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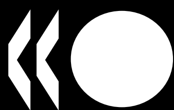

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OECD ECONOMIC SURVEYS

1999-2000

Italy

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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BASIC STATISTICS OF ITALY

THE LAND

Area, (thousand sq. km)	301.3	Major cities, 1.1.90, thousand inhabitants	
Agricultural area (thousand sq. km), 1995	165.2	Rome	2 804
		Milan	1 449
		Naples	1 204
		Turin	1 003

THE PEOPLE

Population, 31.12.98, thousands	57 613	Labour force, 1999, thousands	23 361
Number of inhabitants per sq. km	191	Labour force, 1999, thousands	20 692
Net natural increase, 1998, thousands	–44	In agriculture	1 134
Net rate per 1 000 inhabitants, 1998	–0.8	In industry	6 750
		In services	12 807

PRODUCTION

Gross domestic product in 1999 (trillions of lira))	2 128	Origin of gross domestic product in 1999 at market prices, per cent of total	
GDP per head (1999 US$)	20 330	Agriculture	2.5
Gross fixed capital formation		Industry	25.4
Per cent of GDP in 1999	18.9	Construction	4.6
Per head in 1999 (US$)	3 846	Other	67.5

THE PUBLIC SECTOR

Current expenditure in 1999 (Percentage of GDP)	44.9	Gross financial liabilities in 1999 (Percentage of GDP)	114.9
Current revenue in 1999 (percentage of GDP)	46.4	General government investment in 1999 (percentage of total investment)	13.5

FOREIGN TRADE

Exports of goods and services, as a percentage of GDP, 1999	25.5	Imports of goods and services as per cent of GDP, 1999	23.5
Main export categories, as a percentage of total exports, 1999		Main import categories, as a percentage of total imports, 1999	
Manufactured goods	37.0	Foodstuffs	7.5
Fabric and textile goods	16.1	Manufactured goods	23.4
Chemical products	8.9	Metal, ores and scrap	8.9
Transport equipment	11.5	Chemical products	13.6
Mineral fuels	3.8		

THE CURRENCY

Monetary unit: Lira		Currency units per US$, average of daily figures:	
		Year 1999	1 817
		February 2000	1 967

This Survey is based on the Secretariat's study prepared for the annual review of Italy by the Economic and Development Review Committee on 8th March 2000.

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After revisions in the light of discussions during the review, final approval of the Survey for publication was given by the Committee on 10th April 2000.

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The previous Survey of Italy was issued in December 1998.

Assessment and recommendations

Economic activity has accelerated, and prospects have improved…

A rebound in economic activity has been under way since mid-1999, stimulated by a recovery in external demand. Following an annual average rate of expansion of around 1½ per cent over the past four years, GDP seems set to pick up to close to 3 per cent in 2000, based rather broadly on accelerating world demand, a weaker euro, gradually increasing household disposable incomes and improving business confidence. The combination of firming demand and added labour-market flexibility given by new labour contract laws has underwritten a significant pick-up in employment growth. Unemployment has begun to fall from its currently high level. The underlying momentum of the economy, though difficult to evaluate precisely, appears to be well established and current growth rates of real output should be at least maintained into 2001.

… supported by accommodating monetary conditions…

The recovery in economic activity has benefited from the easing of monetary conditions in the EMU area, where monetary policy remains accommodating. From an Italian perspective, short-term interest rates are at a historical low and money and credit have continued to expand briskly, signalling that there is no financial constraint on growth. Excluding energy and food items, consumer price inflation is currently running at 2 per cent, and the combination of historically-low interest and inflation rates is serving to underpin the impulse to domestic demand growth given by rising incomes. This momentum should be reinforced by the boost to competitiveness arising from the depreciation of the euro. An area of concern is the underlying inflation differential of around 1 per cent *vis-à-vis* the euro area, which is eroding Italy's overall price competitiveness with respect to its EMU partners. But this inflation inertia seems to derive from

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competitive distortions in the sheltered sectors of the Italian economy rather than from macro-economic imbalances. The country as a whole is suffering from a relatively large output gap, and with nominal compensation per employee in the business sector growing at the same rate as in the euro area, the stance of monetary policy would seem appropriate to Italy's economic circumstances.

… and an easing in the pace of budget consolidation

Fiscal policy is also more conducive to sustained growth. Over the five years to 1997, the general government structural deficit was reduced by 7 percentage points of GDP (of which a close to 4 percentage-point decline occurred in 1997), to 2.8 per cent of GDP, in order to achieve the Maastricht deficit target. This was one of the sharpest consolidations in the OECD area in the past decade. The consolidation was helped substantially by interest rate declines, but the primary surplus also rose to 6 per cent of GDP, as a result of tax increases and reductions in transfers, subsidies and investment spending and this was also reflected in the falling interest-rate premium. Since joining EMU, the objective of budgetary policy has been to secure the gains made in fiscal consolidation, a process making for a steadier overall fiscal environment and permitting some short-term support to demand. Italy has used the opportunity allowed by the favourable trend in interest rates to reduce the primary surplus to around 5 per cent of GDP, while still achieving a general government deficit out-turn of just under 2 per cent for 1999, consistent with the Stability and Growth Pact. And with the budget continuing to benefit from past structural measures, notably reforms to widen the tax base and reduce the trend growth of spending, as well as faster growth, there has been no need for abrupt corrective action to keep the deficit on track in 2000.

Maintaining a tight fiscal stance will be essential as the economy strengthens…

The government's new medium-term plan aims to arrive at approximate budget balance by 2003, via an average primary surplus which remains around 5 per cent of GDP; but the debt/GDP ratio is still officially projected to be around 100 per cent. On current policies, the Maastricht level of 60 per cent would be reached only in 2017. While such a cautious approach may be understandable in the light of the severe impact of the preceding fiscal retrenchment on activ-

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ity, as well as the need to maintain support for structural reforms, longer-run considerations suggest that this is the minimum required pace of adjustment:

- While improvements in debt management have made the government's debt service obligations less sensitive to financial market disturbances, the high level of outstanding debt makes the deficit – and hence primary spending plans – vulnerable to interest rate hikes.
- A budget which is balanced on average over a cycle will allow for the fuller exploitation of built-in fiscal stabilisers than has been possible in the past, while providing insurance against the possible need for pro-cyclical fiscal action to prevent the 3 per cent deficit limit from being breached due to the cycle; this should, however, be part of a strategy which ensures the symmetrical use of automatic stabilisers in upturns and downturns.
- Beyond the horizon of the medium-term plan, deficit pressures will intensify as a result of entitlement programmes already in place, especially with respect to pension spending. The conventional measure of debt may thus be an understatement and an added safety margin may need to be built into the primary surplus.

Given these future pressures, any slippage from target should be avoided while revenue windfalls should be used primarily for faster debt reduction.

… which should be facilitated by improved tax collection and better public spending control

The proposed mode of medium-term fiscal consolidation, reducing current expenditure more rapidly in terms of GDP than revenues, is welcome from the perspective of resource allocation, as is the rise in capital spending after several years of restraint. From the tax side, greater efficiency in administration and improved compliance is currently being reflected in buoyant receipts. The ability of a hitherto inefficient state apparatus to make better use of these resources should be aided by the ongoing progress in improving public expenditure planning and control. Reform of the budget process and the clear distinction that has been introduced between political and management functions have made for better spending control at the central level. Incentives for enhanced performance have been built into management contracts. However, whereas institutions and legal frame-

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works are changing rapidly, a cultural change in the public administration has proved more difficult to achieve, and widespread inertia within both central and local administrations may be one of the greatest obstacles to substantive change. A further issue is the difficulty in controlling local and regional spending and the problems in enforcing the domestic stability pact in this regard. Financial data indicate increased borrowing at the local level in 1999, suggesting that local spending exceeded targeted levels. For decentralisation to be effective, spending decisions need to be linked more closely to locally available resources.

Pension reform has been substantial …

Fiscal outcomes over the medium- and longer run will be influenced by the evolution of state pension expenditure, which at 14.2 per cent of GDP (15.3 per cent inclusive of invalidity pensions) in 1998 is one of the highest ratios in the OECD area. On a net-of-tax basis the level would be about 2 percentage points of GDP less. The combination of high replacement rates, generous early retirement provisions, high and increasing life expectancy and a very low and declining fertility rate has threatened to destabilise the system and instigated two major sets of reforms in the 1990s. When fully implemented, the reforms will imply an improvement in incentives affecting the timing of retirement, as average benefits are being brought more closely into line with individual contributions. The system aims to achieve neutrality with respect to the incentives to retire or remain in the workforce up to the age of 65. However, this will be dependent on the revisions required by law every ten years to take account, *inter alia*, of the increasing life expectancy and any revision of potential output growth. These revisions will need to ensure that the system does not revert to being biased in favour of earlier retirement.

… but is being phased in slowly and an accelerated transition needs to be considered

Moreover, the phase-in of the reforms is rather slow. Workers with at least 18 years of service in 1996 are exempted from the bulk of the reforms, meaning that between 40 and 45 per cent of the employed will continue to benefit from the generosity of the pre-reform system. While the reforms may have reduced the projected peak level pension spending by 7 to 8 per cent of GDP, official projections suggest that pension spending will still increase by 1½ per cent of GDP

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up to 2031, before falling back to present pension/GDP levels by around 2050. This continued pressure suggests a need for further adjustments to the state pension system, to achieve better financial balance during the transitional phase. Consideration should be given to moving all workers into the "pro-rata" system, in which pension benefits are determined on the basis of the length of time workers have spent under each programme. So long as incentives to retire early remain strong, this would need to be supplemented by a significant increase in the minimum retirement age. As the scheme becomes fully operative, consideration should also be given to resetting the pension formula to remove the disincentives for people to stay in the workforce when they reach the age of sixty-five.

An increased role for private pensions is needed to allow a rebalancing of social transfers and cuts in contributions

Adjustments to the pension system should be part of a broader package which helps to create a more equitable overall system of welfare spending, while also reducing contribution rates by increasing the role of private pensions. Pensions currently represent two-thirds of all social welfare spending, which is abnormally high by international standards: other types of social welfare spending are correspondingly low, including health spending and unemployment insurance. Yet because of social security charges, the overall tax wedge on labour remains among the highest in the OECD area, at just under 50 per cent of total labour cost. The Italian authorities have recently launched a reform programme whereby savings from pension reform would be used to create a broader and more equitable system of welfare spending, but its approach may not go far enough towards allowing for pension savings to be used for tax reductions. In this context, the government needs to consider introducing a fully-funded, if need be mandatory, second tier, while targeting an overall (private plus public) replacement rate – say 70 per cent – and winding back the public system as the second-tier funds mature. Such a reform would allow for an eventual reduction in social security tax rates and for a gradual correction of the current imbalance in social transfer spending. Debate thus far has focused on the private sector severance funds (TFR), which are seen as the key element in building up these second-tier funds. Since the TFR funds are used by individuals to

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help bridge periods of unemployment and help finance major health or housing costs, as well as by firms for cheap financing, redirecting such funds to financing retirement naturally requires new institutional arrangements, including a more comprehensive unemployment insurance scheme. At the same time, the expansion of a second pillar would be facilitated by steps to increase the range of choices available to workers when deciding how to use their severance fund payments for pension purposes, by removing the restrictions which prevent open-membership pension funds from competing with closed funds.

… especially as the demands for additional age-related spending will increase

Demands for higher welfare spending are likely to become more pressing because of additional age-related spending, such as those for health and care for the frail elderly. The amount involved could be as high as 2 to 4 percentage points of GDP over the next 50 years. Care by the family will become increasingly difficult as average household size decreases and women, who generally provide these services, are increasingly integrated into the labour force. The authorities will need to design policies which ensure that costs are kept to a minimum, while closely evaluating needs and introducing a co-financing principle for long-term care, with income and asset tests, to prevent a large shift in the provision of these services from the family to the state.

Continued enhancement of labour market flexibility is key to employment expansion

Labour-force conditions are key to the evolution of dependency ratios, increased labour force participation and lower unemployment being fundamental to meeting future commitments. There has been progress on several fronts, including in the *Mezzogiorno*. The results achieved from some of the innovations introducing greater flexibility into the labour market have been very positive. Participation rates for women and young people have begun to increase via the use of atypical contracts. But the under-utilisation of resources remains considerable. Female participation remains low nation-wide, and long-duration unemployment is still very high, suggesting that regulatory restraints may act to inhibit labour market performance and that efforts to improve labour-market flexibility need to be continued:

- Moderate wage growth is evidence of forward-looking behaviour, but wage differentials do not match regional

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and sectoral productivity differentials, pointing to the need for more flexibility in employment arrangements, work organisation and labour costs. In the absence of such flexibility, the elimination of public subsidies to cover social security contributions in the *Mezzogiorno* would unavoidably result in a sharp deterioration in competitiveness.

- Restrictions on the application of atypical job contracts have been reduced as recourse to temporary work contracts has been allowed for non-skilled workers; but scope for further increases in part-time work, in particular, still exists.
- At the same time, Italy stands out for its very tight regulations on job protection, which contributes to a duality of the labour market in terms of insiders in permanent employment and growing numbers of outsiders on atypical contracts.

Reform of these remaining rigidities (via government action or on the initiative of the social partners) should be complementary to the harmonisation of benefits in the unemployment insurance scheme and would generate important benefits in terms of job creation.

Income support, active labour market policies and education strategy need rationalising

Policies to increase labour force participation and reduce dependency on state pension provision need also to embrace skill development. Spending on active labour market policies currently totals some 1.1 per cent of GDP and is somewhat higher than the OECD average, but would benefit from redesigning. This would include the simplification of activities and tailored measures to meet the needs of various at-risk categories (women and youths) and long-term unemployed (but not specific sectors which would have adverse allocative effects). As regards human capital and skill-enhancement more generally, Italy shares the common EU problem of a mismatch between courses taught at high schools and the requirements of the business sector, while also suffering from high drop-out rates. The pace of reform also needs to be accelerated in education and training, and a long-term plan (*Masterplan*) is currently being designed with the aim of responding to these weaknesses.

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A new approach aims at realising the growth potential of the South

While the labour-market problems described above have a nation-wide application, perhaps the most striking feature of the Italian economy remains the disparity between unemployment rates in the North and South. A major shift in policy occurred in 1998 with the development of a new strategic approach, valid nationally but with a special focus on the *Mezzogiorno*, aimed at improving the environment for business investment via better evaluation and accountability for public infrastructure projects, greater autonomy for local authorities and competition for resources among administrations. After a slow start, the number of projects under implementation in the South increased sharply in the course of 1999, accompanied by a marked improvement in the ability to spend public funds effectively, both national and EU. Company start-ups have increased, but so far signs of recovery are localised. The lower quality of transport, power, banking, insurance and administrative procedures continue to add to business costs, hampering development. At the local level, *patti territoriali* have been used since 1996 to promote private investment and co-operation between the private and public sectors, while *contratti d'area* between social partners and local authorities in economically depressed regions allow for special agreements with respect to employment arrangements, credit and public order. But the region is still marked by the size of its underground economy and by a weak rule of law, although progress has been made in fighting organised crime. In tackling infrastructure and governance problems it is evident that policies need to be tailored to the specific needs of the South. However, they also need to be underpinned by improvements in the quality and efficiency of the public administration and in the general regulatory environment, including greater scope for a more flexible use of working time, increased wage and labour cost flexibility and product- and financial markets which are more favourable to business risk-taking.

There has been substantial progress in privatisation and liberalisation…

A wide range of legislation and initiatives have been introduced over the last few years to liberalise product markets. After a pause in 1998, the pace of privatisation gathered momentum in 1999 with the sale of the first tranche of the electricity company, ENEL. Reform of the energy sector (both liberalisation and privatisation) has been preceded by

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the establishment in 1995 of a Regulatory Authority for the electricity and gas sectors, which became operative in April 1997.

- As concerns electricity, the price of which is relatively high in Italy, the partial devolution of some of ENEL's service responsibilities in generation, transmission and distribution to newly-created public entities and companies created from demerged ENEL activities, has been followed by measures to introduce competitive mechanisms into the market. These allow for a greater number of operators, wider access to the network and reduced controls.
- Consistent with EU directives, the government has recently approved the main guidelines of a liberalisation plan for the gas sector, leading to significant restructuring. Due to the presence of a small number of participants, the sector seems to be even more concentrated than electricity, again with price levels for households and industrial clients above the EU average.

Partly in response to the threat of third-party access to the network, average prices for electricity have fallen and should continue to do so. The rate of decline may accelerate when a fully-fledged wholesale market is in place, which is expected by 2001. On the other hand it may be slowed by the establishment of a single buyer for resale to the franchise market, the effective control of which will be with the System Operator (a company owned by the Ministry of Treasury). The eventual benefits to consumers will depend heavily on the Regulatory Authority and active enforcement of competition rules.

… but there is still evidence of deficient domestic competition

Notwithstanding the progress noted above, the results achieved so far with regard to product market competition have been scattered. Indeed, the fact that inflation in Italy is persistently above the EU average may point to lack of contestability in certain markets. Competition should increase as the government pushes ahead with selling the portfolio of IRI – a holding company of the Treasury – which includes the sale of stakes in *Società Autostrade* and *Aeroporti di Roma*. But in the transport sector in general, reforms are taking time and the tempo of liberalisation needs to be increased.

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- With respect to the *railways*, Italy faces major medium and long-term challenges to reduce state control and restore sound finances.
- As concerns other transport modes, prior to privatisation the government opted for a twenty-year extension of the *Autostrade*'s concession, which may have resulted in motorway fees declining less rapidly than if the government had guaranteed wider rights of access. For *air transport*, progress has been achieved in the liberalisation of airport land services, although according to the Antitrust Authority it has been less marked than advocated by the Commission's directive (as for instance in the area of baggage handling).

Elsewhere, one of the weak links in the service sector is the *postal service*, where the liberalisation decree introduces a wide margin of discretion in defining activities subject to restrictions (largely determined by the need to improve the financial situation of the incumbent), as well as *public utilities under municipal authority*, including water distribution, energy excluding electricity, public transport and waste management. The authorities have recently embarked on an ambitious liberalisation programme, opening use and management of facilities to private companies. The new law should promote greater efficiency through mergers and acquisitions but proposed exemptions for small local municipal authorities could greatly compromise the scope and effectiveness of the reforms.

… and competitive restraints and inefficiencies are widespread in private non-financial services

The private non-financial service sector is marked by a considerable degree of fragmentation and market inefficiencies, deriving from the presence of strong entry barriers (including a widespread recourse to quantitative restrictions), often arising from mutually reinforcing national and local regulations.

- A major attempt to liberalise the service sector has involved (from 1998) the abolition of city regulations for *retail shops*, including ceilings placed on the number of shops. However, the discretion conferred to local administrations has acted to delay implementation of the overall reform programme.

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- As concerns the *professions*, the role played by professional bodies (business consultants, lawyers and fiscal experts, for example) and small business associations (for example, driving schools, taxis, trucks, beauty shops and cinemas) is still very extensive, without being justified by reasons of general interest. Tariffs are largely established on the basis of self-imposed internal criteria. Italian legislation also imposes rigid boundaries between professions, thereby discouraging mergers and perpetuating market inefficiencies.

Initiatives have been taken by the Antitrust Authority to investigate cases of anti-competitive behaviour. From a medium-term perspective, it is likely that technological progress and the growing flexibility of the labour market will give momentum to the creation of new forms of professions, and appropriate reform measures may be needed in order to prevent these pressures from creating protectionist resistance. A significant reorganisation of the rules determining access to the professions is needed, under which new entry would be greatly eased, the publication and dissemination of quality standards for services and codes of conduct guaranteed and professional demarcation rules softened.

Promoting a business-friendly environment is essential for growth

Future growth prospects are highly dependent upon creating the conditions in which smaller firms can expand. The Italian industrial structure is dualistic in nature, where a small number of large corporations coexist with a vast network of small- and medium- sized firms. This has long being considered a factor of relative strength for the Italian economy, since small firms are thought to be characterised by a high degree of flexibility. Although the so-called industrial district, or cluster, model of geographically-concentrated firms may allow some of the problems of small firm size to be overcome, several disadvantages may remain:

- The system may perpetuate Italy's trade specialisation in traditional, low R&D-intensive products. Overall R&D expenditures in Italy are low compared with the other euro-area countries, while business sector involvement in R&D is minor.

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- While Italian firms have a good record for non-price competitiveness, their smallness seems to have contributed to a disadvantageous commodity composition of exports.
- Unless their productive activities are highly specialised, small companies may encounter difficulties in exploiting economies of scale.

The labour-market rigidities already discussed may play a role in the very high propensity for Italian companies to remain small, but the causes may also include an intrusive public administration. Creating or expanding a company is especially complex in Italy. The *Bassanini reforms* of 1997 provided a general framework for the simplification of administrative procedures, within which several measures have already been implemented. Among these, the most promising has been the introduction of "one-stop shops" for dealing with regulatory and administrative procedures. By the end of 1999 almost a third of all municipalities had opened such shops. Prospectively, this innovation should help to foster business initiative both by reducing administrative red-tape and providing information and advice for economic agents willing to invest.

A more efficient tax structure will aid business development…

Recent tax reforms have aimed to reduce the capital-market biases inherent in the tax system which may have held back enterprise development, by creating a less discriminatory investment- and corporate income tax structure. As a result, the cost of capital faced by companies operating in the Italian territory has fallen and is now close to the EU average. Moreover, the new dual income-tax system taxes equity-financed new investment at a preferential rate, although debt remains the more attractive means of corporate finance. While the eventual aim is to apply the same tax advantage to the old capital stock, for the present, new companies investing fresh capital and mature companies with retained earnings will be the main beneficiaries. This progressive and somewhat piecemeal approach to company tax reform may be partially dictated by the government's budget constraint. It also reflects action to offset conjunctural weakness in investment. These considerations have added to the current complexity of the system. However, when fully implemented, the result should be a more neutral

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company tax system, favourable to business and equity-market development.

... as will the progress made in financial market liberalisation

A firmer base for economic growth is also being provided by significant deepening of Italian financial markets. Although, at around 50 per cent of GDP, the overall capitalisation of Italian companies listed in the stock exchange is still relatively low, it has increased markedly. Take-over bids surged in 1999, a development with important repercussions on the framework for corporate governance and competition. On the demand side, this development was accompanied by a significant rise of mutual funds and private equity- and bond- holdings in households' portfolios. In banking, the process of consolidation has accelerated further in the past few years, with significant benefits:

- Combined with the privatisation of many state banks, the process of consolidation in the banking sector has helped – through opportunities for creating new scale economies – to improve the operating efficiency of the Italian banking system at large.
- Consolidation should lead banks to put more emphasis on the issue of risk assessment. In connection with this, new profit opportunities have been sought and the portfolio of banks' activities has widened.

Despite consolidation, the efficiency of Italian banks remains stifled by problems of overstaffing and high labour costs. Equity alternatives to bank credit are still limited, although the *Nuovo Mercato* (New Market), which has been operational since June 1999, is specifically dedicated to smaller companies with strong growth prospects. So far privatisation, take-overs and mergers and acquisitions have helped to reinforce the predominant role of large corporations in the stock market.

Summing up

Overall, the assessment of the Italian economy identifies significant progress since the previous review. Short-term prospects have improved, with the projections pointing to growth near to the EU average in 2000-2001. The benefits of EMU membership are showing up in terms of historically-low credit costs, while the depreciation of the euro will give a short-term boost to export demand. They are also evident in

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lower public debt interest payments which have helped to ease fiscal pressures. At the same time, longer-term growth potential has improved with added labour-market flexibility, with the privatisation and liberalisation of previously monopolised utility and transport sectors, and with improvements in the functioning of the financial market. Nevertheless, the reform process is very much work in progress and needs to be taken further. The Italian economy still suffers from an onerous fiscal constraint, which will require a high primary surplus in order to meet debt-reduction objectives, while allowing for increasing social spending obligations and cuts in Italy's excessive taxes on labour. Achieving all three objectives will require difficult decisions as to the provision of state and private pension benefits, in addition to those already made. The burden of regulatory and administrative compliance and high charges for private services, arising from inadequate competition, continue to act as a drag on international competitiveness and the growth of smaller businesses. The creation of a more favourable overall business environment is essential for reducing still-high unemployment and is particularly important for correcting the slow development of the *Mezzogiorno*, where the promising new strategy adopted for the development of the South, based more on local initiative and less on central direction, needs to be underpinned by measures to complete the market liberalisation process and the modernisation of the public administration. So far the pace of convergence has remained slow. If the reform path outlined in the *Survey* is followed, there is every reason to suppose that Italy will begin to fulfil its so-far unrealised growth potential, while achieving a more balanced regional and intergenerational distribution of resources.

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I. Economic conditions and the prospects for faster growth

Overview

Economic activity is firming and employment has begun to expand at yearly rates in excess of 1 per cent for the first time since the early 1990s. However, it is still a matter of concern that Italy has been one of the slowest-growing economies of the EMU (Figure 1), despite having benefited from substantial cuts in interest rates. From 1995 to 1999 the economy expanded by only 1.5 per cent a year compared with some 2 per cent for the average of the euro area. The reasons are quite complex, and may relate partly to the difficulties in fully integrating the southern regions into the more dynamic economic mainstream. It must also be recognised that Italy has had to undertake a more aggressive fiscal policy tightening than most of its EMU partners. More recently, Italy has been relatively badly hit by the crisis in the emerging markets of East Asia, as the composition of its exports makes it more exposed to a rise in competitiveness in that area. But the explanations also include structural problems, which reduce competitiveness and growth potential via non-factor input costs increasing more rapidly than on average in the euro area and a marked export specialisation in traditional goods. The present chapter starts with a review of recent macroeconomic developments and the short-term outlook. It then discusses the medium-term supply-side issues raised by Italian export competitiveness. The related challenges for structural policies, including those of the *Mezzogiorno*, are examined in Chapter IV.

Slow growth gives way to renewed expansion

In terms of cumulative output gains, the current upturn has been slower to develop than the previous one, as growth has been held back by domestic demand and particularly consumption, both private and public (Table 1). Moreover, the contribution to growth from net exports has turned negative. Real GDP grew by 1.4 per cent in 1999 (on a new national accounts basis, see Box 1),

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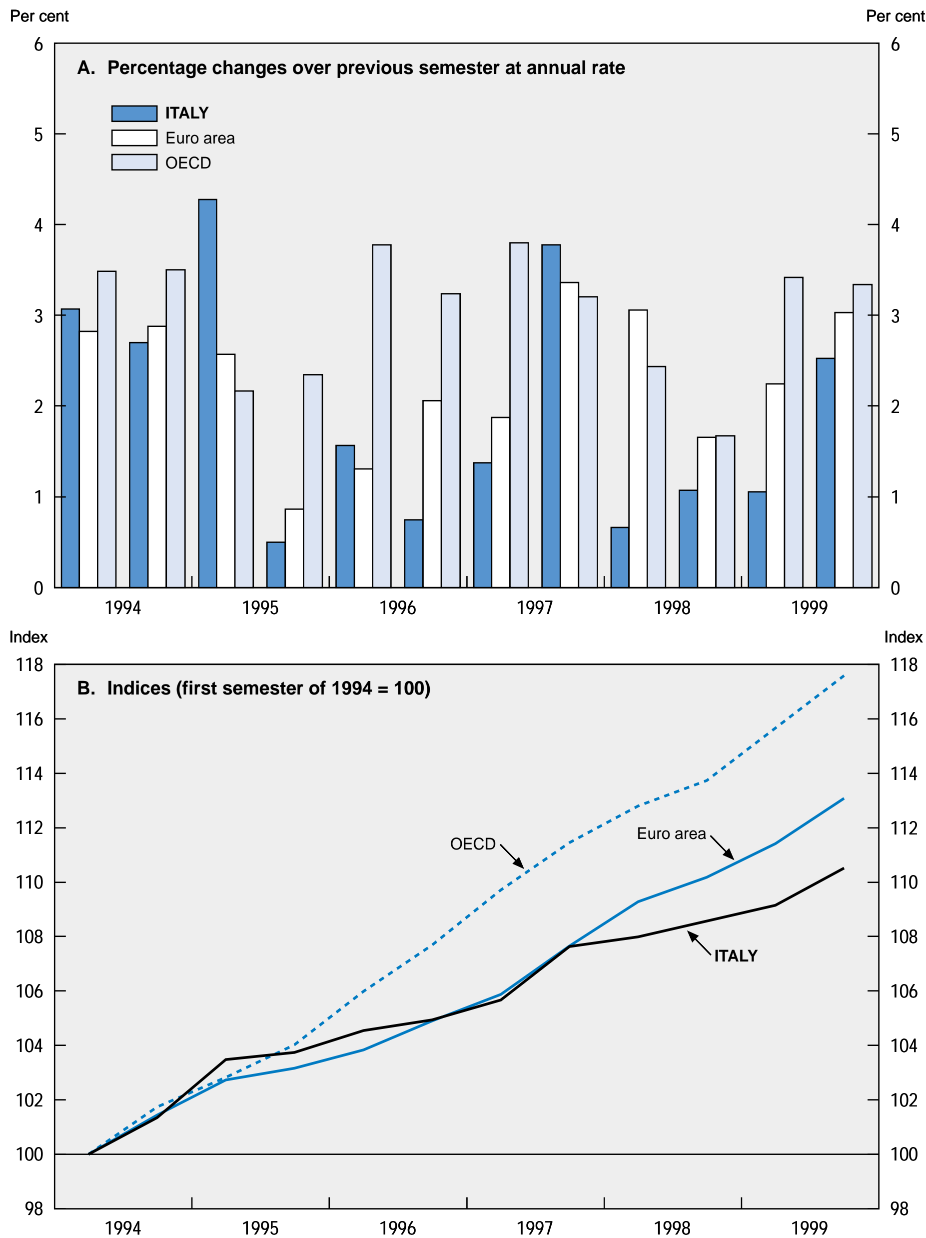
Figure 1. **Real GDP developments compared**



Source: OECD.

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Table 1. **Real output and demand growth: a cyclical comparison**

Cumulative changes since trough

	Cyclical trough = 1982 Q4					Cyclical trough = 1993 Q3				
	Situation after:					Situation after:				
	15 quarters	18 quarters	21 quarters	24 quarters	26 quarters[1]	15 quarters	18 quarters[2]	21 quarters	24 quarters	26 quarters[3]
Real GDP	109.9	111.4	115.5	118.3	120.3	106.7	110.1	110.8	111.6	112.9
Final domestic demand	108.9	111.9	115.5	119.5	121.2	105.4	107.8	109.6	111.4	112.2
Private consumption	110.5	113.4	116.3	120.0	122.4	106.4	108.3	110.6	112.1	112.2
Government consumption	107.9	112.1	116.1	119.3	118.7	98.1	98.6	99.1	99.5	99.9
Gross fixed investment	105.5	107.5	112.5	118.4	120.2	110.1	115.8	117.6	121.8	125.3
Total domestic demand	110.4	113.4	118.3	121.2	124.0	104.9	109.4	110.3	113.6	114.1
Exports of goods and services	117.4	117.0	126.1	128.7	131.5	127.1	136.5	137.9	134.0	140.7
Imports of goods and services	122.3	131.8	146.7	149.1	157.9	121.0	136.1	138.9	146.0	149.7
Foreign balance	99.7	98.2	97.6	97.7	96.9	101.9	101.0	100.8	98.4	99.2
Elasticity of imports[4]	2.2	2.3	2.6	2.3	2.4	4.4	4.1	3.5	3.4	3.5

1. 1989 Q1.
2. 1997 Q4, *i.e.* immediately after the Asian crisis.
3. 1999 Q4.
4. Cumulative change in the volume of imports of goods and services relative to total domestic demand.

Source: OECD.

Box 1. Revised national accounts

According to the national accounts figures released by the National Statistical Institute (ISTAT) in March 2000, the level of real GDP has been revised upward by between 0.2 to 0.7 percentage points for the period from 1996 to 1998. The actual extent of the GDP revision tends to increase over time, which seems consistent with the earlier revision of the labour force survey introduced in July 1999 (see Box 2).

Impact of the revision on the level of real GDP

At 1995 prices

	1996	1997	1998
Total consumption	0.2	0.8	1.0
Total fixed investment	1.3	1.7	2.3
Imports of goods and services	0.5	0.6	3.5
Exports of goods and services	–0.3	0.9	3.1
Real GDP	0.2	0.6	0.7

Source: OECD calculations based on ISTAT figures.

Likewise, the recent change implies the stronger economic role of services. Measured in terms of total value added, for 1998 the weight of services has risen from 64.1 to 65 per cent, while the weight of manufacturing industry has declined from 28 to 27.2 per cent. Including construction, the weight of industry has declined from 33 per cent to 32.1 per cent of total value added. As concerns the different components of aggregate demand, the revision evidences a significant rise in the level of total fixed investment and consumption, the impact on the level of GDP being partly offset by a concomitant rise in imports.

The growth record has also been altered by the revision. Reflecting mainly stronger gross fixed investment and private consumption, the annual growth rate of real GDP over 1997 and 1998 has been increased on average by a quarter of a percentage point. Strong gross fixed investment continued to assist activity in 1999 when real GDP increased by 1.4 per cent.

Earlier in 1999, ISTAT introduced a new system of national accounts in accordance with the guidelines of the new European System of Accounts (ESA95), so as to contribute to the harmonisation of the accounting framework, concepts and definitions within the European Community.* The new system provides more detailed information about the structure of the economy, more integrated and coherent national account estimates, more reliable stock and flow data relationship and more detailed description of links among economic, environmental, social and demographic variables. The revisions include annual and quarterly national accounts, investments by owner and user branch, regional accounts, and financial and economic accounts by institutional sector. The base year is 1995 as agreed by the Community.

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Box 1. Revised national accounts *(cont.)*

Impact of the revision on the growth rate of real GDP

At 1995 prices

	1997			1998			1999
	New series	Old series	Gap	New series	Old series	Gap	
Private consumption	3.0	2.5	0.5	2.3	1.8	0.5	1.7
Government consumption	0.8	–0.5	1.3	0.7	1.2	–0.5	0.6
Gross fixed investment	1.2	0.9	0.3	4.1	3.5	0.6	4.4
Final domestic demand	2.2	1.6	0.6	2.4	2.0	0.4	2.0
Stockbuilding	0.3	0.8	–0.5	0.6	0.6	0.0	0.4
Total domestic demand	2.5	2.5	0.0	2.9	2.6	0.3	2.5
Exports of goods and services	6.5	5.2	1.3	3.3	1.1	2.2	–0.4
Imports of goods and services	10.2	10.1	0.1	9.1	6.0	3.1	3.4
Net exports	–0.6	–0.9	0.3	–1.3	–1.2	–0.1	–1.0
Real GDP	1.8	1.5	0.3	1.5	1.3	0.2	1.4

Source: OECD calculations based on ISTAT figures.

Compared with the old system, the main novelties of the ESA95 national accounts are:

- The change in the classification of economic activities by types.
- The widening of the gross capital formation concept by the inclusion of intangible assets into capital formation. For example, software and mineral exploration are now classified as capital goods while they were previously classified under intermediate consumption.
- The separation between household "final consumption" spending and households' "actual consumption" which is a wider concept of consumption of goods and services including, for example, health and education. The latter are usually paid by the government or non-profit institutions.
- The change in the time of recording to accrual basis.

* ISTAT (1999), "Revisione dei conti nazionali del SEC95", *Note rapide*, April.

somewhat weaker than the already modest performance of the previous two years. The annual average conceals a significant slowing of growth in the early part of the year (Figure 2).

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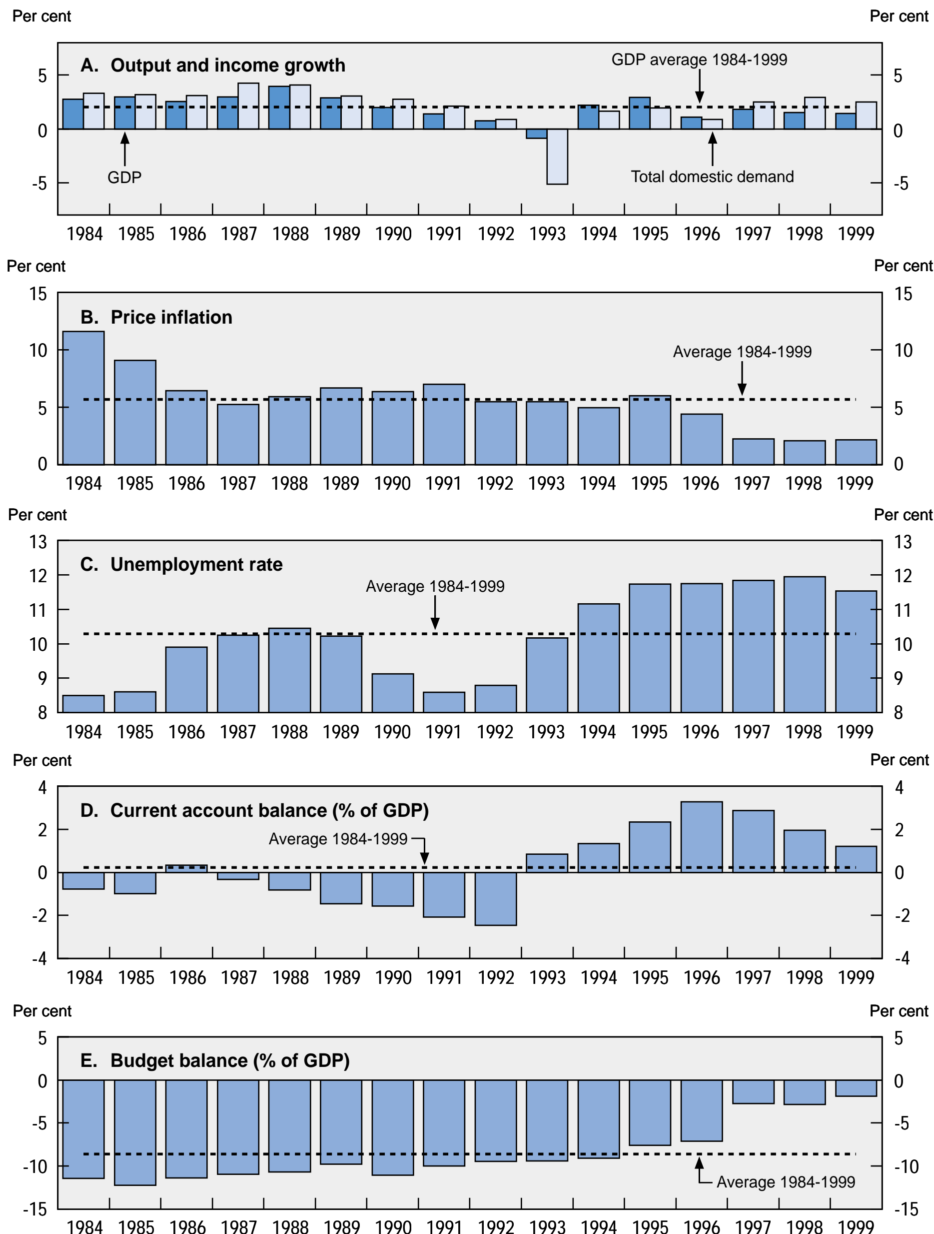
Figure 2. **Macroeconomic performance**



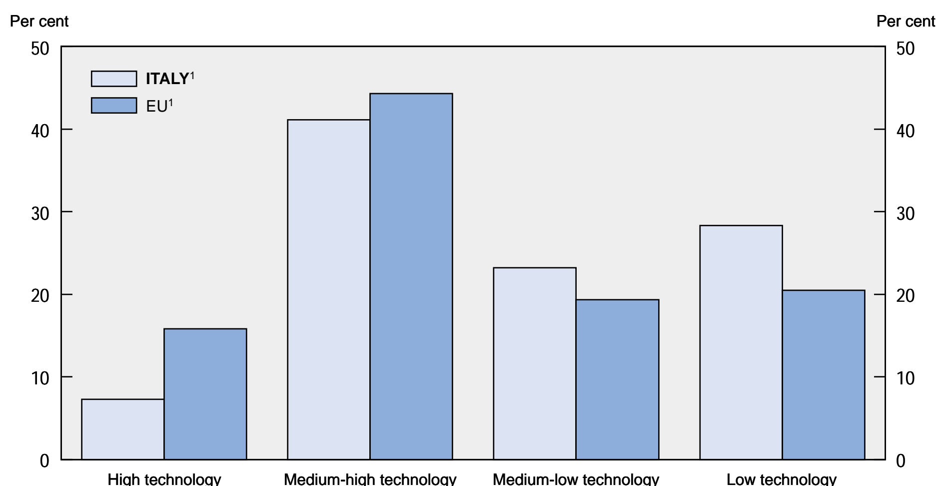
Source: OECD.

Weak export performance has contributed to slow growth

A major feature of developments since early 1998 has been the sharp contraction of exports, reflecting not just weaker industrial activity in the European Union but also a deteriorating performance in emerging markets. As mentioned above, Italy was somewhat more exposed than the other euro-area countries to the effects of the crisis in the emerging markets. In this respect, the product composition of Italian trade appears to have mattered, the crisis having led to cuts in demand for machinery and intermediate goods, whose share in total Italian manufacturing exports exceeds 40 per cent (Figure 3). The resulting decline in the share of Italian exports going to East Asia was relatively sharp (Table 2). More importantly, perhaps, the indirect effects of the crisis were particularly relevant for Italy. Specialisation in traditional goods implies a considerable overlapping with exports from South-east Asian countries, which made important competitiveness gains after the crisis.

There have also been significant developments in the performance of imports, which expanded markedly over the last few years. The financial inducements to car purchases introduced in 1997 might have contributed to the rise, but import elasticities have remained consistently higher than in the previous upturn

Figure 3. **Distribution of Italian exports**
As a percentage of total manufacturing goods exports, 1997



1. See Annex 1 for definitions of groupings.
Source: OECD, *Foreign Trade Statistics.*

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Table 2. **Trade by region**

Per cent

	Italy				Euro area			
	1997		1998		1997		1998	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
OECD	76.5	76.9	77.9	78.4	82.3	81.8	83.7	82.6
European Union	55.0	51.4	56.4	52.2	62.9	49.8	64.0	50.1
Non-OECD	23.0	22.9	21.6	21.4	17.1	18.0	15.7	17.2
Europe	5.8	5.4	5.7	5.3	4.1	3.5	3.8	3.4
Africa	3.6	7.2	4.1	5.9	2.8	3.6	3.0	3.1
America	3.8	2.3	3.9	2.3	2.3	2.1	2.3	2.0
Middle East	3.6	2.7	3.5	2.1	2.3	1.7	2.2	1.4
Far East	6.2	5.2	4.4	5.7	5.5	6.9	4.3	7.2
Other and unspecified	0.5	0.2	0.5	0.2	0.6	0.2	0.6	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: OECD.

even after the incentives expired (Table 1). Shifts in preferences might have played a complementary role, with consumers responding to fiscal consolidation, and the related fall in disposable incomes, by increasing purchases of cheaper foreign substitutes. Again, competitiveness gains made by South-East Asian countries have reinforced this trend, the area-wide share in total Italian imports having increased by half a percentage point after the crisis (Table 2).

Notwithstanding less restrictive economic policies, investor uncertainty increased with the decline of exports and this translated into delayed investment plans. Having recorded the strongest expansion since the beginning of the cycle in the fourth quarter of 1997 (2.3 per cent relative to the preceding quarter), total fixed investment underwent a year-long slowdown thereafter. Private consumption was also weak, under the combined influence of weak disposable income growth and the reduced incentives for car purchases (definitively abolished at the end of 1998). Only stockbuilding cushioned the deceleration in aggregate output growth, but even so the industrial sector displayed a marked slowdown.

Despite the cushioning effect of an improving terms-of-trade, the trade surplus recorded a contraction in 1998 and especially 1999 (Table 3). The decline was accompanied by a reduction in the services surplus, the overall deterioration being only partly offset by the recent improvements of the factor income deficit and the transfer account. Consequently, the current account surplus continued to decline in 1999 (to some 1.0 per cent of GDP), although by an amount smaller than implied by the erosion of the trade balance. The growth of exports turned positive from the beginning of the year, while imports started to slow.

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

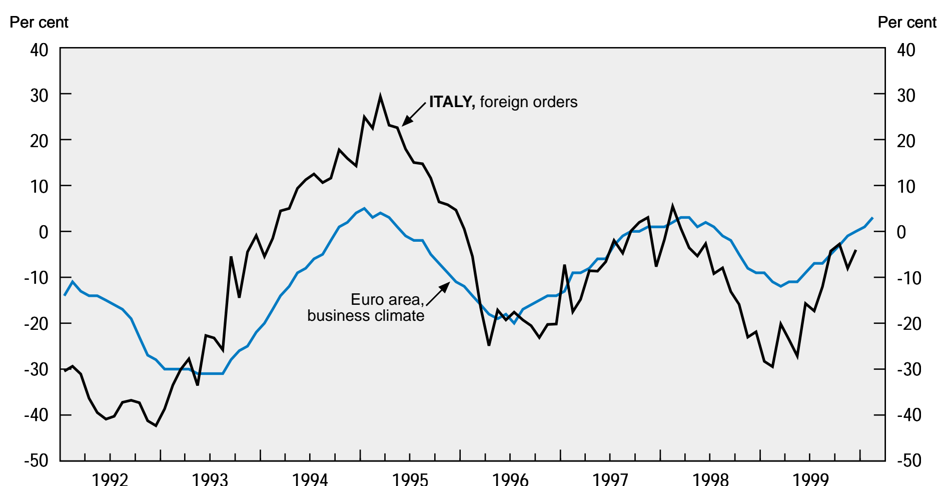
	1993	1994	1995	1996	1997	1998	1999
Current account balance	12.7	21.0	40.9	61.5	55.3	37.8	18.2
Current account balance as a percentage of GDP	0.9	1.3	2.3	3.3	2.8	1.9	1.0
Exports (f.o.b.)	266.2	308.0	381.2	388.9	409.1	426.2	419.6
Imports (f.o.b.)	220.4	257.4	318.1	305.6	341.0	363.1	381.8
Trade balance	45.8	50.7	63.1	83.3	68.1	63.1	37.8
Services, net	5.3	8.5	10.7	12.4	13.3	8.5	5.3
Factor income, net	–27.0	–26.8	–25.5	–23.1	–19.0	–20.9	–16.6
Unilateral transfers, net	–11.4	–11.4	–7.4	–11.1	–7.1	–12.9	–8.3
Invisible balance	–33.1	–29.7	–22.2	–21.8	–12.8	–25.3	–19.6

Source: Banca d'Italia (1999), *Statistical Annex of Annual Report,* Table AB38 and *Economic Bulletin* No. 34, Table 7.

... but recovering export demand has fostered an improving business climate

The business climate began to firm in the second quarter of 1999, as improving export momentum helped to induce a pick-up in machinery investment (Figure 4). The driving force underlying the recovery of exports has been the improved economic conjuncture in Europe, which contributed to particularly strong incoming orders for manufacturing goods (Figure 5). Adding to this, the

Figure 4. **Confidence in the euro area and Italian foreign orders**
Per cent balance of positive and negative answers



Source: OECD.

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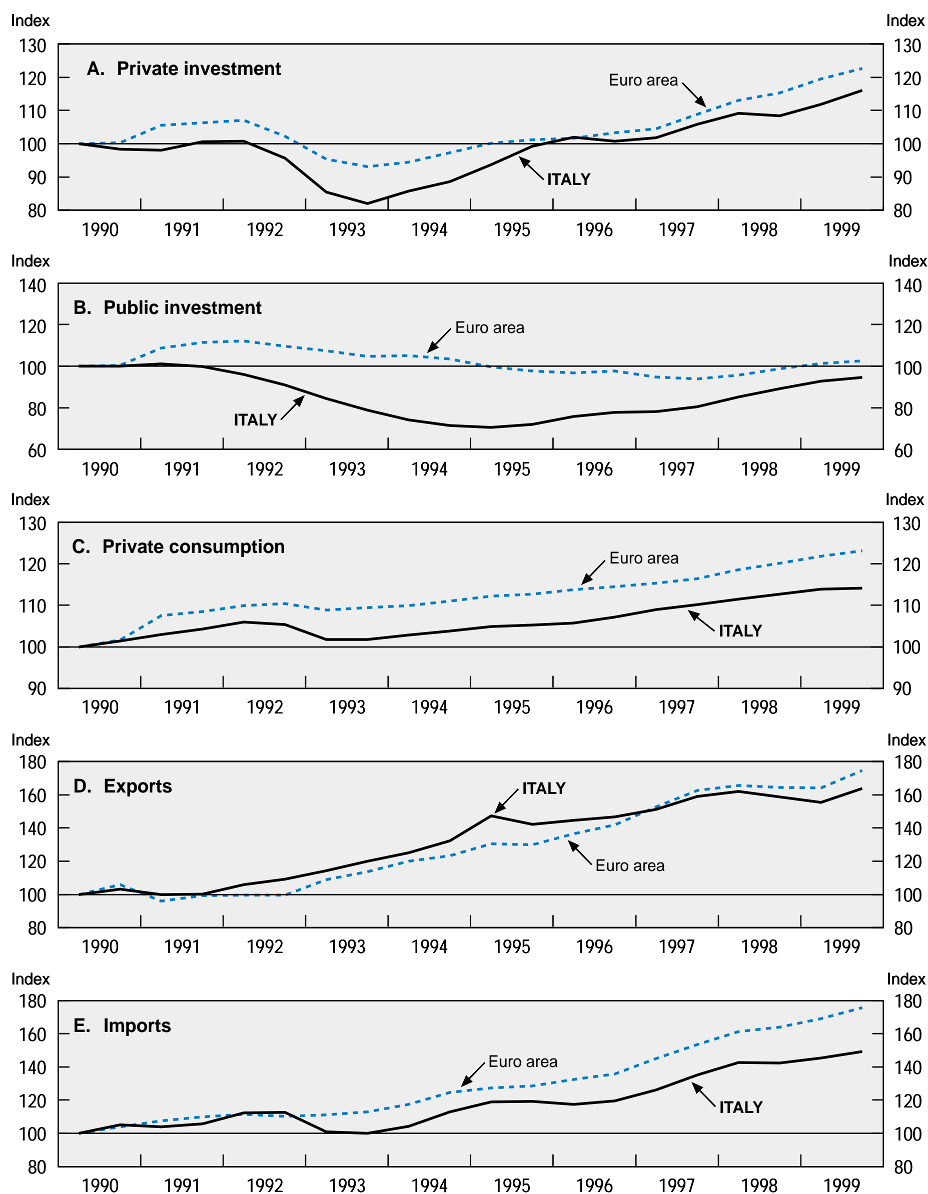
Figure 5. **Demand trends**
First semester of 1990 = 100



Source: OECD.

recovery in construction investment was proceeding quite rapidly, reflecting in part the positive stimulus provided by the special incentives for residential construction and a rebound in public works. Consumer confidence received a temporary setback in April, due to the uncertainties induced by the Kosovo conflict. But the overall picture given by the new composite leading indicator (jointly produced by the Bank of Italy and ISAE) began to be rather encouraging. This indicator displayed a strong pick-up during the summer, signalling an imminent further strengthening of the cycle.[1] Confirming this expectation, domestic orders in manufacturing accelerated over the second half of the year. Finally, a broadening basis for growth was also evidenced by a rapid narrowing of the gap between planned and realised business investment as a consequence of an improved climate of confidence.

... and employment is rising

The employment picture has been strongly affected by a major revision of labour-force statistics (see Box 2). For the past few years, the new figures confirm that the expansion of employment has been weaker than in the other major euro-area countries (Figure 6). Since the second half of 1998, however, employment gains

Box 2. The revision of the labour-force survey

As with the National Account Statistics, a new employment accounting methodology was introduced in 1999 to follow the EC definition.* The most salient change relates to the method of estimating the population age structure. This is now based on data from municipal civic registers covering the entire population and no longer on the series used to update the most recent census figures. The change led the share of young people in total population to shrink and correspondingly the share of adults and middle-aged age groups to rise. For the period from October 1992 to April 1999 the number of employed was revised upward by on average 90 000 units per quarter (0.4 per cent), with the actual extent of the correction increasing over time. For April 1999 the revision amounted to 225 000, or 1.1 per cent. Under the new methodology there has been a fall in the number of persons in search of jobs (–82 000 on average during each quarter). In addition, the sectoral composition of employment has changed, a declining share of agriculture being offset by a rising share of employment in industry. On average over the period, the labour force revision has been comparable to the one observed for the population, implying that the participation rate has remained broadly unchanged.

* ISTAT (1999), "La revisione delle serie storiche delle forze di lavoro", *Statistiche in breve*, July.

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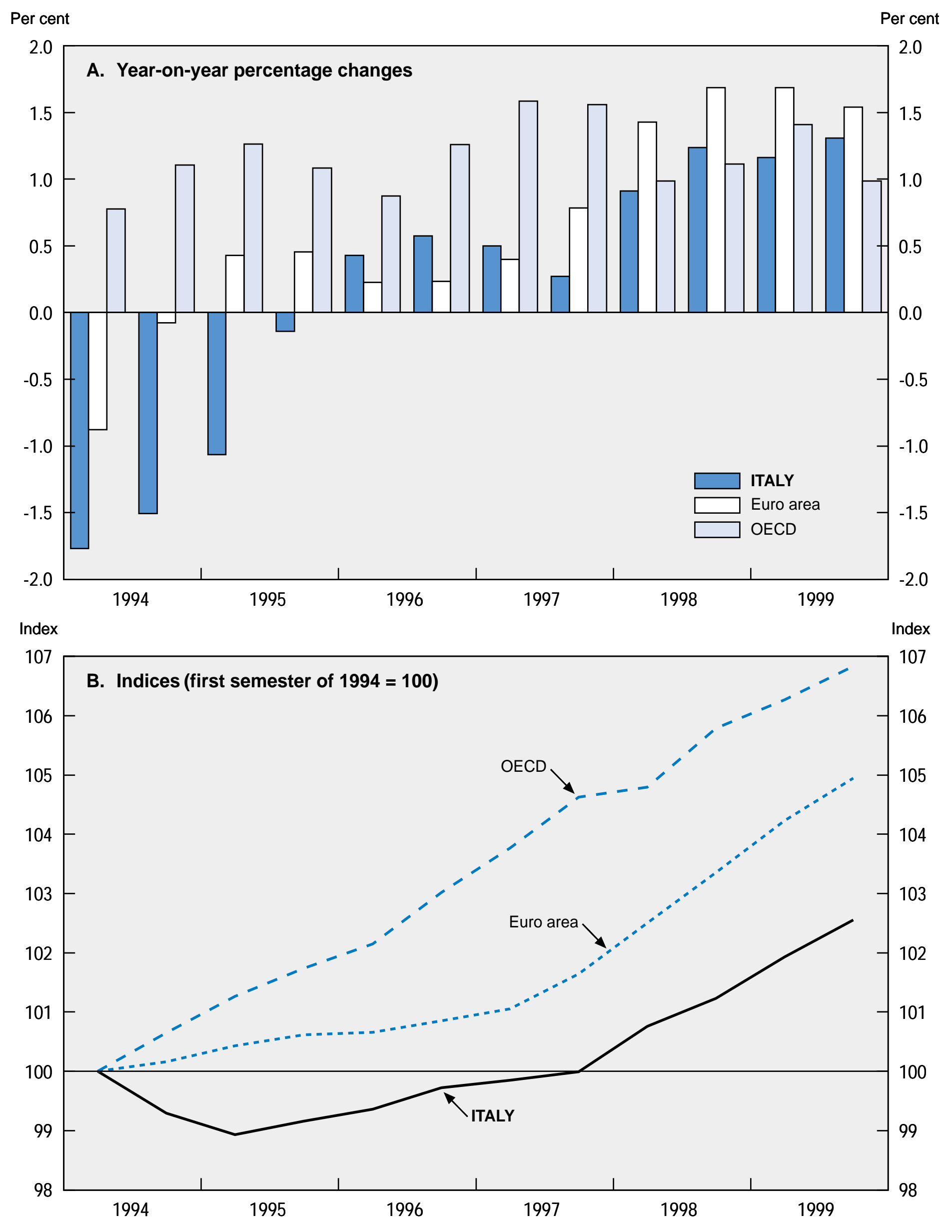
Figure 6. **Aggregate employment patterns compared**



Source: OECD.

