



ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

Public finance and redistribution

Synthesis

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CREDITS

The present Report is the result of the team work of a wide group of researchers co-ordinated by Stefania Gabriele. In particular, the drawing up of single Chapters was edited by:

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** The contributions of Alberto Gabriele and Roberto Longo express their own opinions and not those of UNCTAD and IFAD.*

Summary and Introduction

As usual, the present ISAE Report is devoted to both structural and conjunctural topics. The latter focus on the Italian economic trends after the adoption of the Budget Law and analyses the impact of the new provisions on households and firms. In the previous Reports, the structural part consisted of a thorough discussion of problems – also dealt with in the other part – such as distributive issues debated in Italy and Europe or the social policy approaches inspiring the Budget Law and its accompanying measures.

In the present Report, the structural Chapters address subjects which are less connected to domestic problems, as the Report is aimed at providing a contribution to the discussion on the social problems of countries which do not belong to the industrialised Western world. ISAE interest on these subjects was expressed last year through the organisation of a cycle of Seminars on “Globalisation and Inequalities”. The study started by ISAE on that occasion finds in the present Report a first public expression.

The distributive topics connected with the underdevelopment of some countries and with the start of growth processes elsewhere were widely debated in order to identify if and to what extent economic development brings about a process of human development and reduces the conditions of economic and social deprivation characterising the most backward countries. In this area the approach has changed through time, even within the International Financial Institutions (IFIs). Generally speaking, in the past the stress was laid on economic development fostered by market forces. Policies aimed at attracting capitals, at creating investment incentives and, more generally, at stimulating the economic growth were recommended. The commitment to improve the living conditions of the population was readily sacrificed, in the belief that, wherever a growth process was started, an immediate success would be obtained in this area as well. In the following years, however, a growing importance was attached to the nature of development. The stress was laid on the fall out of growth on poverty, meant not only as low income, but also as delay in the wider concept of human development, comprising educational and health goals and requiring the empowerment of people, particularly of women, and the enlargement of democracy. Finally, the idea of a sustainable development emerged, which means a development including environmental, social and institutional aspects as well.

At the same time, owing to the numerous financial crises which occurred and had tragic effects on the living conditions of the countries concerned, and to the rapid international diffusion of those crises, what is known as the “Washington consensus”, or “market fundamentalism”, was questioned, namely the approach – recommended by the IFIs and particularly by the IMF – based on the opening of economies and financial markets, on macro-stability and on privatisations. That

approach was blamed for contributing to the elimination of protection mechanisms which might have reduced the impact of the financial difficulties on the population and might have limited the diffusion of crises from one country to another. The idea that free market alone could not alleviate poverty and give back the people their own dignity has taken ground also in milieux where those concepts had not been accepted before.

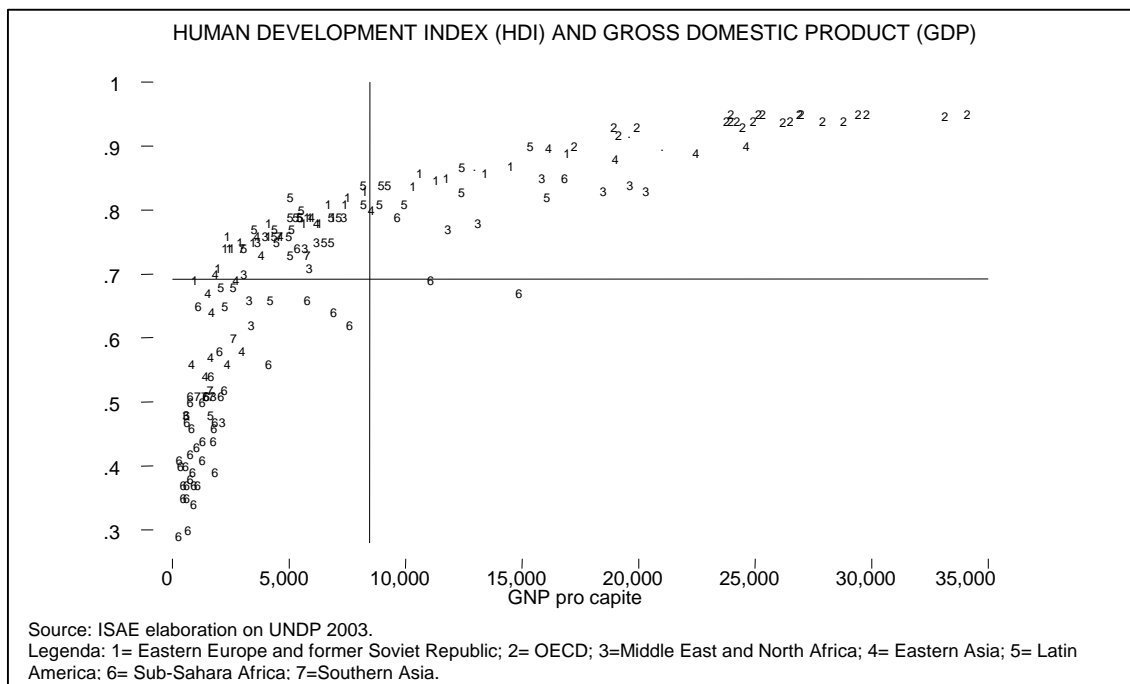
The present Report starts from the basic idea that market and trade do play a role in the economic development. The opportunities they provide must be however enhanced by a regulation which must be effective in both maximising their potential and in minimising their undesirable aspects. As for the attainment of improved educational levels and higher life expectancy, the fight against poverty and inequality, the provision of an income for all, comprising the old and the disabled, there are also other instruments, and the most relevant ones are part of the public intervention.

