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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 17 January 2013. 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 01 February 2013.

The Secretariat's draft report was prepared for the Committee by Paul O'Brien and Oliver Denk, under the supervision of Patrick Lenain. Statistical assistance was provided by Josette Rabesona.

The previous Survey of Italy was issued in May 2011.

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BASIC STATISTICS OF ITALY, 2011

(The numbers in parentheses refer to the OECD average)

LAND, PEOPLE AND ELECTORAL CYCLE

Population (1 000 000):	59.1		Population density per km²	196.0	(34.3)
Under 15 (%)	14.0	(18.4)	Life expectancy (years, 2009):	82.0	(79.7)
Over 65 (%)	20.8	(14.9)	Males	79.4	(76.9)
Foreign-born (%, 2009)	8.0		Females	84.6	(82.5)
Latest 5-year average growth (%)	0.0	(0.5)	Last general election:	February 2013	

ECONOMY

GDP, current prices (billion USD)	2 199.1		Value added shares (%):		
GDP, current prices (billion, local currency)	1 580.4		Primary	2.0	(2.6)
Latest 5-year average real growth (%)	-0.6	(0.8)	Industry incl. construction	24.7	(27.8)
GDP per capita, PPP (thousand USD)	33.9	(35.4)	Services	73.3	(69.5)

GENERAL GOVERNMENT

Expenditure (% of GDP)	49.9	(45.0)	Gross financial debt (% of GDP)	119.8	(90.2)
Revenue (% of GDP)	46.1	(38.1)	Net financial debt (% of GDP)	94.1	(58.1)

EXTERNAL ACCOUNTS

Exchange rate (per USD)	0.719		Main exports (% of total merchandise exports):	
PPP exchange rate (USA=1)	0.790		Manufactured	82.6
Exports of goods and services (% of GDP)	28.9	(52.7)	of which, machinery and transport	35.1
Imports of goods and services (% of GDP)	30.4	(49.7)		
Current account balance (% of GDP)	-3.2	(-0.7)	Main imports (% of total merchandise imports):	
Net international investment position (% of GDP)	-22.3		Manufactured	64.1
			of which, machinery and transport	24.8
			Mineral fuels, lubricants and related materials	19.8

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate (%) for 15-64 year olds:	57.0	(64.9)	Unemployment rate (%):	8.4	(7.9)
Males	67.5	(73.0)	Youth (%)	29.0	(16.2)
Females	46.5	(56.8)	Long-term unemployed (%)	4.3	(2.6)
Average worked hours per year	1 774.0	(1 776.0)	Tertiary educational attainment 25-64 year-olds (%, 2010)	14.5	(30.0)
Gross domestic expenditure on R&D (% of GDP, 2010)	1.3				

ENVIRONMENT

Total primary energy supply per capita (toe):	2.8	(4.3)	CO_2 emissions from fuel combustion per capita		
Renewables (%)	11.7	(8.2)	(tonnes, 2009)	6.5	(9.8)
Fine particulate matter concentration			Water abstractions per capita (dam^3, 2008)	0.9	
(urban, PM10, ug/m^3, 2008)	23.3	(22.0)	Municipal waste per capita (tonnes, 2009)	0.5	(0.5)

SOCIETY

Income inequality (Gini coefficient)	0.337	(0.314)	Education outcomes (PISA score, 2009):		
Relative poverty rate	19.9	(17.7)	Reading	486	(493)
Public and private spending (% of GDP):			Mathematics	483	(496)
Health care (2009)	9.5	(9.6)	Science	489	(501)
Pensions (2007)	14.3	(8.6)	Share of women in parliament (%, July 2012)	20.7	(24.4)
Education (2008)	3.3	(4.0)	Net official development assistance (% of GNI)	0.2	(0.4)

Better Life Index: www.oecdbetterlifeindex.org.

Note: OECD average shown when data are available for at least 75% of the member countries.
Source: OECD.STAT (http://stats.oecd.org); OECD, Economic Outlook Database.

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Executive Summary

Main findings

Italy has embarked on a wide-ranging strategy to restore fiscal sustainability and improve long-term growth. Combined with measures at the euro area level, these welcome actions have reduced downside risks and the economy should emerge from recession by early 2014. However, with the public debt-to-GDP ratio nearing 130% and a heavy debt redemption schedule, Italy remains exposed to sudden changes in financial market sentiment. Large and sustained reductions in public debt are therefore the top fiscal priority. The gains from recent structural reforms must also be consolidated and further measures to promote growth and improve competitiveness need to be implemented, to return Italy to healthy growth.

Sizeable fiscal consolidation was achieved in 2012. While this entailed short-term output and social costs, these efforts have been rewarded by higher confidence in financial markets and have improved medium-term prospects. The government has rightly aimed to halt the rise in the public debt-to-GDP ratio and put it on a downward path, while also seeking ways to use limited resources to protect the incomes of the most vulnerable. This could be achieved either with a balanced government budget or a small fiscal surplus, accompanied by a combination of growth-enhancing structural reforms and the implementation of the new unemployment insurance scheme. While additional fiscal tightening would have transitory negative effects on output, it would be rewarded by faster debt reduction and thus lower risk of renewed financial-market reactions. Fiscal measures should concentrate on spending restraint, and an ongoing policy review process should focus on improving value for money. There is also scope to restructure the tax system to reduce economic distortions, notably through fewer tax expenditures. While the banking system has been overall quite resilient, several banks are experiencing serious difficulties, and the financial sector remains exposed to systemic risks. Ongoing efforts to strengthen capital adequacy and loss provisions are thus essential.

Comprehensive structural reforms have been adopted, which over time will increase Italy's persistently weak productivity growth and, together with modest wage growth, bring much-needed improvement in international competitiveness. The immediate focus for policy in product and labour markets should be on full implementation, monitoring measures for their effect, and making improvement where needed. Future reforms, in carefully planned and co-ordinated legislation, will need to remove remaining restrictions in professional and public services and promote a more inclusive labour market. This requires helping workers with job-search and training, co-ordinated together with income support for the unemployed, whose families are most at risk from the increased poverty that prolonged recession has brought. A new framework is needed within which the economy can adjust more quickly to global changes in trade patterns and innovative technologies.

Good public governance is important for economic growth. Steps have been taken for the **public administration and civil justice** systems to support reform, economic development and the needs of civil society more effectively. These too should be followed through and fully implemented to eliminate major impediments in the business environment. The streamlined civil justice system needs to ensure that, where regulatory constraints are necessary, such as to protect employment rights or the environment, the law is enforced resolutely, rapidly and equitably. The anti-corruption law provides improved tools in the fight against corruption and organised crime. Continued emphasis on transparency in public administration at all levels will help and would be bolstered by a freedom of information act.

Key recommendations

Fiscal and financial policy

- Pursue efforts to halt and reverse the upward trend in the debt-GDP ratio. This could be achieved either with a balanced budget or a small fiscal surplus, supported by strong implementation of growth-enhancing structural reforms.
- Focus budget consolidation on spending control, with a policy review process to select priorities, one of which is the more comprehensive unemployment insurance scheme, already legislated.
- If macroeconomic conditions deteriorate once again, allow automatic stabilisers to work.
- Establish the newly-legislated fiscal council, giving it full independence, well-qualified staff, guaranteed access to data, an adequate budget and freedom to investigate as it judges necessary.
- Encourage banks to further increase provisions against losses, and continue to urge them to meet their capital needs with new equity or sales of non-core assets. Encourage competition in the financial sector.

Product and labour market regulation and other structural policies

Follow through on the 2012 reforms:

- Complete the implementation of the key reforms, including through ensuring that the Transport regulator is set up rapidly and that the Competition Authority uses its new powers actively.

Extending the reforms:

- Remove remaining regulations restricting capacity in retail and professional services; reconsider some backwards steps, notably those limiting the expansion of competition among lawyers.
- Promote a more inclusive labour market, improving employability with more support for job search and training, linked with the broader social safety net, rather than preserving existing jobs.
- Promote the widening of the current agreement among the social partners so as to better align wages compared with productivity, to help restore competitiveness.
- Broaden the tax base by reducing tax expenditures comprehensively, allowing reductions in marginal tax rates on labour, especially on second earners.

Public administration and civil justice

Follow through on the 2012 reforms:

- Encourage use of the transparency provisions of public administration reform and the anti-corruption law by acting decisively on inefficiencies, conflicts of interest or corruption.
- Complete the geographical reorganisation of the courts, streamlining court processes, improving the use of information technology, and widening the incentives for a greater use of alternative dispute resolution mechanisms. Continue streamlining sub-national government.

Extending the reforms:

- Limit the use of decree laws, work towards codified ("testo unico") legislation, ensure effective impact assessment of laws and regulations, and increase the use of sunset clauses.
- Build on the provisions of the anti-corruption law to develop a fully-fledged freedom of information act.
- Revise the law on limitations ("prescrizioni") in criminal corruption cases to reduce incentives to dilatory behaviour, such as the inclusion of the full trial and appeals process in the limitation period.

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Assessment and recommendations

Since late 2011, Italy has been enacting a broad package of structural reforms and fiscal consolidation policies, together aimed at addressing a legacy of weak growth and high public debt. This strategy has been rewarded by higher confidence in financial markets and improved medium-term prospects. In the short term, however, though necessary to avoid even worse outcomes, it has been accompanied by significant output losses and social costs – unemployment has been rising and vulnerability to poverty has increased. Success in turning the economy round depends importantly on euro-area crisis resolution. In this regard, Italy has benefited from actions at the euro area level, including the European Central Bank's readiness to provide support if needed. Success ultimately depends on full implementation of structural reform legislation and commitment to debt reduction policies, which will hasten the return to healthy growth.

Macroeconomic and financial developments

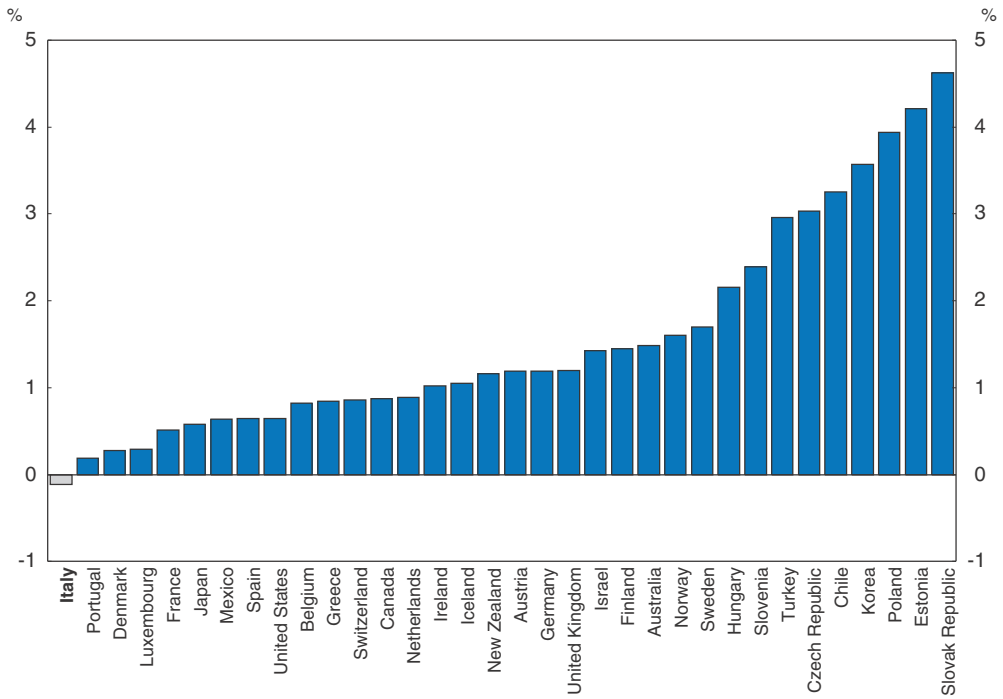
Low growth and poor competitiveness are the underlying causes of Italy's difficult situation

Italy's real GDP growth per capita has been the weakest of all OECD countries over the past decade (Figure 1). This reflects very low underlying productivity growth and has resulted in long-standing fiscal difficulties and in stagnant, and recently declining, real income levels. Many hypotheses have been put forward to explain low productivity growth, which has been at the core of several past OECD *Economic Surveys,* and the interaction of these elements is likely to be more important for productivity growth than any single factor:

- Regulatory barriers to competition and entrepreneurship.
- Institutional barriers to labour market adjustment.
- A "relationship" oriented labour market which undervalues qualifications and experience.
- Low educational attainment, and tertiary education inadequately oriented to the needs of the economy, reducing the capacity for innovation and structural change.
- The small size of firms at a time of rapid technological change and globalisation.
- An industrial and export structure, historically weighted towards slow growing markets and in products particularly exposed to competition from emerging economies.
- The integration of large numbers of low-skilled immigrants which, while boosting the supply of labour, especially for low-productivity jobs, has had the effect of reducing average productivity.
- Inefficient public services, weaknesses in public administration and the influence of corruption and organised crime.

Key past recommendations, maintained in this *Survey*, have argued for better regulation, more competition and better flexibility in the labour market. According to OECD indicators, Italy has made progress in some of these areas since the late 1990s, improving its position relative to other OECD countries. In the same period, however, its relative economic performance deteriorated. Italy's entry into the monetary union in the late 1990s increased the costs of inflexibility, costs which have appeared over time. At the same time, rapid globalisation also increased the need for greater flexibility.

Figure 1. **Average annual growth in real GDP per capita, 2000-11**



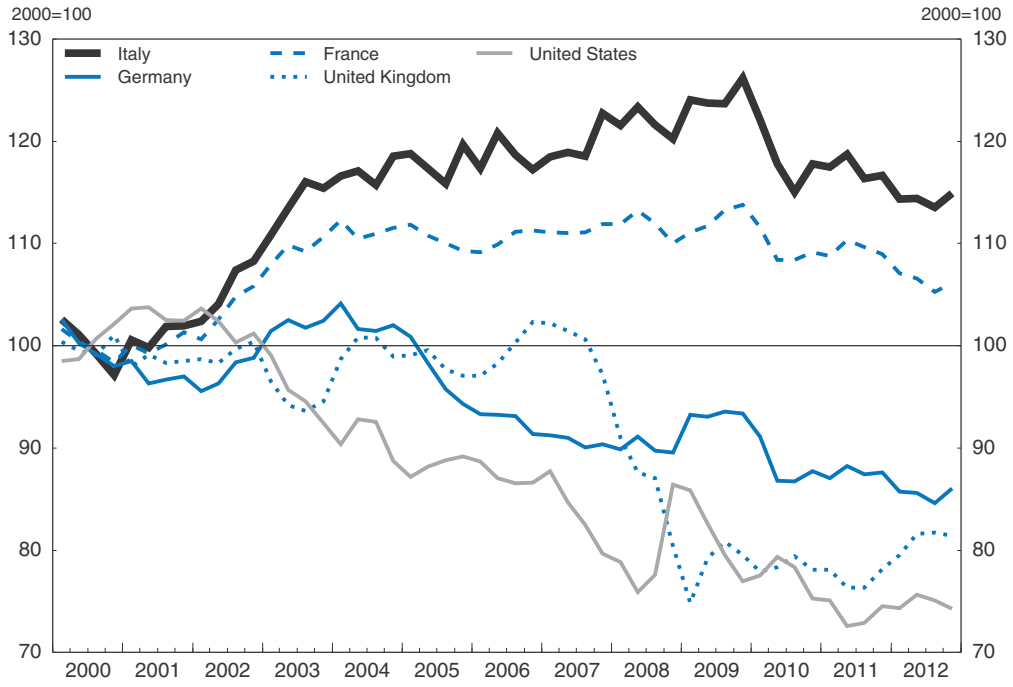
Note: Data for Norway refer to the mainland GDP and for Luxembourg to the resident population. Population data are from 2011 or latest year available.
Source: OECD, *Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932791609

Italy's labour cost competitiveness position *vis-à-vis* key trading partners deteriorated up to the beginning of the 2009 economic and financial crisis (Figure 2). The improvement since then has been mainly due to the euro depreciation and some wage moderation. Prior to joining the monetary union, excessive wage and price increases were compensated for a time by exchange rate depreciation, but this is no longer an option. In key partner countries wages rose less than productivity. Italy's low productivity growth made this largely impossible since this would have meant cuts in real wages (possibly even in nominal wages), something very difficult to achieve in the current wage bargaining system, although the system does not impose explicit indexation. Reforms (discussed further below) should improve the functioning of the labour market, though were not designed to change wage setting behaviour.

Figure 2. **Labour cost competitiveness**

Relative unit labour costs weighted by trade



Source: OECD, *Economic Outlook Database*.

How to read this figure: An increase in the index means that total employee compensation per unit of real output rose relative to that in trading partners. If the index falls by the same amount for, say, both Italy and Germany, this means that their competitive position vis-à-vis the rest of the world has improved, but there has been no change vis-à-vis each other.

StatLink http://dx.doi.org/10.1787/888932791628

The financial crisis hit Italy hard. The Italian financial system weathered the first wave of the crisis better than in many other countries, government intervention was very limited, and credit growth was above the euro area average in 2009-11, although financial conditions still tightened significantly, weakening domestic demand. In 2011-12 the banking system has been vulnerable to contagion from international concern over the level of public debt. The collapse of the interbank market, and indirectly banks' significant holdings of government debt, have restricted the ability of banks to lend; this, combined with the recession-induced fall in demand for new loans, resulted in outstanding credit falling during 2012. Action by the European Central Bank (ECB) has been vital in preventing more dramatic problems. Its announcement in July 2012 that it was ready to provide support as needed, and the possibility of Outright Monetary Transactions schemes announced in September, bolstered confidence and reduced spreads, although they remain significantly above pre-crisis levels.

The economy is projected to remain very sluggish in 2013-14

Fiscal consolidation, declining investment and the rebuilding of household savings, along with tight credit conditions, are likely to hold back growth during the coming months (Table 1). Although confidence and financial conditions should gradually improve, GDP is

unlikely to begin to rise before 2014. The benefits of the broad range of supply-side reforms adopted since late 2011 will take time to materialise, given weak confidence, a relatively slow recovery elsewhere and the continuing need for fiscal consolidation. The plan announced in April 2013 to significantly reduce government arrears to companies is welcome. The impact on growth is uncertain, a conservative estimate is included in these projections.

Table 1. **The short-term outlook**

	2009	2010	2011	2012	2013	2014
	Current prices	Percentage changes, volume (2005 prices)				
	Billion euros					
GDP	1 519	1.7	0.5	-2.4	-1.8	0.4
Private consumption	917	1.5	0.1	-4.2	-2.2	-0.4
Government consumption	325	-0.4	-1.2	-2.9	-1.8	-1.0
Gross fixed capital formation	294	0.5	-1.4	-8.0	-4.3	-1.4
Final domestic demand	1 535	0.9	-0.5	-4.7	-2.5	-0.7
Exports of goods and services	360	11.2	6.6	2.2	2.9	4.9
Imports of goods and services	368	12.3	1.1	-7.8	-1.4	1.5
Net exports[1]	-8	-0.3	1.4	3.0	1.3	1.1
GDP deflator		0.4	1.3	1.6	1.5	0.9
Memorandum items						
Consumer prices index[2]		1.6	2.9	3.3	1.6	1.2
Compensation of employees		1.2	1.8	-0.2	-0.3	0.0
Employment (millions, National Accounts)		24.7	24.7	24.7	24.4	24.3
Unemployment rate		8.4	8.4	10.6	11.9	12.5
Current account balance[3]		-3.5	-3.1	-0.6	0.9	2.0
Potential output		0.2	0.2	-0.3	-0.4	0.0
Output gap[4]		-2.8	-2.4	-4.5	-5.8	-5.3
Public finance indicators:						
Gross debt (Maastricht definition)[3]		119.4	120.8	127.0	131.7	134.3
Overall budget balance (net lending)[3, 5]		-4.3	-3.7	-2.9	-3.0	-2.3
Net debt interest payments[3, 5]		4.3	4.6	5.2	5.0	5.3
Primary balance[3, 5]		0.0	1.0	2.3	2.1	2.9
Structural primary balance[4, 5]		1.5	1.8	4.4	5.4	5.8
Change in overall structural budget balance[4, 5]		1.2	-0.1	2.2	1.3	0.1

1. Contribution to change in real GDP (percentage of real GDP in previous year).
2. Harmonised consumer prices index (Eurostat definition).
3. As a percentage of GDP.
4. As a percentage of potential GDP.
5. General government.

Source: OECD Economic Outlook 93.

In the OECD projections, fiscal policy in terms of changes to the cyclically-adjusted budget balance, as announced in April 2013 (in the *Documento di economia e finanza*), is assumed to be implemented in 2013 and 2014. But the overall budget balance is weaker than in the government projection due to a lower growth outlook. By the end of 2014, according to OECD projections, total government debt would be some 134% of GDP (excluding the impact of potential privatisation revenue and including Italy's guarantees to the EFSF, bilateral loans to Greece and participation in the capital of the European Stability

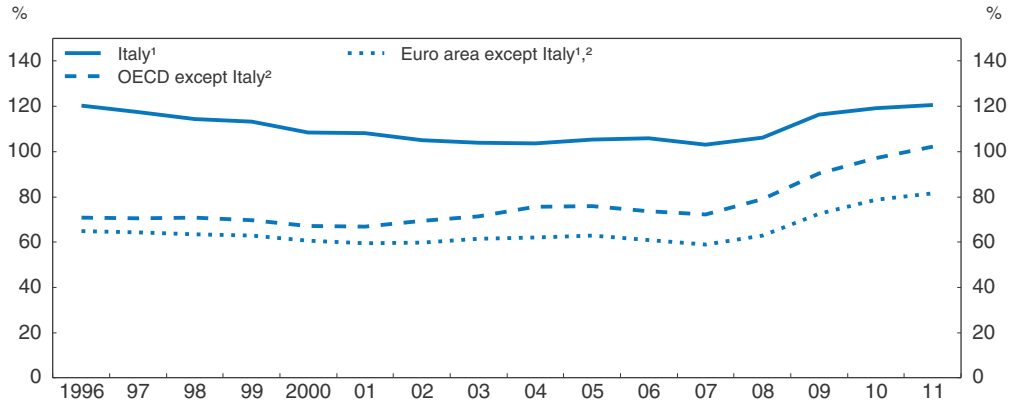
Mechanism and including the effect of reducing arrears), and would likely still be increasing in the absence of further fiscal tightening and/or privatisation proceeds in 2014.

Underlying consumer price inflation is projected to decline thanks to smaller import price and domestic wage increases, although its actual profile will be more variable because of planned VAT changes. Wages initially appeared rather insensitive to the recession following the financial crisis, but since late 2011 wage settlements have declined and average earnings have shown little growth. Employment, relatively stable throughout 2011 and 2012, is projected to fall, exerting downward pressure on wage growth. Labour force participation rates rose in 2011-12, reflected in rising unemployment due to weak demand for labour. This higher participation was due to pension reforms that increased the participation rate of older workers, and to an increase in the number of people, especially women, who began to look actively for work, reportedly also to maintain household incomes.

Sovereign and financial risks, while diminished, are still large

Italy's public debt is among the highest in the OECD, and has exceeded 100% of GDP for the last two decades (Figure 3). Rolling over this debt requires annual funding of about EUR 400 billion for the next few years. The high level of debt makes Italy particularly vulnerable to negative feed-back loops between the fiscal, financial and real sectors in the economic and financial crisis. From the summer of 2011, the financial markets began to seriously challenge the sustainability of Italy's public debt, and this was reflected in rising spreads on government bonds (Figure 4). Low growth and persistent budget deficits explain continuing high debt.

Figure 3. **General government gross debt (as % of GDP)**



1. Maastricht definition.
2. Weighted average.

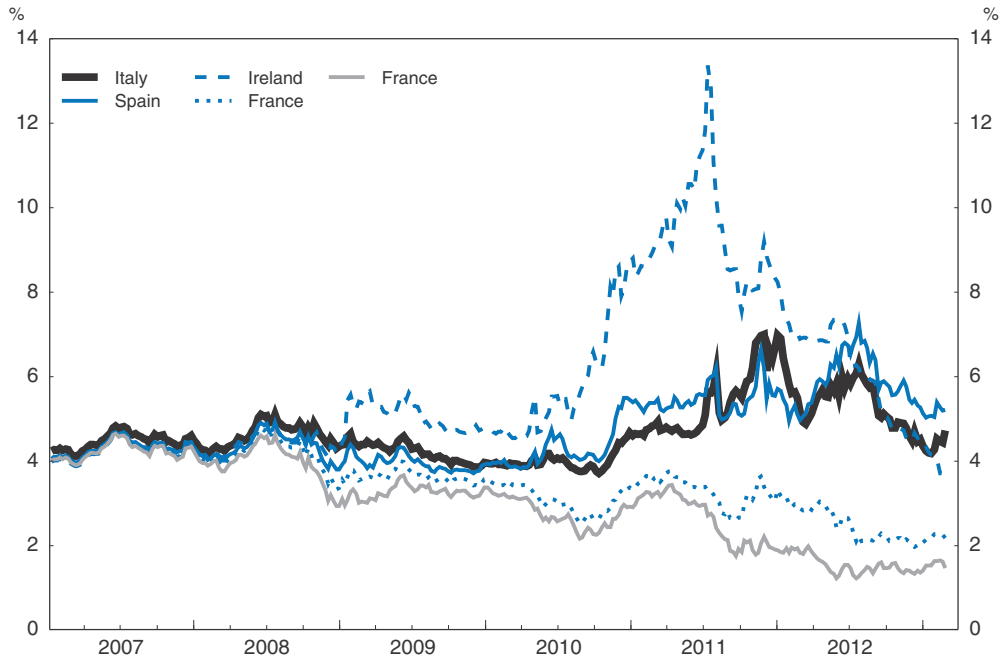
Source: OECD, *Economic Outlook Database*.

StatLink http://dx.doi.org/10.1787/888932791647

By the autumn of 2012, a series of structural reforms – from pensions to a series of measures to improve the medium-term fiscal stance, simplify regulation, strengthen competition and improve the functioning of the labour market – as well as actions and pronouncements by the ECB and then the establishment of the European Stability Mechanism, had brought about a considerable reduction in the interest rate on Italian

Figure 4. **Long-term interest rates on government bonds[1]**

Last observation: week ending 1 March 2013



1. 10-year benchmark government bond yields, weekly average.

Source: Datastream.

StatLink http://dx.doi.org/10.1787/888932791666

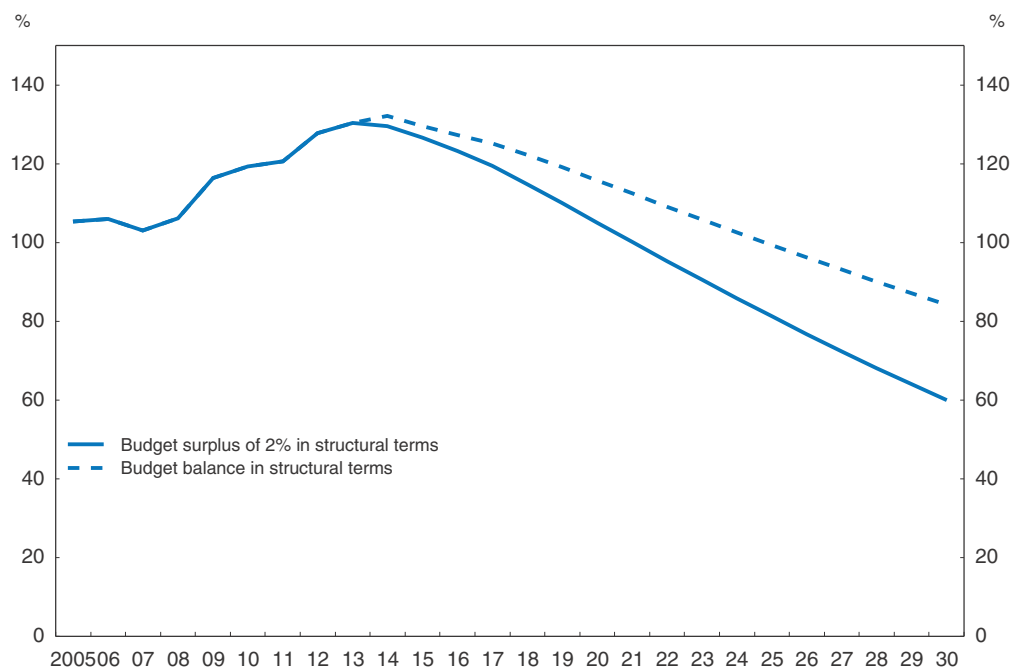
government debt. But it remained far above the German rate. Part of the spread is explained by the high level of public debt. Further, needed reductions in borrowing costs will require significant declines in debt and continuing progress in structural reforms. The Italian authorities have not indicated that they would seek European financial assistance, since they remain able to attract funding from the sovereign bond markets under terms consistent with a sustainable debt path.

Sizeable fiscal consolidation was achieved in 2012 which, although it entailed significant output and social costs, has been rewarded by higher financial market confidence. The government seeks to reverse the public debt trend and then put it on a downward trajectory. This would be best achieved either with a balanced budget or a small fiscal surplus, combined with growth-enhancing structural reforms. While additional fiscal tightening would have transitory negative effects on output, it would be rewarded by faster debt reduction and thus lower risk of renewed financial-market reactions. Fiscal tightening also would have negative social effects in the current economic environment, as real wages have been stagnating while unemployment and vulnerability to poverty have increased. Legislation to widen access to unemployment insurance should therefore be followed through. Though not a panacea, the more comprehensive unemployment insurance scheme should help to protect incomes more effectively as well as supporting a more flexible and inclusive labour market. If macroeconomic conditions deteriorate once again, automatic stabilisers should be allowed to work.

In the longer term, the government plans to maintain a structural budget balance to gradually reduce the debt-to-GDP ratio. According to OECD simulations, introducing and maintaining measures to attain a structural budget surplus of about 2% of GDP by 2017 would lower the debt-to-GDP ratio to the Maastricht ceiling of 60% of GDP by 2030 (Figure 5), while with a balanced structural budget public debt in 2030 would be some 85% of GDP and would achieve 60% of GDP in 2038. Given the high level of debt, any fiscal relaxation would be a very risky strategy. The government should therefore not relax fiscal policy, so as to avoid the benefits of consolidation being dissipated as in the past: in the 1990s a significant primary surplus was built up after the crisis of the early 1990s and in order to meet the conditions of joining the euro area, but the effort was not maintained long enough to achieve a substantial reduction in debt (Box 1). The recent budget law requires setting aside any extra savings coming from lower-than-projected interest payments, which would help debt reduction and is therefore a welcome innovation.

Figure 5. **Long-term simulations of general government gross debt**

As per cent of GDP



Note: For details, see Chapter 1.
Source: Lenain et al. (2010) and OECD, *Economic Outlook Database* and Long-Term Baseline Database.

How to read this figure: The solid curve shows the evolution of general government gross debt assuming the government gradually phases in a budget surplus of 2% of GDP in structural (or cyclically adjusted) terms by 2017 and then maintains it at this level. The broken curve depicts its evolution assuming the government follows its fiscal plans in the 2013 budget and maintains a balanced budget in structural terms from 2016 onwards. A structural surplus of 2% of GDP would reduce public debt to the Maastricht ceiling of 60% of GDP in 2030, while with structural balance it would be some 85% of GDP.

StatLink http://dx.doi.org/10.1787/888932791685

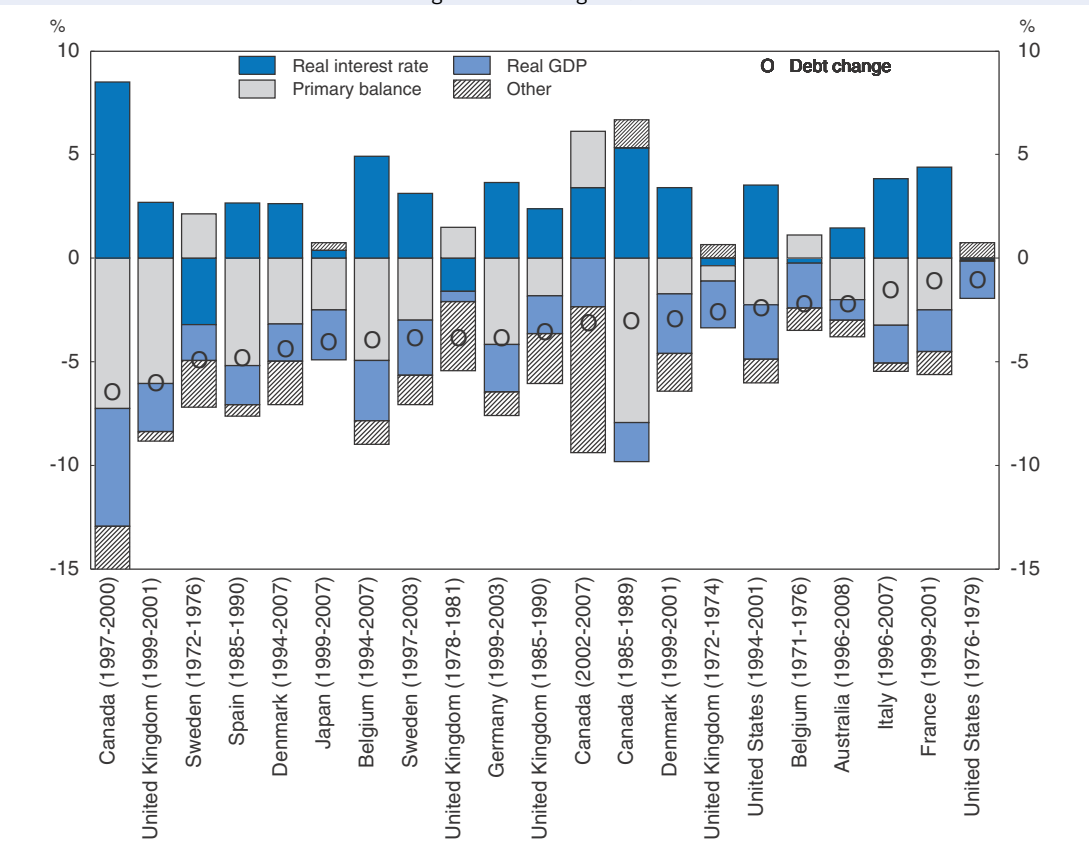
Box 1. **Lessons from past public debt reductions**

Empirical research has associated high public debt with problems such as fiscal policy becoming ineffective as a stabilisation tool, government borrowing crowding out other borrowers and reducing growth. Very high levels of debt can also lead to potentially self-fulfilling doubts about government solvency, with fears of sovereign defaults resulting in adverse effects in the financial market, although there is no well-defined level of public debt that triggers negative market reactions.

Hence, there has been considerable interest in historical lessons on the appropriate speed of and method of debt reduction. A number of OECD countries have substantially reduced their debt in past decades, though debt reduction was sometimes reversed. The most recent wave of debt reduction ran from the mid-1990s to the onset of the recent financial crisis. For instance, over long periods impressive debt reductions were achieved by Belgium (1993-2007: 50% of GDP), Canada (1996-2007: 35%), and Denmark (1993-2007: 52%). In a sample of debt reduction episodes analysed by Sutherland (2012) and shown in Figure 6, the debt-to-GDP ratio declined on average by 3.5% of GDP per year. Debt reduction resulted from the combination of several forces: sizeable primary fiscal surpluses; strong economic growth; and sometimes negative real interest rates.

Figure 6. **Episodes of debt reversals**

Average annual change in % of GDP



Source: OECD, *Economic Outlook Database*.

How to read this figure: This figure separates the average annual change in the ratio of debt to GDP into the individual contributions of three key components and a residual item ("other"). For example, in Canada, from 1997-2000 the debt-GDP ratio fell nearly 7 percentage points per year, on average. Other things being equal, the positive real interest rate would have caused an increase in the ratio of 9 percentage points, but the primary surplus and positive GDP growth more than offset this. In Sweden (1972-76) and the United Kingdom (1978-81) the real interest rate on debt was negative which reduced the debt-GDP ratio.

StatLink http://dx.doi.org/10.1787/888932791704

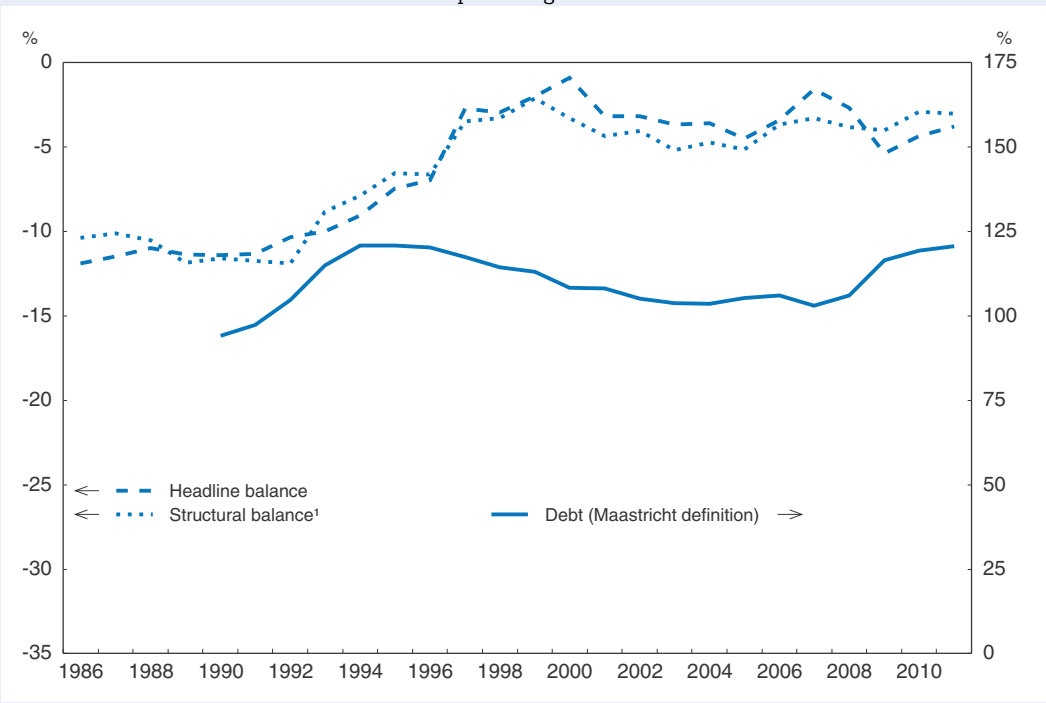
Box 1. **Lessons from past public debt reductions** *(cont.)*

Italy's public debt-to-GDP ratio also declined between 1995 and 2007, by 17.7% of GDP (measured by the Maastricht definition), but this was entirely reversed subsequently. Italy's debt reduction resulted initially from an effort to bring the budget deficit below 3% of GDP in order to satisfy the Maastricht criteria for joining the European Monetary Union. From 1994 to 1997 the general government deficit fell from 9% to 2.7% of GDP. Three successive governments introduced deep fiscal reforms to cut the budget deficit, notably through expenditure cuts. Earlier measures, in particular pension reforms, also slowed outlays considerably (OECD, 1999). Reforms were also made to health services, local government finances, wage setting and public employment. Part of the effort, however, came from temporary tax measures, notably the "Eurotax" surcharge on households introduced in 1996, which yielded revenue of around 0.6% of GDP, and from privatisation revenue of 1% of GDP per year, neither of which could be maintained for long.

