Joint Session
of the Fifth Committees of the
Italian Senate and Chamber of Deputies

# Fact-finding preliminary to the budget for 2000

Statement by the Governor of the Bank of Italy
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Rome, 14 October 1999

## Contents

## 1. *The macroeconomic environment*

In the first half of this year economic activity slowed down in the euro area. Production in France and Spain decelerated but nonetheless increased at a rapid pace; in Germany and Italy it stalled. Activity was helped by the cuts made in short-term interest rates, against a background of price stability, by the national central banks in December 1998 and by the Eurosystem in April this year.

The climate of confidence in the euro area improved during the summer; the growth in production gathered pace; the recovery was also visible in Germany and, to a lesser extent, in Italy. The outlook for the final months of the year brightened for the area as a whole.

There continued to be significant differences between the growth rates of the eleven countries.

In Italy GDP declined in the final months of last year but in the first six months of 1999 it was 0.2 per cent higher than in the preceding half-year. The increase was concentrated in services and construction; industrial production continued to be weak and only began to show signs of recovery in June.

Production was sustained by domestic demand, especially investment, which in the construction sector benefited from the incentives for renovating residential buildings and the low interest rates. Consumption expanded, but only at a modest pace. The improved conditions in the labour market should result in disposable income rising faster, which would benefit households’ spending plans. The contribution to growth of net foreign demand fell further, from -1.1 percentage points in 1998 to -1.4 percentage points in the first half of 1999 in comparison with the same period in 1998. There was a sharp contraction in the current account surplus of the balance of payments that was mostly due to the slowdown in exports, although the latest available data indicate a partial recovery in this component.

Employment has been expanding now for seven consecutive quarters, partly on account of the spread of new types of contract, such as part-time and fixed-term. Between July 1998 and the same month this year there was an increase of 256,000 units, or 1.2 per cent; the unemployment rate declined from 11.4 to 11.1 per cent; the gap between the rates in the Centre-North and the Mezzogiorno widened from 15 to more than 16 percentage points.

The official growth forecasts for this year are substantially the same as those contained in the Economic and Financial Planning Document published in June. For GDP the forecast of 1.3 per cent growth is confirmed. The composition is slightly changed: the expansion in domestic demand is expected to increase from 1.9 to 2.1 per cent; in particular, the contribution of spending by general government and non-profit institutions is forecast to rise; the expected contribution of stockbuilding, which in the June Document was forecast to be -0.3 percentage points, is set at 0.1 points; the negative effect on growth of net exports has been increased from -0.3 to -0.9 percentage points.

The present cyclical recovery will have to strengthen if the Government’s target for growth is to be achieved; the expansion in economic activity in the second half-year would need to be at least on the order of 3 per cent on an annual basis.

## *2. The public finances in 1999*

The Forecasting and Planning Report for 1999 and the subsequent Stability Programme both forecast a reduction in the budget deficit for this year from 2.6 to 2 per cent of GDP as a result of the decline in interest payments. The target for the primary surplus was accordingly left at 5.5 per cent of GDP, as forecast for 1998. In order to achieve this objective, budget measures were needed to reduce net borrowing by 8 trillion lire compared with the figure on a current programmes basis.

The Quarterly Report on the Borrowing Requirement of last March updated the forecasts for the public finances for 1999 to take account both of the less favourable results attained in 1998 and of the deterioration in the outlook for growth. The rise in economic activity forecast for this year was reduced by one percentage point, from 2.5 to 1.5 per cent, and the target for net borrowing set at 2.4 per cent of GDP, as confirmed in the subsequent Planning Document; the primary surplus was set significantly lower.

In the first nine months of this year the state sector borrowing requirement net of settlements of past debts and privatization receipts amounted to 45.5 trillion lire, 13.5 trillion less than in the corresponding period of 1998. According to the forecasts prepared by the Ministry of the Treasury for October, the improvement in the first ten months of the year will be 15 trillion lire, 8 trillion more than expected.

The figures for the general government borrowing requirement, influenced by local government operations, are not so good. The available data cover the first six months of the year and are affected by the postponement of payment of about 25 trillion lire of self-assessed taxes; net of this item the deterioration is about 6 trillion lire.

By contrast, the state sector borrowing requirement for the same period shows an improvement of about 6 trillion lire, net of postponed tax receipts; the divergence of the results of the two sectors is attributable to the considerable volume of borrowing by municipalities and provinces.

The increase in local authority spending is probably larger than forecast. The Technical Note to the Finance Bill refers to the failure to achieve the objectives of the Domestic Stability Pact for 1999 and to a limited overshoot for the year.

