account at Bank of America, which was partly re-invested in a mutual fund, *Epicurum*, again located in the Cayman Islands and not listed in any regulated market. At the beginning of autumn, the main external auditor started to direct criticisms at the funds invested in *Epicurum*. At the end of October, CONSOB requested *Parmalat* to disclose to the market a more transparent picture of its financial situation. As a result, the company issued three press releases including part of the information requested by CONSOB.

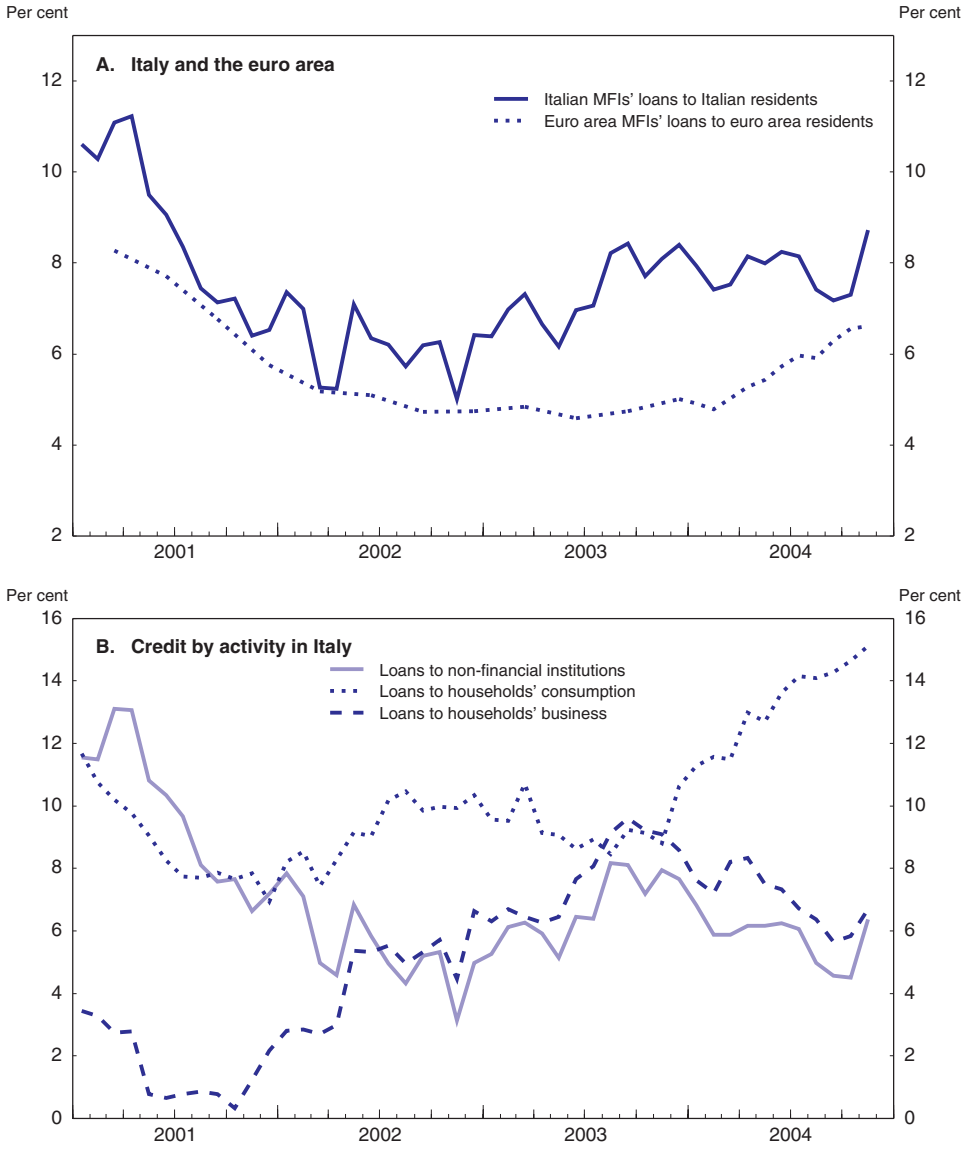
The company's irregularities came to full light only at the end of 2003 and the beginning of 2004, shortly after the group started to be unable to repay some bond issues in mid-December and to service its debt with banks. On the 18th of December it was finally discovered that the liquid assets held by *Bonlat* at Bank of America were non-existent and

that the papers documenting them were forged. The company is still under investigation for its irregularities. At the end of December 2003, the boards of directors of the *Parmalat* group's main companies decided to undertake the "extraordinary administration" procedures (*amministrazione straordinaria*) as recently introduced by the government for companies in "economic and financial crisis".

Parmalat bond prices were at par in November 2003, as the official rating of Standard&Poor was still BBB – which corresponds to a default probability within one year of only 0.43% or within two years of 1.36%. On December 9, the bonds were downgraded to

Figure 3.A1.1. **Credit to the private sector by monetary and financial institutions (MFIs)**[1]

Year-on-year percentage changes



1. Private sector is defined as non-financial sector and households.

Source: Bank of Italy, Supplements to the Statistical Bulletin, Monetary Financial Institutions: Banks and Money Market Funds, various issues.

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B+ and to D on December 22. The bond's price plummeted to 20% of the nominal value after the uncovering of the company's unsustainable financial position. Around 85 000 households have suffered significantly from this fall as they had bought the securities without the intermediation of mutual funds, which would have allowed a greater diversification of risks.

One of the most harmful consequences of the successive defaults (*Parmalat* being the latest of a series involving also Argentina and *Cirio* as well as a number of companies in the segment *Nuovo Mercato* of the Italian Stock Exchange) could be a loss of public confidence in private securities, which would hurt profitable and unprofitable companies alike.

Nevertheless, even after the *Parmalat* case erupted, financing costs for medium and high rated Italian bond issuers remained almost unchanged and in line with those of similar foreign companies. At the same time, despite a deceleration of credit to manufacturing companies and family-run businesses since the second half of 2003,[3] loan growth overall remains sustained and higher than in the euro area on average also thanks to an acceleration of household consumption financing (see Figure 3.A1.1). Another positive development is the lengthening of average loan maturity.

By contrast, after the *Parmalat* default the return on Italian "high yield" corporate bonds – *i.e.* bonds with low or no rating – increased by around 300 basis points compared with similar bonds issued by foreign companies as demand for these bonds fell also because banks have become more cautious to proposing these instruments to the public. In 2003, bond issuing by non-financial companies has almost halved in Italy while it has doubled in the euro area on average. Furthermore, at the end of 2003 and the beginning of 2004 bad loans have increased significantly compared with the previous year as a result of the impact of the *Parmalat* bond default as well as the persistent macroeconomic slowdown. Nevertheless, the level of bad loans relative to supervisory capital remains low.[4] A deeper screening by banks of loans to enterprises cannot be excluded – linked to the need to adapt their evaluation procedures to the new rules and governance mechanisms introduced by the reformed company law as well as the shift to Basle2. These developments point to possible risks of high financing costs for many Italian companies, unless corporate governance issues are solved quickly and confidence is restored in the markets.

Notes

1. This appendix is mainly based on information provided in Bank of Italy (2004a) and (2004b), Cardia (2004), Fazio (2004) and IMF (2004a).
2. It should be noted that Parmalat had disclosed that it did not adhere to some of the self-discipline rules of the Italian Stock Exchange and had explained why. This circumstance indicates that information on corporate transparency is hardly available among individual investors.
3. Bank of Italy (2004b) stresses that loan deceleration was particularly marked for high-size firms. The Parmalat default might have contributed to this development.
4. According to Bank of Italy (2004b), the Parmalat default triggered bad loans equalling 0.2% of the total in 2003.

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Chapter 4

The economic impact of migration

Only in the last decade Italy has witnessed significant immigration inflows. Most immigration has been illegal despite legislative changes, leading to quotas, though a series of regularisations has granted many immigrants legal status. Immigrants have probably increased overall prosperity and provisions of the 2002 law for cumbersome recruitment procedures may be questioned, although the effort for simplification through the "sportello unico" (one stop shop) should improve the situation once implemented. However, more competition has made certain jobs no longer attractive to Italians. A large demand for immigrants in the North alongside high levels of unemployment in the South shows that the labour market suffers from a high degree of friction. The current phenomenon of "brain drain" may also be related to labour market rigidities. The overall fiscal impact of immigration is likely to be positive in both short and long runs. The informal economy plays an important part in the economic integration of immigrants but for social integration more attention should be given to instructions in Italian.

For a good part of the twentieth century migration in Italy meant emigration. As many as 7½ million Italians left the country in the 30 years after the Second World War. Since the 1970s, outflows have diminished considerably, but only in the last decade of the century have there been significant inflows. The number of foreigners in Italy has risen to as many as 2½ million, mostly from low income or former communist countries, from fewer than half a million, mostly OECD nationals, in the late 1980s. At just over 4% of the population, the "stock" of foreigners is relatively low compared with many OECD countries, but the rate of increase ranks higher (see OECD, 2004).

Specific legislation to deal with significant inflows of unskilled immigrants did not exist in the 1980s, when such inflows began to develop.[1] Most immigration since the late 1980s has been illegal despite a series of legislative changes, leading to a system of quotas. But, equally, most immigrants now have legal status through a series of regularisations that have been implemented every few years in this period, along with legal immigration through family reunification.

The rest of this chapter starts with a brief history of migration in Italy. The state of immigration legislation and its evolution are described. The next section explores the economic impact of migration, particularly the labour market and fiscal impacts of immigration. As regards the latter the overall fiscal impact is unclear, partly because of lack of information; on balance, however, in the short run it is likely to be positive given the age profile of the immigrant population, and probably in the longer run too. As regards the former, some parallels are also drawn with the history of internal regional migration. A final section concludes that immigrants now play an important part in many sectors of the Italian economy and have probably increased overall prosperity, even though competition from them has made certain kinds of employment no longer attractive to Italians seeking work. The informal economy appears to play an essential part in the economic integration of immigrants.

Italy and migration

Like other southern European countries, Italy has a long history of emigration, supplying emigrants, often for unskilled manual employment, to northern European countries as well as to North and South America and Australia, from the second half of the 19th century through to the 1970s. Throughout much of this period, internal migration from southern Italy to the north occurred in a process different in degree rather than kind: changes in demand patterns and technology allowed a shift of labour from agricultural activities[2] to manufacturing industry that was growing in northern Italy just as manufacturing and extractive industry in the industrial regions of northern Europe attracted Italian emigrants.

This process continued after the Second World War, and consular data suggest that there may now be some 4 million Italian citizens living abroad.[3] Continuing economic development in Italy gradually reduced the economic incentives for emigration and there

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have not been significant net flows of emigrants for 30 years. Emigration nevertheless continues, at a rate of perhaps 40 to 50 thousand per year over the period 1988-99, but was largely balanced over that period by similar numbers of Italians returning from abroad. More recently emigration has again exceeded returns, by some 20 000 in 1999. It seems that recent emigrants are, however, relatively highly qualified, including notably academics and researchers. It has been estimated that in the 1990s about 2.3% of Italian college graduates were abroad while only 0.3% of graduates resident in Italy were foreigners (Becker *et al.* 2004).

Returning migrants continued the pattern of population movement from the south to the north. 60% of Italians abroad registered in the AIRE[4] originated in the southern regions of Italy and the Islands, but only 40% of returnees settle there. Recent departures also seem to be disproportionately from the south.

Only since the mid-1980s has immigration to Italy become quantitatively significant. The foreign population, according to residence permit statistics, rose from about 150 000 in 1970 to some 300 000 in 1980, reached half a million in 1985, and almost a million in 1995. By the end of 2003 it reached 2.2 million. If children under 18 and illegal immigrants are included, the total number of foreigners may be 2.7 million or more (Table 4.1).

Table 4.1. **Estimated legal and illegal inflows 1986-2003**[1]

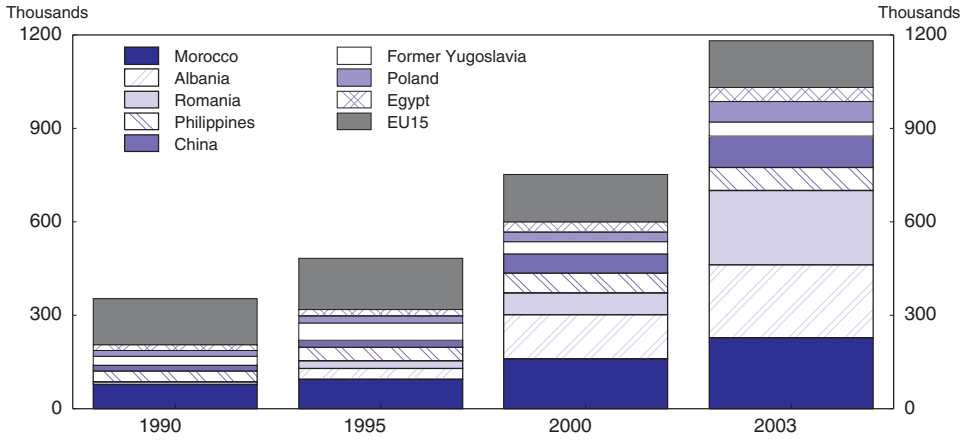
	Annual average immigration flows from non-EU countries			Number of permits issued in regularisation (date)	Estimated non-EU population, registered and unregistered[3]
	Permits issued or quota[2]	Change in registered resident non-EU population	Estimated total net flows, legal and illegal[3]		
1982				5 000	
1986				105 000 (1986-88)	
1986-1990		85 000	100 000		
1990				220 000 (1991)	1 million
1990-1998		68 000	85 000		
1995				250 000 (1996)	
1998				220 000 (1999)	1.5 million
1998-2002	30 000	100 000	175 000		
2002				650 000 (2003)	2.7 million (2002)

1. First and fourth columns refer to measures of gross annual inflows, while the second and third are net annual flows.
2. Excluding seasonal.
3. These figures are approximations.

Source: Caritas, Ministry of the Interior, OECD estimates.

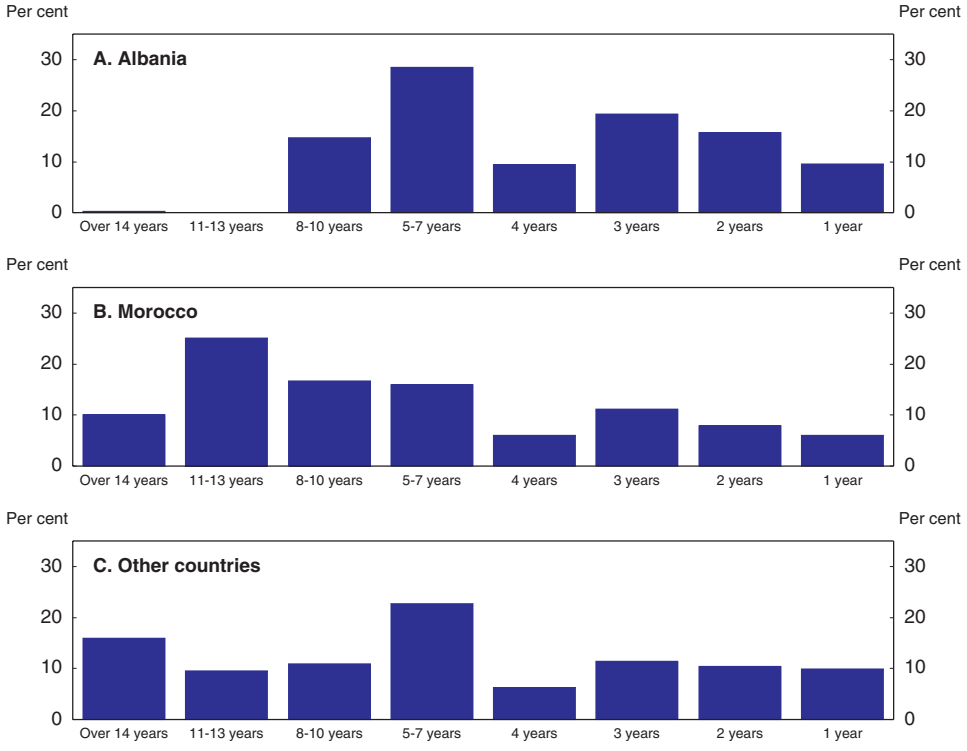
The impression of immigration as a rather dynamic aspect of Italian demography is reinforced by the rapid changes in structure of the immigrant population. Whereas the first non-EU immigration of the late 1980s was dominated by north-Africans, in the 1990s flows from Albania rapidly overtook those from Morocco as the most significant country of origin. With the 2002 regularisation, Romanians (who accounted for 20% of the requests for regularisation) overtook Albanians (Figure 4.1). These changes in the structure can be seen from a different perspective in data on length of stay. In 2001 more than half of the Albanians in Italy had been in the country for 4 years or less, whereas this was true for less than a third of Moroccans (Figure 4.2).

Figure 4.1. **Foreigners in Italy with residence permits**
Selected countries of origin



Source: OECD and Ministry of Interior.

Figure 4.2. **Immigrants' duration of stay, selected countries of origin**
2001



Source: ISTAT, permits to stay, from IRPPS questionnaire answers.

