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Ministry of Economy and Finance
Department for Development Policies

2005 Annual Report on Actions in Under-Utilised Areas

Executive Summary

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Submitted to the Italian Parliament by the Hon. Minister of Economy
Mr. Giulio Tremonti

and by the Hon. Minister for Development and Territorial Cohesion
Mr. Gianfranco Micciché

January 31, 2006

2005 ANNUAL REPORT

on Actions in Under-Utilised Areas

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31 January 2006

This Report, prepared by the Department for Development and Cohesion Policies (DPS) of the Ministry of Economy and Finance, provides an outline of economic trends and development policies at a territorial level.

All units of DPS were involved in writing the Report: under the responsibility of the Research Service headed by Letizia Ravoni, these include the Service for Territorial Development Policies headed by Aldo Mancurti, the EU Structural Funds Policy Service headed by Paola De Cesare, the CIPE (Interdepartmental Committee for Economic Planning) Secretariat headed by Paolo Emilio Signorini, the Service for External Cooperation headed by Vincenzo Donato, the Evaluation Unit co-ordinated by Laura Raimondo, and the Verification Unit coordinated by Antonio Caponetto.

The Report was planned and co-ordinated by the Head of Department, Fabrizio Barca, with Letizia Ravoni and Paola Casavola.

The responsibility for individual chapters was entrusted to Francesco Stella, Laura Raimondo, Mariella Volpe, Letizia Ravoni, Giampiero Marchesi and Paola Casavola.

The Appendix was overseen by Lorenzo Paccusse, Norina Salamone, Sabina Guidotti, Attilio Turri Bruzzese.

The second chapter, overseen by the Evaluation Unit, regards results and assessments about public investments.

The Research Service Offices constantly supported and coordinated the Report.

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Marina Bugamelli, Elvira Germogli, Simona Panei, Paola Picciotti, Daniela Fusco, Luca Murrau, Katia Salvatori and Paola Stirati contributed to the layout of text and tables.

The presentation and distribution of this Report were overseen by the Office for Communications and External Relations headed by Emanuela Poli.

Special thanks go to all the staff involved in the preparation of this Report for their dedication and care.

The Report on initiatives in under-utilized areas provides Parliament with information on the state of regional development, the use of appropriated resources, the implementation of policies, and progress made in modernizing the public administration.

The year 2005 stood out for the significant commitment undertaken by the Department for Development Policies, central government departments and the Regions, together with local authorities and the economic and social partners, in programming regional policy for 2007-2013. It was also marked by the effort made in negotiations concerning the European Union's financial perspectives, which produced a successful outcome for Italy at the European Council of 15 and 16 December 2005.

The Report is preceded by an introduction by the Minister for Development Policies, who is responsible for overseeing and coordinating regional policy for the South.

INTRODUCTION

by the Hon. Minister for Development and Territorial Cohesion

Mr. Gianfranco Micciché

2005 was a special year for development policy in Italy. It was the final year of a Parliament that, perhaps for the first time ever, enjoyed true political stability and, as a result, was able to ensure the continuity of a strategy for supporting development in the weakest areas of the country. We also witnessed the completion of an important and difficult negotiation on the financial perspective for the European budget, which ended on a high note for Italy (this, too, perhaps, a first).

These two events represent a real turning point for domestic and European development policies. It is therefore the right time to take stock of our achievements so far and to offer a number of observations for the future.

The Department's eighth report clearly shows positive signals mixed with indications of backwardness, especially regarding the state of public services. In short, the South offers a mixed picture. The economic growth that has taken place is below expectations, but, over the past five years, it is above Italian average and is heading in the right direction. Improvements are emerging in several areas.

Since 2002, we have become "a model to imitate" (in the words of Danuta Hubner, European Commissioner for Regional Policy) in our use of Structural Funds, which underscores the irreversible improvement in the quality of programming at both the central and regional level.

In the area of public investment there is now a solid set of projects, the number of tenders for infrastructure development has risen ten-fold and new construction sites can finally be seen throughout the South.

Ever since the first year, a courageous decision was taken in order to accelerate growth: to drastically cut state aids and to increase funding for public investment. Incentive mechanisms for firms, however useful, had not been boosting competitiveness, since they were designed to compensate for the gap in services and infrastructure. So, filling this gap, became the main policy target.

A number of important innovations were also introduced concerning policy strategy and implementation. The first was the creation, in 2002, of the "Unified Fund", which, through very rigorous sanction mechanisms, has achieved considerable results in speeding up expenditure for investments and in improving the quality of public investments.

Secondly, in line with the new European rules following Lisbon strategy, a reform of incentives was devised which provides for the gradual reduction of capital grants and involvement of the banking system, which has in so far failed to play an adequate role in the development of southern firms. The reform will be the object of close monitoring.

