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Public Spending in Italy: Policies to Enhance Its Effectiveness

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ABSTRACT/RÉSUMÉ

Public spending in Italy: policies to enhance its effectiveness

This paper aims to identify structural reforms for better public spending management in Italy –in turn a critical need in view of the country's high debt and tax burdens, notwithstanding significant progress in the past decade. The analysis proceeds on two distinct levels. At the central government level, a misallocation of public resources is suggested by excessive pension spending against inadequate spending in infrastructure, labour market and human capital areas, as well as by high and inefficient government employment. These problems can be traced in large part to the incentive structures built into the public institutions charged with the planning, implementation, and control of spending policies. The main recommended policy actions are to pursue further pension reform while strengthening other income transfers, make the budget process more transparent and accountable, undertake deeper reform of the public administration, and to make greater use of market instruments in areas such as public investment. At the local government level, perverse incentives have arisen from a pattern of fiscal federalist relations characterised by insufficient devolution of both spending and financial responsibilities. This has led to inefficient outcomes, notably in the health care area which registered very high rates of spending growth in recent years. The main recommended action is to implement fundamental health care reform on the basis of hardened budget constraints and enhanced spending autonomy for the regions.

JEL *classification*: H11, H5, H72, H74, H77
Keywords: Public economics, Structure and scope of government, government expenditure, health, welfare programmes, local government, Italy.

Les dépenses publiques en Italie : mesures pour renforcer leur efficacité

L'objet de ce document est d'identifier les réformes structurelles de nature à améliorer la gestion des dépenses publiques en Italie – amélioration essentielle en raison de l'ampleur de la dette et du poids de la charge fiscale du pays, malgré les sensibles progrès réalisés au cours de la dernière décennie. L'analyse se situe à deux niveaux. Au niveau de l'administration centrale, l'affectation des ressources publiques laisse à désirer, comme en témoignent les dépenses excessives au titre des pensions comparativement à l'insuffisance des dépenses consacrées aux infrastructures, au marché du travail et à la formation du capital humain, ainsi que l'ampleur et l'inefficience des effectifs du secteur public. Ces problèmes résultent pour une large part de la structure des incitations inhérentes aux institutions publiques chargées de la planification, de la mise en œuvre et du contrôle des politiques en matière de dépenses. Les principales mesures recommandées visent à poursuivre la réforme des pensions tout en renforçant les autres transferts de revenu, améliorer la transparence du processus budgétaire, entreprendre une réforme en profondeur de l'administration de l'Etat, et faire plus largement appel aux mécanismes du marché, par exemple dans le domaine des investissements publics. Au niveau des administrations locales, un fédéralisme budgétaire caractérisé par une décentralisation insuffisante des responsabilités en matière de dépenses et de financement a fait naître des incitations perverses. Il en est résulté un manque d'efficience, notamment dans le secteur de la santé où les dépenses ont très fortement augmenté ces dernières années. La principale action recommandée est la réalisation d'une profonde réforme du système de soins, fondée sur un durcissement des contraintes budgétaires et l'octroi aux régions d'une plus grande autonomie sur le plan des dépenses.

C*lassification*: H11, H5, H72, H74, H77
Mots-clés : Economies publiques, structure et compétences du gouvernement, dépenses publiques, santé, programmes sociaux, gouvernement local, Italie.

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PUBLIC SPENDING IN ITALY: POLICIES TO ENHANCE ITS EFFECTIVENESS

Alexandra Bibbee and Alessandro Goglio[1]

Introduction

1. The control of public spending has been an essential element in bringing the general government deficit down to levels consistent with Italy's EMU obligations, which required one of the sharpest retrenchments in the OECD (Figure 1). However, though a significant proportion of the savings made were structural in nature, the consolidation process was assisted by a series of "one off" interventions — such as a freeze on wage contracts, ad hoc interventions in the health service and curbs on investment spending — which have created large compositional imbalances in public spending. Moreover, pressures from certain programmes — particularly those related to one of the fastest ageing populations in the OECD and to the *Mezzogiorno* — could intensify. At the same time, it is desirable on efficiency grounds to reduce the tax burden, but this is impossible without spending economies, on account of Italy's large public debt. Priorities in public spending will need to be reset and control mechanisms for their effective implementation put in place.

2. More fundamentally, there are wide margins for improvement in Italian public services and this paper recommends new reform measures in the light of the policy actions taken so far. In a situation where political, social and economic objectives are intermixed, the analysis relies on indirect evidence and a degree of inference, using criteria related to international benchmarking, information on the efficiency of the planning and control processes (the presumption being that the nearer outcomes are to plan, the nearer they are to meeting social welfare objectives) and analysis of incentive structures built into the public institutions charged with implementing spending policies. Following this approach, the paper identifies requirements for better public spending management at the central level. The issue of decentralisation is then taken up, since the realisation of a viable balance of responsibilities and incentives between central and local fiscal powers is an important element in determining the efficient allocation of resources and achieving better budget control. An overall assessment and agenda for policy action are presented in the final section of the paper.

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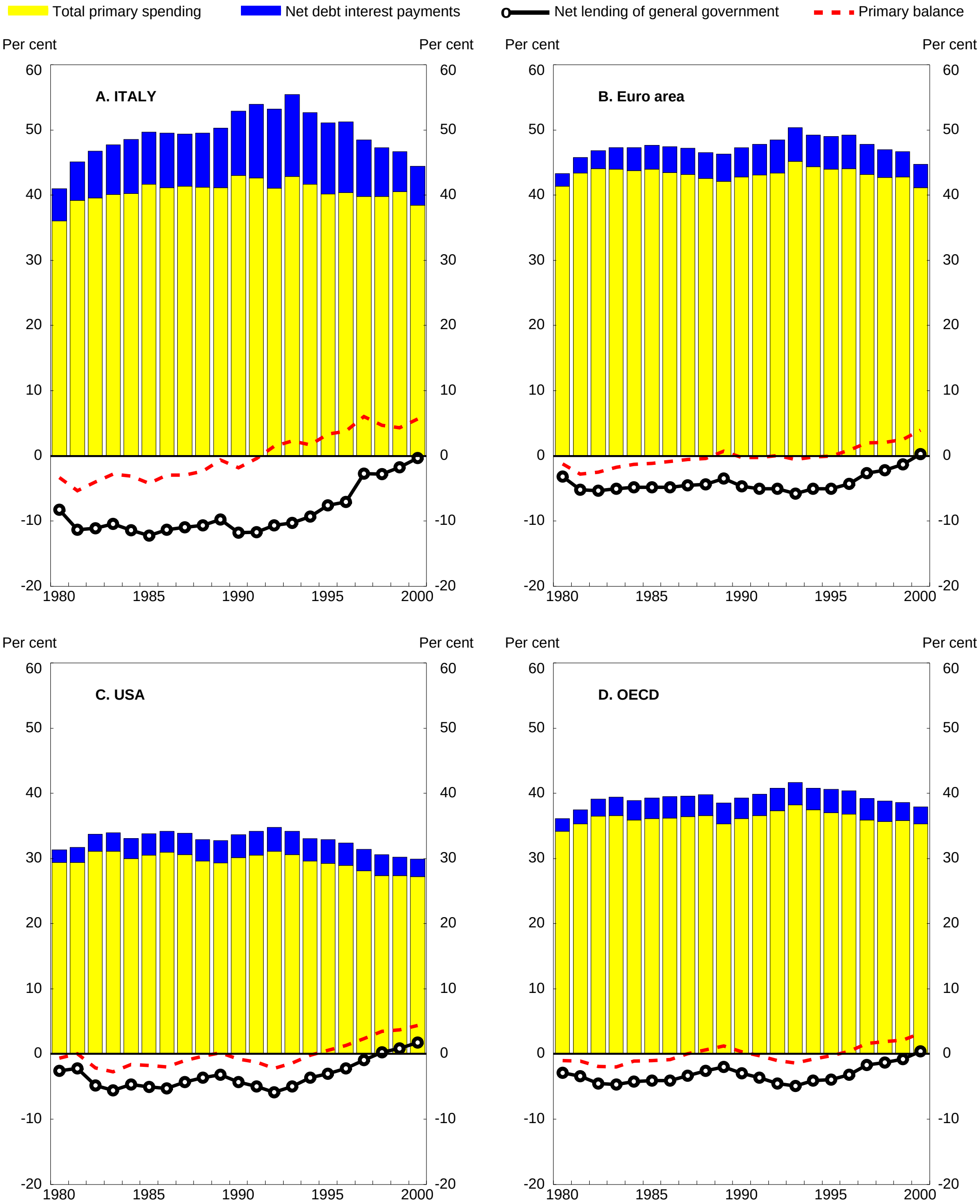
1. This paper was originally produced for the 2001 *OECD Economic Survey of Italy*, which was published in January 2002 under the authority of the Economic and Development Review Committee. Alexandra Bibbee is senior economist on the Italy/Turkey Desk in the Economics Department, where at the time of writing Alessandro Goglio was working as an economist. They are indebted to Robert Price and Nicholas Vanston for substantial drafting contributions and to Ignazio Visco, Andrew Dean, Michael Feiner and Jørgen Elmeskov for valuable comments. Special thanks go to Jean-Marie Strub and to Sylvie Foucher-Hantala for technical assistance and to Valérie Luccioni-Lassaut and Nadine Dufour for technical preparation. The paper has benefited from discussions with numerous Italian experts, in the private sector, as well as in ministries and government agencies responsable for policy-making in this area.

Figure 1. Trends in general government spending and the budget deficit (1)

Per cent of GDP



1. For Italy and the other European countries concerned, the figures for 2000 take into account the revenues from the sale of third-generation mobile phone licences, UMTS.

Source: OECD.

General government expenditure and forces shaping them

Effects of fiscal consolidation on spending

3. There have been two distinct general government spending trends since the 1960s (Table 1). Total public spending rose from less than 30 per cent of GDP in 1960 to a high of 55 per cent in 1993. As elsewhere, structural pressure on primary spending arose from the establishment and expansion of social programmes and services.[2] The revenue side did not adjust as quickly, and the primary balance of the general government rapidly fell into a structural deficit. Negative real interest rates and the associated "inflation tax" at first delayed the growth of public debt, but from the mid-1980s an inflation rate persistently higher than in the EU and OECD areas led to high nominal interest payments on government bonds.[3] As a result, by the early 1990s total public spending was significantly higher than the EU average, with the level of interest payments exceeding 10 per cent of GDP. Government debt continued rising until 1994 when it reached 124 per cent of GDP.

Table 1. **Trends in public spending by economic category**
Per cent of GDP

	1960	1970	1980	1990	1993	1996	1999	2000
Government wages	8.6	9.9	11.0	12.6	12.3	11.5	10.7	10.5
Goods and services	5.2	5.1	5.7	6.9	7.3	6.6	7.4	7.5
Social security outlays	8.4	10.5	12.6	15.5	17.0	16.9	17.2	16.7
Subsidies	1.7	1.8	2.7	1.9	2.0	1.5	1.2	1.1
Other current transfers	0.8	0.9	0.7	0.9	1.3	1.2	1.3	1.3
Interest on public debt	1.4	1.6	5.2	9.6	12.3	11.5	6.8	6.5
Total current spending	26.0	29.7	37.9	48.1	52.5	49.1	44.6	43.6
Net capital outlays	1.9	2.3	3.2	4.3	2.8	2.2	2.1	0.8
Total expenditures	27.9	32.1	41.1	52.4	55.4	51.3	46.7	44.4
Total primary expenditures	26.5	30.5	35.9	42.8	43.1	39.8	39.9	37.9

Source: OECD.

4. The second distinct phase covers the period of fiscal consolidation, prior to, during, and after Italy's entry into the Economic and Monetary Union in January 1998. From 1994, in particular, the Maastricht criteria spurred the Italian government to reassess its spending policy in the context of a longer term stabilisation strategy. Total public expenditure was reduced by 11 percentage points of GDP, to the current level of 44 per cent, a proportion not out of line with the rest of Europe (Figure 1). Primary expenditure restraint contributed some 30 per cent of the deficit improvement, most of which was accomplished *via* a combination of falling interest payments — as interest rates fell and privatisation receipts rose — and rising taxes (Table 2). Although the debt to GDP ratio fell, at about 110 per cent of GDP it is still one of the highest in the OECD. Combined with a still high tax burden (jointly with the need to reduce it), it is an important reason for looking for greater effectiveness of public spending.

5. The composition of spending differs from that in other major OECD countries. *First*, debt interest payments, although declining, are still high internationally (6 per cent of GDP, about double the OECD

2. The leaving age for compulsory schooling was raised to fourteen years in 1962, while both a social pension system and a universal national health care programme were introduced in the 1970s.

3. See for a wider discussion of these developments Signorini and Visco (1999).

average), a reflection of high public indebtedness. *Second*, with a high hangover of debt interest payments, primary spending is low by continental European standards (by about 2½ percentage points of GDP), because of relatively low final consumption expenditure and much lower capital outlays (fixed investment and capital transfers). *Third*, public pensions are significantly higher than the OECD average, totalling about 13.8 per cent of GDP in 2000 (inclusive of survivor and invalidity pensions).[4]

Table 2. **Sources of budget consolidation**
Changes in per cent of GDP

	1992-1997	1997- 2000	1992-2000
Total expenditures	-5.6	-3.4	-10.0
Final consumption	-1.9	-0.2	-2.0
Social security benefits	0.8	-0.6	-0.3
Transfers and subsidies	-0.5	0.1	-0.8
Current expenditure less interest payments	-1.6	-0.7	-3.1
Interest payments	-3.3	-2.9	-6.6
Total current expenditures	-4.8	-3.6	-9.7
Capital outlays[1]	-0.8	0.2	-0.3
Total receipts	4.2	-2.2	-2.1
Tax revenues[2]	2.8	-1.5	-1.0
Non-tax revenues	0.5	-0.2	-0.0
Total current receipts	3.3	-1.7	-1.0
Capital receipts	0.9	-0.5	-1.1
Primary balance	4.6	-0.4	3.3
Overall balance	8.0	2.4	10.0

1. The figure for 2000 does not take into account one-off revenues from the sale of third-generation mobile licences, UMTS, which should otherwise be quantified as a negative capital outlay, worth L 26 750 billion (1.2 per cent of GDP).
2. Direct and indirect taxes plus social security contributions.