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Many migrants arrive without permission and while this phenomenon has often been associated with the beaches and ports of the southern regions in some of the extreme years in the 1990s, most now arrive legally with tourist visas and become illegal by overstaying. The geographical distribution of the foreign population within Italy is quite differentiated, with relatively low concentrations in the south, despite the high illegal inflows there in the 1990s, and much higher concentrations in the north and centre. The links between the geographical distribution of the foreign population and economic developments are discussed further below.

Migration policy

Specific laws to regulate immigration into Italy are relatively recent. Until 1986, the regulating framework was based on public order legislation from 1931, which left many issues to administrative discretion. When levels of immigration were very low, this aroused little concern at the level of central government, but by 1977 the Constitutional Court felt the need to point out that "… this issue needs to be thoroughly reorganised by Parliament taking into account the need to develop comprehensive and consistent regulations…"[5] Between 1986 and 2002 a number of laws have been voted, principally in 1986, 1990, 1998 and 2002.[6]

In many cases, important aspects of these laws were implemented with a long delay, or not at all. For present purposes, the most important characteristics of the legislation concern the development of quantitative restrictions on immigration, amnesties or regularisations, and the link between entry and the labour market situation. Other aspects of the laws have focused on precise measures to be taken against illegal immigrants, establishing basic rights for foreign residents and, in the 1998 law, provisions to promote integration of immigrants.

Quantitative limits and regularisations

Until 1990 there were no specific limitations on the overall numbers of immigrants who could be admitted. Nevertheless, it was sufficiently difficult for non-EU citizens to obtain legal entry that there were increasing flows of illegal immigrants. The 1990 law provided for an inter-ministerial decree that would fix an annual quota for immigrant entries, including their dependents.[7] This provision was not enacted until 1995, when quotas of 20 000 to 30 000 workers were enacted each year, but the quota was frequently announced towards the end of the year to which it applied. The 1998 law also provided for a quota system with an annual quota, implemented with quotas between 58 000 and 83 000 workers in 1998-2001, within a three-year planning period, and this system was retained in the 2002 law.[8]

The quota covers both seasonal workers and those intending to remain for a longer period – in recent years the seasonal workers quota has been over half the total quota. The 1998 law had provided for country-specific quotas within the overall limit, and the 2002 law further developed this as a means of "rewarding" origin countries for co-operating with Italian efforts to repatriate illegal immigrants by signing agreements on readmission. In practice quotas have continued to be announced rather late until 2002. One reason why quotas are announced so late is that the provisions of the 2002 law that were intended to serve as a basis for setting them – studies of the regional and national labour market situation (discussed further below) – have yet to be implemented.

Throughout the whole of the period since 1986, immigration flows into Italy have been much larger than those permitted under the normal provisions of the law. Recognition that large numbers of immigrants had *de facto* established themselves in Italy despite legal restrictions led governments to want to start with a clean sheet with each major change in the law. In 1986 an amnesty was offered to all foreigners who could show they had regular employment, while in 1990 it was available to all foreigners who could show they had arrived before 1990. In 1993 a Commission was set up with the intention of drafting a comprehensive law covering all aspects of immigration policy. A reform was attempted by decree in 1995 but subsequently lapsed, with the exception of a regularisation exercise, from which 250 000 people benefited. The conditions that foreigners need to fulfil have tended to become more demanding at successive regularisations, even as the numbers of people regularised have increased – over 600 000 people were accepted (of about 700 000 who applied) under the amnesty that followed the 2002 law. This regularisation was initially announced as available only for those working in domestic service, but was subsequently extended to cover all foreigners. The large number of people in the 2002 regularisation and the fact that a disproportionate number of them claimed to be working in domestic service suggest that the regularisation itself, announced six months in advance, may have encouraged illegal inflows.[9] This also highlights that the need for assistance is very strong in Italian families, in order to take care of an ageing population and allow women to enter the labour market.

With relatively frequent regularisations and a fairly high degree of acceptance of foreigners in the labour market, many irregular immigrants are relatively well settled. Following the introduction of the 2002 Immigration Law, activity in tracing and expelling illegal immigrants was increased at the same time as the regularisation was being implemented. There was some increase in the number of illegal immigrants found and expelled in 2002. A decline in 2003 was probably related to the effects of the regularisation, though less than might have been expected if a high proportion of illegal residents had successfully applied for regularisation (Table 4.2).[10]

Table 4.2. **Foreigners without permits found in Italy**[1]

	1998	1999	2000	2001	2002	2003
Total	67 096	75 944	99 920	103 707	113 090	81 755
of which						
Expelled and actually left	22 975	35 455	35 186	47 074	50 845	40 951
Expulsion not verified	44 121	40 489	64 734	56 633	62 245	40 804

1. This table does not include people refused entry at the border, asylum seekers, or people given temporary shelter under the provisions of the 1999 Kosovo decree.

Source: Ministry of the Interior.

Entry policy and the labour market

Despite the fact that a majority of migrant inflows probably by-pass legal channels, successive changes in legislation have attempted to align entry policy with labour market "needs".[11] (A later section of this chapter discusses the ambiguous nature of the empirical evidence on the labour market impact of immigration.) The 1986 law was mainly concerned with "rules concerning the employment and working conditions of non-EU immigrants and against illegal immigration;"[12] it did provide for labour market conditions to be taken into account through use of regional labour market commissions, with the employment of workers from abroad to be permitted only if no Italian workers were

available. This applied to all jobs other than domestic workers, for whom it was assumed no Italians were available. Issuing work visas was the responsibility of provincial offices of the Ministry of Labour. The 1986 law also had provisions for lists of people who had applied to work for Italian companies to be established at Italian consulates in countries of origin, but these were not implemented.

The 1990 law did not significantly change the notion of the labour market test introduced in the 1986 law, but the quotas introduced in this law were intended to be determined as a function of the needs of the labour market. In principle having a quota system could significantly improve efficiency since it can avoid requiring a labour market test for each individual request. It is not clear whether this functioned well or not as far as legal immigrants were concerned; quotas were generally announced well into the year to which they referred, "in the expectation that [they] would have almost no effect" (Caritas, 2003b). Furthermore, the circumstances of the time (*i.e.* throughout most of the 1990s) meant that migration pressure from former Yugoslavia and Albania rendered the quotas, if not irrelevant, at least of less immediate importance than dealing with those illegal flows. Provision was also made in 1998 for agencies and associations to sponsor the entry of immigrants, allowing them to obtain an entry visa and residence permit in order to look for a job rather than having to have one before travelling to Italy; this provision was not implemented in practice.

The 1998 law[13] implemented this sponsored immigration option (limited to 15 000 per year in 2000 and 2001 alone, plus dependants), and also abolished the labour market test (that no Italian or EU citizen be available for the job in question) for individual "nominative" visa requests (*i.e.* when an employer requests a work permit for a named individual). All employment related visas remained subject to overall quotas, however. The 1998 law also provided for a quite wide eligibility for family reunion, with family members entering in this manner having the right to work. Furthermore, someone who enters with a permit for self-employment also has the right to take dependent employment, and *vice versa*.

Current immigration legislation…

Current legislation dates from 2002. Broadly speaking it maintained the structure of the 1998 law, but made it more restrictive in a number of areas. Most notably, the system for sponsoring immigrants to look for work was abolished; the definition of family eligible for reunion was also substantially tightened.

Entry visas are available under a number of headings; the principal visas for "settlement"[14] (*i.e.* other than for tourists and other temporary stays) are employment (which may be for dependent or self-employment), family reunification, and study (Table 4.3). By 2001-2002, despite the relatively short history of immigration in Italy, family reunion is more important than employment as far as legal entry for long term residence is concerned – a considerable proportion of the work visas recorded in Table 4.3 are seasonal (experience in the Veneto region suggests that the average stay on a seasonal permit is around 40 days). Entry visas (and the corresponding residence permits issued after arrival by the Interior Ministry) for employment purposes initially last up to a maximum of two years, and are renewable under the same conditions as for their issue (though renewals are not subject to any quota). After 6 years of continuous legal residence, immigrants may apply for a permanent residence permit, available if the immigrant is deemed to have sufficient income to support themselves and any dependants.[15] After 10 years it is possible to apply for citizenship.

Table 4.3. **Visas issued in 2001-2003**

	2001		2002		2003	
		As % of total settlement		As % of total settlement		As % of total settlement
Total settlement	207 916	100	175 259	100	204 580	100
Employment	94 219	45	65 101	37	87 607	43
Dependent employment[1]	74 039	36	59 920	34	82 461	40
Sponsored	14 203	7	470	0	0	0
Self- employment	5 977	3	4 711	3	5 146	3
Family reunion	64 772	31	62 063	35	65 816	32
Study	38 356	18	40 655	23	43 453	21
Other	10 569	5	7 440	4	7 704	4
Memorandum items:						
Other visas	739 169		678 207		674 748	
Of which: Business visas	137 650		122 766		118 546	
Tourism visas	434 463		389 505		394 565	

1. Excluding sponsored, including seasonal.

Source: Caritas.

Under the 2002 law, entry permits for work purposes are available only for migrants with an employment contract, or for self-employment, and are subject to an annual quota which is to be determined in the light of surveys of labour market needs in each of Italy's regions. As under the 1998 legislation, the quota covers both seasonal and non-seasonal work, and both dependent and self-employment. The legislation foresees a labour market monitoring system to be developed by linking databases on job vacancies and regional migration observatories; this is supposed to allow migration policy to be linked with labour market needs.

Immigrants are required to have a *contratto di soggiorno* ("residence contract") which covers their employer and job, and under which the employer guarantees adequate housing accommodation and finance for the migrant's return trip. Employers seeking to recruit a foreign worker apply to the *sportello unico* ("one-stop shop") for their region, which in turn is to make the appropriate labour market checks, then inform the employer of the decision at the same time informing the foreign ministry that a visa can be granted, supplying the work permit, and then the residence permit when the immigrant arrives. This should increase efficiency compared with the earlier system where a number of different agencies were involved with employers having to wait for a decision from one before applying themselves to the next.

... Implementation in practice

However, in practice what is meant by the "needs" of the labour market is not clear, and the information gathering system intended to implement the 2002 law is still under construction. Regions submit requests for quite large numbers of immigrant permissions, but in recent years the overall quota has largely been determined using provisions under which, in the absence of a formal and complex process of consultation, the quota is set at a similar level to that of the previous year. Thus, firms responding to a survey in the Veneto region alone felt that they could use 24 000 immigrant permits in 2003 (thus not including those for domestic workers), only 9 000 were allocated and the national total was only 79 500 for all regions and types of employment taken together, of which more than three quarters were for seasonal work only.

Despite the likely excess demand for immigrants as employees, the labour market test is still required. The *sportello unico* does not yet exist in most regions, but will be fully implemented as soon as the required secondary legislation reaches the statute book so that employers still have to visit a number of agencies – the prefecture who administer the quotas, the ministry of labour who issue labour market authorisations and deliver work permits, the foreign ministry for entry visas, the police who deliver residence permits. The system thus seems more cumbersome than it needs to be, even if not so cumbersome as to deter its use – the quotas are always fully exhausted.[16]

For 2004, the government has announced a provisional quota of 79 500, of which 77 000 is for dependent workers (Tables 4.4 and 4.5). 50 000 of these permits are for seasonal workers. The quotas are allocated by region, taking some account of relative labour market conditions so that, for example, southern regions where unemployment is high are currently allocated fewer permits.[17] Two further decrees in 2004 allocated an additional 36 000 permits for workers from the new-accession countries of the European Union; many of these are likely to be taken up by people already working illegally in Italy.

Table 4.4. **Immigration quotas 2004**

		Notes
Total non-EU	79 500	Decrees of 19th December 2003
Of which		
Dependent workers	29 500	
Reserved for countries with bilateral agreements	20 000	Albania 3 000; Tunisia 3 000; Morocco 2 500; Egypt 1 500; Nigeria 2 000; Moldavia 1 500; Sri Lanka 1 500; Bangladesh 1 500; Pakistan 1 000.
		2 500 additional for future agreements.
Italian origin from Argentina, Uruguay and Venezuela	400	
Unrestricted	6 100	
Highly qualified or managers	500	
Self-employment	2 500	Covers: researchers; entrepreneurs in activities that further the interests of the national economy; partners and managers of companies (other than co-operatives); internationally famous artists; highly qualified professionals engaged by private or public bodies.
		Up to half of these may be for people already studying in Italy who wish to convert their permits.
Seasonal	50 000	Covers people from countries with bilateral agreements listed above, EU accession countries, Bulgaria, Croatia, Serbia-Montenegro and Romania; and workers who have had a seasonal permit in 2002 or 2003.
New EU member countries – as from June 1st 2004	36 000	Additional to the 79 500 in the decree of December 2003. Announced in two decrees in April and October 2004.

Source: Ministry of the Interior.

The economic impact

Immigrants in the economy

For much of the twentieth century, migration in Italy concerned Italians: they moved within Italy, largely from south to north, or they moved abroad. More recently, with migration in Italy coming to mean inward rather than outward movement, some characteristics of the earlier migration remain relevant, others have reversed. In particular it remains the case that the major industrial and commercial centres of the northern regions are the principal destination for immigrants, just as they have in the past attracted Italians from the south.

Table 4.5. **Immigration quotas 2000-2004**

	2000	2001	2002[3]	2003[3]	2004[3, 4]
Albania	6 000	6 000	3 000	1 000	3 000
Morocco	3 000	1 500	2 000	500	2 500
Tunisia	3 000	3 000	2 000	600	3 000
Roumania	2 500				
Somalia		500			
Egypt			1 000	300	1 500
Nigeria			500	200	2 000
Moldavia			500	200	1 500
Sri Lanka			1 000	500	1 500
Bangladesh				300	1 500
Pakistan					1 000
Argentina[1]			4 000	200	400
Venezuela[1]					
Uruguay[1]					
Other privileged[2]	6 000	4 000			2 500
Total for privileged countries	20 500	15 000	14 000	3 800	20 400
"Generic" quota			56 000	68 500	50 000
Total inflow in Government Decree	83 000	89 400	79 500	79 500	79 500
of which seasonal	46 883	39 400	60 000	68 500	50 000
In percentage	56.5	44.1	75.5	86.2	62.9

1. Limited to citizens of Italian origin.
2. Reserve quota for countries which have, or will have, signed bilateral migration agreements.
3. In 2002 the generic privileges were extended to citizens of EU candidate countries (Slovenia, Poland, Hungary, Estonia, Latvia, Lithuania, Czech Republic, Slovakia, Cyprus, Malta), Romania, Bulgaria, Tunisia, Albania and (for seasonal work) foreigners who held a permit for seasonal work in 2001. In 2003 generic privileges were extended to countries as for 2002, with the addition of Serbia, Montenegro, Croatia, Nigeria, Moldavia, Sri Lanka, Egypt, and the requirement for seasonal work changed to those who had held a work permit in 2001 and 2002. In 2004, the list of countries was unchanged, the requirement seasonal work changed to those who had held a work permit in 2002 and 2003.
4. In 2004 an additional quota of 36 000 was introduced for citizens of the new European Union member countries. This is not included in the total in the table.

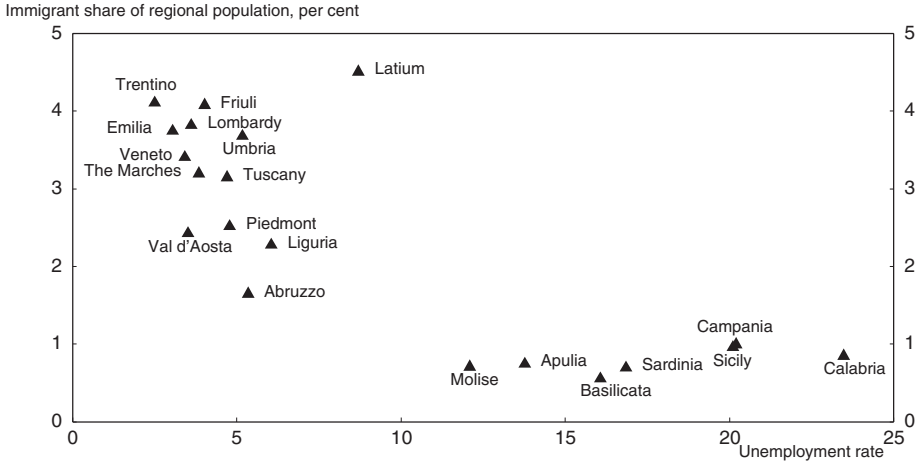
Source: Ministry of the Interior.

For part of the 1990s, the southern regions, notably Apulia, were receiving large numbers of illegal immigrants across the Adriatic Sea from Albania and elsewhere. But these immigrants quickly moved to the north – despite those large inflows, immigrants now represent a much lower proportion of the population in the south than in the north.[18] Thus, immigration in Italy appears strongly sensitive to labour market conditions within the country. The Veneto region, previously one of the poorest regions in Italy and a major source of emigrants up to the 1960s, now has very low unemployment – just above 4% – and over 5% of its population is immigrant. Only 1% of Apulia's population is immigrant and its unemployment rate is over 13% (Figure 4.3, Box 4.1).