Once entry to the euro area was secured, fiscal policy soon loosened and the government deficit widened again (Figure 7). By 2001, it exceeded the 3% Maastricht limit. This budgetary easing was initially hidden by the decline of long-term interest rates, as spreads diminished prior to, and practically vanished after, the establishment of the European Monetary Union. The loosening of fiscal policy eventually brought debt reduction to a halt. In 2006 and 2007, fiscal consolidation resumed, but at an insufficient pace. When the global financial crisis started, Italy's public debt still exceeded GDP. In the decade 1998-2007, the primary surplus was on average 2.7% of GDP. In a notable contrast, Belgium maintained on average a primary surplus in the range of 5.1% of GDP throughout, until 2007. From a higher starting point, Belgium's debt burden fell well below Italy's, leaving it better prepared for the financial crisis and the global economic recession of 2008-09.

Figure 7. **Fiscal indicators in Italy, 1986-2011**

As a percentage of GDP



1. As a percentage of potential GDP.

Source: OECD, *Economic Outlook Database*.

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The difficult environment has put banks under severe stress. Increased risk aversion and a fragmented financial sector across national borders accentuate the impact of nervousness about banks' liquidity, and Italian banks have suffered from the general tendency for foreigners to reduce cross-border deposits. As a consequence, they had to obtain significant funding through special refinancing operations of the ECB. Banks' holdings of government debt, normally a "safe" asset, have exposed banks to additional pressure, as Italian government securities are now around 8% of Italian banks' assets, with loans to government accounting for another 6%. Following European Banking Authority recommendations, banks have increased their capital buffers in relation to sovereign risk. Balance sheet ratios indicate that Italian banks are on average less leveraged than their European peers. Nevertheless, with the renewed recession the already high level of non-performing loans is growing and remains an important concern.

As a result of these supply factors, as well as reduced demand for credit, towards the end of 2012 bank lending to non-financial corporations was declining at an annual pace of 5-10% in real terms. It might be challenging for the banking sector to maintain current capital levels in order to meet regulatory requirements, while supporting additional lending. A source of additional capital might be from abroad. In the past there was some hostility to foreign ownership and the authorities should ensure that attachment to, for example, the special position of banking foundations does not hinder potential new investment.

Longer-term action on fiscal policy

A constitutional amendment approved in April 2012 and secondary legislation approved in December 2012 provide for a balanced-budget rule, to come into effect in 2014, and a fiscal council. These are welcome innovations, which should be implemented in full, and with the objective of maintaining a prudent approach to long-term fiscal challenges. The fiscal council is mandated to assess the underlying assumptions of fiscal projections, including macroeconomic projections. It will need to be strongly independent, with well-qualified staff, perhaps including non-Italian members, and be adequately funded, with the prerogative to investigate whatever issues it considers relevant to fiscal sustainability. It should be guaranteed access to whatever data it feels it needs. The new law explicitly provides for the application of the debt rule under the reinforced Stability and Growth Pact, introduced with the EU "Six-Pack" decision, which requires annual reductions in the debt-GDP ratio by 1/20 of the gap to the 60% reference, measured over a 3-year average.

How to follow up the spending review

Consolidation needs to concentrate on permanent spending reductions, in order to avoid significant increases in the already high level of taxation. A "spending review" was carried out in mid-2012 by a specially established unit, and a second phase of the spending review was launched in October 2012. This was helpful in the circumstances, but a spending review process should be built into the regular cycle of public spending planning. To help design such spending plans, the regular assessments of both spending priorities and other policy settings are important. The former Technical Commission on Public Spending, set up in the Ministry of Economy and Finance, initiated such a process, producing valuable suggestions on policy settings – not just spending items – in a number of policy areas, including education and justice, transport and infrastructure, in its report in 2008. This policy review process should be renewed.

Once public spending plans have been agreed in the budget, it could be useful to give ministries and agencies strong incentives to respect the targets by setting binding cash limits for non-cyclical spending, with the aggregate respecting overall budget targets. The 3-year spending programme, ministry by ministry, presented each year could be made binding on ministries for the whole 3-year period, giving ministries and agencies information for planning ahead and an incentive to find the most efficient use of available funds. With the entry into force of the reinforced Stability and Growth Pact in December 2011, Italy also has to comply with a new "expenditure benchmark" that places a cap on the annual rate of growth of public expenditure. For countries like Italy that have not yet reached their medium-term budgetary objective, this cap will be tighter. This new instrument is a welcome innovation because it can improve budgetary planning and outcomes by ensuring that expenditure plans are adequately resourced by equivalent permanent revenues.

Box 2. **Recommendations for macroeconomic and financial policies**

- Pursue efforts to halt and reverse the upward trend in the debt-GDP ratio. This could be achieved either with a balanced budget or a small fiscal surplus, supported by strong implementation of growth-enhancing structural reforms.
- Focus budget consolidation on spending control, with a policy review process to select priorities, one of which is the more comprehensive unemployment insurance scheme, already legislated.
- If macroeconomic conditions deteriorate once again, allow automatic stabilisers to work.
- Establish the newly-legislated fiscal council, giving it full independence, well-qualified staff, guaranteed access to data, an adequate budget and freedom to investigate as it judges necessary.
- Once 3-year plans consistent with aggregate fiscal constraints have been set, fix these plans as cash limits on spending by ministries and agencies, as originally planned in 2009.
- Establish clear operational rules to implement the constitutional balanced budget rule and newly-legislated provisions.
- Encourage banks to further increase provisions against losses, and continue to urge them to meet their capital needs with new equity or sales of non-core assets. Encourage competition in the financial sector.

Competitiveness and the labour market

Cost competitiveness has been steadily deteriorating

One underlying factor in Italy's difficult economic situation is that unit labour costs (total employee compensation divided by real GDP) have been rising relative to its trading partners, which may have contributed to a decline of export market shares. This is more noticeable within the euro area, whereas the depreciation of the euro in the last few years has moderated the position with respect to the rest of the world (Figure 2). Unit labour costs have adjusted less in Italy than the other crisis countries, where much higher unemployment has influenced the more pronounced adjustment. Compared with a decade ago, unit labour costs are about 10% higher in Italy than in the euro area as a whole and 25% higher than in Germany. Price competitiveness has deteriorated by less, at the cost of squeezed profit margins in Italy.

The liberalising reforms introduced in 2011-12 should increase productivity growth, making it easier to make gains in relative unit labour costs. Labour market reform was not intended to touch the wage bargaining process, but discussions between unions and employers led to an agreement in November 2012 on local or firm-level bargaining which would link wage gains to productivity improvement, while national bargaining would set other terms and conditions, including a partial inflation compensation mechanism. The productivity component of wage increases would attract tax incentives, following an earlier announcement by the government reserving budgetary funds for this to encourage wage structures with better incentives for productivity. It is not certain how this mechanism will work in practice, and one of the three main union federations did not sign the agreement. If successful, this agreement could reduce contractual wage growth while increasing productivity-linked differentiation across companies. However, tax incentives should not generally be necessary to promote productivity gains, since these in any case should provide benefits to be divided between profits and wages which should be taxed like any other incomes. There is a risk that agreements will be structured to benefit from tax advantages without any underlying benefits for productivity and unit labour costs.

Relative wages can be reduced only slowly, depending on inflation elsewhere in the euro area. In Italy, public sector wages have been frozen in nominal terms since 2011, and will remain frozen until 2014 under current plans. In the private sector, nominal wages appear to have fallen in some cases, not enough to reduce unit labour costs relative to France and Germany. A more rapid adjustment may be attained by widening the agreement among the social partners, to set an overall limit on wage growth to better align wages compared with productivity (this would be distinct from the company-based productivity-related agreements mentioned earlier). Such agreements, for example, succeeded in keeping wage growth well below productivity increases in Germany after reunification. In some Nordic countries, annual wage rounds start with an agreement between employers and unions on the average level of wage increase the economy can afford. In different ways, Belgium and the Netherlands also arrive at a consensus on this issue.

Important labour market reforms, dependent on effective implementation

Attention has been rightly focused on labour market reforms that could contribute to improving productivity growth and reduce segmentation of the labour market. Apart from regional differences, which are quite significant, legislation and history have divided the labour market, before the recent reforms, into several different parts:

- Formal sector, open-ended and "standard" fixed-term contracts. Quite strict employment protection legislation (EPL) applies here. The OECD EPL indicators understate the real cost of making workers redundant, a significant part of which was due to slow judicial decisions and the fact that reinstatement was the main sanction for unlawful dismissal. These factors, while of critical importance, are not reflected in the OECD EPL indicators.
- Formal sector, "atypical" temporary contracts, such as project workers. Here there is much less protection following significant liberalisation of temporary contracts over the past 15 years. Given the profusion of specific types of contract, workers and employers may not always have been certain what rights apply; following the 2012 reforms this should no longer be the case.
- Informal sector. Many people work in otherwise legitimate occupations but without formal contracts, in order to evade taxation or regulation. Estimates of this activity are

included in the national accounts, including in figures for employment (approximately 10% of total employment).

The level of self-employment is very high, although this figure itself is inflated by the fact that many self-employed in fact work full-time for only one employer, due to the lower tax wedge for independent contractors compared with that for direct employees. In the formal sector, over 5 million people, some 20% of the labour force, are listed as self-employed, and the ISTAT estimate of the informal sector includes an additional 450 000 self-employed.

Previous *Economic Surveys* recommended increasing wage flexibility, because of increasing concern over cost competitiveness. Wage flexibility may be quite high in the "atypical" sector but a high level of employment unpredictability generated by wide use of fixed term and atypical contracts may inhibit productivity growth through two main mechanisms:

- There is little incentive for employees on short-term contracts, nor for their employers, to invest in job-specific human capital, since they may expect to have to change job frequently.
- Income support for the unemployed has until now been largely restricted to those in permanent jobs, giving job-seekers from the temporary or informal sector little access to public resources to finance job search. They are more likely to have to take the first job rather than the one that maximises their income (and productivity).

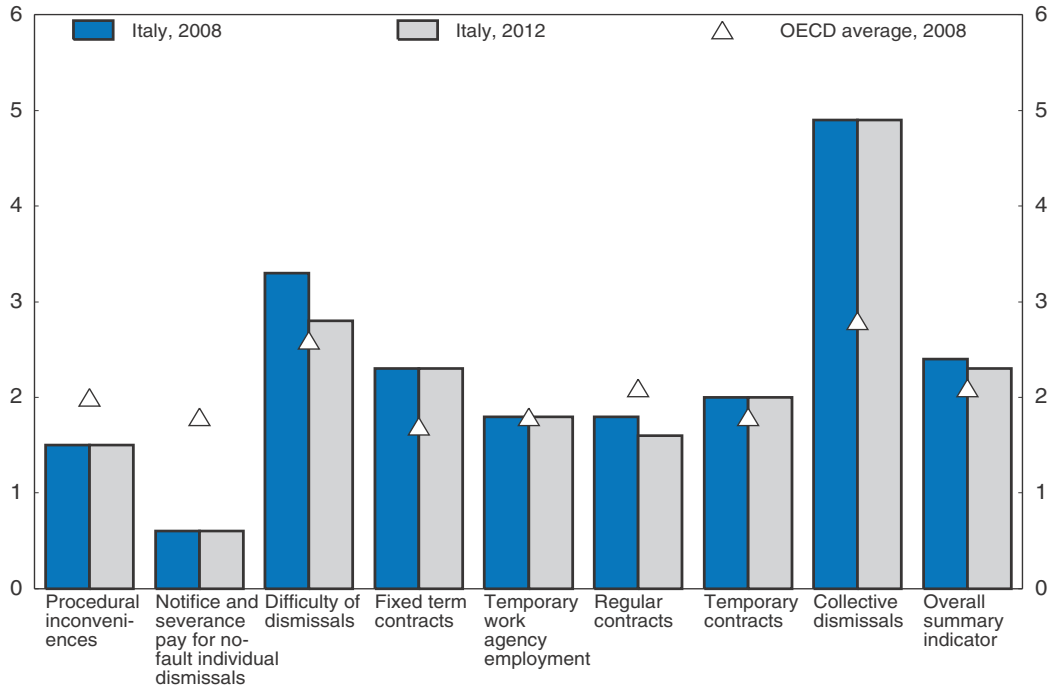
The 2012 labour market reform, which comprised steps to rebalance employment protection, modify the apprenticeship system and phase in a universal unemployment benefit system, was the first time that Italy has attempted to comprehensively tackle labour market weaknesses. The modification of Article 18 of the labour code allows the labour judges to graduate the sanction in case of unfair dismissal depending on the severity of the case rather than, as previously, requiring reinstatement. The labour reform also introduced a compulsory pre-conciliation process which may reduce the number of court actions. The impact of this element of the reform will depend on the effectiveness of conciliation and on how the judges will interpret the new provision and the jurisprudence that will be developed over time. There is a possible incentive for employees to bypass the new provisions by taking action against their employer on the grounds of dismissal for discriminatory reasons (for which the law is unchanged, though the burden of proof is on the employee). The authorities should, as intended in the legislation, monitor the operation of the new legislation and new court arrangements and consider what modifications may be necessary for them to be effective. The courts must take length of service into account in deciding compensation for unfair dismissal, but the minimum compensation is high by international standards, suggesting benefits from reducing it over time and setting it as a function of the length of service. However, no compensation is paid to the employees when the court regards dismissal as fair.

To help fund the expanded unemployment insurance scheme and promote stable jobs, the government introduced a 1.4 percentage point surcharge on employers' social contributions on fixed term contracts. The surcharge is repayable if the temporary contract is converted to an indefinite one. However, it increases the overall tax wedge on labour, which is already high. Other measures also discourage the renewal of temporary contracts. At the same time, it has been made much easier to offer a temporary contract up to one year for a new employee, which is a useful step, in part because it can be used in effect as a one-year probation period that could lead to an indefinite contract. As measured by OECD indicators, the overall level of employment protection changes little (Figure 8), but this is

partly because the index does not take into account certain changes, such as some of the changes in legislation concerning temporary contracts.

Figure 8. **Estimated impact of the labour market reform on indicators of employment protection**

Employment protection legislation index



Note: The labour market reform refers to Law no. 92/2012.
Source: 2008, *OECD Employment Protection Legislation Database*; 2012, estimate by Ministry of Economy and Finance.

How to read this figure: OECD indicators measure employment protection legislation on a scale from 0 to 6, where 0 indicates the least restrictive from the employer's point of view and 6 the most restrictive. While Italy's provisions on collective dismissal are much more restrictive than the average (in fact they are the most restrictive in the OECD), provisions for notice and severance pay for individual dismissals are less restrictive than the OECD average.

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An important part of the labour market reform is to introduce a homogeneous and universal unemployment benefit system. The new system is to be phased in slowly by 2017; it will not be very generous by OECD standards but will fill a significant gap in the current welfare system.

Perhaps the most difficult part of the reform will be to build up more effective institutions to both support and provide incentives to job search. This includes training and job-search institutions, both of which are under the competence of regional governments, and co-ordinating them with the provision of unemployment benefits, which are administered by the national social insurance institution, INPS. Other countries as diverse as France and Norway have found it useful to bring social insurance, job-search facilities and training providers together in "one-stop shops" while many others have made efforts to strengthen the co-ordination between the different administrations. Experience has shown that improvements in co-ordination can take some time to appear.

Further policy steps should build on these important reforms and shift labour market support in the direction of "flexicurity", a more inclusive approach to labour market policy. More flexibility for hiring and firing would be backed up with effective job search, activation and training policies, and the planned universal social safety net. Previous *Economic Surveys* have emphasised the importance of improving the school-to-work transition to enhance human capital formation and reduce Italy's very high youth unemployment. Education policy has a key role here. Increased employer engagement and improved work-based training to improve the vocational education and training systems (which is the responsibility of regional government) could make an important contribution, along with the recent reforms to the apprenticeship system. Through the development of Higher Technical Institutes (ITS) since 2009 and recent pilot projects in improving links between vocational schools and companies, the government has begun to take action in this area. Promoting certification of existing competences, as foreseen by the legislative decree adopted on 11th January 2013, for people with low formal education would improve mobility and job matching in the labour market.

Italy's overall low labour participation rate is largely due to low female participation. To a significant extent, this is due to women's role in the provision of care functions that are often provided, at least in part, by the public sector in many other countries. Public spending on families with children is well below the OECD average and deserves a higher priority among competing uses for scarce public resources. The funds recently allocated, through the deployment of the Cohesion Action Plan, to raise coverage and quality of childcare services in the South have been a move in this direction. Lowering the effective tax rates on second earners, currently among the highest in the OECD, as part of revenue neutral tax reform, would also reduce work disincentives.

Box 3. **Recommendations for labour market reform**

- Promote a more inclusive labour market, improving employability with more support for job search and training, linked with the broader social safety net, rather than preserving existing jobs.
- Promote the widening of the current agreement among the social partners so as to better align wages compared with productivity, to help restore competitiveness.
- Use the monitoring provisions of the labour market law to evaluate its impact and to plan possible future policy measures.
- Consider lowering the minimum monetary compensation for unfair dismissal and setting it as a function of length of service.
- Co-ordinate the action of nationally-organised INPS and regional training and job-search agencies so as to effectively align passive and active labour market policies.
- Improve the vocational education and training system through more employer engagement and work-based training to better bridge the transition from education to the labour market.
- Within overall budget constraints, give more priority to increasing the supply and coverage of childcare, consider redistributing part of the parental leave right to fathers and reducing marginal tax rates on second earners, to reduce the disincentives to female labour market participation.

Competitiveness and product markets

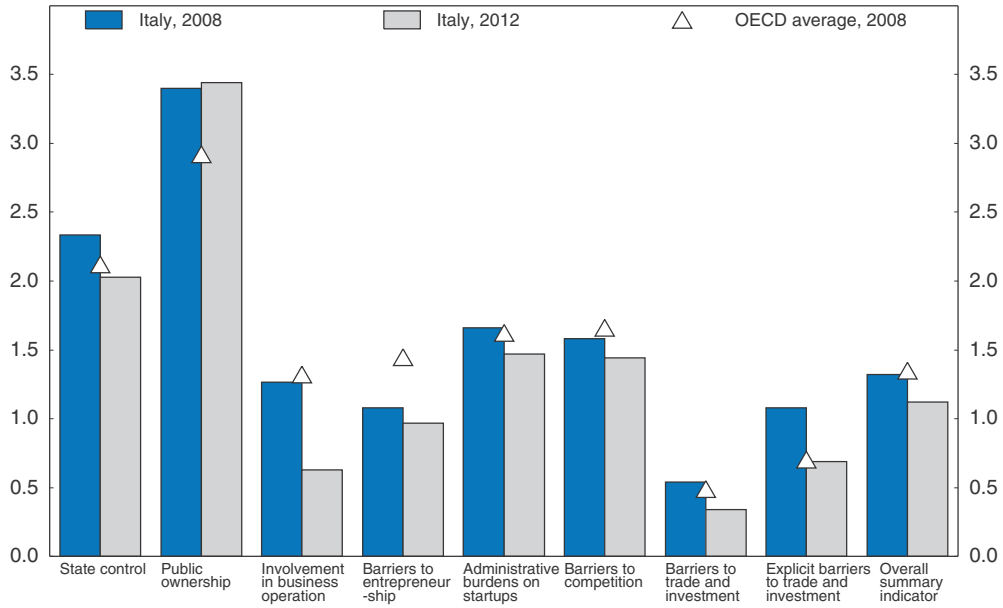
Since December 2011, the government has introduced a wide range of measures, in a series of omnibus decrees, to help improve the business environment by reducing product market regulation and promoting competition. These measures have had a noticeable impact, as measured by OECD product market regulation (PMR) indicators (Figure 9). The broad areas include the following:

- Strengthening the powers of the Competition Authority, including over local public services and the operation of tenders.
- More competition in public transport, with a new independent regulator.
- Bringing water services into the regulatory structure for utilities.
- Separating network ownership from production and supply in the gas industry.
- Further deregulation in some professional services and the retail sector.
- Further simplification of administrative procedures for businesses and individuals.
- Increasing the average size of judicial districts and developing specialised commercial courts.

These measures should increase productive potential through three mechanisms. First, direct cost reductions mean that the resources saved can be used elsewhere. Second, lower costs in some sectors reduce costs in downstream sectors. Third, stronger competitive pressure increases the incentive to innovate, raising both the level of productivity and its rate of growth. A number of other measures have been introduced which should have little effect on PMR indicators, but could have an effect on productive potential. These include promotion of greater use of information technology (the "Digital Agenda"), simplified procedures for strategic infrastructure investment and assistance for "high technology" start-ups.

OECD estimates, based on OECD product and labour market indicators, suggest that reforms legislated up to November 2012 (including all policy changes since 2008) could increase GDP by 5.5 % over 10 years. While the growth estimates by the government and the OECD are broadly similar in magnitude, they are essentially indicative, and there are many methodological problems in using cross-country data to investigate the impact of such measures. These models rely on some difficult-to-verify assumptions and assume that all economies studied behave like the "average" OECD economy. The PMR indicator for Italy has improved significantly since 1998 and more than in other countries, which would therefore predict a significantly improved economic performance, while Italy's relative productivity performance in fact deteriorated. One explanation could be that past reforms have not in all cases been implemented as intended by the law. Other estimates of the impact of the recent reforms, for similar though not identical policy packages, cover a wide range, from 0% to 11% (Table 2).

Figure 9. **Product market regulation, changes since 2008**



Source: 2008, OECD Product Market Regulation Database; 2012, estimate made by OECD Secretariat in consultation with the Ministry of Economy and Finance.

How to read this figure: OECD indicators of Product Market Regulation (PMR) measure legislation on a scale from 0 to 6, where 0 indicates the least restrictive and 6 the most restrictive. Italy's position on explicit barriers to trade and investment was more restrictive than the OECD average in 2008, but after the 2012 reforms it has dropped to the level of the 2008 OECD average. Restrictiveness eased in all but public ownership.

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Table 2. **Estimates of the GDP impact of structural reforms in Italy**

Source and estimation approach	Reforms whose impact is estimated	Estimated impact on GDP
OECD: Reduced-form regressions	All product market reforms since 2008; the labour market reform in 2012.	5.5% after 10 years from the product market reforms; very little impact from the labour market reform
OECD, based on Aghion et al. (2009): Reduced-form regressions	All product and labour market reforms of the current government (autumn 2011-end 2012).	0%
Ministry of Economy and Finance (2012): Dynamic general equilibrium	*Cresci Italia* and *Semplifica Italia* decrees (i.e. measures announced up to March 2012).	2.4% after 8 years
Bank of Italy (Forni et al., 2010): Dynamic stochastic general equilibrium	Stylised reform package reducing service price mark-ups by 20 percentage points.	11% in the long run
International Monetary Fund (Lusinyan and Muir, 2013): Dynamic stochastic general equilibrium	Stylised reform package assuming 50% reduction of the gap between Italy and best practice.	10.5% in the long run

Note: For details of the different estimates, see Chapter 2. Where work prior to 2012 is quoted, the procedure was to use coefficients from that work to estimate the impact of changes in indicators in 2012.

Priorities for the future

Implementation

Using fiscal policy to try to kick-start demand is not an option in current conditions of high debt. Governments need to concentrate on providing framework conditions that favour growth. The first priority is clear, but one that political pressures often make difficult: to ensure that the reforms already legislated are followed through in a coherent fashion, are transparently presented to the public and are consistently enforced.

Policy making must also take into account the dangers of too frequent changes. To take just one example, policies promoting energy saving and renewables were changed many times during the 2000s without any clear empirical rationale (OECD, 2013). Uncertainty over the duration of such incentives – some of which were unjustified anyway (OECD, 2011) – blunts their impact. Avoiding the use of tax amnesties is another example. After a decade in which Italian governments avoided their use, in 2009 a partial amnesty (the "fiscal shield") was extended to funds illegally held abroad. Such amnesties risk undermining tax compliance.

Competition and regulation

Priority should be the full implementation of the Liberalisation, Simplification and Development laws. Separation of ownership in the gas industry and the integration of water services in the regulatory structure for utilities, while ensuring its operational independence, should be completed and the new transport regulator should be brought quickly into operation. The transport regulator was to have already been in place before the end of 2012, but this decision was delayed and has now been put off until after the 2013 national elections. The government needs to ensure also that the Competition Authority uses its new powers actively. Greater competition should be promoted in local public services and in retail and professional services by removing remaining regulatory capacity restrictions. In December 2012 certain liberalisation measures originally planned for lawyers as part of general measures in the professional services, were reversed, retaining, for example, their monopoly on legal representation and assistance in alternative dispute resolution (e.g. mediation), some restrictions on advertising and the ban on contingent fees; these backward steps should be reconsidered.

A key task of the reformed regulatory structure is to limit conflicts of interest. These were present, for example, in the case of water utilities, which have been regulated locally, by municipalities and regions. The companies themselves, however, are typically part or wholly-owned by local governments and politicians may be on their managing boards. Plans to force local government to fully divest ownership of such companies were reversed by a referendum in 2011, and a consequent constitutional court ruling in 2012 annulled plans to give the competition authority powers to promote competition and enforce tendering procedures. The new national water regulator will not be able to eliminate such conflicts of interest, but should improve transparency.

Network and utility regulators should monitor pricing and impose quality-of-service rules. These rules should also be as stable as possible. When regulating multiple comparable companies (such as local distribution networks) comparative performance could be used. Such a 'yardstick' framework, where improved efficiency in the better performers is reflected in the pricing rules, provides strong incentives for efficiency, but has strong information requirements to work effectively. A system of yardstick

competition is part of the framework for regulating privately-run water utilities in the United Kingdom. Media regulation too has for some time neglected the issue of competition, with an effective duopoly at national level between a dominant private broadcaster whose parent company has large interests in the printed press, and a large public sector operator. The media regulator, AGCOM, should act to ensure competition among both private and public operators.

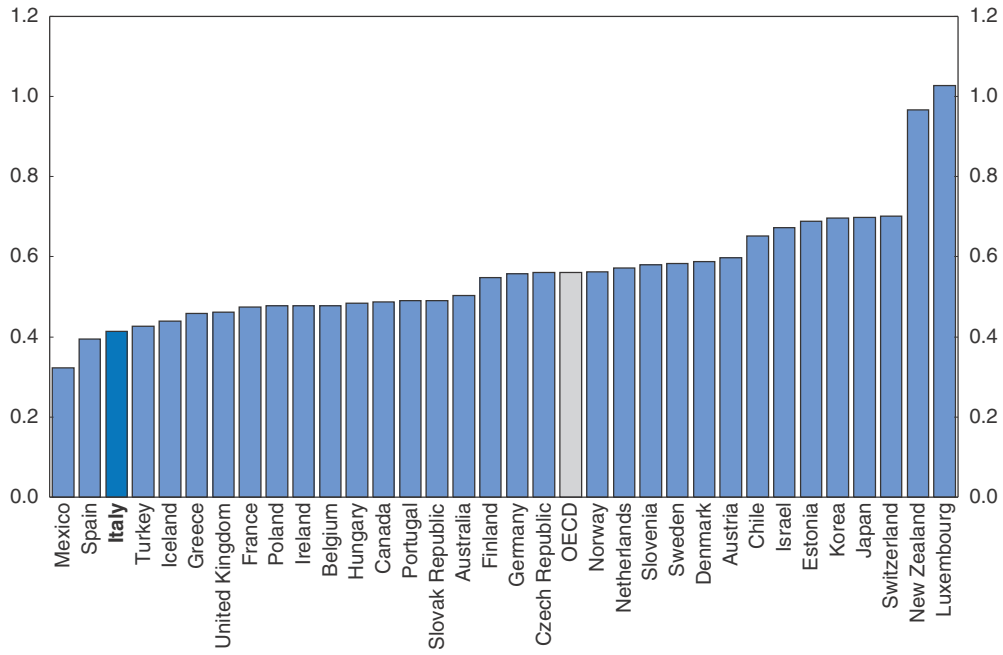
The basic principle of competition law and regulation is to promote the interests of consumers and citizens, not those of enterprises *per se*. But regulation is needed in many areas, such as protection of health and the environment. The trade-offs, for example between pollution and employment opportunities, are difficult, but clear rules and effective enforcement are needed: they are sometimes lacking. One case concerns a steel plant in Taranto (one of the largest in Europe). A court has found evidence of serious pollution, and past non-compliance with standards, and required the plant to close, at least temporarily; but the central government disagreed with this decision and has planned a specific decree to allow it to remain open, while giving time for the plant to adjust to environmental requirements. While the trade-offs in this case are particularly difficult to resolve, similar issues, not necessarily involving the environment, may arise in other, less individually significant, cases.

The tax system

Significant reductions in the overall tax level cannot be made yet, but reducing tax expenditures can raise revenue at relatively little cost to economic efficiency. The Ministry of Economy and Finance (2011) identifies 720 of these. IMF (2012) lists the largest 20 of them, which together cost around 10% of GDP in lost revenue. For example, the effective rate of VAT is lower in Italy than elsewhere (Figure 10); evasion also contributes to the low effective VAT yield. Eliminating tax expenditures with no clear justification would, by widening the tax base, allow marginal tax rates to be reduced in a revenue-neutral reform. An early target should be to reduce the tax wedge on low-paid workers, which is higher than all but 4 or 5 OECD countries (France and Germany are among those with higher rates), especially for second earners – likely a contributory factor to low female participation. Reducing tax expenditures would also lower administrative costs, notably by making tax compliance simpler and cheaper. Some tax expenditures are, however, components of a sensible tax system and should be retained. Future tax measures should follow the advice of IMF (2012) in its favourable assessment of the draft framework law for tax reform, notably strengthening predictability and transparency, clarifying and limiting the role of the criminal law in tax assessments, and strengthening the new real estate tax with up to date and fairer, market-related valuations. These measures had not been definitively adopted before parliament was dissolved for the elections. They could form the basis of future plans for tax reform.

Other well intentioned fiscal measures have increased specific tax exemptions or reductions. "Project bonds", intended to finance companies undertaking public infrastructure projects, will be subject to the same tax advantages as direct government debt. Companies hiring specific kinds of workers and/or in specific regions will be exempted from part of the regional company tax (IRAP). These measures have to be financed by higher taxes somewhere else, and there is also a danger that they attract creative accounting behaviour, in which case companies benefit from the deductions without any real change in behaviour.

Figure 10. **VAT revenue ratio, 2011[1]**



Note: The OECD area is the simple average.
1. Or latest year available. Data for 2011 are estimates.
Source: OECD, *Consumption Tax Trends 2012*; OECD *Revenue Statistics and Annual National Accounts Database*.

How to read this figure: The VAT revenue ratio is defined as the ratio between the actual value added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. This ratio gives an indication of the revenue losses in the VAT system due to preferential (lower) rates, tax evasion and weaknesses in administration.

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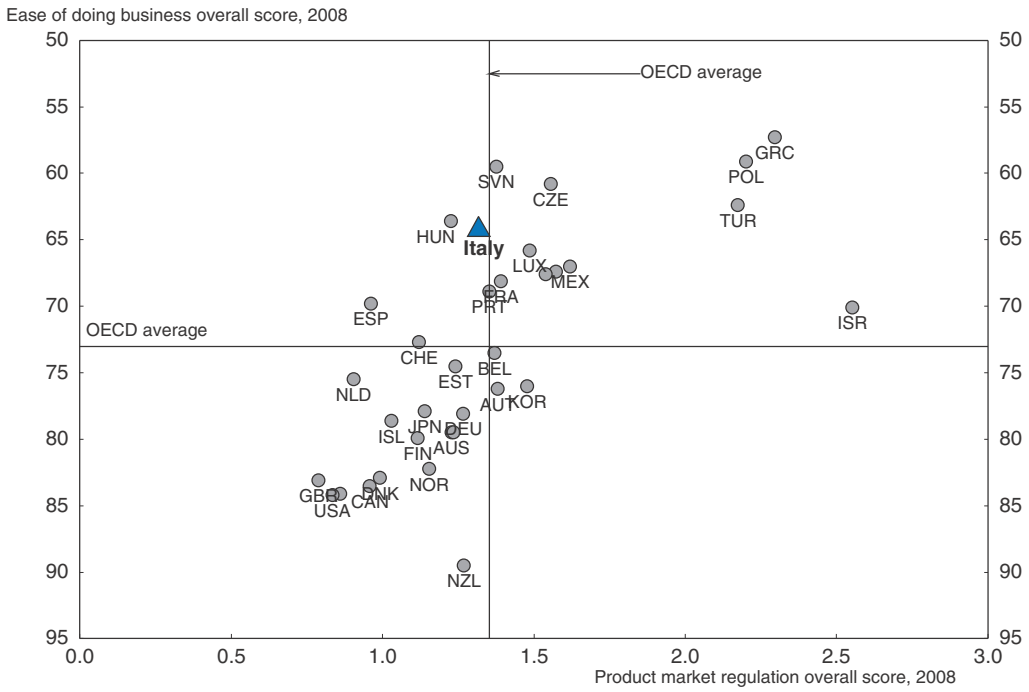
Box 4. **Recommendations for competition policy and other structural reforms**

- Complete the implementation of the key reforms, including through ensuring that the Transport regulator is set up rapidly and that the Competition Authority uses its new powers actively.
- Remove remaining regulations restricting capacity in retail and professional services; reconsider some backwards steps, notably those limiting the expansion of competition among lawyers.
- Broaden the tax base by reducing tax expenditures comprehensively, allowing reductions in marginal tax rates on labour, especially on second earners.
- Complete the framework of regulations for water services and other local utilities, ensuring the operational independence of the regulators.
- Promote greater competition in local public services, as well as in television and other media.

Improving public policy implementation: legislation, public administration and the rule of law

Despite Italy's improved relative performance on OECD indicators of product market regulation (PMR) its relative productivity performance deteriorated well before the financial crisis. PMR indicators show that by 2008 Italy was somewhat better than a simple average of OECD countries, but other indicators tell a different story showing that progress was particularly strong in PMR-measured areas. The World Bank "Doing Business" survey shows Italy as significantly worse than the corresponding average (Figure 11). Much of the difference between Italy's position on these two indicators arises because they do not cover the same set of issues (only two sub-indicators coincide exactly). But one area that Doing Business considers, not included in PMR, is the speed of civil justice (where Italy ranks very low) and a small number of Doing Business indicators are based on perceptions. An international survey that specifically covers perceptions of the business framework in different countries (as opposed to OECD indicators and almost all of Doing Business which focus on a strict legal interpretation of the legislation) shows Italy as very much worse than almost all OECD members (Fraser Institute, 2012). Other governance and perception indicators, such as the World Bank's governance indicators, suggest that Italy is likely relatively weak when it comes to putting measures into action and effectively enforcing them. (World Bank, 2012; World Justice Project, 2012). There is thus a case for suspecting

Figure 11. **Italy scores relatively weaker on "Doing Business" than on OECD regulatory indicators**



Source: OECD, *PMR Database* and World Bank, Doing Business.

How to read this figure: Italy's PMR 2008 score of 1.3 (the best possible score is 0, worst score 6) is between that of countries such as France and Germany, and is slightly below the OECD average, so one would expect conditions for business to be relatively good. But its score on the World Bank Doing Business indicator (best possible score = 100, worst = 0) is worse than most OECD countries.

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that the legislated principles of business regulation may be further from practice, or at least perceptions of practice, in Italy than in most countries.

There may be many sources of such a difference, not unique to Italy. Examples which are often highlighted in Italy include: legislation which is sometimes fragmented, poorly drafted, or ambiguous; regional/local regulation which is inconsistent with national legislation; regulations which are not effectively implemented by the public administration; inadequate administrative capacity in some regions; implementation or enforcement which is ineffective because of slow moving courts; regulations which are undermined by corruption or supplanted by organised crime.

Streamline and re-organise legislation

The "Taglia leggi" law – the "law-cutting law" – passed in 2005 aims to eliminate redundant legislation from the statute books. In a rough comparison with other countries, there may have been more than twice as many as in France and four times the number of federal laws in Germany (Clarich and Mattarella, 2011). Regional governments, particularly but by no means only those with autonomous status, add to the total. According to OECD (2012), since 2005 around 200 000 national level laws have been repealed. The effect is not immediately noticeable, but by removing them from the body of potentially relevant laws, the process has reduced the burden on courts interpreting them and of companies and individuals needing to respect them, and probably reduced the need for lawyers.

The number of individual laws passed by parliament has been declining, but they have become longer, and increasingly introduced as government decrees with immediate effect, with parliament therefore taking a lesser role in debating and drafting them. Use of decree laws needs to be more effectively restricted to their legitimate use for very urgent measures, as in most of the legislation introduced in 2012, but in more normal times it can result in good governance procedures being by-passed. In the case of regulatory impact assessments, for instance, exemptions to the requirement for producing them include both urgent measures and complex issues (OECD, 2012). Laws are frequently difficult to read – as may be the case in many countries – and the Italian parliament's own guidelines for drafting laws are often not followed.

A study from the Confindustria research institute (Clarich and Mattarella, 2011) suggests guidelines for improving the quality of legislation, many of which match previous recommendations in *Economic Surveys*. They include: avoiding too-frequent changes of rules without impact and cost analysis; following coherent guidelines on plain-language drafting; moving towards codification to bring disparate laws regulating specific sectors or activities into single coherent texts; promoting "soft law", in which legislation provides guidelines but leaves room for common sense interpretation instead of complicated over-prescription; ensuring that laws and regulation are easily accessible to the public on the internet; promoting co-ordination among regions to ensure compatibility of language and substance of laws; and undertaking a periodic investigation of regulations in different sectors to assess their cost-effectiveness and efficiency. The authorities argue that these guidelines are already being followed: a number of *Testi Unici* (consolidated laws) have been issued and a website "*Normattiva*" provides access to the full body of laws in force; some form of monitoring, perhaps in a follow-up study along the lines of the Confindustria study reported above, would be useful.

Public administration: efficiency and integrity

Successive governments, since at least 1998, have introduced reforms intended to improve the performance of the public administration, generally with the ambition to improve accountability and encourage a performance-oriented culture. The "Brunetta reforms" in 2009-10 showed both how much progress was needed and what was possible (OECD, 2010). It seems that so far most ministries have concentrated only on easy targets where sanctions were attached and have not internalised the importance of transparency (CIVIT, 2012). The work of CIVIT, the commission for integrity and evaluation in the public administration, in monitoring progress should be encouraged. The reforms introduced a link between earnings and performance through a system of performance bonuses based on achieving performance targets. In at least some cases there seems to have been collusion to set easy-to-reach performance targets, adding to official paperwork with little effect on incentives. Requiring ministries to post absenteeism records on their website appears to have reduced the problem of (recorded) absenteeism.

