



A Broadened Approach to the Budget: an example from Italy

**New Approaches to Economic Challenges, OECD
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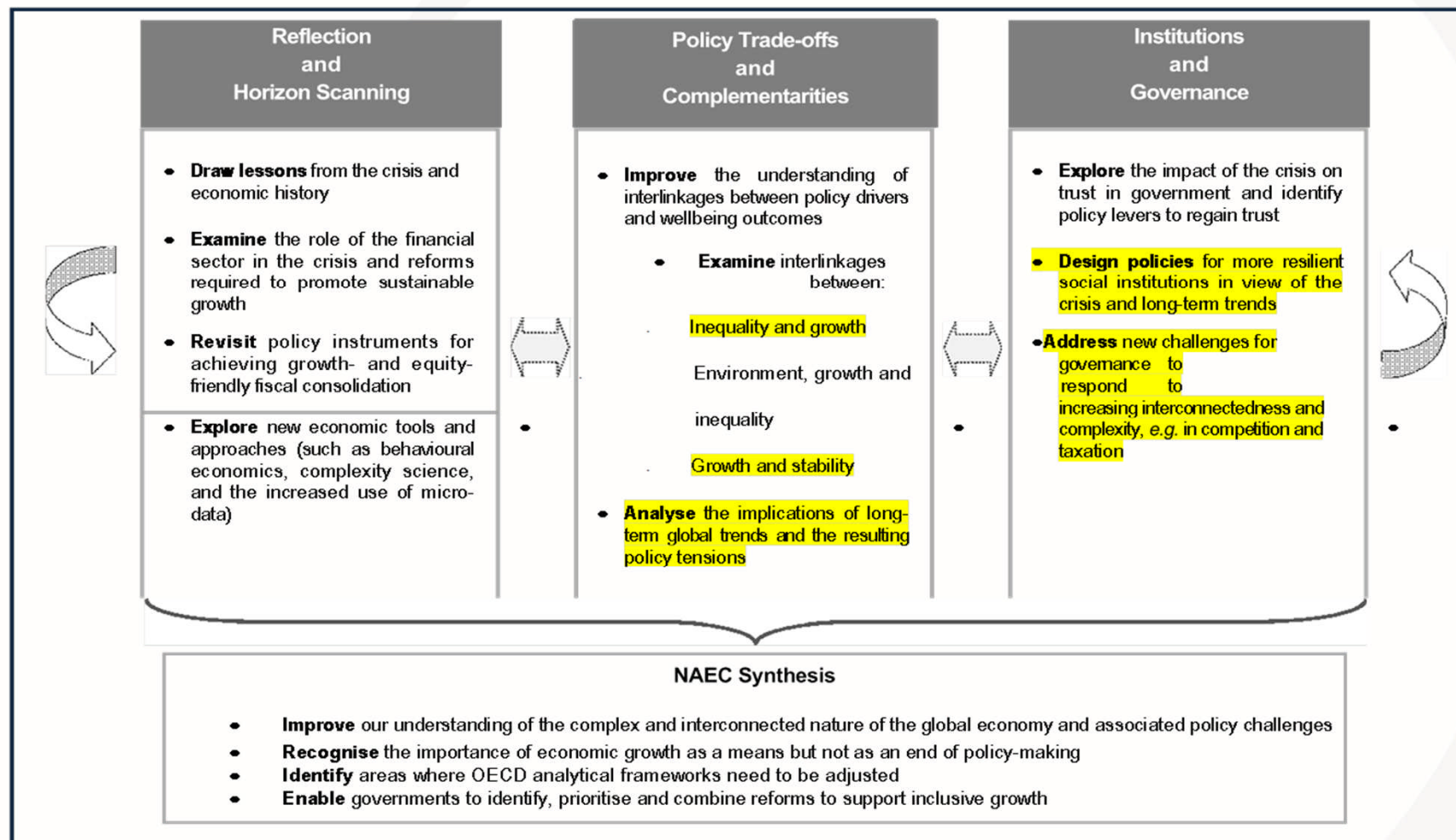
Overall context: the Italian economic conditions and the rationale for action

- 2013 **deficit** to remain below 3 per cent threshold due to successful **fiscal consolidation**.
- **GDP** decreased by -1.7 per cent in 2013, with a cumulative reduction of -8.5 per cent over 2Q2008-2Q2013; still high levels of public **debt** (133 per cent of GDP in 2013).
- **Unemployment** (12 per cent in 2Q2013), especially for young people (37.3 per cent in 2Q2013), remains a top priority.
- **Poverty rate** increased over 2007-2010 by 2.2 pps (vs. OECD increase of only 0.5 pps, anchored to 2005 threshold).
- **ULC** increased by 1.3 per cent in 2013; the **tax wedge on labour** in 2012 equaled 47.6 per cent of labor cost.
- Growing importance of **measuring impact** and **understanding the underlying relationships** between the different variables involved.