This Parliament will be renewed in 2006, leaving whomever will take government responsibility a great deal of work yet to be done, but also a solid foundation upon which to operate. This foundation includes: faster economic growth than the rest of the country for a decade now; an unemployment rate that has dropped to 14

per cent (in line with objectives); significant achievements in the administrative capacity of the Regions, which must be preserved; a marketing structure, through Sviluppo Italia, for attracting foreign investment; a partnership with Regions that has enabled much of the results. Finally, the negotiations on the European budget produced an outcome that will ensure that the volume of resources available for Objective 1 regions over the next few years will be much higher than in the past.

We must continue the process of accelerating investment in infrastructure in order to eliminate the gap with the Centre-North – now an achievable goal – while the reform of incentives requires close monitoring. At both central and regional level, we must strengthen again the process towards greater competition in public services: the price of public, monopolistic management of services is too high, especially in the South.

I believe it is necessary, and fair, to give credit to the Department for Development Policies for having achieved a high level of competence and commitment, which commands attention from anyone involved in development issues in Europe. The Annual Report, which I have had the honour of presenting to the Parliament in the past few years, has become a point of reference for politicians, scholars and economists who analyze the South.

Last but not least, I would like to give my personal thanks to all members of the Department for the support that they provided, with true institutional dedication, skill and intelligence, to the Government during the long, arduous and difficult negotiation on EU financial perspectives, which produced a more than positive result for Italy. This Department represents the most solid base for continuing to believe in the development of the South and for achieving our objectives.

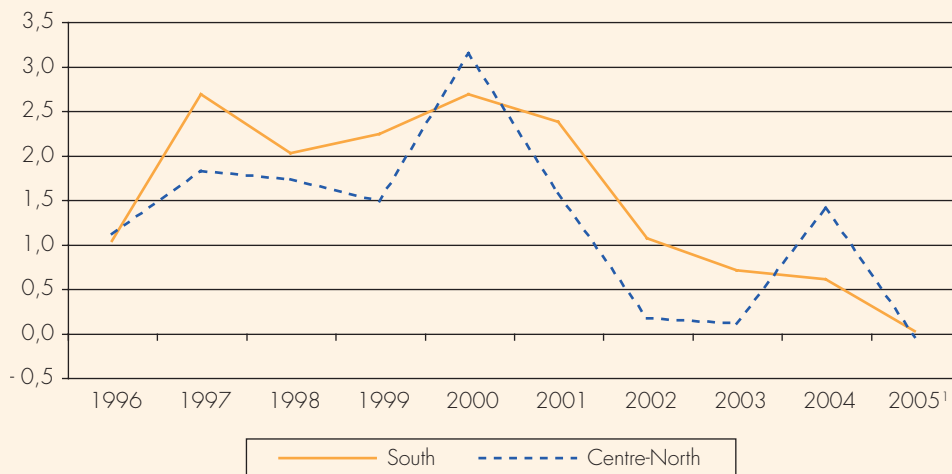
EXECUTIVE SUMMARY

Short term outlook

Against a background of slack economic activity at national level, the southern economy did not grow in 2005, although developments during the year show a less clear-cut picture (Fig. 1).

Gross domestic product did not expand, labour market problems remained significant and consumer demand was weak. On the other hand, an improvement in business confidence over the year, a moderate increase in exports, the resilience of the tourism sector and continuing entrepreneurial dynamism demonstrate (albeit not uniformly across the entire area) that the mainly supply-side determinants of the new phase of growth of the southern economy are still in place.

Figure 1 - TERRITORIAL GDP GROWTH: 1996-2005 (percentage changes at constant prices)



¹ For 2005, provisional DPS estimates.

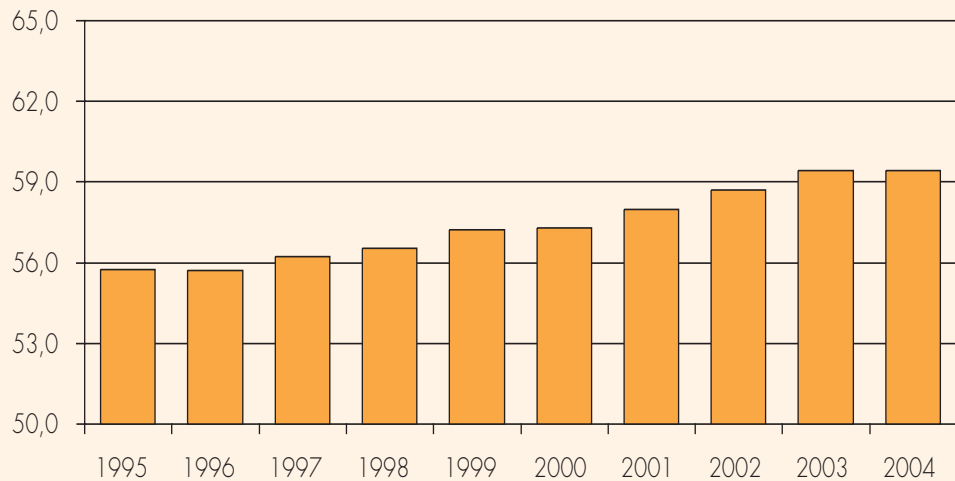
Source: Istat - Regional Public Accounts

A long term perspective: 1996-2005

Ten years after the turnaround in the southern economy in the mid-1990s, with a sharp reduction in state subsidies and a revival of entrepreneurial and civic spirit, some general trends can be detected.

