OECD Economic Surveys
ITALY

MAY 2013

OVERVIEW

Summary

Main findings

Italy has embarked on a wide-ranging strategy to restore fiscal sustainability and improve long-term growth. Combined with measures at the euro area level, these welcome actions have reduced downside risks and the economy should emerge from recession during 2013. However, with the public debt-to-GDP ratio nearing 130% and a heavy debt redemption schedule, Italy remains exposed to sudden changes in financial market sentiment. Large and sustained reductions in public debt are therefore the top fiscal priority. The gains from recent structural reforms must also be consolidated and further measures to promote growth and improve competitiveness need to be implemented, to return Italy to healthy growth.

Sizeable fiscal consolidation was achieved in 2012. While this entailed short-term output and social costs, these efforts have been rewarded by higher confidence in financial markets and have improved medium-term prospects. The government has rightly aimed to halt the rise in the public debt-to-GDP ratio and put it on a downward path, while also seeking ways to use limited resources to protect the incomes of the most vulnerable. This could be achieved either with a balanced government budget or a small fiscal surplus, accompanied by a combination of growth-enhancing structural reforms and the implementation of the new unemployment insurance scheme. While additional fiscal tightening would have transitory negative effects on output, it would be rewarded by faster debt reduction and thus lower risk of renewed financial-market reactions. Fiscal measures should concentrate on spending restraint, and an ongoing policy review process should focus on improving value for money. There is also scope to restructure the tax system to reduce economic distortions, notably through fewer tax expenditures. While the banking system has been overall quite resilient, several banks are experiencing serious difficulties, and the financial sector remains exposed to systemic risks. Ongoing efforts to strengthen capital adequacy and loss provisions are thus essential.

Comprehensive structural reforms have been adopted, which over time will increase Italy's persistently weak productivity growth and, together with modest wage growth, bring much-needed improvement in international competitiveness. The immediate focus for policy in product and labour markets should be on full implementation, monitoring measures for their effect, and making improvement where needed. Future reforms, in carefully planned and coordinated legislation, will need to remove remaining restrictions in professional and public services and promote a more inclusive labour market. This requires helping workers with job-search and training, coordinated together with income support for the unemployed, whose families are most at risk from the increased poverty that prolonged recession has brought. A new framework is needed within which the economy can adjust more quickly to global changes in trade patterns and innovative technologies.

Good public governance is important for economic growth. Steps have been taken for the public **administration and civil justice** systems to support reform, economic development and the needs of civil society more effectively. These too should be followed through and fully implemented to eliminate major impediments in the business environment. The streamlined civil justice system needs to ensure that, where regulatory constraints are necessary, such as to protect employment rights or the environment, the law is enforced resolutely, rapidly and equitably. The anti-corruption law provides improved tools in the fight against corruption and organised crime. Continued emphasis on transparency in public administration at all levels will help and would be bolstered by a freedom of information act.

Key recommendations

Fiscal and financial policy

- Pursue efforts to halt and reverse the upward trend in the debt-GDP ratio. This could be achieved either with a balanced budget or a small fiscal surplus, supported by strong implementation of growth-enhancing structural reforms.
- Focus budget consolidation on spending control, with a policy review process to select priorities, one of which is the more comprehensive unemployment insurance scheme, already legislated.
- If macroeconomic conditions deteriorate once again, allow automatic stabilisers to work.
- Establish the newly-legislated fiscal council, giving it full independence, well-qualified staff, guaranteed access to data, an adequate budget and freedom to investigate as it judges necessary.
- Encourage banks to further increase provisions against losses, and continue to urge them to meet their capital needs with new equity or sales of non-core assets. Encourage competition in the financial sector.

Product and labour market regulation and other structural policies

Follow through on the 2012 reforms:

- Complete the implementation of the key reforms, including through ensuring that the Transport regulator is set up rapidly and that the Competition Authority uses its new powers actively.

Extending the reforms:

- Remove remaining regulations restricting capacity in retail and professional services; reconsider some backwards steps, notably those limiting the expansion of competition among lawyers.
- Promote a more inclusive labour market, improving employability with more support for job search and training, linked with the broader social safety net, rather than preserving existing jobs.
- Promote the widening of the current agreement among the social partners so as to better align wages compared with productivity, to help restore competitiveness.
- Broaden the tax base by reducing tax expenditures comprehensively, allowing reductions in marginal tax rates on labour, especially on second earners.

Public administration and civil justice

Follow through on the 2012 reforms:

- Encourage use of the transparency provisions of public administration reform and the anti-corruption law by acting decisively on inefficiencies, conflicts of interest or corruption.
- Complete the geographical reorganisation of the courts, streamlining court processes, improving the use of information technology, and widening the incentives for a greater use of alternative dispute resolution mechanisms. Continue streamlining sub-national government.

Extending the reforms:

- Limit the use of decree laws, work towards codified ("testo unico") legislation, ensure effective impact assessment of laws and regulations, and increase the use of sunset clauses.
- Build on the provisions of the anti-corruption law to develop a fully-fledged freedom of information act.
- Revise the law on limitations ("prescrizioni") in criminal corruption cases to reduce incentives to dilatory behaviour, such as the inclusion of the full trial and appeals process in the limitation period.

Assessment and recommendations

Since late 2011, Italy has been enacting a broad package of structural reforms and fiscal consolidation policies, together aimed at addressing a legacy of weak growth and high public debt. This strategy has been rewarded by higher confidence in financial markets and improved medium-term prospects. In the short term, however, though necessary to avoid even worse outcomes, it has been accompanied by significant output losses and social costs – unemployment has been rising and vulnerability to poverty has increased. Success in turning the economy round depends importantly on euro-area crisis resolution. In this regard, Italy has benefited from actions at the euro area level, including the European Central Bank's readiness to provide support if needed. Success ultimately depends on full implementation of structural reform legislation and commitment to debt reduction policies, which will hasten the return to healthy growth.

Macroeconomic and financial developments

Low growth and poor competitiveness are the underlying causes of Italy's difficult situation

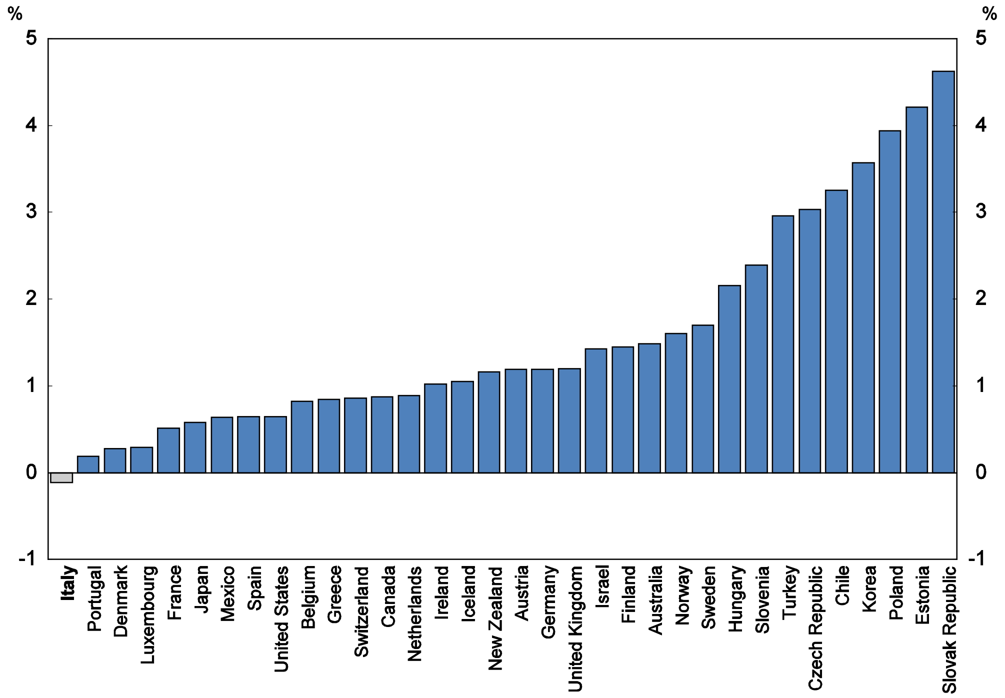
Italy's real GDP growth per capita has been the weakest of all OECD countries over the past decade (Figure 1). This reflects very low underlying productivity growth and has resulted in long-standing fiscal difficulties and in stagnant, and recently declining, real income levels. Many hypotheses have been put forward to explain low productivity growth, which has been at the core of several past OECD Economic Surveys, and the interaction of these elements is likely to be more important for productivity growth than any single factor:

Regulatory barriers to competition and entrepreneurship.

- Institutional barriers to labour market adjustment.
- A "relationship" oriented labour market which undervalues qualifications and experience.
- Low educational attainment, and tertiary education inadequately oriented to the needs of the economy, reducing the capacity for innovation and structural change.
- The small size of firms at a time of rapid technological change and globalisation.
- An industrial and export structure, historically weighted towards slow growing markets and in products particularly exposed to competition from emerging economies.
- The integration of large numbers of low-skilled immigrants which, while boosting the supply of labour, especially for low-productivity jobs, has had the effect of reducing average productivity.
- Inefficient public services, weaknesses in public administration and the influence of corruption and organised crime.

Key past recommendations, maintained in this Survey, have argued for better regulation, more competition and better flexibility in the labour market. According to OECD indicators, Italy has made progress in some of these areas since the late 1990s, improving its position relative to other OECD countries. In the same period, however, its relative economic performance deteriorated. Italy's entry into the monetary union in the late 1990s increased the costs of inflexibility, costs which have appeared over time. At the same time, rapid globalisation also increased the need for greater flexibility.

