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OECD Economic Surveys: Italy

Assessment and recommendations

Italy is now in the midst of a deep recession, as are many other countries, and there is great uncertainty about the timing and strength of the recovery. The banking system itself was not immediately threatened by the first wave of the financial crisis, but credit supply has nonetheless been sharply restrained, as elsewhere, and households have suffered large financial losses following the steep fall in equity markets. The contraction of output is likely to persist well into the current year and only a slow recovery can be expected next year. Some long-term structural problems remain to be addressed, even as attention is focused on ways to alleviate the effects of the crisis and to shorten its duration.

Limited exposure of banks did not protect from recession

The depth of the Italian recession has come as a surprise. The authorities were counting on the relatively solid balance sheet of the banking system and its moderate leverage to deflect the adverse problems experienced elsewhere. But while hopes for the financial system itself have so far been borne out, although exposure to some vulnerable countries in Eastern Europe is a risk, Italy has so far nonetheless suffered significantly from collapsing demand, both foreign and domestic. Moreover, several years of low productivity growth and declining aggregate profitability left Italy's export-oriented economy particularly vulnerable to the slump in world trade.

The underlying fiscal situation, the relatively weak capital position of the banks (even though they do not suffer from a risk of insolvency) and a history of weak trend growth mean that economic dynamism is likely to be slow to recover from the blows it has suffered in the crisis. Room for discretionary fiscal stimulus is restricted for the time being because the downturn implies a widening of the public deficit and an increase in the already high level of public debt. On the positive side, relatively healthy household and corporate balance sheets may allow Italy's recovery to be on a more solid footing than elsewhere.

The recession focuses attention on the fiscal situation

Gross public debt was around 106% of GDP in 2008. Substantial progress had been made in cutting the ratio of debt to GDP since the mid-1990s, but partly based on one-off tax and revenue measures that were not sustained. After 2006, progress seemed to have resumed, partly as a result of improved tax collection, but without much success in reducing government expenditure. A fiscal programme for 2009-11, finalised in September 2008, aimed to bring the budget into balance by 2012 and debt below 100% of GDP by 2011. Such an ambitious programme was what Italy had needed, though it would have been difficult to achieve even in normal times. But by now, OECD projections suggest that the public deficit will reach 6% of GDP in 2010, with debt over 115% of GDP and rising, even with some effort at fiscal consolidation.

This prospect is almost entirely due to the deteriorating outlook for the economy. Real GDP is expected to fall by at least 5% between early 2008 and the trough of the recession. On the revenue side, the buoyancy of tax revenue seen in 2006-7 may have been less directly linked to the financial boom than in other countries; but, as the economy contracts, that part which was due to reduced evasion may become vulnerable. Reduced activity and employment could also hit revenues hard, while on the other hand there should not be a large increase in expenditures because, notwithstanding recent measure to enlarge it, Italy's social safety net is less well-developed than in many other European countries.

Financial markets pay more attention to fiscal risks

The interest rate differential between Italian and German 10-year public debt widened from 35 basis points in 2007 and stood at between 140 and 150 basis points in March 2009, although the average interest cost of new debt actually fell slightly. With Italy's high level of debt, the widening differential is a warning that investors are increasingly concerned about fiscal risks, as in other European countries, though fiscal prudence demonstrated so far and overall financial stability may have limited the widening in the spreads. While well short of the levels seen before monetary union, when it was dominated by a significant exchange rate risk, a differential at this level and in combination with the likelihood of significantly lower inflation could over time produce a higher real cost of long-term borrowing.

Careful debt management is crucial in uncertain times

About one sixth of existing public debt has to be refinanced every year. With new borrowing to finance the ongoing budget deficit added to this, the government has to sell debt equivalent to over 20% of GDP each year. The sharp increase in the differential with rates in most other euro area countries need not bring severe short-term problems as the government would have time to react to signals from rising interest rates and adjust policy. Public debt auctions have remained successful. However, the fact that the usually highly liquid interbank borrowing market ceased to function for a while highlights the risks for the public debt market.

When the economy recovers, fiscal consolidation should resume

Membership of monetary union reduced debt servicing costs greatly, providing a good opportunity to bring debt down very rapidly. Unlike in Belgium, for example, a significant part of this opportunity was wasted, leaving Italy more exposed in the current situation. It is true that several pension reforms since the mid-1990s transformed the very long run outlook for public finances. The magnitude of the further measures needed to offset the fiscal consequences of population ageing is now at a more manageable level than in most countries. But these costs are still significant and the progressive implementation of the pension reform itself will require strong commitment, as it involves longer working lives, higher private pension saving or much lower levels of replacement rates in the long run for future pensioners than today's pensioners receive. When the economy begins to recover, the government will need to commit itself to a serious medium term programme of debt reduction based on expenditure control and probably further reforms of pension and health care. In the shorter term, the government's room for fiscal manoeuvre will depend, among other things, on financial markets' views of Italy's long-term fiscal sustainability.