Reforms of public administration and regulatory processes are partly dependent on achieving cultural change in the bureaucracy, including simple recognition of the importance of exposing and reducing conflicts of interest. This requires continued insistence on accountability and the need for an outcome-based approach to performance evaluation. CIVIT is to become the key public body responsible for monitoring the implementation of a number of provisions which should improve efficiency and integrity. The 2012 anti-corruption law, whose first draft was proposed by the previous government, provides for a number of key mechanisms. These include developing a new code of conduct for civil servants and provisions for protecting whistle-blowers – employees who expose misuse of funds, corruption or crime and who thereby put themselves at risk of retaliation by their employers, and additional conflict of interest measures. According to the OECD *Integrity Review*, the anti-corruption law marks considerable progress in these and other areas, though it notes that the whistle-blower provisions contain some gaps which should be dealt with over time (OECD, 2012). The details of many of these provisions are left for the government to develop within lines set out in the anti-corruption law; as in other areas, it is important that these are fully followed up.

The national public procurement agency, Consip, is an example of good practice in keeping costs down. Its contribution can be amplified both by – as planned in recent legislation – extending its range of activity and promoting transparency so that its comparisons of prices and purchases across the country become easily accessible public information.

Corruption

Italy suffers more from corruption than most OECD countries and more than some non-members, as a number of surveys show (GRECO, 2009; Transparency International, 2010), although there is always room for different interpretations. Some surveys are exceptions; Italians themselves report a relatively low level of attempts by public officials to extract bribes, for example, but these are not typical. In 2012 there was a level of revelation of misuse of public office in regional government unprecedented since the early 1990s. The administrations of two of the twenty regions resigned amid accusations of misuse of public funds, though it remains to be seen whether this was corruption in a legal sense, or rather poor spending control. (Bandiera et al. (2009) suggest that 80% of inefficiencies are explained by poor management and 20% by corruption). A feeling that

corruption is widespread or occasionally acceptable to deal with practical problems can make it more difficult to make progress than when cases are relatively isolated. As the government recognises, however, a determined approach to transparency, well-designed laws and efficient enforcement can succeed in modifying behaviour.

Italy should therefore further promote transparency to facilitate simple efficiency comparisons, but also "naming and shaming" based on verifiable information. The recent anti-corruption law was a useful step. Its commitment to bring all transparency provisions into a consolidated document is welcome, while a fully-fledged freedom of information act would be a powerful additional force for greater transparency. Some further measures taken in late 2012, enhancing transparency in local government and political finances, and reinforcing the role of the Court of Auditors, should also contribute to reducing corruption. Modifying the operation of the statute of limitations on criminal corruption cases to remove incentives to dilatory behaviour is important. One current such incentive is the inclusion of the full length of the trial and appeals process in the limitation period for all criminal cases (though not for civil cases).

Organised crime

Organised crime often operates a parallel economy, and actively seeks to undermine the normal government. It has frequently succeeded at the local level. In most years several municipal governments are dissolved by the president on the grounds that they have fallen under the control of organised crime, though the dissolution of a regional capital's municipal council in 2012 was unusual. Trying to reduce the gains from organised crime can help to constrain it. As a signal of commitment, the government introduced the anti-mafia "White List", a rating for enterprises certified as not exposed to mafia infiltration, and measures to facilitate the seizure of mafia assets. The role played by the Financial Intelligence Unit in fighting and preventing money-laundering is central and might be strengthened. Continued, and if possible enhanced, co-operation from other countries to increase the traceability of funds held abroad or invested abroad in otherwise legal activities is important.

Civil justice

Effective implementation of the law is above all dependent on the judicial system. The Italian civil justice system is extremely slow and expensive compared with many other OECD countries (Table 3) and there is a high rate of appeal, including second appeals, to the *Corte di Cassazione*, the highest court. The government took some welcome measures in 2012, including increased specialisation of judges and courts, geographical rationalisation, and some filtering of appeals. Other reforms, focusing on incentives and constraints faced by lawyers, their clients and judges must be pursued, as well as key technical measures such as deepening the use of information technology. Incentives for the use of alternative dispute resolution mechanisms, such as mediation, should also be considered. Increasing the (very low) minimum cost of taking small claims to courts already seems to have reduced the inflow of such claims.

Adapting policy

While measures to directly improve the efficiency of public administration, to reduce corruption and to limit the reach of organised crime are essential, policy may sometimes be able to create better incentives to reduce these problems. A simple case is the use of standard-cost pricing in financing decentralised service provision with central funds. This gives regions and municipalities incentives to improve efficiency since they will not be

Table 3. **Civil courts can be slow and expensive**

	Number of days necessary to settle a first level civil case		
	2006	2008	2010
Italy	**507**	**533**	**493**
Portugal	449	430	417
Spain	261	296	289
France	262	286	279
Austria	135	129	129
	The cost of resolving commercial disputes (2012 data)		
	Number of procedures necessary	Number of days	Cost, as % of the amount in dispute
Italy	**41**	**1 210**	**30**
Germany	30	394	14
France	29	331	17
Spain	39	515	17
United Kingdom	29	399	23
United States	32	300	14
OECD average	31	518	19

Source: Clarich and Mattarella (2011), using data from CEPEJ and World Bank Doing Business 2012.

compensated with higher transfers. Such an approach is foreseen by the legislation on fiscal federalism but is not yet in operation. Further rationalisation of procurement, through the extension of the operation of Consip, the central procurement agency, is another example.

Another possibility, more difficult to use, could be a severe cost-benefit analysis in considering infrastructure projects: where corruption or crime increases construction costs, and the use of public funds is indirectly supporting organised crime, public investment needs to have a very high social rate of return to be justified. Education is potentially a key tool in developing civic society, especially by finding ways for children to see wider role models and more opportunities for employment. The government's Cohesion Action Plan reallocates some EU Structural Fund resources to reduce school dropout in some specific areas, to encourage legality, with the participation of schools and the private sector. Investment in primary and secondary education, and ensuring it remains free of the influence of corruption and organised crime, should be given a high priority. The planned development of a wider social safety net could also help, since some of the criminal organisations operate their own quasi social security system, while many unemployed people currently receive little help from the state.

A final consideration arises from the known tendency of corruption (as well as organised crime) to affect the operation of administration, politics and even justice at the local level. In such cases the central government or justice system intervenes from outside. There is, *a priori*, a risk that the same thing can happen at the national level. Ultimate responsibility for preventing this resides with parliament and the electorate, acting on reports from the bodies monitoring transparency and conflicts of interest. There are potential conflicts of interest at this level too, where outside monitoring is more difficult. One possibility could be international co-operation, which could help reinforce the checks and balances of the constitution. CIVIT, the existing independent commission for evaluation, transparency and integrity in the public administration, has been given the powers of a national anti-corruption authority. Sufficient resources and a guarantee of continued independence are essential for CIVIT to fulfil its anti-corruption responsibilities.

Box 5. **Recommendations on improving policy implementation**

- Encourage use of the transparency provisions of public administration reform and the anti-corruption law by acting decisively on evidence of inefficiencies, conflicts of interest or corruption.
- Complete the geographical reorganisation of the courts, streamlining court processes, improving the use of information technology, and widening the incentives for a greater use of alternative dispute resolution mechanisms. Continue streamlining sub-national government.
- Limit the use of decree laws, work towards codified ("testo unico") legislation, ensure effective impact assessment of laws and regulations, and increase the use of sunset clauses.
- Build on the provisions of the anti-corruption law to develop a fully-fledged freedom of information act.
- Revise the law on limitations ("prescrizioni") in criminal corruption cases to reduce incentives to dilatory behaviour, such as the inclusion of the full trial and appeals process in the limitation period.
- Pursue performance-oriented management (not just performance pay) in the public administration.
- Widen the range of operation of the centralised public procurement body, Consip, to cover as much procurement activity as possible, making a database of comparative purchase prices publicly available.

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ANNEX

Taking stock of structural reforms

This table summarises recommendations from previous *Economic Surveys* and notes significant measures that have been taken since the previous *Economic Survey* (May 2011).

Policy area, main recent OECD recommendations	Recent action (2012 unless otherwise indicated)
Public sector efficiency	
Ensure competition for provision of public services. Widen use of performance indicators in public administration. Reinforce auditing mechanisms for regulatory and spending decisions. Improve efficiency in civil justice administration. Embed integrity and anticorruption tools within current structures of the Italian public administration. Consolidate technical expertise in Italy's Better Regulation bodies. Control the dynamics of regulatory inflation at regional level and focus on continuity and implementation of regulatory reforms. Monitor and evaluate progress towards administrative simplification, including through greater use of perception surveys.	Some measures in all these areas. In particular: Anti-corruption law passed, and the Commission for the evaluation, transparency and integrity of the public administration, CIVIT, is identified as the National Anti-Corruption Authority (2012). Changes in civil justice: (2011) increased court fees; monetary and other incentives to reduce backlog of court cases; (2012) creation of 20 specialised courts for some company law issues; introduction of some restrictions on appeals to appeal courts and supreme courts; reorganisation of judicial districts in order to close small courts and reduce public expenditure; extension of compulsory use of electronic mail to accelerate procedures; more stringent conditions for awarding penalties for excessive length of trials. Public administration in State and local governments are being restructured and employment is to be reduced. Use of performance management is to be expanded. Bureaucratic procedures for citizens and business are to be simplified, including by wider use of e-government tools, new administrative burdens to be avoided. Administrative reviews have been conducted to improve the quality of public services and facilitate more rational spending within the public administration. The range of goods and services procured by Consip, the national public procurement agency, was widened.
Product markets	
Increase powers of competition agency. Reduce public ownership, especially in TV media, transport and energy utilities, local public services. Privatise and liberalise in energy and transport sectors. Remove unnecessary licensing in professional services. Remove quantitative restrictions on supply in services. Introduce national oversight of regional regulatory competences (e.g. retailing, land-use planning).	Competition Authority has greater powers, new or overhauled regulators in network industries. Separation of ownership in gas supply and distribution. Reduction of restrictions on fees and entry restrictions for some professional services. Relaxation of planning procedures in retailing.

Policy area, main recent OECD recommendations	Recent action (2012 unless otherwise indicated)
Education	
Ensure the development of a comprehensive evaluation and assessment framework. Strengthen teacher quality. Improve the performance of vocational education and training system and provision of post-secondary vocational education. Improve business-academic research links, designing intellectual property rights in line with the incentives of researchers and business. Increase student contribution to the cost of tertiary education, provide income-contingent-repayment loans. Reduce dropout rates with more widespread selection at entry. Ensure merit-based recruitment to universities and accountability of recruitment panels. In universities separate strategic leadership from management functions and recruit leaders with skills and incentives to achieve their mission; where this is in place, give universities autonomy on strategic direction, recruitment and performance incentives. Build capacity and legitimacy in ANVUR, whose quality assurance reports should focus on student and research outcomes and be widely disseminated. Support innovation in education. Promote early access to care of good quality. Prevent school failure and reduce dropouts	Improved testing of school students being progressively introduced (since 2010). Increased share of university funding allocated on performance indicators, but some funding withheld as part of budgetary cuts. Significant cuts in overall spending (since 2009). Recent experimentation with school and teacher evaluation schemes; establishment of a fully fledged national evaluation system to be co-ordinated by INVALSI. National plan for the introduction of digital technologies in schools (ongoing). The 2010 law on universities reformed the supervisory structure along the suggested lines. No significant action on: early child education; student contributions; selection at entry; university autonomy.
Labour market	
Increase participation. Reform permanent employment protection. Reduce labour market duality. Reduce tax wedge on labour income. Promote greater wage responsiveness to productivity.	Tax incentives for female and youth participation. Comprehensive labour market reform (with explicit provision for monitoring of its effects) including: relaxation of employment protection rules, reduced incentives to hire on non-permanent contacts, stronger framework for apprenticeships, gradual introduction of a universal unemployment benefit, potentially increase in flexibility on the firing side (mainly depending on the interpretation of the new provisions by the courts). Certain short-term contracts made easier to use. Tax incentives to productivity related components of wage increases.
Boosting innovation	
Make science, technology and innovation policy more business-oriented and receptive to the varied needs across the whole spectrum of firms, including SMEs. Simplify and rationalise public support for business R&D and innovation, by achieving an appropriate mix of direct and indirect measures. Improve linkages between the business sector, universities and the public research system, including through mobility of researchers, and appropriate intellectual property rights. Foster the creation and growth of start-up firms, by lowering regulatory barriers, simplifying bureaucracy, and supporting the collateralization and securitisation of innovation-related assets (e.g. through adhesion to the European Unitary Patent).	Reduction of costs of starting a new enterprise. Simplification of bureaucratic and public administration procedures, both for citizens and businesses. Introduction of a tax credit on an experimental basis for companies that fund research projects universities or public research bodies. Several measures were adopted to support start-ups, including tax exemptions and simplified regulation.
Enhance corporate governance, protection of small shareholders. Encourage mergers, including cross-border mergers, in financial sector governance. Reform bankruptcy legislation.	Measures to reduce cross-directorships in banks. Restructuring of bankruptcy procedures, to better facilitate the continuation of business activity.
Introduce expenditure caps to prevent any growth in overall public spending in real terms.	Legislation implementing the balanced budget constitutional amendment also aligns the fiscal framework to the European rule regarding annual expenditure growth introduced by the Six-Pack in December 2011.
Ensure equal treatment of all shareholders, in both private and partially publicly-owned companies.	No action.

Policy area, main recent OECD recommendations	Recent action (2012 unless otherwise indicated)
Environment	
Fully privatise water supply and treatment, and waste-management companies, strictly enforcing public tendering rules.	A referendum in 2011 repealed an article in a 2008 law which required water supply to be managed exclusively by companies in which private investors hold at least 40%, as well as an article in the 2006 Environment Code which guaranteed a minimum remuneration of 7% on capital costs in the calculation of water tariffs.
Make the water commission, Conviri, an independent national regulatory authority	The Salva Italia decree from November 2011 suppressed Conviri and transferred regulatory responsibilities for water supply and sanitation to the National Gas and Electricity Authority (AEEG), regarded as an independent professional body, although the precise functions to be transferred to AEEG have not finally been decided.
Revisit national legislation on water pricing. Allow water charges to fully reflect costs including the need to renew infrastructure. Pricing should also reflect the polluter-pays principle and not be a function of the nature of the water consumer.	In December 2012 the new water regulator (the Energy and Gas Authority), approved a new pricing scheme. This does not fix tariffs but defines criteria for their quantification, according to the principles of complete cost recovery and the polluter-pays principle.
Protect groundwater resources through effective licensing, abstraction charges and tradable water rights.	No action.
Verify that absence of competition in packaging waste recycling consortia does not reduce efficiency.	No action.
Make greater use of green taxation, with taxes as a function of economic and environmental costs. Eliminate all energy tax rebates, except those that reflect differences in externalities.	No significant action on rebates, though the method of calculation for rebates for large industrial energy consumers has been revised.
Encourage urban congestion and pollution charging schemes. Ensure objective and transparent use of cost-benefit analysis in assessment of projects.	No action.
Ensure the White Certificate scheme addresses only true information barriers. Ensure efficiency-related building standards on new property are properly enforced.	No action.

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Chapter 1

Italy and the euro area crisis: Securing fiscal sustainability and financial stability

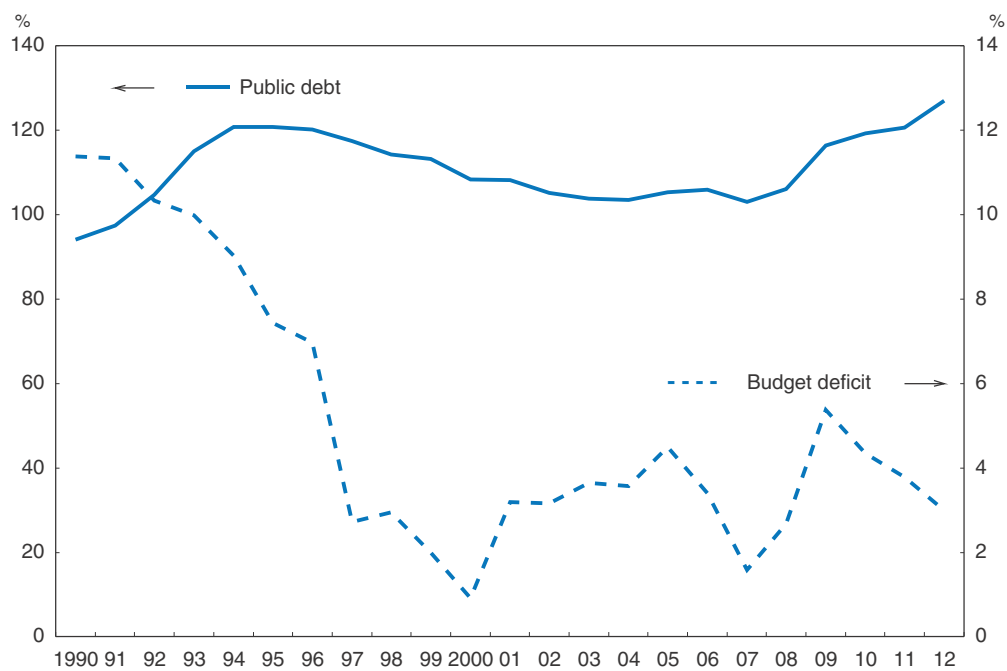
Italy's policy of fiscal consolidation and growth-friendly structural reforms has substantially improved its economic prospects, but the adverse sentiment that the country has faced in the sovereign bond market over the past years has deep roots. It reflects lingering anxieties over the euro area's future, as well as persistent economic and financial difficulties, in particular the high level of public debt and low potential growth. The government has rightly aimed to halt the rise in the public debt-to-GDP ratio and put it on a downward path. This could be achieved either with a balanced government budget or a small fiscal surplus. While additional fiscal tightening would have transitory negative effects on output, it would be rewarded by faster debt reduction and lower risk of renewed financial-market reactions. In addition, automatic stabilisers should be allowed to work.

Concerns about fiscal sustainability and the prolonged recession have spilled over to the financial sector. Lending conditions are tight, non-performing loans are high and rising, and capital flowed out of Italy to the core countries of the euro area. The Bank of Italy should continue to ensure that banks increase provisions against losses, and strengthen their capital asset position by raising new equity from private sources, including from foreign stakeholders, by retaining earnings, and by disposing of non-core assets. Resolution of the fiscal, economic and financial crisis in Italy depends in part on action at the euro area level. As a member of the euro area, Italy has benefited from the establishment of the European Stability Mechanism, the announcement by the European Central Bank of the Outright Monetary Transactions scheme and the plans for a euro-area banking union.

The Italian economy is the third largest in the euro area, and its successful exit from present difficulties would be an important determinant of the single currency's future. The government's financing problems have their roots in the build-up of fiscal imbalances and persistently weak economic performance. On joining the euro area in 1997, Italy committed to lower the public debt-to-GDP ratio from some 120% to 60%, but serious declines ceased in 2003 (by which time it had troughed at some 105%; Figure 1.1), despite the large bonus of reduced interest payments due to euro adoption. Efforts to reduce the fiscal imbalances resumed in 2009 under the pressure of the bond market and in the framework of reinforced euro area fiscal rules. This has led to a large fiscal tightening, reflected in a declining budget deficit, and implemented in an environment of weak domestic and external demand, which has contributed to a severe double-dip recession. In 2011-12, the fragile situation of Italian banks, the ongoing pressure of the sovereign bond market and concerns about a euro-area break-up gave rise to substantial capital flight. This caused liquidity in the banking system to dry up which, together with regulatory pressure to build up equity capital, has resulted in tightening credit conditions. This chapter analyses the challenges faced by Italy to secure fiscal sustainability and financial stability against the background of the financially-stressed euro area.

Figure 1.1. **General government gross debt and budget deficit**

As a percentage of GDP



Source: OECD, *Economic Outlook Database.*

StatLink http://dx.doi.org/10.1787/888932791818

Fiscal sustainability

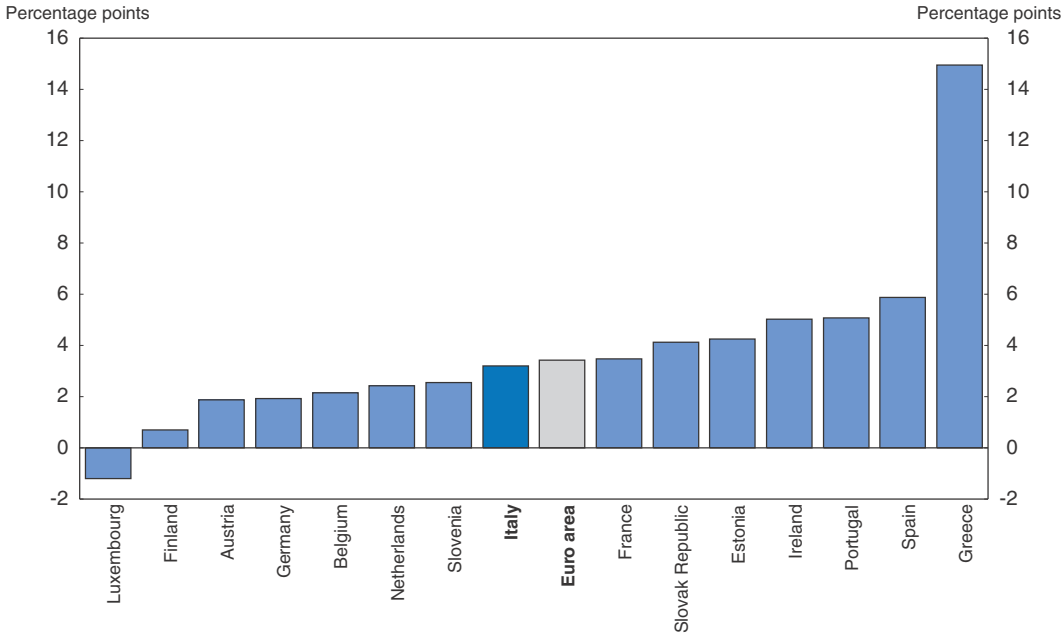
Italy's general government gross debt reached some 127% of GDP at end-2012, the third highest level in the OECD, behind Japan and Greece. By contrast, the general government budget deficit, which fell to 3.0% of GDP in 2012, is comparatively low and on a declining trend so far. Nevertheless, since national accounts figures for GDP include an estimate for the relatively large tax-evading informal economy, measures of fiscal sustainability based on the debt- and deficit-to-GDP ratios somewhat understate Italy's fiscal challenge relative to other countries, where the size of GDP reflects the capacity to tax a larger part of the economy.

Sizeable fiscal consolidation has been achieved, largely through higher tax revenues

Sizeable fiscal consolidation, as measured by the change in the structural (or cyclically-adjusted) budget balance, was achieved during the period 2009-12. The total consolidation is estimated to have been 3.2% of GDP (OECD, 2012b), the largest part of it in 2012. While substantial, this is somewhat smaller than in the euro area as a whole (Figure 1.2) and considerably less than in the other troubled peripheral economies – Greece (improvement of 14.9%), Spain (5.9%), Portugal (5.1%), Ireland (5.0%) – where in 2009 fiscal deficits and, correspondingly, fiscal consolidation needs were larger. Because growth has been below potential since 2009, there has been less progress in reducing the headline

Figure 1.2. **Fiscal consolidation in the euro area countries**

Projected change in the structural balance (% of GDP), 2009[1] to 2012



Note: Euro area is the weighted average of the euro area countries shown. Figures for 2009 are data, and those for 2012 are projected.

1. 2008 for Estonia and 2010 for Finland, Germany, Slovak Republic and Slovenia, as in those years the structural deficit reached its maximum.

Source: OECD, *Economic Outlook Database*.

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deficit than in reducing the structural deficit. The pro-cyclical fiscal tightening has had significant effects on output and large social costs, reflected in higher unemployment and lower incomes. But it was necessary to reduce the risk of further rises in spreads, which could have led to even less growth and higher deficit and debt (Égert, 2010; Laubach, 2009).

Over the past three years, rising tax revenues and other receipts accounted for 80% (or 2.5% of GDP) of the fiscal consolidation (Table 1.1), and lower spending only 20% (or 0.7% of GDP). Abstracting from the increase in interest expenditure, which partly was a result of the rise in spreads, the contribution of revenues to fiscal consolidation was about two thirds. Cyclically-adjusted revenues rose on account of increased taxes on production and imports (which mainly consist of the value-added tax and other taxes on production) and direct taxes on households, whereas those from social security contributions and direct taxes on businesses remained constant.

Table 1.1. **Fiscal consolidation in Italy from 2009 to 2012**

Cyclically-adjusted, % of potential GDP	2009	2012	Consolidation[1]
Revenues:	**45.5**	**48.0**	**+2.5**
Current revenues:	45.0	47.4	+2.4
Taxes on production and imports	13.6	14.9	+1.4
Social security contributions	13.9	13.8	-0.1
Direct taxes on households	11.9	13.1	+1.2
Direct taxes on businesses	2.5	2.3	-0.2
Property income	0.5	0.5	+0.0
Other current revenues	2.7	2.8	+0.1
Capital revenues	0.4	0.5	+0.2
Expenditures:	**49.2**	**47.9**	**+1.3**
Current expenditures:	47.3	47.2	+0.1
Current expenditures excluding interest	42.9	41.6	+1.3
Interest	4.4	5.1	-0.7
Capital expenditures	1.9	1.2	+0.7
Structural balance	**-3.8**	**-0.1**	**+3.7**

Note: Figures for 2012 are estimated.
1. Entries in the column "Consolidation" are positive when the item reduces the structural deficit. This means, in particular, that expenditure reductions enter positively.
Source: OECD, *Economic Outlook Database*.

The most important consolidation measures in 2012, as planned by the government, were: revenue increases through the municipal property tax IMU (EUR 11 billion), higher excise taxes on fuels (EUR 6 billion), the reduction of tax relief (EUR 4 billion), and increasing the VAT rate from 20% to 21% (EUR 4 billion); expenditure cuts by ministries (EUR 6 billion), the ISPE (Structural Economic Policy Programmes) Fund (EUR 5 billion), and the Domestic Stability Pact governing local government spending (EUR 7 billion). These numbers are the planned savings relative to what revenue/spending would have been in 2012 with no policy change.

The budget deficit and public debt were worse than expected by the government

The Update of the Economic and Financial Document (DEF) in September 2012 provided for fiscal consolidation (i.e. an improvement in the structural balance) of 2.8%

of GDP in 2012 and 0.9% in 2013, but a small fiscal expansion of 0.3% in 2014. These estimates for the structural balance are based on methodologies agreed at the European level. The plan was to reduce the headline fiscal deficit to 1.5% of GDP in 2014. This fiscal projection represented a substantial revision to the plans adopted in April 2012 and the April 2013 DEF shows further revisions (Table 1.2). The changes are mostly due to the worse outlook for activity, primarily a result of the distress in financial and credit markets which the government had not included in its earlier baseline projections. The government also somewhat delayed the planned fiscal consolidation, though still planning to reach structural balance in 2013 with a further improvement in 2014.

The fiscal projection for 2012 made in September (in the DEF Update) was somewhat optimistic, as data during the year showed only a modest improvement in the deficit-to-GDP ratio. A concentration of receipts at the end of the year improved the situation but the outturn, a deficit of 3.0% of GDP, fell short of the revised objective. In reporting on public accounts developments during 2012, the government focused on the state sector cash balance. This figure does not fully capture fiscal developments at the level of sub-national governments and, unlike the national accounts, is not accruals-based. On the other hand, the state sector cash balance includes payments to the European Stability Mechanism (ESM), which are not included in the EU definition of the government balance. To facilitate the interpretation of public finance developments during the year, the government should report measures whose definitions are comparable to the end-year target for general government net lending.

Table 1.2. **Revision to the fiscal plans of the government from April 2012 to April 2013**

	2011	2012	2013	2014
Headline fiscal balance	-3.9	-1.7 —> -3.0	-0.5 —> -2.9	-0.1 —> -1.8
Structural fiscal balance	-3.6	-0.4 —> -1.2	+0.6 —> 0.0	+0.6 —> +0.4
Gross public debt	120.7	123.4 —> 127.0	121.5 —> 130.4	118.2 —> 129.0
Memo: Real GDP growth	+0.4	-1.2 —> -2.4	+0.5 —> -1.3	+1.0 —> +1.3

Note: Headline fiscal balance, structural fiscal balance and gross public debt refer to general government, measured relative to (potential) GDP. The first number in each cell refers to the government's plan in April 2012 and the second to its revised plan in April 2013. Gross public debt includes loans to Greece and Italy's share in the EFSF/ESM.
Source: Economic and Financial Document, April 2012 and April 2013.

Fiscal policy should aim at a balanced budget or a small surplus after 2013

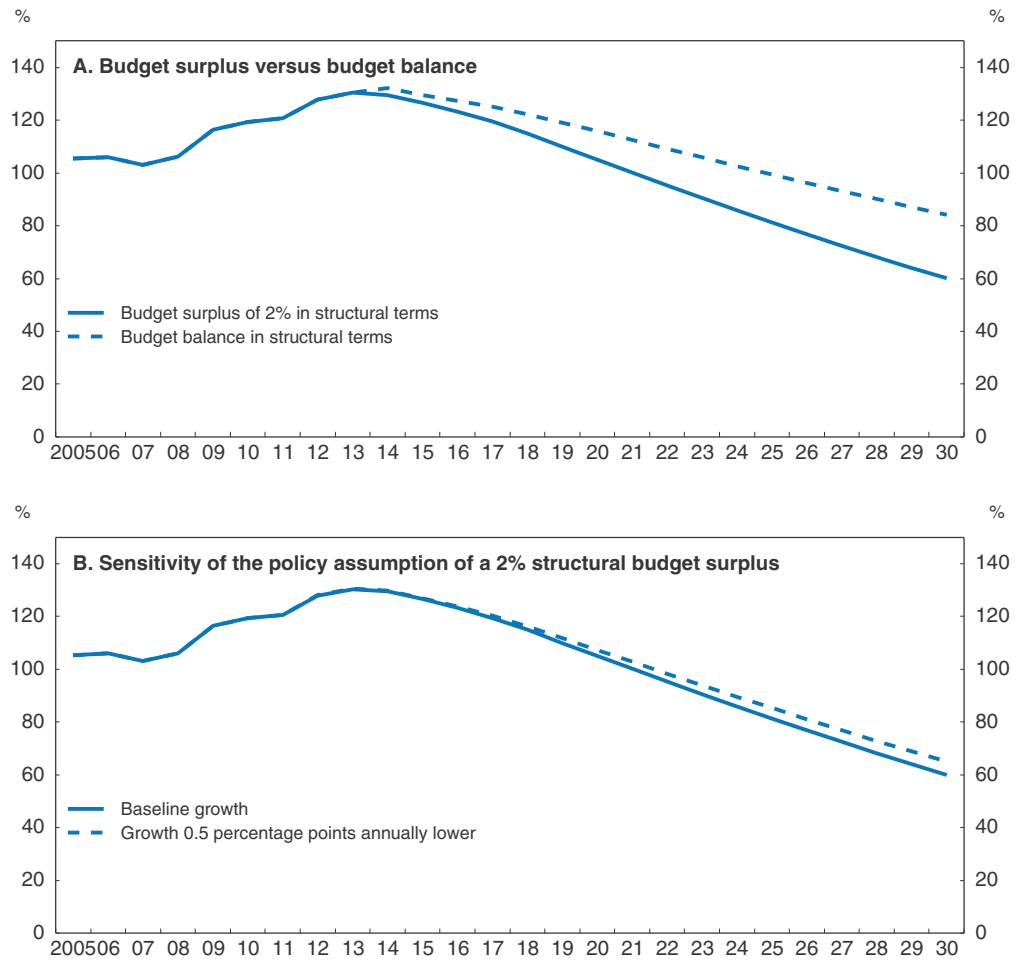
The government's objective is to reduce the structural deficit by about 1% of GDP in 2013, which under its projections would balance the general government deficit in structural terms, in line with euro area requirements, and thereafter stay close to structural balance. This fiscal consolidation is appropriate. However, under the macroeconomic projection of the OECD, which assumes the government implements the envisaged path for the changes in the structural balance, the headline deficit falls only slightly and debt would continue to rise through 2014.

According to simulations based on a model similar to Lenain et al. (2010) and potential growth projections from the Long-Term Baseline database (OECD, 2012a), introducing and maintaining measures to attain a structural budget surplus of 2% of GDP by 2017 would

reduce the debt-to-GDP ratio to the Maastricht ceiling of 60% of GDP by 2030 (Figure 1.3, Panel A). To reach the assumed structural surplus of 2% of GDP, fiscal consolidation from 2013 onwards would need to be of an amount similar to that achieved since 2009, when the structural deficit was some 4% of GDP. By contrast, the government's longer-term plan to maintain a balanced structural budget would leave debt in 2030 at 85% of GDP and reduce it to 60% of GDP in 2038. Reversing the public debt trend and putting it on a downward trajectory could thus be achieved either with a balanced budget or a small fiscal surplus. Given the high level of debt, even a small fiscal relaxation would be a risky strategy.

Figure 1.3. **Long-term simulations of general government gross debt**

As a percentage of GDP



Note: The solid curve in Panel A shows the evolution of general government gross debt assuming the government gradually phases in a budget surplus of 2% of GDP in structural (or cyclically-adjusted) terms by 2017 and then maintains it at this level. The broken curve depicts its evolution assuming the government follows its fiscal plans in the DEF Update and maintains a balanced budget in structural terms from 2016 onwards. The solid curve in Panel B is the same as the solid curve in Panel A. The broken curve depicts the evolution of general government gross debt assuming the same changes to the structural balance but with the annual real GDP growth rate being 0.5 percentage points lower.

Source: Lenain et al. (2010), OECD, *Economic Outlook Database* and OECD, *Long-Term Baseline Database*.

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Continued fiscal consolidation would be politically difficult and have transitory negative effects on output, especially in the current environment of simultaneous deleveraging in many OECD countries and limited scope for offsetting monetary policy reactions. It would, however, be rewarded by faster debt reduction and a lower risk of renewed financial-market turbulence and a "bad equilibrium" (e.g. Corsetti et al., 2012; Padoan et al., 2012). The likelihood of such a "bad equilibrium", characterised by negative feedbacks between high sovereign risk premia, falling economic activity and low confidence, tends to increase with the level of public debt. A speed of debt reversal (of approximately 5% of GDP annually) similar to that implied by a structural surplus of 2% of GDP has previously been achieved by several OECD countries, including Canada (1997-2000), Spain (1985-1990), and Belgium (1994-2007). If macroeconomic conditions deteriorate once again, automatic stabilisers should be allowed to work.

The benchmark simulations assume that the level of real GDP gradually converges to potential output, whose annual growth rate rises to 1.3% in 2030, one percentage point up from the current 0.3%. There are downside risks to these assumptions. The global financial crisis may have significantly reduced the level of potential output. Or the euro area crisis could intensify further and lead to subdued growth for a prolonged period. Long-lasting hysteresis effects could arise from today's high unemployment. The policy assumption of a 2% structural budget surplus is, however, relatively robust to real GDP growing 0.5 percentage points below the baseline, which would bring the debt-to-GDP ratio to 65% by 2030 and 60% in 2031 (Figure 1.3, Panel B).

Contrary to the consolidation thus far, future policy should, however, place more emphasis on spending control rather than tax increases, because of the already high level of taxation and empirical evidence (e.g. Mertens and Ravn, 2012; Alesina et al., 2012), though not entirely conclusive, of less harmful effects on output. Spending cuts should be selective, and policy measures need to raise value-for-money. Although state budget expenditure data showed no decline in 2012 relative to 2011, the government legislated several measures with the objective to exert some downward pressure on spending in future years, which on its projection would help to rebalance the composition of fiscal consolidation undertaken so far. In July 2012, parliament adopted a law (the "spending review") with savings estimated at EUR 10.8 billion in 2013, EUR 11.6 billion in 2014, and EUR 12.1 billion in 2015 (see also Chapter 2 of this *Economic Survey*). The recent budget law requires setting aside any extra savings coming from lower-than-projected interest payments. Over the medium term, temporary savings stemming from the pension reform approved in December 2011 will materialise. The government projects them to amount to EUR 7.6 billion in 2014, increasing to almost EUR 22 billion in 2020, before declining to near zero in 2040.

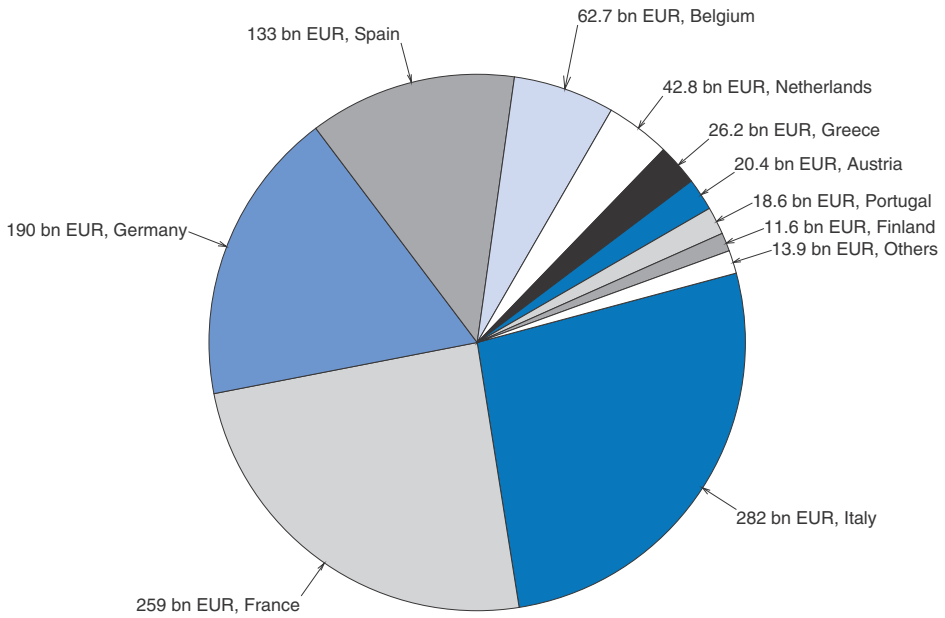
Debt redemption requirements for 2013 are significant

Italy had the largest amount of maturing public debt among euro area countries for 2013, exceeding both France and Germany (Figure 1.4), which reflects the large absolute size of its debt. The redemption requirements for government bonds (debt instruments with maturity of more than one year) will be EUR 159 billion in 2013. A significant amount of current debt is also due for redemption in each of the following two years (Figure 1.5). Actual refunding needs in future years will be higher than shown in the chart, as debt rolled over each year itself has to be refunded in the future. In addition, in 2013 EUR 151 billion of Treasury bills (debt instruments with maturity of up to one year) will fall due at least once. The total redemption of bonds and bills in 2013 as of 1 January 2013

worth some EUR 310 billion will be of broadly similar magnitude as in previous years (Figure 1.6); compared to 2012, for example, it will be EUR 23 billion less. Accounting for the multiple maturing of bills and new debt issuance, borrowing needs for 2013 should total some EUR 410 billion, or 26.5 % of GDP.

