Italy

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OECD ECONOMIC SURVEYS

2002-2003

Italy

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BASIC STATISTICS OF ITALY

THE LAND

Area (thousand sq.km.)	301.3
Agricultural area (thousand sq.km, 1995)	165.2

Population of major cities (thousands, 20.10. 2001)	
Rome	2 547
Milan	1 256
Naples	1 005
Turin	865

THE PEOPLE

Population , 1.1.2001, thousands	57 844
Number of inhabitants per sq. km	192
Net natural increase, 2000, thousands	-17
Net rate per 1000 inhabitants, 2001	-0.2

Labour force, 2002, thousands	23776
Employment, 2002, thousands	21 612
In agriculture	1 096
In industry	6 932
In services	13584

THE PRODUCTION

Gross domestic product in 2002, billions of euros	1258.3
GDP per head (2002, US $)	18 795
Gross fixed capital formation	
Per cent of GDP in 2002	19.7

Origin of gross domestic product in 2002 at market prices, per cent of total	
Agriculture	2.2
Industry	23.9
Construction	4.8
Other	69.1

THE PUBLIC SECTOR

Current expenditure in 2002	
(percentage of GDP)	47.7
Current revenue in 2002	
(percentage of GDP)	45.2

Gross financial liabilities in 2001	
(percentage of GDP)	106.7
General government investment in 2002	
(percentage of total investment)	9.3

THE FOREIGN TRADE

Exports of goods and services,	
as a percentage of GDP, 2002	26.9
Main export categories,	
as a percentage of total exports, 2001	
Manufactured goods	36.6
Fabric and textile goods	15.9
Chemical products	9.2
Transport equipment	10.6
Mineral fuels	2.0

Imports of goods and services	
as a percentage of GDP, 2002	25.8
Main import categories,	
as a percentage of total imports, 2001	
Foodstuffs	6.9
Manufactured goods	26.8
Metal, ores and scrap	9.7
Chemical products	12.9

THE CURRENCY

Monetary unit: Euro

Currency units per US$, average of daily figures:	
Year 2002	1.0611
June 2003	0.8569

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

The economic situation and policies of Italy *were reviewed by the* Committee *on* 26 May 2003. *The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole* Committee *on* 24 June 2003.

The Secretariat's *draft report was prepared for the* Committee *by* Alexandra Bibbee, Flavio Padrini, Ali Culha, Maria Maher *and* Boris Cournède *under the supervision of* Nicholas Vanston.

The previous Survey *of* Italy *was issued in* February 2002.

Assessment and recommendations

An economy lacking resilience

The Italian economy has not proved resilient to the global slowdown that started in 2001. The ambitious programme of structural reforms over the past decade allowed Italy to join the EMU and to improve macroeconomic fundamentals, but has not been enough to spare the country from a disappointing performance in 2002, when the deceleration of growth was one of the sharpest among OECD countries. Discretionary fiscal support and low real interest rates temporarily revived both consumer and business spending in the second half of last year; however, it is unlikely that activity will pick up in Italy in advance of that of its trading partners, with Italian GDP rising this year broadly in line with the Euro-area average. A bright spot in the current downturn has been a strong employment performance, a clear result of the greater flexibility of the labour market following the reforms of the 1990s. It is worrying, though, that both inflation rates and unit labour costs are rising faster than the euro-area average, while Italian exporters appear to have lost competitiveness, and certainly have lost market shares. In addition, the convergence between North and South recorded in recent years needs to be maintained. This suggests that to derive the full benefits of reforms, existing ones need to be implemented fully, and others pursued with vigour.

Challenges for policy

Looking ahead, Italy's key challenges are to raise the potential rate of growth and increase resilience to future shocks, to address the issue of competitiveness by closing the inflation gap with the euro-area, and to safeguard the sustainability of public finances while also continuing to provide appropriate fiscal policy support to the growth process. Greater competition, reduced red tape, and more

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efficient public spending are critical elements of such a policy mix. Lower taxes, provided they are matched by a reduction in structural expenditure, are also important. Indeed, the present government came to power with a mandate – and sufficient parliamentary support – to carry out a major programme of growth-oriented economic reforms, some of which have already been implemented. Several of these have fiscal costs, at least in the short run, but the unexpectedly low economic growth since late 2001 has put strain on public finances. There is thus a pressing need at present for the government to find ways of continuing to finance its programme of necessary reforms in the areas of taxation, education and social policies, while also complying with Italy's obligations under the EC Treaty and the Stability and Growth Pact. The reforms themselves are likely to generate faster growth and thus eventually higher tax revenues, but the experience of other countries suggests that this will not come about in the short term. Meanwhile, recovery in Europe could quicken the pace of deficit reduction, although this would be partly offset insofar as higher interest rates feed through into higher debt-servicing costs. Hence, an optimal policy would be early and permanent cuts in primary spending in those areas which do not directly improve competitiveness and growth performance, using the fiscal room created to finance reforms in other areas, including tax cuts. In this context, it is encouraging that the Italian authorities have refrained from attaching a specific timetable to their tax reform plans. In recent years, one-off measures have been taken to alleviate shortfalls in revenue, mostly due to weaker than expected economic growth, though some of them, such as the tax amnesty, could lead to some permanent enlargement of the tax base. In general, the government should avoid financing permanent tax cuts and/or permanently higher spending *via* one-off measures taken within an annual budgetary process. For the medium term, the adoption of a strategic multi-year framework, such as those implemented in some other OECD countries, could strengthen the implementation of fiscal policy, conducted in accordance with the Stability Programme. In the coming years, Italy should run substantial primary surpluses in order to reduce public debt more rapidly.

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Cuts in primary expenditure are necessary to reduce debt, and an orderly divestiture of public assets should be programmed

Although Italy's public debt has fallen substantially in the past decade, it still exceeds 100 per cent of GDP. Its average maturity structure is longer than in the past, lowering somewhat the sensitivity of the debt service burden to changes in interest rates. The net worth position of the public sector is believed to be more comfortable, as there is a large amount of public assets, mainly real estate earning low returns. A complete inventory of them is being compiled. If there is no reason to keep them in public hands, and the private sector can make more effective use of them, a long-term programme of gradual and orderly divestiture should be envisaged. While such real estate asset sales would allow the levels of the deficit and debt to fall, it is important that they not be used instead to substitute for structural spending reforms. In the longer term, fiscal pressures from an ageing population will mount, and it is therefore doubly important that primary expenditures be reduced wherever possible, and the level of debt fall.

The new budget forecast for 2003 is a deficit of 2.3 per cent of GDP

At the end of 2002, new legislation to strictly control and limit spending was introduced, and proved effective. The 2003 budget aimed at a deficit of 1.5 per cent of GDP. It included revenue-boosting measures, largely tax amnesties, equal to about 0.7 per cent of GDP. The deficit will also be reduced by continuation of the programme of real estate asset sales in the amount of 0.7 per cent of GDP. However, the deficit projection for 2003 has recently been revised to 2.3 per cent of GDP, mainly in the light of continuing weakness in activity. Under the 2002 update to the Stability Programme, the objective for 2004 is a deficit of 0.6 per cent of GDP, based on a GDP growth rate of 2.9 per cent.

Medium-term fiscal targets will also be challenging

Looking further ahead, the medium-term fiscal target is for a progressive reduction in the general government budget deficit, with a small surplus being registered by 2006. The medium-term plan projects primary surpluses of 4-5 per cent of GDP till 2006, although OECD projections indicate that the primary surplus (adjusted for the cycle and one-off measures) in 2003 will be around 3 per cent of GDP and will fall to under 2 per cent in 2004. According to these projections, additional measures will be required.

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Reducing the tax burden is under way…

The tax reforms introduced in the 2003 budget aim at reducing the overall tax burden and simplifying the tax system. This first stage of a more ambitious tax-cutting programme primarily targets low-income families and should facilitate greater participation of marginal workers. The main feature of a new framework law, still to be implemented, is a move to a system of only two tax rates on personal incomes, with tax deductions on lower incomes. The tax reform also replaces the dual income tax by a single corporate tax rate, which however is still nearly 20 percentage points above the tax rate on financial income, thus favouring debt over equity finance. Narrowing this gap is desirable and could be achieved by broadening the corporate tax base while reducing the rate. The IRAP, a regional tax on productive activities, is to be phased out by the tax reform, but it would be unwise to implement this before alternative revenue sources are found for the regions.

… and tax amnesties have been introduced

The tax reform is also intended to lessen the size of the underground economy, *via* the introduction by the 2003 Budget Law of a large number of tax amnesties (*concordato* and *condoni*). They differ from traditional tax amnesties in that there are no penalties for unpaid tax in previous periods, simply requiring one-off payments by taxpayers. An additional goal of the tax amnesties is to clear the huge backlog of pending litigation, allowing a more efficient assessment and collection of taxes in the future, and an enhanced capacity to fight tax evasion. This approach could lead to an increase in tax revenue, but there would be moral hazard problems if the amnesties were to become a regular feature of government policy.

Product market competition has improved

Product market competition intensified in the 1990s thanks to liberalisation of network industries and local services, public administration reform, active enforcement of competition legislation and extensive privatisation. However, there is still considerable scope for improvement, and raising potential growth will be aided by removing obstacles to competition. The legacy of government intervention and the remnants of restrictive practices have hampered the development of competition in some sectors. Local governments should follow practices that strengthen competition

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in their dealings with the private sector. In general, the rents that are eroded by stronger competition are concentrated among entrenched incumbents, while the benefits are broadly distributed and thus less visible. This weakens support for further reforms.

Further easing of regulatory burdens is needed

The introduction of the one-stop shop to reduce the administrative burden on setting up enterprises has reduced waiting times for opening new businesses, but administrative burdens and red tape associated with running a business are still considered to be major problems by companies and may inhibit their growth. In public services, the introduction of competition through public procurement has been less than expected given commitments by the authorities as reflected in the 2001 *Regulatory Reform Review of Italy*. There has been little experience to date with outside bids, contracting out or tendering.

Entry barriers in service sectors remain high

Entry barriers remain substantial in the professional services and retail distribution sectors despite regulatory reforms in the past few years. Recent reforms still allow for the involvement of professional associations in the tariff setting process. Their role should be reduced, to lessen the probability of regulatory capture. Decentralisation carries the risk that local regulations on urban planning prevent the opening of large retail outlets, thus hindering competition. Better co-ordination of competition policy objectives across different levels of government and a rethinking of devolution strategy as regards competition in local markets are required.

Regulatory reforms in network industries have started to pay off, but competition needs to be increased further

Regulatory reforms in network industries have been effective and, although incumbents retain dominant positions, competition is emerging. In particular, the liberalisation of telecommunications has been a success. Electricity prices are comparatively high, which is due mainly to high costs in generation. Privatisation of network industries should be speeded up. The government has a controlling interest in electricity and gas and still retains a golden share in telecommunications. More recently, the powers of some sectoral regulators have been circumscribed. The authority to issue telecommunications licences has been transferred

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back to the Ministry for the time being. The introduction of an electricity pool has been delayed due to insufficient competition in generation, and the government has also intervened in recent tariff-setting by the energy regulator. The government now has the over-riding authority to approve tariffs, and future tariffs may have to be settled through a consensual process with the parliament. These actions risk a step backwards in earlier competition progress and should be reversed. In particular, the independence of the regulatory authorities should be reaffirmed, especially as the government is now planning a review of the regulatory authorities.

The industrial structure may now be impeding competitiveness

The international competitiveness of Italian industry is also influenced by its structure and governance. The enterprise sector is characterised by a large number of very small firms, and a small number of large ones, evidently with disincentives for small firms to grow. Although small firms have traditionally been a source of dynamism, their limited resources hamper the ability to invest in human capital. At the same time, foreign direct investment, an important potential source of technological know-how (and competition), is not attracted by Italy for many of the same reasons that hamper domestic businesses: red tape, an infrastructure gap in the South alongside bottlenecks in the North, and remaining product and labour market rigidities, issues that the authorities are trying to address.

Corporate finance and governance institutions should be improved

The Italian system of corporate finance and governance features weak market scrutiny of firms and underdeveloped long-term risk finance. Equity market participation is limited to a small number of large firms, where insider (family group) control is consolidated by means of pyramidal shareholding schemes. Banks provide the bulk of financing to all firms, but play a limited role in monitoring them. Their role is by and large an arms-length one. Short-term financing is higher than in other EU countries, though the trend is downwards, while long-term lending is usually collateral-based. As in many countries, small firms find it hard to finance expansion. They may be reluctant to grow in any event, because of a higher burden of regulation and taxation at larger scales. But a key problem is an out-of-date bank-

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ruptcy law wherein bankrupt debtors can face criminal sanctions, creditors have no directive rights in a bankruptcy and can also face legal liability for pre-emptive actions, and there is scant regard for the goal of increasing firm value. A lengthy and costly judicial process greatly exacerbates these risks.

Financial markets have been converging to best practice

To address these shortcomings, Italy has over the 1990s implemented reforms of its financial system in tandem with real-side reforms, bringing its banking sector into line with EU norms and reforming the governance of listed firms. In this perspective, reforms continue. A new company law provides both listed and non-listed firms with greater autonomy to organise, finance, and govern themselves. The development of a private funded pension pillar could spur capital market development and create a new class of institutional investors to monitor firms. Banks are adapting to more stringent risk regulations in the context of Basle 2, which should improve their own incentives to monitor firms.

But reforms need to be geared more to competition and transparency

Nevertheless for the reforms to be fully effective, several steps need to be taken. *First*, minority shareholder rights need strengthening, given the disproportionate degree of control exerted by holdings at the apex of pyramidal groups. The high cost of calling shareholders' meetings needs to be reduced. *Second*, conflicts of interest are not fully resolved. Because mutual funds are mainly owned by the banks, who also provide lucrative services to the firms, incentives by institutional investors to monitor firms in the interests of small shareholders are weak. Management of the new pension funds should be delinked from control by companies, and should be separated from the commercial banks' normal lending and savings management activities. Workers should be able to change funds without losing tax incentives. *Third*, market transparency and investor protections need strengthening, especially if private pension funds are to provide workers with genuine retirement security. Penalties for accounting fraud have been substantially weakened, especially for non-listed firms who are often at the top of pyramid holdings. *Fourth*, bank reform needs to go further. Basle 2 should be implemented while also striking a reasonable balance between the application of adequate

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risk-assessment mechanisms and their implications for small- and medium-size banks and firms. Bank governance should be strengthened by further divestiture and greater private-sector orientation of the banking foundations, but the government's most recent reform proposals (currently put on hold by the constitutional court) appear to go in the other direction. Competition for bank property rights should be enhanced also by a more open regulatory environment for takeovers. A bankruptcy reform currently in the drafting stages should pay greater attention to creditor rights and be completed and implemented without delay.

Growth will be boosted by labour market reforms

Since the second half of the 1990s, labour market policies have been directed towards the liberalisation of employment contracts as well as fiscal incentives, and this has been followed by strong employment growth, albeit accompanied by a decelerating productivity. Although the gap is narrowing, the unemployment rate is still higher than the OECD and EU averages. The employment ratio remains relatively low, especially for females and older workers in spite of recent increases. Moreover, despite aggregate wage moderation, wages still tend to be rigid at the micro level. Hence, Italy's external (and internal) competitiveness would be aided by further labour market reforms that enable firms to adjust their production techniques and levels in response to changing demand patterns.

The "Pact for Italy" can help here

To respond to these challenges, in 2002 the government and the social partners (with the exception of the largest trade union) agreed on a "Pact for Italy" (*Patto per l'Italia*). The Pact is directed at a better functioning labour market and more effective social policies. New types of contracts should help firms and workers to find better job/skill matches. The emphasis of the government on an efficient placement system is thus appropriate; priority attention should be given to the South, and incentives are required to ensure that the low-skilled receive adequate attention. A balanced approach in the reform is needed, as there is the risk of a dual labour market emerging if job protection for traditional contracts remains rigid. As stated in previous *Surveys*, too rigid rules on permanent contracts risk excessive recourse to increasingly precarious ones for new entrants.

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Conflicts should primarily be resolved through bilateral agreements or through multilateral committees rather than through the judicial system. Finally, to maximise the impact of flexible contracts on participation, the government should also promote higher and better provision of care for children and other dependents and develop policies which make work pay.

The Pact also tackles the unemployment benefit reform

The Pact has announced measures – in part already implemented – to strengthen social inclusion and unemployment insurance, areas where public spending has traditionally been low in Italy. The main poverty-fighting weapon in the Pact is the introduction of tax cuts targeted at low income families. This strategy is welcome, as in the 1990s and early 2000s the share of people with relatively low income has increased considerably in Italy as compared with other OECD countries. Tax cuts for the low-paid and other making work pay policies can promote social inclusion through stronger incentives to work in the formal economy, while also allowing the implementation of a more differentiated and flexible wage structure including across regional lines. But an effective welfare system also requires an adequate unemployment insurance and assistance system. There are currently many types of unemployment benefits of varying generosity. For ordinary beneficiaries, replacement rates are low, and advice, control and incentives to search for a job are limited. The new reforms provide for higher replacement rates for the ordinary unemployment benefits, while beneficiaries are required to attend specific training programmes and to accept a job offer, when available. This mix of improved incentives and strong sanctions is appropriate. Nevertheless, different categories of workers will still face very different levels of generosity in unemployment benefits. These should be streamlined, preferably by re-balancing the various levels of generosity. Furthermore, work incentives tied to eligibility conditions should be strengthened also in order to permit a wider sectoral coverage.

The regional divide requires regionally differentiated policies

Notwithstanding recent improvements in regional disparities, employment rates and productivity levels remain low in the South where a third of the population lives. Policies that aim at reducing the large infrastructure gap of the South, at improving the quality of public services and at

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modernising local administrations can have a significant impact on output and employment growth, by improving the framework conditions in which private agents operate. The process initiated in 1998 and aimed at enhancing local governance systems, has produced positive outcomes (*i.e.* increased capacity of spending by regions). More needs to be done in terms of effectiveness (capacity of selecting and implementing high quality projects). The development of public-private partnerships (PPPs) could help fill the infrastructure gap, while minimising the impact on public finance, as long as partners are selected objectively, and cost-benefit calculations are performed rigorously. To stimulate private-sector involvement, the government has established I*nfrastrutture* S.*p*.A., which will act as a financial intermediary favouring the more rapid realisation of infrastructure projects thanks to a more thorough evaluation procedure. Private investment could also be encouraged *via* greater wage differentiation. To this end social partners should develop a more decentralised bargaining structure, for example by allowing the variable wage component in national agreements to adjust for productivity differentials both downward and upward, or by allowing individual firm opt-outs from the national contract.

Raising competitiveness will require raising skills and pursuing educational reforms

In the longer term, raising productivity levels and competitiveness will depend on improving the usable skills of the labour force. Despite significant improvements, the share of the population with at least upper-secondary education is much lower than the OECD average. In 2003 the parliament approved a reform of the primary and secondary level education system to reduce drop out rates. A vocational education and training stream is proposed, alongside the current system which is characterised by a broadly-based educational approach. Switching between the two streams at various points is provided for. The reforms should also facilitate the school-to-work transition, contributing to reduce mismatches in the labour market. In the process, the authorities should make sure that an early decision between high school and vocational training by pupils introduced by the reform is not driven by liquidity constraints on poorer families with negative consequences for their children's participation in tertiary education. Appropriate track

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counselling and the guidance instruments proposed by the reform should be quickly instituted. In any case, immediate and nation-wide implementation of such a major reform would be both impractical and very expensive. A programmed transition is indicated.

Incentive systems in education need improvement

Teachers' wages grow only to a limited extent with tenure and are not linked to performance, sapping their incentive to provide high quality of teaching. Career systems and rewards for school teachers and managers that more clearly reflect individual efforts and results should be implemented also in relation to participation in training schemes as proposed by the government. Performance indicators for schools at the local or central level should be quickly implemented and extended in order to benchmark best practices and help households and students in their educational choices. Finally, the government should set broad objectives for educational standards and achievements, and permit the regions to experiment in the most effective ways of meeting them.

The public pension system is very costly and should be reformed further

Although the reforms enacted in the mid 1990s were important steps toward ensuring the sustainability of the system in the long run, the level of public spending on pensions is still one of the highest among the OECD countries. Among other effects, this reduces available resources for other social programmes. Although the contribution rates financing the pay-as-you-go system are quite high and significantly impact on the tax wedge on labour, they are too low to finance current benefits. Topping-up from the central budget is and will be needed. Furthermore, the incentives built into the current pension regime encourage early retirement. Previous reforms will both reduce replacement rates and penalise early retirement, but they will not become fully effective for many years to come. The government has presented to the parliament an enabling bill on pension reform, mainly aiming at encouraging the growth of a private funded pillar through the transfer of future flows of the firms' leaving payment funds (*Trattamento di fine rapporto*) to the pension funds. Older workers will be encouraged to remain in the labour force *via* tax incentives. Finally, contribution rates are being reduced in order to boost labour demand. However, the

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latter measure will further increase the deficit of the public system. Higher contribution rates for part of the self-employed can only partly compensate for this, and only in the short term.

The reforms should assure financial sustainability and discourage early retirement

In addition to promoting the development of a private funded pillar, a main priority of the pension reform should be to further increase the employment of older workers. This could strengthen the affordability of the pension system for the near future and increase the coverage of future pension entitlements at the individual level. This may require additional measures in the pension system and a reorientation of labour market policies. Concerning the reform of the pension system, several options, not necessarily mutually exclusive, are available, the main ones being: the immediate extension to all workers, on a pro-rated basis, of the 1995 shift to a defined-contribution system (workers with at least 18 years' seniority at the time of the reform were totally exempted); a further gradual increase in the minimum age for pension eligibility; and annual automatic revisions of the benefit formula to ensure actuarial neutrality. As for the reorientation of labour market policies, the authorities should discuss with the social partners ways of improving the "employability" of older workers, allowing wages to better match productivity.

Health spending is high and rising, and could be more effective

As in most Member countries, public spending on health is on an upward trend, with expenditures often exceeding projections and demand for health services rising faster than incomes. A fundamental issue is the blurred division of responsibilities between the central government, which takes most of the financing responsibility, and the regions, for whom health care accounts form the lion's share of total spending in their – much smaller – budgets. To address these issues, the central government and the regions have reached agreement on resources to be devoted to the sector, minimum standards of services, and reduction of waiting times for medical services. But in the case of recurrent deficits, the current penalty to overspending regions is the reduction of state transfers to their lower levels before the 2001 agreement. However, the actual implementation of this penalty is still to be tested, and

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there may be a risk that health administrators would seek to avoid penalties by running hospital arrears. Bailing out should be explicitly excluded in the case that a region overshoots *ex-post*. An important role for the central government should also be to provide adequate information among regional administrations and hospitals on best practices and to develop a system of benchmarking. In the longer term, demand for health services is likely to expand faster than GDP, because of ageing, and decisions need to be taken as to whether all, or only a well-defined part, of the higher demand is financed out of public budgets.

Human resource management in the public administration should be tightened

Spending on public administration is high in Italy, and value for money could be improved. The previous *Survey* of Italy addressed this topic in the chapter on public expenditure. As in many Member countries, job protection legislation is both stricter and more strictly implemented in the public sector than in the private sector. There are large numbers of public employees performing – quite adequately – tasks which are nevertheless comparatively undemanding, and of doubtful utility. It is very difficult and costly to suppress occupied posts, easier to create new ones, and there are barriers to mobility both within levels of government and between them. Given that the size of the labour force is set to shrink in coming years, the way forward would be to make global assessments of minimum human resource needs in public administration, and to ensure that as older employees in unproductive tasks retire, they are not replaced by new recruits performing the same tasks.

Water charges do not cover costs

Policies for achieving sustainable development need to make more use of market forces. In the water sector, pollution discharges from urban wastewater are still a cause for concern. Investment has been hampered by pricing policies that keep water charges at a fraction of those in other OECD countries. Moreover, consumers face marginal rates that increase with the volume of consumption, even though marginal costs are unlikely to show this pattern, reflecting a desire to redistribute income through water policy – an inefficient choice of instruments. Agricultural nutrient run-offs are also a problem but priority needs to be given to ensuring that urban water systems meet water quality goals, by

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putting in place prices that reflect the costs of meeting these goals and transferring social elements of water pricing to the overall budget.

Taxes on different sources of CO_2 emissions are uneven

Greater use of market forces is also needed to achieve the goal of reducing greenhouse gas emissions, an orientation that would reduce the need for detailed government intervention in this area. A liberalised electricity industry is likely to reduce greenhouse gas emission intensity as the currently most economic fuel in this sector produces low emissions. In addition, a low carbon tax has been introduced, and there are announced intentions to change the tax into a more efficient levy on emissions. However, considerable effort will be required to ensure that an adequate infrastructure is available for implementing this levy and, later, introducing a trading system. Moreover, the market will deliver the most efficient solution only if incentives to abatement are similar in all sectors. Two sectors where prices may be generating inefficient results stand out. One is transport, where high taxes may result in much higher abatement costs than elsewhere and hence in over-investment in fuel-saving technology, the other is renewable energy. In this sector, the price of green electricity permits are much higher than elsewhere in Europe and the United States, suggesting that there could be significant gains from trade in these permits.

Summary

The traditional dynamism and flexibility of the Italian economy has faltered in recent years, in part because of the unfavourable developments in the international economy. Furthermore, structural reforms have not yet gone far enough to turn the tide. Despite supportive fiscal policies and monetary conditions, growth is sluggish, confidence is at a low ebb, inflation is above the euro-area average, and there are perceptions of a pervasive loss of competitiveness. As regards fiscal policy, room for manoeuvre has now been greatly reduced by tax cuts – desirable in themselves – and significant additional corrective measures will be required for some years to come, if medium-term targets are to be achieved and long-term fiscal sustainability is to be assured. Such corrective measures should be of a structural and permanent nature, with prime candidates

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being savings in public pensions and health care, and increased public sector efficiency. The pension system is very expensive, in large part because it still encourages early retirement, thus resulting in inefficient public spending and low employment rates. These perverse features need to be removed. Public health spending is not efficiently administered: recent agreements on standards and financing with regions are a step forward, and a more incisive control of costs could derive from the quarterly monitoring of spending that has already been implemented. In public administration, the retirement of large numbers of public employees creates opportunities for a more effective and less costly redeployment of human resources. Overall economic performance would be improved by policies that further strengthen competition in product markets, for example by not eroding the powers and independence of the sectoral regulators. Privatisations should be vigorously resumed and effective financial market monitoring of firms ensured. Speedier bankruptcy procedures should be introduced that give priority to efficient reallocation of resources. Together with less rigid employment protection legislation, this might encourage more small firms to expand to levels that would permit more investment in both human and R&D capital. Recent employment developments have been positive, and further improvements could be achieved by encouraging the social partners to allow wages of workers of all ages to more closely reflect their productivity and local conditions. Planned improvements in the social safety net and the functioning of employment services should also boost job creation by making employees willing to accept more flexible employment conditions. In the longer term, increasing the levels of output and living standards will also depend on raising the skills and qualifications of Italy's labour force. Proposed educational reforms could improve them both and thereby help to realise Italy's full economic potential.

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I. The economic situation

Introduction

Italy was for many of the post-war years one of the fastest growing countries in the OECD area, and its labour productivity is among the highest in the OECD.[1] It embarked on an ambitious programme of structural reforms in the 1990s, and by 1997, achieved a dramatic reduction in the public sector deficit allowing Italy to qualify for entry into EMU. More recently, it has had a good record on employment creation, and is the only one of the three largest euro-area countries to respect the 3 per cent upper deficit limit of the Stability and Growth Pact in 2002. Yet it faces serious problems, many of them long-standing:

- although labour productivity levels are high, their growth has been quite low for a decade;
- multi-factor productivity growth has been low, and even decelerating;
- there are very large and persistent differences in productivity levels, employment and unemployment rates as between the South and the North;
- overall employment rates (including estimates of large numbers working in the underground economy) are low even by EU standards;
- Italian exporters have steadily lost market shares;
- inflation continues to be higher on average than in other euro-area countries;
- R&D expenditure appears to be very low;
- levels of human capital, though rising, are low for a country at this stage of development;
- the country attracts very little foreign direct investment (FDI);
- the underlying fiscal situation is in need of strengthening: the respect of the Stability and Growth Pact rules partly relied on temporary measures;
- the reforms proposed by the incoming government go in the right direction, but several of them pose challenges to the attainment of fiscal targets.

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There are many reasons for the low growth during the nineties and beginning of the current decade. Despite the impressive fiscal consolidation and the introduction of numerous reforms, the transition process towards an efficient and modern public sector is not yet completed. Public expenditure as a share of GDP remains high, in large part because of the need to service the high debt. Spending on social programmes is dominated by pensions whose financing is crowding out other requirements, like an effective unemployment benefit system or education. Along with inefficiencies in other primary spending, this also impedes a more decisive reduction in the debt and tax burdens. The state is keeping a controlling interest in a few key companies, and substantial liberalisation and deregulation have yet to be implemented at the central and local governments levels. In such an uncertain environment, investments in both tangible and intangible capital – especially from abroad – are difficult to develop.

Macroeconomic trends and prospects

Fragility in the current cycle

Given this background, it is regrettable but not entirely surprising that the recent performance and immediate prospects for the Italian economy are unsatisfactory. The slowdown of the Italian economy, already apparent before the events of 11 September 2001, continued in the first half of 2002, being led by falling exports but also accompanied by weak domestic demand (Table 1). A moderate pick up of consumption and investment favoured a limited rebound of economic activity in the second half of 2002, but growth for the year as a whole remained at less than ½ per cent, substantially below the EU average. The OECD projects that in 2003 growth will pick up but remain modest and roughly in line with the rest of Europe.[2] A marked strengthening of the recovery, led initially by exports, to above the euro-area average is projected for 2004, based on the forces of policy stimulus in both Italy and abroad. However, downside risks seem high, while the forecast recovery has been repeatedly delayed.[3]

Slowing activity has been accompanied by a substantial fall in productivity growth (Figure 1), entailing corporate distress as revealed in declining profitability and investment, and high rates of firm exits (Table 2). While labour hoarding in downturns is usual in Europe, because of high firing costs, in Italy's case it overlays a process of labour deepening in response to ongoing reforms, which over a transition period has dampened the trend rate of productivity growth and lowered structural unemployment. In the absence of a counterpart adjustment in unit wages, the combined cyclical and structural productivity developments have led to rising labour costs, in both absolute and relative terms (Figures 1 and 8). Indeed, high labour costs have been a main complaint of Italian industry in recent surveys.[4]

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Table 1. **Demand and output**
Percentage changes

	2000	2001	2002	2001:S2	2002:S1	2002:S2
Private consumption	2.7	1.0	0.4	–0.5	–0.2	2.8
Government consumption	1.6	3.6	1.7	2.8	2.2	–0.2
Gross fixed capital formation	7.1	2.6	0.5	–0.1	–2.9	8.4
Machinery and equipment	8.0	2.2	0.6	–0.5	–4.4	12.7
Construction	5.9	3.2	0.3	0.3	–0.7	2.5
Residential	5.3	1.7	0.9	0.4	1.0	1.0
Non residential	6.7	5.1	–0.3	0.2	–2.8	4.4
Final domestic demand	3.4	1.8	0.7	0.2	–0.4	3.4
Stockbuilding[1]	–1.1	–0.0	0.4	0.2	1.9	–2.4
Total domestic demand	2.3	1.8	1.1	0.4	1.6	0.9
Exports of goods and services	11.7	1.1	–1.0	–8.9	–3.0	12.0
Imports of goods and services	8.9	1.0	1.5	–8.3	2.1	11.0
Net exports[1]	0.9	0.1	–0.7	–0.4	–1.5	0.4
Gross domestic product	3.1	1.8	0.4	0.0	0.1	1.3
Memorandum items:						
GDP deflator	2.1	2.7	2.7	3.0	2.6	2.7
GDP at current prices	5.3	4.6	3.1	3.0	2.7	4.1
Private consumption deflator	2.9	2.7	3.0	2.7	3.1	3.1
General government financial balance (per cent of GDP)	–0.7	–2.7	–2.5	–2.9	–2.5	–2.5
Current balance (percent of GDP)	–0.5	–0.0	–0.5	0.1	–0.5	–0.5
Unemployment rate (per cent)	10.7	9.6	9.1	9.5	9.2	9.0

1. Contributions to changes in real GDP (as a percentage of real GDP in the previous year).
Source: OECD.

The failure of real wages to adjust to lower productivity growth might reflect rigidities in the labour market. Furthermore, some of the observed employment growth may represent the shift of existing workers into the formal economy,[5] or new hires that would have occurred anyway, in order to take advantage of generous fiscal incentives. Nevertheless, the structural reforms to date have permitted the development of many more flexible types of work contract, implying a greater ability by Italian employers to adjust employment in response to the production cycle. Unemployment is likely to rise somewhat in 2003, and productivity to recover from the second half of 2003 through 2004 (Figure 1). To the extent that this is accompanied by wage moderation, part of the ULC inflation gap *vis-à-vis* Europe would be cut, reducing the drag on exports and investment.

Geopolitical uncertainties and depressed stock-market prices have sapped household confidence, which fell to record lows and pushed savings rates back up after a long period of decline (Figure 2). At the same time, real incomes were reduced by a rise in consumer price inflation to around 3 per cent in late 2002 and early 2003 in reaction to the combined productivity, euro

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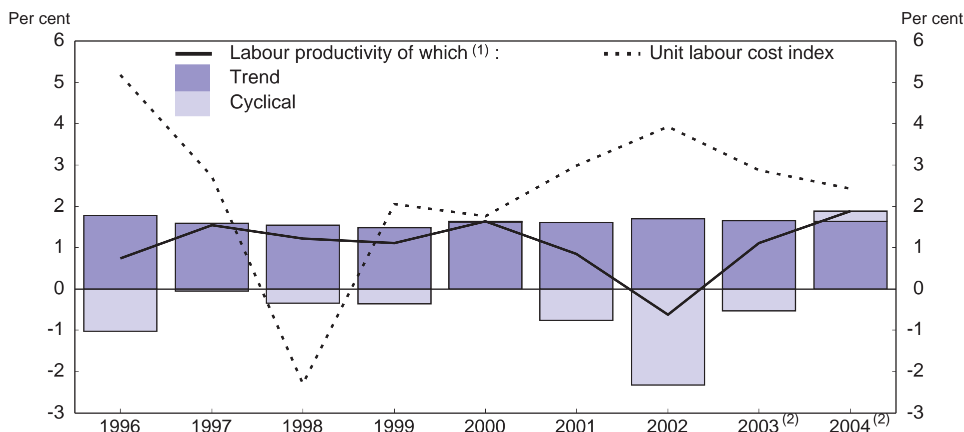
Figure 1. **Labour productivity and unit labour cost**
Annual growth rates



1. Labour productivity is decomposed into trend and cyclical components based on OECD interlink model estimates.
2. OECD *Economic Outlook* 73 (May 2003) projections.
Source: OECD.

changeover, and oil price shocks.[6] A decline to under 2 per cent is foreseen by 2004 as the shocks unwind, helped by the moderating impact of euro appreciation, health-sector price controls, and the negative output gap, in turn giving support to consumption recovery. The inflation differential between Italy and the euro area, currently around 0.8 percentage points (Figure 3), is expected to narrow considerably by end 2004. However, the remaining gap is suggestive of structural problems, particularly in the area of product market competition, and it continues to erode Italian competitiveness.

Table 2. **Corporate indicators**

	1999	2000	2001	2002
Net after tax income[1]	1.3	0.8	0.4	..
Firm exits[2]	–1.5	1.5	3.4	7.2
Capacity utilisation (%)	76.9	79.3	78.1	77.5

1. As a percentage of value added.
2. Percentage changes.
Source: OECD, ISTAT and Infocamere.

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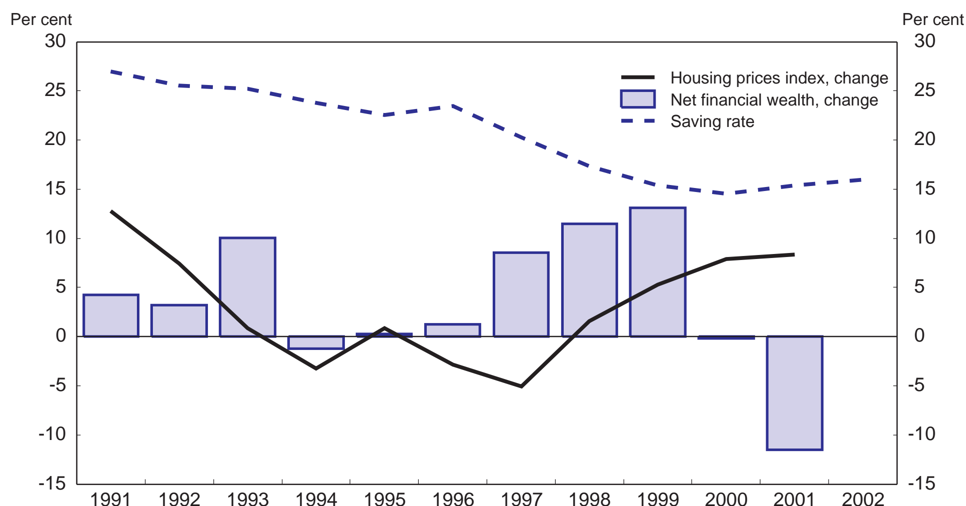
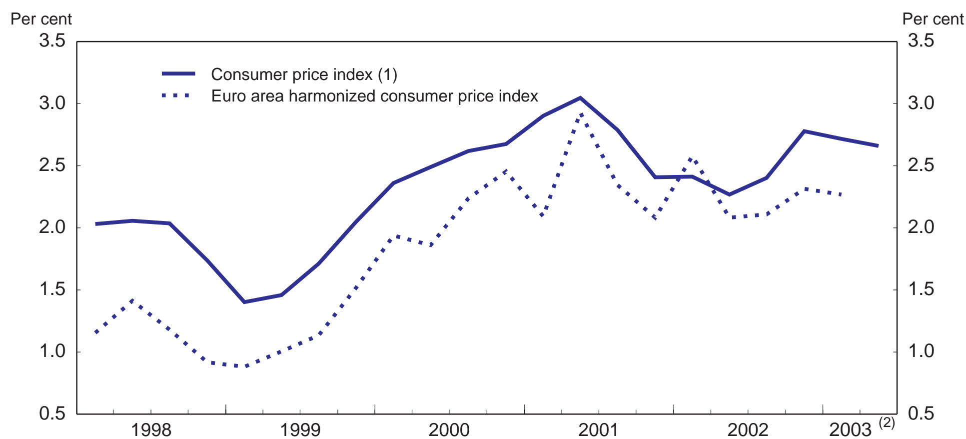
Figure 2. **Household financial indicators**



Source: Banca d'Italia and Bank for International Settlements.

Figure 3. **Inflation differential**

Italy *versus* Euro area, year on year changes



1. All items, preliminary for June 2003.
2. Up to June 2003.

Source: OECD.

The policy response

Monetary conditions are supportive (Figure 4). The real short-term interest rate is below zero for the first time in decades, and is lower than the EMU average because of the positive inflation gap. On the other hand, euro appreciation offsets part of this ease, perhaps more so in Italy than elsewhere because of the highly price elastic nature of its exports (see next section below). Recent surveys suggest that small firms – accounting for the bulk of Italian employment and production – are experiencing difficulty in accessing bank credit, especially beyond short-term maturity and in the South.[7] Even so, bank loans to small firms in 2002 and early 2003 grew much faster than lending to larger ones (as the downturn affected the former less severely), while the share of medium and long term credits to small firms has been trending up since the mid 1990s. Banks are moving to stricter capital adequacy requirements in the context of Basle 2, and may in the process be scrutinising smaller and riskier borrowers more closely, of which there are especially many in the South. At the same time, they are increasing exposures to large distressed firms ("too big to fail"), that even prior to the downturn had been doing poorly in international competition. But even healthy firms facing no problems in credit supply will not respond in any significant way to cheap credit until current excess capacity is unwound (Table 2) and investment confidence restored.[8] In the persisting absence of internal engines of growth, this would require a prior recovery of world exports.

Both banks and households are now unwinding positions that they had built up during the period of surging global equity markets: households had shifted into equity-based savings instruments, while bank profits became dependent on fee income deriving from the sale of such products to their customers. This portfolio shift was more marked than in the rest of Europe, partly because Italian households had been accustomed to high yields on government bond holdings in the pre-EMU period. With the bursting of the equity bubble, wealth losses by households may have prompted them to save more despite low real interest rates, and the parallel hit to bank profits has made the rebuilding of bank assets more difficult. Also, households' already high uncertainty may be aggravated by recent financial losses stemming from poor management by some banks of certain high-risk bond products, to which households had more recently shifted. The bank-centred nature of the Italian financial system makes the economy quite sensitive to banking developments, and also affects the monetary transmission mechanism.

The fiscal stance has been expansionary. The automatic stabilisers have not only been allowed to work fully in the downturn, in line with EC and OECD recommendations, but were also enhanced by discretionary policy easing.[9] A substantial bonus from declining market interest rates, and a more intensive use of one-off measures, gave Italy relatively greater room for manoeuvre than elsewhere

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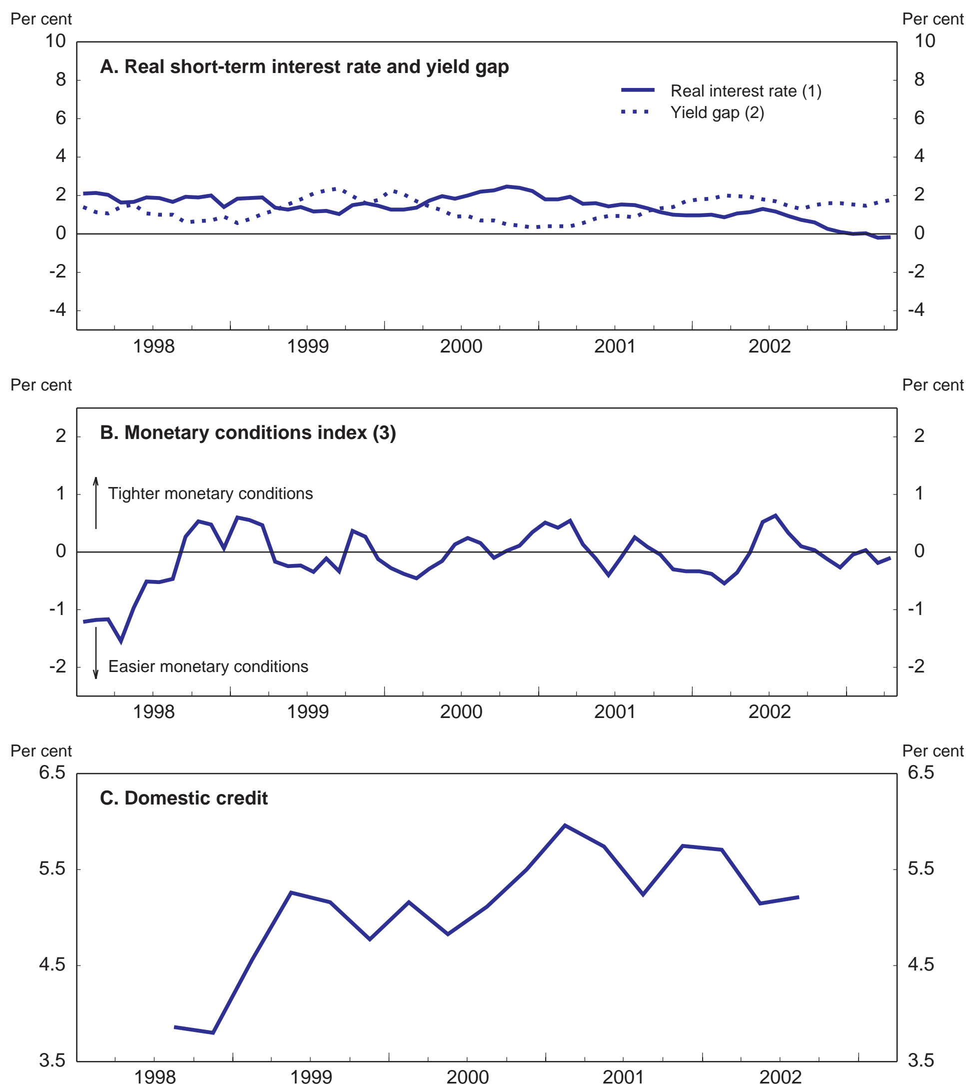
Figure 4. **Monetary conditions**



1. Three-month interbank rate deflated by CPI.
2. Long-term interest rate (yield on ten-year government bonds) minus short-term interest rate.
3. The MCI is defined as MCI = (r – r*) + 0.3 * (e/e * – 1) where r is the real interest rate , r* the long-term trend value of r, e the real effective exchange rate expressed as relative unit labour cost in a common currency, and e* the long term trend value of e.

Source: OECD.

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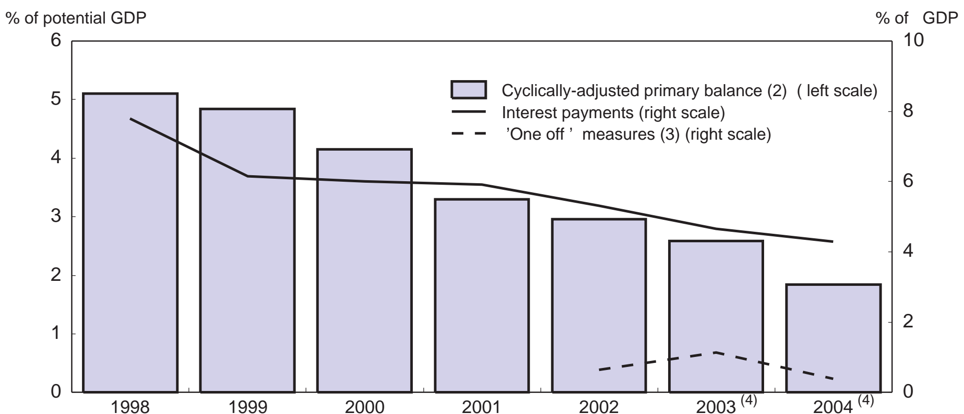
in the euro area (Figure 5). Fiscal incentives have thus been able to give substantial support to employment creation over the past several years, and to investment in 2002, without which the weakness in domestic demand might well have been greater. In 2003 and 2004, the focus of support to domestic demand will shift from subsidies toward income tax cuts to low-income (high propensity to consume) households and to businesses. All in all, Italy may be said to have enjoyed a cyclical policy "advantage" *vis-à-vis* euro-area partners in terms of the amount of fiscal easing it managed to achieve.

The strategy may help to close the growth gap with Europe by 2004. There are a number of downside risks, however, in both the near and medium terms, given that the public debt is very high (over 100 per cent of GDP) and that the pace of debt reduction has progressively slowed.[10] *First*, the fiscal position remains exposed to any future interest rate increases. *Second*, the future room for fiscal manoeuvre is limited as any further discretionary net easing would risk approaching the 3 per cent threshold. *Third*, a strong and credible commitment to fiscal rigor is necessary to prevent that rational households save part of their tax cut in anticipation of future tax increases or reductions in pension benefits considered necessary to re-establish long-run fiscal sustainability.

Figure 5. **Fiscal stance**[1]



1. Fiscal stance equals change in cyclically adjusted primary balance.
2. Net of securitisations.
3. Securitisations and tax amnesties.
4. OECD *Economic Outlook* 73 (May 2003) projections.

Source: OECD.

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The medium-term policy challenge

The prime objective for Italy is thus two-fold. *First*, reducing the public debt quickly *via* lasting and deep current spending cuts is needed to increase room for growth-enhancing policies such as lower taxes and higher public investments in infrastructure and human capital, and also to meet ageing-related needs. *Second*, raising the potential rate of economic growth *via* market-based reforms is essential to reinforce the sustainability of public finances, to reduce inflationary pressures, and to increase resilience to future shocks.

Raising potential growth

During the last few years, trend growth of per capita GDP has been gradually recovering from the low rates experienced in the first half of the 1990s (Figure 6). Still, trend growth is far from the rates experienced between the 1960s and late 1980s. In part, this is because the catching-up process has basically come to an end. In fact, Italy's per capita GDP is now in the middle range of EU countries and above the OECD average (Figure 7) and Italian labour productivity is relatively high on a per-employee or per-hour basis. Nevertheless, compared with the experience in other OECD countries at a similar or higher level of income per capita, Italy's performance is disappointing.[11] Compared with the United States with a similar level of labour productivity, the capital intensiveness of production is quite high. This implies smaller roles for labour utilisation and multi-factor productivity as engines of growth. The challenge is to raise them.

Recent trends in this respect have been mixed. Multifactor productivity growth has in the last few years dropped by half compared with earlier years (Figure 6). When adjusted for human capital improvement, it appears to be falling even faster.[12] On the other hand, the growth of the capital-labour ratio has been slowing, seemingly the result of a process of labour deepening following the labour market reforms implemented at the end of the 1990s and at the beginning of the current decade. The reforms are slowly translating into a lower unemployment rate and higher participation. Per capita hours worked are still decreasing but at a lower rate than in the past.

Current developments in the labour market are potentially beneficial for trend growth. In fact, most of the highest growth countries (United States, Australia, Canada, the Netherlands and New Zealand) have been showing a greater utilisation of labour. Even if the Italian employment rate were to rise to the comparatively modest EU average over a decade or so, potential GDP growth could increase by a full percentage point per year.[13] Even more significant gains are possible. However, a number of conditions are needed for this to happen. Reduction of the high tax wedge on labour would seem to be a principal condition for stimulating both the supply and demand of labour. The latter would also critically require more wage differentiation, in lieu of the rather high wage floors

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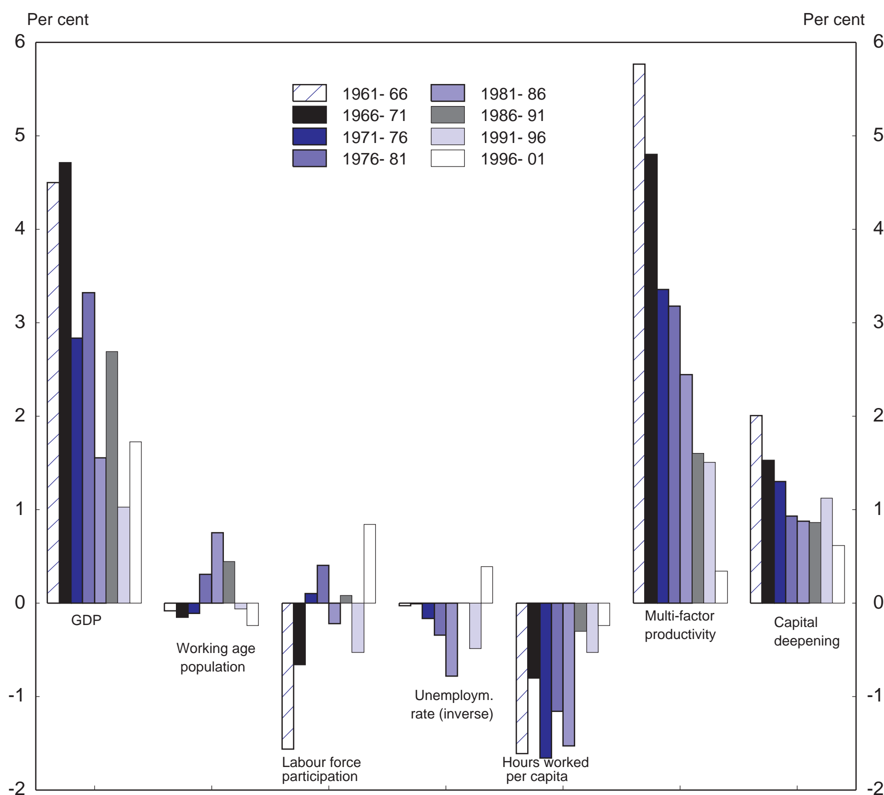
Figure 6. **Per capita real GDP growth and its components**
Annual average growth rates



Source: OECD, Analytical Database.

implied by centralised wage bargaining. Pension reforms to remove the incentives to retire early would also be important.

The ongoing process of labour deepening is likely to lead to the entry of low skill workers that were previously excluded from the labour force. This process can entail a slackening in labour productivity growth in a transition period. This could be offset by faster MFP growth, which would require a more decisive reform effort towards greater product market liberalisation, especially the state's retrenchment from the business sector and the removal of barriers to entry.[14] Impediments to the growth of small firms should be removed. Earlier work by the

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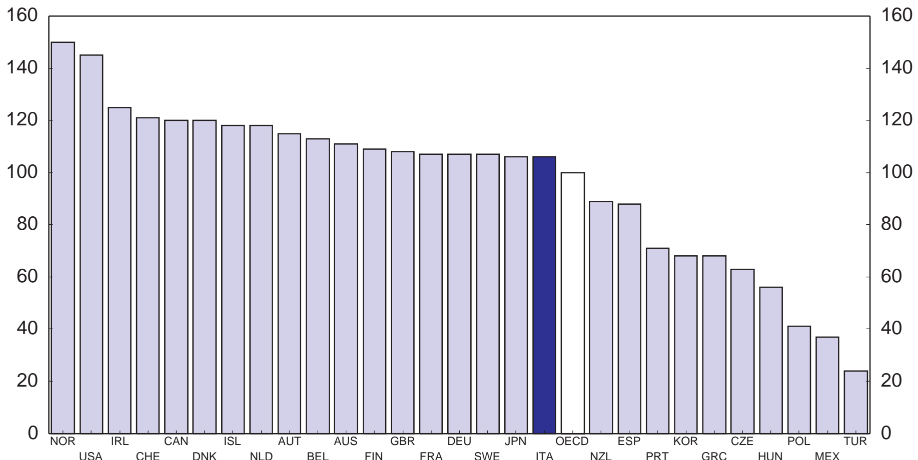
Figure 7. **Per capita GDP in industrialised countries**
Volumes indices – Levels of PPP – year 2002



Source: OECD, *Main Economic Indicators*, May 2003.

OECD indicated that Italy's long-term growth between the 1970s and 1990s had been close to what could have been expected on most counts, but that the negative impact of low human capital had been broadly offset by a "country-specific" effect, which could be interpreted as the ability of the typically small but flexible Italian firm structure to adapt rapidly to changes in demand.[15] Arguably, that source of strength is now counterbalanced by the accompanying disadvantages of lack of ability to exploit economies of scale, and lack of incentives to engage in R&D. A more decisive improvement in human capital would allow better exploitation of existing technologies, and, eventually, development of new ones. Finally, labour market reforms in the direction of higher participation and lower unemployment need to be continued in order to offset the decline in working age population, which is expected to subtract from potential per capita GDP growth for many years to come.[16]

Assuring fiscal sustainability

In the next few years and over the medium term, the role of public finances in supporting the Italian reform process will continue to be crucial. As a matter of priority, strong fiscal consolidation should be pursued to ensure that

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public finances are irreversibly brought to a more sustainable path despite the ageing of the population. In this context, the planned reforms regarding infrastructure, tax cuts, education, pensions, public employment services and the unemployment benefit system would entail budgetary costs that need to be compensated by savings in other components of the budget.

This calls for some fundamental policy choices by the Italian authorities. Relying only on future increases in potential growth as a way of financing current reforms is risky, as their impacts become evident only in the medium term and can be actually hampered by the uncertainty regarding their financial sustainability. The priority should be to achieve a brisker downward path for government debt, based on more efficient and lower primary public spending, which gives rise to a favourable dynamic in the fiscal accounts and is thereby able to allow future cuts in the tax burden. This strategy should be accompanied by a re-balancing of spending from generous programmes like pensions, or unproductive ones like state subsidies, towards other sectors more likely to help boost productivity and equity, like education and well-targeted social spending. The experience in other OECD countries suggests that this venue of reform is more likely to lead to a sustained path of potential income and to enhanced social cohesion.

Pension spending would seem a particularly apt area for cuts in current spending, as fully one-quarter thereof goes to individuals below the statutory retirement age, raising issues of economic efficiency as well as budget profligacy. Although the pension reforms of the 1990s radically reduced the projected rise in pension spending stemming from population ageing, and in this sense Italy is well ahead of many of its OECD peers, the present level of pension spending is considerably higher than elsewhere, reflecting pension benefits that are substantially out of line with the OECD norm. Fiscal pressure due to current pension system excesses compromises growth prospects and is difficult to defend.

Macro-structural interactions and tensions

Declining external competitiveness

Italy's external competitiveness, the main source of its economic strength in the past, is now regarded in public discussion in Italy instead as a major risk to growth and external balance. International competitiveness measures consistently place Italy toward the middle or bottom of the rankings.[17] OECD indicators of price and cost competitiveness show a trend deterioration beginning around 1996, when the exchange rate *vis-à-vis* EMU partners was fixed (Figure 8). This has been reflected in a poor export performance: market shares have been lost every year since then, especially in response to the Asian crisis of 1997-98, and while subsequent weakness of the euro against the dollar allowed a substantial diminution in the rate of market share loss, this provided only temporary relief (Figure 9). The

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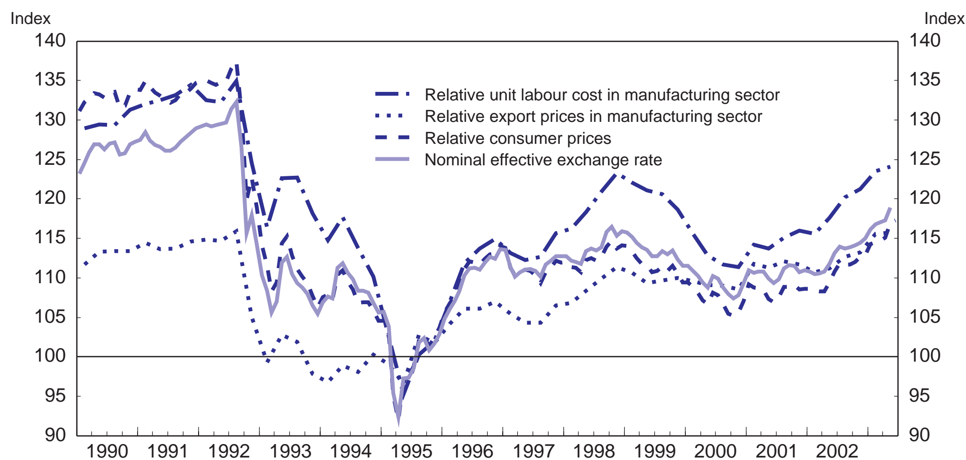
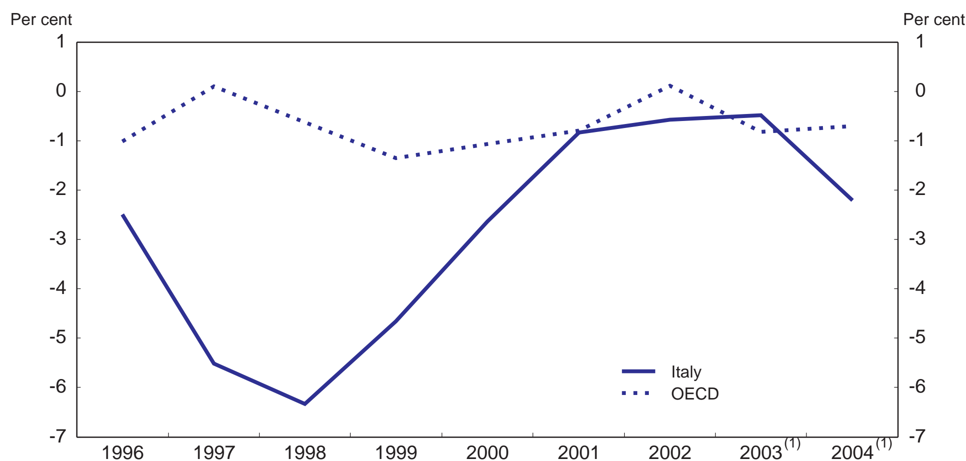
Figure 8. **Competitiveness indicators**[1]
1995 = 100



1. An increase in the indicator denotes a loss of competitiveness.
Source: OECD.

Figure 9. **Export performance**
Annual per cent changes



1. *Economic Outlook* 73 (May 2003) projections.
Source: OECD.

