

PUBLIC INTERVENTION TO SUPPORT INVESTMENTS IN INDUSTRIALISED COUNTRIES

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Abstract

The main challenge the traditionally developed countries have to face today is competition from the newly industrialized countries. As the engine of development and the means for infusing and diffusing technological progress, and therefore for the growth of productivity in the system, levels of investment are crucially important. This article considers the tools for public intervention that can affect business investment decisions. It underlines the importance of interventions that reduce the tax wedge and the quasi-fiscal burden on labor costs.

The main difficulty lies in finding cover within public budgets to compensate for the loss of revenue and/or the additional expenditure required for these incentives. The answers are to be found in reducing the less productive parts of the public expenditure, in modifying the composition of the fiscal and parafiscal levy, and in interpreting the constraints of the Stability Pact in a less "accounting-orientated" way based more on economic effects.

1. Background

In growth models a key role is played by capital and investments, whether to increase manufacturing capacity, infusing technological progress or enhancing skills (human capital).

Reflecting on the causes of the great crisis of 1929-1930, Keynes warned that it is difficult to identify the determinants of investment decisions since they are linked to

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the subjective expectations of entrepreneurs (“animal spirits”). Whilst he recognized the influence of capital costs on these decisions, he also warned that manipulating the interest rate may not be sufficient to stimulate recovery of investment if the expectations of investors remain negative.

The recent economic crisis, which hit hard the traditional industrialized countries² and holds out for them the prospect of greater difficulties as growth resumes, makes Keynes topical again³. But his neoclassical synthesis (the well-known IS/LM Model) offers no explanation for the fact that although interest rates in the European Union today have fallen to historically extremely low levels, and the recovery of investment we would expect to occur when there is a normal relationship between investment and the cost of capital is not taking place.

Without doubt, this is a question whose relevance goes beyond theoretical debate. The governments that are attempting to promote a recovery of investment are encountering difficulties in finding ways of doing so, other than the solution already attempted: reducing interest rates. As is well known, Keynes suggested that as a way of restarting the expenditure-manufacturing-income mechanism and encouraging a more favorable outlook on the part of the private sector, governments should implement programs of direct public investment and/or to sustain levels of domestic consumption.

But under today's conditions, when public finance tends to go out of balance due to inbuilt factors that relate to increasing public expenditure for purposes of redistribution, in many countries the Keynesian prescription (public investment and government support for consumption) looks dangerous for the monetary and financial balance of the system⁴. Furthermore, experience suggests that as and when the economic recovery gets under way, political decision-making mechanisms will make it difficult to reduce many categories of public expenditure (such as transfers to

² Hereinafter referred to as TI Countries.

³ See the considerations set out in *The Economist* (18/07/2009).

⁴ Above all because of the high levels of public and private indebtedness already built up in most countries (particularly in Italy, so far as public debt is concerned).

households and business, net remuneration to employees, and "tax expenditures")⁵. Nor can it be overlooked that in recent decades the prevailing economic ideology has tended to take an unfavorable view of expanding public intervention in the economy and has counted instead on liberalizing private markets by allocating resources more efficiently, in the expectation that this would favor a higher rate of economic growth⁶.

Naturally it has to be added that whilst in Keynes's time the model of the substantially closed economy might have been an adequate representation of reality, in today's global economy a recovery of internal demand will not be enough to increase levels of manufacturing and income within any one country if differentials in manufacturing costs make it cheaper to shift manufacturing abroad.

In this picture it would appear difficult to identify what instruments would be appropriate for publicly sustaining investment in a TI country; we therefore need to reconsider the variables affecting decisions about which types of public investments can be encouraged.

The literature offers numerous schemes, some of them very sophisticated, for economically assessing investments, and any modern state should certainly take these into account when deciding its direct investment programs. On the other hand in the operational real world of private entrepreneurs, above all of **small and medium enterprises** (and also some large enterprises⁷ where the ownership is centralized and retains control over company decisions) the schemes used for assessing the advisability of investments are frequently structurally simple and even crude, but suitable enough for synthesizing the entrepreneur's intuitive reasoning process, based on

⁵ In reality even a significant reduction in public investment, where economic recovery has been initiated, may face political obstacles due to rigidities and frictions in the processes of reconvertng firms that previously served the public demand to obtaining commissions from the private demand. These rigidities include not only a production - product sector content but also a territorial location content.

⁶ See ALESINA A. et al (2006); HOI et al (2006); even after the outbreak of the world financial and economic crisis, in advancing its recommendations on fiscal policy within the "European Economic Recovery Plan" (ERRP) the European Commission still refers back to the Lisbon Strategy, which aims at improving the functioning of markets (including the labour market) in a pro-competition sense. See EUROPEAN COMMISSION (2009).

⁷ This excludes firms in the financial and insurance sectors, which operate structurally using schemes for analyzing financial investments that can be very sophisticated.

just a few essential points of reference and using whatever information the entrepreneur believes s/he can master and use sufficiently well.