Internal migration and regional variations

Bonifazi and Heins (2000) document the long-term decline in rates of internal migration. In 1995 the (gross) rate of long-distance migration[19] was almost one third below that of 1955, and net flows had fallen by more than this. Much of this fall occurred between 1970 and 1975 but the rate continued to decline into the 1990s. Among the explanations for this decline is the development of the welfare state in Italy which reduced the impact of the large differences in incomes per head between the north and south and hence the incentive for individuals to move.[20] The movement of immigrants from outside

Figure 4.3. **Unemployment and immigrants in the labour force: Italian regions**
2003



Source: Caritas and ISTAT.

the country lends considerable support to the hypothesis that this kind of policy has reduced internal mobility. Nevertheless, since the late 1990s there appears to have been a substantial upturn in the number of Italians moving from the south to regions in the centre-north, mainly among highly educated young people.

The role played by immigrants in the economy varies by region, partly as a function of the different regional industrial structures, but not only for this reason: the difference between the share of immigrants employed legally in agriculture in the south and that in the north-east is larger than the relative sizes of the agricultural sector (Table 4.6). And there is considerable specialisation by sector for immigrants from certain countries of origin. This varies from region to region since it appears to depend in part on incidental factors such as the sector in which the first arrivals from particular countries initially found jobs; nevertheless, the strong tendency of Moroccans to be involved in commerce shown in data for Rome (Figure 4.4) is typical in most areas.

In manufacturing companies, the regional distribution is somewhat different. A survey of manufacturing industry showed that the share of non-EU immigrants in the workforce varied less by region than the share of immigrants in the population: in the North-East 10.5% of the manufacturing workforce was immigrant, but in the South also the figure was as high as 7.5% (ISAE, 2002). Immigrant presence was less in larger firms: in firms with less than 100 employees the share was over 11%, but was under 5% in companies with 500 or more employees.

The underground economy

While figures from official sources give a fair idea of the economic role of immigrants, they can clearly take little account of immigrants working in the underground or informal economy. There are various estimates of its size, but reasonable estimates by Istat suggest that the "underground" share of total (including both national and foreigners) dependent employment rose from just over 16% in 1992 to 18% in 2000. That for self-employment remained stable at about 8% (Censis, 2003). One analysis suggests that the structure of the informal labour market is changing faster than these figures may suggest. Participation of

Box 4.1. **Migration in two Italian Regions**

	Veneto (Capital: Venice), north-east Italy	Apulia (Capital: Bari), south-east Italy
Population 2001	4.5 million	4.0 million
Unemployment rate, 15-64 (2002)	3.6%	13.5%
No. unemployed and looking for work (mid-2003, Istat labour force statistics)	71 000	199 000
Estimated legal immigrants, 2004	250 000	45 000
(per cent of regional population)	5.6%	1.1%
% non-Italian school children, 2003	4.6%	0.8%
No of non-Italians registered for language courses (2001-02)	7 633	549
Migration history	In the early twentieth century the Veneto was one of the poorest regions in Italy, and suffered net losses of population through emigration for most of the first half of the century. However, in the second half of the century, the region's economy, following Lombardia, Piemonte and Emilia Romagna, became much more successful, and now has very low levels of unemployment. Immigrants came first from southern Italian regions, in the 1990s from abroad. Illegal immigrants from Albania and north Africa used to arrive *via* southern Italy; now those from Romania and other eastern European countries arrive directly in Veneto.	Apulia too was a region of emigration for practically all of the twentieth century. Net outflows were small, however, from the 1970s onwards. Small numbers of north African immigrants arrived in the late 1980s, and a group of Mauritians had arrived in the late 1970s, but large scale inflows began in the 1990s when many Albanians crossed the Adriatic, in some years equivalent to over 1% of Apulia's population. In recent years, illegal inflows have been much reduced, as the situation in Albania is less dramatic (and a quarter or more of the population has already left) and organisers of illegal immigration have responded to tighter controls in Albania and Apulia by using other points of departure and landing more in Sicily and other areas of Italy. Despite the large inflows, few migrants remain in Apulia, moving to northern Italy or to other countries as soon as they can.
Principal sectors employing immigrants	Mechanical engineering Clothing and footwear (*e.g.* in the leather industry, 40% of new employment are of immigrants) Hotels and restaurants Domestic services Construction	Agriculture Domestic services Construction
Economic impact of immigration	Reduced "delocalisation" (lower wage costs) Reduced demand for old-age care homes	Lower costs in agriculture Higher female participation rates Trafficking and enforcement related costs
Principal concerns of immigration policy	Improving match between inflows and firm requirements	
Estimated "need" for immigrants, 2004	24 000	n.a.
Quota, 2004 (excluding new EU members)	10 895 (8000 seasonal 2620 non seasonal, 215 autonomous, 60 dirigenti)	2 967 (2000 seasonal, 955 non seasonal, 10 autonomous, 2 dirigenti)
Emigrants	Network of 350 emigrant *Veneti*. Most active in S. America. Business training in Italy of 3rd generation emigrants, looking for joint ventures.	Undertaking census of enterprises run by *Pugliesi* abroad. Business training of *Pugliesi* descendants in Argentina.

Italians in the informal labour market can be grouped into two broad categories: second jobs or "moonlighting" by people who have "normal" jobs but supplement their income with undeclared activity; and "pure" illegal jobs where they are the principal source of income for the worker. According to Reyneri (2001), "pure" illegal employment among Italians is steadily diminishing, while moonlighting is broadly stable as a share of total activity.[21] If this is an accurate interpretation of trends, the increase in employment in the informal economy is thus coming from immigrants who are replacing, or more than replacing, Italians in pure illegal employment.[22]

Table 4.6. **Share of non-EU immigrant employment by sector and region**

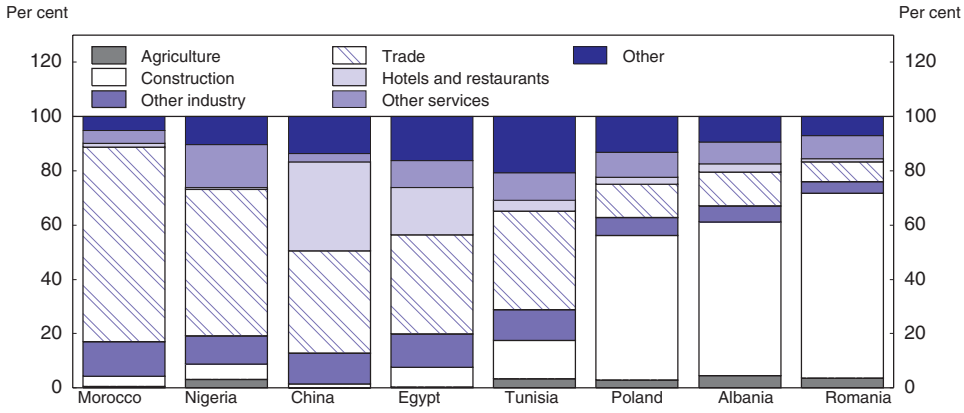
In percentage of regional total, 1998

	Agriculture	Construction	Industry	Services	Domestic services
North-West	7	7	31	24	32
North-East	20	8	39	21	11
Center	12	5	16	16	50
South	33	2	7	11	47

Source: Institute for Research on Population and Social Policy, social security data.

Figure 4.4. **Immigrants with work permits, Province of Rome**

2002, as a percentage of total



Source: Strozza S. (2004), "Immigrati stranieri e inserimento nel mercato di lavoro nella provincia di Roma: la situazione prima e dopo la grande regolarizzazione".

This concerns not only illegal but legal immigrants: in inspections by the Ministry of Labour in 2002 covering nearly 22 000 employees, of which over 12 000 were non-EU foreigners, about 30% of these foreigners were employed in some way illegally, but about 40% of these were actually *present* in Italy legally (Caritas 2003a, p. 337). Some corroboration of this can be seen in the re-emergence of the *caporalato* system of recruitment for day labourers. In the past, a common early-morning sight in many, especially agricultural, areas was men congregating in town squares to be recruited (or not) for a day's work by farmers or contractors. This system had died out, not least under pressure from trade unions, but has now reappeared in the labour market for foreigners. The fact that an immigrant is working in the informal economy does not automatically mean there is some kind of exploitation of the employee by the employer: some immigrants may prefer to avoid paying taxes and contributions if this means higher immediate earnings, if they have no or little interest in acquiring future rights.[23] This may be, for example, when the immigrant has no family in Italy and does not plan to stay for long (see Anastasia *et al.* 2004). There is a large grey area of intermediate situations, in particular legal migrants with irregular employment (see Anastasia and Sestito, 2004). Earnings are, nevertheless, lower for illegal than legal immigrants: Baldacci *et al.* (1999), studying two specific regions, estimate a significant difference of 20 to 30% between the earnings of legal and illegal immigrants in 1993-94. More recent estimates are not available. It must be stressed

however that if a large underground economy provides opportunities for illegal immigration, the latter also perpetuates the existence of the former.[24]

On seasonal workers

Two sectors of the Italian economy are particularly seasonal – tourism and agriculture – and both are important employers of immigrants. As already mentioned, the largest legal flows of immigrants are for temporary work, and are issued through allocations by region, with most permits being issued in a small number of regions (Bolzano and Trento in the North took more than 60% of seasonal permits in 2001). Immigrants with a seasonal work permit are in fact a small minority among seasonal workers, some of which are Italian nationals. Among the immigrants, just under half have a seasonal permit, others may be legal residents with a permit for full-time work, or a tourist or study visa, or be illegal immigrants (Censis, 2002a).[25] Many of the illegal workers are from eastern European countries for which no entry visa was required, such as Poland, and the Czech and Slovak Republics; some of those present legally were doing second jobs.

The impact of immigration on unemployment and wages

The short-run impact of an increase in labour supply such as that caused by immigration could be expected to depress the labour market, causing some combination of increased unemployment and/or lower wages. The Italian economy, with its strong regional contrasts ranging from areas of very high unemployment to areas where unemployment is practically zero, is unlikely to present a uniform response to immigration. Immigrants themselves certainly show a "normal" market response to demand and supply for labour – they move quite quickly to where the demand is, and areas where unemployment is high have relatively low immigrant populations even though they are, or have been, areas in which large numbers of immigrants arrived in the country. Italians themselves have not recently made such moves so readily, probably because a combination of labour market institutions, the property market, family structures and the welfare system renders the costs of internal mobility quite high.

Investigating whether immigration does in fact increase unemployment by using a simple correlation of unemployment levels across the country thus tends to show the opposite – the higher the presence of immigrants the lower the unemployment rate (see Figure 4.3). On the other hand, using a different dataset, from the social security archives shows a negative correlation across regions between natives' wages and the share of immigrants in the labour force, for individual years from 1990 to 1995 (Gavosto *et al*., 1999).

In fact this paper, when taken together with two others using similar or the same datasets from the social security archives, produce rather conflicting results as to how the labour market responds to immigration (Box 4.2). Taking each of these studies at face value, it would seem that illegal immigrants (and natives working in the informal economy) do displace natives in regular employment to some extent (Venturini, 1999), and this can only happen if the presence of immigrants in the informal labour market lowers wages or conditions of employment for natives in the regular labour market. However, once legal (and therefore able to compete on the formal labour market), immigrants either improve labour market outcomes and wages for natives or at least have little deleterious effect (Gavosto *et al.* (1999) and Venturini and Villosio (2004)).

On the face of it, these conclusions are inconsistent with one another, since they imply that *illegal* immigrants compete with natives in legal employment but that *legal* migrants

Box 4.2. **Three econometric studies of the impact of immigrants on the labour market**

Three articles have used similar dataset to investigate different aspects of the possible link between immigration and labour market outcomes. Gavosto *et al.* (1999) look at the impact of (legal) immigrants on wages; Venturini (1999) and Venturini and Villosio (2004) look, in different ways, at the impact of irregular employment of immigrants (and natives) on employment of natives.

Gavosto *et al.* (1999) estimate panel-data wage equations by region, branch of economic activity, and time period, for the years from 1990 to 1995. Immigration appears to increase wages of native workers.[1] Overall this effect would be imperceptible – an increase of one percentage point in the share of immigrants in employment increases wages by 0.01% – though it is stronger in small firms, and among those in the north, and the effect is larger on the wages of native manual workers than of white collar workers. These estimates may be subject to bias from the endogenous response of migrants to wage levels, but this may not be very large – there is a negative correlation between wages and the share of immigrants, across regions and sectors mentioned above (despite the sensitivity of migrants to labour market conditions in general). They attribute this complementarity to labour shortages in certain areas and sectors that, until relieved by the presence of immigrants, constrain the productivity of native workers.

Venturini (1999) reports that both natives and immigrants in non-regular work[2] have the effect of reducing the regular employment of natives. When broad sectors are considered, there appears to be a stronger negative effect in industry and construction, with a positive, complementary, effect in non-tradable services. Overall, taking all sectors together, the study implies about 25 fewer native jobs for every 100 foreigners employed illegally. A similar employment offset occurs for irregular employment of natives. The study does not distinguish effects by region. An effect of this magnitude suggests that illegal immigrants do indeed have a noticeable effect in competing away the jobs of some natives, even though they clearly also act to expand the overall labour market. Venturini (1999) has, however, sometimes been misinterpreted as suggesting that the displacement effect is negligible, other than in agriculture.[3] See also Box 4.3 for a discussion of how to interpret the observation that "immigrants take jobs natives no longer want."

Venturini and Villosio (2004) use Labour Force Survey data, combined with INPS data on employment of foreigners, to analyse transition probabilities between unemployment and employment. This was done for transitions measured from one year to the next, for years from 1993 to 1997, looking at different regions of the country and economic sectors. Although there are a number of sectors/regions where there are significant positive effects (*i.e.* the presence of legal immigrants improves labour market prospects for natives) in particular years, they can sometimes be of opposite sign in other years, and most coefficients are in fact insignificant with, broadly speaking, as many positive impacts as negative ones.

1. More precisely, a two stage approach is followed. First, an equation determining wage growth as a function of individual characteristics such as age, sex and type of employment along with dummies for branch, region and time, is estimated. Secondly, the coefficient estimates for the dummy variables by branch, region and time are themselves used as dependent variables in an equation including output growth and the immigrant flow, as well as a time dummy. (The dataset covers the years 1990-95). Branch and regional dummies are introduced in variant equations. The authors note that this two stage approach follows a suggestion by Moulton (1990). The model also suggests a threshold effect – the higher the share of immigrants in the relevant population, the lower is the positive impact on wages. The overall effect would turn negative at shares nearing 10%, but this is well outside the sample range used in the estimation and cannot therefore be considered very reliable.
2. The data source used – an Istat survey of the shadow economy – does not distinguish immigrants by whether they are legally resident or not, only by whether they are in regular or non-regular employment. By irregular is meant someone whose full earnings or conditions of employment are not declared to the authorities.
3. The model is parameterised in logarithms, to generate elasticities of regular native employment with respect to illegal employment of foreigners. Since the sizes of the two populations are very different, a 25% displacement effect is represented by an elasticity of –0.01, which indeed sounds very small. The elasticity for agriculture is estimated as around –3.0, corresponding, approximately, to a loss of 200 regular native jobs for every 100 immigrants. In some variants, the estimates imply "crowding in" in the non-tradable services sector.

Box 4.3. **Immigrants do not compete for jobs with natives?**

In many OECD countries unskilled immigrants are frequently found to have taken over almost entirely certain types of "dirty" or unpleasant work. The argument is sometimes heard that natives do not want to do these jobs any more and that therefore the immigrants in these sectors are not competing with native workers, so cannot be affecting their wages.

One of these sectors is cleaning services. It is striking, however, that in Rome immigrant workers are rarely seen cleaning streets, unlike in many European capitals, and unlike many other cleaning services in Italy.

Street cleaning in Italy was until recently done directly by public sector employees, and non-EU citizens may not be public sector employees. Although much cleaning has now been outsourced in principle, many of the private companies that do the cleaning are created from the cleaning departments of local authorities and are still wholly-owned by them. This is the case in Rome. Recent wage negotiations with the unions have established that the same pay and conditions are to apply in the public and private sector, including the restriction that only Italian nationals may by employed.

Hence, pay and conditions (including job security) for street cleaners in Rome are quite favourable, native workers find them attractive, and competition from foreign workers has up to now not been permitted. It seems likely that if wage competition in the sector did exist, competition with migrants might well lower wages, at which point it may be that natives no longer want those jobs. This will be because of competition rather than a demonstration of its absence.

Evidence that immigrants tend to work in poorly paid jobs comes from an econometric analysis conducted on a representative sample of firms in both manufacturing and service sectors. It shows that firms at the bottom of the wage distribution tend to have a larger share of immigrants among their workers (Brandolini *et al*. 2004).

don't (recall that probably half or more of the legal migrants were illegal first). One argument is that small Italian enterprises in the north find it hard to recruit Italians with certain key skills and are unwilling to recruit them from among illegal migrants;[26] once they are able to recruit such key workers from legal (perhaps regularised) migrants, output bottlenecks are relieved allowing productivity gains for existing workers, increasing the demand for labour and wages.[27] If this is the explanation it suggests significant inflexibility in the labour market: in the absence of legal immigrants – firms are unable or unwilling to increase wages sufficiently to recruit crucial workers from the native population, even though they should be very valuable since they would improve productivity significantly.