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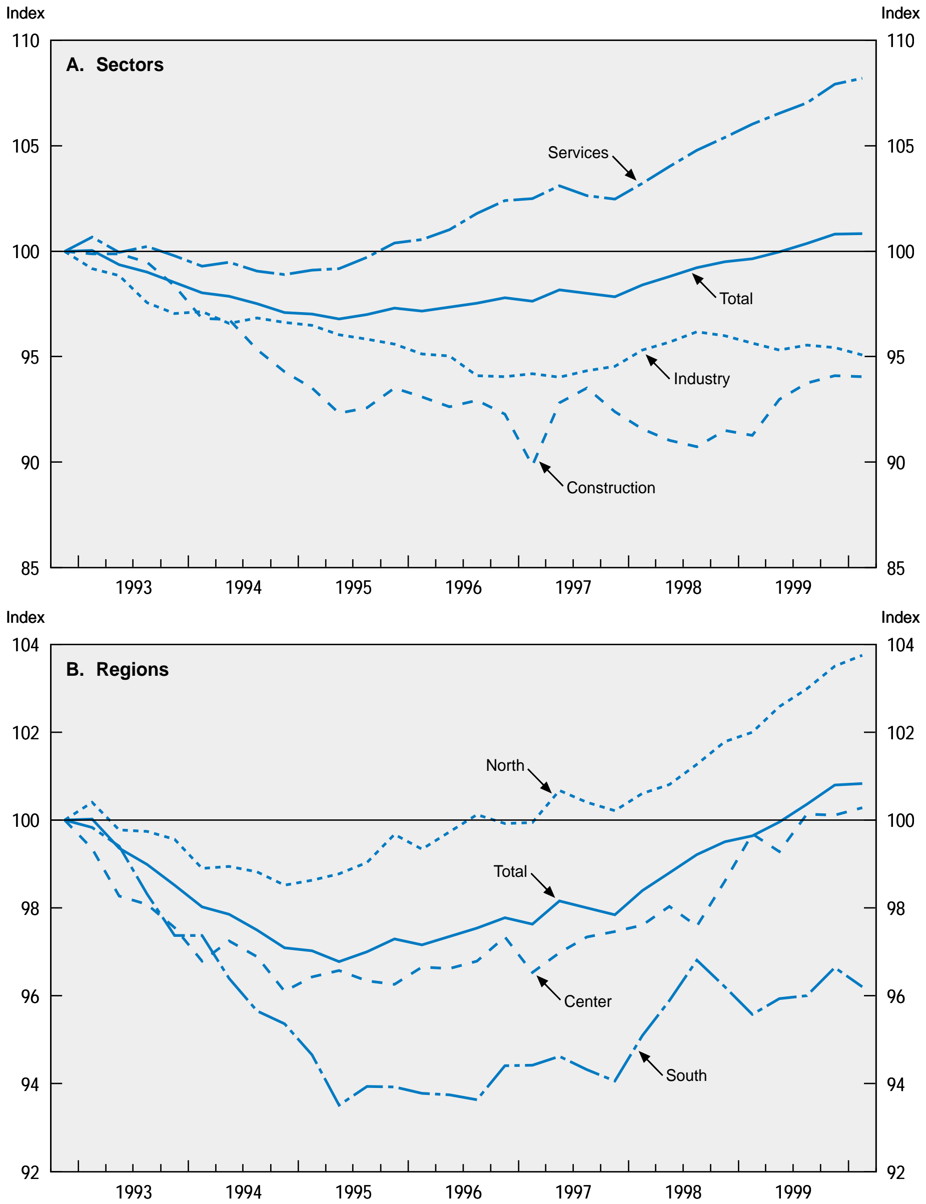
Figure 7. **Employment by sectors and regions**
Fourth quarter of 1992 = 100



Source: ISTAT.

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Table 4. **Regional labour-force indicators**

	European Union[1]	Italy[2]	North[2]	Centre[2]	Mezzogiorno[2]
Unemployment rate	9.9	11.4	5.2	9.1	22.1
Males	8.7	9.0	3.5	6.8	17.5
Females	11.5	15.3	7.6	12.6	31.5
Participation rate[3]	67.9	59.1	63.5	60.5	52.9
Males	77.8	73.0	74.4	73.2	71.0
Females	58.0	45.3	52.5	47.9	35.0

1. In 1998.
2. In the first quarter of 2000.
3. Ratios refer to persons aged 15 to 64 years who are in employment or in the labour force divided by the working-age population.

Source: ISTAT; OECD.

have been quite important and not too dissimilar from those recorded on average by the euro area, despite a much slower pace of economic expansion in Italy.

Consistent with the pattern observed in many OECD countries, the employment expansion has been supported by a significant rise in the number of workers in services (Figure 7). The most notable progress was attributable to employment in private services to households and corporations. Compared with most manufacturing activities, these are typically characterised by a higher labour requirement per unit of value added. Employment in services rose by 2.1 per cent over the first quarter of 2000, during which period employment in the industrial sector underwent a small contraction. Figure 7 shows that most of the additional jobs created reflected the dynamism of the Centre-North. The South registered strong employment growth during 1998, but little job expansion thereafter. Diverging regional labour-market dynamics meant that the already wide gap between northern and southern unemployment rates did not come down (Table 4).

Forces acting and short-term prospects

Monetary policy background

Monetary conditions eased significantly over the survey period. By December 1998, when the discount rate reached the euro area co-ordinated level of 3 per cent, it was 2.5 percentage points below the level at the beginning of the year (Figure 8).[2] However, the convergence of short-term rates towards euro-area levels was virtually complete, in real terms, several months before the launching of the euro on 1 January 1999. By April 1999, evidence that conjunctural risks were increasing, while inflation remained subdued, prompted the first policy-rate reduction by the ECB. Accordingly, the interest rate on two-week repurchase

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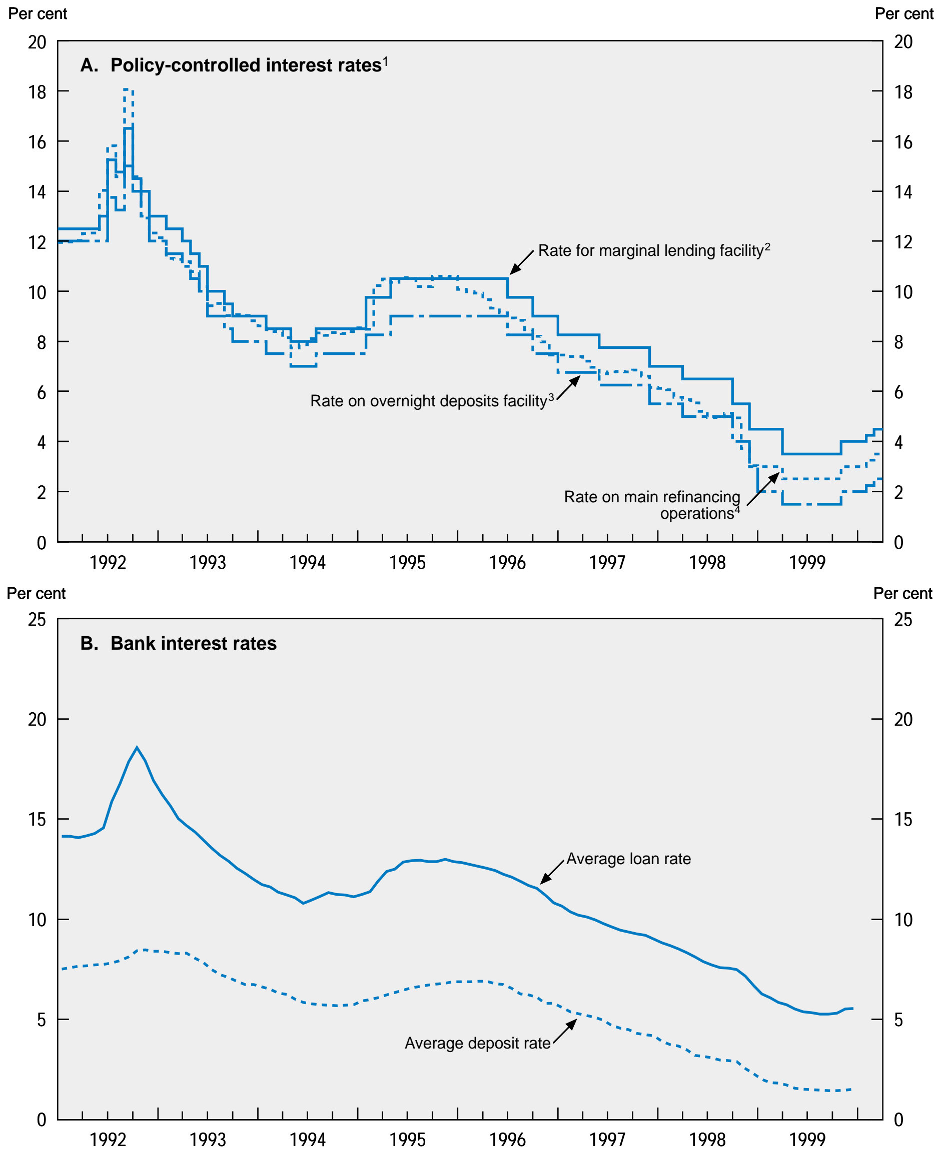
Figure 8. **Interest rates**



1. End of period.
2. Rate on fixed term advances from the Bank of Italy until December 1998.
3. Italian official discount rate until December 1998.
4. Rate on Bank of Italy repurchase operations until December 1998.

Source: Banca d'Italia, ECB.

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Table 5. **Money and credit aggregates**

Year-on-year percentage changes, end of period

	Contribution to the euro zone money aggregate M3[1]	Financial assets[2]		Credit[2]	
		Domestic	Total	Domestic	Total
1998					
December	1.6	0.4	5.6	3.6	3.6
1999					
September	1.6	–0.8	8.8	5.4	6.6
December	3.4	. .	. .	. .	. .

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

Source: Banca d'Italia.

operations, the main refinancing instrument of the new central bank, was lowered by 50 basis points to 2.5 per cent. With economic activity having picked up since April, key official rates were increased by 50 basis points in November 1999 and subsequently by 25 basis points in February and March 2000. These increases brought the repo rate back to 3.5 per cent.

The expansion of monetary aggregates has accelerated since 1998 (Table 5). For 1999, the contribution of Italy to the euro area aggregate M3 increased by 3.4 per cent (year to December), under the influence of changes in the composition of households' portfolios in response to the fall in interest rates. Portfolio shifts were evidenced by a strong expansion in both sight deposits (10.1 per cent) and currency in circulation (11.5 per cent) and the concomitant fall in less liquid money market assets (notably both deposits redeemable with a 3-month notice and with an agreed maturity up to two years). The differential between the average treasury bill rate and the return on deposits, equal to 3 percentage points in 1997, fell to 2.5 per cent in 1998 and 1.3 per cent in 1999.

Based on a range of indicators, the current fairly easy stance of monetary policy in the euro area appears to be a force underpinning the recovery in Italy. Real short-term interest rates remain low historically (Figure 9), while at around 1 per cent they are below the European average. Rising yields on ten-year government bonds have translated into higher costs of borrowing from banks for both corporations and households.[3] Nevertheless, the volume of credit made available to the private sector has continued to expand briskly, signalling that there is no financial constraint on growth. The yield curve, having shifted down in 1998 – partly in response to a "flight to quality" in the aftermath of the crisis in emerging markets – has thus steepened (Figure 10). This may also be interpreted as reflecting a

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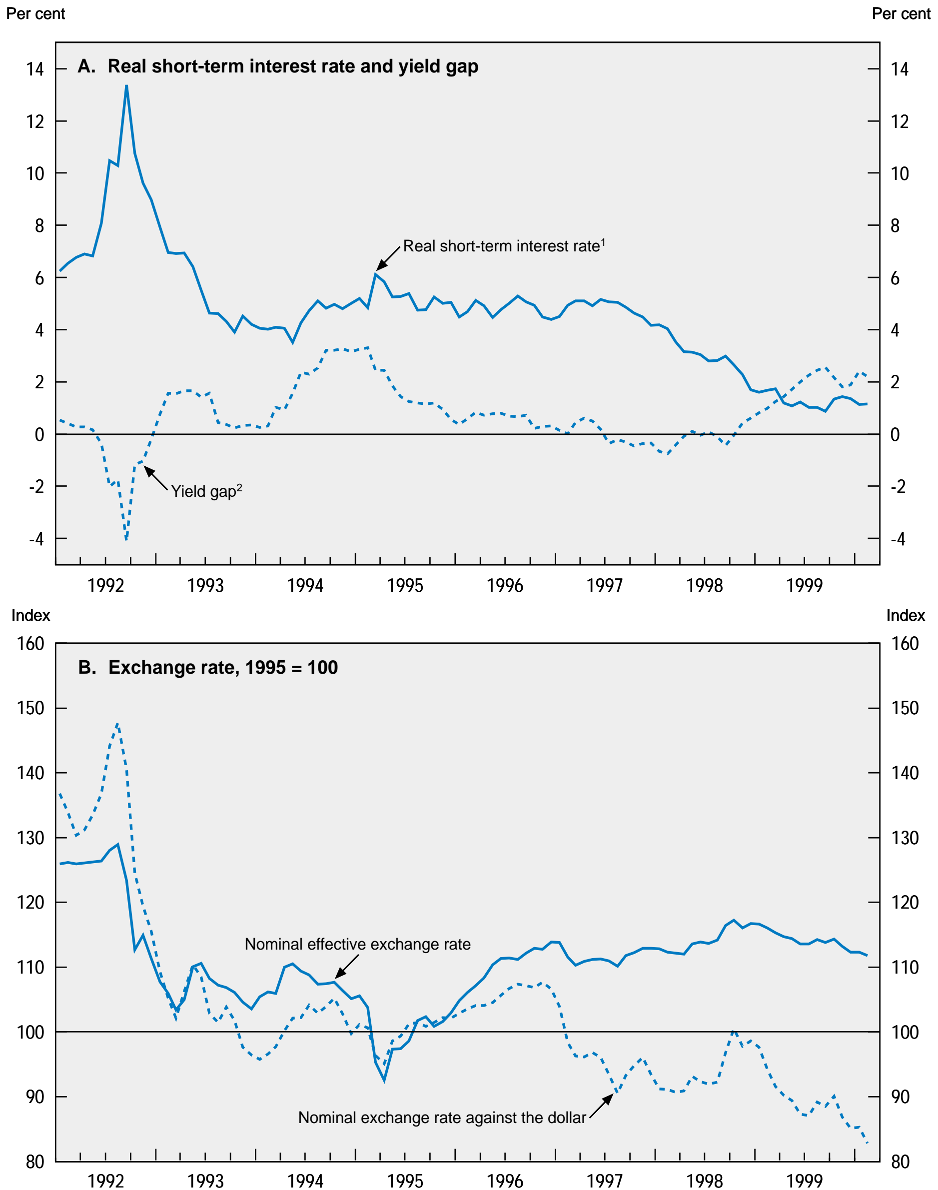
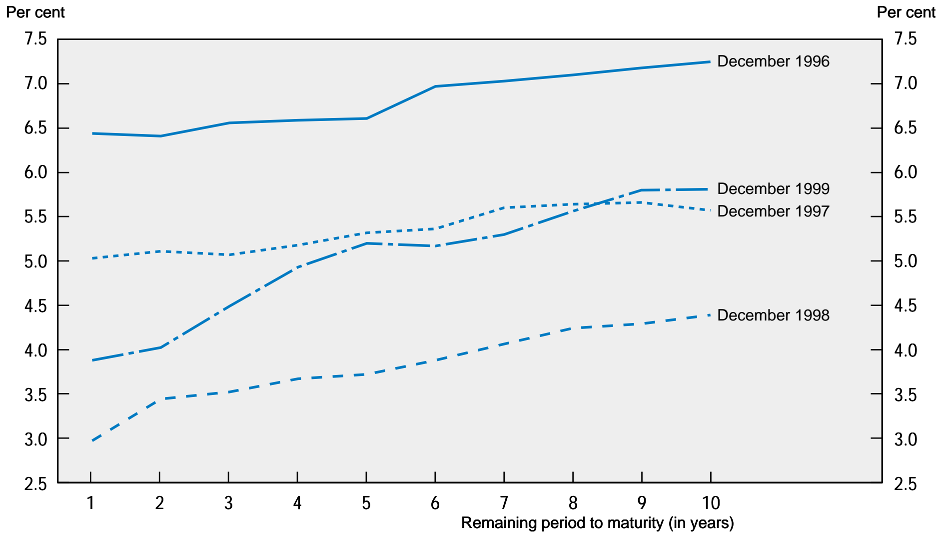
Figure 9. **Monetary conditions**



1. Three-month interbank rate deflated by CPI.
2. Long-term interest rate (yield on ten-year government bonds) minus short-term interest rate.

Source: OECD.

Figure 10. **Yield curves**



Source: Bloomberg.

relatively expansionary stance of monetary policy in the euro zone. As mentioned above, forward-looking indicators signal a strengthening of both gross fixed investment and exports.

Short-term prospects

With the second half of 1999 having already shown a considerable firming in demand, real GDP growth is projected to pick up, from some 1½ per cent in 1999 to close to 3 per cent in 2000 (Table 6). The momentum thus achieved should be maintained in 2001. Domestically a less restrictive fiscal stance is expected to support demand (see Chapter II), while on the external side, the expansion of exports will be mainly supported by better world demand conditions amplified by the significant competitiveness gains induced by the weakening euro. These will offset the adverse terms-of-trade effect induced by the rise of oil prices, leaving room for some progress in the trade balance. This improvement, together with rising non-factor services, should prevent the current account surplus from declining further. The pick-up in activity may lead to a rise in participation rates, which will limit the decline of the unemployment rate to one percentage-point.

There are several uncertainties attached to projections. On the downside, an accelaration of already relatively high inflation could prevent Italy from fully

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Table 6. **Short-term outlook**[1]

	1996	1997	1998	1999	2000	2001
	Current prices L trillion	Percentage changes, volume (1995 prices)				
Private consumption[1]	1 109.4	3.0	2.3	1.7	1.5	2.2
Government consumption	343.8	0.8	0.7	0.6	0.5	0.5
Gross fixed investment	348.8	1.2	4.1	4.4	5.5	4.9
Machinery and equipment	190.5	4.2	7.4	6.2	5.7	5.3
Construction	158.4	–2.3	–0.1	1.8	5.2	4.2
Residential	89.2	–2.7	–0.6	1.6	3.4	3.0
Non-residential	69.2	–1.8	0.5	1.9	7.5	5.7
Final domestic demand	1 802.0	2.2	2.4	2.0	2.1	2.5
Stockbuilding[2]	6.4	0.3	0.6	0.4	–0.2	0.0
Total domestic demand	1 808.5	2.5	2.9	2.5	1.8	2.4
Exports of goods and services	491.1	6.5	3.3	–0.4	10.9	9.5
Imports of goods and services	397.3	10.2	9.1	3.4	7.1	7.5
Net exports[2]	93.8	–0.6	–1.3	–1.0	1.1	0.8
GDP at market prices	1 902.3	1.8	1.5	1.4	2.9	3.1
GDP at market prices in billion euros	982.5					
Memorandum items:						
GDP price deflator		2.4	2.7	1.5	2.2	2.2
GDP at current prices		4.3	4.2	2.9	5.2	5.4
Private consumption deflator		2.2	2.1	2.2	2.6	2.3
Industrial production		3.8	1.3	0.0	3.7	3.5
General government net lending, as a percentage of GDP		–2.7	–2.8	–1.9	–1.5	–1.1
Current balance, as a percentage of GDP		2.8	1.9	1.0	1.6	2.2
Unemployment rate, level		11.8	11.9	11.5	11.0	10.5

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

exploiting the recovery of world demand and the lower euro. It could also undermine consumer confidence, which in any case has been erratic partly due to the uncertainties of pension reform. On the upside, a fuller catch-up of wages to productivity growth would allow consumption to be stronger, but at the cost, perhaps, of more entrenched inflationary forces. A risk of overheating could, moreover, arise if strengthening domestic and external stimuli were reinforced by budget slippage, which could occur if current spending is not kept under control (Chapter II).

Medium-term growth impediments: inflation inertia and export performance

The projection is contingent upon the pick-up in world trade growth and accompanying turnaround in net exports. But declining market shares in world

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Table 7. **World trade exports and market shares**

Percentage changes

	World trade[1]	Exports		Market shares	
		Euro area	Italy	Euro area	Italy
1994	10.6	9.6	11.5	–0.9	0.8
1995	9.0	7.9	7.9	–1.0	–1.0
1996	6.7	6.0	4.5	–0.7	–2.1
1997	10.0	9.1	4.6	–0.8	–4.9
1998	5.1	7.5	1.8	2.2	–3.2
1999[2]	4.9	3.5	–2.1	–1.3	–6.7
1994-99	**41.2**	**38.7**	**17.5**	**–1.7**	**–16.8**

1. Growth rates of the arithmetic average of world import volumes and world export volumes.
2. Figures for 1999 are estimates.

Source: OECD.

trade have called into question the competitiveness strength of Italian exports, and market share losses have been much sharper than the ones suffered by the other euro-area countries[4] (Table 7). Moreover, domestically, labour-cost increases and barriers to competition in the sheltered sectors could contribute to inflation inertia, further undermining competitiveness. This section examines the problems and issues involved.[5]

Inflation inertia in the sheltered sectors...

Having sunk to 1.3 per cent at the beginning of 1999 the annual rate of inflation, measured by the consumer price index, rose to 2.5 per cent by March 2000 in the wake of sharply rising oil prices and currency depreciation against the dollar. Accompanying these developments, the inflation differential between Italy and the euro area has continued to hover at around half a percentage point in 1999, despite economic activity being significantly weaker in Italy (Figure 11, panel A). Only in recent months have the effects of the import price shock shown up in a closing differential, although there remains a strong gap of close to 1 percentage point as far as "core" inflation – *i.e.* consumer price inflation excluding food and energy components – is concerned (panel B).

The forces underlying these developments seem to include both cyclical and structural elements. With regard to the former, the unfavourable inflation performance of the Italian economy during 1999 is the result of re-accelerating unit labour costs (Figure 12), due essentially to weak productivity gains, related in part to cyclical effects.[6] Moderate wage increases have ensured that total compensation per employee in the business sector has been growing in line with the

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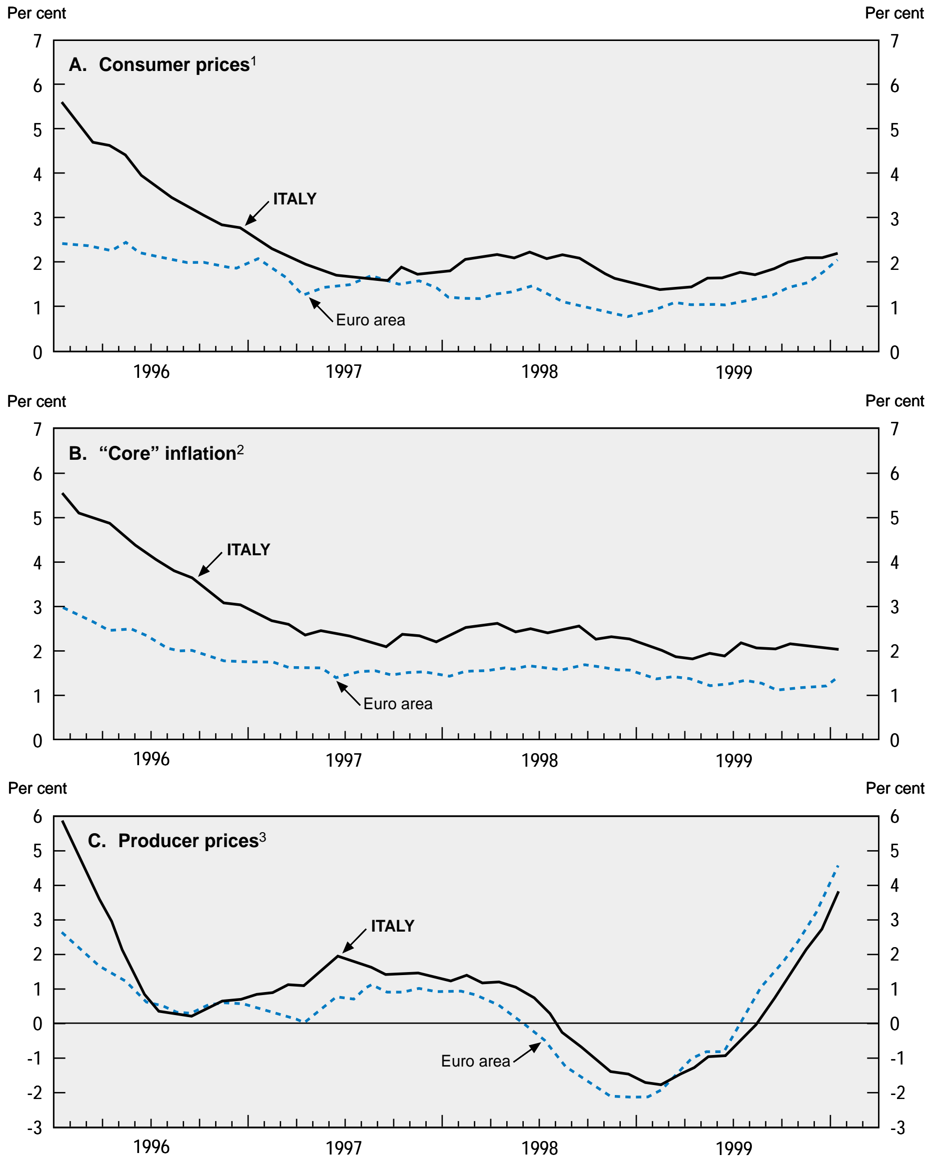

1. Harmonised index.
2. Harmonised consumer price index less energy, food, alcoholic beverages and tobacco.
3. Manufacturing index.

Source: OECD.

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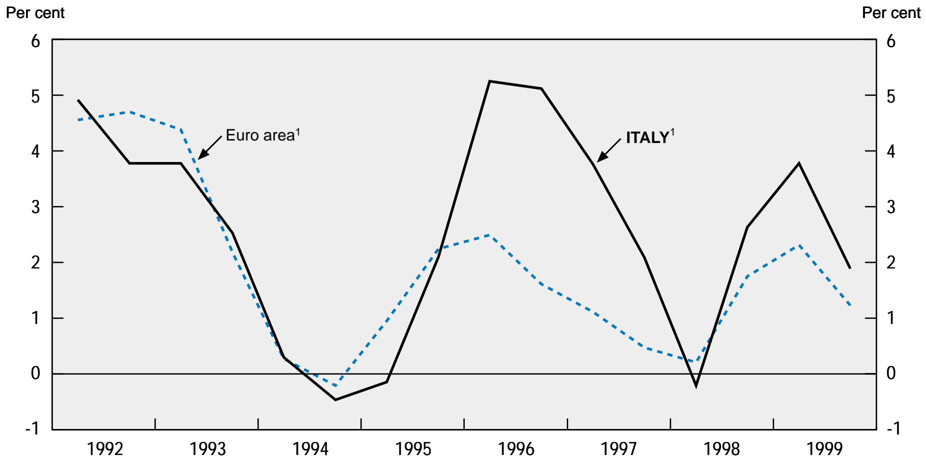
Figure 12. **Unit labour costs**

Percentage changes over the corresponding semester



1. Calculations for Italy have been done netting out the introduction of the regional tax IRAP in 1998.
Source: OECD.

average of the euro area, but have not been enough to offset the effects of poor productivity performance on unit labour costs. Judging from recent wage settlements (metalworkers, banking sector, and construction), moderate nominal wage growth is likely to continue, remaining consistent with inflation objectives.

Turning to structural factors, one source of concern is that for a number of sheltered sectors, insurance and financial services, hotels and restaurants for instance, price behaviour in Italy has been quite dissimilar to that prevailing in most other euro area countries. Some light can be thrown on this problem from the decomposition of the "core" consumer price index into different spending items. Figure 13 shows that, even apart from transport prices – which are partly energy-related, inflationary pressures have been to a great extent driven by the ongoing rise of service prices.

... has a negative bearing on export competitiveness...

Contrary to the consumer price index, the inflation differential between Italy and the euro area measured in terms of producer price indices is slightly negative (Figure 11, panel C). These asymmetric dynamics point to a situation in which profit margins within the sheltered service and quasi-service sectors are growing

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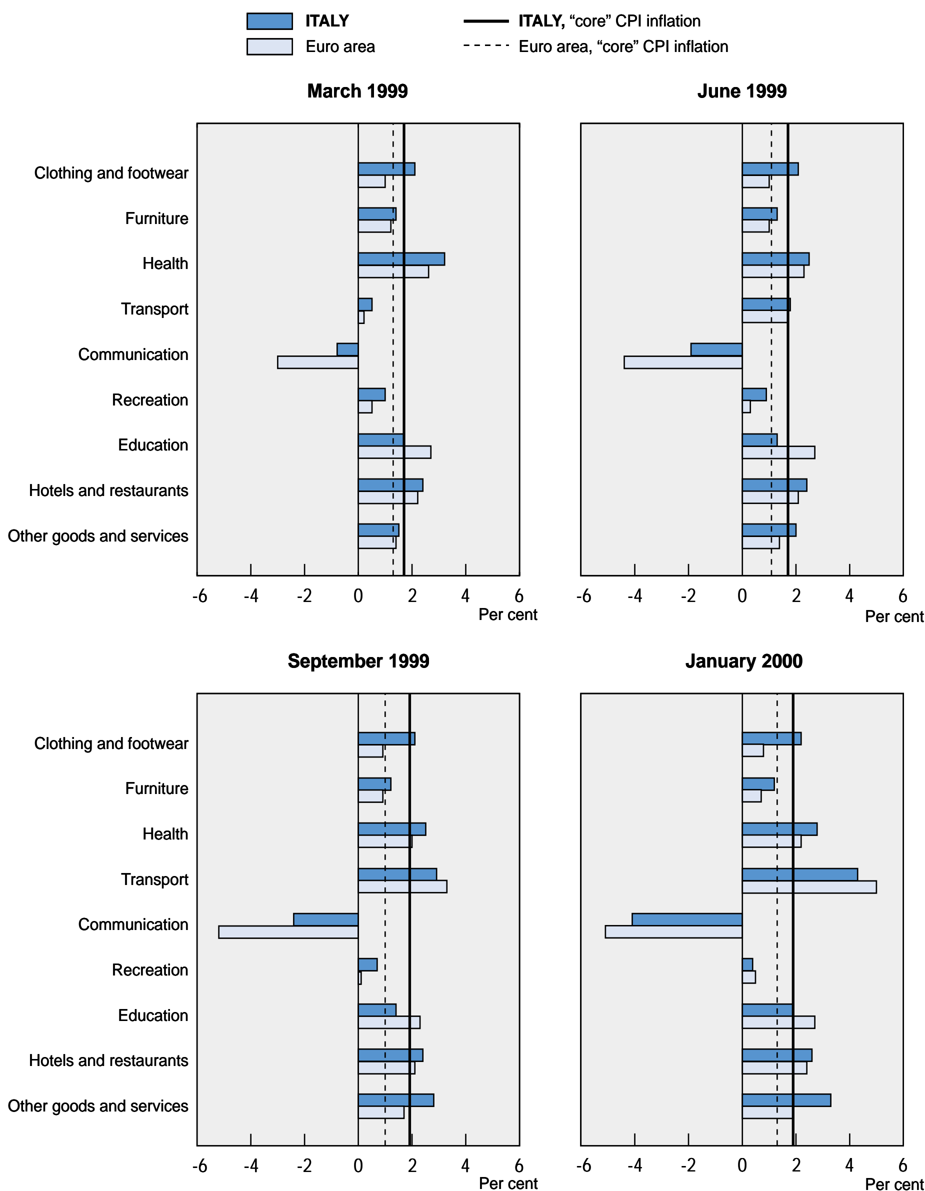

1. Harmonised consumer price index less energy, food, alcoholic beverages and tobacco.

Source: ISTAT, Eurostat.

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more rapidly than in the exposed sectors. Table 8 sheds some light on this point by showing that as of 1998 the positive effects of sharply falling foreign input prices on the margins of manufacturing companies have been partly offset by a rise of domestic non-factor input prices, the weight of services in such inputs amounting to around 65 per cent. When prices increase more rapidly within the sheltered sectors than in the exposed sector, competitiveness is at risk, particularly if the economy in question operates in an irrevocably fixed exchange-rate regime, as higher domestic input prices spill over into export prices. Figure 14 shows that increases in non-factor input prices have been the main driving force behind total variable cost increases in the industrial sector. However the available data for 1999 do not allow separation of the relative contribution of foreign as compared with domestic input prices on such costs which were to a great extent led by the rise in oil prices.

External competitiveness has been quite stable since late 1996, the date of the return of the lira into the exchange rate mechanism (Figure 15, panel A). Thus the substantial competitiveness gains that occurred in the 1992-1995 period have not been eroded. Nevertheless, measures of relative competitiveness *vis-à-vis* the other euro area countries point to a significant deterioration of competitiveness both at home and on third markets, especially in terms of the consumer price index (panel B). Relative indicators which take into account the fact that domestic prices have risen at a faster pace relative to other euro area partners, possibly give a more adequate description of Italy's competitiveness difficulties than relative export prices. Competitiveness losses, which were also experienced at the end of the 1980s, have been reinforced by the underlying problem of structural inflation in the less exposed sectors.[7] Appropriate market incentives would seem necessary

Table 8. **Input costs and output prices in the business sector**

Percentage changes over the previous period

	Domestic inputs[1]	Foreign inputs[1]	Output prices
1995	8.0	12.2	7.8
1996	5.3	. .	2.0
1997	0.7	–1.4	0.4
1998	1.5	–2.2	0.9
January	0.7	1.0	2.0
March	1.3	–0.3	1.7
June	1.5	–1.3	1.6
September	1.8	–4.0	0.8
December	1.7	–5.9	–0.6

1. In 1998 domestic input costs totalled 24.9 per cent of total variable input costs per unit of output, while foreign input costs totalled 25.5 per cent. The remaining part (49.6 per cent) was accounted for by the cost of labour per unit of output (not shown in the Table)

Source: Banca d'Italia (1999), *Annual Report,* Annex table AB36.

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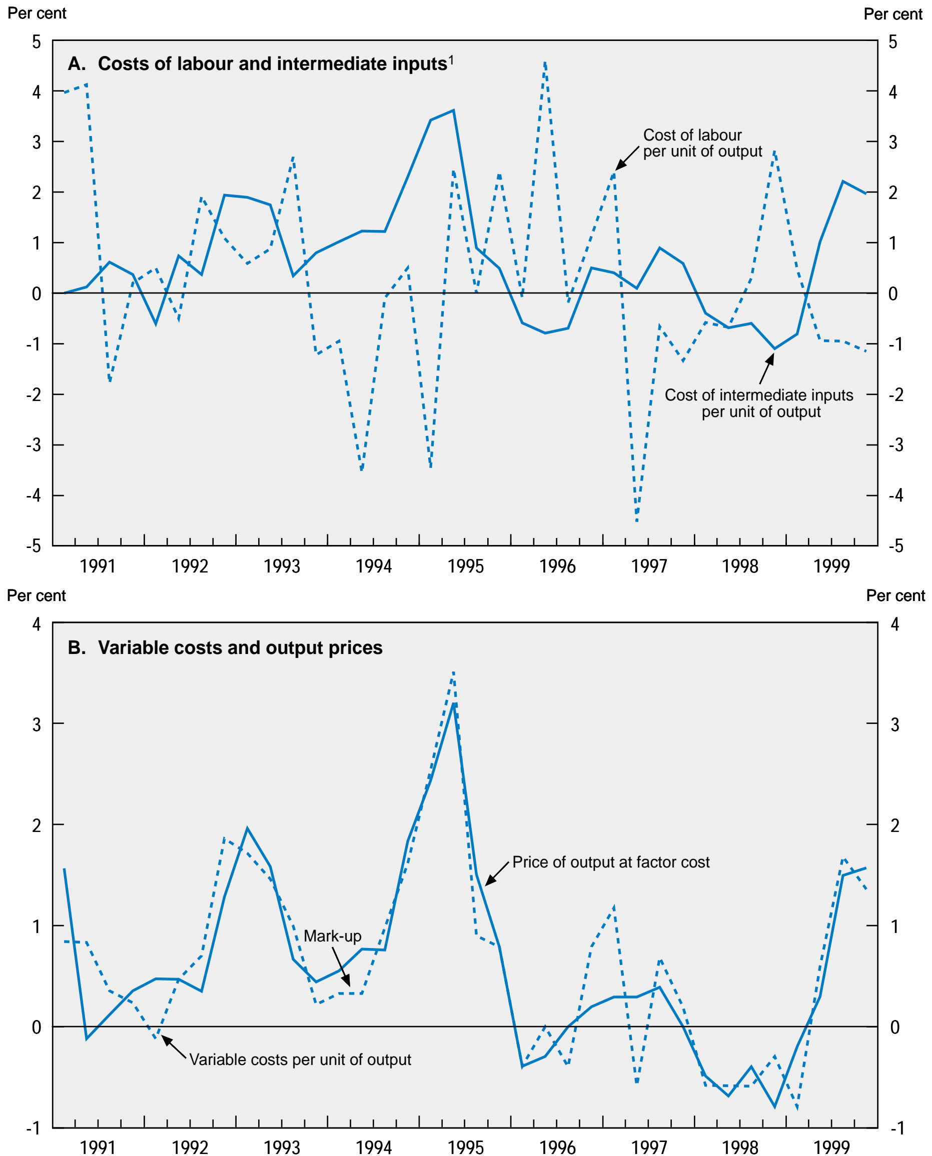
Figure 14. **Contributions to output prices in industry**
Percentage changes relative to previous quarter



1. Break in the series of unit labour costs in 1998, reflecting the introduction of the regional tax IRAP, which abolished employers' compulsory contributions to the health care system.

Source: OECD, ISTAT.

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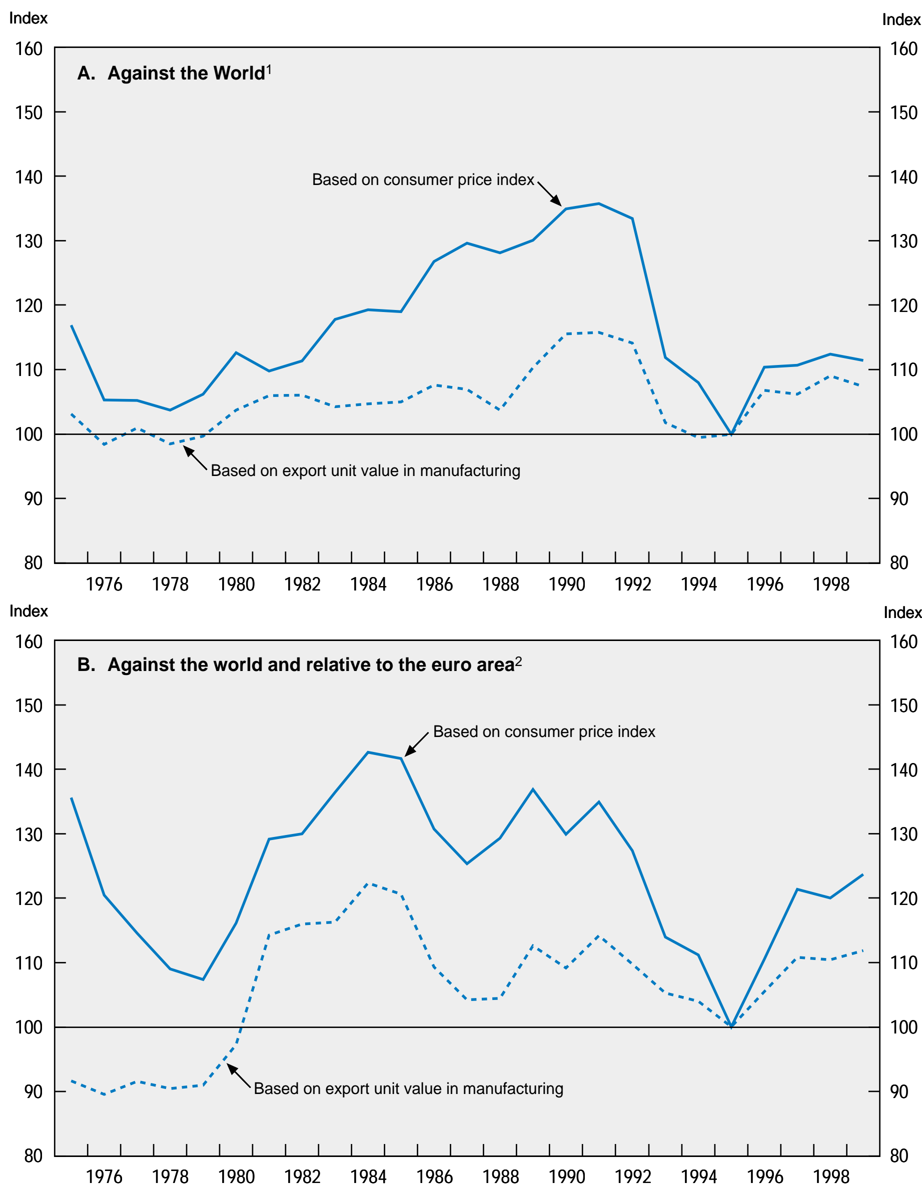
Figure 15. **Measures of the real effective exchange rate**

1995 = 100



1. Weighted real external value of the Lira against currencies of 40 countries.
2. The series refers to the ratio between Italian and euro-area real effective exchange rates.

Source: OECD.

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in order to exploit the opportunities offered by the coincidence of wage moderation at home and economic recovery in the global economy.

... reflected in a poor FDI performance

Price behaviour more consistent with the other euro countries will also be required to attract a larger share of foreign direct investment. Inflows from the OECD area, already small as a percentage of GDP in the mid-1980s, have not expanded over the 1990s (Table 9). Italy is among the few European countries to receive only a negligible proportion of FDI inflows, while it also stands out for its negligible proportion of outward investment.[8] This is surprising for a country that has developed a strong degree of economic interdependence with the other euro area countries and which needs to attract foreign direct investment from abroad to deal with wide territorial income disparities.

A disadvantageous market and commodity composition

In addition, a rapid adjustment of relative prices will be essential to contain the disadvantages arising from the composition of Italian trade and its comparatively strong reliance on exports of traditional products that has apparently been growing more marked over time (Figure 16). Italy's market share, in volume terms, has been declining since the mid-1990s, despite the overall neutral role played by the real exchange rate. Persistently high inflation relative to the euro norm and the related pressure on the real exchange rate would risk reinforcing an already disappointing trend.

Table 9. **Foreign direct investment flows**

As a percentage of GDP

	Inward investment from other OECD countries		Outward investment to other OECD countries	
	1986-90	1991-95	1986-90	1991-95
Italy	**0.47**	**0.27**	**0.36**	**0.42**
Austria	0.33	0.39	0.48	0.65
Belgium	2.72	4.23	1.99	2.58
Finland	0.36	0.74	1.60	1.36
France	0.65	0.93	1.36	0.99
Germany	0.21	0.19	1.14	1.01
Ireland	0.72	0.69	0.00	0.00
Netherlands	1.66	1.93	2.82	3.45
Portugal	1.60	1.63	0.08	0.43
Spain	1.70	1.54	0.40	0.42

Source: OECD.

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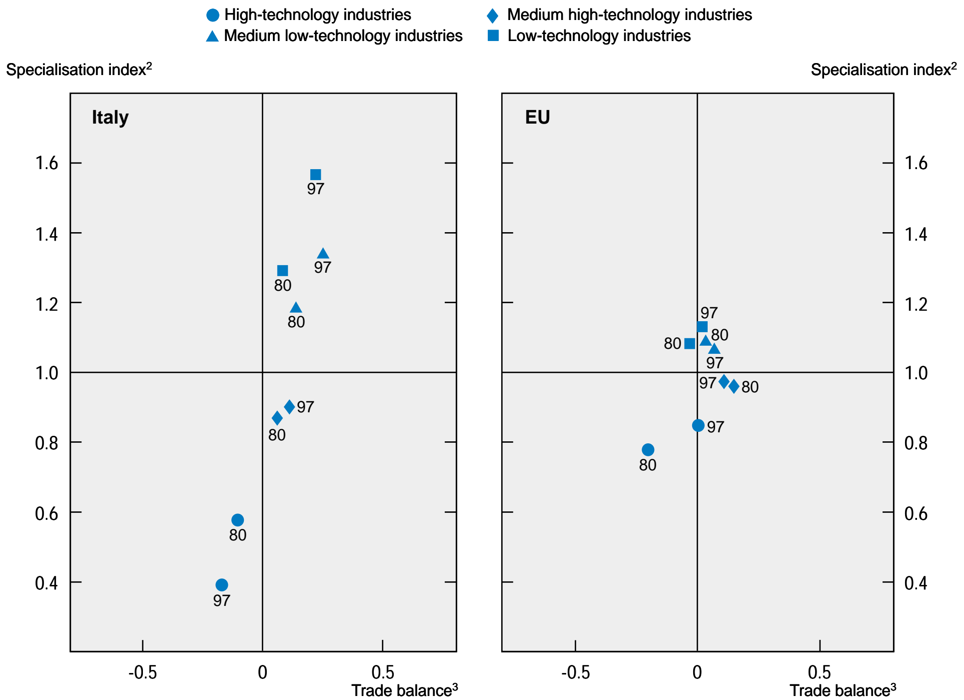
Figure 16. **Export specialisation and net trade performance**[1]



1. See Annex 1 for definitions of groupings.
2. Sectoral weight in total Italian manufacturing exports relative to sectoral weight in total OECD manufacturing exports. A value above 1 indicates a comparatively stronger specialisation of Italy.
3. Sectoral trade balance as a ratio of total trade of sector.

Source: OECD, *Foreign Trade Statistics.*

In order to shed light on the export performance issue, the OECD has decomposed the change in Italy's market share into five components: a competitiveness effect; a commodity composition effect; a commodity adaptation effect, a market composition effect and a relative market adaptation effect (see Annex 1). This illustrative analysis focuses on the manufacturing sector. In general, the results shed light on two key major medium-term issues in the Italian debate, namely *a)* a failure to diversify exports into sectors characterised by the highest rates of growth in world demand; and *b)* the absence of an efficient distributive network that might help to target the most rapidly growing markets. More specifically, the results of the analysis show (Table 10) that the commodity composition effect and the market composition effect are both strongly negative. This seems to be in line with the anecdotal evidence according to which Italy not only lacks an

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Table 10. **Constant market share analysis of Italian exports**[1]

Manufacturing products

Period	Market share[2]			Market share effect	Commodity composition effect	Commodity adaptation effect	Market composition effect	Market adaptation effect
	Beginning of the period	End of the period	Difference					
1990-1997	6.32	5.93	–0.39	0.07	–0.07	–0.17	–0.20	–0.02
1983-1990	6.18	6.32	0.14	0.11	–0.57	0.59	–0.15	0.15
1976-1983	5.61	6.18	0.58	1.77	–1.16	0.12	–0.23	0.08
1976-1997	5.61	5.93	0.33	1.41	–0.66	0.10	–0.40	–0.11

1. See Annex 1 for methodological details.
2. Expressed in terms of total OECD manufacturing exports.

Source: Calculations based on figures from OECD, *Foreign Trade Statistics.*

adequate specialisation in goods characterised by the highest rates of growth in demand (for instance, high-tech goods), but also experiences difficulties in permanently breaching fast-growing markets (due to problems with commercialisation, logistics, distribution and marketing, for example).

… masks a strong performance in terms of non-price competitiveness

The results also suggest that Italy's export success since the mid-1970s has actually been based on a strong competitive performance, corroborating the conventional wisdom that Italian exports, despite a bias towards traditional goods, have a reputation for their high quality, or non-price competitiveness. This has a counterpart in a low price elasticity of demand. The positive commodity adaptation effect, which may be treated as a dynamic indicator of production flexibility, reflects the ability of Italian exporters to continuously improve both processes of production and products at the margin through imitation and engineering. Importantly, however, over the more recent period of a falling Italian share of world goods exports (1990-97) the impulse provided by the commodity adaptation effect turned negative. This may be taken as an evidence of the difficulties experienced by Italian exporters in staying ahead of dynamic emerging-market export competitors with a specialisation similar to the one of Italy. The positive market-share effect recorded over the same period was assisted by the real depreciation of the exchange rate, measured using the relative export price of manufactures.

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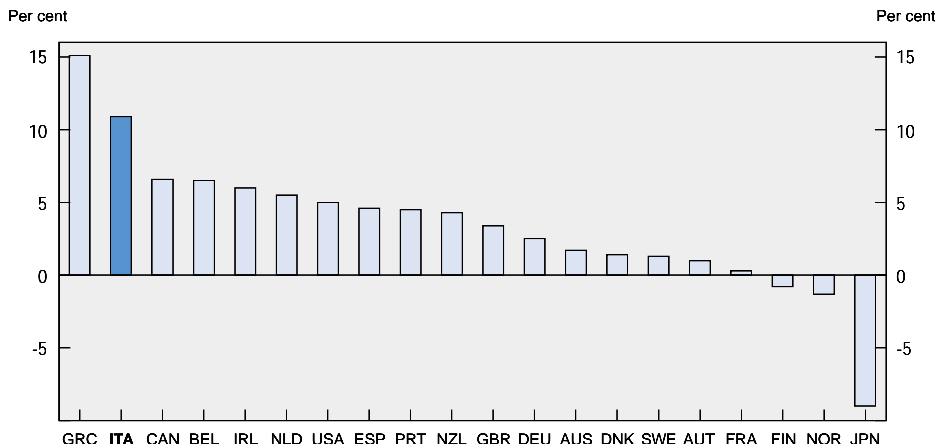
II. Issues in fiscal policy

Introduction and overview

The achievement of the Maastricht deficit target in 1997, when the deficit came in at 2.8 per cent of GDP was the result of one of the sharpest consolidations in the OECD area in the past decade (Figures 17 and 18). Over the five years to 1997, the general government deficit was reduced by around 7 percentage points of GDP.[9] The consolidation process was helped by interest rate declines, but the bulk (around three-quarters) was accomplished by an increase in the primary surplus to almost 7 per cent of GDP, achieved in the main via tax increases, but also by reductions in transfers, subsidies and investment spending (Tables 11 and 12).

Figure 17. **Change in general government structural balance, 1990-99**
As a percentage of potential GDP



Source: OECD.

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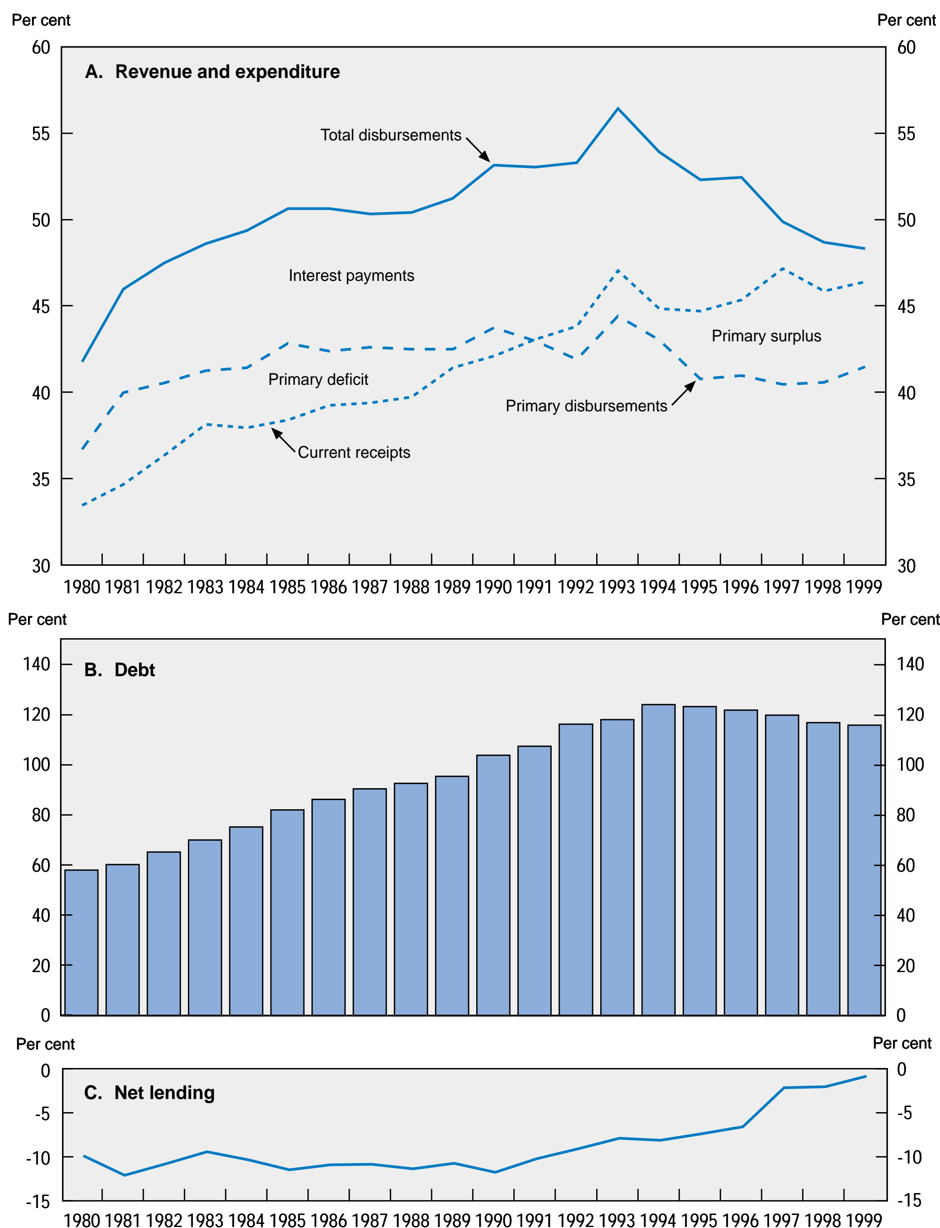

Source: OECD.

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Table 11. **Sources of budget consolidation**

Changes in per cent of potential GDP

	Pre-EMU 1993-1997	EMU entry to end of Medium-term plan period: 1998-2003[5]	Full consolidation period: 1993-2003
Total primary spending[1]	–1.7	–0.2	–1.9
Consumption	0.6	–1.0	–0.5
Transfers[1]	–1.9	0.2	–1.7
Subsidies	–0.5	–0.2	–0.7
Investment[2]	–0.8	0.4	–0.4
Other capital transactions	0.9	0.5	1.4
Total taxes[1, 3]	3.3	–1.8	1.5
Non-tax revenues[4]	0.0	0.0	0.1
Primary balance[1]	5.1	–1.7	3.4
Interest payments	–2.0	–3.4	–5.4
Overall balance[1]	7.1	1.8	8.8

1. Cyclically-adjusted.
2. Gross investment less consumption of fixed capital.
3. Direct and indirect taxes and social security contributions.
4. Net non-interest, property income and receipts of current transfers other than social security contributions.
5. 2000-2003 projections from OECD medium-term baseline as of mid-April 2000.

Source: OECD.

Since joining EMU, progress in consolidation has been more measured, though consistent with Italy's obligations under the Stability and Growth Pact, as Italy has exploited favourable trends in interest rates while reducing the primary surplus to just under 5 per cent of GDP. With the budget continuing to benefit from past structural measures, notably reforms to widen the tax base and reduce the trend growth of spending, and cyclical forces turning favourable, the government's new medium-term plan aims to arrive at approximate budget balance over the 2000-2003 period. Budgetary goals also include a reduction in tax pressure and an acceleration of investment, but deficit, tax and expenditure aims may not be mutually compatible without corrective steps, especially if macroeconomic assumptions and baseline revenue projections prove optimistic. The risks and challenges for budgetary policy thus remain significant.

