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Fact-finding preliminary to the examination of the budget documents for the period 2008-10

Testimony of the Governor of the Bank of Italy
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The public finances have steadily improved since 2006 as a result of a sharp increase in tax revenue, attributable in part to progress in reducing tax evasion and avoidance. The ratio of taxes and social security contributions to GDP will be two percentage points higher in 2007 than in 2005. It will remain stable in 2008 at a relatively high level by international standards.

During 2007 the unexpected revenue has mostly been used to fund increased spending. Similar choices have been made for the 2008 budget, which increases the deficit in relation to that on a current legislation basis. The progress in reducing the budget imbalances is modest. The measures needed to balance the budget are put off to the three-year period 2009-11.

In the two years 2007-08 the ratio of primary current expenditure to GDP will remain constant at the highest levels recorded in recent decades.

The key issue for the public finances in Italy is curbing primary current expenditure. A public spending review, budget reform, and strengthening the mechanisms for making local authorities accountable are important ways of improving the use of resources in the public sector. Studies by the Ministry for the Economy and Finance show that there is ample scope for making savings without compromising the achievement of the main policy objectives.

The progress made in fighting tax evasion and avoidance means that the levy can be redistributed in a fairer and less distortionary way. It is important that social policy be carefully aimed at achieving objectives of fairness. Funded by reductions in expenditure, vigorous action to reduce the burden of taxes and social security contributions on labour and firms would boost the potential growth rate of the economy.

1. *The public finances*

The public finances improved in 2006, reflecting the sharp rise in revenue

Between 1997 and 2005 the general government primary surplus fell from 6.6 to 0.3 per cent of GDP. In 2005 net borrowing amounted to 4.2 per cent of GDP and the debt ratio began to rise again.

Excluding one-off measures, in the three years 2003-05 net borrowing and the borrowing requirement were about 5 per cent and above 6 per cent of GDP respectively.

The increase in the imbalances was influenced by the gap between the strong growth in current expenditure net of interest payments and the modest increase in GDP.

In 2006 the accounts improved significantly. Excluding the extraordinary charges deriving from the cancellation of State Railways debt towards the State and from a European Court of Justice decision on VAT (which together cost nearly 2 percentage points of GDP), net borrowing fell to 2.5 per cent of GDP.

Excluding the effects of the economic cycle and a broader set of one-off measures, net borrowing fell by 1.5 percentage points to about 3 per cent of GDP.

The improvement in the accounts was due to a significant increase in revenue. Taxes and social security contributions rose from 40.6 to 42.3 per cent of GDP. Despite the fairly strong growth in output, the ratio of primary current expenditure to GDP remained basically constant.

In 2006 expenditure (net of the extraordinary charges referred to above) and revenue increased by €25.6 billion and €48.5 billion respectively and the deficit was reduced by €23 billion.

In 2006 the ratio of debt to GDP rose further, to 106.8 per cent.

The improvement in the accounts in 2007 is again due to the rapid growth in revenue

The improvement in the accounts has continued in 2007. As in 2006, tax revenue forecasts have been increased several times.

In September 2006 the Forecasting and Planning Report estimated net borrowing in 2007 would be 2.8 per cent of GDP.

In March, the Combined Report on the Economy and Public Finances projected net borrowing on a current legislation basis at 2.3 per cent of GDP.

In June half of the unexpected revenues were earmarked to finance additional spending

At the end of June, the Economic and Financial Planning Document lowered the projection to 2.1 per cent, mainly as a result of a further upward revision of revenue. At the same time measures were adopted entailing additional expenditure amounting to 0.4 percentage points of GDP; net borrowing for 2007 was therefore estimated at 2.5 per cent.

Decree Law 81 of 2 July 2007 provides for an increase in outlays of €5.6 billion in 2007 (a further €0.8 billion comes from the simultaneous revision of the budget) and of €1.6 billion in each of the two following years. Most of the provisions (€2.5 billion) consist in supplementary appropriations or attenuate spending constraints on central government departments. A further €0.9 billion is allocated to finance an increase in low pensions. Resources are made available to modernize the ordinary road and railway network (€0.5 billion and €0.7 billion respectively), for current transfers to public enterprises (€0.3 billion, of which two thirds to the State Railways) and for international peace-keeping missions and humanitarian aid (€0.3 billion). Finally, €0.2 billion is made available for short-term substitution of school personnel and around €0.3 billion for changes to the domestic stability pact.

Additional provisions inserted when the decree was ratified have no final effect on net borrowing. The amendments that increase the deficit (the easing of the constraints imposed by the domestic stability pact, the extension of the IRAP relief on labour costs to banks, financial companies and insurance companies, and the attenuation of the rules on sector studies) are offset by new tax measures (changes in the deductibility of expenses for company cars) and by a reduction in current and capital spending.

In September the further improvement in the projections was used to finance additional spending

At the end of September, the Forecasting and Planning Report further updated the projections for the public finances on a current legislation basis: revenue was revised upwards by more than €6 billion, while expenditure was reduced by nearly €3 billion.

A decree law approved together with the Forecasting and Planning Report allocated the improvement largely to finance a one-off measure for persons with low incomes who are unable to exploit all the income tax reliefs (€1.9 billion, accounted for in the official estimate as a reduction in revenue) and a net increase in expenditure of €5.4 billion.

The technical note appended to Decree Law 159 of 1 October 2007 estimates that the measure entails an expenditure increase of €5.9 billion – most of which for the advance payment of charges pertaining to 2008 – and expenditure savings of €0.5 billion. The additional current expenditure amounts to €2.1 billion, excluding the indirect effects on revenue, and the additional capital expenditure to €3.8 billion. The decree's effects in subsequent years will be negligible. Measures to support the weakest households include the start of a public housing construction programme (€0.6 billion), which will also be used for the modernization of existing dwellings. A further €0.1 billion is allocated for the purchase of property to be leased for social housing. Additional resources are granted for the 2006-07 public employment labour contracts; adjusted for the indirect *impact on revenue, the measure will cost around €0.5 billion. Some current transfers to the State Railways (€1.0 billion) and the National Road Agency (€0.2 billion) are also brought forward. A further €1.5 billion is allocated for other capital expenditure, mainly on the metropolitan transport systems of Rome, Naples and Milan (€0.8 billion) and for the MOSE barrier project and other measures to safeguard Venice (€0.2 billion). Finally, expenditure of €0.9 billion is brought forward for development cooperation and assistance, of which €0.4 billion on capital account. A one-off payment of €150 is to be made to taxpayers whose net personal income tax liability for 2006 was nil, plus an additional €150 for each dependent (€1.9 billion).*

The Report now estimates general government net borrowing for 2007 at 2.4 per cent of GDP.

The fiscal ratio increases; primary current expenditure remains virtually unchanged in relation to GDP

With respect to the forecasts made in the autumn of 2006, which put net borrowing at 2.8 per cent, revenue has been revised upwards by a total of €16.4 billion (1.1 per cent of GDP); excluding the measure in favour of persons with low incomes who are unable to exploit all the income tax reliefs, the increase amounts to €18.3 billion. The estimate for expenditure has been raised by €10.7 billion (0.7 per cent of GDP) mainly as a result of the measures passed in June and September (€11.8 billion).

Over half of the revision to the estimate for revenue (€9.3 billion) was made in March 2007 on the basis of the 2006 outturn for receipts. The subsequent revisions have mainly involved direct taxes (€6.4 billion, excluding the effects of the measure in favour of persons with low incomes who are unable to exploit all the income tax reliefs), in connection with the sharp increase in receipts of self-assessed taxes in the four months from June to September compared with the same period of 2006 (31.1 per cent).

According to the official estimates, without the above provisions net borrowing in 2007 would be close to 1.5 per cent of GDP.

The Report estimates that the ratio of revenue to GDP in 2007 will be 0.6 percentage points higher than in 2006. This increase is largely ascribable to self-assessed taxes paid by enterprises and social security contributions, which include allocations to severance pay provisions.

Compared with 2006, the ratio of primary current expenditure to GDP declines by 0.1 percentage points, to 39.8 per cent. This estimate does not include the cost of the measure in favour of persons with low incomes who are unable to exploit all the income tax reliefs, which, as mentioned earlier, is accounted for as a reduction in revenue. Using the consumer price index as a deflator, expenditure in real terms increases by 2.5 per cent, broadly in line with the average for the last ten years (2.3 per cent).

The estimates given in the Forecasting and Planning Report show capital expenditure increasing by 12.6 per cent and its ratio to GDP by 0.3 percentage points (excluding for 2006 the extraordinary expenditure connected with the decision on VAT and the cancellation of the debts of the State Railways). The measures passed in the second half of the year to increase and anticipate expenditure, of which more than €5 billion on capital account, should reverse the decline recorded in the first half of the year (-4.1 per cent, according to Istat).

