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2002 UPDATE

OF THE STABILITY PROGRAMME OF ITALY

(2002-2006)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS

The fourth update of Italy's stability programme, covering the period 2002-2006, broadly complies with the data requirements of the revised "code of conduct on the content and format of stability and convergence programmes"¹, although minor inconsistencies persist in the aggregation of expenditures and revenues in ESA 95 terms. However, it falls short of the requirement to "describe the budgetary and other economic policy measures [...] proposed to achieve the objectives." From 2004 onwards the achievement of the budgetary targets requires significant unspecified "future measures". This does not allow to determine whether the correction takes place on the expenditure and/or the revenue side and makes an assessment of the medium-term adjustment plan very difficult.

The programme complies only in part with the Broad Economic Policy Guidelines for 2002, specifically, the recommendation in the BEPG that Italy's budgetary policies should ensure "the respect of a steady path of deficit reduction, in order to achieve a close to balance budget in 2003."

Following the much worse deficit in 2001 compared to the previous update and the delayed recovery in the economy, and in spite of corrective measures adopted in the course of the year, the projected deficit for 2002 significantly exceeds the original objective. In turn, this implies that the adjustment path has moved further away from the "close-to-balance" position, which, according to the government's own projections, would not be reached before 2004. As in recent years, the deficit for 2002 could be higher when measured in cash terms², implying the continued existence of large and not fully explained "below-the-line" operations. As a consequence, and in spite of a large transaction between the Italian Treasury and the Bank of Italy aimed at the redemption of non-marketable government debt held in the latter's asset and resulting in a one-off reduction in outstanding government debt, the decline in the debt ratio has slowed down considerably since 2001 and the reduction of the debt ratio below 100% of GDP is now envisaged to occur only in 2005.

The programme's macroeconomic scenario assumes a gradual pick-up in economic activity. In 2003 the pace of the recovery is somewhat stronger than the current consensus view. In the years 2004-06 real GDP growth is projected to average around 3% per annum. The implicit acceleration in the rate of potential output growth after 2003 (if estimated applying correctly the commonly agreed production function methodology) reflects a set of markedly favourable assumptions about the underlying determinants of growth, particularly the evolution of the labour market, specifically a strong increase in the participation rate and a marked decline in the non-accelerating inflation rate of unemployment. Therefore, in the medium term, the macroeconomic scenario is not consistent with the degree of caution that should underpin a prudent fiscal strategy.

The adjustment path over the programme period builds on a projected recovery, after the deterioration since 2000, in the primary surplus ratios to levels close or above 5% of

¹ *Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes*, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

² General government cash borrowing requirement net of settlement of debts outstanding and disposals of financial assets.

GDP. Such surpluses would be accompanied by reduced revenue and expenditure shares. However, the credibility of the fiscal strategy is weakened by the questionable quality of the measures already announced and by the lack of indications on future measures.

The budgetary target for 2003 relies heavily, as in the previous year, on one-off measures, including the sale of publicly-owned real estate assets through securitisation operations, an accelerated tax litigation settlement scheme and a new tax amnesty. Even assuming that such one-off measures yield the expected results, achieving the 2003 budgetary target may prove difficult, on account of the risks to the trend budgetary projections, particularly on the revenue side. The cyclically-adjusted budget position may therefore fail to improve as planned. Taking into account such risks, the Commission 2002 Autumn forecast foresees only a marginal improvement in both the actual and cyclically-adjusted deficits. Irrespective of these risks, no significant improvement over the 2002 estimated outcome can be expected in the underlying deficit (calculated by deducting from the cyclically-adjusted balance the effect of the above-mentioned one-off measures). This does not appear in line with a minimal adjustment of 0.5% of GDP. The underlying balance would remain significantly distant from the “close-to-balance” objective of the Stability and Growth Pact.

The decisive year in the programme is 2004, as the close-to-balance objective crucially hinges on replacing the main one-off measures implemented in 2003 with permanent measures, together with an additional correction in structural terms. Combining a more prudent assessment of public finance trends with lower growth assumptions, as in the Commission forecast, leads to the conclusion that in the absence of corrective measures the deficit might breach 3% of GDP. The size of the structural correction that would be needed in 2004 (of the order of 2% of GDP) is such as to make achievement of the close-to-balance objective by that year very unlikely. The credibility of the targets in the remaining years of the programme is correspondingly undermined.

The upward shift in the path of reduction of the government debt ratio compared to the previous programme results from a substantially higher level of debt in 2001 and 2002. Comparing changes in the debt level with those for net government borrowing suggests the persistence of large and unexplained “below-the-line” operations throughout the programme period. The impact of such operations appears to be particularly strong and positive in 2005 and 2006, resulting in a marked slowdown in the pace of debt reduction. The risks to the programme deficit targets imply a corresponding deterioration in the debt ratios. The resulting path of actual debt reduction would become considerably slower, and might even be reversed under adverse cyclical circumstances.

The programme reviews the progress in the government’s structural reform programme, particularly the tax system, labour market regulation and the social security system. Based on recent experience, especially concerning the labour market, there are potential supply-side effects of the reform programme. However, while the immediate negative impact on the budget, in particular of the imminent tax reduction in 2003, can be quantified, the eventual pay-off in terms of an increased tax base is uncertain and to some extent subject to the approval of further legislation, specifically changes in labour market regulation. Overall, the financing of the reform programme does not appear ensured.

The sustainability of public finances depends on maintaining large primary surpluses over the long run. The achievement of a position of underlying budget balance in the medium term is critical to placing public finances on a sustainable footing. Given Italy’s

high debt, large primary surpluses will be required for many years. The analysis of long-term trends suggests that, although following the 1990s' reforms of Italy's pension system the future increase in age-related expenditure is expected to be relatively low, the risk of emerging public imbalances cannot be excluded. The relative low increase in pension expenditure depends crucially on Italy's ability to achieve very large increases in the participation rate. It also depends on the full and effective implementation of the 1990s' reforms, including adjusting future entitlements to reflect changes in life expectancy. The announced changes in the social security system, while promoting the expansion of privately-funded pension schemes, do not address the outstanding critical issue in the public pension system, namely the excessively long transition period to the new contributions-based system. Moreover, the planned reductions in contributions for newly-hired workers, if not matched by corresponding reductions in workers' entitlements, could put into question the long-term balance of the system.