Some steps to alleviate the immediate crisis have been taken, and the automatic stabilisers are being allowed to work

The government has rightly allowed automatic stabilisers to work. Although the orientation towards underlying consolidation foreseen in the budget planning for 2009-11 has been maintained, a number of mostly budget-neutral anti-crisis measures have been introduced. For the most part any additional expenditure and tax cuts have been financed by offsetting measures. Many of the measures, though small, are useful in the context of the current recession. Examples include the extension of the mainly company-based unemployment insurance scheme to some previously uncovered workers, increased support for low-income families, and a reduction in the delay by the public administration in paying its bills. These measures make some contribution to protecting those likely to be worst affected by the recession and redirect expenditure towards areas likely to have a high fiscal "multiplier".

Some measures are likely to have unwelcome side-effects

Support to the car industry risks resource misallocation. This policy was triggered by concern over unfair competition from companies in other countries that have received state loans and other support to a substantially greater degree than in Italy. However, the auto industry is not of systemic importance and, although there has been an impact in lifting car sales in the near term, it is unlikely that such support is the best use of public resources. *Measures that essentially shift expenditure from one category to another should be limited to those which make cost-effective improvements in protection for vulnerable parts of society, or satisfy a clear need for structural reform; if this corresponds to expenditure with high fiscal multipliers, so much the better.*

Credit tightened, despite the relatively sound financial system

As the authorities have asserted, Italian banks are less exposed to high-risk products than those of other large countries, certainly as originators but also as investors. This is partly due to their conservative behaviour and also to some regulatory and supervisory caution. No banks have closed or had to be bailed out. Nevertheless, the two largest banks made extensive acquisitions in certain eastern European countries which may be vulnerable to downturns in those economies. Despite their low exposure to the key risky assets, Italian banks suffered along with banks worldwide from the difficulties on the interbank market, fall in their share prices and diminished or vanishing profits as the economy slowed. While they may have operated a relatively cautious lending policy, they were not carrying excess capital reserves and many of them are well integrated into international capital markets. Hence, generally tighter international credit conditions were already obliging Italian banks to restrain their own lending in Italy – the European bank lending survey shows that credit standards have tightened in Italy to a very similar degree as elsewhere. Banks have used ECB liquidity facilities and are energetically selling bonds to the public.

An innovative response to problems on the interbank market…

In response to the difficulties on the (uncollateralised) interbank market, the Bank of Italy promoted a collateralised interbank lending clearing facility. The Bank acts as a market facilitator, monitoring the quality of collateral to give participating banks sufficient confidence to maintain liquidity in this anonymous market. Participating banks agree to guarantee the collateral vetted by the Bank, but there is a potential residual liability for the Bank of Italy (in the event of the default of a trader and the collateral issuer). Branches of foreign banks can participate only if their own central banks accept a share in this potential liability, a potential disadvantage for such banks. However, as a useful way to overcome the problems on the normal interbank market, the distortion to competition and implicit subsidy involved seem minimal, especially compared with other measures to support banks that have been taken elsewhere.

… and a scheme for bank recapitalisation

Banks have not so far needed crisis measures but are likely to need more capital as the recession deepens. There is no perfect solution to this problem. In a banking system that was until relatively recently dominated by publicly-owned institutions, there is reluctance to return to public sector stakes. The special facility set up in the February anti-crisis measures was aimed at avoiding direct equity injections which might lead to effective public ownership, although some of the loan conditions amount to policy direction by the government anyway. *Special facilities for lending to banks, or guarantees on their lending, should not be conditional on what use banks make of the funds; monitoring this in practice is a hopeless task and at best likely only to divert funds from one form of lending to another.*

Medium term measures to promote an effective financial system

The authorities should be ready to act to maintain the functioning of the financial system if the downturn accentuates problems for banks. It will also be important to continue to strengthen information-sharing and co-ordination domestically and with foreign counterpart regulators, both to avoid regulatory arbitrage and to keep track of potential risk. In the longer term, policy should ensure strong competition for both deposits and lending business, within prudent regulatory standards, to promote strong long term growth. Revising capital requirements to make them less pro-cyclical is a useful direction to consider, in conjunction with other European regulators.

