



**OECD Economic Surveys**

**ITALY**





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## **Italy**

### **2007**



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

# ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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*The Secretariat's draft report was prepared for the Committee by Alexandra Bibbee and Benoît Bellone, under the supervision of Patrick Lenain.*

*The previous Survey of Italy was issued in November 2005.*

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## BASIC STATISTICS OF ITALY

### THE LAND

Area (thousand sq. km.)	301.3	Population of major cities (thousands, 20.10.2001)	
Agricultural area (thousand sq. km, 1995)	165.2	Rome	2 547
		Milan	1 256
		Naples	1 005
		Turin	865

### THE PEOPLE

Population, 31.12.05, thousands	58 751	Labour force, 2006, thousands	24 481
Number of inhabitants per sq. km	195.0	Employment, 2005, thousands	22 306
Net natural increase, 2005, thousands	-20	In agriculture	947
Net rate per 1 000 inhabitants, 2005	-0.3	In industry	6 940
		In services	14 484

### THE PRODUCTION

Gross domestic product in 2006, billions of euros	1 476.7	Origin of gross domestic product in 2005	
GDP per head (2006, USD)	31 720	at market prices, per cent of total	
Gross fixed capital formation		Agriculture	2.3
Per cent of GDP in 2006	20.8	Industry	20.8
		Construction	6.0
		Other	70.9

### THE PUBLIC SECTOR

Current expenditure in 2006 (percentage of GDP)	50.1	Gross financial liabilities in 2005 (percentage of GDP)	120.0
Current revenue in 2006 (percentage of GDP)	45.6	General government investment in 2003 (percentage of total investment)	16.3

### THE FOREIGN TRADE

Exports of goods and services in 2006 (percentage of GDP)	27.9	Imports of goods and services in 2006 (percentage of GDP)	28.7
Main export categories in 2006, as a percentage of total exports		Main import categories in 2006 as a percentage of total imports	
Manufactured goods	34.6	Foodstuffs	6.3
Fabric and textile goods	12.5	Manufactured goods	22.5
Chemical products	9.7	Metal, ores and scrap	15.0
Transport equipment	4.7	Chemical products	12.7
Mineral fuels	0.3		

### THE CURRENCY

Monetary unit: Euro		Currency units per USD, average of daily figures:	
		Year 2006	0.7967
		April 2007	0.7402

## Executive summary

**A**welcome economic recovery is under way in Italy. In part, this reflects the cyclical upswing in the rest of Europe, but there are also early signs of a more fundamental improvement, notably in terms of export and labour market performance. Even so, medium-term prospects remain challenging: total factor productivity shows little signs of resurgence, high public indebtedness threatens fiscal sustainability and population ageing looms large. Without further reforms to restore economic dynamism, living standards will be dragged down relative to other countries. This Survey discusses policies undertaken by the government to address these challenges, notably to boost competition on product markets, achieve fiscal sustainability and make fiscal federalism work – all in support of growth and adjustment.

**Boosting competition among providers of services.** Total factor productivity growth has stagnated since the start of the decade, not responding to technological innovation like in other OECD countries. This, in large part, results from the prevalence of competition-restraining regulatory policies. The government has recently adopted two helpful packages of liberalisation in areas such as retail trade, liberal professions and banking. Yet, it is crucial that the liberalisation process continues as there is still scope to strengthen market forces. There is a need to reduce government interventions in the enterprise sector, lower local barriers to retail trade, suppress excessive licensing requirements in professional services, restrain the influence of professional associations and enhance competition in retail banking. This would fuel competition, putting downward pressure on prices and leading to consumer-friendly outcomes.

**Achieving fiscal sustainability.** Even though buoyant revenues brought down the public deficit last year, Italy should maintain a prudent fiscal policy in 2007 and beyond, in view of the high public debt, which is still above 100% of GDP. The government's objective to raise the primary surplus to 5% of GDP by 2011 seems adequate to ensure fiscal sustainability and create the room for an eventual alleviation of the tax pressure. However, it should be possible to reach this target ahead of time. In this respect, the blueprint for public administrative reform agreed with the trade unions demonstrates good intentions but its implementation remains uncertain. Fiscal sustainability also hinges on the full enactment of pension reforms; it is therefore regrettable that the already legislated adjustment to life expectancy was delayed and that the legislated step increase in retirement age is now being reconsidered.

**Making fiscal federalism work.** Italy has started to decentralise the provision of public services to lower levels of government. This is a promising development that could improve the allocation of resources in the economy and enhance the accountability of government. But the process of decentralisation has run into teething problems, notably on the financing side. Transfers to subnational governments are still largely based on historical spending, weakening incentives to develop local tax bases and be efficient in spending. Next steps should include tying regional equalisation transfers to objective structural parameters such as "standard costs" and own tax capacity. This would help eliminate soft budget constraints and improve incentives to promote local development. As well, the functioning of the internal stability and health pacts could be improved via sanctions that "bite"; for instance, health deficits should not be covered ex post, nor debts be assumed without involving strong accountability of local officials.

## Assessment and recommendations

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### *Italy's recent economic trends have been looking up*

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A welcome economic rebound is underway in Italy. After having recorded real GDP growth of 1.9% last year – below the average for the euro area, but above the potential rate – growth is set to maintain that pace in 2007. While this partially reflects ebullient foreign demand, there are also early signs of more fundamental improvements. Some Italian exporters have regained export market shares in the segment of high-quality consumer items and machinery to produce them, in which they have traditionally specialised. The rapid increase of export prices may signal that these firms have recouped some of their pricing power and moved upscale towards highly-priced products. However, there are also firms that failed to restructure, innovate or outsource and must still downscale, as suggested by the overall decline of profitability and continuing loss of export market shares in the aggregate. The fact that Italy's export structure remains heavily biased towards low-skill production, hence exposing it to competition from emerging market economies, continues to handicap growth.

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### *Employment gains have been impressive*

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In addition to early signs of export revival, labour market performance has been impressive. The level of job creation has been remarkable, bringing down the unemployment rate sharply, below that of neighbouring countries. Several forces seem to have acted in boosting employment gains. *First*, there has been a long period of wage moderation in the private sector following the renegotiation of wage contracting arrangements (elimination of *scala mobile*) in the early 1990s, bringing to a halt past overruns in real wages. *Second*, the reform of labour contracts and taxation have triggered a surge of atypical jobs, notably part-time and fixed-term contracts for low-skilled workers with reduced social security contributions. *Third*, inward migrants have contributed positively by filling vacancies unoccupied by Italian workers, helping to get a better matching and lowering structural unemployment. *Finally*, the regularisation of migrants has helped the functioning of the labour market, not by directly creating new jobs (existing jobs were brought into the formal economy), but by allowing migrant workers to build up their skills and move upscale in their careers. The burst of new jobs has been highly beneficial, but the increase in labour market flexibility implied by rising fixed term contracts (some 12% of total employment) has mainly affected workers at the margin of the labour market, as the protection of workers with indefinite contracts remained untouched. There is a need for rebalancing employment protection legislation so as to reduce labour

market duality, while still providing adequate security for workers. Other employment issues also remain unresolved. Levels of participation are low in the formal economy, notably among women and older workers, making it crucial to reduce marginal effective tax rates, particularly for groups with high labour supply elasticities, and to implement the increase in the pension age. There are large regional gaps in labour market participation and unemployment rates, which is a source of unrealised growth potential.

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### *But the Italian economy still faces daunting challenges*

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Notwithstanding the early signs of better export and employment performance, it is too soon to say that the economy has turned the corner. Italy's trend growth was held back by the weak growth of total factor productivity (TFP) during the latter half of the 1990s, and TFP growth further declined during the first half of the present decade, particularly in manufacturing. In the service sector, there has not been the type of productivity acceleration witnessed in other countries following the diffusion of new technologies. Special factors such as immigrant regularisations could have contributed to depress measured productivity growth, though to a relatively minor extent. Other explanations have been put forward to explain this sluggishness, such as the entry of low-skilled workers on the labour market. As well, weak investment in research and development may reflect the specialisation of firms in traditional sectors, such as textiles and automobiles, and the prevalence of small family businesses, which appear to be less prone to innovate. While acknowledging these factors, analysis presented in the present *Survey* suggests that the stagnation of productivity results mainly from the setting of structural policies and their effects on human capital utilisation and market competition. Structural reforms to boost productivity are therefore essential to spur economic dynamism. Otherwise, Italy may very well face a long-lasting slowdown in income growth, widening the gap vis-à-vis other OECD countries.

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### *Key policy challenges need to be addressed*

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A variety of structural policy settings exert a drag on trend economic growth. The stifling of competition in the sector of services reduces incentives for firms to operate efficiently, invest into innovative technologies and undertake organisational changes. As well, regulations give firms incentives not to expand, notably thresholds in labour market regulation and in some tax provisions, so they mostly stay small and remain unable to exploit scale economies. The inefficient judicial system deters business development, as investors run into difficulties in enforcing their legal rights, although the bankruptcy reform enacted at the end of 2005 goes in the right direction. The equity market is not deep enough and competition in the financial system should be increased so as to support enterprise growth and risk-taking. The weak level of educational achievement by international standards is an impediment to the expansion of living standards relative to many OECD countries. In addition, achieving fiscal sustainability is a precondition to enhance long-term economic growth. The high public debt ratio prevents significant reductions in the tax burden; yet tax cuts would be necessary to restore work and employment incentives. A solution must be found in the restraint of discretionary public spending, but past efforts in this direction have failed, as shown by the strong growth

momentum of primary public spending, notably at the regional level. The Italian authorities are determined to confront all of these challenges and have outlined a strategy for this purpose in the *Documento di Programmazione Economica e Finanziaria* adopted in July 2006 (DPEF 2007-11). The five policy priorities outlined in *Going for Growth* also encompass a variety of these goals. While past *Economic Surveys of Italy* discussed challenges related to the labour market and human capital which remain important, the present one focuses on:

- Liberalising competitive forces, via easier regulatory burdens, so as to boost productivity.
- Ensuring fiscal sustainability, via spending restraint, so as to lower debt and allow tax cuts.
- Making fiscal federalism work, via improved policy rules, so as to enhance public services.

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#### *Competition-restraining regulatory policies hamper productivity*

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Over the past decade, TFP growth has been dramatically slow in the sector of services, representing a missed opportunity for Italy. This was in sharp contrast with developments in leading OECD countries such as in the United States and certain Nordic countries where productivity growth surged in the service sector, notably in retail trade and financial services. Acknowledging increasing evidence that competition-restraining regulations contributed to this sluggish performance, the Italian government recently passed two major packages of liberalisation in areas such as retail trade, taxis, pharmaceuticals, professional services, local public services and retail banking. Even though some of these measures are symbolic (opening barber shops on Monday) and some of them were only half-heartedly implemented (taxis), most of them should help reduce barriers to entry, cut bureaucratic red tape, expand consumer choice and diminish rents in protected sectors – and are therefore welcome steps forward to boost competition and revive productivity. The momentum of liberalisation efforts should be preserved, as there is still scope to enhance competition further.

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#### *The most stringent restrictions for professional services have been relaxed but major constraints remain*

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In the sector of professional services (such as lawyers, pharmacists, accountants and notaries), the Bersani decree laws removed some of the most protectionist regulations among European countries. Minimum tariffs were banned and advertising was allowed for informative purpose. However, barriers to entry are still high. Important steps forward could include *replacing excessive licensing requirements by other mechanisms such as certification, fully liberalising advertising, removing quantitative restrictions and holding back the influence of firm or professional associations*. This would surely accelerate the process of commercialisation of professional services, thus fuelling price competition and accelerating productivity gains – to the benefit of consumers.

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### More liberalisation is needed in retail and wholesale trade

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Enhancing competition is of paramount importance in the sector of retail and wholesale trade as market contestability, productivity and job creation seem low. The “Bersani decree” removed many restrictions at the central level. The sector however remains heavily regulated at the local levels, notably by zoning restrictions, creating risks that vested interests hamper the recent liberalisation. As national competition authorities do not have the capacity to review and correct local restrictions, *competition “watchdogs” should be established at the regional level and be empowered to monitor their local authorities, applying a checklist of pro-competition practices defined at the national level. Besides, shopping hours could be relaxed.* As experiments suggest, further liberalisations could have large positive effects: higher productivity coupled with lower margins should push down consumer prices, while consolidation of traditional small stores is likely to be balanced by net gains in job creation.

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### Public ownership and government controls should be reduced

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State control of the enterprise sector is still comprehensive in Italy relative to other countries, despite past privatisation programmes. According to the OECD product market regulatory indicators, government involvement remains large in business operations, direct control of companies is significant and the size of the public enterprise sector is still above average. *Hence, divestiture programmes should be continued, notably in the sectors of media, transportation and public utilities.* The Italian government retains golden shares in some divested companies operating in “strategic sectors”, such as energy. Although a law passed in 2003 significantly reduced the scope of golden shares, *the authorities should explore whether alternative arrangements – such as appropriate sectoral regulation and strengthening independent authorities – might in the future replace golden shares, so as to conform to OECD and EU recommendations and avoid discouraging foreign investment.*

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### More transparency is needed in the procurement of local utilities

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Local public services (such as public transport and water distribution), which are often in the hands of municipalities, must improve their quality and reduce operating costs. By allowing private companies to bid for the provision of public services, the “Bersani decree” may help to spur competition and efficiency. However, there is a lack of transparency and market contestability in local bidding procedures. Even though the “Lanzillotta decree” goes in the right direction by requiring more competitive practices and transparency in procurement procedures at the local level, more needs to be done. *For instance, the proposed competition “watchdogs” at regional levels could carefully monitor tendering procedures and quality of services to guarantee pro-competitive behaviour.*

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### Banking sector restructuring is regaining momentum

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The restructuring of the banking system is speeding up. After the wave of concentration, involving small-scale banks during the late 1990s, there has been foreign bank entry onto the Italian financial scene through acquisition of controlling interests in two major local institutions, and there have been mergers among the largest domestic banking groups. New legislation has reshaped and streamlined the bodies responsible for regulating the financial sector, giving to the Competition Authority the power to deter anti-competitive practices in the sector. The first “Bersani decree” prohibited bank account closing fees and the Bankers’ Association has reacted to recent criticisms by encouraging greater transparency in fee-setting. New procedures are being put into place to further reduce the costs of switching banks. New codes were enacted in order to improve the quality of corporate governance and financial market transparency. However, competition between intermediaries in serving customers must remain the cornerstone of regulations governing bank-customer relations. *To stimulate competition in retail banking and help reduce banking fees, it will be important to enact the “Bersani decree” in a fully transparent manner and in co-operation with the competition authorities. The authorities and banking association should continue to make it easier and less costly for bank customers to switch banks.*

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### The fiscal position improved in 2006

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Buoyant tax revenue helped the budget last year, in combination with greater spending restraint. The general government deficit reached 4.5% of GDP, but adjusted for deficit-increasing special transactions (VAT refund ordered by the European Court and high speed railways debt forgiveness), it was only 2.5% of GDP on a national accounts basis (4.4 and 2.4%, respectively, on Maastricht definition), while subtracting all one-off measures it was 3¼ per cent, in any case better than expected. The strong outcome during the past year reflects to some extent the cyclical upswing and its effect on tax collection, as well as stricter control on current expenditure. In addition, the regular automatic stabilizers were magnified by special factors such as high VAT receipts on energy products (which are difficult to evade), higher business profits and the exhaustion of earlier years’ loss carryover provisions. As well, measures in the 2006 Budget to improve compliance gave better than expected results in a context of growth optimism, notably with respect to revaluation of firms’ assets. A residual in the buoyancy of revenue is yet to be explained. There are indications that the government’s tough stance against tax fraud and the welcome decision to bring tax amnesties to an end may well have generated greater compliance across the board, and to that extent the benefits would be permanent rather than transitory. Revenue inflows have remained strong in the first months of 2007, confirming that the revenue buoyancy appears to be continuing. Nevertheless, there is some degree of uncertainty, which the budget takes into account, as to how much of this buoyancy will be repeated in the year as a whole.

### Fiscal discipline is required to preserve budgetary gains

Based on the approved budget, things are looking up for fiscal performance in 2007. Preliminary indications for the first few months suggest that some of last year's tax buoyancy might carry forward to this year. The budget will also be helped by new measures to raise revenues. This includes a mix of higher tax rates, further steps in the fight against evasion and the transfers of part of the flow of worker severance pay contributions (*trattamento di fine rapporto* or TFR) to the government. The overall rise in tax pressure is being held down by cuts in the company value added tax (IRAP) amounting to 3 percentage points of the overall tax wedge for the average worker, more generous for poorer regions, but targeted to companies hiring workers on permanent contracts. The TFR transfers are earmarked to specific projects, mainly infrastructure, set out in the 2007 budget, while at the same time representing general government revenue. However, their positive budgetary impact is expected to fade away over the next 8-9 years, when additional revenues and expenditure obligations attached to TFR liabilities will balance out. At the occasion of its periodic review of budgetary prospects, in March, the government reduced its budget deficit projections from 2.8% to 2.3% of GDP, reflecting the strong outturn of the past year and upward revisions in the growth projection. *The authorities should seek to build on last year's fine outcome and make further consolidation in 2007, so as to preserve hard-won gains and make further steps towards achieving fiscal sustainability.* This will not be easy, as there is already political pressure for a boost to spending, or early tax reductions. The parliamentary commitment to enact tax cuts for the amount of extra revenues coming from the fight against tax evasion is a source of concern. Such policy changes would be premature and would make the medium-term budgetary prospects more difficult, in particular if the revenue windfall gains turned out to be temporary. *Insofar as revenues continue to over-perform in the present budget, this should be entirely used to reduce the deficit further rather than for ratcheting up public spending or cutting taxes, in view of the still high level of public indebtedness.*

### A new fiscal rule must focus on spending restraint

Beyond these short-term prospects, the government aims at increasing the primary surplus to 5% of GDP by 2011, its level upon EMU entry, which would accelerate the projected downward trend in the debt ratio. This is a welcome objective because Italy's public debt ratio of 106.8% of GDP – the second highest in the OECD – most likely impedes growth. The budget has performed more strongly than expected since this medium-term objective was adopted. *Therefore, it should be possible to reach the 5% target ahead of time.* Responding to recent calls for increased spending in social protection, day care, education, research, and infrastructure – areas that suffered from past budget stringency – would make this objective more difficult to undertake. The ratio of primary spending to GDP has risen inexorably since EMU entry and is now at a post war high, illustrating the importance of strengthening the fiscal stance. *It is therefore important that the fiscal consolidation hinges on expenditure discipline, notably in pensions, public employment, health and local spending as stated in the DPEF, in view of high tax pressure and low potential growth.* The initiative of the Italian authorities to carry out a “spending review” and to reform the budgetary process, in order to improve efficiency and effectiveness of non-entitlement public spending, is welcome.



Within this process, the government should consider introducing medium term expenditure caps to constrain the growth of primary spending – for example, a ceiling consistent with zero real increase in central government primary spending until the primary surplus reaches 5% of GDP. Future tax cuts should be strictly matched by lower spending over and above that which is needed for deficit reduction.

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### *Pension reform should be implemented*

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In this context, it will be particularly important to enact already legislated pension reforms, namely: i) the step increase (scalone) in the minimum age to receive seniority pension benefits, from 57 currently to 60 (61 for the self-employed) in 2008 and rising further to 62 (63 for the self-employed) starting from 2014; and ii) the 10-yearly adjustment in the actuarial transformation coefficient to account for rising life expectancy, the first one having been due in 2005 but not yet enacted. However, these are being called into question by the trade unions and are currently the subject of discussions with the government. The authorities have estimated that failure to enact the reforms would boost pension spending by almost 2% of GDP over the long term, which would further raise the required fiscal effort. Both reforms are essential to achieve budget control in the medium term and fiscal sustainability in the long term. By encouraging (even mandating) longer working lives, they also underpin adequate retirement income in the actuarially fair system. Hence, the adjustment to life expectancy should be made automatic and more frequent. The development of a fully-funded private pension pillar will likewise be important to the success of reform, so as to create a new source of pension income. Moving in this direction will send an adequate signal to younger workers that it is important to start saving for their retirement. The government's decision to allow allocation of deferred compensation (TFR) funds to private pension schemes, on a voluntary basis, is promising because it will encourage the development of private pension funds, although that part of TFR that workers decide to keep with firms will potentially hold down the amount available for private pension funds.

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### *Administrative reform in the public sector must be pursued*

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An important step towards public administrative reform has been the signing of a memorandum by the trade unions on labour contracts for the government workforce. The unions have accepted to consider the introduction of important changes, including performance-based remuneration, merit-based career advance and the reduction of the workforce by attrition. In exchange, they have obtained a reduced usage of fixed term contracts and the conversion of some existing fixed term contracts into more secure, permanent contracts, but also a significant say on how some of these reforms are to be implemented in practice. There is also a political commitment for additional financial resources for national public employment working contracts. The authorities are hopeful that this memorandum will enhance flexibility in the public administration, and improve the quality of public services as well as promoting cuts in the wage bill. It is important that the memorandum be implemented without delay, making use of international best management practices, so as to facilitate control of the budget's single biggest spending item and to improve the quality of government.

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### *A reformed fiscal federalism can improve quality of government*

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Over the past decade or so, Italy has extensively decentralised the provision of public services to lower levels of government (with the major exception of education). This is a promising development that could improve the allocation of resources in the economy and enhance the accountability of government, insofar as closer interface with citizens can better identify needs and enhance transparency in the sources and uses of public funds. In a sense, it exposes the government to competitive forces in line with the direction being taken by the whole economy. Indeed, the quality of local public administrations has improved in various ways with the devolution of powers from Rome – including in the lagging southern areas. EU structural funds have had a similar impact because local governments stand to lose these funds, along with matching central government grants, if they fail to prepare convincing proposals that are well executed.

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### *Fiscal federalism requires changes to financial arrangements*

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This project has nevertheless hit serious teething problems, including on the financing side. The “fiscal federalist” provisions of the 2001 constitutional reform should have involved a radical transformation of funding arrangements: discretionary central transfers should have been sharply reduced, autonomous tax bases and tax sharing increased and “equalising” transfers linked to objective structural parameters. However, these changes have met great resistance from poorer regions who stand to lose under a more rational transfer system, at least in the short term. The reform therefore remains on paper, and financial transfers from the central government are still based on historical spending and on the results of a bargaining process. This increases incentives to spend more in order to get more and reduces expected gains in terms of efficiency. The benefits of developing local tax bases are muted for the same reason. Some regions have taken the central government to court to extract more money, and won, on the argument that the requirement to satisfy high “national standards” in social services like health care implies a financial responsibility for the central government. There is therefore a need to reform financial arrangements with subnational governments. In particular, *regional equalisation transfers should be linked to the “standard cost” of providing essential guaranteed services and to own tax capacity. A reduction of transfers from the central government should be accompanied by the development of autonomous taxes at the local level, so as to provide a better match between spending responsibilities and taxing powers and allow some scope for tax competition. As well, there should be a standardisation of accounting at all levels of government, so as to improve the monitoring of the internal stability pact.*

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### *Italy should decide on the minimum level of social services*

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A major difficulty with the decentralisation process has been the need to identify the minimum level of social services guaranteed across the nation. Under the new constitution, the state must decide on the level of services provided to all citizens in the social sphere (*Livelli Essenziali di Assistenza, LEA*) and guarantee the financing to achieve

them in every region. This guarantee has made fiscal federalism more politically acceptable, by reducing fears of a “race to the bottom” accompanying the decentralisation of public services. Indeed, it makes sense to set a minimum level of basic services available to all in the country and leave the regions free to top up this basic level with additional provisions, depending on the socioeconomic preferences of each regional government. *The LEA should, however, be defined in terms of output, rather than input, so as to encourage the efficient delivery of services; in regions lacking efficiency, more generous services would require increasing taxes, thus improving accountability about government decisions.*

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#### *Restricting regional overshoots on health care spending is a major challenge*

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The health care sector is by far the largest regional spending area and therefore a case in point. Health care spending was sharply squeezed in the run up to EMU but has subsequently surged. With acute ageing still ahead, health care is therefore the main pressure point for long run public finances. Also, despite virtually equalised per capita resources across regions through transfers, spending quality varies widely and persistently. Regional overshoots in health spending have been financed by *ex post* clean-up operations from the national budget, by expanding suppliers’ credits and by creative accounting – all indicating soft budget constraints. The 2006 and 2007 budgets have tried for the first time to impose sanctions, obliging regions with health care deficits to raise their tax rates up to the maximum level allowed. The regions currently unable to respect health care balance must undergo restructuring plans to be agreed with and under the control of central government. These plans foresee containment programmes of health expenditures temporarily accompanied by additional public resources, and are aimed at balancing the health care account by 2010. They may involve a further increase in regional tax rates as long as the health care expenditure containment is not achieved according to the programme. This mechanism seems to be contributing to more spending discipline, although it may lead to higher tax wedges in deficit regions and has been associated with the central government assumption of part (0.2% of GDP in 2007) of the large debt to suppliers. Thus, *the health care pact should have sanctions that “bite” more involving stronger accountability of responsible local officials, the ultimate sanction being a temporary management takeover by central government.*



## Chapter 1

### Italy's key challenges

*The Italian economy rebounded significantly in 2006. Growth has remained well above its potential rate, also entailing a sharply lower public deficit. The main motor has been strong foreign demand and an evident adjustment process among Italian exporters that has allowed them to benefit from the better external conditions. Even so, Italy's export structure remains heavily biased toward low skill production, hence highly exposed to cost competition by emerging market economies in the present era of globalisation. The process of deindustrialisation has also not triggered a take off in services sectors, as in some of the more successful OECD countries. This macro-structural weakness can be traced to a lack of total factor productivity growth, reflecting the shortcomings in efficiency, process and product innovation. A main policy challenge is to raise human capital and market competition to spur both the supply and demand for innovation and skills, imparting needed dynamism to the economy. Employment creation has been a main bright spot in the economy, but needs to go further by rebalancing employment protections to reduce labour market duality. A large regional gap and still low formal labour market participation may be part of the current problem but are the source of significant unrealised growth potential. Reducing the drag of fiscal policy on the economy will involve sustaining a rapid pace of consolidation beyond the current upswing, while also raising spending quality to allow lower spending and tax-to-GDP ratios.*

The Italian economy is emerging strongly from five years of near-stagnation and disappointing fiscal outcomes. This may herald the beginning of an adjustment. It will be vital to leverage the favourable conjuncture to put economic growth and fiscal policy on a solid long run path, just as the government intends. A lack of structural dynamism as suggested by low TFP growth has been entrenched for over a decade now, and if it were to go on (say, once the global upswing fades), slumping wages and decelerating employment would be the main means of boosting productivity and facing global competition. To avoid that bleak scenario, reforms to achieve growth in both employment and productivity – not one or the other as has usually been the case – are needed along the lines of some OECD countries' experience. Italy is in some ways ahead of some other countries in Europe in this endeavour. It has deeply reformed pensions, its industrial base is broad and its private sector is inherently dynamic. But, resistance to change by “insider” interests is still strong, and the public policies that protect them must be, and are being, dismantled and reoriented to the interests of the wider good.

## Encouraging improvement in Italy's macroeconomic performance

### ***A cyclical recovery is underway***

Rising foreign demand triggered a welcome recovery of activity in 2006. Stronger growth in Germany was particularly important, where internal consumption helped to sustain Italian exports of traditional goods. Machinery and metal exports, including to emerging market producers, also benefited from the global boom. Even though exports still lagged Italy's external market growth (by over 4%), it was less so than in each of the previous four years (by almost 7% on average). Export strength and optimism spread to domestic demand, in particular fixed investment. Consumption accelerated in response to strong employment growth, recovering household confidence and large wage awards in the public sector. All sectors (save agriculture) contributed to the recovery. Helped by a very strong carry-over from the fourth quarter of 2006, growth should remain in the area of 2% in 2007, and still above potential in 2008 (Table 1.1).

Compared with past downturns – that endured by Italy from 2001 to 2005 was unusually long – the only other one coming close was that of 1980-83, which was caused by a competitive crisis in Italian industry and a subsequent process of restructuring with high unemployment. The recent period of Italian slow growth put it well below the already weak euro area average, despite Italy's tempering wage growth and exceptionally accommodative monetary conditions upon EMU entry, following the lira's final EMS realignment (Figure 1.1). Since EMU entry, Italy's real exchange rate has appreciated sharply, which in a longer run perspective may be viewed at least in part as a correction for the pre-EMU “overshooting”.<sup>1</sup> However, Italy's greater structural vulnerability to the globalisation shock, reflecting its very price elastic pattern of production, may have required a permanently lower real exchange rate than in the past. Within EMU, Italy has no choice other than to use structural reforms to lower the real exchange rate.

**Table 1.1. Short-term outlook**  
Percentage changes from previous period, at 2000 constant prices, unless indicated

	Current prices € billion in 2003	2004	2005	2006	2007 <sup>1</sup>	2008 <sup>1</sup>
Private consumption <sup>2</sup>	789.1	0.7	0.6	1.5	1.5	1.8
Government consumption	262.9	1.6	1.5	-0.3	0.8	0.8
Gross fixed investment	272.1	1.3	-0.2	2.4	3.2	2.8
Machinery and equipment	147.0	1.4	-0.9	2.7	2.6	3.7
Construction	125.2	1.1	0.6	2.2	3.8	1.9
Residential	52.0	2.0	5.5	4.1	4.1	1.5
Non-residential	73.1	0.5	-3.0	0.6	3.6	2.1
Final domestic demand	1 324.2	1.0	0.6	1.3	1.7	1.8
Stockbuilding <sup>3</sup>	4.6	-0.2	-0.1	0.4	0.5	0.0
Total domestic demand	1 328.9	0.8	0.5	1.7	2.2	1.8
Exports of goods and services	328.6	2.7	0.0	5.5	4.0	5.1
Imports of goods and services	321.3	2.0	1.0	4.5	4.7	5.5
Net exports <sup>3</sup>	7.3	0.2	-0.3	0.3	-0.2	-0.2
GDP at market prices	1 336.2	1.0	0.2	1.9	2.0	1.7
General government financial balance <sup>4, 5</sup>	..	-3.5	-4.3	-4.5	-2.5	-2.5
Structural primary balance	..	-0.1	0.2	1.7	2.2	2.0
Current account balance <sup>4</sup>	..	-0.9	-1.6	-2.4	-2.5	-2.6

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see OECD Economic Outlook Sources and Methods, [www.oecd.org/eco/sources-and-methods](http://www.oecd.org/eco/sources-and-methods).

1. Economic Outlook No. 81 projections.

2. Final consumption in the domestic market by households.

3. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

4. As a percentage of GDP, national accounts basis.

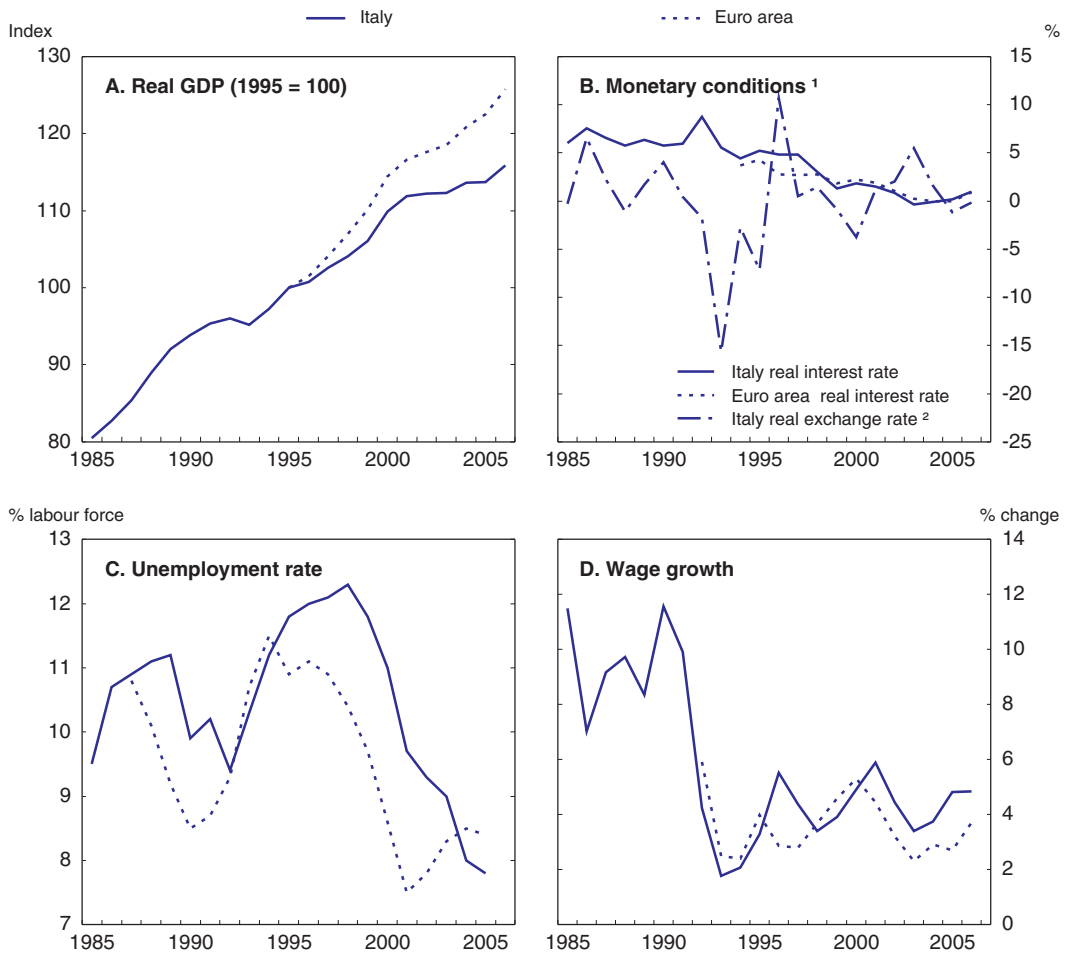
5. In 2006, includes a 1.1% of GDP refund of VAT receipts on company cars following a judgment by the European Court of Justice, and a 0.9% of GDP high speed train (TAV) debt forgiveness operation. Net of these extraordinary payments, therefore, the 2006 balance was -2.5% of GDP.

Source: OECD Economic Outlook No. 81 database.

By now, monetary conditions in Italy and its euro partners have more or less rebalanced, and inflation has converged. The euro area (as the OECD) has itself been disinflating largely thanks to competition from fast rising non-OECD trade. Nevertheless, the Italian picture remains a mixed one: stubbornly high inflation on non-energy goods has been offset by relatively low energy price inflation, with only services inflation equalising by 2004 (Table 1.2). High manufacturing unit labour cost growth – due to stagnating productivity in the presence of broadly stable real wages – lies behind the persistence of non-energy goods inflation. Furthermore, the prices of goods with a strong technological component have grown at a substantially higher pace in Italy, probably suggesting a scarce penetration of foreign competition. The more muted pass through of global oil price shocks into final energy prices partly reflects a stabilising energy tax mechanism. By the same token, the late 2006 energy price declines will have less of a moderating effect in Italy than elsewhere so that headline inflation may again begin to diverge.

### **Employment growth has been robust**

Real labour costs have been reduced in Italy through a combination of wage moderation and structural reform of the labour market. Wage indexation was eliminated in 1993, the new anchor for national wage formation becoming programmed inflation (system of *concertazione*). Stronger immigration and low productivity growth put further downward pressure on real wages. Average real private salaries stagnated during 1995-2000 and

Figure 1.1. **Economic trends**

1. Deflators used are consumer price indices.

2. Annual percentage change.

Source: OECD Economic Outlook No. 81 database and Eurostat, New Chronos database.


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Table 1.2. **Inflation differentials<sup>1</sup>**

Italy-euro area, per cent change

	CPI (harmonised)				Unit labour costs	
	Total	Energy	Non-energy industrial goods	Services	Goods	Services
1999	0.6	-1.2	0.7	0.8	2.06	-0.95
2000	0.5	-1.5	1.2	0.9	0.70	0.00
2001	-0.1	-0.6	0.1	0.4	2.12	0.02
2002	0.3	-2.0	0.9	0.3	2.09	0.42
2003	0.7	0.2	1.0	0.7	2.60	1.20
2004	0.2	-2.1	0.8	-0.1	4.44	2.04
2005	0.0	-1.4	1.1	0.1	3.29	1.70
2006	0.0	0.3	0.6	0.0	4.30	1.33

1. Inflation differential for food items not shown in the table.

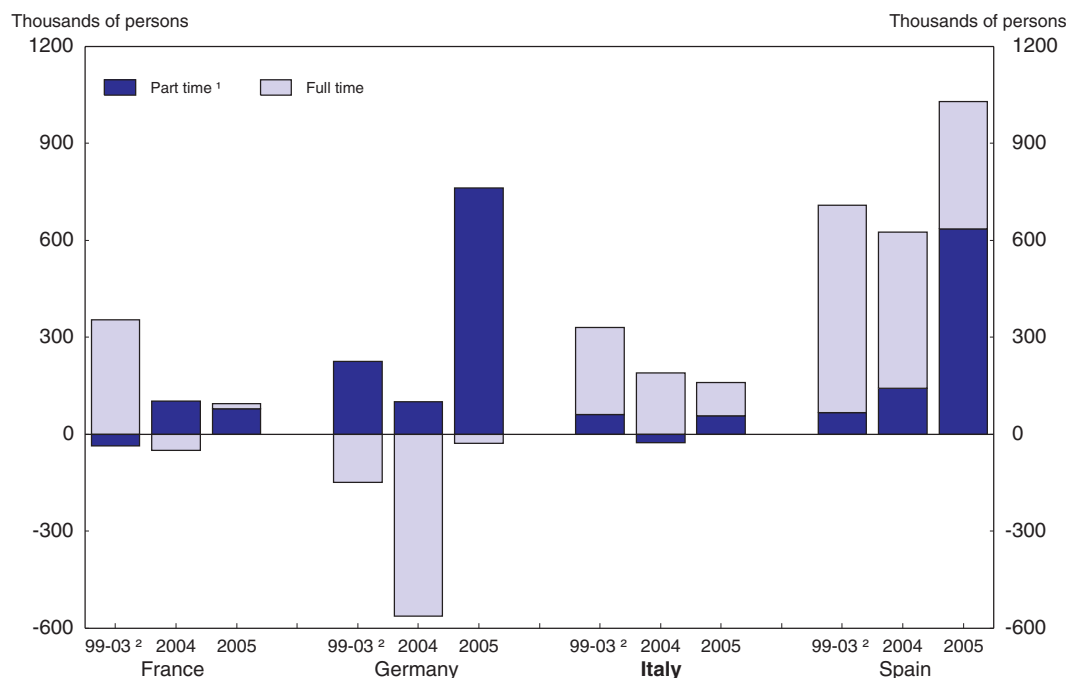
Source: Bank of Italy, Eurostat.



have fallen since around 2000.<sup>2</sup> As to reforms, the 1997 (Treu) and the 2003 (Biagi) packages extensively liberalised the use of part time, fixed term and intermittent contracts; this process was made effective by unions and industrialist organisations in national contracts. The new contract forms reduced the marginal price of labour *via* lower firing costs and greater flexibility in adjusting hours, often supplemented by fiscal bonuses.

Total employment growth has been the strong point of the economy since 1995 and stood out in relation to other large EU countries' performance (except Spain; Figure 1.2), in turn supporting domestic demand even prior to the present upswing. But it is puzzling in two ways: first, it was at odds with Italy's own low output growth during much of this period, and second, real wage moderation was still not enough to avoid fast rising unit labour costs given collapsing productivity growth, especially in industry, so that it is surprising that Italian firms would still be hiring. It seems that the new flexibility afforded by reforms counted for a lot. It is estimated that the advent of flexibility in the Italian labour market explains between 40 and 80% of the decade long employment rise.<sup>3</sup> During 2006, employment surged and unemployment dropped from 8 to under 7%, *i.e.* to well under the EU average. These results were amplified by a new wave of immigrant amnesties in the same year, which added to recorded employment and labour force numbers.<sup>4</sup> However, national accounts employment and productivity numbers should not have been greatly affected as they already include estimates of informal workers and output.<sup>5</sup>


Figure 1.2. **Job creations**



1. Part time is based on a common definition of less than 30-usual weekly hours of work.

2. 1997-2003 average job creations.

Source: OECD Labour Force database and ISTAT.

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### The fiscal position has improved

Italy experienced a large improvement in the fiscal balance in 2006, thanks mainly to an unusually large positive cyclical impact (Chapter 3). Such “non-linear cyclical effects” were shared by a number of other European countries but were apparently stronger in Italy. The deficit in the latter year declined from 4.3% of GDP in 2005 to 2.5% in 2006, net of extraordinary payments. This came as a surprise even to the government, which had estimated the net deficit at 3.6% of GDP as late as autumn 2006.<sup>6</sup> The structural primary balance as estimated by the OECD jumped from 0.2% of potential GDP in 2005 to 1.7% in 2006. Higher than expected growth interacted favourably with one-off measures in the 2006 Budget, but a 0.5-0.7% of GDP “unexplained” residual remains (Ministry of Economy and Finance, 2007). With higher growth now expected, the official 2.8% target in the 2007 Budget has been revised down to 2.3%. The OECD projection is approximately in the same area, as assumed slippages should be offset by a carry over of tax buoyancy from last year,<sup>7</sup> so that the projected structural primary balance increases further by ½ per cent of GDP compared with ¾ per cent in the official budget projection. There would be no improvement in 2008 in the absence of further measures (Table 1.1).

The strength of the recovery may be surprising in light of the large fiscal contraction. “Non-Keynesian” effects could be at play, even though their typical channels – a reduction in the deficit reduces the country risk premium and bids down the exchange rate – are by definition absent in EMU (Italy already obtained them up front). Such effects are in any event usually associated with a spending-based consolidation whereas the current episode is mainly revenue-based (Chapter 3). But other channels are still possible. Part of the unexplained residual for 2006 tax receipts may reflect improved compliance, a structural feature that should not really affect short run demand. The public deficit and debt is likely to be inversely related to private sector confidence in Italy.<sup>8</sup> A final possibility is that the impacts of the 2007 tax measures have yet to come through, with downside risks for demand.

### But longer term economic prospects remain challenging

Last year's acceleration was largely cyclical (demand-led) and Italy's challenge is to ensure a more durable turnaround. Supply potential is limited by a sharp productivity growth slowdown which began around 1995 and an absolute total factor productivity decline after the turn of the millennium – a rare event in the OECD context. Ageing is at the same time starting to bite as the working age population declines. Per capita income growth has been propped up in recent years by rising total hours worked associated with labour market reforms (Table 1.3).

Table 1.3. **Decomposing Italy's per capita GDP growth, 1970-2005**

Annual average growth rates

	Per capita GDP	GDP per hour worked	Hours per working age person	Working age population over total population
1970-1980	3.1	4.7	-1.6	0.0
1980-1995	2.0	2.2	-0.6	0.4
1995-2005	1.2	0.9	0.6	-0.3
1995-2000	1.9	1.5	0.6	-0.2
2000-2005	0.9	0.7	0.5	-0.4

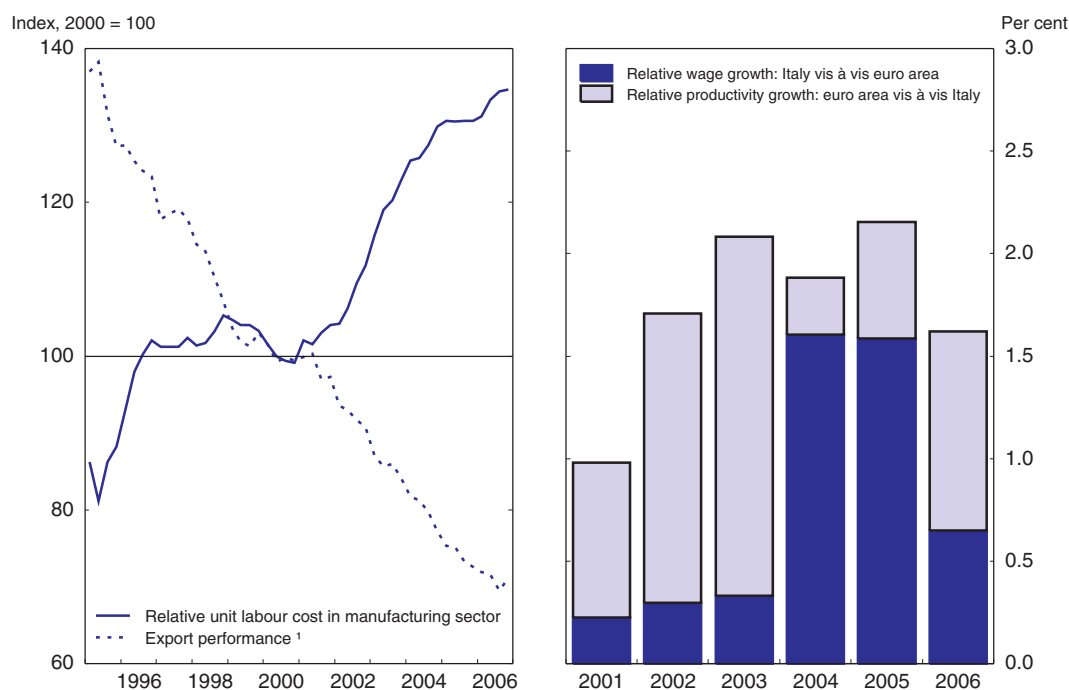
Source: OECD Economic Outlook No. 81 database and OECD Productivity database.

## Difficulty in coping with globalisation

### Collapsing competitiveness and market shares


Italy is an export-oriented economy. In the past, the manufacturing sector enjoyed high productivity growth which, along with elimination of automatic indexation and periodic lira devaluations (notably following the 1979 oil shock), secured a high degree of international price competitiveness and export performance. But the engine has seriously stalled: between 1995 and 2005, nearly 50% of Italy's export market shares evaporated and Italy's share of world trade in value terms declined by one-third, while net exports detracted from growth. In turn, this reflected a severe loss of international competitiveness, as relative unit labour costs jumped by more than 50% over the same period (Figure 1.3). Though the real exchange rate as measured by relative consumer prices appreciated only by about half as much, the gap between the two measures suggests a marked profit squeeze. As this period coincides with dismantling of trade barriers between OECD and non-OECD countries and the entry of Italy into EMU at an irrevocably fixed exchange rate, it seems that Italy has found it difficult to cope with the shock of globalisation solely via structural flexibility, without the aid of monetary independence as in the past.

Figure 1.3. **Competitiveness indicators**



1. Defined as the ratio between export volumes and export markets weighted by Italian trade shares.

Source: OECD Economic Outlook No. 81 database.

