Italy's Stability Programme

November 2001 Update

FOREWORD

The *Economic and Financial Planning Document 2002-2006*, drafted by the Government last summer, sets out an ambitious programme of reforms designed, within a framework of macroeconomic compatibility, to restore the competitiveness of the Italian economy and accelerate growth.

The *Finance Bill for 2002*, submitted to Parliament at the end of September in a sharply worsened economic context with respect to the summer, reaffirms the objectives of fulfilling Italy's European commitments, sustaining growth, and furthering social equity.

The Finance Law will be followed, even before the end of 2001, by a series of measures implementing the Government's programme of structural reforms in key sectors such as taxes, social security, labour market and welfare system in general. The reform project hinges also on accelerating privatisations and liberalisation, to enhance the competitiveness and efficiency of the economy.

As a whole, all these measures are designed to achieve a significant increase in the economy's potential growth rate.

1. INTRODUCTION

Italy’s Stability Programme Update is adopted in accordance with Article 4 of European Council Regulation 1466/97 of 7 July 1997. The Regulation requires each Member State to submit an updated version of its stability programme to the Council and the Commission every year.

The Programme Update is based on the *Economic and Financial Planning Document* for 2002-2006 (DPEF 2002-2006) approved by Parliament on 1 August 2001, on the *Forecast and Planning Report for 2002* (RPP 2002), presented to Parliament by the Minister of Economy and Finance on 27 September 2001, on the *Finance Bill for 2002* presented to Parliament on 29 September 2001, and on the *Update to the Economic and Financial Planning Document* for 2002-2006 presented to Parliament at the end of October.

The Programme Update sets out the macroeconomic and public finance framework for 2001 and the Government's targets for the next four years.

The short-term growth outlook for the Italian economy has deteriorated since last year's Stability Programme Update. Two are the main reasons of the worsening: the slowdown in the world economy, which became more pronounced starting from the summer 2001, and the political and economic uncertainty provoked by the terrorist attacks against the United States in September.

The GDP growth forecast has accordingly been revised downward by nearly one percentage point for 2001 and for 2002 with respect to last year's Programme. Therefore, growth will be significantly below the economy's potential for these two years. Nevertheless, even the new growth forecasts are subject to considerable uncertainty and could be revised in the light of new information on the economic juncture.

Once the current international crisis has been overcome, it is estimated that Italy can achieve the objective of sustained growth of about 3 percent per year, thanks to the planned structural reform of tax and social security systems, to a greater utilization of the resources in the less developed parts of the country and to continuing liberalization of the labour and goods markets.

Even in the less favourable outlook foreseen in the present Update, Italy's public finance strategy maintains the objective of a balanced budget in 2003 and of a reduction in the public debt. This objective implies an improvement of the cyclically adjusted budget balance in comparison with the one envisaged by last year's Stability Programme.

Overall, Italy's economic policy strategy is aimed at creating the conditions for sustained growth in a context of broad price stability, through the implementation of structural reforms, the reduction in the tax burden, and the progressive improvement in the public finances. The Government's budget for 2002 is an important first step in this strategy. The budget package is intended to combine stability, social equity and support to the economy, with full commitment to the public finance objectives laid down in the Stability and Growth Pact.

2. THE MACROECONMIC FRAMEWORK

Reflecting the steady worsening of the world economic outlook (see Appendix 1), the Italian economy has slowed down in 2001. GDP should expand by 2 percent on average, nearly a full percentage point less than forecast by the Stability Programme Update submitted in December 2000. The contribution of domestic demand to growth is estimated at 1.7 percentage points; that of net exports is practically nil. Investment records a marked deceleration in comparison with 2000, in connection with the slowdown in growth and the deterioration of expectations. A growth of 2.5 percent is currently estimated for investment in machinery and equipment and of 2.7 percent for investment in construction.

Consumer spending will be less than forecast, given a more cautious attitude on the part of households, the slower rise in disposable income, and the erosion of purchasing power due to inflation. This effect has been partly offset by tax relief and the constantly improving state of the labour market. Consumer spending should rise by 1.6 percent.

In the labour market, even assuming a slowdown in the second half of the year, employment should expand by 1.5 percent in 2001, continuing the upward trend of recent years. The unemployment rate should thus decline further to 9.6 percent, basically in line with the forecast given in last December's Stability Programme despite slower economic growth. This mainly reflects the improved functioning of the labour market. Nevertheless severe disparities by region, gender and age remain, which will be dealt with by appropriate measures.

The persistent weakness of the euro and the significant pick-up in unit labour costs, only partly offset by the reduction in raw materials prices and basically constant mark-ups, are reflected in an inflation rate that will be 2.8 percent on average in 2001 but slowing steadily in the course of the year. By December the year-to-year rate should be 2.2 percent.

In 2002, economic growth is estimated at 2.3 percent, 0.6 percentage points less than forecast in the December 2000 Stability Programme. This revised forecast, on which the *Finance Bill* for 2002 is based, reflects the assumption that the sharp deterioration in the world economy registered in the past few months will gradually give way to improvement in the course of 2002 and that domestic demand will rebound thanks also to the economic policy measures, such as the tax relief on reinvested profits and the acceleration of investment in public works already enacted in the second half of 2001.

Turning to individual components of demand, household consumption should increase by 2.5 percent, spurred by recent income support measures, by the positive trend in the labour market, by the decline in inflation, and by a recovery in confidence.

The improvement in expectations and the full impact of the economic stimulus measures should also boost gross fixed capital formation, which is forecast to rise to an annual rate of growth of 4.8 percent. Investment in construction should grow by 3.5 percent and that in machinery and equipment by 5.7 percent. The public sector will contribute to investment growth by speeding up the completion of works planned in the past thanks to the reform of the authorization process for strategic public works and the use of public and private financial resources

Given the trend in world trade, export growth should slow down slightly from 5.6 percent this year to 5.3 percent in 2002. By contrast, import expansion stimulated by the recovery in domestic demand, especially in investment spending, is expected to accelerate from 5.5 to 7.6 percent.

The expansion of economic activity should give rise to employment growth of 2.8 percent in the private service sector and 2.7 percent in construction. In industry (excluding construction), there should be a slight decline in employment levels. Therefore, it is estimated that the number of standard labour units (full-time equivalent workers) will rise by 1.2 percent, representing a modest slowdown with respect to 2001. The unemployment rate should come down to 9.2 percent.

