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BETTER POLICIES FOR BETTER LIVES

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

The Economic situation and policies of Italy were reviewed by the Committee on 12 January 2015. The draft was revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 30 January 2015.

The Secretariat's draft report was prepared for the Committee by Paul O'Brien and Yosuke Jin under the supervision of Patrick Lenain. Hermes Morgavi and Josette Rabesona provided statistical research assistance, and Brigitte Beyeler provided administrative support. The Survey also benefited from contributions by Willem Adema, Jonathan Barr, Ivana Capozza, Chiara Criscuolo and Federica Maiorano.

The previous Survey of Italy was issued in May 2013.

BASIC STATISTICS OF ITALY, 2013

(Numbers in parentheses refer to the OECD average)[a]

LAND, PEOPLE AND ELECTORAL CYCLE

Population (million)	61.2		Population density per km^2	203.0	(34.7)
Under 15 (%)	14.0	(18.2)	Life expectancy (years, 2012)	82.3	(80.2)
Over 65 (%)	20.9	(15.6)	Men	79.8	(77.5)
Foreign-born (%, 2012)	9.4		Women	84.8	(82.9)
Latest 5-year average growth (%)	0.4	(0.6)	Latest general election	February 2013	

ECONOMY

Gross domestic product (GDP)			Value added shares (%)		
In current prices (billion USD)	2 149		Primary sector	2.3	(2.6)
In current prices (billion EUR)	1 619		Industry including construction	23.3	(26.9)
Latest 5-year average real growth (%)	-1.5	(0.8)	Services	74.4	(70.5)
Per capita (000 USD PPP)	34.7	(38.1)			

GENERAL GOVERNMENT
Per cent of GDP

Expenditure	50.5	(42.6)	Gross financial debt	144.0	(110.2)
Revenue	47.7	(36.7)	Net financial debt	117.5	(69.9)

EXTERNAL ACCOUNTS

Exchange rate (EUR per USD)	0.753		Main exports (% of total merchandise exports)		
PPP exchange rate (USA = 1)	0.762		Machinery and transport equipment	34.6	
In per cent of GDP			Manufactured goods	18.4	
Exports of goods and services	28.6	(53.4)	Miscellaneous manufactured articles	17.6	
Imports of goods and services	26.3	(49.4)	Main imports (% of total merchandise imports)		
Current account balance	1.0	(-0.1)	Machinery and transport equipment	22.7	
Net international investment position	-30.0		Mineral fuels, lubricants and related materials	19.9	
			Chemicals and related products, n.e.s.	15.4	

LABOUR MARKET, SKILLS AND INNOVATION

Employment rate for 15-64 year-olds (%)	55.6	(65.2)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	12.2	(7.9)
Men	64.8	(73.1)	Youth (age 15-24, %)	40.0	(16.1)
Women	46.5	(57.4)	Long-term unemployed (1 year and over, %)	6.9	(2.7)
Participation rate for 15-64 year-olds (%)	64.4	(71.1)	Tertiary educational attainment 25-64 year-olds (%, 2012)	15.7	(32.2)
Average hours worked per year	1 752	(1 771)	Gross domestic expenditure on R&D (% of GDP, 2012)	1.3	(2.4)

ENVIRONMENT

Total primary energy supply per capita (toe)	2.5	(4.2)	CO_2 emissions from fuel combustion per capita (tonnes, 2012)	6.2	(9.7)
Renewables (%)	15.8	(8.8)	Water abstractions per capita (1 000 m^3, 2008)	0.9	
Fine particulate matter concentration (urban, PM_{10}, µg/m^3, 2011)	33.8	(28.0)	Municipal waste per capita (tonnes, 2010)	0.5	(0.5)

SOCIETY

Income inequality (Gini coefficient, 2010)	0.321	(0.308)	Education outcomes (PISA score, 2012)		
Relative poverty rate (%, 2010)	13.0	(11.1)	Reading	490	(496)
Median equivalised household income (000 USD PPP, 2010)	21.1	(20.4)	Mathematics	485	(494)
Public and private spending (% of GDP)			Science	494	(501)
Health care (2012)	9.2	(9.2)	Share of women in parliament (%, December 2014)	30.6	(26.8)
Pensions (2011)	17.1	(8.7)	Net official development assistance (% of GNI)	0.17	(0.37)
Education (primary, secondary, post sec. non tertiary, 2011)	3.1	(3.9)			

Better life index: *www.oecdbetterlifeindex.org*

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

Executive summary

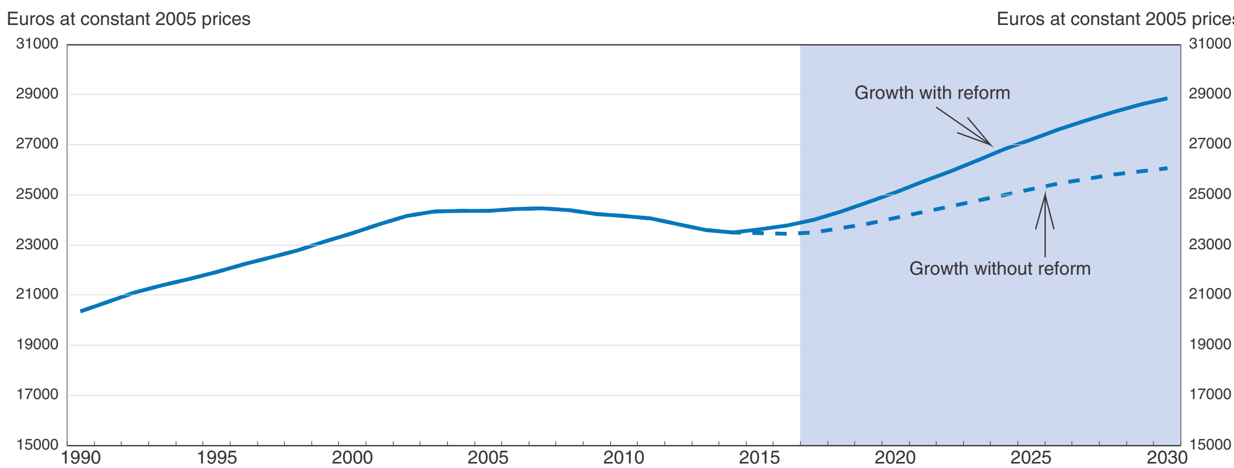
- *Main findings*
- *Key recommendations*

Main findings

Ambitious institutional reforms are under way

After a long period of stagnation that left the economy vulnerable when the financial crisis hit, Italy is undertaking broad-based and ambitious reforms to boost growth, taking advantage of synergies across policies. In the past, many good reform projects were not fully implemented, depriving the economy of their full benefits. The government is therefore focusing on changes in the political and institutional frameworks and judicial system to remove previous impediments to full implementation of reforms.

Reforms underway can boost average annual per capita GDP growth by 0.6% over 10 years



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Labour market reforms and improved competition to boost productivity growth

The key challenges going forward are to make the economy more productive, more competitive, and more adaptable, thereby raising the living standards and well-being of all Italians. The immediate priority is to reform the labour market, where much rigidity prevents job creation and efficient matching of skills; the government intends to complete this task by mid-2015. For example, it intends to transfer the responsibility for active labour market policy from local governments to the central government, so as to increase effectiveness. There are structural weaknesses in other areas, notably competition and regulation, which the government intends to tackle with broad-based reforms over the next two years. These steps are needed to reverse past declines in productivity and put the economy back on a path of steady growth. If fully implemented, they could increase the level of GDP by 6% within 10 years.

A small fiscal surplus, combined with renewed growth, will bring down public debt

Sustained public expenditure restraint and tax increases have gone a long way to strengthen the fiscal position. Together with renewed growth and low interest rates, this will help to bring down the public debt burden.

Key recommendations

Fully implement the institutional reforms

- Follow through the reform of parliament and the re-assignment and clarification of competences between the central and sub-national governments.
- Ensure that legislation is clear, unambiguous and supported by improved public administration, including through reduced use of emergency decrees.
- Further streamline the court system, with more specialisation where appropriate; increase the use of mediation; enhance monitoring of court performance.
- Consider establishing a Productivity Commission with the mandate to provide advice to the government on matters related to productivity, promote public understanding of reforms, and engage in a dialogue with stakeholders.
- Reducing corruption and improving trust must remain a priority. For this, the new anti-corruption agency ANAC needs stability and continuity as well as support at all political levels.

Give full priority to labour-market reforms to boost productivity growth and jobs

- Fully roll-out the new standard contract for new hires, with employment protection rising with job tenure, while grandfathering existing contracts.
- Change the composition of spending on active labour-market policy: limit training programmes to those who need them most; tailor assistance to job seekers according to their specific situation.
- Encourage female labour force participation with more flexible working-hours arrangements, and promote wider provision of good quality care for children and the elderly.
- Fully implement the unified unemployment benefit system. Require recipients to actively seek work, and to accept employment or training when offered.
- Encourage social partners to allow modification of national wage agreements at the firm level, through agreement with representatives of a majority of the firm’s employees.
- Adopt a competition law following the recommendations of the competition authority to introduce competition into local public services, improve competition in insurance, banking, network industries, the regulated professions and retail trade.

Fiscal and financial challenges

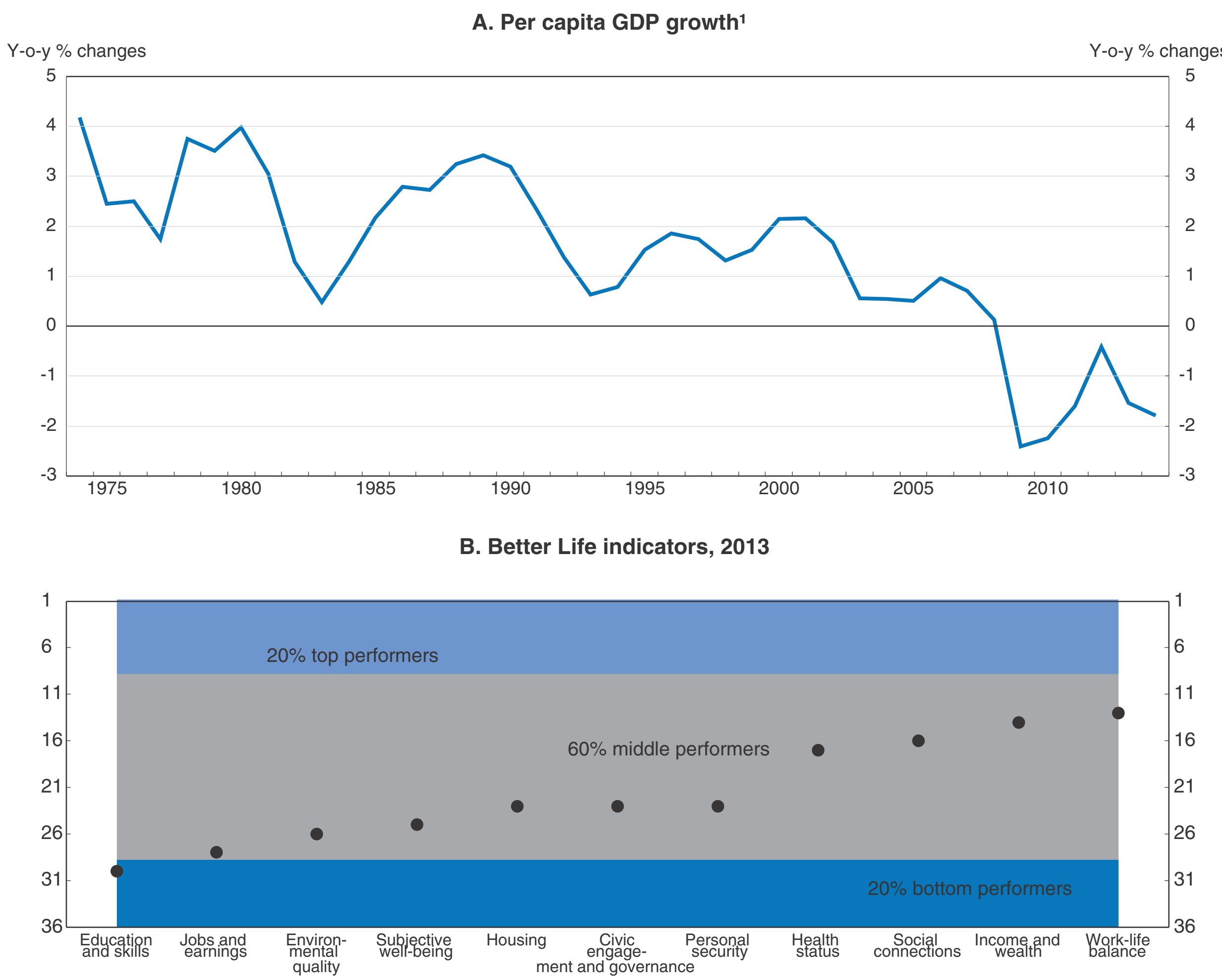
- Stick to the planned fiscal strategy so as to bring the debt-to-GDP ratio onto a declining path.
- Promote greater use of centralised procurement, cost information systems and benchmarking.
- Urgently take action to achieve a lower level of non-performing loans in the banking sector, including through enhancing the insolvency regime applied to distressed borrowers.
- Continue efforts to reduce tax evasion through more effective enforcement and increase tax compliance through simplified collection procedures. Broaden tax bases, in particular by cutting the number of tax expenditures, and simplify the tax system.

Assessment and recommendations

- *A prolonged recession and uncertain prospects*
- *Institutional reforms can be the basis for better policymaking and stronger implementation*
- *Labour market and competition reforms to improve productivity and well-being*
- *Addressing fiscal and financial challenges*

Italy's key problem is the lack of economic growth since the late 1990s (Figure 1). The stagnating economy has left Italy behind in many dimensions of well-being, notably education and skills, jobs and earnings, and housing; in no dimension of the OECD's Better Life indicators does Italy rank in the top fifth of OECD countries. Poor performance in some dimensions of well-being, such as weak education and skills, has itself also contributed to poor growth.

Figure 1. **Lack of growth is linked to low scores on well-being**



1. 3 year moving average.

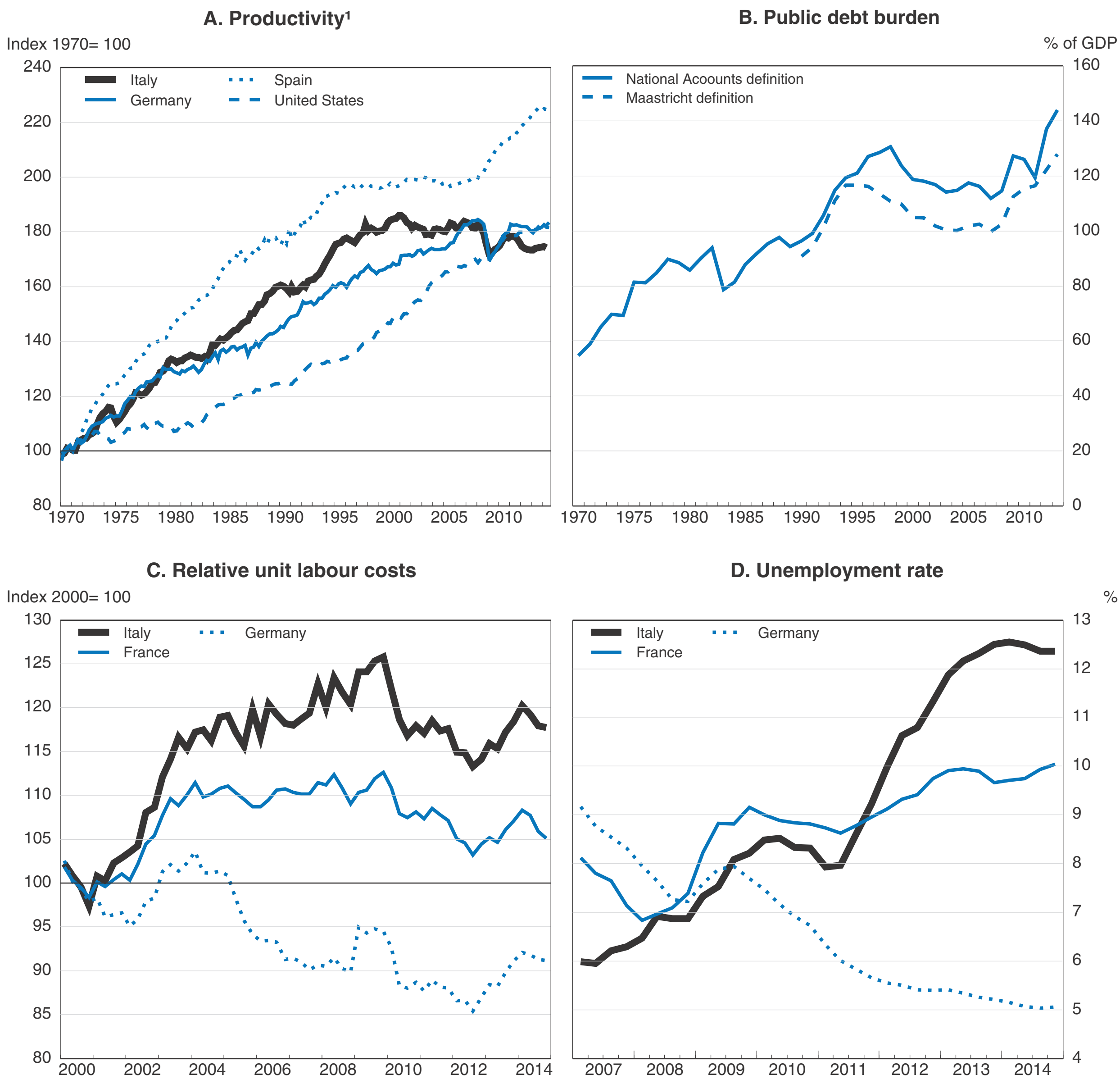
Source: *OECD Economic Outlook 96* (database), OECD Better Life Indicators.

How to read this figure: Italy's best ranking on the Better Life Indicators is for work life balance, where it has the 12th highest score of 36 countries. For subjective well-being it ranks 24th.

StatLink http://dx.doi.org/10.1787/888933184642

The government has launched an ambitious reform programme to overcome deep-seated structural problems that led to productivity stagnating since the end of the 1990s (Figure 2A). Low productivity growth led to worsening cost competitiveness soon after joining the currency union, without improvement since then (Figure 2C). Low economic growth coupled with persistent budget deficits have kept the debt-to-GDP ratio at one of the highest levels among OECD countries (Figure 2B). This left Italy exposed to sudden changes in market perceptions when the global financial and the euro area crises struck.

Figure 2. **Low productivity has led to poor competitiveness, high unemployment and rising debt**



1. GDP divided by total employment.

Source: *OECD Economic Outlook* (database).

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In part, some of these structural problems were not effectively tackled in the past because the existing institutional setting has not been conducive to pursuing structural reform, especially due to political instability and weak administrative capacity. This resulted in incomplete implementation and, at times, reversals by subsequent governments. The government has therefore focused its efforts on improving the law-making process with a new structure of parliament and a reduced and more clearly-defined role of sub-national governments. These important institutional changes are expected to be completed by the end of 2015, when a referendum is planned. Once in place, they should permit more efficient policymaking, less ambiguity about who is responsible for what, and avoid implementation delays due to sub-national governments not following through on national legislation.

The government's programme includes broad-based and ambitious reforms to boost growth, taking advantage of synergies across the various reforms. By launching reforms in many areas at the same time the government expects that opposition to any particular change will be diluted by the recognition that many people who might lose from one reform will gain from another. The government has launched important reforms of the labour market, the product market, the public administration and the judicial system. There has been an increased focus on rapid implementation: significant parts of the labour market reform were in place by the beginning of 2015. In addition, the backlog of subsidiary legislation from laws passed in 2012 and 2013 has been reduced significantly: in February 2014, 889 pieces of secondary legislation were still pending, this was reduced to 383 by the end of 2014.

Reforms that have been announced so far will have a significant impact. OECD estimates suggest that within five years GDP would be 3½% higher than otherwise thanks to reforms – assuming swift, full implementation – through improvements in productivity and employment (Table 1). In the following five years a further gain of similar magnitude could be expected. Such estimates should be thought of as a broad guide to the expected impact rather than precise estimates. Delays, or less than full implementation, would reduce the gains.

Taking this background into account, the key messages of this *OECD Economic Surveys* are:

- The reforms will boost living standards over the next decade if they are fully implemented. This will require institutional and constitutional reforms to instil more political stability, more efficient legislative processes, greater administrative capacity, less corruption, and more efficient justice.
- Labour market reform is essential to give companies the flexibility to innovate, restructure, and boost productivity. This can be achieved by eliminating rigidities while protecting the unemployed and helping them return to work.
- Past fiscal consolidation efforts will soon pay off provided the government sticks determinedly to its plans. Continuous attention to value for money and tax reform will support this effort.
- Productivity growth should be encouraged by greater competition and better regulation in all sectors, as well as developing human capital and skills.

The low productivity growth in Italy is explained to a large extent by misallocation of resources: potentially more productive firms cannot attract more resources and thus cannot grow, while less efficient firms – many of which are old and small – maintain resources and market share (Andrews et al., 2014, see also Chapter 1). Job mismatch, where low-skilled people occupy jobs which require high skills, or vice versa, typically embodies this misallocation problem, and potential gains from resolving this problem are very large for Italy (Adalet McGowan and Andrews, 2015). Institutional factors, including the stringent

Table 1. **Reform impacts on the level of GDP in the medium and long runs**

A. OECD estimates

	Impact after 5 years			Impact after 10 years		
	GDP	Via employment growth	Via productivity growth	GDP	Via employment growth	Via productivity growth
Product market reform[1]	1.5		1.5	2.6		2.6
Labour market reform (Jobs Act)[2]	0.6	0.5	0.1	1.2	1.1	0.1
Labour tax wedge	0.3	0.5	-0.2	1.2	1.6	-0.4
Tax structure reform	0.4		0.4	0.4		0.4
Public administration and judicial system reform	0.6		0.6	0.9		0.9
Total[3]	**3.4**	**1.0**	**2.4**	**6.3**	**2.7**	**3.6**

B. Government estimates of adopted and planned measures[4]

	2020	Long-run	
	Adopted measures	Measures to be approved	
Product market reform	0.3	1.1	3.2
Labour market reform	0.4	0.9	1.6
Reform in public administration	0.5	1.0	2.3
Reform in judicial system	0.2	0.4	1.0
Total	**1.4**	**3.4**	**8.1**

1. OECD estimates for the impact of product market reform include the results of reforms from 2012 onwards. Approximately two thirds of the quoted impact are due to measures taken in 2012-13.
2. The impact of the labour market reform is based on a judgement, based on the Jobs Act *Legge Delega* (enabling law), although not all details are defined yet.
3. Reforms that are planned (and announced) for 2015 and 2016, or in 2014 but not yet legislated in detail, have not been included, with the exception of those under the Jobs Act as described in Note 2.
4. Estimates by the Ministry of Finance, in Economic and Financial Document (DEF), update 2014.

Source: Ministry of Finance and OECD calculations.

employment protection legislation, hamper better and quicker reallocation of resources (Andrews and Cingano, 2014). Labour market reform is essential to tackle this problem, and is also an important signal of the government's commitment to enacting tough reforms.

A prolonged recession and uncertain prospects

Real GDP has not grown much since the late 1990s and not at all since 2011; industrial production retreated in the great recession more than in many other OECD countries. Bank lending has fallen for several years, business confidence is low and investment has fallen to a level where it is now insufficient to replace capital as it wears out. To reverse the trend in productivity, the government's programme seeks to address some of its longstanding causes – uncompetitive non-tradeable sectors, regulated professions and the efficiency of the public administration and judiciary, among others. Together with the labour market reform, the government expects that this will increase investment.

There has been some improvement in overall cost competitiveness, measured by relative unit labour costs, since 2009, but this has not offset earlier losses (Figure 2). Price-based measures of competitiveness show less of a problem, and the trend decline in export shares has stabilised in the recession, while the current account balance has moved into surplus, as exports have held up relatively well recently while weak domestic demand has dampened imports.

A weak but strengthening recovery is projected

Prospects are for a gradual recovery in 2015 and 2016, supported partly by additional unconventional policy by the ECB and partly by the fading effect of the earlier fiscal consolidation, and also by real income gains due to the oil price decline (Table 2). In 2015, rising export market growth, restrained labour cost growth and the weaker euro should strengthen exports. Successful labour market reform, the budgeted reduction in the tax wedge on labour and better tax treatment of equity investment should help to underpin investment growth. Private consumption will remain weak but accelerate somewhat as lower energy prices and low inflation boost real incomes. Unemployment will edge down.

Risks are to the downside. The additional unconventional monetary policy measures assumed in the forecast might, even if introduced, be less effective than hoped in reviving credit, which would prevent the ECB from fighting deflation. ECB action has been decisive

Table 2. **The *Economic Outlook* to 2016**

Annual percentage change, volume (2010 prices)

	2010 Current prices (billion EUR)	2011	2012	2013	2014	2015	2016
Gross domestic product (GDP)	**1 604**	**0.7**	**-2.3**	**-1.9**	**-0.4**	**0.4**	**1.3**
Private consumption	980	0.0	-4.1	-2.7	0.2	0.7	0.8
Government consumption	328	-1.8	-1.5	-0.7	-0.2	-1.0	-0.3
Gross fixed capital formation	319	-1.7	-7.5	-5.4	-2.7	0.1	2.2
Housing	89	-6.5	-6.7	-5.4	-3.3	-0.5	0.0
Final domestic demand	1 628	-0.7	-4.2	-2.8	-0.4	0.1	0.8
Stockbuilding[1]	8	0.2	-0.8	-0.1	-0.1	0.0	0.0
Total domestic demand	1 636	-0.5	-5.0	-2.9	-0.5	0.1	0.8
Exports of goods and services	402	6.1	1.6	0.9	1.7	2.7	4.6
Imports of goods and services	434	1.2	-8.2	-2.6	1.4	2.1	3.4
Net exports[1]	-32	1.2	2.8	1.0	0.1	0.2	0.5
Other indicators (growth rates, unless specified)							
Potential GDP	..	0.0	-0.2	-0.2	0.0	0.2	0.4
Output gap[2]	..	-1.9	-3.9	-5.6	-5.9	-5.8	-5.0
Employment	..	0.3	-0.3	-2.0	-0.3	0.1	0.4
Unemployment rate	..	8.4	10.7	12.2	12.4	12.3	11.8
GDP deflator	..	1.5	1.6	1.4	0.4	0.2	0.2
Consumer price index (harmonised)	..	2.9	3.3	1.3	0.2	-0.3	0.5
Core consumer prices (harmonised)	..	2.0	2.0	1.3	0.7	0.2	0.5
Household saving ratio, net[3]	..	3.7	3.1	3.9	4.6	5.6	5.0
Trade balance[4]	..	-1.1	1.0	2.3	..	..	..
Current account balance[4]	..	-3.1	-0.5	1.0	1.5	2.0	2.3
General government fiscal balance[4]	..	-3.5	-3.0	-2.8	-3.0	-2.7	-1.8
Underlying general government fiscal balance[2]	..	-3.2	-1.0	-0.3	0.1	0.3	0.7
Underlying government primary fiscal balance[2]	..	1.2	3.8	4.1	4.4	4.4	4.9
General government gross debt (Maastricht)[4]	..	116.4	122.2	127.9	130.6	132.8	133.5
General government net debt[4]	..	96.1	111.1	117.5	120.4	122.7	123.1
Three-month money market rate, average	..	1.4	0.6	0.2	0.2	0.1	0.1
Ten-year government bond yield, average	..	5.4	5.5	4.3	2.9	2.4	2.4

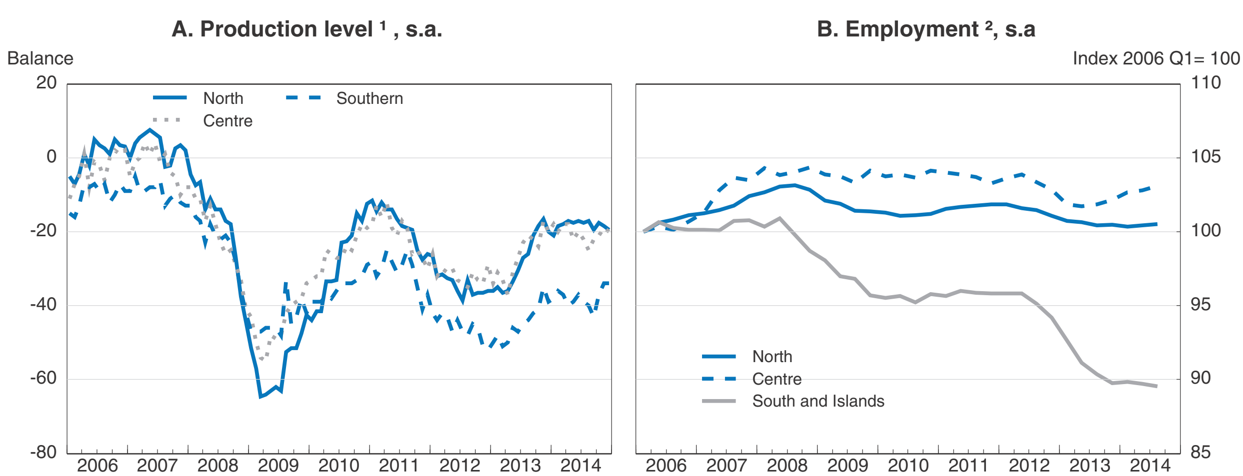
1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of household disposable income.
4. As a percentage of GDP.

in sustaining market confidence in Italian debt, but market sentiment could turn against Italy with its history of low growth and high debt, especially in the absence of other measures to sustain aggregate demand in the euro area. The general level of interest rates and the risk spread against Germany could rise, further delaying the point at which public debt will fall significantly. Containing this risk will require continued political commitment to steady debt reduction. More prolonged weakness in other euro area countries would undermine the hopes of stronger net exports, while a key internal risk is that the ambitious reform programme is somehow derailed or the political commitment to reform fades. This would damage confidence and the prospects for economic recovery.

On the upside, investment tends to be quite volatile in recoveries and, having fallen so much, it could rise more quickly with a return of confidence and available finance. Furthermore, the weakening euro could give a stronger boost to net trade, while lower energy prices benefit Italy directly as a major energy importer but also through the effects on effective demand of increased real incomes in important trading partners.

The recession has accentuated the longstanding regional divide. Italy has long suffered from large divergences between the north and south with respect to key socio-economic factors such as unemployment, female participation, household incomes, and many types of crime, especially violent crime. The recession's impact on both economic activity and employment has been more severe in the south than the north (Figure 3). Internal migration might be expected to serve as a safety valve, with people moving from low- to high-employment parts of the country. Indeed, in the 1950s and 1960s there were quite high rates of net emigration from the south, both to northern Italy and to other countries. However, in recent years, despite the widening gap in unemployment rates, net migration has been low. The planned constitutional change, centralising responsibility for key policy areas such as active labour market policy and competition, should help reduce the regional divide.

Figure 3. **Recession has widened the regional divide**



1. Business survey of production levels, manufacturing sector. Balance of companies responding that production has risen over companies responding that production has fallen.
2. Total employed, persons aged 15 and over.

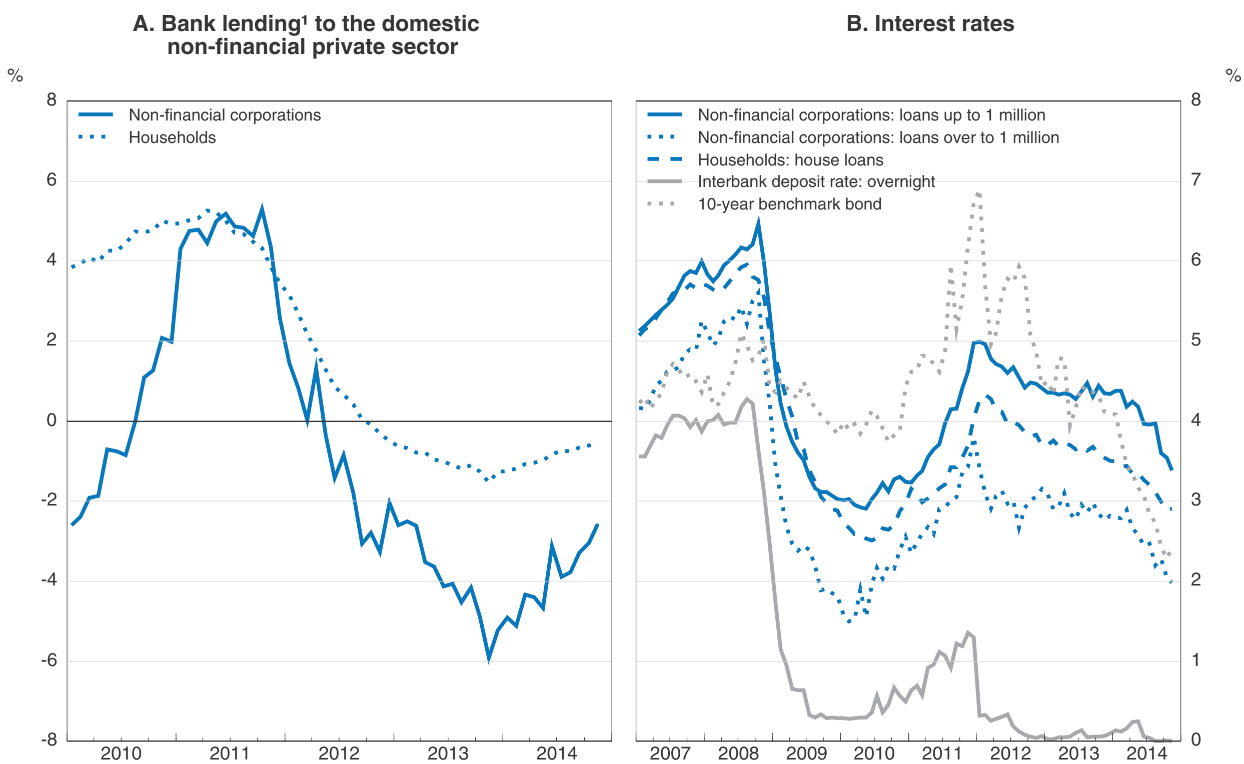
Source: Istat and Datastream.

StatLink http://dx.doi.org/10.1787/888933184665

The prolonged recession has weakened banks and company balance sheets

Falling bank lending has been a contributory factor in the continuing recession (Figure 4). The banking system as a whole meets capital requirements, but even though provisioning has been improving, non-performing loans amounted to some 17% of total loans in mid-2014 and weigh heavily on the balance sheet of many banks. This accentuates their traditional conservativism regarding risky loans. It is probably one reason why interest rates to the private sector have fallen less than those on government debt, as banks keep margins high to cover losses. The Asset Quality Review and stress tests – focusing on the capital required to survive three years of heavy losses – revealed in October 2014 that a small number of banks needed some recapitalisation, totalling around EUR 3 billion, or about 0.2% of GDP.

Figure 4. **Bank lending has been declining, while interest rates remain high for private borrowers**



1. Annual growth rate.

Source: Bank of Italy and Datastream.

StatLink http://dx.doi.org/10.1787/888933184678

Reducing non-performing loans is a priority for any bank, as dealing with them ties up capital and burdens banks' loan officers with restructuring tasks rather than making new loans that could finance investment and growth. Banks are increasingly active in using the secondary market to sell these loans and it is important there are no disincentives to recognising the losses implicit in selling them. Further action is needed to achieve a lower level of non-performing loans. Despite reforms to the bankruptcy law itself, judicial processes remain slow and could be accelerated by expanding the use of specialised courts and out-of-court debt workouts. The disposal of these troubled loans can be accelerated by setting up specialised asset management companies ("bad banks") that would acquire them with appropriate haircuts (Gandrud and Halleberg, 2014); this process is already underway in the private sector, but at a slow pace. Some euro-area countries have successfully set up public bad banks. If progress remains slow, the establishment of a public bad bank could be envisaged in Italy. Meanwhile, together with changing the tax treatment of loan-loss-provisions, the government has taken a number of measures to improve the flow of finance to companies from non-bank sources, in its "Finance for growth" measures (Box 1).

Box 1. **Recent government measures to increase "Finance for Growth"**

The government has taken a number of measures to make it easier or cheaper for finance to flow to small companies or infrastructure projects and investment in general, as well as encouraging wider stock market listing to improve access to equity finance.

Easier access to credit. Some institutions previously prohibited from lending directly to companies, such as credit funds, securitisation companies and insurance companies, may now lend directly to firms. The withholding tax for EU investors on medium-long term financing, unlisted bonds and certain other securities is removed. The endowment of the Central Guarantee Fund has been increased and the scope of the Fund widened by including guarantees for mini-bonds issued by SMEs.

Fiscal and other incentives for investment. Measures recently enacted Include a temporary tax credit for companies increasing their level of investment and a subsidy targeting loans to small and medium-sized enterprises for the purchase of machinery, equipment, capital goods and for investment in IT. A tax credit for incremental investments in R&D in the 2015-19 period has been introduced. A favourable "patent box" taxation on income deriving from direct/indirect use of intellectual property, patents and trademarks has been also been introduced (see also Criscuolo and Appelt, 2015). Project bonds for infrastructure investment have been made cheaper and simpler to issue. Regulations governing the involvement of institutional investors in real estate have been relaxed.

Encouraging the supply of equity finance. The allowance for corporate equity has been increased and can also now be set off against regional corporate taxes (IRAP). Measures to simplify public listings by SMEs and by family companies include the possibility of multiple-voting shares, reduced minimum capital requirements, variable thresholds for compulsory takeover and an increased threshold for compulsory communication of holdings or admissible cross-shareholdings. The allowance for corporate equity is to be increased by 40% for newly-listed companies (Super ACE).

Early results are encouraging. Within the first few months additional lending SMEs from the "Sabatini law" fund was EUR 2 billion, and 26 new companies raised EUR 1 billion in bond issues.

