



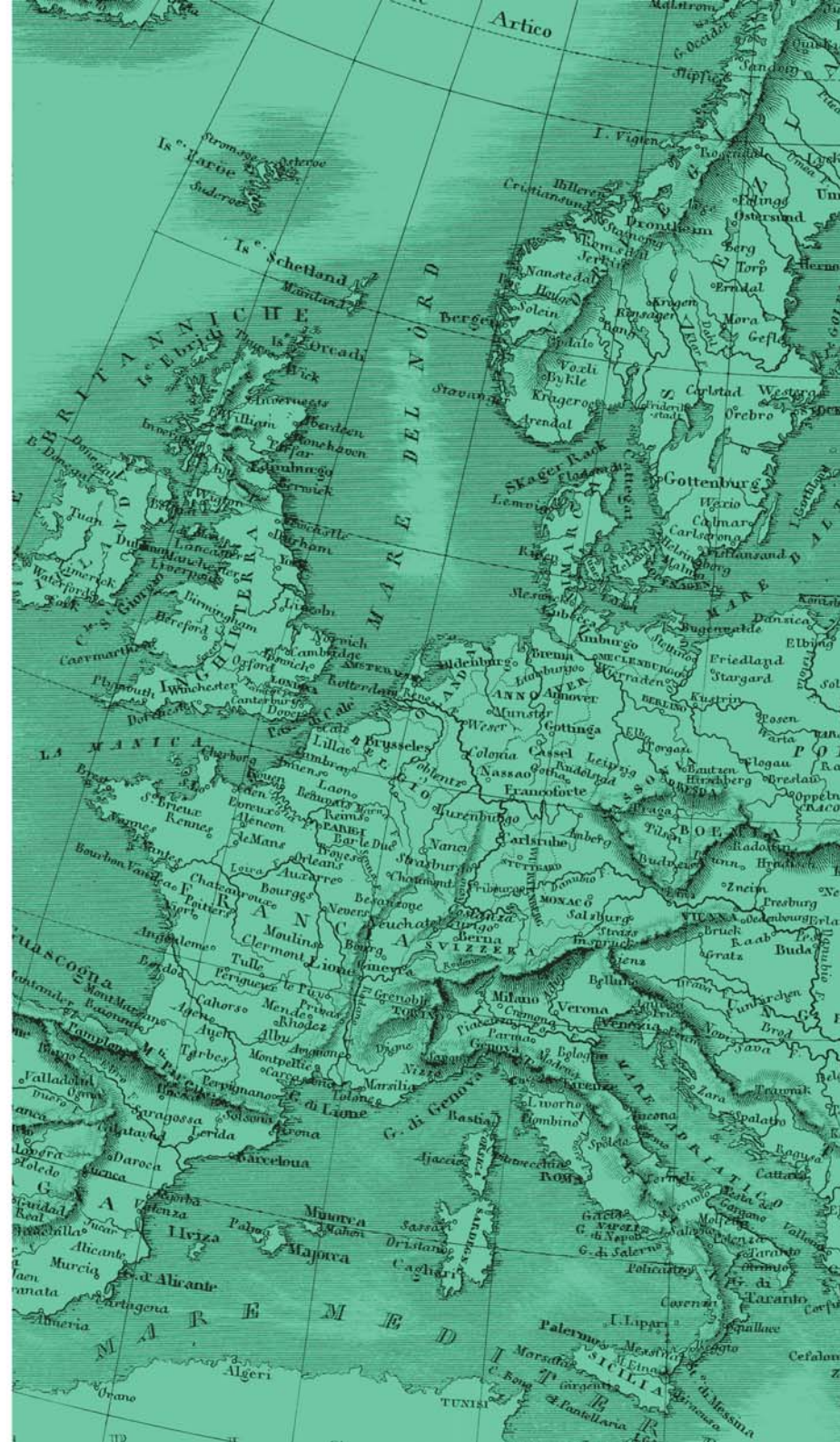
MINISTERO DELL'ECONOMIA E DELLE FINANZE

Italy's Stability Programme

November 2007 Update

The
ITALY'S STABILITY PROGRAMME
is available on line at
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Ministero dell'Economia e delle Finanze

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November 2007 Update



*The final approval of the Financial Law is still pending.
The Update describes budget measures as presented by the Government.*



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I. INTRODUCTION

The Update to Italy's Stability Programme outlines the macroeconomic scenario for the 2007-2011 period, identifies the Government's public finance objectives for the above-mentioned period as well as the fiscal strategy to achieve those objectives¹. The 2008 budget measures allow the Government to continue on the convergence path leading to a balanced budget in the medium term, after reducing the deficit in 2007 within the limits of the EU criteria. For the 2006-2007 period, the cumulative reduction in cyclically adjusted terms, net of one-off measures, amounts to 1.8 per cent of GDP, which is above the Recommendation made by the Ecofin Council under the excessive deficit procedure. In 2008, the consolidation effort continues. The overall adjustment, amounting to 2.0 per cent of GDP over the 2006-2008 three-year period, even though spread over a different timeframe, is broadly in line with requirements indicated in the July 2005 Recommendation and consistent with the strategy for balancing the budget in the medium term. From 2009 onwards, the deficit is expected to be within the reference value (minimum benchmark) which, under particularly unfavourable, yet still possible, cyclical conditions and taking into account budgetary sensitivity to output, ensures compliance with the excessive deficit limit.

Consistently with the ongoing budget consolidation process, this document contains projections of the reduction in the debt-to-GDP ratio for the coming years.

Following a practice introduced with last year's Update, also this document contains a specific section on the fiscal implications of the structural measures set out in the 2006-2008 *National Reform Programme (NRP)*, in line with the requirements of the Code of Conduct and the Ecofin Council decisions, as well as a review of the fiscal rules and institutions responsible for the pursuit of fiscal policies.

As usual, the document also contains an analysis of the sensitivity of public finance to changes in the macroeconomic baseline scenario.

Finally, the document also gauges the impact of Italy's ageing population on the sustainability of public finances.

¹ *The Update to Italy's Stability Programme* is drawn up in accordance with European Council Regulation 1466/97, taking into account the amendments introduced by Regulation 1055/2005 of 27 June 2005 and the guidelines on the application of the New Stability and Growth Pact.

This year's Update is largely based on the *Update to the Economic and Financial Planning Document for the 2008-2011 period* submitted to Parliament on 28 September 2007, on the *2008 Forecasting and Planning Report*, submitted to Parliament on 28 September 2007, on the *2008 Draft Budget* and on *Decree Law No. 159/2007*, submitted on September 28 and October 1 2007 respectively.





II. MACROECONOMIC SCENARIO

II.1 THE INTERNATIONAL SCENARIO

World economic growth was strong in the first six months of 2007, mainly thanks to the Asian economies. The world economy is expected to grow by 5.0 per cent for the whole year and by 4.8 per cent in 2008. World trade is expected to increase by 6.8 per cent this year and by 6.9 per cent in 2008.

However, in the summer the sub-prime mortgage crisis in the US rocked international financial markets, causing an increase in risk premiums and a lower propensity of intermediaries to lend. These tensions occurred against a positive international backdrop and were countered by prompt action taken by central banks to ensure orderly functioning of financial markets.

In the US real GDP growth in the third quarter was 3.9 per cent on a quarter-on-quarter annualised basis, in line with that of the previous quarter, but clearly accelerating compared to the first quarter of the year (0.6 per cent). In the third quarter, growth reflected the increase in private consumption (3.0 per cent) and in exports (16.2 per cent). Gross fixed investment remained broadly flat, reflecting a further significant drop in residential investment (-20.1 per cent annualised).

For the whole year the US economy is expected to grow by 1.9 per cent, a notable slowdown compared to 2006 (2.9 per cent). A 2.1 per cent growth is expected in 2008, also thanks to the contribution of exports favoured by the dollar depreciation and the still sustained economic growth of its main trade partners. However, the housing market crisis could continue and adversely affect consumption, while business confidence could deteriorate further.

After the 50-basis-point cut in September, on October 31, the Federal Reserve cut the federal funds rate by a further 25 points to 4.50 per cent.

Japan's economy, after the contraction in the second quarter (-0.4 per cent) recorded a 0.6 per cent growth in the third quarter. On the domestic demand side, private consumption increased only slightly (0.3 per cent), while private residential investment showed a marked drop (-7.8 per cent), as did public investment (-2.6 per cent). On the foreign demand side, exports continued to grow briskly (2.9 as against 0.9 per cent in the second quarter).

Consumer prices do not show a clear trend and continue to show slightly negative yearly changes. In September, the inflation rate was 0.2 per cent year-on-year, while nominal wages continued to decrease. At its late October meeting, the Bank of Japan kept its reference rate unchanged at 0.5 per cent.

A 2.0 per cent growth is expected in 2007, which will edge down in 2008 to 1.8 per cent.



China's economic growth was very strong in the first half of the year (11.5 per cent), thanks to the increase in investment and exports; it remained strong in the third quarter at a rate of over 11.0 per cent. Early in September the Chinese Central Bank adopted a more restrictive monetary policy stance by increasing the level of reserve requirements and interest rates. Consumer price inflation has increased since the beginning of the year, even though it edged down in September (6.2 per cent). India should also continue to make a significant contribution to world economic growth.

Euro Area GDP rose 0.7 per cent in the third quarter, thus growing more rapidly than in the previous quarter (0.3 per cent). Household consumption is supposed to have given significant impetus to growth, thanks to the good performance of the labour market. Consumer and business confidence was weakening compared to the peaks reached in the summer months.

Since the second half of September the dollar has continued to depreciate as against the euro, reaching 1.47 in early November.

At its November meeting the European Central Bank left its reference rate unchanged at 4.0 per cent. The latest increase of 25 basis points dates back to June.

Euro Area GDP is projected to grow by 2.5 per cent in 2007 and by 2.3 per cent in 2008.

Currently the risks for the world economy come from the strong oil price increases (in November the prices of Brent oil reached an all-time high of 95 dollars a barrel), which could fuel inflationary pressures, and the impact of the US sub-prime mortgage crisis on financial markets and the banking system. Finally, the risk of disorderly adjustments in exchange-rate markets was confirmed by the currency developments of the last two months.



TABLE 1: ASSUMPTION ON INTERNATIONAL ECONOMIC VARIABLES (percentage change, unless otherwise specified)

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|------|------|------|------|------|------|------|
| Short-term interest rate ¹ | 2.0 | 2.8 | 4.0 | 4.3 | 4.5 | 4.7 | 4.8 |
| Long-term interest rate | 3.5 | 4.0 | 4.4 | 4.7 | 5.0 | 5.1 | 5.1 |
| USD/EUR exchange rate | 1.24 | 1.26 | 1.35 | 1.35 | 1.35 | 1.35 | 1.35 |
| Change in nominal effective exchange rate | -0.8 | 0.6 | 2.7 | 0.0 | 0.0 | 0.0 | 0.0 |
| GDP Growth, World excluding EU | 5.5 | 5.8 | 5.5 | 5.3 | 5.4 | 5.3 | 5.3 |
| EU GDP Growth | 1.8 | 3.0 | 2.7 | 2.6 | 2.4 | 2.4 | 2.4 |
| Growth in Italy's foreign markets | 6.2 | 8.4 | 5.1 | 6.4 | 6.6 | 6.6 | 6.6 |
| World import volumes, excluding EU | 8.4 | 9.5 | 7.6 | 7.6 | 7.6 | 7.8 | 7.9 |
| Oil price (Brent, USD/barrel) | 54.4 | 65.1 | 68.0 | 72.0 | 72.0 | 72.0 | 72.0 |

1) 3-month interest rates.

II.2 PROSPECTS FOR THE ITALIAN ECONOMY

After a period of modest growth in the second quarter of 2007 (0.1 per cent), GDP increased by 0.4 per cent in the third quarter compared to the previous quarter. Industrial production rose 0.6 per cent in the same period, despite the drop suffered in September (-1.0 per cent compared to the previous month).

Manufacturing confidence indicators showed signs of improvements in October, after months of decreasing confidence, whereas construction industry confidence is deteriorating, also reflecting the overall mood in the Euro Area.

Economic activity is expected to grow by 1.9 per cent in 2007.

Consumption is believed to be growing more rapidly compared to 2006, at 2.0 per cent. It is expected to be sustained by the good performance of the labour market and benefit from the increase in real disposable income following the past drop in consumer price inflation. Investment in machinery seems to be less dynamic, whereas investment in construction, thanks to carry-over effect from last year, still shows sustained rates of growth above the average of the past five years.

Export volumes are believed to be still failing to fully exploit the buoyancy of world trade. Export deflators are supposedly showing stronger growth compared to last year.

In the first nine months of the year the cif-fob trade balance showed a 7.8 bn deficit. Net of energy products, the balance would show a 25.6 bn surplus.



The current account of the balance of payments is anticipated to average -1.5 per cent of GDP a year, as against -2.4 per cent last year.

Employment – measured in full-time equivalent units – is expected to grow by 0.9 per cent, slowing down compared to last year. At sectoral level, construction and private-sector services are expected to post significant employment gains. In manufacturing, full-time equivalent units are expected to increase at rates above the average of the last five years (by 0.7 per cent). The rate of unemployment is expected to decrease as against 2006, levelling off at 6.0 per cent.

Gross compensations per employee are projected to increase above consumer price inflation, even though at a slower rate compared to last year. Alongside a modest rise in productivity, increases in the cost of labour per unit of production measured in terms of value added are expected to slow down compared to 2006. Domestic inflation, measured by the GDP deflator, is expected to be higher than last year, in line with an expected increase in domestic profit margins. Consumer price inflation measured by the NIC index including tobacco is expected to decrease to 1.8 per cent (2.1 per cent in 2006), partly as a result of deregulation policies implemented in the past.

Last summer's turbulence in the financial markets, caused by the US sub-prime mortgage crisis, has so far had no direct impact on the Italian economy. Indirect effects, however, will probably be felt at the end of the year and especially in 2008.

GDP growth is therefore expected at 1.5 per cent in 2008. In the medium term, GDP is expected to increase by approximately 1.7 per cent, while at the end of the forecast horizon it is projected at 1.8 per cent.

Next year, household consumption is expected to benefit from the good performance of disposable income, sustained by the renewal of employment contracts that have expired both in the public and private sector. In the coming years, household consumption is expected to be sustained by lower taxation and good labour market performance. Investment in equipment and machinery is expected to slow down in 2008, while at the end of the period their growth rate is expected to be back in line with the average growth of the past ten years. Investment in the construction industry is projected to slow down over the whole period, reflecting the end of the expansionary cycle in this sector that started at the end of the '90s.

The net exports contribution to growth is expected to turn slightly positive throughout the whole four-year period. Foreign demand is expected to accelerate somewhat. This is based on the assumption that the international economic outlook remains positive and Italian exporters lose market shares at a slower rate. Against a backdrop of improved terms of trade, the current account deficit of the balance of payments as a percentage of GDP is expected to decrease, reaching -2.0 per cent at the end of the forecast period.

Employment is expected to increase by 0.6 per cent. Assuming labour supply grows more compared to 2007, the unemployment rate is expected to continue to



decrease to 5.7 per cent. In the following three-year period, employment is expected to continue to increase at average rates of 0.7 per cent. Unemployment is expected to resume a downward trend, reaching 5.2 per cent at the end of the forecast period.

Unit labour cost is expected to temporarily accelerate in 2008 (3.4 per cent) as a result of the renewal of employment contracts of civil servants and of private sector employees. In the following three-year period it is projected to gradually slow down as a result of smaller pay rises.

Domestic inflation, measured by the GDP deflator, is expected to edge down in 2008. Due to external inflationary pressures, the consumption deflator is projected to grow more rapidly than in 2007 (2.0 as against 1.8 per cent). In the medium term, consumer price inflation is projected to average less than 2.0 per cent, consistent with the assumption of stable oil prices.

The macroeconomic forecasts outlined above are based on the exogenous variables used for the 2008 *Forecasting and Planning Report* published in September. Compared to the exogenous variables contained in the Autumn Forecasts of the European Commission published on November 9, there are sizeable differences especially as regards two major variables: the euro exchange rate and oil prices. However, if the assumptions made by the EC were used here, GDP growth and consumer-price inflation would show only a modest change. Specifically, the adverse effect on growth is estimated at 0.1–0.2 percentage points in 2008 (GDP growth down from 1.5 per cent to 1.3–1.4 per cent). The impact of the EC assumptions on consumer prices in the 2007–2009 three-year period is also non-negligible but on the whole modest. The deflator of private consumption would increase by 0.1 percentage points in 2007 (from 1.8 per cent to 1.9 per cent), by 0.2 percentage points in 2008 (from 2.0 per cent to 2.2 per cent) and by 0.1 percentage points in 2009 (from 1.8 per cent to 1.9 per cent).

**TABLE 2a: MACROECONOMICS PROSPECTS**

| | 2006 level ¹ | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|----------------------------|----------|------|------|------|------|------|
| | | % change | | | | | |
| Real GDP | 1,255,848 | 1.9 | 1.9 | 1.5 | 1.6 | 1.7 | 1.8 |
| Nominal GDP | 1,475,402 | 3.7 | 4.6 | 4.0 | 3.4 | 3.5 | 3.4 |
| COMPONENTS OF REAL GDP | | | | | | | |
| Private consumption expenditure | 742,742 | 1.5 | 2.0 | 1.8 | 1.8 | 1.8 | 1.8 |
| Government consumption expenditure ² | 248,771 | -0.3 | 1.6 | 0.3 | 0.0 | 0.0 | 0.0 |
| Gross fixed capital formation | 262,593 | 2.3 | 2.4 | 1.6 | 1.8 | 2.1 | 2.3 |
| Changes in inventories (% of GDP) | | | | | | | |
| Exports of goods and services | 328,106 | 5.3 | 2.0 | 2.8 | 3.5 | 3.8 | 4.1 |
| Imports of goods and services | 335,294 | 4.3 | 1.8 | 2.5 | 3.1 | 3.3 | 3.4 |
| CONTRIBUTIONS TO REAL GDP GROWTH | | | | | | | |
| Final domestic demand | | 1.3 | 2.0 | 1.4 | 1.5 | 1.6 | 1.6 |
| Changes in inventories | | 0.3 | -0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| External balance of goods and services | | 0.3 | 0.0 | 0.1 | 0.1 | 0.1 | 0.2 |

1) € million.
2) Including NPISH = Non Profit Institutions Serving Households.