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### Entrenched low skill specialisation

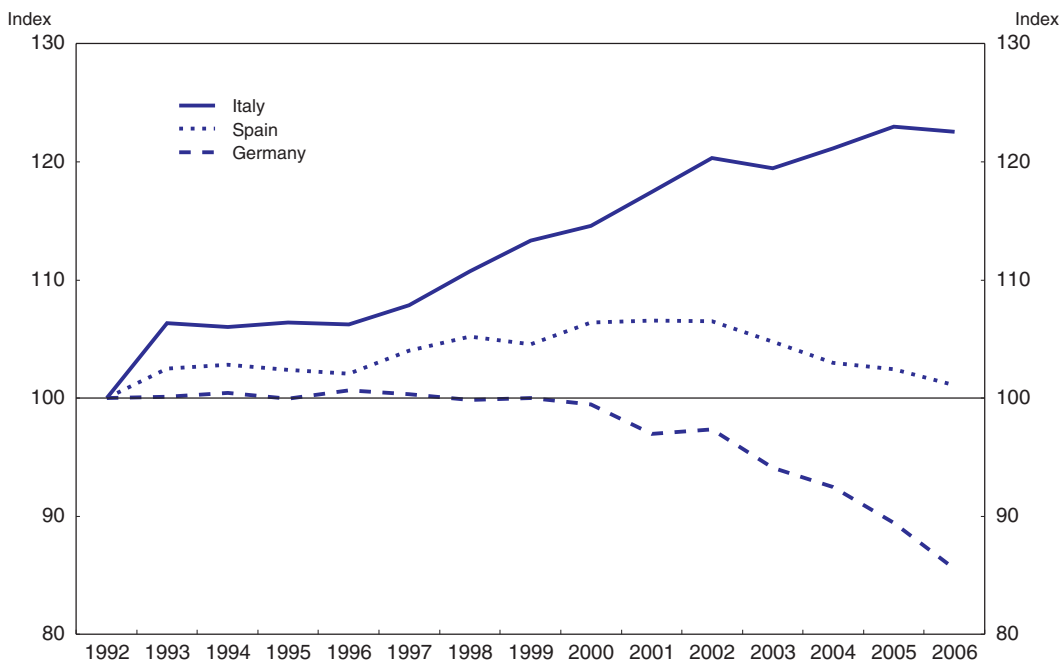
Italy has been especially vulnerable to the globalisation shock because it started out with a production structure quite similar to emerging market competitors, i.e. heavily based on traditional low skill products. What is more, it seems to have reinforced this

comparative disadvantage by shifting its relative specialisation even more toward such products (Faini and Sapir, 2005). Countries that seem to be coping better with globalisation are shifting resources toward areas less sensitive to low-cost competition, notably high tech goods and services or other niche areas. Other euro area countries (though less so Spain) appear to be in this category and have better preserved market shares. Other OECD countries have also been moving much more rapidly than Italy toward higher shares of university educated people to not only supply the knowledge base for high tech production but also to be able to adequately diffuse new technologies throughout the economy (Faini and Sapir, 2005). Furthermore, deindustrialisation has elsewhere triggered processes leading to an increasing specialisation in dynamic non-tradeables service sectors (see below). Germany, like Italy, has been relatively slow to shift to services, compared with countries like the United States and United Kingdom, but under very different circumstances: it has maintained strong international competitiveness in terms of both quality and price.

### Some signs of adjustment


This is not to say that there has been no adjustment in Italy. To the contrary, competition is forcing exposed sector firms to adjust in order to merely survive. This could partly be inferred from the fact that export prices are rising relative to general product prices much more in Italy than elsewhere (Figure 1.4), allowing it to maintain market shares much better in value than in volume terms.<sup>9</sup> Hence, the share within each sector of firms producing higher value-added seems to be growing, either because such firms themselves are upgrading and able to exercise greater market pricing power, or because

Figure 1.4. **Relative export prices**<sup>1</sup>  
1992 = 100



1. Export unit prices of goods and services deflated by producer prices index.

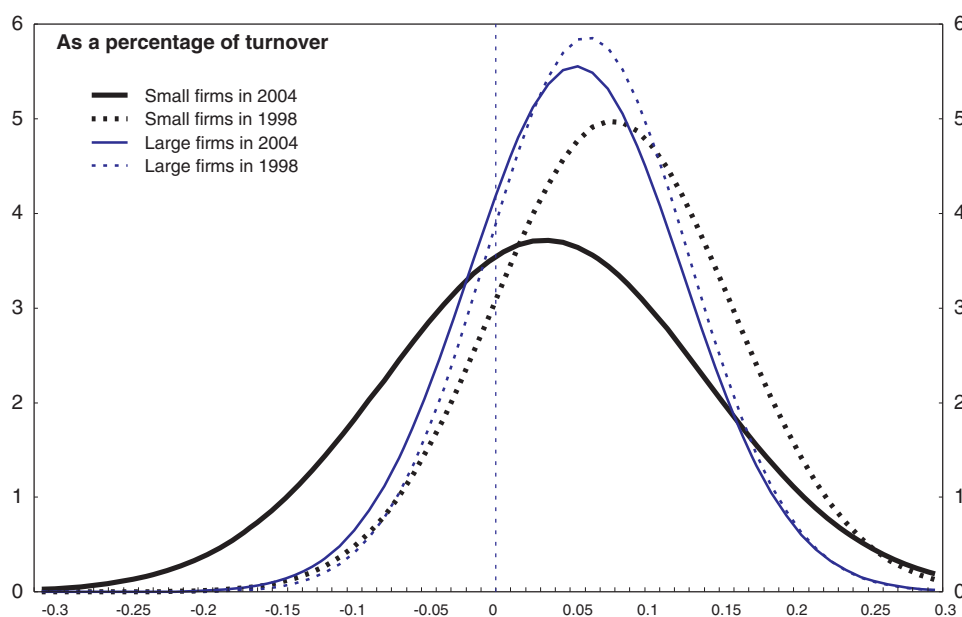
Source: OECD Economic Outlook No. 81 database.

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lower value added firms drop out of the market. Both effects are probably relevant, though as noted above there is no evidence yet of inter-sector or major cross product shifts. There could also be more pricing to market in the strong global upswing. Indeed, average price rises have been especially sharp in luxury high ends of traditional goods, for which there is a growing demand by an emerging middle class in non-OECD countries. A higher variability of profit outcomes in Italian industry, along with a descending mean value, seems to corroborate this evidence. Larger firms seem much better able to outsource and innovate in order to survive than are smaller ones – perhaps aggravated by the fact that small firms find it difficult to grow to medium (later large) size in Italy as a means of adjusting (Figure 1.5).

Figure 1.5. **Restructuring is under way with evidence of rising variability in profitability**

Earning before interest and tax (EBIT) on turnover distribution according to firms size<sup>1</sup>



1. Small firms are firms with less than 2 billion euros turnover. Large ones have a turnover of more than 50 billion euros. Source: Confindustria.

StatLink  <http://dx.doi.org/10.1787/013424205348>

Another way to view the situation is that rising stars like India and China are themselves shifting into high tech areas and investing in human capital. New OECD areas of comparative advantage may before long become contested and overcrowded. Export prices of such goods have in fact been falling, also because of technology, so that the terms of trade for countries specialising in them are an income loser. Italy may one day look to be better placed for the long run: it has a solid export base featuring high grade consumer items and the machinery to make them, much prized by China and others. Italy, for all its export woes, has avoided current account balance deterioration after netting out oil imports (Banca d'Italia, 2007), while the extra-euro-area trade balance has held up better than that *vis-à-vis* the euro area (Cotis, 2006). It is probably wise to build upon traditional strengths even while restructuring.

### **Low TFP growth is the core problem**

But the fact that export market shares are still being lost, and at a significant rate, suggests that at the aggregate level the adjustment is still unsatisfactory; more export firms are exiting the export market than are staying in and thriving.<sup>10</sup> That labour is being released by the many less efficient firms exiting traditional sectors could itself be another encouraging sign of adjustment. Yet such resources are apparently not yet being used productively enough in the sheltered sectors. All in all, an inability to adjust the structure of production to the demands of globalisation suggests a fundamental problem with dynamism and innovation, normally associated with total factor productivity (TFP).<sup>11</sup>

### **A growth accounting analysis**

A standard OECD growth accounting analysis substantiates that Italy experienced an unusually sharp deceleration in TFP in the last decade (Figure 1.6). At the same time, however, Italy forged ahead of other countries (except the United States) in terms of labour utilisation, thereby limiting the absolute and relative decline in its potential rate of growth. Capital deepening slowed only marginally, and further analysis shows that this reflected a steady growth in the capital to labour ratio along with a slowly falling rate of return to capital. This suggests that the productivity slowdown cannot be attributed to any large extent to “labour deepening” endogenous to labour market reforms themselves.

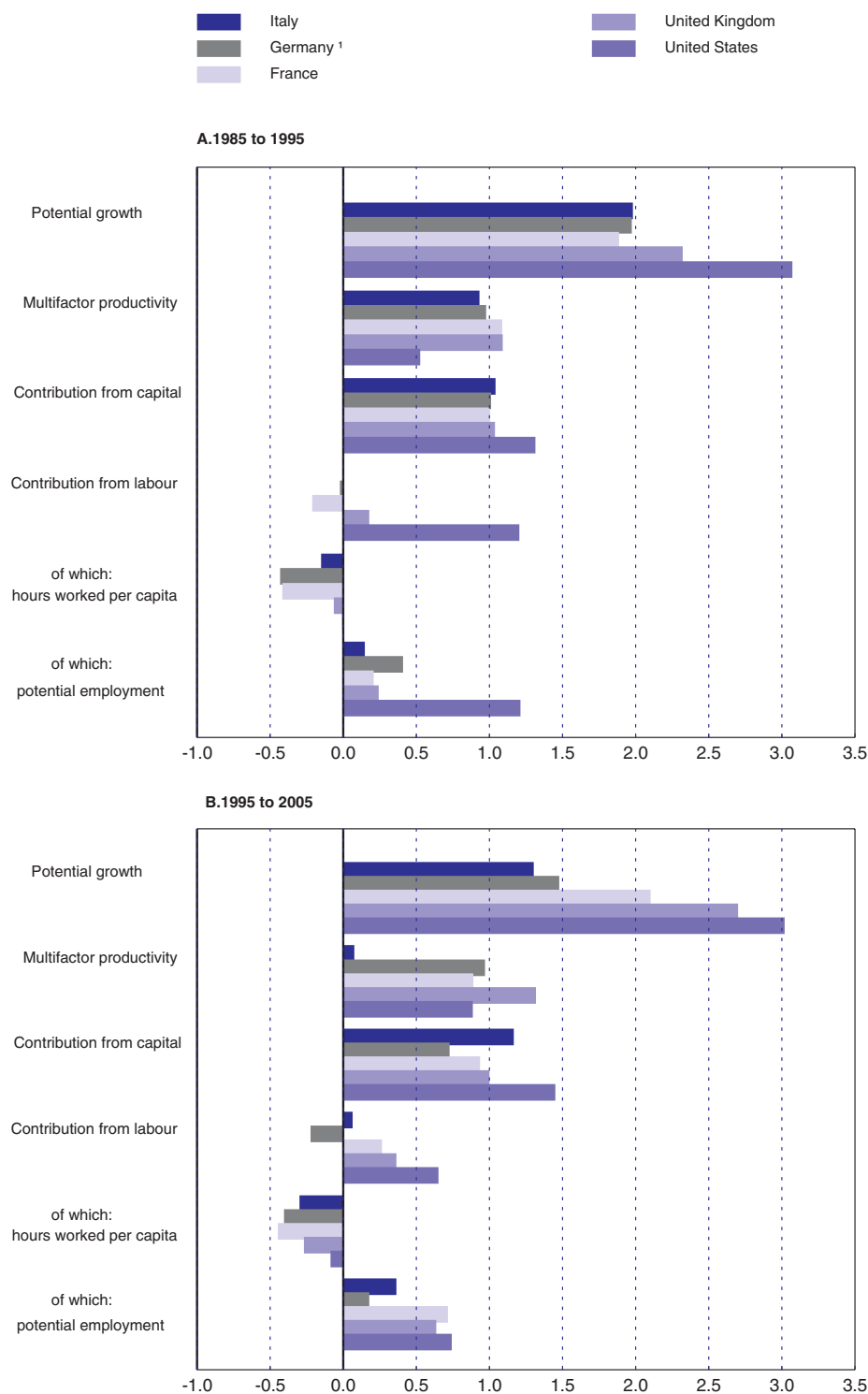
A more refined decomposition of labour productivity, taking into account labour quality, is useful in order to test the hypothesis that TFP may have been momentarily depressed by more low skill people entering employment under the new atypical contracts. In fact, reform-induced composition effects seem to have reduced the rate of rise in labour quality otherwise implied by cohort effects, which themselves have been slowing down and could thus explain part of the productivity decline (Table 1.4). By the same token, a large part of the *prima facie* strong TFP growth of the 1980s and early 1990s disappears when correcting for these cohort effects; hence the slowdown in TFP correcting for such effects is smaller, though still substantial.<sup>12</sup>

Like elsewhere, manufacturing was the quintessential fast growing part of the Italian economy up until 1995 – its TFP growth averaged 1¼ per cent annually during 1980 to 1995. But thereafter it stalled and then fell in the new millennium, explaining virtually all of the aggregate TFP growth collapse. According to Table 1.4, around 20% of the TFP decline in the 2000s has been offset by intra-sector shifts as Italian manufacturing firms are successful in upgrading their products as a strategy against increasing competition from emerging market economies – a factor also reflected in higher export prices, as discussed above.<sup>13</sup> In the services sector, there was also a TFP slowdown but it was to a much smaller extent since long run productivity performance was already dismal (Table 1.5). This slowdown may have been largely cyclical (Zollino, 2006). The United States at the same time experienced an important surge in services productivity – finance, ICT services and retail and wholesale trade, from low rates of growth traditionally. This suggests a global technology that was available and a missed opportunity for Italy.

### **A human capital lag**

TFP growth is often thought to reflect managerial efficiency and innovative activity, the creative process that gives rise to value added. To stimulate it, a strong human capital endowment is needed to supply the requisite skills. But a demand for such skills is also

Figure 1.6. **Decomposition of potential growth: an international comparison**  
Annualised growth rate



1. 1991-95 for Germany.

Source: OECD Economic Outlook No. 81 database.


StatLink  <http://dx.doi.org/10.1787/013448504878>

Table 1.4. **Labour productivity and its determinants**

Percentage values

	Labour productivity	Capital deepening	Capital quality	Labour quality	Supply composition	TFP
Total private sector						
1981-85	1.42	0.66	-0.02	0.49	0.03	0.27
1986-90	2.36	0.69	0.14	0.29	0.01	1.22
1991-95	2.28	0.86	0.03	0.47	0.02	0.90
1996-2000	0.74	0.40	0.16	0.22	0.03	-0.07
2001-06	-0.27	0.41	0.05	0.11	0.05	-0.90
Manufacturing						
1981-85	3.47	1.62	0.45	0.12	0.07	1.21
1986-90	3.06	0.70	0.12	0.19	0.04	2.02
1991-95	3.58	1.14	0.04	0.46	0.00	1.94
1996-2000	0.80	0.72	0.04	0.31	0.04	-0.31
2001-06	-0.39	0.58	-0.03	0.23	0.19	-1.37

Source: Bassanetti and Zollino (2007).

necessary. Competition is the main stimulus to innovation demand by firms, especially if accompanied by a deep and efficient financial system to cushion the risks involved and accelerate the development of small and medium enterprises. But as just seen, Italy's exposed sector is subject to brutal competition, giving it every incentive to innovate; but this was the sector that suffered the TFP collapse precisely because it failed to innovate. The fault must lie on the supply side of human capital and in the institutional basis for risk taking and enterprise growth. However, services sectors utterly failed to respond to a sharp internal terms of trade shift in their favour (as reflected in the real exchange rate), implying a problem with competitive stimuli to innovation there – this issue is taken up further below.

Human capital indicators for Italy support the conclusion of weak TFP growth (rather than capital adequacy) as the main source of the productivity slowdown (Figure 1.7).<sup>14</sup> Italy has one of the lowest proportions of researchers and engineers in total employment across the OECD, and more broadly its innovation performance (private R&D spending, patents, ICT diffusion) ranks poorly in international comparison. Active research skills are needed not only to initiate innovations locally but also to absorb knowledge and adapt inventions from abroad. Poor innovation performance can be traced back to deficiencies of the tertiary education system.<sup>15</sup> But technological progress also requires broader human resources in

Table 1.5. **Growth accounting by sector**

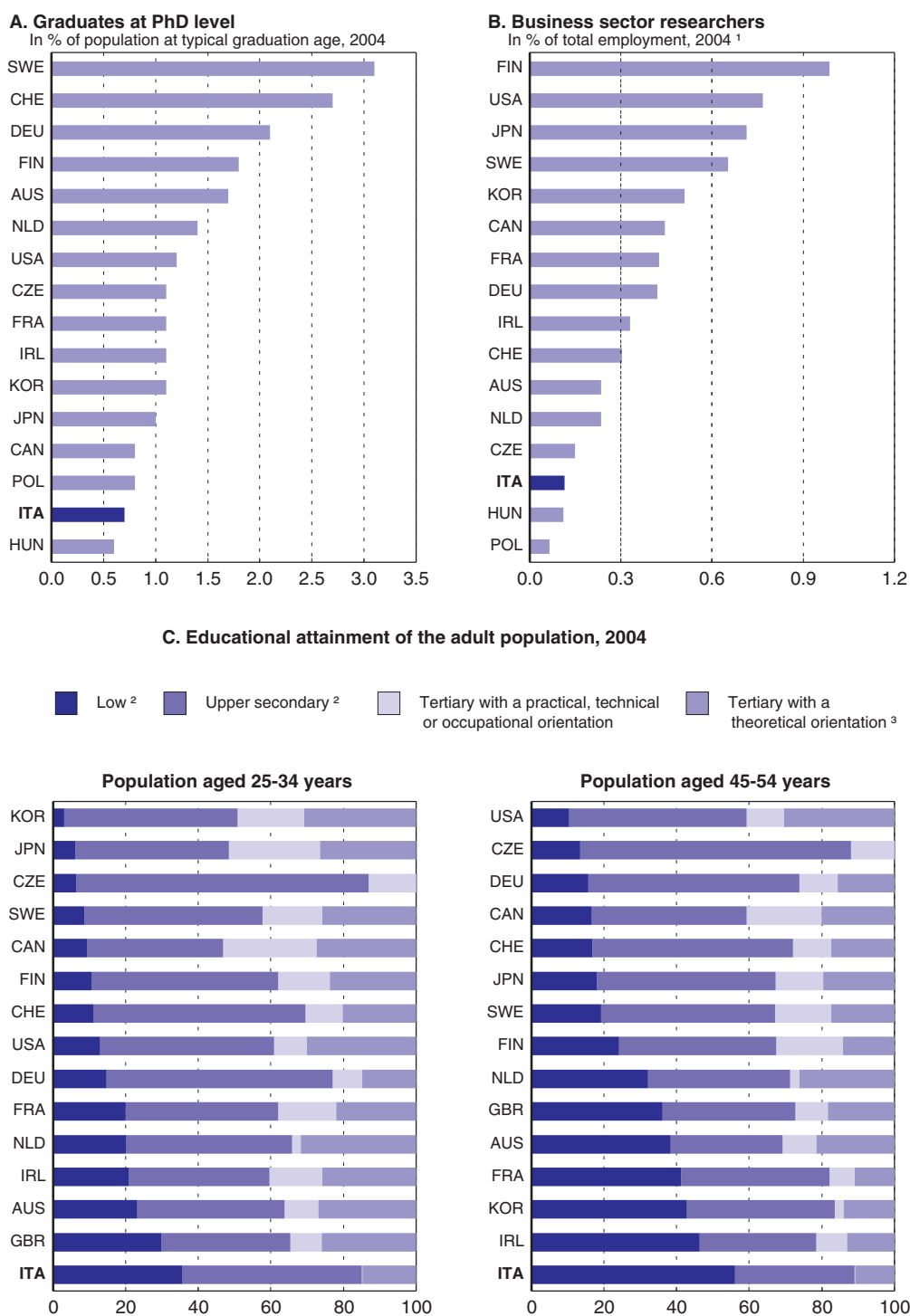
Percentage changes

	Growth in value-added			Contribution from labour			Contribution from capital			Total factor productivity		
	Total	Manufacturing	Services	Total	Manufacturing	Services	Total	Manufacturing	Services	Total	Manufacturing	Services
1981-85	1.7	0.6	2.6	0.7	-1.8	2.4	0.8	1.2	1.0	0.3	1.2	-0.8
1986-90	3.1	3.7	3.0	0.8	0.6	1.2	1.0	1.0	1.5	1.2	2.0	0.4
1991-95	1.3	1.5	1.4	-0.2	-1.0	-0.1	0.6	0.6	0.9	0.9	1.9	0.6
1996-2000	1.6	0.5	2.1	0.8	0.1	1.1	0.9	0.7	1.2	-0.1	-0.3	-0.3
2001-06	0.7	-0.9	1.1	0.7	0.0	0.9	0.8	0.5	1.4	-0.9	-1.4	-1.3

Source: Bassanetti and Zollino (2007).



Figure 1.7. A low-skill bias in Italy




1. 2003 for Netherlands and Sweden, 2002 for Canada and United States.

2. Low comprises persons having primary school, lower secondary school or ISCED 3C short programmes as their only formal qualification; upper secondary includes also post-secondary-non-tertiary programmes.

3. Includes tertiary with a practical, technical or occupational orientation for Italy.

Source: Cotis (2006).

StatLink  <http://dx.doi.org/10.1787/013458433468>

terms of a skilled workforce capable of implementing the needed organisational changes. In this respect, a major weakness for Italy is the very high share of the workforce having little or no formal qualifications beyond compulsory schooling – the mirror image of the productive structure.

### Low participation in an ageing society

On top of being exceptionally exposed to the globalisation shock, Italy is among the OECD countries to be most severely hit by population ageing. This vulnerability reflects rock bottom fertility rates and lengthening life spans of its relatively large post war baby boom generation. The practical response to the unavoidable sharp rise in the dependency ratio over the next 30 years (to 62%, at the EU's high end<sup>16</sup>) is to make fuller use of the human resources available, including via immigration. Participation rates of females and older workers, and youth employment rates, are still well below corresponding European and OECD averages, despite progress (Table 1.6). Hence Italy has substantial scope to boost long run growth rates by converging to these norms. But labour market and fiscal distortions hamper its ability to do so.

Table 1.6. **Labour market performance: international comparisons**

	1985-1995			1995-2005			1995			2005		
	Italy	EU15	OECD	Italy	EU15	OECD	Italy	EU15	OECD	Italy	EU15	OECD
Employment rate <sup>1</sup>	52.1	60.3	52.5	54.1	62.9	54.9	51.2	58.5	63.4	57.5	65.2	65.5
<i>of which:</i>												
Men	69.2	72.7	76.5	68.3	72.1	75.6	67.0	73.0	76.3	69.7	72.9	75.0
Women	35.3	48.1	52.5	39.9	53.7	54.9	35.4	44.2	50.8	45.3	57.5	56.1
Unemployment rate	11.4	10.0	7.3	10.2	9.1	6.9	11.7	10.7	8.0	7.8	8.4	6.8
<i>of which:</i>												
Men <sup>1</sup>	8.0	8.6	6.8	7.9	8.1	6.5	9.0	9.6	7.5	6.3	7.7	6.5
Women <sup>1</sup>	17.3	12.0	8.0	14.0	10.4	7.4	16.3	12.5	8.7	10.1	9.2	7.1
Long term <sup>1,2</sup>	81.8	67.8	48.3	75.9	64.4	47.5	80.2	71.8	48.8	67.7	60.4	46.9
Young <sup>3</sup>	32.6	19.4	14.2	28.7	17.3	13.1	31.9	22.3	16.4	24.0	16.6	13.3
Participation rate	58.8	66.9	69.5	60.2	69.2	69.9	57.9	65.5	68.8	62.4	71.1	70.2
<i>of which:</i>												
Men	75.2	79.5	82.0	74.1	78.4	80.8	73.6	80.7	82.5	74.4	78.9	80.3
Women	42.6	54.3	57.2	46.3	60.0	59.2	42.3	50.5	55.6	50.4	63.3	60.3
Older persons <sup>4</sup>	32.5	40.4	49.3	30.1	42.8	51.2	29.6	41.3	49.2	32.6	50.6	54.5
<i>of which:</i>												
Men	51.6	55.7	32.5	44.0	53.7	30.1	46.5	59.3	33.9	44.3	57.2	32.6
Women	15.1	26.3	35.2	17.2	31.9	39.5	14.1	25.4	34.1	21.5	38.3	43.9
Hours worked <sup>5</sup>	1 906.6	1 543.0	1 448.2	1 847.7	1 665.8	1 669.5	1 876.0	1 413.2	1 292.0	1 791.0	1 634.0	1 541.2

1. Refers to population aged 15 to 64.

2. Share of unemployment for 6 months and over.

3. Refers to population aged 15 to 24.

4. Refers to the population aged 55 to 64.

5. Refers to annual average, including self employed persons, unweighted average for OECD.

6. Refers to annual average per working age person, unweighted average for EU15 and OECD.

Source: OECD (2006), *OECD Employment Outlook*.

### Insider vs. outsider problem

Labour market reforms have so far been piecemeal, creating new ways of entering work rather than restructuring across the board. They have clearly succeeded in creating employment: over 40% of new jobs in recent years have been on a fixed term basis. Thanks

to these jobs, unemployment has sharply fallen, thereby improving household confidence and sustaining consumption. First time and less skilled workers have also been able to get a foothold in the job market. This is nonetheless a second best solution. Flexibility is consigned to the margins of the market, among new entrants on atypical contracts which have tended to be rolled over. Indeed, tax incentives have had to be given for conversions into permanent contracts. Youth, women and other marginals lack unemployment insurance, yet face a high risk of intermittent unemployment, accounting for 12% of total employment but around one-third of unemployment at any moment (Table 1.7). Meanwhile, strong employment protection for the bulk of workers with tenured contracts is firmly in place, including the right to judicial recourse for individual, unfair, dismissals. Larger firms provide such workers with unemployment insurance. This creates a dual labour market, and a rebalancing of protections seems in order. EPL for permanent contracts should be eased, even if that requires modest universal unemployment insurance.<sup>17</sup>

Table 1.7. **Workers with a temporary contract**

Contract form	Occupational status	Number of workers	
		Thousands	Per cent of total
1) Dependent workers with involuntary terms (all types of contracts)	Employed	1 979	
	No longer employed	789	
2) Co-co-co and project workers	Employed	394	
	No longer employed	67	
3) Occasional collaborators	Employed	71	
	No longer employed	54	
4) Self-employed with VAT registration	Employed	365	
	No longer employed	38	
Total precarious	Employed	2 809	12.2 <sup>1</sup>
	No longer employed	948	36.3 <sup>2</sup>
	Total	3 757	14.7 <sup>3</sup>

1. As per cent of total employment.

2. As per cent of total unemployment.

3. As per cent of labour force.

Source: Mandrone, E. (2007), "Quanti sono i lavori precari", *www.lavoce.info*, 21 March.

EPL is furthermore highly likely to impede innovation and growth (OECD, 2007b). Excessive job protection makes it costly for firms to restructure and reduces the incentives for the employee to exert effort, besides making the employer more reluctant to hire in the first place. This is an important reason why atypical contracts have been such a success: they greatly reduce firing costs and permit restructuring, besides enabling greater flexibility in the use of labour in response to fluctuations in demand. As the strictest part of EPL legislation kicks in only above a certain threshold (15 employees) it may also be an obstacle to firm growth, with deleterious impacts on firms' innovation capacity, although the overall effect appears to be small (Annex 1.A2). In sum, EPL on open-ended contracts may be a major obstacle to raising productivity and job creation as it slows down the creative-destructive process in Italy.

### **A large underground economy**

A relatively large underground economy in Italy is but an extreme form of the insider-outsider dichotomy.<sup>18</sup> To be sure, it is better to be working in the informal sector than not

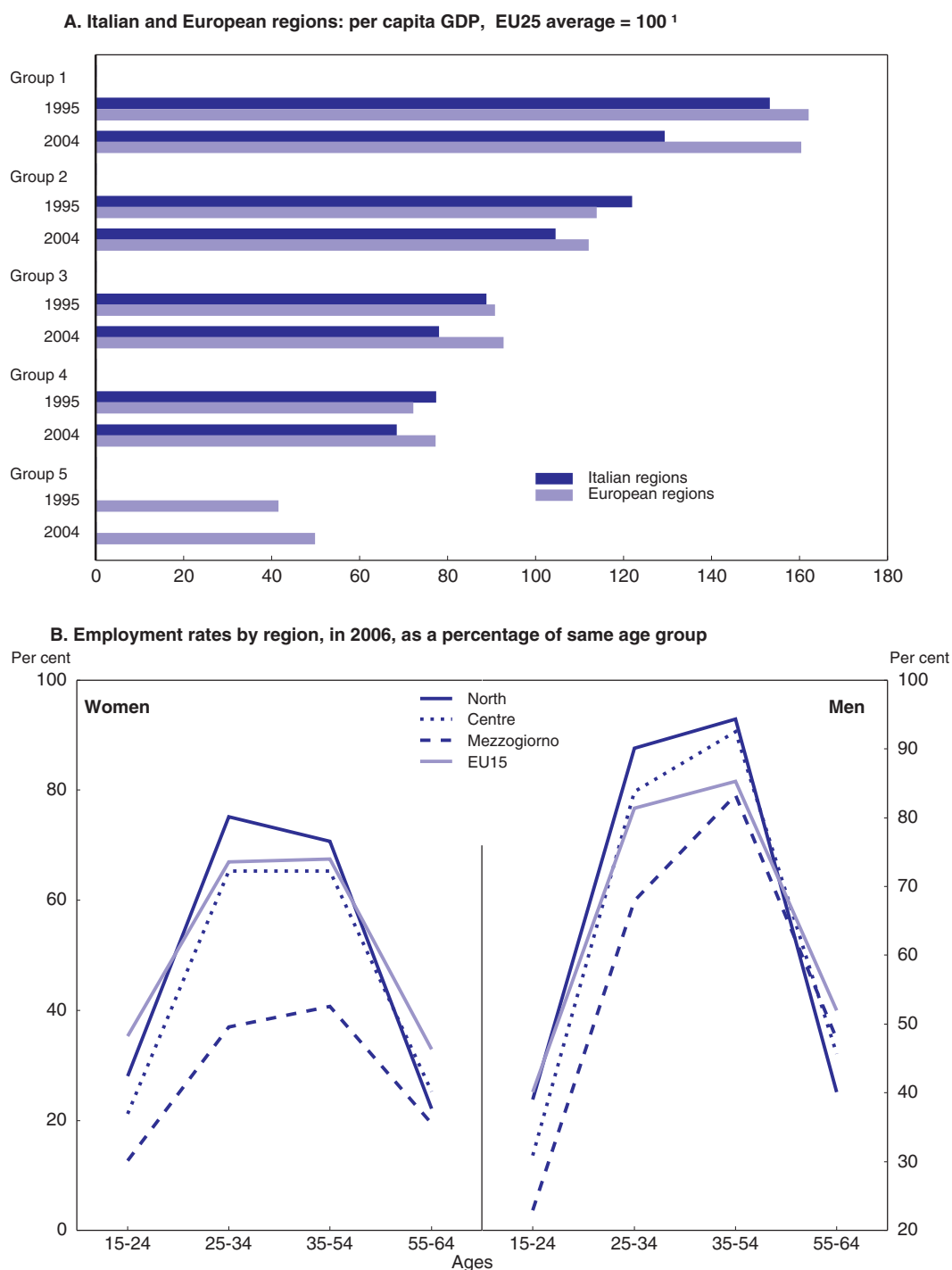
at all, so that many southern youth, women and early retirees may actually be participating in this way. Given that immigration quotas are far below the needs of firms (in the north), the informal sector also provides an entry point for the required extra immigrants, easing labour market pressures. A high tax wedge (47% not counting the labour component of the company value added tax, IRAP) and labour regulations (EPL, safety standards, benefits) imply “rents” to the employer of such workers, which may be shared, whereas risk of prosecution is low – perhaps because some small firms might go bust if suddenly forced to pay full labour costs. Big firms likewise make use of undeclared labour through a system of subcontracting. Globalisation may have aggravated informality by intensifying cost competition, though also providing a safety valve for firms insofar as they can now more easily move operations to EU countries like Romania in order to cut costs.

Widespread informality does not seem propitious for the development of a modern market economy. *First*, it narrows the tax base, entailing a higher tax rate on those who pay. This distortion is estimated to amount to nearly 5 percentage points of GDP – a 32% effective tax rate on the formal economy comparing with a 27% overall tax burden (Ministry of Economy and Finance, 2006). In the end, lower skill people are likely to enter work through the informal door, as the economy gets stuck in a sub-par equilibrium. Rapid public spending growth exacerbates the syndrome by further pushing up tax pressure. *Second*, it undermines the development of human capital, hence productivity, because informal workers are rarely trained and, being consigned to second class status, have no pension rights either.

The new atypical contracts are a policy answer to the informality problem as these should serve as a bridge to better jobs in the formal sector while easing the costs of transition for firms. Pension reforms have introduced actuarial mechanisms that provide incentives to stay in formal work longer. The government has vowed to “get tough” with tax evaders. But it is still necessary to remove the fundamental policy distortions that feed the underground economy. More rational immigration quotas (with fewer amnesties) are needed. Lower fiscal pressure is essential, as it is one of the main incentives to informality. Social charges on low skilled workers should be reduced to induce their participation; raising them on very flexible contract forms, as with current policy (Chapter 3), may drive them into the informal economy rather than into permanent jobs.


### ***Persisting north-south gap***

In the southern part of the country, per capita GDP levels are around one third lower than in the north, mainly reflecting a productivity gap; unemployment, highly concentrated among youth, is triple that in the north, and the female employment rate, extremely low among all age groups, accounts for virtually all of Italy’s lag *vis-à-vis* Europe; the bank system is less developed and the shadow economy more widely diffused; and there is a serious lag in scholastic performance (Figure 1.8). Most discouraging, southern Italy’s gap *vis-à-vis* northern Italy has hardly narrowed since unification 150 years ago, despite large government transfers in the past. Transfers apparently cannot compensate for a fragile quality of public administration and infrastructure, weak property rights and security,<sup>19</sup> and relatively high unit labour costs. Italy thus highlights the paradox that convergence across countries is often faster than that within countries, where regional differences can become deep seated.<sup>20</sup>

Figure 1.8. **Some North-South comparisons**

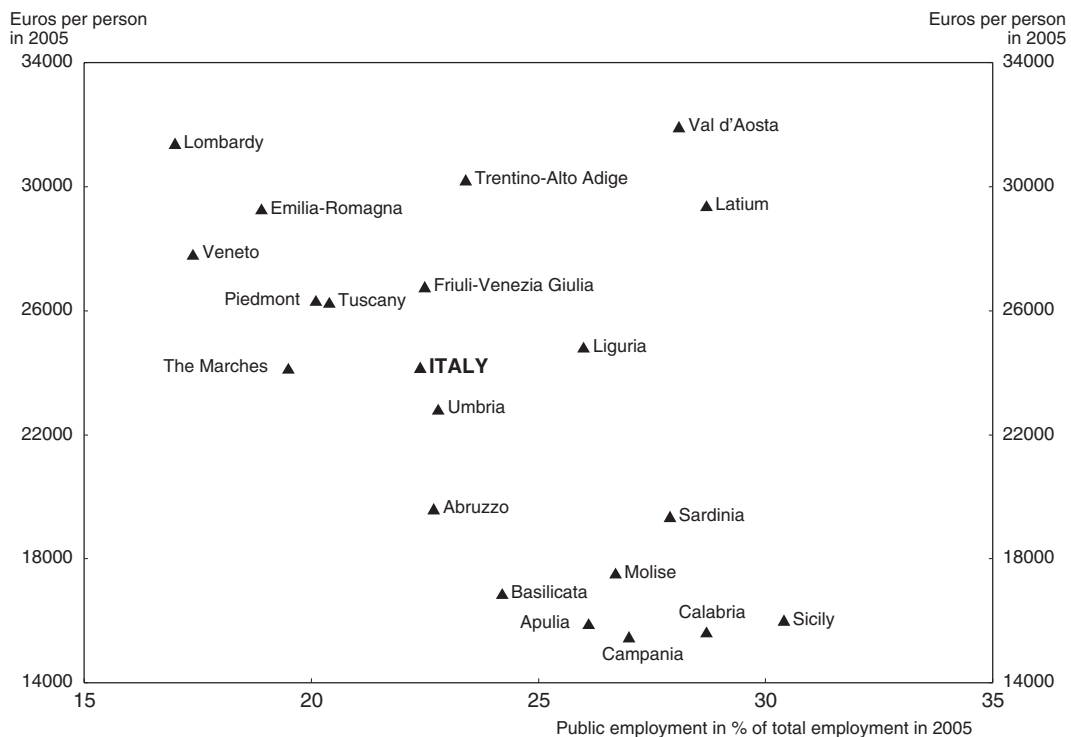
1. Per capita GDP at market prices, adjusted for purchasing power parities, compared with the 25 countries European average in 1995 (EU25 average). Group 1 is made of regions with a per capita GDP of more than 135% of the EU25 average, Group 2 is made of regions between 100 and 135%, Group 3 is made of regions between 80 and 100%, Group 4 is made of regions between 65 and 80%, and Group 5 is made of regions below 65%. There are no Italian regions in Group 5.

Source: Based on Eurostat data, NUTS2, ISTAT.

StatLink  <http://dx.doi.org/10.1787/013500351415>

There is an upside as well. Southern Italy is not beset by obsolescence of its industrial structure (it is not yet highly developed): the TFP decline affected mostly the industrial north. Whereas per capita GDP of the richer Italian regions fell nearly 10 percentage points behind their rich European counterparts over the last decade, the poorer ones improved their position (Figure 1.8, Panel A). Credit growth in the same period was stronger in the south than in the north. The south thus has the advantage of a fresh start in helping Italy to face up to the globalisation challenge, using best technology and practices available, for instance in new service industries and retail trade, which could generate a lot of employment, notably for females and youth. The South has less of an ageing problem as well, thanks to higher fertility rates (albeit declining). University attainment rates are close to those of the north, reflecting in part that government acted as employer of last resort in poorer regions and tends to have a relatively high skill mix (Figure 1.9). The university sector could retool to serve the development of high-tech “green field” sectors, or “culture tourism” to exploit the South’s natural advantages. Once the catch-up process takes off, southern growth rates should be high, lifting Italy’s average. The regional policy has changed dramatically in order to better assist the catch-up (Chapter 4).

Figure 1.9. **Public sector employment share and per capita income**



Source: ISTAT, Conti Economici Regionali.

StatLink  <http://dx.doi.org/10.1787/013525431125>

In light of Italy’s need to mobilise the labour force, regional segmentation of the labour market is particularly worrisome. Tight labour markets in the north coexist with abundant slack in the south, reflecting low cross-regional mobility and a skill mismatch. Thus, ironically, immigrants typically arrive in the south but quickly migrate to the north where the jobs are, leaving south Italy’s own unemployed youth behind (OECD, 2005).<sup>21</sup> Italian firms outsource jobs abroad, often bypassing the south. A national *de facto* minimum wage

imposes a strong competitive disadvantage on the south on top of that faced by Italy as a whole. Relatively higher wage rates in the north, including premia for skills, could ease pressures there, while relatively lower wages in the south, together with a programme to improve public infrastructure and services, could attract private investments and provide jobs for lower skilled youth, and also encourage emigration northward. Greater wage differentiation to reflect quality could improve the incentives to stay in school and study hard. Employers are not pushing for decentralisation, though, because they fear that only higher wage pressures, especially in the north, could be the result.

### **The reform process**

The EU has revitalised the Lisbon process designed to close the innovation and growth gap with the United States, while the ongoing Maastricht process (Stability Programmes) aims at medium term fiscal adjustment to underpin the euro. Italy faces some of Europe's biggest challenges on both counts. Growth and jobs monitoring by the Lisbon Council puts Italy at the bottom of an overall ranking of 10 countries, with noteworthy lags in labour productivity, employment, tertiary education, and public finances. The council's Human Capital Index gives Italy the lowest scores out of 13 countries on human capital utilisation (but only fourth lowest on human capital endowment) and on the impact of demography.<sup>22</sup> Italy also shows by far the highest public debt in the EU. It is recognised that the two processes reinforce each other. It is hard to grow without sound public finances and fiscal stability is enhanced by growth.

Italy shares these goals and acknowledges the distance it has to cover to meet them. The government's 2007-11 DPEF (medium term economic and financial programme) makes a diagnosis of economic and policy needs in line with the objectives of the Lisbon Strategy and the Stability Programme (Table 1.8). It says (summarising):

- Low TFP growth, inadequate mechanisms to reward quality, a business and consumer-unfriendly environment, and large areas sheltered from competition have reduced Italy's potential growth rate. *More rapid growth* is necessary for social well-being and to reduce the deficit. The present recovery must be transformed into durable growth. The Government should assist with a better administrative and judicial framework, and adequate physical and human capital infrastructure.
- A high deficit, reduced primary balance, rising debt and low growth are undermining fiscal sustainability and increasing vulnerability. It is essential to *reduce the deficit* to free families and businesses from the paralysing fear of new measures and new sacrifices, and to underpin equity. Fiscal consolidation (5% primary surplus by 2011) is to be based on spending cuts, mainly in the four areas of pensions, public employment, health and local spending. Because of the need to lower taxes and accommodate new spending, value for money will be the watchword.<sup>23</sup>
- Low growth, a poor social safety net and widespread civil service backwardness are contributing to increasing inequity and new forms of marginalisation. *Greater equity* is indispensable both to protect those with no voice and to procure political and social support for private and public restructuring needed to revive growth and reduce debt. It is especially important to redirect current transfer spending to the truly needy.

Thus, there seems to be little disagreement on either what is wrong or what to do. There is broad consensus among the EU, the Italian authorities and experts, and the OECD. Nevertheless, Italy has often failed to meet its DPEF targets and to fully implement promised

Table 1.8. **DPEF 2007-11 objectives**  
As of July 2006

	2006		2007		2008	2009	2010	2011
<b>Macro framework (growth rates)</b>								
Actual GDP	1.5	(1.9)	1.2	(2.0)	1.5	1.6	1.7	1.7
Potential GDP	1.0		1.2		1.3	1.4	1.6	1.7
Productivity	1.0	(0.2)	0.8	(1.1)	0.8	0.8	0.9	0.9
Employment	0.5	(1.6)	0.4	(1.0)	0.7	0.7	0.8	0.8
<b>Budget (% of GDP)</b>								
Trend net lending <sup>1</sup>			-4.1		-4.1	-4.1	-3.9	-3.8
Net lending	-4.0	(-4.4)	-2.8	(-2.3)	-2.2	-1.6	-0.8	-0.1
Primary balance	0.5	(0.2)	2.0	(2.6)	2.7	3.4	4.1	4.9
Interest payments	4.6	(4.6)	4.8	(4.8)	4.9	5.0	5.0	5.0
<b>Debt (% of GDP)</b>	107.7	(106.8)	107.5	(105.4)	107.0	105.1	102.6	99.7

Note: Numbers in parentheses denote 2006-07 updates in *Relazione Unificata*, Ministry of Economy and Finance, 16 March 2007.

1. At current legislation.

Source: Ministry of Economy and Finance.

reforms, in part because of the difficult macroeconomic context but also political and social obstacles (Box 1.1). But short term prospects have now improved and an adjustment process has begun. The challenge is to use this opportunity to vigorously push ahead with reforms – which also means avoiding the risk of becoming complacent when things are going well.

Given the need to find social consensus and to overcome the resistance of losers from reform, public advocacy of reform benefits will be of the utmost importance. In this sense, it may be important to understand better why the above discussed productivity growth collapse coincides (uncomfortably) with the period of liberalisation reforms. More flexible labour contracts should in principle have facilitated firms' restructuring, while outsiders being bid into jobs by virtue of these contracts ought to have been trained and well integrated. This would have ignited employment and productivity growth alike, in turn boosting real incomes and garnering more social support for reform. Major privatisations during the 1990s like those in utilities and banking should have raised productivity by unleashing forces of competition. What has been blocking the adjustment?

There have been arguments that difficulties in recording illegal immigrants and their output may have exaggerated the extent of the competitiveness problem (see Chaney 2006, Gros 2007 and Codogno 2007). These arguments rely on a twofold data distortion. First, large periodic immigrant regularisation programmes imply that the earlier level of productivity in Italy may have been exaggerated since ISTAT may have understated the size of the underground economy on the output side in relation to the factor input side; hence, the current productivity collapse is really a process of adjustment to the "true", lower productivity level. Second, the collapse of export volume market share which on the surface appears wholly consistent with the published productivity series (via competitiveness indicators), must also be incorrect. The culprit here is using export unit values to proxy export prices,<sup>24</sup> and the volume/unit value split is notoriously difficult to make because of the difficulty of allocating quality improvements which are erroneously put into unit values rather than volumes. Hence, the proper export performance measure to look at is value market shares, where Italy is doing much better. These arguments may have partial validity, but probably of a lesser order of importance.



### Box 1.1. Political economy of Italian reforms

#### Implementation strategy

There is no lack of ideas, institutional capacity, or good legislation in support of economic reforms in Italy. A main problem is one of implementation, the most common failure in the past. Ambitious and excellent reforms in areas like pensions, business sector liberalisation, the civil service and fiscal federalism have been passed into law or even enshrined into the constitution, then only partially implemented or not at all, and finally subject to renewed “discussions” with full involvement of the social partners as if there were no law already there. Each new government seems to start all over again on the same reforms. The search for social consensus goes on. The Italian case highlights that it is not sufficient to have good constitutions and laws; policy makers must internalise them too.

The underlying problem seems to be twofold: i) a tradition of weak coalition governments magnify peripheral voices, and the leadership’s ability to enforce compromise is often challenged, ii) excessive politicisation of the government bureaucracy allows for no “permanent secretariat” to guard institutional memory and follow through on phasing in of reforms; managers are regularly replaced with each incoming administration in a massive “spoils system”.

The government is working on the political aspects and is about to propose a new electoral reform law that among the available options under discussion, could reduce the role of proportional representation which increases the clout of minority parties in ruling coalitions. But public administration reform is also essential. A Memorandum agreed in early 2007 was designed to implement performance related pay in the civil service (an attempt to extend to administrators and lower-level employees a system already existing for middle and top public managers). It goes in the right direction if implemented, but still leaves unions a strong say on the fairness of performance evaluations which might imply a potentially greater interference of trade unions in the government workforce management.

A way around these roadblocks to reform may be via direct appeal to public opinion, which all powers ultimately have to obey. Indeed, the unions signed the Memorandum probably because they could not ignore a growing public outcry over public workforce inefficiency. This will involve education of the public of what is really at stake, with a simple explanation of the benefits of reforms to them. Implementing the long standing project of legal code simplification is also desirable. The rule of law is comparatively weak in Italy in part because there are many complex laws, undermining respect for laws or even the ability to obey them. The Budget Law, which is cumbersome and hard to read, especially in recent years, and apparently little-understood by members of Parliament or the public, is one such example. The government intends to simplify the budget process.