Figure 1.4. **Maturing public debt for payment in the euro area**

4 February – 31 December 2013



Note: Others include Ireland, Slovak Republic, Luxembourg, Slovenia and Estonia. There are some small differences between this source and the numbers mentioned in the text from the Ministry of Economy and Finance, partly because of some debt falling due between 1 January and 4 February 2013.
Source: Bloomberg.

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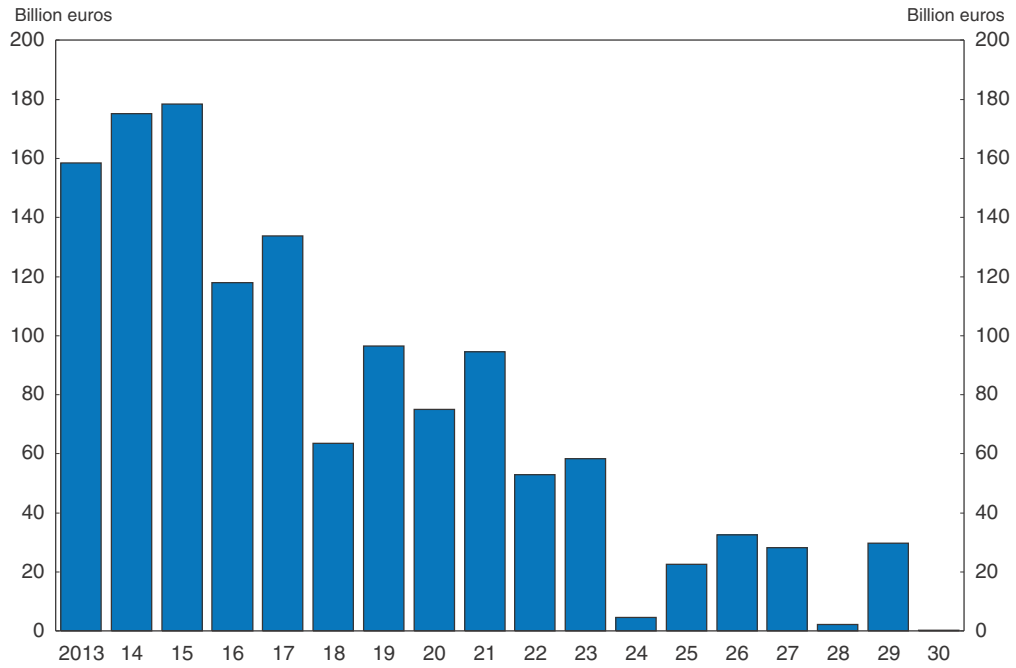
The pass-through of the higher interest rates paid on new debt over the last 18 months on the fiscal balance is mitigated by the relatively high average maturity of government debt of 6½ years. Also, with the rise in interest rates more pronounced at the long end of the yield curve, the government has increasingly issued short-term securities. This has contained interest spending, but also had the consequence of reducing the average maturity of government debt somewhat, after a long period during which it rose (Figure 1.6). The authorities saw this reduction as a tactical move allowed for by the previous lengthening of the maturity structure. Demand has held up so far. In October 2012, the government raised EUR 18 billion through the issue of a 4-year inflation-linked bond primarily aimed at domestic retail investors, the largest amount ever sold in a single debt offering in Europe. In general, the investor base has increasingly shifted to domestic sources (more details on this below). Debt management should continue to seek to maintain debt at different levels of maturity and offer debt instruments attracting a broad set of investors.

Figure 1.5. **Redemption of government bonds by year**



Note: Government bonds only include debt instruments with maturity of more than one year. In addition to the figures shown here, in every year, approximately EUR 150 billion of Treasury bills, debt instruments with maturity of up to one year, fall due. Actual refunding needs in 2014, etc. will be higher than indicated in the chart, as debt rolled over each year itself has to be refunded in the future.
Source: Ministry of Economy and Finance.

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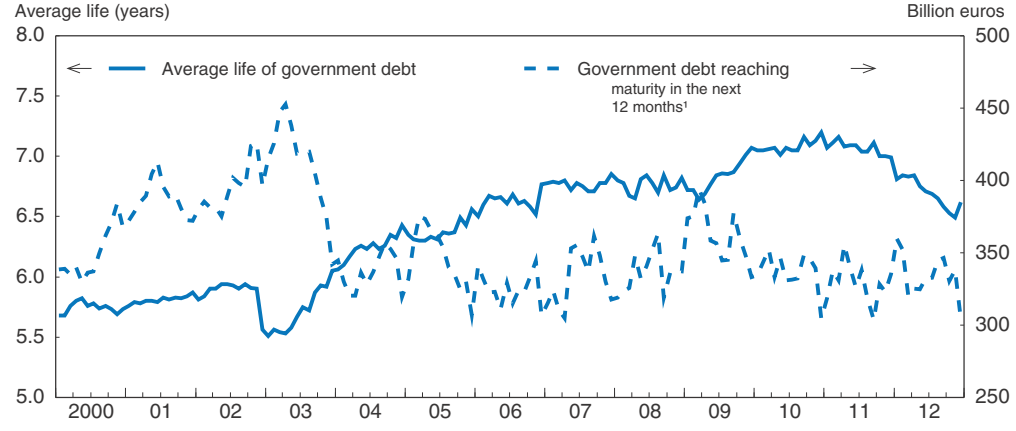
Figure 1.6. **Average life of government debt and government debt reaching maturity in the next 12 months**



1. Adjusted by harmonised consumer price index. Data are based on the last observation.
Source: Ministry of Economy and Finance and OECD, *Economic Outlook Database*.

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Italy has also benefited from the ECB's announcement of the Outright Monetary Transactions scheme

Interest rates on government bonds increased significantly during the second half of 2011, though they declined during 2012 as government fiscal policy and structural policy reforms, along with action at the European level, reassured markets. Yields on 10-year bonds were at times above 7% and in January-April 2013 remained at 4-4¾ %, while the German equivalent rates were around 1½ %. Hence, to obtain over the next 10 years the same return on German bonds as on Italian bonds, investors were willing to pay some 25% more for the German bond. Although the large public debt and low growth expectations are probably important explanatory factors, spreads have departed substantially from conventional calculations of their fundamental value. Regression estimates (IMF, 2012) suggest that the health of the banking sector and euro area market fragmentation, proxied by the accumulation of cross-border TARGET2 liabilities (more details on this below), have given rise to excess risk premia. Di Cesare et al. (2012) argue that the spread of Italy's 10-year interest rates with Germany that is consistent with the state of the economy would be around 2% rather than the 2½-3½ per cent observed in early 2013.

Spreads fell significantly after the announcement by Mario Draghi, the President of the European Central Bank (ECB), in July 2012 to do "whatever it takes" to save the euro, which was followed by the ECB's introduction of the Outright Monetary Transactions (OMT) scheme on 6 September 2012. The ECB may conduct OMTs (purchases of sovereign debt with up to three years of maturity in the secondary market) for countries under a macroeconomic adjustment or a precautionary programme with the ESM. The objective is to help lower policy rates to be transmitted to borrowing costs in peripheral countries. The Italian authorities have not indicated that they would seek European financial assistance, since they remain able to attract funding from the sovereign bond markets under terms consistent with a sustainable debt path.

The balanced-budget rule and the fiscal council already legislated should be put into operation rapidly

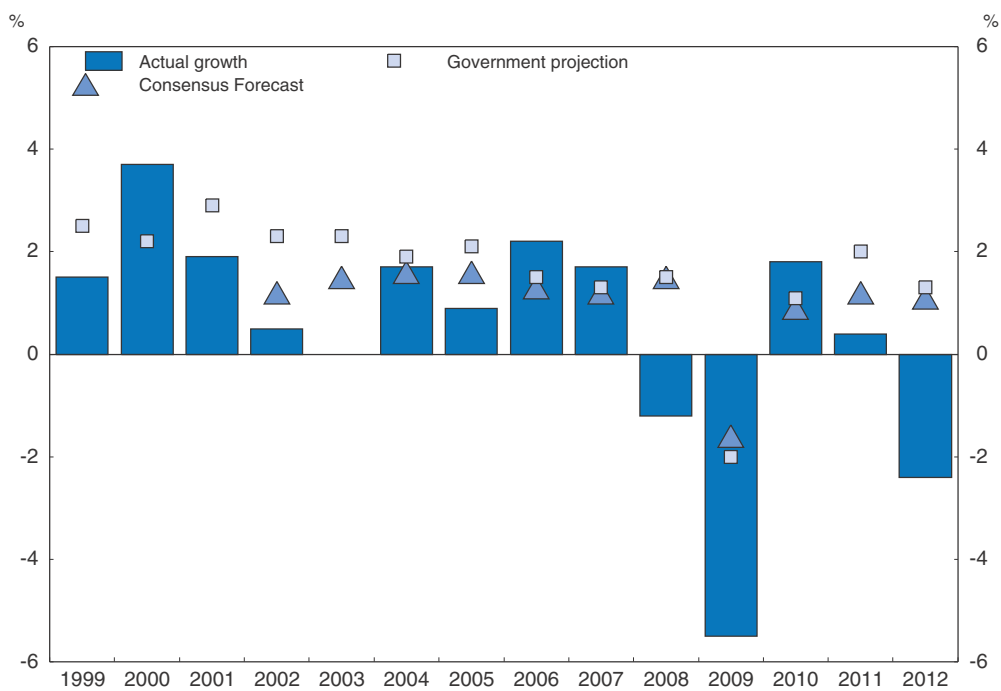
In April 2012, parliament approved a constitutional amendment that introduces a balanced-budget provision. It will require the government to achieve structural budget balance, i.e. general government net borrowing will be permitted only in cyclical downturns (with surpluses in upturns), or exceptional circumstances. Sub-national governments will be subject to a new balanced-budget requirement, too, but this will be defined in nominal terms, i.e. with no adjustment for the economic cycle. The constitutional amendment, which is consistent with the budgetary framework of the European Union, will become effective as of the fiscal year 2014. The secondary legislation of December 2012 determined, *inter alia*, the definition of exceptional circumstances (i.e. severe economic recessions and natural disasters) and the setting of the maximum cumulated deviation in structural terms beyond which corrections are required (i.e. more than 0.5% of GDP from the medium-term objective). The reform also establishes an independent body, within parliament, responsible for monitoring public finances and compliance with the fiscal rules.

The fiscal rule and the fiscal council are welcome innovations, which should be implemented in full, and with the objective of maintaining a prudent approach to long-term fiscal challenges. They are suitable institutional mechanisms to support fiscal discipline and credibility of debt reduction (IMF, 2009; Hagemann, 2010). By anticipating

their role as a commitment device, both could have positive impacts on financial markets even in the short term. For this effect to be lasting, the government will have to put them into operation rapidly. The new law also introduces a debt rule, consistent with the "Six-Pack" decision of the European Union, which requires annual reductions in the debt-to-GDP ratio by 5% of the difference between the level of debt and the 60% reference level, measured over a 3-year average. The newly-established balanced-budget rule and fiscal framework need to be implemented with transparent data and methodology to allow effective monitoring of compliance.

The fiscal council is charged with assessing the underlying assumptions of fiscal projections, including the macroeconomic projections. Since the establishment of the euro, the projections by the government in the Stability Programme for real GDP growth in the following year have been broadly in line with an average of other forecasters (Figure 1.7). Yet, they overestimated actual GDP growth in 10 out of 14 years; the average and median of the projection error has been an overestimation of 1.1 percentage points. Ensuring that the assessments of the fiscal council are an informative counterpart to official macroeconomic and fiscal projections and plans could help to improve their accuracy. To this end, the fiscal council will need to be strongly independent, with well-qualified staff, perhaps including non-Italian members, be adequately funded, and be given the prerogative to investigate any issues it considers relevant to fiscal sustainability. It should be guaranteed access to whatever data it feels it needs to carry out its analyses.

Figure 1.7. **Real GDP growth rates and government projections**



Note: Government projections are from the Stability Programme of the preceding year. Consensus Forecast projections are as near as possible from the same month as the Stability Programme.
Source: Ministry of Economy and Finance, ISTAT and Consensus Forecast.

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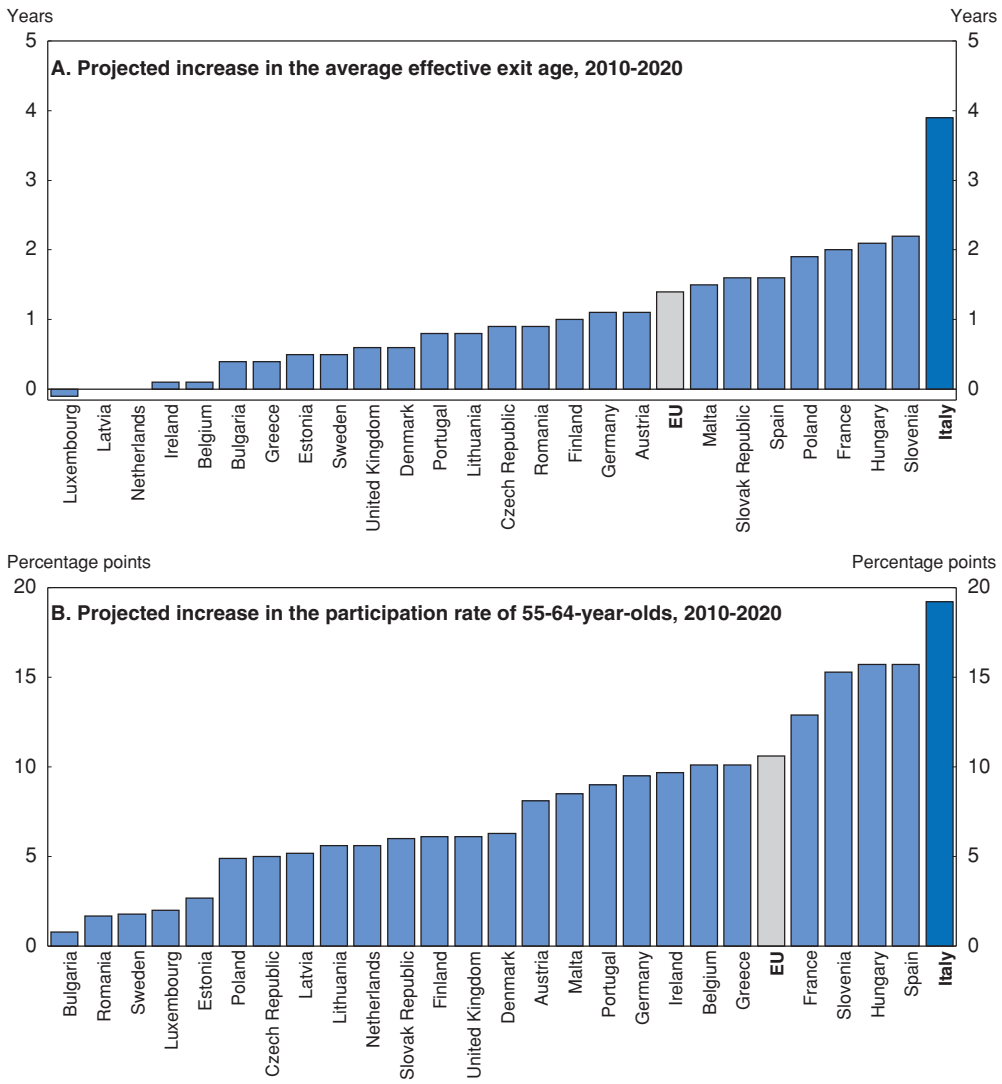
An ambitious pension reform has been introduced, but the effects will depend crucially on the labour market

Public pension expenditure in 2010 was 15% of GDP, exceeding that of any other country in the OECD (OECD, 2012c). Successive governments, in a series of reforms beginning in 1992, have worked to avoid a cost explosion in the long term. The pension system now provides a flexible framework for retirement decisions, with actuarial neutrality at the margin; pensions are related to the actuarial value of contributions and the pension age is linked to life expectancy. Chapter 2 of this *Economic Survey* summarises some of the most recent adjustments. These reforms have helped to stabilise the projected level of pension expenditure relative to GDP. Following measures in 2012 with estimated savings of up to 1% a year during 2020-30, the government projects it to stay below 16% of GDP through the next 50 years, although it will remain high in international comparison. Over the next decade, the main savings will come from a higher retirement age. The average effective exit age from the labour market is assumed to rise from 61 in 2010 to 65 in 2020, a much more rapid increase than in any other country of the European Union (Figure 1.8, Panel A; European Commission, 2012). This would have profound implications for the labour market: by 2020 the participation rate of the 55-64-year-olds is assumed to rise to 57%, a considerable increase relative to the 38% participation rate in 2010 (Figure 1.8, Panel B). The resulting rise in labour supply should have a significant positive impact on potential output in the long run.

The overall impact of the pension reforms will therefore crucially rest on the ability of the labour market to successfully absorb the increase in labour supply into productive employment, particularly over the next 5-10 years. Reliable statistics on age-productivity profiles are scarce, but the productivity of many older workers is likely to be declining between ages 50-65, precisely those for whom employment rates need to rise for the pension reform to be successful. A key issue, then, is whether the labour market is flexible enough to generate wage declines as people extend their working lives. This may be a particularly salient problem in Italy, where the education of workers around age 50 is much lower than that of younger cohorts. In the public sector, for example, wages, together with responsibilities, often increase with seniority; hence a higher retirement age, with no increase in the flexibility of the current wage system, could lead to the government paying workers more than their productivity would justify. Greater use of training policies (OECD, 2011), in the context of a more general move to a more inclusive "flexicurity" system of the labour market (see also Chapter 2 of this *Economic Survey*), and remuneration policies encouraging the alignment of wages with productivity developments through the lifecycle would help to underpin the large rise in the employment of older workers that is currently projected. The authorities are aware of these challenges (which also face most countries with ageing populations) and have taken some steps, but further sustained measures will be necessary.

Figure 1.8. **Projected consequences of the pension reforms**



Note: EU27 is the weighted average of all countries.
Source: European Commission (2012).

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Financial stability

The financial sector had weathered the initial phase of the global financial crisis in 2008-9 comparatively well with the banks, for instance, receiving no large-scale equity support from the government. However, over the past 18 months the banking system has come under increasing stress. Causality has mainly run from fiscal imbalances and the prolonged recession to financial sector problems, contrary to some other countries in difficulty. Granger causality tests by the Italian Banking Association over the sample period from January 2006 to June 2010 indicate that in Italy sovereign risk caused banking risk, while banking risk did not cause sovereign risk, different to some other euro area countries. Although low interest rates in the 2000s fuelled significant credit expansion,

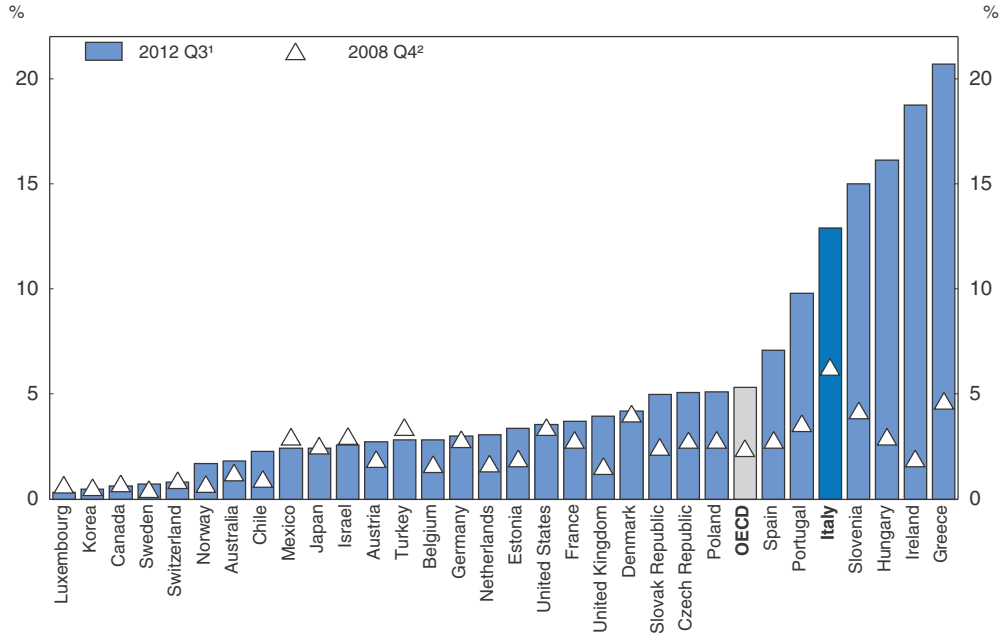
there were no extreme excesses, as was the case for the property markets in Ireland and Spain, for example.

Main catalysts for the increased fragility of Italy's financial sector have been the weakening of real activity, the deterioration of the sovereign debt and the risk of a euro-area break-up. The recession has led to a rise in credit losses and a fall in corporate profits, damaging banks' balance sheets. Banks have been caught up in a negative feedback loop with the sovereign and have faced funding pressures amid increased market fragmentation in the euro area. Foreigners have shed investments and deposits in Italy. Reflecting these developments, rating agencies downgraded many Italian banks, including large and medium-sized banks. For example, Standard & Poor's downgraded 15 Italian banks in early August 2012, several to junk status. Also reflecting these developments, for the past two years the share prices of Italian banks have underperformed relative to those of a broad group of their European peers.

The double-dip recession has reduced banks' asset quality

Two recessions within three years have reduced the asset quality of the banks. The share of non-performing loans in total gross loans has risen to 12%, a high level in OECD comparison (Figure 1.9). Although in some cases the definition for impaired loan classification is not entirely standardised across countries, possibly exaggerating the stock of impaired loans in Italy, this is less relevant for the measurement of new impaired loans, which are also high and rising. Corporate balance sheets have suffered from the decline in

Figure 1.9. **Ratio of non-performing loans to total gross loans**



Note: OECD area is the simple average of OECD countries for which data are available. The definition for impaired loan classification is not entirely standardised across countries, possibly exaggerating the stock of impaired loans in some, including Italy, relative to others.

1. Or latest quarter available. Data for Germany and Switzerland refer to the year 2011.
2. Or the year 2008. For Denmark: 2010 Q4; Israel: 2011 Q1; Japan: 2009 Q3; Luxembourg and United States: 2009 Q1; and Chile and Mexico: December 2008.

Source: IMF, *Financial Soundness Indicators Database*.

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profitability to a 20-year low, and financial expenses now absorb more than 20% of internally-generated resources. Banks' profits are also under pressure from the real estate market, particularly through their exposure to loans to construction firms. Over the five years to mid-2012, the number of house sales nearly halved, and investment in residential construction declined by almost 20%. The re-introduction of a municipal real estate tax on the primary residence, an important component in the government's strategy for budget consolidation, has likely contributed to the depressed housing market.

Indebtedness of the private sector is low in Italy compared with other OECD economies, although its rate of growth since the pre-boom years in 2000 has been relatively high (OECD, 2012a). Non-financial corporations' gross debt-to-GDP ratio in late 2011 was 93% (up from 67% in 2000), just below the euro area average of 97% (79% in 2000). Similarly, households' gross-debt-to-disposable income ratio grew more in Italy than in the euro area as a whole, reaching 80% in late 2011 (up from 45% in 2000), below the euro area average of 108% (85% in 2000). Contrary to some other OECD countries, such as the United States and the United Kingdom, leverage of the private sector has continued to rise since the beginning of the crisis in 2007. The developments of these simple indicators suggest that Italy's financial sector, while traditionally careful in its lending practices, engaged in some significant credit expansion in the run-up to the global financial crisis, which increased its risk exposure, and has not drawn back since then.

Banks have increased their provisions for credit risk, but coverage ratios (the stock of provisions over the total amount of impaired loans) have nonetheless declined. As a consequence, the Bank of Italy (the national financial supervisor) has been intensifying its assessment of the adequacy of provisions, taking into account both aggregate variables (system-wide averages, the outlook for the real economy) and individual variables (composition of loan portfolio, collateral, accounting practices, etc.), and is requiring banks with inadequate coverage ratios to take prompt corrective measures (Bank of Italy, 2012b). These actions are welcome, and the Bank of Italy must continue to ensure that banks increase their provisions against losses and coverage ratios.

Supervisors need to encourage banks to recognise losses as they occur and to develop strategies for the sale, restructuring or write-down of impaired loans. This should support the deleveraging process in the non-financial private sector and force the financial sector to raise new capital some of which would be available for new lending. It might also stimulate economic activity by redistributing losses from debtors with a high propensity to consume to creditors with a lower propensity. Stronger supervisory action may be necessary. The Bank of Italy's inspections have revealed that banks misclassify the status of about 20% of examined loans. Although these 20% include misclassification within the non-performing category and the pool of examined loans is biased toward those more problematic, this is still a large number. The large stock of non-performing loans is a result also of the long processing times in the legal system for loan write-downs. Speeding up foreclosure procedures should thus be an important objective of judicial reform (see also Chapter 3 of this *Economic Survey*).

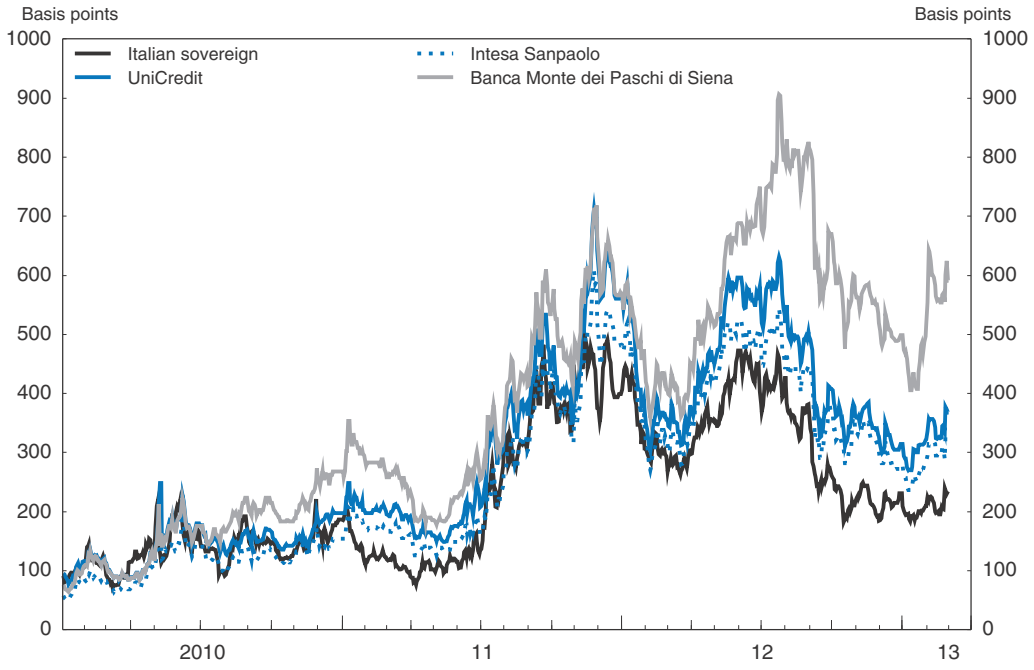
Risks of negative feedback loops between banks and public debt remain large

The sustainability of the public finances and health of the banking system are highly interdependent. The substantial deterioration in the assessment of the quality of Italian government debt since the beginning of the euro area crisis has sharply affected the market assessment of the value of banking sector debt. Credit default swap premia for the

Italian sovereign and the three biggest banks – UniCredit, Intesa Sanpaolo, Banca Monte dei Paschi di Siena – have exhibited strong co-movements (Figure 1.10). The weak situation of the public finances has resulted in increasing banks' exposure to mark-to-market losses on their holdings of government debt, reductions in the value of banks' collateral, credit rating downgrades of banks, and declines in the value of banks' state guarantees. At the same time, financial sector stress has increased the potential liabilities of the government.

Figure 1.10. **Credit default swaps[1] (CDSs): Italian sovereign and Italian banks**

Last observation: 1 March 2013

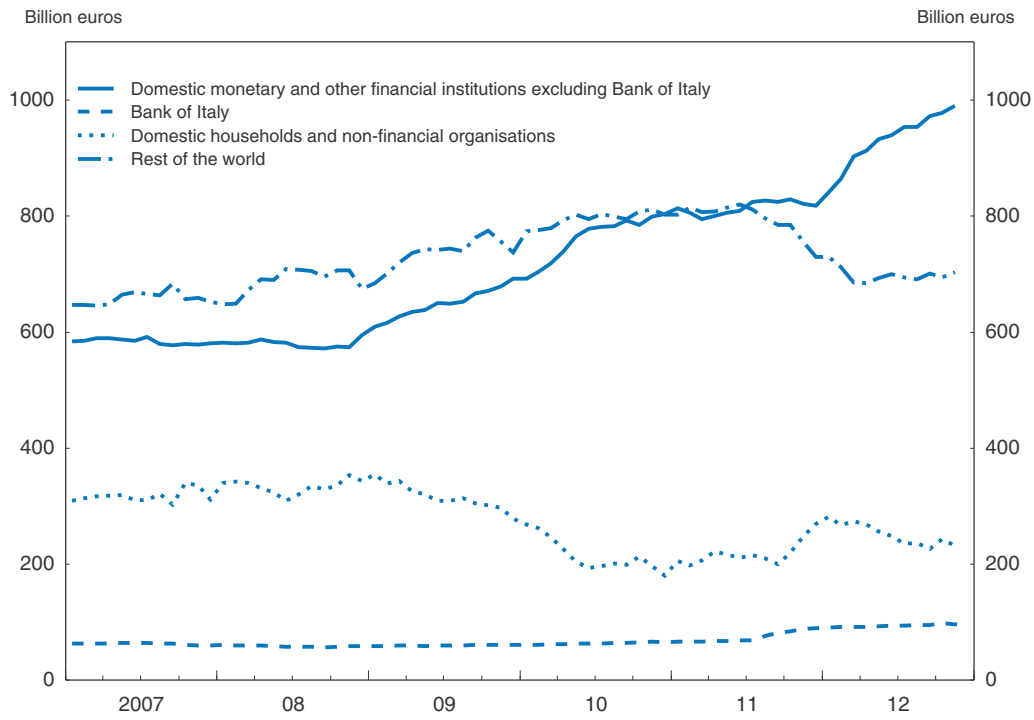


1. Senior 5-year CDS premium (middle spread).
Source: Datastream.

StatLink http://dx.doi.org/10.1787/888932791989

Investment by domestic banks in Italian government debt has significantly risen over the past five years. Since early 2009, domestic monetary financial institutions, excluding the Bank of Italy, have increased their holdings of general government debt from EUR 410 billion to EUR 630 billion, while other domestic financial institutions (such as insurance companies) saw their holdings rise from EUR 200 billion to EUR 350 billion; i.e. for monetary and other financial institutions as a whole (excluding the central bank) holdings rose from some EUR 600 billion to almost EUR 1000 billion (Figure 1.11). Over the same period, domestic households and non-financial organisations as well as foreign investors have maintained similar amounts invested in Italian government debt, although since mid-2011 foreign investors have reduced their holdings, while those owned by domestic households and non-financial organisations have stayed unchanged. Hence, nearly all additional public debt accumulated since 2009 has been financed by domestic monetary and other financial institutions. The increase was particularly pronounced during the first half of 2012, a consequence of the 3-year long-term refinancing operations (LTROs) by the ECB.

Figure 1.11. **Composition of general government gross debt by holders**



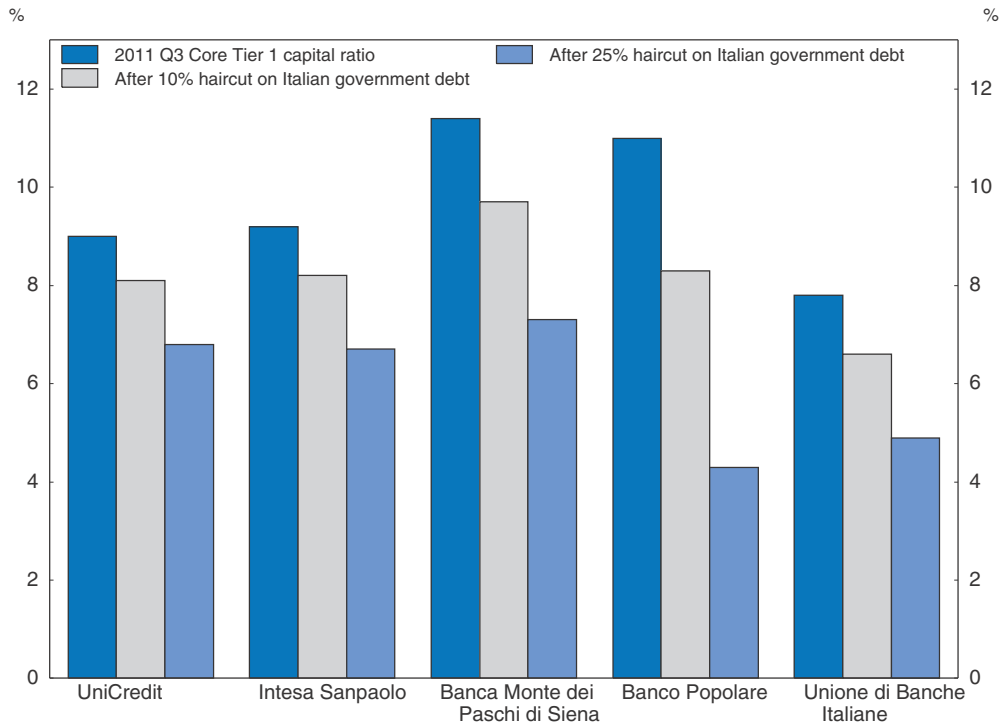
Source: Bank of Italy.

StatLink http://dx.doi.org/10.1787/888932792008

Exposure of banks to debt issued by the Italian Treasury is substantial in terms of their share in total risk-weighted assets and compared with banks' own capital. Calculations suggest that a small haircut, or fall in the market value, of 10% on Italy's public debt would reduce the Core Tier 1 capital ratio of the largest domestic banks by approximately 1-2½ percentage points; a haircut of 25% would lower it by 2-6½ percentage points (Figure 1.12). The numbers indicate how the lower prices on Italian government debt may have impacted Italian banks. With regard to the value of state guarantees, which the government provides either explicitly (through e.g. guaranteed bank bonds; see Grande et al., 2011, and Levy and Schich, 2010) or implicitly (through e.g. the possibility of bail-out), Schich and Lindh (2012) show that they have significantly fallen over the past two years. As the situation of the sovereign has become more tenuous, the likelihood that the government would be able to provide support to ailing banks, should the need arise, has declined.

The problem of the link between the weak sovereign and weak banks could, in principle, be tackled by strengthening the capital positions of banks. Given the banks' difficulty in raising capital in the current environment, however, it is likely that the national government would have to provide some of the extra capital which would probably lead to an adverse reaction in financial markets. Thus, there is little Italy can do on its own to reduce the interdependence between its banks and public debt. Continuing the course of fiscal consolidation and growth-friendly structural reforms, together with firm supervision and regulation of the financial system, would help to improve the

Figure 1.12. **Capital ratio simulations for Italy's top five banking groups**



Source: OECD Secretariat estimates based on SNL European Banks Sovereign Exposure Template v1.

StatLink http://dx.doi.org/10.1787/888932792027

respective strength of the banks and sovereign, thereby limiting the negative consequences arising from their interdependence.

A euro-area banking union would help to break the bank-sovereign interaction in Italy, as in other countries. While the decision in June 2012 to create a common supervisory system for the euro area was a first step, followed up by a more detailed agreement in December, this is unlikely on its own to cut the feedback loop. A full banking union would have to add a common fiscal backstop together with a joint bank resolution regime and a joint deposit guarantee scheme to the already-decided single supervisory system. In the meantime, swift implementation of the decision on direct capital injection by the ESM into troubled banks would sever the links between the banks and the government. A euro-area banking union, plans for which Italy is providing support, may have other implications, however. For example, a central regulator might not look favourably on banks maintaining disproportionate holdings of their national government debt.

The large-scale capital flight has stalled, though not significantly reversed

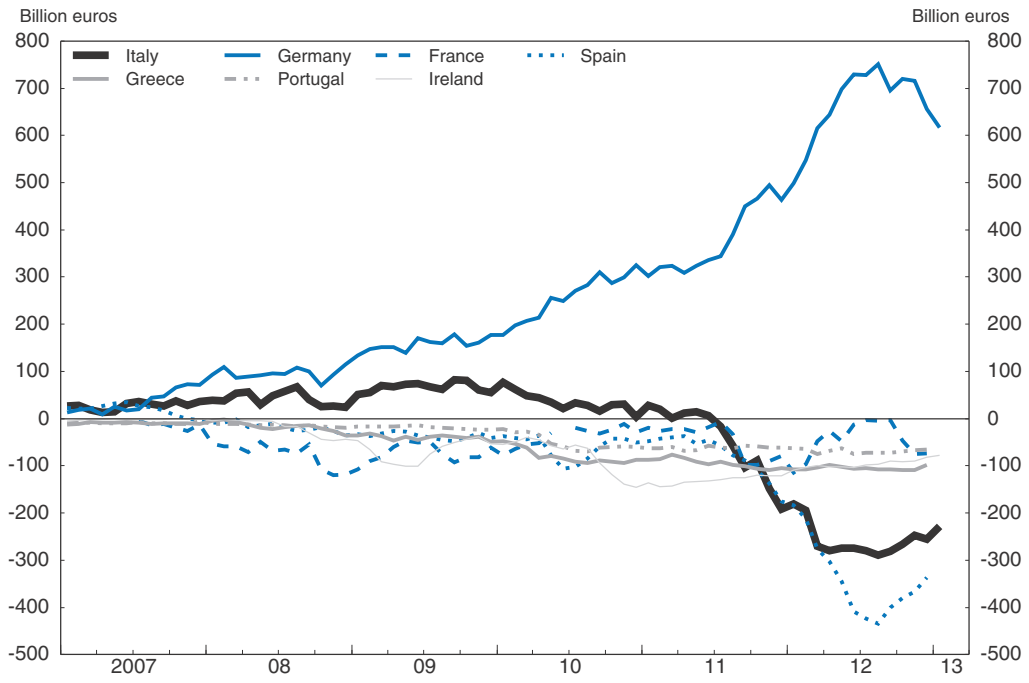
Investor perceptions of the risk of a euro-area break-up, and also according to some observers anticipation of higher taxes, led to substantial capital outflows from Italy to the core countries of the euro area from mid-2011 to early 2012. The size of the capital flight can be gauged by the change in the TARGET2 balances with the ECB. TARGET2 balances represent the net position of each national central bank towards the ECB within the settlement system of the Eurosystem. Changes in TARGET2 liabilities are recorded in the capital account of the balance of payments. An increase in a country's TARGET2 liabilities

can therefore principally arise for two reasons: a current account deficit (with the rest of the euro area) or a deficit on the capital account (with the rest of the euro area) that excludes changes in TARGET2 liabilities (e.g. Buiter et al., 2011).