It is not clear whether this is an accurate description of how the Italian labour market works. If it is, it would be an argument in favour of less restrictive immigration policy if it were true that only illegals have negative consequences for native workers. Equally, however, the reasons for the apparently short-sighted, if not actually perverse, behaviour of some firms should be sought. However, given the difficulties of obtaining reliable data it would be unwise to treat these results, though they may be suggestive, as definitive.

Fiscal impacts

Little work has been done at the official level on analysis of the fiscal impact of migration, although one of the reasons for the frequent regularisations of illegal

immigrants is the hope that they will increase public sector revenues. Some government departments are reluctant to publish or collect the necessary data for fear of its possible political implications. No official data is available about revenues or expenditures due to immigrants at the national level, other than an estimate from INPS (the social security and pensions administration) that annual revenues from social security and pension contributions from immigrant dependent workers were around € 2.2 billion in 2003, and from immigrants in household employment about € 0.5 billion, together about 0.25% of GDP. For pension payments at least, it is clear that INPS will gain a substantial surplus (whose size will depend on the volume of net migrant inflows) from immigrants for at least 20 years.

At the national level no academic empirical work is available either.[28] One recent study makes estimates for Tuscany, however. This is a region of low unemployment, and accounts for about 7% of all immigrants and 6% of the total population. Giovani *et al.* (2004) calculate public revenues and expenditures attributable to legal immigrants; for the most part these are estimates based on assuming that, controlling for age and sex, immigrants create the same basic expenditure needs as nationals on education and health care, with estimates for social assistance and specific expenditure on immigrants (including their children) based on data from the region. Information on immigrant incomes from INPS data was used to estimate various tax revenues. On this basis, it is estimated that immigrants in Tuscany benefit the overall budget, in the year 2000, by almost € 1 000 per capita. If this were assumed to be the case for the average legal immigrant across the whole country there would currently be a net benefit of around € 2 billion per year, about 0.2% of GDP.[29]

As the authors note, much of this benefit is due to the age structure of the immigrant population. There are relatively few pensioners and relatively few children or adults in education. Furthermore, for those immigrants that are of pensionable age, the study assumes that they have, as yet, no pension rights in the Italian public pension system, hence the net cost even of the older immigrants is low relative to that for Italians (Figures 4.5 and 4.6). Despite the relatively small number of young immigrants, more than half of the estimated expenditure is attributed to education and training, one third to health and about 15% to social assistance.

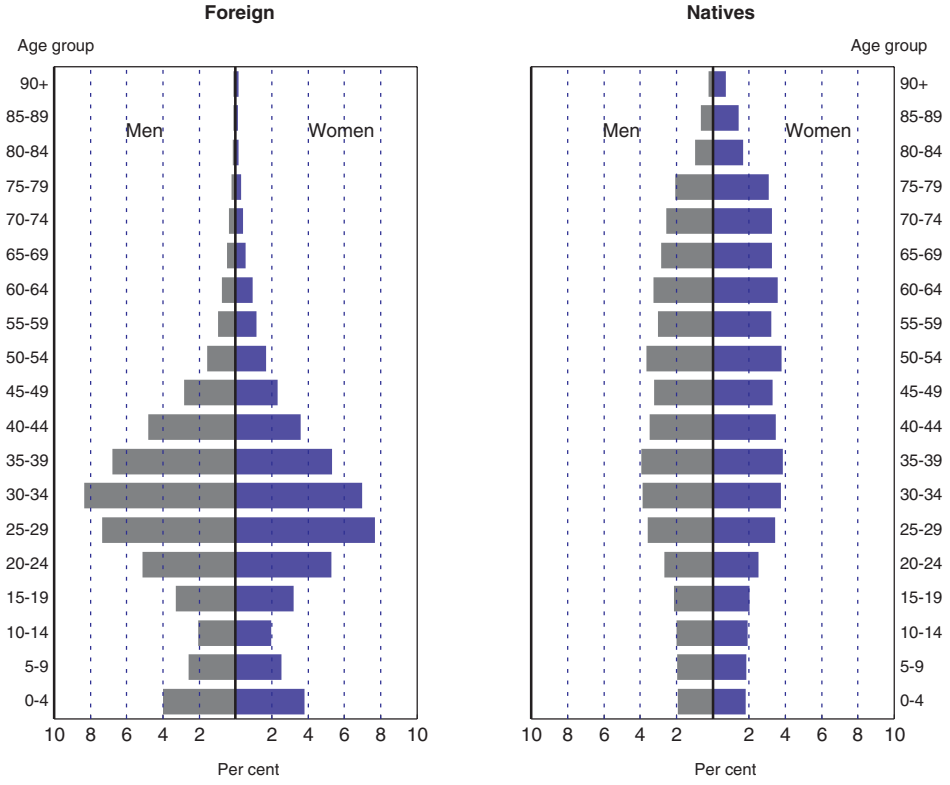
Over time, the size of this benefit would diminish, as immigrants became entitled to pensions on retiring and as the share of children in the immigrant population increased. Giovani *et al.* (2004) estimated that there would still be a substantial positive impact (though down to just over € 600 per capita) in 20 years' time, however.

An earlier study, Coda Moscarola (2001), looked at legal immigrants' impact on public finance using a generational accounts approach. To a rather greater extent than in Giovani *et al.*, most of the information on expenditures and revenues due to immigrants was based on assuming that their age- and sex-specific characteristics were the same as those for Italians, an assumption that has yet to be empirically tested. This paper, too, found that immigration made a positive contribution to public finances, this time in the sense that the balance of expected lifetime receipts and expenditures due to immigrants was positive.

Generally, it is likely that temporary immigration provides more fiscal benefit than permanent immigration because immigrants are present during the period of their lives when they are most likely to be net contributors; Coda Moscarola (2001) revealed an opposite result – immigrants who stayed after they retired were more beneficial than those

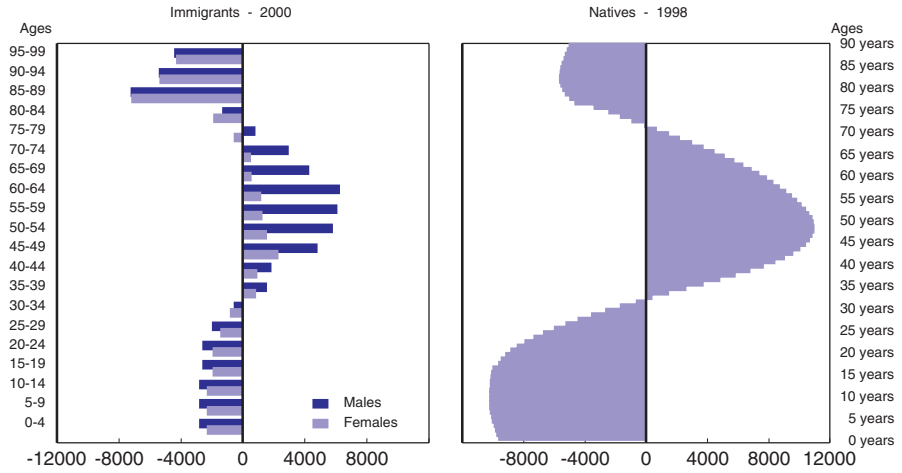
Figure 4.5. **Age structure of foreign and native population in Tuscany**

5-year age groups as a percentage of each population



Source: Istituto Regionale per la Programmazione Economica della Toscana.

Figure 4.6. **Net per capita fiscal contribution by age, foreigners and natives, Tuscany**



Source: Giovani F., S. Lorenzini and S. Versari (2004), 'Immigrazione e finanza pubblica: il caso della Toscana,' Istituto Regionale Programmazione Economica Toscana, Florence.

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who returned to their home country on retirement; this was due to a provision in the Italian pension system that immigrants returning to their home country would be reimbursed their pension contributions including interest at a rate that exceeded the implicit rate of return within the pension calculations. This is no longer the case, however, the relevant provision having been removed.

Aside from the impact on overall budget balances, the presence of immigrants can create practical difficulties in a decentralised system. In Italy, health care is managed at the regional level, but financed from central government funds. These are allocated to regions according to their population as recorded in the population registers. These registers are particularly likely to be out of date in periods when there are large inflows of immigrants (who may take some time to register), and an estimate of this number is included when calculating regions' entitlements. But illegal immigrants are not included and are nevertheless entitled to a certain level of medical care which could stretch "normal" resources. After initial problems of this nature, and following negotiations between regional and central governments, treatment of immigrants not recorded in the population register is now financed by funds from the Interior Ministry on the basis of treatment provided.[30]

Output and economic structure

The inflow of immigrants into Italy over the past 20 years has had some significant impacts on the economy, at least in certain sectors. The concentration of immigrants in the northern parts of the country has already been noted. Within these areas it seems that immigrants are found particularly working in industries where production is itself quite mobile internationally and where Italian companies have been active in moving production facilities out of Italy in response to relatively high labour costs; this includes textile related activity, the leather industry and some mechanical engineering, for example.

The availability of immigrants has slowed down the rate at which this "delocalisation" process occurs. According to research by the Ente Veneto del Lavoro[31] significant numbers of companies would have been forced to move their production abroad without the presence of immigrants. There may in fact be some link between delocalisation and migration flows: Romania is a major source of recent immigration and is also an important destination for foreign investment by Veneto firms. In the longer run one might expect that capital and labour movements would substitute for each other – with a lot of investment capital moving to Romania the demand for labour there should increase, reducing the incentive to emigrate; for the moment, however, it may be that these labour and capital movements feed each other, essentially through expanding the information networks for both Romanians seeking employment and Italian companies looking for places to set up production.

As immigrant labour helps to keep some production activity in Italy, it may help to maintain the capital stock higher than it otherwise would have been. By relieving labour shortages in areas where demand for labour is highest it may also allow overall demand levels in the economy to be higher without increasing inflation.[32] These mechanisms could help to explain the results of studies, reported earlier, that immigration can have a positive impact on the labour market.

Immigrants working illegally (whether they are legally in the country or not) also have an impact that is specific to certain sectors, generally working in service industries or in agriculture. Their impact on manufacturing industry is smaller (or at least, less visible) than that of legally working immigrants, since for the most part they are not working directly in the kinds of firms susceptible to delocalisation, though they may influence them indirectly in working for subcontractors for such things as cleaning services. Street trading, quite a significant activity in some local economies, is largely dominated by immigrants, and is often semi-legal – street traders require licenses, but there are active markets trading these licenses (illegally) so that they may be in use even while the person to whom they were issued makes a trip to their home country, for example.

A major, but not always visible, impact has been on the provision of care for older people. Women from eastern European countries have been specialising in this activity, providing care at home. Two different kinds of impact are being felt, according to the degree to which the traditional approach of caring for older people at home within the family has declined. In areas where this tradition remains strong, Italian women, who would otherwise have been caring for their parents, are freed to participate in the labour market. In other areas (for example, the Veneto and other northern regions) the traditional approach has much diminished because women wish to work outside the home, and residential care homes for old people are more common than in other parts of the country. In such areas, foreign women often now provide full time care in the family home, at lower cost than in residential care homes: demand for places in these homes has diminished noticeably. Until 2003 most of this care was provided by illegal immigrants, whose situation was widely tolerated, hence the initial provisions of the 2002 Regularisation exercise which was first intended only for such people. Nearly half of those given permits under this regularisation were declared as carers, though it may be expected that many of these will not in fact intend to work as carers once regularised.

Emigrants

Partly because Italy ceased to be a major emigration country 30 years ago and because immigration has been an important new phenomenon more recently, but also because of the inherent difficulties involved, little work has been done on assessing the impact that emigrants have had on the Italian economy. Emigrants' remittances in the balance of payments, their most obvious impact in macroeconomic terms, have been outweighed for some time by transfers out of Italy by immigrants now working in Italy. Reyneri (1979) concluded that post-second world war emigration from the south of Italy had not contributed anything to its development, despite the flows of remittances, and that the loss of human capital had probably retarded development. However, it also seems plausible that one of the reasons for emigration was that other factors than human capital were already acting as a brake on development and that aggregate welfare (including both the emigrants and those who remained) was improved by the emigration, even if average income growth in the south may have been lower than it might otherwise have been.

In the 1970s and 1980s there was a certain amount of return migration from northern Europe, and very recently there have been inflows of descendants of migrants from Italy in Latin America, particularly Argentina and Venezuela, in response to economic difficulties in those countries. The migration connection with Argentina meant that Italian savers were probably more affected than in most countries by the crisis, since a relatively large number of Italians were holders of Argentinian government debt.

Feeling that the presence of Italians, or their descendants, abroad *ought* to be able to bring positive benefits to Italy, Italian regions and the Italian government are trying to find ways to make use of these connections. In the case of Italian nationals, the register of Italians abroad means that in principle maintaining contacts is feasible. Regions such as the Veneto and Apulia are trying to establish surveys of Italians abroad with business activities, and promote trade fairs and other links. An assessment of concrete results from these initiatives is not yet possible.

Brain drain

Although numerically not very large, a notable ongoing emigration phenomenon in Italy is that of highly qualified researchers. According to Becker *et al.* (2004), in 1999 2.3% of the highest qualified Italians are living abroad, compared with 1.1% for France and less than 1% in Germany, Spain and the United Kingdom. This appears to be mainly due to the lack of demand for researchers in both the public and private sectors, possibly also because the career structure in many university institutions is rather rigid and the link between reward and performance is not very close.

A number of OECD countries have concerns about brain drain, even countries such as Australia and New Zealand which are favoured destinations for highly qualified migrants. But in many countries it emerges that there is as much of an inflow of highly qualified immigrants as there is an outflow of natives, so that it may be more appropriate to talk about brain "exchange". This does not apply to Italy however, again perhaps due to lack of demand and the nature of the labour market, and also to recognition of qualifications: for example, to have a non-EU university degree recognised in Italy (for example for employment as a public servant or in the university sector, other than on temporary contracts) it is necessary to find an Italian university ready to ratify the degree in a procedure that may even require the degree holder to pass an examination.

Integration

Some limited information is available on the degree to which immigrants integrate into the labour market. Venturini and Villosio (1999) compare native and immigrant wages (in a dataset of people affiliated to the social security system) in 1991 and 1993, and find that the gap diminished between the two dates, controlling for certain characteristics of immigrants. Bonifazi and Chiri (2001) trace some comparative statistics for the average immigrant and average native contributor to INPS (covering legal immigrants, therefore) from 1988 to 1994. Over this period average immigrant wages fell from above those of natives to below, as the composition of the immigrant population changed from having a large proportion of skilled or managerial workers from OECD countries towards the unskilled. Bonifazi and Chiri conclude, however, that most of this gap is explicable in terms of this composition, which would imply that wage discrimination was not all that widespread. More recent analysis based on the Bank of Italy Survey on Households Income and Wealth suggests that wage differentials between natives and immigrants have been around 5-6% in the 1990s. However, it seems that this gap has been shrinking over time from 11-12% in the early 1990s to 4% in 2002 (Brandolini *et al.*, 2004).

There is little direct evidence on the amount of discrimination, however. Labour market integration, in the sense of an absence of heavy unemployment among foreigners, seems to be fairly well established. But this probably owes a lot to the presence of a flexible informal market, and other evidence points to integration proceeding unevenly. The ISAE

survey referred to earlier showed some evidence of a dichotomy between firms with foreign employees and those without. Although overall just under 10% of employees in the firms sampled were non-EU foreigners, two-thirds of the firms employed no such foreigners at all, including almost 90% of southern firms surveyed. Among those who employed foreigners 80% would be happy to employ more foreigners in the future (and about 10% would not) whereas 70% of firms currently employing no foreigners had no intention of doing so in the future either (and about 8% did intend to).[33] A survey of immigrant workers and trade union officials (CGIL, 2004) reveals some subjective information on discrimination, showing for example that foreign workers feel they suffer as much or more discrimination from colleagues as from their employers (except in the south, where 80% felt discriminated against by employers). Unfortunately, it is not easy to correlate this subjective evidence on discrimination by employers (which concerns, notably, issues such as low-status work and unsocial working hours) with more objective labour market data.