Source: OECD.

Low public investment

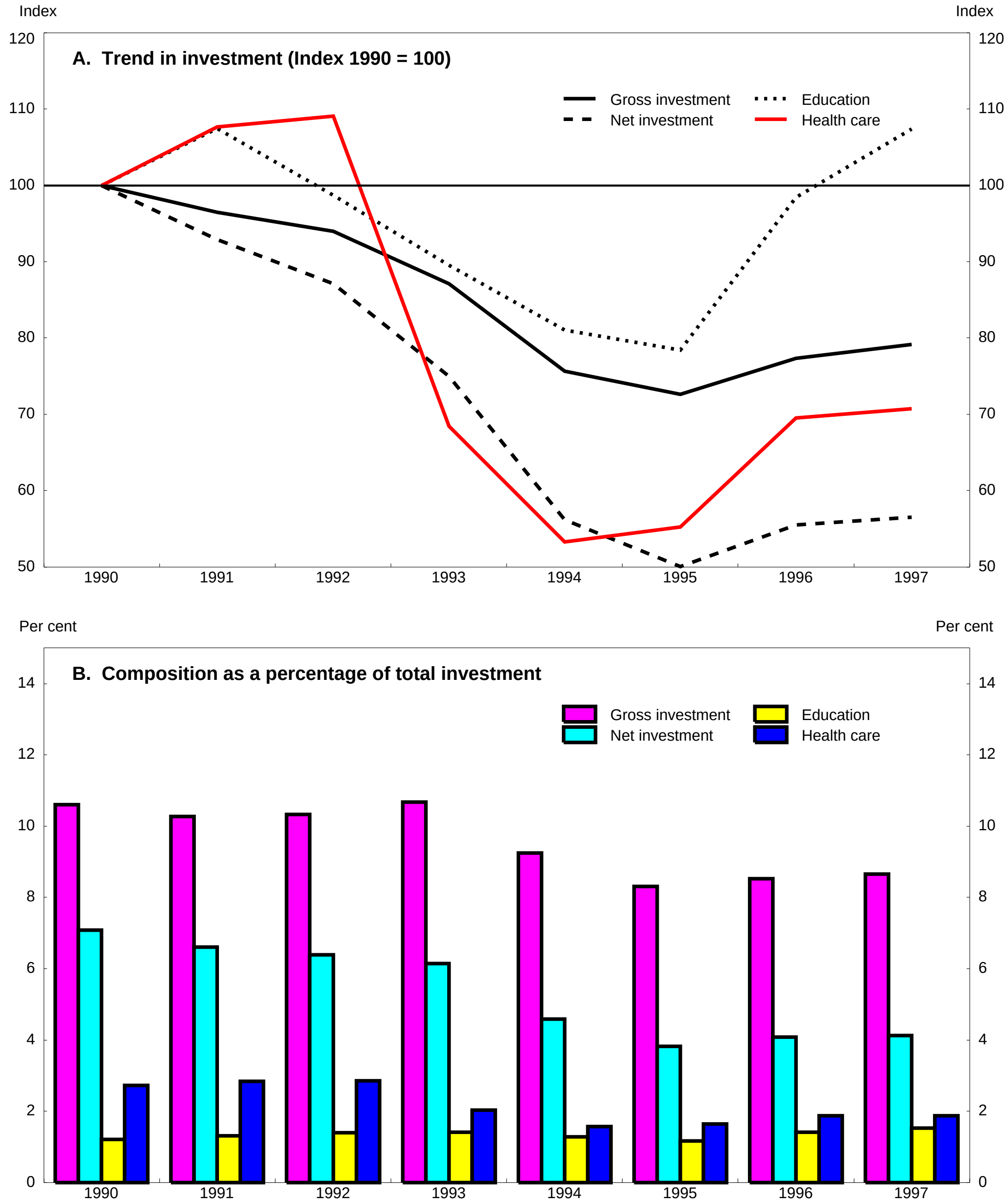
6. Cuts in public spending in the first half of the 1990s involved both service provision and, most markedly, capital spending. The fall in public investment also reflected the fight against corruption (*tangentopoli*) and the related problems of mismanagement in the use of public resources.[5] As a result, Italy currently has a relatively low public investment share in overall fixed capital spending (12 per cent for 2000, 1½ percentage points lower than the OECD average) (Figure 2). This implies a need to catch up with uncompleted construction works (for example, the road network) and urgent maintenance requirements (for other segments of the transport sector, especially the railways, along with energy and water). The backlog is particularly pronounced in the *Mezzogiorno*. The investment shortfall has exacerbated the inefficiencies characterising the supply of many public services, in turn reinforcing demands for improving and expanding the infrastructure endowment.[6]

4. See EC (2001).

5. In part this reflected a fall in prices as bribes were substantially reduced.

6. See ISTAT (2001), pp. 231-283. From the supply viewpoint, several factors contributed to the decline in public works, including reductions in commitments for investment projects in the annual financial law,

Figure 2. The performance of government investment



Source: ISTAT.

postponements in the execution of several multi-year projects and administrative cash management by the Ministry of the Economy and Finance.

Table 3. **Functional distribution of social benefits**

1998

	Italy	France	Germany	Netherlands	United Kingdom	Spain	Sweden	European Union	United States	Japan	Canada
	Per cent of GDP										
Income transfers											
Invalidity	**1.5**	1.4	2.2	3.2	3.0	1.7	3.8	2.2	0.8	0.3	0.5
Old age pension[1]	**13.0**	11.0	11.4	9.6	10.4	8.8	12.2	10.8	5.1	5.8	4.3
Survivors	**2.6**	1.8	0.5	1.4	1.0	0.9	0.7	1.4	0.9	1.1	0.5
Family	**0.9**	2.8	2.8	1.2	2.2	0.4	3.5	2.2	0.6	0.5	0.7
Unemployment	**0.7**	2.2	2.5	1.9	0.9	2.8	3.1	1.9	0.3	0.6	1.0
Housing	**0.0**	0.9	0.2	0.4	1.6	0.1	0.8	0.6	0.2	..	..
Merit goods											
Health care	**5.7**	8.5	7.9	7.6	6.6	6.1	7.7	7.1	5.9	5.7	6.3
Education	**5.0**	6.2	5.5	4.6	4.9	5.3	6.8	5.6	6.4	4.7	6.2
Total of above	**29.4**	34.8	33.0	29.9	30.6	26.1	38.6	31.8	20.2	18.7	19.5
	Percentage distribution										
Income transfers											
Invalidity	**5.1**	4.0	6.7	10.7	9.8	6.5	9.8	6.9	4.0	1.6	2.6
Old age pension[1]	**44.2**	31.6	34.5	32.1	34.0	33.7	31.6	34.0	25.2	31.0	22.1
Survivors	**8.8**	5.2	1.5	4.7	3.3	3.4	1.8	4.4	4.5	5.9	2.6
Family	**3.1**	8.0	8.5	4.0	7.2	1.5	9.1	6.9	3.0	2.7	3.6
Unemployment	**2.4**	6.3	7.6	6.4	2.9	10.7	8.0	6.0	1.5	3.2	5.1
Housing	**0.0**	2.6	0.6	1.3	5.2	0.4	2.1	1.9	1.0	..	..
Merit goods											
Health care	**19.4**	24.4	23.9	25.4	21.6	23.4	19.9	22.3	29.2	30.5	32.3
Education	**17.0**	17.8	16.7	15.4	16.0	20.3	17.6	17.6	31.7	25.1	31.8
Total of above	**100.0**	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. For Italy, including TFR ("Trattamento di fine rapporto").

Source: Eurostat and OECD.

7. Legislation governing public works — once highly fragmented and complex — started to be revised from 1994 in a sequence of attempts to make access to public works more open, transparent and efficient (*Merloni Laws*). With the programming capacity for public works improving, government investment has been recovering since 1996, even though the gap relative to the level of the early 1990s remains marked. This reflects the fact that new public investment programmes typically require long preparatory periods. It also appears that the Merloni Laws tend to be excessively prescriptive and this may pose problems, particularly in light of the need to increase the involvement of the private sector in public works.

The fiscal dimension of population ageing

8. The 2000 *Economic Survey of Italy,* which covered the major fiscal issues arising from population ageing, recognised that the efforts made so far to contain the generosity of the system, to limit the trend towards early retirement, as well as to reform aspects of the social support system (other income transfers, health care and care for the frail elderly), have substantially reduced future fiscal pressures. After a transitional period, the new system implies a major improvement in incentives affecting the timing of retirement. However, the phase-in of the reforms is still rather slow and the *Survey* pointed out the risks of a further deterioration in the public sector primary balance, reflecting both direct pension spending and other old age-related spending, such as for health care.[7] Thus in setting medium- to longer-term budgetary targets, an extra safety margin would, in principle, need to be built in to take into account not only the full extent of the current debt problem, but also the future overhang associated with ageing.

9. OECD calculations in the context of the 2000 *Survey* suggested that maintaining a non-age-related primary surplus within the current levels while assuming a “no policy change” long-run GDP growth rate of just under 1 per cent would not suffice to let the debt to GDP ratio reach the 60 per cent threshold in the first half of this century, because of rising ageing costs.[8] Thus the Survey concluded that reaching this threshold would require a more up-front fiscal effort, as well structural policies to boost long-run growth[9]. This would lead to a faster decline of the debt-to-GDP ratio earlier on, which would be needed to offset the impact of ageing through 2015 and 2030, within which period the impact of the demographic transition will be concentrated. This would allow resources which would otherwise be devoted to debt service in that period to be freed up for addressing ageing related needs.

Implications of high pension spending for other income transfer programmes

10. The counterpart of an income transfer system narrowly concentrated on pensions is a comparatively modest involvement of the state in other social transfers, in education and in health care (Table 3).[10] Largely as a consequence of social and cultural factors, under the Italian approach, an

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7. This is a problem common to many OECD countries. For a general discussion see OECD (2001*a*), pp. 145-167, and Dang *et al.* (2001).

8. OECD (2000*a*), p. 65.

9. The calculations show that raising the long-term growth rate to nearer to 1½ per cent would allow the 60 per cent threshold to be eventually reached at the current level of the primary surplus despite the expected rise in ageing costs. However, also raising the primary surplus to above 6 per cent would allow the debt target to be reached much more quickly, creating room for tax cuts and an easing of the primary surplus requirement relatively early on.

10. In a number of areas, including education, for example, the Italian public sector spends even less than is the case in the United States and Canada, which are known for their stronger reliance on the private sector for the provision of social services. See Atkinson and van den Noord (2001).

emphasis on the private provision of non-pension social services derives from the central role played by the family as a social safety net. In most other European countries, by contrast, such services are under the responsibility of the state. Given this, for Italy the overall extent of public outlays on social programmes is not overly large by international standards.[11]

Table 4. **Share of population receiving transfers**[1]

Percentage of total

	Pensions	Other social benefits	All social benefits together
Italy	**40**	**18**	**51**
Austria	34	69	86
Belgium	28	69	89
Denmark	19	75	85
France	25	62	79
Germany	29	57	78
Greece	39	19	50
Ireland	23	82	90
Luxembourg	29	66	86
Netherlands	19	66	81
Portugal	36	68	89
Spain	34	33	58
United Kingdom	28	71	85
European Union	30	52	73

1. The first line of the table reveals that 40 per cent of Italians live in households where at least one member draws a pension. For other social benefits, the figure is 18 per cent. For all social benefits together, the figure is smaller than 58 per cent (*i.e.* 40 per cent plus 18 per cent) since some households receive more than one type of social benefit.

Source: Eurostat.

11. The family plays a dual re-distributive role.[12] During periods of recessions, it acts counter-cyclically through the *pooling* of the resources made available by its various members. In addition, it permits favourable scale economies in consumption. In quantitative terms, the family is estimated to absorb between 70 and 90 per cent of the existing income inequalities among individuals, a remarkably high proportion by international standards.[13] Nevertheless, the available data suggest that the importance of the re-distributive function of the family has begun to decline since the end of the 1980s, both under the influence of changes in cultural and social habits and because of structural economic developments.[14] Hence, looking in prospective, falling pension benefits and further increases in female labour-market participation will mean that the ability of the family to care for its members will continue to decline, implying that pressures for state provision will increase.

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11. The functional breakdown is less comprehensive than that by economic categories, a reflection of differing systems of classification and data constraints, while there is also a lack of sufficiently up-to-date figures. See Adema (2001).