The Report estimates that the ratio of public debt to GDP will fall from 106.8 to 105 per cent.

The borrowing requirement is sharply down again this year

The information currently available on the performance of the public accounts basically confirms the estimates contained in the Report.

In the first nine months of the year State budget tax revenue grew by 6.4 per cent. In the first seven months the general government borrowing requirement, net of privatization receipts, was €25.8 billion, almost €15 billion less than a year earlier. Its ratio to GDP in 2007 is the lowest of the last ten years.

The increase in tax revenue has been driven by receipts from self-assessed taxes, which reflect the upturn in economic activity in 2006, the measures taken to counter evasion and avoidance, and the provisions broadening the tax base to offset the effects of the European Court's 2006 decision on VAT. Overall revenue from other taxes has also grown faster than GDP: excluding one-off taxes (receipts from which are down from €5.6 billion to €1.2 billion) and receipts from self-assessed taxes, State budget receipts grew by 5.3 per cent in the first nine months of the year.

As in 2006, VAT receipts have increased faster than consumption, reflecting the shift in the composition of demand towards goods taxed at a higher rate – while consumption of food products has declined, there has been a significant rise in purchases of durables – and the measures taken to reduce the scope of tax evasion and avoidance. Revenue from the withholding taxes on income from financial assets has reflected the strong performance of share prices in 2006 and the rise in interest rates. The rapid growth in social security contributions has been influenced both by payments connected with the transfer to INPS of the portions of workers' severance pay accrued during the year and by the increase in some contribution rates introduced with the Finance Law for 2007.

In the first seven months of the year general government debt rose by €44.9 billion. The main contributory factors were: the overall borrowing requirement (€22.3 billion), curbed by the reduction in the share capital of SACE, which led to €3.5 billion in revenue for the Treasury; the increase, of a seasonal nature, in the assets held by the Treasury with the Bank of Italy (€18.7 billion); and the issue of securities at a discount (€4.1 billion). In the *two-month period from August to September the above-mentioned assets fell by about €9 billion, slowing the rise in the debt by an equivalent extent. In the last quarter they are likely to fall further; at the end of September they exceeded €32 billion.*

2. Forecasts on a current legislation basis and objectives for 2008 and the following years

Despite the improved outlook for the public finances the deficit targets are confirmed

The update of the Economic and Financial Planning Document, presented at the end of September, contained improved public finance forecasts on a current legislation basis for the years 2008-11.

Net borrowing on a current legislation basis in 2008 is estimated at 1.8 per cent of GDP, compared with an estimate of 2.2 per cent last June and 2.9 per cent in last year's Forecasting and Planning Report. However, the objective of 2.2 per cent for net borrowing indicated in the Report is confirmed.

Compared with 2007, the planning scenario shows the ratio of tax and social security receipts to GDP unchanged at 43 per cent. Primary current expenditure increases by 0.2 percentage points, to 40 per cent, equal to the peak reached in 2005. Capital expenditure is expected to fall by 0.4 percentage points.

The targets for net borrowing indicated in last June's Economic and Financial Planning Document for the years 2009-11 are substantially confirmed, even though the estimates on a current legislation basis improve by 0.3 percentage points each year. A balanced budget is expected to be achieved in 2011, the last year of the current legislature; the primary surplus should reach 4.9 per cent of GDP. The public debt should fall below GDP in 2010.

In the planning scenario of the update of the Economic and Financial Planning Document the budget balance adjusted to take account of the economic cycle and one-off measures improves by 0.2 percentage points of GDP in 2008 and by about 0.7 points in each year of the three subsequent years, going from structural net borrowing of 2.1 per cent of GDP in 2008 to close to balance in 2011.

In the official estimates the achievement of these objectives will require yearly interventions to curb net borrowing from 2009-11 of the order of 0.4 percentage points of GDP. This estimate is based on projections on a current legislation basis and therefore excludes some outlays that, while forecast, require the formal adoption of legislative measures (in particular, expenditure for the renewal of public employment contracts, service contracts and contracts for public works). To finance this additional expenditure, the corrective measures will have to be significantly greater than those indicated.

3. The budget for 2008

The budget increases the deficit, offsetting the improvement in the public finances on a current legislation basis

The budget includes several related provisions that the Government intends to present over the coming weeks. These regard the implementation of the Social Security, Labour and Competitiveness Agreement signed by the Government and the two sides of industry in July, government rationalization measures, and social, family, health, infrastructure and environmental policies.

Overall, the budget increases net borrowing in 2008 by €6.5 billion (0.4 percentage points of GDP). It raises resources amounting to €5.4 billion and increases expenditure and introduces tax reliefs amounting to almost €12 billion.

Beginning this year, the analysis of the budget measures and documents has been made easier by their organization according to missions and programmes recently introduced for the State budget.

3.1 Expenditure

Extra resources will be allocated for public employment and the implementation of the welfare agreement

The budget increases public expenditure by €3.9 billion.

An expected €4.7 billion in savings is offset by an increase of almost €8.7 billion in expenditure, two thirds of which is current expenditure.

The increases in current expenditure principally regard public-sector employment (€2.2 billion) and allocations for the July agreement (€1.3 billion).

The resources for public employment serve almost entirely for the renewal of the 2006-07 national contract; together with what was allocated by previous Finance Laws and by the decree law of 1 October, they guarantee an increase in earnings equal to 4.85 per cent beginning in February 2007, as agreed in the spring with the trade unions. Regarding the 2008-09 contract, it should be noted that the accounts on a current legislation basis include: €0.7 billion for an indemnity in 2008 for late signing of the new contract. Other increases in current expenditure regard the ministries (€1 billion), the armed forces (€0.3 billion) and social policies (€0.2 billion).

The domestic stability pact remains largely unchanged

For the first time since 1999, the rules of the domestic stability pact remain substantially unchanged; this contributes to the stability of the legislation and accordingly to its effectiveness. The structure of the pact outlined in the 2007 Finance Law, centred on local government monitoring of balances rather than expenditure, is confirmed. The new structure requires that local entities have significant margins of financial autonomy.

Several new provisions, with costs amounting to €0.3 billion, are introduced to resolve problems that emerged in the first year of applying the new rules for local authorities. The objectives set for those that on average recorded a budget surplus in the three years 2003-05 have been made less demanding; the administrative surplus can be used to finance investment expenses. An adjustment is introduced for the authorities that recorded extraordinary one-off revenue in the period 2003-05, making the objective (calculated on the basis of the results in the same period) less stringent.

In the health sector several regions will be granted a thirty-year central government advance of €9.1 billion, to help implement the plans agreed with the Government to eliminate their deficits. While having significant effects on the borrowing requirement and on the debt in view of its financial nature, the measure does not affect net borrowing.

Under this transaction the regions' liabilities will be replaced by government debts (needed to finance the advance granted to the regions). The impact on the borrowing requirement and on the public debt will not be null (it is officially estimated at €3.2 billion) since about one third of the debts to be repaid are of a commercial nature and accordingly are not included in the public debt.

The increases in capital expenditure (€2.5 billion) are mainly for ministries and the refinancing of measures to support the economy (€1.2 billion), territorial protection, local transport and infrastructure.

More than half of the expenditure savings (€4.7 billion) are on capital account; those on current expenditure (€1.8 billion) are mainly due to a reduction in intermediate consumption.

In detail, savings are expected from the shortening from 7 to 3 years of the time limit before extinction of expenditure arrears (€1.6 billion), from ceilings on extraordinary maintenance expenditure for public buildings (€0.5 billion) and from the requirement that social security institutions' real-estate investments consist exclusively in units of real estate investment funds or shareholdings in real-estate firms (€0.4 billion). Capital grants for business investment are reduced by €0.1 billion.

The reduction in the intermediate consumption of central government departments (€0.8 billion) derives from the introduction of expenditure ceilings on ordinary maintenance of public buildings and on rentals (€0.3 billion) and from the rationalization of procurement of goods and services (€0.5 billion). Parameters are introduced to permit more effective management control by the single departments, and the use of a central purchasing system is encouraged.

Measures to improve public spending and reorganize general government are expected to yield savings of €0.4 billion. Reorganization will involve military justice, local government and mountain communities. Rules are introduced to speed up the computerization of government.

The provisions setting limits on the utilization of some types of tax credit will reduce outlays by €0.3 billion.

3.2 Revenue

The budget measures are expected to reduce tax revenue by €2.6 billion, providing for €3.3 billion in tax reliefs and €0.7 billion in tax increases.

Tax relief of €2.8 billion is granted to households, mainly in relation to first homes (€2.5 billion), and the structure of taxes on companies is modified.

