Ministero dell'Economia e delle Finanze

Italy's Stability Programme

Update December 2005

CONTENTS

1. INTRODUCTION

The *Update of Italy's Stability Programme* is issued in accordance with Article 4 of the European Council Regulation 1466/97, taking into account the modifications introduced by Regulation 1055/2005 issued on June 27, 2005 and the guidelines regarding the application of the new Stability and Growth Pact.

This year's Update is based on the *Economic and Financial Planning Document* (DPEF) for the period 2006-2009 issued on July 15, 2005, the *Forecasting and Planning Report* (RPP) for 2006 presented to Parliament on September 29, 2005, and the *Finance Bill for 2006* and *Law Decree* n. 203/2005 which became Law n. 248/2005, both submitted to Parliament on September 30, 2005.

The present Update outlines the macroeconomic framework for the period 2005-2009 and indicates the Government's public finance objectives for those years. For 2006, this year's Budget Law envisages a correction of 1.4 percent of GDP higher than previously indicated, and is aimed at assuring and strengthening public finances. The Budget Law complies fully with the Ecofin Council Recommendations of July with regard to the excessive deficit procedure imposed on Italy and is consistent with the objective to reduce the deficit below the 3 percent of GDP limit in 2007 and also to achieve a balanced budget in the medium term. Over the years 2006-2007, the cyclically-adjusted correction net of one-off measures is well in line with the Recommendation and is equal to 1.7 percent of GDP, 0.9 percentage points of which should occur in the first year, higher than the requested 0.8. In the years following 2007, the consolidation process allows for an annual reduction of the cyclically-adjusted deficit net of one-off measures of at least the 0.5 percent of GDP requested and is coherent with the objective of achieving a balanced budget position in the medium term. At the end of the period considered in this Update, the deficit should settle within the minimum benchmark that, in the presence of normal cyclical conditions and taking into account the budget sensitivity, provides a safety margin in order to guarantee the avoidance of an excessive deficit.

This document describes the debt to GDP ratio reduction process, using updated estimates following lower than expected proceeds from the valorisation and divestment operations of financial assets in 2005, and presents the revised estimate and profile for the declining debt to GDP ratio for the years 2006-2009.

The Update also includes the sensitivity analysis of public finances according to different macroeconomic scenarios.

In compliance with the new Code of Conduct endorsed by the Ecofin Council on October 11, 2005, and in line with the strategy outlined in the DPEF 2006-2009, the present document describes the broad structural improvements in public finances in the medium term, taking into consideration that Italian legislation does not provide a detailed multi-year Budget.

Finally, the document analyses the impact of the ageing population on the sustainability of public finances.

2. THE MACROECONOMIC FRAMEWORK

For the years 2006 and 2007, prospects for the world economy are positive, GDP and world trade should growth at satisfactory rates, allowing the Euro Area to benefit: GDP is forecast to grow by 1.2 percent this year and to accelerate to 1.8 in 2006.

The medium-term international prospects are also encouraging, though high oil prices constitute the main downward risk to growth.

Within the Euro Area, the Italian economy showed signs of recovery during 2005. After two consecutive quarters of negative growth (last quarter of 2004 and first quarter of 2005), the recession ended. Following a net recovery of 0.7 percent in the second quarter, with the contribution of all the components of growth, including net exports, third quarter figures from ISTAT (0.3 percent) confirmed the recovery.

The increase of industrial production in the third quarter of 2005 compared to the second quarter remained strong (0.6 percent) and based on the trade figures, exports (in nominal terms) have been steadily increasing since March. Notwithstanding, the balance of payments registered a current account deficit equal to 14.8 billion between January and October 2005.

The zero GDP growth rate for 2005, as forecast in the DPEF 2006-2009 and the RPP 2006, is confirmed: a slightly lower figure than that forecast by other main international organisations, namely the IMF, the EU Commission and the OECD.

Despite zero GDP growth rate, employment, measured in terms of standard work units, in the light of the positive results of the first two quarters should increase by 0.4 percent, while the unemployment rate should decline to 7.7 percent.

Inflation has increased slightly, largely due to pressures in the energy sector though the very moderate increase in the non-energy sectors leads to the realization of an average consumer price increase of about 2 percent for 2005.

In 2006, Italy’s economic rate of growth should accelerate: a rate of growth of 1.5 percent GDP is expected. Household expenditure, driven by higher employment (estimated to grow by 0.6 percent in 2006) and by measures aimed at helping the less well-off families, should increase at the rate of 1.1 percent. In addition, gross fixed capital formation should increase at a sustained rate (2.3 percent), mainly due to the prospects of stronger demand and to the effects stemming from the lower social security contribution burden on companies. The favourable dynamics of international trade would help the recovery of exports (2.8 percent), while imports should increase by 2.7 percent. In this context, the unemployment rate should decline to 7.6 percent.

The contribution of final domestic demand net of inventories should be 1.1 percent. The contribution of the export sector, although registering a strong improvement when compared to 2005, should nevertheless be zero.

The increase in consumer prices should be in line with that of 2005, though there could be a slight acceleration if the current uncertainties regarding oil prices were to remain.

In accordance with current legislation, the updating of the macroeconomic framework for 2006 will be outlined in the next planning document, that will be presented to Parliament next spring. However, in order to allow for the effects of any possible over or under estimation of growth, paragraph 4.1 illustrates the results of the sensitivity analysis with respect to various growth scenarios.

Italy’s economic rate of growth should progressively accelerate over the period 2007-2009. GDP is expected to increase by an average of 1.7 percent per year over the period 2007-2009, benefiting also from the growth enhancing policies undertaken by the government. Private consumption should benefit from higher disposable income due to a lower tax burden, and also from an improvement in the labour market, and increase by an average of 1.6 percent over the same period. Investment in equipment is forecast to increase by an average of slightly more than 3 percent, driven above all by machinery and equipment.

Exports should expand by an average of 3.5 percent over the same period, thanks largely to the gradual increase in competitiveness and to the substantially favourable international economic scenario. The contribution of net external demand to growth should remain, however, slightly negative over the entire forecast period, due to the effect of higher import dynamics (4 percent annual average) resulting from stronger demand.

Over the same period the current account deficit will decline, due to a reduction of income liabilities and transfers.

Regarding the labour market, a positive evolution in employment is expected, with growth rates of around 0.8 percent projected. Consequently, the unemployment rate would decline to 7.3 percent.

Inflation is expected to remain at near 2 percent throughout the triennium 2007-2009, thanks to limited external inflationary impulses and to the containment of the Unit Labor Cost dynamics, reflecting the continuation of moderation in wage developments and the expected productivity increases.

Table 1a – MACROECONOMIC PROSPECTS

	2004		2005	2006	2007	2008	2009
	Level (1)	rate of change	rate of change				
Real GDP	1,052	1.2	0.0	1.5	1.5	1.7	1.8
Nominal GDP	1,351	3.9	2.4	3.7	3.8	3.7	3.9
Components of real GDP							
Private consumption expenditure	633	1.0	0.8	1.1	1.3	1.8	1.8
Government consumption and NPISH expenditure (2)	193	0.7	1.2	0.0	0.2	0.3	0.3
Gross fixed capital formation	216	2.1	-1.0	2.3	2.7	3.1	3.4
Changes in inventories	4	-0.1	-0.1	0.3	0.2	0.1	0.1
Exports of goods and services	301	3.2	-0.1	2.8	3.3	3.7	3.8
Imports of goods and services	297	2.5	1.4	2.7	3.6	4.3	4.3
Contributions to real GDP growth							
Final domestic demand		1.1	0.4	1.1	1.4	1.8	1.9
Changes in inventories		-0.1	-0.1	0.3	0.2	0.1	0.1
External balance of goods and services		0.2	-0.4	0.0	-0.1	-0.2	-0.2

(1) € billions
(2) NPISH = non-profit istitution serving household

Table 1b – PRICE DEVELOPMENTS

	2004	2005	2006	2007	2008	2009
			rate of change			
GDP deflator	2.7	2.4	2.2	2.2	2.0	2.0
Private consumption deflator	2.2	2.1	2.3	2.2	2.0	2.1
HICP	2.3	2.3	2.3	2.2	2.0	2.0
Public consumption deflator	2.1	4.2	-1.8	0.7	0.8	1.0
Investment deflator	3.1	3.7	3.8	2.4	2.2	2.1
Export price deflator	3.8	5.4	2.8	2.0	1.8	1.8
Import price deflator	3.7	6.2	1.8	1.3	1.5	1.6

Table 1c – LABOUR MARKET DEVELOPMENTS

	2004	2005	2006	2007	2008	2009
			rate of change			
Employment	0.8	0.4	0.6	0.7	0.8	0.7
Unemployment rate	8.0	7.7	7.6	7.5	7.4	7.3
Labour productivity	0.4	-0.5	0.9	0.8	0.9	1.1
Employment incomes	3.4	4.3	3.0	3.3	3.3	3.3

Table 1d – SECTORAL BALANCES

	2004	2005	2006	2007	2008	2009
			% of GDP			
Net lending/borrowing vis a vis the rest of the world (*)	-0.9	-1.4	-0.9	-0.8	-0.7	-0.7
Balance of good and services	0.8	0.2	0.6	0.7	0.6	0.5
Balance of primary incomes and transfers	-1.7	-1.6	-1.5	-1.4	-1.3	-1.2

(*) Net capital account

3. NET BORROWING AND THE PUBLIC DEBT

3.1 General Government net borrowing

The sharp decline in economic growth in 2005, together with the accounting revisions agreed with Eurostat and a reevaluation of the budgetary effects, has led to a revision of the forecasts indicated in the *2004 Stability Programme Update.*

Already in the *Update to the Forecasting and Planning Report (RPP)* issued last April because of a downward revision (0.9 percent) of growth, the deficit to GDP ratio was raised from the initial 2.7 to between 2.9 and 3.5 percent, depending on some critical issues underlying the estimate.

Then, in July, the DPEF, taking into account the even lower growth forecast (0.0 percent), and the impact on 2005 of the accounting revisions agreed with Eurostat, raised the net borrowing to 4.3 percent of GDP, in line with the two-year deficit re-entry path requested at the Ecofin Council on July 12, 2005.

The Government, firmly aimed at keeping the deficit below the target, adopted further emergency measures (Law Decree n. 211/2005 subsequently incorporated into Law Decree n. 203/2005 and that became Law n. 248/2005) within the 2006 Budget. These measures will have a positive impact on public finance balances of around 0.1 percent of GDP this year as well as being a further guarantee for the overall process of consolidation of public finances.

The difference between the deficit forecasts projected last year and the current Update reflects several factors: the sharp decline in growth (2.1 percentage points) that, in terms of the budget elasticity established at European level, has had an impact of around 1 percentage point on the deficit; the impact of the accounting revisions agreed with Eurostat, 0.23 percent of which is attributable to the treatment of the capital injections to the state railroads; 0,15 percent to the operation of the state road agency (ANAS); lower than expected proceeds from the sale of real estate, and other minor items (Table 2).

However, attention must be drawn to the fact that the accounting harmonisation process to ESA95, as defined in accordance with EU Regulation n. 1500/2000, has now been completed, in line with the process of refining statistical sources. The accounting revisions make comparisons with the forecasts of the previous Update difficult, especially on the expenditure side. A proper comparison shows that higher expenditures are correlated to an increase in the outlays for health care and investments, the latter relating to operations regarding state assets smaller than projected. On the revenue side, there was a fall in tax revenues, both in direct taxes, on account of less growth, and in indirect taxes, because of weaker consumption.

Table 2 DIVERGENCES FROM PREVIOUS UPDATE

	2004	2005	2006	2007	2008
GDP growth					
Stability Programme 2004	1.2	2.1	2.2	2.3	2.3
Stability Programme 2005	1.2	0.0	1.5	1.5	1.7
Difference	0.0	-2.1	-0.7	-0.8	-0.6
Net borrowing (% of GDP)					
Stability Programme 2004	-2.9	-2.7	-2.0	-1.4	-0.9
Stability Programme 2005	-3.2	-4.3	-3.5	-2.8	-2.1
Difference	0.3	1.6	1.5	1.4	1.2
Public debt (% of GDP)					
Stability Programme 2004	106.0	104.1	101.9	99.2	98.0
Stability Programme 2005	106.5	108.5	108.0	106.1	104.4
Difference	0.5	4.4	6.1	6.9	6.4

The current forecast for 2005 shows an increase of more than one percentage point in the deficit to GDP ratio from 2004.

