



MINISTERO DEL TESORO, DEL BILANCIO
E DELLA PROGRAMMAZIONE ECONOMICA



Italy's Stability Programme

December 1998



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I. INTRODUCTION

Italy's Stability Programme follows Article 5 of Council regulation (EC) n. 1466/97 of 7 July 1997 which requires the presentation of information necessary for multilateral surveillance to the Council and the Commission.

The present programme was approved by the Italian Council of Ministers on December 17, 1998. The programme is based on the *Documento di Programmazione Economico-Finanziaria per gli anni 1999-2001 (DPEF 1999-2001)*, approved by the Italian Parliament in May 1998, and on the *Relazione Previsionale e Programmatica per il 1999* and the 1999 Budget Law presented to Parliament by the Italian Government at the end of September 1998. The 1999 Budget Law is currently under discussion in Parliament and is expected to be approved by the end of December 1998.

The first part of the programme assesses the degree of macroeconomic and public finance stability that Italy has achieved so far and the targets set by the Italian Government for the next years. The second part focuses on two specific measures: the "internal stability pact" and the measures implemented to enhance growth in Italy's "aree depresse".



II. PUBLIC FINANCE

II.1 Budgetary outcome in 1997 and estimates for 1998

Several years of uninterrupted budgetary consolidation have resulted in the reduction of general government deficit from 11.1 per cent of GDP in 1990 to 2.7 in 1997. The adjustment was particularly marked in 1997 when the deficit to GDP ratio dropped by 4 points and the primary balance reached a peak surplus of 6.8 per cent of GDP.

Table II.1.1 GENERAL GOVERNMENT MAIN AGGREGATES (as a percentage of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998(*)
Revenue									
Current	42.4	43.4	44.3	47.4	45.2	45.0	46.0	47.9	47.2
Capital account	0.3	0.4	2.2	0.9	0.5	0.8	0.5	0.9	0.6
Total revenue	42.7	43.8	46.5	48.3	45.7	45.8	46.5	48.8	47.8
Expenditure									
Primary current	38.7	39.0	39.9	40.8	39.7	37.6	38.4	38.5	38.5
Interest payments	9.5	10.2	11.5	12.1	11.0	11.3	10.8	9.5	8.0
Total current	48.2	49.2	51.4	52.9	50.7	48.9	49.2	48.0	46.5
Capital account	5.6	4.7	4.7	5.0	4.1	4.7	4.0	3.5	3.8
Total expenditure net of interest payments	44.3	43.7	44.6	45.8	43.8	42.3	42.4	42.0	42.3
Total expenditure	53.8	53.9	56.1	57.9	54.8	53.6	53.2	51.5	50.3
Current balance	-5.8	-5.8	-7.1	-5.4	-5.5	-3.9	-3.2	-0.1	0.6
Primary balance	-1.6	0.1	1.9	2.6	1.8	3.6	4.1	6.8	5.4
Net borrowing	-11.1	-10.1	-9.6	-9.5	-9.2	-7.7	-6.7	-2.7	-2.6

(*) Estimates of the Italian Government.

To a large extent, these results were achieved during a weak cycle. Adjusting for the effects of the business cycle, the structural deficit-to-GDP ratio, as calculated with the method described in Section II.5, decreased to 1.4 per cent in 1997. The structural ratios for 1998-2001 are estimated to remain below the actual ones.

Up to 1993, measures concerning revenue were the prevailing means of correcting imbalance in public finance. In the following years, however, important structural reforms had a relevant impact in curbing expenditure growth. This is reflected in the reduction of primary expenditure as a ratio of GDP since 1994. The reforms dealt mainly with



the pension system, public health, civil service and transfer payments to decentralised authorities.

Fiscal adjustment, decline in inflation and the consequent fall in interest rates set up a virtuous circle linking interest spending reduction, deficit reduction and lower public debt. The burden of interest payments dropped to 9.5 per cent of GDP in 1997 and is expected to decline further to 8 per cent in 1998. The debt-to-GDP ratio has shown a continuous downward trend since 1994. Though the initial pace of reduction was slow, the process has now accelerated, due to revenue from the privatisation programme (see Box below). As a result, the debt-to-GDP ratio fell to 121.6 per cent in 1997 and is expected to reach 118.2 per cent by the end of 1998.

Consistent with the process of budgetary consolidation, both central and local governments have decreased their deficits, as shown in the Table below. The effort of restructuring public finance is mainly visible in the reduction of central government deficit as a ratio of GDP by almost 7 and a half percentage points in the 1990-1998 period. Local government deficit decreased by more than 1 percentage point of GDP in the same period, from 1.3 per cent in 1990 to 0.1 in 1998. Social security bodies recorded an average surplus of around 0.1 per cent of GDP in the 1990 - 1997 period. In 1998, their surplus is expected to be 0.2 per cent of GDP¹.