Taxation of households: municipal property tax and income tax relief

Households will get relief on the municipal property tax (ICI) and income tax relief mainly in connection with house rental.

For persons with annual income of €50,000 or less, there is a reduction in the tax on first houses of up to €200, or 1.33 per mille of the tax base, over and above the basic reduction provided for by the central government and others enacted by each municipality. The cost of this measure (€0.8 billion) is charged to the central government, as the revenue loss to municipalities will be made good by central government transfers.

In addition, tenants with a registered lease for their first house are allowed a personal income tax credit of €300 if total income does not exceed €15,493.71 and €150 if it is between that figure and €30,987.41. There is an alternative tax credit for young people aged 20 to 30 for the first three years of a registered lease for their first house. The amount is €991.60 for incomes up to €15,493.71 and €495.80 for incomes between that amount and €30,987.41. Persons with incomes so low as not to be taxable will receive an amount equal to the portion of the tax credit they are unable to benefit from; the procedures have yet to be determined. Overall these measures will entail a revenue loss of €1.3 billion.

It is provided (at a cost of €0.4 billion) that the imputed income from first houses will no longer count in calculating tax credits for dependents and for labour income, and also that taxpayers with only income from real estate up to €500 will be exempt from income tax.

Some other tax reliefs for households are extended, at a total cost of €0.3 billion. Income tax credits for housing renovation expenses are extended to the years 2008-10 (retaining the €48,000 ceiling and the 10 per cent VAT *rate). So are the incentives for upgrading the energy-efficiency of buildings (retaining the 55 per cent tax credit and the ceilings already in place, which vary with the type of work performed).*

Corporate income tax and IRAP: lower rates, broader tax bases

Taxes on companies are reorganized on a large scale, with essentially no net impact on the public finances. The measures involve significant simplification.

Tax rates are lowered. The rate of corporate income tax (Ires) is reduced from 33 to 27.5 per cent and that of the regional tax on productive activities (IRAP) from 4.25 to 3.9 per cent. Nevertheless, the overall rate of taxation remains higher than in many EU countries, including Germany and the United Kingdom.

However, the lowering of the rates will be essentially offset, when the new system is fully in place, by the broadening of the tax bases and by the limits to the use of reliefs granted via tax credits.

The Ires tax base is broadened mainly by setting a new limit to the deductibility of interest expenses and abolishing accelerated depreciation. There will be redistributive effects among firms, generally to the benefit of the less heavily indebted. Also, a more favourable treatment for corporate reorganizations is reinstituted.

To broaden the corporate income tax base, the treatment of consolidated reporting is also revised. The portion of capital gains enjoying the participation exemption is raised to 95 per cent, as for dividends; this measure tends to shrink the tax base. Consistently with the new treatment of interest expense, the rules on thin capitalization and the pro rata capital tax are abolished, simplifying the system.

The tax base for IRAP can now be drawn directly from the company's income statement without the adjustments required for business income, independently of the rules followed in drawing up the accounts (Italian Civil Code or international accounting standards). This produces not only a simplification of formalities but also greater certainty for firms, by reducing the scope for possible disputes.

The restructuring of IRAP is accompanied by the diminution of some tax credits (those for small enterprises and the fixed-amount credit in connection with labour costs); and as for Ires, accelerated depreciation is no longer allowed. For banks and insurance companies the tax base will include 50 per cent of dividends.

Sole proprietorships and partnerships will be able to opt, in place of personal income tax, for separate taxation of retained earnings, at the same rate as corporate income tax.

For self-employed workers and small enterprises with revenues of less than €30,000 a substitute tax regime is introduced with a tax rate of 20 per cent, exemption from VAT and IRAP, and documentation and accounting simplifications.

In addition to the revenue requirement, eligibility for this regime also requires that the taxpayer not have made export sales, not have had any employees during the year, and not have purchased capital goods worth more than €15,000 in the last three years.

At present self-employed workers and small enterprises can opt for one of four different, favourable tax regimes, if they comply with a specific set of requirements (involving amount of revenues, start-up of new business, inclusion within sector studies). Of these regimes, the only one that will remain is that for persons who start up new professional or business activities, and only for the tax year in which the business is started up and the following two.

Finally, some sectoral tax reliefs are extended to 2008, reducing estimated revenue by €0.7 billion.

4. Some evaluations

The crucial problem: controlling expenditure

The Government has said on more than one occasion that the crucial challenge of Italy's public finances consists in simultaneously bringing down the debt ratio and reducing the fiscal burden on honest taxpayers. To achieve these objectives it is necessary to curb primary current expenditure, which in the past few years has grown at a real rate of between 2 and 2.5 per cent a year, and to "spend better" by improving the effectiveness and efficiency of public-sector operations.

Recent fiscal policy decisions do not brake the growth in expenditure. The unexpected additional revenue that has come in this year has gone largely to increasing expenditure. For 2008, the budget will result in a net increase in expenditure of almost €4 billion with respect to the projection on a current legislation basis. This estimate includes the expected effects of an effort to rationalize outlays. However, the spending cuts planned in recent years have not always been carried out in full. Moreover, the recent agreements on pensions will have a significant amplifying impact on expenditure in the medium term.

Partly as a consequence of these fiscal policy decisions, the Government's estimates show primary current expenditure growing by 4.3 per cent both this year and next. In real terms, the increases are close to those registered in the last ten years.

These developments are difficult to square with the medium-term objectives set out in the update of the Planning Document. According to this document's macroeconomic scenario, in order to achieve budget balance in 2011 without increasing taxes or cutting back investment with respect to the levels planned for 2008, the ratio of primary current expenditure to GDP needs to fall by more than 2 percentage points in the three years 2009-11; expenditure would have to decrease slightly in real terms.

If it were also intended to bring revenue as a percentage of GDP back down to the 2005 level (44.4 per cent), the ratio of primary current expenditure to GDP would have to fall by more than 4 percentage points in 2009-11, with expenditure contracting in real terms by more than 2 per cent per year.

As the "Green Paper" prepared by the Advisory Committee for the Public Finances observes, there is ample scope for achieving savings in all the main expenditure items by reorganizing departments, reviewing priorities, assigning duties more precisely and establishing clear criteria for the evaluation of results.

The budget reform and the start of the spending review, implemented at some ministries (Justice, Infrastructure, Interior, Education and Transport), go in the direction of improving the quality of public spending and curbing its level in the medium term. Added to them are the revision of the classification of the State budget, the action begun last year in the health care sector and the proposals for the universities and for the school system.

Entrenched practices, the multiplicity of actors, and the inevitable complexity of the rules mean that expenditure reform is a long-term endeavour. However, it is important to achieve results in the short term too.

The budget balances: a risky postponement

The projected reduction of net borrowing in the two years 2007-08 is slow-paced. Forecast net borrowing this year (2.4 per cent of GDP) is barely lower than last year's figure (2.5 per cent excluding the extraordinary charges for high-speed rail infrastructure and for the decision on VAT). For 2008 the Government confirms the objective of 2.2 per cent, which had been fixed assuming much less favourable developments in the public finances. Excluding the contributions received in respect of employees' severance pay, which will have to be returned to workers, net borrowing would be significantly higher in both years.

According to the Government's estimates, net borrowing will decrease by 0.5 percentage points of GDP in 2007, excluding cyclical effects and one-off measures. The improvement would be smaller if the contributions in respect of *employees' severance pay were included among one-off measures. A further improvement of 0.2 points is planned for 2008.*

The experience of the years 2000-01 suggests it would have been advisable to exploit the positive cyclical phases in order to reduce net borrowing. The decision again to postpone action on the expenditure side increases the budget adjustments needed to achieve a balanced budget in 2011. And there is the risk that cyclical conditions in the future could make the adjustment put off today even more complicated.

The jump in revenue is due in part to factors that may not be repeated in the coming years. Revenue has exceeded the forecasts not only in Italy but in other countries too. In some of them, the extra revenue has gone above all to reducing the budget deficit. In Germany it has been used to achieve a budget position that is broadly in balance as early as this year, with a small surplus planned for 2008, while as recently as 2005 net borrowing exceeded 3 per cent of GDP. Furthermore, as part of the reform of the federal structure, the German government has proposed adopting budgetary rules aimed at ensuring budget balance over the entire economic cycle.

The high fiscal ratio does not come down

The official forecasts indicate that in 2008 the ratio of tax and social security receipts to GDP will remain at the same high level of 2007.

The taxation of households will be affected above all by the new tax breaks for the taxpayer's home, largely offset by the automatic increase in taxation due to fiscal drag.

Personal income tax (Irpef) has a highly progressive structure that, in the presence of inflation, results every year in households' tax liability increasing more than their taxable income. A periodic evaluation of the effects of fiscal drag would help to increase the transparency of fiscal policies.

