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OECD Economic Surveys: Italy
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Chapter 1

The impact of the crisis and the potential for fiscal stimulus

Along with the rest of the OECD, Italy is facing a deep and possibly prolonged recession. A decade of slow productivity growth and gradually deteriorating competitiveness meant that the financial crisis hit a weakened economy. Fortunately, the banking sector itself has – up to now – escaped the risk of insolvency that has crippled banks in some countries, but this has not protected the economy from the credit crunch. The inability of successive government to take effective action to reduce public debt in the past has left the government with little room to manoeuvre in fiscal policy, other than to allow automatic stabilisers to work as best they can.

Italy is suffering a serious economic recession, which started earlier than elsewhere but has now accelerated following the downturn elsewhere and collapse in world trade. There were early hopes that the lack of participation in key factors supporting the boom that some countries experienced in recent years might mean that Italy's economy would be equally insulated from the downturn. These hopes have now been definitively dashed. The European Central Bank has taken steps, including unconventional ones, to support demand, but many countries have taken significant fiscal action in addition to any measures to reinforce the banking system. Italy is one of the few large countries which have not so far taken any fiscal action that increases the budget deficit; instead, measures have reallocated resources in budget-neutral packages. Its distant history of running up public debt partly financed by exchange rate depreciation and its more recent history of failing to take sufficient advantage of more favourable circumstances to reduce the debt level have left Italy with little room for manoeuvre.

This chapter outlines the shape of the recession as it has hit Italy and as it may develop further in the short term. It also assesses the fiscal situation and the scope for any discretionary fiscal response. Chapter 2 considers the situation of the financial system, while the remaining chapters look at longer term issues of regulatory reform and public sector efficiency (Chapter 3) and education (Chapter 4).

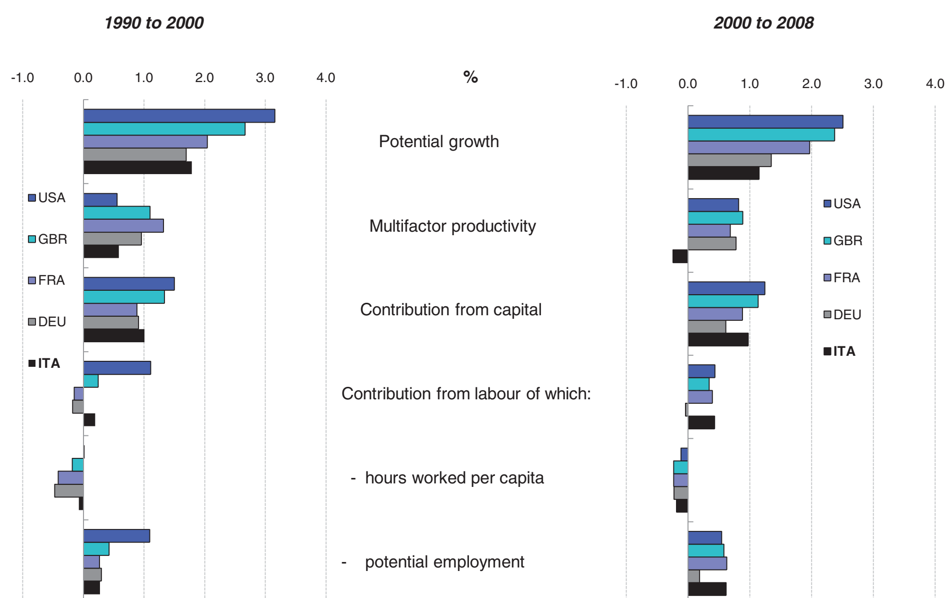
The impact of the crisis on Italy

Both potential and actual GDP growth in Italy have been low for a long time. Already beginning to fall behind in the 1990s, the gap in underlying productivity growth has opened up further since then and has been only partially offset by some improvement in labour supply (Figure 1.1). Previous *Economic Surveys* have made many recommendations for supply-side reforms. There have been a number of improvements, for example in indicators of product market reform, and many of the issues are discussed in Chapter 3. Annex 1.A1 summarises recent policy responses in some of the areas concerned; in fact there has been a significant amount of relevant legislation, though in some cases it is subject to the issuing of implementing decrees and regulations before it can take effect. It is important that the authorities follow through in implementing all such reforms.

Profitability has been low, some activity has moved abroad

Slow growth in Italy has been accompanied by a steady increase in labour costs relative to prices (since 2000 unit labour costs have risen by 6% more than the GDP deflator), implying a considerable weakening in overall profitability. An accompanying trend has been the tendency for an increasing number of Italian companies, as for those of many western European countries, to transfer part or all of their production to eastern European countries such as Romania. This is an interesting complement to the phenomenon of Romanians moving to Italy for work, many of them ending up in northern Italy working mostly in small or medium-sized companies. This flow of business investment abroad has undoubtedly also encouraged the investment that Italian banks have made in subsidiaries in those countries.