Other indicators may show social integration proceeding, though they are perhaps better interpreted as part of the normal dynamics of migration flows: the growing share of females in the immigrant labour force, and the number of children of immigrants (whether born in Italy or not) who are in school. In the early 1990s, only 40% of immigrants with residence permits were females, and many of these were from the Philippines, Latin America, or OECD countries. For African and other Asian countries only about one third were females. By the end of the decade the overall average had risen to 45%, and rose from 10 to 28% for Moroccans, 14 to 34% for Albanians. This partly reflects the expansion of domestic employment where females specialise, but also represents immigrants increasingly establishing themselves as family groups.[34]

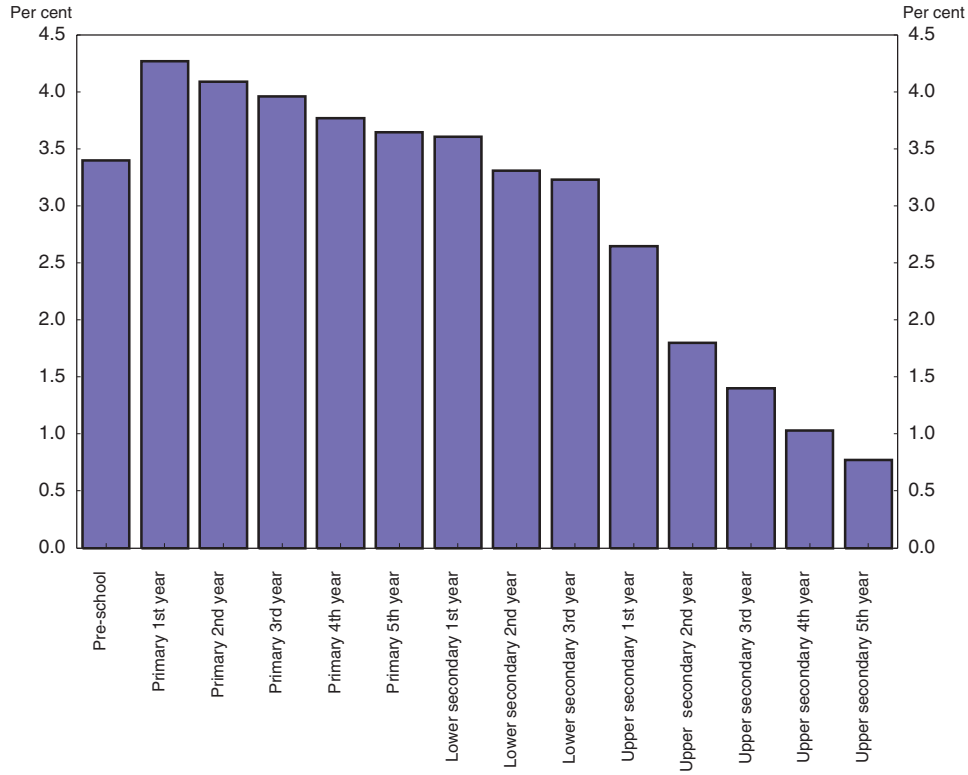
A further reflection of the changing nature of the immigrant population is in the strongly increasing number of foreign children in schools. In 2003-04 there were some 280 000, up from 230 000 the previous year and 182 000 in 2001-02. 280 000 children represents about 3.6% of the total school population, somewhat less than the share of immigrants in the overall population. Their distribution across the country also seems to be more concentrated than that of the overall immigrant population, with relatively more in the central and northern regions than the south. The proportion of foreign children is much lower at the upper secondary level (aged 14-18), which probably reflects a higher dropout rate for foreigners than for natives, although there may be some cohort effect due to the growing immigrant population (Figure 4.7).[35]

According to the ministry of education, children of immigrants who enter school at the early elementary level perform as well as children of natives, but those who enter later, especially those who enter at secondary level, do not.[36] At secondary level they also choose the vocationally directed courses much more often than the more academically oriented ones.[37]

Integration policy

There is no national policy on promoting social or economic integration of immigrants. The 1998 and 2002 laws do provide for such measures, but in practice the initiatives are left to the regional and local levels. Until 2003, most such policies were financed by an earmarked grant from central to regional governments; from 2004 onwards, this transfer is subsumed within the general transfer of funds for social policy, regions are free to decide for themselves the resources they devote to immigrant integration.[38] In the

Figure 4.7. **Share of foreign children in school**
School year 2002/03



Source: Ministry of Education.

three years 2001-2003, for example, the Veneto region spent about € 27 million annually on immigration matters, of which about 40% on housing; two thirds of the funding was from central government, the rest from the region's own resources. € 27 million represents just under 5% of the region's total expenditure on social policy, and 0.15% of its total expenditures.[39]

The three main areas where efforts are felt to be needed[40] are language training, housing assistance and the provision of "cultural mediators".[41] In the Veneto region it is estimated that 80% of new immigrant arrivals do not speak Italian. Although adult language courses are available it is probable that most immigrants will have to pick up the language through the workplace or, for children, school. In the latter, the majority of immigrant children, other than those who start school at the same time as Italian children, are behind in their studies due to language problems. The Education Ministry believes that sufficient means are available to tackle this problem, but even if this is true it is not clear that resources are being directed to where they are most needed.

Housing assistance is felt to be particularly important in regions like the Veneto where migrant numbers are large and where the same economic conditions that have created the demand for immigrants have tended to increase property prices at the same time, although it does not appear to be preventing migrants from being attracted to these regions. Local governments are constrained in their ability to provide social housing (to which legal immigrants are entitled) because there is very little available and because they

do not want to appear to favour immigrants over Italians. Some projects are therefore designed to allow immigrants to enter the ownership market more easily, in particular by providing guarantees for mortgages. Another kind of scheme is exemplified by a small-scale semi-private initiative in Vicenza whereby the chamber of commerce and a local bank set up a revolving fund, with initial capital of € 1 million, to help immigrants to set up housing associations to build homes. These schemes seem likely to benefit only a very small proportion of immigrants directly.

Another issue in housing is the requirement of the 2002 Immigration Law that employers guarantee housing for those on whose behalf they apply for regularisation. It is thought that in many cases these guarantees may not be honoured,[42] and it is not clear what provisions in the 2002 law have been implemented to enforce them.

Cultural mediators are intended to be a means by which immigrants unfamiliar with the language and/or laws and institutions of Italy can get help in overcoming the difficulties that such ignorance creates in everyday life, particularly for interaction with public services, health and education institutions. They are provided in what currently seems to be an *ad hoc* basis in all regions. The intention is that such mediators are available to offer guidance and translation or explain procedures, to immigrants who may not understand the Italian language or the working of public institutions such as hospitals, local government or schools. They are typically immigrants themselves and are rarely employed full time as mediators. Although they are quite numerous (for example the hospital in Padua has 40 mediators, there may be over 1 000 in the Veneto region as a whole, no precise numbers are known), it is hard to assess how well they meet the needs; up to now, no specific training is provided, or qualifications required.

Conclusions

Few direct implications for economic policy in respect of migrants emerge from this review of the economic impact of the experience of immigration in Italy. This has been the case in most of these reports on migration in OECD countries. But it does throw some interesting light on how the labour market works for migrants, and also some reflections on the role of labour market considerations in migration policy.

First, the fact that there is a clear demand for large numbers of immigrant workers in some parts of the country at the same time as high levels of unemployment in others shows that the labour market suffers from a high degree of friction. Immigrants are highly sensitive to labour market conditions in a way that natives are not; this is demonstrated, for example, by the way in which clandestine immigrants who entered in the 1990s typically did not stay in the generally higher unemployment areas where they arrived, but moved rapidly to where work was available. One reason for their mobility is that immigrants are less constrained by housing concerns than are natives.

Secondly, the informal labour market seems to work well as a means of filtering incoming migrants and providing a transition, often rapid, into formal work. Most immigrants were initially illegal, and were able to become "regularised" only by virtue of finding employment sufficiently stable and well-paid to persuade a legitimate employer to declare them as in regular work. Furthermore, contrary to what sometimes occurs, regularised immigrants appear to revert to clandestinity only rarely, suggesting that the formal and informal labour market works well in selecting immigrants capable of integrating (economically, at least). To ensure that immigrants integrate socially as well,

attention should be given to making available instructions in Italian, and about Italian institutions.

There is a curious parallel here with developments in migration policy in New Zealand. In that country, immigration policy has for some time been heavily focused on selecting immigrants for their qualifications. Recently, while maintaining this focus on qualifications, emphasis has been shifted towards testing potential immigrants for employability by allowing them in for up to two years to see if they can establish themselves in the labour market, and then giving them permanent residence if they succeed. Apart from the level of qualifications, the big difference is of course that New Zealand can directly control the overall volume of inflows quite well.

The Italian government has the difficult task of reconciling diverse views on the desirability of immigration, taking into account a range of factors for which economic analysis is largely irrelevant. But it seems that repeated regularisations – the last of which effectively increased the legal labour force (though not, of course, the effective labour force) by some 2½ per cent at a stroke – are feasible at least in part because of the wide recognition that there are economic benefits from immigrants who find productive work. In this light, the appropriateness of the provisions of the 1998 and 2002 laws for cumbersome procedures for employers to recruit from lists established in overseas consulates may be questioned, and the fact that some complex aspects of the labour force programming mandated by immigration laws have not yet been put into operation may not be a bad thing. This is not to say that there are not some losers from increased wage competition, though ambiguous results from empirical work do not allow strong conclusions to be drawn.

The example of street cleaning in Rome, though a particular and special case, serves to illustrate both the gains that are foregone by protecting the labour market position of public sector workers, and the potential impact of removing that protection. Local taxpayers in Rome could benefit considerably both from competition in cleaning services and from opening up employment to foreigners, just as many private sectors users of cleaning services have benefited already. But clearly those workers currently in jobs that are considered desirable – because of protection from competition – would suffer if such changes were made, losses that would however be reduced in more flexible labour markets.

One of the reasons hostility to immigration sometimes occurs can be the feeling that foreigners are costing the taxpayer money. Although there are no detailed studies into this at a national level, it seems that the average legal immigrant is probably making a positive contribution to public budgets, partly because of the age structure of the foreign population, but also because of relatively high rates of employment. This is likely to continue to be the case for as long as immigrants have the same demographic profiles and employment rates as at present.

As far as integration is concerned, although this is not the central concern of this chapter, Italy may be at a crucial stage. Immigration is a relatively recent phenomenon, so the integration of children of immigrants is only just beginning to be an issue. Since the migrants themselves are generally significantly better off than they were before migrating – even if their housing conditions, for example, may not be very good compared with those of natives – they tend to be satisfied with what they have achieved. Second generation immigrants will not have the same perspective and policies to favour their continued

integration – notably to ensure access to education and to avoid discrimination in the labour market – need to be pursued.

Finally, although evidence here is sparse, the current phenomenon of emigration of highly qualified Italians may also be related to some labour market rigidities. At the least, if there is felt to be a shortage of such people in Italy this may be the first place to look rather than in increasing the supply. Simpler and faster procedures for recognition of qualifications would also be useful in promoting a two way flow of such people, and would probably be useful for skills and qualifications more generally.

Notes

1. In common with a number of other European countries, notably Spain and Greece.
2. Even in this process of transformation, there were elements of continuity. Some of the first Italians who moved to work in the mines of Luxembourg and Lorraine before the first world war were from communities in Abruzzo whose economies depended, until the 1890s, on seasonal migrations of several hundred kilometres by farmers with their animals. In the first decade of the 20th century, almost 20% of Italian emigrants were Abruzzesi. They initially returned frequently to Italy, but most eventually became permanent emigrants. See Galloro (2001).
3. Colaiocomo and Licata (2003). The authors also estimate that there are some 60 million descendants of the approximately 20 million Italians who emigrated in the twentieth century.
4. AIRE stands for the Anagrafe degli italiani residenti all'estero, a register of Italians living abroad maintained by Italian consulates. Within Italy, the anagrafe is the corresponding population register – all residents of Italy are supposed to register in their district of residence.
5. In ruling No. 46, January 1977, quoted in Caritas (2003b).
6. These laws are, respectively, 943/1986, 39/1990 (the "Martelli" law), 40/1998 ("Turco-Napolitano" or the Testo Unico) and 189/2002 ("Bossi-Fini"). This chapter refers to the laws simply by the year in which they became law.
7. This and subsequent quota systems did not cover citizens of non-European OECD countries, nor family reunification.
8. The planning document to cover the period 2004-2006 was adopted in a preliminary form by the government in December 2004.
9. The 2002 regularisation was subject to a limited number of proven irregularities. It has been reported that there were a number of cases where employers were paid to make applications for people who were not actually to be their employees.
10. Only around one half of people found without papers had applied for the regularisation, but it is likely that the half of the peopled that the police decided to record as not having papers after control had not applied for regularisation. Most of those having applied were provided with a "credolino" and if the police had no other specific reason to suspect their behaviour they would not be recorded after a random control if they could prove their application for regularisation.
11. Prior to the 1980s, entry policy did not systematically take into account any aspect of the labour market situation. According to Caritas (2003b) it was in the mid-1980s that immigration, previously largely unnoticed in Italy, began to be perceived as a problem, with potential effects on the labour market.
12. Quoted in Caritas (2003b). The 1986 law also defined a series of rights – to equal treatment at work, to certain social services – for non-EU residents.
13. The appellation "Testo Unico" results from the fact that it brought together and/or superseded all previous legislation in respect of immigration policy. In addition to the labour market aspects discussed in the main text, the legislation guaranteed legal immigrants the same rights of access to health, education and housing as for Italian nationals; illegal immigrants were also guaranteed access to health care and to compulsory education for their children.
14. Inserimento in Italian, which includes, however, the seasonal permits.

15. Permanent residence permits are available at the same time for the spouse and dependent children. Additional conditions for a permanent permit include the absence of a criminal record (including convictions under appeal).

16. Unlike the quotas introduced in Spain in 2002, where a large proportion of the quotas went unused (OECD, 2003). Some of the country-specific quotas in Italy are not in fact fully used.

17. In 2001 southern regions were entirely denied quotas and thereafter they have been very small, it being assumed that areas with such high unemployment have no "need" for immigrants. There is some logic to this, although it may be noted too that dependent labour in the agricultural industry in many southern regions is almost entirely composed of illegal immigrants.

18. Partly as a result of changed conditions in countries of origin and partly due to stronger measures to prevent illegal inflows across the Adriatic to the south, eastern European migrants now tend to arrive more directly in the northern regions. There are still significant flows into other southern regions; most such arrivals have the explicit intention to move further north or to other EU countries.

19. "Long distance" here is taken to be movement from one "division" to another, where Italy is divided into four divisions: North-West, North-East, Centre and Mezzogiorno. There were 5.6 such moves per 1000 population in 1955, 3.8 in 1995. See Bonifazi and Heins (2000) Table 1.

20. Other explanations include wage-setting, particularly in the public sector, which sets wages for similar jobs equal in all regions, inefficiencies in job-matching institutions, and a rigid housing market.

21. The nature of the irregularity varies significantly across the regions; for example, direct employment of illegal immigrants is more frequent in the south than in the north, whereas fiscal evasion is more important in the north than in the south. See Caritas (2003a) pp. 335-338.

22. And the sheer numbers of people regularised in 2003 would imply a big drop in the size of the informal economy.

23. Including those following from employment protection legislation, which employers may be keen to avoid and immigrants less worried about than natives.

24. Data from the regularisation indicates that a much larger share of immigrants is irregular in the south, where only 7.5% of legal permits delivered in Italy were located before the legalisation but where 14.3% of all requests of regularisation were located. This is particularly true of Campania, where only 3.9% of legal migrants were located but where 9.6% of all application for legalisation for the whole of Italy were presented. Instead in Sicily and Sardinia irregular presence is lower than national average.

25. On their working conditions, according to Censis (2002a), at least one third of the seasonal workers had no labour contracts, and about half reported that they were paid less than had been agreed (although 95% report good or neutral relations with their employers). Most had found the work on their own or through friends or family. On average they worked 10 hours a day, 23 days a month, for less than € 40 a day. Agricultural workers earn less, while street vendors might make twice as much.

26. Or it may not be possible to employ immigrants illegally in such jobs; in this case, illegal employment has its negative effect on regular employment through competition from other enterprises or subcontractors which do employ irregular labour.

27. See also ISAE (2002), which reports the results of a survey of Italian companies and their employment of non-EU foreigners. Asked the principal reason for employing these immigrants, 60% of employers replied inability to recruit Italians, about 10% mentioned greater flexibility and only 8% mentioned either lower pay or willingness to work below level of qualification. This need not in fact mean that immigrants have little impact on wages, though this kind of evidence is often taken as proof of this.

28. Recent work by Sartor (2004), for example, is restricted to theoretical exposition and references to studies on other countries.

29. *I.e.* assuming a legal immigrant population of around 2 million.

30. There are still some arguments, for example over whether to charge marginal or average costs for individual treatments.

31. A research organisation working under the Veneto regional government.

32. Borjas (2001) develops a related argument for the United States.

33. See ISAE (2002), pp. 175 et seq. The residual percentages were non-responses.

34. This is not always reflected in the stated reason for applications for residence permits. In 1990 the number of applicants claiming family reasons was just over half the number asking for dependent employment; this ratio fell in the early 1990s and remained between 35 and 45% until 1997. It has grown more consistently since then and was about 70% in 2002.

35. The proportion declines markedly from year to year in upper secondary schools, from about 2.7% in the first year to under 1% in the fifth and final year. No such decline occurs in elementary and middle schools.

36. The PISA study results for Italy do not allow comparison of overall performance between natives and immigrants, owing to the small number of immigrants in the sample. A comparison on the combined literacy test is possible, where immigrants indeed scored significantly lower than the native students, although the performance of the latter was also low by comparison with most OECD countries, and the gap between the two groups was not as wide as in some. See OECD (2001), Annex B1 Table 6.10.

37. In the north-east in 2002-03, nearly 10% of students in secondary level vocational schools are children of immigrants, but only 1.7% of students in the "scientific" and "classical" schools. The national average for vocational schools was 4.9%.

38. This is probably only a notional change, since regions were already treating the transfers as largely fungible.

39. Note that these figures do not include health, education, or social security expenditure.

40. This section is based to a considerable extent on information from the Veneto region, which may not be typical of other regions. The OECD Department of Employment, Labour and Social Affairs is currently working on a programme of country case studies into integration policies in OECD countries, Italy will be the subject of such a study in 2005.

41. Though these priorities are not obviously reflected in the budgetary allocations, where direct expenditure on language training (other than in schools) is very small.

