Ministero dell'Economia e delle Finanze

Combined Report on the Economy and Public Finance for 2008

Note on financial and economic prospects

by Minister of Economy and Finance

Tommaso Padoa-Schioppa

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If one does not know to which port he is sailing, no wind is favourable

Seneca, «Lettere a Lucilio», LXXI

The public accounts for 2006 and 2007 recorded better-than-expected results. This is the outcome of an economic policy that rejected a two-step logic (fiscal consolidation first, and then economic growth) in favour of simultaneously pursuing three objectives: economic growth, fiscal consolidation, and social justice.

1. Public accounts move beyond the state of emergency

The situation that the Government of this very brief legislature had inherited could not be accepted lightly: it is a single country, regardless of who governs it. The primary surplus had practically zeroed out, and was lower than its 1992 level. The deficit had exceeded 4 per cent of GDP, thereby cancelling out the arduous public finance consolidation completed in the run-up to the euro in 1997. After having declined since 1994, the debt-to-GDP ratio had once again started to rise. The weight of the primary current expenditure had touched an historical high. Italy had entered the European excessive deficit procedure. With the accounts in the red, Italy was at risk of again facing a spiralling deficit.

The remedy could not be an indiscriminate tightening of the budget because Italy was not - and is not - suffering from its public accounts only. Social disparities and injustice were becoming more pronounced, and economic growth, though showing signs of greater momentum, appeared to be driven by strong global expansion rather than by strengths at a domestic level. A comprehensive series of measures was needed to address expenditure and revenue in detail and simultaneously work on different fronts, dealing with: efforts to prevent the waste of the taxpayers' money; refunding of underfinanced sectors (defence, public works, etc.); fight against tax evasion; and the need for tax relief and the streamlining of regulation. The economic-policy action thus had to be focused not only on bringing the deficit back to a compatible level; in other words, not only on fixing the gears but also on getting the entire car back in order, restoring strength to the economic fabric and solidarity to the social framework. Redistributing income is much more controversial than sticking to painful, but also limited, measures that only act as a brake: the measures need to address the realities of society, the vested interests that are harboured in the niches of tax evasion, in the pockets of inefficiency of public services, and in the den of the protected economy.

The measures taken in mid-2006 that went into effect that same year and the measures contained in the 2007 Finance Law were designed to bring about a rapid change in direction, to halt a deterioration in the accounts that would have led to a currency crisis in the past, and that was eroding the confidence of financial markets, the European Union and international institutions, and simultaneously deepening the decline of our economy.

As of 2007, with the two budget packages introduced during the year and the drafting of the 2008 Finance Law, it was already possible to take into account that fiscal consolidation was proceeding even better than planned, and thus use the fruits of the success on each of the three fronts of action undertaken since 2006: new social initiatives, expansion of public investments, and greater reduction of the deficit.

The results are available for everyone to see. The net borrowing of the public administration - the most significant aggregate for European requirements - has been more than halved, going from 4.2 per cent of GDP in 2005 to 1.9 per cent in 2007. Italy has by far exceeded the objectives to which it had committed with the European Union, and is on its way to exiting the excessive deficit procedure, holding its head up high. The weight of the public debt has again started to fall.

Contrary to what some pundits have asserted, both revenues and expenditures contributed to the outcome, and in the case of revenues, the key contribution came from the results of the fight against tax evasion. The expansion of primary spending - the weight of which had climbed by almost 2.5 percentage points of GDP during the 2001-

2005 five-year period - was stopped and the trend began to turn around. The tax burden on law-abiding taxpayers has not been increased. Simplification measures have reduced the red tape for vast groups of businesses and individuals. The increase in the overall tax burden that appears in the statistics is essentially the by-product of the recovery of revenues from tax evasion as a result of both more effective enforcement and increasing tax compliance. The rise in the tax burden also came from several very specific measures to step up the coverage of future pensions, particularly for people working on temporary contracts.

