MINISTERO DEL TESORO, DEL BILANCIO
E DELLA PROGRAMMAZIONE ECONOMICA

Italy's Stability Programme

Update December 2000

CONTENTS

INTRODUCTION

The Italian Stability Programme has been updated and adopted in implementation of article 4 of the European Union Council Regulation 1466/97 of 7 July 1997. The Regulation requires each Member State of the Union to submit an updated version of the Stability Programme every year to the European Union Council and the European Commission.

The updated Programme is based on the *Economic Financial Planning Document for 2001-2004 (DPEF 2001-2004)* adopted by Parliament on 27 July 2000, its *Update Note*, the *Italian Forecast and Planning Report 2001 (RPP 2001)* and the *Financial Law 2001* that was laid before Parliament by the Italian government on 29 September 2000.

This updated version of the Programme describes the macroeconomic and public finance framework for the year 2000 and the government's targets for the next four years.

I. THE MACROECONOMIC FRAMEWORK

In 2000 GDP growth is expected to reach 2.8 per cent (Table I.1), 0.6 percentage points above last year's forecasts. The upward revision is consistent with improvements in the international economic climate.

For the first time in three years, foreign trade will make a net positive contribution to growth (0.4 per cent of GDP). Exports, sustained by the weakening of the exchange rate and the greater buoyancy of world trade, should rise by 9.5 per cent (Table I.2). Imports, consistently with strong demand, are also rising sharply and should grow at a rate of 8.5 per cent during the current year.

On the domestic demand side, household expenditure should rise by just above 2 per cent, because of the increase in disposable income, contributing 1.4 per cent to economic growth. Investment should play a major role, contributing 1.3 per cent to growth. Investment in machinery and equipment should rise by 8 per cent as a result of favourable demand conditions; investment in construction should increase by 5.5 per cent, on the strength of government policies designed to hasten capital accumulation in depressed areas.

The expansion of production is accompanied by a clear improvement in employment levels. Taking the average for the year, the number of people in employment is expected to rise by 1.2 per cent (Table I.1). Unemployment is expected to fall to 10.7 per cent.

Despite increasing oil prices and the depreciation of the euro, household expenditure deflator should rise by just around 2.8 per cent, mainly because of the slowdown in unit labour costs – a result of wage moderation and productivity upturn – and because of lower corporate profit margins.

In 2001, GDP should rise by 2.9 per cent, just above the figure set out in last year's Stability Programme (2.6 per cent). The acceleration in growth stems from strong domestic demand, whose contribution should rise to 3 per cent (from 2,8 per cent in 2000), and should offset the expected decline in the contribution of net exports caused by the slowdown in world trade. Estimated household expenditure is expected to grow by about 2.5 per cent, and should benefit from higher disposable income and household confidence. Investment will be driven mainly by the improved prospects for both domestic and foreign demand. In particular, investment in the construction industry should rise by 5.5 per cent over the previous year, while investment in machinery and equipment should rise by 8 per cent.

The expected slowdown in world trade and the gradual appreciation of the euro should reduce the growth rate of exports to 6.8 per cent. Import growth is also expected to slow down (to 7.5 per cent) despite the expansionary effects of the domestic demand recovery. The expected improvement in terms of trade should bring about a gradual increase in the current account balance which, after the negative result in 2000, should once again close in surplus.

Labour market prospects should continue to improve in 2001. The number of labour units is expected to rise by 1.1 per cent, while the unemployment rate is expected to fall below the annual average of 10 per cent.

During 2001 the household expenditure deflator is expected to rise by only 2.3 per cent as a consequence of the moderate rise in unit labour costs and a reduction in imported inflation due to a reduction in oil prices and a gradual recovery of the euro.

In the medium term, against a favourable international background, economic growth is expected to rise just above 3 per cent in line with other European countries.

Table I.1 **MACROECONOMIC FRAMEWORK** (percentage values)	1999	2000	2001	2002	2003	2004
Real GDP growth rate	1.4	2.8	2.9	3.1	3.1	3.1
Growth rate of households'consumption deflator	2.2	2.8	2.3	1.5	1.5	1.5
Growth rate of GDP deflator	1.5	1.4	2.4	1.6	1.5	1.5
Employment growth rate	1.0	1.2	1.1	1.1	1.1	1.1
Unemployment rate	11.4	10.7	9.9	9.0	8.3	7.6
Current account balance (as a percentage of GDP)	0.5	-0.1	0.2	0.5	0.6	0.8

Source: For 1999, ISTAT and Bank of Italy. For 2000-2004, Government estimates.