42. It is also said that there are cases where the guarantees were provided in exchange for a payment by the illegal immigrant to the sponsoring employer. Furthermore, according to the law, the housing guaranteed by the employer has to meet the standards for social housing: a minimum of 46 m^2 for a single person and 9 m^2 for each additional person in a family; it is unlikely that many immigrants could afford such housing in an urban area, and many natives in private housing have less space than this.

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Chapter 5

Human capital and the labour market

Italy exhibits a significant human capital gap vis-à-vis *the OECD average, encompassing: relatively low rates of completion of secondary and especially tertiary education; disappointing PISA test scores despite high spending at the secondary level; a large brain drain toward the US and UK but very few foreign students in Italy; low spending and organisational problems at Italian universities and research establishments; low numbers of researchers and lagging R&D activity, especially private. The lack of a degree bears a high correlation with unemployment risk especially in the South, for women, and among older age cohorts. The education premium in wages appears lower than in Germany or the US, in part reflecting relatively weak demand for higher skills by the enterprise sector. Yet the social return to education is high, especially in the South. The present school reform needs to be implemented fully, as up front budget costs are much more than compensated by lasting economic benefits. A system of income-contingent student loans could help reduce class and regional education discrepancies. More education spending needs to be directed to the South, and more autonomy and performance-related management is needed in the university sector. R&D activity needs to be boosted, via fiscal incentives and enhanced financial market support of enterprise growth.*

The level of human capital in Italy has risen substantially in recent years: the secondary-school drop-out rate has been declining since 1990, and the percentage of the population attaining at least upper secondary education has increased. Although they are growing, human capital endowments are characterised by regional disparities. This chapter focuses on the contributions that education makes to enhancing people's performance in the labour market, and outlines the main reforms under consideration to bolster those achievements.

Overall trends in the level of human capital

Shortfalls at the higher levels of education

Despite recent improvements to the level of human capital, Italy lags substantially behind in its percentage of upper secondary and tertiary education graduates (Table 5.1). The proportion of 25 to 64-year-olds to pursue their studies until at least upper secondary school was only 44% in 2002, or 20 percentage points less than the OECD average. There has been a catching up over time, albeit not impressive. Indeed, even among 25 to 34-year-olds, the proportion is well below the OECD average (by 15 percentage points).

Table 5.1. **Population with at least upper secondary education**
Percentage, by age group, 2002

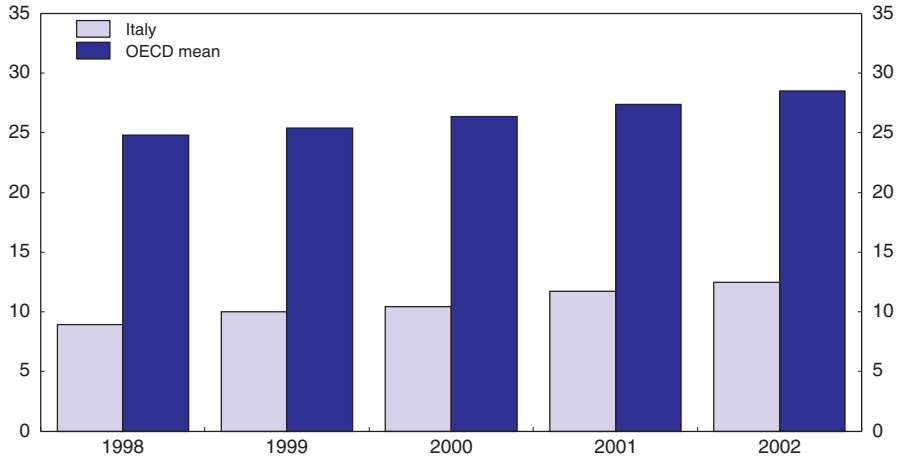
	25 to 64	25 to 34	35 to 44	45 to 54	55 to 64
Italy	44	60	50	39	24
EU 15	62	72	66	58	47
OECD average	65	75	69	61	50

Source: OECD, *Education at a Glance* (2004), Eurostat, New Chronos.

Tertiary graduation rates are still very low in Italy. In addition, the level of tertiary education has not evolved significantly in recent years (Figure 5.1). The proportion of persons aged 25-34 attaining that level of education was only 12% in 2002 (versus 28% for the average of countries) – one of the lowest in the OECD. A good part of this gap is explained by tertiary type B education (post-secondary professional-type teaching establishments) that has been virtually absent in Italy until very recently.

University enrolment rates are fairly high (35.8% of young people aged 19 to 25 for the 2001-02 academic year),[1] but the drop-out rate is also very high, insofar as only a little over 40% of students who matriculate actually complete their studies (OECD, 2004b). The low proportion of young people who pursue their studies not only represents a lost opportunity to enhance human capital, but it can also cause a problem for society in that looking for work can prove more difficult. A large part of this drop-out rate can be explained by family background and type of high school attended. The selection along family characteristics is particularly strong because only better and more motivated

Figure 5.1. **Trends in tertiary education**
Percentage of the population aged 25 to 34 with tertiary education



Source: OECD, *Education at a Glance* (2004).

children born to poor parents manage to enrol into university. Yet even they still face a higher chance of dropping out (Cingano and Cipollone, 2004).

Persistent regional disparities

While near-total uniformity across regions in enrolment rates has been achieved at the primary and secondary levels, with impressive catch-up over the last decade at the upper secondary level, remaining regional disparities are found at the tertiary level (Table 5.2). However, the latter is partially mitigated by inter-regional student flows: in 2001-2002 around 18% of students in the South were are registered in universities in the Centre-North, whereas only 5% of students from the Centre-North were registered in universities in the South.[2]

Table 5.2. **Enrolment rates in Italian regions**[1]

	Italy	North-West	North-East	Center	Mezzogiorno
			1996-1997 school year		
Pre-school	93.9	95.9	96.9	95.3	91.4
Primary	99.4	100.4	100.5	100.2	98.4
Lower secondary	104.4	103.6	103.7	105.2	104.7
Upper secondary	81.2	80.8	83.7	91.1	76.1
Tertiary	28.7	27	31.1	41.6	22.9
			2001-2002 school year		
Pre-school	101.3	100.8	100.0	102.9	101.6
Primary	101.8	102.9	101.9	103.3	100.6
Lower secondary	105.5	105.6	104.6	107	105.2
Upper secondary	90	88.3	89.6	98.3	87.7
Tertiary	35.8	31.7	39.9	53.3	29.2

1. Enrolment rates per 100 persons registered at the theoretical corresponding age (3-5 years, 6-10 years, 11-13 years, 4-18 years and 19-25 years, respectively). Rates in excess of 100% are due to grade-repeating.

Source: ISTAT (2004) *Rapporto annuale, La situazione del Paese nel 2003*.

Quality of education

Concerning the quality of education, the 2003 PISA (Programme for International Student Assessment) cycle highlighted lagging performance in reading literacy, scientific literacy and above all mathematical literacy and problem solving (a test of cross-disciplinary skills) among students in Italy (Table 5.3). Student performance differentials on the other hand are slightly lower within the country than internationally for mathematical literacy and problem solving, though higher for reading. Such differentials worsened for Italy since the last PISA cycle in 2000, mainly reflecting deteriorating performance (especially in reading) by the lower percentiles (5th to 25th), with constant or even improving performance (in mathematics) for 75th percentile and above. As in most of the OECD countries, these differentials are attributable in great part to differences between institutions. In Italy, differences between institutions combined with attendance at different types of institutions are aggravated by differences in social and family backgrounds (OECD, 2003a). This may be a consequence of selection or self-selection: students from lower social backgrounds may tend to be directed to, or choose for themselves, less demanding study programmes, or may opt not to participate in the selection procedures of the education system. Bringing students in the bottom quartile nearer to the current average would raise the overall national performance.

Table 5.3. **Results of the 2003 PISA analysis**

Performance of all students

	Italy	OECD average
Reading literacy		
Average	476	494
Difference between the 75th and 25th percentiles	136	130
Mathematical literacy		
Average	466	500
Difference between the 75th and 25th percentiles	130	139
Scientific literacy		
Average	486	500
Difference between the 75th and 25th percentiles	148	148
Problem Solving		
Average	469	500
Difference between the 75th and 25th percentiles	134	137

Source: OECD, *Learning for Tomorrow World: First Results from PISA 2003* and OECD (2004), *Problem Solving for Tomorrow's World: First Measures of Cross-Curricular Competencies from PISA 2003* (2004).

Financial resources for education

If human capital continues to suffer gaps, it is to some extent because of budget constraints. While trends in the share of public spending earmarked for education between 1995 and 2001 were similar to the OECD average, the actual percentage remained 2½ points below that average in 2001 (Table 5.4). However, this reflected the high share of public spending devoted to debt service in Italy, since as a proportion of GDP, public spending on education was the same as the EU average and only slightly below the OECD one. On the other hand, private expenditure on educational institutions as a proportion of GDP in 2001 remained below the OECD average (0.4 vs. 1.4%).

Table 5.4. **Public expenditure on educational institutions**[1]

	2001			1995
	Primary, secondary, and post-secondary non-tertiary education	Tertiary education	All levels of education combined	All levels of education combined
	As a percentage of total public spending			
Italy	7.6	1.7	10.3	9.1
EU-15	8.0	2.8	11.7	10.5
OECD average	8.9	2.8	12.7	11.8
	As a percentage of GDP			
Italy	3.7	0.8	5.0	4.9
EU-15	3.6	1.3	5.0	5.5
OECD average	3.6	1.3	5.3	5.3

1. Including government subsidies to households, including subsistence allowances, and to other private entities.

Source: OECD, *Education at a Glance* (2004), Eurostat, New Chronos.

While public expenditure on education is below the OECD average, outlays per student for primary and secondary schools are higher than those recorded in most of the OECD countries (Table 5.5). In contrast, spending per student in tertiary institutions is below the OECD average. These divergences stem in large part from the fact that student-to-teacher ratios are relatively low in primary and secondary schools but high in tertiary education (Table 5.6). Since low student to teacher ratios are usually associated with greater educational quality, the gap in performance at the secondary level points to teaching and educational inefficiencies.

Table 5.5. **Total expenditure on educational institutions**

Per student, as a percentage of per-capita GDP, based on full-time equivalents, 2001

	Primary	Lower secondary	Upper secondary	All secondary	All tertiary
Italy[1]	27.0	34.0	32.0	33.0	33.0
EU-15	19.8	25.6	26.8	26.0	38.9
OECD average	20.0	23.0	28.0	26.0	42.0

1. For Italy, expenditure is public expenditure only.

Source: OECD, *Education at a Glance* (2004); Eurostat, New Chronos.

Table 5.6. **Ratio of students to teaching staff in public and private institutions**

By level of education, expressed in full-time equivalents, 2002

	Pre-school	Primary	Lower secondary	Upper secondary	All secondary	All tertiary
Italy	12.8	10.6	9.9	10.3	10.2	23.1
EU-15	15.8	14.7	12.1	13.3	11.8	15.3
OECD average	14.8	16.6	14.4	13.1	13.6	15.4

Source: OECD, *Education at a Glance* (2004); Eurostat, New Chronos.

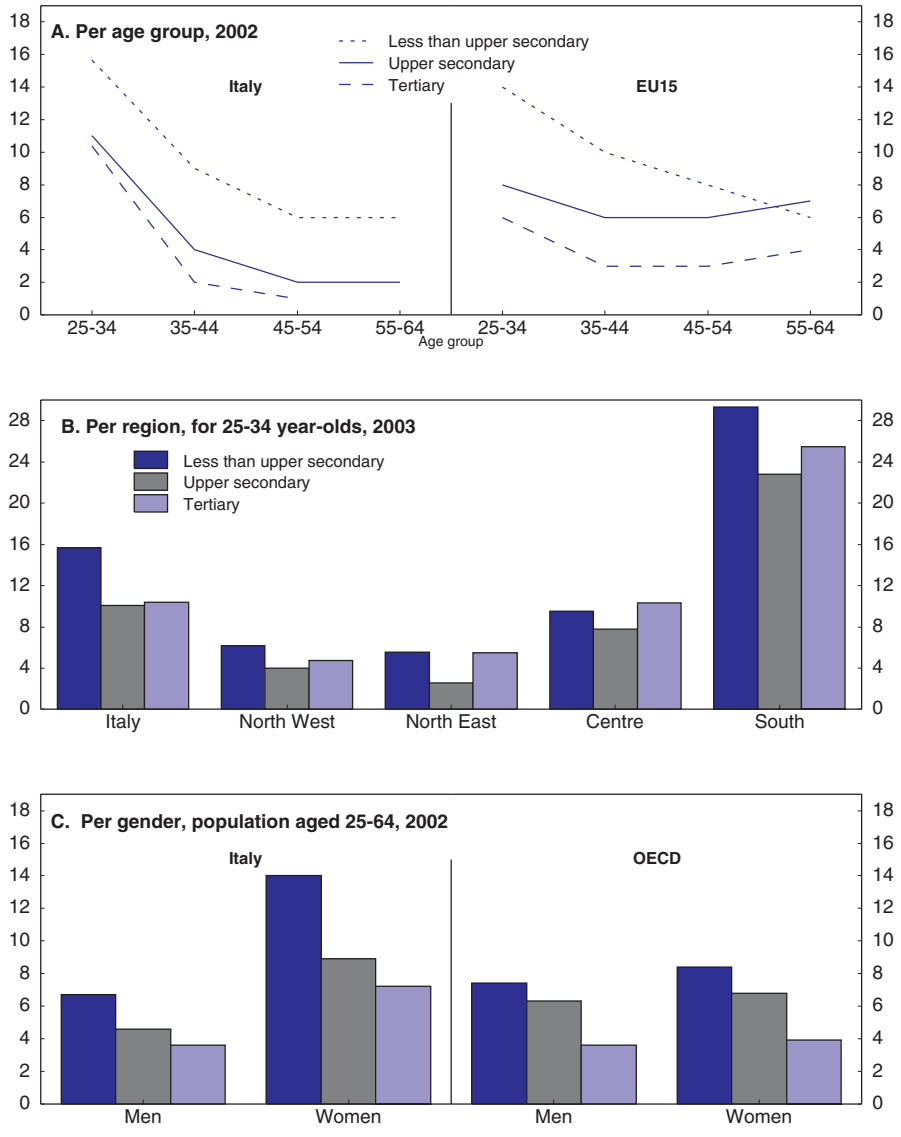
The impact of education on unemployment and labour force participation

Unemployment rates by level of education

In Italy, unemployment rates for individuals with little schooling are higher than for persons with average or high levels of education (Figure 5.2). Moreover, the differential is wider for the 35 to 44-year-old age group. People who are less educated are especially exposed to the risks of economic marginalisation because they are more likely not to be part of the labour force (see below), and if they do seek work they have less chance of finding it.

Figure 5.2. **Education levels and unemployment rates**

Per cent



Source: OECD, Employment Outlook database; Eurostat, New Chronos.

Unemployment rates and regional disparities

The labour market is characterised by regional segmentation, with relatively high levels of employment, and productivity in the North and Centre, and the opposite in the South.[3] The unemployment rate for young people aged 15 to 24 is very high in Italy (Table 5.7), and more particularly in the Mezzogiorno. The especially high youth unemployment rate stems both from skills levels and from difficulties making the transition from school to the labour market. With regard to the first factor, the extension of compulsory schooling from age 15 to 17, as envisaged by the recently approved reforms, constitutes progress towards the improvement of human capital.[4] With regard to the second factor, Italian education tends to be general and theoretical. Work-study programmes are rare, and co-operation between schools, businesses and training institutions is still insufficiently developed. Other countries, including Germany, Austria, Switzerland and Denmark, emphasise apprenticeship, which comprises not only theoretical, general learning but also work-study programmes in business enterprises. Also in this respect, the approved reform, if fully implemented, could represent a major step forward (see the 2003 *Survey*).[5]

Table 5.7. **Unemployment rates by age group and region**

2003

	Italy	North-West	North-East	Center	Mezzogiorno
15 to 24 years	27.1	13.6	8.8	22.4	49.1
25 to 34 years	11.4	4.9	4.0	9.3	24.3
35 to 54 years	5.0	2.6	2.1	3.7	10.0
55 to 64 years	3.8	2.5	2.0	2.4	6.6
Total	8.7	4.2	3.2	6.5	17.7

Source: ISTAT (2004), *Rapporto annuale, La situazione del Paese nel 2003*.

Among 25 to 34-year-olds with average or above-average skills, the risk of unemployment and difficulty finding work would seem relatively unaffected by their level of education. It is only later in people's working lives that unemployment rate differentials widen between upper secondary and tertiary education categories. Even if the differentials are increasing, they are still far less sharp than for the EU-15 average (Figure 5.2, Panel A). This finding underscores one feature of the Italian labour market – the great demand for average-skilled workers.

For persons having the same level of skills, the risk of unemployment is greater in the South than in regions of the North or Centre (Figure 5.2, Panel B). The higher unemployment in the South could partly stem from the low northward mobility of southern Italian workers and the low southward mobility of northern Italian capital. Research into the linkages between immigration and the labour market highlights the low mobility of native-born Italian workers with average or low skills (see Chapter 4). In contrast, immigrants appear to be highly sensitive to labour market conditions and tend to move to regions where the demand for labour is greater. Most of these immigrants in fact entered the country illegally *via* the southern regions and migrated northward, where the demand for medium-skilled labour is high. At present, the industrial and commercial districts of the North are the primary destinations for immigrants. Regions with the highest concentrations of immigrant populations record the lowest unemployment rates.