An easing of inflationary pressures is forecast, due to both a recovery in the value of the euro and a slowdown in unit labour costs. The inflation rate should be no more than 1.7 percent on average for the year.

In the years to follow, once the present downturn is over, the outlook for world economic growth should turn positive. In this context a growth rate of 3 percent can be expected in the medium term. A series of factors will contribute to the achievement of this growth target, including continuing efforts in labour market reform, which will continue to lead to high rates of employment growth; structural reform in the product markets, which will foster productivity gains; tax and welfare reform, which will stimulate labour demand, capital formation and investment in research and development; and the completion of the public finance consolidation process, which will contribute to an increase in national saving and a robust growth of investment.

The growth forecasts for the next few years are consistent with fuller utilization of the resources available especially in the less developed regions of the country. To this end the Government intends to take measures to reinforce the results of recent years, when GDP growth in the South has been faster than in other regions.

In the medium term, on the demand side growth will be sustained not only by the recovery in investment, which should increase at an average annual rate of 5.7 percent in 2003-2005, but also by the growth of household consumption and the positive trend in exports.

The consolidation of growth will create jobs with employment increasing at a pace of 1.5 percent, leading to lower unemployment. At the end of the projection period, in 2005, the unemployment rate should be 7.5 percent and the employment rate 58.5 percent, in line with Italy's European targets.

In the absence of external inflationary pressures, wage growth in line with productivity gains should allow a slow but steady decline in inflation, which should stabilise at 1.0 percent from 2004.

Table 1 - Macroeconomic Framework

	2000	2001	2002	2003	2004	2005
GDP growth at constant market prices	2.9	2.0	2.3	3.0	3.0	3.1
GDP level at current market prices (billions of euros)	1,165.68	1,224.39	1,281.79	1,344.17	1,404.49	1,469.12
Growth rate of GDP deflator	2.2	3.0	2.4	1.8	1.5	1.4
Inflation rate [1]	2.5	2.8	1.7	1.3	1.0	1.0
Employment growth[2]	1.5	1.5	1.2	1.5	1.6	1.5
Labour productivity growth [3]	1.4	0.6	1.2	1.5	1.4	1.6
Composition of GDP growth: percentage change at constant prices						
Private consumption expenditure	2.9	1.6	2.5	3.0	3.0	2.8
Government consumption expenditure and of NPISH [4]	1.7	1.1	0.3	0.2	0.3	0.3
Gross fixed capital formation	6.1	2.6	4.8	6.2	5.4	5.6
Change in inventories and net acquisition of valuables [5]	-1.0	0.2	0.3	0.2	0.1	0.1
Exports of goods and services	10.2	5.6	5.3	7.2	7.3	7.4
Imports of goods and services	4.1	5.5	7.6	8.6	8.0	7.4
Contribution to GDP growth						
Final domestic demand	3.3	1.7	2.6	3.2	3.1	3.0
Change in inventories and net acquisition of valuables	-1.0	0.2	0.3	0.2	0.1	0.1
External balance of goods and services	0.6	0.1	-0.6	-0.4	-0.2	0.0

1 Change in harmonized consumer price index (HICP).
2 National accounts definition.
3 Real GDP growth per person employed.
4 NPISH: non-profit institutions serving households.
5 Contribution to GDP growth.

3. NET BORROWING AND THE PUBLIC DEBT

Budgetary policy for 2001 has been mainly directed to achieving the target for general government net borrowing set in last December's Stability Programme and confirmed in the *Economic and Financial Planning Document* for 2002-2006. The measures taken have the twofold aim of sustaining growth, given that GDP is still below potential, and further improving the budget balance.

Specific measures have accordingly been taken in the components of expenditure that showed the most serious problems in the first half of the year. The curbing of expenditure – through cuts in appropriations for this year, careful monitoring of spending by local bodies, greater accountability of regional governments for controlling health expenditure – and the start of a vigorous plan for enhancing the value of public assets, in particular real estate, have succeeded in bringing the projected budget balance back onto the adjustment path set out in preceding Stability Programmes.

Table 2. Divergence from previous update of Stability Programme

	2000	2001	2002	2003	2004
GDP growth					
Stability Programme 2000	2.8	2.9	3.1	3.1	3.1
Stability Programme 2001	2.9	2.0	2.3	3.0	3.0
Difference	0.1	-0.9	-0.8	-0.1	-0.1
Actual budget balance (% of GDP)					
Stability Programme 2000	-1.3	-0.8	-0.5	0.0	0.3
Stability Programme 2001	-1.5	-1.1	-0.5	0.0	0.0
Difference	-0.2	-0.3	0.0	0.0	-0.3
Gross debt levels (% of GDP)					
Stability Programme 2000	112.1	106.6	103.5	99.6	94.9
Stability Programme 2001	110.5	107.5	104.3	101.0	98.0
Difference	-1.6	0.9	0.8	1.4	3.1

In the *Forecast and Planning Report* for 2002 submitted in September, with an economic growth projection 0.9 percentage points lower than forecast in the previous Programme, the estimated general government deficit was revised to 1.1 percent of GDP (Table 2), just 0.3 percentage points above the objective set in last year's Stability Programme, thus continuing the downward trend in both actual and structural deficit in relation to GDP.[1]

[1] See Section 3.1 for an analysis of cyclically adjusted budget balances.

Table 3 shows the projected trends in the main general government budgetary aggregates for 2000-2005. The estimates include only the expected impact of the *Finance Bill* for 2002. [2] Hence the figures consider neither the effects of tax and social security reform, still being finalised, nor those of the Finance Laws of future years.

Net borrowing for 2001 is the result of total expenditure equal to 47.2 percent of GDP, in line with last year's Stability Programme. Stabilising this ratio was made possible by the careful management of total expenditure during the second half of the year. Public debt management succeeded in holding interest expenditure to 6.2 percent of GDP, just one tenth of a percentage point more than previously indicated.

Total receipts are expected to amount to 46.1 percent of GDP, 0.3 percentage points less than previously expected.