Figure 1. Average annual growth in real GDP per capita, 2000-11



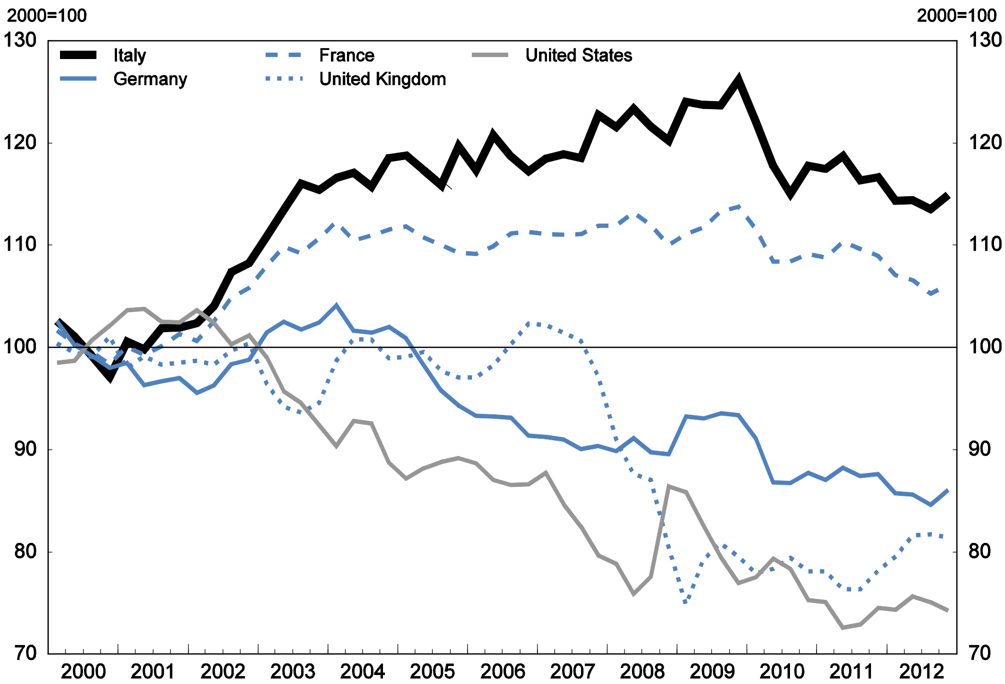
Note: Data for Norway refer to the mainland GDP and for Luxembourg to the resident population. Population data are from 2011 or latest year available.

Source: OECD Economic Outlook Database.

Italy's labour cost competitiveness position vis-à-vis key trading partners deteriorated up to the beginning of the 2009 economic and financial crisis (Figure 2). The improvement since then has been mainly due to the euro depreciation and some wage moderation. Prior to joining the monetary union, excessive wage and price increases were compensated for a time by exchange rate depreciation, but this is no longer an option. In key partner countries wages rose less than productivity. Italy's low productivity growth made this largely impossible since this would have meant cuts in real wages (possibly even in nominal wages), something very difficult to achieve in the current wage bargaining system, although the system does not impose explicit indexation. Reforms (discussed further below) should improve the functioning of the labour market, though were not designed to change wage setting behaviour.

Figure 2. Labour cost competitiveness

Relative unit labour costs weighted by trade



Source: OECD Economic Outlook Database.

How to read this figure: An increase in the index means that total employee compensation per unit of real output rose relative to that in trading partners. If the index falls by the same amount for, say, both Italy and Germany, this means that their competitive position *vis-à-vis* the rest of the world has improved, but there has been no change *vis-à-vis* each other.

The financial crisis hit Italy hard. The Italian financial system weathered the first wave of the crisis better than in many other countries, government intervention was very limited, and credit growth was above the euro area average in 2009-11, although financial conditions still tightened significantly, weakening domestic demand. In 2011-12 the banking system has been vulnerable to contagion from international concern over the level of public debt. The collapse of the interbank market, and indirectly banks' significant holdings of government debt, have restricted the ability of banks to lend; this, combined with the recession-induced fall in demand for new loans, resulted in outstanding credit falling during 2012. Action by the European Central Bank (ECB) has been vital in preventing more dramatic problems. Its announcement in July 2012 that it was ready to provide support as needed, and the possibility of Outright Monetary Transactions schemes announced in September, bolstered confidence and reduced spreads, although they remain significantly above pre-crisis levels.

The economy is projected to remain very sluggish in 2013-14

Fiscal consolidation, declining investment and the rebuilding of household savings, along with tight credit conditions, are likely to hold back growth during the coming months (Table 1). Although confidence and financial conditions should gradually improve, GDP is unlikely to begin to rise before 2014. The benefits of the broad range of supply-side reforms adopted since late 2011 will take time to materialise, given weak confidence, a relatively slow recovery elsewhere and the continuing need for fiscal consolidation. The plan announced in April 2013 to significantly reduced government arrears to companies is welcome. The impact on growth is uncertain, a conservative estimate is included in these projections.

Table 1. The short-term outlook

	2009	2010	2011	2012	2013	2014
	Current prices	Percentage changes, volume (2005 prices)				
	Billion euros					
GDP	1 519	1.7	0.5	-2.4	-1.5	0.5
Private consumption	917	1.5	0.1	-4.2	-2.0	-0.4
Government consumption	325	-0.4	-1.2	-2.9	-1.9	-1.3
Gross fixed capital formation	294	0.6	-1.4	-8.0	-3.9	-1.3
Final domestic demand	1 536	0.9	-0.4	-4.7	-2.4	0.0
Exports of goods and services	360	11.2	6.6	2.2	3.0	5.2
Imports of goods and services	368	12.3	1.1	-7.8	-1.5	1.5
Net exports[1]	-8	-0.3	1.4	3.0	1.4	1.2
GDP deflator		0.4	1.3	1.6	1.5	0.9
Memorandum items						
Consumer prices index[2]		1.6	2.9	3.3	1.9	0.9
Compensation of employees		1.2	1.8	0.2	0.2	0.1
Employment (millions, National Accounts)		24.8	24.7	24.7	24.6	24.5
Unemployment rate		8.4	8.4	10.6	11.4	11.8
Current account balance[3]		-3.5	-3.1	-0.6	0.3	0.7
Potential output		0.2	0.3	0.3	0.3	0.3
Output gap[4]		-2.9	-2.7	-5.3	-6.9	-6.9
Public finance indicators:						
Gross debt (Maastricht definition)[3]		119.3	120.6	127.0	131.5	134.2
Overall budget balance (net lending)[3, 5]		-4.5	-3.8	-2.9	-3.3	-3.8
Net debt interest payments[3, 5]		4.3	4.6	4.9	5.0	5.0
Primary balance[3, 5]		-0.0	1.0	2.3	1.8	1.2
Structural primary balance[4, 5]		1.6	1.9	4.8	4.9	4.5
Change in overall structural budget balance[4, 5]		1.1	0.0	2.5	1.1	-0.4

1. Contribution to change in real GDP (percentage of real GDP in previous year).
2. Harmonised consumer prices index (Eurostat definition).
3. As a percentage of GDP.
4. As a percentage of potential GDP.
5. General government.

Source: OECD Economic Outlook 92, revised to take account of data released in early 2013.

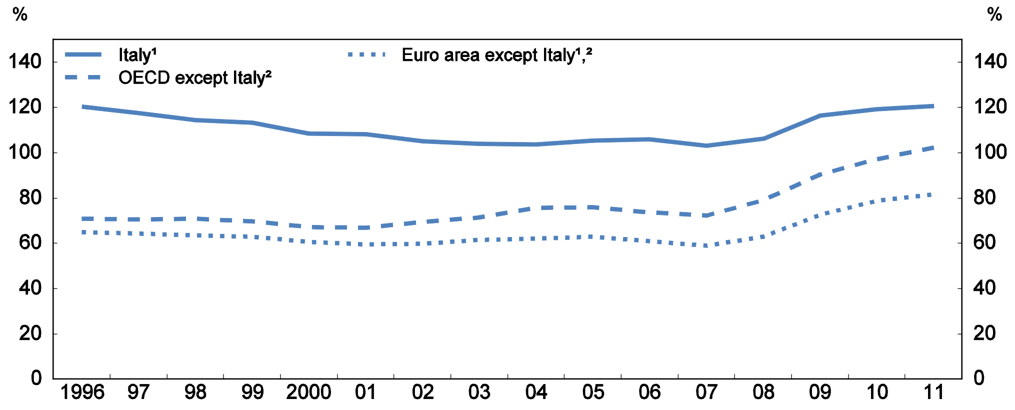
In the OECD projections, fiscal policy in terms of changes to the cyclically-adjusted budget balance, as announced in April 2013 (in the Documento di economia e finanza), is assumed to be implemented in 2013 and 2014. But the overall budget balance is weaker than in the government projection due to a lower growth outlook. By the end of 2014, according to OECD projections, total government debt would be some 134% of GDP (excluding the impact of potential privatisation revenue and including Italy's guarantees to the EFSF, bilateral loans to Greece and participation in the capital of the European Stability Mechanism and including the effect of reducing arrears), and would likely still be increasing in the absence of further fiscal tightening and/or privatisation proceeds in 2014.

Underlying consumer price inflation is projected to decline thanks to smaller import price and domestic wage increases, although its actual profile will be more variable because of planned VAT changes. Wages initially appeared rather insensitive to the recession following the financial crisis, but since late 2011 wage settlements have declined and average earnings have shown little growth. Employment, relatively stable throughout 2011 and 2012, is projected to fall, exerting downward pressure on wage growth. Labour force participation rates rose in 2011-12, reflected in rising unemployment due to weak demand for labour. This higher participation was due to pension reforms that increased the participation rate of older workers, and to an increase in the number of people, especially women, who began to look actively for work, reportedly also to maintain household incomes.

Sovereign and financial risks, while diminished, are still large

Italy's public debt is among the highest in the OECD, and has exceeded 100% of GDP for the last two decades (Figure 3). Rolling over this debt requires annual funding of about EUR 400 billion for the next few years. The high level of debt makes Italy particularly vulnerable to negative feed-back loops between the fiscal, financial and real sectors in the economic and financial crisis. From the summer of 2011, the financial markets began to seriously challenge the sustainability of Italy's public debt, and this was reflected in rising spreads on government bonds (Figure 4). Low growth and persistent budget deficits explain continuing high debt.

Figure 3. General government gross debt (as % of GDP)



1. Maastricht definition.

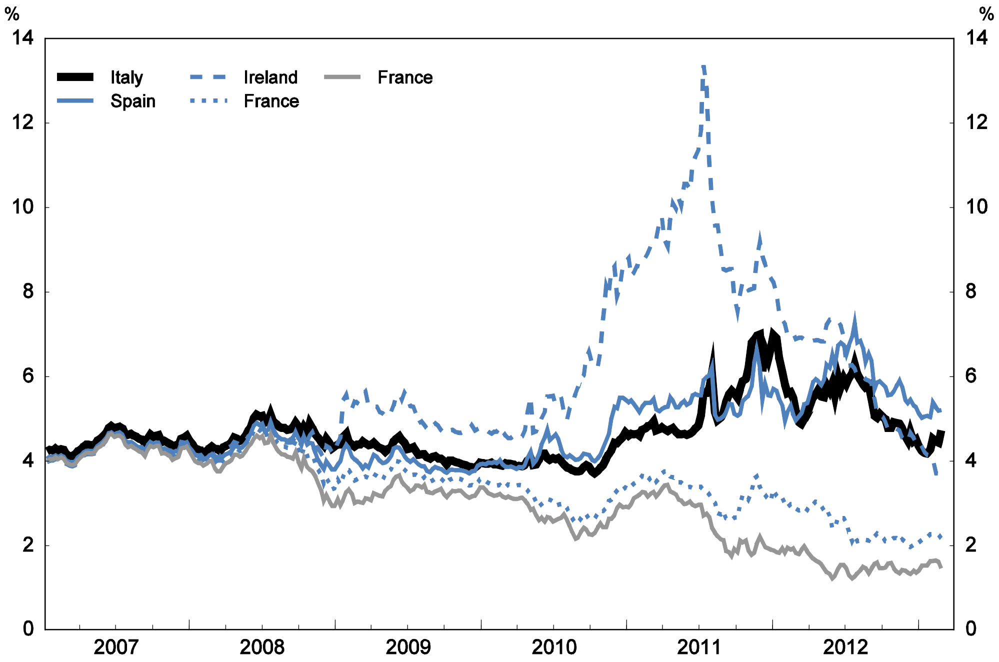
2. Weighted average.