Part of this different behaviour could be explained by higher house ownership by natives compared to immigrants.

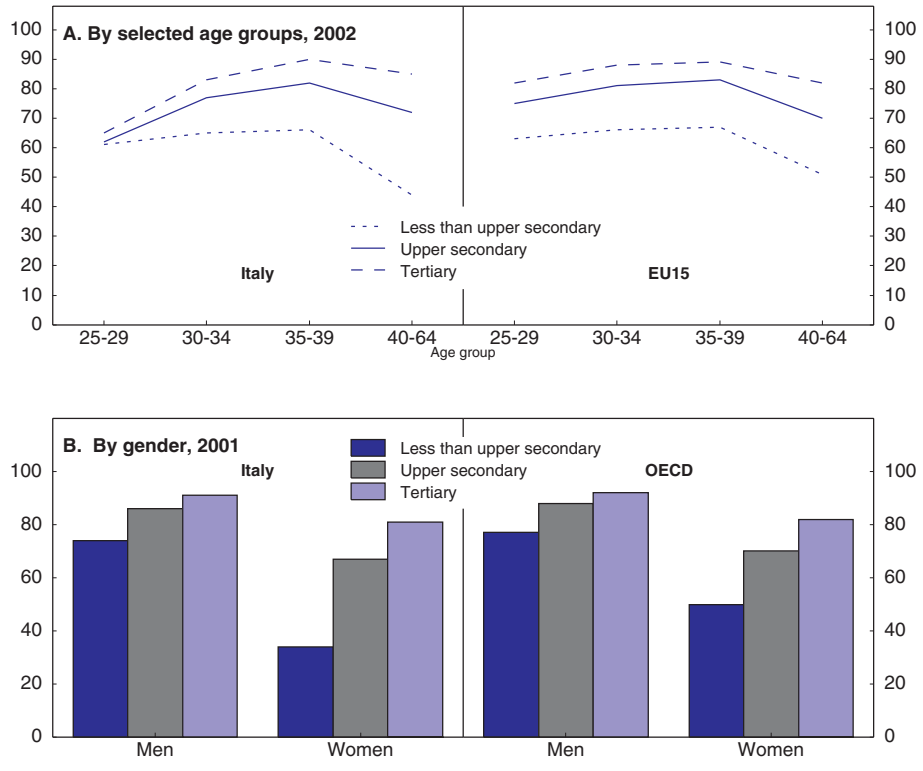
Alongside regional labour market disparities are those between males and females (Figure 5.2, Panel C). For equal skills levels, joblessness affects women more than men. Gender disparities are widest when skills levels are lowest. The correlation between unemployment rates and educational levels can also be seen for men, but the disparity between those with low and high levels of education is not as great. Moreover, unemployment rates for women at all levels of educational attainment are higher than the OECD average. The risk of unemployment is therefore greatest for low-skilled young women. The impact of educational attainment on unemployment risk increases as a person gets older.

Labour force participation rates by level of education

Labour force participation rates clearly increase with the level of education (Figure 5.3). The correlation between labour force participation rates and level of education furthermore increases with age. This finding is not true, however, for the 25 to 29-year-old segment of the population, whose participation rates are similar, irrespective of educational attainment, this being due mainly to the difficulties involved in the transition from school to the labour market (see above).

Figure 5.3. **Education levels and labour force participation**

Per cent



Source: OECD, Employment Outlook database; Eurostat, New Chronos.

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Educational attainment and labour force participation disparities by gender

Differences in labour force participation rates between males and females aged 25 to 64 diminish as levels of education rise. Even so, the rate differentials between the genders are very substantial at all levels of educational attainment. The participation rate for all women aged 25 to 64 was only 50% in 2001 – 15 percentage points below the OECD average (65%). The main problem involves the especially low participation rate, as compared with the OECD average, of women with less education.

These trends stem from a number of factors. Insofar as earnings tend to rise with the level of education, the monetary incentive to work is greater when a person is better educated. The hard physical labour generally associated with the lowest educational levels may also cause people to stop working earlier. Lastly, levels of education and participation ratios have historically been lower for women than for men, and despite the considerable progress in recent decades, women's participation rates still reflect this legacy of the past.

Returns on education

Levels of education and earnings

In Italy as elsewhere, there is a direct, positive correlation between levels of education and earnings (Table 5.8, Panel A). Pre-tax income differentials between tertiary and upper-secondary school graduates are far smaller than in the United States, but quite similar to those in Germany, being even somewhat higher for males albeit lower for females. Post-tax

Table 5.8. **Pre-tax earnings of the population with labour income**

A. Index with upper secondary education = 100

	Below upper secondary education		Post-secondary non-tertiary education		Tertiary education	
	25-64	30-44	25-64	30-44	25-64	30-44
United States 2002						
Men	68	70	122	125	193	195
Women	67	67	118	117	176	182
Total	71	71	120	121	186	187
Germany 2002						
Men	85	87	110	110	142	137
Women	75	72	132	136	142	138
Total	78	80	116	116	146	139
Italy 2000						
Men	71	72	..	..	143	140
Women	84	80	..	..	137	132
Total	78	77	..	..	138	133

B. Relative females' earnings[1]

	Below upper secondary education		Upper secondary and post-secondary non-tertiary education		Tertiary Type B education		Tertiary type A and advanced research programmes	
	30-44	55-64	30-44	55-64	30-44	55-64	30-44	55-64
United States 2001	79	78	72	53	67	83	77	69
Germany 2002	59	65	61	61	58	59	61	58
Italy 2000	48	66	60	55	59	65	58	54

1. Measured as average annual earnings of females as a percentage of males' earnings.

Source: OECD, *Education at a Glance* (2004).

differentials would be even smaller because of more progressive tax systems in continental Europe than in the United States. These low income differentials may partly explain why such a small proportion of tertiary school students completes its studies, especially in comparison with US students.

The observed earnings disparities between men and women persist, and are more pronounced than in the United States, though once again similar to Germany (Table 5.8, Panel B). These disparities are heightened by the frequency of part-time work among women. For all levels of education combined, women's earnings are lower than men's. The differentials tend to widen as the level of education increases. For persons aged 30 to 44 with tertiary education, the earnings of women in 1998 were only about 60% as great as those of men.

Private internal rate of return to education

The private internal rate of return[6] measures incentives to invest in human capital, taking into account both benefits and costs thereof.[7] The private internal rates of return to both secondary and tertiary education seem much lower than the corresponding estimated OECD averages, confirming the fact that incentives to pursue higher education might be weaker than elsewhere (Table 5.9). Nevertheless, compared to financial assets, schooling still appears a very attractive investment from the individual point of view in Italy, and especially so in the South.[8]

Table 5.9. **Private and social returns to education**
in percentage points

	Private internal rate of return		Social rate of return[3]
	Upper secondary[1]	Tertiary[2]	
Italy North-West	7.3	6.1	5.9
Italy North-East	6.7	6.5	5.9
Italy Centre	6.8	7.3	6.2
Italy South	8.4	9.9	7.8
OECD average	11.4	11.8	..

1. The rate of return to upper secondary education is calculated by comparing the benefits and costs with those of lower secondary education, including taxes on wages and student support.
2. The rate of return to tertiary education is calculated by comparing the benefits and costs with those of upper secondary education, including taxes on wages and student support.
3. The social returns to schooling considers the effect of one additional year of schooling on output rather than on wages, while ignoring tax and benefit flows between the public and private sector.

Source: Ciccone *et al.* (2004) and OECD, *Education at a Glance* (2004).

Social returns to education

The OECD (2003c) has estimated that the long-term effect on per-capita GDP of one additional year of education varies between 4 and 7%. Recent estimates for Italy point to 5%.[9] Productivity gains can then be passed along to workers and businesses and boost both the incentive to work and demand for labour. As a result, raising productivity and competitiveness in Italy will hinge, in the long term, on improving the useable skills of the labour force.

The positive effects of education are much greater in the South than in the rest of the country (Dalmazzo and De Blasio, 2003), insofar as the difference (four percentage points) between the unemployment rate[10] for highly skilled workers (25%) and the rate for low-

skilled workers (29%) is higher there (the difference being roughly one percentage point in the North). Similarly, Table 5.9 shows that the social return to each additional year of schooling is nearly 2 percentage points higher in the South than in the regions of the North-Centre. Consequently, Italy could raise employment and productivity if it could really close the gap in the South, which is home to one-third of the population.

The North features relatively high levels of employment and productivity. Businesses look more for medium-skilled workers than for highly skilled ones. This characteristic of the Italian labour market explains the low unemployment rate for medium-skilled workers (see above). While that category of the population is not greatly affected by joblessness, it would still seem necessary to raise the level of education. In response to growing global competition, Italy should improve its endowment in highly skilled human capital and develop research and development (R&D) activities in order to raise its levels of productivity and competitiveness.

Reforms to expand employment and labour productivity by enhancing human capital

Primary and secondary education

The authorities rightly attach overriding importance to enhancing human capital, and they are gearing reforms towards that goal. In 2003, the parliament approved a reform of the system of primary and secondary education in order to reduce drop-out rates (OECD, 2003b). The main innovations are: *a)* an increase from 10 to 12 years of compulsory schooling; *b)* the introduction of a new vocational track in addition to the existing high schools (*licei*) for pupils after lower secondary education; *c)* the teaching of one and two foreign languages during primary and secondary education, respectively; *d)* the elimination of the national examination after primary school; *e)* pupil evaluation every two years rather than each year; *f)* the introduction of internships in the curricula; *g)* the obligation for teachers in primary and secondary levels to hold a university specialisation degree and the possibility to obtain a tenure contract only after a two-year trial period; and *h)* the implementation of training programmes for currently employed teachers. The reform will be carried out at the local level with guidelines and minimum standards prepared centrally. Legislation at the regional level might complement decisions taken at the centre. Regional authorities will also be responsible for part of the schools' programme.

The implementation of the new school system will take place gradually, and in line with the financing made available annually by the budget law. On top of this, the *Patto per l'Italia* (see the 2003 *Survey*) stresses the need to strengthen the ability of post-secondary professional schools – introduced in 1998 – to create a better link between education and the labour market, as well as more direct involvement of social partners. A vocational and training track will be offered in parallel with the existing system, which is geared heavily towards general education. The measures foreseen in the reform represent a notable step towards raising and improving human capital in Italy. The extension of compulsory schooling will have beneficial effects on potential GDP. The introduction of a vocational track will facilitate the school-to-work transition, which will help reduce mismatches in the labour market.

Tertiary education

In recent years, the Italian system of higher education has undergone, and is still evoking, far-reaching reforms. Among the aims of those reforms is to make the system more competitive by striving for enhanced economic benefits through investment in technical innovation and training. Achieving this will entail solving a great many problems, and especially the shortage of funding and human resources.

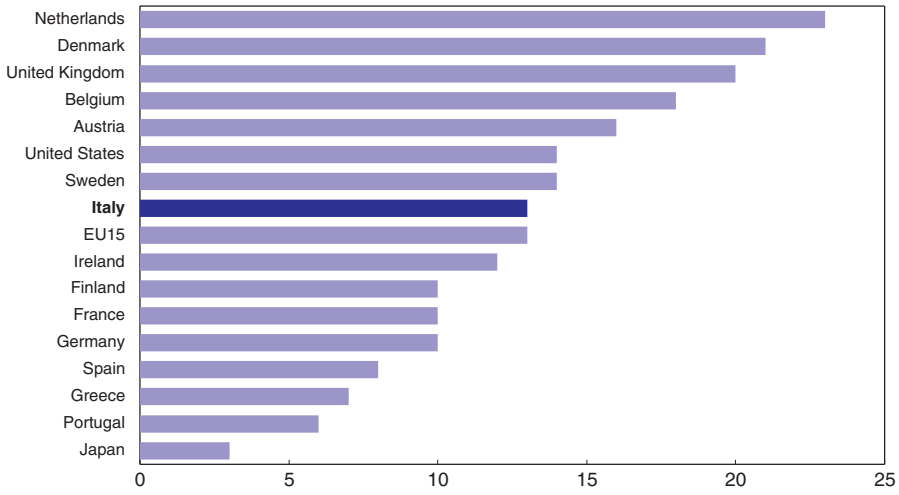
University reform, entering into force at the start of the 2000-01 academic year, was undertaken to overcome higher education's lack of efficiency and attractiveness, seizing the opportunity provided by the implementation of the European system of bachelor's degree,[11] master's degree[12] and doctorate. The division of studies into two segments – bachelor and master – of respectively three years and two years, enabling those wishing to complete a shorter course of study to obtain the schooling they need to enter the labour market, has made a positive impact: the number of new matriculates has risen on average by roughly 9.2% per year since the reform (Augier and Carles, 2004). Regarding drop-out rates and the age of graduates, it is still too soon for reliable figures to be available. However, insofar as liquidity constraints may play a role, especially in observed high drop-out rates by students from poorer families, a system of income-contingent loans may need to be developed, as has proved successful in other OECD countries such as Australia.

Young people's disenchantment with university studies stems in part from a shortage of professors. With a ratio of 1 868 tertiary education professors per million persons in the labour force (versus an EU-15 average of 2 805), Italy is one of the EU-15 countries with the smallest number of professors. The human resource shortages are reflected in the shortcomings of the university system: the average age at which students leave university is high (averaging 26-27), and the success rate (defined as new PhDs in science and engineering fields of study per thousand population aged 25-34)[13] and number of publications per capita are very low. Italy is one of the EU-15 countries with the fewest scientific publications per million persons in the labour force (674, *versus* 924 for the EU-15 average). It should be pointed out however that Italian researchers themselves are productive: the number of publications per thousand researchers is 346, *versus* an EU-15 average of 269. Also, in terms of frequently cited papers, Italian researchers compare similarly to their European colleagues (Figure 5.4).

The insufficiency of Italian research also stems from governance problems. Universities encounter such problems because there is little incentive for professors to improve their schools' performance, because of guaranteed employment and a lack of effective sanctions. Like public research centres, universities rely too heavily on transfers from the State, which are not tied to performance. Performance-related transfers could increase competition between institutions and thus enhance their quality. To improve this quality further, teaching staff ought to be likewise subject to merit-based systems of promotion and compensation.

The Italian higher education system has also to grapple with the problem of faculty ageing and non-replacement. According to a CNVSU[14] survey using figures from 2002-03, 21.6% of faculty members are over 60 years of age, and over 10% of those are over 70. It is for *professori ordinari* (full professors) that the figures are highest: roughly 42% of them are over 60 years old. The situation is also worrisome in the case of *professori associati,*[15] about 23% of whom are over 60. The concern caused by this ageing teaching corps is accentuated by the fact that in Italy the retirement age for professors is the highest in the European

Figure 5.4. **Frequently cited papers per thousand researchers**



Source: Rizzuto, C. and R. Rochow (2003), "*Quale è il rendimento della spesa di ricerca nelle Università (e nella ricerca pubblica) : qualche evidenza dai dati statistici*".

Union: 70 for *professori associati* and 75 for *professori ordinari*. The government is therefore trying to rectify the staffing shortage and revitalise the system so as to recruit more young people.

A new law on the legal status of university instructors was proposed recently. The bill's three main features are: *a)* a national competition to recruit researchers and professors; *b)* fixed-term contracts for researchers; and *c)* the ability to fill teaching posts with distinguished scientists. Regarding the first point, the decree seeks to replace local recruiting by nation-wide recruiting, as was the case prior to 1998. If the proposed reform is approved and adopted by Parliament, the selection process will be conducted every other year, once for *professori ordinari* and then for *professori associati*. Initial contracts will be for three years and can be renewed once. Universities may, however, grant professors tenure before their contracts expire. Another new feature concerns professors' compensation, to be made up of a fixed portion and a variable portion depending on their subsequent commitments in research, teaching and administration. Professors will be able to work outside the university, in the private or public sector, as long as it is not detrimental to the university's operations. This change also entails the elimination of the difference between full-time[16] professors and "defined-time"[17] ones. As a result, the base salary becomes that of a full-time professor. The second point involves young researchers who currently begin work after an entrance examination, with open-ended contracts. This will change, the contract being only for a fixed period of time. Lastly, in respect of the selection of distinguished scientists, universities may hire recognised Italian or foreign scientists to fill up to 6% of faculty positions. Contracts may not exceed three years and are solely for teaching.

The CNVSU considers that the prospects of resolving the university staffing problem are highly uncertain, even with adoption of the new law. Fewer and fewer young Italians are planning to pursue advanced tertiary studies, in particular because of the relatively advanced age at which students obtain doctorates in order to begin university careers.

R&D and innovation in Italy

The innovative capacity of a country stems directly from the quality and quantity of its human capital investments, depending as well on the adequacy of linkages between research and business. Innovation is shown in OECD work to be the main determinant of total factor productivity, hence long run real wages, profitability, employment and per capita GDP. As Italy has been a particularly weak performer in the area of TFP (see Chapter 1), reforms to boost R&D and innovation will be primordial.

