© OECD, 2002.

© Software: 1987-1996, Acrobat is a trademark of ADOBE.

All rights reserved. OECD grants you the right to use one copy of this Program for your personal use only. Unauthorised reproduction, lending, hiring, transmission or distribution of any data or software is prohibited. You must treat the Program and associated materials and any elements thereof like any other copyrighted material.

All requests should be made to:

Head of Publications Service,
OECD Publications Service,
2, rue André-Pascal,
75775 Paris Cedex 16, France.

© OCDE, 2002.

© Logiciel, 1987-1996, Acrobat, marque déposée d'ADOBE.

Tous droits du producteur et du propriétaire de ce produit sont réservés. L'OCDE autorise la reproduction d'un seul exemplaire de ce programme pour usage personnel et non commercial uniquement. Sauf autorisation, la duplication, la location, le prêt, l'utilisation de ce produit pour exécution publique sont interdits. Ce programme, les données y afférantes et d'autres éléments doivent donc être traités comme toute autre documentation sur laquelle s'exerce la protection par le droit d'auteur.

Les demandes sont à adresser au :

Chef du Service des Publications,
Service des Publications de l'OCDE,
2, rue André-Pascal,
75775 Paris Cedex 16, France.

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

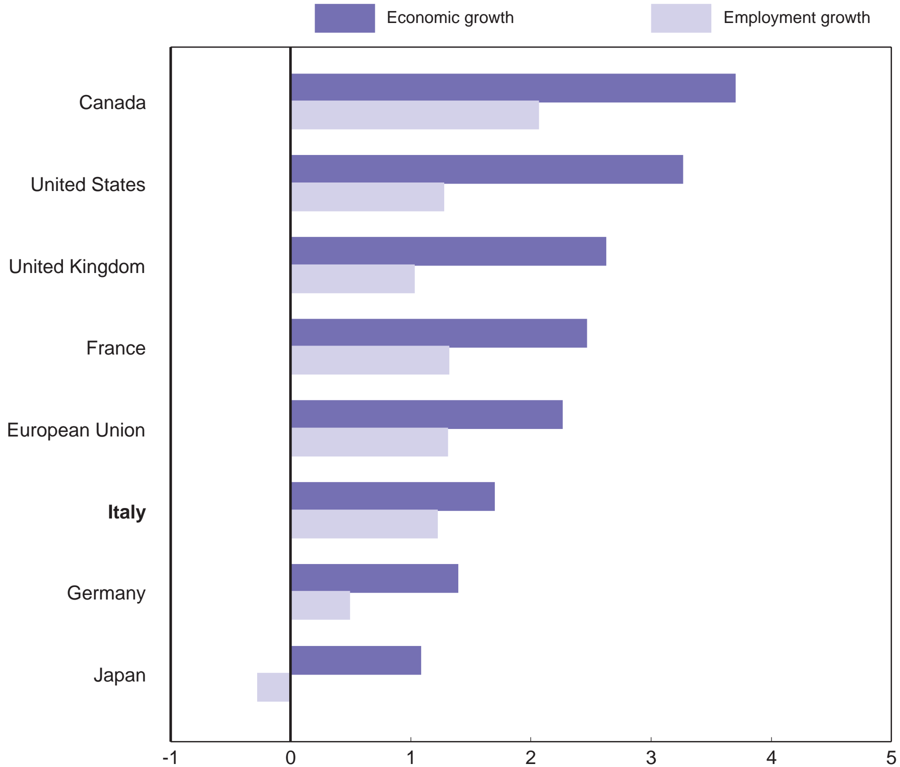
Labour market

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

© OECD 2003

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

© OECD 2003

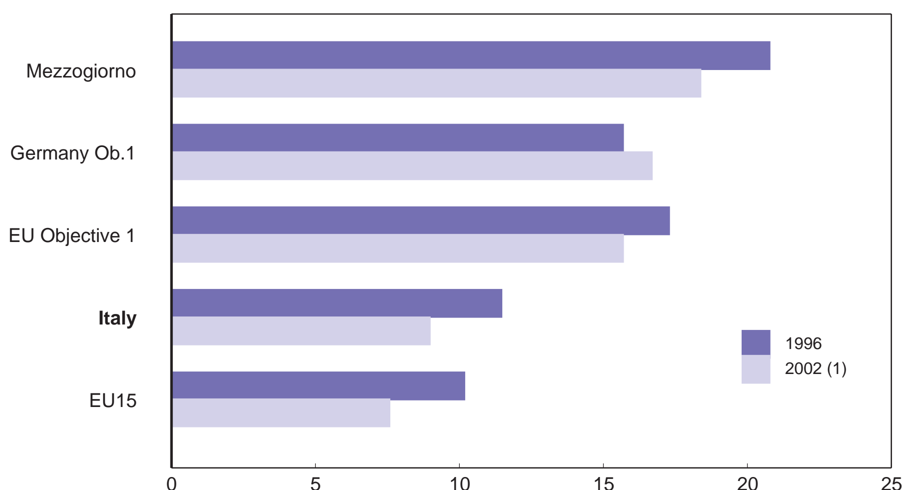
Table 24. **Labour market indicators, 2001**
(percentage values)

	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.