Figure 1.1. **Decomposition of potential growth: an international comparison**



Source: OECD, *Economic Outlook No. 85.*

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Competitiveness has been poor though the economy remains export oriented

The economy's international exposure through trade is also a key factor. Low productivity growth and the tendency, noted earlier, for wage growth to outstrip it are reflected in weak performance, at least according to simple measures of comparative labour cost competitiveness (Figure 1.2). Export performance, measured by the volume of Italian exports compared with the volume of demand in world export markets has declined (as it has for many other OECD countries, due to the rapid growth of emerging non-OECD exporters). Price competitiveness measures tend to look worse than cost measures, but this is probably a reflection of a tendency by Italian producers to move "up market" and also means that the share of exports in GDP has continued to rise, and the share of Italian exports in OECD exports measured in current prices has been more stable, so the diagnosis need not necessarily be pessimistic (Codogno, 2009). The overall trade balance has remained relatively buoyant, with no serious deterioration in recent years, once the effect of higher prices for energy imports, on which Italy is very dependent, is excluded.

Industrial production has been weakening since 2007

Industrial production had already been weakening in 2007. Industry represents 21% of GDP and together with construction (a further 6% of GDP), seems to have led the economy into the slowdown and recession (Figure 1.3). Both internal and external demand slowed very much at the same time so tightening credit at home and falling demand abroad seem to have acted more or less together. Data from surveys by ISAE also show that industrial entrepreneurs' judgements about their order books began to decline suddenly in May-June 2008. This was almost simultaneous for both domestic and foreign orders, although if anything expectations about internal demand may have slowed a month or two before external demand.

Figure 1.2. **Italian competitiveness**

Source: OECD Economic Outlook No. 85.

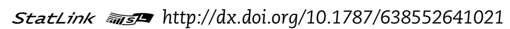
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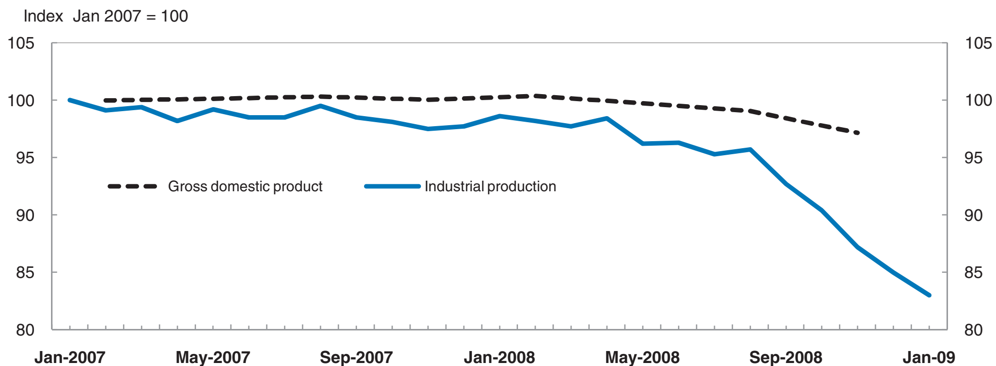
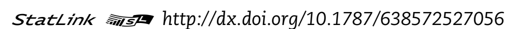
Figure 1.3. **Industrial Production has fallen steeply**



Source: OECD Economic Outlook No. 85.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Unemployment has risen and consumers are cautious

The labour market took a long time to react but is now weakening. Total full-time equivalent employment continued to grow up to the third quarter of 2008, with only a small fall in the fourth quarter even as GDP plunged. The pace of decline can be expected to pick up in the first half of this year; the use of the *cassa integrazione,* in which companies may put workers in short time, already began to rise very sharply in January and February, having reached a historical low a year earlier. Unemployment had fallen fairly steadily for nearly 10 years until mid-2007, at least partly due to earlier labour market reforms introducing a considerable degree of flexibility in short term contracts. Throughout this period the labour market had successfully coped with a growing labour force due to both immigration and rising female participation. But this trend seems now to have reversed and by the end of 2008 unemployment was half a per cent above a year earlier, whereas GDP had fallen 3%.

Rising unemployment (and expectations of further rises) is likely to be one reason for slowing consumption despite an already relatively high saving rate and rises in real incomes as energy prices fall. One interpretation of the high saving rate in Italy[1] is the natural caution of Italian households. This may partly be in reaction to the less thrifty

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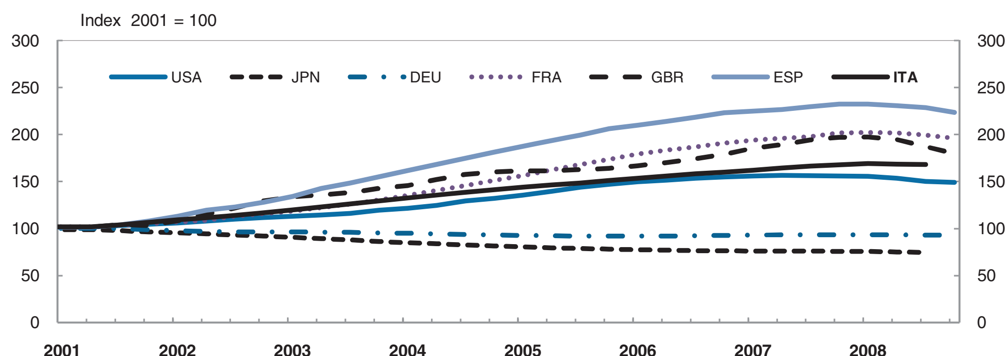
habits of the public sector, but is also probably related to the fact that social spending is quite high but disproportionately accounted for by old-age pensions. Unemployment benefits are reasonably generous for those who are eligible. However, unemployment insurance does not give permanent cover for many workers in the private service sector and nearly all workers on short-term contracts. It is in these sectors and types of job contract that employment growth has been most buoyant in recent years.