Looking at the components of total receipts, although tax revenues reflect the expiration of tax amnesties, ordinary receipts remained stable. In a proper comparison with the 2004 results that takes into account the overall amnesty revenues total receipts to GDP ratio is expected to remain stable.

Excluding the effects of real estate sales, the primary expenditure to GDP ratio is expected to increase by around one percentage point compared to 2004.

For 2006, the deficit to GDP target has been raised to 3.5 percent from 2.0 percent indicated in the previous *Stability Programme Update*. This figure is consistent with the re-entry path of the deficit within the parameters of the new Stability and Growth Pact in 2007.

Net borrowing is expected to decrease steadily over the period 2008-2009 and this should mitigate the need for a rapid adjustment with the evolution of the economic growth. Net borrowing is expected do decline to 1.5 percent at the end of 2009.

Table 3 GENERAL GOVERNMENT BUDGETARY PROSPECTS (1)

	2004 level	2004 % of GDP	2005	2006	2007	2008	2009
					% of GDP		
Net borrowing by sub-sector							
1. General Government	-43,652	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
annual correction (2)					0.5	0.7	0.4
2. Central Government	-36,664	-2.7	-3.9	-3.4	-3.1	-3.2	-3.1
3. State Government	-36,104	-2.7	-3.6	-3.1	-2.8	-2.8	-2.7
4. Local Government	-12,652	-0.9	-0.8	-0.6	-0.7	-0.6	-0.5
5. Social Security Funds	5,664	0.4	0.4	0.4	0.5	0.4	0.5
General government							
6. Total revenue	612,466	45.3	44.9	45.0	44.3	44.2	43.9
7. Total expenditure	656,118	48.6	49.2	48.4	47.6	47.5	47.0
annual correction (2)					0.5	0.7	0.4
8. Net borrowing	-43,652	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
9. Interest expenditure (incl.FISIM)	68,434	5.1	4.9	4.7	4.7	4.7	4.7
p.m. 9a. FISIM	453	0.03	0.03	0.03	0.02	0.02	0.01
10. Primary balance	24,782	1.8	0.6	1.3	1.9	2.6	3.2
Selected components of revenues							
11. Total taxes	390,156	28.9	28.2	28.3	27.9	27.8	27.6
11a.Taxes on production and imports	195,207	14.4	14.4	14.4	14.3	14.2	14.0
11b.Current taxes on income etc.	185,377	13.7	13.7	13.8	13.6	13.6	13.6
11c.Capital taxes	9,572	0.7	0.1	0.1	0.0	0.0	0.0
12. Social contribution	174,756	12.9	13.1	13.0	12.8	12.8	12.7
13. Property income	8,319	0.6	0.8	0.7	0.6	0.6	0.6
14. Other	39,235	2.9	2.8	3.0	3.0	2.9	2.9
15. Total revenue	612,466	45.3	44.9	45.0	44.3	44.2	43.9
p.m. Tax burden		41.8	41.3	41.3	40.7	40.6	40.3
Selected components of expenditure							
16. Collective consumption	98,169	7.3	7.3	7.1	6.7	6.7	6.6
17. Total social transfers	396,075	29.3	29.9	29.7	29.3	29.3	29.0
17a.Social transfers in kind	161,894	12.0	12.4	12.1	11.7	11.7	11.6
17b.Social transfers other than in kind	234,181	17.3	17.5	17.7	17.6	17.7	17.4
18. Interest expenditure (incl.FISIM)	68,434	5.1	4.9	4.7	4.7	4.7	4.7
19. Subsidies	14,471	1.1	1.1	1.0	0.9	0.9	0.9
20. Gross fixed capital formation	34,875	2.6	2.7	2.8	2.8	2.8	2.8
21. Other	44,094	3.3	3.4	3.1	3.2	3.1	3.0
22. Total expenditure	656,118	48.6	49.2	48.4	47.6	47.5	47.0
p.m. Compensation of employees	148,248	11.0	11.2	11.1	10.5	10.3	10.1

(1) Details may not add, due to rounding.
(2) The cumulated correction amounts to 1.2 in 2008 and to 1.6 in 2009.

The forecasts for 2007-2009 take into account the effects of the structural measures of the 2006 Budget. The annual targets indicated by the DPEF 2006-2009 will be achieved year after year by implementing additional measures, consistent with public accounting norms, as specified by the Budget laws for the coming years. On account of the permanent nature of the interventions, the amount of additional measures decreases.

Box 1 – The accounting revisions

Following the subsequent accounting revisions agreed with EUROSTAT, the deficit and debt for the period 2001-2004 have therefore been recalculated.

With the first revision, the capital injections from the State to the state railroads have been recorded as capital transfers rather than financial transactions, not significant for the deficit.

With the second revision, in May, the following operations have been recorded as follows:

- *the debt issued by Infrastrutture S.p.A. (ISPA) for the financing of the high-speed railway has been recorded as general government debt without any impact on the deficit;*
- *the payment of compensation to households, referring to the discount allowed for the purchase of properties subjected to securitization within the context of the SCIP2 operation (Società Cartolarizzazione Immobili Pubblici Srl), has been recorded in 2004;*
- *the prepayments of the banks entrusted with the collection of taxes ("Concessionari d'Imposta"), initially recorded as capital taxes, have been accounted as financial transactions that impact the debt but not the deficit;*
- *the central government transfers to firms have been upwardly recalculated for the period 2001-2004;*
- *transfers to firms for tax credits, previously not recorded, have been registered. These transfers, however do not include the bonus for employment and investment which had already been recorded.*

The following table shows the impact of the new accounting classification on both the deficit and debt.

Impact on general government deficit and debt for years 2001 – 2004 of the new accounting classifications agreed with EUROSTAT (millions of euro)

DEFICIT	2001	2002	2003	2004
Injections of capital to FS	-3,615	-4,078	-3,934	-2,665
% GDP	-0.3	-0.3	-0.3	-0.2
Deficit	-35,963	-32,656	-37,792	-40,877
Deficit / GDP	**-3.0**	**-2.6**	**-2.9**	**-3.0**
ISTAT MAY 2005 REVISION				
SCIP2 Operation				-182
Pre-payments of "Concessionari d'imposta"			-2,691	-1,149
Integration of transfers to firms	-1,995	-1,135	-843	-882
Credits of tax different from bonus for employment and investments	-783	-672	-429	-562
TOTAL	**-2,778**	**-1,807**	**-3,963**	**-2,775**
% GDP revisions	-0.2	-0.1	-0.3	-0.2
Deficit	-38,741	-34,463	-41,755	-43,652
Deficit / GDP	**-3.2**	**-2.7**	**-3.2**	**-3.2**
DEBT	**2001**	**2002**	**2003**	**2004**
Pre-payments of "Concessionari d'imposta"			2,691	5,185
Debt Infrastrutture S.p.A. (ISPA)				6,413
TOTAL	**0**	**0**	**2,691**	**11,598**
% GDP revisioni	0.0	0.0	0.2	0.9
Debt	1,351,360	1,365,007	1,389,223	1,439,755
Debt / GDP	**110.9**	**108.3**	**106.8**	**106.5**

3.2 The cyclically-adjusted budget

The methodology adopted to determine the cyclically-adjusted budget, or structural budget, allows the specification, in a direct way, of both the fiscal position consistent with the potential GDP and the amount of the automatic stabilisers (cyclical component).

The cyclical component measures the change of tax revenues and social expenditures due to cyclical fluctuations. It is measured by the product of the output gap with the elasticity of the budget to economic growth. This latter value is estimated by the European Union, and, for Italy, has recently been changed from 0.45 to 0.50.

Table 4 Cyclical developments [(1)]
(percentage of GDP)

	2004	2005	2006	2007	2008	2009
GDP growth rate at constant prices	1.2	0.0	1.5	1.5	1.7	1.8
Net borrowing	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
Interest payments	5.1	4.9	4.7	4.7	4.7	4.7
Potential output growth rate[(2)]	1.4	1.2	1.2	1.3	1.4	1.6
Contributions						
Labour	*0.8*	*0.6*	*0.5*	*0.5*	*0.5*	*0.5*
Capital	*0.6*	*0.6*	*0.6*	*0.6*	*0.6*	*0.7*
Total Factor Productivity	*0.0*	*0.0*	*0.0*	*0.2*	*0.3*	*0.4*
Output gap[(2)]	-0.5	-1.7	-1.4	-1.3	-1.0	-0.8
Cyclical budgetary component[(2)]	-0.3	-0.9	-0.7	-0.6	-0.5	-0.4
Cyclically-adjusted budget balance[(2)]	-3.0	-3.5	-2.8	-2.2	-1.6	-1.1
Cyclically-adjusted primary balance[(2)]	2.1	1.5	2.0	2.5	3.1	3.6
One-off measures	1.3	0.5	0.3	-	-	-
Cyclically-adjusted budget balance net of one-off measures[(2)]	-4.2	-3.9	-3.0	-2.2	-1.6	-1.1
Cyclically-adjusted primary balance net of one-off measures[(2)]	0.8	1.0	1.7	2.5	3.1	3.6
Change in cyclically-adjusted budget balance net of one-off measures		-0.3	-0.9	-0.8	-0.6	-0.5

(1) Decimals may not add, due to rounding.
(2) Taking into account the smoothing of the active population series in order to reduce the hike in 2004 caused by the legalisation of immigrant workers.

The output gap dynamic and the profile of potential GDP have been obtained applying the agreed Ecofin Council methodology to the medium-term forecasts published last September in the RPP for 2006.

Table 4 shows the evolution of the cyclically-adjusted budget balance and other relevant variables during the period 2004-2009.

The Update to the Stability Programme 2004 forecast a GDP growth rate of 2.1 percent for 2005. However, the rate of growth over the last year slowed down considerably, with real growth declining from 1.2 percent in 2004 to zero this year. Consequently, there has been a reduction in the potential growth rate, settling at 1.4 percent in 2004, and 1.2 percent in 2005. Half of the potential growth should come from the contribution of labour factor, with the remainder attributable to the growth of capital endowment, whereas there should be practically no contribution from total factor productivity (TFP)[1].

Given a net borrowing figure for 2005 of 4.3 percent of GDP, the cyclically-adjusted budget should be about 3.5 percentage points, 0.5 percent higher than last year. However, net of one-off measures that amounted to 1.3 percent of GDP in 2004 and to 0.5 percent in 2005, the cyclically-adjusted budget should decrease by 0.3 percentage points, from 4.2 to 3.9 percent.

In 2006, the GDP growth rate should be around 1.5 percent while potential GDP should be equal to 1.2 percent, with a practically unchanged labour and capital composition.

Thanks to the largely permanent nature of the fiscal consolidation, net borrowing should decline to 3.5 percent, with one-off measures equal to little more than half of those of 2005. The cyclically-adjusted budget would decline by 0.7 points compared to 2005 (Table 4), while, net of one-off measures, would decline by 0.9 points, from 3.9 percent in 2005 to 3.0 percent in 2006.

[1] Following the proposal put forward by the Working Group on Output Gaps, the Economic Policy Committee (EPC) recently approved the use of the series of hours worked for calculating potential GDP according to the production function methodology. However, due to technical reasons, it has not been possible to incorporate this new factor in the estimate of potential GDP in this Update. Nevertheless, we can presume that, by using the series of hours worked, the contribution of total factor productivity to potential GDP is positive and significantly above zero.

Therefore, the consolidation of public finances is in line with the Ecofin Council Recommendation on the existence of an excessive deficit in Italy. The Recommendation calls for a cumulative reduction in the cyclically-adjusted deficit, net of one-off measures, of at least 1.6 percent of GDP over 2006-2007 relative to its level in 2005, with at least half of this correction taking place in 2006.

Due to low growth, between 2005 and 2006, the automatic stabilisers should reach 0.9 and 0.7 percent of GDP respectively, with an average increase of more than 0.3 percentage points compared to the figures in the 2004 Update. However, after the reduction of 0.6 percentage points seen between 2004 and 2005, the cyclically-adjusted primary balance should once again increase, from 1.5 to 2.0 percent in 2006.

