Ministero dell'Economia e delle Finanze

Comment on the Economic and Financial Outlook

by Minister of Economy and Finance
Tommaso Padoa-Schioppa

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The good economic and financial results of 2006 and the positive assessment that the European Union, the International Monetary Fund and markets have expressed on Italy's 2007 Budget Law, confirm that the public accounts emergency in our country has finally ended. At the same time, many are induced to believe that the constraints limiting Government action have also disappeared, assumingly because resources have suddenly become copious enough to enable the Government to perform large public expenditure increases and rapid tax reductions.

Compared to one year ago, the situation has shifted from seeking to avoid an impending threat to actually governing a success. So as to ensure wise action, it is pivotal that the debate on economic and financial policies should remain anchored to reality and based on long-term views. Available resources and potential new initiatives need to be simultaneously evaluated in light of accurate estimates both of public finances and the whole economic situation. We will not allow an averted danger to turn into a missed opportunity.

Those are the reasons that led me to bring forward the traditional release of the report on economic and public accounts developments and forecasts. Thus, the *Relazione Trimestrale di Cassa* and the *Aggiornamento alla Relazione Previsionale e Programmatica* are unified into a single document, jointly produced by the various departments within our Ministry. The present introduction adds to the analysis provided in the rest of the document by dealing, item by item, with a few core issues.

1. 2006 results and the outlook for 2007 and beyond

Firstly, 2006 results and the outlook for 2007 and beyond need to be considered. The analysis shows that Italy's economy has started to grow again. Over the very long period of stagnation – which lasted 48 months and ended in February 2005 – industry went through deep restructuring and strengthened its competitive position. Exports notably benefited and their performance exceeded all international and domestic research institute forecasts at the end of 2006.

Nevertheless Italy's economy has remained fragile. Recent gyrations both in industrial production and international stock markets are a sign of how uncertain domestic conditions and the international framework actually are. Furthermore, Italy's trade specialisation, based on traditional manufactured goods, has yet to be broadened and deepened. The cyclical recovery has not yet become sustainable growth. Recent projections show a modest slowdown in 2008 and 2009 versus 2006 developments and 2007 expectations. Such projections can be exceeded, although sustainable growth enhancement can only be achieved if the transformation of the Italian economy deepens – namely via: expansion into new sectors, enlargement of the service sector, increase in company size, labour market changes and innovation. Only by proceeding along these lines will Italy be able to face the competition arising from emerging economies and take advantage of their growth.

The objective is ambitious but achievable. It requires a joint effort from entrepreneurs, employees and the Government, which will have to play a guiding and steering role in forthcoming negotiations with social partners. The Government has to guarantee a framework of regained macroeconomic stability, improve the quality of primary public services (i.e. justice, security, legality, education), develop infrastructure and support R&D, as well as improve market functioning and bring the welfare system in line with new labour market needs.

Public finances have benefited from economic recovery and from Government's curbing of expenditure growth and fight against tax evasion since last summer. The Government has reduced risks of expenditure overruns and, at the same time, allowed financing public works initiated in the past. Furthermore the Government has launched a spending review on the efficiency and effectiveness of public expenditure that – if performed with determination – will free financial and human resources to be used to enhance growth and social fairness. The fight to tax evasion and the ongoing changes in industry and distributive services have increased revenues on a permanent basis. The twofold action carried out both on the revenue and expenditure side lowered the general government net borrowing requirement below the 3 per cent threshold already in 2006. On the other hand, public debt will decrease as a percentage of GDP only if fiscal discipline persists. It is nevertheless worrying that in 2006 the Public Administration cash requirement, relevant for public debt development, turned out 1 percentage point above the net borrowing requirement (on an accrual basis), and public debt thus further increased versus GDP.

Pundits have pointed to possible overestimation of risks, alarmism, and over sizing of budget measures. Such criticism has already been analytically addressed, and the 2006 improvement is not a sufficiently good reason to resume the debate. As a matter of fact, such improvement is due to the positive international backdrop and, at least partly, to the policies implemented by the Government over the early months of its mandate. The series of estimates in the course of 2006 – carried out both by the previous and the current Governments – was consistent with the information and methodologies available at the time, and proved in line with all the estimates published both by Italian and foreign research institutes, as well as the European Commission, the ECB, the IMF, and the OECD.