The rise in unemployment and prospects of a continuing increase in the future are likely to have depressed consumption expenditure in many potentially vulnerable households. One part of the February 2009 anti-crisis package took steps to deal with this by introducing a 90-day unemployment benefit to workers laid off with no unemployment insurance, an experimental one-off payment to some categories of independent workers made unemployed, and a widening of the coverage of unemployment schemes to small and medium-sized firms in additional sectors, with the participation of the social partners, as in existing schemes. These may be helpful measures, though they are rather *ad hoc* and serve to underline the only partial nature of current coverage, unusual in a European country.

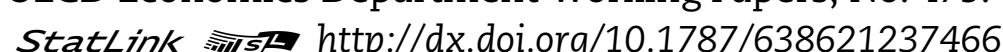
The housing boom had less effect than elsewhere, and households have relatively low debt

The housing boom had been an important factor in the upswing in many countries and the bursting of that bubble a key source of the financial crisis. In Italy it played much less of a role, econometric research finds little impact of housing wealth on consumption expenditure. Property prices did rise substantially during the decade but the rate of increase had already peaked in 2003; prices were still rising in nominal terms in much of 2008, but probably beginning to fall back slightly in real terms (Figure 1.4). Restrictions on the maximum loan-to-value ratio for mortgage loans may have helped to restrain demand. While delinquency among housing loans remained low and stable through 2008,[2] the share of underperforming loans in lending to companies was increasing through the year. Italian households not only take relatively lower mortgages than in many other countries, they also carry less debt. This is another factor that had led to hopes that Italy would suffer a milder slowdown – on the one hand the credit crunch would have less effect on consumption because not much of it is credit-financed and, on the other hand, banks would not suffer from delinquent consumer debt because households are not highly

Figure 1.4. **House prices, selected countries**



Source: Various national sources, see Table A.1 in Girouard, N., M. Kennedy, P. van den Noord and C. André (2006), "Recent house price developments: the role of fundamentals", OECD Economics Department Working Papers, No. 475.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geared. So far, the latter assumption seems to hold (see Chapter 2) but consumption has declined sharply anyway, despite an acceleration in earnings in 2008 as a number of national wage settlements were renewed.

Banks were thought to be in a relatively good position

As the financial crisis developed in late 2007 and early 2008, Italian bankers and the authorities were quick to claim that Italian banks had relatively low direct exposure to the kind of lending that was rapidly going bad as a result of gross underestimation of the risks involved. Italian banks were more concentrated on "traditional" "relationship" banking that made such mistakes much less likely. Hindsight shows that Italian banks have indeed been less directly affected, and have not suffered catastrophic write-offs from sub-prime lending or derivative assets, though they have not been entirely unscathed. But this has been no protection for the real economy so far.

Chapter 2 looks at the banks' situation in some detail. Their role in the recession appears to hinge on the fact that, although they had operated a cautious lending policy, the relatively low-risk portfolio was fully reflected in their low overall capitalisation. And although they had some advantage on the funding side in their relatively high ratio of stable retail deposits to overall lending, they were nevertheless quite well integrated into international capital markets. Despite some historical resistance to foreign involvement in the banking sector and the absence of a major presence of any single foreign-owned bank, the share of foreign-owned capital in the banking sector is now slightly above average for large euro area countries (see Table 2.1). So once credit began to tighten in other countries, the heightened sense of overall risk and difficulties on the inter-bank market seem to have forced Italian banks to tighten their lending conditions more or less in parallel with other countries. Hence the decline in industrial production began as credit tightening began in late 2007 and accelerated just as the crisis and slowdown in world trade intensified in September 2008.

Overall, the combination of a relatively trade dependent economy, parts of which have become increasingly uncompetitive, the size of certain cyclically sensitive industries such as vehicles and other investment goods, and the importance of credit finance for the vehicle industry[3] in particular, seem to have worked together to transmit and even amplify the international demand shock in Italy at the same time as banks were tightening credit domestically. Although nearly all sectors of industry have experienced large falls in output, with overall output falling about 12% in the 12 months to December 2008, they have been particularly severe in the vehicle industry where output fell by a quarter over the same period. Overall output of consumer goods has fallen less than that of other goods, but within that category durables output has fallen much more than that of non-durables as uncertainty among consumers, even without strong credit constraints, causes spending to be delayed.

The outlook

The parallel downturn in all OECD countries is very steep. In Italy, as in most other OECD countries, it is without precedent except for 1974-75 (Figure 1.5). The contraction in output is expected to continue through to the end of 2009, with a very slow return to positive growth during 2010 (Table 1.1). The contractionary effects of the financial market turbulence are projected to continue, although there should be some lessening of their intensity through the year. While household debt is relatively low, households as well as

Figure 1.5. **Italian recessions since 1974**

1st quarter in each period = 100, GDP at constant prices

1974-1976

1996 - 1998

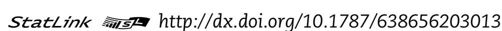
1982-1984

2001 - 2004

1992-1994

2008-2010

Source: OECD Economic Outlook No. 85.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businesses are expected to remain cautious in their spending this year and no support will be forthcoming from foreign markets. Unemployment will rise strongly during 2009 and may reach 10% by the end of the year though considerable uncertainty surrounds the reaction of the labour to the crisis; and falling activity will cause the budget deficit to increase considerably in Italy as elsewhere.