#### EMU and the propensity to undertake reform\*

The OECD has recently undertaken empirical studies of the political economy drivers of structural reforms. One of the more interesting results relates to the impact of EMU on the propensity to undertake reform. From a political economy standpoint, EMU can have certain drawbacks:

First, in a flexible exchange rate regime, one of the gains from structural reform is to lower risk premia in long-term interest rates. This incentive to undertake reform has vanished with EMU. This is evident in the very narrow spread enjoyed by Italian bonds with respect to German ones. Second, within a monetary union, structural reforms may be easier to carry out in small countries than in larger ones such as Italy.

**Box 1.1. Political economy of Italian reforms (cont.)**

The basic explanation is that, in the short run, many structural reforms boost supply more than demand. In a flexible exchange rate regime, downward wage and price inflation expectations would normally bring about lower interest rates and real exchange rate depreciation, which in turn would boost demand and allow the added supply capacity to be “crowded in”. This “crowding-in” mechanism should facilitate the implementation of reforms in the first place. In a monetary union, however, only the real exchange rate channel remains available. And it is typically more powerful in small open economies than in larger, more closed ones. For the latter, market-based adjustment to short-run economic slack may be so slow that it could discourage reforms in the first place.

An alternative under EMU is for fiscal policy to accommodate the short-run costs of reforms and to compensate reform losers. This requires, however, that the underlying situation of public finances is sufficiently sound to start with. This is clearly not the case in Italy today. But EMU really leaves Italy no choice but to regain competitiveness through structural reforms, eschewing the short term fix of an exchange rate devaluation. This is the so-called “TINA” (there-is-no-alternative) argument. This powerful argument must ultimately prevail over the political economy obstacles to reform, in order that Italy recapture competitiveness and restart the engines of durable growth.

\* Cotis (2006), Hoj *et al.* (2006) and Duval and Elmeskov (2005).

It is useful to look clearly at what has been achieved and what critical failures remain. Italian firms are no longer adjusting to competitive crises by massive lay-offs as in the past: labour is a resource to be treasured not discarded. This in itself reflects a deep structural reform that benefits social welfare remarkably. As to the productivity puzzle, it has been shown above that structural failings still untouched by reforms are probably the dominant factors and have been varied and widespread.<sup>25</sup> Labour market reforms may have expanded the supply curve of labour but not the demand curve, so that employment merely expanded at a lower real wage (Daveri and Jona-Lasino, 2005). Remaining labour market rigidities still impede full use of labour potential. “Framework conditions” still seem inadequate. Human capital endowment may be limited by a lagging educational system. Capital quality may suffer from infrastructure weaknesses. The financial system may not support risk taking and firm growth. Sheltered service sectors may see no need to innovate anyway, enjoying extensive public protection. Privatisation may have preserved monopoly positions, with low efficiency and high rents the result. Thus, dealing with such issues so as to further liberate Italy’s full business potential will be necessary in order to assure sustainable high growth.

### The survey deals with three of these important policy challenges

This survey makes the case for structural reforms, in line with many aspects of the government’s ambitious agenda. There is also no lack of recommendations for further actions that could help achieve goals. The survey confines itself to three priority fields of policy action: product market competition, fiscal policy, and fiscal federalism. Other areas will be left to future surveys, and some have been covered in past ones.<sup>26</sup> A short motivation of policy issues in each of these areas is now provided.

### **Deepening the forces of competition**

Over the last decade, services have been increasingly driving growth and productivity in leading OECD countries. This has contributed to offsetting the more generalised weakening of industrial productivity growth, suggesting that resources and innovative focus were able to shift rather quickly to new areas of international comparative advantage. Besides, in a context of ageing and a shrinking labour force, potential output will in the future grow ever more dependent on efficient market services. Yet, whereas most of the recent slowdown in total factor productivity must be attributed to the manufacturing sector, TFP growth in services has been dramatically low over the past twenty years in Italy (Table 1.5).

With domestic services accounting for a growing share of value added, stimulating efficiency in financial industries, distribution or business services may be a key driver to boost productivity and employment in Italy. On the one hand, direct effects on productivity may arise from the reduction in the costs of doing business and from removal of barriers to competition in those sectors. The cases of the banking industry or professional services in Italy are relevant: in these sectors prices are relatively high, margins comfortable, competition is apparently modest and productivity gains are low. On the other hand, indirect effects on productivity may operate through different channels: better reallocation of resources (allocative efficiency), improvement in the utilisation of inputs by firms (productive efficiency), and incentives for firms to innovate and move to the “technology frontier” (dynamic efficiency).

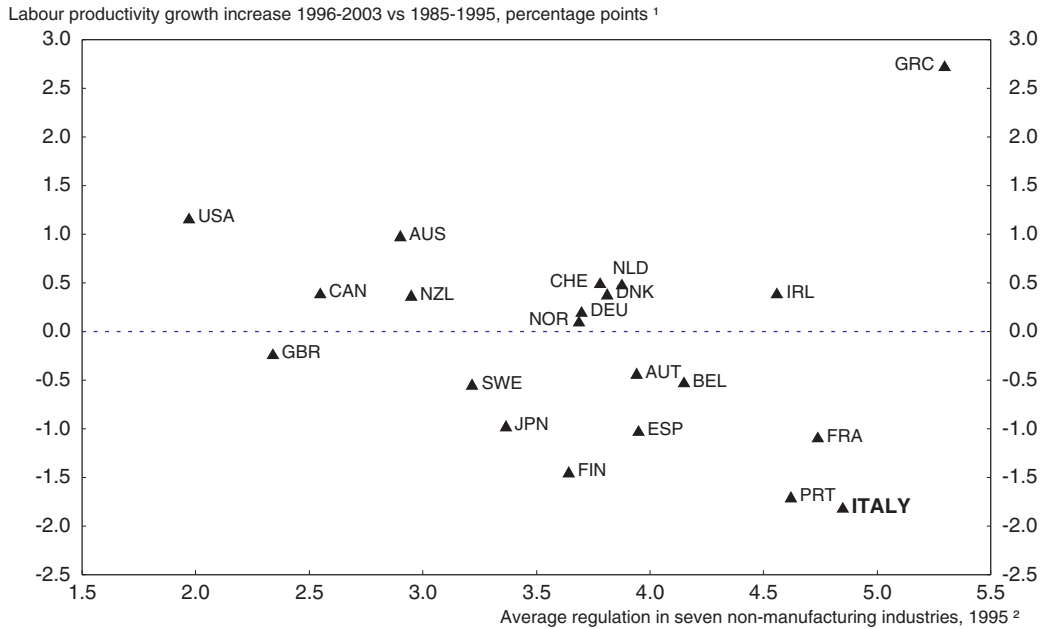
Some tentative measurements by the OECD seem to confirm the importance of both indirect and direct effects of service sector competition on productivity (Conway and Nicoletti, 2006). The key finding is that services as a whole are key suppliers of inputs to other industries in Italy, notably in the exposed sector. For instance, 80% of Italian business and financial services output (50% in electricity and 70% in post and telecoms) is destined to be used as an intermediate resource. The authors evaluate through an input-output analysis that the impacts of deregulation in non-manufacturing on the manufacturing sector would be stronger in Italy and Greece than in other OECD countries.<sup>27</sup>

There is growing evidence that product market competition is a key to promoting productivity and employment simultaneously, by reinforcing efficiency and incentives to innovate (Conway *et al.*, 2005; Nicoletti and Scarpetta, 2005). It is even argued that product market regulations, including land-use policies, along with macroeconomic policies are the most important causal factors for economic performance (Lewis 2004). New OECD empirical analysis shows that competition-restraining regulations slow the rate of catch-up with the technological frontier (Conway *et al.*, 2006). For instance, labour productivity may have accelerated in lightly-regulated economies over the past ten years, but decelerated in highly-regulated countries that are behind the frontier such as Italy (Figure 1.10).

In the case of Italy, competition intensity seems, up to now, rather low. For instance, recent empirical research shows that weak productivity gains accompany one of the slowest rates of price responsiveness in the euro area (Dhyne *et al.*, 2005). Compared to the United States, the differences are even more striking, with consumer prices changing three times more frequently in the United States than in Italy (Table 1.9). The authors suggest that wage rigidities as well as regulated prices or other restrictions are important determinants of those diverging price developments, notably in service industries.


**Figure 1.10. Cross-country differences in product market regulation may have contributed to divergent productivity growth**

The scale of the indicators is 0-6 from least to most restrictive



1. Labour productivity is defined as output per hour worked. In absence of sufficient retroplation at the time of publication, data for Greece do not take into account the 25% upwards revision to the level of GDP announced in 2006.
2. The seven non-manufacturing industries are airlines, telecommunications, electricity, gas, post, rail and road freight.

Source: OECD (2007), *Going for Growth*.

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**Table 1.9. Frequency of price changes by product type<sup>1</sup>**  
As a percentage of products exhibiting price changes over the period investigated

	Unprocessed food	Processed food	Energy (oil products)	Non-energy Industrial goods	Services	Total <sup>2</sup> (country weights)	Total <sup>3</sup> (euro area weights)
Belgium	31.5	19.1	81.6	5.9	3.0	17.6	15.6
Germany	25.2	8.9	91.4	5.4	4.3	13.5	15.0
Spain <sup>4</sup>	50.9	17.7	n.a.	6.1	4.6	13.3	11.5
France	24.7	20.3	76.9	18.0	7.4	20.9	20.4
<b>Italy</b>	<b>19.3</b>	<b>9.4</b>	<b>61.6</b>	<b>5.8</b>	<b>4.6</b>	<b>10.0</b>	<b>12.0</b>
Luxembourg	54.6	10.5	73.9	14.5	4.8	23	19.2
Netherlands	30.8	17.3	72.6	14.2	7.9	16.2	19.0
Austria	37.5	15.5	72.3	8.4	7.1	15.4	17.1
Portugal	55.3	24.5	15.9	14.3	13.6	21.1	18.7
Finland	52.7	12.8	89.3	18.1	11.6	20.3	..
Euro	28.3	13.7	78.0	9.2	5.6	15.1	15.8
United States	47.7	27.1	74.1	22.4	15.0	24.8	..

1. Figures presented in this table are computed on the basis of the 50 products sample, with the only exception of Finland for which figures derived from the entire CPI are presented. Figures based on a larger coverage of the CPI for each individual country, when available, are presented in their respective national paper.
2. The total is calculated using country-specific weights for each item.
3. The total is calculated using common euro area weights for each sub-index. No figures are provided for Finland because of the lack of comparability of the sample of products used in this country.
4. In the Spanish database no energy products are included, which biases downwards the aggregate frequency.

Source: Dhyne et al. (2005).

Why do some countries enjoy higher competitive intensity than Italy? As with many continental European countries, Italy may have in the past followed a path designed to protect professions and businesses. Regulations likely insulated firms from competition and prevented actors from being able to enter markets, to innovate and to grow. It is rational for established companies to spend considerable efforts trying to find market segments with little or no competition, so that they can charge higher prices and margins. Preserving those rents may even be the main purpose of professional associations and lobbies such as “Ordini” (professional associations) in Italy. It is up to public institutions, however, to make sure markets are open to fair competition, and to enforce efficient regulation guaranteeing consumers’ interests.

The government has recently moved forcefully to lower entry barriers and ease restrictions in a variety of private services, cut bureaucratic red tape, expand consumer choice, and reinforce the competition framework. All these changes are welcome and should stimulate competition and productivity. They are reviewed carefully in Chapter 2. Yet, even if policies are heading in the right direction, there is still scope to strengthen market forces further, and to boost competition and innovation in Italy. For instance, supporting the forces of competition at local levels, with a view to protecting consumers’ interest rather than local vested interests, could be a key factor to stimulate the retail and wholesale trade sector. In the same vein, the consolidation process of the banking industry is promising, but Italy might need more competition to spur productivity in this area. The country would also surely benefit from a more market-based financing system to allow firms to grow (Annex 1.A2).

### **Bringing public finances back on a sustainable path**

The fiscal situation, characterised by high effective tax rates (at least in an OECD if not a European context) and very high debt, places a large burden on the private sector.<sup>28</sup> Italian households and firms not only face a poor trade-off between taxes and public services provision, but also are hampered in the ability to make long range plans, not knowing what new measures lay in store for them so long as debt dynamics are not brought under control.<sup>29</sup> Constant tinkering with reforms has only exacerbated such uncertainty. For example, frequent revision of the pension reform may have pushed people into early retirement because they want to lock in benefits. Achieving the 5% primary surplus target of the DPEF, and maintaining it, is critically needed to reduce the debt to the Maastricht ceiling within a reasonable (15-20 years) time frame (OECD, 2007a).

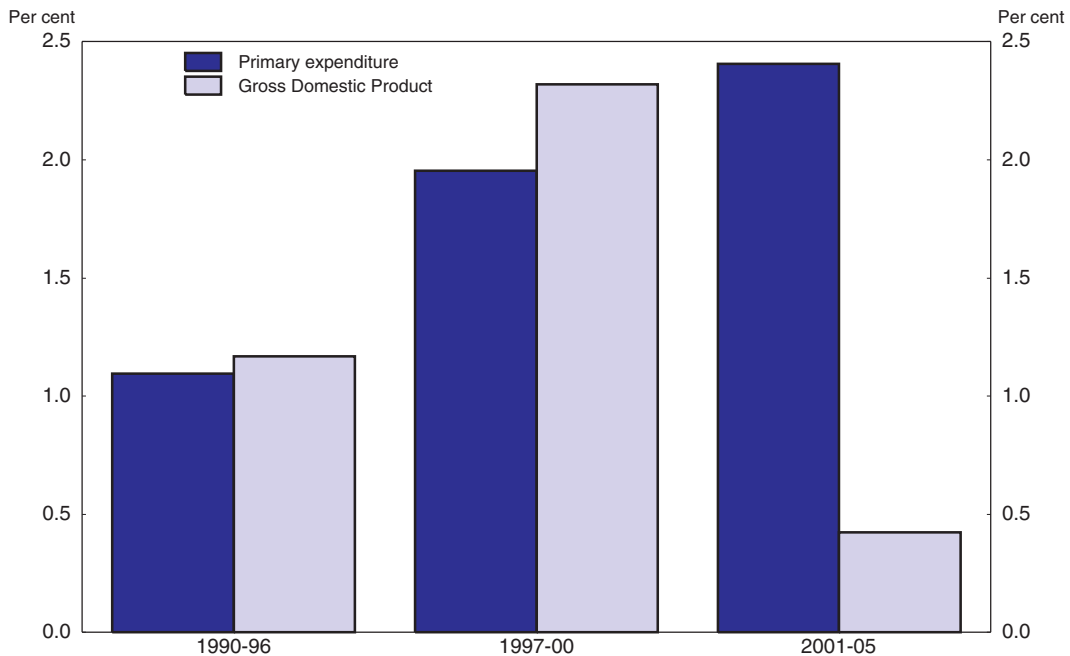
Equity suffers too. The 5% or so of GDP that is devoted to public debt service goes to bond holders and crowds out welfare spending. Also, as in several other continental European countries, pensions are regressive in their impact and feature very high replacement rates for older generations. Such a system is very expensive. A sound pension reform was made in 1995 based on actuarial principles, *i.e.* both welfare-neutral and growth-friendly. However, the transition to the new scheme is excessively long, implying large opportunity costs for the budget and unjustified inter-generational unfairness.<sup>30</sup>

As to discretionary spending, the lion’s share goes to public employment, but Italy provides few services to people. Many people seem to be just “pushing paper”, sometimes implying negative value added, *e.g.* an excessive burden of red tape. The state of public infrastructure is deficient since investment spending bore the brunt of past budget cuts, and because of sometimes poor local governance. Spending on education may be misaligned: compared to OECD averages, too much is spent on primary and secondary, but inefficiently,

and too little on tertiary, which is starved for funds (OECD, 2005). There is definitely a job to do in reprioritising the uses of scarce public money in the pursuit of growth and equity.


A key problem is high tax pressure, reflecting high spending. An econometric analysis by the OECD (OECD 2007b) shows that the high tax wedge in Italy is a main factor explaining its low participation rate, although the government intends to reduce it. Primary spending has been rising steadily in relation to GDP during the slow growth period, and is now at a historical post war high (Figure 1.11). Public wages since 2000 have grown almost twice as fast as wages in the rest of the economy, and health spending rebounded after a strong containment in the run up to EMU. The political will to restrain this structural dynamism has not yet been found, despite year by year squeezes and caps of various sorts. A detailed spending review has been launched to identify priorities; this is a promising sign and should be followed through. Chapter 3 takes up these tough challenges, and offers suggestions for improved spending control and to secure long run fiscal sustainability.

Figure 1.11. **Spending and revenue growth rates**  
In real terms<sup>1</sup>



1. Deflated by consumer price index for primary spending, and volume for GDP.

Source: OECD (2007), Economic Outlook No. 81 database.

StatLink  <http://dx.doi.org/10.1787/013577215170>

### **Making federalism work**

Italy initiated an ambitious fiscal decentralisation around the time that it set out on the course of fiscal consolidation and market-oriented reforms in the 1990s. Major spending and regulatory functions were devolved to regions, mostly those involving interface with citizens, and new tax bases were accorded. A constitutional reform in 2001 set the stage for an even deeper transfer of powers. This signifies a major change from its highly centralised past.

The parallel pursuit of structural flexibility in private and public sectors seems to make a lot of sense for Italy, for a number of interrelated reasons:

- *Micro-efficiency*: bringing the delivery of services closer to the citizen-user should allow government to attend to the real needs of citizens which may well differ across the country, resulting in improved resource allocation.
- *Accountability*: making the financing of these services transparent should result in more responsible behaviour by government agents – in other words better accountability and oversight on the uses of public funds are possible only when local citizens see that their own tax payments and the related quality of services they receive are at stake; reduced opportunities to “free ride” on national transfers would likewise encourage local development and tax base growth.
- *Changing nature of government services (dynamic efficiency)*: local services must be adapted to provide new types of services to cope with deep demographic shifts, i.e. rapid ageing and immigration; also the push toward more efficient and technologically performing public services requires modern management techniques and openness to private sector competition, which is in principle more likely to occur where local fiscal accountability and spending autonomy is present.
- *Political forces*: years of transfers to southern regions seem to have created a dependency culture in the south while pushing up the tax burden on the more productive north, now facing intense competitiveness pressures of its own; this trend has reinforced the need for a governance model giving freer rein to local incentives and promoting local responsibility.<sup>31</sup>

But top-down federalism is a heroic undertaking and the reality is still some way from the theoretical ideal suggested by the literature.<sup>32</sup> Fiscal decentralisation has been at the core of the public policy debate over the last decade,<sup>33</sup> yet there is still a lack of social consensus about the real goals of federalism and the acceptable equity-efficiency tradeoffs involved. It has proven easier to devolve spending powers than to promote local accountability. Attempts to control spending, for instance by tightening central transfers, have driven some regions to off-the-books debts and creative accounting to cover their health deficits. The government has now assumed part of these debts, in a fresh start, but this may itself create moral hazards. Decentralising spending therefore poses clear risks to its proper control unless accompanied by financial responsibility and hardened budget constraints. More devolved tax bases, dynamic enough to cope with future health spending pressures, and a more rational system of regional transfers are still necessary. Chapter 4 investigates these issues and proposes ways to make federalism work for Italy.

## Notes

1. Faini and Sapir (2005) show that the real exchange rate is now slightly above its level just prior to the 1995 lira devaluation, but still some 30% below its level before the ERM realignment of 1992.
2. For entry level workers, they have fallen much more since around 1995, as globalisation and technology have implied a widening of income dispersion much as in the rest of the OECD (Faini and Sapir, *op. cit.*).
3. Cipollone and Guelfi (2006) estimate that firms value the possibility of hiring 1% new workers on a fixed term contract as much as a cut in the labour cost of an open-ended worker of 1.3-2.8 per cent.
4. The number of immigrant amnesties in 2006 was about 160 000.

5. Cf. Gros (2007) who argues that productivity statistics have been seriously distorted by immigrant regularisations.
6. The November 2006 OECD *Economic Outlook* No. 80 showed the official 2006 estimate with the warning that there was a significant risk that final tax revenues would be higher than expected and hence the budget outcome better than estimated.
7. The 2006 deficit could also be revised up, as health spending is often undercounted in the initial estimates.
8. See IMF (2005).
9. Chaney (2007) argues that volumes are incorrectly represented in the data: export unit values are a very poor substitute for export price, and tend to overstate price because of a faulty accounting for quality changes. This would understate volumes and exaggerate the market share losses – and be consistent with his earlier theory that competitiveness measures are not as bad as they seem.
10. The same could be inferred from simulation of a standard export volume growth equation by the OECD (Cotis, 2006). After around 2000, the fitted values of the equation – fully accounting for Italy's price competitiveness as well as market growth – were substantially above the actual ones. This suggests a lack of quality adjustments to compensate for the price disadvantage.
11. Inadequate public infrastructure following years of budget cuts could also play a role. For example, between 2001 and 2005 container traffic grew by around 50% in the ports of the Mediterranean regions of France and Spain as well as in those of northern Europe, while for the main Italian ports the increase was of the order of 10%. Shortages of space, inadequate links with road and rail networks, and road and rail congestion lay behind the loss of market shares to competitor ports. See Banca d'Italia (2006).
12. The estimate of TFP growth is very dependent on how labour input is measured. Productivity is higher if measured as value added per hours worked than per full time equivalent employee, simply because average working hours have been declining secularly. Thus, Brandolini and Cipollone (2001), using the full time equivalent measure of labour input, find that virtually all of TFP growth in the 1980s and early 1990s captures such cohort effects. Scarpetta *et al.* (2003) finds a similar result. It also has to be noted that measuring labour quality is not without controversy. The above authors get very large quality effects when assuming that quality is proportional to number of years of schooling completed. Brandolini and Cipollone show that if a milder measure is used, say wage differentials, then the quality adjustments are much smaller.
13. Daveri and Jona-Lisinio (2005) indicate that one important exception to the general picture was utilities where productivity stagnated under public ownership for years but zoomed in the 1990s thanks to privatisations – which probably reflected monopoly profits rather than true TFP – though also exerting adverse compositional effects as labour shifted out of these highly capital intensive industries to less capital intensive ones. Agriculture has also stopped contributing to economy wide productivity growth since modernisation has fallen off as have exits to higher productivity activities.
14. The above calculations of TFP are of course only approximate, depending on some strong simplifications and inadvertently capturing measurement errors on factor inputs, notably those related to quality. Thus, it is wise to corroborate them with other evidence.
15. Currently, less than 15% of a generation obtains a tertiary diploma, far below the 40% and up reached in top OECD performers. See OECD (2005) for a discussion of problems and policies for the university sector.
16. See EC Economic Policy Committee, *The Impact of Ageing on Public Expenditure: Projections for the EU25 Member States on Pensions, Health Care, Long-Term Care, Education and Unemployment Transfers* (2004-50), Table 3-6.
17. The unions do not seem to be pushing too hard for a UI scheme since they perhaps see no need for one so long as EPL stays so strong and its coverage widespread.
18. Istat estimates that in 2004, 17-18% of total output and 11½ per cent of employment were in the underground economy, not counting illegal activity. See ISTAT (2006), "La misura dell'economia sommersa secondo le statistiche ufficiali", December. Outside estimates usually go higher.
19. The DPEF 2007-2011 states that the continuing precariousness of the legal and security situation in many southern regions constitutes a grave obstacle to economic and social development. Over one quarter of southern families report irregularities in water supply, for example, against less than 10% in the north.



20. By comparison, Spain started out with a similar gap vis-à-vis Italy when it joined the EU but then mostly caught up in a matter of decades, and the Irish case is well known.
21. Immigrants' educational levels are on average higher than those of native Italians; however, these skills are still underutilised in the jobs they receive (ISAE, 2007).
22. See The Lisbon Council (2007), *European Growth and Jobs Monitor* and *Making Europe fit for the future, The European Human Capital Index*.
23. The *Relazione Unificata sull'Economia e la Finanza Pubblica* published by the Ministry of Economics and Finance in mid March 2007 announces the government's intention to use the permanent part of the fiscal bonus (2006 tax overshoot) to reduce taxes and that rising demands for new spending has to come from spending cuts elsewhere. It also warns that it will not be easy to circumvent the EU's demand that the tax bonus be used to speed up deficit and debt reduction.
24. For evidence that export unit values overestimate the growth of export prices, and hence lead to understated export quantities, see Bugamelli (2007).
25. Cyclical factors could also have played a role after 2000, when low interest rates may have facilitated labour hoarding. A special structural factor was that the opportunity cost of capital increased with opening of low wage countries in east Europe to investments, though studies have shown that firms who outsource tend to better support employment at home because of their enhance profitability on foreign operations (Banca d'Italia and ISAE).
26. See, e.g., OECD (2005) for a discussion of education and labour market policies.
27. Using an inverted Leontief Matrix at a two-digit ISIC level, the authors calculate how many units of an industry's output have to be produced at any stage of the value chain to produce one unit for final demand. Those weights are then used to calculate a weighted average index, so called regulation impact indicators.
28. The government (Ministry of Economy and Finance, 2007) has recently refashioned fiscal consolidation not as an objective but rather a constraint, i.e. a *sine qua non* for achieving its real objectives, which are growth and equity.
29. The government may also be faced with many more "one-off" operations to bring public company debts on budget and make the fiscal accounts more transparent, as it had to do last year.
30. The old PAYG system continues to weigh on public spending for quite some time, and it is regressive since rich and better educated people tend to live longer whereas future taxpayers earning markedly lower pension rights will be carrying the financial burden.
31. These tensions also gave rise to a new party, the Northern League whose platform is greater autonomy for the northern regions. In any event this seemed coherent with the decreasing relevance of national boundaries and increasing relevance of regionalism in a European Union and globalising economy.
32. Existing OECD federal systems have tended to evolve more slowly, with quasi-independent states coming together to form a federal union, ceding powers to central government for the common good.
33. Franco et al. (2004).

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## ANNEX 1.A1

*Taking stock of structural reforms*

This table reviews recent action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed in the relevant chapter.

Recommendations	Action taken since the previous <i>Survey</i> (November 2005)
<b>A. LABOUR MARKETS</b>	
Raise labour force participation	No action
Promote greater wage differentiation	No action, but there are new plans in the public sector towards greater wage differentiation taking into account productivity gains and individual performances.
Reform Employment Protection Legislation on permanent contracts	No action
Reduce tax wedge on labour income	The second phase of income tax cuts was implemented by the previous government. The new government kept reducing tax rates for lower income workers but raised them for higher income ones. The 2007 budget includes a reduction in IRAP equivalent to a cut in the labour tax wedge, more generous for companies in poorer regions and targeted to hiring workers on permanent contracts.
<b>B. EDUCATION</b>	
Raise quantity and quality of tertiary level degrees	No action
Reduce the drop out rate from schools	Secondary school reform slowly implemented by previous government but not completed for lack of funds.
Improve business-academic research links	Industry Law Decree (Industry 2015) includes general mechanisms to promote research through more cooperation between Ministries. Research and venture capitalism should be supported by a "Competitiveness Fund" and a Fund for corporate Finance. Universities are allowed to patent technology and receive revenues from their own inventions.
<b>C. FINANCIAL MARKET</b>	
Ensure competition in the banking sector	The July 2006 and January 2007 decree laws cover extensive measures to liberalise retail banking and promote a new legal framework to boost competition: abusive clauses related to bank account fees are forbidden; penalties on early extinction of home mortgages have been abolished; switching costs are reduced.
Enhance corporate governance and transparency of financial instruments	The Saving Law (Law No. 262/2005) and the following Pinza decree (Legislative Decree No. 303/2006) reinforce the regulatory framework relating to the independence of the board of directors, secure the representation of minority shareholders in the board and in the supervisory body of the company, lay down an <i>ex ante</i> disclosure regime of stock option plans, etc. The recent proposal for the introduction of class actions (draft of bill No. 1495) should also improve the means for protection available to investors.

Recommendations	Action taken since the previous <i>Survey</i> (November 2005)
Strengthen Financial Market Supervision	The financial regulatory authorities have recently been re-organised, with better partition of supervisory responsibilities according to a separation between the functions of competition oversight and financial stability; notably, regulation of competition has been moved from Bank of Italy to Antitrust.
Reform bankruptcy legislation	Law No. 80/2005 was approved by the Parliament delegating the Government to reform bankruptcy law. The new bankruptcy law was enacted in January 2006 (Legislative Decree 6/2006) and came into force in July 2006. Valid for both medium size and big companies, it proposed to streamline procedures, provide greater protection for creditors and make it easier to preserve assets of the firm in order to restructure itself and restart business as a going concern.
<b>D. QUALITY OF PUBLIC FINANCE</b>	
Reduce debt on a sustained basis	Debt to GDP ratio rose 2 years in a row (2005-06) as primary surplus fell to almost zero; the 2007-11 DPEF seeks to establish sustainable debt reduction by increasing the primary surplus to 5% of GDP by 2011.
Reform the pension system	No action
Contain public employment and wage growth	Public wages rose considerably faster than private wages in past 2 years; employment growth is being contained by attrition and better control of consultancies.
Make greater use of market mechanisms in devolved government services	No action
<b>E. ENVIRONMENTAL POLICIES</b>	
Limit CO <sub>2</sub> emissions and develop renewable energy resources	The new energy bill encourages energy saving and use of renewable energy sources. Additional measures including tax credits have been introduced.
<b>F. SUPPORT COMPETITION AND REDUCE STATE AID</b>	
Increase regulatory power of competition authorities	The decree law of June 2006 enhances the Antitrust's capacity of reaction and power of sanctions.
Reduce state ownership	The government recently launched a new privatisation plan for Alitalia, the national airline company.
Improve state-owned activities governance	No action
<b>G. PRODUCT MARKET COMPETITION</b>	
Continue liberalisation and privatisation in electricity and gas	A new bill should open up and liberalise the energy market by fully transposing European directives envisaging the principle of neutrality in access to transportation networks and grids.
Reduce rents, increase competition and reduce barriers to entry	The Bersani decree laws include packages of liberalisation in stifled areas like retail trade, taxis, pharmaceuticals, liberal professions, public services and retail banking, but entry regulations and licensing authority nonetheless remain a powerful long arm of professional associations.
Speed up liberalisation in transport	A special package, the "Lanzillota draft law", still under discussion, should introduce a major change in the provision of local public services. Following the Bersani decree, private companies will thus be allowed to tender for public services such as public transportation, waste management and sewerage (water provision is still under debate). A new authority dedicated to transport services (covering airlines, trains and highways) should also be created to improve the regulatory framework.
Keep up competition in telecommunications	Telecom operator fees for recharging prepaid cellular telephones are abolished (Bersani decree 2007).

## ANNEX 1.A2

*How to make Italian firms grow ?*

It is common knowledge that Italy is predominantly made up of small and medium-sized enterprises (SMEs), mainly family firms, with a few large internationals, and a very thin layer of intermediate-size firms. Whereas it is difficult to say that firms face strong barriers to entry, Italian firms do not grow. Pagano and Schivardi (2003) find a positive and robust association between average firm size and growth. This scale effect may have grown more critical in the recent context of globalisation and rising competition for Italian small firms, which have faced a sharper fall in their profitability over the past decade (Figure 1.5). What are the main reasons behind this stylised fact? How to factor in corrective measures?

**Employment legislation may deter rapid labour reallocation**

EPL raises the cost of adjusting the workforce. This slows down the adoption of latest production techniques and discourages major innovations, because these typically require work-place reorganisation and substantial changes in the composition of the workforce. OECD research finds support for this view at both micro and macro levels.<sup>1</sup>

If indeed countries with soft EPL incorporate best production techniques more quickly than others, then productivity may diverge when general purpose technologies emerge. This is precisely what has been happening in recent years with the emergence of new information and communication technologies. Less stringent EPL may contribute to explaining why the English-speaking countries and – to a lesser extent – the European Nordic countries have so far reaped greater benefits from new technologies than most continental European countries, where EPL is stricter (Table 1.A2.1).<sup>2</sup>

In the case of Italy, EPL for temporary workers has been relaxed over the past decade. This has benefited employment and the economy, albeit at the cost of growing labour market “dualism”. However, EPL for permanent workers has been left untouched. In particular, heavy involvement of the judicial system still makes the cost – notably the length – of firing procedures hard to predict, which in turn may discourage firms from undertaking sweeping changes in the composition of the workforce that would be needed to undertake or implement major innovations. Furthermore, the legislation imposes substantially higher firing costs for unfair dismissals to firms above the 15-employee threshold. This, along with other existing thresholds might explain in part the relatively small size of Italian firms, although the effect seems small from available estimates (Garibaldi, Pacelli and Borgarello, 2003; Schivardi and Torrini, 2004). This small enterprise sector is flexible, but may have a weaker productivity growth potential, for example

Table 1.A2.1. **Employment protection legislation in OECD countries**

	Regular procedural inconveniences	Notice and Severance pay for no-fault individual dismissals	Difficulty of dismissal	Fixed-term contracts	Temporary work agency employment	Collective dismissals	Employment Protection Legislation-Regular	Employment Protection Legislation-Temporary	Summary indicator
Australia	1.5	1.0	2.0	1.3	0.5	2.9	1.5	0.9	1.5
Austria	2.5	0.9	3.8	1.8	1.3	3.3	2.4	1.5	2.2
Belgium	1.0	2.4	1.8	1.5	3.8	4.1	1.7	2.6	2.5
Canada	1.0	1.0	2.0	0.0	0.5	2.9	1.3	0.3	1.1
Czech Rep.	3.5	2.7	3.8	0.5	0.5	2.1	3.3	0.5	1.9
Denmark	1.0	1.9	1.5	2.3	0.5	3.9	1.5	1.4	1.8
Finland	2.8	1.0	2.8	3.3	0.5	2.6	2.2	1.9	2.1
France	2.5	1.9	3.0	4.0	3.3	2.1	2.5	3.6	2.9
Germany	3.5	1.3	3.3	1.8	1.8	3.8	2.7	1.8	2.5
Greece	2.0	2.2	3.0	4.5	2.0	3.3	2.4	3.3	2.9
Hungary	1.5	1.8	2.5	1.8	0.5	2.9	1.9	1.1	1.7
Ireland	2.0	0.8	2.0	0.8	0.5	2.4	1.6	0.6	1.3
<b>Italy</b>	<b>1.5</b>	<b>0.6</b>	<b>3.3</b>	<b>2.5</b>	<b>1.8</b>	<b>4.9</b>	<b>1.8</b>	<b>2.1</b>	<b>2.4</b>
Japan	2.0	1.8	3.5	0.5	2.0	1.5	2.4	1.3	1.8
Korea	3.3	0.9	3.0	0.8	2.6	1.9	2.4	1.7	2.0
Luxembourg	2.5	2.0	3.3	5.3	4.3	5.0	2.6	4.8	3.9
Mexico	1.0	2.1	3.7	2.5	5.5	3.8	2.3	4.0	3.2
Netherlands	4.0	1.9	3.3	0.8	1.6	3.0	3.1	1.2	2.3
New Zealand	2.0	0.4	2.7	1.5	1.0	0.4	1.7	1.3	1.3
Norway	2.0	1.0	3.8	3.3	2.5	2.9	2.3	2.9	2.6
Poland	3.0	1.4	2.3	0.0	2.5	4.1	2.2	1.3	2.1
Portugal	3.5	5.0	4.0	1.8	3.8	3.6	4.2	2.8	3.5
Slovak Rep.	5.0	2.7	2.8	0.3	0.5	2.5	3.5	0.4	2.0
Spain	2.0	2.6	3.3	3.0	4.0	3.1	2.6	3.5	3.1
Sweden	3.0	1.6	4.0	1.8	1.5	4.5	2.9	1.6	2.6
Switzerland	0.5	1.5	1.5	1.3	1.0	3.9	1.2	1.1	1.6
Turkey	2.0	3.4	2.3	4.3	5.5	2.4	2.6	4.9	3.5
United Kingdom	1.0	1.1	1.3	0.3	0.5	2.9	1.1	0.4	1.1
United States	0.0	0.0	0.5	0.0	0.5	2.9	0.2	0.3	0.7
<i>Min.</i>	0.0	0.0	0.5	0.0	0.5	0.4	0.2	0.3	0.7
<i>Max.</i>	5.0	5.0	4.0	5.3	5.5	5.0	4.2	4.9	3.9
<i>OECD average</i>	2.2	1.7	2.8	1.8	2.0	3.1	2.2	1.9	2.2
<i>EU15 average</i>	2.3	1.8	2.9	2.4	2.1	3.5	2.4	2.2	2.5

1. The summary EPL indicator is a weighted average of EPLR, EPLT and the strictness of collective dismissals, with weights 5/12, 5/12 and 2/12. Source: OECD, OECD Employment Outlook, 2004.

because it prevents firms from taking full advantage of increasing returns to R&D (Pagano and Schivardi, 2003).

## Removing obstacles to finance firms' growth

Administrative burdens on start-ups have been considerably reduced since 1998, and more recently new headway has been made thanks to the "Bersani decrees". However, as described further below, Italy's relatively small financial market system and restrictive practices in bank lending may still explain below average performance in terms of firm growth and innovation.

Benfratello *et al.* (2005), in a recent microeconomic study, link banking development to innovation and engagement in R&D, particularly for small firms. Besides, there is increasing evidence that the financial sector, which includes capital markets and banks, supports output growth, investment and total factor productivity. Some authors (Padoan and Mariani, 2006) consider that financial integration may not be sufficient and call for a move towards a more market-based system to the extent that this is necessary to support more knowledge intensive activities. (Figure 1.A2.1, Panel B). Venture capital and private equity may thus play a key role in the entry and growth of small innovative firms in Italy. Yet, venture capital investment – excluding management buyout – and private equity are low in Italy (Figure 1.A2.1, Panels A and C). Indeed, the analysis of the determinants and the effects of venture capital finance for a sample of Italian enterprises indicates that venture capital helps in reducing financial constraints for firms with asymmetric information problems (Del Colle *et al.*, 2006). On the contrary, larger firms resort to venture capitalists when their indebtedness with banks is high. The analysis shows that venture capital is more frequent after periods of high growth and investment, a result that points to the advisory role of the venture capitalist.

Developing forms of investment risk bearing such as venture capitalism or private equity is strongly related to a sound financial environment, having in place corporate control structures ensuring that resources are used efficiently. This in turn requires a well developed stock market and a larger role of long term oriented institutional investors such as pension funds. To boost private equity and venture capital, fiscal incentives (tax credit on research and grants to researchers) have recently been introduced (Industry 2015 decree). By creating the legal status of “Business networks”, the decree will give the opportunity to independent SMEs to create a “cluster” to bargain with banks, private investors, suppliers and clients, and even launch research, equity fund and investment projects with a critical mass. This should encourage business angels and pension fund to invest in Italian small ventures.

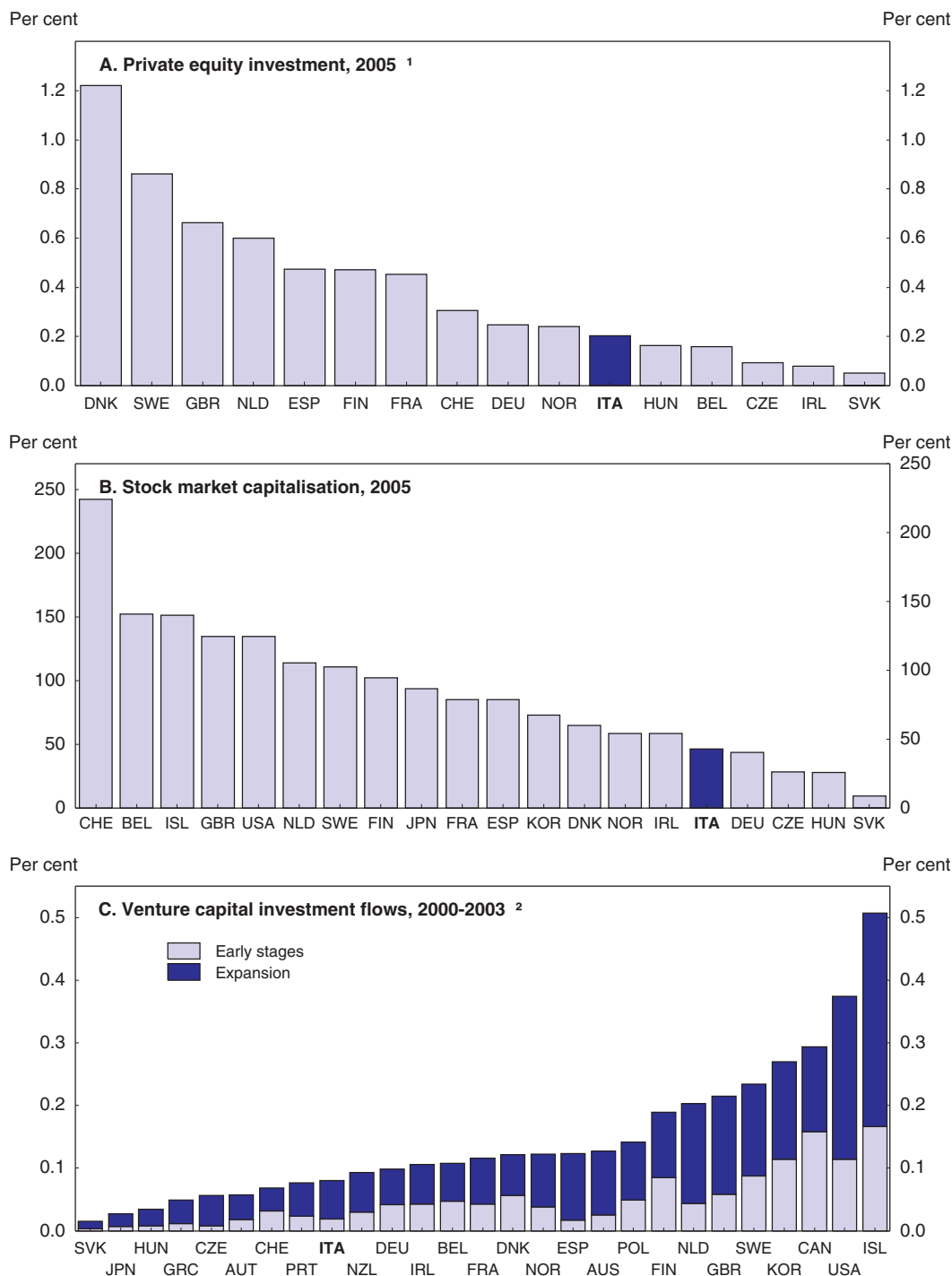
To finance firms’ growth, Italian banks should also play a bigger role. They should as a priority improve their lending policies. Business loans should not be granted only if debt is collateralised and related lending is significant. This practice, still common in Italy, may indeed exert a strong brake to launching capital-intensive start-ups and might explain the reason why family firms do not engage themselves in ambitious projects, except through self-financing.

According to Guiso *et al.* (2004), countries that currently have a comparable weak financial structure (such as Belgium, Denmark, Greece and Italy) would benefit most from an integrated internal European financial market. Whereas there were encouraging signs as Borsa Italiana opened merger discussion with both Euronext and Deutsche-Börse in early 2006, the situation seems now to be at a standstill. There are two domestic entities performing clearing and settlement functions and acting as central counterparty (CCPlinked), but independent from LCH Clearnet or Clearstream, the giant European post service providers. However, Italian stock-exchange representatives argue that their platform is highly competitive in term of prices for equity or bond transactions and the fees for securities custody are also slightly below the average (this statement is provided by studies published by the European Commission). Italian regulators are deeply involved in the project launched by the ECB for the establishment of the so-called Target2 securities. Moreover, on 7 November 2006, Borsa Italiana and the Italian clearing houses subscribed, together with other national EU trading platforms and post-trading service providers, to the European Code of Conduct for Clearing and Settlement aimed at ensuring greater



Figure 1.A2.1. **Italy needs more financial deepening**

As a percentage of GDP



1. The asset class of VC or PE (or Buyout) funds dedicated to invest from funds raised by third parties into growth or restructuring cases.

2. 2000-02 for Iceland; 1998-2001 for Australia, Japan, Korea and New Zealand.

Source: European Venture Capital Associations, World Bank Financial Development and Structure Database, and OECD venture capital database.

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transparency, interoperability and competition in Europe. It should also be acknowledged that MTS, the regulated market for trading of government bonds, had been set up in Italy and has spread its trading system all over Europe and beyond the European borders. Besides, a new trading platform for SMEs has recently been launched.

Merging or venturing with big European actors might help in streamlining further transaction and clearing systems, stimulating in the end the development of the Italian stock exchange and opening the financial sector to larger prospects. As recommended recently by the Bank of Italy, Borsa Italiana should continue its efforts to participate in the construction of a broad-based integrated European financial stock market.

### **Improving financial trust and reinforcing the legal framework**

Recent scandals such as the Parmalat case may have tarnished the Italian financial market reputation as has happened for other international markets due to corporate scandals such as Enron in the US. However no evidence was found, including by the external reviewers (IMF) that this was due to a lack of regulation or supervision. A strong will from family firms to remain independent, and maybe a lack of trust in markets, may also be one of the major obstacles for private equity and venture capital to develop in Italy. Recent research studied the effect that a general lack of trust can have on stock market participation. There is evidence, in the case of Italian micro data, that lack of trust could be an important factor in explaining the limited participation puzzle in the stock market, especially among more wealthy investors (Guiso *et al.*, 2007).

Closing definitely the “Parmalat” scandal (see OECD, 2005), the Italian parliament ended a one year long debate and finally adopted the so-called Saving Law in December 2005 and a consequent Legislative Decree (Pinza Decree) was enacted in December 2006. As anticipated in the last Survey, the Saving Law, combined with the Pinza Decree, contains a wide range of interventions on regulation of financial markets. The supervision system has been re-organised, along the lines of a better separation of functions on competition, on financial stability and on transparency of financial markets.

As regards corporate governance of listed companies, the texts: i) strengthen the presence of independent directors in the board of listed companies; ii) require directors and members of the internal board of auditors or of supervisory board to be appointed by a cumulative voting system; iii) strengthen minority shareholders' rights;<sup>3</sup> iv) require a general meeting to approve in advance any remuneration scheme based on equity addressed to members of corporate bodies or employees and provide for an *ex ante* transparency regime. Internal controls have been reinforced, and listed companies are required to appoint a chief financial officer certifying that any financial information disclosed by the company to the market corresponds to the accounting records. External auditors' independence has been reinforced.

In March 2006 a revised version of the Corporate Governance Code was issued by the Italian Stock Exchange. The new Code takes into account the reform of limited companies enacted in 2003 and the results of the implementation of the previous issues of the Code (1999 and 2002). The most important changes refer to the Board whose goals and modus operandi are spelled out more clearly, with a greater attention devoted to: transactions with related parties, evaluation of board composition and performance, directors' classification and definition of directors' and internal auditors' independence. Moreover, it sets forth conditions on some board committees such as the audit committee, which must

have at least one member with demonstrated financial expertise. One gap in this new code might be that corporate social responsibility guidelines are absent. Dominance of family firms in Italy also sets a limit to this new exchange code, which includes lots of exemptions for SMEs, as family and individual owners are often afraid of losing corporate control.<sup>4</sup> The new code entered into force at the end of 2006.<sup>5</sup> A recent proposal for the introduction of class actions should also improve the means at the disposal of investors to protect their own interests.