As for GDP, data are known: between 1995 and 2005, the South recorded a positive growth differential of 0.3 percentage points per year. With a smaller share of foreign immigration going to the South than to the Centre-North and renewed internal migration from South to other areas of the country, the differential was also translated into a reduction of almost two percentage points of the gap in per capita GDP over the period (Fig. 2).

Figure 2 - SOUTH PER CAPITA GDP AS PERCENTAGE OF CENTRE-NORTH VALUES: 1995-2004



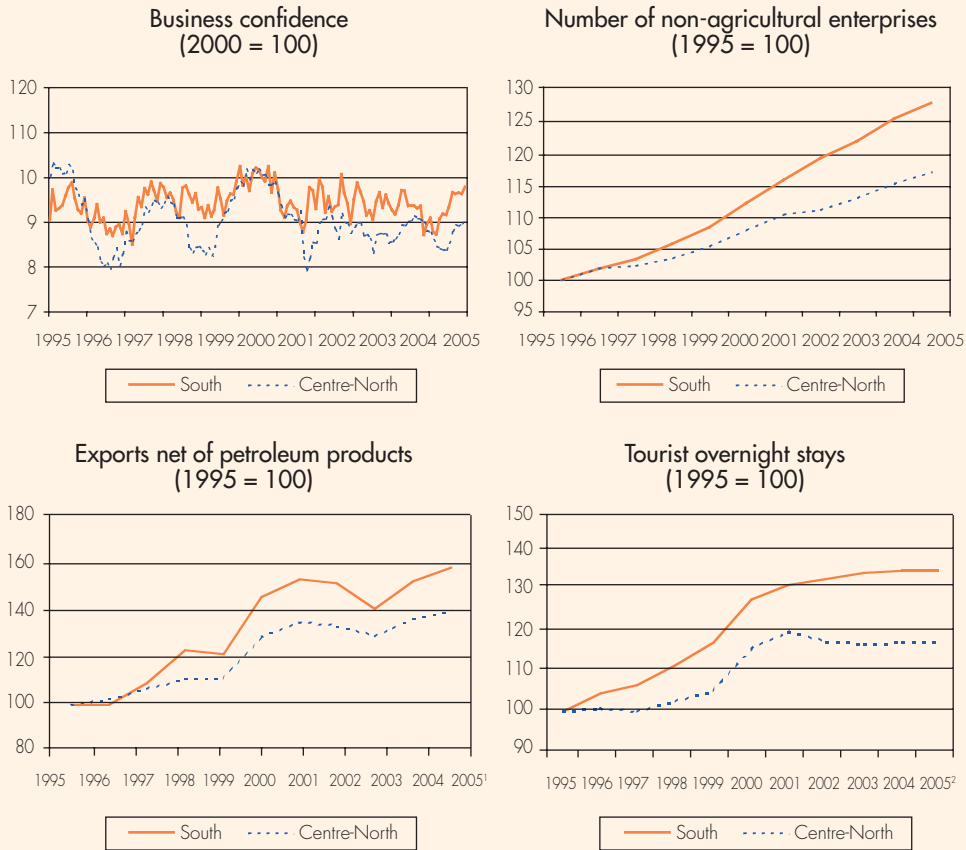
Source: Istat - Regional Public Accounts

This higher growth was driven by the new dynamism of firms and by a higher business confidence than in the rest of the country. This stimulated both a firms' net birth rate, and a flow of private investment greater than in the Centre-North. The South has become more open to foreign markets than in the past, with exports growing at a faster rate than in the Centre-North: exports net of oil products are now 60 per cent higher than ten years ago, compared with the Centre-North's 40 per cent gain. Tourist flows have also grown more rapidly than in the Centre-North (Fig. 3). At the same time, however, exports and receipts from tourism remain lower than the area's potential would suggest and far below the Centre-North standards.

Development over the past decade was characterised by a recovery in efficiency. Productivity grew more than in the Centre-North, thereby reducing the gap between the two areas from 15 to 12 percentage points. However, the stronger performance was limited to services and agriculture, while in industry (excluding construction) productivity gains were quite modest, as in the rest of the country (Fig. 4).

Faster GDP growth in the South was not enough to stimulate adequate job growth. Employment rose until 2002 but then stabilized, with employment rate declining slightly after having increased sharply over the previous five-year period. It now stands at around 46 per cent (Fig.5), compared with the EU average of about 63 per cent. In the presence of a decline in the supply of labour, however, the unemployment rate still fell significantly, from 18 per cent in 1995 to 14.5 per cent in 2005, after peaking at 20 per cent in 1999.