The primary balance, as shown in Table 3, is projected at 4.9 percent of GDP. This ratio is not directly comparable to that of the previous Stability Programme, because under the new Code of Conduct on the content and format of the stability programmes it is calculated considering interest expenditure net of interest income. Using last year’s definition, the primary balance would be 5.1 percent of GDP, 0.2 points less than indicated in the last Programme.

The debt to GDP ratio, owing in part to slower implementation of the privatisation plan due to the instability of the equity market, is expected to decline to 107.5 percent, about one percentage point higher than was forecast in the previous Programme.

Based on the measures taken already this year and the provisions of the budget for next year, the Government reaffirms the target of general government net borrowing of 0.5 percent of GDP in 2002, as in the previous Programme.

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[2] Its effects also extend to the following years.

Table 3. General government budgetary developments[1]

As percentage of GDP[2]	2000	2001	2002	2003	2004	2005
Net lending by sub- sector						
General government	-1.5	-1.1	-0.5	0.0	0.0	0.2
Future measures[3]				0.3	0.1	-0.4
Central government	-2.2	-2.3	-1.4	-1.1	-1.0	-0.3
Local government	0.1	0.6	0.5	0.5	0.5	0.5
Social security institutions	0.5	0.5	0.4	0.3	0.3	0.4
General government						
Total receipts	45.8	46.1	46.5	45.7	45.1	44.8
Total expenditure	47.3	47.2	47.0	46.0	45.2	44.2
Future measures[3]				0.3	0.1	-0.4
Actual budget balance	-1.5	-1.1	-0.5	0.0	0.0	0.2
Net interest payments[4]	6.3	6.0	5.7	5.5	5.2	5.1
Primary balance[5]	4.8	4.9	5.2	5.5	5.2	5.3
Components of revenues						
Tax revenue	29.6	29.5	29.4			
Social security contributions	12.7	12.7	12.4			
Interest income	0.2	0.2	0.2			
Other receipts	3.2	3.8	4.4			
Total receipts	45.8	46.1	46.5			
Components of expenditures						
Collective consumption	7.1	7.3	7.1			
Social transfers in kind	10.8	10.6	10.4			
Social transfers other than in kind	16.7	16.6	16.9			
Interest payments	6.5	6.2	5.8			
Subsidies	1.2	1.1	1.1			
Gross fixed capital formation	2.4	2.5	2.5			
Other expenditures	2.6	2.9	3.1			
Total expenditures	47.3	47.2	47.0			

1 Figures do not include the effects of structural reforms on taxation and on pensions.
2 Details may not add, due to rounding.
3 Planned for future Finance Laws. The positive (negative) sign indicates a correction increasing (reducing) the primary balance.
4 Interest payments net of interest income.
5 Actual budget balance less net interest payments.

For the years after 2002, budgetary policy will continue to be compliant with the financial adjustment path agreed at European level. One of the benefits of a rigorous fiscal policy is the lowering of interest payments, which is of special importance for a country like Italy burdened with the legacy of a large public debt. Starting in 2003 the Government intends to achieve a substantial reduction in the tax burden, so as to foster both economic growth and greater social equity. Taking the uncertainty of the world economy into account, the Government proposes, in harmony with the letter and the spirit of the Stability and Growth Pact, to revive the countercyclical function of fiscal policy by achieving a budget surplus and thereby allowing effective operation of built-in stabilizers in response to cyclical fluctuations vis-à-vis potential output.

In short, for 2003 the Government confirms the target of a balanced budget, as in the previous Stability Programme. The same target is set for 2004. At the same time, with a substantial reduction in taxes, the Government is committed to taking the measures needed for a budget surplus from 2005 and to bringing this forward if public finance conditions allow it.

The attainment of these objectives will be facilitated by the commitment to an appreciable reduction in current non-interest expenditure[3], a revision of the evolution of interest rates and, therefore, lower state sector borrowing requirements.

Thanks to the high primary surplus as a percentage of GDP and the resumption of privatisations, the debt/GDP ratio will continue its progressive decline, coming down to 95.4 percent in 2005.

3.1 The cyclically adjusted budget balance

Table 4 sets out cyclically adjusted public finance balances. The balances have been calculated using two different methods consistent with those used by the OECD and by the European Commission.[4]

First, it has been assumed that the increase in growth predicted starting from 2003 is entirely cyclical, linked to world economic recovery and to a fuller utilization of productive factors. Even under this hypothesis, both methods result in estimates of the output gap that remain negative for 2001-2003 and turn positive in 2004. In 2001,

[3] The containment of primary expenditure is not reflected in Table 3, which from 2003 projects public finance aggregates on a trend basis.

[4] The OECD approach to estimating the output gap is more closely bound with an economic model (the "production function method"), while that of the Commission is a statistical method (the "Hodrick-Prescott method").

the cyclically adjusted balance[5] according to the European Commission method amounts to –0.9 percentage points; under the OECD approach, it is –0.5 percentage points. Therefore, both estimates show an improvement of 0.5 points compared with the previous year.

In 2002, the cyclically adjusted budget will be in balance and in 2003 it will turn into a small surplus, continuing its upward trend. The targets of budgetary balance for 2004 and the surplus for 2005 imply structural budgets close to balance in both years.

The expected improvement in the structural balance as a percentage of GDP between 2001 and 2003 is accompanied by an increasing primary surplus as a percentage of GDP on a cyclically adjusted basis. In subsequent years the cyclically adjusted primary surplus as a percentage of GDP declines.