In the three-year period 2002-2004 growth should continue to be driven by domestic demand. Household expenditure – due to growth in employment and the positive trend of disposable income - is expected to grow by about 2.6 per cent. The contribution of net exports is projected to be slightly positive. In this context, the accumulation process is expected to continue at high levels. Gross fixed investment should grow on average at 6.5 per cent per year in 2002-2004: construction industry is expected to grow in real terms by an annual average of 5.5 per cent; investment in machinery and equipment should rise by just above 7 per cent.

The consolidation of economic growth at such high levels and the greater flexibility of the Italian labour market will make it possible to continue the strong growth in employment levels, averaging 1.1 per cent per year. The unemployment rate should therefore drop by more than 2 percentage points, declining, on an annualised average basis, from 9.9 per cent in 2001 to 7.6 per cent in 2004.

In this three-year period, the combination of improved productivity, wage moderation, and stability of commodity prices will keep household expenditure deflator at around 1.5 per cent.

Italy's external current accounts will gradually improve, due to a smaller deficit in capital income and the sound performance in services, thus consolidating the surplus recorded in 2001.

Table I.2 COMPOSITION OF REAL GDP GROWTH (percentage changes at constant prices)

	1999	2000	2001	2002	2003	2004
GDP	1.4	2.8	2.9	3.1	3.1	3.1
Households'consumption	1.7	2.1	2.5	2.6	2.6	2.6
Consumption of general government and of N.P.I.S.H.'s (*)	0.8	1.1	0.6	0.3	0.3	0.2
Fixed investments-equipment	6.2	8.0	8.0	7.5	7.0	7.0
Fixed investments-construction	1.8	5.5	5.5	5.5	5.5	5.5
Changes in inventories and valuables (**)	0.4	-0.4	0.0	0.0	0.0	0.0
Exports	-0.4	9.5	6.8	6.5	6.5	6.5
Imports	3.4	8.5	7.5	6.5	6.5	6.5

(*) N.P.I.S.H. = No Profit Institutions Serving Households.
(**) Contribution to GDP growth.
Source: For 1999, ISTAT. For 2000-2004, Government estimates.

II. PUBLIC FINANCE IN 2000

The target for general government borrowing for 2000 has been set at 1.3 per cent of GDP (Table II.1), based especially on expectation of a growth in GDP of 2.8 per cent. Reaching the borrowing target is linked to the fulfilment of those expectations.

After the implementation of tax relieves the ratio between total revenue and GDP should remain at the level programmed in the DPEF 2001-2004 (46.8 per cent).

Public expenditure should decrease with respect to GDP by around 0.7 per cent, as indicated in the previous Stability Programme.

Table II.1 GENERAL GOVERNMENT MAIN AGGREGATES (as a percentage of GDP)

	1996	1997	1998	1999	2000(*)
Revenues					
Current revenues	45.4	47.2	45.9	46.4	46.3
Capital revenues	0.4	1.0	0.7	0.5	0.5
Total revenue	**45.8**	**48.2**	**46.6**	**46.9**	**46.8**
Expenditures					
Primary current expenditure	37.6	37.9	37.5	38.1	37.7
Interest payments	11.5	9.4	8.1	6.8	6.5
Total current expenditure	49.1	47.3	45.6	44.9	44.2
Capital expenditures	3.8	3.6	3.8	3.9	3.9
Total primary expenditure	41.4	41.5	41.3	42.0	41.6
Total expenditure	**52.9**	**50.9**	**49.4**	**48.8**	**48.1**
Current balance	-3.7	-0.1	0.3	1.5	2.1
Primary balance	4.4	6.7	5.3	4.9	5.2
Net borrowing (**)	**-7.1**	**-2.7**	**-2.8**	**-1.9**	**-1.3**

(*) Government estimates.
(**) The plus sign indicates a surplus and the minus indicates a deficit.

The net borrowing estimate for 2000 is lower than the one presented in the previous Stability Programme because of an improvement in the primary surplus of 0.2 percentage points of GDP, to 5.2 per cent in 2000. Interest payments are expected to fall to 6.5 per cent of GDP in line with the forecasts set out in last year's Stability Programme. The budget current surplus should improve in 2000 to 2.1 per cent (in the previous Programme it was 2.0 per cent), while the budget capital deficit should remain at around 3.4 per cent of GDP (0.1 per cent more than in the previous Stability Programme).