Figure 1.13 plots the total level of TARGET2 claims for selected euro area countries over time. The increase in TARGET2 claims of the Bundesbank has been mirrored by the increase in TARGET2 liabilities of the national central banks in the peripheral countries. In Italy, TARGET2 liabilities, which were around zero until the summer of 2011, subsequently increased to EUR 290 billion in August 2012, the second highest in the euro area after Spain. The increase was particularly high from October 2011 to March 2012, during the period of the two LTROs.

Figure 1.13. **Net claims of national central banks within the Eurosystem**

TARGET2 balances



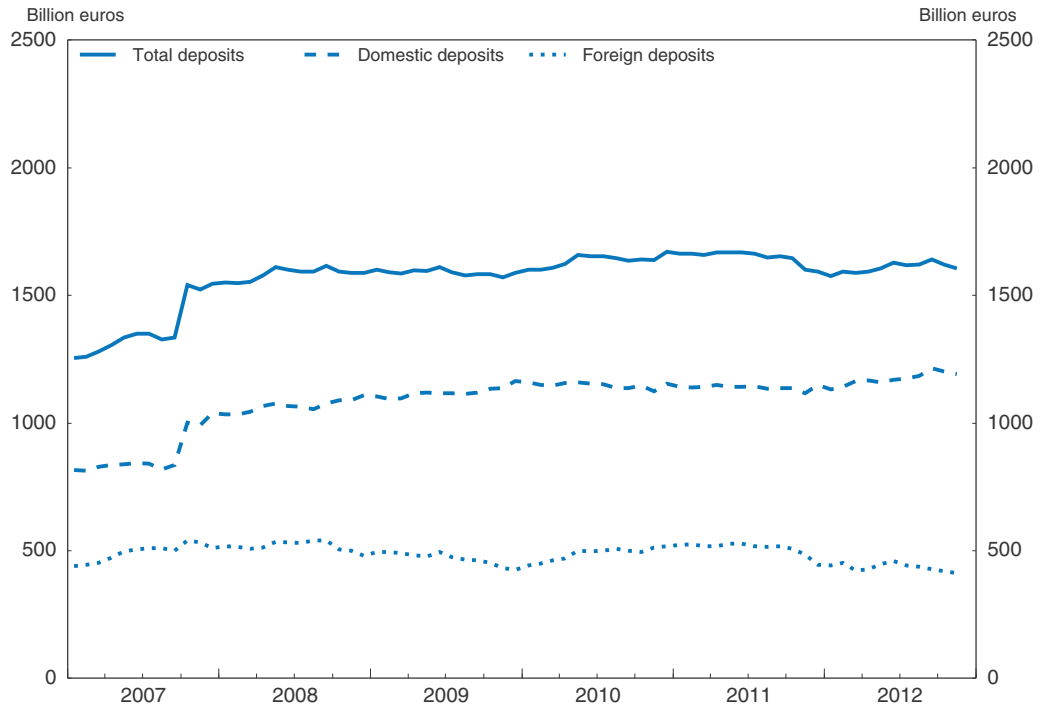
Source: Institute of Empirical Economic Research – Universität Osnabrück (*www.Eurocrisismonitor.uos.de*).

StatLink *http://dx.doi.org/10.1787/888932792046*

Not all of the TARGET2 liabilities reflect capital movements; a proportion may be due to the current account deficit with the rest of the euro area. While those data are not available, current account data with the rest of the world, including the euro area, provide some indicative evidence. From the third quarter of 2011 to the second quarter of 2012, the aggregate current account deficit was only EUR 28 billion, suggesting that it is unlikely to explain most of the rise in TARGET2 liabilities. Using a detailed breakdown of balance of payments data, IMF (2012) estimates the capital outflows during this period to have been EUR 235 billion, approximately equal to 15% of GDP. The capital drain stopped in mid-2012, perhaps in response to the ECB's efforts to reduce the perceived probability of a euro-area break-up, and about 15% of the initial outflows returned from September to November.

Capital flight is partly explained by foreigners withdrawing their deposits in Italian banks. The nominal amount of total deposits in Italy has fallen somewhat since mid-2011. However, whereas domestic deposits have increased over this period, foreign deposits have declined by more than 20% (Figure 1.14). They now account for only about 25% of Italy's deposit base, down from some 35% in 2007.

Figure 1.14. **Domestic and foreign deposits**



Source: Bank of Italy.

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Capital flight is partly a result of some retrenchment within national borders in many European countries. It also reflects some pessimism about future prospects in Italy, however, reinforcing the importance of future governments in Italy continuing to improve fiscal sustainability, structural policies and financial stability. Euro-area wide measures to reduce the risk of Italy exiting the euro area are also necessary. The ECB's determined action in this regard since the summer of 2012, and the euro-area agreement on a single supervisory mechanism seem to have had some positive consequences for the evolution of Italy's TARGET2 liabilities and foreign deposits, whose balances have stabilised since.

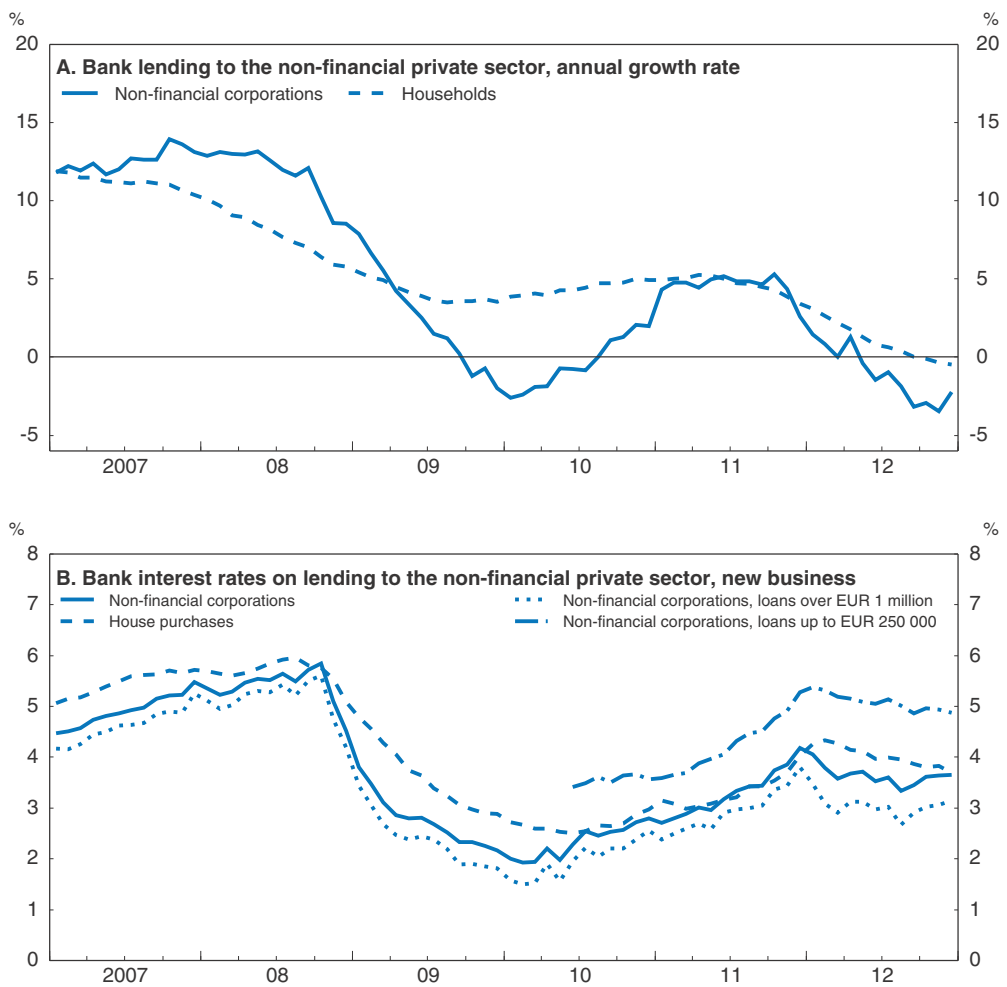
Lending growth to the private sector has been declining sharply

The strains in the financial sector, caused by the weak situation of the economy and the public finances, as well as the tight liquidity conditions and higher capital requirements, have been limiting credit growth. Domestic banks' increased investments in Italian government bonds are likely to have raised the risk of crowding out some of the lending to the private sector. Due also to the fall in credit demand, year-on-year growth rates in bank lending to the non-financial private sector, both non-financial corporations

and households, have fallen significantly since mid-2011 and in late 2012 were negative, and lower than at any time during the 2008-10 crisis (Figure 1.15, Panel A). The contraction in credit has paralleled the steep declines of investment.

Bank interest rates on lending to non-financial corporations and households have broadly mirrored the development of interest rates on government bonds, rising significantly from mid-2010 to early 2012 (Figure 1.15, Panel B). Since then they have eased somewhat, more so for large loans to non-financial corporations than for small loans to non-financial corporations and loans to households. Albertazzi et al. (2012) estimate that a 100 basis point increase in the sovereign spread produces, after one year, an increase of about 100 basis points in interest rates on loans to firms and 80 basis points in the rates for household mortgage loans.

Figure 1.15. **Credit provision to firms and households**



Source: Bank of Italy.

StatLink http://dx.doi.org/10.1787/888932792084

Lower lending is the result of both flagging demand and tight supply. Demand by firms has been affected by the severe falls in investment and consumption since mid-2011, reflecting the unfavourable economic outlook and low confidence. In addition, reductions in inflationary expectations have raised real interest rates, hence have had an effect equivalent to monetary tightening (e.g. Eggertsson and Woodford, 2003). However, the rise of nominal bank interest rates indicates that deteriorating conditions in credit supply have played a major role, too. Supply conditions registered exceptional tensions in late 2011/early 2012, and continue to be restrictive. In the Bank of Italy's Bank Lending Survey conducted in early October, banks related the tightening of supply to the poor economic situation and consequent increase in credit risk. Signals indicate a slight worsening of credit access conditions: the percentage of firms reporting a tightening increased slightly in December 2012, both according to the quarterly survey of the Bank of Italy-Il Sole 24 Ore and the monthly ISTAT survey.

Tight lending has especially affected small and medium-sized enterprises (SMEs). In the surveys by Confcommercio (2012), which have been conducted since 2008, the period since October 2011 has been the first time when more SMEs indicated that their loan applications were either refused or only partially accepted, rather than fully accepted. The impacts on SME lending have been significantly cushioned, however, by the *Confidi*, organisations providing banks with credit guarantees on behalf of their members, largely SMEs. The *Confidi* are supported by public institutions, trade associations and chambers of commerce. There are nearly 600 *Confidi* in all regions of Italy (Leone, 2012), and almost one million SMEs are members of a *Confidi* (OECD, 2012d). The *Confidi* play an important role in reducing asymmetric information between banks and enterprises. In doing so, they help SMEs to negotiate improved lending conditions (e.g. longer-term loans, lower interest rates, less collateral), compared with loans that each SME could obtain on the basis of its own securities only.

Less than 10% of all *Confidi* are currently under the supervision of the Bank of Italy. As a potential form of shadow banking, they need to be monitored. Indeed, strengthening their oversight is one of the G20/Financial Stability Board recommendations for Italy. A legislative framework from 2010 provides for a supervisory regime that divides the *Confidi* into two tiers according to the volume of their financial activity performed (the threshold is not set yet). "Larger" *Confidi* are subject to the same prudential measures as ordinary non-bank intermediaries, including authorisation by the Bank of Italy, while other *Confidi* are supposed to register with a self-regulatory body (the body is not set up yet) and to comply with a set of "lighter" rules. The Ministry of Economy and Finance needs to proceed with defining the threshold dividing the two tiers of *Confidi* and the operational and organisational aspects of the self-regulatory body. A general investigation of the efficiency of the *Confidi* system would be useful as, for example, by continuing to focus on providing collateral to banks, the *Confidi* may reduce banks' incentive to consider more innovative, project-based, financing to support innovation and growth in small firms.

Banks need to make efforts to retain normal market funding

The capital outflows and deterioration of wholesale funding conditions explain why over the past year and a half Italian banks have relied extensively on refinancing operations of the ECB. In the first half of 2012, banks funded more than 6% of their assets by central bank borrowing, compared to just around 1% a year earlier. Corporations, both financial and non-financial, in the euro area are trying to match their assets and liabilities in each country to protect themselves against currency redenomination risks; this keeps liquidity from flowing from the core to the periphery, including Italy. Nonetheless, an

expansion of ECB liquidity cannot be a permanent source of financing. The Italian authorities need to encourage banks to make efforts to retain normal market funding. Indeed, an increasing contribution has come from retail funding over the past year, and the improvement in the sovereign debt situation allowed some banks to issue bonds in September 2012, although the contribution of wholesale funding continues to decline (Bank of Italy, 2012a).

Banks should maintain high levels of capital

Italian banks met the European Banking Authority's (EBA) target of 9% of the Core Tier 1 capital ratio at end-June 2012. In December 2011, the EBA had asked four of Italy's top five banking groups (UniCredit, Banca Monte dei Paschi di Siena, Banco Popolare, Unione di Banche Italiane; Intesa Sanpaolo had no shortfall) to strengthen their capital positions. Of the four, only UniCredit, whose request by the EBA for additional capital was the second largest among all European banks (after Spain's Banco Santander), was able to raise fresh money from shareholders, though with some difficulties. Banco Popolare and Unione di Banche Italiane, rather than raising their capital, mainly shored up their balance sheets through the adoption of internal risk assessment models, authorised by the Bank of Italy, which implied a reduction in the calculation of the risk-weighted assets, not necessarily a sign of strength (Moody's, 2012).

Banca Monte dei Paschi di Siena (MPS), Italy's third largest banking group, required a capital injection by the government of EUR 2 billion to meet the EBA's target in June 2012, bringing the total lent to it by the Italian taxpayer to EUR 3.9 billion. If it is unable to pay the interest on these bonds, the state could become a stakeholder. MPS could not raise capital on its own, partly because of the reluctance of its existing shareholders, in particular the charitable foundation Monte dei Paschi, to accept a dilution of their stakes. In addition, subordinated debt holders effectively did not participate in the loss sharing (Box 1.1). Prior to receiving state aid, the Board of Directors was replaced, and a team from the Bank of

Box 1.1. **The debt swap by Banca Monte dei Paschi di Siena in mid-2012**

On 27 June 2012, Banca Monte dei Paschi di Siena announced it would sell EUR 2 billion of special bonds to the Italian Treasury, thus bringing the total amount lent to it by the government to EUR 3.9 billion. In addition to the new EUR 2 billion loan, the bank asked for its EUR 1.9 billion in Tremonti bonds to be rolled over. On 6 July 2012, the bank announced that holders of EUR 831.8 million and GBP 139.7 million of subordinated debt agreed to a debt swap, where bondholders had been offered senior fixed-rate euro-denominated bonds due in 2015 in exchange for their subordinated ones. Notionally, the holders of these notes accepted a haircut, suggesting that they effectively participated in the loss sharing.

However, in net present value terms the exchange was actually favourable to the debt holders, taking into account that market value of this type of debt was already significantly lower than its nominal value. In fact, the debt swap meant that the holders of subordinated notes became senior creditors which were promised much higher interest rates, effectively compensating for the haircut within the 3-year maturity of the bonds. At the same time, the rollover of Tremonti bonds together with the new government equity injection of capital effectively meant that these claims are now protected by a larger equity cushion. Hence, holders of bank debt experienced effective market value gains in their claims as a result of the government intervention.

Italy closely oversaw operations. Subsequently, in October 2012 Moody's cut the bank's rating to junk status, on the grounds that the bank might have to ask for still more public money, and in January 2013 MPS unveiled additional losses of EUR 220 million as a result of some previous derivative transactions.

The case of MPS exemplifies the complexity of the task involved in banking supervision. As outlined in Bank of Italy (2013), the national supervisor has undertaken a series of measures to guarantee the viability of the bank, yet it could not avert the significant problems that have been building up in the bank. Given the prevailing idiosyncratic and systemic financial sector risks, the Bank of Italy needs to continue to refine the efficiency of its supervisory approach.

The largest five Italian banks all passed the most recent stress tests of the EBA in July 2011. However, in other OECD countries medium- and small-sized banks have been among the most vulnerable institutions during the course of the financial crisis, for example the *Landesbanken* in Germany or *cajas* in Spain. While the Bank of Italy regularly undertakes several exercises to examine the soundness of Italy's banking system as a whole, little official information is available on the health status of individual banks (except the five largest ones). Supervisors should transparently communicate recommendations issued to banks, and conduct and publish stress tests for a larger set of banks than is currently done. Such a more comprehensive approach to banking supervision (which may require co-ordination on the European level) would help to alleviate adverse selection problems among banks and investors, potentially promoting banks' access to capital through the retail and wholesale markets.

Although balance sheet ratios indicate that Italian banks are on average less leveraged than their European peers, the banking sector will need more capital to meet regulatory requirements, to offset ongoing losses, and to support additional lending. The Italian authorities should thus encourage banks to meet their capital needs through raising equity from private sources, by retaining earnings, or by disposing of non-core assets, rather than by restricting lending. The Bank of Italy has broadly followed this approach, for example by asking banks to frame their dividend and executive compensation policies to contribute to achieving the EBA's capital targets.

The ownership structure of many banks, including the largest ones, may constrain their ability to raise new capital. Important shareholders are banking foundations – local, private and not-for-profit organisations (including for tax purposes), supervised by the Ministry of Economy and Finance. Local communities are strongly represented in the governing bodies of the banks owned by banking foundations. The foundations, which rely on the income from their investments in banks to fund local projects, including social and cultural activities, have in the past, like Banca Monte dei Paschi di Siena, often been reluctant to accept a dilution of their voting rights. This may be a problem, as rating agencies attribute the relatively worse performance of some Italian banks to the observation that they are more beholden to foundation shareholders.

Encouraging competition in the financial sector is likely to improve banks' efficiency. There are some signs of inefficiency. For example, the degree of development across a range of financial products (including credit cards, asset management, life insurance, pension funds, mortgages) is lower in Italy than elsewhere in Europe. Also, the number of bank branches has risen over the last decade, despite the sharp increase in telephone and online banking services. As has previously been argued by the Governor of the Bank of Italy

(Visco, 2012), Italian banks must rationalise their distribution networks by making more efficient use of information and communication technologies. One source of additional competition, and capital, might be from abroad, although this is likely to depend on a notable reduction in the market fragmentation in the euro area. In the past, there was some hostility to foreign ownership, and the authorities should ensure that excessive attachment to, for instance, the special position of the banking foundations and the *Confidi* does not hinder potential entrants into the sector.

An important interconnection between the value of banks and public debt is related to the too-big-to-fail (TBTF) status. This reflects the perception that the government would be compelled to support failing banks if they are considered sufficiently large and interconnected to matter for the financial system as a whole and the real economy. Evidence (e.g. Schich and Kim, 2012) suggests that actual resolution practises matter for the perception of the TBTF status. Making failing institutions more easily resolvable and resolving institutions in distress is helpful in reducing these links. Italy has a modern special failure resolution regime for banks (for a brief summary see, for example, European Commission, 2009), and the regime was successfully used in a few high-profile cases in the 1990s.

The regime is designed so as to treat all banks, including those owned by banking foundations, as well as financial intermediaries like the *Confidi*, as if the identity of the owner, as opposed to the underlying capital and solvency and other fitness tests, was not important. In the case of a bank failure, other OECD countries have often avoided the bail-in of subordinated and senior unsecured debt holders. When banks are in distress, the Italian authorities should encourage the involvement of unsecured debt holders in the pre-insolvency loss sharing. Their consequent participation in case of failure resolution is part of the G20/Financial Stability Board recommendations. It would protect secured creditors, depositors and taxpayers, and ensure market discipline in the financial sector.

Banks should be encouraged to adopt specific corporate structures

Financial sector reform efforts present the opportunity to put the financial system on a more stable long-term footing by changing the organisation of banks. In particular, the Italian authorities should consider separating securities businesses from commercial and retail banking to address the TBTF issue by encouraging banks to adopt the non-operating holding company (NOHC) structure (OECD, 2009; Blundell-Wignall and Atkinson, 2012). In this, the parent is a non-operating holding company that raises equity which it invests in separate subsidiaries. The subsidiaries are divided (at a minimum) into: *i)* the retail bank which is a deposit-taking entity, to which deposit insurance and strong capital and liquidity rules apply; and *ii)* the securities businesses which face more limited regulation but have no deposit insurance. The subsidiaries are ring-fenced, so that the parent requires regulatory approval to shift capital and assets between them. While the retail bank's main activities are deposit-taking and lending to households and SMEs and hence its risks are mainly related to the domestic economy, the securities businesses act in global capital markets with highly interconnected counterparties, including the shadow-banking sector.

Adopting the NOHC structure would help to further strengthen the structural resilience of Italy's banking system, although currently consolidation rules by the Bank of Italy already provide some protection against poor capitalisation of subsidiaries. The NOHC has the advantage of preventing the creditors of one subsidiary pursuing the creditors of others in case of failure, thereby eliminating contagion risk. It also removes the cross-

subsidisation of investment banking via the implicit guarantees in the TBTF status. NOHCs have recently been put in place voluntarily in some OECD countries by holding company groups containing a bank. For example, Macquarie Group in Australia, which has a banking license, uses a listed non-operating parent, an operating banking arm, and an operating securities arm (with a large set of listed and unlisted securities businesses), and in the United States General Electric also uses a similar structure.

Box 1.2. **Summary of recommendations to improve fiscal sustainability and financial stability**

Fiscal sustainability:

- Pursue efforts to halt and reverse the upward trend in the debt-to-GDP ratio. This could be achieved with a balanced budget or small fiscal surplus; while additional fiscal tightening would have transitory negative effects on output, it would be rewarded by faster debt reduction and thus lower the risk of renewed financial-market reactions.
- If macroeconomic conditions deteriorate once again, allow automatic stabilisers to work.
- Rebalance fiscal consolidation away from tax increases more towards spending control; spending cuts should be selective, and policy action needs to raise value-for-money.
- Implement the newly-legislated balanced-budget rule and fiscal framework with transparent data and methodology to allow effective monitoring of compliance.
- Establish the newly-legislated fiscal council, giving it full independence, well-qualified staff, perhaps reinforced by non-Italian members, guaranteed access to data, an adequate budget, and freedom to investigate as it judges necessary.
- Follow through on the pension reforms; greater use of training policies for older workers, in the context of a more general move to "flexicurity" (see Chapter 2), and remuneration policies aligning wages with productivity through the lifecycle would help to underpin the increase in the employment of older workers currently projected.

Financial stability:

- Ensure that banks further increase provisions against losses and that they recognise losses as they occur. To reduce the large stock of non-performing loans, speeding up foreclosure procedures should be an important objective of judicial reforms (see Chapter 3).
- Continue to urge banks to make efforts to retain normal market funding and to meet their capital needs by raising equity from private sources, including from foreign stakeholders, by retaining earnings, and by disposing of non-core assets, rather than by restricting lending.
- Promote competition in the financial sector, e.g. through new entrants, including from abroad.
- Publish more detailed information on the health status of individual banks, and conduct stress tests for a larger set of banks than is currently being done.
- Use all bank failure instruments available for banks in distress, and encourage the involvement of unsecured debt holders in the pre-insolvency loss sharing.
- Encourage banks to adopt a non-operating holding company structure to separate securities businesses from commercial and retail banking, thereby addressing the too-big-to-fail issue.

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Chapter 2

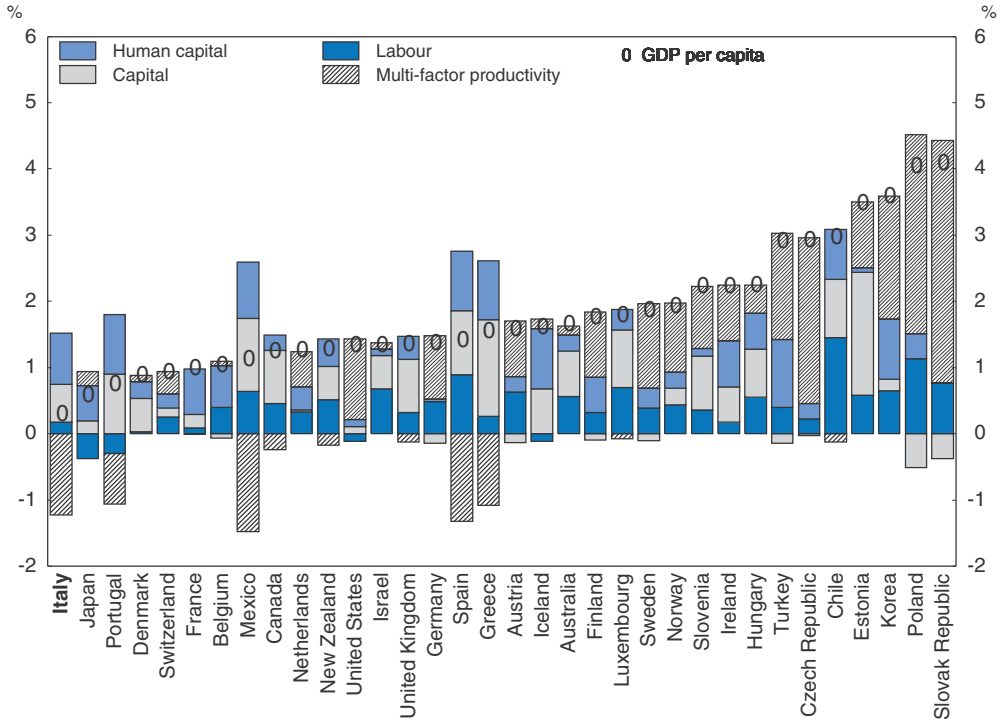
Structural reforms in Italy: Impact and priorities

To lift Italy's economic performance, the government has legislated reform measures in many areas: the pension system, the tax system, product markets, the labour market, the public administration, and the rule of law. These structural reforms have mostly been in line with previous OECD recommendations. They should be fully and consistently implemented. Overall, once implemented, they are expected to have a positive effect on GDP. Among the priorities for the future should be to continue to promote greater competition in product markets, to improve the education system and incentives for innovation, to enhance the inclusiveness of the labour market, and to broaden tax bases through a comprehensive reduction of tax expenditures.

Over the past 20 years, Italy's GDP per capita has fallen behind other OECD countries. This relative decline is largely explained by extremely weak labour productivity growth which has been held back by an unfavourable innovation and business environment and insufficient human capital accumulation. Reflecting this, the contribution of multi-factor productivity to real GDP growth per capita over the decade leading up to 2011 has been negative, at -1¼ percentage points per year (Figure 2.1). During this period, progress to address the weaknesses of the economy had been slow, and frequently resisted and undermined by interest groups. However, over the past one-and-a-half years, the government has taken a series of measures to enhance the growth potential. These measures have mostly been in line with previous OECD recommendations (see Annex for a tabulated overview). They include reforms of the pension system, the tax system, product markets, the labour market, the public administration, and the rule of law. This chapter presents a summary of the most significant reform measures that have been adopted and evaluates their economic impact. It ends with recommendations for the next steps of a

Figure 2.1. **Contribution of production factors to the growth rate of real GDP per capita**[1]

Average percentage change 2000-2011



1. Population aged 15 and over. The growth rate of real GDP per capita is approximated by differencing logs of the levels.
Source: OECD Secretariat calculations.

StatLink http://dx.doi.org/10.1787/888932792103

reform agenda. In particular, while the legislation of reforms has been a major improvement, one important challenge will be their full and consistent implementation, which is necessary if they are to produce results.

The main structural reforms since December 2011

The "technical" government, after having taken office in mid-November 2011, adopted in a first step the *Salva Italia* ("Save Italy") law in December 2011, which mainly consisted of fiscal consolidation measures, including a new round of pension reforms, but also of some growth-enhancing actions, mostly focused on the business environment and liberalisation. Building on these structural reform measures, the *Cresci Italia* ("Grow Italy") and *Semplifica Italia* ("Simplify Italy") laws, adopted in March 2012, had the primary objective of promoting competition in key product and service markets, and further improving the business environment, notably by reducing the administrative burden on firms and citizens. Significant reform actions that followed include the two "development" decrees, the spending review, the labour market reform, and the anti-corruption law. This section provides a thematic summary of the most important reform measures.

Pension system

The pension reform measures in the *Salva Italia* law extended the contribution-based regime to all workers as of 2012, including those who, on the basis of previous legislation, would have received a pension calculated on the earnings-related system. For female workers in the private sector, the statutory retirement age increased from 60 to 62 (63½ for self-employed female workers) as of 2012, and further increases are foreseen in subsequent years to align their age requirement with that for all workers by the beginning of 2018 at 66 years and 7 months. The reform also restructured the rules applicable to early retirement. As from 2012, all workers are able to retire earlier, regardless of their age, if they have accrued at least 42 years and 1 month of contributions (for men) or at least 41 years and 1 month (for women). In addition, starting in 2013, all the requirements for old-age and early retirement, namely the age and the number of contributory years, will be indexed to changes in life expectancy in the three preceding years. The incomes of farmers and self-employed will be subject to higher social contribution rates and those of high-income pensioners to a temporary indexation freeze in 2012-13 and to solidarity contributions.

Tax system and corporate incentives

Revenue measures included: the re-introduction of a municipal real estate tax on the primary residence (IMU, replacing ICI which was abolished on primary residences in 2008) based on cadastral values of buildings; the introduction of a municipal levy on waste and services from 2013 and the simultaneous repeal of related existing taxes; and increased taxation of luxury cars, yachts, helicopters, and aircraft. Labour income taxation of new employees was effectively lowered by allowing the deductibility of the labour component from the regional tax on productive activities (IRAP), with greater deductions in the case of women, workers under 35 and for Southern regions. In addition, higher excise duties were imposed on transport fuels, and a tax surcharge was levied on "tax-shielded" assets. The Stability law adopted in December 2012 provides for an increase in the top rate of the value-added tax (VAT) by one percentage point to 22% in the third quarter of 2013, while leaving the 10% reduced and 4% super-reduced rates unchanged. The Stability law also

provided for the extension of the reduced taxes on productivity-linked wage increases to 2014 and increased tax allowances for families with children.

The introduction of an allowance for corporate equity (ACE), which allows firms to deduct an allowance for new equity from taxable profits, has rebalanced the taxation of debt and equity finance and lowered the effective corporate income tax rate. The two development decrees expanded the capital-raising alternatives of unlisted companies by facilitating their issuing of bonds, commercial paper, profit participation bonds and hybrid capital securities. In particular, like public companies, unlisted companies can now deduct interest on bonds and similar securities and qualify for the exemption of the withholding tax (currently 20%) on the interest. Another objective was to promote the growth of innovative start-ups; that is, newly established businesses focusing on research, development and innovation. Such firms are now exempt from the payment of stamp duties and some administrative fees, and may benefit from tax allowances up to a maximum of EUR 0.5 million for personal income taxpayers, and EUR 1.8 million for corporate income taxpayers.

Product markets

To promote competition in the different product markets, the government took measures in four areas: *i)* strengthening the authority of the Antitrust Agency (AGCM); *ii)* improving competition in network industries; *iii)* reducing some restrictions on professional services; and *iv)* improving competition in retail trade.

The powers of the AGCM have been significantly extended. It can now appeal through the regional administrative court (TAR) against the actions of any public administration at the national, regional or local level violating the principles of competition. To raise the incentives of local authorities to award services through public tender, exclusive contracts for local public service provision in municipalities with more than 10 000 inhabitants have been subjected to a mandatory opinion by the AGCM regarding the existence of suitable and sufficient reasons for assigning such exclusive rights. A judgement by the Constitutional Court in 2012 has, however, interpreted the outcome of a referendum in 2011 to mean that the law should not restrict the ability of local governments to award contracts directly to in-house companies, which could be used to reduce competition.

Another important component of the reforms has been the ownership unbundling of the gas network operator (SNAM) from the incumbent gas operator (ENI), which should create more effective competition and transparency in the market for natural gas. Fuel distribution at the retail level has been substantially deregulated by allowing petrol stations to source part of their supply from producers other than their mother company, removing limitations to self-service at stations outside cities and to locating near supermarkets, and expanding the range of articles that are allowed to be sold at petrol stations. In transport, the *Cresci Italia* law from March 2012 legislated to establish a new independent regulatory authority, to be responsible for highways, airports, ports, taxis and railways both at the national and local level, but it has not yet been created. The surveillance of the water and postal sectors has been assigned to the Energy and Communication Authorities, respectively.

Some restrictions to professional services have been reduced. For example, standard pricing has been eliminated and it has become easier for young people to begin practising, by allowing them to complete part of the compulsory practical training in parallel with

university education. Pharmaceutical distribution services have been enhanced through an increase in the number of pharmacies (one per 3 300 inhabitants), and allowing the sale of certain pharmaceuticals outside pharmacies. On the other hand, the period within which a person inheriting a pharmacy, but who is not enrolled in the profession's register, must sell the property was shortened from 2 years to 6 months, providing members of the register with greater leverage in sales negotiations. An increase in the number of licensed notaries is expected to occur gradually between 2012 and 2014. In December 2012, certain liberalisation measures originally planned for lawyers as part of general measures in the professional services were reversed. For example, their monopoly on legal representation and assistance in alternative dispute resolution (e.g. mediation) has been retained, along with some restrictions on advertising and the ban on contingent fees; the prohibition on the formation of a company with capital held by people who are not members of the lawyers' order is also reinstated. These are backward steps from the perspective of competition in the sector.

In retail trade, the *Salva Italia* law has extended the freedom of opening hours to all shops, not only those located in tourist resorts or artistic cities, and has reduced unjustified restrictions on the exercise of a business activity, such as minimum distances between commercial outlets. Retail regulation is, however, under the competence of the regions, so the implementation of these measures taken at the national level is unclear (see also Chapter 3 of this *Economic Survey*).

Labour market

The labour market reform from June 2012 was built on policy measures in four key areas: *i)* some increase of the incentives to award permanent contracts; *ii)* some re-shaping of the incentives to award fixed-term contracts; *iii)* changes to the apprenticeship system; and *iv)* some rationalisation and expansion of the unemployment benefit system. In addition to these changes in policy itself, a programme of monitoring and evaluation of the changes has been set up, with a view to assessing their effectiveness and considering what further measures may be necessary.

To increase the incentives to hire workers on permanent contracts, some relaxation of dismissal restrictions and simplification of procedures for dispute resolution have been introduced. In particular, the circumstances in which judges can order reinstatement following unfair dismissals have been circumscribed, and the procedures for dispute resolution have been streamlined through the introduction of mandatory conciliation and simplified court procedures for dismissal cases. In addition, the justification for the first fixed-term contract was suppressed, provided that its duration is no longer than one year, which *de facto* creates a probationary period of up to one year that could lead to a permanent contract.

At the same time, the incentives to hire workers on fixed-term contracts have been re-shaped. The cooling-off period between two fixed-term contracts has been extended. In addition, the fiscal incentive for some types of fixed-term contracts has been reduced; in particular, employers will have to pay higher social contributions (+1.4 percentage points) on fixed-term contracts, which can be reimbursed when these are converted into permanent ones (the so-called "stabilisation bonus"). Also, employers will face stricter limits on the use of so-called "atypical" contracts. Tests to re-classify persons as employees who claim to be independent contractors, but who work almost exclusively for one company, have been introduced.

These measures have been complemented by modifications of the apprenticeship system, following an overhaul of the system by the previous government in 2011, to facilitate youth employment. They include a temporary exemption from the payment of contributions for small enterprises hiring apprentices and the introduction of tax incentives for companies investing in training programmes. The overall number of apprentices that an employer can hire has been increased. To be allowed to hire new apprentices, employers will have to take on at least 50% of recent apprentices with permanent contracts.

The reform has also laid out steps towards a more universal unemployment benefit system, which is to be fully phased in by 2017; it intends to extend the pool of workers eligible to standard unemployment benefits. All workers with at least two years of social security contributions and 52 working weeks over the preceding two years will be eligible. Where workers have less than two years' contributions, but have worked more than 15 weeks in the previous year, benefit is available under the same conditions, but its duration is linked to the number of weeks worked over the past year; this provision is particularly relevant for people previously ineligible for any unemployment insurance, such as new entrants and those with discontinuous careers. The new system foresees an increase in the effective level of unemployment benefits; OECD estimates suggest that they would increase the net average replacement rate over the first two years of an unemployment spell from the currently comparatively low level of 22.5% to close to 34%.

Public administration

Measures in the area of public administration were mainly taken in four forms: *i)* the *Semplifica Italia* law; *ii)* the spending review; *iii)* measures to step up privatisation; and *iv)* others to solve the problem of payment arrears by the public administration.

A package of measures in the *Semplifica Italia* law reduced the administrative burden on citizens and businesses through, for instance, wider possibilities to obtain certificates online, fewer controls to start a business and the introduction of a single license for SME's compliance with environmental regulations. Another part of the law concerned the setting up of Italy's Digital Agenda, with the objective of fostering e-government to improve public services and spread digital technology in public places and for public procurement purposes. Some measures also simplified procedures for launching public infrastructure projects.

The spending review has stipulated that government departments must make purchases of several categories of goods using the National Public Procurement Agency (CONSIP). The law also envisages a reduction in the number of civil servants by 10% (20% at the managerial level) through a reorganisation of services, redeployment of employees and phasing out of external consultancies. The envisaged reduction refers to the entire public administration, central and local, agencies, public entities and research centres. Rents paid by the public administration are frozen until the end of 2014 and are then to be renegotiated with a reduction of 15%. The Boards of all provinces were abolished, and in 2012 it was planned to reduce the number of "ordinary" provinces from 86 to 51 by January 2014, with significant cost savings expected. 21 autonomous provinces or provinces in autonomous or special regions, whose powers cannot be altered by central government without changing the constitution, will also have to implement similar reforms. These plans were shelved due to the early elections and the new government will

have to decide how to proceed; according to the 2013 Stability law relevant decisions have to be made by December 2013.

The government expressed a commitment to sell public assets (e.g. real estate and companies) worth 1% of GDP (or EUR 15 billion) per annum starting in the period 2013-15. In 2012, the Ministry of Economy and Finance transferred shares worth about EUR 8 billion in several organisations (SACE, Fintecna, SIMEST) to *Cassa Depositi e Prestiti*, a state financing agency, 70% controlled by the Ministry of Economy and Finance. Further payments are expected in 2013. *Agenzia del Demanio*, the State Property Agency, will establish an investment fund to enhance the value of, and then sell, government real estate, including property belonging to the Ministry of Defence, Municipalities and Local Entities.

Payments due by national, regional and local governments can now be certified through a swift online procedure. Subsequently, companies may either obtain compensation for credits owed in the form of an equivalent reduction in their payables registered on the tax roll as of April 2012, or obtain bank advances in exchange for credits owed.

Rule of law

The government has taken several measures to strengthen the rule of law, primarily in the areas of the judicial system and anti-corruption (see also Chapter 3 of this *Economic Survey*).