Institutional reforms can be the basis for better policymaking and stronger implementation

The government has launched constitutional reforms in two important areas: the structure of parliament and the division of responsibility between central and sub-national governments. The reform of parliament will transform the Senate into a second-tier body. Since 1946 the two houses of parliament, the Senate and the Chamber of Deputies, have had equal powers and prerogatives in terms of drafting legislation, though they are elected on different bases. Legislation can be passed from one to the other for modification. This can mean long and protracted negotiations, many amendments, and complicated legislation. Under the proposed constitutional change, which has already been voted by the Senate itself and the constitutional commission of the Chamber of Deputies, the Senate would have an equal legislative function to the Chamber of Deputies only for a narrow range of issues. For all other matters, the Senate would have the power only to propose modifications to drafts from the Chamber of Deputies. The Senate will also participate in monitoring the public administration and policy implementation. Reduced from 315 to about 100 members, it would be composed of a number of representatives for each region, drawn from members of the regional councils and mayors, and up to five notables nominated by the president of the republic.

The reform of centre-sub-national relations, which would reverse some of the changes introduced in a 2001 constitutional reform, would recentralise a number of devolved functions and eliminate concurrent competences. A number of OECD studies have drawn attention to the difficulties the current structure has generated in regulation and environmental policy (OECD, 2009b, 2013a, 2013c). Policy regarding energy and most infrastructure would revert to national level. The change would also convert the *de facto* abolition of the 110 provinces, which was achieved in 2014 through legislation and administrative measures, into a constitutional fact. One underlying principle will remain, with more limited scope of application: all matters that are not expressly reserved for central government will be regional competences. Regions with a balanced budget will be given more autonomy for as long as they keep their budget balanced. In addition, the public functions financing of all regions and municipalities will be based on standard indicators of costs and needs (which are already available on-line).

This important constitutional reform is expected to be completed by the end of 2015, when a referendum is planned. Once in place, the reform should permit more efficient policymaking, reduce ambiguity about who is responsible for what, avoid implementation delays due to sub-national government not following through on national legislation, and improve the coherence of the domestic market by reducing the extent of regulatory variation between regions.

The 2013 *OECD Economic Survey* noted that policy implementation appears to be a weakness (OECD, 2013a; O'Brien, 2013). Effective policy implementation needs well-designed and well-written (i.e. in clear and unambiguous language) legislation, effective public administration (ranging from prompt introduction of implementing regulations to effective enforcement of their specific provisions) and an efficient legal system to back up enforcement and prevent corruption.

Poor policy implementation can arise from various sources. For example, legislation has sometimes been unclear, or imposed unreasonable deadlines (Allio and Rangone, 2015). This can lead to non-compliance occurring inadvertently, but may also cover deliberate non-compliance and make it seem normal. Another problem can be institutional instability. If the structure or mandate of a body is changed too frequently, its ability to focus on its key tasks may be reduced. For instance, the anti-corruption agency created in 2004 was modified four times before its abolition in 2008. Its successor, ANAC, created in 2012, has had its mandate changed twice since then.

The language of legislation itself can be important. An OECD study on international investment agreements notes that French, UK and German agreements, covering several decades, used unchanged phrasing to refer to the period of validity of the agreement (Pohl, 2013). The equivalent Italian documents use at least a dozen different formulations. Unjustified variations in language (many of which were noted in Italian legislation by Clarich and Mattarella, 2010) can create unnecessary waste of time and, potentially, legal ambiguity. The ongoing process of regulatory simplification and codification of existing laws and regulations can also improve the transparency of legislation and should continue.

Difficulties with policy implementation have arisen from potential conflicts or overlapping responsibilities between levels of government. One example where this can occur is with environmental policy, where policy design is a central government responsibility, but implementation is delegated to the regions (OECD, 2013c). Energy planning and retail regulation are other examples where several levels of government have powers or responsibilities. The government's intention to clarify the division of responsibility between centre and regions, as well as the phasing out of the provincial level of government, could yield more decisive action.

Other difficulties with implementation can arise because legislation is introduced hurriedly, with the corresponding risk of insufficient attention to detail or poor assessment of possible alternative policies. For this reason the 2013 *OECD Economic Survey* recommended that less use be made of decree laws. The constitution reserves the use of decree laws for "urgent" measures. Given the long time scale over which structural reform takes effect, taking time to get the measures right, and to get effective parliamentary consent and "ownership" to improve the durability of the measures, will often be more important than "urgent" action. The reformed structure of parliament should allow legislation to be agreed more quickly without the use of decree laws; the time saved should be used to improve all aspects of the process, including drafting but also use of impact assessments and other processes designed to subject policy choices to scrutiny for efficiency and effectiveness. A proposed constitutional change will limit the use of "urgent" decrees to a specific list of issues, and also introduces the possibility of time-limited debate (imposing a vote by a definite date) in the Chamber of Deputies.

An inefficient public administration can be a barrier to effective implementation of reforms. Weaknesses in the Italian public administration have included absenteeism, low skills, mismatch, lack of transparency and cronyism (Department of Public Administration, 2008; Commission on corruption in public administration, 2012). Past reforms have tackled many of these areas, though progress has been slow. The government needs to continue its efforts to pursue more performance-oriented management and improve skill levels. The revision to public employment regulations that allows them to be reassigned more easily should improve both flexibility and skill-matching, if used by a management system that focuses on performance. Transparency has improved, and is an important tool in the fight to avoid waste and corruption, but more could be done. An example is to move to a more general freedom of information provision, where all information held by the public administration should be available on request to the public, except to protect privacy or security. This would contrast with the current duty to publish only information that is specified by law, although this covers a wide range of areas.

Monitoring and ongoing policy assessment is important

The current government is aware of policy implementation problems. It maintains a record, developed under the two predecessor governments, of the extent to which subsidiary legislation has been completed. This shows that much work in implementing legislation from both 2013 and 2012 remained to be done even in early 2014. By the end of 2014 about half the backlog had been cleared, though 383 specific pieces of subsidiary legislation were still needed to complete legislation from 2012 and 2013. Some policy changes were introduced rather hurriedly in 2014, such as changing the effective status of provinces in advance of considering the details of the constitutional law, which will not come into force until 2015 at the earliest. A number of measures introduced in 2012, for example the labour market changes, included provision for monitoring their impact so as to have concrete evidence on which to assess their effectiveness. This is a good idea which should be continued.

The government's approach of setting its reform programme within a broad three year timetable, together with broad consultation on proposals in the main reform areas (public administration, education, justice), is an important step in the direction of a more considered approach to policy making. A legislative timetable has been set out for the period 2014-15 and published on the Ministry of Economics and Finance website (Table 3).

Table 3. **Progress on structural reforms**

	Further measures foreseen
Fully legislated	
New labour contract	
Revised unemployment benefit	
Income tax cut. Tax benefits for small farmers	
Corporate tax: extended allowance for corporate equity; "patent box"	Ministerial decree requirement for confirmation
Courts: expansion of access to alternative dispute procedures	
Administrative justice	
Anticorruption measures; public procurement and infrastructure investment	
Expanded SME access to non-bank finance. Easier SME listing requirements	
Partially legislated	
Active labour market policy	Decree by June 2015
Minimum wage	Decree by June 2015
Administrative simplification for citizens and business	
Electoral law	Further confirmation votes in parliament. Constitutional referendum
Senate reform	
Central – sub-national relations	Agreement of regions. Further confirmation votes in both chambers. Constitutional referendum.
Further tax reform	Decrees due by March 2015
Strengthening sanctions against financial fraud and mafia; revise statute of limitations	Further confirmation votes in parliament
Yet to be approved	
Strengthening business courts	Decree pending
Liberalisation and deregulation in local services, regulated professions, network industries, etc.	Draft Competition Law planned for June 2015
Enhance strategic energy infrastructure	
Education reform for labour market	Draft legislation due in February 2015
Public administration reform	
Criminal justice reform	

Source: MEF (2014a).

Policies to improve productivity can cover a wide range of policy areas, in many different ministries, each with their own specific mandates. Generating comprehensive reform programmes across disparate ministries can be difficult. Some countries have found it useful to have an independent permanent productivity commission to investigate and advise on what structural reforms are needed and to advocate reform. Australia has had an effective commission for a long time. New Zealand and Mexico recently introduced similar bodies, while Norway instituted a commission with a two-year mandate. Early signs suggest that they are working well. In Mexico, success has led to moves to integrate the commission more systematically into the legislative process, including a requirement that the government publically respond to its policy recommendations. Productivity commissions have been found to play a useful role in the public debate when they provide advice that is independent from political considerations and based on sound research, which both enhance credibility (Banks, 2011). Such a commission, with a mandate to provide advice to the government on matters related to productivity, to promote public understanding of reforms, and to engage in a dialogue with stakeholders, would be useful in Italy. Its recommendations would be able to take account of analysis by international institutions but could be better tailored to specific country characteristics.

A more efficient judicial system and efforts to tackle corruption

Important steps have been taken to improve efficiency in the judicial system. Measures to gain economies of scope and scale through amalgamation of small courts, thus allowing some specialisation by judges as recommended in previous OECD work (OECD, 2013a; Palumbo et al., 2013), are being implemented, for example in labour law. The planned establishment of specialised business courts should be swiftly implemented. Another OECD recommendation, to modify the application of the statute of limitations to reduce the incentive to prevarication, has also been implemented. Other steps, including consideration of measures to limit the very high rate of appeal, could further improve efficiency.

Reducing corruption and improving trust in Italy must also remain a priority (OECD, 2013d). The new anti-corruption agency ANAC needs stability and continuity as well as support at all political levels if it is to effectively monitor the public administration and providers of public services and infrastructure. Following revelation of major waste of public funds, at least partly due to corruption, in important public infrastructure projects, the national agency formerly responsible for overseeing public works projects (AVCP) was absorbed into ANAC. The government's view was that the task of ensuring value for money and preventing corruption can be mutually reinforcing given that much corruption in public administration affects public procurement. In the longer run, it might be efficient to have a separate agency like AVCP to concentrate on value for money, while ANAC focuses on ensuring that measures to avoid corruption are in place. Until recently, ANAC, unlike other "authorities" in Italy such as the competition authority, has been essentially a monitoring and reporting institution, focusing mainly on anti-corruption and transparency procedures and practices in public agencies rather than specific instances of corruption. It has now been given some additional powers, however. ANAC can submit files for court proceedings to the judicial authorities and can also request that the local Prefect put firms, or parts of firms, suspected of being involved in corrupt behaviour with regard to public procurement into compulsory administration.

Recommendations to boost efficiency through institutional reform

Key recommendations

- Follow through the reforms of parliament and the re-assignment and clarification of policy competences between the centre and sub-national government.
- Ensure that legislation is clear, unambiguous and supported by improved public administration, including through reduced use of emergency decrees.
- Further streamline the court system, with more specialisation where appropriate; increase the use of mediation; enhance monitoring of court performance.
- Consider establishing a Productivity Commission with the mandate to provide advice to the government on matters related to productivity, promote public understanding of reforms, and engage in a dialogue with stakeholders.
- Reducing corruption and improving trust must remain a priority. For this, the new anti-corruption agency ANAC needs stability, continuity as well as support at all political levels.

Other recommendations

- Support active and independent action by the anti-corruption agency, complementing the pursuit of increased efficiency in the judicial system.

Labour market and competition reforms to improve productivity and well-being

If successful, the reform programme could make Italy a place where families can live better lives. While life is already enjoyable for many, especially in terms of work-life balance, some dimensions of well-being rank low relative to other OECD countries (see Figure 1). Some of these, such as low scores on education and skills, civic engagement and governance, contribute to the economy's poor performance. Large gender gaps between men and women in terms of well-being, labour-market participation and wages deprive the country of an important source of dynamism.

Inefficient labour market institutions contribute to low labour utilisation. The crisis aggravated weaknesses in the labour market: low participation, high structural unemployment and increasing duality. The unemployment rate has been between 12% and 13% since mid-2013 with large regional disparities: it is as high as 20% in the south. High structural unemployment and low participation rates leave many people out of employment. The proportion of young people neither in education nor employment (NEET) has risen by over 6 percentage points since the onset of the crisis, reaching nearly 23% by the end of 2013, the second highest share in the OECD. Stringent laws and weak employment prospects also encourage developments in the underground economy: the Italian National Statistical Institute, Istat, estimates the number of workers in the underground economy is equivalent to 12% of total employment.

Protecting individuals rather than specific jobs

Current legislation provides very strong protection for employees in larger firms (over 15 employees) with indefinite employment contracts, accounting for about 50% of total employment, with less protection for those in small companies and very little security for the rest. Under the existing legislation, dismissed workers can file a case in court claiming that their dismissal was unfair and claim monetary compensation and/or reinstatement. A reform in 2012 restricted the possibility of reinstatement to cases in which the alleged justification was unfounded (Table 4). This reform reduced somewhat the frequency of reinstatements (Bank of Italy research suggests by as much as one third), but gave rise to many interpretation problems which have slowed down the judicial process.

Table 4. **Recent reforms easing regulation on labour market contracts in selected countries**

	Italy	Spain	France	United Kingdom	Greece	Portugal
Reduce procedural inconvenience for dismissal cases		x	x		x	
Reduce severance pay for permanent contracts	1	x			x	x
Relax the definition of unfair dismissal			x			x
Reduce compensation for unfair dismissal		x				
Reduce possibility of reinstatement for unfair dismissal	**x**					x
Reduce regulation on collective dismissals	**x**	x			x	
Reduce regulation on non-permanent contracts	**x**	x	x		x	x
Increase regulation on non-permanent contracts				x		

Note: The 2012 reform relaxed employment protection rules on permanent contracts, notably limiting the possibility of reinstatement following unfair dismissal. The 2012 reform reshaped incentives to hire on fixed-term contacts; no justification required for the first fixed-term contract if its duration does not exceed one year, which was extended to three years in early 2014; the interval period between two fixed-term contracts was extended, which was withdrawn in early 2014.
1. There is no severance pay in Italy.
Source: OECD (2013), *OECD Employment Outlook 2013*, OECD Publishing, Paris; and EPL indicators.

With the "Jobs Act" adopted in December 2014, the government has a mandate to introduce measures to rationalise employment protection, expand active labour market policy and make social protection more effective. Such policies will improve skill matching and enhance productivity. To rebalance job protection, a standard contract with employment protection increasing with tenure was introduced in early 2015. This further limits the possibility of reinstatement of workers following unfair dismissal, excluding this possibility for dismissal for economic reasons (*motivo oggettivo*). These new arrangements imply quite radical changes for Italy. To avoid unwarranted disruption, they are applied only to new employment contracts ("grandfathering" existing rights).

The new contract provides a basic level of protection for the first two years, after which the level of compensation for unfair dismissal increases up to a maximum of 24 month's wages. Such contractual arrangements will benefit both the employer and the employee, since they facilitate more job creation for those with little professional experience while paving the way to more stable professional careers.

The reform ensures that workers judged to be unfairly dismissed for objective reasons (i.e. where the firm gives economic or technological changes as reasons for the redundancy) are not eligible for reinstatement, with firms providing monetary compensation instead. By increasing predictability this lowers the effective costs of dismissal, even if judged to be unfair by courts, helping firms create more jobs. The reform should substantially reduce the average amount of such compensation, which is currently very high, averaging about 21 months of salary against the OECD average of 14 months. It also envisages that courts can judge only a few well-defined issues: discriminatory dismissal; the proof of dismissal motivation; and wrong dismissal procedure.

The Jobs Act also introduces a new form of out-of-court procedure, according to which the employer can pay the worker an indemnity equal to 1 monthly wage per year of service (a minimum amount equivalent to 2 monthly wages and a maximum amount equivalent to 18 monthly wages). This compensation could be considered as similar in some respects to severance pay. The acceptance of this transaction prevents any further dispute by the worker, that is, appealing to courts for a dismissal to be unfair or not. Both parties have a strong incentive to settle the dispute through this procedure, since the sum paid is not subject to social contributions or taxation. The government should monitor the developments on this new procedure and, if necessary, it should consider alternative measures to reduce uncertainty on court decision.

All of these reforms, if fully rolled-out, will go a long way towards making Italy's labour market institutions more efficient, thus improving the allocation of labour resources and increasing productivity. They will reduce legal risk and financial costs associated with dismissal provisions, which have been identified as the most burdensome and affecting job creation (OECD, 2013b). Less frequent recourse to the courts and more rapid court decisions will reduce the difficulties faced by employers, thus encouraging more job creation. Altogether, this will improve turnover on the labour market, resulting in better skill matching and, therefore, greater ability of firms to adapt the skill profile of their workforce to their changing environment.

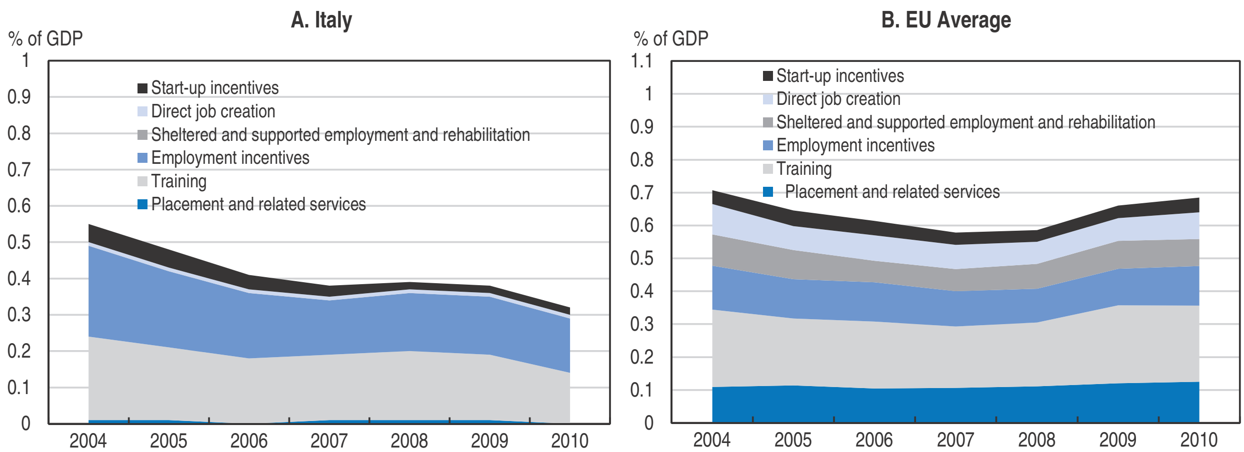
Increasing job-matching efficiency and workers' skills

The government identifies active labour market policy (ALMP) as a priority. The EU Youth Guarantee scheme has been in force since mid-2014. The Youth Guarantee programme targets those who are 15-29 years old within four months after leaving school or being laid off. This programme offers a range of activities which facilitate school to work transition for young people, including guidance, training, apprenticeship or traineeship places, and incentives for firms to hire young people.

The Jobs Act further strengthens ALMPs and creates a National Employment Agency. The Agency will be responsible for co-ordinating ALMP policy, currently the responsibility of local governments, including co-ordination with social benefit providers. OECD studies show that different people need different kinds of measures and that profiling their needs can help to determine who is job-ready and who should receive more comprehensive help (OECD, 2013b; Jin et al., 2015). For example, most displaced workers find jobs needing similar skills to their previous employment; in such cases, measures facilitating job matching such as career orientation and placement services are important. Currently ALMP spending is concentrated on job training (Figure 5). Employment training is expensive and should be targeted at specific groups such as the long-term unemployed and low educated people, provided they show that they are motivated to seek work (OECD, 2013b).

Labour market policy improving workers' existing skills and matching them with available jobs needs to be supported by an education system that provides initial knowledge and skills needed in the labour market. Both PISA (Programme for International Student Assessment) data on school student performance and new PIAAC (Programme for the International Assessment of Adult Competencies) data on adult skills show that Italy lags many countries in this regard. Education policy has been constrained by funding cuts, but needs to continue its effort to improve its performance, including the development of post-secondary technical schools and improving vocational schools, in co-ordination with industry's needs.

Figure 5. **ALMP spending is relatively low and concentrated on some categories**



Source: *OECD Economic Outlook 96* (database).

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Providing adequate labour incentives and targeted social benefits

A more efficient social security system is important so that displaced workers are protected against poverty and given facilities to help finding new jobs, while avoiding pervasive disincentives for labour supply. In Italy, the unemployment benefit system has been very generous for certain workers, notably those in the industrial sector. Other workers have had little cover. Indeed, social benefits as a whole are poorly targeted and tend to provide least income protection for those who already have least protection in employment.

In 2012 the government at the time began streamlining the benefits system, by gradually integrating the standard unemployment benefit and extensions of the short-time working scheme (which has become a *de facto* unemployment scheme) into a new unemployment benefit, *Assicurazione Sociale per l'Impiego* (ASpI) by 2017. The current government has recently adopted a draft decree adopting a new unemployment benefit system which extends coverage to all dependent workers.

The new legislation introduces conditionality for unemployment benefit, requiring recipients to participate in activating measures proposed by the employment service; full definition of this conditionality will be defined in later decrees. Without such an obligation, unemployment is likely to be higher than otherwise and training inefficient. For example, the obligation could consist of periodic interviews and mandatory referrals, enforced by benefit sanctions, to employment and training programmes where appropriate (OECD, 2013b). The National Employment Agency, in co-ordination with the national social insurance provider (INPS) and the local public employment services should develop and enforce appropriate conditionality.

More flexible wage setting

The response of wages has been weak compared with those in some of the hardest hit European countries. For some time after the crisis began it seemed to be having very little effect on wages, partly because most collective bargaining settlements cover a three year period. Growth in contractual wages has declined through time, but only rather slowly, making it difficult to improve labour cost competitiveness given Italy's poor productivity performance.

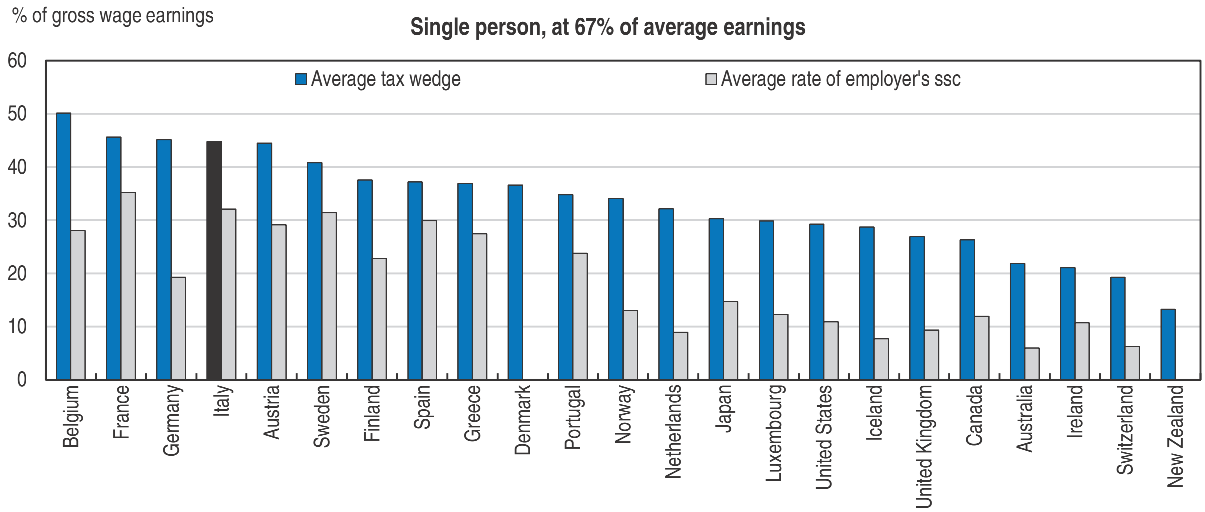
Flexible wage setting is important in achieving low structural unemployment rates and in mitigating the direct impact of shocks on employment by facilitating adjustments (*OECD Employment Outlook 2014*). Since joining the European monetary union, the Italian system has not adapted to the impossibility of periodic devaluation to compensate for too high wage growth relative to productivity. As a result, competitiveness has suffered. *Contratti collettivi nazionali di lavoro*, the three-year industry agreements at national level, play a dominant role in wage setting. They are applied uniformly across the country, so wages are influenced mainly by the economic conditions prevailing in the leading sectors and regions. Firms cannot easily adjust wages to suit their conditions in terms of productivity and competitiveness.

Agreements between the social partners in 2011 and 2012, still in force, allow more local flexibility in wages and non-wage terms. However, they have not had much effect so far, as they allow only incremental adjustments to collectively agreed terms. Firm-level deals could take into account local conditions, and could adjust other working practice, such as arrangements to adjust weekly working hours. This would improve firms' ability to respond to changes in market conditions, another contribution to improving competitiveness and employment prospects. In Spain, reforms to wage bargaining, including for firms to opt out fully from sectoral wage contracts, are credited with having helped competitiveness (OECD, 2014). In Italy such "opting-out" clauses exist but are little used in practice, as firms need to strike a deal with all trade unions, which can be complicated to achieve. Wage flexibility would be greater if firms deciding to opt out of collective wage bargaining were allowed to strike a deal with trade unions representing a majority of employees, rather than all trade unions.

The Jobs Act provides for introducing a legal minimum wage on an experimental basis, for sectors not covered by national collective agreements. This can induce wage rigidity, resulting in higher unemployment, if not carefully designed or if the minimum wage is set too high. Given the sharp regional divide in Italy, the minimum wage should be set at different levels in different regions, taking into account such factors as variations in the cost of living and productivity levels; such a system is currently used in the United States, Canada and Japan. Otherwise, workers in the south will be priced out of employment while those in the north will subsist on too low a wage.

The tax wedge has been high in Italy, but especially so among low-income earners (Figure 6). Social security contributions on employees are the second highest in the OECD. For new hires in 2015 on permanent contracts, the government has removed employers' social security contributions from 2015-17. The tax wedge for these new hires will be reduced substantially; for an employee (single, no children) with gross earnings of EUR 20 000 (around 67% of average earnings), the tax wedge falls by 18 percentage points. Taking into account the regional business tax (IRAP), presently not included in the methodology used in the OECD publication *Taxing Wages*, the removal of labour costs from IRAP results in an even larger fall in the tax wedge of some 20 percentage points (from 46.1% to 26.7%). This should stimulate employment, along with the cut in income tax of a fixed amount per month up to a certain income limit (and phased out above that limit) introduced in 2014. Including the impact of that income tax cut, the tax wedge for the same employee falls from 46.1% in 2013 to 21.9% for the first three years of a permanent contract started in 2015. In addition, a change in the forced saving scheme (*Trattamento Fine Rapporto*), allowing employees to receive it directly (though they thereby lose a tax advantage), can also be interpreted as similar in some respects to a reduction in the tax wedge, of nearly 4 percentage points (the methodology used in the OECD publication *Taxing Wages* does not treat deductions such as the TFR as taxes).

Figure 6. **The tax wedge for low-income workers is high**



Source: OECD, *Taxing Wages*, OECD Tax and Wages Model.

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Encouraging participation

Italy has very low labour force participation. This is especially true among women and in the south. To some extent, the large informal sector may make up for this, but by no means entirely. In the past, the pension system imposed a high implicit tax on continuing work, explaining low participation among older age groups. With the acceleration of the phasing-in of the reformed system and rises in the retirement age, participation among older age groups has begun to rise noticeably. Participation by 55-64 year olds rose from 46% in 2008 to 57% in 2013 and has begun to catch up with that in other countries, though still remains below most. The pensionable age is now set to rise in line with life expectancy, so further increases in participation can be expected.

The female labour force participation rate is among the lowest in the OECD: 54.4% against the OECD average of 62.6% in 2013. This is strongly influenced by social norms, including responsibility for caring for children or older family members. Availability of child care facilities is very limited in Italy. Only 24% of Italian children up to three years old are enrolled in formal childcare, against the OECD average of 33%, and some 8% of women withdraw from the labour market for family care reasons. The birth rate is very low, so child care provision might have less impact on female employment than elsewhere, but the traditional female role as carer for elderly parents is probably just as important. The government intends to support female labour force participation by increasing child care facilities and introducing a tax credit for low- and medium-income families with children.

Liberalising services and improving competition

In addition to reform specifically targeted at the labour market, policies in product markets can also boost job creation, if well-designed. This concerns particularly markets that remain closed to entry, preventing new firms from bringing new competition and raising activity. Previous *OECD Economic Surveys* and *Reviews of Regulatory Reform* have made recommendations on liberalising services and improving competition. Reforms launched in 2012 made progress in a number of areas, including some liberalisation of the regulated professions (such as lawyers, accountants, architects, pharmacists, etc.), and better regulation of water and transport. It remains particularly important to promote more effective competition, especially in network industries, local services, regulated professions and the retail sector. There are still barriers to entry that need to be reduced or eliminated; failure to do this in the area of taxi and legal services illustrates the political difficulties involved.

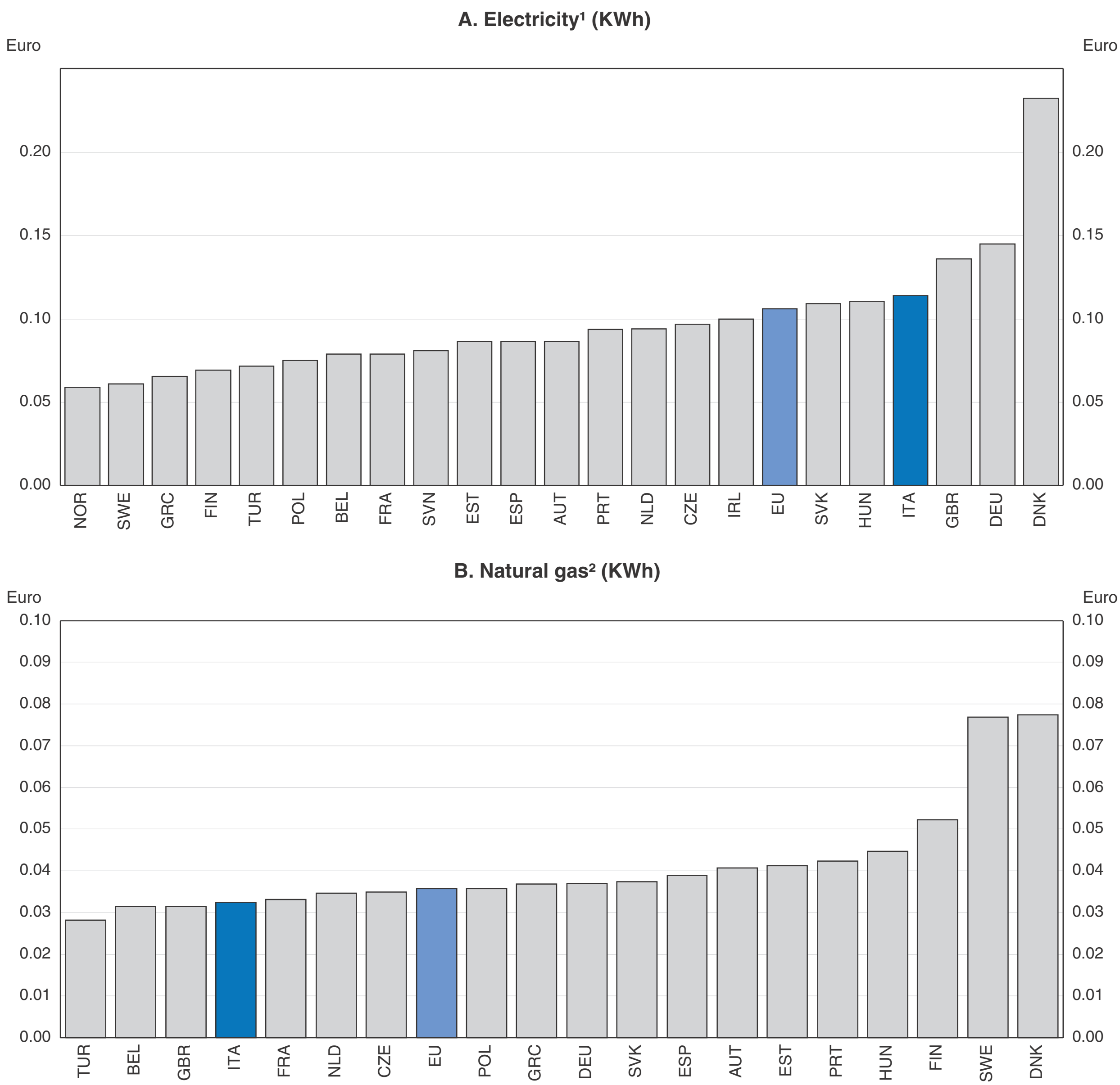
Local public services (such as public transport, water treatment and supply, waste management) are in many areas dominated by monopolies assigned to companies either owned directly by, or closely related to, local government. Public tenders are normally required but seem to be frequently manipulated and can be dispensed with under some conditions. Local authorities have to publish on their websites reports on the tendering of local services and justify the choice on a specific method of contract award. In addition, they have to send this report to the observatory of local public services at the Ministry of Economic Development. Since 2012, the competition authority has had powers to question some actions by local authorities; and there are new transparency measures for local public expenditure that should make it clearer how public money is being spent. New regulators have been set up, in line with earlier recommendations, for water and transport. They must now be assured of the opportunity and resources to carry out their mandate independently. These measures should be made to work together to improve value for money through a combination of increased competition in the market. Where there are natural monopolies, competition "for the market" can be employed through competitive tendering for the right to run services for a certain number of years. In some cases, privatisation of existing public entities may be an essential step towards increasing competition. The 2015 budget law allows revenue from such privatisation to be excluded from the provisions of the internal stability pact.

At the national level, high energy prices have been a cost disadvantage for Italian companies. Italy has few indigenous low-cost energy sources other than significant hydro-electric power in the north, so somewhat higher prices than neighbours can be expected. However, high prices have also reflected inadequate infrastructure links with the rest of Europe, though connections have improved in recent years. The gas market shows how deregulation and links with the European market can bring down costs. Until 2012 spot wholesale prices for gas could be 20% or more higher than other European countries (GME, 2014). This gap has now completely closed following liberalisation of the spot market and ownership unbundling, an illustration of how some measures can have rapid effects (Figure 7). Electricity prices remain well above other countries, however, although some liberalisation has occurred. This is partly due to raw material costs and the impact of the dash for renewables, but better transmission infrastructure, further liberalisation and effective regulation would reduce the gap, as in the case of gas.

In addition to reforms to increase productivity and output, important reforms are needed to reduce losses to living standards through pollution and other environmental damage. The recent OECD Environmental Performance Review has many recommendations in this area, which could both improve environmental outcomes and reduce the associated costs (OECD, 2013c). These include streamlining energy efficiency incentive measures and ensuring that multiple incentives do not entail excessive costs. The use of price-based mechanisms should be extended, such as pollution and congestion charges, to reduce emissions from vehicle use in urban areas, and vehicle taxation should be restructured to include components reflecting CO_2 emissions and other environmental externalities.

Figure 7. **Low gas prices, high electricity prices**

Industrial sector, 2013 or latest year available



Source: Eurostat.

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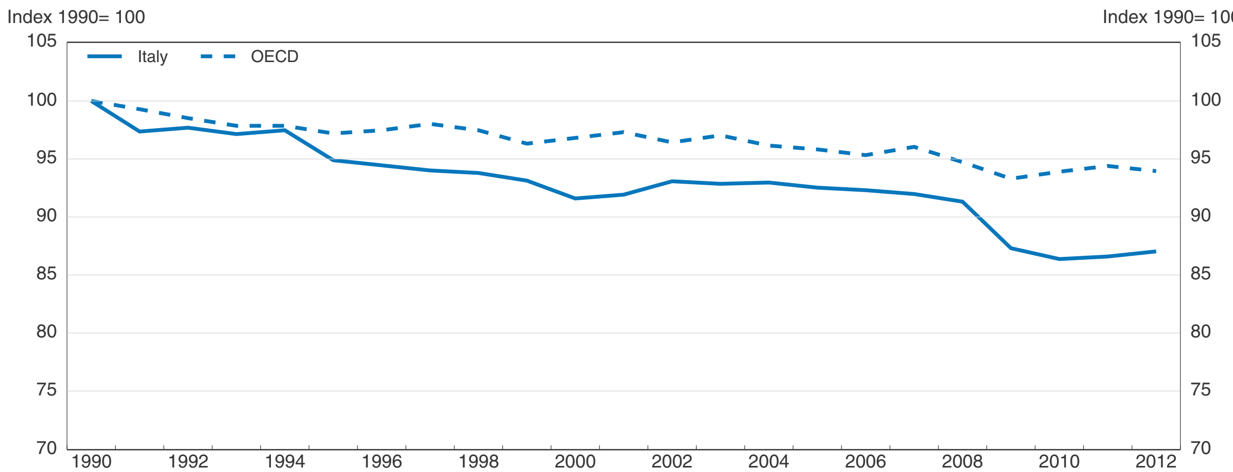
In the framework of the EU Burden Sharing Agreement to achieve the EU-wide target under the first commitment period of the Kyoto Protocol, Italy committed to reduce its GHG emission by 6.5% below the 1990 level (which was already low compared with many countries) over 2008-12. Italy needs to purchase carbon credits to reach this target, but the necessary financial resources have not been allocated yet: average 2008-12 emissions were 4.6% below the 1990 level (ISPRA, 2014). This is despite Italy performing somewhat better than the OECD average in reducing carbon emissions per unit of primary energy supply (Figure 8).

Figure 8. **Carbon intensity index[1] of the energy mix**

CO_2 emissions from fuel combustion per total primary energy supply, index 1990 = 100



1. The IEA Energy Sector Carbon Intensity Index (ESCII) tracks how many tonnes of carbon dioxide (CO_2) are emitted for each unit of energy supplied (TPES, total primary energy supply). It shows the global aggregate impact of changes in supply technologies over recent decades.

Source: IEA (2013), "Indicators for CO_2 emissions", *IEA CO_2 Emissions from Fuel Combustion Statistics* (database), International Energy Agency.

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Italy's strategy for climate mitigation has relied heavily on promoting renewable energies through economic incentives. The incentives have not been well-coordinated and have been repeatedly changed, which has created some uncertainty in the markets. Between 2009 and 2012 electricity generation from renewables was supported by three different mechanisms: a feed-in premium for photovoltaic, a tradable (green) certificate scheme and technology-specific feed-in tariffs for all other renewables. The cost of these incentives is recovered via a surcharge on electricity bills. Italy's incentives to renewables have been generous, leading to a substantial increase in renewables generation, meeting European targets, but have led to increasing costs for retail electricity consumers and entailed high GHG abatement costs (OECD, 2013c). Specific measures to reduce electricity costs for small companies were also introduced. To cut costs quickly, some changes were made retroactively and revised incentive programmes appear to be more cost-effective (IEA, 2015). However, the retroactive features of these changes may undermine investor confidence and increase the cost of capital for future investments.