The taxation of firms will undergo a series of changes that will ultimately tend to counterbalance each other. Some measures involve an appreciable simplification of formalities and an improvement from the standpoint of the certainty of tax rules.

The proposal for the municipal property tax (ICI), a tax that is relatively non-distortionary for economic activity, does not appear to be consistent with the objective, confirmed with the draft enabling law presented in August, of strengthening the tax autonomy of local government bodies. The municipal property tax is the linchpin of local finance in many countries, thanks to the ease of assessing it, the low mobility of its tax base and the latter's relatively uniform geographical distribution compared with other forms of wealth.

The threshold of income below which taxpayers may benefit from the ICI relief, set at €50,000, excludes a limited number of taxpayers. The size of the break for taxpayers who live in a rented home is independent of the number and income of other members of the household and of the zone of residence.

The agreement on pensions attenuates the 2004 reform

The July agreement between the Government and the social partners, which will be incorporated into a bill accompanying the Finance Bill, increases the eligibility requirements for length-of-service pensions, starting in 2008, more gradually than had been established in the 2004 reform.

In a context marked by pronounced ageing of the population, it will only be possible to pay adequate pensions by raising the average effective retirement age.

The agreement postpones the updating of the coefficients for converting accrued contributions into benefits until 2010. This will be 15 years after the introduction of the coefficients, which, moreover, were based on the 1990 mortality tables. The agreement creates the conditions, after 2010, for the coefficients to be updated more frequently and automatically.

Some proposals are inconsistent with the principles of the defined-contribution system

Some of the solutions envisaged in the agreement risk moving the system further away from the basic principles of a notional defined-contribution system: equal treatment of workers and a close link between contributions and benefits. The latter improves labour market incentives, in particular making irregular employment less advantageous, and allows greater freedom to be offered in the choice of retirement age.

More specifically, the agreement indicates the possibility that the coefficients will no longer be the same for all workers, with distinctions made according to sector of activity. The possibility is also mooted of guaranteeing some workers a minimum income replacement ratio of 60 per cent, independently of the contributions paid, the growth of the economy and demographic developments.

Supplementary pension provision remains insufficient

The new rules on supplementary pensions, which entered into force on 1 January 2007, have led to a significant increase in the number of persons signed up with private pension funds, but the proportion of workers who have enrolled is still insufficient.

According to data collected by Covip, the supervisory authority for pension funds, in the middle of 2007 the workers signed up with some form of supplementary retirement scheme (pre- and post-1993 occupational pension *funds, open pension funds, individual pension plans) numbered about 4.3 million (3.3 million at the end of 2006). Counting only private-sector payroll workers, who were affected by the reform of the severance pay system, the number signed up rose between end-2006 and mid-2007 from 1,828,000 to 2,730,000, corresponding to a membership rate of 22 per cent. Members of pre- and post-1993 occupational funds authorized at the end of 2006 numbered 28 per cent of the potential total. The data do not take account of those who were registered for supplementary pension plans via tacit consent (whose number is not yet available).*

To make sure that future pensioners have adequate incomes, it is necessary to continue the efforts to increase the proportion of workers signing up. In particular, it needs to be increased among young workers and employees of small firms and service businesses.

The contribution of persons operating in the asset management field is crucial to ensure that individuals' retirement saving choices are as appropriate as possible. The resources devoted to advising customers need to be increased; the products offered must be simple and meet workers' needs. Administrative and management expenses must be kept as low as possible. Competition between funds must be fostered by guaranteeing the maximum transparency and comparability between the different products. Workers should periodically receive clear information on the public and supplementary pensions they can expect to receive.

Poverty: a serious problem

Some measures are intended to counter poverty and social exclusion. They are in addition to the increases in small pensions approved at the end of June and the measures to strengthen unemployment benefits outlined in the July agreement. According to Istat, in 2006 some 11 per cent of Italian households were poor, that is 2.6 million households and 7.5 million individuals. Poverty is especially common among households in the South, those in which the head of the household is unemployed and those with a large number of members, above all children not of legal age. Italy's poverty rate is high by international standards.

It is important to identify instruments that give systematic support to persons in need. A preliminary assessment suggests that some of the measures proposed could be targeted more specifically at the weakest categories.

Apart from its temporary nature and the implementation difficulties, the subsidy for persons with low incomes who are unable to exploit all the personal income tax reliefs, introduced only for 2007, might not be very effective in reducing the extension of poverty. In particular, it does not take account of households' overall economic conditions.

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The budget for 2008 keeps the main items of the public finances at the levels forecast for this year; it does not take advantage of the good performance of revenue to accelerate the reduction in the public debt; it does not return a significant share of the recent increases in revenue to taxpayers.

Over a longer span of time the Forecasting and Planning Report shows that a one percentage point increase in the growth rate of the economy for ten years would reduce the ratio of the public debt to GDP by about 10 percentage points.

Fiscal policy can be a major factor in the growth of the economy. A pension system that encourages people to continue to work; a tax system that attenuates the heaviest and most distortionary forms of taxation (the measures on corporate income tax and the regional tax on productive activities are steps in the right direction); an education system that, reformed along the lines of the Government's White Paper, guarantees higher and more uniform levels of learning across the country; and a system of social assistance carefully targeted to needy citizens – these are the pillars of such a fiscal policy.

A start has been made on measures to increase the efficiency of public expenditure and improve the organization of the public sector. The challenge is now to achieve a sharp slowdown in primary current expenditure, reduce the burden of taxes and social security contributions on workers and firms, and increase the share of public resources invested in infrastructure and human capital, together with that allocated to the alleviation of poverty.

Tables and Figures

Table 1

Main indicators of general government finances (1)
(billions of euros)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Primary surplus (2)	69.4	55.8	54.8	51.8	40.3	34.4	21.7	17.6	4.7	2.0	38.2
as a percentage of GDP	*6.6*	*5.1*	*4.9*	*4.3*	*3.2*	*2.7*	*1.6*	*1.3*	*0.3*	*0.1*	*2.5*
Interest payments (3)	97.4	86.3	74.4	75.6	78.8	71.5	68.4	65.7	64.2	67.6	74.5
as a percentage of GDP	*9.3*	*7.9*	*6.6*	*6.3*	*6.3*	*5.5*	*5.1*	*4.7*	*4.5*	*4.6*	*4.8*
Net borrowing (2) (3)	28.1	30.5	19.6	23.8	38.5	37.1	46.6	48.1	59.5	65.5	36.4
as a percentage of GDP	*2.7*	*2.8*	*1.7*	*2.0*	*3.1*	*2.9*	*3.5*	*3.5*	*4.2*	*4.4*	*2.4*
Borrowing requirement	19.0	28.5	15.3	26.0	56.9	37.7	40.1	49.7	70.3	54.5	....
as a percentage of GDP	*1.8*	*2.6*	*1.4*	*2.2*	*4.6*	*2.9*	*3.0*	*3.6*	*4.9*	*3.7*	....
Borrowing requirement net of privatization receipts	30.0	36.4	38.0	41.5	61.5	39.7	57.0	58.0	74.9	54.6	....
as a percentage of GDP	*2.9*	*3.3*	*3.4*	*3.5*	*4.9*	*3.1*	*4.3*	*4.2*	*5.3*	*3.7*	*2.4*
Borrowing requirement net of settlements of past debts and privatization receipts	30.2	33.9	31.7	36.9	52.2	34.3	48.4	57.5	73.0	54.3	....
as a percentage of GDP	*2.9*	*3.1*	*2.8*	*3.1*	*4.2*	*2.7*	*3.6*	*4.1*	*5.1*	*3.7*	....
Debt	1,238.1	1,254.2	1,281.9	1,300.0	1,357.3	1,367.2	1,392.4	1,443.4	1,511.2	1,575.4	....
as a percentage of GDP	*118.1*	*114.9*	*113.7*	*109.1*	*108.7*	*105.6*	*104.3*	*103.8*	*106.2*	*106.8*	*105.0*

Sources: For the general government consolidated accounts for the period 1997-2006, based on Istat data; for 2007 estimates in *Relazione previsionale e programmatica per il 2008*.

(1) Rounding may cause discrepancies. – (2) The figure for 2000 does not include the proceeds of the sale of UMTS licences, which are deducted from expenditure in the national accounts. – (3) Includes the effects of swaps and forward rate agreements.

