



ITALY

SELECTED ISSUES

September 2014

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ITALY

SELECTED ISSUES

Approved By
European Department

Prepared By Sergi Lanau and Anita Tuladhar (both EUR),
Benoît Chevauchez (FAD), Gianluca Esposito (LEG),
Nadege Jassaud (MCM) and Stephanie Segal (SPR).

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OVERVIEW

Judicial Reforms for Growth

The chapter investigates options for improving the efficiency of the Italian judicial system and closing the regional performance gap. Better courts would bring about macroeconomic benefits, including increased employment opportunities, and higher productivity, investment, and R&D. Reforms should focus on court management, rationalization of the appeal system, reduction of the backlog of pending cases, and wider use of out-of-court mediation.

Future Challenges Facing Italy's Financial Sector

The Italian financial system faces a number of challenges in order to restore profitability under weak growth conditions and to adapt to a changing global environment. This chapter explores ways of improving profitability and the challenges of shifting from a bank-based financial system, common in EU countries, to a more "market-based" ("arm's length") system. Along with this shift comes a diversification of financing sources, led by further development of capital markets.

Improving Public Spending Allocation and Performance in Italy: An Efficiency Analysis

Budget allocation in Italy will need to increasingly rely on efficiency analysis to find savings and improve performance. The analysis in this chapter finds that large social spending in Italy, particularly current pensions, will need to be tackled to generate sizable expenditure savings. In education and non-pension social protection there is scope for improving outcomes with current resources. In other areas, reducing cross-regional variation in spending efficiency could also lead to savings.

The Use of Performance Information in Resource Allocation

The role of performance information in budget management is growing in advanced economies. In Italy, performance information will be critical for making the Spending Review a permanent part of the budget process. Italy generates significant performance information and more can be done to actively use this information in budget decision making. High quality performance information needs to be used more proactively to evaluate public policy and inform resource allocation decisions.

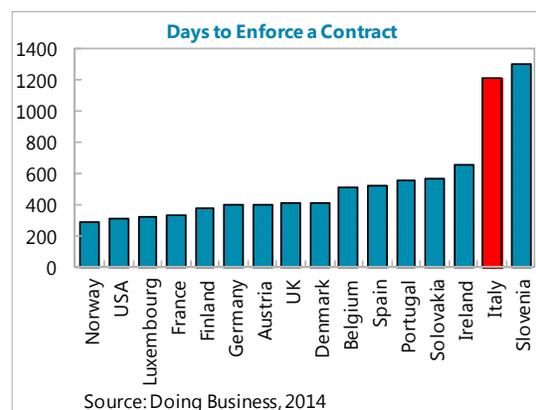
JUDICIAL REFORMS FOR GROWTH¹

There is ample room to improve the efficiency of the Italian judicial system and close the regional performance gap. Better court performance would bring about macroeconomic benefits, including increased employment opportunities, and higher productivity, investment, and R&D. Reforms should focus on court management, reduction of the backlog of pending cases, wider use of out-of-court mediation, and rationalization of the appeal system.

A. The Macro-Judicial Linkages—A Regional Perspective

1. The Italian judicial system performs significantly worse than the average OECD country in terms of court times and case backlog.

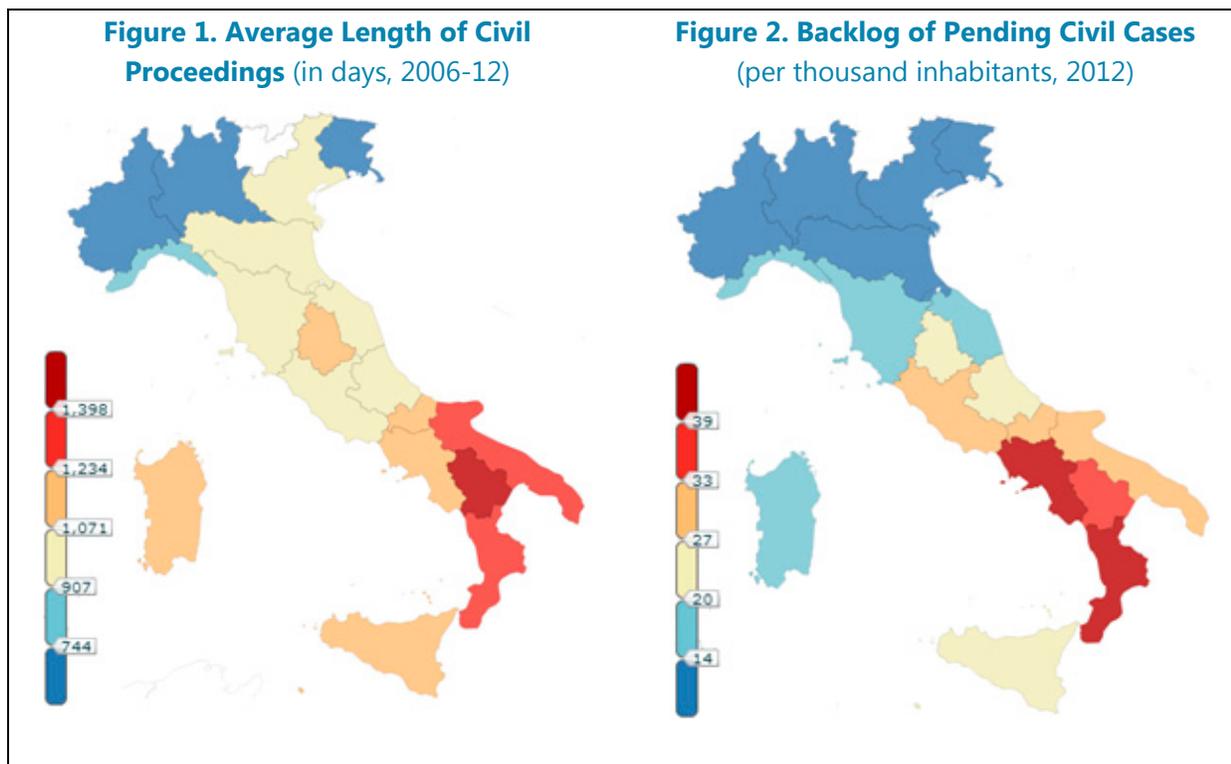
As discussed in Esposito, Lanau, and Pompe (2013), it takes an average of 1,185 days to enforce a contract in Italy according to the Doing Business survey (more than twice the OECD average). Italy also has the highest number of violations of the reasonable time requirement enshrined in Article 6 of the European Convention of Human Rights. The backlog of pending civil cases has fallen by about 11 percent since 2009 but still stood at 5.2 million cases in mid 2013.



2. **Court performance differs across regions, with the north generally faring better than the south.** Figure 1 maps regional court efficiency under the assumption that the average duration of civil proceedings and the per capita stock of pending civil cases are reasonable proxies for judicial efficiency. These statistics abstract from factors such as the predictability of court decisions but do proxy for the economic opportunity cost of drawn-out trials. The indicators show that the gap between the north and the south is as wide as two years for the average length of civil proceeding and four times the number of per capita backlog cases. A similar picture emerges if the proxy is the regional public sector efficiency measure in Giordano and Tommasino (2011), which relates the number of judges per 1,000 new trials to the average length of trials. Performance heterogeneity across judicial districts within regions also exists but it is not explored in this paper. Since the procedural rules and the structure of the judicial system are set at the national level and are the same throughout the country, factors such as managerial practices in each court, individual judge effort, degree of specialization, court size, productivity of court clerks, availability and use of IT tools, and degree of regional informality may explain the large interregional differences in court performance.

¹ Prepared by Gianluca Esposito (LEG) and Sergi Lanau (EUR).

3. **Regional macro outcomes such as productivity and unemployment are associated with the performance of the justice system (Figure 3).** A statistically significant correlation exists between improved judicial efficiency (proxied by the duration of court proceedings) and better regional macro outcomes. The correlations span a number of important areas for potential growth and highlight a north-south gap in most performance indicators:

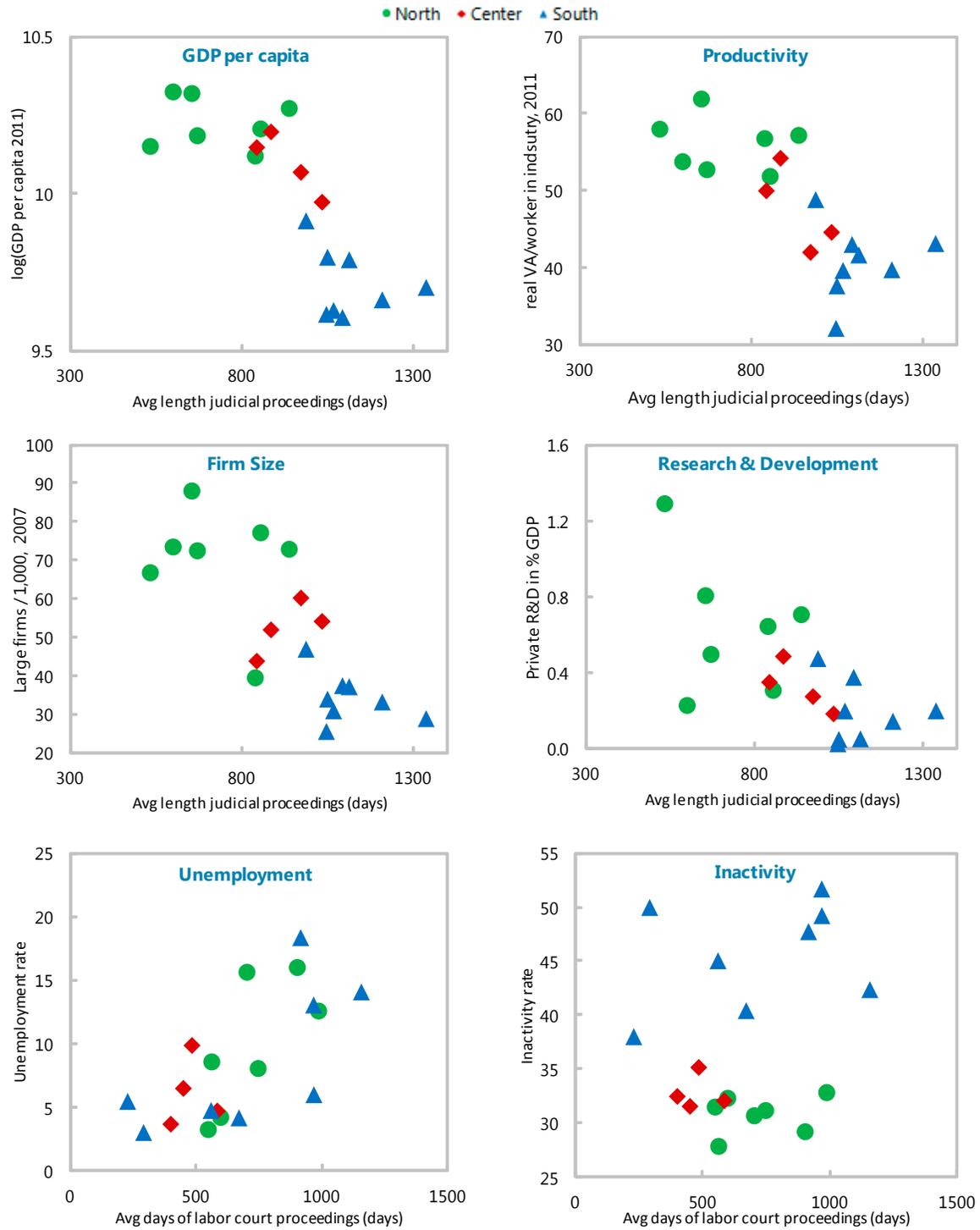


- **GDP per capita and productivity.** Productivity in industry is 44 percent higher in the three regions with the most efficient courts than in the bottom three. The correlation between GDP per capita and judicial efficiency is also present at the provincial level (Table 1). For a given initial GDP per capita, growth in the province where the judicial system is the most efficient is 1.9 percentage points higher than in the province with the most inefficient judicial system.

Variable	Coefficient
Judicial efficiency	0.020**
Initial GDP/capita (log)	-0.018***
Constant	-0.067***
Observations	100

1/ Judicial efficiency is the 2006 civil justice public sector efficiency score in Giordano and Tommasino (2011). ** statistically significant at the 5 percent level. *** statistically significant at the 1 percent level.

Figure 3. Italy: Regional Judicial Efficiency and Macro Outcomes



Source: Istat, Ministry of Justice

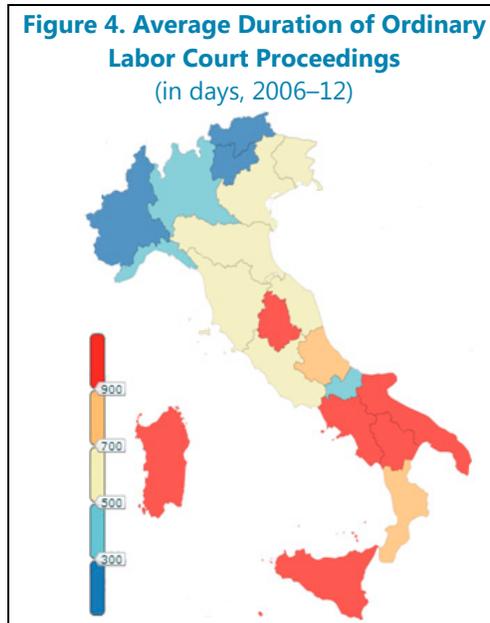
- **Firm size and R&D.** Italian firms are small from a cross-country perspective, and are even smaller in the regions where judicial efficiency is low (30 large firms per thousand, compared to more than 70 in regions where courts are more efficient). Private R&D expenditure is ½ percent of GDP higher in the three regions with the most efficient courts than in the bottom three.
- **Employment.** The average duration of labor court proceedings is significantly correlated with inactivity and unemployment rates. The unemployment rate is 10 percentage points higher in the three regions with the most inefficient courts than in the three best.

4. **These regional patterns are consistent with the findings of a growing literature on the macro impact of judicial efficiency** (see Esposito et al. 2013 for a full literature survey). Regional factors beyond judicial efficiency may also correlate with macro outcomes, opening up the possibility that some of the relationships in Figure 4 are not causal. That said, the literature has shown that judicial efficiency does cause certain macro outcomes. For instance, Giacomelli and Menon (2012) have established a causal link between judicial efficiency and firm size exploiting performance differences across Italian judicial districts. Moreover, business surveys suggest that the justice system is indeed an important determinant of the business environment and macro outcomes.

B. A Deeper Look at Court Efficiency and Employment

5. **Labor courts are no exception to the regional heterogeneity in court performance.** It takes less than 300 days to resolve a labor dispute in Piemonte or Trentino, but more than a thousand in Puglia or Sicilia (Figure 4). Since labor laws are set at the national level, local court management and individual judge effort likely play a role in explaining the differences. Factors such as the complexity of cases in certain regions may also be relevant.

6. **Long labor court proceedings increase the expected cost of dismissals and may result in less job creation.** Inefficiencies in other parts of the judicial system could have an indirect impact on employment to the extent that they result in reduced firm size, limited access to credit, or reduced incentives to invest. Using Italian data, Gianfreda and Vallanti (2013a, b) have linked labor court efficiency to the composition of employment, labor market participation, and job relocation rates and find that difference between best and worst courts in Italy results in a 6 percentage point gap in relocation rates.



7. **Micro data allow for a closer examination of the correlation between court efficiency and employment outcomes.** Table 2 provides descriptive statistics of the dataset grouped by macro-region.

- A probit model is estimated for the probability of an individual being employed, based on a cross-section of 12,430 individuals in 19 Italian regions from the 2012 Survey on Household Income and Wealth by the Bank of Italy.² An individual is considered to be employed if they worked full-time for at least 7 months in 2012.
- The key independent variable is a measure of regional judicial efficiency. In a first set of regressions, the log average duration of court proceedings for the period 2005–12 is the proxy for judicial efficiency. Three versions of the variable are used (in separate regressions): duration of ordinary civil proceedings, duration of ordinary labor court proceedings, and combined duration of ordinary and appeal labor court proceedings.³ In an alternative specification, the log stock of pending civil cases per thousand inhabitants is the judicial efficiency proxy.
- The control variables include individual characteristics such as gender, education, and age, and two regional macroeconomic variables that likely affect an individual’s employment prospects: GDP growth and employment growth. Other variables such as GDP per capita, the degree of labor market informality, and the composition of output display significant variation across regions and could affect the labor market. Unfortunately, these variables are highly collinear with judicial efficiency measures and cannot be included in the regressions. The implications of this limitation are discussed in more detail below.

	North	Center	South
Employed	40.8	36.2	27.9
Young	12.8	12.2	15.5
Old	13.0	13.1	11.5
College education	14.3	14.8	10.7

8. **Halving the duration of civil proceedings would be associated with a 7.7 percentage point increase in the probability of individual employment.** The regression results show a statistically significant correlation between employment probabilities and the four measures of judicial efficiency (Table 3):

² Only persons age 16–64 are considered. Results are similar for previous vintages of the survey and are not reported.

³ Combined duration is defined as duration of ordinary proceedings + appeal rate*duration of appeal proceedings.

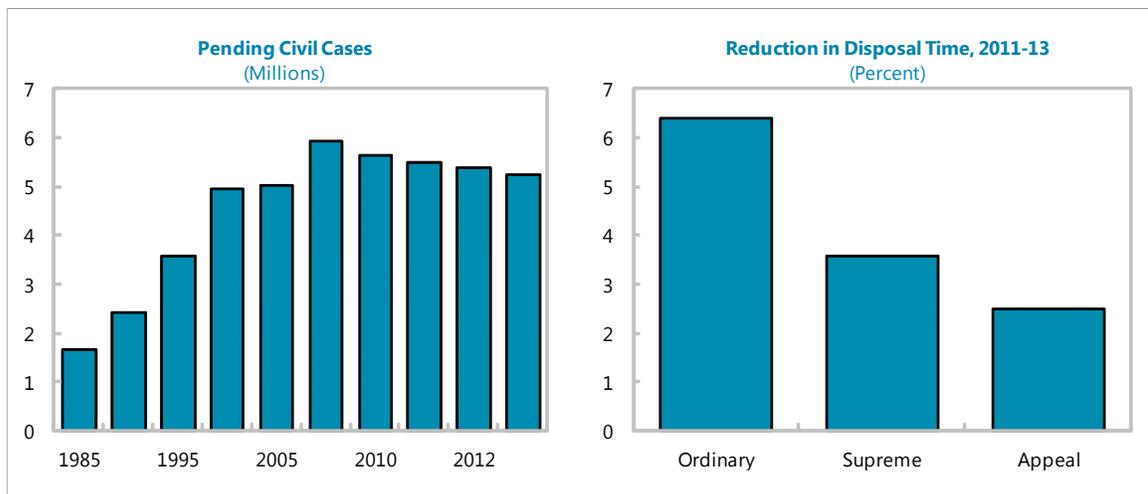
- The marginal effects of a one percent reduction in the duration of court proceedings on the probability of employment range from 6 to 13 percent depending on the type of court considered. The magnitude of the correlation is the largest for civil courts, suggesting that the indirect effects of court efficiency on employment discussed in ¶6 may be important. A one percent reduction in the backlog of pending cases is associated with a 7 percentage point increase in employment probabilities. It is worth emphasizing that since the judicial efficiency measures are very collinear with other factors such as GDP per capita and labor market informality, there is a chance that the regression coefficients capture some phenomena not strictly linked to the judicial system.
- The regressions can be used out of sample to trace the change in employment probabilities from halving the duration of court proceedings holding other control variables constant. In the case of labor courts, halving the duration of proceedings is associated with an average 3.8 percentage point increase in the probability of employment. The equivalent figure for civil proceedings is 7.7 percentage points. There is some regional variation in the estimated probabilities but it is relatively moderate and does not follow a clear north-south pattern (for example, the increase in employment probabilities in Abruzzo is 1.2 percentage points higher than in Campania).
- The two regional macroeconomic controls are generally insignificant. The individual controls have the expected signs and are highly significant in line with the literature. For instance, all else equal, a female is 6 percent less likely to be employed than a male.

9. **A causal interpretation of the results is not straightforward.** As discussed above, the correlation between judicial efficiency and other slow-moving regional factors is very high and the possibility that these factors cause both employment outcomes and court efficiency cannot be ruled out. Moreover the 25 percent R^2 indicates a risk of omitting in the regression other relevant factors to explain employment outcomes. Another econometric issue is relevant when considering a causal interpretation of the results: the most capable individuals, and thus more likely to be employed, may migrate to the regions where institutions and courts work better. Under these circumstances, the probit could overestimate the relationship between labor courts and employment outcomes. Finally, there is the possibility that the length of labor court proceedings could be endogenous since courts may be busier and slower at times when employment is falling sharply. The potential endogeneity problem should be attenuated by the fact that the duration variable is averaged over 2005–12.

C. Judicial Reforms for Growth

10. **Judicial reform could help increase growth, create jobs, and improve the business environment.** The research discussed above and related findings in the literature suggest that increased judicial efficiency could help lift potential growth by increasing productivity and R&D investment, and reducing unemployment.

11. **Improving the efficiency of the Italian justice system has been a central concern for the governments of the past few years...** (see Esposito et al. (2013) for a full survey of the measures adopted). The measures taken have yielded some results, including an 11 percent reduction in the backlog of pending civil cases and an average reduction in disposition times of 3.7 percent. However, with over 5 million civil cases still pending and more than a thousand days to enforce a contract, faster progress is needed. A comprehensive reform and a fundamental simplification of civil justice are needed to restore judicial efficiency.



...and the Renzi government is no exception. On June 30, 2014, PM Renzi announced a series of measures aiming at (i) reducing the length of civil trials (one year in first instance); (ii) reducing the backlog of civil cases by a half; (iii) creating “fast-track procedures” for company and family law cases; and (iv) reforming judges’ careers progression and their civil liability.⁴ At this time, the specific measures to deliver on these objectives and their timing have not been unveiled.