TABLE 2b: PRICE DEVELOPMENTS

| | 2006 level | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|------------------------------|---------------|----------|------|------|------|------|------|
| | | % change | | | | | |
| GDP deflator | 117.5 | 1.8 | 2.6 | 2.4 | 1.8 | 1.8 | 1.6 |
| Private consumption deflator | 117.0 | 2.7 | 1.8 | 2.0 | 1.8 | 1.8 | 1.6 |
| HICP | 102.2 | 2.2 | 1.9 | 2.0 | 2.0 | 1.8 | 1.9 |
| Public consumption deflator | 122.8 | 3.4 | 1.1 | 3.3 | 0.7 | 0.7 | 1.0 |
| Investment deflator | 116.8 | 2.4 | 3.1 | 1.8 | 1.8 | 1.8 | 1.8 |
| Export price deflator | 125.2 | 5.2 | 6.6 | 3.9 | 3.0 | 2.4 | 1.9 |
| Import price deflator | 126.1 | 9.1 | 4.0 | 3.0 | 2.5 | 2.3 | 1.9 |

**TABLE 2c: LABOUR MARKET DEVELOPMENTS**

| | 2006 level ¹ | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---------------------------------------|----------------------------|----------|------|------|------|------|------|
| | | % change | | | | | |
| Employment, persons | 24,754 | 1.7 | 0.8 | 0.7 | 0.8 | 0.8 | 0.8 |
| Employment, hours worked | 44,568,247 | 0.9 | 0.8 | 0.5 | 0.7 | 0.7 | 0.5 |
| Unemployment rate (% on labour force) | | 6.8 | 6.0 | 5.7 | 5.5 | 5.4 | 5.2 |
| Labour productivity, persons | 50,733 | 0.1 | 1.1 | 0.8 | 0.8 | 0.9 | 1.0 |
| Labour productivity, hours worked | 28 | 1.0 | 1.1 | 1.0 | 0.9 | 1.0 | 1.3 |
| Compensation of employees | 607,699 | 4.6 | 3.5 | 5.2 | 2.9 | 2.9 | 2.9 |
| Compensation per employees | 34,437 | 2.5 | 2.4 | 4.3 | 2.1 | 2.1 | 2.1 |

1) In thousand for employment, persons and hours worked.
 As percentage of labour force for the unemployment rate.
 In real € for labour productivity.
 In current € for compensation of employees and per employees.

TABLE 2d: SECTORAL BALANCES

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|--|----------|------|------|------|------|------|------|
| | % of GDP | | | | | | |
| Net lending/borrowing vis-à-vis the rest of the world | -1.1 | -1.9 | -1.3 | -0.8 | -0.6 | -0.4 | -0.2 |
| Balance on goods and services | -0.1 | -0.8 | -0.1 | 0.3 | 0.5 | 0.7 | 1.0 |
| Balance of primary incomes and transfers | -1.1 | -1.2 | -1.3 | -1.3 | -1.3 | -1.3 | -1.3 |
| Capital account | 0.1 | 0.1 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 |
| Net lending/borrowing of the private sector | 3.2 | 2.6 | 1.1 | 1.4 | 0.9 | 0.3 | -0.2 |
| Net lending/borrowing of general government ¹ | -4.4 | -4.5 | -2.4 | -2.2 | -1.5 | -0.7 | 0.0 |
| Net lending/borrowing of general government | -4.2 | -4.4 | -2.4 | -2.2 | -1.5 | -0.7 | 0.0 |
| Statistical discrepancy | - | - | - | - | - | - | - |

1) In 2006 the net lending of general government B.9 was introduced because ESA95 uses this balance to calculate the balance with the rest of the world.
 For data on Italy see the web site of ISTAT http://www.istat.it/salastampa/comunicati/non_calendario/20070719_00/.





III. NET BORROWING AND PUBLIC DEBT

III.1 NET BORROWING OF GENERAL GOVERNMENT

Forecasts of budget balances made in the Update to the 2006 Stability Programme have been revised later in the current year. In April, the *Unified Report on the Economy and Public Finance* revised the net borrowing estimate for 2007 from 2.8 to 2.3 per cent of GDP. The new estimate was based on more favourable growth prospects, higher than expected revenues and higher expenditure on public sector wages and intermediate consumption. In addition, the forecast also implied some risk elements of spending linked to the higher-than-expected funding requirements for programmes that had already been envisaged or already being implemented and a more accurate estimate of the funds needed to honour Italy's international commitments.

In June, the macroeconomic scenario and further developments in public accounts predicted a more favourable situation for public finances. In the Economic and Financial Planning Document net borrowing was estimated at 2.1 per cent of GDP mainly due to a higher estimate of revenues. At the same time, measures were undertaken totalling 0.4% of GDP¹ to support the weaker brackets of society and to encourage growth. As a result, net borrowing for 2007 was estimated at 2.5 per cent of GDP.

In September, the *Forecasting and Planning Report* and the *Update to the Economic and Financial Planning Document* again revised net borrowing to take into account new data on tax revenues that once again were higher than expected. In addition to the Report, measures were devised amounting to 0.5 per cent of GDP, whose impact on spending is limited to the current year.²

Net borrowing was thus revised and estimated at 2.4 per cent of GDP.

Overall, the difference between the current estimates of net borrowing for 2007 and those of last year is 0.4 per cent (Table 3). Leaving aside the reviews made during the

¹ Decree Law No. 81/2007, confirmed into Law No.127/2007 envisages programmes entailing a €5.6 billion increase in spending, €1.2 billion of which for investment in upgrades of the road and railway network, €0.9 billion for the provision of an additional allowance to low-income pensioners over 64, €2.5 billion as a supplement to appropriations envisaged in the budget, €0.3 for business incentives, €0.3 billion for changes to the Internal Stability Pact, €0.3 billion for peace-keeping missions and humanitarian aid and €0.2 billion for urgent programmes in education.

² Decree Law No.159/2007, linked to the 2008 Budget Law ('Collegato'), envisages programmes amounting to €7.5 billion, 2.2 of which linked to tax breaks for poorer families and 5.3 to higher spending. €1.3 billion of the latter are allocations to fund infrastructure programmes (National Road Board and Railways) planned for 2008 that have been brought forward, €2.2 billion have been allotted to new initiatives, mainly aimed at improving mobility in big cities and reducing the environmental and economic impact of public transport, €1.4 billion to honour aid and development commitments, as well as other commitments to civil servants, while the remaining €0.5 billion have been allotted to other urgent programmes.



year, the smaller deficit is accounted for by a lower incidence of current spending, especially spending on welfare benefits other than in kind and lower interest payments.

Increasing tax revenues - which confirm last year's positive trend showing a broadening of the taxable base - are offset by a similar reduction in the incidence of other types of revenues. Economic growth is 0.6 per cent above the previous Update's forecast.

TABLE 3: DIFFERENCE FROM PREVIOUS UPDATE

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---------------------------------|-------|-------|-------|-------|-------|------|
| GDP GROWTH | | | | | | |
| Stability Programme 2006 | 1.6 | 1.3 | 1.5 | 1.6 | 1.7 | 1.7 |
| Stability Programme 2007 | 1.9 | 1.9 | 1.5 | 1.6 | 1.7 | 1.8 |
| Difference | 0.3 | 0.6 | 0.0 | 0.0 | 0.0 | 0.1 |
| NET BORROWING (% of GDP) | | | | | | |
| Stability Programme 2006 | -4.8 | -2.8 | -2.2 | -1.5 | -0.7 | 0.1 |
| Stability Programme 2007 | -4.4 | -2.4 | -2.2 | -1.5 | -0.7 | 0.0 |
| Difference | 0.4 | 0.4 | 0.0 | 0.0 | 0.0 | -0.1 |
| PUBLIC DEBT (% of GDP) | | | | | | |
| Stability Programme 2006 | 107.6 | 106.9 | 105.4 | 103.5 | 100.7 | 97.8 |
| Stability Programme 2007 | 106.8 | 105.0 | 103.5 | 101.5 | 98.5 | 95.1 |
| Difference | -0.8 | -1.9 | -1.9 | -2.0 | -2.2 | -2.7 |

Nominal net borrowing is 2.0 percentage points below the figure for 2006, down from 4.4 per cent in 2006 to 2.4 per cent of GDP in 2007. The 2006 figure is affected by a number of extraordinary transactions that have had both positive and negative impacts. Extraordinary transactions that have a detrimental effect on net borrowing amount to approximately 2.0 percentage points of GDP – 1.7 percentage points of which was due to one-off measures³. The positive impact was the result of some extraordinary revenues, amounting to 0.4 percentage points of GDP, and real-estate divestments (0.1 per cent of GDP).

Therefore the net effect of one-off measures is approximately 1.2 per cent of GDP. Thus net borrowing adjusted for the overall impact of one-off measures is 3.3 per cent of GDP. Compared to the 2007 figure, this one, estimated in homogeneous terms at

³ The extraordinary transactions refer to VAT reimbursements on company cars due to the ruling by the European Court of Justice (amounting to about 1.0 percentage points of GDP), the State's cancellation of the RFI/TAV railway company's debt (0.9 percentage points of GDP) and the retrocession to the credit securitisation company ISPA of receivables for the social contributions from farm workers (0.04 percentage points of GDP). As for the impact of the VAT sentence, only the share related to the debt of previous years (about 0.7 percentage points of GDP) is to be considered a one-off item. The residual part recorded in 2006 (about 0.3 percentage points of GDP) represents a steady-state worsening.



2.5 per cent of GDP, shows a 0.8 percentage point cut net of one-off measures between 2006 and 2007 (see Table 6).

Growth in total revenues is estimated at 0.6 percentage points of GDP, mainly thanks to the 0.5 increase in social-security contributions as a result of the measures included in the 2006 and 2007 Budgets. Tax revenues are expected to increase by 0.3 percentage points of GDP, mainly from direct taxation.

TABLE 4: GENERAL GOVERNMENT BUDGETARY PROSPECTS ¹

| | € million | 2006 | 2007 | 2008 % of GDP | 2009 | 2010 | 2011 |
|---|-----------|------|------|------------------|------|------|------|
| Net borrowing by sub-sector | | | | | | | |
| 1. General Government | -65,504 | -4.4 | -2.4 | -2.2 | -1.5 | -0.7 | 0.0 |
| annual correction ² | | | | | 0.4 | 0.4 | 0.4 |
| 2. Central Government | -57,782 | -3.9 | -2.5 | -2.1 | -1.9 | -1.5 | -1.2 |
| 3. State Government | -57,905 | -3.9 | -2.3 | -2.0 | -1.8 | -1.3 | -1.0 |
| 4. Local Government | -16,933 | -1.1 | -0.5 | -0.6 | -0.6 | -0.5 | -0.5 |
| 5. Social Security Funds | 9,211 | 0.6 | 0.6 | 0.5 | 0.6 | 0.5 | 0.4 |
| General Government | | | | | | | |
| 6. Total revenue | 673,118 | 45.6 | 46.2 | 46.3 | 45.9 | 45.8 | 45.7 |
| 7. Total expenditure ³ | 738,622 | 50.1 | 48.6 | 48.5 | 47.9 | 47.3 | 47.0 |
| annual correction ² | | | | | 0.4 | 0.4 | 0.4 |
| 8. Net borrowing | -65,504 | -4.4 | -2.4 | -2.2 | -1.9 | -1.5 | -1.3 |
| 9. Interest expenditure ³ | 67,552 | 4.6 | 4.8 | 4.9 | 4.9 | 4.9 | 4.8 |
| 10. Primary balance ³ | 2,048 | 0.1 | 2.5 | 2.7 | 3.0 | 3.4 | 3.6 |
| 11. One-off and other temporary measures ⁴ | -17,283 | -1.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| Selected components of revenues | | | | | | | |
| 12. Total taxes | 432,136 | 29.3 | 29.6 | 29.4 | 29.2 | 29.2 | 29.1 |
| 12a. Taxes on production and imports | 218,250 | 14.8 | 14.6 | 14.4 | 14.3 | 14.2 | 14.2 |
| 12b. Current taxes on income etc. | 213,664 | 14.5 | 14.9 | 15.0 | 14.9 | 15.0 | 15.0 |
| 12c. Capital taxes | 222 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 |
| 13. Social contribution | 192,038 | 13.0 | 13.5 | 13.6 | 13.5 | 13.4 | 13.4 |
| 14. Property income | 9,076 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 | 0.6 |
| 15. Other | 39,868 | 2.7 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| 16. Total revenues | 673,118 | 45.6 | 46.2 | 46.3 | 45.9 | 45.8 | 45.7 |
| <i>p.m. Tax burden</i> | | 42.3 | 43.0 | 43.0 | 42.7 | 42.6 | 42.5 |
| Selected components of expenditure | | | | | | | |
| 17. Compensation of employees + intermediate consumption | 241,171 | 16.3 | 16.1 | 16.4 | 15.9 | 15.6 | 15.4 |
| 17a. Compensation of employees | 162,999 | 11.0 | 10.8 | 11.1 | 10.7 | 10.4 | 10.2 |
| 17b. Intermediate consumption | 78,172 | 5.3 | 5.4 | 5.3 | 5.3 | 5.1 | 5.1 |
| 18. Social payments | 294,421 | 20.0 | 19.9 | 20.0 | 19.9 | 19.9 | 19.9 |
| 18a. Social transfers in kind supplied via market producers | 41,428 | 2.8 | 2.7 | 2.7 | 2.7 | 2.7 | 2.7 |
| 18b. Social transfers other than in kind | 252,993 | 17.1 | 17.2 | 17.3 | 17.2 | 17.2 | 17.2 |
| 19. Interest expenditure | 67,552 | 4.6 | 4.8 | 4.9 | 4.9 | 4.9 | 4.8 |
| 20. Subsidies | 13,539 | 0.9 | 1.0 | 0.9 | 0.9 | 0.8 | 0.8 |
| 21. Gross fixed capital formation | 33,850 | 2.3 | 2.7 | 2.5 | 2.6 | 2.5 | 2.4 |
| 22. Other | 88,089 | 6.0 | 4.0 | 3.8 | 3.8 | 3.7 | 3.6 |
| 23. Total expenditure | 738,622 | 50.1 | 48.6 | 48.5 | 47.9 | 47.3 | 47.0 |
| <i>p.m. Government consumption (nominal)</i> | 299,512 | 20.3 | 19.9 | 20.2 | 19.7 | 19.3 | 19.0 |

1) Components may not add as to total revenues and expenditures, due to decimal rounding.

2) The cumulated correction amounts to 0.8 per cent of GDP in 2010 and 1.2 per cent of GDP in 2011.

3) Net of swaps, equal to €563 million in 2006.

4) A plus sign means deficit-reducing one-off measures.



As far as overall expenditure is concerned, if a homogeneous comparison is made adjusting the 2006 figure for extraordinary expenditure, primary expenditure is forecast to edge up compared to 2006 (0.2 percentage points of GDP)⁴. This trend reflects the Government's choice to bring forward some 'possible' expenditure (mainly concerning infrastructure investment⁵) envisaged in the *Economic and Financial Planning Document* as commitments for 2008. As a result of such programmes, capital expenditure is expected to increase by 0.5 per cent of GDP compared to 2006 (net of extraordinary expenditure).

The estimate of the general government net borrowing target for 2008 has been confirmed at 2.2 per cent of GDP, as mentioned in the previous Update. Hence, the measures introduced in the 2008 Budget do not cause any delay in delivering the medium-term consolidation objective.

The net borrowing targets for the 2009-2011 period have been set on the basis of a declining trend line, with a 0.7 percentage point yearly drop until a balanced budget is reached in 2011. The primary surplus, with interest payments hovering around 4.9 per cent of GDP, is estimated to increase from 2.7 per cent of GDP in 2008 to 4.9 per cent in 2011.

Considering the measures adopted in the 2008 Budget only, net borrowing is expected to decrease between 2009 and 2011 by about 1.0 per cent of GDP.

The financial targets set in the *Economic and Financial Planning Document* will therefore be pursued year after year through additional measures to be identified in future budgets. The additional correction required, equal to 1.2 percentage points, is spread over a different timeline to ensure the consolidation process is more evenly distributed (Table 5).

TABLE 5: PROJECTIONS OF GENERAL GOVERNMENT BUDGETARY PROSPECTS INCLUDING THE 2008 FINANCIAL MEASURES (percentage of GDP)

| | 2007 | 2008 | 2009 | 2010 | 2011 |
|--|------|-------|-------|-------|------|
| Upward revision of total tax revenues | 0.4 | 0.4 | 0.3 | 0.2 | 0.2 |
| Net borrowing after revision (before 2008 Budget) | -1.9 | -1.8 | -1.6 | -1.2 | -1.0 |
| Effects of DL 159/2007 | -0.5 | 0.0 | 0.0 | 0.0 | 0.0 |
| Net borrowing after DL 159/2007 (before 2008 Budget) | -2.4 | -1.8 | -1.6 | -1.2 | -1.0 |
| Effects of the 2008 budget on primary balance | | -0.4 | -0.3 | -0.3 | -0.3 |
| Effects of the 2008 budget on interest payments | | -0.01 | -0.02 | -0.01 | 0.03 |
| Net borrowing (after 2008 Budget) | | -2.2 | -1.9 | -1.5 | -1.3 |

⁴ 2006 expenditures include extraordinary items amounting to about 2.0 per cent of GDP (see previous footnote for details).

⁵ See footnote 2.



FORECASTS OF TAX REVENUES FOR 2007-2011

Forecasts of general government tax revenues for 2007 reflect the revenues performance registered in the first nine months of the year⁶. In the period between January and August 2007, the revenue collections of the State budget and of a number of major local taxes that were monitored on a monthly basis showed a growth rate of 5.6 and 8.0 per cent respectively compared to the same period last year. Both increased more rapidly than major macroeconomic aggregates in the first two quarters of the year. This performance is confirmed by the early data on taxes paid in the month of September⁷.

STATE BUDGET – Tax revenues accrued

| | Jan-August 2006 | Jan-August 2007 | |
|--|-----------------|-----------------|----------|
| | (€ million) | | % change |
| State budget total taxes | 246,533 | 260,428 | 5.6 |
| Indirect taxes | 130,834 | 138,411 | 5.8 |
| Direct taxes | 115,699 | 122,017 | 5.5 |
| Local Government total revenue | 24,554 | 26,521 | 8.0 |
| GDP 1 st semester (current prices, unadjusted data) | | | 4.8 |
| Private consumption 1 st semester (current prices, unadjusted data) | | | 3.7 |

As a result of the revenues performance, forecasts for 2007 are approximately €4.2 billion above the forecasts made in the Economic and Financial Planning Document published in June. The latter reflected macroeconomic forecasts and did not include the revenue collections resulting from self-assessment taxes paid by taxpayers ('autoliquidazione'), which are an important indicator for the fiscal outcome of the whole year and at the time were still unknown⁸. The new forecasts show elasticity of tax revenues to GDP at 1.21 points. This elasticity includes the effects of budget measures and one-off changes.

Estimates of tax revenues for 2008 have been revised upward by approximately €6.3 billion compared to the estimates made in the Economic and Financial Planning Document due to a change in macroeconomic forecasts and in 2007 revenues. Considering the differential effect of the budget package on revenues between 2007 and 2008 (mainly the effect of the 'tax wedge'), the elasticity of revenues to GDP for 2008 is approximately equal to 1 point. This figure is at the highest margin of the variability interval typical of the forecasting model (between 0.95 and 1.00, if

⁶ The reference is to the latest forecasts of tax revenues made in the *Forecasting and Planning Report* for 2008 submitted in September 2007.

⁷ For a more detailed analysis of tax revenues trends see the *Bollettino delle entrate tributarie* (www.finanze.it).

⁸ Estimates for 2007 predict smaller revenues (€-1.9 billion) as a result of Decree Law No. 159/2007 – a package of measures linked to the 2008 Budget ('Collegato').



no budget measures are adopted and no exceptional event occurs).⁹ This depends on the composition of Italy's macroeconomic forecasts for 2008. The growth rate of gross compensations, which affects high-elasticity taxes, is higher than the GDP rate of growth, resulting in an increase in the total elasticity of revenue forecasts to GDP.

GENERAL GOVERNMENT – Total Taxes (€ million) ¹

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|----------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Total taxes | 432,136 | 456,354 | 474,535 | 488,081 | 504,173 | 520,172 |
| Direct taxes | 213,664 | 229,939 | 242,452 | 250,528 | 259,759 | 268,460 |
| Indirect taxes | 218,250 | 225,532 | 231,727 | 237,520 | 244,384 | 251,682 |
| Capital taxes | 222 | 883 | 356 | 33 | 30 | 30 |
| Nominal GDP | 1,475,402 | 1,543,824 | 1,605,043 | 1,659,615 | 1,717,445 | 1,776,298 |

1) The forecasts are those made in the *Forecasting and Planning Report* submitted in September and include the effects of Decree Law No. 159/2007.