The first two Chapters of the Report provide some elements of information on the present conditions of human development, on the elements which might improve education and health, on the social and environmental sustainability of growth and on the institutional elements representing the framework where actors operate and interact in the different countries. The third Chapter analyses the role of the public finances in enhancing the quality of life and the development of human capital, referring to the experience in the industrialised Western countries to envisage the possible scenarios in other areas of the world. Some microeconomic analyses follow, aimed at verifying the role of single policies and of specific measures to aid the weaker social groups. In particular, the approach adopted in social protection is considered, with reference to the Latin-American experience, on the choices made in the management of the water supply service, on the new approach in international aid, on the programmes of microfinance addressed to the poor and the poorest. With reference to macroeconomic aspects, only one case study is analysed, namely Argentina, in order to highlight to what extent the choices made in the overall economic management might have a violent impact on the standard of living of the people involved. The controversial (two-way) relationships between growth and inequality, growth and poverty, growth and human development – which have been given great coverage in the literature - are out of the scope of the present Report. We limit ourselves to quote in the first Chapter the results of some studies on the evolution of income distribution in the “era of globalisation” and on the interaction between economic and human development.

The experience of the industrialised Western world shows, in the long-run, a sharp improvement in the standard of living and in human development going alongside with an economic growth and an even faster increase of public expenditure. Paradoxically enough, the very targets reached point to an equity problem which cannot be ignored, namely the gap between the standards of living of

different peoples or – in other words – the need to spread the benefits of welfare. This is by no means an attempt to enter the discussion on alternative models of society so as to set one model as reference for all, but just a way to state that the chances guaranteed to the peoples of the Western world must be granted to all citizens of the world.

The following Graph provides an extremely synthetic picture of the existing gaps, as it locates the world countries according to the per capita GDP and to the Human Development Index (HDI). The high-income OECD countries, some countries of the Eastern Asia, Argentina, Chile and few other



countries from Latin America, many Eastern European countries and the former Soviet Republics and almost all oil-producing Arab countries present above-average levels of both variables (I quadrant). The countries of Sub Sahara Africa and of Southern Asia remain generally more backward from both points of view (III quadrant). However, even though the economic conditions are similar, the countries of this group show a high HDI variability. A last group of countries (IV quadrant) presents a below-average per capita GDP but an above-average HDI. This group comprises some former Soviet Republics, some Middle Eastern countries and nations from Eastern Asia particularly involved in the globalisation process (China, the Philippines and Thailand). An improvement of the HDI and of its single components has taken place through time but, looking at the period 1990-2001, one notices that Sub Sahara Africa is particularly late and that, in the group of Eastern European countries and of former Soviet Republics, the HDI remained almost unchanged. Southern Asia – one of the most backward areas – however registered an improvement in the nineties, and also the Middle East presents a better situation in 2001 compared to the past.

When looking at aspects of environmental sustainability – such as those measured through the Environmental Sustainability Index (ESI), which is an index comprising institutional effectiveness standards as well–, one observes that areas ranking high in the list based on this parameter are – after OECD – Latin America, Eastern Europe and the former Soviet Republics. The Middle East ranks in the bottom group. The idea of a sustainable development implies the hypothesis that it is possible to conceive a development model that the planet can afford. Therefore it is possible to decouple the economic growth from the generation of unsustainable pressures due to resource depletion and waste production. The OECD elaborated thirty-one decoupling indicators – sixteen of which aimed at measuring the climate change, pollution, water quality, waste disposal, the use of natural resources and material compared to the overall economic activity and fifteen of which focused on the sectors of energy, transportation, agriculture and the manufacturing activity – and computed them for its member countries. Unfortunately there are no estimates referring to other areas.

BASIC ESI RANKINGS

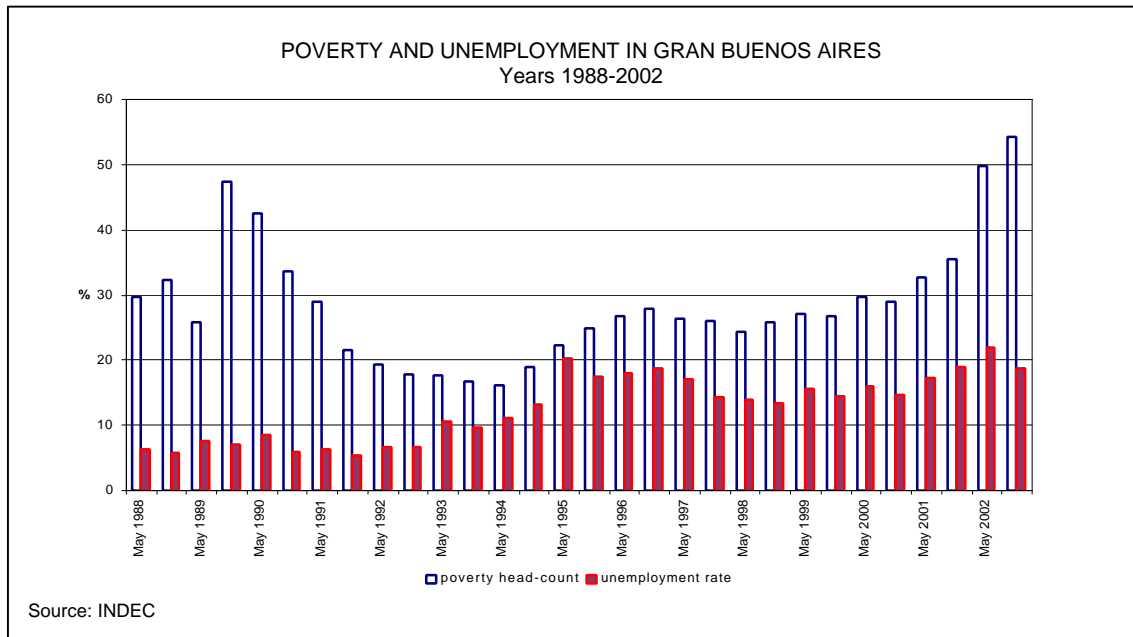
| Area | HDI | <i>Per capita</i> GDP (PPP) | ESI |
|--|-------|-----------------------------|-------|
| OECD | 0.928 | 26,781 | 58.72 |
| Latin America | 0.759 | 6,697 | 53.15 |
| Eastern Europe and former Soviet Republics | 0.779 | 6,605 | 51.41 |
| Southern Asia | 0.8 | 2,932 | 46.84 |
| Sub Sahara Africa | 0.478 | 2,927 | 45.78 |
| Eastern Asia | 0.71 | 7,094 | 45.71 |
| Middle East and North Africa | 0.702 | 8,334 | 41.95 |

Sources: ISAE elaboration on UNDP 2003 data and Environmental Sustainability Index 2002.