12. **The online civil trial (“*processo civile telematico*”) introduced on June 30, 2014 is an important measure that could deliver efficiency gains.**⁵

- Under the new process, most judicial acts by court professionals (e.g., lodging of a lawsuit by a lawyer, issuance of an injunction order, or delivery of a judgment by judges) should gradually be carried out electronically. The data are collected on a web platform and available to judges, lawyers, and court clerks. The online civil trial is expected to produce economies of scale and reduce the length of civil trials. It is also accompanied by a 15 percent increase in the so-called unified court fees (“*contributo unificato*”).

⁴ Proposed measures in the criminal area include the criminalization of the false accounting offense and of self-laundering, as well as the reform of the limitation period.

⁵ See Law Decree 90/2014 for more details.

Table 3. Probit Models for Probability of Employment

Dependent variable = 1 if person is employed, zero otherwise

Variable	Marginal effects			
	(1)	(2)	(3)	(4)
Duration civil proceedings	-0.13***			
Duration labor court proceedings		-0.07***		
Duration combined labor proceedings			-0.06***	
Pending cases / capita				-0.07***
Young	-0.24***	-0.23***	-0.23***	-0.23***
Old	-0.28***	-0.28***	-0.28***	-0.28***
Female	-0.06***	-0.06***	-0.06***	-0.06***
Head of household	0.41***	0.41***	0.41***	0.41***
Log(family income)	0.02***	0.02***	0.02***	0.02***
High school education	0.10***	0.10***	0.10***	0.10***
College education	0.14***	0.14***	0.14***	0.14***
Postgraduate education	0.10*	0.10*	0.10*	0.10**
Regional employment growth	0.97	0.91	0.85	1.53*
Regional GDP growth	-0.53	-1.26	-0.64	-1.14
Observations	12,430	12,430	12,430	12,430
Pseudo-R ²	24.8	24.7	24.7	25.0

* statistically significant at the 10 percent level; ** statistically significant at the 5 percent level; *** statistically significant at the 1 percent level. Young equals one if the person is 16–24 years old. Old equals one if the person is 60 or older. Head of household and female are self-explanatory dummies. Family income is the income of other members of the household. High school, college, and postgrad are education dummies, with elementary schooling or less being the omitted category. Marginal effects for dummy variables are for a discrete change from 0 to 1. Regional employment growth and regional GDP growth are the change in log of total employment and log GDP in the region where the person lives. Robust standard errors clustered by region.

- While it is too early to assess the effectiveness of the online civil trial, it is certainly a welcomed development. IT solutions are not objectives in themselves, but tools which will need to be complemented with the measures (including those discussed below) to improve the performance of the justice system fundamentally. The increase in fees primarily offsets revenue losses and it thus remains to be seen whether it will play any role in deterring the inflow of (especially ill-founded) cases.

13. **The 2013 Article IV identified options to improve the efficiency of the judicial system** (Esposito et al. 2013). This paper further develops some of these options taking into account the policy developments since the last Article IV. The measures identified by Esposito et al. (2013) are: the development of a performance and accountability framework for courts; measures to limit review by the Supreme Court of Cassation⁶ (SCC henceforth); action to incentivize the use of mediation; and backlog reduction measures.

Court Performance and Accountability

14. **Developing court performance indicators would help speed up court processes and increase accountability.** These productivity indicators include the number of cases and the length of procedures amongst other variables. A key feature of any performance management framework is the setting of time management for judicial proceedings. The Council of Europe's Commission for the Efficiency of Justice (CEPEJ, 2006) has developed best practices in this area which should be implemented. In a nutshell, these include: (i) setting realistic and measurable timeframes; (ii) enforcing the timeframe; (iii) monitoring and dissemination of data; (iv) procedural and case management policies and practices; and (v) caseload and workload policies. Some of best practices in this area are being followed in Italy and disseminating them across the country may help reduce the performance gap. For example, Box 1 describes a successful Italian scheme, the so-called "Strasbourg Program" of the Turin Court. Since the approach was successful in Turin, there is no objective reason why it cannot be institutionalized and made operational throughout the country.

15. **Performance evaluation must respect judicial independence.** The latter relates to judges' decision-making and to the non-interference by the executive and the legislative branches, but not to the judges' performance and accountability. Owing to the potentially complex relationship between judicial independence and accountability, the performance framework should ensure that any court evaluation system upholds judicial independence.

Review by the Supreme Court of Cassation

16. **Measures to reduce the number of pending cases before the Supreme Court of Cassation and their processing time are needed.** There are nearly 100,000 pending cases with an average time for resolution of 1,200 days (the respective figures in France are about 24,000 cases

⁶ The Supreme Court of Cassation is the highest court in the Italian judicial system

and 395 days; in Germany, there are about 8,000 cases pending before the Supreme Court). Moreover, a high number of lawyers can plead before the SCC (about 55,000 compared to 105 in France). This situation calls for reforms to make sure that the SCC, to use the words of its First President, Mr. Lupo, preserves its role of “jurisdictional guidance [...] and of guarantee for the *jus constitutionis*, rather than the *jus litigatoris*.”⁷ Reforms could occur at two levels:

- **Role of lawyers.** Relatively non-binding filters to regulate lawyers’ access to the SCC exist but their efficacy could be improved. Consideration could be given, as in other countries, to creating a special category of lawyers allowed to plead only before the SCC, thus increasing their specialization and reducing the number of lawyers with access to the SCC.
- **Screening.** Similarly to other Supreme Courts in Europe, filters should be instituted to reduce the inflow of cases, including through summary dismissals and pre-selection (Esposito et al. 2013). This would allow the SCC to focus on those cases that are complex and of general interest, as opposed to simple cases of limited relevance (e.g., decisions by the Peace Court could be appealed to the Court of Appeal). In addition, the very limited types of cases that could be allowed before the SSC could be set by law, effectively establishing two levels of jurisdiction to review the substance of most cases (first instance and appeal).

Out-of-court mediation

17. **The participation rate in the mediation process is low, although the success rate is high when the parties engage.** Mediation should not be seen as a “pre-trial room” or a necessary routine step before going to the first instance court. It should instead be a device for parties to genuinely attempt to reach a “win-win” solution to their dispute. The measures discussed Esposito et al. (2013), such as allowing mediation without the compulsory presence of lawyers, would help strengthen mediation.

Backlog of pending cases

18. **The authorities announced their intention to reduce the civil case backlog by half.** This is a welcomed policy objective but detailed information about how and when such a target will be achieved is not yet available. Developing specific targeted measures to reduce the backlog is necessary to make future civil justice reforms more effective. Full implementation of the measures in the *Decreto del Fare* (e.g., auxiliary judges in appeal courts) would also help reduce the backlog.

19. **Measures to reduce the backlog of pending cases need not be the same as those aimed at improving the general efficiency of the court system.** Ad-hoc measures, including measures similar to those taken elsewhere in Europe, could help reduce the backlog of pending cases:

⁷ See Opening of the Judicial Year (2014) by the First President of the Italian Supreme Court of Cassation, which is also the source for some of the statistics in this paragraph.

- Creation of special staff units composed of so-called “judicial advisors” working under the supervision of a few judges to clear the backlog of civil cases (as in the Netherlands in the early 2000s);
- Issuance of pilot judgments to address a large number of similar cases simultaneously;
- Monitoring and labeling backlogged cases, as in the Court of Turin (Box 1);
- Allowing parties in cases lodged, for instance, prior to 2012, to resort to a sort of “arbitration chamber” to resolve their dispute, in exchange of the elimination of all legal fees, tax deductibility of the costs incurred so far, and a commitment by the parties to not request compensation for excessive length of the procedure (under the so-called “Pinto Law”).

Labor court procedures

20. **Since 2012, the Italian labor law has a new fast procedure for deciding upon dismissal disputes...** (Law 92/2012, so-called “Fornero Law”). This is a specific, rapid summary procedure to ascertain the legitimacy (or otherwise) of a dismissal decision. Proposals for the reform of this new procedure, two years after its entry into force, have been voiced in some quarters.⁸ Without entering at this stage into the merit of these reform proposals, it would be important to assess the experience with this new procedure and to discuss possible enhancements, if needed.

21. **....but the interaction of this new procedure with the existing “ordinary” procedure should be clarified.** Title IV of the Italian Code of Civil Procedure contains provisions on labor-related disputes in court. Within this title, Article 414 provides for the ordinary procedure governing the submission of labor-related disputes to courts. This provision remained after the introduction of the fast procedure in 2012. The relationship between fast and ordinary procedures is somewhat unclear. It could be clarified whether the former replaces the latter, is an alternative, or cumulative. Staff recommends the authorities clarify this issue when assessing the overall effectiveness of the new labor court procedure.

⁸ See, for instance, the reform proposal by the National Judges Association and the Labor Law Lawyers Association.

Box 1. The Strasbourg Program of the Turin Court

The “Strasbourg Program” is among the first experiences of successful case management in Italy. It resulted in a significant reduction of the backlog (about 27 percent in five years) and a substantial increase in speed of civil cases. Born in 2001 (as an idea of the then President of the First Instance Court of Turin, Mr. Barbuto), the program proved very successful and obtained the Crystal Scale of Justice Prize of the Council of Europe. Starting from the assumption that cases lasting more than three years would be against the “reasonable time” requirement of the European Convention on Human Rights (Article 6), the program entailed a number of sequenced steps:

- Monitoring of the backlog: a regular six-month survey of the backlog was carried out with a view to categorizing cases by length and type.
- Issuance of a “Decalogue”: the President of the Court issued a “Decalogue” aimed at ensuring a uniform practice in all civil sections of the Court, for the speedy and targeted treatment of cases. This “Decalogue” included recommendations for judges to: (i) make sure they play an active role in the proceeding; (ii) prevent and address dilatory tactics and avoid adjourning cases, if possible (if not, such an adjournment should not exceed 40-50 days and be granted only on the basis of specific reasons); (iii) promote a mediated solution to the dispute; (iv) make an effective use of the rules relating to evidence and witnesses; (v) ensure compliance with deadlines by experts; and (vi) strive for concise motivations of judgments.
- Special tags: Cases were marked with special tags of different colors depending on whether they were pending before the court for (i) more than six months; (ii) between six months and two and a half years; and (iii) more than two and a half years, to allow priority treatment by judges.

Securing buy-in by stakeholders: the “Decalogue” was shared with the local Bar Association to ensure their necessary buy-in.

Conclusion

22. **There is scope for significant improvements in the efficiency of the Italian judicial system, with potentially important macroeconomic effects.** The reform should be structural, comprehensive and should have the necessary institutional support. It should also have the buy-in of all relevant stakeholders, notably judges and lawyers. The strategy should follow a four-pronged approach: (i) reducing the backlog; (ii) promoting wider use of alternative disputes resolution proceedings, such as mediation; (iii) rationalizing the appeal system, including review by the Supreme Court of Cassation and the role of lawyers in this context; and (iv) focusing on courts' management and accountability. Such a comprehensive reform package, if taken together and effectively implemented, could help reduce unemployment and lift potential growth by increasing investment.

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FUTURE CHALLENGES FACING ITALY'S FINANCIAL SECTOR¹

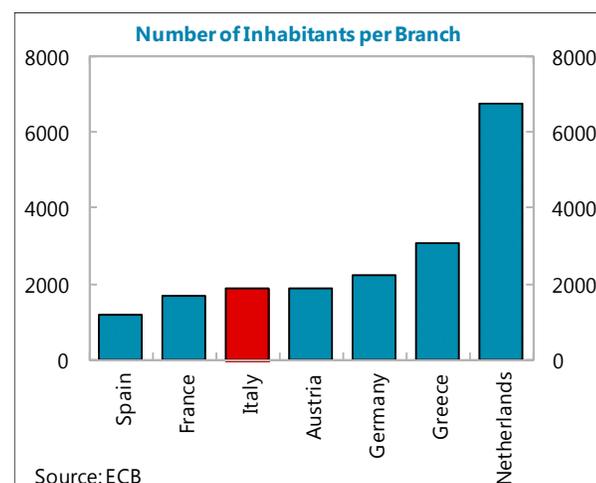
The Italian financial system faces a number of challenges in order to restore profitability in a weak growth environment and to adapt to a changing global environment. The most challenging will be to shift from a bank-based financial system, common in EU countries, to a more "market-based" ("arm's length") system. Along with this shift comes a diversification of financing sources, led by further development of capital markets.

A. The Evolution of the Bank Business Model

Structural Issues

1. **Banks in Italy play a strong intermediation role, particularly towards corporates, where lending decisions rely heavily on relationships.** Lending to corporates represented 52 percent of Italy's GDP in 2013, against 35 percent for Germany.² Relationships and collateral are important drivers for lending decisions. On average, two-thirds of bank loans are secured by personal guarantees or real estate collateral.³ In smaller banks, this coverage reaches three-quarters.

2. **The large number of banks and bank branches, and the low level of digitalization are notable features of the banking sector.** Market concentration, as measured by the Herfindahl-Hirschman Index (HHI),⁴ remains low in Italy, at 0.04 against 0.1 in Belgium and 0.2 in the Netherlands. Italy also displays one of the lowest numbers of inhabitants per branch among EU countries, with 1,871 inhabitants, three times less than the Netherlands (Figure 1). The over-branching is even more apparent in the Italian cooperative sector, which had 1,179 customers per branch in 2012, four times less than France and twelve times less than the Netherlands. This also reflects country-specific preferences with respect to banking services and in particular, the low level of digitalization in Italy.



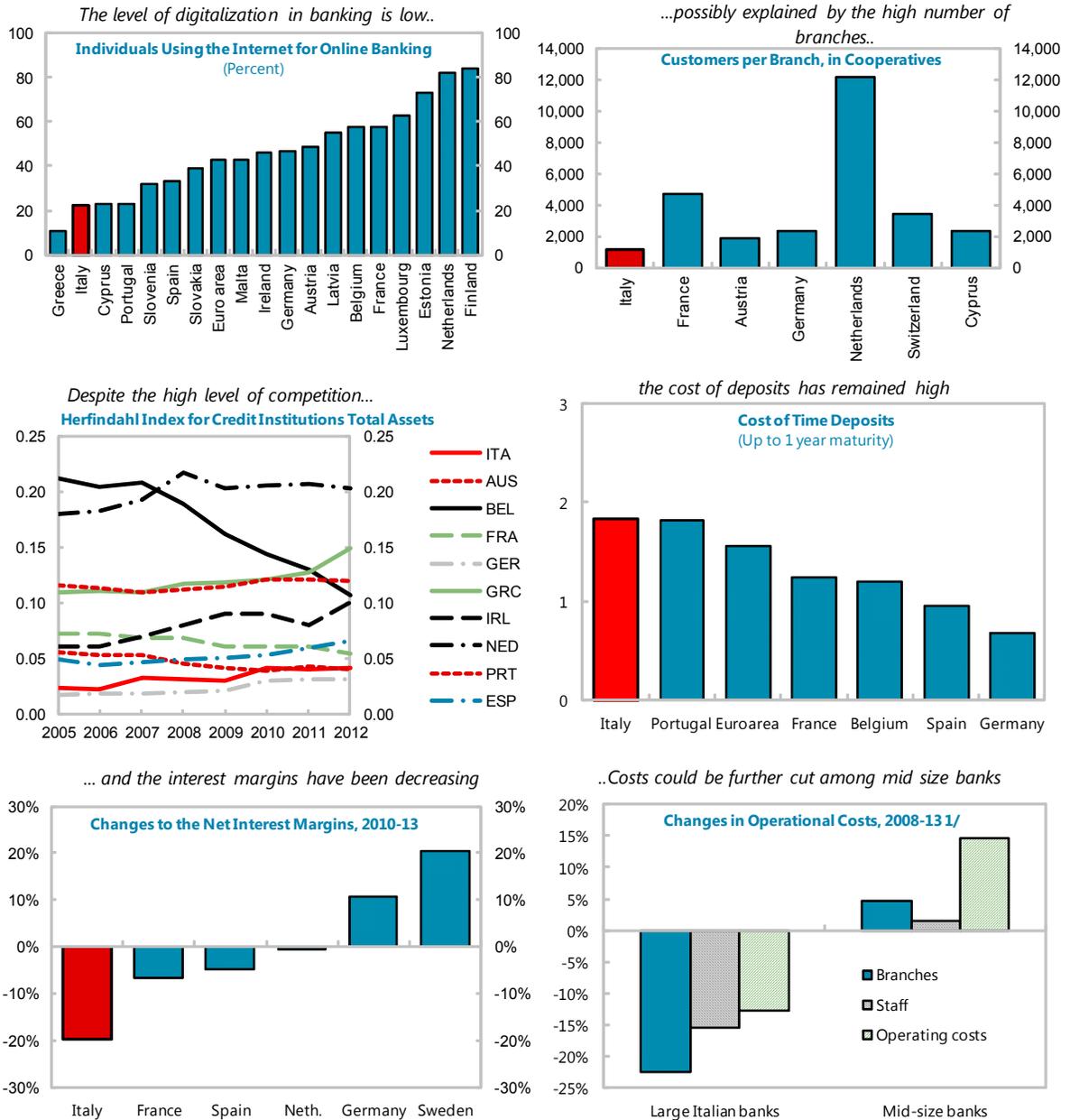
¹ Prepared by Nadege Jassaud (MCM) and Stephanie Segal (SPR).

² December 2012 (2013 FSSA)

³ According to the Credit Register data, one quarter of loans to corporates is backed by real estate collateral, as of December 2013 (28 percent for all loans, i.e. including households and producing households). The remaining secured lending is backed primarily by personal guarantees.

⁴ The HHI is defined as the sum of the squared market shares of individual banks. As a general rule, a low HHI signals low concentration, while a high HHI signals a high concentration.

Figure 1. Structural Issues and Profitability in Italian Banks

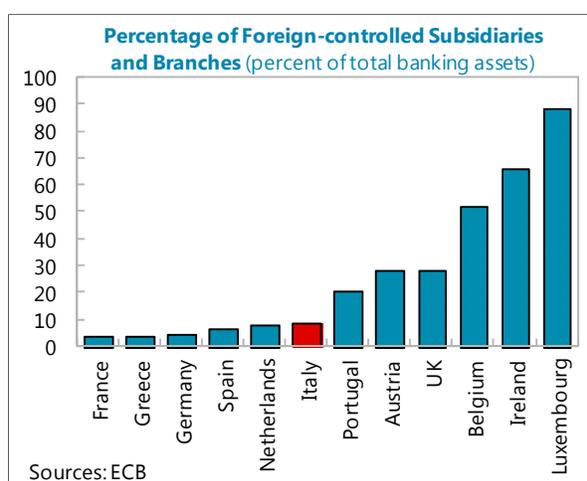


Sources: Bank of Italy; ECB; Eurostat; Morgan Stanley, SNL, European Cooperative Association; IMF staff estimates.
 1/ Data for large banks' branches and staff are as of 2014Q1.

Only 22 percent of customers use on-line internet banking, the lowest percentage in the EU, after Greece.

3. **Bank ownership is dominated by cooperatives and non-profit foundations.** Italy has a large cooperative banking sector (Banche di Credito Cooperativo and Banche Popolari) accounting for 20 percent of banking assets. Restrictions on ownership (caps on investments) and voting rights (one member-one vote) limit the incentive for outside participation. Foundations, which are non-profit organizations with political representatives on their boards, remain major shareholders in Italian banks. As of March 2013, they controlled nearly one-fourth of banking system assets through large participations (above 20 percent of bank equity). In the large banks, they often exert de facto control, despite a lower capital share.⁵

4. **Foreign ownership in the financial sector is low.** According to the OECD data, foreign investment in the Italian financial sector is 4 percent of GDP, compared to 5 percent in France and levels close to 9 percent in Spain and the Netherlands. This may be related to the corporate governance of cooperatives and foundations, and also the low level of foreign investment overall in the Italian economy. Foreign-owned branches and subsidiaries account for 9 percent of the total banking assets, compared with 20 percent in Portugal and 28 percent in the UK. Only France, Germany and the Netherlands have a lower foreign bank ownership rate.



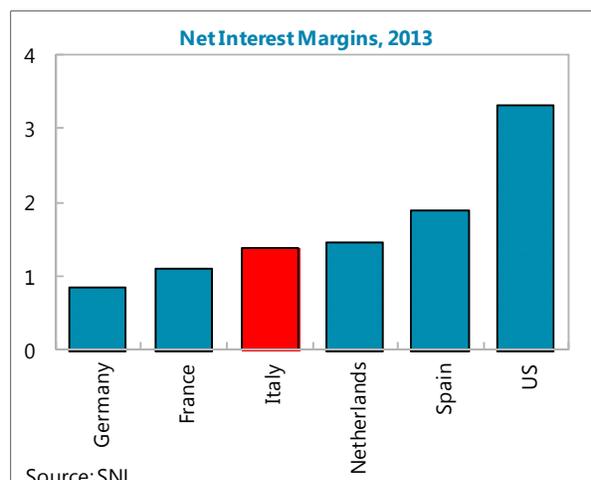
Low Bank Profitability

5. **The Italian banking system faces a number of challenges to restore profitability and support the economy.** Low net interest margins, rising regulatory costs, weak loan demand and high cost of credit have undermined banks' profitability. While large banks⁶ have cut costs through staff reductions, branch closures, and cost savings, mid-size banks have not pursued a similar path. The weak economy, affecting indebted SMEs in particular, and persistent financial fragmentation have contributed to pressure on banks to deleverage and reduce risk exposures.

⁵ See IMF Working paper // :reforming the governance of Italian banks

⁶ In this paper, large banks refer to the 5 largest Italian banks in terms of total assets. Mid-size banks refer to the 6th to 15th largest Italian banks, banks that will be under the ECB Balance Sheet Assessment (BSA). Small banks refer to banks outside of BSA, beyond the 16th largest bank.