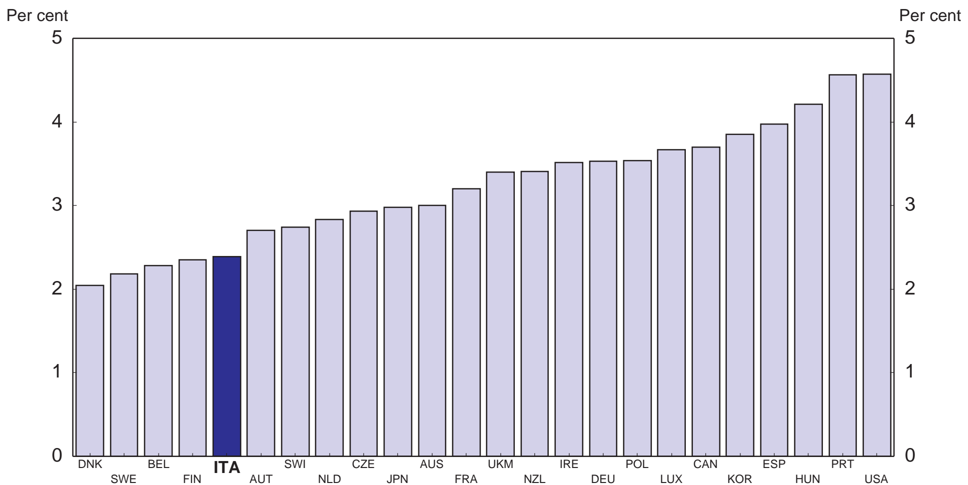
© OECD 2003

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.*

© OECD 2003

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

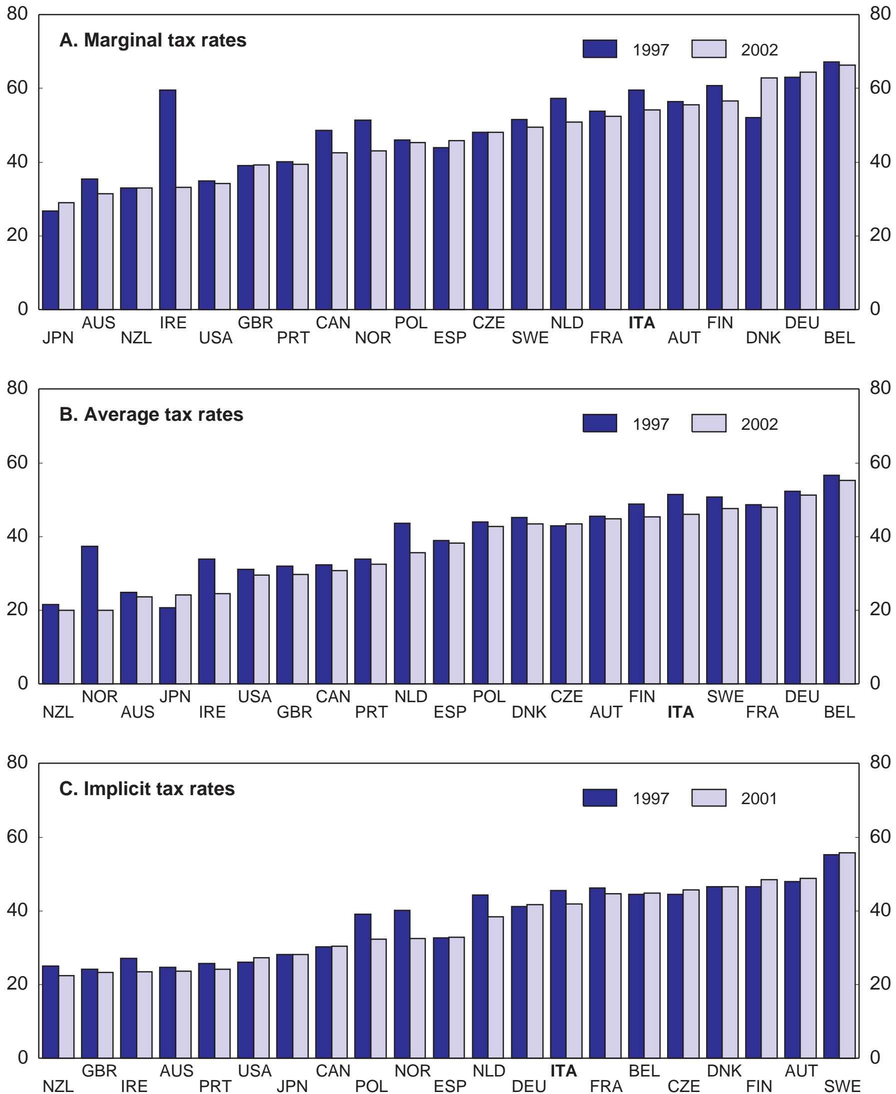
Active labour market policies have been significantly developed in the past few years. Public resources devoted to these policies increased during the second half of the 1990s and are now comparable to the spending in other EU countries.[96] Most of the financing is devoted to hiring subsidies that are 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

© OECD 2003

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.*

© OECD 2003

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" (P*atto per l'*I*talia*). 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 (S*istema* I*nformativo* L*avoro*) 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

© OECD 2003

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

© OECD 2003

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.

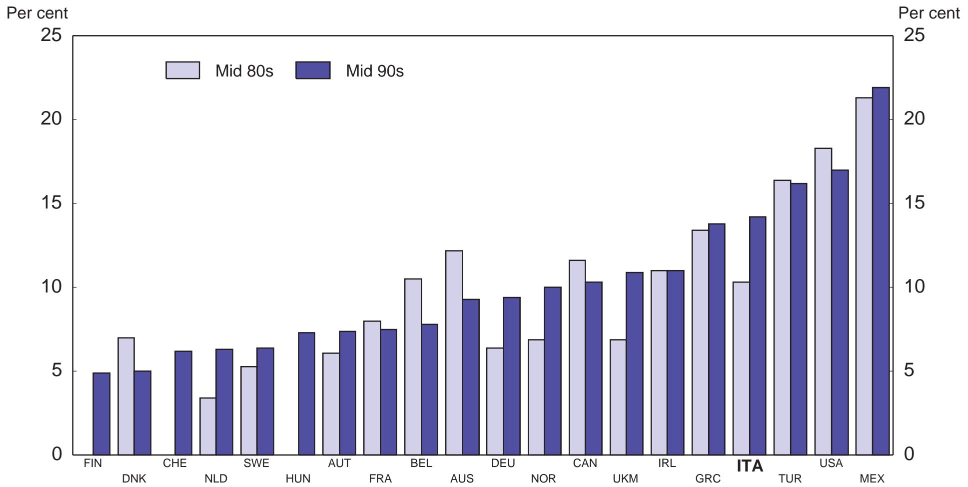
More generally, however, both pervasive job protection legislation and low wage differentiation is encouraged by an unemployment benefit system and public employment services that fail to adequately insure all workers against temporary income loss, to re-train them, and help them to find a suitable job. 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