Table II.1.2 BREAKDOWN OF GENERAL GOVERNMENT NET BORROWING INTO SUB-SECTORS (as a percentage of GDP)

	1990	1991	1992	1993	1994	1995	1996	1997	1998(*)
Central government	-10.1	-9.6	-9.6	-9.3	-9.0	-7.5	-6.5	-2.7	-2.7
Local government	-1.3	-0.6	-0.1	-0.3	-0.3	0.0	-0.1	-0.3	-0.1
Social security institutions	0.3	0.1	0.1	0.2	0.2	-0.2	-0.1	0.3	0.2
General government	-11.1	-10.1	-9.6	-9.5	-9.2	-7.7	-6.7	-2.7	-2.6

(*) Estimates of the Italian Government.

During the first eleven months of 1998, central government deficit evolved in line with the annual target of 2.6 per cent of GDP for the general government net borrowing. Furthermore, the general government current balance should record a surplus of 0.6 per cent of GDP in 1998.

¹ It should be noticed that revenue of local governments and social security institutions includes transfers from central government.



The privatisation programme

Since 1994, the Treasury has directly handled the sale of its holding interests in financial institutions (IMI, INA, San Paolo, Banco di Napoli, Banca Nazionale del Lavoro) as well as in telecom and oil conglomerates (Telecom Italia and ENI respectively), and raised approximately Lit. 83.6 trillion (US\$ 50 billion). About 83 per cent of these proceeds was raised through global offerings and the remaining 17 per cent through trade sales. According to the OECD, Italy has had the largest and most consistent equity privatisation programme in Europe in the last five years.

In 1998, the Italian Treasury carried out the sale of a fourth tranche of ENI raising about Lit 13,000 billion and has just completed the privatisation of BNL, raising over Lit 6,800 billion. The total amount raised is approximately one per cent of the GDP, thus exceeding by almost Lit 5,000 billion the target set in last May's DPEF 1999-2001.

The privatisation proceeds have contributed to the reduction in Italy's public debt burden. In 1998, government bonds redeemed by the Treasury from these proceeds will amount to more than Lit 21,000 billion. For 1999, this figure is expected to be about Lit 15,000 billion and will fall to Lit 10,000 billion for each of the two years 2000-2001.

The privatisation programme has contributed towards structural change in the Italian industrial and financial markets, with a significant decrease of direct State involvement in the management of industrial and financial companies. It was also an opportunity to increase transparency and foster the growth of the Italian capital market, which was lagging behind other major markets, in terms of protection for minority shareholders and presence of foreign and domestic institutional investors.

Privatisation has promoted growing equity culture among retail investors and enlargement of the equity market: from 1992 to October 1998, the market capitalisation/GDP ratio increased from 11.5 per cent to 38 per cent, thus nearing the Continental European average.



II.2 Medium-term macroeconomic framework

In 1998, economic activity was weaker than initially expected, reflecting a temporary slowdown in private consumption and negative net exports due to the international economic situation. On the other hand, the increase in manufacturing investments, seen in the second half of 1997, accelerated further as a consequence of lower interest rates.

Revised Government estimates released last September (*Relazione Previsionale e Programmatica per il 1999*), brought 1998 growth down to 1.8 per cent. The latest evidence on economic activity, however, appears to indicate that GDP growth may be closer to 1.5 per cent. If this is the case, the 1999 estimate of 2.5 per cent may also need to be decreased. The next Government estimates (*Relazione sull'andamento dell'economia nel 1998 e aggiornamento delle previsioni per il 1999*), available in February 1999, will evaluate this latest development.

It should be considered, however, that the effect on budget balances of lower than expected output could be compensated to some extent by lower than projected interest payments. In fact, the September estimates still assumed interest rates well above today's level (see Table II.2.1).

In the sensitivity analysis section, we assess the impact of these possible forecasts errors.

Returning to 1998 economic performance, for the first time in six years, employment is increasing: the manufacturing sector currently shows a 0.7 per cent growth. Because of higher participation in the labour market, however, the unemployment rate has not declined significantly.

Wage moderation in both public and private sectors, productivity gains and low commodity prices have favoured price stability. The average inflation rate, measured by CPI, is expected to be 1.8 per cent in 1998.

For the next three years, Government projections assume a gradual improvement in the international economic outlook (Table II.2.1). An upward trend in world trade is expected by the end of 1999. Although Italian GDP growth is currently lagging behind the EU average, 1999 should mark a gradual catching up, due to improving domestic demand.

Wage moderation and absence of significant external inflationary factors will contribute to price stability. Italian inflation will remain low, in line with the other countries of the Euro area. No significant changes are expected in the terms of trade.



