ISTITUTO DI STUDI E ANALISI ECONOMICA

ISAE Report

Public finance and redistribution

Synthesis

OCTOBER 2005

CREDITS

The present Report is the result of the team work of a wide group of researchers coordinated by Stefania Gabriele. In particular, texts have been written by:

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The Report is based on the information and data available up to October 26, 2005.

Synthesis

The ISAE Report for October deals with distributive issues both structural and conjunctural. It examines budget policies with particular regard to their effects on households and firms, as well as on the short-term economic trend.

The first chapter in the structural part of the Report reconstructs the evolution of the functional distribution of income in the 1990s and early 2000s. This information is flanked with data on personal income distribution, the purpose being to determine consistencies and conflicts between the two approaches.

The second chapter joins the debate on the sustainability of welfare in societies with ageing populations and which foresees marked increases in their spending on pensions and health care. As regards the latter, there is empirical evidence that the costs are concentrated in the last years of life. Hence, by postponing death, ageing may generate effects different from those generally expected. The Report addresses this issue by estimating hospital expenditure profiles as a function of demographic variables in four Italian regions.

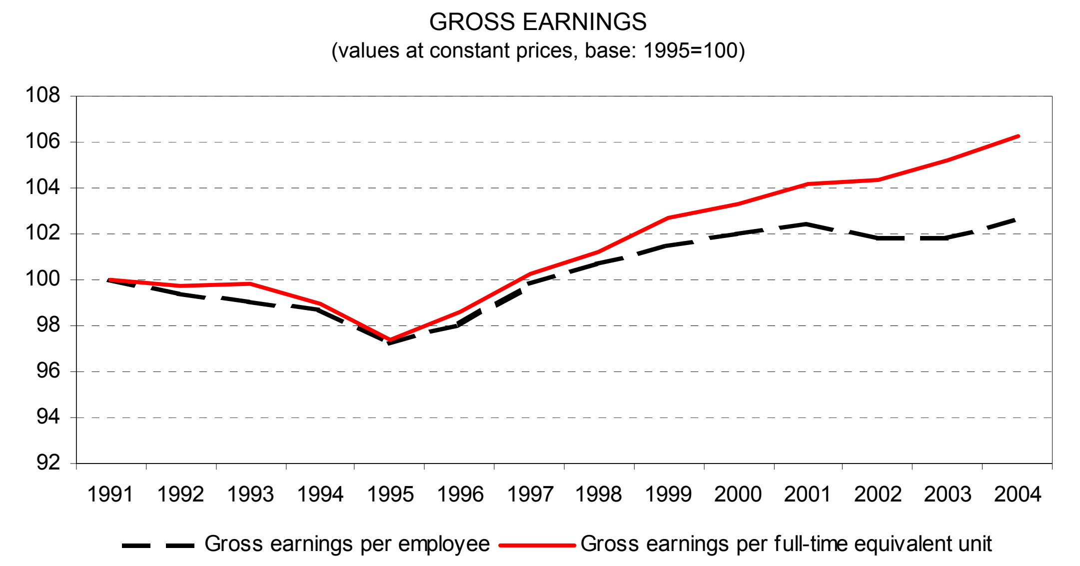
The General Assembly of the United Nations has designated 2005 as the "International Year of Microcredit". The ISAE has therefore deemed it appropriate to devote the third structural chapter of its Report to analysis of microcredit in Europe and Italy (the situation in the poor countries, where microcredit was introduced in the early 1970s, was examined by the Report of October 2003).

The second part of the Report begins with analysis of the current economic situation and budget manoeuvres (Chapter 4). The fifth chapter deals with business taxation. It furnishes information in particular on the yield from the IRAP regional tax on productive activity. It then describes simulations of the effects of the consolidated taxation of business group on the tax debt and estimates the effects of the reduction in social security contributions on the cost of labour, doing so by occupational category and sector.

As this Report goes to press, information is still not forthcoming on the family benefit measures which the Government intends to introduce with the funds already allocated for the purpose (1.14 billion euros). However, the Government has recently published the text of its legislative decree on the transfer of severance pay (*trattamento di fine rapporto*, TFR) to pension funds, a proposal which has now returned to

Parliament for a second reading. It was considered more helpful here to concentrate on this provision, with its intent to boost the supplementary pensions system in Italy.

Now considered in greater detail are the contents of the first chapter, which conducts a rapid survey of an important aspect of Italy's economic history and industrial relations since the freeze on automatic cost-of-living allowances and the July 1992 Agreement on the cost of labour. It is almost unanimously agreed that, by guaranteeing wage moderation, the 1992 Agreement made a major contribution to reducing the public deficit and to combating the inflation which ensued from the devaluation of September 1992. However, the trend in functional distribution during the period in question has been extremely onerous for dependent employees.



Source: ISAE calculations on ISTAT data, various years.

Contractual wages fell by 2% between 1991 and 1993 in concomitance with the freeze on automatic cost-of-living allowances and the disbursement of only a lump-sum payment of 20 thousand lire a month to cover the 1992-93 collective agreement period. And contractual wages fell by a further 4% between 1993 and 1996. There was a partial recovery thereafter, followed by another, though less pronounced, loss of purchasing power between 1999 and 2003, which was only partly off-set in 2004. Contractual wages had not returned their real 1991 levels by the end of the period, and still fell short of them by around 3 points.