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contribution of net exports to output growth over this period has therefore shrunk, having also adverse repercussions on investment demand *via* accelerator effects. In the past, when exports were a main motor of growth, the exchange rate was devalued every 7 years or so to correct for appreciation of the real effective exchange rate stemming from high domestic inflation. At the same time, expansionary public finances with seignorage helped to limit the debt rise, financial market repression helped to keep real interest rates low, and explicit or implicit aid came from trade restrictions, barriers to entry and bias of public procurement toward national companies. In order to offset the irrevocable loss of the exchange rate instrument, as well as other instruments of protection, productivity and non-price dimensions of competitiveness need to be boosted in the tradeable sectors.[18]

Analysis indicates that the specialisation pattern of Italian exports makes them especially vulnerable to the forces of globalisation. The "Balassa index" shows that Italy's comparative advantage is in two main areas: traditional manufacturing sectors, characterised by a low income elasticity and a high relative price elasticity of demand, and machine tools (Annex I). Competition from low-cost emerging market competitors is keen in the former sectors. Italy does not specialise in the high-tech sectors and those characterised by high economies of scale – areas where OECD countries should display a strong comparative advantage. Furthermore, there seems to be a high level of persistence in Italy's pattern: the autocorrelation of the Balassa indexes shows that the Italian economy has a low capacity to adapt and to change its specialisation. Italian exports of services are low compared to other G7 countries, which may reflect the slow general transformation of the Italian production structure from manufactures toward services (Figure 10), in turn partly a function of its high cost of labour relative to capital. OECD studies have shown that removing just the tax disadvantage would give a big boost to services exports.[19] The economy's overdependence on manufactures, and exports thereof, also likely reflects a general insufficiency of competition in many sheltered service sectors (Chapter III).

At the same time, Italy has some clear competitive advantages upon which to build going forward (Box 1). In particular, the Italian industrial zones have been able to exploit the user-producer relation between the traditional manufacturing and machine tools sectors to achieve success on world markets. By constant upgrading of products, based on inter-firm interactions as well as district collaborations with universities and larger firms, Italy has attained virtually unmatched quality standards in niche areas. As a concrete example, the textile machinery sector has remained an area of excellence despite the downturn, and has been able to improve its labour cost competitiveness *vis-à-vis* principal competitors because it is so flexible in adapting to changing circumstances. Nevertheless, even this sector faces constraints in terms of its ability to meet international competition,

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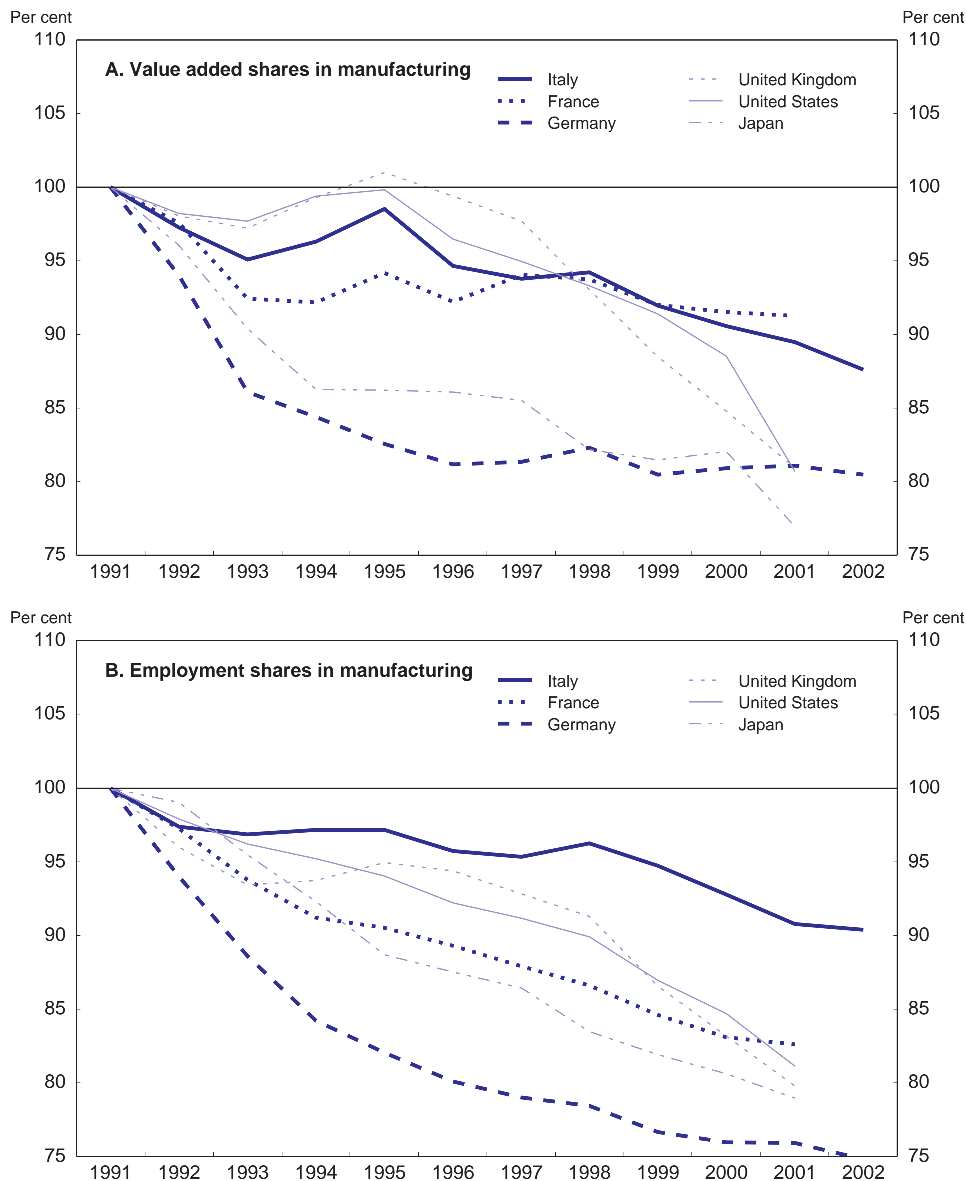
Figure 10. **Value added and employment shares in manufacturing**
1991 = 100



Source: OECD, Annual National Acounts Database.

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Box 1. Italy's competitive strengths and weaknesses

Strengths

- a very high rate of *entrepreneurship*, denoting strong adaptability to the below policy impediments
- clusters of small firms able to mimic economies of scale and achieve high quality (*Made in Italy*) *via* innovative design based on firm interactions, as opposed to research activity in a more organised setting
- continuing high *private savings rate* despite fiscal consolidation, well above that in Germany, United Kingdom, or United States, *i.e.*, indicating an availability of home capital for domestic investment
- relatively high *labour productivity level*, denoting high level of adaptation to labour market costs and rigidities

Weaknesses

- *infrastructure* deficit *vis-à-vis* competitor countries
- among the highest *energy costs* in the world
- a still rigid *labour market*
- low *innovative capacity*, reflecting low R&D rates in business and government
- excessive and uncertain *environmental regulation*
- low ICT diffusion
- competitive disadvantage of the *banking system*
- excessive state control in *network industries* despite extensive past privatisation, indicating problems of transition in market liberalisation
- heavy burden of *bureaucratic red tape*, with highest costs (€ 7 800) in the OECD and second highest after Germany in time (21 weeks) for setting up new business; also excessive barriers to product innovations
- "asphyxiating" *fiscal pressure*, with a tax wedge on labour (excluding indirect taxes) of over 42 per cent, compared with 10 per cent in Hong Kong, 27 per cent in Japan, 28 per cent in United States, and 37-38 per cent in United Kingdom, Greece and Germany

Source: Ministero delle Attività Produttive (2003).

chiefly because of a lack of access to credit beyond the short term and a consequent inability to grow, having the lowest rate of capitalisation among competitor countries.[20] In general, the innovative capacity of Italian firms is hampered by both credit and regulatory constraints to growth of individual small firms.

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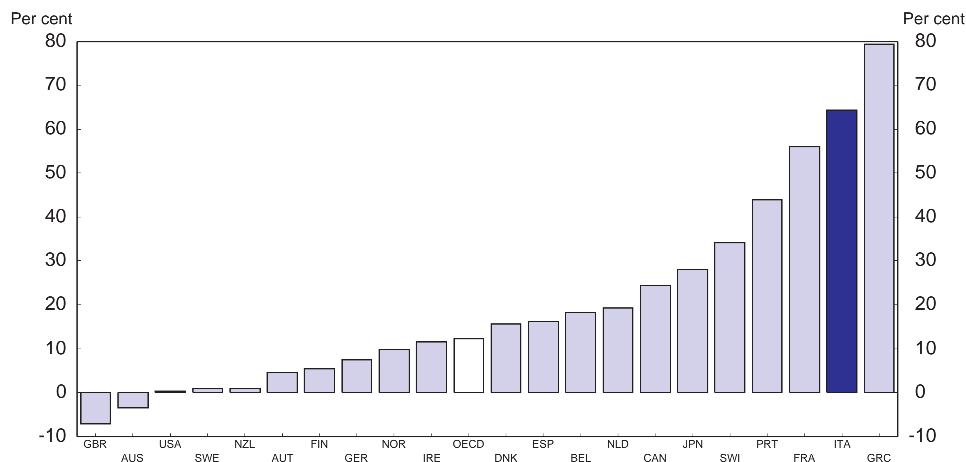
Figure 11. **Inward FDI and product market competition**[1]
Percentage change as a proportion of the average over the 1990's



1. Effect of a decrease in regulation to the level of the United States.
Source: Nicoletti *et al.* (2003).

Another telling indicator is the comparatively low share of the inward foreign direct investment position in Italian GDP (see Figure 19, Chapter III). This suggests a problem on two levels. *First*, the fact that Italy does not attract foreign investment implies relatively high costs of setting up or doing business there and/or an uninteresting product or enterprise base for exports, as most FDI is undertaken by multinationals with a global orientation going beyond the host country market. The former effect may be the more relevant one. Recent OECD work has shown that explicit barriers to direct investment are not particularly high in Italy, but that a large labour tax wedge and burdensome regulations in product and labour markets strongly inhibit FDI inflow.[21] In other words, the same factors that hobble Italian exporters in global competition also impede the entry of foreign investments into Italy. Indeed, no other OECD country (except Greece) seems to have as much to gain from the removal of product market barriers to competition, in terms of its ability to attract FDI, as Italy (Figure 11). *Second*, the lack of such investments reinforces the innovative deficiency of Italian exports. OECD work has shown that FDI is a main vehicle for diffusion of technological and managerial know-how.

Persisting regional gap

Italy's ability to raise its potential growth rate would be eased by success in raising economic growth in the South, an area with many underutilised

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resources. The "new planning" strategy for the South, in operation for the past 5 years, has been directed to achieving such a result, with some success. Per capita income in southern Italy has risen from around 66 to 68 per cent of the average Italian level, while the decline in unemployment rates, especially for youths, was relatively sharp (Table 3). Also, junior high-school drop-out rates have plummeted since 1990 and crime trends have improved. However, the income gap is still wider than it was in 1991, while part of its recent narrowing reflects out-migration to richer regions ("depopulation"). GDP growth in the South, albeit since 1996 higher than in the rest of the country, does not reflect what one would expect of an area that is "taking off".[22] The 18½ per cent rate of unemployment is still unacceptable and productivity levels remain far below those in the North.

In part, the problems of the South reflect, in magnified form, the problems of the transition phase that Italy faces as a whole. In the early 1990s, when the political decision was made to sanitise public finances in preparation for EMU membership, the large government subsidies to banks and large public enterprises, which had sustained the southern economy, were abruptly withdrawn. The result was, in the short term, a severe economic crisis in the South, including a banking crisis that was resolved only when the southern banks were taken over by northern banks (thus avoiding the use of public funds), but in the medium term, stronger incentives for the southern entrepreneurial system. New planning guides were introduced in 1998 by the central government to help these regions' adjustment to the new market incentives. In public governance, there was to be a radical transformation from a mentality of *contributi a pioggia*, almost limitless transfers often associated with public waste and sometimes corruption and low investment capacity, to one of hardened budget constraints implying efficient use of carefully

Table 3. **Regional differential in macroeconomic performance**
1995 and 2001

	Italy		North Centre		Mezzogiorno	
	1995	2001	1995	2001	1995	2001
GDP at market prices (shares)	100.0	100.0	75.8	75.6	24.2	24.4
GDP per capita	100.0	100.0	119.2	118.0	66.4	67.8
Productivity, measured as GDP per worker	100.0	100.0	105.3	104.9	86.3	87.2
Employment rate, as per cent of working population[1]	57.4	61.0	60.9	65.3	51.1	53.2
Unemployment rate, as a per cent of labour force[1]	11.6	9.1	7.6	4.8	20.4	18.6

1. Latest labour data refer to January 2003.
Source: Istat.

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targeted public aids and EU structural funds. In the event, all regions have improved their public governance systems and economic performance in accordance with the new approach, in particular Basilicata, Campania and Puglia.[23] The system of sanctions and rewards has represented a major incentive to support the modernisation of local public administration and enhance its efficiency:[24] as a result, all the regions have made full use of EU funds in 2002. More is still required, however, in terms of effectiveness of the local administration and quality of public spending, notably to improve the capacity of the regions in selecting and implementing high quality projects.

The present government considers that private sector agents cannot respond to the improved incentive regime without a better infrastructure base in the South, which has suffered from years of budget cuts, most acutely in the water, waste, energy and transport areas. Hence, public investment spending is being increased and oriented more to southern regions. In these regions, the share of capital expenditure earmarked for infrastructures has increased significantly as compared with that for direct incentives to business and households.[25] This reorientation is being supported by speedier approval times and central government supervision of major works (*grandi opere*). Partnerships with the private sector will also be developed.

The infrastructure gap is a very real barrier to investment in the South, and efforts to fill it are overdue and commendable. However, it will be very important to apply careful cost-benefit analysis to new public projects, especially large ones, to avoid further inefficient use of public funds. Furthermore, continued building of "social capital" will be a critical complement to improved physical infrastructure. Even though the rule of law has been extended in recent years, extortion rackets in areas such as water services continue to push up the costs and risks of investing in the South. Continuing to raise the quality of the local public administration will also be important in this regard. Finally, the viability of investments will require a better matching of wages to productivity levels in addition to better infrastructure and public governance.

The authorities envisage replacing many current incentives to firms with long-term loans. This will surely help to speed the transition to a market economy, but in the short run there could be negative impacts on resource availability. It would have been reasonable to assume that the financial sector would step into the gap with ample credit. Even though bank loans granted to business firms in the South have recently grown substantially faster than in the Centre-North, the government feels that bank credit to small firms and self-employed, who dominate the enterprise landscape in the South is insufficient.[26] It has requested the banks to redress this situation. However, a policy of moral suasion is unlikely to be very effective now that banks are also required to be more careful in their risk assessments. And one reason for the southern banking crises was the tendency to

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extend loans to dubious clients under political pressure. There is also sound empirical evidence that the policies based on government subsidies to loan interest, extensively used until the 1990s, impaired the ability of banks to screen and monitor investment projects.[27] Further evidence suggests that, at present, the allocation of public investment subsidies by the banks is inefficient.[28]

What seems to be needed is policy support to enhanced competition in the banking sector, and to the development of more non-bank forms of financing to small-scale, risky entities, such as venture capital. While the differential between bank lending rates to firms in the South and those in the Centre and North has narrowed since the mid-1990s, firms' opaqueness represents a major hindrance to a further increase in credit market competition. The paucity of verifiable information about the financial soundness of firms and viability of their investment projects, exacerbated by the large size of the underground economy, exposes potential entrants into local credit markets to severe problems of adverse selection.[29] Therefore measures enhancing public information disclosure by enterprises are likely to have a beneficial impact on the overall efficiency of credit markets, especially in the South. Also, reforms aiming at improving creditor protection, particularly in the context of bankruptcy procedures, seem essential. Inefficiencies in this respect are conducive to strong incentives for banks to lend mostly against collateral and at short-term, thus potentially encouraging overinvestment in low-return projects by profitable firms, at the expense of potentially high-return projects by not yet profitable firms.

Large underground economy

During the 1990s, the already large underground economy increased considerably further in Italy. According to ISTAT (2002d) estimates, the share of irregular workers in the total was 15.1 per cent in 2000 compared with 13.4 per cent in 1992.[30] The rise was particularly marked among employees: for the self employed, irregular activity stabilised after 1993 (Figure 12). These different developments possibly reflect rising irregular immigration, mainly influencing dependent employment. The sectors mostly affected by underground activities are agriculture, retail trade, hotels and restaurants, road transport, and services to households. Informal employment is more prevalent in the South,[31] where the phenomenon is mainly characterised by the high presence of unregistered firms, whereas in the North by the hiring of undeclared workers in registered firms.[32]

In many respects, the causes of widespread and rising irregular employment are the same as for high unemployment,[33] in particular, high fiscal pressure. In fact, despite its decline since 1997 fiscal pressure, calculated as the tax wedge for a single average production worker in regular employment, is still almost 50 per cent.[34] Other reasons are institutional factors such as: *i*) high administrative burden on companies' activities; *ii*) inadequacy of consulting and training services

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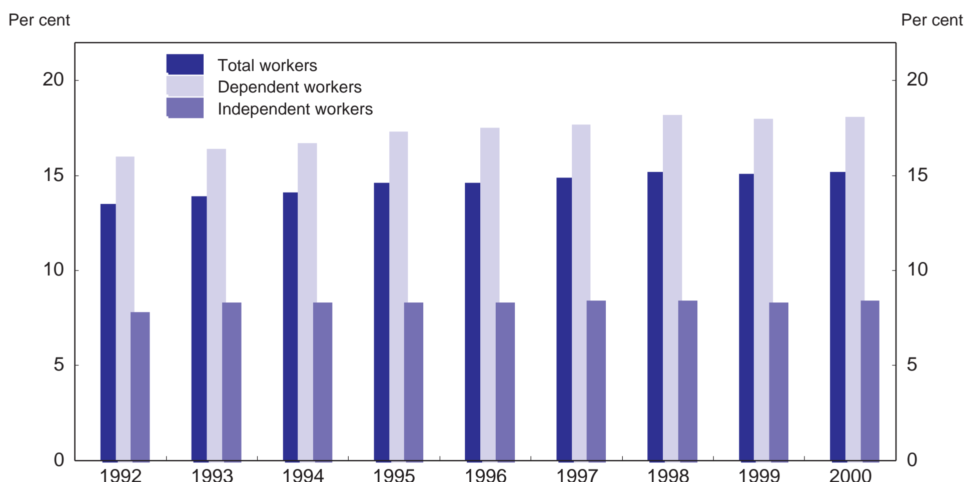
Figure 12. **Share of irregular workers**
As a percentage of their category



Source: ISTAT.

in supporting firms and workers; *iii*) cost of compliance with labour market regulations; and *iv*) *de facto* wage floors penalising low productivity workers, whose share is higher in the South.

In many respects, remedies to reduce the underground economy are the same structural measures needed to reduce unemployment and increase labour force participation. In particular, greater wage differentiation would help low productivity workers to find jobs in the formal sector, with a particularly positive impact in the South. Moreover, subject to fiscal sustainability a structural reduction in fiscal pressure would give higher incentives to firms and workers to operate legally. This process would be helped by a drastic simplification of labour market regulations and of administrative and tax procedures together with better public services available to firms. Finally, a strengthened commitment to more frequent and widespread controls and more severe sanctions – together with enhanced co-ordination among relevant public institutions – should be regarded as a more permanent feature of the tax, social security and judiciary administrations (see Box 2).

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Box 2. The policy programme to fight the underground economy

Reducing the diffusion of the underground economy has been one of the priorities of the authorities. In 2001 and 2002, a series of measures were introduced with the objective of providing an incentive for firms and workers to emerge into the formal sector. First, a series of generous cuts in tax and contribution rates lasting for three years has been granted to previously unregistered firms and workers together with an amnesty for the previous years. Furthermore, some of the labour regulations concerning large firms have been temporarily lifted for previously unregistered firms. Moreover, they have been given the opportunity to gradually implement a restructuring plan to progressively comply with legal requirements – *e.g.* concerning safety at work – and with wages set in national contracts. Provincial committees with the participation of the social partners, the central and local governments and the social security institutions have been set up in order to assist and monitor firms in the presentation and implementation of the restructuring plan. Finally, harsher penalties have been introduced for firms not participating to the government incentives together with a new plan contemplating more severe controls.

Despite the generous incentives, participation in the government programme has been lower than expected, forcing the authorities to progressively postpone the deadline to firms for the presentation of the declaration of underground activity and of the restructuring plan. One of the reasons for this outcome might be that the measures are mainly directed to forgive the past (especially for firms) more than to structurally reduce labour costs in the future, especially in the South where labour productivity is lower.[1] Another aspect of the programme that should be rethought is the proliferation of new committees in addition to the ones already in place at the local Chambers of Commerce and at the social security institutions. While the active participation of the social partners can contribute to a strengthened participation in the programme, the co-existence of different committees dealing with the same issue will probably lead to a wasting of financial and human resources.

Despite the low participation in the programme so far, the priority given by the authorities to the issue might have led to a slower increase in numbers of irregular workers, as suggested by the increase of workers' registration at social security institutions and by the significant growth of regular employment until recently in the South. Other measures like tax credits for permanent hiring and the *prestiti d'onore* (public loans to new self-employed), might have contributed to these improvements, as did the plan to regularise illegal immigration.[2] While raising hopes about the success of the programme in the future, these results also indicate that, so far, firms and workers might not have fully believed the government's commitment to forgive their past behaviour. Such uncertainty would have discouraged them from officially admitting their irregularities. The frequent changes to the programme and to its deadlines – even if gradually more favourable to firms – might have contributed to exacerbating this uncertainty.

1. Boeri (2002).
2. Ministero del Lavoro e delle Politiche Sociali (2001).

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Distributional conflicts

Despite a high degree of wage compression, Italy has one of the highest levels of inequality in income distribution in Europe, equivalent to that observed in the United States (Table 4). However, there is a key difference: low employment in Italy makes for a more unequal market distribution of incomes than in the United States, where high employment considerably more than offsets the impact of high wage dispersion.[35] Fiscal policy therefore does more to redress the market result in Italy, *via* steeply progressive taxes; on the side of transfers, by contrast, the public pension system is highly redistributive in the United States, while in Italy it accounts for virtually the whole of social spending but may be even slightly regressive. In much of the rest of continental Europe, wage compression tends to be less severe than in Italy, but in the absence of such acute regional, age and gender employment rate disparities as in Italy, there is generally a more even market distribution of incomes. Moreover, the fiscal system in Europe on average redistributes income more than in the United States or Italy: labour market and non-pension welfare schemes tend to be much larger and income-equalising, and progressivity in the tax schedule also tends to be steep.

This analysis suggests that market-based reforms in Italy may well improve the market distribution of incomes, reducing the redistributive burden on fiscal policy. Greater wage flexibility at the micro level would help raise employment and growth in Italy. Regional imbalances could be narrowed as wages could better reflect diverse productivity levels, and there would be a greater incentive for workers to accept training, and for employers to offer it. A less progressive tax rate structure could provide positive feedback effects on work effort. However, individuals are likely to perceive the income distribution as worsening in response to reforms. Not only are wages and out-of-wage benefits likely to become more unequal, but also the ongoing trend to greater contract flexibility suggests more frictional unemployment, while the next stages of the tax reform will concern tax breaks to middle- and upper-income individuals. It will be important that, under these circumstances, the public become more aware of the fact

Table 4. **Income distribution in Italy, other EU and the US**

Gini coefficients

	Italy	EU[1]	United States
Mid-1980s	30.6	26.4	34.0
Most recent year	34.5	27.3	34.4

1. Refers to European Union countries mean excluding Italy, Luxemburg, Portugal and Spain. For the three latter, data are not available.

Source: OECD (2001), *Society at a glance*.

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that a dynamic, growing economy provides the best social safety net. Nevertheless, certain fiscal redistribution mechanisms may need to be strengthened to promote fairness and sustain the social consensus for reform. These should remain modest, given the fiscal problem as well as the need to avoid disincentive effects on work effort, and sharply focussed on giving workers the widest opportunities to raise their educational levels and to fully use their abilities in the labour market.

A key distributional issue is a sharp rise in intergenerational inequality linked to the implementation of structural reforms. In particular, the long phase-in of the 1995 pension reform means that workers with very short contribution histories face far lower rates of return to pension contributions than do other workers, who enjoy much more generous benefits than are financially justifiable. Thus, fairer spending priorities might involve a more widespread reduction of benefits for all cohorts of workers, to make way for more unemployment insurance, training, and education spending in support especially of younger and female workers. It may also be reasonable to target more of the future tax cuts to in-work benefits to the extent that it could improve the equity-efficiency trade-off.[36] It would also seem important to reduce the labour market "duality" expressed in increasingly precarious contracts for new workers *versus* rigid job protections for more senior workers with permanent contracts (who constitute the majority of union membership). Finally, it will be vital to develop market-based insurance mechanisms for new cohorts of workers. In this respect, the current policy initiative to build a private pension pillar is an important one, and should be strengthened by appropriate institutional safeguards in the area of investor protections.

The agenda for structural reform

In brief, the short-term outlook is not buoyant, and though monetary conditions are not hindering recovery, there is little justification or possibility of further direct fiscal stimulus. On the contrary, it is likely that business confidence would be strengthened, and household precautionary savings weakened, if public debt was reduced significantly, especially in the context of a broader strategy to raise potential growth. This raises the question of whether structural features are hindering or helping the economy to expand, what sorts of (further) structural reforms are desirable, and in what order they should be implemented.

In fact, the past 5-10 years have seen a continuing programme of implementation of structural reforms, and it is ironic that the prolonged period of slow growth and stubborn inflation gap has coincided with one of sustained reform and alignment of Italy's institutions to the EU. An important phase was the meeting of the fiscal and inflation criteria for entry into EMU in 1997, enabling a large reduction in real interest rates. But these macroeconomic gains, along with progressive withdrawal of state protection and distortions, have so far failed to produce a

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durably better economic performance, implying that much more may need to be done. Given the overhang of public debt and entitlement spending, a heavy fiscal burden persists. At the same time, membership of the euro-area puts a greater onus on real-side flexibility to maintain competitiveness, but there are still many barriers to this in Italy today. Rigidities in the tax system, product, labour and financial markets are discussed in subsequent chapters. In addition, innovation is increasingly important as a source of global competitiveness, but the human and infrastructure capital base for such activity remains deficient, in part due to budget constraints.

The implementation of labour market reforms, also begun around 1998 and by now among the more advanced of the euro area countries, should have further helped to cushion shocks to the household sector *via* the associated structural decline in the unemployment rate, and to the corporate sector by reducing hiring costs at the margin. Yet economic growth has remained weak in comparison with the EU average. These previous reforms were nevertheless significant, and it cannot be excluded that in their transitional phase of growing exposure to market forces, Italy's vulnerability to shocks may have increased, just when global shocks have been intensifying. Italy also remains overly dependent on exports as an exogenous determinant of investment propensity. Encouraging private consumption smoothing – for example by developing mortgage markets, assuring fiscal sustainability and enhancing labour market functioning – could improve resiliency to external (as well as internal) shocks.

The present government came into power two years ago with a strong electoral mandate to improve economic management. The subsequent relatively sharp economic slowdown has, if anything, increased the pressure on policymakers to bring about substantive changes. The government is implementing a programme of phased tax cuts as one of its top priorities. In consultation with the social partners, it has been accelerating labour market liberalisation while improving social protection, including the development of an unemployment insurance scheme and a privately funded pension pillar. It has also proposed innovative reforms of the education system and corporate law, along with plans for long-overdue reforms of the judicial system and bankruptcy procedures. To improve public sector efficiency, the processes of public administration reform and fiscal devolution begun in the previous legislature are to be carried forward, and public infrastructure will be upgraded. These are clearly major steps, some made at substantial political cost. That the "first best" solutions may not always have been arrived at, notably in the areas of pensions and job protection legislation, is perhaps understandable given the goal of maintaining widespread consensus toward reforms.

This *Survey* nonetheless argues that, despite the indubitable scope and ambition of the reform programme, the underlying structural problems are such

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that its ultimate success in achieving stated aims requires a reinforcement in two critical dimensions:

– L*ower structural spending* is needed to support the key objective of lower tax pressure. While tax cuts in the Maastricht context might themselves necessitate spending cuts, and public asset sales could for a while delay the "hard choices", this strategy could pose risks to longer-run fiscal sustainability and economic performance. A clearer prioritisation of public spending goals is thus desirable. A greater application of market principles to public spending (cost-benefit analysis of both infrastructure projects and manpower requirements, user fees, outsourcing, etc.), would allow savings at minimum disruption to public services. Stronger public finances in a long-run perspective are needed to support the growth process in the desired areas of tax reduction, R&D, infrastructure, education, and worker security.
– M*arket competition* needs to be strengthened and given more prominence in the overall policy approach. Regulatory and policy barriers to the contestibility of markets in services sectors and corporate control, and still rigid wage bargaining structures, need to be addressed by policy actions in order to improve the basic commercial incentive to innovate and compete and make supply more elastic and sensitive to changes in demand patterns.

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II. Fiscal policy issues

Overview

Although the debt to GDP ratio continued to fall, the pace of fiscal consolidation slowed considerably in Italy in 2001 and 2002 (Figure 13). After rising from 1.8 per cent of GDP in 2000 to 2.7 per cent in 2001, a slight narrowing, to 2.5 per cent of GDP was registered for the budget deficit in 2002 in spite of the marked economic slowdown. The narrowing reflected the effects of a number of measures such as tighter controls on central government spending, enlargement of the business tax base and a strengthened health spending agreement with the regions. Recourse to one-off measures, particularly the sale of public-owned real assets and proceeds from securitisation (*cartolarizzazioni*) helped to contain the deficits in a period of marked cyclical slowdown. Nevertheless, there is also an underlying excessive debt problem, and addressing it will require measures of a more permanent nature in future. Thus, the fiscal consolidation process and the achievement and maintenance of the medium-term balanced budget targets may require additional measures.

The public debt to GDP ratio fell nearly 3 percentage points, to 106.7 per cent, in 2002 thanks to low real interest rates and a swap operation of governments bonds held by the Central Bank. However, the still-high level of the debt ratio leaves the fiscal balances vulnerable to any unexpected rise in interest rates, and limits the room for expansionary budgetary manoeuvres.

Securing additional and lasting reductions in the primary expenditure to GDP ratio is the key to eliminating fiscal vulnerability in the medium and long run. In this respect, reductions in expenditure on the pension system constitute an important step given that the age-related expenditure absorbs a very high share of current spending.[37] Containing health spending, a major source of the recent budgetary slippage, and imposing "hard" budget constraints on the regions will also be crucial. In addition, the authorities estimate that the ongoing tax reform – especially the recent tax amnesties – will provide permanent revenue increases by reducing tax avoidance and tax evasion and thereby broadening the tax base. The two newly created agencies, namely I*nfrastrutture* S.*p*.A. and P*atrimonio* S.*p*.A. (which provide for private involvement in public infrastructure projects, and the

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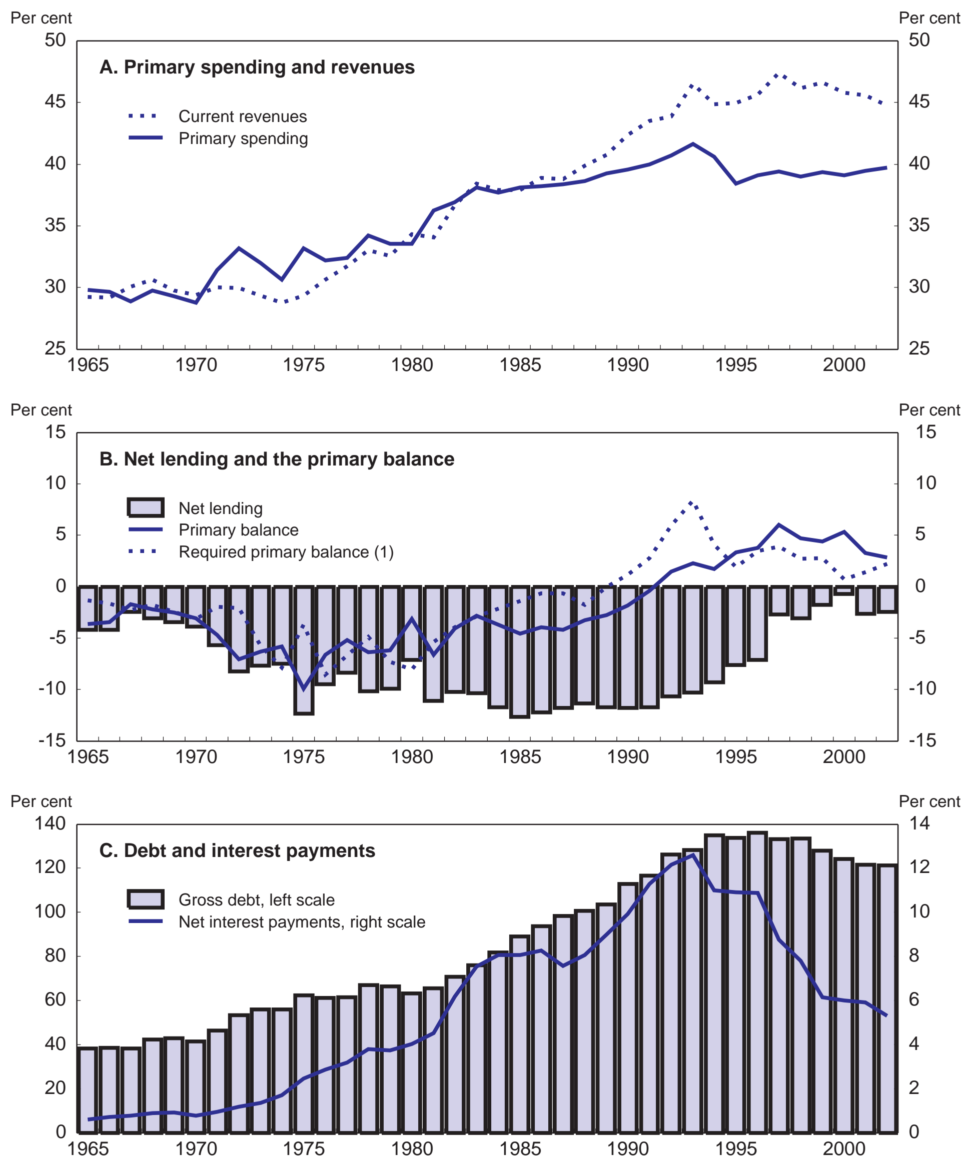
Figure 13. **Fiscal indicators**
Per cent of GDP



1. Primary surplus needed to stabilise the net debt ratio.
Source: OECD.

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revaluation and eventual sale of publicly-owned real-estate respectively) are also expected to contribute to raising the value of the existing public capital stock and increase and improve it in the short-medium term (see also Chapter IV). Nonetheless, to ensure value for money, and maximum value, a careful preparation process with a well-specified cost-benefit analysis for all new projects is required.

Recent budgetary developments

Fiscal consolidation slowed in 2001 with no significant improvement in 2002

The Economic and Financial Planning Document (*Documento di Programmazione Economica e Finanziaria*, DPEF) formulated in June 2000 had set an objective for the underlying budget deficit at 1 per cent of GDP in 2001, whereas the actual outcome was 2.7 per cent of GDP (Table 5). While part of this fiscal deterioration is attributable to the economic slowdown, the increase in the deficit was mainly due to the rise in non-interest expenditure and in particular to spending on healthcare, boosted by the abolition of prescription co-payments. Spending on pharmaceuticals increased by 33 per cent, compared with 19 per cent in 2000. Spending problems inherited from the previous year made the implementation of the 2001 budget more problematic. For example, though helping to contain expenses in 2000, the deferral of most of the costs attached to the two-year wage contract renewals for public sector employees running from 2000 have clearly contributed to surging compensation in 2001.

The July 2001 DPEF had set the deficit target for 2002 at ½ per cent of GDP, while the DPEF submitted one year later raised the deficit target for 2002 to 1.1 per cent of GDP in recognition that recovery in economic activity had been delayed. The budget deficit outturn was in fact 2.5 per cent of GDP in 2002, a slight improvement on the previous year, but considerably worse even than the revised mid-year estimate. A large part of this slippage stemmed from unexpected further weakening of activity in the second half of the year, but tax revenues were even lower than could be explained by this, and there were also slippages in health spending. There were falls, relative to expectations, in receipts of self-assessed corporate and personal income tax, tax receipts on the disposal of business and equity investments, and the yield of the tax on the revaluation of corporate fixed assets. Social security outlays also widened the deficit, driven by the rising number of long-service pensions and the increase of minimum pensions to just below 520 euros.

The large increase in the borrowing requirement, especially in July and August, led the government to introduce a number of corrective measures aimed at curbing expenditure and boosting revenues. A decree law had already been issued in April with the aim of curbing expenditure on pharmaceuticals, reducing the price paid for most drugs by the National Health Service by 5 per cent. Overall

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Table 5. **General government income statement**[1]

Per cent of GDP

	1997	1998	1999	2000	2001	2002
Receipts						
Direct taxes	16.2	14.5	15.1	14.7	15.1	14.2
of which:						
from households	11.9	11.9	12.1	12.1	11.8	11.6
from enterprises	4.3	2.6	3.0	2.6	3.2	2.6
Indirect taxes	12.4	15.3	15.1	15.0	14.5	14.6
Social security contributions	15.3	12.8	12.7	12.7	12.6	12.7
Other current transfers	1.4	1.4	1.3	1.3	1.4	1.3
Property and enterprises income	0.6	0.5	0.7	0.5	0.5	0.5
Total current receipts	45.9	44.7	45.0	44.2	44.0	43.3
Disbursements						
Government consumption	18.2	17.9	18.0	18.3	18.8	18.8
Subsidies	1.2	1.3	1.2	1.2	1.1	0.9
Social security outlays	17.3	17.0	17.1	16.7	16.6	17.1
Other current transfers	1.3	1.3	1.4	1.3	1.3	1.4
Interest on public debt	9.4	8.3	6.8	6.5	6.4	5.8
Total current disbursements	47.4	45.8	44.6	44.0	44.3	44.0
Saving	–1.4	–1.2	0.4	0.2	–0.3	–0.7
Gross investment	2.2	2.4	2.4	2.4	2.5	2.5
Net capital transfers received	–0.3	–0.8	–1.1	0.3	–1.1	–0.6
Consumption of fixed capital	1.2	1.2	1.3	1.3	1.3	1.3
Net capital outlays	1.3	1.9	2.2	0.8	2.4	1.8
Total disbursement	48.6	47.7	46.8	44.9	46.7	45.8
Net lending	–2.7	–3.1	–1.8	–0.6	–2.7	–2.5
Primary balance	6.1	4.7	4.4	5.3	3.3	2.9
Memorandum items:						
Cyclically-adjusted primary balance	6.5	5.1	4.8	4.3	3.7	3.8
Cyclically-adjusted net lending	–2.2	–2.7	–1.3	–1.7	–2.2	–1.4

1. OECD definitions. In particular, the primary balance is calculated excluding from the overall balance both interest payments and interest receipts. In accordance with Maastricht definition for excessive deficit procedure (which, unlike the OECD definition, includes interest swaps and excludes UMTS receipts), the data for net lending as a per cent of GDP are –2.7 in 1997, –2.8 in 1998, –1.7 in 1999, –1.8 in 2000, –2.6 in 2001, and –2.3 in 2002.

Source: OECD.

expenditure was effectively limited by the so-called "expenditure-blocking" decree law issued in September.[38] The Decree reinforced some controlling and monitoring procedures that in some cases had already existed but had not been effectively enforced. *First*, each spending item is authorised only within the limits contemplated by the related legislative measures and subject to an inviolable limit, the amount set forth in the budget, or in the law authorising the additional spending. When limits are reached the State Accounting Office notifies the relevant Ministry, and no further spending is authorised. Any overshoot beyond what is provided in the law must be covered by new financing approved by the parliament.

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Second, in case of significant overshoots with respect to the public finance targets, across-the-board limits may be set on the utilisation of discretionary budget appropriations by order of the Minister for the Economy and Finance acting on a resolution of the Council of Ministers, and after consulting the competent committees of parliament. *Third*, this decree also reduces the time period during which unspent appropriations may be kept in the budget.[39] After the enactment of these measures, public expenditure started to slow down in late 2002. As regards the measures concerning revenues, a decree law on corporate taxation was issued in September, which reduced the benefits of the dual income tax substantially and

Box 3. Securitisations and real public estate asset sales

It is important for Italy to reduce primary expenditures to create room for the already announced structural reforms and to cope with the public finance implications of age-related expenditures in the coming years. In this respect, putting public real estate assets, which are estimated at around 65 per cent of GDP in 2002,* to their most productive or socially desirable uses, could significantly increase the economic and non-economic returns to the public. When the social return of the assets is not dissimilar from the private one, a long-term programme of gradual and orderly sell-off of these assets could also be envisaged. Nevertheless, selling off the real assets on a year-by-year basis to fill the financing gaps would not yield the expected permanent improvement in the public finances as it could postpone more fundamental spending reduction reforms.

The government established *Patrimonio dello Stato* S.p.A. in 2002, which is the agency designated for the management and the eventual sale of public assets, including real estate. This agency can retain the ownership of these assets or dispose them in the market by means of direct sales or securitisation.

The Italian government carried out securitisations (*cartolarizzazioni*) and the sale of public real estate assets in both 2001 and 2002, which helped to contain the slippage from Stability Programme targets. In December 2001, the first securitisation of residential real estate assets belonging to the *Enti Previdenziali* was launched, covering 27 292 residential houses and 262 commercial units. In 2002, a second operation was carried out including 54 000 houses belonging to the *Enti Previdenziali*. In 2003, residential houses belonging to the *Ferrovie dello Stato*, *Poste Italiane*, Ministry of Defence, and *Demanio* (State Property Agency) are planned to be sold through securitisation. The revenue raised from the disposal of public real estate sales by means of securitisation amounted to around ½ per cent of GDP in both 2001 and 2002, and the government expects to reach the same level in 2003.

* Public sector total assets are estimated at more than 100 per cent of GDP. See Cantarelli (2003).

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made the tax treatment of capital losses and insurance companies' allocations to technical reserves more restrictive. This decree significantly increased tax receipts in the last two months of the year, by around 3.2 billion euros according to official estimates.

The budget deficit remained under the 3 per cent limit due, in part, to a number of one-off measures amounting to nearly 1½ per cent of GDP, of which the largest share came from the disposal of real estate by means of securitisations (Box 3).[40] These operations amounted to 6.6 billion euros. They will contribute to accelerate the disposal of real assets – mainly owned by social security institutions – whose returns were low and uncertain. Nevertheless, their proceeds are temporary and, therefore, cannot represent the main instrument to improve the budgetary position on a permanent basis. Given Italy's very high level of public assets, a gradual and orderly divestiture of these assets in the context of a long-term programme could be envisaged to pay down debt. A lower level of interest-bearing financial liabilities would also contribute to providing a margin to sustain primary current spending within an overall expenditure limit as net interest payments decrease.

The 2003 budget and the new medium-term plan

The budget deficit target for 2003, originally set at 0.8 per cent of GDP, was revised to 1.5 per cent in the 2002 Stability Programme Update, and recently raised to 2.3 per cent in face of adverse economic conditions. For 2004-2006, a gradual improvement in public finances is envisaged as growth picks up and the output gap narrows. The budget deficit is forecast by the authorities to fall gradually and reach a surplus of 0.1 per cent in 2006 (Table 6). Declining interest payments and higher growth will help meet those targets, but additional measures to replace the temporary measures introduced for 2003 will be required in 2004 to achieve the objectives (see below).

The budget for 2003 aims at continued fiscal consolidation while avoiding excessively restrictive measures that would hurt growth on top of the effects of the global slowdown. The budget measures for 2003 are officially expected to reduce general government net borrowing by 12.3 billion euros (Table 7). The estimated additional revenue amounts to 9.1 billion euros, or around 1 per cent of GDP, and is mostly one-off, with the bulk coming from regularisation schemes and tax amnesties. The amendments introduced by parliament include new schemes for settling tax and social security contribution liabilities, in addition to the three schemes originally contained in the Budget Bill (the tax conciliation scheme, the regularisation of assets held abroad by natural persons, and the closing of tax disputes). Several different regularisation schemes have been introduced for firms, to both avoid future disputes and resolve those already pending. Concerning personal income taxation, the 2003 Budget Law provided tax amnesties (*concordato* for

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Table 6. **The medium-term budget plan**
Per cent of GDP

	2003	2004	2005	2006
Net lending by sector				
General government	–1.5	–0.6	–0.2	0.1
Future measures		1.6	1.4	0.8
Central government	–2.9	–3.1	–2.4	–1.5
Local government	0.5	0.5	0.5	0.4
Social security institutions	1.0	0.4	0.3	0.3
General government				
Total receipts	46.1	44.9	44.8	44.6
Total expenditures	47.6	47.1	46.3	45.4
Future measures		1.6	1.4	0.8
Net borrowing	–1.5	–0.6	–0.2	0.1
Net interest payments	5.8	5.5	5.4	5.3
Primary balance[1]	4.3	4.9	5.2	5.3
Components of revenues				
Tax revenues	29.1	28.6	28.7	28.7
Social security contributions	12.8	12.7	12.5	12.4
Interest income	0.2	0.2	0.2	0.2
Other receipts	4.0	3.4	3.3	3.3
Total receipts	46.1	44.9	44.8	44.6
Components of expenditures				
Collective consumption	6.7	6.7	6.7	6.6
Social transfers in kind	11.6	11.3	11.0	10.7
Social transfer other than in kind	17.2	17.0	16.6	16.4
Interest payments	6.0	5.6	5.5	5.4
Subsidies	1.1	1.1	1.1	1.1
Gross fixed capital formation	1.9	2.5	2.7	2.6
Other expenditures	3.1	2.9	2.7	2.6
Total expenditures	47.6	47.1	46.3	45.4

1. Net borrowing plus net interest payments.
Source: Italy's Stability Programme (November 2002).

the self-employed and *condono* for all taxpayers) aimed at increasing government revenues in 2003, with the possibility of permanent gains through the reduction in the size of the underground economy. These measures differ from traditional tax amnesties in that they do not envisage penalties for the missed obligations in previous periods but simply require one-off payments by the taxpayers based mainly on the income declared in the 1997-2001 period. This approach could improve the relationship between taxpayers and the administration and lead to an enlarged tax base. However, frequent recourse to tax amnesties may nurture the expectation that they will be repeated, thereby giving rise to moral hazard and militating against efforts to control the informal economy. Therefore, rather than resorting to amnesties in future the government should rather become more vigorous in detecting fraud and imposing deterrent penalties.

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Table 7. **Estimated effects of the 2003 Budget Law on the 2003 general government budget**

Millions of euros

REVENUE	
Increase in revenue	**9 110**
Tax regularisation and conciliation schemes	7 900
Change in taxation of video games	650
Increase in excise duties on tobacco	430
Other measures	130
Decrease in revenue	**–4 790**
Change in structure of Irpef	–3 490
Effects on Irpef surtaxes	–210
Reduction in Irpeg rate	–190
Irap relief for agriculture	–330
Extension of building renovation incentives	–200
Extension of excise duty relieves	–90
Extension of VAT deductibility for company cars	–160
Other measures	–120
Net change in revenue	**4 320**
EXPENDITURE	
Decrease in expenditure	**–8 100**
Domestic stability pact	–2 250
Health care and pensions	–2 460
Purchases of goods and services	–730
Staff costs	–360
Rationalisation of grants to firms and other capital expenditure	–2 300
Increase in expenditure	**3 420**
Staff costs	870
Local finances	630
Social assistance and pensions	570
Capital expenditure and other	1 350
Net change in expenditure	**–4 680**
Reduction in net borrowing due to measures introduced in the Budget Law	**9 000**
Other expenditure savings not included in the Budget Law	**–3 300**
TOTAL REDUCTION IN NET BORROWING	**12 300**

Source: Banca d'Italia.

The adjustments in 2003 also included the effects of net expenditure savings that could total around 4.7 billion euros according to the authorities (Table 7). The bulk of the savings in expenditures is to come from the reductions in outlays for health care. The 2003 Budget law modified the provisions for patients' cost sharing for specialist examinations, diagnostic equipment and thermal cures. The government purchase discount rate charged to pharmaceuticals was revised and

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the charges for diagnostic and specialist services were maintained. Another important provision regarded the conversion of grants to firms into supported loans, although the parliament left interest rate support, incentives for industrial research and grants under local development agreements out of this measure. In the area of regional and local government finances, the deficit of the local administrations is required to remain in real terms at around the level registered in 2001. The authorities thus expected a saving totalling 2.3 billion euros from this measure. The authorities should strengthen their monitoring activities in order to ensure that the targets are actually met.[41] The expenditure saving measures for 2003 also include the rationalisation of intermediate consumption to strengthen the role of Treasury-owned *Consip S.p.A.* as the central purchasing agent for the government and set the standards of consumption for various categories of goods. A better prioritisation of the utilisation of the revolving funds for investment projects, public works and firms is also expected to yield substantial expenditure savings in 2003. Transformation of ANAS – the agency responsible for state roads – into a joint stock company, and the rationalisation of financing to *Post Office* and *State Railways* are the other measures that aim at reducing expenditures in this year.

The one-off nature of the above-mentioned revenue measures should reduce their negative impact on economic activity. However, given the prospect that GDP growth may well be less than the initial official estimate,[42] which would in turn trigger the operation of built-in stabilisers, in April 2003 the authorities revised the deficit target for 2003 from 1½ per cent of GDP to 2.3 per cent.[43] Given the nature of the corrective measures, it is difficult to quantify their effects precisely. To achieve the official fiscal targets both in 2003 and in the medium-term, against a background of tax reductions, it is important to secure additional and lasting reductions in primary expenditure, while improving the quality of expenditure. The achievement of the deficit targets for 2004 depends on the implementation of the corrective measures. In fact, corrective measures amounting to at least 1½ per cent of GDP are likely to be needed to compensate for the loss of the one-off tax amnesties and reconciliation measures in 2003.[44]

Recent developments in public debt

Reducing the still high debt-to-GDP ratio…

After reaching a peak of 124.3 per cent of GDP in 1994, the debt-to-GDP ratio has continued to decrease, reflecting the sequence of comparatively high primary surpluses. Nevertheless, Italy is still the most indebted country in the EU (Table 8). Furthermore, the pace of debt reduction slowed in 2001, with the decline in the debt ratio being only 1.1 percentage points, the smallest decrease since 1996. In 2002, the debt-to GDP ratio declined by nearly 3 percentage points

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Table 8. **International comparisons of gross public debt in the EU**

Face value, per cent of GDP

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Austria	61.8	64.7	69.2	69.1	64.7	63.7	67.5	66.8	67.3	67.6
Belgium	138.1	135.8	133.9	130.5	124.8	119.5	114.8	109.6	108.5	105.4
Denmark	78.0	73.5	69.3	65.1	61.2	56.2	53.0	47.3	45.4	45.2
Finland	55.8	57.8	57.1	57.0	54.0	48.6	47.0	44.5	43.8	42.7
France	45.3	48.4	54.6	57.0	59.3	59.5	58.5	57.3	57.3	59.5
Germany	46.9	49.3	57.0	59.8	61.0	60.9	61.2	60.2	59.5	60.8
Greece	110.1	107.9	108.7	111.3	108.2	105.8	105.1	106.2	107.0	104.9
Ireland	96.5	90.9	82.9	74.1	65.0	54.9	49.3	39.3	36.8	34.0
Italy	**118.2**	**124.3**	**123.8**	**122.7**	**120.2**	**116.4**	**114.9**	**110.6**	**109.5**	**106.7**
Luxembourg	6.0	5.6	5.7	6.3	6.4	6.6	6.3	5.9	5.6	5.7
Netherlands	79.0	76.3	77.2	75.2	69.9	66.8	63.1	55.8	52.8	52.6
Portugal	59.1	62.1	64.3	62.9	59.1	55.0	54.3	53.3	55.5	58.1
Spain	58.4	61.1	63.9	68.1	66.6	64.6	63.1	60.5	56.9	54.0
Sweden	73.4	73.8	73.6	73.5	70.5	68.0	62.7	52.8	54.4	52.4
United Kingdom	45.4	48.5	51.8	52.3	50.8	47.7	45.1	42.1	38.9	38.4
Euro area	66.7	69.0	72.9	74.5	74.3	73.5	72.0	69.5	69.1	69.1
EU	65.3	67.3	71.2	73.1	71.4	69.3	67.8	63.9	63.0	62.5

Source: OECD, Eurostat, Ministero dell'Economia e delle Finanze.

to 106.7 per cent of GDP, mainly reflecting low interest rates and the exchange of public bonds held by the Bank of Italy. The end of the state participation in *Telecom Italia* also helped to decrease the debt ratio.

... with more effective public debt management

The debt service ratio has declined in terms of both levels and volatility since 1997, reflecting both a lengthening of the debt maturity structure and falling market interest rates (Figure 14). The Ministry of the Economy and Finance continues to emphasise the transparency, regularity and predictability of its operations *vis-à-vis* financial markets as well as diversifying the debt instruments to accomplish a debt structure that is less responsive to financial market disturbances. The share of fixed-rate bonds increased to 70 per cent (Figure 15) reflecting the strategy of increasing the average maturity of debt and reducing the share of treasury bills and floating rate notes. The average duration of government debt increased from 5.8 years in 2001 to 6 years by the end of 2002 reflecting a lengthening of the debt maturity structure since mid-1990s.

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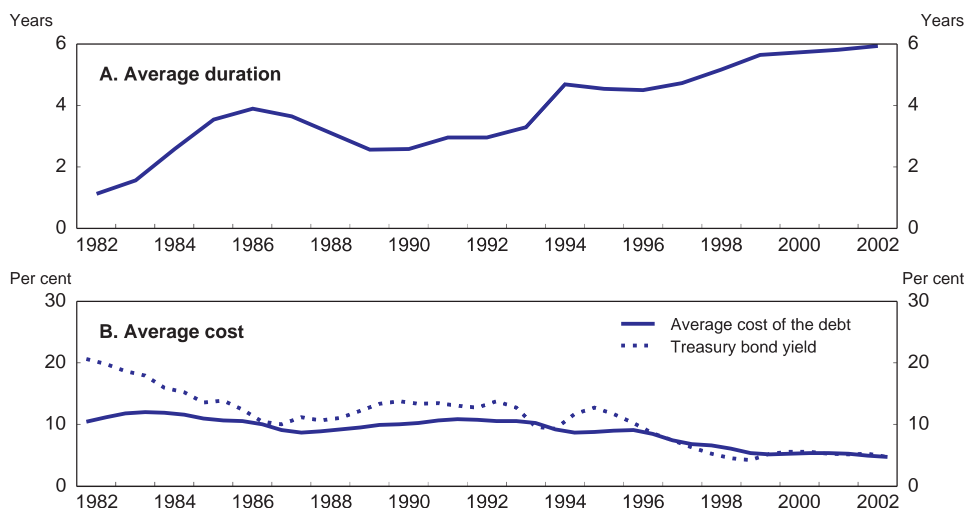
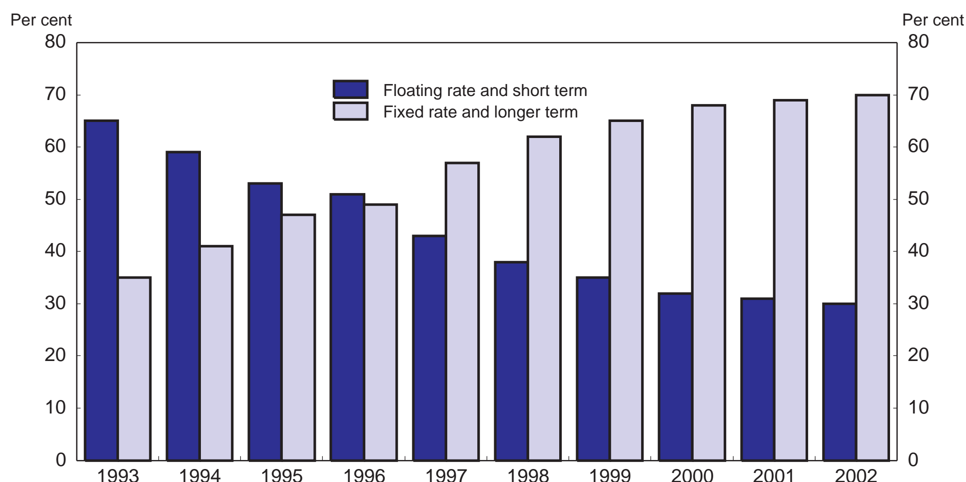
Figure 14. **Average duration and average cost of the debt**



Source: Ministero dell' Economia e delle Finanze.

Figure 15. **Maturity breakdown of state sector domestic debt**
Per cent of total



Source: Banca d'Italia.

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III. Product market competition and economic performance in Italy

Overview

The OECD (2001b) *Review of Regulatory Reform in Italy* acknowledged the vast distance that has been covered since Italy began liberalising product markets at the start of the 1990s. This entailed a sustained programme of privatisation, market opening, and deregulation followed by appropriate re-regulation and institution building. However, there is still considerable scope for further improvement, and raising growth will depend critically on removing the impediments and distortions to competition. Rigidities and protections have a large influence on the structural features of the Italian economy impacting upon, amongst other things, the intensity of product market competition, size and growth of firms, innovative activity, the capacity to attract foreign direct investment and employment growth. Problems with productivity and growth, and low R&D spending, are linked to an industrial structure heavily weighted towards small enterprises. Despite the large number of firms, the intensity of competition and rivalry is particularly weak in retail distribution and in professional services. Without the elimination of entrenched positions and an easing of barriers to entry and firm growth, innovative activity, one of the main engines of economic growth, is unlikely to thrive in Italy.

The chapter looks at what role product market competition, and the policies that impact upon competition, may have played in the performance of the Italian economy over the past decade. While recognising that considerable progress has been made, the analysis primarily seeks to identify areas where policies continue to impair performance. The first section briefly looks at Italy's economic performance at the aggregate and sectoral level. With an emphasis on the manufacturing sector, it examines the interplay between economic performance, product market competition and industrial structure and the role of policies and institutions, including labour market policies, bankruptcy law and the administrative burden on firms. Several policy areas that directly impact upon the intensity of competition in product markets are examined next, including competition legislation and enforcement and regulatory policies in service industries. This includes service industries that are intrinsically competitive, such as retail distribution and

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professional services, and network service industries containing non-competitive segments, such as telecommunications, electricity and gas. A concluding section draws on the analysis to provide a set of policy recommendations aimed at increasing product market competition.

