

Three big challenges for the Berlusconi cabinet

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The new Italian cabinet, Silvio Berlusconi's fourth government, is both strong and weak. It is strong because the government has solid majorities in the House and Senate, and the supporting coalition is less fragmented than in previous Berlusconi cabinets. It is weak because the government is starting with relatively low popular support and no political honeymoon. Italians voted more against Romano Prodi's government than in favour of Mr Berlusconi. They are rightly tired of a political class that has raised its own wages – up 10 per cent per year in the past 50 years compared with 2.3 per cent for average Italians – rather than address structural impediments to growth in Italy. Fiscal federalism, the electoral law and the fight against tax evasion will be the three most important challenges in the first year.

The first challenge is fiscal federalism. The real winners in the election were two local movements in the Berlusconi coalition: the Northern League and the Movement for Autonomy (of Sicily). The House and Senate majorities depend on them. The Northern League calls for fiscal federalism to prevent public money going south, with proposals that 90 per cent of tax revenues stay in the areas that generate them. The Movement for Autonomy, by contrast, wants revenues from oil refined on the island – no matter where it is sold! – to go to Sicily. Mr Berlusconi's party (Popolo della Libertà) has endorsed a bill recently voted on in the Lombardia region. It keeps 80 per cent of revenues from value added tax in the region in which it is generated, 15 per cent of the income tax and all the revenues from taxes on oil, tobacco and gambling. The bill also proposes devolving a number of programmes funded at the national level

Fiscal federalism, the electoral law and fighting tax evasion will be key issues of the new Italian government's first year

to local administrations, limiting how much redistribution can occur across regions. If this is adopted nationwide, it would leave some regions without sufficient resources to pay school teachers. Italy badly needs to cut public spending, which has grown faster than its gross domestic product, especially at the local level. By making local governments fiscally responsible it could reconcile these two goals, by imposing political costs if they run large deficits.

However, the first cabinet meeting, scheduled today in Naples, is in danger of undermining the move to local accountability. It proposes wiping out property tax on housing, the only real local tax that exists.

The second challenge is the electoral law. There will be a referendum on it within a year. The current law is based on a complex mix of blocked lists decided by party leaders, proportional rules and regional thresholds. The system works well for relatively small parties with a locally concentrated base, such as the Northern League. However, Italians want to decide who should sit in parliament, by choosing candidates as well as parties. Polls show that two out of three Italians want to change the law. Large parties would gain by adopting a majoritarian system, which would increase both political stability and the accountability of politicians. Mr Berlusconi's party and the other large party, the Democratic party, have much to gain, yet smaller ones, such as the Northern League, would lose their pivotal role in the coalition. Thus the referendum is a time-bomb on the future of the coalition.

Third, it would be suicide for the new government to trash the remarkable results achieved by the Prodi government in cutting tax evasion. It is estimated that up to €20bn was raised by widening the tax base. The tradition of Mr Berlusconi's cabinets, by contrast, has been one of declining tax revenues even when it left tax rates unchanged. The first steps of the new government are not encouraging. The fiscal measures, to be passed today, would introduce a reduced tax rate for the variable components of wages such as bonuses, performance-related pay and overtime pay. It is a good idea to cut taxes on labour as the marginal tax rate for the average worker is about 60 per cent. The variable wage would instead be taxed at 10 per cent. Such a big difference in taxation creates strong incentives for the employers and workers to collude in transforming fixed into variable pay. A better approach would be to raise tax deductions for all employees.

Overall, Mr Berlusconi is proposing a number of popular tax cuts. Italy should certainly cut taxes to restore growth, but the tax cuts he is proposing will end up magnifying tax distortions. Public spending also needs to be cut alongside taxes. Otherwise someone else will have to pay the bill.

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