12. D'Alessio and Signorini (2000). See also Brandolini and D'Alessio (2000).

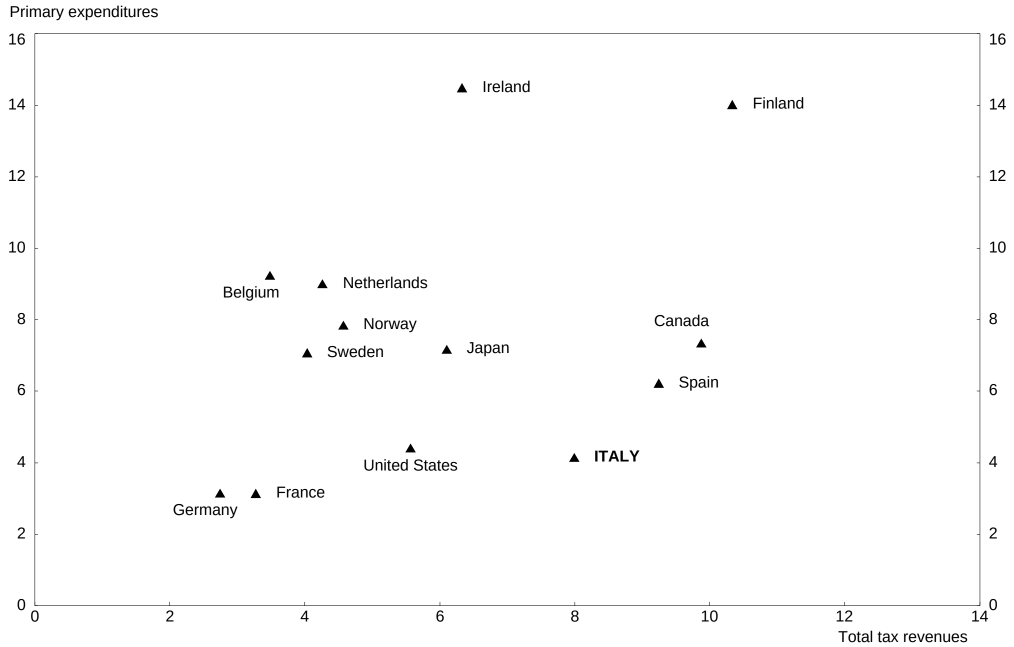
13. A number of recent studies on the personal distribution of incomes show that the pattern of income inequalities has tended to worsen for Italy. See, for example, Brandolini (1999).

14. Included in the latter are major labour market changes and the related increase in female participation rates, which have been accompanied by a declining average family size.

12. The peculiar structure of Italy's welfare spending system has an impact on the distribution of income.[15] Although nearly three quarters of the EU citizens receive some kind of monetary transfer, in the case of Italy (and Greece) this share falls to a low of 50 per cent (Table 4). Moreover, in Italy (as in Greece and Spain) 80 per cent of transfer recipients are pensioners, which is significantly higher than the European average.[16]

13. A notable feature of Italy's welfare spending is its low cyclical sensitivity which also translates into a low overall cyclical sensitivity of public expenditure (Figure 3). In part, this reflects the low level of unemployment-related transfers. As it turns out, shocks in Italy have mainly been absorbed through revenue adjustments — since the built-in elasticity for corporate and indirect taxes is quite high — rather than through a combination of spending and revenues-side adjustments, as appears to be the case in many other OECD countries.[17] This situation may not be desirable from the standpoint of the long-run effectiveness of spending programmes, partly in view of the likely further decline in the ability of the family to care for its members during spells of unemployment. This highlights the scope for creating some margin for increasing the size and impact of automatic fiscal stabilisers.

Figure 3. Cyclical sensitivity of primary expenditures and tax revenues (1)
Per cent of GDP



1. Cyclical sensitivity measured as coefficient of variation. The latter is defined as is the standard deviation divided by the average of the tax/GDP ratio (including social security contributions) and primary expenditures of general government in per cent of GDP. Sample period is 1980 to 2000.

Source: OECD.

15. Marlier and Cohen-Solal (2000).

16. Furthermore, with this share decreasing quite slowly with income, the third, fourth and the top fifth quintiles combined together still total 36 per cent of overall non-pension benefits, a much higher proportion than the corresponding EU average.

17. van den Noord (2000).

Public employment and the government wage bill

Recent employment trends

14. An important factor behind the sustained decline in primary spending has been the adoption of more binding employment policies at both the national and sub-national levels of government. Assisted by a freeze on new hiring and by better-designed measures to help the redeployment of public workers, general government employment declined from 1993 on. By 2000, the general government absorbed about 16 per cent of total employment, implying that it has shrunk by approximately 1 percentage point relative to the beginning of the 1990s (Table 5). Both the central and local governments have been reduced in size. Nevertheless, the international comparison suggests that the overall size of the general government sector is still larger in terms of overall employment than the euro-area average, albeit smaller than that of the G7 (Table 6).

Table 5. **Size of general government employment**[1]

	General government	Central	Local	Social security
1990	**16.8**	9.7	6.8	0.3
1993	**17.4**	10.1	7.1	0.3
1996	**17.4**	9.6	7.5	0.3
1999	**16.6**	9.1	7.2	0.3
2000	**16.2**	9.2	6.8	0.3

1. As a percentage of total employment.

Source: ISTAT.

Table 6. **International comparisons of general government employment**

As a percentage of total employment

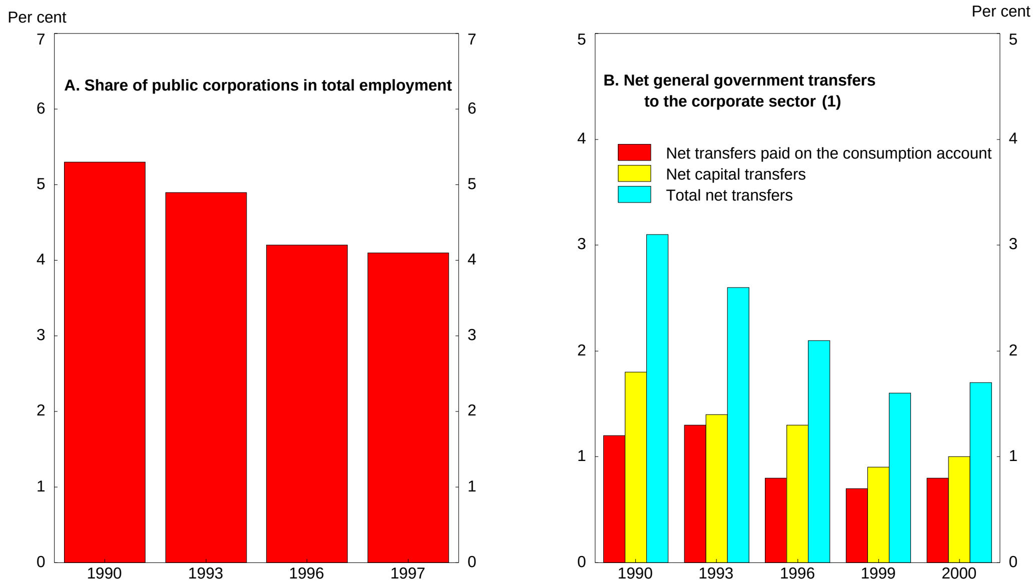
	1990	2000
Italy	**16.8**	**16.2**
Canada	21.5	20.2
France	23.1	24.2
Germany	15.1	11.4
Japan	8.1	8.5
United Kingdom	22.4	17.9
United States	15.4	15.3
Big seven	15.4	14.6
Euro area	16.9	15.7

Sources: ISTAT and OECD.

Privatisation and the wider public sector

15. As in other OECD countries, expenditure restraint in Italy occurred within the context of a broader programme of structural reforms, so that the general government accounts tell only part of the story. Privatisation also played a key role in reinforcing the credibility of the fiscal adjustment process. The public enterprise sector has been significantly downsized since 1993, reflecting a strategy of disengagement from a large number of productive activities in order to refocus on essential functions.[18] Employment in public corporations was brought down to around 4 per cent of total employment in 1997, from 5½ per cent in 1990, corresponding to a cut of about 310 thousand employees (Figure 4, Panel A). Privatisation also responded to the pressure of the European Commission to cut public subsidies and transfers, along with the related need to adjust the finances of several major state groups. As a result, during the period between 1990 and 2000 the overall amount of (net) transfers accruing to the corporate sector declined from 3 per cent of GDP to less than 2 per cent (Figure 4, Panel B).[19]

Figure 4. Impact of privatisation on public spending



1. Including subsidies.
Sources: ISTAT, Ministero dell' Economia e delle Finanze.

Public administration wages

16. Table 7 measures compensation per worker in the public administration against the private sector benchmark (private dependent employment). On this basis, the general government is characterised by high per-capita wages, although it is difficult to determine whether this reflects higher human capital in the

18. For a general discussion see OECD (2001*b*) and Goglio (2001).

19. The fiscal dimension of privatisation is also important, with massive sales of state assets aimed at debt redemption having been needed to assist the beneficial effects of a high level of the primary surplus. Since 1995 privatisation sales acted to reduce the debt ratio by about 7½ percentage points of GDP.

public administration or other factors. Moreover, public sector wages were allowed to increase quite substantially in 2001. Also, local governments have experienced sizeable wage gains over the 1990s, suggesting that wage moderation is needed at all levels of government.

Table 7. **Per-capita public employment compensation**[1]

	General government	Central	Local	Social security
1990	132.5	139.2	120.9	185.7
1993	126.2	133.7	114.0	164.6
1996	129.2	136.3	118.3	175.3
1999	133.4	138.7	125.6	159.8
2000	133.2	134.5	130.1	167.7

1. Percentage points of the corresponding indicator for the rest of the economy including social security contributions using dependent employment figures.

Source: OECD calculations based on ISTAT figures.

17. There are regional asymmetries in the distribution of government jobs. Public employment is equivalent to 7.7 per cent of total population in both the Centre (excluding Rome and its surroundings) and the Mezzogiorno, compared with 7.0 per cent in the North (Table 8). Measured as a proportion of total employment, the concentration of public employment is particularly pronounced in the Mezzogiorno, also reflecting a lower employment rate. Given this background and the context of relatively uniform per-capita wages across regions, it is not surprising that the overall public workers' wage bill in the Centre-South of Italy is higher than in the North, as a percentage of regional GDP. It is much higher in the South alone, though the share of the Mezzogiorno in the total public wage bill has declined over recent years (from 39.8 to 36.1 per cent between 1996 and 1999).

Table 8. **Regional public employment and compensation**

Percentage values, 1998

	All Italian regions excluding Lazio[1]	North West	North East	North	Centre excluding Lazio[1]	*Mezzogiorno*
Regional output	100.0	36.3	24.9	61.2	11.8	27.0
Regional population	100.0	28.8	20.1	48.9	11.1	40.0
General government employees as a percentage of:						
Total population	7.4	6.6	7.5	7.0	7.7	7.7
Total employment	18.6	14.7	15.7	15.1	17.6	25.2
Compensation per worker in the general government	100.0	98.6	99.8	99.1	101.3	101.0
General government compensation as a percentage of GDP	12.0	8.5	9.9	9.1	12.0	18.8

1. The Lazio region comprises Rome.

Sources: OECD calculations using ISTAT figures.

Correcting the deficiencies in public spending management and control

18. In some OECD countries, a strategic role for expenditure management is assumed by the executive authority, and within the government by the ministry in charge of the budget. In others, budgetary powers are shared between the executive and the legislature.[20] Neither model is intrinsically sounder from a spending control viewpoint, but the second requires well-adapted institutions or close constitutional constraints to ensure policy cohesion between economic and financial objectives and effective co-ordination between overlapping authorities. The public economy literature suggests that budgetary rules and the transparency of the budgetary system may affect the size of public expenditures and hence fiscal performance.[21] The 1997 *Survey* criticised the Italian system of expenditure management both for its emphasis on legal and procedural compliance rather than on the specification of objectives and assessment of performance, and for its fragmentation and complexity at all stages of the budgetary process (see Box 1). At the operational level, poor human resource management is a problem, because of lack of wage differentiation, labour mismatches and failure to devolve managerial competencies. Also, inflexible bureaucratic structures, complex administrative procedures and inefficient and non-competitive procurement processes give the system a reputation for poor quality of service provision.

19. A comprehensive reform strategy for the modernisation of administrative and budgetary procedures was launched during the early 1990s, gaining significant momentum in the last few years, and targeted at the efficiency of the public administration. It has involved the processes by which decisions are taken and the introduction of market mechanisms into the civil service sector, both addressed at producing better working methods and enhancing the quality of the services delivered. In addition, measures have been taken to improve the budget management framework.

Box 1. **Main weaknesses of the Italian budget**

The Italian budget system has exhibited major structural problems in public spending management, because of *i)* an intricate and formalistic budget review and approval process; *ii)* complex accounting methods*; iii)* the absence of effective cash control mechanisms at the implementation stage; *iv)* the lack of incentives for agencies and line ministries to perform efficiently and v) weak auditing processes.

An intricate and formalistic budgetary process. Budgeting involves multiple Ministries and/or Departments and a proliferation of budget chapters and items. For historical reasons, budget preparation reflects a strong legalistic approach, where economic constraints come into play only at a later stage. A distinct feature of the Italian budget process lies in the need to comply with a broad range of legislative details, to the detriment of both clarity and scrutiny.

The budget process moreover is based on multiple budget concepts and documents which tend to differ in terms of timing, accounting basis and sectoral coverage. This complicates the organisation of the calendar for budgetary discussions and generally impedes parliamentary evaluation. The Parliamentary debate effectively centres on the size of policy measures (*manovra*) needed to bridge the gap between the trend deficit (*fabbisogno tendenziale*) and the deficit target (*fabbisogno programmatico*) of the general government. This encourages recourse to one-off revenue measures, the efficiency and durability of which are hard to predict, but which has probably tended to impede coherent structural adjustments to public spending and borrowing.[1]

20. See Tanzi (1994), p. 306 and Commissione Tecnica per la Spesa Pubblica (1998), p. 15.

21. See Von Hagen and Harden (1996) and Koutopoulos and Perotti (1999).

Complex accounting methods. The existence of wide differences in out-turns between cash and accrual accounting methods complicates control and monitoring. While the underlying accounting method used by the State is in cash terms, the accounts of the general government, which is the relevant entity for the Maastricht evaluation criteria, are expressed in accrual terms. Reflecting the lack of a full set of reconciliation data, opportunities for transferring expenditures off budget are enhanced, which in turn means that the financial bill cannot effectively satisfy the key function of bridging the gap between the trend and the target deficit. In addition, the existence of wide and highly variable disparities between cash and accrual accounting methodologies, a major concern during the recent past (Chapter II), further compromises the effective control and monitoring of budget developments.