Table II.2.1 MACROECONOMIC FRAMEWORK (percentage values)

	1997	1998	1999	2000	2001
Real GDP growth rate	1.5	1.8	2.5	2.8	2.9
Growth rate of private consumption deflator	2.4	2.3	1.5	1.5	1.5
Growth rate of GDP deflator	2.6	2.6	2.1	1.7	1.6
Employment growth rate	-0.2	0.3	0.6	0.9	1.0
Unemployment rate	12.3	12.2	11.9	11.3	10.6
12-month BOT interest rate (year-end)	4.9	4.5	4.5	4.5	4.5
Current account balance (as a percentage of GDP)	3.2	3.2	3.2	3.3	3.3

Source: For 1997, ISTAT and Bank of Italy. For the 1998-2001 period, official estimates and projections of the Italian Government.

Table II.2.2 COMPOSITION OF REAL GDP (1990 prices, percentage changes)

	1997	1998	1999	2000	2001
GDP	1.5	1.8	2.5	2.8	2.9
Private consumption	2.4	1.5	2.1	2.5	2.5
Public consumption	-0.7	0.6	0.3	0.3	0.2
Fixed investments- equipments	2.6	6.5	8.2	8.4	8.2
Fixed investments- constructions	-1.6	2.0	5.0	5.3	5.5
Inventory (*)	1.0	0.3	0.2	0.1	0.1
Exports	6.3	6.0	6.3	6.8	7.2
Imports	11.8	8.1	8.2	8.3	8.2

(*) Contribution to GDP growth.

Source: For 1997, ISTAT. For the 1998-2001 period, official estimates and projections of the Italian Government.

In 1999, economic growth is expected to be driven by domestic demand, stimulated by lower tax pressure and by a particularly favourable monetary stance. In particular, private consumption should respond to higher real disposable income, while investments should take advantage of lower financing costs and higher profits for companies. To be prudent, it is assumed that net export contribution to growth will remain negative, although there will continue to be a surplus in the current account balance. Improving economic conditions together with increased labour market flexibility are expected to produce a rise in employment of about 0.6 per cent.

In 2000 and 2001, international economic activity is expected to improve further. Exports are expected to accelerate gradually as world trade recovers and the Italian competitive position is consolidated. The main drive for growth, however, will continue to be domestic demand. The Italian economy is gradually expected to catch up with the other EU countries. GDP growth will approach 3 per cent. The number of employed is expected to rise by about 2 per cent in the two-year period. Current account balance surplus will near 3,5 per cent of GDP, further improving Italy's net foreign asset position.



II.3 Budgetary targets for 1999-2001

The next three-year budgetary policy is based on three fundamental principles: compliance with the Stability and Growth Pact, renewed efforts for sustaining economic growth and employment, improvement in the fairness of the welfare system.

In line with the above principles, in the *DPEF 1999-2001* the Italian Government has indicated the following public finance targets.

Table II.3.1 PUBLIC FINANCE TARGETS: GENERAL GOVERNMENT (as a percentage of GDP)

	1999	2000	2001
Current balance	1.5	2.3	2.9
Capital balance	-3.5	-3.8	-3.9
Primary balance	5.5	5.5	5.5
Interest payments	7.5	7.0	6.5
Net borrowing	-2.0	-1.5	-1.0
Public debt	114.6	110.9	107.0

General government deficit will be reduced each year by 0.5 per cent of GDP, thus reaching 1 per cent by 2001. This result will be achieved by maintaining primary surplus at 5.5 per cent of GDP throughout the period and through a reduction in interest spending from 7.5 per cent of GDP in 1999 to 6.5 per cent in 2001.

At the same time, the current surplus will progressively grow, reaching 2.9 per cent of GDP in 2001. To a large extent, this result is due to the measures aimed at reducing current expenditure. In particular, current expenditure net of interest spending are projected to increase at an average rate of 3.2 per cent per year in the 1999-2001 period, compared with an average growth rate of 4.5 per cent for the nominal GDP.

Higher public saving will then be available as a financial resource for public investment, especially in the economically depressed areas of the country (see Section III.2). The growth target of capital account expenditure is, on average, 10 per cent per year. Consequently, the capital balance is expected to increase from 3.2 per cent of GDP in 1998 to 3.9 in 2001.

Mindful of the net borrowing targets, resources will be shifted to support two key growth-enhancing policies: reduction of the tax burden and investments in infrastructure and human capital. This will entail relief of particularly disadvantaged groups of individuals and of families with children.



The additional resources which have been set aside for these purposes are summarised in the Table II.3.2.