Normally the intuition of the entrepreneur (and this is a characteristic of Keynes's "animal spirits") concerns the probability (subjectively estimated) that within a given time span, after deducting direct and indirect manufacturing costs, repayments of loans in relation to the desired amortization period for the investment, and all related taxes and charges, a given initiative will generate a revenue stream that will make it possible to realize returns on the (financial and entrepreneurial) capital invested such as will be likely to cover normal return on the capital, and compensate for the **risk**.

As a way of identifying what opportunities exist for public intervention to incentivize entrepreneurs to invest, the decisional variables generally taken into consideration by entrepreneurs are highlighted below.

2. Investment decisions and public intervention

The literature offers many sophisticated and also evaluation schemes convenience of investments, of which the modern State certainly should be taken into account to establish their own programs for direct investment. On the other hand, in real operations of private businesses and especially small and medium-sized enterprises (and even some large when the property is centralized and retains control of the decisions of the enterprise) is common to use patterns of investment appraisal structurally simple, even crude formally, but that can be adapted to synthesize the intuitive reasoning of the entrepreneur, which takes a few essential points of reference uses information it considers to possess and to use in appropriate measure.

Normally intuition (an aspect of the "animal spirits") of the likelihood of the entrepreneur (assessed subjectively) to achieve a given initiative and on a given period of time a stream of revenues, minus the direct production costs and indirect depreciation as a function of the recovery period required investments, and all taxes related,

realize returns on invested capital (financial and human) that it finds, to cover the normal return on capital and to compensate for the entrepreneurial risk.

We highlight the following decision variables generally considered by entrepreneurs summarized above, so as to identify opportunities for public interventions that encourage investment decisions.

2.1 Prospects for generating revenue

In the normally accepted terms of Keynesian economics, the advisability at the “macro” level of increasing market sales, and thereby justifying new investments, is a function of the expected level of demand, which can be controlled by governments⁸ via the well-known instruments of macroeconomic policy. By taking a disaggregated intersectoral approach, information about trends within particular manufacturing sectors and their interdependencies makes it possible to calibrate the action to be taken.

As mentioned in the introduction, the present difficulties derive from the fact that an increase in domestic demand, induced by fiscal policy and aimed at some or all manufacturing sectors, could prove largely ineffective for stimulating domestic investment, particularly in the TI countries, if business predicts that the resulting increases in internal demand are likely to be met mainly by producers located in other countries⁹.

In this situation, which is new as compared to what Keynes was able to observe, we need to ask what instruments for public intervention in a TI country are still available for improving the prospects for business to achieve adequate returns from new investments.

⁸ As already warned, this affirmation holds true for an essentially closed economy or for an open economy whose businesses are sufficiently competitive to meet the bulk of the increase in domestic demand.

⁹ This includes domestic entrepreneurs who relocate their manufacturing to companies based abroad.

In debates around this issue the responses are usually worried with the high manufacturing costs in the already industrialized countries as compared to those in the emerging countries. These issues are examined below in the section dealing with manufacturing costs.

But so far as the returns expected by business are concerned, there is in fact considerable other space (particularly in the EU countries) for intervening on the net revenues from VAT and other taxes on consumption. Taxes on final consumption introduce a tax wedge between the prices paid by domestic consumers and the net revenues received by entrepreneurs. But since VAT and other excise duties apply equally to imports, a reduction in VAT and other taxes on final consumption would reduce the tax wedge not only to the benefit of domestic producers but also to that of foreign producers exporting to the country of reference. All the same, it is possible to suppose that when consumers at the upper end of real purchasing power in countries with a long industrial tradition weigh up the relationship between price and quality, they will give more weight to the quality factor, since there is a tendency to presume that the quality of their own national products is higher¹⁰. Reducing taxes on final consumption could therefore encourage such consumers to choose national products and thus stimulate internal investment.

Since VAT is an indirect tax whose revenue goes partly to finance the EU budget¹¹, any reductions in VAT would need to be agreed at the EU level (where currently the expected standard minimum rate is 15%). Since with a certain degree of diversity the current economic difficulties are shared in common by all EU countries, it might be worth considering manipulating the standard rate of VAT at the European level.

But as part of a strictly national public budget, "funding" a reduction in VAT is quite a different matter. In theory, the possibilities are: increase other taxes; reduce public

¹⁰ Well aware of this argument, firms in the TI Countries including Italy are calling for greater protection of trademarks, quality certifications, and secure indication of the actual country of manufacture (such as requests for protection of the "Made in Italy" mark).

¹¹ If the rate reduction has to fall below the levels provided for by Community agreements (currently 15%). One of the fiscal stimuli to economic recovery provided by the European Commission (2008) is "temporary rate reductions" to sustain consumption. But if (as that text says) we take into account the investment decisions of entrepreneurs, it appears unlikely that temporary restrictions with no certain end date can have any significant effect.

expenditure (or some items thereof); or widen the public deficit. Since this affects any proposal to encourage public investment that involves reducing the tax levy or levy and/or increasing public spending, at least in the short term until the economy recovers, this aspect of financing incentives to encourage investment will also be considered in paragraph 3.