The need to reduce globally the pressure on the environment and to narrow the wide economic and social gaps, promoting the most backward regions, implies a re-thinking of the policies adopted.

From a macroeconomic point of view, as already mentioned, the stress on financial balances, on the risks of acceleration of the inflationary processes and on international competition often led to neglect the chance to really improve the living conditions of people. For instance, in Argentina, the policies adopted to combat hyperinflation in 1989-1990 (anchorage of the national currency to the dollar, privatisations, labour market flexibility, full liberalisation of trade and capital movement) were carried out for a decade with the support of the IMF, in spite of the unemployment growth and the rise of poverty since 1994, after the drastic fall registered in the early-nineties. In the face of the recession which coincided with the Russian financial crisis and the following depreciation of the Brazilian currency in 1999, Argentina refused to abandon the convertibility and to depreciate. The IMF provided aids, linking them to a reduction in the budget deficit. The provisions adopted by the Government were successful, in decreasing prices and improving the current accounts, but the

restrictive effect was very strong on the domestic demand and brought about more recession and an unemployment rise, while the public finance objectives were not reached. The final social impact of the crisis were diffused poverty (25% of households at the end of 2001, more than 40% at the end of 2002) and starvation (17% of households and 25% of households with children declared to starve in 2002). One might wonder whether a different policy – aimed at sustaining demand – might have reduced recession and favoured an exit from convertibility.



From a microeconomic point of view, the attention paid on the unreliability of corrupted bureaucrats and on non-democratically-elected ruling class, on the width of an informal system, limiting the fiscal draw and on the ineffectiveness of many programmes of international aid limited the scope for direct interventions aimed at “steering” the economic development and globalisation, favouring the allocation to the private sector of public and social services provision. Even the satisfaction of primary needs was left to the market. For instance, in water supply, the solution to the terrible problem of the insufficient water availability (according to the UNDP data, reported in the Table herein below, in Sub Sahara Africa slightly more than 60% of the population has access to water, but there are serious problems also in other areas) was often found in the intervention of multinationals, that were judged able to invest sufficient resources and know-how to significantly extend the water supply system. The analysis of some experiences, reported here, shows that problems are much more complex. Great multinationals are indeed really able to create the necessary infrastructures, but to do so they require huge funds both from the IFIs (as in the case of Guinea) and from tariff rises. Those rises hamper access to the weakest social groups. On the top of it, the search for profit leads to bring the ducts in areas where more well-off households (able to pay

for the service) live, thus neglecting the most backward areas where the poorest – who risk to be unable to pay - are located. This situation should be managed through a public regulation aimed at setting conditions and constraints for private operators. However, the regulation in a sector where the supply tends to be monopolistic and the service is at the same time a public and a merit good – according to many (the WHO as well) it is an inalienable right – is by no means easy and the possibilities that regulators are “captured” are very high. The situation is so delicate and complex that the privatisation process is losing ground, and the firms themselves are re-thinking to the whole matter as they are squeezed between the frequent population protests and the scarce profitability of the service if it were extended to the poor. Given this situation, the World Bank is starting to re-think the role of State in this field.

ACCESS TO WATER BY GEOGRAPHICAL MACRO-AREAS ⁽¹⁾

| Area | Average | Maximum value | Country | Minimum value | Country |
|---------------------------------|---------|---------------|-----------|---------------|----------|
| Middle East and North Africa | 80 | 100 | Lebanon | 39 | Oman |
| Eastern Asia | 71.1 | 100 | Singapore | 30 | Cambodia |
| Southern Asia | 86.2 | 100 | Maldives | 62 | Buthan |
| Sub Sahara Africa | 61.8 | 99 | Mauritius | 24 | Ethiopia |
| Latin America and the Caribbean | 88.3 | 100 | Bahamans | 46 | Haiti |
| OECD | 100 | 100 | OECD | 100 | OECD |

Source: ISAE elaboration on UNDP 2003 data.

(1) WHO sets the availability of 20 litres of safe water *per capita* per day within one kilometre from the users' dwelling as an acceptable standard (WHO, 2003).

A problem of regulation is emerging also in social protection, where a general reform movement has been spreading around to replace the pay-as-you-go system with a multi-pillar model, the management of which should be left – partially, at least - to private capitalisation-based schemes. This process mainly involved Eastern European countries, the former Soviet Republics and Latin America. In Latin America, following upon the experience of Chile (1981), other seven countries left the almost total responsibility of the social security system to private funds, and others are moving towards this direction. In most cases, social security contributions of employers were eliminated and workers were left free to choose their pension fund (and indeed the possibility was introduced to modify one's choice even twice a year). As mentioned above, the State has retained the task of regulating the private fund market as well as guaranteeing the benefits provided through the granting of minimum integrations and social benefits to those who do not meet the minimum pension requirements. An attempt to evaluate these experiences shows that the gains offered by the capitalisation-based system are high, but decreasing. However, the administrative costs are very high and are such that capital is reduced to an extent ranging in most cases between slightly less than 15% and slightly more than 20%. Furthermore, changing one's pension fund or subscribing a new one implies further costs (and they are high, in particular, for workers with unstable jobs with

frequent interruptions), as indeed there are costs to pay upon retirement. The administrative costs are inflated by the pension fund marketing expenditure. Besides, the scarce participation to the social security system gives rise to great concern for the future, as only 50% of workers pay for social contributions, which are often very limited. The excluded brackets consists of women and low-income workers, owing to their often-interrupted careers, to their long periods of unemployment and to their informal jobs. The cost of the wage support to these group of people shall be borne by the public sector.