1. INTRODUCTION

The Italian authorities submitted the fourth update of the stability programme, covering the period 2002-2006, on 20 November 2002.³ The previous update, examined by the Economic and Financial Committee on 1 February 2002 and by the Ecofin Council in its opinion of 12 February 2002, covered the years 2001-2005.

The update confirms the strategy of consolidating public finances by keeping a high primary surplus over the period, consistent with a trend reduction in primary expenditure and taxation as a percentage of GDP. In a setting of considerably weaker output growth in 2002 and 2003 than assumed in the previous update, although with practically unchanged assumptions for the medium term, the budgetary targets are revised downwards, specifically the balanced budget originally planned for 2003. The ratio of the general government debt to GDP is now expected to fall below 100% only in 2005, postponing by a further year the commitment made by Italy in 1998.

2. IMPLEMENTATION OF THE PREVIOUS UPDATE

2.1. Budgetary developments

In the stability programme update of November 2001, the budgetary target for 2002 was a deficit of 0.5% of GDP. By contrast, the Commission 2002 Autumn forecast projects an actual general government deficit of 2.4% of GDP.⁴ Table 1 compares the government plans for 2002, as presented in the 2001 update with the Commission forecast, highlighting in both cases the effects on expenditures due to the cyclical position, (the effects on revenues, being almost negligible, have not been reported in the table).⁵ The

³ The programme is available on the Ministry of Economics website (<http://www.tesoro.it>).

⁴ The latest official budgetary estimate for 2002, announced at the end of September in the *Forecasting and Programming Report (RPP)* is a deficit of 2.1% of GDP. The difference between the Commission's forecast for 2002 and the latest official forecast is concentrated on the revenue side. Expenditures in the two scenarios are broadly equivalent.

⁵ The effect of the cyclical position are estimated using the standard elasticities of revenues and expenditures. The elasticity of revenues with respect to GDP is around one, implying that the ratio of revenues to GDP is almost unaffected by cyclical developments. On the other hand, the ratio of expenditures to GDP changes significantly over the cycle, as the elasticity of expenditures to the

table also provides a breakdown of the 1.9% of GDP difference between target and expected outcome into three components: revenues, primary expenditures and interest payments.

Examining the table, a number of conclusions can be drawn. Firstly, revenues are 0.2 percentage points of GDP lower than projected in the 2001 update. The Commission's estimate reflects a more cautious evaluation of the impact of a transitory revenue-boosting measure introduced in the Budget Law for 2002 (art. 5) and an estimated negative effect of the tax incentive scheme for investment (*Tremonti Law*).

Table 1. Budgetary developments in 2002: USP 2001 plans and Commission 2002 estimates⁶

in % of GDP	2002
Government plans (USP 2001)	
Government budget balance	-0.5
Total revenue *	46.0
Primary expenditure *	40.7
CAB **	(-0.2)
<i>p.m. real GDP growth</i>	2.3
<i>p. m. effect of cyclical position ***</i>	0.4
Estimated outcomes (Commission 2002 Autumn forecasts)	
Government budget balance	-2.4
Total revenue *	45.8
Primary expenditure *	42.3
CAB **	-1.8 (-2.1)
<i>p.m. real GDP growth</i>	0.4
<i>p. m. effect of cyclical position ***</i>	0.3
Difference: estimated outcomes (Commission 2002 Autumn forecasts) – Government plans (USP 2001)	
Government budget balance	-1.9
Total revenues	-0.2
Primary expenditure	1.6
Interest expenditure	0.2
Source: Commission services calculations on USP 2001 and Commission 2002 Autumn forecasts.	
* To allow comparison, all budgetary figures in the table are computed according to the national definition used in the USP 2002, which is not consistent with EU Regulation n. 1500/2000.	
** Cyclically-adjusted balance, production function method (Hodrick-Prescott filter figures in brackets).	
*** Effects of cyclical position on expenditures $CPE = \varepsilon_E (ygap)$ where ε_E is the semi-elasticity of expenditures to the output gap ($ygap$).	

As regards primary expenditures, the assessment is more complex. While the difference in the effect of the cyclical position is minimal⁷, the large discrepancy results firstly from

output gap is very low (in Italy even more so than in most industrial countries, given the low share of unemployment benefits in total primary expenditures).

⁶ In order to compare the Commission forecast, the November 2001 stability programme update and the November 2002 stability programme update, the budgetary figures in Table 1, Table 6 and Table 7, have been computed according to the definition of revenues and expenditures used in the November 2002 stability programme update. It should be stressed that this definition is not consistent with EU Regulation n. 1500/2000.

⁷ The effect of the cyclical position on primary expenditures is calculated according to the following relation $CPE = \varepsilon_E (ygap)$, where ε_E is the semi-elasticity of expenditures to the output gap. The stability programme output gap was calculated applying the HP filter to the actual output growth in the

repeated overruns in expenditures (mainly, but not solely, for healthcare) in 2000 and 2001, which were not captured in the official forecast and were not reabsorbed in the course of 2002. The divergence is also the result of an overoptimistic GDP forecast, which “freed” on an *ex ante* basis resources for higher expenditure. The pitfalls of an over-optimistic growth scenario were highlighted in the Commission assessment of the November 2001 programme, as well as in the Council’s opinion.

The Eurostat decision of 3 July 2002, which invalidated the deficit-reducing impact of the securitised sales of real assets carried out in December 2001 has an impact on 2002, in so far as all effective disposals on the market of the real assets that had been securitised in 2001 entail an improvement in the budget balance of 2002.⁸ This impact is estimated at 0.2 percentage points of GDP.

