EUROPEAN SOCIAL POLICY NETWORK (ESPN)

Financing social protection

Italy

Matteo Jessoula
Emmanuele Pavolini
Michele Raitano
Marcello Natili

Social Europe

EUROPEAN COMMISSION
Directorate-General for Employment, Social Affairs and Inclusion
Directorate C — Social Affairs
Unit C.2 — Modernisation of social protection systems
Contact: Giulia Pagliani
E-mail: Giulia.PAGLIANI@ec.europa.eu

European Commission
B-1049 Brussels

EUROPEAN COMMISSION

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ESPN Thematic Report on Financing social protection

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Jessoula, M., Pavolini, E., Raitano, M., Natili, M.

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Summary

An in-depth analysis of current levels and trends in respect of both social protection receipts and social protection expenditure allows us to formulate a set of considerations on the existing model for funding social expenditure in Italy.

First, in the period 2005-2016 social protection expenditure did not increase dramatically in real terms in Italy (1.2% annually on average compared with 1.9% in the EU-28); and the growth in social protection expenditure in relation to GDP was mostly due to the contraction of GDP following the economic and sovereign debt crises between 2008 and 2014. Moreover, when different indicators are taken into account – primarily, gross versus net social expenditure; social expenditure in real terms versus social expenditure as a share of GDP; per capita expenditure versus expenditure as a share of GDP – Italy does not appear as a big spender.

Second, the report highlights that there exists a problem of low expenditure (especially visible when per capita values are considered) for several functions: healthcare, family and children, unemployment (to some extent), housing and social assistance (although in the latter case, the recent reforms of 2018 and 2019 have improved the situation).

Third, nonetheless, the (limited) growth in welfare state expenditure between 2005 and 2016, which required more financial resources for social protection as a share of GDP, was actually matched by an increased reliance on government general revenues, which by the end of the period had become almost as important as social contributions in welfare state funding. There is thus a clear trend toward a larger role played by general taxation versus social contributions.

Fourth, this change was not, however, the result of an explicit reform plan. It has instead been mostly related to 'composition effects'; that is, the fact that the composition of the labour market has shifted towards groups of workers/individuals/employers less subject (or not subject at all) to social contributions – for example, from dependent employment to self-employment, where the latter is usually subject to lower contribution rates than those paid jointly by employees and employers.

Fifth, means-testing is becoming more important than in the past, and this represents a further driver of the larger role played by general taxation in financing social expenditure. Also significantly contributing to this outcome has been the recent expansion of traditionally underdeveloped welfare sectors in Italy such as unemployment benefits, and (especially) family and social assistance policies, that mostly rely on general revenue funding.

Finally, sixth, fiscal/occupational welfare is becoming a policy tool which deserves attention, given its relative weight and the fact that it is often overlooked when the mechanisms of funding social policies are assessed.

Changes such as rapid demographic ageing, structural labour market transformations and the impact of economic digitalisation and robotisation, are likely to be significant stress factors for the current system of social protection financing in Italy – as well as persistent economic difficulties, weak labour market performance and an ineffective tax system. The combination of these issues leads us to anticipate substantial challenges to both the sustainability and the adequacy of the Italian welfare state in the years to come, which is likely to call for innovative and effective funding solutions, including a more efficient system to tackle high tax evasion rates and expand the tax base, and a gradual shift of taxation away from labour to capital.

Against this backdrop, recent reforms aimed at increasing fiscal welfare, in practice substituting part of direct social expenditure with tax expenditure, cannot be considered an optimal choice in terms of equity, since – as shown by a large body of literature on fiscal welfare – the beneficiaries tend to be concentrated in the middle-upper part of the income distribution. In sum, these considerations show that the apparent stability of the system of social protection funding might soon come very under severe stress, and a

more thoughtful discussion about gradual but essential transformations of its functioning seems of the utmost importance.

1 Current levels and past changes in financing social protection

The first step in the analysis of the levels, trends and composition of social protection financing in Italy consists of outlining the current 'welfare effort' (i.e. total social protection expenditure), changes in the period considered (2005-2016) and the main drivers of those changes.

When looking at gross expenditure on social protection as a share of GDP (Table 1), two main conclusions can be drawn. First, Italy appears among the big spenders: in 2016, expenditure amounted to 29.7% of GDP compared with 28.2% in the EU-28, and Italy had the sixth-highest social expenditure in the EU. Second, social protection expenditure significantly expanded in 2005-2016: Italian spending went from 25.3% of GDP in 2005 (below the EU-28 average at 26.0%) to 29.7% in 2016, corresponding to a 4.4 p.p. increase, which was the third-highest percentage point increase in the EU-28 (only Finland, 6.4 p.p., and Greece, 6.2 p.p. had higher increases). In sum, the share of GDP that had to be allocated to finance the welfare state increased over the period examined.

Table 1: Gross expenditure on social protection, EU-28 and Italy (IT) 2005-2016

	As a share of GDP (%)			At constant prices (2005=100)		
	2005	**2016**	**Change 2005-2016 (p.p.)**	**2005**	**2016**	**Mean annual change 2005-2016 (%)**
EU-28	26.0	28.2	+2.2	100.0	122.6	+1.9
IT	25.3	29.7	+4.4	100.0	114.2	+1.2

Source: Spasova and Ward (2019), Annex ESSPROS tables

Nonetheless, other indicators – such as gross expenditure at constant prices, net expenditure as a share of GDP, and per capita expenditure at constant prices or in terms of purchasing power standard (PPS) – give a different picture: both the trend and the current values for Italy assume rather different traits, and the image of Italy as a big spender fades away.

