Abstract

The paper suggests that local fiscal policies can be implemented in the less developed European regions, like the South of Italy, in order to capture some foreign direct investments (FDI) necessary to promote economic development, and solve the problem of catching up with the more developed European regions. These policies must be addressed to increase new investment projects coming from abroad, also by applying a corporate tax which must be fiscally competitive in attracting FDI at an international level.

[JEL Code: H71, H87, O23].

1. Introduction

A point which I think is very important for the ultimate solution of the European unemployment problem is given by the differentials in regional economic growth and employment rates inside each European country. There is evidence that the lower productivity and higher unemployment in some regions, like the South of Italy, France, Spain, and East Germany reflects a paucity of entrepreneurs.

Statistically, we see that near in all Member Countries there are underdeveloped regions where the unemployment rate is considerably higher than the European average. Apart from the Italian Mezzogiorno, where the unemployment rate is 17%, in Belgium the region of Brussels has an unemployment rate of 16%; in Germany, the regions of Berlin and Brandenburg have a rate of 18%, while the Mecklenburg-Vorpommern and the region of Sachsen-Anhalt have 20%; in Spain, Andalusia has a rate of 19%, and Extremadura of 17%; in France, apart from the overseas territories with 27%, also the region of Nord-Pas-de-Calais has 13%.

These rates much contrast with the corresponding unemployment rates of the most developed regions, which range between 2 and 3%. (Eurostat, 2004).

In these less developed regions, more active policies are needed in order to encourage new firms and help small and medium-size firms, whose growth can be accelerated by some appropriate measures (Modigliani et al., 1998, p. 350). Among these, a possible approach to stimulate investments could be through fiscal measures, like subsides, tax rebates or tax credits (Modigliani et al., 1998, p. 348). This suggestion takes account of the fact that among the many motives for finding investment attractive, the most important is the fiscal incentive. Labour cost, sound functioning of the labour market, and the presence of efficient infrastructures in the region then follow in order of importance.

2. The contribution of FDI to regional development in Europe

Regional development policies in Europe are largely based on the possibility of attracting foreign direct investment (FDI) from abroad, in order to accelerate the investment process needed to the backward regions to catch up with the most developed areas.

Recently, some countries like Ireland and Spain have attracted a large part of Foreign Direct Investments (FDI) coming into Europe with shrewd application of fiscal policy. Ireland, in
particular, succeeded in attracting around 25% of these FDI, which saw the Irish GDP rise from 67% of the European average in 1985 to 123% in 2003 in the space of about 15 years. At the same time, the Irish rate of unemployment decreased from 17 to 4%.

The literature on the role that FDI play in the economic process and in the diffusion of new technologies is very large, particularly on the empirical grounds. At this regard, many studies confirm the existence of a strict relationship between FDI and the growth rate in many countries (Blomström-Lipsey-Zejan [1994]; Balasubramanyam-Salisu-Sapsford [1996, 1999]; Barrell-Pain [1997b]).

This literature grew up once it appeared evident that FDI expanded very fast at an international level, passing from 4.6% of GDP in 1980 to 9.4% in 1995. In the same period, in Europe they passed from 185 b/$ (6.4% of GDP) to 1,028 b/$ (14.8% of GDP), growing 5.6 times during the last fifteen years (Barrell-Pain [1997a, p. 1771]). In 2002, the FDI directed towards Europe can be estimated around 2,500 b/$, which correspond to 18-20% of European GDP (Tab. 6).

The European countries that most benefited from the inflow of FDI are UK, Holland, Ireland, and Spain. These countries taken together cover 70% of the total inflow of FDI towards Europe. The three major continental countries (Germany, France, and Italy) taken together, on the contrary, attract less capitals than Spain (only 15% of total FDI directed towards Europe).

Anyway, the impact of FDI on the economic development of European small countries (not only Ireland, but also Belgium, Holland, and Denmark) is very high. At this regard, Cassiers-De Villé-Solar [1996] calculated that about 59% of GDP in the manufacture sector of some of these countries is produced by foreign multinational firms. Two papers, Balasubramanyam-Salisu-Sapsford [1999] and Keller [1996], found that the level of human capital represents a limit to the positive effects generated by the importation of FDI in a backward country, and Blomström-Kokko [1998] find a strict microeconomic correlation between FDI and the diffusion and the assimilation of new technologies, nonetheless with the improvement of human capital in the host country.