Table II.3.2 GROWTH-ENHANCING MEASURES AND WELFARE-IMPROVING POLICIES
(as a percentage of GDP)

	1999	2000	2001
Projected in the DPEF 1999-2001			
Sectoral policies	0.05	0.09	0.09
Investments in infrastructure	0.12	0.25	0.32
Reduction of tax burden	0.09	0.09	0.09
Additional measures included in the 1999 Budget Law			
Welfare-improving policies	0.05	0.06	0.05
Total growth-enhancing and welfare-improving measures	0.31	0.49	0.55

Table II.3.3 shows public accounts broken down into government sub-sectors. The figures in the Table include the effects expected from the implementation of the 1999 Budget Law. Therefore, the figures for 1999 represent targets whereas the figures for the 2000-2001 period are trend projections including the 1999 Budget Law but not the corrective measures expected in the following two years.

As the Table shows, the central government deficit is expected to decline further, local authorities should reach a near to balance budget and the social security bodies should continue to show a surplus².

Table II.3.3 BREAKDOWN OF GENERAL GOVERNMENT NET BORROWING INTO SUB-SECTORS (as a percentage of GDP)

	1999 Targets	2000 Trend projections	2001 Trend projections
Central government	-2.5	-2.0	-1.5
Local government	0.1	0.0	-0.1
Social security institutions	0.4	0.3	0.3
General government	-2.0	-1.7	-1.3

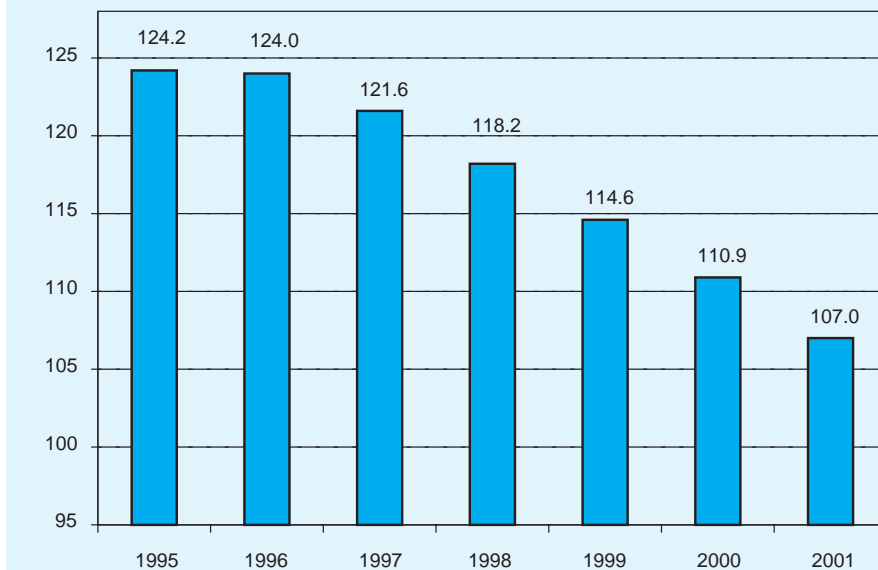
As far as the year 2002 is concerned, macroeconomic forecasts and detailed public finance accounts will be available in May next year, with the approval of the *DPEF 2000–2002*. However, the Italian Government intends to set a net borrowing target that will respect the medium term commitments undertaken in the Stability and Growth Pact requirements.

¹ See note in section II.1.



The ratio of general government debt to GDP will continue to decrease. The pace of reduction will gain further momentum as the decline in interest rates displays its full effects. Over the next three years, the debt to GDP ratio will be cut by over 3 percentage points per year. This is consistent with the goal of reducing the debt to GDP ratio below 100 per cent by 2003.

Figure II.3.1 GENERAL GOVERNMENT DEBT (as a percentage of GDP)



The implications of the ageing population

Demographic trends are leading to population ageing in all the industrialised countries. The ratio between population aged over 64 and the working-age population (conventionally aged between 15 and 64) is rising. In 1960, the OECD average was 15 per cent; it will exceed 20 per cent in 2000 and will be near 40 per cent in 2030.

These demographic developments have consequences on public finance, pension systems, financial markets, health care, education and training. If these problems are not tackled in time, ageing could have negative effects on the living standards of future generations.

