ITALY: FISCAL CONSOLIDATION AND ITS LEGACY

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1. Introduction

For about 25 years, from the mid-Sixties to the early Nineties, Italy ran unsustainable fiscal policies. High deficits, stemming from persistent primary imbalances, fuelled public debt accumulation. In 1994 the debt reached 124 per cent of GDP. Over the same period, future pension liabilities gradually increased to about 400 per cent of GDP. Fiscal policy and rapid population ageing set public finances on an unsustainable path, with large generational imbalances and perspective deficits.

In this context, from the mid-1980s debt stabilisation became the main target of Italian fiscal policy. Initially, in spite of the favourable macroeconomic conditions, results were limited. Progress on the primary balance was offset by increasing interest expenditure. Fiscal consolidation gained momentum in the early 1990s, when primary deficits were replaced by sizeable primary surpluses. The overall deficit declined from double digit levels to well below the 3 percent limit established in the Maastricht Treaty. The debt to GDP ratio shifted to a downward path. Pension liabilities were substantially cut.

The consolidation process was characterised by a large resort to corrective measures with only temporary effects, which made it necessary to adopt sizeable budgetary manoeuvres repeatedly. The focus was on deficit reduction and left little space to issues related to stabilisation policies. Allocative and distributive targets were also frequently forfeited. The adjustment relied on significant increases in tax revenues and a sharp reduction in capital expenditure. The ratio of primary current outlays to GDP did not change significantly. The increasing expenditure trend of the previous decade was halted thanks to reforms of the pension system and to reductions in the resources transferred to local governments. The decline in the cost of servicing the debt, stemming from the increasing confidence in the success of the consolidation effort and from the reduction of the

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inflation rate, significantly contributed to the outcome. The participation of Italy to EMU consolidated these results by further reducing the risk premium on Italian bonds.

Notwithstanding the success of the adjustment, its characteristics may have been unapt to minimise its costs. The heavy reliance on tax increases and capital spending reduction may have hampered the growth performance of the economy. The recurrent corrective measures may have negatively affected expectations of households and companies. Emergency action frequently prevailed over long-term solutions. This particularly applied to the pension system, where reforms were incremental, and to local government finance, where the rationing of transfers was preferred to the design of permanent budgetary rules. In the tax domain, the pressure to sustain revenue levels conflicted with the need to reconsider allocative targets in a context of increasing economic integration. In recent years structural reforms were finally set up; however, their design did not follow a linear path and subsequent modifications have at times pulled the system in opposite directions. These factors may explain why, in spite of the large reduction in interest rate, the success of the consolidation effort has not lead to a significant acceleration in growth.

In the present context of rapid institutional change (both at the international level, with EMU and globalisation, and at the national level, with a drive towards a federalist reform) these elements leave the country with a problematic legacy.

Sustaining a high tax burden may become more difficult as the integration of the Single European Market is strengthened and the process of globalisation accelerates: the competitiveness of the Italian productive system may suffer excessively. The lack of infrastructures negatively affects several sectors and regions. The quality of public services limits the competitiveness of the Italian economy. Moreover, some public services become increasingly exposed to international competition.

There is a need to make close-to-balance budgets a permanent feature of Italian fiscal policy and shift the focus of budgetary policy from short-term deficit control to the traditional functions of stabilisation, allocation and distribution. The new more decentralised features of the country should obviously be taken into consideration. This may require changes in budgetary procedures and institutions.

Reducing the tax burden while complying with EMU fiscal rules calls for tight expenditure control, a task made more difficult by the upward pressure on outlays exerted by the ageing process. Pension reform was a central tenet of the fiscal policy debate over the 1990s. Further changes, although necessary, may prove politically difficult. Ageing will also put budgetary pressures on health and long-term care.

Consistency between fiscal decentralisation and EMU fiscal rules may require significant institutional engineering. There is a need to replace the quantitative limits on transfers to local governments with other budgetary arrangements more suitable to a federal system based on financial autonomy of local administrations.

Distributional targets may also have to be reconsidered. In spite of several reform projects, the social protection system still concentrates its resources on pensions, while limited resources are devoted to family support, unemployment benefits and welfare services.

Finally, in the context of EMU, fiscal stabilisation has regained importance. Budgetary targets should allow sufficient room for manoeuvre. The size and quality of stabilisers should be reconsidered.

In the late 1990s, the policy debate to some extent re-focused on these issues. Reforms were introduced to simplify the tax system, reduce distortions in productive and financial decisions and gradually reduce the tax burden. A restructuring of social programmes was widely debated, with spending to be shifted from pensions to unemployment and welfare benefits. The issue of fiscal rules for local governments came to the fore. But, little progress was achieved.

This paper examines the consolidation process and the new challenges faced by Italian fiscal policy. In particular, it focuses on what may be seen as a gradual shift of attention from the arithmetic to the microeconomics of fiscal sustainability .

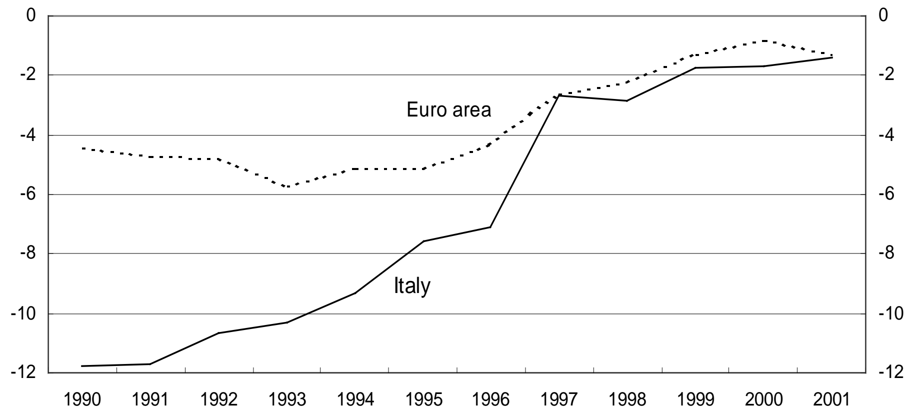
Section 2 provides a broad overview of the fiscal policies implemented in the 1990s. Section 3 examines the pension reform process. Section 4 considers the changes introduced in the tax system. Section 5 discusses the most prominent issues to be dealt with in the coming years.

2. The consolidation process

At the start of the 1990s, public finances showed severe imbalances. Net borrowing in 1990 was equal to 11.8 per cent of GDP, more than 7 percentage points above the average for the other countries of the euro area. Public debt was growing rapidly (23 percentage points between 1989 and 1993). In 1997, the deficit gap with the other countries of the area was closed: the deficit was below the 3 per cent Maastricht threshold (Chart 1) and the debt was on a downward path. There was also a drastic improvement of the inter-generational imbalances.[1] These remarkable and generally unexpected results[2] were obtained in a relatively unfavourable macroeconomic context.[3]

Chart 1

General Government Net borrowing in Italy and in the Euro Area
(percent of GDP)



[1] On the basis of 1990 public accounts, the gap between the net taxes paid by the last new-born generation (on the basis of current policies) and those paid by future generations (taking into account policy actions to restore government solvency) was extremely wide and comparatively larger than in the other western countries (Franco *et al*., 1992). In the following years the gap substantially closed and was in line with the other countries (Leibfritz, 2000, and Cardarelli and Sartor, 2000).

[2] "Still in the middle of 1996 the prevailing opinion was that the participation of Italy to the Monetary Union was impossible, given the existing distance from respecting, in 1997, the condition set in the Maastricht Treaty" (Spaventa and Chiorazzo, 2000, page 9).

[3] The macroeconomic context was not particularly favourable even when account is taken of the impact of consolidation on growth (see Section 2.4).

The budgetary problems of the early Nineties were the result of two decades, from the mid-Sixties to the mid-Eighties, when the sustainability of public finances was an issue largely neglected by Italian policy makers. These decades, together with the unsuccessful consolidation policies of the late Eighties, are briefly recalled in paragraph 2.1. Paragraphs from 2.2 to 2.5 focus on the fiscal consolidation in the 1990s. After a short chronicle of the run-up to EMU and the following years, three important aspects of the adjustment are examined: the rise and fall of the debt and its determinants; the bi-directional relation between the budget and the economy; the composition of the fiscal consolidation.

2.1 The Prologue

The roots of Italian budgetary troubles can be traced back to the mid-Sixties, when sizeable primary deficits started being recorded. Between 1964 and 1979 government expenditure increased from 30 to 42 per cent of GDP, a pace similar to that recorded in other European countries.[4] Expenditure growth was not matched by revenue growth: over the same period the ratio of revenues to GDP increased only from 29 to 32 per cent (Chart 2). As a result, the primary deficit progressively increased, reached a peak at 8 per cent of GDP in 1975, and fluctuated around 4 per cent of GDP in the late Seventies and early Eighties. However, up to the early 1980s, the increase in the debt to GDP ratio was moderated by high inflation and negative real interest rates.

Revenues substantially increased in the first half of the 1980s (to 39 per cent of GDP in 1985), but further expenditure growth (to 51 per cent of GDP in 1985) precluded the reduction of the deficit. The Italian expenditure to GDP ratio, which had long been below the EU average, moved above it in 1983. While fiscal consolidation prevailed elsewhere in Europe, Italian imbalances increased even further.

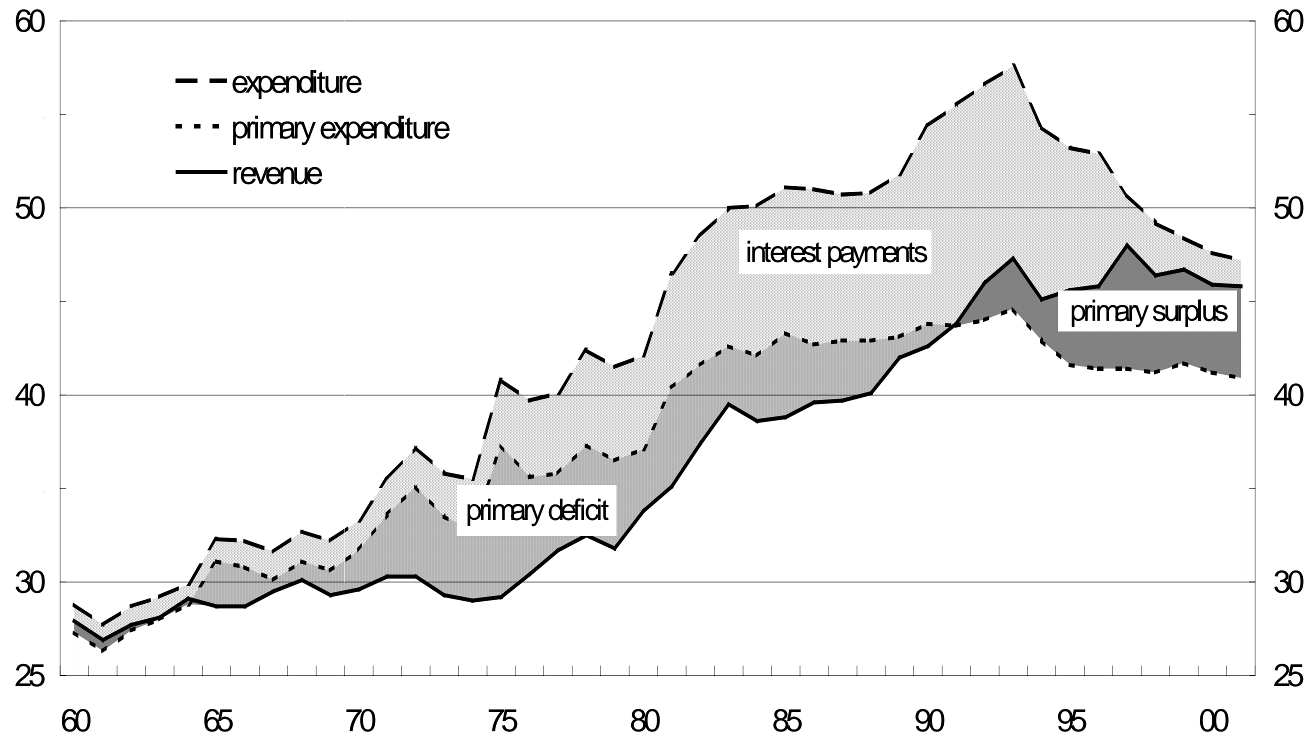
In the 1980s, with the shift in monetary policy, the opening of financial markets and the worldwide rise in real interest rates, the cost of public borrowing rose sharply; debt accumulation became rapid. In those years the unsustainable state of public finances began to be widely

[4] See Franco (1993).

Chart 2

General Government Revenue, Expenditure and Primary Surplus

(percent of GDP)



recognized and fiscal consolidation became the main objective of budgetary policies.[5]

However, consolidation policies in the second half of the 1980s lacked determination and had limited success. Italy lost the last chance for implementing a gradual fiscal adjustment. It also missed the opportunity for stabilising the debt to GDP ratio without necessarily creating high primary surpluses.[6]

Notwithstanding the reverse oil shock, which allowed governments to increase tax rates without increasing inflation, in 1990 the primary deficit was only 2.1 points below the 1984 level, with about ¾ of the decline determined by the change in cyclical conditions.[7] There was no improvement in the overall balance, as the reduction of the primary deficit was entirely offset by the increase in interest payments. The debt ratio climbed to 100 per cent of GDP, 23 points higher than in 1984.

In the late 1980s there was also a large recourse to budgetary measures of a temporary nature (anticipating revenues, deferring expenditures, increasing the stock of tax credits), which left a difficult legacy to the policy makers of the early 1990s.[8]

2.2 A chronicle

In the early 1990s, the consolidation process accelerated considerably under the pressure of external constraints.[9] In 1991 the primary balance returned to surplus for the first time since the mid-Sixties. In the second half of 1992, the adjustment process speeded up, spurred by the exchange rate crisis which forced the lira to quit the EMS.

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[5] The Italian budgetary policy in the 1970s and 1980s is examined in Amato (1990), Baldassarri and Briotti (1990), Bosi, Golinelli and Stagni (1990), Giavazzi and Spaventa (1989) and Morcaldo (1993).

[6] See Sartor (1998).

[7] European Commission (2001).

[8] The stock of tax credits in 1990 has been estimated at 4 per cent of GDP.

[9] Different authors place at diferrent times the the take off of Italy's consolidation process. The analyses by Alesina and Perotti (1997) and Zaghini (2001) begin, respectively, in 1989 ad in 1991. Spaventa and Chiorazzo (2000), while noting the efforts made in the late 1980s, put the start of the adjustment in 1990-91. Degni *et al.* (2001), taking into account the effects of the cycle on the budget, attribute a crucial importance to the measures taken in the second half of 1992.

The looming financial crisis forced the government to take unprecedented corrective actions, which for 1992 included one-off levies on bank and post office deposits and on real estate. The 1993 budget represented a turning point in Italian fiscal policy. In order to curb the deficit expected for 1993, expenditure cuts and revenue increases amounting to nearly 6 per cent of GDP were implemented.[10] Structural measures were also adopted to attenuate the expansionary trends in the major expenditure items.

The pension system was eventually reformed after the long inconclusive debate of the 1980s (see Section 3). The organisation and the financial structure of the National Health Service was reshaped with a view to decentralise decisions and responsibilities. Local authorities powers of taxation were broadened. Rules governing public employment were also reformed and an independent body was set up to conduct bargaining.