Absence of cash constraints. The responsibility for the management of the state cash resources falls upon the Ministry of Treasury (now the unified Ministry of the Economy and Finance, *Ministero dell'Economia e delle Finanze*) and specifically the Department of the *Ragioneria Generale dello Stato*. Although the local authorities and the other public agencies are required to deposit budgetary transfers and own resources (local taxes, charges or borrowing) in accounts held with the Treasury, the extent to which the executive can curtail spending is constrained. Neither are there effective cash limits at the state level because of the practice of allowing carry-overs from previous years. Thus, the budget law specifies line-item limits on a commitment basis (*autorizzazioni di competenza*) but allows unspent appropriations to be "carried over"' for two years (five years for capital spending). Annual cash resources (*autorizzazioni di cassa)* are determined as the sum of appropriations plus carry-overs *(residui).* These are converted into cash figures by the application of standard, notional, "realisation coefficients" for each economic category. Moreover, at times, cash resources of one state agency have been used to meet needs of other institutions, leading to deferral of payments or additional general government borrowing.

Although the carryover phenomenon is common to many countries, an Italian peculiarity lies in the fact that the amount of carry-over is not accurately specified in the budget law. The cash figures on a programme-by-programme basis are not subject to Parliamentary approval and are usually available with long delays, creating uncertainty about the actual availability of cash resources. This makes resource allocation amongst sub-programmes and management of public services difficult. When Parliament approves a budget, this is based on a preliminary quantification of carry-overs, which, because it is drawn from a limited range of information, tends to be underestimated. This feature can exacerbate expenditure management problems, insofar as it creates uncertainties about the actual availability of cash resources.

The institutional and legal framework imposes stringent rules on budgetary decisions, with the Constitutional Law (Article 81) requiring that any additional spending must be covered by offsetting expenditure cuts or additional revenues (*copertura*). But the safeguard can be circumvented temporarily when external agencies, not covered by the Central State budget (*e.g.* social security funds) or local governments overspend with respect to initial targets. Thus, extra general government spending can arise even when the *copertura* requirement is formally met. Overestimation of offsetting measures has at times weakened fiscal discipline.[2]

Inadequate audit and evaluation. As concerns audit and evaluation, special emphasis has been given to legal compliance, at the expense of internal — *i.e.* agency or department specific — performance evaluation, and this has probably impeded the diffusion of cost-benefit and cost-efficiency practices in programme selection. Within this framework, control procedures mainly take the form of conventional *ex ante* and *ex post* review of conformity with existing legislation. The burden of performing these activities falls upon Parliament and the Audit Court (*Corte dei Conti*) — whose initiatives, according to its critics, are excessively focused on the strict interpretation of the financial regularity of accounts rather than value for money audit.

1. See Alesina *et al.* (1998).
2. Cassese (2000), pp. 195-218.

Pathways to state budgeting reform

Streamlining budget administration

20. A principal area of reform has related to the streamlining of the activities of the central government, *via* ministerial consolidation. Until the mid-1990s, the Budget Ministry supplied the underlying macroeconomic assumptions, the Ministry of Finance was responsible for the revenue projections and the *Ragioneria Generale dello Stato*, itself a branch of the Ministry of Treasury, was involved in the quantification of expenditures in co-operation with various spending ministries. Since then, Budget and Treasury have been merged, and then Treasury and Finance unified in 2001, leading to the creation of the Ministry of the Economy and Finance (*Ministero dell'Economia e delle Finanze*). The reorganisation is too recent to draw a conclusion about the magnitude of the results achieved. While the original aim of the reform was to reduce the overall number of Ministries from above 20 to some 15, this has yet to occur.

21. In 1997 expenditures were reclassified, with a view to reducing the management and organisational problems arising from the fragmentation of the budget into many detailed items.[22] The number of budget chapters and items (some 5 000, initially) was drastically reduced. The 400 or so budget forecasting units (*unità previsionali*) were subsequently consolidated into homogeneous spending areas, which were placed under the responsibility of the various Ministries with spending authority. These changes have contributed to a simpler and more accountable public administration, creating a more transparent budget process, by drawing a clearer line of demarcation between political and managerial responsibilities at the implementation stage. However, the links between financial resources and policy targets are still quite vague, so that in many instances the activities of the forecasting units remain primarily focused on fulfilling bureaucratic obligations, rather than implementing a cost-benefit approach.

22. Further reforms were carried out in 1999 to speed the process of approval of the annual budget law (Legge Finanziaria).[23] This required making the calendar for presentation of the various documents involved in the budget process more efficient, while also separating the approval of the annual financial bill from the examination of the different instruments "connected" with the budget decision process (the so-called *provvedimenti collegati*). By shifting the discussion of such instruments to after the approval of the annual fiscal manoeuvre, risks of overlapping and delays have been considerably reduced.

Better strategic fiscal control

23. Major institutional challenges were posed following EMU entry by the adherence of Italy to the convergence parameters of the Stability and Growth Pact (SGP), providing an opportunity to encompass within the medium-term plan (DPEF) a more rigorous analytical presentation of the underlying forces shaping the economy.[24] The disciplining role of the DPEF has been enforced by the introduction of a proviso establishing that net borrowing under the annual financial law is to be defined in a way consistent with the targets set by the DPEF. Any deviation from this rule (from unexpected cyclical economic developments, for example) has to be agreed by Parliament.

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22. Perez (1997).

23. Perez (1999).

24. From the strategic viewpoint, the role of the DPEF in overall economic programming has been increased *via* the incorporation of an annual review of structural reforms, in both product and labour markets, an illustration of privatisation objectives and an assessment of policy initiatives targeted on enhancing the growth potential of the *Mezzogiorno* (such as in the domain of infrastructure investment, for example).

24. Clearer rules and more enforceable procedures and controls, together with the building of mutual trust, now assist the working relations between the government and the Parliament. The Parliamentary office in charge of the budget law can devote a greater proportion of its resources to evaluating fiscal targets and their adherence to the underlying macroeconomic assumptions. Less emphasis than previously is placed on compliance with detailed legal definitions of programme entitlements. On the other hand, prominent attention being given to the state net borrowing targets during the budget preparation stage may divert attention from effective Parliamentary scrutiny of current expenditures. The Audit Court's bureau which is responsible for preparing an annual ex-post report to Parliament, remains under-staffed.

Accounting improvements

25. The quality of control is most closely linked to the issue of accounting. If the relationship between budget provision and resultant spending is relatively close, it is less likely that in financial auditing the need to "recalculate the sums" will take prominence over performance assessment at the agency level, which is key to ensuring value for money.[25] An important precondition is the move from cash-based to accrual accounting (as has been done in New Zealand and Australia, for example) and this is now being introduced in Italy in connection with the SGP. Implementation of a fully-fledged system of quarterly fiscal accounts on an accrual basis, though in the pipeline, may require several years. However, the adoption of the European accounting requirements has not been matched by a decline in emphasis on the cash-based side of the budget system, which still risks distorting the picture of the country's fiscal situation.[26]

Improving human resource management

26. Recognising that a major source of waste and inefficiency relates to the lack of a proper controls and sanctions at the agency level, human resource management was finally implemented with the reforms launched in 1992. These attempted to introduce techniques of private sector management into the public administration and to de-politicise the status and career of civil servants. Changes in personnel management are critical for motivating public-sector workers and supporting staff morale. Incentives for enhanced performance have been built into management contracts, backed up by intensive training of managers. New performance evaluation and merit-based career systems have been established. Following these developments, the proportion of managers hired under fixed-term contracts at market-related salaries has increased. As yet, however, the reforms impose strict ceilings over the number of public jobs open to private sector applicants and focus virtually exclusively on higher-skilled civil servants.[27] Thus, they have largely failed, so far, to effect a change in the culture of mid- and lower-level civil servants, which is much needed to achieve a substantive modernisation of the public administration.

27. To address the lack of performance-related incentives for civil servants, human resource management was reorganised in 1999, focusing on the creation of internal (ministry-specific) evaluation and audit units, while the merit-based payment system was improved. Following these initiatives, the first labour contracts under the new provisions became effective from 2000. Jurisdiction for civil service sanctions and disputes has been moved from the administrative to the civil courts, while the criteria for controlling and sanctioning local government performance have been harmonised. Recent years have also seen the introduction of a pay determination system whereby new labour contracts for civil servants are to

25. Tanzi (1994).

26. OECD (2002), Chapter II.

27. ISAE (2001).

be bargained collectively. (Formerly, their pay was set by Parliament through an annual law thereby further complicating the budget approval process.) In parallel, a special agency was created to represent the state as the employer in negotiations with the unions. The law governing union representation was also reformed and part-time work was permitted in the public administration.

Simplifying public service delivery

28. The above changes have been complemented by the creation of the mandatory Citizens Charters (*Carte dei servizi*) for public services, including transport and health care. One year after their introduction in 1997, almost 7 000 agencies and local governments had adopted their own charter, specifying their standards. Innovations have included disclosure of public servants' salaries. As part of a widespread programme of regulatory simplification begun in 1996, successive initiatives have been launched to reduce duplication of functions among ministries and governmental departments. Since 1999, an Annual Simplification Law sets measurable short-term targets for eliminating and improving administrative procedures and for reorganising the functioning of governmental institutions, including the consolidation of ministries and/or their departments. Measures have also been introduced recently to secure the preparation of routine regulatory reviews of the quality of new laws and regulations.

29. The OECD report on regulatory reforms in Italy (OECD, 2001) stresses that reform of the regulatory state is a formidable and long-term task due to the legacy of decades of regulatory complexity, corruption and inefficiency. It goes on to say that, while the above reforms to streamline government are ambitious, they have not been very accountable with respects to results, so far — and there is still a tendency to estimate progress in terms of legal changes rather than concrete outcomes.[28] But the report also affirms that early results are now becoming concrete in other areas, such as declining administrative costs for citizens. Moreover, the broad regulatory quality strategy built over the past decade includes new procedures and institutions, most importantly new competition watchdogs. Since 1997, Italian simplification efforts have concentrated on two high profile projects aimed at easing the lives of citizens and businesses: self-certification and the one-stop shop.[29]

More rational public procurement

30. Historically, the Italian public procurement system has been characterised by restricted tenders as opposed to open tenders, by a lack of clear specifications and award criteria, and a complex legal framework. This has translated into costly public contracts and a significant gap between planned and effective costs compared with other European countries.[30] However, public procurement procedures have become more transparent in recent years, partly as a response to the active role of the EU in ensuring a more open public procurement market.[31] Access to information has been assisted by the implementation of electronic procurement, with foreign trading partners recognising that access of their firms to Italian public contracts has become easier more recently. Measures have begun to be implemented to introduce a fully operational internet system of government purchases.[32]

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28. OECD (2001*b*), p. 52.

29. OECD (2002), Chapter IV.

30. OECD (2001*b*), p. 74.

31. Commissione Tecnica per la Spesa Pubblica (2001*a*).

32. OECD (2002), Chapter II.

31. The planned reorganisation of the public purchasing network is based upon an initiative by the former government of December 2000, whereby purchases made by all central government entities are managed by a new central agency (*Consip*) which stipulates purchasing conventions with private suppliers. The new initiative does not extend to the local governments, although they have been granted free access to the Consip's information network. While the fiscal benefits of a truly integrated purchasing system can be large, these may not be forthcoming unless proper mechanisms to preserve competition among potential suppliers of goods and services are established.

Towards a more effective investment strategy

32. The OECD "growth project" suggests that public investment can have a significant effect on output growth.[33] Government investment does not seem to influence the rate of private capital accumulation, but it may affect growth by improving the framework conditions in which private agents operate. For example, high quality public investment in R&D, transport, communication and infrastructure, to the extent that it generates high economic and social returns, can help to create an environment conducive to entrepreneurship, innovation and private sector activity. Similarly, efficient government spending on education should improve the stock of human capital.

33. Recognising this, the former Italian government devised a new investment programme for the period 2000-2006 envisaging the use of 48 billion euro — approximately 4 per cent of 2000 GDP, almost equally split between European fund and national co-financing — for public investment in the *Mezzogiorno*. Following approval by the EU (August 2000), the plan was endorsed as the new Community Support Framework (CSF) for the Italian objective 1 regions. Under the new programme, regional governments are responsible for allocating 70 per cent of total funds of which most is destined to infrastructure projects (including transport, infrastructure and water). By 2003, when the programme will have become fully operational, the share of nationally financed public investment in total domestic investment will be around 13½ per cent, thus eliminating the current 1½ percentage point gap relative to the average of the OECD countries. The Ministry of the Economy and Finance has defined, in collaboration with the European Commission, the set of new rules underlying the allocation of the funds and has been entrusted with general supervisory and co-ordination tasks over the design and implementation of regional plans.