6. **Bank interest margins are relatively low in Italy compared to other international advanced economies.** Net-interest margin (NIM) equals net-interest income divided by the interest earning assets.¹ It reflects interest profitability in banking activities and allows comparison over time and across countries. The NIM of Italian banks (1.4)² ranks low compared to U.S. banks (3.3) and some other EU banking systems (Spain, at 1.9 and the Netherlands, at 1.5). Italian banks often lend against guarantees that offer some security, but typically interest rates are lower than for unsecured loans. The high number of banks and branches also fosters price competition that impairs bank margins. Finally, the ownership structures, mostly composed of non-profit bank owners, may limit the internal returns required from lending activities.



7. **The crisis has eroded margins in Italy more severely than in other European countries.** Net interest margins of large Italian banks have shrunk by 20 percent since 2010, against 9 percent for other EU banks,³ driven by tightened spreads in a low interest rate environment, lower loan volumes and rising funding costs. Although funding costs have eased thanks to the ECB's Long Term Refinancing Operations (LTRO), they remain high compared to those also affected by the crisis. The deposit rates of Italian banks are 80 bps above those of Spanish banks, mostly because of retail bonds⁴ that carry higher interest rates than sight deposits. Retail bonds account for 17 percent of Italian banks' liabilities (2013 FSSA) compared to less than one percent in Spanish banks.

8. **Revenues from fees and commissions have not offset lower interest margins.** Non-interest income includes fees and commissions paid by households (credit cards, account management fees), corporates (investment banking, issuance of bonds), and trading income. Fees

⁷ Interest earning assets encompass gross loans and investment securities.

⁸ Data is based on a sample of 34 European banks' financial statements (SNL database): Unicredit, Intesa, MPS, BP, UBI, Deutsche Bank, Commerzbank, Landesbank Baden Wurttemberg, Bayerische Landesbank, BNPP, SocGen, CASA, Dexia, KBC, Rabobank, Erste Group, Raiffeisen, Bankia, Santander, BBVA, Banco Popolar Espanol, Caja de Ahorros y Pensiones, HSBC, Barclays, RBS, Lloyds, Swedbank, SEB, Svenska Handelsbanken, Nordea Bank, Danske Bank, AIB, Bank of Ireland, and six American commercial banks: PNC financial, Citigroup, Wells Fargo, US Corp, BB&T, SunTrust.

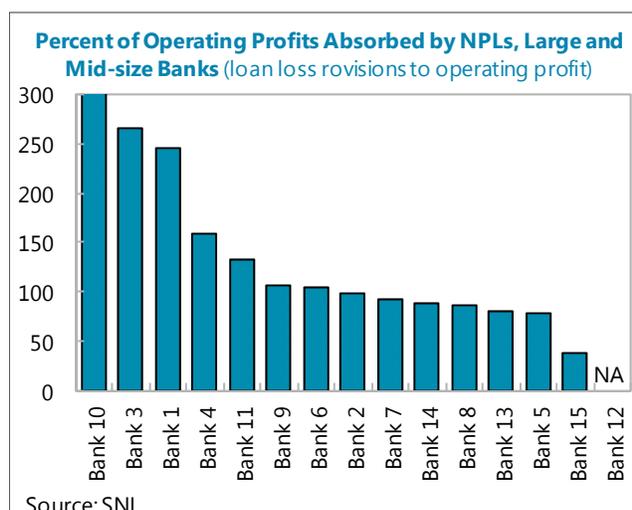
⁹ SNL Database

¹⁰ In Italy, retail bonds are bonds issued by banks with maturities from 1 to 3 years. Sold to retail customers, these bonds were senior debt instruments, but in rare cases included risky subordinated debt (2.2 percent of bank liabilities). In Spain, the retail bonds bailed-in under the Financial Sector Assistance Program (2012-2014) accounted (12 billion EUR, i.e. less than 1 percent of bank liabilities) were all subordinated debt, mostly sold to retail customers.

and commissions have remained stable or declined, as banks have made limited progress in expanding asset management, private banking, and bank insurance products.

9. **This drop in interest margins, however, does not reflect accrued interest on non-performing loans and carry trades.** The accounting for accrued interest under International Financial Reporting Standards (IFRS) permits interest on all loans, including non-performing loans (NPLs), to be accrued. As a result, Italian banks continue to recognize interest income on NPLs even though the borrower is likely not to repay either the principal or the interest or both, resulting in the NIM being overstated.⁵ This accounting treatment also encourages weak banks to keep old NPLs that have accrued large amounts of uncollected interest. The interest earned on the large volumes of government bonds financed by cheap central bank funding (LTRO) has also temporarily boosted interest margins. Since 2011, exposures on Italian government securities have almost doubled, from €200 bn in January 2011 to €382 billion in May 2014.

10. **NPLs have absorbed most of banks' operating profits.** Like in other EU countries, the protracted recession and the high levels of corporate leverage have significantly deteriorated the asset quality of Italian banks. About half of the corporate debt is from highly leveraged corporates, with interest expenses accounting for over half of the gross operating profit (IMF, FSSA, 2013). This high leverage, interacting with weak profitability, has created debt-servicing difficulties for corporates and led to an increase in NPLs on bank balance sheets ("corporate-bank" nexus). Corporate NPLs reached 29 percent, as of December 2013. As a result, Italian banks have increased loan loss provisions, absorbing more than their entire profits over 2012-2013.

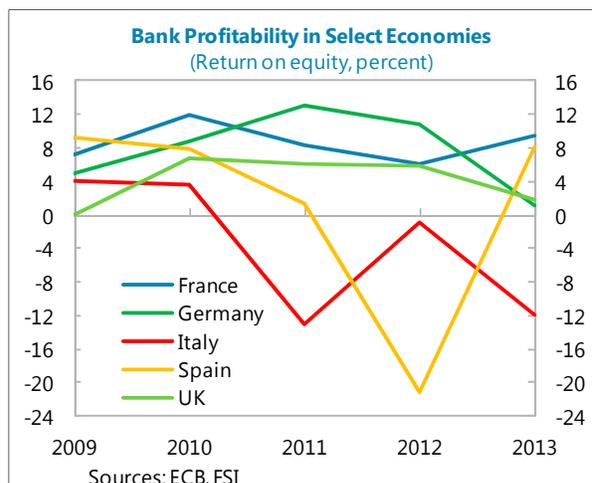


11. **While large banks have proactively cut costs, through staff reductions, branch closures, and cost savings, progress has been uneven among mid-size banks.** In the recession, banks have improved their cost-to-income ratio by reducing fixed expenditures (staff, buildings, and infrastructure), reducing other costs, and increasing productivity. According to the Bank of Italy, between 2008 and 2013 the total number of bank branches in Italy shrank by 7 percent. However, the large banks accounted for this decline, reducing their branches by more than 20 percent on

¹¹ As NPLs account for 16 percent of total loans, the proportion of accrued interest in the interest revenues is likely to be of the same size order, or above (due to penalty interests).

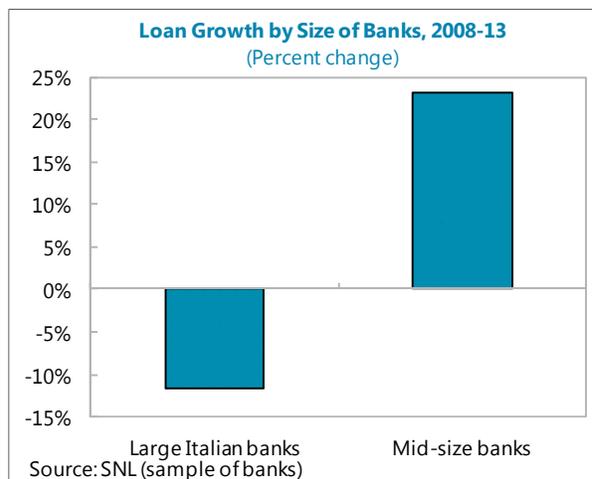
average, and making sharp reductions in total staff.⁶ In contrast, the mid-size banks expanded their networks, and as a result, their operating costs increased by 15 percent from 2008 to 2013.

12. The return on equity of Italian banks has been negative since 2010, making it difficult to raise outside capital. The Return on Equity (ROE) is defined as net profit (or loss) divided by equity. The ROE of Italian banks has been negative for three years, as banks booked more than €42 billion in losses. In contrast, the ROE has remained positive in France and Germany, and rebounded in Spain. Italian banks are still trading at a discount compared to peers. Their price-to-book value stood at 0.6 in May 2014, against 0.8 for European banks and 1 for US banks.



Contracting Bank Credit

13. Credit has continued to contract. Aggregate bank credit started contracting in 2014, declining 4 percentage points year-on-year. However, the situation varies according to the size of the bank. The largest banks have been deleveraging since 2008 (-12 percent), while mid-size banks, and in particular cooperatives, have been increasing lending since 2008. This increase in lending by mid-size banks (+23 percent) has offset the deleveraging by large banks by almost one-third.⁷



B. Recommendations

14. Boosting lending margins, diversifying lending activities, and incorporating new technology will support profitability. A combination of measures will be necessary to improve bank profitability. Italian banks will have to rethink their business models, further cut costs, and move to less capital intensive activities. Bank disintermediation is already advanced in the United States, but less so in Europe and in Italy.

¹² SNL Database

¹³ SNL Database

15. **Restoring lending margins is a key priority, while diversifying towards non-lending activities will provide new sources of revenues.** On the funding side, efforts to clean up bank balance sheets, raise capital, and reform governance will help ease the premium paid by Italian banks on capital markets. In addition, banks will have to boost their deposit base and progressively move away from expensive retail bonds. This will help moderate their funding costs, and improve the loan-to-deposit ratios. On the revenue side, banks will have to resume lending on sounder grounds, and price risk based on creditworthiness rather than on guarantees. Banks will also find it beneficial from a capital and liquidity perspective to diversify towards market issuances and asset management, which generate more stable revenues in a low growth environment.

16. **Streamlined branch networks and more digitalization will increase productivity.** Banks should reduce further their operational costs through continued rationalization of branch networks in order to compensate for the lower revenues. Cost savings should also be used to invest in the “digitalization” (online channels, advanced ATMs, etc.) which will prepare banks for the next cost-cutting wave. While some large banks have already started, the authorities should encourage the smaller banks to streamline their physical networks and deploy internet banking.

17. **Governance reforms will increase the attractiveness of Italian banks’ equity.** Governance reforms should continue by requiring published audited accounts by foundations participating in banks, limits on their leverage, and proper governance rules. The ban on foundations controlling banks should be applied in practice, and over time, foundations should reduce their stake in banks to within proper concentration limits. The largest cooperative banks should also be encouraged to convert to joint stock companies and consolidate as a way to achieve synergies. Mergers based on solid economic foundations and market logic can facilitate increased efficiency, absorb higher compliance costs, and achieve better diversification.

Restructuring Bank Balance Sheets

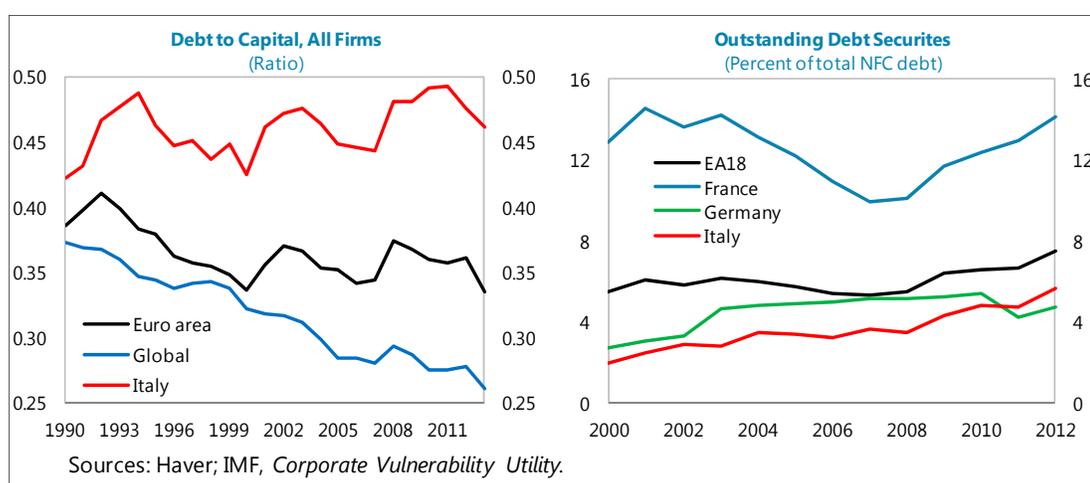
18. **Cleaner balance sheets would support new lending as the economy recovers.** As noted in the Article IV, a three-pronged approach to the regulatory push should be considered:

- **Stronger provisioning and write-offs.** Supervisory guidelines could foster convergence in provisioning rates. To encourage write-offs, the supervisor could monitor bank progress in working out NPLs, conduct targeted on-site inspections and tighten supervisory rules (higher capital charges or time-limits for writing off old NPLs).
- **Development of the private distressed debt market.** An active NPL market would provide an alternative to lengthy bankruptcy, draw in needed financing, and boost loan recovery values.
- **An enhanced insolvency regime.** The authorities should expand specialized bankruptcy courts and introduce time-limits to expedite reorganization. Greater reliance on online court filings could speed up foreclosures, while best practice guidelines for restructuring would encourage more out-of-court workouts.

C. Developing Further the Capital Markets

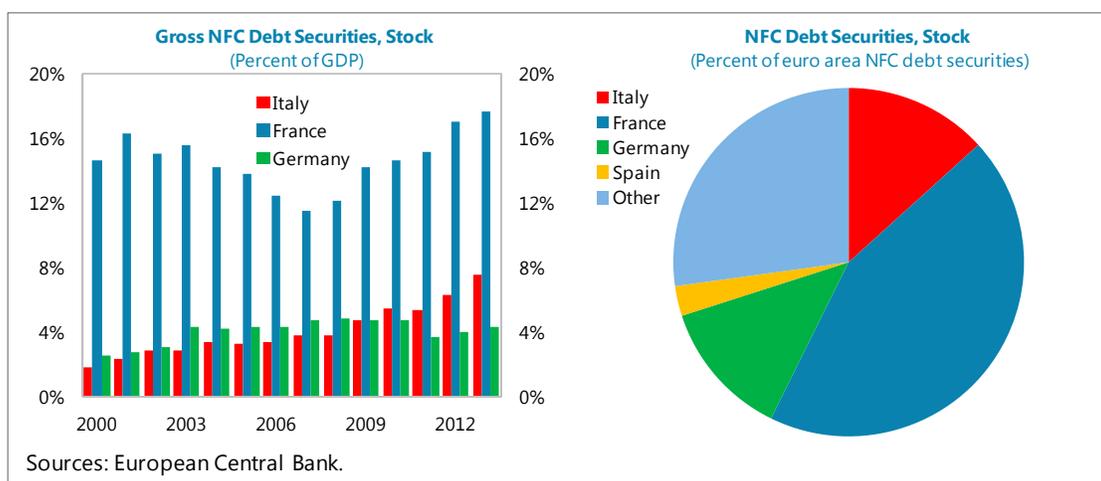
19. **Italian corporates rely heavily on debt over equity financing.** From 2000-2013, Italian firms' debt-to-total capital ratios have averaged more than 10 percentage points above the euro area average (47 vs. 36 percent); and almost 20 percentage points above the global average (29 percent). The divergence narrows only slightly if the sample is limited to those firms included in global equity indices, where Italian firms' debt-to-total capital averages 49 percent versus 39 percent for the euro area and 35 percent globally. While the ratio of debt-to-total capital has declined somewhat since the advent of the global financial crisis, the gap between Italian corporates and their euro area and global peers has widened slightly. This heavy reliance on debt financing and "undercapitalization" of Italian corporates exposes the sector to risks from higher interest rates and banking distress.

20. **On debt finance, Italian firms rely more on bank funding than their euro area peers.** On average, Italy's non-financial corporate (NFC) sector has financed only 3.6 percent of its debt from securities issuance, versus the euro area average of 6 percent. At the same time, the share of debt raised from the markets has been steadily increasing over the past decade.



21. **Notwithstanding the greater reliance on bank finance, the volume of Italian NFC debt securities issuance is on par with Italy's relative economic weight in the euro area.** Italian NFC debt securities outstanding, at €117 billion, represent about 13 percent of the euro area total. By comparison, Italy contributes about 16 percent to the euro area's GDP, suggesting that Italian corporates, in aggregate, enjoy access to debt capital markets that is broadly in line with Italy's weight in the euro area. NFC debt issuance as a share of GDP is also within the range of euro area peers, at 7 percent, as compared with 18 percent for France and just 4 percent for Germany.

22. **By contrast, Italy's equity market capitalization is below European peers, and well below market capitalization in the US and UK⁸.** Italy's equity market has also been slower to recover from the crisis period relative to European peers, although equity valuations globally have picked up in 2014, with Italian market capitalization now above 30 percent of GDP. Even with this uptick, however, equity market capitalization in Italy remains below its peak of around 50 percent of GDP. In terms of relative performance, among select euro area countries, only Greece's Athens Stock Exchange index has performed worse than Italy's Milano Italia Borsa (MIB) index since 2005.



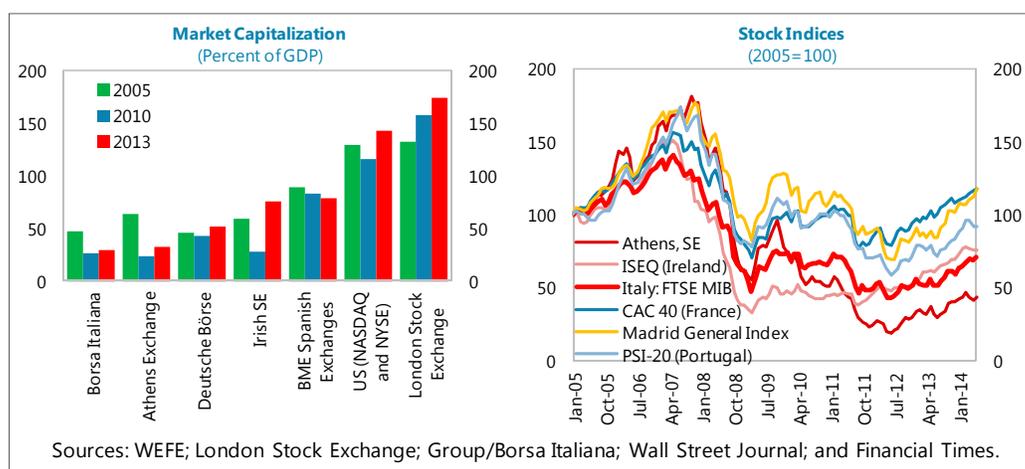
23. **Low market capitalization can itself discourage investment in Italy.** Institutional investors increasingly rely on benchmarking – referencing the composition of a given performance index – to guide investment decisions and measure performance. Research shows that benchmarks have significant and large effects on investment allocations and capital flows across countries (Raddatz, 2012). Given that benchmarks are closely related to market capitalization, it follows that low market capitalization can result in a relatively lower weight in a given benchmark, thereby influencing investors' decisions to invest (or not) in a country.

24. **These developments occur against a backdrop of lower public equity issuance by advanced economies more generally.** A 2013 report by the OECD noted that public equity funding raised by OECD companies fell to half of the previous decade, while public offerings by emerging market (EM) countries' companies increased more than five times and exceeded the total funds raised by OECD companies (OECD, 2013). This trend likely reflects a range of factors, all of which are relevant to Italy. They include i) the global financial crisis and sovereign debt crisis which acutely impacted a number of advanced economies; ii) better growth (and earnings) prospects in many EMs

¹⁴ As of year-end 2013, there were 326 listed companies on the Borsa Italiana, of which 87 percent are domestic firms. This compares with 720 listed companies on the Deutsche Börse (89 percent domestic) and more than 3,200 (99 percent domestic) on the BME Spanish Exchanges.

relative to advanced economies; iii) higher regulatory barriers to public filings; and iv) the growth of private equity as a source of equity capital.

25. **The low level of equity capital in Italy reflects a range of factors.** Tax treatment has historically favored debt over equity finance, owing to the deductibility of interest payments for corporate income tax purposes (IMF, 2013). In addition, distributed corporate earnings (in excess of a normal rate of return) are taxed at effective rates that are close to the top marginal progressive personal income tax rate (43 percent) rather than the rate on interest income (26 percent), reducing the net return on equity investment. So-called “cultural” factors, such as a reluctance to include outside equity investors, as well as a higher aversion to market risk and volatility – from the perspective of the entrepreneur as well as the investor – are also cited as reasons why equity capital is low in Italian corporates (Bocconi, 2013). Until recently, the ready availability of debt financing has meant that businesses were able to access financing without having to raise additional equity.



26. **The low contribution of equity to total capital limits Italian firms’ access to market financing.** The quality of Italy’s corporate sector’s capitalization is relevant to capital market access insofar as a firm’s capital structure is a key determinant of a company’s creditworthiness, its ability to withstand shocks and cyclical downturns, and to finance investment. While the traditional bank-based model, facilitated by long-standing relationships, may have mitigated the need for formalized risk assessment, outside investors and markets in particular are more discerning on the basis of corporate fundamentals, for instance, relying on leverage and interest ratios, and credit ratings as assigned by independent rating agencies. Rating agencies, in turn, assign ratings based on companies’ business and financial risk profiles, including factors such as capital structure, financial policy, liquidity, and management and governance, which can all impact on investor interest (S&P, 2013).

27. **Initiatives designed to boost equity investment in Italian corporates have the potential to improve their access to public capital markets.** The authorities’ have taken steps to encourage Italian corporates to raise additional equity finance. In particular, the government introduced the Allowance for Corporate Equity (*Aiuto Alla Crescita Economica* or ACE), effective in 2012, which provides a tax deduction on new equity investment from retained earnings. In so doing, the policy

reduces the tax advantage of debt finance and aims to improve the quality of capital. The ACE was expanded this year to include a tax credit on regional corporate taxes for loss-making companies and to increase the size of the ACE benefit for listed companies to promote funding on capital markets. However, the higher tax rate imposed on distributed corporate earnings versus interest income continues to favor investment in debt over equity from the investor's perspective.