Table 2

General government revenue (1)
(as a percentage of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Direct taxes	15.8	14.3	14.9	14.4	14.7	13.9	13.4	13.3	13.4	14.5	14.9
Indirect taxes	12.2	15.1	14.9	14.7	14.2	14.3	14.0	14.1	14.2	14.8	14.6
Current tax revenue	**28.0**	**29.3**	**29.8**	**29.1**	**28.9**	**28.2**	**27.4**	**27.4**	**27.6**	**29.3**	**29.5**
Actual social security contributions	14.6	12.2	12.2	12.1	12.0	12.2	12.4	12.4	12.6	12.8	13.2
Imputed social security contributions	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2
Current tax revenue and social security contributions	**43.0**	**42.0**	**42.3**	**41.5**	**41.2**	**40.6**	**40.0**	**40.0**	**40.5**	**42.3**	**43.0**
Capital taxes	0.7	0.4	0.1	0.1	0.1	0.2	1.3	0.6	0.1	0.0	0.1
Tax revenue and social security contributions	**43.7**	**42.3**	**42.4**	**41.6**	**41.3**	**40.8**	**41.4**	**40.6**	**40.6**	**42.3**	**43.0**
Other current revenue	3.7	3.6	3.6	3.4	3.5	3.5	3.4	3.6	3.5	3.5	3.4
Other capital revenue	0.3	0.3	0.4	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.2
Total revenue	**47.7**	**46.2**	**46.4**	**45.4**	**45.0**	**44.5**	**45.1**	**44.5**	**44.4**	**46.1**	**46.7**

Sources: For the period 1997-2006, based on Istat data; for 2007 estimates in *Relazione previsionale e programmatica per il 2008*.

(1) Rounding may cause discrepancies.

Table 3

General government expenditure (1)
(as a percentage of GDP)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Compensation of employees	11.5	10.6	10.6	10.4	10.5	10.6	10.8	10.8	11.0	11.0	10.8
Intermediate consumption	4.8	4.9	5.0	5.0	5.1	5.2	5.3	5.4	5.5	5.3	8.1
Market purchases of social benefits in kind	2.0	2.0	2.1	2.3	2.5	2.6	2.6	2.7	2.8	2.8	
Social benefits in cash	17.0	16.7	16.9	16.4	16.2	16.5	16.8	16.9	17.0	17.1	17.2
Interest payments	9.3	7.9	6.6	6.3	6.3	5.5	5.1	4.7	4.5	4.6	4.8
Other current expenditure	2.5	3.2	3.1	3.1	3.2	3.3	3.6	3.6	3.6	3.6	3.8
Total current expenditure	**47.0**	**45.2**	**44.2**	**43.6**	**43.9**	**43.8**	**44.2**	**44.1**	**44.5**	**44.5**	**44.6**
of which: *excluding interest payments*	*37.7*	*37.3*	*37.6*	*37.3*	*37.6*	*38.3*	*39.1*	*39.3*	*40.0*	*39.9*	*39.8*
Gross fixed investment (2)	2.2	2.3	2.4	2.3	2.4	1.7	2.5	2.4	2.3	2.3	2.8
Other capital expenditure (2)	1.2	1.4	1.5	1.4	1.8	1.9	1.9	1.5	1.7	3.7	1.6
Total capital expenditure (2)	**3.4**	**3.8**	**3.9**	**3.7**	**4.2**	**3.6**	**4.3**	**3.9**	**4.1**	**6.0**	**4.4**
Total expenditure (2)	**50.3**	**49.0**	**48.1**	**47.4**	**48.1**	**47.4**	**48.6**	**48.0**	**48.6**	**50.5**	**49.0**
of which: *excluding interest payments* (2)	*41.1*	*41.1*	*41.5*	*41.0*	*41.8*	*41.9*	*43.4*	*43.3*	*44.1*	*46.0*	*44.2*

Sources: For the period 1997-2006, based on Istat data; for 2007 estimates in *Relazione previsionale e programmatica per il 2008*.

(1) Rounding may cause discrepancies. – (2) The figure for 2000 does not include the proceeds of the sale of UMTS licences (1.2 per cent of GDP); in the national accounts these receipts are entered as a deduction from the item "Other capital expenditure".

Table 4

General government borrowing requirement
(millions of euros)

	Year			First 7 months		
	2004	2005	2006	2005	2006	2007 (1)
Borrowing requirement net of settlements of past debts and privatization receipts	**57,462**	**73,047**	**54,336**	**55,699**	**40,610**	**25,527**
Settlements of past debts	529	1,864	243	363	89	299
in securities	*2*	*11*	*2*	*11*	*2*	*0*
in cash	*527*	*1,853*	*241*	*353*	*87*	*299*
Privatization receipts	-8,316	-4,618	-38	-4,025	-38	-3,500
Total borrowing requirement	**49,675**	**70,294**	**54,541**	**52,038**	**40,661**	**22,325**
FINANCING						
Cash and deposits (2)	16,364	21,574	7,601	17,207	10,613	-18,705
of which*: Post Office funds*	*-1,187*	*-4,177*	*-4,957*	*-351*	*-3,107*	*-21,839*
Short-term securities	-998	-924	4,867	20,541	22,804	21,385
Medium and long-term securities	41,609	39,989	33,156	52,971	37,293	36,333
Loans from MFIs	-1,409	5,593	63,594	2,651	914	1,470
Other transactions (3)	-5,890	4,061	-54,677	-41,333	-30,964	-18,158
of which: *deposits with the Bank of Italy*	*-2,578*	*1,197*	*-8,230*	*-41,765*	*-38,251*	*-18,651*
Memorandum item:						
Borrowing requirement financed abroad	4,904	4,007	-7,104	4,749	283	-664

(1) Provisional. – (2) Post Office funds, notes and coins in circulation, and deposits held with the Treasury by entities not included in general government. – (3) Deposits held with the Bank of Italy, securitization receipts and Cassa Depositi e Prestiti S.p.a. loans to general government. Since September 2006 the latter are included in the item "Loans from MFIs".

Table 5

General government selected fiscal indicators: government projections – EFPD of June 2007 and September update (1)

(as a percentage of GDP)

	2006	2007				2008				2009				2010				2011			
	Outturn	Baseline		Target		Baseline		Target		Baseline		Target		Baseline		Target		Baseline		Target	
		June	Sept.	June	Sept.	June	Sept.	June	Sept.	June	Sept.	June	Sept.	June	Sept.	June	Sept.	June	Sept.	June	Sept.
Net borrowing	4.4	2.5	2.4	2.5	2.4	2.2	2.2	2.2	1.8	1.5	1.5	1.9	1.6	0.7	0.7	1.4	1.2	-0.1	0.0	1.3	1.0
Primary surplus	0.1	2.3	2.5	2.3	2.5	2.7	2.6	2.6	3.0	3.4	3.4	3.0	3.3	4.2	4.2	3.4	3.7	4.9	4.9	3.6	3.9
Interest payments	4.6	4.8	4.8	4.8	4.8	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.9	4.8	4.8	4.9	4.9
Debt	106.8	105.1	105.0	105.1	105.0	103.2	103.5	103.2	103.1	101.2	101.5	101.4	100.9	98.3	98.5	99.3	98.4	95.0	95.1	97.2	95.9

(1) The figures for June include the effects of Decree Law 81/2007; those for September take account of the effects of Decree Law 159/2007.

Table 6

Estimated effects of the budget on the general government consolidated accounts (1)

(millions of euros)

REVENUE	
Increase in revenue	**710**
Limitation of group setoffs of VAT	450
Other measures	260
Decrease in revenue	**3,310**
Tax relief for households	2,830
Irpef – deduction first home rent	*1,300*
ICI – deduction for first home	*820*
Irpef – deduction first home	*380*
Other	*330*
Tax relief for companies (2)	480
of which: *tax regime for small and marginal taxpayers*	*210*
NET DECREASE IN REVENUE	**2,600**
EXPENDITURE	
Decrease in expenditure	**4,730**
Current expenditure	1,760
Intermediate consumption	*820*
Reorganization of government departments and improved quality of expenditure (3)	*440*
Cap on tax credit offsets	*320*
Public employment	*90*
Ministry transfer payments	*90*
Capital expenditure	2,970
Lapsing of expenditure carryovers	*1,640*
Building maintenance	*450*
Investments of social security institutions	*400*
Territorial protection	*260*
Investment subsidies	*100*
Other	*120*
Increase in expenditure	**8,650**
Current expenditure	5,900
Public employment	*2,200*
Social security (4)	*1,280*
Intermediate consumption and expenditure of ministries (5)	*1,000*
Armed forces	*310*
Domestic stability pact	*280*
Social and development policies	*180*
Other	*650*
Capital expenditure	2,450
Expenditure of ministries and refinancing of measures to support the economy (6)	*1,170*
Territorial protection	*360*
Local transport	*350*
Infrastructure	*110*
Other	*460*
Other net effects (7)	300
NET INCREASE IN EXPENDITURE	**3,920**
TOTAL INCREASE IN NET BORROWING	**6,520**

(1) Based on official estimates contained in the technical reports and annexes to the finance bill for 2008 (Parliamentary Act No. 1817). – (2) Excluding the initial effects of the changes to corporate income tax (Ires) and the regional tax on productive activities (Irap). – (3) Includes the reassignment of €300 million of revenue under Article 79(1) of the finance bill. – (4) Concerns the appropriations to finance last July's Protocol on social security, labour and competitiveness. – (5) Of which €900 million deriving from changes to Table A. – (6) Changes to Tables B and D. – (7) Effects of the changes introduced with Tables C, E and F.