The debt to GDP ratio is expected to go down to 112.1 per cent in 2000 (from 115.1 in 1999) slightly higher than the estimated 111.7 per cent set out in the previous Stability Programme. This is partly due to a revision of the debt estimates of local authorities in light of results for 1999 showing a greater exposure than initially projected.

In 2000 both central government and local authorities' net borrowing is expected to remain at a level similar to that of 1999, namely, 1.4 per cent and 0.1 per cent, respectively. The budget of the Social Security Institutions, after the small deficit recorded in 1999, should once again return to a surplus of 0.1 per cent (Table II.2).

Table II.2 GENERAL GOVERNMENT NET BORROWING (*) BY SUB-SECTOR
(as a percentage of GDP)

	1996	1997	1998	1999	2000
Central government	-6.9	-2.9	-2.7	-1.4	-1.4
Local government	-0.4	-0.2	0.1	-0.2	-0.1
Social Security funds	0.2	0.3	-0.3	-0.2	0.1
General government	-7.1	-2.7	-2.8	-1.9	-1.3

(*) The plus sign indicates a surplus and the minus indicates a deficit.

UMTS auction and privatisation programme 2000-2001

UMTS (Universal Mobile Telecommunications System) is an advanced mobile telecommunications system making it possible to use cellular handsets to receive multimedia and interactive services for the new broadband applications. In Italy, the licences for the use of these applications were allocated using a mixed competitive tendering system: a first selection based on the soundness and reliability of the providers (meeting the technical requirements in terms of financial position and experience in the telecommunications industry) and their industrial record (beauty contest); a second selection through an auction where the bidders made their offers with respect to the floor price of 4000 billion lire, equivalent to about 2000 million euro. For each licence, the difference between the final amount of the tender and the floor price could, at the request of the bidder, be spread over a maximum of 10 yearly instalments beginning in 2001. The licences will last 15 years, beginning on 1 January 2002, when the service is scheduled to start.

The auction offered to the market blocks of frequencies of the same spectrum (2 x 10 MHz of the symmetrical spectrum and 5 MHz of the asymmetrical spectrum), plus two further portions of the symmetrical spectrum (2 x 5 MHz) set aside for two new market entrants winning the basic licences.

Six competitors got through the beauty context and on 19 October 2000 they started to put in competitive tenders, which took 11 rounds to complete, when one of the bidders withdrew from the auction. Licences were allotted to the 5 remaining competing bidders.

Government revenues from the auction are of 23,550 billion lire, to be added to the 3,200 billion lire coming from the award of *the additional portions of the asymmetric spectrum reserved for the two new entrants at their request.*

The 2001 Financial Law *provides that 10 per cent of the revenues from the award of the UMTS licences are used to fund scientific research and programmes in the IT sector.*

For the two years 2000-2001, the DPEF 2001-2004 *anticipated revenues from privatisation for an amount of 65,000 billion lire, including 90 percent of the revenues from the UMTS licences. To achieve this target, the government plans: a) to sell-off between the end of 2000 and 2001 its remaining holdings in banks and insurance companies; b) to cash in the proceeds from the winding up of IRI S.p.A. Moreover, in normal market conditions, the Government plans to sell his holdings in Telecom Italia, and shares in ENI and ENEL corresponding to 5 per cent and 10 per cent of their respective capital.*

III. PUBLIC FINANCE TARGETS FOR 2001-2004

Budgetary policy for 2001-2004, consistently with the trends of the public finance aggregates and the planned consolidation path, is designed to support growth, while respecting the previously established objectives and targets.

Table III.1 PUBLIC FINANCE TARGETS IN 2001-2004 (as a percentage of GDP)

	2001	2002	2003	2004
Primary balance	5.3	5.5	5.6	5.5
Interest payments	6.1	6.0	5.6	5.2
Net borrowing (*)	-0.8	-0.5	0.0	0.3
Public debt	106.6	103.5	99.6	94.9

(*) The plus sign indicates a surplus and the minus indicates a deficit.

The overall general government deficit in 2001 should drop to 0.8 per cent of GDP, reach balance in 2003, and attain a surplus in 2004 (Table III.1).