Tax receipts in the first nine months were higher than expected, with a consequent increase in their ratio to GDP for the year. The update of the Economic and Financial Planning Document gives no estimate of the increased revenue, leaves the expected value of the ratio for 1999 unchanged and only quantifies the carryover effects from 2000 onwards. The unexpected rise in revenue is attributable to VAT on domestic trade, corporate income tax and receipts from Lotto and other lotteries.

The rise in VAT is due to several factors. The direct tax incentives granted for building renovation projects have had an expansionary effect; as well as providing an incentive to anticipate spending decisions, they may have contributed this year to bringing incomes into the open on which tax would otherwise have been avoided.

Part of the increase is probably the result of administrative measures and steps taken to combat evasion, such as the introduction of sector studies, more incisive controls and the deterrent to reporting manifestly inconsistent income levels following the introduction of the new unitary payment system, and amendments to the procedures for making income tax returns.

Receipts from Lotto and other lotteries have increased substantially; in the first nine months of 1999 they amounted to 10.5 trillion lire, compared with 4.9 trillion in the same period of 1998.

In evaluating the result for the state sector borrowing requirement so as to make an estimate of general government net borrowing for the entire year, there are several factors calling for caution that the Government has rightly taken into account. The Forecasting and Planning Report for 2000 and the Update of the Economic and Financial Planning Document have confirmed the figure of 2.4 per cent for the ratio of net borrowing to GDP in 1999. A better result is possible.

In addition to the difficulty of quantifying the actual size of the increase in revenues, there are uncertainties concerning the instalments of self-assessed taxes still to be received and the receipts from the planned sale of claims of the National Social Security Institute (INPS).

According to the Forecasting and Planning Report, the ratio of debt to GDP will decline by 1.1 percentage points in 1999, from 116.8 to 115.7 per cent, which is less than in 1998. The smaller reduction is primarily due to the slower growth in GDP: at current prices the figure for 1999 is expected to fall short of those recorded in the two previous years by more than one percentage point; other secondary factors contributing to the less pronounced reduction in the debt ratio include the movements on the accounts the Treasury holds with the Bank of Italy and the smaller balance between receipts from the sale of assets and expenditure on debt settlements (forecast at about 3 trillion lire in 1999, compared with almost 10 trillion in 1998). Finally, on the basis of the latest exchange rates, the lira value of liabilities denominated in dollars and yen increased by about 9 trillion lire.

### *3. The objectives for the public finances in the four years 2000-2003*

The Forecasting and Planning Report for 2000 and the Update of the Economic and Financial Planning Document for the four years from 2000 to 2003 confirm the medium-term planning framework. Net borrowing is expected to be close to zero at the end of the four-year period (0.1 per cent of GDP in 2003), after declining from 2.4 per cent of GDP in 1999 to 1.5 per cent in 2000, 1 per cent in 2001 and 0.6 per cent in 2002.

More than 75 per cent of the reduction in net borrowing is expected to come from the fall in interest payments. Even though the official estimates assume an increase in interest rates on twelve-month Treasury bills, this item is forecast to fall from 7.1 per cent of GDP in 1999, to 6.5 per cent in 2000 and to 5.3 per cent in 2003 as a result of the lagged effects of the steep decline in yields in recent years. The primary surplus is forecast to increase from 4.7 per cent of GDP in 1999 to 5 per cent in 2000 and then to rise gradually to 5.2 per cent in 2003.

The ratio of debt to GDP is projected to fall by more than 15 percentage points over the four-year period, from 115.7 per cent in 1999 to 100 per cent in 2003.

The June 1999 Planning Document forecast that revenue would fall from 46.5 per cent of GDP in 1999 to 44.9 per cent in 2003, with the ratio of taxes and social security contributions to GDP falling by 1.3 percentage points over the four years.

Current primary expenditure was forecast to fall from 37.9 to 36.2 per cent of GDP and capital expenditure from 4 to 3.6 per cent. The task of finding the resources needed to increase the latter was deferred to subsequent Finance Laws and seen as depending on the achievement of more favourable macroeconomic results than those projected.

The planned figures for revenue and primary expenditure in the four years from 2000 to 2003 were basically the same as those on a current programmes basis.

Considering that at least part of the increase in tax revenue expected in 1999 was of a structural nature, the Government has increased the estimates on a current programmes basis by 9.3 trillion lire in 2000, by 9.5 trillion in 2001 and in 2002, and by 10.5 trillion in 2003. The Government proposes to use the increased receipts to grant a roughly equal amount of tax relief, so that the reduction in the fiscal ratio indicated in the June Planning Document remains confirmed.