This chapter begins by discussing budgetary developments in 1998 and 1999. It then turns to an analysis of the new medium-term fiscal plan, the parameters of which will be largely fixed in the 2000 budget. Other issues considered are the sensitivity of the budget to the cycle and interest rate shocks; the role of automatic stabilisers, and the primary surplus required to bring the debt-to-GDP ratio down to more sustainable levels. Finally, the chapter examines the progress made towards better expenditure control and a more allocationally efficient tax system.

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Table 12. **General government appropriation account**

Per cent of GDP

	1997	1998	1999	2000[1]	2001[1]
Receipts					
Direct taxes	16.1	14.4	15.1	14.6	14.3
of which:					
From households	12.2	10.5	11.1	10.8	10.5
From enterprises	3.8	3.8	4.0	3.8	3.8
Indirect taxes	12.5	15.4	15.3	15.2	15.2
Social security contributions	15.4	12.9	12.7	12.5	12.4
Other current transfers	2.3	2.3	2.3	2.4	2.2
Property and enterprises income	1.0	0.9	0.9	1.0	1.1
Total current receipts	47.2	45.9	46.4	45.8	45.3
Disbursements					
Government consumption	18.2	18.0	18.1	17.7	17.3
of which: Wages and salaries	11.6	10.7	10.7	10.4	10.1
Subsidies	1.3	1.2	1.2	1.1	1.1
Social security outlays	17.3	17.0	17.4	17.3	17.3
Other current transfers	1.1	1.3	1.3	1.1	1.0
Interest on public debt	9.4	8.1	6.8	6.5	6.3
Total current disbursements	47.3	45.6	44.9	43.8	43.0
Gross investment	2.2	2.4	2.6	2.8	2.7
Net capital transfers received	–0.9	–1.3	–1.5	–1.4	–1.4
Consumption of fixed capital	0.6	0.6	0.6	0.7	0.7
Net capital outlays	2.6	3.1	3.4	3.5	3.5
Total disbursements	49.9	48.7	48.3	47.3	46.5
Net lending	–2.7	–2.8	–1.9	–1.5	–1.1
Primary balance	6.7	5.3	4.9	5.0	5.2
Memorandum item:					
Cyclically-adjusted primary balance[2]	6.8	5.7	5.6	5.2	4.9

1. Projected.
2. OECD definition.
Source: OECD.

Fiscal consolidation in 1998 and 1999

The objective of budgetary policy in 1998 was to secure the gains made in 1997, with a targeted decline in the budget deficit to 2.6 per cent of GDP and a slight lowering of the primary surplus. In the event, the deficit outcome was near to target. The primary surplus came in ¾ percentage point of GDP below target, while interest payments declined by an unexpectedly large 1½ per cent of GDP. The

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reduction in the primary surplus largely reflected a decline in revenues, in part due to the unintended effects of the tax reform introduced in that year and in part to the continuation of sluggish demand and activity (Table 12).[10] The ratio of primary expenditures to GDP was stable in 1998, reflecting a decline in current primary spending offset by a rise in capital outlays. The composition of both revenues and expenditures was, however, significantly altered by the introduction of *IRAP*, a regional tax on productive activity which replaced a series of taxes and contributions,[11] as well as by the switch to the new version of the national accounts (Box 3).

In 1999, the original target was to bring down the deficit to 2 per cent of GDP, consistent with a primary surplus of 5.5 per cent. These targets were based on projected GDP growth of 2½ per cent. The budget incorporated expenditure-reduction measures amounting to L 10.6 trillion, including savings on transfers to local authorities under the "domestic stability pact",[12] and revenue-raising measures of L 8 trillion, notably L 5.3 trillion in sales of securitised social security contribution arrears owed to the social security institution for private sector workers and self-employed (INPS).[13] Part of budget savings were to be used to finance higher social security and investment spending and a variety of tax relief measures, including repayment of a portion of the remaining special Europe tax.

In March 1999, the government downgraded its growth projection to 1½ per cent, and raised the projected deficit to 2.4 per cent of GDP. This projected overshooting reflected not only perceived economic weakness, but also persistent difficulties in controlling some items of primary spending.[14] However, the general government deficit eventually came in within the original target of 2 per cent of GDP. Revenue growth in the state sector was well above the programmed amount. Particularly favourable results were observed for direct tax and VAT receipts, proceeds from Lotto and the lottery, and excise and sales taxes (including receipts from the new carbon tax). The government has attributed this outcome to success in its fight against tax evasion, stemming from reform of the tax system in 1998 (see below). However, other one-off factors may also have played a role,[15] and there is some uncertainty as to whether there will be a marked permanent influence on receipts.

The increase in state sector expenditures was in line with nominal economic growth, but a rise in primary spending[16] largely offset a significant reduction in interest spending. Financial data indicate an increased recourse to borrowing outside the State sector (Table 13), suggesting that local authority spending exceeded targeted levels. The obligations of the domestic stability pact do not appear to have been fully respected at the regional level, where health care spending in particular has incurred large overruns. The government estimates that half of the targeted savings under the pact were not achieved in 1999, although it is difficult to monitor performance accurately as the data for local government accounts come in with a long lag. The pact carries no sanctions for misbehaviour.[17]

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Box 3. General government accounting changes

The data on general government net borrowing used in the procedure for monitoring excessive deficits will be based on the new version of the European System of Accounts, ESA95, for the notifications from March 2000 onwards. This implies three main changes to the general government accounts in 1998 and previous years:

1. the inclusion of social security benefits in kind (*e.g.*, health care) among intermediate consumption rather than transfers, which raised the former and lowered the latter;
2. a stricter application of the accruals principle, which mainly affected the recording of interest expenses (moving forward interest paid on post office savings certificates which had previously been recorded at the time of redemption) and compensation of employees (in 1998 leading to the deletion of disbursements for health contributions for previous years); and
3. the elimination of certain agencies (including port authorities, housing agencies, the Italian Automobile Club, CONSOB and ISVAP) from the definition of the general government.

The main overall impact of these changes on the 1998 accounts has been to raise expenditures by L 15 trillion and revenue by L 11 trillion; net borrowing rose by L 4 trillion while the primary surplus improved by L 11 trillion. In relation to GDP (which itself rose by around 2 percentage points in nominal terms), the result was to reduce both revenue and expenditure, while raising interest payments and the primary surplus, all by roughly ½ percentage point (see Table below).

General government accounts for 1998

Comparison between ESA79 and ESA95

	Trillions of lire			As a per cent of GDP		
	ESA79	ESA95	Difference	ESA79	ESA95	Difference
Total expenditure	1 006	1 021	15	49.7	49.4	–0.3
of which:						
Compensation of employees	226	222	–4	11.2	10.7	–0.5
Intermediate consumption	99	142	43	4.9	6.9	2.0
Social security benefits	396	351	–45	19.6	17.0	–2.6
Interest payments	152	168	16	7.5	8.1	0.6
Capital expenditure	78	78	0	3.8	3.8	0.0
Total revenue	952	963	11	47.0	46.6	–0.4
of which:						
Direct taxes	293	297	5	14.5	14.4	–0.1
Indirect taxes	312	318	6	15.4	15.4	0.0
Social security contributions	271	267	–4	13.4	12.9	–0.5
Net borrowing	54	58	4	2.7	2.8	0.1
Primary surplus	98	109	11	4.9	5.3	0.4

Source: Bank of Italy, *Annual Report for 1998*, May 1999; ISTAT.

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Table 13. **Public sector finances**

As a percentage of GDP

	1997	1998	1999
Borrowing requirements			
General government	1.9	2.5	0.7
State sector	1.6	2.4	0.0
Debt outstanding[1]			
General government	119.8	116.3	114.9
State sector	109.0	107.5	106.3

1. EU definition.
Source: Banca d'Italia.

The debt-to-GDP ratio diminished by 3½ percentage points in 1998 and by almost 1½ percentage points in 1999, to just under 115 per cent. In 1999, budget consolidation was enhanced by strong privatisation receipts, around L 38 trillion against L 14 trillion in 1998. However, there were significant offsetting items: an increase in settlement of past debts, euro depreciation which caused the lira value of foreign currency debt to rise, and slower nominal GDP growth (less than 3 per cent, compared with 4¼ per cent in 1998).

The medium-term plan and 2000 budget: a greater emphasis on growth

The current medium-term plan(*Documento di Programmazione Economica e Finanziaria, DPEF*), formulated in June 1999 and running from 2000 to 2003, forms the basis of the Stability Programme presented to the EU in December. It shows a reduction in the general government deficit to 1½ per cent in 2000, progressing toward a position of broad balance by 2003 (Figure 19, panel A). The new programme thus reaffirms the targets set out in the 1998 plan, although economic activity is projected to be weaker than initially expected (panel E).[18] Reflecting the decline of the deficit and further revenues from privatisation (totalling 0.4-0.5 per cent of GDP this year), the government debt is projected to decline to 100 per cent by 2003 (panel D). However, an unchanged deficit profile is the outcome of two offsetting forces, since both the primary surplus and interest payments are markedly lower than in previous plans, especially when corrected for recent national accounting data revisions (panels B and *C*). Thus, as in 1998 and 1999, the bonus from lower interest rates is being used to relax the target for the primary surplus.

The new plan includes policies to support economic development, in particular in the *Mezzogiorno* (mainly through capital investment and tax incentives), and to attain social objectives, *e.g.* in the area of family support. These factors, and

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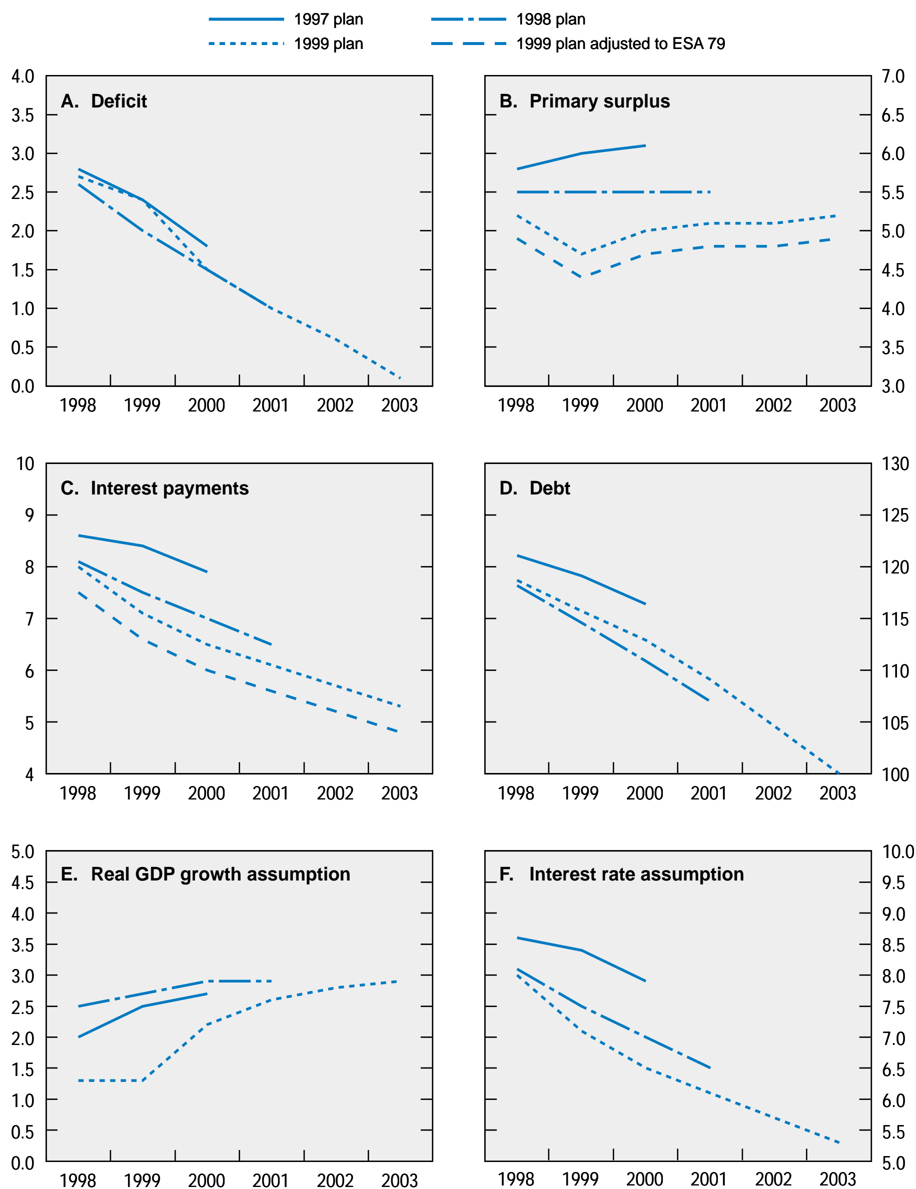
Figure 19. **Medium-term fiscal plans**
Per cent of GDP



Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica, *Italy's Stability Programme, Update*, December 1999; OECD calculations.

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the slower assumed pace of the recovery, are behind the downward revision to the primary surplus. The fiscal correction needed to fund such a "development budget", while bridging the gap between the baseline and targeted deficit, is estimated at around ¾ per cent of GDP in 2000-01, and around ½ per cent of GDP in 2002-03 (Table 14).[19] On a cyclically-adjusted basis, however, this correction is not sufficient to prevent a modest downward trend in the primary balance after 1999 (Table 12 above).

In September 1999, the government issued an update to the *DPEF*, in the light of the above-noted surge in tax receipts. This allowed for an improvement of the baseline scenario for future revenues by some 0.4 per cent of GDP, this being the estimate of the structural improvement as a result of the 1998 tax reforms.[20] It will be given back in the form of tax relief, consistent with an earlier promise to use money recovered from the fight against tax evasion to reduce the overall tax burden. At the same time, the development budget was increased and is set to expand rapidly in future years (Table 14).

The budget for 2000 provides a detailed blueprint for the execution of the medium-term plan, as many of the measures continue to operate in future years (Table 15). The development measures noted above amount to 0.6 per cent of GDP and include significant tax reductions (see below) and increased spending for

Table 14. **Fiscal adjustments 2000-03**

Trillions of lire

		2000	2001	2002	2003
(1)	Trend primary surplus	107.3	118.5	132.8	142.6
	Initial (June 1999) estimates	98.0	109.0	123.3	132.1
	Higher receipts attributed to tax reforms	9.3	9.5	9.5	10.5
(2)	Development measures	12.7	17.0	21.5	22.5
	Tax reductions, taking into account revision of baseline receipts	10.3	10.9	11.5	12.5
	Increased capital spending	1.5	3.0	5.0	5.0
	Increased current spending	1.0	3.1	5.0	5.0
(3)	Interest payments	142.5	139.3	136.3	133.9
(4)	Planned deficit	33.0	22.8	13.5	2.3
	(per cent of GDP)	(1.5)	(1.0)	(0.6)	(0.1)
Implied fiscal correction[1]		**14.9**	**15.0**	**11.5**	**11.5**
	(per cent of GDP)	**(0.7)**	**(0.7)**	**(0.5)**	**(0.5)**

1. Calculated as the sum of lines (2) and (3), less the sum of lines (1) and (4).

Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica, *Nota di Aggiornamento del DPEF* 2000-03, 30 September 1999 and *Relazione sull'andamento dell'economia nel 1999 e aggiornamento delle previsioni per il 2000*, April 2000.

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Table 15. **The 2000 general government budget**

Changes relative to baseline, trillions of lire

Revenues	
Increases in revenues	4.00
Sales of public real estate	4.00
Social and development policies	–10.20
Reduction in second lowest rate of personal income tax	–7.00
Reduced taxation for real estate renovation	–1.20
Reduction in tax on property transfers and other	–2.00
Total revenues, net	**–6.20**
Expenditures	
Reductions in expenditure	10.90
Internal stability pact	3.30
Pact 2000	(2.20
Make-up for slippage under 1999 pact	(1.10
Debt management operations	2.60
Consumption of goods and services	2.60
Social security	1.50
Public sector employment	0.65
Other	0.25
Social and development policies	–2.50
Support to technology, research and education	–2.00
Social and family support	–0.50
Total expenditures, net	**8.40**
Net borrowing	**2.20**
of which:	
Development measures	12.70
Corrective measures	14.90

Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica, *Relazione sull'andamento dell'economia nel 1999 e aggiornamento delle previsioni per il 2000*, April 2000.

social and development policies.[21] Roughly one-half of the corrective measures[22] are one-time, *e.g.*, special social security contributions,[23] net interest savings from debt management operations, and state real estate asset sales. Others produce immediate savings but will involve higher spending later on, such as the postponement and (5 per cent) across-the-board cuts in consumption, the latter potentially creating inefficiencies or longer run pressures in certain departments or areas. Contrary to earlier expectations, the 2000 budget does not include pension reforms. And the new budget assumes that local authorities will not only fulfil the objectives set for 2000, but also make up for the non-fulfilment of the 1999 targets, despite the fact that no penalties have been put into place to ensure that the internal stability pact is effective. Indeed, the spending initiatives on the whole

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appear to involve marginal adjustments rather than forming part of the ongoing effort to improve the longer-run control of public expenditures (discussed below).[24]

A further set of risks underlies the medium-term revenue projections, which could make the medium-term baseline overly optimistic. First, recent experience shows that considerable obstacles exist to the rapid disposal of public real estate assets. Second, as noted, part of the expansion in the tax base observed in 1999 could prove to be temporary. Third, real GDP growth is projected to rise from 2.2 toward 3 per cent, whereas it has averaged only 1½ per cent over the past four years. And although the interest rate assumption is prudent (as is customary), Italy, as a high debt country, remains vulnerable to unforeseen shocks in financial market conditions. Table 16 provides some estimates of the sensitivity of the medium-term deficit projection path to secular variations in growth and interest

Table 16. **Sensitivity of medium-term budget outlook to changes in macroeconomic assumptions**

	2000	2001	2002	2003
The 1999 plan				
Targets (per cent of GDP):				
Primary surplus	5.0	5.1	5.1	5.2
Interest payments	6.5	6.1	5.7	5.3
Deficit	1.5	1.0	0.6	0.1
Debt	112.9	109.1	104.6	100.0
Assumptions:				
Real GDP growth	2.2	2.6	2.8	2.9
CPI inflation rate	1.7	1.6	1.5	1.5
Treasury Bill rate (end of year)	3.7	4.2	4.7	5.0
Shock 1: no acceleration in real GDP[1]				
Real GDP growth	**2.2**	**2.2**	**2.2**	**2.2**
Primary surplus	5.0	5.0	4.7	4.3
Interest payments	6.5	6.2	5.9	5.6
Deficit	1.5	1.2	1.2	1.3
Debt	112.9	109.7	106.8	104.9
Shock 2: 1 per cent higher nominal interest rate[1]				
Treasury Bill rate	**4.7**	**5.2**	**5.7**	**6.0**
CPI inflation rate	1.3	1.6	1.3	1.4
Primary surplus	4.9	5.0	5.0	5.1
Interest payments	7.0	6.8	6.5	6.1
Deficit	2.1	1.8	1.5	1.0
Debt	113.7	110.8	107.1	103.3

1. CPI inflation is endogenous under both simulations 1 and 2. In the slower growth scenario, inflation is slightly lower, raising the real interest rate and thus contributing to the fiscal deterioration. In the 1 percentage point higher interest-rate scenario, inflation also falls slightly due to the associated slowing of growth, raising the real interest rate by somewhat more than 1 percentage point.

Source: OECD.

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rates. It is seen that if real GDP growth were to fail to pick up after 2000, the primary surplus would fall back to less than 4½ per cent of GDP by 2003, with the deficit ratio barely declining from this year's 1½ per cent and the debt ratio remaining at 105 per cent of GDP. A 1 percentage point rise in interest rates (with real interest rates rising by roughly the same amount), starting this year, would raise debt service costs and produce only slightly less deleterious effects, with the deficit falling only to about 1 per cent of GDP by the end of the projection period.

Medium-term strategy: automatic stabilisers and fiscal flexibility

As mentioned in Chapter I, one of the reasons for slow domestic demand growth in the 1990s was the heavily pro-cyclical stance of policy needed to keep pace with the deficit convergence timetable. But a clear benefit of the policy has been markedly lower real interest rates, as the formerly high sovereign risk premia on Italian debt virtually vanished in the process of interest rate convergence. Thus, fiscal consolidation from an unsustainable starting point may not, on balance, have been very restrictive.

In the light of Italy's more sustainable fiscal situation, a relevant question for the medium run is whether and to what extent Italy can now allow automatic stabilisers to work. The role of the fiscal stabilisers in offsetting output fluctuations is made especially important by the loss of policy autonomy in the monetary sphere. Italy in fact allowed the stabilisers to work fully in 1998-99 (but without violating budget targets due to conservative interest-rate assumptions). Looking ahead, it is necessary to ask whether the secular target of fiscal balance offers an adequate degree of built-in flexibility, without risking a breach of the Stability and Growth Pact's 3 per cent deficit ceiling. In this respect, Annex II shows that the adopted target of budget balance would provide an adequate safeguard against unforeseen cyclical variability over the short to medium term. A modest surplus (in the range of perhaps 1 per cent of GDP or more) would be needed if the aim were to ensure that the 3 per cent deficit limit will not be breached over a longer-run (ten-year) planning horizon, on the basis of past variability, both cyclical and random, in both budgets and real output.

At the same time, any use of the fiscal stabilisers in a downturn is subject to the caveat that they also be allowed to work fully in the upturn. An asymmetric use of fiscal stabilisers, in fact, was one of the reasons that public finances in OECD countries got out of hand during previous decades: the stabilisers were allowed to work in recessions, building up the debt, but not in expansions, when a favourable cyclical position was used to reduce taxes or increase spending. In light of this historical pattern, the pro-cyclical tax reductions that are embodied in the current budget would appear to be a risky strategy, particularly given Italy's still-high level of the debt. Fiscal prudence would require that any tax reductions be matched by structural spending cuts.

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Public debt and longer-term issues

Reducing high public debt

Italy has the highest debt-to-GDP ratio in the OECD, and though interest payments on the debt have declined sharply since the start of the 1990s, they still constitute a high proportion of government spending: 7 per cent against half as much in the EU excluding Italy. Figure 20 shows that, partly as a result, primary expenditures in Italy are currently lower, while taxes are higher, than in the rest of the EU on average (itself a highly-taxed group), highlighting the burden of the debt on the current generation.[25] The adverse debt dynamics arising from a rate of real GDP growth which has been significantly lower than the real interest rate (Figure 21), has meant that Italy has had to maintain a comparatively high level of the primary surplus. As GDP growth accelerates, the pace of debt reduction should increase to 5 percentage points of GDP per year, according to the medium term plan. Though the primary surplus has fallen, the re-acceleration of the privatisation programme (Chapter IV) should mean a renewed contribution from asset sales. However, the debt-to-GDP ratio will still be 100 per cent by the end of 2003 (Figure 19, panel D).

Besides a high explicit debt, Italy's other fiscal constraint is that of a rapidly ageing population. The associated future burden of pension and health spending can be seen as a hidden debt, falling on future generations, insofar as it is not funded. Although recent pension reforms have done much to reduce this burden, the transition to the reformed system is slow and implies a renewed debt build-up due to population ageing, mainly between 2015 and 2035 (see Chapter III).[26] Thus, in setting the medium to longer run budget targets, an extra safety margin would, in principle, need to be built in to take into account the debt and ageing problem, thereby allowing a more rapid decline in the debt-to-GDP ratio. Achieving or exceeding the Maastricht debt target in advance of the demographic problem would free up resources currently devoted to debt service for addressing the needs of ageing.

The fiscal challenge may be looked at from several different angles using simulations of long-run debt dynamics (see Annex III):

- A "baseline" simulation, holding the primary surplus at its current medium-run plan level of 5¼ per cent of GDP, implies achievement of the Maastricht level by 2017. This assumes productivity growth of 1.6 per cent per year, no trend increase in labour force participation or decline in structural unemployment, together implying long-run growth of around 1 per cent on average, and real interest rates of 4 per cent. Raising the primary surplus by ¾ percentage points of GDP, to 6 per cent (the former medium run target), allows the achievement of the Maastricht criterion four years earlier, while lowering it by ¾ point, to

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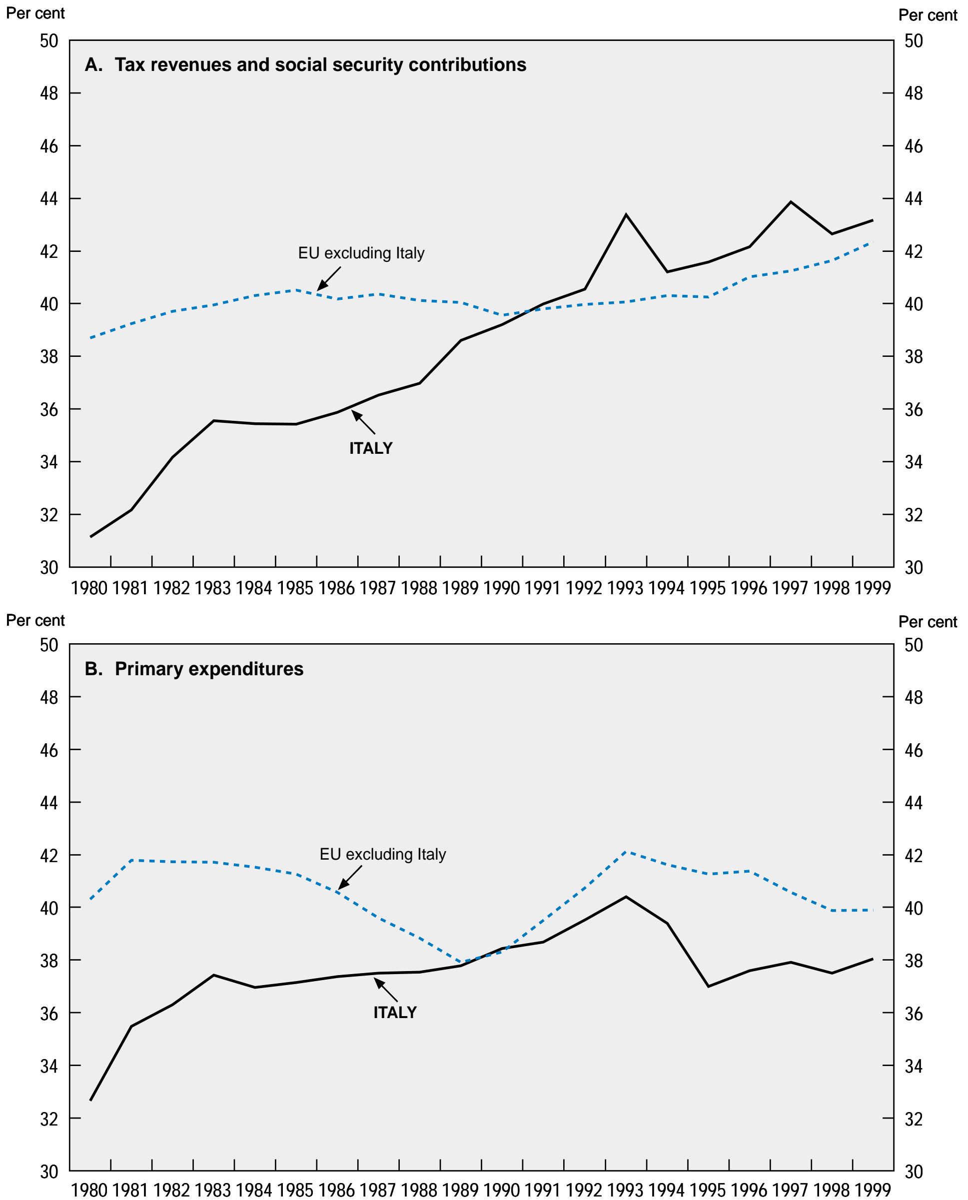
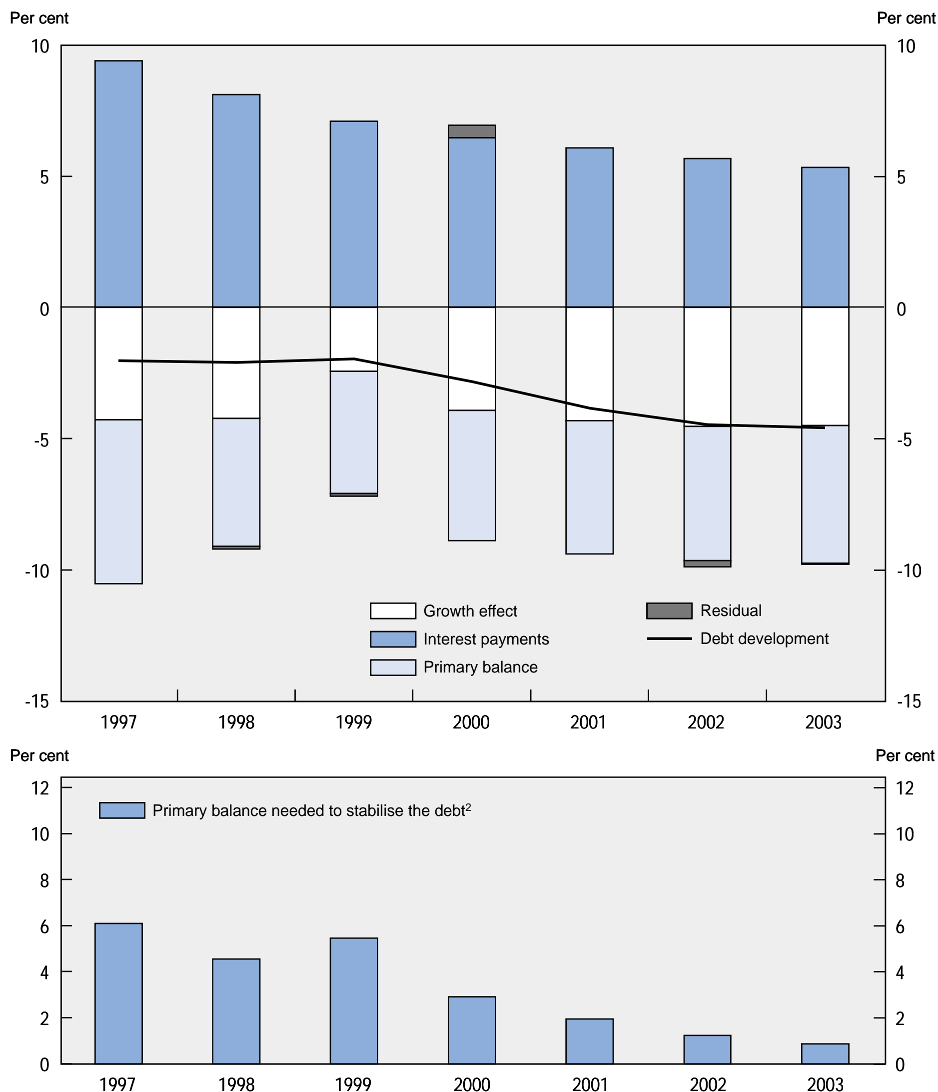
Figure 20. **Taxes and spending in the EU context**
Per cent of GDP



Source: OECD.

Figure 21. **Components of changes in debt-to-GDP ratio**[1]
Per cent of GDP



1. Changes in debt to GDP ratio can be separated into four components (each one expressed in per cent of GDP), as follows:
   $d(t) – d(t – 1) = – [g(t)/(1 + g(t)] d(t – 1) + i(t) + prim(t) + r(t)$
   where: g = growth rate of GDP, i = interest payments, prim = primary balance, r = residual.
2. Needed primary surplus = $[d(t) – d(t – 1)] – d(t) [i(t) – g(t)]$.

Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica and OECD estimates.

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4½ per cent (below the actual 1999 level) extends the required number of years by five.

- A "faster growth" simulation examines the impact of structural policies to boost the growth rate (including, endogenously, measures to reduce the debt). Such policies, if successful in moving Italian participation, unemployment, and productivity growth rates over the long run closer to the EU average, could raise the GDP growth rate by around ½ percentage point on average per year. They might have only a small effect on the time needed to achieve Maastricht, as structural policies take some time to have effect. But they would exert more powerful effects from the longer run perspective of containing the debt build-up from ageing costs.

- The final simulation explicitly takes into account the pensions component of ageing costs. It starts out with a high primary surplus, which then is allowed to decline gradually over time as accumulating interest savings are sufficient to pay for the ageing burden. Using the macroeconomic assumptions of the baseline case, the calculations suggest that an underlying primary surplus of close to 7 per cent (exclusive of ageing costs) might be needed by 2002 and maintained for a number of years, thereafter falling gradually to around 5 per cent by 2040; the debt ratio reaches 60 per cent by 2013 and falls further to stabilise at under 40 per cent by 2050. Under the faster growth case, an initial underlying primary surplus of 6½ per cent, falling to around 2 per cent by 2040, would be sufficient to stabilise the debt at around 15 per cent by 2050 – clearly enhancing the political feasibility of the fiscal effort while allowing greater room for tax cuts. By contrast, simply staying at the baseline primary surplus indefinitely and adding to this the costs of ageing, would not even allow achievement of the Maastricht target within the fifty-year horizon. This scenario demonstrates the need to act forcefully early on.[27]

The role of debt management

As debt reduction is a long run process, another aspect of the government's debt strategy is to minimise funding costs and reduce risks, in the meantime, by making the debt structure more robust and less responsive to financial market disturbances. There are two main elements in this strategy:

- Italy is continuing its strategy of fostering an increase in the liquidity of Italian government paper. This involves regular emissions of 3 month to 30 year debt to assure sustained negotiability on the secondary market. Transparency of information is based on an annual calendar of bond

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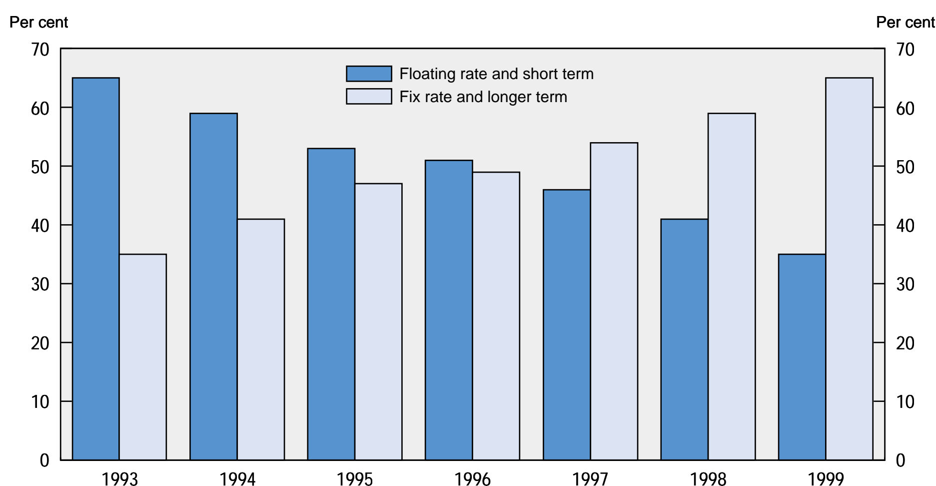
sales, quarterly announcements, and all relevant information available on the Internet.[28] Portfolio diversification, to reach the broadest pool of investors to reduce risk and stabilise the cost of debt, is encouraged by issuing more tailored investment vehicles.

- The second element involves increasing the average maturity of debt through the policy of reducing the share of treasury bills and floating rate notes. As a result, the share of debt exposed to short term rates has declined, gradually but steadily, from 65 to 35 per cent in six years, while the share of fixed-rate bonds has gone up from 35 to 65 per cent of the total (Figure 22). The average duration of government debt has increased to over five and a half years (Figure 23, panel A).

The different composition of the debt, implying a higher fixed rate component and a longer duration, reduces the sensitivity of interest payments to variations in the risks tied to financial markets (Figure 23, panel B). The yearly turnover of government debt has likewise decreased (from 465 billion euros in 1995 to a projected 342 billion euros in 2001). Less frequent recourse to the market could contribute to lowering the cost of debt, as investors may perceive auction frequency as a signal of sovereign risk.

Figure 22. **Maturity breakdown of state sector domestic debt**
Per cent of total, as of 31st July 1999



Source: Banca d'Italia.

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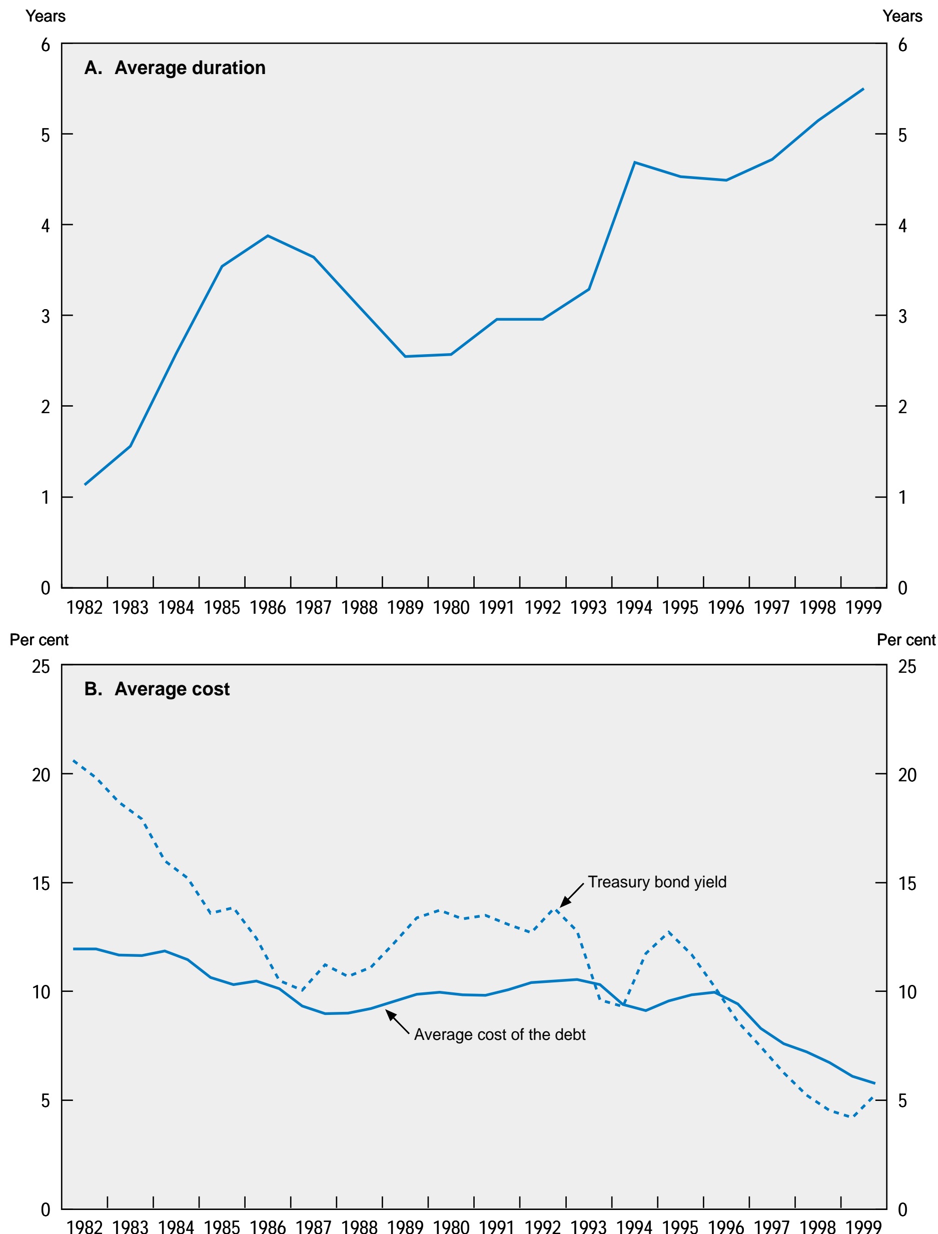
Figure 23. **Average duration and average cost of the state sector domestic debt**



Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica.

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Progress in primary spending control

As noted, public spending overall in Italy is high by international standards. Though spending in certain areas like debt service and pensions is high, the national resources applied to areas such as health and education are relatively low (Table 17). Achieving a more equitable and efficient allocation of public spending depends in part on exploiting the scope for greater efficiencies, both in the provision of general government services, which currently pre-empt 4½ per cent of national resources, and in the specialised departments. Indeed, gaining better control over primary spending trends, in combination with tax reform, is essential to sustained improvement of both fiscal and economic performance.

The effort to meet Maastricht was based in part on cuts in primary spending, amounting to 1½ percentage points of GDP over the 1993-97 period and representing under a quarter of the overall adjustment (see Table 11 above).[29] It included temporary measures such as periodic salary and recruitment freezes, and cuts in subsidies and public investments. However, it also comprised a rationalisation of procurement policies, a series of pension reforms, a health reform, a reform

Table 17. **Functional breakdown of government spending**[1]

As a percentage of GDP

	Italy	Germany	France	United Kingdom	Spain
General services	4.5	4.1	4.6	1.9	1.8
National defence	1.7	1.4	3.0	3.3	1.5
Public order and safety	1.8	1.7	1.2	2.2	2.2
Education	4.7	4.4	6.0	5.4	4.9
Social security and welfare	24.5	28.8	34.0	23.7	22.4
Health	5.4	8.4	7.1	5.7	5.7
Unemployment insurance	0.9	1.6	1.7	0.9	2.4
Family assistance	0.5	2.6	2.5	2.4	0.4
Pensions	15.0	12.0	13.6	9.9	10.6
Housing	1.2	0.2	0.9	1.9	0.1
Other	1.5	4.0	8.2	2.9	3.2
Recreation, culture	0.6	0.8	1.2	0.6	1.2
Economic services	4.6	11.3	4.9	3.3	6.2
Fuel and energy	0.2	0.3	..	0.5	0.1
Agriculture, forestry, fishing and hunting	0.6	0.6	..	0.1	1.0
Mining, manufacturing and construction	1.0	0.1	..	0.2	0.3
Transport and communication	2.4	2.0	1.0	1.6	2.8
Other economic services	0.4	8.3	3.9	0.9	1.9
Other functions	10.3	3.8	1.8	3.9	7.0
Total	**52.7**	**57.4**	**56.6**	**44.3**	**47.2**

1. 1995 figures except for France (1993).
Source: OECD, *National Accounts,* and SOCX Database.

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of the public employment rules, decentralisation of spending, and reform of the central administration and budget process. These structural measures in particular have brought about enduring improvements in spending control. The expansionary trend in government employment has been arrested and that in social spending has been attenuated, while the ability to meet spending targets (mainly at the central level) has greatly improved.

In part due to the set of measures adopted in this respect, personnel costs have dropped from 11.5 per cent of GDP in 1996 to 10.7 per cent in 1999,[30] and are expected to further decrease to 10.1 per cent by 2003. Nevertheless, public employment and the public wage bill are still relatively high (Table 18), and an important avenue for both further personnel savings and broad-based spending reduction is ongoing reform of the public administration. Box 4 provides a brief summary and update of the principal aspects of public administration reform.[31] As already described, decentralisation is one of the most important changes potentially, although a "soft" budget constraint currently weakens local authority spending discipline. Greater accountability in expenditure is needed through an acceleration of regional finance reforms. Equally important, and with more immediate impact, the streamlining of the state administrative apparatus, reform of the budget process, and the clear distinction that has been introduced between political and management functions have made for better spending control at the central level. Incentives for enhanced performance have been built into management contracts, backed up by intensive training of managers. However, complementary changes in personnel management are critical. Changing the culture of the mass of public-sector workers, in particular mid-level civil servants, has not been

Table 18. **Public employment**

	1980	1990	1999
General government employment as a percentage of total employment			
Italy	**15.4**	**17.3**	**16.8**
Germany	14.6	15.1	12.4
France	20.2	23.1	24.3
United States	16.4	15.4	15.1
Japan	8.8	8.1	8.3
Euro area	15.4	17.3	16.5
General government personnel costs as a percentage of GDP			
Italy	**11.1**	**12.6**	**10.7**
Germany	10.7	9.5	8.4
France	12.9	12.5	13.8
United States	10.5	10.4	9.1
Japan	7.9	7.0	7.5
Euro area	11.5	11.2	11.1

Source: OECD.

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Box 4. Public administration reform: progress to date

Decentralisation of government functions. Functions affected by the decentralisation programme[1] are being assigned to lower levels of government according to the EU's "subsidiarity principle", whereby the function is devolved to the level best placed to respond to the associated public needs. Thus far, trade and industrial development policies have been devolved to the regions while permits for new business start-ups are now under the responsibility of the municipalities.[2] In the last stage of the decentralisation process, financial and human resources related to the functions will be devolved as well. Heretofore, regional finances have been purely derivative with budget deficits covered by the state,[3] a disincentive to savings. The introduction of *IRAP* in 1998 was a major first step toward greater regional fiscal autonomy, and in 1999 a major medium-term programme for regional finances was introduced, limiting regional access to automatic state transfers and providing more equitable access to shared national tax revenues. The Decree Law of 18 February 2000 (issued in application of the enabling legislation of May 1999) introduces additional allotments to regions from national revenues and institutes a federal offsetting fund for revenue sharing starting from the year 2001. At the same time, central government workers are slowly being transferred to lower levels of government.

Simplification of administrative procedures and legislation. The current over-regulated decision-making process is rigid, slow and inefficient, placing a burden on both the public and businesses. Since 1997, legislative powers for over 200 administrative procedures have been devolved and are being simplified, making it much easier to adapt regulations to changing needs. Other important changes have included: "self-certification" which obviates the need for obtaining many personal certification documents from various departments (due to these changes, there has been an average drop of 50 per cent in the issuing of certificates as compared to 1996); "one-stop shops" for businesses seeking administrative approvals; and replacement of thousands of obsolete laws in eight economic subject areas to a single reference law for each area (a project to be completed over the next 2 years).

Contracting out of government services. A law now in Parliament would end *de facto* monopoly provision of local government services by making the tendering of such services obligatory. Deregulation has also allowed new modalities and more efficient provision of local authority services, for example, by allowing the grouping together of localities to provide services.

Streamlining of central government. In July 1999, an enabling law was passed for a major ministerial consolidation in the next legislature, whereby the number of ministries will be reduced from 22 to 12. Ministries will also be reorganised to be more clearly responsible for implementation of policy goals, including the introduction of two levels of ministerial appointments as in much of Europe. This will eliminate much of the fragmentation and mere procedural compliance of the past. The Prime Minister's office has been reorganised to enhance its policy making and co-ordinating function.

New personnel management systems. This process (the so-called "privatisation" of the civil service) has now been completed: *i)* Employment conditions are now governed by national collective contracts. *ii)* Legislation allowing for more flexible human resource management, term contracts, training contracts, temporary employment and part time work has been extended to the public sector. *iii)* A new

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Box 4. Public administration reform: progress to date *(cont.)*

performance evaluation system has been established whereby performance is assessed in terms of efficiency and effectiveness as opposed to the perfunctory review process of the past. *iv)* A substantial part of managers' salaries are now performance-related and all management assignments have fixed terms of 2-7 years;[4] access to management is now based on public competition at the national level; many resources have been poured into reforming public administration management-training institutes, and there are plans to set up an institute for the training of local authorities. *v)* A clear distinction between policy-making powers and management responsibility has been established.

Reform of the budget process. Extensive reforms were completed in 1997-98, the objective being to improve state ability to monitor and control changes in the size of the budget and ensure more efficient implementation of economic policy. As noted in the 1999 *Survey*, spending targets are now much more clearly related to allocated resources, making the budget process more transparent. Under the previous system, the incremental budget allocation criterion was related to the amount effectively spent in the previous budget year – a clear incentive to pursue high spending programmes. Future spending is now decided following a cost-benefit approach, making the allocation of resources more efficient and the monitoring of public spending more effective. Most importantly, the objectives outlined in the medium-term plan are now fully reflected in the commitments contained in the corresponding budget documents, making for overall better strategic control of spending. And following clearer separation within the public administration of policy-making and administrative functions, civil servants have been given greater autonomy in managing spending, hence greater responsibility for achievement of policy targets. In June 1999, another major reform was introduced: the finance law that accompanies the budget can no longer include so-called "structural" (delegatory, procedural, or organisational) measures, which are to be held over to the next session of Parliament, allowing it to focus on financial issues in the end-year budget debate.

1. This includes everything but the functions that were decided *not* to be decentralised: justice, national security and defence, international relations and trade, energy policy, transport, education and research.
2. In general, the regions have a high degree of autonomy in deciding their own policies and are granted legislative powers by the Constitution. Provinces have administrative powers only, while municipalities are slowly being granted statutory powers in accordance with the principle of subsidiarity.
3. This has been especially true for the 15 so-called "ordinary regions" for whom a key source of revenue is state transfers, determined by history and the annual budget bargaining process. Deficits (including arrears) in the areas of health and transport have been periodically cleared by the state, which fostered spending excesses. By contrast, the five so-called "special regions", with broader expenditure responsibilities, depend less on state transfers as their primary revenue source is shared national taxes. The 1999 reform is geared to removing such differences in sources of revenue (see Decressin, J. (1999), "Regional income, redistribution and risk-sharing: how does Italy compare with Europe?", *IMF Working Paper WP/99/123*, September).
4. About 5 per cent of all managers are in a special highly-skilled category, hired under term contracts at market-related salaries.

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satisfactorily dealt with, so that managers may be frustrated in their ability to achieve goals. Indeed, whereas institutional systems and legal frameworks are changing rapidly, inertia at all levels of the administration may be the greatest obstacle to substantive change.[32]

The government has been mandated to overhaul the entire system of welfare spending, which provides relatively low levels of support to the most needy segments of the population. This is to be done by expanding unemployment and assistance benefits, while respecting the current ceiling on total social spending (around 24 per cent of GDP in 1998). It will be important that such new social programmes be well-designed and well-targeted in order to avoid undesirable moral hazard effects in labour markets and excessive pressure on primary spending. It is even more important that pension reforms (accompanied by other spending reforms) be deep enough to offset *both* the cost of new programmes and the projected increase in age-related spending, discussed above.

Progress in tax reform

Objectives of tax reform

When launching the reform in 1997, three goals were underlined by the Government as being particularly important: the granting of greater fiscal autonomy and responsibility to local governments (and to regional government in particular); a reduction in the numerous and wide-ranging forms of distortion introduced by the tax system in capital markets and business activity; the broadening of the base and lowering of statutory rates imposed on labour income. It is too early to make a full assessment of the tax reform that has been implemented so far. Nevertheless, it is possible to appraise some of the changes that have been put into place with respect to the capital- and labour-market impacts of the reform, as well as its possible impact on compliance.

Impacts on the cost of capital

Since the implementation of reforms in 1998, Italy taxes corporate income, dividends, capital gains and interest income accruing to individuals at a low rate compared with most OECD countries. Existing tax rates have been reduced to two, 12.5 per cent on dividends and interest from private and public bonds and 27 per cent on interest from bank deposits, while the tax base has been broadened by making capital gains and incomes from derivatives trading taxable. Capital gains accrued by individual savers are also subject to a low 12.5 per cent final withholding tax,[33] and among the countries which tax capital gains at the individual level, Italy levies the lowest rate (Table 19).

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Table 19. **Statutory tax rates on income from capital (individuals and companies)**

1999

	United States	Japan	France	Germany	**Italy**	United Kingdom	Canada[1]	Belgium	Ireland	Netherlands
Personal tax rates:										
(top income earners)										
Interest on bank deposits	46.6[2]	20	25	55.9	**27**[3]	40	54.1	15[4]	24	60
Capital gains	20	26	26	0	**12.5**	40	54.1[5]	0	20	0
Dividend income	46.6[2]	50	63.6	55.9	**12.5**	40	54.1	15[4]	46	60
Corporate tax rate	39.5[6]	40.9[7]	40	51.8[6]	**31.25**[8]	30[9]	46.1	40.2[10]	32[11]	35

1. Rates include the highest sub-central government tax rates.
2. This top rate of personal income tax applies to a resident in New York City.
3. 12.5 per cent applies to government bonds and fixed term deposits over 18 months.
4. Both for interest and dividend income, a rate of 25 per cent may apply under certain conditions.
5. Only 75 per cent of capital gains net of losses are subject to taxation.
6. The corporate tax rate includes the average of sub-central government tax.
7. The overall tax rate was reduced from 46.6 per cent to 40.9 per cent (both rounded) as from 1 April 1999.
8. This is an average tax rate, Italy has adopted a dual income tax system (DIT) by which the return from new equity capital invested into the company is taxed at 23.25 per cent (= CIT at 19 per cent + IRAP 4.25 per cent), while the rest is taxed at regular CIT rate of 41.25 per cent, inclusive of IRAP. The floor to the average corporate tax rate is 31.25 per cent (= 27 per cent + IRAP), and new share income which cannot benefit from the lower rate can be carried forward.
9. From 1 April 1999, the corporation tax rate has been lowered from 31 to 30 per cent.
10. Reduced rates apply for taxable income below BEF 13 million.
11. 10 per cent on new investments in manufacturing.

Source: OECD Tax Database; EBFD (1998), *European Tax Handbook.*

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The 1997-98 tax reform also introduced a two-tier system of corporate taxation (*Dual income tax, Dit*) with the intent being to reduce the relative cost of financing new investment via own-capital. Under the new tax rules, income from new investment financed with new shares or retained income is subject to the lower central government corporate tax rate of 19 per cent, up to a "normal" (7 per cent) rate of return. The ordinary 37 per cent corporate tax rate (*Imposta sui redditi delle persone giuridiche, IRPEG*) continues to apply to remaining profits and a floor is set so that the average tax rate cannot be below 27 per cent (20 per cent for quoted companies).[34] Together with a new definition of the corporate tax base that is very much in line with main OECD countries, this reform has placed Italy among the countries that provide generous tax provisions for new investment. Moreover, the pre-tax required rate of return on capital, that is the cost of employing an extra unit of capital before taxes, faced by companies operating in the Italian territory, has fallen and is close to the EU average. However, the non-neutrality with respect to debt finance has not been eliminated in full as, at the margin, financing new investment with debt is still more attractive (Table 20).

Table 20. **Required rates of return to capital in manufacturing**[1]

Top personal tax rates, real interest rate assumed to be 5 per cent

1998

	Retained earnings	New equity	Debt
United States	4.19	7.25	3.95
Japan	8.04	10.26	4.02
Germany	3.14	2.67	3.06
France	7.36	10.52	4.38
Italy	**5.31**	**5.67**	**3.65**
United Kingdom	4.44	5.05	4.06
Canada	6.87	7.59	3.88
Australia	4.32	4.15	4.15
Austria	4.28	6.22	3.59
Belgium	5.53	6.72	3.54
Denmark	6.38	6.85	4.35
Finland	5.59	4.21	4.21
Greece	5.91	5.91	3.32
Ireland	3.04	5.01	3.90
Luxembourg	5.79	4.59	3.81
Netherlands	1.35	7.17	3.74
Portugal	5.62	8.20	3.40
Spain	5.33	4.35	3.66
Sweden	5.45	6.17	4.16
Average EU15	4.68	5.54	3.55

1. The pre-tax real rate of return represents the cost of capital to the firm when accounting for corporate and personal tax rates.

Source: Adapted from Gordon, K. and H. Tchilinguirian (1998), "Marginal effective tax rates on physical, human and R&D capital", *Economics Department Working Paper No. 199,* OECD; and OECD (1991), *Taxing Profits in a Global Economy.*

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Box 5. Tax policy measures in the 2000 budget

Households

Reduction of personal income tax: the statutory rate of the second bracket of the personal income tax (*Imposta sui redditi delle persone fisiche, IRPEF*) covering incomes of L 15-30 million, will be reduced from 27 to 26 per cent. The maximum tax saving available will be L 150 000 for incomes of L 30 million and above. The median tax saving – measured on the median income within the second tax bracket – will be equal to L 75 000 per year.

Tax credit for low-income earners: workers and self-employed with income below L 15 million will be entitled to a further tax credit of 150 000.

