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Report

Synthesis

Public finance and redistribution

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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 Authors obviously take full responsibility for any remaining mistakes or omissions.

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Summary and Introduction

The October ISAE Report thoroughly investigates the existing relationships between public finances, tax policies, social policies and income distribution, both through a specific reference to the Budget Law and to its micro-and macroeconomic effects, and through an analysis of structural problems of national and/or international interest.

Last year, the subject of human development (HD) in developing countries (DCs) was included, with a focus on the role of public policies aimed to improve the standard of living. The present Report tackles this topic. Indeed, Chapter I, through an economic-institutional analysis referring to two case-studies – Uganda and India –, analyses the problems of public finances in countries needing policies to improve the standard of living. In particular, attention is paid to the budget procedures adopted in Uganda, to verify whether they respond to the transparency requirements necessary to control the resources and their allocation to guarantee human development improvement. Furthermore, the performances of four Indian regions are assessed, in an effort to trace back the causes for the different policies adopted in those regions within a framework characterised by serious public account imbalances.

Chapter II examines the crucial problem of human development financing in DCs, by investigating the different tax systems, the taxable capacity of a group of countries and its distance from the actual revenue and by providing some indications on the opportunity to raise that revenue.

Chapter III focuses on the Italian situation and, in particular, on one of the major shortcomings of Italian social policies, namely the absence of an income-support instrument as a means to combat poverty. The paper lists the main points of the recent debate on that matter, before estimating the incidence of absolute poverty, computed with different thresholds according to the geographical area, and before quantifying the costs of a possible intervention.

Chapter IV investigates the cyclical trend and the latest public finance provisions. The analysis of the evolution of the main macroeconomic variables for 2004 was updated and forecasts on the 2005 trend are provided under the assumption that the public finance provisions are implemented according to the official evaluations and taking account of the new fiscal plan announced by the Italian Government.

Chapter V deals with the households' income taxation, highlighting the unsolved horizontal equity problems existing in the present system and estimating the impact of a family quotient scheme.

What follows is a brief summary of the content of each Chapter.

Chapter I assumes that the poor results obtained in the past by international aid policies led to a critical re-examination of the overall approach: hence, in the Nineties', a new approach emerged. In particular, the awareness of the poor effectiveness of a system based on a multiplicity of projects funded by different donors - each with its own mechanism to test the fund-access prerequisites and with its own procedures - led, on the one side, to favour national sector-wide plans (such as the SWAPs, Sector-Wide Approaches), or general programmes, aimed at combating poverty (such as the PRSP, Poverty-Reduction Strategy Paper) and, on the other side, to concentrate funds in budgetary aids to the receiving countries. This went alongside with a review of access mechanisms, traditionally based on macroeconomic adjustments usually imposed by the IMF and on controls of the programme implementation. Conversely, the new approach – whereby the receiving country identifies its own priorities – assumes a partnership-based relation between donors and receiving countries which is only possible if the latter adopt “sound policies”. Sound policies are aimed at supporting macroeconomic stability (mainly by controlling inflation and the deficit and by liberalising trade, while policy-makers are now more cautious on free capital movements and privatisations) and at creating “good institutions”. The creation of good institutions requires a system of rules to guarantee private property and the respect of contracts. However this an approach leaves little room to collective actions. Conversely, the present work hinges on a thorough analysis of the State role which we consider – as Nitti states – “the major form of social cooperation”.

To shed light on this viewpoint, it is worth mentioning Mancur Olson, who, by analysing the self-interest of those in power, justifies collective actions. For an economy to be wealthy, the safeguard and clear definition of private interests – namely the respect of private contracts and private property - must be guaranteed. Olson's second point is the absence of predatory behaviour, including those of lobbies seeking to maximize their own group interest at the cost to the whole society. According to Olson, those in power find it convenient to reduce taxes and provide collective goods to maintain a stable and wealthy economy. In a democratic regime, policy-makers, representing a wide portion of society, have an encompassing interest and find it convenient to enlarge the overall economic wellbeing.

Now, setting aside Olson's analysis, let us investigate the collective objectives which, in our opinion, go beyond mere prosperity. We share Sen's vision, whose priority is the expansion of the opportunities offered to human beings. The pillars of Sen's analysis are freedom and equality in terms of “functionings” – final acquisitions – and, in particular, in terms of “capabilities”, namely combinations of functionings which are available to citizens. The human development (HD) approach is based on those ideas and gives way to the construction of multivariate wellbeing indicators, such as the Human Development Index (HDI) of the UNDP. This approach favours the

citizens' participation to the decision-taking process, though recognising the ties stemming from inadequate capacities or the conditioning deriving from the acceptance of a situation of deprivation; it also envisages gap narrowing in income distribution and in the relations between market operators and between different countries and requires the granting of structural aids to DCs to fight poverty. In this optics, the State plays a leading role in creating opportunities for the whole population. However, the HD approach does not identify a given set of actions, nor does it indicate the optimal public expenditure level, but it fosters a thorough analysis in institutional and historical-empirical terms to underpin the decisions on the best policies to adopt.