The actual fall in the fiscal ratio in 2000 will be larger than that indicated in the Planning Document; compared with 1998, it will be two tenths of a percentage point.

In particular, personal income tax is to be reduced next year by around 6 trillion lire by lowering the second income bracket tax rate by one percentage point to 26 per cent, increasing the deduction for the first home and increasing the tax credits for large families. In addition, 3.3 trillion lire of relief is planned to sustain the building industry and reduce the levy on property transfers; the possibility of reducing VAT to 10 per cent for building works is also being considered. Lastly, measures are planned to bring forward the application of Dual Income Tax and extend its application to partnerships with effect from 2001.

## 4. The budget for the year 2000

Setting the additional tax cuts of 9.3 trillion lire outlined above against the deficit reduction of 11.5 trillion lire estimated in the original budget shows that the correction compared with the new improved value of the deficit on a current programmes basis is equal to 2.2 trillion lire.

The expenditure measures are intended to produce a net saving of 8.5 trillion lire; the revenue measures, a net reduction in revenue of about 6.3 trillion.

The contraction of 8.5 trillion lire in disbursements is the net effect of 11 trillion of cuts and 2.5 trillion of increases (1.5 trillion of additional capital expenditure and 1 trillion of additional current expenditure). The cuts comprise 3.3 trillion for transfers to regions, provinces and municipalities, 2.5 trillion for the management of the public debt, 2.4 trillion for intermediate consumption, 1.7 trillion for social security items, 0.7 trillion for public employment and 0.4 trillion for minor items. Around 1.5 trillion of the forecast reduction in expenditure refers to interest payments.

*The reduction in transfers to regions, provinces and municipalities (3.3 trillion) is obtained under the Domestic Stability Pact, which was introduced in 1999 and requires local authorities to contribute to the achievement of the objectives for the public finances. In the four years from 2000 to 2003 they must reduce their net borrowing by at least 0.1 per cent of GDP every year (about 2.2 trillion lire in 2000); the larger saving indicated in the budget reflects the inclusion of the planned saving that was not achieved in 1999.*

*The saving connected with the management of the public debt (2.5 trillion) is due to lower interest payments and higher interest receipts. Action is foreseen on four fronts: the renegotiation of loans raised by public entities with the related cost borne by the State (0.7 trillion); the early repayment of postal savings securities and their replacement by others with yields that are lower, although still above market rates (0.6 trillion); the investment of treasury balances in higher-yielding assets (1 trillion); and the introduction of repo operations in the government bond market (0.2 trillion).*

*The saving in intermediate consumption (2.4 trillion) is achieved in large part by postponing certain expenditures (1.1 trillion), the remaining part primarily by reducing the related budget appropriations by 5 per cent, making the renewal of supply contracts conditional on price reductions and rationalizing procurement procedures.*

*The saving in social security expenditure (1.7 trillion lire) is to consist primarily of payments by electricity and telephone companies to make good the deficits of their respective pension funds.*

*Public sector hiring will be restricted further and school personnel reduced. Cost-of-living adjustments to certain allowances will also be frozen. The related saving is expected to amount to about 0.7 trillion.*

The net reduction in revenue of 6.3 trillion lire is the result of the additional tax relief (9.3 trillion lire), the temporary investment subsidies introduced this year (1 trillion) and the measures to increase non-tax revenue by 4 trillion lire.

*The increase in non-tax revenue will be generated by the disposal of real estate, mainly by social security institutions. The sales may be made through intermediaries that will subsequently place the assets with final buyers. The public administration may intervene to accelerate the disposals.*

For general government as a whole, it should be noted that some of the measures concerning the public debt and social security are stated as reducing expenditure by around 2.5 trillion lire, whereas they will actually increase revenue. Expenditure will therefore be reduced by 6 trillion lire and revenue by 3.8 trillion.

## 5. Assessment of the budget adjustment and the outlook

The forecast reduction in the deficit from 2.4 per cent of GDP this year to 1.5 per cent in 2000 can be considered adequate for the purposes of achieving a budgetary situation close to balance in a context in which the economic recovery is still uncertain. About two thirds of the improvement is due to the further decline in interest payments.

As mentioned earlier, the Update of the Planning Document assumes that the better-than-expected result foreseeable for revenue in 1999 has a structural component that will increase tax revenue by more than 9 trillion lire in 2000 and even more in subsequent years. As regard VAT, the additional receipts attributable to the incentives for renovating residential buildings are certainly temporary and matched by future revenue losses as the related personal income tax credits mature. Lotto receipts depend on the behaviour of players; it is therefore difficult to identify the structural component.