Source: OECD Economic Outlook Database.

By the autumn of 2012, a series of structural reforms - from pensions to a series of measures to improve the medium-term fiscal stance, simplify regulation, strengthen competition and improve the functioning of the labour market - as well as actions and pronouncements by the ECB and then the establishment of the European Stability Mechanism, had brought about a considerable reduction in the interest rate on Italian government debt. But it remained far above the German rate. Part of the spread is explained by the high level of public debt. Further, needed reductions in borrowing costs will require significant declines in debt and continuing progress in structural reforms. The Italian authorities have not indicated that they would seek European financial assistance, since they remain able to attract funding from the sovereign bond markets under terms consistent with a sustainable debt path.

Figure 4. Long-term interest rates on government bonds[1]

Last observation: week ending 1 March 2013



1. 10-year benchmark government bond yields, weekly average.

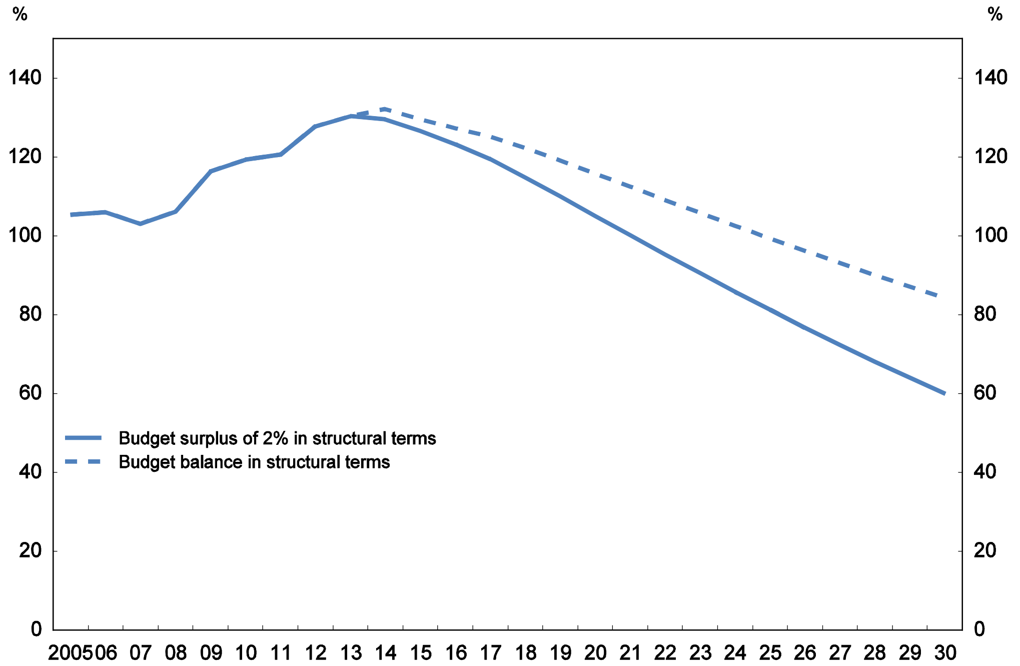
Source: Datastream.

Sizeable fiscal consolidation was achieved in 2012 which, although it entailed significant output and social costs, has been rewarded by higher financial market confidence. The government seeks to reverse the public debt trend and then put it on a downward trajectory. This would be best achieved either with a balanced budget or a small fiscal surplus, combined with growth-enhancing structural reforms. While additional fiscal tightening would have transitory negative effects on output, it would be rewarded by faster debt reduction and thus lower risk of renewed financial-market reactions. Fiscal tightening also would have negative social effects in the current economic environment, as real wages have been stagnating while unemployment and vulnerability to poverty have increased. Legislation to widen access to unemployment insurance should therefore be followed through. Though not a panacea, the more comprehensive unemployment insurance scheme should help to protect incomes more effectively as well as supporting a more flexible and inclusive labour market. If macroeconomic conditions deteriorate once again, automatic stabilisers should be allowed to work.

In the longer term, the government plans to maintain a structural budget balance to gradually reduce the debt-to-GDP ratio. According to OECD simulations, introducing and maintaining measures to attain a structural budget surplus of about 2% of GDP by 2017 would lower the debt-to-GDP ratio to the Maastricht ceiling of 60% of GDP by 2030 (Figure 5), while with a balanced structural budget public debt in 2030 would be some 85% of GDP and would achieve 60% of GDP in 2038. Given the high level of debt, any fiscal relaxation would be a very risky strategy. The government should therefore not relax fiscal policy, so as to avoid the benefits of consolidation being dissipated as in the past: in the 1990s a significant primary surplus was built up after the crisis of the early 1990s and in order to meet the conditions of joining the euro area, but the effort was not maintained long enough to achieve a substantial reduction in debt (Box 1). The recent budget law requires setting aside any extra savings coming from lower-than-projected interest payments, which would help debt reduction and is therefore a welcome innovation.

Figure 5. Long-term simulations of general government gross debt

As per cent of GDP



Note: For details, see Chapter 1.

Source: Lenain *et al*. (2010) and OECD Economic Outlook Database and Long-Term Baseline Database.

How to read this figure: The solid curve shows the evolution of general government gross debt assuming the government gradually phases in a budget surplus of 2% of GDP in structural (or cyclically adjusted) terms by 2017 and then maintains it at this level. The broken curve depicts its evolution assuming the government follows its fiscal plans in the 2013 budget and maintains a balanced budget in structural terms from 2016 onwards. A structural surplus of 2% of GDP would reduce public debt to the Maastricht ceiling of 60% of GDP in 2030, while with structural balance it would be some 85% of GDP.

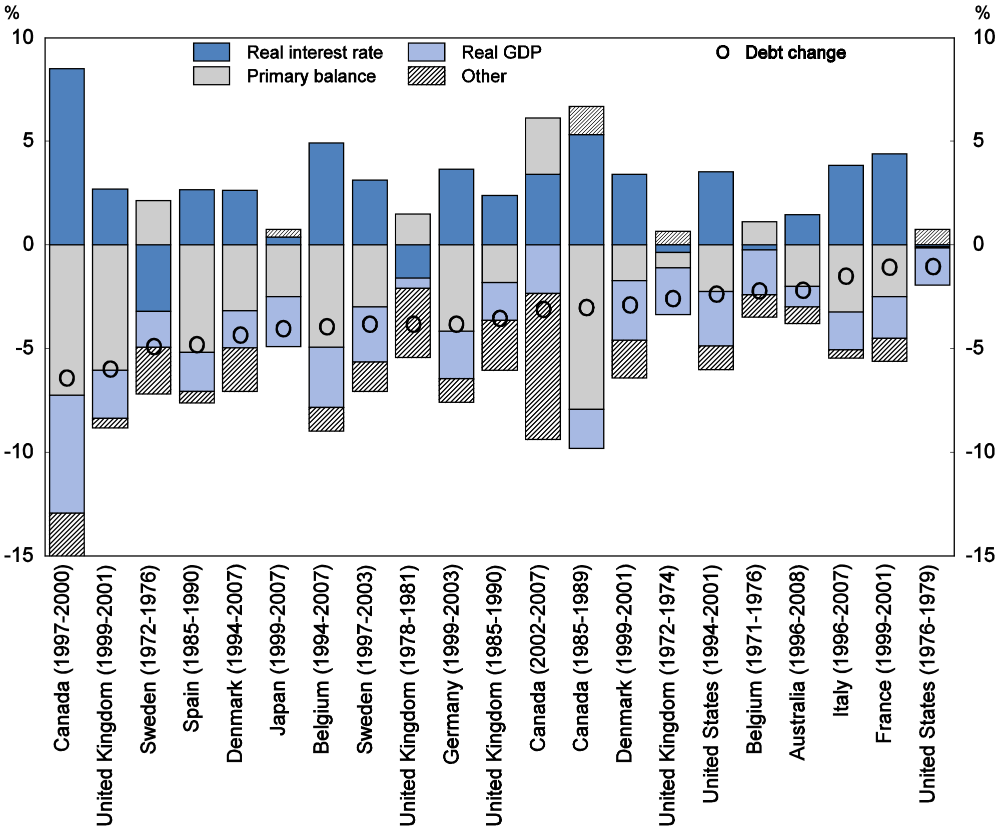
Box 1. Lessons from past public debt reductions

Empirical research has associated high public debt with problems such as fiscal policy becoming ineffective as a stabilisation tool, government borrowing crowding out other borrowers and reducing growth. Very high levels of debt can also lead to potentially self-fulfilling doubts about government solvency, with fears of sovereign defaults resulting in adverse effects in the financial market, although there is no well-defined level of public debt that triggers negative market reactions.

Hence, there has been considerable interest in historical lessons on the appropriate speed of and method of debt reduction. A number of OECD countries have substantially reduced their debt in past decades, though debt reduction was sometimes reversed. The most recent wave of debt reduction ran from the mid-1990s to the onset of the recent financial crisis. For instance, over long periods impressive debt reductions were achieved by Belgium (1993-2007: 50% of GDP), Canada (1996-2007: 35%), and Denmark (1993-2007: 52%). In a sample of debt reduction episodes analysed by Sutherland (2012) and shown in Figure 6, the debt-to-GDP ratio declined on average by 3.5% of GDP per year. Debt reduction resulted from the combination of several forces: sizeable primary fiscal surpluses; strong economic growth; and sometimes negative real interest rates.

Figure 6. Episodes of debt reversals

Average annual change in % of GDP



Source: OECD Economic Outlook database.