2.2. The general government debt

The programme confirms that in 2001 and 2002 the process of reduction of government debt relative to GDP has slowed down considerably (Table 2). The 2001 outcome was significantly higher than expected in the November 2001 update, due to a much lower primary surplus and a slightly less positive contribution from nominal GDP growth. The adverse contribution of the residual component, traditionally referred to as “stock-flow adjustment”, was particularly large, implying the existence of sizeable and not fully explained “below the line” operations. In 2002, much smaller than planned primary surpluses and lower GDP growth are equally responsible for the lack of progress in the reduction of the debt ratio. The Commission 2002 Autumn forecast projects a slight increase in the debt ratio in 2002, to 110.3% of GDP.⁹

Recent developments in the debt ratio are also a consequence of ongoing increases in the cash general government borrowing requirement. Since 2000, Italy’s accounts have displayed a persistently large and partly unexplained discrepancy between the government borrowing requirement (net of settlement of debts outstanding and disposals of financial assets) and the Maastricht deficit (which is expressed in accrual terms), raising concern that this may lead to further *ex post* upward revisions in the general government Maastricht deficit.

2001 programme ($ygap_{usp} = -0.7$); the Commission output gap is that of the Autumn 2002 forecasts ($ygap_{com} = -0.6$).

⁸ In national accounts sales of publicly-owned real assets are recorded as gross fixed capital investment with a negative sign.

⁹ However, it should be noted that the Commission forecast does not include the impact of privatisations carried out in December, nor the effect of an important financial transaction between the Italian Treasury and the Bank of Italy, estimated to reduce the debt ratio by 1.9 percentage point of GDP (see footnote n. 23).

Table 2. Debt developments: differences between Government plans (USP 2001) and estimated outcomes (Commission 2002 Autumn forecasts)

in % of GDP	2001			2002		
	COM 2002(a)	USP 2001(b)	(a)-(b)	COM 2002(a)	USP 2001(b)	(a)-(b)
Change in government debt ratio:	-0.7	-3.0	2.3	0.4	-3.2	3.6
Primary balance	-4.1	-5.1	1.0	-3.5	-5.3	1.8
Interest payments	6.4	6.2	0.2	5.9	5.8	0.1
Real GDP growth contribution	-1.9	-2.2	0.2	-0.5	-2.4	1.9
GDP deflator growth contribution	-2.9	-3.3	0.4	-2.6	-2.5	-0.1
Stock flow adjustment	1.8	1.2	0.6	1.1	1.1	0.0
of which: privatisation receipts	-0.4	N/A		0.0	N/A	
Level of government debt ratio	109.9	107.5	2.4	110.3	104.3	6.0
Note: the decomposition of changes in the gross debt ratio is based on the following equation for the budget constraint:						
$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \frac{D_{t-1}}{Y_{t-1}} * \frac{i - y_t}{1 + y_t} + \frac{SF_t}{Y_t}$						
With: D _t = government debt; PD _t = primary deficit; Y _t = GDP at current prices; y _t = nominal GDP growth rate; i = average cost of debt; SF _t = "stock-flow adjustment".						
Source: Commission services calculations on USP 2001 and Commission 2002 Autumn forecasts.						

3. MACROECONOMIC ASSESSMENT

3.1. External economic assumptions

As highlighted in the programme, the assumptions on the external economic environment build on information and data available at the end of September, when the authorities presented the *Forecasting and Programming Report (Relazione Previsionale e Programmatica - RPP)*. Consequently, the scenario does not fully reflect developments up until the transmission of the stability programme at the end of November, which point to a weaker than previously expected recovery of the world economy.

For the most part, the programme external assumptions are close to those provided by the Commission, which, according to the Code of Conduct, Member States "[...] *should endeavour to use [...]*".¹⁰ It assumes a gradual acceleration of global economic activity throughout the programme period accompanied by a pick-up in non-oil commodity prices. The acceleration is somewhat stronger than in the assumptions provided by the Commission, on account of a markedly more optimistic outlook for world import growth.

On the whole, the external assumptions appear to be relatively balanced compared to the prevailing consensus view. In particular, they do not carry the excessive degree of optimism encountered in the previous programme.

3.2. Domestic macroeconomic developments

The domestic macroeconomic scenario of the programme confirms the projections presented in the September *Forecasting and Programming Report*. It implies a significant revision compared to the medium-term *Macroeconomic and Financial*

¹⁰ ECFIN/525/02-EN External assumptions, Note for the attention of the Economic and Financial Committee.

Planning Document (DPEF) released in July, which in turn already incorporated a downward revision relative to the 2001 programme. The revisions essentially reflect the progressive deterioration in the economic outlook for 2002-2003 observed since mid-2001. Real GDP is estimated to increase by a modest 0.6% in 2002 as a whole, followed by a fairly quick recovery to 2.3% GDP growth in 2003, essentially in line with the consensus view prevailing at the end of September. While the programme explicitly acknowledges that economic conditions have worsened in the two months up to November, the weakened outlook has not been taken on board. The early cut-off date, relative to the date of transmission of the programme to the Commission, also explains the difference compared to the Commission 2002 Autumn forecast, which expects slightly lower GDP growth in 2002 followed by a slower recovery in 2003 (see Table 3).

For the years 2004 and beyond, the programme reiterates the projections presented in the previous two updates, i.e. real GDP growth is expected to hasten towards 3% and to stabilise around that rate. As regards the labour market, the programme's projections hinge on a buoyant assumption about the job content of economic growth. The apparent ratio of employment (measured in full-time equivalents) to real GDP growth is taken to remain above 50% throughout the programme period.

Table 3. Macroeconomic developments

Annual % change	2002		2003		2004		2005		2006	
	COM*	USP 2002**	COM*	USP 2002**	COM*	USP 2002**	COM*	USP 2002**	COM*	USP 2002**
Real GDP growth	0.4	0.6	1.8	2.3	2.4	2.9	-	3.0	-	3.0
<i>Contribution to GDP growth</i>										
<i>Final domestic demand</i>	-0.2	0.1	2.0	2.0	2.4	2.8	-	2.9	-	2.9
<i>Change in inventories</i>	0.9	0.4	-0.2	0.1	0.0	0.1	-	0.1	-	0.1
<i>External balance of trade</i>	-0.2	0.1	-0.1	0.1	0.0	0.0	-	0.0	-	0.0
HICP	2.6	2.6	2.0	1.9	1.9	1.3	-	1.2	-	1.2
Employment growth	1.0	0.9	0.4	1.3	1.0	1.6	-	1.6	-	1.6
Potential GDP growth	2.0	2.2	1.9	2.2	2.0	2.4	1.9	2.5	2.0	2.6
<i>of which: Labour contribution</i>	0.7	0.9	0.5	0.8	0.5	0.8	0.3	0.8	0.4	0.8
<i>Capital accumulation contrib.</i>	0.7	0.7	0.7	0.7	0.7	0.8	0.7	0.8	0.7	0.9
<i>TFP contribution</i>	0.6	0.6	0.7	0.7	0.8	0.7	0.8	0.8	0.9	0.9
Output gap***	-1.2	-1.5	-1.3	-1.4	-1.0	-0.9	-	-0.4	-	0.0

* Commission Autumn 2002 Forecasts.
** Italy stability programme update (Nov. 2002).
*** In % of potential output (Commission Autumn 2002 forecasts and Commission services estimates (see footnote n. 11).