Throughout the whole four-year period, the primary surplus should remain stable around an average of 5.5 per cent of GDP. Interest expenditure will continue to fall as a proportion of GDP from 6.5 per cent in 2000 to 5.2 per cent in 2004. The reduction of the cost for debt service should be reined in by the constant reduction in the borrowing requirement and by a comprehensive debt management policy.

Table III.2 shows the projected balances of the general government sectors throughout the period 2001-2004. Data take into account the expected effects of the *2001 Financial Law*. Therefore, data for 2001 represent the targets for that year, while the values for

Table III.2 GENERAL GOVERNMENT NET BORROWING (*) BY SUB-SECTOR (as a percentage of GDP)

	2001 Targets	2002 Trend projections	2003 Trend projections	2004 Trend projections
Central government	-1.1	-1.2	-0.5	0.7
Local government	0.1	0.1	0.2	0.3
Social security institutions	0.2	0.4	0.4	0.3
General government	-0.8	-0.7	0.1	1.3

(*) The plus sign indicates a surplus and the minus indicates a deficit.

subsequent years are (projected trends) that take into account the effects of the corrective measures introduced in 2001, but not those coming from the measures planned for subsequent years.

Thanks to the enhanced privatisation programme in 2001 and the allocation of the UMTS licences, the debt to GDP ratio will continue to fall to reach 99.6 per cent in 2003 (0.3 percentage points below last year's Stability Programme figure) and 94.9 per cent in 2004 (Figure III.1).

Figure III.1 GENERAL GOVERNMENT DEBT *(as a percentage of GDP)*

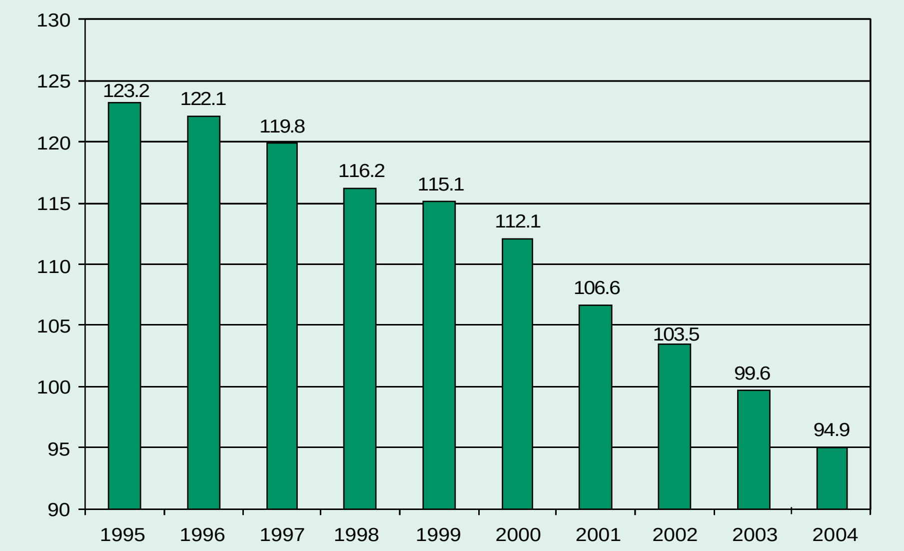


Table III.3 illustrates the structural public finance balances consistent with the targets presented in Table III.1. The structural balance for the period 2001-2004 shows a gradual improvement and will eventually come close to balance. In the first two years the estimated output gap for the Italian economy is still negative and the structural deficit therefore is lower than the official target. Conversely, in the period 2003-2004, the output gap is assumed to be positive, which means that the balance or surplus in terms of the official targets corresponds to a small structural deficit.

Table III.3 CYCLICALLY-ADJUSTED GOVERNMENT DEFICIT (-) OR SURPLUS (+) (as a percentage of GDP)

	Structural balances (*)	Official targets
2001	-0.4	-0.8
2002	-0.4	-0.5
2003	-0.2	-0.0
2004	-0.2	0.3

(*) Structural balances are calculated by using estimates of potential output (OECD data) and estimate of the elasticity of the deficit/GDP ratio to the output gap (OECD data as revised by European Commission: *Public Finances in EMU-2000*).

In the event that the higher GDP growth indicated in this Update is structural rather than cyclical ([1]), the structural budgetary surplus in the two years 2003-2004 could be closer to the official targets.