In order to make pension expenditure sustainable, the Italian Government implemented a series of reforms in 1992, 1995 and 1997. These reforms were aimed at:

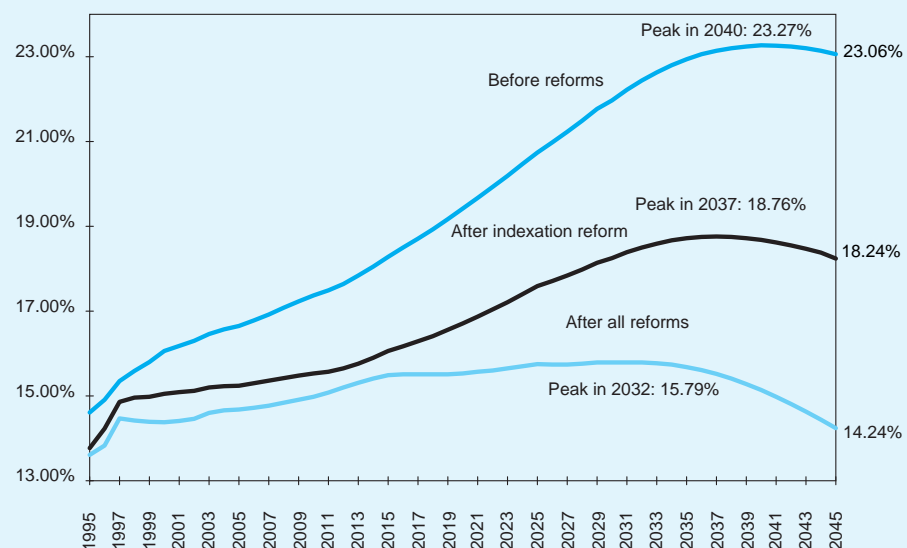
- *increasing the life-time spent in employment;*



- increasing people's participation and responsibility in the building up of their old-age savings by providing incentives for a multi-pillar system (public pensions, pension funds and personal insurance).

The 1995 reform also called for a constant monitoring of pension expenditure trend. Corrective measures will be adopted if unexpected deviations from the projections are detected.

PENSION EXPENDITURE AS A PERCENTAGE OF GDP BEFORE AND AFTER THE REFORMS IN 1992, 1995 AND 1997



The figure above shows the effect of the reforms on pension expenditure as a percentage of GDP for the 1998-2045 period. In 1998, the total expenditure reduction equals 1.17 per cent of GDP with respect to the scenario before the reforms. In the following years, savings are expected to increase further and reach 8.8 per cent of GDP in 2045.

As far as the national health service is concerned, important reforms have already been introduced aimed at cost rationalisation and more efficient use of resources. The most important reform is the transformation of the local health units (USL) and hospitals – particularly where highly specialised or with national relevance – into enterprises (ASL and Aziende Ospedaliere, respectively) headed by managers, with new accounting practices based on separate cost centres.



II.4 The 1999 Budget Law

The Budget Law, to be approved by the end of December, lays down both budget corrections and growth-enhancing and welfare-improving reforms.

The corrective measures have a net effect on primary surplus totalling Lit. 8,000 billion corresponding to 0.4 per cent of next year's estimated GDP. This additional saving will allow the 1999 target of 2 per cent to be reached for the general government net borrowing to GDP ratio.

Moreover, additional measures totalling Lit. 6,700 billion, 0.3 per cent of GDP, will be introduced to finance the growth-enhancing and welfare-improving reforms.

The measures implemented in 1999 will have further effects corresponding to 0.18 per cent in 2000 and 0.07 per cent of GDP in 2001.

Table II.4.1 EFFECTS OF 1999 BUDGET LAW ON GENERAL GOVERNMENT ACCOUNT
(as a percentage of GDP)

	1999		2000		2001	
	Measures	Targets	Measures	Trend projections	Measures	Trend projections
Revenue						
Current	0.15	46.95	0.25	46.86	0.24	46.55
Capital account	0.01	0.49	0.02	0.41	0.03	0.41
Total revenue	0.16	47.44	0.27	47.27	0.27	46.96
Expenditure						
Primary current	-0.37	37.92	-0.33	37.62	-0.30	37.27
Interest payments	0	7.5	0	7.00	0	6.52
Total current	-0.37	45.42	-0.33	44.62	-0.3	43.79
Capital account	0.13	4.02	0.42	4.35	0.50	4.47
Total expenditure net of interest payments	-0.24	41.94	0.09	41.97	0.20	41.74
Total expenditure	-0.24	49.44	0.09	48.97	0.20	48.26
Current balance	0.52	1.53	0.58	2.24	0.54	2.76
Primary balance	0.40	5.50	0.18	5.30	0.07	5.22
Net borrowing after the 1999 Budget Law	0.40	-2.00	0.18	-1.70	0.07	-1.30
<i>Memorandum items:</i>						
<i>Corrective measures planned for 2000</i>	<i>0.20</i>					
<i>Target for 2000 net borrowing</i>	<i>-1.50</i>					
<i>Corrective measures planned for 2001</i>	<i>0.10</i>					
<i>Target for 2001 net borrowing</i>	<i>-1.00</i>					



Table II.4.1 shows the detailed effects of the 1999 Budget Law on general government accounts. Figures for 1999 represent targets while figures for 2000 and 2001 represent the new trend projections. Further corrective measures totalling 0.2 per cent of GDP in 2000 and 0.1 per cent of GDP in 2001 will be needed to achieve the deficit/GDP targets of 1.5 per cent and 1 per cent, respectively.