Product market competition and macroeconomic performance

There is a well-identified empirical connection between the intensity of competition in product markets and better productivity outcomes (OECD 2002f). In addition, product market competition can have significant effects on employment not only due to increases in real wages but also through improvements in the functioning of labour markets. Over the past decade Italy has had comparatively poor economic performance (Table 9). At the aggregate level, average GDP growth between 1990 and 2001 was one of the lowest of the G7 countries, and well below the OECD and European Union averages. While the level of GDP per capita and GDP per hour are higher than average, the poor growth performance can be explained by weak employment growth over this period as a whole. Moreover, weak employment growth may have in particular affected low-productivity workers, implying that underlying productivity growth was probably worse than the headline numbers. A sectoral breakdown shows that labour productivity growth was relatively weak in manufacturing. In contrast, performance was relatively better in electricity, gas, water, transport and communications.

Indicators of product market competition in manufacturing

The poor performance of the Italian economy, and in particular the manufacturing and distribution sectors, may be due in large part to a lack of competitive forces. This section looks at indicators of competition in the manufacturing sector, while the retail distribution sector is discussed in detail in a separate section below. Although it is difficult to classify markets according to the strength of market forces, the strength of product market competition may be gauged from jointly considering a number of imperfect proxy measures.

In general, mark-ups, a frequently used gauge of competitive pressures, appear to be relatively low in Italy compared with other countries (Figure 16). According to this indicator, competition pressures seem to be quite intense in segmented industries (*i.e.* more concentrated industries characterised by relatively large firms). Lower than average estimated mark-ups could imply that Italian firms in these sectors have relatively little market power. However, somewhat higher than average mark-ups in low R&D, fragmented industries (*i.e.* less concentrated industries characterised by a large number of small firms), could indicate that there are problems with competitive pressures in these industries. While fragmented sectors have a large number of firms, these firms may not be competing very aggressively.

Import penetration ratios indicate that Italian producers face weaker competitive pressure from foreign firms than their counterparts in other large Euro-

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Table 9. **Output, employment and productivity**

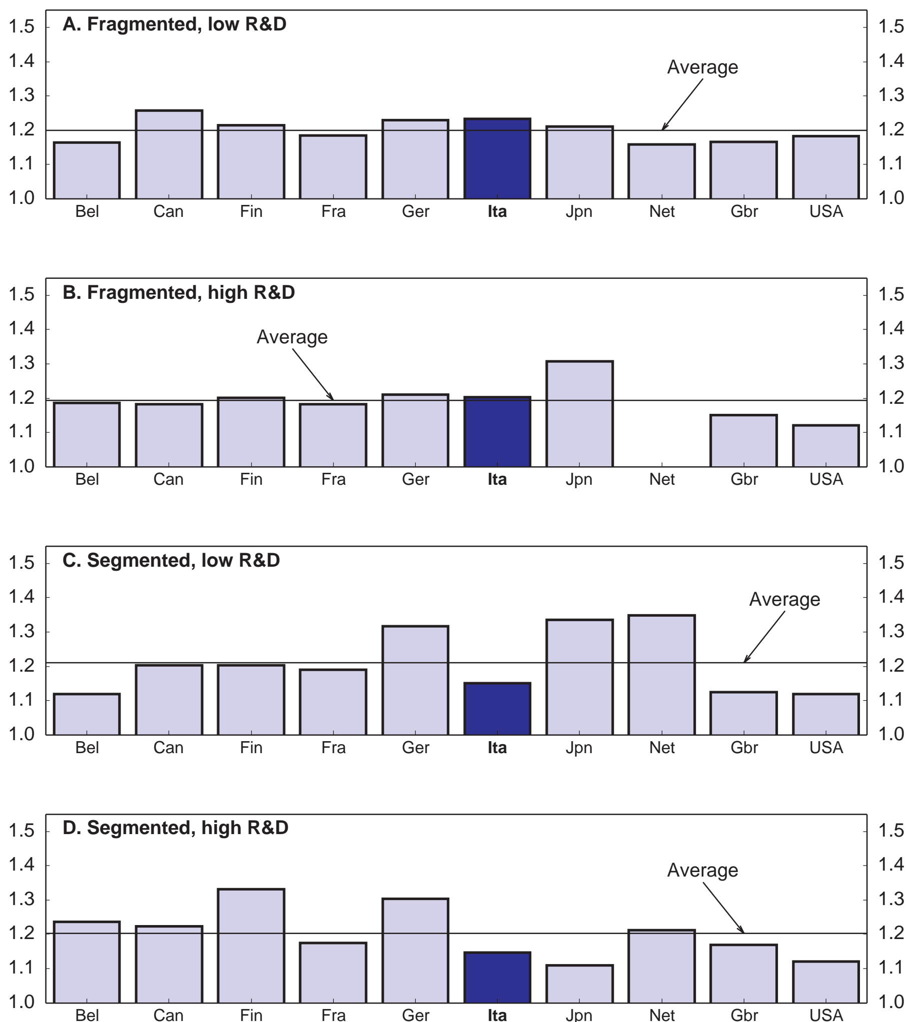
1990 to 2001[1]

	United States	Japan	Germany	France	Italy	United Kingdom	Canada	OECD	European Union
Average GDP growth	2.8	1.7	1.5	1.9	1.7	2.2	2.5	2.6	2.1
of which:									
Productivity	1.3	1.3	1.4	1.2	1.4	1.9	1.2	1.6	1.5
Employment	1.5	0.4	0.1	0.7	0.2	0.3	1.3	1.0	0.6
of which:									
Unemployment[2]	0.0	-0.2	-0.2	0.1	0.1	0.1	0.0	0.0	0.0
Labour force	1.3	0.6	0.3	0.7	0.2	0.2	1.2	1.5	0.6
Demographics[3]	1.2	0.7	0.2	0.8	0.1	0.2	1.3	1.6	0.4
Participation rates[4]	0.0	-0.1	0.2	-0.1	0.0	0.0	0.0	-0.1	0.2
Labour productivity growth									
In selected industries[5]									
Total manufacturing	3.8	2.2	2.7	3.5	1.9	2.7	2.2	n.a	n.a
Electricity, gas and water supply	2.2	2.5	5.1	3.7	3.1	10.5	0.9	n.a	n.a
Construction	0.1	-2.0	0.1	-0.5	0.1	2.4	-0.5	n.a	n.a
Wholesale and retail trade; restaurants and hotels	3.4	1.4	-0.6	0.7	1.1	1.8	1.9	n.a	n.a
Transport and storage and communication	2.8	0.6	7.6	2.9	3.2	4.3	2.4	n.a	n.a
Memorandum items:									
MFP growth[6]	0.9	0.1	0.6	0.5	0.7	1.1	0.9	n.a	n.a
GDP per capita[7]	100.0	75.7	74.8	75.0	74.6	75.0	82.2	71.7	72.7
GDP per hour worked[7]	100.0	75.1	98.2	109.9	102.6	85.1	87.6	83.1	94.9

1. Except for Germany, OECD and European Union: 1992-2001.
2. A positive sign indicates that unemployment has declined and contributed to boost output growth.
3. The contribution for demographics comprises changes in the size and age composition of the working age population.
4. Measures the effect from changes in age specific participation rates.
5. 1990-2000. Except for Canada and France 1990-99, Japan 1990-98 and Germany 1992-2000.
6. Total economy.
7. 2001 levels, PPP based, USA =100.

Source: OECD.

Figure 16. **Average mark-ups by market structure, 1981 to the latest available year**[1]



1. The average mark-up is an unweighted average of the available mark-ups, based on Roeger's method (Oliveira Martins *et al.*, 1996). *ISIC, Rev3 classification.* 1981-2000: Belgium and Finland, 1981-99: France, Netherlands and United States, 1981-1998: Italy, Japan and United Kingdom, 1981-96: Canada, 1992-99: Germany.

Source: OECD STAN database.

pean countries (Table 10). Only Japan and the United States have lower import penetration rates in total manufacturing.[45] A sectoral breakdown shows that the lack of competitive pressure is not across the board. Import penetration rates in segmented industries are comparable with other OECD countries. However, in "traditional" industries (*i.e.* fragmented, low R&D industries) Italy often has the

Table 10. **Import penetration by manufacturing industry**

Latest available year

	Canada	France	Germany	Italy	Japan	United Kingdom	United States
	1999	2000	2000	2000	2001	2000	2001
Total manufacturing	55.4	36.6[3]	40.8[3]	30.6	11.6	44.8	23.1
Fragmented, low R&D							
Textiles	65.0	52.1[3]	88.1	20.0	35.6	54.0	27.2
Wearing apparel	42.7	53.4	77.1	23.2	33.8	65.2	53.3
Leather products and footwear	81.8	80.6	89.2	37.9	57.2	86.2	79.5
Wood products	19.3	22.9	20.7	17.8	25.6	32.0	12.7
Paper and pulp	..	38.9	42.7	27.4	4.6	35.2	10.4
Printing and publishing	..	9.0[3]	7.1	7.0	1.8	8.0	2.5
Non-metallic products	40.9	18.9[3]	18.4	8.7	4.8	17.9	13.5
Fabricated metal products	35.8	14.3	15.0	7.3	3.9	16.7	8.9
Fragmented, high R&D							
Medical precision and optical instruments	..	44.7	58.9	59.9	68.1	63.5	22.7
Machinery and equipment	84.1	54.0	36.2	37.4	8.3	57.0	26.4
Other manufacturing	56.8	33.4	38.8	19.5	9.9	38.8	38.5
Segmented, low R&D							
Refined petroleum, coke	13.2	18.1[3]	33.2	17.1	10.8	21.4	17.9
Basic metals	41.9	45.7	47.5	42.7	6.7	46.9	22.0
Shipbuilding and repairs	52.9	11.8	32.4[4]	18.9[4]	2.9[1]	21.0	6.8
Rubber and plastic[1]	46.3	30.9	29.2	22.0	4.7	26.6	12.1
Food, beverages, tobacco[1]	18.6	18.5[3]	19.0	19.0	11.2	20.5	6.3
Segmented, high R&D							
Chemicals	60.3	49.9	53.2	44.5	12.1	53.3	20.4
Pharmaceuticals	56.6	42.6	60.3[4]	33.1[4]	8.8[2]	63.1	18.7
Office and computing machines	113.9	110.6	107.3	97.8[4]	28.8[2]	105.7	68.2
Electrical machinery	91.0	47.5	33.1	20.7[4]	12.0[2]	53.6	46.6
Radio, TV and communication equipment	67.4	73.6	97.5	61.0	14.7[2]	90.8	41.8
Motor vehicles	77.3	36.5[3]	34.6	58.5	3.7[2]	59.0	36.5
Aircraft	87.3	49.4	120.2[4]	69.5[4]	43.6[2]	87.4	30.2
Railroad equipment	36.6	51.7	39.7[4]	29.8[4]	186.9[2]	43.6	20.3
Other transport equipment	70.2	43.3[3]	98.3	54.6	32.6[2]	72.2	25.4

Note: Imports as a percentage of domestic demand (estimated as production minus exports plus imports). Values greater than 100 can occur when exports exceed production because of the inclusion of re-exports, *i.e.* products that are imported and then re-exported without any further transformation.

1. Mix of fragmented and segmented sectors.
2. 2000.
3. 2001.
4. 1999.

Source: OECD STAN database.

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lowest import penetration ratios of all the G7 countries. The low import penetration rates in these industries, in conjunction with stable higher than average mark-ups, would seem to suggest a lack of rivalry amongst firms in these sectors. Alternatively, it could suggest that Italian firms in "traditional" industries are more efficient than competitors in world markets and so enjoy unusually high margins. However, export rates are also comparatively low (Table 11).[46]

Table 11. **Export ratio by manufacturing industry**
Latest available year

	Canada	France	Germany	Italy	Japan	United Kingdom	United States
	1999	2000	2000	2000	2001	2000	2001
Total manufacturing	55.1	37.7[3]	47.6[3]	34.2	16.3	39.9	16.8
Fragmented, low R&D							
Textiles	48.6	47.6[3]	86.5	36.2	22.7	38.9	12.9
Wearing apparel	28.9	37.4	57.1	37.4	1.0	37.0	10.1
Leather products and footwear	44.9	73.3	77.5	59.8	4.3	66.8	29.4
Wood products	67.9	17.5	15.9	8.7	0.2	5.4	3.7
Paper and pulp	..	31.3	44.9	20.3	2.9	18.0	8.5
Printing and publishing	..	7.5[3]	9.7	7.4	0.7	8.6	3.8
Non-metallic products	33.6	18.7	20.9	23.6	7.2	16.2	7.5
Fabricated metal products	28.6	13.8	20.6	16.5	5.5	14.5	6.2
Fragmented, high R&D							
Medical precision and optical instruments	..	40.6	67.7	52.2	77.3	62.5	26.3
Machinery and equipment	73.1	52.2	56.2	59.9	25.2	57.6	27.5
Other manufacturing	56.0	24.3	33.8	49.6	7.2	23.2	15.1
Segmented, low R&D							
Refined petroleum, coke	24.8	14.9[3]	23.1	16.6	1.3	26.7	4.7
Basic metals	52.0	41.8	48.5	27.5	9.9	42.3	12.8
Shipbuilding and repairs	67.4	35.9	53.5[4]	51.4[4]	60.5[2]	22.6	9.2
Rubber and plastic[1]	42.6	30.8	37.8	33.4	17.9	22.2	11.0
Food, beverages, tobacco[1]	21.7	22.7[3]	17.4	15.1	1.1	14.9	5.8
Segmented, high R&D							
Chemicals	49.9	53.9	61.8	36.1	16.7	56.2	20.3
Pharmaceuticals	29.4	46.8	72.1[4]	31.0[4]	5.5[2]	68.6	15.5
Office and computing machines	136.9	118.0	113.3	94.4	34.1[2]	107.9	58.2
Electrical machinery	80.5	50.8	38.8	24.7[4]	25.0[2]	51.3	37.6
Radio, TV and communication equipment	56.2	74.7	97.4	47.6[4]	29.2[2]	89.6	37.4
Motor vehicles	81.6	42.5[3]	53.3	51.0	25.6[2]	50.5	18.7
Aircraft	89.2	63.2	119.0[4]	68.2[4]	26.7[2]	88.4	44.1
Railroad equipment	44.0	47.0	30.0[4]	39.2[4]	107.5[2]	17.2	10.8
Other transport equipment	74.6	58.5[3]	98.3	62.5	61.4[2]	72.8	35.4

Note: Exports as a percentage of production. Values greater than 100 can occur when exports exceed production because of the inclusion of re-exports, *i.e.* products that are imported and then re-exported without any further transformation. ".." indicates not available.

1. Mix of fragmented and segmented sectors.
2. 2000.
3. 2001.
4. 1999.

Source: OECD STAN database.

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Fragmented low R&D sectors make up the backbone of the Italian industrial structure and account for 41.5 per cent of value added in total manufacturing. The seeming lack of competitive pressure in these sectors is likely to contribute to the poor performance of the Italian economy. It appears that the large number of

Table 12. **Herfindahl-Hirschman indices of industry concentration**[1]

	1996	1999
MANUFACTURING		
Fragmented, low R&D		
Food products	6.4	6.2
Textiles	4.0	4.2
Wearing apparel	3.9	4.4
Leather products	11.8	13.8
Footwear	6.4	8.9
Wood products	3.7	3.1
Paper and pulp products	25.5	26.6
Publishing and printing	11.9	13.3
Plastic products	6.5	6.6
Non-metallic products	8.1	9.1
Fabricated metal products	1.2	1.2
Furniture	3.9	5.3
Segmented, low R&D		
Beverages	38.4	56.2
Tobacco products	423.8	840.0
Refined petroleum products	318.0	274.0
Rubber products	83.4	84.5
Glass products	68.2	85.4
Basic metals	23.2	22.2
Iron and steel	57.6	61.1
Non-ferrous metals	131.6	119.0
Shipbuilding and repairs	195.2	88.0
Fragmented, high R&D		
Machinery and equipment	3.7	3.2
Medical appliances	17.9	17.6
Other manufacturing	10.5	10.7
Segmented, high R&D		
Coke and petroleum products	294.3	256.2
Chemicals products	17.0	16.5
Drugs and medicines	60.0	60.7
Office & computing machinery	530.8	271.7
Electrical machinery	11.2	10.8
Radio, TV and communication equipment	53.0	38.9
Optical and photographic equipment	85.0	78.6
Watches and clocks	1 531.4	585.4
Motor vehicles	36.6	34.6
Other transport equipment	76.1	73.0
Railroad equipment	498.1	463.6
Aircraft	635.0	689.7

1. The Herfindahl-Hirschman index is the sum of the squared market shares of firms and thus combines elements of both firm numbers and inequality. The value declines with increases in the number of firms and increases with rising inequality among any given number of firms.

Source: OECD, Statistics on enterprises by size class (SEC database).

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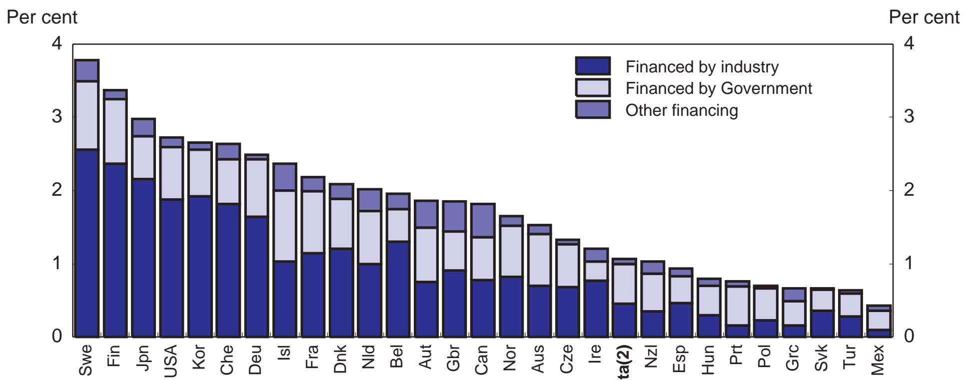
firms is not sufficient to bring about intensive product market competition and that rivalry amongst firms is not that strong. Indeed, it may be that the lack of economies of scale may be inhibiting more "efficient" or aggressive competition from emerging. A recent report by the Italian statistical office finds that Italian firms are too small, failing to benefit from economies of scale which could lead to more "efficient" competition (ISTAT, 2002c). However, concentration rates in manufacturing, as measured by the HHI, have generally risen over the second half of the 1990s (Table 12), suggesting that Italian enterprises may be moving towards a more efficient business model.

Economic performance and industrial structure

A more competitive environment tends to strengthen R&D and diffusion of technologies, both of which are primary factors contributing to economic growth (Ahn, 2002; OECD, 2003b). Italy's low R&D expenditure (Figure 17), both private and public, therefore, may in part be explained by a lack of competitive pressures. Indeed, regulatory restrictions to competition account for a large part of Italy's deviation of R&D intensity from the OECD average (Figure 18). Foreign direct investment (FDI) is also a major source of innovative activity through technology transfer and FDI in Italy (both inward and outward) is very low (Figure 19). However, intra-EU FDI

Figure 17. **Gross domestic expenditure on R&D**
Per cent of GDP, 2000[1]



1. Except Belgium, Denmark, Greece, Iceland, Ireland, Mexico, Netherlands, New Zealand, Norway, Portugal, Sweden: 1999.
2. The breakdown between private and public expenditure for Italy was unavailable. The 2000 figure was estimated using weights from 1996, which was the latest year for which the breakdown is available.

Source: OECD, *Main Science and Technology Indicators*, November 2002.

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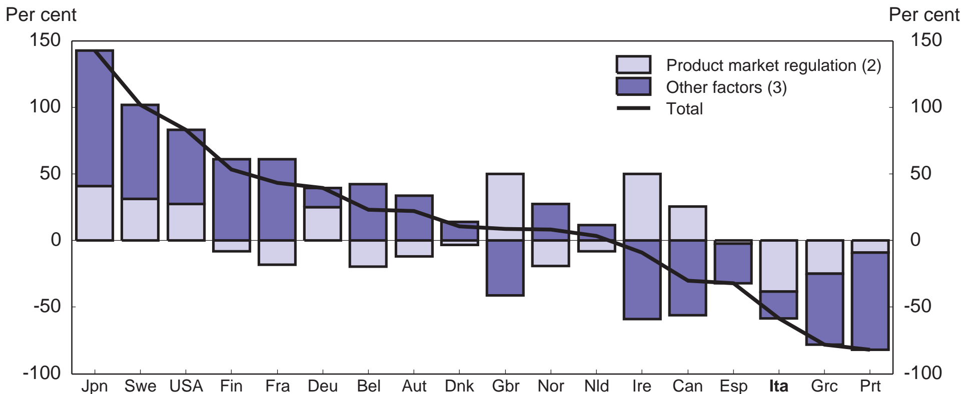
Figure 18. **The contribution of product market regulation to differences in R&D intensity across countries**

Percentage deviations from OECD average[1]



1. Adjusted for industry composition.
2. Includes administrative and economic regulations.
3. Includes EPL, other controls, and country-specific effects.

Source: OECD (2002), *Economic Outlook*, No. 71.

increased considerably between 2000 and 2001: inward FDI from 0.47 per cent to 1.17 per cent of GDP and outward FDI from 0.40 per cent to 1.76 per cent.

In Italy, as in other countries, the manufacturing sector accounts for the largest share of private R&D expenditure. However, output in Italy's manufacturing sector is heavily weighted towards low-technology industries, accounting for a higher share of manufacturing production than in all other G7 countries (Figure 20). Indeed, Italy's manufacturing sector has a larger share of "traditional" industries whose production requires technologies operated by low-skilled workers *e.g.* textiles, clothing, leather products, furniture, etc. (ISAE, 2003b). This higher weight of "traditional" industries, combined with the seeming lack of competitive pressures may therefore be a factor hindering aggregate growth performance.

Firm size seems to matter for R&D. Italy's low level of R&D expenditure is therefore likely to be explained, not only by the sectoral specialisation pattern and the limited competitive pressure to innovate but also by the size distribution of firms (Nicoletti *et al.*, 2001; Foresti, 2002). Italy's industrial structure is heavily weighted towards small and medium sized enterprises (SME's), more so than any of the G7 countries, with 98 per cent of all Italian firms having between 0-49 employees (Figure 21). The small size of firms discourages innovative activity since it is usually

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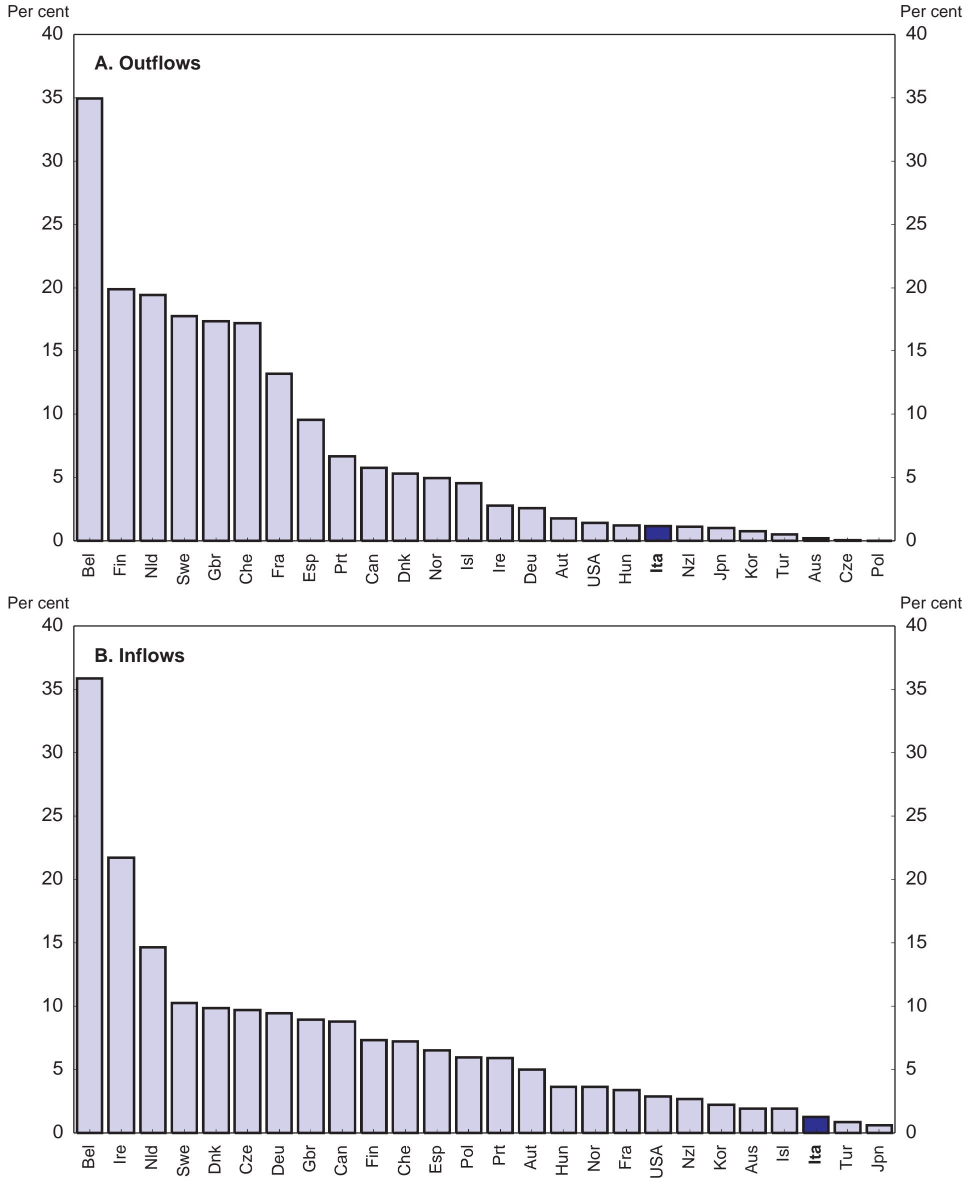
Figure 19. **Foreign direct investment outflows and inflows**
Per cenf of GDP, 2000



Source: OECD (2001), *International Direct Investment Statistics Yearbook.*

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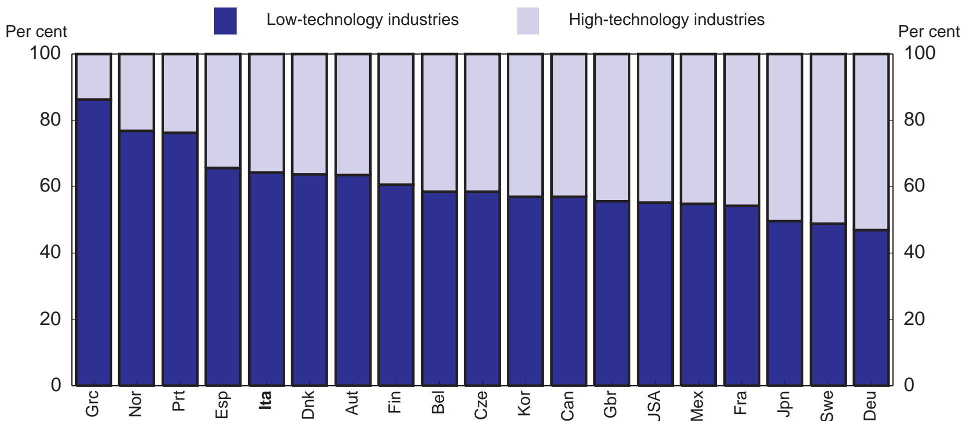
Figure 20. **Share of production in manufacturing sector by technology intensity**[1]

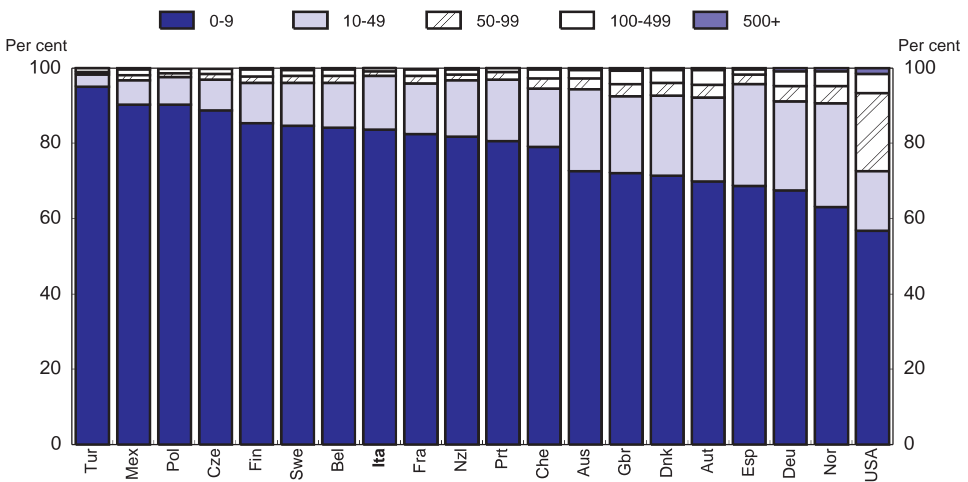


1. Latest available year: Denmark and United States: 2001, Belgium, Czech Republic, France, Mexico, and United Kingdom: 2000, Austria, Canada, Finland, Germany, Greece, Italy, Norway, Portugal, Spain and Sweden:1999, Japan and Korea: 1997.

Source: OECD, STAN database.

Figure 21. **Distribution of enterprises, by size class**

Total economy, 1999 or nearest year



Source: OECD (2002), *Small and Medium Enterprise Outlook*.

large firms that have the available resources and can exploit the economies of scale needed for R&D. Recent studies by the Italian statistical office find that problems with productivity, growth and low R&D spending are linked to the industrial structure being heavily weighted towards small enterprises (ISTAT, 2002b).

Even after correcting for the sectoral composition of output and the size distribution of firms, work by Foresti (2002), Nicoletti *et al.* (2001) and Confindustria (1995) find that Italian firms engage in less innovative activity than comparable firms in other countries.[47] These studies confirm that a large part of the difference in R&D spending between Italy and other G7 countries can be attributed to the low level of R&D undertaken and financed by manufacturing firms in Italy.[48] Indeed, Italian enterprises with fewer than 100 employees contribute less to R&D expenditure than in all other OECD countries, with the exception of Sweden and Korea (Table 13).

Policies, institutions and industrial structure

The seemingly weak competitive pressure in fragmented low-R&D manufacturing industries in Italy is a puzzling feature. However, both industry structure and the intensity of product market competition can be affected by policies. Institutional and regulatory arrangements in Italy may therefore help to shed some light on this issue.

There are important interactions between product and labour markets. Numerous labour market policies and institutions such as the industrial relations systems and employment protection legislation (EPL) are potentially relevant for explaining the size distribution and innovative activity of firms, (Nicoletti *et al.*, 2001). For example, EPL that only applies to firms of a certain size of more than 15 employees may be one factor contributing to an industrial structure heavily weighted toward small firms, and can impinge upon firm growth. This may partly explain the apparent weakness of competitive forces in fragmented sectors where the lack of economies of scale is inhibiting more "efficient" competition from emerging. Moreover, enhanced flexibility in the labour market can accelerate the positive effects of product market reforms and facilitate the re-structuring of industries in response to competitive forces, while at the same time ensuring a more rapid reallocation of labour between companies and sectors. In the last few years, Italy has made considerable progress in reducing hiring costs for firms.[49] However, legislation on firing procedures has hardly changed since the seventies, contrary to developments in most OECD countries.

The efficiency of bankruptcy legislation and the development of financial markets can also impact upon product market competition, the size distribution and innovative activity of firms.[50] The current Italian bankruptcy law, dating from 1942, treats bankruptcy as an event mainly due to reprehensible behaviour by the debtor, rather than a possible outcome of normal business risks. It is extremely harsh to

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Table 13. **Total business R&D broken down by size classes of firms, 1999**
(percentage of total)

	Employees			
	Fewer than 100	100 to 499	500 to 999	1 000 or more
Canada[1]	16.8	15.8	10.1	57.4
Mexico[2, 3]	13.8	24.5	61.6	→
United States[4]	10.4	8.3	3.8	77.5
Australia[5]	29.2	20.7	12.3	37.8
Japan[6]	←	7.2	10.7	82.1
Korea[7, 8]	4.1	8.8	8.2	78.9
Belgium[3]	19.0	17.3	12.3	51.4
Czech Republic	10.5	24.3	12.5	52.6
Denmark[1, 9, 10]	16.1	23.4	13.2	47.4
Finland	14.0	15.0	9.6	61.4
France[1]	6.8	14.3	9.2	69.7
Germany[8, 9]	5.8	9.3	5.7	79.2
Hungary	16.3	13.7	15.2	54.7
Iceland	38.6	56.8	2.8	1.8
Italy[1]	5.4	18.9	12.3	63.4
Netherlands[1, 11]	10.6	18.2	71.2	→
Norway[3, 9, 12]	25.8	29.4	44.8	→
Poland	11.2	50.6	8.4	29.8
Portugal	25.7	41.2	9.9	23.3
Spain	18.0	26.2	16.5	39.3
Sweden[13]	3.8	14.0	9.6	72.6
Switzerland[10, 14, 15]	10.1	20.3	11.3	58.3
Turkey[14]	6.0	31.5	13.2	49.2
United Kingdom	8.0	17.2	13.3	61.5

1. 1998.
2. 51 to 100 employees.
3. 1995.
4. Lower cut-off point is 5 employees.
5. Excludes agriculture.
6. Fewer than 300 and 300 to 399.
7. Companies only.
8. 1997.
9. Excludes institutes.
10. Lower cut-off point is 6 employees.
11. 10 to 99 employees
12. Total manufacturing and mining only.
13. 50 to 99 employees.
14. 1996.
15. Excludes banks.

Source: OECD (2001), STI *Scoreboard*.

debtors, imposing personal and potential criminal liability on borrowers.[51] The punitive nature of bankruptcy procedures, by discouraging entrepreneurial activity and risk-taking, can impinge on both firm entry and growth. In addition, although aimed at satisfying creditor's claims, the current law offers little protection to credi-

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tors as their claims are usually achieved through a compulsory sale of the enterprises assets carried out by bankruptcy officials. Indeed, scant consideration is given for the protection of the enterprise as a going concern and no room for a potential re-organisation is provided for in the law (Cappiello, 2002). On top of this, the very lengthy judicial process usually results in the disappearance of any company value remaining for creditors in the end.[52] This lack of creditor protection can impinge on the availability and type of financing (*e.g.* creditors may be less willing to lend for riskier R&D projects). Although reforms are currently under consideration, given the large costs that the current law may be imposing, reform of bankruptcy legislation is a key structural reform that should be undertaken forthwith.

Administrative burdens on firms and red tape remain comparatively high in Italy and can discourage entry by both domestic and foreign firms. A recent study by the EC shows that, despite recent reforms, Italian firms had the third highest costs (after Austria and Greece) and still faced the longest waiting times for starting up a new business (EC, 2002a). Benchmarking reports on the quality of public administration show that Italy is among the countries with the lowest ranking as regards the quality of bureaucracy and the highest with respect to administrative burden, and that these factors are a major obstacle to firms' activities (Confindustria, 2002). Restrictive product and labour market regulations have also led to an inhospitable market environment making Italy relatively unattractive for inward FDI, and account in large part for its comparatively low level of FDI (Nicoletti *et al.*, 2003). Recent programmes are producing their first effects (Coco and Ferrara, 2003), but the margins for improvement in this area still remain large.

Competition legislation and enforcement

Italy was a latecomer in adopting competition legislation, which it did in 1990. However, it was among the first EU countries to bring the complete system of EU competition law into its national law, including both the prohibitions against restraints and abuse of dominance from the Rome Treaty and criteria for merger control modelled on EU merger regulation.[53] Basing the national law on the European model implies that elaboration of Italian competition policy depends upon European institutions and reinforces the independence of competition policy in Italy. Enforcement of Italy's Competition Act by the Antitrust Authority (*Autorità Garante della Concorrenza e del Mercato*) has been challenged from the start by long-term patterns of entrenched monopoly, direct government control, regulatory protection and industry co-operation. In spite of this, the Antitrust Authority has been promoting competition in product markets by actively enforcing competition legislation.

Institutional setting

The Antitrust Authority is a separate and independent agency, with unusually broad freedom of action and strong protection of its decision-making

independence within the government structure. Unlike many other countries, it does not share competencies with a ministry secretariat for investigation or prosecution. The Authority, like the European Commission, acts both as the initiator and investigator and as the first-instance decision-maker in law enforcement matters. In Italy, the risks that are commonly associated with the combination of these functions have been checked so far by vigorous oversight from the courts. The Authority's five members are appointed by the Parliament for non-renewable seven-year terms. The members have mostly been experts from outside the government. The law provides no avenue for political control or influence, both in general or over particular decisions, beyond the appointment process itself. The budget is a separate line item in the law, approved by Parliament and subject to inflation adjustment, so ministries cannot exert indirect pressure by that means.

After vigorous increases in staff and budget while the Authority was becoming established, its resources have levelled off in the past few years. The total staff, currently about 190, is somewhat lower than in Germany, France, and the United Kingdom, and it is even lower than staff numbers in some smaller economies with active competition policy regimes, such as the Netherlands and Australia (Table 14). Some of the staff resources are allocated to deceptive advertising and marketing practices (as is also true for the United Kingdom, Canada and Australia). Although funding has been adequate so far, the statutory ceiling on the staff level could impair the Authority's ability to handle cartel enforcement and the responsibilities that could follow from the EU's modernisation programme.

Table 14. **Competition Agency resources, 2001**

	Staff	Budget[1]
Australia	540	62.4
Canada	383	30.8
France	380	20.2
Germany	225	17.8
Italy	180	24.9
Japan	607	39.4
Korea	416	34.5
Mexico	195	9.7
Netherlands[2]	255	28.9
Poland	188	6.2
Spain	100	6.2
Turkey	318	24.0
United Kingdom	232	34.5
United States	1 165	160.0
European Union	570	

1. US$ millions, PPP.
2. 2002.
Source: OECD.

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Key features of the competition legislation framework

Substantive law

In principle, Italy has adopted the European legal framework of prohibition, notification, and exemption, but in practice the Authority has focused on enforcement marked by an emphasis on economic analysis of causes and effects. P*er se* prohibitions, obviating economic assessment of the particular case, are generally limited to horizontal cartels. Vertical restraints are subject to a rule of reason approach, and the requirement that a restraint have an "appreciable" impact is in Italy's statute.[54] Indeed, even resale price maintenance does not appear to be treated as *per se* illegal. In general, there have been comparatively few cases about vertical restraints. Unless they are part of an industry-wide pattern with horizontal effects, vertical restraints are usually of interest only if they involve an abuse of dominance. Hence, Italy applies a market power screen regarding vertical restraints, and it does so more explicitly than the EU's treatment of vertical restraints.

In its application of merger control, Italy's practice contrasts with that of its neighbours. Decisions are based on the competition issues, and other policies are not considered. A never-used provision of the Competition Act (Sec. 25.1) could permit balancing competition considerations against other national interests, but the regulations needed for the Authority to do so have not been promulgated. As mentioned above, the Authority also combines its antitrust duties with responsibilities for advertising and unfair competition that arise under different legislation.[55] The rules concerning deceptive and comparative advertising follow from EU directives that have been enacted into Italian law. These matters represent a large part of the Authority's workload, measured by the number of actions – several hundred per year – if not by resources employed. In 2001 the Authority was given some role in claims about the abuse of "economic dependence", such as refusal to deal, burdensome or discriminatory contract conditions, and termination of trading relations. The Authority may authorise Competition Act sanctions against abuse of economic dependence where this conduct "is relevant to the protection of competition and the free market."[56] The breadth of its responsibilities underscores the concern that the Authority's staff is comparatively small.

Coverage

The Competition Act promotes competition as a general, horizontal principle, with virtually no explicit exclusions. However, sectoral laws set special rules or limits based on market share in several areas, mostly involving the media and utilities sectors. While these may be aimed at competition-policy goals, such as eliminating or reducing dominant positions, they may dampen competition among the firms that remain, encouraging a comfortable oligopoly instead of

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rivalry amongst firms. Entities with ties to the state are fully subject to the Competition Act. Because many of them are traditional infrastructure monopolists whose markets have been opened to competition in recent years, and which have resisted competitive entry, they have been principal enforcement targets. In some areas other legislation or regulations create immunities or distortions inhibiting competition. The most important problems arise from local-level regulations constraining competitive entry, which are discussed in further detail below. In a test case that may set an important precedent for competition policy in Europe, the Authority has argued for an extension of EU treaty principles about competition to counter anti-competitive regulations.[57]

The banking sector is the only sector where enforcement is not under the jurisdiction of the Antitrust Authority. Banking is not exempt, but the Bank of Italy rather than the Authority enforces the Competition Act in this sector. This approach is a way of institutionalising the concern that system stability factors in banking are unusually important to the economy at large. It also allows for some benchmarking between the competition enforcement bodies, as the Authority comments on the Bank of Italy's initiatives and has enforcement power over other financial products such as insurance. However, such benchmarking could also be attained by other means, *i.e.* benchmarking at the European level. Price fixing and market sharing agreements tend to be the major antitrust problems in banking, and the Bank of Italy has been a comparatively active competition enforcer, tackling collusive agreements and abuses of dominant position. Still, the Bank of Italy's concern regarding financial stability may be taken into consideration when making antitrust decisions, possibly inhibiting the development of a more dynamic sector. For example, while there have been numerous mergers and acquisitions in the sector there have been no hostile take-overs. However, this is hardly conclusive evidence since hostile take-overs are extremely rare in the banking sector worldwide.

Enforcement

The courts in Italy are unusually important and active, both in reviewing and correcting the Authority and in providing an alternative outlet for complaints. Appeals from the Authority are taken to the Administrative Court and then to the Council of State. Thorough, effective judicial oversight is particularly important whenever an agency, like the Authority, combines the functions of initiation or prosecution and first-instance decision-making. The Authority's actions were often rejected at first – indeed, the Authority appeared to be treated more like a prosecutor or litigant than an independent decision-maker – but its record on appeal has improved over time. The review process had typically taken much too long, but recently adopted rules have accelerated it. Both stages of appeal can now be completed within about a year after the Authority's decision. This is substantially

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faster than the comparable process of appeal of European Commission decisions to the Court of First Instance and the European Court of Justice.[58] Italy's merger review timetable, which is now shorter than the EU deadline of 4 months, may be too fast to allow for a careful assessment of the competition issues involved.

The Authority currently does not have the power to grant interim relief pending final action. Some interim relief can be obtained from the courts, but only through a private lawsuit, to which the Antitrust Authority is not a party. Providing for interim relief power in conjunction with the Authority's enforcement of the Competition Act could be particularly significant in cases alleging abuse of dominance through denial of access to a network facility. The Authority has the power to order access after finding a violation. Giving it the power to order access provisionally, pending the final decision, could speed up the development of competitive markets. The revised EU competition enforcement regulation (Art. 8) gives the European Commission interim relief power. As the EU system moves toward decentralised application of common rules though national processes, consistency would support extending this power, in parallel, to the national competition enforcement body.

In Italy, private parties can bring independent suits in the civil courts, either for damages or, more importantly, for orders and interim relief to protect the party's interests. Since 1994, about 80 private suits have been reported under the Competition Act.[59] Filings peaked in the mid-1990s as parties were testing what could be done with the new law, falling off thereafter, as few complaints were successful. They have revived since 1999 (averaging around 11 cases per year) probably because complaints, building on experience and guidance, have focused more carefully on what the law can and cannot do. Most of the unsuccessful early actions involved ordinary commercial relationships, and the courts were probably leery of extending the new legal principles to such ordinary contract matters. Recent suits have sought access to infrastructure monopolies and challenged anti-competitive actions by public officials. If the Authority had the power to order interim relief, private actions for that purpose would decline, although the courts could presumably still intervene to correct abuses of that power.

Sanctions

To enforce compliance and deter violations, the principal sanction under the Competition Act is a financial penalty. There are no provisions for criminal penalties or for sanctions against individuals. So far, the Authority is not concerned that deterrence is weakened by the lack of penal or individual sanctions.[60] However, the threat of criminal penalties provides an important complement to financial penalties and may act as a stronger deterrent than financial penalties alone. The lack of individual sanctions may also pose particular problems in some areas such as professional services (see below). After amendments to the Competition Act in 2001,

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Italy's basic sanctions system, permitting fines of up to 10 per cent of overall turnover, is now generally comparable to that of the European Union and other European jurisdictions.[61] The Authority has been unusually aggressive. Even before the amendments that increased the potential fine, the Authority imposed the highest fines against horizontal price fixing of any national enforcer in Europe: €360 million against tying and information exchange in the insurance industry. The only competition enforcers to have imposed higher sanctions in such matters are the United States, the European Commission and Germany. And in a current case against airlines for strategically targeting new entrants, the Authority had imposed higher fines (which have, however, been annulled on appeal) than the European Commission and other national authorities in similar cases.

The Authority's powers of sanction, however, may be too limited for violations achieved *via* an association. Professional associations or self-regulatory bodies are often the means for reaching and implementing the most serious restrictive agreements. Evidence of such agreements often appears in the associations' activities. However, associations typically have little or no turnover on which to base a fine, so a sanction based on turnover would necessarily be small and therefore not an effective deterrent. Basing sanctions on the turnover of the associations' individual members, and making the members liable for the fines, would make the sanction fit the offence. Sanctions of this kind are provided for in several other jurisdictions that use the EU model. Though Italy does not have a formal leniency programme, the recent amendment that increased possible financial penalties also increased the Authority's sanctioning flexibility in the other direction by permitting it to impose a fine of zero (*i.e. de facto* leniency), even in the case of a serious violation. A clear and explicit leniency programme, to encourage conspirators to come forward with evidence, would be a valuable additional enforcement tool.[62]

Regulatory policies

Focusing on regulations that restrict competition and market mechanisms, OECD indicators of regulation show that in 1998 Italy's economy-wide regulatory environment and regulatory settings in the non-manufacturing (service) sectors was one of the most restrictive in the OECD area. Accounting for reforms undertaken during the 1998-2000 period shows that while Italy's market environment improved, its gap with respect to countries with the least restrictive environments (such as the United Kingdom, United States, Canada and Australia) remains large (Figure 22).[63] While the recent reforms provide a formal framework of competition, they do not always implement the structural changes and regulatory provisions that are needed for actual competitive pressures to arise (Nicoletti, 2002).

While Italy was a latecomer in opening up its network industries and introducing competition, it has embraced regulatory reforms and implemented many best practices. However, more recently, it seems that the pace of reforms is slow-

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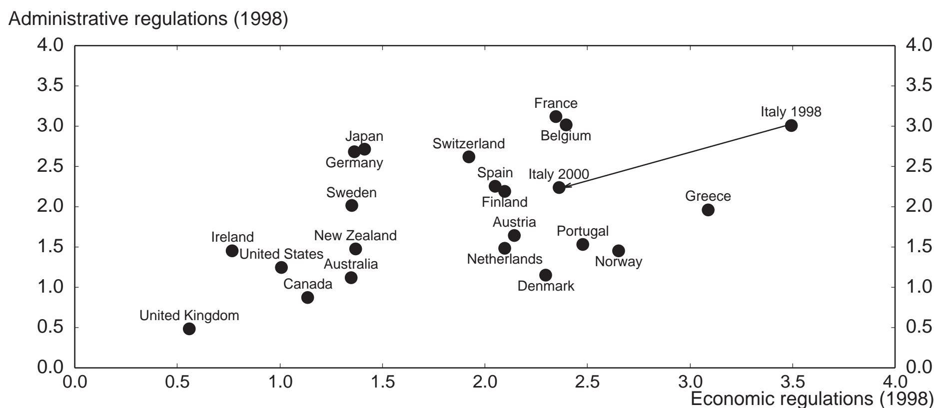
Figure 22. **Recent reforms in Italy, 1998-2000**[1]

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



1. The indicator for Italy in year 2000 is based on information provided by Italian authorities. It does not show if Italy has advanced relative to other OECD countries, who may also have implemented reforms during the 1998-2000 period.

Source: OECD (2001b); Nicoletti (2002).

ing and further privatisation also seems to be on hold. The introduction of *sportelli unici* or "one-stop-shops" aimed at reducing the administrative burden on enterprises does not seem to have introduced major advantages for existing companies. The administrative burden and red-tape associated with running a business in Italy are still high by international standards. However, the *sportelli unici* have significantly reduced waiting times for opening new businesses. In potentially competitive service industries, such as distribution and professional services, a satisfactorily competitive environment has yet to emerge even though these industries have been involved in reform processes for the past 3 to 5 years (Ministero dell'Economia e delle Finanze, 2001). National legislation is quite advanced but implementation at the local level is difficult because of the devolution process, requiring an adequate level of good regulatory practices at the regional level. Some regions and local authorities are beginning to introduce streamlined regulations.

Competitive industries

While retail distribution and professional services are inherently competitive sectors, regulation of entry conditions can impinge upon competition and result in higher prices and lower productivity. In comparison to other OECD coun-

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tries, Italy's distribution and professional services sectors are highly regulated and characterised by measures restricting market entry. In addition to direct entry barriers, restrictions are often imposed, for example, on the range of products to be sold, opening hours, advertising, prices and tariffs.

Retail distribution

While the retail distribution sector is considered to be conducive to strong competition, the sector benefits from economies of scale and scope. In many countries, this is manifest in the ongoing process of structural change involving larger retail outlets, consolidation into retail chains and greater concentration and vertical integration.[64] Regulatory easing in many countries (*e.g.* Japan) has reinforced these structural changes, involving the closing down of scale-inefficient outlets and improvements in productivity (OECD, 2002j). This has not, however, been the experience in Italy.

Compared to other OECD countries, Italy's retail distribution sector is characterised by a large number of small firms and low concentration. In food retailing, the combined market shares of the five largest retailers in Italy is 17.6 per cent, the lowest ratio in the EU, and considerably lower than the EU average of around 50 per cent (Figure 23). While market concentration increased somewhat during the 1990s, Italy's restructuring of the sector lagged behind that of Greece and Spain, countries that also had comparatively low market concentration at the beginning of the 1990s.

Other characteristics of the Italian retail sector include its comparatively high outlet density (only Portugal and Spain have higher density) with an average number of employees per enterprise that is the lowest in the EU (Table 15). This reflects the absence of medium and large retail outlets, which is also manifested by the comparatively low average surface area per 1 000 inhabitants. These features would not be of concern if sectoral performance were relatively good. However, it seems that the market structure of Italian retailing has had a notably negative impact upon performance in the sector. Productivity, both in the retail sector as a whole and in non-specialised large outlets, is the lowest in the EU and 20 to 30 per cent lower than the EU average. In addition, estimated mark-ups in wholesale and retail distribution in Italy are the highest for OECD countries for which data are available (Figure 24). The high mark-ups suggest a lack of effective competition in this sector in spite of the large number of firms.

The poor performance of the sector is likely to be the result of prevailing regulatory policies. Retail distribution in Italy has traditionally been subject to more extensive regulation than in other OECD countries and is hindered by numerous restrictions that do not seem to be motivated by any general interest (Boylaud, 2000). For example, entry in pharmacies is restricted by numerical limits that are established on the basis of very strict parameters[65] and beauty parlours

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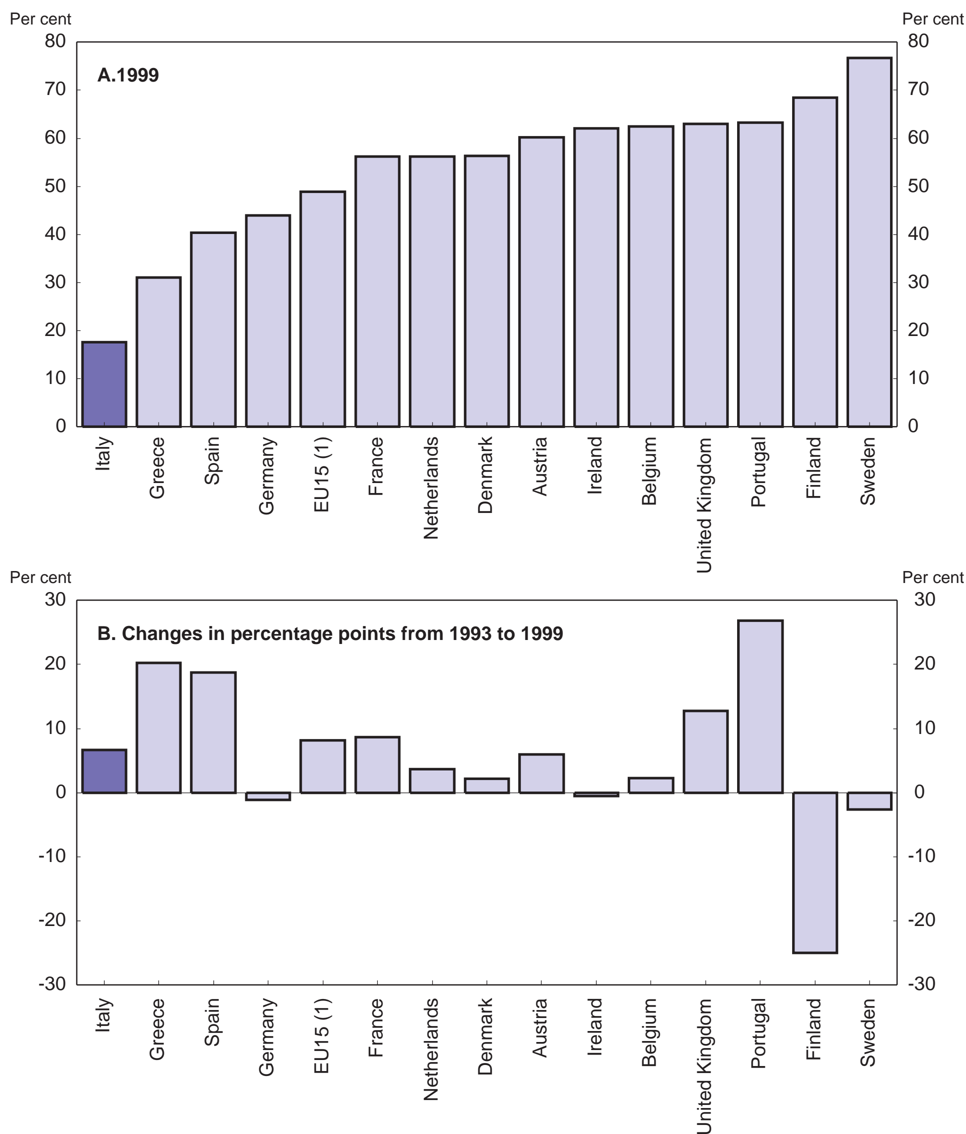
Figure 23. **Five-firm market concentration in grocery and daily goods retailing in EU countries**

1993-1999



1. Weighted average.

Source: Estimates based on data from Corporate Intelligence on Retailing's European Retail Handbook, reported in Dobson *et al.* (2001).

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Table 15. **Key structural features of the retail distribution sector, 2000**

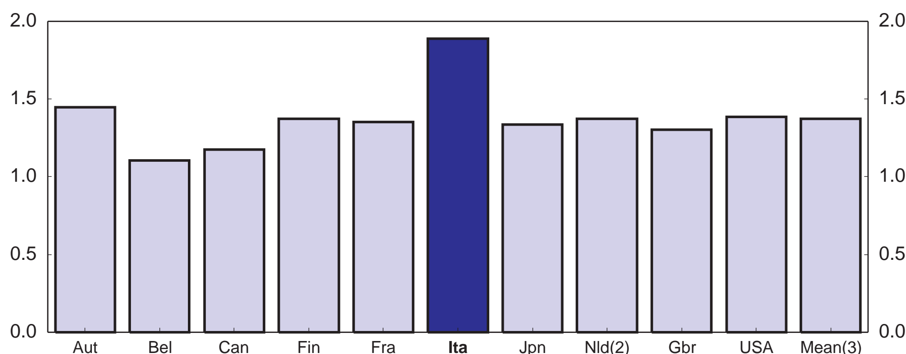
	Retail distribution, total				Non-specialised stores[3]			
	Outlet density[1]	Employees per enterprise	Value added per employed person[2]	Value added per unit of labour costs[2]	Value added per unit of labour costs[2]	Hypermarkets[4]	Supermarkets[4]	Free service[4,5]
Austria	43	7.7	108	98	86			
Belgium	80	3.5	109	95	96	47	148	236
Denmark	47	8.1	103	99	95			
Finland	46	5.0	132	110	108			
France	64	4.2	133	104	109	109	122	255
Germany	35	9.0	113	116	107	56	83	204
Ireland	36	9.3	95					
Italy	130	2.2	81	72	79	17	81	118
Netherlands	54	8.5	80	117		24	184	264
Portugal	150	2.5	44	81	98			
Spain	133	2.8	73	97	106	54	85	165
Sweden	65	4.3	130	88	89			
United Kingdom	36	14.2	99	123	127			
European Union	71	6.3	100	100	100			
Norway	68	6.0	112	98	100			
Switzerland	56	6.8	201					

1. Number of enterprises per 10 000 inhabitants.
2. EU = 100.
3. Includes large-format outlets such as hypermarkets and department stores.
4. Square meters per 1 000 inhabitants in 1999.
5. Free service areas are those outlets with size greater than 400 square meters.

Source: Eurostat, New Cronos.

Figure 24. **Mark-ups in wholesale and retail distribution in selected OECD countries**

1981 to the latest available year[1]



1. Austria, Finland and France: 1981-00, Netherlands and United States: 1981-99, Italy and Japan: 1981-98, Canada: 1981-97, Belgium: 1996-00 and United Kingdom: 1993-96.
2. Including restaurants and hotels.
3. Unweighted average of available countries.

Source: OECD.

cannot open within 250 meters of another beauty parlour. National legislation, *Legge* 114/1998, implemented in 1999, liberalised the opening, relocation and expansion of small sized outlets.[66] The 1998 reform also included the abolition of the system of commercial licenses for small retail business, and a notification to the local authority is now the only requirement for starting such a business. In spite of these reforms, Italy's retail sector is still subject to more extensive regulation than in many other OECD countries (Boylaud and Nicoletti, 2001). Implementation at the regional level has effectively entailed that new commercial establishments, rather than being subject to regulation on commercial activities, are now subject to regulations on urban planning. In practice this has meant that authorisation for medium and large outlets is required (and rarely granted) in order to integrate them into urban development plans, while the opening of small shops has been liberalised.

Regulations on large-scale outlets often aim at promoting non-economic objectives such as protection of the urban environment or to protect small shopkeepers. A recent study by ISAE (2002c), looking at the effects of the 1998 reforms, shows that efficient competition in the retail distribution sector has not emerged and that the devolution process is not consistent with competition objectives in this sector. The devolution of regulatory powers to the regional lev-

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els has been problematic for the liberalisation process in that local governments are even more susceptible than national government to blocking pressure by incumbent firms and other vested interests. In addition, the study finds that a multitude of regulatory constraints on pricing, entry and product or service quality persists, mainly imposed at the regional level. While there are very few restrictions left on small format shops, medium-sized shops still have their opening hours regulated, but often local authorities relax these limits. And entry for large formats has become almost impossible as local authorities rarely grant planning permission.