The estimates of potential output growth obtained from applying the commonly agreed production function method to the macroeconomic scenario of the programme¹¹ shown above imply a stable rate of 2.2% per year in the 2002-2004 period, followed by a swift acceleration to above 2.5% in the last two years of the programme period. This compares with a more steady projection of around 2% for the years up to 2006, drawn from the

¹¹ The potential output estimates provided in the programme were not produced by applying the commonly agreed production function method (endorsed by the Ecofin Council on 12 July 2002) to the data of the macroeconomic scenario. The programme simply states that potential output growth is assumed to be around 2.3% throughout the programme period and refers to the Commission's estimates available at the end of September, i.e. the figures of the Commission 2002 Spring forecast. The programme also reports estimates of potential output growth from the OECD June 2002 Economic Outlook and the IMF September 2002 World Economic Outlook. Consequently, potential output estimates corresponding to the data in the programme macroeconomic scenario were produced by the Commission's services.

Commission 2002 autumn forecast. The difference largely originates in a significantly more favourable forecast for the labour market. In particular the programme assumes a stronger increase in the participation ratio and a more marked decline of the non-accelerating inflation rate of unemployment (NAIRU). The sudden acceleration of underlying growth in 2005 and 2006 also reflects a rise of gross fixed capital formation beyond the historical norm.

Taken as a whole, although affected by the early cut-off date, the risks to the programme macroeconomic scenario appear to be relatively balanced in the short term. However, in the medium term, the scenario reveals a marked bias towards the high end of the possible growth outcomes.

4. FISCAL TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES

4.1. Programme overview

The new update revises the budgetary objectives for all the years which overlap with the previous programme period. The budget is planned to approach a balance in actual terms in 2005, two years later than in the previous programme. Together with the budgetary targets, the programme also provides expenditure and revenue projections based on the legislation in force (the so-called “trend projections”), including the draft Budget Law for 2003. As in all previous programmes, the difference between the budgetary targets and the trend projections is bridged by unspecified “future measures”. This does not allow to determine whether the correction takes place on the expenditure and/or the revenue side and therefore makes it difficult to assess the precise path and composition of the adjustment.¹² Moreover, the amount indicated in the programme for “future measures” understates the size of the correction required from 2004 onwards to achieve the budgetary objectives, as the trend forecasts, being based only on legislation now in force, underestimate future expenditures, in particular those linked to increases in compensation of employees and investment.

Table 4. Composition of the adjustment in public finances

In % of GDP	2001	2002	2003	2004	2005	2006	2002-06
Total revenues	45.9	46.0	46.1	44.9	44.8	44.6	-1.4
Total expenditure	48.1	48.1	47.6	47.1	46.3	45.4	-2.7
Primary expenditure	41.8	42.2	41.6	41.4	40.8	40.0	-2.2
<i>of which: Gross fixed capital formation</i>	2.5	2.1	1.9	2.5	2.7	2.6	0.5
Interest payments	6.3	6.0	6.0	5.6	5.5	5.4	-0.6
<i>p.m. primary expenditure excluding sales of real assets</i>	<i>41.9</i>	<i>42.8</i>	<i>42.2</i>	<i>41.5</i>	<i>40.8</i>	<i>40.0</i>	<i>-2.8</i>
Primary balance	4.1	3.8	4.5	3.4	4.0	4.6	0.8
Government budget balance	-2.2	-2.1	-1.5	-2.2	-1.5	-0.8	1.3
Future measures				1.6	1.4	0.8	
Government budget balance (targets)		-2.1	-1.5	-0.6	-0.2	0.1	2.2

Source: Commission services calculations on Italy's Forecasting and Programming Report (Sept. 2002) and USP 2002

¹² “Future interventions” are in fact a quantification of future adjustment seen from the present day perspective. When a fiscal package for 2004 is adopted, the size of “future interventions” in 2005 and 2006 will vary accordingly.

An overview of the programme budgetary framework is provided in Table 4. Given the government's policy strategy to reduce the tax and social security contributions burden, the planned adjustment over the programme period would necessarily have to result mainly from a reduction in primary expenditure. In addition, one should note that, excluding the impact of the one-off sales of real assets, trend primary expenditures in 2004 are already projected to decrease by a sizeable 0.7 percentage point of GDP.

Given that public investment expenditure figures in 2002 and 2003 are affected by the impact of the sales of publicly-owned real estate, we remark that the trend path of capital expenditures is essentially flat. However, it is worth recalling that these figures are based on legislation currently in force and hence do not include the impact of future investment projects after 2003. The "true" profile of government investment expenditure is therefore likely to be higher, although the operations of *Infrastruttura spa* may exert a dampening impact which cannot be gauged at this stage.¹³

The programme presents cyclically-adjusted budget balances together with the principal elements of the adjustment method. However, the adjustment method applied by the authorities departs from the conventional approach, entailing significantly higher negative output gaps in the first years of the programme compared to those resulting from the correct application of the method agreed by the Ecofin Council on 12 July 2002.¹⁴ For a given level of actual budget balances this in turn implies a more favourable estimate of the cyclically-adjusted figure.