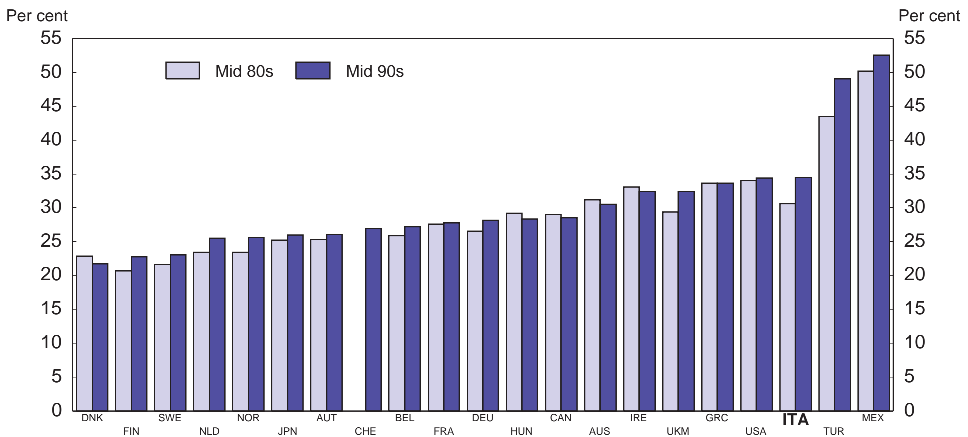
© OECD 2003

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*.

© OECD 2003

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

© OECD 2003

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.

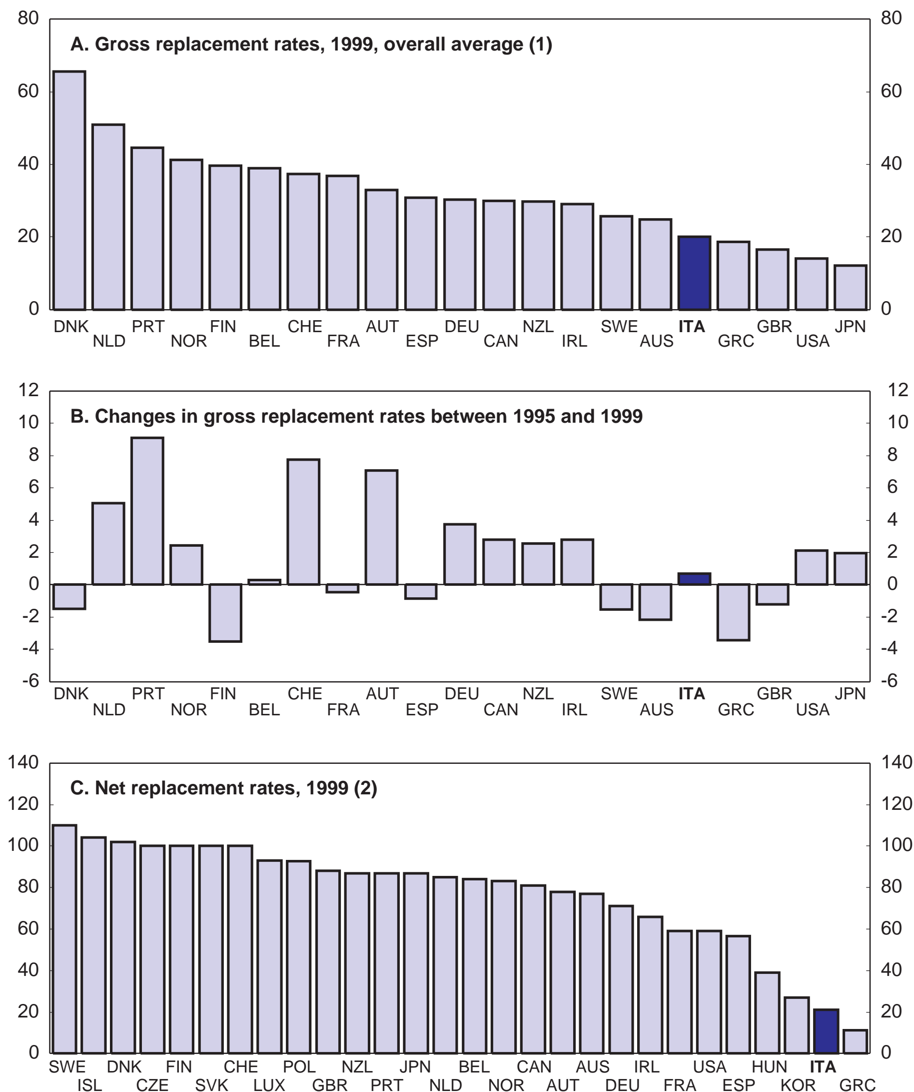
The P*atto per l'Italia* announced measures – in part subsequently introduced in the 2003 Budget law – to strengthen unemployment insurance and social inclusion. The main stress of the Pact is the introduction of tax cuts especially targeted to low income families. Moreover, the replacement rate of the 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

© OECD 2003

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.