First, when gross expenditure on social protection in *real terms* is taken into account, instead of the ratio of spending to GDP (Table 1), Italian spending grew at a rather lower pace (1.2% annually on average) than in the EU-28 (1.9%).

Second, when considering *net* instead of gross expenditure on social protection as a share of GDP, the gap between Italy and the EU-28 almost disappears: net expenditure amounted to 26.2% of GDP in Italy, and 26.1% in the EU-28, in 2015 (Table 2). Actually, Italy is among the countries with the highest gap between gross and net total social expenditure — 3.7 p.p. versus 2.2 p.p. in the EU-28 (Table 2). Only the Netherlands and Denmark showed a larger gap, and the gap was also expanding more quickly in Italy (it amounted to 2.7 p.p. in 2007). Thus, looking at net social expenditure allows us to argue that the higher expenditure levels in Italy relative to GDP are mainly related to the gross-net distinction: although its gross expenditure is well above the EU-28 average, Italy is around the average for net expenditure, and several countries such as France, Finland, Belgium, Denmark, UK, Austria and Germany had a higher net expenditure than Italy in 2015. Furthermore, it should be noted that, in the last decade, none of these countries witnessed an economic crisis comparable to the Italian recession — which, as discussed below, has implications for the balance between welfare effort and financing, due to the reduction in GDP and the parallel increase in social demand (e.g. for unemployment or social assistance benefits).

Table 2: Gross and net social protection expenditure as a share of GDP, EU-28 and Italy 2007-2015 (%)

	Gross expenditure			Net expenditure			Net minus gross (p.p)		
	2007	2010	2015	2007	2010	2015	2007	2010	2015
EU-28	25.2	28.6	28.3	23.5	26.5	26.1	-1.7	-2.1	-2.2
Italy	26.7	28.9	29.9	24.0	25.8	26.2	-2.7	-3.0	-3.7

Source: Spasova and Ward (2019), Annex ESSPROS tables

It should also be noted that, in Italy, no relevant changes in the taxation of welfare benefits have been introduced since 2005; in Italy, as mentioned, taxation of benefits plays a major role (the difference between gross and net expenditure, as a share of GDP, rose from 2.7 to 3.7 p.p. between 2007 and 2015; see Table 2). Indeed, cash welfare transfers (pensions and unemployment benefits) are taxed according to the progressive personal income tax (PIT) schedule whose brackets and tax rates only slightly changed in Italy in the last decade; whereas means-tested social assistance benefits (e.g. minimum pensions and incomes) are not taxed, since the beneficiaries do not reach the minimum threshold for PIT. According to ESSPROS (European System of integrated Social PROtection Statistics) data, effective tax rates on social protection expenditure increased in Italy from 9.8% to 12.1% in the period 2007-2015. However, since no relevant changes in the PIT schedule have been introduced, this increase was mostly due to changes in the composition of benefits (as between the various welfare functions) and to changes in the distribution of benefits – for instance, an increase in inequality in pension benefits may increase the average tax rate when pensioners with high incomes are subject to higher tax rates.

The view that Italy is not, comparatively, a big welfare spender is further confirmed when per capita expenditure (at constant prices and in PPS terms) is considered (Table 3). In fact, in 2016, Italy spent 10.5% less for each inhabitant than the average in the EU-15 when spending is computed in PPS terms, and 14.4% less at constant prices; and the Italian figures were in line with those for the EU-28. Moreover, the gap in social protection spending per inhabitant between Italy and EU-15 increased in the period 2005-2016, amounting to 8.7% and 9.8% at constant prices and in PPS terms, respectively.

Table 3: Per capita social protection expenditure, EU-28, EU-15 and Italy 2005-2016

	€ per inhabitant (constant 2010 prices)			€ per inhabitant (PPS)		
	2005	2016	% change	2005	2016	% change
EU-28	n.a.	7,657.40	n.a.	n.a.	8,232.00	n.a.
EU-15	7,780.10	9,065.50	+16.5	6,996.80	9,097.00	+30.0
Italy	7,103.30	7,756.90	+9.2	6,308.70	8,137.60	+29.0

Source: Eurostat online database, indicator 'spr_exp_sum'.

Shifting from aggregate expenditure to its main components (i.e. by functions) social protection expenditure in Italy is notoriously concentrated in the field of pensions (Ferrera 1996; Ferrera et al. 2012) – especially old-age pensions, which accounted for 48.7% of total social spending in 2016 (Table 4), despite a decreasing trend since 2005 (the share was 51.3% in 2005 and 49.7% in 2010). By contrast, when computed on a per inhabitant basis or as a share of GDP, spending for the old-age function increased in the 2005-2016 period (Table 4), even if at a much slower pace than in the EU-15 due to

severe austerity measures included in the three subsequent pension reforms adopted in 2009, 2010 and 2011.[1]

Similarly, healthcare/sickness expenditure – and thus financing – as a share of GDP rose only slightly in Italy between 2005 (6.5%) and 2016 (6.6%); whereas the EU-15 figure rose from 7.3% to 8.2% in the same period (Table 4). Its share of total social expenditure in Italy fell from 26.7% in 2005 to 23.1% in 2016 – placing Italy at the bottom in the EU with the fourth-lowest share, and very far from the EU-28 average (29.5% in 2016). Furthermore, the gap with the EU-15 was still wide, and increasing at a faster pace, when spending per inhabitant is considered (Table 4): in terms of real spending per inhabitant, the gap increased from 15.0% to 33.3% between 2005 and 2016.