Policy recommendations for the labour market and competition

Key recommendations

- Fully roll-out the new standard contract for new hires, with employment protection rising with job tenure, while grandfathering existing contracts.
- Change the composition of spending on active labour-market policy: limit training programmes to those who need them most; tailor assistance to job seekers according to their specific situation.
- Encourage female labour force participation with more flexible working-hours arrangements, and promote wider provision of good quality care of children and the elderly.

Policy recommendations for the labour market and competition *(cont.)*

- Fully implement the unified unemployment benefit system. Require recipients to actively seek work, and to accept employment or training when offered.
- Encourage social partners to allow modification of national wage agreements at the firm level, through agreement with representatives of a majority of the firm's employees.
- Adopt a competition law following the recommendations of the competition authority to introduce competition into local public services, improve competition in insurance, banking, network industries, the regulated professions and retail trade.

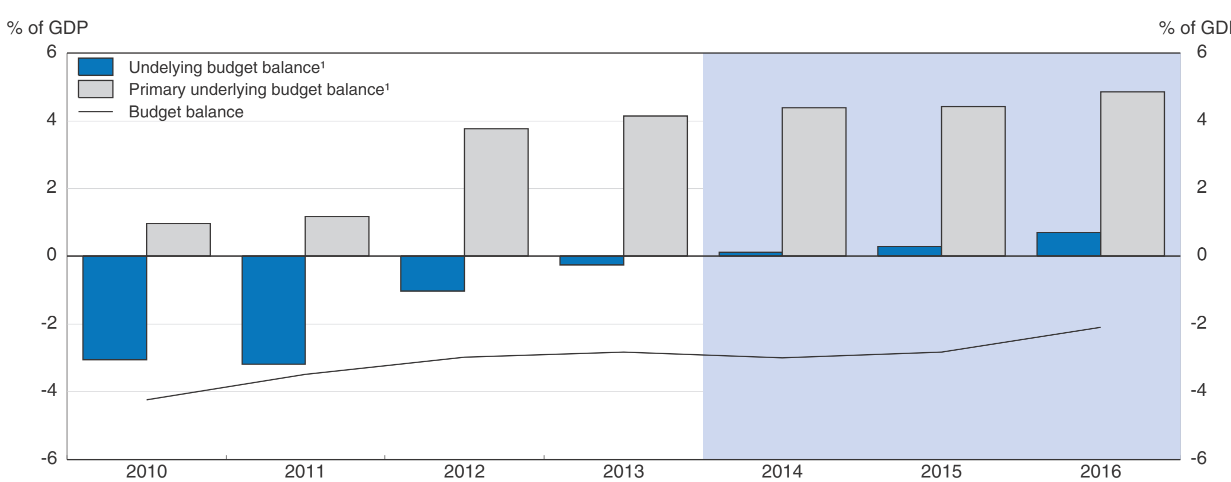
Other recommendations

- Carefully monitor the impact of the labour market reforms in reducing the recourse to legal action. Consider generalising automatic severance pay linked to length of service in case of dismissal for objective reasons (redundancies) at affordable levels no higher than the OECD average.
- Carefully monitor action to tackle youth unemployment.

Addressing fiscal and financial challenges

Italy's underlying fiscal situation has improved, although this improvement remains partly hidden by the large cyclical downturn. Past efforts have established the preconditions to put the debt-GDP ratio on a downward path when growth returns. Adjusting for the effects of the recession and excluding interest payments, the budget balance has improved by 4-5 percentage points of GDP since 2009, with most of the adjustment occurring in 2012 (Figure 9). A small structural surplus is expected by the OECD for 2015. National and EU commission estimates of the output gap are lower than the OECD's, so the budget is still estimated to be in structural deficit (Table 5). Further tightening was envisaged by the government in its April 2014 Stability programme, but was delayed in order not to stifle domestic demand, a position that was justified as the euro-area economy has proved exceptionally weak.

Figure 9. **The underlying primary budget surplus is now large**



1. As a percentage of potential GDP.

Source: *OECD Economic Outlook 96* (database).

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Table 5. **Fiscal consolidation in successive budgets**

Structural budget balance (structural primary balance), % GDP

	2011	2012	2013	2014	2015	2016	2017	Level of debt predicted for 2017, % GDP[1, 2]
2012	-3.6 (1.3)	-0.9 (4.6)	0.0 (5.9)	-0.2 (5.7)	-0.4 (5.7)			105
2013	-3.6 (1.4)	-1.3 (4.3)	-0.4 (5.0)	-0.3 (5.1)	0.0 (5.3)	0.0 (5.3)	0.0 (5.2)	115
2014		-1.5 (3.7)	-0.7 (4.2)	-0.9 (3.8)	-0.6 (4.0)	-0.4 (4.1)	0.0 (4.2)	125

1. Debt due to financing the EFSF and ESM, about 3.6% of GDP, is excluded. Debt projections in the original budgetary documentation have been adjusted to take account of the revised system of national accounts.
2. The 2012 budget did not project debt beyond 2015; the table shows an estimate for 2017 based on the projected figure for 2015.

Source: Ministry of Finance, "DEF Update" for successive years.

Reading note: The pre-budget documentation issued in September 2013 foresaw a structural deficit of 0.3% of GDP for 2014, a structural primary surplus of 5.1% of GDP. The same projections expected the debt-to-GDP ratio (adjusted for the exclusions in Note 1) to fall to 115% by 2017.

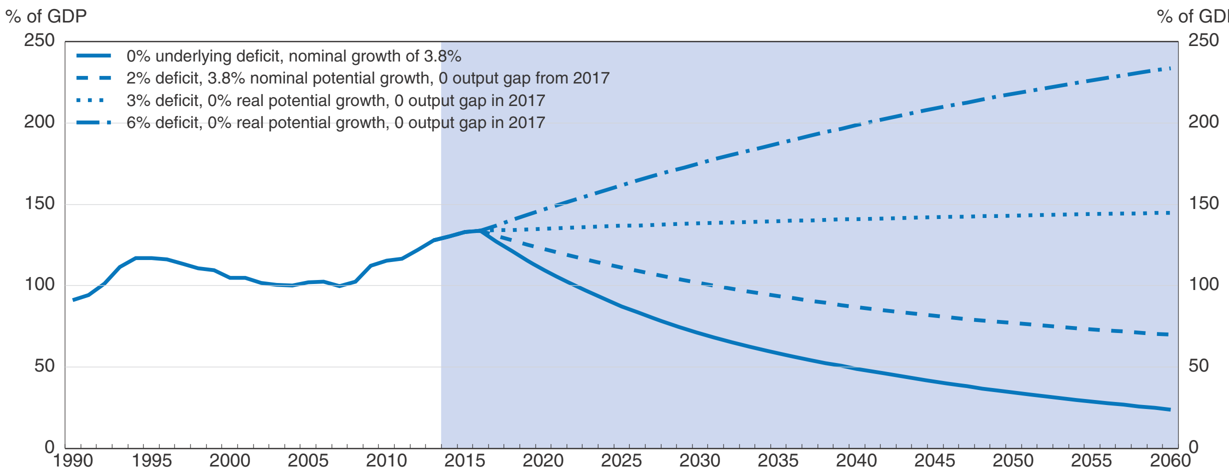
Official forecasts need to be cautious in order to avoid revenue shortfalls and spending overruns if growth turns out to be weaker than expected, especially when these forecasts are subject to large downside risks. In the future, verification of the official forecasts by the newly-created Parliamentary Budget Office – "Ufficio parlamentare di bilancio" (UPB) – may encourage greater cautiousness when forecasting short-term prospects for the economy and the fiscal position. The UPB's mandate does not require it to carry out forecasts itself; its ability to assess government forecasts would be improved if it nevertheless develops its own forecasting expertise.

On OECD calculations, Italy will have a structural budget surplus after the planned tightening in 2015-16. Even assuming a smaller output gap (a little over 4% in 2014 compared with the OECD estimate of nearly 6%), the Ministry of Economy and Finance estimates that the cyclically adjusted budget net of one-off measures will reach balance in 2017. Under the EU fiscal rules Italy would then have reached its medium term obligation. Technically, the debt rule (under which a country should keep tightening the budget if the debt-to-GDP ratio does not fall by one twentieth of the difference between its level and 60% each year) implies that Italy should tighten more. However, given the weak economy, the fiscal stance appears appropriate and Italy should take full advantage of the flexibility allowed by European Union rules.

With the budget in structural balance already in 2014, Italy has reached the point needed to bring the debt-to-GDP ratio down in the medium term. Once the output gap closes and growth converges on trend, debt would fall steadily, reaching 60% of GDP soon after 2030 (Figure 10; see also Denk, 2013; OECD, 2013a). With the lower estimate of potential output used by the government, debt will still fall, though somewhat more slowly. Estimates of potential output (and, therefore, the output gap) and also of future potential growth are quite uncertain. If growth does not return, or if current estimates of slack are much too high and the budget deficit returns to its 30-year average (6% of GDP), debt will decline more slowly or could drift upwards.

Sustaining a strong fiscal position will depend to a large extent on Italy's ability to keep the confidence of financial markets and to secure low risk spreads. Gross debt issuance is the equivalent of over 20% of GDP each year, so retaining the confidence of bond investors is essential. To achieve debt reduction, it will be essential to avoid repeating past mistakes and keep the budget balance on track. Once debt falls, some tax cuts or growth in non-interest expenditure would be feasible if interest rates remain low.

Figure 10. **Debt will decline if the budget remains balanced**



Note: Simulations assume the output gap closes by 2017. With a balanced budget and nominal growth at 3.8% of GDP (as in OECD@100) the debt-to-GDP ratio declines to 60% within 20 years, in line with EU rules.
Source: Ministry of Finance and OECD calculations and estimates.

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Keeping track of contingent liabilities

There are potential risks from hidden debt. One source of risk has been payment arrears of sub-national government and other bodies. It is still not known exactly how large these are; steps have been taken to improve centralised information on such debts. The government made provision to pay off the equivalent of about 4% of GDP of such debt during 2013-14. Later estimates were that the total figure was less than this; by late 2014 debt worth about 2% of GDP had been paid off and the government estimate that a further amount of no more than 1% of GDP was required. New accounting methods and the electronic invoicing already implemented should allow keeping better track of these liabilities. Other sources of possible future debt are contingent liabilities such as guarantees, liabilities of state-owned enterprises and potential costs of bank rescues that could be required under crisis conditions. Budget documentation shows contingent liabilities of EUR 99 billion (about 6% of GDP) in state guarantees, of which EUR 82 billion are to the financial sector. This data is regularly reported to Eurostat, helping to improve transparency; more could be done to assess potential vulnerabilities, which would enhance confidence in the sustainability of public finances.

Table 6. **Public debt, arrears and contingent liabilities, 2013**

	Billion EUR
Government debt, Maastricht definition	2 070
of which: Loans to foreign entities (bilateral, EFSF and ESM)	56
Contingent liabilities	
State guarantees	99
of which: Financial sector	82
Memorandum item:	
GDP, 2013	1 619

Source: Ministry of Economy and Finance, Bank of Italy and Istat; based on Eurostat methodology.

On the positive side, future spending commitments for public pensions have been brought under control. Following measures taken in 2012 they are even set to decline by as much as one per cent of GDP over the next 10 years before increasing somewhat thereafter. Nevertheless, they still represent a higher proportion of GDP in Italy than in most other countries.

Improving the efficiency of public spending

Given the prospect of a tight budget situation for some years to come, scarce public resources need to be used as efficiently as possible. The current and previous governments have launched a number of initiatives to improve efficiency in public spending. Benchmarking comparisons can say a lot about public spending efficiency. For example, in 2009 a comparison of expenditure on compulsory education with PISA results showed that many countries got better results with similar expenditure or the same results with lower expenditure (Boarini, 2009; OECD, 2009); since then education spending has been reduced significantly, with no deterioration in Italy's PISA results.

A spending review set up in late 2013 set out to apply benchmarking in a wide range of comparisons, though not all studies were completed. Other methods identified savings from better use of technology, reorganisation, amalgamation or abolition of public bodies, including at local and regional level. Taking all items together, the spending review estimated (on what it described as conservative assumptions) that the ratio of primary spending to GDP could be reduced by as much as 2 percentage points by 2016 (Commissario straordinario, 2014). These are large savings.

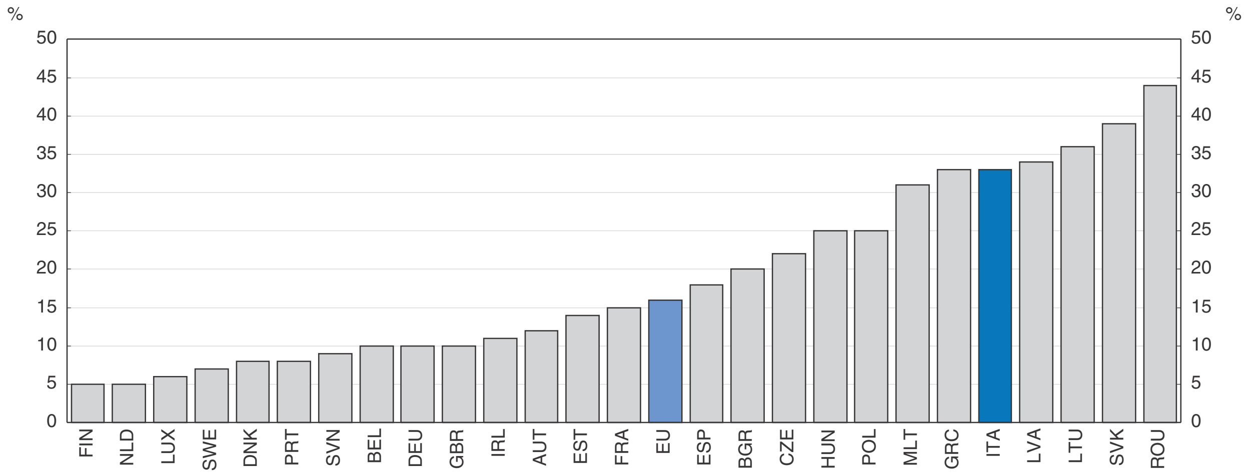
It is important that the approach of the spending review – continuous benchmarking and attention to the possibilities for improving efficiency – be adopted throughout the public administration. Otherwise inefficiencies will build up again even if initial economies are achieved. Some important steps are being made to ensure this, such as much wider use of the CONSIP public procurement agencies, as recommended in previous *OECD Economic Surveys*, and the development of the online database (SIOPE) for public scrutiny of the expenditure of local administrations.

Tax expenditures

Since all taxes create distortions and since high revenues are required to maintain fiscal sustainability, an efficient tax system is essential. One of the weaknesses of the Italian tax system is the large number of tax expenditures. Reducing them would broaden the tax base, allowing the same revenue to be raised with lower tax rates. A report by the Ministry of Finance in 2011 identified 720 individual cases of exceptions or reduced tax rates. A significant number of these, including many of the most expensive in terms of lost revenue, are a necessary part of an equitable and efficient tax system (for example, the tax thresholds below which no income tax is payable), but many of them are not and overall revenue losses are high. The 2015 budget eliminates seven tax expenditures (while introducing a number of others), but takes no action on VAT, whose structure is a key candidate for revision.

Application of reduced rates and exemptions under the VAT, mainly for redistributive purposes, results in revenue losses about twice as high in Italy as in other EU countries (Figure 11). Further losses arise from non-compliance, perhaps as much as 2% of GDP (Tyson, 2014). Many reductions and exemptions in VAT are presented as redistributive measures, but such policy objectives can generally be achieved at less cost with targeted

Figure 11. **VAT Gap estimates in the EU26 countries, 2012**



Note: The VAT Gap is the difference between the amount of VAT actually collected and the VAT Total Tax Liability (VTTL), in absolute or percentage terms. The VTTL is an estimated amount of VAT that is theoretically collectable based on the VAT legislation.
Source: European Commission, 2012.

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spending measures. Rich households receive as much benefit in aggregate terms from a reduced rate as do poor households; at worst, rich households benefit vastly more in aggregate terms than poor households. A case-by-case examination of this kind of measure is called for. Indeed, for future budgets, there will be a requirement for a special parliamentary session to discuss the annual survey of tax expenditures and decide possible eliminations or reductions. The planned revision of the social support system in Italy creates a good opportunity to phase out expensive tax expenditures while raising targeted support, potentially increasing the overall amount of redistribution.

The Internal Stability Pact

The Internal Stability Pact (ISP) is a set of measures intended to ensure that the financial situation of local, provincial and regional administrations is consistent with Italy's obligations under the European Union fiscal rules. Introduced in 1999, it has been progressively modified, with different targets for regions, provinces and municipalities and specific rules for health spending (the most important item and under the responsibility of regional government). The European Union fiscal rules concern only deficits and gross debt, so the ISP could have been designed to set objectives only for deficits, with consolidation targets for indebted administrations. In addition to these objectives, the ISP has also been used to pursue other objectives, notably pursuing national spending priorities by exempting some types of spending; the details change from year to year. Some of the early problems with different definitions of expenditure have been eliminated and new accounting procedures allow the central government to monitor sub-national developments more closely.

Enabling legislation in 2009 foresaw a move to a system of fiscal federalism in which central transfers to sub-national government were made on the basis of a standard estimate of the finance necessary to implement nationally mandated policies. Sub-national government could use local taxes to finance their own spending priorities, with a tax compensation mechanism to allow some redistribution to poorer regions and municipalities.

Some of the provisions of the 2009 law have been implemented. Standard costs now apply to health and an increasing range of other expenditure. But central transfers to sub-national government are still strongly influenced by historical spending rather than needs. The constitutional reform provides for financing sub-national government on the basis of standard costs.

Once the new constitutional arrangements are in place and fiscal federalism institutions are in place along the model of the 2009 enabling law, adjusted to be in line with the new structure of sub-national government, it should be possible to simplify the Internal Stability Pact. With well-defined sub-national taxation powers and expenditure responsibilities, there should be no need for central government to interfere in any detail. A simpler ISP should be able to focus largely on deficits, and debt reduction where necessary, rather than expenditure ceilings, and without special exemptions. A 2012 law foresees a balanced budget rule for local government as from 2016; the 2015 budget law imposes a balanced budget on ordinary regions already for 2015.

Recommendations for fiscal and financial policies

Key recommendations

- Stick to the planned fiscal strategy so as to bring the debt-to-GDP ratio safely onto a declining path.
- Promote greater use of centralised procurement, cost information systems and benchmarking.
- Urgently take action to achieve a lower level of non-performing loans in the banking sector, including through enhancing the insolvency regime applied to distressed borrowers.
- Continue efforts to reduce tax evasion through more effective enforcement and increase tax compliance through simplified collection procedures. Broaden tax bases, in particular by cutting the number of tax expenditures, and simplify the tax system.

Other recommendations

- Continue to assess the magnitude of budgetary contingent liabilities, including the vulnerability of public finances to risks associated with the financial sector.
- Make taxation more environmentally-friendly by reducing the gap between duties on diesel and petrol.
- Shift the tax burden from electricity to the energy products used to generate it, with the respective rates set to reflect the carbon emissions and other pollutants associated with each fuel.
- Implement the planned reform of the Internal Stability Pact to regulate only overall borrowing of sub-national government, with consolidation targets for indebted administrations. Replace its detailed provisions with a fiscal federalism structure that reflects the desired degree of decentralisation.
- If progress in reducing nonperforming loans remains slow, consider setting up a public specialised asset management company (“bad bank”) to accelerate the process, with due regard for state aid rules.

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ANNEX

Taking stock of structural reforms

This table summarises recommendations from previous OECD Economic Surveys *and notes significant measures that have been taken since the previous* OECD Economic Surveys *(May 2013).*

Public sector efficiency

Policy area, main recent OECD recommendations	Recent action (2014 unless otherwise indicated)
Ensure competition for provision of public services.	An Observatory for local public services was created in August 2014 to complete and update information on local public services management, especially urban waste, water services and local public transport.
Improve efficiency in civil justice administration: ● Streamline geographical organisation. ● Reform statute of limitations.	Revision of the judicial districts: by January 2014, 30 courts and related public prosecutor offices had been shut down; another 271 satellite offices are in the process of being closed. Sub-offices of the Regional Administrative Courts (TAR) will be closed by July 2015. Electronic filing of documents for civil proceedings is to become obligatory ordinary and appeal courts by mid-2015. Use of alternative dispute resolution procedures expanded. Acceleration of judgements in relation to public procurement.
Embed integrity and anticorruption tools within current structures of the Italian public administration: ● Build on transparency to move to freedom of information. ● Act decisively on evidence of inefficiency conflict of interest or corruption.	Reorganisation of entities overseeing transparency, corruption prevention and performance of the public sector into ANAC: AVCP, formerly responsible for overseeing public works projects, was absorbed into ANAC. Public Administrations have a dedicated space on their websites, called "Amministrazione Trasparente" where all relevant data are published. Three-year programmes for transparency and integrity are elaborated according to the ANAC directives. Not all administrations comply with these requirements. Wider use of the CONSIP public procurement agency Electronic invoicing obligatory for central administration by June 2014 and sub-national entitites by April 2015.
Widen use of performance indicators in public administration. Reinforce auditing mechanisms for regulatory and spending decisions. Consolidate technical expertise in Italy's Better Regulation bodies. Control the dynamics of regulatory inflation at regional level and focus on continuity and implementation of regulatory reforms. Monitor and evaluate progress towards administrative simplification, including through greater use of perception surveys. Less use of decree laws, do better *ex ante* impact assessment, more codification.	Most policy responsibilities of provinces reallocated to regions or communes. The Government may act on its substitution powers by 30 September 2014, to appoint special commissioners for the purpose of accelerating the planning and realisation of projects to upgrade sewage and purification systems. Creation of single administrative access point for foreign direct investors.

Product markets

Policy area, main recent OECD recommendations	Recent action (2014 unless otherwise indicated)
Ensure competition Authority uses increased power effectively.	
Remove unnecessary licensing in professional services. Remove quantitative restrictions on supply in services.	The principles of free access to regulated professions have been strengthened. No limits shall be imposed on the number of people certified to practice the profession, subject to exceptions based on reasons of public interest.
Reduce public ownership, especially in TV media, transport and energy utilities, local public services.	
Privatise and liberalise in energy and transport sectors. Get transport regulator into effective operation quickly; complete framework for regulation of water and other local public services, ensuring regulatory independence Introduce national oversight of regional regulatory competences (e.g. retailing, land-use planning).	Development of wholesale gas market, allowing market participants to take full advantage of spot prices on the gas market. Regulatory bodies have been reformed with a view to ensuring independence. The Transport Authority was made operational in January 2014. Its operations are fully financed by contributions from companies in the transport sector. The Authority is independent from Government, accountable to Parliament, and subject to judicial control.

Education

Policy area, main recent OECD recommendations	Recent action (2014 unless otherwise indicated)
Ensure the development of a comprehensive evaluation and assessment framework. Strengthen teacher quality. Improve the performance of vocational education and training system and provision of post-secondary vocational education. Improve business-academic research links, designing intellectual property rights in line with the incentives of researchers and business. Increase student contribution to the cost of tertiary education, provide income-contingent-repayment loans. Reduce dropout rates with more widespread selection at entry. Ensure merit-based recruitment to universities and accountability of recruitment panels. Give universities autonomy on strategic direction, recruitment and performance incentives. Build capacity and legitimacy in ANVUR, whose quality assurance reports should focus on student and research outcomes and be widely disseminated. Support innovation in education. Promote early access to care of good quality. Prevent school failure and reduce dropouts.	Reorganisation of course programmes in vocational education and training institutes, with a focus on technological innovations and the international expansion of markets. Schools to submit standardised self-assessment reports by July 2015, containing information on resources, learning outcomes and processes. This National Evaluation System is linked with the INVALSI evaluation system, with the aim of stimulating school self-assessment. Greater emphasis on *ex post* evaluation of universities and research insitutions. Simplification of the university financing system.

Labour market

Policy area, main recent OECD recommendations	Recent action (2014 unless otherwise indicated)
Increase participation: • Improve child care provision. • Share parental leave with fathers. Reduce tax wedge on labour income.	Tax reduction for low-paid workers introduced in mid-2014. A three-year exemption from social security contributions for new hires on indefinite contracts as from January 2015. Possible backward action: private sector employees may choose to take what was previously compulsory saving for a lump-sum retirement benefit (the "TFR") in their current pay; if they do so, the tax rate on that income is increased.
Monitor the impact of labour market reforms to evaluate impact and plan future policy.	The first Ministry of Labour monitoring report published in January 2014 describes the situation with regard to entry and exit flexibility, and the status of social safety nets. In August 2014, the second monitoring report covered data related to social safety nets during the 2011-13 period.
Move to more inclusive labour market by reforming permanent employment protection and reducing labour market duality.	*De facto* removal of nearly all restrictions on use of fixed term contracts, with up to 5 renewals within a maximum overall duration of three years. Simplification of administrative procedures and requirements for declaration of labour contracts and certification of social insurance contributions and benefit entitlement. Apprenticeship contracts made easier to use.
Promote greater wage responsiveness to productivity, to help restore competitiveness. Co-ordinate social benefit providers with needs of active labour market policy. Encourage more employer engagement in vocational education, including through more and work-based training.	Gradual phasing in of "*Assicurazione Sociale per l'Impiego*" (or ASpI), unifying the standard unemployment benefit and a special benefit following collective dismissal (*Indemnità di Mobilità*), currently in transition and achieved toward 2017. A pilot programme of social assistance, "*Sostegno per l'Inclusione Attiva*" (or SIA), targeted to households of specific categories, will be gradually extended to the whole country. An ad hoc mission office has been set up within the Ministry of Labour and Social Policies, to ensure that recipients of income-support benefits find a new job.

Policy area, main recent OECD recommendations	Recent action (2014 unless otherwise indicated)
	A 2014 enabling law mandates: ● Introduction of a new indefinite employment contract with dismissal protection increasing with length of service. ● Pursuit of the "ASpI" reforms, phasing out most of the *Cassa Integrazione* extensions beyond strict temporary short-time working. ● Set-up of the National Employment Agency, responsible for an efficient conditionality approach for provision of unemployment benefits (mutual obligation) and for harmonisation of ALMPs across regions. ● Introduction of a legal minimum wage. ● Facilitating reconciliation of work and childcare through maternity allowance, tax credits for low paid parents of young children, and increased provision of childcare services.

Boosting innovation

Policy area, main recent OECD recommendations	Recent action (2014 unless otherwise indicated)
Make science, technology and innovation policy more business-oriented and receptive to the varied needs across the whole spectrum of firms, including SMEs. Simplify and rationalise public support for business R&D and innovation, by achieving an appropriate mix of direct and indirect measures. Improve linkages between the business sector, universities and the public research system, including through mobility of researchers, and appropriate intellectual property rights. Foster the creation and growth of start-up firms, by lowering regulatory barriers, simplifying bureaucracy, and supporting the collateralisation and securitisation of innovation-related assets (e.g. through adhesion to the European Unitary Patent).	Simplification of criteria for creating start-ups. 50% tax credit (corporate income tax and regional tax on prodctive activity) on the R&D expenditure of businesses over the 2014-16 period. Subsidies to digitalisation and technological upgrade of SMEs (vouchers of EUR 10 000). Incentives for self-employment business initiatives: subsidised long-term loans for investments. Tax subsidies to ultra-wide broadband investment beyond that already foreseen (in mid-2014) in service providers' business plans. Tax credit for the hiring of highly qualified professionals, with a research doctorate or a specialised degree in a technical or scientific field, involved in research and development activity. The financial resources available for the tax credit are: EUR 25 million for hiring carried out in 2012; EUR 33.2 million for those in the year 2013; EUR 35.5 million for 2014 and EUR 35.5 million for 2015. Tax deductions for investors in innovative start ups for 2013-15. Rate of deduction varies from 19% to 27%.
Enhance corporate governance, protection of small shareholders. Encourage mergers, including cross-border mergers, in financial sector governance. Reform bankruptcy legislation.	The "Fail-fast" initiative for start-ups has been established. With this initiative, the time required to issue a judicial liquidation order has been reduced for start-ups in distress. A weakness of the 2012 bankruptcy reform allowed companies to protect themselves from creditors without providing sufficient evidence to a court. This has been altered by requiring the submission of a preliminary recovery plan. Banking, financial and insurance companies may deduct certified losses due to write-downs or write-offs of debts from corporate and personal income tax (IRES and IRAP), over a period of five years.
Ensure equal treatment of all shareholders, in both private and partially publicly-owned companies.	

Environment

Policy area, main recent OECD recommendations	Recent action (2014 unless otherwise indicated)
Fully privatise water supply and treatment, and waste-management companies, strictly enforcing public tendering rules.	With the aim – among others – of accelerating the correct fulfillment of the tendering procedures, including in the water sector, the Observatory of local public services has been created and is now fully operational.
Revisit national legislation on water pricing. Allow water charges to fully reflect costs including the need to renew infrastructure. Pricing should also reflect the polluter-pays principle and not be a function of the nature of the water consumer.	The sectoral Authority introduced the "Water tariffs method" (*Metodo Tariffario Idrico* – MTI) in 2014, Four possible pricing methods are available to take account of varying investment and operational needs; the eventual aim is to converge on a single pricing scheme.
Protect groundwater resources through effective licensing, abstraction charges and tradable water rights.	
Verify that absence of competition in packaging waste recycling consortia does not reduce efficiency.	
Make greater use of green taxation, with taxes as a function of economic and environmental costs. Eliminate all energy tax rebates, except those that reflect differences in externalities.	The 2014 enabling law on tax reform provides for greater use of environmental taxation.
Encourage urban congestion and pollution charging schemes. Ensure objective and transparent use of cost-benefit analysis in assessment of projects.	
Ensure the White Certificate scheme addresses only true information barriers. Ensure efficiency-related building standards on new property are properly enforced.	

Thematic chapters

Chapter 1

Labour market reform for more and better quality jobs

A well-functioning labour market is indispensable to promote job creation, increase living standards, and develop a cohesive society. In Italy, the various deficiencies of the labour market have resulted in high unemployment, low labour force participation and job-skill mismatch. These deficiencies have contributed to the problem of allocation of resources, income distribution, and low productivity, reducing people's well-being. The current government, following on past governments' reforms, is introducing a package of labour market reforms – the Jobs Act – to improve the labour market in a consistent way. The reform will make the labour market more flexible and inclusive, and reduce duality. The long-lasting problem of effective enforcement will need to be overcome, with an increased focus on rapid implementation by the current government. A set of well-designed institutions, not only labour market policies but also the education system and product market regulation, would encourage higher labour force participation, especially among women, and produce more and better quality jobs in a more skill-intensive economy.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

In Italy, unemployment is high, especially among youth, and labour force participation is low, notably among women and older people, particularly in southern regions. The mismatch between the supply and demand of skills is significant, in particular among youth. Labour productivity has stagnated for many years, but real wages in the aggregate have continued to increase, resulting in unit labour costs rising faster than in other countries. Income growth, however, has not been shared equally among workers, and the widening inequality of market income has been barely remedied by the redistribution system. The duality of the labour market, with around half of workers benefiting from stringent protection legislation and a significant minority having precarious or less protected jobs, has led to increased inefficiency and inequality.

The government is introducing a labour market reform package, the Jobs Act. It simplifies the different employment contracts, addresses the problem of labour-market duality, seeks to improve the income losses of job seekers, and strengthens activation policies. Successful labour market reform would promote more and better quality jobs and improve the distribution of the benefits of growth. Furthermore, a set of well-designed institutions, improving the quality of the labour force and stimulating entrepreneurial activities, would help to boost long-term prospects associated with better labour outcomes. The present chapter assesses how well the government's plans meet these needs and what further measures are necessary.

The main findings of this chapter are:

- In Italy, labour productivity has trended down since the mid-1990s. Institutional factors hamper a better allocation of resources and business incentives in general. The government is introducing a comprehensive labour market reform – the Jobs Act – and implementing successive reforms in the product market in order to unleash potential of Italian firms and workers.
- The Jobs Act will make the labour market more flexible by protecting individuals rather than specific jobs. Overall, employment protection legislation will be less stringent, facilitating job creation. The unemployment benefit system will be extended in association with enhanced support to job seekers (active labour market policies). These measures will encourage activity and reduce unemployment. The wage setting system should be more flexible, which would reinforce the beneficial effects from the Jobs Act.
- In the medium- to long-term, labour force participation, the skill intensity of workers and entrepreneurship are key for higher and sustainable growth, but currently all these are weak in Italy. For the labour market to create more jobs, workers' skills should be enhanced and job-oriented, and more quality-improving innovations and adoption of leading technologies would be required. This will be facilitated by a better reallocation of resources.

Table 1.1. **Stocktaking of recent and current labour market reforms**

2011	**Pension reform** All age requirements and the contribution requirements for full pension to be linked to life expectancy. The required contribution period to obtain full pension are currently 42 years and 3 months for men and 41 years and 3 months for women which will continue to be increased in line with life expectancy.
2012	**A comprehensive labour market reform ("the Fornero reform")** Relaxation of employment protection rules on permanent contracts, notably limiting the possibility of reinstatement following unfair dismissal (see Box 1.2). Reshaping incentives to hire on fixed-term contacts; no justification required for the first fixed-term contract (duration: no longer than one year); the interval period between two fixed-term contracts was extended. Restricting atypical labour contracts (many of them out of the social security system, such as "collaboration"). New unemployment benefit (*Assicurazione Sociale per l'Impiego*, "ASpI"), unifying the standard unemployment benefit and a specific benefit following collective dismissal (CIG severance pay, see Box 1.3). Introduction of "Mini-ASpI", a benefit for those with shorter contribution records, thus extending the unemployment benefit coverage to temporary workers.
2013	**Adoption of Italian Youth Guarantee plan** Ensuring good-quality offers of employment, continued education, and an apprenticeship or a traineeship. Setting up a *Struttura di missione* to harmonise active labour market policy designed and implemented at local level.
2014	**A comprehensive labour market reform – The Jobs Act** Liberalisation *de facto* of standard fixed-term contracts (provided that the maximum duration of successive contracts is no longer than three years). Simplification of administrative procedures and requirements (for e.g. declaration of labour contracts). Tax refund for low-paid workers in 2014, which will be extended to 2015.
2014 – on-going and/or planned	**Launch of Italian Youth Guarantee programme (May 2014)** **A comprehensive labour market reform – The Jobs Act** Introduction of a new standard employment contract: less rigid dismissal protection than the current open-ended contract. More universal unemployment benefits, integrating "ASpI" and "mini-ASpI" under consistent eligibility requirements, with its coverage extended to all workers (minimum contribution records required). Phasing out most of the *Cassa Integrazione* extensions ("CIG", wage supplementation for short-time working scheme, see Box 1.3). A pilot programme of social assistance (*Sostegno per l'Inclusione Attiva*, "SIA"), targeted to households of specific categories, possibly extended to more households in poverty. Set-up of the National Employment Agency, responsible for an efficient conditionality approach for provision of unemployment benefits (mutual obligation) and for harmonisation of ALMPs across regions. Introduction of a legal minimum wage on an experimental basis.

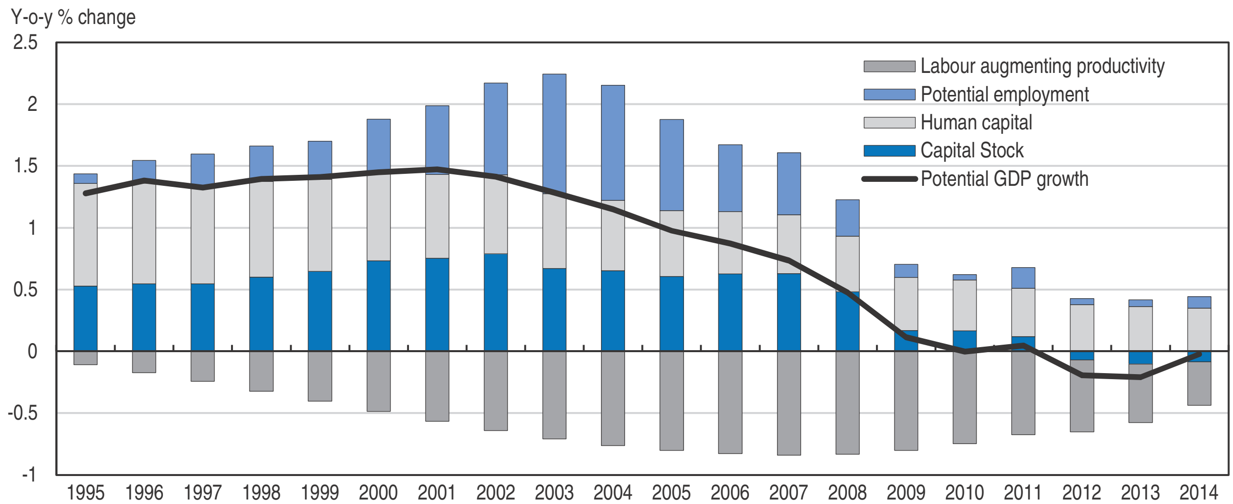
The labour market suffers from structural problems

In Italy, both labour utilisation and labour productivity are low. Productivity has trended down since the mid-1990s (Figure 1.1), because of misallocation of resources and other challenges such as unfavourable innovation and business environment (OECD, 2013a). More specifically, potentially more productive firms cannot attract more resources and thus cannot grow, while less efficient firms – many of which are old and small – maintain resources and market share (Andrews et al., 2014). Weak prospective on business conditions associated with low labour productivity, in turn, does not encourage firms to create jobs.

Low labour utilisation

The employment rate and the labour force participation rate have been low for a long time, especially in southern regions. The unemployment rate has increased to a high level by historical standards in mid-2014, when it reached 12.5%. The youth unemployment rate is among the highest (Figure 1.2). The labour force participation rate remains low, although it has increased slightly in the past years. The female labour force participation rate is the third lowest (Figure 1.3). Labour force participation among older people has increased markedly but its level remains still well below the OECD average (Figure 1.3). High unemployment and low labour force participation are particularly prevalent in southern

Figure 1.1. **Italy's potential output has stagnated mostly due to weak productivity**



Source: OECD *Economic Outlook 96* (database).