Figure 3 - CYCLICAL INDICATORS: 1995-2005

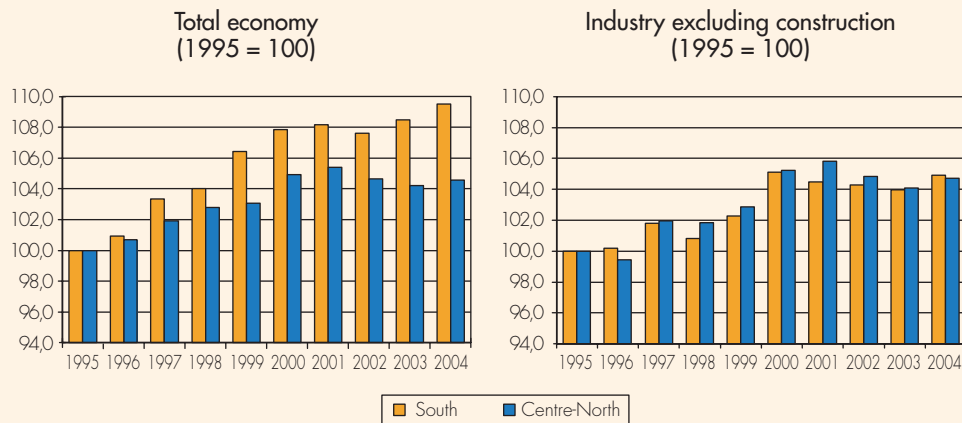


¹ Until the third quarter.

² Annual DPS estimate.

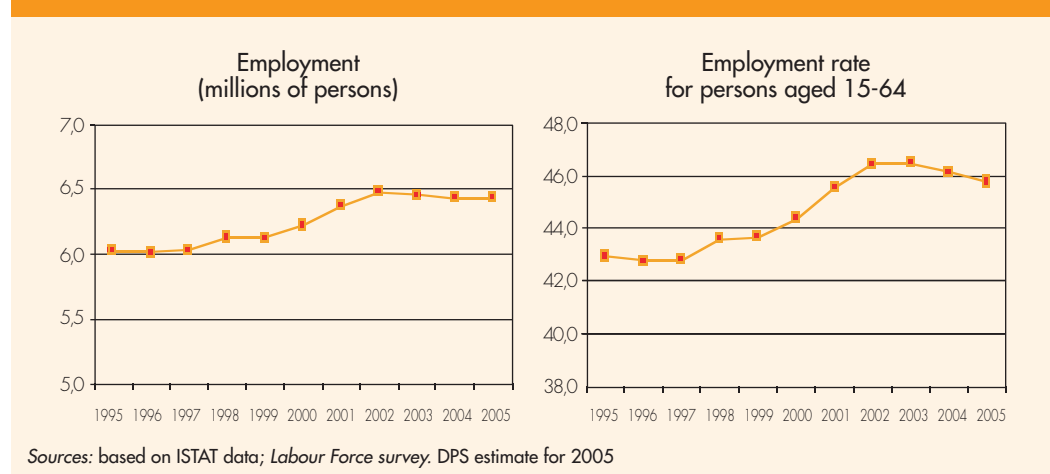
Sources: ISTAT, ISAE and Unioncamere

Figure 4 - LABOUR PRODUCTIVITY: 1995-2004



Source: based on ISTAT data

Figure 5 - EMPLOYMENT AND LABOUR FORCE IN THE SOUTH: 1995-2005



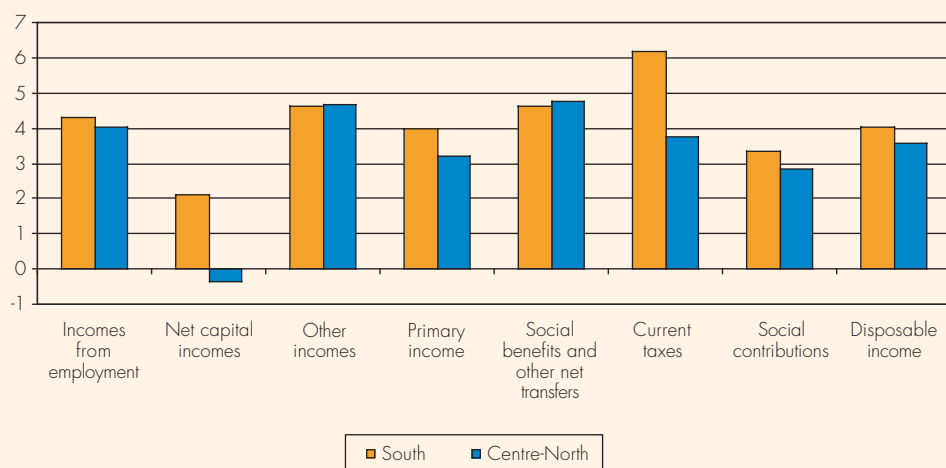
Several factors pushed the growth of Southern regions under its potential over the period.