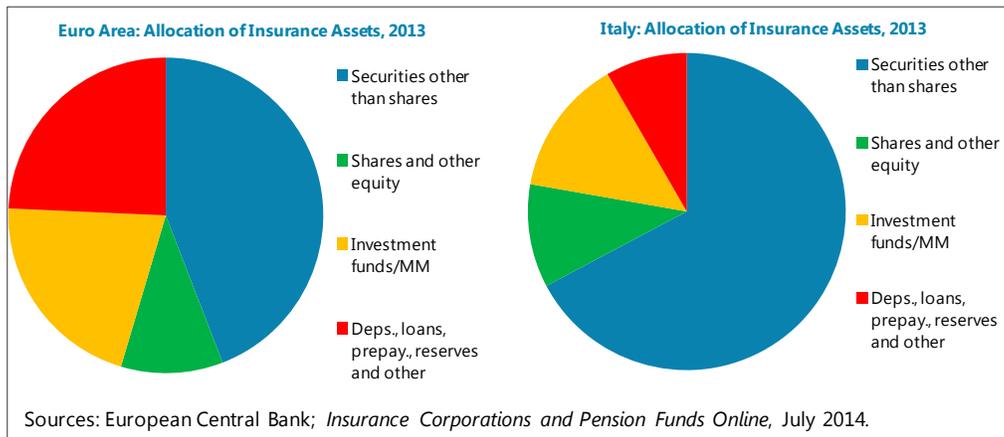
28. **Industry participants have also taken steps to improve equity capital market access for Italian firms.** In 2012, the Borsa Italiana introduced AIM Italia—MAC (Mercato Alternativo del Capitale), which encourages small and medium-sized companies to list on the exchange by introducing greater flexibility (for instance, reducing the time needed for admission to the exchange; reducing the minimum required free float of shares; and eliminating the minimum capital requirement for listed companies, among others). The program also assigns eligible companies a “Nominated Adviser” that will assist the filing company with information transparency, including financial filing requirements, and provide the listing country with introductions to legal and other advisors. Since its introduction, over €450 million in equity capital has been raised through initial public offerings (IPOs) associated with the program. Closely related is the ELITE program, which was established in 2012 by the Borsa Italiana, Italian industry association, Confindustria, private equity funds, the Ministry of Finance, among others. The program aims to identify and promote potential candidates for an eventual IPO by preparing selected enterprises via organizational changes and introductions to capital market participants.

D. Role of Institutional Investors

29. **A well-funded and well-managed institutional investor base can play an important role in fostering capital market development.** Such a base can create demand for traded securities and generate market liquidity that allows for market entry and exit while minimizing the potential for destabilizing price movements. While Italy's institutional investors – pension funds, insurance companies and investment funds – manage a substantial pool of assets, their investment in Italian capital markets has typically been concentrated in fixed income securities, a large portion of which is government debt. Creating an environment in which such investment pools will find equity investment an attractive option depends importantly on Italy's fundamentals, while a number of structural factors (e.g., higher contribution rates to private pension plans; the phasing out of defined benefit plans) also have the potential to expand the eligible investment pool and support greater investment in Italian securities, and Italian equities in particular.

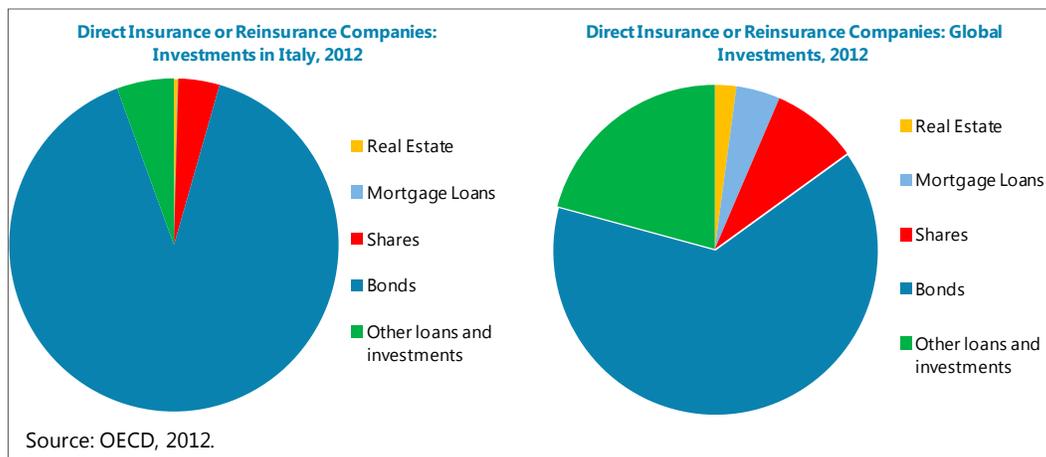
Insurance Companies

30. **Insurance companies are the largest institutional investors in the euro area, with €6.2 trillion in assets as of end-2013.** For the euro area as a whole, nearly half of all insurance company assets are invested in securities other than shares, namely sovereign and non-financial corporate debt (44 percent of assets). Investment and money market funds account for the next largest share, accounting for 21 percent of assets, while shares and other equity account for 10 percent, currency and deposits account for 9 percent, and loans account for 7 percent. The balance (9 percent of assets) is comprised of prepayments and other reserves, non-financial assets, and other investments.



31. **By contrast, Italian insurance companies are more concentrated in debt instruments.** Italian insurers’ assets total about €600 billion or 38 percent of GDP, of which two-thirds are invested in securities other than shares, about 50 percent higher than for the euro area as a whole. More than half of this amount (45 percent of the total) is invested in Italian government bonds. The allocation to shares and other equity investments, at just over 10 percent of total assets, is consistent between Italy and the rest of the euro area, while allocations to currency and deposits, loans, prepayments and other reserves, non-financial assets, and other investments are all below the euro area as a whole, resulting in an asset portfolio that is much more concentrated in fixed income.

32. **Looking at how insurance companies across the globe invest in Italy, there is an almost exclusive focus on debt instruments.**



In general, insurance companies are heavily invested in fixed income instruments, with bonds accounting for 64 percent of the \$12 trillion in insurance investments among OCED and other insurance companies globally⁹. Of the \$12 trillion, only 1 percent or \$122 billion is invested in Italy, whereas Italy accounts for nearly 3 percent of global GDP in US dollar terms. Of the \$122 billion invested in Italy, the vast majority (90 percent) is invested in bonds; by contrast, among the 42 countries for which this data is reported, only investments in Costa Rica, Hungary and Turkey are more heavily concentrated in debt instruments.

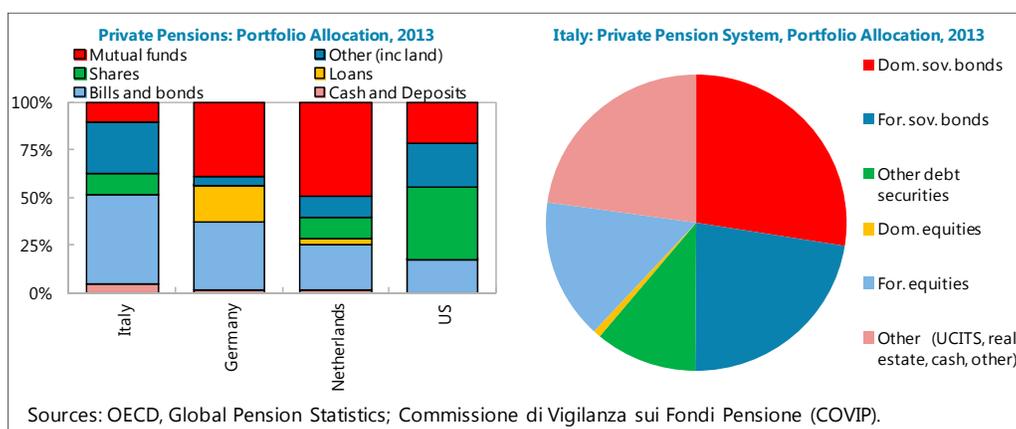
Pension Funds

33. **As an investor class, Italy's private pension funds have the potential to play a significant role in meeting the financing needs of Italy's corporate sector.** At €116bn, the market value of Italy's pension fund assets is equal to about 7½ percent of GDP¹⁰. While the size of private pension systems among euro area countries varies considerably, the current size of Italy's system, while having more than doubled since 2007, remains well below the OECD average of 35.5 percent of GDP. Growth in private pensions as a store of wealth and savings will expand the pool of resources available for investment in publicly traded securities.

34. **Investment in domestic equity securities represents less than 1 percent of Italian private pension funds' portfolios.** While asset allocation among Italian pension funds is broadly in line with the median allocation among OECD countries by *type* of investment, this masks the very low investment by private pension funds in *domestic* equity securities. Roughly half of Italian pension assets are invested in fixed income instruments, while 16 percent of pension assets are invested in equities, broadly in line with OECD average. However, there are wide disparities between countries, with assets in the largest pension market, the US, invested roughly 50 percent in equities, and only 20 percent in fixed income. On the other end of the spectrum, Germany, Japan and Korea are among the countries with less than 10 percent of assets allocated to equity shares. In addition, while 16 percent of Italy's private pension portfolio is invested in equities, domestic equities account for just 5 percent of total equities, or less than 1 percent of the total portfolio. The single largest allocation is made to domestic sovereign bonds which account for 27.5 percent of the portfolio.

¹⁵ OECD dataset, "Destinations of investments by direct insurance or reinsurance companies". Sample includes OECD countries minus Canada, plus Argentina, Bolivia, Colombia, Costa Rica, El Salvador, Indonesia, Malaysia, Panama, Peru, South Africa and Uruguay.

¹⁶ Italy's total private pension system consists of: (i) "old" pension funds, which refer to both defined contribution and defined benefit pension funds in operation prior to the 1993 reform and account for just over 40 percent of system assets; (ii) contractual pension funds, which support occupational plans, and account for 30 percent of the system; (iii) individual pension plans, or "PIPs", which are offered by insurance companies to support personal plans and account for 17 percent of the system; and (iv) open pension funds, which support both occupational and personal plans, and comprise just 10 percent of the system.



35. **Institutional investors' asset allocation reflects a number of considerations.** These include the regulatory environment and treatment of certain asset classes for regulatory purposes, which relates closely to the need to match assets and liabilities. While regulations are designed to provide adequate capital buffers, they also can limit investor interest in certain asset classes, including equities. Another critical aspect is the choice made by individual investors, where "guaranteed return" products and the legacy of defined benefit pension plans may favor fixed income investments with defined coupons and maturity dates over higher risk but potentially higher yielding equity investments. As mentioned, the preference among institutional investors for debt over equity instruments when investing in Italy also likely reflects Italy's relatively low market capitalization in the context of a high degree of benchmarking among institutional investors, as well as the overall economic outlook.

E. Recommendations

Increasing Supply: Boosting Equity in Italian Corporates

36. **Efforts to increase equity capital in Italian corporates will support the diversification of funding sources to include capital markets.** Boosting entrepreneurs' interest in outside sources of equity finance is essential to the development of Italy's capital markets. In particular, increasing equity issuance will expand the available pool of equity instruments for investment.

37. **Incentives to encourage market listings can also improve corporate governance and support market access.** Filing requirements typically include corporate governance elements such as the inclusion of outside directors on corporate boards and board oversight of senior executive compensation. "Light" filing and other reduced requirements for public listing (e.g., no formal requirement for internal audit or remuneration committees) such as those supported by the AIM Italia program should serve as a bridge to best practice and foster the overall business environment in Italy.

Boosting Demand: Investor Interest in Capital Market Investments

38. **Institutional investors' interest in Italian securities and equities in particular will be bolstered by improving the capitalization of Italian corporates.** Attracting new equity capital into

Italian corporates will help improve the quality of capital, reduce leverage ratios, and support investor interest for both equity and debt instruments. While the improved capital quality will support investor interest in Italian corporate securities, a higher market capitalization should boost Italy's weight in industry benchmarks, spurring additional inflows. Noting the disparity in asset allocations between Italian institutional investors and other large global investors, and highlighting the potential impact on returns, can encourage a higher allocation to equities and alternative assets, thereby expanding the demand for long-term risk capital instruments. Over time, reducing the gap between the taxation of public and private securities in Italy would encourage more investment in the private capital markets¹¹.

39. **Future work should investigate the drivers behind investment allocation in Italy.** As mentioned, Italian savings in the form of institutional pools is low relative to peers. It is worth evaluating the key drivers behind investor preferences, including various incentives (e.g., fiscal treatment), institutional quality, and the macroeconomic environment (e.g., growth and stability considerations). Sovereign credit quality also has an important role to play in supporting capital market access, as sovereign credit quality has been shown to have a strong effect on the volume of corporate credit or equity issued (Das, 2010).

F. Conclusion

40. **The underlying challenges facing Italian banks have abated rather than disappeared.** Their business models and asset and liability management would benefit from substantial changes. Efforts should prioritize measures targeted towards cost-cutting and NPL disposals in the weakest banks to break the vicious circle between weak financial metrics and lower credit growth. In turn, these measures would help restore confidence in the wider banking sector and restore credit growth.

41. **The ECB's forthcoming BSA could provide valuable assistance in restoring banks back to health.** More broadly, it is also a possible catalyst for banks to restructure, and may put pressure on banks to merge, improve their corporate governance, and sell distressed assets to the market.

42. **Market funding can help bridge this gap and rebalance the financial system towards a more "market-based" system.** On the supply-side, this means encouraging capital market issuance, and equity issuance in particular, among Italian corporates. On the demand-side, stronger corporate capitalization and an improving economic outlook should support investor interest in Italian private sector securities. A higher allocation among Italian institutional investors to equities, in line with large global investors, could also expand the demand for long-term risk capital instruments, provided some of the higher allocation is directed toward domestic securities.

¹⁷ Income earned on corporate securities is taxed at 26 percent versus 12.5 percent on government securities.

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- Standard & Poor's Rating Services, Ratings Direct, Corporate Methodology. November 19, 2013

IMPROVING PUBLIC SPENDING ALLOCATION AND PERFORMANCE IN ITALY: AN EFFICIENCY ANALYSIS¹

Budget allocation in Italy will need to increasingly rely on an efficiency analysis to find savings and improve performance. Achieving sizable expenditure savings will require addressing the large social spending, in particular, current pensions. In the education and non-pension social protection sector, the room for savings may be limited, but there exists scope for improving outcomes. In the health sector, the analysis shows room for savings, particularly in the areas of goods and services by reducing cross-regional variation in spending efficiency. Improving allocation of regional transfers to sub national governments using standard costs based on more efficient benchmarks could provide an important avenue for savings.

A. Background

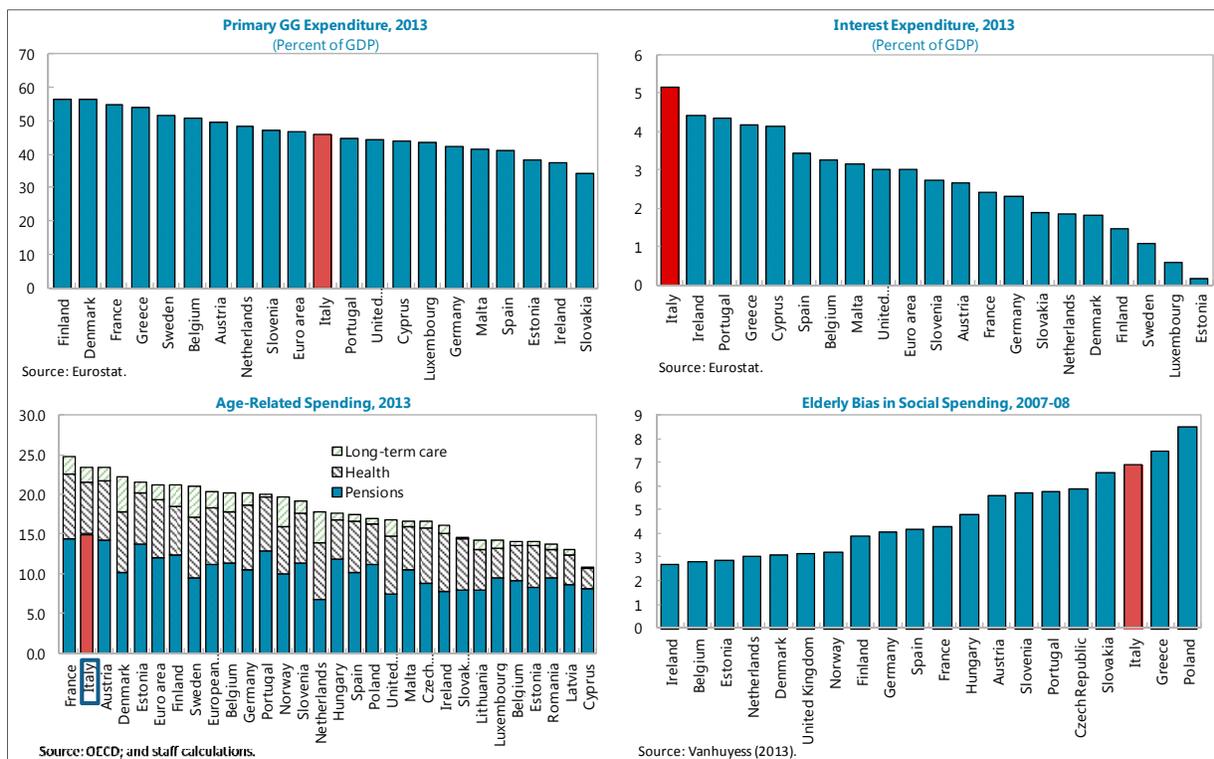
1. **Italy faces a challenging situation to reduce its high public debt.** Public debt, at over 134 percent of GDP, is the second highest in the euro area. Refinancing needs of over 24 percent of GDP leave Italy vulnerable to financial market swings. Sizable efforts to curtail spending and raise taxes have been undertaken over the past decade. Nevertheless, the debt overhang and the interest burden means that Italy needs to keep running a sizable primary surplus in order to lower debt. The tax burden is also very high stifling the economic recovery. Furthermore, low trend growth and disinflation are leading to unfavorable debt dynamics.
2. **Italy's medium-term fiscal strategy relies heavily on spending reforms to lower the tax burden while also undertaking fiscal consolidation to strengthen fiscal sustainability.** In the April 2014 DEF, the authorities aim to reduce the fiscal deficit by 2¾ percent of GDP by 2017, in keeping with its fiscal rule of zero structural balance. Spending levels will be lowered to 3¾ percent of GDP while revenues will also decrease by ½ percent of GDP. Under the reform plans, the tax wedge will be reduced further by 0.7 percent of GDP annually from 2014 to 2017.
3. **Fiscal reforms will require an in-depth spending analysis to identify savings while preserving public spending quality.** The government has undertaken a spending review and identified savings of EUR 34 billion over 2014–16 to lower the tax burden and support fiscal consolidation. Going forward, the priority will be to take better account of the quality concerns in the resource allocation framework. Accordingly, this paper seeks to examine the efficiency of spending on a cross-country and cross-regional basis to identify potential areas of savings and further improvements.

¹ Prepared by Anita Tuladhar (EUR).

B. Comparison with Euro Area Spending and Efficiency Indicators

Spending Structure in Italy

4. **Primary spending level in Italy is average by Euro area standards, but is heavily biased towards pension spending.** Overall spending is slightly above the euro area average reflecting the large debt servicing burden, the highest in the euro area. A breakdown by economic classification shows that public spending is concentrated in social benefits spending with a large share in public pensions (about a third of primary spending). This reflects both a high share of elderly population as well as a generous pension system with a high replacement rate (OECD, 2013). As a result, Italy has the highest elderly bias in social spending in the euro area after Greece (Vanhuyess, 2013). Indeed, Italy currently spends about 7 times more on each elderly (above age 65) compared to a non-elderly. In terms of functional classification, spending in Italy also exceeds euro area average spending in general services, defense, public order and environmental spending, although the excess relatively small. In contrast, the main areas where Italy under spends are in education and economic affairs.



5. **Further decomposition across classifications (COFOG) shows pockets of overspending relative to euro area average.** In particular, intermediate consumption spending (mainly comprising goods and services spending) is more than 25 percent higher in environment and health sectors compared to the euro area, but is much lower in education. Similarly, wage spending is at least 15 percent higher in defense, health, and public order and safety. Capital spending also exceeds euro area averages in defense, general services, environment, and health.