Moreover, adjustment of pensions to inflation was temporarily stopped and constraints on the hiring of public sector employees were strengthened. Legislation enacted in previous years had not been able to stop the increase in public employment, but the trend was reversed in 1993. The steady decline of public employment in the following years lead to a cumulated 5 per cent reduction in the number of public employees at the end of the decade.[11]

Notwithstanding the large fiscal effort, the initial budgetary outcomes were relatively unsatisfactory, influenced by the worst recession since 1975, the growth in interest payments and the expansionary tendency of the deficit on a current-program basis.

After the start of the second stage of EMU in 1994, compliance with the deficit requirement set in the Maastricht Treaty was the external constraint of greatest importance for Italian budgetary targets. The reference balance for budgetary policy was changed from the state sector borrowing requirement to general government net borrowing, the yardstick for the 3 per cent limit established by the Maastricht Treaty.

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[10] Banca d'Italia (1992) presented in May the results of an econometric exercise envisaging corrective measures similar to those introduced in the following months. The exercise envisaged for 1993 a correction of the budget balance of 6 percentage points of GDP. As a result, over the period 1991-96, the ratio of primary expenditure to GDP would have declined by 4 points, while the revenue ratio would have increased by 2 points. The interest burden was projected to decline by 1.5 points. Structural reforms in several areas were considered necessary to achieve these results.

[11] Banca d'Italia (2000).

Progress towards the 3 per cent threshold was not linear. Budgetary policy for 1994 aimed at avoiding hampering the macroeconomic recovery and at consolidating the results of 1993. Within the unfavourable context of world-wide increasing interest rates, this pause fuelled concerns over the credibility of the fiscal consolidation process in Italy, widening again the spread between Italian public bonds and other comparable financial instruments (Chart 3). The difference in interest rates peaked in the first quarter of 1995, when the lira depreciated very much. This was the last occasion in which the success of the consolidation efforts was called in question. In the following months the situation gradually improved. Overall, fiscal adjustment continued in 1995 and in 1996, in spite of the slowdown in economic activity.

The consolidation process was given a final boost in 1997, with the aim of ensuring Italy's participation in the Monetary Union from the outset.[12] A two-step budget adjustment amounting to about 3 per cent of GDP was implemented, mainly in the form of revenue increases. Substantial use was made of temporary measures, which amounted to more than 1.5 per cent of GDP and mainly concerned one-off taxes.[13] These included the so called "euro-tax", which was a progressive surcharge on the personal income tax. The deficit reduction was accelerated by the sizeable decline in interest rates (the ratio of interest expenditure to GDP declined by 2.1 percentage points).

Over the 1990s, corrective measures accounted for about 22 points of GDP. This reflected both the need to offset the sharply rising trend of expenditure and the extensive recourse to temporary measures. In several years supplementary budgets were introduced.[14] Economic agents' expectations were influenced with adverse repercussions on demand and interest rates. The latter only fell to the levels prevailing in the rest of Europe towards the end of 1997.

The successful conclusion of the drive to qualify for adoption of the single currency brought to an end the long period in which Italian budgetary policy primarily aimed at correcting imbalances. The focus of budgetary policy shifted towards strengthening social policies and fostering

[12] Ministero del Tesoro (1998).

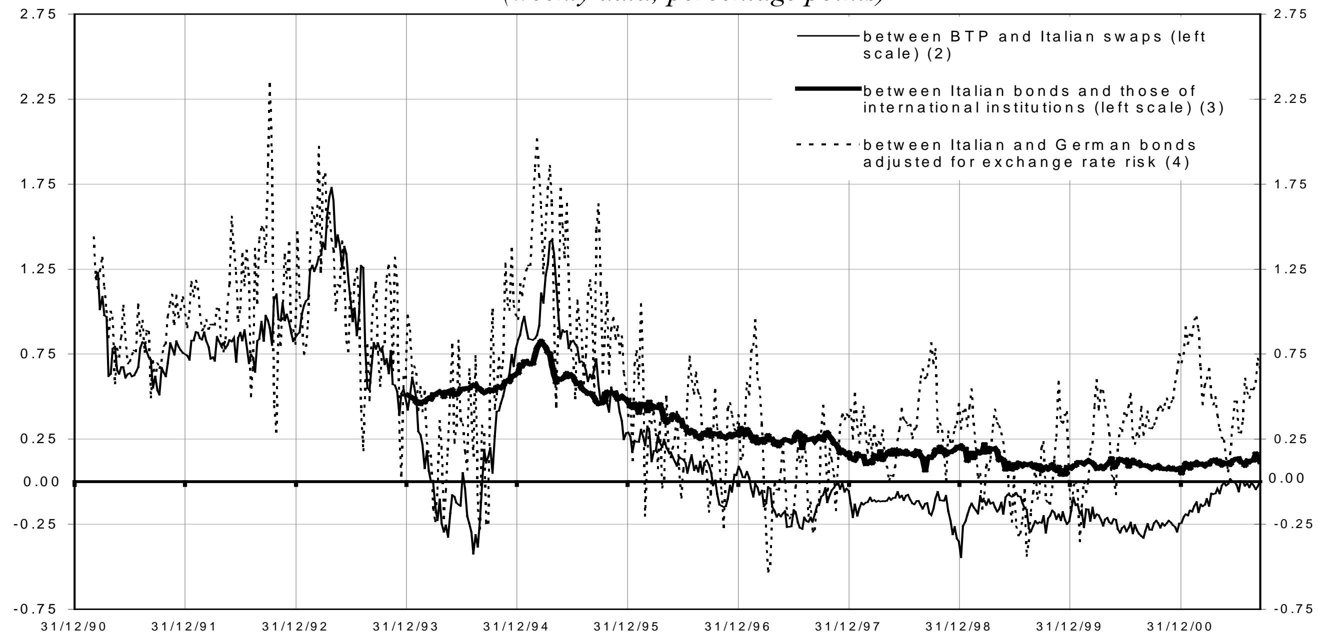
[13] Ministero del Tesoro (1998).

[14] The corrective measures are examined in the Annual Reports and the Economic Bulletins of Banca d'Italia and in Degni *et al.* (2002).

Chart 3

Italian Bond Spreads (1)

(weekly data; percentage points)



(1) Source: BIS and Bank of Italy.
(2) Differentials between 10-year BTP and 10-year Italian swaps.
(3) Simple average of yield differentials between Republic of Italy issues and IBRD bond with similar caracteristics.
(4) Differentials between 10-year BTPs and Bunds adjusted for swap rates differential.

economic growth. An extensive reform of the tax system was introduced. It aimed at simplifying the tax structure and increasing its neutrality, while gradually reducing the tax burden.

In the years 1998-2001, the stance of fiscal policy relaxed: the primary surplus, which had peaked at 6.7 per cent of GDP in 1997, went down to 5.2 in 1998 and remained approximately constant in the following three years. The overall balance remained nevertheless on a declining trend, as a result of the steady fall in interest payments.

The dynamics of interest payments was extremely important, both in determining the changes in the overall deficit and in influencing the orientation of fiscal policy. Between 1980 and 1990 the interest burden as a share of GDP rose by 5.4 percentage points, to 10.5 per cent. This increase largely outsized the improvement in the primary surplus recorded in that period (2 percentage points). Interest payments rose further by 2.5 per cent of GDP in the following three years, almost entirely offsetting the large fiscal corrections in those years. From 1994 the cost of the debt started to fall, reflecting the subdued inflation, the decline of the debt ratio and the gathering confidence on the success of the consolidation process. In the period 1994-97 interest payments contributed to about half of the 7.6 points reduction in the overall deficit.

The gains from low interest rates remained significant after 1997. In the years 1998-2001 interest expenditures fell further by 3.1 points, to 6.3 per cent of GDP, enabling fiscal policy to change its orientation and focus. Assuming unchanged interest rates, a further decline of about 1 point can be expected over the 2002-04 period.

2.3 The dynamics of the debt

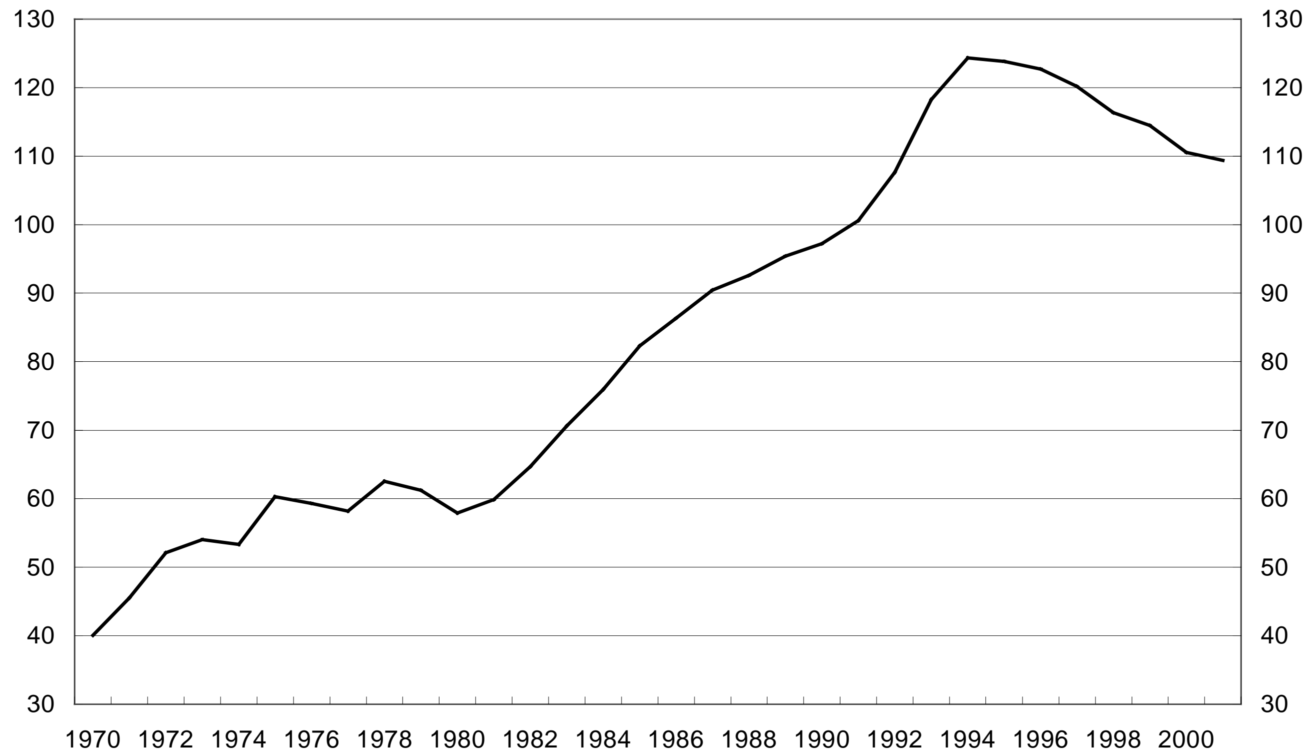
The debt to GDP ratio grew almost continuously from a level of 35 per cent of GDP in mid-Sixties to a peak value of 124.3 per cent in 1994 (Chart 4). Thereafter it has declined, reaching a low of 109.4 per cent in 2001.

The bulk of the debt accumulation occurred in the 1980s and the early 1990s. In the 1980s, the increase in the debt-to-GDP-ratio was boosted by large primary deficits and stock-flow adjustments. Initially, the impact of these factors was partly offset by the negative differential

Chart 4

Debt to GDP ratio: 1970-2001

(percent of GDP)



between the average cost of the debt and GDP growth, which had kept the dynamics of the debt-to-GDP ratio nearly constant in the late 1970s. The differential progressively waned and was approximately nil over the second half of the decade (Chart 5).

In the early 1990s, the differential between the average cost of the debt and GDP growth rate turned positive and was the main determinant of the large increases of the debt ratio, largely offsetting the effects of the primary surplus, achieved since 1991. In 1993, also as a consequence of the negative GDP growth, the differential reached a peak of 9.5 points.[15] The differential more than halved in the following two years and fluctuated around a declining trend afterwards. In the years 1992-93, the debt ratio was also driven up by unfavourable stock-flow adjustments.[16]

Since 1995 the debt ratio has fallen, owing to the large primary surpluses (about 5 per cent of GDP per year) and the reduction in the differential between the average cost of the debt and GDP growth. The impact of stock-flow adjustments was kept broadly neutral by a large privatization programme (in the 1990s its proceeds amounted to 4.9 per cent of GDP, almost entirely accrued in the second half of the decade).

2.4 The budget and the economy in the 1990s

In the 1990s, the Italian economy grew at the yearly rate of 1.5 per cent, half the average growth of the period 1971-1989. The slowdown in growth characterised most industrialised countries, but its extent was generally more limited (1 per cent in the OECD countries). It is likely that fiscal consolidation contributed to the slowdown in Italy, as well as in other European countries, but other factors also played an important role.[17]

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[15] This gap had an impact on the debt dynamics of about 10 points.

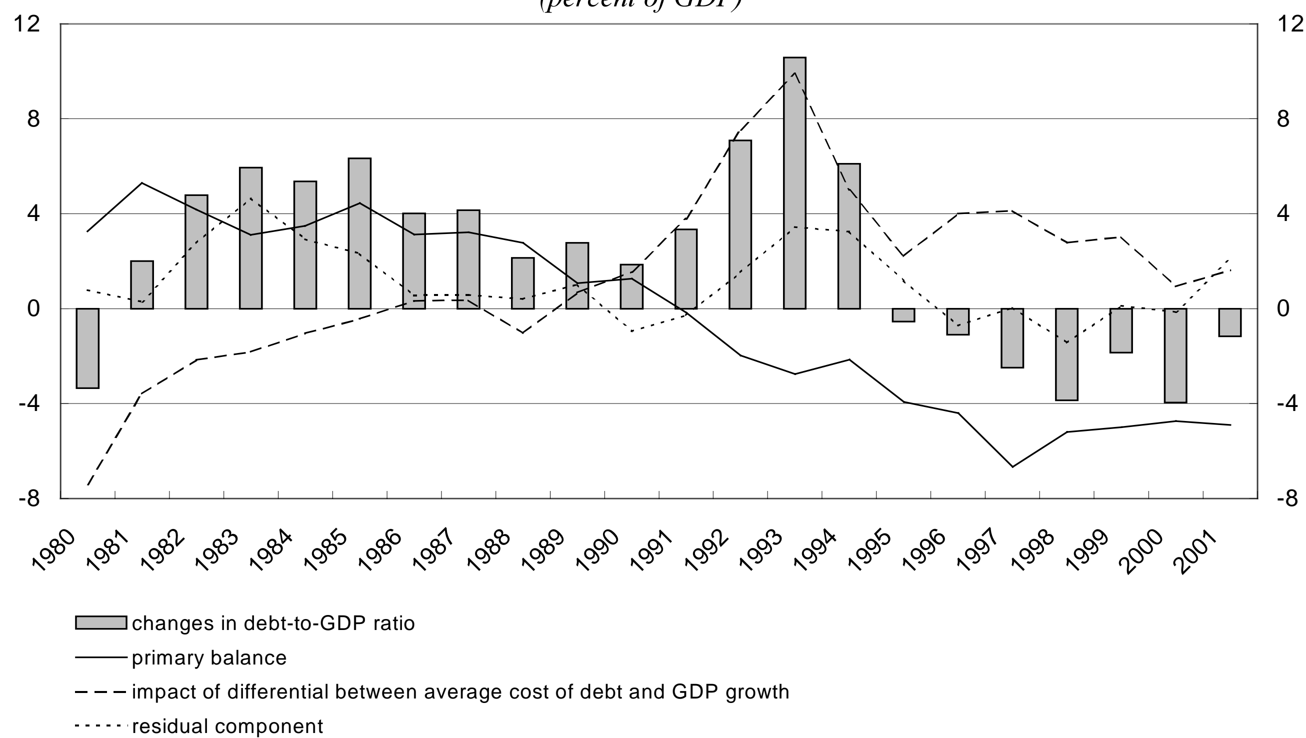
[16] These were related to the devaluation of the lira (which caused the lira value of foreign currency debt to rise in relation to GDP by about 1.5 percentage points), to the issue of securities to provide resources for the Treasury payment account at the Bank of Italy (amounting to nearly 2 per cent of GDP), to the assumption by the state of debts of the former autonomous government agencies (amounting to about 1 per cent of GDP), and to settlements of general government past debts.