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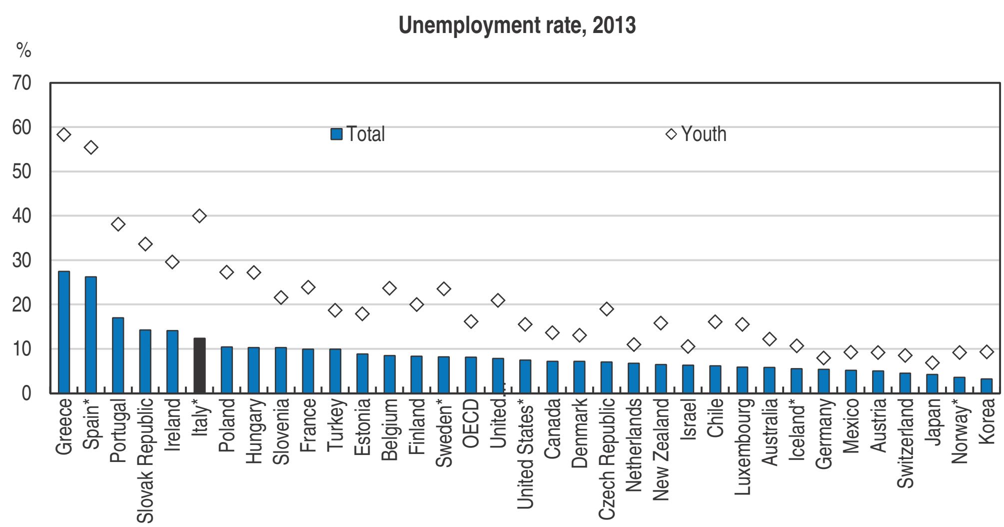
Figure 1.2. **Unemployment is high and increasing especially among youth**



Note: Countries with *: the lower age limit is 16 instead of 15, for Iceland up to 2008, Italy after 2009, Norway up to 2005 and Sweden up to 2006. OECD: Weighted average.

Source: OECD (2014), *OECD Employment Outlook 2014*, OECD Publishing, Paris *http://dx.doi.org/10.1787/empl_outlook-2014-en.*

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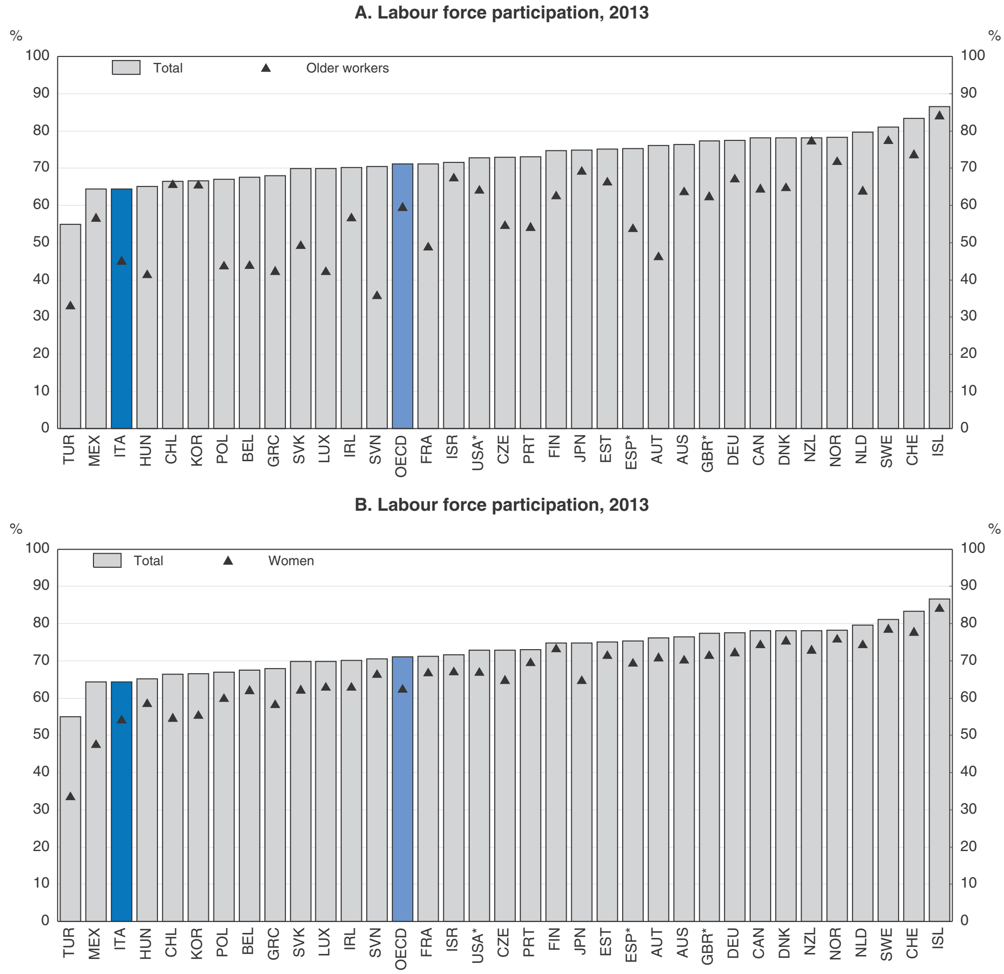
regions, possibly in association with weaker economic activities (Figure 1.4). A large number of workers are employed in the underground economy, estimated to be equivalent to 11.8% of total employment and concentrated especially in southern regions, according to estimates by Istat.

The longer unemployment remains high, the greater the risk that long-term unemployment will persist, caused by damages to the skills and employability of job seekers (hysteresis effects). The structural unemployment rate is estimated to have risen from 8.0% in 2007 (just before the global crisis) to 9.0% in 2014 (OECD, 2014a, Box 1.1). Currently, more than 50% of the unemployed fall into the category of long-term

Figure 1.3. **Labour force participation is low especially among women and older people**



Note: Countries with *: the lower age limit is 16 instead of 15, for Iceland up to 2008, Italy after 2009, Norway up to 2005 and Sweden up to 2006. OECD: Weighted average.
Source: OECD (2014), *OECD Employment Outlook 2014*, OECD Publishing, Paris, *http://dx.doi.org/10.1787/empl_outlook-2014-en*.

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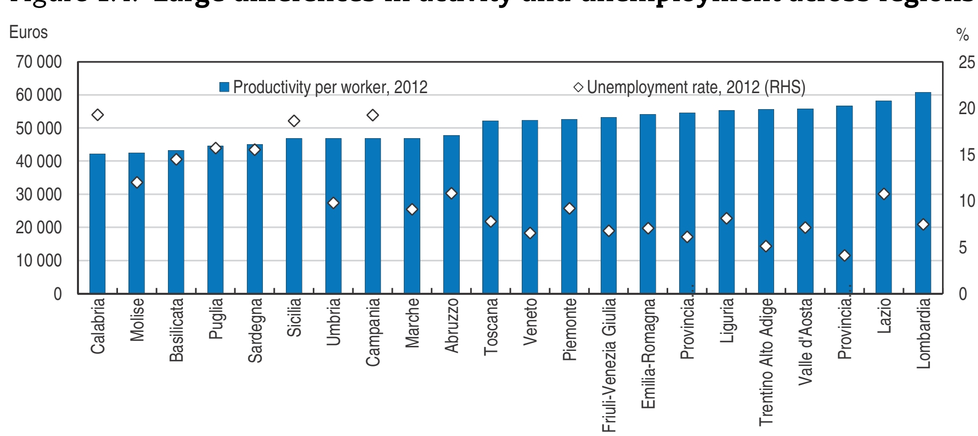
Figure 1.4. **Large differences in activity and unemployment across regions**



Source: Regional Accounts, Istat.

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unemployment – those who remain unemployed for more than one year. Those who remain unemployed for a long time tend to lose necessary skills and employability. Thus, unemployment due to cyclical weakness may become increasingly entrenched, leading to high rates of structural unemployment, which would continue to persist even after the economic recovery. According to OECD estimates, two out of three job seekers are likely to remain unemployed even when the economy will have fully recovered (Rusticelli, 2015).

The labour market is divided between those who are well-protected with open-ended contracts in large firms and those who are marginally attached with temporary or atypical contracts – the "duality" in the labour market. Flexible employment contracts have their merits because they facilitate the adjustment of the labour force when necessary, but these are known to increase job insecurity rather than to serve as a stepping stone for temporary workers (OECD, 2014b). Such jobs are disproportionately held by youth, especially less-educated and lower skilled workers and in most of the cases these jobs are not a voluntary choice (OECD, 2014b). According to Labour Force Survey data, nearly 15% of

Box 1.1. **The new OECD modelling framework for estimating structural unemployment**

The OECD recently revised the specification used to model the relationship between inflation and structural unemployment for all OECD countries. The fall in inflation over the course of the Great Recession has been surprisingly modest given the massive increase in unemployment. Lower sensitivity of inflation to demand has been attributed to a variety of factors, especially the increased credibility of monetary authorities, leading to better anchored inflation expectations (IMF, 2013). The assumption that inflation expectations are anchored to inflation targets has been incorporated into the Phillips curve equation used to estimate equilibrium unemployment. This generally leads to estimated equations with better econometric properties and for some countries leads to a significant change in the assessment of labour market slack.

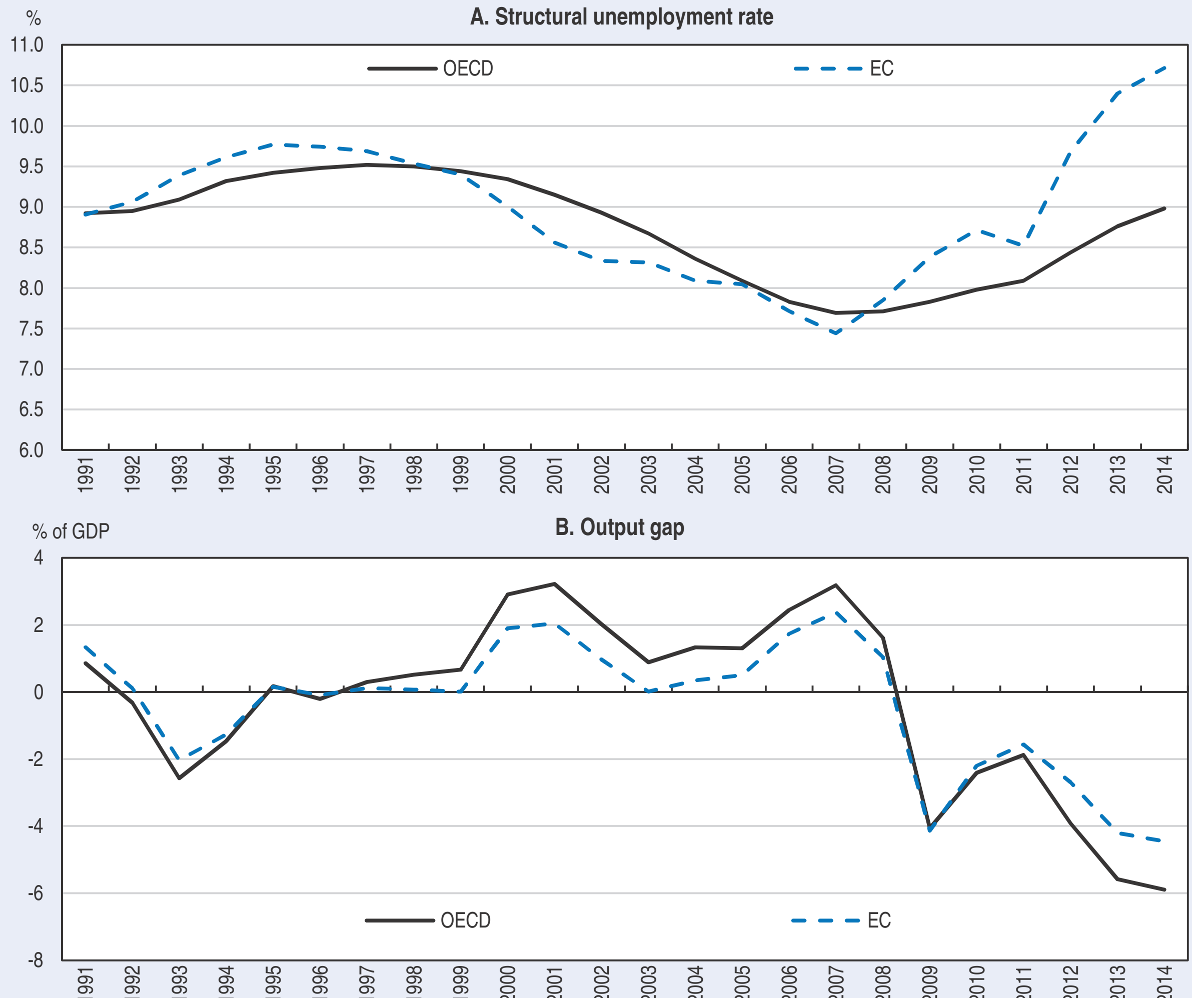
The implications for inflation of a negative unemployment gap (i.e. actual unemployment exceeding the equilibrium rate) are different between the two different specifications. The previous "accelerationist" model implies a continuing process of disinflation which will persist as long as the unemployment gap remains. The "anchored expectations" model implies that inflation will fall to a new level below expectations, but will not continue falling (for details see Annex 2, Chapter 1, *OECD Economic Outlook 96*).

The different models can generate different estimates of structural unemployment. Where unemployment has risen steeply and inflation has stabilised at a low level: the "accelerationist" model would reconcile relatively stable inflation with a smaller negative unemployment gap and a higher equilibrium unemployment rate (previously referred to as a NAIRU); the "anchored expectations" model would match a low level of inflation with a larger persistent unemployment gap and a lower equilibrium unemployment rate (for details, see Rusticelli et al., 2015). For Italy, the accelerationist model would have produced an estimate of the NAIRU in 2014 of 11.0% whereas the anchored expectations model gives an estimate of 9.0%. Differences in the equilibrium unemployment rate explain most of the difference between the OECD's estimate of the 2014 output gap of -5.9% and the European Commission estimate of -4.5% (the latter being associated with a "NAWRU" of 10.7%).

Estimates of equilibrium unemployment are by nature unobservable and hence subject to great uncertainty, especially so in the current economic environment. On balance, however, the new model seems to be preferable for Italy: relatively stable structural unemployment is in line with the stable relationship between job openings and unemployment (no apparent shift in the Beveridge curve, see OECD, 2014b). It is also difficult to see why structural unemployment would increase very sharply within a short period of time (for instance, skills would not become obsolete so quickly).

Box 1.1. **The new OECD modelling framework for estimating structural unemployment** *(cont.)*

Figure 1.5. **OECD estimates of structural unemployment and the output gap differ from the European Commission**



Source: OECD *Economic Outlook* (database); European Commission, *AMECO Database*.

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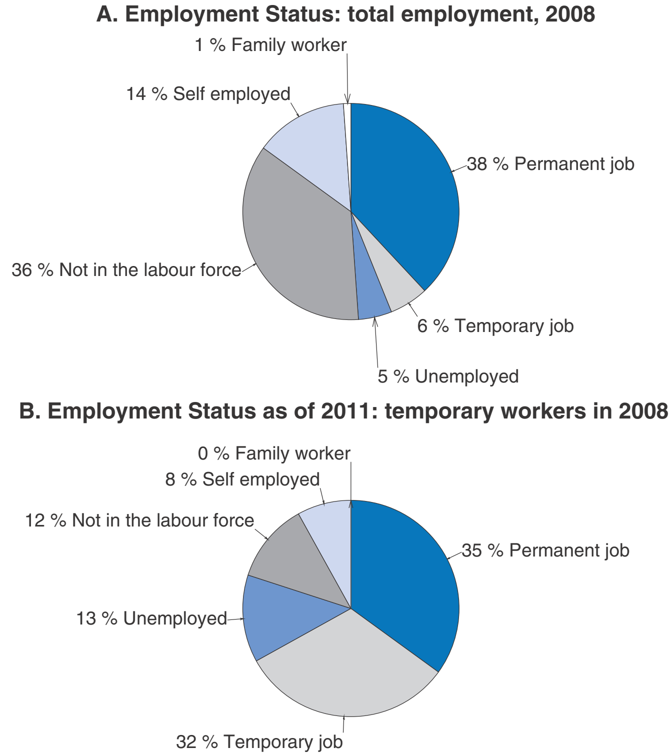
workers are on flexible contracts and, among such workers, only a third will be able to obtain an open-ended contract three years later, while a quarter will be unemployed or have left the labour market (Figure 1.6).

High labour costs

Labour costs have evolved faster than labour productivity, reducing competitiveness. Wages responded little to a large labour slack, in contrast with other euro area countries facing financial stress. Italian firms have been the most reluctant to cut real wages in the OECD area, and this contrasts starkly with other financially-stressed euro area countries where incidence of nominal wage cuts has become more frequent (OECD calculations from

Figure 1.6. **Limited employment prospects for temporary workers**



Note: The reported figures may be biased as it does not take in account of the distribution of the irregular workers (in the underground economy). Istat estimates that the number of such workers is equivalent to 11.8% of total employment.

Source: Eurostat EU-SILC (Community Statistics on Income and Living Conditions) Survey.

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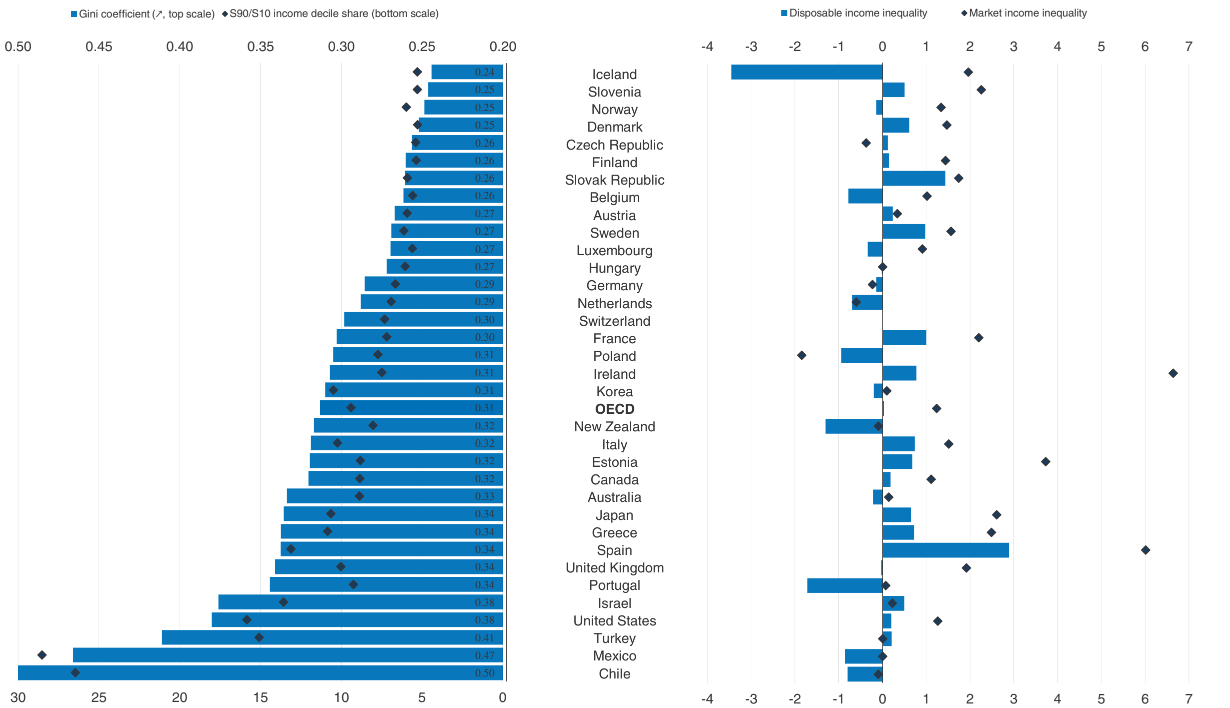
Eurostat EU-SILC survey; OECD, 2014b). More wage flexibility would have facilitated the recovery while reducing the risk of hysteresis effects. These findings reveal some problems in the wage setting system.

Wage rises have not been shared equally among workers and market income inequality has continued to widen. During the crisis and recovery, real wage growth declined by 1% at the bottom decile of the earnings distribution (where the share of temporary workers is higher), while it increased by 1% at the median (OECD, 2014b). This occurred despite the predominance of labour adjustment at the margin, i.e. shedding temporary workers, which in isolation tends to bring up the average earnings at lower deciles. Also, many temporary workers do not necessarily work all year long. Against this backdrop, inequality in annual labour earnings has increased (Figure 1.7).

Figure 1.7. **Both earnings and household income inequality have increased**

Panel A. Gini coefficient of household disposable income and gap between richest and poorest 10% in 2010

Panel B. Percentage point change in the Gini coefficient at disposable and market incomes between 2007 and 2010



Note: Gini coefficients refer to 2009 for Hungary, New Zealand, Japan and Turkey, and 2011 for Chile instead of 2010, and to 2006 for Chile and Japan, 2008 for Australia, Finland, France, Germany, Israel, Mexico, New Zealand, Norway, Sweden and the United States instead of 2007. Data for Switzerland are not available for 2007.

Source: OECD (2014), *Society at a Glance 2014*, Chapter 5, OECD Publishing, Paris, *www.oecd.org/social/societyataglance.htm*; *OECD Income Distribution Database*, *www.oecd.org/social/inequality.htm*.

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Household income inequality

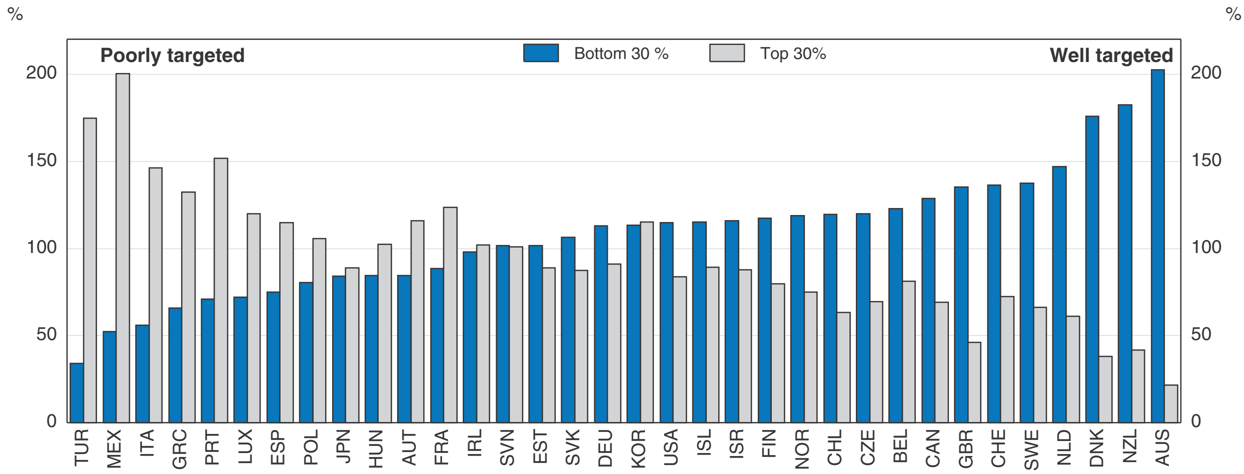
Net household income inequality has increased and the redistribution system has not been well designed to remedy it. As identified by a comprehensive OECD study on inequality (OECD, 2011a), labour earnings inequality as well as longer jobless spells contributed significantly to the overall inequality. In Italy, rising household income inequality has not been contained through the redistribution system. The unemployment benefit system has not been universal, excluding *de facto* workers with flexible employment contracts due to short tenure, and any non-contributory benefit (on account solely of low income) did not exist. Overall, Italy's social safety net is currently not well designed (Figure 1.8), though the needs for social assistance are increasing with the weak economic situation.

The government's labour market reform package: Will it work?

The government's programme for the labour market and social policy is broadly set out in the Jobs Act. The Act seeks to outline a number of broad objectives for the labour market, which the government will be entrusted to implement. It aims to go further than earlier reforms. Its broad orientation seems to be adequate and consistent: reforming employment protection legislation and its dualism, which would allow more efficient turnover, and extending social safety nets as well as strengthening activation policies, which would help people attached to the labour market.

Figure 1.8. **Social transfers are currently poorly targeted**

Average total cash transfers received by low- and high-income groups,percentage of average transfers in 2010



Note: Transfers include all social benefits. The reference year is 2009 for Hungary, Japan, New Zealand, Switzerland and Turkey. "Bottom 30%" and "top 30%" refer to average public transfers received by decile Groups 1 to 3 and 8 to 10, respectively. Decile groups are determined in relation to household disposable income after accounting for taxes and transfers. All incomes and transfer amounts are adjusted for household size.

Source: OECD (2014), *Society at a Glance 2014*, Chapter 1, OECD Publishing, Paris, *www.oecd.org/social/societyataglance.htm*; *OECD Income Distribution Database*, *www.oecd.org/social/inequality.htm*.

How to read this figure: In Portugal, the average total transfer payment received by low-income families (in the bottom 30% of the income distribution) is 71% of the average payment across all families, and less than half of the average benefit payment received by high-income families, who receive 52% more than the average family.

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Employment protection legislation (EPL)

Why EPL matters?

Strict EPL hampers efficient allocation of labour resources and induces unfavourable labour outcomes such as higher unemployment and lower productivity. By imposing costs on the firm to adjust its workforce, strict dismissal protection may inhibit efficient job separations and, indirectly, reduce efficient job creations (e.g. Mortensen and Pissarides, 1994, 1999). For Italy, Boeri and Jimeno (2005) empirically confirm such effects of employment protection on job turnover (see also similar findings by Schivardi and Torrini, 2008; Kugler and Pica, 2008). Low turnover matters especially when technological changes progress faster. Caballero et al. (2004), for example, find that countries with stricter EPL have slower rates of adjustment of productivity to long-run levels.

Italy has a problem of allocation of resources which can be evaluated in terms of the correlation between firms' productivity and their market share. Andrews and Cingano (2014) show that labour productivity in the Italian manufacturing industry is only around 10% higher than it would be if employment were allocated randomly across firms (Figure 1.10). They also show that this allocation problem is explained by institutional factors, including EPL along with product market regulations and bankruptcy regimes. For instance, according to their estimates, a reduction by 1 point (e.g. from 3.0 to 2.0 on the 0 to 6 scale used in Figure 1.9) in the OECD EPL indicator would improve labour productivity by around 6.5%.

In the labour market, inefficient allocation of resources can be illustrated by job-skill mismatch. If more productive firms find it more difficult to attract skilled labour and gain market shares because less productive firms retain them, thus the share of over-skilled workers is high, then the reallocation mechanism is hampered. Adalet McGowan and Andrews (2015) find such job-skill mismatch as well as under-qualification (which reduces productivity in each firm) contributes to reducing overall productivity, especially in Italy (Figure 1.11). They also attribute this reallocation problem to institutional factors, including EPL.

Legal risk and financial costs associated with unfair dismissal provisions have been identified as most burdensome and affecting gross worker flows in general (OECD, 2013b). For Italy, the OECD Employment Protection Legislation indicators which aggregate different aspects of EPL show that uncertainly on the decision of fair/unfair dismissal as well as

Box 1.2. **Employment protection legislation for different employment contracts before the reform**

The OECD Employment Protection Legislation indicators present quantitative estimates of the degree of stringency of EPL in a comparable way across countries. The indicators take into account the relevant legislation, collective agreements and case law.

There are three broad categories: protection of permanent workers against individual dismissal, additional provisions for collective dismissals, and regulation on standard fixed-term contracts. These are also broken further into details, for instance the first broad category consists of: protection against unfair dismissal; notice and severance pay for no-fault individual dismissal and procedural inconvenience. Among them, protection against unfair dismissal, which is the major issue in this chapter, includes: definition of justified or unfair dismissal; length of trial period; compensation following unfair dismissal; possibility of reinstatement following unfair dismissal; maximum time for claim.

Concerning protection against unfair dismissal, definition of justified or unfair dismissal and compensation following unfair dismissal are found to be relatively more stringent for Italy (Figure 1.9); the former is due to the fact that dismissal for objective reasons (production and technological factors in the firm) is judged as unfair if a transfer and/or a retraining to adapt the worker to different work is not attempted prior to dismissal ("*repechage*"); the latter is because such compensation is equivalent to 21 months of salary for a worker at 20 years of tenure (a model case) against the OECD average of 6 months. For the case of smaller firms employing 15 or less employees, less strict provisions are in force.

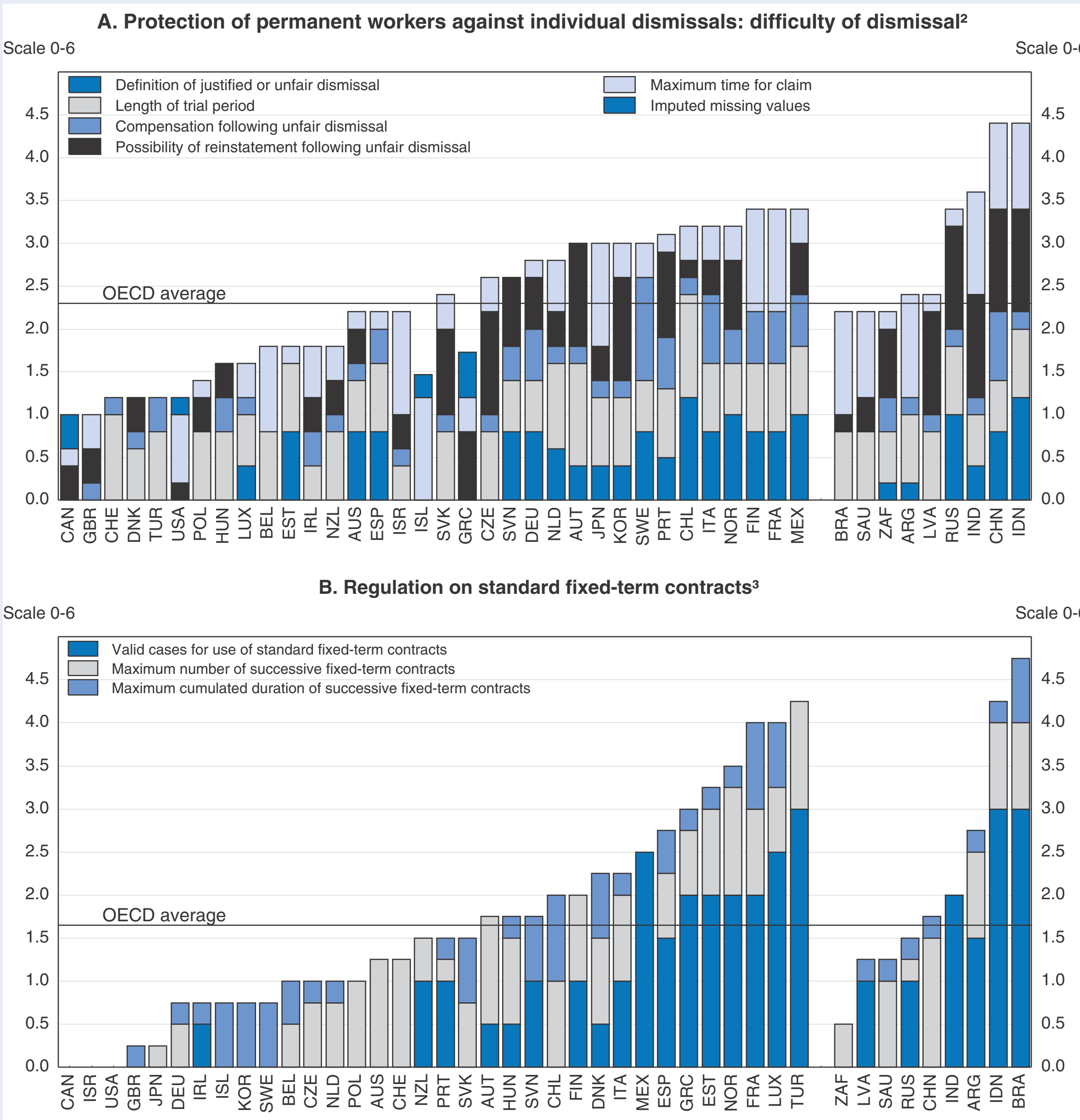
The first two broad categories focus on stringency of EPL on dismissal of permanent workers whereas the last one on the readiness of the use of flexible types of employment contract. OECD (2014b) considers stringency of EPL on dismissal of temporary workers during the contract and finds that there are no significant differences and costs or restrictions in the case of termination at the end date do not exist in general. For Italy, the EPL indicator on fixed-term contracts has been reduced to the level closer to the OECD average, following the measures introduced in early 2014.

For details and comparison across countries, see Country Notes for OECD Employment Protection Legislation indicators.

In the case of redundancy parties must attend pre-trial conciliation organised by the Provincial Labour Office or through dispute settlement procedures set out in collective agreements. If no settlement is reached, the behaviour of parties in the conciliation stage is considered in court rulings. For details and comparison across countries, see Table 2 Annex 2.A2, Chapter 2 in *OECD Employment Outlook 2013* (OECD, 2013b).

Box 1.2. **Employment protection legislation for different employment contracts before the reform** *(cont.)*

Figure 1.9. **Employment protection legislation[1] for permanent workers has been restrictive**



1. Data refer to 2013 for OECD countries and Latvia, 2012 for other countries.
2. The figure presents the contribution of different subcomponents to the indicator for difficulty of dismissal. The height of the bar represents the value of the indicator for difficulty of dismissal. For the sole purpose of calculating the indicator of difficulty of dismissal, missing values of specific subcomponents are set equal to the average of other non-missing subcomponents for the same country, excluding the maximum time for claim.
3. The figure presents the contribution of different subcomponents to the indicator of regulation for standard fixed-term contracts (EPFTC). A standard fixed-term contract is defined here as a generic employment contract with a precisely-specified end date (in the form of day, month and year at which the employment relationship is set to end, if the contract is not renewed). The height of the bar represents the value of the EPFTC indicator.

Source: *OECD Employment Protection Legislation* (database).

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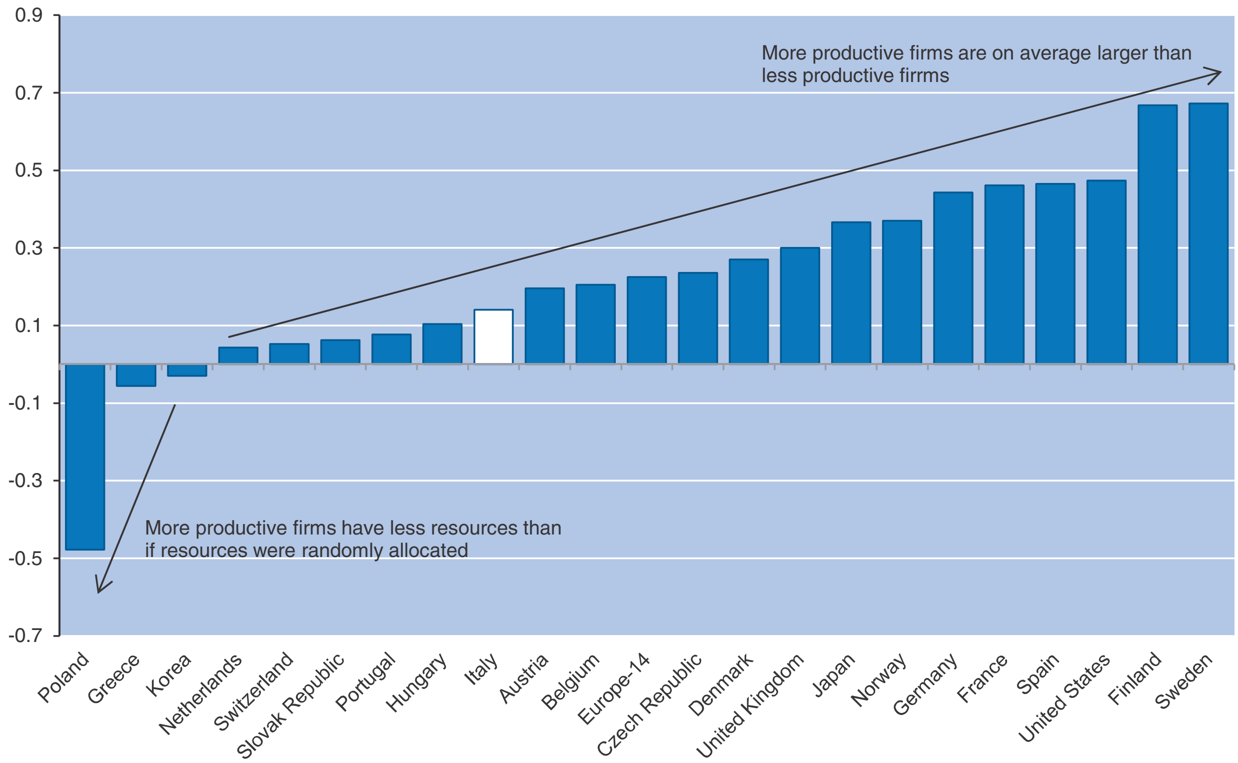
Figure 1.10. **Allocation of labour to the most productive firms is limited**

Covariance across firms between firm size and labour productivity; log points; manufacturing sector in selected OECD countries in 2005



Notes: The estimates show the extent to which the firms with higher than average labour productivity have larger employment shares. In most countries, the covariance between productivity and employment share is positive, suggesting that the actual allocation of employment boosts manufacturing labour productivity, compared to a situation where resources were allocated randomly across firms (this metric would equal zero if labour was allocated randomly). For example, manufacturing labour productivity in the United States is boosted by around 50% due to the rational allocation of resources. Europe-14 includes: Austria, Belgium, the Czech Republic, France, Greece, Germany, Hungary, Italy, the Netherlands, Portugal, Poland, Spain, the Slovak Republic and Switzerland, and is obtained by aggregating the respective allocative efficiency indicators by each countries share in manufacturing sector employment.