Table 4. Cyclically adjusted public finance indicators (as percentage of GDP)

	2000	2001	2002	2003	2004	2005
GDP growth at constant prices	2.9	2.0	2.3	3.0	3.0	3.1
Actual budget balance	-1.5	-1.1	-0.5	0.0	0.0	0.2
Interest payments	6.5	6.2	5.8	5.6	5.4	5.2
Output gap						
OECD method; scenario (a)[1]	-1.2	-1.4	-1.3	-0.6	0.2	1.1
OECD method; scenario (b)[2]	-1.2	-1.4	-1.3	-0.8	-0.5	-0.3
Commission method	-0.3	-0.6	-0.7	-0.2	0.3	0.8
Cyclical budgetary component						
OECD method; scenario (a)[1]	-0.5	-0.6	-0.5	-0.2	0.1	0.4
OECD method; scenario (b)[2]	-0.5	-0.6	-0.5	-0.3	-0.2	-0.1
Commission method	-0.1	-0.2	-0.3	-0.1	0.1	0.3
Cyclically adjusted budget balance						
OECD method; scenario (a)[1]	-1.0	-0.5	0.0	0.2	-0.0	-0.2
OECD method; scenario (b)[2]	-1.0	-0.5	0.0	0.3	0.2	0.3
Commission method	-1.4	-0.9	-0.2	0.1	-0.1	-0.1
Cyclically adjusted primary balance						
OECD method; scenario (a)[1]	5.5	5.7	5.8	5.8	5.3	5.0
OECD method; scenario (b)[2]	5.5	5.7	5.8	5.9	5.6	5.5
Commission method	5.1	5.3	5.6	5.7	5.3	5.1

1 Under scenario (a) the estimated potential annual GDP growth corresponds to the one of the OECD (around 2.2 per cent).

2 Under scenario (b), over the period 2003-2005 it is assumed an increase of potential GDP growth equal to about 0.2 percentage points per year.

[5] The cyclical component of the budget balance is computed using the deficit/GDP elasticity estimate of the European Commission (*Public Finances in EMU - 2000)*.

The assumption that the economic upturn after 2003 will be merely cyclical in nature is restrictive. The reforms of the social security and tax systems, and of the labour and product markets are aimed at having a permanent impact on the potential of the economy. It can thus be assumed that starting in 2003 economic growth will also reflect a structural component, increasing over time, in connection with the working in of the effects of reforms. On this hypothesis, the output gap would be negative for the entire estimation period. The cyclical adjusted budget balance would be in surplus from 2003 through 2005.

4. SENSITIVITY ANALYSIS

4.1 The sensitivity of the deficit/GDP ratio to economic growth

For a fuller assessment of the impact of the output gap and built-in stabilizers, this section offers two exercises on the sensitivity of the net borrowing/GDP ratio to different assumptions on economic growth. In both exercises, the impact of growth on the primary surplus to GDP ratio is calculated using the elasticity estimates of the budget balance to growth supplied by the European Commission (*Public Finances in EMU 2000*). It is further assumed that the average cost of debt does not depend on the real GDP growth rate.

The first exercise illustrates the effects of different growth assumptions for 2003-2005 on the deficit to GDP ratio for each year from 2003 to 2005. GDP growth is assumed to be half a percentage point higher or lower than forecast in the macroeconomic scenario described in Section 2. The effects are thus cumulative on GDP levels and hence on fiscal revenues.

As Table 5 shows, in 2005 slower growth corresponds to a larger deficit of 0.5 percent of GDP, compared with a slight surplus under the baseline scenario. The sensitivity of the deficit/GDP ratio to different growth assumptions is the same as in the previous Programme Update. This means that the present path of debt reduction and the level of primary surplus are such that the sensitivity of the deficit/ GDP ratio with respect to growth is unchanged, so that the continuation of the public finance adjustment path is maintained.

The second exercise, limited to 2002, assumes a decline in growth of 1.1 percentage points.[6] This lower growth would result in a deficit of about 1 percent of GDP in 2002. Thus even a scenario of much slower growth in 2002 would not impede the reduction of both actual and structural deficit as a percentage of GDP .

Table 5. Sensitivity of the actual budget balance/GDP ratio to GDP growth
(percentages values)

	Average GDP growth rate 2003-2005	Actual budget balance/GDP 2005
Baseline scenario	3.0	0.2
Low-growth scenario	2.5	-0.5
High-growth scenario	3.5	0.9

4.2 Sensitivity to interest rates

With respect to the last Stability Update, public debt management policy in Italy is directed to further increasing efficiency, combining greater flexibility in the use of short-term instruments with regularity and continuity in the issue of the entire range of medium- and long-term securities.

In September 2001 fixed rate securities accounted for about 70 percent of the total outstanding debt and the average maturity was 5.8 years.

As a consequence, assuming a 1-percentage-point shift in the entire yield curve starting in January 2002 with respect to the central scenario, the impact on interest expenditure as a ratio to GDP would be 0.18 percent in 2002, 0.38 percent in 2003, 0.49 percent in 2004 and 0.54 percent in 2005.[7]

[6] This corresponds to the most pessimistic scenario currently envisaged by international organizations.

[7] It should be noted that this exercise focuses on interest spending gross of withholding tax. Specifically, we do not take into account the effects of rate changes either on economic activity or on tax revenues on capital income (the tax on interest income from bonds and bank deposits, which is positively related to interest rates). Thus we cannot automatically deduce the sensitivity of the overall budget balance to interest rate changes from these results.

5. THE QUALITY OF THE PUBLIC FINANCES

The Government's economic policy strategy aims at creating the conditions for rapid economic growth in a framework of substantial price stability, through structural reforms, the complete adjustment of the public finances, an easing of the tax burden and the reduction of the public debt. These measures will have a permanent effect on the potential growth rate of the economy.

The first economic policy measures formed part of a bill for economic stimulus presented by the Government in June 2001, just days after taking office, and passed by Parliament in October. Budgetary policy for next year is set forth in the *Finance Bill* for 2002. As a whole, this legislation gives special attention to the quality of the measures taken: stability, growth and equity are the three pillars underpinning the entire package. The financial effects are set forth in Table 6.

The objective of economic and financial stability is served by a series of measures:

- the containment of public expenditure by stronger controls over payments both by central government and by local bodies, cautious planning of public hiring, and rationalization and centralization of government purchasing;
- conversion and rationalization of a number of public agencies;
- enhancing the value of public real estate assets and privatisation through simplification and acceleration of sales, with streamlined and transparent procedures;
- possibility for firms to revalue equity holdings and real estate property in the balance sheets, thus favouring restructuring of ownership;
- a new internal stability pact with the regional governments, for stricter control of health spending;
- the regularisation of the underground economy through tax and social security contribution incentives, to the benefit of the public finances as well as the efficiency of the economy.