The observed trends in restructuring in Italy are of concern in that they are going in the opposite direction of the modernisation that has been emerging in other countries. During the 1990s, retail distribution in Italy witnessed more closures than openings. However, following the 1998 reform, there has been substantial growth with openings outnumbering exits. Entry has been almost exclusively confined to small format shops (Table 16). In 2001, small retailers accounted for 97.2 per cent of all entry, whereas medium and large formats accounted for 2.6 per cent and 0.2 per cent respectively. The mode of entry also differs significantly between small retailers and medium and large retailers. New openings accounted for around 80 per cent of entry by small retailers whereas takeovers accounted for only 20 per cent. Reflecting the fact that new openings are difficult for medium and large formats (due to difficulties in obtaining authorisation at the local level), they accounted for less than 40 per cent of entry, whereas entry by takeovers accounted for over 60 per cent. While in general entry or the easy possibility thereof is a good thing, entry by small retail shops does not intensify competition in this sector since these shops are unable to reap the advantages of economies of scale and scope required for effective competition to emerge (Dobson *et al.*, 2001).

Table 16. **Entry in retail distribution, 2001**
(broken down by dimension, as a percentage of total)

	Small	Medium	Large
Entry	97.2	2.6	0.2
Method of entry:			
mergers	0.0	0.8	0.0
new opening	79	36.6	37.4
take-over	21	62.6	62.6
Total	100	100	100

Source: Ministry for Productive Activities.

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Professional services

Professional services in Italy are subject to pervasive regulation, including the exclusive exercise of certain functions, entry and access requirements, minimum price determination, and restrictions on advertising and business structure. Barriers to entry in Italy also arise from mandatory membership in professional orders, quantity restrictions (*e.g.* the number of notary seats is fixed), and nationality or residency requirements. Restrictions on competitive practices such as price competition and advertising or nationality requirements do not explicitly address the issue of quality, and there is little empirical evidence to suggest that these restrictions improve consumer welfare. In practice these restrictions have been correlated with higher prices and less innovation, without improving quality and it appears that the principal beneficiary of such restrictions is the profession itself.[67]

Competition in the professional services sector in Italy is rather weak due to oversight by professional bodies. Such self-regulation can be in the interests of both consumers and the profession if it improves service quality and prevents market failure.[68] But it also raises concerns regarding independence and the effectiveness of such regulatory bodies since the risks of regulatory capture are high. The Italian professional services sector is characterised by active trade associations and very strong ties with political bodies, in which the interests of incumbents are often represented in national legislative bodies. For example, according to law, minimum fees for various services are set by a ministerial decree after hearing the recommendations of professional associations. Although in practice the Minister formally takes the final decision on fee level and structure, professional associations have been able to "impose" their proposals. In 1998, the Antitrust Authority found against two professional bodies for co-ordinating tariffs, but the decision was reversed on appeal, since the professional bodies have an obligation to fix a tariff according to the law. Given the extent and nature of state involvement and regulation in this sector, room for enforcement of competition law is therefore rather limited.

Several attempts have been made in recent years to deregulate the professional service sector in Italy. The system of market entry has been liberalised to some extent. The same is true for regulations on marketing and advertising, as well as for the system of fee setting. While the prohibition on advertising has been relaxed, restrictions still exist and the current codes provide guidance on the forms and mean that have to be respected. Regulatory reforms in the latter part of the 1990s also eased restrictions regarding business structure but they have not as yet been adopted, so that for the moment neither incorporation or limited liability partnerships nor inter-professional co-operation is possible. In spite of recent reforms, the overall regulatory system is still rather rigid.

Paterson *et al.* (2003), in a recent study for the European Commission, examine the differences in a host of regulations governing a range of professional

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services (accountancy, legal, architecturals, engineering, and pharmaceutical) across the EU member states. They differentiate between two different groups of regulations: regulations on market entry and those on market behaviour or conduct[69] and construct an overall index for the degree of regulation. Despite recent reforms, Italy is one of the few countries with a high degree of regulation in all professions, the only other countries being Austria and Luxembourg (Table 17). In pharmaceutical services Italy has the highest degree of regulation after Greece, and particularly restrictive market entry regulations in architectural and engineering services give rise to a comparatively high overall index. Italy also has a highly restrictive environment in legal and accountancy services due to regulations on entry and some of the most restrictive regulations on conduct in the European Union.

The authors find that countries with a high degree of regulation tend to have relatively higher turnover from fees, indicating higher mark-ups.[70] They also found a negative correlation between productivity and the degree of regulation, and no evidence that less restrictive regulation led to a lower quality of services. Their results support the view that restrictive regulatory frameworks, rather than supporting the needs and interests of consumers, are often used by the professions to obtain economic rents. Lastly, they found that countries with a low level of regulation have also witnessed a tendency of a market "shake-out", allowing the formation of larger enterprise units. In Italy, however, regulatory restrictions, par-

Table 17. **Regulation indices in professional services**[1]

	Accountants	Legal	Architects	Engineers	Pharmacists
Austria	6.2	7.3	5.1	5	7.3
Belgium	6.3	4.6	3.9	1.2	5.4
Denmark	2.8	3.0	0	0	5.9
Finland	3.5	0.3	1.4	1.3	7.0
France	5.8	6.6	3.1	0	7.3
Germany	6.1	6.5	4.5	7.4	5.7
Greece	5.1	9.5	n.a.	n.a.	8.9
Ireland	3.0	4.5	0	0	2.7
Italy	5.1	6.4	6.2	6.4	8.4
Luxembourg	5	6.6	5.3	5.3	7.9
Netherlands	4.5	3.9	0	1.5	3.0
Portugal	n.a.	5.7	2.8	n.a.	8.0
Spain	3.4	6.5	4.0	3.2	7.5
Sweden	3.3	2.4	0	0	12.0
United Kingdom	3.0	4.0	0	0	4.1

1. The higher the degree of regulation (intensity), the higher the respective figure (within a range from 0 to 12). All the regulation indices with a value of 5 or higher are shown in dark grey boxes, indices between 2.5 and 4.9 are in light grey boxes, and, those below 2.5 have a white background.
Source: Paterson *et al.* (2003).

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ticularly those on business structure, have hindered this restructuring process. The professional service sector in Italy is characterised by low concentration, and the recent trend has been towards even less concentration.

A number of proposals to reform professional services are currently being considered by the parliament. The proposed reforms include, in general, a relaxation of restrictions on advertising, on the choice of business structure so that professionals may set up a partnership, and mandatory indemnity insurance by professionals against the risks stemming from their activity. These proposals, particularly the one on mandatory insurance, indicate a trend towards more pro-active forms of consumer protection and quality management. However, the current proposals do not substantially change regulation of entry and only make minor improvements with regard to conduct regulation, *e.g.* minimum tariffs would still be set by the Minister on the basis of proposals where the views of professional associations are represented.

In the current regulatory setting, the role of professional associations enables incumbents to successfully hinder reforms aimed at relaxing entry restrictions and eliminating rent opportunities. In this respect, the role of self-regulatory bodies should be reduced and limited to evaluation of professionals' capacity. More importantly, the determination by law of minimum fees or recommended price schedules should be removed and restrictions on truthful advertising and on business structure should be eliminated. A problem in Italy is that regulatory changes take a very long time to be decided and, if they are decided, it takes even longer to implement them. For example, the 1997 reforms on business structure and inter-professional co-operation have yet to be implemented. This leads to a considerable lack of transparency and uncertainty, and it is unclear how a more dynamic market can evolve in such a situation. Legislation should permit a wide range of organisational solutions and ease the rigid rules on the incompatibility between professions, as these restrictions contribute to the perpetuation of a rather small-scale market structure that may be sub-optimal since economies of scale and scope remain unused. Given current trends in this sector in other countries, it is likely that in the long run, and where an increasingly internationalised market may emerge, the rather small-scale structure of some professional services sectors in Italy will not be competitive.

Network Industries

There is now a solid body of cross-country evidence that liberalisation policies in network industries have led to higher productivity, better quality and, often, lower prices.[71] However, capturing these benefits is not straightforward and close attention needs to be paid to the design of reforms (Gonenc *et al.*, 2001). Reflecting problems with market power that are inherent in these industries, about half of the Antitrust Authority's actions over the 1990-2001 period have dealt

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with the network sectors such as telecommunications, energy, and transport. This is consistent with a strategy of focusing on sectors or issues with the largest overall economic impact, as network sectors account for 18 per cent of GDP and for a large share of intermediate inputs.

Regulatory reforms in Italy have opened up these sectors to competition and the government has privatised previously state owned enterprises in electricity (ENEL), gas (ENI) and telecommunications (*Telecom Italia*). Privatisation plays an important role in eliminating possible conflicts of interest between regulators and the firms they are regulating. However, the government retains a controlling interest in electricity and gas and golden shares in both these industries and telecommunications.[72] Golden shares, by hindering the market for corporate control, strongly reduce the positive effects of privatisation and are a strong disincentive to investment. For these reasons, the European Commission has repeatedly called upon the Italian government to justify its golden shares.[73] A recently issued recommendation by the Privatisation Advisory Committee urged the government to reduce the breadth of golden share powers and to define more narrowly and transparently the requirements and the criteria by which such powers can be exercised. The Italian government recently sold its remaining stake of 3.46 per cent in *Telecom Italia* and confirmed its intention to reduce its holdings in ENEL, pending favourable market conditions. With the aim of reducing monopoly power, vertical restructuring has also taken place. However, full ownership (vertical) separation, which would eliminate the incentive for firms who own the network facility to engage in abusive exclusionary or discriminatory conduct, has as yet not taken place, though there are plans to do so.[74] The government is currently considering further reforms involving vertical separation and putting a limit on the shareholdings by ENEL and ENI in the network companies to 10 per cent within 3 years.

A recent amendment to the Competition Act gives the Antitrust Authority additional legal tools aimed at controlling abuse in these sectors by preventing anti-competitive cross-subsidisation. It requires legal separation between operations in competitive and non-competitive markets or services of general economic interest such as essential facilities. In addition, if owners of essential facilities supply goods or services to their own subsidiaries in different markets, then they must make those available to competitors on the same terms. The last rule, in particular, may lead to private suits and Antitrust Authority enforcement actions.

Telecommunications

Since the mid 1990s, the reform of the Italian regulatory framework in telecommunications has been driven by the implementation of the European Directives into national legislation. The communications regulator, *Autorità per le Garanzie nelle Comunicazioni* (AGCOM) was established in 1997 as an independent body responsible for implementation the regulatory framework. However, a lack of clarity

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in the assignment of regulatory tasks has necessitated coordination between the Ministry and the regulator (EC, 2002b).[75] The regulatory framework provides for a dispute/complaint procedure involving AGCOM and for AGCOM to act as a mediator between the parties. AGCOM's interventions have helped reduce the number of court cases with the incumbent, and where operators fail to comply with its decisions, AGCOM can impose penalties. While the responsibility for awarding licenses originally rested with AGCOM, in 2001 this task was given back to the Ministry of Communications. The government should consider giving this responsibility back to AGCOM as soon as possible.[76] However, a reform of the legislative framework that assigns new regulatory competencies to the Ministry is currently under discussion. Compared with other EU countries, AGCOM appears to be well staffed and funded. Its responsibilities include the communications sector, including the press, and not just telecommunications so that it is well positioned to deal with issues of convergence between broadcasting and telecommunications (Table 18).

The Italian regulatory regime in telecommunications is one of the most pro-competitive in OECD countries. The market is very dynamic and labour productivity growth over the 1990s has been relatively good. However, there is still considerable room for improvement, as prices in both fixed and mobile telephony and for internet access remain comparatively high (Figures 25 and 26). This is gradually changing as the pro-competitive regulatory framework has resulted in

Table 18. **Competencies and resources of telecommunications sector regulators, 2002**

	Licensing	Price controls/Access	Staff numbers	Budget (€ m)
Belgium	R	R/R	39	36.3
Denmark	M and R	R/R	236	29.8
Germany[1]	R	R/R	1 859	139.9
Greece	R	R/R	61	16.5
Spain	M and R	M and R	114	19.1
France	M	M/R	149	16.1
Ireland	R	R/R	102	23.6[2]
Italy	M	R/R	225[3]	44.5
Luxembourg	M	R/R	30[2]	3.5[1]
Netherlands	R	R/R	107[2,3]	13.3[2]
Austria	R	R/R	60	7.9
Portugal	R	R/R	396	78.6
Finland	M	R/R	249	28.0
Sweden	R	M and R/R	204	23.9
United Kingdom	M	R/R	236	27.9

Note: R-regulator responsible, M-ministry responsible.
1. The regulatory authority regulates both the telecommunications and postal services.
2. 2001.
3. Includes staff working on other matters than telecommunications (audio-visual, publishing etc.).
Source: EC (2002), Eighth Report on the Implementation of the Telecommunication Regulatory Package, Annex II.

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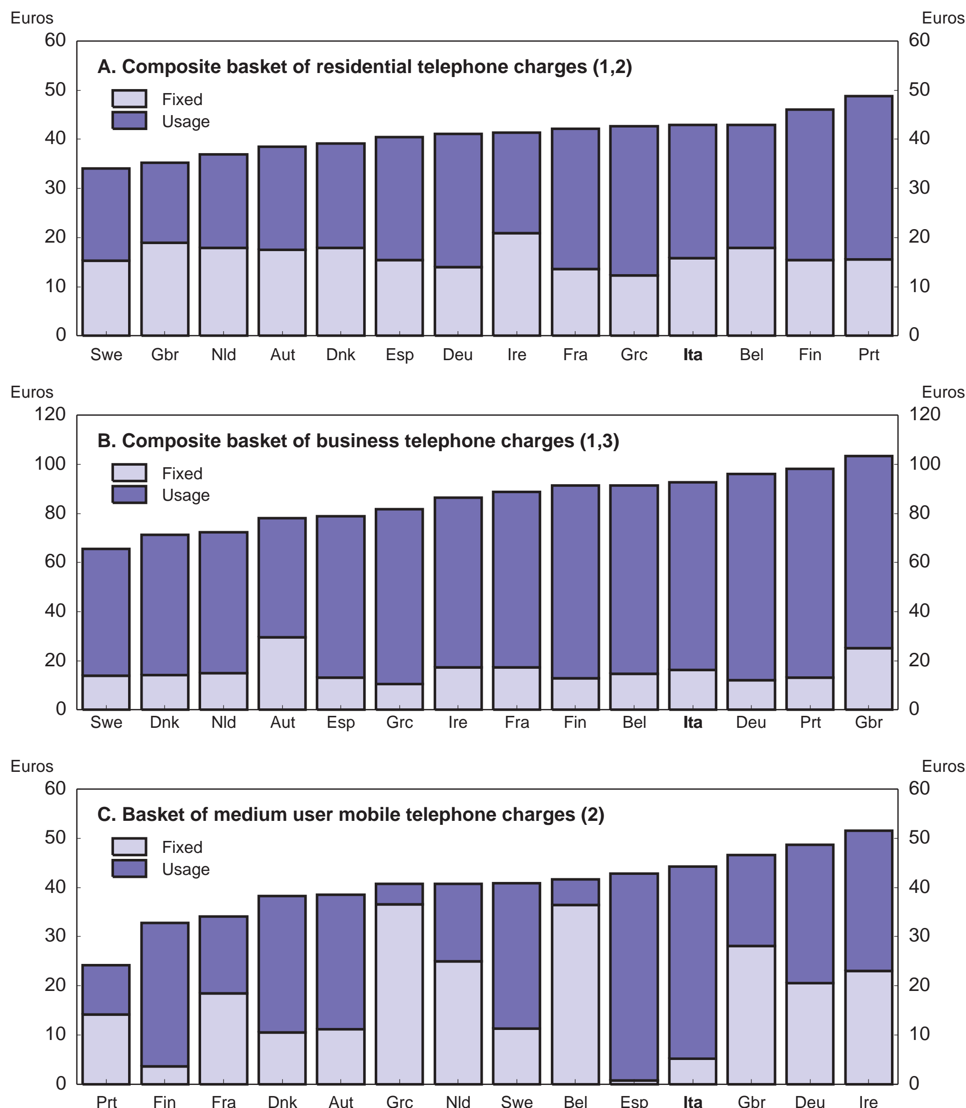
Figure 25. **Average monthly telephone charges**
August 2002



1. Composite basket includes international calls and calls to mobile networks.
2. Including tax.
3. Excluding VAT.

Source: OECD (2003), *Communications Outlook.*

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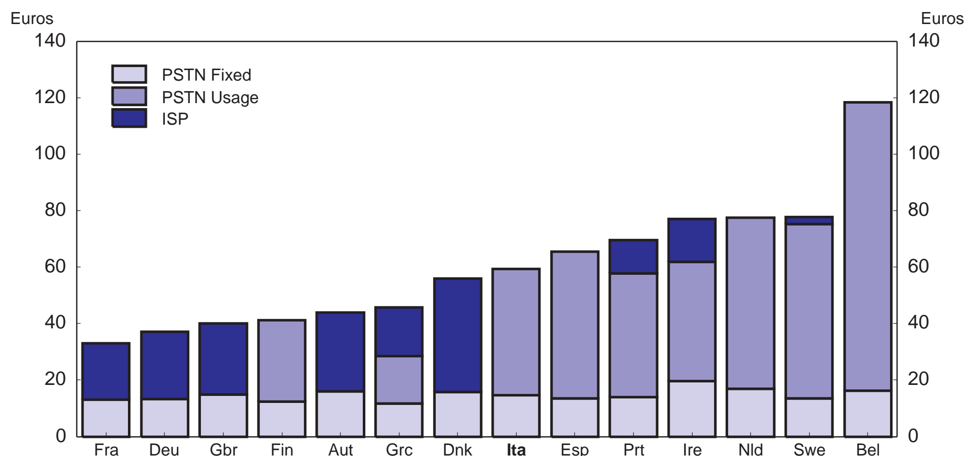
Figure 26. **Internet access basket**[1]
September 2002



1. For 40 hours at day-time discounted PSTN rates, including VAT.
Source: OECD (2003), *Communications Outlook.*

important benefits for consumers in both fixed and mobile telephony. The regulatory regime for retail tariffs is based on a price-cap system and has brought about a general reduction in average consumer expenditure.[77] Average fixed telephony tariffs in Italy have fallen by 44 per cent since 1998 and mobile telephony tariffs by 33 per cent since 1995 (AGCOM, 2002).

Other structural measures that have been taken in order to improve competition include the introduction of long-run incremental costs (LRIC) for determining interconnection charges (which have not been applied yet), carrier preselection (for local and long-distance calls, and for fixed to mobile calls), number portability for fixed numbers and local loop unbundling. Interconnection charges are important for determining the prices set by new entrants and are now below the EU average for all three levels of termination. This difference is particularly marked at the local level where reductions imposed by the regulator were designed to foster competition in this market segment (Figure 27). There has also been a notable fall in interconnection charges for call termination from fixed to mobile. Previously Italy had been one of the EU Member States with the highest mobile termination charges and is now around the EU average (EC 2002b).

Local loop unbundling has progressed significantly and Italy now has the second highest number of unbundled lines in the EU after Germany. Operators

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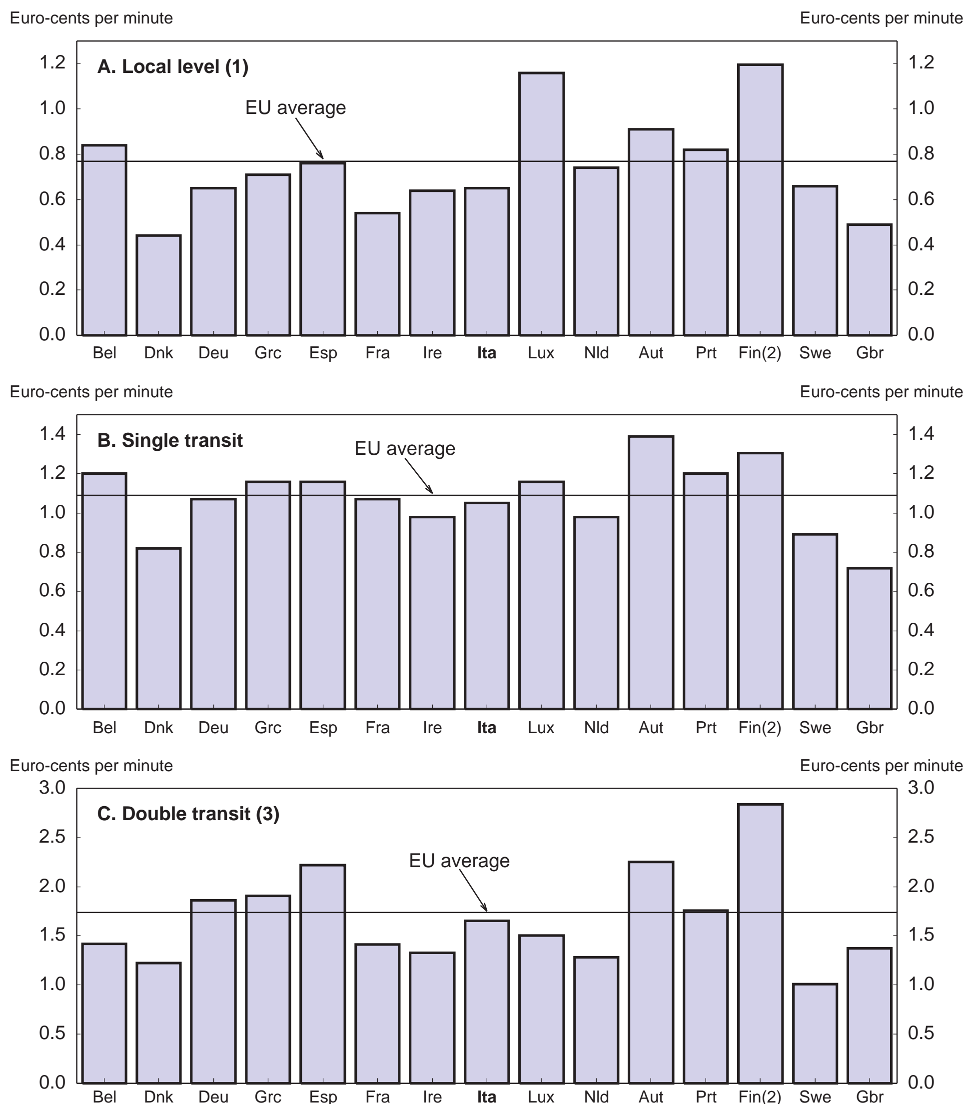
Figure 27. **Interconnection charges for call termination on fixed networks**

2002



1. In Luxembourg there is no distinction between local and long-distance domestic calls.
2. The charges refer to an unweighted average of the charges applied by the two major operators Sonera and Elisa.
3. Data for United Kingdom refers to a 100-200km connection length.

Source: EC (2002), *Eighth Report on the Implementation of the Telecommunications Regulatory Package*.

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identified with significant market power (SMP) must offer fully unbundled access, where the entire line is rented to a new entrant, as well as shared access, where the new entrant only rents the high frequency part suitable for high speed internet. SMP operators must publish a reference unbundling offer (RUO). The price of full unbundling has fallen in the past year to well below the level of the line rental for both residential and business customers. Italy now has the lowest price in the EU for shared access and the connection and monthly charges for the full unbundled loop are below the EU average (Table 19). These prices should encourage entry in local access and help competition to develop particularly in the market for high-speed internet access since 60 per cent of unbundled lines are used for the provision of DSL services. Italy's broadband growth has been quite slow and Italy's broadband penetration is the lowest among G7 countries, despite government incentives, because of the lack of alternate infrastructures in Italy, notably cable television networks.[78]

Despite these reforms, competition may be hindered to the extent that Telecom Italia has maintained a dominant position in all markets (Figure 28). Furthermore, Telecom Italia has actively obstructed competitors through both anti-competitive behaviour and legal action.[79] However, in 2001 entrants have started to erode its monopoly position thanks to the introduction of unbundled local loop. Charges for interconnection and the local loop set the terms for competitive

Table 19. **Prices for unbundled local loop, 2002**
Euro

	Full unbundling		Share access	
	monthly rental	connection	monthly rental	Connection
Belgium	13.3	79.9	3.2	86.5
Denmark	8.3	45.4	4.1	178.4
Germany	12.5	70.6	4.8	74.9
Greece	11.5	123.4	6.9	141.9
Spain	12.6	20.0	4.8	27.0
France	10.5	78.7	2.9	78.7
Ireland	16.8	121.5	9.0	123.4
Italy	11.1	91.4	2.8	81.0
Luxembourg	15.8	185.6	7.5	196.2
Netherlands	13.5	79.0	5.6	89.2
Austria	10.9	54.5	5.5	109.0
Portugal	13.8	82.9	7.9	173.8
Finland	14.7	216.0	7.0	160.0
Sweden	11.3	165.2	5.4	118.0
United Kingdom	16.2	140.3	7.0	186.5
EU average	12.8	103.6	5.6	121.6

Source: EC (2002), *Eighth Report on the implementation of the Telecommunication Regulatory Package*, Annex I.

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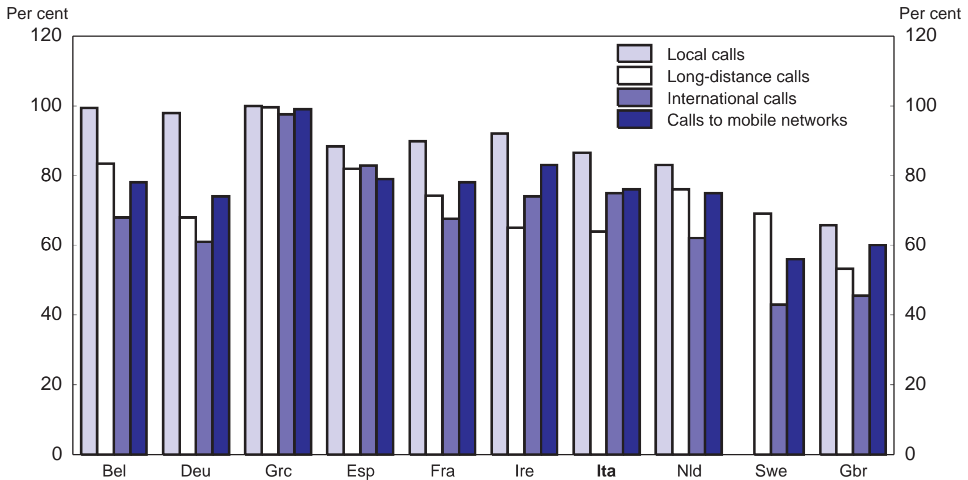
Figure 28. **Estimates of incumbent operators' market share, 2001**
Retail revenue



Source: EC (2002), *Eighth Report on the Implementation of the Telecommunications Regulatory Package*.

tariff offers by new entrants. The low level of tariffs set for these intermediate services should encourage entry and result in further reductions in the final prices that consumers and businesses face in both fixed and mobile telephony and for internet access. Indeed, over 40 per cent of subscribers now use an alternative provider to Telecom Italia for local calls and over 50 per cent for long-distance and international calls (EC, 2002b).

Energy sector

Significant progress has been made in liberalising, restructuring and privatising the energy sector. These reforms have contributed to the comparatively high productivity performance in this sector, especially in the second half of the 1990s (Table 9). Both the EU Electricity and Gas Directives have been transposed into Italian law and considerable progress has been made in opening up these sectors to competition. However, in spite of the legislative decrees that Italy has passed to liberalise the energy sector and to implement the EU Directives, effective competition in these markets still has to be established. A legal framework alone does not bring about effective competition.

An independent regulatory authority for electricity and gas (*Autorità per l'Energia Elettrica e il Gas*, AEEG) was formally established in 1995, and began oper-

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ating in 1997. Its regulatory powers include the setting of tariffs (including network access tariffs), service quality standards, implementing unbundling obligations and conditions governing access and interconnections to the network. In general, the AEEG has enjoyed a high degree of autonomy from the government. The AEEG can employ up to 120 employees and in December 2000 a law was passed providing the AEEG with up to 30 additional staff to cope with the extra duties associated with implementing the EU Directives. The Energy Authority is funded through annual contributions paid by the service providers and, compared to other EU countries, seems to be well funded (Table 20).[80]

Reflecting an industrial structure of primarily small firms with low energy intensity, and imports of many goods whose production is energy intensive, Italy has one of the lowest energy intensities in the world, and less than half the OECD average (OECD, 2002e). It is also the result of past energy efficiency efforts. In the gas sector prices are around the EU average whereas electricity prices in Italy are generally higher than in other EU countries (Table 21). While in part this is due to a lack of competition, it is also the result of past decisions regarding the development of the sector. Strong environmental opposition to coal and nuclear power has led to high costs due to the structure of generation (*i.e.* mostly oil). Energy prices in Italy are also generally higher than in the rest of OECD Europe due to the relatively high level of taxes compared with other countries.[81] While reforms in these sectors are still too recent to evaluate, they seem to be producing some result as electricity and gas prices have fallen in the past year (Figure 29).

Table 20. **Competencies and resources of energy sector regulators**

	Network access conditions	Dispute settlement	Staff number	Annual budget 2002 (€m)
Austria	R(elec)/R (gas)	R/R	45	9
Belgium	R/R	R/R	68	15
Denmark	R/R	R/R	30	3
Finland	R/R	R/R	15	1
France	R/R	R/n.a.	80	9
Germany	N/N	C/C	n.a.	n.a.
Greece	M/n.a.	R/n.a.	43	4
Ireland	R/R	R/R	31	6
Italy	R/R	R/R	86	18
Luxembourg	M and R	R/R	2	n.a.
Netherlands	R/H	C/C	55	6
Portugal	R/n.a.	R/n.a.	52	7
Spain	M/M	R/R	153	19
Sweden	R/R	R/R	33	3
United Kingdom	R/R	R/R	330	58

Note: R – regulator responsible, M – ministry responsible, C – competition authority, N – not regulated, H – hybrid, n.a. – no regulator.
Source: EC (2002*c*).

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Table 21. **Electricity and gas retail prices**

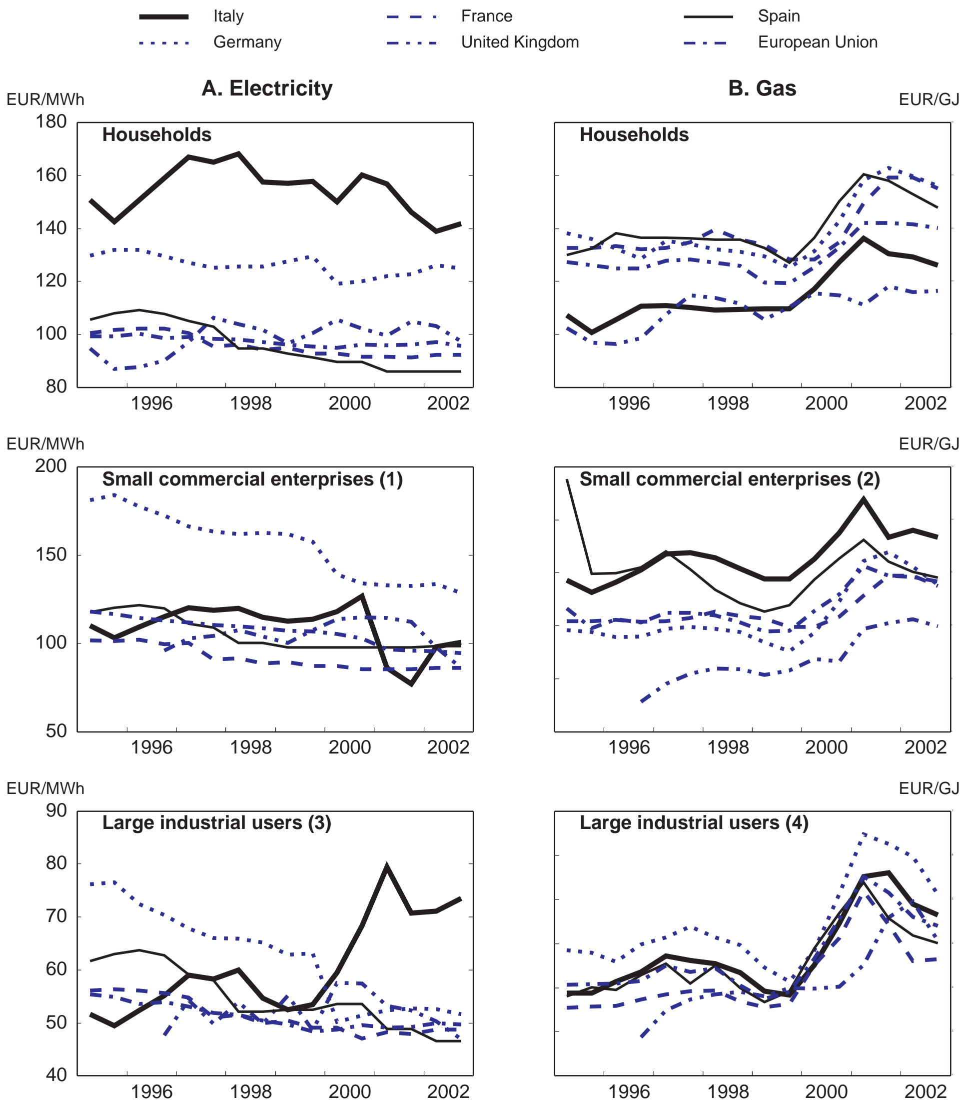
2002h2

	Electricity (euros/MWh)			Gas (euros/GJ)		
	Households	Industry		Households	Industry	
		Large industrial users[1]	Small commercial enterprises[2]		Large industrial users[3]	Small commercial enterprises[4]
Austria	93.1	59.8[5]	96.5	11.6	4.8	8.1
Belgium	111.1	58.1	129.9	13.8	4.3	7.4
Denmark	84.4	43.3	66.6	8.1	4.3	8.1
Finland	70.2	36.5	56.6	nd	4.4	nd
France	92.3	48.7	86.1	13.5	3.7	7.5
Germany	124.9	51.7	128.6	13.6	5.1	7.5
Greece	58.0	50.0	87.0	nd	nd	nd
Ireland	88.3	64.8	127.4	14.4	4.6	7.1
Italy	141.8	73.5	100.6	10.6	4.6	9.3
Luxembourg	115.1	38.3	121.7	11.6	5.4	6.5
Netherlands	98.2	48.5[6]	106.4[7]	9.9	2.8[8]	6.1[7]
Portugal	122.3	55.6	99.9	15.0	4.4	9.6
Spain	85.9	46.6	98.6	12.8	4.0	7.8
Sweden	68.8	25.8	35.7	11.6	3.5	7.1
United Kingdom	97.4	47.0	86.1	9.6	4.1	6.0
European Union[9]	96.8	49.9	95.2	12.0	4.3	7.5

1. Eurostat category Ig (Annual consumption: 24000 MWh).
2. Eurostat category Ib (Annual consumption: 50 MWh).
3. Eurostat category I4-1 (Annual consumption: 418600 GJ).
4. Eurostat category I1 (Annual consumption: 418.6 GJ).
5. 1999h1.
6. 1999h2.
7. 2001h2.
8. 2000h1.
9. Unweighted average.

Source: Eurostat.

Figure 29. **Prices of electricity and gas, 1995-2002**



1. Eurostat category Ib (Annual consumption: 50 MWh).
2. Eurostat category I1 (Annual consumption: 418.6 GJ).
3. Eurostat category Ig (Annual consumption: 24000 MWh).
4. Eurostat category I4-1 (Annual consumption: 418600 GJ).

Source: Eurostat.

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Compared with other European countries, Italy has done rather well in implementing the electricity Directive and introducing competition (Table 22). Electricity generation, transmission and distribution are separate legal entities under common ownership. In addition to legal unbundling of transmission, a transmission system operator (*Gestore Rete Trasmissione Nazionale*, GRTN) was established in 2000 as a state-owned company. Although ENEL still owns the transmission assets, the GRTN is independent and has control over the use, maintenance and development of the transmission system. It even has the authority to build new lines and, due to continued delays on the part of ENEL, has chosen this strategy with respect to an interconnection line with Switzerland. The parliament is currently discussing a comprehensive energy sector reform (the "Marzano decree"), including plans for the reunification of the transmission ownership and management under a single (separate) company to be listed on the stock exchange.[82] Other measures in the upcoming energy sector reform include *i*) a more market-oriented tariff regime for access to the electricity transmission grid, *ii*) an acceleration of demand-side electricity liberalisation, *iii*) streamlined decision making procedures for investments in the energy networks, *iv*) strengthened incentives for projects in interconnection capacity in electricity, and *v*) a clearer definition of local authorities' powers and responsibilities regarding permission for new energy projects. While these are steps in the right direction, the government also needs to proceed quickly with the introduction of an electricity exchange market. Its launch has been delayed for some time because of concerns regarding incumbents' abilities to act strategically. It is envisaged that ENEL will sell an additional 15GW of capacity, thereby reducing its influence on pool prices. The launch of the pool is now envisaged for the latter part of 2003.[83]

Wholesale market concentration in electricity remains an issue in most Member states with Italy being one of the few countries where progress has been made recently. Competition in generation is slowly emerging and ENEL recently divested itself of an additional 15GW of generation capacity. Cross country comparisons of three firm concentration ratios show that Italy's electricity generation market is less concentrated than that of other European countries. However, the Herfindahl-Hirschman index (HHI) for generation is higher than most European countries, reflecting the unequal distribution of market shares.[84] Paradoxically, the Decree implementing the EU Gas Directive (see below) may have more immediate effects on competition in the electricity generation market by providing an incentive for ENI to expand its use of gas in electricity. The introduction of competition in generation, and divestiture of some the distribution grid in the larger municipalities, has also led to the progressive increase in customer switching, with over 50 per cent of large industrial users switching suppliers. As a result, ENEL group's total sales declined by 8 per cent between 2001 and 2002 (AEEG, 2002).

The Decree implementing the EU Gas Directive is in many important respects more pro-competitive than the minimum requirements of the EU Gas Directive (Table 23). Despite this, the development of a competitive market is still

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Table 22. **Electricity market indicators and implementation of the EU Directive, 2002**[1]

	Date of full opening of demand	Unbundling		Large users switching Suppliers[4]	Concentration (CR3)		Concentration HHI[5]	Potential competition from imports[6]	Network access charge[7]	
		Transmission[3]	Distribution[3]		Generation	Retail sales			Medium voltage	Low voltage
Austria	2001	L	A	20-30%	45	67	2 028	21	20	65
Belgium	2003	L	L	2-5%	96	53	6 118	25	15	n.a.
Denmark	2003	L	L	n.a.	78	38	4 018	39	15	25
Finland	1997	O	M	n.a.	45	33	2 472	22	15	35
France	–	M	A	10-20%	92	90	9 606	12	15	50
Germany	1999	L	A	20-30%	64	50	1 756	11	25	55
Greece	–	L	A	0%	97	100	10 000	12	15	n.a.
Ireland	2005	L	M	10-20%	97	90	9 418	7	10	40
Italy[2]	2004	L	L	>50%	69	72	5 560	14	10	n.a.
Luxembourg	–	M	A	10-20%	n.a.	100	8 158	100	20	n.a.
Netherlands	2003	O	M	20-30%	59	48	1 814	19	10	35
Portugal	2003	L	A	5-10%	82	99	4 008	30	15	n.a.
Spain	2003	O	L	10-20%	83	94	2 466	4	15	45
Sweden	1998	O	L	n.a.	90	47	2 538	29	10	40
United Kingdom	1998	O	L	>50%	36	42	1 044	3	n.a.	40

1. The information refers to 2002, except for concentration measures, 2000.
2. The market opening in 2004 concerns non-household customers only.
3. Unbundling concerning operators. A = Accounting, L = Legal, M = Management and O = Ownership.
4. Switching estimates for the period 1998-2001.
5. HHI in electricity generation. A market is generally considered competitive with a HHI<1000; moderately concentrated with 1000 < HHI <1800; and highly concentrated with a HHI > 1800.
6. Per cent of domestic generating capacity.
7. Estimated average charge, €/MWh.

Source: EC (2002*c*), AEEG (2002).

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Table 23. **Gas market indicators and implementation of the EU Gas Directive, 2002**[1]

	Date of full opening of demand	Unbundling		Large users switching Suppliers[3]	Concentration		Gas release programme	Network access charges
		Transmission[2]	Distribution[2]		% of available gas (CR1)	HHI[4]		Large users (€/mwh)[5]
Austria	2002	L	L	<2%	80	7 598	NO	n.a.
Belgium	2003	L	L	n.a	n.a.	10 000	NO	1.0 – 2.0
Denmark	2004	L	L	2-5%	90	2 841	NO	2.5
France	–	A	A	20-30%	90	5 932	NO	2.0 – 5.0
Germany	2000	A	A	<2%	54	2 405	Planned	2.0 – 7.5
Ireland	2005	M	M	20-30%	n.a.	5 883	NO	1.5 – 2.5
Italy	2003	L	L	10-20%	75	4 916	YES	2.0 – 4.0
Luxembourg	–	A	A	5-10%	100	10 000	NO	1.0 – 1.0
Netherlands	2003	M	A	30-50%	80	2 634	NO	0.5 – 1.0
Spain	2003	O	L	20-30%	57	9 761	YES	2.0 – 2.5
Sweden	2006	A	A	<2%	100	10 000	NO	3.5
United Kingdom	1998	O	O	>50%	50	894	YES	1.5 -3.0

1. The information refers to 2002, except for the concentration measures (2000).
2. Unbundling concerning operators. A = Accounting, L = Legal, M = Management and O = Ownership.
3. Switching estimates for the period 1998-2001.
4. A market is generally considered competitive with a HHI<1000; moderately concentrated with 1000 < HHI <1800; and highly concentrated with a HHI > 1800.
5. Estimated range, rounded to the nearest €0.5/mwh.

Source: EC (2002*c*), AEEG (2002).

far off. One requirement for competition to emerge is non-discriminatory access to the network at competitive prices. However, unlike electricity, the gas transmission network is both owned and controlled by a subsidiary of ENI. Network access charges still tend to be on the high side as compared to other European countries, possibly indicating the need for stronger regulatory oversight and unbundling between transmission and distribution networks (EC, 2002c).[85] The other requirement for competition is ending the monopoly on the import and sale of gas. Recently the Antitrust Authority found ENI S.p.A. was abusing its dominant position and required the company to upgrade its transportation network. The ENI group also owns 98 per cent of storage facilities.[86] Access to storage facilities is key for effective competition against ENI to emerge and vertical separation would be highly desirable. Failing this, at a minimum, legal separation of storage is needed. While the gas market for final consumers has been completely liberalised, in many instances there is still only one firm to "choose" from, especially at the local level where many markets continue to be supplied by only one firm. Public tendering for gas distribution, also foreseen in the Legislative Decree, will not begin before 2005. Furthermore, the devolution of powers to local authorities will push the ending of monopoly provision by incumbent operators even further into the future (AEEG, 2002).

The Italian government has tended to focus on concentration on the domestic supply side, with obligatory divestiture of electricity generation capacity and ceilings on the market shares for gas.[87] However, electricity and gas markets in Italy are to some extent cut off from the other European markets, and insufficient attention has been paid to potential competition from abroad *e.g.* reducing ENI's controls over gas interconnections and increasing interconnection capacity in electricity (though the latter will be partially addressed by the Marzano decree). In addition, devolution of powers to local authorities has created particular problems for the energy sector, as this has introduced uncertainty regarding permission for new energy projects, slowing down the pace of investment in infrastructure (IEA, 2003). This has happened in spite of the "*sblocca centrali*" decree introduced in 2002 to streamline the decision making process for energy projects through an accelerated 180-day procedure.

Independence of regulatory authorities

Experience from OECD countries shows that independence of regulators reduces uncertainty and enhances performance (Gonenc *et al.*, 2001; OECD, 2002i). Though Italy was quite advanced as compared to other European countries when it created its regulatory bodies, there are currently some tensions regarding the role and independence of the regulators. More recently, the powers of the sectoral regulators have been clawed back somewhat. For example, the power to issue licences has been taken away from the Communications regulator and transferred

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back to the Communications Ministry. In the electricity sector, the introduction of a wholesale pool has been delayed and in 2002, the government blocked a decision by the electricity regulator to increase electricity prices, citing concerns over inflation. The government now has the over-riding authority to approve tariffs. In addition, while the gas sector is regulated by the AEEG, overall policy regarding the sector is set by the Ministry of Industry.[88] The government is currently reviewing the role of regulatory authorities in general and a reform of the legislative framework that assigns new regulatory competencies to the Ministries is currently under discussion. Government intervention in the regulators' decisions creates uncertainty and is a step in the wrong direction.

Summary and recommendations

Product market competition increased in the past decade thanks to a sustained programme of privatisation, market opening, and deregulation followed by appropriate re-regulation and institution building. Despite liberalisation, important product market regulations still exist and, in combination with strict labour market regulations, may hinder the development of firms and reduce growth potential. There is considerable scope for further improvement and raising growth will depend critically on removing barriers to entry and distortions to competition. Reducing regulatory complexity, administrative burdens and red-tape would lift major impediments to firm entry and growth, innovative activity and foreign direct investment. While there are no general exemptions to Italy's Competition Act, anti-competitive conduct is often authorised or required by other laws or government regulations. Implementation of many reforms is hampered in some areas by the fact that local authorities, who have substantial regulatory powers, are more exposed to the pressure of established local businesses that stand to lose from greater competition. Box 4 provides a summary of recommendations that follows from the findings presented in this chapter.

The Antitrust Authority has been active in competition advocacy and enforcement. However, it lacks some of the enforcement powers of antitrust regulators in other countries and needs to be given a wider range of sanctions including more effective sanctions against restraints through associations and against individuals. For example, some countries have applied criminal penalties in the case of hard-core cartels. Entry barriers remain substantial in the distribution and professional services sectors even though these sectors have undergone regulatory reform processes in the past few years. Further reforms in these sectors are particularly warranted given the poor performance of these sectors compared to other OECD countries. The decentralisation process has also hindered competition in retail distribution where a host of local regulations have prevented the opening of large retail outlets. And in professional services, recent reforms still allow for the involvement of professional associations in the tariff setting process.

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Box 4. Recommendations for increasing product market competition

Product market competition has increased in the past decade due to extensive privatisation, liberalisation and regulatory reform of network industries and local services, and the introduction and active enforcement of competition legislation. However, there is still much to do and, based on the analysis presented in the chapter, policy initiatives are needed to both ensure and increase competition in product markets.

Competition legislation and enforcement

While the Antitrust Authority has been an active advocate and enforcer of competition legislation there is scope for improvement. In particular:

- Aspects of the sanctions system should be strengthened. Providing for individual sanctions would improve enforcement in areas such as professional services. Where restraints are imposed *via* an association, the Authority should have the power to assess fines on their members themselves since the associations typically have no turnover to speak of.
- A clear and explicit leniency programme should be adopted to strengthen deterrence and enforcement, and criminal penalties against hard-core cartels should be considered.

Regulatory policies

Competitive industries

Regulatory reforms in distribution and professional services are particularly warranted given the poor performance of these sectors compared to other OECD countries. While there are no general exemptions to the Competition Act, other legislation or regulation often creates immunities or distortions inhibiting competition. In particular:

- Further deregulation of retail distribution is required to ensure effective competition. While regulatory reforms have led to a removal of restrictions on small shops, entry barriers and restrictions on the opening of large retail outlets need to be reduced.
- The devolution of regulatory powers to regional and local levels has been problematic for the liberalisation process. A greater effort is needed to ensure that the devolution strategy does not hinder competition in retail distribution. Better co-ordination of competition policy objectives across different levels of government is required.
- Regulatory reforms in professional services need to go further than current proposals if competition objectives are to be attained. The role of professional associations should be reduced and limited to evaluation of professionals' capacities.

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Box 4. Recommendations for increasing product market competition (*cont.*)

– The determination by law of minimum fees or recommended price schedules should be abolished.
– While restrictions on advertising have been eased in the past few years, the changes do not go far enough. While regulatory reforms easing restrictions on business structure were passed in 1997, they have yet to be implemented and should be executed forthwith.

Network industries

While great strides have been made in liberalising network industries, and many best practices have been implemented, obstacles to competition remain. Priorities in this area include:

– Continue with privatisation by selling the remaining government holdings in electricity and gas and eliminate the golden share in both these industries and telecoms.
– In all network industries more restructuring of the dominant firms and reduction in their market shares is needed. Create more competition in network industries through vertical separation. Vertical separation is desirable to ensure non-discriminatory access to essential facilities and the current use of legal separation may be insufficient, if not coupled with strong and independent regulatory oversight.
– In electricity, combine the ownership and control of transmission into a single entity, vertically separated from generation. In gas, vertical separation of storage facilities is desirable. Failing that, at a minimum legal separation should be undertaken.
– Proceed quickly with the introduction of an electricity pool.
– Ensure the independence of the sectoral regulators. Responsibility for licensing should be given back to the Communications regulator.

While incumbents retain dominant positions in network industries, and further restructuring is warranted, competition is slowly emerging as regulatory reforms have opened up these sectors to competition. The liberalisation of telecommunications in particular has been a success and the market is very dynamic. While electricity prices are comparatively high, this is due in part to strong environmental opposition to coal and nuclear power that has led to high costs in generation. Privatisation of network industries should be speeded up. The government retains a controlling interest in electricity and gas and still holds golden shares in both these industries and in telecommunications, despite

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repeated requests from the European Commission to justify these shares and, in some cases, to terminate them. More recently, the independence of the sectoral regulators seems to have been weakened somewhat. The power to issue licences has been taken away from the Communications regulator and transferred back to the Communications Ministry. The introduction of an electricity pool has been delayed and the government has also stepped in with respect to recent tariffs set by the energy regulator. These actions risk a backsliding on earlier competition progress and should be reversed. In particular, the independence of the regulatory authorities in issuing licenses and setting tariffs free of political influence has to be insured.

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IV. Structural reforms to raise growth and ease the fiscal burden

Introduction

Italy faces two major medium-term challenges at present: how to raise the underlying growth rate, and managing public finances so as to reduce high debt levels and keep the deficit under the 3 per cent of GDP Stability and Growth Pact obligation. These objectives do not conflict in the longer term: higher growth would both generate more tax revenue for given tax rates and automatically reduce the debt to GDP ratio more quickly. The main reforms to which the administration is committed in the fields of education, labour markets and tax are likely to have positive effects on growth, but implementing them will have significant up-front budgetary costs. It is therefore important that they be phased in over time, with priority being given at first to those aspects of the reforms that can be implemented with comparatively lower costs and that can provide higher returns in a relatively short time.

This chapter discusses recent and proposed reforms that could help lift Italy's potential growth rate, assessing them also in relation to the fiscal constraints. First, reforms designed to raise employment rates are discussed, followed by those reforms that could help raise labour productivity, leaving aside product market competition which is dealt with in Chapter III. Finally, reforms that have mainly fiscal implications are reviewed.

Raising employment rates

Labour market

Employment and unemployment

In the six-year period from 1996 to 2002, annual average employment growth exceeded 1 per cent compared with an annual average GDP growth of less than 2 per cent, an elasticity that compares favourably with other countries (Figure 30). Three reasons have been postulated for this relatively high elasticity of employment to growth.[89] *First*, the 1993 agreement between the government and the social partners led to a new round of incomes policy resulting in wage and price moderation compared with the past. *Second*, structural reforms, especially

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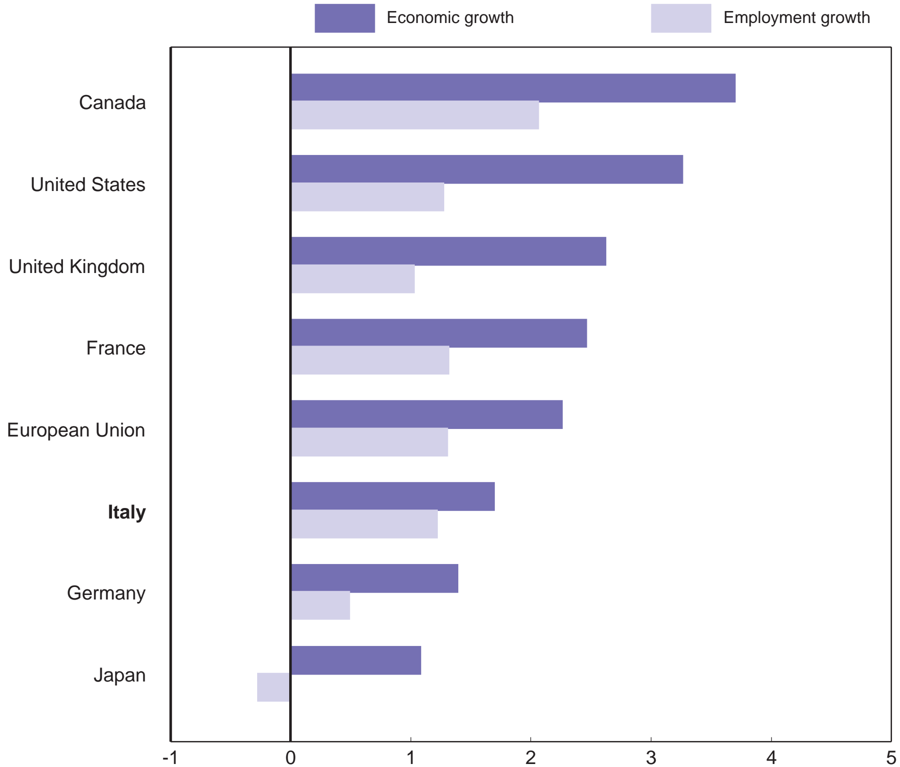
Figure 30. **Employment growth and GDP growth, 1996 to 2002**
Average annual rates



Source: OECD, Labour Force Statistics Database.

since the mid-nineties, lowered hiring costs and increased flexibility in the labour market. Reforms encouraged a process of labour deepening, which seems to have continued despite the current slowdown. *Finally*, from October 2000 to July 2002 the government granted generous tax credits to firms hiring workers on permanent contracts. The number of beneficiaries, including those who went from temporary to permanent contracts, was around 190 000 or 0.8 per cent of the labour force.[90]

Despite this, the Italian unemployment rate, at 9 per cent, was in 2002 still well above the OECD and EU averages (Table 24). Slightly less than two-thirds of total unemployment in 2001 was long-term, the highest proportion in any OECD

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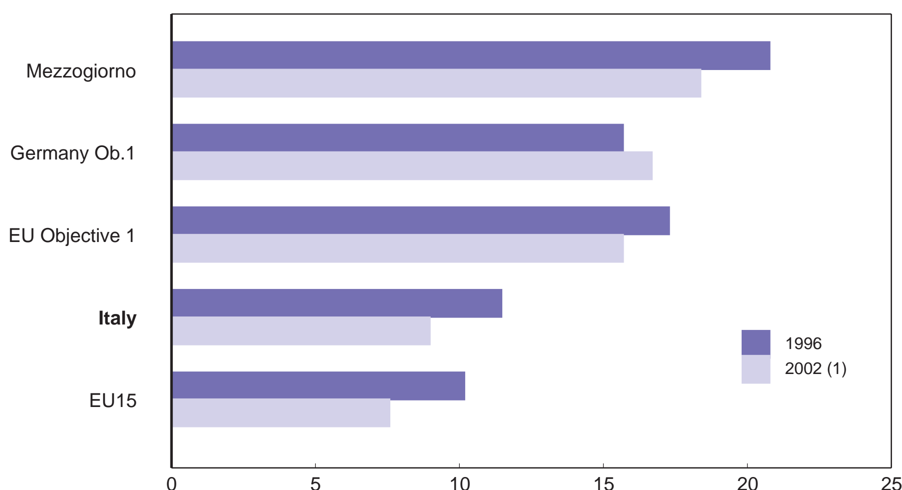
Table 24. **Labour market indicators, 2001**
(percentage values)

	Italy	EU	OECD
Unemployment rate[1]	9.0	7.6	6.9
Long-term unemployment[2]	63.4	43.7	27.5
Youth unemployment rate	27.0	13.9	12.4
Employment ratio – males aged 25-54[3]	81.7	86.8	87.5
Employment ratio – females aged 25-54[3]	49.5	66.0	63.9
Employment ratio of older workers (55-64)	28.0	38.6	48.4

1. Data refer to 2002.
2. As a percentage of total unemployment.
3. For Italy, the age range is 25-60.
Source: EUROSTAT and OECD.

country, and the youth unemployment rate was almost double that in the EU or the OECD. The employment ratio was still relatively low, especially for females and for older people (over 55 years of age). Despite higher employment growth in the South in the last few years, regional differences in the labour market remain marked. At the end of the 1990s, the unemployment rate in the *Mezzogiorno* was not only significantly higher than in the whole country but also 3½ percentage points higher than in the relatively poorer regions included in the Objective 1 programme of the EU (Figure 31). It is thus clear that the Italian labour market is

Figure 31. **Unemployment rates in selected areas, 1996-2002**



1. For Objective 1 areas, data refer to 1999.
Source: Eurostat , ISTAT.

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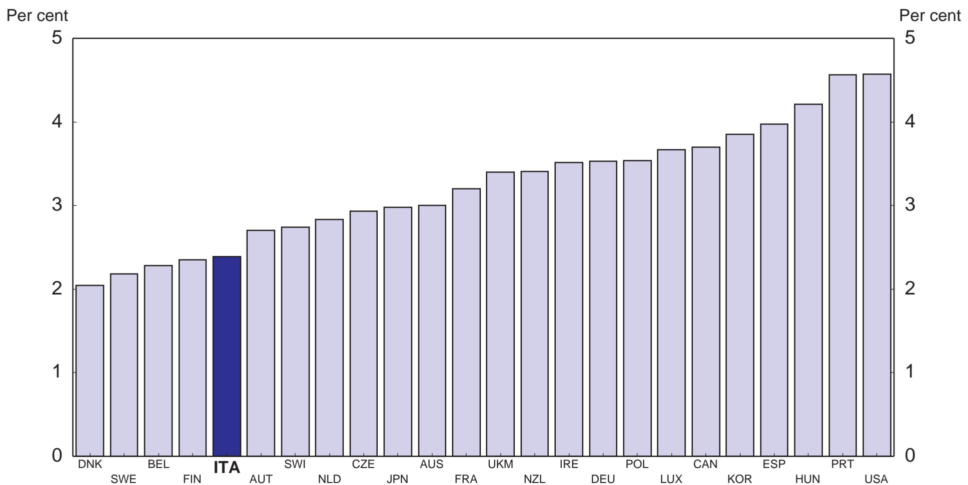
regionally segmented, with comparatively high employment rates and low unemployment rates in the North, and the reverse in the South.

Wage flexibility

Employment rates for marginal groups, and for those living in regions where productivity differs from the average, can be influenced by wage differentiation. But in Italy this is limited by a highly centralised bargaining system. In principle, the system is characterised by two layers: a national layer which sets wage developments in line with (national) inflation and a second, decentralised, layer that fixes wages according to firms' productivity. However, the system – as actually implemented – has a number of shortcomings: *a*) the wage set at national level represents a *de facto* minimum wage valid in the whole country; *b*) as a result, productivity adjustments can be implemented only above this minimum; and *c*) the second layer mainly applies to large firms. Therefore, earnings dispersion in Italy is very low and comparable only to that in Scandinavian countries (Figure 32) without sharing with these countries the same degree of bargaining centralisation and co-ordination. As applied in practice, therefore, the centralised wage setting system contributes to low real wage differentiation across the country despite the very different productivity and local labour market conditions, contributing to the

Figure 32. **Earnings dispersion in OECD countries, mid- to late 1990s**
Ratio of 9th decile earnings to 1st decile earnings for all full-time workers



Source: OECD (2001), *Society at a glance*.