After such a sharp downturn, and with a very wide output gap, the relatively good position of the domestic banking sector, once financial market functioning returns to normal, might permit a strong rebound of activity in 2010. However, the expected rapid rise

Table 1.1. **Demand, output and prices**

	2005	2006	2007	2008	2009	2010
	Current prices € billion	Percentage changes, volume (2000 prices)				
Private consumption[1]	844.0	1.3	1.2	–0.9	–2.4	0.0
Government consumption	290.8	0.5	1.0	0.6	0.3	0.2
Gross fixed investment	296.7	3.2	1.6	–2.9	–16.0	1.3
Machinery and equipment	142.2	5.4	2.4	–4.1	–20.2	1.1
Construction	154.4	1.1	0.8	–1.8	–12.2	1.4
Residential	69.9	4.1	1.1	–0.9	–10.3	1.7
Non-residential	84.5	–1.3	0.6	–2.7	–13.9	1.2
Final domestic demand	1 431.5	1.5	1.2	–1.0	–4.7	0.3
Stockbuilding[2]	–0.7	0.5	0.1	–0.3	–0.3	0.3
Total domestic demand	1 430.7	2.0	1.3	–1.3	–4.9	0.5
Exports of goods and services	371.4	6.5	4.0	–3.9	–21.5	–0.7
Imports of goods and services	372.2	6.2	3.3	–4.5	–20.2	–0.2
Net exports[2]	–0.9	0.1	0.2	0.2	–0.2	–0.1
GDP at market prices	1 429.9	2.1	1.5	–1.0	–5.3	0.4

Note: National accounts are based on official chain-linked data. This introduces a discrepancy in the identity between real demand components and GDP. For further details see *OECD Economic Outlook* Sources and Methods (*www.oecd.org/eco/sources-and-methods*).

1. Final consumption in the domestic market by households.
2. Contributions to changes in real GDP (percentage of real GDP in previous year), actual amount in the first column.

Source: OECD Economic Outlook No. 85 database. These projections are based on information available up to 19th May.

in unemployment, which is likely to continue to climb in 2010, and concern over the level of the budget deficit (even though the increase is less than in many countries and in cyclically adjusted terms there may be some improvement) are likely to promote continued caution on the part of both consumers and producers, keeping domestic demand growth low in 2010. There will be some recovery in export demand but, given the sluggish performance of the economy even in better times, a sharp recovery in overall activity seems unlikely. All economic forecasts are subject to uncertainty, but there is of course an exceptional degree of uncertainty around these projections. This is a combination of uncertainty over the outcome of the crisis in the financial sector, its impact on the world economy as a whole, and finally the response of the Italian economy. The relatively low impact on the Italian financial system and the healthy financial position of the personal sector might mean that the Italian economy could recover quite sharply, but this cannot be relied upon. These projections balance the possibility of a more dynamic recovery against that of further disappointments as the year progresses.

Part of the explanation for weak growth in the past has been slow progress in structural reforms to improve the degree of competition in the service sector and efficiency in the public administration. As Annex 1.A1 outlines, there have been a number of measures taken in the past two years to address these issues, though some of them are only initial plans rather than fully implemented policies. Chapter 3 takes up these long term issues in more detail. In the shorter term, the only policy levers directly available to a country in a monetary union concern fiscal policy.

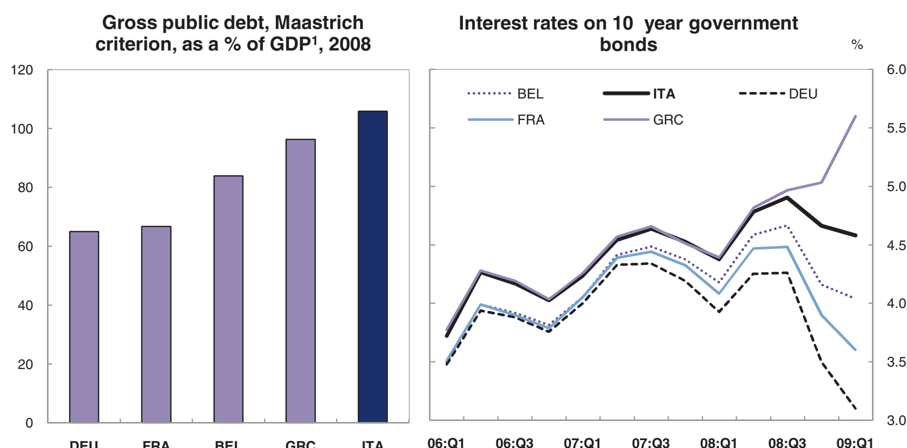
Fiscal policy and the macroeconomy

Italy has missed earlier chances to continue debt reduction

Italy's fiscal position at the start of this recession is poor. The authorities realised in the 1990s that public debt levels had reached excessively high levels and debt was reduced significantly after it peaked in 1994 at about 120% of GDP (Maastricht definition). After 2000, the rate of decline in the debt/GDP ratio slowed. The ratio actually rose in 2005-06 before the decline resumed. As has been regularly documented in OECD, IMF and other reports, the high primary surplus that had been necessary to finance the interest rate premium previously demanded on Italian debt was not converted into the overall surplus that was needed to continue to cut into the debt mountain.[4] The longer run risk of further deterioration in public finance may be less serious than in most other European countries. Provided the pension reform is fully followed through, and other parts of the welfare system are not expanded to offset this, the planned reductions in replacement rates for public pensions will make a major contribution to consolidation. European Commission estimates put Italy in a better situation in this respect than countries such as France and Germany (European Commission, 2008).