The objective of economic growth is served by tax relief measures, some of them designed also to stimulate the economic system and restore the efficiency of the public administration. These measures include:

- tax deduction for earnings reinvested in capital goods, in order to encourage an upturn in productive investment;
- the restructuring of local public services of an entrepreneurial nature, enabling municipalities to separate infrastructure from the management of services, capitalizing on government networks and opening operation up to the private sector;
- the rapid implementation of a vast programme of public works for a greater regional integration, through a revision of decision-making and authorization processes, the use of equal amounts of public and private resources and the involvement of the *Cassa Depositi e Prestiti*;
- simplification of bureaucratic requirements to boost the birth and growth of firms.

The objective of social equity, but also growth, is served by other measures:

- raising the minimum pension;
- increased tax credits for lower and lower-middle income households;
- appropriations for the contract renewals of public employees already signed.

The measures adopted with the *Finance Bill* will reduce total expenditure in 2002 by a further 0.2 percentage points of GDP (Table 3). Total revenues will come to 46.5 percent of GDP.

These measures have immediate effect towards achievement of the public finance targets, while maintaining sufficient support for economic activity. They will also affect the growth rate in the medium term, especially the public investment measures and the public administration reform.

An enduring impetus to growth requires an ambitious programme of structural reforms, with three principal thrusts: tax reform, social security reform, and labour market reform. Tax reform will allow a significant reduction of tax and social security contribution rates. Planned measures on corporate income taxation aim to align the system with European best practices to enhance competitiveness, transparency and neutrality.

Social security reform aims not only to curb pension expenditure in the long run but also to promote supplementary private retirement provisions, given that public pension spending cannot be reduced without introducing a broad system of private retirement plans.

The reform for a more efficient labour market, along the lines of the measures introduced with success in recent years, will continue with the aim of increasing the employment rate.

Structural reforms, to be implemented in gradual and balanced fashion through Parliamentary *enabling acts*, aim at increasing actual and potential economic growth by easing the tax and social security contribution burden, decreasing current non-interest expenditure, and improving the functioning of the markets.

The process of growth will be accelerated by labour market reform (described extensively in the Government White Paper and already started with the transposition of the European directive on fixed-term employment), by an intensified drive to liberalize the product markets, and by opening up corporate ownership, in connection with completion of the privatisation programme (see Appendix 2).

Table 6. Economic policy measures, 2002-2004 (millions of euros)			
	2002	**2003**	**2004**
Measures for growth	**2,780**	**3,783**	**5,512**
-abolition of INVIM tax and other taxes	472	100	107
-measures supporting employment	1,170	1,289	1,542
-further intervention for the South	754	1,632	2,660
-extension of tax relief for house renovation	278	357	253
-other measures on capital account	106	405	950
Measures for social equity	**6,748**	**10,368**	**10,523**
-increase of minimum pensions	2,169	2,169	2,169
-increased tax deductions for low and middle income households	1,085	1,841	1,601
-renewal of civil service contracts (school system and police)	3,159	5,906	6,015
-grants for schoolbooks	103	103	103
-social policies (for less developed countries)	232	349	635
Measures for economic and financial stability	**17,145**	**17,891**	**11,557**
-privatisation of real estate assets	7,747	7,230	1,549
-transformation and rationalisation of public agencies	362	516	671
-emersion of underground economy	1,033	2,066	0
-revaluation of assets	2,434	636	525
-re-entry of capital from abroad	981	826	516
-Domestic Stability Pact	1,549	2,582	3,977
-growth of income from lotteries	516	516	516
-rationalization of consumption of goods and services	207	516	620
-planning of public hiring	411	876	1,303
-further spending cuts	1,074	1,590	2,107
-other revenues and side effects	831	537	-227
Total effect of measures	**7,617**	**3,740**	**-4,478**

6. THE SUSTAINABILITY OF THE PUBLIC FINANCES IN THE MEDIUM TERM

Over the coming decades, the population share of old people will rise significantly in most industrial countries. Eurostat's latest demographic projections[8] for Italy show that the old age dependency ratio[9] will rise from around 29 percent in 2000 to just under 67 percent in 2050.

Such a dramatic rise in the elderly population may carry significant implications for the public finances, especially for pension and health spending. Table 7 gives the medium-to-long-term projection of these two expenditure items, using the baseline demographic and macroeconomic scenario agreed at the EPC-WGA.[10] The present projection differs from the EU baseline projection presented in last year's Stability Programme in that it takes into account the pension measures of the *Finance Law* for 2001 and the *Finance Bill* for 2002, as well as the updated data on GDP and pension spending in 2000. Specifically, it includes increased outlays of €2.2 billion a year (about 0.2 percent of GDP in 2002) owing to the increase in minimum pensions envisaged by the *Finance Bill* for 2002. This projection and those described below do not take into account the effects of social security reform.

The projection given in Table 7 is based on the baseline Eurostat demographic scenario previously mentioned. The macroeconomic scenario assumes a rise in the overall labour force participation rate from 63 percent in 2000 to 75 percent in 2050, thanks above all to rising women's participation. The unemployment rate is projected to decline from 10.6 to 7 percent. The productivity growth rate is assumed to rise to 2.1 percent in 2005 and then to decrease to an average rate of 1.8 percent for the rest of the projection period. As a consequence of these trends, the real GDP growth rate should average about 1.5 percent, with significantly higher rates in the early part of the period and lower ones towards the end.

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[8] Presented to the working group on the effects of population ageing of the Economic Policy Committee (EPC-WGA) at the European Union. See *Report on the impact of ageing populations on public pension systems*, discussed by ECOFIN on 7 November 2000 and *Budgetary challenges posed by ageing populations* discussed by ECOFIN on 6 November 2001.

[9] The ratio of the population older than 65 to the population aged 20-64.

[10] Projections by the Dipartimento della Ragioneria Generale dello Stato.

With this economic and demographic scenario and in the absence of further reform, pension expenditure is estimated to rise from 13.8 percent of GDP in 2000 to 16 percent in 2033. The ratio should then decline during the following years to reach 14.2 percent in 2050. These estimates do not differ significantly from those set out in last year's Stability Programme. Health care expenditure should rise from 5.5 percent of GDP in 2000 to 7.5 percent in 2050.[11]

If we take the baseline demographic and macroeconomic scenario from the *Economic and Financial Planning Document* for 2002-2006,[12] pension and health care spending trends do not change significantly. With these assumptions, pension expenditure, including the appropriation for minimum pensions, peaks at 15.9 percent of GDP in 2030 and decreases to 13.5 percent in 2050. Health spending rises from 5.5 percent of GDP in 2000 to 7.2 percent in 2050.