Similarly, Xu (2000) studies the effects of American foreign investments in 40 underdeveloped countries and finds that FDI exert a positive effect on the labour productivity growth because of the implied transfer of technologies. These effects are generally remarkable, unless the country is totally underdeveloped. In fact, Xu’s paper confirms the former results that below a certain threshold of human capital the effects of FDI on economic development are very small or null.

Furthermore, there exist some other empirical studies about the effects of FDI on the labour productivity of the host country. One of these, e.g., is Barrell-Pain [1997b] who, according to an

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1 From a theoretical point of view, Walz U. [1997] incorporate FDI in a dynamic model of general equilibrium analysis with endogenous growth of technical progress. In this model, FDI allows backward economies to come to know on new technologies used by the multinational firms that set up inside the country. The transfer of technologies allows for an increase of productivity in the host country, while the multinational firm has an incentive to transfer a part of production, and the connected technology, in those countries where production costs are low. So, the convenience to transfer FDI does exist for both countries. The paper shows that an endogenous growth equilibrium exists where the spatial distribution of economic activities is optimized.

2 Anyway, the idea that multinational firms are bearer if technological innovations and constitute a privileged channel of technological diffusion, specially for those innovations incorporated in their specific activities, was first explained by Romer [1993].

3 More in general, Borensztein-De Gregorio-Lee [1998] use an endogenous growth model to capture the effects of FDI on the growth of 69 OCDE countries. According to these authors, the effect on income passes through the process of technological diffusion. They find that this effect is positive in most of considered countries, provided that the level of human capital in the host country has reached a minimum threshold. The same conclusion is reached in Blomström-Sjoholm [1999].

4 The spillover effect produced by FDI on the transfer of new technologies toward the host country, on turn, can follow three channels. The first one is the demonstrative effect (Mansfield-Romeo [1980]; Krugman [1997]; Barry-Bradley [1997]; Barry-Bradley-O’Malley [1997]); the second exploits the workers’ mobility (Fosfuri-Motta-Ronde [2001]), while the third emerges from the relations established by the multinational enterprises with the domestic firms, both in the role of suppliers (backward linkages), and in that of customers (forward linkages) (Rodriguez Clare [1986]; Markusen-Venables [1997]).
investigation conducted in 1994, estimate that the productivity of American multinational affiliates in UK was about 30% higher than the average productivity of British enterprises. Some more studies confirm a similar relation for other countries.\(^5\)

More generally, the effects of FDI on the trade balance in three European countries (Belgium, Spain, and Ireland) after their joining the European Community is analysed by Sleuwaegen-De Backer [2001]. These authors study the effects produced by the transfer of specific technologies and immaterial activities (patents) on the productive structure of the host country. They demonstrate that an increase of FDI directed toward these countries determined a greater differentiation of exported items instead of a greater specialization in the production of undifferentiated goods, as argued by the traditional theory of international trade.

3. The incentive policies that can be implemented to attract new investments into the underdeveloped regions

To attract new investments from outside into the underdeveloped regions, we can implement many policies at various levels of government (local, regional, state, and community level). Anyway, two of them are the most important. The first one is to promote new public investments, especially in infrastructure, while the second consists in incentive policies of private investment.

The theoretical background to justify the opportunity to promote regional incentive policies is that the capital invested in a backward region in general is less productive than that invested in a developed one, mainly because of the absence, or insufficiency, of external positive effects (external economies) in the former. So, the incentives compensate this lack of external economies, and give to these regions the same opportunity to promote economic development as the yet developed ones.\(^6\)

The microeconomic foundations of investment incentive policies can be illustrated by the equation of the internal rate of return (IRR), net of tax. If \(j\) is the expected IRR, public incentives (financial and fiscal) influence the net return of an investment according to the following relation:

\[
\sum_{t=0}^{T} \left[ R_t(PS_t) + TR_t \right] - \left[ C_t(PS_t) + A_t \right] = 0
\]

where \(T\) is the time horizon of the investment, and \(t\) is a single period, e.g. one year; \(R_t\) are the financial proceeds expected for period \(t\), which positively depend on public services \(PS_t\); \(TR_t\) are public financial transfers obtained from the Government according to the incentive rule; \(C_t\) are the expected costs for period \(t\), which negatively depend on public services \(PS_t\); finally \(A_t\) are the expected taxes for period \(t\).