Total revenue as a percentage of GDP will progressively decrease to around 47 per cent by 2001. Current expenditure will also decline as a percentage of GDP and fall below 44 per cent by 2001 allowing the current balance to show a surplus of 1.5 per cent of GDP in 1999. Capital expenditure, on the other hand, is expected to grow over time and reach 4.5 per cent of GDP by 2001.

II.4a Measures on the revenue side

On the revenue side, the Government's objective is to lower the overall fiscal pressure. Consistent with the goal of enlarging the tax base, efforts against tax evasion will be intensified along the lines first introduced in the 1997 Budget Law. Additional revenue will be raised mainly from the sale of credits of the National Pension Fund (*INPS*).

Fiscal pressure on labour will see a strong reduction in the most depressed areas of the country. The loss in revenue will be compensated by the new 'carbon tax' introduced in accordance with the Kyoto directives.

II.4b Measures on the expenditure side

The measures on the expenditure side are concentrated on current spending reduction. The most relevant corrections concern public employment, national health service, company subsidies and the so called 'internal stability pact' whereby local governments will be obliged to contribute to the reduction of the general government net borrowing and debt. The 'internal stability pact' is described in greater detail in Section III.

As far as public employment is concerned, the most important actions are designed to increase part-time jobs and on-the-job training contracts. In the health service, the Budget Law includes measures both on the demand and on the supply of services, as well as on new means



of funding the National Health Service, such as the partial payment of costs by patients. The Budget Law also considers further reductions in transfers to the State Railway and the Postal Service.

In contrast, capital account expenditure is expected to increase in support of both public and private investments, especially in the less developed areas of the country.

II.5 Sensitivity of targets to macroeconomic assumptions

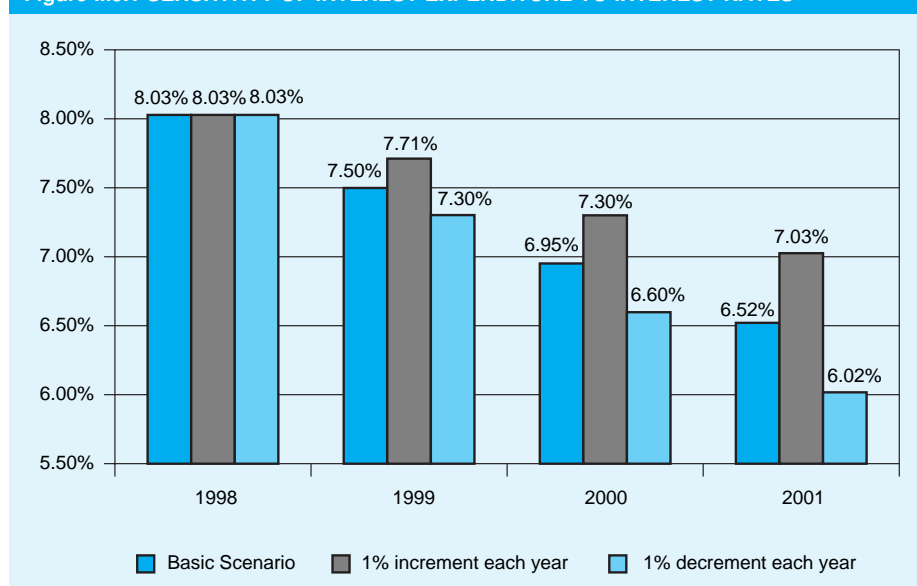
The present Section analyses the response of the main public finance variables to changes in interest rates and GDP growth rate.

II.5a Sensitivity to interest rates

Since the approval of the *DPEF 1999-2001* last May, the financial variables' scenario has changed considerably from the previous assumption of a constant 4,5 per cent interest rate on 12-month BOT.

The following figure shows estimates of interest expenditure to GDP ratio under the hypothesis that, for the 1999-2001 period, the whole term structure of interest rates moves 1 per cent higher or lower than the one previously assumed. In fact, interest rates today are below the more optimistic scenario of the 1 per cent reduction.

Figure II.5.1 SENSITIVITY OF INTEREST EXPENDITURE TO INTEREST RATES





In the figure, the baseline scenario is described by the left bar and represents the interest expenditure/GDP ratio presented in the DPEF. The middle and right bars depict interest expenditure as a ratio of GDP assuming that interest rates are 1 per cent higher or lower than in the basic scenario, respectively.