If we take the growth scenario for 2002-2006 set forth in the *Forecasting and Planning Report* for 2002 and adopted by this Update, the ratio of pension expenditure to GDP remains basically the same as in the previous projection at the end of the forecasting period, but with a reduction of about 0.4 percentage points around the year 2030 (15.5 as against 15.9 percent). The trend in health care spending remains basically unchanged.

These trends should not jeopardize the medium-term sustainability of the public finances, partly because in Italy the increase in expenditure related to population ageing is relatively moderate and will in any case be very gradual. In the light of these forecasts, maintaining the sustainability of the public finances in the medium term will follow a three-pronged strategy. First, as noted in Section 3, the policy of debt reduction will be pursued for the entire reference period. Second, the reforms of the labour and product markets will be strengthened so as to increase the employment rate and accelerate productivity growth. And finally, the *Economic and Financial Planning Document* for 2002-2006 states the Government's intention to verify the role and the incidence of retirement provisions in the overall system of

[11] The forecasts for health spending, as agreed within the EPC-WGA, assume that per capita spending in each age-group will rise in the future at the same rate as per capita GDP.

[12] The demographic scenario follows Istat's 2000-base projections, according to which the old-age dependency rate rises to 69 percent in 2050. The macroeconomic assumptions are: productivity growth gradually accelerating to 2 percent in 2026 and holding constant for the rest of the projection period; unemployment rate falling to 4.5 percent in 2050; the average participation rate for the population aged 20-64 rising to 72 percent by the end of the period. On these assumptions, the real GDP growth rate should average 1.5 percent for the projection period; until 2010, growth rates should be higher than the average.

social spending. The "Ministerial Committee for the evaluation of the effects of Law 335/1995 and subsequent measures" has recently set out four objectives for the pension system: 1) financial stability and observance of the intertemporal budget constraint; 2) equity within and between generations; 3) neutrality of retirement arrangements with respect to choices concerning work; 4) diversification of retirement saving.[13]

Turning to the health care system, the agreement of 8 August 2001 between central and regional governments provides that the funding of the National Health Service must tend to stabilize at 6 percent of GDP "within a reasonable period of time".

Table 7: Long-term sustainability of public finances
EPC-WGA baseline scenario

As percentage of GDP	2000	2005	2010	2020	2030	2050
Pension expenditure[1]	13.8	14.0	14,1	14.9	15.8	14.2
Health care expenditure[2]	5.5	5.8	6.0	6.4	6.9	7.5
Assumptions						
Labour productivity growth	1.0	2.1	1.9	1.8	1.8	1.8
Real GDP growth	2.9	2.6	1.9	1.4	0.8	1.2
Male participation rate (20-64)	77.7	80.2	81.0	80.8	79.4	79.8
Female participation rate (20-64)	49.0	52.1	53.6	55.8	58.4	70.1
Total participation rate (20-64)	63.3	66.2	67.4	68.4	69.1	75.1
Unemployment rate	10.6	9.6	9.2	8.7	8.2	7.0

1 Figures do not include the effects of future pension reforms.
2 Including long-term care for the elderly.

[13] See "Verifica del sistema previdenziale ai sensi della legge 335/95 e successivi provvedimenti, nell'ottica della competitività, dello sviluppo e dell'equità," September 2001.

APPENDIX 1 – THE INTERNATIONAL FRAMEWORK

The world economic outlook has progressively deteriorated during 2001. As a consequence, the growth of world trade has been less than forecast in last year's Stability Programme.

The economic slowdown originated in the United States in the second half of 2000, as the result of several factors: the effects of a series of interest-rate increases by the Federal Reserve beginning in 1999, the rise in oil prices, and the sharp fall in the stock market (especially technology stocks). The slowdown spread progressively to Japan (already burdened with severe structural and financial problems) and to Europe and other economic regions.

The *Economic and Financial Planning Document* for 2002-2006, released in July, took this downtrend into account but assumed a world cyclical upturn for the second half of 2001. However, in the summer a further deterioration in the world economy occurred. The September *Forecasting and Planning Report* for 2002, on whose assumptions the present Update is based, revised the *Planning Document* projections. US economic growth is now estimated at 1.2 percent in 2001, European growth at 1.8 percent.

The impact of the American slowdown on the European economies has been greater than initially predicted. The growth of internal demand has not offset the adverse externally-generated impact. For the first time in years the labour market has not recorded any significant gain. Finally, the slowdown in the three main economic areas has been much more synchronized than in the past. The scenario is worsened by the uncertainty over the political and economic repercussions of the terrorist attacks of September 11, which are hard to quantify. In many countries there has been an adverse effect on consumer confidence. The uncertainty surrounding current economic projections, and in particular the economic outlook for 2002, has been accentuated.

The current scenario assumes that the world economy will improve in 2002, with GDP growth in both the United States and the European Union forecast at 2.1 percent. It is estimated that world trade will pick up from growth of 4.3 to 6 percent. The recovery in the U.S. and Europe should be fostered above all by fiscal policy, thanks to built-in stabilizers and the discretionary measures taken by the U.S.

administration. A contribution will also come from the gradual working-in of the effects of monetary policy, which thanks to the abatement of inflation has turned expansionary in Europe as well. The inflation outlook remains good, in view of the slack oil market. The stabilization of oil prices, and more generally the improvement in the terms of trade, should stimulate consumer demand and overall economic growth as well as bolstering the confidence of economic agents. The sound fundamentals of the U.S. economy, its high degree of competitiveness, and the constant improvement in European competitiveness thanks to structural policies and financial adjustment will help stabilize the overall economic situation and foster better performance in the medium term. Beginning in 2003 average annual growth both in the United States and in Europe is estimated at 3 percent.

