

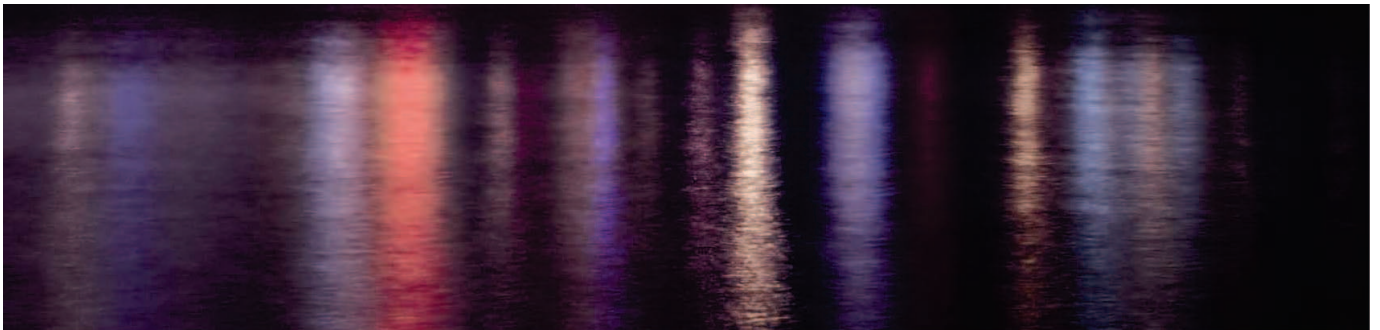


OECD Economic Surveys

ITALY

February 2015

OVERVIEW



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BASIC STATISTICS OF ITALY, 2013
(Numbers in parentheses refer to the OECD average)^{a)}

LAND, PEOPLE AND ELECTORAL CYCLE				
Population (million)	61.2		Population density per km ²	203.0 (34.7)
Under 15 (%)	14.0	(18.2)	Life expectancy (years, 2012)	82.3 (80.2)
Over 65 (%)	20.9	(15.6)	Men	79.8 (77.5)
Foreign-born (% , 2012)	9.4		Women	84.8 (82.9)
Latest 5-year average growth (%)	0.4	(0.6)	Latest general election	February 2013
ECONOMY				
Gross domestic product (GDP)			Value added shares (%)	
In current prices (billion USD)	2 149		Primary sector	2.3 (2.6)
In current prices (billion EUR)	1 619		Industry including construction	23.3 (26.9)
Latest 5-year average real growth (%)	-1.5	(0.8)	Services	74.4 (70.5)
Per capita (000 USD PPP)	34.7	(38.1)		
GENERAL GOVERNMENT				
Per cent of GDP				
Expenditure	50.5	(42.6)	Gross financial debt	144.0 (110.2)
Revenue	47.7	(36.7)	Net financial debt	117.5 (69.9)
EXTERNAL ACCOUNTS				
Exchange rate (EUR per USD)	0.753		Main exports (% of total merchandise exports)	
PPP exchange rate (USA = 1)	0.762		Machinery and transport equipment	34.6
In per cent of GDP			Manufactured goods	18.4
Exports of goods and services	28.6	(53.4)	Miscellaneous manufactured articles	17.6
Imports of goods and services	26.3	(49.4)	Main imports (% of total merchandise imports)	
Current account balance	1.0	(-0.1)	Machinery and transport equipment	22.7
Net international investment position	-30.0		Mineral fuels, lubricants and related materials	19.9
			Chemicals and related products, n.e.s.	15.4
LABOUR MARKET, SKILLS AND INNOVATION				
Employment rate for 15-64 year-olds (%)	55.6	(65.2)	Unemployment rate, Labour Force Survey (age 15 and over) (%)	12.2 (7.9)
Men	64.8	(73.1)	Youth (age 15-24, %)	40.0 (16.1)
Women	46.5	(57.4)	Long-term unemployed (1 year and over, %)	6.9 (2.7)
Participation rate for 15-64 year-olds (%)	64.4	(71.1)	Tertiary educational attainment 25-64 year-olds (% , 2012)	15.7 (32.2)
Average hours worked per year	1 752	(1 771)	Gross domestic expenditure on R&D (% of GDP, 2012)	1.3 (2.4)
ENVIRONMENT				
Total primary energy supply per capita (toe)	2.5	(4.2)	CO ₂ emissions from fuel combustion per capita (tonnes, 2012)	6.2 (9.7)
Renewables (%)	15.8	(8.8)	Water abstractions per capita (1 000 m ³ , 2008)	0.9
Fine particulate matter concentration (urban, PM ₁₀ , µg/m ³ , 2011)	33.8	(28.0)	Municipal waste per capita (tonnes, 2010)	0.5 (0.5)
SOCIETY				
Income inequality (Gini coefficient, 2010)	0.321	(0.308)	Education outcomes (PISA score, 2012)	
Relative poverty rate (% , 2010)	13.0	(11.1)	Reading	490 (496)
Median equivalised household income (000 USD PPP, 2010)	21.1	(20.4)	Mathematics	485 (494)
Public and private spending (% of GDP)			Science	494 (501)
Health care (2012)	9.2	(9.2)	Share of women in parliament (% , December 2014)	30.6 (26.8)
Pensions (2011)	17.1	(8.7)	Net official development assistance (% of GNI)	0.17 (0.37)
Education (primary, secondary, post sec. non tertiary, 2011)	3.1	(3.9)		

Better life index: www.oecdbetterlifeindex.org

a) Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 29 member countries.

Source: Calculations based on data extracted from the databases of the following organisations: OECD, International Energy Agency, World Bank, International Monetary Fund and Inter-Parliamentary Union.

Summary

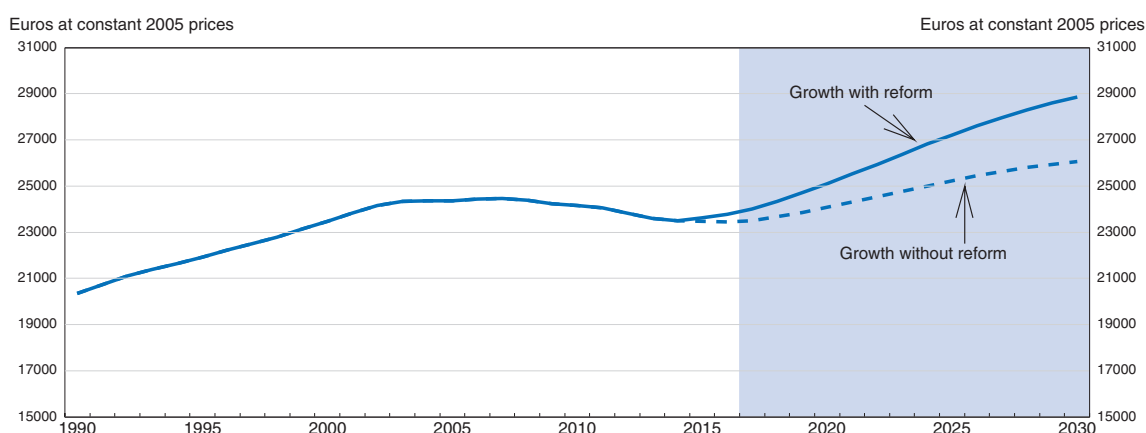
- *Main findings*
- *Key recommendations*

Main findings

Ambitious institutional reforms are under way

After a long period of stagnation that left the economy vulnerable when the financial crisis hit, Italy is undertaking broad-based and ambitious reforms to boost growth, taking advantage of synergies across policies. In the past, many good reform projects were not fully implemented, depriving the economy of their full benefits. The government is therefore focusing on changes in the political and institutional frameworks and judicial system to remove previous impediments to full implementation of reforms.

Reforms underway can boost average annual per capita GDP growth by 0.6% over 10 years



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Labour market reforms and improved competition to boost productivity growth

The key challenges going forward are to make the economy more productive, more competitive, and more adaptable, thereby raising the living standards and well-being of all Italians. The immediate priority is to reform the labour market, where much rigidity prevents job creation and efficient matching of skills; the government intends to complete this task by mid-2015. For example, it intends to transfer the responsibility for active labour market policy from local governments to the central government, so as to increase effectiveness. There are structural weaknesses in other areas, notably competition and regulation, which the government intends to tackle with broad-based reforms over the next two years. These steps are needed to reverse past declines in productivity and put the economy back on a path of steady growth. If fully implemented, they could increase the level of GDP by 6% within 10 years.

A small fiscal surplus, combined with renewed growth, will bring down public debt

Sustained public expenditure restraint and tax increases have gone a long way to strengthen the fiscal position. Together with renewed growth and low interest rates, this will help to bring down the public debt burden.

Key recommendations

Fully implement the institutional reforms

- Follow through the reform of parliament and the re-assignment and clarification of competences between the central and sub-national governments.
- Ensure that legislation is clear, unambiguous and supported by improved public administration, including through reduced use of emergency decrees.
- Further streamline the court system, with more specialisation where appropriate; increase the use of mediation; enhance monitoring of court performance.
- Consider establishing a Productivity Commission with the mandate to provide advice to the government on matters related to productivity, promote public understanding of reforms, and engage in a dialogue with stakeholders.
- Reducing corruption and improving trust must remain a priority. For this, the new anti-corruption agency ANAC needs stability and continuity as well as support at all political levels.

Give full priority to labour-market reforms to boost productivity growth and jobs

- Fully roll-out the new standard contract for new hires, with employment protection rising with job tenure, while grandfathering existing contracts.
- Change the composition of spending on active labour-market policy: limit training programmes to those who need them most; tailor assistance to job seekers according to their specific situation.
- Encourage female labour force participation with more flexible working-hours arrangements, and promote wider provision of good quality care for children and the elderly.
- Fully implement the unified unemployment benefit system. Require recipients to actively seek work, and to accept employment or training when offered.
- Encourage social partners to allow modification of national wage agreements at the firm level, through agreement with representatives of a majority of the firm's employees.
- Adopt a competition law following the recommendations of the competition authority to introduce competition into local public services, improve competition in insurance, banking, network industries, the regulated professions and retail trade.

Fiscal and financial challenges

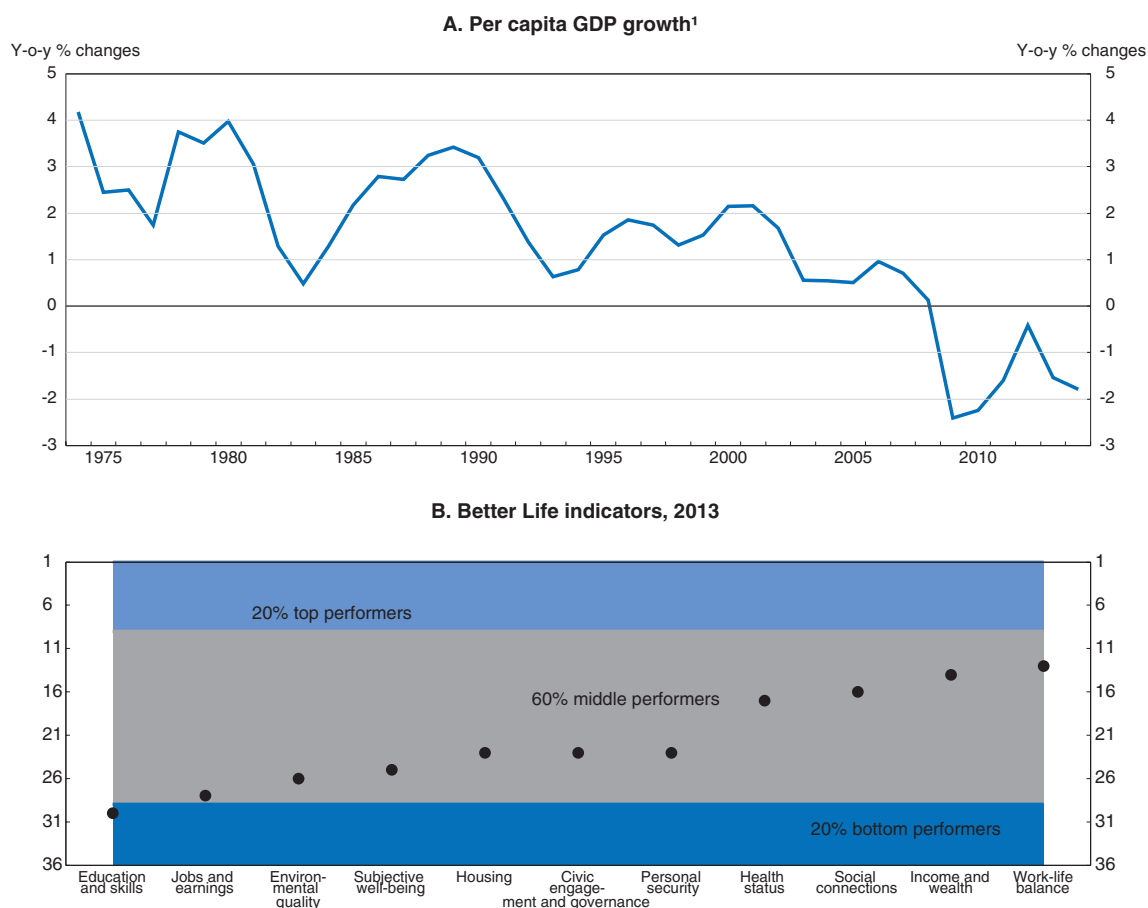
- Stick to the planned fiscal strategy so as to bring the debt-to-GDP ratio onto a declining path.
- Promote greater use of centralised procurement, cost information systems and benchmarking.
- Urgently take action to achieve a lower level of non-performing loans in the banking sector, including through enhancing the insolvency regime applied to distressed borrowers.
- Continue efforts to reduce tax evasion through more effective enforcement and increase tax compliance through simplified collection procedures. Broaden tax bases, in particular by cutting the number of tax expenditures, and simplify the tax system.