For the years after 2008, forecasts of tax revenues reflect the predicted trends in macroeconomic variables and the impact of past budget measures. Specifically, starting from 2009 tax revenues are expected to decline as a result of the negative impact associated to the revaluation of business assets introduced by the 2006 Budget.¹⁰ This causes a drop in the elasticity of revenues to GDP.

III.2 THE CYCLICALLY ADJUSTED BUDGET BALANCE

The cyclically-adjusted budget balance net of one-off measures is a synthetic measure of the situation of public finances, consistent with potential economic output and the amount of automatic stabilisers (cyclical component).

The cyclical component, obtained by multiplying the output gap by the elasticity of the budget balance to economic growth¹¹, measures the change in revenue collections and in spending on social safety nets due to short-term economic fluctuations.

⁹ It is necessary to net out several factors from the new data in order to calculate the elasticity of revenue forecasts to GDP, such as: (i) the effects of Decree Law No. 159/2007, which reduces tax revenues by approximately €1.9 billion; (ii) measures concerning the 'tax wedge' introduced by the 2007 Budget, which will become fully operational in 2008, with a differential impact of smaller revenue collections amounting to approximately €2 billion a year.

¹⁰ Law No. 266/2005, Art. 1 paragraphs 469-471.

¹¹ This is calculated at European level and the figure for Italy is 0.50.



Output gap developments and changes in potential GDP have been calculated on the basis of the medium-term objectives set in the *Forecasting and Planning Report* according to the methodology agreed upon at the Ecofin Council.

Table 6 shows the trends in macroeconomic and public finance variables more directly linked to the estimate of the cyclically-adjusted budget balance for the 2006–2011 period.

GDP growth is projected to be flat in 2007 versus 1.9 per cent in 2006, and to slow down in 2008, both as a result of the expected slowdown of the US economy and the anticipated smaller carry-over effect of the current year. Growth is then expected to pick up again in the 2009–2011 period.

Potential growth over the 2007–2011 period is expected to stand at 1.5 per cent, in line with the 2006 forecasts. As for the contributions to potential GDP growth, the most significant one is made by capital, which is broadly constant throughout the whole 2007–2011. Labour makes a smaller contribution to potential growth over time, while total factor productivity – which includes technological progress and more generally the efficiency of the whole economy – plays an increasingly bigger role. Finally, it may be interesting to note that with the publication of the new series of hours worked by ISTAT, the estimated contribution of total factor productivity in the 2007–2011 period has been revised upward and is now positive¹².

Throughout the period considered, GDP remains below its potential level, with a gradually declining output gap and a cyclical component in the budget balance of marginal size. After a number of years in which one-off measures had significantly affected the deficit figures, in the 2007 and 2008 budget the Government resorted to them only to a small extent and intends to continue pursuing this policy until the end of its term.

In the current year the budget balance (net borrowing), adjusted for the cycle and net of one-off measures, amounts to 2.3 per cent, which is a clear improvement over last year's 2.8 per cent. The increase is even more marked if one looks at the most significant indicator used for assessing permanent improvements of public finances, i.e. the structural primary surplus, which grew by 0.8 per cent from 2006 to 2007.

Given the 1.8 per cent decrease in the budget balance, adjusted for the cycle and net of one-off measures, in the 2006–2007 period, the 2008 Budget envisages a structural improvement of 0.2 percentage points of GDP. Thus the cyclically-adjusted budget balance net of one-offs will be at 2.1 per cent in 2008, the lowest figure ever recorded since 2000.

¹² The increase in the contribution by total factor productivity was made at the expense of labour, a predictable effect given the adoption of the number of hours worked as a standard to estimate potential growth.

**TABLE 6: CYCLICAL DEVELOPMENTS¹ (percentage of GDP)**

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|--|------------|------------|------------|------------|------------|------------|------------|
| GDP growth rate at constant prices | 0.1 | 1.9 | 1.9 | 1.5 | 1.6 | 1.7 | 1.8 |
| Net borrowing | -4.2 | -4.4 | -2.4 | -2.2 | -1.5 | -0.7 | 0.0 |
| Interest payments | 4.5 | 4.6 | 4.8 | 4.9 | 4.9 | 4.9 | 4.8 |
| Potential output growth rate | 1.2 | 1.5 | 1.5 | 1.5 | 1.5 | 1.6 | 1.7 |
| Contributions of productive factors to potential growth: | | | | | | | |
| <i>Labour</i> | <i>0.4</i> | <i>0.6</i> | <i>0.5</i> | <i>0.4</i> | <i>0.4</i> | <i>0.3</i> | <i>0.4</i> |
| <i>Capital</i> | <i>0.6</i> | <i>0.6</i> | <i>0.6</i> | <i>0.6</i> | <i>0.6</i> | <i>0.6</i> | <i>0.7</i> |
| <i>Total Factor Productivity</i> | <i>0.2</i> | <i>0.2</i> | <i>0.3</i> | <i>0.4</i> | <i>0.5</i> | <i>0.6</i> | <i>0.7</i> |
| Output gap | -1.3 | -1.0 | -0.5 | -0.5 | -0.4 | -0.4 | -0.3 |
| Cyclical budgetary component | -0.7 | -0.5 | -0.3 | -0.2 | -0.2 | -0.2 | -0.2 |
| Cyclically adjusted budget balance | -3.5 | -4.0 | -2.1 | -2.0 | -1.3 | -0.5 | 0.2 |
| Cyclically adjusted primary balance | 1.0 | 0.6 | 2.7 | 2.9 | 3.6 | 4.4 | 5.0 |
| One-off measures | 0.6 | -1.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| Budget balance net of one-off measures | -4.8 | -3.3 | -2.5 | -2.3 | -1.6 | -0.8 | -0.1 |
| Cyclically adjusted budget balance net of one-off measures | -4.1 | -2.8 | -2.3 | -2.1 | -1.3 | -0.6 | 0.1 |
| Cyclically adjusted primary balance net of one-off measures | 0.4 | 1.8 | 2.6 | 2.8 | 3.6 | 4.3 | 4.9 |
| Changes in cyclically adjusted primary balance net of one-off measures | 0.5 | 1.3 | 0.5 | 0.2 | 0.7 | 0.8 | 0.7 |

1) Decimals may not add due to rounding to the first decimal place.

With a view to meeting the medium-term target of a balanced budget by 2011, the Government is committed to speeding up structural adjustment as of 2009. The cyclically-adjusted deficit net of one-offs is expected to shrink at an average rate slightly below 0.8 per cent a year. In this way, the adjustment path is largely in line with what was recommended by the Ecofin Council of 2007, as the structural deficit will decrease by over 0.5 per cent a year. The cyclically-adjusted primary balance will therefore start growing again substantially, reaching 4.9 per cent of GDP in the final year, a rate which can ensure the long-term sustainability of public finances (see chapter 6).



III.3 THE PUBLIC DEBT

In 2006 the debt-to-GDP ratio increased by 0.6 per cent compared to 2005, from 106.2 to 106.8 per cent. This increase was 0.4 per cent below the forecast made in the 2006 Update to Stability Programme.

The difference with respect to the estimate of the debt-to-GDP in the previous Update, i.e. a decrease of 0.8 percentage points, is due to a number of factors.

A first reduction, equal to 0.4 percentage points, is related to the March revision of GDP figures by ISTAT.¹³ With forecasts of nominal debt remaining unchanged for 2006, the debt-to-GDP ratio for 2006 was expected to decline from 107.6 per cent to 107.2 per cent simply by revising GDP in 2005. The downward revision of a further 0.4 per cent was due to the following factors: nominal growth that was slightly higher than expected (3.7 per cent instead of 3.6 per cent thanks to more sustained real growth); a pre-funding volume (to cover the refunds following the ruling by the European Court of Justice on VAT¹⁴) that was slightly (about €700 million) below the amount estimated in last year's Update to the Stability Programme; lower than expected public-sector cash requirements (approximately €2,500 million, even including the impact of the reclassification of the securitisation of the health-care liabilities of local authorities). In 2007, the debt-to-GDP ratio is expected to decline to 105.0 per cent. This estimate, which is below that of the latest Update (106.9 per cent), is mainly attributable to the upward revision of GDP in 2005, which in itself already causes an initial reduction in the ratio. In addition to this effect, one should consider that the forecasts of nominal growth for 2007 have been significantly revised upwards, from 2.8 per cent in the latest Update to 4.6 per cent. These two factors have almost entirely determined the new estimate of the debt-to-GDP ratio because, compared to last year, the forecast of the change in the outstanding debt between 2006 and 2007 has basically remained unchanged. The estimated increase in the public-sector cash requirements for 2007 is in line with last year's forecasts¹⁵.

In future years the reduction rate of the ratio is expected to be in line with last year's forecasts. In 2008 the decline is approximately 1.5 per cent of GDP compared to 2007 (as in the last Update) while in 2009 the decrease reaches 2 per cent compared to 2008 (0.1 per cent more than in the last Update).

¹³ The upward revision of 2005 GDP reduced the debt-to-GDP ratio in 2005 from 106.6 to 106.2 per cent.

¹⁴ According to the SEC95 accounting principles, the impact of the sentence on VAT is recorded in the net borrowing of the year in which the sentence is issued, while its cash settlement – that is its effect on the debt – is recorded at the time reimbursement procedures are filed, verified and completed (in this connection see footnote No. 8 in the 2006 Update).

¹⁵ The forecasts of the public sector cash requirements for 2007 include payments for VAT refunds resulting from the 2006 ruling by the European Court of Justice. Payments amount to €2,000 million, approximately €3,700 million less than what had been forecast last year. By contrast, the overall estimate of the 2007 public sector cash requirements remains the same as in the last Update, totalling 2.5 per cent of GDP.



In the final years of the forecast the rate of change is more marked compared to last year's Update. Even though both reports expect a balanced budget to be achieved by 2011, in this year's Update the cash requirements are projected to decrease more rapidly. The debt-to-GDP ratio decreases below 100 per cent as early as 2010 (a year earlier compared to the 2006 Update) reaching 95.1 per cent in 2011. The forecast of changes in the debt-to-GDP ratio does not assume revenues from divestments over the 2007-2011 period, as was the case in last year's Update.

TABLE 7: DEBT-TO-GDP RATIO ¹

| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|-------|-------|-------|-------|-------|------|------|
| Government debt | | | | | | | |
| Debt | 106.2 | 106.8 | 105.0 | 103.5 | 101.5 | 98.5 | 95.1 |
| % change in debt | 2.4 | 0.6 | -1.8 | -1.5 | -2.0 | -3.0 | -3.4 |
| <i>Contributions to change in Government debt (as % of GDP)</i> | | | | | | | |
| Primary balance (accrual basis) | -0.3 | -0.1 | -2.5 | -2.6 | -3.4 | -4.2 | -4.9 |
| Snow-ball effect | 2.1 | 0.8 | 0.1 | 0.9 | 1.5 | 1.5 | 1.6 |
| of which: Interest expenditure (accrual basis) | 4.5 | 4.6 | 4.8 | 4.9 | 4.9 | 4.9 | 4.8 |
| Stock - flow adjustment | 0.6 | -0.1 | 0.6 | 0.2 | -0.1 | -0.3 | -0.1 |
| of which: <i>Difference between cash and accrual basis</i> | -0.3 | -1.5 | -0.3 | 0.0 | | | |
| <i>Net accumulaztion of financial assets</i> | 1.0 | 0.8 | 0.5 | 0.4 | | | |
| of which: <i>Privatisation proceeds</i> | -0.3 | | | | | | |
| <i>Evaluation effects of Government debt</i> | -0.1 | 0.2 | 0.3 | 0.1 | | | |
| <i>Other</i> | -0.1 | | | | | | |
| p. m. Tasso di interesse implicito sul Debito | 4.4 | 4.5 | 4.7 | 4.8 | 4.9 | 5.0 | 5.1 |

1) Decimals may not add due to rounding to the first decimal place.
2) The 2005 and 2006 data include changes in cash holdings on the Treasury deposit account held at the Bank of Italy. In particular 2006 data includes the increase in cash holdings needed to cover the pre-funding of the VAT reimbursements related to the ECJ 2006 sentence (in this connection see footnote No. 8 in the 2006 Update).

HEALTH CARE: THE REGIONAL AUTHORITIES' SPENDING-CUT PLANS

The recently introduced regulations tackle the issue of the Regional Authorities' health-care deficits selectively. The data from health spending monitoring have shown that the National Health Service deficit is almost entirely attributable to few Regional Authorities that have large and persistent deficits also due to financial transactions involving particularly burdensome conditions for them (i.e. above current market rates). With a view to implementing structural adjustment, the conditions had to be put in place first for a transparent and efficient financial management of the Regional Authorities.



The main elements of the new regulations are spending-cut plans for the Regional Authorities with large and persistent deficits and action aimed at rescheduling the debt of the Regional Authorities with large deficits and high interest payment costs.

Spending-cut plans

For Regional Authorities running a deficit the new regulations envisage the following:

- *The automatic increase of tax rates up to the maximum level set in the existing regulations, if the Regional Authorities running a large and persistent deficit do not adopt adequate measures after a warning to this effect given by the Prime Minister¹⁶;*
- *The signing of an agreement with the State, including a health-care spending-cut plan and programmes to reorganise, strengthen and improve the quality of regional health services¹⁷. Specifically, in addition to reorganisation measures for the provision of essential health care services (LEA Livelli Essenziali di Assistenza) spending-cut plans must also envisage the necessary measures for balancing the budget by 2010.*

With a view to facilitating the implementation of spending-cut plans the following has been agreed:

- *A transient bridging fund of €1,000 million for 2007, €850 million for 2008 and €700 million for 2009¹⁸;*
- *A selective deficit-reduction plan, amounting to €3,000 million for the Regional Authorities implementing plans envisaging further tax measures in addition to the planned increase, amounting to the maximum level of IRAP (regional tax on business activities) and the additional regional personal income tax (IRPEF)¹⁹.*

Debt rescheduling

Within the spending-cut plans the Government requires the Regional Authorities with large debts and high interest payments to avail themselves of the support of an accounting advisor, to improve administrative and accounting procedures and to certify past debts, as well as the support of a financial advisor.

The agreements also require all regional spending decisions and health-care planning relevant to the spending-cut plan to be submitted to the approval of the Ministry of Health and the Ministry of Finance and the Economy. To achieve financial consolidation the State requires the Regional Authorities to accept a cash advance to be fully refunded (including interests) by the Regional Authorities through segregated regional revenues²⁰.

¹⁶ Law No. 311/2004, Art. 1, paragraph 174 as later amended.

¹⁷ Law No. 311/2004, Art. 1, paragraph 180 and Law No. 296/2006, Art. 1, paragraph 796 subparagraph b).

¹⁸ Law No. 296/2006, Art 1, paragraph 796 subparagraph b).

¹⁹ Decree Law No. 23/2007 confirmed into Law No. 64/2007.

²⁰ Law No. 296/2006 Art. 1, paragraph 796, subparagraph e.

**TABLE 8: MAIN INDICATORS OF PUBLIC FINANCE 1990-2006 (percentage of GDP)**

| | GDP at constant prices | Output gap | Cyclical budgetary component | Net borrowing cyclically-adjusted and net of one-off measures | Primary balance cyclically-adjusted and net of one-off measures | Change in net borrowing, cyclically-adjusted and net of one-off measures |
|------|------------------------|----------------------|------------------------------|---|---|--|
| 1990 | 2.1 | 2.0 | 1.0 | -12.5 | -2.4 | |
| 1991 | 1.5 | 1.1 | 0.5 | -12.1 | -0.7 | -0.4 |
| 1992 | 0.8 | -0.2 | -0.1 | -12.2 | 0.0 | 0.1 |
| 1993 | -0.9 | -2.1 | -1.1 | -9.6 | 3.0 | -2.6 |
| 1994 | 2.2 | -1.2 | -0.6 | -8.6 | 2.8 | -1.1 |
| 1995 | 2.8 | 0.4 | 0.2 | -8.1 | 3.5 | -0.4 |
| 1996 | 0.7 | -0.2 | -0.1 | -7.1 | 4.4 | -1.0 |
| 1997 | 1.9 | 0.3 | 0.1 | -3.5 | 5.8 | -3.6 |
| 1998 | 1.4 | 0.0 | 0.0 | -3.2 | 4.8 | -0.3 |
| 1999 | 1.9 | 0.4 | 0.2 | -2.0 | 4.6 | -1.2 |
| 2000 | 3.6 | 2.2 | 1.1 | -2.0 | 4.3 | 0.0 |
| 2001 | 1.8 | 2.3 | 1.1 | -4.8 | 1.5 | 2.8 |
| 2002 | 0.3 | 1.1 | 0.6 | -4.6 | 0.9 | -0.2 |
| 2003 | 0.0 | -0.1 | 0.0 | -5.2 | 0.0 | 0.5 |
| 2004 | 1.2 | -0.2 | -0.1 | -4.6 | 0.1 | -0.5 |
| 2005 | 0.1 | -1.3 | -0.7 | -4.1 | 0.4 | -0.5 |
| 2006 | 1.9 | -1.0 | -0.5 | -2.8 | 1.8 | -1.3 |
| | Primary balance | Interest expenditure | Net borrowing | One-off measures | Net borrowing net of one-off measures | Public debt |
| 1990 | -1.4 | 10.1 | -11.4 | 0.1 | -11.5 | 94.7 |
| 1991 | 0.0 | 11.3 | -11.4 | 0.2 | -11.6 | 98.0 |
| 1992 | 1.8 | 12.2 | -10.4 | 1.9 | -12.3 | 105.2 |
| 1993 | 2.6 | 12.7 | -10.0 | 0.6 | -10.7 | 115.6 |
| 1994 | 2.3 | 11.4 | -9.1 | 0.1 | -9.2 | 121.5 |
| 1995 | 4.2 | 11.6 | -7.4 | 0.5 | -7.9 | 121.2 |
| 1996 | 4.6 | 11.5 | -7.0 | 0.2 | -7.2 | 120.6 |
| 1997 | 6.6 | 9.3 | -2.7 | 0.7 | -3.3 | 118.1 |
| 1998 | 5.1 | 7.9 | -2.8 | 0.3 | -3.1 | 114.9 |
| 1999 | 4.9 | 6.6 | -1.7 | 0.1 | -1.8 | 113.7 |
| 2000 | 5.5 | 6.3 | -0.8 | 0.1 | -0.9 | 109.1 |
| 2001 | 3.2 | 6.3 | -3.1 | 0.6 | -3.6 | 108.7 |
| 2002 | 2.7 | 5.5 | -2.9 | 1.2 | -4.1 | 105.6 |
| 2003 | 1.6 | 5.1 | -3.5 | 1.7 | -5.2 | 104.3 |
| 2004 | 1.3 | 4.7 | -3.5 | 1.3 | -4.7 | 103.8 |
| 2005 | 0.3 | 4.5 | -4.2 | 0.6 | -4.8 | 106.2 |
| 2006 | 0.1 | 4.6 | -4.4 | -1.2 | -3.3 | 106.8 |



IV. SENSITIVITY ANALYSIS

This Chapter illustrates the debt's sensitivity to GDP growth and to change in interest rates, in line with the Code of Conduct.