**PARTICIPATION RATES TO THE SOCIAL PROTECTION SYSTEM
(Retirees/Workers Ratio)¹**

| High-income OECD Countries | | Latin America and the Caribbean | | Eastern Europe and Central Asia | | North Africa and the Middle East | | Sub Sahara Africa | | South-east Asia and the Pacific Area | |
|----------------------------|-------------|---------------------------------|-------------|---------------------------------|-------------|----------------------------------|-------------|-------------------|------------|--------------------------------------|-------------|
| Austria | 95.8 | Argentina | 53.0 | Albania | 32.0 | Algeria | 31.0 | Benin | 4.8 | Bangladesh | 3.5 |
| Belgium | 86.2 | Bolivia | 11.7 | Armenia | 66.6 | Egypt | 50.0 | Burkina Faso | 3.1 | South Korea | 58.0 |
| Canada | 91.9 | Brazil | 36.0 | Azerbaijan | 52.0 | Iran | 29.8 | Burundi | 3.3 | Malaysia | 48.7 |
| Denmark | 89.6 | Chile | 70.0 | Belarus | 97.0 | Jordan | 40.0 | Cameroon | 13.7 | Pakistan | 3.5 |
| Finland | 90.3 | Colombia | 33.0 | Bulgaria | 64.0 | Morocco | 20.9 | Chad | 1.1 | Philippines | 28.3 |
| France | 88.4 | Costa Rica | 47.0 | Croatia | 66.0 | Tunisia | 39.4 | Congo | 5.8 | Singapore | 73.0 |
| Germany | 94.2 | Dominican Rep. | 11.5 | Czech Rep. | 85.0 | Turkey | 34.6 | Ivory Coast | 9.3 | Sri Lanka | 28.8 |
| Greece | 88.0 | Ecuador | 26.0 | Estonia | 76.0 | Average² | 35.1 | Gibuti | 12.0 | Vietnam | 8.4 |
| Island | 92.0 | El Salvador | 26.2 | Georgia | 77.0 | Israel | 82.0 | Gabon | 7.3 | India | 10.6 |
| Ireland | 79.3 | Guatemala | 28.9 | Hungary | 77.0 | | | Ghana | 7.2 | Average | 29.2 |
| Italy | 87.0 | Honduras | 24.0 | Kazakhstan | 51.0 | | | Guinea | 1.5 | | |
| Japan | 97.5 | Jamaica | 39.0 | Kyrgyz Rep. | 44.0 | | | Kenya | 18.0 | | |
| | | | | Latvia | 60.5 | | | Madagascar | 5.4 | | |
| Netherlands | 91.7 | Mexico | 30.0 | Macedonia | 49.0 | | | Mali | 2.5 | | |
| Norway | 94.0 | Nicaragua | 13.6 | Poland | 68.0 | | | Niger | 1.3 | | |
| Portugal | 84.3 | Panama | 50.0 | Rumania | 55.0 | | | Nigeria | 1.3 | | |
| Spain | 85.3 | Paraguay | 31.0 | Slovakia | 73.0 | | | Rwanda | 9.3 | | |
| Sweden | 91.1 | Peru | 20.0 | Slovenia | 86.0 | | | Senegal | 6.9 | | |
| Switzerland | 96.1 | Uruguay | 82.0 | Ukraine | 69.8 | | | Sudan | 3.9 | | |
| United Kingdom | 89.7 | Venezuela | 34.2 | | | | | Tanzania | 2.0 | | |
| United States | 94.0 | Average | 35.1 | Average | 65.7 | | | Togo | 6.0 | | |
| Average | 90.4 | | | | | | | Uganda | 8.2 | | |
| | | | | | | | | Zambia | 10.2 | | |
| | | | | | | | | Average | 6.3 | | |

Source: Palacios and Pallares-Miralles (2002).

1) Data concerning different observation years in the lapse of time 1989-1997.

2) For North-African and Middle-eastern countries the average is computed without taking account of the Israeli figure.

Other examples are useful to explore the problems emerging in the area of social services, such as education and health care. The case of Kerala, one of the poorest states of India upon its creation at the end of the fifties, marks an interesting case, as it shows that, whenever there exists the will to use the existing resources to improve the living conditions of the population, this is possible even with limited investments. With a domestic product per capita below the average Indian one and a dramatic problem of water scarcity, in Kerala it was possible to guarantee the inhabitants a life expectancy at birth of 73 years, an almost total level of literacy, equality between men and women and between town and countryside which is surprising for the Indian standards, as well as a drastic poverty reduction. And all this with a limited public expenditure for health care (equalling 2% of the domestic product in the eighties before the cuts which were introduced afterwards) and slightly

higher (but decreasing) expenditure for education (from 5.2% to 3.2% in the nineties). Indeed, beyond these results, there is an important factor, that is the cultural tradition and the social conscience which have historically characterised the population of Kerala, as well as the good administration of this state. The fair public management of primary social services, of the health care and of the education systems is a fundamental key for the success of the policies for human development and fight to poverty.

The case of Vietnam, where good results were also reached in terms of human capital growth, shows that, whenever the particular nature of these services is forgotten and they are left to the market, there are serious consequences in terms of fair distribution of the benefits (for instance the failure to reduce children's mortality in the poorest brackets of the population) and that, pending an effective regulation, private expenditure eventually increases but the cost-benefit ratio is disappointing (in the specific case of Vietnam, the paradoxical situation emerged of an excessive consumption of pharmaceuticals, often prescribed by staff without any licence to exert the medical profession or by shop-keepers, or even self-prescribed).