Nevertheless, in the short run, due to the crisis, debt is now rising towards 110% of GDP, even on relatively cautious projections; current OECD projections suggest it will be near 120% of GDP by the end of 2010. As the crisis unfolded potential purchasers of government debt seem to have taken Italy's fiscal situation and high existing debt into account: the premium on Italian debt rose significantly, along with that of other countries with significant, or rapidly growing, debt levels (Figure 1.6). In contrast with Italy, Belgium has made a sustained effort to reduce the level of debt and has been rewarded with a lower premium over German debt than Italy. Over the last decade or more, Italy has succeeded in lengthening the term structure of its debt so that only about one sixth of it needs to be refinanced each year.

Figure 1.6. **Public debt and interest rates**



1. Belgian data refer to 2007.

Source: Eurostat and OECD *Economic Outlook*.

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Can fiscal policy be used to increase aggregate (private) demand?

The fact that Italy has missed past opportunities to further improve its fiscal position does not mean in itself that fiscal action to improve aggregate demand is now impossible. There are legitimate questions as to what measures would be most useful, however. If it can be financed, fiscal policy clearly *can* expand demand, though empirical estimates of the magnitude of its impact are somewhat uncertain. Knowing that higher government deficits now mean higher taxes or lower public spending at some point in the future, both consumers and investors they may cut their own expenditure or save income from tax cuts in the short term to be ready for that. One concern is that such an effect would be more powerful when debt levels are already high, which would be a particular risk for Italy. On the other hand, households and companies could now be more credit-constrained than in normal times so that they would use a fiscal stimulus to maintain the level of consumption or investment. In general, the literature does not support multiplier-pessimism for most countries (Haugh and Turner, 2009). A reasonable estimate might be that Italy could expect a reasonably high multiplier on fiscal action oriented towards direct government spending, especially on infrastructure, and transfers to households.

In practice, the government has been very cautious and avoided any discretionary fiscal action that would lead to a significant increase in the budget deficit. It has taken this line largely because of concern over the market nervousness reflected in the interest rate spread; the government's commitment to stability in public finance may in fact have played a role in declines in the spread in May.

What might happen to the cost of finance?

The nominal cost of Italian debt has risen much less than the increase in the interest rate differential between Italy and Germany might suggest, because German rates have fallen considerably. The picture may be different in real terms, as the near term prospects, at least, are for lower inflation. Furthermore, although the differential has risen substantially compared with the average of the last ten years, it has been much higher in the past (before Italy joined the European monetary union, when the key risk on debt was exchange rate risk). This may lead to concern that a reassessment of risk, taking into account Italy's high level of debt, may mean that the differential will not fall back even when financial markets return to normal.

Most of the econometric literature on the link between long term interest rates suggests that, while spreads may be influenced by relative debt levels, the marginal increase due to any extra debt that would come from fiscal expansion would be quite small, though not insignificant. Chinn and Frankel (2005), for example, in a cross-country study, estimate that an increase in the debt/GDP ratio of 1 percentage point raises long-term interest rates by 5-8 basis points. In addition to uncertainty around econometric estimates for individual countries, the overall impact of developments for Italy is quite uncertain in a context where debt levels for a number of countries will be rising even faster than Italy's, though from lower levels.

The authorities are right to be cautious

Although this may be reassuring about the marginal impact of changes in debt, the starting point is uncertain. A reassessment of relative risk as a function of the stock of debt, following the lower estimate of Chinn and Frankel (2005) would imply, other things being

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equal, a spread of up to 250 basis points – more than 100 points higher than the level in early 2009 – to match the difference between Italian and German debt to GDP ratios of around 50 percentage points. This surely does not match any reasonable estimate of the relative likelihood of default. And it probably does not reflect the relatively favourable position of Italy when it comes to longer-term prospects due to ageing, mentioned earlier (European Commission, 2008).

But when markets are nervous one cannot rely on their being "reasonable". They are likely to behave as a function of expectations about the future path of public deficits, both in Italy and elsewhere; this can give behaviour which, when viewed solely in terms of the current level of the deficit, may seem highly non-linear. The case of Ireland may be an example of this. In the presence of non-linear effects,[5] and taking into account that spreads even in March 2009 may not incorporate the likely deterioration in the budget deficit foreseen in current OECD projections, small mistakes in the calculation could lead to major consequences for debt service.