© OECD 2003

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-

© OECD 2003

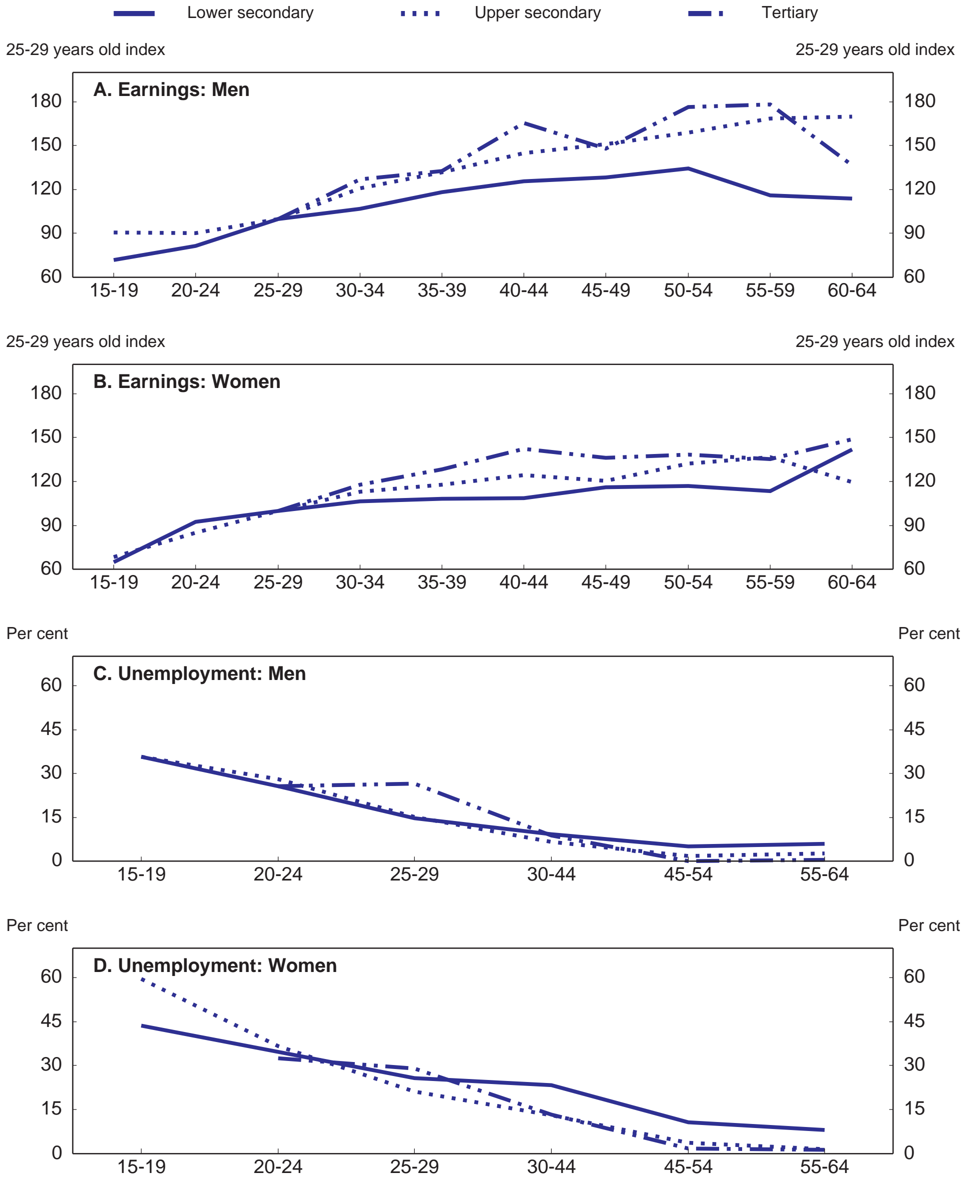
nity for improving human capital, but it can translate in a social problem as searching and finding a job might prove difficult for low-skill young workers.[118]

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 P*atto per l'*I*talia* 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

© OECD 2003

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



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

© OECD 2003

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.

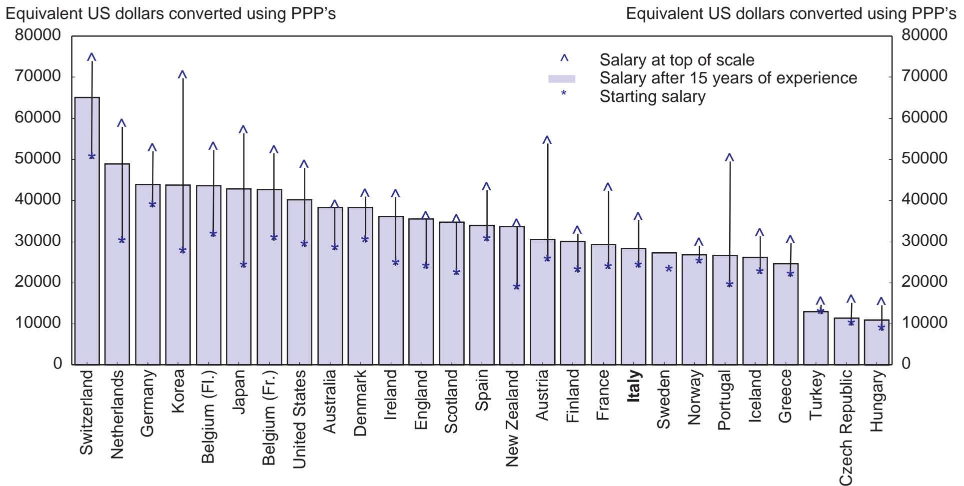
Careful consideration should be given to the introduction of measures favouring private provision of education. On average, public schools are at present of higher quality than private ones, though this might of course change if private institutions could compete directly with public schools for resources.[125] 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-

© OECD 2003

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*.

© OECD 2003

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.

© OECD 2003

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.

© OECD 2003

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

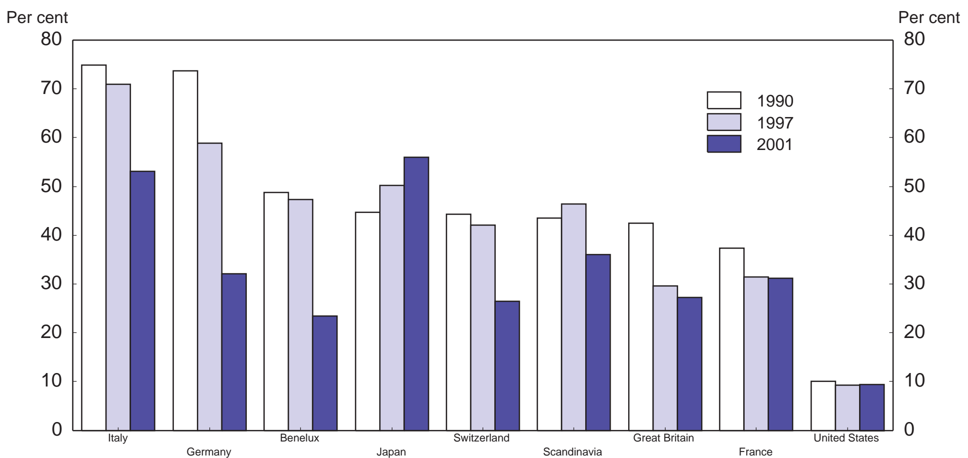
Bank credit is important for large and small firms alike, though proportionately more so for the latter given their lack of access to securities markets. Even abstracting from small firms, which have a particularly large weight in Italy, this country emerges as one of the most bank-centred of the OECD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

© OECD 2003

(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.

© OECD 2003

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.

© OECD 2003

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,

© OECD 2003

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.

© OECD 2003

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

C*o-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.

© OECD 2003

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-

© OECD 2003

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

© OECD 2003

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). S*econd*, 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). T*hird*, 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. F*ourth*, 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,

© OECD 2003

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).

© OECD 2003

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.

© OECD 2003

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).

© OECD 2003

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

© OECD 2003

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.

© OECD 2003

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.

© OECD 2003

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.

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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.