Furthermore, in the former Soviet Republics and in the Eastern European countries, but particularly in the former ones, the lack of public involvement in the service provision had dramatic consequences on the school attendance rate, on the health conditions of the population, on the emerging of pathologies connected to the dismantling of the compulsory vaccination system.

Those examples point to critical aspects of the problem: namely whether there is room for different kinds of policies, and whether it is possible to make social interventions and create systems of social security in the poorest countries. The example of Kerala goes in this direction. More generally, we think that the public intervention is fundamental in the provision of social services, particularly basic ones, even though it is not easy to identify the relation between the public expenditure devoted to this area and success indicators. Indeed, the economic growth, the level of education, health conditions, demographic trends, public and private resources invested for the human capital improvement and the quality of expenditure all interact in a very complex way and with two-way relationships. For these reasons, the estimated correlation between expenditure in health care and education and literacy indicators, school attendance rates, health status is not very high. Indeed, one might notice that the relationship between these same parameters and the per capita GDP is positive, but moderate, as it also happens with variables revealing the access to health care and to hygienic facilities and to safe water. The correlations between the indicators of education and health care, between literacy and the education gender differential, between fertility, on the one side, and literacy, mortality and – with inverse sign – life expectancy, on the other, are stricter.

The following step – going beyond the mere provision of basic social services – is giving an answer to the demand for economic safety, which mainly emerges when overcoming the traditional forms of protection of the weakest individuals which often occurs when industrialisation starts. To this end, it is useful to recall in the debate on the reforms and on new social protection systems in countries having no adequate pension systems, the central role of social security, which is typical of the early systems born in Europe and almost neglected today in favour of macroeconomic objectives fostering saving and the capital market development.

Looking at the whole of public expenditure – and excluding the industrialised Western countries and the group of the Eastern European countries and former Soviet Republics – in most cases it remains below 25% of the GDP. This is a small share, even though one endorses the approach of those who are against any “excess of State” in developed countries.

However, in the most backward countries, gathering enough revenues to finance public expenditure seems a problem almost without solution. Suffice it to quote that the main taxable income for Sub Sahara countries comes from international trade. Maybe those difficulties can be tackled as development processes are activated. Many feel that, to create effective fiscal systems, the intervention aimed at reforming the administrative aspects of revenue gathering is particularly important, as is the adoption of consistent models.

Another tool to gather resources to fight poverty and support human development comes from international aid. The failure of aid policies, the deviation of fund flows towards the industrial interests of donor countries – or towards interests of lobbies or of military nature – led to a generalised skepticism, which is however useful to justify the small funds allocated by many countries and their further contraction. Hence, given the shifting of attention on the many dimensions which must be taken into account when assessing growth, on the institutional aspects and on the so-called participation-based development, a new approach emerged aiming at the drawing up of action plans against poverty - or Poverty Reduction Strategy Papers (PRSPs) – on the part of the receiving countries’ Governments. The adoption of PRSPs has become a prerequisite to have access to the funds granted for the foreign debt cancellation. These plans should take account of all the interventions foreseen, of all the funds granted by IFIs and by single countries, thus enabling to avoid duplications and to convey policies towards objectives in a more consistent way.

Furthermore, they should be elaborated through a participation-based process which involves the population as much as possible. The analysis of the PRSP-drawing up process shows that much remains to be done for all expectations to become true. Often participation becomes mere consulting and the bodies involved and their representation role are questioned. The insufficient

participation-based process also depends on the urgent need to obtain funds for the debt cancellation. It was often impossible to identify consistent priorities, and the result was a Plan pooling together a list of single sector policies and of the single ongoing aid programmes. However, the process has led to a more thorough analysis of the characteristics of poverty in the single countries and to a recognition of its multi-dimensional nature.

COUNTRIES INVOLVED IN THE PRSP PROCESS

| Full-PRSPs | <i>Interim-PRSPs</i> | Forthcoming-PRSPs |
|--------------|-----------------------|-------------------|
| Albania | Armenia | Afghanistan |
| Azerbaijan | Bosnia-Herzegovina | Angola |
| Benin | Cameroon | Bhutan |
| Bolivia | Capo Verde | Burundi |
| Burkina Faso | Central-African Rep. | Comore Islands |
| Cambodia | Chad | Congo Brazzaville |
| Ethiopia | Ivory Coast | Dominican Rep. |
| Gambia | Congo (former Zaire) | Timor Est |
| Ghana | Gibuti | Eritrea |
| Guinea | Georgia | Grenada |
| Guyana | Guinea Bissau | Haiti |
| Honduras | Kenya | Indonesia |
| Kyrgyzstan | Lao | Kiribati |
| Malawi | Lesotho | Maldives |
| Mauritania | Macedonia | Nepal |
| Mali | Madagascar | Nigeria |
| Mozambique | Moldova | Samoa |
| Nicaragua | Mongolia | Solomon Islands |
| Niger | Pakistan | St. Lucia |
| Rwanda | Sao Tome and Principe | St. Vincent |
| Senegal | Sierra Leone | Sudan |
| Sri Lanka | Togo | Tonga |
| Tajikistan | Yugoslavia | |
| Tanzania | Uzbekistan | |
| Uganda | Vanuatu | |
| Vietnam | Zimbabwe | |
| Yemen | | |
| Zambia | | |

Source: World Bank website.

Another instrument aimed at reducing poverty is microcredit, acting through the granting of small loans and other financial and social services to subjects who are usually excluded from traditional financial circuits. This instrument was born from the idea that 90% of the population of developing countries have no access to credit. The idea which is at the basis of the initiative is that obtaining a financing might help creating microactivities, which – in turn – increase the income of poor households and their economic-social condition. The stress is laid on the prospects by gender, with programmes aimed at favouring the empowerment of women and at reducing discriminations. In 2001, microcredit reached about 55 million people, 27 million of whom were among the poorest, 21 million of whom were women. It may seem surprising that the loan restitution rate be estimated

between 80 and 95%. The studies to estimate the impact of this instrument show that in most cases – even though not always – a positive result is obtained on the poorest social groups, particularly women, and on human development. The macroeconomic effects of long-term growth are indeed more uncertain, maybe because they have not been much studied. The most debated aspect of microfinance is whether it must necessarily meet sustainability requirements, thus forgetting the need to obtain funds from donors. To reach that objective (recommended by IFIs), however, institutions should renounce to the objective of helping the poorest among the poor, limiting their range of action to those who seem more reliable. To answer this “tragic choice”, one cannot but further deepen the analysis of the social benefits of microcredit: should this provide good results, donors are likely to continue to fund programmes to alleviate extreme poverty, thus enabling the survival of non-self-sufficient institutions.