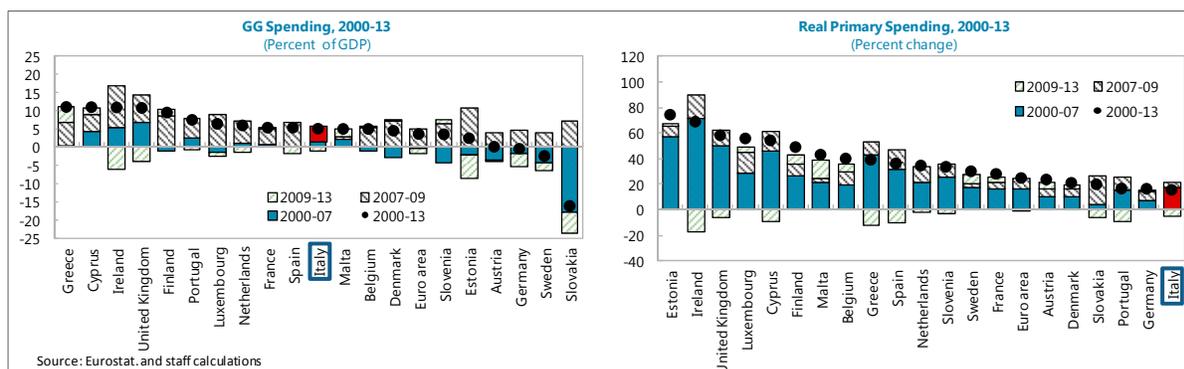
Italy and Euro Area: General Government Spending, 2000–12 (Percent of GDP)

		Functional Classification											
		Total Expenditure	General Services	Defense	Public Order and Safety	Economic Affairs	Environmental Protection	Housing	Health	Rec/Culture	Education	Social Protection	
Economic Classification	Total Expenditure	Italy	50.6	9.1	1.4	1.9	3.4	0.9	0.7	7.3	0.7	4.2	21.0
		Euro area	49.8	6.8	1.3	1.8	4.3	0.8	0.8	7.4	1.1	5.0	20.5
	Intermediate Consumption	Italy	5.7	1.0	0.3	0.3	0.3	0.6	0.2	1.9	0.3	0.4	0.3
		Euro area	5.5	0.9	0.5	0.3	0.7	0.4	0.2	0.9	0.3	0.7	0.5
	Compensation of Employees	Italy	10.6	1.4	0.9	1.5	0.4	0.1	0.1	2.4	0.2	3.2	0.3
		Euro area	10.5	1.5	0.7	1.3	0.6	0.2	0.2	1.6	0.3	3.3	0.8
	Subsidies	Italy	1.0	0.0	0.0	0.0	0.9	0.0	0.0	0.0	0.0	0.1	0.0
		Euro area	1.3	0.0	0.0	0.0	0.9	0.0	0.0	0.1	0.0	0.1	0.1
	Other current transfers	Italy	1.6	0.9	0.0	0.0	0.1	0.0	0.0	0.1	0.2	0.1	0.1
		Euro area	2.2	1.0	0.0	0.0	0.2	0.0	0.0	0.1	0.1	0.3	0.4
	Other social benefits	Italy	22.6	0.0	0.0	0.0	0.0	0.0	0.0	2.5	0.0	0.0	20.1
		Euro area	23.4	0.0	0.0	0.0	0.1	0.0	0.0	4.5	0.0	0.2	18.6
	Capital Transfers	Italy	1.2	0.0	0.0	0.0	0.9	0.0	0.1	0.0	0.0	0.0	0.0
		Euro area	1.5	0.2	0.0	0.0	1.0	0.0	0.1	0.0	0.0	0.1	0.0
	Gross Capital Formation	Italy	1.9	0.3	0.1	0.1	0.7	0.2	0.2	0.2	0.1	0.1	0.0
		Euro area	2.1	0.2	0.0	0.1	0.7	0.1	0.2	0.2	0.2	0.3	0.1

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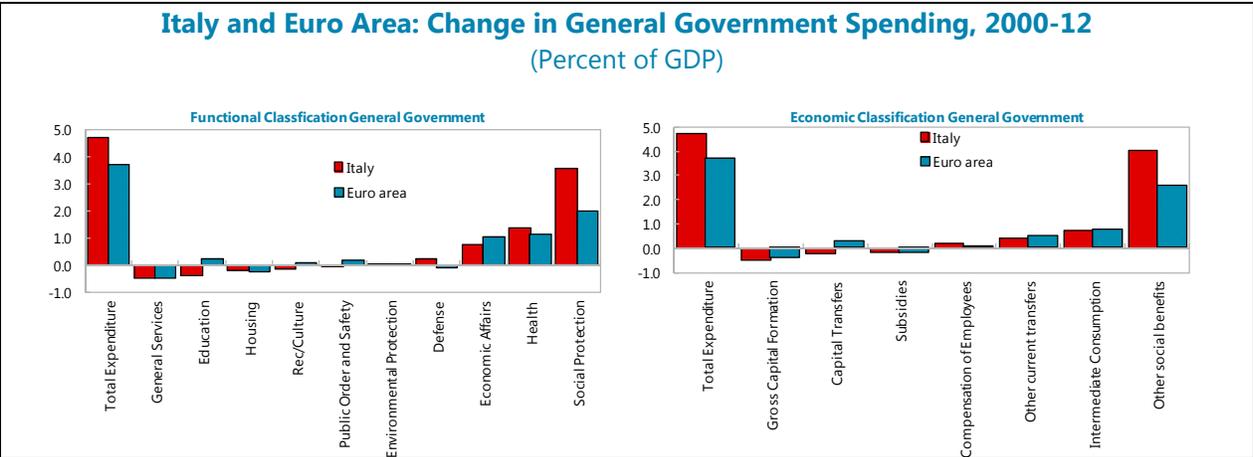
Evolution of Public Spending

6. **Since 2000, overall spending in Italy, as a share of GDP, has increased broadly in line with the euro area.** This reflects not only the higher spending growth, which increased mostly during pre-crisis period, but also the decline in nominal GDP since the crisis. In real terms, primary spending growth has been the lowest in the region, declining by 5 percent over 2009–13. The largest spending increases were in social protection and health followed by economic affairs. These increases have been partly offset by reduced spending on education and general services.



7. **The rapid increase in current spending has crowded out capital spending.** Most of the current spending increase was in social benefits. Intermediate consumption and compensation of employees also increased, mainly in general services, defense and health sectors. The wage bill increased modestly despite significant reductions in public employment, which at 14 percent of the labor force, is below OECD average. Public wages have risen significantly over the past decade

driven by collective wage bargaining process and automatic grade progression (Report on Expenditure of Central Government Administration, 2012). The post-crisis wage freeze has helped to curtail this growth. Current transfers also increased, mainly in the general services sector. In contrast, capital spending has declined at a slightly higher pace than in the euro area.



8. **Spending has increased at all levels of government.** At the central government level, the largest increase was in other current transfers in social protection and general services sectors which may reflect the high internal transfers under decentralization. In contrast, capital transfers and subsidies declined as a share of GDP. At the social security level, pension benefits increased by more than 2 percent of GDP compared to the euro area. For local governments, increases in current spending more than offset the decline in capital spending. This increase was mostly concentrated in the health sector, offsetting the decline at the central government level.

9. **The above trends mask a sizeable decline in spending over the past few years.** As in the rest of the region, spending has declined as a share of GDP in 2009–12. This decline was across the board, except in the areas of general services (reflecting interest payments) and social protection where the increases were much larger than the regional average, partially offsetting the cuts in other areas especially in capital transfers.

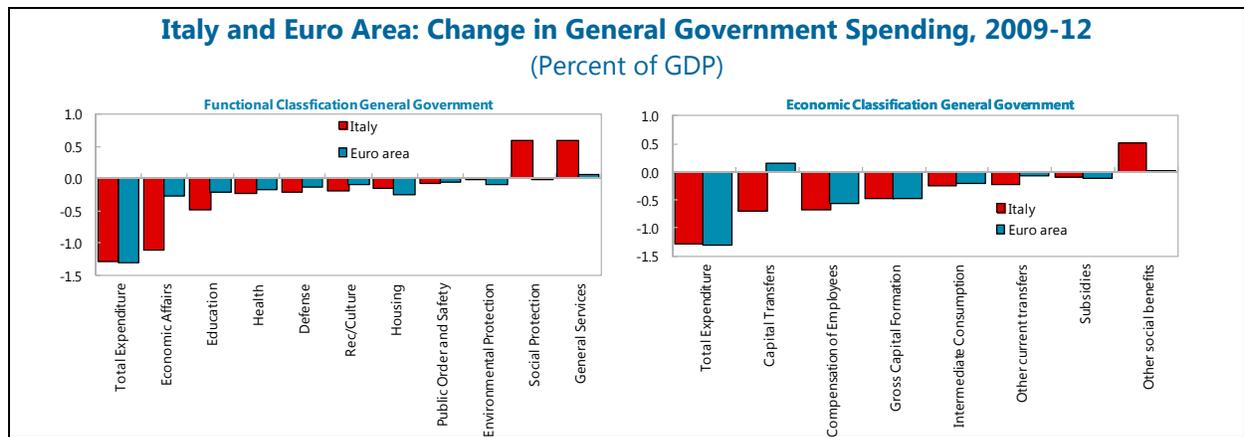
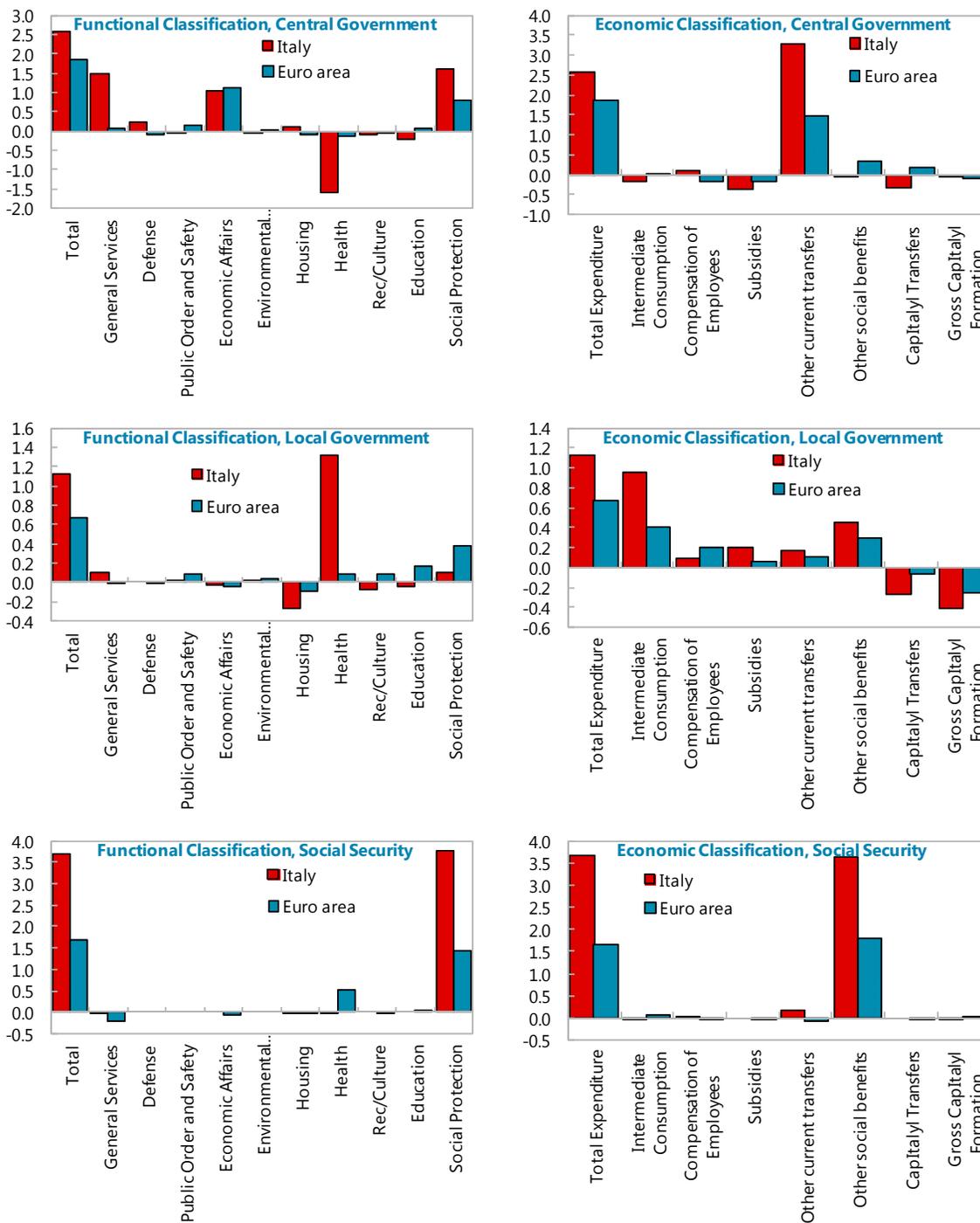
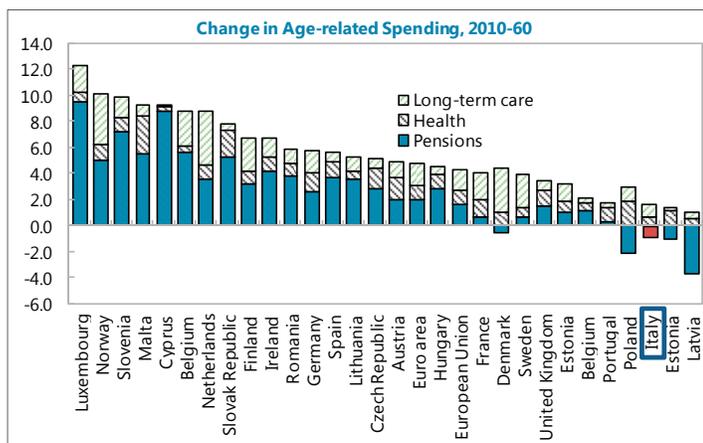


Figure 1. Italy and Euro Area: Increase in Spending by Level of Government, 2000–12



Source: Eurostat; and staff calculations.

10. **Looking ahead, Italy fares relatively well compared to the euro area in terms of future spending pressures.** With pension and health care reforms already underway, the pace of increase in Italy's age-related spending is projected to be one of the lowest in the euro area over the coming decades (OECD, 2013). Pension spending is expected to decline over 2010–60, most of it before 2025. While pension benefits are expected to fall significantly, this mainly affects future pensioners while current pensioners are largely unaffected by the 2012 pension reforms.



11. **To summarize, an analysis of the spending level and growth shows that additional savings is likely difficult without addressing current pensions.** Pensions and health have been the main sources of spending pressures since 2000 and have crowded out other areas including education and capital formation. Over the past few years, health care reforms have been implemented and pension reforms have addressed long-run sustainability concerns, but leaving existing pensions largely unaffected. Significant savings is likely to be difficult without addressing the large spending on current pensions.

12. **Beyond an analysis of the level and growth in spending, identification of possible savings or reallocations requires an assessment of efficiency and effectiveness.** Such an analysis would assess the effectiveness of public spending in achieving specific policy goals. Furthermore, public spending reductions can be achieved without sacrificing outputs by cutting inefficient and wasteful spending. Below, we examine some broad indicators of efficiency of public spending in key social spending areas to gauge potential efficiency gains and possible savings.

Benchmarking Using Efficiency Indicators

Methodological issues

13. **We analyze spending efficiency in some key social sectors such as health, education, and social protection using a Data Envelopment Analysis (DEA) methodology.** Together, these account for 64 percent of total expenditure. The DEA uses cross-country efficiency scores in a sample of EU/euro area countries to analyze the relative performance in different sectors. Furthermore, the DEA method is also used to analyze spending efficiency at the regional level in Italy.

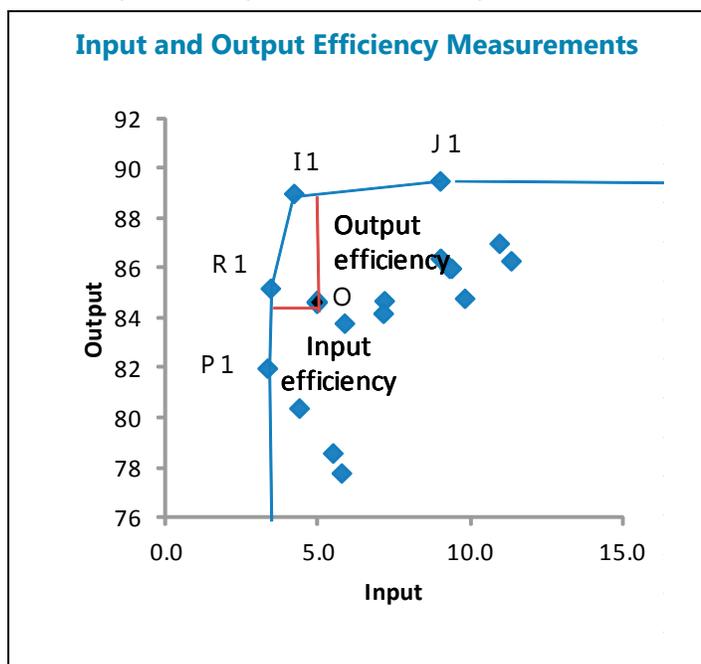
14. **DEA efficiency scores provide a theoretical benchmark of potential savings that can be achieved without sacrificing outcomes.** The methodology uses linear programming techniques to construct an efficient frontier of countries that have the maximum output for a given level of input and production technology. This frontier “envelopes” a set of countries based on their input/output

combinations. The distance to each of these countries' input relative to the distance to the frontier provides the efficiency score. The countries on the frontier have an efficiency score of 1. The efficiency scores can be measured in two ways: the input efficiency score provides the horizontal distance to the frontier and the output efficiency score measures the vertical distance to the frontier. So, for example, an input inefficiency score of 0.7 would imply that one could achieve the same output with 30 percent less input.

15. **Efficiency analysis at the macro level should be viewed as indicative and requires further in-depth analysis.** While this methodology has the advantage of not requiring assumptions on a specific functional form, there are important caveats. The DEA score is a relative concept that is subject to sample bias and to outliers. Importantly, outcomes do not solely reflect public spending. The distance to the frontier may reflect not only inefficiencies, but also idiosyncratic conditions. Since exogenous non-discretionary factors can also impact outcomes, a second stage regression analysis is undertaken to analyze what factors explain the efficiency scores. Where significant, a corrected efficiency score is also calculated. Given these caveats, the efficiency scores below should be considered as indicative rather than an absolute level of savings.

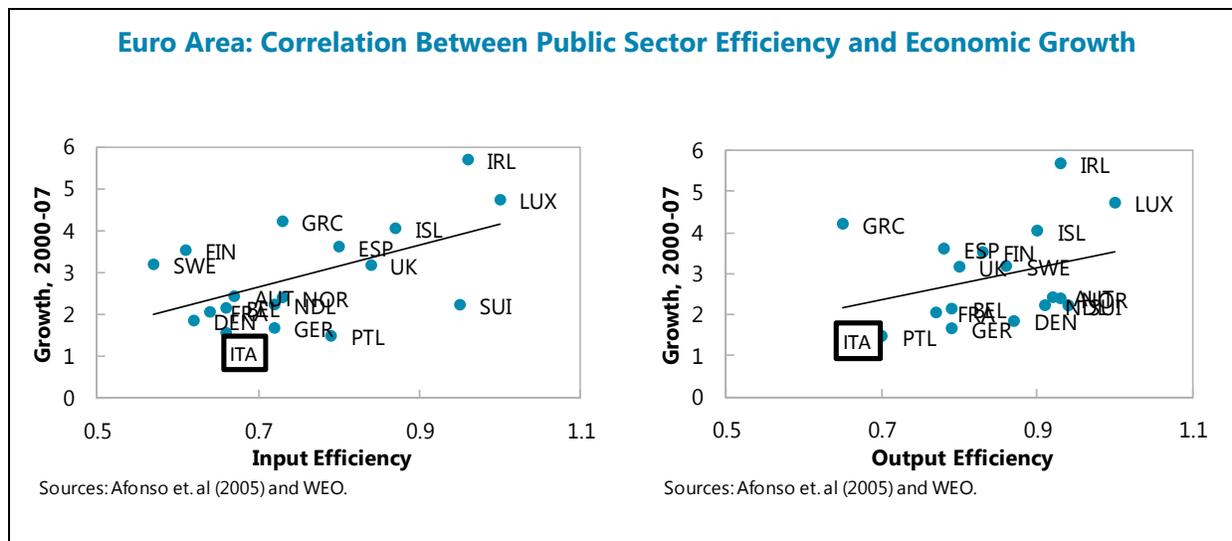
Efficiency of Public Spending in Italy

16. **Studies of Italy's public spending pointed efficiency scores that were relatively low with significant variations across regions.** For example, a composite indicator of public sector performance looking at administrative, education, health and public infrastructure outcomes as well as indicators of economic distribution, stability and performance showed Italy with a relatively low efficiency in the OECD (Afonso, et. al., 2005). Specifically, public administration efficiency ranked very low. These scores have likely improved over time given the changes in public administration. Nevertheless, more recent studies of public sector efficiency at the regional level show a consistently lower efficiency in the southern regions (Giordano and Tomassino, 2011). Below, we estimate the efficiency scores for health, education and social protection sectors using the latest available data and discuss policy implications.



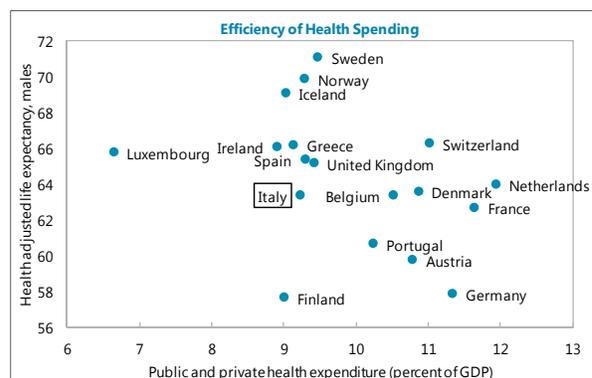
Health

17. **Reforms have helped to reverse the rapid rise in health spending over the past decade.** Health care accounted for much of the spending increase at the regional government level. Since 2009, the Health. Pact has been implemented with the goal of cost containment through supply-side reforms such as limiting hospital beds, admission and length of stay and procurement reforms. Consequently, health care spending has declined over the past few years and is currently slightly below the EU average.



18. **Efficiency indicators of public health spending suggest scope for improvement.**

Outcome indicators such as life expectancy are high in Italy, but adjusted for quality (i.e. adjusted for both mortality and morbidity), health adjusted life expectancy (HALE) indicators and mortality rates appear weaker. Efficiency indicators using the latter indicators (HALE) suggest the same outcomes could be achieved with 25 percent less public health care spending (Text table and Table A1.1). To control for exogenous non-budget factors, these efficiency scores were regressed on per capita income (PPS), old-age dependency ratio and private spending on health as a share of GDP. In this fairly homogenous sample, however, none of these factors were significant in explaining the variation in efficiency scores.