From equation 1) it follows that there exist at least three channels through which the Public Administration (PA) influences the net internal rate of return (IRR) on private investment. The first one is through public services, here indicated by \(PS\). These work in the same way as the external positive effects, which improve the receipts and reduce the costs to the firms. There exist many indices (level of infrastructures, extension of roads and rail roads, connections, traffic nodes, etc.)

\(^5\) As regards to China, there exists a study by Wu [2001] where it is demonstrated that, if the technology transferred with the FDI is of high quality (advanced technology), then an increase of FDI generates a corresponding increase of profits in the sector of exported goods, and further a corresponding increase in the wage gap between skilled and unskilled workers. If on the contrary the transferred technology is of low quality, this causes an increase in employment and a reduction in the wage gap. In the case of an overpopulated country like China, then, it is very important to choose the right kind of FDI that are better to transfer, so as to have the expected effect on employment and wages, particularly now after China has entered the WTO.

\(^6\) The incentive policies for regional development implemented, respectively, in the EU and in the South of Italy are also discussed in Moro [2001, 2002, 2003].
which show that the quantity and the quality of public services in the Italian Northern Regions are much better than the corresponding standards in the South. Government intervenes to compensate the shortage of these services in the South through the use of a second channel, the transfers $TR$, which take the form of financial incentives to the firms. Usually these take the form of financial capital contributions, or interest contributions and/or employment contributions, that some national and regional acts (among which Italian act 488/1992) dispose to pay in order to promote the development of the backward regions.

Finally, the third channel through which the Government influences the investments net return is taxation, here indicated by $A$. As shown in equation 1), a reduction in taxes, which means a decrease of $A$, improves the investment net return ratio. This is exactly what the fiscal incentives are supposed to do, as well as the financial incentives $TR$, does. In fact, both kind of incentives improve the investment net of tax IRR $j$. Usually, the incentives are given only to those firms that promote new investments, because the financial or fiscal aids to the current management of the firm is not permitted by the EU.

From a theoretical point of view, as shown by equation 1), there is no difference between financial (an increase of $TR$) or fiscal (a reduction of $A$) incentives, and between incentives to new investments or incentives to the firm’s current management, as long as both improve the investment net IRR. Nonetheless, in practice, fiscal incentives showed to be more efficient and effective than financial ones. Anyway, as said, we must take account that the incentives to new investments are permitted by the EU, while the incentives to the current management are not.

4. The fiscal residue

There are many attraction factors that push FDI toward an underdeveloped region, but among them the most important for multinational firms are a low level of taxation, an efficient labour market, and a good level of public infrastructures in the host country (Hannigan [2000, 1999]). In fact, taxation is by large the most important factor, while the labour cost, the level of public infrastructures and the good industrial relations are considered as pre-requisites for economic development (Gunnigle-McGuire [2001]).

With an appropriate fiscal policy, countries like Ireland succeeded in creating the convenience conditions to capture a large part of foreign investments. The economic factor that creates these convenience conditions is the fiscal residue, which can be defined as the difference, perceived by a firm who must decide on the best location of its plants, between the value of the public services produced by the PA of a country and/or a region, and the taxes paid to obtain these services. To calculate the fiscal residue, then, it is necessary to estimate the present value of the flow of public services, minus the present value of future taxes that the firm is supposed to pay during its economic life time horizon. Otherwise, the fiscal residue can be defined as the net present value (NPV) of the expected economic profitability of taxation in a particular region.