MICROCREDIT FIGURES

| Year | Number of micro-finance programmes surveyed | Number of clients reached | Number of the “poorest” clients reached (1) |
|------------|---|---------------------------|---|
| 31/12/1997 | 618 | 13,478,797 | 7,600,000 |
| 31/12/1998 | 925 | 20,938,99 | 12,221,918 |
| 31/12/1999 | 1,065 | 23,555,689 | 13,779,872 |
| 31/12/2000 | 1,567 | 30,681,107 | 19,327,451 |
| 31/12/2001 | 2,186 | 54,904,102 | 26,806,014 |

Source: Microcredit Summit Campaign, 2002.

(1) The poor are those having an income below their country’s poverty line. The poorest are those who are in the bottom half of those living below their nation’s poverty line.

Let us turn to the second part of the Report, which is devoted to the cyclical analysis and to the evaluation of the distributive effects of the Budget Law. The short-term forecast includes a sufficiently robust international recovery led by the US and by Asia, in which Italy and the euro area are definitely late. The GDP growth rate of Italy is stabilising on the very low level of last year (0.4%), while in 2004 it should go up to 1.5%. The 2004 growth will be mainly fostered by consumption, and then by investments, while, with regard to exports, a further erosion of the market share will take place. The unemployment rate will decrease to 8.7% in 2004, which reveals a still high employment elasticity to GDP, even though it is below the figure of the past two years. The inflation rate will decrease from 2.7% in 2003 to 2.2% in 2004.

With regard to the public finance evolution, the net borrowing equals 2.7% of GDP in 2003, with a rise of 0.4% compared to the previous year. A slight decrease to 2.5% is expected in 2004, taking account of the fiscal manoeuvre, which is equal to 0.8% of GDP, net of the interventions to support the economy. Therefore, deficit remains below the Maastricht threshold, even though – compared to the Government’s forecasts (2.5 and 2.2% respectively in the two years) – ISAE is slightly more

pessimistic, mainly because of a less sustained growth framework than Government's hypothesis. The primary surplus shows a reduction from 3.4% of GDP in 2002 to 2.6% in 2003 and to 2.4% in 2004. The tax burden increases in 2003 (+0.5 points of GDP) and falls down in 2004 (-1.3), mainly owing to the fiscal amnesty measures. The debt-to-GDP ratio is continuously decreasing, even though more slowly than in the past, and reaches 105.6% in 2004.

ISAE FORECAST ON THE ITALIAN ECONOMY: GENERAL SUMMARY
(percentage changes, unless specified)

| | 2002 | 2003* | 2004* |
|---|-----------|-----------|-----------|
| Gross domestic product | 0.4 | 0.4 | 1.5 |
| Imports of goods and services | 1.5 | 2.0 | 5.9 |
| Exports of goods and services | -1.0 | -1.9 | 4.2 |
| Resident households' expenditure for consumption | 0.4 | 1.9 | 2.1 |
| Expenditure of General Government and NPISH (1) | 1.7 | 1.4 | 1.0 |
| Gross fixed investments | 0.7 | -1.6 | 2.9 |
| Contribution to GDP growth attributable to (percentage points): | | | |
| - domestic demand (net of stock changes) | 0.7 | 1.1 | 2.0 |
| - stock changes and valuable objects | 0.4 | 0.5 | 0.0 |
| - net exports | -0.7 | -1.1 | -0.5 |
| Current and capital account balance (as a percentage of GDP) | -0.5 | -1.4 | -1.5 |
| Consumer prices | 2.5 | 2.7 | 2.2 |
| Producer prices | 0.2 | 1.8 | 1.1 |
| Propensity to consume (percentage level) | 87.6 | 88.0 | 88.3 |
| <i>Per capita</i> gross earnings in the economy | 2.6 | 3.0 | 3.1 |
| Total employment (2) | 1.1 | 0.9 | 0.69 |
| Unemployment rate | 9.0 | 8.8 | 8.7 |
| General Government net borrowing (as a percentage of GDP) | -2.3 | -2.7 | -2.5 |
| General Government primary surplus (as a percentage of GDP) | 3.4 | 2.6 | 2.4 |
| Fiscal pressure of General Government | 41.6 | 42.1 | 40.8 |
| General Government debt (as a percentage of GDP) | 106.7 | 106.4 | 105.6 |
| 3-month Treasury Bills yield (3) | 2.9 | 2.0 | 2.3 |
| p.m. Nominal GDP (millions of euros) (4) | 1,258,349 | 1,303,101 | 1,355,799 |

Source :ISTAT.

* ISAE forecasts.

(1) Non-Profit Institutions Serving Households.

(2) In standard labour units.

(3) End-of-year annual yields. Gross compound Treasury yield bills.

(4) GDP seasonally adjusted for different annual working days.

The forecast risks mainly concern the impact on Italy and on the euro area of possible less favourable evolutions with regards to the international framework. In the United States, deficits in current accounts and in the Federal Budget are widening, as happened in the eighties. The need to correct those balances, sooner or later, will imply instability risks in the exchange rates and/or the need to introduce corrective measures. Besides, a higher-than-foreseen exchange rate strengthening

of the single currency might slow down the (already small) growth expectations in the euro area and in Italy. In particular, a strong instability might emerge after 2004.