A decrease (increase) of 100 basis points in the interest rate assumptions for the whole period 1999-2001 would result in a decrease (increase) of interest expenditure by approximately 0.2 per cent of GDP with respect to the baseline scenario in 1999, 0.35 per cent of GDP in 2000 and approximately 0.5 per cent of GDP in 2001. As a result, the deficit in 1999, 2000 and 2001 would fall (increase) to 1.8 (2.2), 1.15 (1.85) and 0.5 (1.5) per cent of GDP, respectively.

II.5.b Sensitivity of public finance to economic development

Following the discussion in Section II.2, we view here the current output estimate as the best-case scenario, i.e. as the upper bound of a hypothetical confidence interval. Consequently, we construct a lower bound scenario assuming GDP growth rate 0.6 per cent lower over the three years, i.e. 1.9 per cent for 1999, 2.2 for 2000 and 2.3 for 2001.

The slow growth scenario takes into account the worldwide risks arising from a further deterioration of the situation in Asia or other emerging markets. For example, half a percentage point of lower GDP growth in one year would be consistent with a world trade decline of around 3 percentage points.

Given an estimated elasticity of the deficit to GDP ratio to the output gap of half a percentage point, the direct impact of a 0.6 per cent lower annual growth would approximate to a 0.30 per cent higher deficit to GDP ratio. Since the effect of the assumed shocks cumulate over time, the above scenario would be translated in 2001 into a 0.9 higher deficit to GDP ratio than in the higher growth scenario.

Even in the lower bound scenario, however, the net borrowing to GDP ratio would maintain its downward trend, remaining well within the 3 per cent threshold over the whole simulation horizon. Also the debt/GDP ratio would continue to decrease even if at a slightly slower pace.



In Table II.5.1, we also show the combined effect of lower growth and lower interest rates, where net borrowing is estimated to decline from 2.1 in 1999 to 1.4 in 2001.

Table II.5.1 SENSITIVITY OF PUBLIC FINANCE AGGREGATES TO GDP GROWTH
(percentage values)

	1999	2000	2001
Upper bound			
GDP growth rates	2.5	2.8	2.9
Deficit/GDP	2.0	1.5	1.0
Debt/GDP	114.6	110.9	107.0
Lower bound			
GDP growth rates	1.9	2.2	2.3
Deficit/GDP	2.29	2.07	1.86
Debt/GDP	115.4	113.0	110.4
Combined scenario (100 bp lower interest rates and lower bound growth)			
Deficit/GDP	2.09	1.72	1.36
Debt/GDP	115.2	112.4	109.3

II.5.c Structural balances

A complete evaluation of the public finance performance needs an adjustment for the effects of the business cycle fluctuations. In terms of structural balances the extent of the Italian budgetary adjustment is all the more evident.

Structural budget balances as a percentage of GDP are shown in the Table below, together with the official objectives:

Table II.5.2 STRUCTURAL PUBLIC FINANCE BALANCES (*) (as a percentage of GDP)

	Structural balances	Official objectives
1997	-1.4	-2.7
1998	-1.1	-2.6
1999	-0.7	-2.0
2000	-0.5	-1.5
2001	-0.4	-1.0

(*) Structural balances are calculated by using estimates of potential output from the OECD and the elasticity of deficit/GDP to output gap as reported in European Commission (1995): The Commission services' method for the cyclical adjustment of government budget balances. *European Economy* 60.

In the period between 1997 and 2001, the Italian economy is estimated to stay below trend showing negative output gaps. Output gaps are estimated particularly large in 1998 and 1999 so that structural deficits as a percentage of GDP are 1.3-1.5 percentage points lower than



actual deficits. Given the higher output growth projected in 2000 and 2001, the cyclical component of budget balances is expected to drop to 1 percentage point and 0.6 percentage points of GDP, respectively.

As the Table shows, structural balances as a ratio of GDP are estimated to decrease at an average pace of 0.25 per cent of GDP each year from 1997 to 2001, moving from -1.4 per cent of GDP in 1997 to -0.4 per cent in 2001.



III. FOCUS ON SPECIFIC MEASURES

III.1 Internal stability pact

The 1999 Budget Law provides a framework within which the obligations deriving from the Stability and Growth Pact are shared among central government and regional and local authorities. Accordingly, decentralised authorities are committed to reduce their net borrowing and the ratio between their stock of debt and national GDP.

In 1999, the reduction of regional and local authorities' net borrowing will have to be at least 0.1 per cent of GDP compared to 1998. In the following two years, the net borrowing/GDP ratio is not allowed to increase. Accounting rules will be defined by the end of February 1999 in a decree agreed upon by the Minister of the Treasury and the Minister of the Interior and based on the recommendation of the National Statistical Office (*ISTAT*).

The 1999 Budget Law sets out five budgetary policies that regional and local authorities will have to adopt in order to control their borrowing. Two of these are directed to reduce expenditure, the others to increase revenue.