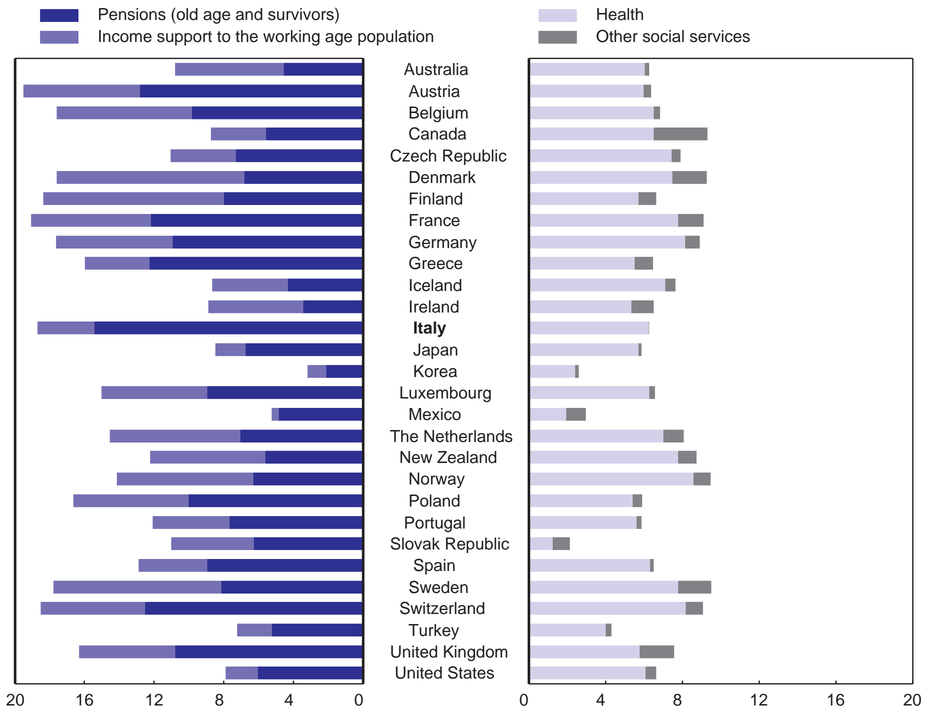
P*ension system*

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

© OECD 2003

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).

© OECD 2003

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

© OECD 2003

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-

© OECD 2003

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

© OECD 2003

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

© OECD 2003

© OECD 2003

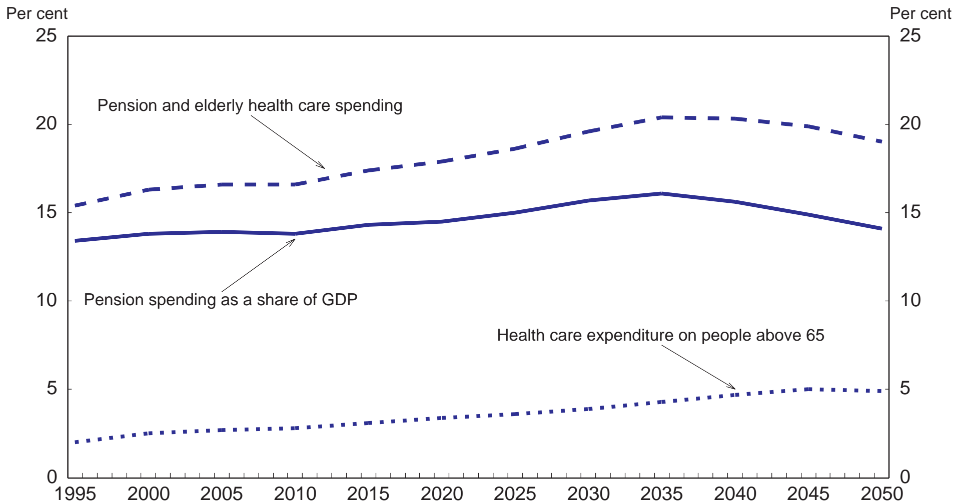
Table 32. **Performance indicators: sustainable retirement income**

	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.

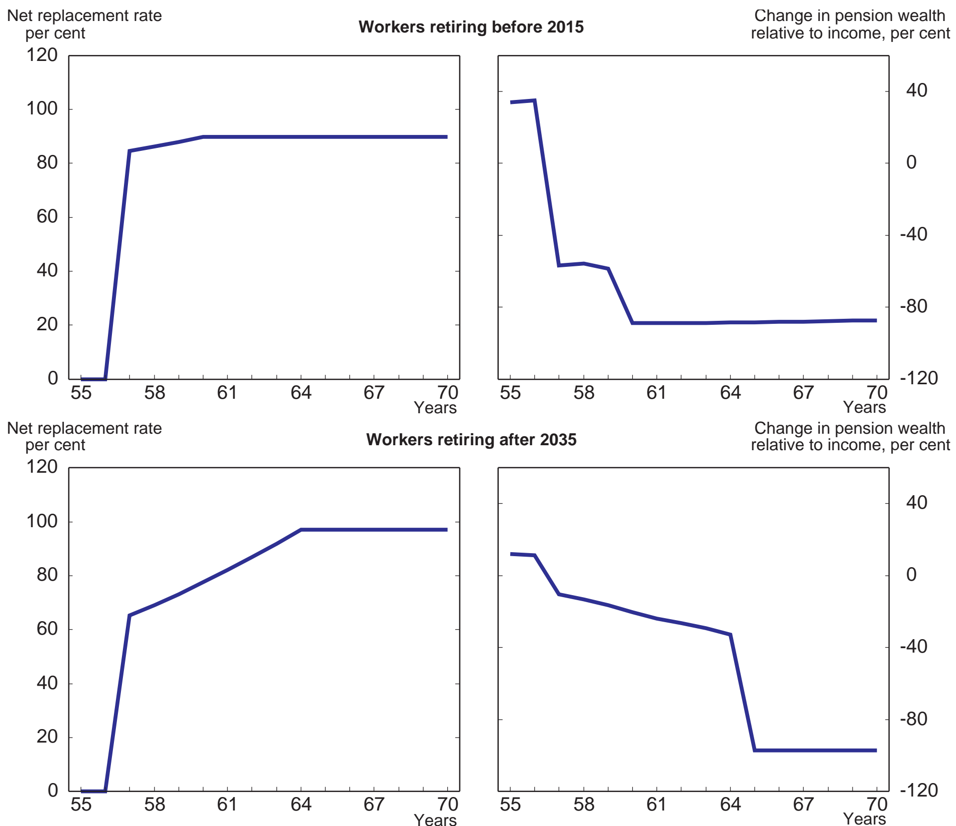
adjustment. Based on the current transformation coefficients, the system would deliver a final year replacement rate of 54.9 per cent and 65.3 per cent for a person who works continuously for 35 years up to 60 and 65 respectively. These replacement rates will change every ten years in line with movements 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.