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unemployment rate differentials between the North and the South.[91] It also acts as a barrier to geographical mobility as an equilibrating labour market mechanism.[92]

On top of this, despite some interventions to reduce social security contributions during the 1990s, the tax wedge on labour remains large (Figure 33). High taxes and contributions not only limit labour demand but might also provide an incentive for widespread household production, especially regarding the care of children and the elderly. Therefore, the high tax wedge coupled with the inadequate supply of care services by both the public and the private sector – together with some concern on their quality – contributes to low labour force participation by the second earner.[93]

Employment protection legislation

Italy is now equipped with a variety of contracts whose different degree of flexibility allows satisfactory matching between workers and firms, and low hiring costs for the latter.[94] For the most part, flexible contracts are an instrument used by new entrants, who often transfer to a more permanent position later on.[95] However, employment protection legislation (EPL) on permanent contracts has been only marginally relaxed in the past years, and remains one of the highest in the OECD, so that dismissal costs for these contracts remain high. Strict EPL might have more adverse effects on labour market outcomes in the South than in the North. IMF (2002a) stresses two reasons why this might continue to be the case: *a*) EPL rules seem to be applied more strictly in the South, because of the influence of higher unemployment rates on Courts' decisions; *b*) legal proceedings last longer in the South so that in case of wrongful dismissals, monetary compensation from firms to workers is higher (as compensation is proportional to the length of proceedings).

Active labour market policies

Active labour market policies have been significantly developed in the past few years. Public resources devoted to these policies increased during the second half of the 1990s and are now comparable to the spending in other EU countries.[96] Most of the financing is devoted to hiring subsidies that are automatic, and thus with large deadweight costs. On the contrary, the financing of adult training and the provision of services for disadvantaged groups are still negligible and not very effective. While the public support to youth seems to have contributed to higher employment for this category of workers, the capability to selectively help weaker groups, especially in the South, is still very limited.

The "Pact for Italy"

During 2002, the authorities took a number of initiatives to further improve labour market performance. In June, the government approved the

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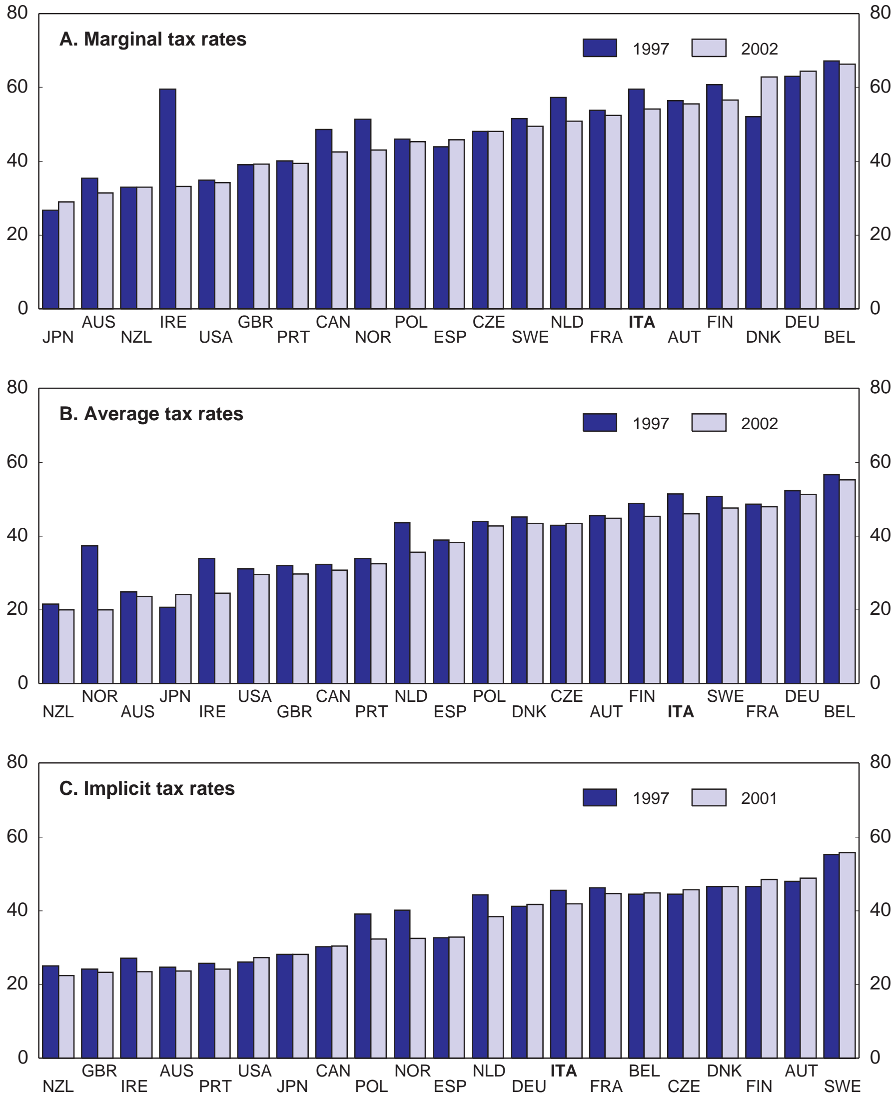
Figure 33. **Tax wedges on labour**[1]



1. For a single individual at the income level of the average production worker. Tax wedges are calculated by expressing the sum of personal income tax, employee plus employer social security contributions together with any payroll taxes as a percentage of labour cost. The effect of indirect taxes is not taken into account.

Source: OECD (2002), *Taxing Wages.*

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Employment National Action Plan and submitted it to the European Commission. It includes the goal of increasing the employment ratio by 4 percentage points by 2005, with more ambitious targets for older people and females (12 and 5 percentage points respectively). In July, the government and the social partners (with the exception of the largest trade union) agreed on a "Pact for Italy" (*Patto per l'Italia*). The overall objectives of the Pact are: *a*) building up a modern and efficient labour market; *b*) reducing the underground economy (see Chapter I); *c*) reinforcing education and training; *d*) reducing fiscal pressure, especially on low-income families so also boosting labour supply through a making-work-pay approach; and *e*) applying a supply side approach to the regional policies in the Mezzogiorno. To attain a more efficient labour market, the measures to be implemented are the restructuring of the public employment services (PES) and a greater opening of the services to the private sector, the relaxation of some individual dismissal procedures on an experimental basis coupled with the streamlining and strengthening of the unemployment benefit system, further flexibility in the use of part-time contracts, the introduction of new types of contracts ("job on call" and "staff leasing"[97]), and a reorganisation and better targeting of hiring subsidies.

PES are still moving towards greater regional and local decentralisation – a process that started 5 years ago. The regions in the South are generally lagging behind despite a relatively higher use of human resources.[98] The project of a nationwide electronic network system (*Sistema Informativo Lavoro*) connecting all regional and local public employment offices and aiming to simplify matching between firms and workers in different regions had lagged behind. Its implementation has recently been boosted and will evolve towards a system where private and public operators may cooperate in the dissemination of information while competing among each other. Indeed, it is the private placement system that had developed rapidly, contributing to a widespread use of temporary contracts.

The government approved measures in October 2002 reforming the functioning of the PES. The decree introduced deadlines for the PES on assisting and training dismissed people on a personal basis. Moreover, it specified the conditions under which the unemployed can take advantage of active and passive measures (including the obligation of accepting a training programme or a "fair" job offer if available), conditions which the PES has the obligation to monitor. Finally, the reform simplifies the administrative obligations for firms when hiring. Many details of the PES governance and behaviour have been entrusted to Regions so as to better shape them according to local needs. The openness to private operators and the activation role of the PES *vis-à-vis* the job-seekers have been ensured by nationally defined rules. Nonetheless, the resulting multilevel governance and the development of such a novel role for the Italian PES represent a challenge.

All the other measures on the labour market listed in the Pact are included in two framework laws, one of which was approved in February 2003 and

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the other still under discussion by the parliament. The approved law allows temporary work agencies to offer any type of job placement and employment services, including training, and envisages a more flexible regulation of part-time contracts, the introduction of other flexible contracts and the reform of the training-related temporary contracts. The other bill includes the lifting of the obligation for firms to re-hire a worker in case of wrongful dismissal for a "just cause" or a "justified reason",[99] substituting this obligation with a financial compensation. Such an obligation is currently applied only to firms with more than 15 workers. The lifting is implemented on an experimental basis by limiting the measure for a period of three years to small firms surpassing the limit of 15 employees. The experiment is intended to test whether its lifting actually leads to greater hiring by small firms. The same bill also contains provisions for the strengthening of unemployment benefits and an overall reorganisation of hiring subsidies.

Recommendations

The overall strategy envisaged in the Pact for Italy, when fully implemented, will represent a further step towards a better functioning labour market. The introduction of more flexibility in part-time contracts and the introduction of new types of contracts will provide more opportunities for firms and workers to enhance matching. To fully exploit the possibilities for higher participation, the government should also promote higher and better provision of care for children and other dependants, for example by introducing longer and more flexible hours for public institutions providing care and liberalising the working hours for the private ones.

The government's emphasis on an efficient placement system is appropriate. In the implementation of the PES' reform, authorities should give priority to the South where the need is higher but where current developments are less satisfactory. A system of premiums could be envisaged for the regions with quicker implementation of the reform and better quality of the services supplied. Furthermore, the implementation of the *Sistema Informativo Lavoro* – started five years ago – should be accelerated. The authorities should also make sure that the greater role given to the private sector on placement services does not conflict with the need for providing adequate services to all workers, especially the low-skilled.[100] This objective could be attained either by prioritising the work of the public employment agencies towards the low-skilled, including their training, or by granting to all employment agencies financial incentives linked to their capacity of job placement for the low-skilled, as is now the case in Australia, for example.

The experiment with the lifting of the obligation of re-hiring in case of wrongful dismissal received a great deal of attention in Italy during 2002. However, the results of the experiment will be difficult to judge for a number of reasons. *First*, most small firms have well under 15 workers. *Second*, there might be other

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reasons why firms decide not to expand, for example credit rationing (which is more common during a slowdown) or a tougher control on tax evasion (that would be welcome after the wave of tax amnesties introduced with the latest Budget law). Finally, the uncertainty surrounding the continuation of the programme after three years could *per se* represent a barrier for firms to take advantage of the temporary measure.

In any case, a more generalised approach should be envisaged for simplifying procedures on job protection legislation. An appropriately designed unemployment benefits system and dismissal compensations might help prevent costly and lengthy conflicts. More room should be given to the resolution of conflicts through bilateral agreements or through multilateral committees involving social partners, where cases can be resolved more quickly and with lower costs for both the firms and the workers. The role of the judicial system should be limited to cases that cannot be solved by means of simplified procedures.[101]

Finally, the government should promote greater wage differentiation by encouraging social partners to introduce a more flexible bargaining system, including in the public sector. This could be implemented also in the context of the current two-layer system introducing the possibility for the second layer wage component to adjust to productivity, both upward and downward. A more flexible bargaining system would lead to a stronger link between wages and productivity at regional levels with a positive impact on the reduction of differentials in the unemployment and employment rates. To avoid a polarisation of high skills only in the North, the government should support this policy with decisive efforts to improve public infrastructure and the provision of public services in the South.

More generally, however, both pervasive job protection legislation and low wage differentiation is encouraged by an unemployment benefit system and public employment services that fail to adequately insure all workers against temporary income loss, to re-train them, and help them to find a suitable job. Therefore, flanking measures for a more flexible labour market such as streamlining and reinforcing the tax/benefit system towards reducing income loss during unemployment, income inequality and poverty risk are required.

Unemployment risk insurance and the social safety net

During the 1990s, the proportion of people with relatively low incomes increased substantially in Italy compared with other OECD countries (Figure 34). Moreover, despite wage compression, income dispersion has been one of the highest among OECD countries, at around the level observed in the United States (Figure 35).[102] The latest data from ISTAT show a rate of relative poverty slightly below 14 per cent in 2001, while the proportion of people in absolute poverty – defined as those with monthly income below € 560 – is 5.3 per cent. Two thirds of

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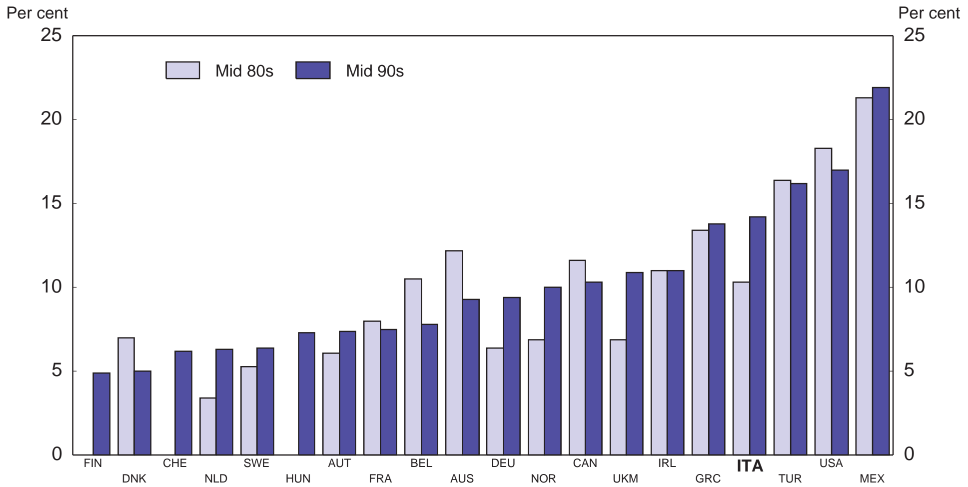
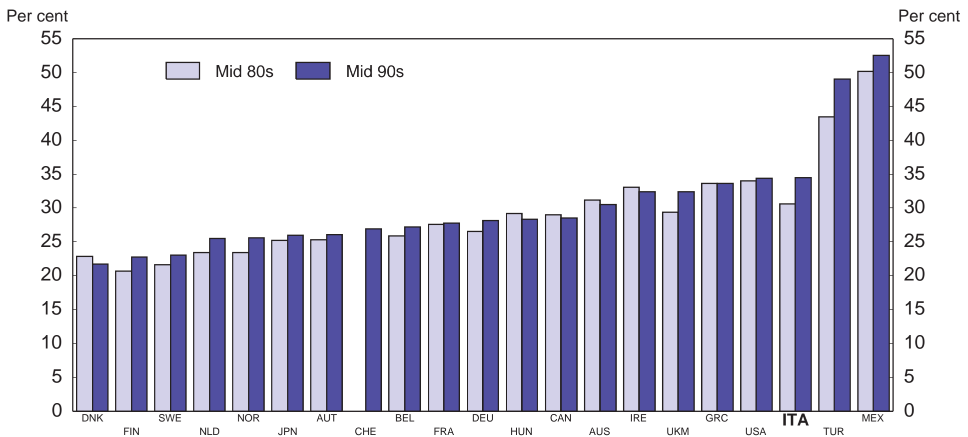
Figure 34. **Proportion of people in relative poverty**



Note: Data for Finland, Hungary and Switzerland in mid 80s are not available, for Mexico in mid 80s is 1989.
Source: OECD (2001), *Society at a glance*.

Figure 35. **Income inequality in OECD countries**
Gini coefficient changes



1. Note: Data for Switzerland in mid 80s is not available, for Mexico in mid 80s is 1989.
Source: OECD (2001), *Society at a glance*.

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the relatively poor households live in the South where the population is one third of the total.[103]

Traditionally, the main goal of the Italian social security system has been to insure against loss of income because of old age or invalidity.[104] In 2001, a significant share (2.2 per cent of GDP) of the high pension spending actually represented social assistance – mainly directed to the elderly – and was financed by general taxation.[105] The share of public spending against unemployment risk and social exclusion (poverty and labour market dissociation) is far less than the EU average.[106] Moreover, the risk of poverty before and after social transfers is only slightly different.[107] This model of social protection is inadequate to fight poverty, especially among individuals without strong family links.

The unemployment benefit system is currently characterised by a large number of different schemes. To those instruments managed by the public administration is added the mandatory leaving-payment scheme (*trattamento di fine rapporto*, TFR), which is managed as a book reserve within the companies and which provides for an income cushion in case of dismissal or voluntary quit as well as retirement. Some of these instruments – in general the most generous ones – are confined to large firms in the industrial and construction sectors. Workers in the service sector or in small firms – where flexible contracts are in general more widespread – have access to ordinary unemployment benefits which are less generous than in most OECD countries. At the same time, mechanisms of advice, control and incentive to search for a job for the unemployed receiving benefits are limited.[108] A third model characterises mainly workers in the agricultural sector, who get an *ex post* compensation if during a given year they do not cumulate beyond a certain amount of contributions. Finally, persons with no or little work experience – who constitute the major part of the pool of unemployed people in Italy – hardly have access to benefits and have to predominately rely on other family members for their support.

As for social assistance, the 2001 changes to the state's Constitution establish the exclusive legislative power of regions in this domain. The central authority retains the power of setting the minimum standard of social services to be attained by all regions in the whole country. A process of streamlining of resources and decentralisation already started in 2000 with the creation of a single budgetary fund, through which each year the central government channels resources to local authorities for financing and managing social services.[109] One programme – innovative for Italy – financed by the fund has been the experimentation with a "minimum income for social inclusion" (*reddito minimo di inserimento*) implemented by around 300 municipalities, most of them in the South. The scheme provided monetary transfers to families guaranteeing a minimum monthly income of around € 270 (plus family allowances), conditional on participation in programmes of a various nature aimed at supporting a permanent escape from poverty. The outcome of the experiment has been very heterogeneous. In some municipalities, the

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size of the deprivation area and the difficulties in properly assessing the many applications submitted in a context of high incidence of hidden economy activities has led to very high rates of participation into the programme.[110] In many municipalities, the quantity and the quality of the services for social inclusion were not adequate and did not lead to any significant increase in the exit rate from the programme. In part, this is due to the insufficient financial resources available to municipalities – most of them among the poorest in Italy – for organising high-quality inclusion services. While the assessments available hint at a positive impact in reducing inequality,[111] the evidence also highlights the difficulties in running the activation components of the programme. Furthermore, it has proved difficult at the local level to manage the work disincentives risks and preserve fairness in contexts of a high incidence of hidden economy activities, and provide a cost effective and incentive-compatible governance structure of the state funds.

The P*atto per l'Italia* announced measures – in part subsequently introduced in the 2003 Budget law – to strengthen unemployment insurance and social inclusion. The main stress of the Pact is the introduction of tax cuts especially targeted to low income families. Moreover, the replacement rate of the ordinary unemployment benefits will be increased to 60 per cent (from 40) of the last wage in the first six months after dismissal and to 40 and 30 per cent in the following two quarters (from zero). Gross and, especially, net replacement rates were previously well below the OECD average (Figure 36). The beneficiaries of the transfers are required to attend specific training programmes. The transfer is also made conditional on the acceptance of a job offer, when available. In addition, the establishment of shock absorber schemes directly managed by companies and workers will be promoted through tax incentives in those sectors where it is currently absent. Finally, it has been envisaged to replace the *reddito minimo di inserimento* described above with a yet to be detailed social safety net. More responsibilities will be given to regions and local authorities in its financing and management.

The stress of the Pact on fighting poverty through tax cuts is welcome, since the objective of social inclusion might be achieved through stronger incentives to work and earn an income in the formal economy. Nevertheless, tax cuts to the low-income earners should not remain as an isolated measure against poverty for a number of reasons: 1) a welfare system based primarily on low tax rates for low-income earners is less counter-cyclical than an unemployment insurance or assistance system; and 2) a system of tax deductions for low-wage earners was already in place in Italy before the introduction of the latest tax cuts, so that families in the first two deciles of the income distribution already paid no or little tax.[112] Therefore, the impact of the new measures might not be enough by themselves to reverse the trend of increasing poverty.

The process of further decentralisation of the social assistance programmes could lead to a more effective use of public resources. Still, the role of the state

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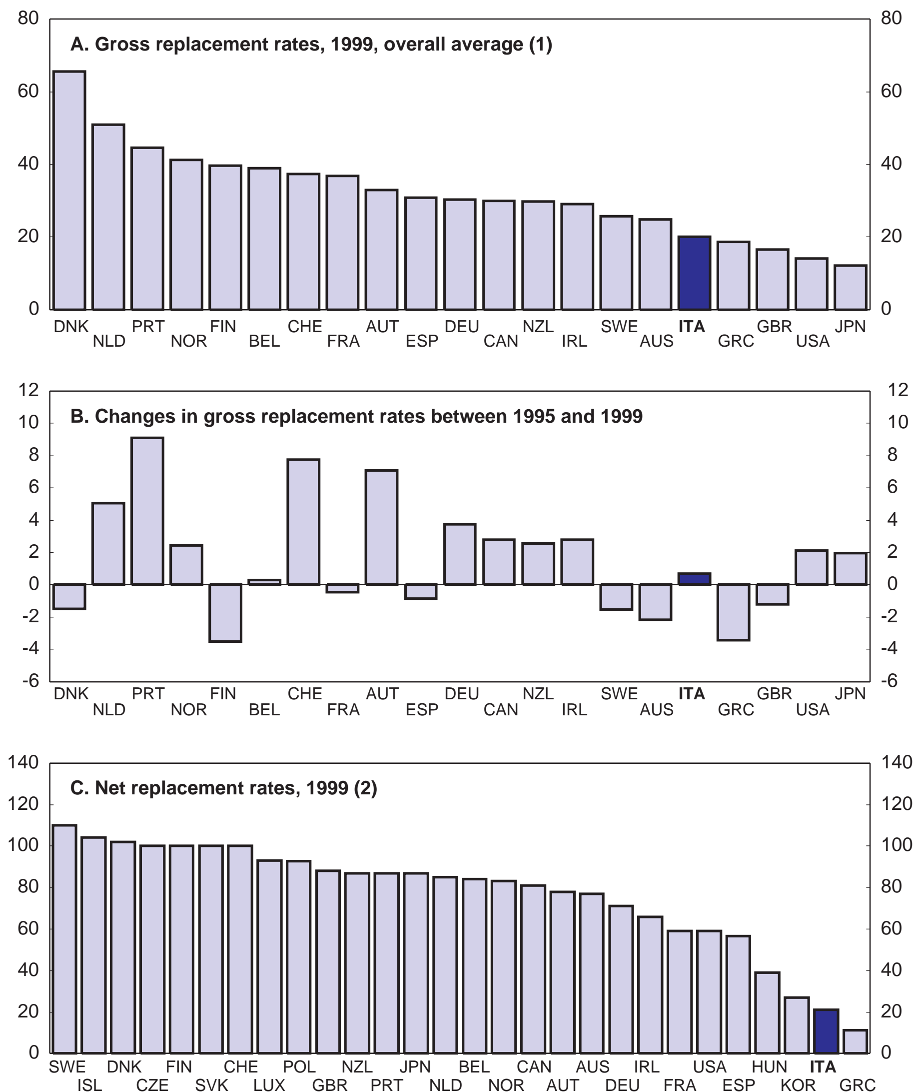
Figure 36. **Estimate of gross and net replacement rates, unemployment compensation**



1. Average of gross rates computed for different family situations, earning levels and durations of unemployment.
2. After tax and including family and housing benefits for long term benefit recipients; situation corresponding to a couple with 2 children and a single earner paid 66.7 per cent of the average production worker's salary.

Source: OECD (2002), Benefits and wages database.

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might be fundamental in avoiding that poor regions with a low tax base have inadequate resources to fight poverty. In this context, the cut of 6 per cent in the central budget fund for social assistance – introduced by the 2003 budget law – could lead to the termination of many programmes against social exclusion, unless budget transfers are concentrated to the poorest areas of the country. Finally, increasing the generosity of the ordinary unemployment benefits is an important step towards a more modern social security system. However, it might overshadow the prior need for streamlining the existing instruments to make sure that workers with the same needs get the same benefits, and for strengthening institutions so that beneficiaries face strong incentives to search for and find a new job.

The authorities should take additional steps to reform the unemployment insurance and welfare systems. The priority of the reform should remain the promotion of social inclusion through work participation mainly through the implementation of labour market reform (see the section on the labour market). The stress on means testing of the benefits should be maintained.[113] At the same time, the capacity of the relevant public institutions – *e.g.* the public employment services – should be strengthened to make sure that participation in the programmes is only a transitory period aimed at finding a new job. To reinforce job search, access to unemployment benefits should be strictly time-bound. The process of decentralisation in these domains should go hand in hand with a continuing role for the central government in monitoring the cost effectiveness of the social assistance measures. Finally, the authorities should consider further streamlining the unemployment benefit schemes, while avoiding both an impact on public finances and high effective marginal tax rates especially at the lower end of the income distribution.[114]

Reforms to enhance labour productivity through human capital

Education system

Despite significant improvements in recent years, in 2001 the share of the population aged 25-64 with at least upper-secondary education was only 43 per cent, 20 percentage points lower than the OECD average. Even for the 25-34 age cohort, the share is well below the OECD average (57 per cent compared with 74 per cent).[115] The share of the population in the same age range with at least tertiary education is only 10 per cent, one of the lowest in the OECD. Entry rates in universities are quite high (40 per cent of 19-year-olds in 1999), but the drop-out rate is also very high, with slightly more than 40 per cent of the enrolled students completing their studies.[116] Furthermore, around 85 per cent of those graduating do so after spending longer than the standard number of years pursuing their studies.[117] Low participation in education not only represents a missed opportu-

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nity for improving human capital, but it can translate in a social problem as searching and finding a job might prove difficult for low-skill young workers.[118]

One of the reasons for low participation in education – especially at the tertiary level – might be the lack of adequate public resources after compulsory age schooling.[119] In fact, while expenditure per student in primary and secondary schooling is equal to or higher than in most other OECD countries, the amount of resources per university student stands below the average. This reflects the relatively low ratio of students to teaching staff in primary and secondary education and the high one in tertiary education. Another important reason for low participation in education after compulsory schooling is related to the low internal returns from education.[120] In turn, this might be due to a structure of earnings by age that is only marginally affected by the attainment of higher school or university degrees (Figure 37). Moreover, only later in working life does the risk of unemployment seem to decrease with higher educational attainment. A further obstacle to higher participation after compulsory schooling might be the traditional way with which Italy subsidised education, *i.e.* through supplying services at low cost to everybody, granting only a limited amount of scholarships and with basically no recourse to (subsided or non-subsided) loans. This way of financing is particularly unfavourable to liquidity-constrained individuals, who generally belong to the low-middle part of the income distribution.

In March 2003 the parliament approved a reform of the primary and secondary level education system. The main innovations are: *a*) an increase from 10 to 12 years of compulsory schooling;[121] *b*) the introduction of a new vocational track in addition to the existing high schools (*licei*) for pupils after lower secondary education;[122] *c*) the teaching of one and two foreign languages during primary and secondary education, respectively; *d*) the elimination of the national examination after primary school; *e*) pupil evaluation every two years rather than each year; *f*) the introduction of internships in the *curricula*; *g*) the obligation for teachers in primary and secondary levels to hold a university specialisation degree and the possibility to obtain a tenure contract only after a two-year trial period; and *h*) the implementation of training programmes for currently employed teachers. The reform will be carried out at the local level with guidelines and minimum standards prepared at the central level. Legislation at the regional level might complement decisions at the central level. Regional authorities will also be responsible for part of the schools' programme. The implementation of the new school system will take place gradually and in line with the financing made available annually by the budget law. On top of this, the *Patto per l'Italia* stresses the need to strengthen the ability of post-secondary professional schools – introduced in 1998 – to create a better link between education and the labour market also through a more direct involvement of social partners. The introduction of higher technical education could help relieve crowded universities and increase the number of persons holding post-secondary degrees. Finally, the 2003

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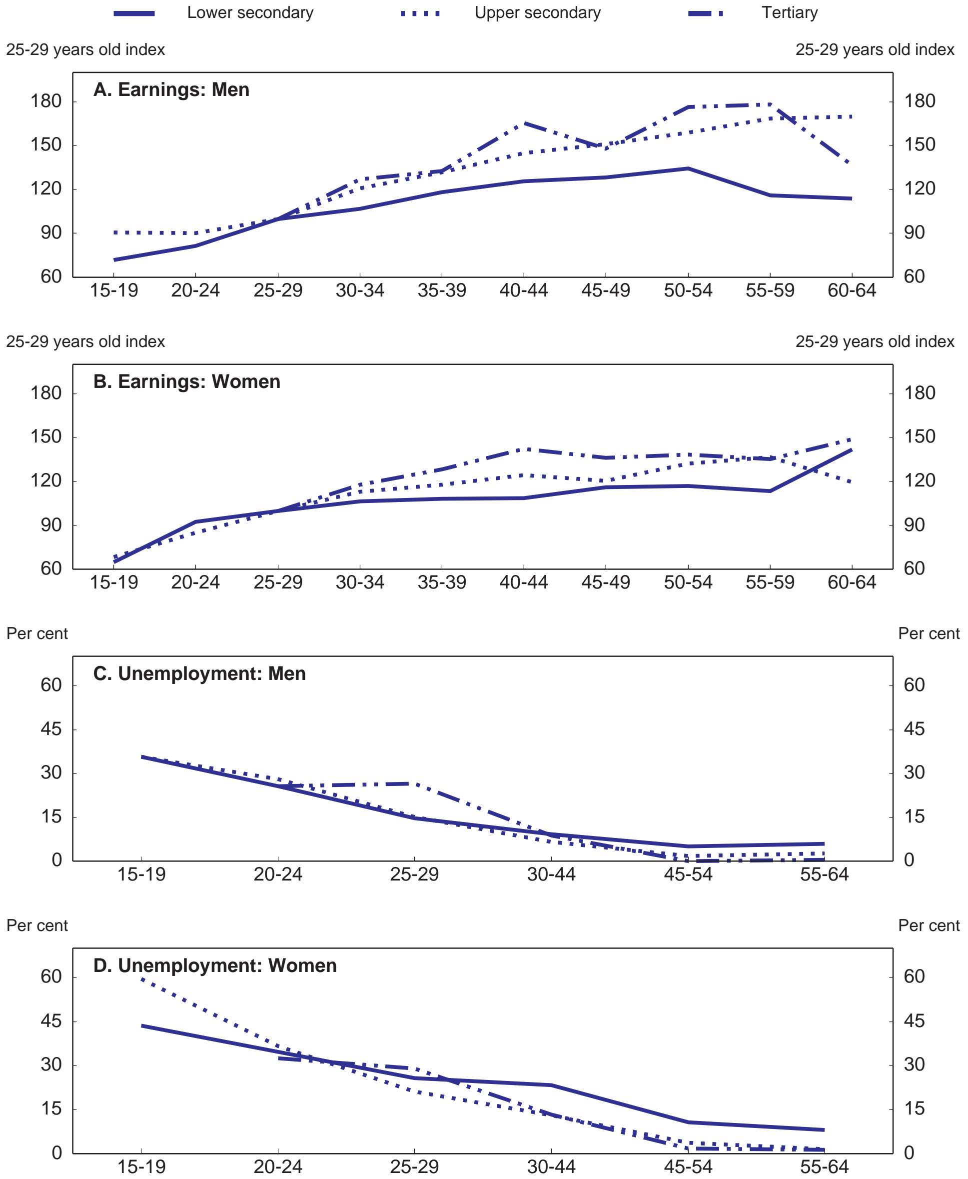
Figure 37. **Earning structure and unemployment by educational attainment**



Source: OECD (2002), *Economic Studies* No. 34.

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Budget law introduced a tax credit for households choosing private schools for their children, while some regional administrations instituted vouchers with the same purpose.

The measures foreseen in the reform represent a notable step towards raising and improving human capital in Italy. The increase of compulsory schooling will have beneficial effects on potential GDP.[123] The new system, *via* the new vocational track, will also facilitate the school-to-work transition with the double result of limiting the number of young people neither in education nor in employment and of reducing mismatches in the labour market. Moreover, other proposed measures like the reduction of evaluations could contribute to reducing the drop-out rates. However, the authorities should make sure that some of the measures do not introduce unintended effects. For example, a too early decision between high school and vocational training by pupils could be excessively driven by parents' education with negative consequences on subsequent decisions of students from relatively poorer families regarding participation in tertiary education, hampering upward mobility.[124] Appropriate track counselling and the guidance instruments proposed by the reform should be quickly implemented.

Careful consideration should be given to the introduction of measures favouring private provision of education. On average, public schools are at present of higher quality than private ones, though this might of course change if private institutions could compete directly with public schools for resources.[125] Introducing measures to favour participation in private schools could be justified in principle on equity grounds, as until now, only the better-off have had the opportunity of enrolling low-ability children – who could not complete public schools – in private education, allowing them to get a secondary school-leaving qualification giving access, for example, to tertiary education or to national examinations for many public jobs. Also, experience in the United States has shown that school vouchers may help raise school quality by introducing competition into the system. However, the tax credit might be of limited help for poor families, which already pay few or no taxes, while a voucher experiment should be carefully monitored before its implementation on a wider scale.

Improving the education system is appropriately given priority importance by the authorities. Other measures could be considered to strengthen the effectiveness of the recently approved reform, subject to public finance sustainability. To increase demand for education, as already recommended in the 2002 *Survey*, a system of means-tested co-payments, merit-based scholarships and direct or guaranteed private loans for liquidity-constrained households should be set up.

To improve quality of supply, performance-based wage and career systems for school teachers and managers should be implemented. In fact, salaries currently grow only to a limited extent with tenure and are not linked to perfor-

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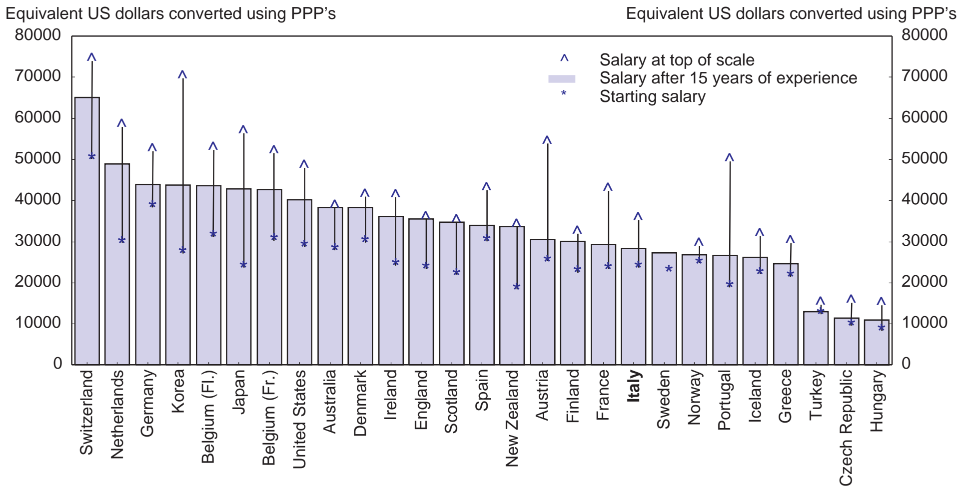

Figure 38. **Teachers' salaries at upper secondary level**
Year 2000

Source: OECD (2002), *Education at a glance*.

mance or quality of teaching (Figure 38). A system of performance indicators for schools at the local or central level should be quickly implemented and extended in order to benchmark best practices and help households and students in their educational choices. Finally, the government should make sure that the ongoing process of regional devolution in this field does not impede the respect of the overall public finances' objectives.

Reforms to raise productivity by improving the allocation of capital

Work at the OECD and elsewhere has shown that the level of development, and institutional features of financial sectors can have independent effects on potential growth rates and total factor productivity.[126] A deep, liquid and efficient financial sector can ensure that available savings are directed to the most productive investment projects, and that the financial sector itself does not absorb many resources relative to its intermediation function. A well-functioning financial system can usually also monitor managers and their investment projects more effectively and more cheaply than can individual savers. Finally, there is evidence that countries with an active and large stock market tend to experience faster growth, *ceteris paribus*.

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The current system of corporate finance and control

Securities markets

The market for equity finance in Italy is underdeveloped relative to most other G7 countries, both as a comparative source of firm finance and in relation to GDP, despite the global bull-market of recent decades (Table 25). The corporate bond market is likewise relatively limited. Only a limited number of firms are large enough for securities market entry. The entrepreneurial "culture" in Italy attaches a high value to family (insider) control, something which is simpler to achieve in small-sized firms. Small firms may also wish to avoid the accounting transparency that is the normal prerequisite of securities market access, as this would invite scrutiny of the public authorities and thus the full impact of the nation's high tax and regulatory burden. Excessive personal liability embedded in bankruptcy procedures (below) could also reduce the willingness to take investment risks and to grow. Many large firms choose not to list, moreover. Listed firms have themselves succeeded in maintaining insider control *via* the 20 or so family-based industrial groups and complex pyramidal shareholding schemes ensuring high control leverage (rights far out of proportion to own funds at risk). The resulting concentration of share ownership surpasses other OECD countries by a large margin (Table 26).

Demand side disincentives to private securities ownership have reinforced those on the supply side, as investor protection has traditionally been weak, albeit mitigated to some extent by regulatory oversight of outside audits of listed firms (as opposed to self-regulation as in the United States). On the

Table 25. **Stocks of financial assets**

Per cent of GDP

	1997	1998	1999	2000	2001	2002[1]
Monetary gold, currency and transferable deposits	129.4	119.0	123.6	122.4	117.7	114.2
Short term securities	16.3	14.3	12.3	9.8	10.6	10.9
Bonds	126.5	140.1	143.5	147.8	149.9	153.6
Derivatives	5.6	6.2	5.3	6.7	9.0	8.7
Short term loans	57.4	57.2	64.6	70.4	71.2	67.8
Medium and long term loans	58.8	58.3	62.1	63.2	64.7	66.7
Shares and other equity	100.5	130.2	178.2	194.4	173.1	156.8
Mutual fund shares	21.3	38.1	48.1	45.0	39.6	36.7
Insurance technical reserves	23.2	25.1	28.3	30.5	32.1	33.7
Other	25.7	25.6	27.2	25.5	26.4	24.9
Total	564.6	614.0	693.1	715.7	694.5	673.8

1. For 2002, data refer to September.
Source: Banca d'Italia.

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Table 26. **Concentration of share ownership**[1]

Year-end data

	2000	2001	2002
Largest shareholders	44.0	42.2	40.7
Other major shareholders	9.4	9.2	8.0
Market	46.6	48.6	51.2
Total	100.0	100.0	100.0

1. As a percentage of the total market value of the ordinary share capital of the companies listed on the Stock Exchange at the end of December.

Source: Consob (2002), Annual Report.

other hand, EMU convergence, and consequently sharply reduced attractiveness of Italian government bonds as savings vehicles, has implied a shift in household portfolios toward private securities, largely benefiting domestic privatisation issues and foreign equities throughout the decade of the 1990s, and more recently corporate bonds (Table 27). In some circumstances, banks have accommodated customers' demand by shifting onto them high-risk securities without adequate disclosure, as in the case of the defaulted bonds of Argentina (of which Italian households held one-quarter) and of a large domestic food processing company.[127]

The above features may or may not have adverse impacts on economic performance. It can be argued that concentrated share ownership does not neces-

Table 27. **Household saving instruments**

Percentage shares

	1997	1998	1999	2000	2001	2002[1]
Bank deposits	9.7	6.1	4.1	3.9	4.0	4.1
Cash and other deposits	24.4	23.1	21.2	20.8	23.5	23.9
Bonds	23.2	21.0	16.9	18.7	21.4	26.3
Government	13.2	9.6	6.6	7.0	7.1	9.3
Corporate[2]	10.1	11.3	10.3	11.8	14.3	17.0
Equities	31.7	38.8	46.6	44.4	36.7	29.2
Issued by residents	28.7	35.3	41.4	38.6	31.6	24.9
Issued by rest of world	3.0	3.5	5.2	5.8	5.1	4.3
Insurance technical reserve	10.8	10.9	11.1	12.0	14.2	16.2
Other accounts receivable/payable	0.2	0.2	0.2	0.2	0.2	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

1. Data refers to September 2002.
2. Includes MFIs and other residents.

Source: Banca d'Italia.

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sarily imply inefficient management. Indeed, "agency costs" (misalignment of interests of owners and managers under information asymmetries) should be smaller than under a system of dispersed market control.[128] However, research has shown that management turnover in listed companies – though high – is not clearly related to any measure of firm performance, making it hard to infer the actual objectives of the controlling groups.[129] With control rights exceeding ownership rights, these groups can capture significant "private" benefits of control at the expense of the small shareholder.[130] This is also suggested by the abnormally high price premium in Italy enjoyed by majority shares compared to minority shares (block premia on control block transactions).[131] Minority shareholders are thus discouraged from getting involved in company management to protect their interests; indeed the legal means to do so, granted by the 1998 reforms of listed companies, have gone largely unutilised.[132] At the macroeconomic level, excessive private benefits of control reinforce the status quo of underdeveloped capital markets, implying substantial inefficiency, *i.e.* not just distributional, costs.[133]

It is also possible that insiderism in the labour, product, and financial markets are all linked. Empirical work has shown that in financial systems displaying widespread equity ownership, labour markets tend to be less rigid as the interest of workers, as shareholders, in having efficient and competitive firms modifies their interest in preserving jobs at all costs. Conversely, systems with concentrated share ownership tend to display higher levels of job protection and concentrated wage setting. Encouraging workers to hold more shares on a dispersed basis is thus a good way to develop a vested interest in structurally adaptable labour and product markets.[134] In Italy, workers sometimes participate in share ownership schemes in the firms in which they work, an arrangement which, despite its other merits, could operate to intensify firms' resistance to market disciplines such as hostile takeovers.

A competitive product market would likewise act as a natural brake on the extraction of private benefits insofar as the distortions thereby created would be more likely to jeopardise the survival of the firm.[135] Conversely, a lack of contestability of corporate control prevents more vibrant inter-firm competition from taking root, and may have contributed to current difficulties in Italian capitalism. In particular, family-based control may not be well-adapted to the exigencies of global competition based on innovation and technological change, much as state control was deemed inadequate a decade ago.

Bank credit

Bank credit is important for large and small firms alike, though proportionately more so for the latter given their lack of access to securities markets. Even abstracting from small firms, which have a particularly large weight in Italy, this country emerges as one of the most bank-centred of the OECD industrial countries

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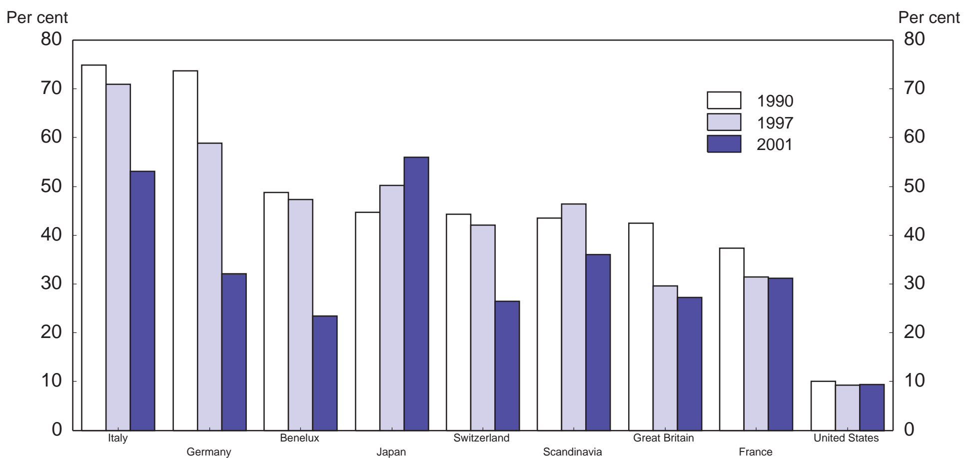
(Figure 39). The result is that Italian banks tend to be comparatively specialised in credit to domestic enterprises.[136] Larger national banks tend to focus on large firms as their customers while small local and regional banks cater to local SMEs. Whereas in the aggregate, recourse by large Italian firms to bank credit has tended to decrease as a share of their total financial indebtedness in recent years (Figure 39), some of the groups have become heavily indebted in order to finance acquisitions, using little own capital, mainly in the privatising network industries.[137] The recent global economic downturn has had a depressive impact on a number of these large industrial groups, requiring even more bank credit for their restructuring and implying a potential deepening of large firm-large bank linkages.

Nevertheless, the relationship in Italy between banks and firms for the most part is more detached than in other OECD bank-dominated systems. Main bank monitoring of insiders in relationship-based systems often replaces missing external markets for corporate control, but such a mechanism has been largely absent in Italy.[138] The following factors appear to be relevant: strict laws preventing cross-shareholdings between banks and firms;[139] a history of government subsidies to firms and banks; a tendency by firms to have relationships with several banks;[140] and good collateral as the main criterion for the granting of credit.[141] Many of these factors have started to unwind since around the mid-1990s, as pro-

Figure 39. **Bank credits**[1]
As a share of total financing



1. Data for 274 multinationals.
Source: Mediobanca, Ricerche e Studi, www.mbres.it.

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hibitions on cross-shareholdings have been partly relaxed, bank privatisation is proceeding more rapidly, subsidies to firms are being cut, and the frequency of multiple bank relationships is declining.[142] This suggests that underlying incentives to monitor firms could be gradually improving.

The contribution of banks to growth and development is a critical issue. Roughly half of bank lending is at short term maturity, a relatively high proportion in international terms[143] and partly a heritage of the high real interest rates of the past. Along with the collateral requirement for longer term lending, this could make it difficult for small firms to raise finance for investment projects. In the past, banks have contributed to development by their willingness to finance, at the local level, small firms coming together to form industrial clusters, helping thereby to compensate for the lack of scale economies. The more recent process of bank consolidation may have resulted in a weakening of the traditional links between local and regional banks and local small firms. This may be a particular issue in the South, where most firms tend to be very small. Empirical evidence does not offer much support to the view that bank consolidation has reduced credit availability to small and medium-sized enterprises.[144] Nevertheless, the structural features of Southern firms, and the associated higher risks justify a large part of the lending rate differentials (Table 28). The risk premium, which partly reflects firms' differences in size and specialisation, is mainly due to poor infrastructure and inefficient private and public administration in the South, a very high non-performing loan ratio,[145] excessive fixed costs of credit evaluation for small scale loans, and enterprises' opaqueness. Furthermore, according to empirical evidence banks exclusively value the guarantees provided by collateral while attributing a marginal role, in the quantification of costs and access to credits, to the quality of projects.[146] Thus another relevant cost factor could be the inefficiencies in selection of borrowers and projects and in risk monitoring of firms by banks. This influences the perceived risk of lending to individual small firms with valid prospects.

Table 28. **Cost of credit**[1]

	2000	2001	2002[2]
Northwestern	6.22	5.66	5.31
Northeastern	7.04	6.34	6.16
Central	6.86	6.35	6.19
South	8.48	8.04	7.60
Islands	8.46	7.70	7.84
Italy	6.69	6.11	5.85

1. Short-term interest rates.
2. Data for 2002 refer to September.
Source: Calculations of Banca d'Italia from *Centrale dei rischi* data.

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These costs and risks are exacerbated by currently weak bankruptcy protection of creditor rights (below).

Reform of company law

The government has presented a company law that will come into effect in 2004 (Box 5). The reform touches upon many areas of company regulation, but its main objective is to improve the efficiency and competitiveness of the Italian economy by fostering entrepreneurial activity, protection of minority shareholders' rights and capital market funding. It pursues these goals principally by: *i*) increasing companies' organisational and operational autonomy ("private ordering"), especially in the case of smaller and closely held companies, *i.e.* limited liability and "closed" stock companies; *ii*) simplifying mandatory provisions and restricting them mainly to the areas of protection of small shareholder rights and information disclosure, in particular for companies with dispersed share ownership, *i.e.* "open" stock companies; and *iii*) broadening the scope for company fund-raising *via* the securities markets, including bond market funding for all company forms.

The reform is far-ranging and in a way revolutionary, releasing many Italian firms from excessive regulatory burdens of the past. Its ultimate success in reaching stated goals, nevertheless, will depend on addressing key problems of minority shareholder rights, informational transparency, and conflicts of interest. Reducing distortions in these areas would underpin the ability of financial markets to fund, monitor, and discipline firms, to enhance their performance. The reform, in fact, takes a number of especially positive steps in this direction. It substantially expands the menu of minority shareholder powers in terms of both "voice" and "exit" instruments. It promotes market transparency *via* tighter accounting standards and reporting requirements in particular for groups and shareholder pacts. It reduces the possibility for conflicts of interest *via* clear identification of interests by executive board members.

On the other hand, such important progress could be attenuated by certain inconsistencies or gaps in the reform. The penal part of the reform decriminalises accounting fraud in the case of non-listed companies, which dilutes transparency standards and weakens the discipline of pyramidal groups with a family holding at the top, even encouraging an increasing use of pyramid schemes to erode controls.[147] As already seen, excessive control leverage in such groups has been a key underlying factor in weak minority rights and underdeveloped capital markets in Italy. It is also important that minority shareholders rights are bolstered by improving the ability of institutional investors to play a monitoring role *vis-à-vis* management in the firms where they hold significant positions. Potential conflicts of interest, outside the scope of the present reform, come into play here. For example, mutual funds in Italy are overwhelmingly held by the banks,

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Box 5. The new Company Law

On 17 January 2003, the Italian Government presented a new Company Law (Title V of the Civil Code), updating and replacing the previous law mostly based on the original civil code from 1942 which had allowed little scope for company autonomy, especially relevant for small, closely-held firms which are the backbone of the Italian economy.[1] By building a consistent legal framework for listed and non-listed companies alike, it also fills a regulatory gap created by the major reforms for listed companies emanating from the Unified Financial Text Law of 1998 (Draghi reform). After one year of transition and review, it is to come into effect on 1 January 2004. The main innovations are as follows:

Company organisation. Three company forms are now possible, with the following chief characteristics:[2]

Srl (*Società a responsabilità limitata*, limited liability society): The new discipline of Srl is aimed at encouraging entrepreneurs who formerly chose the partnership scheme (*società di persone*) because of its greater flexibility compared to the old Srl scheme, to shift to the new Srl scheme. In other words, it should become easier for small firms to incorporate. Conversely, the capital-based Srl's which formerly were subject to many of the more rigid rules governing the functioning of stock companies (differing mainly from them only in the minimum required amount of public capital needed), will now benefit from many of the former easier regulations on societies of persons, enhancing company autonomy. Many aspects which were formerly regulated will now be the subject of company by-laws, *i.e.* self-regulation and autonomy. There are some mandatory provisions intended to maintain the "fiduciary relationship" among shareholders pivotal to this corporate form (enhanced shareholder rights to request information, to bring lawsuits, and to withdraw in cases of dissent). The possibility to issue debt instruments is admitted only in case of underwriting by professional investors which are subject to prudential supervision. Professional investors cannot transfer these debt securities to non-professional investors, and if they do, they are liable *vis-à-vis* the holders of the debt securities if the issuer defaults.

Spa (*Società per azioni*, joint stock company): The use of mandatory rules rises as compared to Srl's, but more on "open" Spas (using equity capital markets) than "closed" Spas (with concentrated ownership). The procedures for incorporation are simplified and scope for fund-raising broadened (different types of shares and shareholder loans are allowed, limits on bond issues are eased). Spas are free to choose among 3 alternative governance forms: *a*) the traditional (latin) model consisting of a board of directors (*consiglio di amministrazione*) and an auditing council (*collegio sindacale*); *b*) the dualistic (Germanic) model, characterised by an executive council and a supervisory council; and *c*) the monistic (Anglo-Saxon) model with a board of directors which nominates its own internal auditing committee. With all three models, the company's accounts must be audited by an external auditor; "closed" Spas may be audited by the internal auditing council, instead of an external auditor, under an express provision in the by-laws, if they are not obliged to draft a consolidated balance sheet. There is a clear distinction made between the tasks of the board of directors and of the shareholders' meetings.

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Box 5. The new Company Law (*cont.*)

Co-op (*co-operative*): The reform stresses the pursuit of the social function and mutualistic purpose, introducing the class of co-op "with prevalent mutual nature", defined as those with 51 per cent of their activity being of a genuinely mutualistic nature. (The original intent, as expressed in the November 2001 delegating law, was for a higher threshold, for fear that public subsidies could be used to cross-subsidise the for-profit part of the company.) Such companies are now also permitted to issue debt and equity instruments.

Conflicts of interest. In the case of Spa's, members of the board of directors must notify other board members and the auditing body of any interests they may have in any operation under consideration. Also, any shareholder actions *vis-à-vis* management must respect a necessary quorum of shareholders.

Minority rights. In the case of Spas, various provisions aim at facilitating minority shareholder involvement: lower threshold for exercise of minority rights, mandatory disclosure of shareholders' agreements, simpler requirements to attend shareholders' meetings, and right to bring lawsuits above a certain threshold. The reform has also widened the scope for dissenting shareholders to withdraw. Company by laws can in some cases further expand these rights.

Discipline of groups. The notion of responsibility of the lead company in the group is established, with the objective of protecting the interests of shareholders and creditors of the controlled companies in the group. The latter will have the right to take action against the former in case that these interests are violated without subsequent satisfaction having been obtained from the lead company.

Transparency. In case of groups, the clear identification of both controlling and controlled companies must now be officially registered and the consolidated group balance sheet reported in addition to the regular reports. For all companies, a *nota integrativa* (supplementary information) must show certain off-balance sheet items such as intangible assets and financial leasing. "Economic function" will be used to a greater extent in presenting accounts, and purely tax-based accounting gimmicks are to be eliminated (also requiring appropriate changes in the tax code, now under study).

Shareholders pacts. Shareholder pacts are agreements among some shareholders and may have different objectives (*e.g.*, they may discipline how to exercise voting rights or establish limits on share transfers). They were regulated, for listed companies only, by the Draghi reform of 1998 and were limited to three years or unlimited in time but with right of withdrawal for each shareholder (with six months notice). The new Company law provides for unlisted companies that shareholders' pacts can last a maximum of five years or be unlimited in time but with right of withdrawal (with six months notice). The new law also establishes disclosure requirements for "open" Spa's.

Legal disputes. The legal process involving company disputes are to be streamlined in both content and time, serving in part as a test case for a broader judicial reform that the government is planning. Moreover, greater emphasis is to be given to arbitration committees, rather than to costly judicial processes, as a vehicle for solving disputes.

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Box 5. The new Company Law (*cont.*)

Penalties. The penal part of the reform was passed in February 2002. It reduced penalties for accounting fraud, in particular for non-listed firms where it was downgraded from a crime to a misdemeanour. While intending to reduce the regulatory burden on small firms, this part of the reform may be at odds with the other parts seeking to raise accounting transparency and to eliminate the regulatory "divide" (*scalino*) between listing and non-listing.

Removal of government guarantee for State-owned enterprises. The new company law abolishes the unlimited liability of the single shareholder of a limited liability company, thus furthering the liberalisation process and better clarifying financial relations between SOEs and the Government.

1. Cappiello and Marano (2003). The reform effort had its roots in the previous legislature (Mirone Commission).
2. As of 30 September 2002, 890 000 companies were registered under the Srl form, 61 000, Spa; 1 214 000, partnerships; 3 454 000, Individuals; and 188 000, Other; (source: *Il Sole 24 Ore*, 11 January 2003). The ratio of Spa's to Srl's is far higher than in the rest of Europe, despite the lower average size of Italian firms, because the 1942 Civil Code did not adequately distinguish the regulation between these two company forms.

which in turn provide a variety of consultancy and investment banking services to firms. The former may be inhibited from fulfilling their role as shareholder activists if their bank owners seek to avoid antagonising firm directors.[148] The banks also control insurance companies and are likely to become the owners of the new pension management companies.[149] It would thus be important for banks to find ways of separating their substantial interests in non-bank financial intermediaries, consultancy services and traditional banking activities (*e.g.*, "Chinese walls"). For similar reasons, *i.e.* to avoid conflicts of interest and promote competition in the market for asset management, it will be important to ensure that "open", rather than "closed" pension funds (managed by company stakeholders) are the norm. In particular, tax incentives should be neutral as between the two types of funds, and workers should also be able to easily switch between pension funds and insurance investment funds. Strengthening of the pension fund regulator (COVIP) would also be highly desirable.

It is also not certain how the new provisions to take effect in 2004 for company organisational forms, which clearly enhance autonomy and choice, will serve the broader goals of increasing transparency and better protecting minority shareholder rights. For example, the newly introduced Anglo-Saxon unitary board model as one of the options for stock companies differs from that in other coun-

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tries in having an internal audit function both in and out of the board. In the Italian system, the auditing committee (named the "committee for management control") is given duties of control over the board similar to those of the external *collegio sindacale* of the traditional Italian model. At the same time, the new law allows one of them to be an independent member of the board of directors. Such an arrangement could serve to confuse the responsibility and accountability of the board of directors something which is key to the success of the unitary board in the countries of origin of this model.[150] Other parts of the reform which seek to reduce conflicts of interests problems might also be weakened. Also, "closed" stock companies choosing the traditional model are exempted from the discipline of outside audits. Regulatory hurdles between non-listed and listed "open" stock companies (*e.g.* the new rules on accounting fraud) could act as a disincentive to listing and compromise the ultimate goal of equity market development.[151]

Bank restructuring

Italian banks are coming under pressure, from various sources, to improve their operational capabilities. In line with an EU-wide decision by the central banks, they are adapting to the Basle 2 new regulation which will require that capital ratios be more strictly correlated with actual risks. Big banks are likely to develop their own risk models, allowing them to evaluate projects and enforce internal control (internal rating). Smaller banks, however, will be more likely to use external ratings, which may imply higher capital requirements for loans to unrated small firms, their main customers. Smaller firms are thus worried about possible credit rationing, and many firms may be worried about having to provide more hard information.[152] This has given rise to demands within Italy that during the implementation of Basle 2, sufficient attention be paid to the needs of small- and medium-size banks and firms.[153] At the same time, banks are having to adjust to the slowdown in domestic economic growth, the fall in stock prices, financial instability in some Latin American countries, international corporate bankruptcies and domestic corporate difficulties (the largest industrial group, Fiat, is currently going through a restructuring plan). This has intensified pressures on banks to improve their evaluation and monitoring of borrowers, while at the same time shielding savers from excessive financial risks by the provision of better asset management services.

Policies can help banks in responding to these pressures in several ways. *First*, it will be important to fully implement Basle 2, while paying attention to the reality that most Italian firms are small family – controlled concerns, and many Italian banks are also quite small. The intent of the new capital adequacy regulations is to require better risk monitoring by the bank and better selection of borrowers and projects. To the degree that banks develop the capability to assess borrowers more effectively, the perceived risk of lending to individual small firms with valid

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prospects, especially in the South, should diminish. To ease the costs of transition to the new regime, precautions have recently been taken by the Basle Committee in order to insulate smaller firms and banks from adverse consequences of asset risk weighting (Box 6). *Second*, a greater emphasis on competition in the banking sector could serve to enhance its performance. Italian banks have, to be sure, made major strides in recent years in the degrees of private ownership, stock market listing, and foreign participation.[154] They are in this sense much better prepared for stronger bank competition in the European context, but points of weakness remain: they are overly oriented to the domestic market and their ownership structures suffer from a lack of transparency and contestability.[155] Greater foreign bank entry could help in this regard, but the bank regulator (Banca d'Italia) has tended to be conservative in its approach. Current banking regulations impose strict reporting requirements on intended bank acquisitions, *i.e.* well in advance of the decision having been reached within the acquiring bank itself to purchase more than 5 per cent of an Italian bank, and give the regulator wide discretionary powers in approving them.[156] These should be eased. Better bank governance in terms of the safeguarding of the private character of the foundations – who still own around half of all bank capital – will also be important, and to the extent that their objectives are necessarily non-commercial, even if private, continuing divestiture is appropriate. A recent government reform proposal would have, inappropriately, increased the public character of the foundations; it is currently on hold by the constitutional court (Annex II). *Third*, a continuing shift to market based development will be necessary to strengthen not only public finances, but also the incentives for efficient credit allocation by the private sector. Both credit subsidies of the past, and bank-administered investment subsidies more recently, have weakened banks' evaluation and monitoring of projects and firms.The planned diversion of the TFR, a form of subsidised credit, to the new pension funds should likewise be salutary, as it may have gone hand-in-hand with a misallocation of resources, the more labour-intensive firms having access to larger amounts. *Fourth*, a bankruptcy reform to enable banks to enforce credit contracts is still an urgent matter (below), as are more effective accounting standards among firms.