[17] See Buti *et al.* (1999). The quality of public expenditure in some key sectors (e.g. education, infrastructures) and a relatively costly public regulation are also likely to have contributed to the poor performance of the Italian economy in the period. See Ferro, Momigliano and Salvemini (1999).

Chart 5

Change in debt-to-GDP ratio and its determinants

(percent of GDP)



Source: Banca d’Italia and Istat.

In the period 1991-97, when most of the adjustment was achieved, the economy grew at a yearly rate of 1.3 per cent, 1.7 points below the average of the previous two decades. On the basis of a preliminary assessment,[18] which takes into account the short-term impact of the budget on growth, fiscal policy accounts for about a third of the growth differential over the consolidation period. In 1998, 1999, and very likely in 1990, the impact was instead positive. The restrictive impulse from fiscal policy was amplified by the composition of the adjustment, which heavily relied on cuts of purchases of goods and services and investments. The labour market was also unfavourably affected by the freeze on the hiring of public employees. Moreover, tax increases and cuts in capital spending may have reduced growth via supply effects.[19]

While restrictive on average, fiscal policy was significantly anti-cyclical over the period, in the relatively narrow sense that deviations from the decade's average growth were generally accompanied by counteracting deviations from average of the impact on growth of the budget (Chart 6). The only exceptions are in the year 2000, when the relaxation of fiscal policy added to the relatively high growth, and in 1993, when fiscal policy was largely dictated by financial emergency. In each of the other seven years examined, the deviations from the averages of the impact of fiscal policy and of the growth of the economy show opposite signs.

To fully appreciate the fiscal efforts made over the period, it is important to take into account also the impact of the cyclical conditions on the budget balance. The estimates of this impact for Italy unambiguously indicate that macroeconomic conditions significantly hampered fiscal consolidation in the run-up to EMU (Chart 7).[20]

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[18] See Momigliano and Siviero (2002).

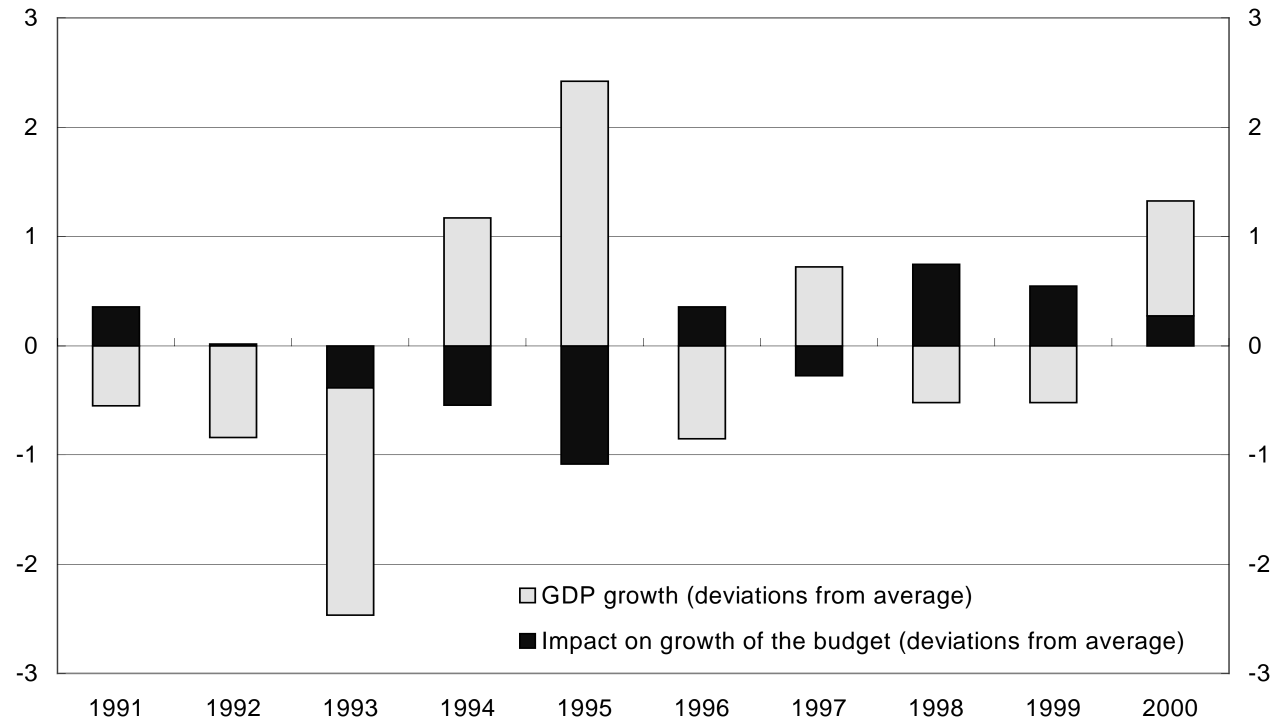
[19] Spaventa and Chiorazzo (2000) compare primary balance changes and GDP growth in EU countries over the period 1991-1998 and notice that the costs of Italian fiscal consolidation had been significant, but – taking into account the size of the adjustment – had been in line with those of the other countries.

[20] The relevance of underlying macroeconomic conditions to the success of fiscal consolidation is stressed in Von Hagen and Strauch (2001).

Chart 6

GDP growth and budget impact on economic activity, deviations from period averages (1991-2000)

(percent of GDP)

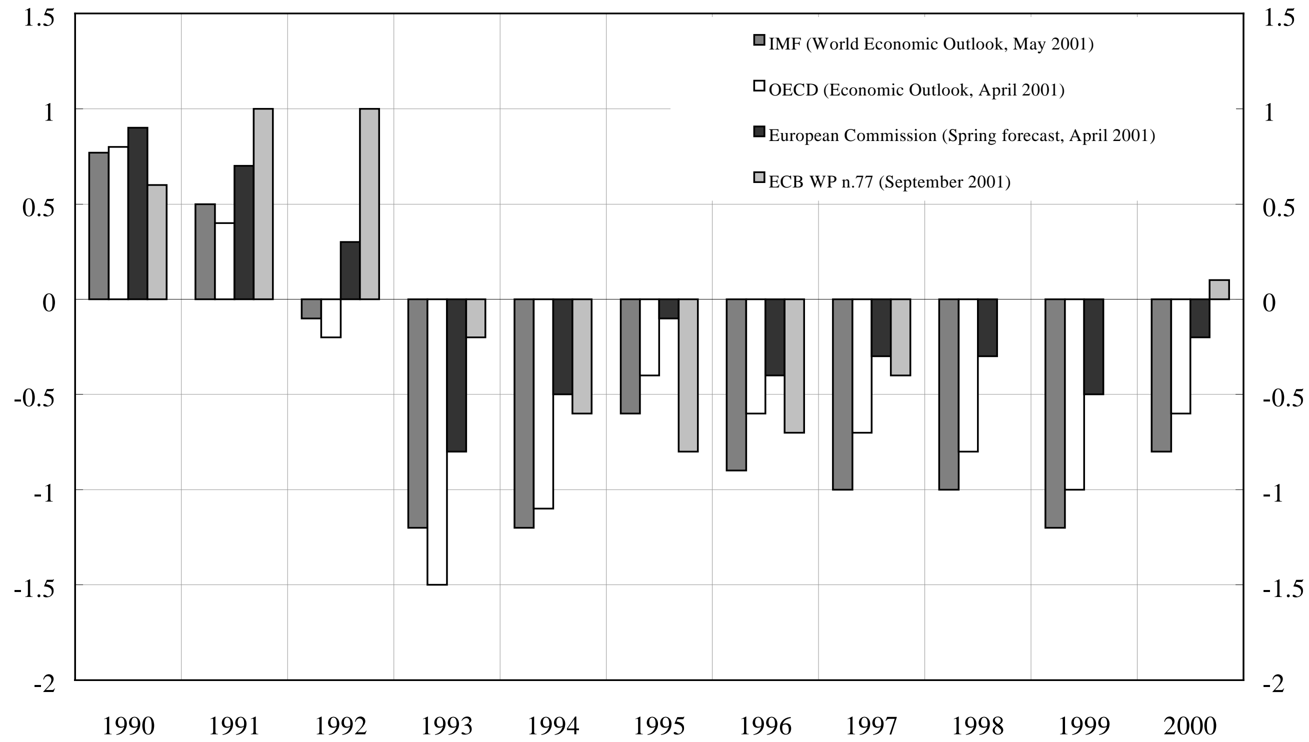


Source: Momigliano and Siviero (2002).

Chart 7

The cyclical component of the Italian General Government balance (1990-2000)

(percent of GDP)



Focusing on the estimates based on the method developed within the European System of Central Banks,[21] the initial three years of the decade were relatively favourable, with the cyclical component averaging 0.9 per cent of GDP. The cyclical component of the budget became negative already in 1993 and declined further until 1996; in 1997 it improved slightly. Overall, in the period 1991-97, the cycle worsened the balance by 1.4 percentage points (the cyclical component declined from 1.0 to –0.4 per cent of GDP). In the following years the cyclical component went gradually to zero.

2.5 The composition of the adjustment

In the 1990s, the ratio over GDP of primary expenditure in the EU countries initially rose fast. From 1992 it declined, reaching the level of the late 1980s at the end of the decade. The revenue to GDP ratio followed a similar pattern, but with more limited changes (Chart. 8).

In Italy, the dynamics of revenue and primary expenditure over the 1990s followed a more complex pattern. Until 1993, continuing the trend which had characterised the 1980s, both sides of the primary budget grew rapidly, with the increase in revenue being by far faster. Afterwards, primary expenditure decreased, while the revenue ratio initially declined, then rose again to an historical peak in 1997 (at 48 per cent of GDP). Since 1998, the primary current expenditure ratio stabilised just below the level of 38 per cent of GDP and the revenue ratio declined to about 46 per cent.

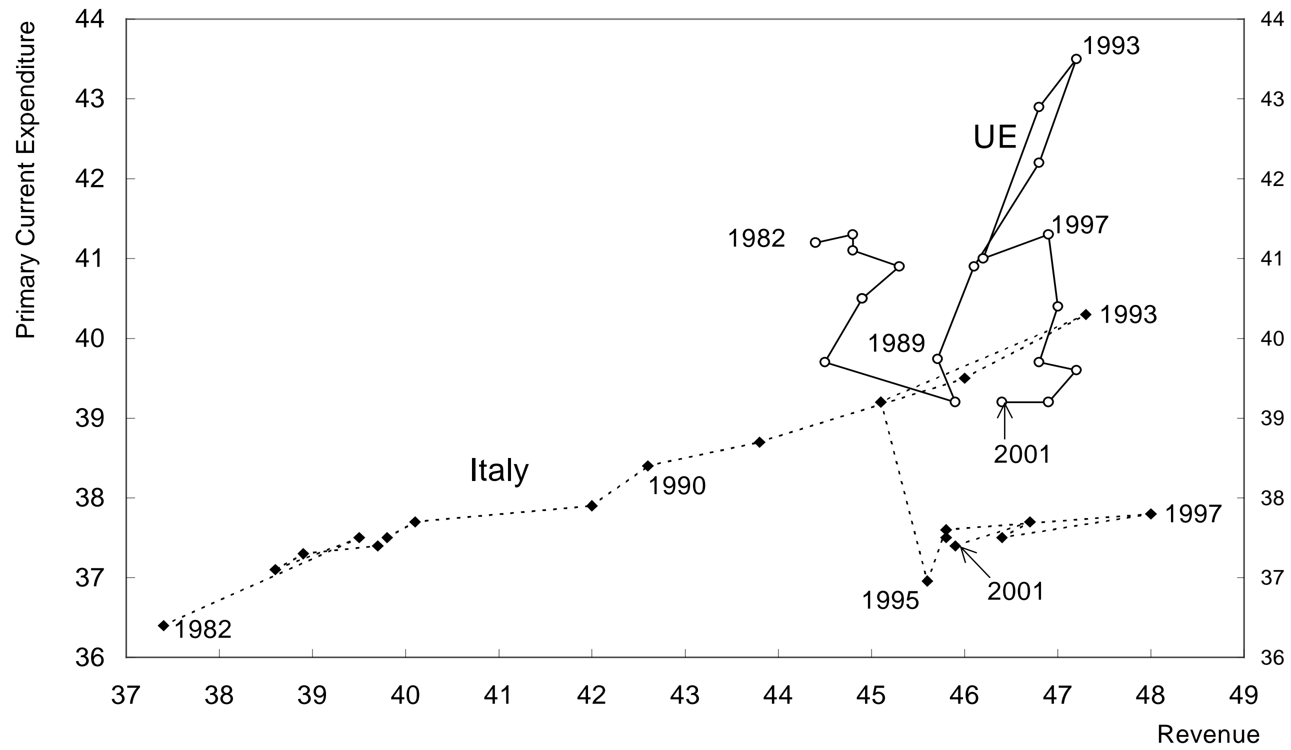
Overall, the reduction in the Italian budget deficit in the 1990s was largely due to revenue increases. In terms of GDP, the latter increased by 4.7 percentage points between 1989 and 1999. Most of this increase occured before 1992, the two peaks of 1993 and 1997 being mainly the result of one-off measures. The contribution of capital expenditure to fiscal adjustment, 1.1 points, was also significant, as a proportion of its share of the budget. Primary current expenditure, growing rapidly until 1993, were subsequently reduced and eventually returned to the level prevailing at the start of the decade.

[21] The ESCB method (Bouthevillain *et al.*, 2001) is more disaggregated then those used by the OECD, the IMF and the European Commission, and thus allows to take account of the effects of changes in the composition of income and aggregate demand. These effects were particularly large in the early 1990s (Momigliano, 2001).

Chart 8

Primary Current Expenditure and Total Revenue in 1982-2001

(percent of GDP)



Focusing on the years 1991-97, when the primary balance improved by 7.9 per cent of GDP, the relative contribution of revenue and expenditure is slightly more balanced, but revenue still accounts for over two thirds of the adjustment (Chart 9).[22] Social security monetary benefits, mainly pensions, continued to increase as a ratio to GDP, notwithstanding the reforms (see Section 3). The effects of the corrective measures showed up more evidently on the dynamics of the other components of current expenditure (in particular, the wage bill), and of capital expenditure: both declined by about 2 percentage points of GDP over the period. In particular, the ratio to GDP of public investments was cut by a third, from 3.3 to 2.2 per cent.[23] Expenditure cuts were mainly carried out at local level, under the pressure of falling state transfers, not entirely offset by a greater tax autonomy (Chart 11 and Section 4). The large revenue increase was distributed among the three main components: direct taxes, indirect taxes and social security contributions.