Over the period 2007-2009, GDP growth rate should return to an average of 1.7 percent, and the potential GDP growth rate should increase, from 1.3 percent in 2007 to 1.6 percent in 2009 (Table 4). Provided that contributions of the capital and labour factors should not change significantly, the higher potential growth should be mainly due to an increase in the contribution of the total factor productivity.

Starting from 2007, net borrowing should return to under the 3 percent of GDP ceiling. Over the period 2007-2009, the cyclically-adjusted budget balance should decrease by 1.1 percentage points. This would allow both the complete fulfilment of the excessive deficit procedure and the convergence towards the medium term objective. In line with the Ecofin Council Recommendation, the cyclically-adjusted budget would decline by more than 0.5 percent per year. The cyclically-adjusted primary balance would significantly increase, from 2.5 percent in 2007 to 3.6 percent in 2009.

The pursuit of a close to balance budget continues: at the end of the projected period, the deficit should be within the minimum benchmark that, under normal cyclical conditions and taking into account the budget sensitivity, assures a safety margin so as to not exceed the 3 percent ceiling.

3.3 The public debt

In 2004, the debt to GDP ratio declined by 0.3 percent, from 106.8 in 2003 to 106.5, 0.5 percent above what was forecast in the previous Stability Programme Update

(106.0). This difference is due mainly to the revisions carried out during 2005 by Istat and Eurostat, which led to an upward revision in the estimates for public debt for the period 2001-2004. In particular, the recent decision by Eurostat to consider the liabilities of Infrastutture SpA (Ispa) high speed railway as public debt, together with advance tax payments, had an impact on the 2004 debt estimated to be about 0.9 percentage points of GDP.

Furthermore, some minor standard revisions have been carried out in 2005 and have led to a partial compensation of the above impact.

At a macroeconomic level, the nominal GDP growth rate has been less than expected (3.9 rather than 4.1 percent forecast in last year's Update), and a smaller than expected primary surplus (1.8 instead of 2.4 percent). On the contrary, interest payments were about 0.2 percentage points lower at 5.1 percent.

The overall effect of the above mentioned factors has therefore led to a debt to GDP ratio in 2004 of 106.5 percent.

Table 5 **General government debt developments** (1)
(percentage of GDP)

	2004	2005	2006	2007	2008	2009
Gross debt						
Gross debt level	106.5	108.5	108.0	106.1	104.4	101.7
Change in gross debt ratio	-0.3	2.0	-0.5	-1.9	-1.7	-2.7
Contributions to change in gross debt						
Primary balance (accrual basis)	-1.8	-0.6	-1.3	-1.9	-2.6	-3.2
Interest expenditure (accrual basis and incl. FISIM)	5.1	4.9	4.7	4.7	4.7	4.7
Stock-flow adjustment*	0.4	0.2	0.0	-0.8	0.0	-0.3
of which:						
differences between cash and accruals	-0.2	0.1	0.5			
net accumulation of financial assets	0.8	0.0	-0.5			
of which privatization proceeds	-0.6	-0.3	-0.7	-0.7		
valuation effects and others	-0.3	0.1	0.0			
p. m. Implicit interest rate on debt	5.0	4.8	4.5	4.5	4.6	4.7

(1) Decimals may not add, due to rounding.

For 2005, the debt to GDP ratio is expected to be around 108.5 percent, 0.3 percentage points higher than the objective indicated in the DPEF for 2006-2009. Compared to the previous Stability Programme Update, the overall worsening of the macroeconomic situation has had this negative impact on the debt level. Indeed, because of the general macroeconomic downturn, a primary surplus of 0.6 percent is expected for 2005 instead of the 2.4 percent forecast in the previous Update. This decline is only partly compensated by lower interest payments (4.9 instead of 5.1) due to both the evolution of interest rates over the course of the year, and to the debt management policies undertaken. In addition, the nominal GDP growth rate for 2005, forecast at 4.4 percent in the previous Update, appears to be about 2.0 percentage points lower. Another crucial factor to the evolution of the debt is linked to the privatisations envisaged for 2005, which posted a performance of only 0.3 rather than the 2.1 percent of GDP forecast in the previous Update.

The implementation of the economic policies presented in the Economic and Financial Planning Document for 2006-2009 will lead to a progressive increase in the primary surplus and in economic growth, starting from 2006, albeit at lower levels than those forecast in the previous Update. These factors, together with the realisation of the privatisation programme, will assure a constant decline in the debt to GDP ratio, projected to be down to 101.7 percent in 2009.

4. SENSITIVITY ANALYSIS

Public finance targets can be subject to both economic (underestimate or overestimate of GDP growth) and financial risks (changes in interest rates). Thus, in order to evaluate the impact of different macroeconomic scenarios on public finances, a number of simulations based on alternative assumptions on growth and interest rates have been carried out.

4.1 Sensitivity to growth

For the period 2006-2009 two alternative scenarios to the baseline macroeconomic forecast have been considered. In the high-growth scenario, the GDP growth rate is assumed to increase by 0.5 percentage points more per annum compared to the baseline scenario, whereas in the slow-growth scenario, it is reduced by 0.5 percentage points. The higher or lower growth scenarios depend on different assumptions concerning some key international variables.

In the high-growth scenario the Italian economy would grow by at least an extra 0.5 percent per annum because of significant increases in both consumption and exports, which, in turn, would lead to higher investment. The more favourable economic outlook would positively affect consumers and firms' confidence. On the supply side, it is expected that the recovery of exports will cause an increase in industrial production and services, thus leading to higher employment. Labour productivity will increase considerably compared to the baseline scenario, helping to curb rising unit labour costs. It is only from 2006 onward that inflation will accelerate by 0.1 percent entirely as a result of stronger demand.

In the low-growth scenario, the Italian economy would grow by less than 0.5 percent per annum due to lower consumption and exports, which in turn, would discourage investment, and lead to lower household and business confidence.

On the supply side, weaker export growth would adversely affect industrial production, and have a negative impact on employment. Labour productivity would be lower than that of the baseline scenario.

Table 6 SENSITIVITY TO GDP GROWTH [1]
(percentage values)

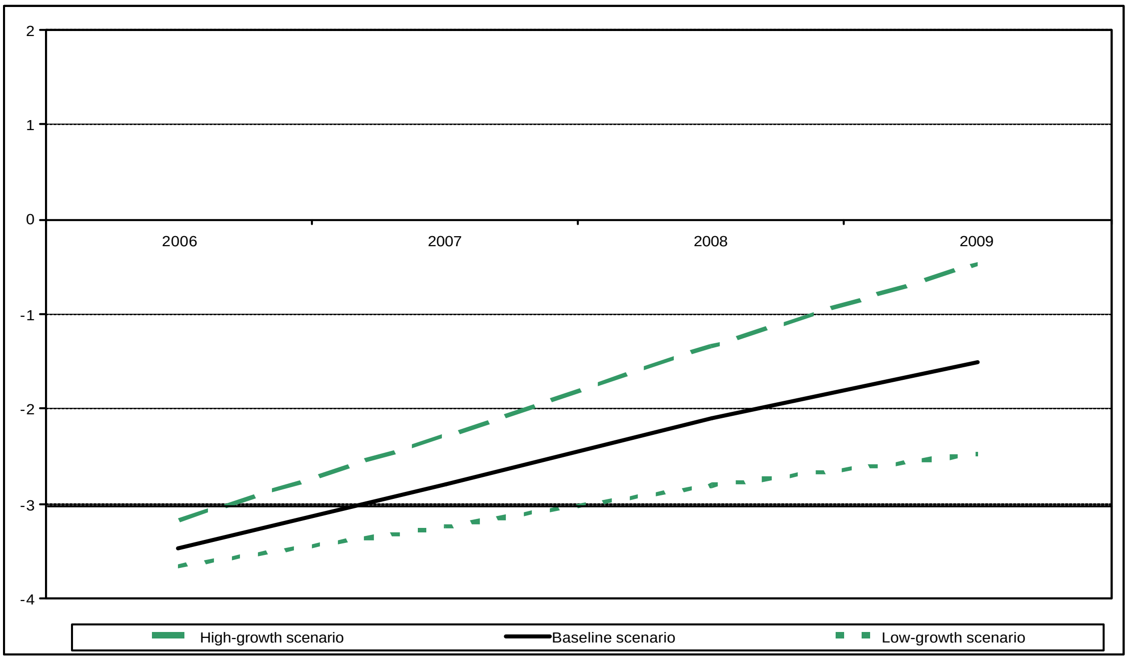
		2006	2007	2008	2009
Nominal GDP growth rate	*High-growth scenario*	4.3	4.3	4.3	4.5
	Baseline scenario	3.7	3.8	3.7	3.9
	Low-growth scenario	3.3	3.4	3.3	3.5
GDP growth rate at constant prices	*High-growth scenario*	2.0	2.0	2.2	2.3
	Baseline scenario	1.5	1.5	1.7	1.8
	Low-growth scenario	1.0	1.0	1.2	1.3
Potential output growth rate	*High-growth scenario*	1.4	1.6	1.8	1.9
	Baseline scenario	1.2	1.3	1.4	1.6
	Low-growth scenario	1.0	1.0	1.2	1.3
Output gap	*High-growth scenario*	-1.4	-1.0	-0.6	-0.2
	Baseline scenario	-1.4	-1.3	-1.0	-0.8
	Low-growth scenario	-1.6	-1.6	-1.5	-1.5
Net borrowing	*High-growth scenario*	-3.2	-2.3	-1.3	-0.5
	Baseline scenario	-3.5	-2.8	-2.1	-1.5
	Low-growth scenario	-3.6	-3.2	-2.8	-2.5
Cyclically-adjusted budget balance	*High-growth scenario*	-2.5	-1.8	-1.0	-0.4
	Baseline scenario	-2.8	-2.2	-1.6	-1.1
	Low-growth scenario	-2.8	-2.4	-2.0	-1.7
Primary Balance	*High-growth scenario*	1.5	2.3	3.2	4.1
	Baseline scenario	1.3	1.9	2.6	3.2
	Low-growth scenario	1.1	1.5	2.0	2.4
Cyclically-adjusted primary balance	*High-growth scenario*	2.2	2.9	3.6	4.2
	Baseline scenario	2.0	2.5	3.1	3.6
	Low-growth scenario	1.9	2.3	2.7	3.2
Public Debt	*High-growth scenario*	107.2	104.2	101.3	97.1
	Baseline scenario	108.0	106.1	104.4	101.7
	Low-growth scenario	108.7	107.5	106.9	105.5

(1) Decimals may not add, due to rounding.

Both scenarios are based on the assumption that higher or lower growth can have permanent as well as temporary effects. Thus, it is assmed that the higher or lower GDP growth can affect potential output. Consequently, in the alternative scenario, the potential output, calculated by applying the methodology agreed at the EU level, varies compared to that of the baseline scenario. The output gap also changes according to the new profiles of effective and potential GDP.

Changes in GDP growth impact public finances through a variation of the structural and cyclical components of the primary surplus[2]. The cyclically-adjusted primary surplus is measured by distinguishing between structural revenues and expenditures.