Nevertheless, since outcomes exceeded the most optimistic expectations and public accounts' emergency is now over, the extra-cautious approach adopted by the Government as it took office can now be somewhat eased. As a matter of fact, an updated evaluation based on less strict criteria reveals that extra resources are now actually available. A part of them is cyclical whilst another is permanent, but clearly assessing their ratio seems impossible at present. The cyclical part cannot obviously be used to finance long-term spending programmes; the part estimated to be permanent needs to become the subject of an open debate so as to select its best use.

First conclusion: Current estimates suggest that the extra resources on which we can permanently count on – both to reduce the deficit as well as for possible other uses – are in the range of €8-10 billion per annum, which represents 0.5-0.7 per cent of GDP.

2. Objectives and constraints of the economic and budget policy

Secondly, the objectives and constraints of economic policy, in general, and budget policy, in particular, have to be considered. Growth and social fairness are the *objectives*. Fiscal consolidation – the third element in Government's economic policy strategy – is instead a *constraint*, which guarantees that both growth and equality are sustainable. Our objectives shall be *genuine* growth and *genuine* fairness, not short-term stimulus to growth or social transfers to those who may not be wealthy but do not actually belong to the poverty area. Our main challenge is to allow the current cyclical upswing to become sustainable long-term growth. This second consecutive year of expansion has highlighted the priority need to act on supply rather than on demand. An array of interventions is thus required to spur new wealth through improved material and non-material infrastructures (social, as well), R&D boosting, human capital enhancement, as well as improvement of State administrative and judiciary actions. More than interventions on revenues or expenditures, it is now essential to ensure proper regulation and better administration. We therefore have to increase competition, streamline bureaucratic procedures, shorten judicial timing, increase legality and enhance education.

Fairness means intervening in situations of real discomfort and poverty, as well as in other weak areas of Italy's welfare. For instance, unemployment benefits in Italy are provided exclusively for workers with open-ended contracts and therefore exclude the great majority of young people who do not have open-ended contracts.

Our twofold *constraint* is financial sustainability, both related to deficit and public debt. Without fiscal balance there can be neither growth nor equality. Therefore, by the end of our mandate we shall have eliminated the structural deficit, achieved a primary surplus in the range of 5 per cent and lowered public debt below 100 per cent of GDP.

The Government's commitment undertaken within the Excessive Deficit Procedure (EDP) provided by the Stability and Growth Pact is to achieve a deficit/GDP ratio equal to 2.8 per cent by the end of 2007, and carry out a structural fiscal adjustment of 0.5 percentage points of GDP via the 2008 Budget Law. The recommendation recently approved by the Ecofin Council states that better-than-expected improvement in public finances should be used to ensure faster and more pronounced reduction of the deficit.. This is how Germany and France moved out of the special fiscal surveillance applied to any country violating the Stability and Growth Pact budgetary discipline, and Italy is therefore unlikely to decide differently without triggering serious tensions within the European Union.

Second conclusion: In the more* restrictive case*, both in 2007 and 2008 all the available resources shall be allocated to more rapidly ensure a balanced budget. The less restrictive case instead – upon EU verification of its feasibility – implies the possibility to use part of the resources mentioned in point* 1 *to lower revenues or increase expenditures. In both cases, a further structural adjustment in the range of 0.5 per cent of GDP will be necessary in 2008, equal to €7.5 billion.

3. Potential expenditure increases and potential revenue cuts

Thirdly, an exhaustive and detailed inventory of potential expenditure increases and revenue cuts is also required. Such inventory is not a task for this document, but it will constitute the work of the next few weeks. It is indeed a difficult and complex task, as it encompasses remarkably diversified measures in terms of projection reliability, degree of urgency and compliance with commitments undertaken. The actual contribution that alternative measures could bring to growth and equality policies could be significantly different. Some of the requests are discussed on the occasion of negotiations with social partners – notably as to public employment, social security and labour – whilst others stem from Government's resolutions not specifically discussed and negotiated in advance.