2.2 Incentives for innovation

In debates about the outlook for manufacturing and as a consequence, for investment in the TI countries, which have to face growing competition from the emerging countries, it is often asserted that these countries (in particular those in the EU) ought to orientate their strategic investment decisions towards products that use more advanced technologies. It is believed that technological innovation ought to give these countries a competitive advantage both in their manufacturing processes and in their ability to offer new products which (in the perceptions of consumers) will be of better quality. In pursuing these objectives it is held that the more industrialized states should increase and coordinate their expenditure on basic and applied research, and should incentivize decisions that encourage any innovative outcomes from this research to be infused into the manufacturing system. This strategy offers considerable scope for public intervention to support and organize research, support investments that incorporate innovative outcomes from this research, and demonstrate to business the advantages of making use of these outcomes.

These are certainly important indications but as experience is showing, they are far from simple to put into effect. Before looking for spaces in which to finance, to any significant degree, new public spending on research and as support for investment to incorporate its outcomes, there are other public budget decisions that have to be taken under conditions of constraint on balances in which the most important items of expenditure¹² (staff costs, pensions, interest on the debt) remain inflexible.

¹² In public budget decisions, allocations for scientific research that can be used by the production system also encounter the obstacle of the natural reluctance of researchers to work "on commission"

Furthermore, particularly in Italy, there are efficiency problems within the agencies that are responsible for basic and applied research and for disseminating it into the manufacturing system, not least the frequently unjustifiable complexities of the procedures, and overlapping or interference between public agencies or between one program and another.

Bearing in mind that by now the major emerging countries (for instance China and India) have reached a level of scientific knowledge comparable to that in the countries of traditional industrialization, a second critical aspect is the amount of capital required for major programs of innovative research. Whether for reasons of cost or the effectiveness of this research, it seems plausible to assert that major research programs ought to be organized and promoted, including financially, at the scale of large geographical areas, (e.g. the EU as a whole)¹³.

Another critical aspect is that scientific and technological innovation is only infused into the industrial system after entrepreneurs have accepted it.

For a long time business theory has recognized that entrepreneurship is a scarce factor that is difficult to divide. Some innovations can be immediately incorporated into a manufacturing process or product that already exists and that the entrepreneur can therefore recognize, evaluate, and accept positively and quickly. But in the case of an innovation that would require major changes to a manufacturing process or an existing product, or the immediate creation of new business activity, the (scarce and indivisible) "entrepreneurship" factor can become a limit that prevents the innovation from being absorbed into the manufacturing system at the right time.

It must also be considered that if an innovation has been created as a result of investment, in some situations this would require the obsolescence of previous investments, not yet fully depreciated, to be brought forward; but in the absence of

or in any case on themes and for purposes declared as priorities by government authorities; it can in fact be argued that research should be free and funded in all directions as an instrument of cultural progress, not made to serve shorter term objectives aimed at improving the competitiveness of the manufacturing system. This is a very complex issue because it involves ideological aspects that concern the nature of social organization and the meaning of individual freedom within it.

¹³ See MONTI (2010).

any public form of compensation, to the entrepreneur it might seem anti-economic to reorganize a manufacturing process to accommodate the innovation.

Finally, public schemes that incentivize investment in technological innovation and increase business productivity might come up against the well-known difficulties that derive from information asymmetry (between principal and agent) and **moral hazard**¹⁴.

In conclusion, the route of stimulating and promoting basic and applied scientific research, and incentivizing investments whose outcomes can be infused into the manufacturing system, is certainly an obligatory one for the TI countries – but is not so much to be pursued separately by individual countries as based above all on strategies that take in extensive geographical areas. This is the road to take if those countries intend to maintain their historic position of primacy in the world economy and along with it, their pre-eminent levels in the average standard of living of their inhabitants. But it does not seem like an easy or obstacle-free way to go, and the outcomes that can be expected will only come over the medium/long term. So in a situation of economic crisis it seems necessary, not least for reasons of political and institutional stability, that nation states should also use other tools to incentivize other types of investment that can generate short-term effects.

I mentioned earlier the advisabilities of manipulating VAT and other taxes on consumption to create positive revenue expectations. In the next section I consider the advisability of incentivizing investments by manipulating the structure of the costs that entrepreneurs take into consideration when considering an investment.

2.3 The prospects for reducing costs

Even in the most favorable hypothesis that public policy can succeed in raising the rate of technological and organizational innovation in the manufacturing system of the TI countries, it is unlikely that the outcomes could suffice (at least in the short

¹⁴ On this issue, see in particular the work of LAFFONT, J.J., MARTIMORT, D. (2001); LAFFONT, J.J., TIROLE, (1993).

term) to resolve the crucial issue of the differentials between the manufacturing costs in the economies of the TI countries and those in the economies of the emerging countries.

In fact in today's global economy and global information transfer, technological innovations tend to spread rapidly from their country of origin to the others whilst as experience shows, the legal protections afforded by patents tend to be quickly circumvented.