Figure 1 **SENSITIVITY OF THE ACTUAL BUDGET BALANCE TO THE GDP GROWTH**
(percentages of GDP)



Structural revenues react to a change in the GDP growth with an elasticity of 1.2 percent. Structural expenditures, in both the alternative scenarios, are obtained by subtracting a specific component from the cyclically-adjusted outlays of the baseline framework. This component is given by the product of the baseline structural expenditures and the discrepancy of the alternative scenarios' potential output with

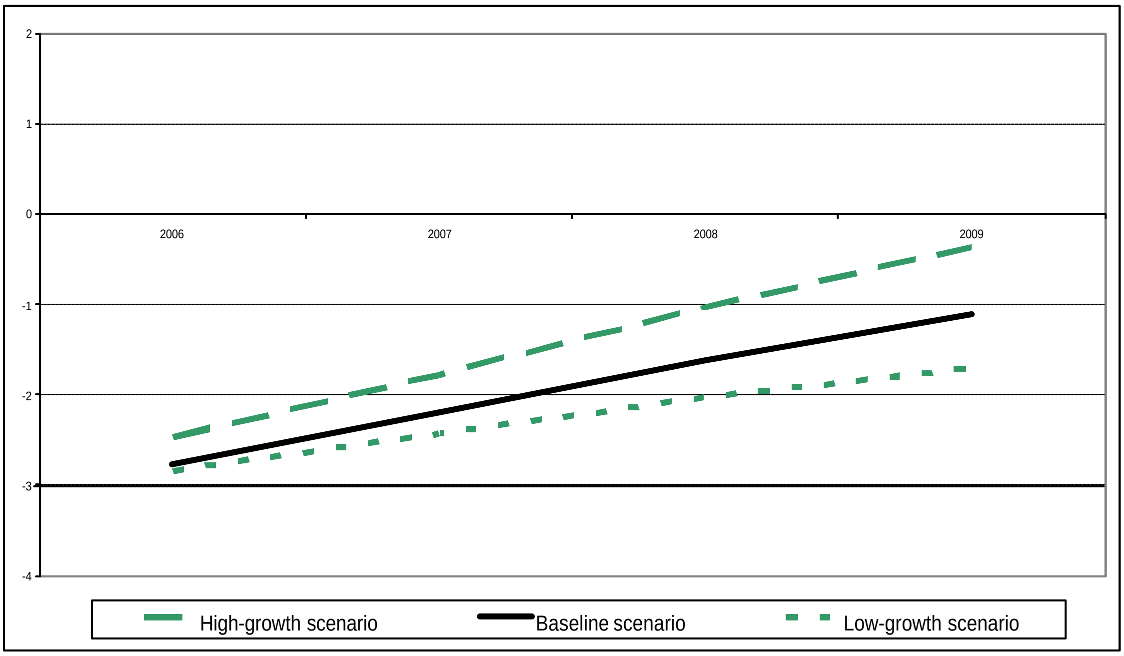
[2] Analogous to the 2004 Stability Programme, the future measures for 2007, 2008 and 2009, which will be defined by forthcoming Budget Laws, have been broken-down into higher revenues and savings proportionally to the ratio of current revenues and expenditures with respect to GDP as projected in Table 3 for the same period.

respect to the baseline one. Moreover, it is assumed that the cyclical component of the primary surplus varies according to an elasticity that, according to the Ecofin Council has to be set at 0.5 for Italy. Finally, public debt is derived on the basis of the assumption that the stock flow adjustment and implicit interest rate in the alternative scenarios do not change with respect to the baseline (Table 5).

In the lower-growth scenario, the deficit for 2006 would increase by around 0.1 percentage points compared to the baseline figure. Over the following years the deficit would continue to decrease at slower rates than in the reference scenario, from 3.2 percent in 2007 to 2.8 in 2008, and would be equal to 2.5 percent of GDP in 2009. In a similar scenario the containment of interest rates could compensate for the slower correction rate (see par. 4.2).

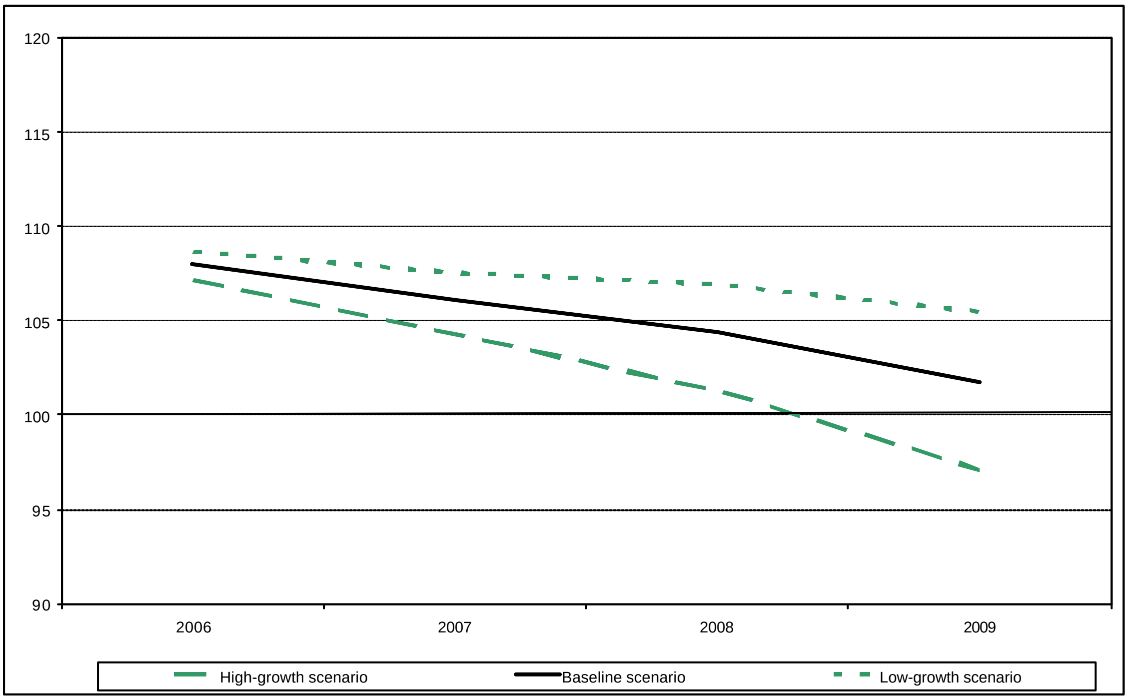
In the high-growth scenario, the cyclically-adjusted deficit for 2006 would be equal to 2.5 percent, 0.3 percentage points lower than the baseline scenario (Figure 2). Over the following years the cyclically-adjusted deficit would decrease significantly so as to reach, at the end of the period, a figure close to 0.4 percent, near to a balanced budget position and in line with the medium-term objective.

Figure 2 **SENSITIVITY OF THE CYCLICALLY-ADJUSTED BUDGET BALANCE TO GDP GROWTH**
(percentages of GDP)



On the contrary, in the low-growth scenario, the cyclically-adjusted deficit for 2006 would be around 2.8 percent while, in 2007, would continue to decrease by 0.4 percentage points. In 2009 there would be a structural deficit equal to 1.7 percent, above the budgetary safety margin.

Figure 3 **SENSITIVITY OF THE PUBLIC DEBT TO THE GDP GROWTH.**
(percentages of GDP)



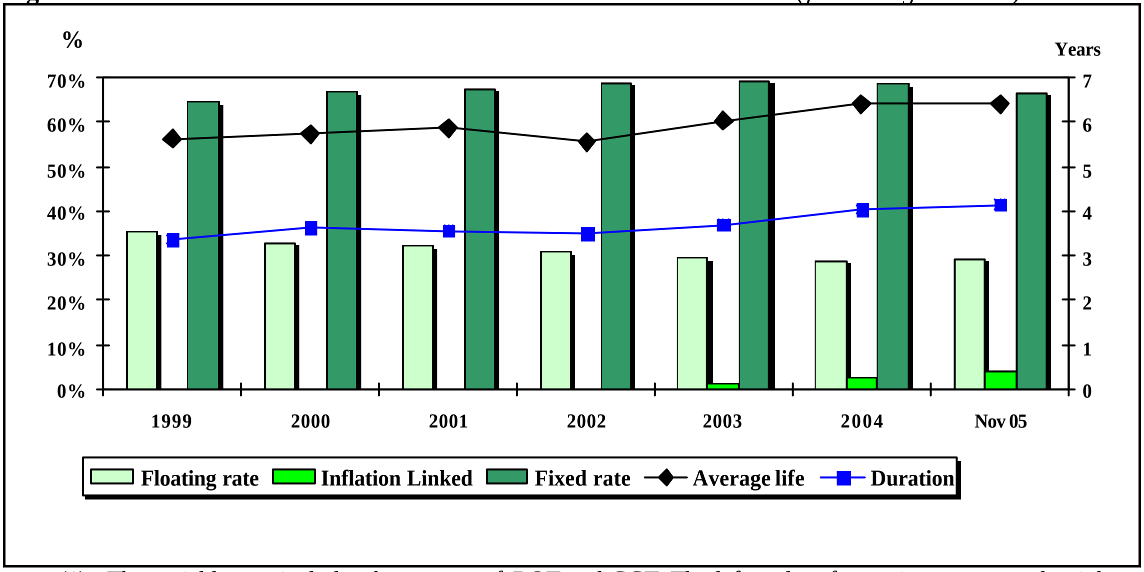
An important result emerging from the present analysis is that the debt would continue to decline in both alternative scenarios (Figure 5). However, the combined effect of the higher primary surplus and the stronger nominal GDP growth (snowball effect) would cause the fall to be more accentuated in the "optimistic" scenario. In this case, the debt would decline from 107.2 percent in 2006 to 97.1 percent in 2009.

In the lower growth scenario, there would be a more modest primary surplus as well as a lower nominal GDP. Consequently, the debt would be higher than the baseline scenario in 2006 and would decline at a very slow pace, decreasing to 105.5 percent in 2009, a figure which is 3.8 percentage points higher than the respective value in the baseline scenario.

4.2. Sensitivity to interest rates

This section examines the effects of alternative interest rate scenarios. The key element of the simulation is the current structure of the public debt and its expected changes. In brief, at the end of October 2005, Italy's debt, referring to the total amount issued in euros on the domestic market, consisted mostly of fixed-rate bonds (about 66 percent of the total), while about 4 percent were Euro Area inflation-linked and the remaining 30 percent represented short term or variable rate bonds (Figure 4). The average maturity of all government bonds up to November 30, 2005 was about 6.42 years, a slight decrease compared to the figure of 6.43 years at the end of 2004, whereas the duration increased more significantly, reaching 4.15 years compared to around 4 in December 2004.

Figure 4 COMPOSITION OF ITALY'S PUBLIC DEBT IN EURO *(percentages values)*

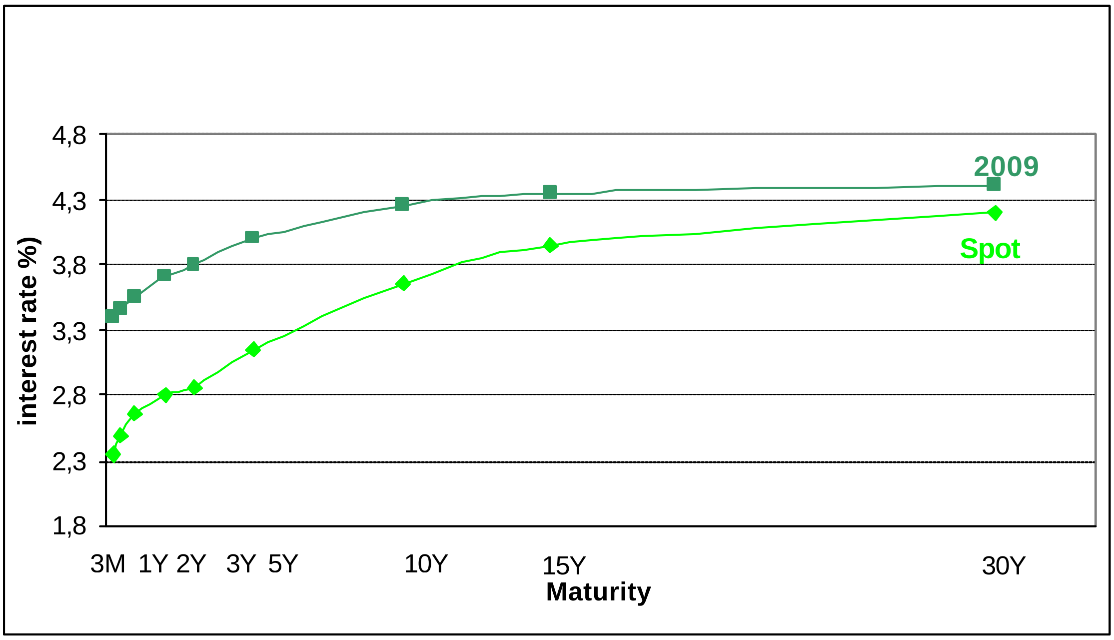


(1) The variable rate includes the amount of BOT and CCT. The left scale refers to interest rates, the right scale refers to average duration.