On the demand side, growth was adversely affected by the State sector contributing less than in the Centre-North (a result of an otherwise necessary redesign of State intervention):

- unlike in the past, general government expenditure on salaries and final consumption grew slightly less than in the Centre-North. Between 1995 and 2003 (the last year for which information is currently available), annual nominal growth averaged 5.6 per cent and 5.4 per cent, respectively;
- investment in construction, which includes public works, expanded more slowly in the South, with real average annual growth of 0.9 per cent between 1995 and 2004, compared with 2.7 percent in the Centre-North;
- during the period, the public contribution to households' disposable income had a negative impact on the differential vis-à-vis the Centre-North (Fig. 6). Between 1995 and 2003, primary income, consisting of compensation and property income, showed a positive growth differential between the South and the Centre-North of 0.8 percentage points annually (attributable - in addition to faster growth in the South - to the sharper impact of the decline in interest rates in the Centre-North, where households' portfolios of financial assets are much larger), whereas the overall redistributive impact of transfers for social benefits and taxes and social contributions penalized the South, trimming the positive growth differential for disposable income to 0.4 per cent per year.

The impact of these demand factors was accompanied by the persistence of two supply factors: a quality of public services for enterprises and households still poorer than in the Centre-North; inadequate competition, especially in the market for public services, in some regions of the South, takes the extreme form of the monopoly exercised by organized crime.

Figure 6 - HOUSEHOLD DISPOSABLE INCOME AND ITS COMPONENTS BY MACRO-AREA: 1995-2003 (average annual percentage changes at current prices)



Source: Based on ISTAT data

An assessment of the new policy

In recent years, economic policy has pursued a strategy aimed at reversing these negative supply factors, by improving their supply and quality and, consequently, the economic and social environment. Both strengths and weaknesses of the results obtained in so far are measured and analysed in the National Preliminary Strategy Document¹, prepared by central administrations, through consultation with economic and social partners, as part of the preparatory phase for the 2007-2013 European Cohesion policy.

The Document's evaluation shows a major improvement in financial programming and in the institutional capability of most public administrations, especially regional governments, that are responsible for implementing policy in the South.

Financial programming is today performed by using an information system far superior to that available just a few years ago. Its main features are: quality and timeliness of Regional Public Accounts; monitoring of expenditure objectives; identifying and addressing the causes of implementation delays. Strategic planning and management capacity have also greatly improved thanks to internal auditing mechanisms, better training renewal of administrators with qualified professionals, the diffusion of evaluation methods. Many results were achieved through the adoption of a performance-based grant system, very advanced even by international standards.

However, significant weaknesses remain in ensuring true additionality of regional funds and timely implementation.

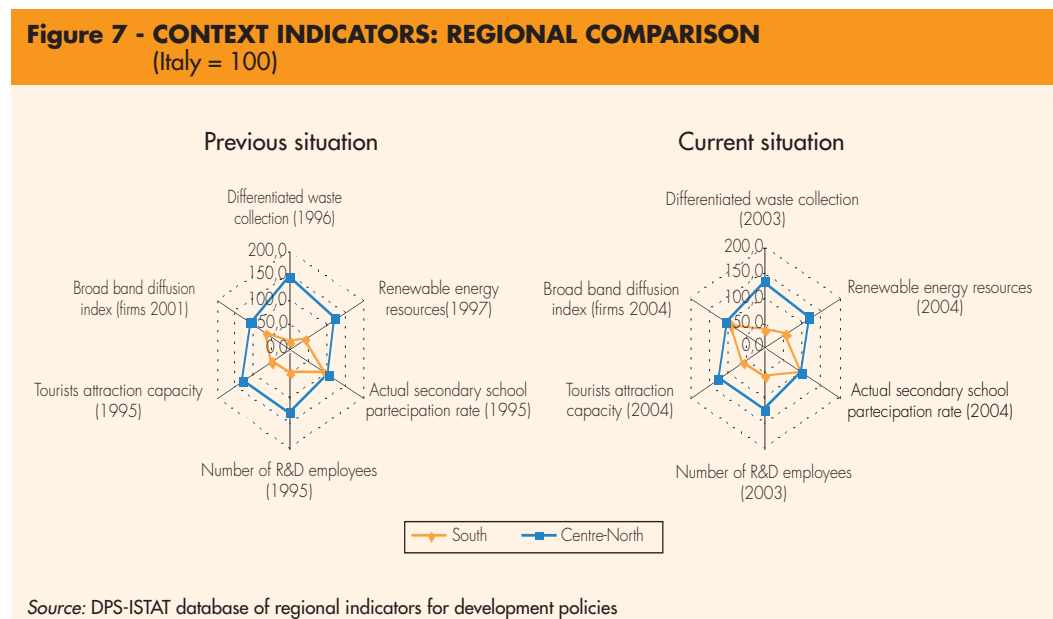
The additionality (i.e. the extent by which funds for regional policy exceed expenditure granted by ordinary policy) renegotiated (downward) with the Eu-