Table 5. Cyclically adjusted balances

	Italy's updated stability programme				Commission's Autumn 2002 Forecasts			
	Output gap (in % of Potential Output)	Budget balance (in % of GDP)	CAB* (in % of GDP)	CAPB* (in % of GDP)	Output gap (in % of Potential Output)	Budget balance (in % of GDP)	CAB (in % of GDP)	CAPB (in % of GDP)
2000	0.6	-1.7	-2.0	4.5	0.9	-1.7	-2.1	4.4
2001	0.1	-2.2	-2.2	4.1	0.3	-2.2	-2.4	4.0
2002	-1.5	-2.1	-1.4	4.5	-1.2	-2.4	-1.8	4.1
2003	-1.4	-1.5	-0.9	5.1	-1.3	-2.2	-1.6	4.0
2004	-0.9	-0.6	-0.2	5.4	-1.0	-2.9	-2.5	3.1
2005	-0.4	-0.2	0.0	5.5				
2006	0.0	0.1	0.1	5.5				

Source: Commission 2002 Autumn forecasts and Commission services calculations on USP 2002. Budgetary figures in 2000 do not include one-off proceeds relative to UMTS licences amounting to 1.2% of GDP.
* Including "future measures" amounting to 1.6% of GDP in 2004, 1.4% of GDP in 2005 and 0.8% of GDP in 2006.

¹³ *Infrastruttura Spa* is a financial intermediary co-financing large infrastructure projects (provided the projects can be "used economically") and development-supporting projects. It can carry out securitisation operations. The classification of this entity outside the general government will depend on a thorough examination of its activities and accounts on the part of Eurostat.

¹⁴ The output gap is not obtained by taking the difference between the level of actual and potential output underlying the macroeconomic scenario. The calculation follows a rough approximation which: i) takes as a starting point the output gap of 2001 implied by the Commission 2002 Spring forecast and ii) updates the output gaps for the 2002-2006 period by adding the difference between actual and potential GDP growth. The approximation directly results from the fact highlighted in section 3.2, that the authorities do not derive an estimate of potential output from the macroeconomic scenario.

If the agreed method for calculating output gaps is applied to the official macroeconomic scenario, the achievement of a “close-to-balance” position is pushed out by one year to 2004 compared to the programme calculations (Table 5).¹⁵ After deteriorating in 2001, the cyclically-adjusted balance shows an annual improvement in 2002 and 2003 of at least 0.5% of GDP until the close-to-balance is achieved. However, in both years the result is obtained with substantial one-off measures: without such measures the cyclically-adjusted balance would improve very marginally. In 2004, about half of the decline in the cyclically-adjusted deficit would appear to come from lower interest payments.

4.2. Public finances in 2003

In 2003, the government aims to achieve an actual budget balance of 1.5% of GDP, thanks to a fiscal package with a net impact of around 1 percentage point of GDP, which includes expansionary measures, notably a reduction in the personal income tax for lower-income and corporate taxpayers (the first step of the government’s tax reform)¹⁶, and an array of corrective measures of varying quality, a large number of which have essentially temporary effects. Indeed, apart from sales of real assets (0.6% of GDP) already foreseen in the budget for 2002, the draft Budget Law for 2003 introduces a new tax amnesty on capital assets illegally held abroad (0.1% of GDP) and a settlement system for pending tax litigation (0.5% of GDP). Planned savings in government consumption and in subsidies to enterprises are estimated in the official forecast to yield 0.9% of GDP.¹⁷

Table 6 shows the difference between the official plans and the Commission forecast for 2003, which in the absence of alternative information, incorporates the official estimates of the effects of the above-mentioned one-off measures.¹⁸ In contrast with the official target, the Commission deficit forecast of 2.2% of GDP would represent only a marginal improvement compared to the estimated 2002 outcome. The difference between the official objective and the Commission forecast can be attributed mostly to lower revenues, due to a less favourable assessment of discretionary measures (*inter alia* because the Commission forecast includes a lagged effect of the *Tremonti law*) and to the fact that the official appears to overestimate both the tax base and the dynamics of revenues. As for expenditures, the difference in the two forecasts is essentially a question of composition, between primary and interest outlays. Planned savings in public consumption and in subsidies to enterprises in the Commission forecast are 0.3% of GDP lower than in the official forecast.

¹⁵ Output gap estimates obtained with the HP-filter are only marginally lower compared to the production function approach. The difference has no effect on the main conclusions about the cyclically-adjusted budget balance.

¹⁶ In the case of corporate income taxes, the effects of the tax reduction are offset at least in part by a provision increasing tax receipts adopted at the end of 2002.

¹⁷ On 13 December the majority presented to Parliament a new amendment to the draft Budget Law for 2003, introducing an unprecedented number of tax amnesties and settlement schemes. The amended draft Budget Law has not been assessed and its effects are clearly not reflected in the Commission forecast.

¹⁸ Such estimates clearly carry a considerable degree of uncertainty. Even the estimated 0.6% of GDP from planned sales of real assets cannot be considered assured, as they concern not yet fully identified state property.

Table 6. Budgetary developments in 2003: Government plans (USP 2002) and Commission 2002 Autumn forecasts.

In % of GDP	2003
Government plans (USP 2002)	
Government budget balance	-1.5
Total revenue *	46.1
Primary expenditure *	41.6
CAB **	-0.9 (-0.9)
<i>p.m. Δ CAB</i>	-0.5
<i>p.m. real GDP (annual % change)</i>	2.3
<i>p.m. effect of cyclical position ***</i>	0.7
Commission 2002 Autumn forecasts	
Government budget balance	-2.2
Total revenue *	45.4
Primary expenditure *	42.0
CAB **	-1.6 (-1.9)
<i>p.m. Δ CAB</i>	-0.2
<i>p.m. real GDP (annual % change)</i>	1.8
<i>p.m. effect of cyclical position ***</i>	0.7
Difference: Commission 2002 Autumn forecasts – Government plans (USP2002)	
Government budget balance	-0.7
Total revenues	-0.7
Primary expenditure	0.4
Interest expenditure	-0.4
Source: Commission services calculations on USP 2002 and Commission 2002 Autumn forecasts.	
* To facilitate comparison, all budgetary figures in the table are computed according to the national definition used in the USP 2002.	
** Cyclically-adjusted balance, production function method (Hodrick-Prescott filter figures in brackets).	
*** Effects of cyclical position on expenditures $CPE = \varepsilon_E (ygap)$ where ε_E is the semi-elasticity of expenditures to the output gap ($ygap$).	