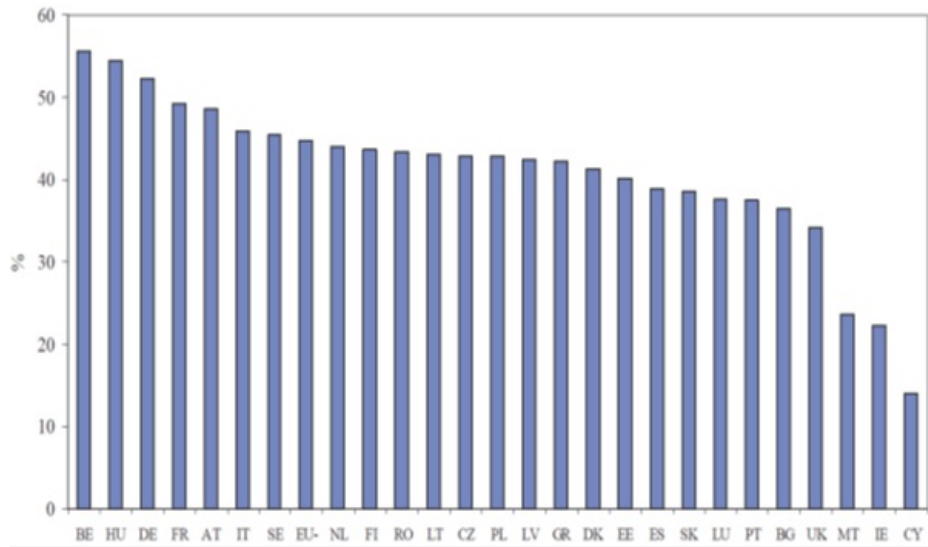
This means that any competitive advantages generated by technological innovation often prove to be of short duration. Not only: the fact that firms are aware of the high risk that innovation in one country will be quite quickly transmitted to the manufacturing systems of other countries means that when firms based in the TI countries decide to invest in innovation they also consider whether it would not be more opportune to make this investment directly into the other countries where costs are lower. Apart from the hypothetical case of a highly significant technological innovation, when the entrepreneur, comparing expected costs with expected revenues to determine the profit margin in relation to capital invested, assesses the advantages of making an investment referred to manufacturing costs at normally expected levels, the crucial variable of reference will be whether this can be considered satisfactory. As previously mentioned, in today's ever more internationally integrated economy a Keynesian stimulation of internal demand within an IT country may not be sufficient to promote growth in that economy if the demand is largely to be met by manufacturing located outside that country, where costs are lower.

In almost all the manufacturing sectors of the TI countries, labor is the most important cost item; and in open international markets the differential between this cost in the TI countries and in competing manufacturing sectors in the emerging countries is the main factor that contributes to the loss of competitiveness of the TI countries.

So in the TI countries, what instruments can a state use to reduce labor costs? As can be seen from Tables 1 and 2, simple observation of the structure of labor costs in the TI countries shows that the fiscal and quasi-fiscal levy is an essential compo-

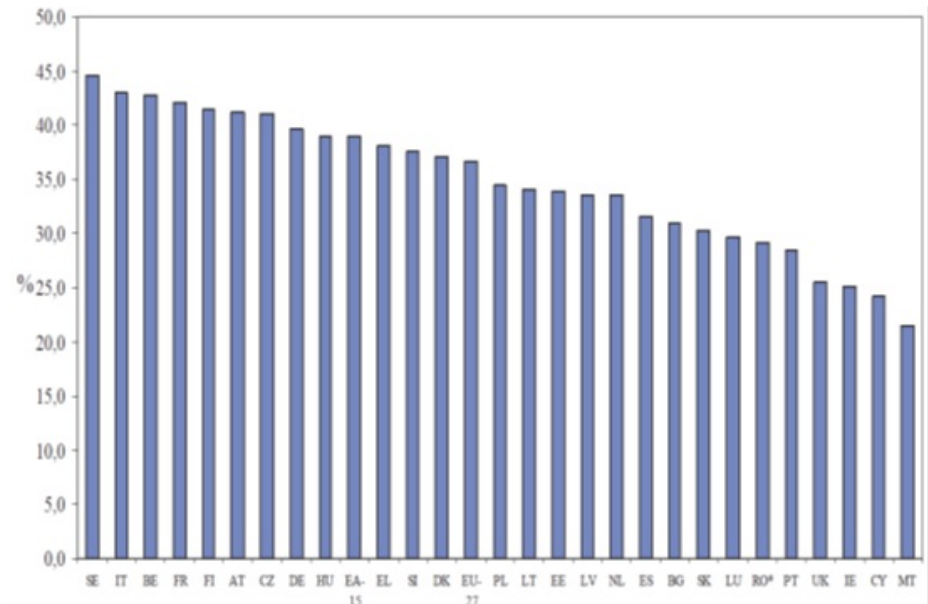
ment of these costs, represented in the EU countries respectively by the “tax wedge” in the average wage and the implicit rate of the levy on employee incomes.