Family tax credit: as of 1 January 2000, the tax credit for each dependent child rises from L 336 000 to L 408 000 (to L 516 000 in 2001 and L 552 000 in 2002) per dependent child. A further tax credit of L 240 000 is allowed to parents with children under 3 years old. A further credit of L 150 000 is available to households with a dependent spouse and an overall income below L 22.5 million.

Tax allowance for owner-occupied dwelling: it rises from L 1.4 million to L 1.8 million for the income declaration of 1999 and subsequent years. Moreover, households renting their principal dwelling can deduct from their tax liability L 640 000 if annual income is below L 30 million and L 320 000 if annual income is between L 30 and L 60 million.

Incentives to housing renovation work: the VAT rate on housing renovation has been reduced from 20 to 10 per cent, whereas the share of costs that can be credited against the personal income tax liability has been reduced from 41 to 36 per cent. Up to 19 per cent of passive interest on loans used to finance renovation of an unsafe part of a dwelling can be credited against personal income tax liability.

Business sector

The* super-Dit *is applied as of 1 January 2000 to incorporated companies

As of 1 January 2000, the 19 per cent corporate income tax levied on income gains ("normal return") attributable to increases in own capital or new reserves will be also applied to part of the old stock of capital.* A "blow-up" factor of 1.2 (it will rise to 1.4 in 2001) will be applied to the increase of the stock of capital in order to extend the tax advantage to part of the income originated by old capital. For example, assuming a company has a stock of own capital of L 1 billion and in year 2000 it increases it by 10 per cent (either by issuing new shares or with retained earnings), if the given rate of "normal return" is 7 per cent, the base for the calculation of the return to capital would be L 120 instead of L 100 million and the "normal return" would rise from L 7 to L 8.4 million. Moreover, the *super-Dit* system will apply to the overall increase of capital stock since 1996. If the same company has increased its stock by 20 per cent in 1997, 30 per cent in 1998 and 10 per cent in 1999, the overall increase is 60 per cent and base for the calculation of the 19 per cent rate becomes L 720 million (L 600 million x 1.2).

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Box 5. **Tax policy measures in the 2000 budget** *(cont.)*

Measures for the whole business sector (including the self-employed)

The *Dit* system will be fully employed by the entire business sector starting from 1 January 2000, in particular by banks and insurance companies, who on their incomes for the year 2000 will immediately profit from the tax advantages granted by the *Dit* system for the own-capital stock.

* The floor set for the average tax rate at 27 per cent (20 per cent for quoted companies) remains in place as well as the special temporary tax concessions granted to companies admitted to the stock exchange.

In order to counteract the weak economic situation, the government decided to introduce temporary incentives to new investments in the 1999 budget law. Known under the name *Legge Visco,* these tax breaks apply only to business activity in 1999 and 2000, and complement the *Dit* by basically providing a subsidy to all new investment financed with own-capital (*i.e.* retained earnings or new shares). It was estimated that the measure would cost L 2 000 billion, entirely financed by the national budget. It was also expected that by stimulating the creation of new enterprises and new investment, the measure would eventually yield new tax revenues. This is not certain, however. New companies investing in new capital and mature companies with retained earnings should be the main beneficiaries: the former are unlikely to pay taxes in their first years of operation while the latter could exploit the tax benefit without undertaking much net new investment.

In the context of the 2000 budget law, the government decided to bring forward by one year the application of the *Dit* to the whole capital stock originally envisaged for 2001, and to bring into force the *Super-Dit* for incorporated companies in 2000 (see Box 5). The *Super-Dit* progressively extends the tax advantage of the *Dit* to the old capital stock, and thus makes the *Dit* system more neutral with respect to already well-established and capitalised enterprises which could not take full advantage of the previous reform. The ultimate aim is to give a further incentive to the business sector to invest in new assets and to reduce leverage without reducing revenues.

Impacts on the cost of labour

In an attempt to reduce the tax component of labour costs, the 1997-98 tax reform eliminated some employers' compulsory health contributions, bringing the

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Table 21. **The tax wedge on labour**[1]

Single worker, no children

	1991	1993	1994	1995	1996	1997	1998	1999
Total tax wedge as a percentage of gross labour cost	48.80	49.20	49.90	50.30	50.80	51.50	47.47	47.10

1. Tax wedge defined as gross labour costs less net take-home pay, divided by gross labour cost.
Source: OECD (1999), *Taxing Wages.*

overall employers' contribution rate down to 34.1 per cent from 46.4 per cent. But the impact of this tax change on the overall cost of labour remains uncertain. The suppressed health contributions were replaced by *IRAP*, which includes in its base the cost of labour and which is not deductible from the corporate income tax base. As a consequence, the tax base has been broadened and the financing of part of social security expenditure has been transferred from contributions to general taxation. Thus, the decline in the tax wedge on labour in 1998 as shown in Table 21 may be exaggerated.[35] Even so, at 47 per cent, it was among the highest in the OECD countries (Table 22).[36]

Improvements in tax administration

The 1997-98 tax reform also introduced considerable changes to the tax administration. The principal objective of the reform of the tax administration is to improve compliance, by both simplifying the tax system and improving efficiency in tax collection, in order to enable the Government to gradually reduce tax rates in the future. One of the most relevant changes was the reduction in the number of annual tax instalments for the payment of the main taxes (income tax, social security contributions, VAT and *IRAP*) from 60 to 15. This was made possible with the introduction of the *versamento unificato*, a single form of tax declaration for all individual taxpayers registered with the VAT registry (affecting mainly the self-employed). From the viewpoint of the taxpayer, the main attraction is the opportunity of offsetting tax credits against tax liabilities in a single tax form.[37] This simplifies the refund procedure and reduces the time lag between the claim and the actual refund. At the same time, the Government has reached an agreement with banks and post offices, by which they can collect tax payments and communicate electronically the related pieces of information to the fiscal authority within up to seven days from the date of payment. This procedure will speed up the collection process, increase auditing of returns and reduce the incentives to cheat.

Another step forward in the battle against evasion was the completion of studies by sector (*studi di settore*) and the initial partial application of the results. Such studies, based on a sophisticated statistical methodology, consider businesses with profits below L 10 billion, and check low profit figures against other

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Table 22. **The tax wedge on labour: international comparisons**

Single worker, no children, 1998

	United States	Japan	Germany	France	**Italy**[1]	United Kingdom	Canada	Belgium	Ireland	Netherlands	Spain	Sweden
As percentage of gross wage:												
Gross labour cost	108	107	121	139	**135**	110	107	135	112	116	131	133
Gross wage earnings	100	100	100	100	**100**	100	100	100	100	100	100	100
Net take-home pay	74	86	58	73	**71**	75	73	58	75	66	80	66
As percentage of gross labour cost:												
Tax wedge	**31**	**20**	**52**	**48**	**47**	**32**	**32**	**57**	**33**	**44**	**39**	**51**

Gross labour costs = gross wage earnings plus employer's compulsory social security contributions.
Net take home pay = gross wage earnings plus government transfers minus income taxes and employees' compulsory social security contributions.
1. Cost of labour for a worker employed in a manufacturing firm with a number of employees above 50. The cost does not include the 1 per cent employer's contribution to the National Industrial Accident Insurance Institute (INAIL), and the 7.4 per cent employee contribution to the severance fund (TFR).
Source: OECD (1999), *Taxing Wages;* ISTAT.

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variables available for the firm, such as sales and employment. The main novelty of the *studi di settore* rests on the agreement between the tax administration and professional associations to co-operate through exchanges of information. The incentive for such co-operation is that tax-evaders introduce harmful price competition among businesses that carry out the same activity. The approach of the *studi di settore* brings more transparency in auditing, and paves the way to a more effective use of other instruments, for example the random selection of individuals and companies for audit and cross checking of data from various databanks. Such instruments can be more effective in identifying those who completely evade tax, who have always been active in the informal economy and whose activities could be partly registered thanks to these means.

Distributional effects

The budget law for the year 2000 has introduced new measures to reduce tax pressure on households and enterprises (see Box 5). In particular, it attempts to reduce the overall tax burden, to support low-income groups and to boost demand in certain sectors of the economy. While some measures aim to redistribute resources to the least affluent, the measures introduced to reduce the tax burden and stimulate demand tend to benefit the medium-high income groups rather more, so that on balance, there may be little redistributive impact. The introduction of numerous new targeted incentives will also have the unintended effect of moving the tax system further away from the goal of simplicity.

The lowering of the second *IRPEF* rate – the key tax burden-reducing measure – does not by itself have redistributive effects. According to ISAE (*Istituto di Studi ed Analisi Economica*),[38] the majority of households who benefit from this measure are in the upper quintiles and they reside in central and northern Italy (Tables 23 and 24). Including the increase in the tax credit for low-income earners

Table 23. **Distributional impact of household tax measures by quintile**

	Quintile					Total
	1	2	3	4	5	
A. Impact of decrease of the second personal income tax rate bracket						
Percentage of households not benefiting	64.4	28.0	8.1	3.7	1.7	21.2
Percentage of households benefiting	35.6	72.0	91.9	96.3	98.3	78.8
B. Impact of all measures						
Percentage of households not benefiting	32.6	4.8	1.0	0.5	0.7	7.9
Percentage of households benefiting	67.4	95.2	99.0	99.5	99.3	92.1

Source: ISAE (1999), *Rapporto Trimestrale*, October.

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Table 24. **Distributional impact of household tax measures by geographic area**

	Geographic area			Average
	North	Centre	South	
A. Impact of decrease of the second personal income tax rate bracket				
Percentage of households not benefiting	13.3	14.7	36.2	21.2
Percentage of households benefiting	86.7	85.3	63.8	78.8
B. Impact of all measures				
Percentage of households not benefiting	3.3	5.6	15.9	7.9
Percentage of households benefiting	96.7	94.4	84.1	92.1

Source: ISAE (1999), *Rapporto Trimestrale*, October.

and for families, the overall impact of the household measures looks more progressive, though households in the first quintile and those residing in southern Italy still benefit less in relative terms. This reflects the fact that those who do not benefit from the tax measures are mainly the unemployed, first-job seekers and retired people without a pension.

The temporary measure relating to the reduction of the VAT rate on house renovation has been introduced mainly to stimulate demand and employment in the labour-intensive construction sector. Higher income tax revenues are expected as part of the informal economy should be brought back to the surface (the disincentive to pay VAT is greatly reduced), more than compensating the potential loss in VAT revenues. ISAE estimates that, although this tax measure will affect all income groups, the highest income groups will benefit in absolute terms twice as much the lowest income groups.

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III. Coping with the ageing problem

Policies aimed at addressing problems associated with the ageing of the Italian population evolved rapidly during the 1990s. Confronted by rapid increases in pension spending linked to the generosity of the system and a trend towards early retirement, and faced by the prospect of one of the sharpest rises in old-age dependency ratios in the OECD area, Italy introduced major pension reforms in the 1990s. In addition, a framework for supplementary private pension arrangements was set up, and reforms to other aspects of the social support system (other income transfers, health care and care for the frail elderly) were laid down or are under consideration. However, despite the impressive reduction in the imbalances once the new pension system is fully introduced, pension reforms are being phased in very slowly. Pension spending as a share of GDP will increase as the baby-boom generation enters retirement and this will leave a good part of the burden of adjustment with future generations.

Despite higher-than-average pension spending, Italian social welfare spending is somewhat below the average in Europe as a ratio of GDP, although it remains above the OECD average. Pensions represent an unusually high two-thirds of all social welfare spending, a dominance which has served to restrict the scope for spending on other segments of the social welfare system (such as those addressing the needs of working-age households). Many of the social services which are the responsibility of the state in other OECD areas are provided within the family in Italy. But looking to the future, falling family size and rising labour-market participation of women will mean a reduced ability to care for the frail elderly within the family, leading to growing pressure for state provision. Health care spending and the costs of care for the frail elderly are also likely to rise at the same time as pensions. Policies are therefore needed both to contain pension spending and to increase the capacity of the system to meet future commitments, both by reallocating resources and creating the conditions for faster resource growth. Indeed, policies to contain pension spending and enhance growth may be linked: for example, if lower pension spending permitted a reduction in the tax wedge on labour, employment and aggregate growth could increase.

The focus of this Chapter is on factors and policies that may help achieve a smoother transition, and highlights some of the key problems that are likely to be

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peculiar to the Italian situation. To this end the Chapter first examines the large demographic shock facing Italy over the next half century. The institutional arrangements for income support, recent reforms, and the impact of these changes on benefit rates and the incentive to retire are then discussed and a number of remaining problems with the public pension system are considered. The scope for the development of second-tier pensions is subsequently outlined. The Chapter then examines the fiscal sustainability of the current system during the transition period. Finally, in light of the sharp increase in the number of elderly expected over coming years, various issues concerning their care and their economic situation are discussed. The section concludes with an assessment and policy recommendations, following the model set out in *Maintaining Prosperity in an Ageing Society.*

The demographic shock

Italy had one of the highest fertility rates in the 1960s and, along with Spain and the Czech Republic, currently has the lowest of all OECD countries (Table 25). Life expectancy in Italy is also high compared with other OECD countries (Table 25) and is rising. These two factors will lead to a sharp increase in the number and share of elderly people in the population. On the basis of the latest EUROSTAT population projections,[39] by 2050, 31 per cent of the population will be 65 or older (37 per cent will be 60 or older), up from 16 (22) per cent in 1995. This compares to 26 (32) per cent for the OECD by 2050.

Over the same period, the population is projected to fall by an average of 0.3 per cent per year (Figure 24). The fall is mainly concentrated among the working-age population, which is expected to decline by about 0.7 per cent annually: a reduction of 29 per cent over the period. The working-age population (aged 20 to 64) will decline from 62 per cent of the total to 51 per cent. Consequently, the old-age dependency ratio (those aged 65 or more as a per cent of the working-age population) will increase very sharply, from the 1995 level of around 26 per cent to around 61 per cent by 2050 (Figure 25). There could be as few as 1.6 working age individuals for each old age person at the peak in 2040, while for the OECD average, the rate will be around 2.1.

These negative population developments are compounded by the fact that Italy currently has the lowest employment-to-population ratio in the OECD (except Turkey). Relatively few individuals in the 55 to 64 age group work. The effective average age of retirement in Italy is currently around 59[40] and the participation rate of women of prime working age (25 to 54) is very low (Table 26). Assuming no change in retirement and employment behaviour, the ratio of those aged 65 or more to those in employment[41] (Figure 25, panel B) could rise to 1.1 in 2050 compared with a projection of 0.7 for OECD countries in aggregate. Assuming no change in participation and unemployment rates, average growth of labour supply

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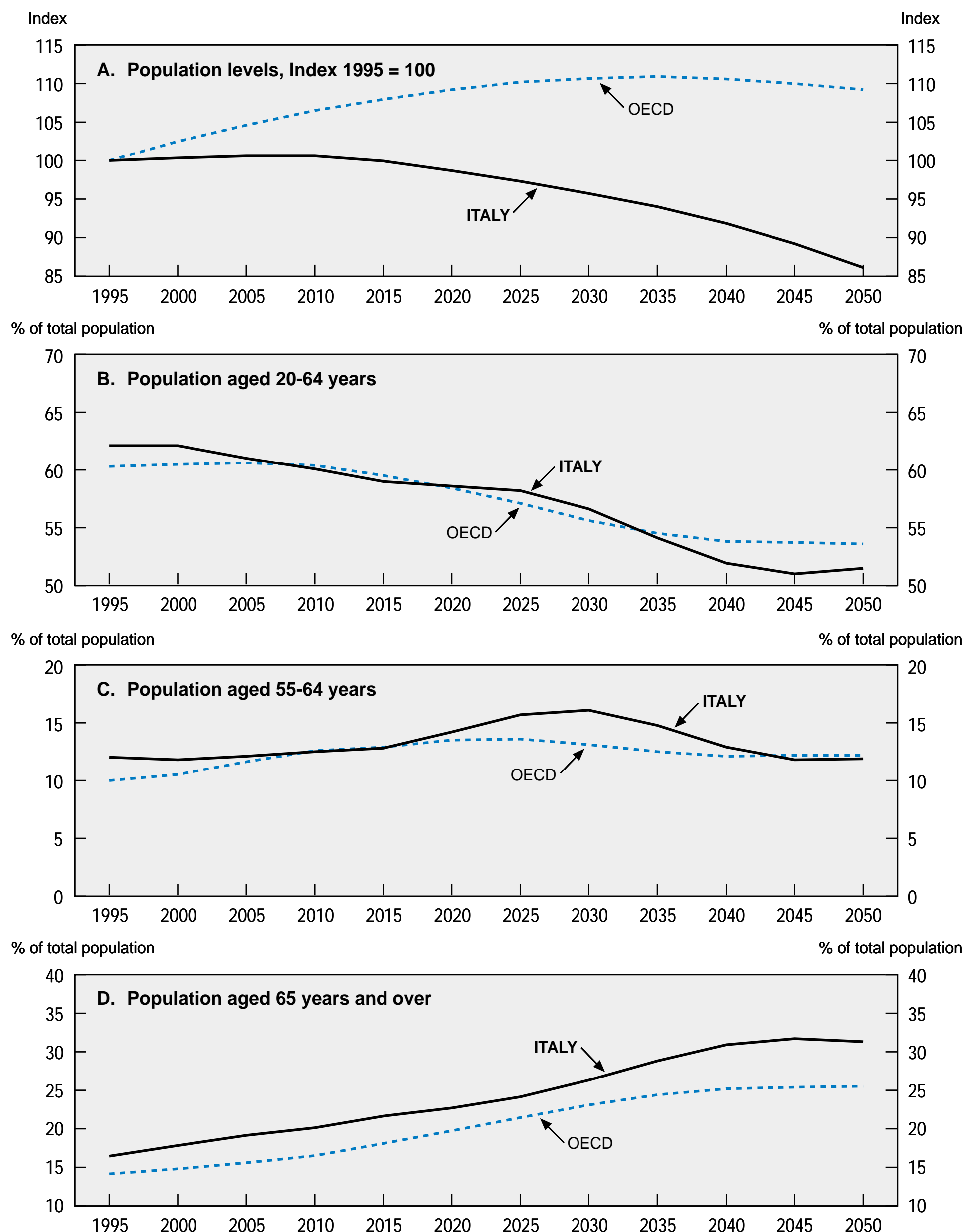
Table 25. **Fertility rates and life expectancy: selected OECD countries**

	Fertility rate			Fertility rate Life expectancy at birth						Life expectancy at 60 years					
				Males			Females			Males			Females		
	1960	1975	1997	1960	1975	1996	1960	1975	1996	1960	1975	1996	1960	1975	1996
Italy	**2.4**	**2.2**	**1.2**	**. .**	**69.5**	**74.9**	**. .**	**75.9**	**81.3**	**. .**	**16.3**	**19.0**[1]		**20.3**	**23.5**[1]
Australia	3.5	2.2	1.8	67.9	69.2	75.2	73.9	76.2	81.1	15.6	16.3	19.6	19.4	20.8	23.8
Austria	2.7	1.8	1.4	65.4	67.7	73.9	71.9	74.7	80.2	15.0	15.6	18.9	18.6	19.6	23.0
Belgium	2.6	1.7	1.6	67.7	68.6	73.5	73.5	75.1	80.2	15.4	. .	19.0	18.7	. .	24.0
Canada	3.9	1.8	1.6	. .	. .	75.7	. .	. .	81.4	. .	. .	20.1			24.3
Czech Republic	2.1	2.4	1.2	67.9	67.1	70.4	73.4	74.0	76.6	15.6	14.6	16.3	18.4	18.5	20.4
Denmark	2.5	1.9	1.8	70.3	71.1	72.9	74.1	76.8	78.0	17.2	17.1	17.7	19.1	21.1	21.5
Finland	2.7	1.7	1.8	64.9	67.4	73.0	71.6	75.9	80.5	14.4	15.0	18.3	17.5	19.7	23.1
France	2.7	1.9	1.7	67.0	69.0	74.2	73.6	76.9	82.0	15.6	16.5	19.7	19.5	21.3	25.0
Germany	2.4	1.5	1.4	. .	68.1	73.6	. .	74.7	79.9	. .	15.4	18.5	. .	19.6	22.8
Greece	2.3	2.4	1.3	67.5	. .	75.1	70.7	. .	80.4	17.0	. .	19.9	18.9	. .	22.9
Hungary	2.0	2.4	1.4	65.9	66.3	66.6	70.1	72.4	74.7	15.6	15.2	14.9	17.6	18.4	19.4
Japan	2.0	1.9	1.4	65.3	71.7	77.0	70.2	76.9	83.6	14.8	17.4	20.8	17.8	20.7	25.9
Mexico	6.8	5.8	2.7	58.6	60.5	70.1	59.1	66.4	76.5	16.8	17.1	19.1	18.1	19.4	22.6
Netherlands	3.1	1.7	1.5	71.6	71.4	74.7	75.5	77.6	80.4	17.8	. .	18.1	19.9	. .	22.8
New Zealand	. .	2.4	2.0	68.7	69.0	74.3	73.9	75.3	79.6	16.3	16.1	19.2	19.5	20.3	23.1
Norway	2.9	2.0	1.9	71.3	71.7	75.4	75.8	78.1	81.1	18.0	17.5	19.3	20.1	21.5	23.7
Portugal	3.1	2.6	1.5	61.7	65.2	71.2	67.2	72.6	78.5	15.9	. .	17.9	18.6	. .	21.9
Spain	2.9	2.8	1.2	67.4	70.4	74.5	72.2	76.2	81.8	16.5	17.1	19.8	19.2	20.5	24.4
Sweden	2.2	1.8	1.5	71.2	72.1	76.5	74.9	77.9	81.5	17.3	17.6	20.0	19.3	21.4	24.0
Switzerland	2.4	1.6	1.5	68.7	71.4	75.7	74.1	77.8	81.9	16.2	17.4	20.2	19.2	21.5	24.6
United Kingdom	2.7	1.8	1.7	68.3	68.6[2]	74.3	74.2	75.2[2]	79.5	15.3	15.2[2]	18.5	19.3	19.9[2]	22.4
United States	. .	1.8	2.1	66.6	68.8	72.7	73.1	76.6	79.4	15.8	16.8	19.2	19.5	21.9	22.9

1. 1994 data.
2. 1970 data.

Source: OECD, *Health Data 99.*

Figure 24. **Population trends: 1995-2050**



Source: Eurostat for EU countries and United Nations for others.

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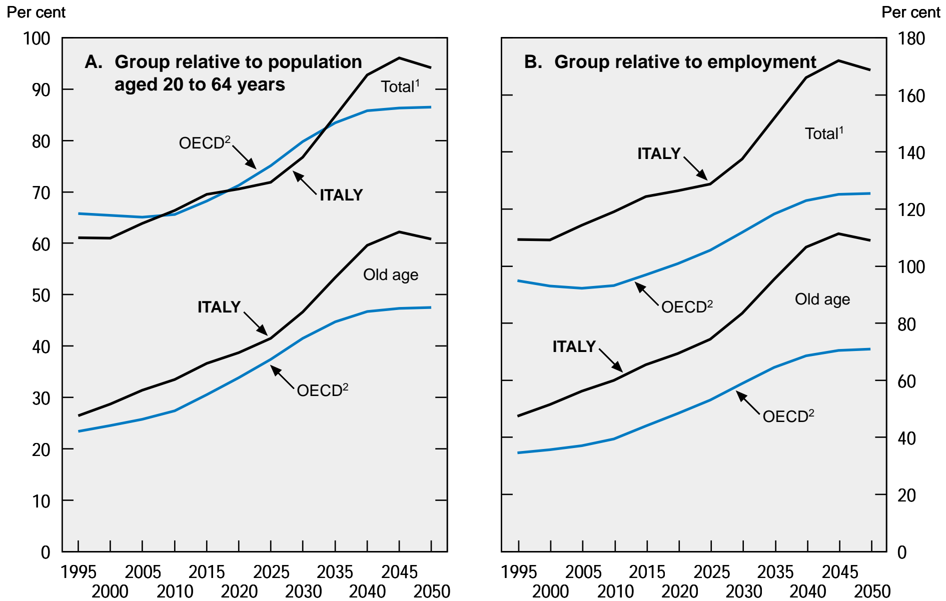
Figure 25. **Total and old-age dependency ratios**



1. The total dependency group refers to young population (0-19 years) and old-age population (65 years and over).
2. Data are calculated as the average of the rates of individual countries (excluding Turkey and Mexico).

Source: Eurostat for EU countries and United Nations for others.

would fall from 0.2 per cent in the period 1990-1999 to –1.2 per cent for the period to 2025-35. And if productivity growth averaged 1.75 per cent through the period 2000 to 2050, growth of GDP per capita could decelerate from around 2 per cent over the past 15 years to around 1 per cent on average over 2000-2050. Since higher employment and GDP growth would ease the financing constraint, policies encouraging higher demand for and supply of labour as outlined in the following Chapter would go a long way to easing the financing problems associated with the future costs of ageing.

It should be emphasised that these projections are sensitive to assumptions regarding fertility, average lifetimes and immigration (Box 6). EUROSTAT and ISTAT population projections assume a small rise in fertility early in the period, and continuing immigration in the range of 50 000 rising to 66 000 and 80 000 persons per year for ISTAT and EUROSTAT projections respectively. In contrast, United Nations projections, which assume a lower fertility rate over the next few decades and virtually no immigration, show a markedly different trajectory for the population and its age composition. By the end of the period the overall

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Table 26. **Participation and employment ratios[1] by age and sex**

	Men						Women					
	Participation			Employment/population			Participation			Employment/population		
	1990	1995	1998	1990	1995	1998	1990	1995	1998	1990	1995	1998
Italy												
15 to 24	**50.7**	**43.8**	**42.7**	**38.8**	**31.1**	**30.7**	**43.0**	**33.8**	**32.2**	**27.8**	**21.1**	**20.2**
25 to 54	**94.0**	**89.5**	**89.8**	**90.2**	**83.5**	**83.3**	**52.1**	**53.7**	**56.1**	**46.2**	**47.0**	**48.6**
55 to 64	**51.7**	**44.1**	**42.6**	**50.9**	**42.3**	**40.5**	**15.0**	**13.8**	**15.1**	**14.7**	**13.1**	**14.4**
United States												
15 to 24	71.8	70.2	68.4	63.5	61.5	60.8	62.9	62.3	63.3	56.1	55.1	57.2
25 to 54	93.4	91.6	91.8	89.1	87.6	88.8	74.0	75.6	76.5	70.6	72.2	73.6
55 to 64	67.8	66.0	68.1	65.2	63.6	66.2	45.2	49.2	51.2	44.0	47.5	50.0
Japan												
15 to 24	43.4	48.0	48.8	41.4	45.1	44.8	44.8	47.2	47.8	43.0	44.4	44.3
25 to 54	97.5	97.5	97.3	96.2	95.3	94.3	64.2	65.2	66.6	62.9	63.2	64.0
55 to 64	83.3	84.8	85.2	80.4	80.8	79.8	47.2	48.5	49.9	46.5	47.5	48.5
Germany												
15 to 24	62.5	54.6	52.9	59.7	49.8	47.5	58.8	50.3	46.3	56.0	46.2	42.5
25 to 54	93.9	93.1	93.2	90.5	87.3	86.1	65.6	73.2	73.5	61.5	66.3	67.6
55 to 64	58.3	54.5	55.6	54.4	48.8	48.9	27.5	31.3	33.4	25.0	27.0	28.7
France												
15 to 24	39.6	32.8	30.9	33.6	25.9	24.2	33.1	26.7	25.0	25.2	18.1	17.5
25 to 54	95.4	94.9	94.5	89.8	86.6	85.8	72.9	77.3	77.9	65.1	67.5	68.0
55 to 64	45.8	41.5	41.3	43.0	38.4	37.9	31.3	30.9	31.2	28.8	28.9	28.3
United Kingdom												
15 to 24	83.5	74.4	73.4	74.2	61.1	63.3	72.4	64.9	65.4	65.9	57.0	58.5
25 to 54	94.8	92.7	91.4	89.5	84.8	86.4	72.9	74.0	75.1	68.6	69.5	71.7
55 to 64	68.1	62.4	62.6	62.4	56.1	58.3	38.7	40.8	39.8	36.7	39.3	38.5
Canada												
15 to 24	71.4	63.9	63.6	61.5	53.1	53.0	67.0	60.4	60.4	59.4	51.9	52.1
25 to 54	93.3	91.0	91.3	86.6	83.2	84.7	75.7	75.9	77.3	70.0	69.6	71.8
55 to 64	64.9	58.9	59.6	60.9	54.0	55.5	35.5	36.3	38.2	33.5	33.4	35.6
European Union												
15 to 24	58.8	51.4	50.4	50.8	41.4	41.6	51.1	43.9	42.7	41.8	34.1	33.8
25 to 54	94.3	92.6	92.4	89.6	85.3	85.6	64.0	68.7	70.1	58.3	61.1	62.9
55 to 64	56.7	51.9	52.2	53.2	47.2	48.0	26.7	28.0	29.0	25.1	25.6	26.6
OECD Europe												
15 to 24	61.1	52.7	51.3	52.6	42.8	42.7	49.4	41.8	40.0	40.8	33.1	32.3
25 to 54	94.3	92.5	92.2	89.7	85.5	85.8	61.1	66.4	66.5	55.9	59.4	60.1
55 to 64	57.8	52.4	52.5	54.4	48.1	48.7	27.3	27.8	28.6	25.8	25.7	26.5
Total OECD												
15 to 24	61.3	57.9	57.0	54.5	49.9	49.9	50.4	47.1	46.4	44.3	40.3	40.3
25 to 54	94.6	93.2	93.0	90.8	87.9	88.2	63.7	66.8	67.5	60.0	62.1	63.0
55 to 64	66.5	62.7	63.7	63.5	59.0	60.2	35.5	36.4	38.0	34.3	34.7	36.3

1. Rate of participation and employment as a per cent of age group.
Source: OECD, *Employment Outlook*, June 1999.

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Box 6. Assessing the impact of different demographic assumptions

Demographic projections are very sensitive to assumptions about fertility rates, net migration flows and life expectancy. To this end, this box compares EUROSTAT, ISTAT and UN demographic projections for Italy over the period from 2000 to 2050. They show that there can be large difference in outcomes, particularly when taken over a period as long as a half century.

Main assumptions

EUROSTAT and ISTAT projections assume that fertility rates rise mildly until 2020 – reflecting the view that part of the earlier fall in fertility was the result of the delay in the arrival of the first child for many women into their 30s – and remain constant thereafter. By contrast, UN projections assume a small decline in fertility rates at the beginning of the period but a higher end point such that the curves tracing fertility rates in the EUROSTAT and ISTAT projection rises above the line for the UN projections around 2025.

With migration flows highly uncertain, simple extrapolations of past trends may be particularly inappropriate given the difficulty in estimating the size of the recent inflows into Italy (many are hidden in the informal sector) and the fact that many are in transit. Future trends will also be affected by the structure of demand (many immigrants are employed in low skill services) and the degree to which domestic participation rates adjust to ageing. Despite these caveats, EUROSTAT (ISTAT) projections assume an annual inflow of 50 000 rising to 80 000 (66 000) persons per year and are less conservative than those of the UN, which have virtually no immigration beyond 2015.

Both EUROSTAT and UN projections assume increasing life expectancy of about five years over the period, the increase being slightly larger for the former. In contrast, ISTAT has virtually no increase in life expectancy at birth in the last half of the projection period.

Implications and outcomes

The key implications of the above demographic assumptions are summarised in the table below:

- The combination of stronger fertility rates and migration flows, along with longer life expectancy for females, contributes to a gradual widening of the gap between EUROSTAT and UN projections of total population to around 8 million individuals by 2050. ISTAT projections appear to lie in between but closer to the EUROSTAT projections;
- Taking the two extremes, by 2050, the age group 20-64 accounts for 66 per cent of the difference between EUROSTAT and UN population projections, while the 0-19 accounts for 21 per cent. The remaining 13 per cent of the total population difference in 2050 is accounted by the above 65-years age group.

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Box 6. Assessing the impact of different demographic assumptions *(cont.)*

- Old-age dependency ratios (65+/20-64) are much higher for the UN projections: by around 10 percentage points relative to EUROSTAT and marginally less for the ISTAT.

Difference in population projections: United Nations, EUROSTAT and ISTAT

	2000			2020			2050		
	UN	ISTAT	EURO-STAT	UN	ISTAT	EURO-STAT	UN	ISTAT	EURO-STAT
Fertility rates (per woman)	1.20	1.31	1.37	1.40	1.45	1.50	1.66	1.46	1.50
Female life expectancy at birth (years)	81.2	82.3	81.7	83.1	84.7	84.0	85.5	84.6	85.0
Male life expectancy at birth (years)	74.9	75.9	75.10	77.3	78.3	78.3	79.8	78.2	80.0
Net migration rate (per thousand)	0.73	0.87	0.87	0.11	1.00	1.41	0.00	1.44	1.62
Net immigrants (000)	41.83	49.96	50.0	5.29	56.14	80.0	0.000	66.0	80.0
Total population (000)	57 298	57 456	57 455	52 913	55 939	56 543	41 197	45 997	49 287
Share of population 0-19	19.4	19.8	20.0	16.1	18.0	18.7	16.5	16.2	17.2
Share of population 20-54	50.5	50.4	50.3	44.0	44.4	44.4	35.8	39.1	39.6
Share of population 55-64	11.9	11.8	11.8	15.8	14.4	14.2	12.9	12.5	11.9
Share of population 65+	18.2	18.0	17.8	24.1	23.2	22.7	34.9	32.3	31.3
Total dependency ratio (< 20+65+)/(20-64)	60.1	60.6	61.0	67.1	70.1	70.6	105.6	93.9	94.2
Old-age dependency ratio (65+/20-64)	29.1	28.9	28.7	40.2	39.5	38.7	71.7	62.6	60.8
Old-age dependency ratio (65+/15-64)	26.9	26.6	26.5	37.4	36.3	35.5	65.7	57.6	55.7

Source: United Nations (1999), *Wolrd Population Prospects: the 1998 revision*, New York. EUROSTAT (1999), *Demographic Statistics*, Luxembourg. ISTAT (1977), "Previsioni della popolazione residente per sesso, età e region, Base 1.1.1996", *Informazione* No. 37.

Since many of the differences in the projections are found in the working-age population (differences in the shares of the 65+ are relatively small between the three projections), there are strong implications for potential output growth. Assuming no change in labour market behaviour, the UN projections would imply an annual labour-force growth of some 0.4 per cent less than those of EUROSTAT over the period 2000 to 2050 (representing a difference in the level of GDP of around one quarter by the end of the period), and similar differences (although slightly smaller) are found for ISTAT projections.

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population would be approximately 8 million persons lower, with the majority of the difference roughly split between the effects of the small difference in fertility assumptions and immigration. Because these two effects lead to a slower growth in the working age population, dependency ratios tend to be higher. While highlighting the uncertainty of the outcomes over such a long period, these results also suggest that if fertility were not to rise as expected in coming years or the rate of immigration were lower, the size of the population shock could be larger.

Institutional background to the Italian pension system

The Italian system of old-age income support is largely based on a mandatory old-age insurance, which also provides insurance to survivors and disability benefits (*invalidità, vecchiaia e superstiti* (*IVS*)). It covers the majority of the working population and is managed by the State through the National Social Insurance Institute (INPS) for the private sector and the INPDAP for the public sector as a PAYG system. There are additional schemes – sometimes of a funded nature – covering around 7 per cent of workers[42] and are largely concentrated in banking, insurance and journalism. Second-tier pension funds, which can be individual ("open") funds or occupational ("closed") funds, are generally fully funded and participation is voluntary, unless they substitute for the public programme (some banks and financial institutions). The 1995 reform (see below) tried to increase the role of this second pillar, but success has so far been limited. Current proposals to strengthen occupational pensions include re-directing severance payments (currently paid by employees into a fund held by the employers (trattamento di fine rapporto or TFR)) to voluntary occupational pension funds. Finally, individuals can make individual savings arrangements for retirement with private financial institutions ("open" pension funds)

Benefits and contributions

Focusing on the public pension system, the pension benefits and the rules for pension entitlements were quite diverse before the reforms, depending on whether the individual belonged to a private- or public-employee or self-employed scheme (Table 27). In general, pension benefits were based on the last five years average earnings for private employees, with benefits reaching a maximum of around 80 per cent of wages for an individual with 40 years of contributions.[43] Benefits were indexed to minimum contractual wages. While benefits were less generous for the self-employed (based on the last ten years of income using the same procedure as for private employees), the self employed paid significantly less contributions. Benefits for public employees were calculated using the last salary and traditionally a promotion was given a short time before retirement.

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Table 27. **The Italian reforms in the 1990s**

	Pre-1992			Amato (1992)		Dini (1995)		
						All of the working population		
	Private employees	Public employees	Self-employed	Private employees and self-employed	Public employees	Young workers (hired from 1996)	Middle-aged workers (with less than 18 years of contributions at the end of 1995)	Older workers (with at least 18 years of contributions at the end of 1995)
Retirement age	60 for men 55 for women	65	65 for men 60 for women	65 for men[1] 60 for women[1]	65	57 to 65 With actuarial adjustment	65 for men and 60 for women[1]	
Indexation of pension	Wage growth		Inflation	Inflation		Inflation		
Years of contributions for eligibility	15			20[2]		5 and if pension benefit is of at least 1.2 times the social assistance benefit[3]	20[2]	
Early retirement provision, seniority pensions, minimum years of contributions for eligibility	35	20 for men (25 in the local institutions) 15 (20 in the municipal institutions) for women with children	35	Gradually increasing for public employees[4]			57 years of age and 35 years of contributions or 40 years of contributions[5]	57 years of age and 35 years of contributions or 40 years of contributions[5]
Survivor's pension	60 per cent to spouse, 20 per cent to each child, (40 per cent for each child if spouse not present). Total must be less than 100%.			60 per cent to spouse, 20 per cent for each child, (40 per cent for each child if spouse not present). Total must be less than 100%.		The previous (Amato and pre-Amato) percentages are gradually reduced if the survivor's total income exceeds a fixed amount[6]		
Pension benefits	2 per cent of pensionable wages for each contribution year			2 per cent of pensionable wages for each contribution year		The pension is calculated using the contribution-based method $P = ct \times M$ where: ct = conversion coefficient M = the total of contribution accrued during the whole working life capitalised on the basis of a five-year moving average of GDP growth.	The pension (P) is obtained as a sum of two components (P = PA + PB). The first (PA) is calculated by using the earning-related method while the second one (PB) the contribution-based-method. PA = 2% × (C1 × W1 + C2 × W2) where: W1 and W2 = reference wage C1 and C2 = years of contribution before 1995 *a)* for contribution before 1992 (C1).	The pension (P) is calculated using the earnings-related method. P = 2% × (C1 × W1 + C2 × W2) where: W1 and W2 = reference wage C1 and C2 = years of contribution *a)* for contribution before 1992 (C1). W1 is the last monthly wage for public employees and the average of the last 5 or 10 years, respectively,
Pensionable wages	Last five years' average salary	Last month's salary	Last ten years average earnings	Average of whole working life earnings They are re-evaluated at 1 per cent annually[7]				

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Table 27. **The Italian reforms in the 1990s** *(cont.)*

Pre-1992			Amato (1992)		Dini (1995)		
					All of the working population		
Private employees	Public employees	Self-employed	Private employees and self-employed	Public employees	Young workers (hired from 1996)	Middle-aged workers (with less than 18 years of contributions at the end of 1995)	Older workers (with at least 18 years of contributions at the end of 1995)
						W1 is last monthly wage for public employees and the average of the last 5 or 10 years, respectively, for private employees and the self-employed *b)* for contribution between 1993-1995 (C2), W2 is the average wage of a progressively increasing number of last years. PB = cT × M (M is calculated for contribution after 1995)	for private employees and the self-employed. *b)* for contribution after 1992 (C2). W2 is the average of the last 10 years for private (starting from 2001) and public employees (starting from 2008) and 15 years for the self-employed (starting from 2003)

1. Gradually increasing. Fully operational from 2000.
2. Gradually increasing. Fully operational from 2001.
3. 1.2 times the social assistance benefit is about 5 140 euros in 2000.
4. Amato reform included the requirement for retirement of 35 years of contributions for workers with less than 8 years of contributions at the end of 1992, and a gradual increase for the others.
5. For those with 35 years of contributions, a gradual increase in the minimum age for seniority pensions. Following the Prodi amendments minimum ages are as follows: 57 years from 2002 for private sector employees and from 2004 for public sector employees; 58 years from 2001 for the self-employed. The length of the contribution period required for access to seniority pensions irrespective of age is increased to: 37 years in 2001 to 40 years in 2008 for employees; and, 40 from 1998 for the self-employed.
6. The coefficient of reduction is 25% (40%, 50%) if total income is 3-4 (4-5, > 5) times the annual minimum pensions. Means-tested.
7. Gradual extension to entire working life for those with less than 15 years of contributions at 31 December 1992. For those with more than 15 years of contributions at 31 December 1992, the extension of the pensionable wage was gradually increased to 10 years for employees and 15 years for the self-employed.

Source: OECD and Italian Treasury.

A key characteristic of the Italian system has been the right to obtain a seniority pension. This permitted private sector employees and the self-employed to take retirement after only 35 years of contributions, irrespective of the age at which a person starting his working life. For example, an individual starting work at the age of 16 could retire in his or her early fifties with a pension benefit of just under 70 per cent of income just prior to retirement. Retirement was possible even earlier in the public sector: after 20 years contributions for men and 15 for women with children. Since these benefits were not actuarially adjusted to allow for the fact that pensions were received over a longer period, individuals could obtain a very large addition to their pension wealth (the sum of total pension benefits over the retirement period) by retiring early. There were very strong incentives to take this option when individuals became unemployed and faced difficulties in finding a new job. In addition, before the reform in 1984, there was widespread abuse of disability pensions. Thus, although the official retirement for private employees was 60 for men and 55 for women (65 for men and 60 for women

Box 7. The system of income support for the elderly

The public pension system

The Italian public pension system (INPS and INPDAP combined) covers all employed persons (including domestic employees). It is a combination of schemes rather than a unified system, which makes the system difficult to characterise. There are special systems for industrial managers, liberal professions, railway employees, public utilities, air transport workers, journalists, civil servants, self-employed artisans, merchants, and self-employed farmers. The main schemes, in terms of workers involved are (1997 data):

- The private sector employees' fund (FPLD), under INPS, covering around 11 million active workers and 10.2 million pensions. It represents 58 per cent of all pensions and 56 per cent of all people paying contributions.
- The public sector employees' schemes, under the umbrella of INPDAP, covering 17 per cent of all people contributing and 12.5 per cent of all pensions.
- The self-employed schemes under the umbrella of INPS, covering 21 per cent of all people contributing and 23.4 per cent of all pensions.
- Other schemes – those not under the umbrella of INPS or INPDAP (*e.g.* liberal professions, doctors, railway and public utilities employees) – representing 6 per cent of all people contributing and 4 per cent of all pensions.

All schemes provide old-age, survivor and disability benefits. Participation is compulsory and pensions are earnings-related with the system having only a small redistributive component through low minimum pensions.

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who were self-employed and 65 for those who worked in the public sector), individuals typically retired earlier and this has pushed up the overall costs of the pension system (Boxes 7 and 8).

The public pension system was, therefore, very generous: indeed, Italian pensioners have benefited from one of the higher old-age pension gross replacement rates in the OECD area (Table 28).[44] Combined with the demographic shock just described, this generosity would have led to sharp increases in pension spending over the next half century in the absence of reforms.

Italy has one of the highest tax wedges amongst the OECD countries and the contributions for income support for those in retirement is an important component. The funds to finance the public pension system in the private sector come from three sources.

- For private-sector employees, employers pay 23.8 per cent of payroll. The insured person pays 8.89 per cent for earnings up to 63 054 000 lire (1.7 times the Average Production Worker (APW) earnings) per year; or 9.9 per cent for earnings between 63 054 000 and a

Box 8. Some characteristics of the pension system prior to reforms

At the beginning of the 1990s, the pension benefits and the rules for pension entitlements were quite different, depending on whether the individual belonged to a private, public employee or self-employed scheme (see Table 28). Pension benefits were based on the last month's salary for public employees, but the last five years' average for private employees. The statutory retirement age varied substantially for different groups, ranging from 65 for a public employee to 55 for female private employees. But public employees had access to early retirement after only 20 years of contributions, while seniority pension in the private sector required 35 years of service. In both cases there was no adjustment to allow for the fact that early retirees receive pension over a longer period than those retiring at the official retirement age. Although the system has not been fully integrated and harmonised, reforms in the 1990s have eliminated a number of key differences across the groups. These are being phased-in over a long period, although the Prodi measures accelerated this process (see below).

While the earnings base (pensionable earnings) used to calculate benefits in the private sector differed between employees, civil servants and the self-employed, pensions were calculated on the basis of 2 per cent of pensionable earnings for each year of employment (Table 27). Pensions were indexed on minimum contractual wages.

The pension system also provided both invalidity and survivors' pensions. In 1998, around 10 per cent of pensioners received an invalidity pension.

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Table 28. **Expected old-age replacement rates in OECD countries**[1]

Per cent

	1995
United States	56.0
Japan	52.1
Germany	55.0
France	64.8
Italy	**70.0**
United Kingdom	49.8
Canada	51.6
Australia	40.9
Austria	79.5
Belgium	67.5
Czech Republic	53.2
Denmark	56.2
Finland	60.0
Greece	120.0
Hungary	54.6
Iceland	93.0
Ireland	39.7
Luxembourg	93.2
Netherlands	45.8
New Zealand	61.3
Norway	60.0
Poland	53.7
Portugal	82.6
Spain	100.0
Sweden	74.4
Switzerland	49.3
Average of above countries	64.8

1. The figures refer to theoretical replacement rates and are based on assumptions as reported in Blöndal and Scarpetta (1998), Box III.1.

Source: Blöndal and Scarpetta (1998), *The retirement decision in OECD countries, OECD Economics Department Working Paper* No. 202.

ceiling of 250 000 000 lire (6.6 times APW earnings). In addition, employers in certain industries pay a special contribution and employers in certain economically distressed areas are relieved of part of the contribution.

- Public-sector employees pay 8.75 per cent and the employer – the State in this case – pays 24.2 per cent.
- The self-employed currently pay around 16 per cent but this will be increased to reach 19 per cent by 2014.

This represents the bulk of the tax wedge on labour (See Chapter II). The government covers the full cost of means-tested allowances and any overall deficit.

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Attributing all of the severance allowance contributions (*Trattamento di fine rapporto* or TFR – see below) to income support for the elderly, the overall cost of retirement income systems is around 40 per cent of wages.[45]

The reforms implemented in the 1990s

Faced with the prospect of an increasing fiscal imbalance, two sets of pension reform were introduced in 1992 and 1995 by the Amato and Dini governments respectively. Further adjustments to accelerate the phase-in of certain aspects of the previous changes were made by the Prodi government in 1997. These reforms have transformed the pension arrangements and significantly reduced the problems of the system. This section describes the reforms, identifying, in particular, changes in generosity and the impact on the incentives to retire. Possible areas where the reforms could be adjusted are suggested at the end. The three reforms are presented in greater detail in Box 9. Briefly:

- The *Amato reforms* of 1992 used lifetime earnings (rather than the last five or ten years) as the base for calculating pensions and indexed pension benefits to prices, rather than minimum wages;[46] they also began a gradual abolition of the special arrangements applying to public sector workers and of the different treatment of private employees and the self-employed. Official retirement ages were to be progressively increased to 60 for women and 65 for men, where they were lower. Individuals with 15 years of contributions were excluded from the reform, except for the change in the indexing rule.
- The 1995 *Dini reforms* changed the underlying architecture of the system and further increased its long-term sustainability. The total of pension benefits received by an individual during retirement were to be directly linked to notional contributions over a person's working life (see Box 9). Although the new system permitted retirement as early as 57,[47] the pension benefits of those retiring earlier were reduced to allow for the fact that the pension is received for a longer period, thus maintaining the link between the sum of the stream of benefits and accumulated contributions. Thus, individuals retiring earlier would have a sharply reduced pension compared to the pre-Amato rules. Pension contributions were to be indexed to GDP growth, making the system more sensitive to the capacity to finance it.
- The *Prodi amendments* in 1997 made no further changes to pension benefit calculations, but the reforms brought forward the harmonisation of the public sector and private sector pension regimes. The minimum age needed to obtain a seniority pension after 35 years of contributions was raised to 57 years from 2002 for private sector

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Box 9. Reforms of the Italian pension system in the 1990s

Prior to reforms the Italian pension system was characterised by different rules for private or public sector employees, pension benefits were indexed to the growth of wages and access to early retirement in the form of seniority pension was easy. Italy undertook three sets of pension reforms during the 1990s: in 1992 (Amato), 1995 (Dini) and 1997 (Prodi). The first two made major changes to the architecture of the system. The latter largely concerned the speed of implementation of the preceding changes. The reforms were designed to contain future pension expenditure, ensure the long-term sustainability of the pension system, and reduce the disparities among different types of workers. These reforms have affected rules governing the calculation of pension benefits, the indexation of pensions, access to early retirement and the statutory age of retirement.

1. Amato reform (1992)

The goal of this first reform of the pension system was to secure immediate financial sustainability by cutting pension outlays. The key element with an immediate impact on the cost of the system was the indexing to consumer prices instead of to minimum wages. Other important changes were:

- A lengthening of the reference period of average wage earnings used to calculate benefits, to the individual's entire work history rather than the last few years of employment.
- An increase in the minimum requirements for seniority pensions.
- A gradual abolition of the generous special provisions applying to public sector workers.
- A progressive increase in the statutory age of retirement from 60 and 55 years for men and women to 65 and 60 years, respectively (the official retirement age remained 65 for men and women in the public sector).

Workers with fifteen years of contributions as of 1992 were not covered under the new rules, apart from the new rule on indexing. Partly for these reasons, the reforms did not achieve the long-term sustainability of the system and new reforms were passed in 1995.

2. Dini reform (1995)

This reform introduced a substantial change in the structure and institutional design of the Italian pension system, aimed at improving longer-term fiscal sustainability and labour market incentives. The most profound change was achieved by switching from a defined-benefit system to what can be termed as a "notional" defined-contribution system coupled with an annuity (see Annex *IV* for details). A key feature was the link between the contributions made over an individual's lifetime and the sum of the benefits an individual receives in retirement. Each individual has an "account" in which "contributions"[1] – equal to 33 per cent of earnings for employees and 20 per cent for the self-employed – accumulate. Contributions for each year are indexed to a five-year moving average of GDP.

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Box 9. **Reforms of the Italian pension system in the 1990s** *(cont.)*

On retirement, which can be taken as early as 57, the sum of the contributions (re-valued by GDP) at the time of retirement is multiplied by a "transformation coefficient" to convert it to a pension (annuity). The size of the "transformation coefficient" and the corresponding pension benefit depends on the age at which retirement is taken.[2] In other words, to ensure that the total of the value of the accumulated benefits (discounted by real GDP growth) of the individual equals his or her "contributions" (re-valued by a five-year moving average of nominal GDP growth), those retiring earlier receive smaller pensions because they will be receiving it for a longer time period (assuming that all individuals have the same expected life span at retirement). The "transformation coefficients" are laid out in the Pension Act and were established after negotiation with the unions. While they take into account the expected lifetimes of the new pensioner on retirement and a discount factor (equal to an estimate of GDP growth set at 1.5 per cent), there is no further rise in the transformation coefficients for those continuing to work beyond 65.

The Dini reform also tightened the conditions on seniority, disability and survivor's pensions, and broadened the contribution base. As noted in the main text, these changes are to be phased in very gradually.

3. Prodi amendments (1997)

Since the Dini reforms were insufficient to achieve the short-term target of stabilising pension spending as a percentage of GDP, a number of amendments were introduced under the Prodi government in November 1997. These included:

- An acceleration of the harmonisation of the public and private pension regimes.
- A gradual increase in the contribution rates for the self-employed to 19 per cent.
- A tightening of the conditions governing access to seniority pensions (see Annex IV). Blue collar workers and "equivalent" workers, workers who started their careers between 14 and 18 years of age, and those on Cassa Integrazione Guadagni, were excluded.
- Harmonisation of rules for special schemes, in particular for air pilots, judges, university professors, employees of the Bank of Italy and CONSOB, with those for private employees in terms of contribution rates, yield coefficients, and eligibility criteria on seniority pensions.

1. Note that the "contributions" are notional and only represent an accounting method for establishing the base for calculating the pension benefit. The actual contribution rates to pay for the system (see above) could increase depending on the future cost of the existing system (particularly during the transition period) and how it is financed.
2. The current coefficients range from 0.0472 for retirement at 57 to 0.06136 for retirement at 65. Thus if the cumulated contributions of an individual over his or her lifetime were L 700 million at age 57, the annual pension of the individual would be L 700 million times 0.0472 if he or she retired at that age.

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employees and 2004 for the public sector (instead of 57 years from 2008). Contributions paid by the self employed were increased.

The transition period and the pro-rata system. Only individuals beginning work in 1996 are totally covered by the Dini reforms. Unless they opt for the new regime, pension benefits of remaining workers are as follows:

- For those with more than 18 years of contributions at the end of 1995, pension benefits are based on a "modifed" pre-Amato system. It is modified in the sense that pensions are indexed to prices (rather than wages) and age and contribution requirements for retirement and seniority pensions increase progressively, so that these workers are partially subject to the Amato reforms.
- For workers with less than 18 years of contributions, pension rights are to be based on the benefits they would have had under the rules of the three systems (modified pre-Amato, Amato and Dini) weighted by the number of years of contributions under each one. The latter is referred to as the "pro-rata" system.

System generosity and retirement incentives

Identifying the precise incentives facing individuals as they reach retirement age is difficult, given the long phase-ins of the different vintages of reforms and the consequent mix of systems that will be in force over the next several decades. Indeed, the bulk of those retiring before around 2015 will do so under the modified rules of the old system (see above) and these rules will continue to weigh heavily in calculating benefits for some time after this. At the end of 1995, 45 per cent of all workers (employees and self-employed) had eighteen years or more of contributions.