Actual wages display a less dramatic trend, despite the loss of purchasing power in the period 1991-95 due to the trend of contractual wages, the suspension of company-level bargaining, and the effects of the recession, which probably reduced bonuses and overtime. Trends subsequent to 1995 show a recovery in real terms and also an increase in purchasing power, compared with 1991. The average annual increase in actual gross wages in real terms per full-time equivalent unit (FTE) in the entire period 1991-2004 was slightly less than 0.5%. However, pay per employed person rose to a much smaller extent (an annual average of 0.2%), probably because the increase in FTEs was due to the growth of fixed-term and part-time forms of employment (in fact, the number of ‘heads’ in the labour market increased more than did the units of labour).

The incomes of self-employed workers per FTE – reconstructed from ISTAT’s national economic accounts by institutional sector and deflated with the retail prices index – fell in 1992, although they rapidly recovered in the years immediately thereafter, and then rose until 2002, with an average annual increase of 1%. However, the crisis of 1992-93 hit self-employed workers especially hard, provoking a 6.5% (480 thousand labour units) fall in employment between 1991 and 1994 – in the presence of an increased incidence of irregular work – which was only partly recouped by the end of the period.

Inspection of the income shares of dependent employees, self-employed workers and profits in the sum of these three components shows a fall until 1992 in the proportion due to dependent employees. This fall was partly off-set in subsequent years (however, net of changes to social security contributions, and also in coincidence with the introduction of the IRAP regional tax, the share of work incomes would have grown slightly more vigorously). Also self-employed workers lost ground in the early years of the period until 1995, but they then managed to bring their share back to the 1991 level. The profits share increased substantially in the first half of the 1990s, but then diminished, except in the years straddling the turn of the century. The reduction between 2001 and 2003 was rather marked, and it coincided with a downturn in labour productivity. To be borne in mind is that the latter trend is generally set in relation to low capital accumulation in previous years. Indeed, wage restraint and the favourable trend in profits do not seem to have stimulated investments.

There follows preliminary analysis of the data on personal income distribution collected by the Bank of Italy’s Survey of Household Income and Wealth (SHIV), to which was applied ISAE’s ITAXMOD model for microsimulation of gross incomes. The wages of dependent workers and the gross incomes of self-employed workers were reproportioned on the basis of the corresponding aggregates in the national economic accounts by institutional sector already used for analysis of the shares in the functional distribution. Of course, both comparison of the results of the SHIW sample-based surveys for different years, and reproportioning on the basis of a different source, are operations with substantial margins of approximation. The results of the analysis should therefore be treated with caution.

Nonetheless, examination of the macroeconomic and microeconomic information thus gathered shows that, in the early 1990s, the households of both self-employed workers and dependent employees went through an extremely difficult period. As employment fell, and as actual wages together with incomes from self-employment decreased in real terms, income disparities widened in both groups. This was brought about by an increase in the number of people expelled from the labour market and by greater dispersion among dependent workers – and even more so among self-employed ones.

Thereafter, as workers recovered their purchasing power – self-employed workers doing so more rapidly (already by 1994) and dependent employees more slowly (by 1997) – a narrowing of the income range for self-employed workers and an upturn in employment slightly reduced the disparities. Although the differing trends in actual wages and contractual wages during this period would suggest an uneven distribution of wage increases among workers, this is not borne out by the microdata. Nor did the increase in part-time and/or fixed-term employment produce an increase in the concentration index.

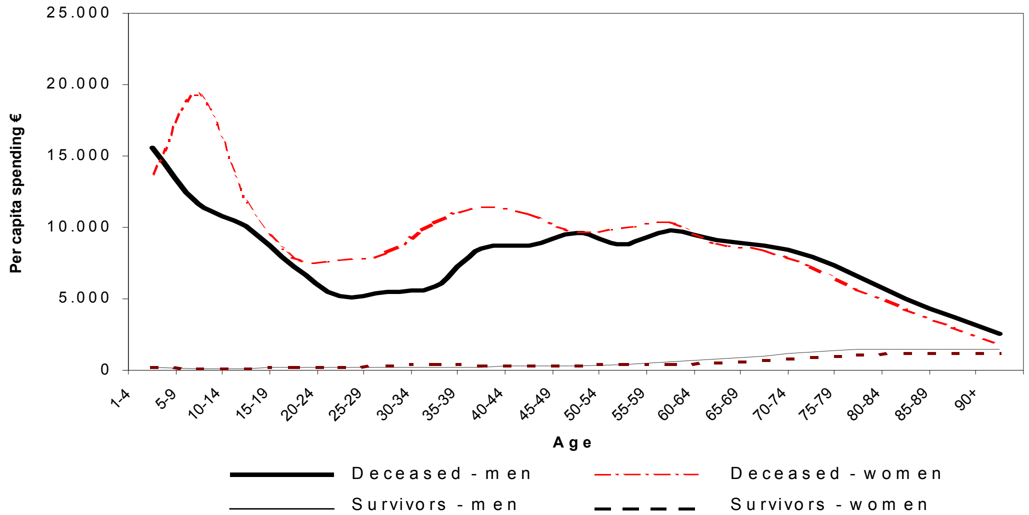
The ageing of the population is of great concern to economists, given the risks that may ensue from an increase in the dependency ratio (i.e. the ratio between the elderly and the working-age population). Fears are voiced concerning the impact on public financial balances of increased pension and health care spending. As regards the latter, there is a propensity to believe that, because the elderly consume more on average than young people, a larger proportion of people of advanced age in the population will entail a higher level of health expenditure. One problem with this view – which assumes the constancy over time of expenditure profiles by age – is that it does not take account of possible changes in the state of health in the future. A second problem, which is only partly connected with the first, is that various studies conducted on numerous countries have shown that large part of health costs are concentrated in the last months of life (and so-called ‘death costs’ apparently diminish with age). If the J-shaped curve of health expenditure by age – and in particular, the increase in costs in old age – depended on the higher mortality rate in this age cohort, because ageing postpones death, it would delay the expenditure rather than increase it. In light of these considerations ISAE has carried out a detailed study of health costs in the last months of life.