The overall conclusion has to be that Italian debt is simply too high for the government to be able do more. What the authorities may have feared most when anxiety in financial markets was at its peak in late 2008, was not an increase in the interest rate but an inability – even a temporary one – to sell bonds at any price. In normal times this would be an unrealistic fear. However, the normally highly liquid interbank market did seize up, and it would have been unwise not to consider the possibility, although in fact public debt auctions have remained fully successful so far; around half of Italian government debt is held abroad, perhaps more sensitive to any hint of lax policy than national investors. About € 300 billion of Italian public debt matures in 2009 and a similar amount in 2010, of which just over half is medium or long term. The budget deficit will require additional borrowing of over € 80 billion.[6]

Anti-crisis measures in Italy have been small scale but are welcome

Despite their limited room for manoeuvre, the authorities have introduced a number of anti-crisis measures in two packages, one in November and the second in February. The government also intends to increase support to an existing guarantee fund for lending to SMEs. As far as public spending is concerned, overall there have been a number of small changes to existing plans, with additional expenditure offset by reductions elsewhere (Box 1.1). Overall these have shifted spending somewhat towards more vulnerable people and have probably, if anything, increased the expansionary impact of public spending, but to a degree that will have a negligible impact on overall aggregate demand.

Measures to increase support for newly unemployed people are welcome, at least on social grounds, and they highlight some weaknesses of the Italian welfare system. Social transfers account for a significant part of the general government budget but are currently heavily weighted towards pension spending. Support for the unemployed is provided mainly through the employer-based *cassa integrazione* system which provides far from universal coverage. In 2008 and early 2009 the Government adopted various temporary measures to provide some income security to workers likely to be hit by the recession through an increase of resources devoted to finance additional unemployment benefits further to those foreseen on a permanent basis under current legislation (so-called "ammortizzatori in deroga"). This should also add some strength to the macroeconomic automatic stabilisers. The macroeconomic affect will be small, since relatively small numbers of workers are covered.[7]

Box 1.1. **Spending measures in the anti-crisis packages**

Two packages have been presented, one announced in November 2008 and finalised in January 2009, the second announced in February 2009.

These packages have two main characteristics: individual elements are small in macroeconomic terms, and they are designed to be fiscally neutral overall with spending increases or tax cuts in individual areas being offset by spending cuts or revenue increases elsewhere.

The main spending increases are:

- Increased income support for low-income families, through a family bonus.
- The extension of unemployment benefits and temporary inactivity payments to some short-term contract workers in some sectors.
- Acceleration of some infrastructure projects, notably school and prison building, environmental infrastructure, museums and archaeological infrastructure.
- Incentives to buy low-emission cars.
- More spending on railway operation and infrastructure, provided new operating contracts are better oriented towards rationalisation and efficiency.

Revenue cuts involve:

- Freezing the prices of services provided by publicly-owned operators.
- A cap on the rate of interest on variable-rate mortgages (the government to make up the different to lenders).
- Tax incentives to buy household appliances and furniture.
- Prolonging the partial tax exemption on productivity-based pay increases.
- Partial deductibility of the IRAP (regional tax on productive activities) against corporate and personal income tax.
- Reductions in advance tax payments by incorporated companies.

Spending reductions include:

- Lower spending on training and employment measures.
- Lower spending on regional policy.

Revenue increases include:

- Bringing tax accounting better into line with company accounting, on a voluntary basis.
- Better checking of tax declarations.
- Better tax collection.

Fiscal federalism

A draft law on further developing fiscal federalism was published in 2008 and, after much discussion and some revision, was passed in April 2009. Wide-ranging constitutional steps to delegate responsibility for spending in a number of policy areas to the regional level were taken in 2001, but the delegation of corresponding revenue raising powers has never been fully carried through, although foreseen in the reformed constitution.

The law sets out a fairly clear blueprint for how to allocate tax revenues to levels of government and includes a sketch for a system of revenue equalisation. Where spending responsibility is delegated for programmes which are subject to national definitions of

objectives – notably in order to guarantee civil and social rights cross the country, including in the key areas of health, social assistance and education – the idea is to allocate central funding from national taxes to cover the "standard costs" of providing the centrally-defined "essential levels" of services. Revenue equalisation is to be based on compensating the poorer regions for their lower revenue raising potential, based on variation in the per capita tax bases for income tax. Similarly, "fundamental functions" devolved to local (*i.e.* provincial and municipal) governments, would be guaranteed through central funding from national taxes based on the evaluation of standardized spending needs (corrected to take territorial peculiarities into account) and an equalisation mechanism is foreseen.

This seems a well-conceived design for the basic rules. The recently-passed law is an *enabling* law, however; it does not specify the detail of how standard costs are defined and provides only general guidelines on the revenue sharing mechanism. These are to be defined in subsidiary legislation. Both the definition of standard costs and the revenue sharing mechanism may yet require difficult negotiations. Using a standard cost approach, which focuses on financing output targets rather than resource inputs, is essential to ensure that sub-national governments have incentives to improve spending efficiency. But, as is pointed out in Chapter 4 in the case of education (where the final choice of which kind of expenditure will remain a central responsibility seems yet to have been clearly defined), it can require difficult choices in the definition of output. For example, for education, should output be defined as bringing pupils to a certain level of attainment (in standardised national assessments) with no reference to background conditions, or should it be bringing them to a certain level of attainment *conditional* on the social background of the pupils or of the area in which the school is located? Both of the latter are known to have an impact on pupil performance, but should the system require regions with favourable conditions to compensate those with unfavourable conditions, over and above any compensation they may receive through the revenue equalisation system?