IV.1 SENSITIVITY TO ECONOMIC GROWTH

The sensitivity of Italy's public finances to economic growth is analysed by simulating the trend of macroeconomic scenarios that are alternatives to the baseline scenario. In line with the projections of some international economic variables over the 2007-2011 period, it is assumed in the two alternative scenarios that real GDP growth will respectively be 0.5 percentage points above and below the rates forecast for the baseline scenario for each year.

In the more favourable scenario, the incremental growth of the Italian economy is determined by an oil price that remains around \$65/barrel for the entire four-year period and by the assumption that the US economy is capable of quickly getting beyond the financial turbulence related to the sub-prime mortgage lending business. For the Euro Area, it is assumed that the components of domestic demand are stronger, and that the dollar appreciates slightly vis-à-vis the baseline scenario for the effect of the recovery of the US economy. This international macroeconomic scenario translates into higher growth of Italian exports which, in turn, stimulate business investment with continuing positive repercussions on business confidence and private consumption. On the supply side, the positive effects on employment are related to the impact of stronger exports affecting on industry and private services performance. In addition, the growth of unit labour costs is restrained thanks to the recovery in productivity.

In the less favourable scenario, the oil price is forecast at \$95/barrel, which has the effect of reducing world economic growth and international trade. The less favourable scenario also assumes that the financial turbulence linked to sub-prime mortgage lending will have negative effects on both the US economy and the economy of the leading countries in the Euro Area.

TABLE 9: SENSITIVITY TO GDP GROWTH ¹ (percentage changes)

| | | 2007 | 2008 | 2009 | 2010 | 2011 |
|-------------------------------------|-----------------------------|-------|-------|-------|-------|------|
| GDP at constant prices | <i>High-growth scenario</i> | 1.9 | 2.0 | 2.1 | 2.2 | 2.3 |
| | <i>Baseline scenario</i> | 1.9 | 1.5 | 1.6 | 1.7 | 1.8 |
| | <i>Low-growth scenario</i> | 1.9 | 1.0 | 1.1 | 1.2 | 1.3 |
| Potential output | <i>High-growth scenario</i> | 1.7 | 1.7 | 1.8 | 1.9 | 2.0 |
| | <i>Baseline scenario</i> | 1.5 | 1.5 | 1.5 | 1.6 | 1.7 |
| | <i>Low-growth scenario</i> | 1.4 | 1.3 | 1.2 | 1.3 | 1.4 |
| Output gap | <i>High-growth scenario</i> | -1.0 | -0.7 | -0.4 | -0.1 | 0.1 |
| | <i>Baseline scenario</i> | -0.5 | -0.5 | -0.4 | -0.4 | -0.3 |
| | <i>Low-growth scenario</i> | -0.1 | -0.3 | -0.4 | -0.5 | -0.7 |
| Net borrowing | <i>High-growth scenario</i> | -2.4 | -2.0 | -1.0 | 0.1 | 1.1 |
| | <i>Baseline scenario</i> | -2.4 | -2.2 | -1.5 | -0.7 | 0.0 |
| | <i>Low-growth scenario</i> | -2.3 | -2.4 | -1.9 | -1.4 | -0.9 |
| Cyclically-adjusted budget balance | <i>High-growth scenario</i> | -1.9 | -1.6 | -0.8 | 0.1 | 1.0 |
| | <i>Baseline scenario</i> | -2.1 | -2.0 | -1.3 | -0.5 | 0.2 |
| | <i>Low-growth scenario</i> | -2.3 | -2.3 | -1.7 | -1.1 | -0.6 |
| Primary balance | <i>High-growth scenario</i> | 2.5 | 2.9 | 3.8 | 4.9 | 5.8 |
| | <i>Baseline scenario</i> | 2.5 | 2.6 | 3.4 | 4.2 | 4.9 |
| | <i>Low-growth scenario</i> | 2.5 | 2.4 | 3.0 | 3.6 | 4.0 |
| Cyclically-adjusted primary balance | <i>High-growth scenario</i> | 3.0 | 3.2 | 4.1 | 4.9 | 5.7 |
| | <i>Baseline scenario</i> | 2.7 | 2.9 | 3.6 | 4.4 | 5.0 |
| | <i>Low-growth scenario</i> | 2.6 | 2.6 | 3.2 | 3.9 | 4.4 |
| Public debt | <i>High-growth scenario</i> | 105.0 | 103.0 | 100.1 | 95.9 | 91.4 |
| | <i>Baseline scenario</i> | 105.0 | 103.5 | 101.5 | 98.5 | 95.1 |
| | <i>Low-growth scenario</i> | 105.0 | 104.1 | 102.9 | 100.9 | 99.1 |

1) Variables may be inconsistent due to decimal rounding.

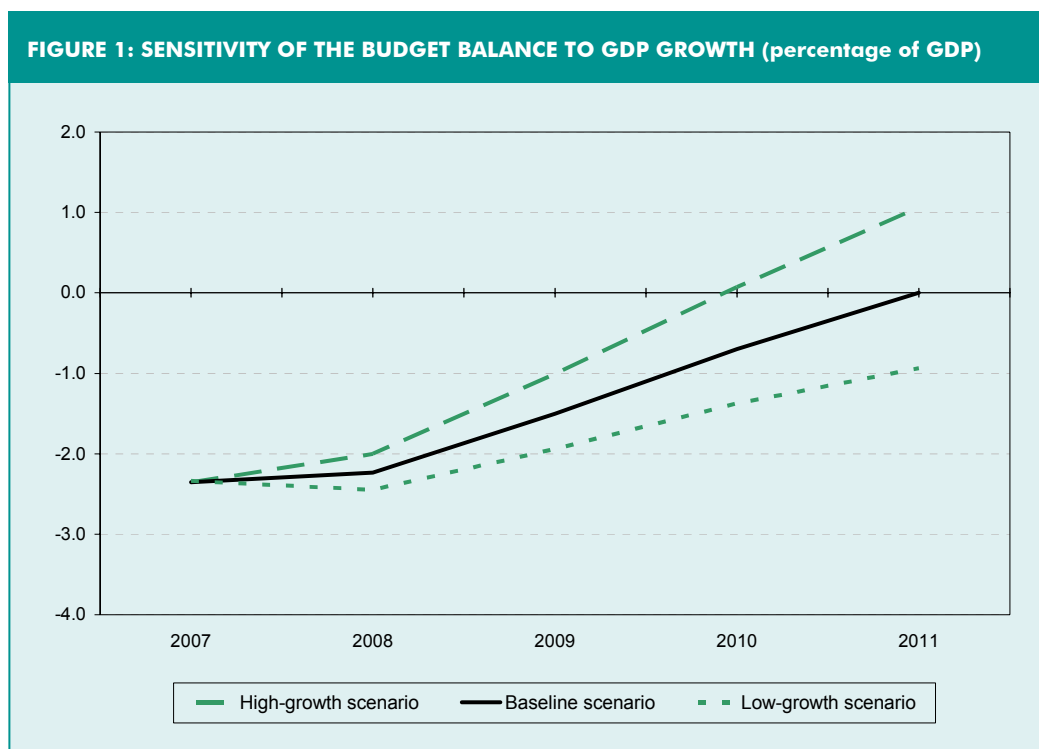
The consequences for the Italian economy are lower growth of exports which, in turn, cause a slowdown in investment, with repercussions on consumer confidence and private consumption. In addition, given the pronounced slowdown of the property market, investments in residential construction dramatically decelerate. On the supply side, the export difficulties have an impact on industrial production with negative effects on employment. Finally, productivity grows at a slower pace vis-à-vis the baseline scenario, with unit labour costs rising as a result.

Both of the alternative scenarios are based on the assumption that any higher or lower economic growth also has a permanent impact on potential GDP. Consistent with



such conclusion, the output gap changes in line with the new profiles for actual GDP and potential GDP¹.

Differing GDP growth causes changes in the structural and cyclical components of the primary surplus. The structural component is measured as the difference between structural revenues and expenditures, which are estimated by applying the method agreed at an EU level. The profile of the primary surplus changes the trend of the debt balance and thus, interest expenditure.



For the purpose of estimating the public debt, it is assumed that the stock flow adjustment and the implicit interest rate for both alternative scenarios remain unchanged vis-à-vis the baseline scenario.

As shown by Table 8, if the low-growth scenario were to develop, the 2008 net borrowing would be equal to 2.4 per cent of GDP, a figure that is still below the 3.0 per

¹ More specifically, it should be noted how the cyclical component of GDP (represented by the output gap) is larger in the high-growth scenario vis-à-vis the baseline scenario for 2007 and 2008. This is due to the fact that the increase in the potential GDP in comparison with actual GDP in the high-growth scenario is greater than in the baseline scenario. This seeming anomaly disappears as of 2009.

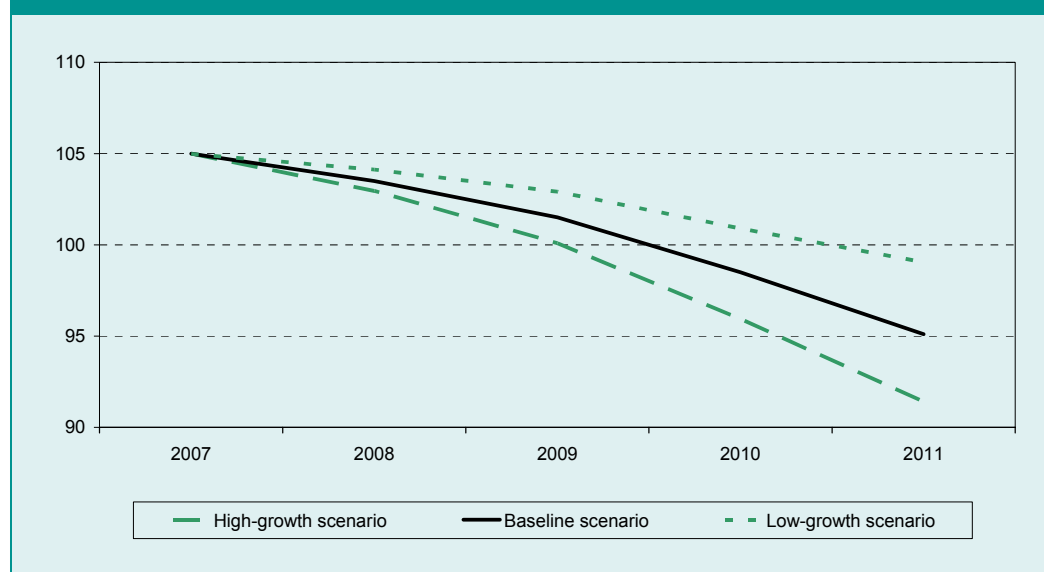


cent threshold contemplated by the Stability and Growth Pact. At the same time, the lower growth scenario would not allow for achieving a balanced budget in 2011.

In the high-growth scenario, the 2008 net borrowing would fall to 2.0 per cent of GDP and a balanced budget would be achieved in 2010, i.e. one year ahead of the schedule provided by the baseline scenario.

A significant result of this analysis is that the debt-to-GDP ratio should continue to fall in both alternative scenarios (Figure 2). More specifically, in the high-growth scenario, the debt-to-GDP ratio would go from 105.0 per cent in 2007 to 91.4 per cent in 2011, while in the low-growth scenario, the ratio would descend at a slower pace, getting to 99.1 per cent of GDP in 2011, or 4 percentage points above the level shown by the baseline scenario.

FIGURE 2: SENSITIVITY OF PUBLIC DEBT TO GDP GROWTH (percentage of GDP)



IV.2 SENSITIVITY TO INTEREST RATES AND PROSPECTS FOR THE ITALIAN ECONOMY

This section considers the effects of an increase in the market yield curve on the interest paid on government securities.

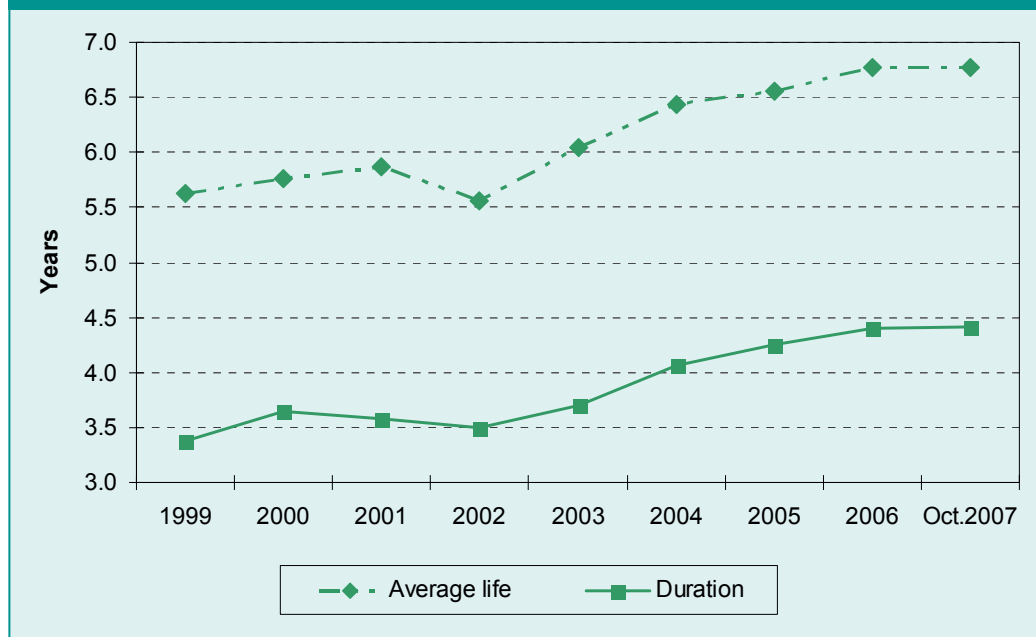
At 31 October 2007, the stock of government securities (which represents about 80 per cent of the general government public debt) had risen in absolute terms by 5.63 per cent compared with the balance at 31 December 2006. The negotiable government



securities consist of domestic securities, i.e. those issued on the domestic market (93.86 per cent), and securities issued on foreign markets, whether denominated in euros or in foreign currency (6.14 per cent). In comparison with the end of 2006, the percentage of the foreign component had fallen slightly (from 6.79 per cent to 6.14 per cent on 31 October 2007), with part of the decrease due to reduced issuing activity as a result of cost conditions that have been relatively worse than those for domestic securities.

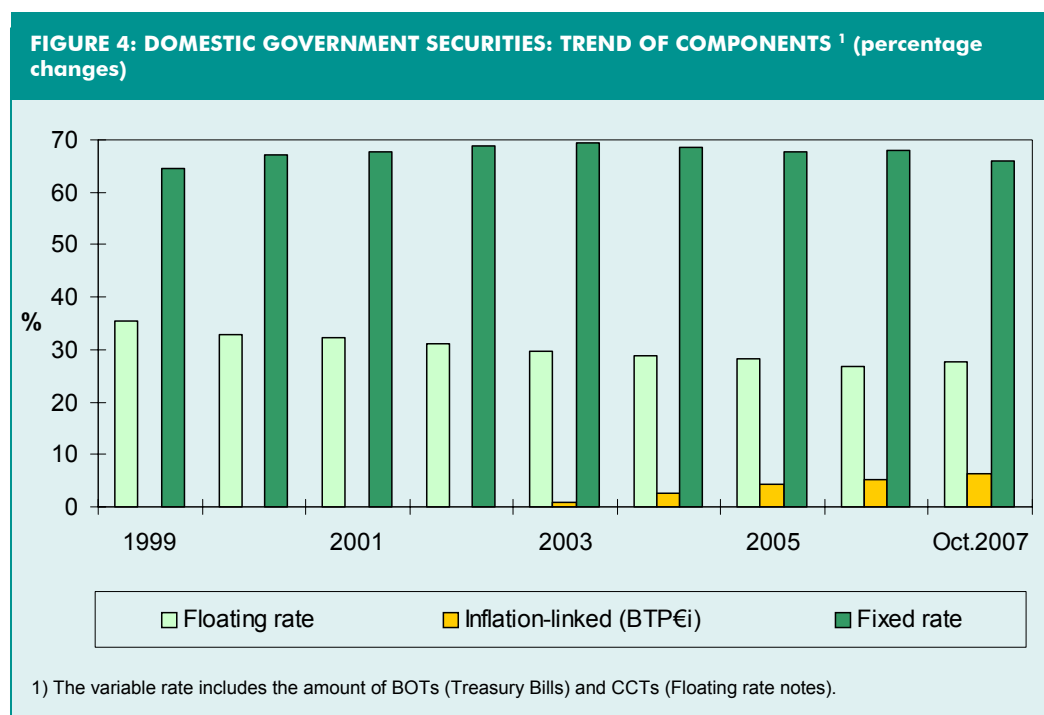
The summary data about the structure of the debt (Figure 3) show that the exposure to refinancing risk and interest rate risk has remained virtually unchanged. Overall, the average life of all government securities at 31 October 2007 was 6.78 years, and was thus very similar to the comparable figure for the end of 2006 (6.77). The financial duration showed a limited increase, going from 4.40 years in December 2006 to 4.41 at the end of October 2007. Consequently, the track record for the first ten months of 2006 can be viewed as a consolidation of the results achieved in 2006. On the other hand, considering the scheduling of the maturities and new issues for the final two months of 2007, it is expected that both the average life and the financial duration of the debt could significantly increase by year end.

FIGURE 3: TREND OF DURATION AND AVERAGE MATURITY FOR GOVERNMENT SECURITIES (percentage changes)





In comparison with 31 December 2006, the fixed rate component of the euro-denominated government securities issued in the domestic market as of 31 October 2007 (Figure 4) was 2.01 percentage points lower (going from 68.03 per cent to 66.02 per cent of the total) and the short-term or variable rate component rose by a slight 0.34 percentage points (going from 26.77 per cent to 27.69 per cent of the total). The component indexed to European inflation rose considerably, going from 5.20 per cent to 6.29 per cent. In any event, it is projected that the fixed rate component at the end of 2007 will be broadly in line with that at the end of 2006.



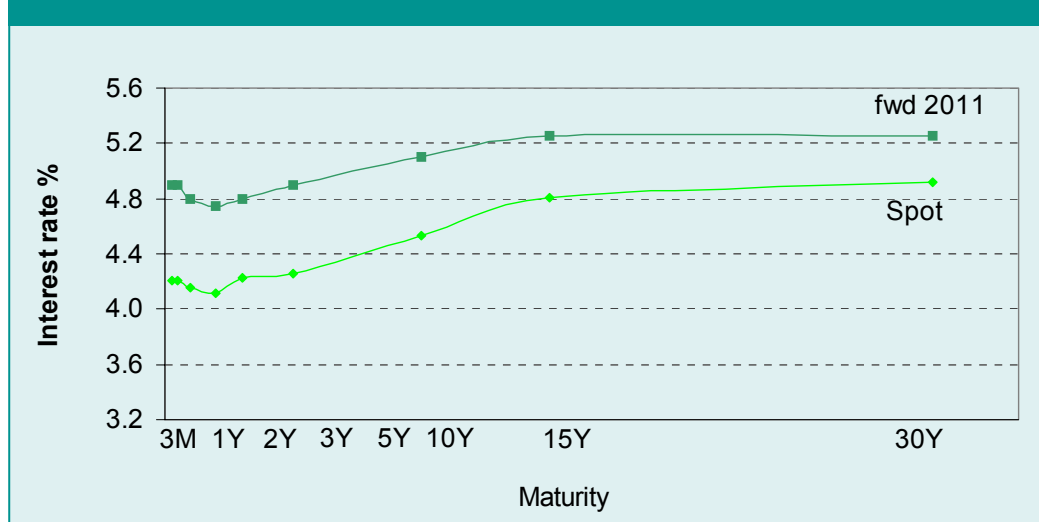
During the first ten months of 2007, the Treasury continued to pursue the issuing policy developed in recent years and aimed at minimising the cost of the debt, while also constantly controlling the refinancing and interest-rate risk. From this perspective, the fixed rate component of the debt, though slightly declining, has basically been kept at a level that is equal to two-thirds of domestic issues. In addition, the issuing policy has focused - as in past years - on longer term instruments: in October, for example, the Treasury floated a new 30-year BTP on the market. At the same time, the consolidation over the medium term of the percentage of securities indexed to inflation has continued via the introduction of new issues with a 15-year maturity so as to cover the entire Italian



yield curve. The percentage of short-term or variable-rate securities has been kept below 30 per cent again in 2007, a year when only a limited amount of variable rate issues comes due.