As to the reasons why it has been assumed that health spending increases markedly with ageing, commentators have suggested that this feature is nothing but a ‘red herring’ used to conceal other, more important causes of the increase – thereby distracting attention from assessment of the appropriateness and effectiveness of treatments – and to justify requests for greater resources on the supply side.

It therefore seems important to investigate the extent to which health spending at different ages depends on the distance from birth, and to what extent it depends on distance from death. The second chapter of this Report sets out an empirical study on these aspects in Italy. However, given the differing availability and varying quality of data across the country, the analysis concentrates on hospital care, with examination being made of health costs in four regions (Lombardy, Tuscany, Apulia and Abruzzi) located in the country's three macro-areas (entirely preliminary analysis was made of pharmaceutical and outpatient specialist care in Tuscany).

As for the methodology used, the administrative databases on health care consumption in the regions examined were connected with the databases on mortality by means of a record linkage procedure based on tax codes as subject identifiers. It was thus possible to separate the hospital costs profiles of survivors from those who were deceased within 12 months.

PER CAPITA HOSPITAL SPENDING BY AGE AND GENDER
OF SURVIVORS AND DECEASED



Source: calculations on regional and ISTAT data.

Average per capita expenditure per survivor was between 406 euros in Lombardy and 568 euros in Abruzzi. The expenditure for the deceased ranged from 5481 euros in Apulia and 5868 in Tuscany. The curves for survivors exhibit the well-known J-shape. Expenditure is lower for women than for men, except at the age of greatest fertility. Per capita expenditure diminishes in the oldest age classes (Lombardy and Abruzzi) or remains constant (Apulia), whilst in Tuscany it continues to rise, albeit at lower rates, after the age of ninety. Tuscany, for that matter, is the region with the lowest overall per capita expenditure, except in the case of people aged over eighty, whose per capita cost is lower in Lombardy – probably because of the wide availability in that region of residential care and nursing facilities (*Residenze Sanitarie Assistenziali*, RSA), which may take the place of hospitals in providing care for the elderly. The curve for the deceased lies constantly above the curve for survivors. The expenditure is high for the very young, decreases until the age of 20 (probably because of the high rate of accident-related deaths at that age), and then increases again. After the age of 55-to-59 (women reach a relative maximum at around 35) the expenditure diminishes steeply, and the distance from the survivors curve narrows. Expenditure on the deceased in the over-90 age group is, for men, 26% less than that on subjects aged 55 to 59 (18% for women).

The ratios between per capita expenditure on the deceased and survivors vary between 10 and 14 among the regions examined (12-16 for men, 8-12 for women). In terms of age, to be noted is that the trend of this parameter is constantly decreasing for subjects aged over 40. The ratio for over 90-year-olds is between 1 and 2, while in the 35-to-39 age group it varies between 36 and 43 for men, and between 21 and 40 for women.

Different methods, data and hypotheses notwithstanding, the ratio between the costs of the deceased and survivors – with reference to both the entire population and the oldest age groups – is similar to those calculated by other studies on the Netherlands, the USA, and Spain, as well as on certain Italian regions (Tuscany and Emilia Romagna).

Per capita hospital expenditure for persons deceased in the last twelve months of their lives grows constantly from the twelfth to the last month before their deaths, this latter being the month in which the increase is the most marked. In Abruzzi and Apulia, expenditure becomes substantial only eleven months prior to death. In Lombardy and Tuscany, by contrast, the deceased are hospitalized for longer periods of time.

In the final month of life, per capita expenditure for all ages exceeds 2000 euros for men and 1500 euros for women in Apulia, between 2000 euros and 2500 euros for men and between 1500 euros and 2000 euros for women in Abruzzi and Tuscany, and between 3000 euros and 3500 euros for men and between 2000 euros and 2500 euros for women in Lombardy.

A preliminary study on drugs prescriptions and outpatient specialist treatment in Tuscany found trends similar to those exhibited by hospital expenditure.

Overall, the conclusion is that geographical differences and the adoption of different models of regional healthcare delivery do not significantly influence the phenomenon examined. On the contrary, the per capita expenditure profiles for the deceased and the trend in the ratio between deceased and survivor expenditure in the four regions confirm the results of previous studies on Tuscany and other countries. ISAE's estimates may therefore be used to revise long-term expenditure projections for Italy (since all studies which make long-term projections show that excluding death costs gives rise to a more or less pronounced overestimation of healthcare spending).

The third chapter of this Report deals with microcredit. It first points out that the main cause of financial exclusion is the exposure of banks to credit risk due to information asymmetries and, sometimes, to serious enforcement problems in developing countries – but also in certain areas of the developed ones as well. Banks consequently demand guarantees that certain categories of borrowers cannot provide, even though they are in fact able to repay their loans. High transaction costs in ratio to the value of microcredit operations are also a dissuasive factor. Decisive, too, are the difficulties caused by the inaccessibility of credit institutes, the high prices that they charge, or the other repayment conditions that they impose. A further factor is self-exclusion connected with feelings of inadequacy, distrust, and linguistic and cultural barriers.