Once again, if we indicate with $PS_t$ the firm’s value of the expected public services in period $t$, with $TR_t$ the transfers from the PA to the firm, and with $A_t$ the corresponding expected taxation of the firm ($t = 0,\ldots,T$, where $T$ is the number of years of the firm’s economic life), the fiscal residue $FR$ can be defined as follows:

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7 This concept of fiscal residue differs from that used in the public economics literature, which originally was introduced by Buchanan [1950]. According to this Author, the fiscal residue is defined as the difference between the amount of taxes paid by a citizen and the value of public services enjoyed by him (Pica F. [2001, p. 317]). The theory of the fiscal residue is based on this definition. One distorted interpretation of this theory, known as fiscal federalism, extremises the possibility that each person exactly receives as social services the same amount paid through taxation, so as the fiscal residue by definition is always null. This means that the PA gives back to the citizen in the form of public services exactly the same amount levied by taxes.
where \( i \) is the discount rate. Here the transfers appear as negative taxes.

As shown by equation 2), the fiscal residue increases if public services increase quantitatively and qualitatively, and if the transfers also increase. On the contrary, it decreases if taxation increases. So, one way to improve the fiscal residue by the PA is to raise financial incentives (increase of \( TR \)) or fiscal incentives (decrease of \( A \)). Therefore, one way to influence the fiscal residue in order to promote one region’s economic growth consists in the assignment of public contributions to the firms that promote new investments.

In fact, we can have various forms of assignments, but for our purpose here we distinguish between financial contributions (increase of \( TR \)), which usually take the form of lump sum contributions to investment or favoured interest rate credits, and fiscal contributions (decrease of \( A \)), which usually consist of bonus and tax rebates. The financial contributions, in order to be assigned, necessitate of an administrative examination by the PA which decides on their approval. This process is costly and often inefficient, because of the discretionarily of the PA, and takes to much time, usually from one to three years to be completed. The fiscal incentives, on the contrary, are granted automatically according to the rules in charge, without any administrative pre-examination by the PA.

The fiscal residue is the factor that regulates the fiscal competition among different countries, and different regions of the same country, in order to attract as many FDI as possible. It is influenced not only by the Government taxation, but also by the public expenditure, and the quality and efficiency of public services.

There is no doubt that, according to many empirical studies and the experience of some new industrialised countries like Ireland, the fiscal incentives and, more in general, the adoption of fiscal policies have been more effective to promote regional economic development than the use of the standardised policies based on financial incentives. This is why the economic development policies implemented for the South of Italy, based on financial incentives, did not succeed at all, nevertheless the enormous amount of resources employed in their implementation.

Therefore, we need a change in the incentives policy that can shift the interest from the discretionary financial incentives to the automatic and fiscal ones; more in general, it is necessary to implement a new fiscal policy, which can be differentiated on a territorial basis, to attract more FDI than in the past, and in this way we can promote the economic development of the EU backward regions.\(^8\)

5. The experience of the Italian Mezzogiorno

Both forms of facilities, financial and fiscal incentives, as we said, influence the fiscal residue, which increases in those backward regions where the same facilities are introduced, but their effectiveness is not the same. In fact, according to the past experience of Ireland, Portugal, Austria, Greece, Belgium, The Netherlands, Spain, and the UK, and at regional level of Catalonia, Balers Islands, Algarve, Wales and Scotland, the fiscal incentives are more effective than the financial ones in modifying the convenience to invest as measured by the fiscal residue.

For the development of the South of Italy, instead, only financial incentives have been implemented in the past, and this explains the un-success of this policy. According to the European Commission, the European financial incentives to firms for the period 1996-98 amount to 32.6 b/€, a quarter of which accrued to Italy. They correspond to the 4.4% of the firms value added in Italy, which is a level that comes soon after Greece (4.9%), but much before Germany (2.6%) and Ireland.

\(^8\) Bollino-Signorelli [2001] and Jossa [2001] arrive to a similar conclusion.
(1.9%), while the European average is 2.3%. This confirms that the fiscal incentives implemented in Ireland, in fact, were more effective and efficient in promoting economic growth than the corresponding financial incentives implemented in Italy, nevertheless the fact that the latter were quantitatively double.