On the expenditure side, the measures taken must be aimed at:

- increasing efficiency and productivity and reducing costs of public services provision by local authorities;
- progressively reducing the annual growth rate of current expenditure.

On the revenue side, the measures have to be directed at:

- increasing fiscal revenue through the enlargement of the tax base and the reduction of tax evasion;
- increasing revenue from fares charged for public services;
- increasing the sale of real estate not strictly necessary to institutional activities.

Privatisation of local public utility companies will also contribute to the decline of local authorities' debt/GDP ratio.

The 1999 Budget Law also introduces incentives for the reduction of local authorities' debt. Local authorities can submit a five-year financial plan to the Treasury Department which must include a reduction of their stock of debt as a percentage of GDP. If the goals of the plan are achieved, the local authorities will be able to take advantage of special debt settlement conditions.



In order to verify the results during the financial year, expenditure and borrowing requirements of local authorities will be monitored on a monthly basis. If deviation from the objectives occurs, regions and local authorities will have to take corrective actions.

III.2 Growth-enhancing measures for the “aree depresse”

During 1997 and the first months of 1998, resources for about Lit. 12.600 billion have been allocated to economic initiatives in the less developed regions of the country. Additional Lit. 41,000 billion will be made available in 1999-2001.

These resources will be used to finance three different sets of measures:

1. incentives to offset the higher cost of capital and labour in less developed areas, particularly in the South;
2. promotion of local economic initiatives, through incentives to new enterprises and direct foreign investments;
3. public investments in infrastructures.

Table III.1.1 NEW RESOURCES FOR ECONOMICALLY DEPRESSED AREAS (Billion Lit.)

	1998	1999	2000	2001 and following years	Total
Incentives to private capital and labour	2,227	2,654	3,138	2,855	10,874
Promotion of local initiatives(*)	1,126	1,196	1,793	4,050	8,165
Infrastructures and other public investments	1,604	1,742	2,007	7,464	12,817
Other interventions	1,878	1,458	2,008	3,918	9,262
TOTAL	6,835	7,050	8,946	18,287	41,118

(*) Of which: Contratti di programma Lit. 2,715 billion; Patti territoriali Lit. 3,200 billion; Contratti d'area Lit. 2,000 billion.
Source: *Relazione previsionale e programmatica 1999.*

The first set of measures is directed to reduce the higher costs of investments in some areas of the country. These costs derive from the lower availability and quality of public services, from the high cost of credit and from the level of illegal and criminal activity. Together with the low degree of flexibility in the labour market, these factors determine the existence of a widespread hidden economy.



To reduce these costs, the Government has reorganised the existing incentive schemes to the use of private capital and labour, through a better system of information to enterprises, a more transparent link between incentives and objectives, and an increased co-operation between central government and local authorities.

The second set of measures, the development of local initiatives, covers the main instruments of negotiated planning: *patti territoriali*, *contratti di programma* and *contratti d'area* (see Table below).

Significant progress has been made in developing the instrument of *patti territoriali*. They aim at fostering agreements between public and private agents for the realisation of public infrastructures and private productive investments. In 1997, twelve *patti territoriali* have been approved. At the same time, further steps have been made to guarantee financial coverage to the new *patti territoriali*, by establishing a transparent criterion of selection.

The purpose of the *contratti di programma* is to stimulate productive initiatives of large firms or of agglomeration of small and medium-sized firms which, through cultural affinity and networks of local institutions, tend to create and exploit external economies of scale. The Government proposal is to use this instrument to encourage the establishment of industrial districts in the South already operating in other parts of the country.

The *contratti d'area* are intended to finalise agreements and investments capable to contrast the decline of industrial areas in crisis. Under these schemes, employers commit to increase investments and employment at the local level in return for a temporary derogation from national wage agreements and more flexible working arrangements.

Table III.2.1 INVESTMENTS IN PATTI TERRITORIALI, CONTRATTI DI PROGRAMMA AND CONTRATTI D'AREA UP TO JUNE 1998 (*)

	Total investments (Billion Lit.)	Public investments (Billion Lit.)
Patti territoriali	1,245	910
Contratti di programma	23,430	11,336
Contratti d'area	342	202

(*) Estimates.

Source: *Relazione sull'andamento e i risultati dell'intervento ordinario nelle aree depresse nel 1997*.



The third set of measures planned by the Government is directed at increasing public investments in economically depressed regions in order to provide companies with the adequate infrastructures.

The selection criteria for the projects will focus on the final use of the investments rather than on the infrastructure itself. The five priority sectors on which the Government is concentrating are:

1. the promotion of natural and environmental resources;
2. the exploitation of human, cultural and historical resources;
3. the improvement of cities and local institutions;
4. the development of local production;
5. the expansion of transport infrastructures.