In keeping with this approach, two case studies are hereafter examined. The former concerns the experience of Uganda, a country which made a great effort to provide a reliable public budget to obtain international aids. It is by no means a banal process, as proved by the history of countries which first conquered the right to have a public budget, such as France and Britain, but also Italy – where the debate on possible reforms in this area is still ongoing -. The Chapter provides a detailed description of the budget procedure adopted in Uganda. It is worth underlining some critical assessments. The system adopted in Uganda seems to meet the pre-requisites identified in the literature to guarantee sustainable public accounts, such as a tough and competent Finance Minister guiding the budget procedure by setting spending objectives in advance (according to the delegation-approach model) and the respect of the financial plans. With reference to the “right to have one's budget”, namely the democratic control on spending policies and financing priorities – which in Italy is mainly exerted by Parliament –, an effort was made to improve transparency, even though great difficulties still remain, particularly whenever decentralised bodies, which are often ineffective and corrupted, are involved. However, it is worth highlighting that the introduction of stringent budget procedures - aimed at guaranteeing the accountability towards citizens and towards donors – is an ongoing process and it is no rapid attainment. Indeed, in countries where democracy is young, it is important for the civil society to control budget. As a matter of fact, in Uganda the representatives of donors and of the civil society do take part in the decision-taking process, but they are unable to intervene suitably, hence many feel their involvement is more formal than substantial.

In spite of those hurdles, it is important to verify whether the adopted policies ultimately favour HD. In the first half of the Nineties', education funds allocated to local bodies did not reach their destinations and households were compelled to cover $\frac{3}{4}$ of education costs, which meant serious access problems for children from poor families. With regard to health care, the public system was ineffective and the medical staff used to ask for “informal” tariffs and for the payment of medicines.

The situations was tackled by diffusing information on school allowances, by granting free admission to primary schools to four children per household, by banning ticket collection in public health care centres and, at the same time, by raising public expenditure on education and health care funded through international aids. This led to the doubling of school enrolments, to the reduction of fund distractions (20% of the total amount) and reduced the problem of service access for the weakest brackets of the society, though public funds are still not sufficient to ensure a wide coverage and in spite of the medical staff discontent and of the difficulty to meet the growing health care demand. Indeed, all this had an impact on the service quality.

In spite of the great effort made to attract aids and adopt public policies to improve human development, Uganda met enormous difficulties as progress and development require large resources, which should partially come from tax revenues (we shall come back on this point afterwards) and partially from the help of richer countries. The Government of Uganda wants to reduce its dependence on international aids by cutting the public deficit from 11.4 to 6.5% of GDP in the next decade, but that policy seems unfeasible, unless very high social costs are paid. The developed countries cannot subtract themselves to the responsibility of supporting HD-favouring policies.

The case of India shows how, in a poor country, the concentration of policies on social objectives may be a crucial element to attain important targets. The GDP growth was very high in India in the past two decades (5.6 in the Eighties' and 6.9 in the Nineties' on average), but it had a dishomogeneous distribution between States. Indeed, poverty decreased (from 39% in 1987-1988 to 26% in 1999-2000), with important differences between rural and urban areas and between States. The General Government deficit represents a heavy burden limiting the possibility to spend for economic and human development objectives. The tax revenue collection is concentrated at Central Government level and the State Governments are mainly financed by large flow of transfers from the centre to the periphery. Most observers consider that funding mechanism complicated and inefficient, as it leaves room to discretionary choices and does not favour strict budget policies at local level, but it rather fosters moral hazard behaviours. Granting more funds to the poorest States with budget difficulties often means providing unlimited support to the States which are unable to manage their own public expenditure both in terms of financial equilibrium and of effective policies to combat poverty and prompt HD.

A closer look at the situations of four Indian States (Tamil Nadu, Kerala, Bihar and Madhya Pradesh), highlights different levels of *per capita* GNP and HD. Tamil Nadu has the highest *per capita* GNP, but its HDI is below Kerala. Indeed, Tamil Nadu adopted market-friendly policies, which provided good economic results, and invested in human capital, thus reaching good targets

for India. Kerala obtained even better results in health care and education, through its continuous commitment and high expenditure in those sectors, at least until it was necessary to adopt deficit-reducing policies because of the fiscal crisis, and through a reliable resource management and the support of a people who proved to be well informed and aware of its own social rights. Unlike Kerala, Bihar obtained from the Indian Government a huge amount of resources to finance its deficit, due to a high and ineffective public expenditure. Indeed, Bihar has the worst education indicators among the four States considered and a life expectancy just above the one of Madhya Pradesh. Over the past few years, Bihar – with a low *per capita* GNP – has adopted a stringent policy to improve its educational attainment, by involving households and carrying out a decentralisation process towards local bodies. Though filled with contradictions, that process seems to foster the improvement of indicators. However, the development of the health care system was not equally favourable.