Another key issue is that bank lending should not be the only finance vehicle for small scale borrowers. There should be a bigger role for a venture capital industry which provides close monitoring, nurturing, and acceptance of high risk (based on expectation of high return). Such an industry exists in Italy but is still in its infancy, largely because of high risk aversion by entrepreneurs and financiers alike. However, only a very small minority of firms are likely to be suitable candidates for venture capital finance in any event. This implies that capital markets would need to develop to the point where not only larger firms find it attractive to list but also small companies can issue bonds and shares if they so desire,

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Box 6. The shift to Basle 2

The proposed shift to Basle 2 capital adequacy requirements – *i.e.*, to maintain bank capital at a minimum level of 8 per cent of risk-weighted assets by 1 January 2007 – has inspired a lively debate within Italy. The objectives of the reform are twofold: *i*) to make banks more responsive to the riskiness of their lending activities; and *ii*) to incentivate banks to adopt more modern and objective methods to measure and manage credit risks. While these objectives are widely shared, there is concern about the reform's "collateral damage", arising from four main sources:

1. *Small-medium banks* fear being penalised insofar as they are more likely to choose the more simple external ratings (fixed risk weights according to very general asset classes), making them ineligible to benefit from "discounts" granted by the internal ratings more likely to be adopted by the large banks. However, the Basle Committee has proposed a "discount" for retail clients which weigh heavily in the portfolios of small banks. This is expected to provide an alleviation of capital requirements of small banks, even greater than that obtained by large banks.
2. *Small-medium firms* fear an increase in the cost of credit and/or a reduced availability of credit (credit rationing). As these firms are generally unrated, lending to them could require a larger capital counterpart by the bank, relative to the larger firms with good ratings. However, the Basle Committee's recent proposal foresees an significant "discount" for these enterprises. At the same time, Basle 2 should encourage banks to evaluate counterparty risks more precisely, rather than grouping together all firms of a similar size or region in particular risk classes, hence effectively reducing credit rationing.
3. *Pro-cyclicity* is feared by some policy makers, given that banks' capital requirements are now likely to vary more sharply with the different phases of the cycle. For example, in the downturn, a rise in non-performing loans (having a very high risk rating) would increase the cost of credit and bank capital requirements, potentially aggravating the recession. Banks would need to keep capital in excess of the minimum required in order to attenuate the second effect; the former is harder to control.
4. *Adverse selection* is the very real risk that there could arise a concentration of risky debtors among those banks which adopt the external risk rating method. Low risk firms will have incentives to borrow from banks adopting internal ratings, hoping to get a good evaluation and hence a credit at lower cost. High risk firms, conversely, will be attracted to banks adopting external ratings, where the risk weight assigned to them will inevitably be lower than that given to them by a bank making its own evaluation.

Source: Baglioni (2003).

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with independent rating agencies coming into being, and building upon adequate accounting and informational transparency.

Bankruptcy reform

The current Italian bankruptcy law embodies extremely inefficient and costly resolution procedures for business crises.Such costs are especially relevant for the Italian economy because it is characterised by: *i*) a high birth/death rate of firms who are therefore quite likely to be involved in insolvency procedures; *ii*) bank-centred finance so that insolvency inefficiencies have a high impact on the cost of capital and economic performance; and *iii*) a prevalence of small firms, who already face higher inefficiencies in the market for allocating control due to higher information problems.[157]

The 1942 Insolvency Act provides for one procedure for judicial liquidation of the firm (bankruptcy) and two procedures aimed the reorganisation of distressed enterprises (the deed of arrangement and the moratorium). A law of 1999 provides for a special procedure for large insolvent companies (special administration), as an alternative to bankruptcy. This procedure aims at the reorganisation of insolvent corporations by restructuring business or transferring assets to other companies as going concerns.[158] The main problem with the present laws is that they offer few directive rights to creditors in bankruptcy (see Box 7). The bankruptcy procedure pays scant attention to the goal of maximising the value of the firm, lacking provisions to transfer the firm as a going concern and allowing virtually no room for a potential reorganisation plan. The procedures aimed at the reorganisation of firms are inflexible and ineffective. Debtors, for their part, face severe civil sanctions and can be subject to criminal prosecution for bankruptcy due not only to fraud but also to negligence.[159] This reflects a 1942 attitude of bankruptcy as resulting from reprehensible behaviour by the debtor rather than a possible outcome of normal business risks, and makes debtors reluctant to file for bankruptcy at the appropriate time or indeed to take on business risks in the first place.[160]

The reform of bankruptcy legislation is therefore one of the most important structural reforms to be undertaken in Italy.[161] It is also critically needed to complement the reform of company law under a wider process of legal system reform aimed at giving firms the right incentives for efficient business conduct and enabling Italy to compete on a level playing field in the European single market.[162] A bankruptcy reform is currently in the drafting stages (Trevisanato Commission). However, the presentation of a draft for the government's consideration and eventual enactment has been repeatedly delayed.

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Box 7. Creditor rights under bankruptcy law

In the proceedings provided by the present legislation, creditors are given no directive role and may express only non-binding opinions. In many other OECD countries, by contrast, creditors themselves are given directive rights over the insolvent firm. Thus in Italy, a very long, costly and complex judicial process absorbs a high part of any company value, lowering recovery rates for creditors at the end. Whereas in Sweden, UK and Germany the mean length of a bankruptcy court proceeding is around one year or less, and in France it is 2-3 years, in Italy it takes an average of 6 years (Table 29). In the case of loan default, claiming collateral takes 5-9 years as opposed to 2-3 in France and less elsewhere. Furthermore, banks are discouraged from engaging in pre-emptive rescue operations (for sound commercial reasons) because of the risk of heavy legal liability (involvement in the bankruptcy crimes in co-operation with the debtors; voidness or unenforceability of restructuring operations due to the application of provisions on acts detrimental to all the creditors).

Table 29. **Costs for creditors of judicial asset recovery procedures**

	Bankruptcy procedures		Executive procedures
	Powers of creditors	Mean length of procedure (months)	Length for recovery of collateral in case of loan default (years)
Sweden	Directive	12	n.a.
United Kingdom	Directive	<12	<1
Germany	Directive	12-27	Similar to France
France	Consultative	24-36	2-3
Italy	Consultative	72	5-9

Source: Santella (2003).

Bankruptcy law affects companies not only *ex post* (when insolvency occurs) but also *ex ante*, when firms select their projects, calculate risks and borrow funds to fulfil their plans. Inadequate creditor rights in bankruptcy thus penalise companies in a variety of ways. Creditors attempt to shift to debtors the costs of inefficient bankruptcy legislation, notably in the form of higher interest rates but also through other forms of self protection such as credit rationing, heavy collateral requirements, multiple creditors, lower average credit length or amount. The main goal of bankruptcy reform should thus be to guarantee creditors credible powers in the management of firms' crises.*

* Santella (2002).

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Reforms to improve quality of public finances

Many of the reforms proposed by the government are expected to enhance potential growth for the Italian economy. However, most of them have both transitory and permanent costs. In particular, the tax reform will have an immediate and lasting impact on public finances. Also the public infrastructure programme could imply higher costs for the public administration, as the private sector is likely to finance only the share of the projects that have an economic return. Compensating measures will have to be found in other parts of the budget in order to preserve sustainability of public finances. In this section the tax reform and the public infrastructure development programme are reviewed. Reforms that can potentially provide the authorities with room for manoeuvre are also assessed, notably in the pension and health care sectors. Furthermore, the Special Chapter of the previous Italy's Survey ("Public spending in Italy: policies to enhance its effectiveness") exhaustively described the scope for improvement in terms of efficiency of the public administration and for spending saving – *inter alia* – in the area of human resources management and public procurement. Annex III contains a follow-up assessment of the most recent measures introduced by the government in this area.

Tax reform

The tax system in Italy is close to the EU average in terms of overall tax pressure, relative importance of direct and indirect taxes, marginal rates, and types of exemptions and special tax rates.[163] In particular, labour income is heavily taxed compared with non-EU countries, and the statutory indirect tax rate is high. However, the complex set of exemptions and the difficulty of enforcement have meant that tax revenue has been significantly below its theoretical level (for example, the effective value-added tax rate, at 8 per cent, is far below the statutory 20 per cent rate), and it is a policy assumption in the current reforms that the self-employed avoid or evade tax on a substantial scale.

The Italian government has embarked on a fundamental tax reform, the guidelines being set out in a *Legge Delega* approved by the parliament in March 2003 and the first steps have already been taken in the Budget law for 2003.The tax reform envisages a substantial reduction in the overall tax burden and far-reaching changes in the structure of the tax system. Personal income tax (*Imposta sul reddito delle persone fisiche*, the IRPEF), corporate income tax (*Imposta sul reddito delle persone giuridiche*, the IRPEG) and capital income taxation are the major tax categories involved in the tax reform programme. Moreover, the reform envisages that the regional tax on value added (*Imposta regionale sulle attività produttive*, the IRAP) will be phased out in the coming years. The reform will be implemented gradually starting from 2003 and is expected to stimulate the economy *via* reducing the tax burden and strengthening the effectiveness of measures to bring the underground

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economy to the surface. An important aspect of the reform is the introduction of a substantial share of income exempted from tax. According to the new regulation, the exemption threshold is raised to 4 500 euros for the self-employed, to 7 000 euros for pensioners, and to 7 500 euros for employees; for the other incomes, the threshold is set at 3 000 euros. Tax allowances are reduced as new tax exemptions are introduced. In addition, tax exemptions and allowances will be computed on overall income rather than on the income deriving from professional activity. As well as these exemptions, the marginal tax rates have been rearranged. The number of personal income tax brackets remain at five in 2003, as previously, but tax bands have been modified (Table 30). When the reform is fully phased in by 2006, there will be only two marginal rates of IRPEF, 23 and 33 per cent. The lower rate will apply to income up to 100 000 euros, and the higher rate to income in excess of that amount. This income level is high and it has been estimated that the higher rate will apply to less than 1 per cent of taxpayers.

The introduction of the tax exemptions is intended to offset the rise of the marginal rate in the first bracket from 18 to 23 per cent. The composite effects of new deductions and decreases in tax allowances differ as between employees and self-employed, based on the assumption, not easily testable, that tax evasion is more prevalent among the self-employed in Italy. Nevertheless, the relative position of the self-employed improves for very low income classes, as they are no longer subject to tax payment. Also, the benefit for those who are not entitled to tax exemption because they belong to high income brackets is smaller for employees, who lose the deductions they enjoyed in the past.

Another important feature of the tax reform includes the suppression of the "dual income tax" or Dit, introduced in 1997, with the aim of favouring investment from own-funds by reducing the tax rate on undistributed profits. Depending on the level of the average tax rate applied under the dual income tax, the new tax regime will result in tax increases or reductions for individual firms. The new reforms also reduce the standard rate of corporate tax to 33 per cent from 38 per cent, but phasing out the Dit means that the marginal effective rate of corporate

Table 30. **New tax bands for IRPEF**

Taxable income (Euros)	Marginal rate (per cent)
Up to 15 000	23
From 15 000 to 29 000	29
From 29 000 to 32 600	31
From 32 600 to 70 000	39
Over 70 000	45

Source: Ministero dell'Economia e delle Finanze.

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tax will become significantly positive, instead of negative as before.[164] The introduction of a single corporate income tax rate will, however, render the tax system more transparent. One reason for phasing out the Dit is that it distorted the allocation of resources, encouraging mature, profitable companies to over-invest, rather than distribute profits, putting at a disadvantage recently created companies not yet earning profits. Other reforms to corporate taxation are directed to harmonise the Italian tax system with other European countries. Particularly, it aims to make consolidated companies' accounts more transparent, removing disincentives to consolidate and to introduce new regulation against thin capitalisation and for participation exemption.

The reforms also envisage phasing out the IRAP, a regional tax on productive activities, which currently generates revenue equivalent to 2½ per cent of GDP.[165] Given the importance of this tax in the autonomous financing for regional administrations, alternative sources to replace it must be found before it is abolished. Care is also needed in order not to cause any further burden on the government budget; the repeal of this tax should not be accompanied by increasing central government transfers to the local government.[166] Indeed, phasing out the IRAP is something that should be done gradually, as fiscal circumstances permit.

The tax reform also introduces some changes to the taxation of groups of companies. For the first time, the new legislation recognises group consolidation for tax purposes and therefore groups will be taxed as single taxpayers for corporation tax purposes. The reform proposes two alternative definitions of group consolidation: domestic and international. For the companies that are resident only in Italy, domestic consolidation operates between the parent company and its subsidiaries, subject to the condition that the subsidiaries are under the control of the parent company. A company is deemed to be controlled if the parent owns directly or indirectly at least 50.1 per cent of the voting rights. However, each subsidiary will be free to opt whether or not to consolidate. If a company decides to consolidate, this option is irrevocable for 3 years, unless the company ceases to be controlled by the parent. The parent will be liable to fill the consolidated tax return and will pay the corporation tax, but the consolidated subsidiaries will remain jointly liable together with the parent. As for international consolidation, the regime allows for the consolidation of the non-resident subsidiaries under the same principles as domestic consolidation (the parent company must be resident in Italy), but the option of subsidiaries for consolidation cannot be revoked for 5 years in this case. The new legislation also introduces a general participation exemption under which gains on disposals of shares in other companies are to be tax-exempt. Dividends distributed by resident and non-resident corporate entities to resident corporate entities will also be 95 per cent tax-exempt. These new provisions on corporate group taxation will make the system more transparent and simpler. The consolidation provisions also provide a useful rationalisation of corporate taxation. Hence, the inefficiencies associated with small firm size in Italy will be to some extent offset and incentives to avoid tax will be reduced.

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In Italy, dividends and interest from private and public bonds have been currently taxed at a rate of 12½ per cent, and interest from bank deposits has been taxed at 27 per cent. Capital gains accrued by individual savers are also subject to a 12½ per cent final withholding tax. Capital gains on financial assets have been taxed on an accrual basis. However, with the enactment of the tax reform, capital gains will be taxed on the basis of realisation rather than on an accrual basis, which has been the standard practice in the majority of the countries that tax capital gains. In addition to this, the tax reform will eliminate the higher rate on the interest income and all financial income will be taxed at a single flat rate of 12½ per cent. Nonetheless, this new provision could amplify the tax arbitrage possibilities created by the gap between taxes on corporate income and capital income.[167] Although some rules have been envisaged to restrict transactions of this kind, unifying the rates of tax applied to corporate and financial income could remove a source of distortion and provide a useful rationalisation of the taxation of business.

The authorities already took some steps in the implementation of the reform in the context of the 2003 Budget law. Tax reductions, mostly consisting of personal income tax cuts for low-income families, are expected to amount to ½ per cent of GDP in 2003. With the introduction of an *ad hoc* safeguard clause, which gives the right to taxpayers to resort to the past provisions in case they are penalised by the reform, the changes to the IRPEF guarantee that nobody is worse off, while others draw benefits.[168] According to the micro-simulations carried out by ISAE (2002b), the first stage of the IRPEF reform does not affect the income of half of the lowest income quintile households, mainly because they already pay no tax given their low level of income. On the other hand, the labour supply of secondary earners and low wage people might be boosted by the tax cuts already enacted and in total, more than 80 per cent of households would benefit, whereas only 2½ per cent would risk a loss, while the rest would remain unaffected. However, the loss could also be avoided through appealing to the safeguard clause.

Public infrastructure investment

Public investment in Italy has been low relative to the EU average, especially since 1993, as a consequence of the transition towards more transparent rules and management after the fight against corruption (*tangentopoli*) started to limit the mismanagement in the use of public resources. Legislation governing public works started to be revised from 1994 in a sequence of attempts to make access to public works more open, transparent and efficient (Merloni Laws).[169] 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.

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The backlog is particularly pronounced in the Mezzogiorno. In fact, the infrastructure gap presents some stark regional contrasts: for example, in the water sector, the south of Italy lags 23 per cent behind the national average in terms of sewage and drinking water.[170] Successive Italian governments have been seeking to attract a greater level of private participation in the ownership and management of infrastructure projects to bridge this gap, which have been reflected in some government White Papers. Economic and Financial Planning Document (DPEF) 2000-03 states that "the involvement of the private sector in financing, building and operating infrastructure and public utility services is a priority and especially for southern Italy". Also, DPEF 2002-06 emphasises the need to enhance infrastructure investments as a main driver of economic growth.

Government investment can have a significant effect on output growth by improving the framework conditions in which private agents operate. For instance, public investment in transport, communication and infrastructure can help to create an environment conducive to entrepreneurship, innovation and private sector activity. Recognising this, the Italian government designed new measures to promote the economic recovery of the Mezzogiorno which constitutes an important part of the "Pact for Italy" (*Patto per l'Italia*). The new pact sets out some objectives regarding the Mezzogiorno, one of the most important ones being the improvement of infrastructures, including upgrading water supply systems and strengthening and modernising the railway and road systems. On this point, the government confirmed that the construction of a bridge over the Straits of Messina (between mainland Italy and Sicily) would start within 36 months from the beginning of 2003.[171] The economic resources to help achieve these objectives will come from ensuring that at least 30 per cent of the resources allocated to the public sector in areas such as railways, road and other infrastructure go to the Mezzogiorno.

In this context, the 2003 Budget law sets up two interconnected funds for southern Italian areas, within the Ministry of Economy and Finance and the Ministry of Productive Activities. The CIPE (*Comitato Interministeriale per la Programmazione Economica*) – chaired by the Prime Minister – is entrusted with the task of seeing to a timely allocation of resources among the various intervention tools on the basis of criteria including spending speed and quality. The additional resources for under-utilised areas (mainly in the South) allocated with the Budget law 2003 – 500 million euros in 2003, 750 million euros in 2004, and 7 750 million euros in 2005, for a total of 9 billion euros – will be gathered in these two funds. The Budget law also sets aside 1 billion euros (of which 350 million euros will be allocated for 2003) for the creation of a fund for public works and infrastructure (*Fondo rotativo per opere pubbliche*, Frop) which will financially support such works.

The development of public-private partnerships (PPPs) is viewed as an important way of filling the infrastructure gap of certain parts of the country, while

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minimising the impact on public finances. The approval of Law 415/1998, the so called "Merloni Ter", introduced the possibility of using project finance techniques for the construction and management of public infrastructure. To this end, the *Unità Tecnica Finanza di Progetto* (UFP) was created in July 2000 with the main objectives being: to promote the use by public administrations of financing techniques for infrastructures in which private capital can be involved; to provide assistance to CIPE in its decisions in the field of infrastructure financing; and to provide administrations with direct support to identify different needs which can be satisfied through initiatives financed by private capital. Regarding PPPs, a pivotal role is now played by a host of regional bodies which, following the re-allocation of competence to the Regions in the area of public works, are now pushing the Regions in the area of public infrastructure. These bodies are inspired by the same philosophy followed by the government in setting up the UFP.

A major reform initiative has been the law approved by the parliament in August 2002, known as the *Legge obiettivo* (Strategic Infrastructure Law) designed to enhance public infrastructure investment, whilst stimulating the growth of the Italian PPPs. This regime applies to those infrastructure investments deemed as strategic, *i.e.* those projects considered to play a pivotal role in the growth and modernisation of the country. This legislation aims at reducing the level of red tape and simpler procedures for administrative authorisations. The most significant objective of this legislation is to provide the market with clear and simpler rules for the administrative approvals process with heightened political commitment. However, a strong centralised strategy for strategic public investment without independent oversight appears to be inconsistent with the shift towards greater spending transparency. To bring the Italian public works system fully into line with international best practices, enhanced surveillance is essential. These mechanisms are built into the Strategic Infrastructure Law, but their effectiveness has yet to be demonstrated.

Two new companies, *Infrastrutture S.p.A.* and *Patrimonio dello Stato S.p.A.* have been established by the government with their main objectives being to finance major public works and exploit the value of state assets. *Infrastrutture S.p.A.* has been created to assist the increase in infrastructure endowment, while *Patrimonio dello Stato S.p.A.* will evaluate, manage and make the best use of public assets *inter alia*, by disposing them in the market by means of direct sale or securitisation.

Particular importance has been attributed to *Infrastrutture S.p.A.* in terms of the role that it is expected to play in the financing of infrastructure investment through public-private partnerships in line with the experience of similar agencies in the EU (such as KfW in Germany; OKB in Austria and ICO in Spain).[172] *Infrastrutture S.p.A.* will act as a financial intermediary favouring the more rapid realisation

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of infrastructure thanks to a more rigorous evaluation procedure, including importantly the use of cost-benefit analysis, and acting to complement and stimulate private sector involvement. The company will raise funds in the market by issuing securities and contracting loans, which may be guaranteed by the government. The involvement of the private sector in infrastructure investment will broaden the range of works eligible for project financing that have been the exclusive competence of the public sector until now. In 2003, I*nfrastrutture* S.*p*.A.'s financing share for new projects is expected to reach almost 1 per cent of GDP.[173] However, since the government is a co-owner of the project, failure of a private partner would entail a greater exposure of the budget. Given Italy's commitment to control its budget deficit, the government should be wary in choosing a potential project, which would require a careful comparison among a wide range of alternatives and routine use of cost-benefit calculations to all proposals, rejecting all those that do not pass such a test, irrespective of their technical feasibility or political visibility. In addition, the authorities would have to make "equity capital" available in case of need, with the objective of preventing the build-up of future liabilities for the state from those operations.

P*ension system*

The Italian pension system experienced a series of reforms during the 1990s, which significantly reduced the expected increases of pension spending as a share of GDP.[174] When fully phased in, the new system will be insulated *vis-à-vis* macroeconomic and demographic shocks as the returns notionally accruing to workers are related to GDP performance, and therefore to the social contributions paid, with an actuarial adjustment, whose parameters are to be revised at ten year intervals in order to take account of the evolution of the life expectancy at retirement age. Moreover, by changing the benefit indexation system and the eligibility requirements also for the pension arrangements currently in force, the reforms had an impact in the short run as well. In fact, in the 1998-2001 period pension spending in real terms increased at an annual average of 1.6 per cent compared with 6.1 per cent in 1990-92 and 3.8 per cent in 1993-1997.[175] Pension spending as a percentage of GDP decreased by half of a percentage point from 1997 to 2001. Moreover, from the mid-1990s to 2001 the average effective retirement age increased by 1.2 and 1.6 years for the private and public employees, respectively, and the employment rate begun to pick-up in the 50-54 year age bracket but not yet in the subsequent age brackets.

There remains unfinished business, however. Public pension spending relative to GDP is still one of the highest among the OECD countries and accounts for most of the resources devoted to social spending (Figure 40). At the same time, the development of private pension funds is still in its infancy.[176] A further stabilisation of public pension spending relative to GDP in the present decade is

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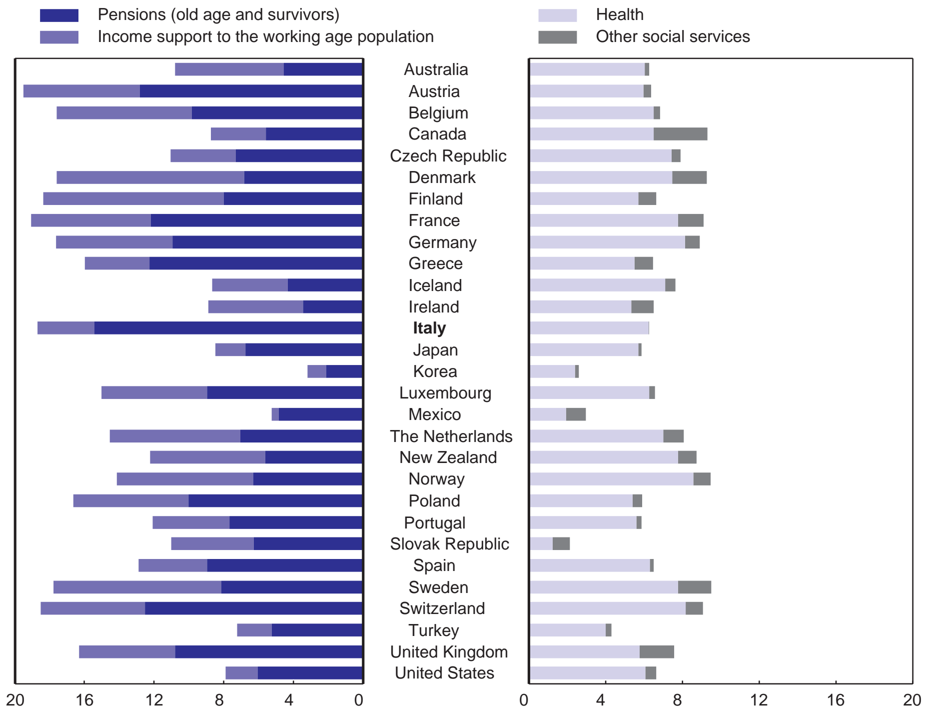
Figure 40. **Public social expenditure**
Per cent of GDP, 1998



Note: For Italy, the figure refers to the Eurostat Old Age and Survivors definition which does not correspond to the national authorities' definition mainly because it includes the leaving-payment scheme (*Trattamento di Fine Rapporto)*, amounting to around 1.5 per cent of GDP (see Ragioneria Generale dello Stato, 2002, Box 2.2).
Source: OECD (2001), Social Expenditure Database.

conditional on attaining an average annual real GDP growth of more than 2 per cent, which is higher than both average recent years' growth rates and estimated potential GDP. The average replacement rates for new retirees are not going to decrease significantly before 2015 with an abrupt discontinuity around that date which may raise equity concerns.[177] Indeed, during the 1995 reform authorities decided to apply the contribution-based method of pension calculation – resulting in lower replacement rates for new pensioners – only to workers having paid less than 18 years of contributions.[178] Furthermore, even though contribution rates are high, they are well below the theoretical rates equilibrating the public pension funds (Table 31).

Table 31. **Actual and equilibrium pension contribution rates, 2001**
(percentage values)

	Theoretical equilibrium contribution rate	Actual contribution rate
Private employees	44.1	32.7
Public employees	44.0	32.7
Self employed	30.7	16.8

Source: Nucleo di Valutazione della Spesa Previdenziale.

Finally, the average age at withdrawal from the labour force was 59½ in 2001, one of the lowest in the OECD. The disincentives built into the pension regime currently in force are in part responsible for the low employment ratio for workers aged 55 and over (Table 24).[179] Some further increases in the retirement age are likely in coming years as the existing seniority requirements may become progressively more binding as, for given rules, the cohorts which are going to approach retirement age are increasingly characterised by a later average age of entrance into the labour market and thus less seniority rights than the previous cohorts. In addition, past reforms while not fully eliminating seniority pensions, nevertheless still imply a further gradual tightening of their eligibility criteria.[180] Despite this, the employment rate of workers aged 55 and over is unlikely to register a prompt and sizeable rise in the absence of policy interventions.[181] Apart from disincentives built into the pension system, the low employment ratio among older people has other structural reasons:[182] *a*) many women in the 55-64 year range have so short a contribution history that participating in the labour market might not guarantee them any pension entitlement; *b*) many older male workers left school in their early teens and they might not have the skills currently requested by companies; *c*) but because they started to work while young, they have built up a long contribution history well before the statutory retirement age. About one quarter of total pension benefits are paid to people below the official retirement ages.

At the end of 2001, the government presented to the parliament an enabling bill on pension reform, aiming at developing a more balanced public-private pension system and encouraging continued participation of older workers. The main measures of the bill are: *a*) transferring the future flows of the companies' fund for the leaving-payment scheme (*trattamento di fine rapporto*, TFR) to pension funds, with an obligation for pension funds of re-investing part of the future contributions in the companies' shares; *b*) in order to increase labour demand, a cut of up to 5 per cent in the contribution rates paid to newly hired workers on permanent contracts, without changing their future public pension entitlements,; *c*) a tax cut on returns from private pension funds; *d*) a contribution exemption for

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workers eligible for seniority pensions who decide to postpone their retirement; *e*) an extension of the possibility for the retirees to combine pension and labour income; *f*) an increase of contribution rates for certain categories of self-employed (*collaboratori coordinati e continuativi*), a share of whom at current rates would not receive sufficient pension benefits for an adequate standard of living. Apart from the measure allowing the combination of pension and labour income already included in the 2003 Budget law, the other measures are still under discussion by the parliament.

The objective of increasing diversification of retirement income is commendable and deserves continued attention and support. However, the announced reduction of employee contribution rates could be seen as tampering with the shift to an "actuarially fair" pay-as-you-go system established by the reforms of the 1990s.[183] The authorities estimate that in the medium term, this would lead to higher costs in the range of 0.5-0.8 percentage points of GDP. These costs will have to be financed through further transfers from the central budget. Also the other proposed measures helping the development of private funds require non-negligible financing from the central budget. Higher contribution rates for part of the self-employed can partly compensate for these costs, but only in the short term. Moreover, the *trattamento di fine rapporto* has a role as shock absorber for dismissed workers. If it is transferred to pension funds, a more effective public insurance system for the unemployed will have to be established, adding further pressure to public finances (see the section on unemployment risk insurance).[184] Therefore, it would seem that the expensive transition costs towards private pension funds will be financed mainly through public resources, adding further strain to public finances. Workers and firms should bear a more significant part of the transition costs in building a private pension pillar. In particular, given that it is the relatively young workers who will have to bear the double burden of financing the pensions of those already retired, as well as building up their own pension savings, it is important from both a public finance and distributional viewpoint that older workers remain in employment for significantly longer than at present.

One of the reasons why the authorities aim at increasing the importance of private funds is the expected drop in public pension replacement rates for workers who will retire with the new contribution-based regime. Still, thanks to the adjustment mechanism implicit in the new calculation method, the drop will be less significant if the workers decide to retire later.[185] Hence, a greater concern for the authorities should be how to introduce as soon as possible the same incentives in the system currently in force – whose generous eligibility requirements and replacement rates will be in place until around 2015.

Likewise, increasing the employment ratio for older workers should be pursued as an effective way to attain a more sustainable system without substan-

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tially lowering the lifetime wealth of workers. By contrast, as pensions at the lowest eligible age are already quite generous, the new tax incentives to postpone retirement proposed by the government also need to be quite generous if they aim to significantly affect the older workers' decisions to exit the labour market.[186] Hence, overall savings from this measure might be marginal (although the impact on output levels could be significant). In addition, the tax incentives are further weakened by the implementation of the recently approved measure allowing the combination of retirement and labour income, which might introduce a further disincentive to postpone the retirement decision beyond the new thresholds introduced by such a measure (58 years of age and 37 years of contributions).[187]

The main priority of the pension reform should be to reduce the ongoing costs of the system, especially if room has to be made in the budget for a higher structural primary surplus, further tax cuts and for reforms in other expenditure sectors like education, unemployment and social assistance benefits. The preferred means to attain this goal should be to eliminate incentives to retire earlier, thereby also increasing the older worker employment ratio. In this respect, eliminating seniority pensions (or applying actuarial adjustment rules to them), immediately extending to all workers the mixed regime combining the earnings-based and the contribution-based calculation method of pension benefits, and increasing the minimum age for pension eligibility for all workers could represent the main priorities to be considered by the authorities. In a mixed regime, further savings and disincentives to retire earlier would derive from an automatic annual revision (instead of a discretionary adjustment every 10 years as at present) of the coefficients for the contribution-based calculation of pension annuities to ensure consistency with the latest demographic figures, as applied in Sweden. Finally, the government could introduce the opportunity to retire after 65 with pension benefits adjusting upward in an actuarially neutral fashion.

To reinforce these reforms, the authorities should remove barriers in the labour market preventing a greater "employability" of older workers. In particular, allowing wages to better match productivity might increase firms' demand for older workers.[188] The government should also consider granting a tax incentive or a subsidy to firms providing re-training to older workers and indeed to workers close to the end of "prime age" to ensure that their skills are renewed. The cost-effectiveness of these measures should be regularly and carefully assessed. Moreover, the authorities should organise specific re-insertion programmes for dismissed workers above a certain age. Finally, the minimum contribution year requirement should be lifted for persons with no or irregular working history entering the labour market for the first time after a certain age, allowing them to join the new contribution-based regime. This measure might encourage higher participation of older women to the labour force and, more generally, reduce the extent of the shadow economy. In conclusion, further and well-focussed pension reform together with measures to eliminate barriers for the "employability" of

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older workers should yield the triple benefit of reducing public expenditure, raising tax revenues, and increasing the employment rate and the level of potential output (indirectly boosting tax collections further).

Ensuring sustainable retirement income in the medium term

OECD estimates made in 1989 suggested that the impact of the fall in the birth rate and the increases in life expectancy would more than double the old-age dependency ratio by 2040. However, major reforms of the state retirement income scheme in 1992 and 1995, and a smaller reform in 1997, are likely to broadly neutralise the impact of the demographic shock on public pension spending.[189] Indeed, in contrast with projections for most other OECD countries, public pension outlays as a proportion of GDP are expected to be relatively stable over the coming decades. This is particularly remarkable as Italy is among the countries with the fastest growing rate of old age dependency (Table 32).

The income retirement system currently offers a high level of income to pensioners relative to that of the working-age population. For people who enter retirement under the earnings-related regime (about until 2013), state pensions will amount to around 77 per cent of previous earnings in the first year of retirement for a person who has earned median earnings for 40 years and retires regardless of age.[190] Replacement rates are expected to gradually decrease afterwards as the pro-rata and contribution-based systems are replacing the earnings-related regime. With investment income representing over 20 per cent of the income of people over 65, the average disposable income of this group is equal to 84 per cent of that of households under 65 (Table 32) and rises to 94 per cent when allowance is made for the implicit rents for home owners (Winqvist, 2002). For the poorest segments of society, disposable income is even significantly higher at older ages than at working ages.

The reforms in the 1990s aimed at stabilising pension outlays relative to GDP and at ensuring the financial stability of the state pension system (Figure 41). In the 1992 reform, the period used to determine the earnings base was lengthened and there was a shift from wage to price indexation for pensions in payment. Moreover, the age at which seniority pensions (based on the completion of a set number of years of employment) could be drawn was raised to 55, while subsequent measures are gradually raising it up to 57 for dependent employees and 58 for the self-employed. The 1995 reform aimed at ensuring that increased life expectancy and changes in economic growth did not result in increased contribution rates. According to the so-called notional contribution system established by this reform, annual pensions are equal to life-time contributions re-valued in line with GDP growth transformed into an annuity using transformation coefficients based on life expectancy and interest rates.[191] The minimum age of retirement in the system is 57, but the pension will rise with continued work up to age 65, after which there is no further

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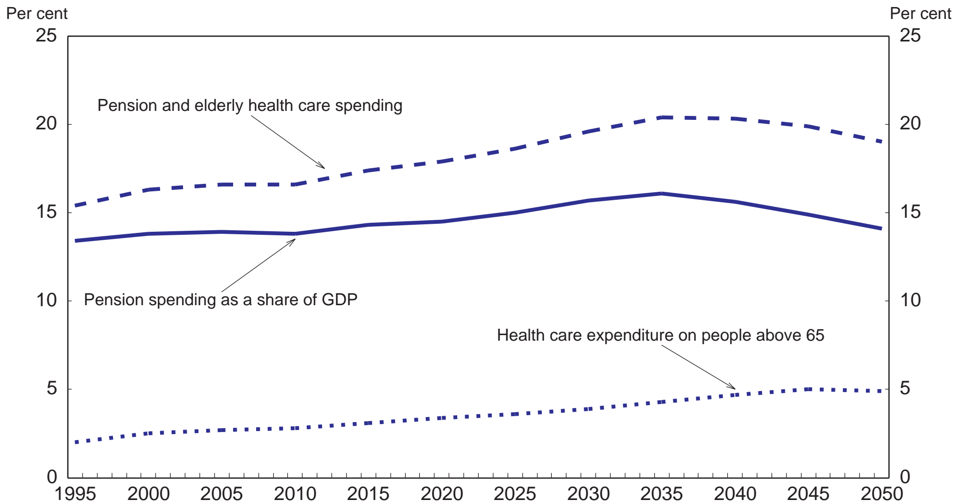
Table 32. **Performance indicators: sustainable retirement income**

	Projected increases in old age pension spending[4]	Low income rate of the elderly[1]	Relative disposable income of the elderly[1]	Private pension funds 1999	Age of withdrawal, 1994-1999		Participation rate, 2001, per cent		
								Aged 55-64	
	Change in per cent of GDP 2000-2050	Per cent of the elderly with income less than 50 per cent of median disposable income	Per cent of the disposable income of all individuals	Per cent of GDP	Male	Female	Aged over 65	Male	Female
Australia	1.6	16.1	67.6	63.8	59.7	61.3	6.0	60.0	36.9
Austria	2.2	14.9	86.6	3.6			2.8[1]	42.1[1]	17.5[1]
Belgium	3.3	13.8	77.9	6.1			1.3	36.6	15.7
Canada	5.8	2.5	97.4	45.7	62.6	61.1	6.0	61.3	41.7
Czech Republic	6.8			3.8			4.0	55.0	24.5
Denmark	2.7	9.2	73.0	24.4	62.4	61.5	4.6	65.5	51.8
Finland	4.8	7.5	79.0	10.7	59.8	60.0	3.7	51.2	49.5
France	3.9	10.7	89.7	6.3	59.3	59.8	1.2	43.8	34.1
Germany	5.0	10.4	85.6	3.2	60.5	60.8	3.0	50.6	32.4
Greece		29.2	76.8	4.6	61.7	62.2	5.0	57.0	23.6
Hungary	1.2	6.0	85.2	2.2			3.1	36.3	15.4
Iceland				86.0			19.9	92.8	81.7
Ireland		16.7	74.6	57.8			7.9	66.1	29.5
Italy	**–0.3**[5]	**15.3**	**84.1**	**3.0**	**59.3**	**58.4**	**3.4**	**42.3**	**16.9**
Japan	0.6			18.7	69.1	66.0	21.8	83.4	49.2
Korea	8.0			3.2	67.1	67.5	29.6	71.3	47.9
Luxembourg		6.7[2]		..			0.0	38.1	14.3
Mexico		32.9	85.3	2.4			30.5	80.5	27.6
Netherlands	4.8	1.9	86.3	119.3	61.6	60.1	3.1	52.0	26.9
New Zealand	5.7			..			8.6	74.6	51.7
Norway	8.0	19.1	74.1	7.4	64.2	64.7	13.2	73.6	63.2
Poland	–2.5	8.4[2]		..			7.5	41.5	24.1
Portugal				11.4	65.3	66.5	19.0	63.7	41.9
Slovak Republic							1.1	43.0	11.2
Spain	8.0	11.3[2]		2.3	61.1	61.1	1.6	61.4	23.6
Sweden	1.6	3.0	89.2	..	63.3	61.8	9.4	73.5	67.4
Switzerland		8.4[2]		97.3[3]			11.4	82.4	56.1
Turkey		23.1	92.7	..			18.1	50.8	18.4
United Kingdom	–0.7	11.6	77.8	84.1	62.0	61.2	4.8	64.4	44.6
United States	1.8	20.3	91.7	74.4	65.1	64.2	13.1	68.1	53.0

1. Förster and Pellizzari (2000).
2. Smeeding (2002).
3. 1998.
4. Dang *et al.* (2001).
5. More recent estimates in EPC (2001) indicate +0.3 for Italy.

Source: Dang *et al.* (2001), Förster and Pellizzari (2000), Jesuit and Smeeding (2002), OECD Labour Force Statistics.

Figure 41. **Pension spending and health care spending for older people**
Per cent of GDP



Source: Ragionera generale dello Stato based on the assumptions of the EPC (2001) baseline scenario.

adjustment. Based on the current transformation coefficients, the system would deliver a final year replacement rate of 54.9 per cent and 65.3 per cent for a person who works continuously for 35 years up to 60 and 65 respectively. These replacement rates will change every ten years in line with movements in life expectancy. Given the transition arrangements, it will not be until 2035 that the first employees retire with pensions based entirely on the new system.

The 1990s reforms are officially expected to reduce average pensions relative to average earnings by 30 per cent in the period up to 2050. This is one of the steepest declines in replacement rates envisaged in the OECD area in this period. However, as the fall is from a very high replacement rate, it is unlikely to compromise income adequacy in retirement, especially if individuals choose to offset some of the fall in replacement rates by working longer and retiring later or by accumulating contributions in private pension funds. Indeed, even after the reforms, replacement rates for average earnings will be close to or even exceed the current international average. Moreover, for the poorest workers, income adequacy will be ensured with a minimum pension that, in 2000, was set at a level 25 per cent above the level needed to satisfy basic needs (Sharpe, 2001) and has been raised further in 2002.

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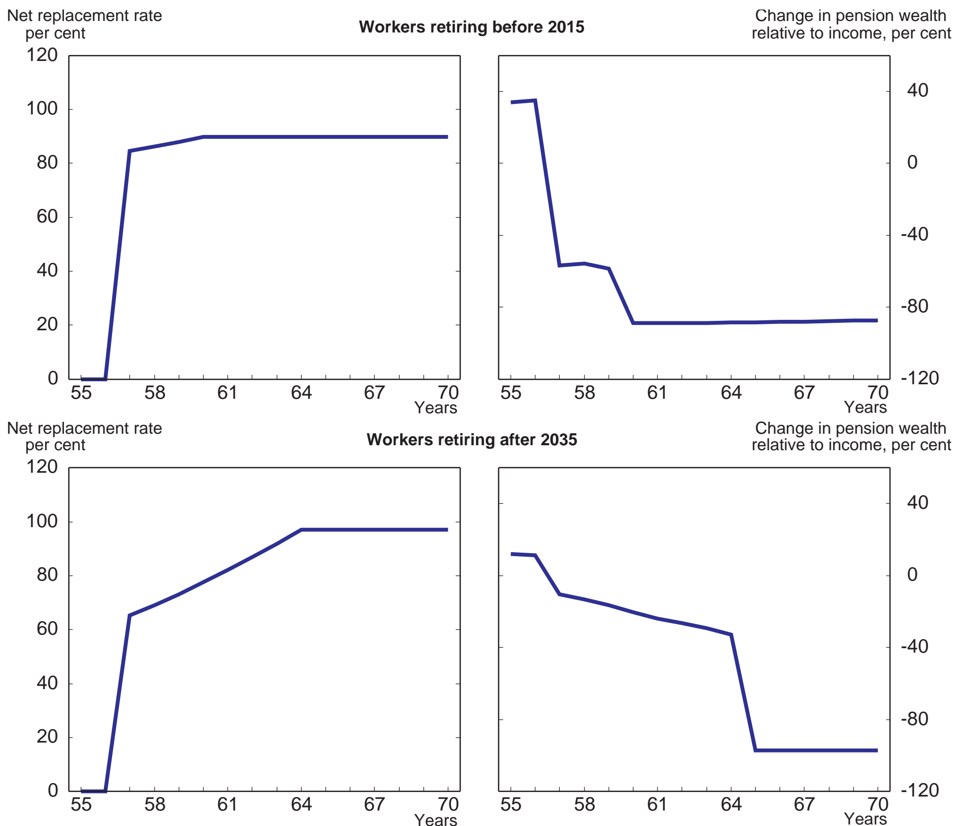
The reforms in the 1990s have significantly lowered disincentives to work after the age of 57. Nonetheless the social security system will continue to encourage retirement at the earliest possible age, especially in the transition period (Figure 42). Until around 2013, workers reaching the age of 57 face reductions in pension wealth that are equivalent to around 60 per cent of the income earned through an additional year of work. Beyond that date, extra years of employment will receive benefits determined by the parameters of the 1995 reform. Even so, under plausible assumptions people aged 57 could be faced with an implicit tax rate of 10 per cent that rises to 30 per cent by the age of 64.[192] For people aged 65 or over, the implicit tax rate will continue to be 100 per cent. Given the long transition before these reforms become

Figure 42. **Incentives for early retirement**



Source: OECD.

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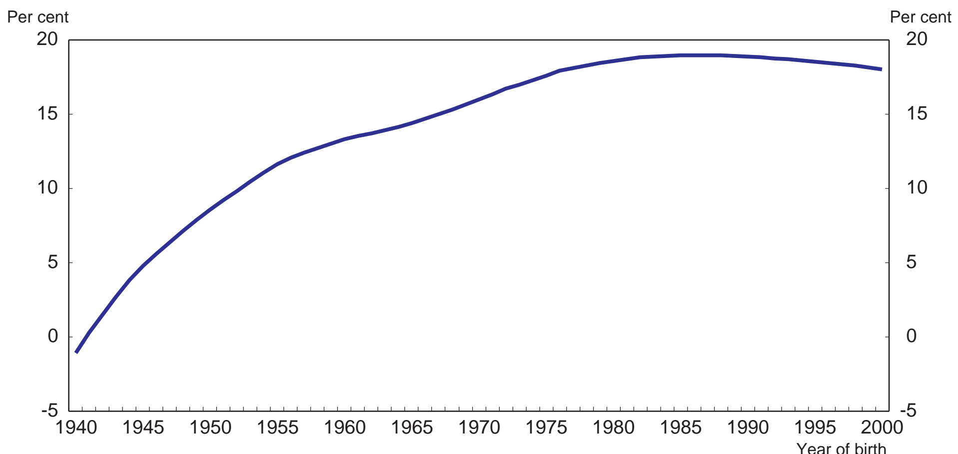
effective, the employment rate of those aged 55 to 65 is likely to remain amongst the lowest in the OECD area for the next decade. In addition, in this period the seniority system for drawing pensions remains in place – enabling people with a set number of years of contributions to retire at 55 (at 57 for dependent employees and at 58 for the self-employed starting from 2008) with no reduction in benefits.

While the reforms have stopped the progression of spending on pensions without compromising income adequacy in old age, they have not completely eliminated the overall disincentive to supply labour stemming from high social security contributions. Under the assumption of a 2.5 percentage point differential between future real interest rates and the growth rate of the economy, the gap between lifetime contributions and benefits will rise steadily from zero for people about to retire to around 19 per cent of lifetime income for those who retire in 2040 (Figure 43) (Fenge and Werding, 2003).[193]

One option to counterbalance the fall in replacement rates of the public system and to reduce labour supply distortions would be to transform the TFR funds to pension funds run on standard actuarial principles and lower other pensions accordingly. The TFR legislation obliges employees to pay a contribution of roughly 8 per cent of their income to the employer, in exchange for the payment of a lump sum when the employee quits a job.[194] Firms invest the contribution in

Figure 43. **Implicit tax rates in Italian pension system**[1]

The excess of contributions over benefits as per cent of life time earnings



1. The calculations assume a real rate of return of 4 per cent and productivity growth of 1.5 per cent.
Source: Fenge and Werding, CESifo Pension Model (2003).

their own business, holding a reserve on their balance sheets. Employees receive a nominal return of 1½ per cent per annum plus a bonus equal to three-quarters of the inflation rate. Typically, this scheme would provide a lump sum on retirement equal to just over 1⅓ year's salary after a life-time career with one employer.[195] Such a second tier system would compensate for the reduction in the replacement rate foreseen in the new public pillar system.

Past governments have attempted to encourage such a move but without much success. Current legislation allows part of the contributions to the TFR funds to be redirected to pension funds, with employees having the option to make extra contributions. Tax concessions raise the rate of return to this form of saving to above the pre-tax rate of return.[196] Nonetheless, by September 2001 only 1.3 million workers had joined such schemes and their total assets mounted to just 0.23 per cent of GDP (Vernière, 2002). The reluctance to use this opportunity to create a funded system may be related to employees losing their rights to severance payments in the process and to employers losing the possibility to borrow funds from their employees at very low real rates of interest.

Conclusions

The authorities appear to have succeeded in their aim of stabilising pension spending relative to GDP in the longer term, but there is still unfinished business on the pension reform agenda. Four areas stand out as in need of change. *First*, the combination of the 1992 and 1995 reforms left intact for a long transition period the seniority system whereby individuals can draw a pension after a fixed number of years of contributions provided they are aged 55-58. Reform here would require diminishing such pensions to take account of the longer period for which such pensions are paid. *Second*, the transition to the new system that lowers disincentives to continued employment after 57 is very slow and should be speeded up considerably. *Third*, even when the new system is fully implemented, there will still be disincentives to work beyond the age of 65 and these need to be eliminated. Even before that age limit, the possibility to retire from the age of 57 onwards might override the incentives to postpone retirement implied by the actuarial adjustment rules currently embedded into the new system and the effect possibly induced by the overall cutback of pension wealth. An important objective would be reforming the current TFR system towards a fully funded second-tier pension system that should eventually permit the replacement of part of the state system and hence greater actuarial fairness in the combined pension systems, without compromising income adequacy for the poorest.

Health care system

The Italian healthcare system accounted for a little over 8 per cent of GDP in 2001, about the OECD average, with public spending on health at around 6 per

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cent of GDP being somewhat above the OECD average. Despite good population health status as measured by indicators like high life expectancy and low infant mortality, a number of problems still persist in the Italian healthcare system:[197] *a*) waiting times for a variety of medical services are long, sometimes exploited as a means for demand rationing; *b*) delays for payment to suppliers are protracted, and are often used as an instrument for short-term financing; *c*) the number of doctors per thousand population is the highest in OECD countries[198] whereas the number of nurses is below the average; *d*) although the rationalisation of hospitals has led to a welcome decrease in the number of beds per thousand population, the share devoted to long-term care remains low compared to expected demand for this type of service; and *e*) the risk is high that many inpatient care services are "inappropriate" for many diagnostic related groups (DRGs),[199] *i.e.* that the pathologies could be treated through less expensive treatments.

In the 2000-2001 period, public health expenditure increased on the order of 9-10 per cent as an yearly average – significantly above (three times) nominal GDP growth – especially as a result of the rise in pharmaceutical expenditure, specialised visits, and purchases of goods and services. The increase in pharmaceutical expenditure continued in the first half of 2002, mainly because of the lifting by the government of co-payments at the national level and the public's expectations of their subsequent re-introduction by the regional authorities.

A fundamental issue negatively affecting the health care system is the blurred division of responsibilities between the central government and the regional administrations as far as management and financing of health care is concerned. In fact, while health care represents one of the largest shares of total spending in regional budgets, many decisions affecting the management and expenditure are taken at central level. For example, wages for doctors and nurses are decided nationally, with little scope for regional variation despite different costs of living across the country. This strategy reflects the need to reach important objectives like ensuring equal access to health care, improving its quality uniformly across the country, while at the same time containing costs. Nevertheless, since productivity improvements are possible only to a limited extent, the objectives of supplying more and better health care and of containing costs can sometimes conflict with each other.

Since the second half of 2001, the central government and the regional authorities have reached three important agreements. In August 2001, the agreement specified *ex ante* the amount of resources that the state would transfer to regions for financing health care in the period 2002-2004. Regional administrations are now responsible for any spending above these amounts. In the event of overspending, they have to introduce specific measures (co-payments, higher regional taxes, spending limits to providers, securitisations) to avoid cumulating deficits as in the past. At the end of 2001, a further agreement specified the minimum standards

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in a detailed range of services that the regions have to provide to the public. The same agreement made state transfers conditional on the introduction by regional administrations of efficiency and quality enhancing measures: *a*) streamlining the hospitals' network (closing small hospitals and exploiting economies of scale and scope of larger ones); *b*) rebalancing the number of beds towards a higher share for long-term care; *c*) enhancing home care; *d*) moving 43 DRGs from inpatient to outpatient care. Finally, with a further agreement reached in February 2002, regions were asked to introduce specific measures in order to reduce waiting times for medical services. The 2003 Budget Law introduced further specific requirements to regions in order to receive the transfers, like the dismissal of general directors of the health institutions (*aziende sanitarie*) in case of deficits. Other saving measures were recently introduced at the central level (with an estimated annual saving of 0.06 per cent of GDP) among which a new methodology based on a reference price system to determine the reimbursement price for certain pharmaceuticals by the national health system, and a very gradual shortening of the length of pharmaceutical patents from the current 38 years to 25 years by 2029.

The agreements represent an important step in the clarification of responsibilities on the managing and financing of the health sector. Still, as long as they do not explicitly exclude the bailing out of regional administrations in case of recurrent deficits, they might not go far enough in eliminating the existing incentives of providing health services beyond the spending limits and without raising unpopular taxes or co-payments. The current penalty to regions for doing so is the reduction of state transfers to the lower levels before the 2001 agreement. However, the actual implementation of this penalty is still to be tested, as it would put at risk the provision of health services in some regions contrary to the government's objective of ensuring a minimum standard of health care across the country. There is also a risk that hospitals continue to build up arrears.

On top of this, pressures to increase spending on health care will be likely to remain strong for three main reasons. F*irst*, per capita health spending has a tendency to increase faster than income per capita (Figure 44). Thus, in the process of catching up by regions in the South, demand for health services might increase significantly. S*econd*, past experience in OECD countries shows that future technological innovation might lead to further upward pressure in per capita health consumption rather than to efficiency gains. T*hird*, the progressive ageing of the population is going to exert a significant impact on health spending. On the assumption that age-specific per capita health consumption remains constant at 2001 levels, health care spending is expected to increase by 2 percentage points of GDP in the next fifty years.[200] Unless more fundamental measures are rapidly introduced, this higher demand (which is likely to be even higher[201]) and the need to ensure equal access to a minimum standard would require adequate financing, with a consequent risk to the attainment of other public finance objectives like the implementation of the tax reform.

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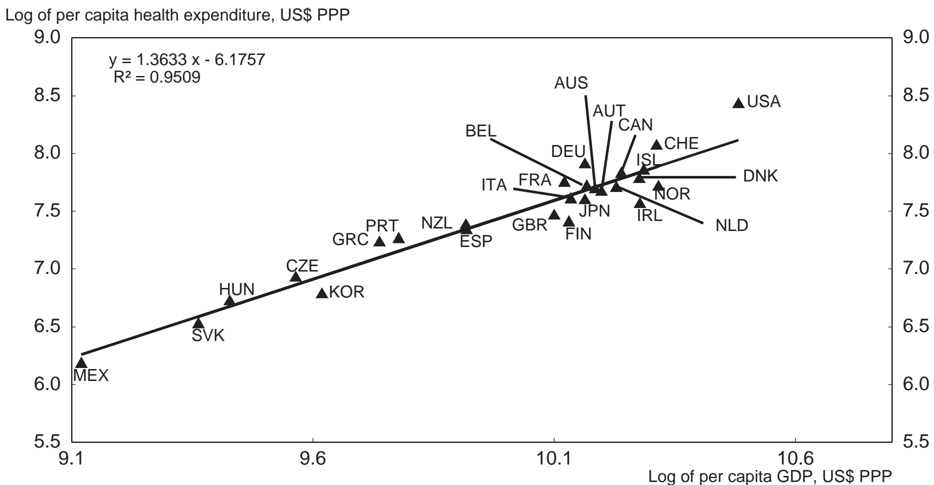
Figure 44. **Per capita health spending and per capita income, 2000**



Note: Health expenditure data are not available for Luxembourg, Poland, Sweden and Turkey for 2000.
Source: OECD (2002), Health Database.

An area for possible saving is to reinforce the responsibility of regional administrations in both the management and the financing of the health care sector. The latest corrective measures taken at the central level, as well as the agreements with regions, give greater responsibility to the regional governments, albeit in a framework of detailed guidelines fixed by the central government. State transfers are conditional on respecting these guidelines. In this perspective, the monitoring capacity of the central government is being improved. The central government should reinforce decentralisation and set-up a more credible mechanism of incentives and penalties to avoid extra deficits as in the past. More decisions should be taken at the decentralised level, like the type of contract and the wage levels for doctors[202] and nurses, or the pharmaceuticals to be reimbursed. If *ex post* a region overshoots, bailing out should be explicitly excluded. An important role for the central government should also be to provide adequate information among regional administrations and hospitals on best practices and to develop a system of benchmarking.

In addition, pressures from health demand could require a more significant share of private financing. The private sector is already paying a relatively high share of total health spending in the form of out-of-pocket payments, whereas private insurance is not very developed (Figure 45). A more balanced system of health financing would require a greater role for complementary private

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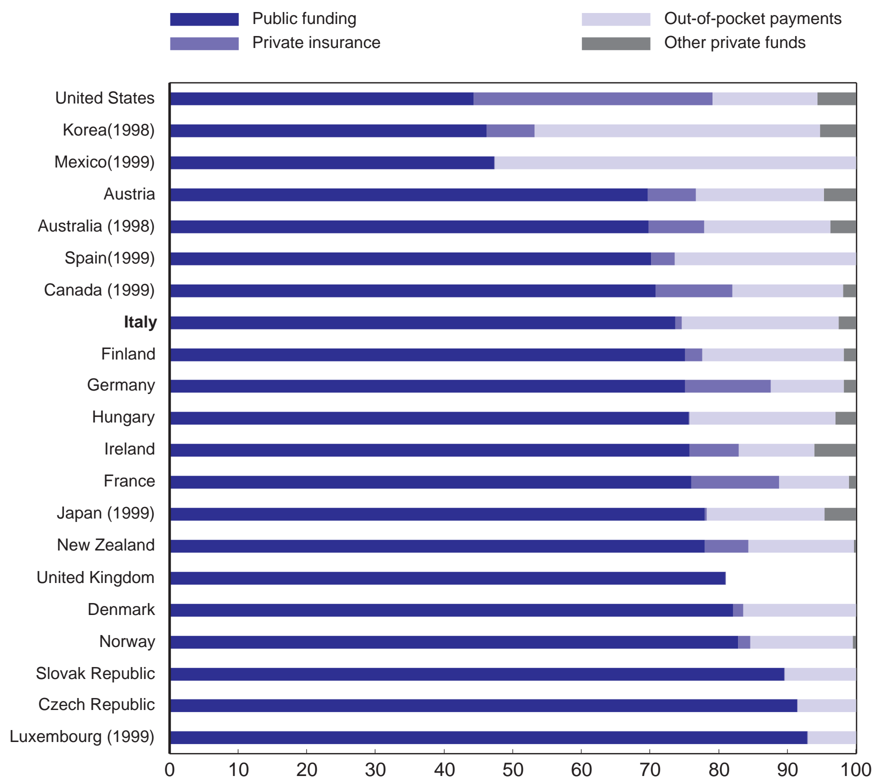
Figure 45. **Distribution of health financing**
Shares of total health expenditure, 2000



Source: OECD (2002), Health Database.

insurance, which at present might be hindered by the generosity of the publicly provided services. In this perspective, Italy could also look at the experience in some OECD countries (Germany, the Netherlands, and Switzerland) which have attempted to introduce more competition between social insurers. In such a context, more significant benefits could also derive from greater competition among providers – already introduced in some regions – as a competitive health insurance market might put more pressure on them to reduce the prices of their services and, consequently, their costs, without putting at risk their quality. However, so far the experience regarding the success of greater competition among insurers and among providers in containing health care costs has been mixed.[203]

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Some aspects of sustainable development

There is growing concern that long-run sustainable development may be compromised unless countries take measures to achieve balance between economic, environmental and social outcomes. This section looks at two issues of sustainable development that are of particular importance for Italy. In each case, indicators are presented to measure the progress and the evolution of potential problems, and an assessment is made of government policies that affect the issue.

