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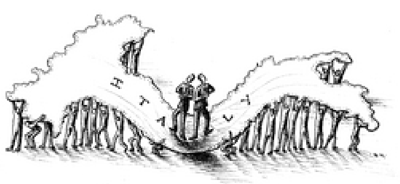
OPINION | AUGUST 6, 2008

All Fear, No Hope

By TITO BOERI | FROM TODAY'S WALL STREET JOURNAL EUROPE

MILAN

Thirty years after the last stagflation, the world may again relive a period of low growth coupled with high inflation. Thanks to the euro's appreciation, which mitigates the oil-price hike, Europe is generally in a slightly better position than the U.S. But of all the economies of the Old Continent, Italy is by far the most vulnerable. That's because the country has already suffered stagnation for the last 15 years.



Barbara Kelley

As a result, Italy's income per capita has fallen below the euro-zone average and is even below the EU-19 average, which includes some of the still relatively poor economies of the former communist countries. Real incomes of Italians have been flat like the Dutch lands over the last decade. Net wages of Italian workers are now 30%-40% lower than those of their colleagues in France and even Germany, which has also seen a period of relative wage restraint.

And Italy has no safety net protecting those hit by a recession. Unlike most countries in the EU, it has no minimum-income guarantee. Two-thirds of Italy's social spending goes to pensions, leaving little for the unemployed.

Due to Italy's high debt (about 105% of GDP), there is not much room for countercyclical fiscal policies. Tax revenues, though, have been exceptionally buoyant in the last three years thanks to Rome's successful fight against tax evasion. In addition, Italy's strongly progressive tax system has led to large windfall profits for the government as inflation is pushing individuals to higher income tax brackets even though their real incomes did not go up. According to estimates by the economic Web site Lavoce, this fiscal drag could bring more than an extra €4 billion into the state coffers this year.

The most sensible thing to do would be to use this money to reduce income taxes, as even average workers pay a marginal tax rate of 60%. This would boost demand -- consumption has been declining in real terms lately -- as well as supply. At the same time, tax cuts would help employers in the coming wage negotiations to argue for wage restraint. Keeping labor costs under control would in turn fuel job creation. Italy has the lowest employment rate in the EU, with about only half of the country's working-age population actually working.

But Rome's budget plan for 2009-2013, approved on Monday by Parliament, envisions no tax cuts for the next five years. Tax revenues as a share of GDP are even supposed to increase mildly, to 43.2% in 2010 from 43% now. Besides betraying voters -- who during this spring's

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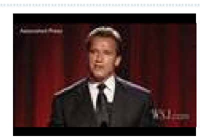
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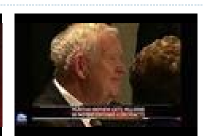
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electoral campaign were promised a reduction of the tax pressure to below 40% of GDP -- this policy is unlikely to help avoid a recession. It will only worsen the country's economic situation.

The budget plan also says nothing about cutting public spending and waste. For example, Italy ranks fourth in the OECD in terms of spending per pupil. And yet its students regularly score significantly lower than the EU average in international tests such as the OECD's Program for International Students Assessment, or PISA. Moreover, the Italian regions with the lowest PISA scores are precisely those where expenditure per student is the largest, and where teachers are paid more in real terms than in regions with better test results. This means that it is possible to cut spending without reducing the quality of education. As a matter of fact, by learning from the more successful regions and EU countries, Italy could improve its quality of education at the same time as it cuts spending.

Another area where large savings are possible while actually increasing the quality of public services is fiscal federalism. About one-fourth of Italy's state budget goes to regions and local administrations. While the decisions over tax levels are centralized, much of the spending is therefore at the local level. This is a recipe for waste. If a local administration has to raise taxes to match its rising expenditure, it risks being punished by voters. But in Italy it is the central government that raises taxes to cover the deficits of local administrations. The latter are therefore not held politically accountable for their poor handling of the budget.

The depressing message of the government's budget plans for the next five years is that fiscal consolidation -- the reduction of the country's mountain of debt and regular deficits -- will not occur by cutting spending but by raising revenues instead.

Meanwhile, as if Italians weren't frightened enough about the country's economic outlook, Finance Minister Giulio Tremonti is spreading only more gloom. "We are falling into a new Great Depression," he likes to claim whenever he gives a public speech or television interview. According to Mr. Tremonti, the poor state of Italy's economy is not so much the result of poor domestic policies but instead caused by the devils of globalization and China's presence in the World Trade Organization.

Just ahead of this spring's electoral campaign, Mr. Tremonti wrote down his abstruse theories about the alleged pitfalls of free trade in a book titled "The Fear and the Hope." Unfortunately, once in power, he forgot about the hope. Cutting taxes and wasteful spending would go a long way to fighting the fear many Italians feel about the economy.

Mr. Boeri is a professor of economics at Bocconi University, Milan.

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