Source: Andrews, D. and F. Cingano (2014), "Public Policy and Resource Allocation: Evidence from Firms in OECD Countries", *Economic Policy*, Vol. 29(78), pp. 253-296.

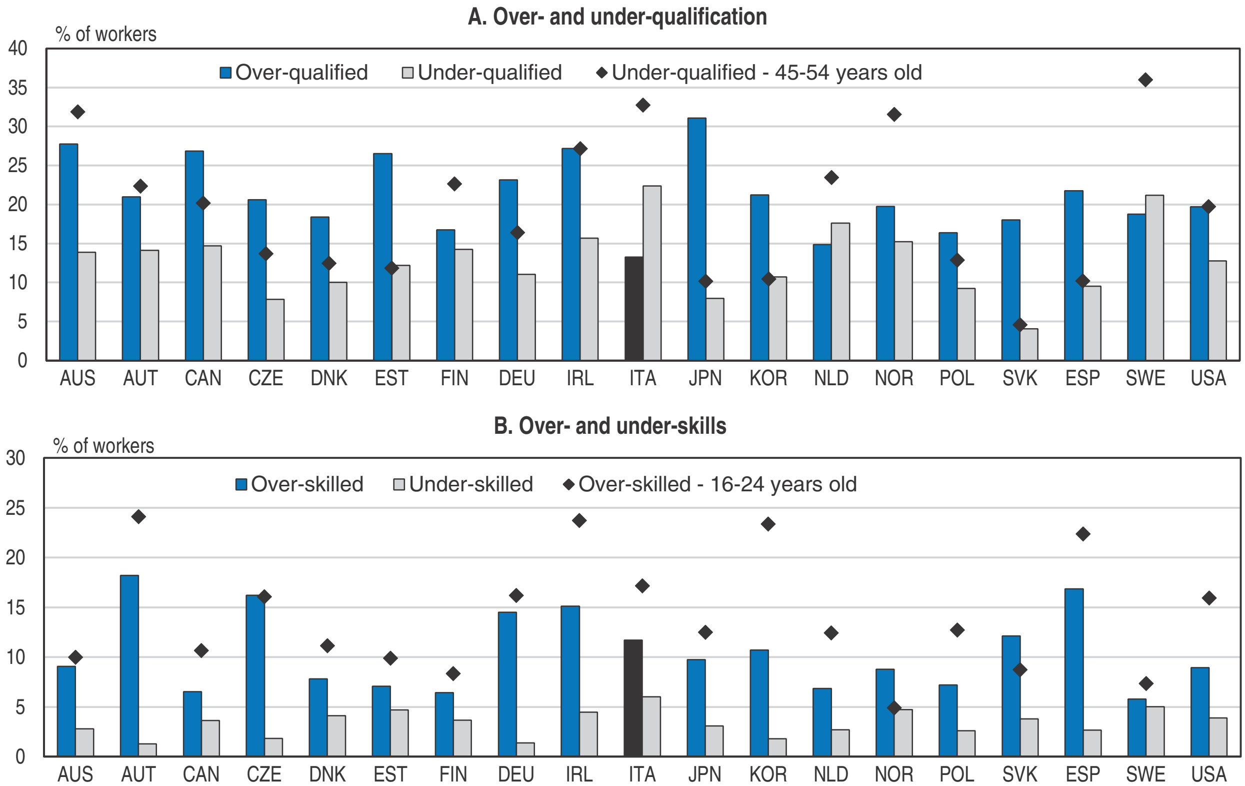
monetary compensation following unfair dismissal are key problems (Box 1.2). The EPL indicators also show that regulation on fixed-term contracts is close to the OECD average, pointing to the remaining duality in the Italian labour market.

A recent reform attempted to reduce dualism

The government in place during 2011-13 introduced a wide-ranging reform to achieve a better balance of employment protection between permanent and temporary/atypical workers. It relaxed the protection of permanent workers, restricting the possibility of reinstatement following unfair dismissal (Table 1.2). It also introduced mandatory conciliation mechanism before lodging a complaint with courts, aiming at simplifying procedures for dismissal cases.

As a result, the difficulty of dismissal procedures seems to have eased, although this has not so far provided the intended result of encouraging hiring of permanent workers. The frequency of reinstatement in case of unfair dismissal has been reduced as far as dismissal for objective reasons (*motivo oggettivo*, i.e. due to production and technological

Figure 1.11. **Job mismatch and under-qualification are significant in Italy**



Source: OECD (2013), *OECD Skills Outlook 2013: First Results from the Survey of Adult Skills*, OECD Publishing, Paris, on the Survey of Adult Skills (PIAAC) 2012.

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Table 1.2. **Recent reforms easing regulation on labour market contracts in selected countries**

	Italy	Spain	France	United Kingdom	Greece	Portugal
Reduce procedural inconvenience for dismissal cases		x	x		x	
Reduce severance pay for permanent contracts	[1]	x			x	x
Relax the definition of unfair dismissal			x			x
Reduce compensation for unfair dismissal		x				
Reduce possibility of reinstatement for unfair dismissal	**x**					x
Reduce regulation on collective dismissals	**x**	x	x		x	
Reduce regulation on non-permanent contracts	**x**	x			x	x
Increase regulation on non-permanent contracts				x		

Note: The 2012 reform relaxed employment protection rules on permanent contracts, notably limiting the possibility of reinstatement following unfair dismissal. The 2012 reform reshaped incentives to hire on fixed-term contacts; no justification required for the first fixed-term contract if its duration does not exceed one year, which was extended to three years in early 2014; the interval period between two fixed-term contracts was extended, which was withdrawn in early 2014.

1. There is no severance pay in Italy.

Source: OECD Secretariat's estimates.

factors in the firm) is concerned. However, this has not yet resulted in encouraging firms to use open-ended contracts more widely: the number of new open-ended contracts has been decreasing while fixed-term contracts continue to account for a large share of labour turnover. The reduction in the use of atypical contracts has been the only visible outcome so far (Ministry of Labour, 2014).

The Jobs Act streamlines labour contracts further

The Jobs Act aims at simplifying and streamlining dismissal rules further. A substantial part of the Jobs Act will be introduced through the enabling law which passed through Parliament late 2014. A new standard contract with employment protection increasing with tenure was swiftly introduced after the adoption of the Law in late December 2014. The Jobs Act also limits further the possibility of reinstatement of workers following unfair dismissal, excluding this possibility for dismissal for objective reasons. It preserves access to courts in case of invalid and discriminatory dismissals (because of race, gender, religion or disability) and for very specific cases of unfair disciplinary dismissals, though courts will be requested to ascertain only the existence of alleged facts and not the proportionality between worker's misconduct and dismissal. These new arrangements will imply quite radical changes for Italy. To avoid unwarranted disruption, the new dismissal procedures will be applied only to new employment contracts ("grandfathering" existing rights).

According to the Jobs Act, workers unfairly dismissed for objective reasons will receive monetary compensation increasing with the tenure, instead of being reinstated. The monetary compensation will be equal to 2 monthly wages per year of service (a minimum amount equivalent to 4 months and a maximum amount equivalent to 24 monthly wages). By increasing predictability the Jobs Act lowers the effective costs of dismissal, even if judged to be unfair by courts, helping firms create more jobs. The amount of such compensation could be reconsidered, however; it is currently very high, considering the OECD average of 14 months at 20 years of tenure (see OECD, 2013b).

The Jobs Act also introduces a new form of out-of-court procedure, according to which the employer can pay the worker an indemnity equal to 1 monthly wage per year of service (a minimum amount equivalent to 2 monthly wages and a maximum amount equivalent to 18 monthly wages). This compensation could be considered as similar in some respects to severance pay. The acceptance of this transaction prevents any further dispute by the worker, that is, appealing to courts for a dismissal to be unfair or not. Both parties have a strong incentive to settle the dispute through this procedure, since the sum paid is not subject to social contribution or fiscal taxation. The government is committed to monitor the developments on this new procedure and, if necessary, it should consider alternative measures to reduce uncertainty on court decision.

Unemployment benefits and social assistance

The problems with the unemployment benefit system

Unemployment benefits help to improve the labour market if well-designed. However, if too generous, especially in terms of income replacement, they may have pervasive effects on labour supply incentives. The replacement income offered by unemployment benefits improves the outside option of workers and raises the reservation wage above which workers generally accept to work. This generates upward pressure on the average wage and raises the unemployment rate (Pissarides, 2000). If unemployment benefits are generous only for those with permanent contracts, and not for new entrants with temporary contracts, then they generate wage premium for the former, though at a higher risk of job destruction for them, resulting in a higher unemployment rate in an economy as a whole (Boeri, 2011).

In Italy, the unemployment benefit system provides generous benefits for those with permanent contracts, while its coverage for non-regular workers has been very low (Box 1.3). The standard unemployment benefit (UB) had a replacement rate close to the OECD average, but with a relatively short duration. At the same time, additional benefits (notably *Cassa Integrazione Ordinaria*, CIG-O; *Cassa Integrazione Straordinaria*, CIG-S; *Indennità di Mobilità*, IM; see Box 1.3) have been provided for workers in specific sectors under certain circumstances. These benefits are generous in terms of both the replacement rate and duration.

Box 1.3. **Unemployment and social benefit system in transition**

The 2012 reform overhauled the unemployment benefit system. The previous ordinary unemployment benefit will have been gradually replaced by the *Assicurazione Sociale per l'Impiego* (ASpI), integrated with one of the special benefits (IM, see below), by 2017. The eligibility condition for the ASpI remains unchanged, requiring two years of contributions, of which 52 weeks have been accumulated in the last 2 years. The so-called "mini-ASpI" is made available for those not qualifying for the ASpI, with a minimum contribution of 12 weeks in the last 52.

ASpI (EUR 2.725 million, 960 000 beneficiaries in 2013) is paid to workers individually laid off in the private sector or collectively laid off but not eligible for other benefits who have paid contributions for at least 52 weeks during the two-year period prior to unemployment. The benefit is 75% of the average gross earnings received over the last 3 months for the first 6 months following unemployment, subject to a threshold (EUR 1 180 as of 2013) above which this ratio is reduced. After 6 months, the benefit amount is reduced to 60%. The benefit duration is 8 months (for those over 50 years old, it is 12 months).

Mini-ASpI (EUR 1 447 million, 380 000 beneficiaries in 2013) has the same amount payable as that for the full ASpI. The duration is limited to 50% of the contribution record for the past 12 months.

There are also special benefits which are provided in a sequential way to workers in specific sectors under certain circumstances. When added up, these benefits accounted for much more than the previous ordinary unemployment benefit.

Cassa Integrazione Ordinaria, CIG-O (EUR 1 132 million, estimated 90 000 beneficiaries in 2013), wage supplementation for short-time working scheme (thus not exactly an unemployment benefit), is usually paid for 13 weeks but it is possible to obtain some prorogation if the firm remains in a reduction of activity for a longer period. In any case, CIG-O cannot be paid for more than 12 months, whether consecutive or non-consecutive, over a period of 2 years. The replacement ratio is 80% of the previous salary subject to a monthly ceiling (EUR 1 166 as of 2013). The beneficiaries are those who work in the firms where activities are reduced or suspended due to cyclical weakness or unforeseen events in the industry and construction sectors (where the social security contribution rate is higher by some 2%).

Cassa Integrazione Straordinaria, CIG-S (EUR 1 952 million, estimated 140 000 beneficiaries in 2013) is normally paid for 12 up to 24 months. The beneficiaries are those who work in firms facing crisis and/or restructuring in the industry sector or other designated sectors. It is possible to obtain prorogation if restructuring lasts more than 24 months. In any case, CIG-S cannot be paid for more than 36 months over 5 years. The replacement ratio is 80% of the previous salary subject to the same monthly ceiling as CIG-O.

Box 1.3. **Unemployment and social benefit system in transition** *(cont.)*

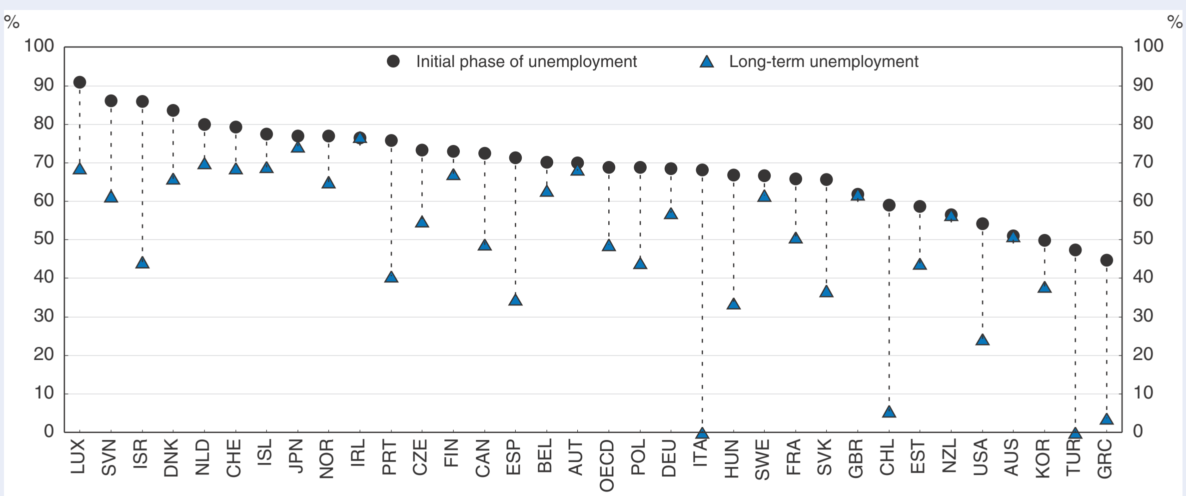
Indennità di Mobilità, IM (EUR 1 951 million, 310 000 beneficiaries in 2013) is provided in case of collective dismissals by firms eligible for benefits from the CIGs and in case of individual dismissal of workers already in CIG-S or under bankruptcy proceedings. The duration of mobility benefits depends on the age of the recipient and on the location of the job. For instance, workers under 40 years old are entitled to this benefit for 12 or 24 months, respectively according to whether they had worked in the Centre-North or the South. The benefit duration is extended up to 36 or 48 months respectively for workers over 50 years old. The benefit amount is 100% of CIG-S for the first 12 months and the reduced to 80% subject to the same monthly ceiling as CIG-O.

The *OECD Benefits and Wages* allows comparisons of the welfare benefits to those in and out of work as well as the taxes they are liable to pay. The series addresses in a systematic way, country by country, the complicated interactions of tax and benefit instruments. It includes analyses of net incomes in and out of work for different family types and labour market situations, presented in a format which facilitates cross-country comparisons.

In the *OECD Tax Benefit Model*, the ordinary unemployment benefit is taken into account for Italy. The net replacement rate is close to the OECD average in the initial phase of unemployment, but it reaches zero after an unemployment spell of two years.

Figure 1.12. **Income support for the long-term unemployed is very weak in Italy**

Overall net replacement rates: net income while out of work in percentage of net income in work, 2011



Note: "Initial period of unemployment" and "long-term unemployment" show the net replacement rate of the first month of benefit following any waiting period and of the 60th month of benefit receipt, respectively.

Source: OECD (2014), *Society at a Glance 2014*, Chapter 5, *www.oecd.org/social/societyataglance.htm*; *OECD Tax-Benefit Models*, *www.oecd.org/els/social/workincentives*.

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The 2012 reform streamlined different kinds of benefits while introducing eligibility for short-term workers. The reform first introduced a new benefit scheme *Assicurazione Sociale per l'Impiego* (ASpI) which integrates the standard unemployment benefit (UB) and one of the special benefits (IM). The ASpI will be gradually phasing in by 2017. The replacement ratio under ASpI is higher than under UB but lower than special benefits including IM. The reform also introduced the so-called "mini-ASpI" which covers those with a minimum contribution record of 13 weeks out of the last 52 weeks, thus extending *de facto* the eligibility to many temporary workers. These measures extended the population of potential beneficiaries by some 1.5 million, according to estimates by INPS, the Italian Social Security Institute.

The Jobs Act integrates the benefit system

The Jobs Act further extends the coverage of unemployment benefits, consistent with easing EPL, thus bringing Italy closer to a "flexicurity" approach. The Jobs Act integrates ASpI and mini-ASpI, thus harmonising their different eligibility requirements and durations. The "new ASpI" will be paid for a duration reflecting the number of weeks of contributions over a longer reference period and it will be extended – on an experimental basis – to around 350 000 project workers (currently excluded from the protection).

The Jobs Act will also more closely associate the provision of unemployment benefits with individual efforts made to return to work. The implementation of such "mutual obligation" approach depends on detailed criteria, such as the types of jobs that an unemployed person must accept, the degree of geographical mobility that is required and requirements concerning job referrals and active job search (OECD, 2013b). In addition, this may include the obligation to enter into employment and training programmes enforced by benefit sanctions, (OECD, 2013b).

The Jobs Act will reform the social assistance provided to vulnerable people attached to the labour market. In Italy, non-contributory benefits (on account solely of low income) have not existed. The government introduced a new pilot programme, *Sostegno per l'Inclusione Attiva* (SIA) to support the population in poverty. SIA targets households with children and a working-age member out of employment for at least three years. It aims at closing the gap between the household income and the absolute poverty level. In return, beneficiaries must commit to an activation plan. The Jobs Act plans to extend the coverage of SIA, but it will fall short of financing all the population in poverty. SIA should be prioritised so that it extends its coverage as much as public finance would allow, while avoiding perverse effects on labour incentives.

Active labour market policies (ALMPs)

What can be expected from ALMPs?

ALMPs aim to strengthen matching efficiency in the labour market, reducing frictions in the vacancy filling process by assisting job seekers. ALMPs act on recruitment costs (through job counselling, placement services, etc.) as well as on after-tax wages (making work pay). Such measures encourage firms to open new vacancies and unemployed workers to accept a job. Thus, both parties are better off from a job matching, the profit of which is shared depending on their bargaining power (Boeri, 2011). ALMPs are targeted to new job matches by definition and they are opportune when the new standard contract imposes some disadvantage on newly hired workers.

In Italy, ALMPs have been under-developed and their implementation has been dispersed across regions. The budget allocated to ALMPs has been much lower than the EU average (Figure 1.13). Local authorities manage the implementation and design of ALMPs. They take into account regional-specific economic and social situations, thus possibly pursuing different efficiency goals. Provision of social benefits, on the other hand, has been managed at the central level by INPS with virtually no direct link between passive and active policies.

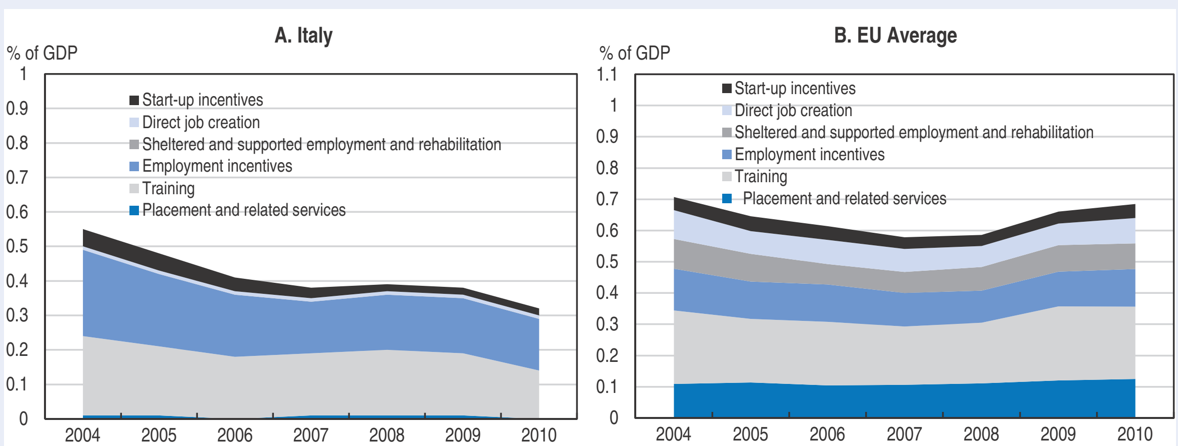
The previous government began strengthening ALMPs in 2013 while designing the national plan for the EU Youth Guarantee programme. That government launched a new *Struttura di missione* in the Ministry of Labour, to co-ordinate and promote active policies: collecting data on public employment services (PESs); defining national guidelines for

Box 1.4. **Structure of authorities/institutions and ALMPs**

In Italy, the public employment service (PES) is organised at different levels: central government, 19 regions and 2 autonomous provinces. The Ministry of Labour and Social Policies designs labour market policies in co-operation with the regions and autonomous provinces and co-ordinates PES actions at local levels. It is regions and autonomous provinces who are responsible for designing and implementing regional labour market policies. This structure results in different organisational models which can be found at local level.

The following are services typically provided at local level in Italy: registration and information services; career guidance; collection, submission and promotion of job vacancies; profiling; support for self-employment and entrepreneurship; support to the employers; assistance to the disabled and disadvantaged groups.

Figure 1.13. **ALMP spending is relatively low and concentrated on some categories**



Source: OECD database on labour market programmes.

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EU Youth Guarantee

The EU Youth Guarantee scheme has been in force since mid-2014. The Youth Guarantee programme provides those who are 15-29 years old an opportunity of job orientation and job training within four months after leaving school or being laid off.

This programme offers a range of activities to young people such as: guidance, education and training courses including self-employment interventions and measures to help young people in opening up new entrepreneurship activities, incentives for the enterprises to employ young people or for making available apprenticeship or traineeship places. These measures are expected to facilitate school to work transition.

At the end of 2014, half of the resources available (EUR 1.5 billion) have been allocated for activation measures and employment incentives by local authorities responsible for the implementation of the programme; 126 670 NEETs have been profiled and taken in charge by PES for tailored services provision.

In Italy, the implementation of this programme is considered to be an opportunity to more permanently improve the activation system, which will be eventually extended to other categories of people. An integrated information system has been established monitoring beneficiaries of this programme, and such an information system will be useful to identify relevant polices for different job seekers.

ALMPs; assessing PES performances. It also took measures to strengthen the role for PESs, in particular their capacity to provide career orientation services. The national Youth Guarantee scheme planned by the previous government has been in place since May 2014 (Box 1.4).

The Jobs Act aims at efficient implementation of ALMPs

The Jobs Act aims to strengthen effective implementation of ALMPs by creating *Agenzia Nazionale per l'Impiego*, the National Employment Agency. The Agency will be responsible for assuring an efficient conditionality approach for provision of unemployment benefits. This is an essential point, but its enforcement may be difficult: a conditionality approach was foreseen by the 2003 law but has never really been enforced because of difficulties in co-ordinating the different institutions involved. The institutional reform this time would hopefully overcome such difficulties, since the constitutional reform attributes ALMPs to the exclusive competence of the central government avoiding fragmentation and assuring a coherent framework. However, the details on conditionality are unclear at this stage and should be clarified.

The Agency, which will be also responsible for co-ordinating ALMPs across regions, should identify the appropriate measures for different job seekers and in different regions (Box 1.4 and Jin et al., 2015). In general, profiling is necessary to determine who is job-ready and who should be involved in more comprehensive programmes. Those who are job-ready need to quickly return to work before skills are lost. Most of displaced workers find jobs that use similar skills to their pre-displacement jobs, even if they move to a new occupation or industry (OECD, 2013b). In such cases, measures facilitating job matching such as career orientation and placement services seem to suffice. Job training programmes are costly and should be targeted to some identified groups, such as the long-term unemployed, lower educated people, and job seekers in southern regions. The government has installed an integrated information system monitoring beneficiaries of ALMPs and this system will enable policy makers to identify relevant policies in the future.

Wage setting system

Wage setting is a decisive factor which contributes to both structural performance and labour market resilience. Flexible wage setting is important in achieving low structural unemployment rates and in mitigating the direct impact of shocks on employment by facilitating adjustments (OECD, 2014b). In general, the wage bargaining system has an essential role in wage setting, especially when there is no legal minimum wage, as in Italy.

What characterises Italy's wage bargaining system?

In Italy, *Contratto collettivo nazionale di lavoro* (CCNL), plays a determinant role in wage formation. CCNL is an industry agreement reached between business associations and labour unions in each industry. This agreement is applied uniformly within the same sector across the country, through the functional equivalent to administrative extension: the terms and conditions of collective contracts are extended to the total workforce, whether unionised or not, since a clause in the Constitution guarantees a binding character of collective contracts (OECD, 2004). This system of collective bargaining has contributed to reducing labour conflicts.

However, the wage bargaining system in Italy has many characteristics which have been thought as less efficient in terms of wage setting. Bargaining at industry level is less efficient than centralised bargaining, which takes into account macroeconomic effects of wage settlement, and firm-level bargaining, where unions exercise relatively little monopoly power (Calmfors and Driffill, 1988). Higher bargaining coverage through administrative extension is generally found to be performing worse (for e.g. higher unemployment, see Aidt and Tzannatos, 2008). Among recent studies, Bassanini and Duval (2009) empirically confirm the negative effects of this institutional setting.

In Italy, wages have not been reactive enough to macroeconomic developments. CCNL basically links contractual wages to the CPI forecast (excluding energy) over the following three years. Once committed, adjustments can be made only at the next round of negotiation, thus three years later. Sluggish wage adjustment is reflected in the evolution of contractual wages: nationally negotiated wages have increased on average by 2.7% per year in the industry sector excluding construction and by 2.3% in the private service sector, both in the 2001-07 period and in the 2008-13 period, according to Confindustria.

What are other factors influencing wage setting?

Wage setting is also interrelated with other labour market institutions such as EPL and its dualism. For Italy, Leonardi and Pica (2013) find that EPL affects the wages of those with long job tenures, but they found no such impact on entry wages, reflecting the duality in the labour market. According to OECD estimates, the wage penalty for temporary workers is 7-10% in full-time equivalence all else equal (i.e. controlled by age, education, regions, etc., see Figure 1.14).

Wage adjustment against cyclical weakness has been borne disproportionately by new entrants. OECD (2014b) finds that in EU countries an increase of one percentage point in the unemployment rate generates a decline in earnings of -0.5% and -3.0% for job stayers and job movers, respectively (Figure 1.15). This suggests that adjustments have been largely made at the margin both internally (labour costs) and externally (employment quantity). These findings indicate the need to reform employment protection legislation and wage setting process in a co-ordinated way.

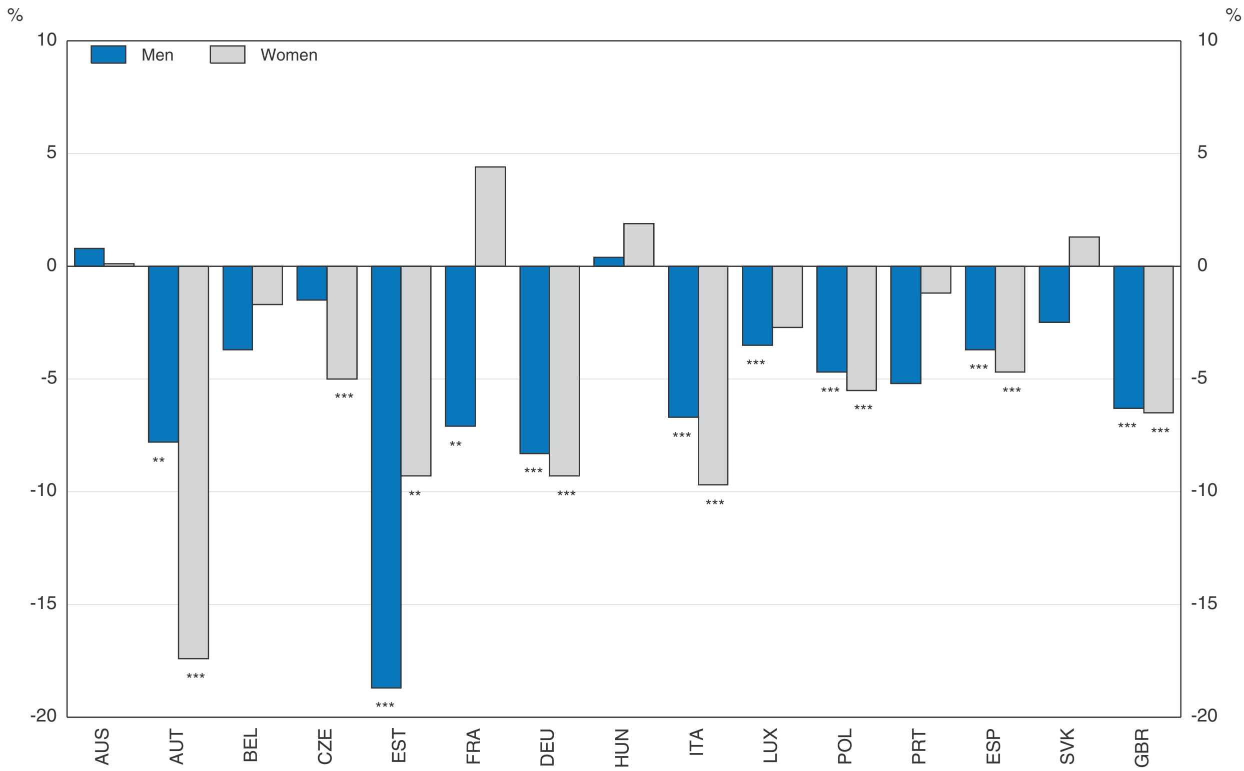
How the wage bargaining system can be improved?

The wage setting mechanism should be made more flexible, so as to take into account firm-specific conditions such as productivity. The three-party pacts in 2011 and 2012 by the government, business associations, and trade unions increased, in theory, the role of firm-level negotiations. However, their role is still very limited (subject to the fields specified in collective agreements) and generally allowed for incremental adjustments, linked to productivity, to collectively agreed terms. Consequently, firm-level negotiations currently remain of little importance. Alternatively, wage flexibility would be made greater if firms deciding to opt out of collective bargaining were allowed to strike a deal with trade unions representing only a majority of employees, and not all trade unions as currently is the case. In Spain, provision for firms to opt out fully from national contracts to achieve lower costs is credited with having helped competitiveness (OECD, 2014c).

Such an arrangement in the wage bargaining system would also alleviate regional disparities in labour outcomes and economic performance. Insufficient wage adjustment at the regional level may be partly responsible for the persistence of employment disparities. In general, regional disparities in employment are positively correlated with

Figure 1.14. **Labour market institutions affect wages for different categories**

Estimated wage difference between full-time non-regular and permanent employees



Note: The figure reports the estimated average difference in hourly wages between non regular and permanent employees working full-time, expressed in percentage of the wage of the latter. Estimates are obtained through a fixed-effect linear model of log hourly wages controlling also for dummies for five age classes, three education levels, married status, children below 13 years and bad health conditions as well as region and time dummies. Casual workers are classified as non-regular employees.

***, **: significant at the 1% and 5% level, respectively.

Source: OECD (2014), *OECD Employment Outlook 2014*, Chapter 4, OECD Publishing, Paris, *http://dx.doi.org/10.1787/empl_outlook-2014-en.*

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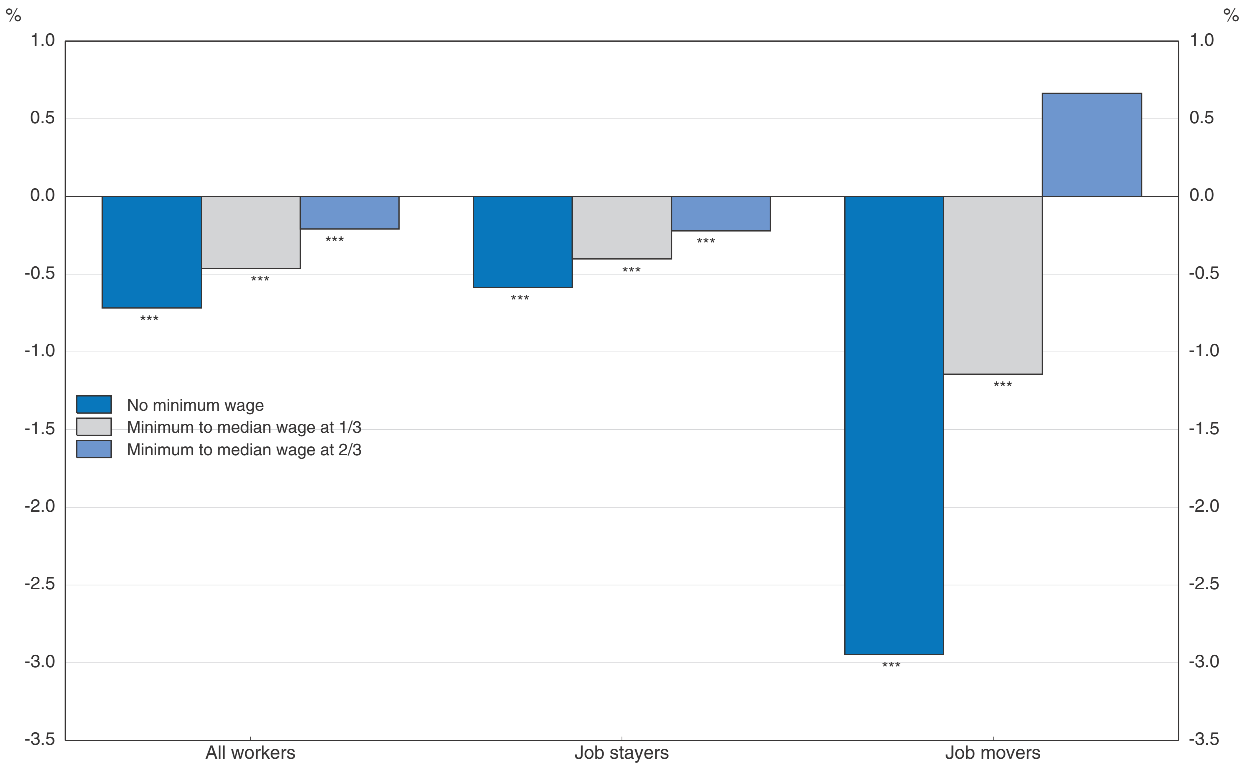
disparities in productivity levels (e.g. Sestito, 2004). In intermediary wage-bargaining systems, those relying mostly on industry-level bargaining, outcomes are influenced mainly by the economic conditions prevailing in the leading sectors and regions. This may create a gap between wages and productivity in lagging regions. Such a gap would reduce the incentives for investment in those regions. Decentralising wage-setting could thus help in reducing regional employment disparities, by stimulating job creations in lagging regions (OECD, 2006).

What will be changed in introducing minimum wage?

The Jobs Act will introduce a legal minimum wage on an experimental basis, an institutional feature that has not existed so far in Italy. A minimum wage, if not carefully designed, tends to induce wage rigidity, in turn resulting in higher unemployment. On the other hand, it has some balancing effects, limiting large wage penalties for those with less bargaining power: Figure 1.15 shows that the extent of disproportionate wage adjustments between incumbents and new entrants is reduced when a minimum wage is in place.

Figure 1.15. **Wages are more elastic for new hires than incumbent workers**

Percentage change in real hourly wage in response to a one percentage-point increase in the regional unemployment rate for all workers, job stayers and job movers[1]



Notes: ***, **, *: statistically significant at 1%, 5% and 10% levels, respectively.

1. OECD estimates using worker-level panel data for selected European countries during the period 2005-10. The estimates are based on the European Union Statistics on Income and Living Conditions (EU-SILC) and national labour force surveys for France and the United Kingdom. Estimates control for person fixed effects.

Source: OECD (2014), *OECD Employment Outlook 2014*, Chapter 2, OECD Publishing, Paris, *http://dx.doi.org/10.1787/empl_outlook-2014-en*.

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Though not foreseen in the enabling law, introducing a legal minimum wage could be an opportunity to set an adequate floor on wages across different regions. The optimum wage level is almost certainly different across regions, given the productivity differential. Such region-specific minimum wage rates exist in other OECD countries, such as the United States, Canada and Japan where minimum wage rates are set taking account of different levels of productivity across regions. It is possible to maintain the system without reducing potential employment opportunities, as is the case in Japan (Higuchi, 2013). Such a differentiated minimum wage across regions should be considered in Italy given different productivity levels (see Figure 1.4). The differentiated minimum wage can be also justified by different costs of living: in lagging regions, lower prices (especially housing) sometimes more than offset lower wages in terms of purchasing power (Boeri et al., 2014).

More and better quality jobs in a dynamic and inclusive economy

A set of well-designed institutions, not only labour market policies but also the education system and product market regulation, would encourage higher labour force participation and produce more and better quality jobs in a more skill-intensive economy. Such institutions would bring higher sustainable growth and inclusiveness, thus improving people's well-being.

Labour force participation

A further increase in labour force participation shifts up the trajectory of potential output. This is especially important for Italy, since the working age population will soon begin to diminish due to demographic factors, while immigration is expected to have very limited influence over the long run according to Eurostat's estimates. Overall, downward pressure in the labour force participation rate will become stronger due to the aging society. The current policy stance linking the average duration of active life to life expectancy will only moderately offset the negative impacts from diminishing working age population. Instead, the policy should aim at further reducing the gap between the effective working life in Italy and that in other countries, as potential gains are very large for Italy (OECD, 2014d).

Institutions can distort incentives to work

Low labour force participation can result from disincentives to work due to the fiscal system and labour market institution. These include high and/or ill-targeted labour taxation and implicit tax on continuing work which has encouraged *de facto* early retirement.