Law No. 80/2005 was approved by the Parliament delegating the Government to reform the bankruptcy law. The new bankruptcy law was enacted in January 2006 (Legislative Decree 6/2006) and came into force in July 2006. Valid for both medium size and big companies, it proposed to streamline procedures, to provide greater protection for creditors and to make it easier to preserve assets of the firm in order to restructure itself and restart business as a going concern.

As recommended in OECD (2005), there is still some room to improve the financial and legal framework in Italy. The scope of application of the bankruptcy reform should be enlarged, as small companies are today excluded from the benefit of a fresh start. An insolvent debtor from a SME should be allowed to launch a new business, private settlements with creditors should be encouraged and the liquidation procedures of insolvent companies should be speeded up: while the adoption of revised and enhanced laws and codes dealing with corporate governance is a positive step, a more rapid private enforcement (through civil suits) is still needed.

## Notes

1. At the micro level, OECD research finds that product innovation is negatively related to the stringency of EPL. See Jaumotte F. and N. Pain (2005a), "From Innovation Development to Implementation: Evidence from the Community Innovation Survey", *OECD Economics Department Working Paper No.458*. At the macro level, using cross-country time-series data, a clear negative impact of EPL on patenting is found. See Jaumotte F. and N. Pain (2005b), "From Ideas to Development: The Determinants of R&D and Patenting", *OECD Economics Department Working Paper No. 457*. Finally, at the sectoral level, strict EPL is found to reduce R&D spending in high-tech, low-concentration sectors such as software. See Bassanini A. and E. Ernst (2002), "Labour Market Institutions, Product Market Regulation and Innovation: Cross-Country Evidence", *OECD Economics Department Working Paper No. 316*.
2. OECD EPL indicators may under-estimate the stringency of EPL in Italy on the ground that these indicators do a poor job at capturing judicial uncertainty surrounding the cost of firing procedures.
3. Providing that: at least one director and one member of the board of internal auditors (or of the supervisory board in the two-tier model) is appointed by minority shareholders, the chair of the board of internal auditors or of the supervisory board is chosen among those members appointed by minority shareholders; minority shareholders representing at least 2.5% of the voting capital are entitled to add items to the agenda of a general meeting already convened.
4. Notwithstanding that the code is a voluntary instrument in line with the international best practice, the stock exchange has imposed its adherence to any company wishing to obtain and maintain the STAR status, a special equity segment in Borsa Italiana (see Market Rule No. 2.2.3). Entrance to the STAR segment is discretionary, but implies a clear commitment to more stringent requirements of corporate governance, transparency and liquidity. Moreover, according to Italian law all listed companies shall explain on a yearly basis any practices that deviate from the code and internal control bodies shall monitor and report any violation to the securities regulator (CONSOB). This is a particular feature of the Italian system since in very few countries does the securities regulator have enforcement powers *vis-à-vis* corporate governance, even in most advance markets such as the US.

5. The first report on corporate governance taking into account the revised Code will be issued by each listed company by July 2007. A wide analysis of the reports is carried out every year by the Association of limited companies (Assonime) and it is usually available at the end of the year.

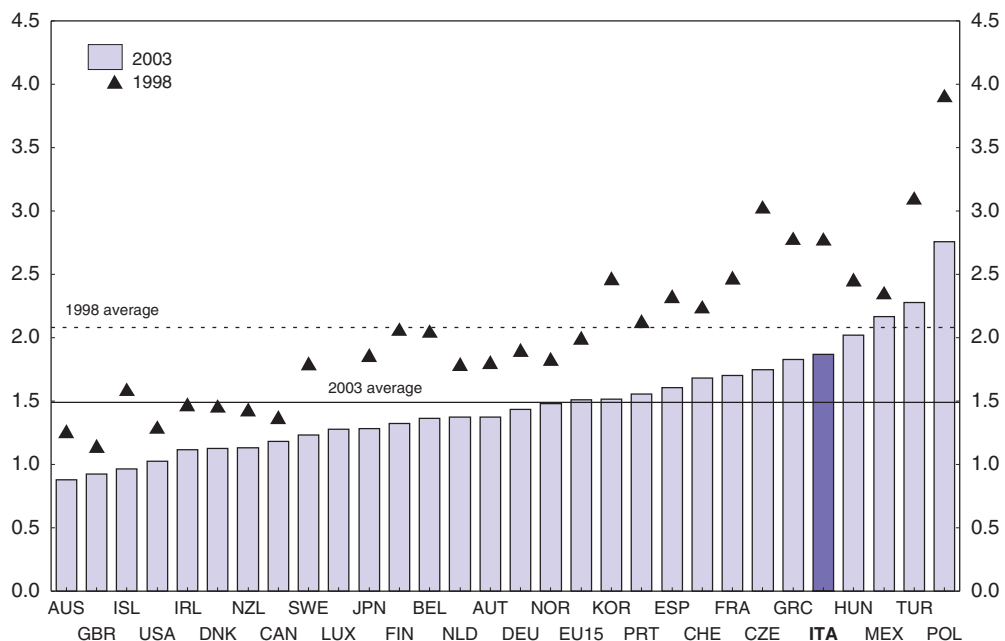
## Chapter 2

# Enhancing competition and productivity in services

*Italy has experienced a marked slowdown in productivity growth since the mid-1990s. While it is not entirely clear what caused this slowdown, it is likely that insufficient product market competition played a key role. Hence, the two recent waves of liberalisation are welcome. These reforms are not only likely to reduce entry barriers and rents in a number of services sectors, but could also positively impact on other industries. Yet there is still scope to strengthen market forces. For instance, implementing new competition bodies at local levels, driven primarily to protect consumers' interest, could be a key factor to stimulate the retail and wholesale trade sector and improve transparency in local public utilities. As well, Italy needs more competition in the financial sector so as to spur innovation and productivity; in this respect, recent reforms in the banking industry appear promising.*

Until recently, competitive forces were severely constrained in Italy. The index of product market regulation (PMR) of 2003 ranked the stance of regulatory policies as one of the strictest in the OECD, despite some progress made in previous years (Figure 2.1). Among the three components of the PMR index, the indicator of state control, which measures the degree of public ownership, was twice as high as in the United States, despite past privatisations. As well, the indicator measuring the restrictions restraining foreign acquisitions of equity suggested a strict stance. In the same vein, barriers to trade and investment and to entrepreneurship were high by international standards. It is quite plausible that such competition-restraining regulation played a key role in the slowdown of productivity. While manufacturing industries have long been exposed to international competition, the services sector has remained sheltered from competitive pressure. The services sectors contributed a modest  $\frac{1}{4}$  percentage point to the economy's labour productivity growth between 1986 and 1995, and this contribution fell even further after 1996 (Table 2.1). This was in sharp contrast with developments in other countries, such as in the United States and some Nordic countries, where there was a surge in productivity growth, notably in financial services and retail trade. Hence, the two recent waves of liberalisation are welcome, even though there remains scope for further strengthening of market forces. The present chapter assesses the measures recently

Figure 2.1. **Product market regulation in OECD countries**



Source: Conway and Nicoletti (2006).


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Table 2.1. **Contribution to the growth of labour productivity per employee**

Annual rates						
1991-1995						
Total change	Contribution of total private services	<i>Of which</i>				
		Repairs, wholesale and retail	Hotels and restaurants	Transport and telecommunications	Finance, insurance, real estate, business services	
United States	0.7	0.2	0.2	-0.1	0.1	0.2
Netherlands	0.6	0.0	-0.1	-0.1	0.1	0.2
Norway	3.0	0.6	0.3	0.0	0.2	0.2
<b>Italy</b>	<b>2.3</b>	<b>0.5</b>	<b>0.2</b>	<b>0.0</b>	<b>0.2</b>	<b>0.1</b>
Spain	1.4	-0.1	-0.1	0.0	0.2	-0.1
France	1.4	0.1	0.2	0.0	0.1	0.0
EU15	2.0	0.5	0.1	0.0	0.2	0.2
Germany	2.4	0.8	0.0	-0.1	0.2	0.5
1996-2003						
Total change	Contribution of total private services	<i>Of which</i>				
		Repairs, wholesale and retail	Hotels and restaurants	Transport and telecommunications	Finance, insurance, real estate, business services	
United States	2.1	0.8	0.3	0.0	0.1	0.5
Netherlands	0.8	0.2	0.1	0.0	0.2	0.1
Norway	1.2	0.6	0.4	0.0	0.2	0.1
<b>Italy</b>	<b>0.3</b>	<b>0.0</b>	<b>0.0</b>	<b>-0.1</b>	<b>0.1</b>	<b>0.0</b>
Spain	0.6	0.0	-0.1	0.0	0.2	0.1
France	1.0	0.2	0.0	0.0	0.1	0.2
EU15	1.1	0.3	0.1	-0.1	0.2	0.2
Germany	1.2	0.2	0.1	-0.1	0.1	0.1
1991-2003						
Total change	Contribution of total private services	<i>Of which</i>				
		Repairs, wholesale and retail	Hotels and restaurants	Transport and telecommunications	Finance, insurance, real estate, business services	
United States	1.6	0.6	0.3	0.0	0.1	0.4
Netherlands	0.7	0.1	0.0	-0.1	0.2	0.1
Norway	1.9	0.6	0.4	0.0	0.2	0.2
<b>Italy</b>	<b>1.1</b>	<b>0.2</b>	<b>0.1</b>	<b>-0.1</b>	<b>0.2</b>	<b>0.1</b>
Spain	0.9	0.0	-0.1	0.0	0.2	0.0
France	1.2	0.2	0.1	0.0	0.1	0.1
EU15	1.5	0.4	0.1	0.0	0.2	0.2
Germany	1.6	0.4	0.1	-0.1	0.1	0.2

Source: Groningen Growth and Development Centre, 60-Industry database.

introduced by the authorities to boost competition notably in the sectors of retail trade, professional services and financial intermediation. Suggestions for further liberalisation conclude the chapter.

## Recent measures to liberalise the economy

The government that came into office in mid-2006 undertook to deepen past liberalisation efforts. In July 2006, a decree law was promulgated by the new government

and rapidly adopted by the parliament (the so-called first Bersani decree). It included a package of liberalisation in stifled areas like retail trade, taxis, pharmaceuticals, liberal professions, public services and retail banking. It also strengthened consumer protection and bolstered the power of the Competition Authority (Box 2.1).

#### Box 2.1. The “Bersani decree”: an impressive liberalisation package

The 3 July 2006 decree law covers extensive measures to liberalise retail trade, professional services, retail banking and promote a new legal framework to boost competition in the non tradable sectors.

##### Retail and wholesale trade

- Restrictions related to market shares (both predefined and calculated on regional sales volumes) are removed, but the authorisation system for opening up stores (including large outlets) remains for food products.
- Restrictions imposing minimum distances between similar stores are lifted.
- The range of products sold in retail outlets is no longer restricted.
- Quantitative restrictions on the production of bread are eliminated.
- “Outstanding sales” (promotional sales, destocking and rebates) are fully liberalised.

##### Professional services

- Minimum tariffs for all professional services are abolished, and advertisement, only for informative purposes, is allowed.
- Companies bundling several professional services are allowed.
- Taxi licenses are somewhat liberalised, allowing cities to expand their numbers. However, attributions need the agreement of professional organisations (*auto-gestione*) and multiple licenses can still not be held.
- Pharmaceuticals delivered without prescription can now be sold in supermarkets (this concerns 10% of the drugs sold in Italy), but pharmacists’ counsel is still required.
- Requiring notaries to certify transactions on used cars is no longer obligatory.

##### Public services and utilities

- Private bus services are allowed to compete with public service in cities.
- Local public services are to be assigned through competitive tendering.

##### Retail banking and insurance

- Banks will be obliged to provide clients with the option of closing their accounts (and moving to another bank) at no cost in the case of changes in contractual conditions.
- Insurance brokers are no longer required to market a single exclusive insurance company contract.

##### Consumer protection and antitrust

- The scope of antitrust power is enlarged, its independence and capacity of reaction strengthened, financial and administrative penalties enhanced.

A second decree law was issued in January 2007, further liberalising services along the lines recommended by the Competition Authority. Significant reforms were made in the sectors of financial, transport, communication and retail services (Box 2.2). Measures



**Box 2.2. The “Bersani January 2007 decree”, a second wave of liberalisation**

The 25 January 2007 decree law covers a second wave of measures to liberalise financial services, gasoline distribution, retail trade, and some professional services. The most significant measures are the following:

**Financial services**

- Abusive clauses related to bank account fees are forbidden (“*Massimo scoperto*”).
- Penalties on early extinction of home mortgages have been abolished; transferring a mortgage between banks should be made easier.

**Retail and wholesale trade**

- To lower gasoline prices, which are among the highest in Europe: opening hours are liberalised; and minimum distance between stations and ban on sales of non-oil products removed.
- Small firms are allowed to buy natural gas on line instead of importing it from abroad which requires a strong contractual power.
- Telecom operator fees for recharging prepaid cellular telephones are abolished.
- Restrictions on minimum distances between cinemas are removed.

**Reducing barriers to entrepreneurship**

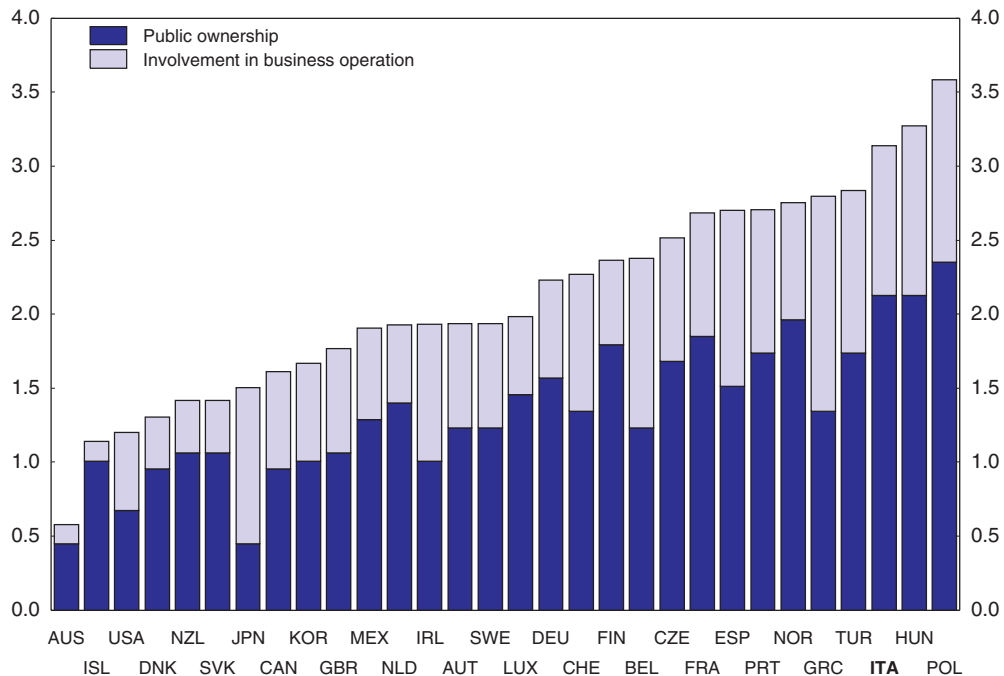
- Administrative red tape is removed: due to the creation of a “one-door” internet portal, the time for setting up a company should be reduced from 35 days to just one week.
- Restrictions on driving school licensing have been eased, barber shops are allowed to open on Mondays, realtor licensing has been simplified.

headed in the direction of fostering price transparency, reducing bureaucratic red tape and lowering barriers to entry.


**Reducing public ownership**

In 2003, Italy still had a high degree of public ownership (Figure 2.2). However, an ongoing program of privatisation continues to lower the degree of public ownership, even if important firms in the sectors of energy, transport and media are at least in part owned by the state (OECD, 2005a). In addition, the Italian government retains *golden shares* in divested companies operating in strategic fields, such as Telecom Italia, Eni, Enel and Finmeccanica, though these special powers have never been exercised and their scope has been significantly reduced by a law passed in 2003. Admittedly, the Italian privatisation law, passed in 1994, introduced some measures for the protection of minority shareholders (e.g. cumulative voting and voting by post) prior to the 1998 “Draghi Law”. Besides, the government has decided to abide by the *Codice di autodisciplina*, adopted in the context of the 1998 “Draghi Law” and every other subsequent rule adopted for the listed companies in order to protect minority shareholders. Nevertheless, by potentially enabling the government to veto strategic decisions, it is a slight possibility that the golden shares could reduce the interest of private investors for divested companies and thus lower the beneficial effects of privatisation. In June 2006, considering that these special powers may unduly restrict the freedom of capital movements and establishment, the European Commission referred the case to the European Court of Justice.<sup>1</sup> So as to conform to OECD and EU recommendations and to avoid discouraging foreign investment, the authorities

Figure 2.2. **Indicator of state control in 2003**  
0-6 scale from most to least favourable to competition



Source: OECD, Product Market Regulation database.

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should explore whether alternative arrangements – such as appropriate sectoral regulation and strengthening independent authorities – might in the future replace golden shares.

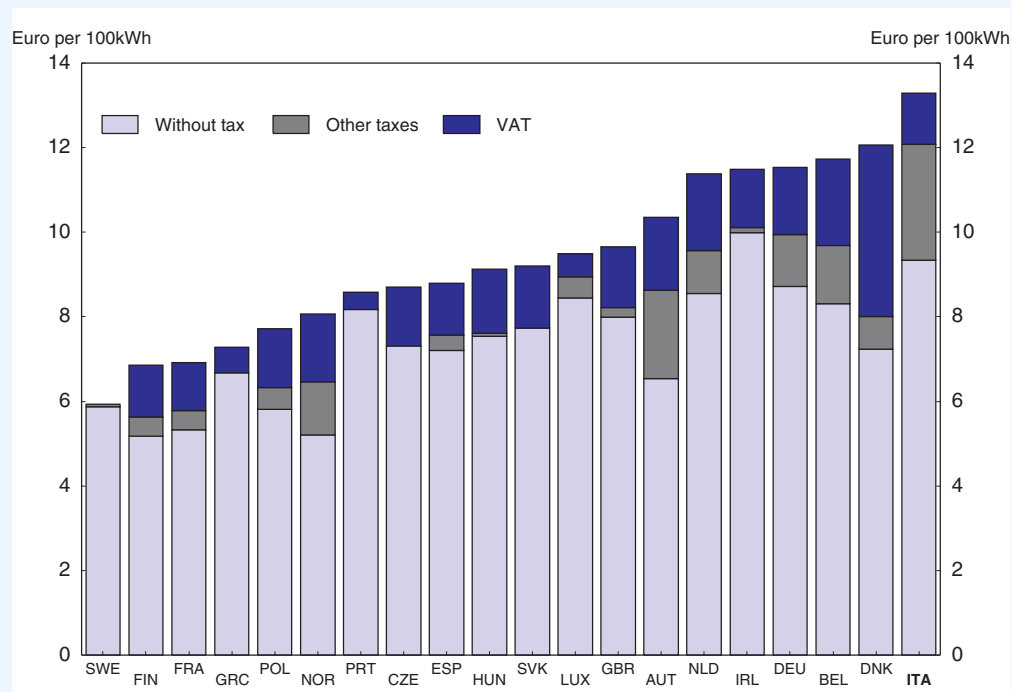
The present government considers that there are still “strategic” sectors.<sup>2</sup> As well, the authorities consider that media broadcasting services should retain their peculiar identity, RAI being organised as a state-controlled holding. The recent privatisation plans of Alitalia, the main incumbent on the domestic air transport market, have nonetheless been heading in a positive direction. It is important that the privatisation process remains fully transparent, and that recent government proposals to limit the number of Italian airports that can host international flights and new restrictions on advertisements may not disproportionately favour Alitalia.

As for local public services, the “Bersani decree” and the draft “Lanzillotta decree” should introduce major changes. The decrees seek to open the market of local public services to competition, so as to improve the quality of services and reduce costs. They also look for more transparency in public-private partnerships and reduced cross-subsidies. For the supply of public services such as public transportation, waste management and sewerage (water provision is still under debate), calling for bids should be the rule and the local tendering process should follow a general checklist requiring minimum quality standards, defined at the national level. A new bill also proposes to create an integrated transport authority and bring water under the purview of the energy regulator. Adopting these proposals would go a long way toward establishing a more efficient framework in the public utility market. However, more should be done. Procurement procedures and quality of services should be carefully monitored by a competition body at the regional level so as to prevent any rent-seeking and to guarantee pro-competitive procurement practices.

### Box 2.3. Recent reforms on the energy market

Italian electricity prices are far above the EU-25 average, even when taxes are taken into account (Figure 2.3). This may in part reflect the large share of electricity generated with fossil fuels, which currently involve higher running costs than nuclear power plants. Yet, the insufficient strength of competitive forces in the energy market may also be at stake. The government is currently adapting the legal framework to European pro-competition directives. In particular, it envisages adopting the principle of neutrality in access to transportation networks and grids. In the natural gas market, the liberalisation decree of January 2007 and subsequent legislation seek to introduce a degree of competition: ENI should be forced to reduce its share to 20% in Snam Rete, the company which owns the gas network, and a gas exchange marketplace should rapidly be put in place. In the gasoline market, the Competition Authority recently opened an investigation into nine of the biggest oil companies operating in Italy for possible price-fixing at the pump. Despite these ambitious plans, there remains large scope to improve cost efficiency in the network and energy sectors, as stressed in previous OECD surveys: energy markets should be made, in practice, fully open to competition; quality of services should be improved and production capacities (especially on the gas and electricity markets) should be increased; networks and providers should thus be totally unbundled as soon as feasible, the key issue on energy markets remaining to guarantee an access to networks at a fair price.

Figure 2.3. Electricity prices are high in Italy<sup>1</sup>



1. Composition of electricity prices for industrial consumers on 1 January 2006, in euro per 100 kWh, standard consumer – annual consumption of 2 000 MWh.

Source: Eurostat, New Chronos.

StatLink  <http://dx.doi.org/10.1787/013675157345>

### **Enforcing law and empowering regulators**

Important reforms were made recently to reform the authorities responsible for enforcing competition. When Italy adopted its competition law in 1990, the policy focus shifted from serving or implicitly protecting the interests of producers and workers to serving the interests of consumers. Yet no less than eleven sectoral regulators or authorities were also created, calling for some clarification or streamlining. In the new institutional framework, the Competition Authority is entrusted with the ultimate responsibility for competition, thus reducing the risk of coordination failure. The decree law of June 2006 gave more freedom to react and power to sanction to the Authority. It was authorised to adopt emergency *safety measures* when competition is seriously and fatally endangered.<sup>3</sup> Under the “leniency programme”, the Authority was allowed to independently reduce the amounts of financial and administrative sanctions when firms agree to collaborate in the assessment of infractions.<sup>4</sup> The power to deal with competition law violations achieved via an association may however still be too limited (OECD, 2003). Improving the Competition Authority’s powers of investigations and sanction in this respect may be particularly important for taking action against price fixing and market sharing in professional services. Legal protections that shield anti-competitive conduct by professional associations or special groups should be removed. Fines for violations achieved through an association should not be capped by the turnover of the association, but should be based on the turnover of its members, and the members should be liable for paying them. Co-operation among the supervisory authorities should also be encouraged and increased. Recent experiences between the Competition Authority and the Bank of Italy are promising in this respect (see below).

In addition, the financial regulatory authorities were re-organised recently, with better separation between the functions of competition oversight and financial stability. The Government has recently submitted to the Parliament a bill aiming at further refining the twin pick model by suppressing the insurance regulator (ISVAP) and occupational pension fund supervisory authority (COVIP): The Bank of Italy and Consob will remain the sole two regulatory authorities competent for financial supervision.

### **Strengthening consumers’ clout**

Until recently, consumer associations did not play a powerful role in Italy, much as in other continental European countries. However, promoting class actions and “whistleblower institutions” for competition issues may be a powerful lever to tackle collusive behaviour. In July 2006 it was proposed to introduce the possibility of collective actions, in conformity with EU standards and several alternative draft laws are currently under discussion at the Parliament.<sup>5</sup> One of these alternatives provides that consumer associations certified by the Ministry of Economic Development and local chambers of commerce are allowed to sue firms and ask financial compensation for anti-competitive behaviours such as abuse of dominant position or collusion price fixing or market sharing. These groups should be allowed directly to notify the Competition Authority of any suspicion of unfair competition conditions and request the Competition Authority to launch investigations and emergency procedures.

This new institutional framework is positive, strengthening the power of consumers and deterring further attempts at collusive and anti-competitive practices. The government should be praised for these reforms, promoting a new mindset in Italy that economic policy should serve consumers first. Nevertheless, the process of certification of

consumer groups is merely aimed at ensuring that the associations are actually sufficiently representative of consumers; it may, however, raise some issues. To prevent any risks of political interference and to enforce good governance, it may be considered a procedure where consumer associations are not certified by political institutions, but rather by more independent ones such as the Competition Authority or an independent commission.

## Wholesale and retail trade

### **Low productivity gains, poor job creation**

The retail trade sector remains mainly composed of small traditional shops with few employees, and little market contestability from large trade outlets (Table 2.2). It is therefore unsurprising that the sector performed poorly over the past decade. Productivity gains virtually stalled between 1995 and 2002, by contrast with the gains made in the United States or Norway (Figure 2.4). In the United States, modern supermarkets are four to five times more productive than mom and pop stores. This reflects the use of information technology and innovative organisations. Research also shows that the easing of restrictions on outlet size, opening hours and product selection lead to increases in both sales and employment (Nicolletti and Scarpetta, 2003). Worse, the Italian productivity performance slipped back between the first and the second halves of the 1990s, whereas a number of other countries saw an acceleration of productivity. As well, employment growth has been modest in this sector, running behind those of other European countries.

In the same vein, ICT penetration has been lagging behind and the development of e-commerce has been slow (Box 2.4). Lagging e-literacy, low trust in electronic transaction systems and a low-tech financial culture – Italians have not been heavy users of ATM and

Table 2.2. **Key structural features of the retail distribution sector**

	2002-03		
	Outlet density <sup>1</sup>	Employees per enterprise	Productivity <sup>2</sup>
Austria	52	7.5	2.4
Belgium	74	4	1.6
Czech Republic	137	3	4.4
Denmark	45	8.4	2.1
Finland	44	5.7	1.9
France	70	4.1	0.3
Germany	30	9.9	0.9
Hungary	114	3	2.6
Ireland	47	8.7	..
<b>Italy</b>	<b>124</b>	<b>2.5</b>	<b>0.3</b>
Luxembourg	60	6.6	4.4
Netherlands	49	8.9	1.4
Norway	65	6.3	4.6
Poland	113	3	4.2
Portugal	138	2.6	-1.1
Slovak Republic	9	15	-1.1
Spain	125	3.1	0.2
Sweden	64	4.5	2.7
United Kingdom	43	15.4	2.3
European Union	73	4.4	..

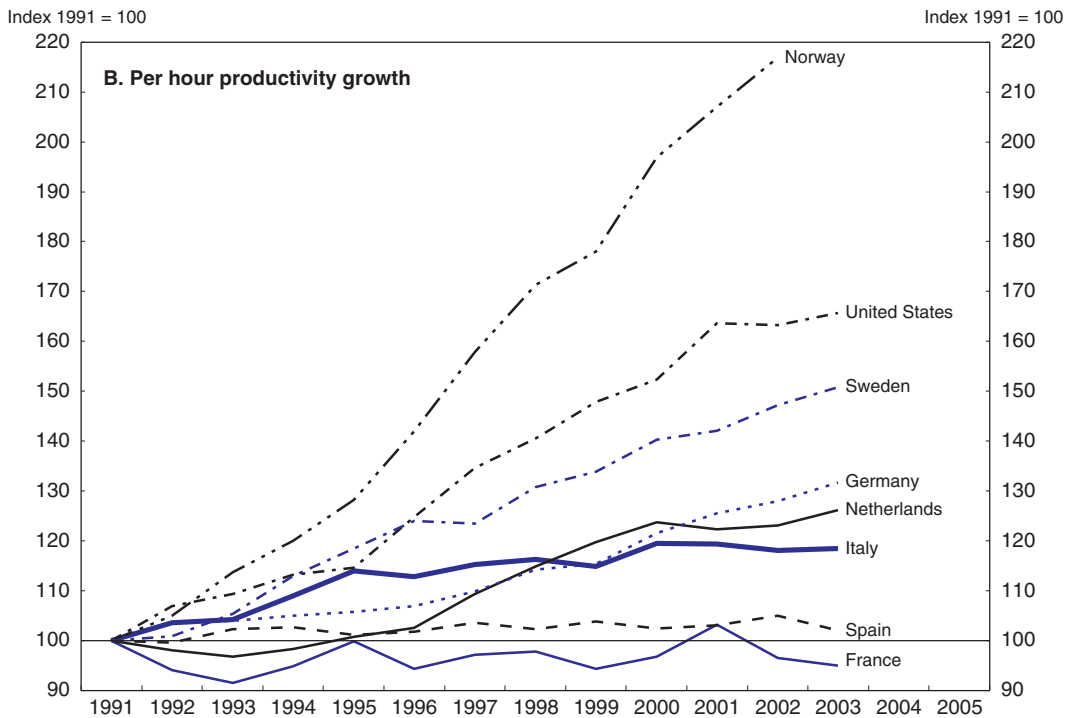
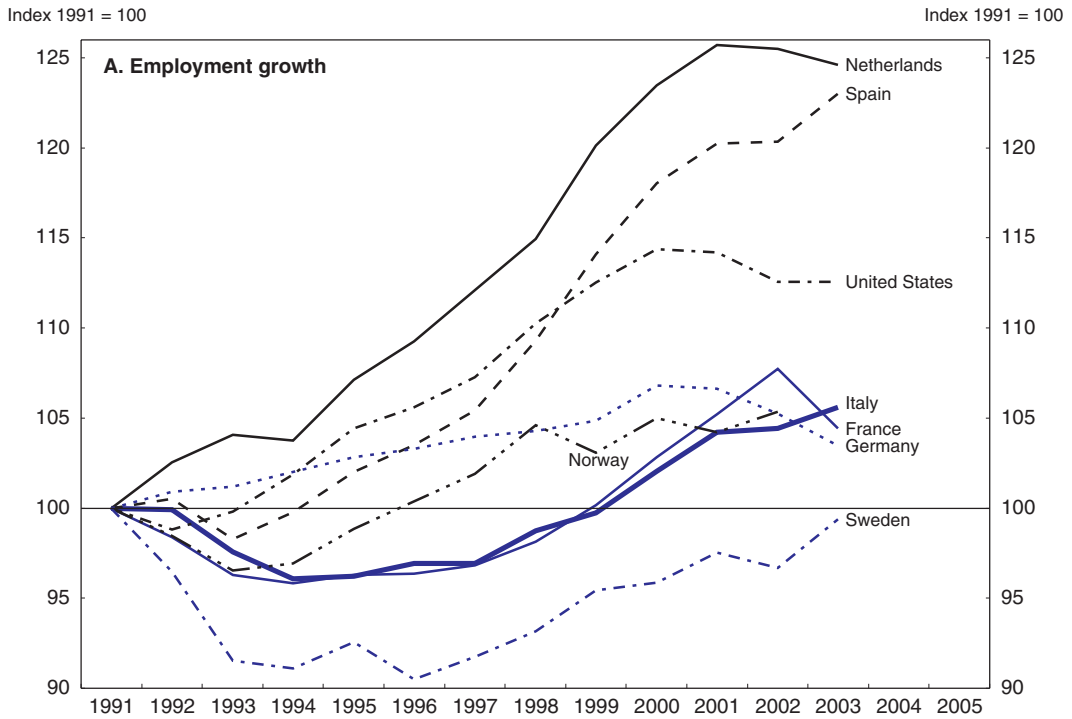
1. Number of enterprises per 10 000 inhabitants.

2. Value added per employee, 1998-2003 average growth (1998-2002 for Poland).

Source: Eurostat, New Cronos, OECD STAN database.

Figure 2.4. **Productivity and employment performance in retail and wholesale trade<sup>1</sup>**

In selected OECD countries



1. Except repairs of motor vehicles and motorcycles.

Source: Groningen Growth and Development Centre, 60-Industry Database, September 2006, [www.ggd.net](http://www.ggd.net), updated from O'Mahony and Van Ark (2003).

### Box 2.4. Italy is lagging in e-business and e-commerce

Italy's computer and internet access, previously low compared to that of other European countries, has risen somewhat in the last few years. In 2005, 57% of Italian families had broadband Internet access, close to the situations in Germany and in the United Kingdom, but well behind that of the Nordic countries and Spain (more than 75%). Internet sales are growing quickly, but they are still lower than in other large European countries. In 2005, e-commerce accounted for 0.7% of total sales in Italy, considerably lower than in other European markets (4.1% in the United Kingdom, 3.1% in Germany and 2.2% in the European Union, respectively). There is no evidence that the gap has been closed more recently. The government's "Action Plan for the Information Society" established university information-technology courses and centres, and invested heavily in computers in schools and in training teachers and employees. But progress is slow: a recent survey by Eurostat showed that Italians were among the least e-literate Europeans, with 59% of Italians declaring no computer skill at all. In the context of business, because of a larger share of small and medium-sized enterprises (SMEs), Italy seems to be slower to adopt new technologies (Table 2.3). In 2005, while 54% of firms in the United Kingdom and 48% in Germany enabled remote access to a computer network (an important precondition for flexible forms of work), only 25-35% of firms in Italy, Poland and the Czech Republic did so. Significant differences also still exist with respect to B2B trading activities and supply chain integration.

Table 2.3. **Italy scores low on the e-business survey**

	A. Basic ICT	B. Internal processes	C. Supply-side activities	D. Customer-facing activities
Germany	98	94	96	97
United Kingdom	100	80	100	100
France	81	100	83	68
Spain	80	72	99	75
Czech Republic	77	71	64	51
Portugal	70	71	65	51
<b>Italy</b>	<b>70</b>	<b>65</b>	<b>50</b>	<b>63</b>

1. Compound Index of ICT adoption and e-business intensity, based on 4 sub-indices and 16 component indicators in total (four per sub-index). Indexed values (max. = 100). All component indicators weighted by employment.

Source: European Commission, E-business scoreboard 2005.

credit cards – may also account for this situation. E-business is growing slowly and Italy scores relatively low in providing e-services to suppliers and customers (Box 2.4). The government recently introduced new measures that should encourage using electronic payments: Italians will be invited to pay all public certificates or services through credit card or e-payment. Rapid diffusion of broadband access and third generation mobile services should also help to fill the gap with leading European countries in this area. It is encouraging that the Bank of Italy intends to promote the development of e-banking, notably by contributing to enhanced security of transactions and payment services (Draghi, 2006; Draghi, 2007).

A growing literature suggests that strict regulation to protect small shops from the competition of large-scale outlets tends to increase incumbents' market power and price

margins, pushing retail prices up. Such regulation also fails to protect employment, and deters investment and modernisation (Bertrand and Kramarz, 2002; McGuckin et al., 2005). As in France, Germany and Japan, Italian zoning laws and planning restrictions have prevented the entry of global retailers and hard discounters (Lewis, 2004). They have also kept supermarkets from expanding and from competing against each other by lowering prices. The result is lower productivity and higher food prices for consumers.

In 1998, the “Bersani law” reformed the legislation of large trade outlets. The law shifted the regulation of large store openings or enlargements<sup>6</sup> from the municipal to the regional governments. It also required regional government to issue commercial zoning plans consistent with environmental and urban criteria. It required the creation of regional boards to review applications for new opening stores.<sup>7</sup> Yet, because it did not regulate the composition of regional boards or elaborate guidelines for regional zoning plans, this reform led the Italian retail trade sector to be regulated by a wide variety of regional laws, differing by the extent to which they limit the expansion of stores. Contrary to the initial objectives, 17 out of 20 Italian regions introduced substantial limits to the development of large-sized malls, restricting the maximum number of large store openings and/or the maximum floor space authorised in their territory (ISAE, 2002). Only three regions followed the national orientation toward liberalisation (Piedmont, Emilia Romagna and Marche), delivering encouraging results in terms of productivity gains and job creation (Box 2.5).

#### **Box 2.5. Evaluation of the 1998-2002 liberalisation experiences of the retail trade sector**

Abruzzo and Marche, two similar regions in central Italy, followed different approaches in implementing the Bersani law of 1998 (Viviano, 2005). Abruzzo introduced tough restrictions on the opening and enlargements of large stores, while Marche did not impose substantial entry barriers, except in historical, congested and polluted areas. Competitive pressure in Marche’s retail trade sector encouraged the development of more efficient retail trade shops (chains of small shops owned by a single wholesaler, retail co-operatives, franchising, etc.). Large stores did not drive small shops out of business: even though the number of small shop owners declined, the number of workers in small outlets did not significantly decrease. The share of retail trade employment in the total population increased by 1% in Marche between 2000 and 2002, by 1% more than in Abruzzo. Liberalising entry had other positive effects. In regions that deregulated retail trade, inflation in “food and beverages” was approximately half of a percentage point lower than the other regions: higher productivity coupled with lower margins resulted in lower consumer prices (Schivardi and Viviano, 2007). These natural experiments gave promising evidence on the potential gains of adopting a pro-competitive framework at the local level. However, this positive experience lasted just three years in Marche, as local governments and the region, worried about the unexpected and rapid increase in large store applications, stopped this process at end 2002.

#### **Fostering innovation and productivity through price competition**

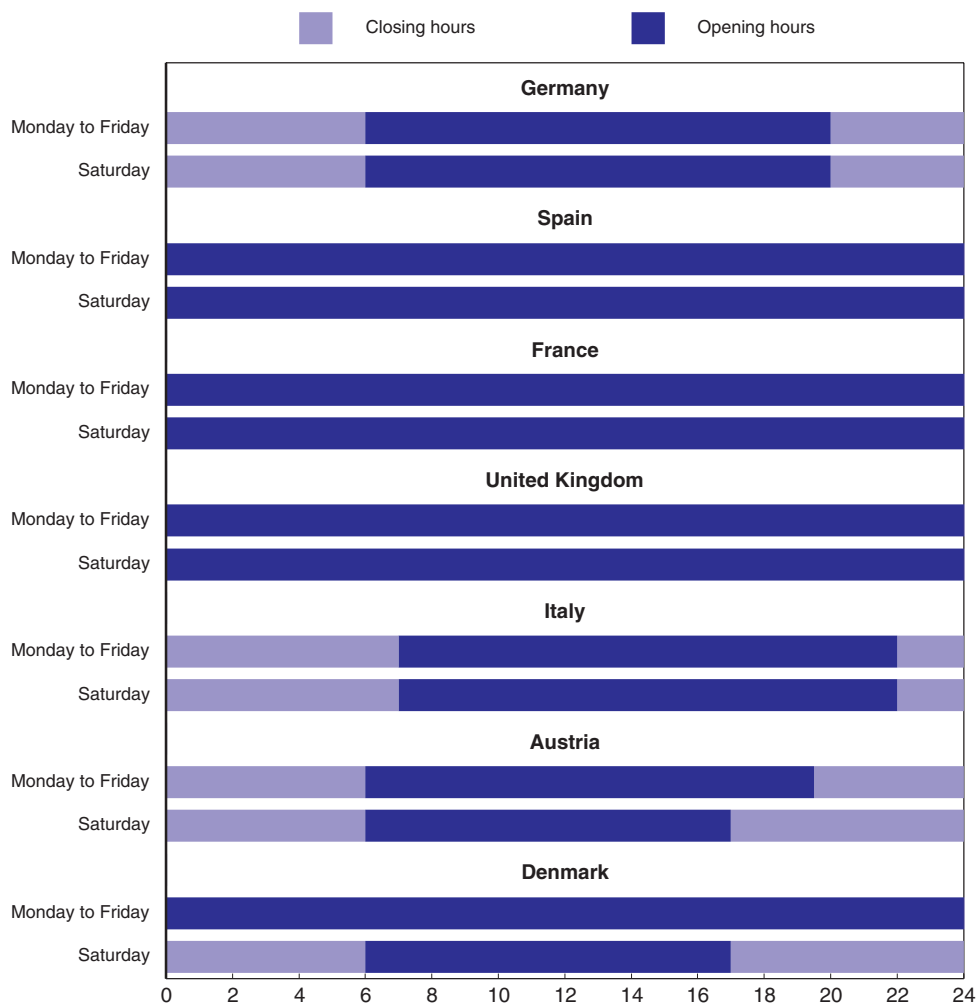
With the “Bersani decree law” of July 2006, the government introduced a long-awaited set of measures to liberalise the retail trade sector (Box 2.1). Sales promotions were allowed during the whole year, within some limits. As well, existing rules on market shares were removed. However, zoning laws and zoning restrictions are still in place, creating risks that



local authorities, influenced by incumbent retailers, will try to hamper this wave of deregulation. The government should thus continue to spur liberalisation in the retail trade sector. As the competition authority does not have the capacity to perform an overall review of this sector at the local level, there is a need for a local presence, responsible for monitoring a checklist of pro-competition practices defined on a national basis with the help of the Competition Authority. These new local “whistleblowers” should be financially and administratively independent from regional governments. They should in particular ensure that restrictions on the development of large stores are removed. In addition to the wholesale and retail trade sector, these bodies could also cover local transports and utilities.

The July 2006 and January 2007 Bersani decrees made small changes to the regulation of opening hours, but the legislation remains more restrictive than in many EU countries.<sup>8</sup> The United Kingdom, France and Spain have fully liberalised shop opening hours from Monday to Saturday. In Italy, shops may not be open more than 15 hours at a time, those hours being limited to 7 a.m. to 10 p.m. (Figure 2.5). In addition, most shops are closed on Sundays. In this respect, there is still some room for further liberalisation.

Figure 2.5. **Store opening hours**



Source: Federal Statistics Office, KPMG (2005 forecast).

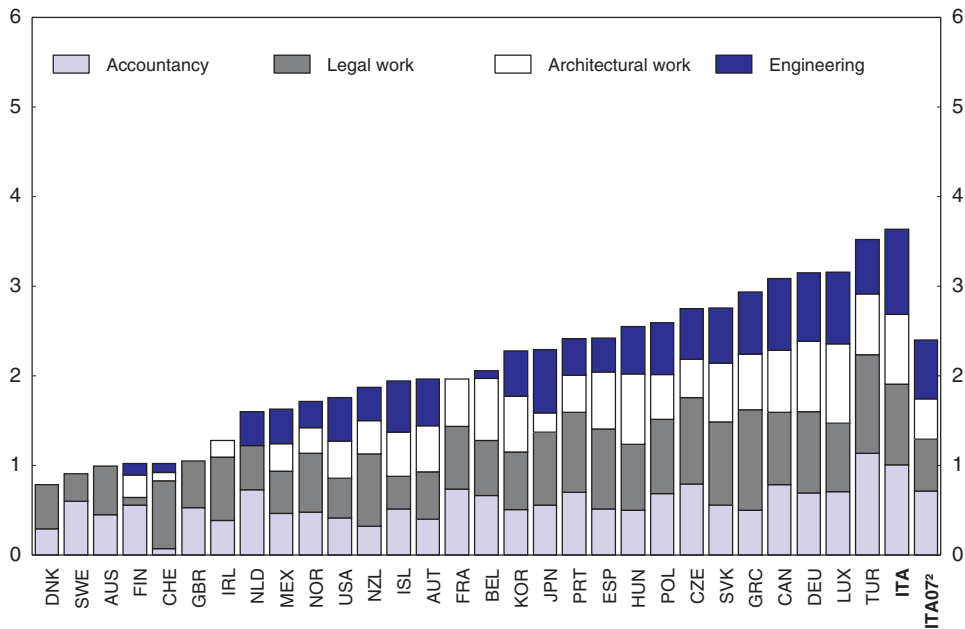
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## Professional services

### High rents and high prices caused by protectionist regulations

Liberal professions operated in a highly regulated environment until recently. Professional associations have long argued that competition among their members may be harmful to consumers and that the special status covering their activities should be preserved.<sup>9</sup> Professional services have thus been subject to a large array of restrictions enforced through professional bodies or associations (*Ordini*), self-regulation and rules co-administered with the public administration. Italy was, before the Bersani Decree, one of the countries with the highest degree of regulation in all professions (Figure 2.6). The case of notaries and legal services is emblematic (Box 2.6). Health services such as those provided by pharmacists and general practitioners are also particularly regulated: in pharmaceutical services Italy has the highest degree of regulation in Europe after Greece (Paterson et al., 2003). Growing evidence shows that such a regulation may account for low productivity gains and high price levels (Conway et al., 2005). For instance, a taxi ride today is twice as expensive in Milan as in New York, with no economic justification (Giavazzi, 2005).


Figure 2.6. **Regulation in selected service sectors**<sup>1</sup>  
Professional services, 2003



1. Index 0-6 scale from least to most restrictive.

2. Preliminary estimations for 2007 before next PMR updates, taking into account the two Bersani decrees.

Source: OECD Product Market Regulation Database.

StatLink  <http://dx.doi.org/10.1787/013805760111>

### Remaining stringent restrictions should be relaxed

Despite recent liberalisation measures, barriers to entry remain high: *first*, licensing and entry requirements often remain restricted by self-regulation for many professions (such as for journalists, alpine guides and ski masters), which means that there is a control on the number of future competitors; *second*, university degrees are often not mutually

### Box 2.6. Notaries, lawyers and pharmacists in Italy

#### Monopolistic competition in legal and pharmaceutical services

Until recently, competition was severely restricted in legal and pharmaceutical services (Faini et al., 2004). There is a legal limit to the number of notaries or pharmacists authorised to operate in each area, depending on the sizes of the population and the territory. The area covered by each notary should count at least 8 000 people and each notary is expected to deliver a minimum of revenue. These limits are re-examined only every 10 years, which may explain the implicit rationing of the number of notaries (which has grown by only 7% since 1976). The national councils exert self-regulation, setting standards of conduct and providing surveillance. These standards include “deontological and ethical rules”, restrictions to competition among members and guidelines to protect local markets (Giavazzi, 2005). Similarly, lawyers’ associations regulate entry and advertising rules. There were also price-fixing procedures: a special consultative commission made up of lawyers and attorneys proposed minimum fees and the final decision belonged to the government (Giavazzi, 2005). In 2004, the latest negotiation in the *Consiglio Nazionale Forense* led to a real rise in minimum fees by 100%.

#### The Bersani decree law should help to dent some rents but there is some room for further liberalisation

Requirements for notary certification do not always seem to be justified, such as for sales of used cars. The elimination of the latter under the 2006 Bersani law should reduce transaction costs on the automobile market. In the case of pharmacists, supermarkets were allowed to sell drugs not requiring a doctor prescription – a fast growing segment of the market.\* The decree however requires that a pharmacist be available on the premises at all time; because there is a shortage of pharmacists, this could limit the full benefit of this measure. A way to relax this rule would be to only require that qualified pharmacists are required only for prescribed drugs. However, the number of pharmacies is still limited and only self-employed (or associated) pharmacists can own pharmacies. The Bersani law reduced the power of *Ordini* – and especially lawyers’ associations – by removing their prerogatives on minimum fees and advertising. Entry regulations and licensing authority nonetheless remain a powerful long arm of such associations.