Table 7a

Requirements to qualify for early retirement (July 2007 agreement)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	as of 2014
Employee workers											
age	57	57	57	57	58	59 (1)	59	60	60	61	61
and											
years of contribution	35	35	35	35	35	35	35	35	35	35	35
and											
sum of age and years of contribution						95 (1)	95	96	96	97	97
or											
just years of contribution	38	38	39	39	40	40	40	40	40	40	40
Self-employed workers											
age	58	58	58	58	59	60 (1)	60	61	61	62	62
and											
years of contribution	35	35	35	35	35	35	35	35	35	35	35
and											
sum of age and years of contribution						96 (1)	96	97	97	98	98
or											
just years of contribution	40	40	40	40	40	40	40	40	40	40	40

(1) As of July.

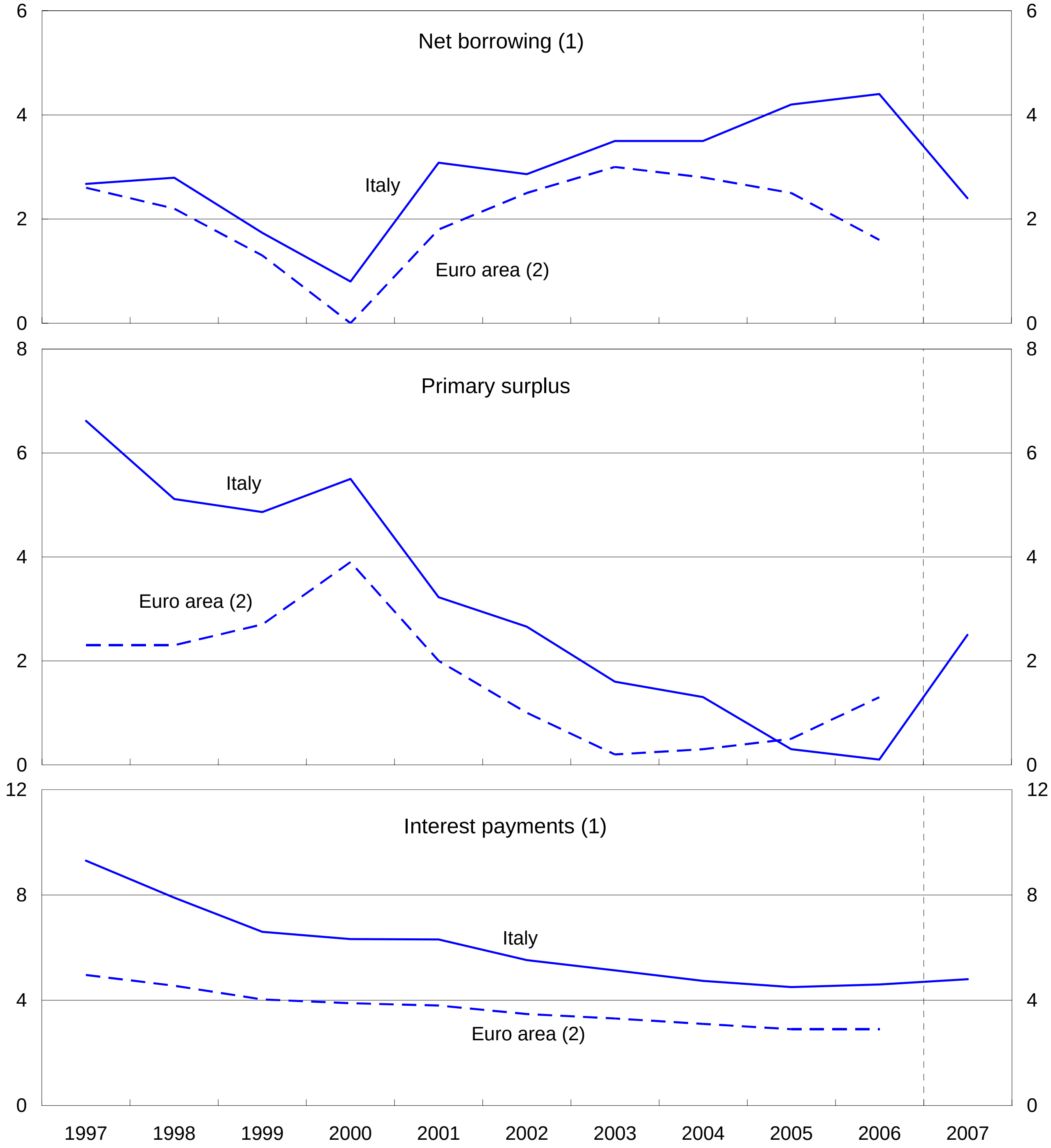
Table 7b

Requirements to qualify for early retirement (2004 reform)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	as of 2014
Employee workers											
age	57	57	57	57	60	60	61	61	61	61	62
and											
years of contribution	35	35	35	35	35	35	35	35	35	35	35
or											
just years of contribution	38	38	39	39	40	40	40	40	40	40	40
Self-employed workers											
age	58	58	58	58	61	61	62	62	62	62	63
and											
years of contribution	35	35	35	35	35	35	35	35	35	35	35
or											
just years of contribution	40	40	40	40	40	40	40	40	40	40	40

Figure 1

General government net borrowing, primary surplus and interest payments
(as a percentage of GDP)



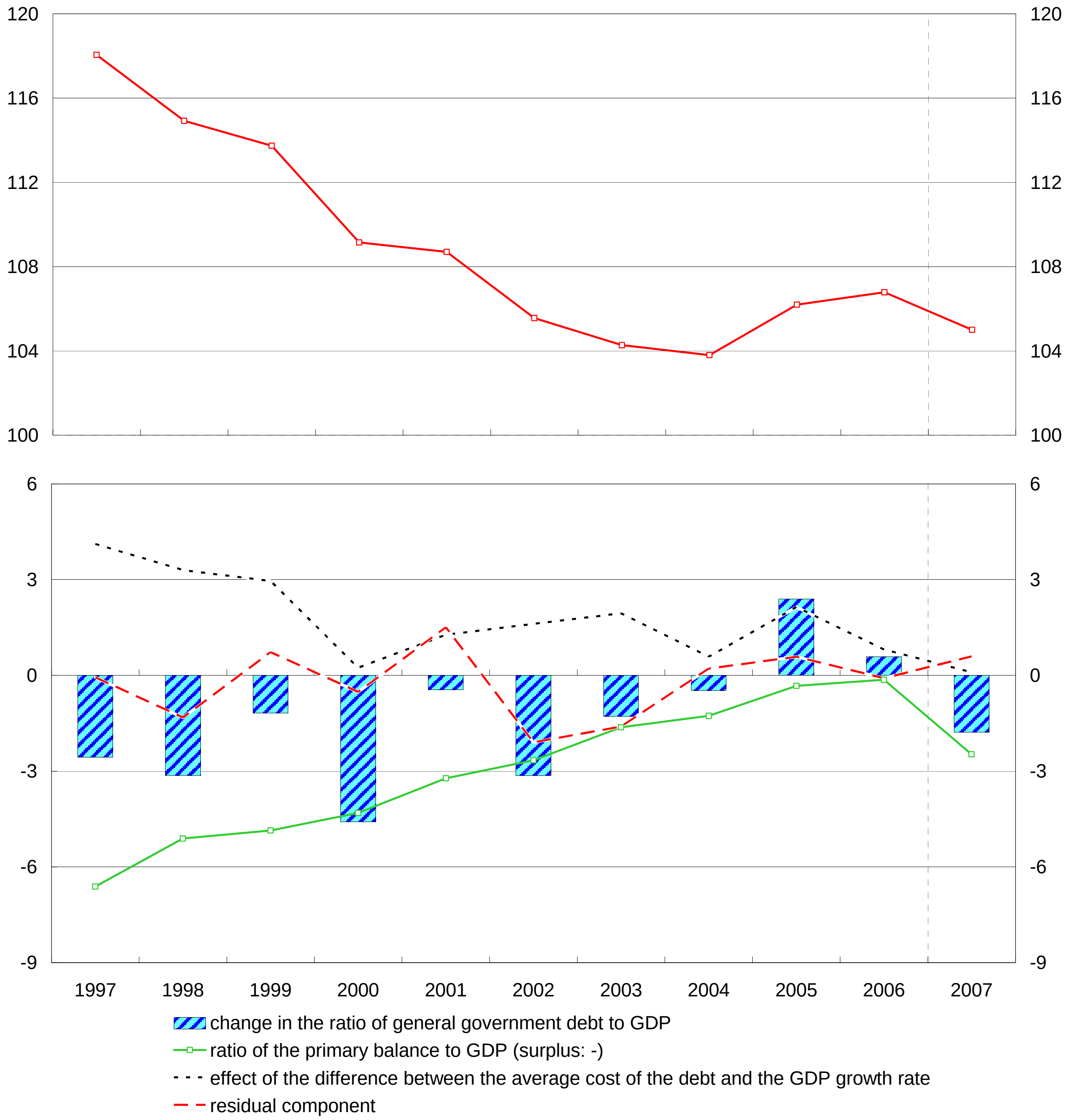
Sources: For 1997-2006, based on Istat and European Commission data; for 2007, estimates in *Relazione previsionale e programmatica per il 2008*.