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Regulatory reform can improve business framework conditions

Despite adopted reforms, growth in Italy was low, partly as a result of still excessive or cumbersome regulation, low competition in some sectors and a mostly inefficient public sector. These problems need to be addressed in order to restore confidence in the Italian economy. Progress has been made in improving regulation, but higher productivity growth remains elusive. Parts of the service sector remain largely protected from competition or encumbered with excessive regulation, sometimes varying across regions. Inefficiencies in public administration can also add to the obstacles faced by the private sector. Much of the analysis of these questions in this *Economic Survey* is based on work carried out as part of the forthcoming OECD *Regulatory Reform Review of Italy*.

Pursue service sector liberalisation and promote competition…

It is important to maintain momentum in liberalisation policy, required in most service sectors and liberal professions, as highlighted in the OECD Review of Regulatory Reform. In the case of local public services, further progress will need to involve full separation of ownership interests in service providers from local governments and members of local government. The role of the Competition Authority in increasing competition in Italy, and in improving legislation itself through its regular reports on relevant issues, has been significant. The government should maintain and strengthen the basic rule that competition policy's key yardstick must be the interests of customers, not of producers, employees or the state.

… and support this with more efficient public administration

The business environment is affected not only by the structure of regulations and competition enforcement, but also by the efficiency with which the public administration designs, implements and enforces regulations. Successive governments have tried to increase the focus of the administration on outcomes and there have been successes such as the partial separation of the tax collection agency from the civil service, allowing it to pursue a policy based on output-based performance targets. Such an approach is part of the government's "industrial plan" for the public administration. *Reform of public administration to increase the focus on improving output-based measures of performance should be pursued. It is important to take this beyond useful, but in themselves insufficient, transparency measures such as publishing senior officials' salaries and interests, to include operational ways to focus attention on* outcomes *rather than* procedures *at all levels of the administration*. An important example of where efficiency needs to be enhanced is the administration of civil justice, where delays are among the longest in all OECD countries. Reforms have tended to concentrate on procedural rules but have neglected issues – such as fee structures and career management – that in practice generate incentives which discourage simplification of documentation and accelerated handling of cases.

Strengthen the use of auditing mechanisms in the public sector

Many of these issues have been well-documented in the work on Public Expenditure Reviews, the first set of which were published in June 2008. *The work on Public Expenditure Reviews should be strengthened, both to cover work on other policy areas and with a view to implementing some of the key reforms to incentives that they recommend*. At the moment this work has switched focus to specific budgetary management and information issues; these are important but should not prevent further work on assessing substantive issues. Other auditing mechanisms, such as Regulatory Impact Assessment or cost benefit analysis for infrastructure projects, are also under-utilised in Italy. They should be strengthened. In the context of the current crisis, some infrastructure expenditure could usefully be brought forward. But, given the reputation for mismanagement, it should be subject to strict cost-benefit and monitoring criteria.

Plans for fiscal federalism may be difficult to pursue

A draft law on extending further spending and revenue responsibility to the regions, as foreseen in 2001, was introduced last year. However, the introduction of such a comprehensive reform of fiscal federalism mechanisms in the present period may be challenging and it is important to ensure strong political and regional consensus. Having said this, the basic lines of the law on fiscal federalism, notably financing essential expenditure from central revenues on a standard cost basis and a transparent revenue sharing mechanism based on VAT and income tax capacity, are sound. *The definition of "essential" expenditure should be carefully defined to match national policy targets and it needs to remain stable through time*. As the example of education shows, it is not straightforward to assess what "standard cost" implies in a country with such wide regional variations. The intention to phase in its implementation should help to minimise the difficulty of adjusting to the new system. *Stability over time, along with transparency, is also important for the revenue sharing mechanism. A new local tax, partly based on the value of the housing properties, would be highly desirable from the point of view of fiscal federalism.*

Compulsory education is less effective than in most countries, but reliable performance information is scarce

Compulsory school education in Italy produces poor results at secondary school level, despite a relatively high level of expenditure, although international comparisons of children in primary education often show a better performance in Italy. It also shows, according to the OECD PISA results, large differences in pupils' performance between regions, which may reflect socioeconomic conditions rather than regional differences in school efficiency. These regional differences in performance do not appear in most national assessments of school or pupil performance, notably the examinations at the end of lower and upper secondary school. Either the national examinations assess very different aspects of achievement from PISA, or the national assessment system is not applied uniformly. The national school assessment agency, INVALSI, was set up to overcome this information deficiency, but in its early years failed to establish a reliable

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system of testing that had the support and understanding of teachers. INVALSI needs to be strengthened, both in terms of financial and human resources, so as to provide nationally comparable, independent information on pupil and school performance and specific support to school leaders for them to understand how to improve. *In parallel, uniform national testing of educational attainment of pupils at key points in their school career is needed*. In both cases, *it will be necessary to ensure that results in individual schools are fully comparable with those in other parts of the country, which will require strong external controls on the administration and marking of exam results*.