The answer to most of these questions clearly lies in political discussion rather than economic analysis, though the latter can help to clarify the issue. But it is important that the system to be implemented embodies clear answers, accepted by sub-national governments themselves; otherwise, the system will be undermined in the future as some regions find they are not allocated the funds that they believed they were entitled to, but may spend anyway and expect central government to bail them out; this is essentially what has happened in the past with health finance.

In sum…

In all, although some temporary discretionary action would not objectively threaten fiscal sustainability, the already high level of public debt prevents the government from taking discretionary action that would further expand the deficit. This is particularly true as OECD projections are for a more serious cyclical deterioration than in the government's revised Stability Programme.

A full re-design of the welfare system cannot be envisaged over such a time period, though desirable in the long run. However, further measures such as those in the February package could be envisaged, if they could be financed without excessive disruption by cuts in less urgent spending programmes; despite the short term urgency, care must be taken not to undermine longer term labour market incentives. A review of pending or proposed infrastructure projects, to assess their likely contribution to underlying growth, their

short-term impact on demand and output, and the speed with which they could be brought forward without compromising value for money, could be useful in planning for what use could be made of any additional finance (or, indeed, of which projects could most rationally be delayed if the situation required cuts in expenditure).

Plans for fiscal federalism should be based on the blueprint in the draft law, and the method for calculation of standard costs and the parameters for the revenue equalisation system should be as simple and transparent as possible. The overall cost will be difficult to calculate *ex ante*. It should be possible to phase the new system in over a number of years – the current law allows a five year period for the transition – both to allow the regions to adjust gradually to potential changes in resource levels and to allow across-the-board adjustments if the overall impact on general government (central and local) finance is different from expected.

Box 1.2. **Summary of recommendations on fiscal policy**

Allow automatic stabilisers to work, around a baseline that involves some modest fiscal consolidation in line with that implicit in the Stability and Convergence programme.

Anti-crisis measures to redirect spending towards categories likely to have a high short-term multiplier effect such as support for poor families or the unemployed is useful. Infrastructure spending also comes into this category, provided it passes normal cost-benefit tests.

Expenditure on sector-specific support should be restricted to those with genuine systemic importance, that is the financial sector.

Once economic recovery is well under way, the government will need to commit itself to a strong medium-term programme of debt reduction, based on expenditure control and probably further reforms of pensions and health care.

Plans for fiscal federalism must focus on transparency and stability. “Standard costs” for essential service provision need to be defined carefully. Variation in local circumstances also need to be carefully taken into account.

Local property taxation is an efficient source of revenue for local government and a reformed system should be introduced when feasible.

Notes

1. Precise cross country comparisons of saving rates are not reliable, but the relatively high rate in Italy seems clear. But it is not an extreme case; the rate seems to be higher in France, for example.
2. According to Bonnacorsi di Patti and Felici (2008), non-securitised home mortgages were more risky than securitised lending in Italy.
3. As mentioned earlier, the household sector in Italy is relatively free of debt. But car sales are nevertheless strongly associated with credit, as in other countries.
4. Whereas in 1995 interest paid on government debt amount amounted to over 11% of GDP, by 2002 it had fallen to under 6%.
5. One interpretation of the presence of non-linear effects in econometric modelling is that it indicates that a high degree of ignorance about the underlying behaviour.
6. Over the past two decades, the Italian government has succeeded in significantly reducing the share of short term debt. In the early 1990s, the average residual term of debt was just over 2½ years, now it is over 6. See *www.dt.tesoro.it/opencms/opencms/handle404?exporturi=/export/sites/sitodt/modules/documenti_it/debito_pubblico/risorse_correlate/Bollettino_trimestrale_4x_trimestre_08.pdf&%5d*.

7. ISAE (2009) notes that the anti-poverty measures in the emergency decrees may create social stigma for claimants while still covering only some of the people in need, while doing nothing to rationalise the complexities and incoherencies of the existing system.

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ANNEX 1.A1

Taking stock of structural reforms

This table summarises recommendations from previous *Surveys* and notes significant measures that have been taken since the previous *Survey* (June 2007).

