Standard§Poor's: Italy's 2007 Budget: The Door Closes On Another Consolidation Opportunity
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The 2007 budget bill in the Republic of Italy (A+/Stable/A-1+) is the most important in many years. It constitutes the first major economic policy test for the new center-left coalition of Prime Minister Romano Prodi, following its extremely narrow election victory in April 2006. The hopes surrounding the budget were certainly high--maybe too high. The new government's medium-term financial planning document (known by its Italian acronym DPEF) was published in July 2006 and had outlined ambitious targets of a sustained expenditure-based fiscal consolidation program (see media release "Republic of Italy Will Need Concrete Structural Reforms To Turn Fiscal Plans Into Reality," published on RatingsDirect on July 10, 2006). The swift passage of a mid-year budget correction, accompanied by a first wave of (admittedly relatively minor) supply-side reforms had also raised expectations that this government, after years of tinkering by its predecessor, might at last have the will to address head-on the profound structural problem of Italy's public finances (see media release "Mild 2006 Budget Correction Measures Not Decisive For Sovereign Ratings on Republic of Italy," published on RatingsDirect on July 5, 2006).

Focus On Revenue-Raising Is Inadequate Hope Triumphs Over Experience: The Measures In Detail

Or perhaps not. The 2007 budget bill has disappointed by focusing primarily on revenue-raising measures, while leading to an increase of the share of government spending in GDP, which is very much against the spirit of the DPEF and in stark contrast to what Italy needs. Deep structural supply-side measures to promote productivity and undo the loss of competitiveness that Italian producers endured over the past decade would be far more effective. This would best be accompanied by unerring public expenditure restraint tackling the largest items of current spending, including health care, pensions, civil service costs and intergovernmental transfers. Although the planned overall budget adjustment is very substantial, the aforementioned vital areas of policy intervention have received only scant attention, with the focus very much on raising revenue and redistributing income. Tax increases are designed to achieve both objectives simultaneously. The heavy focus on redistribution was unexpected and is likely to be a reflection of the heterogeneous multi-party coalition, where shifting balances of power and influence can lead to sudden policy reorientation.

The budget bill targets a deficit of 2.8% of GDP for 2007, after 3.6% of GDP in 2006 (or 4.8% including a one-off cost emanating from an adverse VAT decision by the European Court of Justice). Although this is a large adjustment by any measure, it is unlikely to fully materialize. This is not so much because of undue official optimism about the economic environment (the government's 1.3% growth expectation is not far from Standard & Poor's Ratings Services projection of 1.2%) but because of the dependence on the broad success of measures of a largely unquantifiable nature, such as clamping down on tax evasion and making efficiency gains in public administration. The budget also foresees a transfer of around 0.4% of GDP from the company-run severance payment scheme to the state social security institute, which Standard & Poor's will account for as a financing item below the line, irrespective of Eurostat's decision on whether this flow constitutes a deficit-reducing revenue. More worryingly, the budget has not laid the foundations for structural expenditure containment in the future. On the contrary, it may even undermine reform prospects by weakening the hand of the reformers within the government, as many priorities of the trade unions and the less fiscally frugal parties within the coalition have already been satisfied, thus reducing their incentive to relent in the upcoming negotiations on pension reform. In sum, this budget is a far cry from the great leap forward for Italian public finances that some had dared to hope for.

This is a complex budget bill with an even larger number of discretionary interventions than usual. We have summarized the main adjustment measures (the so-called "manovra"), as well as the expansionary (...) initiatives intended to stimulate growth

(...).

The net adjustment is a sizable 0.9% of GDP.

Nevertheless, there are several critical sources of doubt that may lead to a lower-than-planned deficit reduction.

(...) There is little doubt that this government has brought a new fervour in fighting tax evasion into office.

Nevertheless, the hopes pinned on additional revenues from clamping down on the widespread practice of tax fraud seem exaggerated. If measures widening the tax base to control tax avoidance are included, this component of the budget is meant to bring in 0.5% of GDP. As there is no reliable way to objectively predict the productivity of anti-evasion measures, the inclusion of such sizable receipts into the budget is risky.

Another perennial favourite in Italian budgets is the faith in being able to make the public administration more efficient and thus cheaper. Again, the government's assumption may come true in the end, but saving €2.7 billion (0.2% of GDP) within one year is not a trivial task considering that previous budgets have attempted the same, largely without success. The envisaged cuts for central government intermediate consumption are equivalent to 7% of 2005 levels, a tough reduction demand that may not be sustainable even if spending can be curtailed in the short term.