Microcredit consists in the granting of small loans, which must be repaid in frequent instalments, to people who do not generally have access to financial services because they are unable to provide the usual guarantees. Different types of repayment incentives are therefore used, such as group loans with joint liability, which reduce transaction costs and ensure a reciprocal control among the members which reduces the moral hazard (also under the threat of economic and social sanctions) and adverse selection (the members can easily select each other because they belong to the same community). Other incentives for repayment are the requirement that a deposit be made as guarantee, and the granting of increasingly larger loans as previous ones are repaid. Moreover, in the developing countries, preference is given to women on the grounds that they are more reliable.

The microfinance institutions seek geographical proximity to their clients. Loan conditions are adapted to need, with rapid application procedures, the minimum possible amount of paperwork, small loan amounts, and frequent repayment instalments – and the possibility of renegotiation. Interest rates vary greatly and are generally high. The reference rates for applicants for microcredit are not bank rates but those charged by the informal sector, including usurers.

The beneficiaries of microcredit programmes are estimated at around 81 million (end of 2003). The microfinance system is highly developed in Asia (88% of beneficiaries), but much less so in Africa (8%), Latin America and the Caribbean (3%), and the Middle East (0.1%).

The beneficiaries in the industrialized countries number just over 200 thousand (although the figure may be underestimated), 77% of them resident in Europe. Women account for only a small percentage of microcredit clients (22%, against 56% in the developing countries), and so do the poorest beneficiaries (40%, against 68% in the developing countries).

GEOGRAPHICAL DISTRIBUTION OF MICROFINANCE PROGRAMMES AT END 2003

Area	Microfinance programmes	Beneficiaries	'Poorest' beneficiaries	'Poorest' women beneficiaries
Africa	919	6.438.587	4.725.912	3.180.419
Asia	1.603	71.585.413	48.797.590	41.272.188
Latin America & Caribbean	261	2.519.299	1.121.324	719.191
Middle East	30	106.464	54.039	22.785
Developing countries total	2.813	80.649.763	54.698.865	45.194.583
North America	48	53.147	24.817	10.782
Europe & transition countries	70	165.433	61.751	37.360
Industrialized countries total	118	218.580	86.568	48.142
Global total	2.931	80.868.343	54.785.433	45.242.725

Source: Daley-Harris (2004).

In Europe, the aim of microcredit is to reduce poverty and exclusion and to promote local development, mainly through independent work, the creation of microenterprises, and self-employment projects, especially for categories such as the unemployed and immigrants, but its purpose is also to solve households' temporary liquidity problems.

Microfinance encounters greater difficulties in the advanced countries than in the developing ones. For example, the number of clients in the population is limited, and microcredit programmes attract fewer applicants, with the consequence that more serious problems of financial sustainability and greater risks arise. Moreover, setting up microenterprises is a more complicated and more costly undertaking, so that the average loan is of a larger amount. Interest rates are lower (10-15% compared with 40-60% in the developing countries) because of lower inflation, and also because specific legislation has been enacted. Repayment is made in the medium-to-long period rather than the short one (within one year), given that it takes longer in Europe for an investment to yield returns.

In Europe, the duration of loans varies between six months and ten years (29 months on average); the average interest rate is 8% (oscillating between 0% and 20%); and the average amount of a loan is 12 thousand euros. Some 91% of loans are repaid. As for the resources used, a major role is performed by public funds (allocated by the state, regional governments, the European Union), but some financing is provided by private organizations. The financial institutes operating in the microcredit sector do not seem to find it difficult to obtain resources for loans; rather, they have difficulties in covering their overheads and in finding interested clients with entrepreneurial abilities.

As regards Italy in particular, given the lack of accurate estimates on the number and features of microcredit clients, it may be helpful to report on certain segments of potential demand for which specific indicators are available. Principal among these is the frequency of usury: it has been estimated that in 1993 just over 340 thousand Italian households resorted to usurers. Further indicators of the need for credit are measures of poverty: its incidence (11.7% of households suffered relative poverty in 2004, according to ISTAT); intensity (just over 6% of households were ‘almost poor’ and just under 8% were at risk of poverty); and persistence (it is estimated that 48% of households falling below the poverty line are able to recover after a year). In a country like Italy, small loans schemes could be targeted principally on people affected by less severe and/or temporary hardship. Another segment of potential demand consists of people in precarious employment, and who consequently have sporadic incomes (there were 2.69 million ‘atypical’ workers in 2003, more than 12% of the total). The granting of microcredit to young unemployed persons intending to set up a microenterprise is one way to develop active employment policies. Finally, also immigrants could be helped to undertake small-scale entrepreneurial initiatives, especially those immigrants who have settled in the country and have substantial levels of education and training.

As regards the supply of microcredit, the third chapter describes the situation using data and information from a variety of recent studies. Here we merely point out that both private intermediaries (some of a mutualistic or cooperative character) and public institutions (state, region governments, local authorities) have been operating for some time in Italy. Often created are networks of private, public and non-profit organizations which allocate tasks according to their respective remits – a feature which constitutes the main strength of such schemes. Their main initiatives concern loans to students (cases in point being the so-called ‘honour loans’ introduced in 1991 for deserving students without adequate economic resources), loans to set up or develop economic activities, or non-specific loans. In the majority of cases, the loans amount to no more than 10 thousand euros, although in some cases they may involve sums of more than 20 thousand euros. Interest rates are generally market rates, but they may be less, or even zero, when the financier does not require a return of capital, or when a public promoter covers at least some of the financial charges. The repayment rate is very high.