How to read this figure: This figure separates the average annual change in the ratio of debt to GDP into the individual contributions of these key components and a residual item ("other") for example, in Canada, from 1997-2000 the debt-GDP ratio fell nearly 7 percentage points per year, on average. Other things being equal, the positive real interest rate would have caused an increase in the ratio of 9 percentage points, but the primary surplus and positive GDP growth more than offset this. In Sweden (1972-76) and the United Kingdom (1978-81) the real interest rate on debt was negative which reduced the debt-GDP ratio.

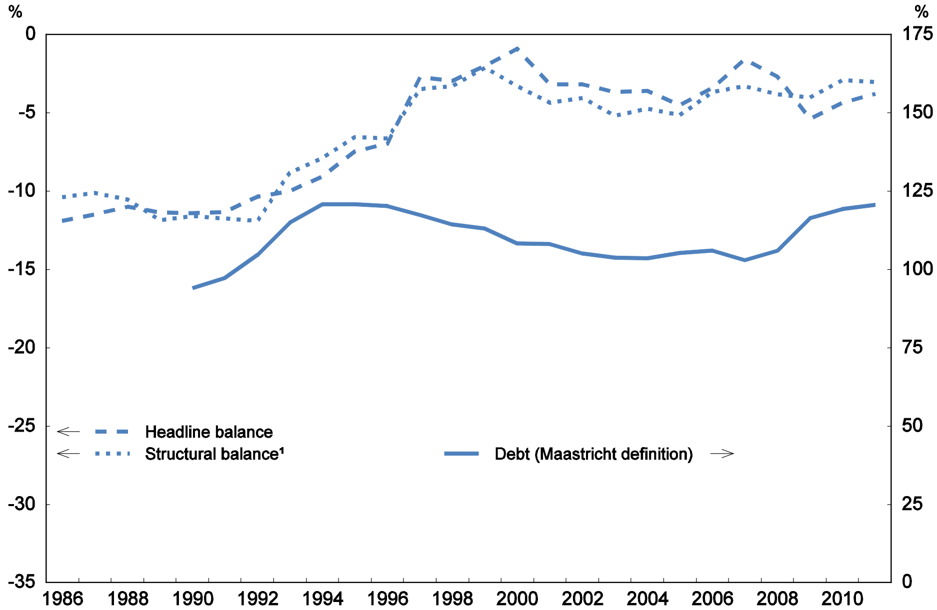
Box 1. Lessons from past public debt reductions (continued)

Italy's public debt-to-GDP ratio also declined between 1995 and 2007, by 17.7% of GDP (measured by the Maastricht definition), but this was entirely reversed subsequently. Italy's debt reduction resulted initially from an effort to bring the budget deficit below 3% of GDP in order to satisfy the Maastricht criteria for joining the European Monetary Union. From 1994 to 1997 the general government deficit fell from 9% to 2.7% of GDP. Three successive governments introduced deep fiscal reforms to cut the budget deficit, notably through expenditure cuts. Earlier measures, in particular pension reforms, also slowed outlays considerably (OECD, 1999). Reforms were also made to health services, local government finances, wage setting and public employment. Part of the effort, however, came from temporary tax measures, notably the "Eurotax" surcharge on households introduced in 1996, which yielded revenue of around 0.6% of GDP, and from privatisation revenue of 1% of GDP per year, neither of which could be maintained for long.

Once entry to the euro area was secured, fiscal policy soon loosened and the government deficit widened again (Figure 7). By 2001, it exceeded the 3% Maastricht limit. This budgetary easing was initially hidden by the decline of long-term interest rates, as spreads diminished prior to, and practically vanished after, the establishment of the European Monetary Union. The loosening of fiscal policy eventually brought debt reduction to a halt. In 2006 and 2007, fiscal consolidation resumed, but at an insufficient pace. When the global financial crisis started, Italy's public debt still exceeded GDP. In the decade 1998-2007, the primary surplus was on average 2.7% of GDP. In a notable contrast, Belgium maintained on average a primary surplus in the range of 5.1% of GDP throughout, until 2007. From a higher starting point, Belgium's debt burden fell well below Italy's, leaving it better prepared for the financial crisis and the global economic recession of 2008-09.

Figure 7. Fiscal indicators in Italy, 1986-2011

As a percentage of GDP



1. As a percentage of potential GDP.

Source: OECD Economic Outlook database.

The difficult environment has put banks under severe stress. Increased risk aversion and a fragmented financial sector across national borders accentuate the impact of nervousness about banks' liquidity, and Italian banks have suffered from the general tendency for foreigners to reduce cross-border deposits. As a consequence, they had to obtain significant funding through special refinancing operations of the ECB. Banks' holdings of government debt, normally a "safe" asset, have exposed banks to additional pressure, as Italian government securities are now around 8% of Italian banks' assets, with loans to government accounting for another 6%. Following European Banking Authority recommendations, banks have increased their capital buffers in relation to sovereign risk. Balance sheet ratios indicate that Italian banks are on average less leveraged than their European peers. Nevertheless, with the renewed recession the already high level of non-performing loans is growing and remains an important concern.

As a result of these supply factors, as well as reduced demand for credit, towards the end of 2012 bank lending to non-financial corporations was declining at an annual pace of 5-10% in real terms. It might be challenging for the banking sector to maintain current capital levels in order to meet regulatory requirements, while supporting additional lending. A source of additional capital might be from abroad. In the past there was some hostility to foreign ownership and the authorities should ensure that attachment to, for example, the special position of banking foundations does not hinder potential new investment.

Longer-term action on fiscal policy

A constitutional amendment approved in April 2012 and secondary legislation approved in December 2012 provide for a balanced-budget rule, to come into effect in 2014, and a fiscal council. These are welcome innovations, which should be implemented in full, and with the objective of maintaining a prudent approach to long-term fiscal challenges. The fiscal council is mandated to assess the underlying assumptions of fiscal projections, including macroeconomic projections. It will need to be strongly independent, with well-qualified staff, perhaps including non-Italian members, and be adequately funded, with the prerogative to investigate whatever issues it considers relevant to fiscal sustainability. It should be guaranteed access to whatever data it feels it needs. The new law explicitly provides for the application of the debt rule under the reinforced Stability and Growth Pact, introduced with the EU "Six-Pack" decision, which requires annual reductions in the debt-GDP ratio by 1/20 of the gap to the 60% reference, measured over a 3-year average.

How to follow up the spending review

Consolidation needs to concentrate on permanent spending reductions, in order to avoid significant increases in the already high level of taxation. A "spending review" was carried out in mid-2012 by a specially established unit, and a second phase of the spending review was launched in October 2012. This was helpful in the circumstances, but a spending review process should be built into the regular cycle of public spending planning. To help design such spending plans, the regular assessments of both spending priorities and other policy settings are important. The former Technical Commission on Public Spending, set up in the Ministry of Economy and Finance, initiated such a process, producing valuable suggestions on policy settings - not just spending items - in a number of policy areas, including education and justice, transport and infrastructure, in its report in 2008. This policy review process should be renewed.

Once public spending plans have been agreed in the budget, it could be useful to give ministries and agencies strong incentives to respect the targets by setting binding cash limits for non-cyclical spending, with the aggregate respecting overall budget targets. The 3-year spending programme, ministry by ministry, presented each year could be made binding on ministries for the whole 3-year period, giving ministries and agencies information for planning ahead and an incentive to find the most efficient use of available funds. With the entry into force of the reinforced Stability and Growth Pact in December 2011, Italy also has to comply with a new "expenditure benchmark" that places a cap on the annual rate of growth of public expenditure. For countries like Italy that have not yet reached their medium-term budgetary objective, this cap will be tighter. This new instrument is a welcome innovation because it can improve budgetary planning and outcomes by ensuring that expenditure plans are adequately resourced by equivalent permanent revenues.

Box 2. Recommendations for macroeconomic and financial policies

- Pursue efforts to halt and reverse the upward trend in the debt-GDP ratio. This could be achieved either with a balanced budget or a small fiscal surplus, supported by strong implementation of growth-enhancing structural reforms.
- Focus budget consolidation on spending control, with a policy review process to select priorities, one of which is the more comprehensive unemployment insurance scheme, already legislated.
- If macroeconomic conditions deteriorate once again, allow automatic stabilisers to work.
- Establish the newly-legislated fiscal council, giving it full independence, well-qualified staff, guaranteed access to data, an adequate budget and freedom to investigate as it judges necessary.
- Once 3-year plans consistent with aggregate fiscal constraints have been set, fix these plans as cash limits on spending by ministries and agencies, as originally planned in 2009.
- Establish clear operational rules to implement the constitutional balanced budget rule and newly-legislated provisions.

- Encourage banks to further increase provisions against losses, and continue to urge them to meet their capital needs with new equity or sales of non-core assets. Encourage competition in the financial sector.

Competitiveness and the labour market

Cost competitiveness has been steadily deteriorating

One underlying factor in Italy's difficult economic situation is that unit labour costs (total employee compensation divided by real GDP) have been rising relative to its trading partners, which may have contributed to a decline of export market shares. This is more noticeable within the euro area, whereas the depreciation of the euro in the last few years has moderated the position with respect to the rest of the world (Figure 2). Unit labour costs have adjusted less in Italy than the other crisis countries, where much higher unemployment has influenced the more pronounced adjustment. Compared with a decade ago, unit labour costs are about 10% higher in Italy than in the euro area as a whole and 25% higher than in Germany. Price competitiveness has deteriorated by less, at the cost of squeezed profit margins in Italy.

The liberalising reforms introduced in 2011-12 should increase productivity growth, making it easier to make gains in relative unit labour costs. Labour market reform was not intended to touch the wage bargaining process, but discussions between unions and employers led to an agreement in November 2012 on local or firm-level bargaining which would link wage gains to productivity improvement, while national bargaining would set other terms and conditions, including a partial inflation compensation mechanism. The productivity component of wage increases would attract tax incentives, following an earlier announcement by the government reserving budgetary funds for this to encourage wage structures with better incentives for productivity. It is not certain how this mechanism will work in practice, and one of the three main union federations did not sign the agreement. If successful, this agreement could reduce contractual wage growth while increasing productivity-linked differentiation across companies. However, tax incentives should not generally be necessary to promote productivity gains, since these in any case should provide benefits to be divided between profits and wages which should be taxed like any other incomes. There is a risk that agreements will be structured to benefit from tax advantages without any underlying benefits for productivity and unit labour costs.