Table 1 – Total (average) tax wedge, single worker; 100% average wage



Source: European Commission

Table 2 – Implicit tax rate on wages (%), 200



Source: European Commission

Note: data for Romania (RO*) refers to 2005

To use language that is familiar to entrepreneurs, these tables suggest that in order to pay a worker a given wage or salary, the entrepreneur has to bear a cost that is increased by the extent of the fiscal and quasi-fiscal levy. Since as shown in Table 1, the wedge for most EU countries is between 40% and 50% (or more) of the average wage, it is evident that reducing this could have a significant effect on the competitiveness of firms in the TI countries as compared to those in the emerging countries. Noting that “the average tax (and quasi-fiscal) burden on labor is very high in Europe”¹⁵, the previously mentioned recent report of the European Community deduces that heavy taxation “is one of the factors underlying the poor occupational levels in Europe in recent years, which take the form of high rates of unemployment, low rates of participation, and low numbers of hours worked” adding that other significant factors may be the minimum wage and poor flexibility in the labor market.

The main conclusion that can be drawn from this is that if in governmental budgets there were no difficulties in finding cover for reducing a significant part of the proceeds of the fiscal and quasi-fiscal levy on labor, thus reducing the public components of labor costs in the TI countries, there would be immediate prospects for effectively improving the competitiveness of their national products.

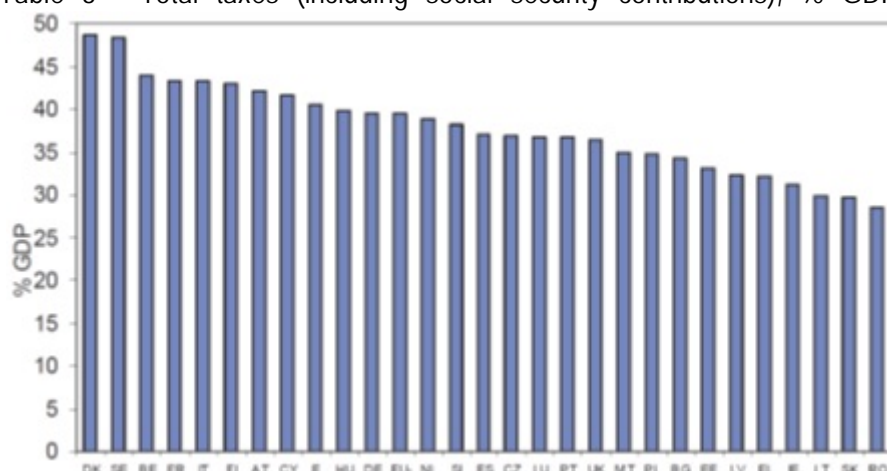
In this regard, which is crucial for the recovery of competitiveness in the TI countries and thus for the prospects of investment in them, it is worth reiterating that with respect to the emerging countries (but also with respect to the other industrialized countries) the EU is a high tax area (measured in relation to GDP)¹⁶. Unfortunately, the difficulty for governments of covering such operations to reduce taxes and levies on labor costs would seem to preclude their widespread use¹⁷.

¹⁵ EUROPEAN COMMISSION (2009) pp.43- 44. The Commission also notes that taking together the aggregate rate of tax on labor and the benefits offered by social assistance schemes, in the EU countries there are high disincentives to employment, to participating in the world of work, and to any increase in working hours and effort. It therefore calls on Member States to reform their disincentivising institutions: pp. 50-54.

¹⁶ See EUROPEAN COMMISSION (2009).

¹⁷ In relation to this issue, see par. 3.

Table 3 - Total taxes (including social security contributions), % GDP, 2007



Source: European Commission

Note: data for Romania (RO*) refers to 2006.

As can be seen from Table 3, in the EU as a high tax area (in which the average total tax take for all 27 Countries is 39.5% of GDP) Italy, specifically, is one of the highest taxing countries (at no. 4 with France).

In this regard it has been noted that the relatively high level of the tax and quasi-fiscal take in the EU reflects the greater robustness and extent of the systems of social protection in those countries as compared to countries outside the EU. The solidity and wide coverage of these systems of social protection, it is argued, have provided decisive support for the social coherence of the EU as a community against the effects of the recent severe economic crisis.

It should be added that the purpose of levying social welfare contributions is to fund the costs of social security (pensions, subsidies, social benefits)¹⁸ and that reducing these contributions would pose with great immediacy the problem of financing these expenditures. One option might be to reduce inefficiencies and abuses caused by information asymmetries and social resistance, but this in any case would encounter technical difficulties. And the social importance of these expenditures (which include expenditures for social safety nets) is well known.

¹⁸ In countries such as Germany that have maintained the insurance-based healthcare system (the "Bismarck model"), social contributions also fund most expenditure on health.

From a methodological point of view this issue is similar to that rose earlier in relation to proposals for reducing VAT and other taxes on consumption; such operations have to be covered by reducing some items of public expenditure and/or increasing other forms of taxation. Thus, see once again paragraph 3 below.