Over the years 1998-2001, the primary surplus diminished by 1.8 per cent of GDP. Primary expenditure continued to decline, by 0.5 points, mainly due to the dynamics of expenditure on social security monetary benefits. Revenue fell by 2.2 per cent of GDP from its 1997 peak (Chart 10). The composition of revenue changed significantly, with a reallocation from social security contributions to indirect taxes, mainly determined by the introduction of IRAP (see Section 4).

These data seem to indicate that the Italian consolidation process has been eminently revenue based. As the recent strand of literature on the composition of adjustment has shown, this feature is often correlated with the absence of positive macroeconomic effects coming from the improvement of expectations and lack of success of the consolidation effort.[24] The Italian case seems to confirm only the first of the two

[22] 1993 is not suitable as a reference point in order to assess the composition of the adjustment in terms of GDP ratios because of the sharp slowdown in growth recorded that year.

[23] The fall in investment expenditure was due in part to the discovery of widespread irregularities in tenders for public works. The need to ensure the efficient use of the resources allocated to investment led in 1993-94 to the start of a reform process, which is still under way, aimed at reducing the scope for irregular behaviour on the part of public officials and firms, guaranteeing more competition in tenders and increasing the project planning and evaluation capabilities of central and local government.

[24] See Giavazzi and Pagano (1996), Alesina and Perotti (1997) and Zaghini (2001). On the relationship between fiscal policy composition and the level of economic activity, see also Ardagna (2001).

Chart 9

Changes in the composition of the budget in the years (1991-97)

(percent of GDP)

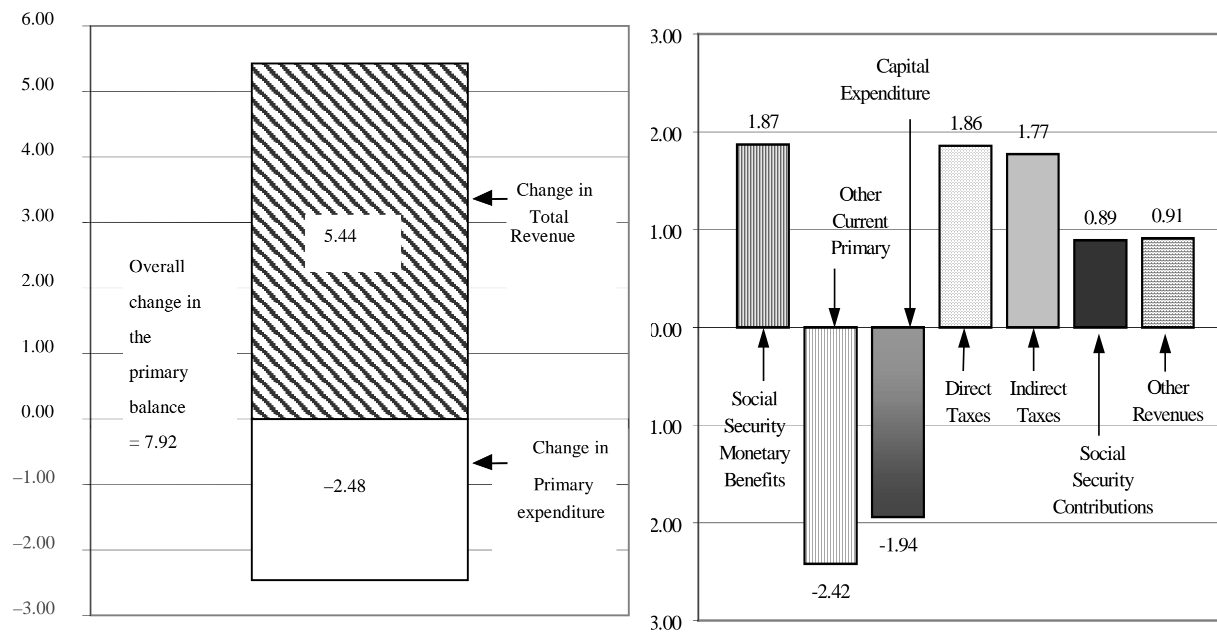


Chart 10

Changes in the composition of the budget in the years (1998-2001)

(percent of GDP)

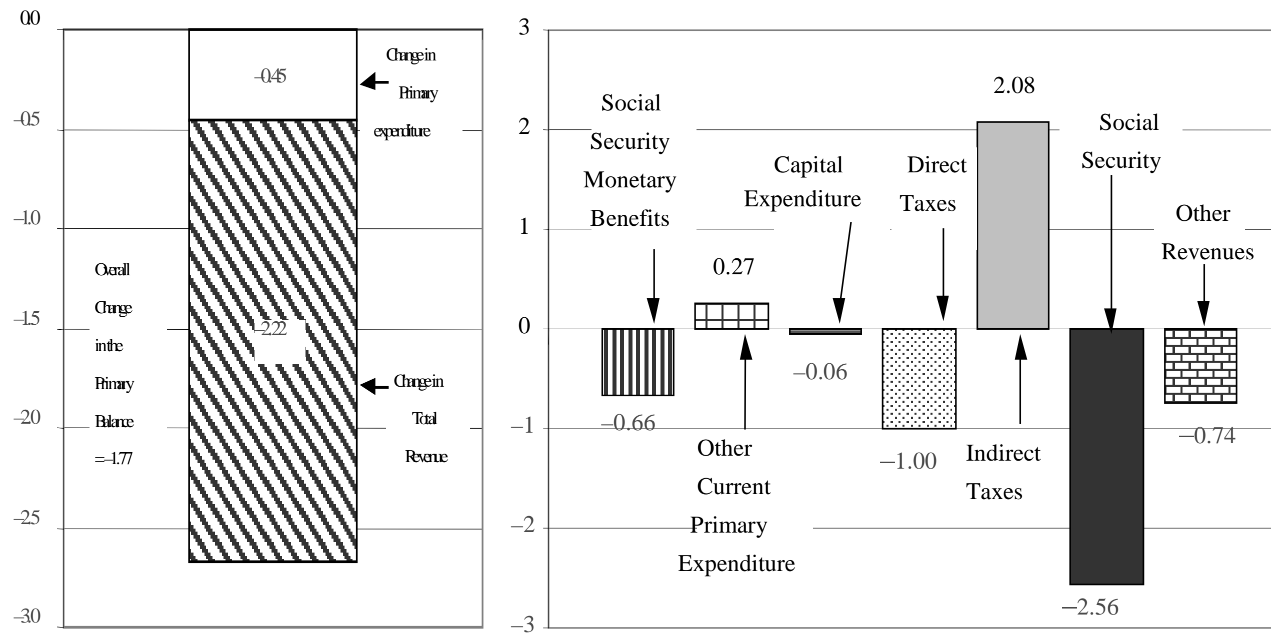
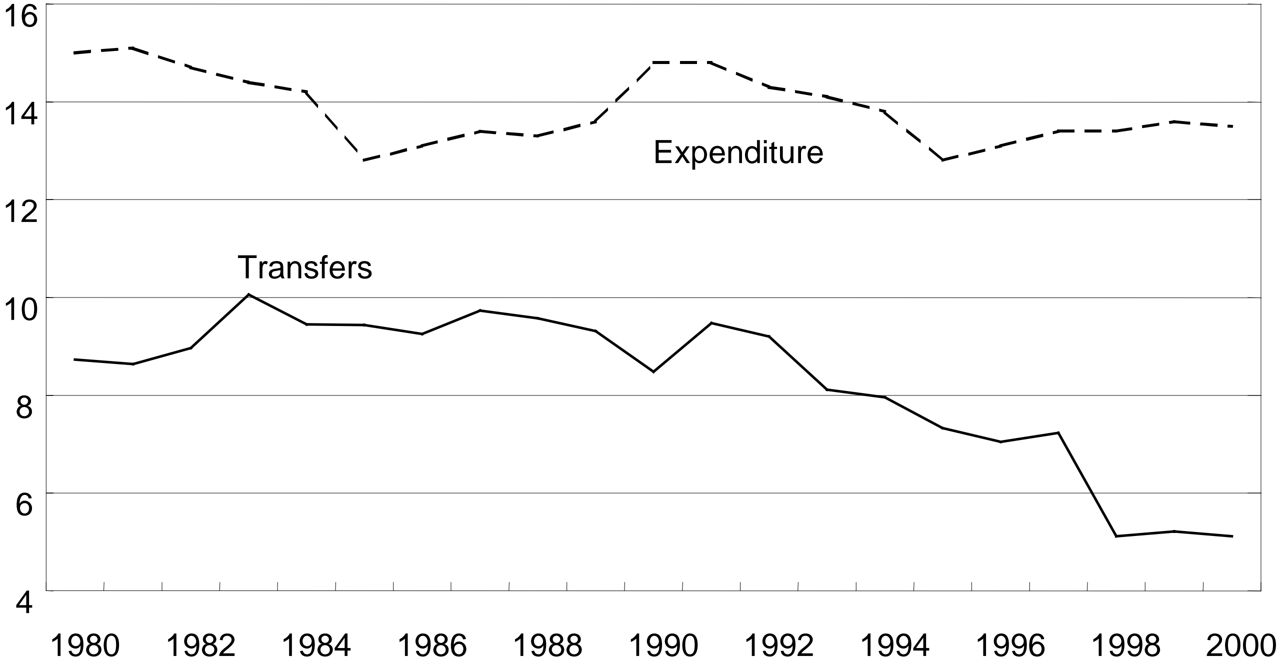


Chart 11

Local Government transfers and expenditure (1980-2001)
(percent of GDP)



predictions, as internal demand did not accelerate towards the end of the consolidation. However, a partly different view on the composition of the adjustment can be reached when account is taken of the impact of corrective measures on the tendency of expenditure to expand inherent in programs that were in place at the outset of the decade. The policies implemented in the 1970s and 1980s had created large future commitments, implying a significant increase in the expenditure to GDP levels also in the 1990s, especially in the social protection domain. In terms of correction of budgetary trends, the consolidation of the 1990s was probably almost evenly split between revenue and expenditures.[25]

It should also be pointed out that the political burden for reversing these trends was enormous, especially for coalition governments with limited political legitimisation.[26] The policy makers were also facing a credibility problem, partly stemming from the failure to consolidate public finances in the second half of the 1980s, when the macroeconomic context was favourable.

Most of these caveats do not apply to recent years, making particularly worrisome the seeming incapacity to gradually reduce primary current expenditure as a ratio to GDP. Lacking the pressure for consolidation previously exerted by large fiscal imbalances, governments seem now unable to achieve further reductions in order to alleviate the tax burden. Progress in restructuring public expenditure also seems limited. In particular, the calls for moving resources from pensions to welfare and unemployment benefits have been basically unanswered.[27]

3. The search for a sustainable pension system

The reform of the pension system has long been at the core of the effort to ensure fiscal consolidation and long-term sustainability in Italy. The ratio of pension expenditure to GDP is one of the highest in industrial countries, while Italy's fertility rate is among the lowest (1.2 children per woman of childbearing age). Moreover, the ratio of the elderly to the

[25] In a similar vein Spaventa and Chiorazzo (2001) stress the change occurred in the trend ratio of public expenditure to GDP.

[26] Bernardi (2000a).

[27] See Commissione per l'analisi delle compatibilità macroeconomiche della spesa sociale (1997). The issue is also examined in Franco (1996) and Monacelli (1998).

working age population is expected to increase from 21 per cent in 1990 to about 30 per cent in 2010 and 48 per cent in 2030; it will be among the highest in the world.

In the 1980s it was gradually apparent that the system governing pension benefits and demographics were mutually incompatible: the pension formula, the eligibility conditions and the indexation rules granted rates of return which were considerably higher than the rate of growth of the social security tax base. Pension expenditure increased from 5.0 per cent of GDP in 1960 to 10.2 in 1980 and 14.9 in 1992, far outstripping the growth of the other items of social spending which only increased from 5.1 to respectively 6.7 and 7.3 per cent of GDP. Later projections estimated that pension expenditure would have reached 25 per cent of GDP by 2030.[28] In spite of frequent calls for a general reform of the pension system, no large-scale change was introduced. Still in 1990 prospective expenditure was further increased by the decision to raise the benefits for the self-employed.

Pension reform has also been recognised as an important component of any policy aimed at improving the functioning of the labour market, namely at increasing labour mobility and the low participation rate.[29] Given the relevance of pension spending, pension reform is also a key element in any strategy aiming to reduce the tax burden while keeping a broadly balanced budget. Finally, since the incidence of pensions on total social spending is very high (70 per cent), pension reform is also a precondition for implementing policies which may increase public support for the non-elderly groups of citizens and finance additional spending on long-term care.

3.1 The 1992 and 1995 reforms

The situation radically changed in 1992. Under the pressure of the exchange rate crisis and the urgent need to curb the deficit, the pension formula and the eligibility conditions were extensively modified. The reform implemented in 1992 cancelled about a quarter of net pension

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28 See Ministero del Tesoro (1994).

29 See Franco and Frasca (1992).

liabilities (Chart 12).[30] Most of the savings were obtained by the switch from earnings to prices as the basis for revaluations and the determination of new pensions on the basis of workers' entire working lives.

The reform also started a gradual harmonisation of pension rules and, by relating the pension levels of younger workers to lifetime contributions, strengthened the link between contributions and benefits. However, it did not tackle the issue of seniority pensions, which allowed retirement at any age provided certain contributory requirements were satisfied. This substantially reduced the impact on the effective retirement age of the increase in the age-limit for old-age pensions. Moreover, the exclusion of individuals with at least 15 years of contributions from changes in the pension formula implied a long transition period and an uneven distribution of the reform burden.

Expenditure prospects remained rather worrying. However, by breaking the deadlock of Italian pension policy and immediately restraining expenditure increases, the 1992 reform set the conditions for better planned and more systematic changes.

A new major reform was introduced in 1995.[31] While the 1992 reform changed the parameters of the system and primarily aimed at cutting pension expenditure, the new reform changed the basic design and had a wider range of objectives. It aimed at stabilising the incidence of pension expenditure on GDP, at reducing distortions in the labour market and at making the system more fair.[32] A tighter link of pensions to individual contributions was instrumental in achieving the latter objectives.