Two factors are likely to affect the retirement decision: the level of the benefit that an individual receives and whether the pension system is "actuarially neutral". A pension system is defined as "actuarially neutral" if the value of pension wealth of an individual (*i.e.* the discounted sum of pensions received during his or her retirement) remains unchanged, irrespective of the age of retirement. The degree of "actuarial neutrality" of the retirement system with respect to the retirement decision is a key indicator for the assessment of incentives. Table 29 presents indicators of system generosity and of the incentives to retire for hypothetical workers having begun work at the age of 22 on a pre-tax basis in the form of: *i)* replacement rates (accrued pension rights as a ratio of earnings in the last year of employment); *ii)* accrual rates (the increase or decrease in pension wealth from working for an additional year); and *iii)* the implicit tax on this extra year's earnings (the pension loss/increase as a share of earnings during the additional year of work). Where the tax rate is positive and the accruals rate is negative,[48] the

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Table 29. **Retirement benefits and incentives: full systems**

Year of retirement	Last year of work	Years working	Replacement rates			Accrual rate			Implicit tax		
			Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini
Single persons											
56	55	34	65	58		–0.029	–0.033		0.487	0.383	
57	56	35	67	59	51	–0.033	–0.037	–0.008	0.519	0.406	0.078
58	57	36	69	61	54	–0.037	–0.041	–0.011	0.550	0.428	0.095
59	58	37	71	62	57	–0.041	–0.046	–0.012	0.580	0.451	0.105
60	59	38	73	64	60	–0.046	–0.052	–0.013	0.609	0.473	0.113
61	60	39	75	65	64	–0.051	–0.058	–0.016	0.636	0.494	0.135
62	61	40	77	66	67	–0.085	–0.066	–0.019	0.987	0.515	0.154
63	62	41	77	68	71	–0.094	–0.075	–0.023	0.972	0.536	0.177
64	63	42	77	69	75	–0.104	–0.086	–0.026	0.958	0.556	0.193
65	64	43	77	70	80	–0.116	–0.099	–0.098	0.944	0.576	0.681
66	65	44	77	72	82						
Couple, one worker, where the man dies at 80 and the wife outlives him by four more years with a survivor's pension											
56	55	34	65	58		–0.024	–0.027		0.436	0.341	
57	56	35	67	59	51	–0.027	–0.031	–0.002	0.469	0.364	0.015
58	57	36	69	61	54	–0.030	–0.034	–0.003	0.501	0.387	0.029
59	58	37	71	62	57	–0.033	–0.038	–0.004	0.532	0.409	0.035
60	59	38	73	64	60	–0.037	–0.043	–0.004	0.561	0.430	0.038
61	60	39	75	65	64	–0.041	–0.048	–0.006	0.590	0.451	0.055
62	61	40	77	66	67	–0.074	–0.053	–0.008	0.987	0.472	0.070
63	62	41	77	68	71	–0.080	–0.060	–0.010	0.972	0.493	0.087
64	63	42	77	69	75	–0.087	–0.068	–0.011	0.958	0.513	0.096
65	64	43	77	70	80	–0.096	–0.077	–0.083	0.944	0.533	0.681
66	65	44	77	72	82						

Note: Calculated on the basis of an individual born on 1 January starting work at 22 , with wage rates rising at 2 per cent and GDP at 1.5 per cent both in real terms. Replacement rate is the value of the pension as a per cent share of the previous wage at different ages of retirement. The accrual rate is the per cent increase (+) or loss (–) of pension wealth from working an additional year. Pension wealth is defined as the discounted value of the stream of pension benefits between the time of retirement and death. The discount rate applied is 1.5 per cent. The stream of pensions for each age of retirement was calculated on the basis of the accumulated contributions and the transformation coefficients (which take account of the expected age of death). The implicit tax of working an extra year is the change in the pension wealth as a share of the estimated earnings from working an additional year. A positive value indicates a decline in pension wealth. In the Dini system people can only retire at 57 or after and there is no actuarial adjustment on pension rights after the age of 65 leading to a sharp rise in the implicit tax at this age.
Source: OECD.

system discriminates *ceteris paribus* in favour of earlier retirement, since pension wealth declines the longer the individual remains employed.

Table 29 presents this information for the pre-Amato, Amato and Dini systems for each of the three arrangements standing alone and fully introduced. (The Prodi reforms are not separately assessed as they did not modify the way in which pension benefits were calculated.) While results will differ depending on the household type, earnings profile and growth rates of productivity and GDP,[49] they show that replacement rates were significantly reduced for all ages by the Amato

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reform and for all ages retiring before 62 by the Dini reform. Moreover, because benefits are actuarially adjusted under the Dini reform, the benefits increase more rapidly with each year of active employment under the Dini system than under both the previous regimes. There is a particularly large difference in benefits for individuals retiring below 60 years of age. Lower replacement rates should encourage individuals to delay retirement.

There were very strong incentives to retire early under the pre-reform system, as is demonstrated in the pension accrual and tax rates. These simulations suggest that, under the pre-Amato reforms, there was a reduction in pension wealth from working an additional year equivalent to a 50 to 90 per cent tax rate on an additional year's earnings. These rates, combined with the high average benefit, at least partly explain the current patterns of early retirement. Following the Dini reforms, the implicit tax on earnings for an additional year of work has been reduced significantly up to the age of 65, at which point it rises sharply because there is no further actuarial adjustment for those retiring after that age.[50] For ages 57 to 65, the fully phased-in Dini system has been constructed, in principle, so as to be neutral with respect to the retirement decision. However, the actual outcome will depend on whether the transformation coefficients adequately take into account expected lifetimes and other factors (such as the probability that there is a survivor and his or her life expectancy).[51] Even if these have been correctly allowed for, estimates of neutrality will depend on the calculation method and the rate of time discount assumed (see Annex IV). The estimated degree of neutrality will also differ across household types because only one set of transformation coefficients is applied to all cases. Estimates by the Italian Treasury across a range of household types, suggest that the current transformation coefficients produce a system that is broadly neutral. On the basis of a slightly different calculation method than that used by the Treasury, Table 29 considers two different individual types: a single man who will live until 80 (the average life expectancy at 60 in Italy), and a married person who will live until 80 (the average life expectancy at 60 in Italy) whose wife will outlive him by four years (difference in average life expectancy of men and women at 60). For both these household types, the neutrality of the system is approximately confirmed by the results, although the incentive to early retirement is slightly positive.[52]

Nonetheless, pressures towards early retirement will remain strong at least until around 2015, as those with work histories of more than eighteen years in 1996 will be covered under the modified pre-reform system. In addition, access to seniority pensions before 57 (although reduced) will remain up to 2008. The system will, thus, continue to encourage early retirement, although the incentive will decline significantly when the new system is fully phased in. Lower replacement rates for early retirees should also induce later retirement. After 2015, there will be a significant improvement (Table 30). For individuals retiring around 2020 and 2030 (who will have benefits calculated under the "pro-rata" system) the accrual

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Table 30. **Retirement benefits and incentives: pro-rata system**[1, 2]

Year of retirement	Last year year of work	Years working	Replacement rates		Accrual rate		Implicit tax	
			Case 1	Case 2	Case 1	Case 2	Case 1	Case 2
56	55	34	56	51				
57	56	35	57	53	–0.019	–0.013	0.201	0.122
58	57	36	60	55	–0.022	–0.015	0.223	0.140
59	58	37	62	58	–0.025	–0.017	0.240	0.152
60	59	38	64	61	–0.028	–0.019	0.256	0.163
61	60	39	67	64	–0.032	–0.022	0.280	0.184
62	61	40	70	68	–0.047	–0.028	0.397	0.220
63	62	41	73	71	–0.052	–0.032	0.411	0.241
64	63	42	75	75	–0.058	–0.035	0.422	0.257
65	64	43	78	79	–0.054	–0.046	0.365	0.315
66	65	44	80	81				

Note: See Table 29 for explanation.
1. Case 1: individual begins working at 22 and, in 1995, has fifteen years of contributions. Case 2: five years of contributions in 1995. The individual will thus reach 62 at 2020 in case 1 and 2030 in case 2.
2. The accrual rates and implicit tax are for an individual who dies at 80 (no survivor's pension considered).

Source: OECD.

rates and the implicit tax rates for an additional year of work are not far off those under the full Dini system.

There is a growing consensus that, with continuing downward pressure on participation rates among older workers for some time to come, measures are needed to bring about an immediate increase in the average effective retirement age. With significantly lower average benefits (particularly before 60) and weaker incentives to retire earlier under the pro-rata and full Dini arrangements, individuals should be encouraged to work longer. Nonetheless, retirement between 60 to 65 may remain an attractive option for individuals who have begun working in their early 20s. A person with 40 years of contributions in his or her early 60s will receive a replacement rate of around 70 per cent (a rate at which many took pre-retirement under the previous arrangements). With continuing downward pressure on participation rates among older workers likely up to 2015, the accelerated phase-out of seniority pensions would be an important first measure but may need to be supplemented by increasing the minimum age at which retirement can be taken. Indeed, as is shown below, increasing the effective average retirement age to 65 would do much to keep the ratio of retirees to employed people at around today's level, given the population projections set out above.

Remaining problems after the phase-in of the Dini reforms

There remain four aspects of the post-Dini system, which may need to be reconsidered before the system is fully phased in. First, although the coefficients as they currently stand are broadly neutral on a pre-tax basis for retirement below

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65, the implicit tax rises sharply for retirement after 65, reflecting the absence of further actuarial adjustments. Later retirement would be encouraged by extending the actuarially-adjusted transformation coefficients beyond 65. However, as this would involve a one-off increase in the pensions of those who would work beyond 65 in any case, the immediate impact would be to increase pension spending (without any compensating increase in contributions) while the benefits of a positive labour-market response would be delayed. Decisions as to the timing of the introduction of such a change would need to take these considerations into account.

Second, as explained in Box 9 and Annex IV, the contributions are capitalised between the year they are earned and the moment retirement takes place, using a five-year moving average of nominal GDP growth. This allows for some automatic correction of the pension system when an economic shock occurs. For example, a slowdown in the growth (or decline) in the working age population, leading, in turn, to slower growth in GDP, will be reflected in lower benefit levels on retirement. These effects will only appear with a long lag and the reduction of pension spending is unlikely to be synchronised with the economic shock itself. Somewhat in contrast, the transformation coefficients used to calculate the pension benefit are constructed assuming a constant growth of real GDP of 1.5 per cent over the remainder of the pensioner's lifetime.[53] The responsiveness of the system to economic circumstances would be enhanced if the transformation coefficients took into account expected developments in potential output, particularly over the next few decades when rapid ageing will occur. Over this period there will be a sharp fall in the working-age population and GDP growth, other things held equal, could decelerate.

There is concern that the existing system may not be politically sustainable if real wages rise, and there is a growing real income gap between older pensioners and younger pensioners and wage earners more generally.[54] This may lead to political pressure for *ad hoc* real increases in pension benefits over time. This pressure could potentially be reduced if the pension system had lower replacement rates at the time of retirement followed by a predetermined rate of increase in real pension benefits during retirement.[55] Such modifications would need to ensure, however, that the lower real benefits in the earlier years of retirement are just balanced by higher real benefits later on, such that the existing link between an individual's "contributions" and his or her pension wealth is maintained. Such a reduction in the replacement rate at the time of retirement would also have the benefit of encouraging later retirement, but it could be difficult to introduce.

Finally, while the transformation coefficients are to be revised every decade to take into account, in particular, increases in life expectancy, the law embodies only the transformation coefficients and not the rules to be followed

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(*e.g.* the formula for calculation). These principles for adjustment need to be made more explicit to avoid political and discretionary risks. In particular, they need to ensure that the system remains neutral as regards the retirement decision and is fiscally sustainable.

Obstacles to supplementary pension provision

Italian private pension arrangements

Private pension funds were explicitly recognised and regulations governing them introduced by reforms in April 1993. However, private pension provision in Italy has not shown a significant expansion, possibly reflecting the high degree of coverage provided by the compulsory public pension system and the existence of a severance payment system (*Trattamento di fine rapporto*, TFR) which provides a lump sum to individuals on leaving their employer. Given the high level of overall retirement resources in these two arrangements, the tax advantages attached to the TFR (and the tax disadvantages of pension funds), the limited scope for transferring the TFR to the pension funds and employer resistance to change, it is perhaps not surprising that private pension arrangements have not taken off. A more favourable tax treatment of pension funds, including the end to double taxation of pension fund income, was only introduced in May 1999[56] and was to be implemented over the subsequent nine months. While there is a widespread consensus that reform of the current severance pay system is needed, uncertainty remains about government policies regarding the extent of the shift in TFR to the pension fund system and the degree of competition between the different classes of funds. This section presents the system and discusses possible reform options.

Two types of pension funds are allowed in Italy[57] and both are almost exclusively of a defined-contribution nature. "Closed" funds are independent legal entities having their own assets and organisation, set up usually on the basis of agreements between the two sides of industry, although they can also be organised at the unilateral initiative of either employers or workers. They are "closed" because they are restricted to particular companies, groups, categories, geographical areas, etc.[58] "Open" funds are set up at the initiative of banks, investment firms, asset management companies and insurance companies. Unlike closed funds, they are open to anybody, regardless of the category or company to which he or she belongs. Nonetheless, employees can sign up with an open fund only where a closed fund for which they would qualify does not exist or is not yet operational,[59] thus limiting competition between funds and placing open funds at a disadvantage. Partly for this reason, and a minimum stay period of five years, open funds have shown little development, with only 20 000 members at the end of 1999. Funds are almost entirely of a defined contribution nature, paying out the cumulated amounts in individual accounts at the official retirement age. Pension

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fund income is taxed at a rate of 11 per cent as it is accrued. The remaining tax-sheltered income is taxed as it is withdrawn at marginal rates of income tax. On retirement, the individual is required to take at least half of the accumulated savings in the form of an annuity.

In January 2000, reforms to tax arrangements for retirement savings were introduced, with effect from 2001. These allow tax-exempt contributions of employees and the self employed to "open" or "closed" pension funds or to life insurance schemes up to 12 per cent of earnings (and an annual ceiling of 10 million lire). In the case of employees, the tax break is conditional on roughly half their contribution coming from the employees' TFR contributions.[60] In addition since 1993, individuals just entering employment for the first time can choose to allocate the full TFR to the pension funds (these sums are also tax exempt).

By the end of 1999, there were only four fully operational private closed pension funds. Nineteen have been authorised by the regulatory body (covering 430 000 workers) and a number of others are in the pipeline. Several factors have slowed the use of the new arrangements. First, there has been some administrative inertia. Rules governing the application of the 1993 law were only promulgated in 1995. The regulatory agency – the *Commissione di vigilanza sui fondi pensioni* (*Covip*) – has had its powers progressively extended and is currently putting in place the necessary regulatory framework for the new funds to operate. Second, the negotiation of closed pension funds has been slow because of employer and, possibly, employee resistance. Employer contributions are over and above wages and negotiations for setting up funds are independent of wage negotiations. The transfer from the TFR means the loss of a cheap form of finance. There is also a loss of liquidity for households. While the TFR is a lump sum on retirements, which individuals can dispose of as they wish, at least half of the pension fund assets must be taken as an annuity – which is costly and not entirely risk free. Finally, there are only limited tax advantages as the income earned by the funds pay tax of 11 per cent. As membership in the funds is voluntary, current pension-fund arrangements may not be attractive. The enrolment rates of the existing four funds is only 29 per cent and lowest among younger workers, which is of concern as state pensions will be considerably below their current level (for equivalent retirement age) when they take retirement.

Building a second tier

As it stands, the present framework does not encourage a rapid expansion of second pillar arrangements. Much of the recent debate has concerned whether the existing severance payment system *(TFR)* could be used for this purpose. This system, which has existed in its present form since 1966 (but was introduced long before), consists of a form of forced saving equal to 7.4 per cent of salary held by the firm to be taken as a lump sum on departure.[61] These funds were taxed favourably when they were withdrawn although this has now been removed under legis-

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lation introduced in January 2000. With a relatively under-developed capital market, the arrangement has been a particularly important source of funds for small and medium-sized firms; they reduce their corporate tax and generally pay less than market interest to the employee (1.5 per cent plus three-quarters of the rate of inflation). In periods of inflation above 6 per cent this meant a decline in the real value of the employees' savings and a real transfer of resources to the enterprise sector. The amount set aside each year for severance pay is substantial: in the year 2000 it is estimated that it will be of the order of 24 trillion lire (1.1 per cent of GDP) in the private sector. A similar system is being introduced in the public sector, replacing an existing leaving allowance.

For long-serving workers, the TFR system provided an additional sum to finance retirement but it also provided an important form of liquidity for individuals during unemployment and could be drawn upon for purchase of a principal residence or to pay for important health care costs. Thus, the total sums available for retirement purposes could differ between individuals. In laying down a framework for supplementary pension provision, the 1993 reforms allowed the transfer of severance pay to pension funds. However, concern over the impact on enterprise liquidity has meant that the existing stock of TFR has remained completely untouched: up to now, only individuals just entering the labour market have the right to transfer all of the TFR into a pension fund. Recently the Government has proposed a bill to give the employee the opportunity of transferring the entire value of future TFR flows to the pension funds. According to this bill, this will occur automatically unless he chooses to retain the current TFR regime.[62]

A number of adjustments to the current system are likely to be needed if the second pillar is to be expanded on a voluntary basis:

- The current arrangements favour closed schemes. This can have certain advantages if administrative and selling costs are kept low. However, it constrains competition between funds and thus does not provide adequate incentives to governing boards to maximise fund income. Open competition – and, thus, the right of individuals to shift assets to other closed or to open funds – should be allowed, as long as the individual accepts the transaction costs associated with such shifts.

- The savings could be made more liquid. The TFR allowed for withdrawal of savings for purchase of primary residence and for large medical expenses. While current regulations do not exclude these possibilities, closed funds may benefit from a more open policy in this regard and allow individuals greater flexibility in the path of their savings over their lifetime. Further, the requirement to take half the accumulated funds in the form of an annuity could be replaced by rules

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limiting the amount of accumulated funds that can be drawn down in any one year after retirement (*e.g.* Iceland).

- The limits on the amount of the TFR which workers can place in pension funds would also need to be lifted, there being little justification to imposing this type of forced lending. As noted, a bill to this effect is under discussion.
- On the other hand, further fiscal incentives are likely to be inappropriate. In practice, extensive tax sheltering of pension savings probably leads to the substitution between forms of savings rather than increases in the overall rate of saving.

The appropriate direction for government policy for the second tier would be clarified if there were a clearer linkage between first and second tier arrangements. Initially, the promotion of the second tier reflected the desire to compensate for the reduced generosity under the Dini system. To the extent that this concern persists, the second tier arrangements could be made mandatory, ensuring that the current TFR funds are used for this purpose. There should then be scope for further reductions in the generosity of the public pension schemes as second tier funds reach maturity.[63]

Trends in pension spending and system imbalances

Current trends and long-term projections

Pension expenditure (including welfare pensions) increased from 11.1 per cent of GDP in 1980 to just under 15 per cent in 1995.[64] Following the freeze on pensions in 1995, the pension/GDP ratio resumed its rise up to 1998, reaching 15.3 per cent of GDP. Over this latter period, the largest share of the increase in pension spending appears to have arisen from increases in the average value of pensions. The average increase in the number of pensions[65] was less than 1 per cent per year despite the fact that there are clear incentives for individuals under the pre-Amato rules to take seniority pensions while this option is available (Figure 26).

The Treasury projections use a slightly different definition of pension spending, which amounted to 14.2 per cent of GDP in 1998. Taking 1998 as a starting point, Treasury projections,[66] based on ISTAT population projections, point to an increase of 1½ percentage points in the pension/GDP ratio over the next thirty years (Figure 27). This would take the overall state pension ratio to a peak of 15.8 per cent, excluding welfare pensions, in 2031. Thereafter, the share will fall to about 1998 levels by 2050, as pensions based on the Dini reforms make up an increasing share of total pension spending.[67]

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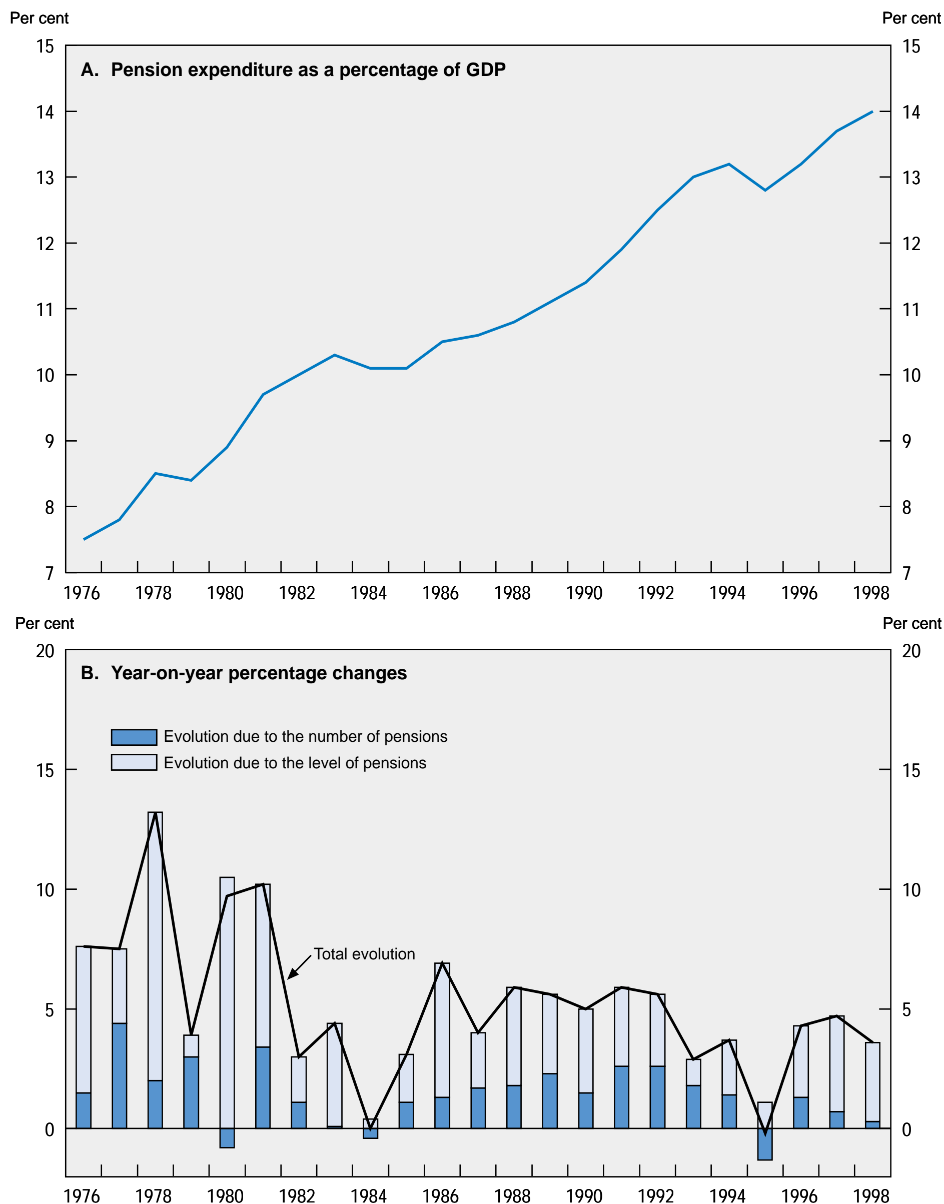
Figure 26. **Evolution of pension expenditure**
1997 prices



Source: ISTAT (1998), *I trattamenti pensionistici.*

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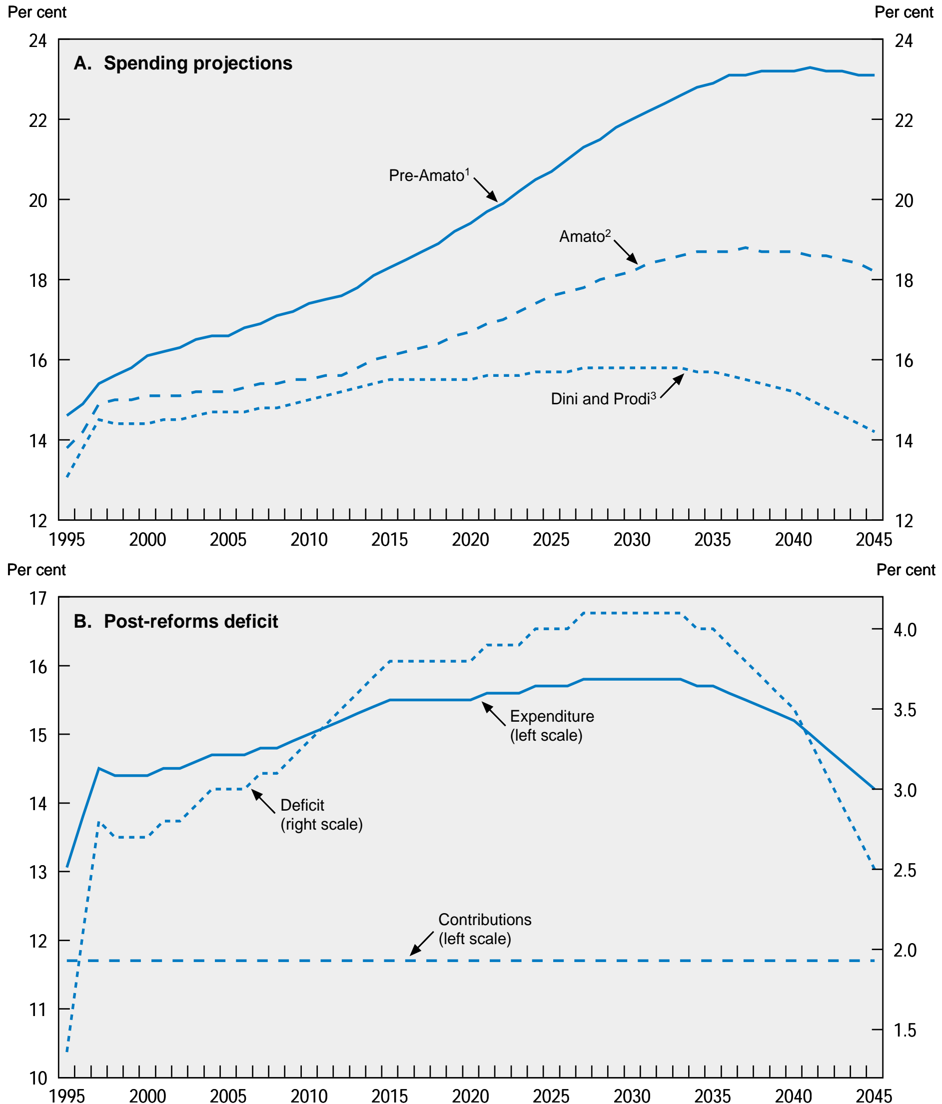
Figure 27. **Treasury pension spending projections pre- and post-reforms**

As a percentage of GDP



1. Peak in 2040: 23.3 per cent.
2. Peak in 2037: 18.8 per cent, except for indexation.
3. Peak in 2032: 15.8 per cent. After three steps reform of 1992-1995-1997.

Source: OECD.

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The impact of reforms on expected pension spending

In judging the current situation, the importance of the past reforms needs to be recognised. Available studies point to a significant improvement in the underlying situation. Treasury forecasts suggest that the increase in pension spending in the absence of reforms would have reached as much as 25 per cent of GDP around 2030. The increase in taxes necessary to balance the generational accounts on the basis of the pre-Amato system would have been 160 per cent rather than the current 5 per cent.[68] Even though cross country comparisons of generational accounts are hazardous because small changes in assumptions can lead to large differences, Italy now looks more favourable than a number of other EU countries. Improvements needed to bring the system closer into balance may thus be smaller relative to those already undertaken. However, because they will need to address the hump in expenditure over the next few decades, additional reforms will be all the more difficult to introduce because they will affect the pension wealth of those now approaching retirement.

Care for the elderly

Care for the elderly needs to be seen within the context of overall social policy. As noted above, total social expenditure in Italy as a share of GDP is roughly 2 percentage points more than for the average of the OECD countries but less than for the other European Union countries (Table 31).[69] Within this, transfers largely destined for working-age households tend to be small. At the same time, spending on health care (a large portion of which goes to the elderly) is one of the lowest in the OECD area and care for the frail elderly is very small indeed (although this component may not be measured very accurately).[70] With social spending dominated by age-related transfers, social policy appears to give excessive weight to income support for all of the elderly, while the problems of care for the elderly – and particularly the frail elderly – may have received inadequate attention. Indeed there appear to be significant problems of service provision to this group. With an important increase in the number of the very old expected over the coming decades, policies in this area will need to evolve.[71] However, with the overall budget situation constraining the scope for increased spending in general, reforms to social policy – including care for the frail elderly – depend, in part, on limiting the growth of expenditure on age-related pensions. In this context, Parliament has asked for a review of social policies but has also imposed a ceiling equal to current overall social spending as a share of GDP.

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Table 31. **Social spending, Italy and the OECD**

Per cent of GDP, 1995

	Canada	France	Germany	**Italy**	Japan	United Kingdom	United States	OECD[1]	European Union
Social expenditure	18.24	30.07	28.01	**23.71**	13.80	22.52	15.76	21.95	26.64
Old-age cash benefits	4.34	10.36	10.29	**10.99**	5.49	6.46	5.36	6.50	8.08
Disability cash benefits	0.55	1.07	1.09	**1.37**	0.31	2.64	0.89	1.55	1.99
Sickness benefits	0.06	0.54	0.49	**0.15**	0.06	0.19	0.24	0.81	0.98
Services for the elderly and disabled	..	0.78	0.58	**0.20**	0.27	0.68	0.05	0.81	0.93
Survivors	0.49	1.86	0.57	**2.59**	0.77	0.82	0.96	1.08	1.55
Family cash benefits	0.80	2.23	1.23	**0.43**	0.20	1.87	0.33	1.41	1.64
Family services	..	0.37	0.78	**0.10**	0.22	0.48	0.31	0.48	0.63
Active labour-market programmes	0.57	1.31	1.36	**1.13**	0.13	0.45	0.20	0.84	1.18
Unemployment	1.30	1.79	2.37	**0.87**	0.39	0.89	0.35	0.15	2.20
Health	6.58	7.98	8.13	**5.38**	5.57	5.73	6.33	5.72	6.15
Housing benefits	..	0.92	0.15	**0.00**	..	1.85	..	0.31	0.47
Other contingencies	3.09	0.49	0.63	**..**	0.18	0.27	0.63	0.59	0.54
Pension as a per cent of social expenditure	**29.51**	**44.23**	**42.67**	**63.08**	**47.61**	**44.06**	**45.77**	**41.59**	**43.62**

1. Excluding Korea, Mexico and Turkey.

Source: OECD Socx Data base, 1998.

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Current institutional arrangements

Italy has a national health care system, organised on a regional basis, providing both primary and hospital care.[72] Within each region, health care services are organised by Local Health Agencies (*Aziende sanitarie locali*, ASL), which either provide services directly or under contract with accredited institutions. Primary health care for the elderly is provided by general practitioners under contract with the ASL, in their surgeries or at home with specialist treatment largely found in the hospital sector. The contractual relations for primary care doctors are on a capitation basis. Hospital care is mainly provided by public hospitals or private hospitals under contract. Different forms of contract exist between the ASLs on the one hand and public and private hospitals on the other.

Public health care services appear adequate in terms of the total numbers of beds and doctors per capita. While the data suggest that these services are reasonably well distributed across the country, there are areas, particularly in the South, which may be less well-endowed (Table 32). Public spending and service provision for care of the frail elderly is widely considered to be low. In the past, these services have been primarily provided informally within the family. Some estimates suggest that the enlarged family network provides 75 to 80 per cent of care for the elderly. Survey data indicates that almost 80 per cent of the caregivers are women, often cohabiting with the elderly person.

Until recently, residential accommodation for the elderly was provided by a few municipalities, but it was aimed at the poor rather than individuals no longer

Table 32. **Supply of health care facilities: the OECD and Italy**

1996

	In-patient care beds per 1 000 population (public and private)	Acute-care beds per 1 000 population (public and private)	Private hospital beds as a per cent of total bed stock	General practitioners 10 000 population	Nurses per 1 000 population
OECD	7.1	4.3	31.6	8	7.3
OECD Europe	7.3	4.4	20.5	8	7.7
Italy	6.5	5.5	21.9	9	4.9
North-west	5.6	5.0		8.41	
North-east	5.8	5.3		8.11	
North	5.7	5.1		8.29	
Centre	6.2	5.2		8.97	
South (excluding islands)	5.2	4.7		7.90	
Islands	4.8	4.5		7.80	
South	5.1	4.6		7.87	

Source: OECD, *Health Data;* ISTAT.

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capable of living on their own. While precise information is scarce, current retirement home arrangements might provide for 2 to 3 per cent of the total population but at least some of these are poor, rather than in need of special care. Further, while the share of the frail elderly in these institutions has been increasing, they are not necessarily adapted to individuals requiring high levels of care. Some municipalities provide social services including economic assistance allowances and social and home help services. Day care centres for the elderly – providing a range of special services and entertainment – are appearing but are limited to larger urban areas and mainly service individuals who are able to care for themselves. A large part of long-term or chronic care has therefore fallen onto the hospital system. This is often an inappropriate solution: acute care hospitals are designed for cure rather than prevention and rehabilitation (which is often what the elderly require) and they tend to be more expensive compared to more cost-effective and flexible solutions, such as home care and residential care. In addition, the elderly block beds that could be used for regular hospital services. With overall health spending seriously constrained since 1992, hospitals are becoming progressively more reluctant to accept older patients in long-term care as hospital funding mechanisms have been increasingly set to encourage shorter stays.[73] To facilitate a more appropriate pattern of care for the elderly, funds for community and home care have been increased and some investment in residential accommodation has been undertaken. Both policies aim to improve the system of residential care (*Residenze sanitarie assistenziali*) and reduce inappropriate acute hospital care.

The current underlying demand for various kinds of care that could substitute for direct services from the family is probably already substantial. A 1994 survey by ISTAT of the non-institutionalised population[74] indicated that around 21 per cent of the elderly were disabled in at least one Activity of Daily Living (ADL) classification,[75] 4 to 5 per cent were confined to their homes and 2 per cent were confined to their beds. While information from other countries suggests that the extent of disability among the elderly has been falling somewhat, the large future increase in the number of the elderly suggests that the demand for care for the frail elderly will increase. This will occur just as the capacity of the traditional family network to care for the elderly declines. The very sharp fall in fertility is reducing family size and, thus, the future capacity for families to care for parents. Further, as the labour force participation of women grows (as seems likely on the basis of younger cohorts), the time available for care will be more limited. Evidence shows that increasing female employment leads to considerable strain on the care-givers where it does take place,[76] limiting the scope for full integration of women in the labour market[77] and, thus, reducing their ability to build up pension rights.[78] Privately supplied care services have increased in some areas. However, their high cost probably limits the ability of the immediate family to finance them in most cases. Thus, there will be growing political pressure for these services to be provided by the public sector.

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Recent policy initiatives

Policy makers have been conscious of the gap between needs and services and the costs of chronic care in an acute-care environment. There have been a number of policy initiatives. In 1992, the government introduced a *Plan for the protection and health of the elderly*. This proposed:

- setting up Geriatric Assessment Units, aimed at co-ordinating care for the elderly on an interdisciplinary basis;
- the development of integrated home care services, comprising health, nursing, rehabilitation and social care provided to individuals who were not self-sufficient. Policies also allowed experimentation with "home hospitalisation", where low intensity care would be provided in the home. Integrated home-care services were intended to reach 2 per cent of the population;
- the promotion of health care residences providing a mix of social and health care for the non-self-sufficient elderly.

More recently, policies have refocused attention on better integrating the elderly into society with the family continuing to play a key role. Within this approach, public provision is seen as a back-up where such services cannot be provided within the family unit. A new National Plan for the Elderly is currently under preparation and will be issued shortly.

The 1999-2000 National Health Plan recognises the need for elderly-friendly policies aimed at finding the best balance between needs and costs within a broad range of institutional alternatives, ranging from home help to intensive nursing care. The National Health Plan thus includes a proposal for allocating 3 per cent of the 1998-2000 health budget for special programmes, including, for example, home care. These resources would be allocated from the National Health Fund to the Regions, which then utilise the resources for special programmes. So far only18 per cent of the planned funds (150 billion lire) have been allocated to home care and hospice services. These facilities have been introduced slowly, possibly reflecting budgetary constraints, but also the weak regional policy response. More generally, the overall effectiveness of the new policies has also been hampered by a lack of integration between the health care system and care for the elderly more generally. As it stands, few Geriatric Assessment Units have been set up. While 140 000 new beds were proposed in the health care residence programme, only 17 per cent of the new beds had been authorised by 1998. Integrated home care is found in only a few municipalities and is estimated to reach less than 0.3 per cent of the above-65 population. While some regions in the North and in the Centre are responding to the increased state budgetary allocations, overall supply remains very unequally distributed across the country.

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As it stands, the elderly already absorb a large share of health care budgets and they are likely to put further upward pressure on costs in the future. Estimates by the Italian Treasury suggest that the shift in the population structure taken alone could lead to a rise in the cost of health care of 1 per cent of GDP over the next 50 years; OECD calculations (although not based on the same macroeconomic assumptions) suggest an increase of between 1½ and 2½ percentage points[79] between now and 2030. Neither of these estimates take into account the increased costs of care associated with technological change which is likely to be the dominant factor in explaining cost increases in the future as it has in the past[80] or the offsetting effects of longer periods of disability-free lives.[81]

As regards care for the frail elderly, continued reliance on the family as a first level provider of care is desirable for financial reasons and family members are probably best placed to organise and oversee support of parents in their own homes – with back-up support services in an ambulatory environment where necessary – in the case of light handicaps. Nonetheless, as noted, families are becoming less able to take on the role of direct provision of care and increasing state supply may well be needed as well as a different structure of services aimed at prevention and rehabilitation of the elderly. It is difficult to judge the importance that this might take in the Italian context. In Europe, OECD social expenditure data suggest that spending averages around 1 per cent of GDP with much higher rates in the Nordic countries. However, the basket of goods included in this category and the form of provision can differ considerably between countries. If Italy spent the same on the elderly on a per capita basis as a group of non-Nordic European countries,[82] such spending would be in the area of ¾ per cent of GDP but would be higher than this if spending per head were at Nordic rates. If the population structure were the same now as it will be in 2050, spending could amount to around 2 per cent of GDP.

In the short run, an increase in supply of long-term care is needed to improve the allocation of resources in the hospital sector and this may reduce overall health care costs. But if significant rises in long-term care costs are to be avoided – as families attempt to shift the burden of care – the government will need to ensure that the appropriate incentives are in place:

- On the supply side, it will need to ensure that the level and structure of service provided is in relation to needs and that care is offered in cases where it is appropriate. A broader range of services to the elderly may need to be considered; the presence of the Geriatric Assessment Units needs to be extended and their role strengthened; criteria will need to be established to judge the required level of care; and, family support needs to be encouraged as long as possible.
- Where services can lead to reductions in longer-term costs (*e.g.* prevention), there may be call for state subsidisation. However,

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long-term or residential care services will need to be priced, through income and wealth testing. Budgetary constraints and the capacity to increase supply of care for the elderly would be eased – and the demand for these services limited – if the elderly (who have the necessary financial resources) bear as much of the cost of these services as possible.

The economic situation of the elderly in Italy

Estimates of the cost of the pension system and long-term care need to take into account the relative financial position of the elderly. Scattered data suggest the retirement-age population has incomes in the range of 90 to 100 per cent of average incomes (Table 33). These data suggest that current retirees are in a relatively satisfactory situation – particularly if the positive value of leisure is considered – and this may be particularly the case for those on a seniority pension.[83] Moreover, households whose head is 65 or older save a higher proportion of their income than households with a head under 50 and savings rates decline only marginally at higher ages. Although information on wealth and its distribution is scarce, high aggregate savings rates suggest that many households will have built up assets prior to retirement: around 60 (80) per cent of single (two adult) households with a head aged 67 have housing wealth and the shares of individuals with housing wealth in the bottom two quintiles are only marginally lower.[84] A large share of households (around 90 per cent) also has financial wealth although the distribution of this is highly skewed towards the top quintile. This suggests that, on average, pensioners may have enough retirement income to finance part of their long-term care expenses and may be able to support a slight downward adjustment in their pensions. However, these results will overstate average benefits of individuals who will retire under the Dini system.

The scope for such adjustments will depend on the situation among the elderly belonging to the bottom quintiles of the income distribution. Rates of poverty (defined in terms of a poverty threshold of 50 per cent of median disposable income adjusted for household size) were around 15 to 16 per cent in 1993, roughly in line with the average for the entire population (Table 32), but high compared to most European countries. OECD research suggests, on the basis of data for 1993, that a large proportion of retirement-age households appears bunched around the poverty threshold: a shift in the poverty threshold from 50 to 60 per cent of median income increases the poverty rate from around 15 per cent to around 26 per cent.

The concentration around the poverty line at least partly reflects the fact that the current pension benefits are tightly linked to previous income and the degree of redistribution within the system at the level of benefits is small.[85] There are only limited ceilings on pension benefits and, while minimum pensions exist,

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Table 33. **The economic situation of the elderly**[1]

	Equivalent household income by household type				
	Households with at least one old-age person	Households with only old-age people	Household with at least one member receiving a pension	Households with no old-age person	Italy
Household equivalent disposable income (index)[2]	97.57	92.62	100.09	101.35	100
	All households	Households with no labour income but pension income	Household with old-age pensions	Households with seniority pensions	Households with social pensions
Equivalent disposable Income (index)[3]	100.0	83.86	102.93	129.81	76.81

	Household expenditure by household type			
	Households with at least one old-age person	Households with only old-age people	Household with no old-age person	Italy
Household expenditure per head (index)	84.16	94.78	104.53	100.0
Food	32.8	36.2	27.9	30.0

	Savings ratio by age								
	< 30	30-40	40-50	50-65	65-70	70-75	75-80	> 80	Total
Saving ratio[4]	16.9	16.7	21.7	26.9	28.1	25.5	26.2	26.8	23.4

	Poverty rates by household type			
	Households with at least one old-age person	Households with only old-age people	Households with no old-age person	Italy
Poverty rates	9.13	12.73	17.13	14.97

1. Data refer to 1995. OECD calculations from CER data, obtained from simulations of the Bank of Italy household survey data.
2. Adjusted for household size. From Pace and Pisani. "Le condizioni economiche degli anziani", *Raporto CER-SPI,* 1998.
3. Data from Baldacci and Tuzi, 1999. OECD calculations from ISTAT.
4. For households according to the age of the head. Based on cross-section data provided by Banca d'Italia.

Source: See footnotes.

they are low relative to average incomes. Minimum pension are in the range of 20 to 25 per cent of Average Production Worker income.[86] In reviewing options, careful attention will have to be paid to the situation of the least well-off.

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Ageing, labour supply and economic growth

Calculations of the budgetary cost of age-related spending need to take into account the implications of an ageing population for economic growth, which, in the absence of marked changes in labour-market participation or productivity can be expected to decelerate, particularly over the period from 2000 to 2030. But with low female participation rates, high unemployment and a pattern of early retirement, Italy has considerable scope for increasing growth as and when labour-market conditions are favourable. The potential size is suggested by the following three hypothetical examples:[87]

- A decline in unemployment from current levels to those in the 1960s, could lead to an increase in GDP over the period from now to, say 2030, at a rate of 0.2 per cent.
- Alternatively, if labour market participation of prime-age women rose to close to those of men (10 percentage points less), GDP growth could increase by 0.5 per cent.
- Finally, if the effective retirement age were delayed to 65 for all individuals (rather than the current effective retirement age of around 60) – *i.e.* if participation rates for prime age individuals were broadly maintained for the age group 55 to 64, GDP growth would also increase by 0.5 per cent.

Combining all three, GDP growth could increase in the range of 1 per cent if labour-market conditions were favourable, or a little more than half of this if the adjustments were spread out until 2050. The change in the retirement age would also have an additional impact on the ratio of the retired to the total number of employed. If the effective retirement age were delayed to 65, the ratio of the retired to the number of employed – and hence the number of contributors available to finance the system – would remain broadly constant.[88] While translating these simulations on expected spending patterns is difficult, it would seem likely that a combination of more rapid economic growth, and changes in pension rules aimed at significant increases in the retirement age, could eliminate the hump in pension expenditure as a share of GDP, and might also provide the necessary space for improving other aspects of policy for the elderly. However, while these calculations indicate the scope for more rapid growth if labour could be mobilised, achieving such outcomes will require structural changes to both factor and product markets (see Chapter IV).

In judging the impact of demographic trends on growth, it is important to recognise that there are likely to be strong shifts in the composition of domestic demand. There may be a fall in the need for new housing as the population declines. However, the extent of this may well depend on the extent of migration from the South to the North of the country. On the other hand, forthcoming

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changes in pension regulations and the related lower retirement benefits may contribute to higher household and aggregate savings.[89] This is likely to have an impact on investment patterns, although less so than in the past as interest rates are set on a European basis and capital markets are becoming more integrated. The share of consumption expenditure in total output is also likely to increase and there may be a shift in patterns of consumption away from goods towards services, particularly in the North of the country, where the falls in fertility have been sharpest. This implies the need for important shifts in the structure of supply and for flexible product and labour markets if this is to occur smoothly.

As regards labour productivity, there will be a significant ageing of the labour force and, given the sharper fall in fertility in Italy than in other OECD countries, this shift in average age may be more marked than elsewhere. While this does not necessarily have implications for productivity, the shift in average age – combined with changes in the structure of demand and supply – suggests that somewhat more attention may need to be paid in Italy to the training of older workers if skills and employability are to be kept as high as possible.[90]

Conclusions and policy recommendations

The series of reforms carried out in the course of the 1990s has gone a considerable way towards correcting the perverse incentive and financial effects of Italy's pension arrangements. Average benefits have been reduced; the stream of benefits are to be brought more closely in line with individuals' contributions (thus reducing the incentives to retire early); and access to seniority pensions is being tightened up. Once the transition period is over, the new system implies a major improvement in incentives affecting the timing of retirement. However, the phase-in of the reforms is rather slow and the authorities may need to consider policies to reduce the hump in spending over the next three decades. This section draws the main implications for policy, which are summarised in Box 10, following the framework of *Maintaining Prosperity in an Ageing Society*.

Under the "18-year" rule, between 40 and 45 per cent of the employed will continue to benefit from the modified pre-Amato system, so that incentives to retire early will continue to be strong for some time. They will weaken after 2008 when the phase-in of the tighter rules for seniority pensions will be completed and again in 2015 when those under the pre-Amato system will have taken retirement. Nonetheless there will remain some loss of pension wealth for each year of work beyond the minimum retirement age of 57, so that the system will still favour earlier retirement until all individuals retire under the Dini system. The effective age of retirement is, thus, likely to remain low and the burden of the pension system high. Treasury projections suggest that total pension spending will continue to increase up to 2030, by around 1½ percentage point of GDP, peaking at just under

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Box 10. Maintaining prosperity in an ageing society: recommendations for Italy

Easing the fiscal burden during the transition period

While there has been extensive reform to the state pension system, expenditure on pensions is expected to increase over the transition period. At the same time, there will be growing pressure on services for the elderly which may be reflected in increased government spending. The authorities need to:

- Move all individuals covered by the "18-year" rule into the pro-rata system for the calculation of benefits.
- In calculating the transformation coefficients, ensure that they allow for expected developments in potential output as the growth rates of the working age population decelerate.
- Raise the age at which retirement can be taken to an age well over 60.

Removing disincentives to later retirement in the public system

Despite reforms, the method of calculating pension benefits will still encourage earlier retirement during the transition period. The government should:

- Ensure that rules for calculating transformation coefficients are explicit and that they allow, in particular, for changes in expected lifetimes.
- As the transition period progresses, consider the extension of the transformation coefficients to allow actuarial adjustment of pensions for those retiring after 65.

Diversifying retirement income by encouraging private arrangements

Income of the elderly is dominated by state pensions and second pillar pension arrangements have only recently been introduced:

- Second-pillar savings should be increased by channelling the current employee TFR savings into pension funds, possibly supplemented by additional employer and employee contributions.
- Pension funds should be mandatory but allow for greater flexibility in the use of these funds during working lives and in retirement.
- As second-pillar pension funds mature, a progressive reduction in the size of the state pension should be allowed.

Explicit policies should be developed for providing care to frail elderly people

Care has traditionally been carried out within the immediate family. Policies aimed at a more comprehensive approach to care for the elderly have been inadequately implemented in most parts of the country. Action is needed to correct this:

- While continued family surveillance is crucial, government policies need to adapt to an environment where smaller families and higher labour force participation of women will make care for the frail elderly within the family less and less prevalent.
- A broader range of services for the elderly may need to be provided, with greater emphasis on prevention to reduce the call on these services.

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Box 10. Maintaining prosperity in an ageing society: recommendations for Italy *(cont.)*

- To encourage better co-ordination of policies, the Geriatric Assessment Units need to become more widespread with the goal of finding the most cost-effective institutional arrangements for care.
- Where financial resources permit, these services need to be priced (*e.g.* via income and wealth tests) to minimise the overall budgetary costs.

Pension funds should have a modern and effective regulatory framework

The current regulatory environment for second-pillar arrangements has already been introduced; however, the accreditation of second-tier closed pension funds needs to be accelerated, and the rules should allow greater competition between closed funds and between closed and open funds.

Job opportunities should be improved for older workers

More attention may need to be paid to maintaining the human capital and skills of older workers as the labour force ages and the size of the labour force declines.

At the same time, continued labour-market participation should be encouraged by labour-market reforms to increase labour demand (see Chapter IV) and upgrade skills of older workers.

Creating a strategic policy framework

Policies for ageing included under the previous headings are poorly co-ordinated. A broader policy approach is needed, linking reforms to pensions and to care for the elderly to new social policies for the working-age population and to labour-market and product-market reforms.

16 per cent of GDP. Thereafter, pension spending will begin to decline once the Dini system is fully phased in.

In reviewing policies, the government needs to reconsider the transitional phase. To achieve a pension system which is more neutral as to the retirement decision, all workers should be shifted into the pro-rata system – *i.e.* setting pension benefits on the basis of the length of time workers have spent under each programme. This would mean that the actuarial adjustment inherent in the Dini reforms would start having an effect immediately, albeit in a modest way. However, this may need to be supplemented by an increase in the earliest age at which an individual can retire. The earlier this occurs, the bigger the impact on pension

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spending will be. Simulations with generational accounts suggest that an increase in the retirement age by three years would reduce the long-term budget imbalances by more than half. A combination of a higher retirement age and a shift to a "pro-rata" system would go a long way to reducing the hump in costs.

For retirement before 65, the Dini system, once fully operational, is broadly neutral with respect to the retirement decision on the basis of existing transformation coefficients. However, two aspects of the current approach to setting the transformation coefficients, which are revised every ten years, may need to be considered. First, the capacity of the pension system to adapt to changing economic conditions would be enhanced if the calculation of the transformation coefficients were to take into account expected developments in potential output – for example, the expected impact of the sharp slowing of the working age population projected over coming decades. Second, actuarial adjustments do not continue beyond the age of 65 and the implicit tax of working an additional year beyond 65 is consequently high. Extending the actuarial adjustment would involve a short-term budgetary cost as pension payments increased to those who would work beyond 65 anyway. But as the transition to a fully neutral system progresses, the authorities may wish to consider such an extension, taking account of the longer-term positive labour-market effects, in the form of higher participation rates and pension contributions.

These adjustments might be easier to introduce if they were accompanied by an increased role for private pension arrangements. One of the difficulties in reforming the current system is the heavy reliance on the public first pillar. With the prospect of lower replacement rates under the Dini reforms, measures to encourage a fully-funded second pillar were introduced. While they have yet to get underway in a substantive form, they are likely to become more important in coming years. There are two key issues: the method of finance and the linkages to the reforms of the public pension system. The private sector severance funds (TFR) are generally seen as the key element in building up these funds. However, they also have other uses: for individuals, to help bridge periods of unemployment and help finance major health costs or housing; and, for firms, cheap financing. If these funds are now to be entirely directed to financing retirement, arrangements may be necessary to serve the other objectives (*e.g.* better coverage for the unemployed, easier access to financing by firms). Currently, individuals will be restricted to joining the "closed" funds in the industry to which they belong. However, this places the current "open" funds at a disadvantage and reduces competition between the funds. It would seem preferable to ease these restrictions, as greater choice on the part of the individual will ensure that the governing boards aim at achieving the highest possible rate of return for their members.

One possible reason why the funds have not taken off more quickly is the limited fiscal incentives. This issue can probably best be judged within the wider

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context of the relative roles of – and interrelation between – the first and second pillars. There is no direct linkage between the two systems and there is no intention to reduce the public benefits further if the second tier were to expand. In this context, the government may wish consider making the second tier mandatory, while targeting an overall replacement rate – say 70 per cent of income before retirement (which is broadly in line with many OECD countries) – and winding back the public system as the second-tier funds mature. At maturity, such funds could undoubtedly achieve a replacement rate of at least 20 per cent with a contribution rate of around 10 per cent and probably much more if recent returns on private pension funds were to continue. In this case fiscal incentives would not be needed.

At the same time, there are likely to be demands for additional age-related spending arising from increased cost of health care and care for the frail elderly. While it is difficult to assess these increased costs, they could easily be in the range of 2 to 4 percentage points of GDP over the next 50 years. Government policies in the area of ageing will thus be under pressure to bring about an increase in the supply of care for the elderly and to better adapt it to the requirements of an ageing population. Care by the family is probably preferable for social and financial reasons. But this task will become increasingly difficult in coming years as average household size decreases. Since women generally provide these services, this limits their integration into the labour force and has longer-run effects on their incomes in retirement. However, the authorities will need to design such policies carefully to ensure that the costs are kept to a minimum. On the one hand, this will require generalisation of the Geriatric Evaluation Units to evaluate needs and the organisation of an appropriate and least-cost balance of services (home help/care, home nursing and geriatric care). On the other, policies should, where possible, introduce a "user pays" principle, with income and asset tests to prevent a large shift in the provision of the services from the family to the state. The income and assets of the elderly population appear to be substantial enough to permit the government to recoup a large part of the cost of these services.

The various strands of reform need to be addressed as a common package. In this context, the need to reduce the overall burden of the public sector and the tax wedge should also be addressed. This is important because the analysis points to the fact that higher rates of economic growth – which could become possible if Italy's low participation rate were raised – would go a long way to resolving remaining social spending problems. Thus, policies aimed at minimising the bulge in spending in the period up to around 2030 need also to be defined in terms of their potential positive labour market impact. A significant increase in the effective age of retirement would have a strong impact on pension spending and increase labour market supply, thus favouring growth.

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IV. Towards more balanced growth: progress in structural reform

Overview

In assessing medium term prospects, the previous *OECD Economic Survey of Italy* acknowledged the wide range of legislation and initiatives introduced over the last few years to liberalise product and factor markets. As noted in Chapter I, there are strong indications of labour markets having become less rigid, as atypical work contracts have grown in importance and labour has been used more flexibly. The rate of employment growth should continue to strengthen as the economic expansion gathers pace and the liberalisation process takes effect. However, the rate of unemployment remains very high, female participation remains low nation-wide and long-duration unemployment has trended up throughout the current expansion. A falling export-market share and inflation inertia suggest that obstacles to domestic competition and international competitiveness may remain. Tackling the remaining structural problems, or increasing the pace of reform where it has been too slow, is made more urgent and more difficult by the weaknesses evidenced by Italy's marked territorial dualism. While the most advanced regions of the Centre-North have continued to boost living standards, the growth rate of the *Mezzogiorno* has been poor. In this part of the country, reliance on external transfers has remained high and unemployment has been on a rising trend, despite the fact that regional wage differentials have widened marginally and labour mobility has begun to rise from low levels. This Chapter first considers the recent economic performance of Italy from the perspective of persistent regional imbalances. It then discusses the progress in product- and labour-market liberalisation and future policy requirements in these domains.

A new strategy for convergence

The Mezzogiorno at a crossroads

For much of the 1990s, the productivity record of Italy has been considerably stronger than the euro-area average (Table 34). Measured in terms of output per person employed, productivity growth has averaged some 1.8 per cent per

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Table 34. **Sources of growth in real GDP per capita**

Average contribution of annual growth rates over specified period

	Growth in real GDP per capita	Working-age population	Labour-force participation rates	Unemployment rate	Productivity[1]	Capital deepening
Italy						
1993-1998	**1.0**	**–0.1**	**–0.2**	**–0.6**	**1.8**	**0.0**
1993-1995	**1.0**	**–0.1**	**–0.7**	**–1.1**	**2.4**	**0.4**
1996-1998	**1.0**	**–0.2**	**0.3**	**–0.1**	**1.4**	**–0.4**
Centre-North						
1993-1998	1.3	–0.3	–0.1	–0.3	1.8	0.1
1993-1995	1.5	–0.1	–0.3	–0.8	2.4	0.3
1996-1998	1.2	–0.4	0.2	0.2	1.3	–0.1
Mezzogiorno						
1993-1998	0.2	0.1	–0.5	–1.2	1.8	–0.0
1993-1995	–0.2	0.1	–1.4	–1.8	2.1	0.8
1996-1998	0.6	0.2	0.4	–0.7	1.5	–0.9
Euro area						
1993-1998	1.4	0.0	0.1	–0.3	1.1	0.5
1993-1995	0.9	–0.1	–0.2	–0.8	1.2	0.7
1996-1998	1.8	0.1	0.4	0.2	1.1	0.2

1. Productivity per person employed.

Source: OECD, SVIMEZ and ISTAT.

year in both the Centre-North and the *Mezzogiorno*, compared with 1.1 per cent for the euro-area average. Despite these developments, real GDP per person has grown by only 1 per cent per year, which is a significantly slower pace than the euro-area average. A falling working-age population and declining participation rate explain this, together with rising unemployment. Italy as a whole stands out in the European context for its comparatively low rate of participation. However, to a large extent, slowly progressing living standards reflect the poor performance of the *Mezzogiorno*. The marked regional divide in Italy is evidenced in a high variability of participation and employment rates across ages, genders and regions, and by the size of the underground economy, where the number of irregular workers in the *Mezzogiorno* is estimated to equal some 30 per cent of the overall workforce in industry and services (Table 35). This situation also demands a differentiated approach to structural reform.