The consequences of population ageing

Figure III.2 shows three scenarios for pension expenditure trends as a percentage of GDP in the forecasting period 2000-2050 ([2]). The first scenario is the one published in the DPEF 2001-2004. *The other two scenarios have been prepared for the* Report

([1]) The estimated potential annual GDP growth rate corresponds with the one of the OECD, and in the period 2001-2004 equals about 2.3 per cent.

([2]) Forecasts provided by the Ragioneria Generale dello Stato.

on the Impact of Ageing Populations on Public Pension Systems *by the Economic Policy Committee of the European Union, and discussed at the Council of Economic and Finance Ministers of the European Union (ECOFIN) on 7 November 2000.*

The three scenarios differ in terms of the underlying demographic and macroeconomic assumptions. The forecasts presented in the DPEF 2001-2004 *use ISTAT's demographic central scenario. Real GDP growth is on average slightly above 1.4 per cent throughout the forecasting period, above average in the first decade, slightly below it in the following period, and converging with it just before 2045. Productivity growth averages 1.8 per cent in the forecasting period, rising slightly above average after 2020. The scenario presented in the ECOFIN Report, defined "under current EU policies", uses the main variant demographic forecasts that have been specifically updated by EUROSTAT. Italy's data on life expectancy and immigration flows are higher here than in the central ISTAT scenario. The macroeconomic scenario has been agreed by EU and OECD technical working groups. Both scenarios show that Italy's GDP will grow at just above 1.4 per cent on average in the whole forecasting period, with significantly higher values in the first part of the period, a decline up to 0.9 per cent in the period 2035-2039, followed by a rise of up to about 1.2 per cent at the end of the forecasting period. Labour productivity will average 1.8 per cent throughout the whole period, with slightly higher values in the first few years.*

A second scenario given in the ECOFIN Report is defined as the "Lisbon scenario" because it is based upon EU employment rates consistent with the conclusions of the Lisbon Council in March 2000. This scenario uses the high variant demographic forecasts specifically updated by Eurostat(3)*. The average GDP growth rate throughout the period is just below 1.5 per cent. However, in this scenario the employment rate is significantly*

(3) Fertility rates and life expectancy are therefore higher than in the main variant scenario.

higher than in the other scenarios([4]) *whereas productivity growth rate will be slightly above 1 per cent on average throughout the forecasting period.*

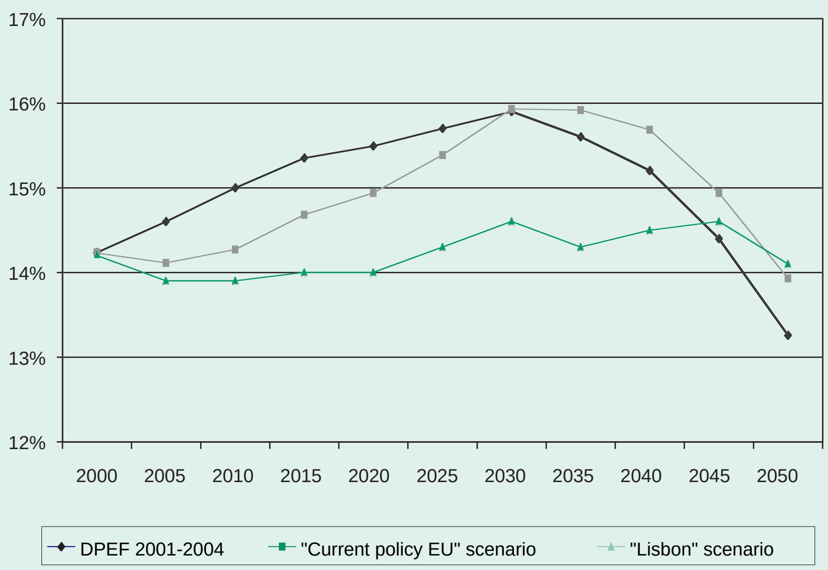
In the DPEF scenario, the ratio of pension expenditure to GDP will rise from about 14.2 per cent in 2000 to about 15.9 per cent in 2030, before falling thereafter. The increase is due to the expected rise in the ratio of retirees to employed people. This is offset only partially by a reduction in the ratio between average pension outlays and productivity stemming from the reform measures adopted.