Relative wages can be reduced only slowly, depending on inflation elsewhere in the euro area. In Italy, public sector wages have been frozen in nominal terms since 2011, and will remain frozen until 2014 under current plans. In the private sector, nominal wages appear to have fallen in some cases, not enough to reduce unit labour costs relative to France and Germany. A more rapid adjustment may be attained by widening the agreement among the social partners, to set an overall limit on wage growth to better align wages compared with productivity (this would be distinct from the company-based productivity-related agreements mentioned earlier). Such agreements, for example, succeeded in keeping wage growth well below productivity increases in Germany after reunification. In some Nordic countries, annual wage rounds start with an agreement between employers and unions on the average level of wage increase the economy can afford. In different ways, Belgium and the Netherlands also arrive at a consensus on this issue.

Important labour market reforms, dependent on effective implementation

Attention has been rightly focused on labour market reforms that could contribute to improving productivity growth and reduce segmentation of the labour market. Apart from regional differences, which are quite significant, legislation and history have divided the labour market, before the recent reforms, into several different parts:

- Formal sector, open-ended and "standard" fixed-term contracts. Quite strict employment protection legislation (EPL) applies here. The OECD EPL indicators understate the real cost of making workers redundant, a significant part of which was due to slow judicial decisions and the fact that reinstatement was the main sanction for unlawful dismissal. These factors, while of critical importance, are not reflected in the OECD EPL indicators.

- Formal sector, "atypical" temporary contracts, such as project workers. Here there is much less protection following significant liberalisation of temporary contracts over the past 15 years. Given the profusion of specific types of contract, workers and employers may not always have been certain what rights apply; following the 2012 reforms this should no longer be the case.

- Informal sector. Many people work in otherwise legitimate occupations but without formal contracts, in order to evade taxation or regulation. Estimates of this activity are included in the national accounts, including in figures for employment (approximately 10% of total employment).

The level of self-employment is very high, although this figure itself is inflated by the fact that many self-employed in fact work full-time for only one employer, due to the lower tax wedge for independent contractors compared with that for direct employees. In the formal sector, over 5 million people, some 20% of the labour force, are listed as self-employed, and the ISTAT estimate of the informal sector includes an additional 450 000 self-employed.

Previous *Economic* Surveys recommended increasing wage flexibility, because of increasing concern over cost competitiveness. Wage flexibility may be quite high in the "atypical" sector but a high level of employment unpredictability generated by wide use of fixed term and atypical contracts may inhibit productivity growth through two main mechanisms:

- There is little incentive for employees on short-term contracts, nor for their employers, to invest in job-specific human capital, since they may expect to have to change job frequently.

- Income support for the unemployed has until now been largely restricted to those in permanent jobs, giving job-seekers from the temporary or informal sector little access to public resources to finance job search. They are more likely to have to take the first job rather than the one that maximises their income (and productivity).

The 2012 labour market reform, which comprised steps to rebalance employment protection, modify the apprenticeship system and phase in a universal unemployment benefit system, was the first time that Italy has attempted to comprehensively tackle labour market weaknesses. The modification of Article 18 of the labour code allows the labour judges to graduate the sanction in case of unfair dismissal depending on the severity of the case rather than, as previously, requiring reinstatement. The labour reform also introduced a compulsory pre-conciliation process which may reduce the number of court actions. The impact of this element of the reform will depend on the effectiveness of conciliation and on how the judges will interpret the new provision and the jurisprudence that will be developed over time. There is a possible incentive for employees to bypass the new provisions by taking action against their employer on the grounds of dismissal for discriminatory reasons (for which the law is unchanged, though the burden of proof is on the employee). The authorities should, as intended in the legislation, monitor the operation of the new legislation and new court arrangements and consider what modifications may be necessary for them to be effective. The courts must take length of service into account in deciding compensation for unfair dismissal, but the minimum compensation is high by international standards, suggesting benefits from reducing it over time and setting it as a function of the length of service. However, no compensation is paid to the employees when the court regards dismissal as fair.

To help fund the expanded unemployment insurance scheme and promote stable jobs, the government introduced a 1.4 percentage point surcharge on employers' social contributions on fixed term contracts. The surcharge is repayable if the temporary contract is converted to an indefinite one. However, it increases the overall tax wedge on labour, which is already high. Other measures also discourage the renewal of temporary contracts. At the same time, it has been made much easier to offer a temporary contract up to one year for a new employee, which is a useful step, in part because it can be used in effect as a one-year probation period that could lead to an indefinite contract. As measured by OECD indicators, the overall level of employment protection changes little (Figure 8), but this is partly because the index does not take into account certain changes, such as some of the changes in legislation concerning temporary contracts.

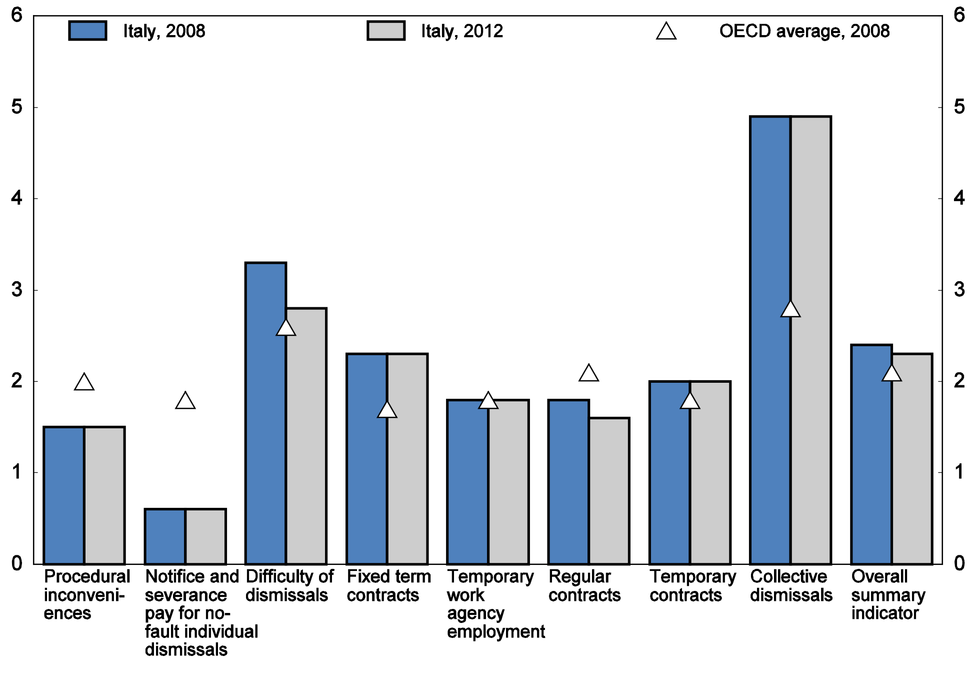
An important part of the labour market reform is to introduce a homogeneous and universal unemployment benefit system. The new system is to be phased in slowly by 2017; it will not be very generous by OECD standards but will fill a significant gap in the current welfare system.

Perhaps the most difficult part of the reform will be to build up more effective institutions to both support and provide incentives to job search. This includes training and job-search institutions, both of which are under the competence of regional governments, and coordinating them with the provision of unemployment benefits, which are administered by the national social insurance institution, INPS. Other countries as diverse as France and Norway have found it useful to bring social insurance, job-search facilities and training providers together in "one-stop shops" while many others have made efforts to strengthen the coordination between the different administrations. Experience has shown that improvements in coordination can take some time to appear.

Further policy steps should build on these important reforms and shift labour market support in the direction of "flexicurity", a more inclusive approach to labour market policy. More flexibility for hiring and firing would be backed up with effective job search, activation and training policies, and the planned universal social safety net. Previous Economic Surveys have emphasised the importance of improving the school-to-work transition to enhance human capital formation and reduce Italy's very high youth unemployment. Education policy has a key role here. Increased employer engagement and improved work-based training to improve the vocational education and training systems (which is the responsibility

Figure 8. Estimated impact of the labour market reform on indicators of employment protection

Employment protection legislation index



Note: The labour market reform refers to Law no. 92/2012.

Source: 2008, OECD Employment Protection Legislation Database; 2012, estimate by Ministry of Economy and Finance.

How to read this figure: OECD indicators measure employment protection legislation on a scale from 0 to 6, where 0 indicates the least restrictive from the employer's point of view and 6 the most restrictive. While Italy's provisions on collective dismissal are much more restrictive than the average (in fact they are the most restrictive in the OECD), provisions for notice and severance pay for individual dismissals are less restrictive than the OECD average.

of regional government) could make an important contribution, along with the recent reforms to the apprenticeship system. Through the development of Higher Technical Institutes (ITS) since 2009 and recent pilot projects in improving links between vocational schools and companies, the government has begun to take action in this area. Promoting certification of existing competences, as foreseen by the legislative decree adopted on 11th January 2013, for people with low formal education would improve mobility and job matching in the labour market.

Italy's overall low labour participation rate is largely due to low female participation. To a significant extent, this is due to women's role in the provision of care functions that are often provided, at least in part, by the public sector in many other countries. Public spending on families with children is well below the OECD average and deserves a higher priority among competing uses for scarce public resources. The funds recently allocated, through the deployment of the Cohesion Action Plan, to raise coverage and quality of childcare services in the South have been a move in this direction. Lowering the effective tax rates on second earners, currently among the highest in the OECD, as part of revenue neutral tax reform, would also reduce work disincentives.

Box 3. Recommendations for labour market reform

- Promote a more inclusive labour market, improving employability with more support for job search and training, linked with the broader social safety net, rather than preserving existing jobs.
- Promote the widening of the current agreement among the social partners so as to better align wages compared with productivity, to help restore competitiveness.
- Use the monitoring provisions of the labour market law to evaluate its impact and to plan possible future policy measures.
- Consider lowering the minimum monetary compensation for unfair dismissal and setting it as a function of length of service.
- Coordinate the action of nationally-organised INPS and regional training and job-search agencies so as to effectively align passive and active labour market policies.
- Improve the vocational education and training system through more employer engagement and work-based training to better bridge the transition from education to the labour market.
- Within overall budget constraints, give more priority to increasing the supply and coverage of childcare, consider redistributing part of the parental leave right to fathers and reducing marginal tax rates on second earners, to reduce the disincentives to female labour market participation.