34. Among the recent reform initiatives included in the "100 days package", a major one has been the presentation to Parliament of a draft law designed to enhance public infrastructure investment (known as the *Legge obiettivo*, Strategic Infrastructure Law). The new regime will apply to strategic infrastructure, *i.e.* those projects considered to play a pivotal role in the growth and modernisation of the country. Strategic infrastructure is to be identified yearly by the central government in consultation with the local authorities. The government's intention is to introduce a fast track investment process, based on reduction of red tape and simpler procedures for administrative authorisations, and to create greater public accountability via a system of surveillance and support by the central government over the awarding authorities. The law also introduces a new institution, the general contractor, to speed up the building of infrastructure; in parallel, the government plans to dismantle the Authority for public works (*Autorità per la vigilanza sui lavori pubblici*, created by the Merloni laws but becoming operational only in 1999). Once the new law is approved, the government will enact implementing legislation to set out specific procedures for administrative approvals and concession contracts, in line with EC public procurement rules The law thus aims to provide the market with clear and simpler rules for the administrative approvals process, while signaling heightened political commitment. In this sense, it does not necessarily imply a drawback from the recent strategy to enhance the growth potential of the *Mezzogiorno*, which stresses the public-private sector

33. OECD (2001*b*), p. 65.

partnership. On the other hand, a strongly centralised strategy for strategic public investment without independent oversight may not be consistent with the shift towards greater spending transparency. Enhanced surveillance is a key precondition for bringing the Italian public works system fully into line with international best practices.

Issues in fiscal federalism

35. As part of the strategy of public sector reform, Italy has been undergoing a process of decentralisation. As a result, the Italian governance system has characteristics both of a centralised state, with its close control over local spending, and a federal model, with its focus on local taxes as a means of financing a large part of local expenditure programmes. Currently, the local (*i.e.* regional, provincial and municipal) authorities account for some 40 per cent of total general government employment (Table 5). Local government consumption and investment spending total around 60 per cent of the general government total, equivalent to 12 per cent of GDP for 2000, a high proportion compared with other centralised states but low relative to federal states (Table 9). Neither the centralised model nor the federal one is intrinsically better from the point of view of expenditure control, although if the right conditions are present, the latter can impart important efficiency gains to the budget and the economy at large (Box 2). But based on the below analysis, the existing arrangements between central and local authorities have not enhanced spending discipline. Revenue and spending autonomy at the lower levels of government appear not to be closely matched, with accompanying incentive and co-ordination failures.

Table 9. **Shares of local governments in overall receipts and expenditure**[1]

	Italy	Canada	France	Germany	Japan	United Kingdom	United States
	In per cent of GDP						
Consumption spending	**9.6**	16.1	5.5	9.7	7.6	7.4	9.7
Capital spending	**2.3**	1.8	2.0	1.7	4.9	0.8	1.5
Total	**11.9**	17.9	7.5	11.4	12.5	8.2	11.2
Taxes	**5.9**	17.6	4.8	11.3	7.4	0.1	10.0
Transfers received from public entities	**5.1**	3.8	2.9	2.4	5.5	7.9	3.0
	In per cent of general government						
Consumption spending	**46.8**	73.1	30.6	70.1	47.6	33.3	55.5
Capital spending	**11.5**	8.3	11.0	12.2	30.6	3.7	8.5
Total	**58.3**	81.4	41.6	82.3	78.2	37.0	64.0
Taxes	**20.1**	53.9	19.2	49.9	41.3	0.1	42.6
Transfers received from public entities	**17.3**	11.6	11.6	10.6	30.7	79.0	12.8

1. In 2000 or nearest year available.

Sources: OECD and Ministero dell'Economia e delle Finanze, *Relazione generale sulla situazione economica del paese*.

The objectives of decentralisation

36. In concept and design, reform has been motivated by both fiscal policy and regional development concerns. In the first stage, during the 1970s, decentralisation on the spending side began with the assignment of health care, local transport, manpower training, and environmental policies to the newly created "ordinary statute regions", according to constitutional mandate. (The spending responsibilities of provinces and municipalities had already been established in 1934, and those of the five "special statute regions" in 1948.) Expenditure devolution was coupled with an enhanced redistributive role for central government to reduce the regional disparities in the ability to finance and deliver a consistent quality of services. A curious feature was that, as the devolution of spending responsibilities to the regions began, taxing power was taken away from the municipalities and substituted by a system of grants from the national government, which extended to the new regions as well.

Box 2. **The attainment of efficiency gains from fiscal devolution**

The arguments for fiscal devolution

The arguments in favour of fiscal devolution include the following:

- *Subsidiarity*: with devolved government the diversity of preferences across jurisdictions would be better reflected in local spending patterns; this yields a welfare gain, *i.e.* better allocational efficiency.
- *Competition*: local jurisdictions would be able to compete with each other for tax bases, leading to lower tax rates, greater fiscal discipline and heightened operational efficiency of the public sector. Devolution brings the principal and agent together, promoting accountability of local administration on issues of a truly local nature.
- *Democracy*: devolution would give a boost to local democracy by "empowering" citizens.

The theory underpinning this view (developed by Musgrave, Oates and Tiebout), in turn, rests on three basic assumptions:

i. Local public goods are by nature non-distributive — *i.e.*, the poor and wealthy equally benefit from public goods provided by local governments. Voting behaviour is therefore guided by efficiency rather than equity motives.

ii. The benefits from local public spending are fully internalised in local resident taxes. In other words, local jurisdictions are neither exporters nor importers of public goods. There are no inter-jurisdictional conflicts over "who should pay the bill".

iii. Voters are mobile, therefore the pressure on local governments to offer value for (tax-) money is strong.

Caveats

Clearly these conditions are only partially met in reality and central governments rely on the following mechanisms to tie the hands of local governments:

- Local governments have the possibility to raise user charges or property taxes to test voter's willingness to pay at the margin, but the bulk of local government funding is based on a formula sharing source taxes with the central government. That is, local tax autonomy is really undesirable, if social equity is a stronger priority.
- Formula-based block grants (untied grants) or horizontal transfers are further used to achieve equalisation of potential revenue and expenditure across local jurisdictions. Conditional grants may be justified where there is evidence of strong inter-regional spill-over effects, but strict limits are needed.
- Fiscal rules or borrowing controls are enforced to limit deficit spending. A co-operative approach may be a useful complement or even substitute for mechanical rules.

However, such "solutions" have the potential to create new problems of their own which could ultimately undermine the rationale for devolution. In particular, excessive controls emanating from the centre may obscure local administrations' accountability to local citizens, while overly generous equalisation formulas weaken the incentive of tax competition (100 per cent equalisation eliminates it). The advantages of fiscal devolution may also cease to exist in cases where functions are inappropriately devolved to lower levels, *e.g.* not truly local goods or those benefiting from clear economies of scale, or where local governments suffer from a poor capacity to implement spending. According to the basic principles of fiscal federalism, the central government should have the responsibility for macroeconomic stabilisation and income redistribution, as well as other functions providing clear collective benefits or spillovers (national defence, R&D). Local governments are usually best placed to provide merit goods and services, where local preferences are likely to differ from any given set of uniform national standards.

Welfare could even be reduced if soft budget constraints were to arise as a consequence of devolution. In Italy's case, an unclear division of national and local competencies, *e.g.* in the area of health, and conditional grants taking on the character of entitlements, have prevented full fiscal responsibility in the receiving governments. For budget constraints to be binding, lower level governments should not be able to rely on transfers from above to bail them out of financial difficulties. But where arms-length relations with financial markets cannot be assured or local governments cannot be allowed to suffer the consequences of their own mismanagement, there is little alternative to maintaining tight central control over their spending and borrowing. Exercising strong central control, in turn, requires good provision of information and a strong reporting system, elements also missing in the case of Italy.

37. The second phase of decentralisation, during the 1990's and still ongoing, was a reaction to the evident failure by the initial devolution model to achieve its objectives. *First*, centralising taxation while decentralising spending led to a loss of general government spending discipline.[34] The corruption scandals at the beginning of the 1990s (*tangentopoli*) brought into sharp relief widespread waste of public funds due to years of poor co-ordination among procurement agencies and extensive collusion between suppliers and local administrations. *Second*, development in the poorer regions was obstructed by an over-dependence on transfers, while equalisation of per capita resources produced no convergence in service quality and gave no incentives for better governance. The decision was made to devolve a broader range of activities and powers to both the regions and municipalities, and the movement was termed "administrative federalism". The "Bassanini reforms" of the late 1990s then sought to increase the capacity of lower-level administrations to undertake their new functions.

38. In terms of actual amounts of spending devolved, the 1970-1985 phase was by far the more significant: subnational government spending doubled from 7 to 14 per cent of GDP. After remaining broadly constant, the administrative federalism phase accounted for a further increase of only about ½ per cent of GDP. In the past year, however, new "rules of government" have emerged and been locked into the constitution by a set of amendments. These take Italy closer to a fiscal federalist model and enlarge the scope for future devolution.

Contradictions in the devolution of spending

39. The devolution of functions was from the outset financed almost totally by tied transfers, the intention being to assure adequate funding and standards of service in particular in the health and transportation areas (Table 10).[35] But this left central government in *de facto* control of many activities. To

34. On the other hand, centralisation of tax *administration* was probably warranted insofar as a myriad of local taxes and fees had complicated the system and fragmented tax collection had been inefficient. This probably contributed to the substantial increase in real tax revenues in the late 1970s and early 1980s.

35. The National Health Fund and the National Transport Fund are the two main earmarked funds. Health and transportation services are not provided directly by the regions but rather by the local health units and public (and private) enterprises in the transport sector, and although these entities in principle can charge fees and tariffs, these are kept low for reasons of social policy.

counter the risk that further decentralisation might exacerbate already large inter-regional discrepancies in service performance, the 1990 framework law reforming local administration reaffirmed the constitutional requirement that a standard level of service must be guaranteed to all citizens, and established the principle of the responsibility of managers (managers of Local Health Units, public hospitals, university hospitals, etc.), ostensibly in support of this goal. In their practical application, however, the two principles have collided, as the powers of local managers are severely limited by overlapping responsibilities. For example, co-payment rates for drugs[36] and salaries of health workers, school equipment and teachers' salaries, transportation tariffs, and rules for hiring and firing are strictly controlled at the central level. To a large extent, central intervention has reflected its own (non-transparent) pursuit of social and employment policies. Efforts by regions to control expenditures or adapt them to local circumstances have in such ways been repeatedly frustrated, particularly in the area of health care. As a consequence, the constitutional court is constantly taking decisions on the proper boundary between national interest and regional autonomy. The imposition of specific "essential" standards in health care provision also creates moral hazard in that regions can come back to the central government and demand higher transfers in order to cover the extra cost to them of providing such levels of service.[37]

Table 10. **Functional breakdown of regional government expenditures**
Percentage

	Ordinary statute		Special statute	
	1992	1999	1992	1999
General administration	4.8	5.7	8.1	10.5
Justice	0.0	0.0	0.0	0.0
Police	0.0	0.7	0.4	0.3
Education and culture	1.4	5.0	4.8	10.5
Housing	1.1	0.0	3.5	0.0
Social affairs[1]	78.3	62.5	46.5	35.7
Transport	6.2	6.6	3.7	2.2
Economic development	5.9	10.7	16.8	14.8
Non attributable	2.0	6.1	12.0	7.3
Repayment loans	0.3	2.7	4.2	9.1
Total current expenditure	86.7	82.9	60.3	70.4
Total capital expenditure	13.3	17.1	39.7	29.6

1. Mainly health care for the regions, mainly social welcare and public health for the provinces and municipalities. For the provinces, expenditure on housing is included in social action.

Source: Ministero dell'Economia e delle Finanze, *Relazione generale sulla situazione economica del paese*.

40. Regional autonomy has also been frequently challenged in the area of regional development, and this has stymied efforts to develop local initiative in the southern regions. The central authorities have long doubted the lower level administrations' ability to manage public investment projects properly. Access to central funding was conditional upon satisfying complex procedural requirements which often resulted in long delays in realisations and unfinished projects.[38] With the lack of autonomy tending to reinforce initial

36. In early 2001, prior to national elections, the central government prohibited imposition of the "ticket", a copayment on pharmaceuticals, by local health units. This denied regions an important tool for meeting commitments under the internal stability pact, which were still expected by central government.

37. In a recent case, the constitutional court has sided with the regions in this matter and ordered the central government to provide grants to cover the extra cost of providing nationally mandated "essential" services.

38. See Giarda (2000). To some extent, of course, the corruption scandals justified these doubts.

conditions of poor administrative capacity in the lagging areas, northern and central local governments have remained consistently better performers than their counterparts in the south despite roughly equalised per capita expenditure levels due to equalising transfers. To tackle these problems, recent policy action has thus been directed at improving local administrative capabilities for evaluation, through the promotion of a network of technical units in central and local administrations.

Incentive effects of financing arrangements

41. Conditional grants have been a main source of perverse incentives in regions, since they were set largely with reference to the previous year's expenditures and without any reference to objective performance criteria, and thus provided a constant incentive to overspend. These arrangements have further been perverted by the budget process (see Box 3). The central government had an incentive to underfund *ex ante*, under the pretence that regional expenditures could be thus controlled, or to limit the apparent deficit at the time of budget approval. The resulting local deficits were financed by arrears to suppliers and borrowing from banks, so as to bypass legal limits on borrowing by subnational governments.[39] The government periodically cleared the informal debts of the regions *via* capital transfers every two or three years for health and every three to five years for transport, thereby implicitly rewarding high or inefficient spenders. These off-budget operations amounted to about 6 per cent of budget appropriations in the health sector in 2000 (Table 11). An attempt was made in 1993 to limit grants in both sectors to a notion of "standard" per capita costs and own revenue capacity, with the intent of punishing any deviation in actual from standard costs (which would have to be covered by raising new regional taxes). However, the efforts failed due to the inability to define standard costs.