The debt issuance strategy has continued with the objective of minimising costs but at the same time minimising risks. To this end, the ratio of short term and variable rate bonds has been maintained at around 30 percent of the total, while the presence of real securities (Euro Area inflation-linked BTPs but excluding tobacco) has led to a further reduction in real interest rate and refinancing risks, and therefore optimizing the debt structure.

The estimates of interest expenditure contained in this document are based on the implicit rates of the Italian government bonds yield curve (represented in the graph Figure 5) registered on December 5, 2005 and which takes into account the interest rate increase by the ECB on December 1, 2005.

Figure 5 **YIELD CURVE**



The current structure of Italy's debt makes it less exposed to interest rate fluctuations than in the past, in fact, on the basis of these rates, in the case of a sudden one percentage point increase of all the yield curves underlying the estimates of this Update, the impact on interest expenditure is estimated to be equal to 0.20 of GDP in 2006, 0.38 in 2007, 0.48 in 2008, and 0.56 in 2009[3], with the full impact of the rate

[3] It should be noted that this exercise focuses on interest spending gross of withholding tax. Specifically, account is not taken of the effects of interest rate changes, economic activity or tax revenues deriving from investment income (the tax on interest income from fixed-rate bonds and bank deposits, which are positively correlated to rate increases). Therefore, it is not possible to immediately assess the sensitivity of the overall budget balance to interest rate changes.

increases being felt after 5.51 years[4]. In order to verify these results, the exercise was repeated using slightly different interest rates, taking the spot and forward yields both on days that in the last two months were characterised by an average lower rate compared to the date in October (September), and on days with higher levels (mid-November). The results, in terms of sensitivity, were substantially the same, with an increase or decrease of only two decimal points in 2008-2009.

[4] This period does not coincide with the average maturity of the debt owing to the nature of floating-rate Treasury Credit Certificates (CCT), which have a six-month coupon.

5. THE QUALITY OF PUBLIC FINANCES

The budget strategy indicated in the DPEF for the period 2006-2009 envisages the correction of the deficit tied to the plans for re-launching the economy. The consolidation of public finances and fostering higher growth remain the primary objectives of the Government.

The 2006 financial manoeuvre is consistent with these objectives and gives priority to the compliance of the commitment for fiscal consolidation undertaken at European level.

In order to allow the deficit to fall within the limits of the new Stability and Growth Pact in 2007, as agreed by Ecofin, the financial manoeuvre has been strengthened and now envisages a deficit to GDP ratio of 3.5 percent in 2006.

This chapter summarizes the 2006 Budget and shows the Plan for Innovation, Growth and Employment in the context of the Lisbon Strategy.

5.1 The 2006 Budget.

The 2006 Budget consists of three specific legislative instruments: 1) the *Financial Law*; 2) the related *Law Decree 203/2005* which became *Law n. 248/2005*, that includes the measures of *Law Decree 211/2005*, subsequently promulgated and aimed at achieving the 2005 targets agreed at European level to guarantee public finances in 2006; 3) Government amendments that strengthened the manoeuvre providing for an improved enforcement of the Budget, including the introduction of mechanisms to guarantee the full implementation of the measures.

The manoeuvre provides measures for the correction of the deficit amounting to 20.3 billion euros (equal to 1.4 percent of GDP), increased from the initial 11.5 billion (0.8 percent of GDP).

The strenghtened manoeuvre consists of two parts, one represented by the reduction of the budget deficit through measures equal to 27.9 billion, the other by measure to foster economic growth, amounting to 7.6 billion.

Table 7 THE 2006 BUDGET (millions of euro)

	2006	2007	2008
CORRECTIVE MEASURES	**27,854**	**24,399**	**24,527**
Lower Expenditures	**17,092**	**15,490**	**15,296**
- Staff costs (net values)	886	886	886
- Intermediate Consumptions	5,343	5,468	5,277
of which:			
- Central Government	1,693	1,828	1,925
- Local Government	2,648	3,078	2,790
- Health	2,500	2,500	2,500
- Current transfers fund to enterprises	960	1,121	1,121
- Gross fixed capital formation	1,057	660	1,013
- Capital transfers	3,167	1,367	920
- Other expenditures	3,179	3,488	3,579
Higher Revenues	**10,762**	**8,909**	**9,231**
- Machinery depreciation (energy sector)	971	990	990
- Revaluation of enterprises assets	912	0	18
- Games	738	1,182	1,419
- Measures to counter tax evasion and customs investigations	335	496	498
- Tax collection	300	450	780
- Banks and insurance companies	1,339	680	632
- Goodwill depreciation	1,680	952	952
- Leasing and anti-elusive measures	826	925	1,144
- Substitute tax on real estate sales	500	468	482
- Fiscal planning	1,040	1,100	1,100
- Adjustment years 2003-2004	990		
- Other revenues	1,131	1,666	1,216
GROWTH MEASURES	**7,597**	**6,099**	**6,322**
Lower Revenues	**3,741**	**2,424**	**2,554**
- Extension of tax relieves	1,166	265	89
- Labour cost reduction	1,996	2,429	2,518
- Industry clusters	50	50	50
- Other measures	529	553	586
- Effects linked to labour cost reduction		-873	-689
Higher Expenditures	**3,856**	**3,675**	**3,768**
- Households and solidarity fund	696	0	0
- Staff costs (net values)	592	710	710
- Public safety fund	180	60	70
- Internal Stability Pact	180	598	233
- Legge Obiettivo	0	0	200
- Previous charges	759	580	580
- Other	1,449	1,727	1,975
Net impact on primary balance	**20,257**	**18,300**	**18,205**
in % GDP	*1.4*	*1.2*	*1.2*

The corrective part of the manoeuvre is based on the quality of permanent interventions, equal to around 26 billion, of which 65 percent aimed at curbing expenditure and the remaining 35 percent at increasing revenues.

5.1.1 Corrective Measures

The corrective measures, amounting to 27.9 billion euros (equal to 1.9 percent of GDP), consist of additional net revenues of about 11 billion and of lower expenditure for 17 billion.

The containment of expenditure is aimed at reconciling the need for rationalising discretional expenditure with that of assuring the effectiveness of public administrations. The measures are based on the principle of mutual involvement of sectors of the public administration, though in full respect of autonomy in decision and management of different sectors.

Applying this principle leads to a stronger containment and control of current expenditure.

Savings amounting to 5.3 billion euros are expected from the containment of intermediate consumption concerning different levels of government. At the central government level, a cut in expenditure referring to studies, consultancies, public relations and other discretionary expenses will allow for savings of around 1.7 billion euros. To give further support to this containment, more incisive administrative instruments (for each Ministry) are to be introduced for the monthly monitoring of expenditures and to make the management of ministerial budgets more efficient and in line with forecast. Moreover, the role of Consip is to be strengthened: control on buying procedures will apply not only to the price of goods and services but also to their quantity. Furthermore, those who stipulate contracts will be held personally responsible.

As for local governments, the measures aim to involve more effectively the de-centralised authorities in the consolidation process of public finances through the re-negotiation of the Internal Stability Pact. The new rules set different expenditure ceilings to current expenditure according to type and institutions involved, except for personnel and social expenditures. In this context, the controls carried out by the Court of Auditors (*Corte dei Conti*) are to be strengthened. Greater flexibility is provided for investment expenditures. The new margins will lead to savings of around 3.1 billion, of which 2.6 billion referring to intermediate consumption.

Regarding health care expenditure, the measures aim for a more rigorous control of costs through a more efficient use of the existing health care services. The implementation of the Tessera Sanitaria (National Health Card), through computerised control, will also help to contain costs by eliminating waste and abuse. In the pharmaceutical sector, the measures provide for a more stringent regulatory framework through the setting-up of a national commission on the appropriateness of medical prescriptions and the validation of the functions granted to the Italian Pharmaceutical Agency (AIFA). The regulations aim at giving greater responsibility to the institutions involved: the Regions that are still in deficit are encouraged to improve their budget balances, also through additional financial incentives. In order to ensure that the level of expenditure remains within the set limits, a more effective use of the procedure of *commissariamento* (i.e. administration through an external commissioner) is provided. In the absence of actions by the commissioner, there will be the automatic application of the additional personal income tax (Irpef) and regional tax on productive activities (Irap) at the highest rate. A more efficient monitoring system of the use of resources by the national system for the certification and control of health care (SiVeAS), established at the Ministry of Health, will also be introduced. As a whole, the measures should bring about savings of 2.5 billion.

With regard to public sector employment, a more selective hiring strategy, reducing the use of temporary contracts, integrative bargaining, flexibility and overtime, should lead to savings of around 0.9 billion.

In addition, a reduction of current transfers to enterprises is achieved setting-up specific funds in each Ministry to record the flows of the allocated resources. This should bring about a reduction of expenditure of around 1 billion.

Further measures are directed to capital expenditures: they include a revised allocation for gross fixed capital formation to be borne by the State Government and by Anas amounting to around 1 billion, a limitation in the capital contributions to the Technological Innovation Fund to the amount of 1.2 billion as well as limits to transfers to former public enterprises.

On the revenue side, two new instruments aimed at fighting tax evasion should bring in an extra 0.6 billion euros. The first is the reform of the tax collection system through the creation of a special company "Riscossione S.p.A." with the aim of improving tax collection. The second instrument envisages an increase in the personnel of government tax agencies and greater involvement of Municipalities in tax assessment procedures. A quota (30 percent) of the collected sums will be kept by the Municipalities enforcing tax assessments. The higher number of assessments increases the per capita performance of the employees with positive effects on tax revenues.

Furthermore, in order to permanently widen and stabilise the tax base, a predefined tax liabilities scheme is introduced. This is limited to company owners and self-employed who are subjected to the tax arrangement based on the sectoral studies. The regulation envisages that tax revenues of single activities refer to three years planning. This measure will lead to a permanent increase of tax revenues of more than 1 billion euros annually, beginning from 2006. Those adhereing to this tax regime will have, moreover, the right to adjust their income for the biennium 2003-2004; this involves further revenues amounting to 1 billion euros for the year 2006.

Additional revenues of around 0.5 billion are expected from the introduction of a substitute tax on capital gains from real estate sales that take place within five years of purchase, while another 0.8 billion will come from operations aimed at fighting the illegality and irregularities of games and betting.

The budget law also introduces a revision of the tax regime for enterprises. It provides an increase in the levy on banks' and insurance companies' income, and this should amount to 1.3 billion of additional revenues. Further revenues of 1 billion will derive from aligning the depreciation period for investments undertaken by enterprises operating in the energy sector. Further 0.9 billion will be collected by reinstating rules for the revaluation of enterprises' tangible and intangible assets and for real estate areas. Finally, the manoeuvre includes additional measures estimated 2.5 billion, to face tax avoidance and the erosion of the tax base. They are: new regulations for capital losses arising from share exchange operations; the extension of the depreciation period, allowed to business goodwill from ten to eighteen years; modification to the tax regime regarding property leasing.

5.1.2 Growth Measures

The budget includes measures aimed at enhancing growth amounting to 7.6 billion euros, about 0.5 percent of GDP, consisting in lower revenues of around 3.7 billion and higher expenditure of around 3.9 billion.

Starting in 2006, lower tax receipts occur from a reduction in labour costs through a cut in social contributions, up to a maximum of one percent, and should have an impact of around 2 billion. Additional tax reduction come about the extension of some tax relief schemes currently in force in the agricultural sector, and of those offered for home improvements, for total 1.2 billion.

Although not specifically relevant at the budget level, the manoeuvre also includes rules with significant relevance for economic policy. It introduces specific measures of fiscal, administrative and financial nature for relaunching industrial clusters through aggregating enterprises – by area or function – to foster greater competitiveness.

On the expenditure side, the measures are aimed at supporting the income of families rearing children, through the setting up of a Fund of 0.7 billions in 2006, allocating funds for public employee salaries following contract renewals in 2006-2007 and financing investments.

5.2 Plan for Innovation, Growth and Employment

Fulfilling the commitments undertaken at the European Spring Council of 2005, Italy presented its first National Action Plan (Plan for Innovation, Growth and Employment) in October, illustrating the policies and reforms envisaged by the government in order to attain the strategic goals of the Lisbon Agenda. The commitment to implement the Lisbon Strategy meets the needs of improving the quality of public finances in order to foster potential growth and employment in a constantly evolving global economic context.