The most recent figures suggest that the increase in social expenditure in Italy as a share of GDP was mostly related to the relative expansion of traditionally underdeveloped welfare state sectors, such as family and unemployment. The share of GDP devoted to welfare functions other than sickness/healthcare and old age increased by 2.9 p.p. (Table 4) between 2005 and 2016; and, remarkably, the share of total social protection expenditure devoted to family and unemployment functions went from 3.9% and 1.9% (respectively) in 2005 to 6.2% and 6.1% in 2016 (Table 5) – due to the introduction of various 'bonuses' paid as family benefits, on the one hand, and increased generosity in the unemployment benefit system, on the other (see next Sections).

Table 4: Breakdown of gross expenditure on social protection by function, EU-28, EU-15 and Italy (IT) 2005-2016

	2005			2016		
	Sickness/ Health	Old age	Other	Sickness/ Health	Old age	Other
As % share of GDP						
EU-28	n.a.	n.a.	n.a.	8.0	10.9	9.2
EU-15	7.3	9.8	9.4	8.2	11.1	9.7
IT	6.5	12.5	6.3	6.6	13.9	9.2
As % share of social expenditure						
EU-28	28.7	38.6	32.7	29.5	40.1	30.4
EU-15	27.7	37.0	35.3	28.5	38.4	33.1
IT	26.7	51.3	22.0	23.1	48.7	28.3
€ at 2010 constant prices						
EU-28	n.a.	n.a.	n.a.	2,174.90	2,961.30	2,240.90
EU-15	2,152.80	2,880.00	2,448.20	2,583.40	3,478.50	2,664.00
IT	1,830.80	3,509.80	1,505.60	1,723.60	3,635.00	2,112.90

Source: Spasova and Ward (2019), Annex ESSPROS tables and Eurostat online database indicator 'spr_exp_sum'.

[1] Importantly, cross-country comparisons of spending on the old-age function might be distorted by the fact that the Italian figures also include annual spending on severance payments (TFR and TFS) paid to employees (also before retirement), amounting to around 11% of total pension spending.

Table 5: Breakdown of gross expenditure by function in 'other' category (Table 4), EU-28, EU-15 and Italy (IT) 2005-2016 (% total social expenditure)

	Disability	Survivors	Family	Unemploy-ment	Housing	Social exclusion n.e.c.
			2005			
EU-28	8.0	6.7	8.4	5.8	2.0	1.8
EU-15	7.9	6.6	8.4	5.9	2.1	1.8
IT	5.6	9.9	3.9	1.9	0.0	0.6
			2016			
EU-28	7.4	5.5	8.7	4.6	2.0	2.2
EU-15	7.4	5.4	8.6	4.8	2.1	2.2
IT	5.8	9.1	6.2	6.1	0.1	0.9

Source: Spasova and Ward (2019), Annex ESSPROS tables

How to explain the current levels and recent trends in respect of social protection expenditure presented above, and, consequently, financing needs in Italy?

At least four main potential types of drivers – affecting the amount of available resources and/or the number of individuals asking for these resources – are to be considered: a) economic drivers, related to the stage of development of a country and to GDP growth over time;[2] b) socio-demographic drivers, mostly related to population ageing; c) socio-economic drivers, related to changes in the labour market, also affecting the socio-economic conditions of a population; and d) institutional drivers, related to changes in social protection rules.

a) Economic drivers

The first factor to be considered in interpreting (gross) social expenditure trends, especially the increased share of resources devoted to welfare state programmes between 2005 and 2016 (see Table 1 above), regards economic growth. In fact, both the economic crisis and the sovereign debt crisis had a strong impact on the Italian economy − which had already presented weaknesses since the mid-1990s – resulting in a severe and prolonged recession between 2008 and 2014. GDP grew on average by 1.2% yearly in real terms in the EU-28 between 2005 and 2016, whereas it contracted by 0.3% annually in Italy; in total, in the period 2005-2016, EU-28 GDP increased by 12.9% whereas Italian GDP shrank by 3.4% (Table 6). This trend is important when looking at the size of the social protection system expressed in terms of share of GDP, since it affects the denominator in the ratio: due to low GDP growth, Italy displayed an above-average increase in gross social protection expenditure relative to GDP, but in real terms expenditure increased less than the EU average (Table 1 above).

Table 6: GDP trends in real terms, EU-28 and Italy 2005-2016

	EU-28	Italy
2016 value (2015=100)	112.9	96.6
Average yearly GDP real growth, 2005-2016	+1.2%	-0.3%

Source: Eurostat online database, indicator 'nama_10_gdp'

b) Socio-demographic drivers

Italy has an age structure characterised by a large share of the population aged 65+ and 75+ (Table 7). 22% of individuals residing in Italy were at least 65 years old in 2016 (19.2% in the EU-28) and as many as 11.3% were aged at least 75 (9.2% in the EU-28).

[2] Within economic drivers one might also include the willingness to cut social protection spending to reduce labour costs, or the general tax burden in order to increase competition. We will discuss this issue in next Sections.

Moreover, during the 2005-2016 period the increase in the 75+ population was particularly large in Italy compared with the EU-28 (+31.3% and +27.7%, respectively). Population ageing does not only put pressure on old-age (and survivor) pension schemes, but also on healthcare and on the protection of individuals with either disabilities or long-term care needs, given the concentration of such needs in the later stages of the life cycle. Italy is more strongly affected by such types of demand, given that the differential in ageing between Italy and the EU-28 has either increased or remained relatively constant over time. Nevertheless, in the period under consideration, such a robust demographic driver of welfare expenditure was in practice neutralised in Italy by a strict and continuous commitment to austerity and cost-containment reforms, both in the field of pensions – mostly through a steep increase in the pensionable age, which was also automatically linked to changes in life expectancy (Jessoula 2017a; Jessoula and Raitano 2017) – and in the field of healthcare (Jessoula et al. 2018).