The uncertainty arising from the inclusion in the calculation of general government net borrowing of receipts from the assignment of contributions claims of the National Social Security Institute also applies to the forecast of receipts of 5.9 trillion in both 2000 and 2001. The trend of the general government borrowing requirement and the failure to achieve the objective the Domestic Stability Pact set for local authorities in 1999 suggest that there is a risk of their expenditure growing faster than expected.

The budget measures can usefully be assessed from three points of view: a) the ability to ensure the objective is met; b) the presence of structural measures; and c) the implications for the competitiveness of the Italian economy.

Some expenditure reduction measures may be difficult to implement. Incentives or more stringent constraints are needed for non-state public bodies. There must be adequate procedures to ensure achievement of the benefits of the measures concerning the management of treasury balances and repo operations, and the rapid disposal of real estate.

In the years to come, new measures will be necessary to offset the increased expenditure deriving from the planned postponement of certain items and the drying up of the temporary effects of the payments by electricity and telephone companies, the measures concerning postal savings and property disposals in order to strengthen the structural character of the budget adjustment.

Italy continues to grow more slowly than the other European countries, in part owing to the larger and more intense effort it made to consolidate the public finances. It is also the result of insufficient competitiveness. The weakness of growth in turn prevents a significant increase in productivity, thus increasing unit labour costs.

Since 1997 foreign trade has slowed the growth in GDP. A model of specialization based on low-technology products exposed Italy more than other countries to the effects of the Asian crisis. Despite the modest expansion in domestic demand, the current account surplus is shrinking. The available indicators signal the erosion of Italian industry’s competitiveness.

In the forecasts presented at its recent annual meeting, the International Monetary Fund pointed to an improvement in the outlook for the world economy in the year 2000. Differences in growth rates in the leading economies are expected to narrow. GDP in the euro area is expected to expand by 2.8 per cent, as against 2.1 per cent this year. The growth rate of the industrial countries as a group is expected to remain at 2.5 per cent.

Gross domestic product in Italy could increase by between 2 and 2.5 per cent in 2000; the Government has reasonably forecast a rate of about 2.2 per cent.

Recent budgets have sought to sustain production through incentives aimed primarily at stimulating households’ demand and, to a lesser extent, investment.

In order to strengthen the outlook for growth, it is necessary to boost private and public investment.

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Economic policy for the year 2000 is oriented in the right direction. Economic activity will be stimulated by the planned resumption of public investment, the incentives for private investment in 1999 and 2000 and the acceleration of the planned reduction in the rate of corporate income tax made possible by Dual Income Tax. Nevertheless, in order to achieve faster investment growth it is necessary to improve expectations and, more fundamentally, increase the competitiveness of the Italian economy.

In the medium term, raising competitiveness requires a substantial reduction in the tax burden and a significant expansion of the country's stock of infrastructure, especially in the South. Plans for streamlining government departments and increasing the quality of services must be carried out. Constraints that often restrict the activities of firms without producing corresponding benefits for the public interest must be eased.

Expectations can be improved significantly and a more favourable business environment created at no cost by amending company law, the reform of which is under study, and more generally by reforming business law within a unitary framework.

The Financial Services Law brought the regulation of listed companies closer into line with that in the other leading countries. The reform must be extended to unlisted companies - the most dynamic component of the Italian economy - in order to turn their entrepreneurial drive to full advantage. Bankruptcy procedures are long and costly; they should be adapted to take account of the reform of company law. The new laws should ensure more rapid and final solutions to commercial disputes. The process of simplifying legislation and administrative procedures must be accelerated. The completion of the plans to increase the efficiency of the tax authorities will bring benefits.

Firms must implement strategies that enable them to seize the opportunities for growth offered by the international recovery, technological development and the innovations in economic policy.

Social security reform is a necessary condition for achieving, albeit in the medium term, the objectives for economic growth and tax reductions mentioned above. It is essential to head off the difficulties that will begin to arise in the middle of the next decade. Independently of the budget for the year 2000, the Minister of the Treasury has suggested that it is necessary to reduce social security spending by between 3 and 4 per cent of GDP.

A significant reduction in the ratio of public pension expenditure to GDP could be obtained by tightening the criteria that govern eligibility for long-service pensions while still leaving the necessary margin of flexibility for individual decisions, increasing the age at which citizens qualify for the standard old-age pension and extending the use of mixed (earnings and contributions-based) mechanisms. Ceilings on pensions whose cost is borne by the budget must be accompanied by corresponding limitations on pension contributions. Individuals can achieve the desired level of pension coverage with supplementary pensions.