In the "EU current policies" scenario, even though pension expenditure as a percentage of GDP only increases from 2005, the acceleration is faster. Pension expenditure in percent of GDP is expected to rise from 14.1 per cent in 2005 to 16 per cent in 2030, where it will remain for about five years before starting to fall. The difference between this trend and the results presented in the DPEF 2001-2004 is due to the larger increase in both employment and productivity in the first decade of the forecasting period. The larger increase in the two variables produces a greater number of pensions and higher average pension outlays, respectively, in the final decades of the forecasting period.

Finally, in the "Lisbon" scenario, the pension expenditure to GDP ratio remains constant from 2005 to 2020, while dipping briefly in the first five years of the forecasts. After 2020 the ratio rises, although significantly less sharply than in the other two scenarios. The difference in this case lies in the assumption of a higher increase in employment, and this can only be achieved if the average retirement age rises by about three years.

([4]) For Italy, the participation rate will rise from the present level of just above 50 per cent to about 80 per cent by the end of the forecasting period, with an acceleration in the first decades.

Figure III.2 PENSION EXPENDITURE PROJECTIONS (as percentage of GDP)



IV. BUDGET MEASURES FOR 2001

On the basis of the revised public account trends submitted in the *Update to the DPEF 2001-2004*, the general government balance in 2001 should be in surplus thanks to the tax reforms introduced in recent years, rigorous budgetary policy and ongoing development of the macroeconomic framework. In particular, increased revenues of 26,800 million lire (13.84 billion euro, or 1.1 per cent of GDP), which is higher than the deficit target of 23,700 billion lire (2.24 billion euro) given in *DPEF 2001-2004*, would raise fiscal pressure by about one percentage point over the forecasts set out in DPEF 2001-2004.

However, since Italy's fiscal pressure is already higher than the European average ([5]) the government has decided to use the extra tax revenues for tax reductions higher than those already planned, while at the same time improving the programmed targets set out in DPEF 2001-2004. The 2001 Financial Law provides measures to foster growth for an amount of 32,600 billion lire (16.84 billion euro) equivalent to 1.4 per cent of GDP, and corrective measures for 8,000 billion lire (4.13 billion euro) equivalent to 0.3 per cent of GDP. The former consist of tax relief for 22,400 billion lire (11.57 billion euro) and increased expenditure on current and capital budget respectively for 6,400 billion lire (3.3 billion euro) and 3,800 billion lire (1.96 billion euro). The corrective measures consist of a reduction in expenditure consequent to rationalising procurement of goods and services by government departments and to the proceeds from the sale of real estate.

The effect of the measures provided by the *2001 Financial Law* will therefore reduce the deficit to 19,500 billion lire (10.07 billion euro), equivalent to 0.8 per cent of GDP.

([5]) In 1999, Italian fiscal pressure was 43.7 per cent compared to the 43.4 per cent average for the European Union (European Commission: *Public finances in EMU-2000*).

The 2001 budget measures are designed to affect 4 intertwined areas:

- To stabilise and increase the purchasing power of households, particularly by gradually reducing fiscal pressure;
- To raise employment and to update the skills of the labour force;
- To improve the efficiency of public services, particularly in the sectors of health care, education, public security, justice, university and research by hastening the pace of computer utilisation and by improving workforce pay in these sectors;
- Accelerating growth in southern Italy.

Table IV.1 EVOLUTION OF PUBLIC FINANCE INDICATORS 2001-2004 (as a percentage of GDP)

	2001 Targets	2002 Trend projections	2003 Trend projections	2004 Trend projections
Revenues				
Current revenues	45.6	45.2	44.6	44.3
Capital revenues	0.8	0.4	0.4	0.4
Total revenues	**46.4**	**45.6**	**45.0**	**44.7**
Expenditures				
Primary current expenditures	37.0	36.4	35.7	34.7
Interest payments	6.2	6.0	5.6	5.2
Total current expenditures	43.1	42.4	41.3	40.0
Capital expenditures	4.1	3.9	3.6	3.4
Total primary expenditures	41.0	40.4	39.3	38.1
Total expenditures	**47.2**	**46.3**	**44.9**	**43.3**
Current balance	2.4	2.8	3.3	4.3
Primary balance	5.3	5.3	5.7	6.5
Net borrowing (*) (**)	**-0.8**	**-0.7**	**0.1**	**1.3**
Corrective measures planned		0.2	-0.1	-1.0
Net borrowing target		**-0.5**	**0.0**	**0.3**

(*) For 2001 net borrowing target; for 2002-2004 net borrowing trend projections.
(**) The plus sign indicates a surplus and the minus indicates a deficit.