To exploit economies of scale for the judiciary, the government aims to reduce the number of courts: 31 (smaller) courts, 220 secondary courts (*sezioni distaccate*) and 667 small claims courts are to be closed. In addition, courts specialised in company law (including competition and intellectual property rights) have been set up and fast track procedures for employee dismissals introduced, with the objective of speeding up case-handling of judicial matters in these areas. Bankruptcy procedures have been restructured to better facilitate the continuation of business activities under "Chapter 11" type procedures. More stringent conditions have been imposed on compensation for excessive length of trials. A trial can last no more than 6 years, of which three in the first stage, two in the Appeal Court and one in the Supreme Court. If it lasts longer, legislation (introduced in 2001) provides for every additional year to trigger a compensation of only between EUR 500-1 500.

To fight corruption, cash payments above EUR 1 000 have been banned, to make it easier to identify undeclared income and fight tax fraud. Cheating the tax authorities, under some circumstances, has been made a criminal offence. Also, *Equitalia* (the agency for collecting unpaid taxes) is to co-ordinate with the National Social Security Agency (INPS) to uncover fraud. Under the provisions of the anti-corruption law, measures were introduced to ban from public offices anyone convicted in final judgement or subjected to judicial measures. The anti-corruption law revises corruption norms and introduces two new offences to combat preferential treatment of private persons by public officials, and increases penalties for managers for doing or omitting acts in violation of their obligations resulting in damages to their company.

The economic impact of the structural reforms since December 2011

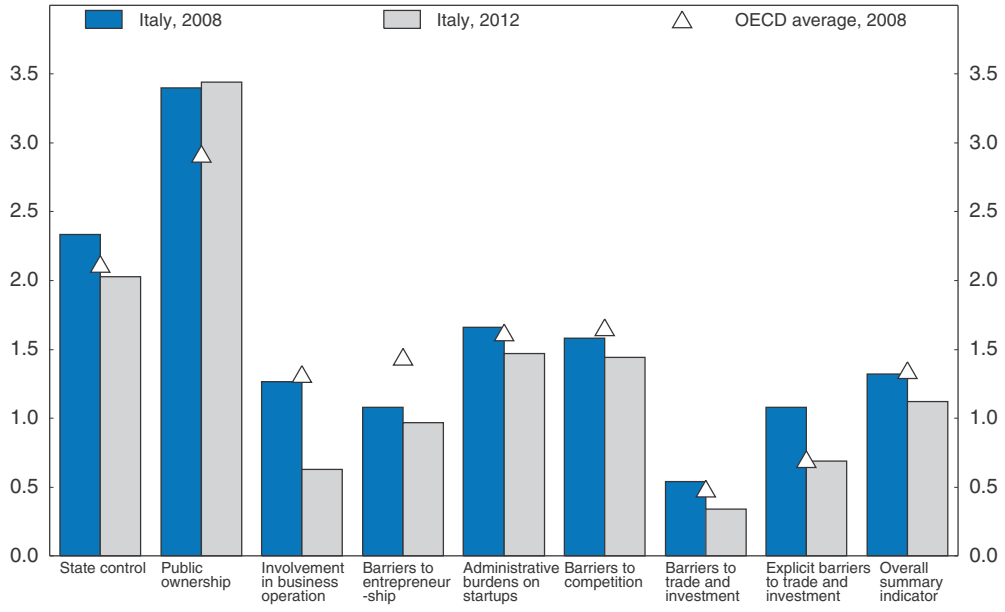
The impact of product market reforms

Product market reforms should increase the productive potential of the economy through three mechanisms. First, with better regulatory procedures, and outright abolition of restrictions on certain activities, reduced costs mean that the resources saved can be used elsewhere, or that some goods and services that were not produced due to restrictions or high costs become available. Second, increased competitive pressure will lower prices in some intermediate sectors, reducing costs for downstream sectors. In Italy, this should be particularly the case for professional services and network industries. For example, simplified regulation of the gas market has brought prices on Italy's spot market down substantially during 2012 to a level more closely in line with those elsewhere in the European Union. Third, stronger competitive pressure should increase the incentive to innovate, increasing not only the level of productivity but also the underlying rate of productivity growth.

A useful method to assess the impact of the measures on the degree of liberalisation in the economy is provided by the OECD's Product Market Regulation (PMR) indicators (Figure 2.2), although, like other indicators, they cannot capture every element of the reforms. The last time they were collected for all OECD countries was in 2008, and they have since been updated for Italy to reflect the situation as of November 2012. The indicators are constructed on a scale from 0 to 6, where 0 is the least restrictive and 6 the most restrictive. Since 2008, there have been significant improvements in the areas of state

Figure 2.2. **Product market regulation, changes since 2008**

OECD Product Market Regulation indicators



Note: Most of the differences between 2008 and 2012 are due to the reforms since December 2011. The PMR indicators do not capture every element of product market regulation.

Source: 2008: OECD *Product Market Regulation Database*; 2012: OECD Secretariat estimates in consultation with the Ministry of Economy and Finance.

StatLink *Note:* To download the data corresponding to this graph, refer to Figure 9.

control, involvement in business operations, and explicit barriers to trade and investment; but for public ownership there has been no real movement. Regulation is now either below or equal to the 2008 OECD average in all areas, with the exception of public ownership. However, such OECD-wide comparisons do not take account of reform measures being taken over the past four years in many other OECD countries. Most of the change in Italy's PMR since 2008 is likely due to the more recent reforms.

The impact of labour market reform

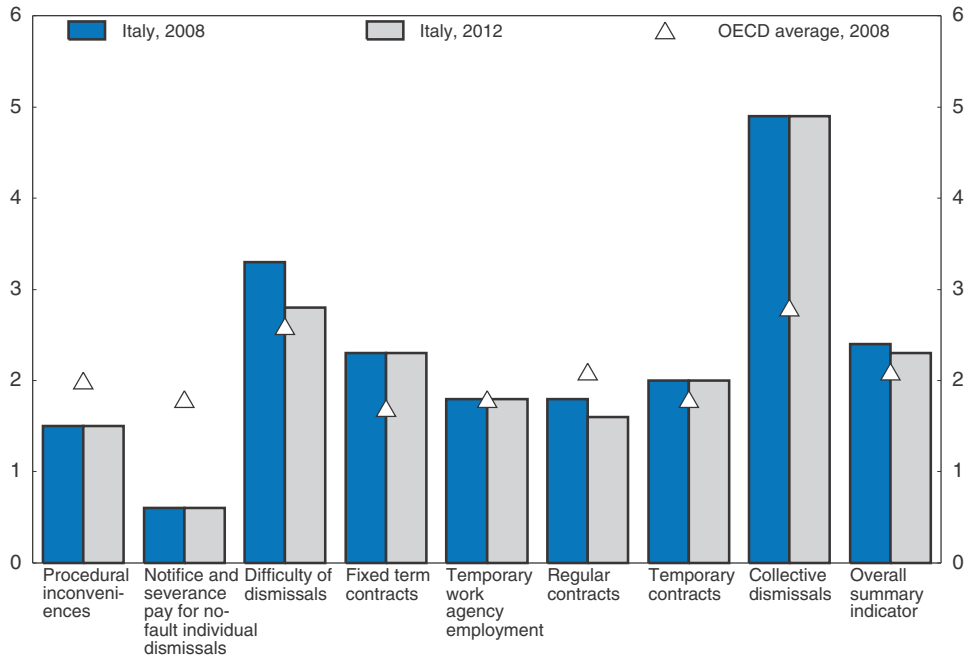
Labour market reform, which comprised steps to rebalance hiring incentives from fixed-term to permanent contracts, modify the apprenticeship system and phase in a universal unemployment benefit system, was the first time that an Italian government has attempted to comprehensively tackle labour market weaknesses. The rebalancing of hiring incentives from fixed-term to permanent contracts should encourage employees to invest in job-specific human capital. The modification of Article 18 of the labour code widens the number of cases in which courts can impose a financial penalty on an employer who unjustifiably dismisses an employee rather than, as at present, requiring outright reinstatement; no monetary compensation is due if the judge finds the dismissal fair. Although this step was politically sensitive, it is unclear how large its impact will be. The interpretation of the new provisions will depend on the courts, employees may bypass them by taking action against their employer on the grounds of dismissal for discriminatory reasons (for which the law is unchanged), and the increased discretionary power of the courts may raise the uncertainty costs for employers and employees. In addition, the financial penalty is high by international standards (the third most generous in the OECD, after Sweden and Turkey), which reduces the effective difference between financial penalty and required reinstatement. The streamlined court procedures for dispute resolution may reduce the effective cost of labour force adjustment.

On the more flexible end of the labour market, the new 1.4 percentage point surcharge on employers' social contributions for fixed-term contracts, while reducing the relative cost of and thereby encouraging permanent contracts, raises the average overall tax on labour, which is already high. Other measures also discourage the renewal of fixed-term contracts. At the same time, it has been made much easier to offer a temporary contract up to one year for a new employee (by removing, in this case, the requirement that all fixed-term contracts should specify why such contracts are being used), which is a useful step, in part because it can be used in effect as a one-year probationary period that could lead to a permanent contract. In other cases, restrictions on the use of "atypical" contracts have been tightened somewhat, notably, in the case of project contracts, by removing the possibility of terminating them early and limiting their use to activities that are not the core business of the firm.

The overall level of employment protection has changed little, when measured by the Ministry of Economy and Finance's estimate of their effect on OECD indicators of Employment Protection Legislation (EPL) (Figure 2.3). The reform reduced the degree of restrictiveness in the sub-categories, "difficulty of dismissals" and "regular contracts", and the small fall in the overall index leaves the level of employment protection after the reform still somewhat above the OECD average for 2008. However, the changes in the EPL index do not capture every element of the reform influencing labour market flexibility. One important element is the pace of the courts in resolving disputes; if the reform succeeds in reducing this, through measures to streamline procedures for dispute resolution, as well as

through the provision of a mandatory conciliation preliminary to the process, the cost of EPL for employers could fall significantly, even though there is only a small reduction in the level of protection for workers. OECD EPL indicators do not pick up the new short-term contract, which enhances flexibility for firms, nor tightened restrictions on the use of project contracts, which restricts flexibility.

Figure 2.3. **Estimated impact of the labour market reform on indicators of employment protection**



Note: EPL indicators are constructed on a scale from 0 to 6, where 0 is the least restrictive and 6 the most restrictive. All differences between 2008 and 2012 are due to the labour market reform Law no. 92/2012. The EPL indicators do not capture every element impeding labour market flexibility, for example, they do not take account of the slow pace of Italy's courts, which effectively tends to increase employment protection and may improve following some measures in the reform. Other changes the indicators do not capture are the fact that legislation has in fact become more flexible for some fixed-term contracts (suppression of justification in the case of the first contract provided that its duration is no longer than one year, creating *de facto* a probationary period of as long as one year) and that, by contrast, legislation has become more rigid on others (in particular for project-work contracts, by suppressing the possibility of termination before the end of the project and imposing that the project must concern activities that are not the core business of the company).

Source: 2008: OECD, *Employment Protection Legislation Database*; 2012: Ministry of Economy and Finance estimates.

StatLink *Note:* To download the data corresponding to this graph, refer to Figure 8.

The impact of the other structural reforms

Pension reform

The measures in the new pension reform have added to the long-term sustainability of the public finances, mostly by increasing the statutory retirement age and linking the eligibility requirements to changes in life expectancy. As Chapter 1 of this *Economic Survey* argues, this approach has been desirable, although, in the absence of additional measures enhancing the demand for older workers, there is room to doubt whether currently the labour market is sufficiently flexible to accommodate declining productivity and wages for workers at higher ages. Unintended consequences of the design of the reform left

130 000 persons (over the period 2012 to 2020), without a pension for a significantly longer period than they had anticipated. In the press these are referred to as "Esodati", although in most cases they are or were laid off by companies managing redundancies through collective or individual agreements for earlier retirement; subsequent legislation provided that the reform will leave their rights as they were on the basis of the criteria in force before the reform.

Tax system and corporate incentives

The re-introduction of a municipal real estate tax on the primary residence has contributed to better aligning the taxation of owner-occupied and rental housing and more generally of real estate with those of other asset classes, such as shares and bonds. It has therefore reduced the distortions in the allocation of capital across assets (although to varying degrees in different municipalities depending on their setting of the tax rate), while at the same time raising the overall taxation of capital. Extra taxes on "luxury" durable goods, including cars, yachts, helicopters and aircraft, are equivalent to higher consumption taxes on these goods, hence they effectively imply further differentiation of indirect tax rates across goods; it would have been preferable to increase the taxation of high incomes directly. The envisaged rise of the standard VAT rate, with no change to the reduced and super-reduced rates, also increases the distortion induced by the reduced rates, where again it would be preferable to use other measures to tackle income inequality. Special deductions of the labour component from IRAP for women, young workers and workers in certain regions, while founded on good intentions, have added to the already large number of tax expenditures, foregone revenue which must be raised elsewhere.

The allowance for corporate equity is an example of a tax exemption with a clear economic rationale: to align the taxation of debt and equity finance, which should promote corporate investment. The experience of Belgium, which introduced an ACE some time ago, is not wholly positive, however. Removing unjustified fiscal disincentives for unlisted companies to issue corporate bonds was also a valuable step forward. The first company making use of this new financing possibility was Guala Closures Group in November 2012. More widespread adoption of corporate bonds would be helped by the support of the banking sector. In general, it remains to be seen to what extent these measures, as well as some others, such as the promotion of innovative start-ups, will improve corporate financing and innovation.

Public administration

The simplification measures, such as those to reduce the administrative burden on citizens and businesses and set up the Italian Digital Agenda, should reduce costs, thereby improving the efficiency of the public administration. As for the reduction in the number of civil servants, so far redundancies of 7 500 places (out of 121 000 in ministries and national agencies concerned) have been identified and must be dealt with by the end of 2014, through early retirement and mobility schemes as well as significant restrictions on hiring. Currently the average age of civil servants is 48 years, and the reform entails the danger of a further ageing of public administration staff. The planned 15% reduction of rents paid by the public administration is supposed to be automatic, although private landlords can terminate the contract if they disagree. Reducing the number of provinces should contribute to a consolidation of sub-national competences, but it may be a long and complicated process. Finally, privatisation will reduce gross debt but not net debt, although it would still be

beneficial if the privatised companies are managed more efficiently. In any case, however, the government has not yet provided details about how privatisation is to be achieved.

Rule of law

The improvements to the efficiency of the civil justice system, to the extent they are attained, should contribute to growth by promoting financial development, private investment and competition. The government expects the amalgamation of courts to result in public spending savings of approximately EUR 100 million per year. More specialised courts and measures to reduce litigation and appeals have the potential to lower the large backlog of pending cases. The introduction of "Chapter 11" provisions in the bankruptcy procedures should allow faster resolution of bankruptcy, reduce the economic losses that arise by increasing the chances of viable parts of business being preserved, and may reduce firms' cost of banking finance (Rodano et al., 2012). The series of measures to reduce corruption should enhance transparency in the public administration and meritocracy in the private sector.

Model estimates of the impact of reforms on GDP

Overall, the structural reforms are mostly in line with past OECD recommendations and, once fully implemented, are expected to have a positive impact on GDP. Several models have been employed to quantify the growth impact of Italy's structural reforms. Simulations usually follow one of two approaches: they are either based on reduced-form regressions (examples: OECD's study by Bouis and Duval, 2011; Aghion et al., 2009), or a dynamic general equilibrium (DGE) analysis (examples: Ministry of Economy and Finance's study by Annicchiarico et al., 2012; Bank of Italy's study by Forni et al., 2010; IMF's study by Kumhof et al., 2010). The first approach relies on historical data to estimate parameters which causally relate GDP growth to certain structural indicators, in particular the OECD's PMR and EPL. Therefore, reforms which change the index for PMR or EPL will impact GDP growth, with the magnitude of the effect given – loosely speaking – by the estimated coefficient times the size of the change in the indicator. The second approach uses a micro-founded model of Italy's economy as the starting point. Reforms are then reflected in assumptions about changes to the values of some of the calibrated parameters, such as wage mark-ups.

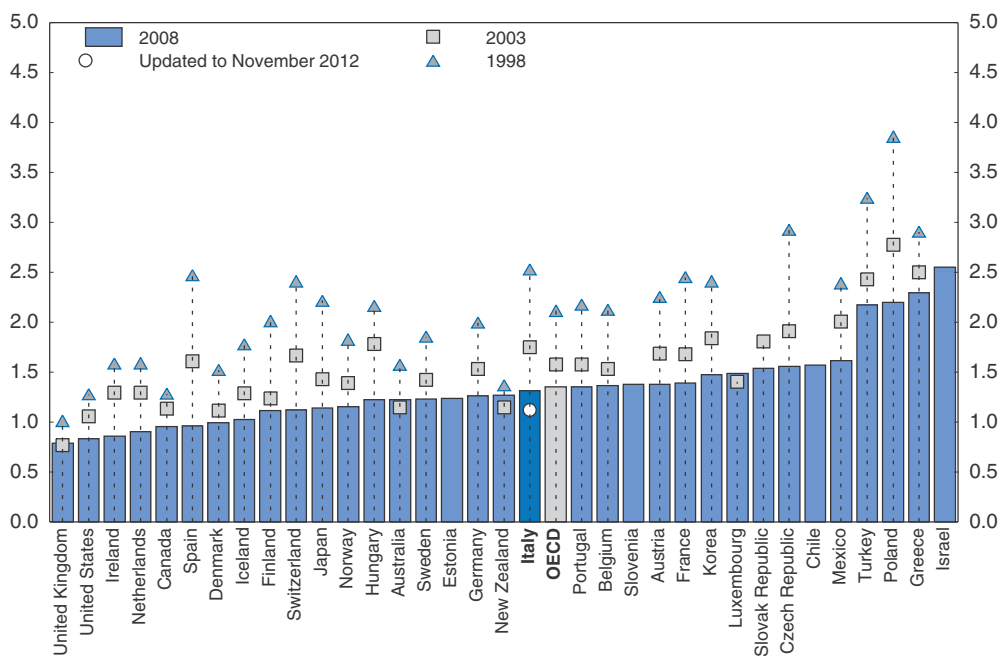
Bouis and Duval (2011) provide a framework commonly used by the OECD (e.g. OECD, 2010) to estimate the impact of product market reforms on GDP. Their study is in turn based on econometric results by Bourlès et al. (2010) who exploit the heterogeneity across sectors within a country in the degree of their reliance on inputs influenced by product market regulation. Regressing sector-specific productivity growth on the sector-specific level of the PMR index, they obtain a (positive) estimate for the impact on productivity growth in sectors more reliant on inputs influenced by product market regulation relative to others of an economy-wide relaxation in product market regulation. Bouis and Duval (2011) use Bourlès et al.'s (2010) relative coefficient to simulate the impact of changes to the PMR index on aggregate productivity growth in the economy.

Simulation exercises based on reduced-form regressions yield quantitative insights about the potential effects of structural reforms, although as with any such model the results must essentially be seen as indicative. There are many methodological and statistical problems in using cross-country data to investigate the impact of such measures. For example, to identify the impact of the PMR on a country's GDP, Bouis and

Duval (2011) rely on within-country (sector-specific) variation in the PMR. By calculating a country-level effect from estimates that are identified using within-country variation, they thus make the implicit assumption that a lower PMR has a strictly positive impact on the productivity growth of all sectors. In particular, this rules out the possibility that a decrease in the PMR index leads to a fall in productivity in sectors that are generally less influenced by PMR (i.e. that lose their relative advantage).

Another caveat is that Italy has experienced a stronger improvement in its PMR over the past 15 years than most OECD countries (Figure 2.4). Yet, so far this improvement has had no discernible impact on GDP growth, suggesting that the average cross-country estimate may overstate the specific effect in Italy relative to other OECD countries. Despite the notable decreases in the PMR index from 2.53 in 1998 to 1.75 in 2003 and 1.32 in 2008 (much larger than the 0.20 decline from 2008 to 2012), the rise in potential output over the subsequent 5-year period fell from 7.5% up to 2003 to 4.6% up to 2008 and 1.3% up to 2013. Hence, at face value, the estimation and simulation results imply that, in the absence of past reforms, Italy's current potential growth rate would be substantially negative. One explanation of the apparent paradox could be that past reforms have not in all cases functioned as was intended by the adopted law (for example owing to slow judicial processes in civil courts, or the dependence of some measures on implementation by sub-national government), which serves to underline the importance of implementing the recent reforms (see also Chapter 3 of this *Economic Survey*). It could also be that the cross-country estimate by Bourlès et al. (2010) bears relatively little validity in the case of Italy.

Figure 2.4. **Product Market Regulation (PMR) indicator: international comparison**



Note: OECD area is the simple average of the countries for which data are available.
Source: OECD, *Product Market Regulation Database*.

StatLink http://dx.doi.org/10.1787/888932792160

With these caveats in mind, the simulation results show that the expected impact on output from the product market reforms that have taken place in Italy is sizeable. Compared with 2008, the PMR index improved from 1.32 to 1.12 by November 2012, reducing it further below the 2008 OECD average of 1.35. The model implies that the 0.20 decrease in the PMR translates into a rise in the level of GDP by 5.5% after 10 years. As previously noted, the improvement measured by the PMR relates to all product market reforms between 2008 and November 2012, rather than only those adopted in 2011-12, although most of the change is likely due to the more recent reforms.

Other estimates, for similar though not identical reform packages, cover a wide range, from 0% to 11% of GDP (Table 2.1). For example, Table 2.1 reports estimates based on Aghion et al. (2009), which found that product market reforms have no impact on GDP growth, unless they are accompanied by labour market reforms reducing the EPL index. Thus, given the magnitude of the changes in the EPL and PMR indexes for Italy since 2008, this model suggests that the recent reforms will have no impact on GDP growth. By contrast, the Ministry of Economy and Finance concludes that the liberalisation and simplification measures adopted in early 2012 (the *Cresci Italia* and *Semplifica Italia* laws) will raise GDP by 2.4% by 2020. Other sources, including the Bank of Italy and the IMF, have estimated the GDP effects of stylised reform packages, rather than of the actual reforms the government has enacted. The same caveat applies to those estimates as above: if their magnitude is correct, they imply that Italy's GDP absent past reforms would have been much worse than the stagnation it has already experienced over the last decade.

Most of the payoffs from the structural reforms will appear only over time, as it will take time for them to be implemented and for their benefits to materialise. Indeed, at the implementation stage they may involve some costs of adjustment. While the current crisis has increased the urgency of supply-side reforms, the depressed level of aggregate demand is likely to restrain their payoffs relative to what would be the case in "normal times". None of the models in Table 2.1 is fully suitable to capture the short-term dynamics of reform. Empirical studies by Cacciatore et al. (2012) and Bouis et al. (2012) argue that, at least in the case of product market reforms, the short-term effects should not depend on the cyclical position of the economy, although it is unclear to what degree their results are applicable in Italy's current situation of a historically large negative output gap.

Numerical simulations relying on an otherwise standard dynamic stochastic general equilibrium (DSGE) model show that in economies, such as the euro area countries, where monetary policy does not respond to changes in one country's inflation expectations, the reduced prices that are the desired result of product and labour market reforms increase the real interest rate, thereby have an effect equivalent to monetary tightening (Eggertsson, 2011). In these models, higher real interest rates thus aggravate the recession and lower domestic demand because people prefer to spend in the future rather than today, as prices are expected to become lower; net external demand would increase, however. Such disinflationary effects can also raise the real value of debt, as has happened, for example, in Ireland where the GDP deflator declined by 13% from its peak, and hold back the deleveraging process (e.g. Eggertsson and Krugman, 2012). Testing these hypotheses empirically is difficult given the historical rarity of the situations. The short-term results in Ministry of Economy and Finance (2012), which are also partially incorporated in the government's macroeconomic projections, rely on the assumption that monetary policy is conducted according to a Taylor-type interest rate rule in which policy parameters are weighted by the relative size of the Italian economy. Strictly speaking, a "weighted Taylor

rule" is used so as to keep into account the more attenuated response of the interest rate to changes occurring in an economy belonging to a monetary union (Dornbusch *et al*. 1998). In this modified Taylor rule the weight is equal to the share of the Italian GDP in the euro area. When this rule is switched off, the model shares many similarities with that in Eggertsson (2011) and does not converge.

To summarise, reforms such as those introduced in 2011-12 should increase long-run potential output, but the magnitude of this effect, especially in the short run, is difficult to estimate with any degree of certainty.

Table 2.1. **Estimates of the GDP impact of structural reforms in Italy**

Source and estimation approach	Reforms to be estimated and their impact on GDP
OECD, based on Bouis and Duval (2011):	
Bouis and Duval's (2011) simulations build, for the effects of product market regulation, on the framework of Bourlès et al. (2010) who run **reduced-form regressions** at the sector-level of multi-factor productivity on the OECD's PMR indicator.	– The set of **all product market reforms in Italy from 2008 to November 2012** increases GDP by **5.5% after 10 years**. Given the small change in the EPL, the GDP impact from the **2012 labour market reform** is **very little**. – A **stylised broad package reforming the product and labour markets, as well as the benefit, tax and retirement systems** increases GDP by **14% after 10 years**.
OECD, based on Aghion et al. (2009):	
Aghion et al. (2009) run **reduced-form regressions** at the country-level of multi-factor productivity on the OECD's PMR and EPL indicators, as well as their interactions.	**All product and labour market reforms in Italy by the "technical" government (autumn 2011-end 2012)** have **no impact** on GDP. Aghion et al. (2009) find that product and labour market reforms may increase GDP only if they reduce both the PMR and EPL.
Ministry of Economy and Finance (2012), based on Annicchiarico et al. (2012):	
Dynamic general equilibrium model (QUEST III), developed by the European Commission and confined to Italy, with monopolistic competition (resulting in mark-ups) in the labour market, the manufacturing sector, and the service sector. Other model frictions include the level of entry costs and the costs of the administrative burden.	– The **Cresci Italia and Semplifica Italia laws** increase GDP by **2.4% by 2020**, with half of the GDP increase realised in the first 4 years. This is the result of a mark-up reduction in the manufacturing and service sectors by 1.8 percentage points, a reduction in entry costs by 12% and a cost reduction of the administrative burden by 15%. – A **stylised broad reform package of the product markets and public administration** closing the competitiveness gap with the best performing countries in Europe increases GDP by **5.0% by 2020**, with 2 percentage points of the GDP increase realised in the first 4 years. This is the result of a mark-up reduction in the manufacturing and service sectors by 4.3 percentage points, a reduction in entry costs by 35% and a cost reduction of the administrative burden by 23%.
Bank of Italy, based on Forni et al. (2010):	
Dynamic stochastic general equilibrium model, confined to two regions (Italy and the rest of the euro area), with monopolistic competition (resulting in mark-ups) in the labour market, the manufacturing sector, and the service sector.	– A **stylised reform reducing the mark-ups in the Italian service sector** to those in the rest of the euro area (or by 26 percentage points) increases GDP by **10.8% in the long run**, with half of the GDP increase realised in the first 3 years. – A **stylised reform reducing the wage mark-ups** in Italy to those in the rest of the euro area (or by 26 percentage points) increases GDP by **9.1% in the long run**. – The Bank of Italy has not published documents estimating the GDP impact of the specific structural reforms legislated since autumn 2011.
IMF (Lusinyan and Muir, 2013), based on Kumhof et al. (2010):	
Dynamic stochastic general equilibrium model, consisting of 6 regions (Italy, rest of the euro area, emerging Asia, Japan, the United States and a remaining countries bloc), with monopolistic competition (resulting in mark-ups) in the labour market, the manufacturing sector, and the service sector.	– Assumes the reforms **reduce the gap in product market regulation between Italy and euro area best practice, and the gap in labour market regulation between Italy and OECD best practice; in each case the gap is reduced by one half**. – The combined package of **product and labour market reform increases GDP by 10.5% in the long run**, of which about four fifths is due to the product market measures.

Recommendations for the next steps of the reform agenda

Implementation

Using fiscal policy to try to kick-start demand is not an option, so the government will have to concentrate on providing framework conditions that favour growth. The first priority is clear, but one that political pressures often make difficult: to ensure that the

reforms already legislated are followed through in a coherent fashion, transparently presented to the public, and consistently enforced. Policy-making must also take into account the dangers of too frequent changes. For instance, policies promoting energy saving and renewables were changed many times during the 2000s with no clear economic rationale, often at excessive cost (OECD, 2011a and 2013). Tax reductions or subsidies aimed at innovation change frequently, the most recent being a complicated system of support for high-technology start-ups introduced in late 2012 (this particular policy is partly experimental, which can be useful provided experiments are rare, time-limited and properly monitored and assessed). The property tax on first homes was abolished in 2008, only to be re-introduced in a different form in 2012. New rules for fiscal federalism were foreseen in a constitutional amendment in 2001, a framework for them was finally voted in 2009, but the details of implementation have yet to be agreed. Judges are supposed to prepare a trial calendar ("calendario udienze") but many of them do not comply. Between 2008 and 2012 there were many modifications of the rules relating to tenders for public service contracts, at least six of which were in laws whose object was simplification.

Uncertainty over the duration of policy measures undermines their impact and argues in favour of fewer, better prepared laws, hopefully reducing the chances that they will need successive modifications. Avoiding the use of tax amnesties is another important example. After a decade in which Italian governments had avoided their use, in 2009 a partial amnesty (the "fiscal shield") was extended to funds illegally held abroad. Such episodes undermine other work being done to improve tax compliance.

Product markets

Priority should be the full implementation of the Liberalisation, Simplification and Development laws. Separation of ownership in the gas industry and the integration of water services in the regulatory structure for utilities, while ensuring its operational independence, should be completed and the new transport regulator should be brought quickly into operation. The transport regulator's head and governing body were to have already been in place by mid-2012, but this decision was delayed and has now been put off until after the 2013 national elections. The government needs to ensure also that the Antitrust Agency uses its new powers actively. Greater competition should be promoted in local public services and in retail and professional services by removing remaining regulatory capacity and fee restrictions.

Network and utility regulators should monitor pricing and impose quality-of-service rules. The rules should also be as stable as possible. When regulating multiple comparable companies (such as local distribution networks) comparative performance can be used. Such a "yardstick" framework, where improved efficiency in the better performers is reflected in the pricing rules, provides strong incentives for efficiency. For example, a system of yardstick competition is part of the framework for regulating privately-run water utilities in the United Kingdom. Media regulation, too, has for some time neglected the issue of competition, with an effective duopoly at the national level between a dominant private broadcaster, whose parent company has significant interests in the printed press, and a large public sector operator. The media regulator, AGCOM, should act to ensure competition among both private and public operators.

The basic principle of competition law and regulation is to promote the interests of consumers and citizens, not those of enterprises *per se*. But regulation is needed in many areas, such as the protection of health and the environment. The trade-offs, for example between pollution and employment opportunities, are difficult, but clear rules and

effective enforcement are necessary: they are sometimes lacking. One case concerns a steel plant in Taranto (one of the largest in Europe). A court has found that evidence from the regional environment administration of serious pollution, and past non-compliance with standards, requires the plant to close, at least temporarily, but the central government disagrees with this decision and has planned a specific decree to allow it to remain open, while giving time for the plant to adjust to environmental requirements.

Education and innovation

The current difficulties of Italy's youth in transitioning from education to employment are worrying: almost one in five young Italians is neither in education nor employment (23% of all 15-29-year-olds). Education has a key role to play to enhance their prospects on the labour market. In particular, the restructuring of primary and secondary education levels has to improve the links from secondary schooling to the labour market and tertiary education. In addition, while the reform of the apprenticeship system has been a useful step, OECD experience shows that more should be done through, for example, increased employer engagement and work-based training to strengthen the vocational education and training systems, facilitating transitions to the labour market. Some steps have been planned to help fill this gap in the Italian system. Pilot projects to create Technical Vocational Centres, linking existing technical and vocational secondary schools training centres and companies, are to be developed, following an agreement in late 2012 between the State, Regions and Municipalities. Pilot projects for the development of non-academic tertiary technical education have led to the creation of a number of Higher Technical Institutes since 2008, which place emphasis on student employability and links, for example through job placements, with companies. So far they are relatively small scale, with some 2 000 students in 62 institutes.

Less than half the students who enter tertiary education eventually graduate, and only about one quarter of them graduate by the theoretical end of their studies. Tertiary graduates aged 25-34 are more likely to be unemployed than those with only upper secondary school, in sharp contrast to most OECD countries, suggesting that the tertiary education system is not preparing students well for the labour market. Despite the 2010 law on university reform providing for changes in governing bodies, recruitment, funding and salaries, more is needed to improve the cost effectiveness of tertiary education, enhance the performance of universities and better bridge tertiary education with the labour market. Essential avenues include incentivising higher and faster completion rates, the rationalisation of courses offered, and greater attention to developing valuable skills for the labour market. As recommended in the previous OECD *Economic Survey* (OECD, 2011a), the currently low level of tuition fees should be progressively raised, along with introducing a system of loans with income-contingent repayments and perhaps family means-tested grants. This would reduce the inequity of giving free tertiary education although its benefits are partly private, better balance the demand for courses (i.e. provide both students and universities with incentives to give more attention to whether courses improve students' earning power), and provide a source of needed funds for universities. Generalising and rationalising selection at entry (theoretically there is none except for certain disciplines such as medicine, but it is increasingly used in practice by other faculties) could also help to improve completion rates and times.

With regard to innovation, several indicators point to weak performance. Business start-up and exit rates are low, limiting the economy's flexibility and innovative capacity. In 2010, gross expenditure for R&D (GERD) was only 1.3% of GDP, or about half the OECD

average, and more in line with the R&D intensity of emerging market economies. At 0.7% of GDP, business expenditure on R&D (BERD) also lags far behind the OECD average. Over the past two decades, many countries have put in place a variety of new incentives and frameworks for enhancing co-operation between industry and universities and other institutions of tertiary education and research, including: career path rewards and incentives; more conducive intellectual property and funding regimes; and programmes supporting various types of industry-academic co-operation, ranging from project-based to long-term strategic public-private-partnerships.

Italy's weak innovation performance partly reflects inadequate framework conditions for entrepreneurship and general impediments to firm growth that have to be addressed. But improving innovation outcomes also requires a better innovation policy mix. A comprehensive simplification and rationalisation of the current multitude of policies supporting innovation would help to strengthen their impact. To improve targeting of government subsidies, R&D tax credits should be more closely tied to the most productive sources of innovation. One approach to do so would be to increase payroll tax incentives, more extensively used in Belgium and the Netherlands for example, which raise the relative demand of high-skilled workers and reduce the risk of firms relabeling non-R&D activities as R&D expenditures. In addition, more weight could be put on selective, rather than automatic, subsidies through grants, loans and prizes, based on competitive, objective and transparent selection, for instance by involving in the selection process independent international experts, as in other OECD countries. Empirical evidence (Colombo et al., 2011) shows that selective subsidies are likely to be more beneficial to new technology-based firms than automatic ones. To avoid misuse of public funds and ensure effectiveness of these policies, monitoring and evaluation are important, and these should be systematically factored into the policy at the design stage.

Labour market

As intended in the legislation, the authorities should monitor the operation of the new legislation and consider what modifications may be necessary for it to be effective. This is particularly relevant for the effects of one of its key provisions, concerned with the slow pace of the courts, which is whether to order reinstatement of a worker whose dismissal is judged unjustified. The legislation reduces the number of criteria justifying such reinstatement and introduces the possibility of ordering a financial penalty instead, which was not previously an option in many cases; the effect of the measure will thus depend significantly on its interpretation by the courts. Among the possible options to improve the regulations would be to increase workers' incentives to give up challenging dismissals by granting them a minimum severance pay subject to the condition that no complaint is filed, as is the case in Germany for example. The minimum financial penalty is high by international standards, suggesting benefits from reducing it over time. Setting it as a function of the length of service would be one way to introduce some increase in employment protection with tenure.

In the medium term, the new unemployment insurance scheme provides the platform for a more integrated set of employment protection and income insurance policies suitable to promote a more inclusive labour market. The objective should be to gradually move towards a more inclusive "flexicurity" system in which employers have flexibility to adjust their labour force, while workers have both insurance against the loss of their jobs and assistance in retraining for and finding new ones. For example, this will be important to

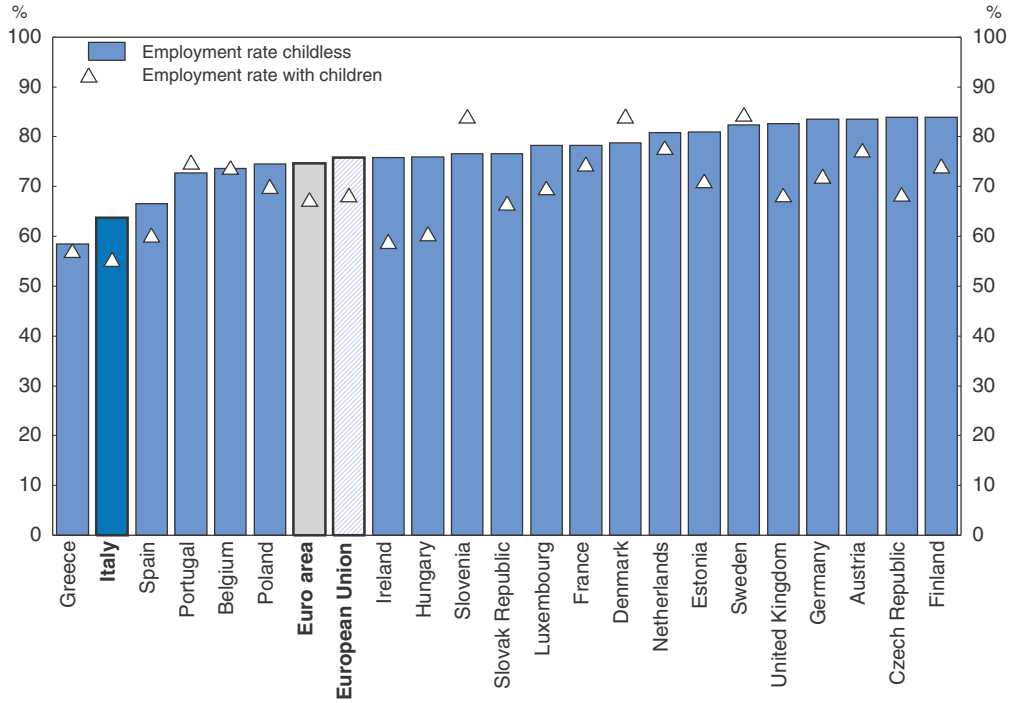
ensure the success of the pension reforms. Greater use of training policies and remuneration policies encouraging the alignment of wages with productivity developments through a person's lifecycle, rather than allowing wages to increase with seniority, will be necessary to enhance the demand for older workers (OECD, 2011b).

Perhaps the most difficult part of the reform will be to build up more effective institutions to both support and provide incentives to job search. This includes training and job-search institutions, under the competence of regional governments, and co-ordinating this with the provision of unemployment benefits which are administered by INPS. Other OECD countries, including France and Norway, have found it useful and necessary to bring social insurance, job-search facilities and training providers together in "one-stop shops". Their experiences have shown that such a merger will take some time. Attention to governance, to ensure both co-ordination and effective performance incentives, is important, and some experimentation can be a good way to find the best approaches in governance and in giving the right incentives to workers and job-seekers.