© OECD 2003

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.

© OECD 2003

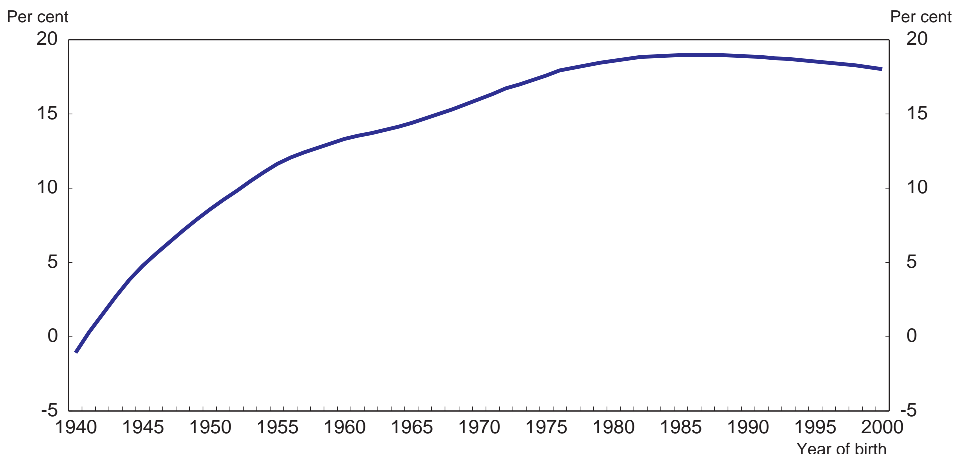
effective, the employment rate of those aged 55 to 65 is likely to remain amongst the lowest in the OECD area for the next decade. In addition, in this period the seniority system for drawing pensions remains in place – enabling people with a set number of years of contributions to retire at 55 (at 57 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).

© OECD 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

© OECD 2003

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

© OECD 2003

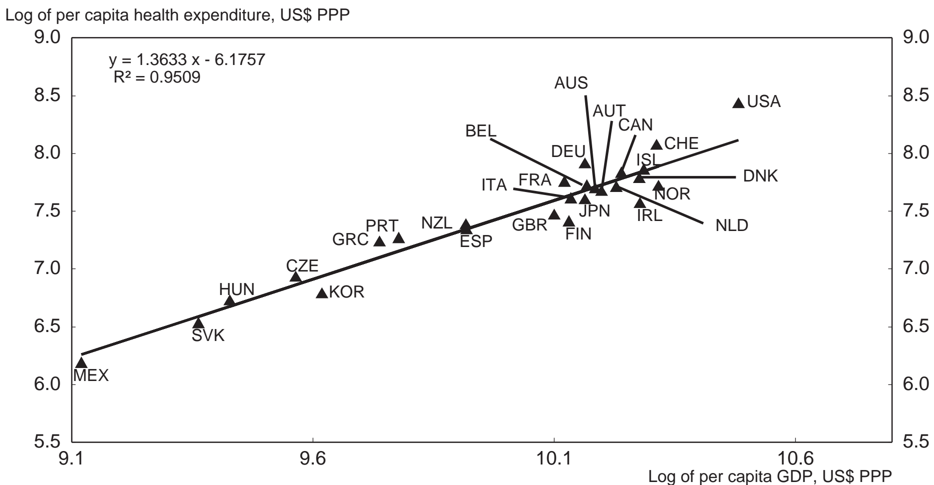
in a detailed range of services that the regions have to provide to the public. The same agreement made state transfers conditional on the introduction by regional administrations of efficiency and quality enhancing measures: *a*) streamlining the hospitals' network (closing small hospitals and exploiting 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.

© OECD 2003

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



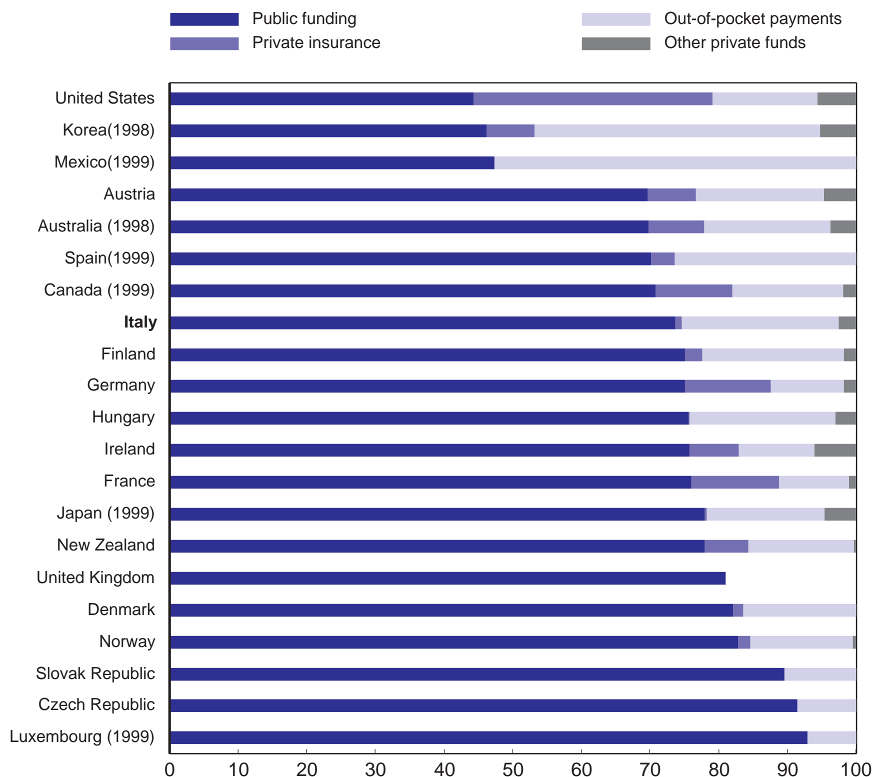
Note: Health expenditure data are not available for Luxembourg, Poland, Sweden and Turkey for 2000.
Source: OECD (2002), Health Database.