The estimates of interest expenditure published in the most recent *Forecast and Planning Report* were prepared on the basis of projections of interest rates starting from the rates implicit in the yield curve for Italian government securities for the month of September 2007. Such scenario incorporates a decrease in the level of interest rates in the short term which is consistent with the market's recent expectations about the direction of the European Central Bank's monetary policy after the sub-prime mortgage loan crisis in the United States. The estimates then gradually move back in 2008 toward levels consistent with the macroeconomic framework contemplated prior to the crisis. In essence, a decision was made to incorporate into the projected trend of the yield curve the assumption of a transitory effect of the current crisis on the rate levels, and therefore, not to assume for the entire forecast period the scenario contained in current implicit rates - a scenario highly conditioned by the significant volatility in financial markets at present.

FIGURE 5: PROJECTED GOVERNMENT BOND YIELDS BASED ON CURRENT YIELD CURVE



Considering the current mix of the public debt, the risk of exposure to rate fluctuations is limited (and, to a certain extent, reduced vis-à-vis the past). Indeed, even with the assumption of an instantaneous and permanent 100-basis-point increase in the yield curves used for the estimates, the impact on interest expenditure as a percentage of GDP would be equal to 0.16 per cent in 2008, 0.30 per cent in 2009, 0.37 per cent in



2010, and 0.43 per cent in 2011, while the increase in rates would transfer entirely onto the cost of the debt after roughly 5.59 years (in the last Update to the Stability Programme such figure was equal to 5.56 years).

Compared with the 2006 Update to the Stability Programme, the estimated reduction of sensitivity is affected not only by the positive trend of the debt mix, but also by an improvement in the overall macroeconomic framework. More specifically, the estimate was developed with the assumption of more moderate growth of the debt stock and better nominal growth than in the prior year, consistent with the macroeconomic framework illustrated in this document.

In order to test the soundness of the analysis, the exercise was repeated by considering yield curves with different slopes; such testing generated sensitivity results that are essentially in line with the rate scenario illustrated.



V. QUALITY OF PUBLIC FINANCES

The more favourable trend of public finance resulting from the major fiscal-consolidation effort undertaken with the 2007 Budget has made it possible to present a 2008 Budget dedicated to development and social equity. The 2008 Budget thus contemplates the streamlining and requalification of public spending, the planning and execution of infrastructure investments, and the partial restitution to the public of the resources tapped through the efforts to fight tax evasion¹.

The 2008 Budget mobilises resources of roughly €11 billion for the commitments already signed, the customary obligations and the new initiatives indicated in the *Economic and Financial Planning Document (DPEF)*. Considering the incremental tax revenues of roughly €6 billion expected for 2008 according to the policy scenario, the resources to be tapped for financing the measures amount to roughly €4.7 billion.

While the net effect of the Budget is an increase in net borrowing equal to approximately 0.4 percentage points of GDP, the target net borrowing-to-GDP ratio of 2.2 per cent can nonetheless be confirmed.

From a qualitative standpoint, the mix of the measures will make it possible to keep the tax burden virtually stable at the 2007 level, while also allowing for a slight reduction in the ratio of expenditures to GDP. With reference to total expenditures, the ratio of capital expenditures to GDP is lower for the effect of the Government's decision to spread over the 2007-2008 period several 'potential expenditures' indicated in the DPEF, moving up the expenditures concerning infrastructure investments to 2007.²

V.1 THE 2008 BUDGET

The 2008 Budget aims at strengthening the Government's policy action in favour of better public spending, aimed both at improving the sustainability of public finances and increasing efficiency in the use of resources. Almost all of the resources quantified for financing the budget measures have been obtained through initiatives that will streamline primary public spending within the Public Administration, the National Healthcare System and the Decentralised Entities. Such initiatives involve the containment of (i)

¹ The 2008 budget incorporates the provisions of the 2008 Budget Law and the related Decree Law No. 159/2007, with regard to economic and financial aspects, for development and social equity. Other, related legislative bills are contemplated, including the one for the implementation of the Welfare Protocol signed on 23 July 2007.

² The expenditures were moved up to 2007 as provided by the Decree Law No. 159/2007.



current expenditures of roughly €1.5 billion and (ii) capital expenditures of approximately €3.0 billion. Additional resources of a very modest amount (€0.3 billion) are coming from revenue measures.

The containment of current expenditures is primarily ensured by measures related to the costs for running the state administrations through a reorganisation of the system of public procurements which is projected to yield savings of roughly €0.5 billion. Limits are being introduced on expenditures for the ordinary maintenance of buildings, and reductions are planned in the cost of rentals, with the aggregate containment therefrom pegged at €0.3 billion. The process of streamlining the costs of operating the public administrations entails new efforts to reduce the size of the central, regional and local government systems through the elimination and transformation of certain entities, the reduction of the number of governing bodies of state-controlled companies and the transfer of investments in companies whose activity is outside the scope of public interest. Limits are also being introduced on the use of full-time equivalent personnel, while instruments are being put in place to contain compensation paid to consultants and fees paid to the members of Parliament. Altogether, these measures are expected to produce savings of €0.4 billion.

With reference to capital expenditures, the biggest savings are slated to come from changes in the terms for using previously appropriated, unused amounts. In line with the process of requalifying the State budget, the limit on the use of the amounts previously appropriated and not used is to be reduced from seven to four years, with savings of roughly €1.5 billion. The new four-year term implies a periodic recognition process after which the residual amounts are cancelled if there are no reasons for keeping them in the budget. Additional measures contemplate the introduction of limits on extraordinary maintenance expenses (€0.5 billion) as well as to the use of a few categories of tax credits, including those for making investments in economically depressed areas (€0.4 billion). Similar limits are being placed on social-welfare entities, which will be able to make investments in buildings only indirectly (€0.4 billion).

The budget initiatives aimed at favouring greater social equity and promoting development consist of measures that will decrease revenues by roughly €2.8 billion and spending measures roughly equal to €8.4 billion.



The fiscal measures contemplate the reduction of the tax burden for households and the reform of income taxes for businesses.

A tax relief package equal to roughly €2.5 billion addressed to individuals is designed to reduce the tax burden with respect to the taxpayer's primary dwelling. More specifically, the deduction allowed in computing the real estate tax (ICI) on the taxpayer's primary dwelling is to be increased to a maximum of €200. In addition, starting in 2008, the income produced by the primary dwelling will not be counted as part of the computation of income used for calculating the deductions for dependent family members.

Deductions in proportion to income levels are being introduced in order to rebalance the system of tax relief between owners and renters with officially registered rental contracts³.

In the case of taxpayers with income below the minimum taxable amount for income-tax (IRE) purposes (so-called 'incapienti'), a deduction will be allowed in an amount equal to the portion of the deduction not used.

Additional measures contemplate the introduction of new deductions for the cost of local transport passes and the extension of certain tax benefits for building restructuring and for the requalification of energy systems in buildings.

With reference to the business taxation, the measures cover changes to the system for the computation of the taxes, with a reduction of the nominal tax rates (from 33.0 per cent 27.5 per cent in the case of corporate income taxes (IRES), and from 4.25 per cent to 3.9 per cent for the regional tax on productive activity (IRAP)) and an expansion of the tax base. The restructuring of the taxation system is expected to have virtually no effect on public accounts.

Additional measures are aimed at making the taxation neutral vis-à-vis the different legal forms of businesses, thereby ensuring that some taxpayers exercising business activity will have the option of taxation on income at the same rate used for corporate income taxes (IRES) (27.5 per cent). A streamlined taxation system is being introduced for marginal and minimum taxpayers (sole proprietorships and free-lance professionals meeting specific requisites) (see box).

³ The deductions for taxpayers who are renting their homes amount to €300 for taxpayers with gross income of less than €15,494 per year, and €150 for taxpayers with gross income of less than €30,978. Such deductions rise to €991 and €496, respectively, for young people between the ages of 20 and 30 years old who are renting their homes, with a limit of the first three years of the rental contract.



With regard to current expenditures, the most important measures provide for additional resources of €1.3 billion for the implementation of the Welfare Protocol, with the creation of a special fund to be used for financing measures in relation to pensions, employment and competitiveness. The pension measures establish the terms for qualifying for early retirement pensions, address the eligibility for retirement for workers involved in strenuous work (*lavori usuranti*), and outline the means for the updating of the transformation coefficients⁴(see box).

Resources of €2.2 billion have been earmarked for the labour contracts for public-sector workers that are to be renewed over the 2006-2007 period⁵.

Additional resources are being mobilised to cover measures that address various areas, including: more efficient reorganisation of the primary, secondary and higher education systems, so as to favour higher quality in both teaching and academic research; the planning and implementation of new programmes for the employment of young university graduates; the efforts to prevent social exclusion; and the start-up of a specific programme to prevent violence against women.

The incremental capital expenditures contemplated by the 2008 Budget are a follow-up to the spending increases that were already moved up to 2007 with regard to the planning and completion of infrastructure works. New resources have been earmarked for: improving local public transport services (€0.4 billion); favouring the national intermodal transport system and providing incentives for the use of transportation means that cause less pollution (0.1 billion); and continuing the execution of strategic works, especially in areas hit by earthquakes within the framework of the special legislation therefore.

Additional measures financed through the use of up to €0.8 billion from the fund for employment mainly provide for (i) extending the salary supplement and job-mobility compensation to a larger group of beneficiaries in the event of a corporate crisis, and (ii) granting incentives for the training activity as part of apprenticeship programmes.

⁴ The increase in small pensions provided by the Protocol was implemented pursuant to Law No. 127/2007, which represented the conversion into law of Decree Law No. 81/2007.

⁵ The amounts in relation to the contract renewals are adjusted for the revenue-driven effects (income taxes, additional local taxes, social security contributions and regional tax on productive activity) equal to roughly €1.9 billion in 2008, €0.7 billion in 2009, €0.6 billion in 2010 and €0.6 billion in 2011. Excluding the incremental revenues, the provisions amount to €4.1 billion in 2008, €1.6 billion in 2009, €1.6 billion in 2010 and € 1.6 billion in 2011.

TABLE 10: THE 2008 BUDGET¹

| | 2008 | 2009 | 2010 | 2011 | 2008 | 2009 | 2010 | 2011 |
|---|-----------|--------|--------|--------|-------------|-------|-------|-------|
| | € million | | | | as % of GDP | | | |
| SOURCE OF FUNDS | 4,769 | 5,522 | 5,973 | 5,973 | 0.30 | 0.33 | 0.35 | 0.34 |
| Higher revenues | 262 | 262 | 263 | 263 | 0.02 | 0.02 | 0.02 | 0.01 |
| <i>Reduction of benefits on excise duties</i> | 245 | 245 | 245 | 245 | 0.02 | 0.01 | 0.01 | 0.01 |
| <i>Recovery of illegal State subsidies in the fishery sector</i> | 17 | 17 | 18 | 18 | 0.00 | 0.00 | 0.00 | 0.00 |
| Lower expenditures | 4,507 | 5,260 | 5,710 | 5,710 | 0.28 | 0.32 | 0.33 | 0.32 |
| Lower current expenditure | 1,475 | 1,779 | 2,227 | 2,227 | 0.09 | 0.11 | 0.13 | 0.13 |
| <i>Reduction in costs for public employees</i> | 234 | 282 | 405 | 405 | 0.01 | 0.02 | 0.02 | 0.02 |
| <i>Reorganisation of purchases of goods and services (intermediate consumption)</i> | 500 | 700 | 900 | 900 | 0.03 | 0.04 | 0.05 | 0.05 |
| <i>Rationalisation of ordinary maintenance spending</i> | 150 | 150 | 150 | 150 | 0.01 | 0.01 | 0.01 | 0.01 |
| <i>Reduction of rentals of buildings used by central administration</i> | 140 | 80 | 70 | 70 | 0.01 | 0.00 | 0.00 | 0.00 |
| <i>Other²</i> | 451 | 567 | 702 | 702 | 0.03 | 0.03 | 0.04 | 0.04 |
| Lower capital expenditure | 3,032 | 3,481 | 3,483 | 3,483 | 0.19 | 0.21 | 0.20 | 0.20 |
| <i>Reduction of terms for utilisation for expenditure arrears (committed but not disbursed balance items)</i> | 1,530 | 1,340 | 1,310 | 1,310 | 0.10 | 0.08 | 0.08 | 0.07 |
| <i>Limits on the utilisation of tax credit for employment and investments</i> | 100 | 700 | 700 | 700 | 0.01 | 0.04 | 0.04 | 0.04 |
| <i>Limits on the utilisation of IRE tax credit</i> | 323 | 323 | 323 | 323 | 0.02 | 0.02 | 0.02 | 0.02 |
| <i>Limits on social security fund's expenditure for investments</i> | 400 | 420 | 440 | 440 | 0.02 | 0.03 | 0.03 | 0.02 |
| <i>Rationalisation of extraordinary maintenance spending</i> | 450 | 465 | 475 | 475 | 0.03 | 0.03 | 0.03 | 0.03 |
| <i>Other</i> | 229 | 233 | 235 | 235 | 0.01 | 0.01 | 0.01 | 0.01 |
| USE OF FUNDS | 11,247 | 10,491 | 11,448 | 11,406 | 0.70 | 0.63 | 0.67 | 0.64 |
| Lower revenues | 2,848 | 4,280 | 3,275 | 3,287 | 0.18 | 0.26 | 0.19 | 0.19 |
| <i>Municipal property tax (ICI) relief for housing</i> | 823 | 823 | 823 | 823 | 0.05 | 0.05 | 0.05 | 0.05 |
| <i>Personal income tax (IRE) relief for home rentals</i> | 1,302 | 960 | 1,069 | 1,069 | 0.08 | 0.06 | 0.06 | 0.06 |
| <i>IRE deduction for housing income</i> | 388 | 213 | 213 | 213 | 0.02 | 0.01 | 0.01 | 0.01 |
| <i>Tax reform for residual taxpayers</i> | 207 | 376 | 165 | 165 | 0.01 | 0.02 | 0.01 | 0.01 |
| <i>Limits on tax credit's compensation for self-employed workers and small businesses</i> | 93 | 124 | 32 | -20 | 0.01 | 0.01 | 0.00 | 0.00 |
| <i>IRES reform</i> | -1,034 | 1,021 | 40 | 40 | -0.06 | 0.06 | 0.00 | 0.00 |
| <i>Other</i> | 1,069 | 763 | 933 | 997 | 0.07 | 0.05 | 0.05 | 0.06 |
| Higher expenditure | 8,399 | 6,212 | 8,173 | 8,119 | 0.52 | 0.37 | 0.48 | 0.46 |
| Higher current expenditure | 6,248 | 4,787 | 6,233 | 6,229 | 0.39 | 0.29 | 0.36 | 0.35 |
| <i>Financing of the Welfare Protocol</i> | 1,278 | 1,231 | 2,752 | 2,752 | 0.08 | 0.07 | 0.16 | 0.15 |
| <i>Costs for public employees (net value of revenue-driven effects)</i> | 2,203 | 907 | 1,011 | 1,011 | 0.14 | 0.05 | 0.06 | 0.06 |
| <i>University: increasing ordinary funding</i> | 78 | 311 | 311 | 311 | 0.00 | 0.02 | 0.02 | 0.02 |
| <i>Internal Stability Pact's modification</i> | 190 | 120 | -162 | -162 | 0.01 | 0.01 | -0.01 | -0.01 |
| <i>Reorganisation and functioning funds</i> | 379 | 64 | 52 | 52 | 0.02 | 0.00 | 0.00 | 0.00 |
| <i>Justice expenditure (exceeding amount art.11 c.3 i-quater)</i> | 200 | 200 | 200 | 200 | 0.01 | 0.01 | 0.01 | 0.01 |
| <i>Reformulation of Budget Law tables</i> | 1,065 | 1,312 | 1,505 | 1,498 | 0.07 | 0.08 | 0.09 | 0.08 |
| <i>Other</i> | 855 | 642 | 564 | 567 | 0.05 | 0.04 | 0.03 | 0.03 |
| Higher capital expenditure | 2,151 | 1,425 | 1,940 | 1,890 | 0.13 | 0.09 | 0.11 | 0.11 |
| <i>Employment fund</i> | 800 | | | | 0.05 | | | |
| <i>Local public transportation</i> | 350 | 100 | 50 | | 0.02 | 0.01 | 0.00 | |
| <i>Improvement of national transportation system</i> | 137 | 144 | 144 | 144 | 0.01 | 0.01 | 0.01 | 0.01 |
| <i>Special-purpose law ("Legge Obiettivo")</i> | 50 | 200 | 400 | 400 | 0.00 | 0.01 | 0.02 | 0.02 |
| <i>Increasing tax credit for R&D investments</i> | 117 | 150 | 157 | 157 | 0.01 | 0.01 | 0.01 | 0.01 |
| <i>Development of wideband and digital system</i> | 40 | 20 | 10 | 10 | 0.00 | 0.00 | 0.00 | 0.00 |
| <i>Occupational safety and health</i> | 20 | 40 | 50 | 50 | 0.00 | 0.00 | 0.00 | 0.00 |
| <i>Cancellation of developing countries' debt</i> | 40 | 50 | 50 | 50 | 0.00 | 0.00 | 0.00 | 0.00 |
| <i>Reformulation of Budget Law tables</i> | 414 | 448 | 766 | 766 | 0.03 | 0.03 | 0.04 | 0.04 |
| <i>Other</i> | 183 | 273 | 313 | 313 | 0.01 | 0.02 | 0.02 | 0.02 |
| Net impact on primari surplus | -6,478 | -4,970 | -5,476 | -5,433 | -0.40 | -0.30 | -0.32 | -0.31 |

1) The table describes budget measures as presented by the Government. The approval by one of two Houses did not modify budget balances.

2) Includes revenues reallocation, ex art.79 of Budget Law, equal to €300 million.