(1) Includes the effects of swaps and forward rate agreements. – (2) For the sake of comparison, the euro area includes Greece for the entire period considered.

Figure 2

General government debt level and determinants of its change

(as a percentage of GDP)

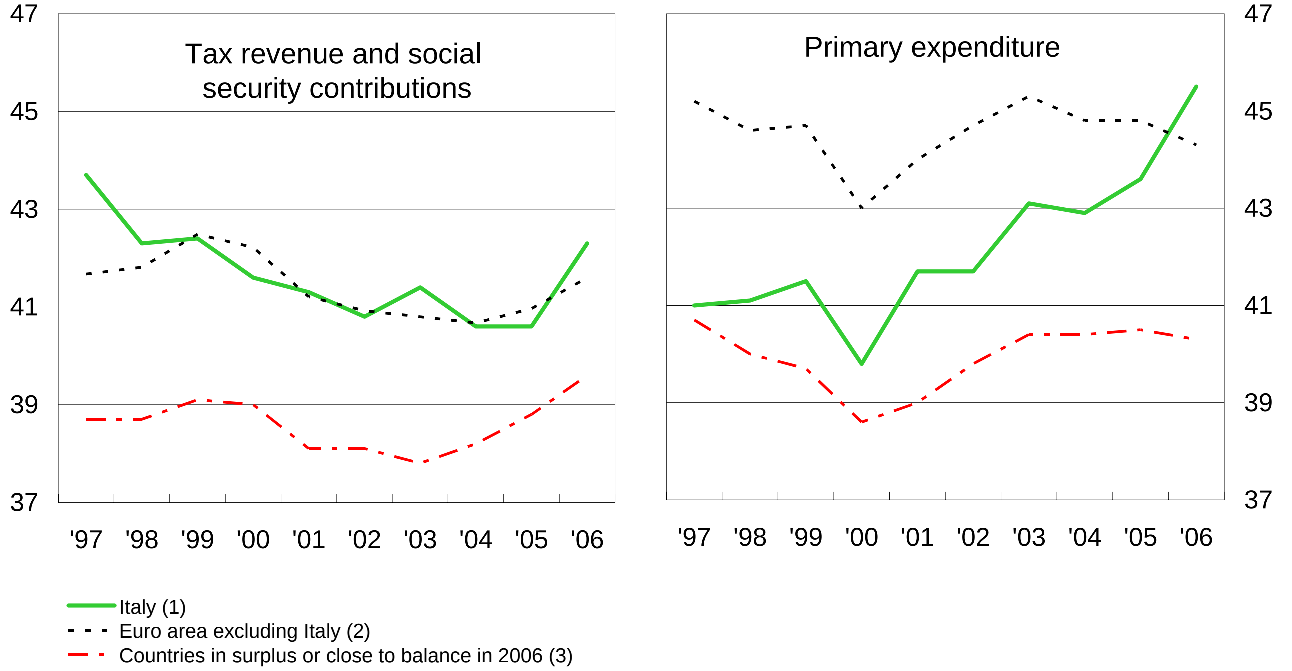


Source: For 2007, estimates in *Relazione previsionale e programmatica per il 2008*.

Figure 3

Tax revenue and social security contributions and primary expenditure in Italy and the euro area

(as a percentage of GDP)



Sources: Based on Istat and European Commission data.

(1) For the sake of comparison with the other countries, the figures for Italy are calculated on the basis of Commission Regulation (EC) No. 1500/2000. Primary expenditure calculated on the basis of this regulation differ from those presented in the traditional general government consolidated accounts owing to the reclassification of some items. – (2) For the sake of comparison, the euro area includes Greece for the entire period considered. – (3) Belgium, Finland, Ireland, Luxembourg, the Netherlands and Spain.

Figure 4

Average cost of the debt, average gross interest rate on BOTs and gross yield of 10-year BTPs

(percentages)