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

© OECD 2003

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]

© OECD 2003

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.

© OECD 2003

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-

© OECD 2003

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

© OECD 2003

© OECD 2003

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.

© OECD 2003

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.

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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

	Biochemical oxygen demand mg O2/litre		Nitrates mg N/litre		Total phosphorus 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

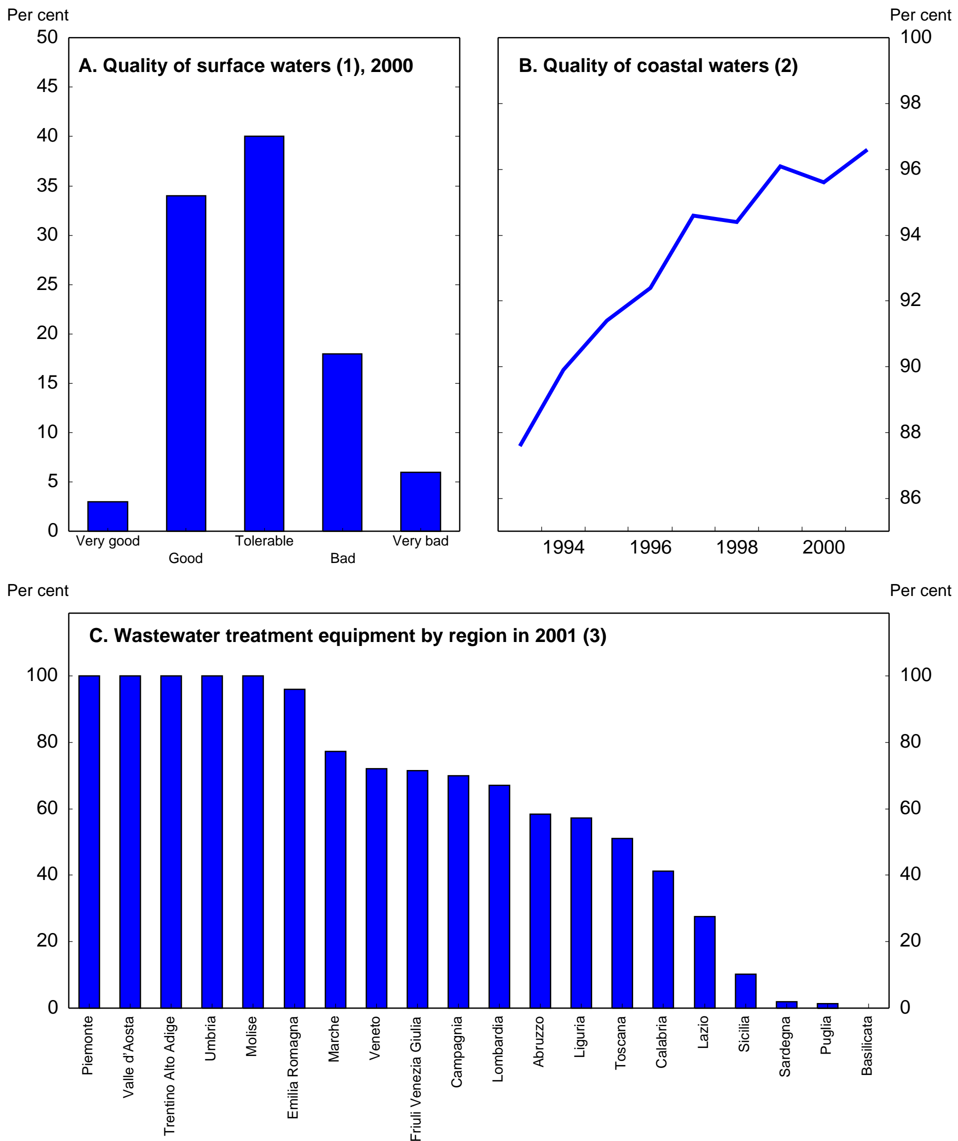
1. Data on biochemical oxygen demand are absent from OECD databases and have not been reported by the national authorities so far.
Source: OECD.

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-

© OECD 2003

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.

© OECD 2003

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.

© OECD 2003

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.

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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	E*x-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

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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).

© OECD 2003

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

© OECD 2003

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.

© OECD 2003

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.

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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

© OECD 2003

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).

© OECD 2003

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

© OECD 2003

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.

© OECD 2003

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

© OECD 2003

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).

© OECD 2003

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

© OECD 2003

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	Sociétà a responsabilità limitata
Spa	Sociétà per azioni
TFR	Trattamento di fine rapporto
TWh	Terawatt hour

© OECD 2003

Table of contents

Assessment and recommendations		9
I.	**The economic situation**	25
	Introduction	25
	Macroeconomic trends and prospects	26
	The medium-term policy challenge	33
	Macro-structural interactions and tensions	36
II.	**Fiscal policy issues**	51
	Overview	51
	Recent budgetary developments	53
	Recent developments in public debt	59
III.	**Product market competition and economic performance in Italy**	63
	Overview	63
	Product market competition and macroeconomic performance	64
	Competition legislation and enforcement	76
	Regulatory policies	81
	Summary and recommendations	105
IV.	**Structural reforms to raise growth and ease the fiscal burden**	109
	Introduction	109
	Raising employment rates	109
	Reforms to enhance labour productivity through human capital	122
	Reforms to raise productivity by improving the allocation of capital	126
	Reforms to improve quality of public finances	141
	Some aspects of sustainable development	162
Notes		180
List of acronyms		196
Annexes		
I.	Balassa indexes	198
II.	The reform of the banking foundations	200
III.	Efficiency of the public administration	206
IV.	Chronology of main economic events	215
V.	Bibliography	218
Boxes		
1.	Italy's competitive strengths and weaknesses	42
2.	The policy programme to fight the underground economy	48

© OECD 2003

3. Securitisations and real public estate asset sales 55
4. Recommendations for increasing product market competition 106
5. The new Company Law 133
6. The shift to Basle 2 138
7. Creditor rights under bankruptcy law 140
8. Policy integration across sustainable development areas 162
9. Progress and recommendations on structural reforms 175