\* Accounting for 10% of private expenditures on pharmaceuticals, products delivered without prescriptions rose by 155% between 1992 and 2004 (Capri, 2005).

recognised across borders (especially at European level for accountants, lawyers, etc.), representing a barrier to foreign entry; and *third*, comparative advertising is still prohibited. Besides, some professions (such as accounting or engineering) can only be exercised by self-employed individuals. This regulatory constraint may have slowed the process of corporatisation and consolidation, barring the possibility of productivity gains arising from standardisation, automation, and economies of scale.

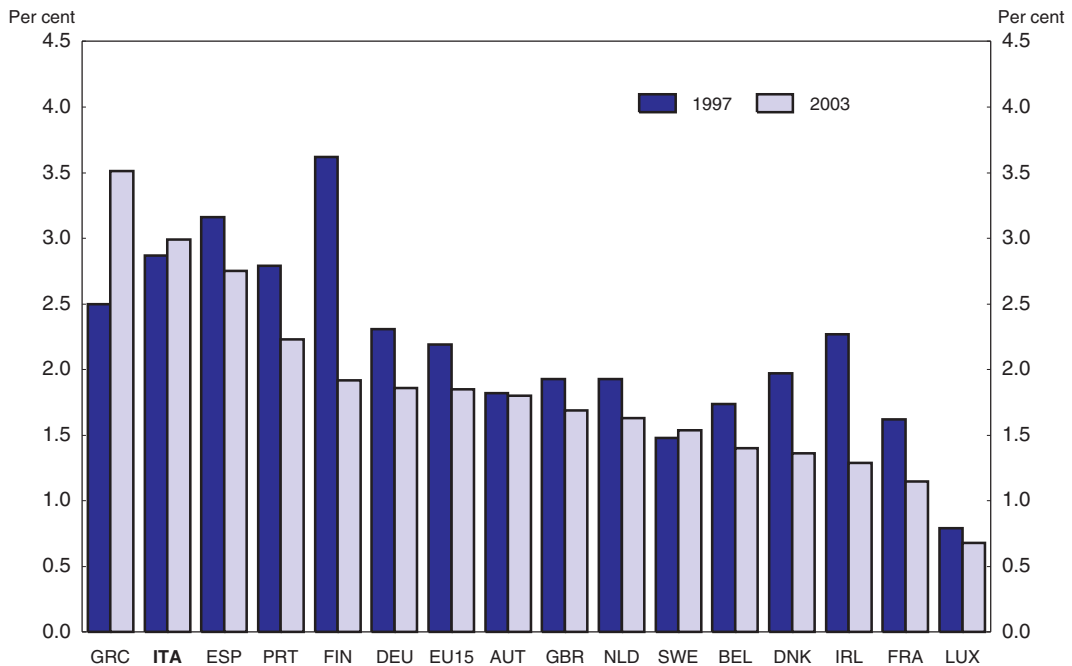
Removing strict barriers to entry should be a priority. This could be done by replacing the system of licenses with a simple certification process (entry is open, but the public authority certifies that the entrant has required qualifications). Prohibitions in the general competition laws against restrictive agreements about price should apply to prices for professional services too, without exception.<sup>10</sup> This issue is particularly critical for notaries, accountants and pharmacists. The development of consumer associations offering advice, certifying or ranking professionals and offering legal protection should be encouraged in the wake of the introduction of class actions. Using lessons from the

UK experience, the key measure would be to subject all professions to competition law (Faini *et al.*, 2004). Advertising rules about professional services should be liberalised to permit claims, even subjective ones, that are not false or misleading.<sup>11</sup> Application of competition law to professional firms and associations should be strengthened by removing legal protections that exclude anti-competitive conduct from coverage and by providing for financial sanctions sufficient to deter violations.


## Financial services

Financial services have a large impact on economic performance either directly or indirectly, via spillover effects on the accumulation of physical and human capital (Guiso *et al.*, 2004; OECD, 2005c). There has been a marked improvement in access to finances in Italy. Yet, stock market capitalisations amounted to just below 50% of GDP over the past two years, well below international standards, and the ratio of household mortgage debt to GDP was below 20%. In addition, some studies suggest that Italian banks are slightly less effective in managing costs than other European banks (European Central Bank, 2006a; Mercer *et al.*, 2005). By international standards, Italian banks seem to face high staff costs as a share of gross income, reflecting lower efficiency (ABI, 2005). As a result, the average price of basic Italian banking services appears to be one of the highest in Europe (Cap Gemini, 2005; Drummond *et al.*, 2007). Recently, the Competition Authority released the results of a sectoral investigation also concluding that Italian fees on bank accounts are the most expensive among major European countries. In the same vein, net interest margins, which may be considered as another partial measure of competitive pressures and efficiency,<sup>12</sup> have been slightly above the EU average (Figure 2.7).<sup>13</sup> Even though it is

Figure 2.7. **Net interest margins**  
As a percentage of total banking assets



Source: BankScope [taken from Allen, Bartiloro, Kowalewski (2005)].

StatLink  <http://dx.doi.org/10.1787/013875667743>

apparently difficult to reach an agreement on cost comparability in financial services among countries, there is a general consensus that banking fees and costs seem to be relatively high in Italy (Draghi, 2006). High fees and costs do not seem to be related to quality standards, as a recent survey suggested a relative dissatisfaction with banking services in Italy (European Commission, 2004).<sup>14</sup> There might be thus room for further improving of efficiency in the financial sector as outlined in the following paragraphs.

### **Progress towards greater efficiency and market contestability**

There is evidence that across European countries, the price of basic banking services is inversely related to the additional revenue from more “advanced” products (consumer lending, revenues from mortgages and asset management) (Mercer *et al.*, 2005). Thus, a lack of development in high value added services may explain the apparent high costs of basic services. Lack of competition may be the alternative explanation. Incentives to increase productivity and reduce margins in this sector may have been weak (Box 2.7). In this regard, high value added services are expected to rise thanks to the recent legislation which enables banks to issue covered bonds,<sup>15</sup> and the recent liberalization of securities issuance exceeding 50 million euros.<sup>16</sup>

Over the past decade, the Italian banking industry has started to consolidate and the market for retail banking services has become more efficient (Drummond *et al.*, 2007). Yet Italian banks remained rather small (Figure 2.8). The consolidation process has recently accelerated: three main banking groups have been created as a result of a series of mergers.<sup>17</sup>

In principle, there are some efficiency gains from consolidation. Bank mergers can allow for better risk pricing through informational benefits, and may tend to increase profitability through a more efficient use of capital (Focarelli *et al.*, 2003). However, bank consolidation may run against the objective of enhancing competition. So far, the national supervision authorities consider that the consolidation process has not been prejudicial to competition: new operators have entered local markets and the spread between lending and deposit rates has recently narrowed. It remains to be seen whether building bigger national champions will lead to increases in productivity and to declines in prices. Encouraging new entrants and developing market contestability might remain important.

Until recently, the presence of foreign banks as controllers of Italian banks was limited. At the end of 2004, only 7% of total bank assets were owned by foreigners compared to 10% in France, and 5% in Germany.<sup>18</sup> No major Italian bank was controlled by a foreign shareholder. In summer 2005, the Antonveneta crisis demonstrated that foreign takeovers were very difficult. More recently, substantial headway was made to facilitate cross-border operations: BNL was taken over by the French bank BNP Paribas, while Antonveneta was finally taken over by the Dutch bank ABN Amro. ING successfully entered the Italian market. The merger of Unicredit with the German bank HVB in 2005 was also an encouraging sign for this integration process. At the end of 2006, market contestability had dramatically improved, as no other western European countries had registered such a widespread growth in foreign participation (20% of total assets were in the hand of foreign institutions).

Italy must, however, participate further in the process of cross-border concentration. It is promising that Banca d'Italia abolished the mandatory requirement of preventive communication due in case of merger and acquisition. This has opened the way to a new

### Box 2.7. Measuring competition in banking systems in OECD countries

Table 2.4 reports the H-statistics estimated from a reduced-form bank revenue function for 16 countries with data covering the 1993-2003 period (OECD, 2005c). The H-statistic is defined as the sum of elasticities with respect to the different factor prices. It measures the reaction of a bank's revenues to change in input prices, representing the percentage variation in the equilibrium revenue resulting from a unit percentage increase in the price of all factors used by the firm. An elasticity close to unity is a sign of perfect competition, and if it is close to zero or negative it is a sign of monopoly. Between 0 and 1, it captures the intensity of a monopolistic competition.

On average, competition seems to be rather low in Italy according to the estimated H-statistics. This result is broadly in line with results found in other studies using this criterion. Cross-country analysis by Drummond *et al.* (2007) suggests that Italian banks face a degree of competition slightly lower than in Spain and in its main neighbour countries. De Bandt and Davis (2000) show furthermore that large banks in Italy have faced monopolistic competition, contrary to small banks which have tended to be closer to monopolies. Although the situation is not that different from a number of European countries, there might still be some room for increasing the degree of competition in the Italian banking system.\*

Table 2.4. **Competition in banking tends to be low in Italy**

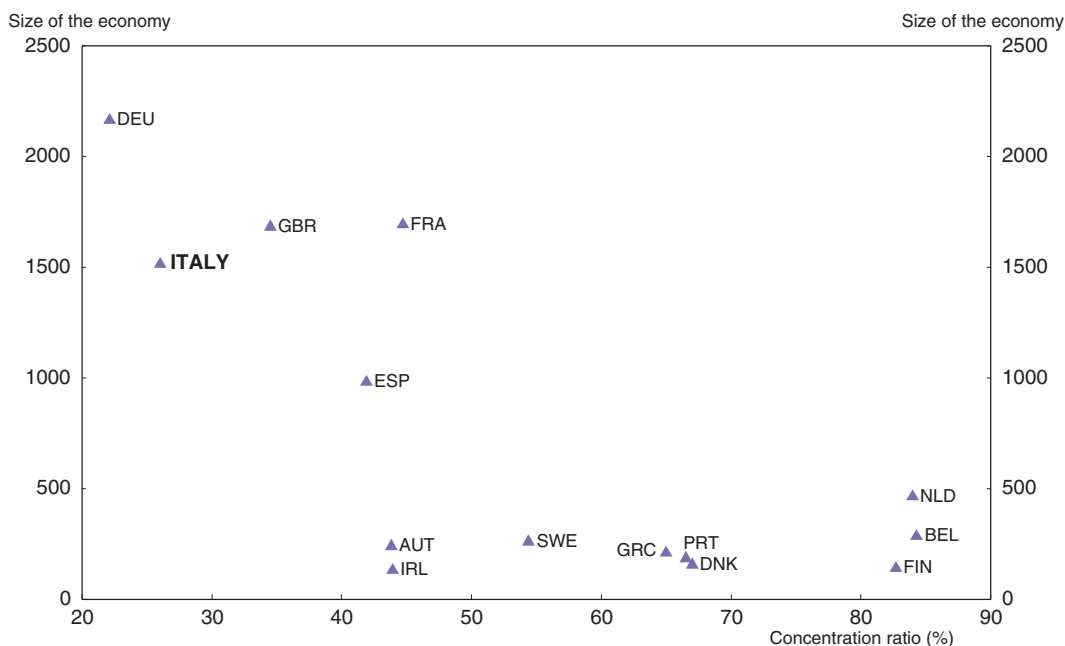
	H-statistic	Std. dev.	P-value <sup>1</sup>
Canada	0.55	0.09	0
Netherlands	0.54	0.17	0
United States	0.52	0.01	0
United Kingdom	0.43	0.06	0
Portugal	0.4	0.13	0
Australia	0.4	0.08	0
Norway	0.32	0.08	0
Denmark	0.21	0.08	0.01
Germany	0.17	0.05	0
Japan	0.16	0.06	0.01
Switzerland	0	0.08	0.98
France	-0.02	0.11	0.85
<b>Italy</b>	<b>-0.05</b>	<b>0.07</b>	<b>0.49</b>
Spain	-0.07	0.12	0.57
Sweden	-0.09	0.17	0.58
Finland	-0.2	0.13	0.15

1. p-values are the outcome of a simple F-test of whether the H-statistic is significantly different from zero and std. dev. is the standard deviation of the sum of the three elasticities from the same test.

Source: OECD (2005c), Annex 3.

\* The H-statistics should be cautiously interpreted, as comparisons between levels of H across countries are valid only under specific hypotheses (Bikker and Haaf, 2002).

consolidation wave in the banking sector. To facilitate those operations, the new Savings Law (see below) has recently transferred the responsibility for enforcing competition law in the banking sector to the Competition Authority.<sup>19</sup> In the area of mergers and acquisitions, the Bank of Italy and the Competition Authority are entrusted with different missions, the

Figure 2.8. **Concentration in the banking sector and size of the economy**<sup>1</sup>

1. Concentration ratio refers to the 5 largest institutions' share of total bank assets. The concentration ratio of the 3 largest banks of some major non-European countries is 30% (USA), 39% (JPN) and 53% (CAN). Size of the economy is measured by GDP volume at PPP, billions of euro 2005.

Source: Allen et al. (2005).

StatLink  <http://dx.doi.org/10.1787/014035372771>

former being entrusted with prudential supervisory tasks and the latter with competition. The “Saving Law” enhanced cooperation between the two authorities.

### **Evidence that competition pressures are mounting**

The July 2006 and January 2007 decree laws introduced new measures to enhance competition and serve consumer interests in the banking and insurance industry, notably making it easier to change banks. Recently, banks have been subject to stronger competition pressures. For instance:

- the banking trust managing the electronic cash dispenser (ATM) network committed to reduce inter-bank fees for debit cards and other payment instruments, following a preliminary investigation by the competition authority;<sup>20</sup>
- the new rules on unilateral contractual changes, aimed to improve contractual transparency and customers' mobility, pushed banks to offer better contractual conditions in order to attract customers from other banks;
- Italy has also supported a rapid adoption of the EU Directive on acquisition of shareholding in the financial sector, so as to eliminate political interferences in the assessment of cross-border mergers.

Regulators have expressed concern that customers might not reap the full benefit of the consolidation process in the banking sector unless steps are taken to dramatically ease

administrative and financial switching costs. High switching costs appear to have been a major obstacle to customer mobility. In early 2006, according to a joint investigation by the Bank of Italy and the Competition Authority, the average cost of closing a current account was relatively high (€ 34 on average), with wide variation among banks (from € 0 to € 100), whereas the average amount charged for transferring customers' securities was € 101, rising to € 136 when inter-group transfers are excluded. In a recent report on banking competition, the European commission estimated that those fees amounted to € 90 compared with a European average of € 14.

The Italian Banks Association (ABI) reacted to this criticism by launching important initiatives. A website – *www.pattichiari.it* – listing more than 170 banks proposes a comparative platform of daily updated banking fees, and offers online courses in financial education. Better consumer education and information about financial alternatives may help to promote greater willingness of consumers to switch from one institution to another. ABI also committed to reduce financial and non-financial switching costs in Italy. Even though this requires tremendous coordination to internalise all administrative burdens, Italy now seems to be at the forefront of this issue.

While competition is undoubtedly rising in Italy, there is still some room to improve conditions. Switching “packs” that simplify the administrative steps and “full account portability” should be generalised so as to ease further the mobility between banks, with no financial fee and administrative cost. Initiatives such as platforms that share financial information or an internet search engine on financial fees should be promoted, but verified by consumer associations and the Competition Authorities, so as to limit the risks of collusion. Fostering new entry in the banking and insurance market is likely to be a channel of price competition. The rise of electronic banking and brokerage<sup>21</sup> has shown success in neighbouring countries to reduce fees. It should thus be a priority to be promoted by supervision authorities.

## Conclusion

The Italian government has recently passed liberalising measures at “zero fiscal cost” to reduce barriers to entry, cut bureaucratic red tape, expand consumer choice and diminish rents in protected sectors. Over the past decade, most of these proposals have been strongly advocated by the OECD, the European Commission and the Italian Competition Authority. The decree laws of July 2006 and January 2007 are big steps forward to boost competition and revive productivity.

However, there are still challenges. The new competition framework needs to be fully implemented and kept under review. The government and local authorities should avoid action that would interfere with these measures. The watering-down of initial proposals to liberalise taxi services, following massive demonstrations in mid-July 2006, set an unfortunate precedent. It is also crucial that the liberalisation process continues. This requires empowering competition “watchdogs” and strengthening regulators, not only at national but at local levels, to serve consumers' interest. Because of its potential impact on productivity and employment, and because past reforms delivered disappointing results, focusing on the wholesale and retail trade sector should be a priority.



**Box 2.8. Recommendations to enhance product market competition****Reduce public ownership**

Limit as far as possible the use and scope of golden shares in the incumbent telecom, postal and energy operators to conform to EU and OECD recommendations and ensure equitable treatment of all shareholders.

Continue divestiture programmes, especially in media (TV), transport (airline and railways) and utilities (energy). Maintain the momentum to ensure a more competitive energy market and a fair access pricing. Networks and providers (energy, railway) should be unbundled as soon as feasible.

Continue the reform of local services: procurement procedures and quality of services should be carefully monitored by a competition body at the regional level to prevent any rent-seeking and guarantee pro-competitive behaviors.

**Enhance competition in wholesale and retail trade**

Introduce regional competition assessment bodies, responsible for monitoring a checklist of pro-competition practices, defined at the national level. They should notably ensure that all restrictions to the development of large stores are removed by limiting the power of local actors on land-use policies.

Consider fully relaxing the rules on shop opening.

Encourage diffusion of e-business and electronic payments with public support for improving IT infrastructure and e-literacy training.

**Liberalise professional services**

Reduce entry barriers by removing excessive licensing and consider mechanisms like certification. All professions should be concerned, including journalists.

Eliminate anti-competitive regulations that fix prices and prohibit truthful, non deceptive advertising.

Consider significant measures to reduce firm or professional associations' influence. Consider increasing deterrent financial sanctions to be applied to all members of *Ordini* in case of collusion or abuse of dominance.

Remove quantitative restrictions to the number of pharmacies and liberalise ownership status by removing the requirement that only qualified pharmacists or firms of qualified pharmacists can own pharmacies.

Monitor the agreement with taxi organisations to judge whether licenses are expanded and quality of services is improved. Entry into the taxi market should eventually be liberalised further, replacing licenses by a certification process.

**Financial services**

To spur competition, by fostering new entry in the banking and insurance market, make it easier for customers to switch their accounts between banks through "full account portability", facilitate e-banking to attract new entrants.

To boost innovation and to transfer efficiency gains to consumers, encourage merging including on a cross-border basis.

## Notes

1. The European Commission considers that the criteria for exercising these powers are vague and indeterminate in scope and therefore give the authorities wide discretionary powers when judging the risks to the vital interest of the state. The Italian authorities argue that in case of illegal use of the special powers, the Italian Administrative Court can declare null, void and, consequently, without effect, the special powers used by the government. Thus, they consider that the presence of the special powers do not prevent effective participation by investors in the management and control of Italian privatised company and do not constitute a restriction to the free movement of capital.
2. The Minister of Economy and Finance (Mr. Padoa-Schioppa) recently declared that the major phase of privatisation is now terminated, and that the government will retain its holdings in enterprises like ENEL and ENI, so as to protect these companies from hostile takeovers.
3. Sanctions have also been introduced to reinforce such power: should a company not abide by a decision imposing interim measures, the Authority may levy fines amounting up to 3% of turnover.
4. But sanctions cannot be reduced by more than half, except for the first party to provide the Authority with decisive proof of a cartel that had been unavailable to the Authority.
5. As EU guidelines set limits on pay awards, risks are limited that class actions can backfire because of enormous jury awards, and in the end, lead to price hikes detrimental to consumers.
6. The authorisation is maintained at the municipal level for stores larger than 1 500 square meters.
7. Those zoning boards, called "Conferenza dei servizi", are composed by region and municipality elected officials, consumers and small shopkeepers' representatives.
8. Hairdressers were allowed to work on Monday and opening hours of gas stations have been liberalised.
9. A rallying cry of the liberal professions against the 2006 Bersani decree is that it "commoditises" intellectual services ("Tutti in piazza contro Bersani", *Il Sole 24 Ore* 21 July 2006).
10. This covers self-regulated professional fees, minimum or maximum prices, collusive influences on tariffs and any other infringements to price competition.
11. Professional services can now advertise on general information purpose only.
12. It could be argued that relative high net interest margins can be associated with a strategy of generating income through interest payments rather than through banking fees. This is rather unconvincing in the Italian case, given rather high level of fees. Yet, the limited number of cross-selling may explain why Italian banks look for higher revenues through traditional banking account fees and interest margins.
13. The ratio of net interest margins to total assets is influenced by the share of loans to total assets, may vary across countries and induce potential distortions. If loans are a larger proportion of total assets the ratio is mechanically higher. Furthermore, the net interest margin-to-total asset ratio depends on securitization activity. Some comparisons based on interest rates from harmonized statistics show that there are no substantial differences across EU countries for most types of loans, except for consumer credit (see Banca d'Italia Economic Bulletin No. 40, March 2005, Box "The cost of bank credit in Italy and the euro area in 2004").
14. This survey tends to measure consumers' assessments through such indicators as: the quality of information provided by banks, the ease of settling disputes with banks, the extent to which banks' advice is trusted and the spread of internet banking services.
15. Decree of the Ministry of Economy and Finance of 12 April 2007, adopted by the Minister as president of the Interministerial Committee for Credit and Saving.
16. This follows an amendment to Article 129 of the Banking Law (Pinza Decree).
17. Nine new banks once belonging to foundations are now encompassed by the Unicredit Group, three by Capitalia. The recent merger between Intesa and San Paolo gave birth to the 15th largest worldwide bank, encompassing 22 former Italian banks. The new Intesa San Paolo has reached the 15th market capitalisation amongst world banks in February 2007, with € 80 billion. In May 2007, UniCredit sealed a deal to acquire Capitalia, that will give birth to Europe's second largest bank.
18. Figures for France and Germany date back to 2002 and have been drawn from the survey of Eisenbeis and Kaufman: [www.fma.org/SLC/Papers/cross-borderdraftrev-11-22-05.pdf](http://www.fma.org/SLC/Papers/cross-borderdraftrev-11-22-05.pdf).

19. Prior to the new saving law, the banking sector was the only one where enforcement was not under jurisdiction of the Competition Authority.
20. Such commitments resulted from the new power conferred to the Antitrust Authority.
21. Italian e-banking is lagging western European countries but growing fast.

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## Chapter 3

# Achieving fiscal sustainability

*Italy's budget deficit contracted last year and further improvement is expected to occur with the implementation of the 2007 budget. This is a welcome development that results from both unexpected revenue buoyancy and a greater degree of spending control. Nonetheless, the state of public finances remains difficult. The public debt ratio is the second highest in the OECD, with no sign of significant decline, making the budget vulnerable to sudden increases in interest rates and changes in market sentiment. Alleviating somewhat the risk to fiscal sustainability is the moderate cost pressure from population ageing, but this still requires the full implementation of measures to adjust pension benefits, which have been approved but not yet fully put into place. Tax rates are high compared to other countries, so that consolidation must come not from new tax increases but from better spending control. Hence, there is no other choice than decisive budgetary consolidation: the authorities' goal of bringing back the primary surplus to the level prevailing at the time of entry into EMU, namely 5% of GDP, is welcome; while it is planned to reach this target by 2011, this should be possible ahead of time considering recent strong fiscal outcomes. The first signs of improvement recorded last year and expected this year are encouraging. But the way ahead remains challenging.*

**B**uoyant revenue brought the public deficit down to 2½% of GDP in 2006 (excluding special operations), a much better outcome than expected. Although a pickup in growth and the fight against tax evasion helped, better expenditure discipline also contributed. Italy's fiscal prospects nevertheless remain challenging. The high public debt ratio makes the budget vulnerable to a sudden increase in interest rates or a change in market sentiment. There is also evidence that high debt has a negative impact on economic dynamism, notably through higher interest rates. It will therefore be crucial to protect the gains already made and to continue on a path of fiscal consolidation, so as to restore the primary surplus prevailing at the time of EMU inception and to bring debt on a firm downward trend, as in some other euro area countries. A fiscal rule could help, notably caps on central government expenditure, but they would have to be accepted by the public and shared at all levels of government. Italy has already done a lot to cope with the ageing of the population, but important measures already adopted need to be followed up and put into place rapidly.

### Short-term fiscal developments

During the run-up to EMU (1992-97), Italy conducted a sharply restrictive fiscal policy, despite sluggish growth, which led to an increase in the cyclically-adjusted primary balance by about 9 percentage points of GDP, allowing Italy to put its debt-to-GDP ratio on a downward path. However, the opportunity was lost to further improve the underlying budgetary position during the period of rapid growth at the turn of the century; economic conditions were very favourable, but the cyclical improvement in tax revenues was unwisely used to ease the fiscal stance, as in a number of other European countries. This led to an expansive fiscal policy and had a negative impact on the underlying budgetary situation. While sizeable one-off measures helped to contain the deterioration of the measured cyclically-adjusted primary balance, the underlying budgetary situation deteriorated. In 2001, the public deficit rose above 3% and it subsequently remained above that threshold.

Joining the euro area meant for Italy a sharp drop in the difference between domestic interest rates and euro area benchmark interest rates, as the exchange rate risk was eliminated. The budget benefited from a large drop in interest payments equivalent to budget savings of about 8% of GDP – a very rare opportunity. It is unfortunate that the benefits from lower debt service were not saved to a greater extent. The decline in the primary surplus by about 5 per cent of GDP since the inception of the euro area suggests that more could have been done to keep the public finances on a trend of consolidation. By comparison, Belgium undertook persistent fiscal efforts to reduce its debt ratio from 140% of GDP in the mid-1990s to about 90% currently. If Italy had followed this path, it could have reduced its debt to an even lower level, given the slightly better initial conditions, and would have reduced its debt service burden as well.

By the end of 2005, it had become clear that fiscal trends had taken a significant turn for the worse. Part of the deterioration was concealed by temporary and one-off measures; excluding these operations, the budget deficit in 2005 had increased to nearly 5 per cent of

GDP. Pressure from the European Union Council was exercised in the form of the excessive deficit procedure. The EU Council called for improvements in the balance on a cyclically-adjusted basis and excluding the effects of one-off measures of not less than 1.6 percentage points of GDP in 2006-07 compared with 2005, with at least half the correction to be achieved in 2006.

### **A surprisingly strong fiscal outcome in 2006**

The budget presented by the government and approved by parliament for 2006 fulfilled this requirement. The authorities planned to bring the net borrowing requirement down to 3.5% of GDP, from 4.2% of GDP in 2005 (Maastricht basis), with measures on both the expenditure and revenue sides of the budget. The aim was to proceed along a path of structural consolidation so as to bring the net borrowing requirement below 3% of GDP in 2007. The budget sought to achieve adjustment measures amounting to € 27 billion (1.9% of GDP), of which € 7 billion was to be used to finance “non-deferrable” expenditure and growth-enhancing actions. On 30 June 2006, the new government approved a mid-year 2006 budget. The package contained deficit-reducing revenue measures, which were partly compensated by some measures increasing expenditure. The net deficit-reducing effect was officially estimated at about 0.1% of GDP in 2006 and 0.4% of GDP in 2007. On the revenue side, a wide range of measures aimed at reducing tax evasion/avoidance in various sectors, including the real estate sector. Expenditure cuts mainly consisted of additional savings on intermediate consumption at the central level. Part of the difference in the budgetary impact between 2006 and 2007 was due to additional capital expenditure authorised for the road maintenance state company (ANAS) and capital transfers to the railway state-owned company (*Ferrovie dello Stato*).

Preliminary data for the budgetary outturn in 2006 indicate a net borrowing requirement of 4.5% of GDP on a national accounts basis and 4.4% on a Maastricht basis, considerably worse than the target of 3.5% of GDP (Table 3.1). However, excluding deficit-increasing special transactions<sup>1</sup> there was a substantial reduction in net borrowing from 4.3% of GDP in 2005<sup>2</sup> to 2.5% of GDP in 2006 (4.2 to 2.4% on a Maastricht basis and Table 3.2). Excluding all one-off measures, the net deficit fell from 4.9% of GDP in 2005 to 3.3% in 2006. In cyclically-adjusted terms (also excluding all one-offs), there was an increase in the structural primary balance of 1½ per cent of GDP (Figure 3.1). While expenditure control played an important part in this budgetary outcome (current primary spending increased in line with nominal GDP), the strengthening mainly took place on the revenue side of the budget. Current revenues increased by 8% in 2006, much faster than nominal GDP (3.7%), implying an elasticity of more than 2, unusually high in comparison to other countries and to past experience (Figure 3.2), although about ¾ per cent of GDP of the higher revenues reflects one-off measures. Direct tax revenue increased impressively (12.4%), reflecting the underlying strength of corporate earnings, the exhaustion of carryover losses that previously weakened corporate income tax liabilities and the revaluation of company assets. Indirect tax revenues also increased robustly (7.8%), in particular VAT receipts, perhaps reflecting the strength of taxes related to energy products, whose prices had increased markedly. The increase in social contributions was less marked, although also slightly faster than nominal GDP (4.7%). The surge in tax revenue in 2006 was used by the government to reduce its underlying deficit (net of one-offs), rather than to finance new spending. The authorities should be commended for this fiscal discipline.

Table 3.1. **General government revenues and expenditure**

As a per cent of GDP; national accounts basis

	Level						Change
	2001	2002	2003	2004	2005	2006	2002-06
Taxes	28.9	28.2	27.4	27.4	27.6	29.2	0.3
On production and imports	14.2	14.3	14.0	14.1	14.2	14.8	0.6
On income and wealth	14.7	13.9	13.4	13.3	13.4	14.5	-0.3
Social contributions	12.3	12.5	12.6	12.7	12.9	13.0	0.7
Other current revenues	3.4	3.3	3.1	3.3	3.1	3.1	-0.3
<b>Total current revenues</b>	<b>44.4</b>	<b>43.5</b>	<b>41.4</b>	<b>42.5</b>	<b>43.2</b>	<b>45.1</b>	0.7
Capital transfers received	0.3	0.4	1.7	0.9	0.4	0.3	0.0
<b>Total revenues</b>	<b>44.6</b>	<b>43.9</b>	<b>43.1</b>	<b>43.4</b>	<b>43.5</b>	<b>45.4</b>	0.7
Government final consumption expenditure	18.4	19.0	19.2	19.7	19.9	20.4	2.0
of which: Compensation of employees	10.5	10.6	10.8	10.8	11.0	11.0	0.5
Social transfers other than in kind	16.2	16.5	16.8	16.9	17.0	17.1	0.9
Primary current expenditure	<b>39.8</b>	<b>40.4</b>	<b>41.1</b>	<b>41.3</b>	<b>41.9</b>	<b>41.8</b>	2.0
Interest	5.7	5.0	4.6	4.3	4.1	4.0	-1.7
<b>Total current expenditure</b>	<b>45.5</b>	<b>45.4</b>	<b>45.6</b>	<b>45.6</b>	<b>46.0</b>	<b>45.8</b>	0.4
Net capital expenditure	2.3	1.5	1.0	1.3	1.9	3.9	1.7
<b>Total expenditure</b>	<b>47.7</b>	<b>46.9</b>	<b>46.6</b>	<b>46.9</b>	<b>47.9</b>	<b>49.8</b>	2.0
Balance <sup>1</sup>	-3.1	-3.0	-3.5	-3.5	-4.3	-4.5	-1.4
Primary surplus	2.6	2.0	1.0	0.7	-0.3	-0.5	-3.0

1. Adjusting for special operations amounting to 2% of GDP in 2006, the government balance in that year was -2.5% of GDP.

Source: OECD, *Economic Outlook* No. 81 database.

Table 3.2. **General government projections (2006-09)**

As a per cent of GDP; Maastricht basis

	2006			2007			2008	2009
	Outcome	Budget	Diff.	New projection	Budget	Diff.	New projection <sup>1</sup>	New projection <sup>1</sup>
Total revenue	46.1	45.4	0.7	46.5	46.6	-0.1	46.3	46.1
Total spending	50.5	50.3	0.2	48.7	49.4	-0.7	48.7	48.2
Current spending	44.5	44.8	-0.3	44.6	44.9	-0.3	44.4	43.8
Net interest payments	4.6	4.6	0.0	4.8	4.8	0.0	4.8	4.7
Primary balance	0.2	-0.3	0.5	2.6	2.0	0.6	2.4	2.6
Overall balance	-4.4	-4.8	0.4	-2.3	-2.8	0.5	-2.3	-2.1
Overall balance, excluding extraordinary measures	-2.4	-3.6	1.2					
Public debt	106.8	107.6	-0.8					
Real GDP growth	1.9	1.5	0.4	2.0	1.2	0.8	1.7	1.6

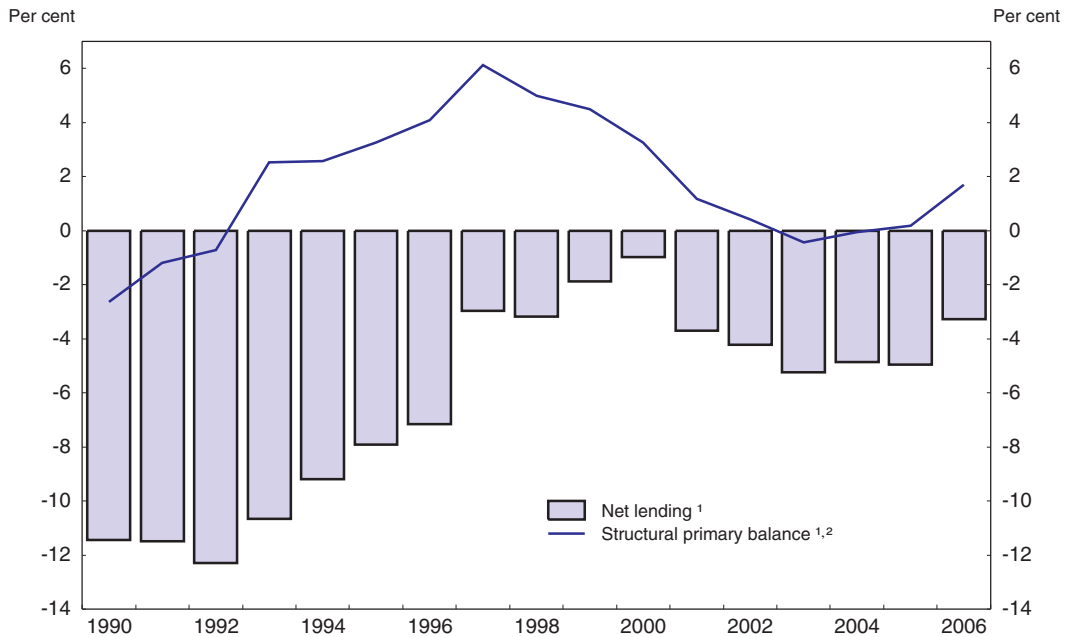
1. At unchanged legislation.

Source: Ministry of Economy and Finance (16 March 2007).

The reasons for tax buoyancy are not entirely clear. There were a few permanent revenue-enhancing measures in the budget (both the personal income tax and the corporate income tax were increased) but they do not suffice to explain the sharp increases in collections. A possible factor behind this development is the announcement by the new government that there would be no further tax amnesties and that tax fraud would be more severely sanctioned. If perceived as credible by tax evaders, such a shift in collection policy may have encouraged greater compliance and deterred tax avoidance. Another possible factor is the influence of global factors, which appear to have been at play in other



Figure 3.1. **Fiscal stance**<sup>1</sup>  
As a percentage of GDP



1. Adjusted for one-off measures and special operations, the latter amounting to 2% of GDP in 2006.

2. Also adjusted for the cycle.

Source: OECD Economic Outlook No. 81 database.

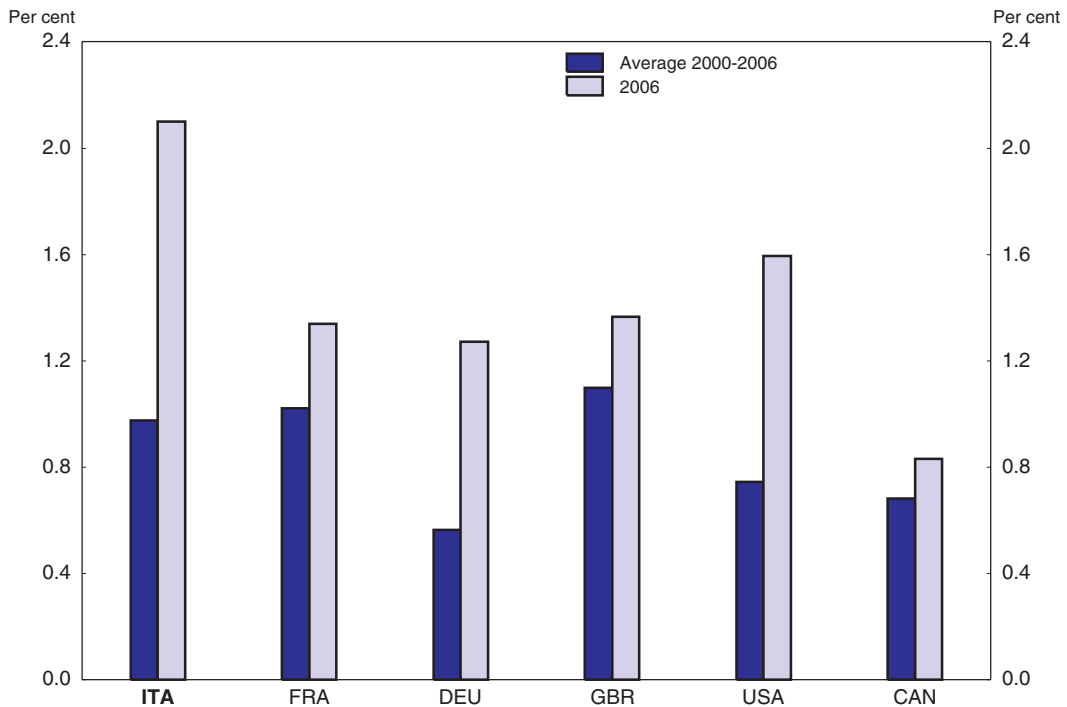
countries experiencing a buoyancy of tax receipts. Internationally, corporate profits were positively oriented and the incomes of highly-remunerated earners have surged, most probably giving a boost to direct taxes in Italy as elsewhere. In the absence of a complete set of data on tax receipts and taxable incomes, the situation will most likely remain unclear for some time; the reasons for the higher revenue buoyancy in Italy than in other countries should, however, be identifiable, once data on tax bases become available

The important question is whether this revenue increase is temporary or permanent. If it resulted from one-off determinants (such as a surge in corporate earnings), the boost in tax revenues may be followed by a reversal in the following years. By contrast, if it was linked to a durable improvement – such as tax collection efforts or higher statutory tax rates – revenues may stay at the higher level that they have achieved. While there is uncertainty, the authorities are hopeful that a large part of the revenue increase will roll over into the 2007 budget. Preliminary analysis from the Italian authorities suggests that, *prima facie*, a substantial part of the good performance on the revenue side of the budget did not result from the contribution of one-offs and other uncertain sources.<sup>3</sup> It is also noteworthy that revenue inflows remained strong in the first few months of 2007.<sup>4</sup>


### **Further consolidation planned in 2007**

The 2007 budget was prepared in September and adopted in December 2006, without full knowledge of the unexpected revenue buoyancy and the deficit reduction. While the targeted deficit of 2.8% of GDP in 2007 appeared ambitious in comparison with an expected outturn of 3½ per cent in 2006, it now seems less so based on the results from the previous year. Assuming that revenue remains strong, the target should be relatively easy to achieve.

Figure 3.2. Elasticity of current revenue to nominal GDP



Source: OECD Economic Outlook No. 81 database.

StatLink  <http://dx.doi.org/10.1787/014123317508>

The 2007 budget contains a number of important new measures aimed at redistributive and growth-enhancing goals. These include i) deductions from the labour tax base of the regional tax on productive activities (IRAP) that seek to further reduce the labour tax wedge; ii) tax concessions for family charges and different sectors, iii) transfers to the state-owned railway company, and iv) funds for increasing compensation of employees and other smaller measures. Overall, growth-enhancing measures are planned to increase expenditure by around 1% of GDP and reduce revenue by around ½ per cent of GDP. The negative budgetary effect of these measures is expected to be more than offset by nearly 2½ per cent of GDP of deficit-reducing measures with respect to the trend deficit at unchanged legislation. The net adjustment largely takes place on the revenue side of the budget. This reflects various tax reforms and adjustments and expansion of the base due to lower evasion (Box 3.1), as well as higher non-tax revenues. A large-scale non-tax measure is the partial diversion of the accumulation of the deferred compensation scheme of private sector employees – the TFR – from enterprises to the national social security institute INPS, which will be used to finance growth-enhancing investments (even though it leads to future social benefit commitments and thus contributes little to long-run fiscal sustainability). There are expenditure cuts distributed among central and local governments in the context of the internal stability pact.

Based on the better-than-expected outcome last year, the measures contained in the budget this year, as well as a significant upward revision in 2007 nominal GDP growth (from 2.8 to 4%), the authorities are confident that their target of a government deficit of 2.8% of GDP this year will be easily met. In the revised official projections presented with the RUEF (“Relazione Unificata sull’Economia e la Finanza pubblica”) on 16 March, the public deficit is expected to fall to 2.3% of GDP in 2007, using fairly conservative

### Box 3.1. Tax raising measures in the 2007 Budget

Out of € 35 billion in total corrective measures featured in the 2007 Budget, € 25 billion are due to higher revenues, of which in turn € 19 billion is generated by changes in the tax system,\* as follows:

- Measures to enhance the *efficiency of the tax administration* focus on improved VAT enforcement, closure of loopholes of various sorts, and new regulations on sectoral studies improving their capacity to estimate the tax liability of small businesses and self employed (expected to raise € 7.5 billion).
- Higher *social security charges* on self employed and employees on atypical contracts arise from removal of the exemptions formerly accorded to these groups (€ 4.4 billion).
- A new reform of the *personal income tax* is designed to make the tax system more progressive in the interest of social equity; it reduces the threshold for the top rate from € 100 000 to € 70 000 and reduces effective rates on poorer families by a system of allowances (net effect € 2.5 billion).
- Increases in *regional and local taxes* (respectively mainly IRAP, company value added tax, and ICI, the municipal property tax) could result from increased tax autonomy and tightened budget constraints in the context of the new Internal Stability and Health Pacts (€ 2.1 billion).
- A unification of the *tax on financial income* raises tax rates on all capital incomes apart from bank deposit income from 12% to 20% (€ 1.1 billion).
- Finally, there are various increases in *indirect tax* (video games, cars; € 0.6 billion) and receipts from *regularisation of immigrants* (€ 0.8 billion).

\* Because “growth-enhancing” measures include € 5 billion of tax cuts, the net tax increase in the budget as a whole is € 14 billion, roughly a 1% of GDP increase in tax pressure.

assumptions for the overall macroeconomic environment. If last year’s higher tax revenues carry over into this year’s budget, it would indeed be possible to achieve a faster-than-expected reduction in the public deficit. Should tax revenue collection exceed expectations, it would be appropriate to use the additional revenue for the purpose of deficit reduction, rather than to increase spending or enact premature tax reductions. Without an adequate understanding of the nature of the tax buoyancy, loosening the fiscal stance would pose a risk for the medium-term budgetary prospects. The revenue windfall gains may still turn out to be temporary; they should therefore not give rise to permanent measures.

In addition, there are a number of risks embodied in the budget law. On the revenue side, the large amount expected from anti-evasion efforts is hard to predict as a whole because it partially depends on how taxpayers adapt their behaviour to the tax rate hikes – though this risk is at least partly compensated by the “structural” component of the 2006 tax overshoot. Also, the size of the additional revenues stemming from the diversion of the deferred compensation scheme TFR is subject to some uncertainty, as it depends on how many employees decide to opt for keeping the TFR outside a private pension scheme.

There are also risks of expenditure overruns. Enforcement mechanisms foreseen in the new domestic stability pact for municipalities and provinces remain weak, as discussed in Chapter 4. In particular, the automatic increase in local taxation foreseen in

the 2007 Budget Law in case of slippages would be effective only as of 2008. Other risks are linked to possible slippages in health care expenditure, also in light of the fact that the automatic increase in private co-payments to finance pharmaceutical expenditure in regions with a structural deficit in health care accounts, originally foreseen in the draft Budget Law, has been dropped. Overall, there are good reasons to hope for another better-than-expected budgetary outturn in 2007; but the uncertain nature of the revenue buoyancy and of some measures embodied in the budget calls for a prudent approach in the conduct of fiscal policy.

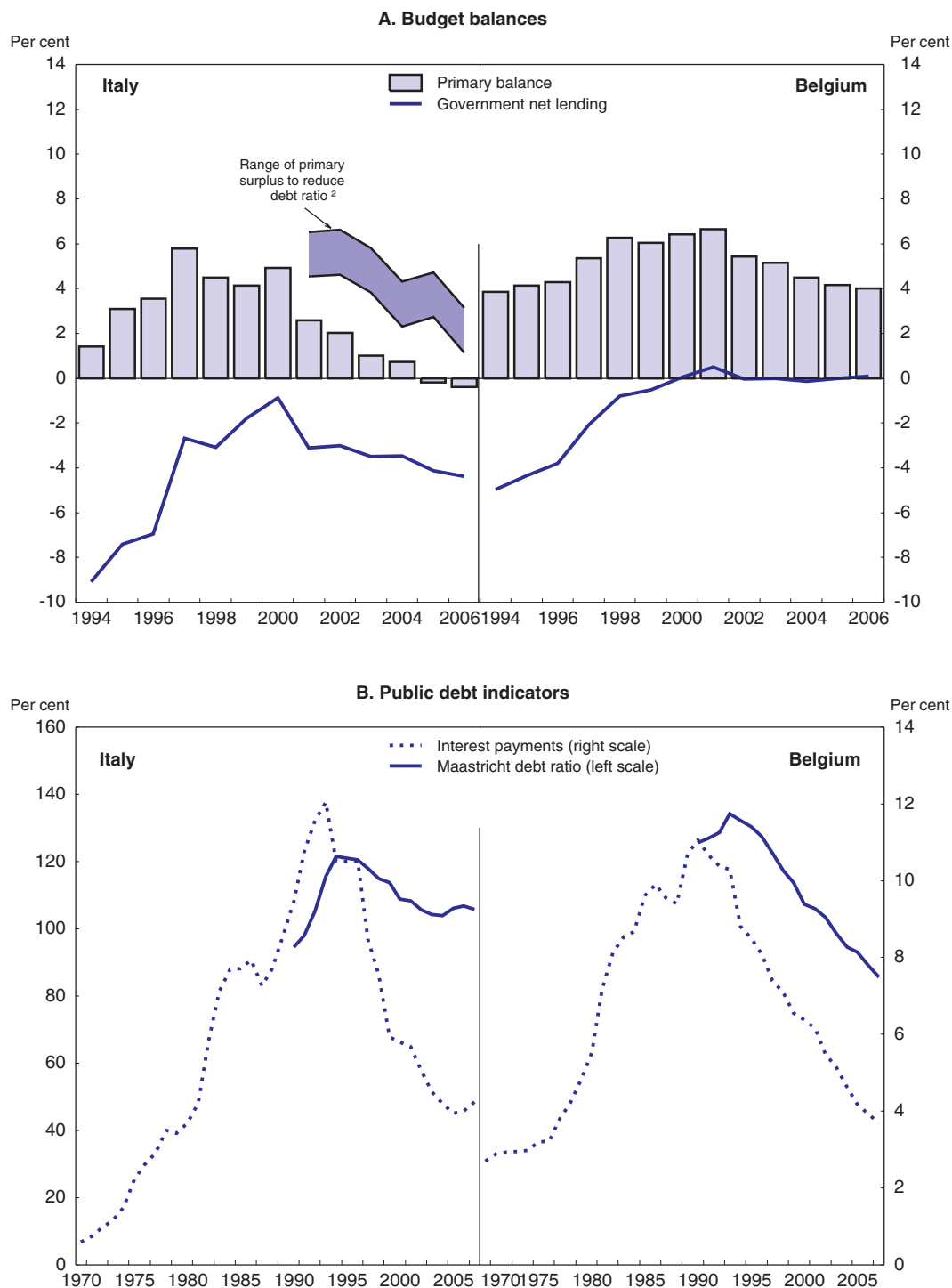
### Reducing public debt

A principal challenge facing Italian public finances is to reduce the public debt ratio. Italy's debt ratio is the second largest in the OECD, after that of Japan, and there has been a lack of progress in bringing it down in recent years. This has been in contrast to debt-reducing policies in other countries, such as Belgium which has balanced its budget consistently since 2000 and now targets a small surplus (Figure 3.3 and OECD, 2007a).<sup>5</sup> Even though Italy's debt-to-GDP ratio decreased from a peak of over 121% in 1994 to around 104% in 2004, it rose again thereafter, reflecting the combination of large budget deficits, persistently sluggish growth and some off-budget operations that increased debt. Bringing the debt ratio back to a downward trend is a crucial objective.