Such measures rely on the existing provisions aiming at fostering the diffusion of knowledge and technology. They are based on five main principles: extending the area of free choice for citizens and firms, granting incentives for scientific research and technological innovation, strengthening education and human capital formation, upgrading tangible and intangible infrastructure, protecting the environment.

In order to increase the productivity and competitiveness of the Italian economy, the measures are aiming at liberalising the supply in the service sector, at improving the efficiency of the Italian public administration and at reducing and simplifying the regulatory and administrative burden on firms.

Granting incentives to scientific research and technological innovation aims at closing one of the most substantial structural gaps existing with other European countries, more visible as globalisation increases. Against this background, projects aim at reorganising the research sector and its financing system, increase the size of the firm, raise the awareness on information technology, promote innovation and strengthen industrial clusters. The National Action Plan also envisages the implementation of 12 strategic research programmes and laboratories in order to create synergies between the public and private sectors in Southern Italy.

Strengthening education and human capital formation through a more effective primary and higher education and professional training aims at supporting the shift towards higher value added production. The recent primary educationl and university reforms are a step in this direction.

Upgrading tangible and intangible infrastructure, designed to improve domestic, inter-European and international connections, aims at reducing economic disparities among areas within the European Union, with particular attention to Southern Italy.

Policies to protect the environment respond to the increasing demand for environmental protection to both improve the quality of life of citizens and to advantages linked to the improvement and valorisation of natural resources.

The measures and projects envisaged by the National Plan for implementing the Lisbon Strategy set the goal of stimulating the potential growth of the Italian economy and significant results are expected in the medium term.

6. THE SUSTAINABILITY OF PUBLIC FINANCES

The ageing of the Italian population is increasingly gaining pace, putting pressure on public finances dynamics. Based on recent projections agreed at EU level, this chapter will firstly describe the long-term trends of the various components of public spending particularly affected by demographic changes (the so-called age-related expenditures: pensions, health care, education, and unemployment benefits). Secondly, the expected long-term expenditure trends will be used for analysis is of the evolution of the debt and the long-term sustainability of public finances.

6.1 The impact of the ageing population on public spending (2004-2050).

The demographic changes that will take place over the coming years will have significant effects on various components of public expenditure as shown by most recent projections of public expenditure for pensions, health care, education, and unemployment benefits for 2004-2050[5] (Table 8 and Figure 6).

The methodology and assumptions on which the projections are based are those recently agreed by the Ageing Working Group of the Economic Policy Committee (EPC-WGA)[6] in its second projection exercise.

The projections are based on the new demographic scenario, provided by EUROSTAT[7], and on the macroeconomic framework of the Ageing Working Group[8], which assumes 2004 as the base year. As in the previous projections, a no policy change

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[5] Education expenditure includes all education levels (from pre-school to university), but excluding adult education (the so-called continuous training), while the expenditure for unemployment benefits does not include some important labour policies (for example, active ones).

[6] The first forecast session was carried out in 2001; see Economic Policy Committee (2001), *Budgetary challenges posed by ageing populations. The impact on public spending on pensions, health and long term care for the elderly and possible indicators of the long term sustainability of public finances*, EPC/ECFIN/655/01-EN final, October, Brussels. Publication of the report containing the new expenditure projections for the twenty-five Member States is expected in February, 2006.

[7] The new Eurostat projections for Italy envisage: I) a net annual influx of 150,000 immigrants; II) an increase in life-expectancy of 5.3 years for males and 4.4 years for females over the period 2005-2050; III) a fertility rate in 2050 slightly higher than the initial level (1.4).

[8] See Economic Policy Committee (2005), *The 2005 EPC budgetary projection exercise. Agreed underlying assumptions and projection methodologies*, ECFIN/CEFCPE/2005(REP)/54722655/01, October, Brussels.

approach has been adopted, so as to highlight the effect of demographic pressure on various components of public expenditures. Differently from the previous forecast scenario, this one is based on a set of new hypothesis such as: a constant real interest rate (equal to an annual rate of 3 percent) over the entire projection period, the use of a cohort approach in the labour market participation rate projections, and, in relation to the estimation of the expected evolution of health care expenditure, more detailed assumptions than those of the first forecast exercise[9].

The key assumptions underlying the exercise concern the participation rate, the unemployment, the productivity and GDP growth rates (Table 8)[10]. The overall participation rate (in the 20-64 age group) is expected to increase by around 8 percentage points, mostly on account of an increase in the female participation rate. Over the same period, the unemployment rate is expected to decline from 8 to 6.4 percent, while productivity growth will, from 2030, stabilize at 1.7 percent. Consequently, real GDP growth should gradually slow down from around 2 percent to slightly below 1 percent during the first years of the forecast period, and then to increase again to slightly above 1 percent by the end of the projection period. The average real GDP growth rate over the period 2006-2050 should therefore be around 1.3 percent.

Turning to the analysis of the individual components of public expenditures, it must be pointed out that the projections have been updated in accordance with the regulatory framework in force in September 2005. Regarding health-care expenditure, on the other

[9] In the previous exercise, health care expenditure projections were based on a per capita expenditure profile per age that was constant and independent of the increases in life expectancy. The recent theoretical and empirical debate has, however, criticised the constant expenditure profile basically on two considerations: I) most health care expenditures occur in the last year of life (the so-called death-related costs). Because of the increase in life expectancy, these costs are incurred later and so the health care consumption profile per age is altered; II) the assumption of a constant health care consumption profile implies an increase in morbidity (in other words, age being equal, the additional years of life are not accompanied by an improvement in health), whereas it seems more plausible to assume an improvement in health of individuals that is in line with the increase in life expectancy (the so-called dynamic equilibrium assumption).

[10] The macroeconomic assumptions are in line with the baseline scenario agreed by the the EPC-WGA; these assumptions have been adopted for the period 2006-2050, while for 2005 these are based on the *Forecasting and Planning Report* (RPP) for 2006.

end, the effects of the measures adopted in the 2006 Budget Law have been taken into account[11].

Table 8 LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES (2004-2050) (1)

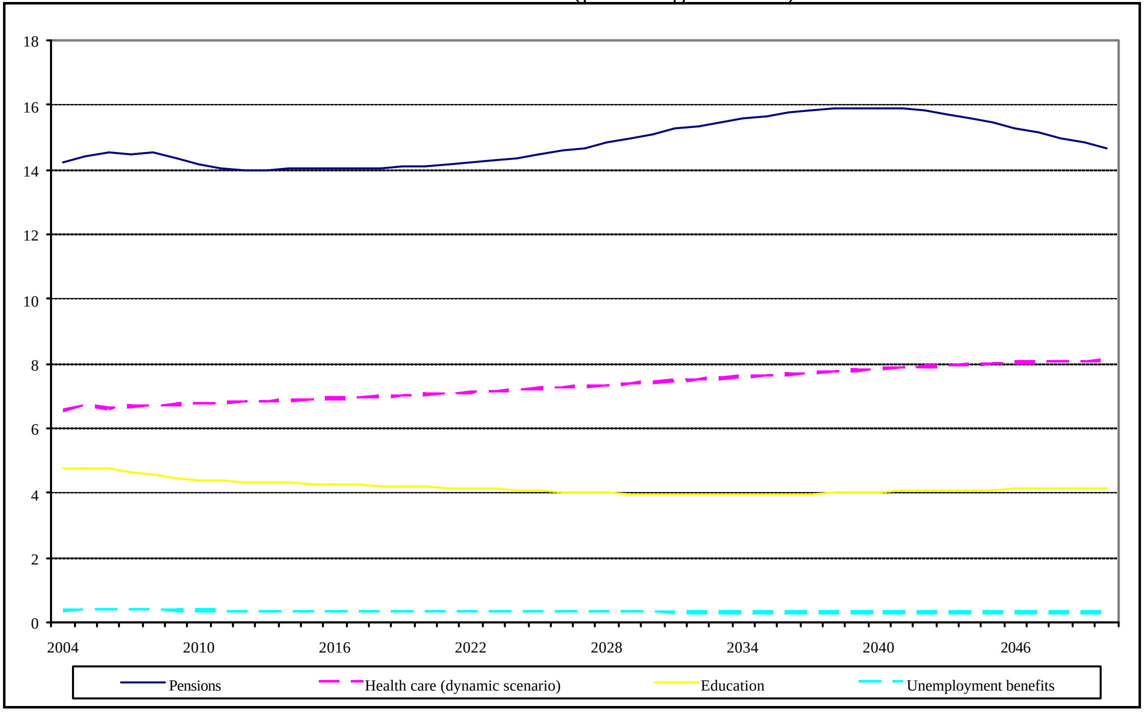
	2000	2004	2005	2010	2020	2030	2040	2050
Total *age-related expenditures*	24.5	25.9	26.3	25.7	25.6	26.8	28.0	27.2
Pension expenditure (2)	13.8	14.3	14.4	14.2	14.1	15.1	15.9	14.7
Of which: social security pension (3)	13.8	14.3	14.4	14.2	14.1	15.1	15.9	14.7
Of which: old age and early pensions		14.0	14.1	13.9	13.9	14.9	15.8	14.5
Of which: other pensions (disability, survivors)		0.3	0.3	0.3	0.2	0.2	0.2	0.2
Health care: dynamic scenario (2) (4) (5)	5.8	6.5	6.7	6.8	7.0	7.4	7.8	8.1
Education expenditure (2) (6)	4.6	4.7	4.8	4.4	4.2	4.0	4.0	4.1
Other age related expenditures (2)	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Assumptions								
Labour productivity growth		0.4	-0.5	1.2	1.7	1.7	1.7	1.7
Real GDP growth		1.2	0.0	1.9	1.6	0.9	0.8	1.2
Partecipation rate males (20-64)		79.3	80.4	81.3	82.7	82.2	83.5	84.3
Partecipation rate females (20-64)		53.7	54.4	58.3	62.0	63.2	64.1	64.9
Total partecipation rate (20-64)		66.4	67.3	69.8	72.4	72.8	73.9	74.7
Unemployment rate		8.0	7.7	7.2	6.4	6.4	6.4	6.4
Old age dependency ratio (7)		31.2	31.9	33.9	39.4	48.0	62.1	67.4

(1) The figures are rounded-off to the first decimal point and therefore the sum of the figures could not add up.
(2) As a percent of GDP.
(3) Corresponds to total public expenditure for pensions.
(4) Inclusive of public health-care expenditure for assisting the elderly.
(5) It is assumed that the profile for age and sex for health consumption varies according to the so-called death related costs for the hospital component and to the assumption of the dynamic equilibrium for the other expenditure components.
(6) Does not include adult education expenditure (continuos training).
(7) Aged 65 + over aged 20-64.

Based on the assumptions described above, pension expenditures would decrease by 0.5 percentage points between 2006 and 2011, and then begin to rise from 2018 onward, reaching a peak of 15.9 percent in 2037, before decreasing again to 14.7 percent in 2050 (Figure 6).

[11] As indicated in the *2004 Update*, the projections for pension expenditure include the financial effects deriving from the reform that was approved in 2004 (Law n. 243/2004). The projection for health care spending for 2006 and for the following years takes into account the effects of the savings envisaged in the *2006 Finance Bill*.

Figure 6 **EXPENDITURE ON PENSIONS, HEALTH CARE, EDUCATION, UNEMPLOYMENT BENEFITS** (percentage of GDP)



With respect to health-care expenditure, Table 8 shows a projection scenario in which, starting in 2009, hospital expenditures vary in accordance with the so-called death-related costs methodology, while the other components of health care change in accordance with the dynamic equilibrium hypothesis. In line with what emerges from economic health-care literature, a simple pure demographic scenario in which health-care consumptions by age are assumed to be constant over the entire projection period has been considered hardly plausible. In the dynamic scenario, health-care expenditure increases by 1.6 percentage points over the period under observation (in the pure demographic scenario the expected increase would be equal to 2.0 percentage points, from 6.5 percent to 8.5 percent).