It was expected that contributions would have been more clearly perceived as deferred earnings, thereby reducing the distortionary effect of labour income taxation. The reform, which was probably inspired by the one undertaken in Sweden in 1994, envisaged the shift from a defined benefit to a defined contribution system. Under the new system, each individual holds a notional social security account. Contributions are transformed into an annuity at retirement on the basis of actuarially determined coefficients linked to retirement age. The 1995 reform aimed at

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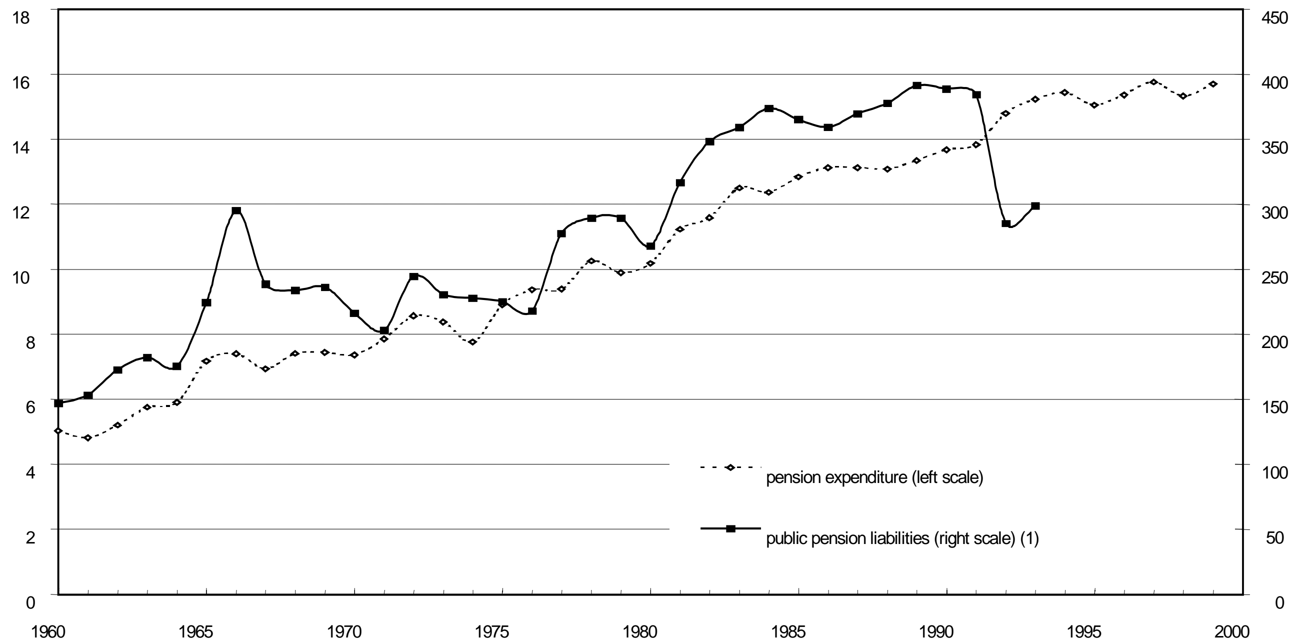
[30] See also Beltrametti (1994) and Rostagno (1996). These estimates refer to the present value of pensions to be paid in the future on the basis of accrued rights to pensioners and existing workers, net of the contributions that the latter will pay under current rules.

[31] See Aprile *et al.* (1996); Banca d'Italia (1995); Castellino (1995); Peracchi and Rossi (1998).

[32] See Rostagno (1996).

Chart 12

Pension expenditure and public pension liabilities
(percent of GDP)



(1) Source: Beltrametti (1996).

equalising the yields of the contributions paid by all workers of the same sex and the same pension cohort. It removed the favourable treatment previously granted to workers with dynamic careers.[33]

Legislation supporting the development of pension funds was also introduced in 1995, supplementing earlier steps. The consensus view reached over the 1990s was that the growth of such funds is a means to adjust retirement provisions to the different needs of the citizens, to allow workers to offset the reduction in replacement rates resulting from reforms of PAYG schemes and also to strengthen the role of institutional investors in the capital market.

3.2 *Critical aspects*

Overall, during the 1990s Italian governments radically redressed the prospects of the PAYG pension schemes, introduced an innovative solution to make these schemes more incentive compatible,[34] successfully harmonised the rules applying to the different schemes (thereby facilitating further reforms) and aimed at gradually developing a two pillar system more diversified and resilient to shocks.

However, some aspects still remain problematic.

The 1995 reform did not significantly affect long-term expenditure trends.[35] In the 1990s, in spite of the reforms, the ratio of the average pension to average earnings rose by around 15 per cent; the number of pensions increased by around 10 per cent. In the year 2000, pension expenditure represented 15 per cent of GDP. Further increases in the expenditure to GDP ratio are expected over the next decades. While these increases are less dramatic than in most other EU countries,[36] the present size of pension expenditure makes them hardly sustainable. Moreover, the implementation of the reform is extremely gradual. The length of the

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[33] Under the new rules, which apply to all categories of workers, the level of the pension wealth of each individual would not be affected by the age of retirement.

[34] The actuarial approach underlying the reform represents a structural break in Italian pension policy-making, since in previous decades actuarial considerations did not have any significant role. See Castellino (1996).

[35] Rostagno (1996).

[36] Economic Policy Committee (2000).

transition phase and other aspects of the reform may significantly reduce its expected microeconomic benefits.[37]

The 1995 reform avoided showing cuts on replacement rates at the cost of increasing pressures from pensioners in the future.[38] Most expenditure cuts came from changes in the indexation mechanisms, which are perhaps more acceptable to public opinion since they are less visible and more gradual, but may prove politically unsustainable in the long run if associated with lengthy retirement periods.[39] More generally, the reliance on the reduction in the transfer ratio, rather than on increases in retirement age, may create political pressure for discretionary increases of pension in real terms.[40]

An actuarially based pension system, such as that introduced in Italy in 1995, can deliver the expected labour market benefits only if the link between contributions and benefits is transparent, easy to grasp and perceived as stable by citizens. This may not be the case in Italy, where a large number of workers are not affected by the new pension regime, no major effort has been conducted to inform citizens, and further reforms are expected by public opinion which thereby perceive the return to the contributions as uncertain.[41]

There is now considerable consensus among pension experts, if not among politicians, that a comprehensive package including a faster implementation of the 1995 reform, some parametric changes in the pension regime established by that reform, and an acceleration of the development of funded schemes would avoid the expected rise of the pension expenditure to GDP ratio and reduce the negative effects of the systems on the labour market and employment. The acceleration of the implementation of the 1995 reform would provide some budgetary margins for a gradual reduction of the contributions to the PAYG system, which could be implemented in parallel with the development of funded schemes.

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[37] Further changes were introduced in legislation in the following years. See Onofri (1998).

[38] Pizzuti (1998) remarks that this decision, which relies on the short-sightedness of individuals, is in stark contrast with one of the main roles of public action in retirement provision, that is that of compensating for this short-sightedness.

[39] Moreover, revisions of conversion coefficients at ten-year intervals may produce large differences in the treatment of contiguous generations of pensioners. This also may also be politically problematic.

[40] See Gronchi and Aprile (1998), Peracchi and Rossi (1998).

[41] See Franco (2002).

The optimal mix of PAYG pensions and funded pensions remains open to discussion. However, high contribution rates and budgetary constraints limit the speed of the transition to funding. It is likely that the Italian pension system will remain for a long time predominantly based on PAYG criteria. If funding were to assume a greater role than PAYG, the optimality of coupling a funded defined contribution system and a PAYG defined contribution system (rather than a defined benefit system) should also be discussed.

3.3 The design of pension policies

The policy-making process also proved problematic.

The delay in introducing a reform imposed high costs on Italian present and perspective pensioners in terms of unexpected reductions in purchasing power (e.g., those produced by the partial suspension of price indexation in 1993) and sudden changes in expectations (e.g., those related to the fast increase in the standard retirement age). Policy-making was affected by short-term considerations. Changes were frequently introduced under external pressure. The effort to minimise the reactions of the more vocal groups led to solutions which may result unsustainable in the long run.[42]

Reforms were introduced without adequate preliminary work. The need to make use of political windows of opportunity to introduce reforms prevented adequate reflections on their design and implications. This deficiency was understandable in the emergency situation of 1992; it was less so in later years, when the focus shifted from expenditure control to a wider range of objectives.[43] No government document was presented in the 1990s to illustrate the case for reform, the alternative changes taken into consideration, the objectives and the expected outcomes. In particular, it is

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[42] The distribution of the burden of reform between generations and group of workers was uneven. The cut in the pension wealth of pensioners and elderly workers is very limited with respect to that imposed on younger workers. Generational disparities replaced industry-based disparities. While workers with long-contributory records retained their seniority pensions, those with shorter periods faced a sudden increase in the age-limit for obtaining an old-age pension.

[43] Gronchi and Aprile (1998) link some deficiencies of the 1995 reform to the speed with which it was introduced, that in effect gave little time to understand its implications. See also Aprile *et al.* (1996).

remarkable that the 1995 pension formula was never officially published.[44] This creates some ambiguity for future revisions of conversion coefficients.

Being lengthy and largely incremental, the reform process introduced additional burdens. The widespread perception that more adjustments are required maintains uncertainty and induces elderly workers to retire at the earliest possible date. This increases public expenditure and negatively affect the labour market. The employment rates of Italian males in the 50 to 64 age-brackets significantly declined over the 1990s in spite of the increase in the age limit for old-age pensions. Moreover, while most experts consider that further changes are required, public opinion is experiencing 'adjustment fatigue'.

4. Tax system between revenue maximisation and efficiency targets

Over the 1990s, the ratio of total government revenues to GDP increased by about 4.7 percentage points, to 46.7 points. This increase does not fully convey the strains imposed by fiscal consolidation on the Italian taxpayers. Tax legislation was frequently modified. The revenue ratio was raised to 47 per cent of GDP in 1993 and 48 in 1997. Moreover, between 1975 and 1990 the ratio had already been increased from 29 to 42 percentage points (Chart 13). This is one of the fastest and largest increases experimented by European countries.[45]

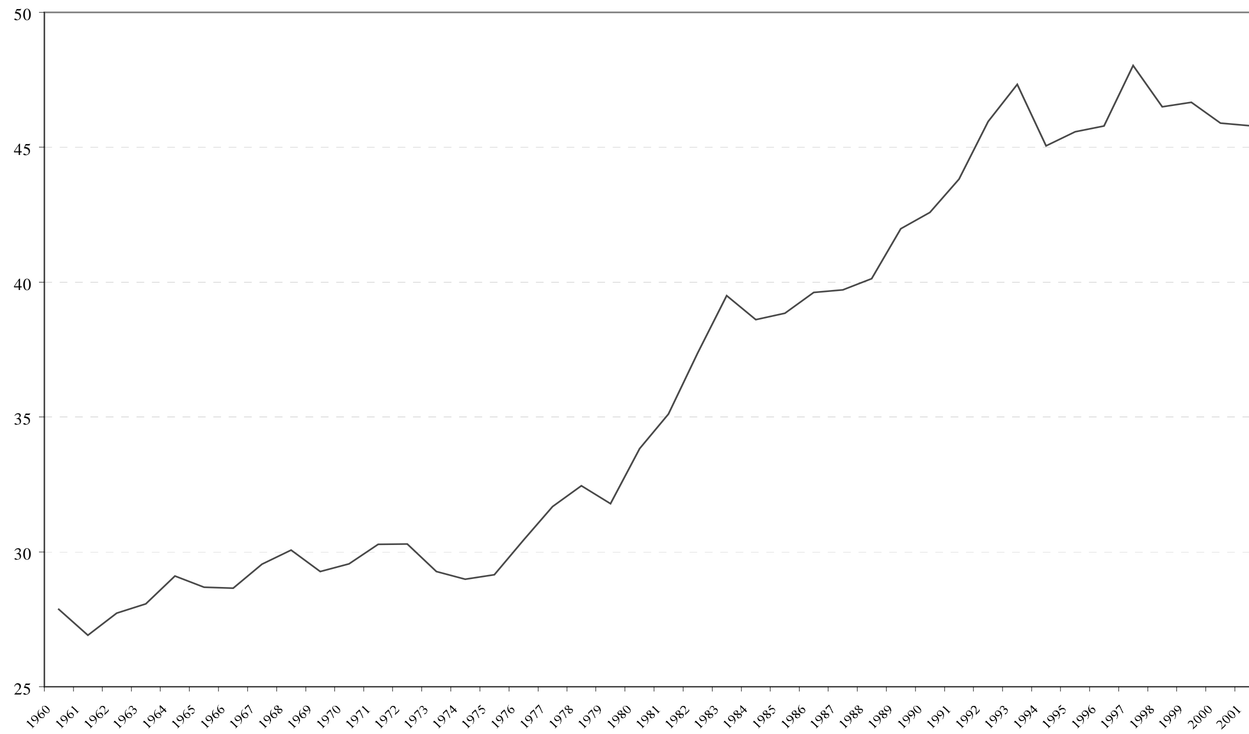
At the beginning of the 1990s, there was clearly a need for consolidating the revenue increase on the basis of allocative and distributive considerations and for tackling some critical aspects of the revenue structure. Revenue growth in the previous 15 years had been the result of a major tax reform in 1973, which had significantly enlarged the number of taxpayers, of the effects of high inflation on nominal tax bases and of several measures taken since the mid 1980s to curb the increasing deficits.

[44] Gronchi (1997).

[45] A review of the evolution of the Italian tax system in an international comparison perspective is in Tanzi (1996). For General Government statistics, see Banca d'Italia, "Public Finance Statistics in the European Union", *Supplements to the Statistical Bulletin – Monetary and Financial Indicators*, various issues.

Chart 13

General Government Revenue
(percent of GDP)



However, over most of the 1990s tax policy remained subordinated to expenditure decisions and overall budgetary constraints. Fiscal packages were introduced, even two or three times a year, to achieve deficit targets.

Only in recent years, has the design of the tax system *per se* again come to the fore. The decline of the tax burden has become a primary policy target. The policy debate has also increasingly shifted to the issue of the structure of public revenues and their effects on the economy.

4.1 The legacy of the 1980s

At the beginning of the 1990s, some problematic aspects of the Italian tax system were quite evident. While the tax burden in GDP terms was not high by European standards, the statutory tax rates were relatively so. Because of tax erosion, avoidance and evasion, the tax burden was concentrated on some groups of taxpayers. This situation largely depended on the structure of the Italian economy, characterised by the small size of enterprises and a vast presence of self-employed workers, and on the inadequacy of the tax-administration to cope with the problems such a structure implied for tax assessment.

A particularly critical point was that of the personal income tax (Irpef).[46] Most of the revenue growth in the late-Seventies and the Eighties came from this tax. Irpef had progressively lost its generality, being unable to assess and tax the overall income of each taxpayer due to increasing erosion, avoidance and evasion. By the beginning of the 1990s, it had already become a tax mostly on dependent labour income. It had needed assiduous amendments to hinder the effects of high inflation via fiscal drag. Heavy reliance on this revenue meant concentration of the tax burden on a specific category of taxpayers.

Another critical area was that of regional and local government finance. The increasing decentralisation of expenditure contrasted with the centralised financing framework. At the end of the 1980s, some limited steps had been taken to increase the municipalities' and provinces' tax autonomy. Regions did not have significant power yet.

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[46] See Gerelli and Valiani (1984).

4.2 Tax policy up to 1997

Up to the late 1990s, the primary concern of tax policy was to increase revenue. Whenever revenue goals were in contrast with allocative or distributive targets, the latter were forfeited.

Between 1990 and 1997, direct taxes grew by 1.8 percentage points of GDP, indirect taxes by 1.7 points and social security contribution by 0.9 points. Capital account taxes, including revenues from one-off measures and tax amnesties, increased by 0.6 points (from 0.1 to 0.7 per cent of GDP); in 1992, they reached 2.0 percentage points.

For personal income tax, the main challenge was to maintain the "social sustainability" of the tax system by limiting the inequity induced by the concentration of the burden on some groups of taxpayers. One way to compensate for the different degrees of evasion possible to the different categories of taxpayers, was by replacing deductions with a very articulate system of tax credits, linked to the different sources of income, the family composition, and other personal characteristics. Equity pursuit shifted from vertical to horizontal.

The priority given to sustaining revenue levels from the personal income tax is also apparent in the choice to suspend in the early 1990s the automatic mechanism for the repayment of nominal fiscal drag introduced at the end of the 1980s.[47]

Measures to limit tax erosion, avoidance and evasion were also implemented. In the late 1980s, an attempt to introduce a minimum tax on autonomous labour and individual firm incomes had failed due to the opposition of the interested categories. In the following years, some procedures to evaluate the adequacy of reported incomes based on predetermined coefficients were introduced with greater success.[48] Such procedures were forerunners of the most recent Sector Studies (Studi di settore), which provided a more sophisticated and articulate set of parameters to estimate ordinary incomes in several economic activities.