Designing the 2014 'Stability law': a new approach

- Working group (Ministry of Economy and Finance and other stakeholders such as the Bank of Italy and the Ministry of Labour): **policy measures and financing options** proposed for the draft budgetary plan.
- Besides the required budgetary projections (impact on public finance): **ex ante assessment** of their **quantitative effects** in the **short-** and **medium term**.
- A **large-scale exercise**, through in-house econometric models, including **simulations of the measures' implications** on both:
 - **Macroeconomic** variables (GDP, employment);
 - **Microeconomic** dimensions (income distribution, (in)equality, labour supply).
- Framework including, in addition to **economy/efficiency, equity and inclusion** in terms of broader wealth distribution.

The Italian experience in the context of the NAEC initiative



Methodological aspects

- To guarantee **comparability** and allow policymakers to evaluate the **optimal mix of measures**: standardisation of the size of each measure to 0.1 per cent of GDP (€ 1.6 bln.)
- **Macroeconomic** assessment of the percentage deviation from the baseline scenario.
- **Microeconomic** estimation of income inequality (percentage change of Gini index pre- and post-reform). Poverty indices and a preliminary efficiency evaluation also included.
- **Trade-offs** and **complementarities** between: *i*) equality/efficiency (GDP/employment growth or labour supply); *ii*) equality/public finance impact; *iii*) efficiency/public finance impact.

Outcome: a full report with a comparative assessment grid

ASSESSMENT OF MACROECONOMIC IMPACT AND DISTRIBUTIVE EFFECTS OF SOME REFORM AND FUNDING HYPOTHESES												
				Measures of standardised size, equal to 0.1 per cent of nominal GDP (€1,600 mln)				Measures with the proposed size				
				Short-term effects: 2 nd year		Medium-term effects: 5 th year		Distributive effects	Budget burden: 1 st year	Short-term effects: 2 nd year		Medium-term effects: 5 th year
				GDP		Empl.		Gini index	€mln	GDP		Empl.
				Workers/ households		Employers		% change between pre- and post-situations		% deviations from baseline scenario		% deviations from baseline scenario
Type of measure		Reform hypotheses										
Cutting labor cost	1	4 groups for active measures										
	2											
	3											
	4											
	5											
Cutting employers' tax burden	7											
	8											
	9											
Rationalizing tax system	10											
	11											
	12											
Income support	13											
	14											
Type of measure		Funding hypotheses										
Additional revenues	1	2 groups for funding measures										
	2											
	3											
	4											
	5											
Lower expenditures	6											
	7											
	7a											
	7b											
	8											
	9											



Some technical caveats to be considered

- Models may not accommodate **complex interventions** such as comprehensive tax reforms.
- Estimates do not take into account **possible spillovers** or additional effects (such as economic actors' **expectations**.)
- Shocks are assumed as **generalised** (“non-selectivity” of the interventions).

Lowering tax wedge: an illustration of *why* we acted...

Country	Tax wedge	Employee's PIT	Employee's SSCs	Employer's SSCs	Total SSCs	Total Labor Cost	Tax Wedge	Net Income
	% on labor cost					US\$ in PPP		
Belgium	56.0	22.1	10.8	23.2	33.9	69,066	38,710	30,356
France	50.2	10.2	9.5	30.6	40.1	61,194	30,734	30,460
Germany	49.7	16.0	17.3	16.4	33.7	67,031	33,348	33,683
Hungary	49.4	12.8	14.4	22.2	36.6	26,824	13,258	13,566
Austria	48.9	12.3	14.0	22.6	36.5	62,223	30,416	31,807
Italy	47.6	16.1	7.2	24.3	31.5	48,293	22,990	25,303
Sweden	42.8	13.6	5.3	23.9	29.2	57,410	24,597	32,813
Finland	42.5	17.7	6.2	18.6	24.8	54,214	23,046	31,169
Czech Rep.	42.4	8.8	8.2	25.4	33.6	29,202	12,385	16,817
Slovenia	42.3	9.4	19.0	13.9	32.9	31,107	13,173	17,934
Greece	41.9	6.9	12.8	22.2	35.0	37,084	15,555	21,529
Spain	41.4	13.5	4.9	23.0	27.9	46,974	19,448	27,526
Estonia	40.4	12.7	2.1	25.6	27.7	26,700	10,787	15,913
Slovakia	39.6	7.4	10.5	21.8	32.3	23,669	9,380	14,290
Denmark	38.9	36.2	2.7	0.0	2.7	49,887	19,399	30,488
Netherlands	38.6	14.9	13.9	9.7	23.6	61,631	23,763	37,868
Portugal	36.7	8.7	8.9	19.2	28.1	31,359	11,521	19,838
Luxemburg	35.8	13.8	11.0	11.0	21.9	60,884	21,772	39,112
Poland	35.5	5.8	15.3	14.4	29.6	24,047	8,526	15,521
United Kingdom	32.3	14.0	8.5	9.8	18.4	58,477	18,905	39,572
Japan	31.2	6.6	12.0	12.6	24.6	52,746	16,439	36,307
United States	29.6	15.6	5.1	8.9	14.0	52,286	15,467	36,819
Ireland	25.9	13.4	2.9	9.7	12.6	43,239	11,220	32,019
Switzerland	21.5	9.7	5.9	5.9	11.8	64,863	13,918	50,945

Source: Our elaboration on OECD data from 'Taxing wages 2011-12, Average personal income tax rate and tax wedge progression in OECD countries (2013)'.