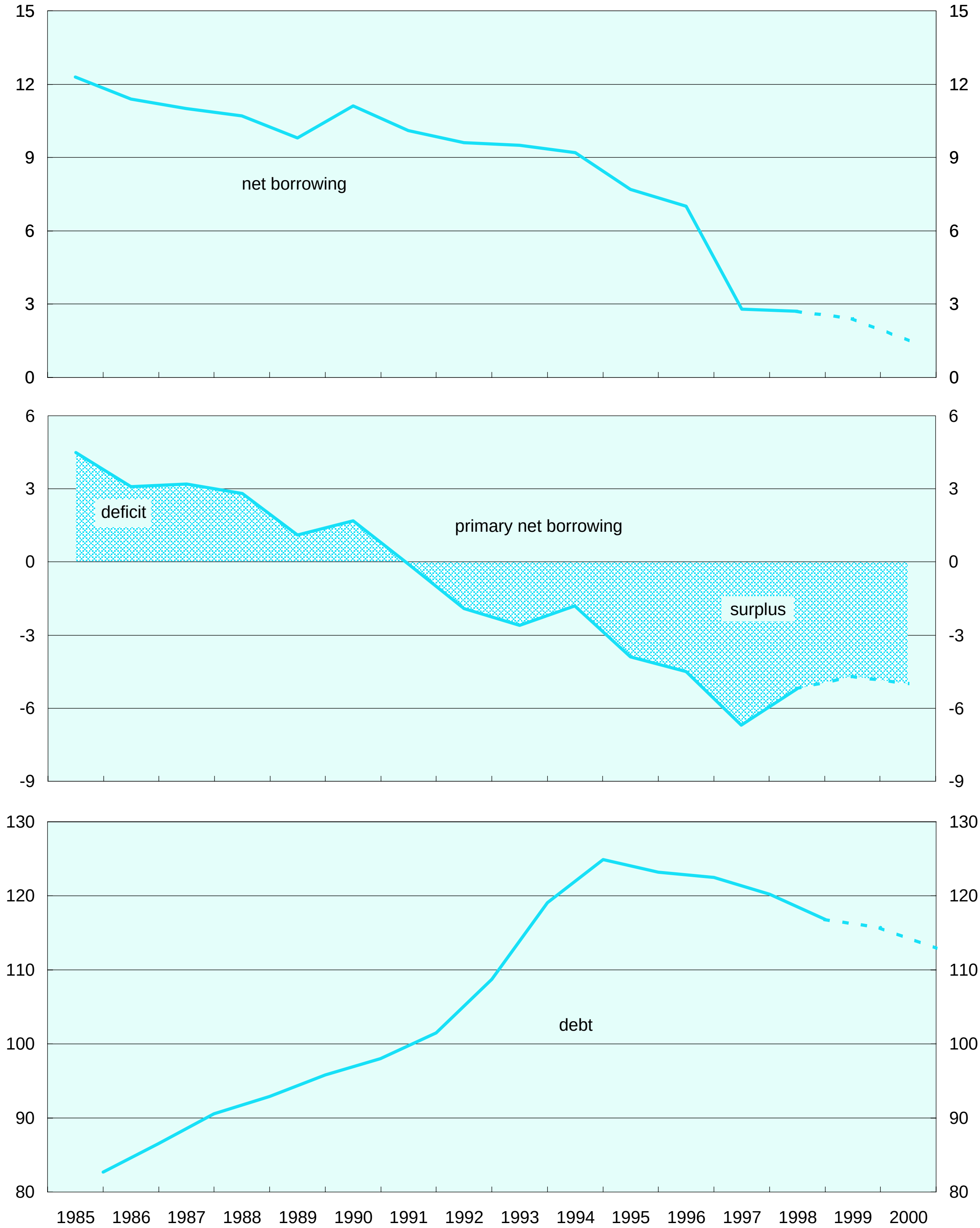
In a situation in which competitiveness can no longer be recouped through exchange rate adjustments and in which markets are increasingly integrated, it is essential to create conditions more favourable to capital accumulation and to curb costs and increase the flexibility of the system in appropriate ways. Italy has the potential to raise its rate of growth even above that prevailing in the euro area and to increase employment by using the available resources of savings and labour.