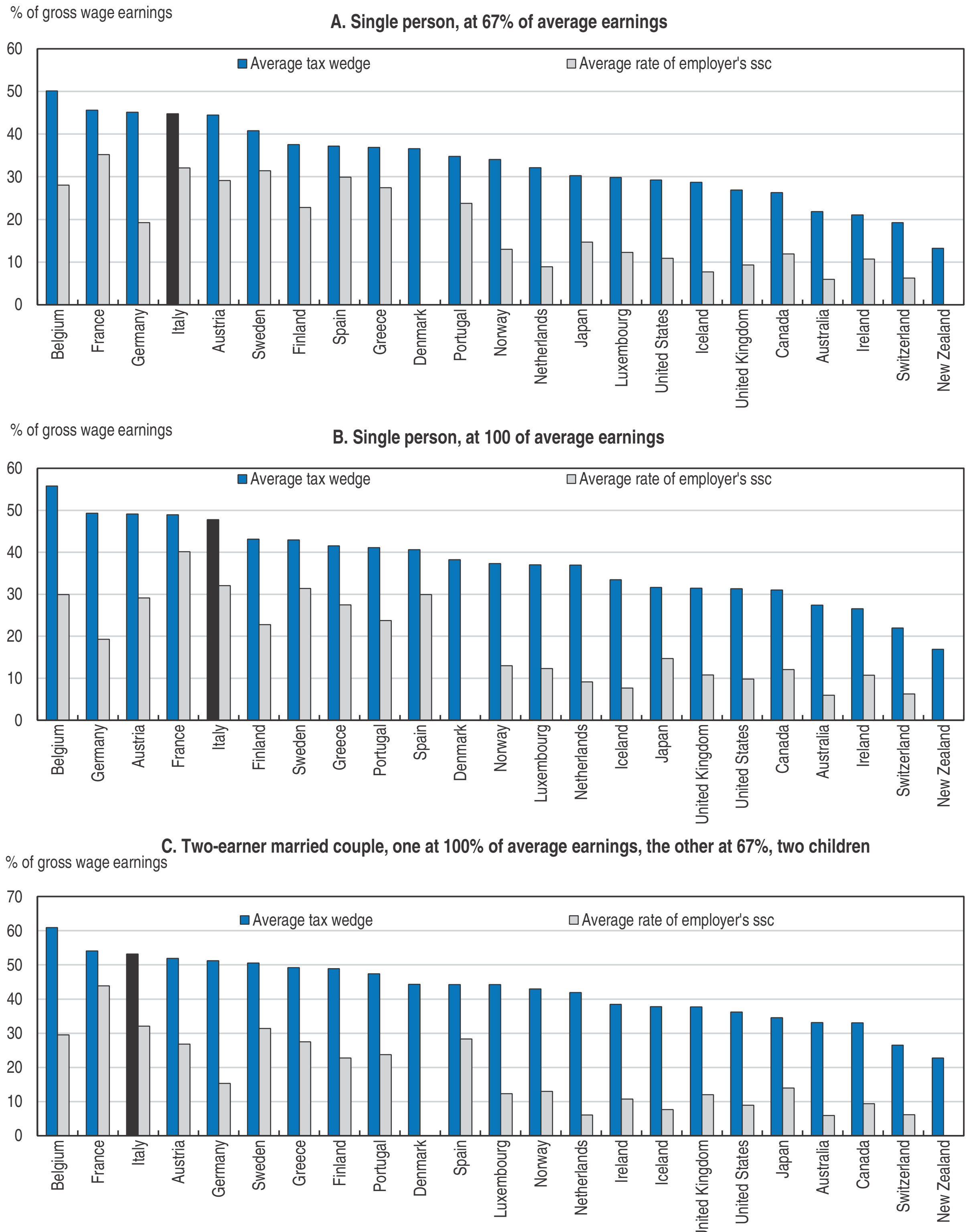
After the 2011 pension reform, all age requirements and the contribution requirements for a full pension will be increased in line with life expectancy. In order to obtain a full pension, the required contribution period is 42 years and 3 months for men and 41 years and 3 months for women as of 2014. Those who are under the statutory retirement age, up to a maximum of three years, can also retire earlier, with a reduced pension, as long as they have a record of more than 20 years of contributions (and if their pension is higher than a certain threshold). The reform has restrained exits from the labour market and the labour force participation rate among older people has visibly increased since then (from 46.3% to 56.7% in the five years to 2013).

The tax wedge is generally high in Italy, and especially so among low-income earners. The high overall tax burden is the mixture of high taxation on labour income and of even higher social security contribution by the employer (Figure 1.16). Such high taxation induces lower labour demand and/or disincentives to work. An across-the-board tax reduction would be expensive so such a tax cut should be targeted to low-income workers, given the relatively high taxation on them compared with other OECD countries. If a tax cut is targeted to certain income levels, then the authorities should carefully avoid trapping workers to the same income levels (i.e. avoiding high and abrupt marginal tax rates).

In 2014, the government introduced a EUR 10 billion overall tax reduction benefitting low-income dependent workers with an annual labour income of less than EUR 26 000. A lump sum tax reduction equivalent to EUR 80 per month is paid on incomes up to EUR 24 000, and gradually phased out as labour income attains EUR 26 000. This tax reduction is estimated to benefit about 10 million employees (those with a take-home pay of less than EUR 1 500 per month). The government has financed this measure broadly in a finance-neutral way. This measure is extended to the year 2015 and will become permanent.

The government will temporarily remove employers' social security contributions for new hires on permanent contracts during the period 2015-17, for low income workers earning up to EUR 25 000. Along with the cut in income tax of a fixed amount per month up to a certain income limit introduced in 2014, this should stimulate job creations with the new standard contract: including the impact of the income tax cut, the tax wedge for the

Figure 1.16. **Tax wedge is high in Italy especially among low-income earners**



Source: OECD, *Taxing Wages*, OECD *Tax-Benefit Model*.

StatLink http://dx.doi.org/10.1787/888933184889

same employee falls from 46% in 2013 to 21%. This measure is expected to be extended in the following years. The government may consider avoiding high marginal tax rates: firms will be penalised in increasing wages above EUR 25 000 by the standard rate of social security contribution of 32.08%.

Reconciling work/family life

Low female labour force participation is not necessarily a result of unconstrained choice. It is influenced by responsibility for caring for children or older family members, and also possibly by the tax system for families. The female labour force participation rate has been increasing steadily, due to the cohort effect reflecting higher educational attainment of the current generation, and is expected to continue to do so. However, its level still remains well below the OECD average. If the gender gap in labour force participation were to be halved by 2030 this is projected to lead to an annual increase in growth of GDP per capita of 0.5 percentage points – about twice the OECD average (Thévenon et al., 2013; see OECD, 2012; and OECD et al., 2014, for recent OECD initiatives to tackle the gender gap).

The government plans to encourage female labour force participation by strengthening financial incentives to work for women. The average tax wedge for a two-earner married couple (with or without children) is generally very high in Italy (Figure 1.16). For instance, for a couple with two children, one is earning 100% of the average earnings and the other at 67% – typical model case –, the tax wedge is 42.9% which is among the highest in the OECD countries. The government introduces a tax credit for low- and medium-income families with children while reshaping tax deductions for a dependent spouse. This enhances their work incentives.

In Italy, fewer children below three years of age are enrolled in formal childcare than the OECD average (24% against 33%). At 2% of GDP, public spending on family benefits is below average in Italy and most of it concerns cash benefits and/or tax measures. Public spending on family services (including on early education and childcare for little children) is also low in international comparison. Access criteria to childcare facilities are rigid, but these are also related to capacity constraints. In this regard, the integration of access criteria and tariffs between public and private childcare services should help optimise access, as should an integration of employer-based childcare services with the public-private system. The government introduces a "baby bonus", a yearly cheque of EUR 960 for each child born or adopted from 2015 to 2017 for medium- to low- income families. In view of the range of benefits such support has it may be advisable to use the available funds for additional investment in childcare facilities.

In addition to childcare supports, flexible working arrangements such as flexibility in working hours as well as teleworking can help parents to reconcile work and care responsibilities. Such arrangements are usually decided by collective bargaining. Social partners may be encouraged to prioritise a change in this area. The government could also consider legislation to support access to flexible workplace measures for workers with very young children, as exist in different OECD countries (OECD, 2011b).

Education and skills

Human capital accumulation is in itself favourable for labour augmenting productivity (OECD, 2014d). Demand for highly educated workers will rise as the economy becomes more skill-intensive. This will raise in turn demand for tertiary education, driven by high economic

Box 1.5. **Gender gaps in paid and unpaid work**

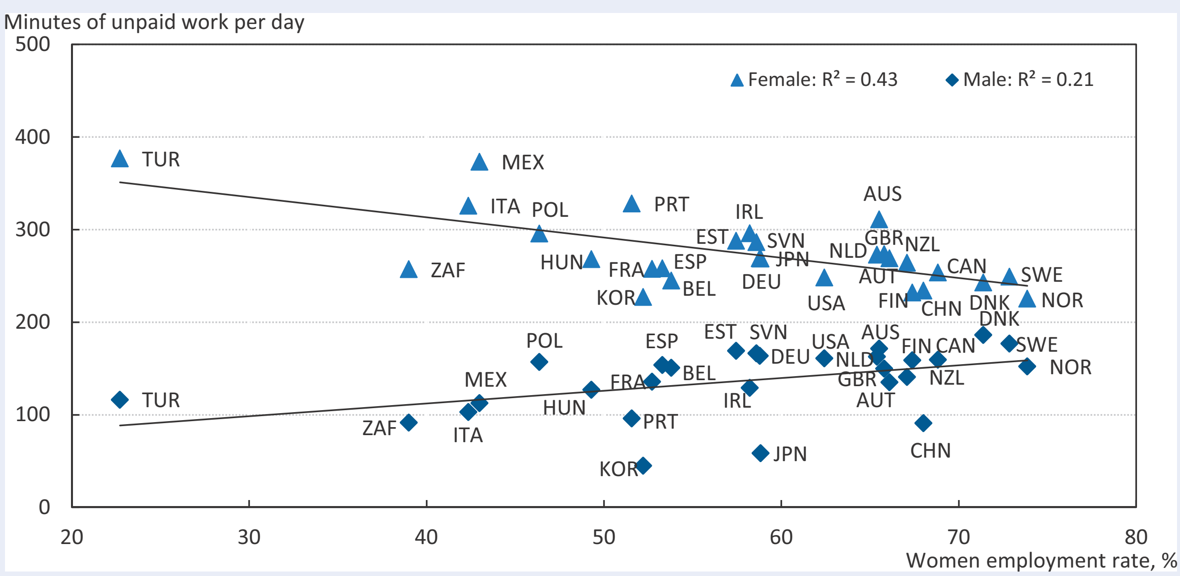
In Italy, prospects for women to progress in the labour market remain limited. The employment rate is low (48.2% compared with 69.2% for men) and characterised by a relatively high incidence of part-time work (32.3% compared with 7.5% for men). The net (i.e. that unexplained by factors like education or job type) wage gap is 10.6%, and the proportion of employed persons with managerial responsibility (2.4% against the OECD average of 4.4%) as well as the share of women on boards of listed companies (7.0% against the OECD average of 10.3%) remains relatively low (all the data in this box are from the *OECD Gender Data Portal*, unless otherwise specified).

According to labour force data from Istat, 6.9% of women left their job to care for their family and 8.2% of women withdrew from the labour market for the same reason in 2013. According to estimates by the Ministry of Finance, the probability of becoming inactive is higher for women by 20 percentage points, all else equal, and this increases with the number of children (+1.7 points) and of the elderly over 84 (+3.7 points).

Across the OECD women more than men engage in unpaid work such as household chores or caring activities, and on average this also holds in couple families where (part-time) employed women live with unemployed partners (Miranda, 2011). However, there is considerable cross-national variation in this regard. Men do relatively little in unpaid work in Italy, Japan, Korea, Mexico and Turkey, and these are also the countries with large gender gaps in unpaid work. Figure 1.17 also shows that the countries where men are least likely to engage in unpaid work are also the countries with the lowest female employment rates. In other words if men were to contribute more to unpaid work this would facilitate increase female employment participation in hours and/or numbers. Women's unpaid work decreases with increases in the national levels of women's employment, but they always do more unpaid work than men.

Figure 1.17. **Women do more unpaid work than men**

Unpaid work and female employment rate



Source: OECD Gender Database.

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Box 1.5. **Gender gaps in paid and unpaid work** *(cont.)*

Thus policies that reduce differences between mothers' and fathers' labour market behaviour also have considerable potential for narrowing gender gaps in paid and unpaid work. One such a policy is parental leave, but entitlements are more often used by women than men. To increase take-up among fathers, some countries grant the exclusive right to parts of the parental-leave entitlement and/or associated income support to fathers. Iceland has the proportionally most gender-equal paid parental leave arrangement because one-third of the parental-leave period is reserved for men (13 weeks). Italy too has legislation that encourages fathers to take leave: when a father takes at least 3 months of paid parental leave (at a replacement rate of 30% up to a maximum) then the household entitlement to paid leave increases from 10 to 11 months (Addabbo et al., 2014). However, this arrangement is little known and so far has had limited effect. Increasing awareness and making the bonus month available after a shorter initial spell could contribute to making this policy more effective.

This box draws on work by the Social Policy Division, Directorate for Employment, Labour and Social Affairs, OECD.

returns and better employment prospects for graduates. Simultaneously, an increase in the supply of highly educated workers would diminish wage premiums, alleviating the upward trend in inequality. Indeed, more and the right kinds of education and skills are needed to keep up with the changing industrial structure and skill-biased technological progress.

Educational attainment should be increased

The average level of educational attainment is currently low in Italy (Figure 1.18), which is related to worse labour outcomes for youth. Low educational attainment is largely explained by early school leaving. Dropout is concentrated in the first cycle of secondary school as well as in technical and professional institutes. Such a phenomenon is more pronounced in socio-economically difficult regions (OECD, 2009). Those who dropped out without a recognisable diploma tend to compound difficulties in the labour market insertion and easily end up becoming not in Employment, Education or Training (NEETs) (OECD, 2010). The NEET rate among youth is around 20%, the highest among European countries. Standard ALMPs are known to be inefficient for this category of people and preventive measures (such as outreaching students whose risk of dropping out is high) are found to be effective (OECD, 2010).

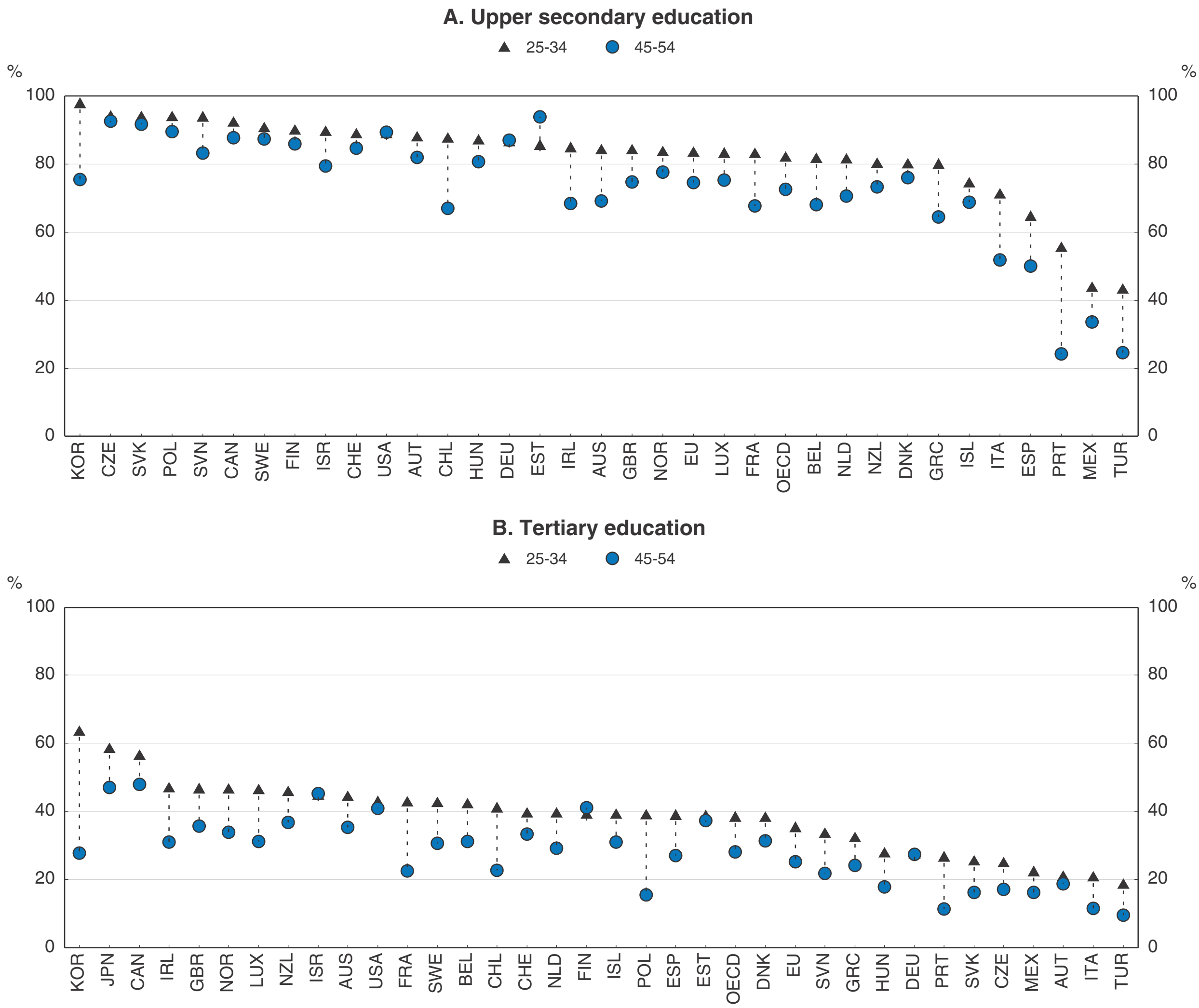
How to increase returns from education?

Returns to education are lower in Italy than other OECD countries (Figure 1.19), which is attributed both to the education system and to the labour market. Educational attainment and specific skills related to field of study have a strong effect on wages, which is especially important for youth (OECD, 2014b). Figure 1.19 shows that returns to education are among the lowest in Italy and they are even lower once skills are controlled, which essentially singles out additional returns generated by specific skills related to field of study (once skills acquired through education are directly taken into account). This is another illustration of inadequate matching between field of study and occupational requirements in Italy.

The evidence on job mismatch suggests a need for better orientation of students in their field of study. ISFOL, a public body for vocational training, studies the total occupational needs over a five-year horizon, forecast for 28 sectors and 129 occupations at national level and at regional level. In addition, employment supply and demand are

Figure 1.18. **Educational attainment is low**

Percentage of population aged 25-34 and 45-54, 2011



Source: OECD (2013), *Education at a Glance 2013: OECD Indicators*, OECD Publishing, Paris.

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estimated for major fields of education both for secondary and tertiary graduates. Such information should be systematically used in the guidance system which the Italian government has been developing: for example, an interactive dashboard involving companies, associations and industry representatives, developed within the context of the Youth Guarantee scheme.

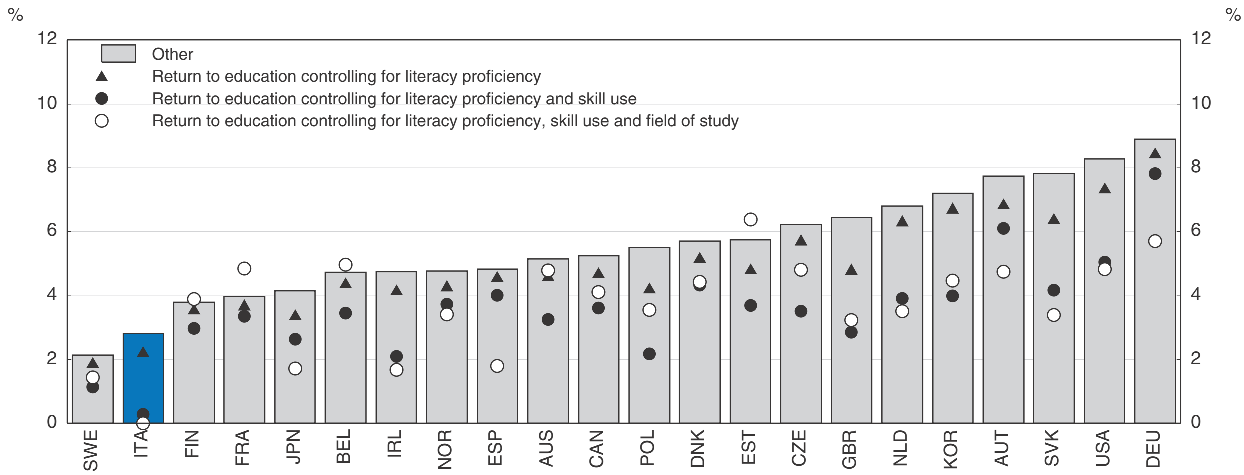
Industry needs should be taken into account

A different kind of misalignment exists between the education system and labour market demand, resulting from lack of practical aspects in the workplace. This holds true even for vocational education and training (VET), which have a strong academic focus but a poor work-related one. OECD evidence shows that professional experience during school also helps youth in their labour market insertion, as it explains some 5% of the variation in hourly wages among youth (OECD, 2014b). In Italy a system called *Alternanza Scuola-Lavoro*,

Figure 1.19. **Returns from education are low**

The return to one additional year of education, with and without controlling for other skill areas (youth 16-29)[1]

Percentage increase in hourly wages associated with one extra year of education



1. Results obtained from a linear OLS regression (run by country and correcting for measurement error and sampling design) of log hourly wages on years of education, gender, marital status, migration status, language spoken at home, experience and its square. Other controls are added in separate steps: literacy proficiency is added in a second step; controls for the use of reading, numeracy, writing, ICT, problem-solving, task discretion, learning, influencing, co-operation, self-organisation, dexterity and physical skills at work are included in a third step; and dummies for field of study are added in the final step.

Source: OECD (2014), *OECD Employment Outlook 2014*, Chapter 5, OECD Publishing, Paris, *http://dx.doi.org/10.1787/empl_outlook-2014-en*.

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through which students alternate between school and learning at the workplace, has existed since the mid-2000s. This remains underdeveloped: only 9% of students used this programme (a majority in vocational or technical schools), while less than 1% of firms hosted such students. In addition, a number of employment contracts related to apprenticeship exist, such as *Apprendistato professionalizzante*. These contracts are designed to promote the labour market insertion of youth through the acquisition of specific skills, while allowing firms to hire young people at low labour costs. Currently two out of three apprenticeship contracts are related to formal education. However, the link between curriculum in formal education and qualification acquired through such apprenticeship contracts should be better formalised through a national standard: qualification acquired in one region is not recognised in other regions. An agreement was reached in late 2014 to establish a national standard for qualification to overcome this problem.

Vocational education and training should be provided in a co-ordinated way with industry needs. *Istruzione tecnica superiore* (high technical institute, ITS), a new post-secondary VET programme, involves employers actively from designing to management of courses and workplace learning is mandatory for students. *Poli Tecnici Professionali* (technical and vocational hub, PTP), a recent initiative at regional level, aims at linking education and industry needs, creating networks between technical colleges, vocational schools and industries. Such a co-operative approach should lead to higher technical specialisation which is effectively matched by demand for highly-skilled workers. These initiatives could be a preferred approach to promote workplace learning or VET in general, but the number of such cases is currently very limited.

Product market/innovation

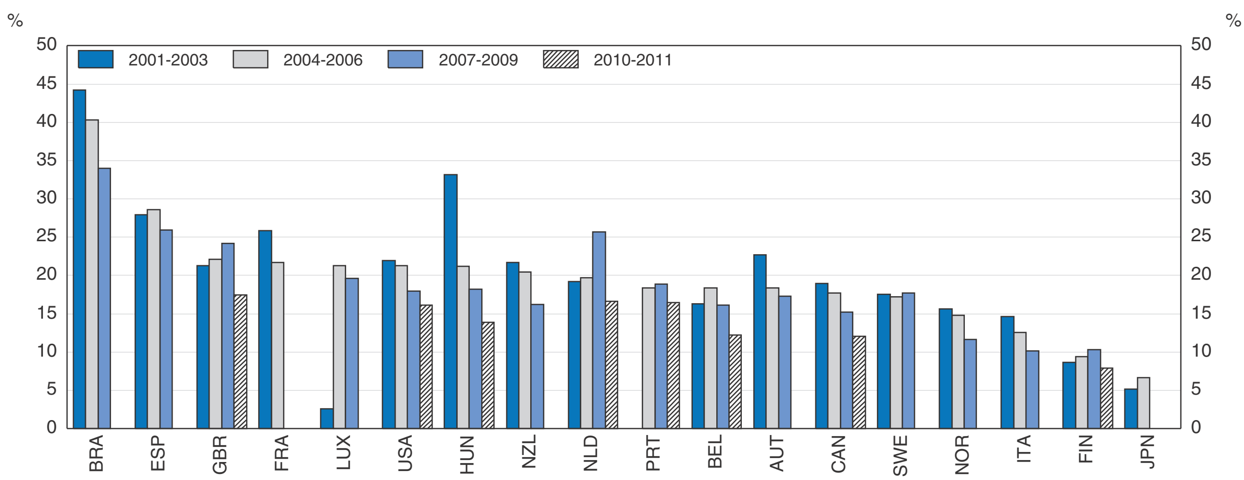
Competition and innovations are key to sustainable economic growth, changing the course of labour augmenting productivity. Productivity growth can be enhanced by increasing competition, through encouraging entry of new firms embodying quality-improving innovations and by strengthening incumbent firms' incentives to adopt leading technologies. Also, increasing the quality of management and private R&D will enable the economy to reap more benefits from new technologies, with additional productivity gains (OECD, 2014d). Product market competition can also be good for jobs by encouraging the creation of new companies and expansion of existing ones that can take advantage of new markets, products or processes.

Better resource allocation through competition

The product market does not seem to function in a competitive way, given the limited number of start-ups. The percentage of start-ups in all businesses has been low and decreasing (Figure 1.20). For the relatively limited number of start-ups, prospects for them to grow over time are also limited (Figure 1.21). This is unfortunate since these start-ups contribute largely to net job creation, as in other OECD countries: these start-ups had just over 15% of total employment in stock, but they accounted for over 40% of contribution to job creation each year over the period 2001-11 (Criscuolo et al., 2014).

Figure 1.20. **Number of start-ups is limited and declining**

The share of start-ups among all firms



Note: The graph reports start-up rates (defined as the fraction of start-ups among all firms) by countries, averaged across the indicated three-year periods. Start-up firms are those firms which are from 0 to 2 years old. The period covered is 2001-11 for Belgium, Canada, Finland, Hungary, the Netherlands, the United Kingdom and the United States; 2001-10 for Austria, Brazil, Italy, Luxembourg, Norway, Spain and Sweden; 2001-09 for Japan and New Zealand; 2001-07 for France; and 2006-11 for Portugal. Sectors covered are: manufacturing, construction, and non-financial business services. Owing to methodological differences, figures may deviate from officially published national statistics. For Japan data are at the establishment level, for other countries at the firm level. Data for Canada refer only to organic employment changes and abstract from merger and acquisition activity.

OECD calculations based on firm level data from the *ORBIS-Patstat Database* for the non-farm business sector. See Andrews, Criscuolo and Menon (2014).

Source: Criscuolo, C., P.N. Gal and C. Menon (2014), "The Dynamics of Employment Growth: New Evidence from 18 Countries", *OECD Science, Technology and Industry Policy Papers*, No. 14, OECD Publishing, Paris.

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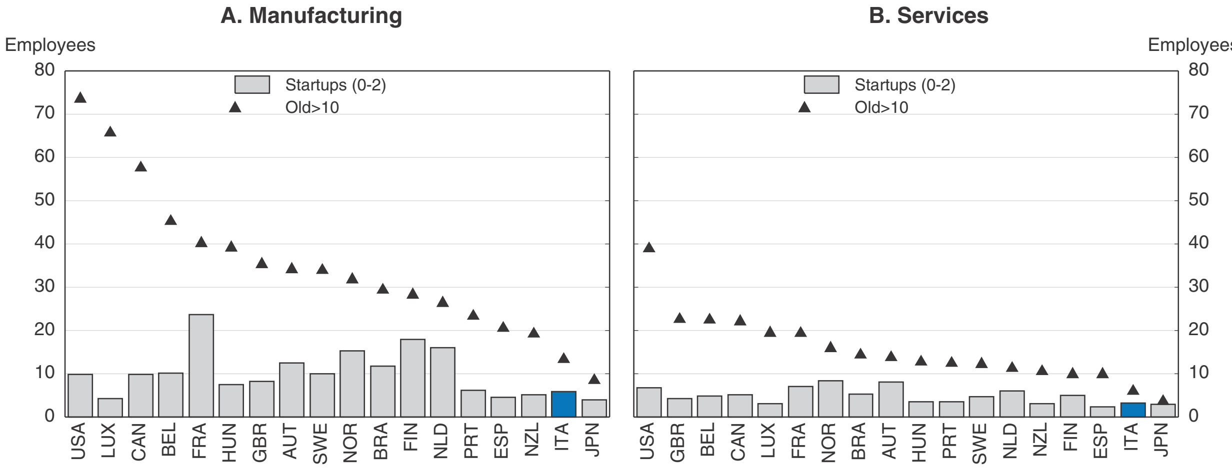
Figure 1.21. **Many start-ups do not grow much**



Note: The graph reports the average size of start-up firms (from 0 to 2 years old) and firms more than 10 years old, as the average over the available years. The period covered is 2001-11 for Belgium, Canada, Finland, Hungary, the Netherlands, the United Kingdom and the United States; 2001-10 for Austria, Brazil, Spain, Italy, Luxembourg, Norway and Sweden; 2001-09 for Japan and New Zealand; 2001-07 for France; and 2006-11 for Portugal. Sectors covered are: manufacturing and non-financial business services. Owing to methodological differences, figures may deviate from officially published national statistics. For Japan data are at the establishment level, for other countries at the firm level. Data for Canada refer only to organic employment changes and abstract from merger and acquisition activity. OECD calculations based on firm level data from the *ORBIS-Patstat Database* for the non-farm business sector. See Andrews, Criscuolo and Menon (2014).

Source: Criscuolo, C., P.N. Gal and C. Menon (2014), "The Dynamics of Employment Growth: New Evidence from 18 Countries", *OECD Science, Technology and Industry Policy Papers*, No. 14, OECD Publishing, Paris.

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The resource allocation mechanism is impaired, as it does not channel resources to the most productive firms. Andrews and Cingano (2014) show that more productive firms are less likely to account for a larger share of employment in Continental and Southern European countries, including Italy (Figure 1.10). Andrews et al. (2014) show that the extent to which capital flows to innovative firms, measures by a change in patent stock, is found to be very low in Italy (Figure 1.22).

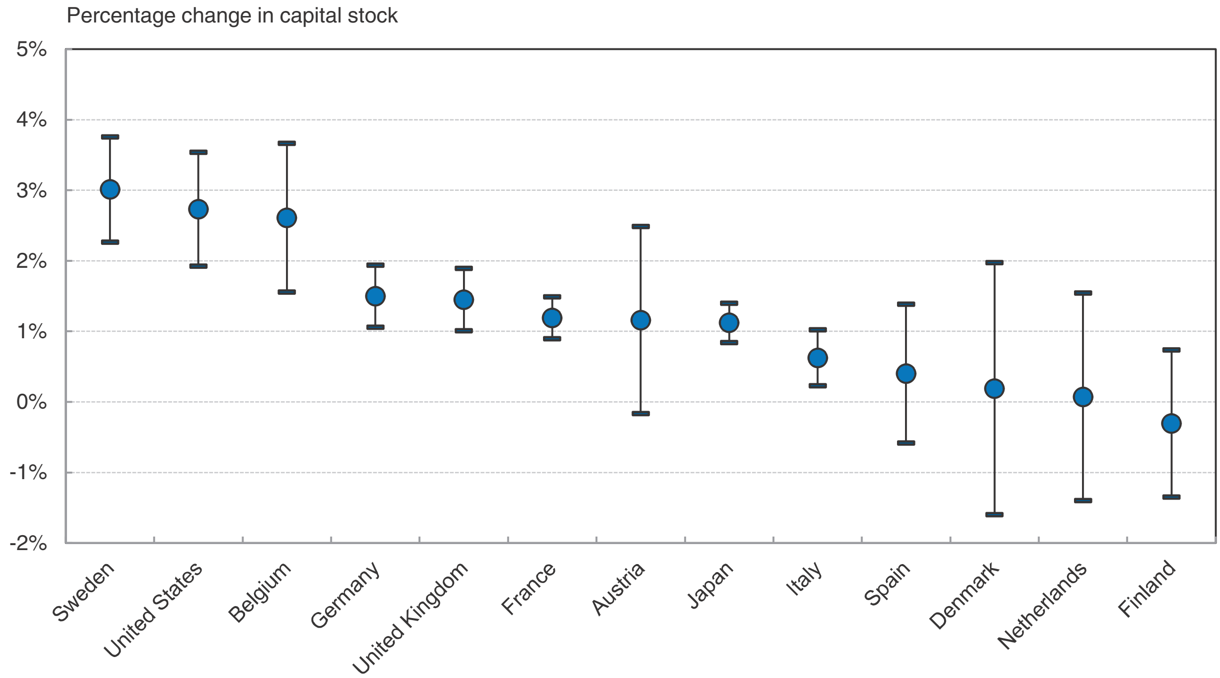
These findings are consistent with the fact that most firms in Italy are very small, old, and not very productive. As a role of public policy, a series of OECD papers (e.g. Andrews et al., 2014) identifies in particular the effects of product market regulation, trade and investment restrictions, employment protection legislation, and bankruptcy legislation.

Product market reforms have been in progress in terms of legislations *per se*. The OECD's Product Market Regulation (PMR) indicators have improved significantly, in the areas of state control, involvement in business operations, and explicit barriers to the trade and investment since 2008, although there has been no real movement for public ownership. Regulation is now close to the OECD average, in some domains much better than it, with the exception of scope of state-owned enterprises which remains high.

However, the problems on implementation and enforcement exist. Other indicators of business conditions show a different picture for Italy: for example the World Bank's "Doing Business" ranks Italy at a lower position. The survey, while somewhat overlapping with the PMRs in terms of laws and regulations as written, analyses business conditions from different perspective, as most indicators are based on the cost of and time taken for

Figure 1.22. **Resources do not flow to more innovative firms**

Additional capital to a firm that increases its patent stock by 10%; selected OECD countries (2002-10)



Note: The chart shows the country-specific point estimate as well as the 90% confidence interval. These estimates are obtained from the following fixed-effects regressions:

$lnY_{i,s,c,t} = \beta_1 ln(Pat\ S_{i,s,c,t}) + \varphi_i + \mu_{s,c,t} + \varepsilon_{i,s,c,t}$

where Y is the capital for firm *i*, in sector *s*, in country *c*, at time *t*; *Pat S* is the patent stock of firm *i*. The specification also includes firm fixed effects and industry * country * year fixed effects. To obtain the country-specific estimate, *Pat S* is interacted with various dummy variables for each country.

The model was estimated based on firm-level data from the *ORBIS-Patstat Database* for the non-farm business sector.

Source: Andrews, D., C. Criscuolo and C. Menon (2014), "Do Resources Flow to Patenting Firms? Cross-Country Evidence from Firm Level Data", *OECD Economics Department Working Papers*, No. 1127, OECD Publishing, Paris.

stylised business operations and including a measure of the efficiency of courts. These facts point to the importance of implementation and enforcement which could be more relevant problems for Italy (OECD, 2013a; Allio and Rangone, 2015).

The focus on implementation by the current government leads to some concrete actions. For example, in the "Simplification Agenda 2015-2017", the government, regions and local authorities have established a shared commitment to the implementation of simplification measures in five areas: digital citizenship; health and welfare; tax law; construction and enterprise. For each sector, the Agenda identifies actions, responsibilities, deadlines and expected results and, for each action, a detailed time schedule provides manner and timing of implementation.

The bankruptcy regime has been slightly improved due to recent reforms, but still weighs on businesses. The average time to close a business has been reduced to 1.8 years, close to the OECD average. However exit costs following business failure are still high, estimated at 22% of the estate's value against the OECD average of 9%. The recovery rate from an insolvent firm is estimated to be 62.7%, well below the OECD average, which reduces firms' access to credit.

More favourable environment for innovation

The current state of corporate finance is overall not favourable for firms' growth and innovation in particular. The very low share of equity capital in firms' financing is itself a problem for potentially productive firms currently facing financial constraints. This problem is more relevant for R&D activities. Firms' internal resources are the primary source of R&D financing, due to the high degree of risk and the information asymmetries associated with innovative activity. Over 80% of R&D spending by firms is internally funded in all four large European countries, according to the Bruegel Institute. In Italy the second biggest source of financing is bank loans (slightly less than 10% of R&D spending), whereas in the United Kingdom, this proportion is much lower (1%) and equity plays a more important role. The role of venture capital funds – investor that provide early-stage

Box 1.6. **Research and development: Tax credits and the patent box**

Innovation is a key driver of economic growth and investments in R&D are among the factors that drive innovation. In Italy, the share of business enterprise expenditure on R&D has been amongst the lowest amongst OECD economies (OECD, 2014e). Many governments support business investment in R&D, with the aim of alleviating the problem of full appropriability of returns from investment and the problem of access to credit often associated with investment in R&D. The Italian government included in the Legge di Stabilità 2015 two measures for supporting firms investment in R&D: 1) an R&D tax credit; and 2) a "patent box" regime.

The tax credit regime offers a 25% incremental-based tax credit, with a more generous rate of 50% if the R&D project is conducted in collaboration with universities and public research institutions or by innovative start-ups and to cover expenditures related to highly qualified R&D staff. The R&D tax credit can be used to offset tax and social contributions liabilities, which means that even loss-making firms might benefit from the incentives. This is important to avoid favouring firms in a profit making position at the expense of firms making losses as is often the case for young dynamic firms. However, the incremental nature of the scheme might raise compliance costs especially for small firms and discourage participation. More generally, in the last decade the R&D tax credit system has seen recurrent changes and uncertainty about the design, the implementation and the funding for the instrument. These are likely to lower its uptake and effectiveness and might have a negative impact on the level of R&D investment.

The patent box allows businesses to benefit from lower effective tax rates (13.75% as of 2017) on profits derived from intellectual assets (copyrights; patents; trademarks which are functionally equivalent to patents and know-how exploited through licenses with the aim of incentivising the location of intellectual assets currently held abroad, avoiding their relocation and more generally supporting investment in R&D. Italy is not the first country that has introduced a patent box: for example France introduced such a scheme in 2000, Hungary in 2003, the Netherlands and Belgium in 2007, followed by Spain and Luxembourg in 2008. Finally the UK that introduced the scheme in 2013 just announced its phasing out between 2016 and 2021. The Italian scheme requires coupling of the intellectual assets to underlying research conducted in Italy in line with BEPS recommendations. However, recent research suggests that might are prone to spur a tax competition that entails a race to the bottom which ultimately results in a fall in tax revenues for all countries concerned (Griffith et al., 2012) might not necessarily be the most cost-effective suitable measure to tackle the fundamental market failures of investment in innovation.