In 2003, the programme implies a cyclically-adjusted deficit of 0.9% of GDP, which would respect the “safety margin” (estimated at 1.5% of GDP) against breaching the 3% of GDP threshold (Table 5). The cyclically-adjusted balance would improve by 0.5% of GDP over 2002. Considering an estimate of the overall impact of one-off measures in 2003 of 1.1% of GDP (compared to 0.7% in 2002), the underlying budgetary position (excluding temporary measures) would improve by a mere 0.1% of GDP.¹⁹ This contrasts with the suggested minimal required adjustment of 0.5% of GDP, which should be higher in countries with high debt.²⁰

Based on the figures of the Commission 2002 Autumn forecast, the cyclically-adjusted budget balance would be a deficit of 2.2% of GDP, leading to decidedly more adverse implications: the safety margin would be at risk and the underlying budgetary position (excluding temporary measure) would actually deteriorate.

¹⁹ While the sale of real assets incontrovertibly qualifies as a one-off, the tax amnesties arguably could lead to some increase in the tax base. However, by historical experience, the repeated recourse to such measures in the absence of credible sanctions has not been accompanied by significant increases in structural tax receipts.

²⁰ Eurogroup press release of 7.10.2002 and Communication from the Commission to Council and the European Parliament on “Strengthening the co-ordination of budgetary policies” of 27.11.2002, COM (2002) 668.

4.3. Targets and adjustment in 2004 and beyond

The budgetary objectives for 2004 and beyond rely on a full replacement of the sizeable one-off measures implemented in 2003 and additional corrective measures, on which the programme is silent. In structural terms, the programme's budgetary targets imply that the "close-to-balance" position is now reached in 2004 and is consolidated over the rest of the programme period.

Taking the Commission's "no-policy-change" forecast for 2004 as a more prudent benchmark, that is a scenario incorporating a less favourable starting point inherited from 2003 and weaker growth in 2004, the nominal deficit is expected to be close to the 3%-of-GDP threshold. This also reflects the expiry of the one-off measures implemented in 2003. In structural terms the total correction needed to reach the "close-to-balance" position would be a minimum of 2% of GDP. In practice, the required correction would be even larger because the "no-policy-change" projection is based on existing legislation and consequently underestimates expenditure trends in public sector wages and investment. Given the almost unprecedented magnitude of correction, the achievement of the "close-to-balance" position by that year is very unlikely. The credibility of the targets in the remaining years of the programme is correspondingly undermined.

Table 7. Budgetary developments in 2004 and beyond: 2002 updated stability programme trend forecasts and targets.

In % of GDP	2004	2005	2006
Government "trend" forecasts (USP 2002)			
CAPB	3.8	4.2	4.6
CAB	-1.8	-1.3	-0.8
Government targets (USP 2002)			
CAPB	5.4	5.5	5.5
CAB	-0.2	0.0	0.1
<i>p.m. potential GDP growth (annual % change)</i>	2.4	2.5	2.6
Commission 2002 Autumn forecasts			
CAPB	3.1		
CAB	-2.5		
<i>p.m. potential GDP growth (annual % change)</i>	2.0	1.9	2.0

Source: Commission services calculations on USP 2002 and Commission 2002 Autumn forecasts.

4.4. Sensitivity analysis

4.4.1. Sensitivity to economic growth

Calculations presented in the programme aim at evaluating the budgetary impact of two alternative growth scenarios, which assume that for the entire programme period annual GDP growth is either lower or higher than the baseline by 0.5 percentage points each year. The impact is assessed by adding the deviation in growth to the output gap of the baseline scenario and multiplying the new output gap with the Commission's assumption of a cyclical sensitivity of the Italian budget of 0.45. According to this calculation, the budgetary surplus of 0.2 percent of GDP targeted for 2006 increases to 2.2% of GDP in the high-growth scenario and turns into a deficit of -1.0% of GDP in the low-growth scenario. The strong assumption underlying this approach is that potential output growth and hence the cyclically-adjusted budget balance remain unchanged. Variations in the budget compared to the baseline are assumed to be purely cyclical.

Table 8 presents the results of a sensitivity analysis based on a more prudent assumption, notably that persistently higher/lower growth does affect potential output and, in turn, the cyclically-adjusted balance.²¹ Under the assumption of unchanged fiscal policy, variations in output automatically translate into a rise or fall of government receipts.²² By contrast, as no clear relationship exists between non-cyclical outlays and the underlying level of economic activity, the working assumption applied is that primary expenditures remain unchanged relative to the baseline level. The comparison of cyclically-adjusted budget balances across growth scenarios can be taken as an estimate of the adjustment gap, i.e. the additional or lower discretionary fiscal policy effort that may be required if expenditure plans of the baseline are not adjusted for deviations in potential growth.

Table 8. Sensitivity to GDP growth

	Baseline scenario		Low-growth scenario *	High-growth scenario *
	Targeted budget balance (in % of GDP)	CAB (in % of trend output)	CAB (in % of trend output)	CAB (in % of trend output)
2002	-2.1	-1.4	-1.6	-1.2
2003	-1.5	-0.9	-1.2	-0.5
2004	-0.6	-0.3	-0.7	0.1
2005	-0.2	-0.3	-0.7	0.3
2006	0.1	-0.4	-1.1	0.1

Source: Commission services calculations based on figures provided in Italy's updated stability programme (Nov. 2002). Due to the lack of information on the determinants of growth in the alternative scenarios, trend output is approximated by applying the HP filter.

* In the 2003-2006 period real GDP annual growth rate is 0.5pp lower/higher each year than in the baseline scenario.

Higher real GDP growth by 0.5 percentage points throughout the programme, results in stronger potential output growth, improving the structural budget vis-à-vis the baseline of 0.4-0.5 percentage point of GDP and the 'close-to-balance' position would be reached one year earlier. By contrast, a shortfall of 0.5 percentage points from baseline growth in the 2003-2006 period would imply that an additional structural effort of around 0.4-0.5 percentage points is required each year to secure the original structural targets. Without such corrections the "close-to-balance" position would not be reached.