HUMAN DEVELOPMENT INDICATORS – INDIAN STATES

Countries	Life expectancy at birth (1992-96)	Adult Literacy Rate (1995-96)	Intensity of formal education (1993) (1)	<i>Per capita</i> GNP (rupees) (1997-98) (2)	Literacy Rate (2001) (3)	HDI (2001)
Kerala	73.1	89.47	3.94	2.490	90.92	0.638
Tamil Nadu	63.7	61.67	3.86	3.141	73.47	0.657
Bihar	59.4	36.81	1.69	1.126	47.53	0.367
Madhya Pradesh	55.2	47.52	2.84	1.922	64.08	0.394
India	60.7	54.32	2.7	2.84	65.2	0.381

Source: National Human Development Report, 2001. Planning Commission Government of India, March 2002.

- (1) The intensity of formal education is estimated as the weighted average of the share of class-wise enrolment in the total enrolment in classes I-XII (the weights increasing over successive classes from 1 to 12). The average is then adjusted by the ratio between the gross enrolment figure and the population of children between 6 and 18 years.
- (2) The *per capita* GNP was computed at constant prices 1980-81 by using the average of three years 1981-82, 1991-92 and 1997-98.
- (3) The literacy rate is computed as the proportion of literates to total population in age group 7 years and above.

What seems fundamental in India is accompanying good performances in terms of economic growth with a more effective public intervention, by improving the financial relations between the Central Government and State Governments and the quality of expenditure. Besides, to finance public expenditure, the tax collection must be raised to offset the revenue decreased which occurred in the Nineties.

Chapter II examines the opportunities to raise funds, particularly those deriving from fiscal revenues, to finance public expenditure. The average tax to GDP ratio (computed on the available data from the World Bank and the IMF) of a group of countries excluding high-income OECD countries, the Republics of former Soviet Union and Eastern Europe, is close to 16%, but some show revenues below 10%. Besides, in the least developed countries, indirect taxation accounts for most tax revenues. Indeed, revenues from income taxation in DCs are usually limited by the characteristics of the productive system itself - as it mainly consists of small firms which just

guarantee workers the bare living - and by the scarce compliance capacity of entrepreneurs, given their poor educational attainment. Among indirect taxes, the value added tax is hardly diffused, while excise duties and duties on international trade prevail.

The reasons for the poor revenue-raising power of DCs are to be found in their inadequate economic systems, where the primary sector plays a leading role, labour markets are segmented, the informal economy is wide-spread and there is a strong dependence on foreign markets. According to some observers, the problem mainly lies in the scarce ability of authorities to exploit the country's revenue-raising power due to lobbies, corruption and inefficiency.

Tax REVENUE 1999
(as a percentage of GDP)

Geographical area	Average	Standard Deviation	Minimum	Maximum
Latin America	16.50	5.86	8.80	27.60
Sub-Sahara Africa	16.74	8.67	6.62	47.90
Middle East and North Africa	17.29	9.69	3.43	35.51
Asia	13.40	5.36	2.75	21.96
Developing countries	15.81	7.31	2.75	47.90
Eastern Europe and Former USSR	23.97	6.99	7.76	40.68
High-income OECD countries	29.28	7.45	19.42	38.50

Source: based on World Bank data (2003) and IMF (various years).

A country's taxable capacity, apart from indicators measuring the real tax revenues (such as the tax to GDP ratio), is also computed through its tax effort index, measured by the ratio of the actual tax burden to the predicted one. Even though this method only assesses the tax performances according to the average characteristics of the reference sample, it is useful to estimate the revenue-raising capacity in a series of countries. The tax effort index is calculated through the ordinary least squares (OLS) method, both for a sample of 74 (either industrialised and non-industrialised) countries, and for the DCs alone, with reference to the years from 1990 to 1999. The most consistent explanatory variables are the *per capita* GDP and the share in GDP of the primary sector, of imports, of exports and of public revenues. Because of the data availability, the analysis was limited to the Central Government tax revenues. The F test rejects an overall null variable hypothesis, as all variables are significant with reference to 1999 and with the expected sign (except for the *per capita* GDP of 1990). The analysis of the estimate results provides some interesting remarks. Please notice that the Tax Effort Index (TEI) is above unity whenever the actual tax revenues exceed the potential one and the other way round. Many countries show a TEI below one. One of the reasons for the poor tax performances of some countries is the wide share of trade duties, collapsing because of the ongoing liberalisation process and because of the dismantling of trade barriers (this is the case for Argentina and Mexico, but also for Ecuador, and Ethiopia has a tax revenue structure running the same risks). In South-East Asia, the economic internationalisation reduced the national autonomy in the tax system definition. In some cases - for example in some countries in Sub-Sahara Africa, but also in

India - corruption and inefficiency of tax administration contribute to explain the low TEI. However, in some countries – even in Sub-Sahara Africa - the index is amply above one, in spite of the limited revenues. In those cases, the backward economic situation seems to offer no opportunities to raise the tax revenues. In other countries, such as Brazil and Peru, some reforms did increase the taxable capacity. This means that if, on the one side, adequate fiscal reforms and provisions to enhance tax management and administration are effective, it is however impossible to draw from taxation all the necessary resources to finance an adequate level of public expenditure to improve human development. Thus, international aids remain a fundamental source for funds. The so-called “developed” countries cannot wash their hands *vis-à-vis* this situation. However the suitable tools to finance DCs are to be identified, and it is with this particular topic that future research will deal.