Assessment and recommendations

- *A prolonged recession and uncertain prospects*
- *Institutional reforms can be the basis for better policymaking and stronger implementation*
- *Labour market and competition reforms to improve productivity and well-being*
- *Addressing fiscal and financial challenges*

Italy's key problem is the lack of economic growth since the late 1990s (Figure 1). The stagnating economy has left Italy behind in many dimensions of well-being, notably education and skills, jobs and earnings, and housing; in no dimension of the OECD's Better Life indicators does Italy rank in the top fifth of OECD countries. Poor performance in some dimensions of well-being, such as weak education and skills, has itself also contributed to poor growth.

Figure 1. Lack of growth is linked to low scores on well-being



1. 3 year moving average.

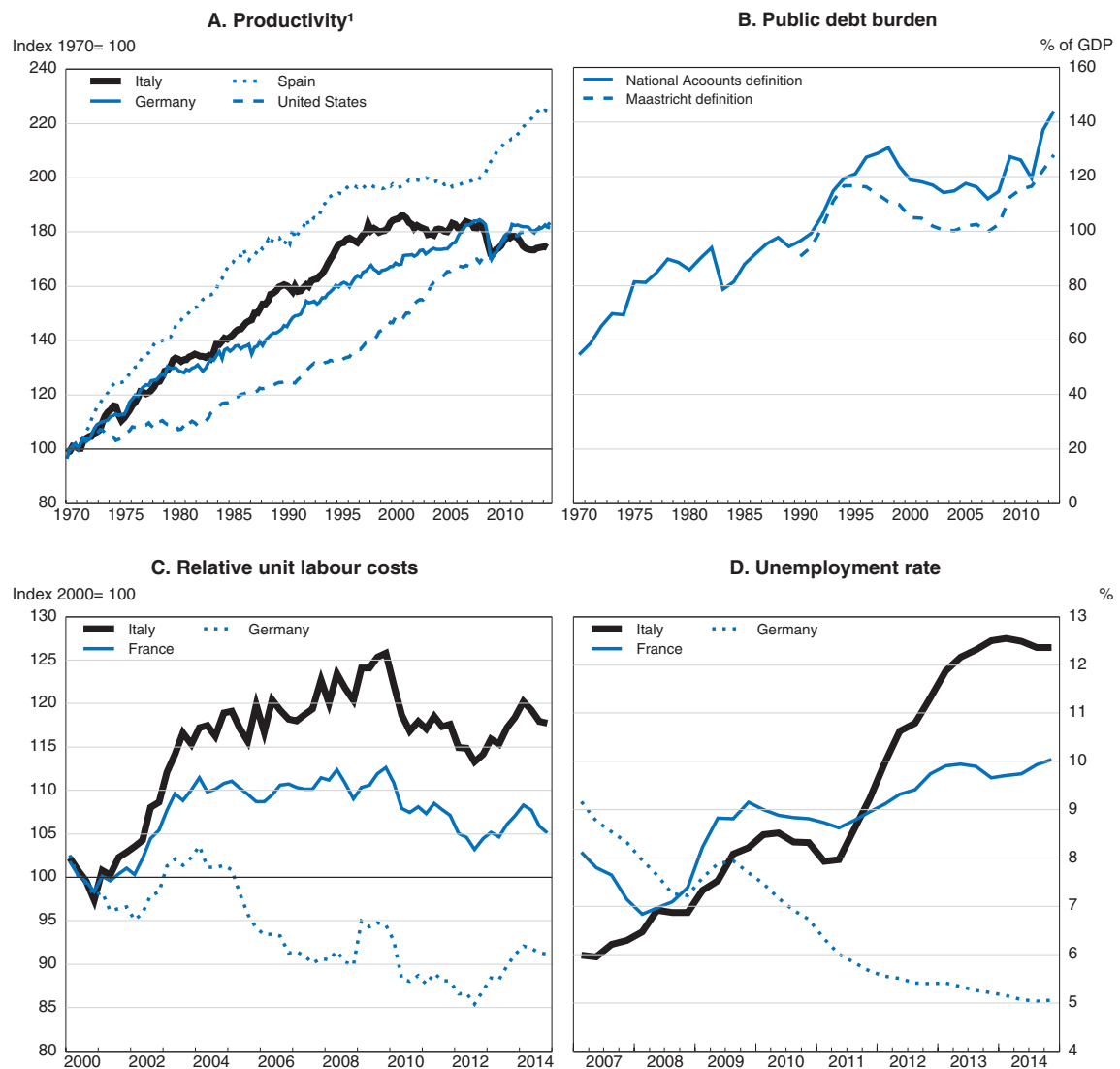
Source: OECD Economic Outlook 96 (database), OECD Better Life Indicators.

How to read this figure: Italy's best ranking on the Better Life Indicators is for work life balance, where it has the 12th highest score of 36 countries. For subjective well-being it ranks 24th.

StatLink <http://dx.doi.org/10.1787/888933184642>

The government has launched an ambitious reform programme to overcome deep-seated structural problems that led to productivity stagnating since the end of the 1990s (Figure 2A). Low productivity growth led to worsening cost competitiveness soon after joining the currency union, without improvement since then (Figure 2C). Low economic growth coupled with persistent budget deficits have kept the debt-to-GDP ratio at one of the highest levels among OECD countries (Figure 2B). This left Italy exposed to sudden changes in market perceptions when the global financial and the euro area crises struck.

Figure 2. **Low productivity has led to poor competitiveness, high unemployment and rising debt**



1. GDP divided by total employment.
Source: OECD Economic Outlook (database).

StatLink  <http://dx.doi.org/10.1787/888933184659>

In part, some of these structural problems were not effectively tackled in the past because the existing institutional setting has not been conducive to pursuing structural reform, especially due to political instability and weak administrative capacity. This resulted in incomplete implementation and, at times, reversals by subsequent governments. The government has therefore focused its efforts on improving the law-making process with a new structure of parliament and a reduced and more clearly-defined role of sub-national governments. These important institutional changes are expected to be completed by the end of 2015, when a referendum is planned. Once in place, they should permit more efficient policymaking, less ambiguity about who is responsible for what, and avoid implementation delays due to sub-national governments not following through on national legislation.

The government's programme includes broad-based and ambitious reforms to boost growth, taking advantage of synergies across the various reforms. By launching reforms in many areas at the same time the government expects that opposition to any particular change will be diluted by the recognition that many people who might lose from one reform will gain from another. The government has launched important reforms of the labour market, the product market, the public administration and the judicial system. There has been an increased focus on rapid implementation: significant parts of the labour market reform were in place by the beginning of 2015. In addition, the backlog of subsidiary legislation from laws passed in 2012 and 2013 has been reduced significantly: in February 2014, 889 pieces of secondary legislation were still pending, this was reduced to 383 by the end of 2014.

Reforms that have been announced so far will have a significant impact. OECD estimates suggest that within five years GDP would be 3½% higher than otherwise thanks to reforms – assuming swift, full implementation – through improvements in productivity and employment (Table 1). In the following five years a further gain of similar magnitude could be expected. Such estimates should be thought of as a broad guide to the expected impact rather than precise estimates. Delays, or less than full implementation, would reduce the gains.

Taking this background into account, the key messages of this OECD *Economic Surveys* are:

- The reforms will boost living standards over the next decade if they are fully implemented. This will require institutional and constitutional reforms to instil more political stability, more efficient legislative processes, greater administrative capacity, less corruption, and more efficient justice.
- Labour market reform is essential to give companies the flexibility to innovate, restructure, and boost productivity. This can be achieved by eliminating rigidities while protecting the unemployed and helping them return to work.
- Past fiscal consolidation efforts will soon pay off provided the government sticks determinedly to its plans. Continuous attention to value for money and tax reform will support this effort.
- Productivity growth should be encouraged by greater competition and better regulation in all sectors, as well as developing human capital and skills.

The low productivity growth in Italy is explained to a large extent by misallocation of resources: potentially more productive firms cannot attract more resources and thus cannot grow, while less efficient firms – many of which are old and small – maintain resources and market share (Andrews et al., 2014, see also Chapter 1). Job mismatch, where low-skilled people occupy jobs which require high skills, or vice versa, typically embodies this misallocation problem, and potential gains from resolving this problem are very large for Italy (Adalet McGowan and Andrews, 2015). Institutional factors, including the stringent

Table 1. Reform impacts on the level of GDP in the medium and long runs

A. OECD estimates						
	Impact after 5 years			Impact after 10 years		
	GDP	Via employment growth	Via productivity growth	GDP	Via employment growth	Via productivity growth
Product market reform ¹	1.5		1.5	2.6		2.6
Labour market reform (Jobs Act) ²	0.6	0.5	0.1	1.2	1.1	0.1
Labour tax wedge	0.3	0.5	-0.2	1.2	1.6	-0.4
Tax structure reform	0.4		0.4	0.4		0.4
Public administration and judicial system reform	0.6		0.6	0.9		0.9
Total³	3.4	1.0	2.4	6.3	2.7	3.6
B. Government estimates of adopted and planned measures ⁴						
	2020	Long-run				
	Adopted measures	Measures to be approved				
Product market reform	0.3	1.1	3.2			
Labour market reform	0.4	0.9	1.6			
Reform in public administration	0.5	1.0	2.3			
Reform in judicial system	0.2	0.4	1.0			
Total	1.4	3.4	8.1			

1. OECD estimates for the impact of product market reform include the results of reforms from 2012 onwards. Approximately two thirds of the quoted impact are due to measures taken in 2012-13.
 2. The impact of the labour market reform is based on a judgement, based on the Jobs Act *Legge Delega* (enabling law), although not all details are defined yet.
 3. Reforms that are planned (and announced) for 2015 and 2016, or in 2014 but not yet legislated in detail, have not been included, with the exception of those under the Jobs Act as described in Note 2.
 4. Estimates by the Ministry of Finance, in Economic and Financial Document (DEF), update 2014.
- Source: Ministry of Finance and OECD calculations.

employment protection legislation, hamper better and quicker reallocation of resources (Andrews and Cingano, 2014). Labour market reform is essential to tackle this problem, and is also an important signal of the government's commitment to enacting tough reforms.

A prolonged recession and uncertain prospects

Real GDP has not grown much since the late 1990s and not at all since 2011; industrial production retreated in the great recession more than in many other OECD countries. Bank lending has fallen for several years, business confidence is low and investment has fallen to a level where it is now insufficient to replace capital as it wears out. To reverse the trend in productivity, the government's programme seeks to address some of its longstanding causes – uncompetitive non-tradeable sectors, regulated professions and the efficiency of the public administration and judiciary, among others. Together with the labour market reform, the government expects that this will increase investment.