4.4.2. Sensitivity to interest rates

The programme also provides an analysis of the sensitivity of interest expenditure as a percentage of GDP to changes in interest rates. An upward/downward shift in the entire yield curve by one percentage point over the period is assessed to determine a slightly higher sensitivity in the entire programme period compared to the previous update, reflecting the intention to maintain the current structure of the debt. Interest payments

²¹ The assumption of unchanged potential output across alternative growth scenarios is clearly an unacceptable approximation for annual deviations from the baseline of +/-0.5% over the entire programme period. It is generally accepted that variations in real GDP have both a cyclical and a permanent component.

²² The effect of lower or higher growth on revenues is captured by using the conventional sensitivity parameters applied for the cyclical adjustment. This is justified as the cyclical slack of revenues is the result of actual output growing at a different rate than that of potential output. What counts in this context is that potential output and actual output simply represent two different realisations of one and the same tax base.

would be 0.22% of GDP higher/lower in the first year of the programme, with the interest burden increasing/decreasing by 0.56% of GDP in the last year.

4.5. Debt ratio

The programme envisages a continuous reduction in the government debt to GDP ratio from 109.9% in 2002 to 96.4% in 2006, a cumulative 13.5 percentage points of GDP. An acceleration in the reduction around mid-programme allows the ratio to decline below 100% of GDP threshold in 2005, two years later than the original commitment made by Italy in 1998 and one year later than projected in the November 2001 update. The upward shift in the reduction of the debt ratio results from a substantially higher level in 2001 and 2002 than previously projected. Underlying the programme scenario are sizeable privatisation receipts in 2003 and 2004, unspecified financial transactions amounting to 1.7% of GDP in 2002-2004²³ and, supposedly, additional not quantified disposals of loans on the part of the *Cassa Depositi e Prestiti* (the public savings and loans bank).

Table 9. Decomposition of changes in the government debt ratio

In % of GDP	2002		2003		2004		2005	2006
	COM 2002	USP 2001	COM 2002	USP 2001	COM 2002	USP 2001	USP 2001	USP 2001
Change in government debt ratio:	0.4	-0.5	-2.3	-4.4	-1.1	-4.6	-2.0	-2.0
1. Primary balance	-3.5	-3.8	-3.4	-4.5	-2.6	-5.0	-5.3	-5.5
2. Interest payments	5.9	6.0	5.6	6.0	5.6	5.6	5.5	5.4
3. Real GDP growth contribution	-0.5	-0.7	-1.9	-2.5	-2.5	-3.0	-2.9	-2.9
4. GDP deflator growth contribution	-2.6	-2.6	-2.7	-2.0	-2.3	-1.8	-1.8	-1.8
5. Stock flow adjustment	1.1	0.5	0.0	-1.6	0.7	-0.5	2.4	2.7
<i>of which:</i> 6. Privatisation revenue	0.0	-0.4	-1.5	-1.7	-1.5	-1.7	0.0	0.0
7. exchange rate effects	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
8. change in assets with Bank of Italy and extraordinary financial transactions	-0.6	-0.8	0.0	-1.4	0.0	-1.3	-	-
9. Stock flow adjustment without 6, 7 and 8	2.0	1.8	1.6	1.5	2.1	2.5	2.4	2.7
<i>pm. implicit cash borrowing requirement (1+2+9)</i>	4.4	4.0	3.7	3.0	5.1	3.1	2.6	2.6
Level of government debt ratio	110.3	109.4	108.0	105.0	106.9	100.4	98.4	96.4

Note: the decomposition of changes in the gross debt ratio is based on the equation for the budget constraint specified in Table 2

Source: Commission services calculations on USP 2002 and Commission 2002 Autumn forecasts.

Table 9 shows that nominal GDP growth and high primary surpluses are the driving forces behind the reduction in the debt ratio.²⁴ As an indication of the general

²³ Although not explicitly stated in the programme, this refers to a transaction between the Italian Ministry of Economics and the Bank of Italy consisting in the replacement of government bonds issued in 1993 with a 1% interest rate carried in the Bank of Italy's assets at book value, with new bonds yielding a market interest rate, entailing a reduction in nominal debt. In 2002, on the basis of information provided by the Ministry of economics, the impact underlying the programme figures was estimated at 0.4 percentage points of GDP. On 31 December the Ministry of Economics communicated that the conversion of all the bonds with a 1% interest rate had taken place. Hence, the operation is now expected to have reduced the nominal debt level by 1.9% of GDP in 2002.

²⁴ The figures in Table 9 are slightly different from those presented in the programme Table 5, which were not always consistent with those published in other official documents. In particular, the primary surplus in 2001 is higher than that obtained on the basis of the ISTAT notification and the privatisation receipts in 2001 do not represent actual receipts, but the sinking fund usage for the debt reduction.

government borrowing requirement on a cash basis, we consider the changes in the level of the debt excluding privatisation proceeds, exchange rate effects, changes in the assets held with the Bank of Italy and extraordinary financial transactions.²⁵ This quantity, which we call “implicit cash borrowing requirement”, is significantly higher than the general government net borrowing as defined in the EDP²⁶. The difference between the two items (line 9 in Table 9) widens considerably after 2003, remaining on average at around 2.5 percentage points of GDP. This implies the persistence of large and unexplained “below the line” operations throughout the programme period, that in 2005 and 2006 would not allow the debt ratio to approach the reference value at an arguably satisfactory pace.

In the Commission forecasts the debt ratio decreases by less than 2 percentage points of GDP on average. These developments depend on much higher deficit projections compared to the official forecast, particularly in 2004. However, it should be borne in mind that while the official forecast is a target, the Commission forecast is a no-policy-change deficit. Moreover, the Commission forecast does not include the extraordinary financial transactions considered in the official forecasts.

5. THE SUSTAINABILITY OF PUBLIC FINANCES

The programme contains a section on the sustainability of public finances, complete with budgetary projections for pensions and health care (including public health care expenditure for the assistance of the elderly) up to 2050. Age-related expenditures are projected to increase by some 3 percentage points of GDP between 2005 and 2040.