Chapter III analyses a social policy matter affecting Italy. Indeed, Italy has no generalised income-support instrument aimed at households in need, unlike all the other EU-15 countries (with the exception of Greece) and even some of the new EU entrants. Indeed, on the basis of the principle of subsidiarity, each EU country autonomously manages its own social security policies; however, the European Social Agenda, in keeping with what is known as the “Lisbon strategy” and with the “open coordination method”, stresses the importance that social protection systems ensure a minimum income guarantee. In Italy, the spreading of social security schemes divided by working category, the mixture of social assistance and social security, the shortage of services in favour of the poorest and the excessive diversification in the selection criteria for social security benefits are often considered the main causes for the poor effectiveness of the social security system in safeguarding beneficiaries from the risk of poverty. This is proved by social transfers hardly reducing poverty rates compared to most European countries (as shown by the Eurostat data). An attempt to tackle this problem was made with the introduction of the “Reddito Minimo di Inserimento” (Minimum Insertion Income, MII) , which provided a support to needy households up to a threshold equalling 520,000 liras in the year 2000 for a one-person household, involving about 25,000 household units (85,000 beneficiaries). The programme also envisaged the participation to social re-integration programmes in the areas of employment, schooling, training, rehabilitation, etc. The MII was considered a new instrument within the Italian social security scheme, as it was not categorical, based on geographically-homogeneous means testing criteria, and because it included mechanisms for professional and social re-integration aimed at avoiding poverty traps (to this end, one might recall that beneficiaries of re-integration programmes in 2000 were 37,000). The critical aspects of the MII mainly concerned its eligibility conditions and the effectiveness of the re-integration plans. Indeed, to begin with, doubts were cast on the option to exclude all patrimony-

owning households (except for dwellings), which was adopted to avoid any means-testing misevaluation, but which appeared too strict. Secondly, the discrimination which eventually took place against not households home-owners was so unfair that many municipalities granted rent deduction on the means-testing taxable income. Thirdly, when setting the threshold, it was also necessary to take into account the different costs of living in the different geographical partitions. As for the re-integration plans, the results were scarce in the areas with high poverty rate, because those areas could invest less economic and professional resources in the programme management and their economies hardly provided job opportunities. From this point of view, it is worth noticing that the MII is not expected to create vacancies in areas where labour market problems are deeply rooted. However, the idea is gaining ground that a municipality is too small a geographical area to tackle these problems. Finally, among the MII shortcomings, it is worth mentioning that several cases of nepotism and opportunism emerged where the number of applications was high.

Even though the Report on the first MII experimental implementation – foreseen by the unpublished MII-introducing Legislative Decree – provided a generally favourable opinion, the Pact for Italy signed by the Government and by the social parties (with the exception of the General Confederation of Italian Workers – *Confederazione Generale Italiana del Lavoro, CGIL*) in July 2002 expressed the will to adopt a new instrument, the “Reddito di Ultima Istanza” (*Last Resort Income, LRI*), thus putting a stop to the BIG introduction. The Finance bill for 2004 mentions the LRI as an instrument to safeguard households at risk of social exclusion are not covered by unemployment benefits. The LRI – which should be adopted whenever other instruments prove ineffective – envisages social integration (and not employment integration) programmes. This approach, which is in keeping with the restructuring of social protection system and the enhancing of active labour policies, is valid inasmuch it does not mean postponing the adoption of the LRI to the time when the whole integrated system of unemployment benefits and active policies is implemented and insofar it does not imply a strict interpretation of the LRI role, which might exclude all individuals in active age (unless there are other reasons for exclusion) and thus restore a category-based approach. In a reformed social protection system, the role of “last resort” is left to an income-support instrument, but the range of interventions should be structured in such a way that no poor household is left without support, while all active individuals should have the opportunity to join active labour policy programmes.

Shifting to the regional level might be a suitable reply to the difficulties met by the MII in managing the reintegration programmes at municipal level, but any social intervention in this area risks to be jeopardised, as the law only foresees a vague form of co-financing on the part of the Central Government, as no suitable allocation is identified to fund that co-financing and no statutory

instruments or final date is set for the introduction of the new instrument. In our opinion, a generalised income-support instrument should be introduced in Italy – even though managed by Administrative Regions - and it should be endowed with uniform criteria for the whole country with regards to identification of beneficiaries and to estimation of income threshold under which the support should be granted. To this end, those criteria should be listed in the *Livelli Essenziali delle Prestazioni* (Essential Performance Standards) foreseen by the Framework Law on Social Security and assumed in the Title V of the Italian Constitution. It is difficult to assess whether an income-support intervention with these features might be obtained through the LRI (which seems to be based on the role of Administrative Regions); nevertheless, this choice could suit both for the LRI positive characteristics and because the continuous change of instruments does not favour the implementation of social policies.