The majority of microcredit schemes in Italy are centred on the set-up or development of microenterprises, and public guarantees mainly concern loans for those purposes. It is to be hoped that public aid will be made available to households with temporary liquidity problems, so that this innovative instrument can be used to achieve social policy goals besides those of active employment policy.

Chapter 4 analyses the short-term situation of the Italian economy, public finances, and the budget manoeuvre for 2006.

The assessments of trends in the public finances and the evolution of the economy in 2005 take account of the effects of decree law no. 211 enacted to curb spending, the regularization of building offences (*condono edilizio*), and the sale of real estate – the revenues from which are presumed to be less than the initial official estimates and the results of 2004. ISAE also predicts that the costs of renewing public-sector agreements in 2005-2006 will next year be of greater weight than estimated by the Forecasting and Planning Report (*Relazione Previsionale e Programmatica*, RPP).

The budget manoeuvre for 2006 is taken at 'face value', while the divestiture of state-owned real estate is expected to yield 4 billion euros. The budget adjustment will amount to 11.5 billion euros (0.8% of GDP). A further 8 billion euros should cover economic support measures, as well as certain non-deferrable costs and spending surpluses. The gross effect of the manoeuvre will therefore be equal to 19 billion euros. Also envisaged is the funding of projects under the Plan for Innovation, Growth and Employment drawn up to implement the Lisbon Strategy, using for the purpose revenues to an amount of 3 billion euros from the divestiture or alienation of state-owned property. Saving measures will require a major effort to curb spending by the central and local public authorities.

FORECASTS FOR THE INTERNATIONAL ECONOMY – SUMMARY
(percentage variations unless stated otherwise)

	2004	2005*	2006*
Exchange rate			
Dollar/euro (level)	1,24	1,25	1,20
Official interest rates (1)			
Euro area	2,0	2,0	2,5
United States	2,0	4,0	4,5
Raw materials prices in dollars			
Brent crude (dollars a barrel)	38,2	55,9	61,0
% variation	33,9	46,2	9,1
Other raw materials	16,7	5,0	-1,6
World demand			
Imports/exports average	10,4	6,6	7,5
Industrialized area	7,6	5,0	5,9
Emerging economies	15,6	9,4	9,1
Gross domestic product			
World	5,0	4,2	3,9
Industrialized economies	3,1	2,4	2,3
Euro area	1,8	1,3	1,5
United States	4,2	3,4	2,8
Japan	2,6	2,2	1,9
Emerging economies	7,0	6,1	5,5
Consumer prices			
Industrialized economies	2,0	2,0	1,8
Euro area (2)	2,1	2,2	2,2
United States	2,7	3,1	2,0
Japan	0,0	-0,3	0,5

Source: calculations on IMF, HWWA data.* ISAE forecasts.
(1) End-of-year rates. (2) Harmonized prices.

Between the end of 2004 and early 2005, Italian GDP fell by 0.9 percentage points during two successive quarters (the last one of 2004 and the first one of 2005). However, the second quarter of 2005 saw the rate of output growth return to positive values following improved performances by manufacturing, services, and above all by the construction industry. Total demand was boosted by increases in both net exports (owing to the acceleration of international demand and a slowdown in exchange rate appreciation) and domestic demand, together with a reduction of stocks. The most recent figures on industrial production show a positive growth rate in the third quarter as well. Together with the ISAE diffusion index (which measures the shares of sectors in expansion and recession), these figures confirm that the upturn began in the first quarter of the year. A slight slowdown of manufacturing activity is expected only in the final quarter of the year.

FORECAST FOR THE ITALIAN ECONOMY: SUMMARY
(percentage variations unless stated otherwise)

	2004	2005	2006
Gross domestic product			
GDP corrected for working days	1,2	0,2	1,3
Imports of goods and services	1,0	0,3	1,4
Exports of goods and services	2,5	1,8	3,2
Expenditure by resident households	3,2	0,2	2,9
Expenditure by general government	1,0	1,0	1,3
and non-profit institutions	0,7	1,1	0,3
Gross fixed investments	2,1	-0,8	2,1
Contribution to GDP growth:			
- by domestic demand net of changes in stocks	1,1	0,6	1,3
- changes in stocks and valuables	-0,1	0,0	0,1
- net exports	0,2	-0,4	-0,1
Current and capital account balance (as % of GDP)	-0,7	-1,3	-1,5
Consumer prices	2,2	2,0	2,2
Producer prices	2,7	4,0	2,6
Propensity to consume (percentage level)	86,4	85,8	85,5
Compensation per employee: whole economy	3,0	3,0	3,2
Total employment (1)	0,8	0,4	0,6
Unemployment rate	8,0	7,8	7,6
General government net borrowing (as % of GDP)	-3,2	-4,3	-3,9
General government primary surplus (as % of GDP)	1,8	0,7	1,0
General government fiscal burden	41,7	41,1	40,9
General government debt (as % of GDP)	106,5	108,6	108,1
Yield on 12-month treasury bonds (2)	2,2	2,3	3,2

Sources: ISTAT, Banca d'Italia.
* ISAE forecasts.
(1) In standard labour units.
(2) End-of-year rates. Gross compound rate for treasury bonds.