Box 8. Policy integration across sustainable development areas*

Institutions capable of integrating economic, environmental and social policies are still under construction. The Commission on Sustainable Development, established in 1998 within the Inter-Ministerial Committee for Economic Planning, is envisaged to play an important role in co-ordinating policies across the different areas. Already, the Commission has approved an environmental action plan for sustainable development that contains broad objectives but no specific measures. The plan will be given operational content through quadrennial planning documents. However, it does not deal with social objectives, as it is felt that consideration of social outcomes is already taken into account in the deliberations of the Parliament.

The Ministry of Environment reviews the environmental impact of infrastructure projects and has the authority to block projects that create excessive damage. However, such reviews come only at the very end of the planning permitting procedure and can therefore create delays and unpredictability. For infrastructure projects, the distribution of decision-making authority between the central government, regions and municipalities has meant that local concerns about the construction of projects have dominated other considerations. For example, it has been difficult for electricity companies to obtain the required planning permits, leading to a dearth of new construction. This situation may be changing as a new law has strengthened the power of the central government in this area, and the courts have ruled that local referenda cannot block projects of national interest. As called for by EU directives, a recent law requires a strategic environmental assessment of major plans and programmes.

The economic impact of environmental policies is reviewed in an analysis that accompanies every draft bill submitted to the Council of Ministers. The economic analysis is prepared by the sponsoring ministry but reviewed by another department, most frequently the Ministry of Economic Affairs and Finance. The value of the analysis to policy-makers may be lessened by the lack of a common framework and a stable set of economic assumptions. Also, greater use of cost-benefit analysis would facilitate policy making in this area.

* The sections in this report dealing with climate change, water pollution and sustainable retirement income policies are inputs into the Organisation's follow up on Sustainable Development as mandated by the Ministerial Council decision in May 2001.

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The section considers first the policies that have been put in place to control emissions of greenhouse gases. It then looks at water pollution policy. The section also considers whether institutional arrangements are in place to integrate policy-making across the different elements of sustainable development (see Box 8).

Climate change

Main issues

Italy is participating in international efforts to limit climate change through the Kyoto Protocol. Under the EU burden sharing agreement, Italy is committed to reducing its greenhouse gas (GHG) emissions by 6.5 per cent from the 1990 level by 2008-2012, an abatement target that is marginally lower than for the EU as a whole. However, since GHG emissions were 5 per cent above their 1990 level in 2000, a major abatement effort is called for in the coming years. Against this background, the main issue is how to honour the burden sharing agreement without placing an excessive burden on the economy.

Performance

Though it is still low in terms of levels, the economy-wide GHG emission intensity has fallen significantly less than in the European Union as a whole since 1990 (Table 33). The comparatively weak decoupling of emissions from economic growth is mainly related to developments in the electricity-generating sector, emissions per KWh falling relatively modestly and electricity generation rising in relation to GDP (Table 34). Movements in emission intensities in other sectors have also helped to explain the economy-wide trend. Thus, GHG emissions due to residential heating rose relative to private consumption, whereas they fell significantly in most other EU countries. Also, CO_2 emissions per vehicle increased somewhat in Italy in contrast to developments in many neighbouring countries. Continuations of these past trends would result in Italy exceeding the EU burden-sharing target by a wide margin. Indeed, government projections, from December 2002, suggest that emissions would be 20 per cent above their target level in 2010 in the absence of any policy actions.

Policies

Against the background of a likely significant overshoot with unchanged policies, the authorities have taken measures, or are preparing new measures, to reduce future GHG emissions both directly and indirectly. These involve liberalisation of energy markets, a new tax on emissions by electricity generators, fostering renewable sources of energy and reducing emissions in heating and transport. The abatement costs associated with these different policies differ markedly, ranging from none to very high. As established by the Law No. 120 of 1 June 2002, that ratified the Kyoto Protocol, the Interministerial Committee for Economic Plan-

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Table 33. **GHG emissions and sectoral indicators**

	Total GHG emissions		CO_2 emissions per Kwh electricity	Manufacturing CO_2 emissions per unit of industrial production	Residential CO_2 emissions per unit of private consumption	Road transport CO_2 emissions per vehicle	Electricity use per unit of GDP	Industrial output per unit of GDP
	Level million tonnes CO_2 equivalent 2000	Annual average percentage change						
		1990-2000	1990-2000	1990-2000[1]	1990-2000[2]	1990-1999	1990-2000	1990-2000[1]
Australia	502	1.7	0.1	–0.8	–1.6	–0.6	–0.5	–1.6
Austria	80	0.3	–2.8	–2.8	–3.4	–1.0	–0.4	1.5
Belgium	152	0.7	–0.8	–0.7	–1.6	–0.1	–0.5	0.0
Canada	726	1.8	0.7	–2.4	–2.7	1.2	–0.5	0.9
Czech Republic	147	–2.7	1.1	–10.1	–11.5	2.6	1.4	1.3
Denmark	69	–0.1	–3.7	–3.4	–5.3	0.3	1.0	1.1
Finland	74	–0.4	–0.5	–7.2	–7.8	–0.6	0.3	3.2
France	550	–0.2	–3.2	–1.8	–2.3	–0.1	0.7	–0.2
Germany	991	–2.1	–2.1	–2.6	–5.1	–0.4	–1.5	–0.4
Greece	130	2.2	–1.9	–0.9	8.2	–1.5	2.0	–1.2
Hungary	84	–1.8	–2.6	–13.4	8.8	0.0	1.3	7.3
Iceland	3	0.7	..	..	–7.5	–1.9	2.9	..
Ireland	67	2.2	–1.1	–11.4	–5.4	2.5	–1.8	5.5
Italy	**547**	**0.5**	**–1.2**	**–2.0**	**–0.7**	**0.3**	**0.8**	**–0.3**
Japan	1 386	1.1	–0.9	0.5	–2.2	0.1	1.0	–1.6
Luxembourg	6	–7.8	–20.3	–12.5	–2.4	1.2	–8.5	–2.8
Netherlands	218	0.4	–0.3	–1.6	–3.9	0.2	–0.7	–0.8
New Zealand	77	0.5	3.7	1.8	–4.3	–1.2	–0.8	–0.8
Norway	55	0.6	0.4	0.2	–9.4	0.3	–2.0	–2.1
Poland	386	–3.7	–3.7	–6.4	11.7	–0.7	–2.9	3.8
Portugal	85	2.7	–0.7	1.3	1.1	–2.2	1.5	–1.4
Slovakia	49	–4.0	–0.3	–9.1	–2.1	0.3	1.3	–1.3
Spain	386	3.0	0.0	–0.2	1.8	0.2	1.2	–0.4

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Table 33. **GHG emissions and sectoral indicators** (*cont.*)

	Total GHG emissions		CO_2 emissions per Kwh electricity	Manufacturing CO_2 emissions per unit of industrial production	Residential CO_2 emissions per unit of private consumption	Road transport CO_2 emissions per vehicle	Electricity use per unit of GDP	Industrial output per unit of GDP
	Level million tonnes CO_2 equivalent 2000	Annual average percentage change						
		1990-2000	1990-2000	1990-2000[1]	1990-2000[2]	1990-1999	1990-2000	1990-2000[1]
Sweden	69	–0.2	0.2	–4.1	–3.7	0.2	–1.7	1.9
Switzerland	53	–0.1	–4.8	0.2	–3.1	–1.0	1.0	1.5
United Kingdom	649	–1.3	–3.6	–2.1	–1.2	–0.6	–0.7	–1.6
United States	7 001	1.3	0.2	–4.7	–1.9	0.9	–0.9	1.1
Total of above OECD countries	14 543	0.6	–0.7	–2.8	–1.8	0.2	–0.3	0.2
OECD excluding US	**7 542**	**–0.1**	**–1.6**	**–1.9**	**–1.8**	**–0.3**	**0.3**	**–0.4**
EU countries	4 073	–0.3	–2.1	–2.0	–2.4	–0.2	–0.3	–0.3

1. 1995-2000 for Czech Republic; 1991-2000 for Germany; 1992-2000 for Hungary and Slovakia; no data for Iceland.
2. 1991-1998 for Czech Republic; 1993-2000 for Slovakia.

Source: GHG National submissions to UNFCCC, national sources and UNFCCC; carbon dioxide data, IEA; industrial production, private consumption, OECD.

Table 34. **Main indicators: climate change**

Indicators of greenhouse gas (GHG) emission intensity, grams of CO_2 equivalent per $PPP of GDP, in 1995 prices

	Total GHG emissions	CO_2 emissions, electricity	CO_2 emissions, transport	Other GHG emissions	Total GHG emissions	CO_2 emissions, electricity	CO_2 emissions, transport	Other GHG emissions
	Level, 2000				Average annual percentage change 1990-2000			
Australia	1 061	360	159	542	–1.82	–0.46	–1.52	–2.70
Austria	403	66	96	241	–2.05	–3.20	–0.02	–2.42
Belgium	600	105	97	398	–1.47	–1.27	–0.19	–1.81
Canada	888	156	183	549	–0.94	0.24	–0.85	–1.28
Czech Republic	1082	468	100	514	–2.77	2.54	6.33	–6.58
Denmark	501	171	88	242	–2.38	–2.73	–0.84	–2.64
Finland	597	178	99	321	–2.56	–0.17	–1.83	–3.84
France	402	30	102	271	–2.00	–2.60	–0.02	–2.57
Germany	519	168	91	260	–3.92	–3.57	–1.05	–4.95
Greece	819	275	122	422	–0.16	0.07	–0.02	–0.34
Hungary	747	192	79	476	–2.60	–1.30	–0.24	–3.40
Iceland	398	0	84	314	–1.82	..	–2.47	..
Ireland	643	152	98	392	–4.63	–2.97	0.23	–6.03
Italy	**432**	**108**	**89**	**235**	**–1.06**	**–0.43**	**0.01**	**–1.70**
Japan	441	132	81	229	–0.34	0.13	0.89	–0.99
Luxembourg	314	6	249	59	–12.47	–27.09	0.62	–23.13
Netherlands	553	138	80	335	–2.49	–0.95	–1.09	–3.34
New Zealand	1078	82	179	817	–2.21	2.87	0.80	–3.12
Norway	454	3	97	354	–2.91	–1.57	–2.86	–2.93
Poland	1109	458	74	576	–7.12	–6.48	–1.39	–8.08
Portugal	516	129	111	276	–0.06	0.85	3.47	–1.51
Slovakia	846	249	70	526	–5.21	0.98	1.98	–7.60
Spain	536	130	127	278	0.35	1.21	0.97	–0.28
Sweden	340	35	110	195	–1.91	–1.52	–0.77	–2.56
Switzerland	267	2	78	187	–0.94	–3.82	–0.40	–1.11
United Kingdom	512	137	106	268	–3.58	–4.30	–1.41	–3.94
United States	779	273	192	315	–1.86	–0.73	–1.30	–3.04
OECD total	639	201	137	307	–1.88	–0.79	–0.58	–2.90
EU	491	120	100	272	–2.43	–2.36	–0.40	–3.10

Source: Greenhouse gas emissions: national submissions to the UNFCCC and national publications. Carbon dioxide emissions for electricity and transport: IEA. GDP: OECD, SNA database.

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ning approved the "Revised guidelines for national policies and measures regarding the reduction of greenhouse-gas emissions" and the related National Action Plan for the reduction of greenhouse gas emission levels on 19 December 2002.

The levels of current targets were set on the basis of the so-called "reference emissions scenario":

- new combined-cycle plants and increase of gas and electricity imports;
- increased use of renewable sources for a total amount of 75 TWh by 2010;
- reduction of energy consumption for residential uses;
- progressive phasing-out of landfills and increased energy production from waste;
- new infrastructures, with effects on the transportation of passengers and goods from road to railways and coasting navigation;
- promotion of the production and use of high-efficiency vehicles and fuels; and
- optimisation of private transportation systems.

The reference scenario also includes the initiatives undertaken in China, in North African countries and in the Balkans that may generate emissions credits under the Clean Development Mechanism and Joint Implementation Mechanisms (12 Mt CO_2 eq.). Except for the measures in the transport sector, for the other measures the authorities consider that the net cost is less than zero.

The liberalisation of the energy market will most likely allow GHG emissions to be cut while bringing economic benefits. In the old regulatory environment, the monopoly power generator was, on occasion, encouraged to invest in coal plants and to re-open domestic mines with the aid of subsidies, even if cleaner gas-fired stations were more attractive from a commercial point of view. At the same time, little effort was made to develop a gas distribution network that would make it easier for users to take advantage of lower-cost gas. With the liberalisation of energy markets, generators are free to choose fuels according to economic criteria, though the privatised incumbent will receive subsidies for stranded costs related to coal-fired stations until 2004. Subsidies were also provided to reopen one coal mine in Sardinia to provide part of the fuel used in a new plant that will have low emissions of local air pollutants. Gas is likely to be the fuel of choice for new plants and should produce about half the carbon emissions per kilowatt relative to existing oil plants and should also reduce air pollution. Domestic emissions are also likely to be reduced in the freer EU power market as the high price of domestically-generated electricity may prompt the transmission company and users to construct new power lines to increase electricity imports once regulatory obstacles are lessened.[204] As most Italian electricity imports come from France and Switzerland, from nuclear and hydro plants, global emissions should be reduced by this policy.

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The planned emission tax on electricity generators is likely to involve only relatively low carbon abatement costs. In 1997 AEEG introduced a new rule for the calculation of the tariff for a four-year period, which led to reducing the use of oil in thermal power generation from 55 to 34 per cent. In a liberalised energy market, the emission tax will encourage producers to shift to fuels with lower carbon content and to improve the thermal efficiency of their plants. The single tax rate on emissions, expected to start at between EUR 5 and 10 per tonne of carbon dioxide (EUR 18 to EUR 27 per tonne of carbon), is a marked improvement over its predecessor, as the fuel tax introduced in 1999 involved different implicit carbon tax rates by fuel and by their use. Nonetheless, the cost efficiency of the new tax has been reduced by limiting it to major electricity generators.

In contrast to the emission cuts induced by liberalisation of the energy market and the emission tax, abatement costs associated with further expansion of renewable energy are likely to be very high. A series of incentives put in place at the beginning of the 1990s resulted in almost one-quarter of the increase in electricity demand in the 1990s being met by increased production of renewables, while output from subsidised co-generation plants also increased rapidly. The associated carbon abatement costs varied across the different sources of renewable energy, but were as high as EUR 1 100 per tonne of carbon saved.[205] The very generous incentives were financed through a levy on overall electricity prices. By 2000, the regulator estimated that this levy was adding over 7 per cent to the average price of electricity. The price of electricity is in general considerably above the European average, while the price of gas is slightly above its European average. While part of this difference is due to taxes and, in the case of electricity, also to high operating costs and to incentives to renewable resources, the price of energy net of these extra burdens is still above the European average.

A new system for the pricing of renewable electricity has now been introduced that is non-discriminatory and may have a lower, but still very high, cost. All generators and importers of electricity are now required to deliver renewable certificates to the regulators that are equivalent to 2 per cent of their sales, rising to 4.5 per cent by 2012. The certificates have to be bought from producers of renewable electricity with approved plants built after 1999. In 2002, the regulator set the price at 8.4 cents per KWh, this compares to the 1 to 1½ cents per KWh in the Irish and Danish markets. Indeed, such a premium implies an abatement cost per ton of avoided carbon emissions at EUR 700 per tonne of carbon – well above the proposed tax rates on excess emissions and likely permit prices on the EU market[206] (IEA, 2002 and Criqui *et al.*, 2002). A further problem with windpower is that most of the areas where there are strong winds are located on islands with poor interconnection facilities to the mainland electricity grid.

Regulations and subsidies aimed at reducing emissions from heating and transport are also likely to involve high abatement costs. Decrees were passed in 2001

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to strengthen insulation requirements. Estimates from other countries suggest that the cost per saved ton of carbon with higher insulation requirements is high. Moreover, these rules affect only new buildings and are therefore likely to be much less effective than taxes that create incentives for owners of existing buildings. In the transport sector, emissions are already low due to the very high taxes on motor fuel. Nonetheless, the climate strategy aims to reduce emissions through subsidies to railways and waterways and a publicity campaign that will promote car sharing. These measures are unlikely to yield the foreseen savings. Over the longer-term, some equalisation of implied carbon tax rates most notably in the transport sector and the other sectors of the economy, especially those covered by permit trading, may be needed to ensure a cost-effective abatement policy and avoid over-investment in fuel-saving technologies. However, a reduction in fuel taxes would require higher taxes elsewhere both to keep any reform revenue neutral and to ensure that all externalities and user costs are covered. In the long term, a tax based on the distance travelled by each vehicle type, allowing for the external costs imposed by each vehicle, could provide an alternative revenue base, especially for heavy goods vehicles.

Conclusions

A significant abatement effort would be required to attain the EU burden sharing target domestically, and the pursuit of cost-effectiveness is therefore necessary to avoid excessively harming economic activity. In the liberalised electricity sector, market forces are likely to result in a marked reduction in emission intensity, as natural gas gains market share, though some offset may occur as prices fall. No further advantages should be granted to coal-fired plants. Equally, policy towards renewable energy, that effectively provides a massive subsidy to the industry, should be rethought. Italian electricity producers should be allowed to submit purchase renewable certificates from abroad, or the renewable quota should lowered, until Italian prices are driven down to a level that reflects the value of both avoided carbon in the future European emission permit system and avoided air pollution. The proposed tax on above-threshold emissions in the electricity sector could prove an interesting instrument but is likely to be superseded by the EU trading system. Economic efficiency requires that little emphasis should be given to reducing emissions in the transport sector as the reductions available at low marginal costs have already been achieved through the high level of tax rates on motor fuels. Importing emission permits could therefore play a useful role in a cost-effective Kyoto strategy.

Reducing water pollution

Main issues

Clean drinking water is a vital commodity that depends on the supply of surface and ground water also being of good quality. In addition, water is of value as a source of recreation and provides a base for many economic activities. Overall

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water quality in Italy is of a reasonably good level but there are large differences between water basins. Since the mid-1990s, Italy has considerably improved its monitoring of water bodies and has begun modernising water management. The principal challenge is how best to ensure that the ambitious national objective of restoring all surface and ground water bodies to acceptable quality for bromati and trialometani by 2008 is achieved in a cost-effective manner.

Performance

For the pollutants for which data are available, the quality of surface waters has remained broadly stable in Italy during the past two decades and at levels commonly observed in OECD countries (Table 35). Most rivers show acceptable or even higher quality, but around a quarter of all river lengths are judged to be unsatisfactory (Figure 46). However, nitrates and a number of other pollutants have built up in groundwater reservoirs, with the result that one-quarter of the water bodies used to produce drinking water (mainly located in Tuscany, Veneto and Sardinia) require significant physical and chemical treatment before the water can be used in public supply system. In parts of the northern region,[207] where the general quality of underground water is monitored in a systematic manner, excessive contamination by human coliforms affects about a quarter of the aquifers and high nitrate levels are also observed in one-fifth of monitoring stations (APAT, 2002). The quality of seawater in coastal bathing areas has shown a continuous improvement since 1993. Nonetheless, the Northern Adriatic area continues to be affected by eutrophic conditions and these are also found around a number of Sicilian towns. Agricultural activity generates a significant proportion of the nitrate and phosphate pollution, as well as accounting for half of all the runoff of soil sediment, that represents a major pollutant of surface water, and accounting for most pesticide runoff.

Policies

Where surface and groundwater quality is unsatisfactory this is partly related to inadequate progress in tackling a large infrastructure deficit as regards wastewater treatment. To some extent this is linked to the fragmentation of the water industry that results in a high cost of wastewater treatment in some areas. However, under the 1994 Galli act, municipalities were required to regroup their water supply services into *optimal management areas* (ATO). The objective was to create 91 ATOs to take over the water services run by 8 102 municipalities. A decade later, ATOs are in place but are not fully operative everywhere. While 63 per cent of the population is now linked to a public sewer system, there are marked differences amongst regions in the policies followed with regard to adequacy of the sewage treatment infrastructure: from full conformity to complete non-compliance. Even in Milan, untreated sewage from 2.7 million residents is discharged into a

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Table 35. **Performance indicators: water pollution**
Selected rivers

	Biochemical oxygen demand		Nitrates		Total phosphorus	
	mg O2/litre		mg N/litre		Mg P/litre	
	Average 1980-85	Average last 3 years	Average 1980-85	Average last 3 years	Average 1980-85	Average last 3 years
Australia	..	..	..	..	..	..
Austria	2.2	2.2	1.2	1.3	0.2	0.1
Belgium	6.6	..	3.8	..	0.7	..
Canada	..	..	0.1	0.1	0.1	0.0
Czech Republic	8.5	4.6	5.1	3.5	..	0.3
Denmark	3.9	2.0	3.5	2.6	0.3	0.1
Finland	..	..	0.2	0.3	0.0	0.0
France	5.2	3.2	2.8	3.1	0.4	0.4
Germany	3.6	2.4	3.5	3.3	0.5	0.2
Greece	..	..	1.3	1.5	0.4	0.4
Hungary	4.4	2.9	2.2	1.6	0.4	0.3
Iceland	..	..	..	..	..	..
Ireland	1.7	1.8	2.2	2.9	0.1	0.1
Italy[1]	**..**	**..**	**2.0**	**2.1**	**0.3**	**0.2**
Japan	2.3	1.4	..	..	..	..
Korea	..	2.8	..	2.6	..	0.1
Luxembourg	3.8	2.7	4.1	4.1	0.6	0.4
Mexico	3.7	15.9	1.9	0.6	..	0.1
Netherlands	2.8	3.1	4.4	3.3	0.5	0.2
New Zealand	..	..	..	..	..	..
Norway	..	..	0.3	0.3	0.0	0.0
Poland	5.0	4.3	1.8	1.9	0.3	0.3
Portugal	..	..	..	..	..	..
Slovak Republic	5.1	3.3	2.0	2.2	0.1	0.2
Spain	4.7	3.6	1.7	3.1	0.6	0.2
Sweden	..	..	0.4	0.5	0.0	0.1
Switzerland	..	..	1.5	1.5	0.1	0.1
Turkey	2.1	2.7	1.3	1.0	0.3	0.2
United Kingdom	3.4	2.9	4.6	5.2	0.8	0.9
United States	1.8	1.6	1.1	..	0.2	0.1

1. Data on biochemical oxygen demand are absent from OECD databases and have not been reported by the national authorities so far.

Source: OECD.

tributary of the Po River. Just over half of all towns with a population of over 15 000 require investment in order to achieve full compliance with the relevant norms.

Inadequate wastewater treatment facilities are partly related to a failure to recover costs from users. The reforms introduced by the Galli Act resulted in a move towards full cost charging. Water companies, which were previously autho-

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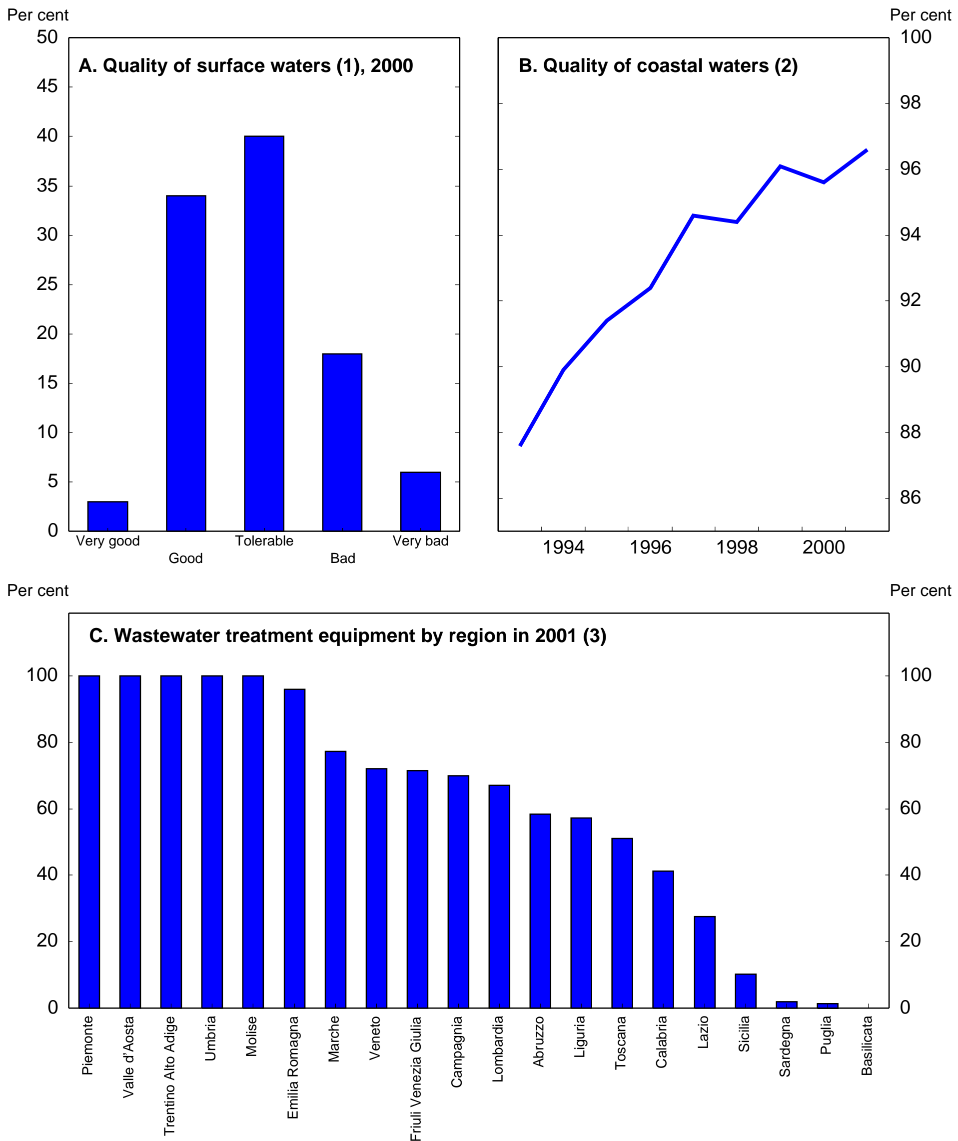
Figure 46. **Water quality**



1. Breakdown of rivers and streams length by class of quality for major pollutants.
2. Per cent of bathing areas in compliance with EU mandatory values.
3. Per cent of towns in conformity with applicable regulations.

Source: Agenzia Nazionale per la protezione dell'ambiente e per servizi tecnici.

rised to charge only current expenditure to users, are now allowed to increase water prices gradually so as to recover the full costs of sewage collection and wastewater treatment, including the renewal of infrastructure when needed. In 1996, the latest year for which data are available, cost recovery reached 80 per cent (APAT, 2002). Nonetheless, in some areas the level of service is low and so water services are cheap by international standards. Moreover, a social water tariff was introduced in 1999, with the charge rising with the amount of water consumed, creating cross-subsidies in favour of small users with the result that prices are very low for many groups. In view of the high costs of building up the infrastructure in the southern region, the central government will finance a large programme to provide uninterrupted drinking water supplies and improve waste water treatment in these areas.

Agricultural activity is also a significant cause of water pollution. It is responsible for about two-thirds of nitrate runoff, half of soil sediment discharge into rivers and one-third of phosphate discharge. Indeed, between 1990 and 1997, the use of mineral fertilisers (phosphorus, nitrogen and potassium) increased by 25 per cent to reach an average of 170 kilograms per hectare (APAT, 2002). In addition, manure is spread on land with the result that not all nutrients can be absorbed, with the nutrient surplus varying from 17 kilogram per hectare of cultivated land in Basilicata to 208 kilograms in Lombardy.[208] A number of regions have instituted limits on the spreading of manure, the strictest being in the Po Valley area where there are also restrictions on the winter spreading of manure in some areas (OECD, 2002e). Another instrument used to check this source of pollution is a code of good agricultural practice, but it is only compulsory in areas that have been classified as vulnerable by the government and these areas represent only 2 per cent of cultivated land against an estimate of 29 per cent made by the EC. The voluntary basis for this code and the limited extent of designated vulnerable zones make it very unlikely that it will curb pollution from agricultural sources. Indeed one key measure of good practice, the proportion of time that the soil is uncovered by vegetation, is particularly high in Italy. River basin authorities have been established to manage water and these authorities need to take their actions on an integrated plan from the reduction of nitrate and phosphate pollution. Such a plan would have to use economic instruments set in line with the benefits of reducing such pollution. A more stringent regime applies to industrial sources which are controlled through discharge permits that cannot be traded even within a given river basin.

Conclusions

Two areas are central to achieving further reductions in water pollution: domestic waste-water treatment and agriculture. At present there are few market incentives in place to ensure that discharges from sewage systems are reduced.

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Moreover, the approach to reducing pollution from agriculture appears piecemeal. Nonetheless a structure for a more integrated approach does exist in the current legislation and should be used more fully. Existing river basin authorities should develop integrated plans to reduce pollution based on economic instruments that would give local authorities incentives to treat wastewater and farmers an incentive to minimise agricultural run-offs. In this latter area more action is called for than has been taken so far, but experience elsewhere suggests that administrative programmes to reduce diffuse run-offs have high costs and voluntary programmes have limited impact. Other countries have implemented a tax on the nutrient surplus of each farm, and this has proved a cost efficient way to reduce water pollution emanating from agriculture and should be developed by the river basin authorities. The water pricing system constrains the ability of water companies to finance investment in pollution abatement as the social water tariff means that users who consume small quantities of water face prices that are only a fraction of those in other OECD countries, reflecting a desire to use water pricing policy as means to redistribute income from high to low water use households. Water prices should not be used to attain social policy targets as much more efficient instruments are available for that purpose. In this way prices would be moved closer to the full cost of provision.

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Box 9. **Progress and recommendations on structural reforms**

Area/Objective	Recent/planned action	Recommendations
I. Labour market reform		
Raise labour force participation	Simplification of administrative obligations for firms when hiring; further flexibility in the use of part-time contracts; introduction of new types of contracts ("job on call" and "staff leasing"); contribution exemption for workers eligible for seniority pensions deciding to postpone their retirement; extending the possibility for the retirees to combine pension and labour income	Promote higher and better provision of care for children and other dependants, *e.g.* by introducing longer and more flexible hours of public institutions providing care and liberalising the working hours for the private ones; grant incentives to firms providing re-training to older workers while assessing the cost-effectiveness of these incentives; provide direct support to dismissed workers over a certain age, *e.g.* organising specific re-insertion programmes; make use of a making work pay approach in designing tax and benefits schemes.
Promote greater wage differentiation		Encourage social partners to introduce the possibility for the second layer wage component to adjust to productivity both upward and downward
Simplify employment protection legislation	On an experimental basis, substituting the obligation for firms over 15 employees to re-hire a wrongly dismissed worker with a financial compensation	Enlarge the scope of unemployment and dismissal compensation in order to improve labour market functioning and minimize employer-worker conflicts; give more room for the resolution of employer-worker conflicts through bilateral agreements or through multilateral committees involving social partners

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Box 9. **Progress and recommendations on structural reforms** (*cont.*)

Area/Objective	Recent/planned action	Recommendations
Improve job matching	Restructuring and decentralisation of the public employment services (PES); introduction of deadlines for assisting and training dismissed people on a personal basis; full opening of the services — including training — to the temporary work agencies	In the implementation of the PES reform, give priority to the South; introduce a system of premiums for regions with quicker implementation of the reform; accelerate the implementation of *Sistema Informativo Lavoro*; prioritise the work of the public services to the low-skilled ; make use of the market mechanism in enhancing the cooperation between private and public operators; grant to all employment agencies financial incentives linked to their capacity of job placement for the low-skilled
II. Enhancing human capital		
Improve the quality of education	Increase of the compulsory schooling years; teaching of one and two languages during primary and secondary school, respectively; introduction of internships in the *curricula*; obligation for teachers in primary and secondary levels to hold a university specialisation degree; possibility for teachers to have a tenure contract only after a two-year trial period; implementation of training programmes for currently employed teachers	Introduce performance-based wage and career systems; implement a system of performance indicators for schools at both the central and local levels in order to benchmark best practices; make sure that decentralisation to regions does not impede the respect of the overall public finance objectives

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Box 9. **Progress and recommendations on structural reforms** (*cont.*)

Area/Objective	Recent/planned action	Recommendations
Reduce the drop rate from schools	Introduction of a new vocational track in upper secondary education; elimination of the national examination after primary school; pupil evaluation every two years rather than each year; introduction of tax credits and vouchers for households choosing private schools	Set up a system of means-tested co-payments, merit-based scholarships and direct or guaranteed private loans for liquidity constrained households; make sure that early tracking does not hamper households' upward mobility
III. Corporate governance and capital market		
Modernise corporate control and finance	Greater operational and organisational autonomy for limited liability companies; possibility for joint-stock companies to choose out of 3 corporate governance models; expansion of financing possibilities including bond issues; clearer identification of interest by executive board members; discipline of groups; redefinition of cooperatives; more "vote" and "exit" possibilities for shareholders	Further bolster minority shareholders' rights; further reduce the cost of calling shareholders' meetings; reduce conflicts of interest between institutional investors and firms; strengthen the role of the pension fund regulator; allow for "open" pension funds; strengthen penalties for accounting and other information irregularities; examine possible conflict of interest issues in adaptation of new corporate governance models
Reform bankruptcy law	Commission formed to draft bankruptcy reform	Guarantee creditors credible powers of deterrence *vis-à-vis* insolvent debtors; adopt a more lenient approach toward bankrupt debtors; reduce the length of the judicial process; facilitate pre-emptive solutions to enterprise crises; develop procedures for firm restructuring or merger/sale if a rescue is feasible, otherwise rapid liquidation; complete and implement the draft reform

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Box 9. **Progress and recommendations on structural reforms** (*cont.*)

Area/Objective	Recent/planned action	Recommendations
Restructure the banking sector	Increasing local authority representation in banking foundations; move to Basle 2 capital adequacy requirements	Ease regulatory framework for bank mergers and acquisitions to avoid discouraging foreign bank entry; safeguard the private character of the foundations and promote their continued divestiture from banks; decentralise wage structure in the banking sector; implement Basle 2
IV. Improve the quality of public finances		
Reduce fiscal pressure	Introduction of cuts in personal income tax rates in 2003 and reduction of two brackets in the medium term; limitation of the tax deductions to low-middle incomes; reduction of the corporate income tax; phasing out of the dual income tax and IRAP (regional value added tax)	Find adequate source of revenues before replacing IRAP as a source of regional financing
Improve public infrastructure	Carrying out of project works, especially in the South, in order to upgrade water supply systems and modernise the railway and road systems; creation of a fund for public works and infrastructure; promoting the development of public-private-partnerships; approval of *Legge obiettivo* designed to reduce the level of red tape for administrative authorisations; establishment of Infrastrutture S.p.A. with the task of promoting private financing of public projects	Introduce independent oversight for strategic public investment; use routinely cost-benefit calculations to choose appropriate projects; avoid building up future liabilities resulting from the possible failure of the private partner; create a specific fund to face the need to make equity capital available

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Box 9. **Progress and recommendations on structural reforms** (*cont.*)

Area/Objective	Recent/planned action	Recommendations
Reform the pension system	Transfer of the companies' fund for the leaving-payment scheme to pension funds; cut of up to 5 per cent in the contribution rates of dependent workers and an increase for parts of the self employed; tax cut on returns to pension funds	Extend to all workers the mixed regime combining the earnings-based and the contribution-based calculation method of pension benefits; eliminate seniority pensions or introduce actuarial adjustments factors into them; gradually increase the minimum age for pension eligibility and give the opportunity to retire after 65; automatically revise every year the coefficients for the calculation of pension benefits in the contribution-based scheme to ensure consistency with the latest demographic figures; equalise the notional contribution rate used to calculate benefits to the actual one paid by firms and workers
Enhance efficiency of the health care system	*Ex-ante* specification of the central budget resources available to regions for health care; transfers conditional to efficiency and quality enhancing measures, *e.g.* streamlining the hospital network and reduction of the waiting lists; new methodology to determine the reimbursement price for certain pharmaceuticals; shortening the length of pharmaceutical patents	Reinforce the responsibility of regional administrations in both the management and financing of the health sector; exclude the bailing out of regional administrations in case of recurrent deficits; promote the development of complementary health insurance provided by the private sector

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Notes

1. Trend GDP per hour worked in 2000 was on a par with that of the United States, data from OECD (2003b), Table A5.1.
2. The steep downtrend in the indicator of consumer confidence appears to have stabilised in the first five months of 2003, albeit oscillating around historic lows, while that in business confidence continued. Hence, a more significant recovery may not begin until much later in the year.
3. Notably, the exchange rate risk appears to be already materialising: at the time of writing, the euro-dollar parity is 1.9 per cent stronger than assumed in OECD (2003a), which contains a complete discussion of the Italian and OECD projections and risks.
4. See Banca d'Italia (2003a), Figures 28 and 29 and Table 16.
5. That is, assuming that these were not already picked up by Istat's estimates of underground employment which form part of the normal labour market statistics.
6. A study by the Banca d'Italia suggest that the euro-changeover shock was larger in Italy than in the rest of the euro area. See Banca d'Italia (2003a), pp. 52-53.
7. See Ferri and Inzerillo (2002) and ISAE (2003b); also *Indagine Sole-24 Ore – Banca d'Italia sulle aspettative di inflazione e crescita*, *www.bancaditalia.it/pubblicazioni/statistiche*
8. The aforementioned surveys list an insufficiency of demand as the primary factor holding back investments recently, followed by lack of financing.
9. The cyclically adjusted primary balance will have declined by a cumulative 3 per cent points of GDP between 1998 and 2004 (OECD projection), of which almost half occurs in 2004 as previous tax cuts register their full impact. The decline would be even steeper if real estate securitisations and other "one-off" measures – which exert nugatory effects on domestic demand – are removed from the measure of the fiscal stance (see Figure 5).
10. Had Italy stuck to the 5 per cent structural primary balance targeted in each medium term plan (DPEF) since 1997, instead of falling to 2 per cent by 2004 as projected by the OECD, debt would have been considerably lower.
11. See OECD (2003b) for a fully-fledged analysis of growth performance across OECD countries.
12. *Ibid.*
13. Assuming that the potential productivity of those not in the labour force is about half of that of those who are currently employed.
14. Nicoletti and Scarpetta (2003) estimate that a move of some EU countries, including Italy, towards an OECD average share of state-owned firms in value added would lead

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to 0.7 percentage points higher MFP growth. A move towards an OECD average of entry liberalisation would turn into 0.2-0.4 percentage points higher MFP growth.

15. See OECD (2001b).
16. OECD estimates that with unchanged policies the estimated cohort effect on labour force participation would be negative at around –0.15 percentage points already in 2008 and progressively increasing (in absolute terms) to reach –4.1 percentage points in 2030.
17. Competitiveness benchmarking studies as of 2001 placed Italy in the following rankings: Merril Lynch, 17th place out of 18 countries; World Economic Forum, 24th out of 58 countries in the overall ranking and among the very last as regards bureaucratic red tape and the efficiency of the justice system; and IMD of Lausanne, 32nd out of 49 countries. See Ministero delle Attività Produttive (2003). For the 2002 IDM rankings, see *Il Sole* 24 *Ore* "Competitività, l'Italia arretra ancora", 14 May 2003.
18. This might suggest to some that Italy entered the euro-area at a "disadvantageous" exchange rate. However, a similar observation is often made about Germany, whose negative growth gap *vis-à-vis* the euro-area is even larger, but the statements are somewhat inconsistent since Germany is Italy's largest trading partner. A cheaper exchange rate peg might have bought Italy more time to make the required structural adaptation, but it may have just as easily delayed it.
19. See Nicoletti *et al.* (2003).
20. See *Il Sole* 24 *Ore*, 3 March 2003, p. 17.
21. See Nicoletti *et al.* (2003)
22. The authorities' medium-term objective has been to achieve sustained annual growth rates in the South of 4-5 per cent.
23. See Comitato di Sorveglianza QCS (2003).
24. The chief incentive has been a performance reserve allocation, amounting to nearly 5 billion euro in 2003; see *www.dps.tesoro.it/uval_linee_premialita.asp*
25. Within overall capital spending in the South, the share going to infrastructure rose from 44 per cent in 1998 to 60 per cent in 2002; conversely the share going to state aids fell.
26. See Ministero dell'Economia e delle Finanze (2003).
27. For an overview of the credit subsidies in Italy see Gobbi (1996). Econometric evidence of a positive correlation between credit subsidies and poor credit quality can be found in Bonaccorsi di Patti and Gobbi (2001).
28. In carrying our their assigned role in evaluating investment projects eligible for public investment subsidies (as by Law 488/92, DLS 297/99) banks have apparently applied "soft" criteria quite different from those used when considering the use of their own money, so as to maximise the number of eligible programmes and their own fees. See Da Rin *et al.* (2000).
29. Bofondi and Gobbi (2003) present empirical evidence supporting this standard theoretical result using data on Italian local credit markets.
30. ISTAT's estimates of the underground economy are obtained through the "production approach" mainly based on the use of the labour input method (see OECD, 2002h). By using the currency demand approach, the estimates of the shadow economy are higher (around 27 per cent of the official GDP in the period 1996-1997 according to

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Schneider and Enste, 2000). Part of the difference between these estimates might be explained by the inclusion of illegal activities in the currency demand approach.

31. ISAE (2002a).
32. CNEL (2002).
33. Boeri (2002).
34. See Figure 33. It should be noted that this figure underestimates fiscal pressure to the extent that workers pay a 20 per cent VAT when buying goods and services. Although this cannot be a differentiating factor between regular and irregular employment, in 1998 the effective VAT rate was 8½ per cent suggesting that compliance might be a problem also for indirect taxes. See Joumard (2002). In addition, employers pay a 5 per cent indirect tax on business value added, a large component of which is wage costs, and which is paid on regular workers only, but not reflected in the above wedge.
35. In the mid-1990s, the Gini indicator before taxes and transfers was 51 for Italy and 45 for the United States. After taxes and transfers, they were both around 34. See Burniaux *et al.* (1998), Table 3.2.
36. See OECD (1994).
37. See Chapter IV on pension reform.
38. During 2003, the parliament transformed the Decree into an ordinary law so that the spending control procedures introduced by the Decree now represent a permanent feature of the Italian public finance monitoring mechanism.
39. There might however be limits on the capacity of this measure for controlling expenditures by public institutions as these can draw financing not only from budget appropriations but also from the cash balances they have at the Treasury accounts. See Giarda and Goretti (2003).
40. During 2002, EUROSTAT identified the conditions under which the receipts from securitisations could be used to reduce the general government net borrowing. In particular, the assets' price paid by the Special Purpose Vehicule to the government needs to be at least 85 per cent of the market price. Securitisations in 2002 passed these conditions, whereas securitisations in 2001 did not. In any case all securitisations and sell off of real estate assets contributed to reduce the general government stock of gross debt.
41. The Budget law also froze the tax rates that regions and municipalities could add on top of the regular income tax rates. On the other hand, the share of the total income tax they are receiving from the state increased. In addition, current and capital transfers to municipalities and provincial administrations were cut and increased, respectively.
42. The current OECD growth projection for 2003 is 1 per cent, 1.3 per cent lower than the initial official one, as is that of the EU Commission. The current official projection assumes a 1.1 per cent growth rate in 2003.
43. The 0.8 percentage points increase in the revised budget deficit target consists of a 0.9 percentage points reduction in total receipts and a 0.4 percentage points increase in total expenditures net of interest payments, whereas a reduction of 0.5 percentage points in interest payments partly offset the rise in the budget deficit.
44. See ISAE (2003c).

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45. The import penetration rates are unadjusted for structural factors such as country size, GDP per capita or transportation costs. These factors, particularly transportation costs, may explain some of the difference in the lower penetration rates for Japan and the United States.
46. A better comparison would be export market shares since export rates could be low due to a higher level of domestic production.
47. Formal measures of innovative activity tend to be biased downwards both by the sectoral composition of output and by the large number of small firms. This is because innovative activity in small firms in 'traditional' industries is principally of the incremental type undertaken in a non-formalised way, and not formal R&D projects that occur in other sectors.
48. Nicoletti (2002) also looks at how institutional arrangements in labour and product markets have conjured to produce a situation in which Italy has relatively low competitive pressures, and a distorted industry structure (both in terms of specialisation and firm size) and employment structure (in terms of skills, wages, and share of self-employed).
49. See previous OECD *Economic Surveys of Italy* and Chapter IV of the present *Survey* for a review of labour market reforms.
50. An in-depth discussion of how financial markets in Italy, including corporate governance and bankruptcy law, impacts upon firm performance and growth can be found in Chapter IV of this *Survey*.
51. The bankrupt debtor is dispossessed of all his real and personal property which is entrusted to a receiver/trustee under the supervision of a judge. Inscription in the Bankrupt Debtors' Registrar triggers severe civil sanctions for the bankrupt debtor (such as limitations on freedom of movement and loss of mail privacy). The debtor is also subject to criminal prosecution not only in case of fraud but even if the business failure is due to mere negligence.
52. The direct costs of bankruptcy procedures are also high and involve huge losses to creditors (see Chapter IV of this *Survey*).
53. That the Italian law is to be interpreted in accordance with the principles of EU competition law appears in the statute's instructions (Sec. 1.4). The reference to EU principles includes secondary legislation, Commission decisions, and jurisprudence of the European Court of Justice. Thus, Italy immediately absorbed 30 years of doctrinal tradition and avoided the delays and uncertainties that would have resulted from the process of establishing such concepts under Italian law.
54. Italy's law varies slightly in some details from parallel provisions of EU law. For example, in the criteria for exempting a prohibited restraint, Italy's Competition Act requires that a claimed consumer benefit be "substantial", implying some scepticism about such claims, but it does not require that consumers get a "fair share" of those benefits, implying a willingness to consider a total-surplus standard.
55. Some other countries that combine these duties include Canada, Poland, United Kingdom, and United States.
56. The Authority had opposed adding the principle to the Competition Act as the concern in these matters is about fair dealing and not market impact. The Authority was concerned that these claims, which are mostly decided through arbitration or private lawsuits, could be used to impede competition and undermine efficiency. With the Authority now empowered to apply this principle (but within the context of its effects

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on the public interest), the courts will most likely look to its decisions for policy direction when deciding private lawsuits.

57. The Authority argues that this result follows from Art. 10 of the EU treaty, which provides that "Member States shall abstain from any measure which could jeopardise the attainment of the objectives of this Treaty, " and Art. 3, which includes among the Community's activities "a system ensuring that competition in the internal market is not distorted". The Authority found that the market division and exclusive supply arrangements of a match industry consortium violated Art. 81 and that the consortium's conduct was not excused by the State's involvement. The Authority's decision was in July 2000; an appeal was taken, and the question has been referred to the European Court of Justice, where it is pending decision.

58. Parties may, and usually do, request suspension of fines pending appeal. When appeals took years, the decision on the *sospensiva* could be outcome-determinative. Now that appeals can be finally decided much more quickly, distortion of the *sospensiva* process should be less of a concern.

59. This is non-trivial by international standards. In many countries there are either very few (single digits) or no private action suits. Other countries besides the United States where private actions do play a role in competition enforcement include Canada, Germany, France and Ireland.

60. The Authority does have a powerful weapon in reserve, though. It can punish repeated violations by requiring the enterprise to cease operations for up to 30 days. Up till now, this deterrent has never actually been used.

61. The basis for computing financial penalties used to be the relevant market affected by the restraint or abuse instead of the firm's total turnover. This change in the law follows the recommendation of the 2001 OECD *Review of Regulatory Reform in Italy*.

62. The Authority has not set up a formal leniency programme because it believes that clearer legislative authorisation is needed before it can issue what would look and act like regulations, that is, commitments and rules of general application for the future.

63. The comparison is made between Italy's position in 2000 and other OECD countries' positions in 1998, which shows that Italy still has a highly restrictive environment compared to other countries. If reforms implemented by other OECD countries during the same period were included than it is likely that Italy's comparative position would be even worse.

64. The link between concentration and competitive pressure is complex in retail distribution and differs from other industries. Dobson *et al.* (2001) argues that greater concentration may benefit consumers through lower retail prices owing to increased monopsony power of the retail sector *vis-à-vis* manufacturing producers with (otherwise) dominant positions. The scope for anti-competitive behaviour is also often limited by the threat of entry and by increasingly mobile consumers.

65. A pharmacy for every 5 000 (or 4 000) inhabitants in municipalities with a population of up to 12 500 (in other municipalities), and pharmacies must be separated by a distance of at least 200 metres.

66. For example, rules regarding opening hours have been made more flexible. Shops can be opened for a maximum of 13 hours (between 7 am and 10 pm) excluding Sundays. Sunday openings are restricted to 8 times per year, plus the December Sundays prior to Christmas.

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67. See OFT (2001) for a review of the empirical evidence. Recent studies include Nguyen-Hong (2000), who examined the effects of regulations on price-cost margins in engineering services and found that they led to an increase in prices on the order of 10 to 15 per cent in countries with the most restrictive regulations. And in Italy, Bortolotti and Fiorentiniti (1997) found that controls served to preserve monopoly rents in the accountancy profession.
68. For example, when self-regulatory bodies are involved in the evaluation of professionals' capacity.
69. Entry regulations include qualification requirements, membership in a professional body, and rules on reserved areas of practice. Conduct regulations include regulations on prices or fees, advertising, location and diversification restrictions, and restrictions on forms of business practice.
70. In the absence of specific profit data, the higher volume of turnover per professional associated with more restrictive regulatory regimes can be indirectly taken as an indicator of excess profit.
71. See OECD (2001) *Economic Studies: Special Issue on Regulatory Reform*, No. 32 which thoroughly reviews the literature and adds more evidence on the relationship between regulation and performance in these sectors. The OECD Reviews of Regulatory Reform also constitute a rich source of information on the effects of industry-specific reforms on performance.
72. The government currently has a 67 per cent stake in ENEL and a 30 per cent stake in ENI. The government also holds golden shares (special powers present in the by-laws) in both these companies and in *Telecom Italia*.
73. In February 2003, the European Commission again requested that Italy justify its privatisation legislation giving the government special powers in privatised companies. The position of the Commission is that these special powers are disproportionate and in violation of Treaty rules.
74. Vertical separation does not remove the incentive for the network firm to engage in monopoly pricing and hence strict regulation of the network is still required to ensure against the abuse of monopoly power.
75. Wide delegation of legislative powers at the local level will require further coordination between central and regional/local authorities to ease concerns regarding the number of authorities involved in the regulatory process.
76. The responsibility to issue licenses includes TV licenses. While giving this responsibility to the Ministry may be less of a problem in the telecommunications sector, where a large number of licenses has already been granted, it is more of a problem in the media sector where such licensing control could underpin the existing weakness of effective competition. One private holding (Mediaset) has a 43 per cent market share of the television audience, and the only competition comes from state television, with a 48 per cent market share (AGCOM, 2002). Unlike most EU countries, there are no developed cable TV networks in Italy (EC, 2002b).
77. In practice, the increase in the line rental and activation fees has been offset by more than proportionate reductions in call prices. Mobile operators are not subject to any specific regulation in fixing final prices, but they have to notify the regulator of each new tariff they introduce. In February 2003, AGCOM imposed a new pricing regime for fixed-to-mobile interconnection on the mobile operators. They will be required to reduce fixed-to-mobile termination charges by 12 per cent from 1 June 2003, followed by a further cut of 20 per cent by the end of 2005.

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78. Unbundling of the local loop and relatively low prices for unbundling are particularly important for the development of competition in this sector due to the lack of alternative infrastructure. Competition in the market for internet services therefore comes almost exclusively from new entrants using the incumbents' local loop facilities.
79. Telecom Italia has gone to court against almost all regulatory rulings made by the regulator, which is unusual by OECD standards (OECD, 2001b).
80. However, the current staff levels of 86 are well below the maximum of 150 that AEEG is allowed to hire.
81. Italy applies different rates of VAT, and excise taxes on a national basis to all energy sources (including electricity), with regions then adding their own taxes (IEA, 2003).
82. This makes sense, as incentives for investment in transmission would most likely improve once ownership and control are combined and are vertically separated from generation.
83. One of the reasons for delay is that there is not enough competition in generation. Although ENEL has a 50 per cent market share, it has engaged in strategic selling of generation plants so that it still controls 80 per cent of the mid-level plants.
84. ENEL's market share is around 50 per cent, while the second largest firm, Edison, has a market share of 9.4 per cent.
85. Currently, only legal separation exists between distribution and transmission.
86. Storage facilities are currently considered a legal monopoly and are destined to remain so for several years to come (AEEG, 2002).
87. A key aspect of the Decree implementing the EU Gas Directive entails the imposition of temporary "antitrust limits" on the shares that any single company can have of potentially competitive activities. However, these limits of 75 per cent (or 61 per cent by 2010) are high if the intent is to create a market structure where prices are relatively competitive.
88. Under the Legislative Decree n. 164 liberalising the gas sector, the Ministry of Industry retains significant regulatory power (OECD 2001b).
89. See, for example, Garibaldi (2002).
90. See Ministero del Lavoro e delle Politiche Sociali (2002a) and Cipollone and Guelfi (2002). From 2003 the credits are granted only under certain conditions rather than automatically as in the past.
91. Vamvakidis (2002).
92. OECD (2002d) shows that inter-regional mobility is among the lowest in the OECD.
93. OECD data show that Italy is among the countries with the lowest proportion of children in the 0-3 age range in day care facilities (amounting to slightly more than 5 per cent). However, the participation of children in the 3-6 age range is more than 90 per cent. Del Boca (2002) finds evidence that limited availability of affordable childcare services (together with relatively low use of part-time contracts) is one of the reasons for both low labour force participation and low fertility rates among Italian women.
94. The statistical classification by ISTAT currently identifies 38 different kinds of contracts.
95. Bernardi (2001) points out that in mid-2001 temporary workers below 30 years of age represented 60 per cent of the total. Barbieri (2001) shows that in the period 1996-2001 the probability of fixed-term workers to be still in work after 12 months was

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between 80 and 86 per cent. The probability of still being in work with a permanent contract was between 33 and 38 per cent.

96. According to OECD (2002a), public resources devoted to adult training, young workers and subsidised employment were 0.60 per cent of GDP in 2000 compared to 0.68 for Germany in 2001, whereas in the same period France (the United Kingdom) had much higher (lower) resources devoted to active labour market policies.
97. "Job on call" refers to the possibility for firms to use workers only when needed in exchange for an indemnity. "Staff leasing" refers to the liberalisation on the use of workers from *ad interim* agencies in terms of duration of contracts, number of workers required and types of skills requested.
98. ISFOL (2002).
99. "Just cause" refers to unfair behaviour of the worker while "justified reason" refers to excess of workforce. See Bertola and Garibaldi (2002).
100. Iacus and Porro (2002) point out the risk that for profitability reasons, private temporary work agencies might limit services to the low-skill.
101. In 1998, the government and the social partners started giving greater consideration to *conciliazione* (a bilateral procedure involving also a multilateral Committee) and *arbitrato* (a more rapid judicial system) for solving labour dispute resolutions but without taking decisive steps for a more pervasive role of these institutions.
102. See also Forster and Pearson (2002). Among other evidence of increasing poverty in the mid-nineties compared to the mid-eighties, they point out that Italy is one of the countries where, during this period, families in the bottom income quintile significantly lost their shares of national income. Finally, EUROSTAT's indicators show that, despite wage compression, in 1998 the ratio of the fourth and the first income quintile in Italy was higher than in the EU on average (5.9 compared to 5.4). Notably, using this indicator income inequality was higher in Italy than in the UK where wage dispersion is significantly higher.
103. Dipartimento Politiche di Sviluppo (2002).
104. For more details, see the special chapter "Public spending in Italy: policies to enhance its effectiveness" in the 2002 OECD *Survey*.
105. See Ministero del Lavoro e delle Politiche Sociali (2002b) and EC (2002d). In addition, the 2002 budget law introduced a measure aimed at guaranteeing a minimum pension of around € 515 monthly to the elderly. The estimated cost of this measure is an annual 0.15 per cent of GDP.
106. EUROSTAT data show that in 1999 the shares of total social protection expenditure devoted to unemployment and social exclusion were 2.2 per cent and 0.1 per cent, respectively, compared with an EU average of 6.8 and 1.6 per cent.
107. See EUROSTAT's structural indicators at http://europa.eu.int/comm/eurostat
108. See Ministero del Lavoro e delle Politiche Sociali (2002a).
109. For more details on the functioning of the single fund see Commissione Tecnica per la Spesa Pubblica (2002) and Da Roit (2002).
110. Paolini (2002).
111. See for example Berliri and Parisi (2002).
112. Baldini and Bosi (2002) show that as a consequence of the tax cuts introduced by the 2003 Budget law the effective tax rate would decrease by around 1 per cent on average for the Italian families. However, the decrease for families in the first income

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decile would be only 0.4 per cent. According to the authors, the reform mainly benefits families in the range of income between the third and the seventh deciles. See also ISAE (2002b).

113. At the end of the nineties, a system of benefit eligibility based on the families' wealth was introduced replacing the former system mainly based on income. The old system could lead to misallocation of public resources because of income underreporting in tax files, mainly used in the evaluation of families' needs.

114. Increasing the generosity of some of the existing shock absorbers might become a more compelling priority if the framework bill on pensions currently under discussion by the parliament is approved, introducing the obligation of transferring the *trattamento fine rapporto* to private pension funds (see the section on pension system).

115. See OECD (2002c).

116. ISTAT (2002a).

117. The average graduation age is 26½ years.

118. In 2001, the share of the population in the 15-19 age range neither in education nor in employment was 12 per cent. The share of the population in the 20-24 age range in the same condition was 25 per cent. See OECD (2002c).

119. Until recently the minimum compulsory age in school was 14 years. The 2000 reform of primary and secondary education increased compulsory age to 16 years.

120. See Blondal, Field and Girouard (2002). Despite low quality and low returns, entry levels in tertiary education are high as fees are relatively low and, in general, participation is not conditional on rigorously adherance to a specified schedule of courses and exams.

121. In addition, pupils will start primary school once they have reached at least 5½ years of age.

122. The vocational track lasts 4 years with an additional one, in case students intend to apply for tertiary education. Pupils are also given the choice of moving from the vocational schools to the *licei* (or *vice versa*) at any time during the upper secondary career.

123. OECD (2003b) estimates that the long-run effect on per-capita GDP level of one additional year of education ranges between 4 and 7 per cent.

124. Checchi (2003) finds that early tracking is strongly correlated with parents' education, *i.e.* the choice of academic oriented secondary schools by pupils is highly influenced by having parents with higher degree of education. The possibility of moving from vocational training to *licei* in later years or applying to university directly after vocational training is unlikely to counterbalance this effect. In fact, after being channelled in a school track, the transition to more advanced education is mainly dependent on past schooling. Moreover, ISTAT (2002a) data show that a small share of professional/technical students deciding to undertake university studies completes them (23-31 per cent compared to 55 per cent of *licei* students). Furthermore, PISA results suggest that greater differentiation between different types of schools and early tracking can lead to both lower average students' performance and higher variation.

125. See Bertola and Checchi (2001).

126. See *e.g.* Tsuru (2000) and Leahy *et al.* (2001) for literature reviews and analysis of the impact of financial development on economic growth.

127. In the case of the domestic food processing company, some banks shifted their own heavy risk exposures to the troubled company onto to their customers by selling to

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them junk-quality bonds issues of the same company, the proceeds of which were then used to repay the company's loans to the banks.