In that optics, we tried to estimate the cost of a generalised income-support instrument for the whole country. The minimum income is set equal to the cost of a basket of goods corresponding to absolute poverty. In the basket computation, the case of households renting their dwelling units was separated from that of owners. Indeed, in the former case, the threshold comprises the home rent. In this way, an attempt was made to avoid a discrimination against households renting their homes. Furthermore, the geographical differentials were also considered in the cost of living so as to obtain a real estimate and to reach a fairer and more rational resource partition to fight poverty. To this end, the ISTAT minimum prices were used to construct the time index, and the Province-based rent prices derived from the Survey *Monitor Immobiliare* carried out by CENSIS and *Scenari Immobiliari* were also used. The data are not enough to signal all the discrepancies in the cost of the minimum basket in the different geographical areas, hence the results are mere indications and may be the basis for a future methodological deepening and for further surveys in this direction.

The average national monthly threshold of absolute poverty for a single person equals 520 euros, but the one referring to the Northern area is worth 550 euros as against the 450 euros in the South and 425 in the Islands. Regional gaps are even wider. Home expenditure accounts for most differences. Hence, the diffusion of absolute poverty – equalling 6.8% if computed against a common national threshold – falls down to 5.5% if one considers prices and its incidence decreases in the Centre and in the *Mezzogiorno* and grows in the North.

ABSOLUTE POVERTY THRESHOLD

(minimum monthly expenditure in euro for a one-person household unit – year 2004)

	Foodstuff	Home	Tariffs and durables	Residuals	Total
North-west	167	304	52	29	552
North-east	180	294	53	29	556
Centre	151	284	45	25	505
South	179	211	44	22	456

Islands	172	190	40	22	424
Italy	169	278	46	25	519

Source: Based on ISAE data.

By supporting poor households up to the income thresholds diversified by geographical area, one would guarantee an average benefit worth 370 euros (420 with a common national threshold), with an overall cost for the General Government of 5.3 billion euros (7.2 billions). Taking into account price differentials, the resource allocation among the different geographical partitions of the country would be more balanced, even though the South and the Islands continue to absorb most funds (77.5% as against 85%). If the income support were cut down to 80% of the amount necessary to get out of absolute poverty, or if one set the threshold at 80% of the initial level, the overall amount with regional thresholds would go down to 4.2 and 3 billion euros respectively. The incidence of absolute poverty would remain unchanged, but its intensity would diminish. A generalised income-support instrument would be a burden for public finances, which however would not exceed other measures in favour of households introduced over the past five years.

Chapter IV focuses the analysis on the economic cycle and on the prospects for next year, taking account of the public finance plan for 2005. Those measures are officially worth 24 billion euros gross of an expenditure rise slightly below one billion euros (5.8 billion euros of net revenues and 16.8 billion euros of net expenditures, including a 7-billion public assets disposals). Furthermore, an economy-boosting intervention was announced but it has not been made public yet. We foresee 5.5-billion tax rebates will be granted to households through the introduction of the second module of the income tax reform foreseen by the delegation law n. 80/03, alongside with a 1-billion cut in the Italian regional tax IRAP. ISAE maintains the hypothesis assumed for previous analyses, namely that the coverage of those tax rebates is provided by transforming non-refundable contributions into a 5-billion fund for credit allocation. The impact of the “pension bonus scheme” – included in the delegation law on social security - granted to workers postponing retirement is also included in our estimates of the public finance trends. Indeed, ISAE tried to find out – through *ad hoc* questions included in its Surveys - the workers’ reactions to the option of maintaining one’s severance pay (TFR) or of subscribing a supplementary pension fund, but, for the time being, uncertainty and risk aversion seem to prevail.

In the public finance plan for 2005, it is worth noticing that the quantity of one-off (*una tantum*) measures (accounting for 30% of the overall measures) decreases compared to the past. With reference to revenues, the main interventions aim at enlarging the taxable income and limiting tax credits (by adjusting sector studies and restructuring tax schemes on real estate and on cooperative companies), and it will be successful if the measures are quickly implemented and all categories

collaborate. Furthermore, tax rate rises are foreseen alongside with provisions to raise lottery revenues. Current expenditures will be reduced by 7.8 billion euros, mainly through the introduction of a new mechanism to reduce the General Government expenditures based on a cap guaranteeing its stability in real terms. With reference to Local Government, that target must be reached through a revision of the domestic Stability Pact and through a new Agreement between the Central State and Regions on the health care system. The introduction of a rule on the expenditure growth (+ 2% y/y in nominal terms for the State Budget, +4.8% for local government, with the exclusion of some items) seems to enable a planning of the General Government expenditure in keeping with the medium-term objectives of financial adjustment, but it requires a constant (somehow unprecedented) attention on the expenditure trend, particularly in the health care sector. This shall require a more thorough monitoring of the expenditure flows, which shall be favoured by the improvement of the means of information. Some Regions will be induced to exploit more their tax autonomy – which they had back after two years' suspension of any rise in the regional additional income tax (*addizionale IRPEF*) and in the regional tax (*IRAP*) - to finance their investments, which may only be raised if they are funded by tariffs and duties.