¹ Available at www.dps.tesoro.it.

ropean Union in November 2004 was subsequently achieved; but renegotiation reflects Italy's failure to reach its original 1999 goal of earmarking 45 per cent of the country's capital expenditure for the South. The current share is around 38 per cent. The objective for ordinary capital expenditure was to devote 30 per cent to the South, but the average share was actually 26.6 per cent. All government entities have revealed shortcomings in accurately forecasting the timing of expenditure and in exploiting existing monitoring mechanisms to extract the information needed to remove barriers. As for the expenditure by the national component of regional policy, only the creation of a Unified Fund in 2003 significantly changed the way resources are used, but will have major positive repercussions only the next few years.

In addition to these financial aspects, difficulties have also been encountered in shifting the goal of public administrations from "fund absorption", i.e. mere expenditure on material and immaterial infrastructures or incentives, to the quality of services that infrastructures should create. Setting quality objectives for services and sharing evaluation methods was not enough to remove these problems, partly due to the lack – as the independent evaluator of the 2000-2006 EU Programme wrote – of a "cultural and political dialogue".

Despite these limitations, there has been widespread improvement in the quality of services in the South, both in absolute terms and in comparison with the Centre-North. The improvement is clear, as it is shown in Figure 7, which summarizes the Report's findings: for a number of basic services, represented by appropriate indicators, the gap between the South and the rest of Italy has narrowed. However, the difference is still very pronounced, as progress continues to lag behind what is really needed and behind the objectives themselves.



The quality of services in the South

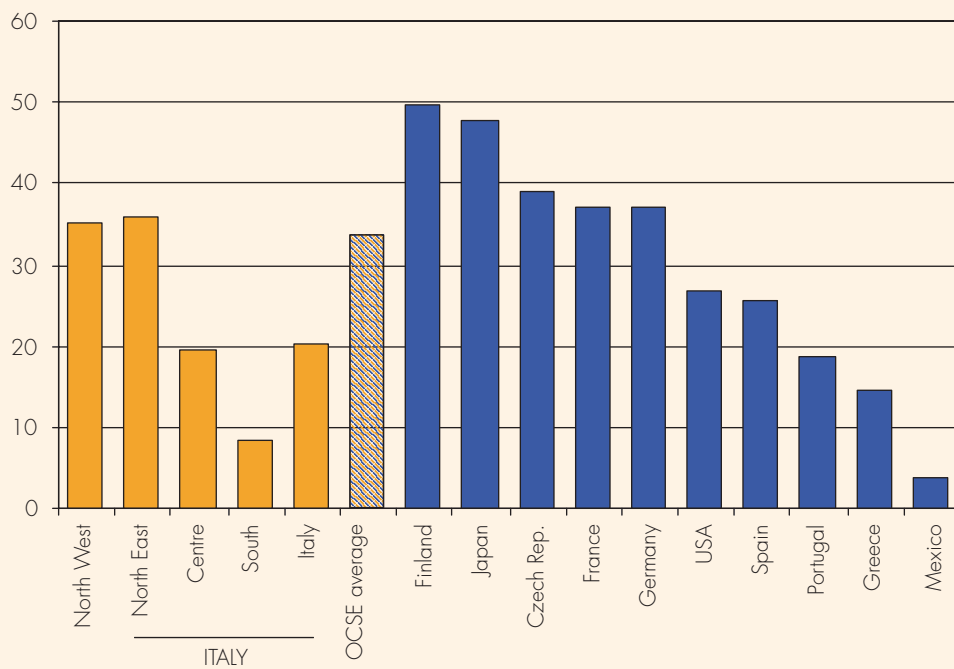
Waste disposal provides a clear example. Figures for the share of differentiated waste collection show that the South, which was nowhere near a decent result in 1996, has moved in the right direction. However, the result obtained (8 percent of total waste) is still far below the share in the Centre-North (28 per cent) and falls much short of the minimum objective set in the 2000-2006 Programme (15 per cent).

As for energy, small improvements have been made in the use of renewable resources (solar, hydroelectric, wind and biomass). However, serious inadequacies remain both in terms of the quality of services provided (related to distribution problems) and costs. The gap with the Centre-North shows up in the average number of long unplanned service interruptions per user, which was about double in the South compared with the rest of Italy in 2003.

Coming to education, progress has been made in the South both in the sharp reduction of dropouts and in the rise of secondary school participation rates. However, the quality of skills still seriously lags behind, as shown by international studies measuring the capability to solve complex mathematical problems, in which southern students rank behind those of the rest of the industrialized world (Fig. 8).