Table 8. Assumptions on international economic variables

	2001	2002	2003	2004	2005
Short-term interest rate, euro area (annual average)	3.5	3.8	4.4	4.9	5.3
Long-term interest rate, euro area (annual average)	5.3	5.6	5.9	6.1	6.3
Short-term interest rate, USA (3-month money market)	2.8	4.1	5.2	5.6	5.9
Long-term interest rate, USA (10-year government bonds)	5.6	6.0	6.3	6.6	6.6
USD/euro exchange rate	0.90	0.96	0.99	1.00	1.00
World economic growth rate excluding EU	2.2	2.4	3.0	3.3	3.2
GDP growth rate, USA	1.2	2.1	3.0	3.2	3.2
GDP growth rate, Japan	-0.5	0.2	1.8	2.3	2.5
GDP growth rate, EU	1.8	2.1	2.9	3.0	3.1
World imports volume growth rate (excluding EU)	4.0	5.9	7.6	7.5	7.5
World import prices growth rate (goods, in USD)	0.7	1.3	1.5	1.5	1.5
Oil prices (Brent, USD/barrel)	26.5	25.0	24.5	24.5	24.5
Non-oil commodity prices growth rate (in USD)	-2.2	2.6	2.5	2.5	2.5

APPENDIX 2 - THE PRIVATISATION PLAN, 2002-2006

A1. Introduction

Since the start of its privatisation programme in 1992, the Italian government has carried out 26 asset disposals involving 15 publicly owned corporations, totalling gross proceeds of some €65 billion. In addition, further privatisations have been carried out by the IRI Group, for around €42 billion, and by the ENI Group between 1992 and 1998 for around €5 billion. The privatisations have thus generated total gross proceeds of about €112 billion.

The amounts paid into the Sinking Fund for Government bonds [14] have been used to buy back or redeem a total of €75 billion worth of government paper from 1995 to 2001, helping to lower the debt/GDP ratio and also, thanks to interest savings, the deficit/GDP ratio. During this period, the two ratios have come down respectively from 123.8 to 107.5 percent and from 7.6 to slightly more than 1 percent.

A2. The objectives attained

A number of initial objectives of the privatisation programme can be said to have been achieved:

Source of revenue: Italy ranks third worldwide in privatisation proceeds, and sixth for proceeds in proportion to GDP. Cumulative gross proceeds over the entire period, adjusted for inflation, represent about 9 percent of Italy's GDP in 2000.

Debt stabilization: The revenue from privatisations has been a major factor in public finance adjustment, contributing significantly, as noted, to the lowering of the debt/GDP ratio.

Development of the financial market: Privatisations conducted through the stock exchange have helped to deepen and provide liquidity to the Italian equity market. Since the start of the programme total stock market capitalization has risen from 11 to 56 percent of GDP, while liquidity (the ratio of trading turnover to capitalization) has risen from 19 to 82 percent.

[14] The Fund received the net proceeds from privatisations, 90 percent of the proceeds from the sale of UMTS licences, liquidation advances from IRI and other extraordinary receipts.

Greater contestability of control of listed firms: Both in banking and insurance and in telecommunications, privatisations have fostered greater contestability of corporate control and encouraged mergers and acquisitions.

A3. Remaining problems

However, the privatisation programme has also left some unsettled questions whose resolution is a precondition for further progress. In particular:

- **The transfer of ownership**: So far the State has transferred only part of its share holdings, at various levels and in diverse sectors retaining stakes, sometimes indirect, in the privatised companies. It has also retained substantial holdings, sometimes even 100 per cent ownership, in industries not considered strategic.
- **The transfer of control**: In some corporations the State, though having disposed of significant stakes, remains the controlling shareholder.
- **The culture of equity investment**: The increase in stock market capitalization has not produced a satisfactory development of the culture of equity investment, which needs to be pursued also by policies to foster the transparency of the financial market and improve corporate governance.
- **Industrial policy objectives**: While privatisations have unquestionably helped to improve the efficiency of corporate operations and management, also by favouring a strategy of alliances, this has not been accompanied by the full liberalisation of strategic sectors or an increase in the Italy's overall competitiveness.

A4. The background to the privatisation plan for 2002-2006

The new privatisation programme will make the most of the experience of recent years while taking account of the new financial constraints and the new opportunities that have arisen. The main constraint is the current adverse developments in financial and real markets in Italy and at the international level. On the other hand, the reform of company law has moved Italy towards the legislation found in the more advanced capitalist countries, opening up new opportunities for mergers and acquisitions that can get the greatest value out of existing assets.

The Ministry of Economy and Finance still holds controlling or substantial stakes in some 20 industrial corporations or groups, as well as smaller, residual interests in banks. The total value of these holdings is estimated at about €80 billion.[15] The central and local governments also hold assets and real estate that can be sold in the short term, the latter estimated at between €23 billion and €30 billion. In addition, there are the interests held by other public bodies, such as municipalized firms. Finally, there are Banking Foundations, organisations that partake of the nature of non-profit institutions, market operators and local government.

A5. The strategic objectives

The privatisation plan for 2002-2006 will further reduce the State's involvement in the economy and lay the basis for solving some of the problems that emerged in the privatisations carried out so far. The priority objectives for this second phase are:

- **Reducing the debt**, i.e. generating privatisation revenues for purposes of fiscal stabilization, allowing:

➢ consolidation of public finance adjustment, in compliance with the Stability and Growth Pact;

➢ greater fiscal efficiency and equity. For the public finances, maximizing privatisation proceeds is efficient, in that the revenue goes to the Treasury and is distributed to the taxpayers in the form of smaller future taxes. Privatisation at cut-rate prices, by contrast, can be distorting, in that it mainly works to the advantage of the shareholders of the privatised firms. It can be regressive, given the greater propensity for equity investment by high-income individuals.

A privatisation programme of around €60 billion between 2002 and 2006 has significant debt-reduction impact; at the end of the period, the public debt should be about 94 percent of GDP. Privatisations also contribute directly to a reduction in interest expenditure and thus help to achieve a balanced budget.

- **Disposing of ownership and control**: The Government's top priority is:

➢ to dispose of the participations not considered strategic and significantly reduce the rest;

➢ to enhance the value of enterprises that are being restructured with a view to privatising them in the medium term.

[15] Listed companies are valued at their average share price for the last six months; unlisted companies are valued at their consolidated shareholders' equity at 31 December 2000, adjusted for any dividends or liquidation advances distributed by their parent companies in 2001.