It should be noted that arguing here in favor of reducing the fiscal and quasi-fiscal burden on employed work may appear to run counter to a theoretical (and fiscal policy) approach that has come to the fore in recent decades, on the basis of which it is thought that income from capital should be taxed to a lesser extent¹⁹ than income from work, as is in fact the case of the Nordic DIT and of the significant reliefs on income from capital that are permitted under the laws of most TI countries²⁰.

Whilst the theoretical debate on the merits or otherwise, in terms of fairness and efficiency, of taxing income from capital at a lower rate remains open²¹, so far as tax policy is concerned - and as has been recognized by the creators of the DIT model - the winning argument has been that in today's highly integrated international economy and its high capital mobility, taxing income from capital at a higher level in one country than in competitor countries would provoke a substantial outflow of capital from the higher-taxing country.

But in my opinion this argument is gradually losing the power it has had over the past twenty years. Fundamentally this is because cooperation between states, above all within the EU, to enable the authorities to track international capital movements, is being strengthened and expanded, and this is also opening up new possibilities for states to apply the "principle of residence", and to more effectively combat tax avoidance and evasion.

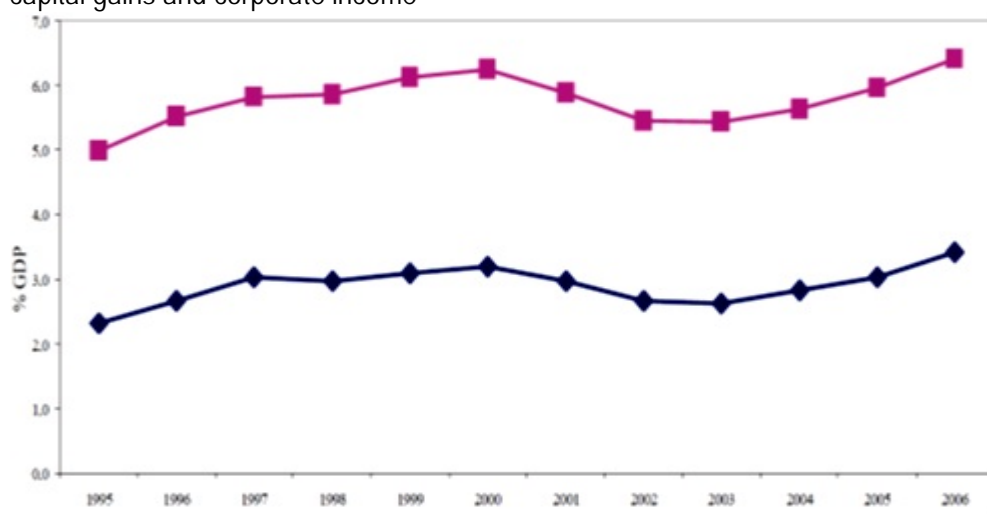
¹⁹ Indeed there is a school of thought that has been arguing since the 19th century that ordinary income from capital should not be subjected to income tax at all. For a discussion of these topics and the "intermediate" solution represented by the Nordic DIT, I refer to my previous article (BERTUCCI, 2007) and the references cited therein.

²⁰ On this issue of the preferential treatment of capital gains as compared to those from work, including in jurisdictions that have not explicitly adopted the Nordic DIT, see EGGERT (2005) and the references cited therein (see bibliography).

²¹ See SORENSEN (1994; 2005a; 2005b; 2006), BOADWAY (2004) and my article, Irene Bertucci (2007).

Furthermore, in the **European Commission** report previously referred to²², the statistics show that the far-reaching economic integration that has taken place in recent years, and the great increase in the international mobility of capital associated with it, have so far not led to any significant reduction of the tax take on income from capital.

Table 4 – Tax revenue from corporate tax against percentage of tax revenue from capital gains and corporate income



Source: European Commission

This is explained by other three other factors (in addition to those given above in relation to the extension of controls as a result of the greater international cooperation between states). The Commission notes, in fact, that enlargements of declared taxable income have accompanied the observed reduction in the rates of business income. Furthermore, the reduction of business tax rates appears to have incentivized an increase in taxable business income at the expense of personal incomes. In its role as a backstop to compensate for reduced personal income, business taxation has begun to lose its strength.

In particular, increasing global competition should induce us to consider that whilst on the one hand because of its lower international mobility, labor cannot to any sig-

²² EUROPEAN COMMISSION, (2009), pp. 57-60.

nificant extent avoid higher internal taxation levels by moving out of the country²³, on the other hand it is equally true that if firms in countries where labor is taxed at higher rates find their costs are not competitive, this will push them to reduce their activity in the higher-taxing country and/or move it somewhere else.

This consideration, which seems necessary to support proposals that favor DIT or similar schemes, is not intended to immediately mean that financing the detaxation of work has to be done by increasing capital gains tax.

The proposal here is to reduce labor costs in the TI countries, for obvious reasons that relate to their competitiveness with the emerging countries. As to how this can be covered financially, see paragraph 3 below.