With regard to domestic risks, they mainly concern the Budget Law. Some uncertainties on its effectiveness concern the preventive agreement and the operations connected to the real estate. With regard to the former aspect, the possibility that the amounts of income declared in the past be corrected upwards, after a long negative cyclical phase, is to be evaluated with caution. With regard to the latter aspect, subsequent overlapping interventions might have brought about a weakening of the market absorption capacity.

Turning to the distributive effects of the Budget Law, let us deal first with those concerning households and, more generally, the main provisions adopted in social security. Effects of the birth grant for non-first children and the impact of the modifications to the bill (including an enabling clause) concerning pension system are analysed in this Report.

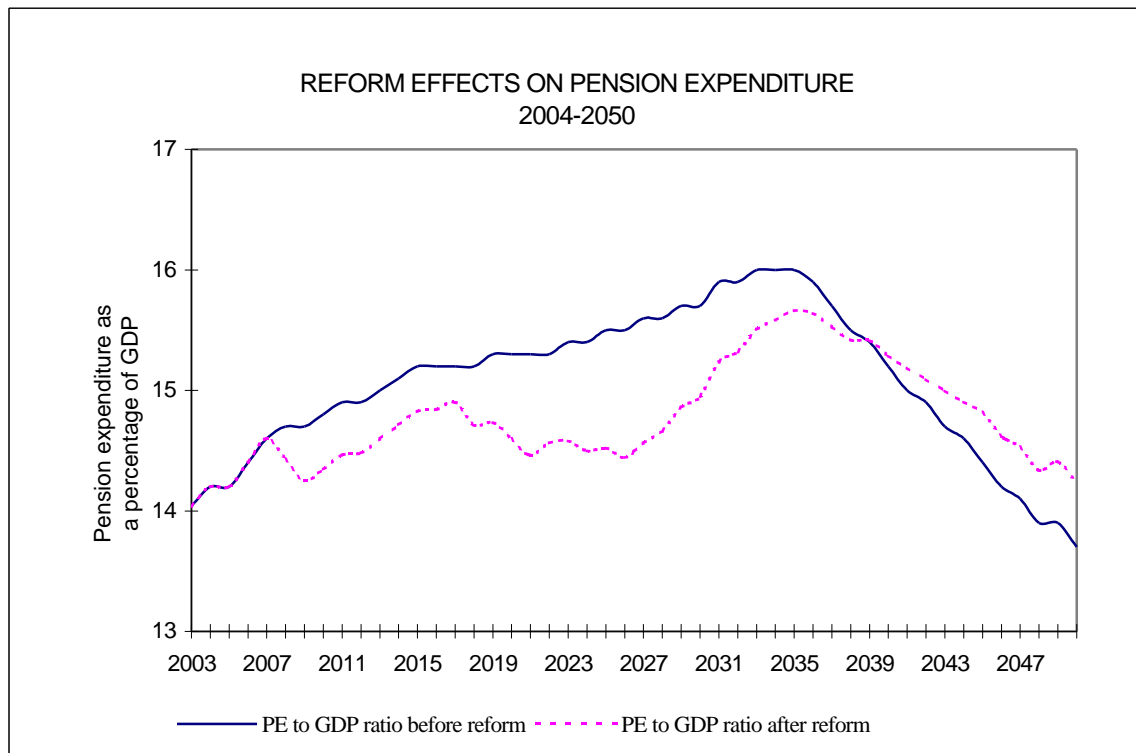
With reference to the first of those provisions, the benefits are concentrated on 1.3% of households and account on average for 3.8% of the mean disposable income of the recipient households. Given that it is a fixed-sum allowance, the benefit is progressive.

The analysed provisions aims at improving the horizontal equity (between households with and without children) and it does not discriminate against those who have no income at all – as indeed other allowances granted through the tax system do –, nor does it make differences between categories of workers or income brackets. However, the birth rate would be better fostered through in-kind benefits, the lack of which is the major obstacle to mothers' participation to the labour market.

With regard to pensions, the measures adopted aim at increasing the average retirement age both through provisions to incentive pension postponement – which will enter into force starting from 2004-2007 -, and through the raising of eligibility requirement starting from 2008. ISAE estimates that the variation of the probability to retire earlier as a consequence of the incentive amounts to 14%. With reference to the impact on the public budget, considering any possible variation of the people's behaviour but also that those who would continue to work anyway will draw benefits from the incentive, there might be a public expenditure cut in the long term, while in the first few years there would be a public expenditure growth.

The tighten of minimum eligibility requirement - which enter into force starting from 2008 - will hardly improve the public budget in the first few years, but will have a strong impact in the medium-long run. The expenditure contraction will reach its 1%-peak of GDP between 2025 and 2030, considerably reducing the social security expenditure in the phase of maximum expansion. Around 2040, there will be higher costs due to the higher benefits linked to the pension age rise in

the contribution based system. The indicators computed through the generational accounting model of ISAE show an improvement both in terms of inter-temporal sustainability of the public finances, and in terms of inter-generational equity as a consequence of the intervention on pensions which succeeds in offsetting the worsening of public accounts estimated for 2003 and forecast by ISAE for next year.



If, on the one side, the structural effects on the public finances are guaranteed, on the other side, the characteristics of the provisions introduced bring about problems of equity and of general consistency of the system, namely the treatment disparity between those who would have retired in 2007 and those who would reach the pre-requisites in 2008; the elimination of flexibility in terms of pension age within the contribution based system which, by its nature, might leave retirees more free to choose; the different pension age foreseen for men and women, even though the coefficient of transformation applied to the amount of contributions to compute the benefits are based on an average life expectancy for both sexes.