***Tables and Figures***

**Figure 1**

## General government net borrowing, primary net borrowing and debt (1)

*(as a percentage of GDP)*

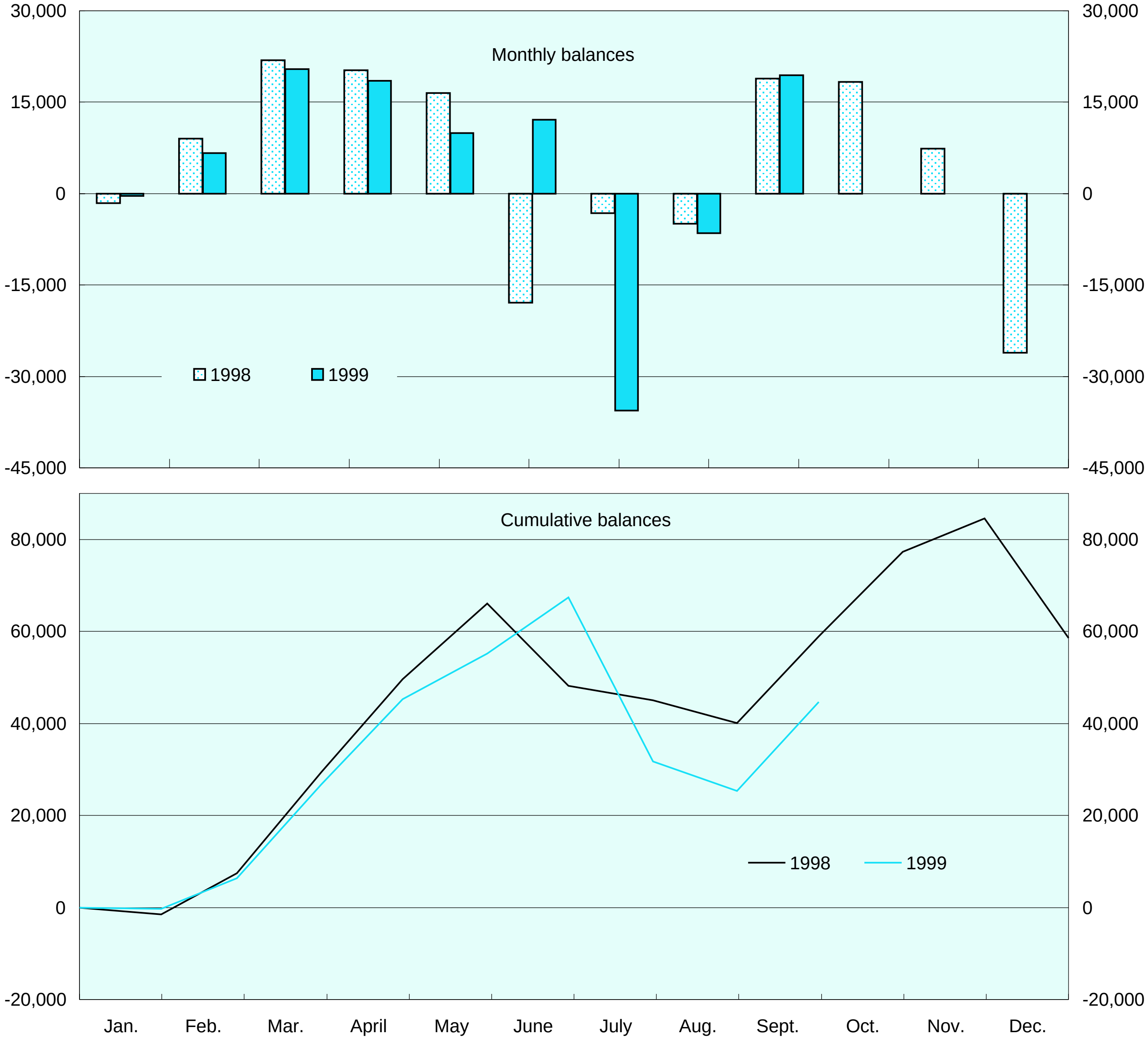



(1) As of 1995 the data are shown according to the new version of the European System of Accounts (ESA95). For 1999 and 2000, forecasts taken from the Relazione previsionale e programmatica (October 1999).