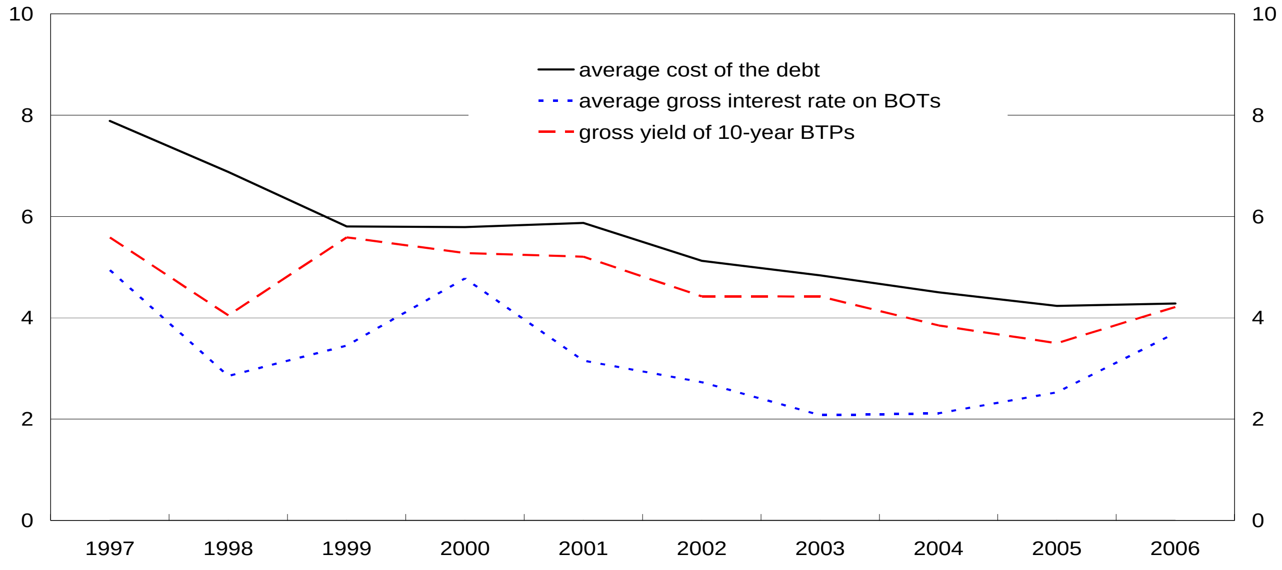


Figure 5

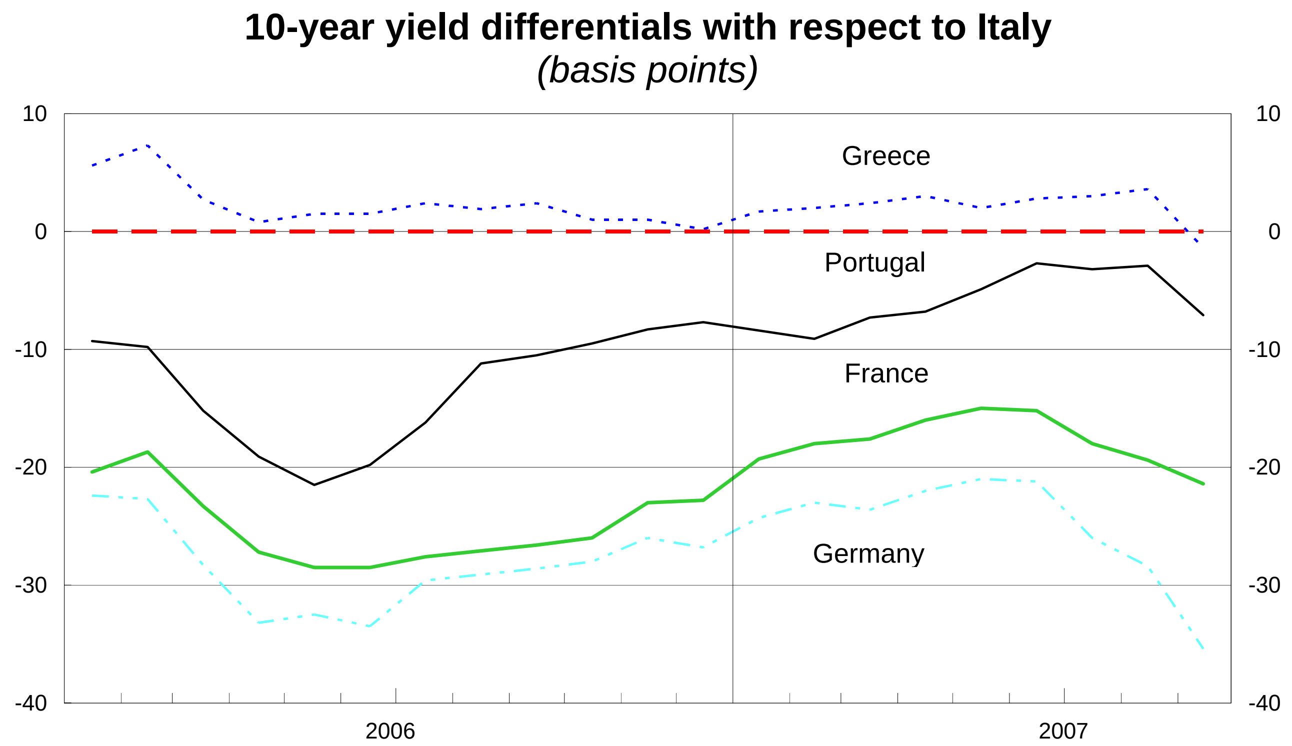
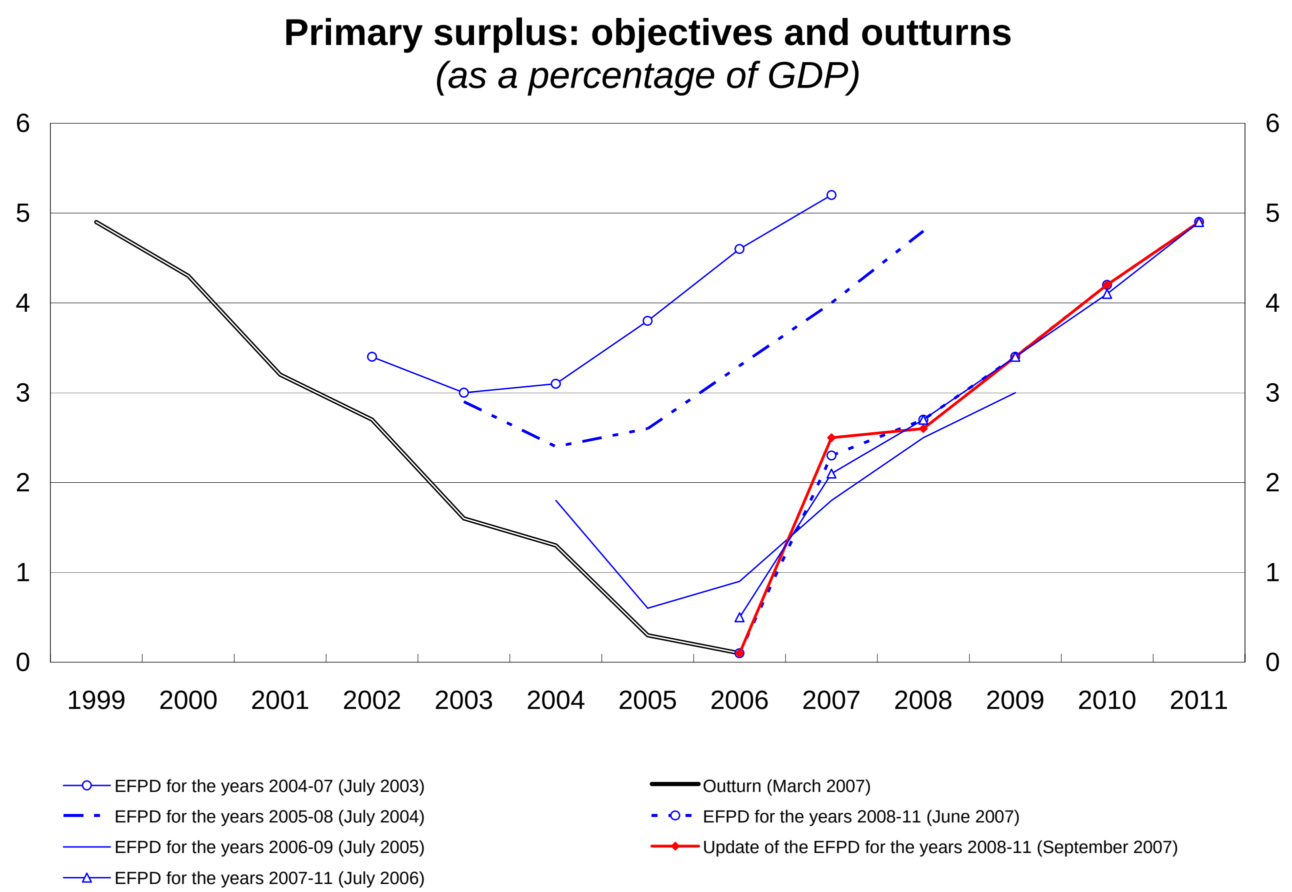


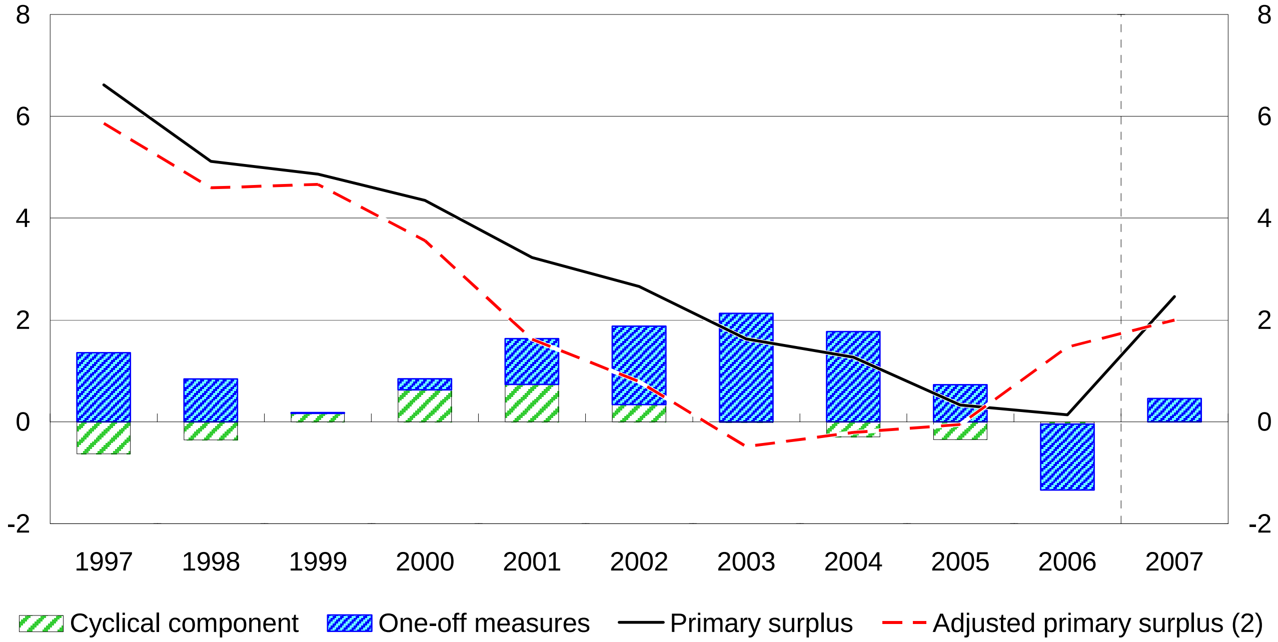
Figure 6



Legend: EFPD = Economic and Financial Planning Document.

Figure 7

Primary surplus and temporary effects (1)
(as a percentage of GDP)



Sources: Based on Istat data; for 2007 the primary surplus is based on estimates in *Relazione previsionale e programmatica per il 2008*.
(1) The estimate of the temporary effects is based on the methods used by the Bank of Italy (see the abridged version of the Annual Report for 2006, pp. 91-92). – (2) Excluding the effects of the economic cycle and one-off measures; as a percentage of trend GDP.

Figure 8

Budget for 2008: composition and effects on net borrowing
(millions of euros)