2. Not just fiscal consolidation

This Report, which marks the premature end of a plan conceived for an entire legislature, provides an account of what has been done for the simultaneous pursuit of social justice, development and fiscal consolidation. Only a few observations will be enough here.

With reference to *social justice*, the initiatives have included: the revival of social housing programmes; the increase of small pensions; the programme to help those situations of poverty that cannot be remedied via tax relief because the income of the individuals involved is already under the minimum thresholds for taxation (the so-called bonus to low-income families); the fiscal measures in favour of working women; and the creation of specific funds in order to assist individuals and families encountering difficulties in the labour market and in social integration.

With reference to *economic growth*, in addition to the reduction of the tax burden and social security contributions on labour (the so-called tax wedge), the measures also included the important reform of taxation on corporate income. Today, entrepreneurs in Italy know that any increase in their earnings will be taxed at a rate of 27.5 per cent, an internationally competitive rate. The resources to finance for several key infrastructures for the country - roads, highways, local transport - were also increased, in some cases sizeably.

With reference to *fiscal consolidation,* the Government addressed two issues left over from the previous legislature, against the backdrop of an ageing population and the consequent imperative of increasing the actual retirement age: the smoothing out of the sudden increase in the retirement age included in a ‘delayed-action’ measure (the so-called "big step") and the fixing of an essential aspect of the 1995 pension reform, namely, the revision of the transformation coefficients. The agreed solution, which was reached at the end of lengthy negotiations, increases the age at which individuals are eligible for retirement, while making the shift more gradual, and updates the coefficients, making their future revisions automatic.

3. Controlling expenditures: a different method

In perspective, perhaps the most important aspect of the actions undertaken by the Prodi Government is the position taken with respect to the key issue of public spending, particularly considering that the control over public spending had been seriously loosened in the preceding five-year period, more as a result of the swelling of the bureaucracy rather than the improvement of services to the country.

Increasing spending is easy, but turning back is a rather arduous task for any country. It is particularly arduous in Italy where the spending, net of interest payments on the debt and the outlays for pension benefits, is not excessively high. Local administrations, which have limited fiscal autonomy, account for the bulk of the spending; given that the misspending is sharply concentrated in the country's southern regions, any containment of expenditure risks being immediately perceived as a policy hostile to those regions.

According to the main budgetary and economic indicators, the *quality* and *quantity* of spending must respectively *improve* and *decline*, in order to allow public finance to become a source of economic development and optimism for the economy and society. They must and *they can*: the work completed over the past two years has demonstrated they can. But the experience of any country that has gone further than we have along this long and treacherous path shows that widespread acknowledgement of the issue and of the true nature of the remedies is *conditio sine qua non* for intervening effectively.

The commonplace expression ‘spending cuts’ should be replaced by a ‘bottom-up’ process that would start from an analysis of procedures, a serene and in-depth examination of that 98 per cent of the public budget that fails to command the attention of anyone obsessed by the relatively limited flows covered by the Finance Law. Spending control is not done by the bashing of impatient policymakers (most of which is only verbal), but by the perseverance of good administration, and, from the standpoint of 'being informed in order to make a decision', by examining in advance the detailed ways of spending and the organisation of the business units involved, by determining priorities, by reclassifying programme expenditures in order to provide for consistent initiatives, by identifying the best practices in order to make them models for all parts of the public administration, by patiently seeking out the possibilities - already inherent in existing laws and regulations - for setting in motion job mobility, training, and the redistribution of tasks and business units. In the 2007 and 2008 Finance Laws, the issue of control over spending is tackled from these humble, but essential, bases. Some basic indicators and strategies for intervention are already contained in the Green Book on spending and in the works of the Technical Commission on Public Finance; they are instruments that the Prodi Government leaves behind for the next Government.