Finally, turning to firm taxation, ISAE estimates the impact on the public budget and the redistribution effects of some provisions contained in the reform of the corporate income taxation and in the so-called “Tecno-Tremonti”. The effects on the public finances are very close to those indicated in the Technical Report accompanying the legislative decree for the reform of the Italian tax system with reference to the non-deductibility of capital losses for tax purposes and to thin

capitalisation. According to ISAE, the revenues arising from the abolition of the DIT and of the tax credit on dividends should be larger. On the other hand, the smaller amount of revenues due to the reduction in the ordinary corporate tax rate turns out to be higher than Government estimates. Indeed, ISAE makes its estimates on the basis of a representative sample, while the Technical

IMPACT ON REVENUES OF THE PROVISIONS FOR THE FINANCIAL YEAR 2004
(percentage variation of the levy)

| | Sample composition (%) | Variation of corporate income taxation rate | DIT abolition | Non-deductibility of capital losses for tax purposes | Partial taxation on dividends | Thin capitalisation |
|---|------------------------|---|---------------|--|-------------------------------|---------------------|
| Overall companies | 100 | -4.28 | 4.33 | 3.16 | 0.32 | 0.89 |
| By geographical partitions | | | | | | |
| North-west | 37.28 | -4.68 | 4.72 | 4.64 | 0.33 | 0.69 |
| North-east | 21.47 | -3.35 | 3.32 | 2.53 | 0.58 | 0.97 |
| Centre | 23.83 | -5.66 | 5.36 | 1.69 | 0.10 | 1.13 |
| South and Islands | 17.43 | -2.80 | 4.44 | 0.07 | 0.09 | 2.89 |
| By firm dimension | | | | | | |
| 1-2 | 45.14 | -3.34 | 4.25 | 0.41 | 0.21 | 1.31 |
| 3-9 | 29.76 | -6.77 | 6.15 | 1.81 | 0.56 | 1.45 |
| 10-49 | 19.49 | -3.61 | 4.62 | 5.92 | 0.07 | 1.03 |
| 50-249 | 3.26 | -4.80 | 3.03 | 1.55 | 0.67 | 0.12 |
| 250-499 | 0.15 | -2.88 | 5.25 | 1.97 | 0.01 | 0.03 |
| >500 | 2.22 | -4.17 | 2.08 | 4.52 | 0.21 | 0.01 |
| By productive sector | | | | | | |
| Manufacturing industry | | | | | | |
| <i>Foodstuff, beverages and tobacco</i> | 1.89 | -2.77 | 5.21 | 1.04 | 0.08 | 1.77 |
| <i>Textiles and textile products</i> | 3.27 | -2.92 | 3.11 | 1.79 | 0.05 | 1.09 |
| <i>Leather and leather products</i> | 1.08 | -2.85 | 2.43 | 0.27 | 0.05 | 1.56 |
| <i>Wood</i> | 6.9 | -2.79 | 5.17 | 0.05 | 0.07 | 0.74 |
| <i>Paper, printing and publishing</i> | 2.25 | -2.93 | 3.10 | 0.50 | 0.10 | 0.76 |
| <i>Chemicals</i> | 1.07 | -2.94 | 2.19 | 0.31 | 0.09 | 0.48 |
| <i>Rubber</i> | 1.33 | -2.75 | 5.41 | 0.06 | 0.04 | 0.74 |
| <i>Non-metallic mineral products</i> | 1.61 | -3.12 | 2.08 | 0.94 | 0.26 | 0.63 |
| <i>Iron and steel</i> | 4 | -2.79 | 4.55 | 0.83 | 0.04 | 0.98 |
| <i>Mechanical equipment</i> | 3.35 | -2.97 | 2.50 | 1.38 | 0.10 | 0.47 |
| <i>Electrical machinery</i> | 2.53 | -3.20 | 4.48 | 0.51 | 0.03 | 0.67 |
| <i>Transport equipment</i> | 0.73 | -2.97 | 6.48 | 0.12 | 0.18 | 0.74 |
| <i>Other</i> | 1.91 | -2.88 | 1.99 | 0.13 | 0.00 | 1.90 |
| Electricity, gas and water | 0.24 | -4.89 | 7.69 | 6.71 | 0.13 | 0.00 |
| Construction | 13.74 | -3.15 | 2.61 | 0.46 | 0.07 | 0.89 |
| Trade | 26.66 | -2.88 | 2.90 | 0.14 | 0.05 | 0.51 |
| Hotels and restaurants | 3.87 | -2.90 | 2.63 | 0.43 | 0.08 | 0.30 |
| Transport and communications | 3.53 | -3.13 | 3.00 | 1.28 | 0.19 | 2.01 |
| Financial intermediation | 2.31 | 0.00 | 0.00 | 0.00 | 0.00 | 0.64 |
| Real estate and others | | | | | | |
| <i>Real estate activities</i> | 11.58 | -2.98 | 3.27 | 0.83 | 0.41 | 1.84 |
| <i>Renting of machinery and equipment</i> | 0.32 | -2.99 | 2.62 | 0.00 | 0.00 | 0.00 |
| <i>Computer and related activities</i> | 3.27 | 0.00 | 0.00 | 0.55 | 0.13 | 0.40 |
| <i>Research and development</i> | 0.12 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| <i>Other business activities</i> | 7.91 | -2.98 | 1.61 | 0.00 | 0.00 | 0.87 |
| <i>Public and social services</i> | | | | | | |
| <i>Refuse disposal</i> | 0.46 | 0.00 | 0.00 | 0.11 | 0.43 | 0.03 |

Source: ISAE elaborations on CERVED and UNICO 2001 data.

Report was elaborated starting from the data concerning the whole corporate firm universe.

The analysis of the distribution effects among firms (apart from possible translation phenomena) shows that, in many cases, though not in all cases, the reduction of the ordinary tax rate, by

geographical partition, firm dimension and sector of economic activity, offset the disadvantages connected to the elimination of the DIT.

According to ISAE, the revenue loss connected to the introduction of incentives in favour of R & D investments and in digital technologies amounts to 350 millions of euros (560 millions of euros according to the Technical Report). In terms of distribution, the main beneficiaries of the provision are firms with 250-500 employees operating in mechanical equipment, transport and computers.