**Figure 2**

## State sector borrowing requirement in 1998 and 1999 (1)

*(billions of lire)*

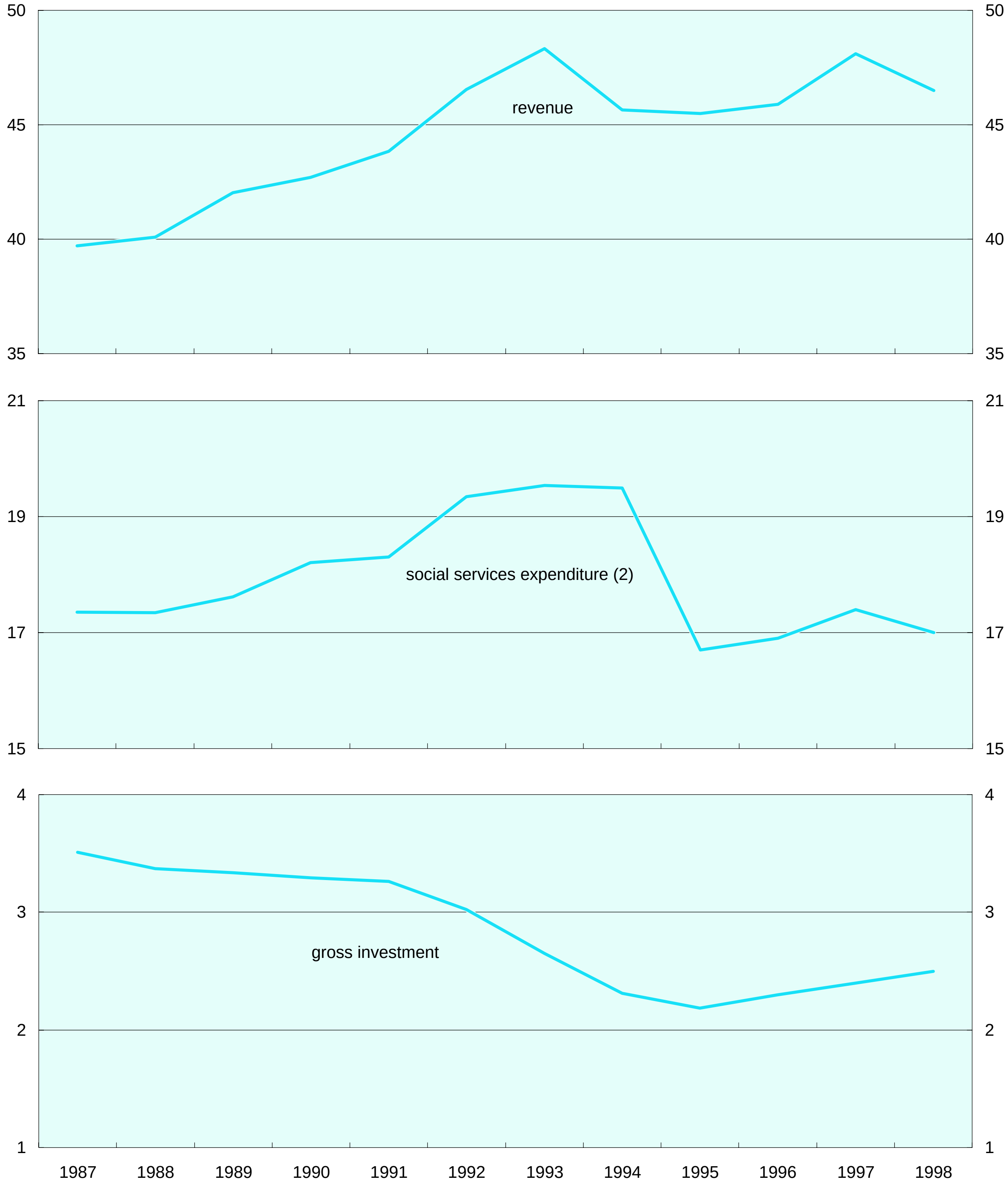



(1) Net of settlements of past debts and privatization receipts.

**Figure 3**

## General government revenue, social services expenditure and gross investment (1)

*(as a percentage of GDP)*




(1) As of 1995 the data are shown according to the new version of the European System of Accounts (ESA95).

(2) The break in the series between 1994 and 1995 is due to the reclassification of social services in kind under intermediate consumption, according to ESA95.

Table 1

# State sector balances (1)

*(billions of lire and percentages of GDP)*

| | Year | | | First 9 months | |
|---|---|---|---|---|---|
| | 1996 | 1997 | 1998 | 1998 | 1999[2] |
| **Primary surplus** | **66,129** | **124,148** | **91,730** | | |
| *as a percentage of GDP* | *3.5* | *6.3* | *4.5* | | |
| **Borrowing requirement net of settlements of past debts and privatization receipts** | **128,871** | **52,670** | **58,523** | **58,949** | **45,446** |
| *as a percentage of GDP* | *6.8* | *2.7* | *2.8* | | |
| Settlements of past debts[3] | 13,502 | -409 | 4,770 | 2,368 | 9,461 |
| Privatization receipts[4] | -6,226 | -21,179 | -14,291 | -8,152 | -1,768 |
| **Total borrowing requirement** | **136,147** | **31,081** | **49,002** | **53,165** | **53,139** |
| *as a percentage of GDP* | *7.2* | *1.6* | *2.4* | | |
| **Financing** | | | | | |
| Medium and long-term securities | 126,909 | 99,009 | 79,662 | 94,171 | 83,651 |
| Treasury bills in lire and ecus | -27,453 | -82,310 | -35,483 | -23,983 | -15,793 |
| Treasury current accounts with the BI | 17,370 | -3,020 | 15,578 | -6,295 | -14,660 |
| Other BI-UIC financing | 304 | 435 | 384 | 228 | 130 |
| Post Office funds | 12,798 | 11,641 | 6,364 | 2,067 | 11,231[5] |
| *of which: current accounts* | *-1,541* | *-1,062* | *-6,104* | *-3,844* | *0* |
| Bank lending | -9,356 | 1,074 | -6,668 | -4,355 | -3,334 |
| Other domestic financing | 194 | 194 | 405 | 334 | 47 |
| Foreign loans[6] | 15,380 | 4,059 | -11,241 | -9,002 | -8,132 |