Italy is characterised by a comparatively low participation of women – with or without children – in the labour market (Figure 2.5). To a significant part, this is due to their role in the provision of care functions, reflecting cultural and social traditions. Greater female labour force participation could, however, help to mitigate the pressures stemming from population ageing and lift real household incomes, stagnant over the past decade. Affordable and effective solutions are available, drawing from best practices and lessons in other countries.

Figure 2.5. **Female employment rates**

Percentage of women aged 25-54 (childless/with children under 15), 2011



Note: Euro area and European Union are weighted averages of all countries.
Source: Eurostat, European Union Labour Force Survey.

StatLink http://dx.doi.org/10.1787/888932792179

In 2011, only 55% of Italian mothers with children aged less than 15 were employed, the second lowest among the European countries of the OECD for which data are available. Partly, this reflects a lack of childcare options. In 2009, public spending on families with children stood at 1.6% of GDP, well below the 2.4% OECD average. In addition to childcare, many women also provide care to elderly relatives. The availability of affordable and good quality care services plays a key role in the decision to work and thus needs to be strengthened. The funds recently allocated to raise coverage and quality of childcare services in the South have been a move in this direction.

Several other policy options could contribute to reducing the barriers for women to participate in the labour market. Lowering the effective tax rates on second earners, currently among the highest in the OECD, would reduce work disincentives. Italy might also consider granting an exclusive right to part of the parental leave to fathers, as has been done in Iceland, Norway and Sweden, to achieve a more equal division of paid and unpaid work. Increasing the flexibility of workplace solutions is another vital element; working-time flexibility and teleworking could be promoted among employers, as an alternative to part-time employment.

Tax system

Significant reductions in the overall tax level cannot be made yet, but reforms can improve efficiency without losing revenue. Among the most important avenues for reform are the 720 tax expenditures currently in place (Ministry of Economy and Finance, 2011). Some are intended to ensure that the tax regime reflects redistributive and other economic considerations, such as the newly-introduced allowance for corporate equity which has the objective of equalising the tax treatment of equity with debt finance, and are thus a core part of the regime. Others, however, lack justification. The 10% reduced and 4% super-reduced rates of VAT, for example, are a poorly targeted way of achieving distributional objectives. It would be more efficient to reduce direct taxes on low-paid workers directly. The implied revenue foregone through the reduced rates is equivalent to some 2.5 % of GDP.

Many tax expenditures are aimed at supporting companies. For instance, "project bonds", intended for financing companies undertaking public infrastructure projects are subject to the same tax advantages as direct government debt. Companies hiring specific kinds of workers and/or in specific regions will be exempted from part of IRAP. Of dubious overall benefit (since they have to be financed by higher taxes elsewhere), these measures are likely to attract creative accounting so as to benefit from the deductions without any real change in behaviour. Unless such company support schemes can be structured to be received only when they genuinely promote a desirable outcome, they can easily be a waste of money (Giavazzi et al., 2012). For example, studies on one programme of innovation and R&D incentives through the Fund for Innovation and Technology (*Fondo per l'Innovazione Tecnologica*) have shown that the innovation behaviour of companies that, by chance, were unable to access the Fund was statistically no different from similar companies that did access the Fund.

Eliminating tax expenditures with no clear economic justification would, by widening the tax base, allow marginal tax rates to be reduced in a revenue-neutral reform. An early target should be to reduce the labour tax wedge on low-paid workers, which is higher than in all but four or five OECD countries (France and Germany are among those with higher rates), especially for second earners, and likely a contributory factor to the low female participation discussed above. A comprehensive reduction in tax expenditures would also reduce administrative costs, by making enforcement of tax compliance simpler and cheaper. Future tax measures should generally follow the advice of IMF (2012) in its favourable assessment of

the draft framework law for tax reform, notably fostering predictability and transparency, clarifying and limiting the role of the criminal law in tax assessments, and strengthening the new real estate tax with up-to-date and fairer valuations.

Box 2.1. **Summary of recommendations for structural reform priorities**

Product markets:

- Complete the implementation of the Liberalisation, Simplification and Development laws, ensuring that the transport regulator is set up rapidly. The Competition Authority should use its new powers actively and it and regulators must remain operationally independent from the political process.
- Ensure that the Antitrust Agency has effective powers to carry out its mandate to monitor regulatory actions.
- Move further to remove remaining regulatory capacity restrictions in retail and professional services, and promote greater competition in local public services, as well as in television and other media. Reconsider some backwards steps, notably those limiting the expansion of competition among lawyers.

Education and innovation:

- Improve the vocational education and training system through more employer engagement and work-based training to better bridge the transition from education to the labour market.
- Enhance the performance and cost effectiveness of universities by incentivising higher and faster completion rates, rationalisation of courses offered and greater attention to developing skills for the labour market.
- Progressively raise the level of tuition fees covering a larger proportion of costs, along with introducing a system of loans with income-contingent repayments and perhaps family means-tested grants.
- Simplify and rationalise current innovation support policies, tie R&D tax credits more closely to the most productive sources of innovation, and put more weight on selective subsidies, including through competitive grants, supported by systematic evaluation and assessment of their impact.

Labour market:

- As provided for by the law, monitor the operation of the revised regulations and judicial arrangements of the labour market reform, and consider modifications if they do not have the desired impact.
- Consider lowering the minimum monetary compensation for unfair dismissal, and setting it as a function of the length of service.
- Move gradually to a more inclusive labour market system which provides employers with more flexibility to adjust their labour force, while improving employability with more support for job search and training. Co-ordinate the action of the National Social Security Agency (INPS) and regional training and job-search agencies.
- Within overall budget constraints, increase the supply and coverage of childcare, promote working-time flexibility, and consider redistributing part of the parental leave right to fathers.

Tax policy:

- Broaden the tax base by reducing tax expenditures comprehensively, allowing reductions in marginal tax rates on labour, especially on second earners.

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Chapter 3

Policy implementation: Legislation, public administration and the rule of law

OECD indicators of structural policy show that policy changes in Italy since 1998 should have improved the environment for entrepreneurship significantly, but in the same period its economic performance has deteriorated noticeably. This may be partly because there is a difference between policy measures intended by the government or parliament and their impact on the business environment perceived by entrepreneurs. There is no certainty as to what are the main culprits, but a number of policy steps would help to improve the situation. These include better thought out and better written legislation and implementing regulations, more use of performance-oriented management in public administration, and further streamlining and reduction of incentives to procrastination in the judicial system. Legislative simplification and transparency will increase economic efficiency in themselves, while also making a contribution to reducing the incentives and opportunities for corruption and organised crime to flourish. Clear operational independence with accountability is essential for bodies monitoring and assessing the extent of corruption.

OECD indicators of product market regulation ("PMR indicators") show that Italy's structure of regulation evolved significantly between 1998 and 2008. Regulation has improved not only in absolute terms, but it has also moved from being much stricter than the OECD average, and therefore likely to be relatively unfavourable to growth, to a level somewhat lower than average. Other things being equal, such an improvement should give a strong boost to per capita GDP, especially relative to other countries. But per capita GDP rose more slowly in the decade up to 2007 than in any decade since the second world war, losing ground to most of its trading partners. Currently, following the renewed recession, per capita GDP is lower than it was in 2000.

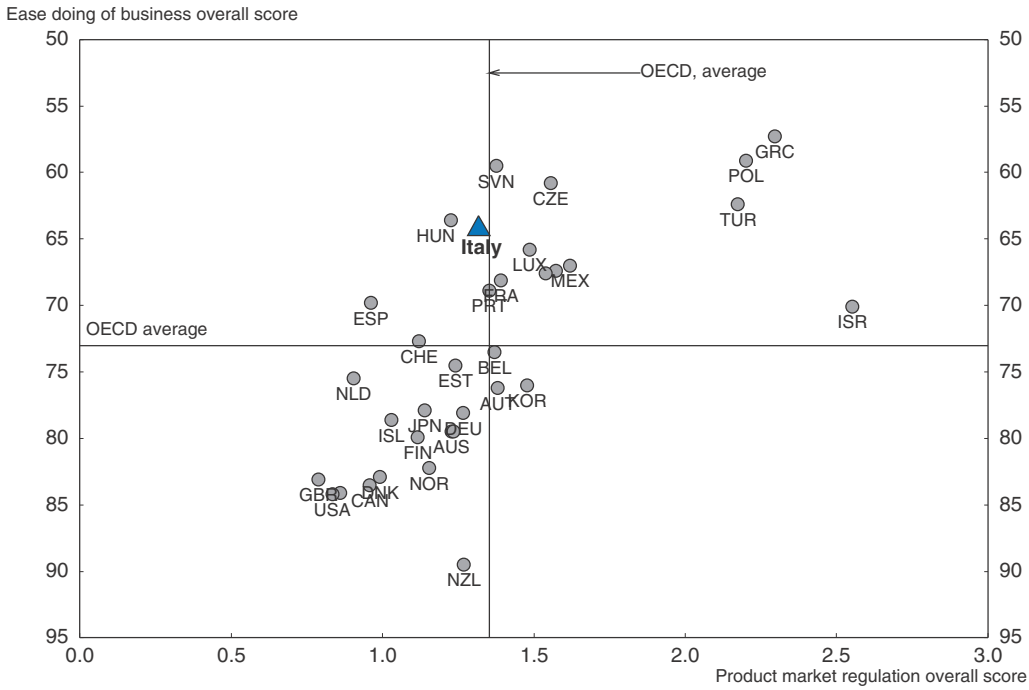
A first observation is that the structure of regulation in practice may be more restrictive than it appears formally. Possible reasons for this vary from the legislation itself, through to the operation of the public administration and to corruption and crime. In most cases, quantifying either these factors themselves or their impact is very difficult. Some will affect growth through undermining economic legislation and some may have a more direct impact on increasing the costs of economic activity. This chapter looks at the ways in which the explanation for this disappointing performance may lie in various aspects of governance, either through direct effects on firms or workers, or perhaps by fostering a gap between intentions and practice in regulation.

Regulation in practice may be less growth friendly than intended

This poor long-term growth is a puzzle if the improvement in PMR indicators reflects a genuine improvement in framework conditions for growth, as OECD research suggests is the case (Nicoletti and Scarpetta, 2003; Bourlès et al., 2010). Assuming that the PMR indicators are as accurate for Italy as for other countries, either productivity in Italy was on track to have fallen considerably in the absence of the policy improvements behind the indicators, or some mechanism is at work that prevents the policy measures having the desired effect. The PMR indicators are compiled from very detailed questionnaires completed by officials in relevant ministries in each country. They are also cross-checked for internal consistency and, though they cannot be linked with specific legislative action, checked for plausibility with known legislative action. There is no reason to suppose they are less accurate for Italy than for other countries.

Other indicators of business conditions present a different picture of Italy's relative position. An important example is the World Bank "Doing Business" survey (see *www.doingbusiness.org*).[1] A large part of Doing Business uses the same type of data as PMR (although they overlap precisely for only two specific indicators), based on laws and regulations as written, though PMR is very much more detailed. Some aspects of Doing Business are different, since most indicators are also based on the cost of and time taken for stylised business operations; it also includes a measure of the efficiency of courts. Generally there is a reasonable correlation between countries' scores on the overall Doing Business indicator and their scores on the OECD PMR indicators (Figure 3.1).

Figure 3.1. **Italy scores relatively weaker on "Doing Business" than on OECD regulatory indicators**



Source: OECD *PMR Database* and World Bank, Doing Business.

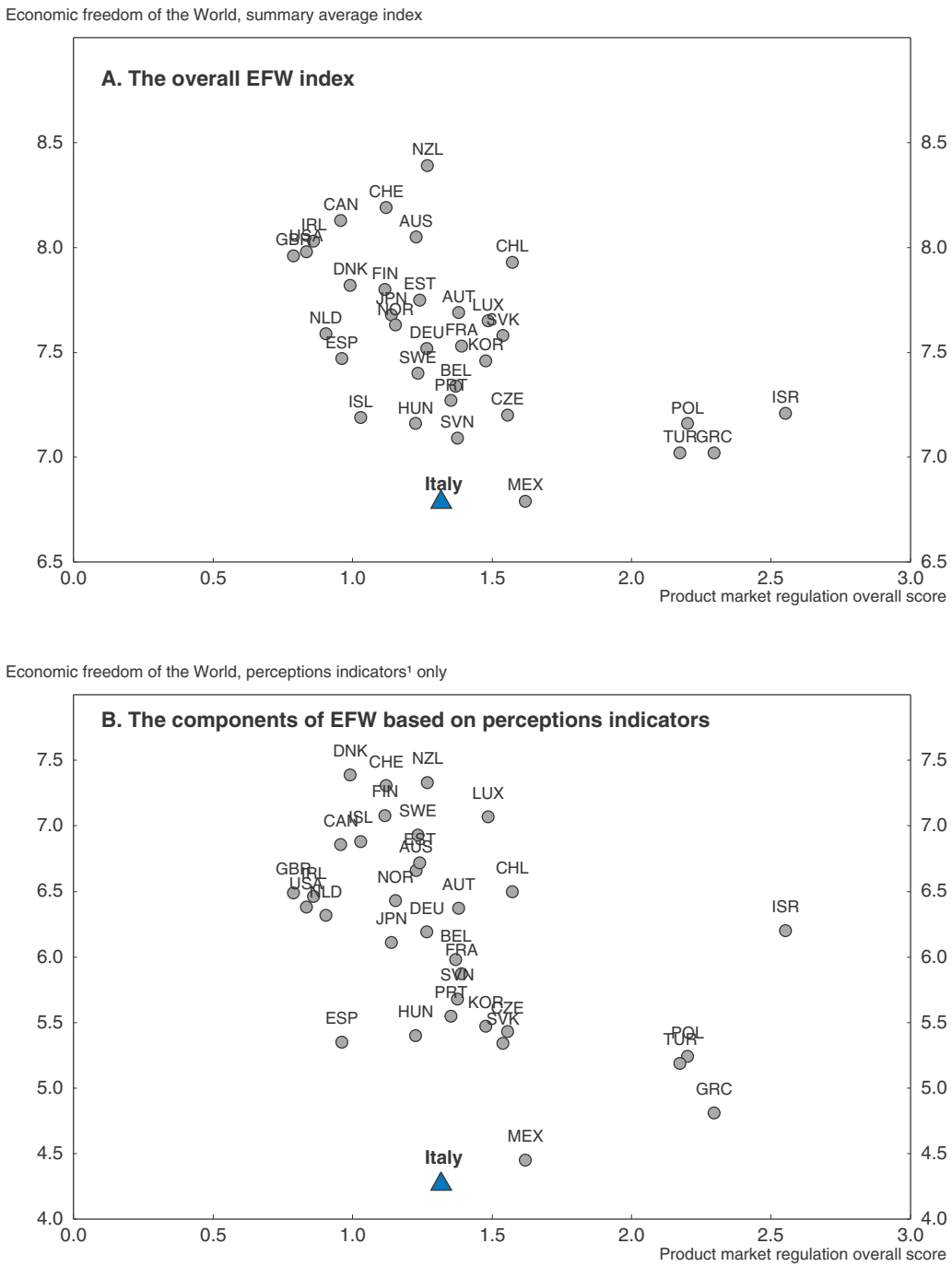
StatLink *Note:* To download the data corresponding to this graph, refer to Figure 11.

Along with Slovenia, Spain, Hungary and the Czech Republic, Italy's Doing Business score for 2008 implied that it was less business-friendly than the PMR indicators suggested should be the case. In terms of ranking, the difference is more marked: while Italy was somewhat below (better than) the OECD average according to PMR indicators, it was the 7th worst according to Doing Business. According to Doing Business 2013, Italy's score has improved since 2008 but other countries have improved more so that its ranking among OECD countries has slipped to 3rd worst, though with a score little different from Hungary and Luxembourg. The PMR indicators are not updated every year so data after 2008 are not available (an update for 2013 will be available during 2013).

A second comparison is with the "Economic Freedom of the World" (EFW) index from the Fraser Institute. This is a compilation of indicators, partly from other sources, including some from the World Bank,[2] and partly from a survey of business perceptions of various issues. The questions are largely about whether business perceives different types of regulation as a restraint on entrepreneurship (Fraser Institute, 2012; methodological annex: *www.freetheworld.com/2012/EFW2012-app.pdf*). Apart from its reliance on perceptions, which may be difficult to standardise across countries, some of the assumptions might be questioned. For example, size of government, measured from national accounts statistics, is treated as in itself reducing economic freedom. But precisely because it uses a lot of perceptions data it is interesting to compare it with the strictly formal approach of the PMR indicators. The overall EFW index shows a somewhat less strong relationship with PMR than in the case of Doing Business, but nevertheless still quite similar (not surprisingly since the EFW index includes a number of items from Doing Business) and Italy is an outlier in the same way (Figure 3.2, upper frame). Limiting the comparison to the components of EFW which are

based on perceptions, the positions of many countries change somewhat, but the overall pattern remains the same, notably with Italy as an outlier (Figure 3.2, lower frame).

Figure 3.2. **Perceptions indicators rank Italy lower than regulatory indicators**



Note: The EFW index is on a scale of 0-10, where higher scores indicate less restraint on business, whereas product market regulation, on a scale of 0-6, is interpreted the other way round, higher scores indicate more restraint.

1. Simple average of 2A, 2B, 2C, 2H, 2I, 4.B1, 4.D1, 5.B2, 5.B3, 5.C1, 5.C2 and 5.C4 (see Fraser Institute (2012)).

Source: OECD *PMR Database* and Fraser Institute (2012).

StatLink http://dx.doi.org/10.1787/888932792217

A final set of indicators is provided by the Global Competitiveness Index of the World Economic Forum. This ranks Italy 42nd, below most OECD countries. The country does well in some indicators of private sector performance, producing goods high on the value chain with one of the world's best business clusters (ranked 2nd). But it displays some institutional weaknesses, including high levels of corruption and organised crime and a perceived lack of independence within the judicial system (World Economic Forum, 2012).

These different perspectives appear to corroborate what anecdotal evidence and popular opinion often suggests: that in Italy there is a gap between what legislation says, or policy intentions, and the actual framework for business and that this gap is larger in Italy than in many other countries.

There are many possible explanations for a gap between policy intentions and outcomes

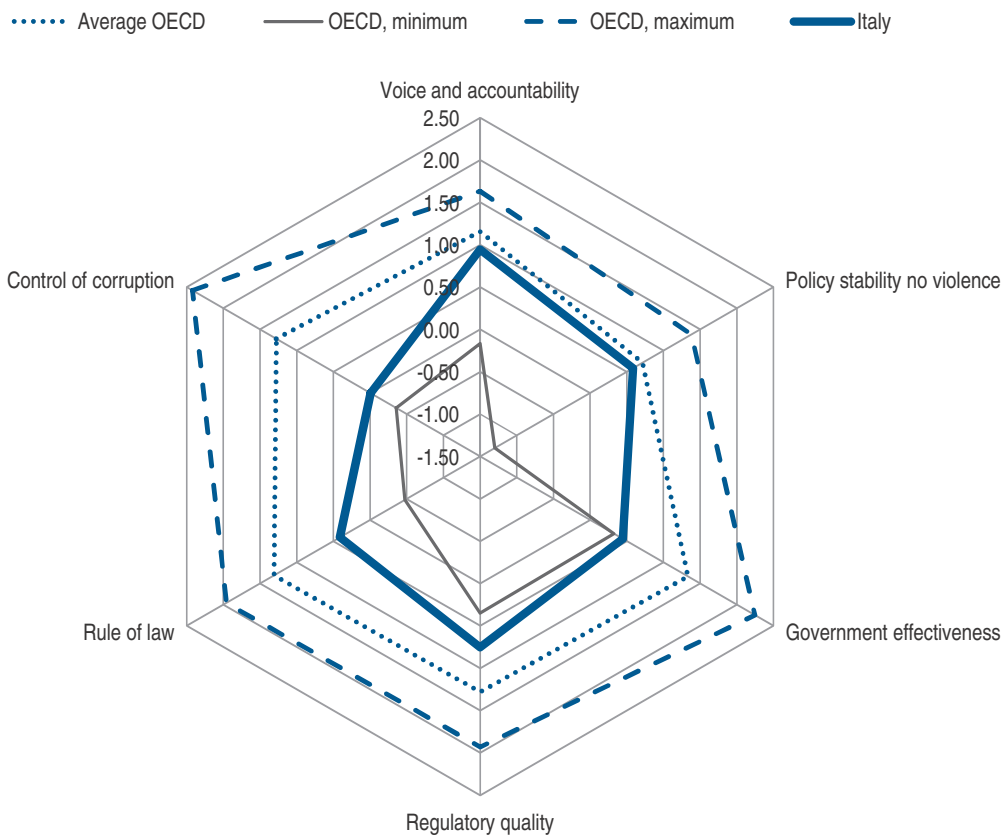
It is not obvious how important the possible implementation gap that Figures 3.1 and 3.2 may indicate might be. The nature of this kind of data may not be robust enough to make quantitative estimates, but it is worth considering what factors might influence any implementation gap. Many of the potential explanations are important in their own right, for their implications for growth or other aspects of welfare.

Considering the chain which links a government's intentions with the reality facing companies and workers, the following factors could contribute to an implementation gap: legislation which is unstable and sometimes fragmented, poorly drafted or ambiguous; regional/local regulation which is inconsistent with national legislation; regulations which are not effectively implemented by the public administration; inadequate administrative capacity in some regions; opposition by vested interests; implementation or enforcement which is ineffective because of slow moving courts; and regulations which are sometimes frustrated by phenomena related to corruption or organised crime. Many of the factors listed are part of what could broadly be called governance.

Governance

The World Bank maintains a database of World Governance Indicators,[3] which have a number of components (World Bank, 2012). They suggest that Italy is not a good performer (Figure 3.3). These indicators are derived from perceptions, not hard facts, based on a relatively small number of sources. Though the number of sources is small, the view about individual countries is fairly well defined, as the example of the component "Government Effectiveness" shows. This "captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies" (World Bank, 2012, *http://info.worldbank.org/governance/wgi/pdf/ge.pdf*). Figure 3.4 shows the level of the indicator (the average across each country's sources), with upper and lower limits derived from the standard error across the different sources used. It shows a clear separation between Italy and the better performing countries, whereas differences between Poland, Italy and Mexico are much less clear. For this indicator the number of sources is 11 for Poland, 10 for Mexico and 7 for Italy and the other countries shown. Even for better sourced indicators, however, the number of contributors is only 12 or 13. Apart from the number of sources surveyed in the questionnaire, the precise questions asked sometimes vary across countries. These indicators clearly have their limitations, therefore, but it would be unwise to dismiss them altogether.

Figure 3.3. **World Bank governance indicators**



Note: The OECD average is the simple average of the OECD member countries.
Estimate of governance performance ranges from approximately -2.5 (weak) to 2.5 (strong).
Source: World Bank, The Worldwide Governance Indicators, 2012 Update (*www.govindicators.org*).

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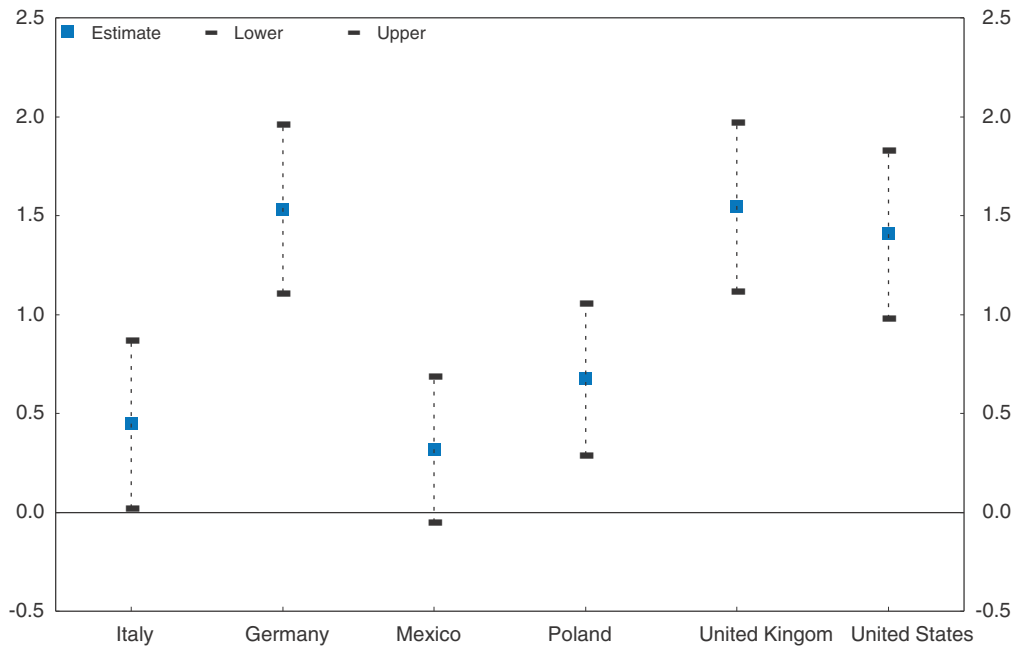
Perceptions of regulatory quality recorded in these governance indicators also seem poor relative to well-performing OECD countries. OECD indicators of regulatory management systems suggest this should not be the case. While Italy scores relatively low on "clarity and due process" in rule-making procedures, it is above average on "appeal, compliance and enforcement" and below average but not dramatically so on regulatory impact assessment (OECD, 2009a). As OECD (2009a) emphasises, however, for example in the case of indicators of clarity and due process, they record the existence of procedures but "[do] not gauge whether these procedures have been effective" (OECD, 2009a, p. 136).

Figure 3.4. **World Bank indicators show relatively low government effectiveness in Italy**



Note: Estimate of governance performance ranges from approximately -2.5 (weak) to 2.5 (strong).
Source: World Bank, The Worldwide Governance Indicators, 2012 Update (*www.govindicators.org*).

StatLink *http://dx.doi.org/10.1787/888932792255*

The quality of legislation

One of the factors likely to influence government effectiveness is the quality of legislation. While difficult to define precisely (what is seen as good in one country might not be so in another, for example) this concept nevertheless has some concrete components, both in terms of procedures and outcomes.

Government by decree

In recent years, much, probably most, significant economic legislation has been issued by government decree (*decreto legge*).[4] In principle reserved for situations of particular urgency, the use of this decree procedure means that many economic reforms are contained in laws entitled "Urgent measures..." This seems inappropriate for many structural reforms which include measures ranging from shop opening hours to modifications to the status of network industry regulators. Under this procedure the measures in the decree become law as soon as the decree is published in the official gazette; if the decree is not converted into law by parliament within 60 days it lapses. Parliament is free in principle to modify the law before finally enacting it but such changes are typically small but occasionally quite significant. This is an efficient way to enact important measures without spending time on long public and parliamentary debate, but has disadvantages.

Public and parliamentary debate can reveal potential weaknesses in policy proposals. Debate should facilitate public and parliamentary understanding of the issues and the legislation, and parliament then has some "ownership" of the legislation.

A further consequence of the use of decree laws appears to be that procedures that should lead to better legislation may be neglected, notably regulatory impact assessment or similar examination of policy measures to establish whether there are better alternatives. According to Clarich and Mattarella (2010), another reason for the widespread use of decree laws is that it avoids the constraints on the public administration's use of regulations. The latter include impact analysis as already mentioned and the fact that regulations can be challenged in an administrative court whereas laws cannot be. An OECD report on regulatory mechanisms also discusses this point (OECD, 2012). The same report also notes that Italy seems to have passed from one extreme to another in terms of regulatory impact assessments (RIA); in the past it was criticised for not using RIA, despite legislative provisions for its use, but more recently has been carrying out so many (150 a year) that they cannot be done effectively or taken seriously in the policy making process.

It should be noted that the situation in 2012 was rather special. In the case of the decrees issued by the current "technical" government many of the fiscal measures were indeed urgent, because of the concerns in financial markets about fiscal sustainability. Furthermore parliament had given the government a mandate to rapidly introduce structural policy measures – most of which indeed followed recommendations that OECD reports had previously made. This could probably not have been achieved in a short time without the use of decrees. But increasing use of decree laws was apparent before 2012; the message is that future governments should aim for fewer, well-prepared laws.

The quantity of laws and transparency

Past and present governments have been conscious of the fact that it is not always easy to understand the structure of legislation. In part this has been because of the volume of laws outstanding and in 2005 the then government introduced (by decree) the "Taglia leggi" ("law cutting") law. This was intended to take stock of existing laws (there was no clear record of how many laws were in fact currently valid), to eliminate obsolete or redundant ones and to reorganise the structure of the remainder to make it more accessible. The work to implement the *Taglia leggi* law has continued under successive governments. There were some difficulties in organising the process of reviewing and repealing old laws, which was less simple than planned, but by now the number of pre-1970 laws in force has been reduced from over 50 000 to about 2 400 and about 36 000 other laws have been repealed. When secondary laws are included, the number that have been eliminated is over 200 000. The reduction of redundant laws and regulations, along with the ongoing codification of existing legislation has significantly rationalised the legislative system, and should produce benefits in terms of greater legal certainty and savings on public and private expenditure.

The government estimates that the reduction in the quantity of legislation produced potential annual savings (to public and private sectors taken together) of EUR 21 billion, over 1% of GDP. Many individual changes may not have been of great practical significance, especially because a large proportion of the laws abolished were either not enforced or redundant. Rete Impresa Italia, the business federation for small and medium sized businesses, reported that the exercise had no identifiable impact on life for business, perhaps because such business interact with the public administration mostly through intermediaries in the professional services sector, where insufficient competition may have hindered the passing through of benefits to very small companies. Such a drastic

reduction in the number of laws that potentially affect citizens or business must certainly produce some savings, however, not least in the public administration.

In some policy areas (for example concerning local public services such as water and waste, or local public transport) recent years have seen quite a large number of changes in laws or regulations, sometimes reversing previous changes, according to the Ministry of Industry and Economic Development. This both adds direct costs as enterprises and clients have to frequently adjust to changing rules and creates uncertainty about what the rules might be in the future. Palumbo (2008) reports that in a sample of sets of laws (*testi unici*) regulating a number of areas an average of 10% of the regulations were changed each year in the period 1990-95; it is not clear how exceptional this is – a similar measure for France was also 10%. The simplification process itself can even contribute to the problem of frequent changes in regulation. For example, between 2008 and 2012 there were many modifications of the rules relating to tenders for public service contracts, at least six of which were in laws whose object was simplification (Rangone, 2008). Future governments should therefore be less quick to take action to respond to specific problems and concentrate instead on making more deliberate, better prepared reforms, and also on better communication of the existing state of regulation in any particular area.

A recent example has been the response to a constitutional court ruling (No. 199, July 2012, also discussed further below) that the competition authority (AGCM) cannot intervene directly in local government contract awards to in-house services organisations as originally foreseen in a law in early 2012. To get round this restriction on AGCM action, a law introduced in October imposes transparency requirements on such contracts. They must be accompanied by publishing on the internet a reasoned justification for the contract decision, a requirement also imposed for existing contracts. The AGCM can verify respect of these provisions. Improved transparency can lead to better decision making, but the measure provides no new power to change the nature of the contracts. It would, arguably, be better for the government to address the issue either with a constitutional change that clarifies the allocation of competencies between central and local levels in the area of local public services, or through a wider and coherent reform of local public services.

Until recently, there was no easy way a citizen could get access to the text of any particular law currently in force, other than by subscribing to a private service. As part of the ongoing programme to simplify laws and legislation, this is now available through a government website (*www.normattiva.it*). This is a significant improvement in transparency. The laws are often impenetrable in their drafting, however. For example, as most laws modify existing legislation, there are frequent references to other texts, but these references are almost always opaque. To understand the impact of a particular modification it may be necessary to trace the text of several previous laws. The logical structure of this arrangement is impeccable, and has become somewhat easier to deal with through *www.normattiva.it*, but it could be made more user-friendly. Some improvement has already appeared in 2012 as a number of laws incorporate an explanation of the previous legislation they are modifying.

The eventual solution to this problem is to bring together legislation in a unified text ("testo unico") for well-defined areas. These already exist in many areas and the 2005 *Taglia leggi* law indeed foresees it as a general objective, once obsolete and redundant laws have been cleared out. Progress is being made, though it is not easy to see how far it has

reached.[5] The process of simplifying legislation also has to be followed through with simplifying regulations themselves. This process is on a slower track, and regulating ministries may not have as strong an incentive to reduce and simplify these as for simplifying the legislation. The *Taglia Oneri* ("burden cutting") programme, which is run by the Office for Administrative Simplification of the Department of Public Administration, seeks to assess the costs of individual regulations and where possible modify or eliminate them if the same objective can be achieved more efficiently.

Transparency in legislation and regulation is helped by clear writing. Legislation is notorious in many, probably most, countries for being difficult for non-professionals to understand and there is currently no way to know whether the situation is worse in Italy than elsewhere. Some OECD indicators may give a misleading impression. The indicators of product market regulation (which use some of the regulatory management systems indicators) show Italy among the leading countries for regulatory transparency, rather the opposite of what is being suggested here. This is because parts of the questionnaires from which the indicators are derived may no longer be well-adapted to distinguishing good from bad performers. Notable amongst these are "Is there a general policy requiring 'plain language' drafting of regulations?" "Is the 'silence is consent' rule used at all?" and "Are there [one stop shops] for getting information on notifications and licences?". These questions require a yes/no answer, and since some countries reply "no" to at least one of the questions and Italy correctly replies "yes" to all, Italy appears among the best performers. As before, being based on questionnaires to the public administration, it is difficult for these indicators to take into account actual practice, e.g. whether the one-stop shops are numerous or effective, whether "silence is consent" is used frequently or only very occasionally, or whether the plain language rules are actually followed. The questions to be used in the 2013 PMR on these particular points have been revised to take account of some of these problems.

According to Clarich and Mattarella (2010), the plain language rule is very far from being followed, at least in legislation and, while guidelines for drafting legislation exist, they are not followed. They cite examples which might appear trivial but which can at the least impose costs and at worst make legislation ambiguous. One such example is the use of several different words to refer to the same concept or entity, which can lead to ambiguity in interpretation. Another example cited is the use in many laws of a final catch-all article that says that the present law takes precedence over all existing laws that conflict with it, but no information is provided about which laws might be concerned. In the absence of such information the utility of such articles is not clear, although by the implication that potentially conflicting laws do exist they strengthen the argument that completion of the process of codification in *testi unici* will be very helpful. As for regulations, in nearly all countries there was by 2008 a register of subordinate legislation (question 5 in the OECD indicators of regulatory management systems), which could help to trace these potential conflicts, but Italy was in the minority of countries without such a register.

The constitution

One final point that might affect the nature of legislation which affects the operation of the market is the constitutional provisions relating to economic initiative and activity. Article 41 states ("*L'iniziativa economica privata è libera*. [...]") that private economic initiative is free but does not explicitly say the same for private economic activity.[6] Free initiative

could be taken to mean freedom to choose the area of one's activity, while not implying any basic freedom about how that activity is exercised, although this is not the only interpretation (De Benedetto (2012) and web discussion at *www.apertacontrada.it/category/articolo-41/*). On economic activity itself, the same article of the constitution states that the law shall define ways in which to ensure that private and public activity are directed towards social ends.

In an attempt to reduce the tendency to over-regulate, rather than change article 41 of the constitution, the government introduced a provision (in the "Save Italy" law of December 2011) which is intended to establish the presumption that all economic activity is allowed unless expressly forbidden. More precisely it requires that any administrative measures that might restrict economic activity must be justified by the existence of a general interest, and gives the Competition Authority the power to query such measures in an administrative court. This could have significant long-term consequences as it probably removes the basis for much of the regulation that regional and local administrations have used to restrict the development of new retail and commercial outlets (Pellegrini, 2012). Sub-national administrations have often used the impact on potential competitors as a criterion for allowing new outlets, if the new law is effective it would restrict them to using more normal planning criteria. This measure could have an effect quite rapidly because it provides for the automatic suppression of rules that are incompatible with the liberalisation of economic activity.

A constitutional court judgment (no. 199, of 17th July 2012) has, however, thrown some doubt on how effective this "all economic activity is allowed unless expressly forbidden" clause, and the consequent suppression of incompatible regulations, can be. This doubt arises precisely because it would potentially interfere with the rights of regions to legislate in areas reserved to them by the constitution and also because the law itself is ambiguous and would lead to uncertainty. The aim of this part of the law was both to promote liberalisation itself and to reduce complications for businesses operating in different parts of the country. But the constitutional court's ruling makes this aim more difficult to achieve.

This raises a related point, not particularly connected with the constitution, as to whether general "horizontal" measures to promote simplification are likely to succeed, since they may inevitably be subject to obstruction in practice by other laws, especially in Italy's context of decentralisation. An example is the s.c.i.a. (*segnalazione certificata di inizia attività*), a document which replaces all specific authorisations to exercise an economic activity unless some direct assessment by the public administration is required. For some time, there was some uncertainty about its validity because the law stated that the s.c.i.a. must be accompanied by certificates of technical conformity only when expressly laid down in "legislation in force"; this led to companies who might be uncertain as to what relevant legislation might be in force asking local public administrations for ad hoc documents anyway (Rangone, 2012). This problem has been dealt with by issuing a regulation listing what kinds of activity are subject to the s.c.i.a. only and which are subject to additional requirements (Rangone, 2012).

Sub-national legislation

Italy has become a quite decentralised country. Health provision, environment, professional training and energy policy are regional responsibilities. The organisation of fiscal federalism has still not caught up with the degree of decentralisation. Responsibility

for revenue raising is not yet well-aligned with the level of spending obligations although some good ground rules for this were laid in legislation in 2008. Laws and regulations made by regional governments may also suffer from some of the same problems as national legislation, but there is no systematic information. The number of laws varies quite widely across regions, with particularly large numbers in the autonomous regions such as Sicily, but not only in those. Some regions, such as Lombardy, have their own *Taglia Leggi* and legislative simplification programmes.

There are provisions for regions to co-ordinate their policy among themselves and with central government, in the Conference of the Regions and the State-Regions Conference respectively. However, for some policy areas the decentralisation to regions does not make much sense, however much co-ordination is undertaken. As OECD (2011a) and OECD (2013b) point out, this is the case for energy policy, where current arrangements require every region to have its own strategic energy plan. The government has proposed legislation to bring energy planning policy back to central government.

An important set of measures simplifies administrative procedures for companies to get authorisation to operate; it emphasises the principle of freedom of private companies to engage in economic activity and limits the range of conditions a company has to meet. The legislation nevertheless lists (in article 12 of the "Simplification" law) the areas where there may be constraints: health, environment, landscape, cultural and historical heritage, human dignity, social utility, public order, and Italy's international obligations. Most of these would be applied by sub-national government and, at first sight, some of them provide a significant source of potential loopholes. The Joint Conference, in which representatives of the State, Regions and local authorities meet to promote policy co-ordination, has set up a panel to work on how to draft implementing provisions of the Simplification Law effectively.