There has been some improvement in overall cost competitiveness, measured by relative unit labour costs, since 2009, but this has not offset earlier losses (Figure 2). Price-based measures of competitiveness show less of a problem, and the trend decline in export shares has stabilised in the recession, while the current account balance has moved into surplus, as exports have held up relatively well recently while weak domestic demand has dampened imports.

A weak but strengthening recovery is projected

Prospects are for a gradual recovery in 2015 and 2016, supported partly by additional unconventional policy by the ECB and partly by the fading effect of the earlier fiscal consolidation, and also by real income gains due to the oil price decline (Table 2). In 2015, rising export market growth, restrained labour cost growth and the weaker euro should strengthen exports. Successful labour market reform, the budgeted reduction in the tax wedge on labour and better tax treatment of equity investment should help to underpin investment growth. Private consumption will remain weak but accelerate somewhat as lower energy prices and low inflation boost real incomes. Unemployment will edge down.

Risks are to the downside. The additional unconventional monetary policy measures assumed in the forecast might, even if introduced, be less effective than hoped in reviving credit, which would prevent the ECB from fighting deflation. ECB action has been decisive

Table 2. The Economic Outlook to 2016
Annual percentage change, volume (2010 prices)

	2010 Current prices (billion EUR)	2011	2012	2013	2014	2015	2016
Gross domestic product (GDP)	1 604	0.7	-2.3	-1.9	-0.4	0.4	1.3
Private consumption	980	0.0	-4.1	-2.7	0.2	0.7	0.8
Government consumption	328	-1.8	-1.5	-0.7	-0.2	-1.0	-0.3
Gross fixed capital formation	319	-1.7	-7.5	-5.4	-2.7	0.1	2.2
Housing	89	-6.5	-6.7	-5.4	-3.3	-0.5	0.0
Final domestic demand	1 628	-0.7	-4.2	-2.8	-0.4	0.1	0.8
Stockbuilding ¹	8	0.2	-0.8	-0.1	-0.1	0.0	0.0
Total domestic demand	1 636	-0.5	-5.0	-2.9	-0.5	0.1	0.8
Exports of goods and services	402	6.1	1.6	0.9	1.7	2.7	4.6
Imports of goods and services	434	1.2	-8.2	-2.6	1.4	2.1	3.4
Net exports ¹	-32	1.2	2.8	1.0	0.1	0.2	0.5
Other indicators (growth rates, unless specified)							
Potential GDP	..	0.0	-0.2	-0.2	0.0	0.2	0.4
Output gap ²	..	-1.9	-3.9	-5.6	-5.9	-5.8	-5.0
Employment	..	0.3	-0.3	-2.0	-0.3	0.1	0.4
Unemployment rate	..	8.4	10.7	12.2	12.4	12.3	11.8
GDP deflator	..	1.5	1.6	1.4	0.4	0.2	0.2
Consumer price index (harmonised)	..	2.9	3.3	1.3	0.2	-0.3	0.5
Core consumer prices (harmonised)	..	2.0	2.0	1.3	0.7	0.2	0.5
Household saving ratio, net ³	..	3.7	3.1	3.9	4.6	5.6	5.0
Trade balance ⁴	..	-1.1	1.0	2.3
Current account balance ⁴	..	-3.1	-0.5	1.0	1.5	2.0	2.3
General government fiscal balance ⁴	..	-3.5	-3.0	-2.8	-3.0	-2.7	-1.8
Underlying general government fiscal balance ²	..	-3.2	-1.0	-0.3	0.1	0.3	0.7
Underlying government primary fiscal balance ²	..	1.2	3.8	4.1	4.4	4.4	4.9
General government gross debt (Maastricht) ⁴	..	116.4	122.2	127.9	130.6	132.8	133.5
General government net debt ⁴	..	96.1	111.1	117.5	120.4	122.7	123.1
Three-month money market rate, average	..	1.4	0.6	0.2	0.2	0.1	0.1
Ten-year government bond yield, average	..	5.4	5.5	4.3	2.9	2.4	2.4

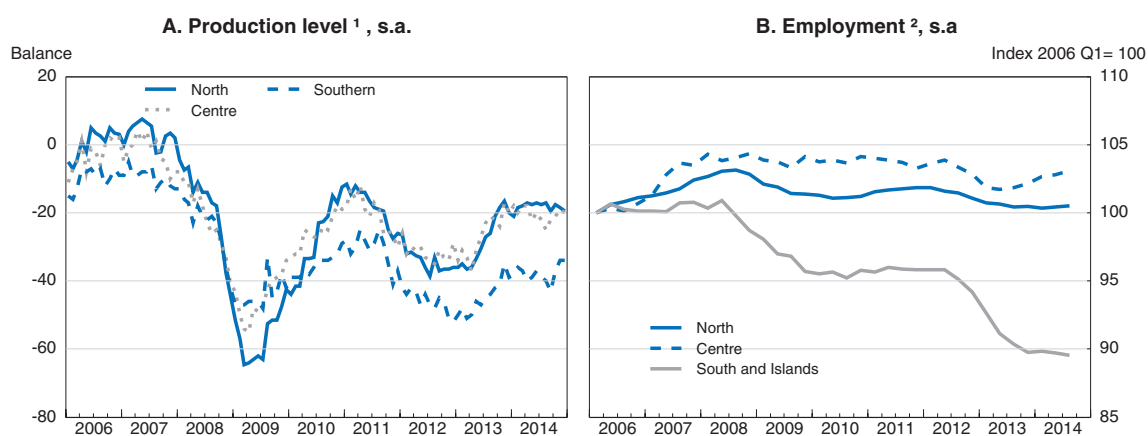
1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of household disposable income.
4. As a percentage of GDP.

in sustaining market confidence in Italian debt, but market sentiment could turn against Italy with its history of low growth and high debt, especially in the absence of other measures to sustain aggregate demand in the euro area. The general level of interest rates and the risk spread against Germany could rise, further delaying the point at which public debt will fall significantly. Containing this risk will require continued political commitment to steady debt reduction. More prolonged weakness in other euro area countries would undermine the hopes of stronger net exports, while a key internal risk is that the ambitious reform programme is somehow derailed or the political commitment to reform fades. This would damage confidence and the prospects for economic recovery.

On the upside, investment tends to be quite volatile in recoveries and, having fallen so much, it could rise more quickly with a return of confidence and available finance. Furthermore, the weakening euro could give a stronger boost to net trade, while lower energy prices benefit Italy directly as a major energy importer but also through the effects on effective demand of increased real incomes in important trading partners.

The recession has accentuated the longstanding regional divide. Italy has long suffered from large divergences between the north and south with respect to key socio-economic factors such as unemployment, female participation, household incomes, and many types of crime, especially violent crime. The recession's impact on both economic activity and employment has been more severe in the south than the north (Figure 3). Internal migration might be expected to serve as a safety valve, with people moving from low- to high-employment parts of the country. Indeed, in the 1950s and 1960s there were quite high rates of net emigration from the south, both to northern Italy and to other countries. However, in recent years, despite the widening gap in unemployment rates, net migration has been low. The planned constitutional change, centralising responsibility for key policy areas such as active labour market policy and competition, should help reduce the regional divide.

Figure 3. Recession has widened the regional divide



1. Business survey of production levels, manufacturing sector. Balance of companies responding that production has risen over companies responding that production has fallen.
2. Total employed, persons aged 15 and over.

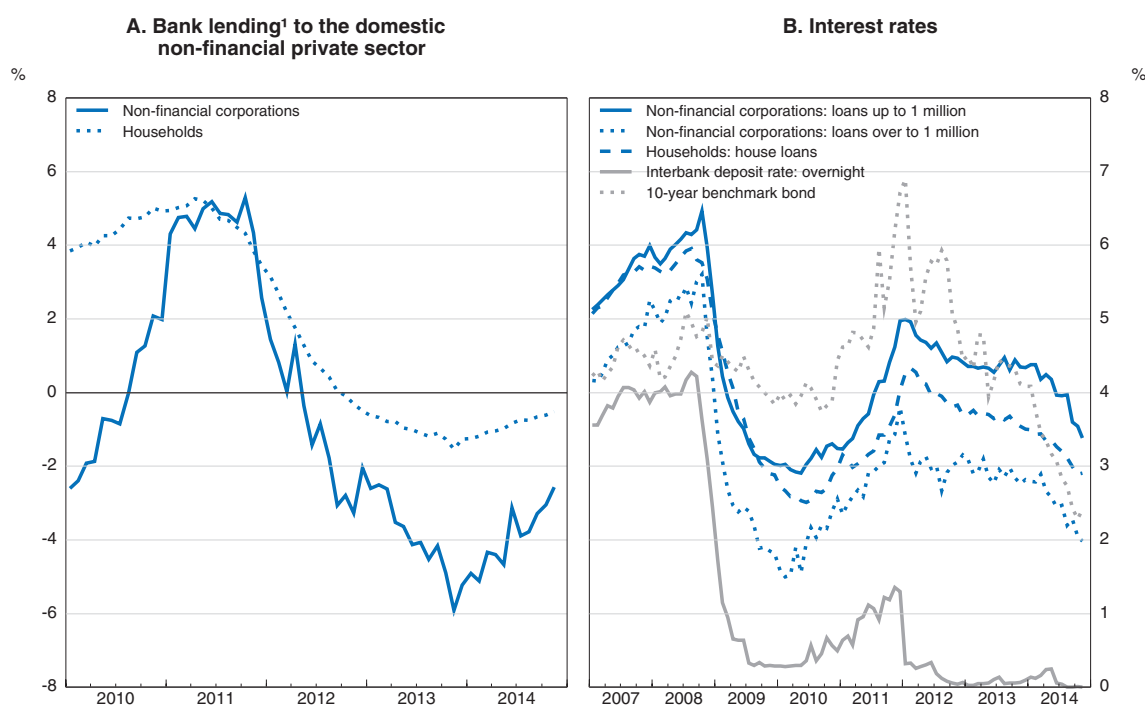
Source: Istat and Datastream.

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The prolonged recession has weakened banks and company balance sheets

Falling bank lending has been a contributory factor in the continuing recession (Figure 4). The banking system as a whole meets capital requirements, but even though provisioning has been improving, non-performing loans amounted to some 17% of total loans in mid-2014 and weigh heavily on the balance sheet of many banks. This accentuates their traditional conservatism regarding risky loans. It is probably one reason why interest rates to the private sector have fallen less than those on government debt, as banks keep margins high to cover losses. The Asset Quality Review and stress tests – focusing on the capital required to survive three years of heavy losses – revealed in October 2014 that a small number of banks needed some recapitalisation, totalling around EUR 3 billion, or about 0.2% of GDP.

Figure 4. **Bank lending has been declining, while interest rates remain high for private borrowers**



1. Annual growth rate.

Source: Bank of Italy and Datastream.

StatLink  <http://dx.doi.org/10.1787/888933184678>

Reducing non-performing loans is a priority for any bank, as dealing with them ties up capital and burdens banks' loan officers with restructuring tasks rather than making new loans that could finance investment and growth. Banks are increasingly active in using the secondary market to sell these loans and it is important there are no disincentives to recognising the losses implicit in selling them. Further action is needed to achieve a lower level of non-performing loans. Despite reforms to the bankruptcy law itself, judicial processes remain slow and could be accelerated by expanding the use of specialised courts and out-of-court debt workouts. The disposal of these troubled loans can be accelerated by

setting up specialised asset management companies (“bad banks”) that would acquire them with appropriate haircuts (Gandrud and Halleberg, 2014); this process is already underway in the private sector, but at a slow pace. Some euro-area countries have successfully set up public bad banks. If progress remains slow, the establishment of a public bad bank could be envisaged in Italy. Meanwhile, together with changing the tax treatment of loan-loss-provisions, the government has taken a number of measures to improve the flow of finance to companies from non-bank sources, in its “Finance for growth” measures (Box 1).

Box 1. Recent government measures to increase “Finance for Growth”

The government has taken a number of measures to make it easier or cheaper for finance to flow to small companies or infrastructure projects and investment in general, as well as encouraging wider stock market listing to improve access to equity finance.