Initial results seem to justify the method chosen. The growth of primary current expenditure has been slowed down notwithstanding the use of part of the incremental resources coming from the fight against tax evasion. A large part of public spending is decided at a regional and local level, and the provisions of the Internal Stability Pact and the Healthcare Pact, which are backed by incentives and penalties, have led to a significant slowdown in budget outlays.

4. New clouds over the economy

The deterioration of the international economic cycle following the so-called 'mortgage crisis' has shown the extent to which the undeniable improvements logged by Italian industry are still fragile. Many producers are still repositioning themselves in segments with higher value added, and several stories of success show that the challenges of technology and globalisation have been accepted by part of the business world: the improvement of Italy's trade balance is proof of it. Still, the old shortcomings remain in terms of research and human capital, and the current adjustment has not yet produced a 'critical mass'. In the past, international turbulence typically negatively affected Italy more than other countries, with the country earning the reputation of being a 'weak spot'. Today, thanks to its inclusion in the Euro Area, Italy has been spared the 'nominal' turbulence (inflation and devaluations) linked to interest- and exchange-rate movements; but it has not been saved from the ‘real’ turbulence (low growth and the standstill of productivity) associated with the country's productive specialisation overly exposed to the increase in competitive pressures stemming from globalisation, while consumer confidence has been dented by sharp increases in the most visible prices (energy and food products), and business confidence reflects the fears from the external environment (threats of recession) as well as those on the domestic front (political instability).

It is reasonable to argue that the current clouds over the global economic outlook reflect something more than a pause in the trend triggered by the sub-prime mortgage crisis. The present situation reflects the combination of two fundamental imbalances, whose correction is necessary and will take a long time: the state of the U.S. economy, which is accumulating foreign debt and is suffering from insufficient public and private savings; the movement of one-third of mankind (China and India) from poverty to prosperity, which is putting pressure on the availability and prices of food and energy products. In terms of the entire global economy, the first situation is causing stagnation, and the second, inflation.

The process of correcting these imbalances has triggered crises and losses in those parts of the financial system that had contributed the most to the excess of spending and debt. This process is anything but over, and the negative developments taking shape in the summer of 2007 could last for a long time, while the communicating vessels for the lack of confidence are amplifying the real effects. A country with a medium-size, open economy such as Italy, with structural weaknesses dating back many years in both the public and private sectors, with a precarious institutional setting, could be affected more than other countries by the turbulence that will inevitably continue to accompany the correction of these fundamental imbalances.

5. 2008 and beyond: the economy is slowing, but the accounts are holding and improving

This Report provides a detailed and transparent account of the changes taking place since the release of the last official projections, which were contained in the Forecast and Planning Report presented in September. The sudden change in the outlook for the international economy inevitably implies a sizeable impact on the country's domestic situation.

The forecast of Italy's growth has been sharply reduced with respect to only a few months ago, from 1.5 per cent to 0.6 per cent, in order to take fully into account the recent information about the international and domestic economy. The forecast is in line with the most up-to-date estimates of leading international institutions.

The new estimates for the current year bring to light the inevitable - albeit, generally marginal - impact of the cyclical slowdown on the public accounts. The deficit is expected to stabilise at 2.4 per cent of GDP. Even though the growth forecast has been cut by more than one-half, the deficit forecast is only slightly higher than that projected in September (2.2 per cent). It is worth looking back to 2005, when, with growth identical to that projected for this year, the deficit-to-GDP ratio was standing at 4.2 per cent. The figures for this year - and only this year - are also affected by the deferral of certain expenditures and some minor revenues previously planned for 2007. Net of these temporary factors (which should run their course in 2008), the negative impact of the slowing down of the economy, and higher interest rates, the 2.4 per cent figure mentioned above is equivalent to 1.9 per cent.

Two other important factors give us reasonable confidence in looking at the months ahead.