In the adoption of information and communication technologies in productive and commercial activities, the South has recouped the lag in the use of broadband by enterprises. However, the use of those technologies to improve corporate organization and productivity continues to be inadequate (as it is in many areas of the Centre-North).

Figure 8 - EDUCATION: PERCENTAGE OF 15 YEAR-OLD STUDENTS IN SELECTED OECD COUNTRIES CAPABLE OF SOLVING COMPLEX MATHEMATICAL PROBLEMS



Source: Based on OECD-PISA data

As to water-related services, there has been no significant change over the past decade in the percentage of households reporting an unstable water supply, nor has the gap with the Centre-North (29.4 per cent, compared with 9.7 per cent in the South) narrowed. The figure also remains far below the minimum objective (15 per cent) set in the 2000-2006 Programme. However, the outlook is more positive when it comes to the implementation of institutional reform in the sector, where a very relevant progress has finally been made.

Significant disparities in transport resources persist between the two macro-areas, while differences also exist within the regions. The southern transport system is marked by a significant lack of development and integration of networks and services, as well as an absence of crucial connections between large networks. For example, while the overall average density of Italy's railway network is 50 km for every 1000 km, in line with the European average, the Centre-North's density is higher, while density in the South is only 24 km for every 1000 km.

Finally, in the key area of law and order, the most recent data available (for 2004) show that the Centre-North has a higher rate of general and violent crime, while the South has more organized and economic crime, though the types of crimes being committed in the various areas of the country are gradually becoming more uniform, a fact that seems to be confirmed by convergence of the data on the perception of the risk of crime. But the pervasive presence of organized crime in four of the eight regions of the South and the combination of widespread illegal activity and a lack of government transparency continue to negatively impact the quality of life and work and the attractiveness of the South.

What changes for policy?

The prospects for growth in the South depend largely on the region's ability to further accelerate the improvement of its services by increasing the quantity and quality of public investment and boosting competition. This goal could be furthered over the next two or three years by the completion of many projects currently under way. The following developments are especially important in this regard:

- Structural Funds projects, which in 2005 achieved the Community goals for the fourth consecutive year, having spent over 16 per cent of the total resources; they will spend an average of about 16.5 per cent of these resources in each of the next three years;
- the acceleration achieved in 2004-2005 by State-Regions Agreements which implement national regional policy will make it possible for new significant projects to be accomplished;
- the acceleration in tenders for infrastructure projects for the 2003-2005 period compared to the previous three-year period, especially in the South, suggests that an acceleration in implementation is actually in the making.

Nevertheless, the efforts under way is still not sufficient to trigger the turn-around the South needs. As the National Document mentioned above states, a number of discontinuities in the existing policy should be introduced to remove the obstacles encountered thus far.

First, with regard to financial additionality of regional policy, the recommendations include:

- adopting more binding tools for implementing the 30 per cent target of ordinary resources in the South;
- improving central planning for national networks and for law and order as a precondition to finance there projects with regional funding;
- seeking greater consistency and coordination between expenditure objectives and public finance objectives.

Second, the quality and effectiveness of public investment could be further improved by establishing targets for a few and supporting their achievements with essential services, incentive mechanisms.

Third, a more focused selection of priorities (starting with the 2007-2013 National Strategic Framework) could certainly help. The identification process is at work through consultation with all partners. It points out to:

- promotion of research and innovation, where the gap within the country is very large but at the same time the return on initiatives is higher;
- investments on human capital, with the aim of improving the quality of skills in the schools and the workplace and, in general, of elevating the capabilities of citizens, with a view to reducing social exclusion;
- improving the environment as a way to rise quality of life and to leverage its enormous potential for attracting tourism and developing agricultural and food industries;
- accomplishing the task of modernization of markets and public administration: namely, strengthening competition in the services market, implementing administrative decentralisation, continuing the dissemination of the evaluation culture.

These priorities would be most effective in urban areas and in local productive systems if they were integrated into projects that selectively match local interests and capabilities with the still-inadequate contribution of both public and private national competence centres.