19. **A regional analysis of health care spending shows cost inefficiencies, particularly in the south.** Health care spending is significantly higher in the southern regions, although outcomes are not particularly worse and outputs are about average (Text table and Table A2.1). This partly reflects the fact that regional health care spending is funded by central government transfers that are determined primarily on a per capita basis. Indeed, efficiency scores based on health spending per

capita suggest lower regional variation. However, efficiency indicators using per capita health spending as a share of PPS based per capita GDP suggest relatively large regional variation. Bringing efficiency scores to national average levels in the low performing regions could provide savings of almost 1 percent of GDP. The magnitude of savings is likely lower now since the analysis is conducted using 2011 data and health care spending has declined over the past few years. Second stage regressions results suggest that these efficiency scores are strongly correlated with socio-economic conditions such as per capita income and population at risk of poverty. Population density is also positively correlated likely reflecting ease of providing services. At the same time, fiscal variables such as transfer dependency and size of borrowing are negatively correlated (Tables A2.5-A2.7) suggesting possible room for savings through better allocation of fiscal transfers.

DEA Efficiency Scores for Health Sector							
	Input	Output				Efficiency (input-based)	Rank
	Public Health Exp/GDP 2011, or latest	HALE Female 2011	HALE Male 2011	Mortality rate, cancer 2010	Mortality rate, heart disease 2010		
Italy	6.9	62.7	63.4	383.3	907.4	0.76	14/16
Average	6.7	64.1	64.5	390.8	893.1	0.91	

Sources: Eurostat; OECD and staff calculations.

	Output			Input	Efficiency	
	Life expectancy at birth, 2012	Available beds (per 1000 inhabitants), 2011	Physicians (per 1000 inhabitants), 2011	Public health spending as a share of regional GDP, 2011	Input-based	Output-based
Nord-Ovest	82.6	3.6	3.9	6.6	0.94	1.00
Nord-Est	83.1	3.8	3.6	6.0	0.95	1.00
Centro	82.8	3.3	4.4	6.9	1.00	1.00
Sud	82.2	3.2	4.0	10.2	0.53	0.99
Isole	81.9	3.2	4.8	10.5	0.80	0.99
Mean	82.6	3.5	4.0	7.9	0.82	1.0

Sources: Eurostat; ISTAT; and staff calculations.

20. **With recent reforms, these scores have likely improved.** Important reforms to base transfer of health care funds on standard costs have been approved. The 2012 health care reform also promoted the prescription of generic drugs, cut the hospital bed ratio, and reduced public financing by €2.1 billion by 2015. At the regional level, measures have also improved primary care;

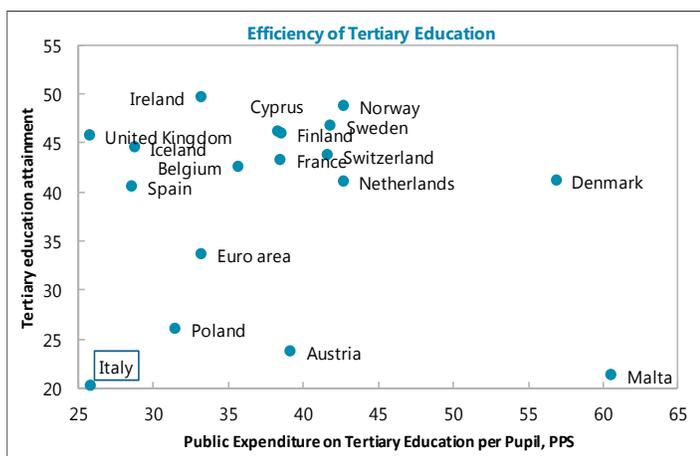
updated health care tariffs; restructured governance of hospitals; revised the list of reimbursable pharmaceuticals; and introduced health technology assessment (HIT, 2013). The Health Pact at the regional level based on standard costs alongside restructuring plans is also being strictly monitored.

21. **Policy measures could focus on further supply side reforms.** Francese and Romanelli (2013) find that improvements in public administration, use of generic drugs and supply-side reforms could help improve efficiency and gain savings. Regional health technology assessments can be stepped up and more market mechanisms for health care services such as in contracting between regional health care units and providers can be used (HIT, 2013). Additional gains particularly in goods and services spending are also under consideration. An evaluation and follow-up on the recent measures should be undertaken.

Education

22. **Increased education spending while improving outcomes is needed to enhance productivity, employability and growth.** Education spending has declined over the past decade and is currently the second lowest in the euro area. At the same time, education outcome indicators are weak, particularly for tertiary education attainment, completion rate of upper secondary education, employability rate and PISA scores. Tertiary graduation rates are particularly low.

DEA efficiency scores using these indicators and education spending input variables, show Italy is close to the efficiency frontier (Text table and Table A1.3). This implies that room for savings is likely not large, while there is possible scope to increase spending to move along the efficiency frontier and improve outcomes.



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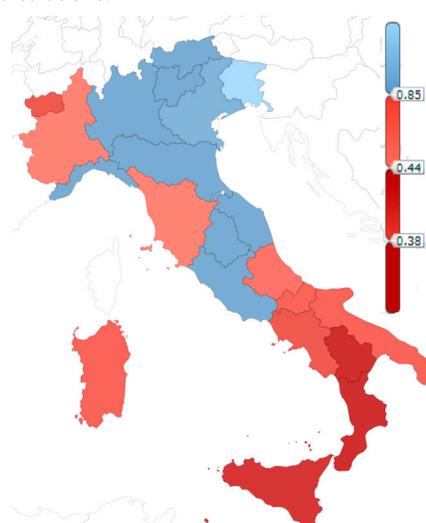
DEA Efficiency Scores for Education Sector											
	Input			Output							
	Public Education Expenditure/GDP 2011	Total education spending per pupil in PPS 2010	Public expenditure on tertiary education per pupil (in percent of GDP per capita) 2010	Tertiary education attainment (percent of population, 30-35 yrs) 2011	Upper sec edu (percent of Population, 25-64 yrs) 2011	pupil teacher ratio 2011	Employability Rate 2009	PISA Reading 2012	Public Spending Efficiency score 1/	Total Per Pupil Efficiency score 2/	Tertiary Education Spending per Pupil Efficiency score 3/
Italy	4.2	6097.3	25.8	20.3	56.0	12.0	59.2	489.8	0.99	1.00	1.00
Mean	5.9	7685.8	38.2	39.0	70.7	12.0	76.8	498.6	0.89	0.94	0.92

Sources: OECD; Eurostat; WDI; and staff calculations.
 1/ Input: Public Education spending to GDP; Output: All five indicators
 2/ Input: Total Education Spending per Pupil, PPS; Output: PISA score, pupil teacher ratio and employability rate
 3/ Input: Total Spending on Tertiary Education per Pupil, PPS; Output: PISA score, tertiary education attainment and employability rate

DEA Efficiency Scores for Education Sector, by Regions

	Invalsi Score	Output			Input	Efficiency	
		Tertiary education attainment, 25-64 yrs (percent)	Enrollment in sec and post-sec education, 15-24 yrs (percent)	Employment rate, 20-64 yrs (percent)		Public spending on education per pupil as a share of per capita GDP	Input-based
Nord-Ovest	1.0	17.3	47.0	67.6	21.4	0.80	0.98
Nord-Est	1.1	16.3	48.3	70.5	19.5	0.97	0.99
Centro	1.0	18.9	47.2	64.9	19.6	0.94	0.99
Sud	1.0	15.1	45.8	48.6	32.0	0.45	0.92
Isole	1.0	13.6	44.8	47.3	33.5	0.41	0.89
Mean	1.0	16.4	46.8	60.4	24.8	0.73	0.96

Sources: Eurostat; ISTAT; and staff calculations.



23. **Significant regional variation in education efficiency is seen with the south being worse.** Sibiano and Agasisti (2013) also find similar regional variations. While the northern regions are close to the frontier, the southern regions could achieve the same outcomes with less than half the resources currently being spent. Spending per student as a share of per capita income is high whilst outcome indicators such as test scores, enrollment rates and completion rates are weak (Table A2.2). The low efficiency scores are negatively correlated with socioeconomic conditions such as per capita GDP (PPS), and dependency on central government transfers (Table A2.4).

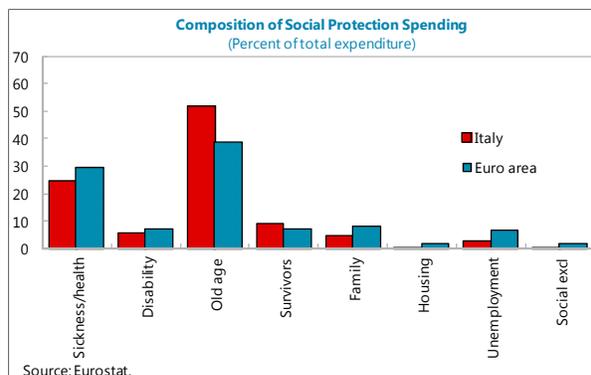
24. **Performance based budgetary reforms in the education sector could improve outcomes.** Italy stands out for its lack of outcome based policy in education, Gounard (2007). Italy's challenge is particularly acute in higher education (OECD, 2011). Fixing funding rules, evaluation systems and institutional autonomy for staffing policy can help reduce cross regional variation in inefficiencies and strengthen effectiveness of spending allocations, which in turn can enhance economic productivity and competitiveness (St. Aubyn, et. Al 2009). Furthermore, adult literacy,

numeracy and technology skills are also relatively weak in Italy (OECD, 2013). Consequently, beyond formal education, more emphasis is needed on continuing education to improve technological skills.

Social Protection and Active Labor Market Policies

Despite low spending, efficiency of social protection spending and labor market policies can be enhanced to improve outcomes.

The efficiency indicator using social protection spending (excluding pensions) as input, and multiple outcome indicators such as income inequality and population at risk of poverty indicators shows that the same outcomes could be achieved with 30 percent less spending. Italy ranks relatively well in the euro area, likely reflecting the below average spending on non-pension social expenditures and the higher reliance on intra-family transfers for social assistance (Text figure and Table A1.2). Outcome indicators are however weak resulting in relatively low ranking in terms of output based efficiency indicator.



DEA Efficiency Scores for Social Protection Spending (excluding Pensions)								
	Input	Output			Efficiency, input based 1/ Rank	Efficiency, output based 1/ Rank		
		Population at risk of poverty after transfers 2011	Gini coefficient 2011	Income quintile share 2011				
Italy	4.4	19.6	31.9	0.2	0.70	6/19	0.89	17/19
Mean	6.8	15.0	28.6	0.2	0.56		0.94	

Sources: Eurostat; and staff calculations.
 1/ Input: Social protection spending, excl pensions; outputs: poverty risk (inverted), Gini coefficient (inverted) and share of income of lowest quintile to highest quintile.

25. **The regional variation in efficiency reflects the highly decentralized and fragmented social assistance system.** Municipalities play an important role in financing and administration of the social assistance system with different institutions responsible for transfers to different vulnerable groups. Southern regions generally have weaker outcomes in terms of poverty risk and the share of long term unemployed. The average efficiency score across regions suggest that the same outcomes could be achieved with almost 25 percent less resources. Alternatively, the same resources could be used to improve outcomes by 12 percent. The regional efficiency indicators are strongly correlated with GDP per capita (PPS) (Table A2.4). Given the relatively low level of spending

in this area, the scope for savings could be more limited. Indeed, it is estimated that bringing the low performing regions to national average levels would yield only around 0.14 percent of GDP in savings.

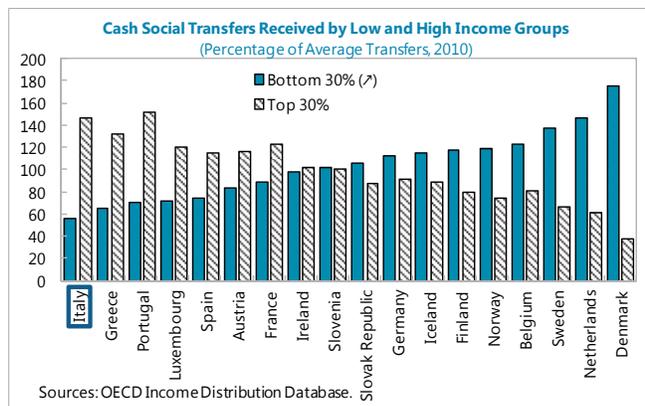
DEA Efficiency Scores for Social Protection Spending, by Regions

	Output		Input	Efficiency	
	At-risk of poverty rate (inverted), 2012	Share of Long-term unemployed (inverted), 2013		Social protection spending as a share of regional GDP, 2011	Input-based
Nord-Ovest	88.3	0.2	1.3	0.9	1.0
Nord-Est	88.4	0.4	1.3	0.8	1.0
Centro	85.6	0.2	0.9	0.8	0.9
Sud	70.5	0.1	1.0	0.7	0.8
Isole	68.7	0.1	1.5	0.5	0.7
Mean	80.8	0.2	1.1	0.8	0.9

Sources: Eurostat; ISTAT; and staff calculations.

26. The weaker outcomes could reflect the limited impact of social transfers on the poor.

Studies have shown that the poverty reduction impact of taxes and transfers in Italy is weak (Caminada and Goudswaard, 2010, OECD, 2014). A disproportionately low share of social transfers accrues to the low-income working-age population. Tighter means testing of benefit eligibility could help improve outcomes. For example, implementing administrative efforts to limit fraud, such as the legal requirement to cross check beneficiaries with the tax register, can also help. This pattern of benefit incidence, however, may also reflect the lack of progressivity in pension transfers and tax expenditures.



27. Given the high share of long-term unemployed, strengthening the coverage of active labor market policies (ALMP), can provide an important pathway for exiting unemployment.

Efficiency indicators on ALMP using as input indicator, public spending on labor market policy (that include training, labor market services, employment incentives and direct job creation) and as output indicators, share of participants in the program among jobseekers and the inverse of share of long term unemployed of the total unemployed, show that Italy is average by euro area standards.

This is mainly due to the relatively high share of long-term unemployed in Italy. However, when adjusted for GDP per capita, which is significant with the efficiency scores, it lags behind most euro area members (Table A1.4).

DEA Efficiency Scores for Active Labor Market Policies							
	Input	Output		Input based		Output based	
	Public Spending on Labor Market Policy Measures (percent of GDP)	Participation in Labor Market Policy Measures (percent)	Share of LT Unemployed	Efficiency, corr. for PC	Rank	Efficiency, corr. for PC	Rank
	2003-11	2003-11	2012	GDP PPS 1/		GDP PPS 1/	
Italy	0.43	31.1	0.53	0.40	22/28	0.51	25/28
Mean	0.43	26.7	0.42	0.56		0.73	

Sources: Eurostat; and staff calculations.
1/ Input: Spending on LMP Measures; output: Participation in LMP measures, inverse share of LTU

28. **Reforms to improve central coordination for collecting performance information and evaluation should be implemented to better inform resource allocation.** Indicators on job placement and employability of participants over the longer run for participants in the ALMP were not available for Italy. Reforms to improve central coordination which can help in the resource allocation process were approved in 2012, but implementation is still lagging. The majority of unemployed are ineligible for unemployment benefits and services for job search, resulting in a weak link between work activation and benefits. As reforms to expand unemployment benefits get underway, conditioning continued unemployment benefit receipts to participation in job search assistance and training could help disincentivize passive unemployment. Combining activation policies with public works may also be self-financing as it reduces unemployment benefits. These reforms are key priorities under the Renzi government's reform agenda.

Regional Spending Efficiency and Transfers to Sub national Governments

29. **An important policy question is whether spending efficiency is affected by dependency on central government transfers.** Regional efficiency scores are negatively correlated to transfer dependency and external borrowing ratios (Table A2.4). One possible explanation is that higher transfers from the central government can weaken spending discipline with negative consequences on spending efficiency. There is little incentive to reduce spending as it would imply possible risk of losing transfers. Indeed, overall health and education spending are positively correlated with transfers (while this is not the case with social protection spending).

30. **This positive relation with transfers may also reflect the regional income level** (Table A2.4). This would be the case if transfers are distributed primarily for equalization goals.

Econometric tests using cross-sectional data show that socioeconomic conditions such as per capita income are indeed strongly correlated with efficiency indicators (Table A2.5). Furthermore, while fiscal variables, such as transfer dependency and external borrowing to GDP, are in general negatively correlated with health and education efficiency scores, they lose significance when controlling for per capita income (Table A2.5). Other demographic and institutional variables are also used as control variables. While population density appears to be associated with higher efficiency scores, other variables are not significant.

31. **Regional efficiency scores show a stronger negative correlation with initial transfer dependency.** While fiscal variables and spending may change annually, policy outcomes likely change only gradually over an extended period. Therefore, to assess whether efficiency scores are affected by lagged transfers rather than contemporaneous ones, efficiency scores are calculated using averages of input and output variables over two time horizons: the first over 2002–08 and the second over 2009–11. This breakdown marks the period when legislative changes to the criteria for transfers were introduced in 2009. Furthermore, large cuts in transfers were initiated as a crisis related measure. As above, regressions show a negative correlation with transfer dependency. The correlations with the initial (first period) transfer dependency are significant especially for health and education and are robust across different specifications. Regressions of the change in efficiency scores between the two periods on initial transfers also suggest that regions with lower transfer dependency have higher improvement in efficiency scores, although the significance level drops.

32. **To enhance the performance impact of transfers, legislative decrees to implement the 2009 Framework Law 42 need to be approved.** Several important decrees have already been approved to enhance autonomy and accountability, such as the definition of standard cost for the health care sector. Efforts are ongoing on the definition of expenditure needs and funding for municipalities; the funding and tax system for ordinary regions; and the harmonization of sub-central accounting principles. The law envisages setting of standard costs (fabbisogno standard) to meet minimum essential services, which determine the formula for an equalization fund. Indicators to determine these standard costs need to be finalized and approved by Parliament (OECD, 2012). At the same time, strict discipline is needed to ensure against ex-post bail outs.

C. Conclusions and Policy Recommendations

33. **Budget allocation in Italy will need to increasingly rely on an efficiency analysis to find savings and improve performance.** In a context where spending has already been tightened significantly, an in-depth analysis on the efficiency of spending is crucial to reduce spending without adversely impacting outcomes. Furthermore, it can also help inform how resources can be reallocated or outcomes improved within the existing resource envelope.

34. **Achieving sizable expenditure savings will require addressing the large social spending, in particular, current pensions.** Public pension and health care have been the main sources of spending pressures over the past decade. Intergenerational imbalances in Italian social spending are among the highest in the OECD. Pensions was the only area, other than interest payments, where spending increased in the post-crisis period. Although reforms have been

implemented in these areas, there is scope to do more to reorient the budget in a growth-friendly manner from the current high pension benefits towards investments, education and active labor market policies for younger generations.

35. To reduce cross-regional variation in spending efficiency, greater use of performance targets in resource allocation decision-making is needed.

- In the education sector, the room for savings may be limited, but there exists scope for improving educational outcomes. More reliance on outcome targets is needed in policy-making and reallocation of resources.
- In the health sector, the analysis shows significant room for savings, particularly in the areas of goods and services spending where growth has been the highest. In 2011, improving efficiency in the low-performing regions to the national average could potentially save as much as 1 percent of GDP. Efficiency scores have likely improved with the reforms such as standard costs recently introduced. Nevertheless, given the regional variation in health spending efficiency, scope to improve performance in less efficient regions remains.
- While non-pension social protection spending is relatively low, there is room to improve outcomes. Better central coordination in collecting performance information and evaluation is needed to improve effectiveness of active labor market programs.
- Regional analysis also shows that spending efficiency is generally weaker in the South that is poorer and more reliant on outside transfers. Improving allocation of regional transfers to sub national governments using standard costs based on more efficient benchmarks could provide an important avenue for savings. Early parliamentary approval of the legislation determining standard costs will be important.

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Annex 1. Selected European Countries: DEA Efficiency Scores

Table A1.1. DEA Efficiency Scores for Health Sector

	Public Health Exp/GDP 2011, or latest	HALE Female 2011	HALE Male 2011	Mortality rate, cancer 2010	Mortality rate, heart disease 2010	Efficiency (input- based)	Rank
Euro area	6.8						
United Kingdom	6.8	65.2	65.2	347.8	681.2	0.76	
Austria	7.6	60.3	59.8	391.4	512.8	0.71	
Belgium	6.9	63.6	63.4	370.2	1091.7	0.75	
Denmark	7.2	59.4	63.6	318.1			
France	7.8	63.6	62.7	388.2	1739.1	1.00	
Germany	6.7	58.7	57.9	387.1	621.5	0.80	
Italy	6.9	62.7	63.4	383.3	907.4	0.76	14
Luxembourg	5.2	67.1	65.8	377.9	1161.4	1.00	
Netherlands	5.7	59	64	330.5	1290.3	1.00	
Norway	7.2	70	69.9	371.1	803.9	1.00	
Sweden	6.7	70.2	71.1	416.7	622.7	1.00	
Switzerland		64.7	66.3	435.4	856.2		
Finland	6.9	58.3	57.7	434.6	410.7	1.00	
Greece	5.9	66.9	66.2	404.7	950.6	0.97	
Iceland	8.1	67.7	69.1	377.4			
Ireland	6.5	68.3	66.1	349.7	554.3	0.85	
Malta	6.3	70.7	70.3	411.7	467.3	1.00	
Portugal	7.2	58.6	60.7	405.2	1314.1	1.00	
Spain	5.7	65.8	65.4	408.8	1213.6	1.00	
Cyprus		61	61.6	507.4	876.4		

Sources: Eurostat; OECD and staff calculations.