Easier access to credit. Some institutions previously prohibited from lending directly to companies, such as credit funds, securitisation companies and insurance companies, may now lend directly to firms. The withholding tax for EU investors on medium-long term financing, unlisted bonds and certain other securities is removed. The endowment of the Central Guarantee Fund has been increased and the scope of the Fund widened by including guarantees for mini-bonds issued by SMEs.

Fiscal and other incentives for investment. Measures recently enacted include a temporary tax credit for companies increasing their level of investment and a subsidy targeting loans to small and medium-sized enterprises for the purchase of machinery, equipment, capital goods and for investment in IT. A tax credit for incremental investments in R&D in the 2015-19 period has been introduced. A favourable “patent box” taxation on income deriving from direct/indirect use of intellectual property, patents and trademarks has been also introduced (see also Criscuolo and Appelt, 2015). Project bonds for infrastructure investment have been made cheaper and simpler to issue. Regulations governing the involvement of institutional investors in real estate have been relaxed.

Encouraging the supply of equity finance. The allowance for corporate equity has been increased and can also now be set off against regional corporate taxes (IRAP). Measures to simplify public listings by SMEs and by family companies include the possibility of multiple-voting shares, reduced minimum capital requirements, variable thresholds for compulsory takeover and an increased threshold for compulsory communication of holdings or admissible cross-shareholdings. The allowance for corporate equity is to be increased by 40% for newly-listed companies (Super ACE).

Early results are encouraging. Within the first few months additional lending SMEs from the “Sabatini law” fund was EUR 2 billion, and 26 new companies raised EUR 1 billion in bond issues.

Institutional reforms can be the basis for better policymaking and stronger implementation

The government has launched constitutional reforms in two important areas: the structure of parliament and the division of responsibility between central and sub-national governments. The reform of parliament will transform the Senate into a second-tier body. Since 1946 the two houses of parliament, the Senate and the Chamber of Deputies, have had equal powers and prerogatives in terms of drafting legislation, though they are elected

on different bases. Legislation can be passed from one to the other for modification. This can mean long and protracted negotiations, many amendments, and complicated legislation. Under the proposed constitutional change, which has already been voted by the Senate itself and the constitutional commission of the Chamber of Deputies, the Senate would have an equal legislative function to the Chamber of Deputies only for a narrow range of issues. For all other matters, the Senate would have the power only to propose modifications to drafts from the Chamber of Deputies. The Senate will also participate in monitoring the public administration and policy implementation. Reduced from 315 to about 100 members, it would be composed of a number of representatives for each region, drawn from members of the regional councils and mayors, and up to five notables nominated by the president of the republic.

The reform of centre-sub-national relations, which would reverse some of the changes introduced in a 2001 constitutional reform, would recentralise a number of devolved functions and eliminate concurrent competences. A number of OECD studies have drawn attention to the difficulties the current structure has generated in regulation and environmental policy (OECD, 2009b, 2013a, 2013c). Policy regarding energy and most infrastructure would revert to national level. The change would also convert the *de facto* abolition of the 110 provinces, which was achieved in 2014 through legislation and administrative measures, into a constitutional fact. One underlying principle will remain, with more limited scope of application: all matters that are not expressly reserved for central government will be regional competences. Regions with a balanced budget will be given more autonomy for as long as they keep their budget balanced. In addition, the public functions financing of all regions and municipalities will be based on standard indicators of costs and needs (which are already available on-line).

This important constitutional reform is expected to be completed by the end of 2015, when a referendum is planned. Once in place, the reform should permit more efficient policymaking, reduce ambiguity about who is responsible for what, avoid implementation delays due to sub-national government not following through on national legislation, and improve the coherence of the domestic market by reducing the extent of regulatory variation between regions.

The 2013 OECD *Economic Survey* noted that policy implementation appears to be a weakness (OECD, 2013a; O'Brien, 2013). Effective policy implementation needs well-designed and well-written (i.e. in clear and unambiguous language) legislation, effective public administration (ranging from prompt introduction of implementing regulations to effective enforcement of their specific provisions) and an efficient legal system to back up enforcement and prevent corruption.

Poor policy implementation can arise from various sources. For example, legislation has sometimes been unclear, or imposed unreasonable deadlines (Allio and Rangone, 2015). This can lead to non-compliance occurring inadvertently, but may also cover deliberate non-compliance and make it seem normal. Another problem can be institutional instability. If the structure or mandate of a body is changed too frequently, its ability to focus on its key tasks may be reduced. For instance, the anti-corruption agency created in 2004 was modified four times before its abolition in 2008. Its successor, ANAC, created in 2012, has had its mandate changed twice since then.

The language of legislation itself can be important. An OECD study on international investment agreements notes that French, UK and German agreements, covering several decades, used unchanged phrasing to refer to the period of validity of the agreement (Pohl, 2013). The equivalent Italian documents use at least a dozen different formulations. Unjustified variations in language (many of which were noted in Italian legislation by Clarich and Mattarella, 2010) can create unnecessary waste of time and, potentially, legal ambiguity. The ongoing process of regulatory simplification and codification of existing laws and regulations can also improve the transparency of legislation and should continue.

Difficulties with policy implementation have arisen from potential conflicts or overlapping responsibilities between levels of government. One example where this can occur is with environmental policy, where policy design is a central government responsibility, but implementation is delegated to the regions (OECD, 2013c). Energy planning and retail regulation are other examples where several levels of government have powers or responsibilities. The government's intention to clarify the division of responsibility between centre and regions, as well as the phasing out of the provincial level of government, could yield more decisive action.

Other difficulties with implementation can arise because legislation is introduced hurriedly, with the corresponding risk of insufficient attention to detail or poor assessment of possible alternative policies. For this reason the 2013 *OECD Economic Survey* recommended that less use be made of decree laws. The constitution reserves the use of decree laws for "urgent" measures. Given the long time scale over which structural reform takes effect, taking time to get the measures right, and to get effective parliamentary consent and "ownership" to improve the durability of the measures, will often be more important than "urgent" action. The reformed structure of parliament should allow legislation to be agreed more quickly without the use of decree laws; the time saved should be used to improve all aspects of the process, including drafting but also use of impact assessments and other processes designed to subject policy choices to scrutiny for efficiency and effectiveness. A proposed constitutional change will limit the use of "urgent" decrees to a specific list of issues, and also introduces the possibility of time-limited debate (imposing a vote by a definite date) in the Chamber of Deputies.

An inefficient public administration can be a barrier to effective implementation of reforms. Weaknesses in the Italian public administration have included absenteeism, low skills, mismatch, lack of transparency and cronyism (Department of Public Administration, 2008; Commission on corruption in public administration, 2012). Past reforms have tackled many of these areas, though progress has been slow. The government needs to continue its efforts to pursue more performance-oriented management and improve skill levels. The revision to public employment regulations that allows them to be reassigned more easily should improve both flexibility and skill-matching, if used by a management system that focuses on performance. Transparency has improved, and is an important tool in the fight to avoid waste and corruption, but more could be done. An example is to move to a more general freedom of information provision, where all information held by the public administration should be available on request to the public, except to protect privacy or security. This would contrast with the current duty to publish only information that is specified by law, although this covers a wide range of areas.

Monitoring and ongoing policy assessment is important

The current government is aware of policy implementation problems. It maintains a record, developed under the two predecessor governments, of the extent to which subsidiary legislation has been completed. This shows that much work in implementing legislation from both 2013 and 2012 remained to be done even in early 2014. By the end of 2014 about half the backlog had been cleared, though 383 specific pieces of subsidiary legislation were still needed to complete legislation from 2012 and 2013. Some policy changes were introduced rather hurriedly in 2014, such as changing the effective status of provinces in advance of considering the details of the constitutional law, which will not come into force until 2015 at the earliest. A number of measures introduced in 2012, for example the labour market changes, included provision for monitoring their impact so as to have concrete evidence on which to assess their effectiveness. This is a good idea which should be continued.

The government's approach of setting its reform programme within a broad three year timetable, together with broad consultation on proposals in the main reform areas (public administration, education, justice), is an important step in the direction of a more considered approach to policy making. A legislative timetable has been set out for the period 2014-15 and published on the Ministry of Economics and Finance website (Table 3).

Table 3. **Progress on structural reforms**

	Further measures foreseen
Fully legislated	
New labour contract	
Revised unemployment benefit	
Income tax cut. Tax benefits for small farmers	
Corporate tax: extended allowance for corporate equity; "patent box"	Ministerial decree requirement for confirmation
Courts: expansion of access to alternative dispute procedures	
Administrative justice	
Anticorruption measures; public procurement and infrastructure investment	
Expanded SME access to non-bank finance. Easier SME listing requirements	
Partially legislated	
Active labour market policy	Decree by June 2015
Minimum wage	Decree by June 2015
Administrative simplification for citizens and business	
Electoral law	Further confirmation votes in parliament.
Senate reform	Constitutional referendum
Central – sub-national relations	Further confirmation votes in both chambers. Constitutional referendum.
Further tax reform	Decrees due by March 2015
Strengthening sanctions against financial fraud and mafia; revise statute of limitations	Further confirmation votes in parliament
Yet to be approved	
Strengthening business courts	Decree pending
Liberalisation and deregulation in local services, regulated professions, network industries, etc.	Draft Competition Law planned for June 2015
Enhance strategic energy infrastructure	
Education reform for labour market	Draft legislation due in February 2015
Public administration reform	
Criminal justice reform	

Source: MEF (2014a).

Policies to improve productivity can cover a wide range of policy areas, in many different ministries, each with their own specific mandates. Generating comprehensive reform programmes across disparate ministries can be difficult. Some countries have found it useful to have an independent permanent productivity commission to investigate and advise on what structural reforms are needed and to advocate reform. Australia has had an effective commission for a long time. New Zealand and Mexico recently introduced similar bodies, while Norway instituted a commission with a two-year mandate. Early signs suggest that they are working well. In Mexico, success has led to moves to integrate the commission more systematically into the legislative process, including a requirement that the government publically respond to its policy recommendations. Productivity commissions have been found to play a useful role in the public debate when they provide advice that is independent from political considerations and based on sound research, which both enhance credibility (Banks, 2011). Such a commission, with a mandate to provide advice to the government on matters related to productivity, to promote public understanding of reforms, and to engage in a dialogue with stakeholders, would be useful in Italy. Its recommendations would be able to take account of analysis by international institutions but could be better tailored to specific country characteristics.

A more efficient judicial system and efforts to tackle corruption

Important steps have been taken to improve efficiency in the judicial system. Measures to gain economies of scope and scale through amalgamation of small courts, thus allowing some specialisation by judges as recommended in previous OECD work (OECD, 2013a; Palumbo et al., 2013), are being implemented, for example in labour law. The planned establishment of specialised business courts should be swiftly implemented. Another OECD recommendation, to modify the application of the statute of limitations to reduce the incentive to prevarication, has also been implemented. Other steps, including consideration of measures to limit the very high rate of appeal, could further improve efficiency.

Reducing corruption and improving trust in Italy must also remain a priority (OECD, 2013d). The new anti-corruption agency ANAC needs stability and continuity as well as support at all political levels if it is to effectively monitor the public administration and providers of public services and infrastructure. Following revelation of major waste of public funds, at least partly due to corruption, in important public infrastructure projects, the national agency formerly responsible for overseeing public works projects (AVCP) was absorbed into ANAC. The government's view was that the task of ensuring value for money and preventing corruption can be mutually reinforcing given that much corruption in public administration affects public procurement. In the longer run, it might be efficient to have a separate agency like AVCP to concentrate on value for money, while ANAC focuses on ensuring that measures to avoid corruption are in place. Until recently, ANAC, unlike other "authorities" in Italy such as the competition authority, has been essentially a monitoring and reporting institution, focusing mainly on anti-corruption and transparency procedures and practices in public agencies rather than specific instances of corruption. It has now been given some additional powers, however. ANAC can submit files for court proceedings to the judicial authorities and can also request that the local Prefect put firms, or parts of firms, suspected of being involved in corrupt behaviour with regard to public procurement into compulsory administration.