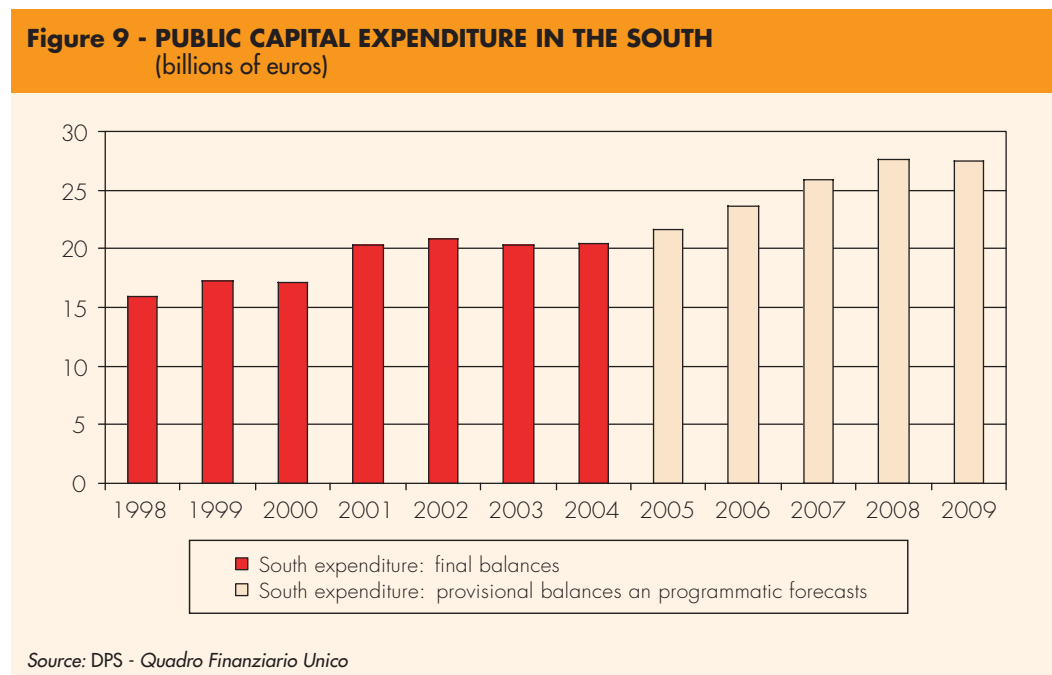
Finally, the institutional design will have to be further strengthened by:

- unifying national regional, national and EU regional policies,
- simplifying and processing State-Regions Framework Programme Agreements,
- establishing for national regional policy too a seven-year time commitment.

Devising long-term goals

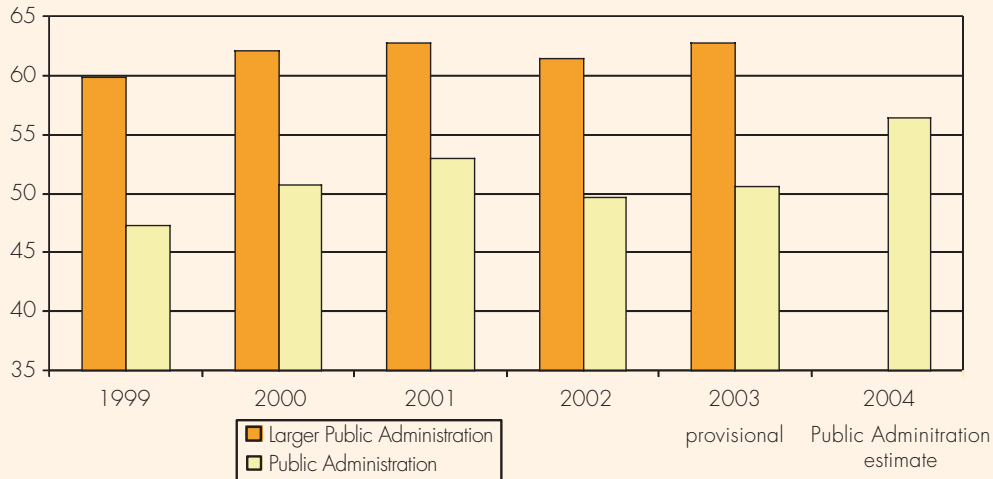
The Strategic National Framework for 2007-2013 due to be drawn by September 2006 should set seven years goals for financial and for macro variables.

According to very preliminary estimates, based, as far as EU regional policy is concerned, on the results achieved at the European Council of December 15-16 and for national regional on the confirmation of current trends, the South's share of total capital expenditure (Fig. 9) could come close to the goal of 45 per cent by the end of the period.



A further rebalancing of capital expenditure towards public investment in tangible and intangible assets should also be achieved. Rebalancing is effectively occurring, not only in the allocation of resources but also in expenditure: between 1999 and 2003 the share set aside for public investment out of total capital expenditure for the wider public sector grew by about 4 percentage points, from 57.6 per cent to 61.5 per cent (Fig. 10). The gap between South and Centre North could be bridged within the next few years.

Figure 10 - SHARE OF INVESTMENT IN TOTAL CAPITAL EXPENDITURE IN THE SOUTH - 1999-2004 (percentages)



Source: DPS - Regional Public Accounts

By accompanying these objectives with the discontinuities in policy making outlined above a more far-reaching and rapid improvement in the quality of services should be achieved.

Growth in the region could then revive in 2006, at a pace close to the national figure. Its gradual consolidation over the following years could finally generate a GDP growth faster than the European average between 2008 and 2009.

We gratefully thank the “Achille Bertarelli” Print Collection of the Milan Municipal Museum for the authorisation to reproduce the etching by Filippo Conti portraying the European States in 1788.