Considering the still-unknown aspects of the public finance manoeuvre, concerning in particular the economy-supporting provisions and the amendments to the Finance Bill which will be introduced during the Parliamentary discussion, the ISAE estimates for 2005 are mere forecasts conditioned by the hypotheses on the public finance plan. The international scenario which is at the basis of those forecasts points to a limited deceleration of the international cycle, which might sharpen in 2005. The world GDP growth (5% in 2004 and 4% in 2005) should remain above the average growth of the past two decades. There is a strong uncertainty on the oil price trend and a debate is under way on whether the recent rise derives from the evolution of the fundamentals or from transitional factors. ISAE considers oil prices shall remain high in the next five-six months, even though they are below the peaks of 50-55 dollars reached over the past few weeks. The oil price trend should gradually decrease in the second half of 2005, reaching an average annual rate of about 39 dollars per barrel (38.6 in 2004). The dollar weakness should go on and the dollar/euro exchange rate in the forecast period should equal the average value of Q 3 2004 (1.22 dollars). A gradual and slow interest rate rise is expected in the United States; in Europe the ECB might start a growing trend of the repo rate starting from next Spring, thus reaching 2.5% in the late-2005. International trade is very dynamic. The world demand might grow on average at a 9% rate in 2005, mainly boosted by the United States and by the emerging countries. The deceleration might start at the end of 2004 and it should lead to an average figure of 7.5% in 2005. The income redistribution at the world level due to the oil price rise is expected to have a less serious impact than in the Seventies, because the

purchasing power shift is less intense today and because producer countries have an higher propensity to consume than in the past. ISAE estimates that the GDP growth rate is worth 1.3% in 2004 with an impact of 0,6-0.7 % on 2005. The second quarter should show a similar dynamics thanks to domestic demand but also to an improvement of exports which should grow by 4.2% in 2004 (after the 2003 contraction). With reference to domestic demand, investment should grow by a 3% annual average (-2.1% in 2003), slowing down in the second quarter, while consumption might increase in the second half of the year thanks to the positive income evolution and to the confidence recovery (+1.4% on annual average). The domestic demand growth should raise imports up to 4.2%. The negative contribution of the net foreign demand to the GDP growth in 2003 seems to have come to an end and its impact in 2004 is null. The inflation rate should be worth 2.3%, with a 0.4% fall compared to 2003.

The General Government net borrowing equals 2.9% of the GDP, which is more than in 2004, though remaining below the 3% threshold of the Maastricht Treaty. The primary surplus should go down to 2.1% (2.9% in 2003), though remaining above the euro area average figure, while the interest payments in term of GDP should contract by 0.3%, thus reaching 5%. The fiscal burden should decrease by more than one percentage point, equalling 41.7%. Should the State-owned real estate patrimony be sold as envisaged in the Economic and Financial Planning Document (DPEF) and with a growing gap between General Government borrowing requirement and net borrowing, the debt should go down to 105.8% of GDP (106.2 in 2003).

The forecast for 2005 shows that the GDP growth rate equals 1.8%. The contribution of domestic demand to growth should be worth 2 percentage points, the contribution of net exports should be slightly negative (-0.4%), while inventories register a small rise (+0.2%). Domestic demand should be mainly boosted by the investment growth (+3.7%), favoured by the domestic and foreign economic cycle, by the favourable profit evolution and by the need for restructuring of the productive structure.

The consumption growth – equalling about 1.8% - should stem from the taxable income rise, which in turn is due to the increase in the *per capita* wages, to the favourable employment trend and to the net effects of the public finance plan. The households' purchasing power should emerge unscarred by the oil price rises.

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

	2003	2004*	2005*
Gross domestic product	0.3	1.3	1.8
Imports of goods and services	-0.6	4.2	6.0
Exports of goods and services	-3.9	4.2	4.5

Resident households' expenditure for consumption	1.3	1.4	1.8
Expenditure of General Government and NPISH (1)	2.2	0.8	0.7
Gross fixed investments	-2.1	3.0	3.7
- construction	1.8	2.7	2.4
- machinery, equipment, means of transportation and real estate	-4.9	3.3	4.6
Contribution to GDP growth attributable to (percentage points):			
- domestic demand (net of stock changes)	0.7	1.6	2.0
- stock changes and valuable objects	0.5	-0.3	0.2
- net exports	-0.9	0.0	-0.4
Current and capital account balance (as a percentage of GDP)	-1.2	-1.6	-1.8
Consumer prices	2.7	2.3	2.3
Producer prices	1.6	2.8	1.9
Propensity to consume (percentage level)	87.3	86.8	86.7
<i>Per capita</i> gross earnings in the economy	3.2	3.6	2.7
Total employment (2)	0.4	0.9	1.0
Unemployment rate	8.4	8.1	7.7
General Government net borrowing (as a percentage of GDP)	-2.4	-2.9	-2.8
General Government primary surplus (as a percentage of GDP)	2.9	2.1	2.1
General Government fiscal burden	42.8	41.7	41.1
General Government debt (as a percentage of GDP)	106.2	105.8	104.5
3-month Treasury Bills yield (3)	2.3	2.5	3.5
p.m. Nominal GDP (millions of euros)	1,300.926	1,356.496	1,411.082

Source :ISTAT, Bank of Italy.

* ISAE forecasts.

(1) Non-Profit Institutions Serving Households.

(2) In standard labour units.

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

In spite of the slowdown of the world demand and of the continuous erosion of the Italian market shares, exports should rise by 4,5%, while imports should grow by 6% also owing to a favourable restructuring of the households' expenditure.