Reflecting poor aggregate growth, the gap between the *Mezzogiorno* and the Centre-North of the country widened further over the 1990s in terms of aggregate output (Table 36). For 1998, real GDP expanded by 1.1 per cent in the *Mezzogiorno*, which was 0.4 percentage points less than in the rest of Italy. However, calculated in per-capita terms, the gap was stable for the first time for several years, thanks partly to a revival of migratory flows from the South to the Centre-North (Table 37).

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Table 35. **Irregular labour in the *Mezzogiorno*[1]**

1998

	Italy	*Mezzogiorno*
Total	22.6	33.8
Industry	18.2	42.8
Services	18.4	21.4
Agriculture	73.1	80.8

1. As a percentage of total (regular and irregular) labour units. Irregular labour is defined as irregular and unregistered workers, including foreign ones, taking account of second jobs.

Source: SVIMEZ (1999), *Informazioni SVIMEZ,* June-July.

Even so, the level of per-capita income in the *Mezzogiorno* was 45 per cent lower than in the Centre-North, a regression of 4 percentage points relative to 1991.

For 1999, government estimates suggest that real GDP growth in the *Mezzogiorno* might have been quite close to the growth rate of the Centre-North. Moreover, a number of signals suggest that restructuring of the *Mezzogiorno* might have gained considerable momentum over the last few years. With a lag, the squeeze of public funds may have spurred a crowding-in of resources for private investment, as suggested by the strong growth in start-ups observed over the second half of the 1990s (Table 38). This dynamism is fully attributable to the increasing role of small firms, as indicated by the fact that employment in micro enterprises (1-9 employees) grew by 12.8 per cent in 1998, while expanding 4 per cent in firms with 10 to 49 employees. By

Table 36. **Regional real GDP developments**

Percentage change

	1992-98[1]	1996	1997	1998
	Mezzogiorno			
GDP	**0.4**	**–0.1**	**1.0**	**1.1**
Final domestic demand	0.0	0.0	1.9	2.2
Private consumption	0.8	0.4	2.5	2.0
Public consumption	0.3	0.3	–0.7	1.2
Fixed investment	–3.7	–0.5	–0.1	3.2
	Centre-North			
GDP	**1.4**	**0.9**	**1.7**	**1.5**
Final domestic demand	1.0	0.4	2.7	2.7
Private consumption	1.1	1.0	2.3	1.8
Public consumption	0.0	0.2	–0.7	1.6
Fixed investment	0.5	0.7	0.8	3.6

1. Average of annual growth rates over the period.

Source: SVIMEZ (1999), *Informazioni Svimez,* No. 4-5, April-May, Table 1, p. 8.

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Table 37. **Comparisons between regional economic indicators**

	1991	1995	1997	1998
		Mezzogiorno		
Population (millions)		20.8	20.9	20.9
Employment (millions)[1]	6.1	5.7	5.7	5.8
Per capita GDP[2]	58.6	55.1	54.6	54.6
Per capita public spending[2]	109.7	104.6	102.5	..
Current	104.4	103.3	102.3	..
Capital	140.8	111.4	103.4	..
Openness to foreign trade[3]	13.0	17.3	17.9	18.1
Performance of exports[4]	8.9	9.3	9.7	10.2
Performance of imports[4]	12.4	11.8	12.9	11.6
		Centre-North		
Population (millions)		36.4	36.6	36.6
Employment (millions)[1]	14.6	14.4	14.5	14.7
Openness to foreign trade[3]	36.3	47.8	46.3	46.2
Performance of exports[4]	88.4	90.7	90.2	89.7
Performance of imports[4]	85.6	87.6	86.6	88.0

1. The first annual figure refers to 1992.
2. As a percentage of the corresponding level for the Centre-North.
3. Sum of exports and imports expressed as a percentage of regional GDP.
4. As a percentage of total national exports/imports. The sum of *Mezzogiorno* and Centre-North might not add up to 100 due to the presence of unspecified provinces.

Source: SVIMEZ (1999), *Informazioni SVIMEZ,* No. 4-5 and ICE (1999), *Rapporto 1998-99.*

contrast, employment in large corporations continued its long-term decline, partly reflecting a process of downsizing going on within the formerly state-owned companies operating in the *Mezzogiorno*. This progress would not have materialised in the absence of improvements in city governance – a result of the direct election of mayors since 1994 – and growing popular participation. Increased social and political stability in the major cities of the *Mezzogiorno* played an important positive role.

Progress was also evident in a significant pick-up in the number of exporting companies. Consistent with the traditional Italian pattern, the new manufacturing plants have been concentrated within several highly specialised areas, which are becoming "export districts". They have contributed to the rise in the weight of the *Mezzogiorno* in total Italian exports (Table 37 above), while the exposure of the area to overall foreign trade has became greater over time. Reflecting the lower share of exports in the *Mezzogiorno*'s GDP the direct impact of the crisis in Asia and elsewhere appears to have mattered less than in the Centre-North. In turn, closer links with the rest of the world have brought about a considerable increase in the flow of goods and passengers through southern airports and ports.

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Table 38. **Net firm start-ups by region**

Percentage changes over the 1996-98 period, excluding agriculture

	North-west	North-east	Centre	*Mezzogiorno*	Italy
Manufacturing industry	–2.0	–0.8	–1.8	1.4	–0.8
Construction	4.5	5.7	1.1	3.1	3.6
Retail	–0.5	1.9	–1.3	1.0	0.3
Other services	5.1	5.8	8.1	11.4	7.5
Total of the above	**1.3**	**2.0**	**1.3**	**3.5**	**2.1**

Source: Banca d'Italia (1999), *Sintesi delle note sull'andamento dell'economia delle regioni italiane nel 1998,* Table B7, p. 30.

Despite this progress, the *Mezzogiorno* economy is heavily unbalanced in terms of domestic production. Table 39 illustrates the problem in the context of a comparison between observed sectoral specialisations in the *Mezzogiorno* and the Centre-North. It shows that as a counterpart to a comparatively stronger reliance on agriculture and construction, the *Mezzogiorno* stands out for the lack of an adequate manufacturing base. Within services, this part of the country appears to be underspecialised in financial intermediation and tourism while by contrast it is overspecialised in low value added activities, which are also characterised by less promising demand prospects (for example, retail).

Table 39. **Sectoral specialisation of the southern economy**

Calculated on the basis of the number of employees

	Percentage composition		Specialisation index
	Mezzogiorno	Centre-north	
	(a)	(b)	(c) = (a)/(b)
Mining	0.5	0.3	1.6
Manufacturing	25.8	37.7	0.7
Electricity, gas and water	1.6	1.0	1.6
Construction	12.3	9.1	1.4
Retail	27.2	20.5	1.3
Hotels and restaurants	4.9	5.4	0.9
Transport and communication	9.7	7.4	1.3
Banking and financial intermediation	3.6	4.2	0.9
Services to business	10.9	11.4	0.9
Services to households	3.6	3.1	1.1
Total	100.0	100.0	

Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica, Dipartimento per le Politiche di Sviluppo e Coesione (1999), *Programma di Sviluppo del Mezzogiorno,* Table 1.3, p. 6.

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A new growth strategy for the Mezzogiorno

In contrast with the traditional strategy of direct government intervention, the new policy approach relies on improving the environment for private investment. This requires a closer focus not just on the efficacy of public investment spending, but also on the quality of government services, including public management of investment support and promotion. The mandate to unify these general principles into an operational framework comprising finely balanced rules and incentives was assigned to a newly formed branch of the Ministry of Treasury, the Department for Development and Cohesion Policies (*Dipartimento per le Politiche di Sviluppo e Coesione*, DPS), which became operational in 1998 (see Box 11). The authorities consider that a new approach to economic policy is indispensable in order to consolidate the momentum for change currently observed in the *Mezzogiorno.*

The new strategy attempts to remedy three main sources of past deficiencies:[91]

- A lack of communication and information-sharing on local needs and opportunities, not just among government entities (state, regions and municipalities), but also between government and business and labour organisations.

Box 11. The responsibilities of the Department for Development and Cohesion Policies

The responsibilities of the DPS loosely resemble those of a public service. The DPS is in charge of promoting and co-ordinating negotiation and co-operation at various levels of local government, as well as between the central administration and the business community, so as to allow for the identification of local opportunities for development. The DPS also provides the framework for public intervention and in so doing it develops and disseminates methods for setting both priorities and evaluation standards. Conditional upon meeting eligibility requirements, it assures operators of certainty about response times and disbursement schedules, while it also verifies the financial feasibility of projects. These responsibilities are valid nation-wide, but the DPS maintains a special regard to depressed areas, including the co-ordination of the 2000-2006 programme for the allocation of EU structural funds in such areas.

The DPS's head also sits on the administrative board of *Sviluppo Italia,* a public entity responsible for providing technical and financial assistance to local governments and to local private operators willing to create new companies.

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- A lack of adequate incentive mechanisms to ensure the selection and realisation of the most valuable and quantifiable projects.
- A lack of a clear and unmistakable attribution of spending responsibilities.

The new approach is built upon two pillars. First, in a departure from the old *ex-ante* top-down system of attribution of public resources, the new approach aims at achieving the widest possible local consensus on a project. Several preconditions have to be met to participate in this consensus-building process, the most important among which is an effective stock of visibly accountable resources. Negotiation is assisted by evaluation, the second pillar of the new strategy. The advocates of a proposal have to provide the best possible documentation about their priorities and targets, as well as the expected time needed for the realisation of a project. This is required for the sake of credibility, while it also facilitates subsequent scrutiny and monitoring of an agreed project during the implementation phase.

Results and medium-term challenges

The launch of the new strategy occurred in mid-1998. After a slow start-up phase, the overall number of projects under implementation in the *Mezzogiorno* recorded a strong recovery from the second half of 1999. This is evidenced in a marked improvement in the ability of the *Mezzogiorno* to effectively spend public funds, both national and EU structural funds. Some 250 unfinished public works due to a lack of financial resources or planning shortfalls – of which there are some 1 000 in the *Mezzogiorno* according to a recent survey – have been re-financed for completion. Other instruments envisaging the promotion or facilitation of contacts and co-operation between local agents (*patti territoriali* and *contratti di area*) have also undergone a significant acceleration. Measures introduced at the end of 1998 to streamline the approval of these instruments greatly contributed to shorten response times.

From a medium-term development perspective, the aim is to enhance the attractiveness of the *Mezzogiorno* as a location for direct investment from elsewhere in the country and abroad. One of the preconditions is the endowment of an appropriate stock of upgraded and well-utilised immobile resources. The framework underlying this policy objective is outlined within the 2000-2006 development programme for the *Mezzogiorno* (*Programma di sviluppo del Mezzogiorno*), which was recently submitted to the EU Commission. Under the programme, within the period from 2000 and 2002 the share of the *Mezzogiorno* in total public capital spending of Italy would increase by about 2.5 percentage points, to almost 47 per cent, before declining gradually thereafter (Table 40). Public spending would be needed to provide adequate network services, prevent and fight crime and contribute to a more law-abiding culture. Despite significant progress having been achieved recently, inadequate law-enforcement continues to act as a major constraint to stronger investment in the South. In addition, the programme comprises

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Table 40. **General government capital spending for the *Mezzogiorno***

Programmed scenario until 2007
Cash basis

	Italy	*Mezzogiorno*	*Mezzogiorno*
	Trillions of lire		Per cent of the total
2000	88.8	39.3	44.3
2001	95.9	43.9	45.8
2002	101.8	47.6	46.8
2003	107.1	49.7	46.4
2004	111.2	51.2	46.1
2005	116.2	52.8	45.4
2006	121.2	54.3	44.8
2007	126.5	56.5	44.6

Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica (1999), *Documento di programmazione economico-finanziaria,* 2000-2003, p. 120.

other areas of public intervention, including natural and cultural resources, alongside the promotion of local systems of development.

The DPS carefully tracks the behaviour of a number of relevant market "jumping indicators" (*variabili di rottura*) in order to detect symptoms of change in confidence about the *Mezzogiorno*. Sector specific export flows, tourism receipts, investment patterns including foreign direct investment, employment trends, training efforts and indicators of the quality of services will be routinely monitored for each province. Breaking past habits and perceptions necessitates clear-cut and irreversible progress in the ongoing process of modernising the public administration (see Chapter II). It also needs to be underpinned by strong action to reduce product and factor market regulations, as well as actions to support business risk-taking initiatives by private agents. These issues will be discussed in turn in the remainder of the chapter. Indeed, deregulation and the fostering of a favourable business climate are nation-wide issues, though they often assume a special intensity in the *Mezzogiorno*.

Privatisation and market liberalisation

The past few years have witnessed the achievement of substantial progress in fostering underlying market mechanisms in Italy. The acceleration of the privatisation programme and increasing market liberalisation, together with the introduction of new provisions to renew the laws on both financial markets and investment services, have been important contributing factors. Progress in these

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Table 41. **Indicators of stock-market capitalisation**

	Number of listed companies	Number of listed shares	Market capitalisation	Average daily transaction turnover
			Per cent of GDP	Millions of euros
1990	229	340	12.7	106
1991	231	342	12.3	65
1992	229	342	11.4	70
1993	222	329	15.0	210
1994	223	324	17.8	389
1995	221	316	18.2	290
1996	217	307	20.4	321
1997	213	301	30.4	695
1998	223	304	45.3	1 672
1999	247	328	65.2	1 980

Source: Borsa Italiana S.p.A.

areas has been matched by a significant deepening of Italian financial markets, evidenced not only by the growing access of firms to risk capital but also a widening range of financial instruments available to households.[92] Since the mid-1990s, the overall capitalisation of Italian companies listed in the stock exchange has increased markedly (Table 41), reaching 65 per cent by the end of 1999. On the demand side, this pattern of development was accompanied by a significant rise of mutual funds and private equity and bond holdings in households' portfolios (Table 42).

Table 42. **Distribution of household financial assets**

Per cent

	1975	1985	1990	1997	1998	1999[1]
Cash	6.8	3.8	2.7	2.3	2.1	2.1
Bank deposits	17.9	15.6	14.1	12.0	11.2	11.0
Saving deposits	34.4	23.9	19.9	13.1	9.4	8.1
Treasury bills	0.1	12.7	12.4	5.1	2.2	1.2
Treasury bonds	3.1	14.1	14.4	12.7	8.2	7.3
Private bonds	10.7	5.0	2.5	7.0	6.8	6.7
Mutual funds	0.0	2.2	2.2	10.4	17.4	20.8
Shares	1.7	10.1	20.3	23.9	29.4	28.5
Foreign securities	5.5	0.8	1.9	2.7	2.6	3.0
Others	19.7	11.8	9.6	10.8	10.7	11.2
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

1. Third quarter.
Source: Borsa italiana S.p.A. for the period 1975 through 1990 and Banca d'Italia thereafter.

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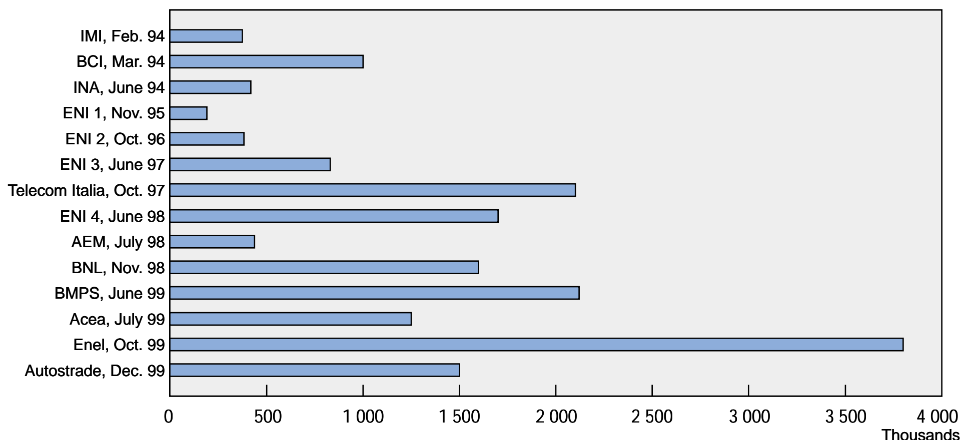
The momentum of privatisation has increased

Over the years 1994 to 1999, Italy was one of the largest privatisers in the OECD. After a temporary deceleration in 1998, the pace of privatisation gathered significant momentum in 1999, reflecting to a great extent the sale in October of the first tranche of ENEL (electricity). The public offering, equivalent to 31.7 per cent of the company's value, was massively over-subscribed. Measured by the number of retail investors, the sale of ENEL was the largest operation ever mounted in Italy (Figure 28). Receipts totalled L 32 trillion, or around 1.5 per cent of GDP, compared with overall receipts of L 38 trillion in 1997 – itself a record year. The efforts of the Treasury also concentrated on the banking sector, including most notably the sale of the entirety of the state's shareholding in *Mediocredito Centrale* to *Banca di Roma* through private placement. The 1999 timetable also included *Banco di Sicilia* and *Credito industriale sardo,* as well as the 16 per cent of *Banco di Napoli* remaining in state hands (Box 12). For 1999, overall privatisation receipts totalled L 37 trillion, thereby overshooting the initial target of L 15 trillion by a large amount. As concerns the extent of the recourse to the government's golden share, which the EU has asked it to terminate, a government decree of May 1999 circumscribed the possibility of its use to a limited number of strategic sectors (health, defence) and only for reasons of public interest. Although the latter change partly complies with

Figure 28. **Number of retail investors in Italian privatisations**
Thousands of retail investors



Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica (1999), *Italy's report on economic reform,* December, p. 12.

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Box 12. Corporate governance and the takeover market

Take-over bids (*Opa*) surged in 1999, a development with important repercussions on the framework for corporate governance and competition. CONSOB (*Commisione Nazionale per le Società e la Borsa*), which is the public authority responsible for regulating the Italian security market, authorised 34 tender offers, compared with a total of 18 tender offers in 1998. Most challenging were the hostile bids launched by *Olivetti Tecnost* to buy *Telecom Italia,* in the telecommunication sector, and by *Assicurazioni Generali* over INA, in the insurance sector. In banking, the merger between *Banca Intesa* and *Banca Commerciale Italiana* was a major step in a consolidation process that the Italian banking system has undergone since the early 1990s and which has accelerated further in the past few years.

These examples were important tests of the adequacy of the 1998 law on financial markets and investment services,[1] as well as of CONSOB's regulations pursuant to this law. The major aims of the reform were to make listed companies less insulated from hostile bids, to increase the flexibility of the rules, and to simplify procedural requirements. All these objectives were successfully met.[2] However, several legal gaps have become apparent, requiring a number of regulatory changes. One such issue relates to the lag between the communication to CONSOB of the intention to launch a bid and the presentation of comprehensive documentation concerning the bidding. This period has not been well specified so far, leading CONSOB to exert a very tight control on the targeted company, which might otherwise be tempted to take actions to reduce its value (*poison pills*).[3] It thus decided that the *passivity rule*, whereby the targeted company cannot take defensive actions unless authorised by at least 30 per cent of its shareholders, would become binding from the notification of the communication, irrespective of when a formal documentation is submitted. The problem with this approach is that it might freeze the ability of the targeted firm to adjust for too a long period, without guarantee that the bid will effectively take place.

1. Consolidated law on financial intermediation, 58/98.
2. See for a discussion of the law's details, OECD (1998), *Financial Market Trends*, No. 7, pp. 26-39. For a discussion of the rationale behind the reform, see M. Draghi (1998), "Corporate Governance and Competitiveness", *Review of Economic Conditions in Italy*, No. 3, pp. 341-356.
3. See Spaventa, L. (1999), "La disciplina dell'Opa in Italia: I risultati di un test", *Mercato concorrenza regole*, No. 2, pp. 245-54. See also Enriquez, L. (1999), "Quale disciplina per le acquisizione ostili? Alcuni modelli teorici e la soluzione italiana", *Mercato concorrenza regole*, No. 2, pp. 177-94.

the EU request, the government does not seem prepared for the moment to sell the state's remaining shareholdings in the energy conglomerate (ENI).

The government is now concentrating on the selling of the portfolio of IRI – a holding company of the Treasury – which under *Italy's Report on Economic Reform* of

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November 1999 will have to be completed by June 2000.[93] Meeting this ambitious objective will necessitate pushing ahead with the privatisation of several utilities, sales of which have sometimes been held back by the lack of a clear regulatory framework, as in the case of transport, for example.[94] In addition, it would require the privatisation of a number of companies operating in the high-tech segment of Italian industry.[95] If implemented as planned, the new privatisation programme is bound to have a considerable allocational impact, considering that despite the gradual dismantling of the conglomerate started in 1992, IRI's labour force still totalled 113 000 workers in 1998. At the same time, the consolidated output value of the holding amounted to L 36.2 trillion (1.7 per cent of GDP).

The first move concerned the sale of the stakes in *Società Autostrade*, using the instruments of both public offering and the creation of a strategic core of national and international shareholders. Privatisation of *Aeroporti di Roma* (Roman airports services company) is also scheduled to occur by the end of 2000, although preparation has been complicated by a number of legal obstacles.[96] Corporate restructuring has been sought prior to the devolution of the remaining 61 per cent state's ownership in *Finmeccanica*, whose businesses are spread across a wide range of sectors (aerospace, defence, power generation and transport), as well as the 53 per cent in Alitalia (the national airlines). Like several other big European airlines, Alitalia recorded a fall in passengers for 1999. Combined with uncertainties concerning the transfer of activities from Milan-Linate to the new Malpensa hub, this was reflected in a sharp decline in the value of Alitalia shares (by 25 per cent). This could adversely affect the tempo of Alitalia's privatisation.

Incomplete market liberalisation

According to a recent European Commission survey, since the end of 1997 the transposition of internal market directives into domestic legislation recorded a significant quickening in all EU countries (Figure 29).[97] A more comprehensive indicator of falling barriers to competition would take into account actual achievements on the implementation side, rather than focusing on *ex-ante* efforts made by each country. Notwithstanding this caveat, the available evidence shows that progress in liberalising product and service markets has been noteworthy in Italy, with the tempo of liberalisation having further strengthened in 1999. Such an acceleration is also confirmed by the relatively good performance of Italy in 9 out of 11 sectors for which transposition delays are routinely measured by the Commission (Table 43). Nonetheless, as progress has been very recent and largely incomplete, Italy still has a relatively high number of directives waiting to be transposed. Moreover, it also appears that the reform programme has been unevenly distributed across sectors, thus failing to offer a full range of opportunities for stimulating competition.

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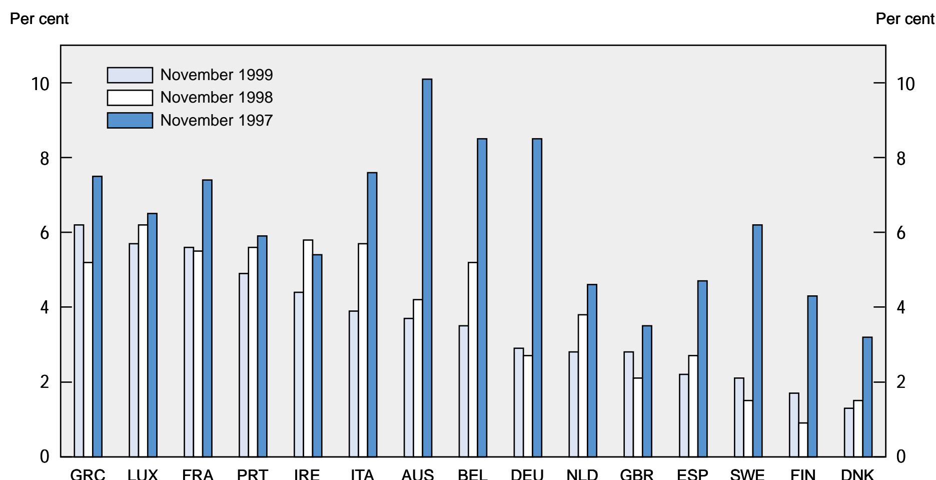
Figure 29. **Progress in transposition of internal market directives**
Percentage of directives overdue



Source: European Union (1999), *Single Market Scoreboard,* November.

Progress in the energy sector

Reform of the energy market follows the liberalisation of the telecommunications market, where also the local segment of the fixed-line market was opened (from January 2000) and the dismantling of monopolies has been helped by the rapid diffusion of new technologies. It comes ahead of the reform of the postal and railway services, where the pace of technological progress is slower and labour relations (and privileges) significantly more entrenched. Within this general framework, the government decided that the reform of the energy environment (both liberalisation and privatisation) needed to be preceded by the creation in 1995 of a Regulatory Authority for the electricity and gas sector, which became operative in April 1997.

As concerns electricity, this is a sector of major importance in Italy, for a combination of historical and economic reasons. ENEL's monopoly was created at the end of 1962, as a result of the nationalisation of 1 400 companies operating in the sector, following the introduction of a uniform tariff system on a nation-wide scale. The strategic role in economic development attributed to the electricity utility was never really challenged thereafter, notwithstanding several changes to the legal status of ENEL.[98] The most relevant measures included the transformation of ENEL into a joint stock company (1992) and the partial devolution to local

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Table 43. **Breakdown of non-transposed directives**[1]

	****	Belgium	Denmark	Germany	Greece	Spain	France	Ireland	Italy	Luxembourg	Netherlands	Austria	Portugal	Finland	Sweden	United Kingdom
Veterinary checks (207)	36	4	5	5	24	11	**27**	18	13	14	9	15	7	4	5	11
Transport (64)	32	7	2	5	12	4	10	11	9	**19**	8	6	18	4	7	5
Motor vehicles (156)	13	10	1	2	9	1	3	6	7	10	5	1	**13**	7	6	3
Chemical products (81)	12	5	3	**6**	5	2	3	3	1	1	4	5	5	2	4	3
Plant-health checks (180)	12	3	1	4	9	4	3	..	3	**10**	3	8	6	1	2	2
Environment (92)	10	6	2	4	**7**	3	4	3	3	3	1	3	3	1	2	4
Social policy (39)	10	1	..	..	1	..	3	1	**5**	4	..	3	..	..	..	..
Food legislation (106)	9	1	..	4	5	2	3	**7**	3	1	1	3	3	..	..	1
Telecommunications (17)	7	**4**	1	..	2	..	**4**	1	3	1	..	..	1	..	..	2
Intellectual and industrial property (8)	4	..	1	1	1	1	1	4	..	2	1	..	1	..	..	1
Public procurement (11)	4	..	..	2	3	1	2	..	1	2	..	2	2	..	..	2

**** Number of Directives.
Numbers in parenthesis refer to total number of Directives concerned in each sector.
1. Ranked according to the number of directives not yet transposed in all Member States. Numbers in bold identify countries with the highest number of non-transposed directives in each sector.
Source: European Commission (1999), *Single market scoreboard No. 5*, November.

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concessionaries of some of ENEL's service responsibilities (generation, transmission and distribution) from 1995. At present, the service split between ENEL and the municipalities is 93 per cent and 7 per cent, respectively, of total final consumption. The electricity sector having been sheltered from market forces for so long, the Authority has repeatedly stressed that introducing competition requires a maximum degree of transparency and accountability, as well as a clear definition of the tasks attributed to the various institutional players involved in the liberalisation process (the Treasury, the Regulatory Authority and the Antitrust Authority).

Regarding economic issues, Italy's electricity consumption is low relative to GDP in comparison with the OECD average, but this ratio is increasing. Comparative tax-exclusive price figures for electricity in 1998 show Italy as a relatively highly-priced country (Table 44).[99] This crude indicator conceals wide regional differences in the quality of the service. Recent data on electricity supply breakdowns scaled by the number of users reveal a quality gap in the network structure between the North and the Centre-South (Figure 30). As for energy taxes, the tax rate applied to households does not differ from the European average, contrary to the one applied to industrial clients, which differs by a wide margin (Table 44). Another issue of concern relates to the tariff system, where Italy stands out in the EU context as being the only country maintaining a progressive pricing structure for households (*i.e.* big consumers pay a relatively high price per unit of energy). As concerns business users, it appears that the price gap between Italy and the major EU countries is particularly marked for small and medium sized firms, whereas bigger industrial clients benefit from comparatively low tariffs.[100]

Major measures envisaging the gradual implantation of competitive mechanisms in the electricity market have begun to be implemented. Based upon EC directive 96/92, a legislative decree was issued by the government in March 1999,[101] allowing for a greater number of operators, wider access to the network and reduced controls.[102] More specifically, from 2003 no operator will be allowed to retain (directly or indirectly) more than 50 per cent of the electricity produced or imported. To meet this requirement, ENEL has been requested to divest at least 15GW of its generation capacity by 2002, while ENEL is also

Table 44. **Average electricity prices**

1998, lire/kWh, current exchange rate

	Households			Industry		
	Including tax	Excluding tax	Tax rate	Including tax	Excluding tax	Tax rate
Italy	**274.6**	**219.8**	**20.0**	**157.8**	**147.4**	**6.6**
EU average	241.1	190.5	21.3	108.2	105.2	2.4

Source: Data provided by Autorità per l'energia elettrica e il gas.

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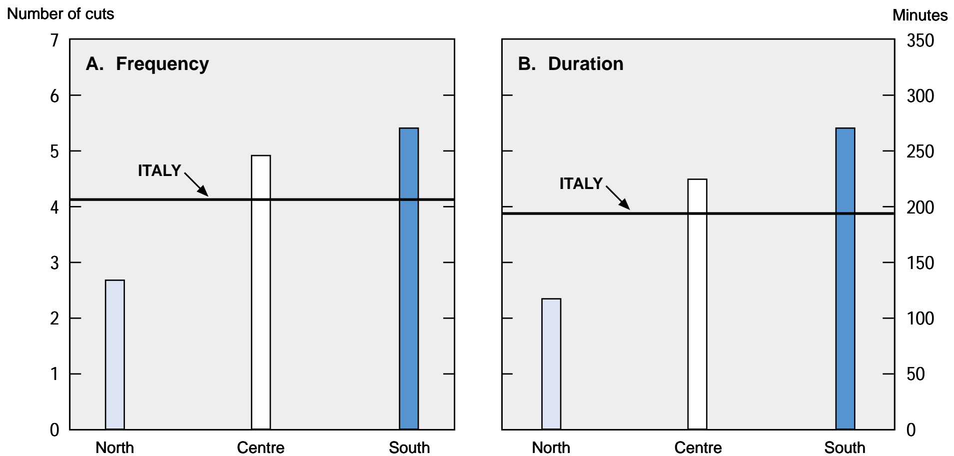
Figure 30. **Frequency and duration of long unplanned electricity outages**
1998, average power cuts per user



Source: Autorità per l'energia elettrica e il gas (1999), *Relazione annuale sullo stato di servizi e sull'attività svolta,* April.

expected to unbundle its vertically-integrated structure. In preparation for this, ENEL has already changed its structure into a holding company, comprising several companies mainly involved in generation, ownership of transmission assets and distribution. A new separate entity – a joint stock company entirely owned by the Ministry of Treasury (*Gestore della Rete di trasmissione Nazionale*, or System Operator) – will be in charge as of April 2000 of the management of high voltage transmission and dispatching. As concerns distribution, liberalisation takes the form of concessions (until 2030) from the Ministry of Industry. A provision allows for the identification of an initial number of big clients (*clienti idonei*, of which there were nearly 700 by February 2000) eligible to choose their electricity suppliers. The eligibility threshold will fall gradually from 2000 to 2002 and companies in the same municipality or in nearby municipalities can be eligible by forming a consortium of buyers. A single purchase system will be established for non-eligible consumers: the "single buyer" will make both purchase contracts with the generators and sales contracts with the distributors for resale to the franchise market. The System Operator will be majority owner of the "single buyer". Meanwhile, a Market Operator will have to be established in order to manage power exchange for wholesale deliveries of electricity as of 2001.

The gas sector will also undergo significant restructuring to complement the reform of the electricity sector. Given the strict interdependence between the

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two sectors, a non-competitive gas market would interfere with the liberalisation of electricity market. Compared with the electricity sector, the gas industry is significantly smaller, however, measured by number of employees, total amount of investment and annual revenue turnover.[103] Italy is the third most important EU market measured by size, following Germany and the UK. Due to the presence of a small number of participants, the gas sector seems to be more concentrated than the electricity one, with only two strong dominant players (SNAM in import supply and AGIP in domestic production, both sub-holdings of ENI). Reflecting the structure of the market, before-tax price levels for households and industrial clients in Italy exceed the EU average by 6 and 7 per cent, respectively. If taxes are taken into account the disparities jump to 43 and 12.5 per cent. Under the Directive 98/30, EU member countries are requested to open at least 20 per cent of their gas markets from August 2000 and a further 13 per cent over the following decade. The draft decree aimed at transposing the gas directive was approved by the government in February 2000. As with electricity, the authorities envisage modifying the organisational and regulatory features of the sector so as to suit the conditions of a competitive market. A set of rules to guarantee greater access to the building and management of gas plants and infrastructures is being studied.

The expected benefits for Italy of greater competition in the energy sector are great, given high average prices. Partly in response to the threat of third-party access to the network, average prices for 1999 have already fallen significantly. Under the plan proposed by the Regulatory Authority, electricity prices could fall in real terms by 4 per cent annually from 2000 to 2004,[104] reflecting a *price-cap* mechanism introduced to promote efficiency gains. Furthermore, a comprehensive tariff reform for franchised customers was finalised by the Authority at the end of 1999, to be gradually enacted in 2000. It appears, however, that an independent Regulatory Authority is necessary to encourage the "single buyer" to perform its activity according to the criteria of economic efficiency. Moreover, an aggressive enforcement of competition may be needed in order to achieve the results expected from liberalisation.[105] Vertically-integrated players already operating in the electricity sector have been required by the Regulatory Authority to comply with a clear administrative separation between regulated and unregulated activities. This measure would assure greater market access through making it more difficult for the incumbents to subsidise competitive activities using revenues from regulated businesses.[106] Moreover, the Regulatory Authority has expressed the opinion that there may be some scope for making market access in electricity less dependent upon the discretion of governmental bodies.

The need to consolidate transport reform

Italy faces major medium and long-term challenges with respect to the reform of the transport system: to reduce state ownership and control; to diminish subsidisation and restore sound financial balances in a number of sectors, most

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notably the railways; and to rebalance the high number of distortions in the pattern of supply and demand for transport services. These issues were covered in detail in the 1999 *Economic Survey*. Great emphasis was placed on the discussion of the difficulties faced by Italy in moving away from the traditional approach to direct public transport provision towards a more marked-based strategy. A year later, it appears that remaining challenges continue to be severe, while in the light of the variety of issues involved and the complexity of the sector, steady and integrated policy efforts continue to be required to address them.

Within this general picture, an issue of particular importance is the reorganisation of the state railways (*Ferrovie dello Stato*, FS), which was launched in 1998. Responding to pressures from EU directives and interventions of the Antitrust Authority, the plan aimed at preparing the ground for opening the market to competition. More specifically, this included the introduction of greater accountability and organisational transparency, along with the legal separation of the business between services and infrastructure components. The separation became operational in January 2000.[107] A new protocol agreement was signed by the Treasury, as shareholder, FS and the unions in November 1999 providing for the return to a balanced financial account by 2003 and 2005 for the service division and the infrastructure division, respectively. Key to achieving these objectives will be a hard budget constraint, which will necessitate the shift towards a new fare system. The gradual rationalisation of the current under-priced passenger fare system started in January 1999. Upward revisions would exclusively affect long distance fares, with short distance fares continuing to be largely influenced by social policy considerations. The agreement also included the stipulation of a new wage and labour contract, according to which wages would start to be aligned to productivity gains and employment conditions made more flexible. This appears to be an important achievement considering that FS employees have for long enjoyed generous wage premia. On the other hand, it remains unclear how the different parties involved in the agreement plan to tackle the problem of over-staffing, the need to re-qualify personnel, and to abolish generous retirement schemes, all of which are highly sensitive issues.[108]

After having completed the legal separation of the core businesses, complying with the obligations imposed by the EC directives of 1995 will require that the government move to the question of guaranteeing rights of access to the network. It is important that this be done both rapidly, so as to reduce the transitional period to a minimum, and fairly, so as to prevent the risk of unjustified exclusions of potential new players. Scope for a rapid liberalisation of train services seems to be wider for freight than for passengers, as the volume of traffic is smaller and the tariff system can more easily be adjusted to demand conditions.[109] The Antitrust Authority has recently suggested the need to entrust an independent body with the task of issuing safety certificates, only companies that satisfy certain appropriate safety reliability standards being able to obtain access to the network. Mean-

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while, the planned devolution to the regions of the state responsibilities for local railways has gained some momentum. By January 2000 many regions had stipulated plans with the government setting targets for regional transportation. Under the planned stepwise decentralisation process, regions would become responsible for the whole range of local transportation services. To this end regions will have to enter a contract with the state.

As concerns other transport modes, the most important competition issues relate to motorways and air transport. As regards motorways, the government opted for a twenty-year extension of the *Autostrade Spa*'s concession, thereby ignoring the views expressed by the Antitrust Authority which recommended more transparent procedures, such as the recourse to open auctions. These conditions may have resulted in motorways' fees declining less rapidly than would have otherwise occurred if the government had decided to guarantee wider rights of access. For air transport, the reduction of the monopoly position of Alitalia which was recommended by the 1999 *Economic Survey*, particularly over domestic flights between Milan-Linate and Rome, did not materialise. Moreover, in 1999, the Antitrust Authority issued rulings against Alitalia and Meridiana, stressing that a code-sharing agreement stipulated between the two companies had resulted in a reduction of competition. Some progress has been achieved in the liberalisation of airport land services, although according to the Antitrust Authority it has been less marked than advocated by the Commission's directive (as for baggage handling, for example). Not only may this affect consumers directly by delaying the land service liberalisation process, but also indirectly via the related distortionary effects on competition among airline companies.[110]

Preparing the reorganisation of local infrastructures

One key segment of the service sector due to be opened to competition comprises the public utilities under municipal authority (*comuni*), including water and local public transports.[111] The configuration of the sector is extremely variegated. Most companies have long been beset by structural weaknesses, including overstaffing, industrial unrest and obsolete capital stock. Within these companies tariffs are usually set taking into account social policy criteria, implying huge financial losses (Table 45) and, in connection with this, strong demand for subsidisation. Economies of scale remain largely unexploited, a consequence of the small size of these companies. At the other end of the spectrum, a few companies, most of which are from big cities, are efficiently run and profit-making. Some of them, AEM of Milan (electricity distributor), for example, are listed on the stock exchange and lead a network integrating several other smaller companies. Big cities have recently created special local authorities in charge of evaluating the quality of the services offered. Within this picture, particularly marked infrastructural gaps can be observed in the *Mezzogiorno* (Table 46). The lack of adequate transport services, water supply and energy infrastructures are sources of significant negative exter-

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Table 45. **Coverage ratios of local public utility companies**

1994

Services	Coverage ratio[1]
Water supply	86
Cemeteries	35
Sewage system	50
Street lighting	0
Waste collection	92
Local transport	24
Funeral services	124
Day-care centres	33
Gas distribution	116
Theatres, museums	30
Hotels and nursing homes	68
Electricity	122

1. Total revenues as a percentage of total costs.

Source: Enea-Nomisma (1999), *Rapporto sui servizi pubblici locali in Italia*, reprinted from A. Heimler (1999), "Local public services in Italy: make or buy?", paper presented at the EUI Conference on Anticompetitive Impact of Regulation.

nalities in productive activities, thereby reducing the attractiveness of the South to foreign direct investment and investment from other regions of the country.

The Italian authorities have recently embarked on an ambitious liberalisation programme of local public utilities with the objective of introducing market principles in several services of vital importance for development (water distribution, energy excluding electricity, public transports and waste management). A draft law was finalised by the government and submitted to Parliament, dividing the activities of a local service into two separate businesses.[112] Of these, infrastruc-

Table 46. **Indicators of infrastructural endowments**

1997, Italy = 100

	Transport	Energy	Communication	Water
Mezzogiorno	80.4	43.6	76.5	46.0
Centre-North	113.4	133.5	113.5	130.6
North-West	112.4	149.3	113.6	138.6
North-East	120.9	160.5	114.4	137.6
Centre	110.4	92.3	112.3	111.8
Total Italy	**100.0**	**100.0**	**100.0**	**100.0**

Source: Ecoter-Confindustria. Reprinted from SVIMEZ (1999), *Rapporto 1999 sull'economia del Mezzogiorno*, Bologna, Il Mulino, p. 730.

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ture planning would continue to be run by the municipalities. The other, including use and management, would be open to private companies and access would be based upon licenses assigned through open auctions. Only joint-stock companies would be eligible to apply for a license, a rule that would also apply to the old concessionaires. No restriction would be imposed as to the origin of an applicant.

If approved, the new law may have a big impact on the structure of local utilities where important merger and acquisition operations would be likely to arise. However, the draft law also suffers from grey areas and possible contradictions. According to a clause, small local municipal authorities may ask to be exempted from the new rules and be authorised to maintain direct controls on public utility companies (*gestione in economia*). Considering that about 86 per cent of Italian municipalities – of which there are some 8 100 – serve less than 10 000 inhabitants, this provision may risk to greatly compromise the scope of the reform. Given that most small players lack financial responsibility, it is highly likely that the effectiveness of the reform will be obstructed by a lack of support from the municipal administrations and a related large number of requests for exemptions.[113]

Liberalising the postal services

Still one of the weakest links in the service sector is the postal service, which has long been over-staffed, loss-making and burdened with relatively high costs, an inefficient delivery system (Table 47) and a lack of product diversification. A restructuring process started in early 1998, when the old and politically controlled post company was turned into a joint stock corporate entity called *Poste Italiane* (PI). In the meantime, the government finalised a reorganisation plan for the corporatised company, which required its separation into three major areas of business, postal services, financial services and territorial network. Furthermore, a

Table 47. **Efficiency indicators of the postal system**

	Average yearly dispatches per head of population	Items delivered to destination a day after dispatch[1]
Switzerland	592	98
Sweden	500	93
France	412	78
Netherlands	403	95
Denmark	335	94
United Kingdom	314	87
Italy	**96**	**49**

1. As a percentage of total item sent.
Source: International Post Corporation. Reprinted from Confindustria (1999), *Il rilancio della competitività italiana,* November.

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new executive manager and an entirely renewed core management were instated.[114] More generally, PI appears to benefit from greater freedom over employment decisions, given the drastic reduction in the number of people employed already achieved (from 183 065 in mid-1998 to 178 343 in mid-1999). In addition, some 10 000 people have been re-deployed from back-office into front-line activities. In part, such higher labour mobility has been used to reinforce window services, so as to reduce clients' discontent through shorter waiting times (post office queuing is almost chronic in Italy). A priority mail service system was implemented in June 1999, aimed at sharply improving the delivery system. This necessitated considerable efforts to improve the network over a preparatory period of six months. While PI recorded a marked decline in net operating losses in 1999, privatisation is unlikely to be in the pipeline until 2002, corresponding to the deadline designed by the government for restoring profitability.

Although Italy has a rather widespread private postal service, the development of which was necessitated to offset the inefficiencies of the public service, new entrants have recently experienced difficulties in obtaining delivery rights for hybrid post services, such as electronic mail addressed to individuals not connected to the Internet. The Antitrust Authority has issued a ruling for abuse of dominant position against PI, which was found to be making suppliers of hybrid mail services pay a delivery price higher than the price applied to its subsidiary in charge of hybrid mail services (*Postel*).

In July 1999 the government approved a legislative decree intended to implement the Commission directive on the liberalisation of the postal service. The decree, which was a response to criticisms by the Commission of an earlier draft, clarified the full range of services that PI will continue to run for a period of 15 years (*riserva*). However, a wide margin of discretion has been used in defining the services subject to restrictions, and in what could be a backward step, the list appears to include several activities previously opened to competition. Included among these, against a recommendation by the Commission, is the delivery of "hybrid services". This restriction, which is largely determined by the need to improve the financial situation of the incumbent, needs to be avoided, insofar it would guarantee PI an undue competitive advantage. It may even be questioned whether it is necessary to preserve it until the planned deadline for the review by the Ministry for Communication of the *riserva* (2001).

Tackling the inefficiencies of private non-financial services

Though on a secular growing trend, the service sector is still quite modest in Italy compared with the other major OECD countries (Figure 31).[115] A particularly wide gap can be observed for retail and distribution, business services and services to the community. In general, these sectors are marked by a considerable degree of fragmentation and consequently high market inefficiencies. Such inefficiencies are often accentuated by the presence of strong barriers to competition

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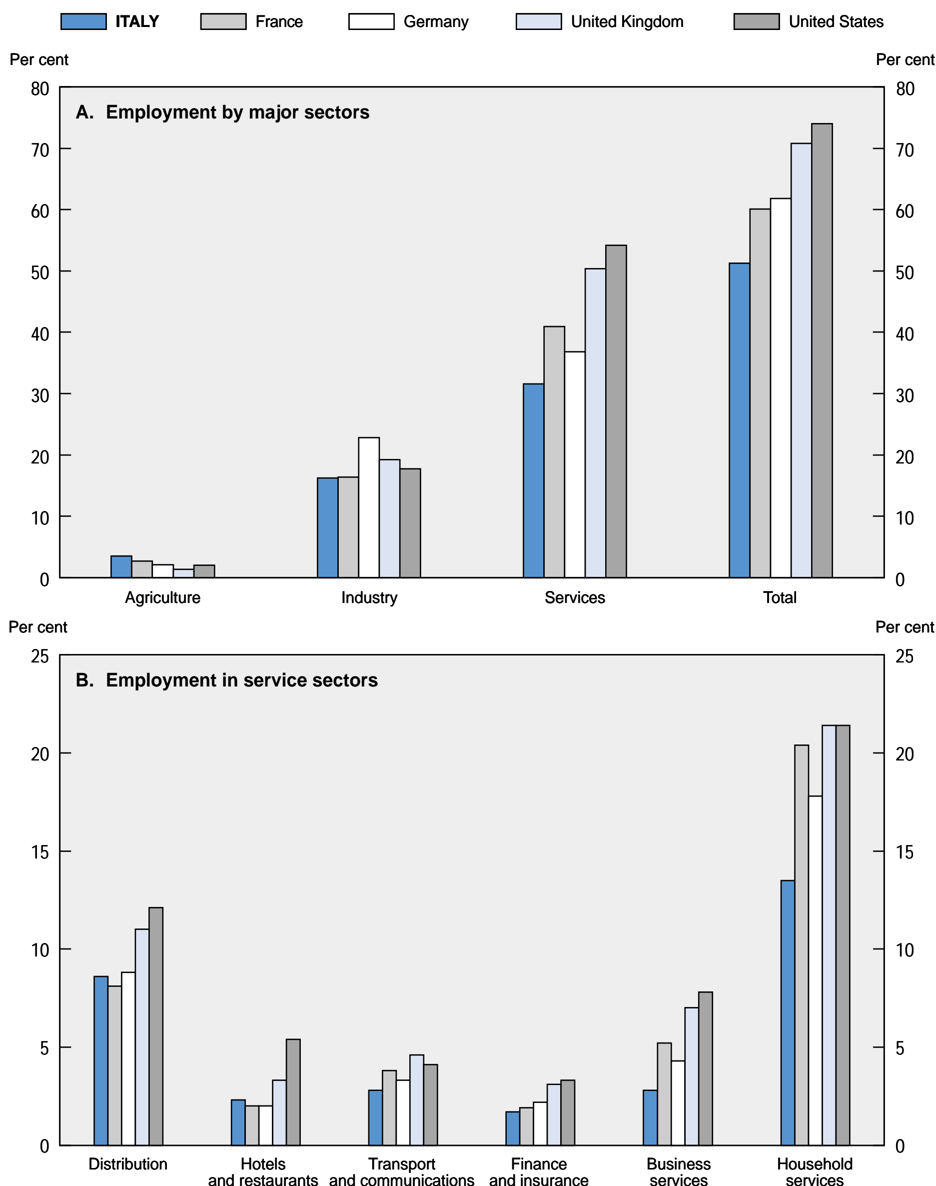
Figure 31. **Cross-country comparative employment figures**
As a percentage of working-age population, 1997



Source: European Commission, *Employment Rates Report,* 1998.

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(including a widespread recourse to quantitative restrictions) which sometimes arise from mutually reinforcing national and local regulations. As concerns professions, the role still being played by professional orders (business consultants, lawyers and fiscal experts, for example) and small business associations (driving schools, taxis, trucks, beauty salons, cinemas, to take a few examples) is very extensive, without being justified by reasons of general interest.[116] Tariffs are established on the basis of self-imposed internal criteria and initiatives have been taken by the Antitrust Authority to investigate cases of anti-competitive practices. A recent one regarded the two associations of accountants (*commercialisti* and *ragionieri*) which were found to have agreed their minimum tariffs so as to restrict competition. Furthermore, Italian legislation often imposes rigid rules of incompatibility between professions, thereby discouraging mergers among highly specialised professionals. In this way it perpetuates market inefficiencies, while it also contributes to exacerbate the likelihood of missing the opportunities posed by the growing opening to foreign competition.

From a medium-term perspective, it is likely that technological progress and the growing flexibility of the labour market will support the creation of new forms of professions, thereby spurring the demand for protection. Appropriate reform measures may therefore be needed in order to prevent these pressures from materialising and the government has been delegated by Parliament to prepare a new set of rules. If the opinions submitted by the Antitrust Authority will be taken into account by the government, a significant reorganisation of the rules determining access to the professions can be expected. Professional orders would become an exception rather than the rule under the new scheme,[117] while registration obligations required of new entrants would be greatly simplified. The publication and dissemination of quality standards for services and codes of conduct would be guaranteed, along with a softening of the rules on the incompatibility between professions.

A major attempt to de-restrict the service sector also involved (from 1998) the regulations for retail shops, including ceilings placed on the number of shops.[118] Under the reforms, regions were required to issue rules for opening up large shops and to accompany these rules with plans for urban development. The experience until now suggests that the latter provision may have resulted in an excessively high degree of discretion being conferred on local administrations, thereby contributing to delay in the implementation of the overall reform programme. By the end of October 1999 four regions had not adopted all the measures designed to implement the reform, while most of the remaining plans submitted to the government were incomplete.[119] The original deadline for submission of the regional plans was April 1999, since when licenses for small shops have been definitely abolished. As concerns the ongoing liberalisation of the vehicle fuel distribution network, the government has recently committed itself to end it by June 2000, a year earlier than originally planned.

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Measures to enhance the comparability among insurance premia applied on vehicles have been introduced as part of the structural provisions linked to the 2000 budget law (*collegato alla finanziaria*). Through assisting consumers in choosing between different insurance companies, these measures are intended to guarantee against excessive price rises. Insurance premia increased sharply in 1999.

Fostering employment expansion

The efforts to foster employment have produced outstanding results in many areas. Growing labour market flexibility is evident in the sharp rise in atypical job contracts, albeit from a low base. This positive development is the consequence of the labour-market reform adopted since the early 1990s, most notably the 1993 agreement between government and social partners and the so called *Treu Package* of 1997. The latter incorporated a number of significant innovations such as the introduction of temporary employment, a lessening of the sanctions on fixed-term contracts, an extension of apprenticeships and the introduction of private employment agencies. Despite these changes, however, there appears to remain considerable scope for further actions to foster labour market performance, not just over time but across different areas of the country. One important element of rigidity relates to the excessive burden of taxation on labour, an issue that was covered in detail in the *1996 Economic Survey*, and is analysed in terms of the tax wedge on labour in Chapter II. While possibilities of corrective action remain limited by the need to achieve continued progress in fiscal consolidation, the potential employment gains arising from a redesign of the tax and social security contribution systems are relatively large in countries like Italy that have a large informal economic sector. Otherwise, there may be substantial scope for Italy to improve performance in the following main areas: improving the efficiency of labour market policies; increasing wage and labour-cost flexibility; harmonising replacement rates and benefit periods across different categories of job losers; and improving labour-force skills and competencies. In addition, Italy may need to streamline and rationalise the system of employment incentives, while easing employment protection legislation.

Labour market deregulation

The 1999 *Economic Survey of Italy* drew attention to the increase in the incidence of part-time and temporary work in Italy over the past decade. Indeed, the growth of non-standard forms of employment helped to offset a decline in full-time employment until 1999, when standard forms of employment also started to show signs of a pick-up. Worries exist as to the high geographical concentration of atypical contracts in the Centre-North, while it also appears that they are perceived as second-best choices by many workers.[120] But the trend was reinforced

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over the survey period, stimulated by the wider diffusion of both fixed-term contracts and interim (temporary) contracts.[121] Recent trends in employment have also been quite encouraging from the longer-term demographic perspective. The Italian participation rate rose somewhat in 1999, as for the first time in many years the adverse effects of the withdrawal of older workers from the labour market (those aged 55-64) was more than offset by a rise of participation rates among both women and the young.

The growing flexibility of the labour market is also evidenced by several marked changes in both working habits and labour practices agreed upon by social partners. With regard to small firms, the most recent labour and business surveys show the annual occupational turnover rising to about a quarter of total workers, while there is also evidence of increasing shift work. In large firms, standard contracts now involve less than half of all new contracts, and the share of newly-hired workers with fixed-term contracts exceeds one-third of total hires. The data available also show a positive correlation between atypical contracts and the increased importance of working-time flexibility. Working times are usually more flexible (including night or weekend work) among workers with a lower degree of education and at the sectoral level, within services.[122]

Various initiatives have been undertaken recently with a view to further expanding the recourse to atypical contracts. New rules providing for the simplification of the use of interim contracts for unskilled jobs have been included by the government within the structural measures attached to the 2000 budget law. Other newly-introduced measures envisage a more flexible use of part-time jobs during periods of surging demand. Being recent, such measures may require some time before displaying the desired effects, while at 8-9 per cent of total dependent employment, the incidence of atypical employment is still comparatively low by OECD standards. In addition, there may remain scope for further broadening the activities of private employment agencies – of which there are some 11 – most notably by allowing them to diversify into training and to establish stronger collaborative links with temporary employment agencies.

Labour costs and wage bargaining

As concerns wage flexibility, the adverse effects on unit labour costs of relatively low productivity levels in the *Mezzogiorno* are only partially offset by lower wages (Figure 32). This contrasting performance of productivity and wages does not show up in the calculated unit labour costs figures, essentially reflecting the partial rebate of social security contributions in some areas (extended until 2001). An alternative indicator of unit labour costs, using total gross wages rather than total compensation, suggests that in the absence of adequate wage flexibility the elimination of public subsidies to cover social contributions would unavoidably result in a sharply deteriorating competitive position of the *Mezzogiorno*. The search

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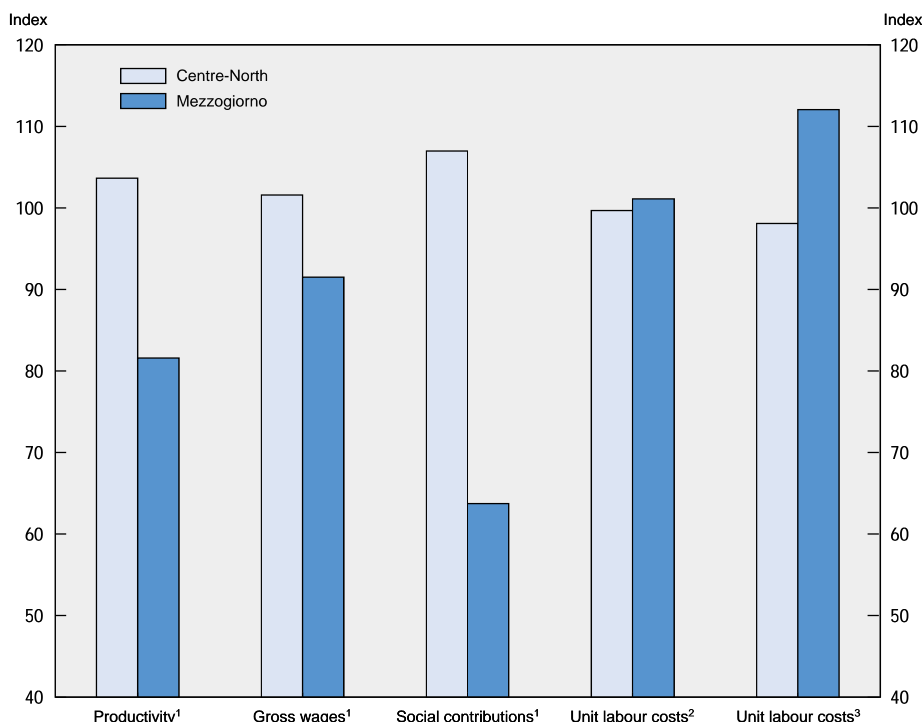
Figure 32. **Regional disparities in productivity and unit labour costs**
Manufacturing sector, 1995, total Italy = 100



1. Per employed person.
2. Calculated using total compensation.
3. Calculated using total gross wages (compensation less social contributions).