Trends in R&D

The Italian research system lacks human and financial resources. R&D spending represented only 1.1% of GDP in 2001. This proportion is very low in comparison with the EU-15 average (2%) or that of EU-25 (1.9%). Italy, along with Greece, Portugal and Spain, lags far behind the rest of EU-15 but, especially, it recorded the lowest rate of increase (0.5% per year) between 1997 and 2001 (European Commission, 2003a). The share of the Italian State budget devoted to R&D in 2001 was equivalent to 0.7% of GDP, in line with an average of 0.8% for EU-15. Therefore, the private sector accounted for only 39% of R&D outlays in Italy, *versus* 52½ per cent in France and 46% in the United Kingdom. Beyond that, foreign-source funds for R&D had a relatively slight impact on the total.

The figures on human resources in R&D show that Italy is placed poorly placed in relation to the other EU countries. Italy is the EU-15 country with the fewest researchers per thousand people in the labour force (Figure 5.5), and it is the only EU-15 country to have recorded a decline in the number of researchers between 1997 and 2001 (down by 3.6%). Even within EU-25, Italy ranks near the bottom in terms of human resources in R&D. Researchers tend more to work for universities and other public bodies (around 60%) rather than in the business sector.

Italy's capacity to develop R&D will also entail getting young people interested in scientific careers (Augier and Carles, 2004). According to the Ministry of Education, Universities and Research (MIUR), 33% of students graduated in technical or scientific fields in 2002. Among the population of 25 to 34-year-olds, 18 out of 10 000 Italians obtain doctorates in science or engineering (according to 2001 data), with annual growth of 7.3% over the years 1998 to 2001. To remedy this, the government has launched a series of measures to combat the shrinking of human resources, including the creation of an additional 4 500 doctoral fellowships in 2003. This brings the total number of such fellowships to 8 000 per year, while their value is also to be increased. These measures will help reduce the number of Italian graduates who leave the country.

A recent publication exploring trends in this area between 1990 and 1998 (Becker, Ichino and Peri, 2003) finds that more and more young people are going abroad, and that they tend to be from the North of Italy. The study concludes that, since 1996, between 3 and 5% of Italian graduates left the country. By contrast, only 0.3% of graduates in Italy were foreign. Censis (2002) surveyed 2 678 Italian graduates abroad, revealing that the United States and the United Kingdom are by far the two preferred destinations for Italian researchers. The reasons why they leave are the lack of paid posts, due in part to the selection process for researchers and professors in the public sector, characterised by bureaucracy and the lack of a meritocracy (see above).

Public R&D

Since 2002, the research system has been at the core of a reform to redefine the number and the role of public research institutes. The underlying idea is to streamline and rationalise the system and make it more efficient, while improving the critical linkages between public and private R&D (Box 5.1).

Under the 2004 Budget law, a number of additional measures have been adopted: *a)* tax bonuses for expatriate researchers who return to Italy in the next few years (€ 20 million); *b)* government appropriations for public research bodies to invest in research and innovation and to finance industrial research programmes (€ 600 million); *c)* funding for scholarships (€ 20 million) and merit bonuses (€ 10 million); *d)* increased operational funding for public and private universities (an additional € 310 million) and subsidies for hiring researchers (€ 40 million); *e)* € 20 million in funding to carry out national public

Box 5.1. **Reorganising the public research system**

The "Italian Government Guidelines for Science and Technology Policies", which were approved on 19 April 2002 by the Council of Ministers, redefine the rules governing research in Italy along four strategic lines: *a)* to promote excellence in independent research; *b)* to develop human capital through a high level of training and research activities; *c)* to help transfer new technology on a nation-wide level in industry and services and, promoting the process of innovation; and *d)* contribute to Italy's competitiveness by working together with the Italian industrial system. At present, the CNR[1] – the most important research institute – is being re-organised and is expected to absorb a number of other institutes (IDAIC,[2] INOA,[3] *Istituto Papirologico*, INFM[4]). Membership of the boards of administration will be reduced, and each organisation is to possess its own evaluation unit. Given the lack of resources, the work of the institutes will focus on specific objectives, relying on a network of excellence and closer ties with other European research centers, but also the active involvement of the local administrations. In addition, the MIUR is striving to increase collaboration between the public and private sectors of R&D.

Greater effort has also been put into strengthening the links between basic and applied research. In this context, the CNR started a number of applied-oriented projects. More generally, the organisation of public research centres has been changed so that they should be able to co-operate more intensively with business. The Ministry of Education and Research has identified and funded (€170 million) seven technological districts[5] with the objective of facilitating co-operation between public and private researchers and venture capitalists. The Ministry has also analysed 60 projects of spin-off that have the potential to develop in technological districts. Some other programmes are being financed by universities. The projects were chosen through an international peer review procedure. The Ministry estimates that a 5 year period is needed to assess the benefits of the programmes, even though the *ex ante* rigorous project selection that has been carried out is considered a guarantee of a satisfactory outcome. These efforts could be important in strengthening the link between private and public research. Nevertheless, the major scientific centres of excellence in Italy specialise in basic research disciplines like physics and astrophysics, for which it is hard to find an easily exploitable link with the private sector.

1. Comitato Nazionale delle Ricerche ("National Research Center").
2. Istituto di Diritto Agrario Internazionale e Comparato ("Institute of Comparative International Agrarian Law").
3. Istituto Nazionale *di Ottica Applicata* ("National Institute of Applied Optics").
4. *Istituto Nazionale per la Fisica della Materia* ("National Institute for the Physics of Matter").
5. For example, the districts of mechanics in Modena, nanotechnology in Padua and polymeric materials in Naples.

research projects; and *f)* inauguration of the *Istituto Italiano di Tecnologia* (IIT) in Genoa (€ 50 million in 2004 and then € 100 million per year over ten years).

Based on a model similar to that of MIT[18] in Boston and founded jointly by the MIUR and the Ministry of the Economy, IIT could make it possible to consolidate relationships between private and public initiatives and resources. The Institute encourages private businesses to take an active part in technological development and training in leading-edge technologies in order to spur productivity growth. Its goal is to become an international centre of excellence for advanced scientific research in technology, and to attract researchers and experts from around the world. During its launch period, the organisational and operational details will be worked out.[19]

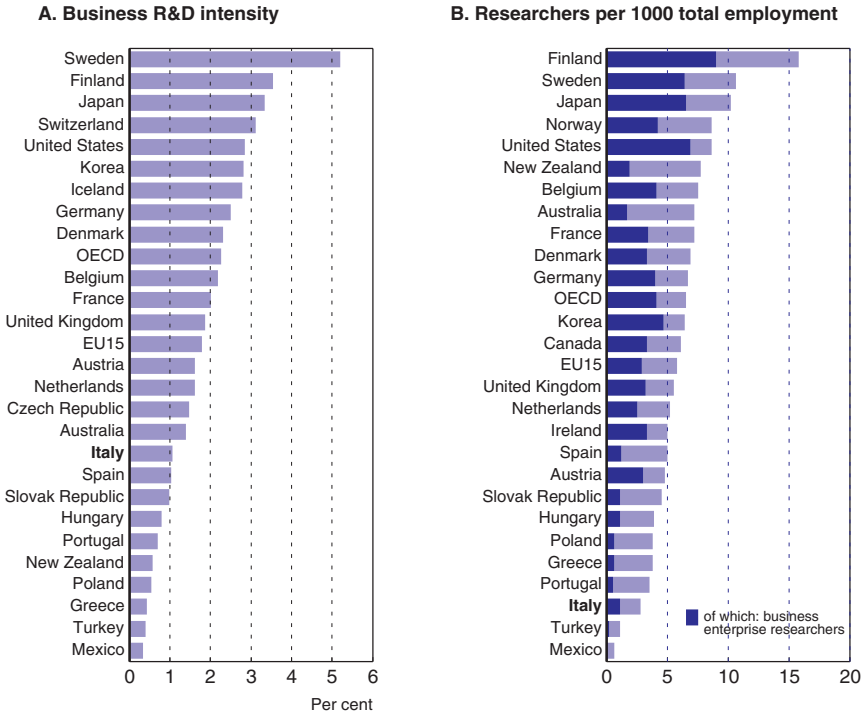
Private R&D

The relatively low level of research intensity in Italy is mainly explained by the low share of private R&D spending, despite an annual average increase of 5¼ per cent in the 1997-2003 period. This low intensity translates in a low number of researchers in the business sector (Figure 5.5). This outcome could be in part accounted for by the specialization of the Italian industry in traditional and mature sectors. Another impediment is the very small size of the majority of Italian firms.[20] Most of private R&D expenditure is indeed performed by firms with more than 50 employees.

Small-sized firms are mainly family-based and are less prone to accept the participation of financial institutions and institutional investors in the companies' capital, which would

Figure 5.5. **Business R&D intensity and researchers**[1]

2001[2]



1. Business enterprise sector R&D expenditure as a percentage of value added in industry, in 2001 or latest available year.
2. Or latest year available.

Source: OECD, *Science, Technology and Industry Scoreboard*, 2003.

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represent an important source of funding for research and innovation.[21] At the same time, banks require large collaterals against loans to business because of shortcomings in the bankruptcy law (see Chapter 3). The third position of Italian companies in the ranking for the latest EU call for projects is perhaps indicative of the existence of financial constraints domestically. In terms of efficiency, nevertheless, Italian private researchers seem to perform satisfactorily compared with other EU countries, judging from the relatively high number of EU or US patent applications per private researcher.

The 2002 Guidelines for the National Research Programme established the ambitious target for private R&D as a ratio of GDP of 1% by 2006, which would mean more than doubling the current level. Public funding for private research in 2003-2004 is not enough to attain this objective.[22] The government has therefore introduced a tax credit for business covering 10% of R&D expenditure in 2004 ("Tecno-Tremonti"). The budget impact of this measure is estimated at € 650 million (around 0.05% of GDP). However, the tax credit is unlikely to help innovative start-ups as they usually pay low or no tax at the beginning of their activities.[23] In 2005, a tax deduction from the IRAP tax base for personnel expenditures related to R&D was introduced (see Annex 2.A1 Table 2). Other measures mainly targeted at start-ups are the establishment of a public guarantee fund and of a public venture capital fund, for innovative projects, with the objective of reducing financial risks for start-up financing and at the same time stimulating private venture capital provision, currently very low in Italy. Moreover, a digitalization plan for small and medium-sized enterprises is being implemented with the help of public funds, mainly covering service sectors like tourism, education and research. Finally, private R&D is being enhanced by public development and funding of new technological districts and applied projects (Box 5.1).

The Italian Stock exchange (*Borsa Italiana*) could have a crucial role in providing funds for innovative businesses.[24] However, new listing has decreased since 2000, especially in *Nuovo Mercato*, *i.e.* the segment specialized in innovative companies. In response, *Borsa Italiana* established two new segments of the market devoted to smaller companies: STAR and *Mercato Expandi* launched in 2001 and 2003, respectively, whereas the *Nuovo Mercato* has been reshaped and given a new name (Techstar). Despite this, the number of listed companies has kept decreasing since 2002. The 2004 budget law therefore introduced a reduction in the business tax rate from 33 to 20% for newly listed companies in the first three years after quotation. Moreover, taxation of capital gains from mutual funds specialized in small listed companies has been reduced from 12½ to 5%.

Conclusions

Although on the rise, the level of human capital and technological innovation is not what one could expect from a country that has reached such an advanced stage of development. Italy must pursue its efforts to raise the level of education, and of tertiary education in particular. Efforts must be made to give priority to the Mezzogiorno to further reduce disparities and enhance productivity. At present, the Italian educational system is highly centralised, and educational spending per student and by region is the same for each level of education (OECD, 2001b), despite the South's more pressing needs. The positive effects of education being much greater for regions in the South, and the benefits extending beyond productivity, public funds ought first to be channelled towards those regions (Dalmazzo and De Blasio, 2003). Moreover, if the objective is to enhance the level of human capital, a better allocation of resources would seem necessary. Thus, the number of teachers in primary and secondary education would seem out of balance in relation to

tertiary education. It is also noteworthy that in the South, social returns to schooling exceed those to physical infrastructure – lack of which is often cited as also a reason for the regional lag – by more than 5% (Ciccone *et al*. 2004).

Finally, current efforts to enhance public and private R&D are commendable. However, more public funding in this area is unlikely to be socially rewarding unless the reform of university and public research center governance is accelerated, objective merit-based mechanisms are introduced, and public efforts are matched by greater involvement of the private sector in the financing of applied research.

Box 5.2. **Recommendations in human capital area**

Raise quantity and quality of tertiary level degrees. Reduce number of teachers in primary and secondary while raising them in tertiary to redress imbalances in teacher-to-student ratios *vis-à-vis* rest of OECD; decentralise university management while exposing it to market forces and reducing the role of bureaucracy; the government grants and promotions in universities to performance; abolish university quotas for foreign professors and researchers; Introduce a system of income-contingent loans and co-payments for university studies.

Improve graduation rates and school-to-work transition: Provide financial assistance to liquidity constrained households by merit-based scholarships and income-contingent loans; promote upward mobility of students from a young age in career counselling when implementing new vocational track; strengthen the post-secondary professional schools, with involvement of the social partners, as stressed by the *Patto per l'Italia*; introduce performance based wage and career systems for school teachers and managers to improve school quality; orient more of education spending to the south, where marginal returns are higher and youth unemployment particularly high.

Improve employability of older workers: institute life-long learning programmes and in-job training to address growing education handicap at higher ages; by the same token, strengthen job-related training; target job placement services to needs of older workers.

Increase labour market rewards to human capital investments. Decentralise wage setting in order to achieve a better match between marginal productivity and wages; increase demand for higher qualifications by, in general, promoting policies encouraging a switch to higher value-added production.

Improve business-academic research links. Introduce a tax credit for companies' transfers to universities related to research projects of interest for business, to the establishment of joint laboratories, to the training and scholarships of young applied researchers; establish industrial liaison offices in universities and a central database accessible to companies with information on universities' research activities; strengthen post-lauream *curricula* towards applied disciplines.

Provide fiscal and financial support to private innovation. Allow credits for innovation and research activities in IRAP; provide support to venture capital industry by appropriate regulation; pass bankruptcy reform in order to increase incentives for entrepreneurs to take innovation risks and for credits to risk capital for such purposes.

Notes

1. ISTAT (2004), Rapporto annuale, La situazione del Paese nel 2003, Rome, p. 457.
2. See Ministry of Economy (2003), Rapporto DPS 2001-2002, p. 41. In absolute terms, however, inter-regional net flows were likely to be small as the population of the South is one about one-third of that of the North.
3. For a discussion of regional productivity level differences, see Chapter 1.
4. On average in the OECD countries, schooling is compulsory until the age of 17.
5. However, the relationship between type of curriculum and unemployment is still unclear. In fact, in Italy students that have been exposed to the most general and theoretical curricula (*i.e.* those attending licei in high school) have the highest probability of enrolling and completing undergraduate studies and show an employment and wage premium (Cingano and Cipollone, 2004).
6. Rate expressed as a percentage and similar to the percentage interest rate on a savings account.
7. In the most comprehensive form of the indicator, costs are equal to tuition fees and foregone after-tax earnings adjusted for the probability of finding a job, less the resources provided to students in the form of grants and loans. Benefits are the higher after-tax earnings, adjusted for the increased probability of finding a job, less any reimbursement of public assistance received over the course of studies.
8. The return to upper secondary schooling exceeds the real before-tax average annual portfolio return by around 4% for Italy as a whole, and even more so for tertiary education. See Ciccone *et al*. (2004). Of course, such comparisons do not take into account the greater effort associated with schooling compared with financial investments. The tax on financial income would also narrow the differential.
9. According to the most plausible estimates, to raise the average level of education by one year would increase overall productivity by at least 5%, and perhaps more in the long term because of the potential for innovation it could unleash (see de la Fuente and Ciccone, 2003, and Ciccone *et al.*, 2004).
10. Unemployment rate for the 25 to 34-year-old age group.
11. Laurea in the Italian university system.
12. Laurea Specialistica in the Italian university system.
13. See European Commission (2003a).
14. CNVSU stands for Comitato Nazionale per la Valutazione del Sistema Universitario..
15. Future professori ordinari.
16. Working exclusively for the university.
17. Working for the university but also as a consultant or an expert for the public sector.
18. Massachusetts Institute of Technology.
19. The MIUR and the Ministry of the Economy have decreed the Institute's provisional organisation, comprising: a single commissioner with responsibility for all current functions, a steering and regulatory committee and, lastly, a board of directors. At the end of the launch period, the Institute's charter will have been completely finalised.
20. In 2001, 58.7% of Italian companies were individual firms (48% in 1991) and 40.7% had between 2 and 49 employees (51.3% a decade earlier). In 2001, the average firm size was 3.85 (4.4 in 1991).
21. The presence of many small firms could also make the measurement of R&D activities more difficult so that their actual amount could be underestimated.
22. The main public funds to finance private research are the fund for applied research managed by the Ministry of Education and Research and the fund for technological innovation managed by the Ministry of Productive Activities.
23. Also companies with losses in previous years will not benefit from the tax credit.
24. Borsa Italiana has surveyed Italian companies and identified almost 1 200 of them – mostly small and medium enterprises – which could be suitable for quotation on the stock exchange.

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