Competitiveness and product markets

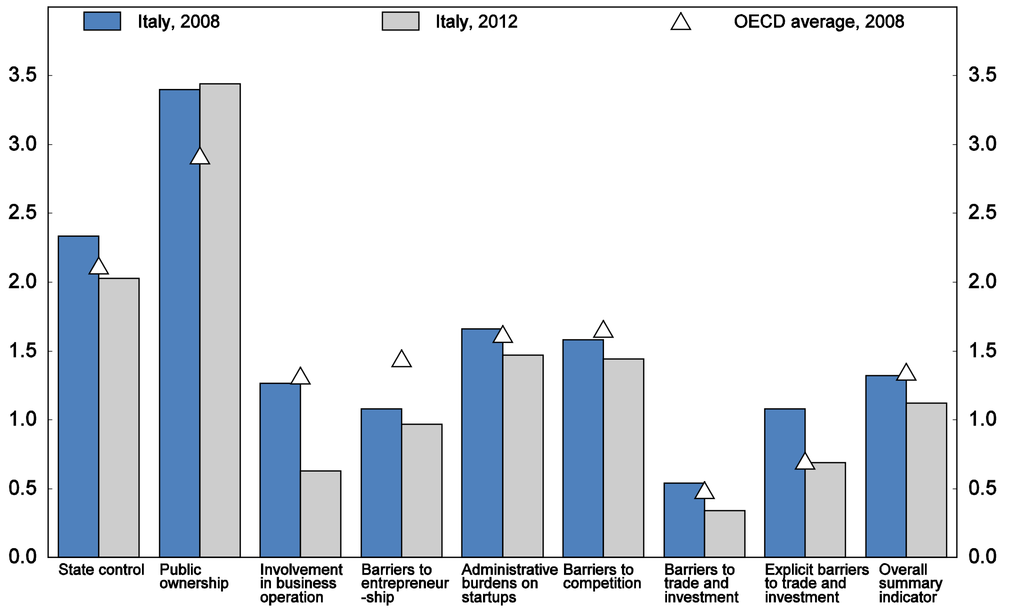
Since December 2011, the government has introduced a wide range of measures, in a series of omnibus decrees, to help improve the business environment by reducing product market regulation and promoting competition. These measures have had a noticeable impact, as measured by OECD product market regulation (PMR) indicators (Figure 9). The broad areas include the following:

- Strengthening the powers of the Competition Authority, including over local public services and the operation of tenders.
- More competition in public transport, with a new independent regulator.
- Bringing water services into the regulatory structure for utilities.

- Separating network ownership from production and supply in the gas industry.
- Further deregulation in some professional services and the retail sector.
- Further simplification of administrative procedures for businesses and individuals.
- Increasing the average size of judicial districts and developing specialised commercial courts.

These measures should increase productive potential through three mechanisms. First, direct cost reductions mean that the resources saved can be used elsewhere. Second, lower costs in some sectors reduce costs in downstream sectors. Third, stronger competitive pressure increases the incentive to innovate, raising both the level of productivity and its rate of growth. A number of other measures have been introduced which should have little effect on PMR indicators, but could have an effect on productive potential. These include promotion of greater use of information technology (the "Digital Agenda"), simplified procedures for strategic infrastructure investment and assistance for "high technology" start-ups.

Figure 9. Product market regulation, changes since 2008



Source: 2008, OECD Product Market Regulation Database; 2012, estimate made by OECD Secretariat in consultation with the Ministry of Economy and Finance.

How to read this figure: OECD indicators of Product Market Regulation (PMR) measure legislation on a scale from 0 to 6, where 0 indicates the least restrictive and 6 the most restrictive. Italy's position on explicit barriers to trade and investment was more restrictive than the OECD average in 2008, but after the 2012 reforms it has dropped to the level of the 2008 OECD average. Restrictiveness eased in all but public ownership.

OECD estimates, based on OECD product and labour market indicators, suggest that reforms legislated up to November 2012 (including all policy changes since 2008) could increase GDP by 5½ per cent over 10 years. While the growth estimates by the government and the OECD are broadly similar in magnitude, they are essentially indicative, and there are many methodological problems in using cross-country data to investigate the impact of such measures. These models rely on some difficult-to-verify assumptions and assume that all economies studied behave like the "average" OECD economy. The PMR indicator for Italy has improved significantly since 1998 and more than in other countries, which would therefore predict a significantly improved economic performance, while Italy's relative productivity performance in fact deteriorated. One explanation could be that past reforms have not in all cases been implemented as intended by the law. Other estimates of the impact of the recent reforms, for similar though not identical policy packages, cover a wide range, from 0% to 11% (Table 2).

Table 2. Estimates of the GDP impact of structural reforms in Italy

Source and estimation approach	Reforms whose impact is estimated	Estimated impact on GDP
OECD: Reduced-form regressions	All product market reforms since 2008; the labour market reform in 2012	5.5% after 10 years from the product market reforms; very little impact from the labour market reform
OECD, based on Aghion *et al.* (2009): Reduced-form regressions	All product and labour market reforms of the current government (autumn 2011-end 2012)	0%
Ministry of Economy and Finance (2012): Dynamic general equilibrium	*Cresci Italia* and *Semplifica Italia* decrees (*i.e.* measures announced up to March 2012)	2.4% after 8 years
Bank of Italy (Forni *et al.*, 2010): Dynamic stochastic general equilibrium	Stylised reform package reducing service price mark-ups by 20 percentage points	11% in the long run
International Monetary Fund (Lusinyan and Muir, 2013): Dynamic stochastic general equilibrium	Stylised reform package assuming 50% reduction of gap between Italy and best practice	10.5% in the long run

Note: For details of the different estimates, see Chapter 2. Where work prior to 2012 is quoted, the procedure was to use coefficients from that work to estimate the impact of changes in indicators in 2012.

Priorities for the future

Implementation

Using fiscal policy to try to kick-start demand is not an option in current conditions of high debt. Governments need to concentrate on providing framework conditions that favour growth. The first priority is clear, but one that political pressures often make difficult: to ensure that the reforms already legislated are followed through in a coherent fashion, are transparently presented to the public and are consistently enforced.

Policy making must also take into account the dangers of too frequent changes. To take just one example, policies promoting energy saving and renewables were changed many times during the 2000s without any clear empirical rationale (OECD, 2013). Uncertainty over the duration of such incentives - some of which were unjustified anyway (OECD, 2011) - blunts their impact. Avoiding the use of tax amnesties is another example. After a decade in which Italian governments avoided their use, in 2009 a partial amnesty (the "fiscal shield") was extended to funds illegally held abroad. Such amnesties risk undermining tax compliance.

Competition and regulation

Priority should be the full implementation of the Liberalisation, Simplification and Development laws. Separation of ownership in the gas industry and the integration of water services in the regulatory structure for utilities, while ensuring its operational independence, should be completed and the new transport regulator should be brought quickly into operation. The transport regulator was to have already been in place before the end of 2012, but this decision was delayed and has now been put off until after the 2013 national elections. The government needs to ensure also that the Competition Authority uses its new powers actively. Greater competition should be promoted in local public services and in retail and professional services by removing remaining regulatory capacity restrictions. In December 2012 certain liberalisation measures originally planned for lawyers as part of general measures in the professional services, were reversed, retaining, for example, their monopoly on legal representation and assistance in alternative dispute resolution (e.g. mediation), some restrictions on advertising and the ban on contingent fees; these backward steps should be reconsidered.

A key task of the reformed regulatory structure is to limit conflicts of interest. These were present, for example, in the case of water utilities, which have been regulated locally, by municipalities and regions. The companies themselves, however, are typically part or wholly-owned by local governments and politicians may be on their managing boards. Plans to force local government to fully divest ownership of such companies were reversed by a referendum in 2011, and a consequent constitutional court ruling in 2012 annulled plans to give the competition authority powers to promote competition and enforce tendering procedures. The new national water regulator will not be able to eliminate such conflicts of interest, but should improve transparency.

Network and utility regulators should monitor pricing and impose quality-of-service rules. These rules should also be as stable as possible. When regulating multiple comparable companies (such as local distribution networks) comparative performance could be used. Such a 'yardstick' framework, where improved efficiency in the better performers is reflected in the pricing rules, provides strong incentives for efficiency, but has strong information requirements to work effectively. A system of yardstick competition is part of the framework for regulating privately-run water utilities in the United Kingdom. Media regulation too has for some time neglected the issue of competition, with an effective duopoly at national level between a dominant private broadcaster whose parent company has large interests in the printed press, and a large public sector operator. The media regulator, AGCOM, should act to ensure competition among both private and public operators.

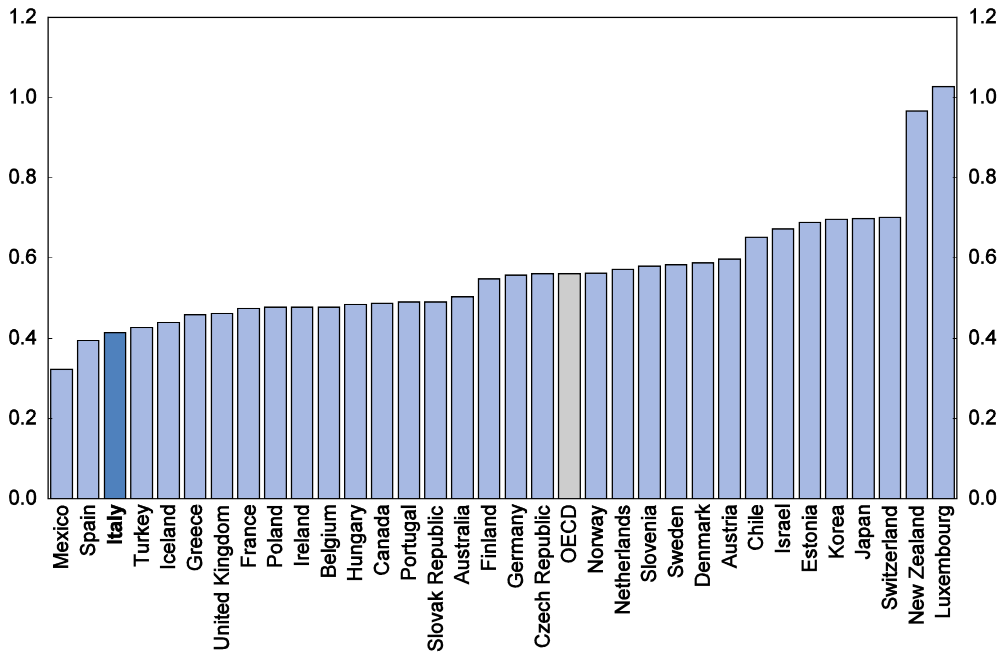
The basic principle of competition law and regulation is to promote the interests of consumers and citizens, not those of enterprises per se. But regulation is needed in many areas, such as protection of health and the environment. The trade-offs, for example between pollution and employment opportunities, are difficult, but clear rules and effective enforcement are needed: they are sometimes lacking. One case concerns a steel plant in Taranto (one of the largest in Europe). A court has found evidence of serious pollution, and past non-compliance with standards, and required the plant to close, at least temporarily; but the central government disagreed with this decision and has planned a specific decree to allow it to remain open, while giving time for the plant to adjust to environmental requirements. While the trade-offs in this case are particularly difficult to resolve, similar issues, not necessarily involving the environment, may arise in other, less individually significant, cases.