...and *how* we acted:

- The WG assumed an **annual expenditure of €10 bn.**, to be divided equally between lowering labour tax wedge (with the consequent reduction of its ratio to labour cost by 0.6 -1.1 pps.) and capital tax wedge.
- **Labour tax wedge:** increase in the **tax credit for employees** from PIT; cut in **tax expenditures**; extension of exemption of the **productivity-linked wage** in business sector; subsidies for **low-wage earners**; reduction in some **employers' SSCs**; and taxation for permanent hirings (**IRAP** and **fiscal incentives**).
- **Reduction in poverty rate:** Active Inclusion Tool (SIA).
- **Capital tax wedge:** **Allowances for Corporate Equity** (ACE) and deduction of **Property Tax** (IMU) on industrial facilities from corporate taxation (IRES and IRAP).

Reduce taxation on labour: possible trade-offs..

- **Equality/efficiency:** lowering taxation on productivity-linked wages promotes labour supply and (possibly) the efficiency of labour organisation but tends to favour especially high-income workers.
- **Equality/public finance:** *i)* a limited reduction in employee's tax credit cannot fully cover the fiscal drag; *ii)* budgetary constraints do not allow more inclusive measures for low-wage workers (income \leq €8,000 per year); *iii)* reducing public expenditure on health (by increasing the tax credit for private insurance) and increasing tax revenue (through VAT increase) both have regressive effects.
- **Efficiency/public finance:** *i)* selective (only new permanent hirings) reduction in IRAP labour component ; *ii)* partial deductibility of property tax (IMU) paid on productive plants from corporate tax (IRES and IRAP) or PIT (IRPEF).

.... and complementarities

- **Equality/efficiency: increase in disposable income** around a gross annual income of €15.000 (low-wage workers) and **reduction in marginal tax rates** by introducing a more favourable scheme for employees' tax credit.
- **Equality/public finance:** *i*) partial indexation of monthly pensions up to about €3,000 and *ii*) introduction of solidarity contribution (PIT surcharge) on pensions > €150,000 per year, with revenues allocated to combat poverty; *iii*) cut in tax expenditures, affecting especially high-income taxpayers.
- **Efficiency/ public finance:** selective reduction in IRAP labour component for new hirings favours permanent employment and creates new taxable base in the future.

Output: 2014 Stability Law (draft budgetary plan)

Measure (€mIn)	Inclusion in 2014 Draft Budget Law	2014	2015	2016	Total resources
Increase in PIT tax credit for employees' gross incomes	Partial	1,561	1,734	1,732	5,027
Introduction of benefits for those earning under €8,000: reduction in the first legal rate from 23 to 20 per cent or the establishment of a negative income tax up to €1,000	No				
Productivity-linked wage in business sector: a comprehensive low PIT rate of 10 per cent will be applied permanently on productivity-linked wage	No				
Tax wedge cut devoted to employees		1,561	1,734	1,732	5,027
Reduction in premiums and social contributions against work accidents and illnesses (INAIL SSCs)	Partial	1,000	1,100	1,200	3,300
Universal increase in deductibility of 10 per cent of labor cost from regional tax on productive activities (IRAP) tax base.	No				
Deduction of labour cost for new open-ended contracts hirings from IRAP	Full	36	115	200	351
Increase in the Allowance for Corporate Equity (ACE)	Full	0	659	717	1,376
Deduction of 20 per cent of Immovable Property Tax (IMU) paid by firms on productive installations from IRES (corporate tax) tax base	Partial	476	274	274	1,024
Complete refund of the SSC surcharge (1.4 per cent) paid by firms for FTCs in case of conversion into open-ended ones	Partial	70	70	70	210
Tax wedge cut devoted to employers		1,582	2,218	2,461	6,261
Total expenditures		3,143	3,952	4,193	11,288
Experimental introduction of the "Active Inclusion Tool", (SIA) in order to support poor people and favour the social inclusion and the participation in labour market.	Partial	40	40	40	120
Reducing poverty		40	40	40	120
Cut in 19 per cent tax expenditures (18 per cent in 2014 and 17 in 2015), as guarantee clause for the adoption of a total reform within January 2015	Full	488	773	565	1,826
Total funding		488	773	565	1,826



Some concluding remarks and challenges ahead

- **Several objectives but limited margin of manoeuvre** (state of the economy, scarce resources; EU constraints; decision-making procedures and implementation tools).
- **How to reconcile different needs** (stable macroeconomic environment as well as growth-enhancing and job-friendly measures) and **how to address specific concerns** (more effective, efficient and fair actions require structural reforms).
- **Current political debate** (fixing spending priorities with focus on social inclusion, increasing involvement of civil society) and **follow-up measures** (rationalisation of public expenditure by up to €32 billion via the Spending review and the application of savings to further cuts in labour tax wedge).