Table 7 Ageing European societies: Italy in a comparative perspective, 2005-2016

		EU-28	Italy
Share of population 65 years or over in total population (%)	2005	16.6	19.5
	2016	19.2	22.0
Share of population 75 years or over in total population (%)	2005	7.4	9.0
	2016	9.2	11.3
Number of individuals 65 years+	Variation between 2005 and 2016 (%)	+19.3	+18.3
Number of individuals 75 years+	Variation between 2005 and 2016 (%)	+27.7	+31.3

Source: Eurostat online database, indicator 'demo_pjanbroad'.

c) Socio-economic drivers

A third potential source of increased demand for social spending concerns labour market performance. The prolonged economic stagnation which affected the Italian economy in 2008-2014 contributed to a stronger increase in unemployment than in the EU on average. As illustrated in Table 8, in 2005 the unemployment rate was 7.7% in Italy, well below the EU-28 level (9.0%). A decade later, the EU-28 unemployment rate had gone down to 8.6%, whereas it had skyrocketed to 11.7% in Italy. The figures are even more dramatic in terms of absolute numbers: the total number of unemployed people in the EU-28 fell slightly between 2005 and 2016 (by 0.1%), whereas it increased by 60.5% in Italy. In other words, there were 1.1 million more unemployed people in Italy in 2016 compared with 2005. Such an increase, combined with two main reforms of the unemployment benefit system (see below), constituted a major trigger of growing expenditure on the 'unemployment' function.

Table 8: Unemployment in European societies: Italy in a comparative perspective, 2005-2016

		EU-28	Italy
Unemployment rate (%)	2005	9.0	7.7
	2016	8.6	11.7
Number of unemployed individuals	Variation between 2005 and 2016 (%)	-0.1	+60.5

Source: Eurostat online database, indicator: 'une_rt_a'.

Table 9: People at risk of poverty or social exclusion (AROPE), EU-28 and Italy 2005-2016

	2005	2010	2016
Thousand persons			
EU-28		117,907	118,040
Italy	14,891	14,891	18,137
% of total population			
EU-28	:	23.8	23.5
Italy	25.6	25.0	30.0

Source: Eurostat online database, indicator: 'ilc_peps01'.

By destabilising the labour market, economic stagnation also dramatically increased the number of individuals at risk of poverty or social exclusion (AROPE), who may be a target group for social assistance benefits (Table 9). The AROPE rate was indeed much higher in Italy than in the EU-28 in 2016 (30.0% versus 23.5% of the population). Moreover, the number of individuals exposed to the risk of poverty or social exclusion was rather constant in the EU-28 over the 2010-2016 period (+0.1%), whereas it dramatically increased in Italy (+21.8%). In fact, until 2018 – when the 'inclusion income programme' (REI) was introduced (subsequently replaced by the citizenship income, r*eddito di cittadinanza*, from May 2019) – no universal minimum income scheme existed in Italy: only some experiments in the possible introduction of such a scheme had been carried out (Raitano et al. 2018). As a consequence, the share of total expenditure on the social exclusion function was very limited and increased only slightly between 2005 (0.6%) and 2016 (0.9%) (Table 5).

d) Institutional drivers

Institutional innovations and reforms are key to fully understanding the trends in expenditure and financing outlined above. On the one hand, as mentioned, a strict and continuous commitment to austerity led Italy to introduce cost-containment reforms in both pensions and healthcare. On the other hand, traditionally underdeveloped areas of spending – such as unemployment, family benefits and (partly until 2016) social assistance – were expanded to deal with the dramatically increased number of potential beneficiaries engendered by the recession.

As to unemployment, since 2005 three main reforms (2007, 2012, 2015), and some emergency interventions in 2009-2011, have significantly restructured the income maintenance system for the unemployed, by making it more inclusive – extending potential coverage to all employees, including apprentices, and to some groups of dependent self-employed people, and loosening the seniority eligibility requirements for access to these benefits – as well as (generally) making it more generous (the replacement rate for the general unemployment benefit rose from 50% to 75% and its duration was also lengthened). However, some very generous schemes devoted to certain groups of workers (mostly those working in large firms in manufacturing) have either been abolished (e.g. the mobility allowance and the 'derogation' wage supplement system, named *cassa intregrazione guadagni*) or drastically 'rationalised' (e.g. the 'extraordinary' *cassa intregrazione guadagni*). This expansionary trend – also related to the dramatic increase in the number of individuals experiencing labour market insecurity, pointed out above – is captured by the growth in spending on unemployment as a share of GDP, from well below the EU average in 2005 (0.5% versus 1.5% in the EU-15) to above-average figures in 2016 (1.7% versus 1.3%); and also in the remarkable increase in per capita expenditure, which (in real terms) went from €132 to €456 between 2005 and 2016 (compared with a fall from €443 to €420 in the EU-15 in the same period).

A similar, though less marked, trend has also characterised programmes directed at families and children (Natili and Jessoula, 2018). Italian expenditure as a share of GDP