**(1) Based on Eurostat general government accounting rules.**

**(2) Provisional data.**

**(3) Includes Local Health Unit debts and the early redemption of a bond loan granted to IRI by the Deposits and Loans Fund.**

**(4) Includes Treasury purchases of shareholdings in STET drawing on the sinking fund for the redemption of government securities: 3,000 billion lire in 1996, 13,500 billion in 1997 and 8,166 billion in 1998.**

**(5) Estimated data.**

**(6) As of 1999 includes commercial paper.**

**Table 2**

# Estimated effects of the budget for the year 2000

*(billions of lire)*

| | |
|---|---|
| **REVENUE** | |
| **1. Increase in revenue** | **4,000** |
| *- Property sales* | *4,000* |
| **2. Social and development policies** | **-10,300** |
| *- Incentives for investments in 1999-2000* | *-1,000* |
| *- Reduction in the 27% personal income tax rate to 26% and tax relief for dependents and housing* | *-6,000* |
| *- Tax credits for building renovation works - Reduction in taxation of transfers of ownership - Other measures* | *-3,300* |
| **TOTAL REVENUE (net increase in revenue)** | **-6,300** |
| **EXPENDITURE** | |
| **1. Reduction in expenditure** | **11,000** |
| *- Domestic Stability Pact* | *3,300* |
| Stability Pact savings in 2000 | 2,200 |
| Recovery of shortfalls in 1999 Stability Pact savings | 1,100 |
| *- Debt management* | *2,500* |
| Management of treasury balances | 1,000 |
| Renegotiation of loans | 700 |
| Post Office savings | 600 |
| Repurchase agreements | 200 |
| *- Intermediate comsumption* | *2,400* |
| Postponement of expenditure | 1,100 |
| 5% reduction in appropriations | 700 |
| Reorganization of procurement procedures for goods and services | 200 |
| 3% reduction in supply contracts | 100 |
| Other | 300 |
| *- Pensions* | *1,700* |
| Special fund for electricity workers | 1,350 |
| Special fund for telephone workers | 300 |
| Other | 50 |
| *- Public employment* | *700* |
| Restrictions on recruitment | 350 |
| Freeze on revaluation of allowances | 200 |
| Reduction in school personnel | 150 |
| *- Other expenditure* | *400* |
| **2. Social and development policies** | **-2,500** |
| *- Increase in current expenditure* | *-1,000* |
| *- Support for capital expenditure* | *-1,500* |
| **TOTAL EXPENDITURE (net reduction in expenditure)** | **8,500** |
| **TOTAL REDUCTION IN PRIMARY NET BORROWING** | **2,200** |

Table 3

## The public finances: outturns and objectives

| | 1998 | 1999 | 2000 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|
| | *(billions of lire)* | | | *(as a percentage of GDP)* | | |
| **State sector** | | | | | | |
| Borrowing requirement[(1)] | 58,523 | 53,800 | 41,333 | 2.8 | 2.5 | 1.9 |
| Interest payments | 150,253 | 143,400 | 137,939 | 7.3 | 6.7 | 6.3 |
| Primary surplus | 91,730 | 89,600 | 96,606 | 4.5 | 4.2 | 4.4 |
| **General government** | | | | | | |
| Net borrowing | 56,238 | 51,400 | 33,000 | 2.7 | 2.4 | 1.5 |
| Interest payments | 164,058 | 150,200 | 142,500 | 8.0 | 7.1 | 6.5 |
| Primary surplus | 107,820 | 98,800 | 109,500 | 5.2 | 4.6 | 5.0 |

**Source:** ***Documento di Programmazione Economico-Finanziaria per gli anni 2000-2003.***

**(1) Net of settlements of past debts and privatization receipts.**