Table 11. **Public health care expenditure overruns**[1]

Billions of lire

	1995	1996	1997	1998	1999	2000
Financing	92502	97849	99993	105416	112958	124586
IRAP[2]	47089	50550	51442	55037	50288	55920
State transfers	38350	38864	38432	39702	51519	52787
Other own revenues	3933	4163	4645	4947	5269	9055
Special statute regions	3130	4273	5474	5730	5883	6824
Spending	93801	101819	110394	114588	120380	132454
Deficit	-1299	-3970	-10400	-9172	-7422	-7868
as a percentage of spending	1.4	3.9	9.4	8.0	6.2	5.9

1. Figures refer to expenditure of the local health units.
2. From 1998 on, including regional income tax (addizionale IRPEF). Prior to 1998, represents other taxes that were replaced by the IRAP in 1998.

Source: Ministero dell'Economia e delle Finanze, *Relazione Generale sulla Situazione Economica del Paese*.

39. Regions are permitted to borrow only for the capital budget and for share participation in public enterprises, with the proviso that capital charges (interest plus principal repayment) not exceed 25 per cent of regional own revenue, net of health contributions. Local Health Units and transportation companies (accounting for about 80 per cent of regional expenditure), on the other hand, can borrow from commercial banks to pay suppliers' bills.

Box 3. **Budget control and co-ordination problems at local levels**

Inadequate co-ordination between central and local government

Many of the defects noted with respect to national budgeting are replicated at the local level, where a complex and legalistic budgeting system makes for a lack of budgetary control and oversight either internally, by citizens, or by the national government. Even though regional and local administrations are the major providers of public services, present accounting methods do not include assessment of the economic costs of such services, either in the project selection or evaluation phases of the budget process. Auditing is mainly internal, non-professional, and purely formal (to make sure no laws were broken).[1] The ability to make economic choices is limited by a lack of flexibility in the use of conditional grants. The inherent lack of accountability and flexibility, in turn, provides little incentive to innovate, especially in regions with low administrative capacity. Popular expectations of local and regional governments are low as dissatisfaction with the services rendered focuses on the central government, which is blamed for insufficient and delayed funding and for imposing inflexible rules on the use of funds and provision of services.[2]

Poor co-ordination with the central government exacerbates these problems. Deliberate *ex ante* underfunding by the Treasury has made for high budgetary uncertainty, which also entails direct economic costs. Delaying provision for local capital projects can increase their costs, while diverting borrowing to commercial banks may allow non-economic projects to proceed due to the implicit government guarantee on the loan. Allowing the local health units to go into arrears encourages suppliers to add a premium to their prices, in expectation of delayed payment. The central government does a poor job in collecting information on aggregate budgets or monitoring spending, and getting data with a long lag in large part because of the lower levels' financial dependence on central government itself.[3] Responsibility for distributing grants to and monitoring regional and local governments rests with Treasury and the Ministry of the Interior, respectively, but there has been little co-ordination on sub-national matters between the two.

The challenge of the Internal Stability Pact

In the context of the Stability and Growth Pact, the national government makes budgetary commitments to the EU on behalf of the general government, so that compliance concerns all levels. The 1999 financial law ushered in the so-called *Internal Stability Pact,* imposing deficit reduction *vis-à-vis* a no-policy-change baseline on subnational governments, with a co-operative mechanism, mainly in the context of the regional and mayors conferences, to deal with corrections of eventual overshoots. The global reduction was apportioned among the three sub-national layers of government (regional, provincial and municipal) as well as single governments according to their levels of primary current expenditure. The deficit governed by the rule is on a cash basis, and excludes capital spending and interest payments on the expenditure side, and central government transfers on the revenue side. There is also a rule on debt, which however is poorly defined: given that pre-existing rules allow borrowing for capital expenditures up to the limit where debt service equals 25 per cent of own revenues, a large potential for borrowing and fiscal expansion seems to exist with the growing devolution of tax bases.[4]

Although the pact provided for the timely provision of data (by both regions and local governments above a certain size) on evolving budget positions, problems in monitoring have arisen because of continuing reporting and accounting difficulties (EU-level commitments are on an accruals basis and refer to a net lending definition of the deficit). The pact was continued under the financial laws for both 2000 and 2001. The latter included for the first time the obligation by regional and local governments to show, *ex ante*, that budgets submitted for approval to local and regional assemblies meet the targets assigned to them. Another provision of the same bill required regional governments to raise taxes if expenditure on health should be higher than target. The latter has been highly disputed, not enforced, and may be suspect on constitutional grounds.[5]

Overall, such co-ordination problems have led to a poor performance under the pact, particularly in the area of health spending. A more fundamental problem, perhaps, has been the lack of effective sanctions on non-compliance, apart from the sharing of sanctions which might be imposed at the European level on Italy. Indeed, the pact could even serve to perpetuate the soft budget constraint by encouraging free-riding. Even if recouped later on (itself doubtful), any budget overshoot at the sub-national government level must be compensated in the current year by the central government, given that it would be the one to bear most of the reputational costs of any breaching of the Maastricht ceiling.[6] The August 2001 health agreement with the regions featured an attempt at sanctions, by making full central funding conditional on the adoption of certain spending measures.[7]

1. For local governments, the 1990 framework law provided for an external Board of Auditors consisting of professionals. All public entities were to use cost accounting, and while still retaining the cash reporting were also to use accrual accounting. However, these provisions have not been implemented. In the case of local governments, accounting is still regulated by a 1934 national law, so that additional national implementing legislation is required to establish accrual accounting. Also, local administrators have generally been unable to solve the technical difficulties in implementing a cost accounting system.
2. See Emiliani *et al.* (1997).
3. Regional budget formulation begins only when the central government budget is approved by parliament. Only when the regions know their tax rates and grant amounts, can their own budgeting begin. Then the regional budgets must be submitted to the national government, which has a 30-day statutory period to approve or comment (it cannot reject them). Meanwhile, the first quarter's operations are conducted on the basis of the appropriations for the first quarter of the previous fiscal year. Moreover, the Treasury is reluctant to release the grants, even those budgeted for — they require continuous prodding by the regional governments. See Emiliani *et al.* (1997).
4. Balassone and Franco (1999).
5. See Giarda (2000).
6. Balassone and Franco (1999) point out that apportioning the required effort across subnational governments according to their levels of primary current expenditures is also unfair: not only does a government which is already running a surplus have to contribute to the effort, but if its level of current primary spending is high, it may be required a larger effort than a government running a large deficit. The pact also does not attempt to deal with the impact of the cycle on lower level budgets, just as devolution of taxation is making these budgets more cyclically sensitive than before.
7. OECD (2002, Chapter II).

42. Reforms entered a new phase with the devolution of tax power and counterpart withdrawal of conditional grants since 1993. Tax devolution has taken two distinct forms:

- The assignment of some autonomy in determining tax rates as well as tax bases to lower level governments, notably the introduction of a regional health payroll tax in 1993, which was transformed in 1998 into a business value added tax, IRAP;[40]

- The sharing of some national tax revenues produced in the regional or municipal authority, notably the personal income tax.

40. Prior to 1992, lower level governments could not levy taxes or modify tax rates, which were set by the central government.

Yields from the new tax sources were to be deducted one for one from transfers, giving no net gain in the short run. In the longer run, however, the possibility of higher revenue growth from own tax sources should have given subnational governments an incentive to encourage local growth, as well as to be more efficient in spending in line with the principles of tax competition.

43. However, conditional transfers continued to account for 55 per cent of regional revenues (Table 12), and the same moral hazard problems continued, with regions having no incentive to use their new tax powers to cover health and transport deficits, or alternatively to limit overruns *via* efficiency savings in order to reduce taxes. Furthermore, the central government continued to collect and set the IRAP during a 2-year transition period, so that it has for the time being remained essentially a tax controlled by the central government.

44. A major reform of regional financing took place in March 2000, whereby a rules-based system of horizontal equalisation using a portion of national VAT receipts was introduced, abolishing almost all transfers to the regions, at least *ex ante*. The VAT fund is to equalise up to 90 per cent of the differences in standardised per capita revenues[41], and also assign resources according to health related indicators (age structure or demographic indicators) in order to take into account the constitutional mandate that financing of regions' activities be "needs related". The more transparent footing of intergovernmental fiscal relations should help to stem regional spending overruns, while the fact that equalisation is less than 100 per cent leaves room for incentives to develop local tax bases. There are also potential problems. The "health needs" financing portion, in particular, could be subject to continual upward revisions as health costs rise due to population ageing, especially as the formula for calculating it is unclear.[42] This would tend to shift resources from the poorer toward the richer regions given the much older age structure of the latter, in turn putting upward pressure on the solidarity component and thus damaging incentives as well as credibility of the rule. The high share of own taxes in the form of the business value added tax (IRAP) may also provide little practical fiscal autonomy to the poorer regions, where the tax base is small; in the case of rapid future rises in health spending, they would have to raise tax rates much more than would the richer regions to balance budgets, which could distort business location decisions and further undermine their growth potential.[43] The new system may fail to harden budget constraints sufficiently insofar as bailouts have not been excluded and the phase-in period is rather long (fourteen years), given the time needed by the poorer regions to build up their administrative capacity and to improve their growth fundamentals in order to cope with it. Finally, repeated attempts to replace the (presently chaotic[44]) system for awarding grants at the municipal level by a more equitable, rules-based system have been so far unsuccessful.

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41. The "solidarity coefficient" of 90 per cent was a compromise solution after a fierce debate — the poorer regions had wanted 100 per cent, and the government 80 per cent. The use of standardised (potential) rather than actual revenues in the formula is meant to sanction the lack of fiscal effort.

42. The concept of eligible health care expenditures is used to determine the average eligible cost and thus the distance from the average. Under the existing law on the national health service, this should be based on a uniform level of services to be provided across the country and an estimate for each region of the per capita cost of providing these services. The previous system for allocating grants was based on the same mechanism. However, it was extremely difficult to come to an agreement, and the allocation formula between 1980 and 1997 changed practically every year. See Annunziata and Szekely (2000).

43. Simulations in Annunziata and Szekely (2000) show that annual increases in health care costs 1 percentage point higher than the real GDP growth rate would create a sizeable imbalance in the system within a decade. While the affluent northern regions could raise their required extra revenue by raising their IRAP and regional personal income tax rates, none of the southern regions would be able to do so. This might lead to a continuous reform of the tax assignment and equalisation mechanism, reducing its credibility.

44. While the overall system of transfers succeeded in more or less equalising per capita nominal expenditure across regions, sharp differences arose among local per-capita expenditure levels *within* regions in

Table 12. **Revenue sources of local governments**

	1992	1996	2000	1992	1996	2000
	Billions of lira			Shares in percentage		
Regions						
Taxes	11680	23999	81499	9.4	17.1	44.2
Social contributions	..	0	0	..	0.0	0.0
Sales of goods and services	0	0	0	0.0	0.0	0.0
Transfers	111990	115344	100156	89.6	82.2	54.3
Capital income	510	683	1267	0.4	0.5	0.7
Others	780	261	1358	0.6	0.2	0.7
Total	124960	140287	184280	100.0	100.0	100.0
Provinces and municipalities						
Taxes	14600	31642	38081	21.2	40.2	43.7
Social contributions	..	0	0	..	0.0	0.0
Sales of goods and services	6850	8765	11441	10.0	11.1	13.1
Transfers	40390	32327	30646	58.8	41.1	35.1
Capital income	1420	2340	3714	2.1	3.0	4.3
Others	5390	3551	3333	7.9	4.5	3.8
Total	68650	78625	87215	100.0	100.0	100.0

Source: Ministero dell'Economia e delle Finanze, *Relazione sulla stima del fabbisogno di cassa*.

45. Thus, the ongoing reform of financing at sub-national levels has yet to produce tangible results. The situation has been complicated, moreover, by recent constitutional changes which significantly widen the scope for further devolution, importantly including in the area of education, but also having unclear implications for fiscal accountability (Box 4). The new government, for its part, has targeted devolution as an important area of attention in its reform agenda. A major initiative has been the new health agreement with the regions,[45] which by eliminating the harmful practice of *ex ante* underfunding should improve the budgeting process considerably. But despite a financial incentive for implementing specified spending economies, it may not eliminate moral hazard insofar as bailouts have not been explicitly excluded. More generally, the government plans to accord full local spending autonomy while centralising control over funding in the areas of health, education, and police. Whether this mix, which seems to be consistent with the new constitutional provisions, will serve to harden budget constraints is debatable and the new strategy awaits further clarification.

Implications for health care spending

46. Despite a relatively modest level of health spending, Italy does quite well in terms of health outcomes.[46] However, a number of indicators suggest serious micro-inefficiencies in health care supply. *First*, payments to suppliers are increasingly delayed (as seen, the predominant mode of financing spending overruns), and waiting times for medical procedures are long.[47] The premia charged for payment

response to different abilities to negotiate with central government officials and/or to differences in political affiliations at the regional level. See Giarda (2000).

45. OECD (2002), Chapter II.

46. In the advanced OECD countries in general, there seems to be little relation between the level of health spending and health outcomes such as life expectancy.