increased from 1.0% to 1.8% in 2005-2016 (it increased from 2.1% to 2.4% in the EU-15 in the same period). Similarly, per inhabitant benefit spending in real terms increased by 72.2% in Italy (from €269 to €463) over the period, compared with a 19.2% increase in the EU-15. Among the expansionary reforms worth mentioning in this policy field is that of the Renzi government in May 2014, which introduced a structural, non-refundable monthly tax allowance (a tax bonus of €80 a month) for low-income employees, with the aim of increasing the net earnings of employees through a permanent deduction in personal income tax (i.e. *IRPEF* in the Italian tax system) (Raitano et al. 2019). The 2014 Stability Law also introduced a new allowance of €80 per month for all newly born (or adopted) children until the age of three. Originally introduced on an experimental basis between 2015 and 2017, this bonus was extended under the 2018 Stability Law (Law no 205/2017) for 2018 (with the same rules on the amount and the means test). Consequently, these programmes usually being based on a means test, means-tested spending on social protection (as a share of total expenditure) rose from 5.7% to 8.0% in Italy between 2005 and 2016 (this share increased from 10.3% to 12.1% in the EU-28 over the same period). The expansion of social assistance anti-poverty programmes also contributed to this outcome. In particular, in 2013 the Monti government introduced a new experimental benefit, the 'social card', which was later re-named 'active inclusion support', with more resources than originally envisaged (€167 million in 2016). As a consequence, Italian expenditure in the field of social exclusion, though remaining comparatively low, slightly increased from €43 to €68 per inhabitant in 2005-2016 (EU-28 expenditure per capita in 2016 was €161). With the following Stability Laws of 2016 and 2017, the Italian anti-poverty strategy was further consolidated, and a new fully fledged minimum-income scheme, called 'inclusion income', was introduced on a structural basis (Natili 2019; Raitano et al. 2018).

2 Current mix and past changes in the sources of financing social protection

In 2005, social protection financing in Italy mostly relied on social contributions, which constituted 56.2% of total financing, although this figure was already lower than the EU average (58.7%) (Table 10). Interestingly, however, in the subsequent decade Italy increasingly relied on general revenues to finance the (limited, in real terms) expansion of social protection expenditure. Thus, in 2016, social protection financing was almost equally shared between social contributions (49.5% of total financing) and general taxation (50.5%, split between 48.4% general government contributions and 2.1% other receipts). This is in line with the 'mixed nature' of the Italian welfare state, characterised by Bismarckian income-maintenance schemes (primarily pensions but also unemployment subsidies) coupled with a Beveridgean healthcare system (Ferrera 1996). This reduced role for social contributions is also visible at the EU level, although the reduction between 2005 and 2016 was lower in the EU-28 (4.2 p.p.) than in Italy (6.7 p.p.).

Considering the various sources of social contributions, the lion's share in 2016 was made up of employer contributions (70.3% of total social contributions), while lower shares were paid by employees (16.8%) and self-employed people (12.9%). The contribution of benefit recipients was negligible. In 2016, the share of social contributions paid by employers was slightly lower than in 2005 (72.9%), whereas self-employed people contributed a higher share (10.7% in 2005) and it remained constant for employees (16.2%). From a comparative perspective, self-employed people in Italy constitute a greater source of welfare state financing, partly due to the broader diffusion of this type of employment compared with the EU-28 (according to Eurostat, self-employment represented 21.5% of total employment in Italy in 2016, and 14.0% in the EU-28).

Table 10: Financing of gross expenditure on social protection by source, EU-28 and Italy (IT) 2005-2016 (% of total financing)

	Employ ers	Employees	Self-employed	Benefit recipients	General government contrib.	Other receipts	Total social contrib.	Total general taxation
				2005				
EU-28	38.5	16.1	2.4	1.7	37.8	3.5	**58.7**	**41.3**
IT	41.0	9.1	6.0	0.1	41.7	2.1	**56.2**	**43.8**
				2016				
EU-28	34.9	15.2	2.4	2.1	40.4	5.1	**54.5**	**45.5**
IT	34.8	8.3	6.4	0.1	48.4	2.1	**49.5**	**50.5**

Source: Spasova and Ward (2019), Annex ESSPROS tables

The financing mix between social contributions and general taxation depends on the different financing rules for each component part of the welfare state (e.g. healthcare, long-term care, pensions, unemployment benefits) – which in most of cases overlap with the ESSPROS functions. Whereas social insurance benefits are mostly financed through social contributions, in-kind benefits tend to be financed through general taxation. The changing importance, in relative terms, of these types of schemes may thus help explain current levels and trends in respect of the various financing sources of social protection expenditure. Therefore, for instance, a reform extending in-kind services or introducing a means-tested cash programme devoted to the whole population, and financed through general revenues, would reduce the role played by social contributions, even if the financing rules of each scheme remained the same.

However, apart from the mix of spending as between the various functions (see Tables 4-5 in Section 1), financing trends may be influenced by several interacting factors, which will be outlined below both analytically and with reference to the Italian case.

a. Changes in contribution rates and in the role played by general taxation within each welfare function. For example: higher contribution rates for unemployment benefits, such as occurred for temporary employees (whose rate was increased by 1.4 p.p. in 2012); new contributions (e.g. a 0.51% contribution rate on 'para-subordinate' collaborators introduced in 2015); or exempting some worker or employer categories from paying social contributions, which are therefore replaced with general revenues (e.g. for a three-year period, those hired through an open-ended arrangement in 2015).
b. Reforms that change entitlement conditions for universal social insurance benefits. These are more often financed through social contributions – for example, extending pension coverage to categories of worker that were previously exempted.
c. Reforms that extend social insurance schemes to individuals not eligible according to their contribution record. For example, increasing minimum pension benefits or extending unemployment benefit coverage to individuals not enrolled in any scheme (as, for instance, in the so-called 'derogation' *cassa integrazione guadagni)*.
d. Reforms that extend/create means-tested programmes, which are more often financed through general revenues.
e. Reforms that extend the role of in-kind benefits, which are more often financed through general revenues.
f. Changes in the workforce composition, where different types of workers are subject to different social contribution rates. For example, from dependent employment to self-employment, where the latter is usually subject to lower rates than those paid by employees and employers.

Hence, apart from the general overview of the weight attributed to each financing source, the role played by each of the aforementioned factors has to be assessed by considering case by case the various welfare state functions.