2008 BUDGET LAW: PROVISIONS TO SIMPLIFY CORPORATE TAXATION SYSTEM

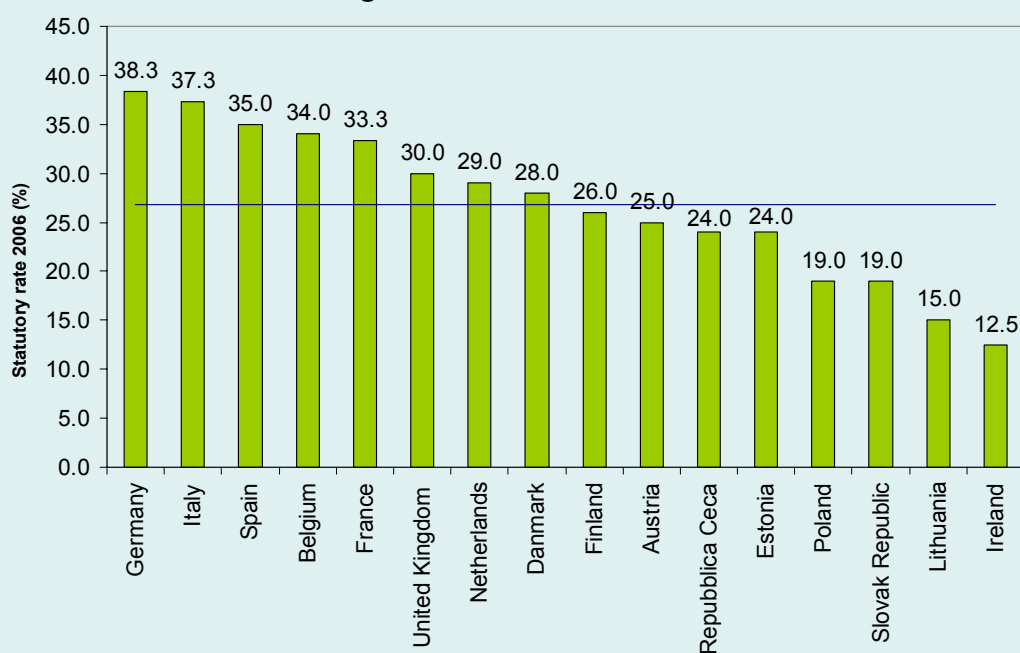
The 2008 Budget Law provides for the extensive restructuring of the system of taxing businesses, with changes that will impact both businesses subject to corporate income taxes (IRES) and smaller businesses. The restructuring is aimed at making taxpayer compliance easier, reducing tax rates and, in some cases, expanding the tax base.

In the case of businesses subject to corporate income taxes (IRES), the measures to streamline the taxation system are designed to simplify compliance, to reduce the rate of taxation, and to expand the tax base, thereby keeping the state's revenue at the same level if the conduct of businesses is held constant. Changes are also being made to the regional tax on business activity (IRAP), with a planned reduction of the tax rate and the tax being applied in a more straightforward manner (i.e. with taxable income being aligned completely with the values used for financial reporting rather than those used for tax reporting).

The IRES rate is set to fall by 5.5 percentage points, going from 33 per cent to 27.5 per cent, and the ordinary IRAP rate by 0.35 percentage points, from 4.25 per cent to 3.9 per cent. The 'legal tax rate' on business income thus moves closer to the average for European countries.

Such reductions, together with efforts to make taxpayer compliance easier, are viewed as a potentially important factor in sustaining economic growth and favouring new foreign investment.

Taxation of businesses – 'Legal tax rates' in EU-15 countries



Source: KPMG, Corporate Tax Rate Survey (2006).



A streamlined taxation system is to be introduced for small businesses which have revenues of less than €30,000, no full-time employees and limited investment in capital goods. Such system will exclude the application of value-added taxes, IRAP, income taxes, and the sector-study practice, and provides for a reduction of accounting obligations. These small businesses will then be taxed through a lump-sum substitute tax on income, at a rate of 20 per cent.

The reduction of the tax rates is offset by an expansion of the tax base. In the case of corporate income taxes (IRES), there are two main measures planned: a limitation on the deductibility of interest expense from business income and the elimination of the fiscal rules on early and accelerated depreciation. In addition, limits are to be introduced with regard to the potential for using tax credits each year.

One major step toward simplifying the taxpayer's obligations is the abolition of the complicated rules for computing non-deductible interest expense with the 'thin-capitalisation' mechanism, as well as with the pro-rata capital method and pro-rata earnings method.

The new rules for computing interest expense are basically in line with similar measures either adopted or about to be adopted in other European countries (Germany, Denmark and the United Kingdom) and provide for the partial carryover of the deductibility of interest expense (net of interest income) to the subsequent year. In Italy's case, the interest expense deductible each year can equal up to 30 per cent of gross operating profit. The remaining interest expense, if any, can be deducted in the five tax periods thereafter. For the first three years when the new rules are in effect, the carryover is allowed for up to ten years.

The new rules for depreciation align the values for tax reporting with the values for financial reporting, eliminating any deductions for amounts not included for financial-reporting purposes. Such rules accordingly eliminate both the possibility of the amount of depreciation charges exceeding the corresponding economic value, and the possibility of businesses deferring the tax charges over time. A similar change has been made for other amounts (writedowns and provisions) that were not computed for financial-reporting purposes and could previously be deducted for tax purposes.

Finally, the use of tax credits has been delayed through an annual limitation thereon of €250,000. Any part exceeding this ceiling may be used in later years and is available for offset for the entire residual amount thereof, starting from the third year after the year in which the excess was generated⁶.

The reduction of the IRAP rate is part of a redefinition of the tax base, which can be taken directly from the profit and loss statement, without making the corrections provided for business income. Other important measures regard the simplification of tax reporting obligations. More precisely, the 2008 Budget calls for the introduction of a new system of substitute taxes for corporate restructurings, while the treatment of entertainment expenses is to be simplified by means of an exact indication of the expenditures allowed.

⁶ There are specific types of expenses excluded from the limitation, including expenses for research and innovation and the incentives provided for investments in businesses located in depressed regions.



THE WELFARE PROTOCOL OF 23 JULY 2007 AND THE RELATED IMPLEMENTATION

The Protocol signed between the Government and the labour unions on 23 July 2007 addresses six major themes: the pension system, social safety nets, the labour market, competitiveness, young people and women. Some measures contained in the Protocol have already been translated into law⁷, whereas other measures are to be financed and implemented within the framework of a special legislative bill that was approved by the Italian Cabinet on 17 October and is to be presented to Parliament together with the 2008 Budget Law.

Pension system

The Protocol delineates the following: an increase in small-sized pensions; the terms for qualifying for early retirement pensions; pension eligibility in the case of strenuous work; and the means for the updating of the transformation coefficients.

- *Small-sized pensions⁸. The Protocol provides that pensioners aged 64 or older whose income is less than 1.5 times the minimum pension (€8,504 for the year of 2007) will receive an additional pension payment equal to €420 in 2008 (€327 in 2007), that will be reduced (increased) by 20 per cent if the pensioner has paid social security contributions for less (more) than 15 (25) years. In the case of pensioners who were self-employed, the 15 (25) year limits become 18 (28) years. Starting in 2008, welfare pensions will also be increased through the mechanism of social add-ons. The system for adjusting pensions to the trend of inflation will also be changes to the benefit of certain pensioners: in the case of pension payments that range from three to five times' the amount of the minimum, the percentage of the adjustment to the inflation rate will be moved up from 90 to 100.*
- *Minimum requisites to qualify for early retirement pensions. From 1 January 2008 to 30 June 2009, workers who have made social security contributions for 35 years and who are 58 years of age (59 if the worker is self-employed) will be eligible for early retirement pensions; the age established compares with the 60 years of age (61 for self-employed workers) defined by prevailing law⁹. In the years thereafter, the requisites for qualifying for early pensions gradually become stricter. By 2013, the minimum age is 61 years (62 years for self-employed workers) who have made social security contributions for at least 36 years, and the minimum age is 62 years (63 years for self-employed workers), who have made social security contributions for at least 35 years.*

⁷ Law No. 127/2007, which represents the conversion of Decree Law No. 81/2007 into law.

⁸ The provisions related to increase the small-sized pensions are being implemented pursuant to Law No. 127/2007, which represents the conversion, with amendments, of Decree Law No. 81/2007 into law.

⁹ See Law No. 243/2004.



- *Exceptions for strenuous work¹⁰. The Protocol provides that workers engaged in strenuous work may take early retirement in advance of the age set by the new requisites for early retirement (with a reduction of up to a maximum of three years, and in any event, not before the age of 57 years old). Within the framework of the resources planned, the Protocol establishes that a maximum of 5,000 workers can qualify each year for retirement under this provision.*
- *Recomputation of the transformation coefficients. A commission will be set up for the purpose of defining proposed changes to the criteria for the calculation of the transformation coefficients on or before 31 December 2008; the changes will need to take into account: (i) macroeconomic, demographic and migratory trends; (ii) the ratio of various forms of temporary workers to total employed, with the scope of protecting the smaller-sized pensions and proposing solidarity measures; and (iii) the ratio between the average life expectancy and life expectancy in the individual sectors of activity. The commission may also propose active policies that will be able to facilitate the achievement of a substitution rate (net of taxation) of no less than 60 per cent, with reference to full-time workers. In any event, the changes proposed must safeguard the trends and balances of pension spending over the long term, according to EU evaluation methods. As of 2010, it is expected that the recomputation of the transformation coefficients will take place according to the procedure indicated in the current legislation¹¹. Thereafter it will take place every three years (rather than every ten years) through simplified administrative procedures, thereby providing greater certainty - that the necessary adjustments are made within the deadline.*
- *Additional measures. The inflation indexing of pensions exceeding eight times' the minimum will be suspended in 2008 only. The criteria for qualifying for early retirement will also be revised for a limited period in the case of individuals who have made social security contributions of 40 years, and new criteria will be introduced during the same period for individuals qualifying for old age pensions.*

Social safety nets

Increases are planned in both the amount and term of compensation for ordinary, non-farm unemployment, while unemployment compensation in the farming sector is also to be revised¹². In particular:

- *in the case of non-farm unemployment, the following measures are provided: i) the extension of the maximum term to 8 months for individuals under 50 years old and to 12 months for*

¹⁰ Workers engaged in strenuous work are those identified as such by the decree of the Minister of Labour issued on 19 May 1999, namely, night-shift workers, employees on assembly lines, the drivers of heavy public transport means, selected also by virtue of the period of time actually spent doing such jobs.

¹¹ Law No. 335/95, article 1 paragraph 6.

¹² An enabling act is also planned for the gradual reform of the social security nets, and will be implemented within 12 months of the date of approval of the legislative bill.



individuals aged 50 and over¹³; ii) increases in the amount of unemployment benefits to: 60 per cent of pre-unemployment wages for the first six months of unemployment; 50 per cent for the seventh and eighth months; and 40 per cent for the period thereafter¹⁴; iii) the payment of a notional contribution for the entire period during which unemployment benefits are received, within the limit of the terms provided by the law¹⁵; and iv) in the case of unemployment benefits with reduced requisites, increases in the amount of unemployment benefits to 35 per cent of pre-unemployment wage for the first 120 days of unemployment and 40 per cent for the period thereafter¹⁶;

- *in the case of farm employment, the provisions require the various types of compensation to be aligned so that unemployment benefits are equal to 40 per cent of the pre-unemployment wage and enhancements to protect the notional contribution.*

Labour market

The following measures are provided: i) an enabling act for reorganising employment services and for employment and apprenticeship incentives, to be implemented within 12 months from the date of approval of the legislative bill; ii) amendments and supplements to the laws governing fixed-term contract employment, with the imposition of time limitations on subsequent fixed-term contracts with the same worker; iii) changes to the regulations governing part-time labour in relation to the execution of flex-time provisions; and iv) the abolition of jobs on call.

Competitiveness

A three-year fund is to be created for financing contribution relief and providing incentives for second-tier labour agreements. A series of tax abatement measures is also planned for 2008 in favour of part of the resources negotiated for performance bonuses. Social contributions currently required for overtime are also to be abolished as part of an effort to reduce labour costs and support competitiveness.

Young people

The Protocol calls for an increase in the rates for social security contributions and the computation rates for workers who are registered in the separately managed accounts with the Social Security Administration (INPS) (the increase is equal to three percentage points for individuals who are not signed up for any other types of retirement plans). The Protocol also provides for enhancements to protect the summing-up of insurance periods and the pension contributions related to periods of study at university (so-called 'riscatti', with the lengthening of the period for the amortisation and the possibility for the parents to obtain a tax deduction of the charge for the contributions, should

¹³ Prevailing laws and regulations put the terms at 7 and 10 months, respectively.

¹⁴ Prevailing laws and regulations put the amount at 50 per cent for the first six months, 40 per cent for the next three months and 30 per cent for the other months thereafter.

¹⁵ Prevailing laws and regulations provide for the payment of the notional contribution within the limit of six months for persons under 50 years old and nine months for individuals aged 50 or over.

¹⁶ Prevailing laws and regulations put the amount at 30 per cent for the entire period.



the young person not be employed). Measures are also planned as income and employment supports that will make it possible for young people under age 25 (or university graduates under age 29) to access credit in the event of an interruption in their employment; such measures entail the creation of revolving funds whose initial financing has been set at €150 million for the year of 2008. Finally, support is planned in favour of young university researchers.

Women

There are plans for an enabling act that will restructure the laws and regulations regarding the employment of women; the act is to be implemented within 12 months from the date of approval of the legislative bill.

V.2 BUDGET IMPLICATIONS OF STRUCTURAL MEASURES INCLUDED IN THE 2006-2008 NATIONAL REFORM PROGRAMME

The 2007 and 2008 Budget Laws have identified the resources for the pursuit of the Lisbon Strategy objectives¹⁷ outlined in the 2006-2008 *National Reform Programme* (NRP) and for the implementation of the Welfare Protocol¹⁸ signed on 23 July 2007.

The Second Report on the state of implementation of the NRP also responds to the recommendations made to Italy by the EU Council at the suggestion of the EU Commission (fiscal consolidation, competition in the market for goods, employment and education) and the points to watch (research and development, sustainability of healthcare spending, sustainable use of resources, infrastructures, analysis of the impact of regulation).

The financial commitment for the achievement of the NRP initiatives is estimated at €63.524 billion (in terms of amounts set aside as of 2008).

¹⁷ Promotion of economic development, employment growth, reduction of regional divides and lessening of social exclusion.

¹⁸ Transposed in the parliamentary bill AC 3178.

**TABLE 11: 2006-2008 NRP PRIORITIES**

| | No. of measures | Funds Allocated to 2008 (€ million) |
|---|-----------------|-------------------------------------|
| Extending the area of free choice | 40 | 2,508 |
| Research and technological innovation | 61 | 10,545 |
| Increasing employment, strengthening social inclusion, reducing disparities | 75 | 14,915 |
| Upgrading infrastructure | 18 | 34,633 |
| Protecting the environment | 20 | 923 |
| Long-term fiscal sustainability | 3 | 0 |
| Total for Lisbon priorities | 217 | 63,524 |

Source: Second Implementation Report of 'National Reform Programme', 23 October 2007.

The national priority of 'extending the area of free choice for citizens and businesses' implies: legislative improvement; the modernisation of the public administration; more rapid ratification of EU law; and deregulation.

An Action Plan for Simplification (PAS) approved in June 2007 provides significant leeway for consultation with local entities and the regions, and for vesting responsibility with these administrations. Business may also present a single declaration for all of their administrative compliance.

With reference to the effort to modernise the public administration, a ministerial directive was adopted in 2007 requiring the automation of public offices, so as to obtain full inter-operability between them. The conclusion of the renewal of the national collective bargaining agreement for public-sector workers and the conversion of some fixed-term contract into open-ended contracts are other developments that should make a further contribution to achieving the objective.

As far as deregulation is concerned¹⁹, the measures undertaken have been aimed at eliminating restrictions on competition and at reinforcing the powers of the antitrust authority and of industry regulators.

With regard to research and development, the 2007 Budget increased the 'Fund for Investments in Scientific and Technological Research' (FIRST)²⁰ by €300 million for each of the years of 2007 and 2008 and by €360 million for the year of 2009. The 2007 Budget also provides for an extraordinary programme to hire researchers at universities and public research entities, with the creation of 1,600 and 600 new jobs, respectively; the

¹⁹ The passage of Law No. 40/2007 continues the effort undertaken with Law No. 248/2006. Parliament is currently reviewing various other measures, including initiatives to improve the competition in fuel distribution and a programme to reduce the administrative charges for the opening of new productive plants.

²⁰ The Ministry of Education, University and Research is currently defining the means for the use of the fund's resources.



programme will be funded with €20 million in 2007, €40 million in 2008 and €80 million starting in 2009.

As part of the drive to build up infrastructures, the National Operating Plan (PON) 'Networks and Mobility' is contributing significantly to the implementation of the Lisbon Strategy with resources equal to €2,216.2 million, or 81 per cent of the financing available.

With reference to sustainable development, Italy has financed research projects in relation to energy efficiency and the use of renewable sources. The restructuring of environmental regulations, the introduction of environmental accounting in the public budget, the environmental management systems within small and medium-sized businesses, urban mobility plans and 'green' tenders are all expected to provide further momentum.

Regional policy is contributing significantly to the achievement of the Lisbon objectives, and in particular, the creation of Structural Funds (FS) and the Fund for Under-utilised Areas (FAS). The projected expenditures for the investment programmes for 2007-2008 (Table 12) total €19,720 million, compared with total capital expenditures of €36,500 million.

TABLE 12: REGIONAL POLICY RESOURCES 2006-2008: ESTIMATES EXPENDITURES BY PRIORITIES

| Priorities | Estimated Expenditure | |
|--|-----------------------|--------------|
| | (€ million) | (% of total) |
| Extending the area of free choice | 684 | 3.5 |
| Research and technological innovation | 2,052 | 10.4 |
| Increasing education, enhancing human capital ¹ | 2,533 | 12.8 |
| Tangible and intangible infrastructures | 6,009 | 30.5 |
| Environmental protection | 4,045 | 20.5 |
| Increasing employment, reducing disparities | 4,397 | 22.3 |
| Total for Lisbon priorities | 19,720 | 100.0 |

Source: 'Quadro Finanziario Unico' (QFU), *Economic and Financial Planning Document 2008-2011* and estimates from data on Structural and Under-utilised Areas Funds monitoring.

1) Amount includes training expenditures, mostly recorded as current expenditures and thus not included in the 'Quadro Finanziario Unico' (QFU).

The unitary planning of the additional EU and national resources (€123 billion) contained in the National Strategic Framework (QSN) for the 2007-2013 period and in the related operational programmes has the effect of uniting the policy for social cohesion with the Lisbon Strategy objectives in all ten priority areas. In particular, it emphasises the measures for research and human capital, and the initiatives for sustainable development and for the sourcing of energy. In addition, significant 'Service Objectives' have been identified both for changing the quality of life in Southern Italy and for the integration of



central and regional policy so as to remove the ongoing difficulty in the supply of public services in essential areas (e.g. childcare, education, health care, and the waste management and water service envisioned by the National Strategic Framework (QSN)).

V.3 FISCAL RULES

Parliament's passage of the 2007 Finance Law served as an occasion for reviving the intense political-technical debate about the guidelines for reforming budget tools and procedures. The reform initiatives promoted by the Ministry of the Economy and Finance in consultation with all of the other ministries affected and with the involvement of various institutions (including the International Monetary Fund²¹) have led to the restructuring of the budget, which is now drawn up based on the identification of 'Missions' and 'Programmes' (see box).

The reform of the classification system for the State budget (which goes into effect with the budgeting session for 2008) is aimed at achieving greater transparency of the public accounts and more flexible, results-oriented public-budget management that will make it possible to adopt appropriate spending policies and procedures for the sustainability of Italy's public finances.

In the current scenario, there are two fiscal rules that are particularly significant. Already presented in the previous Update to the Stability Programme, the rules aim to make local budget policy consistent with the general objectives set out in the DPEF and the Finance Law. The first rule (which is permanent) is designed to prevent the local administrations from incurring debt for any reason other than for the financing of investments²². The second rule (known as the 'Internal Stability Pact') consists of a series of criteria for defining specific financial targets that the local entities must meet, together with a system for sanctioning any defaulting entities. The pact is to be reviewed annually at the time of the preparation of the Finance Law.