The government wants to continue on the path of reducing civil service staffing and replace only one out of every five employees leaving the service. This policy, which is ambitious by international standards, has not been at all watertight in the past. Moreover, even if the new government adheres to it, this measure will show its full impact only over time. In the near term, however, the government pencilled €1 billion of extra spending into the budget to cope with the overdue increases in public sector wages (the previous contract expired in January 2006). This may well prove to be insufficient, as trade unions may feel emboldened by what they consider a government that is better disposed to them in negotiations. The fact that politicians shied away once again from outright freezes in pensions or wages, as previously undertaken in Germany and Portugal, for example, indicates that the urge to control current spending is still not overwhelming. The fact that public service wages have grown at an average of 4.2% per year since 2000 (compared with 2.6% in the non-farm private sector) could have provided the government with ample justification to call on civil servants' solidarity, but no appetite for such a confrontation currently exists.

The most controversial measure of the budget is certainly the transfer of a part of the annual flows to the hitherto company-run severance payment fund (TFR, trattamento di fine rapporto, equivalent to 7% of a worker's income) to the national social security institute INPS. With an eye on establishing a viable private pension fund industry in Italy, the Maroni pension reform of 2004 had envisaged from 2008 onward a default option for the flows to be redirected to second-pillar pension funds if the worker does not express any other preference. Under the new rules, however, the default option will be that any TFR payments not expressly dedicated to a pension fund will be split equally between INPS and the employer (who currently receives the whole amount, which constitutes a source of cheap financing). The government assumes that, of the approximately €18 billion of TFR flows every year from 2007 onward, one-third will be destined for private pension funds, one-third will remain in the company and one-third will be collected by INPS, which will channel it through to the general state budget.

Given the skepticism with which the Italian public views the local financial industry, these assumed ratios may not be too wide of the mark, although it is once again precarious to put a large revenue item (€6 billion, or 0.4% of GDP) into the budget with no experience regarding the behavioural choices that will be made by workers. As the positive cash flow to the budget is associated with a clearly defined future obligation toward the contributing worker leading to an outflow at a future date, this transaction has the financial character of a loan to the government. Unlike the general pay-as-you-go pension system operated by INPS, the TFR payments of the worker do not result in a unilaterally adjustable collective promise of the government to pay a certain level of pensions at some point in the future. Instead, these payments create an individualized entitlement of a future payment for each single worker. Due to the loanlike character of the TFR transfer to INPS, Standard & Poor's will treat this cash flow as a financing item (below the line), which will not reduce the deficit or debt. This approach is independent from any decision that Eurostat may be taking on the same issue. Furthermore, the transfer may be an inferior way of financing the deficit than outright bond issuance due to the higher rate of interest that the TFR transfer could carry once one includes administrative costs and the envisaged compensations to companies for their loss of a source of cheap financing.

Finally, the government has enlisted local and regional governments in the consolidation effort. This is reasonable given their weight in the overall general government, but it may be hard to credibly commit the lower level jurisdictions to the expenditure discipline that the cut in intergovernmental transfers tries to achieve. In particular, the regions, which are responsible for health care, are expected to raise their own taxes if they cannot comply with the budget balance targets set by the internal stability pact. This will lead to an additional bias toward tax hikes more generally associated with this budget.

In practice, the budget contains measures that move in the right direction, for example in health care, where co-payments and other innovations are expected to lead to sizable efficiency gains and cost savings. But considered as a whole, the trademark of this budget bill is that it has, once again, shied away from addressing crucial areas of sustained current spending pressures. If the structure of the budget were based on a political strategy to facilitate fundamental expenditure reform further down the road, there would be a silver lining to the current tax and spend approach. Unfortunately, as the next section will explain, the opposite is more likely to be true and the budget may have undermined prospects of future reforms.

Growing Obstacles On the Road Ahead

The future for comprehensive fiscal reform in Italy is bleak. The 2007 budget may actually have made future progress less likely. The Prodi government is weak, as it has to govern with a single seat majority in the Senate (which has powers equal to the lower house) and depends on a multitude of ideologically incoherent parties, certain of which are overtly hostile to fiscal austerity and economic liberalization. It now appears that the unilateralist approach employed by the centrist reformers around Mr. Prodi and Finance Minister Tommaso Padoa-Schiopppa to push through the 2006 budget amendment and the deregulation measures was not sustainable. The budget bill shows that power within the coalition has shifted. It contains various hallmark projects of the far left, such as redistribution through the tax system and increased social and infrastructure spending, especially in the economically backward south of the country.

Given that most concessions desired by the left have already been made in the bill, it is unlikely that the budget will be further diluted in the ensuing parliamentary deliberations.

From a political economy viewpoint, the real concern lies with the fact that the reformers have conceded additional spending, but at the same time felt strongly about reducing the deficit below 3% of GDP in 2007.

This has led to a revenue-raising budget that has already began to antagonize the centrist middle-class supporters of the coalition, which in turn will weaken the reformers' bargaining power within the cabinet.