Recommendations to boost efficiency through institutional reform

Key recommendations

- Follow through the reforms of parliament and the re-assignment and clarification of policy competences between the centre and sub-national government.
- Ensure that legislation is clear, unambiguous and supported by improved public administration, including through reduced use of emergency decrees.
- Further streamline the court system, with more specialisation where appropriate; increase the use of mediation; enhance monitoring of court performance.
- Consider establishing a Productivity Commission with the mandate to provide advice to the government on matters related to productivity, promote public understanding of reforms, and engage in a dialogue with stakeholders.
- Reducing corruption and improving trust must remain a priority. For this, the new anti-corruption agency ANAC needs stability, continuity as well as support at all political levels.

Other recommendations

- Support active and independent action by the anti-corruption agency, complementing the pursuit of increased efficiency in the judicial system.

Labour market and competition reforms to improve productivity and well-being

If successful, the reform programme could make Italy a place where families can live better lives. While life is already enjoyable for many, especially in terms of work-life balance, some dimensions of well-being rank low relative to other OECD countries (see Figure 1). Some of these, such as low scores on education and skills, civic engagement and governance, contribute to the economy's poor performance. Large gender gaps between men and women in terms of well-being, labour-market participation and wages deprive the country of an important source of dynamism.

Inefficient labour market institutions contribute to low labour utilisation. The crisis aggravated weaknesses in the labour market: low participation, high structural unemployment and increasing duality. The unemployment rate has been between 12% and 13% since mid-2013 with large regional disparities: it is as high as 20% in the south. High structural unemployment and low participation rates leave many people out of employment. The proportion of young people neither in education nor employment (NEET) has risen by over 6 percentage points since the onset of the crisis, reaching nearly 23% by the end of 2013, the second highest share in the OECD. Stringent laws and weak employment prospects also encourage developments in the underground economy: the Italian National Statistical Institute, Istat, estimates the number of workers in the underground economy is equivalent to 12% of total employment.

Protecting individuals rather than specific jobs

Current legislation provides very strong protection for employees in larger firms (over 15 employees) with indefinite employment contracts, accounting for about 50% of total employment, with less protection for those in small companies and very little security for the rest. Under the existing legislation, dismissed workers can file a case in court claiming

that their dismissal was unfair and claim monetary compensation and/or reinstatement. A reform in 2012 restricted the possibility of reinstatement to cases in which the alleged justification was unfounded (Table 4). This reform reduced somewhat the frequency of reinstatements (Bank of Italy research suggests by as much as one third), but gave rise to many interpretation problems which have slowed down the judicial process.

Table 4. **Recent reforms easing regulation on labour market contracts in selected countries**

	Italy	Spain	France	United Kingdom	Greece	Portugal
Reduce procedural inconvenience for dismissal cases		x	x		x	
Reduce severance pay for permanent contracts	1	x			x	x
Relax the definition of unfair dismissal			x			x
Reduce compensation for unfair dismissal		x				
Reduce possibility of reinstatement for unfair dismissal	x					x
Reduce regulation on collective dismissals	x	x			x	
Reduce regulation on non-permanent contracts	x	x	x		x	x
Increase regulation on non-permanent contracts				x		

Note: The 2012 reform relaxed employment protection rules on permanent contracts, notably limiting the possibility of reinstatement following unfair dismissal. The 2012 reform reshaped incentives to hire on fixed-term contracts; no justification required for the first fixed-term contract if its duration does not exceed one year, which was extended to three years in early 2014; the interval period between two fixed-term contracts was extended, which was withdrawn in early 2014.

1. There is no severance pay in Italy.

Source: OECD (2013), *OECD Employment Outlook 2013*, OECD Publishing, Paris; and EPL indicators.

With the “Jobs Act” adopted in December 2014, the government has a mandate to introduce measures to rationalise employment protection, expand active labour market policy and make social protection more effective. Such policies will improve skill matching and enhance productivity. To rebalance job protection, a standard contract with employment protection increasing with tenure was introduced in early 2015. This further limits the possibility of reinstatement of workers following unfair dismissal, excluding this possibility for dismissal for economic reasons (*motivo oggettivo*). These new arrangements imply quite radical changes for Italy. To avoid unwarranted disruption, they are applied only to new employment contracts (“grandfathering” existing rights).

The new contract provides a basic level of protection for the first two years, after which the level of compensation for unfair dismissal increases up to a maximum of 24 month’s wages. Such contractual arrangements will benefit both the employer and the employee, since they facilitate more job creation for those with little professional experience while paving the way to more stable professional careers.

The reform ensures that workers judged to be unfairly dismissed for objective reasons (i.e. where the firm gives economic or technological changes as reasons for the redundancy) are not eligible for reinstatement, with firms providing monetary compensation instead. By increasing predictability this lowers the effective costs of dismissal, even if judged to be unfair by courts, helping firms create more jobs. The reform should substantially reduce the average amount of such compensation, which is currently very high, averaging about 21 months of salary against the OECD average of 14 months. It also envisages that courts can judge only a few well-defined issues: discriminatory dismissal; the proof of dismissal motivation; and wrong dismissal procedure.

The Jobs Act also introduces a new form of out-of-court procedure, according to which the employer can pay the worker an indemnity equal to 1 monthly wage per year of service (a minimum amount equivalent to 2 monthly wages and a maximum amount equivalent to 18 monthly wages). This compensation could be considered as similar in some respects to severance pay. The acceptance of this transaction prevents any further dispute by the worker, that is, appealing to courts for a dismissal to be unfair or not. Both parties have a strong incentive to settle the dispute through this procedure, since the sum paid is not subject to social contributions or taxation. The government should monitor the developments on this new procedure and, if necessary, it should consider alternative measures to reduce uncertainty on court decision.

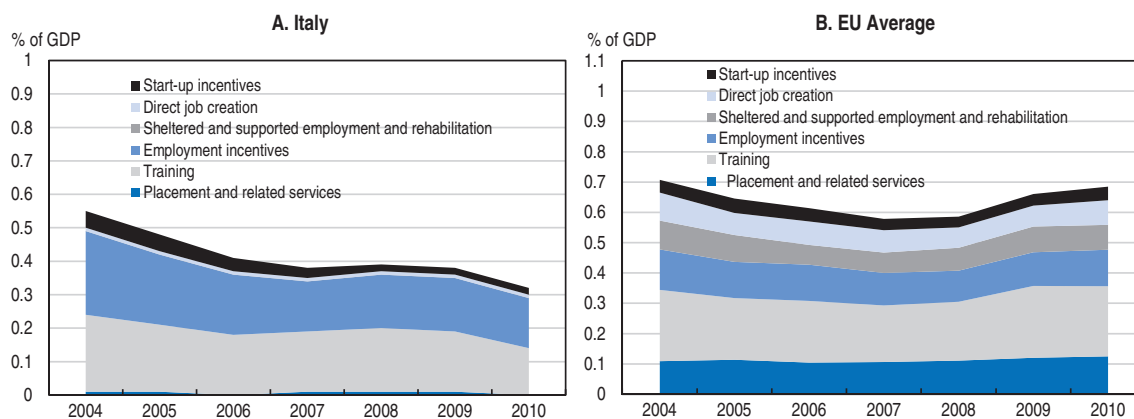
All of these reforms, if fully rolled-out, will go a long way towards making Italy's labour market institutions more efficient, thus improving the allocation of labour resources and increasing productivity. They will reduce legal risk and financial costs associated with dismissal provisions, which have been identified as the most burdensome and affecting job creation (OECD, 2013b). Less frequent recourse to the courts and more rapid court decisions will reduce the difficulties faced by employers, thus encouraging more job creation. Altogether, this will improve turnover on the labour market, resulting in better skill matching and, therefore, greater ability of firms to adapt the skill profile of their workforce to their changing environment.

Increasing job-matching efficiency and workers' skills

The government identifies active labour market policy (ALMP) as a priority. The EU Youth Guarantee scheme has been in force since mid-2014. The Youth Guarantee programme targets those who are 15-29 years old within four months after leaving school or being laid off. This programme offers a range of activities which facilitate school to work transition for young people, including guidance, training, apprenticeship or traineeship places, and incentives for firms to hire young people.

The Jobs Act further strengthens ALMPs and creates a National Employment Agency. The Agency will be responsible for co-ordinating ALMP policy, currently the responsibility of local governments, including co-ordination with social benefit providers. OECD studies show that different people need different kinds of measures and that profiling their needs can help to determine who is job-ready and who should receive more comprehensive help (OECD, 2013b; Jin et al., 2015). For example, most displaced workers find jobs needing similar skills to their previous employment; in such cases, measures facilitating job matching such as career orientation and placement services are important. Currently ALMP spending is concentrated on job training (Figure 5). Employment training is expensive and should be targeted at specific groups such as the long-term unemployed and low educated people, provided they show that they are motivated to seek work (OECD, 2013b).

Labour market policy improving workers' existing skills and matching them with available jobs needs to be supported by an education system that provides initial knowledge and skills needed in the labour market. Both PISA (Programme for International Student Assessment) data on school student performance and new PIAAC (Programme for the International Assessment of Adult Competencies) data on adult skills show that Italy lags many countries in this regard. Education policy has been constrained by funding cuts, but needs to continue its effort to improve its performance, including the development of post-secondary technical schools and improving vocational schools, in co-ordination with industry's needs.

Figure 5. **ALMP spending is relatively low and concentrated on some categories**

Source: OECD Economic Outlook 96 (database).

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Providing adequate labour incentives and targeted social benefits

A more efficient social security system is important so that displaced workers are protected against poverty and given facilities to help finding new jobs, while avoiding pervasive disincentives for labour supply. In Italy, the unemployment benefit system has been very generous for certain workers, notably those in the industrial sector. Other workers have had little cover. Indeed, social benefits as a whole are poorly targeted and tend to provide least income protection for those who already have least protection in employment.

In 2012 the government at the time began streamlining the benefits system, by gradually integrating the standard unemployment benefit and extensions of the short-time working scheme (which has become a *de facto* unemployment scheme) into a new unemployment benefit, *Assicurazione Sociale per l'Impiego (ASpI)* by 2017. The current government has recently adopted a draft decree adopting a new unemployment benefit system which extends coverage to all dependent workers.

The new legislation introduces conditionality for unemployment benefit, requiring recipients to participate in activating measures proposed by the employment service; full definition of this conditionality will be defined in later decrees. Without such an obligation, unemployment is likely to be higher than otherwise and training inefficient. For example, the obligation could consist of periodic interviews and mandatory referrals, enforced by benefit sanctions, to employment and training programmes where appropriate (OECD, 2013b). The National Employment Agency, in co-ordination with the national social insurance provider (INPS) and the local public employment services should develop and enforce appropriate conditionality.

More flexible wage setting

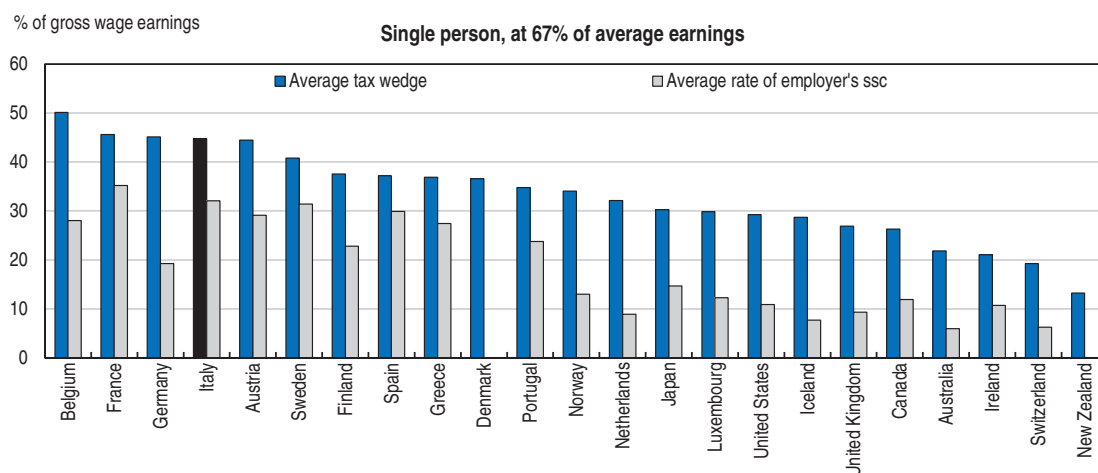
The response of wages has been weak compared with those in some of the hardest hit European countries. For some time after the crisis began it seemed to be having very little effect on wages, partly because most collective bargaining settlements cover a three year period. Growth in contractual wages has declined through time, but only rather slowly, making it difficult to improve labour cost competitiveness given Italy's poor productivity performance.