Annex

A3.1. Recent measures on government decentralisation 208

Tables

1. Demand and output 27
2. Corporate indicators 28
3. Regional differential in macroeconomic performance 44
4. Income distribution in Italy, other EU and the US 49
5. General government income statement 54
6. The medium-term budget plan 57
7. Estimated effects of the 2003 Budget Law on the 2003 general government budget 58
8. International comparisons of gross public debt in the EU 60
9. Output, employment and productivity 65
10. Import penetration by manufacturing industry 67
11. Export ratio by manufacturing industry 68
12. Herfindahl-Hirschman indices of industry concentration 69
13. Total business R&D broken down by size classes of firms, 1999 75
14. Competition Agency resources, 2001 77
15. Key structural features of the retail distribution sector, 2000 85
16. Entry in retail distribution, 2001 87
17. Regulation indices in professional services 89
18. Competencies and resources of telecommunications sector regulators, 2002 92
19. Prices for unbundled local loop, 2002 96
20. Competencies and resources of energy sector regulators 98
21. Electricity and gas retail prices 99
22. Electricity market indicators and implementation of the EU Directive, 2002 102
23. Gas market indicators and implementation of the EU Gas Directive, 2002 103
24. Labour market indicators, 2001 111
25. Stocks of financial assets 127
26. Concentration of share ownership 128
27. Household saving instruments 128
28. Cost of credit 131
29. Costs for creditors of judicial asset recovery procedures 140
30. New tax bands for IRPEF 142
31. Actual and equilibrium pension contribution rates, 2001 149
32. Performance indicators: sustainable retirement income 153
33. GHG emissions and sectoral indicators 164
34. Main indicators: climate change 166
35. Performance indicators: water pollution 171

Annexes

A2.1. Geographical distribution of banking foundations 201
A3.1. Functional decomposition of intermediate consumption 211

© OECD 2003

Figures

1. Labour productivity and unit labour cost 28
2. Household financial indicators 29
3. Inflation differential 29
4. Monetary conditions 31
5. Fiscal stance 32
6. Per capita real GDP growth and its components 34
7. Per capita GDP in industrialised countries 35
8. Competitiveness indicators 39
9. Export performance 39
10. Value added and employment shares in manufacturing 41
11. Inward FDI and product market competition 43
12. Share of irregular workers 47
13. Fiscal indicators 52
14. Average duration and average cost of the debt 61
15. Maturity breakdown of state sector domestic debt 61
16. Average mark-ups by market structure, 1981 to the latest available year 66
17. Gross domestic expenditure on R&D 70
18. The contribution of product market regulation to differences in R&D intensity across countries 71
19. Foreign direct investment outflows and inflows 72
20. Share of production in manufacturing sector by technology intensity 73
21. Distribution of enterprises, by size class 73
22. Recent reforms in Italy, 1998-2000 82
23. Five-firm market concentration in grocery and daily goods retailing in EU countries 84
24. Mark-ups in wholesale and retail distribution in selected OECD countries 86
25. Average monthly telephone charges 93
26. Internet access basket 94
27. Interconnection charges for call termination on fixed networks 95
28. Estimates of incumbent operators' market share, 2001 97
29. Prices of electricity and gas, 1995-2002 100
30. Employment growth and GDP growth, 1996 to 2002 110
31. Unemployment rates in selected areas , 1996-2002 111
32. Earnings dispersion in OECD countries, mid- to late 1990s 112
33. Tax wedges on labour 114
34. Proportion of people in relative poverty 118
35. Income inequality in OECD countries 118
36. Estimate of gross and net replacement rates, unemployment compensation 121
37. Earning structure and unemployment by educational attainment 124
38. Teachers' salaries at upper secondary level 126
39. Bank credits 130
40. Public social expenditure 148
41. Pension spending and health care spending for older people 154
42. Incentives for early retirement 155
43. Implicit tax rates in Italian pension system 156
44. Per capita health spending and per capita income, 2000 160
45. Distribution of health financing 161
46. Water quality 172

Annexes

A1.1. Balassa indices for Italy 198
A2.1. Main legislative events in foundation reform and majority bank participations 202

© OECD 2003

BASIC STATISTICS OF ITALY

THE LAND

Area (thousand sq.km.)	301.3	Population of major cities (thousands, 20.10. 2001)	
Agricultural area (thousand sq.km, 1995)	165.2	Rome	2 547
		Milan	1 256
		Naples	1 005
		Turin	865

THE PEOPLE

Population , 1.1.2001, thousands	57 844	Labour force, 2002, thousands	23776
Number of inhabitants per sq. km	192	Employment, 2002, thousands	21 612
Net natural increase, 2000, thousands	-17	In agriculture	1 096
Net rate per 1000 inhabitants, 2001	-0.2	In industry	6 932
		In services	13584

THE PRODUCTION

Gross domestic product in 2002, billions of euros	1258.3	Origin of gross domestic product in 2002	
GDP per head (2002, US $)	18 795	at market prices, per cent of total	
Gross fixed capital formation		Agriculture	2.2
Per cent of GDP in 2002	19.7	Industry	23.9
		Construction	4.8
		Other	69.1

THE PUBLIC SECTOR

Current expenditure in 2002		Gross financial liabilities in 2001	
(percentage of GDP)	47.7	(percentage of GDP)	106.7
Current revenue in 2002		General government investment in 2002	
(percentage of GDP)	45.2	(percentage of total investment)	9.3

THE FOREIGN TRADE

Exports of goods and services,		Imports of goods and services	
as a percentage of GDP, 2002	26.9	as a percentage of GDP, 2002	25.8
Main export categories,		Main import categories,	
as a percentage of total exports, 2001		as a percentage of total imports, 2001	
Manufactured goods	36.6	Foodstuffs	6.9
Fabric and textile goods	15.9	Manufactured goods	26.8
Chemical products	9.2	Metal, ores and scrap	9.7
Transport equipment	10.6	Chemical products	12.9
Mineral fuels	2.0		

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.

From:
OECD Economic Surveys: Italy 2003

Access the complete publication at:
https://doi.org/10.1787/eco_surveys-ita-2003-en

Please cite this chapter as:

OECD (2003), "Structural Reforms to Raise Growth and Ease the Fiscal Burden", in *OECD Economic Surveys: Italy 2003*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-ita-2003-6-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.

OECD