As far as *revenues* are concerned, a commitment has been taken (as specified in the Budget Law) to use the structural increase in revenues resulting from the fight against tax evasion, so as to enable reduction of tax rates and redistribution of tax burden amongst taxpayers. Secondly, the reduction both of *ICI*[1] rate on first homes (such abolition would result in lower permanent receipts in the range of €3 billion per year) and net tax burden on large families (family allowances and taxes) has recently been considered. Thirdly, as to taxation on financial assets, tax exemptions are being pondered as opposed to full tax rate equalisation (the impact is estimated to be €2 billion per year).
On the *expenditure* side, requests and possible measures are so numerous that they could generate, as a whole, liabilities for tens of billions. Interventions range from social security and welfare to international engagements for cooperation and development; from

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[1] ICI (Municipal Tax on Real Estate Properties)

additional expenditures for infrastructure to aid for research and university; and moreover, from resources addressed to State administrations whose functioning – in light of the outcomes of the newly launched review on efficiency and effectiveness – could be jeopardised by the provisions set by the Budget Law, to the request of excluding from the Internal Stability Pact discipline all investments carried out by local authorities recording a surplus balance.

Social security and welfare require exceptional pondering – also on the back of the potential burden of the above interventions, their aspects to be negotiated with social partners and their diverse contributions to growth and inter-generational fairness.

Third conclusion: Even in the event that additional resources were entirely addressed to uses other than shortening the timing set to achieve a close-to-balance budget (as already said, a very difficult position to be negotiated with Brussels), such resources would always reveal considerably lower than the overall interventions either proposed or envisaged.

4. Resource availability and requests: "better spending"

Albeit difficult, it is thus necessary to match availability and requests of resources. To this end, three considerations shall be recalled.

Firstly, it is excluded that the Government will introduce an expansionary fiscal package this spring, as it would then have to propose a *restrictive* Budget in July via the *DPEF*.[2]

Secondly, it is very unlikely that the next Budget will enable the Government to perform, as in 2006, a "gross" fiscal adjustment significantly higher than the "net" adjustment.

Thirdly, it is also excluded that the Government will introduce new taxes or raise rates on existing taxes. Instead, it will be necessary to employ resources to reduce the tax burden versus current levels. In 2007, the tax burden will reach levels very close to the

[2] *DPEF (Economic and Financial Planning Document)*

early 1990s, when less integrated international markets were less binding for more independent fiscal policy.

It is evident that three such considerations are extremely stringent. Going beyond even only one of them appears technically arduous and politically risky.

Without an overall evaluation of priorities, any measure committing part of the available resources would imply that the budget - and hence Italy's economic policy - is out of control, thus seriously undermining the fiscal consolidation so far achieved, as well as compromising any possible intervention aimed at tackling existing risks.

The ratio between availability and requests of resources can only be improved through significant cost efficiencies. Such direction, already outlined in last July's *DPEF* and pursued by means of Italy's Budget, appears as the main way forward. By reversing the trend experienced over the past few years, the Budget Law has halted current expenditure dynamics, provided new momentum to investments and curbed costs far more effectively than over the previous years. Fiscal adjustments on the expenditure side were nonetheless criticised and considered insufficient, although they encountered fierce opposition from various sectors concerned, several political spheres as well as Parliamentary representatives. Government measures thus appeared less ambitious than theoretically advisable, albeit more than could be politically tolerated.

It has now become impossible to meet requests for resources without "better spending". Nonetheless, a "better spending" policy requires very vigorous interventions in areas such as the number of central and local authorities' public workers, public employment contracts, as well as State organisational structures both at central and non-central level.

Fourth conclusion: In order to match availability and requests of resources, it is essential to decide their allocation by simultaneously evaluating all possible uses (including possible tax reductions). Additional resources can only result from expenditure curbing measures.

5. Schedule and methodologies

We can now look to the future with renewed optimism, and turn the current recovery into long-lasting sustainable growth. The need for stronger curtailment of public expenditures has eased, and we now need to make excellent use of the little room for manoeuvre we have created. Thus we must not waste such an opportunity on low-ambition interventions.

The present memorandum does not outline the priorities and decisions that the Italian Government will have to undertake in its full composition over the next few months. Instead, it simply outlines a compatibility scenario and indicates a working methodology. The evident gap between availability and requests of resources is still significant and will impose a very rigorous selection of priorities, so as to best allocate resources. The Government has already set up such a selection process and will finalise it in the near future.

The gap between availability and requests of resources can only be bridged by selecting requests simultaneously through a single evaluation process for priorities. Thus, the annual schedule of economic policy encompasses time to "draw the budget" and time to revise it.

Fifth conclusion: As by law, the two institutional deadlines to "draw the budget" are: the fiscal balance revision for the current year due in June; the DPEF due in July and Budget for 2008 and beyond due in September.

Rome, 15th March 2007 Tommaso Padoa-Schioppa