Source: OECD calculations based upon figures provided by Ministero del Tesoro, del Bilancio e della Programmazione Economica.

for adequate flexibility in this context may need to take into account various interacting dimensions, notably work organisation, wage and non-wage labour costs.

There appears to be a growing agreement that wage bargaining in the *Mezzogiorno* should take into account the planned abolition of partial social contribution rebates and should therefore start to adapt. At the local level *contratti d'area* between social partners and local authorities in economically depressed regions allow for special agreements with respect to employment arrangements, credit and public order. In addition, some greater wage flexibility has been allowed by the introduction of *contratti di riemersione*, which are special contracts intended to

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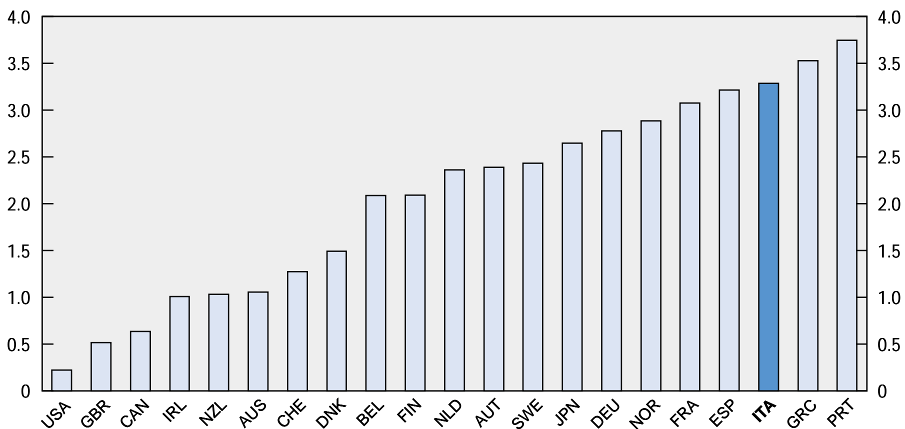
encourage the emergence of activities which are currently part of the underground economy. Other proposals have been debated within the union movement aimed at achieving a higher degree of decentralisation of wage bargaining. If implemented, wage settlements would become more sensitive to regional productivity differentials, while also allowing for a more flexible use of working hours.[123] Decentralised bargaining may help, in particular, to smooth the adverse effects on employment of temporary cyclical slowdowns. Such a higher degree of decentralisation, if achieved, need not exclude a level of co-ordination within a national bargaining framework.

Easing employment protection

A further possible source of imbalance relates to the strictness of the employment protection legislation (EPL) governing the process of hiring and firing workers. Figure 33 presents a summary indicator of EPL for selected OECD countries in 1998.[124] Italy stands out for its very tight regulations, along with the other southern European countries (Spain, Greece and Portugal). The most binding element of rigidity, distinguishing Italy from many other Member countries, is the rule on individual dismissals, which includes the possibility for a company with more than 15 employees to have to reinstate the dismissed worker in case of unfair dis-

Figure 33. **Summary indicators of Employment Protection Legislation**[1]
1998



1. The scale of indicators is 0-6 from least to most restrictive.
Source: G. Nicoletti, S. Scarpetta and O. Boyland (1999), *Summary Indicators of Product Market Regulation with an Extension to Employment Protection,* OECD Working Papers, No. 226, December.

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missal. Where this is interpreted too strictly, it may be particularly detrimental to disadvantaged workers (often low-skilled, long-term unemployed and youths), insofar as it could encourage firms to assume more cautious hiring attitudes. Moreover, EPL may indirectly accentuate the duality of the labour market in terms of "insiders" in permanent employment and growing numbers of "outsiders" on atypical contracts.[125]

The potential employment gains for Italy of easing EPL are significant, particularly as it may stimulate the demand for labour. In the current business conditions, if enterprises feel that they are not obliged to retain workers who are no longer needed, they may become more willing to hire people when demand conditions are strengthening. In framing legislation,[126] there are several lessons from the OECD reform experience. A key one is that improving the EPL regulatory framework may require a clear definition of lay-off provisions, in terms of both length of the notice period and amount of the indemnities involved. This may suggest that the EPL issue needs to be approached in the context of the reform of the unemployment insurance system (see below).

Towards more effective income support schemes and active labour market policies

Public expenditure on income support for the unemployed and other workers at risk in Italy amounted to some 1 per cent of GDP in 1998, a lower figure than in most other OECD countries. There are several schemes providing collective or individual income support for specific group of workers at risk of unemployment.[127] To recapitulate briefly, the Ordinary Wage Supplementation Fund (*Cassa integrazione Ordinaria*, CIGo) provides benefits in cases of collective but temporary suspensions or reductions of activity. The Special Wage Supplementation Fund (*Cassa integrazione Speciale*, CIGs) provides the same benefits as the CIGo but applies when the suspension of activity is non-temporary, following sector- or area-specific restructuring of firms, for example. In addition, firms allowed to benefit from the CIGs are also entitled to special collective unemployment indemnities or mobility indemnities (*liste di mobilità*). The taxonomy of support schemes is completed by the incentives for early retirement. As concerns individual dismissals, support is provided via the ordinary unemployment benefit (the so called *indennità ordinaria di disoccupazione*), while special benefits are granted to agriculture and construction workers (*indennità straordinaria di disoccupazione*).

There are important differences across income support schemes as to the coverage and duration of the benefits provided and requirements governing rights of access.[128] Regarding coverage, for example, the amount of the benefit a worker may receive varies between 80 per cent of the last salary for CIG to 30 per cent in the case of an ordinary unemployment benefit. Nevertheless, a common denominator among different schemes is that they generally favour displaced workers and those affected by collective dismissals in larger firms over workers in small and

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medium-sized enterprises and first-time entrants into the labour market. Some 20 per cent of the overall unemployed labour force receive such benefits in Italy, which is very small by international standards, thus suggesting that the Italian unemployment benefit system is skewed towards a minority of highly protected beneficiaries.[129] As various schemes of income support may often eventually be combined, beneficiaries may exploit them for an extended time period.

The Italian authorities have recently embarked on an ambitious reform programme aimed at correcting the various shortcomings of the income support schemes. The reform is to be realised in a way consistent with the target of fiscal consolidation, and in this way is linked to pension reform, savings from which would be used for supporting more equitable welfare spending accruing to families in need. Thus, according to the draft law which is about to be finalised, the floor for benefits would be significantly reduced and replacement rates and benefit periods across different CIG categories of job losers would be harmonised. Furthermore, the government seems determined to eliminate the gap between benefits provided under CIG mobility, indemnity and ordinary unemployment benefits. Incentives to early retirement would be gradually removed.[130]

A more equitable system of unemployment benefits has prospective benefits for the supply of labour insofar as it may encourage both youths and long run unemployed workers to accept atypical job contracts. In addition a well designed system of income benefits which was complementary to EPL reform might assist in the growth of medium sized companies, which are quite scarce in Italy (see below).[131] Currently, small firms face an incentive to stay small, since by doing so they can preserve less formal working relationships and avoid the rules. They may become less reluctant to expand if access to the new scheme is less costly.

In order to safeguard job losers from large income falls, the reform of unemployment income benefits will be complemented by the rationalisation of existing employment incentive schemes. Spending on active labour market policies totals some 1.1 per cent of GDP in Italy, which is somewhat higher than the OECD average (0.8 per cent for 1997), but the government would also like to promote the rationalisation of employment incentive schemes and the schemes to assist first-time entrants into the labour market. Accordingly, the redesign of these policies would include simplification of activities, greater transparency, as well as tailored measures to meet the needs of the *Mezzogiorno*, categories at the margin (women and youths) and long-term unemployed. It is important that the new regulations not target specific sectors or activities, so as to minimise the risks of adverse allocative effects.

Improving labour force skills and competencies

Italy shares with a number of other Euro area countries the problem of a mismatch between courses taught at high schools and the requirements of the

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Table 48. **Regional distribution of public employment**

Per cent, 1997

	Relative to total employment	Relative to total population
Mezzogiorno	20.1	6.1
Centre-North[1]	11.6	5.1
Italy	**14.8**	**5.7**

1. Excluding Lazio, the region where Rome is located.
Source: Ministero del Tesoro, del Bilancio e della Programmazione Economica (1999), *Conto Annuale*, 1997.

business sector, while the country stands out in the European context for having particularly high drop-out rates. A long-term plan is currently being designed to respond to these weaknesses (*Masterplan*). The plan makes it compulsory for youths of up to eighteen years to participate in training activities. Another law bringing the school leaving age up to 15 years became effective in 1999. A number of medium-term initiatives have been taken to improve the effectiveness of educational institutions, including allowing a greater degree of autonomy to schools, reinforcing training courses for teachers and setting up an independent body to assess the performance of schools. To the extent that a high share of public sector employment in total employment (as in the *Mezzogiorno*, Table 48) is mirrored by a lack of business-oriented universities degrees, better education may encourage the development of private risks and entrepreneurship.[132] In addition, the reorganisation of the secondary school cycles can be expected to help in meeting the education and skill level requirements of the business sector.

Promoting a business-friendly environment

The Italian industrial structure is dualistic in nature. A small number of large corporations co-exist with an extensive network of small- and medium- sized firms.[133] Measured by the number of employees, Italian corporations are on average quite small (Figure 34). The over-representation of small firms, in so called "industrial districts" (*distretti industriali*), partly reflects the structure of manufacturing arising from a specialisation in labour- and resource-intensive industries. It has long being considered a factor of relative strength for the Italian economy. Small firms are thought to be characterised by a high degree of flexibility. But Italian companies have a propensity to remain small, under the influence of unfriendly rules and institutions. These may include some aspects of the labour-market rigidities discussed in the previous section. They may also include the role played by an intrusive public administration, an environment unfavourable to technological

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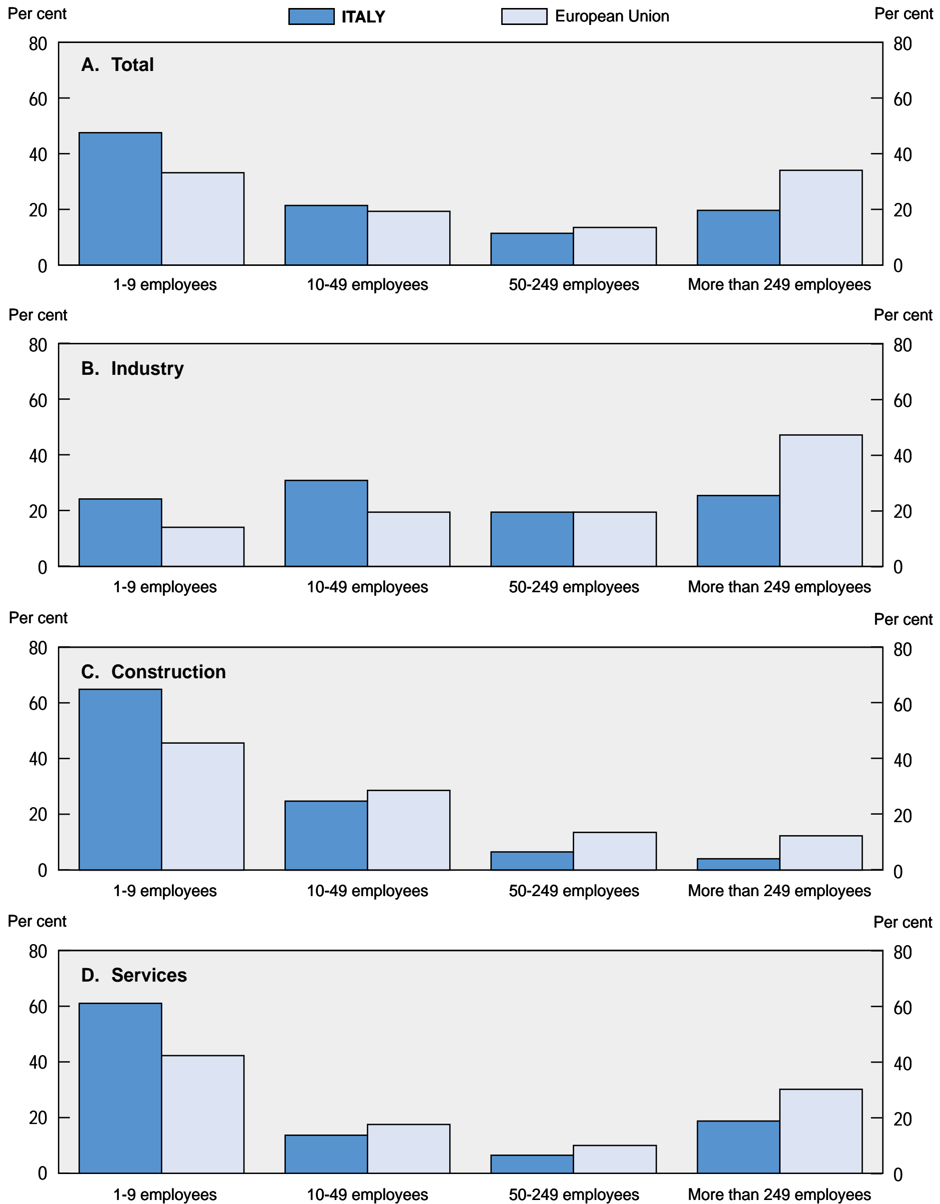
Figure 34. **Size distribution of Italian companies**[1]
1996



1. Number of employees in each size group as a percentage of total employees in each sector.
Source: ISTAT (1999), *Rapporto annuale, la situazione del paese nel 1998.*

progress and innovations, and the scarcity of adequate financing instruments. Furthermore, there is a strong representation of self-employment in Italy, totalling some 15 per cent of overall employment. The incidence of self-employment has been increasing throughout the major OECD countries, but such a high proportion is quite unusual by international standards.[134]

Reducing the burden of government

Administrative costs are particularly burdensome to small firms. It is estimated that they account for 1.3 per cent of total labour costs for firms with between three and five employees. Table 49 reveals that creating or expanding a company is especially complex in Italy, which has both the highest administrative burdens and the highest legal barriers to entry in the OECD area (Figure 35).[135] The *Bassanini reforms* of 1997 provided a general framework for the simplification of administrative procedures and the elimination of quantitative restrictions in services.[136] Implementing such a broad-ranging reform necessitated the adoption of several specific accompanying measures, including the introduction in March 1999 of a new law providing for the simplification of various administrative procedures. A particularly important development, affecting small- and medium-sized companies, was the introduction of "one-stop shops" for companies willing to expand their business. Local municipal authorities (*comuni*) are made responsible for the creation of such services, while the law also encourages the formation of consortia of suppliers in order to contain costs. By the end of 1999, some 30 per cent of all municipalities had opened a one-stop shop.[137] Prospectively, the one-stop shop could contribute to fostering business initiatives not just by reducing red tape, but also by providing information and advice for economic agents willing to invest.

Developments in capital and financial service markets

Between 1990 and 1997 some 265 banks were involved in mergers, while another 90 were taken over. Banks merged or acquired over the period held 22 per cent of the banking system's total assets. This process of consolidation initially involved small banks, many of which were troubled. It has gradually spread to bigger institution, partly fostered by the growing presence of foreign banks in the Italian market.[138] Combined with the privatisation of many state banks, the process of consolidation has helped to improve the operating efficiency of the Italian banking system at large, by creating new scale economies. Despite this, the efficiency of Italian banks remains stifled by problems of overstaffing and high labour costs (Figure 36).[139] The full effects of the restructuring of the banking sector on resource allocation will take time, particularly in the *Mezzogiorno* where in 1998 bad debts still totalled some 22 per cent total loans, compared with a national average of 9 per cent.

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Table 49. **Registration requirements and costs**

Unlimited liability (limited), private limited company and public limited company

	Legal form[1]	Pre-registration requirements[2]	Registration offices[3]	Post-registration requirements	Time (weeks)[4]	Minimum charter capital (ECU)[5]	Cost (ECU)[6]
Australia	Proprietary	3	1	1-5	1	0	200-480
	Public	4	1	1-5	1	0	200-480
France	Artisan	6	1	4	1-7	0	1 100-2 700
	SARL/EURL	10	1	5	4-8	8 000	1 900-4 600
	SA	14	1	7	7-15	40 000/250 000	2 200-6 100
Germany	KGT	1	1	2	1 day	0	10-25
	GmbH	6	2	2	8-24	25 000	750-2 000
	AG	6	2	2	8-24	50 000	750-2 000
Italy	Artigiana	7	1	4	4-16	0	1 150
	SRL/SuRL	17	5	3	4-16	10 000	2 200
	SPA	18	4	3	22	100 000	7 700
Netherlands	Eenmanszaak	1	1	5	3-7	0	0
	BV	3	1	5	12	19 000	1 000–
	NV	2	1	5	12	0	0
Spain	EI	0	3	5	1-4	0	0
	SRL	7	5	5	19-28	3	330+
	SA	7	5	5	19-28	62	330+
Sweden	Enskild Firma	0	1	2	0-4	0	90
	AB	3	1	3	2-4	12 000	1 130
	AB (public)	3	1	3	2-4	60 000	1 130
United Kingdom	Sole Trader	0	0	3	0	0	300
	Private	1	1	3	1	2	420
	Public Limited	1	1	3	1	70 000	900
United States	Sole Proprietor	0	2-6	2-5	1-2	0	200-800+
	LLC	0	2-6	2-5	1-2	0	200-800+
	Corporation	0	2-6	2-5	1-2	0	200-800+

1. Legal form. Three different forms have been selected among each country's many different forms: unlimited liability forms, limited liability corporate form and public corporations.
2. Registration requirements. The number of procedures which must be completed before registering.
3. Registration offices. The number of offices where the business entity must be registered.
4. Time. The number of weeks required before the registration has been processed by the authorities.
5. Minimum charter capital requirements. The value of assets which a business entity must have and maintain.
6. Cost. The direct (fees paid to the registering authorities) and indirect (fees paid to lawyers, agents and consultants) costs of registration.

Source: Logotech S.A., and submissions from the Australian authorities. Reprinted from OECD (1999), *Fostering Entrepreneurship,* pp. 55.

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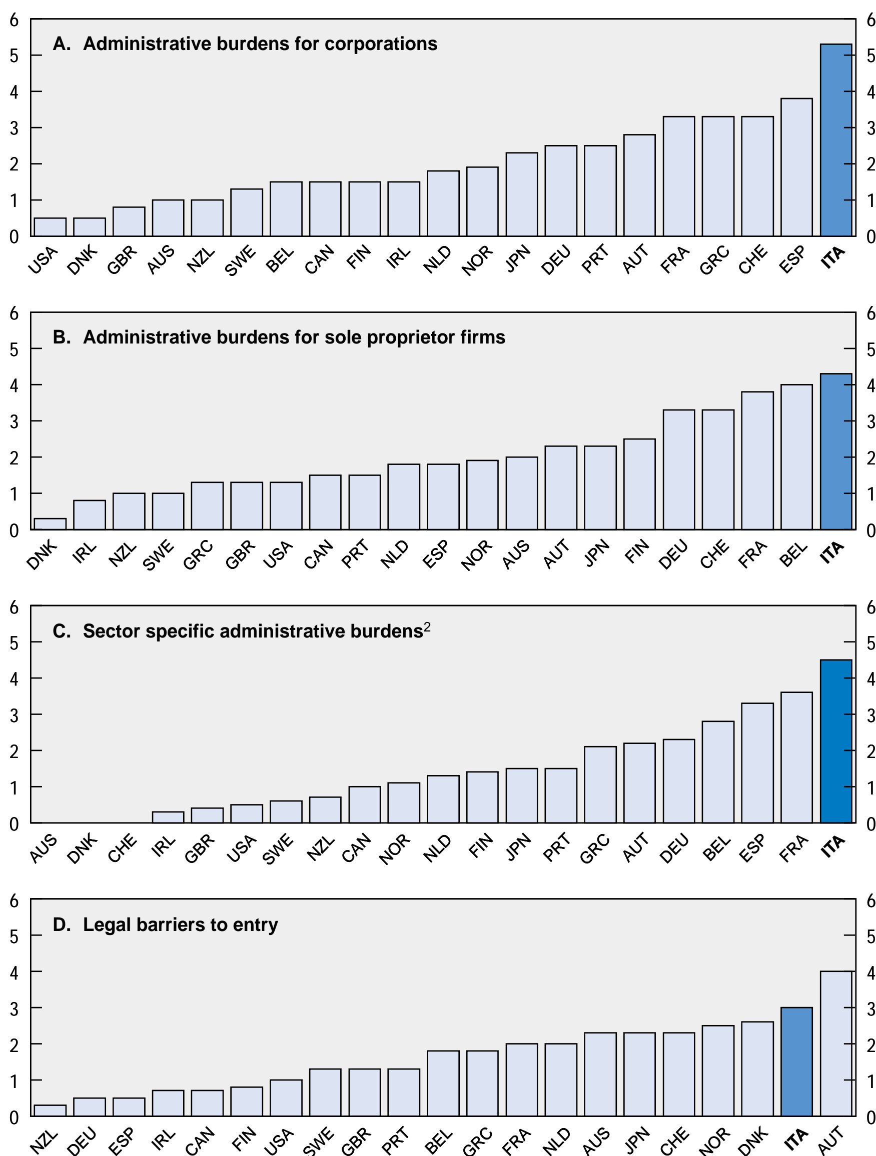
Figure 35. **Barriers to entrepreneurship**[1]



1. The scale of indicators is 0-6 from least to most restrictive.
2. Includes sector specific information on road freight, air transport, retail distribution and some telecommunications services.

Source: G. Nicoletti, S. Scarpetta and O. Boyland (1999), *op. cit.*

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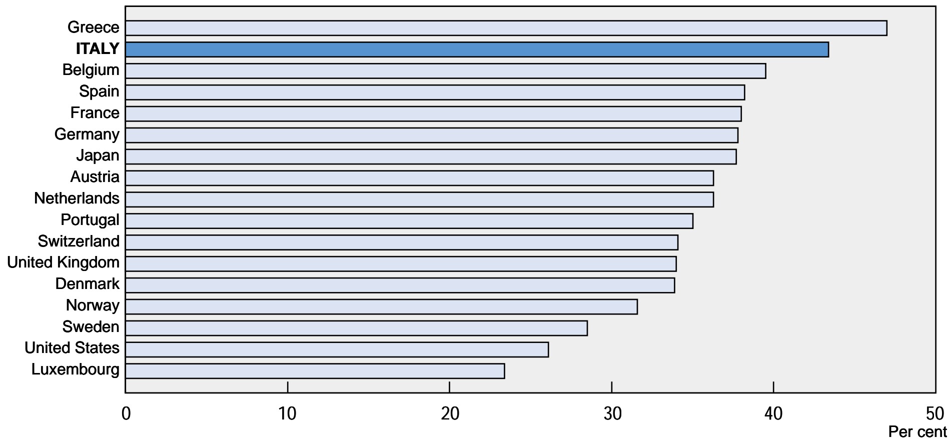
Figure 36. **Gross labour costs in banks**
As a percentage of total intermediation margins, 1996



Source: Associazione Bancaria Italiana (ABI), *Rapporto 1998 su retribuzioni e costo del lavoro nelle banche italiane ed europee.*

Nevertheless, a number of important effects of banking consolidation on entrepreneurial activities are already discernible. A key issue, particularly important from the viewpoint of the small companies is whether bank mergers and acquisitions have damaged, or even destroyed, lending relationships with small and individually-owned companies.[140] To prevent this, Italian banks involved in recent important mergers have chosen to preserve their federal structures.[141] Only time will tell whether this strategy will contain the potential disruption in lending relationships. In any case, it seems that so far large banks have acquired small banks to take advantage of the smaller bank's relations with the local small and medium-sized enterprises.[142] The experience of the United States suggests that the medium run effects may be positive.[143] Moreover, consolidation has led banks to put more emphasis on the issue of risk assessment, which has significantly improved over the last few years.[144] In connection with this, new profit opportunities have been looked for and the portfolio of banks' activities has widened. It can be expected that, as banks become more discriminating as to risk, some traditional customers may have to look for new alternative means of financing.

Evidence supporting this expectation is provided by a recent increase – though from a comparatively low basis by international standards – in the amount of resources invested in unlisted companies by investment funds, invest-

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ment banks and equity financing institutions.[145] Venture capital has also started to expand quite briskly, from a low level. A recent interesting development has been a significantly accelerating availability of funds for seed and start-up programmes, which for 1998 concerned 94 companies. However, the accelerating pattern of privatisation, along with the surge of take-overs and mergers and acquisitions, has helped to reinforce the already predominant role of large corporations in the stock market. Indeed the Milan stock exchange has experienced a fall in the number of listed companies over the last few years. By the end of 1998 privatised corporations exceeded 50 per cent of overall market capitalisation.[146] Following its privatisation in 1997, *Borsa Italiana* has undertaken several measures to bring to the market the potentially vast "equity reservoir" of the small and medium-sized enterprises. The *Nuovo Mercato* (New Market), which has been operational since June 1999, is specifically dedicated to the small and medium-sized companies with strong growth prospects. *Borsa Italiana* also provides services to its clients with a view to encouraging links between investors and potential candidates for listing. A voluntary code for listed companies was introduced in 1999, so as to foster investors' relations through the dissemination of financial information. Guidelines and recommendations have been defined in accordance with international best practices.[147]

Incentives to research and development

As discussed in Chapter I, Italy's trade specialisation in mature and low R&D-intensive products has been further accentuated over the last few years, despite the fact that the country was already a strong exporter of these goods at the beginning of the 1990s. As a matter of fact, there is no tradition of formalised industrial R&D in Italy.[148] The same factors which have contributed to the success of the small firm network and the various *distretti industriali*, – individualism and entrepreneurship, strong family ties and inefficient public administration – have contributed to hinder the development of a core R&D activity. As a result, measured in terms of GDP, overall R&D expenditures in Italy are low compared with the other Euro area countries, while business sector involvement in R&D is also quite minor (Figure 37).[149] As to patents, although Italy has gradually aligned with the other leading advanced economies, such progress has mainly been concentrated in relatively mature sectors, such as textiles, garments, transport and machine tool equipment.

R&D activities can be supported through various direct or indirect public means in Italy. Of these, one is the European Framework Programme for Research and Development which is promoted and financed by the EU. At the national level, two major incentive channels can be identified: the *Fondo di Ricerca Applicata* (FRA, the applied research fund), which is managed by the Ministry for Universities and Scientific Research, and the *Fondo Innovazione Tecnologica* (FIT, the technological

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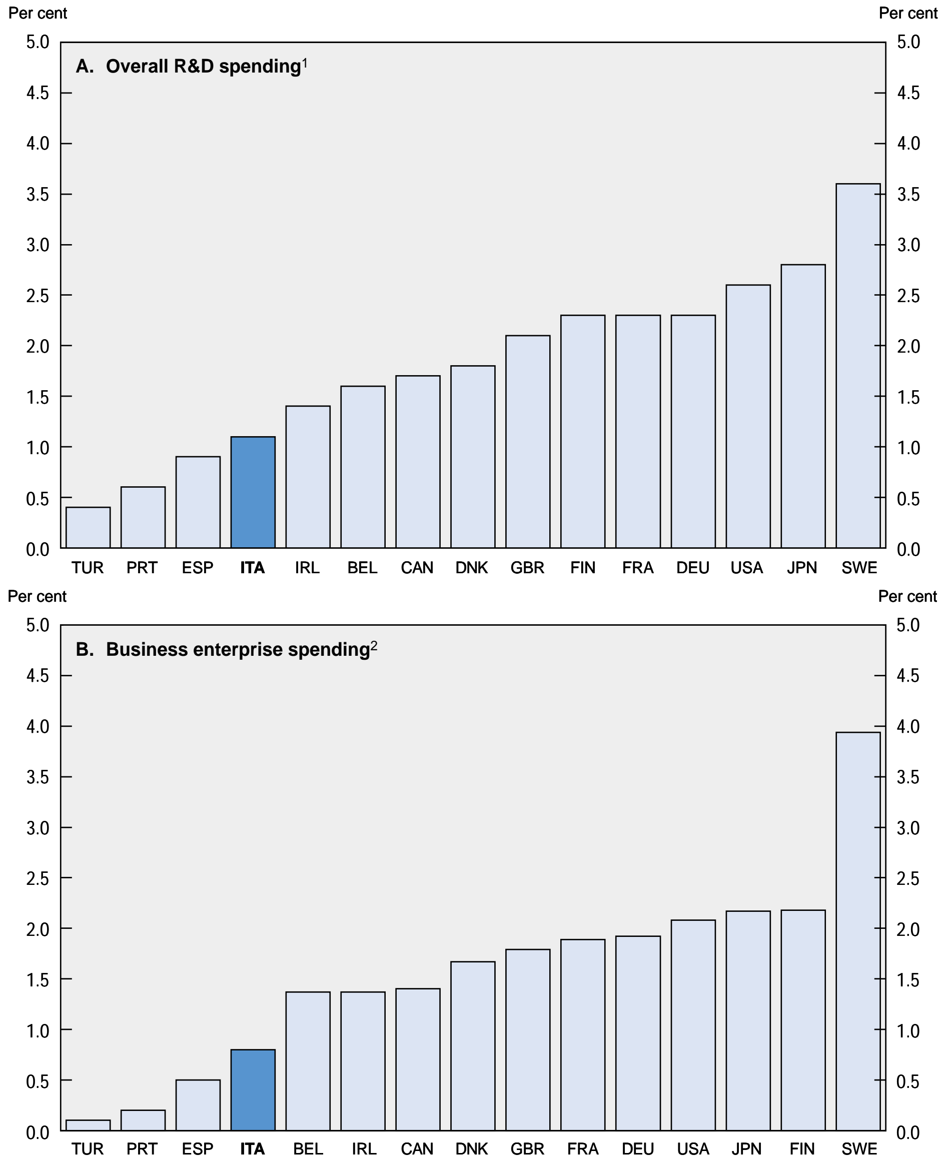
Figure 37. **Research and development spending**
1995



1. As a percentage of GDP.
2. As a percentage of business GDP.
Source: OECD (1998), *Science, Technology and Industry Outlook.*

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Box 13. A review of progress in structural reform

Proposal	Recent action taken	Assessment and Recommendations
A. Competition and entrepreneurial dynamism		
I. Increase product-market competition		
Maintain pace of privatisation	Privatisation gathered some momentum in 1999 following a temporary slowdown in 1998	Step up sale of IRI's stake as announced Ensure the establishment of a corporate governance system capable of fostering competition
Deregulate private non-financial service markets	Limited liberalisation of retail shops	Speed up the implementation of the reform of retail shops Introduce a broadly-based reform of the rules determining access to the professions; encourage the publication and dissemination of quality standards and codes of conduct
Encourage competition in the network sectors	Liberalisation of the telecommunication sector where competition is developing rapidly Competition law further widened so as to cover electricity and segments of the transport sector and the post but results have been very scattered	Ensure the active enforcement of competition rules in electricity; monitor the activities of the "single buyer" for resale to the franchise electricity market Speed up the liberalisation of the gas sector, and the dilution of state control in the railways and air transport Eliminate the existing margin of discretion in defining postal services subject to restrictions Avoid exemptions to the liberalisation of public utilities under municipal authority
II. Foster entrepreneurial dynamism		
Reduce the burden of administrative regulations	Creation of "one-stop shops"	Further reduce administrative and regulatory impediments to the expansion of small companies
Deepen financial markets and foster venture capital	Consolidated law on financial intermediation implemented in 1998	Monitor development of risk capital Continue to reduce regulatory impediments to the expansion of equity alternatives to bank credit
Modernise R&D infrastructure	Actions taken to make public funds more accessible to small firms	Ease access to R&D by small and medium-sized firms through generic support, *i.e.* by supporting projects which may have important knowledge spillover effects; avoid direct R&D subsidisation to small firms

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Box 13. A review of progress in structural reform *(cont.)*

Proposal	Recent action taken	Assessment and Recommendations
B. Progress in labour-market reform		
III. Increase wage and labour cost flexibility		
Lower tax rates	Tax reform 1997-1998	Further reduce the tax wedge in a way consistent with achieving the dual aim of cutting the budget deficit and reviewing social spending priorities
Reduce obstacles to atypical work contracts	New apprenticeship contracts; easier access to part-time work	Enlarge scope for atypical work contracts particularly by reducing remaining restrictions on the recourse to part time contracts Widen circumstances allowing recourse to temporary work contracts Reduce judicial pressures for temporary contracts to be turned into indefinite ones
Ease employment protection legislation	No more automatic transformation of fixed-term contracts into indefinite-term contracts	Make further progress to ease employment protection legislation Reduce judicial uncertainty
Link pay to firm profitability	Implementation of the 1992-93 labour agreement	Further decentralise wage bargaining without excluding co-ordination within a national bargaining framework
Redeploy and raise efficiency of labour in the public sector	Bassanini reforms (1997-98)	Implement Bassanini reforms
IV. Reduce distortions arising from unemployment insurance and related benefits		
Harmonise replacement rates and benefit periods and strengthen incentives to job search	Extension of income support by wage supplementation fund to include banks, trade and public utilities	Re-examine (as planned) income support for redundant employees Unify various programmes; link benefits to active job search Ensure a high level of complementarity between reform of income support schemes and EPL reform

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Box 13. **A review of progress in structural reform** *(cont.)*

Proposal	Recent action taken	Assessment and Recommendations
V. Improve the efficiency of labour-market policies and labour-force skills and competencies		
Use modern job-brokering techniques	Creation of private employment agencies; decentralisation of public employment offices	Further facilitate the activities of private employment agencies, allowing them to diversify their activities so as to include training programmes
Intensify monitoring of active labour-market programmes	Some action taken to simplify incentive schemes	Make further progress in simplification Provide better training through targeting special categories of individuals at the margin; avoid targeting specific sectors or activities in order to minimise risks of adverse allocative effects
Increase opportunities for vocational training	Increase off – and on – the job training	Increase training content of apprenticeship contracts Monitor the efficiency of public support schemes

innovation fund), which is responsible to the Ministry of Industry. A number of actions have been taken to make FRA funds more accessible to small and medium-sized companies. Such efforts have started to show results, as evidenced by a rising share of small firms in total authorised FRA funds (from some 16 per cent in 1995 to 25 per cent in 1996). As concerns the FIT fund, the government has launched a reform aimed at streamlining application procedures and response procedures. Tax credits are planned for companies willing to hire researchers and graduates and for research contracts commissioned from universities or other public research entities. Access to these instruments gives priority to small-sized enterprises in the *Mezzogiorno*, although the initiative is too recent for any concrete effect on the *Mezzogiorno*'s innovation capacities to become visible. The modernisation of R&D infrastructures may have recently gained further momentum, following the creation of a new umbrella company (*Società Ricerca Italia)* for public companies already operating in the domain of research.[150]

A summary of OECD recommendations contained in this Chapter is given in Box 13.

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Notes

1. See Altissimo, F., D. Marchetti and G.P. Oneto (1999), The Italian Business Cycle: New Coincident and Leading Indicators and some Stylized Facts, ISAE, *Documenti di lavoro*, No. 8/99. The composite index anticipates the actual performance of activity by approximately five months.
2. 1998 also saw the completion of the process of bringing the reserve requirements applicable to the Italian banks in line with the system envisaged under the new EMU regime. The maximum reserve ratio was lowered in three stages, the latter in December from 6 to 2.5 per cent of the reference aggregate.
3. At 5.8 per cent, ten-year government bonds are some 190 basis points higher than they were at the beginning of 1999. It should be considered, however, that long-term interest rates declined sharply in 1998, a downward movement that was exaggerated by special factors, most notably the general flight to quality in the wake of turbulence in Asia and elsewhere and the completion of convergence towards German and French rates. The increase registered in 1999 thus partly reflects an adjustment induced by a return to more normal conditions.
4. See Istituto nazionale per il commercio estero (ICE) (1999), *L'Italia nell'economia internazionale*, Rapporto ICE 1998-99.
5. For an investigation of the reasons behind the poor growth performance of Italy over the 1990s, see Buti, M., A. Carparelli, P. Sestito and M. Suardi (1999), Italy's slow growth in the 1990s: Facts, explanations and prospects, *European Economic Reports and Studies*, No. 5, Office for official publication of the EC, Luxembourg.
6. Banca d'Italia (1999), *Bollettino Economico* No. 33, October.
7. See for a wider discussion of the structural inflation problem in Italy, Visco, I. (1994), "Caratteri strutturali dell'inflazione italiana (1986-1991)", in Dell'Aringa, C. (ed.), *Caratteri strutturali dell'inflazione italiana*, Bologna, Il Mulino. See also, Barca, F. and I. Visco (1993), "L'economia italiana nella prospettiva europea: terziario protetto e dinamica dei redditi nominali", in Micossi, S. and I. Visco (eds.), *Inflazione, concorrenza e sviluppo*, Bologna, Il Mulino. See for a recent discussion, Saeraceno, F. and F. de Novellis (1999), "La posizione competitiva dell'economia italiana alla partenza dell'euro: una rassegna degli indicatori", *Contributi di ricerca IRS*, No. 47, December.
8. Effective FDI outflows are probably higher, however, judging from a negative and rising in absolute terms amount of errors and omissions in the balance of payments, which totalled about 2 per cent of GDP in 1998. The phenomenon was due in part to export proceeds reinvested abroad directly without a financial counterpart. Under the new accounting methodology introduced in 1999 in accordance with the Eurostat definitions, the error and omission item turned positive, however. See for a wider discussion, Committeri, M. (1999), "Errori e omissioni nella bilancia dei pagamenti,

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esportazioni di capitali e apertura finanziaria dell'Italia", Banca d'Italia, *Temi di discussione*, No. 352.

9. Most of this adjustment occurred during 1995-97, especially the last year, when the consolidation process markedly accelerated.
10. The revenue decline occurred despite measures in the 1998 Budget estimated to have boosted revenues by 0.6 per cent of GDP. It reflected: *i)* reductions in the tax yield on investment income due to the fall in interest rates and postponement of some payments following the reform that came into effect in June 1998; *ii)* the replacement of a series of taxes and contributions by *IRAP*, which failed to generate an equivalent amount of revenue, contrary to intentions; and *iii)* the non-recurrence of two-thirds of the special Europe surtax of the previous year, *viz.* the entire surtax on personal income and part of that on funds set aside for workers' severance pay.
11. The introduction in 1998 of *IRAP* significantly altered the composition of the general government accounts, both on the revenue and expenditure sides, thereby introducing a structural break into the various series in that year. Direct taxes declined in importance due to the abolition of the local income tax, the tax on companies' net worth, and the municipal tax on business and on the self-employed, and social security contributions declined with the abolition of health contributions. The replacement of all these taxes by *IRAP*, a tax on business net value added, increased the weight of indirect taxes. On the expenditure side, the abolition of health contributions for government workers reduced compensation of employees in the budget, while their replacement by the obligation to pay *IRAP* increased other current expenditure.
12. Under the pact, local governments committed themselves to reducing the balance on current primary expenditures less own revenues by 0.1 per cent of GDP per year (L 2.2 trillion) compared to baseline. This measure of the balance embodies a "golden rule" allowing for debt financing of investment spending.
13. This first tranche of securitised INPS credits was successfully launched in November 1999. However, the receipts from these sales were not in the end counted as 1999 budget revenues as the new accounting system is on an accrual basis (*Box 3*). In any case, the receipts went toward reduction of the 1999 borrowing requirement and debt.
14. The projected primary surplus was lowered from 5½ to 4½ per cent of GDP, the latter figure taking into account national accounts revisions to the 1998 data. *Box 3* above shows that the data revisions *per se* increased the measured primary surplus, thus only magnifying the true undershooting of the primary surplus.
15. The VAT increase partially reflected a special tax incentive to restructure dwellings, in the form of a deduction of such costs from direct income tax payments, which may have caused some spending to be brought forward insofar as the tax incentive may have been perceived to be temporary. The increase in lottery receipts was partly induced by more aggressive marketing tactics but also by the legalisation of gambling and by the broadening of the domestic net of receiving offices for bets.
16. The main increases occurred in: *i)* public sector wages and salaries following the application of the 1998-99 wage agreements; *ii)* social security benefits due to the reversal of the saving (of around 8 trillion lira) produced in 1998 by the switch from two-monthly to monthly payments of pensions; *iii)* transfers to local authorities that were mainly attributable to an increase in health expenditure; *iv)* capital expenditures reflecting the upturn in activity of local authorities, partly in connection with preparations for the Jubilee.

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17. There is a positive incentive for savings, however: for those authorities that respect the budget constraint there is a reduction in interest paid to the *Cassa Depositi e Prestiti* (Deposits and Loans Institute for local authorities) for borrowing (usually for investment purposes). The reduction amounts to 50 or 100 basis points depending on the level of savings realised.
18. The April 2000 update to the 2000 budget taking into account the March 2000 revisions to the 1999 national accounts, however, shows an upward revision of the 2000 real GDP growth assumption from 2.2 to 2.5 per cent. See Ministero del Tesoro, del Bilancio e della Programmazione Economica (2000), *Relazione sull'andamento dell'economia nel 1999 e aggiornamento delle previsioni per il 2000*, April.
19. However, the fiscal effort may be underestimated by the new methodology of calculating the baseline. Reforms to date have meant that *ceteris paribus*, the amount of new measures that would be required simply to keep the deficit on track is rather small, as the baseline deficit is already close to target. Unlike in previous DPEFs, where unchanged policies was used as the criterion for calculating the baseline budget, the new criterion is current legislation, which understates baseline spending insofar as any contractual spending (e.g., wage contracts, investment) would require new legislation in order to maintain current spending norms. Alternatively, the size of the development budget may be exaggerated by inclusion of future legislative measures that will be needed just to maintain current policies.
20. This estimate also incorporates the partially offsetting effect of a L 9 trillion loss of IRAP receipts in 1998 (see footnote 10 above), which structurally lowered the revenue forecasts for subsequent budgets.
21. Such spending includes measures to create employment, strengthen law and order, improve education and training, extend the social safety net and promote technological innovation.
22. As noted above, these amount to 0.7 per cent of GDP, slightly more than offsetting the development measures. Together with an expected fall in interest payments of 0.4 per cent of GDP, this results in a decline of the budget deficit of around ½ per cent of GDP, to 1.5 per cent.
23. These include special contributions from ENEL and Telecom Italia to cover deficits in their pension funds as well as a temporary 2 per cent cut (solidarity levy) in high state pensions (*pensioni d'oro*).
24. See Istituto di Studi ed Analisi Economica (1999), *Rapporto Trimestrale*, October; Banca d'Italia (1999), *Economic Bulletin*, October; and Centro Europea Ricerche (1999 and 2000), *Rapporto,* No. 3/1999 and No. 1/2000, for a more detailed discussion of the composition, impacts, and risks of the 2000 budget.
25. The debt accumulation stemmed from primary deficits recorded between 1965 and 1990, so that earlier generations paid low taxes compared to the level of services received.
26. Estimates based on generational accounting techniques suggest that an extra up-front fiscal adjustment would be needed to eliminate the remaining intertemporal imbalance, while delaying this effort only means a more painful adjustment later on. An analysis by the Istituto di Studi ed Analisi Economica (1999), *op. cit.*,shows that in 1998, a 5 per cent increase in taxes or, equivalently, a 5 per cent decrease in spending (*i.e.* a 2 per cent of GDP increase in fiscal pressure) would have been needed to eliminate long-run fiscal imbalances. Delaying the adjustment to 2001 raises it to a 6½ per cent

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tax increase or a 5¾ per cent spending decrease, while delaying it to 2005 raises the respective adjustments to 7¼ and 6½ per cent.

27. This is akin to the up-front fiscal adjustment needed to eliminate inter-generational imbalances as discussed in the previous footnote.
28. Linking up to the euro network also increases transparency and efficiency due to screen based trading and a centralised trading platform, with the availability of stripping facilities and large daily transactions.
29. Viewed over a longer time span, the adjustment has been even more heavily revenue-based. Between 1985 and 1997, the primary expenditure ratio declined by 1 percentage point of GDP but the revenue ratio rose by 10 percentage points. The rise of pension spending at the same time crowded out other forms of spending, notably public investment and investment grants. See Franco, D. and N. Sartor (1998), "Italy: High public debt and population ageing", study undertaken for the European Commission, July.
30. The drop in personnel costs between 1996 and 1999 also reflected the abolition of health contributions for government workers and its replacement by IRAP, a non-personnel expenditure, in 1998 (see footnote 11 above). Between 1997 and 1998, general government personnel costs fell by 3.6 per cent in absolute terms.
31. The reform was described in greater detail in last year's *Survey*.
32. As an example of such inertia, the Ministry of Cultural Affairs has received an exemption from the general reorganisation of Ministries. See Dente, B. (1999), *In un diverso Stato*, Bologna, Il Mulino, pp. 138-9.
33. Capital gains on financial assets are taxable on an accrual basis in Italy, while in the majority of countries that tax capital gains, the tax is levied on realisation.
34. On top of the central government corporate tax, companies pay the new regional tax on productive activity (*imposta regionale sulle attività produttive, IRAP*) of 4.25 per cent. The tax base of *IRAP* is value added of the net income type: both profits and interests payments (along with labour costs and other components of the value added) are taxed by *IRAP*. Depreciation allowances, including accelerated depreciation allowances, as well as intermediate inputs, are deductible instead from the tax base. When *IRAP* was introduced, *ILOR*, the net wealth tax (another regional tax collected by the central government), plus social security contribution for finance of the National Health Service and some other national and local minor taxes on business, were abolished. The reform was meant to be revenue-neutral. As of 2000 regions are allowed to increase the rate on *IRAP* by up to 1 percentage point.
35. A recent study shows that the tax wedge on the cost of labour (inclusive of IRAP) faced by companies in the manufacturing sector with more than 50 employees and positive profits may rise by up to 1.5 percentage points with respect to the situation prior to the reform. This result is mainly driven by the application of IRAP, since its tax base includes the cost of labour, and by an increase of the ordinary corporate income tax rate. However, the study points out that if the all companies faced the 27 per cent average corporate income tax rate, the tax wedge on labour would be slightly lower. See Giannini, S. (1999), "Dit e Irap e loro impatto sulla competitività internazionale delle imprese italiane", paper presented at Convegno di studio sul tema "Fiscalità d'impresa e concorrenza internazionale", Venice, 14 May.
36. It would be even higher (53 per cent) if the 1 per cent employer's contribution to the National Industrial Accident Insurance Institute (INAIL) and the 7.4 per cent mandatory employee contribution to the severance fund (TFR) were included.

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37. This system of consolidation of tax credits and tax liabilities has been gradually extended to the entire business sector.
38. See Istituto di Studi ed Analisi Economica (1999), Audizione dell'ISAE per la Commissione Bilancio, 7 October.
39. EUROSTAT (2000), *New Chrono Database*, Luxembourg.
40. Based on labour-market surveys. However, this may over-estimate the average age when a pension is received to the degree that many pensioners continue to work in the "grey market".
41. The projection assumes that the ratio of employment to the population of working age remains constant at today's level.
42. Brugiavini, A. and E. Fornero, (1999), A pension system in transition: the case of Italy, *Quaderni del Dipartimento di Scienze Economiche e Finanziarie*, No. 38, University of Turin, January.
43. Brugiavini, A. (1999), Social Security and retirement in Italy, in Gruber, J. and D. Wise (eds.), *Social Security and Retirement Around the World*, Chicago, the University of Chicago Press and Brugiavini and Fornero (1999), *op. cit.* People earning three times median earnings have a replacement rate of around 70 per cent, reflecting the existence of a cap of pensionable earnings. The lowest quintile and those earning less than 25 per cent of median earnings have a replacement rate above 100 per cent, mainly because minimum benefit provision rules apply.
44. Note that these are hypothetical rates based on a "typical" employee working for 40 years and allowing for no real increase in wages. This method probably overstates somewhat the true replacement rate for countries where the benefits are not based on earnings in the last year of employment.
45. The TFR is also used to finance periods of unemployment and thus should not be totally attributed to pensions.
46. In fact pensions are indexed to prices to varying degrees depending on their level: 100 per cent for pensions up to twice the minimum, 90 per cent for those between twice and three times the minimum and 75 per cent for larger pensions. However given the importance of the first two tiers, actual indexation is roughly 95 per cent of the price index in the aggregate.
47. This was possible after contributing for at least five years, but only if contributions were sufficient to obtain a pension benefit of at least 1.2 times the social assistance benefit.
48. A loss of pension wealth shows up with a negative value or as a positive tax when taken as a share of expected earnings.
49. The results are sensitive to the assumptions. Higher growth rates in wages reduce replacement rates. They also reduce to a large extent accrual rates and implicit tax rates. A growth in wages of 3 per cent instead of 2 per cent reduces the replacement rate of an individual with 40 year of contributions at 63 from 71 to 59 per cent. On the other hand, higher GDP growth increases them.
50. Nonetheless, accrual rates and implicit tax rates can differ depending, *inter alia,* on the assumptions regarding the tax position and wage and GDP growth. Brugiavini (1999), *op. cit.* – whose estimates used survey information on wage profiles and are on an after-tax basis – finds that there are implicit tax rates averaging around 5 per cent for retirement between 57 and 61, rising sharply thereafter.

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51. See Annex IV for a description of the Dini pension formula, which requires specifying the probabilities of survival at different retirement ages, the probabilities of being married or not, the probability of the spouse surviving by a specific number of years, and some other distributive factors.
52. Similar results have been found by Brugiavini (1999), *op. cit.,* using after-tax data.
53. This is equivalent to using GDP growth -- in this case set at 1.5 per cent -- as the discount factor to calculate the annuity corresponding to the accumulated contributions at the time of retirement.
54. For example, compare two individuals having contributed for the same number of years with one retiring one year later than the other. If pensions are fixed in real terms and real wages rise by 1.5 per cent a year, the individual retiring one year later than the other would have a pension 1.5 per cent higher. For a person having lived 20 years after retirement, his or her pension benefit would be equal to 74 per cent of those who just retire.
55. The actual system appears to have been designed to obtain a replacement rate *on retirement* that was not too different from those under the previous system. This choice of higher benefits at the time of retirement (compared to a profile of lower benefits initially and real increases thereafter) may, nonetheless, act to bring pension incomes more in line with desired consumption paths, because the consumption of the elderly tends to become progressively more restricted as they grow older.
56. Legislation to reduce the tax rate on pension-fund earnings from 12 to 11 per cent and other tax provisions was recently introduced.
57. Some enterprise pension funds existed prior to 1993, largely in the financial sector.
58. They are also referred to as *contractual* because they are mostly set up under agreements between employers' and employees' associations.
59. However, workers can open a new open fund account after contributing to a closed fund for at least five years, although transferring accumulated savings to the new fund is not allowed.
60. In addition, supplementary employer contributions to the scheme have generally been negotiated.
61. This is equivalent to 7.4 per cent of earnings for private sector employees and, under new arrangements, it will be 8.3 per cent of public sector employee earnings. While this amount is collected, 0.5 per cent is paid to social security leaving a net amount of 6.9 per cent.
62. To partially compensate for the loss of liquidity, an existing contribution of 0.2 per cent of gross wages paid by all firms to guarantee the TFR would also be eliminated and, in addition, resources to sustain the lending to small and medium sized enterprises are to be extended.
63. A fully-funded system combining the existing TFR, plus 2 per cent of earnings from both the employer and the employee would provide an annuity after 40 years of contributions of roughly 20 per cent of last earnings on the basis of an interest rate of 3.5 per cent.
64. This figure includes expenditure on *invalidità, vecchiaia e superstiti* (IVS), *indennitarie* and *assistenziali.* IVS is by far the largest component of total pension expenditure, representing 13.8 per cent of GDP in 1998. Treasury projections are based on a value of 14.2 per cent in 1998 which adds in that part of social assistance spending paid to those over 65 (0.4) to the total IVS.

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65. Only the number of pensions are available. This differs from the number of pensioners, as individuals can have more than one kind of pension: there were roughly 1.3 pensions per pensioner in 1998. Nonetheless, the two series are likely to move together over short periods.
66. Ministry of the Treasury, The Budget and Economic Planning, General Accounting Office (1999), *Update of the RGS Pension System Forecasting Model; the 1999 Forecast*, Rome.
67. Further indications of the possible trend in spending can be obtained from the INPS actuarial model, using much the same macroeconomic scenario as the Treasury, but drawing on INPS data on contributions and pensions and using a methodology based on the approach of actuaries to assess the equilibrium of pension funds. These estimates suggest that pension benefits from these funds might increase by around 1 percentage point of GDP between 2000 and 2020, remain broadly stable until 2030 and then fall by around 3 percentage points by 2050.
68. Auerbach, A. and L. Kotlikoff (eds.), (1999), *Generational Accounting Around the World*, Chicago, Chicago University Press; Sartor, N. (1999), The long-run effects of the Italian pension reform, Dipartimento di Diritto dell'Economia, Università degli studi de Verona, (mimeo), and ISAE (1999), *Conti Generazionali dell'Italia*, Rome. These estimates relate to an increase in taxes or decrease in spending from 1998. Delaying the adjustments by a year would add 2 per cent to the needed adjustment. It should also be noted that the generational accounts include the effects of other demographically-sensitive spending components, such as health care and education.
69. These data are gross spending rather than spending net of tax paid by recipients of income transfers. Since age-related transfers are taxed as income in Italy, this may overstate overall social spending relative to certain other OECD countries where this is not the case or where retirement incomes are taxed more lightly.
70. These data need to be treated with caution. There are difficulties in recording spending in the area of the frail elderly as it is often highly decentralised and care may also be provided to a greater or lesser degree by the health care sector (*e.g.* Japan). In the case of Italy, independent sources cited in Jacobzone, S. (1999), Ageing and Care for Frail Elderly Persons: an Overview of International Perspectives, *Labour Market and Social Policy -- Occasional Papers* No. 38, OECD, Paris, (Table 4) estimate spending on the frail elderly equal to 0.58 per cent of GDP for the early 1990s.
71. The share of very old persons (aged 80 and over) will rise from an estimated 3.7 per cent of the total population in 2000 to 11.6 per cent in 2050. The share of the group in the 65 and over age group will rise from 23 to 37 per cent over the same period.
72. The National Health Service (SSN) is now organised in a decentralised way. Financing comes from general taxation (part of which is placed in a National Health Fund) and paid out to regions on a capitation basis. This is intended to ensure that access to health care is available to all citizens. The Regions also obtain funds from employee and self-employed contributions. Other services outsider the SSN are often covered by private or employer-provided complementary insurance which can cover co-payments to the state system or other services. In the light of the continuing cross-country differences in supply, the State powers of oversight are being strengthened.
73. Hospital care funding is based on preset Diagnostically Related Groups (DRG's), with tariffs defined at the national level which can be marginally adapted at the regional level. Under this approach hospital admissions are classified into clinically meaningful and cost-homogeneous groups that are reimbursed according to the corresponding tariff. With the risk of cost over-runs shifted to the hospitals, this system

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discourages hospitalisation of individuals where the cost of treatment is likely to be higher than the set price.