In some cases the Government may also retain an exclusively financial participation as a viable alternative to privatisation, especially in market downturns. In making such choices, the time frame and the risk-aversion of the State as a seller are fundamental.

- **Fostering the growth of institutional investors and protecting minority shareholders**: One of the problems with the first phase of privatisation was the partial conflict between the aim of developing widespread share ownership and the outcome of the sales. While the methods selected indicated the wish to foster widespread ownership of equities, this was attained only in part. The high concentration of ownership typical of Italian firms was replicated in the ownership structure of the newly privatised corporations.

The upcoming round of privatisations will take these constraints into account. The aims are above all:

- to strengthen the role of institutional investors – especially pension funds – as the most appropriate to play a positive role in corporate governance;
- to strengthen protection for minority shareholders;
- to increase the transparency of the financial market.

- **Liberalizing, to increase Italy's competitiveness**, seeking to forge a solid industrial basis. Many of the firms that could be privatised now operate in non-competitive or heavily regulated environments. A high priority for the new privatisation programme is structural reform for market liberalization, determining a definite regulatory framework in advance at both central and local level. Privatisation and liberalization thus form the two pillars of industrial policy.

- **Gradually transforming** elements of the government bureaucracy that operate at the borderline of the market **into joint stock companies**, thus shrinking the public presence and increasing the efficiency of the economy.

A6. The procedures

To carry out this programme the Government will use the traditional instruments of asset disposal envisaged by the law and used so far, such as public share offerings and private agreements. In addition, the Government will use the new financial instruments introduced by Legislative Decree 351/2001, such as the issue of government securities redeemable in shares of already listed state-owned corporations and the securitisation of the proceeds from disposals of the real estate assets of the central government and other public bodies.

To attract the greatest possible interest on the part of investors, the Government will take action to reorganize the industrial groups in which it holds stakes, with a view to concentration on their respective core businesses, including the separation and disposal of non-instrumental assets and activities. Especially for listed companies, this will permit the real value of the groups, which is not always fully expressed by current stock market prices, to emerge.

The aim is to continue and indeed to deepen the privatisation process, also through the market entry of new actors: pension funds, re-oriented Banking Foundations, protected minority shareholders.

A7. The privatisations planned

The disposals of companies held directly by the State planned during the course of the current Legislature include the 100 percent stake in ETI.

The Government also plans the rapid sale of its residual stake in Telecom Italia. Given the negative trend of the stock market, especially for technology shares, this sale will be scheduled after the strategy of the new majority shareholders' group is implemented and valued by the market.

The sale of significant further holdings in ENEL will occur together with the growth of the corporation's value, not fully expressed by its current share price, also in connection with the strategies to be approved by the majority shareholders.

As for Acquedotto Pugliese, the Government is re-examining the entire legal and institutional context of that company's sale to determine the best way of completing the disposal, taking local realities also into account, so as to carry through the *Acqua nel Sud* water project.

In the energy sector, if market conditions are appropriate the State may dispose of its residual stake in ENI, or at least part of it, but making sure to safeguard Italy's strategic posititioning.

With the budget for 2003 the planned liquidation of IRI will be completed, with the disposal of that holding company's remaining portfolio of assets, beginning with Fincantieri and Tirrenia. The best procedures for managing the risks and costs of the liquidation are being analysed.

Finally, over the five-year span of the Legislature the State's residual holdings in the banking industry will be disposed of.[16] These bank shares will be sold via private agreement, except for the residual stake in Banca Nazionale del Lavoro, which is currently in process of disposal by direct sale on the equity market with the intervention of a financial intermediary.

As for companies indirectly controlled by the State, ENEL's disposal of electricity generating capacity will continue. The sale of the second of three generating companies, begun in August, is expected to be concluded early in 2002; subsequently the third Genco will be sold. ENEL will also sell its Wind subsidiary, thus reducing its stake in the telephone industry. A reorganisation of the ownership of the electricity transmission network is under study.

ENI is planning to gain stock exchange listing for its Snam Rete Gas natural gas distribution subsidiary, as a prelude to ENI's gradual withdrawal from heavily regulated businesses.

As for municipalized companies, the *Finance Bill* for 2002 calls for the separation of networks from services and makes possible the private management of the latter, reserving the ownership of the infrastructures to municipalities.

The rationalization of Finmeccanica will continue with an intensified search for agreements with international aerospace and defence partners; Finmeccanica will dispose of Ansaldo Energia and Ansaldo Trasporti and will evaluate its interest in STMicroelectronics in the framework of its basic strategy of concentration on its core business.

Some state-owned corporations cannot be privatised immediately. For these, over the course of the Legislature the Government will continue reorganization and efforts to enhance their value.

Poste Italiane S.p.A., converted into a joint-stock company in February 1998, is proceeding with its financial adjustment and relaunch, with a broad reorganization of the postal service and the development of new financial services. It could obtain stock exchange listing in 2003 or later.

Ferrovie dello Stato (the railroad corporation), having completed its group reorganization with the formation of a holding company owning 100% of the equity

[16] These holdings are in Cariverona (0.01 percent), Coopercredito (14.42 percent), Mediocredito dell'Umbria (6.86 percent), Mediocredito Fondiario Centroitalia (3.39 percent), Mediocredito Friuli Venezia Giulia (34.01 percent), Mediocredito Toscano (6.51 percent), and Mediovenezie Banca (0.21 percent).

in Trenitalia and Rete Ferroviaria Italiana, is consolidating its corporate structure. Disposal of Trenitalia is under study. As this process gathers momentum, it will become possible to consider the market sale of the equity of the company that operates medium and long-distance passenger trains.

For Alitalia, in addition to financial measures the Government will implement the carrier's restructuring, in part through strengthened international alliances.

As noted above, in the course of the Legislature the Government intends to complete the disposal of real estate owned by the central government and other public administrations. To this end, in recent months the Government has acquired suitable instruments, enacting the possibility of securitizing the proceeds from the disposals, rewriting the regulations governing real estate investment funds to make them more efficient and more attractive from a fiscal point of view, and simplifying the process of value-enhancement and sale of real estate assets.

In 2002 and 2003, if market conditions permit, the Government intends to carry out privatisations generating proceeds of €20 billion to €25 billion, over and above real estate disposals.