Tactically, it might have been preferable for the reformers to aim at a smaller adjustment, while securing concessions as bargaining chips for the internal negotiations. By giving in too early to left-wing demands, there are now few viable compromises remaining to facilitate true structural reform.

Moreover, bringing the deficit below 3% of GDP, while obviously positive if viewed in isolation, may be counterproductive if it happens before the foundations have been laid for lasting current expenditure restraint. This is a risk because in Italy, as elsewhere, reforms appear to have a better prospect of succeeding if the political class and society at large feel that the option of muddling through has vanished.

Returning to "safety" below 3% of GDP removes the immediate urgency of action and hardly acts as a stimulant to engage in painful reforms. The fact that the originally envisaged deficit reduction of €20 billion was reduced to €15 billion, based on the belief that "structural" revenues had improved by €5 billion during 2006, is a case in point. Before the nature of the revenue overshoot was fully understood, the government reduced the effort to do just enough to slip under the 3% limit, thereby exaggerating its significance. The government stresses that the original plan of a total "manovra" of €35 billion was re-established in the end, after having been temporarily lowered to €30 billion. This is beside the point, however. What matters for consolidation is first and foremost the deficit reduction effect of the package, which has remained at the lower €15 billion. The increase in the size of the package resulted in incremental taxation and spending, which, if anything, is likely to have an adverse effect on growth and future consolidation efforts.

During the first quarter of 2007, the shift in the balance of power to the detriment of the reformers is likely to be evident again. The government and the trade unions have signed a memorandum of understanding to conclude talks on the reform of the expensive public pension system by the end of March 2007. Two issues stand out:

First, the desire to smooth out the abrupt jump of the minimum eligibility for a seniority pension to 40 years of service from Jan. 1, 2008, from 35 years currently. This change was part of the pension reform of the Berlusconi government, and Standard & Poor's highlighted at the time that this jump is politically nonviable, and therefore undermines the credibility of the pension reform and its assumed beneficial effect (see commentary "Italy Postpones Fiscal Adjustment--Again," published on RatingsDirect). Ever since the 2006 electoral campaign, the coalition has been adamant that this obvious unfairness needs to be cured.

Secondly, the Dini pension reform enacted in the 1990s foresees a review of the benefit formula every decade to take into account increases in longevity, which should reduce the growth of benefits. The first such review was due in 2005 but was never conducted by the Berlusconi government.

The negotiations around the pensions issue will be complex. The reformers state that they would not yield to a change in the unpopular seniority pension eligibility jump if they cannot ensure that the formula recalculation provides at least enough savings to make the whole package fiscally neutral. This may be a bluff that could be called. Phasing in more gradually the longer work requirement for seniority pensions is quite possibly an issue that could lead to a collapse of the coalition if the reformers refuse to give ground.

The trade unions, which recruit almost one-half of their membership from among pensioners, will stand firm and try to prevent any real savings on benefits from occurring. In principle, the Dini adjustment should be automatic and formula-based, but this principle was already broken in 2005 when the review was not conducted. In summary, there is a real risk that the seniority pension phase-in will lead to additional fiscal costs with only a partial compensation of the benefit adjustment. This would be a major concern in a country that already spends more public funds on pensions than any other in Europe. Evidently, the necessary objective is to reduce the cost of the system, by contrast with the minimalist approach of the reformers to merely make the adjustment fiscally neutral.

Deficits Set To Persist Around 3% of GDP

With pension talks promising to be contentious and possibly costly, and no detectable progress on any of the other areas of expenditure requiring cuts, as identified by the DPEF, it is not easy to be optimistic about the future trajectory of Italy's public finances. The government objective to reach a fiscal surplus in 2011 appears utterly unattainable without a radical change in fiscal management. With the 2007 deficit still close to 3% of GDP, it is hard see where the additional adjustment is to come from. Expenditure reform has proved to be easier said than done and the room for additional tax increases is politically quite limited.

Standard & Poor's base-case scenario is thus that deficits will remain just below 3% of GDP in most of the coming years, which would be enough to keep the EU's Excessive Deficit Procedure at bay. Yet, it would not be enough to generate the urgently needed rapid decline in the public debt burden to prepare the country for the age-related spending pressures of the next decade and beyond.

Italy's fiscal institutions focus excessively on the short-term quick fix rather than the more structural and long-term view, which complicates decisive steps toward a balanced budget. The reform to the electoral system legislated by the outgoing Berlusconi government, in a last-ditch attempt to retain its parliamentary majority, has exacerbated the impasse as it promotes a fragmented parliament, rendering decisive economic and fiscal reform less likely. The 2007 budget is a true reflection of these root causes of Italy's fiscal gloom.

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