2.1 Old age and survivors

The share of pension expenditure financed by social contributions fell by 6.4 p.p. in Italy between 2005 and 2015 (Table 11). As a consequence, the share of pension spending financed through social contributions was the same in Italy in 2015 as in the EU-28 (64.8%). Significantly, the Italian figure had been 6.3 p.p. higher than in the EU in 2005.

This reduction was mostly due to a large drop in the share of social contributions paid by employers (50.0% and 42.0% of total receipts in 2005 and 2016, respectively), only partially offset by an increase in the share paid by the self-employed (8.2% and 9.5% of total receipts in 2005 and 2016, respectively), mostly due to an increase in contribution rates for this category (see below).

A similar trend also emerges in relation to survivor pensions: the share of social contributions in social financing reduced by 2.3 p.p. in Italy between 2005 and 2015, mostly due to a 4.3 p.p. reduction in the share of contributions paid by employers. These parallel trends are explained by the fact that social contributions paid by employers, employees and the self-employed cover both old-age and survivor pensions (in other words, no separate contributions are paid to finance survivor pensions).

The generally reduced reliance on social contributions does not depend on changes in the contribution rates for old-age pensions, which either remained constant – for employees the total contribution rate is 33% of gross wage, shared between worker (9.19%) and employer (23.81%) – or even increased during the period examined, as in the case of 'traditional self-employed' people (i.e. farmers, craftsmen and dealers/shopkeepers),

freelance professionals and 'para-subordinate' collaborators (Jessoula et al. 2017). In particular, contribution rates for traditional self-employed people increased from around 17% in 2005 to the current 24%; those for freelance professionals and para-subordinate collaborators rose from 18% in 2005, and are currently set at 25% and 33%, respectively (for para-subordinate workers, 1/3 of the rate is paid by the worker, 2/3 by the employer).

The reduction in the role played by social contributions, thus, is not due to changes in contribution rates. Rather, four different drivers had a role in this outcome.

Table 11. Financing of old-age benefits by source, EU-28 and Italy (IT) 2005-2015 (% of total financing)

	Social contributions					Govt. revenue	Other receipts
	Employers	Employees	Self-emp.	Benefit recipients	Total social contrib.		
	2005						
EU	43.4	18.4	2.9	0.2	64.9	18.8	16.4
IT	50.0	13.0	8.2	0.0	71.2	17.7	11.0
	2015						
EU	41.8	19.5	3.3	0.2	64.8	19.8	15.4
IT	42.0	13.1	9.5	0.3	64.8	22.4	12.8

Source: Spasova and Ward (2019), Annex ESSPROS tables

First, in order to reduce labour costs and support the employment of specific groups of individuals, a partial and temporary exemption from social contributions was introduced. The main exemption was included in the so-called Jobs Act (2015), establishing a 36-months exemption for employers who recruited workers using a new open-ended flexible contract (a less generous exemption was then extended to workers hired in 2016). Since these exemptions do not reduce the contribution rate used for calculating pension benefit in the notional defined-contribution public scheme, the drop in social contributions had to be replaced with revenues from general taxation.

Second, apart from employees and traditional self-employed people, a number of labour arrangements with reduced contribution rates (e.g. freelance and para-subordinate collaborations, 'jobs on vouchers') (Jessoula et al. 2017) have been introduced since the mid-1990s in Italy. In the pay-as-you-go (PAYG) public pension scheme, when the share of these types of jobs increases, the total contribution amount is reduced and the pension spending has to be filled by an increasing share of revenues from general taxation.

Third, the relative role of social contributions also decreases when the amount and the beneficiaries of the various types of minimum pensions (i.e. benefits whose amount is not based on past contributions) increase, as occurred in Italy due to the adoption of the 2007 and 2016 pension reforms. In fact, in Italy government revenues completely finance the means-tested old-age social allowance (*assegno sociale*) and the minimum pension supplement (*integrazione al minimo*).

Finally, and more generally, the reduced share of contributions might be the result of pension spending in the PAYG public scheme increasing faster than the total wage bill in the economy – meaning that an increasing share of pension expenditure has to be financed by general government revenues. Wages in Italy have stagnated in recent decades while, on the other hand, some argue (e.g. Patriarca and Patriarca 2015) that pension benefits paid to the new cohorts of retirees (who still receive benefits almost entirely based on the previous generous earnings-related formula) lead to gaps in pension financing that have to be increasingly covered through general taxation, rather than by social contributions.

It is true that the accounts of the Italian National Social Security Institute (INPS) show that pension spending (for old-age and minimum pensions) was unbalanced in 2015, since annual spending was around €250 billion, while social contributions amounted to around €190 billion (Fantozzi 2017). However, this evidence is not enough to confirm that the financing of pension spending is inadequate. In fact, on the one hand, around €45 billion was spent on minimum pensions that, by definition, are financed by general taxation. On the other, since pension benefits are taxed according to the normal PIT schedule (see Section 1), taxes paid on pensions amounted to around €40 billion. Once spending on minimum pensions and PIT revenues on pensions are subtracted, social contributions exceeded pension spending by around €25 billion.

2.2 Healthcare

Over the period examined, the Italian National Health System (NHS) became more and more tax-based: in 2015, 95% of funding came from government revenues or other receipts, compared with around 91% in 2005. A comparison with the general EU situation is not appropriate, given the fact that many EU healthcare systems are based on compulsory social insurance, and are then financed by social contributions. Already relatively low due to the universal nature of the Italian NHS, the relevance of employer contributions further decreased between 2005 and 2016 (employees and the self-employed are not subject to social contributions for healthcare): in 2005 employers contributed 8.5% of total health expenditure, but this fell to 4.9% in 2015. This change took place in the 2000s, when a reduction in the specific tax paid by employers to finance the NHS (the so-called IRAP tax) was legislated for. By 2008 the employer share was already down to 6.3%, from 8.5% on 2005.