The tax system

Significant reductions in the overall tax level cannot be made yet, but reducing tax expenditures can raise revenue at relatively little cost to economic efficiency. The Ministry of Economy and Finance (2011) identifies 720 of these. IMF (2012) lists the largest 20 of them, which together cost around 10% of GDP in lost revenue. For example, the effective rate of VAT is lower in Italy than elsewhere (Figure 10); evasion also contributes to the low effective VAT yield). Eliminating tax expenditures with no clear justification would, by widening the tax base, allow marginal tax rates to be reduced in a revenue-neutral reform. An early target should be to reduce the tax wedge on low-paid workers, which is higher than all but 4 or 5 OECD countries (France and Germany are among those with higher rates), especially for second earners - likely a contributory factor to low female participation. Reducing tax expenditures would also lower administrative costs, notably by making tax compliance simpler and cheaper. Some tax expenditures are, however, components of a sensible tax system and should be retained. Future tax measures should follow the advice of IMF (2012) in its favourable assessment of the draft framework law for tax reform, notably strengthening predictability and transparency, clarifying and limiting the role of the criminal law in tax assessments, and strengthening the new real estate tax with up to date and fairer, market-related valuations. These measures had not been definitively adopted before parliament was dissolved for the elections. They could form the basis of future plans for tax reform.

Other well intentioned fiscal measures have increased specific tax exemptions or reductions. "Project bonds", intended to finance companies undertaking public infrastructure projects, will be subject to the same tax advantages as direct government debt. Companies hiring specific kinds of workers and/or in specific regions will be exempted from part of the regional company tax (IRAP). These measures have to be financed by higher taxes somewhere else, and there is also a danger that they attract creative accounting behaviour, in which case companies benefit from the deductions without any real change in behaviour.

Figure 10. VAT revenue ratio, 2011[1]



Note: The OECD area is the simple average.

1. Or latest year available. Data for 2011 are estimates.

Source: OECD Consumption Tax Trends 2012; OECD Revenue Statistics and Annual National Accounts Database.

How to read this figure: The VAT revenue ratio is defined as the ratio between the actual value added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. This ratio gives an indication of the revenue losses in the VAT system due to preferential (lower) rates, tax evasion and weaknesses in administration.

Box 4. Recommendations for competition policy and other structural reforms

- Complete the implementation of the key reforms, including through ensuring that the Transport regulator is set up rapidly and that the Competition Authority uses its new powers actively.
- Remove remaining regulations restricting capacity in retail and professional services; reconsider some backwards steps, notably those limiting the expansion of competition among lawyers.
- Broaden the tax base by reducing tax expenditures comprehensively, allowing reductions in marginal tax rates on labour, especially on second earners.
- Complete the framework of regulations for water services and other local utilities, ensuring the operational independence of the regulators.
- Promote greater competition in local public services, as well as in television and other media.

Improving public policy implementation: legislation, public administration and the rule of law

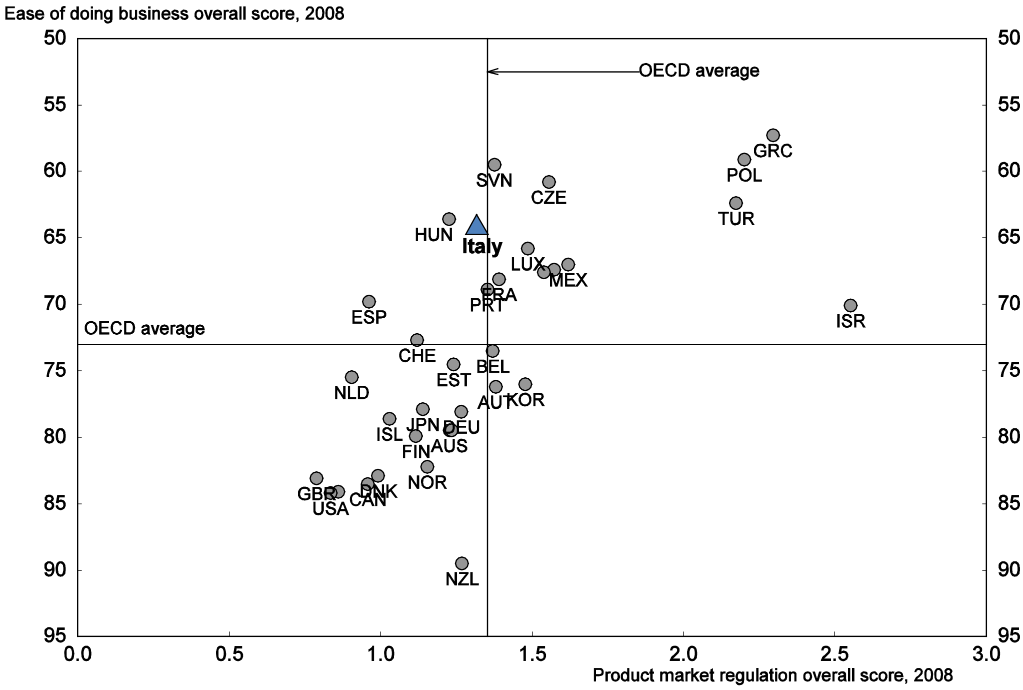
Despite Italy's improved relative performance on OECD indicators of product market regulation (PMR) its relative productivity performance deteriorated well before the financial crisis. PMR indicators show that by 2008 Italy was somewhat better than a simple average of OECD countries, but other indicators tell a different story showing that progress was particularly strong in PMR-measured areas. The World Bank "Doing Business" survey shows Italy as significantly worse than the corresponding average (Figure 11). Much of the difference between Italy's position on these two indicators arises because they do not cover the same set of issues (only two sub-indicators coincide exactly). But one area that Doing Business considers, not included in PMR, is the speed of civil justice (where Italy ranks very low) and a small number of Doing Business indicators are based on perceptions. An international survey that specifically covers perceptions of the business framework in different countries (as opposed to OECD indicators and almost all of Doing Business which focus on a strict legal interpretation of the legislation) shows Italy as very much worse than almost all OECD members (Fraser Institute, 2012). Other governance and perception indicators, such as the World Bank's governance indicators, suggest that Italy is likely relatively weak when it comes to putting measures into action and effectively enforcing them. (World Bank, 2012; World Justice Project, 2012). There is thus a case for suspecting that the legislated principles of business regulation may be further from practice, or at least perceptions of practice, in Italy than in most countries.

There may be many sources of such a difference, not unique to Italy. Examples which are often highlighted in Italy include: legislation which is sometimes fragmented, poorly drafted, or ambiguous; regional/local regulation which is inconsistent with national legislation; regulations which are not effectively implemented by the public administration; inadequate administrative capacity in some regions; implementation or enforcement which is ineffective because of slow moving courts; regulations which are undermined by corruption or supplanted by organised crime.

Streamline and re-organise legislation

The "Taglia leggi" law - the "law-cutting law" - passed in 2005 aims to eliminate redundant legislation from the statute books. In a rough comparison with other countries, there may have been more than twice as many as in France and four times the number of federal laws in Germany (Clarich and Mattarella, 2011). Regional governments, particularly but by no means only those with autonomous status, add to the total. According to OECD (2012), since 2005 around 200 000 national level laws have been repealed. The effect is not immediately noticeable, but by removing them from the body of potentially relevant laws, the process has reduced the burden on courts interpreting them and of companies and individuals needing to respect them, and probably reduced the need for lawyers.

Figure 11. Italy scores relatively weaker on 'Doing Business' then on OECD regulatory indicators



Source: OECD PMR Database and World Bank, Doing Business.

How to read this figure: Italy's PMR 2008 score of 1.3 (the best possible score is 0, worst score 6) is between that of countries such as France and Germany, and is slightly below the OECD average, so one would expect conditions for business to be relatively good. But its score on the World Bank Doing Business indicator (best possible score = 100, worst = 0) is worse than most OECD countries.

The number of individual laws passed by parliament has been declining, but they have become longer, and increasingly introduced as government decrees with immediate effect, with parliament therefore taking a lesser role in debating and drafting them. Use of decree laws needs to be more effectively restricted to their legitimate use for very urgent measures, as in most of the legislation introduced in 2012, but in more normal times it can result in good governance procedures being by-passed. In the case of regulatory impact assessments, for instance, exemptions to the requirement for producing them include both urgent measures and complex issues (OECD, 2012). Laws are frequently difficult to read - as may be the case in many countries - and the Italian parliament's own guidelines for drafting laws are often not followed.

A study from the Confindustria research institute (Clarich and Mattarella, 2011) suggests guidelines for improving the quality of legislation, many of which match previous recommendations in Economic Surveys. They include: avoiding too-frequent changes of rules without impact and cost analysis; following coherent guidelines on plain-language drafting; moving towards codification to bring disparate laws regulating specific sectors or activities into single coherent texts; promoting "soft law", in which legislation provides guidelines but leaves room for common sense interpretation instead of complicated over-prescription; ensuring that laws and regulation are easily accessible to the public on the internet; promoting coordination among regions to ensure compatibility of language and substance of laws; and undertaking a periodic investigation of regulations in different sectors to assess their cost-effectiveness and efficiency. The authorities argue that these guidelines are already being followed: a number of Testi Unici (consolidated laws) have been issued and a website "Normattiva" provides access to the full body of laws in force; some form of monitoring, perhaps in a follow-up study along the lines of the Confindustria study reported above, would be useful.

Public administration: efficiency and integrity

Successive governments, since at least 1998, have introduced reforms intended to improve the performance of the public administration, generally with the ambition to improve accountability and encourage a performance-oriented culture. The “Brunetta reforms” in 2009-10 showed both how much progress was needed and what was possible (OECD, 2010). It seems that so far most ministries have concentrated only on easy targets where sanctions were attached and have not internalised the importance of transparency (CIVIT, 2012). The work of CIVIT, the commission for integrity and evaluation in the public administration, in monitoring progress should be encouraged. The reforms introduced a link between earnings and performance through a system of performance bonuses based on achieving performance targets. In at least some cases there seems to have been collusion to set easy-to-reach performance targets, adding to official paperwork with little effect on incentives. Requiring ministries to post absenteeism records on their website appears to have reduced the problem of (recorded) absenteeism.