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[47] However, it must be acknowledged that the decline of inflation reduced impact of the fiscal drag in terms of equity.

[48] The so-called *coefficienti presuntivi e di congruità*.

Studies to identify sources of erosion in enterprise income were envisaged during the 1990s, as pre-requisites for future reform.[49] Major changes were enacted, however, only in the late 1990s. Meanwhile, revenue needs induced increases in the corporate tax, in contrast with the reductions already taking place in other countries. In 1988, depreciation allowances had already become less generous. In 1991, the local income tax became non-deductible for the purposes of determining taxable corporate income. In 1994, the corporate statutory tax rate was increased. Overall, the statutory tax rate on corporate retained profits was raised from 46.4 per cent to 53.2. In 1992, a special levy on firms' net assets was also introduced (at the rate of 7.5 per thousand). It was meant to be temporary, but was applied until 1997.

Over the same period, transitory incentives were introduced in order to foster investment. In 1991-93, a tax credit on innovative investment was designed for small enterprises. In 1994-95, 50 per cent of the investment spending exceeding the previous 5 years average spending was made deductible from the corporate tax bases.

As to VAT, the harmonisation process in the EU limited the room for manoeuvre at the national level. Only some reallocation of products within the categories taxed at reduced or ordinary rates was possible.[50]

Transitory levies played a relevant role. In 1992, receipts for 1.8 per cent of GDP came from one-off levies on real estate and bank and postal deposits and from a revaluation of companies' assets. Some of these measures were replaced by permanent sources of revenue, like the extraordinary real estate tax that was replaced by a permanent tax on real estate income (ICI) the year after. In 1997 a special "Europe" tax was raised on households and firms. Transitory receipts were also cashed by anticipating revenue from future years.[51]

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[49] Such reform should have aimed at restoring some degree of neutrality in the tax system. Erosion turned out to be mainly ascribable to a very articulate set of incentives, due to a progressive stratification of tax measures over time, the overall effects of which were not always obvious.

[50] The recent acceleration in revenue from VAT mainly reflects the impact of tax incentives granted in determining direct taxes in case of documented building re-structuring. Such incentives favoured the emerging of otherwise evaded transactions on which VAT is paid.

[51] The rules regarding the pre-payment of self-assessed taxes were frequently exploited. Any increase in the tax liability, indeed, gives rise in the second year to an increase of roughly twice the level it would have produced when fully phased in. In the same line, the withholding tax on incomes from financial assets gave a major contribution to the consolidation process, for example, thanks to the high pre-payments on interests from bank deposits imposed since 1995 to the intermediaries acting

(continues)

4.3 Tax policy after 1997

Policy orientations changed in the late 1990s, when the budgetary conditions became less critical. In the period 1998-2001, the revenue to GDP ratio was reduced. With respect to the 1997 peak, direct taxes declined by 1 percentage point of GDP. Capital taxes decreased by 0.6 points, re-gaining their physiological level. Social security contributions declined even more (–2.6 per cent of GDP), as contributions to the National Health Service were replaced, along with other taxes, by a new regional indirect tax (IRAP). Indirect taxes increased by 2.1 percentage points of GDP.

An important reform of the tax system was introduced in 1998.[52] Another major reform is now under way.

The 1998 reform aimed at making the tax system more efficient and neutral. It aimed at reducing tax-induced distortions in capital markets and business activity, lowering statutory rates, increasing fiscal responsibility of local government, particularly regions, and simplifying the tax system. The reform did not envisage immediate effects on the budget balance. The two more relevant features of the reform were the introduction of a dual income tax system (DIT)[53] and IRAP.

DIT envisaged a reduction of the average tax rate on corporate income subject to financing by equity capital. It significantly lowered the fiscal advantage for debt financing.[54] In the years 1999-2000, new

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as tax authority substitutes. These high pre-payments generated high tax credits *vis-à-vis* the bank system. Banks were obliged to anticipate revenue based on previous year's levies, even when the tax base was declining due to decreasing interest rates.

[52] The guidelines were approved by Parliament in 1996. Proposals for a possible reform had already been presented in 1994 in Ministero delle Finanze (1994) by the Centre-Right Government taking office that year, but they could not be implemented as the Government fell a few months later. The same indications are now inspiring the incoming tax reform. In 1996, a new proposal was put forward by the "Commissione Gallo" under the following Government, focusing on the fiscal federalism issues. By that time a new regional tax was envisaged, which was re-considered some years later, in 1998, when finally a tax reform was passed by the Centre-Left coalition. On the 1998 tax reform see Guerra (1998), Pedone (1999), Bernardi (2000b), Giannini and Guerra (2000).

[53] See, among others, Giannini (1998).

[54] A reduced tax rate (19 per cent) was applied to the imputed returns to the increase in equity capital. The residual taxable profit was subject to the ordinary rate (37 per cent). Revenue needs suggested that the *Italian DIT*, contrary to the *Scandinavian DIT*, should have limited the reduced tax rate only to the "new equity capital" (invested in the company through new capital subscriptions and retained earnings since 1996). For the same reason, a minimum ceiling to the average rate was set (27 per cent). Such constraints were gradually softened. In 2000, the new equity capital to be taken (continues)

temporary incentives for investment were also introduced, conditional on equity financing.

IRAP replaced several taxes, such as the local income tax, the net worth tax and the contributions levied on labour income for financing health care. Its tax base includes profits, rents, interest payments and labour costs.

Overall, the introduction of DIT and IRAP increased neutrality in the tax treatment of finance sources. DIT reduced the tax penalisation for new equity against debt financing. IRAP is neutral with respect to different finance solutions, as it applies an identical rate (4.25 per cent) both on profits and on interest payments. The abrogation of health contributions and their substitution with IRAP reduced labour costs. The reform lowered marginal tax rates on labour and capital, although capital was relatively more de-taxed.

Since the contributions were deductible against the personal income tax base, contrary to IRAP, and since self-employed labour incomes were now subject to the new tax, a revision of IRPEF was needed as well.[55]

The 1998 tax reform also revised the taxation of income from financial assets. It confirmed the exclusion of most of saving incomes from the personal income tax base and their taxation via a withholding tax on a proportional rate. The primary aim of the changes was neutrality, which was pursued by broadening the tax base to include capital gains from all financial assets. Intentions to move towards a single rate system (somewhere between the two applying, 12.5 and 27 per cent) were announced, but the actual unification of rates was postponed to avoid revenue losses. Taxation of capital gains was extended to all financial instruments and was based on the maturation criterion. These changes, while increasing revenue levels in a long run perspective, also increase the instability of revenue, in relation to the volatility of the stock market performance.[56]

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as basis for the DIT calculation was increased, by applying a multiplier (1.2 for 2000, 1.4 for 2001). In 2001 the average rate ceiling was removed.

[55] To compensate for the effects of the new tax arrangement, *Irpef* tax brackets were re-designed and tax rates reviewed. Tax credits were even more linked to income levels and family status. Further reductions were enacted only starting in 2000.

[56] A new system of taxation for managed portfolios through approved intermediaries was introduced, which was compulsory for investment funds. A 12.5 tax rate is levied on the total net return from managed portfolios (defined as the difference between the market value at the end and at the

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In 2001, the new government submitted to Parliament a proposal for a new tax reform.

The proposal envisages a radical change of the structure of Irpef. The tax structure is changed, by applying a basic proportional rate (23 per cent) to the portion of incomes below 100 thousand euros and a second rate (33 per cent) above. More than 95 per cent of the taxpayers would end up inside the first bracket. Progressivity is ensured by deductions. All tax credits are replaced by income deductions, the nature of which has not been specified yet.

As to profit taxation, the proposal envisages a return to the pre-1998 situation by the abolition of DIT and IRAP and the enforcement of a uniform corporate tax rate (33 per cent). The incentives in favour of debt finance are restored. Tax levies are redistributed in directions that are opposite to those induced three years ago.

Taxation of savings is affected by milder changes. The issue of a uniform rate is re-affirmed, levelling it out at the lower end between the two rates applying today (12.5 per cent). The choice of a very low rate obviously reduces the redistributive capacity of the tax system. Finally, the new reform would recede from the application of taxation on matured capital gains to go back to the realisation criterion.

4.4 Local government revenue

Local government revenue accounted for less than 8 per cent of general government revenue until 1990. The introduction in 1993 of a municipal tax on real estate incomes (ICI) increased this share to more than 12 per cent in 1997 and the introduction of IRAP in 1998 made it rise above 19 per cent (Chart 14). While since the mid 1990s central government revenue stabilised, local government revenue kept growing.

Fiscal consolidation years were initially characterised by attempts, although limited in scope, to increase the tax autonomy of the lower levels of government. Emphasis was on obligations to fully cover the costs of services supplied. Some increase in local taxes took place, by transferring

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beginning of the period). By doing so, all capital incomes and net gains accruing to the portfolio are included in the tax base and capital gains are taxed according to the maturation rather than realisation criterion. To ensure the same treatment for savings outside investment funds, actually taxed only at the realisation, an equalising system was provided.

minor levies to municipalities and provinces. These measures, however, seemed to contribute to the consolidation process more as a means to justify cuts in the central government transfers to local administrations than to increase tax autonomy per se. In the early 1990s, a substantial revision of the transfer system was enacted. The criteria underlying equalisation moved from expenditure needs to differential endowments in taxable bases. The most important step towards tax autonomy was the above mentioned introduction of ICI in 1993.

At the peak of the fiscal consolidation process, in 1997, the initial push toward an increase in local financial autonomy was somewhat slowed down by the introduction of administrative constraints on local government cash flows. Specific ceilings were set on withdrawals by local administrations from their Treasury accounts.[57] Additional limits were provided for the amounts to be credited on such accounts by central government.[58]

Controls over the Treasury accounts cash flows represented a successful tool to ensure short-term reductions of local public expenditure. Under a longer-run perspective, however, they are inconsistent with tax autonomy and can have adverse effects on efficiency objectives: while financial constraints rely on the scarcity of resources to gain efficiency, financial responsibility implies the possibility to increase available resources through local levies. The ambiguity of the resort to both mechanisms during the fiscal consolidation was not completely overcome in the following years.

The greater boost to local tax autonomy came from the 1998 reform, by the introduction of IRAP. In its early years of implementation, IRAP is earmarked to financing of health expenditure. In perspective, it is going to lose its destination constraint and be available for financing any other category of expenditure.

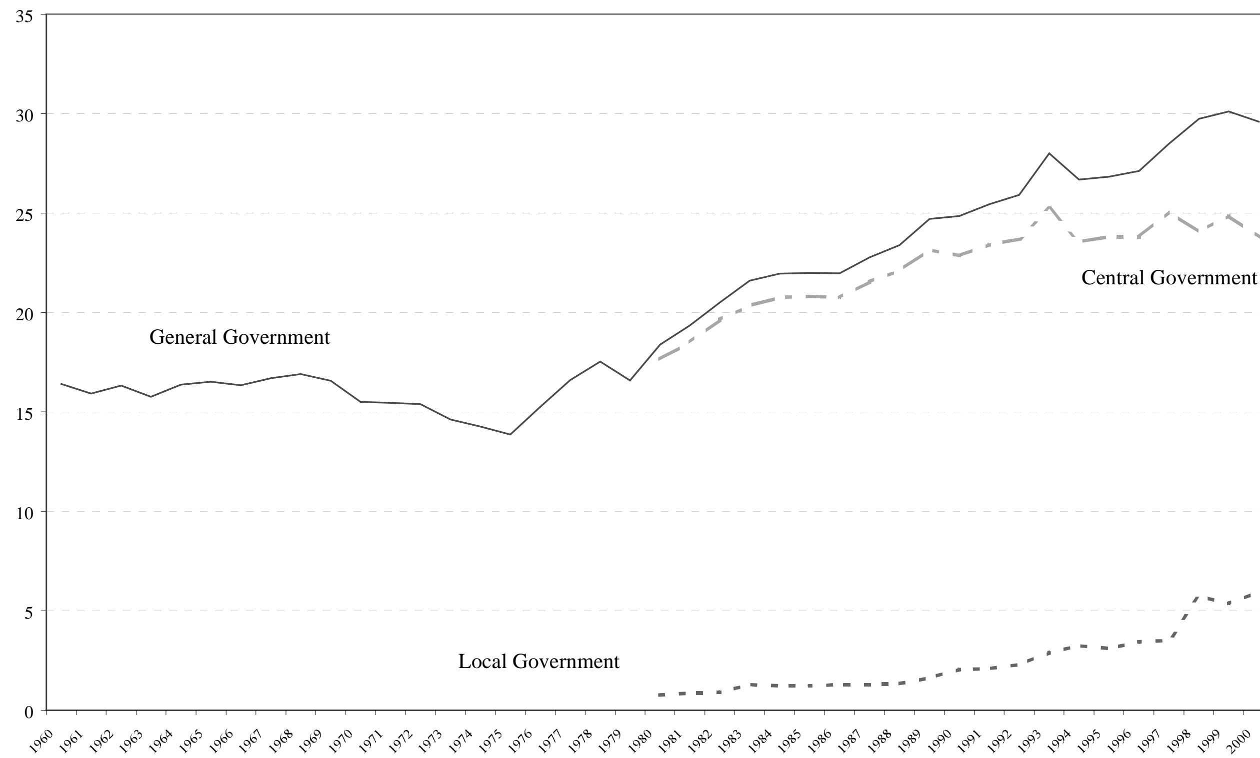
IRAP is levied and administered at the national level, together with personal income and corporate taxes. Revenue is then attributed to regions. To a certain extent, the attribution takes place according to ad hoc parameters rather than to the revenue actually raised in the region's

[57] Within 90 per cent of the amount withdrawn in the same period of the previous year.

[58] No credits were allowed as soon as the cash in hand did not exceed 20 per cent of the amount in stock at the beginning of the year.

Chart 14

General, Central and Local Government tax Revenue
(percent of GDP)



territory. IRAP raises problems of equalisation, since business activity is less equalised across regions than, for example, consumption. To tackle this problem, an equalising fund based on VAT-sharing was introduced.[59]

On the other hand, IRAP has the advantage of a broad tax base, allowing high revenues to be raised (above 20 million euro in 2001). Nevertheless, it is very likely that its revenue will be insufficient to finance health spending in the long run, due to a significantly slower dynamics of its tax basis with respect to health expenditure.

4.5 The tax system in perspective

In the 1980s and 1990s, the Italian tax system largely contributed to fiscal consolidation. The dominance of revenue targets forced tax authorities to postpone important reforms that had already proved necessary by the late 1980s.[60]

In the meantime, the increased openness and integration of the European economies, the liberalisation of commodities and capital movements, the resulting increase in tax competition, shifted the attention of policy makers towards efficiency goals, putting equity in second position. The higher elasticity of economic agents' decisions to tax differences made neutrality, i.e. a reduction in tax distortions, a primary goal. Taxation of capital, more mobile than labour, was attracting most of the attention of policy makers.

This process was common to all the industrialised countries.[61] Many countries revised their tax systems, towards more neutrality, lower tax rates, broader bases. Some countries considered models of dual income tax with increasing interest. By such models, income from capital is excluded from the personal income tax basis and taxed proportionally at the first bracket tax rate. Progressivity is confined to labour income, reducing the redistributive scope of taxation. Significantly, the first countries to introduce these schemes were the Scandinavian ones, where equity reasons had justified high progressivity of personal income taxes for a long time.

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[59] On the calibration of the new system of equalising transfers, see Zanardi (1999).