2.3 Disability

In the area of social protection expenditure on disability, there were no important changes in financing mechanisms in Italy in the period examined. As confirmed by MISSOC (Mutual Information System on Social Protection) information, all the financing principles for contributions remained practically the same during 2005-2015. As a consequence, the share of government revenues or other receipts remained broadly constant at around 83%.

2.4 Family and children

Government revenues have financed a significant – yet not sufficient – increase in expenditure on family benefits in Italy. Indeed, in 2015 government revenues and other receipts financed 80.8% of total expenditure in this area, compared with 51.7% in 2005. Consequently, the largest fall in the share of employer contributions was registered in this policy area: from 46.3% in 2005 to 27.8% in 2015.

The increased role in funding of government revenues, and the reduced role of employers, can be explained in two ways. First, as MISSOC information shows, a decision was taken to reduce the employer contribution rate for employee family allowances – from 2.48% in 2005 to 0.68% in 2015. Second, in the mid-2010s a new set of measures – not directly linked to an individual's employment condition – were introduced to foster childcare provision, mainly paid for through government revenues (for more details, see the ESPN Country Profiles for Italy for 2014, 2015 and 2016). However, the most significant reduction in the share of financing related to employer contributions does not derive from their reduced involvement in the financing of these schemes, but rather from the general expansion in public expenditure in this policy area highlighted in Section 1, which has been financed through general taxation. In particular, in 2014, the introduction of a monthly 'bonus' of €80 for employees with medium-to-low incomes (the income threshold to be eligible to the bonus was €26,600 per year), boosted expenditure in this

policy area. The Ministry of Economy and Finance has calculated an annual expenditure on this programme of around €9 billion since 2015.

2.5 Unemployment

Social contributions on unemployment benefits and wage supplements for working time reductions (the so-called *cassa integrazione guadagni*) are financed through social contributions that largely differ according to several characteristics of both firms and employees (i.e. sector, firm size, geographical area of the plant, worker's age and occupation, open-ended or fixed-term nature of the work contract; the 2015 reform of the *cassa integrazione guadagni* also established an additional contribution paid by firms according to the past use of this allowance). Major changes were introduced by the Jobs Act reform in 2015, which, as mentioned, changed the contribution rates paid by the employer for the *cassa integrazione guadagni* and abolished the derogation type of this allowance (before the reform it was indeed also paid through derogation to the general rule to workers of firms not entitled to pay contributions for the *cassa integrazione guadagni*). Moreover, the 2015 reform introduced a new unemployment benefit for para-subordinate workers – financed by a specific contribution rate that is appropriate to cover the spending on unemployment benefits for these workers; while the 2012 reform abolished the 'mobility allowance' – a generous type of unemployment benefit usually paid to employees of large firms, which was often characterised by annual spending much higher than social contributions (the 2012 reform also increased by 1.4 p.p. the contribution rate for unemployment benefits paid by employers for fixed-term employees). Note, instead, that traditional self-employed categories are not covered by unemployment benefits in Italy (Jessoula et al. 2018) and, hence, do not pay social contributions in this area.

During the period under consideration, contribution rates for the general unemployment benefit (whose named changed from *indennità ordinaria di disoccupazione* to n*uova assicurazione sociale per l'impiego*) and for the 'ordinary' *cassa integrazione* allowance remained broadly constant, but the share of social contributions in total financing rose from 34.7% in 2005 to 50.3% in 2015. At the same time, it should be underlined that the distribution by source of the receipts financing the unemployment benefit has been rather volatile, depending on the specific macroeconomic stance. Indeed, contribution rates are established with the idea of achieving a sort of intertemporal balance, so that the difference between annual spending and social contributions is inversely related to the business cycle (a recession reduces the wage bill and increases the number of beneficiaries).

2.6 Housing and social exclusion

The two 'Cinderella' areas of social protection in Italy – housing and social exclusion – whose joint spending did not exceed 1% of total expenditure for social protection in 2016, are almost entirely financed through general taxation – in line with the EU pattern. The share of government revenues and other receipts in the financing of spending on these two functions amounted to 97.3% and 98.2% in 2005 and 2015, respectively.

2.7 Beyond 'social welfare': the role of fiscal welfare in the Italian social protection system

Around sixty years ago Richard Titmuss (1958) warned that we need to take a broader view of complex mechanisms of welfare provision, and that welfare can be channelled through several different routes. In particular, he developed the idea that, alongside 'social' welfare (cash benefits and in-kind services provided by the state, which is what social expenditure data used so far in the present report focus on), 'fiscal' welfare (tax incentives for individuals and firms to help them provide welfare) and 'occupational' welfare (benefits and services provided by social players, i.e. firms and trade unions)

constituted different sources of protection – with the related advantages as well as risks and shortcomings (Pavolini et al. 2013; Jessoula 2017b). Moreover, a significant part of occupational welfare expenditure is the result of fiscal incentives. Therefore, particular attention was given to fiscal welfare in a recent publication also co-written by the four ESPN experts for Italy (Pavolini, 2019). The main conclusions of the report are as follows.

a) Occupational welfare in Italy is mostly related to pensions and healthcare.

b) Fiscal welfare expenditure, not accounted for in most ESSPROSS and national statistics on social protection, and also often underestimated in the specific analysis by OECD (with its OECD SOCX database), is highly relevant in absolute and relative terms; in Italy in 2016 around €55 billion was spent in this area by the Italian state, an amount equivalent to around 12% of social protection expenditure in the same year.

c) Between 2010 and 2016 the increase in expenditure on fiscal welfare (25%) was much greater than that on social protection (0.3% according to Eurostat data).

d) Most policy fields and welfare functions involve fiscal welfare programmes at work, often reinforcing occupational welfare schemes (e.g. fiscal incentives for occupational and private pensions, as well as integrated healthcare funds).

e) Fiscal welfare is partially and slowly replacing public interventions through social expenditure (‘social welfare’), and is the outcome of political decisions taken by different recent governments which point in this direction.