This box is based on Criscuolo and Appelt (2015).

financing as well as consulting for firms in high growth potential sectors – or business angels, private investors operating on a smaller scale with respect to venture capital funds, is extremely limited in Italy.

Financial incentives for innovation should be reshaped, since the tax credit system seems to over-subsidise incumbent firms at the expense of dynamic young firms (Box 1.6). In Italy, R&D tax credits are neither refundable nor contain carry-over provisions. The design of such schemes may provide less assistance to young firms which are typically in a loss position in the early years of an R&D project, reducing effective rate of the tax subsidy to R&D (Elschner et al., 2011). Also, R&D tax credits should be more closely tied to the most productive sources of innovation to improve targeting of government subsidies. Thus, more emphasis could be put on selective subsidies through grants, loans and prises, based on competitive, objective and transparent selection. Colombo et al. (2011) shows that selective subsidies are likely to be more beneficial to new technology-based firms than automatic ones.

Institutions and job quality

A recent OECD study sheds light on job quality from the view point of well-being (OECD, 2014b). The study defines job quality along the three aspects: earnings quality, labour market security, and quality of the working environment (Table 1.3). The results show that those countries which are ranked high in terms of the quantity of employment tend to be ranked high also in terms of job quality. According to these criteria, the reforms in process are expected to improve job quality overall:

- Reduction in EPL as well as PMR leads to higher earnings level in the aggregate through higher productivity.
- Tackling dualism contributes to reducing earnings inequality.
- A EPL reform usually results in higher probability of unemployment and but also shortens unemployment spells, due to higher probability of re-employment, and the anxiety on long unemployment spells seems to dominate in general (OECD, 2014b).
- Extended unemployment benefit coverage would help to reduce labour market insecurity.
- Flexible wage may result in widening earnings disparity, reflecting differences in skills or innate ability, but it would be better than the situation where inequality is embedded due to institutional factors, that is, high wage for those who protected at the expense of those who stay at the margins of the labour market.

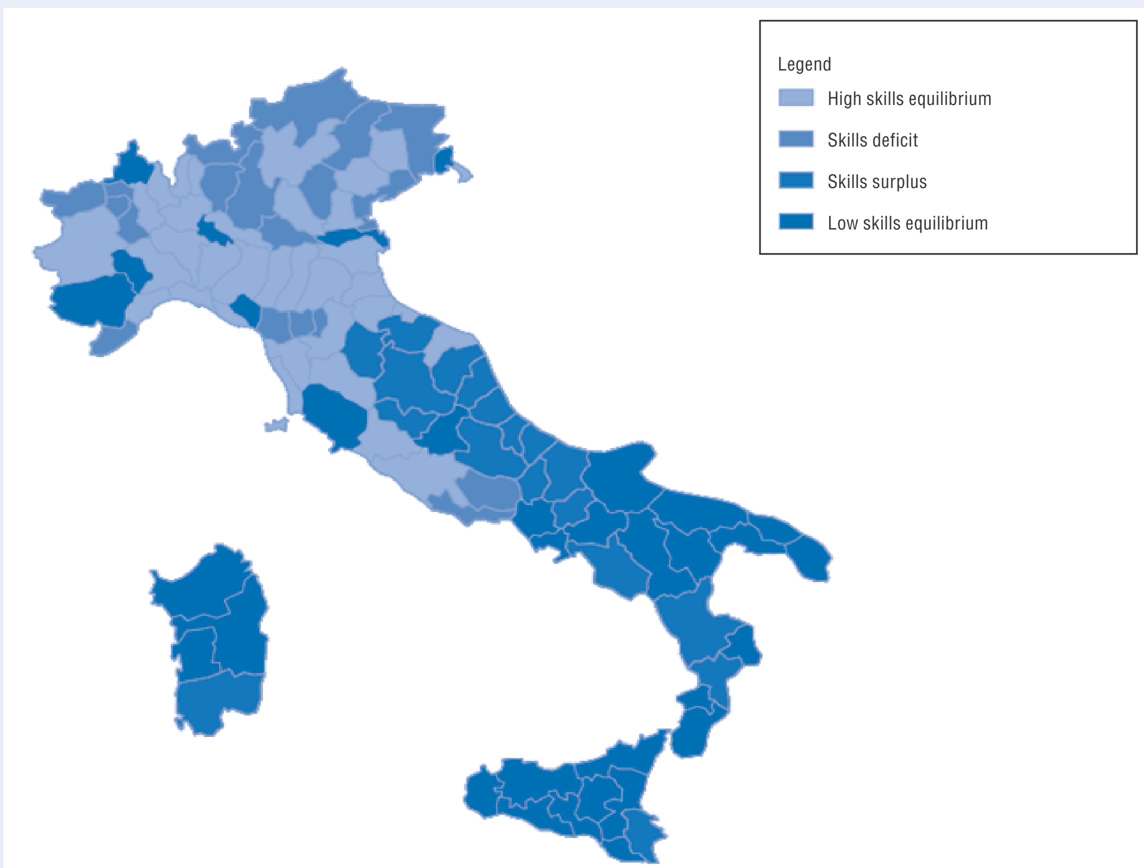
Economic performance as well as job satisfaction can be improved by designing better institutions. It is well-known that the set of institutions interact with shocks, which generates different economic and labour outcomes (Blanchard and Wolfers, 2000; Nickell et al., 2003). The allocation of the factors of production and the distribution of income can be hampered by worse performing institutions, which is often embedded by vested interests of certain groups. Instead, a set of better institutions facilitate the economy to reap more benefits from business opportunities; firms react more promptly to quality-improving innovations and adoption of leading technologies, while workers depend less on wealth and/or social benefits, otherwise costly for businesses as the reservation wage becomes higher all else equal (Phelps, 1994; Fitoussi et al., 2000). Phelps and Zoega (2013) also find that job satisfaction is higher where a set of institutions fostering equality of opportunities and upward mobility provide better economic performance. More and better quality jobs would be produced in such a truly inclusive environment, conducive to higher living standards.

Box 1.7. **Supply and demand for skills at the local level**

Skills are not always effectively used by employers, and this can be particularly the case within certain sectors and regions at the sub-national level. OECD research has highlighted considerable variation in the supply and demand for skills at the local level (OECD, 2014f). Some local economies are characterised by low-skilled, low-quality and poorly productive jobs, which can lead to a low-skills trap where employers have no incentive to invest in skills development opportunities, putting downward pressure on growth and innovation.

Figure 1.23 classifies regions in Italy into a low-skills equilibrium, a high-skills equilibrium, skills surplus and a skills deficit. The north is characterised by "high skills equilibrium" regions, where a high supply of skills (the percentage of people with post-secondary education) is matched by a high skills demand (the percentage of medium and high skills occupations and GVA per worker) and skills deficits. The south is characterised by "low skills equilibrium", where a low skills supply is matched by low skills demand, and skills surpluses, where skills supply exceeds demand. In low-skills equilibrium regions, labour shortages often occur when vacancies remain unfilled either due to a sheer lack of local people to fill them, or because people are not attracted by the pay, job contract provisions or working conditions of the positions.

Figure 1.23. **Skills supply and demand, Italian sub-regions, 2009**



Source: Labour Force Survey and Regional Accounts, Istat.

StatLink http://dx.doi.org/10.1787/888933184948

A more integrated approach to skills (e.g. better connecting employment, training, and economic development policies) can help local economies make structural adjustments and achieve national employment and productivity objectives. In some cases, this will mean actively working with firms and providing management training to help raise product market strategies and increase the skills intensity of local production processes.

This box was provided by the Local Economic and Employment Development Division, Centre for Entrepreneurship, SMEs and Local Development, OECD.

Table 1.3. **Broad outcome measures of job quality and their subcomponents**

Dimensions	Aggregate outcome measure of job quality	Subcomponents (at the individual level)
Earnings quality	Earnings index taking into account both earnings level and its distribution (inequality).	*Level of earnings*
Labour market security	Expected earnings loss associated with unemployment.	*Unemployment risk* ● Risk of becoming unemployed. ● Expected duration of unemployment. *Insurance against unemployment risk* ● Eligibility to unemployment benefits. ● Generosity of benefits (replacement rates).
Quality of the working environment	Proportion of workers experiencing job strain (i.e. imbalance between work stressors and workplace resources).	*Work-related stress factors* ● Time pressure at work. ● Exposure to physical health risk factors. ● Workplace intimidation. *Support and resources to accomplish job duties* ● Work autonomy and learning opportunities. ● Good management practices. ● Good workplace relationships.

Source: OECD (2014), *OECD Employment Outlook 2014*, Chapter 3, OECD Publishing, Paris, *http://dx.doi.org/10.1787/empl_outlook-2014-en*.

Policy recommendations for job creation and job quality

- Fully roll-out the new standard contract for new hires with employment protection rising with job tenure, while grandfathering existing contracts.
- Ensure that access to courts is preserved only in case of invalid and discriminatory dismissals (on the ground of race, gender, religion and disability), and some specific disciplinary dismissals.
- Carefully monitor the impact of the labour market reforms in reducing the recourse to legal action. Consider generalising automatic severance pay linked to length of service in case of dismissal for objective reasons (redundancies) at affordable levels no higher than the OECD average.
- Fully implement the unified unemployment benefit system. Require recipients to actively seek work, and to accept employment or training when offered.
- Change the composition of spending on active labour-market policy: target training programmes to those who need them most, especially among youth, while reinforcing career orientation and job placement services; tailor assistance to job seekers according to their specific situation.
- Encourage social partners to allow modification of national wage agreements at the firm level, through agreement with representatives of a majority of the firm’s employees.
- Legal minimum wage should be set flexibly across regions, taking account of different productivity.
- Encourage female labour force participation, with more flexible working-hours arrangements, and promote wider provision of good quality care for children and the elderly.
- Avoid job mismatch taking into account occupational demands and orienting students accordingly. Strengthen VET to provide more professional experience and to be co-ordinated with industry needs.
- Continue reforming the product market to lower barriers to entry in the regulated professions and to promote competition in all areas. Ensure a level playing field for new entrants in terms of financial incentives for innovations.

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OECD Economic Surveys: Italy

Chapter 2

Maintaining fiscal sustainability: Structural fiscal issues

Major progress has been made in moving towards fiscal sustainability, thanks to substantial consolidation on both spending and revenue sides. Further structural improvements can build on these gains and, more fundamentally, support the government's reform programme aimed at improving productivity and growth. Tax compliance is more expensive for companies in Italy than in most OECD countries, while tax expenditures are very numerous. Simplifying the tax system can raise investment and growth, as well reducing costs in the tax agency and improving compliance. Value for money in public spending is always important but particularly so in a situation of tight budgets. Ad hoc spending reviews have been undertaken, but a systematic approach is needed. Some existing tools to promote value for money can be improved, while reform of public administration, including better use of transparency and anti-corruption measures, can support their effective use. The Internal Stability Pact (ISP) has been a necessary domestic counterpart of European fiscal rules, but has imposed a number of constraints on sub-national administration that go beyond what is needed for EU purposes. Constitutional reforms, balanced budget rules for sub-national administrations and final implementation of long-awaited rules on fiscal federalism provide an opportunity to considerably simplify or eliminate the ISP.

Italy has made much progress in strengthening its fiscal policy, reducing the structural budget deficit by around four percentage points between 2009 and 2012, with some further tightening since. The headline deficit is now below 3% of GDP. However, the debt-to-GDP ratio is still rising as the economy has contracted and inflation fallen. The manner in which the necessarily tight budget targets are achieved can be as important as the level of the targets themselves.

The effort to contain the deficit and to undertake significant fiscal consolidation in difficult circumstances has led to tensions: in relations between central and sub-national government; in public spending control; and in taxation. For example, central government transfers to regions, provinces and municipalities have fallen substantially with little reduction in their statutory obligations; civil servant salaries and recruitment have been largely frozen for four years; and already high levels of taxation have been increased.

Successive governments have aimed to deal with these problems. A 2009 framework law set out the basic lines for fiscal federalism, but the working of the Internal Stability Pact, designed to make local government finances compatible with the European Union standards and constraints, has not always worked smoothly. Two successive governments have started Spending Reviews aimed at finding cost-efficient ways to cut spending. The government is implementing changes to the tax system changes under a framework law passed in the spring of 2014.

This chapter explores tax policy and spending control to suggest ways in which improvements in these areas can help to meet the macro constraints on overall fiscal policy more efficiently. The next section looks at how changes to some aspects of the taxation system could meet policy objectives at less cost and be made more growth-friendly. The subsequent section discusses how government have met spending targets, notably through the Spending Review, and what is needed to ensure effective spending control in the future. The final section looks at the Internal Stability Pact and evolving fiscal federalism, in the context of a continuing, perhaps growing, regional divide.

Taxation

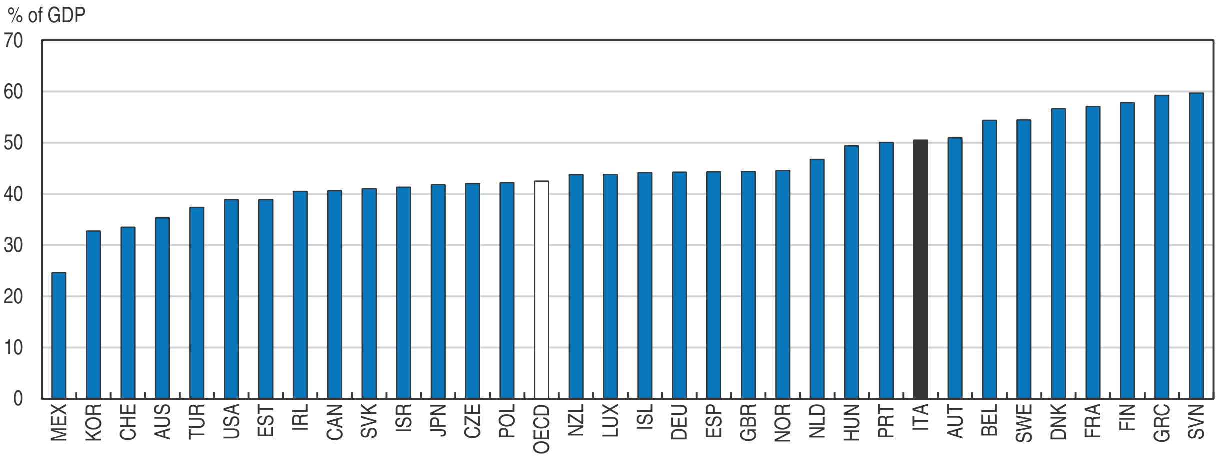
Total public spending is relatively high in Italy (Figure 2.1). High taxation is needed to finance it. The distortionary effect of taxation is amplified by a number of factors. Two of the most important are tax evasion and complexity. Other problems are often related to these two – frequently changing tax rules, difficulty in understanding what the rules are, and an invasive tax administration, for example.

Tax compliance

Tax evasion is a major problem in Italy and, although its full extent is not known accurately, it is considered to be higher than in most OECD countries. Tax evasion is likely one of the main reasons that the underground economy is relatively large in Italy. Prior the latest revision of national accounts methodology, the national statistics institute, Istat,

Figure 2.1. **Public spending is relatively high in Italy**

Total public expenditure, 2013 or latest data available



Source: *OECD Economic Outlook 96* (database).

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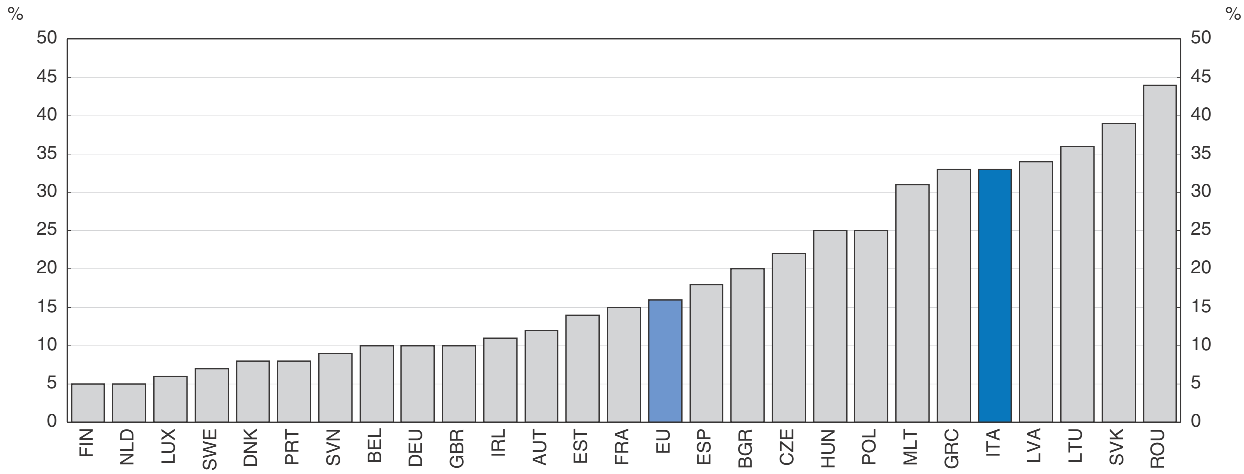
estimated that economic activity that would in itself be legal if declared accounted for some 17% of GDP in 2008, having fallen by around two percentage points of GDP since 2000 (Istat, 2010). A Bank of Italy estimate also put the figure, calculated on a different basis, at just under 17% for the period 2005-08 (Ardizzi et al., 2012). With the recent switch to the new national accounts methodology, Istat now includes estimates of specific illegal activities (related to prostitution, illegal drugs and contraband cigarettes) in the national accounts, along with all other European statistics institutes. Istat estimates that the underground economy now accounts for 12.4% of recorded GDP, of which 0.9% is due to those specific illegal activities (Istat, 2014). OECD (2012) discusses the links between different concepts of the underground economy and measuring tax revenue lost to evasion.

Although now thought to be smaller than previously estimated, the existence of the underground, untaxed, economy increases the effective tax burden on the rest of the economy, undermines fair competition and is a source of social inequity. Attempts to deal with it often lead to second-best (or worse) taxation methods, for example where taxes are used that are economically inefficient but hard to evade, such as stamp duties. Even taxes which are normally thought of as hard to evade, such as the value added tax, lose considerable revenue to evasion in Italy. Tyson (2014) reports estimates suggesting that non-compliance in VAT is equivalent to over 40% of actual revenue of just over 6% of GDP. Reduced rates and exemptions account for revenue losses – compared with full compliance at the standard rate applied to all transactions – of about twice this (Tyson, 2014, Box 1). European commission calculations of the impact of non-compliance show a "VAT gap" for Italy of about 33%, significantly higher than in most other countries and about twice the EU average (Figure 2.2). Responding to this high rate of non-compliance for VAT, the 2015 budget extended the "reverse charge" mechanism, which switches the obligation to pay VAT from the seller to the buyer in certain circumstances, notably when the buyer is large relative to the seller (e.g. supermarkets buying from small suppliers, or purchases by the public administration). This is estimated to raise revenue by about EUR 1.6 billion, about 2% of total VAT revenue.

Figure 2.2. **VAT Gap estimates in the EU26 countries, 2012**



Note: The VAT Gap can be defined as the difference between the amount of VAT actually collected and the VAT Total Tax Liability (VTTL), in absolute or percentage terms. The VTTL is an estimated amount of VAT that is theoretically collectable based on the VAT legislation.
Source: European Commission, 2012.

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In order to reduce evasion, many individuals' income tax declarations are checked against the *redditometro* ("income-meter") where statistical methods are used to judge whether a person's declared income is compatible with the person's ownership of various goods (houses, cars, yachts, etc.) or other known activities. This is a cost-effective way of "profiling" taxpayers to detect those more likely to be evading tax and who therefore justify deeper investigation. Some diversion of expenditure to items known not to enter the calculation is one likely result, and this could be an indirect contribution of tax evasion to the regulatory burden. The *redditometro* is more effective the more information is available about individual transactions. This may reduce the degree of administrative simplification that is advisable, if it would lead to data needed for tax purposes no longer being collected.

Necessary measures against evasion are likely to increase the administrative costs of tax collection in Italy. Unfortunately available data does not allow a reliable comparison. The administrative costs of the tax agency alone are not particularly high compared with other countries (OECD, 2013b, Table 5.4). But that data is particularly unrepresentative for Italy: it does not include social security contributions, and is thought to significantly understate the true cost-to-revenue ratio as it does not take account of expenditure incurred on tax related work carried out by other agencies (e.g. the tax fraud work of the Guardia di Finanza and debt collection activities performed by Equitalia spa). The same report notes that a number of countries (including Estonia, Hungary, the Netherlands and the United Kingdom) have made significant savings by bringing collection of social security contributions into the same agency or ministry responsible for tax collection. Nevertheless there are important challenges associated with these mergers, which need to be considered. These include (non-)comparability of data systems, the different ethos of staff (collecting revenue versus helping people, for example), and different legal frameworks for difference revenue types (OECD, 2013b, Table 1.4).

Tax amnesties and incentives to disclosure

A Ministry of Finance study into evasion makes two important points, first that there is a cultural element in tax evasion; and second that tax amnesties have played an important part in maintaining this culture (MEF, 2014b). MEF (2014b) states quite clearly that the government has no intention of renewing the tradition of tax amnesties.

Amnesties, in which the punishment provided by law is reduced or removed for all (or some categories of) outstanding offences, in order either to clear a judicial backlog, to start a new policy with a clean slate, or in some cases to support other policies, have been prevalent in Italy.* According to MEF (2014b) there have been 80 tax amnesties (*condoni tributari*) in the 150 years of the Italian state. Amnesties are not restricted to taxes, but have also been used frequently in immigration policy where they could be thought of as establishing a *de facto* path to immigration through an employability test (OECD, 2005). Amnesties used also to be *de facto* quite frequent in urban planning for individual violations of construction permit requirements, but are much less frequent now as the rule of law has become better established. Nevertheless in recent years the central government has on occasion suspended or altered planning restrictions (which are in principle reserved to sub-national government) in order to boost the construction industry.

The line between an amnesty and measures to encourage voluntary declaration can be thin. Most countries reduce the penalty on unpaid taxation on assets held abroad when there is voluntary disclosure and the standard Italian provisions for this are similar to many countries (OECD, 2010a). However an additional "one-off" measure was taken in 2008, reducing the penalties to a very low level (50% tax rate on imputed returns of 2% per annum); this was not referred to as an amnesty (it was called a tax "shield"), but, since the penalties were very low, in practice it was very similar. This measure raised a significant amount of revenue in 2009 but likely at the cost of encouraging further evasion.

The March 2014 tax reform enabling law provides for measures to improve relations between taxpayers and the authorities, including simplification measures such as pre-filled tax forms for individuals (Box 2.1). These are good steps. The law also provides for measures such as reduced penalties to encourage voluntary disclosure. An OECD report in 2013 suggested that in some countries incentives for voluntary disclosure are underused, though Italy was at that time one of a minority of countries reporting that it already had such provision (OECD, 2013b). Incentives for voluntary disclosure can be a useful way to improve compliance but they have to strike a difficult balance between generosity that can be exploited by deliberate evaders and too-strong penalties in other cases. In December 2014 the government proposed new rules for dealing with voluntary disclosure, both of capital held abroad and of domestic undeclared activities. Penalties for evasion are reduced in the case of voluntary disclosure, but not eliminated, and full payment of outstanding taxes and interest is required. Criminal sanctions will be retained only for the most serious offences, essentially when evasion is part of an operation to recycle gains from illicit activities. The government subsequently announced it would publish revised proposals in February 2015.

* MEF (2014b) reports that the largest recorded tax amnesty was implemented in the year A.D. 118, when tax arrears of about 900 million sesterces, equivalent to almost one year's imperial revenue, were cancelled by the emperor Hadrian. See MEF (2014b) Footnote 91.

Box 2.1. **The enabling law for tax reform**

In March 2014 Parliament passed the "Delega Fiscale" an enabling law allowing the government to introduce tax reforms in subsequent decrees. The aim of the reform is to achieve a simpler, more equitable and efficient tax system as well as economic growth and higher employment. The main measures planned are in the following areas:

- Reform of the land register and cadastral property values.
- Monitoring and reduction of tax evasion.
- Monitoring and rationalisation of tax expenditures.
- A redefinition of abuse of law and tax avoidance combined with simpler tax rules.
- Revision of tax litigation procedures and electronic services within tax trials procedures.
- Enforcement of audits – electronic invoicing.
- Taxation of small business and entrepreneurial income.
- Indirect taxes and VAT.

Tax compliance costs

The Italian tax system appears complex, at least judging by the number of tax expenditures (discussed below). This may not necessarily imply inefficiency since what matters to taxpayers in practice, apart from the total amount of tax they have to pay, is the administrative cost (which might be a direct financial cost, or the time taken) of dealing with the tax system. It is difficult to measure overall complexity directly, but some indicators of the cost of dealing with the tax system are available from the World Bank. These show that two relevant indicators – the number of separate taxes that businesses are required to pay, and the length of time it takes them to pay the major taxes – are both significantly higher in Italy than in other countries (Table 2.1). It should be noted that the World Bank indicators are quite narrowly defined, for a specific type and size of company, so their international comparability is uncertain.

Table 2.1. **Cost to companies of dealing with the tax system**

World Bank World Development Indicators, 2013

	Italy	Germany	France	Spain	United Kingdom	United States
Number of business taxes to pay	**15**	9	8	8	8	11
Time to prepare and pay taxes[1] (days)	**269**	218	137	167	110	175

1. Corporate income tax, value added or sales tax, and taxes on labour including payroll taxes and social security contributions.

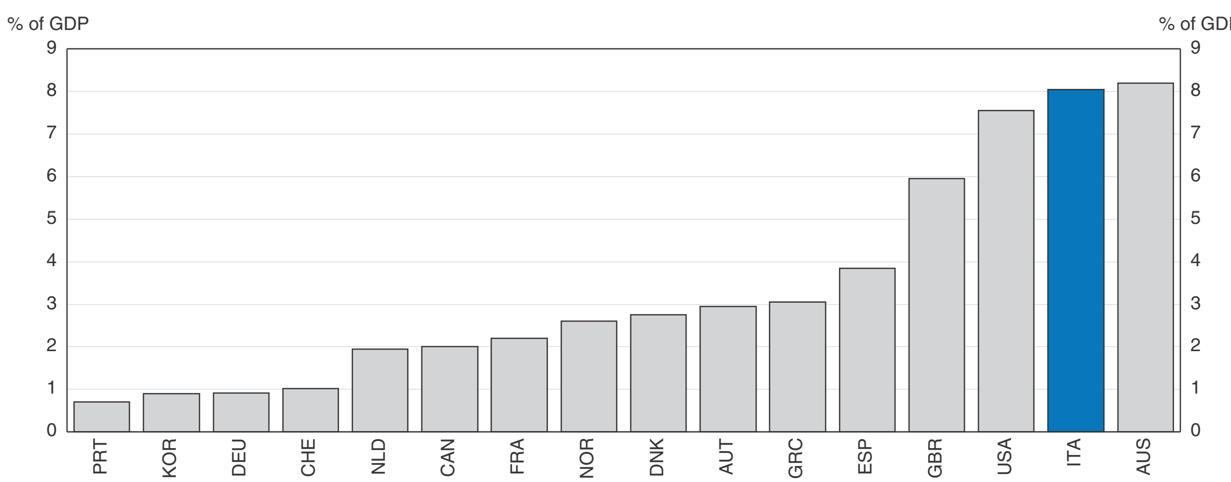
Source: *World Development Indicators*, *http://wdi.worldbank.org/table/5.6*.

The Italian government's policy programme has simplified dealing with the tax authorities. Measures taken in 2014 concern mainly personal taxation, but also reduced paperwork for some company taxation. The scope for simplification is sometimes revealed by an example: prior to the recent simplification, the definition of "first house" for VAT purposes was not the same as that for stamp duty. The ongoing process of simplification to improve efficiency in the public administration needs to continue to identify and eliminate this kind of incoherence.

Tax expenditures

Tax expenditures are an essential part of all tax systems, to adjust them to policy objectives such as progressivity, constitutional constraints, social or industrial objectives. They are not easy to define, since they rely on the interpretation of what the benchmark tax structure is, for which a number of definitions compete (OECD, 2010b); there is no cross-country survey of their use on standardised definitions. It is therefore hazardous to assert that the Italian tax system has too many of them, but this does seem to be the case. Given the difficulty of standardising definitions, cross-country comnparisons cannot be conclusive. Nevertheless, out of ten OECD countries surveyed – but not including Italy – OECD (2010b) reports that none had more than 486 (France, in 2008) tax expenditures, whereas Italy's own report shows 720 (MEF, 2011). Another way of looking at the importance of tax expenditures is in terms of revenue lost, although difficulties defining the counterfactual against which to measure revenue losses, combined with non-standardised definitions of tax expenditures themselves, mean that international comparisons are difficult. An IMF study reports that out of 14 countries Italy loses more revenue than any except Australia (Figure 2.3) Tyson (2014).

Figure 2.3. **Tax expenditures are expensive**



Source: Tyson (2014).

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In some cases, there may be little gain from tax simplification in overall administrative costs for the public administration, so a case by case approach is needed. If there is a switch from reducing poverty through low VAT rates to using means-tested benefits, for example, administrative savings in the VAT system could be more than offset by the costs of effective means-testing. In this example, since the government is aiming to expand means-tested benefits as one part its strategy for labour market reform, it will be incurring these costs in any case. A phase-out of redistribution-motivated exemptions and reduced rates in the VAT system could be planned as part of the expansion of the benefit system. The revenue gains from removing VAT-related tax expenditures could finance both higher social benefits spending and probably a lower standard VAT rate, since currently all consumers benefit – to different degrees – from the tax expenditures but only low-income people would be entitled to the higher benefits.

A small number of tax expenditures were eliminated in 2014. Of the seven items eliminated, 5 were tax credits to encourage specific activities by specific types of firms or in specific areas. Two concerned specific fuel tax reductions: these were very minor compared with the major tax expenditure in this area, such as on road-transport fuel, which, apart from any administrative costs, are environmentally counter-productive.

Transactions taxes – stamp duties

Transactions taxes, especially those associated with change of ownership of land or buildings attract a significant number of tax expenditures. These reveal problems with the taxes themselves, as the tax expenditures attempt to attenuate the worst of the distortions that they create. Most of these taxes come under the heading of stamp duty (*imposta di registro*). The related transactions (including those where no payment is made) are subject to a variety of taxes, some are fixed charges, while others are related to the value of the property transferred. In the latter case, the *imposta di registro*, there are two basic rates (9% and 12%) applied in different cases, but in addition a number of exemptions or reductions are applied. For example, on the purchase of a first house the *imposta di registro* is reduced from 9% to 2% and two other taxes are applied as a fixed charge instead of a proportionate charge. The loss of revenue was estimated at around EUR 1 billion in 2011 (MEF, 2011, p. 365). Another example is a reduction of a similar nature applied to transfers of small tracts of agricultural land. In this case the reduction is much greater (from taxes totalling 12% to a rate of 1%) but the revenue loss is much smaller (EUR 44 million) because there are far fewer transactions, and the total tax paid is limited to EUR 1 000. Other cases concern different rates according to the land's designation for planning purposes. Other minor exemptions and reduced rates exist. In the past there were very many more; most of them were abolished in 2011.

A different kind of transaction, but facing similar taxation, concerns contracts. Rental contracts are also subject to the *imposta di registro*. Where these apply to rental accommodation contracts, a reduced rate is applied. Mortgage contracts are also subject to this tax, except for residential loans whose exemption counts as a tax expenditure. The exemption of insurance policies also counts as a tax expenditure.

In general, taxes on transactions are easy to collect but it is hard to make them proportionate to standard criteria of ability to pay or some negative externality. For instance, a residential property that generates income (either actual or imputed) can be taxed on that income. A wealth tax might also fit some social objectives (though likely to distort savings-investment decisions). But there is no obvious reason in either case why the tax should be a function of how often ownership changes. While charges related to the actual administrative costs for the registry are appropriate, transactions taxes tend to reduce economic efficiency, by making it more expensive to shift resources from one use, or user, to another. In the case of taxes on house purchase, for example, they can inhibit geographical mobility in the labour market.

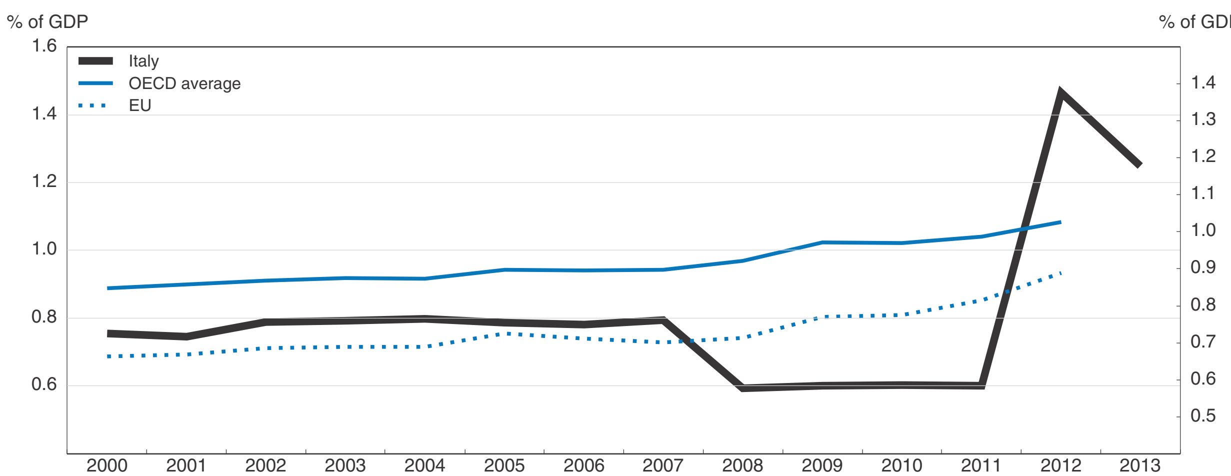
In the case of the *imposte di registro*, therefore, many of the related tax expenditures are needed to avoid their worst distortionary effects. The policy aim should be to remove these taxes altogether (except those directly covering administrative costs) rather than to reduce the tax expenditures. In the short run, this would be difficult because of revenue losses. In fact their high levels in the first place are partly due to tax evasion elsewhere: taxes on transfers of property are very difficult to evade if legal title to a property is to be claimed. A hidden benefit of reduced evasion on "better" taxes on incomes or current expenditure is thus that such inefficient taxation, and the complicated apparatus that avoids some but not all of its effects, could be radically simplified.

Property taxation

Property taxation, at moderate levels, avoids many of the distortions to labour supply from income taxes and even expenditure taxes (Johannsson et al., 2008). Adequate property taxation, including on owner-occupied housing, should therefore be part of a cost-efficient taxation strategy. In Italy there have been sharp swings in revenue from such taxation over the past few years (Figure 2.4). Taxation on owner-occupied houses was abolished in 2008. This tended to disrupt local government finances, since the lost revenue needed to be made up by increased transfers from the centre. Potentially losing revenue, this also reduced the freedom of manoeuvre and accountability of local government since municipalities were no longer free to set that part of taxation as a function of their perceived needs. The lost revenue implicitly means higher taxes elsewhere, and this will have increased distortions in the tax system. Revenue from property taxation revenue fell from 0.8% to 0.6% of GDP, compared with an OECD average of almost 1%, before rising sharply with the reintroduction of the tax (Figure 2.4).

Figure 2.4. **Unpredictable property taxation**

Recurrent taxes on immovable property



Note: The EU area refers to OECD country members. The aggregates are calculated as a simple average.
Source: OECD (2014), *Revenue Statistics* (database).

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A revised property tax (IMU) was re-introduced in 2012, which applied to all homes including owner-occupied houses. In 2013 the government announced that it might abolish IMU on owner-occupied housing and in the meantime its payment would be suspended. Disagreement within the governing coalition left everyone uncertain as to what the legal situation was. In the end the government abolished the IMU on owner-occupied housing and at the same time announced that a new tax would be introduced in 2014. The new tax, "IUC", incorporates the former property tax (IMU) with a new services tax (TASI) and a charge dedicated to financing waste disposal (replacing an existing charge). For owner-occupied homes, IMU applies only to those in a "luxury" category. Some uncertainty continued, as by mid-2014 only about one quarter of municipalities had met the deadline for setting the TASI rate, for example. The government has announced that there will be further modifications to the tax in 2015, probably including all first homes in the tax again, but a final decision has not yet been made.

One of the political difficulties in reintroducing housing tax has been the lack of updated data on housing values. "Cadastral" values are used for evaluating the implied rents that are used to assess tax, but these are based on property valuations that are many years out of date. The government has announced that cadastral values will be re-assessed to take into account market values; a government decree to launch this process is expected in the spring of 2015, with the process expected to take up to 5 years. Such a revaluation is essential. The more difficult cases concern relative cadastral values that differ substantially from relative market values within the same geographical area. This is an obvious source of unfairness, but may also be a source of resistance to reforming cadastral values, from those owning undervalued properties.

