Berlusconi Embraces Tax Hikes to Save Italy

The Italian government revisited its plans for handling the nation's gaping public debt problem. On Friday, Prime Minister Silvio Berlusconi (left) said that tax increases and spending cuts would both be in the new austerity plan. The tax increases included a "special levy" on income above €90,000 per year as well as tax increases on income from financial investments. More specifically, there would be a surcharge of 5 percent on incomes above €90,000 and a 10-percent surcharge on incomes above €150,000. The tax rate on financial income would increase from the current level of 12.5 percent to 20 percent. The government also pledged to crack down on tax evasion.

The spending cuts were directly largely at local government. Giuseppe Castiglione, head of the Union of Italian Provinces, almost immediately bemoaned the government cuts, which he said would fall most heavily on direct services to Italians: "When you talk about municipalities, you're talking about social services, when you talk about provinces, you're talking about schools, security at school, local roads."

Berlusconi and his cabinet proposed these actions after an emergency meeting with the object persuading the European Central Bank to buy Italian government bonds after sellers dumped those bonds threatening to raise the borrowing costs for the Italian government and risking the bond rating of those instruments.

The Prime Minister publicly decried the tax increases, saying that he agreed only after much soul searching and that the decision made his "heart drip blood." Berlusconi told reporters: "We are personally very pained to have to adopt these measures." In the past, the Prime Minister has emphatically rejected tax increases as a way to solve the nation's budgetary problems.

Raj Badiani at HIS Global Insight observed:

> The tax hikes certainly won't help the economy, which is already stagnating, and consumer confidence is sure to fall further. The new fiscal measures appear to be credible, but the real problem is on the reform front. We need a timeline for measures to liberalize the service sector and labor markets.

Other private economic analysts took a restrained view of the condition of Italy. Barclays Capital reduced how much it thought the Italian economy would grow next year to a dismal .7 percent, which is just barely over half of the Italian government's official estimate of 1.3 percent.

Chiara Corsa of UniCredit in Milan is somewhat more upbeat: "The austerity plan is not perfect but it's probably the best we could have hoped for in the current political situation with resistance from inside and outside the ruling coalition, and considering they had to re-formulate everything in a week."

Italian business leaders have already begun to criticize “Robin Hood” approach to the problem.

Complicating matters, Italy’s labor unions have already promised to oppose the government’s austerity measures which, they claimed, hurt ordinary Italians, especially those on fixed incomes. The CGIL, the largest federation of unions in Italy, has threatened a general strike. A decision on that could come as early as August 23.

The package adopted by the Italian Cabinet was an emergency decree, and it must be formally approved by the Italian Parliament within 60 days. Debate will begin in the Italian Senate on August 22, and approval is not automatic. Local governments — including those closely allied with Berlusconi’s political coalitions — have complained that the plan hits them too hard and allows tax evasion to flourish.

Berlusconi had discussed the Italian plans with Chancellor Merkel of Germany, a nation whose cooperation becomes increasingly more vital, prior to Merkel’s visit on Tuesday with President Sarkozy. Although plans for a eurozone-wide bond have been discussed informally, both Merkel’s and Sarkozy’s staffs have said that item will not be discussed during the meeting. The problems which Merkel and Sarkozy face, while not as serious as those of Berlusconi, are grim enough. Unlike the relatively small economies of Greece, Ireland and Portugal, Italy has one of the largest economies in the world and the fourth largest in Europe. Anything approaching a meltdown in that country would ripple across Europe.

First, because Italy’s is the principal Mediterranean economy in the world, what happens there will affect Greece and Spain, creating the increased likelihood of default by those nations. Second, because sovereign debt instruments of Italy (along with the PIGS nations) constitute a meaningful part of the portfolio of banks in France, Germany, and Britain, a partial default would weaken the liquidity and the solvency of those banks. What has happened recently to the Royal Bank of Scotland, which would seem outside the scope of these nations’ problems, is a good example of that. Third, the stresses within the European Union is increasing by the day. The idea of a free trade zone, particularly for coal and iron, which began the modest Common Market about 50 years ago, has grown into vast and unaccountable bureaucracy which rests on the assumption that size makes economies safer.

The principles of financial soundness have never changed. The debt-to-income ratio is just as important to multinational unions as to small businesses. Return on investment is also as crucial to giant governments as to small stockholders. Physical assets, such as gold, ultimately matter just as much to the ephemeral mandate money of the eurozone as to the ordinary factory owner.

Those EU member states which have protected their credit ratings are increasingly reluctant to risk that creditworthiness to bail out spendthrift nations. Although it may be possible to persuade enough members to actually offer a eurozone-wide bond to help stabilize the mess of the PIIGS nations, it would seem certain that the rate of return on these bonds would be relatively high and the risk of default on such bonds would be little short of catastrophic.