The only period when the development policy adopted for the Italian Mezzogiorno succeeded is after 1960 until 1975. In this period, a lot of capital transfers from the North to the South of Italy have occurred, to finance infrastructural investments and new public and private investments in the chemical and metallurgical sectors. So, the South per capita income passed from 53% of the Northern average in 1960 to 65% in 1975 (Table 1, first part). The annual growth rate of GDP in this period was 5% in the Mezzogiorno, against 3.6% in the North. Therefore, a differential growth rate of 1.4% remained constant for all the period in favour of the Mezzogiorno (Table 1, second part).

Anyway, soon after the oil crisis during the Seventies, the Mezzogiorno growth rate fell and the catching up process with the Northern regions was abruptly interrupted. So, the Mezzogiorno per capita income in 1990 again fell to 57.5% of the Northern average (Table 1, first part).

During the Nineties, a new economic programming (NEP) for the South was approved by the Government, but the situation did not improve, in contrast with what happened in the Northern regions. The incidence of the Mezzogiorno per capita income vis-à-vis the Northern regions’ average remained about 57% for all the period, and still remains at this level also in the beginnings of the two Thousands.

The situation is not better for the Mezzogiorno labour market (Tables 4 and 5). The employment rate has been decreasing since 20 years, passing from 50% in mid Seventies to 43% in the beginnings of the two Thousands (Table 4). If we take account that the employment rate in Italy is 55.4%, in Europe is 64.3% and in the US is 75%, we conclude that among the population aged 15-64 years, while in the States three persons out of four are employed, in Europe they are 2.5, in Italy 2 and in the Mezzogiorno they are only 1.7. As regards to the unemployment rate, it is doubled during the last 25 years, passing from 10% in the middle of Seventies to 19% in these last years (Table 5).

In conclusion, the economic situation in the South of Italy has not greatly improved in the last 15 years [Moro, 2001], in spite of the enormous resources’ transfers and financial incentives implemented in favour of the Mezzogiorno until now.

Meanwhile, countries like Ireland, which in the Eighties were less developed than the Italian Mezzogiorno, have greatly developed during the Nineties and now they have a per capita income comparable to the more developed regions of the UK or Italy [Tansey, 1998]. The Irish economic success was obtained by attracting foreign direct investments (FDI) from abroad, with the help of strong fiscal incentives (Moro, 2002). In 2003, Ireland has a per capita income 21 percentage points greater than Italy’s (Tabb. 2 e 3).

6. Fiscal policy for regional development

Why should we not, then, profit from the Irish experience, taking it as a standard model for the other still under-developed European regions, starting with the Italian Mezzogiorno? The useful suggestion is that fiscal policy can be used in these regions to increase the internal rate of return of capital, net of tax. To do so, it would be sufficient to differentiate tax rates on profits among regions inside the same member country, and require that in the less developed ones a lower rate be levied.

Another technical instrument that can be used to improve investment is the mechanism of tax credits. In this case, a tax credit is granted to those firms that make new investments and create new employment in the less developed regions, instead of the traditional financial support

\[9 \text{ On the EU labour market, see Modigliani e al. [1998] and Moro [1998, 2000]. A complete analysis of the statistics of the Mezzogiorno are in SVIMEZ [2004].} \]
commonly given in these cases, like lump sum contributions to investment and/or favoured interest rate credits. Unlike the latter incentives, tax credits work automatically in a short span of time, and they presuppose the existence of a fiscal capacity for the firm, or in other words tax debts that the firm can offset with such credits instead of paying.

This tax credits mechanism was introduced in Italy by law (Act 388/2000) to favour those firms that make new investments in the less developed regions of the South. It was very well received by entrepreneurs, but was abruptly suspended because of the insufficient resources advanced by the Government to ensure its regular working. However, taking this into experience account, I suggest it is possible to solve both the following problems: the tax credit problem together with that of a regional differentiated fiscal policy aimed at increasing economic growth in the Italian Mezzogiorno.

The solution to both problems consists in transforming the tax credit into a tax rate rebate on the profits of those firms that make new investments in the Mezzogiorno. In other papers I have demonstrated that a tax credit as originally formulated by Italian law is exactly equivalent to a tax rebate of 20 percentage points in corporate income tax rate, which lasts for 20 years (Moro, 2002 and 2003).