74. *I.e.* excluding the 2 to 3 per cent already in retirement homes.

75. Activities of Daily Living (ADL) is a classification established in the United States for determining the degree of independence of the elderly. This classification laid out a number of activities (eating, dressing, washing etc.) which are needed if individuals are to live independently.

76. Lamura, G. *et al.* (1999), Elderly Care and Socio Demographic Change: Policy Implications Coming from the Italian Case, paper presented at the VI European Congress on Gerontology, Berlin, 7-11 July. The paper presents evidence showing that women caring for older parents face considerably more stress and psychological problems.

77. There have been a number of attempts to provide support for care-givers by allowing increased days of leave and up to one year of paid leave.

78. Evidence on poverty among the old suggests this is largely concentrated among older women who receive very low pension benefits (minimum benefit pensions or social assistance pension). Under the Dini reforms, pension benefits are to be linked to contributions to the system. Low labour market participation or reduced hours will reduce future income in old age.

79. Italian Treasury expenditure projections show a sustained increase in health expenditure as population ages from around 5.4 per cent in 1997 to around 5.9 per cent around 2025 and 6.3 per cent in 2050. The increase of 1½ per cent in the OECD calculations is based on the assumption that costs are linked to deaths (a high proportion of lifetime health care costs occur in the last few years/months of life), OECD (1996), *Ageing in OECD Countries: a Critical Policy Challenge*, Paris. The increase of 2½ per cent assumes that costs are linked to the number of older people.

80. Oxley, H. and M. Macfarlan (1995), Health care reform: controlling spending and increasing efficiency, *OECD Economic Studies*, No. 24, Paris.

81. Jacobzone (1999), *op. cit.*, reports evidence of longer disability-free lives in a number of countries.

82. France, Germany, Luxembourg, the Netherlands, Ireland and the United Kingdom. The Nordic countries included Denmark, Finland and Sweden. Data on expenditure per head were calculated on the basis of expenditure data contained in the OECD Social Expenditure Data File converted on the basis of PPPs and then divided by the population aged 75 and over in each country for 1995. The average was then multiplied by the Italian population aged 75 and over in that year and the ratio to GDP calculated. This gave a result of around ¾ of a percentage point of GDP. The same procedure was then carried out for Italy assuming that the population structure in 1995 was that of 2040. In this case the ratio rose to around 2 per cent.

83. Average disposable income adjusted for household size is higher among pensioners' households than for non pensioners' households. Seniority pensioners' households can be found in the upper deciles of this distribution. Pensioners with a seniority benefit are mostly concentrated among highly educated people, civil servants and the self-employed living in the northern regions of Italy, aged 50-59 years. Their income is derived by many sources: pensions account for 49 per cent of total income, while labour and capital income shares are respectively 27 per cent and 22 per cent. For details see: ISTAT (1999), *Le caratteristiche individuali e familiari dei percettori di prestazioni pensionistiche,* Rome.

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84. The value of housing wealth in the bottom two quintiles is about half the average for this age group.
85. At the level of contributions, higher income groups pay marginally higher contribution rates.
86. A minimum benefit equal to around 25 per cent of the APW income existed under the pre-Amato system but has been discontinued under the Dini system. A social assistance benefit -- which is income and wealth tested -- equal to around 20 per cent of APW is available for those having no pension rights at all or with pension rights below this.
87. These simulations were based on Eurostat population projections combined with OECD projections for structural employment out to 2005 and participation rate projections by age group by the ILO out to 2010. For the first simulation, unemployment was assumed to fall smoothly from 2005 to 2030 smoothly from current levels to a rate of 4 per cent in 2030. For the second, the participation rate of the group 20-54 of women was allowed to increase smoothly over the period 2010 to 2030 to reach a level equal to the current level for the same group of men less 10 percentage points. Finally, the estimate of raising the retirement age to 65 was approximated by allowing the participation rate of the 55-64 age group for both men and women to rise to the projected level of the participation rate of the 20-54 age group.
88. Simulations suggest that generational accounts could be brought back into near balance by an increase in the average age of retirement from an assumed 57 years to 65 years (ISAE, 1999, *op. cit.*).
89. For a wider discussion of the interactions between pension spending and private agents' savings see Rossi, N. and I. Visco (1995), National saving and Social Security in Italy, *Ricerche Economiche*, No. 49.
90. However it may imply some decline in measured productivity growth as productivity in certain services for the elderly grows more slowly as currently measured in GDP. See Baumol, W.J. (1993), Social wants and the dismal science: the curious case of the climbing costs of health and teaching, *Nota di Lavoro*, No. 6493, Economics Energy Environment, Fondazione Eni Enrico Mattei, Milan.
91. Barca, F. (1998), Interim report of the Department for Development and Cohesion Policies, *Review of Economic Conditions in Italy*, No. 3.
92. See Ministero del Tesoro del Bilancio e della Programmazione Economica (1999a), *Documento di Programmazione Economico-Finanziaria per gli anni 2000-2003*, pp. 37-39.
93. For a wider overview of Italian privatisation and the related adjustment problems, see S. de Nardis (ed.), (2000), *Le privatizzazioni in Italia*, Bologna, Il Mulino, forthcoming.
94. The rationale behind transport sector privatisation policies followed in recent years was reviewed in OECD (1999a), *Economic Survey of Italy*.
95. Ciucci, P. (1999), "Italian privatisation and corporate governance issues in the new euro environment ", paper presented at the September OECD Advisory Group on Privatisation, accessible on http://www.iri.it.
96. The sale was supended following an appeal by the municipally-owned Milan airport service company (*SEA*) against a government decree barring public entities from participating to more than a 2 per cent stake in *Aeroporti di Roma*. Following a rejection of the appeal by the regional administrative court in mid-June, SEA chose to appeal to the Council of State.
97. European Commission (1999), *Single market scoreboard*, No. 5, November.

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98. ENEL's monopoly right covered (with partial exceptions) all key features of the electricity sector, from generation to distribution along with imports. See for a wider discussion of the issue, Polo, M. and C. Scarpa (1996), Il settore elettrico italiano tra privatizzazione e timore della concorrenza, in Baldassarri, M., A. Macchiati, and D. Piacentino (eds.), *La privatizzazione dei servizi pubblici: il caso Italia*, SIPI, Rome.
99. See Paniccia, I. (1999), *Confronti internazionali di prezzo dell'energia elettrica nel 1997*, Quaderni dell'Autorità per l'energia elettrica e il gas, June.
100. Autorità per l'energia elettrica e il gas (1999a), *Relazione annuale sullo stato dei servizi e sull'attività svolta*, April, pp. 86-91.
101. *Decreto legislativo* No. 79.
102. For an in-depth discussion see International Energy Agency (1999), *Energy policies of IEA countries, Italy 1999 Review*, pp. 102-114.
103. See Briotti, M.G. and E. Notarangelo (1996), Il mercato del gas naturale in Italia tra liberalizzazione e privatizzazione, in Baldassarri M., A. Macchiati and D. Piacentino (eds.), *op. cit.*
104. Autorità per l'energia elettrica e il gas (1999b), *Le proposte dell'Autorità per la riforma delle tariffe dell'energia elettrica*, 27 November.
105. OECD (1999b), *Annual Report on Competition Policy Developments in Italy*, pp. 9-10. See also various press releases of the Regulatory Authority available on the web (http://www.autorita.energia).
106. Autorità per l'energia e il gas (1999c*), Nuove regole per la separazione contabile e amministrativa delle attività elettriche,* 16 July.
107. Implying a delay of one year compared with the original intentions of the government. OECD (1999a), *op. cit.*, pp. 102-103.
108. At the beginning of 1998, the Italian press reported extensively the case of a judicial decision compelling the FS to reintegrate into its staff a worker who had been fired 18 years earlier.
109. See Autorità garante della concorrenza e del mercato (1999), *Relazione annuale sull'attività svolta,* April, pp. 18-20. A joint venture between FS and the Swiss railways on freight traffic was signed in February 2000.
110. See Autorità garante della concorrenza e del mercato (1999), *op. cit.,* p. 19.
111. See for a detailed discussion, Heimler, A. (1999), Local public services in Italy: make or buy?, paper presented at the European University Institute, Florence, Conference on *Anticompetitive Impact of Regulation.*
112. In an attempt to accelerate approval, the government has inserted the draft law among the structural provisions linked to the 2000 budget law (*collegato alla finanziaria*). Being structural such provisions can, under new arrangements, be approved after the approval of the current provisions included in the budget law.
113. Cavaliere, A. and F. Osculati (1999), Liberalizzazione e imprenditorialità nei servizi pubblici locali, in Bernardi L. (ed.) *La finanza pubblica italiana*, rapporto 1999, Bologna, Il Mulino.
114. Some 50 managers have left the company on a voluntary departure scheme since the launching of the plan, whereas the new ones have been appointed through internal promotion mechanisms, or applying private contract rules if hired from outside the company.

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115. Ministero del Tesoro, del Bilancio e della Programmazione Economica (1999a), *op. cit.*, pp. 45-47.
116. Autorità garante della concorrenza e del mercato (1999), *op. cit.,* p. 25.
117. The Antitrust Authority recommended that they should be limited to critical social security activities (notably, health and defence), along with activities whose high degree of complexity prevents users from evaluating the quality of the service and the congruousness of the price charged. See OECD (1999b), *op. cit.,* pp. 19-20.
118. OECD (1999a), *op. cit.*, p. 120.
119. *Il Sole 24 Ore,* 28 October 1999, p. 17.
120. See also OECD (1999c), *Implementing the OECD Job Strategy, Assessing Performance and Policy*, Paris.
121. A total of 76 000 workers were employed on interim contracts in the first half of 1999, compared with 52 800 for the whole of 1998 (a 44 per cent increase).
122. See Torrini, R. (1999), "Orari di lavoro atipici in Italia: un'analisi attraverso l'indagine dell'uso del tempo dell'Istat", Banca d'Italia, *Temi di Discussione*, No. 348, March.
123. *Il Sole 24 Ore*, 21 January 1999, p. 13.
124. The summary indicator is calculated as the simple average of the summary indicators for regular and temporary contracts. See for a wider discussion, Nicoletti, G., S. Scarpetta and O. Boylaud (1999), Summary indicators of product market regulation with an extension to employment protection legislation , *OECD Working Paper*, No. 226, December.
125. OECD (1999c), *op. cit.*, pp. 121-22.
126. Two projects are waiting to be discussed in Parliament, both aimed at softening the coverage and implementation of EPL. One has been prepared and submitted in 1997 by the representatives of the majority coalition, the other has been presented in 1999 by the opposition.
127. Such schemes were discussed in detail in the *1996 Economic Survey of Italy*, pp. 74-76. See also for a wider discussion, Belli, E. and F. Rossi (1999), Disoccupati e strumenti di sostegno del reddito, in Capraris, G. de (ed.)*, Mercato del lavoro e ammortizzatori sociali*, Bologna, Il Mulino.
128. Pisauro, G. (1999), La riforma degli ammortizzatori sociali e degli incentivi fiscali per l'occupazione, in Bernardi L. (ed.), *op. cit.*, pp. 279-303.
129. *Il Sole 24 Ore*, 27 May 1997, comment by T. Boeri.
130. One source of complexity will be that insofar as pension reform is lacking, any change in social assistance benefits has to be financed from the budget. Since the reform of unemployment benefits will take effect in 2001, these financing problems have no repercussions on the current budget.
131. Boeri, T. (1996), "La *rigidità flessibile* del mercato del lavoro italiano", *Lavoro e relazioni industriali*, No. 3, pp. 61-74. See also Boeri, T. (1994), "Le politiche per la nascita e lo sviluppo delle piccole imprese", *L'Industria*, No. 4.
132. Alesina, A., S. Danninger and M. Rostagno, (1999*),* "Redistribution through public employment: The case of Italy", *NBER Working Paper No. 7387*. See also F. Padoa Schiappa Kostoris, (1999), "Regional aspects of unemployment in Europe and Italy", *CEPR Discussion Paper, No. 2108.*
133. OECD (1995), *Economic Survey of Italy*, p. 56.

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134. See for a wider discussion Accornero, A. (1999), Poter crescere e voler crescere: i piccoli imprenditori ex dipendenti, in Traù, F. (ed.), *La questione dimensionale nell'industria italiana*, Bologna, Il Mulino.
135. Summary indicators of regulations were obtained drawing from a wide spectrum of both qualitative and quantitative information from member countries. See for a discussion of the methodology involved, Nicoletti, G., S. Scarpetta and O. Boylaud (1999), *op. cit.*
136. The 1999 *Economic Survey of Italy* contained an extensive discussion of the Bassanini reforms, the scope of which extends beyond liberalisation issues and covers a wide range of public management features. See OECD (1999a), *op. cit.*, pp. 65-66. See for a wider discussion of the reform of public administration governance in Italy, Dente, B. (1999), *op. cit.*
137. *Il Sole 24 Ore*, 15 December 1999.
138. Fazio, A. (1999), *Address of the Governor of the Bank of Italy to the 1999 World-Saving Day*.
139. A new labour contract between ABI (*Associazione Bancaria Italiana*, Italian banking association) and the trade unions was signed in July ending a two year long contract negotiation. See for more details, Associazione Bancaria Italiana (1999), *Rapporto 1999 su retribuzioni e costo del lavoro nelle banche italiane ed europee.*
140. Pagano, M. (1999), Consolidation in the banking industry: causes and consequences, *Rassegna Economica*, No. 1, January-June, pp. 17-25
141. This is the case of *Unicredito*, which merged in 1998 with *Credito Italiano* to form *Unicredito Italiano*. The same is true for *Banca Intesa* which was the result of the merger between *Banco Ambrosiano Veneto* and *CARIPLO*. *Banca Intesa* and *Banca Commerciale Italiana*, which have recently merged to form Italy's biggest banking group (and one of the ten biggest in the euro area) have chosen to preserve their names. *Financial Times Survey*, *Italy*: Banking Finance and Industry, p. 2, 13 December 1999.
142. Nardozzi, G. (1999), Banca e credito nelle attuali tendenze dei sistemi finanziari, *Rassegna Economica*, No. 1, January-June, pp. 27-35.
143. Berger, A., A. Saunder, J. Scalise and G. Udell (1998), The Effects of Bank Mergers and Acquisitions on Small Business Lending, *Journal of Financial Economics.*
144. Focarelli, D., F. Panetta and C. Salleo, (1998), "Why do Banks Merge?", Banca d'Italia, *Temi di discussione*, No. 361.
145. Ministero del Tesoro, del Bilancio e della Programmazione Economica (1999b), *Italy's Report on Economic Reform,* December, p. 15.
146. Ministero del Tesoro, del Bilancio e della Programmazione Economica (1999b), *op. cit.,* p. 10.
147. Preda, S., (1993), "La riorganizzazione dei mercati mobiliari", *L'Industria*, No. 4, pp. 763-784.
148. Malerba, F., (1994), The National System of Innovation, Italy, in R. Nelson (ed.), *National innovation systems: A comparative analysis*, Oxford, Oxford University Press.
149. Ferrari, S., G. Guerrieri, F. Malerba, S. Mariotti and D. Palma (eds.) (1999), *L'Italia nella competizione internazionale*, Milano, Franco Angeli.
150. This new government initiative was included among the structural provisions attached to the 2000 budget (*collegato alla finanziaria*). It is not clear, however, the extent to which it may help both the *Centro Nazionale delle Ricerche* (the national research institute) and ENEA (*Ente Nazionale per l'Energia Nucleare*, the national institute for nuclear energy) to move towards more research in tune with firms. Since Italy abandoned its civil nuclear energy programme in the 1980s, ENEA has been struggling to find a new mission.

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Annex I

Constant market share analysis

Description of the methodology

The constant market-share analysis breaks down changes in a country's share in total OECD manufacturing exports (expressed in US dollars) into five effects. The sum of all effects gives the change of the country's market share over a given period (from 1976 to 1997 in the present exercise). Each different effect is the result of a decomposition and does not stem from a causal relationship.*

Market share effect (Mse): This effect may be taken as a measure of the competitiveness of Italian exports. It measures the shift of a country's market share arising exclusively from changes in its share within each importing country. The calculation of the Mse assumes that the weight of each importing country in world trade is constant at the beginning of the period level while also the commodity structure of its imports is fixed.

Market composition effect (Mce): This measures the shift of a country's market share arising exclusively from changes in the weight of the countries of destination in total imports. The calculation of the Mce assumes that an exporter's market share in individual commodities of each importing country is constant. Also fixed is the commodity composition of the imports of each country of destination. Thus defined, the Mce captures the effects on Italian exports of a relatively slower or faster growth of its traditional trading partners.

Commodity composition effect (Cce): This measures the shift of a country's market share arising exclusively from a redistribution of the commodity structure of world trade. The calculation of the Cce is based upon the assumption that the weight of each importing country in world trade is constant. Fixed as well is the market share of an exporter in individual commodities of each importing country. Thus defined, the Cce captures the effects on Italian exports of a comparatively slower or faster growth of world trade in the commodities in which it is specialized.

Market adaptation effect (Mae): This measures the shift of a country's market share imputable to a reorientation of its exports towards markets with above average import growth. Thus defined the Mae captures the ability of Italian exports to expand into emerging fast growing markets.

Commodity adaptation effect (Cae): This measures the shift of a country's market share exclusively imputable to a reorientation of its exports towards commodities with above average demand growth. As such, the Cae captures the ability of Italian exports to expand into the most innovative fast-growing commodities.

* Fagerberg, J. and G. Sollie (1987), "The Method of Constant Market Shares Analysis Reconsidered", *Applied Economics*, Vol. 19, pp. 1571-83.

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Manufacturing sectors

The following breakdown by sector was taken into account in the calculations:

- High-technology industries: aircraft (ISIC 3845), office and computing equipment (ISIC 3825), pharmaceuticals (ISIC 3522), radio, TV, and communication equipment (ISIC 3832).
- Medium-high-technology industries: professional goods (ISIC 385), motor vehicles (ISIC 3843), electrical machinery excluding communication equipment (ISIC 383-3832), chemicals excluding pharmaceuticals (ISIC 351+352-3522), other transport equipment (ISIC 3842+3844+3849), non-electrical machinery (ISIC 382-3825).
- Medium-low-technology industries: rubber and plastic products (ISIC 355+356), shipbuilding (ISIC 3841), other manufacturing (ISIC 39), non-ferrous metals (ISIC 372), non-metallic mineral products (ISIC 36), metal products (ISIC 381), petroleum refining and products (ISIC 353+354) , ferrous metals (ISIC 371).
- Low-technology industries: paper, paper products and printing (ISIC 34), textiles, apparel and leather (ISIC 32), food, beverages and tobacco (ISIC 31), wood products and furniture (ISIC 33).

Trade partners

USA, Japan European Union, Eastern Europe (including Czech Republic, Hungary and Poland), Asia (including Korea) , Middle East, Rest of OECD, Rest of the World.

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Annex II

Safety margins for fiscal stabilisers

Automatic stabilisers

Automatic fiscal stabilisers operate to smooth the business cycle. The impact of automatic fiscal stabilisers may be reinforced by other mechanisms such as imports, consumption behaviour, reactions in financial markets, etc. The counter-cyclical demand impulse of the stabilisers depends on the sensitivity of government lending to cyclical variations in output, which in turn depends mainly on the government sector's size, tax structure, progressivity of taxes, and cyclical sensitivity of unemployment structure and benefits. Table A1 shows that, in Italy, the sensitivity of net lending to the cycle (*i.e.* the change in net lending as a per cent of GDP for a 1 per cent change in GDP) is 0.5. This is in line with the OECD average though reflecting a lower than average expenditure elasticity offset by a higher than average tax elasticity, in particular on corporate and indirect taxes. The low expenditure elasticity derives from the relatively small dependence on unemployment-related transfers, described in the text. Fiscal reforms could change these elasticities over time. Ongoing reform of corporate taxation could lower the tax elasticity by lowering the average corporate tax rate, whereas the planned rebalancing of social expenditures in favour of more unemployment and less pension spending could raise the spending elasticity.

Fiscal stabilisers affect the economy as cyclical variations in tax and unemployment insurance act to cushion the decline or rise in disposable incomes, hence household consumption. Figure A1 shows that for Italy the impact of the automatic stabilisers on output volatility is close to the OECD average, offsetting almost one-quarter of output fluctuations. Cross-country variations reflect not only differences in budget sensitivities, but also different degrees of openness and monetary policy responsiveness.

Prudent budgetary margin analysis

The prudent budgetary margin analysis seeks to define the medium-term (cyclically-adjusted) budget position that would allow automatic fiscal stabilisers to operate to their full extent over the business cycle without running the risk that the deficit breaches the 3 per cent limit set under the Stability and Growth Pact, even in a severe recession. In a recent OECD study,[1] prudent budgetary margins are estimated for 11 EU countries in two steps: 1) estimating a four-variable VAR model in order to capture the effects of economic shocks prevailing in the past – namely a fiscal shock, an aggregate supply shock, a real private demand shock and a nominal shock – on the government net lending ratio; and 2) making stochastic simulations of the estimated VAR equations in order to obtain the confidence

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Table A1. **Tax and expenditure elasticities**

	Tax				Current Expenditure	Total balance[1]
	Corporate	Personal	Indirect	Social security		
United States	1.8	0.6	0.9	0.6	–0.1	0.25
Japan	2.1	0.4	0.5	0.3	–0.1	0.26
Germany	0.8	1.3	1.0	1.0	–0.1	0.51
France	1.8	0.6	0.7	0.5	–0.3	0.46
Italy	**1.4**	**0.8**	**1.3**	**0.6**	**–0.1**	**0.48**
United Kingdom	0.6	1.4	1.1	1.2	–0.2	0.50
Canada	1.0	1.2	0.7	0.9	–0.2	0.41
Australia	1.6	0.6	0.4	0.6	–0.3	0.28
Austria	1.9	0.7	0.5	0.5	0.0	0.31
Belgium	0.9	1.3	0.9	1.0	–0.4	0.67
Denmark	1.6	0.7	1.6	0.7	–0.7	0.85
Finland	0.7	1.3	0.9	1.1	–0.4	0.63
Greece	0.9	2.2	0.8	1.1	0.0	0.42
Ireland	1.2	1.0	0.5	0.8	–0.4	0.32
Netherlands	1.1	1.4	0.7	0.8	–1.0	0.76
New Zealand	0.9	1.2	1.2	1.1	–0.4	0.57
Norway (mainland)	1.3	0.9	1.6	0.8	–0.2	0.46
Portugal	1.4	0.8	0.6	0.7	–0.2	0.38
Spain	1.1	1.1	1.2	0.8	–0.1	0.40
Sweden	0.9	1.2	0.9	1.0	–0.5	0.79
Average	**1.26**	**1.03**	**0.89**	**0.81**	**–0.29**	**0.49**
Standard deviation	0.43	0.40	0.35	0.22	0.24	0.18

1. Based on weights for 1999. Semi-elasticity, *i.e.* change in net lending as a percentage of GDP for a 1 per cent change in GDP.
Source: *OECD Economic Outlook 66*, December 1999.

level for not breaching the 3 per cent deficit limit over different time horizons for a given initial budget balance.[2] In the second step, only shocks from non-fiscal sources are considered in the simulations in order to capture the pure movements in the deficit arising from automatic stabilisation and other induced changes to the budget. Since the amplitude of the shocks examined is a function of past fiscal behaviour (*i.e.* via the interactions between fiscal and non-fiscal shocks embedded in the lag structure of the VAR system), countries' past fiscal "reaction functions" are built into the analysis.

The findings of the study generally validate the "close-to-balance or in surplus" rule of the Stability and Growth Pact over the medium-term. For Italy, there is a high probability it would not exceed the 3 per cent deficit limit over a three to five-year horizon without using discretionary fiscal tightening, if government aimed to keep the cyclically-adjusted deficit-to-GDP ratio around 1 per cent or followed the "close-to-balance" rule (Figure A2). Over a longer horizon, such as 10 years, a surplus of at least ¾ per cent would be needed to provide the proper safety margins for Italy. This is because the longer the time horizon, the higher is the probability of a sequence of adverse events hitting the economy and hence the larger the risk of breaching the ceiling. Under this approach, the cross-country differ-

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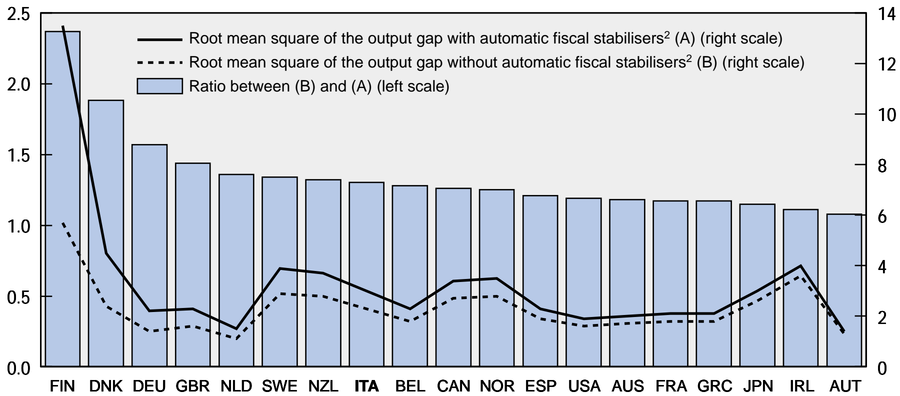
Figure A1. **The impact of the automatic fiscal stabilisers**[1]



1. Unchanged nominal exchange rates for all countries and a Taylor rule for interest rates for all countries except France, Austria, Belgium, Denmark, the Netherlands and Spain, where interest rates were kept unchanged.
2. Defined as $\sqrt{\frac{1}{9}\sum_{t=1991}^{2000} gap_t^2}$

where $gap_t = (y - y^*)/y^*$, y = GDP and y* = potential GDP.

Source: OECD, *Economic Outlook 66,* December 1999, "The Size and Role of Automatic Stabilisers".

ences in the prudent budgetary margins are related to differences in the volatility of the deficit ratio in the past, as well as to the relative importance of fiscal shocks in each country.

The European Commission has estimated safety margins for member countries considering past cyclical fluctuations and the sensitivity of the budget balances to economic swings.[3] The latter are generally close to those of the OECD (above), including for Italy (0.5). The resulting deficit targets – 1 per cent for Italy as for the other two large countries of EMU – are considered to be only "benchmarks" since they do not take into account the risk of unforeseen budgetary developments. They also (like the OECD targets) do not take into account projected ageing costs. Such costs pose a new threat to compliance with the Pact in the longer run. In Italy, ageing costs have been projected to boost the primary spending to GDP ratio by some 5 percentage points by 2030.[4] A recent study[5] shows that an additional effort of 2 percentage points of GDP would need to be built into the Commission's target – giving a budget surplus of 1 per cent – to generate interest savings sufficient to offset these effects (the Maastricht debt criterion would be reached in 10 years). Such a pre-emptive strategy is of particular interest for high-debt countries because the potential for a lower interest burden is correspondingly very high.[6] The study also concludes that the additional safety margin that would be required to cover for fiscal risks may be relatively small, given that fiscal responsibility has increased in the EMU regime.

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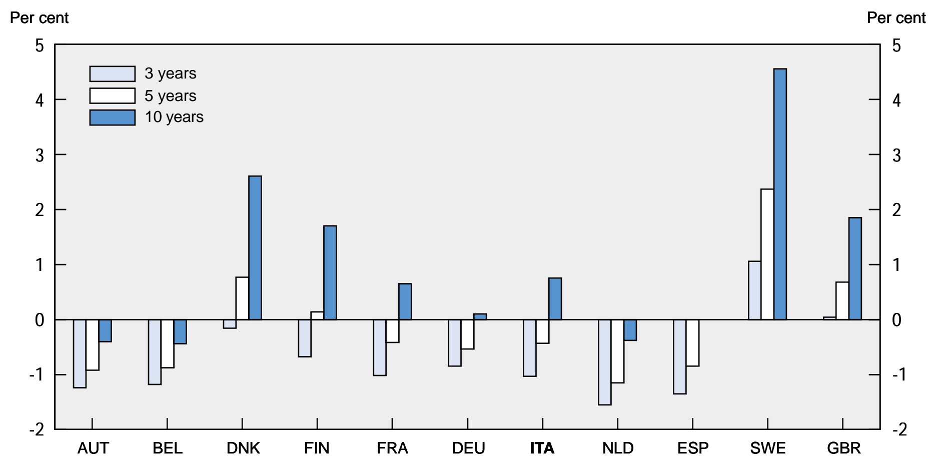
Figure A2. **Estimates of budgetary safety margins over different time horizons (90% confidence)**

As a percentage of GDP



Source: Dalsgaard, T. and A. de Serres (1999).

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Notes

1. Dalsgaard, T. and A. de Serres (2000) "Estimating Prudent Budgetary Margins for 11 EU Countries: A Simulated SVAR Model Approach", *OECD Economic Studies No. 30*, Vol. 1.
2. Each simulation generates a hypothetical path for the four variables of the model depending on the estimated lag structure of the VAR system and a random selection of non-fiscal shocks. After each simulation, the minimum values of the net lending-to-GDP ratio corresponding to different time horizons are extracted. The process is repeated one thousand times allowing the build-up of a distribution of minimum net lending for each of the relevant time horizons (1, 3, 5 and 10 years). Based on these distributions, different levels of prudent budgetary margins can be derived for different time horizons and degrees of confidence.
3. European Commission (1999), "Budgetary Surveillance in EMU: the New Stability and Convergence Programmes", *European Economy*, Supplement A, No. 2/3.
4. This figure is based on Franco, D. and T. Munzi (1999), "Ageing and Fiscal Policies in the European Union" in M. Buti, D. Franco, and L.R. Pench (eds.), *The Welfare State in Europe – Challenges and Reforms,* Edward Elgar. This study does not fully incorporate the effects of the latest (Prodi) reforms, so that the calculations may be on the high side of the spectrum for Italy.
5. Artis, M., and M. Buti (2000), "Close to balance or in surplus? A policy-maker's guide to the implementation of the Stability and Growth Pact", *CEPR Discussion Paper*, forthcoming.
6. The analysis assumes a 2 percentage point differential between nominal interest rates and nominal growth; a differential of 1 per cent would raise the required adjustment to over 3 per cent because the potential for interest savings in this case is lower. Also, Germany which has only a slightly lower ageing cost than Italy or Belgium, would have to increase its structural surplus by twice as much to bring about an equivalent fall in its interest burden, given its much lower debt ratio.

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Annex III

Debt dynamics and convergence to the Maastricht criteria

Italian debt dynamics are analysed in order to see the expected path of convergence to the Maastricht criterion that gross debt cannot exceed 60 per cent of GDP. The simulations use the following basic formula for debt dynamics:

(1) $D_t/Y_t - D_{t-1}/Y_{t-1} = P_t/Y_t + [(r_t - g_t)/(1 + g_t)] + O_t$

where:

D_t/Y_t = government gross debt as per cent of GDP
P_t/Y_t = government primary balance as per cent of GDP
r_t = real interest rate on government debt
g_t = real growth rate of the economy
O_t = other factors

Three policy simulations – namely, baseline simulation, faster growth simulation and a simulation incorporating the effects of ageing costs – are carried out under different long-term assumptions.

Baseline scenario

The key assumptions of the "baseline" simulation are that the primary surplus holds at its projected end-point medium-term plan (DPEF) level of 5¼ per cent of GDP and real interest rates stay at 4 per cent (see Table 16), while growth is built up from the following ("no policy change") assumptions: 1) demographics according to ISTAT projections which implies a declining working age population: 2) no trend increase in labour force participation and no decline in structural unemployment,[1] which together with the demographic assumptions implies rather rapidly declining employment: 3) productivity growth of 1.6 per cent per year.[2] For the years 2000-05, the potential growth calculations are overwritten by the OECD's medium-term baseline projections, which incorporate a cyclical impact on growth (by 2005 the output gap is assumed to be closed). On the basis of these assumptions, the growth rate averages just under 1 per cent over the period 2001-2050 (Table A2). Since real interest rates are higher than the growth rate of the economy, this creates adverse affects on debt dynamics, requiring a high primary surplus.

Under this baseline scenario, Italy will achieve the Maastricht criterion of 60 per cent of GDP by 2017. The speed of deficit reduction could be changed according to the magnitude of the primary surplus. If a further increase in the primary surplus is realised, say ¾ per cent more, to 6 per cent of GDP, the Maastricht criterion will be achieved four years earlier, by 2013. An equivalent decline in the ratio of the primary surplus, *i.e.* to ¾ per cent less than baseline or 4½ per cent, extends the required number of years by five, to 2022 in order to achieve the 60 per cent debt criterion.

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Table A2. **Factors affecting baseline GDP growth**

(annual average growth rates)

	Working-age population	Participation rate[1]	Structural unemployment rate[1]	Employment growth	Productivity growth	GDP growth
2001-2005	–0.3	62	10	0.0	1.6	2.5[2]
2006-2010	–0.3	62	10	–0.3	1.6	1.3
2011-2020	–0.5	62	10	–0.5	1.6	1.1
2021-2030	–0.8	62	10	–0.8	1.6	0.8
2031-2014	–1.5	62	10	–1.5	1.6	0.1
2041-2050	–1.0	62	10	–1.0	1.6	0.6
2001-2050	–0.8	62	10	–0.8	1.6	0.9

1. End-period level
2. OECD medium-term baseline projection (as of mid-April 2000).

Source: OECD calculations.

Faster growth scenario

Under this scenario, a higher growth rate of the economy is assumed, namely 1.3 per cent on the long-run average arising from policies to: push participation rates toward the EU average of around 69 per cent, reduce the structural unemployment rate by one-third by 2050, and boost productivity growth to 1¾ per cent per year by 2020 (Table A3).[3] Higher growth rates tend to speed the reduction of the debt ratio and the Maastricht criterion will be achieved by 2016.

Scenario with ageing costs

In this scenario, the growing deficit due to the ageing problem is integrated into the debt dynamics. The spending ratio is set equal to the Treasury projections (see Chapter III)

Table A3. **Factors affecting higher GDP growth**

Annual average growth rates

	Working-age population	Participation rate[1]	Structural unemployment rate[1]	Employment growth	Productivity growth	GDP growth
2001-2005	–0.3	62.0	10.0	0.0	1.6	2.5[2]
2006-2010	–0.3	62.8	9.4	–0.0	1.7	1.7
2011-2020	–0.5	64.4	8.7	–0.2	1.7	1.5
2021-2030	–0.8	66.0	8.1	–0.5	1.8	1.3
2031-2040	–1.5	67.6	7.4	–1.2	1.8	0.6
2041-2050	–1.0	69.2	6.75	–0.7	1.8	1.1
2001-2050	–0.8	69.2	6.75	–0.5	1.7	1.3

1. End-period level.
2. OECD medium-term baseline projection (as of mid-April 2000).

Source: OECD calculations.

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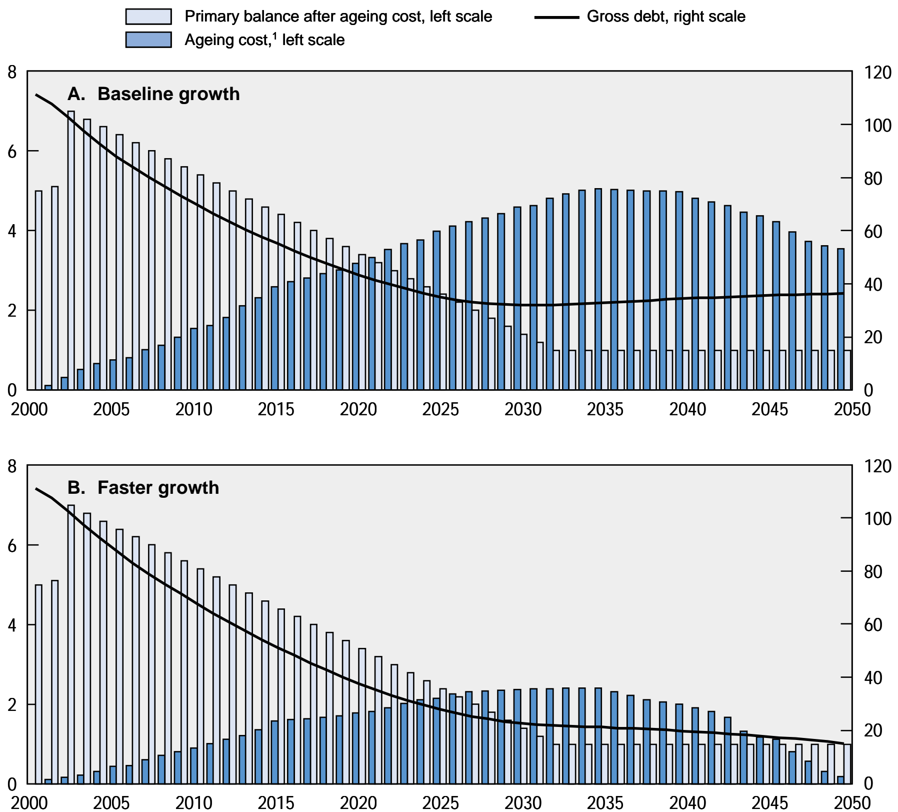
adjusted for the difference in GDP growth assumptions.[4] The contribution ratio is calculated on the basis of unchanged contribution rates and wage shares of the main categories of insured workers. The resulting pension deficit is projected to rise from 2¾ per cent of GDP currently to a peak of 7¾ per cent in 2035 under the baseline assumption and 5 per cent under the fast growth scenario. The simulations assume that since the current level of the pension deficit is already budgeted, the current primary surplus is sufficient to cover it. Any future increases in the pension deficit will require a greater fiscal effort, however. Thus, increases in the pension deficit after the year 2000 are defined as "ageing costs" and entered into debt dynamics equation (1) as part of "other" items. The required primary surplus will now need to offset the implied debt build-up due to ageing costs while also winding down the old debt.

Figure A3. **Scenario with ageing cost**

Per cent of GDP



1. Defined as incremental deficits in the pension system, compared with "base year" 2000.

Source: OECD.

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Table A4. **Debt convergence under different scenarios**

	Year when Maastricht criteria achieved	Debt ratio in 2050 (with ageing costs)		Fiscal effort (per cent of GDP, period average)[1]
Baseline scenario[2]				
DPEF primary surplus	2017			5¼: 2002-2017
¾ % higher	2013			6: 2002-2013
¾ % lower	2022			4½: 2002-2022
Faster growth scenario[3]				
DPEF primary surplus	2016			5¼: 2002 - 2016
Scenario with ageing cost				
7% primary surplus in 2002, declining to 1% by 2032:				
a) Baseline growth[2]	2013	36	*a)*	7: 2002-2016 6½: 2017-2027 5½: 2028-2041 5: 2042-2050
b) Faster growth[3]	2012	15	*b)*	6½: 2002-2016 5: 2017-2027 3½: 2028-2041 2: 2042-2050

1. Defined as the primary surplus plus the amount needed to offset ageing cost.
2. Growth averages 0.9 per cent over the 2001-2050 period.
3. Growth averages 1.3 per cent over the 2001-2050 period.

Source: OECD calculations.

The simulations show that under the baseline growth assumption, the Maastricht criterion can be achieved by 2013 with the help of a higher initial primary surplus, 7 per cent of GDP starting in 2002, which is then allowed to decline gradually to 1 per cent by around 2030 thanks to interest savings on the debt.[5] By 2050, the gross debt ratio stabilises at under 40 per cent (Figure A3). With the faster growth assumption, the same pattern of the primary surplus would achieve the Maastricht criterion by 2012, with the debt to GDP ratio tending to around 15 per cent by 2050. This could create room for decreasing tax rates in Italy relatively early on, as the debt need not fall so much as long as taxes are so high.

The required adjusted primary surplus (*i.e.*, the primary surplus plus the amount needed to offset ageing costs, or "fiscal effort") is as follows: *a)* under the baseline growth assumption, a 7 per cent "pre-ageing" primary surplus is needed during 2002-2016, declining to around 5 per cent during the last 10 years of the horizon; *b)* under the faster growth assumption, 6½ per cent is required during 2002-2016, thereafter falling more sharply and ending at around 2 per cent over the last 10 years (Table A4). It should be noted that a rapid initial debt reduction generates interest savings large enough to reduce significantly the residual required effort. Conversely, in the absence of such an effort, the convergence process gets longer with the growing burden of ageing. Under the medium-term plan assumption, *i.e.* a 5¼ per cent primary surplus exclusive of ageing costs (unchanged fiscal effort), the Maastricht criterion cannot be reached within the 50-year horizon in the baseline growth case once ageing costs are factored in.

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Notes

1. In the OECD's INTERLINK model, the trend labour force participation rate and structural unemployment rate for Italy are 62 and 10 per cent, respectively, by 2005, the end of the current medium-term baseline projection period (as calculated in mid-April 2000).
2. This represents the average productivity growth rate during the period 1999-2005 under the OECD's mid-April 2000 medium-term baseline projections. Furthermore, the IMF (unpublished) suggests a plausible range for long-run productivity growth of between 0.7 and 1.7 per cent, based on a model of "catch-up" to US productivity levels.
3. The assumptions on structural unemployment and productivity growth have been adopted in a recent meeting of the Ad Hoc Working Party No. 1 Experts Group on the Public Finance Implications on Ageing, as reasonable working assumptions for setting benchmarks against which pension systems can be compared across countries. The assumption on the participation rate is that there is some increase in the participation of older workers and that the participation rate of women converges toward that of men (ending up around 10 percentage points below that of men by 2050) although the implied increase in labour force may be overstated insofar as women tend to work more part-time than men. In order to get to a long-run growth rate of 1.5 per cent (the Italian Treasury assumption, see footnote 4), the participation rate would have to increase to around 76 per cent by 2050.
4. The Treasury calculations assume 1.5 per cent growth on average over the 2000-2050 period, compared with 0.9 per cent in the base case and 1.3 per cent in the fast growth case. Lower growth is assumed to raise the spending ratio via the denominator. Impacts on the numerator are possible (*e.g.*, lower productivity growth would lower the contribution base, and hence benefits, over time, whereas a lower participation rate would raise the number of early retirements and hence raise benefits) – but assumed to be small on balance. In the Treasury's projection, the spending ratio peaks at 15.8 per cent by 2030; under the baseline growth assumption, it peaks at 19.4 per cent by 2035, and under the fast growth assumption, at 16.8 per cent by 2030-35.
5. The chosen pattern for the primary surplus is meant to be illustrative, although the lower the starting point, the smaller the cumulative interest savings due to the debt dynamics.

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Annex IV

The Dini pension formula and retirement incentives

The Dini reform made a major change to the architecture of the pension system. This method for calculating the pension benefits creates a tighter link between total contributions made over an individual's working lifetime and total benefits received during retirement. This approach parallels that of a defined contribution system with the accumulated contributions transformed into an annuity at the time of retirement. However, the system differs from a true defined contribution system in three major respects.

- First, the contributions are notional (rather than being actually placed in a fund) and are equal to a fixed share of salary (33 per cent for employees and 20 per cent for the self-employed). This differs slightly from actual pension contributions used which are currently around 32.7 per cent for private sector employees and 16 (rising to 19 by 2008) per cent for the self-employed). Thus, the link between actual contributions and benefits is not perfect, although nearly so;
- Second, the notional contributions are indexed on a five-year moving average of GDP rather than the investment returns which could be obtained if an individual's contributions were invested in the market. One advantage of this approach is that the level of benefits will reflect, to some degree, the capacity to pay for the benefits: slower growth in GDP will be reflected in a smaller revaluation of accumulated contributions;
- Finally, and associated with the previous point, the annuity is currently calculated using an assumed GDP growth rate of 1.5 per cent as the implicit rate of return rather than a market return.[1]

Notional contributions are accumulated in notional accounts and capitalised. Thus the "stock" of capitalised contributions is equal to:[2]

$$VC_T = cr\sum_{N}^{T-1} w_t(1+g)^{T-t}$$

Where w_t are earnings at t, N is the age at which the individual started working, T is the age at retirement, cr is the contribution rate and g is the five year moving average of GDP growth.

The "stock" represented by capitalised contributions (VC_T) is transformed into a pension "flow" (P_T) based on a coefficient k_T (transformation coefficient). The coefficients of transformation are calculated such that they make the present value of the pension "flow" equal to the "stock" of capitalised contribution. That is, $VC_T = k_T.P_T$ where k_T are the transformation coefficients and P_T is the annual pension for each year of retirement T.

$$k_T = \left[\sum_{i=1}^{n}\left(\frac{1}{1+\pi}\right)^{i-1} + \varphi\bullet\alpha\bullet\beta\bullet\sum_{i=n+1}^{n+m}\left(\frac{1}{1+\pi}\right)^{i-1}\right]^{-1}$$

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The value for k_T depends not only on the length of the expected lifetime of the pensioner on retirement (n) but on the expected lifetime of the spouse (m) as well in the case he or she has reversion rights. The factors to be taken into account here are: Φ is the reversion coefficient (*i.e.* the percentage of the pension received by the survivor (currently 60 per cent); α is the probability of death of the insured individual, ß an adjustment parameter to take into account that the accumulation of individual pensions cannot be higher than the pension of the deceased as well as some distribution factors; and p the rate of return granted to pensioners on their remaining capitalised contributions, which, as noted, is currently set at 1.5 per cent.

The coefficients included in the Pension law are shown in Table A5 below. However:

- Only the numerical values of the transformation coefficients are given in the Pension Law, not the underlying formula. Also, little is known about the actual parameter values assumed or about possible subsequent *ad hoc* adjustments.
- Equality between the sum of pensions over retirement life and capitalised contributions depends on the household type specified. The same coefficients are used for all household types, while the stream of benefits will differ. For example, single-adult households with one worker will not receive pension benefits of the surviving spouse, and this will affect the overall pension wealth of the household.

In the absence of the specific coefficients used to calculate the k_T the OECD calculations estimated the neutrality of the system with respect to the retirement decision for a single worker and couple with one worker. A system is defined as neutral if pension wealth is unaffected by a delay in retirement – *i.e.* that the value of the k_T is just sufficient to ensure that the individual is not worse off if he retires one year later. This is verified by examining whether the pension wealth increased or declined when retirement was delayed for one year. These calculations took into account the following factors:[3]

- The change in the stream of benefits from retiring one year later based on the transformation coefficients indicated above. Because the annual benefits are received over a shorter period, they are higher for those retiring later.
- The contributions paid on the additional year of earnings and, hence, the higher level of accumulated contributions and associated pension benefit.
- A discount factor to allow for the effect of time preference on individual decision-making. This was initially set at 1 per cent.

The results of these calculations are shown in Tables 29 and 30 of the main text. As noted, these calculations show that the Dini reforms have resulted in a major improvement in incentives with respect to the retirement decision. After the Dini reforms are fully introduced, the replacement rates fall and the implicit tax on working an additional years is much smaller.[4] These calculations suggest that the system is probably not far from being neutral, although the full range of different household types would need to be evaluated for

Table A5. **Coefficients of transformation**

Age	57	58	59	60	61	62	63	64	65
Coefficient of transformation	0.04720	0.04860	0.05006	0.05163	0.05334	0.05514	0.05706	0.05911	0.06136

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Table A6. **Retirement incentives: alternative discount rates**

Discount rate = 3.5 per cent

Year of retirement	Years working	Single adult working						Couple with 1 worker					
		Accrual rate			Implicit tax			Accrual rate			Implicit tax		
		Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini
56	34	–0.045	–0.052		0.601	0.494		–0.039	–0.047		0.570	0.469	
57	35	–0.049	–0.057	–0.029	0.612	0.500	0.219	–0.043	–0.050	–0.023	0.581	0.474	0.181
58	36	–0.053	–0.062	–0.032	0.622	0.505	0.227	–0.046	–0.055	–0.024	0.592	0.480	0.187
59	37	–0.058	–0.068	–0.034	0.631	0.510	0.228	–0.050	–0.060	–0.025	0.601	0.484	0.186
60	38	–0.064	–0.075	–0.036	0.638	0.514	0.228	–0.055	–0.065	–0.026	0.609	0.489	0.183
61	39	–0.070	–0.083	–0.039	0.645	0.518	0.239	–0.060	–0.072	–0.029	0.617	0.492	0.190
62	40	–0.107	–0.093	–0.043	0.895	0.521	0.247	–0.094	–0.079	–0.031	0.895	0.495	0.196
63	41	–0.118	–0.105	–0.048	0.865	0.524	0.258	–0.103	–0.088	–0.034	0.865	0.498	0.203
64	42	–0.132	–0.120	–0.053	0.835	0.527	0.263	–0.113	–0.099	–0.036	0.835	0.501	0.204
65	43	–0.149	–0.140	–0.126	0.807	0.529	0.583	–0.125	–0.113	–0.108	0.807	0.503	0.583
66	44												

Discount rate = 0 per cent

Year of retirement	Years working	Single adult working						Couple with 1 worker					
		Accrual rate			Implicit tax			Accrual rate			Implicit tax		
		Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini	Pre-Amato	Amato	Dini
56	34	–0.019	–0.020		0.378	0.277		–0.014	–0.014		0.303	0.217	
57	35	–0.022	–0.024	0.006	0.427	0.313	0.062	–0.016	–0.017	0.012	0.353	0.252	0.153
58	36	–0.026	–0.028	0.004	0.474	0.349	0.039	–0.019	–0.021	0.011	0.402	0.288	0.135
59	37	–0.030	–0.032	0.002	0.521	0.385	0.023	–0.022	–0.024	0.010	0.451	0.324	0.126
60	38	–0.034	–0.037	0.001	0.568	0.421	0.011	–0.026	–0.028	0.010	0.499	0.359	0.120
61	39	–0.039	–0.043	–0.002	0.614	0.458	0.019	–0.030	–0.032	0.008	0.546	0.396	0.097
62	40	–0.072	–0.049	–0.005	1.063	0.494	0.047	–0.061	–0.037	0.006	1.063	0.432	0.076
63	41	–0.079	–0.057	–0.008	1.063	0.531	0.079	–0.066	–0.043	0.004	1.063	0.468	0.052
64	42	–0.087	–0.066	–0.011	1.063	0.568	0.104	–0.072	–0.049	0.003	1.063	0.505	0.038
65	43	–0.098	–0.076	–0.082	1.063	0.605	0.768	–0.079	–0.057	–0.068	1.063	0.542	0.768

Source: OECD.

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this be assured. Nonetheless, the implicit tax jumps sharply at 65 because the k remains unchanged for individuals working beyond 65.

However, it should be noted that the results as regards the overall neutrality of the system after the Dini reforms are sensitive to the assumptions used, particularly the rate of time discount.[5] For example, Table A6 shows the accrual rates and implicit tax rates for delaying retirement by one year using a discount rate of 3.5 per cent and 0. While this change in assumptions does not affect the relative improvement when comparing the Dini system with the pre-Amato arrangements or the increase in the implicit tax rate as retirement is delayed beyond 65, the overall implicit tax falls as the discount rate is reduced.

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Notes

1. This will be negotiated in the middle of the next decade and every ten years thereafter. These negotiations will also consider changes to life expectancy.
2. All formulae are expressed in real terms.
3. The calculation method was as follows. Taking two typical household types (single adult working household and a couple with one worker) the pension contributions were calculated in real terms assuming that individuals start work at age 22 with wage rates rising at 2% and GDP increasing at 1.5 per cent and a notional pension contributions at a rate of 33 per cent of earnings. The stream of pension benefits was then calculated using the coefficients indicated above for each age of retirement. Pension wealth for each age of retirement was then calculated as the sum of the stream of pension benefits using OECD data on average lifetimes at age 60 (*OECD Health Data File*), discounted at a rate of 1.5 per cent. The accrual rate for each age was then calculated as the change in pension wealth (as a per cent) resulting from the delay of retirement of one year — say, 57 to 58 or from 63 to 64. In cases where the accrual rate is negative, pension wealth declines as retirement is delayed, indicating that pension wealth can be maximised by retiring earlier. The implicit tax rate is the negative value of the change in pension wealth taken as a per cent of the projected earnings received during the additional year of work (using the same assumptions as above). A positive value indicates that some part of the increased earnings from an additional year of work will be offset by the loss of pension wealth.
4. This fall may be over-estimated to the degree that they are calculated before allowing for income tax. Since higher pension income (in individual years) associated with later retirement will be taxed more heavily under the existing progressive income tax system, the value of pension wealth is progressively reduced (relative to the pre-tax values) as retirement is delayed.
5. In other words, whether individuals judge that benefits received a long time in the future are worth less to them than benefits received at the start of retirement.

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Annex V

Chronology of main economic events

1998

October

Following the fall of the Prodi government, a new Centre-left government headed by Mr D'Alema comes into power.

1999

January

The conversion rate of the lira to the euro is set at L 1 936.27 and the responsibility for setting monetary policy is shifted from the Bank of Italy to the European Central Bank.

Launch of *Sviluppo Italia*, a holding entity for eight public companies already operating in the *Mezzogiorno*.

Parliament approves a resolution adopting the Social Pact for Growth and Employment agreed by the government and trade unions in December 1998. The Pact reaffirms the practice of concertation initiated with the income policy agreements of the early 1990s.

The first Stability Programme in accordance with the EU Stability and Growth Pact is approved by the Council of Ministers of the EU.

March

The government downgrades its initial real GDP growth projection for 1999 from 2.7 to 1.3 per cent and correspondingly raises the deficit target from 2 to 2.4 per cent.

The government issues a decree law providing for temporary tax breaks to new investments (*Legge Visco*).

The government releases extra employment funds to finance training, part-time jobs and traineeships for unemployed.

The government approves a legislative decree allowing for a greater number of operators in the electricity sector, wider access to the network and reduced controls.

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April

Olivetti Tecnost launches a hostile take-over bid to buy the telecommunication utility, *Telecom Italia*, which was privatised in 1997.

The National Statistical Institute (ISTAT) revises national accounts in accordance with the guidelines of the European System of Accounts (ESA95), so as to contribute to the harmonisation of the accounting framework, concepts and definitions within the European Community.

May

The decree establishing the introduction of one-stop shops for companies willing to expand their businesses comes into effect.

June

The Bank of Italy, which is entrusted with supervisory issues in banking mergers, authorises the merger between Banca Commerciale Italiana and Banca Intesa. The new bank is the largest in Italy and one of the ten biggest in the euro area.

July

ISTAT completes the revision of the labour force survey to follow the EC definition. For the period from October 1992 to April 1999 the number of employed is revised upwards by on average 90 000 units per quarter (0.4 per cent).

The government submits to Parliament the 2000-2002 medium-term economic plan which envisages a general government deficit target of 1.5 per cent of GDP in 2000 and 1.0 per cent in 2001, while also aiming at a further deficit cut in the next year.

Adoption of law enabling a major ministerial consolidation in the next legislature, whereby the number of ministries will be reduced from 22 to 12.

The government issues a legislative decree intended to implement the European Commission directive on the liberalisation of the postal service.

September

The government presents budget proposals for 2000 reaffirming the target for the general government deficit set out in July (1.5 per cent of GDP).

October

The Treasury sells the first tranche of ENEL, the national electricity company, through a public placement (L 32 trillion).

November

The Treasury authorises the sale of the totality of its stake in *Mediocredito Centrale* to *Banca di Roma*.

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December

The D'Alema government resigns shortly after the approval of the budget bill. A new government headed by Mr D'Alema is appointed.

The 2000-2006 Development Programme for the *Mezzogiorno* is accepted for consideration by the European Commission.

2000

January

The legal separation between railway services and infrastructure becomes operational.

The fixed segment of the telecommunication market is opened to competition.

The government finalises a reorganisation plan for *Sviluppo Italia*.

February

The government finalises the liberalisation plan for the gas sector.

The second Stability Programme in accordance with the EU Stability and Growth Pact is approved by the Council of Ministers of the EU.

March

ISTAT releases new national account figures in accordance to the European System of Accounts (ESA95) whereby for the period from 1996 to 1998 the rate of real GDP growth is revised upward by between 0.2 to 0.3 percentage points.

April

Prime Minister D'Alema resigns following the results of the regional elections on 16 April. President Ciampi charges former Treasury Minister Amato to form a new government.

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