Flexible wage setting is important in achieving low structural unemployment rates and in mitigating the direct impact of shocks on employment by facilitating adjustments (OECD *Employment Outlook* 2014). Since joining the European monetary union, the Italian system has not adapted to the impossibility of periodic devaluation to compensate for too high wage growth relative to productivity. As a result, competitiveness has suffered. *Contratti collettivi nazionali di lavoro*, the three-year industry agreements at national level, play a dominant role in wage setting. They are applied uniformly across the country, so wages are influenced mainly by the economic conditions prevailing in the leading sectors and regions. Firms cannot easily adjust wages to suit their conditions in terms of productivity and competitiveness.

Agreements between the social partners in 2011 and 2012, still in force, allow more local flexibility in wages and non-wage terms. However, they have not had much effect so far, as they allow only incremental adjustments to collectively agreed terms. Firm-level deals could take into account local conditions, and could adjust other working practice, such as arrangements to adjust weekly working hours. This would improve firms' ability to respond to changes in market conditions, another contribution to improving competitiveness and employment prospects. In Spain, reforms to wage bargaining, including for firms to opt out fully from sectoral wage contracts, are credited with having helped competitiveness (OECD, 2014). In Italy such "opting-out" clauses exist but are little used in practice, as firms need to strike a deal with all trade unions, which can be complicated to achieve. Wage flexibility would be greater if firms deciding to opt out of collective wage bargaining were allowed to strike a deal with trade unions representing a majority of employees, rather than all trade unions.

The Jobs Act provides for introducing a legal minimum wage on an experimental basis, for sectors not covered by national collective agreements. This can induce wage rigidity, resulting in higher unemployment, if not carefully designed or if the minimum wage is set too high. Given the sharp regional divide in Italy, the minimum wage should be set at different levels in different regions, taking into account such factors as variations in the cost of living and productivity levels; such a system is currently used in the United States, Canada and Japan. Otherwise, workers in the south will be priced out of employment while those in the north will subsist on too low a wage.

The tax wedge has been high in Italy, but especially so among low-income earners (Figure 6). Social security contributions on employees are the second highest in the OECD. For new hires in 2015 on permanent contracts, the government has removed employers' social security contributions from 2015-17. The tax wedge for these new hires will be reduced substantially; for an employee (single, no children) with gross earnings of EUR 20 000 (around 67% of average earnings), the tax wedge falls by 18 percentage points. Taking into account the regional business tax (IRAP), presently not included in the methodology used in the OECD publication *Taxing Wages*, the removal of labour costs from IRAP results in an even larger fall in the tax wedge of some 20 percentage points (from 46.1% to 26.7%). This should stimulate employment, along with the cut in income tax of a fixed amount per month up to a certain income limit (and phased out above that limit) introduced in 2014. Including the impact of that income tax cut, the tax wedge for the same employee falls from 46.1% in 2013 to 21.9% for the first three years of a permanent contract started in 2015. In addition, a change in the forced saving scheme (*Trattamento Fine Rapporto*), allowing employees to receive it directly (though they thereby lose a tax advantage), can also be interpreted as similar in some respects to a reduction in the tax wedge, of nearly 4 percentage points (the methodology used in the OECD publication *Taxing Wages* does not treat deductions such as the TFR as taxes).

Figure 6. **The tax wedge for low-income workers is high**

Source: OECD, *Taxing Wages*, OECD Tax and Wages Model.

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Encouraging participation

Italy has very low labour force participation. This is especially true among women and in the south. To some extent, the large informal sector may make up for this, but by no means entirely. In the past, the pension system imposed a high implicit tax on continuing work, explaining low participation among older age groups. With the acceleration of the phasing-in of the reformed system and rises in the retirement age, participation among older age groups has begun to rise noticeably. Participation by 55-64 year olds rose from 46% in 2008 to 57% in 2013 and has begun to catch up with that in other countries, though still remains below most. The pensionable age is now set to rise in line with life expectancy, so further increases in participation can be expected.

The female labour force participation rate is among the lowest in the OECD: 54.4% against the OECD average of 62.6% in 2013. This is strongly influenced by social norms, including responsibility for caring for children or older family members. Availability of child care facilities is very limited in Italy. Only 24% of Italian children up to three years old are enrolled in formal childcare, against the OECD average of 33%, and some 8% of women withdraw from the labour market for family care reasons. The birth rate is very low, so child care provision might have less impact on female employment than elsewhere, but the traditional female role as carer for elderly parents is probably just as important. The government intends to support female labour force participation by increasing child care facilities and introducing a tax credit for low- and medium-income families with children.

Liberalising services and improving competition

In addition to reform specifically targeted at the labour market, policies in product markets can also boost job creation, if well-designed. This concerns particularly markets that remain closed to entry, preventing new firms from bringing new competition and raising activity. Previous OECD *Economic Surveys* and *Reviews of Regulatory Reform* have made recommendations on liberalising services and improving competition. Reforms launched in 2012 made progress in a number of areas, including some liberalisation of the regulated professions (such as lawyers, accountants, architects, pharmacists, etc.), and better

regulation of water and transport. It remains particularly important to promote more effective competition, especially in network industries, local services, regulated professions and the retail sector. There are still barriers to entry that need to be reduced or eliminated; failure to do this in the area of taxi and legal services illustrates the political difficulties involved.

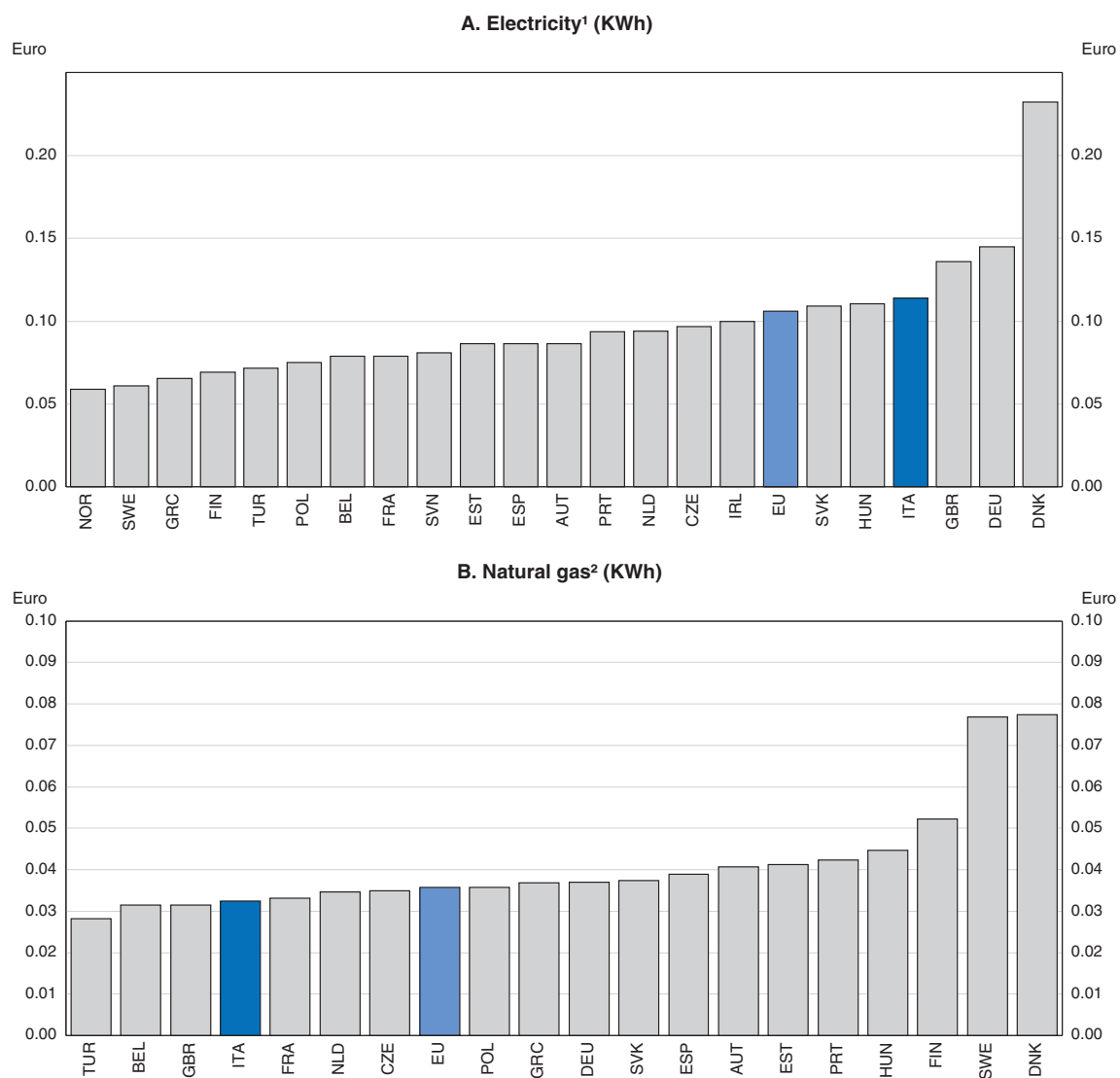
Local public services (such as public transport, water treatment and supply, waste management) are in many areas dominated by monopolies assigned to companies either owned directly by, or closely related to, local government. Public tenders are normally required but seem to be frequently manipulated and can be dispensed with under some conditions. Local authorities have to publish on their websites reports on the tendering of local services and justify the choice on a specific method of contract award. In addition, they have to send this report to the observatory of local public services at the Ministry of Economic Development. Since 2012, the competition authority has had powers to question some actions by local authorities; and there are new transparency measures for local public expenditure that should make it clearer how public money is being spent. New regulators have been set up, in line with earlier recommendations, for water and transport. They must now be assured of the opportunity and resources to carry out their mandate independently. These measures should be made to work together to improve value for money through a combination of increased competition in the market. Where there are natural monopolies, competition “for the market” can be employed through competitive tendering for the right to run services for a certain number of years. In some cases, privatisation of existing public entities may be an essential step towards increasing competition. The 2015 budget law allows revenue from such privatisation to be excluded from the provisions of the internal stability pact.

At the national level, high energy prices have been a cost disadvantage for Italian companies. Italy has few indigenous low-cost energy sources other than significant hydro-electric power in the north, so somewhat higher prices than neighbours can be expected. However, high prices have also reflected inadequate infrastructure links with the rest of Europe, though connections have improved in recent years. The gas market shows how deregulation and links with the European market can bring down costs. Until 2012 spot wholesale prices for gas could be 20% or more higher than other European countries (GME, 2014). This gap has now completely closed following liberalisation of the spot market and ownership unbundling, an illustration of how some measures can have rapid effects (Figure 7). Electricity prices remain well above other countries, however, although some liberalisation has occurred. This is partly due to raw material costs and the impact of the dash for renewables, but better transmission infrastructure, further liberalisation and effective regulation would reduce the gap, as in the case of gas.

In addition to reforms to increase productivity and output, important reforms are needed to reduce losses to living standards through pollution and other environmental damage. The recent OECD Environmental Performance Review has many recommendations in this area, which could both improve environmental outcomes and reduce the associated costs (OECD, 2013c). These include streamlining energy efficiency incentive measures and ensuring that multiple incentives do not entail excessive costs. The use of price-based mechanisms should be extended, such as pollution and congestion charges, to reduce emissions from vehicle use in urban areas, and vehicle taxation should be restructured to include components reflecting CO₂ emissions and other environmental externalities.