The 2007 Finance Law identified the budget balance as the key parameter, albeit with the application thereof being phased in over time for the different entities²³. The 2008 Finance Law has taken the process one step further by formulating the fiscal rules that have the broadest application and are the most indicative of the fiscal autonomy

²¹ In March 2007, the Fund carried out a technical mission in Italy, after which it prepared a conclusive report (available on the Internet site: www.mef.gov.it).

²² This rule limits local decision-making autonomy since it does not allow the use of debt for financing operating activity and it is consistent with the central Government's full exercise of the coordination and control functions with respect to all public finance matters, and thus, through the central Government's definition of additional limitations on local autonomy.

²³ The changeover to the balance as the target is an experiment for the regions, considering the presence of specific provisions for controlling the financial balances within the healthcare sector.



granted to local entities. For the first time, the revision of the Internal Stability Pact was preceded by a specific agreement between the government and local entities.

For the regions, the objective remains the same for 2008, i.e. limiting the trend of spending, net of spending on healthcare. An experimental project got under way in October 2007 with regard to the application of the new rule referring to the budget balance. There are 11 regions participating in the project, with the aim of integrating the rules indicated in the Healthcare Pact into the Internal Stability Pact.

For the municipalities and provinces, the 2008 parameter of reference will once again be the budget balance. The average financial balance for the 2003-2005 three-year period remains the policy objective; this framework is designed to give the entities stability and the possibility of planning over the medium term. Several changes to the accounting criteria have been introduced for the purpose of computing the target balance to be used for determining compliance with the Pact. More specifically, a mixed cash/accrual criterion is to be used whereby the entries to the current accounts will be based on accrued amounts while entries to the capital accounts will be based on cash flows. The new criterion will facilitate the use of expenditure arrears for financing capital spending and will bring the reference balance closer to that to be calculated *ex post* for the purpose of the excessive deficit procedure²⁴. Consistent with the new accounting criteria, a new system for data procurement is to be created that will make it possible a more complete analysis of the local finance trends; the new system will operate alongside the information system tracking the cash flows for transactions carried out by public entities (SIOPE). As a final element to the rules, a more stringent enforcement mechanism has been introduced for both addressing the situations where targets are not met and increasing the accountability of the entities.

THE NEW STATE BUDGET: THE OBJECTIVES AND TIMING OF THE REFORM

In addressing the need to hold down the tax burden while simultaneously increasing the quality of public spending, the Government has inaugurated a programme that is designed to improve the planning and management of public spending over a period of several years. The programme's first initiative was the reclassification of the State budget.

The budget has three main functions: it is an instrument for representing public resources available (information function); it is an instrument for the policy decision (allocation function) and it is an instrument for managing the resources allocated (executive function). The reclassification is aimed at improving all three functions, with the changeover from a structure based on various administrations

²⁴ The Decree Law No. 159/2007, linked to the 2008 Budget Law, contains provisions for annual contributions to give local entities incentives for using surpluses for the prepayment of mortgages and bonds.



(i.e. the people who manage the resources) to a structure based on functions (i.e. what is done with the resources).

The budget is divided into 34 missions – some of which are shared by two or more ministries – which represent the main objectives pursued by the public administration. The table below summarises the 2008 State budget which consists of 34 missions. The table shows each mission's percentage of the total budget, and changes occurring between 2007 and 2008 on the basis of laws already in existence. It is significant to note that the Finance Law generally does not 'drive' more than 2 per cent of the budget (the 2008 Finance Law, for example, covers provisions of roughly €11 billion against a total budget of roughly €460 billion, net of tax reimbursements and the public debt).

Each mission is accomplished through one or more spending programmes (total of 168). The programmes represent standard aggregates of activity within each ministry, and cannot be subdivided among two or more administrations. The programme constitutes the pivotal aspect of the new classification proposed since it has a sufficiently detailed level of aggregation that makes it possible to select the more appropriate use of the resources between alternatives, providing leeway for greater operating flexibility in the future.

The greater transparency of the budget facilitates decision-making by the Government and Parliament, making it possible to evaluate more appropriately the adequacy of the distribution of the resources already allocated with existing laws. The Finance Law then adopts a similar structure (missions and programmes) so as to identify the changes (positive or negative) in resources proposed for each individual programme vis-à-vis the resources already available for the same purposes.

The new structure is intended to move beyond the purely 'incremental' approach to budgeting, i.e. when the efforts focus only on new measures and demands for additional resources, while the policies in effect (which represent the bulk of public spending) are overlooked and left unchanged.

With its reorganisation along the lines of missions and programmes, the budget now also facilitates results-oriented management of resources. The medium-term objective is to shift from a control system focused on inputs and formal compliance with laws (i.e. detailed tracking of the resources assigned to each expense centre) to a system focused on the results achieved (outcomes) by each programme in relation to the objectives set and the resources allocated. In a system of this sort, the administrations have more flexibility with regard to the use of resources, while they are also made more accountable for their actions.

Finally, as a result the reform of the budget process, the expenditure sustained for each programme within the State budget can be analysed and revised on a periodic basis. In 2007, a technical commission within the Ministry of the Economy and Finance initiated a spending review with respect to five ministries. This spending-review process will be gradually expanded to encompass the entire central administration so as to identify efficiency gains, eliminate initiatives no longer deemed a priority, and allocate the resources for more strategic purposes.



| STATE BUDGET BY MISSIONS | | 2008 € million | % of total | Change vs. 2007 |
|--------------------------|---|-------------------|------------|--------------------|
| 1 | Financial relationships with local government | 100,023 | 22.1 | 1,608 |
| 2 | Public debt ¹ | 78,226 | 17.3 | 3,203 |
| 3 | Pensions | 66,903 | 14.8 | 1,574 |
| 4 | Education | 41,609 | 9.2 | 228 |
| 5 | Italy in Europe and the world | 24,048 | 5.3 | -580 |
| 6 | Welfare rights, welfare solidarity and family | 24,046 | 5.3 | -132 |
| 7 | National defence and security | 19,172 | 4.2 | -1,557 |
| 8 | Funds to be allocated | 17,286 | 3.8 | -3,074 |
| 9 | Law, order and public security | 9,422 | 2.1 | -129 |
| 10 | Economic, financial and budgetary policies ² | 8,875 | 2.0 | 159 |
| 11 | University education | 8,168 | 1.8 | -216 |
| 12 | Right to mobility | 7,960 | 1.8 | -1,222 |
| 13 | Justice | 7,275 | 1.6 | -354 |
| 14 | Competitiveness and business development | 5,574 | 1.2 | 1,769 |
| 15 | Development and reduction of regional disparities | 4,545 | 1.0 | 124 |
| 16 | Research and innovation | 3,968 | 0.9 | 86 |
| 17 | Infrastructures and logistics | 3,778 | 0.8 | -24 |
| 18 | Civil aid | 3,710 | 0.8 | 184 |
| 19 | Constitutional bodies, other bodies with constitutional relevance, and Presidency of the Council of Ministers | 3,233 | 0.7 | 88 |
| 20 | General and institutional services of public administration | 2,920 | 0.6 | -164 |
| 21 | Employment policies | 2,701 | 0.6 | -432 |
| 22 | Immigration | 1,427 | 0.3 | 71 |
| 23 | Protection of cultural heritage and natural landscape | 1,380 | 0.3 | -91 |
| 24 | Agriculture, food and farming policies and fishery | 1,255 | 0.3 | -19 |
| 25 | Housing and urban organisation | 1,060 | 0.2 | -8 |
| 26 | Youths and sport | 902 | 0.2 | -72 |
| 27 | Communications | 896 | 0.2 | -516 |
| 28 | Healthcare | 702 | 0.2 | -18 |
| 29 | General administration and backing to the general representation of Government and State over the country | 353 | 0.1 | 13 |
| 30 | International trade and policies to assist Italian businesses with international expansion | 234 | 0.1 | -1 |
| 31 | Tourism | 113 | 0.0 | -6 |
| 32 | Sustainable development and environmental protection | 1,017 | 0.2 | 0 |
| 33 | Energy and diversification of energy sources | 59 | 0.0 | -43 |
| 34 | Market regulation | 16 | 0.0 | -18 |
| Total | | 452,856 | | 431 |

1) Net of State debt's repayments

2) Net of account regulation tax repayments and reimbursements.





VI. SUSTAINABILITY OF PUBLIC FINANCES

This chapter analyses the long-term trend of those components of public expenditure that are most closely linked to demographic trends and their implications on the public debt. Among other things, the analysis is aimed at meeting the requirements of the new Stability and Growth Pact (SGP), which focuses on safeguarding the sustainability of public finances in Europe. It is believed that the objective of sustainable public finances over the long run is crucial for the purposes of a prudent interpretation of the SGP's requirements.

All of the latest demographic projections tend to come to the same conclusion, namely that factors such as lower birth rates and extended life expectancy will significantly alter the demographic structure of the population in Europe in coming decades, with non-negligible consequences on both public finance and the socio-economic framework. Such consequences include a drastic reduction in the working-age population. Against this backdrop, Italy is the country reporting the highest rate of ageing of the population¹ and is among the group of countries reporting a growth rate of more than 30 per cent over time² in the old age dependency ratio. Despite these dynamics, the expected trend of age-related expenditures instead appears to be rather encouraging.

The Italian Government has developed a composite strategy for responding to the challenges posed by an ageing population in the years ahead. One of the core objectives of this strategy is to guarantee that the public finances will be sustainable over the long run, as demonstrated by the scenarios set out in the pages that follow.

VI.1 THE IMPACT OF THE AGEING OF THE POPULATION ON PUBLIC EXPENDITURE

As required by the new Code of Conduct for the preparation of stability programmes, this report sets out below the projections of public expenditure for pensions, healthcare, assistance to the elderly, education and unemployment compensation in relation to GDP, for the 2005-2050 period, as well as details about key

¹ The benefits relative old age dependency ratio was 28 per cent in 2003 (the highest rate among the EU-25) and was projected to grow to 62 per cent in 2050. Source: Ageing Working Group projections, contained in the Special Report No 1/2006 *'The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long term care, education and unemployment transfers (2004-2050)'*.

² Over the 2003-2050 period. Source: data provided by EPC and the European Commission.



demographic and macroeconomic assumptions (Table 13) underlying the analysis.³ The demographic scenario reflects Eurostat's 'ad-hoc Ageing Working Group' main forecasts with 2004 as base year,⁴ while the medium/long term macroeconomic outlook is consistent with the assumptions agreed by the members of the EPC Ageing Working Group (EPC-AWG).⁵

The projections of various expenditures, based on unchanged policies, have been brought up to date with the regulatory framework in existence as of September 2007 and incorporate the effects of the measures introduced with the bill for the 2008 Finance Law and the effects of the measures for the implementation of the Protocol signed on 23 July 2007 regarding 'Pensions, employment and competitiveness for sustainable growth and social fairness'. More specifically, the projection of healthcare expenditure incorporates the effects of increased personnel expenses,⁶ while the trend of expenditures for unemployment benefits includes the changes occurring in ordinary farm and non-farm unemployment benefits.⁷

³ The projections fully incorporate the demographic and macroeconomic assumptions underlying the reference scenario defined and agreed as part of the EPC-AWG, with the exception of the updating of several initial figures and several adjustments needed to make such initial figures consistent with the structural levels of the scenario variables. For additional information on the reference methodology, see the EPC-AWG report cited above.

⁴ For Italy, the scenario considers: (i) a net annual inflow of 150,000 immigrants; (ii) an increase in life expectancy between 2005 and 2050 of 5.3 years for men and 4.4 years for women; and (iii) a total birth rate in 2050 that is just above the initial level (and equal to 1.4).

⁵ The information reported in the 2008 Forecast and Planning Report (RPP) has been used for 2007, whereas reference is made to the main scenario agreed at a European level for the 2008-2050 period. As already noted, there are some exceptions in the form of several adjustments needed to bring the initial levels up to date with the medium-/long-term values. More specifically, an adjustment was made to the unemployment rate for 2007 (6% in the 2008 RPP), so as to put it 0.5 percentage points below the unemployment rate assumed in the EPC-AWG base scenario for 2015. The adjustment was made as follows: the unemployment rate was kept unchanged for the entire forecast period at the 2007 level, offsetting the higher employment levels that would have been achieved over the medium/long term with a reduction equivalent to the rate of activity and thus keeping the structural level of the employment rate almost unchanged with respect to the latest Update (except for the limited effects of the measures changing the requisites for qualifying for early retirement pensions as provided by the legislative bill for implementing the Protocol of 23 July). As a result, the process of converging toward the medium- to long-term rate of employment defined by EPC-AWG automatically entailed some easing of the employment trend and consequently, of GDP (whose growth rate on average is 0.2 percentage points lower in the 2008-2010 period than the original scenario). The trend of productivity is also influenced by the effects of less buoyant employment in the initial years. Over the medium- to long-term, however, the productivity growth rate shows an increasing trend before converging to 1.7 per cent as of 2030.

⁶ In line with the projections contained in the bill for the 2008 Finance Law.

⁷ Increases are planned with respect to: the amounts of unemployment benefits paid and the term over which the benefits are paid for ordinary, non-farm unemployment with normal requisites; and the amounts of unemployment benefits for ordinary, non-farm unemployment with reduced requisites. The revision of farm unemployment benefits is also planned.



The projection of pension expenditure incorporates both the increase in small-sized pensions provided by the Protocol,⁸ and the financial effects of the specific legislative bill drawn up by the Government and approved by the Cabinet on 17 October.

TABLE 13: PUBLIC EXPENDITURES ON PENSIONS, HEALTHCARE, LONG-TERM CARE, EDUCATION, UNEMPLOYMENT BENEFITS (2005-2050) ¹

| | 2005 | 2010 | 2015 | 2020 | 2025 | 2030 | 2035 | 2040 | 2045 | 2050 |
|--|------|------|------|------|------|------|------|------|------|------|
| Total expenditure | - | - | 46.2 | 45.8 | 45.5 | 45.8 | 46.2 | 46.5 | 46.1 | 45.2 |
| of which: age-related expenditure | 26.2 | 26.0 | 25.9 | 26.4 | 27.0 | 27.9 | 28.7 | 29.3 | 29.2 | 28.7 |
| Pension expenditure | 14.0 | 14.0 | 13.8 | 14.1 | 14.5 | 15.2 | 15.6 | 15.8 | 15.3 | 14.6 |
| of which: seniority and old-age pensions | 13.7 | 13.7 | 13.6 | 13.9 | 14.3 | 15.0 | 15.5 | 15.7 | 15.2 | 14.4 |
| of which: other pensions (disability and survivors) | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 | 0.1 |
| Healthcare expenditure ² | 6.7 | 6.8 | 7.0 | 7.2 | 7.5 | 7.7 | 8.0 | 8.3 | 8.5 | 8.6 |
| Long-term care | 0.8 | 0.8 | 0.8 | 0.9 | 0.9 | 1.0 | 1.1 | 1.1 | 1.2 | 1.3 |
| Education expenditure ³ | 4.3 | 3.9 | 3.8 | 3.8 | 3.7 | 3.6 | 3.5 | 3.6 | 3.7 | 3.7 |
| Unemployment compensation | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Interest expenditure | 4.5 | 4.9 | 4.0 | 3.1 | 2.3 | 1.7 | 1.2 | 0.9 | 0.7 | 0.3 |
| Total revenue ⁴ | - | - | 47.1 | 47.0 | 47.0 | 47.0 | 47.0 | 46.9 | 46.9 | 46.9 |
| of which: property income | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.4 |
| ASSUMPTIONS | | | | | | | | | | |
| Labour productivity growth rate | 0.4 | 1.1 | 1.7 | 1.7 | 1.8 | 1.7 | 1.7 | 1.7 | 1.7 | 1.7 |
| Real GDP growth rate | 0.0 | 1.8 | 1.9 | 1.5 | 1.3 | 0.9 | 0.9 | 0.9 | 1.1 | 1.1 |
| Male participation rate (ages 20-64) | 79.2 | 81.1 | 82.8 | 82.4 | 82.3 | 82.6 | 83.1 | 83.6 | 84.1 | 84.0 |
| Female participation rate (ages 20-64) | 53.6 | 56.8 | 59.5 | 60.4 | 60.3 | 60.6 | 61.4 | 62.7 | 63.4 | 63.8 |
| Total participation rate (ages 20-64) | 66.4 | 68.9 | 71.2 | 71.5 | 71.4 | 71.7 | 72.4 | 73.3 | 73.9 | 74.1 |
| Unemployment rate | 7.7 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 | 6.0 |
| Population aged 65 and over / total population ⁵ | 19.5 | 20.6 | 22.0 | 23.2 | 24.7 | 27.1 | 29.9 | 32.3 | 33.7 | 33.9 |
| Old-age dependency ratio (ages 65 and over / ages 20- 24) ⁵ | 31.9 | 33.9 | 36.9 | 39.4 | 42.5 | 48.0 | 55.0 | 62.1 | 66.5 | 67.4 |
| <p>1) Given rounding to the first decimal point, the individual figures added together may not equal the totals shown. In the first part of the table, the figures reflect percentages of GDP.</p> <p>2) Includes public healthcare spending for assistance to the elderly.</p> <p>3) Does not include public spending for adult education and pre-primary education.</p> <p>4) Includes property income.</p> <p>5) Source: Eurostat, central scenario 'Ad hoc AWG', base year = 2004.</p> | | | | | | | | | | |

Altogether, the pension measures adopted by the Government have:⁹ (i) changed the minimum requisites to be met in order to qualify for early retirement pensions (so as

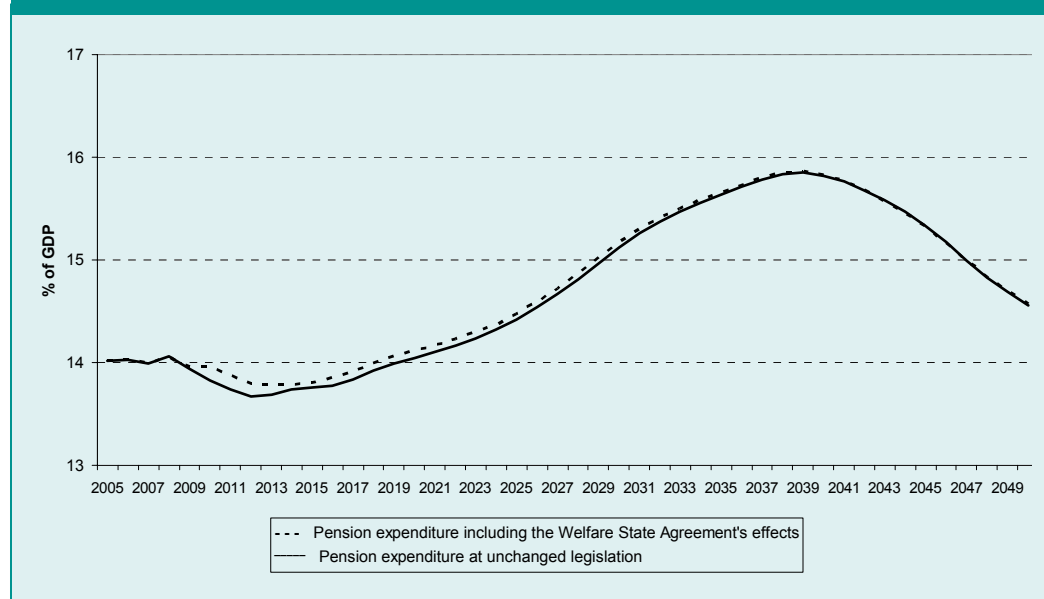
⁸ The provisions in relation to small-sized pensions have been implemented pursuant to Law No. 127/2007, which represents the conversion of Decree Law No. 81/2007 into law, and they are therefore an integral part of the prevailing regulations.



to obtain a more gradual increase of the actual age for retirement), (ii) curtailed the period for updating the relationship between pension benefits and life expectancy,¹⁰ (iii) increased the small-sized pensions, and (iv) introduced an exception for the early retirement of employees engaged in wearing-out work.¹¹

The overall age-related expenditure is expected to increase as a percentage of GDP during the 2005-2050 period, going from 26.2 per cent in 2005 to 28.7 per cent at the end of the period, for a rise of 2.5 percentage points. The expenditure initially trends downward until 2012, and then rises to a high of 29.3 per cent in 2041 before descending anew. The rate of growth of all age-related expenses is one of the most moderate in Europe, partly as a result of the reforms implemented in the past 10-15 years.