128. Schleifer and Vishny (1997) show that a partial alleviation of agency conflicts between controlling and non-controlling shareholders may come from concentrated ownership.
129. See Barontini and Caprio (2002). However, a subsequent paper by Brunello *et al.* (2003) shows that firm performance is negatively related to CEO turnover if (and only if) the controlling shareholder is not the CEO, so that non-CEO controlling shareholders are a governance mechanism substituting for outside members on boards of directors in lowering agency costs.
130. This practice is often referred to as "tunnelling"– *i.e.*, the transfer of assets and profits out of firms for the benefit of the controlling shareholders. See Johnson *et al.* (2000).
131. See Dyck and Zingales (2002); also Zingales (2000).
132. See CONSOB (2002).
133. Dyck and Zingales (2002) suggest that there may be other institutional factors besides the legal framework at work here. According to their empirical findings, a high level of press diffusion and of tax compliance seem to be the most cogent factors curbing private benefits of control. Italy, however, ranks at the bottom among the OECD countries included in their country sample on both indicators. Moreover, in countries where a controlling party can appropriate a large share of the value of a company, entrepreneurs will be more reluctant to take their companies public. Hence, an important conclusion of the paper is that improving tax enforcement can indirectly enhance financial development.
134. See Pagano and Volpin (2000).
135. See Dyck and Zingales (2002), who also note that competitive product markets make prices more transparent, which would curtail the abusive use of transfer pricing to tunnel assets out of the firm.
136. See Giavazzi (2003a).
137. These industries promise future monopoly profits no longer available in these firms' traditional sectors which are increasingly subject to intense global competition. As a result, Benetton group now has a major stake in Autostrada, Fiat group in telecommunications, and Pirelli in energy.
138. See Brunello *et al.* (2003).
139. A severe crisis in the 1930s resulted from the close linkages between banks and firms, and subsequent laws made sure that such linkages were broken. Also, unlike in Germany, banks are prohibited to vote for the shares in custody or to solicit proxy votes (*ibid.*).
140. From the viewpoint of banks, exposure to default risk of any individual company is thus reduced, and from the point of view of firms, the cost of credit they face is reduced *via* "competition" among their multiple creditors. Multiple bank relationships are also (surprisingly) common in Germany; see Hellwig (2003). However, with bank consolidation and despecialisation (universal bank model) of the last decade, the number of multiple bank relationships is declining in Italy.
141. See Brunello *et al.* (2003).
142. According to the data published by Bank of Italy, only 46 per cent of corporate borrowers entertain relationships with more than one bank and just 25 per cent with

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more than two. The large majority of small unincorporated firms have a single-bank relationship.

143. Short-terms loans represent around 23 per cent of total loans for France and above 17 per cent for Germany.

144. See Bonaccorsi di Patti and Gobbi (2001) and Bonaccorsi di Patti and Gobbi (2003). Ferri and Inzerillo (2002) show, on the basis of survey data, that there may have been a transitional period of credit rationing due to interruption in bank/firm relations following the restructuring, but that in the medium and longer-runs, the increased efficiency of banks operating in the South should bring permanent benefits to firms. The same study concludes, however, that banking system restructuring "seems to have produced few of the expected benefits for small and medium-sized firms in terms of innovative financing and internationalisation support" (p. 3).

145. At end-2002, the ratio of non-performing to total loans to companies was 13 per cent in the South v. 3.6 per cent in the Centre-North; for single-owner firms it was 24.4 against 7.7 per cent (Banca d'Italia, 2003b).

146. See the results of the investigation by *Il Sole* 24 *Ore*, "In banca muoiono le idee. Ai nuovi business non si dà credito", 5 May 2003.

147. See Messori (2002b).

148. See Bianchi and Enriques (2001); CONSOB (2002).

149. Bank ownership of insurance companies is also likely to give rise to maturity mismatch problems, in that insurance companies have mostly long-term assets, whereas banks' liabilities are short term (see Giavazzi, 2003b).

150. The adaptation of the dualistic model raises similar issues. The supervisory council does not participate, as in Germany, in strategic decisions of the company, but once again, rather exercises management control functions typical of the former *collegio sindacale*. At the same time, it approves the budget in place of the shareholders' assembly without being affected by changes in company ownership. The budget ends up being approved by a body which carries out systematic internal control functions, and which hence could act as a barrier to the contestability of property rights of the firm. See Messori (2003).

151. *Ibid*.

152. Having to provide information is already a major hindrance to listing. A recent survey by the Stock Exchange shows that 1000 firms in Italy have all the requirements to list, but do not do so.

153. See, for example, the interview by Economics Minister Tremonti in Il Sole 24 Ore, 25 April 2003; Minister Tremonti obtained agreement from other finance ministers at the 17 May 2003 summit of Deauville to "monitor" the work of the technicians regarding the transition to Basle 2 (see Baglioni, 2003). The government has also pointed out that the Basle 2 rules fail to acknowledge the pooling of risks via the system of multiple creditor relationships used by many Italian enterprises. See, for example, *Corriere della Sera*, "Tremonti: troppa tecnocrazia", 16 May 2003.

154. The share of total assets attributable to banks in which the government or foundations held majority interests has fallen to 10 per cent, from 58 per cent in the mid 1990s. The number of listed banks has increased and now account for 80 per cent of the system's total consolidated assets. The share of activity of foreign intermediaries in total assets is 7 per cent, even larger is specific areas of business, such as services to firms, asset management, and consumer credit. In the capital of the major

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banking groups there are significant interests of foreign intermediaries (banks and insurance firms). The degree of entry of foreign institutions into the Italian banking industry, both in term of market shares and shareholding in the largest group mirror the ones of the larger partners in the euro area.

155. Although the intensive banking consolidation process of the 1990s was accompanied by gains in efficiency and competitiveness, it implied increasing distortions in bank ownership structures as competition has been crucially missing in the market for property rights. Banks may also be non-competitive in non-bank services, notably asset management, with their position of strength being sustained by the existence of a large stock of wealth previously invested in government securities. See Messori (2003).
156. According to the October 1999 I*struzioni di* V*igilanza per le* B*anche*, if a subject wants to acquire at least 5 per cent of a bank, either directly or indirectly, it must notify the Banca d'Italia at least 7 days before even its own board of directors has met to decide whether or not to make the purchase. Furthermore, the Banca d'Italia is to follow a rather vague "financial soundness" principle in approving the purchase. The reporting requirement is harsh, and may discourage banks from applying in the first place, while the criteria for approval are rather vague.
157. See Cappiello (2002), who also notes that direct costs of bankruptcy proceedings are high (more than 20 per cent of bankruptcy assets) and involve huge losses to creditors (80 per cent of claims on average).
158. Cercone (2001).
159. Some of the harsher civil sanctions such as loss of mail privacy and limitations of movement are widely acknowledged to be "excessive", but the law that would repeal them has not yet been approved. See Cappiello (2002).
160. See Marcucci (2001).
161. Santella (2003).
162. Cappiello (2002).
163. See Joumard (2002) for a description of the EU tax systems.
164. IMF (2002b).
165. The 2003 Budget Law took some initial steps in reducing the burden of the IRAP by decreasing the rate for the agricultural sector, eliminating fellowships and training contracts from the tax base and introducing a deduction of € 2 000 for each employee up to 5 employees for companies with a turnover below € 400 000. Saving for companies will amount to more than € 400 million.
166. See Chapter II for the recent developments in the area of regional and local government finances.
167. For example, an individual will become liable to tax of 1.25 euros on interest received by lending 100 euros to an Italian corporation at an interest rate of 10 per cent; but deducting the interest payment of 10 euros against corporation tax at a rate of 33 per cent, the company reduces its tax liability by 3.3 euros. This transaction, then, improves the cash position of the private sector by 2.05 euros, at the expense of government. See IMF (2002b).
168. ISAE (2002b).
169. See OECD (2002d) for details.
170. See de Perris and Leone (2000).

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171. Other objectives for the Mezzogiorno mainly include: implementing 'territorial pacts' – *i.e.* agreements involving local authorities, social partners, and other public and private actors – providing for the implementation of a programme of local interventions to promote development; policies promoting the location of production facilities in the South; upgrading the agriculture and agro-industry sector and encouraging new models of organisation; and simplifying procedures to provide business with credit with the involvement of banks.
172. See, for example, DPEF 2003-2006 for more information on these agencies.
173. IMF (2002a).
174. See also the special chapter "Coping with the ageing problem" in the 2000 Italy's *Survey* for a comprehensive assessment of the Italian pension system and the reforms of the 1990s.
175. Nucleo di Valutazione della Spesa Previdenziale (2002).
176. Data from COVIP – the Authority monitoring private pension funds – show that at the end of 2001 the number of funds was 718 and the number of workers involved was less than 2 million, *i.e.* slightly more than 9 per cent of all workers (employees and self employed).
177. For projections of public pension spending in the medium-long term see Ragioneria Generale dello Stato (2002).
178. The contribution-based method of calculation applies fully only to workers hired after 1995. To the persons already working in 1995 but with less than 18 years of contributions, a "*pro-rata*" system will apply mixing the earnings-based and the contribution-based methods of calculation.
179. See Brugiavini and Peracchi (2001).
180. The pension system currently in force is characterised by the presence of both old age and seniority pensions. Eligibility requirements for old age pensions are 65 years of age for males and 60 years of age for females and at least 20 years of contributions for both. Eligibility requirements for seniority pensions are being increased to 57 years of age (58 for the self-employed) and 35 years of contributions, or 40 years of contributions regardless of the age. For new workers after 1995, only one regime will be available allowing retirement between 57 and 65 with at least 5 years of contributions and with a minimum pension entitlement of at least 1.2 times the social pension (a social assistance benefit to the old poor). In this new regime, a progressive upward adjustment is applied to replacement rates through higher transformation coefficients if workers decide to postpone their retirement after 57 until 65 years of age.
181. See Ministero del lavoro e delle politiche sociali (2002b).
182. Reyneri (2003).
183. In the longer run, such tampering was already considered to be a risk with the 10-yearly recalculation of the benefit formula (see below section on sustainable retirement income).
184. A further priority is represented by the setting up of limits for re-investment of the pension funds in the companies' share and, more generally, of an appropriate regulatory framework for the funds avoiding excessive risks for the workers in case of companies' bankruptcy.
185. Ministero del Lavoro e delle Politiche Sociali (2002b) shows that with the new contribution-based regime a worker at 65 years of age and with 40 years of contributions

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the replacement rate will be 63.4, whereas for a worker at 60 years of age and with 35 years of contributions the replacement rate will be 48.1. These estimates assume that the transformation coefficients are going to be adjusted consistently with the latest projections on life expectancy. This is the reason why they differ from the ones in the following section, which are based on current transformation coefficients.

186. IMF (2002a).

187. Another goal of the measure is to limit the widespread phenomenon of informal employment by retirees, with favourable impact on the participation to regular markets. It should be noted, however, that as long as ISTAT includes an estimation of the informal and irregular workers in their employment series, the impact on the older worker employment ratio as currently measured might be negligible. However, the impact on public finances might be significant.

188. OECD (2002b).

189. See Ministero del Tesoro, I*taly towards* EMU, 1998.

190. Ministero del Lavoro e delle Politiche Sociali (2002b).

191. In the notional defined contribution system, an account is kept of the annual contributions (from both the employer and employee) made by an individual to the pension system. Contributions are capitalised at the nominal growth rate of GDP. Contributions for the individual's entire working life are then summed to create a "notional" capital sum. This is then converted into a pension using a factor that is determined from the expected average individual's probability of receiving a pension in future years, discounted at a rate of interest of 1.5 per cent. This factor is expressed as the "yield" that the individual will receive from the "notional" capital. This yield increases for each year of additional work until the age of 64, in line with the falling expected duration of pension payments. As well, the "notional" capital increases in line with additional contributions. Finally, the transformation coefficients will be adjusted every ten years in line with new estimates of life expectancy.

192. These results are based on a male Average Production Worker using the following assumptions: *a*) growth rate of real wages and GDP at 1.75 per cent; *b*) inflation rate at 2 per cent; *c*) real interest rate at 2 per cent; d) age of entry in the labour force at 20; *e*) mortality tables from 2000 World Health Organisation. On the other hand, under different assumption the National strategy report on pensions (Ministero del Lavoro e delle Politiche Sociali, 2002b) shows that for individuals with high disutility to work the change in pension wealth is negative if they decide to continue working at age 57 in the earnings-related schemes currently in place but it is positive in the new contribution-based scheme. These results are based on a male worker with the following assumptions: *a*) growth rate of real wages and GDP at 1.5 per cent; *b*) inflation rate at 2 per cent; *c*) real interest rate at 2 per cent; *d*) age of entry in the labour force at 22; *e*) mortality tables from 2000 Eurostat. Moreover, the National strategy assumes that the transformation coefficients with which the pension annuities are calculated are adjusted so as to reflect the higher life expectancy in 2000 compared to the one used in the 1995 reform.

193. The extent of the imbalance between contributions and benefits is also supported by estimates of intergenerational accounts (Sartor *et al.*, 2001).

194. TFR was first introduced in 1982 to improve the coverage of the unemployment benefit system. Since then, the conditions for the attribution of unemployment benefit are being changed in a way that could remove the original reason for the introduction of the leaving-payment scheme.

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195. If the contributions to this system were to be redirected to a fully funded pension system, then eventually it would provide benefits equal to half of those offered under the current state system, provided that future real financial returns are 1 percentage point above the growth of productivity (Sartor *et al.*, 2001).

196. Contributions are exempt from income tax, investment income is taxed at 11.5 per cent and only the capital element of the pension is taxed. Such a system provides a greater tax incentive than a classic EET system provided that the marginal income tax rate is above 11.5 per cent. It could also provide a greater return than normal saving, given that the latter is taxed at 12.5 per cent.

197. The 2002 OECD *Survey on Italy* already analysed the main challenges facing the Italian health care system, especially in the context of the ongoing reform towards fiscal federalism. In particular, it pointed out the wide margins for improvement as far as quality of care is concerned together with the increasing pressure on expenditures after the squeeze experienced during the 1990s.

198. The figure for Italy is high also because it refers to physicians entitled to practice, *i.e.* enrolled in registry, unlike other OECD countries that report data on practising physicians only.

199. Agenzia per i servizi sanitari regionali (2002).

200. Ragioneria Generale dello Stato (2002).

201. The estimate of Ragioneria generale dello Stato (2002) includes only the demographic effects of an increasing share of older people in the population. It does not account for other likely causes of rising demand for healthcare, notably technology.

202. A recent debate concerns the possible lifting of the "exclusive commitment" (*rapporto di esclusivitá*), which doctors are currently required to undertake with public hospitals. In other words, doctors are now required to choose whether or not they want to work only for the public hospitals. If they decide to work only for the public hospitals, they get a wage premium and the opportunity to undertake a career inside the hospital. Moreover, they can also exercise a private activity but only beyond their normal work schedule and using the infrastructure available in public hospitals, which in exchange will retain part of their profits. According to Cestone (2003), this arrangement might reduce moral hazard and information asymmetry problems that especially arise when doctors simultaneously work in public and private hospitals. On the other hand, imposing too many constraints on doctors' contracts might lead the best ones to migrate to private hospitals, unless the incentives introduced exceed the expected loss of income from not working in private hospitals. Regions and, especially, hospitals seem to be better placed than the central authorities in assessing the benefits and costs of contractual arrangements with their doctors.

203. See Docteur and Oxley (2003) for a comprehensive assessment of reform efforts in OECD countries, including attempts at enhancing competition among insurers and among providers.

204. Planned works on the cross-border transmission grid are expected to reduce annual national emissions by around 2 per cent and private companies can now construct new transmission lines. One planned transmission line will add 2.3 GW of capacity. Given excess demand for capacity on trans-frontier links, the regulator auctioned capacity on the links. However, this auction was cancelled by the courts that ordered a pro-rata allocation of capacity.

205. Solar, biomass and waste plants were guaranteed a price of 15 cents per KWh, wind 10.5 cents and small hydro plants 8.5 cents. Against this, independent producers of

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gas were guaranteed a price of € 0.03 per KWh. Given that gas-fired electricity plants emit 400 grams of carbon dioxide per KWh, the saving in emissions was valued at up to € 1 100 per tonne of carbon saved.

206. Some credit should also be given for reduced air pollution costs. However the externalities for gas plant are between 0.3 and 0.4 eurocents per kilowatt-hour.
207. Lombardia, Emilia Romagna, Veneto and Umbria regions.
208. At 31 kg/ha in 1995-97, the nitrogen surplus was well below the EU average (58 kg/ha) but higher than the OECD average (23 kg/ha).

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List of acronyms

ACRI	Associazione delle Casse di Risparmio Italiane
AEEG	Autorità per l'Energia Elettrica e il Gas
AGCOM	Autoritá per le Garanzie nelle Comunicazioni
APAT	Agenzia Nazionale per la Protezione dell'Ambiente e per i Servizi Tecnici
ATO	Optimal management areas
CNEL	Consiglio Nazionale dell'Economia e del Lavoro
CONSIP	Concessionaria Servizi Informativi Pubblici
CONSOB	Commissione Nazionale per le Società e la Borsa
COVIP	Commissione di Vigilanza sui Fondi Pensione
Dit	Dual income tax
DPEF	Documento di Programmazione Economico-Finanziaria
DRGs	Diagnostic related groups
DSL	Digital subscriber line
EC	European Commission
EMU	European Monetary Union
ENEL	Ente Nazionale Energia Elettrica
ENI	Ente Nazionale Idrocarburi
EPL	Employment protection legislation
EU	European Union
FDI	Foreign direct investment
GDP	Gross domestic product
GHG	Greenhouse gas
GRTN	Gestore Rete Trasmissione Nazionale
GW	Gigawatt
HHI	Herfindahl-Hirschamn index
IEA	International Energy Agency
IMF	International Monetary Fund
IRAP	Imposta regionale sulle attività produttive
IRPEF	Imposta sul reddito delle persone fisiche
IRPEG	Imposta sul reddito delle persone giuridiche
IRPET	Istituto Regionale per la Programmazione Economica della Toscana
ISAE	Istituto di Studi e Analisi Economica
ISFOL	Istituto per lo Sviluppo della Formazione dei Lavoratori
KWh	Kilowatt hour
LRIC	Long-run incremental costs
MECT	Marginal effective rate of corporate taxation
MFP	Multi-factor productivity
Mt	Million tonnes

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OFT	Office of Fair Trading
PES	Public employment service
PPP	Purchasing power parity
PPPs	Public-private partnerships
QCS	Quadro Comunitario di Sostegno
R&D	Research and development
RUO	Reference unbundling offer
SMEs	Small and medium enterprises
SMP	Significant market power
Srl	Société a responsabilità limitata
Spa	Société per azioni
TFR	Trattamento di fine rapporto
TWh	Terawatt hour

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Annex I

Balassa indexes

Description of the methodology

The Balassa index is the most frequent measure used to compare relative advantages in export performance, by country and by industrial sectors. This index is defined as a country export share for a specific industrial sector divided by the export share of a group of countries, named "reference group", for the same industrial sector.

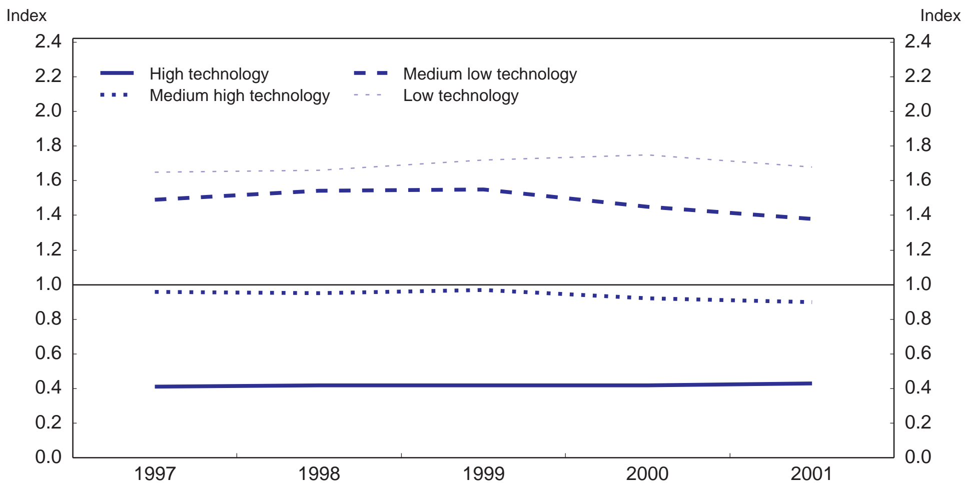
The Balassa index for the country I, compared to the World, for the industrial sector J should be calculated as follows:

$B_{i,j} = (X_{i,j} / X_{world,j}) / (X_{i,total} / X_{world,total})$

where i is the country under study

j is the industrial sector being compared

Figure A1.1. **Balassa indices for Italy**[1]



1. See section on manufacturing sectors for details on definitions.

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

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If $B_{i,\,j}$ exceeds 1, it may be said that the country I has a “revealed comparative advantage” in industrial sector J, since this sector is more important for country I ‘s exports than for the exports of the reference countries.

Repeating these calculations over sectors makes possible the determination of strong and weak sectors for a country. The Italian case is illustrated in Figure A1.1.

Manufacturing sectors

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

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

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Annex II

The reform of the banking foundations

The beginning of the rationalization process in Italian banking

The process of rationalisation and privatisation of the banking sector began as a response to European rules on public aid to firms, and also to the constitution of the Competition authority in Brussels. In 1985, the Italian parliament transformed into law the first European directive on the liberalisation of the credit market (1977): according to the new law, all agents satisfying certain conditions can become a bank operating in a unified European credit market. This exposed the Italian banks, heretofore operating in heavily segmented and protected markets, to greater competition, both internal and external.

The main framework for reform of the Italian credit sector, however, was first given by the law "Amato-Carli" (n. 218, July 1990). According to this law, public-owned credit institutions could transfer their banking activities to limited companies, convert their capital parts into shares and merge with other banks; the rules governing the control of the capital of the banking companies that were set up envisaged a reduction in the influence of the public sector by permitting the sale to the public of minority interests and empowering the government to authorise their privatisation. The law also encouraged the drive to increase the size of banks by granting tax relief for mergers.

In 1994, the General Code on Banking and Credits (*Testo Unico bancario*), approved in 1993, came into force. The new Code (the previous one dated from 1936) contained national rules implementing a new set of EC banking directives . The Code rested on four main principles (Messori, 2002a): *i*) a bank is like any other firm (see above); *ii*) every bank can choose its-own model of organisation (universal bank, multi-functional group, specialised bank, etc.), and is free to provide almost all types of financial services apart from insurance and investment funds (this created the conditions for subsequent bank mergers and reorganisations that greatly strengthened the banking system); *iii*) the monitoring of the banks by the Credit Authorities (Minister of Economy, Interministerial Committee for Credit and Saving, Banca d'Italia) would be prudential and systematic, implying greater space for self-regulation by banks; and *iv*) the separation between banks and industrial firms is softened.

Both texts gave birth to the foundations in their present form. The banking foundations, semi-private structures defined by the law, would acquire the ownership of the large group of banks that had traditionally existed as foundations or associative entities: in the new framework, these banks' executives would formally ensure the credit function, independently from the advice of their owning foundations.[1] Since then, 89 foundations have been created; in 2000 the total assets of the Italian foundations was estimated at € 35.4 billion, around 2.8 per cent of Italian GDP and roughly one-third of total banking system equity. The banks owned or partly owned by foundations accounted for about 60 per cent of all banking system assets. They are heavily concentrated in the Northern-Central regions (Table A2.1).

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Table A2.1. **Geographical distribution of banking foundations**

Geographical area	Number of foundations	Percentage of foundation capital
North West	17	41.5
North East	30	22.0
Centre	31	32.4
South and Islands	11	4.1
Total	89	100.0

Source: ACRI (2002).

However, the early reforms failed to deal with the problem of implicit public control, *via* the foundations, over these banks. By end-1994, 75 per cent of the foundations still held absolute majorities in the capital of their-own banks, while almost 20 per cent had reduced their positions to ones of minority but often exercised effective majority control by means of coordinating agreements with other foundations.[2] A move towards the exit of foundations from banks was first given by the 1994 directive from the Ministry of Economy (*direttiva* Dini) which set the principle of diversification of foundations' assets.

The consolidation of the sector and the new rules

The two main objectives of the law "Ciampi-Visco" (law n. 461 of 1998 and legislative decree n. 153 of 1999) were to force the disengagement of foundations from bank ownership and to constrain the foundations to adopt a strategy oriented to the private non profit sector. To this end:

- *fiscal incentives* were created: a defiscalisation of the benefits realised from the sale by the foundations' of their own-banks; foundations will furthermore enjoy a comfortable delay of time to disengage from control in their banks (4 years or, under particular conditions, 6 years); after this period, they would lose fiscal advantages reserved to non commercial activities if they did not dismiss their controlling shareholdings in the banks;
- the bill established that the foundations are *private entities* (having full autonomy concerning their by-laws and the administration of their assets) and indicated the six *non-profit sectors* where the foundations had to direct at least 50 per cent of their activities (*i.e.*, the extension of grants deriving from the income on their assets): art, public assistance, cultural and environmental goods, education, science, health care. Neither can foundations maintain or, by implication, take over private firms without the clear purpose of acting in one of these six sectors, which obviously would exclude banking. The remaining part of their activities, moreover, should be directed to activities having a high social utility.

The bill succeeded in part because of a more favourable banking context. In 1997, a major wave of consolidation of the banking sector began (by means of mergers and takeovers, mainly among the large banking groups and regional networks), and the whole Italian credit system gained in efficiency and transparency. Therefore, the "Ciampi-Visco" reform had the great merit of going in the same direction taken by the markets two years before, while helping to complete that process of consolidation. Namely, the foundations would now

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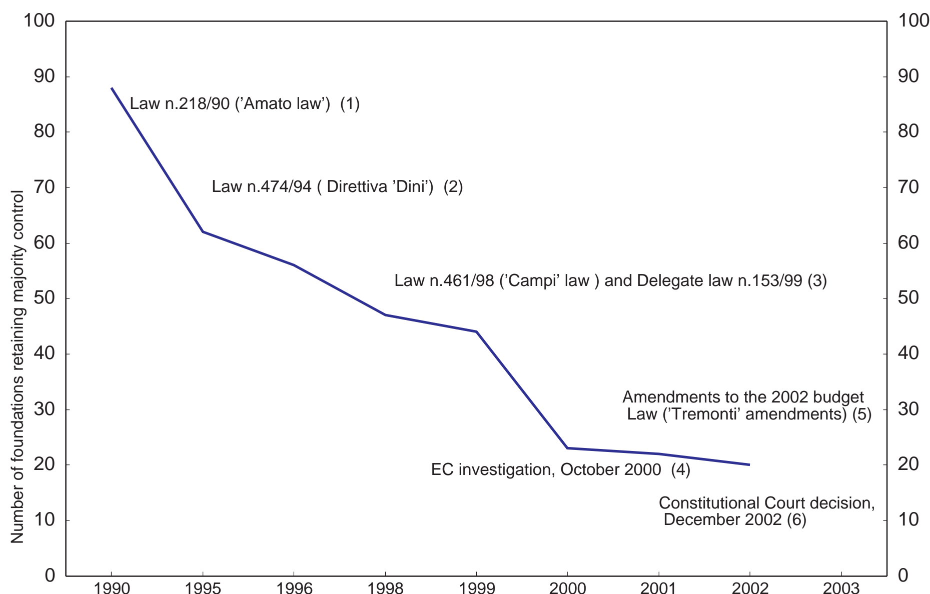
have to allow the markets to judge their banks' executives, but they would have also to make profits from their bank assets and reinvest half of them in the non-profit sector.

Thus, in 1999, just two major foundations controlled directly more than 50 per cent of their old banks,[3] while the average equity participation of the foundations in their own-banks had declined to just 26.3 per cent, down from 100 per cent at the start of the decade (Figure A2.1).

Nevertheless, there remained two weaknesses at this stage of the reform:

- "Ciampi-Visco" established a concept of control over banks based on the *dominant influence* of any single foundation (for instance, the power to nominate or fire the majority

Figure A2.1. **Main legislative events in foundation reform and majority bank participations**



1. Law n.218/90 ('Amato' law). Public banks transformed into joint-stock companies (Spa), 100 per cent owned by the Foundations (Fondazioni). Fondazioni should maintain majority control in the Spa.
2. Law n.474/94 (Direttiva 'Dini') eliminates obligation by Fondazioni to retain majority of capital in the Spa; divestments receive fiscal incentives.
3. Law n.461/98 ('Ciampi' law) and Delegate Law n 153/99. Fondazioni should cede all majority control in 4 years (by 15 June 2003) and the operations receive fiscal incentives. Fondazioni defined as private agents with full statutory and management autonomy, under supervision of the Minister of Economy.
4. The European Commission, in October 2000, begins an investigation of the fiscal measures established by the 'Ciampi' law, which it suspects of being State Aids.
5. Amendments to the 2002 Budget Law ('Tremonti' amendments), in late 2001, propose putting all Fondazioni banking assets into SGR sub-holdings, to be supervised by Banca d'Italia, and to sharply raise the representation of local public authorities in Fondazioni councils.
6. The Constitutional Court, in December 2002, puts the Tremonti amendments on hold.

Source: ACRI (2002); OECD.

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of the administrators of their banks). Even so, though the foundations have reduced their total ownership shares, they have succeeded in maintaining their centrality in the banking system by coordinating agreements with other shareholders.

- To prevent the risk that the foundations replace the state in several public services in the local communities, *i.e.* to ensure that they complement and not substitute for the welfare state, "Ciampi-Visco" stated that a large proportion of the executives of the foundations must be the representatives of the local civil society, instead of local politicians. However, though growing, the former are still not in the majority on foundation councils.[4] There is correspondingly still an unclear vision of what the foundations should be doing, as opposed to the government, in the tertiary sector.[5]

All the incentives created by the two new bills go in the right direction, but they are quite weak. The main point is still to understand whether the single foundation acts for the maximisation of social good, or merely within a trivial logic of power, clientism and local influence. It must be questioned whether foundations have the incentives to effectively select initiatives in the non-profit sector or to efficiently invest their capital. If an executive of a foundation makes a bad investment, for instance, such behaviour will go unpunished as there is no clear mechanism – no stockholders, clients or customers, nor even voters – to assign responsibility or to impose sanctions. Therefore, accountability of the foundations is still insufficient, undermining the attempt by the law to create the incentives for their executives to adopt virtuous behaviours.[6]

As the absence of a market sanction on the non-profit sector jeopardises the efforts to evaluate the assets of the foundations and to understand their influence, in either banking or the non-profit sector, a regulatory effort must be made to provide the foundations with a more efficient and transparent executive council, facilitating the monitoring of their choices by all the stakeholders. Such a process of evaluation will be slow to develop. However the law obliges the foundations to allocate their assets following the principles of profitability, diversification and prudence.[7]

The foundations in the current *Legislatura*

After the election of a new parliament and government, it would have been of capital importance to continue to push the foundations to divest the control they still had in the banks. The new government, however, chose to intervene in this process with a last minute modification of the Budget bill 2002. This led to a heated political debate, ending in an appeal to the Constitutional Court to overturn the amendments, but the only important question is whether these new initiatives follow the twelve-year-old path of the reform or block it. The Budget bill's clause had two main objectives:

- the new bill widens the concept of control to cover situations in which control is exercised jointly by several foundations;
- to fix a number of situations of non-compatibility, the Ministry of the Economy will establish rules to prevent conflicts of interests between the executives who allocate the funds of the foundations and the agents who take grants from them.

This is, in fact, a good starting point for the reform. The 2001 reform has for the first time identified the notion of control to include cases where this is reducible, directly or indirectly, to several foundations, rather than just one. Moreover, some executives belonging to the civil society may have an obvious economic advantage to be a member of the council of a foundation, making more difficult the path towards greater transparency, and the regulator has clearly a role to play in counteracting such conflicts of interest. However, the subsequent

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decree of the Ministry of Economy – implementing the statements of the Budget bill – really overshoots these problems.

As to the first objective, the definition of control of the foundations over banks is indeed tightened, but a number of discretionary elements may distort the implementation. Although foundations have to get rid of their credit control shareholdings, the deadline for the disposal of shareholdings in the companies to which the foundations had transferred their banking business was postponed until June 2006 on condition that shareholdings were entrusted to an independent asset management company (*societá di gestione del risparmio* – SGR).[8] The SGRs are to be regulated by the Ministry of Economy, by as yet unspecified criteria, while the separation of control and ownership will introduce a lot of ambiguities in the allocation of responsibilities. These factors could, in turn, exacerbate weak market competition for bank property and control rights.

The implementation of the second objective, which applies to the foundations the new discipline on conflicts of interest, could also have undesired consequences. According to the new clause the majority of members of the foundation's executive council are to be made up of representatives of local authorities, effectively forcing the foundations to promote local development. This could blur the lines between a foundation and a public agency, even though the former is expressly qualified as a private entity by the law and enjoys a far-reaching autonomy. Any usage of the foundations as a means of local public finance would be an unwelcome departure that is nontransparent and punishes the needy areas (which have few foundations) disproportionately.

The reform process started in 1990 with the clear aim of preventing the public actor from having a role in the credit sector. The new statement could be seen as an increase of public influence over foundations even though the latter must sell their banking control (be it solitary or joint) shareholdings or, alternatively, entrust them to an independent asset manager. The new bill seems to have assumed that the privatisation of the Italian banks will be soon complete and satisfactory, with the foundations no longer linked to the banks nor to the credit function. However, further legislation might be necessary in order to complete the reform process.[9]

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Notes

1. Such banks accounted for around one-quarter of banking system assets at the time of the Amato reform; 93 per cent of these banks, in turn, were *Casse di risparmio* or *Banche del monte* (savings banks), and the other 7 per cent were *Istituti di credito di diritto pubblico* (public charter banks). These banks typically had their roots in local public administrations or in charitable works, and had a history of public control. With the reforms, the banks' governance was to be improved by separating management from ownership, while transforming them into publicly held joint stock companies, which became the predominant mode of ownership in the Italian banking system. Their overall size grew to almost two-thirds of banking system assets by the time of the 1998 Ciampi reforms. See Messori (2002a).
2. The remainder (less than 10 per cent) retained exactly half of their own-bank's capital. *Ibid.*
3. A total of 18 smaller foundations continued to exert majority control as well. See ACRI (2002).
4. In 2000, 50.2 per cent of the executives of the Italian foundations came from local institutions (30.1 per cent from local authorities, 9.4 per cent from the *Camere di Commercio*, 10.7 per cent from the health system, the public agencies of tourism, etc.), so that the share of the local civil society (academics, scientists, clergymen, the charities, artists, etc.) had risen to 49.8 per cent of the 1 550 executives.
5. Messori (2002a) suggests that the activity of the foundations in the non profit sector concern all the situations where there is a clear negative trade-off between efficiency and social fairness. When the State intervenes, to protect social equity, it always kills a market; if a foundation intervenes, competition and the market could be preserved, as the foundations are more flexible and efficient than government. But this author also stresses that the foundations' accountability has to improve before they can be effective. They should renounce control over banks and adopt correct corporate governance structures, with effective supervision by third parties over the return on their assets and uses of such funds in the non-profit sector.
6. Law n. 289/2002 further established that foundations with assets not exceeding 200 million euros or mainly operating in Regions with a special autonomy may hold their control banking shareholdings until June 2006.
7. Legislative decree n. 153/1999 establishes that the Ministry of Economy sets minimum profitability standards.
8. By contrast, in the recent fight for Mediobanca (March-April 2003), the foundations were seen by many commentators as trying to consolidate a position of influence in the bank, *via* complicated cross-holdings, rather than keeping to their proper business.
9. In December 2002, the implementation of the provisions were put on hold by the Constitutional Court, and the status of the reform is currently unclear.

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Annex III

Efficiency of the public administration

The 2002 OECD *Economic Survey* of Italy included a section on the efficiency of public spending. The section focussed, *inter alia*, on human resource management in the public administration, quality of services, and administrative burden. This annex presents an update of recent developments in these areas.

Human resource management

After decreasing in 1998-1999, the number of public employees increased by 0.7 per cent in 2000 and stabilised in 2001. In that year, their numbers were equal to 6 per cent of the total population, slightly lower than in the G7 countries on average (6.9 per cent in 2000). In the 1999-2001 period, wages in the public sector increased considerably faster than in the private sector (the ratio of per capita wages in the public to private sectors increased by almost 3 per cent each year). In 2001, the average wage rate of public workers was around 40 per cent higher than in the private sector,[1] by far the biggest difference among G7 countries.[2] Despite relatively higher wages, the average competence of public sector workers in Italy is perceived to be lower compared with that of private sector workers, more so than in many other OECD and non-OECD countries.[3]

During the 1990's, a more clear-cut division of responsibilities was introduced between the political and administrative authorities at both the central and local levels. Since then, public employees seem to enjoy greater organisational freedom than in the past. However, wage and career prospects are not adequately linked to skills, effort and productivity.[4] The main reason for this outcome is the lack in many administrations of appropriate and transparent mechanisms of personnel evaluation.[5] Human resource management in general is but one of many activities of the broader general affair directorates and it does not always receive priority attention by top level managers and politicians. The main activities of the human resource offices concern relationships with trade unions and administrative procedures.

Poor relationship between ministries and their personnel is also reinforced by the broad and almost exclusive use of formal and legalistic ways of communication (*circolari* and *ordini di servizio*). The lack of wage and out-of-pay incentives have led to increasing dissatisfaction of public workers with their jobs, poor quality of services that they provide, and eventually to a selection process where mostly low-skill and unmotivated individuals choose to work in the public sector because of the relatively high job security there. In fact, in a survey of OECD countries the Italian government indicated a critical skill shortage (as opposed to "recruitment" or "retention" of civil servants) as the main problem currently facing human resources in the public sector.[6] Efforts to upgrade personnel skills are not always sufficient. In 2001, training expenditure was still under 1 per cent of wages, with the regulatory Authorities and

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the Chambers of Commerce having higher than average shares.[7] The shares of regions and local administrations are in general lower than average. Not all administrations evaluate. Only around 60 per cent of municipalities and provinces made *ex post* evaluation of their training programme in 2001.[8]More and better training will probably be needed at regional and local level given the expected process of government decentralisation (see Box A3.1).

As far as the management is concerned, the 1998 reform (launched by the previous government) had introduced, *inter alia*, the possibility for any new political administration of replacing top figures in key posts, fixed-term appointments (lasting from 2 to 7 years) for all managers, a periodical turnover of their tasks, and a greater link between pay and performance. This was deemed necessary not only to improve managers' performance but also to make sure that the more clear-cut division of responsibilities between political and administrative authorities mentioned above would not harm the implementation of the government programme.[9] However, most of the contracts signed after the reform lasted more than 5 years, *i.e.* longer than the legislature period, potentially eliminating the incentives for managers to quickly implement the government's programme. Furthermore, objectives and benchmark indicators specified in the individual contracts were often generic so that wage prospects were still only loosely linked to results and performance.[10]

The current government has taken a number of initiatives to improve the skills and increase the efficiency and accountability of public personnel. One of the main steps has been a further strengthening of the 1998 reform. According to the new law approved in June 2002, after 3 months from the parliamentary investiture of any new political administration the top manager posts (*Segretari generali* and *Capi Dipartimento* amounting to around 60) appointed by the old administration are automatically terminated giving the possibility to the new administration of replacing them. Moreover, the maximum length of the contracts has been cut to 3 years for medium level managers (*Dirigenti generali* amounting to around 400). In addition, there is no minimum length. In 2002, these measures were immediately applied to directors already in place. Around one fourth of them were not confirmed and moved to new posts. Furthermore, contracts as short as 5 months-long have been signed. A more significant share of the managers' pay – as well as the possible confirmation or cancellation of the contracts – is linked to the attainment of specific objectives. Many of the contracts' arrangements will be agreed at the individual level, although those regarding many benefits are still left to collective agreements.

Through other measures, the government has also given a greater role to internal control offices (*Servizi di controllo interno*) in monitoring the actual implementation of the political objectives also by means of appropriate benchmarks and in formulating recommendations for improvement of Ministries' functioning. Finally, a greater accountability of public managers to the political authorities will also draw from the re-organisation of some ministries where general directorates are being introduced (replacing departments) under the control of one secretary-general directly reporting to the Minister.

In order to reduce and rationalise public personnel, the 2003 Budget law introduced an almost total hiring freeze, along with obligations of reducing personnel on permanent contracts starting from 2004, while encouraging greater recourse to personnel mobility and to fixed-term contracts. Some initiatives have also been taken to upgrade the skills of public personnel. The objective is to devote at least 2 per cent of total wage to training. Each public administration is now obliged to present a training programme for its workers at the beginning of every year. In addition, minimum quality standards have been set for the schools providing training to the public workers, with enhanced control of the actual attainment of skill upgrading. Training schools will also be required to acquire quality certification by appropriate institutions. An agreement with universities was signed in order to promote new training

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Box A3.1. Recent measures on government decentralisation

In October 2001, Italy took an important step towards greater government decentralisation. A referendum confirmed the changes – proposed by a Constitutional Law approved by the parliament – of the Constitution's articles concerning the relationship between the state, regions, and the other local administrations (see also the Special chapter in the 2002 *Italy's Survey*).

The new Constitution specifies the exclusive competencies of the state and the competencies that are shared between the state and the regions. All the other (unspecified) competencies are reserved to the regions. As a result, the Constitution now gives to the regions the exclusive competencies in many important areas: agricultural, industrial and retail trade policy; regional energy production and distribution; mines; tourism; labour policy; water resources; urban planning; regional transport networks; local public services; museums and regional libraries; professional training; local police; social services and other functions.

The shared competencies include even more relevant sectors: international relations involving regional issues; external trade policy; job security; education; liberal professions; R&D and innovation policy; health care; civil protection and land management; ports and airports management; national transport and sea networks; communication; national energy production and distribution; complementary pension funds; public finance co-ordination; cultural assets' management; regulation on certain types of banks (*casse di risparmio*, *casse rurali* and banks operating at regional level) and other functions. On the shared competencies, the state retains the power of setting the general principles and of defining minimum levels of services to be provided in the whole country.

Moreover, the Constitution now recognises the fiscal autonomy of regions and local administrations, on both the revenue and the expenditure sides. An equalisation fund is required to be set up redistributing resources towards areas with lower tax bases. The only financial constraint for decentralised administrations is the possibility of borrowing only to finance investment spending. The resources that should be transferred from the state to the local administrations for implementing this decentralisation programme are estimated to be almost 11 per cent of GDP.

After the approval of the Constitutional changes, many regions started to introduce legislation in areas, which – according to the state – were part of shared competencies and, therefore, needed the specification of general principles (not yet introduced). The Constitutional Court ruled on these cases, and *de facto* recognised the power for the regions to legislate in the areas of shared competencies even if general principles have not been set. A Bill presented by the Ministry for Regional Affairs – still under discussion by the parliament – should accelerate the introduction of these general principles.

In the meanwhile, if approved by the parliament, a new Constitutional Bill presented by the Ministry for Institutional Reforms could represent a further step towards government decentralisation. In fact, even if the interpretation is still a matter of different opinions, the Bill might extend the exclusive powers of the regions also to the education and health sectors that are currently among the areas of shared competencies.

Source: ISAE, *Rapporto annuale sull'attuazione del federalismo*, February 2003.

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programmes for current workers and to better inform students of the work and skill requirements needed by the public administrations. Lastly, to widen their skills public managers have now the possibility to work temporarily in the private sector or in international organisations.

The measures being implemented by the government could go in the right direction of both reducing public personnel and increasing their efficiency. The further reform of top and medium management could increase the accountability both of administrative staff (as their pay and career is more linked to results) and of political authorities to the public as they can not blame bureaucrats for the partial or failed implementation of the government programme. However, an excessive recourse to the "spoils system" could bear a number of risks.

- F*irst*, some politicians could be tempted to use appointments in the public sector as a way of gaining consensus *per se*, independently from the actual implementation of the government programme. Admittedly, the vast privatisation effort and the diminishing role of the state in the economy carried out during the 1990s have lowered this risk significantly. In any case, to further reduce this possibility a mechanism of checks and balances between the government and the parliament could be envisaged, as it is often the case in other OECD countries (for example appointments of top officials could be brought to the scrutiny of the parliament before being finalised).
- S*econd*, an efficient activity of public managers often requires a minimum period of continuity especially for establishing confidence and trust with other parts of the public administration and with external counterparts like citizens, companies and international organisations. Many of the signed contracts are too short for this trust to be established. The introduction of a minimum length for contracts should be envisaged. Moreover, the stress on short term objectives should not stop public administrations from identifying also some medium term "core" targets – mainly concerning internal organisation and external relations but possibly extending to some bipartisan objectives – that could be maintained despite governmental changes.
- F*inally*, promotion to medium-level management could represent an incentive mechanism for good performance by lower level civil servants, whose role is often fundamental for an effective implementation of the government programmes and for the day-to-day activity. If appointments are decided by political authorities at each change of government, lower level civil servants could consider efforts to implement the government programme useless, as there is a risk – on top of not being promoted – of being replaced by the next government in case of such a promotion. The authorities could then consider introducing a "special" career stream for a number of medium and top managerial functions, more independent from political influence and whose access could be decided by rigorous public examinations open to internal and external candidates.[11]

The objective of reducing the number of public workers while upgrading their skills should be given priority attention and could go hand in hand with the ongoing reorganisation of administrations (involving also the elimination of around 100 public institutions) having the objective of reducing fragmentation among departments in the implementation of the government's policies, avoiding overstaffing or understaffing in many ministries and departments, providing greater consistency between inputs and functions to be carried out, and avoiding task duplications. However, improving the performance of public workers may be more than just a matter of training, but also one of incentives: hence, the application of performance-based pay and objective monitoring should be implemented to sub-management levels as rapidly as possible. Indeed, managers could be frustrated in their ability to achieve goals without such mechanisms in place.

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Services to citizens and administrative burden on companies and individuals

During the past decade, a number of measures were undertaken to simplify the administrative burden on citizens and companies and to improve the services supplied (one-stop shops, charters of services, offices for communication with the public, decentralisation of many procedures, obligation for administrations to indicate timing and official responsible for each procedure, regulatory impact analysis, greater recourse to streamlined reference codes rather than fragmented legislation). However, these measures were not always fully implemented so that the administrative burden is still high. For example, Confartigianato (2002) estimates that the direct cost of the administrative burden on companies is still around 1.2 per cent of GDP each year, more than half of which due to accounting and fiscal compliance obligations. Moreover, their survey indicates that half of small companies did not perceive any significant improvement in the bureaucratic requirements in the last three years, *i.e.* since the launching of the major reforms in this area by the previous government (see OECD *Regulatory Reform Review of Italy*, 2001). According to Dipartimento della Funzione Pubblica *et al.* (2002), the direct cost of the administrative burden is slightly higher (around 1.5 per cent of GDP). According to their survey, more than 60 per cent of companies are satisfied with the activity of the municipal administrations but room for improvement is still large for regional and provincial administrations Finally, despite considerable progress in the use of information technology, the extensive recourse to self-certification and a better organisation of public offices, citizens still identify as major areas for improvement the overall skills of public personnel, waiting times for finalising administrative obligations and the overall burden of the bureaucratic procedures.[12]

The present authorities' main response to reduce red tape has been to take stock of the best experiences so far on the one hand and to implement an action plan for "e-government" on the other. On the first point, through a series of initiatives under the umbrella of the "*Cantieri*" ("work in progress") programme, the government is enhancing the co-ordination among central and local administrations to disseminate best practices more quickly.

On the second point, the main objectives of the e-government programme are: *i*) the supply of services through a unified electronic access point even when involving more than one government department; *ii*) the introduction of identification instruments like the electronic ID card and digital signatures; *iii*) the use of non-traditional channels to access public services like Internet, call centres, mobile phones; and *iv*) the implementation of a communication infrastructure linking all government departments.[13] Moreover, a training programme for public employees as users of IT has been set up in the context of the action plan.[14] However, the deadline for many programmes could be postponed as the 2003 Budget Law allocated less funding than initially expected, unless public administrations could quickly implement a vast programme of public-private partnerships in these areas. In any case, around 140 projects from regions and local administrations – mainly building electronic services to citizens and companies through Internet – are being financed by national and EU structural funds.[15] Finally, co-ordination of e-government activities could be enhanced by the establishment of a Ministers' Committee for the Information Society chaired by the Minister of Innovation that will have a central role in the planning and prioritisation of funds.[16]

Important steps are being taken in the area of the e-procurement. An increasingly important role has been given to CONSIP S.p.A. – owned by the Ministry of the Economy – in the centralisation of the purchases for the public administration. The main instruments used by CONSIP are online auctions, electronic shops (product and price agreements between CONSIP and companies to which all public institutions can access through the web) and, shortly, marketplaces (Internet sites managed by CONSIP where companies can offer their products to public administrations). Through CONSIP, the authorities have also started a programme

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for contracting out activities (like office maintenance) that were traditionally managed by public personnel. Up to May 2002, the unit price on products and services purchased by CONSIP was around one third lower than in the past.[17] Further savings are also the result of lower transaction costs due to the centralisation of procurement procedures. In 2002, the amount of goods and services involved in the CONSIP programme was EUR 8.5 billion), less than one tenth of total general government intermediate consumption. In 2003, the government expects the programme to reach EUR 22.7 billion. Extending the programme even further could result in significant savings, especially in the health sector where the share of intermediate consumption is larger than on average in the euro area (Table A3.1).[18] In the process, the authorities should make sure that the process of purchase centralisation does not conflict with the need of increasing management responsibility among decentralised administrations and that criteria of competition among companies continue to be pursued in the implementation of procurement mechanisms. In this respect, cooperation between

Table A3.1. **Functional decomposition of intermediate consumption**

	Intermediate consumption, as per cent of GDP					
	Italy			Euro		
	1999	2000	2001	1999	2000	2001
General public services	0.9	1.0	1.0	0.9	0.9	..
Defence	0.4	0.4	0.4	0.5	0.5	..
Public order and safety	0.3	0.3	0.3	0.3	0.3	..
Economic affairs	0.5	0.5	0.5	0.5	0.6	..
Environment protection	0.5	0.5	0.5	0.4	0.4	..
Housing and community amenities	0.2	0.2	0.2	0.2	0.2	..
Health	1.3	1.4	1.4	0.7	0.7	..
Recreation, culture and religion	0.4	0.3	0.3	0.3	0.2	..
Education	0.8	0.8	0.8	0.7	0.7	..
Social protection	0.4	0.4	0.4	0.5	0.4	..
TOTAL	5.7	5.8	5.8	4.9	4.9	..
	Intermediate consumption, as per cent of total					
	Italy			Euro		
	1999	2000	2001	1999	2000	2001
General public services	16.4	17.6	17.2	19.3	19.3	..
Defence	7.4	6.8	6.6	10.5	10.6	..
Public order and safety	5.8	5.5	5.3	5.5	5.6	..
Economic affairs	8.8	8.4	8.6	11.2	11.3	..
Environment protection	8.2	8.6	8.8	7.4	7.6	..
Housing and community amenities	4.0	3.6	3.7	3.8	3.3	..
Health	23.0	24.1	23.9	14.2	14.9	..
Recreation, culture and religion	6.5	5.5	5.3	5.1	4.7	..
Education	13.6	13.7	14.0	13.6	13.5	..
Social protection	6.2	6.2	6.6	9.4	9.2	..
TOTAL	100.0	100.0	100.0	100.0	100.0	..

Source: Eurostat.

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CONSIP and the Antitrust authority has been enhanced in 2002 in order to ensure an adequate degree of competition in large-scale public procurement.

In other areas, the margins for improvement are large. From a recent survey by Taylor Nelson Sofres (2002), in 2002 the Italian users of e-government services were 20 per cent of the population and 47 per cent of Internet users compared to an average of 30 and 61 per cent, respectively, for 31 OECD and non-OECD countries. In part, this might reflect a concern for security as 72 per cent of the surveyed Italian population considered government online unsafe, a higher share than the average of the countries considered by the research. But it could also indicate the need to improve supply of services. In fact, despite recent progress, especially in the areas of online taxes and postal services (in addition to public procurement), recent research by Accenture shows that the quantity and quality of public services offered through Internet by the Italian government, expressed in terms of a composite indicator, are less than half of those supplied by the best performer country (Canada) and around 70 per cent of those supplied by Germany and France.[19]

The stress of the government on spreading more widely the most innovative experiences and on pushing more services online will likely improve the relationship between public administrations and the private sector. Regular cost-benefit analysis before choosing the projects and *ex post* evaluation of the products delivered should be constantly maintained. Nonetheless, online services are likely to affect only a small part of the population and of companies, especially in the short term. Therefore, these programmes should be integrated into a broader plan of administrative simplification and reduction of red tape that would benefit from the full implementation of the measures introduced during the previous decade.

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Notes

1. It should also be kept in mind that by working shorter hours than private sector workers public employees have greater possibilities of engaging in paid activities outside regular working hours. According to the latest annual analysis of the Dipartimento della Funzione Pubblica (2002), in 2000 paid activities of public employees outside regular working hours added on average more than 10 per cent to their regular earnings.
2. While in Canada and the UK wages in the public sector are lower than in the private sector, in Japan they are 27 per cent higher, in Germany 22 per cent, in France 7 per cent and in the US 4 per cent.
3. Italy ranks 49 out of 59 OECD and non-OECD countries regarding the skills of public employees relative to the ones in the private sector. See Confindustria's benchmark indicators in: *www.confindustria.it/dbimg2002.nsf/htmlpages/congprev*
4. Dalla Rocca, Rampino and Burgarella (2001) surveyed the career and pay structures in 143 public administrations including ministries, regions and local administrations in the 1998-2001 period. They found that most administrations chose a personnel career strategy not linked to performance. Moreover, wage premia related to individual productivity have been seldom distributed, with some regional differences. In the North, 53 per cent of the administrations offered premia for collective and individual productivity compared to 9 per cent of administrations in the South. Only in 25 per cent of the cases the individual productivity premia were offered to a limited number of employees; in all the other cases the premia were distributed to all dependent workers without selectivity.
5. Istituto Tagliacarne (2002).
6. OECD (2002k).
7. Scuola Superiore della Pubblica Amministrazione (2002).
8. Bevilaqua (2002).
9. Cerbo (2002) points out that the reforms clearly attributed to the politicians the responsibility of setting objectives and strategies and to civil servants the task of implementing them.
10. Corte dei Conti (2002).
11. This measure was hinted at by the former Minister responsible for the Department of the Public Administration (Frattini, 2002), but it has not been introduced so far.
12. ISPO (2003).
13. Ministero per l'Innovazione e le Tecnologie (2002).
14. OECD (2002k).

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15. De Marco and Pizzicannella (2002).
16. In April 2003, the Committee allocated around EUR 160 mln for 10 projects involving, *inter alia*, specific services to companies and enhanced electronic communication within the public administration.
17. Ministero dell'Economia e delle Finanze (2002).
18. For a functional decomposition of intermediate government consumption see also Fiorito and Kollintzas (2002). Their data show that from the 1970's to the 1990's government intermediate consumption as a ratio of private consumption in Italy decreased in real terms but increased in nominal terms suggesting that price inflation for the goods and services purchased by public institutions has historically been much higher that the one for the private sector.
19. See the article @lfa – Il Sole – 24 Ore: "Avanza l'e-government", 11 April 2003.

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Annex IV

Chronology of main economic events

2002

January

Euro banknotes and coins begin to circulate and national currencies begin to be withdrawn.

February

A new national collective agreement for the Italian chemicals sector is signed. The deal provides for an annual working time reduction of eight hours, an average monthly wage increase of 88 euros over 2002-2003 and the establishment of a supplementary health insurance fund, as well as new provisions on training and health, safety and the environment.

The government and trade unions reach a procedural agreement for the renewal of the national collective agreements for 3.5 million employees in the public sector, which attaches priority to collective bargaining in the legislative regulation of employment conditions.

March

The government approves the tax reform programme, which envisages a substantial reduction in the tax burden and broad changes in the structure of the tax system.

April

The government issues decree law 63/2002 with the aim of curbing expenditure on pharmaceuticals, which will reduce the price paid for most drugs by the National Health Service by 5 per cent.

The three main Italian trade union confederations hold a general strike in protest of the government's proposed labour market reforms.

The government approves new legislation which seeks to promote the "regularisation" of irregular work. The new law provides for a three-year period of "emergence" from the underground economy, during which companies and workers involved in irregular work will benefit from tax and social security incentives as they regularise their situation.

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June

The government approves the Employment National Action Plan and submits it to the European Commission. The plan aims at increasing the employment ratio by 4 percentage points by 2005.

July

The government, employees and trade unions (with the exception of CGIL, the largest one) sign the *Pact for Italy*, which contains a number of measures regarding the structure of taxation, the labour market and intervention in south Italy.

The government submits to parliament the *Economic and Financial Planning Document* (DPEF) 2003-2006, which sets the medium term objectives.

The government issues a *decree law* to limit the cost of tax relief granted in the form of tax credits.

August

New legislation to regulate immigration into Italy comes into force, which lifts the limitations to entry into Italy for high-skilled workers (university lecturers and professors, professional nurses etc.) and allows entry for non-EU immigrants into Italy only if they have a "residence contract" signed by an employer and the immigrant worker.

September

The government issues decree law 194/2002, the so-called "expenditure-blocking" law, aimed at increasing the effectiveness of the controlling and monitoring procedures of public expenditure.

The government presents the budget proposal for 2003.

October

Fiat announces a new reorganisation plan for the group's automobile operations in Italy, and asks the government to declare a "state of crisis" in the car market.

The government introduces a *decree law* to reform the functioning of the public employment services (PES), which lays out deadlines for the PES on assisting and training dismissed people on a personal basis.

November

The Stability Programme for 2003-2006 is presented.

December

The parliament approves the Budget Law for 2003.

The government presents proposals on *corporate social responsibility* (CSR), with the aim of producing a competitive and dynamic knowledge-based economy, capable of sustainable economic growth with more and better jobs and greater social cohesion.

The Constitutional Court puts on hold the government's reform proposals for the banking foundations.

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2003

January

The government approves a reform of the company law rules governing limited liability and joint-stock companies and cooperatives, which will come into force in 2004.

February

The government publishes a "White Paper" on the welfare state, with the stated aim to introduce a decentralised system of social protection, with selective and flexible measures tailored to the needs of local communities.

The government issues a "White Paper" on industrial policies, which aims to provide a basis for discussion with social partners, namely *Confindustria* and trade unions, on improving social and industrial relations.

The parliament approves a "delegated law" on reform of the labour market. The reforms relate to areas such as job placement services, new forms of employment contract and part-time work.

The Chamber of Deputies approves a proposal for a "delegated bill" reforming the social security system, notably pensions. The bill is now under discussion in the Senate.

March

The parliament approves a reform of the schools system. The changes include a new combined school/work path for students between the ages of 15 and 18, as well as greater choice and decentralisation.

The real GDP growth rate in 2002 turns out at 0.4 per cent, the lowest since 1993.

April

The *Relazione trimestrale di cassa* revises the official budget deficit target for 2003 to 2.3 per cent of GDP from 1.5 per cent included in the 2002 Stability Programme.

Key *Mediobanca* shareholders propose changing the bank's ownership structure, which will lead to the resignation of the chief executive of the bank.

June

The referendum on the extension of Article 18 of the 1970 labour code to companies with fewer than 15 employees fails due to low turnout.

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Annex V

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