47. For example, waiting times in Italy average 23 days for a liver sonogram, 74 days for an endoscopy. The average payment-to-supplier delay for the purchase of hospital supplies was 251 days in 1998, an increase

delays have also led to an excessive cost of medical supplies, including pharmaceuticals, equipment, and services. *Second*, there exist large differences across regions in utilisation rates. *Third*, Italy has almost twice the number of doctors per 1 000 inhabitants as the OECD average (4.7 versus 2.5), but only one-fourth the number of nurses per doctor (0.6 versus 2.4), while almost one-third of hospitals have fewer than the minimum number of beds considered necessary for efficiency and quality of care.[48]

47. At the macro level, conversely, health care expenditures have been squeezed, in particular in the first half of the 1990s (in the run-up to EMU), when public health spending fell by almost 2 per cent in real terms — unheard of in the OECD context. At present, the health care spending to GDP ratio remains relatively low, but the savings achieved earlier — administrative cuts in wages and input prices and capital spending freezes — were unsustainable. Indeed, health care spending has started to rise very fast since 1995, leading to the observed overruns, and such aggregate demand pressures may be driving this process independently of underlying micro efficiency problems or defective budget co-ordination observed under the internal stability pact. Population ageing implies an aggravation of such pressures in the future. In addition, the experience of other countries shows that the decentralisation of health spending has normally been associated with an increase in spending during a transition period.[49] This also means that it is very difficult to decentralise health care while constraining its spending, as was required for EMU entry and will continue to be required under the internal stability pact.

Box 4. **The 2001 constitutional amendments**

A set of constitutional amendments in the area of fiscal federal relations was passed by the previous Parliament and ratified by popular referendum on 7 October 2001. The main changes are as follows (see Giarda, 2001):

- *More legislative power for regional governments and differentiated regional autonomy*. Legislative competence belonging exclusively to the central government in certain areas — most notably education — is transferred to a regime of shared responsibility with regions (*i.e.*, national government sets legislation defining “fundamental principles” and regions the implementing legislation). At the same time, concurrent competence in many more areas is transferred to exclusive regional competence. It is, however, up to the regions to ask for these transfers of power, which Parliament must approve. It is not clear how financing arrangements will reflect potentially very differing levels of regional autonomy.

- *More emphasis on regional taxes and sharing of national taxes according to the regional distribution of tax bases.* This is an important change relative to the present constitution, where shared national taxes accrue to a national fund to be divided among regions according to “needs” evaluation. “Needs” will continue to affect financing in areas of concurrent competence, however, probably in terms of a system of block grants (the new text is heavily worded against conditional grants). The reform is thus likely to generate greater interregional differences in service levels: uniformity is no longer an absolute constitutional value.

of 30 per cent from the previous year, while in regions such as Emilia-Romagna and Lazio, the delays were 343 and 449 days, respectively. See Reviglio (2000) and (2001).

48. Reviglio, *op. cit.*

49. ISAE (2001).

- *Constitutional recognition and power of execution for sub-regional governments (municipalities and provinces).* The power of execution, formerly strictly connected to legislative power, is to be transferred to sub-regional governments, which are also for the first time mentioned in the constitution and accorded equalisation principles formerly reserved only for regions. The reform provides something of an institutional revolution, as municipalities in future might be charged with responsibility in fields such as education, now entirely in the hands of central government agencies. What is not clear, however, is the degree of flexibility that will be allowed in the carrying out of their new functions, nor the accompanying mode of finance. Echoing past problems with devolution, rigid mandates would remove performance incentives and require categorical grants (with full pass through conditions); alternatively, autonomy not supported by tax effort is likely to produce fiscal irresponsibility.

Although deficit financing of subnational current expenditures is constitutionally excluded, past experience suggests that the implied hardening of the budget constraint could be counteracted by the possible loss of fiscal accountability associated with: *i)* the bigger share of public activities that will be managed under the regime of concurrent legislative power, and *ii)* the assignment of execution powers for regional and national competencies to sub-regional governments.

Assessment and agenda for further reform

Rebalancing public spending

48. The successive phases of fiscal expansion and consolidation have left the Italian budget with several major compositional and operational weaknesses. Spending in certain areas such as debt service and pensions is high, but in areas such as health, education, infrastructure investment and research, family and unemployment benefits, it is relatively low. There are important needs to be met in human capital and in infrastructure development, and national resources for health, education and research may need to be increased. The social safety net is meagre, apart from pensions, and unemployment assistance, child and old age care will need to be reinforced in view of labour market needs (it would also enhance the performance of automatic fiscal stabilisers). The challenge is to find the resources to do these things while also facilitating tax cuts.

49. There are two ways of achieving this: a transfer of resources among programmes and a more efficient provision. In terms of resources allocated to it, Italian pension spending is almost alone in standing well above the OECD average. Indeed, there is substantial further scope for savings in the area of pensions. The 2000 *Economic Survey of Italy* showed that the reforms of the 1990s imply a major improvement in incentives affecting the timing of retirement and a major containment of benefit generosity, but that the phase-in of the reforms is rather slow. Urgent initiatives are needed to offset the increase of pension spending that can be expected when the baby-boom generation enters retirement. Namely: extend the pro-rata system for the calculation of benefits (which at present applies only to individuals with less than 18 years of contribution before 1995) to all workers; step-up the planned phase-out of the incentives to early retirement (*i.e.* retirement after 35 years of contributions and irrespective of the age of the individual); and remove the strong disincentive to working beyond age 64 in the present pension benefits formula. The findings of the Brambilla pension commission, created in the early days of the new government, would appear to strongly support these conclusions (see Annex I). In particular, the slow transition implies a further rise in the pension spending ratio of 0-4 per cent of GDP in coming decades, depending on the long-run rate of economic growth, and a 5 per cent of GDP widening of the deficit of the pension system. The implications are that measures to speed the transition and substantially cut pension spending further will be needed to avoid a severe crowding out of other

expenditures in the years to come. Although actions have been taken to diminish incentives during the transition phase to retire early, more could be done in this field.

Achieving greater administrative and economic efficiency

50. A broad-based personnel reform needs to be further carried out, *via* a greater use of flexible labour forms and increased mobility, including a much needed shift towards a performance-based pay system. However, such a reform would need to be part of a general overhaul of the administrative system. Also, it is possible that initially the reform could lead to higher costs due to the political reality that losers would need to be compensated, though this should not be a reason not to undertake the reform since long-run savings (both directly in the wage bill and indirectly in greater public service efficiency) could be much higher.

51. A conclusion of the above analysis is that the system of expenditure control has severe defects which have, in the past, led to involuntary overruns and inefficient resource use in the government sector. Exploiting existing scope for greater efficiencies, both in the specialised agencies and in the provision of general government services, could not only release resources for urgent priorities but also produce a more efficient and equitable economic policy. There are several areas calling out for policy action, and the adoption of cost-benefit accounting would allow for better prioritisation. On present accounting practices, there is no way of ascertaining whether, or by how much, public spending exceeds the point of technical equalisation between social marginal costs and benefits.

52. Recent reforms have been significant and have gone some way to improving the budget management and control weaknesses responsible for erratic budget outcomes. New methods of budgeting and reporting have helped control spending levels, reducing (until 2001) deficit overruns. Greater accountability and client-orientation are being built into the public administration apparatus. Better incentive structures have been built into civil-service management structures and regulatory reforms have improved the quality of government service provision. Overall, however, the effort is still far from complete if measured against the objectives of establishing an accessible public administration, a fundamentally changed managerial behaviour and a cost-saving organisational culture that is secure against undue influence from special interests. There is still excessive focus on the annual budget, and not enough attention paid to medium-term objectives. A strategic planning capability remains to be developed. Expenditure programmes will need to be designed in an explicitly medium-term context where goals and instruments are clearly identified.

53. As concerns budget management and control, the ongoing transition towards accrual accounting needs to be stepped up in order to be able to enforce budget ceilings at all levels of government. The amount of funds permitted to be “carried-over” from previous years should be expressly circumscribed over time in terms of the cumulated amounts, in the context of a medium budget framework. Whatever remaining obstacles prevent the budget from focusing on the wider, economic, definitions of the public sector should be removed.[50] As concerns audit activities, the mandate given to the Audit Court — focusing on results rather than mere compliance with legal procedures — needs to be fully implemented, while an expanded role for Parliament in external audit should also be established. A better-informed Parliament is important for it to make a constructive contribution to the budget at the preparatory stage. Both the Parliament's office in charge of evaluating the budget law and the Audit Court should be given the possibility to increase their staff accordingly, which may necessitate changes in the statutory ceilings on permitted personnel, preferably with compensatory reductions elsewhere.

50. Pisauro (2001), Tanzi (1994).

Making decentralisation more effective

54. Italy's process of decentralisation has by and large not succeeded in obtaining the expected efficiency gains from fiscal devolution. Very little progress has been achieved so far towards greater local transparency and moral hazard problems remain strong, because regional authorities know that their overruns will be covered *ex post* by the central government. The lack of credible sanctions implies that the balanced budget requirement is never met. To correct these deficiencies, the devolution of tax and spending power needs to be buttressed by better internal control mechanisms and institutional capacity in the receiving governments. A clear identification and allocation of spending and financing responsibilities across levels of government, with better co-ordination, is needed to make the development of local initiative and responsibility compatible with a hard budget constraint.

Imposing a harder budget constraint…

55. The recent reform of fiscal federal relations in Italy is a major step in hardening the lower tier government budget constraints, as it de-links the provision of grants from historical expenditures, which eliminates an important incentive to overspend, and strengthens the transparency of intergovernmental relationships. But devolving more tax power would be useless unless the moral hazard that perpetuates reliance on *ex post* bailouts is removed. One approach would be to introduce sanctions into the internal stability pact. Regions which build up large arrears might be subject to intervention of the Treasury, *via* the imposition of temporary tight controls over budgets and spending, implying reputational penalties for the politicians responsible.[51] The credibility of the new tax sharing rules needs to be strong at the outset.[52]

… will require greater spending autonomy…

56. Once the "no bail-out" threat can be made credible, regions will be in a position to assume greater responsibility for making good use of the money provided by (rule-based) transfers and local taxes. Accountability to the voters can help to bring about large potential benefits of decentralisation such as better allocative efficiency and public sector productivity. But this will also require devolving more real autonomy on the spending side. The recent phase of administrative federalism introduced new management and organisational tools to allow managers to set and pursue performance goals. Important as these are, without the basic freedom to prioritise activities in response to local preferences, or to set output prices and negotiate for input costs with respect to market-based criteria, they could remain superficial.

…particularly in the health sector

57. These issues are paramount in the health care sector, where the resources needed to improve service provision can come only from more efficient management, given the tight spending ceilings of the internal stability pact. Otherwise, introduction of a hard budget constraint could exacerbate the problems of rationing and low service quality in the poorer areas. A process of implementing health sector reform, giving local health care units strong incentives to allocate resources effectively and to deliver services efficiently, is urgently needed and can only be designed and carried out at the regional level within a framework of national principles. This will require the attainment of full responsibility by regional

51. Some authors have suggested that it may not be wise to eliminate vertical financial imbalances altogether, since some level of grants from the central government is needed in order to give it a lever over subnational governments (see, *e.g.,* Pisauro 2001).

52. See Commissione Tecnica per la Spesa Pubblica (2001*b*).

authorities to determine what services can be provided and to negotiate contracts with health care providers, bearing the full costs of their actions and using their discretion to raise taxes if need be, or to adjust costs in line with sound management principles.[53]

58. At the same time, the inherent contradiction between enhanced regional policy autonomy and social equity as expressed in mandated "national standards" needs to be resolved. Under the new national tax sharing arrangements, nearly all (90 per cent) of regional differences in tax base capacity will be offset. This should provide the basis for social equity, with a possible top-up through a system of block grants. It also should be noted that the new amendments appear to remove the constitutional justification for mandated service uniformity, while affirming the right at all levels to share equitably in national tax resources (Box 4). To end the moral hazard that overlapping responsibilities imply, the central government should therefore end rigid mandates on essential services, co-payments, staff salaries, or hiring and firing rules, etc. Its more appropriate role might be to facilitate mechanisms through which best practice principles could be disseminated, for example creation of a database of nation-wide benchmarks against which regional authorities can assess the performance of their own local health units. National standards need to be defined in terms of a set of "bare minimum" levels of service, as opposed to the current set of entitlements, guaranteed to all residents in any area after appropriate negotiation between the regions and the center.[54]

Improving local institutional capacity…

59. Decentralisation will finally lead to improved public services only if subnational governments have the necessary administrative capacity to manage the transition to higher efficiency.[55] The initial situation in some of the regions and local administrations is greatly lacking in this respect, and radical measures to build such capacity are needed. A key feature of the Bassanini laws has been the reform of human resource management system discussed above; it is important that this be fully implemented. Inefficient staff allocations and poor skills, in particular in the southern regions, have not been addressed, and this calls for intensive retraining of civil servants so as to allow them to perform new tasks or become more productive in their current ones. Policies to allow staff dismissals may also be needed.

…will enhance service capability

60. In the process, real accountability to the public must be created (to fulfil the new "citizen charter" pledges), as opposed to legalistic notions of responsibility. This would include a "value for money" approach to local performance, including the evaluation of efficiency and effectiveness in service provision, and ability to cost services *ex ante*. Enhanced public scrutiny of sub-national budgets and outcomes could be encouraged by publication of such budgets. Modern accounting, budgeting, and auditing principles are an essential step towards the full transparency needed to monitor the performance of local health units and transportation companies.