The main advantages of this corporate income tax rebate can be summarized as follows:

a) the firms that make new investments in the Mezzogiorno would be sure that the tax rebate would stay valid for 20 years; this would be a very big incentive to attract new investments inside the region, as suggested by the Irish experience;

b) the corporate income tax rate in the Mezzogiorno would be reduced from 33% to 13%, which is a level very close to the Irish rate (12.5%). As a result, the Italian Mezzogiorno could compete from a fiscal point of view with Ireland in attracting FDI;

c) the tax proceeds for the Government would not decrease, as the tax rebate would refer only to new investments, letting old activities pay the same tax as before;

d) it is also possible that tax proceeds increase, in that much more FDI could be attracted inside the less developed region than before.

### TABLES

Table 1 – *Per capita GDP in the Italian Mezzogiorno*

First part: *Centre-Northern = 100*

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Second part: *Average per capita GDP growth rates*

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<td>1,4</td>
<td>2,9</td>
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Source: ISTAT [2003] and SVIMEZ [2003].
Table 2 – Average GDP growth rates in some European countries

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<tr>
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<td>1,4</td>
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<td>1,7</td>
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</tr>
<tr>
<td>Ireland</td>
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<td>8,2</td>
<td>10,2</td>
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Table 3 – PPP per capita GDP in Italian Mezzogiorno and in some European countries

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<td>Mezzogiorno</td>
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<td>67,3</td>
<td>73,8</td>
<td>93,3</td>
<td>123,3</td>
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Source: for Italian Mezzogiorno data are from SVIMEZ [2003]; for European countries Commission Européenne [2002].

Table 4 – Employment rates (15-64 years) in Italian Mezzogiorno and in some European countries

<table>
<thead>
<tr>
<th>Years</th>
<th>Mezzogiorno</th>
<th>Italy</th>
<th>Spain</th>
<th>Ireland</th>
<th>EU</th>
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<td>49,7</td>
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<td>50,6</td>
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<tr>
<td>2000</td>
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<td>54,8</td>
<td>65,2</td>
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<tr>
<td>2001</td>
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<td>54,8</td>
<td>56,3</td>
<td>65,7</td>
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<tr>
<td>2002</td>
<td>43,0</td>
<td>55,4</td>
<td>57,3</td>
<td>65,6</td>
<td>64,3</td>
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Table 5 – Unemployment rates in Italian Mezzogiorno and in some European countries

<table>
<thead>
<tr>
<th>Years</th>
<th>Mezzogiorno</th>
<th>Italy</th>
<th>Spain</th>
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<tbody>
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<td>7,1</td>
<td>4,4</td>
<td>7,3</td>
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<tr>
<td>1985</td>
<td>14,7</td>
<td>10,7</td>
<td>21,6</td>
<td>16,9</td>
<td>9,9</td>
</tr>
<tr>
<td>1990</td>
<td>20,6</td>
<td>8,9</td>
<td>16,6</td>
<td>15,0</td>
<td>7,7</td>
</tr>
<tr>
<td>1995</td>
<td>21,1</td>
<td>11,5</td>
<td>18,8</td>
<td>12,3</td>
<td>10,2</td>
</tr>
<tr>
<td>2000</td>
<td>21,0</td>
<td>10,4</td>
<td>11,3</td>
<td>4,2</td>
<td>7,9</td>
</tr>
<tr>
<td>2001</td>
<td>19,0</td>
<td>9,4</td>
<td>10,6</td>
<td>3,8</td>
<td>7,4</td>
</tr>
</tbody>
</table>

Table 6 – FDI in the UE

<table>
<thead>
<tr>
<th>Values</th>
<th>1980</th>
<th>1995</th>
<th>2002*</th>
</tr>
</thead>
<tbody>
<tr>
<td>MLD $</td>
<td>185</td>
<td>1.028</td>
<td>2.500</td>
</tr>
<tr>
<td>% over GDP</td>
<td>6.4</td>
<td>14.8</td>
<td>18-20</td>
</tr>
</tbody>
</table>

* Estimated data.
Source: Barrell-Pain [1997b].

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