2.4 Other possible action

Revising the current tax system to improve the competitiveness of firms in the IT countries should also extend to other taxes, as a way of reducing the tax burden on the manufacturing costs of firms within each of those countries.

It is not possible here to go into specific technical issues as they apply to each tax.

With specific reference to the Italian system, let it suffice to recall the taxes that would be candidates for any such revision:

- IRAP [Imposta Regionale sulle Attività Produttive, or Regional Tax on Manufacturing]. This tax on manufacturing bears directly on the user cost of the manufacturing factors (capital and labor) by introducing the tax wedge between the gross and net remuneration of these factors;
- A whole range of other tax charges levied on a variety of documents required for business transactions and business life (registration tax, stamp duty, and other similar charges).

Obviously these proposals for review should be balanced by giving some indication of how the losses of revenue would be covered (par. 3).

²³ See GORDON (2000).

It is generally accepted, particularly in Italy, that there are ample margins for increasing the efficiency of the action of the public administration (whose inefficiencies have a negative knock-on impact on business costs and business activity). But as experience so far has shown, there are technical difficulties associated with reorganizing the workforce and departments within the public administration; frictions can be generated by resistance to innovation and vested interests representing particular groups and categories have the power to block efforts to increase the efficiency of many of the actions the public administration could take to increase efficiency.

Of course there remains the crucial matter of increasing overall productivity in all sectors of the economy. This will depend on technological innovation and on effectively diffusing it throughout the industrial system. The question of the inefficiency of the public administration cannot be addressed here.

3. Financial cover for the lower revenue and the higher public expenditure required to fund a program of significant investment incentive

In relation to the proposals outlined in previous paragraphs for incentivizing investment in the manufacturing system by reducing the fiscal and quasi-fiscal levy and/or greater public expenditure, we have had to point out that the current conditions of the public finances in most of the TI countries appear to place insurmountable obstacles in the way of finding new financial resources for such public incentive programs²⁴.

In fact any program of public incentive of significant size that would be effective for reaching the goal of recovering economic growth does not appear feasible unless the conundrum of how to cover it financially is resolved.

In particular, I noted above that the high level of the fiscal and quasi-fiscal levy on incomes from employment offers very ample margins for relaunching the competitiveness of the TI countries by taking measures to reduce it. But the preponderant

²⁴ Recalling the constraints on the deficit ratio imposed within the EU by the Stability Pact, and recently reaffirmed and strengthened to defend the value of the Euro.

weight of these levy items as part of the total revenue of the public administrations highlights the difficulty of substituting a significant proportion of these revenues with increases in revenues from other taxes, and/or with corresponding reductions of certain items of public expenditure (and so far as social security expenditure is concerned, the relationship between social contributions and expenditure spending is institutionalized).

Table 5 – Income of the public administration under existing legislation. Final 2008 and forecasts 2009-2013

GENERAL GOVERNMENT ACCOUNT AT UNCHANGED LEGISLATION PRIOR TO DECREE LAW No, 78/2009 (in € mn)						
	2008	2009	2010	2011	2012	2013
BALANCES						
Primary balance	37,912	-5,590	2,589	17,927	28,801	37,805
(% of GDP)	2.4	-0.4	0.2	1.1	1.7	2.2
Current account balance	12,487	-20,061	-22,884	-20,749	-18,409	-15,059
(% of GDP)	0.8	-1.3	-1.5	-1.3	-1.1	-0.9
Net borrowing	-42,979	-81,313	-76,959	-70,853	-69,086	-66,187
(% of GDP)	-2.7	-5.3	-5.0	-4.4	-4.1	-3.8
Nominal GDP	1,572,243	1,521,262	1,549,570	1,606,113	1,666,930	1,731,275

Source: Program and forecast report for 2010 - Chapter 4. Balances of public finance for 2009 and 2010– Table no. 8 – p. 15.

The European Commission²⁵ recognizes that “shifting the levy from employment taxation to taxes on consumption could have positive effects on employment and development.” And yet it also affirms that these effects “tend to be modest in size”; warns that they may create inflationary pressures; and finally that in the current macroeconomic situation it would not be advisable to impoverish the purchasing power of low-income families, and that therefore any increase of taxation on consumption should be accompanied by compensatory measures in favor of low incomes. The

²⁵ EUROPEAN COMMISSION (2009), p. 47, and see also EUROPEAN COMMISSION (2008).

Commission goes on to express a (cautious) preference for greater reliance on environmental taxation, to which less importance has been given in the EU in recent years, and on property taxes, which are also mentioned as an instrument for introducing taxation based on its benefits at the local level²⁶.

Currently, economic experts and the governmental authorities responsible for the economies of the various countries are in discussion about the difficulties of identifying financial cover for reductions to the various types of levy (taxes on consumption, business income, and company documentation) and for increasing expenditure on incentives (grants and "tax expenditures" for investment, research costs, and similar).