53. See Reviglio (2000), p. 24.

54. See Lorenzini and Petretto (2000).

55. See Tanzi (1996).

Options for the use of market instruments

61. OECD experience has shown that the private sector can perform some of the functions traditionally carried out by government more efficiently. Technological developments are helping in this direction. Examples include refuse collection, running utilities, and road passenger transport. For a number of such domains, most notably transportation, electricity, and gas, the introduction of market mechanisms at the local level is instrumental to a successful liberalisation nation-wide. Privatisation could take the form of either outright sale of the underlying assets, as Italy has done to a large degree, or more contracting-out of the management of facilities and delivery of services. In the domain of asset sales, experience shows that market structure is at least as important as ownership. The goal is to deliver services in a competitive market framework, not to maximise privatisation receipts by creating private monopolies. Contracting-out can result in substantial savings if contracts are properly designed, while improving the quality of public services retained in-house *via* the "threat" of outside competition.[56]

62. In the area of infrastructure building and maintenance, where risks to private investors are high but financial and managerial know-how largely lacking in the public sector, private-public partnerships (PPPs) are a promising development. At the same time, the experience of other countries has borne out that local policy-makers should be careful to: *i)* contain project costs for example by use of standardised contracts; *ii)* ensure competition both in the tendering process and over the duration of the contract to avoid creation of monopoly positions; and *iii)* not initiate PPPs where traditional public investment might be more appropriate.[57] Similar principles would apply to the privatisation of government services in general.

63. Directly competing with the private sector is a related approach bringing market discipline into play in the carrying out of public sector activities. Examples are open public procurement and competitive recruitment, schemes which Italy has already adopted (see above). Italian cities have also formed partnerships with each other to improve supply efficiency, as in electricity, for example, while also allowing competing private entry into many areas of local service provision, under the impetus of the Bassanini reforms. The current government plans to step up this trend,[58] but it could be pushed farther, for example liberalising the labour markets in public administration to allow for more flexible wage setting and temporary contracts, depending on local conditions and budget constraints. Other OECD countries have been able to stimulate competition and efficiency in the education sector *via* the use of vouchers and decentralisation of education policy, the latter now being an official policy objective in Italy.[59] A greater use of market-based management principles should be made in both health and education (in particular higher education) sectors in Italy, especially as the problem of overlapping competencies with central government is removed, as recommended above. Also, a greater use of charges and copayments in areas such as health, education, and transport could help reduce budget pressures by shifting costs to the final user.

64. Italy has inaugurated elements of competition and partnership with the private sector in its promising new approach to infrastructure spending in the South. This plan has relied on a set of market-based incentives and private participation in local government infrastructure projects. It provides a model for reinforcing regional autonomy while building their administrative capacity in a context of mutual trust

56. See Atkinson and van den Noord (2001).

57. See 2001 OECD *Survey of United Kingdom*.

58. OECD (2002), Chapter IV.

59. Recent studies of major voucher schemes experiments in the United States (Ohio and Wisconsin) show that school systems making use of vouchers showed much better educational performance outcomes than schools that did not make use of vouchers (see Hoxby, 2001). Competition is likely to be needed in the education sector in order to counteract the strength of treachers unions (in virtually all OECD countries).

and co-operation between levels of government,[60] creative guidance and technical assistance from the centre, and competition-based local management. This experience also goes to show that the EU can impart a useful externality to reform efforts (as in public procurement; see above). However, the above caveats about PPPs need to be considered when deciding how far local governments should go into business activities. Also, the scope of the new Strategic Infrastructure Law should be strictly limited to strategic infrastructure where cross-regional interests are clear and paramount — *i.e.* where there is a national interest at stake — to avoid any undesirable reversal of the trend to greater local autonomy and openness to market forces. And consistent with the above suggestions, all projects targeted by the law should be subjected to careful cost-benefit analysis and a clear identification of the complementarities with private investment;[61] the apparently "fast-track" procedures facilitated by this law should not be allowed to skip this vital step. It remains true as well that general economic framework conditions need to be improved in order to maximise the ability of the private sector to participate, notably *via* more competition and better functioning financial and labour markets. A summary of recommendations provided in this chapter is given in Box 5.

Box 5. **Recommendations for reforming public expenditure in Italy**

Based on the analysis presented in the chapter, policy initiatives are needed to ensure more effective allocation and use of public resources. There are two ways of achieving this: a transfer of resources among programmes and a more efficient provision of services.

Complete the reform of the pension system

Despite reforms, expenditure on pensions, already very high, is expected to increase further. The authorities need to:

- Apply the pro-rata system for the calculations of benefits to all workers, regardless of the years of contributions (the new system applies only to those with less than 18 years of pension contributions before 1995);

- Phase out seniority pensions more rapidly (*pensioni di anzianità*);

- Raise the minimum retirement age to 60 years, and ensure a neutral pension system also as regards the decision to retire beyond 64.

Create a rational health care system

There will be growing expenditure pressure on health services for the elderly which may exacerbate pressure on public spending. The government should:

- Subject regional health spending to national standards in terms of a set of minimum levels of service, ensure that the regions are responsible for what services are provided, while assuming the full financial costs of their actions;

- Give health care units strong incentives to design and implement sound management practices, to match the requirement of fiscal responsibility with spending autonomy.

60. A cross-country analysis by ISAE (2001) shows that the most critical element of success in the decentralisation process seems to be the creation of such an atmosphere of mutual trust.

61. Wurzel (2001) shows that the German government's failure to adopt such practices led to massive waste in infrastructure spending in the Eastern Länder.

Strengthen other income transfers

To modernise the transfer system, the authorities need to:

- Re-examine income support schemes for the unemployed;
- Socialise part of child and old age care;
- Develop a well-targeted and carefully monitored social safety net.

Improve the budget process

A *sine qua non* of effective reform is a more accountable budget process. Reform is still far from complete if measured against the objective of abandoning excessive reliance on detailed legal requirements in favour of a more evaluative approach. The government needs to:

- Encourage budgeting by objectives at all levels of government;
- Reduce the extent to which budget appropriations can be “carried over” from previous years in the annual budget and not change budget allocations unless explicitly permitted by a supplementary appropriation process;
- Step-up the ongoing transition towards quarterly accrual accounting;
- Pay greater attention to medium-term objectives by designing expenditure programmes in an explicitly medium term context;
- As concerns audit activities: reinforce both external and internal audit systems; fully implement the 1994 mandate of the Audit Court and of external Auditing Boards at the local level; strengthen *ex post* political oversight.

Harden budget constraints at lower level of government

The process of decentralisation needs to deliver greater efficiency gains, requiring:

- Action to correct the “moral hazard” problems arising from the fact that the regional authorities assume that their spending overruns will be covered *ex post* by the central government. Sanctions should be introduced into the internal stability pact;
- More local spending autonomy to make fiscal responsibility operational. This requires clarification of areas where there are overlapping responsibilities with central government. More monitoring and evaluation of development projects can enhance the learning process that comes with autonomy;
- Better institutional capacity at the local levels. Skills need to be raised via training and market-based personnel reforms. Negotiation and partnership with civil society and the central government are other elements of success.

Enhance the efficiency of the public administration

Action is needed to exploit existing scope for greater efficiencies at all levels of government:

- Measures should be taken to ensure that the planned shift towards a performance related pay system is fully implemented;
- Enhancing the efficiency of public employees also requires an effective competitive hiring, the use of mobility provisions, and more differentiated wages to eliminate labour mismatches;

- The process of establishing a more accessible and accountable public administration could be facilitated by the issue of a clear calendar of intermediate objectives, progress reports and press releases;

- Fully exploit the potential of information and communications technology for better government and deeper interaction with citizens.

Implement a transparent public investment strategy

The amount of public investment is low by international standards and new investment programmes have been devised to fill this gap. The government should:

- Place the Strategic Infrastructure Law in the context of a comprehensive strategy involving all tiers of government as well as the private sector, and ensuring an adequate degree of surveillance;

- Allow infrastructure investment to be co-financed with private capital from both national and international sources, subject to allowing adequate competition in the market.

Use market instrument more widely

The private sector can perform some of the functions traditionally carried by the government more efficiently. More attention should be paid to bringing market discipline into the carrying out of public sector activities:

- The provision of a broader range of local goods and services (*e.g.* bus services, waste collection and child care services) and the purchase of inputs for public sector agencies (*e.g.* maintenance and cleaning of public buildings and financial services) need to be increasingly contracted-out;

- User charges can be helpful in reducing excess demand for public services and improving their quality through the introduction of market signals, and they relieve the general taxpayer the cost of providing services.

ANNEX I

MAIN CONCLUSIONS OF THE BRAMBILLA PENSION COMMISSION

The "*Commissione ministeriale per la valutazione degli effetti della legge 335/95 e successivi provvedimenti*" (Brambilla Commission) was established in order to assess the financial effects of the 1995 pension reform over the period 1996-2000. The Commission was also in charge of updating the estimates of the financial effects of the 1995 reform for the period 2001-2006 and for the projected path of pension expenditure over the next decades. The Commission's final report[1] does not so much offer specific recommendations for further pension reform (except in the areas of private pension provision and steady state properties), as to point out the tensions inherent in the present pension system. By implication, it is then up to the government to issue new legislation that addresses these concerns. The analysis adopts the optic of the objectives of the original reform law (No. 335/95), the new obligations under membership in the European Monetary Union, and the need to stimulate competitiveness and growth.

Main conclusions of the audit

- The 1995 pension reform has substantially achieved the financial targets that were set for *the period 1996-2000*. The overall effect consists of an improvement in the public finance balance of around 28.3 billion euro, in line with the expected results. Of these, savings and higher revenues account for 31.7 billion euro. Costs of implementing the reform were lower than expected (3.4 billion euro instead of the projected 5.5 billion euro), almost exclusively because of the slow development of the second pillar.

- The updating of the estimates for *the period 2001-2005* shows that the cumulative financial effect is expected to be 5.3 billion euro higher than what was estimated in 1995, with an improvement in the public finances balance of around 52 billion euro.

Problems in the transition

The slow transition to the new steady state system continues to cause serious problems in the fiscal, social equity, and economic domains for at least two decades to come. They are as follows:

- *Pension spending*, already high in EU terms, is set to rise further, crowding out other spending. However, the ultimate ratio to GDP (now around 14 per cent) depends very much on the growth rate of real GDP that is assumed. For example, 1 per cent long-run real annual growth implies a peaking of such spending at over 18 per cent of GDP, 2 per cent avoids any major increase, while 3 per cent

1. Commissione ministeriale per la valutazione degli effetti della legge no. 335/95 e successivi provvedimenti (2001), *Verifica del sistema previdenziale ai sensi della legge 335/95 e successivi provvedimenti, nell'ottica della competitività, dello sviluppo e dell'equità*, September.

allows a decline. The official projections shown in the special chapter of last year's *Survey* assumed long run annual growth of 1½ per cent, and pension spending peaked at close to 16 per cent in 2035. The only reliable constant in the calculations is the demographic tendency projected by ISTAT, which shows a sharp rise in the dependency ratio (in the absence of massive immigration).

- At current contribution rates, moreover, the *financial disequilibrium of the pension system* is set to widen markedly over the next two decades. The "equilibrium" contribution rate is projected to rise by 4.7 percentage points by 2032.[2] In order to cover the gap, the effective contribution rate should have the same increase. However, such an increase would be unacceptable from an economic viewpoint, while issuing more debt is unacceptable from the point of view of obligations under the Stability and Growth Pact. Thus, a further reduction in pension or other public spending will be necessary. After having reached the peak, the "equilibrium" contribution rate is expected to decline to 39 per cent in 2050 following the demographic path.

- *Generational and worker inequalities*, as calculated by pension rates of return (or alternatively effective replacement rates) for the different groups, are severe. This is because of strong preference given to workers with more seniority during the transition. Also, differential contribution rates exist for different categories of workers, with private dependent workers being particularly disadvantaged relative to other groups. Social inequalities in the future are also aggravated by the recent growth of *parasubordinati, i.e.* workers on atypical contracts benefiting from social security tax breaks but at the cost of inadequate pension coverage in retirement, given the lack of supplementary coverage (below).

- Pension system parameters *distort the labour market*, as evidenced in a low and falling (over the past 20 years) employment rate and a large underground economy. The strong recent growth of *parasubordinati* shows the large impact that cuts in social security taxes can have on labour supply and demand. The most affected groups are women and workers aged 51-65. Italy stands out similarly for its low median retirement age, especially for women, the discrepancy with other countries being even larger when taking into account life expectancy. The implication is that the goal of reaching the Lisbon/Stockholm criteria, discussed in Annex III, reinforces the need for further pension reform.

- The high tax wedge furthermore *impairs competitiveness* in the context of the single currency.

- The Commission notes a *slow development of complementary pension provisions*. The following main reasons are given:

1. scarcity of resources at the disposal of potential adherents (again, a problem of too high a labour tax wedge), requiring the usage of other set-aside funds such as *TFR*;
2. there is little competition between various types of pension funds due to excessive restrictions on open and individual pension funds, while negotiated funds are excessively favoured; thus deregulation followed by re-regulation to assure better prudential supervision is needed;
3. obstacles to participation in pension funds by public sector workers, which must be removed even though there is no *TFR* in this case to access;
4. continuing legislative interventions in recent years have created a climate of instability and uncertainty; greater regulatory stability is needed in order to stimulate both supply and demand in the market for pension funds.

2. The equilibrium contribution rate in 2000 was 2.1 per cent. It is projected to reach a peak of 46.8 per cent in 2032.

Issues in the long run

Finally the report points out some structural features of the system (once it reaches the steady state) that leave room to improve its effectiveness in reaching the target of economic and social sustainability. Two of them are particularly relevant. *First*, the difference allowed in the law between the financing contribution rate (actually paid into the system) and the calculated contribution rate (used in the calculation of pension benefits) carries costs, whether for social equity or for financial equilibrium. Unless a good reason can be given for such differences, they should be eliminated. *Second*, the modalities for updating the "transformation coefficients" of the benefit formula every ten years *via* a political process,[3] carry high risks and could generate strong discontinuities in the treatment of different cohorts. A possible solution could be to update at shorter intervals and to adopt an "automatic" method of calculation.

3. See last year's *Survey* for a discussion.

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