A first important reason for bringing down public debt is to lower a source of risk for the budget. With debt exceeding the annual value of GDP, every increase in interest rates by 100 basis points – not unlikely by historical standards – would increase debt service costs by about 1 percentage point of GDP after a lag. A sudden rise in interest rates would have little immediate effects on debt service obligations because the share of fixed-rate bonds has been kept high (about two-thirds of total debt), while interest-sensitive debts (short-term and floating-rate securities) account for only 28% of total debt. This particular debt structure reduces the short-term effects of interest rate changes; nonetheless, the full effects are inevitable after a period estimated by the government at between 5 and 6 years (Ministry of Economy and Finance, 2006).

A second argument for cutting the public debt ratio is to reduce the possible pressure on interest rates. The relationship between interest rates and budgetary positions remains a subject of controversy in the literature. Nonetheless, there is clear evidence that highly-indebted countries are subject to higher interest rates, notably if there is little progress expected in reducing future deficits (Laubach, 2004). In Italy, debt service costs sharply fell after the mid-1990s as the prospect of euro area membership drove down long-term yield differentials. Nonetheless, the difference between Italian and euro area benchmark interest rates on government bonds has fluctuated between 20 and 30 basis points, close to that of Greece but higher than for Belgium (Figure 3.4). The persistence of spreads for those two countries, despite the elimination of exchange rate risk, appears to result from the market's sentiment that there is a greater risk of default in these countries than in other EMU members. Admittedly, financial market concerns about the risk of a default are very small: even the downgrading of Italy's government debt rating by international agencies in October 2006 did very little to the bond spread. Yet, the interest rate spread has remained stubbornly over 20 basis points for Italy; by contrast, the spread on Belgium's bonds disappeared in 2002-06, when it became clear that the government's fiscal policy would safely put the debt ratio on a downward trend. It is also possible that Italy's high public indebtedness has an effect on euro area long interest rates. Faini (2004) finds significant

Figure 3.3. **Two tales of fiscal consolidation, Italy<sup>1</sup> and Belgium**  
As a percentage of GDP



1. Italy's net lending position unadjusted for special operations in 2006.

2. Primary balance required for an annual debt reduction comprised between 2% and 4%.

Source: OECD Economic Outlook No. 81 database.


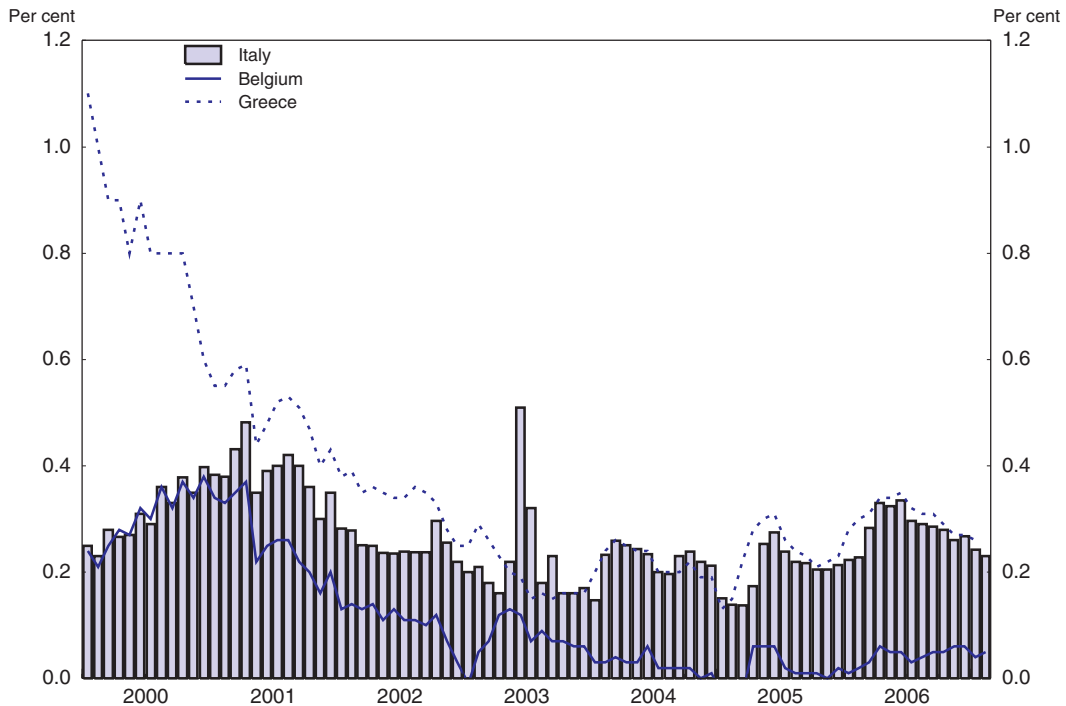

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Figure 3.4. Long term yield differentials

Vis-à-vis Germany



Source: OECD Economic Outlook No. 81 database.

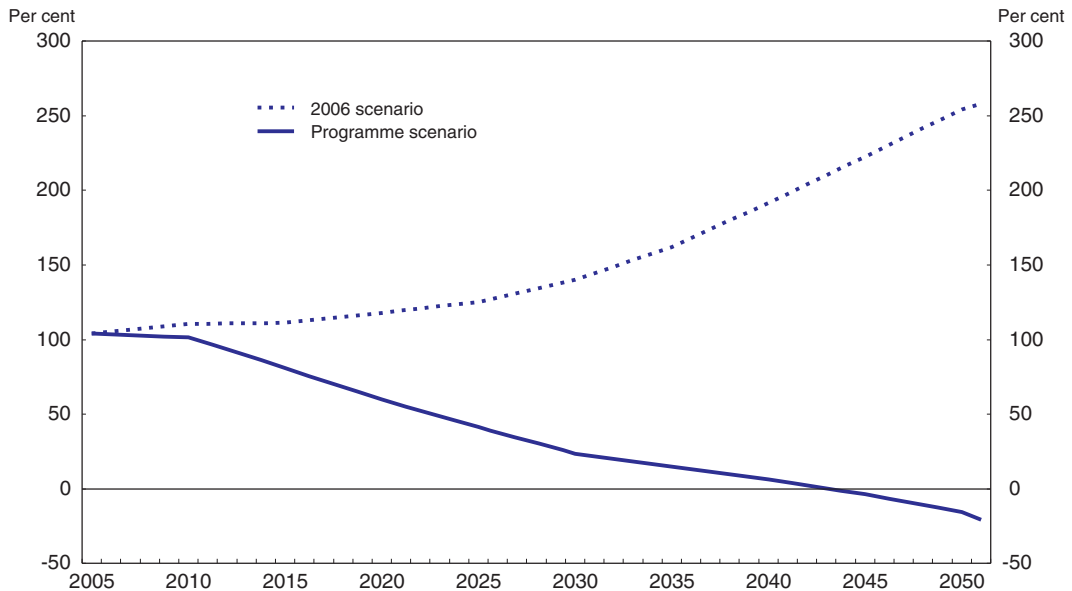
StatLink  <http://dx.doi.org/10.1787/014168831567>

evidence that a deterioration in the budgetary position of one member country affects interest rates of the entire euro area: a one percentage point increase in the public debt ratio is estimated to increase the real long-term interest rate of the euro area by 5-7 basis points.

In order to put the public debt ratio on a downward trend, Italy intends to restore the primary surplus to the level prevailing at the time of entry into the euro area (about 5% of GDP). Assuming that interest rates stay at their current level, this would initiate a decline in the debt-to-GDP ratio, help cut interest payments and improve Italy's international financial standing. By contrast, if the structural primary surplus were to remain unchanged from the 2006 level projected in the latest Stability Programme, the debt ratio would increase continuously, reaching more than 250% of GDP by 2050 (Figure 3.5).


The government's Stability Programme, which targets a primary surplus of 5% of GDP in 2011, projects that the debt ratio would fall from 106% currently to only 98% in 2011 (although on a more rapidly improving path thereafter). This is a rather small decline, which would leave public debt at a precariously high level; this underscores the importance of a persistent, continuous strategy of fiscal consolidation for years to come. Against this background, the objective of achieving a primary surplus of 5% of GDP by 2011 should be considered as a necessary and welcome commitment; recent tax buoyancy (unexpected when the objective was set) has helped make a substantial step in that direction. The government plans to improve the cyclically-adjusted primary balance (net of one-offs) by a bit more than 0.5% of GDP each year during 2007-11, thus exceeding the requirements of

Figure 3.5. **Long-term debt projection**  
As a percentage of GDP



1. The “2006 scenario” assumes that the structural primary balance will remain unchanged from 2006 through 2011, the final year of the stability programme; debt projections in this scenario start in 2007. The “programme scenario” assumes that the macroeconomic and budgetary plans until 2011 provided in the stability programme will be fully respected. Debt and primary balance projections in this scenario start in 2012. The government debt ratio is usually compiled in gross terms – that is, assets are not netted from government liabilities. Therefore, the gross debt can never be negative. In this chart the negative values for the debt ratio should be understood as accumulation of financial assets.

Source: European Commission (2006).

StatLink  <http://dx.doi.org/10.1787/014183055832>

the revised Stability Pact (0.5% per year), which should now make it possible to achieve the 5% of GDP target ahead of time. The difficulty will be to stick to a path of fiscal adjustment for a relatively long period, without allowing slippages, even during periods of cyclical weakness that would most probably reinvigorate political calls for supportive policies. A change in policy rules might therefore be helpful.

### **Should an expenditure rule be reinstated?**

In general, fiscal consolidations of large size are difficult to achieve and, once achieved, it is challenging to preserve the gains. Past experience suggests that fiscal consolidation is more successful when certain factors are in place (see in particular OECD, 2007b): i) large initial deficits and high interest rates have been important in prompting adjustment, plausibly because of greater public awareness of fiscal problems that need to be overcome; ii) fiscal consolidation based on cutting current expenditure has been associated with larger and more sustained consolidation effects; and iii) fiscal rules tend to be associated with larger and longer adjustments and higher success rates. The appropriate design of the fiscal rule is crucial and expenditure targets, in particular, have often proved effective. Most of these factors were present when Italy made a large fiscal consolidation in the run-up to EMU during the mid-1990s. The objective of EMU entry was a helpful factor behind the fiscal consolidation, but also the large initial deficits and interest payments, the readiness to control current expenditure and the

external pressure from a strong fiscal rule (the Maastricht Treaty criteria). The environment of the mid-1990s (run-up to EMU, large deficit, high interest rates, and cyclical weakness) was more conducive to raising public support for fiscal adjustment than the current context. However, the quality of consolidation is also important for a durable effect; following EMU entry, spending bounced back while temporary taxes were withdrawn.

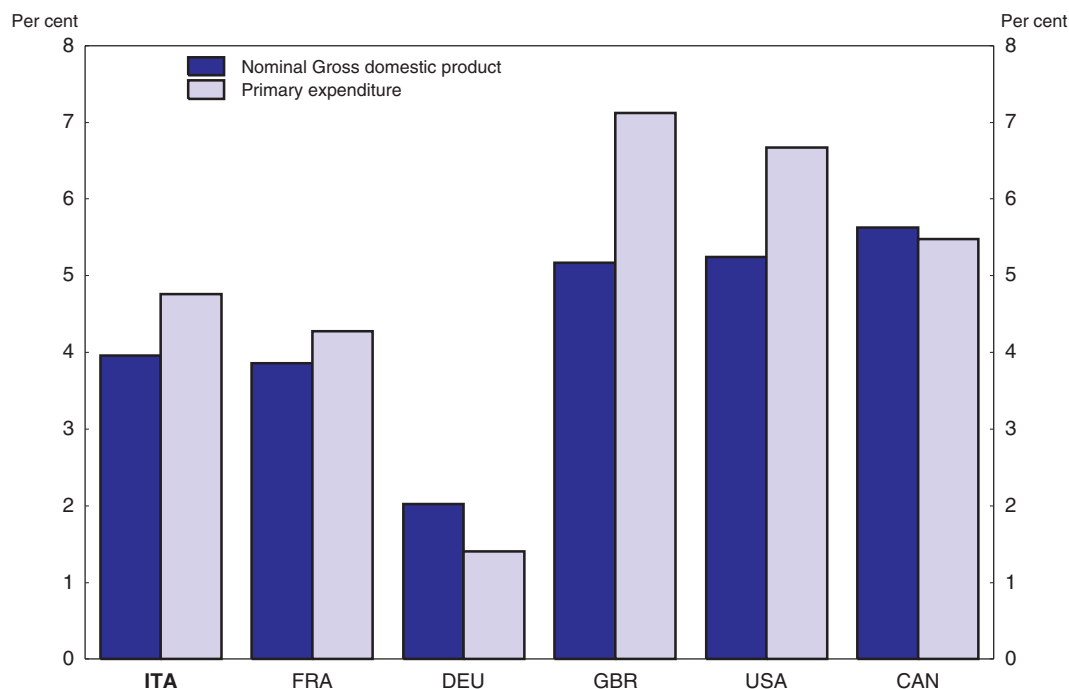
The current situation is very different from the one prevailing in the mid-1990s. With the debt ratio more or less stabilised, the government deficit below 3%, interest rates kept low by euro area membership and a cyclical recovery under way, there might not be a similar sense of urgency needed for the adoption of spending cuts. Illustrating this tepid public support, an amendment to the 2007 budget introduced by Parliament aims at lowering taxes as of 2008, on the back of the possible higher permanent revenue stemming from the envisaged increased fight against tax evasion. A tax cut at an early stage of the consolidation would be premature: it would weaken the underlying adjustment, unless accompanied by expenditure retrenchment. Another reason for avoiding a premature tax cut is that the medium-term programme relies on unidentified spending cuts for about 2½ per cent of GDP, which will be difficult to bring about if public support is wavering.

A policy remedy that might increase the likelihood of success would be the adoption of a well-designed fiscal rule, notably a multi-annual expenditure rule. As pointed out in OECD (2007b), expenditure rules have at times been associated with successful adjustment (*e.g.* the US Budget Enforcement Act of 1990-2002) and many EU countries have supplemented the SGP with national rules, which have enjoyed some success (*e.g.* Finland, the Netherlands, Sweden, Denmark and the Czech Republic), although such rules do not automatically guarantee progress. There is a variety of arguments lobbying in favour of multi-annual expenditure limits (see Box 3.2 of OECD, 2007c). Expenditure rules may help to strengthen transparency in the pace of growth of spending and hold spending ministries accountable for achieving pre-specified outcomes. Combined with the free play of automatic stabilisers on the revenue side, they help reduce the risk of pro-cyclicality (a common problem with nominal budget balance targeting).


Such expenditure rules are unlikely to work without a firm political commitment. But if that commitment can be found, the rule might help reinforce fiscal discipline. In the case of Italy, where excessive primary spending growth has been a problem, like in several other OECD countries (Figure 3.6), an adequate rule would be to limit primary spending growth to no more than inflation. Given the importance of subnational government spending, the domestic stability pact could be amended to fully embody the participation of regions and municipalities to the observance of the spending rule. Spending on entitlement programmes being dynamic, notably health care insurance, achieving this spending rule would require cutting discretionary spending in real terms. The government has already progressed in this direction by planning cuts in the size of the government workforce by attrition: only a fraction of retiring public employees is being replaced. The recent agreement with public sector trade unions, aimed at making human resource management more flexible, is also a step in the right direction, if implemented (Box 3.2). Moreover, a spending review is envisaged with the aim to improve the quality of public expenditure, thus allowing a better allocation of resources.



Figure 3.6. **Average annual increase in nominal primary expenditure**  
Average changes over 2000-06



Source: OECD Economic Outlook No. 81 database.

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### Box 3.2. Managing the public workforce

An important intention to reform the public administration has been signalled by the recent signing of a memorandum by the trade unions on the management of the government workforce. The agreement foresees important changes, including the introduction of performance-based remuneration and merit-based career advance and the reduction of the workforce by attrition. On the other hand, the agreement foresees a reduction in the offering of fixed-term contracts and the conversion – still subject to a selection process – of precarious jobs into more secure, permanent contracts and it also gives a significant say to public sector unions in how these reforms are to be implemented in practice. The authorities are hopeful that this agreement will enhance flexibility in the public service, as well as promote cuts in the wage bill. The reform applies to all levels of governments. There is no intention to decentralise the core elements of wage bargaining in the public sector, as it is feared that greater wage decentralisation, under present circumstances, could lead to higher wage increases.

## Implementing pension reforms

Beyond the short-term challenge of re-establishing an adequate level of the primary surplus, Italy has to cope in the medium and long term with the fiscal effects of population ageing. Fortunately, the Italian pension system has been deeply reformed since the early 1990s, with major laws adopted in 1992, 1995, 1997 and 2004:

- The 1992 reform eliminated the indexation of pensions to real earnings: pensions are now only indexed to prices.

- Arguably the most important reform was in 1995, when it was decided to move from the defined-benefit to a defined-contribution system. This shifted the pension system towards the principles of notional accounts: workers pay contributions that earn a rate of return related to GDP growth<sup>6</sup> and, when retired, receive benefits that are based on the accumulated notional capital and an actuarial transformation coefficient.<sup>7</sup> As a result, benefits are strongly related to the age of retirement – the lower the retirement age, the lower the pension and *vice versa*.
- The notional defined-contributions regime applies in full to labour-market entrants from 1996 onwards. Workers who were already employed at the end of 1995 are in a mixed regime.<sup>8</sup> The new regime will therefore be phased in after 2030-35.
- The latest reform of 2004 made the eligibility requirement more stringent, with a gradual transition period lasting until 2015: the reform postpones the normal pension “age window” to 62-65 for men (63-65 for the self-employed) and 60-65 for women starting in 2008 from 57-65 currently.
- Early retirement will still be possible under various schemes: men with 35 years of contribution will be able to retire from age 60 as of 2008, compared with 57 currently, but the minimum age will subsequently increase to 62 by 2014.
- Aside from the first (state) pay-as-you-go pillar, there are fully-funded second (occupational) and third (individual) pillars, but these parts of the pension system are not well developed (RGS, 2006). As discussed below, reforms introduced in 2005 and 2006 may prove to be important novelties to facilitate the transfer of funds saved under employee deferred compensation schemes (*trattamento di fine rapporto* or TFR) to private individual retirement accounts.

Pension expenditure currently accounts for a large share of public spending: the ratio of pension spending to GDP, at about 14% of GDP in 2005, is among the highest in the OECD, more than that of other large countries and far exceeding the OECD average (about 9% of GDP). This reflects the combination of high replacement rates and incentives to retire early that characterised the pre-reform regime. Statutory replacement rates are high by international comparison for people with full career of 40 years: for the average earner, the mandatory pension statutory replacement rate is 78.8% of individual pre-retirement earnings in gross terms, and 88.8% net of taxes, which are both well in excess of the OECD averages (OECD, 2005). In practice, however, few pensioners have a full 40-year career before retiring and therefore most people do not benefit from these high statutory replacement rates.<sup>9</sup> Many workers decided to retire as early as possible as a consequence of the public perception about the direction of change and uncertainty about the reform process. Indeed, the defined-benefit scheme is not actuarially fair, and it has thus been economically convenient to retire as early as possible.

Despite the marked effects of ageing on the population structure by international standards, expenditure on pensions is projected to rise only moderately in the medium term, albeit from very high levels. This relatively benign prospect has been brought about by the pension reforms discussed above – assuming that they are all implemented as planned. The projections presented in Table 3.3, prepared for the Ageing Working Group of the European Union’s Economic Policy Committee (EPC-AWG) show an increase in pension expenditure of only 0.4 percentage points of GDP by 2050 (Economic Policy Committee and European Commission, 2006). The most recent updating of the baseline projections, based on the EPC-AWG assumptions, released in December 2006 (Ministry of Economy and

Table 3.3. **Projected changes in public spending on health care, long-term care and pensions**

	2005-50, in percentage points of GDP				
	Health care		Long-term care		Pensions
	OECD	EU	OECD	EU	
<b>Euro area (12)</b>	<b>3.7</b>	<b>1.5</b>	<b>2.2</b>	<b>0.5</b>	<b>2.6</b>
Austria	3.8	1.6	2.0	0.9	-1.2
Belgium	3.3	1.4	1.9	1.0	5.1
Finland	3.6	1.4	2.4	1.8	3.1
France	3.5	1.8	1.7	..	2.0
Germany	3.6	1.2	1.9	1.0	1.7
Greece	3.9	1.7	2.7	..	10.3
Ireland	4.0	2.0	3.8	0.6	6.4
<b>Italy</b>	<b>3.8</b>	<b>1.3</b>	<b>2.9</b>	<b>0.7</b>	<b>0.4</b>
Luxembourg	3.7	1.2	3.1	0.6	7.4
Netherlands	3.8	1.3	2.0	0.6	3.5
Portugal	4.2	0.5	2.0	..	9.7
Spain	4.1	2.2	2.4	0.2	7.1
<b>Comparator countries</b>					
Australia	4.2	..	2.0	..	1.7
Canada	4.1	..	2.1	..	1.7
Denmark	3.5	1.0	1.5	1.1	3.3
Japan	4.3	..	2.2	..	0.6
New Zealand	4.2	..	2.0	..	5.9
Sweden	3.2	1.0	1.1	1.7	0.6
United Kingdom	3.6	1.9	1.9	0.8	2.0
United States	3.4	..	1.7	..	1.8

Note: OECD projections for increases in the costs of health and long-term care have been derived assuming unchanged policies and structural trends. The corresponding hypotheses are detailed in OECD (2006a) under the heading "cost-pressure scenario". Projections of public pension spending are taken from EU EPC (2006) for EU countries, from OECD (2005a) for Canada, Japan, Switzerland and the United States and Dang et al. (2001) for Australia and New Zealand.

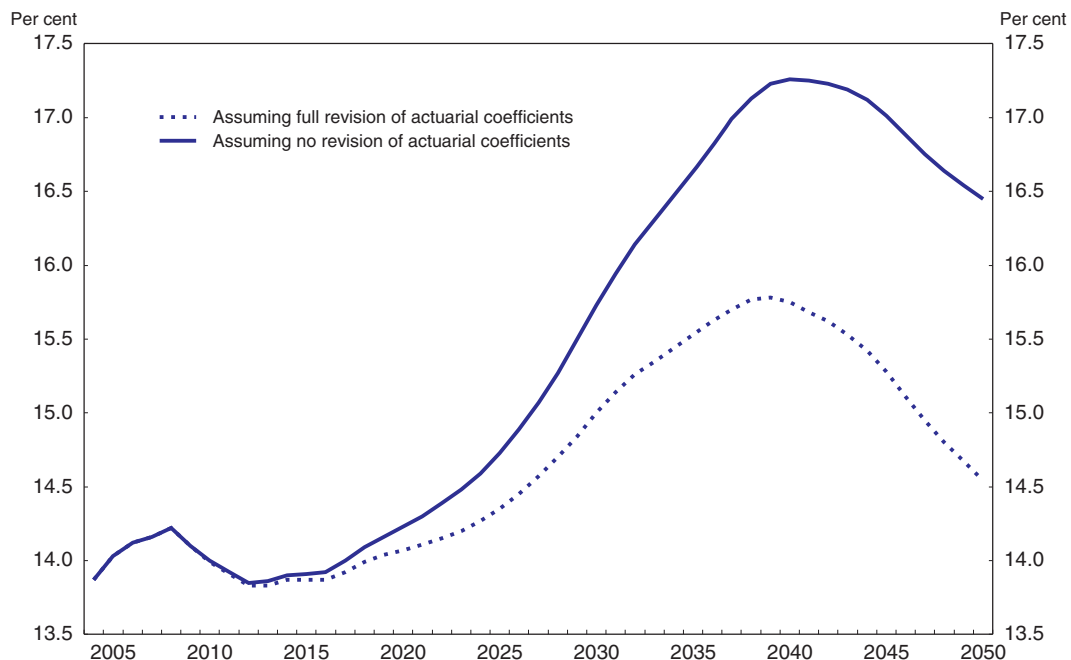
Source: OECD (2006a); OECD (2005a); EU EPC (2006); and Dang et al. (2001).

Finance, 2006) shows almost the same cost pressure: (an increase of 0.5 percentage points of GDP by 2050), while Italy's national baseline projection, based on national assumptions, shows a small decline of 0.3 percentage points of GDP. In both scenarios, after an initial phase of containment stemming from the effects of the 2004 reform, the ratio of pension expenditure to GDP starts to increase until it peaks at 15.2% in the late 2030's; after this, a phase of rapid decline brings the ratio down to 13.8% in 2050 (i.e. close to the present level). During the ascending phase, the effect of population ageing contributes to a substantial rise in spending, with some containment resulting from the gradual introduction of the contribution-based pension calculation method. Thereafter, the bulging of retirees from the baby-boom generation shrinks, so that the ratio of pensioners to employees tends to stabilise, and the new contribution-based pension regime is fully phased in; there is therefore a rapid decline in expenditure. The ageing of population is also projected to increase public spending on health care and long-term care, but this is expected to be partially offset by declining spending on education and unemployment benefits. Altogether, age-related expenditure is projected to increase by only 1.7 percentage points between 2004 and 2050 (European Commission, 2006). It should be noted that the OECD projections include income effects to a greater extent than in the EU projections, under the reference scenario methodology.

The projections crucially hinge upon the implementation of the planned ten-yearly actuarial updates that adjust pension entitlements to life expectancy. The “Dini pension reform” foresaw an adjustment once every 10 years in the transformation coefficient of the actuarial pension regime in line with life expectancy; the first such adjustment was supposed to happen in 2005 but, not being automatic, it was postponed. The second reform (*Maroni-Tremonti* pension reform), which was adopted by parliament but still needs to be implemented, foresees a step increase (*scallone*) in the minimum age to receive seniority pension benefits, from 57 currently to 60 (61 for the self-employed) in 2008 and rising further to 62 (63 for the self-employed) by 2014. The reason for the sharp increase in only one year was the inability to agree on smaller steps in earlier years. The achievement of a sustainable fiscal situation in the long term depends upon the full implementation of these two reforms, or the adoption and subsequent implementation of measures having an equivalent budgetary impact.


Failing this, pension expenditure would be much larger, threatening long-term prospects. According to the authorities’ projections in the Stability Programme, the periodical revisions of the actuarial coefficients are crucial to reduce pension expenditure: without adjustment, pension expenditure would be higher by around 1 percentage point of GDP in 2035 and 2 percentage points of GDP in 2050 (Figure 3.7). For political economy and fairness reasons, the adjustments should in fact be annual and automatic (as they are in most other OECD countries that have this mechanism, *e.g.* Sweden and Norway), rather than every 10 years and discretionary. This could ease the political difficulties and resistance from interest groups that governments would inevitably have to face when the

Figure 3.7. **Effects of the revision of actuarial coefficients on pension expenditure**  
As a percentage of GDP



1. Projections are based on information available at the end of 2006.

Source: Stability and Growth Programme, December 2006.

StatLink  <http://dx.doi.org/10.1787/014186346040>

deadline approaches. The tightening of eligibility conditions (*scalone*) is also important because it lowers pension expenditure by more than ½ percentage point of GDP over the period 2010-35. Both reforms are thus essential to achieve fiscal sustainability in the long term. Nevertheless, there is some reluctance among social partners to allow the implementation of these measures. One concern is that the existing reforms do not pay enough attention to specific situations, notably those of atypical workers (so-called “*parasubordinati*”) who have been subject to lower pension contributions and will therefore receive lower pension income when they retire. For such workers, however, the 2007 budget law has increased the notional contribution rate from 20% to 23% to be used for calculating pension benefit entitlements under the NDC system. Another concern is that it will be difficult to raise the employment rate of older workers, and therefore the effective pension age, without stimulating employers’ demand for older workers. As well, social partners point to the problem of blue collar workers having started their career at a young age (although it is possible to retire at any age after 40 years of contributions). An option examined by the government in the current negotiations is to agree on a package of pension reforms that would address some of these concerns, notably the need to re-establish inter-generational fairness, without upsetting the overall financial equilibrium of the reform and undermining long-term fiscal prospects.

An essential complement to the reform of the public pension scheme is the development of a fully-funded private pension pillar. Over the long term, retirees will see a sharp reduction in pension benefits – although from relatively high replacement rates – bringing down the ratio of average pension to GDP per worker from 16.8% currently to 11.8% in 2050 (Ministry of Economy and Finance, 2006). The long transition towards lower replacement rates opens a window of opportunity for adopting offsetting measures and creating new sources of old-age pension income. The government’s decision to allocate a part of deferred compensation contributions (TFR) to pension funds, on a voluntary basis, is promising, although the 2007 budget will benefit from that part of TFR that workers decide to keep with firms of more than 50 workers (€ 5½ billion). However, the resources allocated to the TFR Treasury account will be utilised to finance growth-enhancing investments. The introduction of pension funds is a signal to younger workers that it is important to start saving for their retirement, and the government will be devising further incentives to that end. Increasing employment rates, notably of older workers, would improve workers’ pensions in the future and contribute to the success of the pension reforms.

A crucial question regarding all of these pension reforms is related to labour market participation: will the shift to defined-contribution arrangements, the introduction of actuarial fairness, the tightening of eligibility conditions and the formation of a second pillar have positive effects on older workers’ labour supply, encouraging later retirement and postponing the effective age of retirement? In principle, the incentive to retire early is reduced in the new system and older workers should feel encouraged to delay their exit from the labour force, but the actual outcome depends on individual decisions and the behaviour of socioeconomic groups. Using an agent based micro-simulation model of labour supply, which reflects individual characteristics, Leombruni and Richiardi (2005) conclude that the participation of older workers is likely to increase in the medium term and the effective age of retirement is likely to rise. Old people will work more in the future, and as a consequence they will impose a lower burden on younger generations. Similarly, Brugiavini and Peracchi (2003) use probit models to evaluate the probability of retirement

decisions; they conclude that the actuarial adjustment in the new system and the tightening of eligibility conditions will tend to delay retirement decisions because they reduce the probability of exit at younger ages and offer incentives to postpone retirement. The increase in the labour market participation of older workers will be important not only to secure fiscal sustainability, but also to reduce a shrinkage in the labour force and its negative effect on per capita GDP.

## Concluding remarks

After a deterioration of fiscal balances during the first half of the decade, there has been a welcome improvement in 2006 and further consolidation is projected for 2007. The unexpected buoyancy of tax revenue explains a large part of this change, but the authorities should be commended for having used the windfall gains to reduce the deficit, rather than engage in premature tax cuts or spending increases. Italy's public finances

### Box 3.3. Policy recommendations to restore fiscal sustainability

#### Budget and debt

- *Reduce significantly the debt ratio.* As planned in the DPEF and the Stability Programme, raise the primary surplus by at least ½ per cent of GDP per year in cyclically-adjusted terms, until reaching at least of 5% of GDP by 2011, net of one-offs, so as to initiate a sustained downward trend of the public debt ratio. Achieving a primary surplus of 5% of GDP in 2011 is an adequate objective, but it should be possible to reach this target ahead of time, in view of the recent strong fiscal outcomes. Allow a budget surplus to be maintained until the debt ratio is reduced to, at least, the Maastricht debt criterion.
- *Preserve the gains from consolidation and from cyclical windfalls.* It will be important to preserve the fiscal gains made in 2006 as a result of unexpected windfall gains in tax revenues, measures against tax evasion and better spending control. Hence, the adjustment measures contained in the 2007 budget should be fully implemented. It will be important to avoid a premature redistribution of fiscal gains, especially in the form of additional spending.
- Given the high level of Italy's tax rates, fiscal consolidation should hinge upon expenditure discipline. To this end, consideration should be given to the introduction of *expenditure caps* that would be consistent with zero-growth of primary central government spending in real terms.

#### Management of the government workforce

- Reform the management of the public workforce so as to underpin spending discipline and raise the public sector's efficiency. Reduce the government workforce by attrition, while controlling the use of consultancies as a way to evade hiring restrictions.

#### Pension reform

- Implement the approved pension measures regarding the ten-yearly actuarial update of pension transformation coefficients based on life expectancy and the step increase in the minimum age to receive seniority pension benefits. Failing that, adopt a pension package that does not upset the financial equilibrium of the pension reform.
- Make adjustments of transformation coefficients for life expectancy yearly and automatic.

nonetheless remain challenging. The public debt ratio is the second highest in the OECD (after Japan), which makes the cost of debt service payments highly sensitive to interest rate increases and therefore complicates the task of restoring budgetary stability. The fiscal strategy should therefore focus on putting the debt ratio on a downward trend, as was done in other highly-indebted countries (such as Belgium). The Stability Programme aims at increasing the cyclically-adjusted primary surplus by at least 0.5% of GDP per year until it reaches 5% of GDP at the latest in 2011; this is appropriate but should be considered as the minimum necessary, especially in the current stronger-than-expected macroeconomic context. As well, past pension reforms are adequate to cope with the demographic effects of population ageing, provided that they are fully implemented, notably the updating of actuarial transformation coefficients and the tightening of eligibility conditions. All told, there are good chances for Italy's public finances to become sustainable in the medium term if the current strategy is implemented. Recommendations to this end are summarised in Box 3.3.

### Notes

1. Special transactions amounted to a deficit-increasing 2% of GDP in 2006: cancellation of railway company's debt related to the high speed project (*Ferrovie dello Stato – RFI/TAV*) (0.9% of GDP); permanent impact of the European Court of Justice's ruling on VAT on company cars (1.1% of GDP).
2. According to the December 2006 update of Italy's Stability programme, there were one-off measures reducing the deficit by 0.5% of GDP in 2005.
3. In its latest budget update (Ministry of Economy and Finance, *Relazione Unificata*, 19 March 2007), the government estimates that the "structural" unexplained residual of the 2006 tax overshoot could be on the order of 0.5-0.7% of GDP, presumably representing improved tax compliance and hence a permanent effect, though the analysis is still ongoing.
4. General government revenues increased by 5.5% in the first quarter of 2007 compared with the same period of one year ago (see *Il Sole 24 Ore*, 16 May 2007). This is lower than the 8% rate for the whole of 2006 but still higher than the OECD projected 2007 nominal GDP growth rate of 4.4%.
5. Belgium's public debt ratio has declined below 90% following persistent fiscal adjustment. The debt-to-GDP ratio of Greece has declined in a different way, as a result of a sharp upward revision of nominal GDP.
6. More precisely, earlier years' contributions are revalued using a five-year moving average of nominal GDP growth.
7. The transformation coefficient is mainly based on the average life expectancy at retirement. It also takes into account the probability of leaving any widow or widower at death.
8. With the important exception of those workers with at least 18 years' service in 1995, who remained fully under the old regime, also implying a long transition period.
9. The distribution of income among the group of pensioners is nonetheless uneven and there is a large proportion of pensioners near poverty level.

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## Chapter 4

### Making federalism work

*Fiscal federalism can be an important complement to structural reforms and budget consolidation. Empowering subnational governments while at the same time making them accountable to local citizens in the uses of tax money could improve the allocation of public resources and promote catch up of the lagging regions. Italy has launched itself in the federalist direction by decentralising spending, regulatory and tax powers in the late 1990s and reinforcing growing lower level responsibilities with a constitutional reform in 2001. The constitution has yet to be fully implemented, though, and the government has signaled its intention to do so. A stronger focus should now be put on the financing side, i.e. getting a better match between spending responsibilities and taxing powers so as to boost local autonomy and responsibility in line with the goals of federalist reforms. As the lower levels are fully in charge of health and long term care, they will face intense pressures due to population ageing which is especially rapid in Italy, so that more tax bases should be devolved to them, especially as pension reform has reduced such pressures on central government. Redistributive mechanisms should be redesigned to improve fiscal effort, and Italy must decide in that context to what extent it can really afford to guarantee uniform national service levels – and conversely, how much regional differentiation of services it will tolerate in pursuit of higher efficiency. Framework conditions need to be strengthened, notably accounting standards which need to be upgraded and standardised. Fiscal discipline under the Internal Stability Pact should be strengthened via better ex ante co-ordination and tougher sanctions ex post.*

Italy in the late 1990s embarked on a path of fiscal decentralisation *cum* liberalisation and confirmed the new orientation with major, so-called “federalist”, constitutional reforms in 2001. These reforms reflected a fundamental desire to boost quality of government in support of better economic and fiscal performance, recognising that a market-based and competitive economy requires a more efficient government that is accountable to citizens’ general welfare, providing “value for tax money”.<sup>1</sup> Federalism could supposedly achieve these goals by bringing the supply of government services closer to the interested taxpayer-users, and the way was shown by decentralising country experiences in the OECD. Federalism also seemed to be an answer to Italy’s problem of a deep regional divide.

This chapter aims to enhance understanding of the federalist process in Italy, and to suggest some guidelines for its further development. The first part looks at the main trends and forces pushing in the direction of decentralisation as a response to Italy’s larger challenges. The second section takes up some key issues on the spending side, mainly within the optic of how devolution can deliver on its promise of efficiency gains. The third section turns to the financing side, asking how reforms there could stimulate the local accountability upon which any successful federalism rests. The final section examines “credible” fiscal rules and processes to ensure compatibility between growing local autonomy on the one hand, and respect of European fiscal commitments for the whole of Italy, on the other.

The chapter’s main messages could be summarised as follows. Fiscal federalism goes in the right direction for Italy – provided it is well done. Significant progress has been achieved but it needs to be followed through to a satisfactory conclusion. The legislative space and basic knowledge to do so is there: the 2001 constitutional reform defines the broad framework for a coherent federalism. But in the five years since its enactment, little has been done by way of implementation. There have been frictions regarding overlapping spending competencies, vertical tax competition and sharing of the fiscal consolidation burden. But the core problem seems to be an equity/federalism trade-off, in particular in the transition to federalism during which redistribution mechanisms have to be adapted to more efficient outcomes. The apparent unwillingness or inability by regions to agree thus far on such a trade-off has led to some policy incoherence. While decentralising spending functions Italy has tried very hard to devolve tax bases and transfer sufficient resources on top, while also imposing regulations on service uniformity, in order to safeguard against possible under provision of public services by lower level governments. It has at the same time attempted to enforce efficiency in such service provision via fiscal rules and periodic limits on tax autonomy and state transfer flows. However, the rules did not function properly and the bargaining mechanisms in their place resulted in soft lower level budget constraints. The result is that federalism is still very much work in progress in Italy.

These considerations will lead to a set of recommendations that should be seen as an integrated whole rather than a sequence of steps. Notably, good fiscal rules should

complement and reinforce an internally coherent system of fiscal federalism. The key points can be summarised as follows (see Box 4.6):

- *Spending autonomy.* Set national social service guarantees at basic yet adequate levels, allowing regions to top them up as their own resources allow. Provide regulatory scope for local wage and personnel determination (equivalently, a looser grip of national bargaining and contract rules). Conversely, circumscribe “autonomy” to violate national competition policies in tendering and procurement practices, zoning laws, privatisation and governance of public enterprises, etc.
- *Revenue autonomy.* Recent unfreezing of tax rate flexibility is beneficial and should go further by widening room for tax rate variations – the key to local autonomy and accountability. More tax bases should be devolved, as ageing pressures are shifted to lower level spending, and national level taxes correspondingly reduced. The state should also minimise its interference with tax bases (e.g., IRAP and ICI) or co-payments (e.g., pharmaceutical ticket).
- *Hardened budget constraints.* Set equalisation transfers in line with standard costs of national social service obligations, and less than 100% equalisation of tax capacities for other spending in order to encourage tax base development. Reduce role of discretionary transfers accordingly.
- *Credible fiscal rules.* Current move toward deficit rules rather than spending ceilings for local authorities is warranted and should be generalised to regions. Sanctions for non-compliance should include reputation costs for local officials and (as currently) tax costs for citizens who elect them. Standardise accounting practices across all levels to enable proper monitoring.
- *Institutional arrangements for efficient bargaining.* Rules on equalisation transfers and budget deficits should be decided in a co-ordinated fashion in order to be credible. Horizontal equalisation arrangements may be more transparent than vertical ones. Deficit rules should be decided in tandem with central government at the start of the budget process.

## The evolution of fiscal federal relations in Italy

Fiscal federalism in Italy has evolved in several steps with the aim of improving the efficient delivery of services (Box 4.1). The general picture is that the constitution calls for a rather high degree of federalism but its implementation has been highly non-linear and uneven, given political disagreements and distributional issues. Today’s level of decentralisation was largely achieved by the end of the 1990s and more remains to be done, particularly as regards financing, but future uncertainties loom large. A main risk to be avoided is that the constitution be interpreted so as to justify a return to derivative financing of the 1980s.

As a result of the devolution during the 1990s, the share of the sub national level in general government spending rose from about 15% in 1990 to almost one third by 2005, around the OECD average and somewhere between unitary countries like France and United Kingdom and federalist countries like United States, Canada, Australia and Germany (Figure 4.1). Leaving out social security and interest on public debt which are particularly large in Italy, subnational governments are responsible for one half of government spending (Figure 4.2). A large share of subnational spending in the hands of (many) local entities of around one half, compares with a more dominant role for regions

### Box 4.1. The federalist process in Italy

#### Creation of the regions and centralisation of financing

In 1948, a new constitution requiring a federalist set up was adopted under the influence of the United States in the post-war setting. At that time only 5 “special statute” regions (border areas and islands) were created, but they were granted extensive spending autonomy and central funding which cannot be changed by ordinary law.<sup>1</sup> In 1970, a fully fledged regional level of government was created, consisting of 15 new “ordinary” regions plus the original 5 special statute regions, all being superimposed upon the extant provincial and community levels. Large (health) expenditures were devolved to the regions whereas local tax powers were heavily centralised, and in this sense the regions served mainly as a sort of administrative arm of government.

#### Liberalisation push of late 1990s-2000: more local autonomy

In the 1990s, economic crisis and Italy’s bid to join EMU forced a deep rethinking of federal relations in the context of a broader liberalisation movement. The 1998 Bassanini reforms devolved spending and regulatory functions involving interface with citizens in line with the principle of subsidiarity. The 1998 Bersani reform at the same time made significant steps toward liberalising markets. Decentralised government services were meant to promote, and in turn benefit from, greater market competition. A system of “negotiated planning” was devised for poorer regions, with more active involvement of local governments in project preparation allowing them to better absorb EU structural funds. On the financing side, specific state transfers were replaced by tax sharing and equalisation schemes, and the new spending responsibilities were accompanied by a substantial block of new regional taxes allowing some latitude in setting tax rates for local needs: notably a regional tax on company value added, the IRAP (*imposta regionale sulle attività produttive*) and national income tax surcharges for all levels. A reform of the system of equalisation transfers was passed into law in 2000, but never implemented as tensions over potential losses of transfers surfaced.

#### The 2001 reform of Title V: consolidating the federalist process

##### The division of spending and regulatory powers

In 2001, a major reform of Title V of the Constitution, governing the distribution of powers across levels of government, was passed just prior to national elections (and later ratified by national plebiscite). Articles 117 and 118 gave precise breakdowns of spending responsibilities, while also allowing for a potential “multi-speed” federalism, i.e. temporarily differing degrees of autonomy in different regions.<sup>2</sup> Areas of exclusive central government and concurrent central and regional government competencies were specified in various spending and legislative areas – all areas not so specified were assigned to the exclusive competence of the regions by default. Clearly this reallocated much power to the regions, as not all potential areas could be enumerated. Regions were for the first time also accorded legislative powers in areas of their exclusive competence in both spending and tax areas. However, power sharing in the areas of overlapping competence was not clear and became the genesis of numerous conflicts subsequently.

The government that came into power in mid-2001 (Berlusconi) proposed a series of follow-up constitutional reform proposals, wanting to put its own imprint on the reform. The regions, meanwhile, did not fail to grasp the significance of the new provisions for their own powers, and they brought numerous cases before the Constitutional Court. The Court subsequently passed a series of decisions interpreting the constitution, having the force of law and tending more often to rule in favour of State powers than of the regions.

#### Box 4.1. **The federalist process in Italy** (cont.)

In the hotly contested areas of overlapping competencies, the Court stated that responsibilities should be split up as follows: a) the central government legislates fundamental principles (for instance, general norms for health protection) for the area in question; b) the region undertakes financing, administrative, and management functions for the spending; and c) the local authorities perform “hands on” delivery of services unless there are cogent reasons to do so at a higher level. Meanwhile, the legal process (widely considered to be a more democratic and consensual way of proceeding) was held up in Parliament by a long debate. Regions’ new powers of legislation in the tax area were never realised because the national Parliament failed to define the required framework law. Finally a “devolution” law, re-specifying health, education and administrative police as areas of exclusive (rather than shared) regional competence, and the creation of a Chamber of Regions was passed just prior to the April 2006 national elections, but it was not confirmed by national referendum the following June.

##### **Local government financing reforms**

The new Title V also called for a revolutionary new financing model under Article 119. It implied virtually complete revenue autonomy for lower levels to finance their normal activities, topped up in poorer regions by a new rules-based equalisation fund, with only a marginal role reserved for discretionary central government transfers to fund “extraordinary” spending. Local governments could borrow to finance their investment expenditures (golden rule). But unlike on the spending side, the separation of powers in terms of precise revenue sources was left vague.