One argument that is put forward with great force by some countries but not others²⁷ concerns the possibility of recovering sufficient revenue from fiscal and quasi-fiscal evasion and avoidance, and using it to finance the types of incentivisation programs mentioned above. Certainly, since violating or exploiting loopholes in laws that ought to be respected by everyone perpetrates avoidance and evasion, it is the duty of individual countries to combat them. As the European Commission also underlines²⁸, combating avoidance and evasion is beginning to produce appreciable outcomes because (a) the state of their public finances has made it necessary for them to make greater efforts in this regard (b) information technology is offering new instruments to finance ministries, and (c) the growing cooperation between Member States to improve the effectiveness of investigations, and with states outside the EU, is beginning to produce its first results. The prospect of increasing the efficiency of tax investigations, thereby finding new fiscal and quasi-fiscal resources that can be

²⁶ In Italy, as compared to the past and in the prospect that federalism is likely to be implemented, it would make sense to pay more attention to tax contributions that are commensurate with the principle of benefit and those that are commensurate with the principle of scope.

²⁷ In Italy, controversies about the high levels of tax evasion and avoidance have become an historical fact. In a brilliant article in "Il Corriere della Sera" the economist Alberto Quadro Curzio recently reiterated that as well as generating efficiency savings in public spending, the new Italian option of fiscal federalism, if used properly, could also mean that submerged revenue and income would be brought to the surface in sufficient quantity to produce very large new revenue streams for the public purse, thus making it possible to cover incentivisation programs for economic recovery.

²⁸ As evidenced by Quadro Curzio (2009).

used to finance incentive programs, introduces a potentially optimistic note to the future possibilities for public incentive of the competitiveness of firms in the TI countries.

However for some countries and some particular manufacturing sectors, and for many SMEs, we should warn that the emergence of this “submerged fiscal activity” will have to be accompanied by simultaneous rate reductions and a start to the incentive programs. Many entrepreneurs (above all SMEs) even warn that this “submerged economy” must be maintained not only because levels of taxation are excessive but more generally because of the pressure of competition due to the lower costs sustained by firms in the emerging countries. This is to say that in a situation of global competition the danger must be avoided that a rapid emergence of tax revenues from the hidden economy, if not accompanied by lower rates of taxation and other incentives, could price firms in the TI countries out of the market, inducing them to cut back their activity, shut it down, and/or outsource it to countries where manufacturing costs are lower and where in general, taxes and levies are also less onerous (and where there are fewer regulatory constraints on manufacturing and on care for the environment).

Even with those qualifications, the prospect of covering the costs of future incentive programs by clawing back avoided or evaded taxes is not an insignificant one.

There is a further argument in favor of programs for reducing the fiscal and quasi-fiscal cost of labor, which I suggest has not been brought to the debate with sufficient insistence. In entrepreneurial decisions about the organization of manufacturing, the high labor costs caused by taxation and the quasi-fiscal wedge are also a disincentive to occupation. As economic theory already highlighted many years ago²⁹, in the economic accounts of governments, the lower revenue resulting from reducing the fiscal and quasi-fiscal levy on labor, to increase employment, is at least partly offset by costs that are lower than those that the public administration, for obvious socio-political reasons, would have to bear to support the unemployed (various

²⁹ For all of these, see STEVE (1976).

forms of unemployment subsidy, implicit or explicit subsidies to firms to encourage them to retain jobs, free social services for the poor, and pressure on public offices to hire unnecessary staff who would otherwise be unemployed). So in accounting properly for social costs the greater "tax expenditures" to reduce labor costs must be compared with the consequent lower need for public expenditure in favor of the unemployed and for providing assistance to the poorest segments of the population.

Furthermore, the current economic crisis has given new voice to those who warn that the "new orthodoxies" concerning the relationships between public debt and GDP³⁰ must be interpreted according to economic logic and not merely in accounting terms. It is well known that the performance of the relationship between public debt and GDP depends not only on the performance of the numerator but also that of the denominator. The economic recession tends structurally to increase this relationship. So in economic terms the proposal of using budget policies to incentive and stimulate investment so that this relationship is allowed to further increase in periods of crisis would appear to be correct so long as later on, additional public intervention generates recovery of investment and growth of GDP. It can be argued that - *mutatis mutandis* and thinking essentially in terms of a closed economy - Keynes in his time was lucidly opposed to the orthodoxy of balancing the public budget, and (despite the limitations of his model) showed that investments would themselves generate the savings necessary to finance them.

Taking up the Keynesian lesson again and adapting it to the new constraints imposed by competitiveness in a global economy, it would appear that adhering too formally to the rules of the new orthodoxy of public finances, and in conceptual terms too statically, could prove to be highly negative for the economic prospects of the TI countries.

So whilst not underestimating the difficulties discussed above, margins do exist for a fiscal strategy that improves the competitiveness of products manufactured in the TI countries. In any case there do not seem to me to be any viable alternatives for in-

³⁰ As in the EU Stability Pact.

tervention if the goal is to stimulate the recovery of rates of growth in the TI countries in such a way as to (at least) maintain the current average living standards of their citizens.

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