Table A1.2. DEA Efficiency Scores for Social Protection Spending (excluding Pensions)

	Social protection spending, 2011	Population at risk of poverty after transfers 2011	Gini coefficient 2011	Income quintile share 2011	Efficiency, input based 1/ Rank	Efficiency, output based 1/ Rank
United Kingdom	5.85	16.2	33	0.19	0.52	0.92
Austria	6.32	12.6	26.3	0.26	0.48	0.96
Belgium	7.15	15.3	26.3	0.26	0.43	0.96
Denmark	10.93	13.0	27.8	0.23	0.28	0.96
France	9.29	14.0	30.8	0.22	0.33	0.95
Germany (until 1997)	7.12	15.8	29	0.22	0.43	0.93
Italy	4.36	19.6	31.9	0.18	0.70	6 0.89 17
Luxembourg	9.00	13.6	27.2	0.25	0.34	0.95
Netherlands	4.18	11.0	25.8	0.26	0.73	0.98
Norway	8.99	10.5	22.9	0.30	1.00	1.00
Sweden	9.36	14.0	24.4	0.28	0.33	0.98
Finland	11.32	13.7	25.8	0.27	0.27	0.96
Greece	5.47	21.4	33.5	0.17	0.56	0.87
Iceland	3.05	9.2	23.6	0.30	1.00	1.00
Ireland	9.79	15.2	29.8	0.22	0.31	0.93
Malta	4.95	15.4	27.4	0.24	0.62	0.95
Portugal	3.31	18.0	34.2	0.18	0.92	0.90
Spain	5.75	22.2	34.5	0.14	0.53	0.86
Cyprus	3.41	14.8	29.2	0.23	0.89	0.94

Sources: Eurostat; and staff calculations.

1/ Input: Social protection spending, excl pensions; outputs: poverty risk (inverted), Gini coefficient (inverted) and share of income of lowest quintile to highest quintile.

Table A1.3. DEA Efficiency Scores for Education Sector

	Public Education Expenditure/GDP 2011	Total education spending per pupil in PPS 2010	Public expenditure on tertiary education per pupil (in percent of GDP per capita) 2010	Tertiary education attainment (percent of population, 30-35 yrs) 2011	Upper sec edu (percent of Population, 25-64 yrs) 2011	pupil teacher ratio 2011	Employability Rate 2009	PISA Reading 2012	Public Spending Efficiency score 1/	Total Per Pupil Efficiency score 2/	Tertiary Education Spending per Pupil Efficiency score 3/
Euro area	5.1	6900.1	33.2	33.7	69.3						
United Kingdom	6.4	8334.6	25.7	45.8	76.4	17.7	74.8	499.3	1.00	1.00	1.00
Austria	5.6	2639.7	39.1	23.8	82.5	10.2	84.0	489.6	0.89	0.88	0.96
Belgium	6.2	8036.5	35.6	42.6	71.3	10.5	79.4	508.6	0.80	0.96	0.96
Denmark	7.8	9604.8	56.9	41.2	76.9	11.4	81.3	496.1	0.63	0.81	0.60
France	6.0	7337.4	38.4	43.3	71.6	14.4	70.2	505.5	0.80	0.99	0.72
Germany	4.4	7737.9		30.7	86.3	15.7	80.2	507.7	1.00	1.00	
Italy	4.2	6097.3	25.8	20.3	56.0	12.0	59.2	489.8	0.99	1.00	1.00
Luxembourg	5.2	:		48.2	77.3	9.7	82.0	487.8	1.00		
Netherlands	5.8	8522.8	42.7	41.1	72.3	16.3	87.9	511.2	1.00	1.00	1.00
Norway	5.6	10403.9	42.7	48.8	81.3	10.1	87.5	503.9	1.00	0.82	1.00
Sweden	6.8	8311.7	41.8	46.8	81.6	11.8	75.9	483.3	0.83	0.87	0.70
Switzerland	6.1	:	41.6	43.8	85.6		87.0	509.0			1.00
Finland	6.4	7379	38.5	46.0	83.7	13.3	74.8	524.0	1.00	1.00	1.00
Greece	4.1	:		28.9	64.5	8.6	67.3	477.2	1.00		
Iceland	8.1	7226.7	28.7	44.6	70.7	10.7	75.9	482.5	0.61	1.00	0.94
Ireland	5.1	:	33.2	49.7	73.6	15.1	70.2	523.2	1.00		1.00
Malta	5.8	7645.4	60.5	21.4	38.1	9.3	78.0				
Portugal	6.3	:	31.4	26.1	35.0	9.1	78.6	487.8	0.68		0.98
Spain	4.8	6865.2	28.5	40.6	53.8	11.4	59.8	487.9	0.97	0.89	0.90
Cyprus	7.2	9144.6	38.3	46.2	75.2	11.4	81.2				

Sources: OECD; Eurostat; WDI; and staff calculations.

1/ Input: Public Education spending to GDP; Output: All five indicators

2/ Input: Total Education Spending per Pupil, PPS; Output: PISA score, pupil teacher ratio and employability rate

3/ Input: Total Spending on Tertiary Education per Pupil, PPS; Output: PISA score, tertiary education attainment and employability rate

Table A1.4. DEA Efficiency Scores for Active Labor Policies

	Public Spending on Labor Market Policy Measures (percent of GDP) 2003-11	Participation in Labor Market Policy Measures (percent) 2003-11	Share of LT Unemployed 2012	Input based		Output based	
				Efficiency, corr. for PC GDP PPS 1/ Rank	Efficiency, corr. for PC GDP PPS 1/ Rank		
Belgium	1.06	83.0	0.45	0.92		0.93	
Bulgaria	0.28	11.5	0.55	0.51		0.70	
Czech Republic	0.14	10.2	0.43	0.61		0.81	
Denmark	1.30	51.5	0.28	0.17		0.80	
Germany	0.63	27.5	0.45	0.15		0.44	
Estonia	0.08	2.2	0.54	0.77		0.73	
Ireland	0.57	30.5	0.62	0.17		0.34	
Greece	0.15	10.4	0.59	0.57		0.65	
Spain	0.63	69.8	0.44	0.60		0.91	
France	0.72	46.6	0.41	0.31		0.66	
Italy	0.43	31.1	0.53	0.40	22	0.51	25
Cyprus	0.16	12.0	0.30	0.98		1.02	
Latvia	0.20	4.4	0.52	0.42		0.68	
Lithuania	0.18	7.3	0.49	0.43		0.71	
Luxembourg	0.39	76.5	0.31	0.28		0.35	
Hungary	0.32	17.4	0.45	0.48		0.71	
Malta	0.05	6.7	0.47	1.07		1.07	
Netherlands	0.81	45.9	0.34	0.19		0.65	
Austria	0.53	28.0	0.26	0.46		0.68	
Poland	0.44	18.5	0.41	0.41		0.68	
Portugal	0.49	29.7	0.48	0.45		0.62	
Romania	0.07	5.3	0.46	0.94		0.96	
Slovenia	0.21	16.3	0.48	0.55		0.70	
Slovakia	0.16	22.8	0.67	0.92		0.89	
Finland	0.77	26.0	0.21	0.51		0.86	
Sweden	0.83	28.4	0.19	0.89		0.90	
United Kingdom	0.05	2.2	0.34	0.99		0.99	
Norway	0.52	27.1	0.19	0.58		0.63	
Mean	0.43	26.7	0.42	0.56		0.73	

Sources: Eurostat; and staff calculations.

1/ Input: Spending on LMP Measures; output: Participation in LMP measures, inverse share of LTU

Annex 2. Italian Regions: DEA Efficiency Scores

Table A2.1. DEA Efficiency Scores for Health Sector, by Region

		Output		Input		Efficiency			
		Life expectancy at birth, 2012	Available beds (per 1000 inhabitants), 2011	Physicians (per 1000 inhabitants), 2011	Public health spending as a share of regional GDP, 2011	Input-based	Output-based	Input-based	Output-based
Nord-Ovest	Piemonte	82.4	3.7	3.7	6.6	0.83	0.99	0.94	1.00
	Valle d'Aosta/Vallée d'Aoste	82.7	3.8	3.6	6.9	1.00	1.00		
	Liguria	82.3	3.3	4.6	7.5	0.91	1.00		
Nord-Est	Lombardia	82.8	3.8	3.7	5.2	1.00	1.00		
	Provincia Autonoma di Bolzano/Bozen	83.3	3.9	3.1	5.8	1.00	1.00	0.95	1.00
	Provincia Autonoma di Trento	83.9	4.0	3.3	6.4	1.00	1.00		
	Veneto	83.0	3.5	3.4	5.6	0.97	1.00		
	Friuli-Venezia Giulia	82.5	3.6	3.9	6.7	0.79	0.99		
Centro	Emilia-Romagna	82.9	4.1	4.3	5.5	1.00	1.00		
	Toscana	82.9	3.1	4.4	6.5	1.00	1.00	1.00	1.00
	Umbria	82.9	3.0	4.4	7.6	1.00	1.00		
	Marche	83.4	3.5	3.7	7.0	1.00	1.00		
Sud	Lazio	82.0	3.6	4.9	6.6	1.00	1.00		
	Abruzzo	82.6	3.2	4.2	8.1	0.67	0.99	0.53	0.99
	Molise	82.7	3.8	4.1	9.8	0.55	1.00		
	Campania	80.8	2.8	4.1	11.1	0.48	0.97		
	Puglia	82.7	3.3	3.8	10.7	0.50	0.99		
	Basilicata	82.6	3.1	3.5	10.5	0.51	0.99		
Isole	Calabria	82.0	3.0	4.2	11.2	0.49	0.99		
	Sicilia	81.4	2.8	4.7	10.8	0.60	0.99	0.80	0.99
	Sardegna	82.3	3.6	5.0	10.2	1.00	1.00		
Mean		82.6	3.5	4.0	7.9	0.82	0.99		
Std. Dev.		0.7	0.4	0.5	2.1	0.22	0.01		

Table A2.2. DEA Efficiency Scores for Social Protection Spending, by Region

		Output		Input	Efficiency			
		At-risk of poverty rate (inverted), 2012	Share of Long-term unemployed (inverted), 2013	Social protection spending as a share of regional GDP, 2011	Input-based	Output-based	Input-based	Output-based
Nord-Ovest	Piemonte	86.4	0.17	0.96	0.73	0.94	0.87	0.96
	Valle d'Aosta/Vallée d'Aoste	92.1	0.34	2.68	1.00	1.00		
	Liguria	83.2	0.20	0.95	0.74	0.91		
Nord-Est	Lombardia	91.5	0.24	0.70	1.00	1.00	0.78	0.97
	Provincia Autonoma di Bolzano/Bozen	88.5	0.83	1.43	1.00	1.00		
	Provincia Autonoma di Trento	86.5	0.45	2.13	0.45	0.95		
	Veneto	89.0	0.26	1.03	0.70	0.97		
	Friuli-Venezia Giulia	86.8	0.29	0.84	0.91	0.95		
Centro	Emilia-Romagna	91.2	0.26	0.85	0.86	1.00	0.80	0.93
	Toscana	87.7	0.24	0.83	0.85	0.96		
	Umbria	86.8	0.20	0.88	0.80	0.95		
	Marche	86.0	0.18	0.93	0.76	0.94		
	Lazio	81.7	0.14	0.90	0.78	0.89		
Sud	Abruzzo	78.4	0.15	1.09	0.64	0.86	0.73	0.77
	Molise	73.0	0.11	0.92	0.76	0.80		
	Campania	63.6	0.07	0.92	0.76	0.70		
	Puglia	70.9	0.09	0.95	0.74	0.77		
	Basilicata	67.4	0.10	0.90	0.78	0.74		
	Calabria	69.6	0.07	0.97	0.72	0.76		
Isole	Sicilia	57.7	0.07	1.41	0.50	0.63	0.47	0.75
	Sardegna	79.6	0.10	1.59	0.44	0.87		
Mean		80.8	0.22	1.14	0.76	0.88		
Std. Dev.		10.0	0.2	0.5	0.16	0.1		

Table A2.3. DEA Efficiency Scores for Education, by Region

		Output			Input	Efficiency				
		Invalsi Score	Tertiary education attainment, 25-64 yrs (percent)	Enrollment in sec and post-sec education, 15-24 yrs (percent)	Employment rate, 20-64 yrs (percent)	Public spending on education per pupil as a share of per capita GDP	Input- based	Output- based	Input- based	Output- based
Nord-Ovest	Piemonte		1.06	15.9	47.8	66.5				
	Valle d'Aosta/Vallée d'Aoste	1.06	16.1	47.6	69.8	33.7	0.43	0.97		
	Liguria	1.01	19.9	47.2	64.8	19.5	1.00	1.00		
	Lombardia	1.04	17.2	45.4	69.3	13.8	1.00	1.00		
Nord-Est	Provincia Autonoma di Bolzano/Bozen		14.8	45.9	76.6	26.5	1.00	1.00	0.97	0.99
	Provincia Autonoma di Trento		16.6	50.2	70.5	23.5	1.00	1.00		
	Veneto	1.04	15.0	48.0	67.8	15.1	0.98	0.98		
	Friuli-Venezia Giulia	1.11	17.2	48.6	67.0	17.6	0.85	0.99		
	Emilia-Romagna	1.05	17.8	48.9	70.6	15.0	1.00	1.00		
Centro	Toscana	1.04	17.0	47.7	68.0	18.8	0.78	0.97	0.94	0.99
	Umbria	1.02	20.0	45.7	65.2	23.1	1.00	1.00		
	Marche	1.05	18.1	49.3	65.3	20.4	1.00	1.00		
	Lazio	1.01	20.5	46.0	61.2	16.3	1.00	1.00		
Sud	Abruzzo	1.03	17.3	44.9	58.8	22.0	0.63	0.92	0.45	0.92
	Molise	0.98	16.6	46.1	51.0	29.7	0.47	0.93		
	Campania	0.96	14.3	45.1	43.4	32.1	0.43	0.90		
	Puglia	0.95	13.2	46.5	45.9	31.9	0.45	0.93		
	Basilicata	0.94	15.1	47.7	49.9	38.7	0.38	0.95		
	Calabria	0.93	13.9	44.2	42.3	37.7	0.37	0.88		
Isole	Sicilia	0.95	13.3	43.9	42.8	35.2	0.39	0.88	0.41	0.89
	Sardegna	0.95	13.8	45.6	51.7	31.8	0.44	0.91		
	Mean	1.01	16.4	46.8	60.4	24.8	0.73	0.96		
	Std. Dev.	0.05	2.2	1.7	10.7	8.1	0.27	0.04		

Table A2.4. Cross Correlation between Regional Efficiency and Exogenous Factors

Correlation t-Statistic															
Probability	EDUEFF1	EDUEFF2	HEALTHEFF1	HEALTHEFF2	SOCEFF1	SOCEFF2	GDPPCPPS	POPDENSITY	POPLN	ELDERLY	UNEMPL	TAXDEP	JUDICIAL	POVRISK	EXTBORR
EDUEFF1	1														

EDUEFF2	0.89 ***	1.00													
	8.35	-----													
HEALTHEFF1	0.76 ***	0.77 ***	1.00												
	5.12	5.31	-----												
HEALTHEFF2	0.60 ***	0.68 ***	0.82 ***	1.00											
	3.24	4.09	6.21	-----											
SOCEFF1	0.26	0.47 **	0.20	0.16	1.00										
	1.18	2.33	0.87	0.69	-----										
SOCEFF2	0.76 ***	0.85 ***	0.87 ***	0.77 ***	0.47 *	1.00									
	5.13	6.94	7.59	5.33	2.33	-----									
GDPPCPPS	0.76 ***	0.84 ***	0.81 ***	0.67 ***	0.53 *	0.90 ***	1.00								
	5.02	6.68	6.04	3.93	2.74	9.17	-----								
POPDENSITY	0.26	0.07	-0.02	-0.31	0.15	-0.08	0.02	1.00							
	1.18	0.30	-0.08	-1.44	0.66	-0.34	0.10	-----							
POPLN	0.16	-0.03	0.03	-0.17	0.12	-0.05	0.06	0.85 ***	1.00						
	0.69	-0.12	0.14	-0.73	0.54	-0.20	0.26	7.07	-----						
ELDERLY	0.43 *	0.49 *	0.37 *	0.41 *	0.16	0.46 *	0.27	-0.09	-0.22	1.00					
	2.06	2.46	1.75	1.96	0.73	2.23	1.24	-0.39	-0.99	-----					
UNEMPL	-0.79 ***	-0.88 ***	-0.79 ***	-0.70 ***	-0.44 *	-0.91 ***	-0.93 ***	0.12	0.13	-0.45 *	1.00				
	-5.65	-8.22	-5.55	-4.23	-2.13	-9.57	-10.74	0.51	0.55	-2.18	-----				
TAXDEP	-0.39 *	-0.52 *	-0.64 ***	-0.65 ***	-0.11	-0.65 ***	-0.58 ***	0.41 *	0.29	-0.49 *	0.62 ***	1.00			
	-1.87	-2.65	-3.63	-3.76	-0.48	-3.73	-3.08	1.95	1.32	-2.46	3.40	-----			
JUDICIAL	0.50 *	0.52 *	0.48 *	0.24	0.31	0.64 ***	0.73 ***	0.03	0.09	0.19	-0.67 ***	-0.42 *	1.00		
	2.51	2.63	2.35	1.09	1.44	3.60	4.65	0.12	0.37	0.84	-3.95	-2.00	-----		
POVRISK	-0.75 ***	-0.84 ***	-0.87 ***	-0.78 ***	-0.46 *	-1.00 ***	-0.89 ***	0.07	0.03	-0.48 *	0.90 ***	0.66 ***	-0.62 ***	1.00	
	-4.94	-6.75	-7.61	-5.37	-2.26	-64.48	-8.37	0.29	0.14	-2.39	8.83	3.82	-3.46	-----	
EXTBORR	-0.44 *	-0.60 ***	-0.58 ***	-0.85 ***	-0.13	-0.64 ***	-0.53 *	0.39 *	0.28	-0.45 *	0.66 ***	0.54 *	-0.14	0.64 ***	1.00
	-2.14	-3.29	-3.09	-7.16	-0.59	-3.63	-2.72	1.85	1.25	-2.20	3.86	2.81	-0.60	3.63	-----

Table A2.5. Multivariate Cross-section Regression on Regional Efficiency Scores

Censored Normal Tobit						
Dependent Variable:	Education Efficiency		Social Protection Efficiency		Health Efficiency	
C	0.74 (***) 5.43	0.0 -1.1	0.74 (***) 9.8	0.13 0.6	0.99 (***) 9.0	0.20 0.5
GDPPCPPS		0.0 (**) -1.7		2.4E-05 0.0		3.0E-05 0.0
POPENSITY	0.0022 (**) 2.5	0.0020 (**) 2.4	0.0005 1.1	-0.0002 0.7	0.0012 (**) 1.9	0.0003 0.7
TAXDEP	-3.1 (***) -3.0	-1.0 2.4	-0.3 -0.6	0.7 0.2	-2.1 (***) -2.8	-0.7 0.4
EXTBORR		-3.4 (*) 2.6	-1.0 -0.7	0.8 0.5	-3.7 (***) -2.1	-1.2 0.4
No. of obs	21	21	21	21	21	21
S.E.	0.235501	0.16251	0.1703	0.1492	0.148	0.121

Table A2.6. Multivariate Panel Regression on Regional Efficiency Scores, Levels

Dependent Variable : Levels Censored Tobit	Education Efficiency		Social Protection Efficiency		Health Efficiency	
	coeff.	t-stat	coeff.	t-stat	coeff.	t-stat
Lagged transfer dependency	-1.26	-2.41 (**)	-0.50	-0.98	-1.48	-2.28 (**)
GDP per Capita PPS	0.00	-1.62	0.00	-0.91	0.00	-1.55
Population density	0.00	0.00	0.00	0.20	0.00	1.05
Judicial	-0.15	-0.62	-0.03	-0.14	-0.05	-0.16
Constant	1.72	5.46 (***)	1.11	3.85 (***)	1.83	4.24 (***)
S.E. of regression	0.20		0.23		0.19	
No. of obs	19		19		19	

Table A2.7. Multivariate Panel Regression on Regional Efficiency Scores, Change

Dependent Variable : Change Pooled OLS	Education Efficiency		Social Protection Efficiency		Health Efficiency	
	coeff.	t-stat	coeff.	t-stat	coeff.	t-stat
Lagged transfer dependency	-1.26	-1.61	-1.35	-2.44 (**)	-0.86	-1.44
GDP per Capita PPS	0.00	-0.58	0.00	-1.62	0.00	-1.26
Population density	0.00	-0.60	0.00	1.91 (*)	0.00	2.01 (*)
Population	0.00	-1.69 (*)	0.00	-1.99 (*)	0.00	-0.77
Elderly	-0.02	-0.60	-0.05	-1.82 (*)	-0.01	-0.41
Judicial	-0.31	-0.89	0.10	0.40	0.10	0.36
Constant	1.13	1.44	1.45	2.62 (**)	0.52	0.88
R-squared	0.39		0.49		0.45	
No. of obs	19		19		19	

THE USE OF PERFORMANCE INFORMATION IN RESOURCE ALLOCATION¹

The role of performance information in budget management is growing in advanced economies. In Italy, performance information will be critical for making the Spending Review a permanent part of the budget process. Italy generates significant performance information but there is less evidence that this is actively used by key budget decision makers. High quality performance information needs to be used more proactively to evaluate public policy and inform resource allocation decisions.

A. Introduction

1. **The role of performance information (PI) in budget management is growing in advanced economies and likely to increase in the future.** Performance information (PI) is quantitative data on actual or expected results of government policies and programs, associated with data on incurred costs. PI on activities, results, outputs or outcomes are non-financial, while PI on inputs and costs are mostly financial. Nonfinancial PI may take different forms such as indicators, benchmarks, ratings, rankings, league tables, or scores. It allows assessment of effectiveness and efficiency of public policies and may be used in a vast array of budget or non-budget environments. More than 80 percent of OECD countries are now using PI to support budget management. This goes hand in hand with the development of program and multiyear budgeting as well as with public policy evaluations and spending reviews. With shrinking fiscal space, demand is growing for PI in order to strengthen the allocation process and identify saving opportunities.

2. **Establishing a link between resources and results, however, is the challenge.** In that regard, this resources-to-results link appears to be easier to establish at the micro level than at macro level. Usage of PI in budgeting process is contentious but, under certain conditions, possible. Italy, with its recent and robust performance management system, could use more effectively PI in its budget allocation process. Accordingly, this paper seeks to: (i) describe the international practices in terms of PI usage at different levels of resource allocation; (ii) discuss challenges of integrating PI into the budget process; and (iii) assess the Italian situation in this regard and make some recommendations.