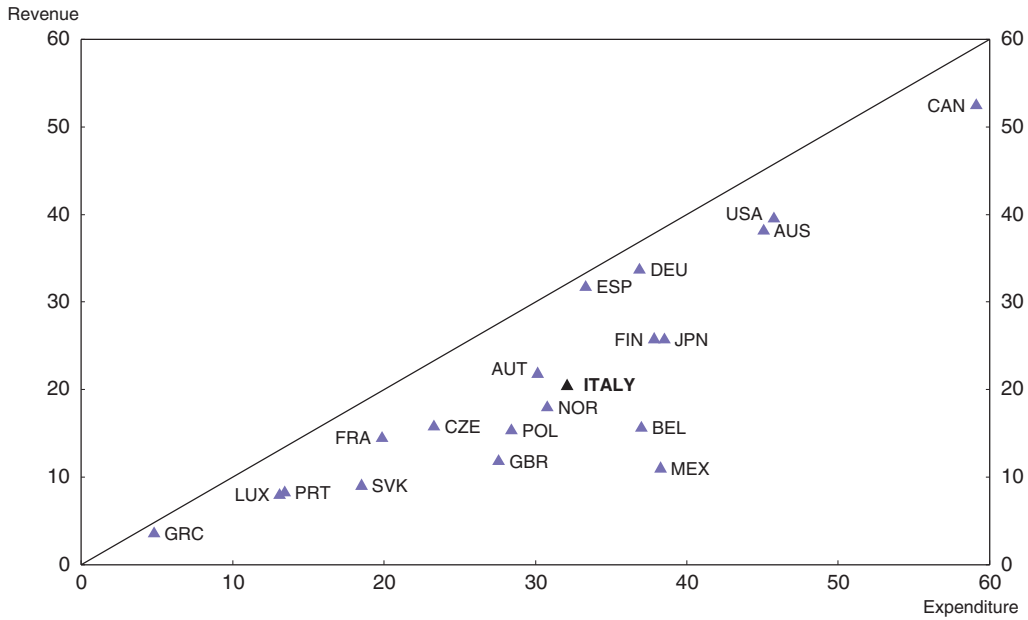
There was even a clawing-back of regional taxing powers. The government made clear its dissatisfaction with IRAP, echoing the complaints of the business community which had also mounted legal challenges, and vowed to phase it out. However because of fiscal constraints, only selected deductions were in the end accorded. The Constitutional Court ruled that IRAP was a national, not regional tax, prompting the government to freeze regional tax autonomy in 2002 while cutting transfers to regions in line with its earlier electoral promises to lower the tax burden; however such autonomy was restored in 2006. The European Court examined the legality of IRAP in light of EU rules on VAT harmonisation, but in the end ruled in Italy’s favour despite the adverse opinion of its own legal counsel.

A High Commission on Fiscal Federalism was formed in 2003 to draw up a set of proposals which should form the basis of a government draft law. After several extensions of its deadline, Commission presented its report only in late 2005 to which there was no legislative follow-up. The Commission was abolished in 2007 by the new government that came into power in 2006 (Prodi), which proceeded to put two draft laws before Parliament, respectively clarifying spending assignments (local autonomy code) and liberalising the supply of local services. It has vowed to implement Article 119 as a future reform priority and a legislative package is forthcoming.

1. For Friuli-Venezia Giulia and Sardegna, however, some parts of the statutes can be changed via ordinary law.
2. The region of Lombardia in late 2006 made proposals to avail itself of such a “multi-speed” federalism, wishing to go ahead with greater spending and tax autonomy before the whole country is ready to do so.


in most other OECD federalist countries. Local entities in turn are comprised of communes and provinces. The latter is by far the smallest of the four levels and seems unique in the OECD context (below).

Figure 4.1. **Indicators of decentralisation: an international comparison**  
Subnational shares of revenue and expenditure in per cent of total general government



1. 2002 for Mexico, 2003 or 2004 for other countries.

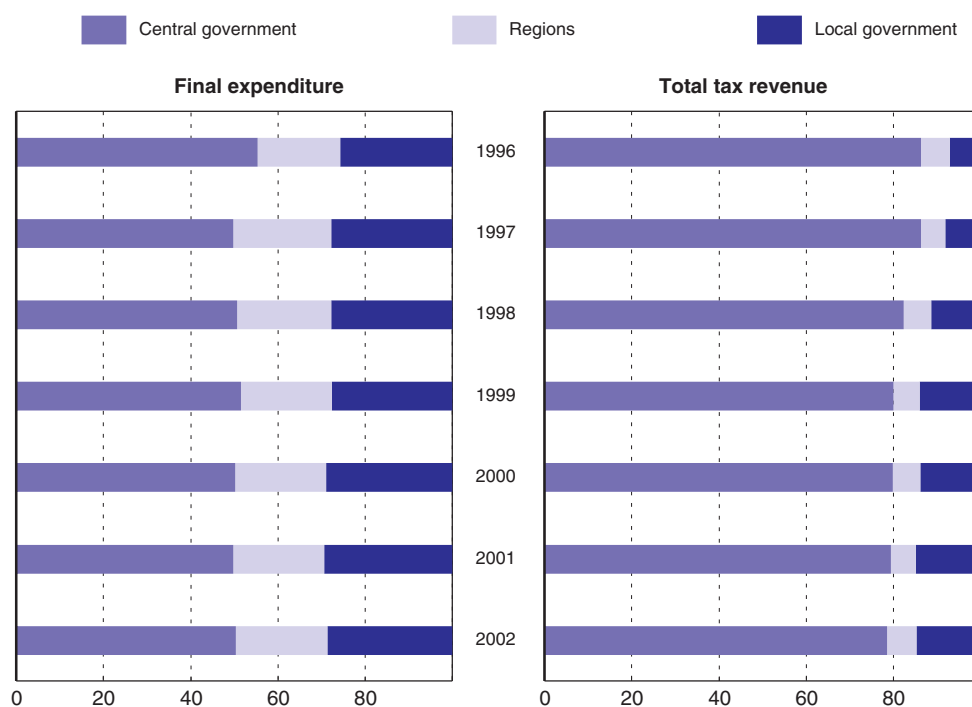
Sources: OECD Annual National Accounts database, May 2006; Belgostat; Statistics Canada; Statistics Norway; US Bureau of Economic Analysis; Australian Bureau of Statistics; Ministry of Economy and Finance, *Relazione Generale sulla Situazione Economica del Paese*.

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The spending assignments across levels appear to obey the principle of subsidiarity. Virtually all public services to individuals are devolved (Table 4.1). Regions focus on health spending, which covers 60% of their total expenditures, as well as transport, vocational training and labour market services. Local entities are responsible for most infrastructure spending as well as welfare services, territorial development, local transport and police. The central level is left with collective provision in tax collection, macroeconomic policy, income redistribution, defence, justice, and debt service, in line with its comparative advantage (Figure 4.3). The main exception is education, a merit good provided by the state but which according to the new constitution should be devolved to regions, as is typically the case in other federalist countries of the OECD. Devolving education would increase regions' spending bill by one-third.

Subnational spending is financed by a mix of own revenues, state transfers and debt. New tax assignments have largely kept pace with new spending responsibilities (Figure 4.2), but the devolution of tax and spending authority remains highly disproportionate: sub national tax revenues cover less than half of their current expenses. With non-tax revenues such as user fees and tariffs also underdeveloped, this leaves a substantial role for state transfers (some 9% of GDP). Italy is thus still some distance from the diagonal (full self-financing) in Figure 4.1, in contrast to mature federations like Canada, United States, Australia, Germany and Spain. However, it should be emphasised that Germany and Australia count VAT sharing as “own resources” while Italy as a transfer. This is likewise reflected in a vertical financing gap (Figure 4.4). Nevertheless, the make-up of transfer financing has changed in a positive direction: the share of central specific grants

Figure 4.2. **Spending and tax shares by level of government**  
As a percentage of total, 1996-2002



Source: Buglione, E. and M. Marè (2007), "Main issues of Italian Fiscal Federalism", Working Paper SIEP.

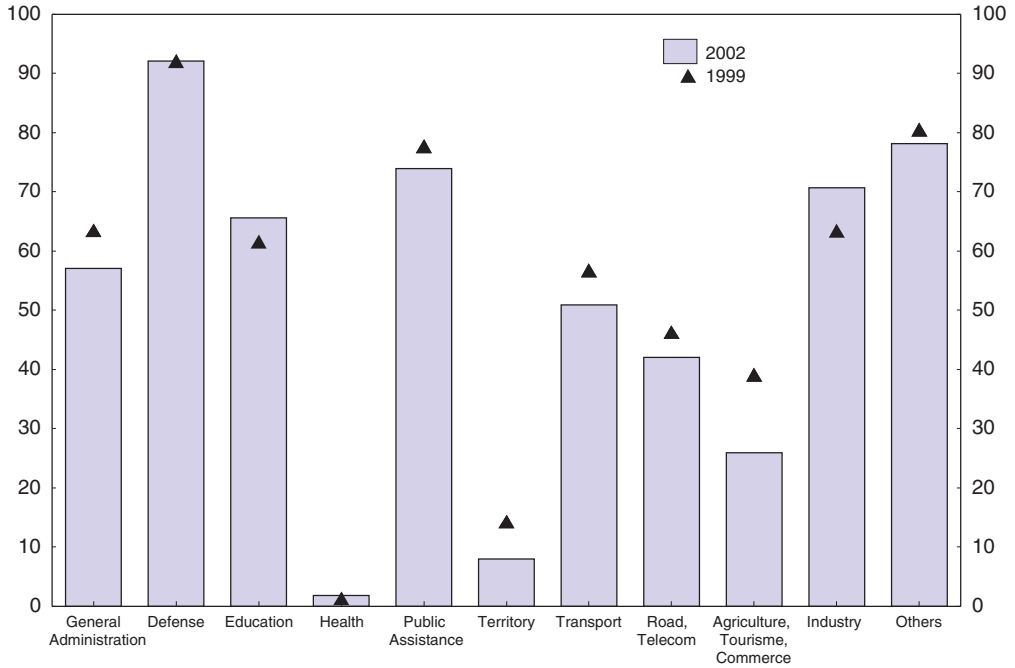
Table 4.1. **Subnational government competencies**  
According to the 2001 constitutional reform

Responsibilities of municipalities	Responsibilities of provinces	Regions
Town planning	Road network maintenance	Health
Social housing	Transport	Health centres and hospitals
Aid to the disabled	Secondary schools (construction of buildings)	Vocational training
Local public transport	Environment including protection and improvement of the energy resources	Culture
Road network maintenance	Cultural heritage	Town planning
Local police	Household waste and sewage	Road networks, civil engineering and regional railway transport
Pre-elementary, primary and vocational schools (building construction and maintenance and teachers' pay)	Some health services	Agriculture
Culture	Vocational teaching	Country planning and economic development
Sport	Economic development	Environment
Sewage and waste disposal	Management of employment services and subsidies	Social services
Upkeep of pharmacies in rural areas		Education

Source: ISAE.

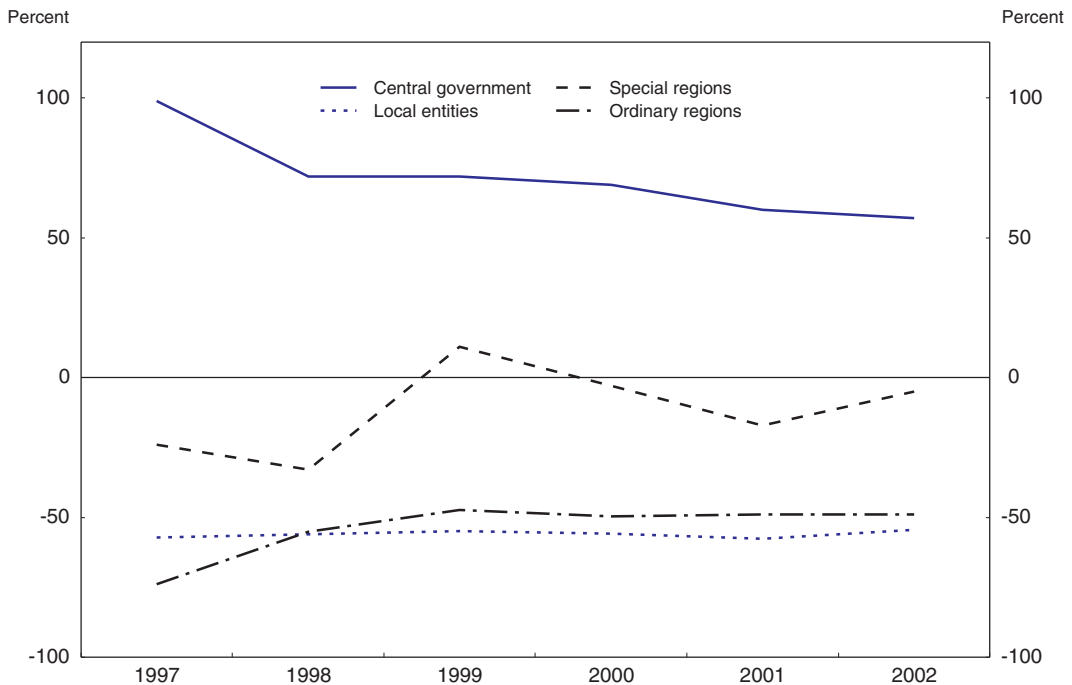
dropped from close to 90% in 1995 to around 50% by 1998, being replaced by national tax sharing and equalisation arrangements. These latter schemes, in principle based on clear, objective and stable rules rather than discretion, are considered by the OECD to be more

**Figure 4.3. Central government spending by function**  
As a percentage of general government spending



Source: Buglione, E. and M. Marè (2007), "Main issues of Italian Fiscal Federalism", Working Paper SIEP.

**Figure 4.4. Vertical fiscal balance by level of government<sup>1</sup>**



1. Fiscal balance defined as tax and non-tax revenues less final spending, expressed as a percentage of final spending.  
Source: Buglione, E. and M. Marè (2007), "Main issues of Italian Fiscal Federalism", Working Paper SIEP.



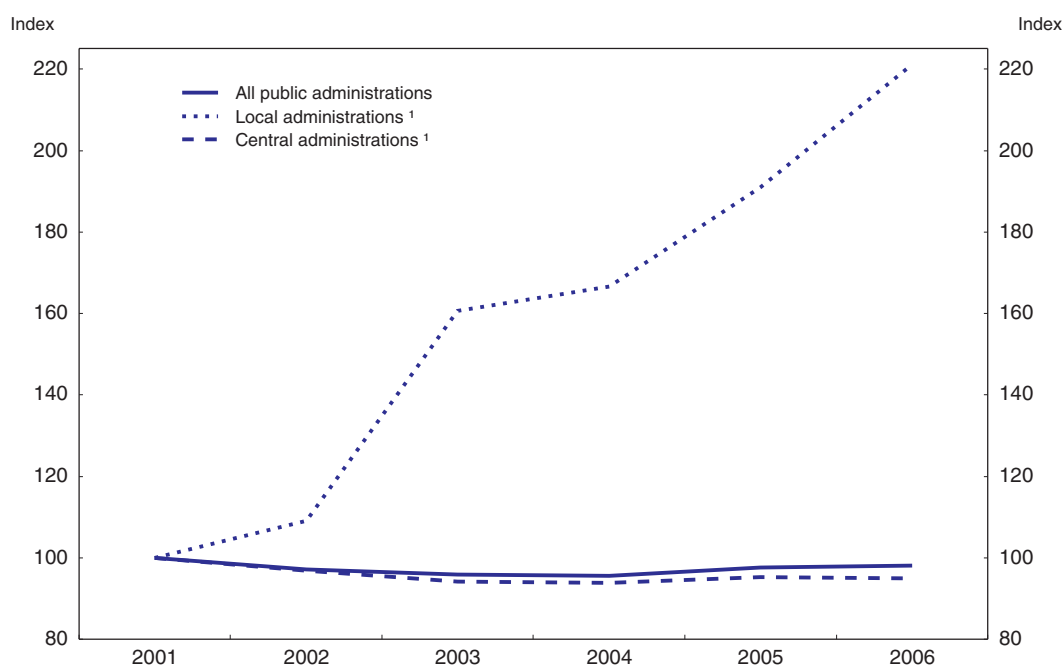
conductive to spending discipline than grants.<sup>2</sup> They also may have given rise to a growing lower level debt (below).

In Italy's case, tax sharing and especially equalisation arrangements are not very obviously rules-based or consistent: i) special regions are in good financial shape thanks to more devolved tax bases and very generous sharing of national taxes collected on their territory, while the richer ones do not have to contribute to equalisation transfers destined for poorer regions; ii) ordinary regions lacking such advantages incur a collective vertical fiscal imbalance, requiring state equalising transfers that are largely based on historical spending; and iii) municipalities show a vertical imbalance of similar magnitude to that of ordinary regions, with the associated equalisation transfers largely based on tradition often with no obvious economic rationale. As there is little hierarchical structure across levels, cities report directly to central government and individually negotiate for funding, bypassing the region. This may reflect the long history of local power in Italy, and relatively recent creation of the regions. With also little accounting standardisation across the various entities, fiscal federal relations can be cumbersome.

Local authorities have the right to incur debt for investment spending, reflecting a constitutional "golden rule". Local level debt has been rising far faster than central government debt, though from a much lower base (Figure 4.5). Whereas national tax sharing revenues have compensated for simultaneous reductions in grants, and own revenue (notably property tax) has remained static, expenditure is dynamic.<sup>3</sup> Thus, local


Figure 4.5. **Debt by government level**

As a percentage of GDP (2001 = 100)



1. These series are affected by privatisation of the Cassa Depositi e Prestiti in 2003, which shifted debt from central to local levels.

Source: Banca d'Italia, Supplement to the Statistical Bulletin: The Public Finances.

StatLink  <http://dx.doi.org/10.1787/014223418102>

authority current spending has in recent years risen by 2½ per cent per year, like that of the state in line with inflation, but revenues have risen by less than ½ per cent per year (state revenues 1¼ per cent),<sup>4</sup> and investment spending growth has also been compressed.<sup>5</sup> Regions can incur debts within certain limits fixed by central government (mostly as a percentage of revenue from taxes and ordinary transfers), but large health spending overshoots have had to be covered by growing suppliers' credits, securitisations of such credits, and finally *ex post* state transfers. The latter bail-outs create a "soft" budget constraint that only exacerbates the syndrome of overspending and creative accounting by regions. As total local government spending has risen at a pace about double that of central government in recent years, and given that local authority spending has been strongly squeezed, regional spending has by implication grown much faster than at any other level (Table 4.2).

Table 4.2. **Spending dynamics**

	% change			Level (€ million) 2005
	1999-2002	2002-05	1999-2005	
<b>General government spending</b>				
Current	13.8	11.1	26.5	630.2
Capital	5.9	21.6	28.7	57.1
Total	13.2	11.9	26.7	687.3
<b>Central government spending</b>				
Current	8.7	11.0	17.2	354.5
Capital	28.0	-14.4	-1.3	30.3
Total	10.4	8.4	15.6	384.8
<b>Local government spending</b>				
Current	25.7	15.0	39.7	181.2
Capital	16.6	11.5	35.8	37.2
Total	24.0	14.4	39.0	218.4

Source: ISTAT, *Conti territoriali delle Amministrazioni pubbliche*.

## Spending issues

Given that devolution has already gone quite far in Italy on the spending side, a tentative *ex post* evaluation should be possible, in particular to see whether the reallocation of functions to lower levels has improved the effectiveness and cost efficiency of public spending.

### Efficiency in social services

The delivery of social services, notably health and (potentially) education, comprises the lion's share of regional spending but, these being areas of concurrent competencies, "fundamental principles" are the prerogative of the state (see Box 4.1). The state must also set national standards of service in the social sphere (*Livelli Essenziali di Assistenza*, LEA), and guarantee the financing to achieve them in every region. National standards on service quality and access, if set coherently with fiscal sustainability needs, can make federalism reforms more palatable and protect shared equity goals during a transition period,<sup>6</sup> reducing the risk of under-provision that sometimes accompanies decentralisation of services.<sup>7</sup>

## Health

Health is the sector most critical for fiscal federal relations and emblematic of their problems. The regions are free to organise the delivery of health care services in their territory with minimal interference from central government, apart from the LEA minimum standard requirements. The actual running of the services is in turn devolved to the regional health enterprises (RHEs), a sort of local authority. This organisational freedom is reflected in innovative health care models. Provider-purchaser splits came with creation of the RHEs, allowing proto-market competition. Modern techniques of financing and running the RHEs have been developed by “best practice” regions, including the use of DRGs (diagnostic related groups) in addition to *ex ante* budgets to allocate funding and the use of professional managers to administer hospitals.<sup>8</sup> At the macro level, performance looks satisfactory: Italy’s health outcome indicators are situated in the medium-to-high end of cross country comparisons while health care spending (7 and 9% of GDP, public and total, respectively) is only slightly above OECD average. But the dynamics are more worrying.

In each year since Italy has presented stability programmes to the EU, health spending has risen up to 15% of the full long run increase to 2050 projected in the previous year’s programme. According to OECD projections, which incorporate stronger income effects than the national projections, health and long term care spending for Italy will double between 2005 and 2050, from 6½ to 13¼ per cent of GDP, 2% of which is due to demography and the remainder to income effects (OECD, 2006). The government has attempted to control the growth of spending by tri-annual Health Pacts. But by now spending is almost 1% of GDP above the target set in the first Pact and health spending continues to exceed a moving target (Table 4.3), even after suppliers’ credits and other creative accounting noted above. Hoping to force lower spending, the state for a time (2002-05) froze regions’ autonomy over tax rates and health co-payments (below). But the regions just blamed health deficits on the need to satisfy high national standards on health and (with the support of the constitutional court) demanded more *ex post* transfers from the State. Such transfers were provided under periodic clean-up operations (*sanatoria*).

Table 4.3. Health deficits

	2001	2002	2003	2004	2005	2006
Spending of the SSN						
€ billion	76.0	79.5	82.3	90.5	96.8	99.2
% of GDP	6.1	6.1	6.2	6.5	6.8	6.7
Health Agreement/Budget						
€ billion	71.9	76.7	80.0	84.7	91.1	95.0
% of GDP	5.8	5.9	6.0	6.1	6.4	6.4
Deficit						
€ billion	4.1	2.9	2.3	5.8	5.7	4.2
% of GDP	0.3	0.2	0.2	0.4	0.4	0.3

Source: Ministry of Health.

The health spending overshoots could reflect either that *a*) the targets themselves are unrealistic, given strong push factors like population ageing and technology, or *b*) regions are inefficient in the uses of health care resources. If the former is the case, then *ex ante* budget allocations should be increased to realistic levels with stronger sanctions for *ex post*

deficits. If the problem is inefficiency, then funding is OK but controls should be all the stronger. Since the financing of health care is decided in a sort of bargaining game between regions and state, both factors could be at play. However, inefficiency seems to be the core problem given that the game motivates higher spending to capture even more transfers down the road – the antithesis of responsibility and federalism principles.

There is indirect evidence of resources waste. Despite near equalisation of per capita health care resources across regions, outcomes differ widely as suggested by substantial inter-regional migration for hospital and specialist services. The migration goes overwhelmingly from south to north, and even if it is sometimes based on perceived rather than real differences in service quality, there is enough anecdotal evidence to support the notion of lower productivity in some parts of the south<sup>9</sup> – apparently substantiating “Wildavsky’s law” that where resources are fewer, there public management is also poorer.<sup>10</sup> But even where quality is higher, cost control may still be weak. Indicators point to “supply-led demand” inefficiencies in certain regions found in all parts of the country, e.g. inappropriate use of hospital services or excessive procedures and drug prescriptions.<sup>11</sup> Furthermore, accounting practices at the regional health enterprises can be slipshod, which prevents sound management; only one region (Tuscany) has been able to pass external audits of its health enterprise accounts. Indeed, the scope for efficiency savings in Italy’s health sector has been estimated at 20-30%.<sup>12</sup>

The upshot is that there clearly exist cost pressures now and in the future. Hence, taxes will have to increase, and the central government has dealt with this problem by making this the responsibility of the regions, giving them more tax instruments (Box 4.2). Yet Italy needs lower tax rates, to spur investment in the catching up regions and to cope with the globalisation challenge in the industrial north. Because of the decentralisation process, however, tax rates should be lowered at the national, not subnational, level. At the same time, greater cost efficiency is required to contain such local tax increases and it will result from transferring to regions spending responsibility accompanied by greater tax autonomy and harder budget constraints. A well functioning federalism, based on accountability, would provide support to contestability and efficiency of public health care services. This would enable eventual easing of local tax pressure and attenuate cross-regional health sector productivity differences.<sup>13</sup>

All this suggests that developing other mechanisms to make regions co-responsible in their spending governance may be urgent:

- Financing reforms will need to phase out funding based on historical spending and *ex post* bargaining in favour of one linked to *ex ante* structural factors (with credible sanctions for spending overshoots). A committee will present in the course of 2007 proposals for new financing rules based on micro methods including standardised processes and inputs.
- The LEA should, in parallel, be defined not in terms of equal per capita spending independently of productivity but rather of cost efficiency for each type of service, upon which its financing is conditioned. To this end, standard cost benchmarks should be developed by central government, drawing on experience with the systems (such as DRGs) developed by certain best practice regions.<sup>14</sup> The menu of “essential” services should be adequate, yet bounded; going beyond them should be a matter of local choice funded by the free exercise of tax autonomy or efficiency savings in spending. An LEA

#### Box 4.2. The 2007-09 Health Pact with the regions

A new Health Pact with the regions covering the period 2007-09 was entirely incorporated into the 2007 Budget Law. It prolongs a key innovative measure of the 2006 Budget, reinstating formerly frozen regional tax rate autonomy while requiring deficit regions to increase their two chief taxes (IRAP and surcharge on personal income tax) to the maximum rates allowable. It further imposes a structural deficit reduction plan, agreed with and monitored jointly by the Ministries of Health and Economics, aimed at cutting costs including reduction of hospital beds. This plan may temporarily involve additional public resources. In case of non-adherence to the plan, it is possible that regions would be required to raise tax rates even beyond current allowable maxima (to stimulate responsibility). For those regions, the off-the-books debts to suppliers are being repaid via special long term state “loans” to regions, amounting to 0.2% of GDP in 2007, which will eliminate distortions in the market and budgets while avoiding the payment of regional risk premia on market debts. The size of such debts may be significant, in particular for Lazio, but is still being estimated within the ambit of the health sector restructuring plans.

Pharmaceuticals prices will continue to be squeezed by the exercise of centralised government monopsony power. Patient copayments (“ticket”) will be activated in new areas like emergency room and ambulatory services, to stem excessive demand. Committees are being set up to revisit the LEA and to analyse their costs and associated financing mechanisms in health care. Central government financing of € 3 billion is provided for hospital restructuring investments.

Finally, the Ministry of Economy and Finance and the Ministry of Health, in agreement with the regions, should elaborate suitable guidelines and models to be adopted by health care enterprises in reporting health accounts. Currently, the treatment of capital is based on how the entities happened to treat inherited capital at their creation, with imprecise and non-homogenous rules on amortisation rendering territorial balance sheets non-transparent and distorted for many years (Persiani, 2006).

committee has been formed, but hard choices may still need to be made on the scope of the guarantees that Italy can really afford, even if efficiently supplied.

- Appropriate *framework conditions* are needed to underpin better health cost control. Modern accounting principles and their standardisation, already available for the whole public administration, need to be made effective for the regional health enterprises – and these should be made subject to internal controls and external audit.<sup>15</sup> The latest Health Pact (Box 4.2) has launched the elaboration of guidelines and models allowing such an evolution to take place.
- To the extent that future pressures on health spending are unavoidable because of rapid ageing, which puts greater pressure on regions than on central government (where long run fiscal sustainability has been anchored by pension reform<sup>16</sup>), more and dynamic tax bases should be devolved to the regions via articulation and implementation of Article 119, while central tax rates should fall.

### Education

The Bassanini reforms devolved considerable organisational and didactic autonomy in education straight down to the schools.<sup>17</sup> The state sets the basic framework for standards, curricula, textbooks, etc., monitors results by national testing and assigns financial

resources and personnel. The local authorities finance infrastructure investments and maintenance, and the regions are charged with vocational training. According to the new Title V, however, regions should undertake all school financing and management, with the state defining the basic framework and setting standards. This would imply a tripling of local authority spending on education (Table 4.4) and greatly increase their role in organising education (with even accompanying legislative powers assigned by the constitution) and in hiring and managing teachers.

The risks to devolving education are threefold: a) still unresolved problems on the financing side; b) efficiency problems nationwide exacerbated by the gap in educational performance between the south and centre-north regions;<sup>18</sup> and c) excessive overlapping of education responsibility. Besides being politically sensitive, since education touches closely on ideology and citizenship, the state may well be worried about exacerbating inter-regional differences in education quality by a premature decentralisation, wishing to do more to prepare the ground. Its latest policy initiative greatly boosts the central government's presence in testing and coaching schools, especially in the south, while adding significant new resources (€ 4 billion in the 2007 budget) for things like substitute teachers.<sup>19</sup>

Giving authority to schools and their direct reporting to the national ministry is not necessarily undesirable: indeed, devolving some responsibility to the provider level instead of to local government means even more decentralisation and can increase accountability, especially if monitoring is reinforced at the national level, as is the case presently. However, what seems also required is a real revolution in the south's public administration culture, which should normally come about with greater local responsibility, including in education.<sup>20</sup> The very different economic challenges of the north and south might also justify more freedom to differently orient education systems – provided that the state retains a strong guiding and monitoring role to protect national standards, especially in light of current problems. Thus,

- The government should consider a long range plan for implementing Title V as regards devolution of education to the regions, and delegating to local entities while safeguarding the autonomy of schools; the new Code on Local Autonomy could start to define these new roles;<sup>21</sup>
- This would entail the need to devolve or create significant new regional tax bases, increasing further the onus on activating Article 119 on financial autonomy;
- It is crucial that as the state decentralises education it reinforces the steering of testing, curricula, standards (minimal attainment and achievement criteria), and information as it is now doing.

### **Welfare**

Non-pension welfare services are poorly developed in Italy. Social assistance has long been under the responsibility of the local authorities, with virtually no involvement or guidance from central government. This has given rise to a free-for-all, with coverage and eligibility for assistance varying widely across regions and localities, reflecting powers and interests of local mayors and creating incentives for welfare migration. The criteria appear arbitrarily tailored to particular cases (*e.g.*, physical disability), leaving many needy people outside the safety net. Labour market services for their part were fully devolved to the regions under the Bassanini reforms but remain limited in scope and scale.

The new constitutional provisions imply that the national legislature must set the basic framework conditions and LEA for local social assistance policies, although so far it has failed to do so despite reforms proposed by the Ministry of Labour and Social Policies calling for such framework conditions.<sup>22</sup> On the other hand, social welfare setting need not always be centralised. Regions may co-ordinate their welfare systems horizontally without recourse to central government (as in Switzerland). The remaining limited interregional competition limits expenditure pressure.

A functional, if modest, social safety is needed to complement reforms in labour markets, product markets and public administration, establishing a missing coherence between welfare policies and structural reform objectives. Establishing a limited yet universal unemployment insurance is a long standing discussion in Italy never resolved because of budget difficulties. But precisely because of the budget context, limiting moral hazards of universal insurance will be primordial. Municipalities, equipped with better local knowledge, could probably enforce job search by welfare recipients more efficiently than could the centre. But the state should still co-ordinate information in order to promote geographical mobility and get a better match of skills with openings across the country.

### **Competition in local economic services**

Economic services fall mostly under the exclusive competence of regions. Areas covered include regulation of retail distribution, professional and personal services, direct provision of local services and procurement – areas where competition problems in Italy are acute. Local utilities are still overwhelmingly in public hands despite past liberalisation efforts, and decision making remains excessively fragmented.<sup>23</sup> In such areas, however, there could be a downside to excessive autonomy. It could give rise to perverse results in terms of possible capture by local special interests – especially as “civil society” is not very strong. Certain local authorities’ direct participation in local economic service provision tends to preserve monopoly positions and related rents, in part as a “secure” revenue source compared with others. Such authorities may purchase market services from companies in which they have an interest (“in-house”) at inflated prices.

The government is attacking such problems head on (Chapter 2). The draft Lanzillotta law on local public service liberalisation requires competitive tendering for all public service contracts (except in the problematic area of water), putting public and private providers of market services on a level playing field.<sup>24</sup> If regulatory and other conditions are there, local entities should privatise outright.<sup>25</sup> Re-establishing coherence with national level competition policies formulated to protect consumers, akin to national standards in social services, might also curb the power of local lobbies.<sup>26</sup> There should be a greater recourse to user fees (customers paying for services) in order to reduce dependence on economic rents and grants, to limit the use of distorting taxes, and to constrain demand for public services.

The quality of local economic services may be suffering from above-noted tensions in the decentralisation process, which includes a difficult mix of expanding responsibilities, state transfer cuts, limited revenue autonomy and rising debt. Many municipalities have had to cut essential investment spending because of lack of funds.<sup>27</sup> But weak local administrative capacity, bred by a history of passive dependence on transfers and reinforced by a lack of competition in public services, also persists in many cases. Thus, inadequacy of services like water and waste management are reaching catastrophic levels

in areas of the south. EU funding has certainly helped, though not entirely. For example, in the Campania region, despite major expansion of the networks (bus and train) made possible by EU structural funds for transport, operating costs cannot be covered so that service levels have had to be cut (such as closing the Naples metro at 10 p.m.) and tariffs raised.<sup>28</sup>

While quality of local administration has improved compared with the past, perhaps more effort has been devoted to project preparation given the incentives of EU structural funds and central matching grants, than to more basic skills relating to good governance. Greater local autonomy should help to develop such broader based skills. Regional policy could well complement the decentralisation process by tackling failures in local capacity and infrastructure in a more targeted manner. Promising new tools have been developed in Italy to reach these objectives, notably novel forms of contracting between central and local governments and output-based funding (Box 4.3).

#### Box 4.3. Regional policies to improve local public service productivity

As of 1992 a *process of radical change in Italian regional policies* has been in progress, partly reflecting the influence of EU economic and social cohesion policies.<sup>1</sup> This process has resulted in: 1) an extension of the targeted areas to less developed areas of the Centre-North; 2) a shift of responsibility from the “Cassa per il Mezzogiorno” (abolished in 1984) to a multiplicity of institutions, including central ministries and territorial authorities (regions, provinces and municipalities), often operating in a system of multilevel governance; 3) an attempt to increase targeting, coordination, monitoring of territorial needs; and 4) a shift from top-down policies to contractual and concerted forms of planning.

At present, the implementation of national territorial development policies rests on a two-tiered system that emphasises *regional policy* and *ordinary policy*. Regional policy is specifically aimed at addressing structural socio-economic imbalances across territories and is financed through additional resources that originate both from the EU budget (structural funds) and from the national budget (the fund of national co-financing to the structural funds and the fund for underdeveloped areas – “Fondo Aree Sottoutilizzate”, FAS). Ordinary policy draws on ordinary financial resources coming from the state budget and addresses broader development objectives that are not related to specific territories. Both policies are implemented at various levels by the central government, regions, and local authorities.<sup>2</sup>

In sum, the new approach to regional policy encourages the mutual commitment of different levels of government by the following means: the negotiation of objectives and indicators between levels for measuring their achievement; the attachment of a bonus and sanction mechanism (in addition to the bonus and sanctions “performance reserve scheme” attached to EU grants); and the assessment of the achievement of targets by a specific tiers body.

These innovative regional policy tools could help to solve certain *paradoxes or contradictions arising in the federalist process*, particularly during the awkward transition when governance capacities of some local governments may seriously lag their rising fiscal and regulatory responsibilities. In particular:

- Large disparities in tax capacity and spending efficiency across Italian regions stem from very differing levels of development. This surely limits the effective exercise of spending



**Box 4.3. Regional policies to improve local public service productivity (cont.)**

and tax autonomy for the lagging regions. Regional policy, which identifies place-based problems and opportunities, could be adapted for addressing these issues. Regional development policy, and in particular, the improvement of the distribution of infrastructure, would help to support more effective local economic projects and thereby develop the local economy and tax base.

- Some recent initiatives could be underlined. They concern the new National Strategic Framework (Quadro Strategico Nazionale) 2007-13. This strategy selected important local public services (children and ageing people care, waste management and water, plus education with other types of arrangements among levels of government) and a specific region, Mezzogiorno. The strategy proposes indicators for policy objectives in terms of outputs and not inputs (as recommended here) and attaches incentive mechanisms based on performance targets. However, there is a sunk cost to be paid for the building of co-operative relationships and the identification of good tools for motivating performance in order to commit local authorities to achieve certain objectives.
  - A too rigid approach to decentralisation – either all responsibility for the central level or all for the sub central level – should be nuanced. Specific arrangements can be used, encompassing mutual objectives, rules for commitments of parties and enforcement procedures. Such a contractual approach to federalism has been stressed by some authors.<sup>3</sup>
1. Between 1950 and 1992, the primary objective of Italian regional development policies was the reduction of the long-standing disparities between the northern and the southern regions (“Mezzogiorno”) through interventions mostly aimed at industrialising the south (in popular parlance, the “Intervento Straordinario”). Many of these interventions were devised by a central entity, the “Cassa per il Mezzogiorno”.
  2. See OECD (2007), *Linking Regions and Central Government: Contracts for Regional Development*, forthcoming in April; also F. Barca, M. Brezzi, F. Terribile and F. Utili (2004), “Measuring for Decision Making: Soft and Hard use of Indicators in Regional Development Policies”, Ministry of Economy and Finance, *Materiali UVAL number 2*, November-December.
  3. See Spahn, P. (2006), “Contract Federalism”, in E. Ahmad and G. Brosio (eds.), *Handbook of Fiscal Federalism*, Edward Elgar; also OECD *op. cit.*

**Costs of devolution****Labour market rigidities**

A public debate has arisen as to whether the costs of devolution may be unaffordable in the chronically tight budget situation. The size of the further total gross spending transfer from centre to periphery which would be needed to comply with the new constitution has been estimated at € 70 billion (5% of GDP), much of which for education (Table 4.4). This should however translate into “zero costs” on a net basis – the stated goal of government – insofar as spending at the central level shrinks correspondingly. But costs of transition are usually unavoidable, even though hopefully more than paying for themselves later on with efficiency gains. Other OECD countries’ experiences suggest that such transition costs can be high.<sup>29</sup>

Employment flexibility in the public sector has been pursued, as in the private sector and in many countries of Europe, by putting new hires on fixed term contracts, leaving insiders’ acquired rights intact. It is thus very difficult to fire or reassign workers, most of whom are tenured, much less move them. Hence, devolution entails a duplication of posts. The experience with the late 1990s Bassanini reforms is not encouraging: of all the

Table 4.4. **Gross transfer of spending under future decentralisation**

Function:	Local authority spending		
	€ billions	€ billions	Per cent
	In 2004	Decentralisation of new competencies <sup>1</sup>	% increase
Commercial services	26.0	0.2	0.7
Defense	..	..	..
Public order and security	3.8	..	..
Economic affairs	34.4	6.9	19.9
Environmental protection	6.1	0.7	10.7
Housing	9.9	0.2	2.4
Health	89.4	0.6	0.6
Recreation	7.9	1.2	15.7
Education	21.1	45.3	214.6
Social welfare	8.7	15.0	172.8
Total	207.4	70.0	33.8

1. Hypothetical and estimated, based on 2001 constitutional reform.

Source: ISAE (2006), *L'attuazione del federalismo*, March.

functions devolved, it was only in the case of labour market placement services that the same staff actually shifted from working for central to regional government (without actually moving as they were already stationed at regional offices of national government). Otherwise, central staff stayed in place but with no clear responsibilities, and lower levels had to hire new staff using government grants for this purpose. Since the initial devolutions, local hiring freezes have become regular fixtures under the Internal Stability Pact (below), and consequent ageing of the workforce may be hardening resistance to needed innovations. Local authorities are further constrained in their ability to manage the costs of devolved responsibilities because of rigid centralised wage setting in the public sector.<sup>30</sup>

Rigid labour markets make decentralisation prohibitively expensive, implying a very long transition period during which efficiency will not improve. Devolution may provide the opportunity for government to negotiate decentralised wage contracts, allowing wage levels to vary with cost of living differences across regions and, ideally, with average regional productivity levels. The so-called “privatisation” of the civil service (begun in the late 1990s) should reach its logical conclusion in flexible work assignments and eased job protections. A recent government Memorandum (Chapter 3) attempts to tackle such problems, and its success will be important for the future of federalism. However, some of the proposals could go in the opposite way; for instance, the conversion in the national civil service of temporary staff to permanent status could remove the even small margin for manoeuvre in personnel management, although the criteria of this conversion still need to be defined.

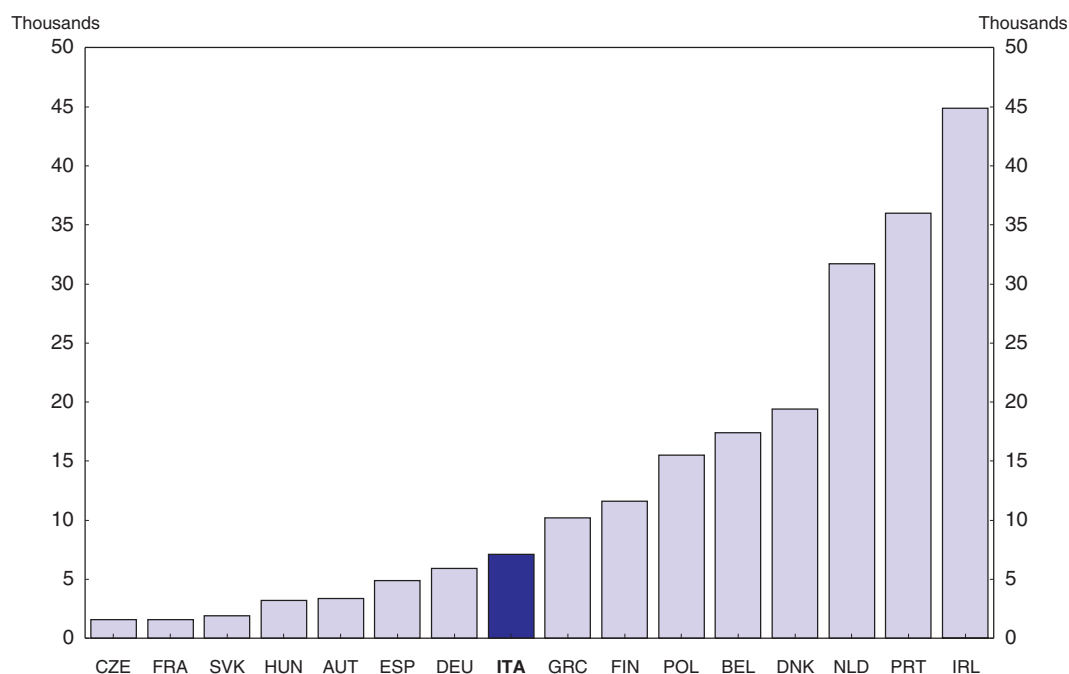
### ***Diseconomies of scale in government***

A further overstaffing issue is a perhaps superfluous level of government that exists mainly to provide jobs. Italy has three subnational political levels, each with its own ministers, staff, electoral, consultancy and representation costs. Transaction costs for government and citizens also increase when there are multiple decision points and authority levels. The “odd man out” here is the provincial level; even though it corresponds

to the Anglo-Saxon counties in an administrative sense, unlike them it has real political authority. Numerous calls in Italy to eliminate the Provinces have met with stiff bipartisan resistance. It can be suspected that the reason for their popularity is to a large extent the opportunities they provide to make more political appointments.<sup>31</sup> Indeed, the number of provinces has been steadily expanding, from 92 originally to 107 at present; legislation was passed under the previous government for another 4 to be created; and there have been proposals to add about 30 more. The already high number of cities (more than 8 000) is likewise expanding with steady creation of new “mountain communities” as authorised by the revised constitution, while their average size is already quite low on the OECD spectrum (Figure 4.6).

Figure 4.6. **Size of the cities**

Average size of cities: number of inhabitants per municipality



Source: Hemmings, P., “Improving public-spending efficiency in Czech regions and municipalities”, OECD (2006), OECD Economics Department Working Paper No. 499.

StatLink  <http://dx.doi.org/10.1787/014231740334>

The present government has rightly put a stop to the further expansion of provinces, and will try to clarify and rationalise their role in the new Code for Local Autonomy. The proposed legislation also offers new incentives for small cities to aggregate; this could slim down bureaucracy, internalise spill-overs and reduce fragmentation in local public service supply.<sup>32</sup> In particular, certain functions could not be exercised unless administrative jurisdictions reached a minimum size (15 000 inhabitants). Indeed, achieving efficiency in local economic services raises questions about the density and scale of jurisdictions. The legislation should try to ascertain what changes in local administrative boundaries and jurisdictions might be appropriate to an environment in which competition becomes feasible.

## Funding principles

The method of financing is critical to creating incentives for the local public administration to be accountable in its use of taxpayers' money.<sup>33</sup> The new constitution is not very clear on the precise model of financing that should be chosen, unlike in the area of spending. But a vague constitution can also be more robust. The important principal that it does establish is that of greater "ownership" of local revenue resources and corresponding reduction of discretionary central transfers. This should remove local incentives to "free ride" on the national taxpayer, allowing a more evaluative demand and better constrained supply. There is also an issue for fiscal sustainability: the more local governments can rely on the growth of local revenue sources to fund their expected spending growth – notably in health and old age care, infrastructure and education – the less dependent they are on the vagaries of intergovernmental transfers to balance their budgets.

### **Fiscal autonomy to reinforce accountability**

#### **Tax and revenue autonomy**

The share of Italy's general government tax revenues that can be ascribed to subnational governments covers only about one-third of their expenditure share (Figure 4.2 above). Non-tax revenues bring the share to somewhat less than half. The greater part of subnational taxes are shared national taxes (for ordinary regions counted as transfers not own taxes), piggy-backed on national taxes, or otherwise have parameters or deductions from base constrained by central government, leaving few genuinely autonomous local taxes (Box 4.4). Most of these taxes are also collected by central government which may be beneficial given likely economies of scale in tax collection, and this should not infringe on local tax autonomy.

Given that investment spending can be financed by borrowing, a better indicator of regional financing autonomy may be the ratio between own taxes and current expenses. In most southern regions this rate of cover is generally only around half that in the northern ones (Figure 4.7). Moreover, differences in the effective margin of flexibility, for equivalent variability in tax rates, are even greater because of the smaller absolute size of poorer regions' tax bases to start with: the remaining scope for greater tax revenues, based on a hypothetical raising of actual own tax rates to the maxima allowable, is around 1% on average in the southern and special statute regions, against 12 % in the other ones.<sup>34</sup> This reflects that the main regional own tax, IRAP, is unequally distributed, being based on widely varying local productive activity and heightening lagging regions' dependence on equalising transfers. On the other hand, the dynamics in the coverage ratio may be worse in the north, as spending needs there are rising faster than GDP given faster ageing and deindustrialisation. This suggests that large equalising transfers, originating in many of these regions, are not sustainable in any event. The issue for reform is to get a tax assignment with a more evenly distributed and dynamic tax base to assist regional convergence and to cope with ageing.

