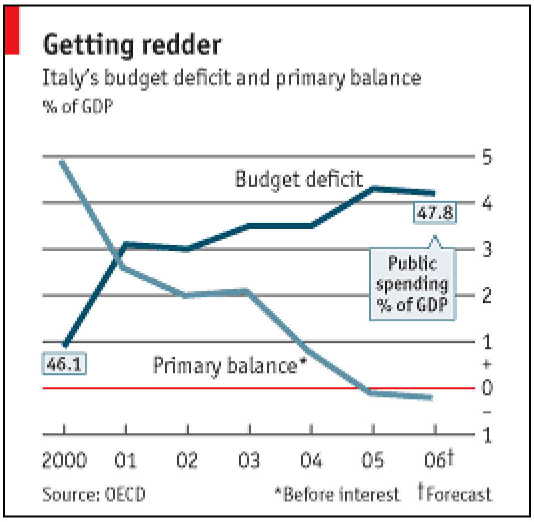
Italy's budget

Smoke and mirrors

Oct 5th 2006 | ROME
From The Economist print edition

Another year. Another Italian budget. Another ruse

THOSE who hoped that Romano Prodi's centre-left government would end the three-card-trick techniques of public accounting so dear to his centre-right predecessor, Silvio Berlusconi, must have been disappointed by its first budget. It does not rely on one-off measures to rein in the deficit. But it has another pernicious dodge.



One of the few liberal reforms passed by Mr Berlusconi's government gave employees a chance to invest in pension funds the contributions that they have to make to severance-pay funds, which were until now held by their employers. But surveys suggest that few will switch when the law takes effect next January.

The draft 2007 budget unveiled by Mr Prodi's finance minister, Tommaso Padoa-Schioppa, includes a provision to transfer half the cash not handed to pension funds to the government. This may be defensible, since it trims a hidden subsidy to Italian business (in the form of cheap financing). What is inexcusable is that the budget treats the cash as revenue, not as a debt that will have to be repaid. The forecast inflow, €5.3 billion ($6.7 billion), makes up over a third of the amount that the government claims to be cutting from the deficit.

This is not the sort of thing you expect of a former board member of the European Central Bank. But it shows how far Mr Padoa-Schioppa has had to bend to placate demands by left-wing parties within the government. The budget includes a watered-down cut in payroll taxes. But it also raises income tax and makes few big reductions in public spending. There is a risk that the net effect will be to curb already low GDP growth.

The main political debate has been about the way the income-tax changes are being imposed. The budget increases the rate of income tax from 41% to 43% for those earning over €75,000 a year. A former centre-right minister called this an “unprecedented social massacre”. Mr Berlusconi invited the middle classes to take to the streets. Mr Prodi said it would ease the inequality of the “most unjust of the major European countries”; the finance minister claimed that 90% of taxpayers would be better off.

That looks optimistic, especially since most of the spending cuts must be enacted by local authorities that may raise other taxes to offset them. That is also one reason to question whether Mr Padoa-Schioppa will cut the deficit by as much as he claims. But there are others. His severance-pay wheeze could be disallowed by Brussels. He is also relying on measures to curb tax evasion that may or may not have the desired effect (in this case, to bring in over €7 billion in revenues).

The biggest danger, though, is that the budget's edge will be blunted as it goes through parliament. Mr Padoa-Schioppa has delighted the trade unions and the left, but infuriated the increasingly restive centrist parties in the government, which fret that tax rises could lose them middle-class votes, particularly in the north. Following the defection of one senator, Mr Prodi's government has a majority in the upper house of just one seat. It is thus acutely vulnerable to demands from either end of its broad political spectrum.