Figure 7. **Low gas prices, high electricity prices**

Industrial sector, 2013 or latest year available

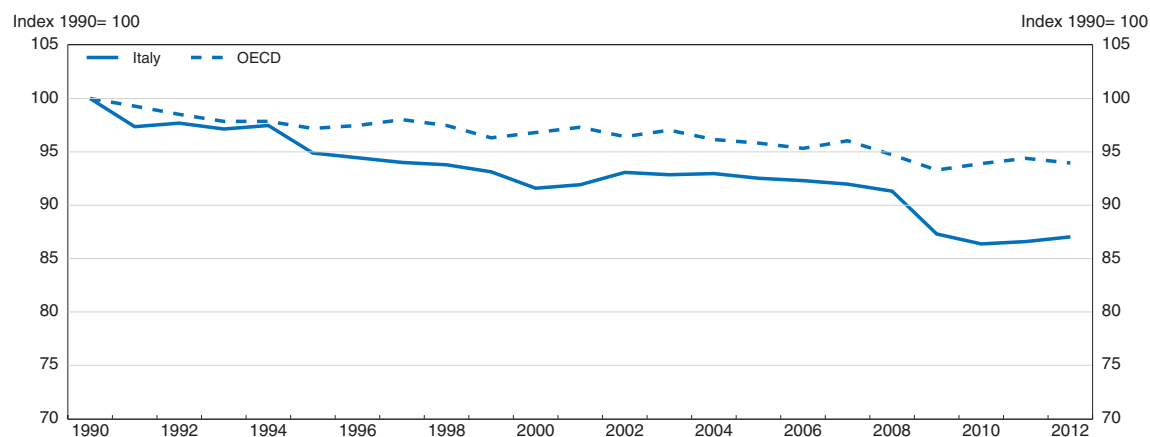


Source: Eurostat.


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In the framework of the EU Burden Sharing Agreement to achieve the EU-wide target under the first commitment period of the Kyoto Protocol, Italy committed to reduce its GHG emission by 6.5% below the 1990 level (which was already low compared with many countries) over 2008-12. Italy needs to purchase carbon credits to reach this target, but the necessary financial resources have not been allocated yet: average 2008-12 emissions were 4.6% below the 1990 level (ISPRA, 2014). This is despite Italy performing somewhat better than the OECD average in reducing carbon emissions per unit of primary energy supply (Figure 8).

Figure 8. **Carbon intensity index¹ of the energy mix**
CO₂ emissions from fuel combustion per total primary energy supply, index 1990 = 100



1. The IEA Energy Sector Carbon Intensity Index (ESCII) tracks how many tonnes of carbon dioxide (CO₂) are emitted for each unit of energy supplied (TPES, total primary energy supply). It shows the global aggregate impact of changes in supply technologies over recent decades.

Source: IEA (2013), "Indicators for CO₂ emissions", IEA CO₂ Emissions from Fuel Combustion Statistics (database), International Energy Agency. StatLink  <http://dx.doi.org/10.1787/888933184712>

Italy's strategy for climate mitigation has relied heavily on promoting renewable energies through economic incentives. The incentives have not been well-coordinated and have been repeatedly changed, which has created some uncertainty in the markets. Between 2009 and 2012 electricity generation from renewables was supported by three different mechanisms: a feed-in premium for photovoltaic, a tradable (green) certificate scheme and technology-specific feed-in tariffs for all other renewables. The cost of these incentives is recovered via a surcharge on electricity bills. Italy's incentives to renewables have been generous, leading to a substantial increase in renewables generation, meeting European targets, but have led to increasing costs for retail electricity consumers and entailed high GHG abatement costs (OECD, 2013c). Specific measures to reduce electricity costs for small companies were also introduced. To cut costs quickly, some changes were made retroactively and revised incentive programmes appear to be more cost-effective (IEA, 2015). However, the retroactive features of these changes may undermine investor confidence and increase the cost of capital for future investments.

Policy recommendations for the labour market and competition

Key recommendations

- Fully roll-out the new standard contract for new hires, with employment protection rising with job tenure, while grandfathering existing contracts.
- Change the composition of spending on active labour-market policy: limit training programmes to those who need them most; tailor assistance to job seekers according to their specific situation.
- Encourage female labour force participation with more flexible working-hours arrangements, and promote wider provision of good quality care of children and the elderly.

Policy recommendations for the labour market and competition (cont.)

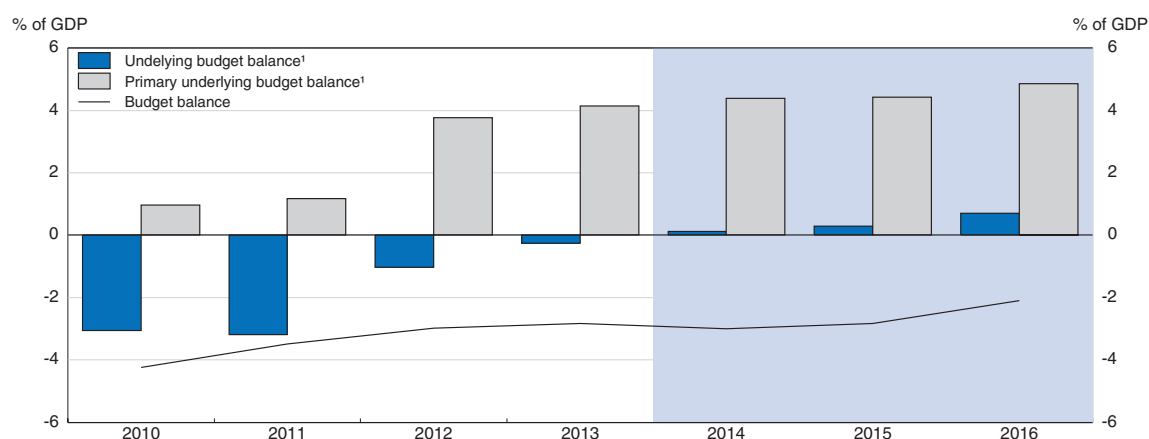
- Fully implement the unified unemployment benefit system. Require recipients to actively seek work, and to accept employment or training when offered.
- Encourage social partners to allow modification of national wage agreements at the firm level, through agreement with representatives of a majority of the firm's employees.
- Adopt a competition law following the recommendations of the competition authority to introduce competition into local public services, improve competition in insurance, banking, network industries, the regulated professions and retail trade.

Other recommendations

- Carefully monitor the impact of the labour market reforms in reducing the recourse to legal action. Consider generalising automatic severance pay linked to length of service in case of dismissal for objective reasons (redundancies) at affordable levels no higher than the OECD average.
- Carefully monitor action to tackle youth unemployment.

Addressing fiscal and financial challenges

Italy's underlying fiscal situation has improved, although this improvement remains partly hidden by the large cyclical downturn. Past efforts have established the preconditions to put the debt-GDP ratio on a downward path when growth returns. Adjusting for the effects of the recession and excluding interest payments, the budget balance has improved by 4-5 percentage points of GDP since 2009, with most of the adjustment occurring in 2012 (Figure 9). A small structural surplus is expected by the OECD for 2015. National and EU commission estimates of the output gap are lower than the OECD's, so the budget is still estimated to be in structural deficit (Table 5). Further tightening was envisaged by the government in its April 2014 Stability programme, but was delayed in order not to stifle domestic demand, a position that was justified as the euro-area economy has proved exceptionally weak.

Figure 9. The underlying primary budget surplus is now large

1. As a percentage of potential GDP.
Source: OECD Economic Outlook 96 (database).

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Table 5. **Fiscal consolidation in successive budgets**

Structural budget balance (structural primary balance), % GDP

	2011	2012	2013	2014	2015	2016	2017	Level of debt predicted for 2017, % GDP ^{1, 2}
2012	-3.6 (1.3)	-0.9 (4.6)	0.0 (5.9)	-0.2 (5.7)	-0.4 (5.7)			105
2013	-3.6 (1.4)	-1.3 (4.3)	-0.4 (5.0)	-0.3 (5.1)	0.0 (5.3)	0.0 (5.3)	0.0 (5.2)	115
2014		-1.5 (3.7)	-0.7 (4.2)	-0.9 (3.8)	-0.6 (4.0)	-0.4 (4.1)	0.0 (4.2)	125

1. Debt due to financing the EFSF and ESM, about 3.6% of GDP, is excluded. Debt projections in the original budgetary documentation have been adjusted to take account of the revised system of national accounts.

2. The 2012 budget did not project debt beyond 2015; the table shows an estimate for 2017 based on the projected figure for 2015.

Source: Ministry of Finance, "DEF Update" for successive years.

Reading note: The pre-budget documentation issued in September 2013 foresaw a structural deficit of 0.3% of GDP for 2014, a structural primary surplus of 5.1% of GDP. The same projections expected the debt-to-GDP ratio (adjusted for the exclusions in Note 1) to fall to 115% by 2017.

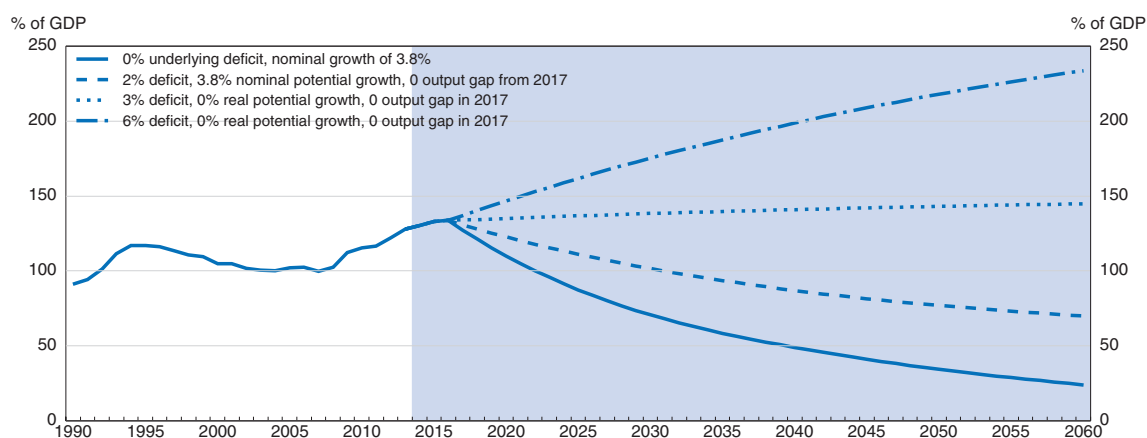
Official forecasts need to be cautious in order to avoid revenue shortfalls and spending overruns if growth turns out to be weaker than expected, especially when these forecasts are subject to large downside risks. In the future, verification of the official forecasts by the newly-created Parliamentary Budget Office – "Ufficio parlamentare di bilancio" (UPB) – may encourage greater cautiousness when forecasting short-term prospects for the economy and the fiscal position. The UPB's mandate does not require it to carry out forecasts itself; its ability to assess government forecasts would be improved if it nevertheless develops its own forecasting expertise.

On OECD calculations, Italy will have a structural budget surplus after the planned tightening in 2015-16. Even assuming a smaller output gap (a little over 4% in 2014 compared with the OECD estimate of nearly 6%), the Ministry of Economy and Finance estimates that the cyclically adjusted budget net of one-off measures will reach balance in 2017. Under the EU fiscal rules Italy would then have reached its medium term obligation. Technically, the debt rule (under which a country should keep tightening the budget if the debt-to-GDP ratio does not fall by one twentieth of the difference between its level and 60% each year) implies that Italy should tighten more. However, given the weak economy, the fiscal stance appears appropriate and Italy should take full advantage of the flexibility allowed by European Union rules.

With the budget in structural balance already in 2014, Italy has reached the point needed to bring the debt-to-GDP ratio down in the medium term. Once the output gap closes and growth converges on trend, debt would fall steadily, reaching 60% of GDP soon after 2030 (Figure 10; see also Denk, 2013; OECD, 2013a). With the lower estimate of potential output used by the government, debt will still fall, though somewhat more slowly. Estimates of potential output (and, therefore, the output gap) and also of future potential growth are quite uncertain. If growth does not return, or if current estimates of slack are much too high and the budget deficit returns to its 30-year average (6% of GDP), debt will decline more slowly or could drift upwards.

Sustaining a strong fiscal position will depend to a large extent on Italy's ability to keep the confidence of financial markets and to secure low risk spreads. Gross debt issuance is the equivalent of over 20% of GDP each year, so retaining the confidence of bond investors is essential. To achieve debt reduction, it will be essential to avoid repeating past mistakes and keep the budget balance on track. Once debt falls, some tax cuts or growth in non-interest expenditure would be feasible if interest rates remain low.