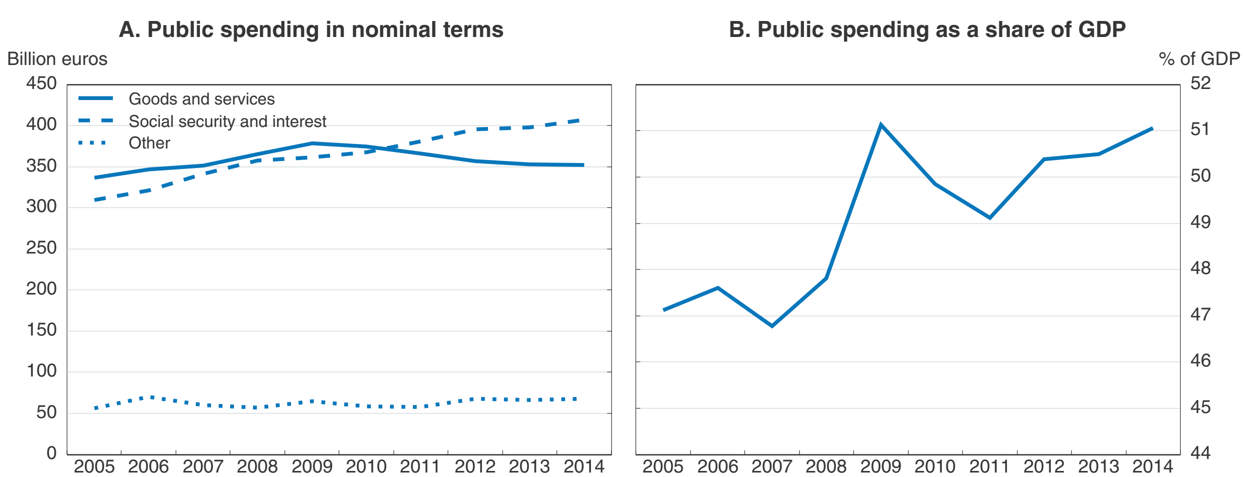
Spending control

Spending on goods and services has declined in recent years

In 2014 public spending on goods and services and public sector wages in nominal terms was below the level of 2008 and has been falling continuously since 2011. Nevertheless, total spending has risen as a share of GDP, despite the intention to concentrate most of the fiscal consolidation on the spending side. The effect on the ratio of total spending to GDP of successful reductions in goods and services spending was offset partly by renewed weakness in GDP after 2011 and partly by continuing increasers in entitlement spending on social security – especially but not only on pensions (Figure 2.5). To cut the budget deficit, taxation has had to be increased as the weak economy cut into revenues.

The impressive results in overall spending control have not always been growth friendly. For example, public investment, including infrastructure, has fallen substantially. The share of investment in public spending is one of the lowest in the OECD (Figure 2.6). Spending on education, vital for the development of human capital, has also been reduced

Figure 2.5. **Cuts in total discretionary spending, while other spending rises**



Source: *OECD Economic Outlook 96* (database). Data for 2014 are estimates.

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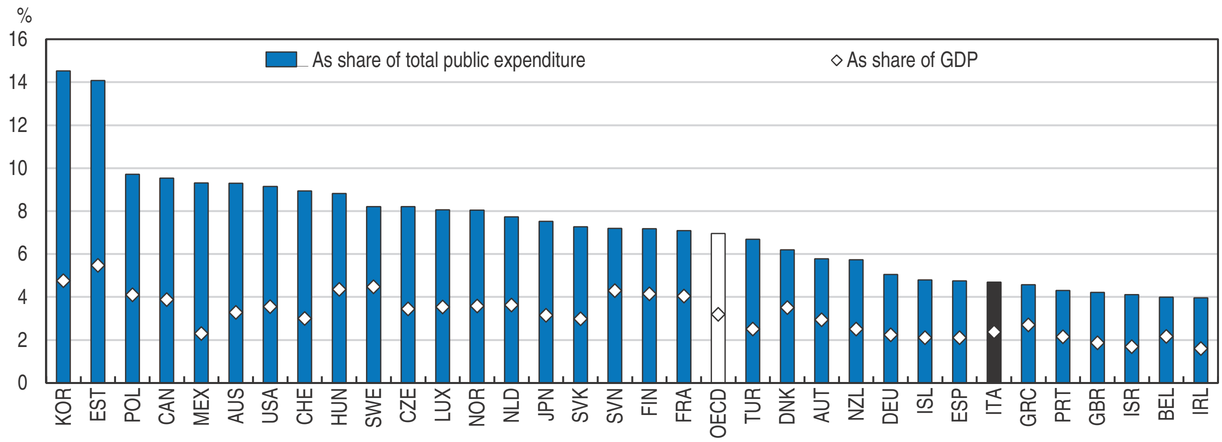
Figure 2.6. **Low public investment**

Public investment, 2013 or latest data available



Source: *OECD Economic Outlook 96* (database).

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since 2009. In that period, average performance of school students measured by OECD PISA data has in fact improved slightly, nevertheless. Although this corroborates analysis that showed that there was previously room for more efficient education spending in Italy (see below), further reductions need to be avoided as the share of spending in GDP is now far below the OECD average.

About one tenth of public spending is on debt interest payments (Table 2.2). The cost of high debt can be seen in the fact that debt interest absorbs more resources than current expenditure on education, or more than three times as much as on defence. Interest spending was the equivalent of about 5% of GDP in 2013, higher than all but two OECD countries, and about twice the median. Along with high pension spending, the result is that actual current primary spending, excluding pensions, is already lower in Italy than in many countries, meaning that the search for economies is particularly difficult.

One advantage that Italy has relative to many other countries is that a series of pension reforms have stabilised the projected future level of pension expenditure as a share of GDP. Indeed, over the next ten years it is projected to fall by around 1% of GDP to around 15%. In many other countries the share is still set to rise, although few have yet reached 15% of GDP. This fall is the result of an acceleration of the phase-in of pension reforms made in the mid-1990s. Owing to the difficulty of reaching political agreement on the reforms in the 1990s, those changes were phased in over a very long period. Though putting a cap on overall costs, this allowed them to remain high in the meantime, contributing to the build-up of public debt.

Spending control has improved

In the years prior to the financial crisis, spending control was not always very effective, both at sub-national level and in central government. One reason for this was that laws were often amended by parliament to add new spending measures or tax deductions in a way that was difficult for the government to control. An important series of budgetary reforms changed this. The government now issues a budgetary plan, in the economic and financial document (DEF), setting overall spending and deficit limits, in the

Table 2.2. **Components of public spending**

General government, per cent of GDP, 2011

	Italy	OECD average
Total spending	**49.1**	44.0
Current goods and services	**19.6**	20.0
Transfers		
Pensions	**14.9**	8.7 (2009)
Companies	**1.4**	
Investment	**2.8**	3.4
Other	**5.9**	
Debt interest	**4.7**	2.6
By programme[1]		
Education	**3.6**	5.1
Health	**6.8**	5.8 (2012)
Defence	**1.3**	1.3
Environment protection	**0.9**	0.7

1. Expenditure by programme is final consumption expenditure only; it excludes transfers and investment.

Source: Istat, *General Government Account*, October 2014; SEC2010; *OECD Economic Outlook 96* (database); *COFOG Database*.

spring of each year, and the actual budget law (currently called the Stability Law) passed in the autumn has to keep within these limits. A constitutional modification, in Article 81, now also requires that any legislative measure that has fiscal implications has to include provision for providing the resources, limiting the possibility of issuing new debt. This now prevents spending (or tax reducing) measures being included in non-budgetary legislation.

The new budgetary process implied a move towards planning spending over a three-year horizon rather than one year at a time, but this was not fully followed through. Since 2009, budgetary documentation has presented projections of programmed spending for three years ahead, but only the first year has legislative force. A pre-commitment to spending control is implicit in the projected spending programme. The latest budgetary projections for 2016, for example, show a continuing fall in public expenditure as a share of GDP in order to meet the structural budget balance targeted for 2017.

Budget projections of spending on unchanged policies, however, show that expenditure will exceed the programme targets without further legislation. To ensure that the targeted budget balance is met, the government has legislated an increase in VAT that will occur automatically in 2016 unless other measures are taken. In the future, an alternative approach could be to legislate spending targets, by main programme or by ministry, for more than one year.

Spending control has begun to focus on efficiency

Gains in efficiency could offset at least some of the impact of cuts in public spending. The 2009 *OECD Economic Survey* of Italy highlighted evidence of spending inefficiency in education, suggesting that "accountability" measures, such as better collection and use of performance information for schools and teachers, and more emphasis on teacher training and less on absolute numbers of teachers, were among the measures that could lead to improvements (Boarini, 2009). Governments have moved somewhat in this direction although resistance to use of improved student performance information has been strong. Some spending cuts in education had indeed been planned before the impact of the financial crisis became clear, as part of a policy to improve efficiency.

Despite the cuts in nominal expenditure on education, and limited progress on improving accountability, average student performance at age 15 as measured by PISA data has been improving. Between 2003 and 2011 average performance in mathematics increased in Italy by more than in most OECD countries, though it is still below average. Student performance would not be affected very quickly by policy changes, so these improvements may be related to trends apparent before the spending reduction; for example there was a substantial increase in teacher's salaries between 2000 and 2010. Nevertheless, the improvement in PISA results at a time of spending cuts at least suggests that efficiency improvements were indeed possible.

Few other spending programmes were subjected to such significant cuts as education. Cuts in expenditure on buildings and equipment could have an impact over a long period, so the government has rightly decided to try to protect education spending from any further budgetary consolidation measures. It should push forward with the programme to develop accountability, however, especially with strenuous efforts to develop systematic information on student performance that can be of practical help to teachers in improving results, to demonstrate that accountability measures are ways to improve overall performance, not to penalise individual teachers or schools.

Spending reviews

Previous *OECD Economic Surveys* have drawn attention to the need to develop spending review processes within the public administration and pointed out that a good start had already been made in 2007-8 with the work of the Technical Committee for Public Finance which was part of a spending review process launched in 2007, but not fully followed through (OECD, 2009, 2011, 2013c). Many of the accountability measures mentioned for education, and the identification of areas where education spending could be reduced with least damage, were suggested in the work of that Technical Committee. Its suggestions in other areas have been taken up much more slowly or not at all. Its preliminary report in 2008 suggested a number of reforms in the judicial sector, for example (MEF, 2008). These began to be taken up in 2012, and are now being further developed under the current government.

In 2012 and again in 2013-14, successive governments called in outside experts to conduct ad hoc spending reviews to identify where spending cuts could be achieved with least impact. The 2012 spending review looked at public investment in general. Between 2008 and 2014 general government capital spending has fallen by about 20% in nominal terms, similar to the fall in private investment, and more than current spending. One of the government's priorities is to boost capital spending especially on important infrastructure projects such as broadband network access and key transport links. But public investment spending appears to be relatively inefficient in Italy. Studies highlight higher unit costs and slower delivery on road and rail projects, adjusting for objective differences, than in other European countries (Bank of Italy, 2012). This report locates the problem in certain key areas: overlapping responsibilities between levels of government, insufficient attention to cost-effectiveness both in selection of projects and in implementation, and lack of technical capacity in evaluation and implementation. A boost to investment is one of the means planned to strengthen Europe's economy, but unless cost-effectiveness is improved in Italy, at best it will be less useful than in other countries and at worst it could waste large amounts of resources.

The spending review launched in 2013 took a further step forward, directing its efforts towards identifying specific candidates for spending reductions. A summary presentation of the review's preliminary results was leaked and is widely available on the web (Commissario Straordinario, 2014), but no full report has been published so it is difficult to know whether it has useful lessons beyond some of the practical examples it highlighted. A key approach was to use whatever data was available to benchmark types of spending either within the country or comparing Italy with other countries. For example, there is an allowance payable to disabled people for them to get help in the home. The number of such allowances paid per head of population is nearly twice as high in some regions as in others. The review concludes that part of this difference is due to over-generous allocations in some regions, so that savings can be achieved through reinforced controls. Another example is that transfers to support rail transport are 30% higher per kilometre of network in Italy than in Germany, France or the UK (though much lower than in Belgium and the Netherlands). The spending review recommends reducing transfers towards to the European average, on the grounds that the excess represents potential efficiency savings.

Identifying likely efficiency savings in this way is one thing, and studies like those carried out in the spending reviews are valuable and should be continued and refined. But obtaining value for money needs to be an integrated part of policymaking and administration, not something that requires recourse to ad hoc commissions.

Obtaining value for money

While strategic policy choices can have important budgetary implications, so can less high profile matters such as public procurement. The 2013 spending review attributed cost inflation in the provision of public services to a number of problems, particularly pervasive gaps in management capacity, wages policy and public procurement systems (Council of Ministers, 2013, p. 14). There are many signs of inadequacies in cost control at this level and it has proven difficult for previous governments to deal with them. As long ago as 1993, budget legislation included provisions intended to reduce variation in public procurement costs across the country and Consip (originally "*Concessionaria Servizi Informativi Pubblici*", established to manage IT development in the then Treasury Ministry) was eventually given a role in providing procurement services for central government ministries so as to ensure all ministries get the best value for money.

Consip reports that in areas where it has taken over responsibility for procurement, ministries can make savings of 22% on average. Despite these apparent benefits, Consip is still used directly for only 3% of total public administration expenditure. Consip estimates that its reference prices or framework contracts are used for something like 5% of total expenditure. This seems a small proportion, partly because most of government spending is either transfers or wages and salaries. When these are excluded, Consip covers something like 20% of relevant expenditure. It is not clear, however, that effective follow-up procedures exist to ensure that actual contracts or purchases make the implied savings.

Much public procurement occurs at sub-national level, for which Consip is not currently responsible. The 2013-14 spending review proposed that the number of purchasing centres nationwide be reduced from an estimated 32 000 to less than 40 – as far as expenditure above a certain threshold would be concerned. These would cover the regions and major cities as well as Consip for the central administration. In April 2014, several provisions were introduced to increase the role of purchasing centres for new procurement, to aggregate demand and obtain better prices and increased control over the public procurement system.

In parallel with Consip, which provides procurement services, ANAC, the national anti-corruption agency, has a section responsible for monitoring value for money in public procurement. Prior to a re-organisation in mid-2014 this was a separate agency, AVCP. Not all major public investment projects were automatically subject to monitoring by AVCP. The emergence of major cost over-runs and suspected corruption at a high level in two key construction projects, the 2015 International Exhibition in Milan, and the construction of the "Mose" the anti-flood gates to protect the Venice lagoon, prompted the government to incorporate it into the anti-corruption agency.

ANAC itself was previously part of the agency responsible for measuring and evaluating performance in the public administration, CiVIT, but was separated from it in 2014. This separation was recommended in the 2013 *OECD Economic Surveys* on the grounds that anti-corruption and performance management were very different things, so that combining them could potentially lead to conflicts of interest without any potential gains in efficiency or economies of scope. From that point of view, incorporating the former AVCP into the anti-corruption agency might not have the anticipated results. On the other hand, since it is fairly clear that the construction industry in general, especially public works, is one of the major activities penetrated by organised crime as well as being vulnerable to "normal" corruption, it could be a rational step. The anti-corruption agency's mandate was initially mainly concerned with developing and promoting procedures in the public administration to avoid and detect corruption, rather than taking legal or other action against actual cases of corruption. It has now been given somewhat stronger powers; these include the power to recommend that prefects force the replacement of executive officers involved in corruption practices in companies, as well as special investigating powers over the biggest public contracts, such as the Milan Expo 2015. It might nevertheless have made more sense to look further into why those particular contracts had escaped AVCP monitoring, and into what other measures that should normally avoid cost-overruns or prevent corruption did not work, before modifying ANAC's mandate yet again.

Improved public administration is essential

As mentioned, measures to improve cost-efficiency in public spending have been sought for at least 20 years. Plans to improve efficiency in the public administration also date back at least to the late 1990s. In two key areas – performance management and transparency – there has been progress but also evidence that the process is slow.

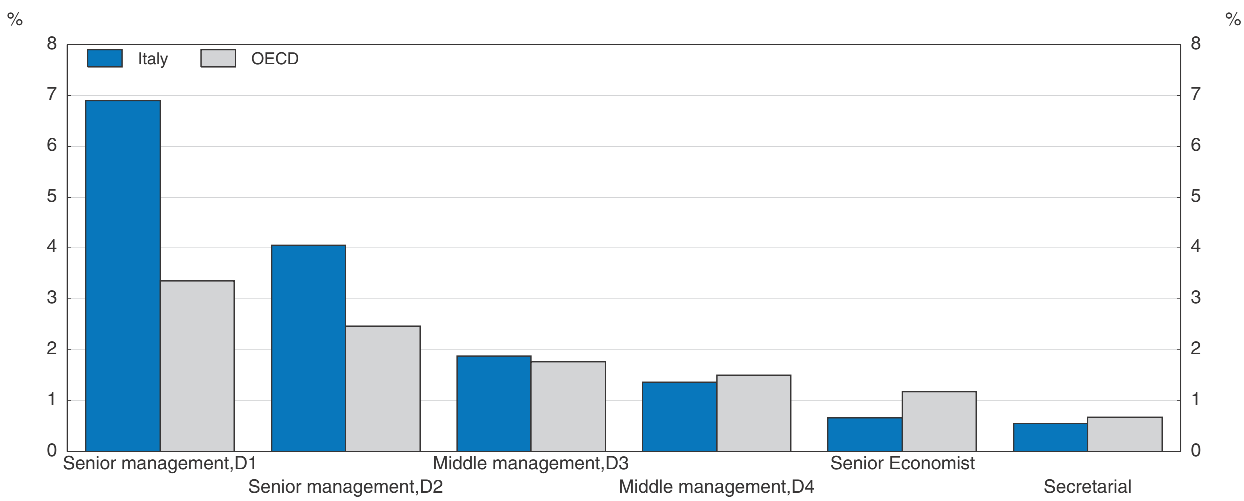
Performance management

The development of performance management techniques has been one constant objective of reforms, especially since the "Brunetta reform" of 2008. But for the moment performance evaluations are applied essentially only for managerial staff, while almost all managers are evaluated as meeting at least 90% of the maximum scores (ANAC, 2014). Earlier reforms changed the employment status of public servants, removing the theoretical right to a job for life, but in practice barriers to mobility within the public administration have remained an obstacle, whether for providing incentives or for managing reorganisations. For example, only in 2014, as part of an emergency decree on simplification and improving public administration, was it made easier for public administrations to re-assign civil servants to jobs different from that for which they were recruited and to move them (within a limit of 50 kilometres from their existing post).

However, other measures in the same decree included imposing immediate cuts on consultancy expenditure by a number of public agencies, including independent regulators. Such expenditure may represent wasted resources, in which case the governance of those agencies needs to be improved; indeed the simultaneous requirement for cuts in salaries in these agencies suggests that they may be overspending. The salary structure across public administration is not standardised. International comparisons show that senior civil servants have much higher relative pay in Italy than elsewhere, whereas at least some types of employee appear much less well paid (Figure 2.7). The government has recently been imposing salary caps on many public appointments to reduce this disparity. Further provisions for eliminating unjustified salary differentiations as part of a new human resources management policy are being planned.

Figure 2.7. **High pay for some civil servants**

Salaries relative to the average for employees with tertiary education, 2012



Source: OECD (2013), *Government at a Glance 2013*, OECD Publishing, Paris.

How to read this figure: In Italy, managers at the most senior civil service level were paid, on average, seven times the average national earnings for tertiary graduates, compared with an average across the OECD of a little over three times. For senior economists, while in the average OECD country they are paid more than a typical tertiary graduate, in Italy they were paid less.

StatLink http://dx.doi.org/10.1787/888933185007

One difficulty in introducing performance management has been the budget constraints of recent years, which have prevented reforms being eased through monetary incentives. Both recruitment and salaries have been largely frozen for several years. The overall number of civil servants, which is not particularly large by international standards, declined by about 6% between 2007 and 2012 – more than half of this reduction coming from a cut of one-third of those on temporary contracts. Over the same period average earnings initially rose quite substantially, but have been largely unchanged since 2009. But there are other signs of change such as the steady rise in the number of women in senior managerial positions: the share of female managers rose from 35% to 43% between 2007 and 2012, while for more senior management it rose from 25% to 35%.

In the future, the increasing numbers of staff retiring and the impact of the last few years of frozen recruitment, will allow recruitment to accelerate somewhat. The government have spoken of the opportunity for generational change that this represents. Generational change does not guarantee behavioural change if incentives are not improved, although it is important to allow the recruitment of employees with the skills required for modernising and digitalising public administration. An important focus, also common to most of the programmes to improve public administration over the years is transparency.

Transparency

According to Allio and Rangone (2015), the tradition of public administration in Italy was more oriented towards secrecy than transparency until the late twentieth century; secrecy was the norm and access to information the exception (De Pretis, 2010, cited in Allio and Rangone, 2015). Factors such as complex procedures and requirements for repeated presentation of documents both create and encourage lack of transparency. This results not only in slow administrative processes but also in fertile ground for corruption. Measures to improve transparency began in the 1990s and have continued to be developed. Often they have been working in parallel with measures to simplify all aspects of public administration.

The 2013 *OECD Economic Surveys* suggested that transparency could be promoted by a general freedom of information act, which a number of other countries, starting with the United States, have already implemented. Italy is moving in this direction in intent, as its transparency provisions have moved in the direction of a total disclosure principle (see Allio and Rangone, 2015, for a detailed discussion of the evolution of transparency provisions, and the link with improving public administration and reducing corruption). Although there is a commitment to total disclosure it is often taken to mean full disclosure of information that is specified in explicit instructions, with no implication for information that is not covered. A freedom of information approach would require that all information should in principle be publicly available, with nevertheless provision for withholding information on grounds such as national security or privacy considerations, as well as on grounds of disproportionate cost.

A significant example of transparency is provided in the case of environmental information. Transposing EU Directive EC/90/313 introduced the obligation to provide environmental information to anyone submitting a request, regardless of their legitimate interest (Allio and Rangone, 2015). That this is possible in the environmental domain should show that such freedom of information provision is compatible with the Italian legal tradition.

Allio and Rangone (2015) also provide evidence that the development of anti-corruption and transparency measures is subject to problems of poor planning and implementation. In particular, transparency measures that are designed in part to improve public administration's compliance with policy intentions can themselves lead to automatic non-compliance. Examples are the introduction of requirements for publication of salary and curriculum vitae information for senior management (part of the Brunetta reforms) and the requirement of the 2013 anti-corruption law that all public administrations publish their plans for preventing and dealing with corruption. In both cases, the law laid down that administration should publish the information much more quickly than was possible. As a result, by early 2014 only a minority of public administrations had published an anti-corruption plan, much less had it approved by ANAC. Such delays are probably unavoidable, in which case they should be taken into account in the originating legislation. If compliance is objectively difficult even when administrations are well-intentioned, non-compliance risks seeming "normal" and becoming a cover for deliberate non-compliance.

Allio and Rangone (2015) suggest a parallel between examples like those – of quasi-automatic non-compliance – and the tendency for Italian legislation to assume that regulation in itself solves problems. Despite significant efforts to simplify regulation, and the creation some years ago of a "simplification unit" within the prime minister's office, it seems that there is still a tendency to introduce regulations without regard for their full impact. For each rule abrogated, 1.2 new rules are drafted (Parliamentary Commission, 2014).

Nevertheless, transparency has improved. For example, information on earnings and the curriculum vitae of public officials is now published online, helping to check whether the right people are in the right jobs and whether they might have conflicts of interest. Another example is the enabling law on tax reform, which provides for the tax collection agency to change its approach towards actively helping taxpayers to comply rather than concentrating on penalising evasion. A first step will be the that the tax administration will issue taxpayers with income tax declarations already filled with information already known to the authorities, leaving the taxpayer with a much simplified task. Developing this kind of public-service approach in the public administration generally should help to improve efficiency, whether it concerns improving tax compliance at least cost or improving value for money in expenditure.

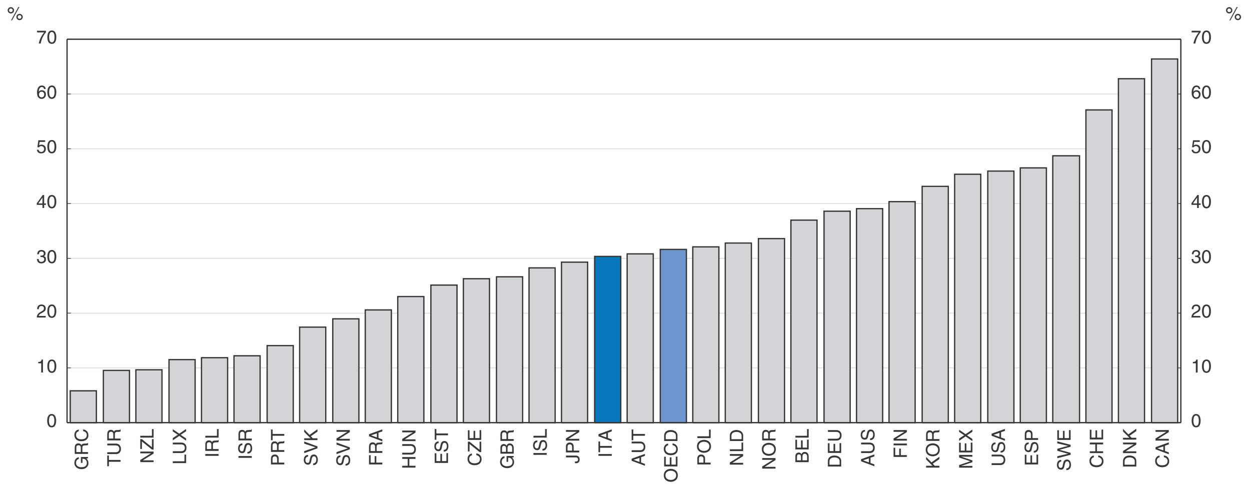
Simplification can improve transparency as well as reducing costs. Progress in simplification has proceeded well in many areas; some are invisible to objective indicators but some are reflected in OECD indicators of product market regulation. Just one example is where reductions in the number of steps required to set up new firms has contributed to improvement in Italy's score on barriers to entry since 1998. Past complexity and the continuing need for administrative reform is nevertheless revealed in recent measures: the 2015-17 Agenda for Simplification included a specific measure to prevent the public administration from requiring individuals to provide information that is already present in the national population register. Yet the Brunetta reforms (from 2009) already included a provision that offices of the public administration could no longer require a citizen to provide a document which itself is produced by the public administration (whether the same or another office). As the 2013 *OECD Economic Survey of Italy* noted, there were many delays in this provision becoming effective (O'Brien, 2013). The need for the additional measure in the 2015-17 Agenda shows that even if the letter of the 2009 reform may by now fully operational, its principle – that the public administration should not require duplication of information provision from citizens – had not been absorbed.

The Internal Stability Pact

Italy has a considerable high degree of decentralisation of government and public spending responsibility for a non-federal state, though somewhat below the OECD average in 2011 (Figure 2.8). This average would be somewhat lower if restricted to non-federal countries. By 2013 the share had fallen to about one quarter of total public spending, as some public spending restrictions have fallen particularly on sub-national spending (Table 2.3). The sub-national share of spending excluding pensions and debt interest is about 50%.

Figure 2.8. **The share of sub-national spending is below the overall OECD average**

Sub-national spending as a share of total government spending, 2012



Source: OECD (2013), *Government at a Glance 2013*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888933185018

Table 2.3. **Sub-national government spending, 2013**

Billion EUR

	Current	Capital	Total
Total sub-national	**171.5**	**26.4**	**198.0**
of which:			
Regions	115.2	13.5	128.7
of which:			
North	*56.7*	*5.3*	*62.0*
Centre	*27.6*	*2.6*	*30.1*
South	*31.0*	*5.6*	*36.5*
Provinces	7.2	2.6	9.8
Municipalities	49.1	10.3	59.4
Memorandum item:			
Health spending	93.7	4.5	98.2
Total public spending	767.7	42.5	792.

Note: current spending is recorded on accruals basis, investment on a payments basis. Data may not be fully comparable with Figure 2.8, as some social security spending may be included in sub-national expenditure in this table.

Source: Corte dei ContI (2014), Ministry of the Economy and Finance, OECD calculations.

The Internal Stability Pact, introduced in 1999, is intended to ensure that the financial situation of local, provincial and regional administrations (collectively, "sub-national government") is consistent with Italy's obligations under the European Union fiscal rules for euro area countries. The European Union fiscal rules concern the levels of the deficit and gross debt. The Internal Stability Pact (ISP) could in principle set objectives only for deficits, since the debt of sub-national government in Italy has always been relatively small. However, the ISP has been used to pursue other objectives than simply those deriving from the EU rules, namely: eliminating deficits in sub-national entities; ensuring sub-national participation in specific priorities for public spending; and limiting the tax burden (Corte dei Conti, 2014).

In 2001, the Italian government made significant changes to the constitution, increasing the policy prerogatives of sub-national government and providing for a system of fiscal federalism under which the tax and spending powers of sub-national governments would be reinforced, and the rules determining fiscal transfers from the central state to sub-national government revised to ensure more financial autonomy. An outline for the rules of fiscal federalism was approved by parliament in 2009, but much of the detail related to standard costs has yet to be agreed and the only part operating in practice is the system for calculating central finance for health expenditure. Health expenditure indeed accounts for around half of sub-national government spending. For regional administrations it accounts for about 85% of spending.

The Internal Stability Pact, non-health spending

For provinces and municipalities with over one thousand inhabitants the ISP sets target budget surpluses, as a certain percentage of expenditure. For regions, however, in addition to restrictions on borrowing (sub-national governments must run balanced budgets, excluding capital expenditure), the ISP imposed limits on total non-health spending. The national government rightly prefers to pursue fiscal consolidation through controlling spending rather than increasing tax, since overall taxation is already high. A significant part of central government spending is accounted for by transfers to the regions, corresponding to about half of total regional expenditure including health. Central government therefore includes cuts in these transfers as part of budget consolidation measures and imposes spending limits on regions in order to prevent them from responding by raising taxation.

The logic for imposing spending restrictions on the regions is therefore clear. But it reveals a weakness in the current arrangements, which clearer definitions of national-sub-national responsibilities and consistent rules for fiscal federalism should be able to deal with. The planned constitutional reform will allow regions which run balanced budgets to obtain further autonomy from central government.

The spending limits are negotiated annually between the central government and the regions, and have been complicated by accounting definitions, and ad hoc exceptions. They have continued to be largely based on historical patterns of expenditure, in the absence of standard cost pricing for transfers that is beginning to be used for health spending. Thus, regions that have traditionally spent more than others continue to do so, while regions wishing to spend more have been prevented from doing so even if they currently spend less than the average.

The Health Pact

The Internal Stability Pact strictly speaking covers only non-healthcare spending, while health spending, financed centrally but administered by the regions, is subject to a separate Healthcare Pact, introduced in 2006. The health pact, which was preceded by attempts to limit spending such as a ceiling on pharmaceutical spending, is based on controlling deficits. Some regions are operating under "re-entry plans" (*piani de rientro*) to correct previous excessive deficits. In some cases the health authorities are under compulsory administration (so-called "*Commissariamento*") where external commissioners are brought in, replacing the normal administration, to ensure compliance with national policy. Between 2008 and 2010 six regions (Abruzzo, Calabria, Campania, Lazio, Molise and Sicily) were brought under this process, as they had failed to comply with their "adjustment plan" targets to eliminate deficits, which were set in 2007. These problems have still not been resolved, as technical working groups seek to find a way for these regions to eliminate their deficits during 2014-16.

Health is also the one area where fairly straightforward fiscal federalism rules for expenditure are now in operation. This is the so-called "standard cost model", where central government transfers funds for health policy on the basis of a calculation of spending needs which assumes a uniform cost for specific kinds of spending. This covers mainly the health care interventions that are mandated by national laws. This results on central transfers being allocated essentially on the basis of demographic indicators. Per capita transfers (adjusted for demographic structure) are calculated on the basis of the previous period's expenditure in three of the five regions who perform best on costs. Implementing this approach in health is an important achievement. In the past, serious overspending on health, frequently accounted for by individual hospitals rather than being generalised in any particular regions was a recurrent problem, plagued by self-fulfilling expectations of central government bailouts.

The use of standard costs leaves regions free to spend more than standard costs, but also to retain the savings if they are able to do better. To be durable, the system for determining standard costs must encourage cost reduction without being too draconian.

While incentives to improve efficiency are present, it is clear that such corrections are not achieved without cost. According to a survey about half the population in the regions in "commissariamento" perceives the quality of the health service to be declining, compared with about 30% in other regions (RbmSalute-Censis, 2014). According to the same survey, health provision, such as measured by waiting times, varied widely across the country, although not according to a simple north-side divide.

Problems of accounting and spending definitions

Accounting differences have been mainly related to those between accruals-based and cash-based accounting and the fact that sub-national accounting conventions were incompatible with national and European standards until 2012. It is still the case that many sub-national governments have to calculate two different balances, one for ISP purposes and one normal one. It is intended to move to a cash-based approach as from 1 January 2015 but this target may be hard to meet. In any case there are good reasons why accruals-based accounts are needed, not least for predicting debt, so moving to cash balances may leave some problems unresolved.

More persistent problems arise from using historical spending as a starting point for deciding on the level of central transfers, rather than an assessment of need, and from the ad hoc changes that happen each year reflecting varying central government priorities.

Use of EU structural funds, which are spent mostly by the regions, has also caused some regions difficulties. EU finance is disbursed only once proof of the use of matching funds has been provided. This has often meant that regions are unable to use EU finance because the domestic share of expenditure required causes them to exceed the spending limits imposed under the ISP, even though the expenditure directly covered by EU funds does not count as net spending by the region itself for the purposes of the Pact. It is not clear whether this is an inherent problem or one that can be managed with good administration, since some regions, such as Puglia, managed to largely eliminate this as a constraint on its use of EU funds, through improvements in capacity. In any case, allowing regions to run up debt providing it was covered by existing agreements on structural funds would be an alternative solution providing somewhat more flexibility. The 2015 Stability Law envisages that co-funding of regions will not be considered by the ISP in 2015, thus providing some mitigation of the problem.

Constitutional changes and fiscal federalism: Inconsistencies and delays

Prior to 2001 problems of co-ordination of national and sub-national budgets were much less important. Constitutional changes in 2001 delegated much wider areas of budget and policy responsibility to the regions and provinces, but left two problems. One was that of legislative overlap where several levels of government could claim competence, such as tourism (where regions, provinces and municipalities have overlapping responsibilities, in addition to central government), or inappropriate delegation of some policies such as that which required every region to have its own energy plan rather than a coherent national approach.

Many of these problems should be resolved by constitutional changes now going through parliament. The government plans to put these changes to a referendum at the end of 2015. These changes will abolish the provinces. Their administrative functions will be absorbed into the regional or municipality levels. These changes are already under way as measures taken in 2014 removed finance for elected officials and initiated the process for transfer of functions. The constitutional changes will also recentralise some functions. Central government will be responsible only for a specific list of policy areas, planned to be wider than under current arrangements, leaving the regions as the default level for other matters. But the national government will have a reserve power to legislate on matters that may not be on that list, if it deems that important national interest are at stake.

The other problem generated by the 2001 constitutional changes was that fiscal arrangements were never aligned with the changed constitutional powers of sub-national government. The constitutional law of 2001 mandated the government to implement an appropriate system of fiscal federalism, which might logically have delegated wide taxation powers to sub-national government, given the range of their spending responsibilities, and could perhaps have avoided some of the problems with the Internal Stability Pact discussed earlier. But it was not until 2009 that a clear plan for a system of fiscal federalism was legislated.

The fiscal federalism legislation passed in 2009 was in the form of enabling legislation, requiring the government to develop rules to implement the guidelines in subsequent decrees. The 2009 legislation side-stepped many difficult issues of implementation, but did set out a rational structure for sub-national finances. On the revenue side, it specified that certain taxes would be for use only by sub-national government, the local property tax and a locally determined surcharge on personal income tax; there would be a system whereby poorer regions were partially compensated for their low revenue-generating capacity by a system of redistribution based on simple rules. The frequent changes in the structure of local property taxation described earlier would have made this system very vulnerable had it actually been in place. On the expenditure side, finance for expenditure that is mandated by national legislation would be provided by transfers from central government, with the level of such transfers set by reference to "standard costs" for meeting those expenditure commitments.

Little of this structure is yet in place, especially as concerns taxation and the equalisation system, so sub-national finances are still dominated by transfers from central government. This is partly because there have been several changes of government since 2009 and perhaps also because of the strong and persistent regional divide. This divide could make it difficult to agree on the details of revenue-sharing and items such as infrastructure spending, where southern regions are in need of investment but also suffer from high costs and risk of corruption.

Although little is in place there has nevertheless been progress. Allocation of central funds for health is now based on the standard cost approach: transfers are calculated on the basis of calculations of need taking into account demographic and other characteristics of the population, taking standard cost as the average of the three best-performing based regions. Some progress has also been made in calculating standard costs for other types of expenditure, but so far only for illustrative purposes.

Simplifying the Internal Stability Pact

The ISP has become more complex than is necessary to bring sub-national finances in line with EU fiscal constraints. This has partly seemed necessary because there has not been a good alignment between responsibility for tax and spending at different levels and the constitutional division of policy responsibilities. Once the new constitutional arrangements are in place and the balanced budget rule for sub-national government implemented (foreseen for 2016), it should be possible to rapidly implement fiscal federalism in accordance with the 2009 enabling law, adjusted to be in line with the new structure of sub-national government. Sub-national government's powers of taxation would be appropriately defined and in line with their autonomous spending responsibilities (i.e. excluding national policies which are delegated, for which central government finance is provided). This should allow the ISP to be considerably simplified, concerning itself only with setting deficits and not with the composition or level of spending. Appropriate accounting rules should be able to deal with the difficulties that have sometimes occurred fitting the expenditure of matching EU funds within the constraints. Once this is done, there should be no need for central government to interfere in any detail.

A further step could be to define the ISP in terms of strict limits on debt rather than the balance. This would provide some year-to-year flexibility (which could be withdrawn in the case of persistent violations).

Recommendations for structural fiscal policy

- Continue efforts to reduce tax evasion, through simplifying the tax code and collection procedures as well as through more effective enforcement.
- Simplify tax collection procedures so as to reduce the cost of compliance to companies.
- Avoid the use of tax amnesties.
- Broaden the tax base and simplify the tax system, in particular by cutting the number of tax expenditures.
- Eliminate *ad valorem* stamp duties in excess of the reasonable charges for administrative costs.
- Extend the use of multi-year budgeting to include legislating spending limits for ministries or major programmes over more than one year.
- Get better value for money in public spending through better use of centralised procurement, cost information systems and benchmarking, at all levels of government.
- Continue public administration reforms, including performance management, transparency and anti-corruption policy, to support moves to increase attention to cost-efficiency.
- Implement fiscal federalism arrangements in line with the 2009 enabling law. This implies clear allocation of spending and taxation responsibilities, in line with the new constitutional arrangements, a transparent revenue-compensation system, and central government transfers to sub-national government based fully on standard costs.
- With sub-national balanced budget rules and full fiscal federalism in place, replace the spending limits and ad hoc measures of the Internal Stability pact with simple rules based on keeping debt of sub-national administrations under control, as foreseen in the 2012 constitutional reform.

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