[60] For the debate about problems and perspectives of Italian tax system at the end of the 1980s, see, among others, Gerelli (1986) Pedone (1989), Ceriani, Frasca and Monacelli (1992).

[61] For an overview of problems and perspectives of the tax systems in the industrialised countries see Sartor (1999), Bernardi (2000a), Tanzi (2000).

Justifications for the choice to tax incomes from capital at a lower rate rely on the need to avoid its migration[62] and gain competitiveness.

Corporate taxation was subject to revisions, with the aim of reducing tax disincentives on investment decisions. Tax treatment of non-resident incomes, subject to withholding levies according to international bilateral treaties, was already a major factor in the tax competition. Most industrialised countries ended up by completely de-taxing such revenues.

In Italy, only at the end of the 1990s the tax authorities started to lessen the tax burden (at first on capital income), introduce more neutrality in firms' finance decisions, revise the personal income tax (reducing the number of brackets and the top marginal tax rate) and decentralise revenue. A delayed timing characterised also the de-taxing of non-residents incomes.

Italy has now to catch up with the other countries. Four main issues are to be tackled.

First, the equity issue is still open and possibly worsening. The personal income tax has failed in redistributing resources across citizens. This failure can be exacerbated, in perspective, by the need to further reduce the taxation of capital incomes due to tax competition. Dual income tax systems put a relatively higher burden on income from labour and raise the problem of redesigning public policy in order to compensate for the tax penalisation of labour *vis-à-vis* capital. Unless vertical redistribution is abandoned or severely curtailed, or it is pursued via public spending, it is difficult to envisage ways to design adequately a new personal income tax.

Changes along the lines followed in the last decades do not seem sufficient. Recent policies linked more strictly tax credits to income levels. By doing so, they met again the problems of unrepresentative tax bases. The recent proposals, on the other hand, seem to put less emphasis on redistribution and more on the reduction of the tax burden. The proposals rely on a substantial tax cut, which can make the new regime socially and politically acceptable in the short run. It is less evident whether such acceptance can be maintained in a longer-run perspective, where one-off reductions gained by all taxpayers will presumably be perceived as less relevant than the relative dimensions of tax burdens.

[62] On the issue of tax competition, see for all OECD (1998).

Second, international economic competition and efficiency reasons suggest the need for a significant reduction in the overall tax burden. This will only be attainable if primary expenditure significantly declines in GDP terms. This result may be rather problematic, especially in view of the possible need to replace some of the redistribution carried out by taxation with redistribution through social expenditure.

Third, the decentralisation of the country raises several critical features. A genuine decisional autonomy requires that a substantial autonomy be granted on the revenue side. Co-ordination between higher financial autonomy and the possible need for budgetary constraints from central government, working through very different incentives, must be though of carefully. The increase in tax autonomy of local administrations can hinder the reduction of tax revenue for the public sector as a whole. Moreover, the dimension and the characteristics of the tax bases to be decentralised are crucial and hard to define. In this framework, the envisaged abolition of IRAP could be very problematic.

Finally, there is a need to limit the resort to frequent tax reforms. Radical fiscal reforms are necessarily costly in terms of adjustment costs and loss of certainty in perspective decisions, like those concerning investment and production. As a rule, global reforms should not be undertaken too often and should give economic agents time to adapt to major changes in the incentives structure underlying the tax regime. On the contrary, in recent years, the Italian tax system has been subject to contrasting, radical changes, mainly reflecting different political views about the role of the public sector.

5. The legacy

Starting with persistently high deficits and growing debt, the consolidation process left Italy with a relatively low imbalance and a debt to GDP ratio set on a downward path. In 1997, the decline of the deficit below the 3 per cent threshold set in the Maastricht Treaty allowed Italy to join Monetary Union. Interest rate spreads clearly signal that the possibility of public debt default is no longer an issue.

However, some aspects of Italian fiscal policy remain problematic. This partly depends on the characteristics of the consolidation process.

The first issue is one of sustainability. There is a need to consolidate the budgetary results of recent years and to offset the effects of ageing on public expenditure and the implications of economic integration on revenues. At the same time, fiscal policy must become more growth compatible. Concern over the effects on growth of a significant reliance on tax increases and capital expenditure cuts has already been voiced, but the issue is more general, being relevant for other budget categories (e.g. expenditure on education and research) and public activities (e.g. regulation in the labour and product markets).

Second, the role of stabilisation policy needs to be reconsidered. In the effort to ensure deficit reduction, little space was left to issues related to fiscal stabilisation. In the context of EMU, these issues have regained relevance. The reforms of the tax and social protection systems currently debated will have an impact in this domain.

Third, consistency between fiscal decentralisation and EMU fiscal rules may require significant institutional engineering. During the adjustment, local governments' outlays were kept under control by introducing quantitative limits to transfers from central governments. The present drive towards federalism makes these instruments no longer viable. The issue of fiscal rules for local governments has come to the fore. More generally, there may be a need for a revision of present budgetary institutions and procedures with a view to improving the quality of policy-making.

5.1 Fiscal sustainability

Fiscal sustainability is a central tenet of EMU: it is a precondition for financial and monetary stability. EMU fiscal rules have been designed with the goal of ensuring that national policies maintain a sound fiscal stance.[63] While the rules have so far proved effective in constraining deficit and debt levels, it is too early to draw definitive conclusions as to their effectiveness in shaping fiscal policy over a long time range. Compliance with EMU rules today says nothing about the possibility of compliance tomorrow. Fiscal discipline can be endangered both by policy changes and by exogenous factors, such as the sizeable demographic changes expected in all Western countries. Continuous policy action may therefore be

[63] Balassone and Franco (2001b).

necessary. The time horizon of politicians may not be long enough to ensure that such action is taken.

The arithmetic of sustainability hinges on four factors: the structural primary budget balance (net of cyclical and temporary components), the cost of public debt, stock-flow adjustments and growth.

The reduction of the debt-to-GDP ratio after 1994 relied on high primary surpluses, a declining interest rate bill and a large privatisation programme that kept the stock flow adjustment broadly neutral. It was hampered by the relatively low growth performance.

Net of cyclical and temporary components the primary surplus in 2001 was in the 4-4.5 per cent range. Challenges to the stability of this level and to the achievement of the balanced budget objective set in the Stability and Growth Pact come from two sources. On the one hand, the ageing process is putting an upward pressure on public sector expenditure such as pensions and health care. On the other hand, the ongoing integration of the Single European Market and the process of globalisation exert a downward pressure on tax rates. It should be noted that, ceteris paribus, a primary surplus lower than the one recorded in 2001 by 1 percentage point of GDP would have halted the decline of the debt to GDP ratio.

Given current interest rates, by the year 2003 the interest bill will have almost completed its declining path: the gap between the average cost of public debt, that is affected by past issues of high yield bonds, and cost of newly issued bonds, that reflect EMU-rates, will have largely been closed. In the future, interest expenditure reductions will mostly come from the reduction in the size of the debt.

Stock-flow adjustments should remain broadly neutral: on the one hand the proceedings of privatisation may be lower than in the past decade; on the other hand hidden liabilities have already been sizeably reduced. However, the difference between cash-based and accrual-based measures of the general government fiscal position increased to unprecedented levels in 2002 and widened further in 2001;[64] should the gap persist in the coming years, it may hamper the reduction of the debt to GDP ratio.

[64] See Fazio (2001a).

After a decade of unsatisfactory growth performance, concern over the relatively high tax rates and the relatively low level of capital outlays prevailing in Italy has gained a centre stage position in the public debate. The focus is gradually shifting from the arithmetic of sustainability to its microeconomic underpinnings.

5.1.1 The primary balance: the perspectives

The major source of perspective budgetary imbalances is represented by the ageing process. Raising dependency ratios is likely to increase expenditure on pensions, health care and long-term care and thereby gradually worsen the primary balance. Over the last two decades several studies have provided estimates of pension expenditure trends,[65] while only a few studies have taken a broader view of the implications of ageing.[66]

The Treasury[67] projects the spending of the main pension schemes to rise from 14.2 per cent of GDP in 1998 to 15.4 per cent in 2015 and 15.9 per cent in 2030 (Chart 15). As noted in Section 3, these increase are less dramatic than in most other EU countries, but the present size of pension expenditure makes them hardly sustainable.

The ratio of pensions to active workers is projected to rise from 90 per cent in 1998 to 94 per cent in 2015 and 112 per cent in 2031. The ratio of average pension to average earnings is expected to increase from 15.5 per cent in 1998 to 16.3 per cent in 2015 and to decline thereafter to 14.0 per cent. The decline in the replacement ratio may imply pressure for discretionary increases of pension levels. If pensions were to be fully adjusted to real wage dynamics, the expenditure ratio would increase by about 5 points.

The level of social security spending in GDP terms heavily depends on the evolution of the labour market. The key factors are the participation rates of older workers and of women. Official forecasts[68] also consider a forecasting scenario based on favourable employment trends (the so-called

[65] For a survey, see Franco and Marino (2001).

[66] Ministero del Tesoro (1997) and Franco and Munzi (1997).

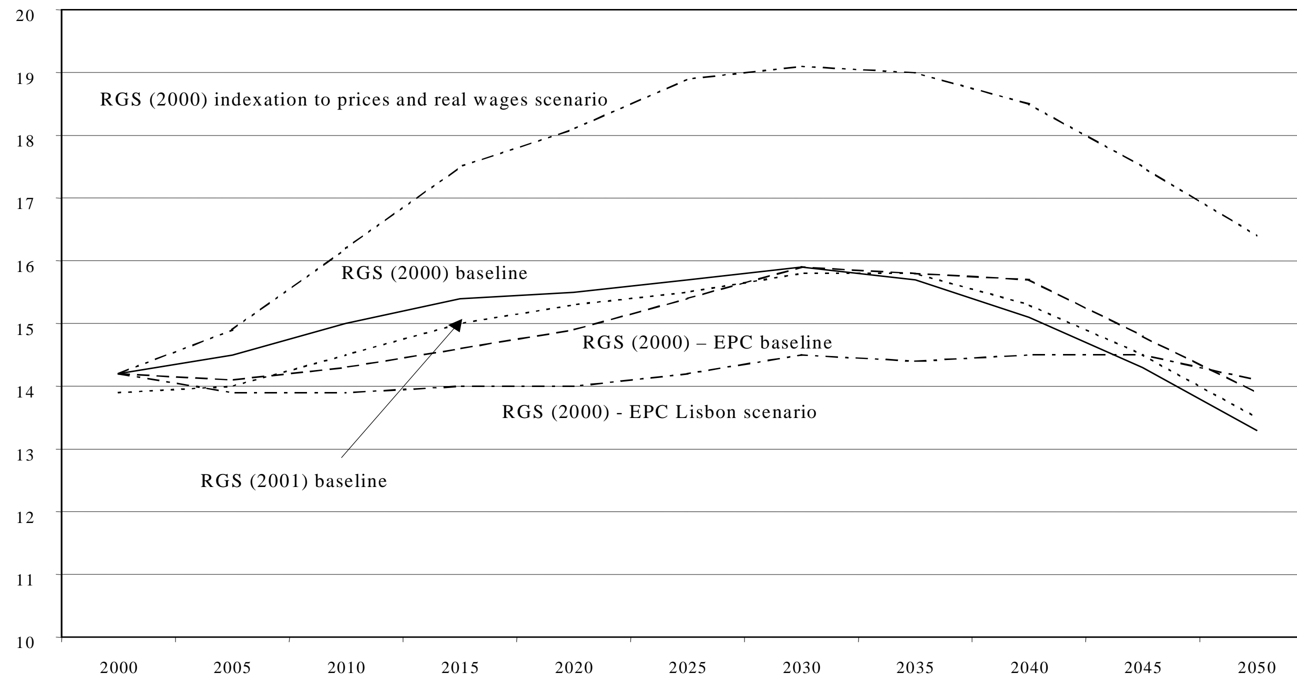
[67] Ministero del Tesoro (2000).

[68] Ministero del Tesoro (2000).

Chart 15

Forecasts of expenditure by the main pension schemes conducted by the State Accounting Office in 2000 and 2001: alternative scenarios

(percent of GDP)



Lisbon Scenario). In this scenario the ratio of pension expenditure to GDP only marginally increases over the next 30 years.

Relevant expenditure pressures are likely to stem also from other areas. On the basis of mechanical projections of current per capita expenditure levels, increases of health spending and non-pension social benefits of about 2 percentage points of GDP by the year 2030 can be expected.[69] Combining these results with the baseline scenario for official pension expenditure projections,[70] the mechanical effects of demographic changes can be estimated in about 3 per cent of GDP.

This implies that, on the basis of current legislation, the primary surplus is set to decline gradually, but that the pressure of ageing is gradual and apparently manageable. The decline in the debt ratio ensuing from the commitment to balance the budget would provide budgetary room for greater age-related expenditure. Lower interest spending will largely offset greater spending on pensions and health and long-term care.

The two alternative pension expenditure scenarios mentioned above point to the uncertainty concerning long-term expenditure trends, to the risks related to the characteristics of expenditure control and to the opportunity offered by the current low activity rates.

On the revenue side, increased openness and integration of the European economies have increased the risk of tax competition leading to revenue losses.

5.1.2 Fiscal policy and growth: the feasibility of tax cuts

According to part of the economic profession and to most policy makers, international economic competition and efficiency reasons suggest the need for a significant reduction in the overall tax burden. However, significant and durable tax cuts will only be attainable if primary expenditure decreases.

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[69] See Franco and Munzi (1997), who also estimated the possible expenditure savings in the educational sector. OECD (2001) offers projections that indicate a rise in the ratio of health spending to GDP in Europe of around 3 percentage points. For Italy, see the projections in Ministero del Tesoro (1996a, 1996b and 1997).

[70] See Ministero del Tesoro (2000).

The narrowness of the path facing Italian fiscal policy can be appreciated by way of reference to the strategy described in *the Economic and Financial Planning Document* (EFPD) for the years 2002-06 and in the *Update of the Stability Programme* presented in 2001 by the Italian government, where the reduction of the tax burden plays a central role.

According to both documents, Italy would achieve a balanced budget by 2003 and keep it thereafter. Over the planning horizon the tax to GDP ratio would decrease by 4 points. The two targets imply a reduction of the expenditure to GDP ratio by about 5.5 points (the deficit amounted to 1.4 per cent of GDP in 2001). Assuming unchanged interest rates, a contribution of about 1.5 per cent may come from interest outlays (Table 1).

Primary outlays amounted to about 41 per cent of GDP in 2001. Pensions account for about 15 points, health care for about 6 points and capital outlays for about 4. Since the government plans not to reduce any of these outlays, other expenditures, currently amounting to about 16 per cent to GDP would have to be cut by 4 points in order to attain the targets set for the deficit and the tax burden. These outlays mainly concern compensation of employees and acquisition of goods and services; assuming a 3 per cent GDP growth rate in real terms – as set in the EFPD, a reduction by four points in terms of GDP would imply and annual cut by about 3 per cent in real terms.

These figures highlight the crucial role that expenditure control is going to play in the next few years. They also suggest that unless action is taken concerning all expenditure items, the task of reducing the ratio of outlays to GDP may prove problematic.

5.2 Stabilisation policies

The need to allow sufficient margins for budgetary flexibility in bad times is another prominent feature of EMU fiscal framework. It is needed for stabilisation policy, which has become more important in EMU as member states can no longer rely either on a monetary policy tailored to national needs or on exchange rate adjustments.

During the 1980s and the 1990s the countries now members of EMU did not use fiscal policy as a stabilising tool. Indeed, according to the European Commission, fiscal policy often assumed a pro-cyclical stance.