Reforms of public administration and regulatory processes are partly dependent on achieving cultural change in the bureaucracy, including simple recognition of the importance of exposing and reducing conflicts of interest. This requires continued insistence on accountability and the need for an outcome-based approach to performance evaluation. CIVIT is to become the key public body responsible for monitoring the implementation of a number of provisions which should improve efficiency and integrity. The 2012 anti-corruption law, whose first draft was proposed by the previous government, provides for a number of key mechanisms. These include developing a new code of conduct for civil servants and provisions for protecting whistle-blowers - employees who expose misuse of funds, corruption or crime and who thereby put themselves at risk of retaliation by their employers, and additional conflict of interest measures. According to the OECD Integrity Review, the anti-corruption law marks considerable progress in these and other areas, though it notes that the whistle-blower provisions contain some gaps which should be dealt with over time (OECD, 2012). The details of many of these provisions are left for the government to develop within lines set out in the anti-corruption law; as in other areas, it is important that these are fully followed up.

The national public procurement agency, Consip, is an example of good practice in keeping costs down. Its contribution can be amplified both by - as planned in recent legislation - extending its range of activity and promoting transparency so that its comparisons of prices and purchases across the country become easily accessible public information.

Corruption

Italy suffers more from corruption than most OECD countries and more than some non-members, as a number of surveys show (GRECO, 2009; Transparency International, 2010), although there is always room for different interpretations. Some surveys are exceptions; Italians themselves report a relatively low level of attempts by public officials to extract bribes, for example, but these are not typical. In 2012 there was a level of revelation of misuse of public office in regional government unprecedented since the early 1990s. The administrations of two of the twenty regions resigned amid accusations of misuse of public funds, though it remains to be seen whether this was corruption in a legal sense, or rather poor spending control. (Bandiera et al. (2009) suggest that 80% of inefficiencies are explained by poor management and 20% by corruption). A feeling that corruption is widespread or occasionally acceptable to deal with practical problems can make it more difficult to make progress than when cases are relatively isolated. As the government recognises, however, a determined approach to transparency, well-designed laws and efficient enforcement can succeed in modifying behaviour.

Italy should therefore further promote transparency to facilitate simple efficiency comparisons, but also ‘naming and shaming’ based on verifiable information. The recent anti-corruption law was a useful step. Its commitment to bring all transparency provisions into a consolidated document is welcome, while a fully-fledged freedom of information act would be a powerful additional force for greater transparency. Some further measures taken in late 2012, enhancing transparency in local government and political finances, and reinforcing the role of the Court of Auditors, should also contribute to reducing corruption. Modifying the operation of the statute of limitations on criminal corruption cases to remove incentives to dilatory behaviour is important. One current such incentive is the inclusion of the full length of the trial and appeals process in the limitation period for all criminal cases (though not for civil cases).

Organised crime

Organised crime often operates a parallel economy, and actively seeks to undermine the normal government. It has frequently succeeded at the local level. In most years several municipal governments are dissolved by the president on the grounds that they have fallen under the control of organised crime, though the dissolution of a regional capital's municipal council in 2012 was unusual. Trying to reduce the gains from organised crime can help to constrain it. As a signal of commitment, the government introduced the anti-mafia "White List", a rating for enterprises certified as not exposed to mafia infiltration, and measures to facilitate the seizure of mafia assets. The role played by the Financial Intelligence Unit in fighting and preventing money-laundering is central and might be strengthened. Continued, and if possible enhanced, cooperation from other countries to increase the traceability of funds held abroad or invested abroad in otherwise legal activities is important.

Civil justice

Effective implementation of the law is above all dependent on the judicial system. The Italian civil justice system is extremely slow and expensive compared with many other OECD countries (Table 3) and there is a high rate of appeal, including second appeals, to the Corte di Cassazione, the highest court. The government took some welcome measures in 2012, including increased specialisation of judges and courts,

Table 3. Civil courts can be slow and expensive

Number of days necessary to settle a first level civil case			
	2006	2008	2010
Italy	**507**	**533**	**493**
Portugal	449	430	417
Spain	261	296	289
France	262	286	279
Austria	135	129	129
The cost of resolving commercial disputes (2012 data)			
	Number of procedures necessary	Number of days	Cost, as % of the amount in dispute
Italy	**41**	**1210**	**30**
Germany	30	394	14
France	29	331	17
Spain	39	515	17
United Kingdom	29	399	23
United States	32	300	14
OECD average	31	518	19

Source: Clarich and Mattarella (2011), using data from CEPEJ and World Bank Doing Business 2012.

geographical rationalisation, and some filtering of appeals. Other reforms, focusing on incentives and constraints faced by lawyers, their clients and judges must be pursued, as well as key technical measures such as deepening the use of information technology. Incentives for the use of alternative dispute resolution mechanisms, such as mediation, should also be considered. Increasing the (very low) minimum cost of taking small claims to courts already seems to have reduced the inflow of such claims.

Adapting policy

While measures to directly improve the efficiency of public administration, to reduce corruption and to limit the reach of organised crime are essential, policy may sometimes be able to create better incentives to reduce these problems. A simple case is the use of standard-cost pricing in financing decentralised service provision with central funds. This gives regions and municipalities incentives to improve efficiency since they will not be compensated with higher transfers. Such an approach is foreseen by the legislation on fiscal federalism but is not yet in operation. Further rationalisation of procurement, through the extension of the operation of Consip, the central procurement agency, is another example.

Another possibility, more difficult to use, could be a severe cost-benefit analysis in considering infrastructure projects: where corruption or crime increases construction costs, and the use of public funds is indirectly supporting organised crime, public investment needs to have a very high social rate of return to be justified. Education is potentially a key tool in developing civic society, especially by finding ways for children to see wider role models and more opportunities for employment. The government's Cohesion Action Plan reallocates some EU Structural Fund resources to reduce school dropout in some specific areas, to encourage legality, with the participation of schools and the private sector. Investment in primary and secondary education, and ensuring it remains free of the influence of corruption and organised crime, should be given a high priority. The planned development of a wider social safety net could also help, since some of the criminal organisations operate their own quasi social security system, while many unemployed people currently receive little help from the state.

A final consideration arises from the known tendency of corruption (as well as organised crime) to affect the operation of administration, politics and even justice at the local level. In such cases the central government or justice system intervenes from outside. There is, a priori, a risk that the same thing can happen at the national level. Ultimate responsibility for preventing this resides with parliament and the electorate, acting on reports from the bodies monitoring transparency and conflicts of interest. There are potential conflicts of interest at this level too, where outside monitoring is more difficult. One possibility could be international cooperation, which could help reinforce the checks and balances of the constitution. CIVIT, the existing independent commission for evaluation, transparency and integrity in the public administration, has been given the powers of a national anti-corruption authority. Sufficient resources and a guarantee of continued independence are essential for CIVIT to fulfil its anti-corruption responsibilities.

Box 5. Recommendations on improving policy implementation

- Encourage use of the transparency provisions of public administration reform and the anti-corruption law by acting decisively on evidence of inefficiencies, conflicts of interest or corruption.
- Complete the geographical reorganisation of the courts, streamlining court processes, improving the use of information technology, and widening the incentives for a greater use of alternative dispute resolution mechanisms. Continue streamlining sub-national government.
- Limit the use of decree laws, work towards codified ("testo unico") legislation, ensure effective impact assessment of laws and regulations, and increase the use of sunset clauses.
- Build on the provisions of the anti-corruption law to develop a fully-fledged freedom of information act.
- Revise the law on limitations ("prescrizioni") in criminal corruption cases to reduce incentives to dilatory behaviour, such as the inclusion of the full trial and appeals process in the limitation period.
- Pursue performance-oriented management (not just performance pay) in the public administration.
- Widen the range of operation of the centralised public procurement body, Consip, to cover as much procurement activity as possible, making a database of comparative purchase prices publicly available.

Chapter summaries

Chapter 1. Italy and the euro area crisis: securing fiscal sustainability and financial stability

Italy's policy of fiscal consolidation and growth-friendly structural reforms has substantially improved its economic prospects, but the adverse sentiment that the country has faced in the sovereign bond market over the past years has deep roots. It reflects lingering anxieties over the euro area's future, as well as persistent economic and financial difficulties, in particular the high level of public debt and low potential growth. The government has rightly aimed to halt the rise in the public debt-to-GDP ratio and put it on a downward path. This could be achieved either with a balanced government budget or a small fiscal surplus. While additional fiscal tightening would have transitory negative effects on output, it would be rewarded by faster debt reduction and lower risk of renewed financial-market reactions. In addition, automatic stabilisers should be allowed to work.

Concerns about fiscal sustainability and the prolonged recession have spilled over to the financial sector. Lending conditions are tight, non-performing loans are high and rising, and capital flowed out of Italy to the core countries of the euro area. The Bank of Italy should continue to ensure that banks increase provisions against losses, and strengthen their capital asset position by raising new equity from private sources, including from foreign stakeholders, by retaining earnings, and by disposing of non-core assets. Resolution of the fiscal, economic and financial crisis in Italy depends in part on action at the euro area level. As a member of the euro area, Italy has benefited from the establishment of the European Stability Mechanism, the announcement by the European Central Bank of the Outright Monetary Transactions scheme and the plans for a euro-area banking union.

Chapter 2. Structural reforms in Italy: impact and priorities

To lift Italy's economic performance, the government has legislated reform measures in many areas: the pension system, the tax system, product markets, the labour market, the public administration, and the rule of law. These structural reforms have mostly been in line with previous OECD recommendations. They should be fully and consistently implemented. Overall, once implemented, they are expected to have a positive effect on GDP. Among the priorities for the future should be to continue to promote greater competition in product markets, to improve the education system and incentives for innovation, to enhance the inclusiveness of the labour market, and to broaden tax bases through a comprehensive reduction of tax expenditures.

Chapter 3. Policy implementation: Legislation, public administration and the rule of law

OECD indicators of structural policy show that policy changes in Italy since 1998 should have improved the environment for entrepreneurship significantly, but in the same period its economic performance has deteriorated noticeably. This may be partly because there is a difference between policy measures intended by the government or parliament and their impact on the business environment perceived by entrepreneurs. There is no certainty as to what are the main culprits, but a number of policy steps would help to improve the situation. These include better thought out and better written legislation and implementing regulations, more use of performance-oriented management in public administration, and further streamlining and reduction of incentives to procrastination in the judicial system. Legislative simplification and transparency will increase economic efficiency in themselves, while also making a contribution to reducing the incentives and opportunities for corruption and organised crime to flourish. Clear operational independence with accountability is essential for bodies monitoring and assessing the extent of corruption.

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 17 January 2013. 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 01 February 2013.

The Secretariat's draft report was prepared for the Committee by Paul O'Brien and Oliver Denk, under the supervision of Patrick Lenain. Research assistance was provided by Josette Rabesona.

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See also http://www.oecd.org/eco/surveys/Italy.

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