As regards the other two components of age-related expenditure, education cost should decline from the current 4.8 percent to 4.1 percent in 2050, while unemployment benefits should settle at 0.3 percent of GDP. (Figure 6).

Overall, age-related public expenditure, as a ratio of GDP, should increase from 25.9 to 27.2 percent (or 27.6 percent, as in accordance with the pure demographic scenario for health care expenditure) over the projection period. It should be noted, however, that largely as a result of the pension curve, the ratio will at first decline to around 25.5 percent around 2011, thereafter, from 2018, it will increase to reach a peak of 28.1 percent in 2040, then it will once again decline gradually.

It should also be noted that in spite of the changes in the demographic scenario and the reference macroeconomic framework, the forecasts presented in this Update do not differ substantially from those presented in last year's Update. This is mainly due to the fact that the average GDP growth rate for the period 2006-2050 has remained practically unchanged, even if there are some differences in the time profile and in the break-down between the dynamics of productivity and employment.

In particular, with respect to the previous Update, the following considerations emerge:

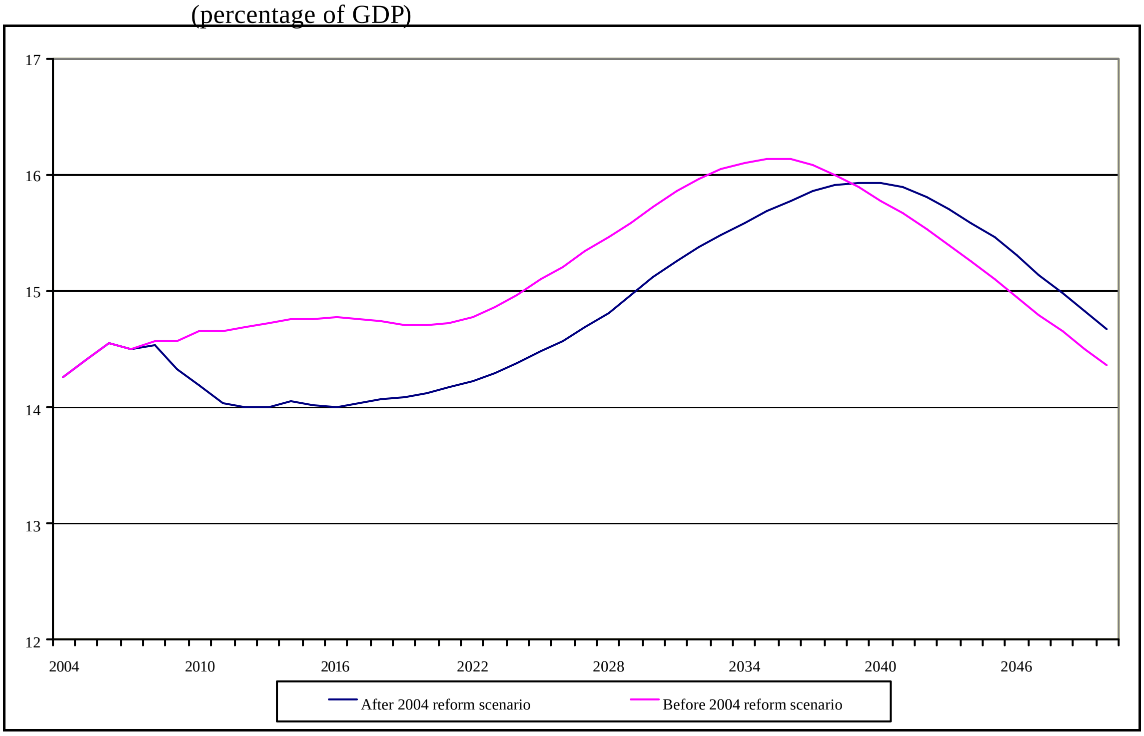
- pension expenditure as a percentage of GDP shows a slight increase both in the first and final years of the projection period. The increase in the early years is due to a revision of the initial values of GDP and to initial slower growth, while the increase in the final years is mainly due to the upward revision of life expectancy;
- health-care expenditure as a percentage of GDP will reach a level of around 0.3-0.4 percentage points higher than last year's forecast at the end of the projection period. This increase is mainly attributable to the revised initial value of the health-care/GDP ratio (assumed to be 6.3 percent for 2005 in the previous Update, and 6.7 percent in this Update);
- expenditure for unemployment benefits shows a slight decrease compared to the previous Update, on account of an expected fall in the unemployment rate over the projection period. Education expenditure does not show any substantial changes.

As stated previously, and as already presented in the *Stability Programme Update 2004*, the projection for pension expenditure takes account of the effects of the reform approved in October 2004. Starting from 2008, more stringent minimum requirements will be required for early retirement[12]. Figure 7 shows the pension expenditure trends

[12] See the previous Update for a detailed description of the reform. It should be noted that the Decree to implement Law n. 243 of 2004, regarding the pension reform and concerning private pension schemes

before and after the 2004 reform according to the new demographic and macroeconomic frameworks defined by the EU. It appears clearly that the more stringent minimum requirements for early retirement imposed by the pension reform will lead to a significant reduction in pension expenditure over a thirty year period. The relatively higher expenditure in the final years of the projection period is due to higher pensions benefits linked to the delayed retiring age introduced by the reform.

Figure 7 **IMPACT OF REFORM ON PENSION EXPENDITURE**
(percentage of GDP)



6.2 The sustainability of public finances

The evolution of public expenditure according to demographic changes is crucial for the analysis of the long-term sustainability of public finances. In this section, the sustainability of public finances is assessed by looking at the expected evolution of the

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is currently being defined. This law will apply the principle of assent by default in cases of transfers of TFR (workers' severance pay) to Pension Funds, and in granting tax concessions for savings paid into supplementary schemes, should favour the launch of the so-called second pillar starting in 2008.

debt/GDP ratio over the 2010-2050 period and taking into consideration some indicators agreed at European level[13].

The simulations presented in this chapter were carried out under the assumption that all the public finance targets (debt and primary surplus) for 2009 presented in this Update will be achieved. It is also assumed that in the period under examination, the expenditures arising from the ageing population, as outlined in paragraph 6.1, will not be offset by higher revenues or lower expenditures. In other words, the primary surplus would vary in line with the change in expenditure on pensions, health care, education and unemployment benefits[14].

In line with what agreed at EU level, the evaluation of the long-term sustainability of public finances is based on the cyclically-adjusted budget net of one-off measures.

The debt to GDP ratio declines steadily over the whole period, declining from around 100 percent in 2010 to 30 percent at the end of the projection horizon (Figure 8). In particular, the debt to GDP ratio is expected to drop under the 60 percent target in 2024.

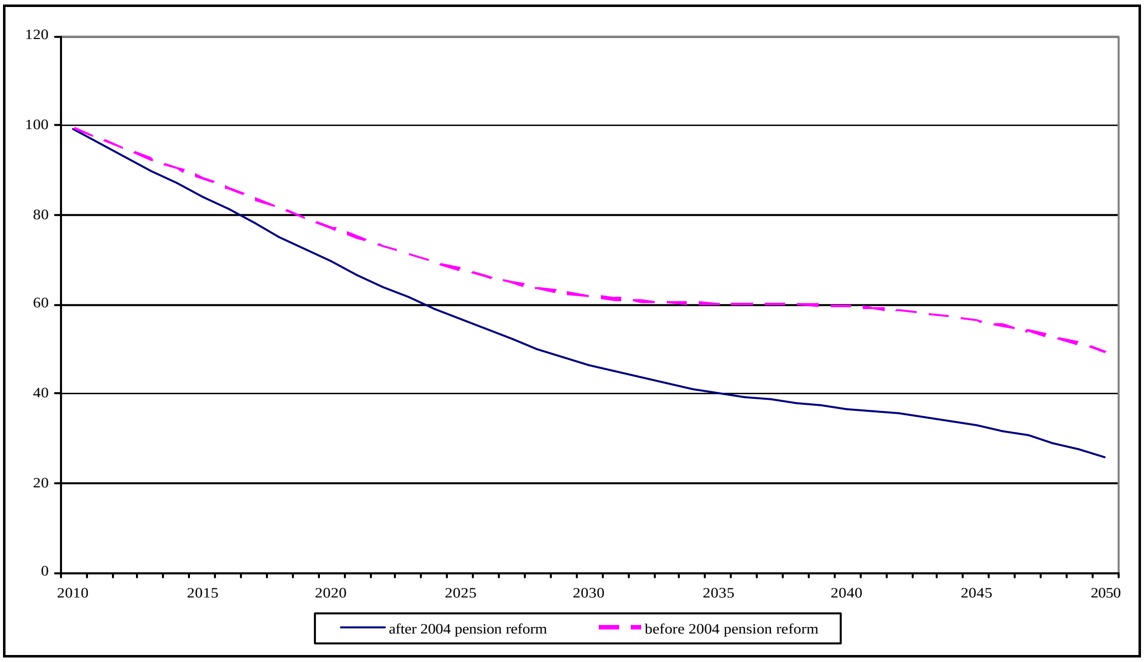
In order to highlight the long-term effects on the sustainability of the pension reform, approved in October 2004, the trend of the debt to GDP ratio is also projected on the basis of the previous pension system in force before the reform (Figure 8). The positive effects of the reform on public finances appear clearly as, without the reform, the debt to GDP ratio, although always declining steadily, would have reached the 60 percent threshold only in the last years of the projection period (around 2040).

Given the high initial level of the debt and the related large interest payments, a sensitivity analysis with different interest rates levels has been carried out. The results are shown in Figure 9.

[13] The assumptions underlying the simulation correspond to the demographic and macroeconomic scenario agreed within the EPC-WGA and described earlier (Table 8). A constant annual real interest rate of 3 percent is assumed for the entire projection period.

[14] The evolution of health care expenditure in the long term is calculated on the basis of the so-called dynamic scenario, consistent with the previous section.

Figure 8 **PUBLIC DEBT** (percentage of GDP)



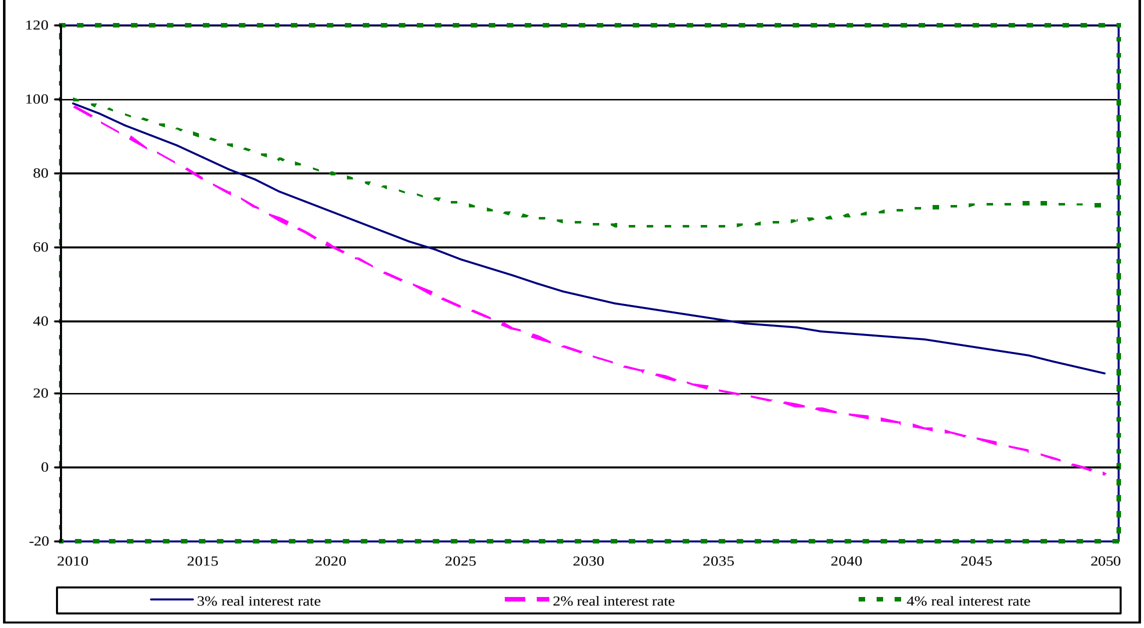
In the previous simulations (Figure 8), in line with the methodology established by the EU, a constant annual real interest rate of 3 percent was assumed over the entire projection period[15]. Instead, the sensitivity analysis was carried out by considering two other scenarios, one optimistic (in which the real interest rate is 2 percent) and the other, pessimistic (in which the real interest rate was 4 percent, and consequently leading to higher interest payments).