The above-mentioned employment rise should be worth 1% in terms of standard labour units, and 470,000 units in terms of heads. Indeed, the unemployment rate should fall down to 7.7%. Even though the employment target set by the Government was overcome (thanks to the review of the ISTAT estimates on the labour force), the GDP elasticity to employment – which remains on high levels – is decreasing. This should lead to a labour productivity growth, which – together with the moderate wage rise which should follow the 2004 acceleration – will slow down the labour cost growth rate per product unit (equalling 2% in 2006). Thus, inflation might stabilise at 2.3%, given the assumptions on the oil price and on the euro exchange rate.

The General Government net borrowing should equal 2.8% in 2005. The 0.1% difference against the Government target (2.7%) depends on the different evolution foreseen for the GDP. The primary surplus should stabilise at 2.1%. The current deficit should be slightly in excess, hence the

net borrowing will only fund the capital account expenditure. The tax burden should further decrease by 0.6% (at 41.1%). In the hypothesis of sales of State-owned real estates worth 25 billion euros as foreseen in the DPEF and of a still high net borrowing-borrowing requirement gap, the debt/GDP ratio should go down to 104.5%.

Generational accounts show that the conditions of public finance sustainability in the long run worsen if the 2004 measures are included in the scenario. However, the correcting interventions foreseen in 2005, associated with the effects of the just-approved pension reform, seem to introduce an improvement: the inter-temporal budget imbalance – defined as the sum of the current General Government deficit and of the present value of net tax revenues paid from present and future generations - decreases from 118.4% of current net financial deficit included in the 2003 basic case to 111.7%.

Chapter V investigates the distribution effects of the fiscal policy provisions. It was impossible to analyse the impact of tax rebates, as the provisions defining their characteristics have not been submitted yet. However, Chapter V provides a study on households' taxation in Italy and on the future prospects for intervention in this area. Indeed, that problem has often emerged within the debate on the recent reform (Law n. 80/03).

From an economic point of view, the objective to support households is justified by the principle that they produce positive externalities thanks to their decisions to procreate and thus contribute to the demographic balance, to their capacity to improve income redistribution by safeguarding weak subjects and to the creation of human capital. Admittedly, the tax unit adopted in Italy today is the individual, whereas households' characteristics are considered through family allowances decreasing with income which are granted on the basis of the family taxable income, on the number of family components and, indirectly, of income earners. In the past, any attempt to introduce a family-based tax system, without changing tax rates, did not succeed due to the high costs. The delegation law (Law n. 80/03), accompanied by a Report emphasizing the role of households as "central subject of the tax scheme", apparently meant that a family-based taxation system has to be introduced, but the first step of the reform - which allows deduction from imposable income linearly decreasing with individuals' incomes – changed that direction.

The choice of the taxable unit (individuals, households or by shares) is to be made by considering various aspects: namely horizontal equity, with particular reference to the households' economic structure (i.e. the number of income receivers and the income distribution within the married couple, on the one hand, and the number and type of family members, on the other), its impact on the marital status, any possible incentives to tax evasion, progressive taxation (vertical equity), labour supply incentives (effectiveness).

The problem of horizontal equity is rather complicated and there is no unanimous consensus either on its definition or on its legal relevance. To express the concept of horizontal equity, suffice it to mention the principle of equal treatment of “equal” individuals in the economically relevant aspects. With reference to the content of that principle, it is worth noticing that some feel households with equal overall income and equal number of components must be taxed in the same way regardless of the number of income receivers. Taxation by shares and tax cumulation meet this need, unlike individual taxation, which penalises households with more concentrated incomes, particularly one-income households. However, there are some who think discrimination in favour of two-income households might offset the higher costs those households have to face for family and child care and for income production. On the other hand, with reference to the number of family components, the family quotient is the only tax scheme taking account at the same time of the growing family needs as the number of family components increases, thus favouring large households. However, it is worth noticing that, if the choice to enlarge one’s family belongs to the private sphere, the State should only intervene in case of really disadvantaged economic conditions, unless specific demographic policies are pursued.

With regard to the other relevant aspects in the choice of the tax unit, tax cumulation disincentives marriage, while taxation by shares makes it convenient in one-income households or in households where one spouse’s income (usually the husband’s) is much higher than the partner’s one. Besides, individual taxation leads to an income redistribution among family members and thus reduces the progressive taxation effects. Vertical equity objectives can be out of keeping with horizontal equity targets in case of taxation by shares, because the former tax scheme – with equal tax rates - provides advantages to households which grow as income increases, while tax progressivity decreases as the number of family components grows. Finally, turning to questions of efficiency, individual taxation avoids distortions in labour market participation choices, while tax cumulation and taxation by shares discourage a second family member (usually the wife) from entering the job market, because her/his earned income is subject to higher tax rates.

Turning to the problems emerging in Italy, the tax system is often accused of not offsetting the discrimination against one-income households and of not taking account of the large households’ needs. According to some studies, the tax rate flattening foreseen by the tax reform, by reducing progressive taxation, should also reduce the former problem, but the introduction of decreasing deductions from the individual taxable income has eventually widened the gap in the tax burden weighting on households with various number of income earners.