3 Strengths and weaknesses of the existing mix of financing options and potential future sources of financing - national debate on the topic

As outlined in the two Sections above, in the period 2005-2016 social protection financing in Italy did not increase dramatically in real terms – while the increase in social protection expenditure as a share of GDP was mostly due to the contraction of GPD following the economic and sovereign debt crises between 2008 and 2014. Such limited growth in expenditure – which required extracting more financial resources as a share of GDP – was matched by increased reliance on general revenues, which at the end of the period became almost as important as social contributions in welfare state funding.

This said, and taking into consideration both the main traits of the Italian welfare state and its funding mechanisms, several points can be put forward for consideration with regard to the potential challenges ahead.

First, continuing the recent trend, a further drop in the share of social contributions is not unlikely, due to the persistently weak economic and labour market performance in Italy, and especially the effects of recent labour market reforms that introduced temporary exemptions from employer social contributions for employees hired on open-ended contracts in 2015-2016, as well as for firms hiring employees on open-ended contracts aged less than 35.

It thus appears reasonable to expect a gradual shift from a funding system based on social contributions to a more tax-based one. If employment-related incomes become less and less the main source of wealth compared with other sources (profits and capital) in western societies – and especially in slow-growing Italy ‒ social protection funding should also increasingly rely on these other sources, in order to relieve employers from high labour costs and improve international competitiveness. This partial move away from contributory financing could also be triggered by a further expansion of means-tested and social assistance benefits – as occurred during the last decade in Italy ‒ in a context where social insurance schemes and employment provide more limited protection against various social risks than in the past (Raitano et al. 2019).

Second, such a shift is even more necessary in an economy where the labour market has been affected ‒ and will probably be even more affected in the near future ‒ by technological innovation and robotisation, with significant consequences for employment and wages. In fact, recent technological innovations are going to challenge pensions and insurance-based unemployment benefit schemes. In particular, digitalisation and automation combined with population ageing pose a number of challenges to both the long-term financial sustainability and the future adequacy of pension schemes. As to the former, technological innovation may lead to a reduction in the labour force and, consequently, to the progressive decline of social contributions – in case this reduction is also associated with a decrease in the wage share. As for the latter, the risk of more fragmented working profiles may prevent many workers from paying adequate contributions during their careers, thus making more evident the need for a safety net (less related to occupational status) for the elderly and the unemployed. In fact, the reduction in the wage share in past decades has been intense in almost all developed countries, and is expected to accelerate due to the effects of digitalisation, which might reduce the wages of low-skilled jobs employed in manual non-routine tasks and displace many jobs, especially for medium-skilled workers employed in routine tasks (Acemoglu and Autor 2011). This is a major challenge for pension systems – especially PAYG schemes (although funded schemes may also encounter financial problems when the labour share reduces, especially in the long run) – since the reduced resources collected through social contributions would put the financial sustainability of the system in danger, unless further financing sources are identified (e.g. profits, consumption, wealth). In the Italian case this challenge is even more acute due to persistently slow economic growth, weak labour market performance and (especially) the strictly

contributory and actuarial nature of the reformed pension system (notoriously based on a notional defined contribution method). Hence, if the effects mentioned above materialise, an effective pension policy (and unemployment benefit system as well) for the digital age requires substantial reforms of the current old-age retirement (and unemployment) schemes, with increased reliance on general revenues on the financing side, as well as strengthened means-tested/universal flat-rate/progressive benefits on the expenditure side.

In a similar vein, an increase in inequalities may weaken the adequacy of contributory schemes, and more redistributive measures ‒ increasingly financed through general revenues ‒ should be implemented to maintain the effectiveness of the retirement system.

Third, from a different perspective, stronger investment and, consequently, increased funding seems to be needed in at least three important sectors of the Italian welfare state: healthcare; policy directed at families and children; and social assistance and anti-poverty measures. Notably, since all these interventions tend to rely on tax financing, expansionary measures in these fields would arguably require further expansion of funding through general revenues.

The combination of the issues mentioned above leads us to anticipate a substantial challenge to both the sustainability and the adequacy of the Italian welfare state in the years to come. This is likely to call for innovative and effective funding solutions. Among these are a more efficient system to tackle tax evasion – which might significantly expand the tax base in a country with high tax evasion rates such as Italy – and a gradual shift away of taxation from labour to capital. As for the latter, taxes on property could be increased – as repeatedly suggested by the European Commission and the Council in Europe 2020 'Country Specific Recommendations' (CSRs) (see for example the 2018 CSRs for Italy) – and new taxes on labour-saving technological innovations might be introduced to finance possible future increases in social protection spending.

Against such a backdrop, recent reforms aimed at increasing fiscal welfare, in practice substituting part of direct social expenditure with tax expenditure, cannot be considered an optimal choice in terms of equity, since – as shown by a large body of literature on fiscal welfare – the beneficiaries tend to be concentrated in the middle-upper part of the income distribution (on the Italian case, see: Pavolini et al. 2013; Jessoula 2017b).

In sum, these considerations show that the apparent stability of the present system of social protection funding might very soon come under severe stress, and a more thoughtful discussion about gradual but basic transformations of its functioning seems necessary.

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