The role of the interest rate in the sustainability of the public finances appears to be crucial. With an interest rate of one percentage point lower than that of the baseline scenario, the debt to GDP ratio would continue to decline, to eventually turn negative at the end of the projection period. On the contrary, with an interest rate of 4 percent, the 60 percent debt to GDP target would never be reached. In fact, the debt to GDP ratio, after having declined to reach a minimum value slightly above 60 percent in 2035, would begin to increase over the later years of the projection period.

[15] As agreed at European level, a constant annual inflation rate of 2 percent has been assumed. In the sensitivity analysis, this assumption does not change when different interest rates are assumed.

In addition, the sensitivity analysis of the debt to a change of the 2009 cyclically-adjusted primary balance (Table 9 and Figure 10) has been carried out[16]. The results show that by reducing the primary surplus from 3.6 to 3 percent, the debt to GDP ratio remains practically constant at around the 60 percent level from 2030 onwards, whereas if the cyclically-adjusted primary surplus is below 3 percent of GDP in 2009 the debt does not converge to the 60 percent level, but instead becomes explosive from the central phase of the projection period onwards.

Figure 9 **PUBLIC DEBT SENSITIVITY TO REAL INTEREST RATES**
(percentage of GDP)



To sum up, according to the baseline scenario presented in this Stability Programme Update, the sustainability of public finances would be guaranteed. In particular, the simulations of the evolution of the debt to GDP ratio show that the long-term sustainability of public finances is assured as long as the primary surplus does not deviate too much from the forecast of the present Update (3.6 percent in 2009), and/or that real interest rates are not much above 3 percent over the coming decades.

However, compared to the *2004 Stability Programme Update*, the declining path of the debt appears to be reduced. Last year's Update, in fact, envisaged that at the

[16] It should be remembered that the cyclically-adjusted primary balance for 2005 is expected to be equal

beginning of the projection period there would be cyclically-adjusted primary surpluses more than one percentage point higher than those indicated in the present Update.

Table 9 **PUBLIC DEBT SENSITIVITY TO THE 2009 CYCLICALLY-ADJUSTED PRIMARY SURPLUS**
(percentage of GDP)

	2010	2015	2020	2030	2040	2050
Primary Surplus in 2009			**Public debt**			
3.6	99.0	84.2	69.5	46.4	36.7	25.7
3.0	99.6	87.7	76.2	60.5	60.4	60.2
2,5	100.1	90.8	82.0	72.8	81.2	90.6
2.0	100.6	93.9	87.9	85.1	102.0	120.9
1.5	101.1	97.0	93.7	97.4	122.7	151.2

Besides the description of the debt dynamics, the long-term sustainability of public finances can also be assessed using indicators adopted by the Ecofin Council (the so-called sustainability gaps). These indicators provide a synthetic evaluation of the fiscal consolidation, i.e. a reduction in expenditures and/ or an increase in revenues, needed to reach a pre-determined debt to GDP target within a certain period.

Given the growing trend of expenditures arising from the ageing population, the sustainability gap indicates the difference between the average primary surplus needed to reach a certain debt to GDP ratio target by the end of the projection period and the primary surplus in 2009. A negative value indicates that the public finances are sustainable in the long term (i.e. allowing the target to be reached); the primary balance needed, would in fact be lower than the existing one and the country could reach the debt target without putting more pressure on public finances.

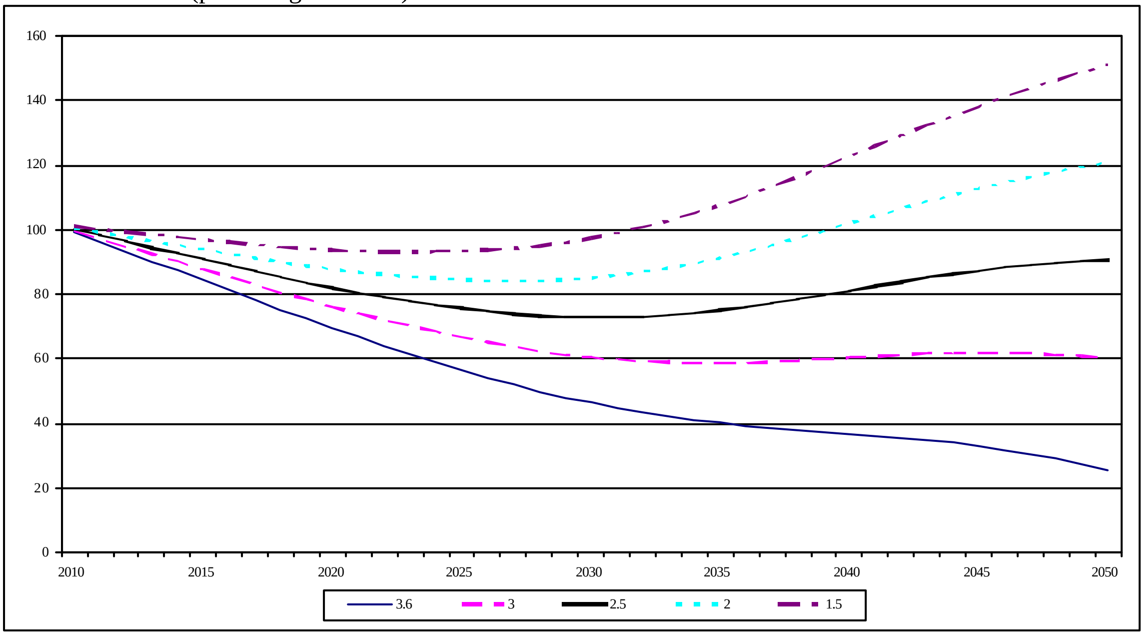
The sustainability gap is herein calculated in two different ways; the first (thereinafter referred to as S_{60}), assumes as a target a debt to GDP target of 60 percent in 2050, while the second (thereinafter referred to as S_{8}), assumes that the government intertemporal budget constraint is respected on an infinite horizon.

In line with the methodology agreed at European level, a third indicator is added to the ones mentioned above. This is the so-called Required Primary Balance (herein after

to 1.5 percent, whilst for 2009 it should be equal to 3.6 percent.

referred to as RPB), which focuses more on the medium term rather than the long term, and indicates what would be the average primary surplus needed in the first 5 years of the projection period to respect the government intertemporal budget constraint on an infinite horizon.

Figure 10 **PUBLIC DEBT SENSITIVITY TO THE 2009 PRIMARY SURPLUS .**
(percentage of GDP)



All three indicators are calculated using two different scenarios, with health care expenditures varying either with respect to the "dynamic" scenario, or to the "pure demographic" (see chapter 6.1).

Table 10 shows that, based on the forecasts of the present Update, the public finances appear to be sustainable in the long term. Indeed, the sustainability gaps have a negative sign in both scenarios considered. Moreover, the RPB is lower than the primary surplus indicated in the present Update, thus highlighting how the government intertemporal budget constraint would be respected even with medium-term primary surplus levels that are lower then those indicated in this Update.

Thus, the indicators confirm that meeting the fiscal targets presented in this Update would enable the objectives of the two sustainability gaps to be achieved (i.e. a debt/GDP ratio equal to 60 percent in 2050 and respect the intertemporal budget constraint on an infinite horizon).

In particular the indicator S_8 is characterized by levels, in absolute terms, greater than S_{60} , thus confirming that the constraints of reaching the target debt to GDP ratio of 60 percent in 2050 are more stringent than that of an intertemporal balanced budget on an infinite horizon.

Finally, the sustainability gap indicators confirm the sustainability of public finances even when considering a less favourable evolution of health care expenditures, such as that arising from the so-called "pure demographic" scenario (see chapter 6.1). By considering a health-care scenario that takes fuller account of the demographic effects (such as the so-called "dynamic" scenario), the sustainability of public finances appears to improve substantially.

Table 10 LONG-TERM SUSTAINABILITY INDICATORS

Scenario	Sustainability gap Indicators		
	S_{60}	S_8	RPB
Dynamic health care costs scenario	-0.626	-0.895	2.886
Pure demographic health care costs scenario	-0.423	-0.595	3.153

THE WORLD ECONOMY

At the end of 2005, the world economy continues to expand at a sustained pace, as shown by both national accounts data for the third quarter and by the available indicators regarding the last months of the year. Prospects for 2006 are equally favourable, with world GDP growth rate expected to reach 4 percent in 2005 and 4.2 percent in 2006.

In the United States output growth continues to be sustained by the demand for consumer goods and, increasingly, by buoyant fixed investments fostered by continuously higher profits. The annual growth rate should reach 3.4 percent and a similar increase is expected for 2006 (3.5 percent). Even though the contribution to growth from net external demand should be less negative than in the past, the current account deficit is forecast to expand and eventually to exceed the 7 per cent of GDP threshold. It is expected that the United States authorities will seek to improve public finances, albeit acting gradually over time.

In Japan the recovery appears to have consolidated, the economy will keep growing, though slightly slower than in the first part of 2005, at a pace close to 2 percent throughout all of 2006. Foreign demand continues to be the driving force in that Japanese exports benefit from the increase in demand of consumption and investment goods from the United States and China. However, the upturn was determined by consumers' behaviour, underpinned by improved labour market conditions. Nonetheless, there remain some elements of uncertainty in relation to the future implementation of corrective fiscal measures.

Overall, the economies of the emerging countries continue to expand at a very brisk pace owing to favourable financial markets conditions and improved macroeconomic policy management by competent authorities. Moreover, in eastern Asia, growth is driven by the continuous expansion of the Chinese economy, which keeps increasing its share of world export. Indeed, the growth of the Chinese economy, in spite of restrictive government measures, will remain robust reaching 9 percent in 2005 and then slowing down to around 8.2 percent in 2006.

The Euro Area posted in the second half of 2005 signs of a more pronounced recovery. This result was due mostly on account of the positive evolution of consumption registered in France and of the good performance of German exports. Looking ahead, it is expected that there will be a gradual strengthening of internal demand, which should lead to an increase in GDP for the Euro Area of 1.2 percent in 2005, accelerating to 1.8 percent in 2006. The main risk to the recovery is represented by the possibility of a lasting weakness in the labour market, particularly in Germany.

In a context characterised by a level of demand still lower than potential output and by overall wage moderation, together with stable – if not declining – core inflation, further ECB interest rate increases (in addition to the one that took place in December 2005) are not expected until the second half of 2006.

Based on the assumptions regarding GDP growth, world trade should increase at a rate of 7 percent in 2005 and accelerate to 7.4 percent in 2006.

As regards the risks surrounding the forecasts presented in this document, the major element of uncertainty regards the evolution of oil prices. Were oil prices to remain at these high levels, with even the possibility of further hikes, a continuous decrease of consumers' purchasing power could be envisaged.

Consequently, this could re-ignite wage disputes that would lead to unavoidable monetary policy tightening. The possibility of continuous increases of interest rates by the Fed also causes some concern (the last rise was in November and was the twelfth consecutive rise since June 2004) in that this could eventually depress the American housing market and dampen consumption.

Table 11 ASSUMPTION ON INTERNATIONAL ECONOMIC VARIABLES
(percentage values, unless otherwise specified)

	2005	2006	2007	2008	2009
Short-term interest rate	2.0	2.4	2.6	3.0	3.2
Long-term interest rate	3.5	3.7	3.8	4.0	4.0
USD/€ exchange rate	1.255	1.255	1.255	1.255	1.255
Nominal effective exchange rate	-0.2	-1.0	-0.3	0.0	0.0
World excluding EU, GDP growth	4.7	4.7	4.4	4.4	4.4
EU-25 GDP growth	1.5	2.0	2.4	2.5	2.5
Growth of relevant foreign markets	4.7	5.8	5.8	5.8	5.8
World import volumes, excluding EU	9.0	8.0	7.9	7.9	7.9
Oil prices, (Brent, USD/barrel)	55	58	55	53	53