A study by the competition authority of commercial liberalisation measures taken by the central government in 1998 shows that while many regions took advantage of the law to increase competition, some did very little and a few actually tightened regulation. The study divided the 20 regions into three groups according to their "competitiveness" (more properly, the level of commitment to competition) and studied outcomes on variables such as investment, consumer price inflation and productivity comparing the period 1994-99 with 1999-2004. Regions that were more committed to promoting competition tended to see a larger fall in inflation (from above average to slightly below average), and an increase rather than a fall in investment. Employment tended to fall, or fall by more, in the competitive regions but wages rose relative to the others (AGCM, 2007).

This suggests that decentralisation of regulatory powers can reduce the ability of central government to effect policy changes in a consistent way across the country, and that some regions are likely to make more use of the reserve provisions for intervention listed in the Simplification law. In one sense, this is not necessarily a problem for policy implementation. Meaningful decentralisation implies the possibility of variation in policies across regions, as the constitutional court judgement mentioned above implicitly recalls. To the extent that this is true, it means that there is no clear, nationally defined, policy in some cases.

In principle, with decentralisation and appropriate fiscal federalism, sub-national government has incentives to ensure such cost-minimisation without centrally-imposed rules. But wide observed variations in prices of identical items (hospital syringes are a

frequently mentioned example), unjustified by considerations of quality or quantity ordered, suggest that in at least some parts of the country capacity to control costs is lacking. There is also some evidence of occasional manipulation of procurement rules by purchasing managers who specify particular characteristics that are only met by one favoured supplier. This lack of capacity or will to control costs, rather than a conscious choice by some regions to restrain competition in commercial distribution, may also be the explanation for the uneven implementation of the 1998 liberalisation of commercial distribution. In 2012 the government took measures to strengthen the obligation on public administration at all levels to make use of competitive tenders and centralised procurement agencies to ensure projects and supplies are procured at least cost, including through the national procurement agency, CONSIP.

The government has tried to reduce the direct costs of decentralisation with legislation that reduces the size of the middle tier of sub-national government, the provinces. There are currently 110 provinces and 20 regions. 24 of the provinces are autonomous or in autonomous or special regions; only the remaining 86 are "ordinary" regions where central government has the power to modify their functions. Some functions have been removed to other levels of government and parts of their controlling bureaucracy abolished. A draft law was presented to parliament to reduce the number of ordinary provinces from 86 to 51 by January 2014, with significant cost savings expected. These plans were shelved due to the early elections and the new government will have to decide how to proceed; according to the 2013 Stability law, relevant decisions were to be made by December 2013. Eliminating provinces altogether from the hierarchy of levels of government would be an alternative step towards simplification and improved co-ordination, reducing the cost of government, but would require a constitutional law, which would take longer to pass the higher parliamentary hurdles. The longer period for discussion could be useful to ensure adequate consensus and preparation for such a significant step.

Although these or other changes may modify the balance of decentralisation, the principles of the plans for fiscal federalism outlined in 2009 legislation remain valid. The main pillars are an agreed allocation of responsibility for raising revenue between the national and sub-national levels, compensation for centrally imposed spending mandates using transfers based on standard costs, and redistribution from richer to poorer regions based on a standard formula. There have been long delays in implementing these plans, which were in principle mandated by the constitutional reform in 2001.

Policy implementation and public administration

A key factor in Italy's low score on perceptions of government effectiveness shown in Figure 3.3 is likely to be weaknesses in public administration. It is often slow, with levels of efficiency that vary widely across the country, vulnerable to favouritism, and occasionally to corruption and even organised crime. Since at least the 1990s (with the "Bassanini reforms") governments have been progressively introducing measures to improve efficiency. The latest comprehensive reform plan dates from 2008-9, the "Brunetta Reform" (OECD (2010) provides a comprehensive description of the Brunetta reform). Anti-corruption legislation, finalised in late 2012, is also an important foundation for improving public sector efficiency.

The Bassanini reform aimed at improving public administration, notably by introducing a performance management system. According to OECD (2010) the results fell short of expectations, while public sector salaries had risen faster than in the private sector. The Brunetta reforms added provisions for greater transparency, simplifying the performance management process, as the incentive system had generally been used to give equal reward to all managers independent of performance.

A 2010 survey by a public relations company of employees in the public administration considered a number of factors that might inhibit progress in public administration reform (Forum PA, 2010). Since respondents could select only from pre-defined problems, the survey indicates perceptions of the relative importance of some issues, rather than necessarily identifying the most significant ones overall. Since respondents were self-selected from a relatively restricted, possibly unrepresentative, group, the results are of uncertain statistical significance. Some indications of relative perceptions of obstacles to reform are nevertheless interesting. In terms of making use of human capital, twice as many people identified the rigid hierarchy and lack of openings for individual talent as identified lack of implementation of incentive systems. As obstacles to change, the fact that organisations were not adapted[7] to the objectives they were pursuing, complex and contradictory rules and lack of functional integration were identified much more frequently than absence of evaluation of policies, poor information flows or system co-ordination. And as obstacles to improved ethics, interference from politics and lack of transparency on appointments were thought more important than the "spoils system".

A final significant indication in this survey was that the most frequently identified obstacle to improving productivity through better use of information technology was incoherence between organisational change and technological change; perhaps surprisingly in a context of fiscal stringency, lack of financial resources for IT was the least often cited problem. If procedures designed to work in a paper-based system are not modified to take advantage of IT, the use of IT may be pointless, or even an extra cost, rather than improving productivity.

According to the same survey, lack of training among employees in the public service did not rank high among the perceived obstacles to change. Lack of willingness, perhaps collective rather than individual, does nevertheless seem to be a problem, at least in some areas. An example concerns implementation of one of the provisions of the Brunetta reform: an office of the public administration can no longer require a citizen to provide a document which itself is produced by the public administration (whether the same or another office). In the past, document chasing has been one of the key complaints of users of the public administration, so implementing this provision should significantly increase overall efficiency and requests for them should be illegitimate. Initially administrative office sometimes continued – illegitimately – to ask for such documents, but a monitoring exercise shows that that production of certificates in local government fell by half in the first 10 months of 2012. In another case, the improved monitoring of the performance reward system may have reduced, but has not eliminated, the phenomenon whereby a tacit agreement to set performance standards that are easily reached prevents the system from rewarding exceptional efforts.

These individual examples show that there is likely to be a delay between introducing a reform and it having a practical impact. Contrary to the view of many of the respondents to the survey discussed above, it also shows that policy evaluation is an important tool,

especially in the case of public administration where there are few self-evident measures of efficiency. Early monitoring of outcomes is important to see whether the expected outcomes are being achieved, especially where the aim is simplification of bureaucracy. Such monitoring is indeed under way to investigate the implementation of decertification measures, through monitoring exercises in municipalities and ISTAT surveys of citizens and business.

Accountability and performance management

Measures taken in 2012 to follow through on the Brunetta reforms include a requirement that offices of the public administration designate identified individuals who are responsible for the provision of particular services. This is a valuable measure to reduce costs and increase transparency and accountability, provided that resources and authority are aligned with the responsibility undertaken. It also supplements moves by successive governments to promote a performance management approach at all levels of the public administration.

Trying to go too far with incentives can also undermine effort. Whereas identifying individuals as responsible for particular services is a good idea for promoting transparency and accountability, concentrating sanctions for poor performance on those individuals could backfire. Demands that are too onerous or unreasonable given the degree of autonomy the person has in reality may encourage defensive behaviour – the person concerned may concentrate on avoiding sanctions rather than improving services. It may be that transparency, along with pursuing outcome-oriented performance management within the administration, but without the threat of individual sanctions would be equally effective, and less likely to provoke counterproductive behaviour.

Both the Brunetta reform and additional measures adopted under the 2011-13 government have put strong emphasis on transparency, generally in the form of requiring ministries and agencies of the national public administration to put various kinds of information on their websites, for example salaries and curriculum vitae of senior staff, absenteeism data, and information on performance management processes. The 2012 anti-corruption law provides for a "consolidated text" of all transparency measures taken in recent years to be prepared by the end of 2012; compilation of this text is under way.

In a working environment where openness was the norm, providing such lists of mandatory provision of information could provide useful guidelines. However, under other circumstances it could be largely ineffective as officials might tend to provide information according to the precise wording of the law rather than in its spirit. Such a box-ticking approach has been observed at least in parts of the Italian administration in the past, for example in the implementation of regulatory impact assessment (RIA) guidelines (OECD, 2009a, 2009b). This was followed by an excessive number of RIA being undertaken without sufficient time to do them properly (at the same time as key legislation was being introduced under "emergency" procedures which by-pass the RIA requirement, as discussed above). This has led to a proposal to introduce some filtering mechanism to ensure that when they are done, RIA are done properly (OECD, 2012).

Hence, even quite clear guidelines can remain without effect when background conditions are not favourable. Given the clear intention of policy, as stated by the Minister of Public Administration (Patroni Griffi, 2012), to aim for maximum transparency, a useful supporting measure would be an explicit freedom of information law. In parallel with

existing and planned guidelines on what information ministries and agencies should make available, such a law could make clear that unless there are specific reasons (in the public interest) to the contrary, information should be made available to reasonable requests. Such an approach would match moves already made towards express freedom of economic activity except on specified grounds, and could also support, and be supported by, the recent provision in the anti-corruption bill to protect whistle-blowers.

Until the passage of the anti-corruption law (November 2012) there was no protection for a civil servant who might choose to expose malpractice, whether corruption, disregarding the law or simple inefficiency, in the public administration. The law now prevents retaliatory action being taken against whistle blowers and protects their identity, including allowing evidence in court to be given anonymously (with some exceptions). This is an important step even if, as the OECD *Integrity Review of Italy* points out, there are some weaknesses in what is otherwise a solid framework. For example, while the law may forbid retaliatory action it does not specify what kind of compensation might be due if this provision is violated nor specify any sanctions against an employer who retaliates (OECD, 2013a). Also, there is no protection for whistle blowers in the private sector, nor for contractors, consultants or former public employees, as the law protects only "public employees".

Civil justice

Efficient civil justice is important to a market economy, in addition to its obviously essential role of providing justice in society more generally. One way to summarise its impact is that it supports the level of trust. Without a high level of trust, complicated transactions can be risky and more costly. This is likely to affect firm size, firm finance and even innovation behaviour. There is some discussion as to whether causality runs from effective legal institutions to a high level of trust, or vice versa. "[I]f trust in friends is generalized so that people assume the good will of strangers, a society can economize on some of the coercive apparatus of the state" (Rose Ackermann, 2001, cited in Berggren and Jordahl, 2006). The opposite causality is also plausible however, so that there is some hope that significant improvements in civil justice can provoke self-reinforcing effects through higher levels of trust, resulting in less recourse to justice and lower costs for society.

A number of cross-country studies show that well-functioning civil justice is economically important (e.g. Kumar, Rajan and Zingales, 2001). It can affect use of resources and technology (Ferguson and Formai, 2011). It can contribute to the development of financial and credit markets by ensuring better creditor protection in bankruptcy or insolvency procedures (Djankov et al., 2008) or better and larger loan facilities (Bae and Goyal, 2009; Qjan and Strahan, 2007). Protecting returns from investment allows firms to grow larger (Leaven and Woodruff, 2007). Testifying to the likely relevance of the subject in Italy, many studies look at geographical regional variation within Italy, reaching similar conclusions, especially relating to firm size (Giacomelli and Menon, 2012) and to labour relations (Ichino, 2003).

The definition of efficiency in justice is not simple, since it clearly involves a combination of providing equitable access to redress, getting the right decisions, and getting them in a timely fashion, whereas a budget constraint is likely to impose clear trade-offs between these elements. Comparisons across countries in order to look for best practice are also difficult since there are few standardised definitions that allow

comparisons to be made. In terms of funding, as a share of GDP, Italy is broadly in line with the OECD average. In terms of access, financial cost is less of a barrier than in many countries, though this leads to some problems, discussed below.

Civil justice is slow

One thing which is clear about Italian civil justice is that it is slow. Differences in types of case and types of law makes benchmarking hazardous, but a number of cross-country comparisons of reasonably similar types of case reach the same conclusion: common civil court proceedings may be twice as long as in many countries, as much as four times longer than in some of the fastest (Table 3.1).

Table 3.1. **Civil courts can be slow and expensive**

	Number of days necessary to settle a first level civil case		
	2006	2008	2010
Italy	**507**	**533**	**493**
Portugal	449	430	417
Spain	261	296	289
France	262	286	279
Austria	135	129	129
	The cost of resolving commercial disputes (2010 data)		
	Number of procedures necessary	Number of days	Cost, as % of the amount in dispute
Italy	**41**	**1 210**	**30**
Germany	30	394	14
France	29	390	17
Spain	39	510	17
United Kingdom	29	399	26
United States	32	370	14
OECD average	31	510	20

Source: CEPEJ (2008, 2008, 2010) and World Bank Doing Business 2012.

The counterpart of the length of time that cases take is a very long backlog of cases in all the civil courts, as the number of new cases has exceeded the number of cases completed in every year since 1990 (except 2000 and 2001) by an average of about 10% over that period (the phenomenon goes back to the 1970s). The lack of cross-country studies of what determines the length of time taken by court proceedings handicaps diagnosis of the problem. Research in Italy has nevertheless highlighted a number of factors that are likely to contribute, suggesting that for the most part it is a problem of demand management ("pathological" demand, according to Marchesi, 2007). Certainly there has been a significant increase in the number of civil cases being opened over the years: in the 1970s the number of new cases was around 1.1 per thousand of the population, this rose to 2 by the late 1990s and was 3 or more from 2005 onwards.[8]

A number of these issues were highlighted in a government study in 2007-8 (Ministry of Economy and Finance, 2008) and also, for example, in Bianco et al. (2007) and Marchesi (2008). These pointed out that the problem had been known for many years and a number of measures had been taken, but that they tended to impose targets without considering what incentives would be needed to reach them. One example is a 2001 law which laid down the maximum acceptable duration for different stages of legal proceedings,

providing for compensation for litigants when these were exceeded. The law did not significantly modify the incentives for different actors in the process and had little visible effect. But in recent years, one source of additional legal actions has been the number of people taking action in the appeal courts to claim this compensation, further diverting resources from dealing with the underlying backlog. There would even appear to be cases where lawyers take into account the possibility of being able to claim such compensation when considering starting legal action in the first place.

Two key aspects of civil justice pricing are the form in which lawyers are remunerated and the cost of access to justice. Action has recently been taken in both of these cases. Traditionally, lawyers have been remunerated on the basis of "fee for service" with specific remuneration for each separately defined act in court proceedings. An act can be, for example, introducing a document into evidence. Since there has been no reward for anyone (except for the parties involved, and sometimes not even for them) for expediting cases, lawyers have an incentive to maximise the number of pieces of evidence they introduce.

Legislation in February 2012 on professional services outlawed obligatory remuneration structures such as the "fee for act" system that applied for lawyers. Lawyers and clients are now free to reach agreement on remuneration, including no result no charge agreements or other forms of incentive. This could have far-reaching consequences. Concerns about a transition to this approach, very novel for Italy, have led to some modifications. The professional services legislation provided for the judge in a case to arbitrate on appropriate remuneration if a lawyer and client could not reach agreement (presumably recognising that it was unlikely that competition between lawyers would serve to overcome such difficulties). The legislation also provides for a scale of charges to help judges define what a fair fee would be in such cases. Although this is logical, so as to avoid arbitrary variation between fees in different courts and under different judges, there is a risk that this scale may in effect be used as a reference for fees.

Sometimes, one party in a case has an active interest in prolonging a dispute s/he is certain to lose, because while a case is in court, settlement of a transaction in dispute (which might be a tax payment due, or a debt between private parties) is suspended. This seems in fact to be the motivation behind a number of cases where the low cost of access to courts gives a simple way to postpone settlement of debt. In 2009 the cost of making small claims was increased, producing a reduction in the number of new cases. In 2011, the cost of appeals was also increased.

These perverse incentives apply, or applied, in all areas of Italy. Yet there is wide regional variation in the speed of civil justice. Some of this is for idiosyncratic reasons; for some time a significant proportion of the national backlog of cases was accounted for by one court in an area where the regional office of INPS, the social security agency, had been making a large number of mistakes in calculating old-age pension entitlements. Such effects cannot explain all regional variation, so steps are needed to improve efficiency, other than getting prices right. Much of this depends on the organisation of courts, where research suggests that three kinds of measures should lead to improvements: increasing the average size of courts, through amalgamations, to take advantage of economies of scale in administration; specialisation of courts and judges to allow complex cases to be handled more quickly; increasing average court size makes specialisation among judges more feasible; and more attention being paid by court managers, in particular the court

president, to finding efficient ways to manage the caseload. Recommendations in all these areas had been put forward in Ministry of Finance (2008) and there was some discussion of this in OECD (2009b) and OECD (2009c).

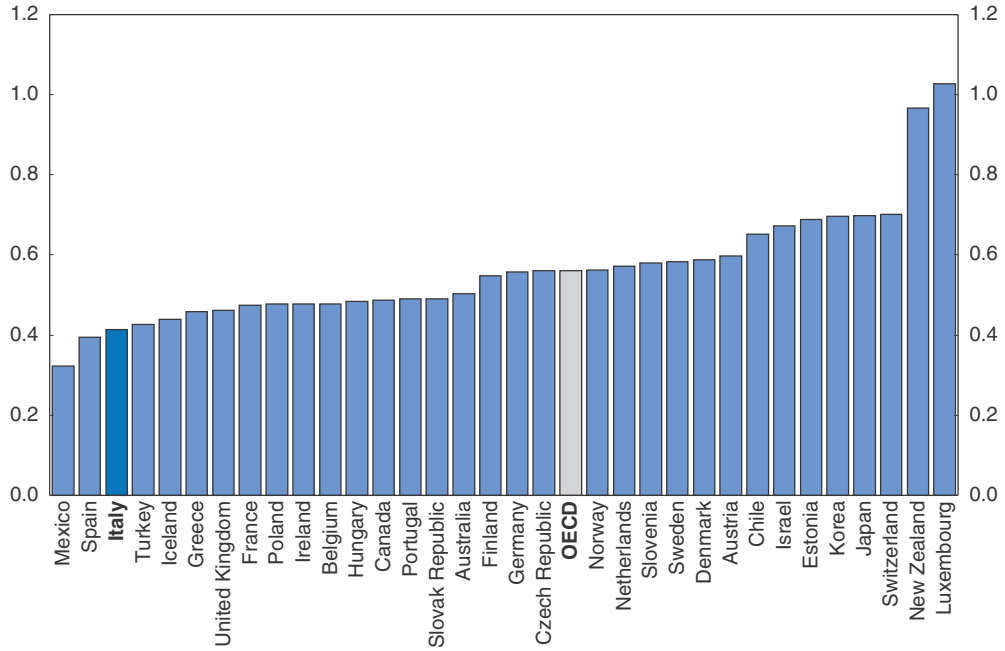
In 2012 action was taken on all these fronts. A process of closing many small courts is now under way, with staff being transferred to other courts on the same area. 20 courts specialising in some commercial cases, and correspondingly specialised judges, have been set up. Heads of courts are also required to produce annual plans for case management and their professional evaluations are now to take into account of how these are managed. Given the need to balance quantity of cases (or speed) against quality, it is important for evaluations to get a good balance between these two aspects. They also need to promote dissemination of best practice information, for which a suitably organised information system is needed, as well as appropriate training and selection of judges for the administrative roles. The 2011 report on the operation of civil justice recognises these needs, though it also notes that the "office culture" can be an obstacle to innovation if not carefully handled, primarily through information and training (Corte Suprema di Cassazione, 2012).

Tax evasion

One specific aspect of the rule of law is the extent of tax evasion. The authorities have been taking increasingly strong measures to improve tax compliance. They have imposed a relatively low limit (€ 1000) on the amount of cash that can be legally used in a transaction, to try to improve traceability for both tax and anti money-laundering purposes. Another example is a method known as the *redditometro* ("income meter"), whereby information from records of purchase or ownership of consumer durables is used as a check against declared income. Tax evasion is also significant elsewhere: the low yield of VAT revenue relative to its theoretical yield reflects both this and the number of exemptions and special rates (Figure 3.5). There can be a trade-off between the strength of anti-evasion measures and the administrative burden on legitimate individuals and businesses. Until the problem of tax evasion diminishes considerably, such higher administrative costs may be a necessary evil. The agency for collecting tax debts ("Equitalia") has also become increasingly aggressive (and unpopular). Sometimes, collaboration between national tax offices, which taxpayers may view as remote, and local institutions such as chambers of commerce and unions can help to build a culture of legality, including better tax compliance. A draft framework law on tax reform provides for developing such co-operation. It has also been suggested that local government take over the collection of local taxes, though for collecting unpaid taxes, and where tax evasion may be linked to corruption or crime, a national agency may be better placed to take effective action.

Decisive follow-up through the courts and punishment of major evasion commensurate with the degree of evasion are important to establish effective dissuasion alongside effective monitoring, though the criminal law should be invoked only for fraud and intentional large-scale evasion. Allowing negotiated out-of-court settlements, with full public disclosure of settlement terms to reduce corruption risk, could speed up decisions and reduce the overall load on the courts.

Figure 3.5. **VAT revenue ratio 2011[1]**



Note: The OECD area is the simple average.
1. Or latest year available. Data for 2011 are estimates.
Source: OECD, *Consumption Tax Trends 2012*; OECD, *Revenue Statistics and Annual National Accounts Database*.
StatLink *Note:* To download the data corresponding to this graph, refer to Figure 10.

Corruption

The extent of corruption

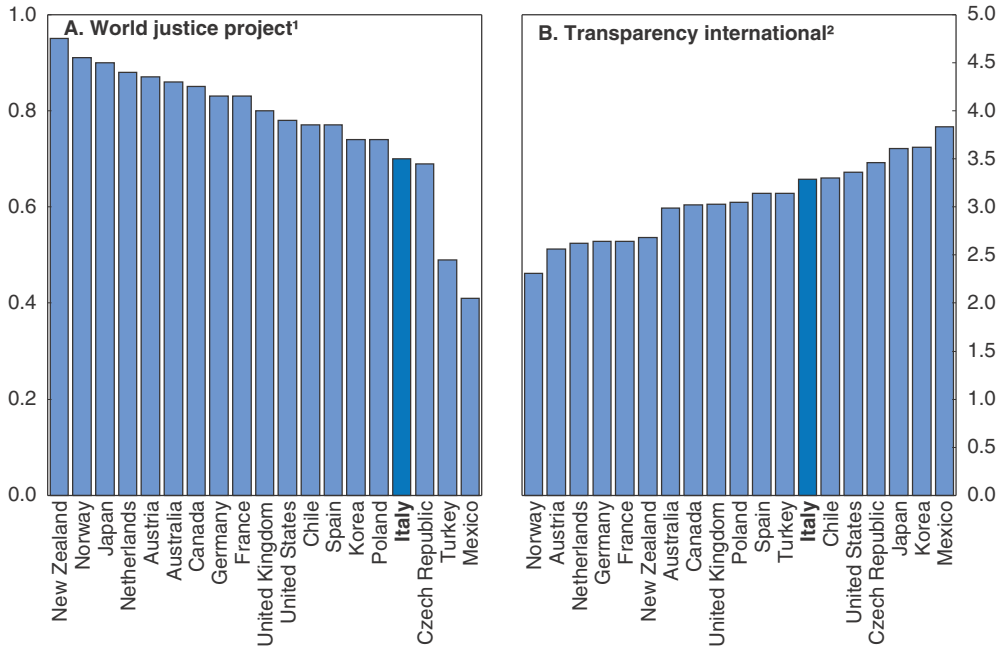
Analysing corruption in a cross-country comparative manner is difficult. It could – perhaps – be argued that Italy suffers as much from a reputation for corruption as from the actual phenomenon, given that objective cross-country evidence on its prevalence cannot easily be collected.

Such international comparisons as exist do show that Italy performs poorly compared with most OECD countries (Figure 3.6). These comparisons clearly depend on what is being looked for, however. While Italy ranks poorly according to both the World Justice Project and Transparency International, countries such as the United States and Japan score better than Italy on the overall rule of law (for the World Justice Project) but worse on the Transparency International index which focuses more precisely on corruption.

The rule of law index has a number of components. Italy scores close to the worst, among OECD countries, for effective enforcement of regulations and transparency in government, but is less extreme in other dimensions, including those most closely related to corruption, *i.e.* "absence of corruption" and "limited government powers" (Figure 3.7).

Whatever the precise international comparison, the Italian authorities take the problem seriously. According to a 2007 study on the phenomenon of corruption in Italy, which was carried out by the High Commissioner against Corruption, corruption in public administration is widely diffused and favoured by some specific features of the Italian administrative system, such as a recruitment and promotion scheme that suffers from a

Figure 3.6. **Italy scores poorly on international perceptions of the rule of law and corruption**



1. 1 = best possible performance; 0 = worst performance.
2. 0 = not at all corrupt, 5 = extremely corrupt.

Source: The World Justice Project 2011 (*http://worldjusticeproject.org/rule-of-law-index*) and Transparency International, the global coalition against corruption, 2010-11 (*http://gcb.transparency.org/gcb201011/*).

StatLink *http://dx.doi.org/10.1787/888932792293*

certain obscurity and inefficiency (Department of Public Administration, 2008). The High Commissioner study also refers to other research pointing out that, in Italy, corruption is deeply rooted in different areas of public administration, in civil society, as well as in the private sector: the payment of bribes appears to be common practice to obtain licenses and permits, public contracts, financial deals, to facilitate the passing of University exams, to practice medicine, to conclude agreements in the soccer world, etc.

The Office of the High Commissioner against Corruption was abolished in the year that report was published and its functions later transferred to the Department of Public Administration, in what became its Anti-Corruption and Transparency Service (see *www.anticorruzione.it/*). If it is true that corruption is "deeply rooted" in the public administration, a more formally independent body to do at least some of the job of monitoring corruption and proposing action against it could be important. The parliament has an anti-mafia commission which covers much of the same ground but is focused on organised crime. A Transparency International study also shows that Italians perceive political parties to be the most corrupt institutions in the country (Transparency International, 2010). An expert committee to consider the prevention of corruption was set up in early 2012 to suggest ways to reduce corruption issuing a report in October (Commission on corruption in public administration, 2012). The anti-corruption law incorporates a number of its proposals, for example the existing independent commission for evaluation in public administration was allocated the functions of an independent National Anticorruption Authority.

Figure 3.7. **Components of the rule of law index**

Note: 1= best possible performance; 0 = worst performance.
Source: The World Justice Project 2012 *http://worldjusticeproject.org/rule-of-law-index.*

StatLink *http://dx.doi.org/10.1787/888932792312*

The economic consequences of corruption

The presence of corruption implies that laws are not being enforced as intended. And some civil servants receive income, or other rewards, to which they are not entitled, at the expense of private individuals and companies and, implicitly, of more honest civil servants. Provided the civil institutions against which corruption is working are "good" it is hard to argue that corruption is not bad. There are a number of channels through which corruption may negatively impact growth. It is a tax on firms and their investments, it is a barrier to entry of new firms, it induces distortions in the allocation of public resources, it distorts the incentives of market operators, reduces the efficiency of public spending (Cingano and Pinotti, 2009), and reduces public consensus and trust.

It is not so easy to find evidence that it has a negative impact on aggregate measures of economic performance such as GDP, but some evidence does exist. Mauro (1995) found an overall negative correlation between cross-country variations in perceived corruption and the rate of growth. Aidt et al. (2008) found evidence that where institutions are "good", higher levels of corruption are associated with lower growth. They also found evidence that with weak institutions, corruption has no impact on growth, a finding that they interpret as showing that there are offsetting benefits from individuals being able to circumvent the

worst institutional deficiencies. Evrensi (2010) finds that corruption may be associated with higher growth in a sample covering both developed and developing countries, but that this result may only reflect the fact that mature (developed) economies have both less corruption than developing countries and also grow more slowly as they are nearer the production frontier. Houston (2007) found a similar result, specifically focusing on the interaction between weak institutions and corruption.

Looking at variations in growth within Italy, Del Monte and Papagni (2001) use objective though indirect data on the extent of corruption (the number of crimes against the public administration per employee) to show a negative effect of corruption on growth. They further argue that one route for this effect is through less effective public investment in areas with high corruption. This latter conclusion, though perhaps hitting the limits of what data analysis can show, is quite important given the correlation between areas of Italy that are clearly lacking in efficient public infrastructure and the prevalence of organised crime. Another paper using regional variation within Italy, which looks at organised crime in general, not just corruption, assesses the impact of the mafia[9]move into Puglia and Basilicata during the 1970s, and estimates the consequences as a long-term loss of 16% of GDP (Pinotti, 2011, which includes a useful literature survey and some concise historical scene-setting).

The context of corruption

Simplistic analysis of the causes of corruption can be misleading, but some observations can be useful. If corruption is "deeply rooted in different areas of public administration, in civil society, as well as in the private sector" (quoting from the High Commissioner's report noted above), then it is likely viewed in many cases as conventional behaviour by those involved. Recalling the link between institutions and the apparent impact of corruption at a macro level mentioned earlier, some occurrences could be viewed as legitimate in view of some real or imagined injustice or inefficiency in the public administration. In this there is a parallel with the strongly linked phenomenon of organised crime, whose origins, it has been argued, are partly in legitimate defence of people's rights against an oppressive (at the time) state or indeed in providing services in purely private transactions (Gambetta, 1996). Today's state is not oppressive, but social structures set up against it survive and their action is now part of what sustains corruption, with credible threats of violence. Seeking to reduce corruption mainly by aiming to punish the corrupt or the corrupters, without changing the institutional arrangements that might make it seem acceptable (or unavoidable), would create feelings of injustice which might undermine the effort.

Treating corruption as intolerable under all circumstances might therefore be counter-productive, although this should obviously be the approach in two key areas, that is, among the judiciary and in parliamentary institutions, since these are the places which decide and enforce institutional and legal reforms. Del Monte and Papagni (2007) investigate regional variations in corruption in Italy and find they are inversely correlated with measures of civic values, but they also argue that political corruption involving "legislators, bureaucrats and businessmen, who are the actors involved in bribery" has become important.

Fiorino and Galli (2010) also used regional variation within Italy to look for explanations of corruption and found a link with level of income and education (using instrumental variables to try to control for endogeneity). While the correlation with

income is negative, there is a positive link with education and also with public investment. The finding of an impact of public investment corroborates other evidence, for example from the parliamentary anti-mafia commission, that public infrastructure investment is a key target for organised crime, while the link with education could be discouraging as education is often, rightly, seen as one of the ways of trying to undermine support for organised crime (Antimafia Commission, 2011). Fiorino and Galli interpret the link with education as being related to the fact that corruption and, to a great extent, the activity of organised crime, is a "white-collar occupation".

In a study which focuses on what might be thought of as a counterpart of (the absence of) corruption, Buerker and Minerva (2012) show that measures of "civic capital" (based on the prevalence of altruistic acts such as donating blood) appear to be one determinant of variation in firms' plant size across Italy's regions. Bank of Italy researchers assess the following factors as being particularly likely to enhance corruption: low social capital; excessive bureaucratic burdens and low quality of bureaucracy (these are both cause and effect); ineffective enforcement; limited independence of the media and a high crime rate (Bianco and Tonello, 2012).

Dealing with corruption

The anti-corruption law, approved in December 2012 after much parliamentary discussion following its original proposal under the previous government, strengthens sanctions, which were perceived to be too weak in many cases. New criminal offences have been introduced: taking into account the suggestions of the Merida Convention and the OECD, "trading in influence" becomes a criminal offence, with a sanction of 1 to 3 years of prison; following the indications of a number of institutions and international conventions a sanction of 1 to 3 years of prison is applied to top managers of private companies that violate their duty in exchange for money or benefits.

The law also takes a number of important steps related to incentives and the context in which corruption occurs, notably its provisions to support transparency. These include assigning responsibility for monitoring corruption to an independent national authority, CIVIT, and the provisions for whistle-blower protection. In line with the general theme of this *Survey*, it is important that the good intentions behind this and other laws are not dissipated when implemented in practice. If corruption is somehow "deeply rooted" in parts of the public administration, while taking into account the fact that the vast majority of civil servants are like those in all countries – doing their best to carry out their assigned tasks – implementation in practice is not a trivial task. To ensure full and continued implementation of the spirit of the law, CIVIT needs to establish and maintain its credentials of independence. Its task of investigating corruption may not always be easily consistent with its more mundane role of overseeing evaluation and efficiency.

The provisions for automatic ineligibility for public office of those convicted of serious offences are among those that could have a significant long-term benefit. Once seen to be operating reliably, they could help to change the position of politicians as one of the least trusted, and perceived as most likely to be susceptible to corruption, groups in society. Speedy judicial action is important for such provisions to be effective. One unhelpful property of the criminal law (it is not the case in the civil law) is in the definition of the statute of limitations. Although it is not an essential part of a judicial system (there is no statute of limitations for criminal cases in the United Kingdom, for example) it has some reasonable properties, such as the length of the time-out period being linked to the gravity

of the offence. But the clock does not stop once judicial proceedings have been initiated (as it does in civil cases in Italy, and also in the United Kingdom), but continues through until a final decision has been reached, including first and second appeals. Incentives to prolong civil proceedings have already been noted earlier, in criminal proceedings the incentive can be even stronger since a case may simply be dropped if it runs out of time. It can happen that difficult prosecutions are not initiated because it is anticipated that they may take too long. In the specific case of cross-border corruption that falls under the OECD Anti Bribery Convention, the OECD Working Group on Bribery has found that shortness of the limitation period applicable to companies (legal persons) inhibits enforcement of the convention (OECD, 2011b). In addition to perhaps adjusting the length of specific limitation periods, changing the operation of the statute of limitations to work as in civil cases, and using other provisions[10] to ensure that trials do not take too long, could improve the credibility of some of the measures in the anti-corruption law.

Along with progress towards fewer and better laws, with proper evaluation – including "risk management", i.e. assessment of their vulnerability to corruption or mafia – the measures in the anti-corruption law should help, no doubt slowly, to make citizens and firms both more able and more willing to respect laws and regulations. The results of Buerker and Minerva (2012), where civic capital appears to influence firm size, may result partly from civic capital acting to reduce the prevalence of corruption and therefore the reliability of the public administration. Government policy has few ways to influence civic values, except by example, but an effective education system, notwithstanding the apparent link between level of education and prevalence of corruption (Fiorino and Galli, 2010), is surely a necessary condition. The indication in Barone and Narciso (2012) that education is, if anything, underfunded in areas with greater mafia presence, suggests that some better targeting of resources for education could help.

In measures designed to promote economic development of the poorer regions, there are difficult conflicts to solve. Barone and Narciso (2012) argue that large parts of central government transfers to Sicily, intended to help diminish the persistent gaps in development between Sicily and other southern regions and the rest of the country, are in fact siphoned off by the Sicilian Mafia. It is hard to argue that such funds should be cut off for that reason, but the tendency for resources to be diverted in this way has to be taken into account in deciding how much to allocate, and especially in designing conditionality on its disbursement to try to ensure that money is not transferred without clear results.

The planned development of the social safety net, and measures to improve female participation, have been signalled as important for improving the working of the labour market. They can also have an indirect influence on the position of organised crime. The main mafia organisations often provide a form of social security, through support given to the families of members killed or imprisoned, typically delivered for obvious reasons to females. An improved universal social safety net could simply provide more resources, without changing the incentives for involvement in mafia activity, but it, and greater employment opportunities for women, could help to improve the range of choices available.

Finally, while organised crime has clear local roots and effects in Italy, it is also highly mobile, nationally and internationally. Co-operation with other countries is important, both in making it more difficult for the proceeds of illicit operations to be legitimised and in preventing the development of mafia organisations in other countries. Some countries

may underestimate the extent to which they are vulnerable to the development of mafia and mafia-like organisations. OECD members thus need to co-operate fully with Italy in tracking cross-border mafia activities, in both their own and Italy's interests. Both they and Italy could probably benefit from greater exchange of information and experience.

Box 3.1. **Summary of recommendations on improving policy implementation**

- Reduce the use of decree laws, work towards codified ("testo unico") legislation, implement rules on impact assessment of laws and regulations and increase the use of sunset clauses.
- Pursue performance-oriented management (not just performance pay).
- Further emphasise accountability and transparency. A Freedom of Information Act could bolster this.
- Widen the range of operation of the centralised public procurement body, CONSIP, to cover as much procurement activity as possible, making a database of comparative purchase prices publicly available.
- Streamline court processes, including length of written judgments and effective use of information technology. Continue streamlining sub-national government.
- Revise the law on limitations ("prescrizioni") in criminal corruption cases to reduce incentives to dilatory behaviour, such as the inclusion of the full trial and appeals process in the limitation period.

Notes

1. A World Bank independent evaluation group reviewed the compilation of data for Doing Business in the light of some criticism (World Bank, 2008). A key criticism was the narrow base of informants for some countries. The report also emphasised that the indicators measure the cost of regulation for business, not the benefits for society. This is also true for OECD indicators, but the usefulness of both sets of indicators is in part to look for ways to get the benefits of regulation with minimum economic costs.
2. Among other World Bank data, it uses indicators of labour market regulation from Doing Business. The World Bank has suspended use of these in its latest, 2013, report, pending revision of the methodology.
3. Information on them can be found at *http://info.worldbank.org/governance/wgi/index.asp*. The full dataset can be downloaded from the website.
4. The following discussion applies to *decreti legge*, not to *decreti legislativi*. The latter are laws prepared by the government following a *legge delega*, through which the parliament defines broad principles and then explicitly delegates the detail of legislation to the government. See OECD (2012a) for a description of the various types of legislation in Italy.
5. In a naive test, a simple search, using www.normattiva.it, for mention of "testo unico" in the title of a law gives 27 linked references since 2005, referring to immigration, military regulations, party finance, bank, apprenticeships, financial intermediation, public security, prisons, drug addiction, media, elections, bio-fuel, excise taxes, income taxes, and local government finance. While this indicates that unified texts indeed exist in many cases, none of the linked references led to the *testo unico* itself, only to laws that modify parts of it. [9/11/12].
6. A translation into English by the Italian Senate translates "iniziativa" as "enterprise". If this were accurate there would be little or no ambiguity to worry about. Other translations (*e.g.* from the municipality of Florence) translate it directly as "initiative."
7. "Non tarate" which might refer to inadequate resources or to inappropriate orientation.
8. Data in this paragraph are all from: Istat, Serie storiche, Tavola 6.3 Procedimenti civili sopravvenuti ed esauriti per ufficio giudiziario.

9. The word "mafia" is commonly taken to cover the main criminal organisations in Italy, while originally referring to "the" Mafia, the specific Sicilian example.
10. In addition to domestic provisions, appeal to the European Court of Human Rights is an option, though over-use of this by Italian litigants led to the 2001 law on compensation for too-long trials discussed earlier.

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