Table 1

Italy's general government budget – A medium-term simulation
(percent of GDP)

	deficit	total revenue	total outlays	interest	primary outlays				
					total	pension	health	capital	other
2001	-1.4	45.8	47.2	6.3	40.9	15	6	4	15.9
2002	-0.5	45.5	46	5.5	40.5	15	6	4	15.5
2003	0	45	45	5	40	15	6	4	15
2004	0	43.4	43.4	4.9	38.5	15	6	4	13.5
2005	0	42.4	42.4	4.9	37.5	15	6	4	12.5
2006	0	41.8	41.8	4.9	36.9	15	6	4	11.9
change over the period:	-1.4	-4.0	-5.4	-1.4	-4.0	-	-	-	-4.0

Table 2

Cyclical sensitivity of EMU member states budgets and its composition

	Bel	Ger	Gre	Spa	Fra	Irl	**Ita**	Lux.	NL	Aus	Por	Fin	Euro	DK	Swe	UK	EU 15
Total	0.56	0.45	0.38	0.40	0.53	0.42	**0.48**	0.33	0.69	0.47	0.50	0.55	0.49	0.67	0.75	0.65	0.53
Revenue	0.49	0.40	0.38	0.35	0.48	0.33	**0.47**	0.30	0.45	0.50	0.42	0.48	0.43	0.56	0.61	0.43	0.44
Expenditure	-0.07	-0.05	0.00	-0.05	-0.05	-0.09	**-0.01**	-0.03	-0.24	0.03	-0.08	-0.07	-0.05	-0.11	-0.14	-0.22	-0.09

Deficits did not fall in periods of high growth, because governments offset the effects of the automatic stabilisers via discretionary tax cuts or expenditure increases. Fiscal relaxation in good times made it necessary to take pro-cyclical action in downturns.[71]

The pro-cyclicality of fiscal policies in EMU member states may to some extent depend on how the fiscal stance is assessed. In the case of Italy, for example, while retaining its basically restrictive impact throughout the decade, the effect of the budget on economic activity was mildly counter-cyclical.[72] Indeed, the largest negative effects were recorded in 1994 and 1995, when GDP growth was relatively high.

However, the issue remains of whether such mild counter-cyclical character would be sufficient in the future, given the new context.

EMU fiscal rules, by demanding that a cyclically adjusted balanced budget is maintained over the cycle, should reduce the pro-cyclical bias that seems to have affected European fiscal policy in the past decades. But EMU rules have not yet been tested in the context of severe recessions or large scale asymmetric shocks and, in any case, it is not clear that the envisaged "automatic pilot" version of fiscal policy – in which stabilisers work freely and a cyclically-adjusted balanced budget is maintained – would provide a sufficient degree of cyclical smoothing, in view of the larger requirements of fiscal stabilisation in EMU.[73]

The issue is whether the size and quality of the automatic stabilisers currently embedded in the budget of the general government is adequate to the new framework.

Italy's budget displays a relatively low sensitivity to the cycle. Recent estimates by the ESCB, which refer to the structure of the budget in 1999, suggest a value close to 0.5, in line with the Euro area average, but significantly below the values prevailing in northern European countries (Table 2).[74]

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[71] European Commission (2001), p. 63.

[72] Momigliano and Siviero (2002), who confirm the results of earlier studies for the 1970s and 1980s.

[73] Brunila, Buti and Franco (2001).

[74] See Bouthevillain *et al.* (2001). The relatively low cyclical sensitivity of the Italian budget also shows in the European Commission estimates of the maximum level that the deficit adjusted for the cycle could take without risking to breach the three per cent threshold should a recession take place: the estimate for Italy (1.4 per cent of GDP) is among the highest.

Italy's budget differs from those of other EMU members also with respect to the source of its stabilising capacity: in the case of Italy unemployment related expenditure represents a minor share of the budget (0.4 per cent of GDP) as against an average of 1.3 for the Euro Area and of 1.4 for the EU.

Almost all of the cyclical sensitivity of the budget comes from revenues (99 per cent) as against 88 per cent for the Euro area and 83 for the EU.

Current plans for tax reform should also be assessed also against this background. Making the personal income tax essentially proportional would imply a further reduction of automatic stabilisers. While assessing the appropriate size of automatic stabilisers is not easy, in the case of Italy it would be difficult to argue that the present level is too high.

The composition of Italian stabilisers also highlights the need for improving their quality. It has long been recognised that the composition of social benefits needs to be reassessed. Italy's social expenditure to GDP ratio is not higher than that prevailing in major EMU member states; however, the share of pensions is much higher. A White Book recently released by the Minister for Welfare acknowledges the need for reform.[75]

Given present budgetary constraints, however, the reduction of pension outlays appears to be a pre-requisite for any reform of unemployment related expenditure.

A revision of the scope and structure of unemployment benefits would also have beneficial effects in terms of labour market efficiency as it would be the counterpart to the necessary increase in flexibility.

However, as Italy's economy is markedly dual and suffers from the presence of a large black sector, this strategy is not without risks. On the one hand, benefits may concentrate in the South and be ineffective if the local economy does not pick up; on the other hand, benefits may in fact subsidise the black economy (Table 3).

[75] See Ministero del Lavoro e delle Politiche Sociali (2001).

Table 3

Italy's main economic indicators – Regional breakdown

	Per capita GDP (1)		Unemploy Rate		Black Economy (2)	
	1995	1999	1995	2000	1995	1999
North	123.82	122.59	6.6	4.7	39.99	37.74
Center	107.95	108.26	10.1	8.3	20.02	20.63
South and Islands	66.42	67.50	20.4	21.0	39.99	41.63
Italy	100.00	100.00	11.6	10.6	100.00	100.00
					14.48 (3)	15.09 (3)

(1) As a percentage of Italy's average.
(2) Irregular labour units.
(3) Irregular labour units as a share of total labour units.

5.3 *EMU fiscal rules and fiscal federalism*

Although the 1948 Republican Constitution placed great emphasis on the role of the Regions, five of which were granted a high degree of autonomy under special statutes, the 15 ordinary statute regions were actually established only during the 1970s. Up to the 1980s the responsibilities attributed to regions have been relatively limited.

The contribution of local governments to the fiscal adjustment of the 1990s was governed by instruments typical of a centralised institutional set-up. Mandatory limits for transfers from the State to local authorities were introduced in 1996 and 1997. Overall expenditure ceilings for health expenditure – the major item in regional budgets – were fixed annually.

During the same years, however, the decentralisation process gained momentum and culminated in the constitutional reform of 2001 which has substantially extended regional powers.[76]

In this context administrative instruments are no longer viable. The difficulties met by the Italian legislator in finding new means of control and co-ordination are evident in the layout of the 1999 Domestic Stability Pact.[77]

Its name notwithstanding, the Domestic Pact is a law of central government and does not mimic the European Pact. It is essentially a rule setting maximum ceilings to local governments' deficit growth. Moreover, its features hardly make it a binding rule. First, the deficit referred to in the Domestic Pact is not a comprehensive measure as it is computed excluding health, capital and interest outlays. Second, overruns with respect to the ceiling can be compensated in subsequent years; in this respect, it is important to note that amendments to the original law introducing the Domestic Pact have retroactively redefined the budgetary ceilings, allowing higher deficits than would have been possible otherwise.

De facto, the Domestic Pact is gradually moving towards a cooperation based mechanism, centred around institutional *fora* where fiscal targets are discussed and agreed upon. One category of such agreements between the State and the regions concern health outlays: their effectiveness seem to suffer of a lack of incentives on the part of the regions.

Overall the Pact's features seem to be of little help in disciplining local governments.[78]

This issue, while relevant *per* se, assumes new importance because of its interaction with EMU fiscal rules. While compliance with these rules depends on the behaviour of all levels of government, it is the central government that is held accountable at the EU level. This asymmetry

[76] On fiscal relationships between different government levels in Italy, see Arachi and Zanardi (2000), Buglione (1998), Fausto and Pica (2000) and Messina (2001). On the recent constitutional reform see Balassone, Degni and Salvemini (2001) and Fazio (2001b).

[77] For an analysis of the solutions adopted in other EMU countries, see Balassone, Franco and Zotteri (2002) and the references therein.

[78] For an analysis of the Italian Pact, see Balassone and Franco (2001a); the results obtained are analysed in Balassone, Franco and Zotteri (2001) and in Balassone and Zotteri (2001); for a more optimistic view, see Giarda and Goretti (2001).

increases the need for rules applying to lower government tiers, not only to ensure fiscal discipline, but also to avoid the allocative efficiency losses which would result if central government ends up systematically compensating for the slippages of other government levels.

There is a need for rules or procedures combining decentralisation of fiscal responsibilities with the respect of EMU rules, while avoiding pro-cyclical policies and cuts in capital spending at the local level.

The problem is not restricted to Italy. The solution currently adopted by most EMU member states rely on the strengthening of consensus-based institutions and procedures, with little recourse to formal rules.[79] However, since European rules call for clear accountability and rapid adjustment, in theory the introduction of explicit domestic rules, mimicking the European ones, has marked advantages over purely cooperative mechanisms. The introduction of predefined rules and sanctions may redress the incentive structure facing politicians and induce faster adjustments.[80] It may also increase transparency and allow better control of policy implementation on the part of both the electorate and the market.

Moreover, while cooperation has in most cases proved effective in terms of general government deficit reduction, it may not withstand stress-testing in terms of both economic and institutional developments. For example, cooperative approaches may require protracted negotiations and prevent rapid adjustment of revenue and expenditure to new circumstances. This may especially apply when a large number of governments is involved, to the detriment of the effectiveness of economic policy.

One should consider whether the existing arrangements are adequate to deal with relevant shocks, such as a deep recession. Cooperative approaches similar to those adopted by Italy for the health sector may require protracted negotiations and prevent rapid adjustment of revenue and expenditure to new circumstances, to the detriment of the effectiveness of economic policy. One should also take into account that the process of decentralisation is still on course. If a larger degree of autonomy is introduced in the future, expenditure control may become unfeasible, while it may be advisable to strengthen the role of rules referring to the budget balance.

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[79] Balassone, Franco and Zotteri (2002).

[80] Kopits and Symansky (1998).

Many EMU countries are taking steps towards supplementing cooperation with some rules. Rules can be especially useful in Italy where decentralisation is relatively young and where the number of governments involved is large.[81]

The feasibility of a rules-based approach depends on the adoption of a common accounting and statistical standard. At the European level this was achieved by reference to ESA95. This was also a key element of the cooperatively-defined rules adopted in Austria. Unfortunately, this principle seems to meet greater difficulties in Italy where it is sometimes claimed that the Constitution gives Regions autonomy also with respect to accounting practices. More generally, there is an issue concerning the quality, homogeneity and timeliness of Italian local governments accounting which has so far made it especially difficult to monitor local developments and enforce budgetary discipline.[82]

6. Conclusions

The consolidation of Italian public finances in the 1990s has been highly successful in putting an end to endemic high deficits and preventing the country from sliding into debt default.

The consolidation process, which was started in the mid-Eighties, involved large and continuous fiscal efforts over a long period of time. It required in many occasions the recourse to supplementary budgeting and forced to tackle structural reforms which had been repeatedly postponed. These features reflect the nature of the Italian fiscal imbalance. The large deficits in the middle of the 1980s were not the outcome of an exogenous shock or a temporary fiscal slippage but the result of two decades in which interest expenditure as well as part of primary expenditure were financed by additional borrowing. The very concept of meeting expenditure needs with revenues was lost.[83] Budgetary targets were systematically missed. Rules for local government finance were frequently breached. There was a

[81] In a longer term perspective, direct democratic procedures at the local level (like a compulsory referendum on the level of deficit allowed) may be an efficient instrument in reducing the issuance of debt. The Swiss and US experiences seem to provide evidence in this respect (Feld and Kirchgassner, 2001; Kiewet and Szakaly, 1996).

[82] For example, the budget deficit referred to for the Domestic Pact is computed according to cash accounting rather than according to accruals accounting as the ESA95 requires.

[83] See Steve (1978), Romani (1980) and Salvati (1984).

persistent incapacity to modify the pension system, which promised unsustainable benefits and gradually crowded out other social benefits. As late as 1990, legislation was introduced to further increase pension expenditure. Overall, the Italian deficit in the middle of the 1980s appears to have been more entrenched than in most European countries.[84]

The need for fiscal consolidation was acknowledged well before the European fiscal rules were set in the Maastricht Treaty. However, the efforts put in place during the second half of the 1980s lacked determination and had limited effects. The consolidation process accelerated in 1992 for domestic reasons, when the debt was increasing fast and there was a clear risk of losing control of public finances. The exchange rate crisis triggered policy actions which were already widely considered necessary. There was a broad consensus on the need to avoid the economic, social and political costs of debt default.

After 1992, EMU fiscal rules and the prospects of joining monetary union played a major role in the consolidation process. They provided an incentive to accelerate the adjustment. They guided the choice of the targets and gave a reward in terms of fast interest rate reduction. Credibility effects were very important. Fiscal consolidation without EMU would have been much more costly. Italy would have needed to attain higher primary surpluses and maintain them constant for a longer period.

While fiscal consolidation has avoided major economic and social shocks, it has not been a panacea for Italian fiscal problems. In some areas of public spending it has reduced waste, but it has also induced governments to neglect allocative, distributive and stabilisation issues.

There is now a need to reconsider the targets, procedures and instruments of fiscal policy.

The EMU framework can provide a safe anchor for Italian fiscal policy also in the coming years. It keeps the debt on a declining trend and allows public finance to meet the ageing of the baby boom generation on sounder positions. It may force the introduction of clear budgetary rules for regional and local governments. The credibility effect stemming from

[84] The fragmentation of Italian governments may have had a bearing on the outcomes. For a review of the literature on the politico-institutional determinants of budget deficits, see Alesina and Perotti (1995). Balassone and Giordano (2001) and Padovano and Venturi (2001) model the effects of government fragmentation on deficits and find evidence that this played a role in determining Italy's fiscal policy the 1970s and 1980s.

adherence to the EMU fiscal rules and procedures will continue to bring benefits to Italian public finances, in terms of lower and more stable interest rates on government securities.

To fully exploit the benefits of this framework, fiscal soundness, as demanded by EMU fiscal rules, should now be reconciled with policies focusing on the issues of allocation, distribution and stabilisation.

Economic integration requires an efficient use of resources in the public sector, in order to limit the tax burden. It also requires policy action supporting the competitiveness of the economic system, such as greater funding for human and physical capital accumulation. The design of the tax system should also be examined, in order to reduce distortions on the allocation of resources and disincentives to invest and work.

In the distribution domain, traditional solidarity and social protection objectives are to be reconciled with population ageing, expenditure containment and competitiveness objectives. Moreover, new needs, such as those of elderly citizens in long-term care and lone-parent families, are to be faced. Labour market policies, while going in the direction of achieving a comprehensive system of unemployment support, should be designed to increase labour supply, by assisting job search, supporting retraining and delivering strong incentives to work.

As to stabilisation, monetary union may require a larger role for automatic stabilisers in case of asymmetric shocks. A shift of social spending from pension to welfare and unemployment benefits may compensate for the reduction in the size of automatic stabilisers determined by a less progressive structure of the personal income tax.

There is also a need to improve the statistical information available during the year at all levels of governments. This would make decentralisation compatible with national fiscal targeting and increase transparency in budgetary procedures. There may also be a need to reconsider the timing and features of budgetary policy in a context in which targets are increasingly set in the framework of European fiscal rules.

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