The variations in the other conjunctural indicators (new car registrations, business confidence, the ISAE forward index) also augur well, despite the historically low level of consumer confidence due mainly to the overall economic trend. The forecast is therefore that GDP will grow in the third quarter to an extent close to that in the second quarter, but will then slow down in the fourth.

Taking account of these features, fiscal policy measures, and the international forecasts set out in the Table, the rate of GDP growth in the current year is estimated at 0.2% (0.3% when corrected for working days). Thanks also to a carryover effect of six-tenths of a point, 2006 should register a 1.3% increase in output (1.4% with the correction).

Net foreign demand is expected to contribute negatively to growth in 2005 (-4 tenths of a point), while domestic demand will have positive effects (6 tenths of a point), this being wholly due to consumption. Both the latter and investments will exert positive impacts in 2006 (1.3 points), while the negative contribution of net foreign demand will be less than in the previous year.

In 2005, consumption (+1%) will reflect the growth of personal incomes and an improvement in confidence. In 2006 earnings and employment will continue to sustain demand (1.3%) despite the slight upturn in inflation and the slowing growth of saving propensity in recent years. Investments will again record a negative rate of variation in 2005 (-0.8%), but they will grow by 2.1% in 2006.

Although exports will grow to a limited extent in 2005 (0.2%), they will increase more substantially in 2006 (2.9%). However, this trend will further reduce Italy's share at constant prices of world trade, although the reduction is predicted to be less than that experienced in the early 2000s. As an effect of the economic recovery, imports will increase by 1.8% in the current year, and by 3.2% in 2006.

As regards employment, the stagnation of the first part of the year – which was partly offset by the regularization of immigrant workers – will nevertheless give rise to a 0.4% increase in standard labour units. The economic recovery will generate a growth rate of 0.6% in 2006, despite a decrease in the elasticity of employment to GDP, which will make a cyclical acceleration of labour productivity possible. The unemployment rate will fall from the 8% of 2004 to 7.6% in 2006 (also due to supply-discouraging effects in the most difficult areas of the country). As a result of collective agreement renewals, pay levels will rise by 3.1% per capita in 2005, and by 3.2% in 2006.

To date, the increase in energy input prices has affected prices at the final distribution to only a minor extent, owing to Italy's lesser dependence on oil compared with the 1970s and 1980s – ISAE estimates put the decrease in oil requirements at 70% – and also because of the relative weakness of consumer demand and the competitiveness of low-cost imports. More specifically, the domestic components of inflation display moderate trends, and in 2006 they may partly offset the effect of the foreign components. The overall forecast is a 2% rate of prices growth for the current year (-0.2% on 2004), which will push the harmonized rate up to just below the average rate for the euro area, and then a 2.2% growth rate in 2006 (with a harmonized rate of 2.3%, which will re-establish a slight gap to Italy's advantage).

As regards Italy's public finances, the ratio between net borrowing and GDP is expected to be 4.3% in 2005, as foreseen by the official documents, with an increase on last year due to the negative economic conjuncture and only partial implementation of the last budget manoeuvre. The forecast for 2006 is 3.9%, due to resumed growth and further corrective measures, should they prove effective.

The general government primary surplus should diminish by just over one GDP point to 0.7% in 2005 and then increase by three-tenths of a point in 2006. Despite the rise in interest charges in absolute value, the incidence on GDP will fall by one-tenth of a point per year to 4.9% in 2006. The current balance will still be down by about half a GDP point, while the capital account balance will oscillate under the influence of extraordinary items.

The fiscal burden will decrease in the current year by more than half a GDP point, and then by two-tenths in 2006, so that it stands at 40.9%, as compared with 41.7% in 2004, by the end of the two-year period. However, when calculated net of revenues on capital account the decrease will be limited to two-tenths of a GDP point.

In 2005, the debt/GDP ratio will increase from 106.5% to 108.6% (owing to increased borrowing requirement and the unfavourable economic trend). It will then fall to 108.1% in 2006 if privatizations yield the 15 billion euros foreseen by the Economic and Financial Planning Document, and if use is made of the Treasury Account held at the Bank of Italy.

The fifth chapter examines the distribution of the taxes and contributions paid by firms, focusing on the measures set out in the draft Budget Law which are currently the cause of much debate.

The chapter begins with discussion of the IRAP regional tax on the value added of firms introduced for three main purposes: to simplify the tax system; to ensure greater neutrality in respect to factor use; and to increase regional financial autonomy. As regards the first of these purposes, the tax system was to be simplified by abolishing various taxes and contributions and replacing them with the IRAP: a simplification which has given rise to a net decrease in yield estimated at around 5 billion euros. At the firm level, the effects have differed according to costs structure, the proportion of profit in value added, and possible relief on or exemption from the ILOR local income tax. Moreover, introduction of the IRAP has produced an average one-point decrease in the cost of labour.

Also to be pointed out in regard to simplification is that the procedure for calculating the tax is particularly complex because it requires specific accounts to be kept – the so-called ‘third track’ – which overlap with the book-keeping required by the civil code and tax law.

It was expected that the introduction of a single tax with a low rate and a broad taxable base would encourage fiscal compliance and reduce tax evasion. However, given that the taxable base is calculated as the difference between the value of production and certain costs (raw materials and services, depreciation costs and those for tangible and intangible assets), any losses by the firm reduce the component relative to the cost of labour. In the previous system, instead, social contributions for healthcare had to be paid irrespective of losses.

Greater neutrality has resulted from the uniformity of the tax rate on labour and capital. From this point of view, the IRAP tax has reduced the incentive for firms to finance themselves through borrowing, rather with their own capital. However, the non-deductibility of the new tax from income generates complex redistributive effects unfavourable to firms declaring profits.