First: the estimates are very conservative. In the case of *revenues*, the figures incorporate the incremental taxes recovered during the past two years as a result of the fight against tax evasion, but they do not assume any substantial new recovery of the taxable base. This pessimistic assumption is in line with past practice, but the experience of the past two years shows that strong increases in tax revenues prompted by greater tax compliance are entirely possible if pursued with determination at the political and administrative level and in the form of communication to the public. On the *expenditure side*, the estimates embrace the cautionary assumption that the trend of the excellent results achieved in the past two years (for example, the exceptional containment of the intermediate consumption of the administration) will not only not continue, but will experience some setbacks. However, such a scenario is neither written into the law nor necessarily in the cards: it depends on the determination with which the Government and the administration will act in the new political term. Official projections are more pessimistic than I am on this point.

Considering the very conservative nature of the estimates based on unchanged legislation, the surprises during the year, if any, are likely to be mostly positive. The Report presents and documents an alternative scenario reflecting such a possibility, just as it presents an even less favourable scenario.

Second: based on currently known facts, the slight increase in the deficit projected for 2008 appears to be completely of a transitory nature. The trend based on unchanged legislation for the years after 2008, estimated with equally prudent criteria, shows a deficit with a sharply decreasing profile; indeed, the deficit should come down to well below 2 per cent of GDP. This applies also and more importantly to the structural deficit, which leaves aside the assumptions made about the position over the economic cycle. For the years of 2009, 2010 and 2011, the estimates based on unchanged legislation point to a decline in the structural deficit from 2.2 per cent of GDP (2008) to 1.2 per cent (2011).

Thus, a clear conclusion can be drawn from the new projections: the economic slowdown does not interrupt the fiscal consolidation process orchestrated by the Government. That result is solid and bound to last. Italy firmly remains in a safety zone, and is on the path to a balanced budget despite the end of a favourable economic period.

Additional resources could well emerge, as has regularly occurred during the past two years; but it will only be possible to assess that in the next few months with a careful analysis of the data. The budget completion in June will be the occasion for such verification.

6. An economic-policy dilemma?

Fiscal consolidation is still not completed, and already the deterioration of the cycle seems to present a dilemma for economic policy: should the efforts under way be interrupted with tax cuts and spending increases to prop up the economy, or should the emphasis on fiscal consolidation continue with the risk of further weakening an already weak economy?

Based on three fundamental economic considerations, it is possible to argue that this is a false dilemma.

- *Economic policy can spur growth, not only through public finance measures, but also with measures that enhance competitiveness and the strength of the business sector.* Today, deregulation and the streamlining of the bureaucracy are probably the issues that rank first in terms of fostering Italy's economic growth. If pursued with strength and determination, they will effectively be able to counter the recessionary impulses.

- *If continued, the fight against tax evasion can provide ample resources for reducing the tax burden on law-abiding taxpayers.* The detection of taxable income that is currently concealed from the tax authorities is a gradual process, far from been completed. It is thus possible to assume an elasticity of revenues to GDP such that, even though not as strong as that in the past two years, will be enough to finance the restitution to law-abiding taxpayers of the resources collected from tax dodgers. The effects of such restitution in supporting the economy (via the restoration of confidence and the ending of distortion to competition) would with all probability be greater than the deflationary effects linked to the reduction of the area of evasion. At the same time, such restitution does not conflict with the fiscal consolidation effort, which is linked to spending reductions.

- *The possible savings in primary expenditure would be enough to allow the continuation of the effort to reach a balanced budget.* Such effort means reducing primary expenditure by roughly two points of GDP between now and 2011; in other words, wiping out the increase that blurred the budget equilibrium in the previous political term.

At a *political* level, the commitment to a balanced budget by 2011 is not negotiable with respect to the European Union; public opinion in Italy would judge a relapse into the excessive deficit procedure of the Stability Pact very severely. But it would be an error to consider that commitment as excessively demanding at an *economic* level. The dilemma between rigour and economic growth is false. Just look at what occurred in 2001-2005, when the higher public spending was flanked by a five-year period with the slowest growth in Italy since World War II. The relationships between public spending and the economy are much more complex than what might appear from the notion (unfounded in economic theory as well) of spending as the coal thrown into the furnace of the productive boiler. In the Italian case, some streamlining of the spending that might improve the quality thereof and leave more resources available to the private sector would have supportive, and not restrictive, effects.