Table IV.1 illustrates the effects of these adjustments for the four-year period. In order to reach a deficit to GDP ratio of 0.5 per cent by 2002, further corrective measures amounting to 0.2 per cent of GDP are planned. The effects that these measures will have on the budget in 2003 and 2004 will ensure that no further corrective measures are needed in subsequent years.

Current expenditure, net of interest payments will be lower by about two percentage points over the four-year period (from 37 per cent in 2001 to 34.7 per cent in 2004). The reduction of current primary expenditure will make it possible to simultaneously reduce total revenues as a percentage of GDP from 46.4 per cent in 2001 to 44.7 per cent in 2004. Capital expenditure, after allowing for the new investment financing measures, will fall from 4.1 per cent of GDP in 2001 to 3.4 per cent in 2004 ([6]).

IV.1 Measures on the revenue side

The purpose of budgetary policy on the revenue side is to gradually reduce the tax and social security contribution burden in particular for low skilled workers by using the additional resources coming from the widening of the tax base. This widening is the consequence of the measures adopted since 1997 to rationalise the tax system and to fight tax evasion. In particular, following an agreement between the Ministry of Finance and business association specific sectoral analyses were introduced. Tax evasion has been reduced by means of cross-inspection, made possible by the introduction of the *delega unica di versamento* (a single tax declaration for individual taxpayers subject to VAT).

Reduction in taxes and contributions will mainly consist of relieves granted to households and business. These will benefit respectively of two-thirds and one-third of the overall amount of reductions. In particular, the upper bound of the first income bracket is increased from 15 to 20 million lire; marginal tax rates for the second and third brackets (from 20 to 30 million lire and from 30 to 60 million lire) are reduced by one percentage point (respectively from 25,5 to 24,5 per cent and from 33,5 to 32,5 per cent); tax deductions for low income households are increased; income tax on the first owned house is abolished and tax relieves for tenants are confirmed.

([6]) These trends are based upon "current legislation", in other words, without considering any new capital investment financing which the Financial Law is required to provide every year.

For the business sector, the main measures consist of a reduction in corporate income tax (IRPEG) rate from 37 to 36 per cent in 2001, and by a further 1 percentage point starting in 2003; a reduction in advance tax payments of IRPEG from 98 per cent to 93 per cent, and of IRAP tax from 98 to 95 per cent for the fiscal year 2000. Additional IRPEG reductions might be granted conditional to the increase in tax revenues stemming from the fight to undeclared work. The assessment of the higher tax revenues in the period 2001 will be carried out by the Ministry of Finance by 31 March 2002 on the basis of the new contracts for previously undeclared workers (*contratti di emersione*) signed up to 30 November 2001. Tax credits will be offered for new investment in depressed areas in Southern Italy and for hiring workers under open-ended labour contracts. Important measures are also being introduced in the field of energy expenditure, for a total of 3,800 billion lire (1.96 billion euro), in order to neutralise the positive effect of increased oil prices on the tax levy. These measures mainly consist of granting, up to 2001, a tax discount on GPL and diesel, as already done since October 1999.

IV.2 Measures on the expenditure side

On the expenditure side, the programmed measures are designed to bring about a net reduction in current expenditure and an increase in capital expenditure. The measures refer to social security, health, public security, justice, research, the procurement of goods and services by government departments, and local finance.

The Social Security measures are aimed to the surfacing of large sectors of informal employment. For this purpose, the share of the pension (above the minimum threshold) allowed to cumulate with earnings from self- employment has been raised from 50 to 70 per cent. Sharing the concerns expressed by the European Union regarding the impact of population ageing on public pensions spending, the government has also made provision to encourage older workers to stay in employment after reaching the legal retirement age. As from April 2001, anyone entitled to a seniority pension may decide to remain in work under a fixed-term contract for a minimum period of two years, being exempted from the payment of pension contributions. They will eventually receive a pension in the amount calculated at the time they became entitled to the pension.