Since 2000, the regions have been allowed to vary the rate according to sector and taxpayer. A series of measures have consequently been adopted in order to increase the burden on financial companies and to assist marginal sectors, new firms, and businesses in mountain communities.

ISAE has analysed the distribution of taxpayers and the yield on the basis of a representative sample of IRAP declarations for 2002. Individual firms and professionals make up the largest group of taxpayers. Joint-stock companies represent 14% of subjects and pay 55% of the yield, physical persons (65% of taxpayers) pay 10% of the yield, and partnerships (18%) pay 9%. Of particular interest is the finding that 31% of firms (37% among joint-stock companies) do not declare positive tax bases. Moreover, fewer than 5% declare value added amounting to more than 250 thousand euros.

NUMBER OF IRAP SUBJECTS BY SIZE CLASS AND TYPE OF DECLARATION

IRAP value added classes	Type of declaration	Physical persons	Partnerships	Joint-stock companies	Non-profit organizations	Public administrations	Total
Nil value added	Number	1.091.449	281.416	293.895	53.031	118	1.719.909
	% column	30,3	27,7	37,0	61,7	0,5	31,1
Between 0 and 50 thousand euros	Number	2.146.124	428.553	167.316	20.143	2.660	2.764.796
	% column	59,5	42,2	21,1	23,4	10,6	50,0
Between 50 and 250 thousand euros	Number	341.196	249.714	174.990	8.998	12.492	787.390
	% column	9,5	24,6	22,0	10,5	49,9	14,2
More than 250 thousand euros	Number	29.160	56.591	158.009	3.800	9.765	257.325
	% column	0,8	5,6	19,9	4,4	39,0	4,7
Total	Number	3.607.929	1.016.274	794.210	85.972	25.035	5.529.420
	% row	65,2	18,4	14,4	1,6	0,5	100,0
	% column	100,0	100,0	100,0	100,0	100,0	100,0

As for the distribution among regions, Lombardy has the highest tax base, also for public bodies. Moreover, this region collects around 23% of the total yield. Whilst in the Centre and North of the country the revenue derives mainly from joint-stock companies, in the South it does so principally from public-sector bodies. In all three macro-areas, large firms account for almost all the IRAP yield, and they also represent about 80% of the taxable base.

Despite the fact that the IRAP has reduced tax receipts (tax burden on firms), it has been widely criticised by economic operators because it is commensurate with production costs rather than earnings. The 2003 delegating law on fiscal reform envisaged a gradual reduction of the IRAP, but it has gone largely unimplemented. A recent opinion by the Advocate General of the European Court of Justice has concluded that the IRAP is incompatible with EC law. While awaiting the definitive ruling, careful consideration should be made of the future of this controversial tax. It seems advisable to give the levy more precise definition, deciding whether to convert it into either a genuine regional tax on production or a tax on business income.

The fifth chapter also analyses the effects of the provision in the draft budget law which reduces by 1 point the contributions rate paid by private-sector employers for family allowances. In the event of a shortfall, the cut will be shifted to contributions for maternity and unemployment.

The ISAE's ITAXMOD microsimulation model was used to estimate the distributive effects of the provision. For this purpose account was taken of the statutory rates, the relief and allowances granted by various measures, and the actual yield reported by the national accounts (which also incorporate evasion effects).

The decrease in yield was estimated at around 2.5 billion euros. The average level of per capita relief (calculated only on the subjects concerned) was estimated at 226 euros, and the average impact on the cost of labour at 0.66%. The percentage varies moderately according to job classifications, being lower for production workers and higher for managers, as the former are subject to higher contribution rates than the latter (so that the reduction is relatively smaller). Consequently there is a lower incidence for the lower labour-cost classes. The effects by economic sector depend on the proportion of workers at different skill levels: the incidence is lower for agriculture, industry and construction.

The final part of the fifth chapter assesses the yield and distribution effects of the consolidated tax return, which is an aspect of the more general reform of corporate taxation that ISAE has not previously analysed. The new regime allows the controlling company or body and each subsidiary company jointly to opt for determination of a single tax base. Required for this purpose is a more than 50% majority control and share of the controlled company's capital stock held either directly or indirectly via another company.

A simulation on data from the income tax returns filed by joint-stock companies and commercial enterprises estimated the tax saving at around 3.5 million euros (3.4 million according to the technical report), and the number of companies able to benefit from the new regime at 7,824 parent companies, which is a relatively small proportion of those entitled to opt for the new form of taxation (22,182). The number that actually took up the option was even smaller: only approximately 3000.

Reasons for the scant use of the consolidated taxation system may be its limited advantageousness due to the restrictions imposed on the number of participating companies, and its ‘competition’ with the alternative system of fiscal transparency.

From a distributive point of view, the advantage – which accrues entirely to the parent company – is greater for enterprises located in the North-East and with more than 50 employees, and as regards economic sector, for non-metallic minerals, textiles and clothing, transport vehicles, and monetary and financial intermediation.

The final chapter of the Report analyses recent initiatives in regard to supplementary pensions, and in particular the transfer of annual payments for severance pay (*trattamento di fine rapporto*, TFR) to a supplementary pension fund unless the worker explicitly states his/her desire that the payments remain with his/her employer. The aim of this measure is to increase the rate of enrolment with supplementary pension schemes, increasing their advantageousness to workers, with low costs to the public finances and zero costs to employers.