B. International Practices and Lessons

3. **International experience shows that the actual use of PI in allocation processes depends on its level of aggregation, from the macro to the micro (see Figure 1).** The main lesson from international experience is simple: the lower the level of aggregation, the tighter the

¹ Prepared by: Benoît Chevauchez (FAD)

resources-to-results link that can be established. Therefore, the higher the level, the less PI is usable in the allocation process.

Figure 1. PI Usage at Different Allocation Levels

	Field	Horizon	Segmentation	Activities	Expected Results	Resource Allocation Tool	Resources-to-Results Link	ITALY
Macro	Policy making	Medium to long	Large	Public policies evaluation and formulation	Outcomes	MTEFs	Absent or loose	Scattered evaluations
			COFOG functions or Policy areas			Strategic planning		Strategic Spending reviews
Intermediate	Budgeting	Short to medium	Programs	Budget preparation and approval	Outputs	Efficiency Spending reviews	Always useful	SR
			100 to 300			budgets		Loose but becoming tighter
Micro	Management	Short	Delivery units thousands	Operational expenditure management	Activities	Management control	Always tight	Fairly developed in some central administrations

4. **At the macro level, advanced countries tend to use PI with caution.** At the level of policy evaluation and formulation, the horizons are long (medium to long term) and the policy segmentation is usually wide: 10 “functions” of government (COFOG), or 30 to 50 policy areas, as in Sweden, the United Kingdom, and France (35 “missions”). This large segmentation erases institutional subsector borders between fiscal players such as central or local governments. The expected results are typically outcomes. Efficiency analysis associated with benchmarks—both in space (between countries or agencies) and through time—is a good way to provide a rough assessment of public policy efficiency. However, while these quantitative exercises at the macro level are necessary they are not sufficient to set long-term budget priorities. In this respect, it is recognized that the use of PI is more relevant for *intra* sectoral prioritization than for *inter* sectoral prioritization: PI is helpful to choose between different education programs or between different health programs but not for prioritizing defense over justice or sport over agriculture. Concrete examples of usage of PI in allocation process at macro level are:

- **Public policy planning** which requires the use of many PI, be it the traditional economic planning (still in use in some countries with comprehensive and centralized planning tradition such as Mexico and Turkey) or the ministerial/sectoral medium-term strategies that are

commonplace in many EU countries (France, Sweden). The same goes for public policy **evaluations** which have enjoyed a recent resurgence in new forms such as strategic reviews (Australia, New Zealand, and United Kingdom). However, in these types of exercise, the resources-to-results link is quite loose and, frequently, strategic planning and resource allocation are two parallel processes, following separated procedures and steered by different institutions.

- As it comes to the **first step of spending reviews (SR)**,² PI may help mapping possible “saving areas” across General Government expenditure (via matrices, crossing functional classification with economical classification and/or with institutional classification) and support policy makers design their saving strategy and priorities.
- **Medium-term expenditure framework (MTEF)**, which sets out medium-term budget priorities, may match these with indicators on expected results (be it outputs or outcomes), with medium-term target values.

5. **At the intermediate level, PI is more commonly used and tighter forms of resources-to-results link are observed.** At the budgeting level, be it at the executive preparation or parliamentary approval stage, the time horizon is shorter (one year, sometime two)³ and the policy segmentation is narrower: some hundreds of programs and/ or spending agencies. Here, institutional fragmentation appears to be an inescapable constraint: every level of government (local, social security and central) prepares its own budget.⁴ The expected results are outputs, often associated with outcomes. Hence, the rationale for a stronger resources-to-results link is more robust and usage of PI is easier than at the macro level, even if it is far from having replaced the classical incremental or legalistic budgeting methods. Concrete examples of usage of PI in allocation process at the intermediate level are:

- The budget cycle starts with an **assessment of the past spending** (during past and current fiscal year) taking stock of the actual outlays and their associated results, in term of activities and outputs; this is useful to define the baseline estimates as well as to clarify the metrics of possible evolution, expansion or downsizing of current programs.
- In the **second step of spending reviews** (see above), PI can also be useful for the definition and calibration of detailed savings.
- **The role of formula funding** appears to be more and more important. Under this method, the amount of resources is calculated in using price and quantity equations, where (i) price may be

² In many countries, SR are a two-step process: the first one is aimed at targeting the possible savings fields, the second one is focused on identifying more precise savings, calculate their size and address implementation issues.

³ Such as in France with the 2+1 FY budget planning or as in the UK for the DEL expenditure.

⁴ And coordination of prioritization may be challenging.

standard costs (based on historical trends or normative patterns) or benefit scales; and (ii) quantities may be the number of outputs, activities or eligible beneficiaries. This type of formula funding provides transparent and ex ante mandatory rules, warranting predictability and limiting discretion. It is widely used in decentralized environments, namely in specific areas such as education and health, where central budget authorities have to fund a great number of agencies or local authorities, performing similar activities or delivering identical services.

6. **At the micro level, PI is most extensively used.** In this case, the time horizons are quite short, quarters or even months, and segmentation of delivery units is narrow. The internal allocation process within spending ministries, both at preparation and execution stages, involves a large use of PI on outputs, activities and costs and the resources-to-results link is widely applicable. In addition, PI helps support transparency and accountability arrangements that are needed in a decentralized environment where more flexibility and managerial discretion is granted as a condition for more demanding performance. Concrete examples of usage of PI in allocation process at the micro level are:

- **Performance contracts**, or quasi contracts, which are in use in many countries (Australia, France, Sweden, United Kingdom and United States) as a managerial tool, linked to budget programs. Aimed at implementing programs, these contracts set out precise service delivery targets, in terms of outputs and/or activities and allocate budget appropriations accordingly.
- **Management control:** directly inspired from the business sector, heads of public agencies make increasingly systematic use of PI to monitor the day-to-day operations and adapt resource allocation to the changing environment.
- **HR performance management:** in limited areas such as the senior staff of some service delivery agencies, some countries have attempted to develop “performance pay” schemes. In these cases, a part of the compensation package is linked to the agency performance. However this type of arrangement, where the resources-to-results link is applied on an individual basis, remains infrequent, for technical as well socio-cultural reasons.

Lessons

7. **Some policy domains are more suited to PI than others.** Education, health, social entitlements, police, or urban transportation are fertile areas for PI development, while justice, foreign affairs, or defense are considered less appropriate. Regulatory or control activities are also less suited to that type of approach and more discretionary resource allocation methods remain in place. Anywhere where a production function appears easy to formulate, especially in repetitive activities, using PI and resources-to-results links is relevant. Modular and progressive implementation of program budgeting is more desirable than an overnight systemic reform.

8. **It is, nonetheless, important to keep in mind that most of PI is a proxy for public policy results.** Result indicators, namely outcome indicators, are not the results themselves. So, when the actual value of an indicator diverges from the targeted path, the right reaction is to

conduct further examination in order to understand the meaning and causes of this divergence, and then take relevant actions. Any mechanistic use of indicators should be avoided. Indicators should be taken as warning signs aimed at drawing policymakers and managers' attention. Caution is warranted especially when indicators are deemed to trigger automatic rewards or sanctions. The PI system sometimes "hits the target but misses the point" (Hood, 2006).

9. **Information asymmetry is one of the major shortcomings of PI.** A great deal of indicators, namely on outputs, activities and inputs are generated by the delivery agencies, and hence are under their control. In the same vein, all players concerned by PI will tend to focus their attention and action on indicators' performance targets, and neglect others. In some case, players will be tempted to manipulate the indicator itself as a substitute for actually improving underlying performance. This is summarized in Goodhart's law: "a measure that becomes a target may thereby cease to be a good measure". To mitigate possible distorting effects of PI, attention has to be paid to their incentive effects. Furthermore, independent control of data reliability and relevancy is needed. The selection, production and use of PI are sometimes overseen by independent bodies: either the general audit body like in Australia, New Zealand and the United Kingdom, or a specific administrative body as the French CIAP.⁵ In the United States, a law on PI quality was passed in 2000.

10. **A cost-benefit analysis is needed to avoid PI overload.** There is a tendency to multiply the number of indicators with the illusory hope of having a better reflection of the actual results and impacts. But too much data can also obscure issues. A limited and careful choice of PI is desirable. This selective approach to PI is not only necessary to prevent information congestion but also to spare resources: collecting PI is costly, especially on outcomes where data are outside the delivery agencies, which require costly panels, surveys, or polls to collect. A cost-benefit analysis should be made prior to embarking on an ambitious PI framework. Any PI which appears to be not actually used—that is triggering no decision—should be abandoned.

11. **Performance does not improve overnight.** Public sector managers need to reconfigure services, redeploy staff, and experiment with new modes of delivery. PI regimes therefore need to be linked to multi-year resource allocations which build in efficient savings not necessarily immediately but over time.

C. Strengthening the Use of Performance Information in the Budget Process

12. **Usage of PI in budgeting at the national level is progressing only gradually.** International experience shows that PI exists in national budget documentation, but its actual usage to directly determine the amount of public resources to be allocated to a given policy goal is limited. In most countries, several non-performance considerations are taken into account in the budget negotiation process: spending history, incrementalism, legal constraints, balance of power between

⁵ Comité interministeriel d'audit des programmes.

Cabinet ministers, and political considerations. Even countries deeply engaged in performance budgeting recognize that PI often plays a secondary role in budget decisions and prefer to use the term of “performance informed budgeting” as opposed to “direct performance budgeting.”

13. **Cultural reasons and conservatism may also explain this limited success of performance budgeting.** Budgeters tend to still maintain their focus on inputs which is their historical core responsibility and skill. They often seem to fear to be drawn on the results field, where they are in a weak position since arguments for expenditure increase are many and often powerful. Spending ministry officials consider also that goals and results are their job and they reluctantly accept that Ministry of Finance officials address this type of issues. Beyond that, two more substantial types of reason are to be considered: methodological challenges are not always properly addressed and policymaker involvement remains weak.
14. **A first methodological difficulty arises from attribution issues.** The chain of causation from resources to outcomes is complex. A given outcome may result from several factors and the amount of public financial resources allocated is just one amongst many others. Not only is the list of these external factors long—private spending, other policy instruments, natural, and cultural environment—but the weighting of their relative contribution is very challenging (Annex 2). Most of these attribution issues are located in the output/outcomes link.
15. **Another technical challenge is to have a full understanding of the value chain linking expenditure to results.** It is necessary to analyze the several steps that transform financial resources into results, be it outcomes or outputs. In this value chain, inefficiencies may occur at every step. The longer the chain, the more difficult it is to understand. For instance, if an improvement of health outcomes is considered a desirable policy goal, a correlated increase of resources may not yield the expected results for several reasons: input prices may increase under the effect of a higher public demand, technical inefficiencies may worsen because of congestion issues and, the outputs mix deemed to contribute to outcomes may prove irrelevant. One cannot expect any strict proportionality between input changes and outcome changes, neither upward, nor downward.
16. **Finally, policymakers are often not sufficiently involved in the choice of PI in budgeting activities.** The PI chain should start from the top. The determination of desired outcomes is often contentious and the choice of indicators is a sensitive issue that depends on the goals assigned to a given policy. These goals are in politicians’ remit. PI cannot be developed only in experts’ circles, public managers and academics, without the involvement of ministers, parliamentarians, and citizens. Budgeting is a political activity: allocating resources to public policies implies setting priorities and making hard choices. Policymakers need to take responsibility: define clear and explicit policy goals and the PI that goes with them. This is an essential prerequisite to the development of any PI framework and performance budgeting system.
17. **If properly addressed, these difficulties can be overcome.** First, countries looking for more performance-oriented budgeting system should focus initially on outputs. This is for two reasons: (i) there are fewer attribution issues in the resources/outputs link than in the

resources/outcomes link; and (ii) outputs are easily computable, via the costing of activities that yield them. Having not the same qualities, outcomes cannot be taken as a direct reference for budgeting. However, a gradual shift from outputs to outcomes can be contemplated over time as data improves and the relationship between resources, outputs, and outcomes becomes better understood. Second, there should be an explicit determination of policy goals without which neither PI framework nor performance budgeting may function. That underlines the need for political implication. In this respect, experience and realism suggest to select limited issues on which politicians' attention might be solicited: setting clear goals and budget priorities. A greater personal implication of ministers in performance budgeting and management often appears illusory, given politicians' agendas and timetables.

D. Performance Information in Italy

Background

18. **Italy is already producing and using a large array of PI.** Beside academics and think tank research, PI is now widely in use in public administration. The introduction of significant public management and performance budgeting reforms, in two laws in 2009, has led to the production of many performance indicators in every policy area and the establishment of a public data bank. Local authorities have followed suit and many local budgets are also using PI. The strong decentralization movement has also spurred more systematic usage of PI to determine the financial transfers (and tax sharing arrangements) from central government to regions and municipalities.

19. **The use of PI in budgeting is supported by a strong methodological and legal framework.** The Ragioneria Generale dello Stato (RGS) has invested considerable time in studying the lessons from international experience, and the Italian performance budgeting approach seems to be in line with the best international practice. A September 2012 decree defines state-of-the-art indicators that are now an important component of a new type of budget documentation known as "integrative notes" describing the objectives and resources of government "missions" and "programs." These "integrative notes" are produced in two successive versions: appended to each ministerial draft budget, the "ex ante" integrative notes describe the goals and the appropriated resources while ex post "integrative notes"—in the same format than the "ex ante" ones but appended to the budget reporting law—give an account on the actual use of resources and the achieved results. The same law also stipulates that every spending ministry should create an "evaluation unit" and develop training courses on spending analysis and performance measurement.

20. **However, there is little indication that this performance information is being used by the main stake holders of the budgeting process.** They are not used in the executive phase of budget preparation: the budget requests are not based on performance information but on legal requirements and other obligations. Consequently, the budget negotiations and the final Cabinet decisions are mainly driven by legal and political considerations. The parliamentary debate and final vote are carried out on the same ground: parliamentarians and their committees pay little attention to the "integrative notes" and the PI they contain. The same goes for the media which do not provide an account of the contents of the integrative notes and their PI. There is also little evidence

that citizens, political parties and NGOs are taking this information into account in their discussions with policymakers. Budgeting and PI appear to be two parallel processes, the former leading to actual decisions, the latter producing formal documents.

21. **Part of the reason for this may be that most of the PI are inward-oriented and bureaucratic in nature.** They tend to focus on the internal functioning of governmental administrations which is of limited interest for policymakers, taxpayers, beneficiaries and their representatives. For example, one of the most frequent indicators is about the rate of budget execution. Another example is the number of meetings held or the number of administrative plans issued. Outcomes indicators, be they ultimate outcomes or intermediary outcomes, are very rare. So-called “output” indicators are more frequent, but many of them are obscure: some measure the degree of implementation of quarterly plans but no information is given on the content and ambition of these plans. Finally, the PI framework is mainly a bottom-up process: indicators are proposed and managed by frontline services and then compiled at the upper level. Top-down guidance from political level is very limited.

22. **Another reason for the lack of attention paid may be that no linkage between resources and results is established in the “integrative notes.”** Though these notes are made of two sections—the first one on programs, goals, and indicators and the second on resources calculation—there is no link made between the two. The second section shows that the criteria and methods of resource allocation focus on compliance to spending laws: historical, incremental or automatic budgeting seems to be prevailing.

23. **A final reason for the lack of public attention be paid to nonfinancial performance, is the absence of any accountability arrangements for PI.** The “integrative notes” do not identify the agencies in charge of each program or the name of the senior officials responsible for their management. Reporting requirements seem limited. There is no ex post assessment of results achieved or the effectiveness and efficiency of the use of resources in doing so. No incentives mechanisms exist linking the achievement of results to further resources. The performance-based compensation system for public services established under the 2009 legislation is not operational.

Recommendations

24. **Politicians, ministers, as well as parliamentarians, should be involved in the design of the strategic components of the performance budgeting framework.** One of their main responsibilities in that regard would be to set explicit policy goals for each “program.” Clear policy goals are the keystone of any PI framework and one of their main advantages. They require politicians to shift from vague, uncertain, implicit objectives to more precise and more demanding goals. The second strategic domain in which politicians should be involved is the choice of policy instruments they consider relevant to reach these policy goals: the output mix they deem necessary as well as the regulatory framework. Some procedures and documents of that type already exist in Italy. But they are complex, too detailed and preformatted: hence, after some years of experience, this appears to be a purely formal exercise without any real impact on policy making or management. Possible ways of reviving this exercise might comprise: (i) dramatically shortening the

documents with a narrower focus on a few political issues; (ii) presenting options, with risk analysis, and not just routine ratifications; (iii) organizing a real, personal, and direct discussion between the top senior officials and their Minister; (iv) widely publicizing the final ministerial decisions inside and outside the Ministry; and (v) presenting this to the relevant Parliament committees. Thus, the present bottom-up PI framework would be reversed and replaced by a top-down process starting from high-level political goals, desegregated downwards in cascading layers.

25. **The “integrative notes” should be combined with reports on ministerial activities prescribed by the 2009 laws.** These two exercises, deriving from two laws adopted in 2009, are similar in term of objectives and content. Their ultimate aims are the same: transparency, performance, and accountability. Both are setting goals and describing activities of a given ministry. Both are sent each year to the Parliament. However they are produced by different channels and they demand a large amount of work in term of data collection and coordination. Efforts have already been made to better coordinate these two documents but performance indicators and costing methods are still different. For the sake of consistency and cost-efficiency, the best solution would be to merge the two documents. As a second best, a provisional solution might be to have a common production process and staff, based on common doctrine, method and data but to keep two separate documents.

26. **Results indicators, primarily on outputs, should take a larger role.** Output is the link between the two spheres of responsibility: the political one which decides outputs’ type and level and the managerial one which is responsible for its delivery. Moreover, outputs are easy to identify for they are tangible, the value chain between resources and outputs is quite easy to control and output indicators are cheap to produce since most of them are deriving from the delivery process. Other countries that have embarked up performance-based budgeting have typically started with output-based targets and then gradually migrated toward a more outcome-based approach. For Italy, the “integrative notes” should systematically comprise at least one output indicator reflecting the actual service provided to the final client (citizen, user/ beneficiary, or businesses).

27. **The cost of delivering those outputs should be fully addressed in the “integrative notes.”** The division of “integrative notes” into two separate sections should be reconsidered in order to allow a closer link between resources and results. Costing methods should be focused on “activities” that are producing the desired outputs: this might be the more convenient option, provided the main indirect costs (overhead, support function, etc.) are taken into consideration. Thus the allocation of resources in the budgeting process would be based on economical rationale rather than the current legalistic approach which refers to the amounts stipulated in the various ordinary laws. This may lead to a revision of the role of ordinary laws in spending matters with the view of giving a stronger authority to the budget laws.

28. **Service delivery areas such as health, education, police as well as social entitlements or transfers to local authorities should be considered as a priority.** These areas are well suited to the metrics of performance budgeting, indicators and costing. They also represent the bulk of public spending. Other policy areas such as foreign affairs are less adapted, for technical and cultural reasons: the amounts at stake are limited and resources allocation might use more classic methods.

Therefore, improvement of “integrative notes” might be progressive starting with those ministries in which the conditions for success are most likely.

29. **Local authorities should be encouraged to adopt similar performance budgeting arrangements and PI frameworks.** Several local budgets are already using this type of approach. While no common mandatory method is advisable, it would be good to encourage cooperation and exchange of experience in creating forums and networks. However, greater attention to PI coordination seems to be necessary in policy areas that are common to central and local budgets (such as economic affairs and education). PI central/local coordination would also be helpful to inform the discussion on budget transfers to local authorities.

30. **Quality control and independent scrutiny of PI should be supported by some procedural and institutional arrangements.** Different options might be considered: the RGS could play this role from the center of government. A more participatory option would be to establish an inter-ministerial committee in charge of validating the PI designs in different ministries and agencies. Another solution might be to entrust the Court of Account (Corte dei Conti) with this task.

31. **The choice, definition, and monitoring of PI should also engage the public.** A first step in this direction would be communication: a limited number of major indicators, related to the political priorities of the day (competitiveness, youth employment, civil service) might be widely communicated and explained in the media. A more ambitious step would be participation: panels and polls (via internet, for instance) on public performance issues would allow citizens to give their opinion on public policies goals and results. “Citizen’s budget” projects, such as developed in several countries, might be encouraged. These initiatives might be another way to tie the Italian PI framework to the political agenda.

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Annex 1. Sample Performance Indicators for the Education Sector

Policy Area	OUTPUTS	Indicators	OUTCOMES	Indicators
<i>Tertiary Education</i>	Students taught	Number of degrees	Employability	Ratio students qualified/students with a job
<i>Heart Health</i>	Heart Surgeries	Number of successful heart surgeries	Life expectancy	Number of years of life after heart surgery
<i>Poor Family Support</i>	Family allowances	Number of allowances distributed	Fairness, Equity	Gini index
<i>Youth Unemployment</i>	Assistance to job seekers	Number of job seekers addressed	Youth Employability	Job seekers addressed/job seekers with a job

Annex 2. Determinants of Health Outcomes

What are the determinants of global health outcomes?

Health public spending is indeed often considered the first determinant. But there are many others, some under the direct control of the government, some others that are not, such as:

- Health **private spending**, via co-payments or private provision and funding of health services, that are so entangled that it is practically impossible to attribute;
- **Many other public expenditures** contribute to health, for example in the budgets of environment (better sewage), housing (better sanitation) or infrastructure (safer roads);
- **Other policy tools may contribute** to achieve health goals: primarily, laws (on drugs, alcohol and tobacco use) that are sometimes more powerful tool than public spending; governmental communication may also play some role.
- Several **socio-cultural and environmental factors** (climate, food habits, life behavior) outside of any direct government control.

Annex 3. The “Chain Value”, From Resources to Results in a Tertiary Education Program