Further savings come from an efficient and co-ordinated system of procurement of goods and services by decentralised spending authorities. This system is designed to increase the bargaining power of these authorities. Local authorities, local health boards and universities will join forces locally and draw up common procurement strategies by standardising their orders by commodity. These authorities can also sign contractual agreements that can apply nationally of regionally, to which all authorities may adhere if they so wish. The new arrangement should also develop thanks to e-commerce and on-line auctions. Additional savings will also accrue as a result of the planned reduction in the number of privately-owned buildings rented by government departments.

As far as capital expenditure is concerned, the public finance measures for 2001 will make it possible to implement programmes over several years totalling more than 80,000 billion lire (41.32 billion euro) in new investment and infrastructure.

In order to strengthen the corrective measures of the *Financial Law for 2001*, new comprehensive rules for the implementation of the Internal Stability Pact have been defined in 2000 concerning the technical calculation of the general government deficit. These rules improve the co-ordination between central, regional and local financial authorities started in 1998. They foster a stricter adherence to the financial constraints of the Internal Stability Pact through a gradual reduction of central authority financing to local authorities deficit.

V. SENSITIVITY OF TARGETS TO MACROECONOMIC ASSUMPTIONS

This Section illustrates the updated estimates of the sensitivity of the public finance targets to the macroeconomic assumptions adopted.

V.1 Sensitivity to interest rates

In recent years Italy's public debt management policy has radically changed the debt structure. As shown in Table V.I, in December 2000 about 70 per cent of the aggregate debt was in fixed-rate bonds (compared to 32 per cent in December 1992 and 47 per cent in December 1996) with an average maturity of 5.7 years (compared to 3 years in December 1992 and 4,5 years in December 1996). The policy of bond issuing has gradually reduced the sensitivity of the cost of the debt to interest rate fluctuations.

Tavola V.1 SHARE OF FIXED-RATE GOVERNMENT BONDS AND AVERAGE MATURITY OF THE DEBT

	December 1992	December 1996	December 2000
Share of fixed-rate bonds (*)	32	49	70
Average debt maturity	3.0	4.5	5.7

(*) Fixed-rate bonds include BTP, CTZ, CTO, CTE and a share of the bonds denominated in foreign currency.

Assuming a one percentage point increase throughout the whole yield curve in January 2001, the impact of the increase on interest expenditure as a proportion of GDP should be 0.19 per cent in the same year (4,500 billion lire or 2.32 billion euro), 0.39 per cent in 2002 (9,650 billion lire or 4.98 billion euro), 0.45 per cent in 2003

(11,600 billion lire or 5.99 billion euro) and 0.50 per cent in 2004 (13,400 billion lire or 6.92 million euro)(7).

As a caveat, it should be recalled that the present exercise is designed to analyse interest expenditure gross of tax deduction. The effects of interest rate variations on economic activity or tax revenues on capital (taxes on interest payments from fixed-yield securities and bank deposits which are positively correlated to interest rate increases) are not taken into account. The results set out here cannot therefore be used to automatically show the sensitivity of the overall budget balance to interest rate variations.

V.2 Sensitivity of the deficit to GDP ratio to economic growth

This exercise illustrates the effect on the deficit to GDP ratio in 2004 of different economic growth assumptions for the period 2002-2004. In particular, in the case of lower (higher) growth, the GDP growth rate is assumed lower (higher) by half percentage point in each year during the period 2002-2004 with respect to the growth forecasts set out in Section I.

In the simulation, the impact of economic growth on the primary balance as a ratio of GDP is calculated using the estimate of the elasticity of the budget balance to growth, as calculated by the European Commission (*Public finances in EMU-2000*). In this exercise it is assumed that the average cost of the debt is independent

Table V.2 SENSITIVITY OF GOVERNMENT BALANCE AS A RATIO OF GDP TO GDP GROWTH (percentage values)

	Average GDP growth rate 2002-2004	Net borrowing/PIL 2004 (*)
Baseline scenario	3.1	0.3
Lower growth scenario	2.6	-0.4
Higher growth scenario	3.6	1.0

(*) The plus sign indicates a surplus and the minus indicates a deficit

(7) A one per cent reduction in interest rates would have approximately a symmetricthe same effect on interest expenditure.

of assumptions regarding the real GDP growth rate. As Table V.2 illustrates, in the final year of the simulation, even if GDP growth rate is lower in the period 2002-2004, the balance will show a deficit of 0.4 per cent of GDP.

Consequently, because of the recent public finance results and the expected high primary surplus, the impact of an economic slowdown will not hamper the path towards achieving medium-term budget balance.

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