Figure 10. Debt will decline if the budget remains balanced



Note: Simulations assume the output gap closes by 2017. With a balanced budget and nominal growth at 3.8% of GDP (as in OECD@100) the debt-to-GDP ratio declines to 60% within 20 years, in line with EU rules.

Source: Ministry of Finance and OECD calculations and estimates.

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Keeping track of contingent liabilities

There are potential risks from hidden debt. One source of risk has been payment arrears of sub-national government and other bodies. It is still not known exactly how large these are; steps have been taken to improve centralised information on such debts. The government made provision to pay off the equivalent of about 4% of GDP of such debt during 2013-14. Later estimates were that the total figure was less than this; by late 2014 debt worth about 2% of GDP had been paid off and the government estimate that a further amount of no more than 1% of GDP was required. New accounting methods and the electronic invoicing already implemented should allow keeping better track of these liabilities. Other sources of possible future debt are contingent liabilities such as guarantees, liabilities of state-owned enterprises and potential costs of bank rescues that could be required under crisis conditions. Budget documentation shows contingent liabilities of EUR 99 billion (about 6% of GDP) in state guarantees, of which EUR 82 billion are to the financial sector. This data is regularly reported to Eurostat, helping to improve transparency; more could be done to assess potential vulnerabilities, which would enhance confidence in the sustainability of public finances.

Table 6. Public debt, arrears and contingent liabilities, 2013

	Billion EUR
Government debt, Maastricht definition	2 070
of which: Loans to foreign entities (bilateral, EFSF and ESM)	56
Contingent liabilities	
State guarantees	99
of which: Financial sector	82
Memorandum item:	
GDP, 2013	1 619

Source: Ministry of Economy and Finance, Bank of Italy and Istat; based on Eurostat methodology.

On the positive side, future spending commitments for public pensions have been brought under control. Following measures taken in 2012 they are even set to decline by as much as one per cent of GDP over the next 10 years before increasing somewhat thereafter. Nevertheless, they still represent a higher proportion of GDP in Italy than in most other countries.

Improving the efficiency of public spending

Given the prospect of a tight budget situation for some years to come, scarce public resources need to be used as efficiently as possible. The current and previous governments have launched a number of initiatives to improve efficiency in public spending. Benchmarking comparisons can say a lot about public spending efficiency. For example, in 2009 a comparison of expenditure on compulsory education with PISA results showed that many countries got better results with similar expenditure or the same results with lower expenditure (Boarini, 2009; OECD, 2009); since then education spending has been reduced significantly, with no deterioration in Italy's PISA results.

A spending review set up in late 2013 set out to apply benchmarking in a wide range of comparisons, though not all studies were completed. Other methods identified savings from better use of technology, reorganisation, amalgamation or abolition of public bodies, including at local and regional level. Taking all items together, the spending review estimated (on what it described as conservative assumptions) that the ratio of primary spending to GDP could be reduced by as much as 2 percentage points by 2016 (Commissario straordinario, 2014). These are large savings.

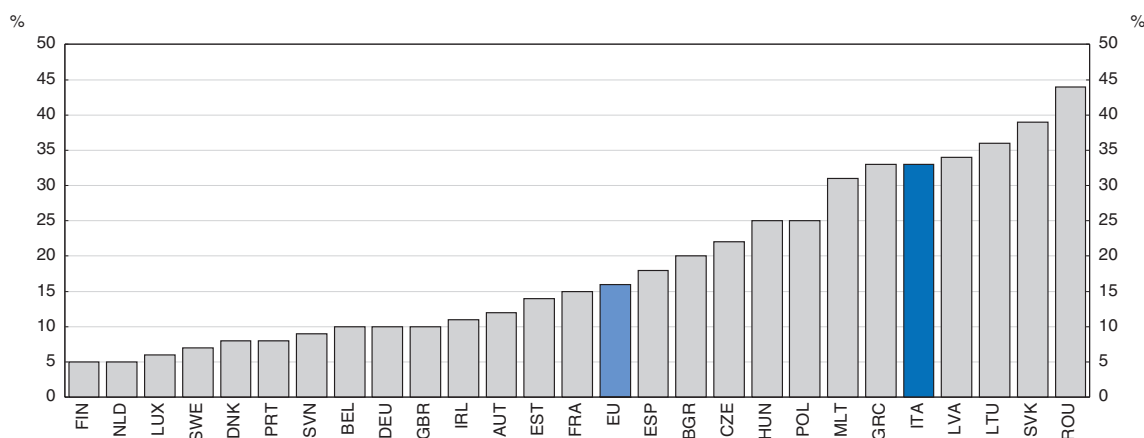
It is important that the approach of the spending review – continuous benchmarking and attention to the possibilities for improving efficiency – be adopted throughout the public administration. Otherwise inefficiencies will build up again even if initial economies are achieved. Some important steps are being made to ensure this, such as much wider use of the CONSIP public procurement agencies, as recommended in previous *OECD Economic Surveys*, and the development of the online database (SIOPE) for public scrutiny of the expenditure of local administrations.

Tax expenditures

Since all taxes create distortions and since high revenues are required to maintain fiscal sustainability, an efficient tax system is essential. One of the weaknesses of the Italian tax system is the large number of tax expenditures. Reducing them would broaden the tax base, allowing the same revenue to be raised with lower tax rates. A report by the Ministry of Finance in 2011 identified 720 individual cases of exceptions or reduced tax rates. A significant number of these, including many of the most expensive in terms of lost revenue, are a necessary part of an equitable and efficient tax system (for example, the tax thresholds below which no income tax is payable), but many of them are not and overall revenue losses are high. The 2015 budget eliminates seven tax expenditures (while introducing a number of others), but takes no action on VAT, whose structure is a key candidate for revision.

Application of reduced rates and exemptions under the VAT, mainly for redistributive purposes, results in revenue losses about twice as high in Italy as in other EU countries (Figure 11). Further losses arise from non-compliance, perhaps as much as 2% of GDP (Tyson, 2014). Many reductions and exemptions in VAT are presented as redistributive measures, but such policy objectives can generally be achieved at less cost with targeted

Figure 11. VAT Gap estimates in the EU26 countries, 2012



Note: The VAT Gap is the difference between the amount of VAT actually collected and the VAT Total Tax Liability (VTTL), in absolute or percentage terms. The VTTL is an estimated amount of VAT that is theoretically collectable based on the VAT legislation.

Source: European Commission, 2012.

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spending measures. Rich households receive as much benefit in aggregate terms from a reduced rate as do poor households; at worst, rich households benefit vastly more in aggregate terms than poor households. A case-by-case examination of this kind of measure is called for. Indeed, for future budgets, there will be a requirement for a special parliamentary session to discuss the annual survey of tax expenditures and decide possible eliminations or reductions. The planned revision of the social support system in Italy creates a good opportunity to phase out expensive tax expenditures while raising targeted support, potentially increasing the overall amount of redistribution.

The Internal Stability Pact

The Internal Stability Pact (ISP) is a set of measures intended to ensure that the financial situation of local, provincial and regional administrations is consistent with Italy's obligations under the European Union fiscal rules. Introduced in 1999, it has been progressively modified, with different targets for regions, provinces and municipalities and specific rules for health spending (the most important item and under the responsibility of regional government). The European Union fiscal rules concern only deficits and gross debt, so the ISP could have been designed to set objectives only for deficits, with consolidation targets for indebted administrations. In addition to these objectives, the ISP has also been used to pursue other objectives, notably pursuing national spending priorities by exempting some types of spending; the details change from year to year. Some of the early problems with different definitions of expenditure have been eliminated and new accounting procedures allow the central government to monitor sub-national developments more closely.

Enabling legislation in 2009 foresaw a move to a system of fiscal federalism in which central transfers to sub-national government were made on the basis of a standard estimate of the finance necessary to implement nationally mandated policies. Sub-national government could use local taxes to finance their own spending priorities, with a tax compensation mechanism to allow some redistribution to poorer regions and municipalities.

Some of the provisions of the 2009 law have been implemented. Standard costs now apply to health and an increasing range of other expenditure. But central transfers to sub-national government are still strongly influenced by historical spending rather than needs. The constitutional reform provides for financing sub-national government on the basis of standard costs.

Once the new constitutional arrangements are in place and fiscal federalism institutions are in place along the model of the 2009 enabling law, adjusted to be in line with the new structure of sub-national government, it should be possible to simplify the Internal Stability Pact. With well-defined sub-national taxation powers and expenditure responsibilities, there should be no need for central government to interfere in any detail. A simpler ISP should be able to focus largely on deficits, and debt reduction where necessary, rather than expenditure ceilings, and without special exemptions. A 2012 law foresees a balanced budget rule for local government as from 2016; the 2015 budget law imposes a balanced budget on ordinary regions already for 2015.

Recommendations for fiscal and financial policies

Key recommendations

- Stick to the planned fiscal strategy so as to bring the debt-to-GDP ratio safely onto a declining path.
- Promote greater use of centralised procurement, cost information systems and benchmarking.
- Urgently take action to achieve a lower level of non-performing loans in the banking sector, including through enhancing the insolvency regime applied to distressed borrowers.
- Continue efforts to reduce tax evasion through more effective enforcement and increase tax compliance through simplified collection procedures. Broaden tax bases, in particular by cutting the number of tax expenditures, and simplify the tax system.

Other recommendations

- Continue to assess the magnitude of budgetary contingent liabilities, including the vulnerability of public finances to risks associated with the financial sector.
- Make taxation more environmentally-friendly by reducing the gap between duties on diesel and petrol.
- Shift the tax burden from electricity to the energy products used to generate it, with the respective rates set to reflect the carbon emissions and other pollutants associated with each fuel.
- Implement the planned reform of the Internal Stability Pact to regulate only overall borrowing of sub-national government, with consolidation targets for indebted administrations. Replace its detailed provisions with a fiscal federalism structure that reflects the desired degree of decentralisation.
- If progress in reducing nonperforming loans remains slow, consider setting up a public specialised asset management company (“bad bank”) to accelerate the process, with due regard for state aid rules.

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Chapter 1

Labour market reform for more and better quality jobs

A well-functioning labour market is indispensable to promote job creation, increase living standards, and develop a cohesive society. In Italy, the various deficiencies of the labour market have resulted in high unemployment, low labour force participation and job-skill mismatch. These deficiencies have contributed to the problem of allocation of resources, income distribution, and low productivity, reducing people's well-being. The current government, following on past governments' reforms, is introducing a package of labour market reforms – the Jobs Act – to improve the labour market in a consistent way. The reform will make the labour market more flexible and inclusive, and reduce duality. The long-lasting problem of effective enforcement will need to be overcome, with an increased focus on rapid implementation by the current government. A set of well-designed institutions, not only labour market policies but also the education system and product market regulation, would encourage higher labour force participation, especially among women, and produce more and better quality jobs in a more skill-intensive economy.

Chapter 2

Maintaining fiscal sustainability: Structural fiscal issues

Major progress has been made in moving towards fiscal sustainability, thanks to substantial consolidation on both spending and revenue sides. Further structural improvements can build on these gains and, more fundamentally, support the government's reform programme aimed at improving productivity and growth. Tax compliance is more expensive for companies in Italy than in most OECD countries, while tax expenditures are very numerous. Simplifying the tax system can raise investment and growth, as well reducing costs in the tax agency and improving compliance. Value for money in public spending is always important but particularly so in a situation of tight budgets. Ad hoc spending reviews have been undertaken, but a systematic approach is needed. Some existing tools to promote value for money can be improved, while reform of public administration, including better use of transparency and anti-corruption measures, can support their effective use. The Internal Stability Pact (ISP) has been a necessary domestic counterpart of European fiscal rules, but has imposed a number of constraints on sub-national administration that go beyond what is needed for EU purposes. Constitutional reforms, balanced budget rules for sub-national administrations and final implementation of long-awaited rules on fiscal federalism provide an opportunity to considerably simplify or eliminate the ISP.

The 2015 Economic Survey of Italy was prepared in the Economics Department by Paul O'Brien and Yosuke Jin, under the supervision of Patrick Lenain. Hermes Morgavi and Josette Rabesona provided statistical research assistance, and Brigitte Beyeler provided administrative support. The Survey also benefitted from contributions by Willem Adema, Jonathan Barr, Ivana Capozza, Chiara Criscuolo and Federica Maiorano..

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