Recommendations	Action taken since the previous *Survey* (June 2007)
A. LABOUR MARKETS	
Raise labour force participation.	Laws 247/07 and 133/08 included small changes intended to raise participation and expand slightly the circumstances where a temporary labour contract is permitted.
Promote greater wage differentiation.	A tax reduction for productivity-linked pay has been introduced.
Reform Employment Protection Legislation on permanent contracts.	No action.
Reduce tax wedge on labour income.	Tax incentives for workers on permanent contract introduced in 2007.
B. EDUCATION	
Raise quantity and quality of tertiary level degrees.	Part (initially 7%) of university funding to be allocated on (yet to be defined) performance criteria. New recruitment rules intend to achieve better transparency and meritocracy and to favour younger appointments.
Reduce the drop rate from schools.	The drop-out rate declined especially in southern regions, partly as a result of increased investment in infrastructure and some targeted measures under the National Operational Programme.
Improve business-academic research links.	Law 133/2008 (Article 16) allows for the Universities to be transformed into private Foundations but details have yet to be announced.
C. FINANCIAL MARKET	
Ensure competition in the banking sector.	No legislative action since April 2007 (requiring the portability of loans and mortgages between banks). The competition authority and Bank of Italy are monitoring the costs of banking services.
Encourage mergers, including international mergers, in the financial sector.	No action.
Enhance corporate governance and transparency of financial instruments.	On 3 March 2008 the Bank of Italy adopted a new supervisory regulation promoting clearer allocation of supervisory competencies within banking institutions.
Strengthen Financial Market Supervision.	EU Market in Financial Industry Directive and Capital Requirements Directive were implemented in 2007; (See Chapter 2.)
Ensure equal treatment of all shareholders, in both private and partially publicly-owned companies.	No action.
Reform bankruptcy legislation.	No action since the 2006 reform.
D. QUALITY OF PUBLIC FINANCE	
Reduce debt on a sustained basis.	In August 2008 the Government approved the first budget planning document to cover three years, for 2009-11. It embodied plans to cut the deficit significantly, though specific measures to achieve the cuts were not generally included in the budget law itself. However, the financial crisis has led to the revision of the previous estimates, involving the growth of the public debt and the postponement of the achievement of the medium term objective.

Recommendations	Action taken since the previous *Survey* (June 2007)
Introduce expenditure caps to prevent any growth in overall public spending in real terms.	The 2009 Budget updates the Internal Stability Pact for 2009-11, by setting new ceilings to the nominal final expenditure of regions (net of health spending and loans). Local entities and regions which do not comply with the Internal Stability Pact will be prevented from committing current expenditure exceeding the minimum spending level over the previous three years. "Virtuous" local entities will be rewarded. These provisions have yet to be tested, and there has been dispute about how well spending targets are formulated, with a mixture of accruals and cash based accounting being used.
Reform the pension system.	Changes required under the 1995 pension reform have been effected. Law 133. 2008 provides that old age and early pensions will be paid in full regardless of pensioners' other income from employment.
Contain public employment and wage growth.	The financial Budget 2009 envisages measures aiming at the re organisation of recruitment with the introduction of a stricter limit to new recruitments, the abolition of the change from temporary into permanent employment for employees with no job security and employment cuts in primary and secondary schools (see Chapter 4).
Make greater use of market mechanisms in devolved government services.	No action.
On fiscal federalism: • Clarify service standards based on output rather than input measures. • Increase flexibility among tenured employees. • Impose hard budget constraints rather than controls on detailed spending items. • Define clear regional and local tax assignments. • Define a clear redistribution mechanism based on objective structural indicators and tax capacity, imposing a hard budget constraint. • Impose transparent and uniform budget accounting methods, externally audited.	In April 2009 a law on fiscal federation, implementing Article 119 of the Constitution, was issued. The law provides for: • The gradual passage to the financing based on the standard costs instead of the historical expenditure. • The provision of additional Government funds for special programmes in favor of specific regional and local authorities financed by special contributions, European funds and national co-financing funds. • The equalization fund will be financed by VAT shares and regional surcharges on income tax. • The introduction of reward mechanisms and sanctions respectively for the more or less virtuous local authorities. But effective implementation of these plans depends on secondary legislation for which drafts have not yet been published.
	E. ENVIRONMENTAL POLICIES
Limit CO_2 emissions and develop renewable energy resources.	The compulsory share of renewable in electricity generation is to rise by 0.75% per year in the period 2007-12. The minimum share of bio fuels in the transport sector has been raised from 3 to 5%.
	F. SUPPORT COMPETITION AND REDUCE STATE AID
Increase regulatory power of competition authorities.	No new powers for the Competition Authority, though it has been given competence in some new areas: some aspect of local public services and in audiovisual rights for sport events.
Reduce state ownership, especially in TV media, transport and energy utilities.	Full privatisation of Alitalia. TV Media remain dominated by state companies and one private company.
Improve state-owned activities governance.	The Budget Law for 2008 contains provision to reduce the number of people appointed to the Boards of state companies.
Continue liberalisation and privatisation in electricity and gas.	Law 125/2007 enacting the Directives 2003/54/CE e 2003/55/CE on internal market of energy and gas. The law provides for the full opening of the electricity demand.
Reduce rents, Increase competition and reduce barriers to entry, notably: • Remove unnecessary licensing in all professions. • Reduce influence of professional associations. • Remove quantitative restrictions on supply in areas from pharmacies to taxis. • Ensure competition in provision of public services.	(See Chapter 3.) Local public services: Article 23bis of Law 133/2008 aims at reordering the entire sector. Accordingly the entrustment of the service must be done through public tendering and any other form should be considered an exception.
Introduce bodies for enforcement of national competition standards in areas of regional regulatory competence (notably retail trade, land-use planning).	No action.
Speed up liberalisation in transport.	No action.
Keep up competition in telecommunications.	No action.

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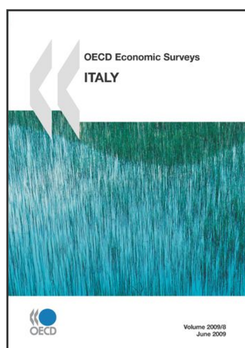

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