INVALSI assessments are currently planned to be undertaken only for a sample of pupils in every school. However, there is no legal obligation for the school to take part in the assessment and therefore participation is voluntary. It is important to avoid assessment fatigue, but *standardised INVALSI assessments would probably be more useful if carried out at all schools, perhaps at fewer grade levels than currently envisaged. This would require legislation to make participation in assessment compulsory for every single school. Full information on the results of the INVALSI assessments, as well as on the national examinations, should be available to schools and individual teachers, building on INVALSI's recent experience in disseminating information from national examinations at the end of lower secondary education.*

To improve standards, accountability is needed…

In parallel with the lack of objective information on standards, there is a lack of accountability at many levels and there is little attention paid to performance. While the national curriculum defines what should be taught in schools, there are no consequences for either teachers or schools attached to the degree of success in meeting the objectives. The current system is rather centralised, giving schools very little autonomy, but the centre does not intervene either to improve performance in poor schools. Notably, teacher recruitment and allocation to schools is also managed on a centralised basis, and is often unrelated to schools' needs or teachers' abilities. School principals themselves have no formal part in recruitment decisions to their schools. Under the plans for developing fiscal federalism, yet to be finalised, it is planned to increase responsibility for managing education at regional levels.

… focusing incentives on results…

The availability of performance information at school level should in itself generate better performance, since conscientious teachers and principals are likely to be motivated to make improvements themselves. However, in a system where currently it is possible for teachers to do rather little with no consequences for their career, *information on performance should be supplemented by increased accountability for results*. Accountability means ensuring that decision makers are responsible for the consequences of decisions, for example by making school principals responsible for recruitment but also making their career dependent on school performance. Publication of aggregate school results, provided they are presented in "value-added" form (adjusted to take account of factors external to the school that can influence pupils' achievement) that can be understood by the wider public can also add a legitimate form of accountability to families. *Whether or not results are published, the information they provide should be used to identify the worst-performing schools so that specific programmes can be put into place for them; provision for such action on failing schools* *should be made whatever the degree of local or school autonomy that is finally chosen.* This is not only to improve equity but also because better performance in the worst schools can be one of the best ways to raise the overall performance of the system.

… and effective training and recruitment

The system of teacher training, recruitment and allocation of teachers to schools should be reformed to take better account of pedagogical skills and individual schools' needs. The draft law in Parliament for reforming teacher initial training and career is a good start in principle, especially its emphasis on pedagogical skills and teaching practice, though progress on finalising it is slow. It remains to be seen whether the system improves on the now-abandoned system of specialised teacher training institutes that was set up a few years ago. *The new training system should feed a recruitment system which is based on school needs and which takes into account the skills and performance of teachers rather than their seniority. Plans to introduce a more developed career structure for teachers should be pursued, but they must serve to improve accountability, with promotion being based on abilities and performance. It would be desirable to use the new training system to introduce voluntary re-certification, linked with career advancement, for existing teachers.*

Social segregation, and its consequences, could be reduced

The influence of social background on pupil performance within individual schools is smaller than average in OECD countries. However, because of social segregation due to family choices among the different types of upper secondary school, there is a wide variation of results between schools. Children of parents with lower socioeconomic status disproportionately end up in the vocationally-oriented schools, which are those which tend to deliver poor results when measured by PISA standards. Analysis of PISA results shows that systems which separate children too early into vocational and non-vocational streams tend to have worse overall performance. *This could be improved in Italy by requiring greater uniformity in at least the first two (out of five) years of upper-secondary school, notably to increase the importance of general education in the vocationally-oriented schools. In all schools reinforced attention to weaker pupils is required, and the provision of early education and care for socially disadvantaged groups should also be reinforced.*

Expenditure cuts can increase efficiency, but must be planned with care

OECD analysis concurs with the conclusions of the previous government's white paper and this government's conclusion that it should be possible to achieve equally good results with lower teacher numbers. But this does not mean that, in practice, rapid cuts in expenditure and teacher numbers can be achieved with no negative impact on outcomes. The government's first target in cutting excessive teacher numbers was correctly focused on primary school, where the pupil-teacher ratio is exceptionally low. But even at this level, and certainly in secondary school, measures to cut expenditure should go strictly along with mechanisms to encourage better performance.

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