7. The road to recovery

The public debt is still more than 100 per cent of GDP, the highest among the countries of the European Union. Every Italian, including newborns, is annually shouldering an interest burden of €1,300; and we cannot even say that we owe the interest to ourselves since roughly one-half of the debt is in foreign hands. Taxes cannot be increased; on the contrary, they should be reduced for taxpayers complying with the law. The sale of assets of the state or territorial entities for the purpose of reducing the debt is still possible, but the major privatisation wave is over and the amounts are limited by now. A family can pawn its jewels and its land holdings, but this is not a solution when spending continues to exceed income.

The only way of pursuing fiscal consolidation is thus through ordinary management, and the challenge - which is today clearer and more compelling than ever - lies in containing and requalifying the spending of the state, the regions and local entities. This means achieving a profound transformation of the public administration.

The Green Book of last September has highlighted the leeway for achieving this objective. There is no need to borrow examples from abroad; in Italy, too, there are areas of excellence in almost every branch of the public administration that show how to supply services that are both better and less costly at the same time. The reclassification of the budget by missions and programmes that was effected last year supplies the knowledge base for initiating ‘programme laws’ that will streamline the use of resources by overcoming problems related to the lack of coordination, the overlap of responsibilities, and the issue of politically protected turf. At the same time, employing comparisons between the same types of services (hospitals, prefectures, ministerial offices, offices of local administrations and so forth) at the time of the allocation of the resources could contribute to aligning the less cost-effective services with those services that are more efficient. This would be beneficial to public spending, the citizens who are using the services, and the country's economic growth.

The reduction of the weight of primary expenditure must exclude infrastructure investment, which instead needs to be increased. It is also difficult to envision the curtailment of welfare spending targeted by recent measures. The need to focus the control on the remainder of the spending - the spending traditionally linked to the supply of public services - makes the challenge even tougher, particularly since it is an issue of keeping such spending at its current level in nominal terms between now and 2011. Any plan to cut spending must also address expenditures on personnel, inasmuch as they represent the biggest single expenditure category by far within a highly labour-intensive sector such as the public administration. Expenditures on personnel depend on the contracts, the organisation of the work, the distribution of personnel, and the structure of incentives. We must have the willingness, which has often been lacking in the past, to deal with all four aspects: wage containment, organisation without duplication, functional mobility to the services in need, and bonuses for whoever is producing more.

This Report focuses its attention on the public accounts, and thus on that part of economic policy that affects revenues and spending. But if we expand the picture to look at the entire range of actions through which the public sector influences the trend of the economy, then it appears clear that the point of reference, the key target must be raising the level of productivity within our economic system. Only in this manner will it be possible to accelerate growth in a society such as ours, where the population is ageing and not increasing.

Positive developments are already strengthening the warp and the weft of the productive fabric, but productivity increases will be extended to all sectors only if the path to success is opened up to the more dynamic players by means of a level playing field: the pursuit of market deregulation is encountering resistance from those who operate in protected markets, but it yields immediate benefits to all citizens in the form of lower prices. The pressures for deregulation at home and those for globalisation from abroad are making it even more necessary to improve the social security net, in order to facilitate the shifting of resources from sectors on the decline to those that are expanding. From this perspective, the 2007 and 2008 Finance Laws have intervened with innovative instruments.

The objective of our economic policy cannot be anything but to get Italy's economic growth back to a level above, and not below, the European average. And it is hard to envision that this objective will be reached without the simultaneous pursuit of efficiency in the use of resources, social justice, and a clean bill of health for the public accounts.