ISAE tried to evaluate the effects of a taxation system based on the family quotient in Italy, by using the ITAXMOD micro-simulation model based on the Survey on the Households’ Income and

Wealth of the Bank of Italy referring to the year 2000. Among the various test assumptions, it is worth mentioning two which compare the basic case (scenario with 2004 provisions) with a family quotient regime envisaging a number of shares similar to the French one (similar but not identical, as it sets 1 for each spouse and 0.5 for all other family components) and with the abolition of tax benefits for dependant family members. The new tax scheme is considered optional. In the less radical hypothesis, that amount (3,000 euros) of deduction from income which is now identical for all kinds of taxable income is applied to the equivalent (or quotient) family income, while the share depending on the type of income (dependent work, autonomous work, pension) is applied to the individual income. In the more radical hypothesis, the whole deduction reduces the equivalent family income. The impact on the public budget should be worth 7.8 billion euros in the former hypothesis and 18 billion euros in the latter one. In the two cases, 41% (10.8 million) and 47% (12.1 million) of households respectively should draw a benefit which should equal on average 740 euros in the less favourable case and 1,500 in the other case.

The crucial aspect of this study concerns the impact in terms of horizontal equity. The impact on the average tax rates paid by the households with identical number of income receivers and components belonging to the same quintile of taxable income is here analysed. In the basic case, there is a gap between the average tax rate applied to one-income households and to two-income households with identical number of components belonging to the same quintile in all quintiles, except for the first quintile (where the tax rate is close to zero because of the tax benefit), the second quintile if the couple has at least two children and the third one if the couple has at least three children. This gap widens as the household shifts to higher income quintiles and decreases for households with children as the number of children grows (with the exception of the last quintile). The quotient introduction reduces the gap between the tax rates applied to one-income and to two-income households, by setting it almost to zero in the most radical hypothesis.

**EFFECTS OF THE FAMILY QUOTIENT SCHEME
BY FAMILY TYPE AND QUINTILES OF TAXABLE INCOME – WITH SAFEGUARD CLAUSE**
(percentages by row)

			average tax rate			Δ (one/two-income)		
			2 nd hyp.	3 rd hyp.	Basic	2 nd hyp.	3 rd hyp.	Basic
Couple with no children	1	one-income	0.11%	0.08%	0.46%	-0.01%	-0.02%	0.11%
		two-income	0.12%	0.10%	0.35%			
	2	one-income	5.60%	0.52%	7.81%	3.52%	0.04%	4.68%
		two-income	2.08%	0.48%	3.13%			
	3	one-income	11.51%	4.64%	13.73%	3.69%	-0.35%	4.08%
		two-income	7.82%	4.99%	9.65%			
4	one-income	16.30%	12.05%	19.56%	3.43%	0.45%	5.38%	
	two-income	12.87%	11.60%	14.18%				
5	one-income	21.63%	19.56%	26.63%	2.17%	0.35%	5.93%	

		two-income	19.46%	19.21%	20.70%			
Couple with 1 child	1	one-income	0.01%	0.00%	0.13%	-0.02%	-0.03%	0.00%
		two-income	0.03%	0.03%	0.13%			
	2	one-income	3.61%	1.01%	4.65%	1.30%	0.48%	1.45%
		two-income	2.31%	0.53%	3.20%			
	3	one-income	9.29%	0.58%	10.87%	2.21%	-1.12%	2.30%
		two-income	7.08%	1.70%	8.57%			
	4	one-income	14.40%	7.43%	17.23%	2.68%	-0.17%	4.27%
		two-income	11.72%	7.60%	12.96%			
	5	one-income	20.44%	17.24%	26.44%	2.52%	0.85%	6.88%
		two-income	17.92%	16.39%	19.56%			

Source: based on Bank of Italy (2002).

With reference to households with children, they are subject to smaller average tax rates in the basic case. This advantage tends to decrease as income increases (if we do not consider the lower quintiles, where the no-tax area emerges) and to increase as the number of children rises. The family quotient redistributes the benefit compared to the tax rebate mechanism by reducing the advantage for households with children in the intermediate quintiles and by increasing it for households with higher income.

Thus, the family quotient option might be the solution to some of the horizontal equity problems raised by the Italian tax scheme. This opportunity must however be assessed by considering the intervention costs for the public budget, the managing costs for the public administration and the time costs tax-payers pay in filling the forms if they have to opt for the family quotient tax scheme, for the traditional system and for the pre-reform scheme, namely the system enforced before the approval of the first reform module foreseen by the delegation law n. 80/03, envisaging a specific safeguard clause.

Besides, it is of the utmost importance to clearly identify the objectives one wishes to pursue, namely guaranteeing equal treatment to households with different number of income-perceivers, or offsetting the larger costs paid by households in which both spouses work and providing support to large households regardless of the income level or only in the presence of economic difficulties.

Finally, the present analysis shows that, even through tax allowances it is possible to reach some horizontal equity objectives. For instance, the present system seems able to provide an adequate support to large households, particularly to those with low income. Thus, one might intervene by raising tax rebates per dependant spouse and possibly by re-formulating family allowances on the number of children according to the income level and type.