#### **Tax competition**

Increased tax autonomy gives the intriguing possibility for regions to engage in horizontal tax competition as a further push to efficient service provision. However, such behaviour has been slow to crystallise in Italy. Some regions did start to exercise tax rate

### Box 4.4. Regional and local revenue sources

#### Tax revenues

Own regional taxes, which were sharply increased in the late 1990s, account for two-thirds of their total revenues. They can be either derived from national taxes or locally based. The main locally based tax, introduced in 1997, is the regional tax on business value added, IRAP (*imposta regionale sulle attività produttive*), accounting for half of total regional tax revenues (Table 4.5), though the State collects it and sets the basic rate. The wide base allows for a low standard tax rate (4.25%), suggesting an efficient tax and less damage to labour market incentives than social security payroll taxes which fall entirely on labour. On the other hand, the base is rather unevenly distributed and the tax only weakly obeys the benefit or correlation principle, as firms (who pay the tax) may have branches spread across regions and not perceive a close correlation between the tax they pay and the services they receive from an individual community, nor are the owners likely to be local taxpayers.

The main derived taxes also introduced in the late 1990s are the regional surcharges (*addizionale*) on the national personal income tax (IRPEF) and sharing (*compartecipazione*) of the national VAT according to the criterion of geographic origin, and surcharges on national gasoline excise taxes, all together accounting for nearly 70% of total regional revenues. However, for the ordinary regions, revenues derived from the sharing of national tax bases are officially recorded as a transfer rather than as an own tax, given that they are totally controlled by the central government, and are therefore somewhat of a grey area. There is also a regional automobile tax and other smaller excise taxes, accounting for less than 10% of total tax revenues.

As of 2000, regions were given more latitude to vary tax rates and to grant reliefs. On IRAP, they were free to vary the basic 4.25% tax rate up to 1% point on either side, also to diversify tax rates within these limits or grant deductions according to sector or contributor. On the income tax surcharge, the basic rate was raised from 0.5 to 0.9% with a possibility to vary this rate by up to 1.4%, although there is no freedom to set reliefs. Such tax rate autonomy was frozen by the central government in the 2003 Budget. Although the central government may be seen as legitimately having tried to encourage lower health and other spending, given its dual commitment to fulfil EMU targets and improve efficiency of government, this also suggests a weak guarantee of regional taxing powers.<sup>\*</sup> It also highlights the difficulty of undertaking profound structural reforms when there is very little margin for manoeuvre in annual budgets.

IRAP and regional IRPEF surcharge rates were freed up again with the 2006 Budget, and the 2007 Budget envisages further increases in tax rate room for maneuver, in particular for regions that fail to get their health spending under control. Such regions (of which there are six) have already been compelled to increase their IRAP rates to the maximum (5.25%) by 2008; Campania and Marche have already raised theirs to 5.25 and 4.5%, respectively. For those regions, taxpayers could see a rise in their IRAP payments, partly or wholly offsetting deductions being offered by the central government in exchange for hiring on permanent contracts, especially in the poorer regions (Chapter 3). But other regions have selectively reduced IRAP rates in support of employment: Toscana 3.25%, Veneto 3.7%, Friuli Venezia Giulia and Liguria 3.24% for special categories like agriculture but 5.25% for banking, and Lombardia 3.25% for firms born after 2004.

The main local level taxes are the property tax (ICI) and the local surcharge on IRPEF. Similarly to the regions, the freedom to vary local surcharges on IRPEF were frozen between 2002 and 2005, but reinstated with the 2006 Budget. Municipalities are likewise taking advantage of their renewed flexibility: so far, 1 435 communes have raised the tax rates for 2007 whereas 4 409 have lowered them (the remaining 2 258 having left them unchanged). The 2007 Budget also expanded the scope for updating property values for the ICI, which should allow needed expansion of the local tax base. However, legislative proposals in early 2007 have called for granting ICI deductions for family support, eliminating the tax altogether for certain categories of family. The impact on local finances could be severe.

Box 4.4. **Regional and local revenue sources** (cont.)**Non-tax revenues**

Non-tax revenues account for 10% of subnational revenues, and include operating surpluses of public enterprises controlled by subnational governments, fees including road taxes and health co-payments levied at the regional level, and various charges by the local governments including for utilities and services like trash collection. The local entities also have access to economic rents owing to widespread holdings in economic enterprises enjoying monopoly positions: while they appreciate having this “sure” source of finance, particularly when many traditional financing arrangements are undergoing upheavals under the federalism process, it reduces government’s incentive to liberalise, distorts the market and thereby undermines the local tax base (Confindustria, 2006).

In 2001, prior to national elections, the central government cancelled co-payments on pharmaceutical products at the national level. The ability for regions to levy co-payments on pharmaceutical products was reintroduced in September of the same year (law decree 347/2001). Co-payments on ambulatory services have been foreseen at the national level since 1994. According to the 2007 budget law, co-payments have also been introduced on medical prescriptions and first aid interventions.

For local levels, non-tax revenues are proportionately more important than for the regions. Given the overall slim revenue base for the local authorities, there is still considerable dependence on transfers including discretionary earmarked grants considered to be particularly detrimental to local incentives.

Table 4.5. **Tax autonomy of subnational governments**<sup>1</sup>

Tax	Weight <sup>2</sup>	Margin of autonomy
<b>Region</b>		
Irap (tax on company value-added)	51.0	Tax rate variable between 3.25 and 5.25%
Surcharge on income tax	9.6	Tax rate fixed by region between 0.9 and 1.4%
Automobile taxes	6.2	Variable by 10% with respect to previous year’s amount
Surcharge (substitutive) on methane gas	0.6	Amount determined by region between € 0.0052 and € 0.00310 per m <sup>2</sup>
Tax on waste disposal	0.3	Varies between € 0.001 and € 0.0258 per kg. of waste
Tax on regional concessions	0.3	Region fixes tax on acts up to 20%
Tax on right to university studies	0.2	Varies within a given range
Tax sharing for special regions	30.0	None: fixed rates
<b>Province</b>		
Tax on automobile insurance	47.5	None: fixed tax
Transcription tax	27.7	Freely set up to 20%
Surcharge on electricity consumption	17.3	Variable within a given range
Tax on environment protection	4.3	Tariff set by regulation
Specific tax on waste disposal	1.3	Amount determined by region by 31 July of each year
Tax on occupation of public space	0.3	Freely set, can be substituted with a tariff decided by commune
<b>Community</b>		
Local property tax	58.0	Tax rate variable between 4 and 7 per thousand, depending on type of property
Tax on urban solid waste disposal	22.7	To be substituted with a tariff decided by commune
Surcharge on income tax	7.1	Freely set by end of year up to 0.5%
Surcharge on energy consumption	3.4	None: fixed rate
Local tax on advertising	1.6	Freely set, can be substituted by concession with tariff
Tax on occupation of public space	1.2	Freely set, can be substituted by concession with tariff
Right to public signs	0.4	Amount set by local regulation

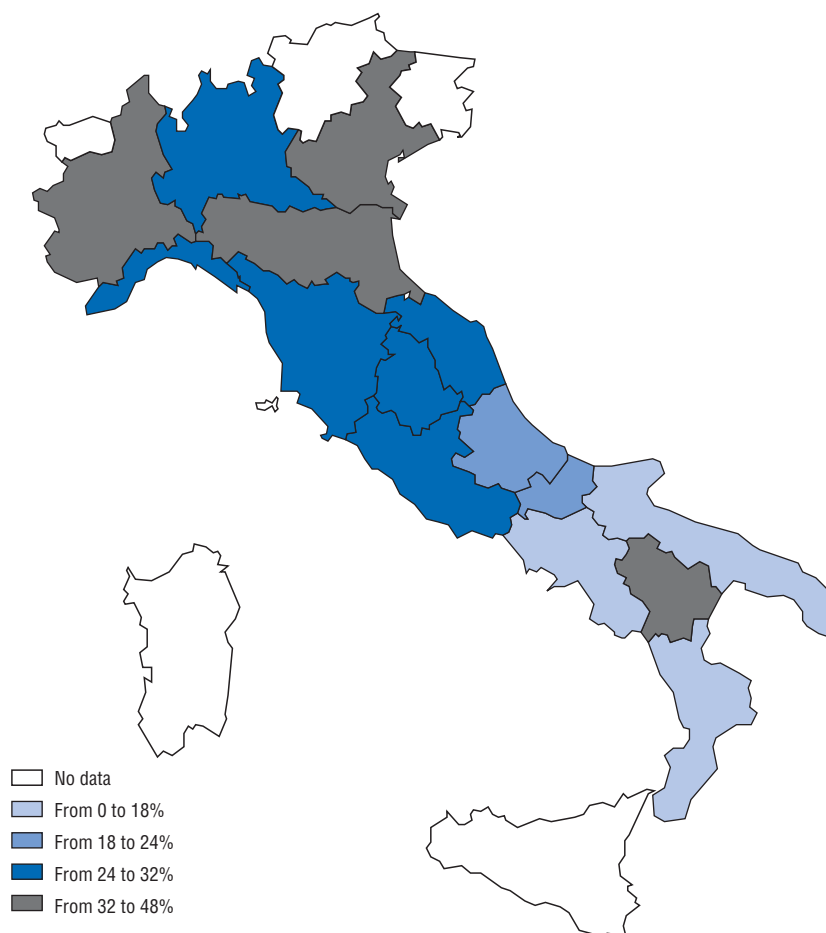
1. The 2007 Budget gave communities the possibility to institute, as of 1 January 2007, a tax dedicated to partial coverage of public investments, and, as of 1 January 2008, an increased sharing of personal income tax.

2. Weights do not add to 100 because of omitted minor taxes.

Source: Messina (2006).

\* The Constitutional Court upheld the right of the government to freeze regional tax rates, ruling that the need to meet EMU commitments overrode regional entitlement to tax autonomy.

Figure 4.7. **Coverage ratio by region**  
Own resource over current expenses ratio, in percentage, 2001



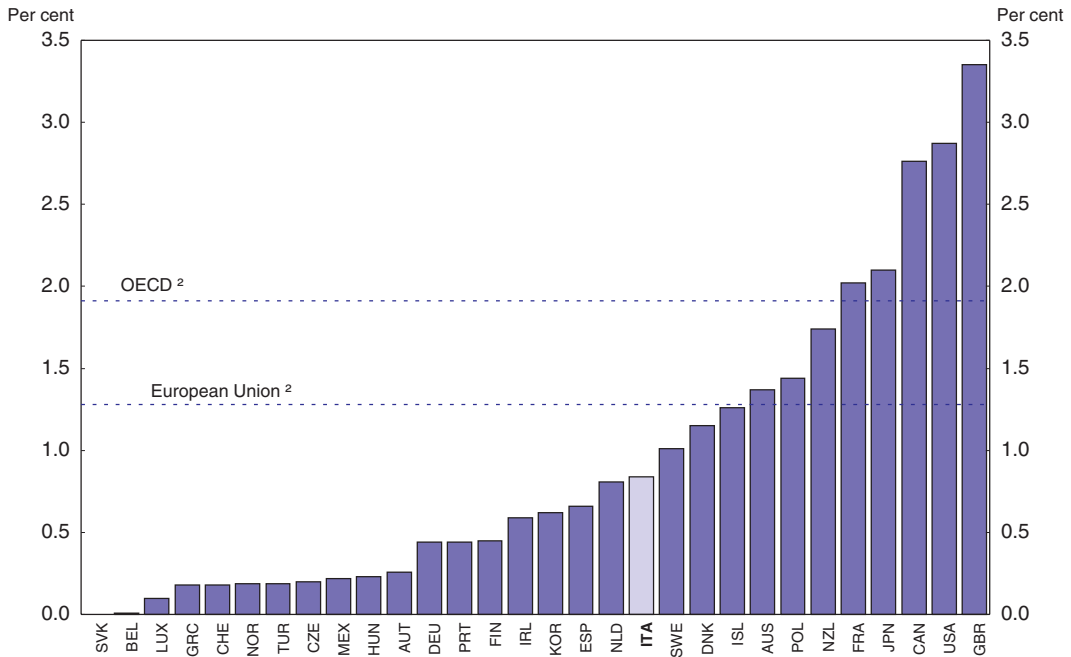
Source: OECD estimates based on Messina (2001) and ISTAT, Conti Economici Regionali.

autonomy as central transfers were being cut in a context of tightening national budgets, before such autonomy was frozen for a time, and once the freeze was lifted some regions even began to cut tax rates (Box 4.3). But reducing tax rates does not seem to be an option where budgets are tight and new competencies have been devolved. There also seem to be widely shared concerns in Italy about the potentially “harmful” effects of internal tax competition. However, the LEA should be sufficient insurance against that risk. Hence, the possibility of accountability-enforcing tax competition should reinforce the case for more tax rate autonomy, even if there is a limit to the extent of rate differentiation to avoid large scale tax base flight. The examples of Ireland, some US states and Switzerland show that tax competition can be highly beneficial to local development while also weakening collusion among neighbouring governments to keep taxes high.

Another factor inhibiting beneficial tax competition might be low inter-regional mobility, which reduces the “citizens voting with their feet” aspect of federalism. Part of the problem is also a weak operation of the benefit or correlation principle, as taxpayers perceive derived taxes only as national level taxes while the main regional tax, IRAP, is paid

by firms which may even be national in scope, rather than by the taxpayers on the receiving end of most public services. The local property tax, ICI, normally follows this principle very well, and other countries' experience shows that it better allows citizens to exercise "yardstick tax competition" across communities.<sup>35</sup> Nonetheless, this tax is relatively underdeveloped in Italy because it is politically very unpopular (Figure 4.8).


Figure 4.8. **Recurrent taxes on immovable property in OECD countries**  
Revenues as a percentage of GDP, 2004<sup>1</sup>



1. 2003 for Portugal.

2. Weighted average using 2000 GDP and PPPs.

Source: OECD, Revenue Statistics Database.

StatLink  <http://dx.doi.org/10.1787/014241070503>

A potentially "harmful" vertical tax competition may be the more important concern for Italy.<sup>36</sup> The central government controls the main bases for lower levels' taxes, IRAP, IRPEF and ICI, with local tax autonomy confined to the rates levied. But central manipulation of these tax bases for social or other policies may work at cross purposes with lower level needs, or *vice versa*. For example, recent offsetting actions on IRAP (Box 4.4) have implied IRAP increases in some regions in place of the cuts promised by central government. Another example of vertical externality occurs on IRPEF: in the 2007 Budget the government replaced tax credits by tax base deductions, with uncertain impacts on the base for local and regional surcharges.<sup>37</sup> A final example is on ICI: after devolving to municipalities the power to update property cadastre values in the 2007 Budget, a positive step, there have been proposals in Parliament to reduce effective ICI tax rates substantially by offering generous family deductions on primary houses (Box 4.4). This could backtrack on federalism in a fundamental way.



### Intergovernmental transfers to balance equity and efficiency

A crucial aspect of fiscal federal relations is the equalisation of regional differences in tax capacity so as to allow comparable levels of public services across the national territory (particularly those covered by the national LEA) without requiring sharp differences in tax rates and hence private consumption.<sup>38</sup> This necessitates cross-regional redistribution of tax revenues. With large economic disparities across regions, this issue is an important and contentious one in Italy. OECD experience suggests that great caution is needed in the design of such systems. In particular, equalisation schemes have a tendency to: i) pose a problem for budget stability, especially if such transfers are open-ended and/or if local governments are entitled to a minimum fiscal capacity, while complicating local budget planning insofar as frequent formula adjustments render such transfers unstable; ii) reduce tax and development effort, especially in poorer regions and particularly if tax capacity is equalised at a rate of 100% or more; and iii) be prone to manipulation and ultimate ineffectiveness, given the complexity of cost equalisation in light of extensive decentralisation of expenditure (as opposed to revenue) and heterogeneity of local services. On the other hand, the choice of standardised revenue or cost bases, for example by the use of Representative Tax Systems to determine tax capacity and sophisticated methods to determine the true cost of service provision, can mitigate disincentives (Bloechligher and Charbit, 2007).

Central government grants in Italy go directly to both the regional and local authority levels, funding the vertical fiscal imbalance, and there are further grant flows going from regions to local authorities within their jurisdiction. Most grants are untied, i.e. general purpose and not earmarked.<sup>39</sup> They are also considered in the statistics to be mostly mandatory, i.e. a running obligation of the central government bound by predefined rules. It should further be noted that around one quarter of the total grants received by the regions and the local authorities come from the EU, in terms of structural funds for project financing, which are matched by the national government upon acceptance of a feasible project proposal. This leaves about half of all central government grants going to cover current spending (Table 4.6).

Table 4.6. **Main transfers**

	Type of revenue	General or ear-marked transfer	Transfer origin	Equilisation transfer	Proportion of local revenue excluding borrowing
Ordinary fund	Operating	General	State	Yes	13%
Equilisation fund	Operating	General	State	Yes	3%
Consolidated fund	Operating	General	State	Yes	2%
National ordinary investment fund	Investment	Earmarked	State	No	0.1%

Source: Dexia, 2002.

Although the predominance of general purpose, mandatory grants over earmarked and discretionary grants following the 1990s reforms should do minimum damage to incentives of lower level governments, in fact they contain a discretionary element which does affect incentives. The amount going to each region and locality is initially set as budgets at all levels of government are (independently) formulated, and is based largely on previous years' spending.<sup>40</sup> However, at the end of the budget year, the amount of transfers is adjusted to cover deficits which have arisen especially at the regional level in health and

transport areas. The rules for such adjustment are not clear, and seem to depend on the relative bargaining power of regions and centre: central government may try to maximise its own bargaining power by budgeting low transfers *ex ante*, and regions try to maximise their own by incurring high deficits *ex post*. The final outcome is a soft budget constraint for the regions and a perverse incentive system, rewarding profligate regions and penalising responsible ones. This contributed to the fast growth of regional spending between 2001 and 2005 (notably health, as seen).

Insofar as central government grants are highly unequal on a per capita basis across regions they contain an implicit redistributive element. This redistribution may be roughly calculated by positing a theoretical transfer based on population, which is simply the national mean per capita transfer, and taking differences of this amount from actual transfers. Calculations by Messina (2001) suggest a substantial *de facto* redistribution from rich (though not middle-income) regions to poor ones, although it is not enough to close the initial gap in per capita own resources, leaving a modest uncovered gap for regions with per capita own revenues below the national mean.<sup>41</sup> The resulting comparatively small difference in per capita spending levels is not necessarily undesirable, as it could reflect regional preferences (including more rapid ageing in richer regions), and/or provide an incentive to improve fiscal effort by the poorer regions.

### **Reform proposals**

#### **Tax assignments**

The High Commission on Fiscal Federalism (2006) proposes a revision of regional tax assignments inspired by the benefit principle. National tax sharing arrangements should finance the bulk of regions' *normal* spending levels (*i.e.* those specified by the LEA), replacing ordinary transfers and eventually IRAP. The main tax base for regional sharing would be the VAT, which as a consumption tax should be more evenly distributed hence requiring smaller equalisation transfers. The role of IRAP should be curtailed. Half of its revenue should be replaced by tobacco, lotto and stamp taxes that better satisfy the benefit principle while also being more evenly distributed. The margin of manoeuvre on IRAP would be reduced as well, while the income tax surcharge would become optional.<sup>42</sup> Hence, effective tax autonomy would be limited mainly to derived and local taxes other than IRAP, currently only a small portion of total revenues. There may also be scope for new local taxes, *e.g.* environmental taxes, given the regions' new legislative powers. It is the opinion of the Commission that the exercise of tax autonomy, even if only at the margin, should be sufficient to assure the proper functioning of fiscal federalism.

There seems to be a downside to heavy reliance on VAT tax sharing as proposed by the Commission. *First*, there is no participation of the regions in the setting of the sharing formula, deciding the national tax rate or granting tax relief. Thus, "ownership" of the tax seems low and it may be viewed as a transfer (as indeed it is currently), undermining regional accountability. *Second*, it is difficult for citizens to assess performance at the individual government level as they cannot tell which part of their taxes goes to the regions and which to the national government. Transparency and accountability would be enhanced if there were two separately specified VAT rates, one for the central government and one for the regions, where the latter, even if uniform, comes closer to an own tax.<sup>43</sup>

Putting more reliance on derived rather than on shared taxes has certain advantages. The allocation of the derived tax is transparent, as the surcharge applicable to the

corresponding national tax is clearly stated, and some leeway in varying the level of the surcharge according to individual regions' financing needs and other objectives could easily be incorporated (as they already are), unlike tax sharing arrangements which impose a common framework for all.<sup>44</sup> The ideal tax for such purposes seems to be the VAT or a sales tax, displaying an elastic tax base with a smoother geographical distribution and clear adherence to the correlation principle. Indeed increasing autonomy of lower level consumption taxes seems to be a worldwide trend.<sup>45</sup> However, in Italy's case such a set up might be problematic, given the EU's prohibition on the setting of any subnational VAT rate. Unless that policy changes, greater recourse may need to be made to surcharges on the national income tax as a means of increasing local tax autonomy.

Furthermore, the substantial advantages of the IRAP as an efficient tax – despite its drawbacks as a regional tax – should not be ignored: with a wide base, small changes in tax rates produce large revenue variations, making the exercise of tax autonomy more effective. This tax base is also likely to be more dynamic than consumption, especially in the richer regions faced with the greater ageing challenge. Hence, the tax should probably not be curtailed or discarded, but remain as a foundation upon which to build new tax bases that better satisfy the benefit principle and are more evenly distributed across the territory, as proposed by the commission. And crucially, the current autonomy that regions have to vary the IRAP rate should not only be preserved but augmented. Greater tax variability is the key to local autonomy and accountability.

Local revenue sources seem to receive scant attention in the Commission's proposals, but they should play a more prominent role in the new fiscal federalism. As local authorities are responsible for 80% of total investment spending, they will need funds in particular to shore up the national infrastructure. Raising the property tax to, say, the French level as a percentage of GDP could increase the local level coverage ratio substantially. Another benefit would be improved compliance, as this tax should be harder to evade and less distorting than other taxes. Further, local fees and charges have many attractive features from the point of view of accountability (the "benefit principle" is perfectly satisfied), as well as their market (demand-constraining) nature and potential for contestability by the private sector. But these revenue types are similarly underutilised (Box 4.4).

Even though there are likely to be significant economies of scale in tax collection, hence a comparative advantage for central government in this domain, there are also informational advantages at the local level which are currently underutilised. This might suggest giving regions and localities a greater say in tax collection, certification, and data. Thus, the 2006 Budget gave financial incentives for local authorities to improve tax collections on their territory, but without the requisite tools and authority these objectives are hard to achieve, and indeed, results of the initiative appear to have been disappointing.

It is appropriate, finally, that central government continue to control the regional and local tax bases as a transparent and easily comparable basis for tax competition<sup>46</sup> – but by the same token it should avoid using the same tax bases to pursue its own social goals, such as family policies. It will be even more important that as lower levels increase tax rates in line with decentralisation, the central level lower theirs. The current situation of unexpected cyclical tax "windfalls" (Chapter 3) may provide the ideal moment to do this. A serious problem in other OECD countries in a decentralisation process has been that total tax rates tend to rise since local increases are not compensated by central decreases (France, Spain).

### Equalisation system

The Commission proposes moving to a vertical equalisation system, judging this to be the intent of the new constitution. A horizontal system, though, may have dealt more effectively with moral hazard. A horizontal arrangement may contain equilibrating checks and balances in the form of distributional conflicts between richer and poorer regions. It is also much more transparent because the giving regions could exercise some oversight over the uses of their money by the receiving regions (and would get recognition). By contrast, in a vertical system the transfers come from an impersonal and distant centre, and there is a stronger risk of “free riding” on the general taxpayer.<sup>47</sup> Horizontal equalisation also favours fiscal stability as it does not eat into the central budget. The Commission argues for 100% equalisation of differential tax capacity, in contrast to the less than full equalisation of initial reform proposals in decree law 56/2000 (Box 4.5). In any case the transfer

#### Box 4.5. The 56/2000 decree

The problem of inter-regional equalisation is the central political problem of Italian federalism (Bordignon, 2005). With acute awareness of the perversity of the existing system of grant distribution, and the wish to develop greater local fiscal autonomy in line with the principles of fiscal federalism, the central government in 2000 made the decision to move to a system which eliminates altogether central government transfers and substitutes these by a strictly rules-based system of regional sharing *cum* horizontal equalisation transfers of a portion of national VAT receipts. This reform was embodied in decree law 56 of the same year, or “56/2000”.

This law foresaw a large boost to regional tax income from the sharing of the national value added tax (*compartecipazione IVA*), making it the single highest source of revenue for the regions. The sharing formula allocates 38.55% of national VAT revenues to the regions as a whole, and then divides up this amount in the first instance by each region's share in national consumption (theoretical share), allocating receipts to the territory where they are presumed to have arisen. In a second step, around 40% of this total (23% of national VAT receipts) is placed in a notional national equalisation fund, which is allocated to the poorer regions at the expense of the richer ones (effective share), using a formula based on historical spending, resident population, and deviation from national mean tax capacity, the latter adjusted by a “solidarity coefficient” of 90%. Less than full (100%) equalisation of tax capacity was considered important for limiting moral hazard effects, as it left an incentive for receiving regions to develop their tax bases and improve fiscal effort. The share of the historical spending component would be 100% in the first of year of application of the new rules but gradually fall to zero, with the long run system based on structural parameters only in force by 2012, allowing poor regions enough time to develop their own tax bases. There would be collaboration in the setting of the tax sharing formula via the State-Regions Conference, with periodic modifications if necessary.\*

In the end, however, the law was not implemented. The reasons were several: i) some serious mistakes were made in the calculation of transfers during the first attempted implementation of the law; ii) regions in general resisted moving from the long-standing negotiated system of transfers to a rules-based one; and iii) the constitutional reform law of 2001 was apparently inconsistent with the decree law of the previous year, as it gave a prominent role to vertical transfers in the system of equalisation (even though the same government was at the origin of both laws). Nevertheless, 56/2000 remains highly relevant as a reference point for proposals to reform the system of fiscal federalist financing. In particular, in its insistence on eliminating ordinary transfers and virtual financial self-sufficiency of regions, the model presented by decree law 56/2000 appears fully consistent with article 119 of the reformed Title V of the constitution (see Box 4.1).

\* The OECD considers tax sharing receipts as own regional taxes if the sharing formula contains no discretionary elements by central government, cannot be changed more frequently than once per year, and does not include any inclusion of “needs” in the sharing formula. See Bloechliger and King (2006). In Italy's case, there is no participation of the regions in the setting of the formula, or in tax rates or relief, nor do they have any certainty that it can be changed at will by the central government. This is why The Italian authorities (correctly) define such revenues as transfers rather than tax revenues of the regions.

mechanism would now be based on objective structural indicators (to be determined), a critical aspect. Indeed, the use of clear formulae is more important than the direction of the transfer: vertical transfer systems based on clear distribution rules can be transparent (e.g. Canada) whereas horizontal schemes can be quite non-transparent in the absence of good formula design (e.g. Austria).

It will be important that discretionary central government transfers are confined to very clear and narrow limits, perhaps as regional development earmarked grants,<sup>48</sup> as appears to be the intention of the constitution. Transfer systems (particularly equalisation) should be entirely formula driven, without any local negotiating power.<sup>49</sup> Otherwise, the risk of carrying on as at present seems too great, notably in catch-up regions. It will also be important to avoid a long drawn out transition, which could happen if no region is willing to accept cuts in its transfer level and then inflation and selective nominal freezes would be the only way to change relative endowments. Policy makers should also take a serious look at moral hazards deriving from the proposed vertical transfer mechanism with 100% equalisation formula, and reconsider the less risky approach of the earlier decree law. Whatever the model chosen, it will be vital that the rules be very explicit and that a strong political consensus be found in order that they be credible. Finally, structural reforms will be an important complement to fiscal reform in order to generate stronger local tax bases that enable regions to cope with a rules-based equalisation system.

## Fiscal rules for budget discipline

### **Internal Stability Pact**

Fiscal rules at subnational levels help to ensure coherence of macroeconomic objectives, in particular the maintenance of global fiscal discipline as fiscal responsibilities become more diffuse. Since entry into the EMU, Italy has sought to engage all levels of government in its effort to abide by the Stability and Growth Pact (SGP) by establishing an “Internal Stability Pact” (ISP). The ISP is set within the framework of the annual Budget Law of the central government, with prior consultation of lower levels. Italy’s deficit has exceeded the 3% of GDP upper limit for the last 4 years but in actuality, the rule was adhered to in all years from 2000 to 2004 at all 3 aggregate levels – regional, provincial, and local – with objectives even surpassed (Annex 4.A1). Thus, unless budget slippage could be entirely attributed to central government, it appears that the rule was not very stringent or coherent with the national SGP target. Importantly, health spending was the subject of a separate pact that was persistently violated.

What may be worse, substantial year to year variability in the ISP has introduced major uncertainty into budgeting frameworks, greatly complicating the ability to pursue wise budget management (Annex 4.A1). Spending ceilings, introduced in 2005 and 2006, may not be very effective for bottom-line budget discipline, especially as they exclude a number of spending items, while infringing on already weak lower level autonomy.

### **Enhancing credibility**

In order to take advantage of the efficiency gains induced by decentralisation, it is crucial that a rigorous budgetary discipline is achieved (Ter-Minassian, 1997). It follows that a serious rethinking of the Pact is needed. The 2007-11 DPEF states that if fiscal federalism is to be implemented in full, it will be necessary to draw up a new framework of reference that includes stability, consistency, compliance with European parameters and respect for

the administrative autonomy of the local authorities. Some useful guidelines that have been noted in the critical literature are:<sup>50</sup>

- i) coverage and intermediate targets of the rule should be consistent with the fiscal target to which Italy as a whole is subject, implying that all local entities and budget lines should be covered and the balance should be targeted;
- ii) better information is needed on local budget performance if the Pact is to be adequately monitored by government, markets and citizens; this includes stability and transparency of rules and regulations, and convergence of accounting rules, reporting and publishing requirements to national best practice (e.g. accrual accounts); the establishment of an independent body to oversee these processes may be necessary;
- iii) strengthened co-ordination of budget policies and management across government levels would lend credibility to rules, for example by giving bilateral State-Regional/Provincial/Local Conferences a more formal and binding role; the conferences should meet at the start of the budget process for *ex ante* budget co-ordination, not at the end for haggling over *ex post* funding of regional deficits;
- iv) as partially introduced in Italy for 2007, in the case of noncompliant behaviour necessitating national government interventions, strong sanctions should be imposed on a) the responsible local public officials, at the extreme leading to a temporary management take-over by the central government, and b) the citizens who elect them, in the form of higher taxes and co-payments to help cover financial deficits; this would also require setting national-level rules on how the sanctions would be applied in a non-discriminatory manner across regions;
- v) regions should speak for all the cities on their territory rather than each locality negotiation separately with government, while also developing a system of consolidated regional budget accounts; and
- vi) a coherence between the functions attributed to lower levels and the means of financing them is needed; otherwise there is a serious problem of credibility that is only partially offset by the “tying of hands” via fiscal rules.

The DPEF 2007-11 wisely calls for a return to more comprehensive deficit targets, in respect of local autonomy to vary tax and spending in line with local needs and preferences. This was partly implemented in the 2007 Budget Law, which puts into place a new balance rule for all local entities (provinces and municipalities). As information on budgets should be promptly available in order to monitor such a deficit rule effectively, Italy also introduced in 2007 an extensive monitoring covering all the local entities subject to the ISP. Data are sent quarterly by the local entities themselves using a web-based system. Spending ceilings are still in the 2007 Budget for regions, however, which are introducing the new deficit rule only on an experimental basis.

A final problem is common to all fiscal rules: how to avoid pro-cyclical policies and excessive cuts in investment spending, which undermine development objectives in order to meet yearly targets. Here the regional and local authority budgets must be distinguished. Regional finances are more dependent on own taxes, so that revenue cyclicity is high and a compensating transfer mechanism may be needed (as in the United States). The local authorities (municipalities and provinces) are much more dependent on transfers which are immune to cyclical swings so that for them such a mechanism would not be needed. To protect investment expenditures from degradation because such cuts are more expedient politically in the short term, it may be necessary to define the balance net of investment expenditures.<sup>51</sup>

### Box 4.6. Recommendations for fiscal federalist reforms

#### Spending efficiency and efficacy

- Clarify national standards in social services (LEA) to reflect output rather than inputs:
  - ❖ in health, cover a basic yet adequate amount of services, using national benchmarks to derive “standard costs” by region in order to arrive at financing needs, drawing perhaps on DRG systems that have been developed in some “best practice” regions that could be used as a model for developing similar practices in other regions;
  - ❖ in education, set clear attainment and achievement standards, leaving the mix of inputs and organisation of services to regions, while providing better national testing, monitoring, and guidelines for compliance;
  - ❖ in local welfare services, define a modest social safety net, phasing in as budget conditions permit.
- Require more flexibility among tenured staff to contain devolution costs and permit local authority innovative capacities to develop; make greater use of second level bargaining at the SNG level to reflect productivity.
- Eschew rules on individual items of spending growth (such as health) and hiring freezes in the ISP, establishing instead a hard budget constraint with accompanying financing reforms as set out below.

#### Financing accountability

- Urgently implement article 119 of the revised Title V, based largely on recommendations of the High Commission:
  - ❖ define new regional and local tax assignments that are well correlated with spending functions, preferably on a consumption base for regions and property base for locals, with adequate tax rate autonomy; the state must define “fundamental principles” underpinning eventual regional legislative powers in this area;
  - ❖ allow regions to participate in determining a VAT sharing mechanisms while putting relatively greater emphasis on derived rather than shared taxation to improve transparency (*e.g.*, surcharges on national income tax);
  - ❖ define a new redistribution mechanism establishing a hard lower level budget constraint, with criteria based on structural indicators. Notably, the base should be tax capacity but with less than full equalisation; the share of national VAT receipts going to fund this scheme should be calibrated to standard costs for basic services; a relatively rapid transition should be foreseen;
  - ❖ set clear limits while also leaving some flexibility on discretionary transfers for “exceptional needs”.
- Reduce local governments’ reliance on economic rents in line with greater competition in contestable market services while increasing user fees and co-payments to better regulate demand and establish correlation.

#### Credibility of fiscal rules

- Strengthen fiscal discipline of subnational governments with credible sanctions in case of current deficits, *e.g.* by holding responsible local officials accountable and continuing to raise IRAP rates in deficit regions as an incentive to better control health spending.
- The Internal Stability Pact should be made more stable in targets and coverage and be consistent with the objectives of the GSP, covering all entities and the entire non-investment budget balance including health.

#### Box 4.6. Recommendations for fiscal federalism reforms (cont.)

- Strengthen the role and legitimacy of the state-regional-local conferences, meetings taking place at the start rather than end of the budget cycle; streamline processes with more internal co-ordination among subnational governments.
- Develop transparent and nationally uniform budget accounts, starting with regional health enterprises with external audits, as these are needed to allow proper monitoring and surveillance by national government and civil society.
- Good rules should complement and reinforce an internally coherent system of fiscal federalism, not try to impose discipline on a structurally flawed system. Hence the reforms set out in this box all go hand in hand.

#### Notes

1. The 2007-11 DPEF states that: “A fully implemented fiscal federalism has become a condition for achieving two key requirements: for local governments to be able to perform their functions in full; and for the system of public accounts to be balanced.”
2. See Joumard and Kongsrud (2003). Certain sharing arrangements could be classified as own taxes if subnational governments participate in the rules-setting or if the central government distributes the entire tax revenue, as is practically the case for the Italian special statute regions.
3. Also, unlike the state, communes cannot by law refinance maturing debt by new debt, so that amortisation adds to current spending needs (Ghisellini, 2007).
4. See Ghisellini, *op. cit.*
5. Fieri (2005) discusses ways in which the local authorities have attempted to circumvent these constraints while also evading the strictures of the Internal Stability Pact, such as creation of separate management units, strategic privatisations and other accounting tricks to shift spending off budget.
6. Pammolli and Salerno (2004b and 2006) stress this point.
7. See Joumard and Kongsrud (2003).
8. Regarding health and decentralisation, see OECD (2007), *The Health of Regions*, forthcoming.
9. For example, the problem of “double dipping” – doctors who are nominally full time public servants while using public facilities to treat private patients – may be more acute in some areas of the South, as are phenomena like unfinished hospitals and stolen or neglected medical supplies and pharmaceuticals. Even though such problems should be getting better as controls are tightening (*e.g.* anti-Mafia certifications of construction firms), these controls also introduce a lot of red tape into local administration project implementation.
10. See Pica (2005).
11. See Corte dei Conti (2006), Table 11. The Lazio (Rome) region with its many public teaching hospitals and closeness to central government has exhibited especially large overruns. There is evidence in this region that private (mainly Catholic church) hospitals provide services much more efficiently than public ones, but competition among them is weak or nonexistent.
12. See Reviglio (2007).
13. The experience of countries like Norway suggests a home-bias in use of health care services. That is, given a choice, people prefer to be closer to home in the event of hospital stays so long as care quality is not too unequal across the country (*Economic Survey of Norway*, 2005).
14. See Pammolli and Salerno (2006). The national government should also play a strong advocacy role in promoting best practices and measuring outcomes. However, OECD experience shows that it is difficult to set up decent benchmarks and even though better use of DRGs and other measures of efficiency and better accounting procedures are desirable, one should not be too optimistic about what they will achieve (OECD, 2007). It is difficult to instil market-type efficiency in a sector marked by severe information asymmetries. A method would also have to be developed to make adjustments to the national benchmark to reflect outlier costly or complex cases, and to derive standard costs in outpatient and pharmaceutical sectors.



15. Thus far, only the region of Toscana has managed to satisfactorily address accounting issues and satisfy external audits. This might serve as a model for other regions to emulate. See Persiani (2006).
16. On current policies, pension spending is set to rise by less than 1½ per cent of GDP between now and 2050 (Chapter 3).
17. As discussed in the 2005 *Economic Survey of Italy*, there was a similar radical devolution in universities, but the experiment was not successful as local authorities interfered excessively with personnel decisions to the detriment of teaching and research quality. The state later re-centralised university management but the situation is still not satisfactory.
18. Though primary and secondary education performance has improved with a series of education reforms, scholastic achievement is still at or below OECD averages whereas spending per pupil is way above average (see *Economic Survey of Italy*, 2005). Many classes are sub-optimally small and becoming more so as ageing accelerates. To exploit obvious scope for efficiency improvements, the 2007-11 DPEF calls for a 20% reduction in teaching staff. Quality problems are most serious in the south, where high absentee (both teachers and students) and drop out rates persist. The 2003 OECD PISA study shows some of the lowest scores occurring in the southern regions of Italy.
19. A new nationwide institute has been created to deal with the issues related to school autonomy, Agenzia Nazionale per lo Sviluppo dell'Autonomia Scolastica (formerly INDIRE). Furthermore, a national agency for the evaluation of the performance of the school system as a whole will be created (formerly INVALSI) to carry out various system level and school-based evaluations.
20. It is interesting that Trentino, a northern special statute region with strong education autonomy, showed the highest score in the 2003 OECD PISA study.
21. If the state decides not to implement this decentralisation then the constitution should perhaps be changed, requiring a national plebiscite – otherwise there might be continual pressures from regions to be given more powers in the education area by claiming constitutional rights.
22. See Saraceno (2005).
23. See Gruppo Bancario Capitalia (2005).
24. Red tape burden also falls under this rubric, remaining excessive even though less so than in the past, and may reflect not only a protectionist device to shelter local incumbents from competitors but also self protection of the public administration, wanting to justify itself by paperwork and preserving its power (or access to bribes) in granting or denying authorisations for often routine activities.
25. Vitaletti (2005) suggests that a major source of the gains from devolution is the greater likelihood that the devolved services will be privatised or quasi-privatised, as being subject to atomistic demand and hence pricing, they are more prone to be in direct competition with private sector production than are services supplied at the national level.
26. A more pro-competitive solution to give play to a broader range of interests (i.e. of citizen/consumers) could also help importantly, e.g. more financial autonomy to increase incentives to expand the tax base.
27. Some cities have defaulted on their debts, e.g. Taranto after it decided to pay workers before “delegating” current receipts to debt service. Such “delegation” has been the common practice permitting the access to credits in the first place (Ghisellini, 2007).
28. Information based on discussions with local authorities in Campania region.
29. See Joumard and Kongsrud (2003).
30. Wage moderation is not being observed in the public sector as a whole despite the fiscal crisis: wage awards in 2005-06 were 3% annually, compared with the objective of containing overall spending growth to within 2% (the rate of inflation). Since 2000, wages in the public sector have increased at double the rate in the private sector.
31. See, e.g., Ginafranco Fabi, “Trovare il coraggio di abolire le Province”, *Il Sole 24 Ore*, 9 August 2006.
32. There have also been proposals to consolidate the 20 regions into 4 or 5 macro-regions able to guide regional development in a more integrated way.
33. According to Ahmad, Hewitt and Ruggiero (in Ter-Minassian, 2007), efficiency gains largely depend on the responsiveness of local government spending to the preferences of citizens in different localities, and local governments tend to be more responsive if they are more accountable for their performance.

34. See Messina (2006). The fact that the special regions' scope for maneuver is so small arises from the fact that tax sharing arrangements, albeit generous, provide no such scope as the sharing parameters are fixed.
35. See Bordignon (2005).
36. According to Keen (1997), vertical tax externalities between levels of government can occur in federal structures and arise from the concurrent taxation of the same base by different government levels, so that responses to the tax policies of one level of government affect the tax base of the other. Such vertical tax externalities may imply transfers paid upward from states to federal government, entailing a perhaps negative fiscal gap.
37. See Zinardi (2007).
38. The Canadian constitution, for example, states that "Parliament and the Government of Canada are committed to the principle of making equalisation payments to ensure that provincial governments have sufficient resources to provide reasonably comparable levels of public services at reasonably comparable levels of taxation" (Messina, 2001).
39. Untied grants could also be block grants, which are not used in Italy.
40. The association with health spending was made clear by a National Health Fund, through which such transfers passed. It was abolished in 2000.
41. OECD equalisation schemes on average reduce disparities in fiscal capacity by around two-thirds (Bloechliger and Charbit, 2007).
42. IRAP margins of fluctuations would be reduced to 10%, from 23.5% currently (i.e. 4.25 plus or minus 1%) while applying the same treatment to public as to private employees (the former currently pay a fixed rate). There are also three different hypotheses regarding the income tax surcharge variability. See Messina (2006), who calculates a reduction of tax autonomy under all three hypotheses, net of transfers.
43. See also Gandullia (2005).
44. See Joumard and Kongsrud (2003).
45. Such countries include United States, India and Canada. See also Keen (2000).
46. Zinardi, A. (2007), "Some notes on Italian fiscal federalism", mimeo.
47. See Etro and Giarda (2002).
48. This would make such transfers accompanying tools for the improvement of efficiency in local spending rather than bad strategies. See Bergvall *et al.* (2006).
49. Bordignon (2005) states that negotiation is in the "DNA" of Italian politicians and any attempt to eliminate it is likely to fail. He cannot imagine that any formula-based transfer allocation that reduces previous discretionary amounts would not be sharply contested by the affected local entity. He thus suggests giving a partial role to negotiation even in the reformed system, say covering 5% of total equalisation transfers, in order to diffuse such tendencies.
50. See, *e.g.* Patrizi *et al.* (2005), IMF (2005), and Franco *et al.* (2004).
51. See Franco *op. cit.*

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## ANNEX 4.A1

*Internal Stability Pact*Table 4.A1.1. **Respect of the Internal Stability Pact in 2000-04**

Province (in millions of euros, cash basis)					
	2000	2001	2002	2003	2004
Total analysed	81	97	99	79	96
A. programmed objectives	-66	-235	323	498	422
B. Financial balance	589	372	567	934	947
<b>Difference (B-A)</b>	<b>655</b>	<b>606</b>	<b>245</b>	<b>435 478</b>	<b>525</b>
Community (in millions of euros, cash basis)					
	2000	2001	2002	2003	2004
Total analysed	942	965	1 758	1 065	1 015
A. programmed objectives	-3 493	-3 766	-4 643	-6 099	-6 894
B. Financial balance	-3 435	-3 763	-9 987	-4 634	-4 565
<b>Difference (B-A)</b>	<b>58</b>	<b>3</b>	<b>3 645</b>	<b>1 465</b>	<b>2 3230</b>
Region (in millions of euros, cash basis)					
	2000	2001	2002	2003	2004
Total analysed	Total RSO	Total RSO	Total RSO	Total RSO	Total RSO
A. Programmed objectives	18 474	21 104	15 118	15 3230	15 591
B. Payment	17 201	19 650	10 639	10 796	10 714
<b>Difference (A-B)</b>	<b>1 273</b>	<b>1 454</b>	<b>4 49</b>	<b>4 534</b>	<b>4 877</b>

Source: Calculations from Corti dei Conti, various years (\*estimates).

Table 4.A1.2. **Yearly evolution of the Internal Stability Pact**

	1999	2000	2001	2002	2003	2004	2005	2006
Reference balance	Pact Revenues: excluding state transfers, borrowings Pact Spending: excluding capital spending, interest, financial (cash)	As in 1999, but excluding exceptional spending and revenues	As in 2000 but excluding revenues and expenses related to functions transferred	As in 2001	As in 2002 but excluding: Income tax sharing, elections, state functions transferred to provinces and natural disasters	As in 2003 but excluding: Changes for wage contracts 2002-03, spending for amnesty instructions	No reference balance. Rule on total expenditures: current and capital	No reference balance. Rule on total expenditures: current and capital
Target	Improve trend balance in proportion to 1998 current spending (1.1% of 1998 current spending of local entities, net of interests)	Analogous to 1999, with the addition of the composition of deviations from target in 1999. Possibility of choosing among different ways of applying the rules (cumulative target 1999-2000)	Limits to the balance (cannot worsen > 3% with respect to 1999)	Limits to the worsening of the balance (not > 2.5% with respect to 2000) Limits to spending (cannot > 106% of 2000 spending)	Limits to the balance (Provinces cannot worsen > 7% with respect to 2001; municipalities balance must be < = to 2001)	Limits to the balance (Provinces cannot worsen > 7% with respect to 2001 plus inflation rate; municipalities balance must be < = to 2001, plus inflation rate)	Total spending (current + capital) cannot > 110% of average spending during 2001-03 (111.5% for "virtuous" entities)	Current spending cannot > 93.5% of spending in 2004 (92% for non-virtuous entities) Capital spending cannot be > 108.1% of 2004 capital spending
Sanctions	EU sanctions allocated in proportion to overshooting of objective			Reduced state transfers (later abolished)	Limits to borrowing, hiring, and intermediate consumption	Limits to borrowing, hiring, and intermediate consumption	Limits to borrowing, hiring, and intermediate consumption	As in 2005
Incentives		Reduced interest on borrowing from Cassa Depositi e Prestiti	Reduced interest on borrowing from Cassa Depositi e Prestiti	Increase in state transfers for compliant entities (later abolished)				

Source: Corte dei Conti.

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