The chapter sets out the results of a survey conducted by the ISAE on workers’ preferences. The survey was carried out in two waves, the first in September-December 2004, and the second in September-October 2005. The results of the first survey suggested that the measures contained in the legislative decree issued in August 2004 were not enough to persuade the majority of workers to change their preferences and therefore devolve their TFRs to pension funds. This reluctance was probably due, at least in part, to the lack of a definitive legal framework for the scheme. It was expected that issue of the legislative decree implementing the delegating law would reduce uncertainty over some of the variables influencing assessment of the advantageousness of one or other of the two forms of retirement saving, and that it would shift some of the uncertain respondents to either acceptance or rejection of the pension fund option. The survey carried out in September and October 2005 – after presentation of the consolidated text of the law on supplementary social security and talks with the social partners on the contents of the implementing decree – found that, although the proportion of uncertain respondents had decreased, there was a strong preference for retaining the TFR (53% of respondents excluding non-replies), mainly because of its security and the high level of liquidity that it guarantees.

ISAE's estimates on the survey data show that the choice between severance pay and a supplementary pension depends mainly on a marked difference in the risk level associated with the two options. While the decision to devolve the TFR to a pension fund was irreversible, that of keeping the allowance within the company meant that the worker could later opt to transfer it to a pension fund at any time.

The empirical analysis shows that implementation of the reform law has clarified the situation for the time being, but that it still leaves broad margins of uncertainty over the future development of the two allocations. Between the first and second waves of the survey, the more elderly respondents – who are not the target of the incentives – demonstrated that they had realized that the new system would have little effect on their economic situations; while the majority of young respondents – who are most closely affected by the reform – were still waiting for the situation to clarify and had decided to postpone their opting for a pension fund.

CHOICE OF ALLOCATION OF THE TFR BY MONTH OF INTERVIEW

	2004					2005			Totale
	September	October	November	December	Total	September	October	Total	
Fund	61	43	63	52	219	60	43	103	322
	15,8	10,1	15,9	13,6	13,8	14,6	10,9	12,8	13,5
Company	168	172	164	165	669	223	201	424	1.093
	43,6	40,6	41,4	43,2	42,2	54,1	51,1	52,7	45,7
Don't know	156	209	169	165	699	129	149	278	977
	40,5	49,3	42,7	43,2	44,0	31,3	37,9	34,5	40,8
Total	385	424	396	382	1.587	412	393	805	2.392

Source: ISAE calculations on 2004 and 2005 data.

In general, therefore, there is a marked preference for the TFR: a rigid demand which not even the fiscal incentives proposed seem to have significantly influenced.

The effectiveness of these fiscal incentives is assessed by comparing four possible taxation schemes (and verifying their effects on the tax burden of a typical payer): (i) the current system (11% levy on the earnings from forms of supplementary social security and IRPEF income tax on the proportion of the supplementary pension still untaxed); (ii) the system proposed by the legislative decree currently being discussed by Parliament (maintenance of the 11% levy on earnings and a 15% tax rate on supplementary pensions, reducible to 9% after 35 years of payments); (iii) a lower tax rate on earnings (6.25%) and separate 20% taxation of the pension share; (iv) complete tax abatement on earnings and full IRPEF taxation of the supplementary pension. The scheme envisaged by the legislative decree does not alter the fiscal burden on the taxpayer (nor the yield for the inland revenue) in the immediate term. Only when the pension is paid, with separate taxation at a low rate, will there be a substantial advantage – with regressive effect – for those who have invested in a pension fund (and a lower return for the treasury). The regressiveness is obviously due to the fact that the taxable base for a progressive tax (IRPEF) is subjected to a fixed rate. While on the one hand this may serve the purpose of encouraging workers to subscribe to supplementary pensions, and it will also increase coverage rates without affecting the public finances in the short term, on the other it raises doubts as to the efficacy of this incentive and its distributive effects. In regards to the latter point it has been said that the discount favours the higher-level beneficiaries (public pension system and pension funds). Moreover, it gives rise to discriminatory tax treatment between the first and second pillar, with the advantage accruing to those whose retirement incomes will consist of a relatively higher supplementary pension share and a relatively lower state pension share (for example, self-employed workers are favoured with respect to dependent employees, given the different compulsory contribution rates for the two categories). As regards the former aspect, the fact the discount is postponed until retirement, its actual payment is uncertain. In other words, when a worker decides between the TFR and a supplementary pension, s/he may base his her choice on considerations concerning the likelihood that the taxation system will change over a multi-year period – because the tax rate is revised, because IRPEF income tax is applied to the supplementary pension, or because the IRPEF regime applying to the TFR is redefined. One may consequently harbour doubts as to the future budget sustainability of the tax discount proposed.

The fiscal benefit could be brought forward to some extent by reducing the tax rate on the returns of funds, off-setting this relief with a less favourable levy on the supplementary treatment. In this case, the loss of yield would be in part anticipated; the regressive consequences on distribution would not be eliminated, but at least they would be reduced; and perhaps a better result would be obtained in terms of subscription to funds, because the immediate discounts may be considered more interesting and credible, while even those obtainable later may appear less risky (their cost to future balances would be lower, in fact, so that their likelihood of proving unaffordable would be less). Finally, if supplementary pensions were made subject to IRPEF income tax, progressive taxation on supplementary pensions would be restored, on a par with state pensions, and the cost to the treasury of granting the incentive would be entirely brought forward. The discount would be less than in the previous case.