FIGURE 6: PENSION EXPENDITURE INCLUDING THE WELFARE AGREEMENT'S EFFECTS – AT UNCHANGED LEGISLATION (percentage of GDP)



⁹ Other measures regard the increase in the rates for social security contributions and the calculation of workers who are registered in the separately managed accounts with INPS, the Social Security Administration (the increase is equal to three percentage points for individuals who are not signed up for any other types of retirement plans), the broadening of the taxable base for the purpose of social security contributions, the enhancements of the protection for the notional contribution, the summing-up of the pension contributions related to periods of study at university (so-called 'riscatti').

¹⁰ As well as the simplification of the procedures, that will be fully brought back with the sphere of administrative action, with the consequent greater assurance that the deadlines will be met.

¹¹ The exception, however, entails certain limitations, i.e. only 5,000 pensioners per year will be eligible and eligibility will also depend on the financial resources in the specific fund in relation thereto.



Figure 6 shows the trend of pension expenditure as a percentage of GDP, including in comparison with that contemplated by the previous legislation. Instead, Figure 7 shows the long-term forecasts of the other components of age-related expenditure. On the basis of the assumptions made, the pension expenditure shows a growing trend, reaching a high of 15.9 per cent in 2039, before starting to descend anew to reach 14.6 per cent in 2050. As shown by Figure 6, the changes introduced will cause the ratio of the pension expenditure to GDP to increase starting in 2009. The magnitude of the increase peaks in 2011 (equal to around 0.10-0.15 percentage points of GDP) and then gradually declines to a negligible amount during the 2030-2035 period. The shortening re-fixing period for the transformation coefficients (from 10 to 3 years) gives rise to economies over the medium- to long-term that are sufficient enough to make up for the effects of the changes referenced above.¹²

The projections of healthcare expenditure¹³ show an increasing trend, with such expenditure initially accounting for 6.7 per cent of GDP in 2005 and rising to 8.6 per cent by 2050. The expenditure for education¹⁴ instead starts at 4.3 per cent of GDP in 2005, and then declines for the first three decades of the forecast period, before moderately advancing to reach 3.7 per cent of GDP in 2050. The projections of expenditures on assistance to the elderly¹⁵ show a trend of moderate growth over the entire forecast period, reaching 1.3 per cent of GDP in 2050. Finally, the projections of expenditures on unemployment benefits incorporate the effects (estimated to be equal to 0.05 percentage points of GDP) of the measures provided by the Welfare Protocol, and remain flat at around 0.4 per cent of GDP for the entire 2005-2050 period.

¹² Reference is specifically made to the effects of the increase in the pension calculation rates, the enhancements of the protection for the notional contribution, the summing-up of the pension contributions related to periods of study at university (so-called 'riscatti'), the broadening of the taxable base for the purpose of social security contributions as provided by the provisions of the legislative bill to implement the Protocol. It is emphasised, however, that the described trend of the projections of pension expenditure is highly contingent on the realisation of the assumptions in relation to the exceptions for employees engaged in wearing-out work, in relation to their obtaining early retirement pensions.

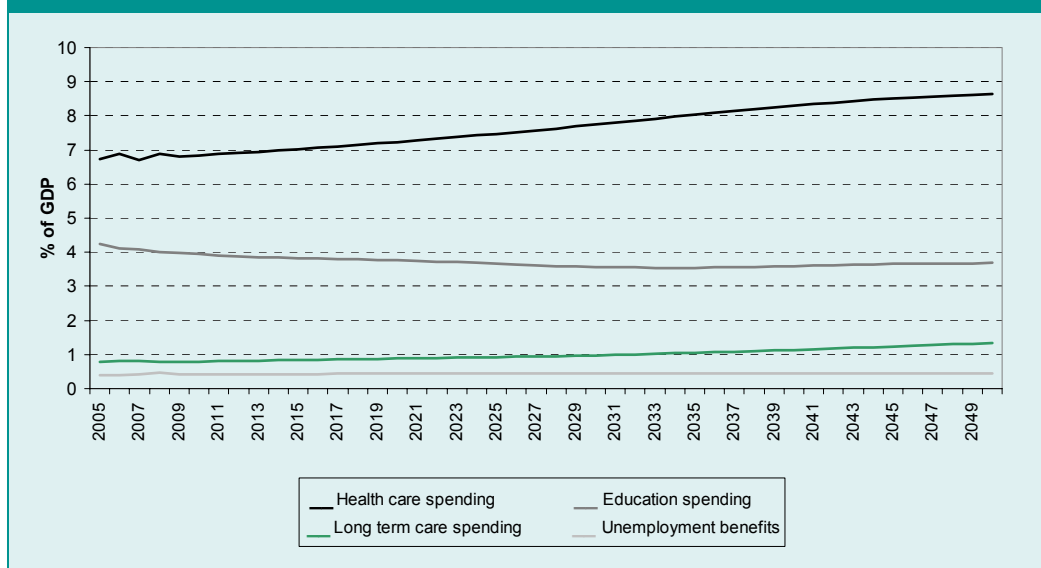
¹³ As in the latest Update, the forecast of healthcare expenditure has been figured on the basis of the reference scenario. Such scenario not only takes into account the effects of the ageing of the population, but also other factors that influence the spending on healthcare over the medium- to long-term.

¹⁴ It is noted that the definition of expenditure for education includes ISCED 1-6 levels of education as agreed during the second EPC-AWG forecasting session. The figure thus excludes expenditures for pre-primary education (ISCED 0) and expenditures for adult education (lifelong learning).

¹⁵ In Italy's case, roughly 80 per cent of the expenditure consists of cash benefits to cover the cost of personnel accompanying the elderly and 20 per cent for social-assistance services supplied at a local level. While the forecast of the expenditure-to-GDP ratio for the latter was prepared by using the assumptions underlying the reference scenario, it was not possible in the case of cash benefits to use the calculation algorithms used by the Commission for the purpose of preparing the EPC-AWG forecasts. Such forecasts are not consistent with the methodological assumptions agreed. Without any link to demographic trends, such forecasts do not incorporate the effects of the ageing of the population.



FIGURE 7: EXPENDITURE ON HEALTHCARE, EDUCATION, LONG-TERM CARE, UNEMPLOYMENT BENEFITS (percentage of GDP)



VI.2 DEBT SUSTAINABILITY

The sustainability of public finances is analysed both by projecting the debt-to-GDP ratio over the 2012-2050 period and by calculating summary sustainability indicators, and in particular the two sustainability gaps (S_1 and S_2) and the required primary balance (RPB).¹⁶

The assumptions underlying the analysis related to the developments of the demographic and macroeconomic scenario agreed by the members of the EPC are reported in the preceding Table 11. It is assumed furthermore that the real rate of interest

¹⁶ These are well known indicators agreed at an EU level and reported in prior Updates of the Stability Programme. S_1 and S_2 measure the permanent adjustment needed for respectively achieving a debt-to-GDP ratio of 60 per cent in 2050 and the meeting of the inter-temporal budget constraint over an infinite horizon. Both indicators can be broken down into an initial budgetary position (IBP) and long-term changes in the primary balance (LTC), the latter of which expresses the cost of ageing. S_1 can be broken down into a third component which represents the debt requirement in 2050. The required primary balance (RPB) instead measures the average primary surplus during the first five years of the forecast period (i.e. from 2012 to 2016) that would satisfy the inter-temporal budget constraint over an infinite horizon. The RPB is equal to the algebraic sum of the projected average structural surplus and the mentioned S_2 . For more detailed information about the indicators and the mathematical derivation of the various components, see Annex I of the 'The Long Term Sustainability of Public Finances – A report by the Commission services' European Economy No. 4/2006.



remains constant over the forecast period at 3 per cent per annum. Projecting from 2012 and thereafter effectively implies assuming the achievement of the debt and primary-surplus objectives indicated for 2011. One change being made with this Update is the introduction of explicit long-term projections of property income into the analysis. This is part of the total revenues in relation to capital income (bond and equity securities) and income from ownership of natural resources.¹⁷ The projections of the primary surplus thus also take into account the trend of these variables.

The results of the simulation show a steadily decreasing trend of the debt-to-GDP ratio over the entire forecast period, with values that go from 95.1 per cent del 2011 to near zero (black solid line in Figure 8). More specifically, the debt-to-GDP ratio descends below the 60 per cent threshold in 2021 (one year after the date contemplated in the latest Update), before falling by a more moderate pace (again with respect to the base scenario for last year). The one-year deferral can be explained by a smaller primary-surplus target, as well as by the marginal impact of the implementation of the Welfare Protocol of 23 July on the trend of pension expenditure. This Update calls for meeting the objective of a virtually balanced budget by 2011 (compared with the surplus of 0.7 per cent of GDP in structural terms set out in the latest Update).

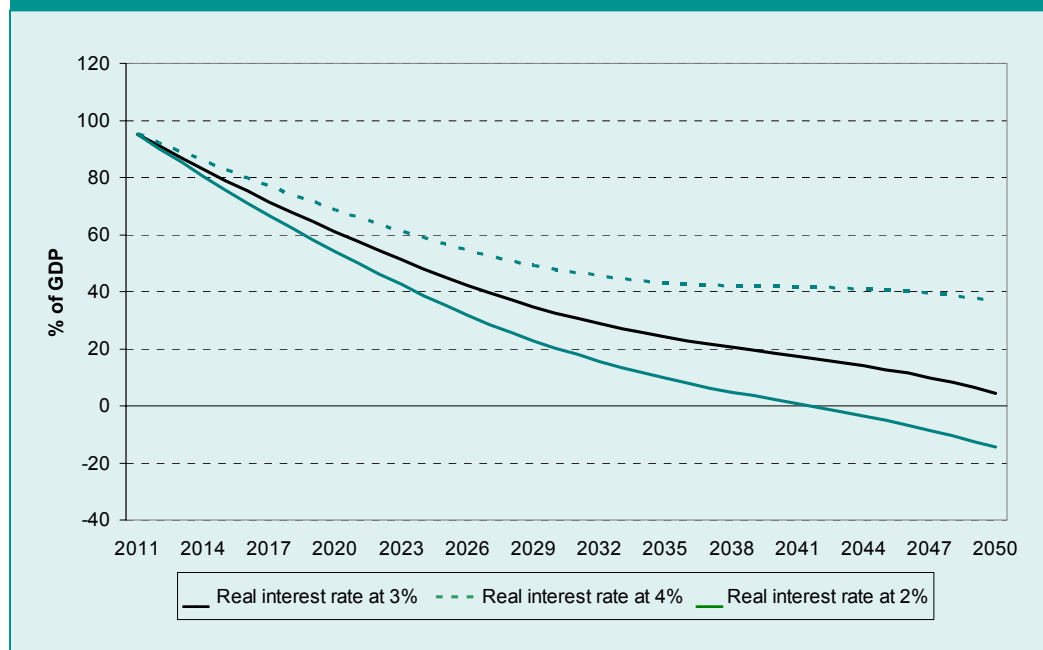
The long-term trend of the public debt as a percentage of GDP is also simulated by taking into account differing assumptions about interest rates and primary-surplus targets.

More specifically, the first sensitivity test regards two alternative assumptions vis-à-vis the baseline scenario in relation to the value of the real interest rate during the forecast period: an optimistic scenario with a real interest rate at 2 per cent and a pessimistic scenario with a rate of 4 per cent. The trend of the debt in the first scenario is obviously more favourable than that for the baseline scenario (Figure 8).

¹⁷ Projected using the AWG-agreed methodology, the data for the 2005-2050 period have been supplied by the European Commission.



FIGURE 8: PUBLIC DEBT SENSITIVITY TO REAL INTEREST RATES (percentage of GDP)



The debt-to-GDP ratio decrease below the Maastricht threshold as early as in 2019 and falls at a more pronounced rate than that shown in the baseline scenario, dipping into negative territory by the end of the forecast period. With the less favourable assumption of an interest rate that rises to 4 per cent in real terms, the debt does not hit the 60 per cent threshold until 2024, and then continues to descend to reach a level of just under 40 per cent. In both cases, however, the trend of debt-to-GDP ratio is decreasing over the entire 2012-2050 period. Therefore, even assuming a permanent increase of 1 per cent in the interest rate, public finances are still sustainable.

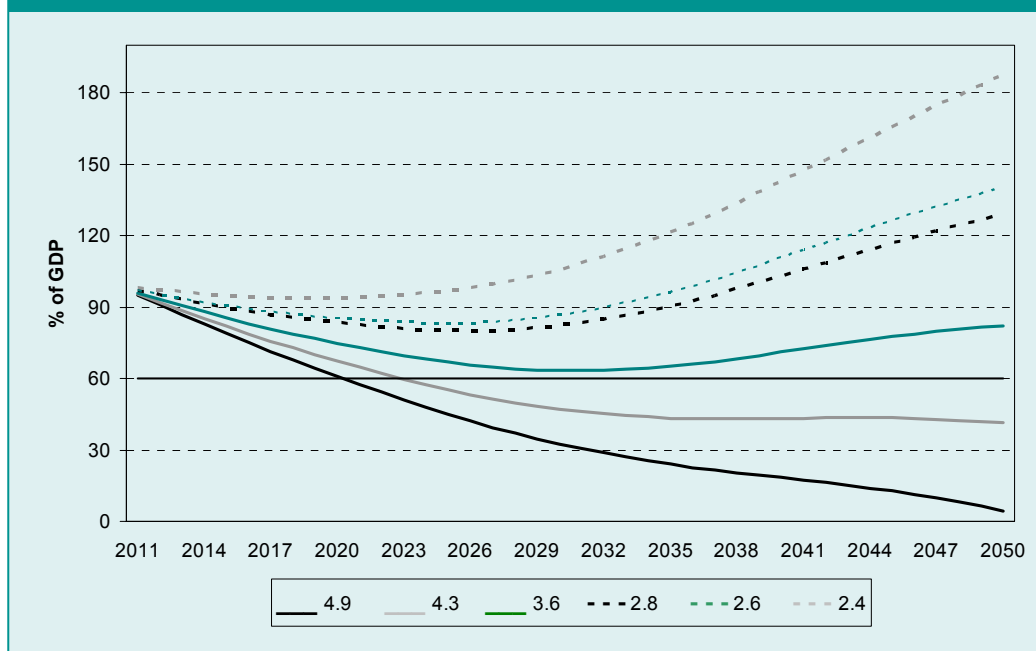
The second simulation entails an evaluation of the impact of different primary-surplus balances in 2011 on debt-to-GDP dynamics. Such balances have been indicated arbitrarily as those equal to the primary surpluses forecast in this Update for the years from 2006 to 2011 (Figure 9).

With a primary surplus equal to 4.3 per cent, the debt-to-GDP ratio exhibits a steadily decreasing trend and touches the 60 per cent threshold only three years after the date indicated in the baseline scenario. It then stabilises at a level just over 40 per cent at the end of the period. With primary-surplus levels below 4.2 per cent of GDP, the debt-to-GDP ratio tends to rise after initially descending. The increase in the primary surplus compared with the balance at the start of the political term is substantial: 1.8 per cent versus a surplus of 2.8 per cent expected for 2008, including the effect of the 2008



Finance Law and Welfare Protocol. Assuming that these two balances are those at the beginning of 2011 (grey and black dotted lines in Figure 9), the improvement of the projections is significant. However, it will still be necessary to meet the policy objectives for the coming years (as indicated in this Update), in order to ensure the sustainability of the debt-to-GDP ratio over the long term. For example, if the primary surplus were assumed to remain constant at the level forecast for 2008 (black dotted line), the debt-to-GDP ratio would start to grow again as of 2029.

FIGURE 9: TREND OF PUBLIC DEBT BASED ON DIFFERING ASSUMPTIONS ON THE 2011 PRIMARY SURPLUS (percentage of GDP)



Summary indicators of the long-term sustainability of the public debt are supplied by the sustainability gaps (S_1 and S_2) and the required primary balance (RPB) in relation to the baseline scenario. On the basis of EU-agreed methodology¹⁸, the magnitude of the permanent budget adjustment needed for achieving (i) a debt of 60 per cent of GDP by 2050 and (ii) the meeting of the inter-temporal budget constraint over an infinite horizon is defined by S_1 and S_2 , respectively. In order to allow for better comparison and more

¹⁸ Reference is again made to the methodology presented in Annex I of 'The Long Term Sustainability of Public Finances – A report by the Commission services' European Economy No. 4/2006, and in particular, to the part explaining how the indicators are derived with respect to variable growth - and interest - rate assumptions over time.



accurate interpretation, this Update also provides a breakdown of the components of S_1 and S_2 (Table 14).¹⁹

The first component, the initial budgetary position, measures the distance between the current primary surplus (structural) and that capable of stabilising the debt-to-GDP ratio over the long term, assuming a constant primary surplus until 2050, while the second component (debt requirement in 2050) which is only part of S_1 , refers to the initial level of the debt.²⁰ Finally, the third component quantifies the cost of ageing, with another adjustment being forecast so to meet the projected increase in age-related expenditures.

The results in relation to the two sustainability gaps are negative, thus confirming that the fiscal consolidation process delineated in this Update through 2011 is sufficient to ensure sustainable public finance over the long run. As it can be worked out from the table, the initial budgetary position ensures the sustainability in both cases, even when incorporating the impact of the age-related expenditures on public finances. More significant consolidation (e.g. a higher surplus in 2011) would significantly improve the results (as was also demonstrated in the latest Update). Finally, at a level of 4.2, the required primary balance is less than the primary surplus projected for 2011. The inter-temporal budget constraint may thus be met even with a 2011 primary surplus that is less than that forecast in this Update.

TABLE 14: LONG-TERM SUSTAINABILITY INDICATORS

| | Sustainability Index | | |
|--|----------------------|-------|-----|
| | S_1 | S_2 | RPB |
| Value | -1.0 | -0.8 | 4.2 |
| of which: | | | |
| Initial budgetary position | -3.3 | -3.0 | - |
| Debt requirement in 2050 | 0.6 | - | - |
| Long-term changes in the primary balance | 1.7 | 2.2 | - |

¹⁹ The breakdown of the sustainability indicators shown here also reflects the changes related to the inclusion of property income projections in the analysis. Reference in this regard should be made to 'Projecting property income over the long term: assumption on income from land and subsoil assets', Note for the attention of the EPC-AWG Group attached to the Economic Policy Committee, ECFIN/C2/REP/54422/07.

²⁰ In particular, for countries with debt in excess of 60 per cent of GDP, the positive value of this component indicates the need for another adjustment in order to reach the Maastricht threshold by 2050.