In assessing the sustainability of public finances, it is first necessary to consider whether the current policies can ensure that the SGP will continue to be respected in the future in the light of the budgetary implications of an ageing population. On the basis of current policies, the risk of emerging budget imbalances cannot be excluded. It is worth noting that the budgetary impact of ageing populations on pensions could be larger than projected in the programme, as the projections assume a very large increase in female participation rates. In addition, the relatively low projected increase in spending on pensions is based on an assumption of a strict application of existing pension provisions as regards the indexation of entitlements to prices and adjustments to entitlements to reflect changes in life expectancy: a strict implementation of these provisions will be required by the authorities when they become subject to review. Sustainability will require maintaining a balanced budget position in underlying terms over the very long run: this will imply running large primary surpluses for many years.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. The achievement of a position of underlying budget balance in the medium term is critical to placing public finances on a sustainable path. However, the credibility of the programme’s medium-term targets is undermined by the large recourse to measures of a temporary nature and the lack of information on future measures required to achieve a lasting consolidation.

²⁵ *Inter alia*, extraordinary financial transactions include the conversion of bonds held by the Bank of Italy and disposals of loans on the part of the *Cassa Depositi e Prestiti* (the public savings and loans bank).

²⁶ The EDP definition of net borrowing is accrual and does not include financial transactions.

Moreover, it is important that debt actually falls, in line with the reduction in the government net borrowing requirement planned in the programme: recent experience and the government's own projections highlight the problem of debt-augmenting below-the-line operations.

Finally, it is necessary to consider the type and scale of the budgetary challenge that will emerge in coming years to ensure sustainable public finances. It is essential that an ambitious, comprehensive and long-term strategy is put in place to meet the budgetary costs of ageing populations. This should include linking specifically long-term budgetary objectives to preparing for ageing populations. However, debt reduction alone will not suffice, and needs to be complemented with reforms to raise employment rates and to control the level of age-related expenditures.

6. STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT

The programme highlights the role of a series of structural measures under the heading "Pact for Italy", which are assumed to have an impact on underlying growth and hence on the underlying budgetary position. The "Pact for Italy" comprises three major elements: (i) the first part of a comprehensive tax reform, (ii) measures to improve labour market flexibility and (iii) the commitment to strengthen and enhance development in the South of the country.

The first phase of the tax reform in 2003 is planned to be achieved through a reduction of the personal income tax for low-income groups, a one percentage point cut in the corporate income tax (on top of another already planned one percentage point cut) and a narrowing of the tax base of the regional tax on productive activities. The overall cost of these measures is officially estimated at €4.4 billion (0.3% of GDP). The programme stresses the likely supply-side effects of lower taxes, in particular on the labour market, where lower marginal tax rates are expected to increase participation. The reduction of tax rates is accompanied by a tax settlement system and a tax amnesty aimed at revealing hidden taxable income and regularising taxpayers' individual positions, which are presented as a necessary complement to the overall tax reform.

The government's plan for the improvement of labour market flexibility dates back to 2001. One part of the plan, that *inter alia* introduces a series of new contracts, is expected to be approved by Parliament at the beginning of 2003. The second, and more substantial part, comprising some loosening of the labour protection legislation along with a strengthening of the income support system has so far not been presented to Parliament. The budgetary effect of the whole package is not quantified in the programme.

The initiatives for the South of the country are planned to include the improvement of public infrastructures, measures to attract private investment and a reorganisation of fiscal incentives.

Finally, an enabling law on the reform of the social security system, submitted to Parliament at the end of 2001 is still pending adoption. The reform includes measures to promote the expansion of supplementary privately-funded pension schemes, but does not address the problem of the excessively long transition to the new contributions-based pension system and the considerable problems of equity across generations and across categories of workers. The draft enabling law introduces reductions in contributions of 3-5 percentage points for newly hired workers. In the short term, it is not clear how the

budgetary costs of this measure are to be offset. In the medium term the government will have to decide whether to reduce workers' entitlements or face additional budgetary costs.

As a general remark, the series of planned reforms appears to be asymmetric in terms of its fiscal impact. While the effect of elements weighing on the budget, in particular the imminent tax reduction in 2003, are (abstracting from forecasting errors) quantified, the pay-off of the reform effort is uncertain. In the short term, temporary measures such as the sale of publicly owned real estate and tax settlements are supposed to offset the shortfall of revenues and higher expenditure entailed by the reforms. However, as highlighted in various occasions in this assessment, the programme is silent on how the planned series of temporary revenues will be replaced after their expiry in 2004. Overall, the financing of the reform programme does not appear ensured.²⁷

The expected supply-side effects from the implementation of the reform package are uncertain and ambiguous and still conditional on the approval of some important elements of the reforms. Moreover, as concerns the projected widening of the tax base through tax settlements and tax amnesties, historical experience suggests that repeated recourse to such measures has an adverse credibility effect on tax revenues. Consequently, the implementation of the reform package would not appear to be in line with the degree of caution expected from a prudent fiscal strategy.

7. OVERALL ASSESSMENT OF COMPLIANCE WITH THE SGP

Although broadly complying with the requirements of the revised "Code of conduct on the content and format of stability and converge programmes",²⁸ the programme falls short of the "Code of conduct" requirement to "*describe the budgetary and other economic policy measures being taken and/or proposed to achieve the objectives of the programme...*". As regards the "corrective measures" necessary to achieve the budgetary targets in 2004 and beyond, the programme provides a rough quantification without however imparting any information on the actual nature of the provisions. This makes it difficult to assess the government's fiscal strategy and the credibility of the budgetary targets. The risks to the macroeconomic scenario appear to be relatively balanced in the years 2002 and 2003. Due to a comparatively early cut-off date, the macroeconomic framework depicts a somewhat swifter recovery in 2003 compared to the current consensus. Reiterating the usual assumptions of real GDP growth of 3%, the medium-term projections seem to be inconsistent with the degree of caution that should underpin a prudent fiscal strategy. This is particularly important, as the "close to balance" has been postponed to 2004.

Following the deterioration in 2001, the official targets for 2002-2006 in cyclically-adjusted terms respect the safety margin against breaching the 3% of GDP threshold. The

²⁷ In this respect and as a further point, it is regrettable that the programme does not provide any information on the budgetary repercussions of the government's devolution plan currently discussed in Parliament.

²⁸ However, it should be noted that the programme figures are not in accordance with Council regulation n. 2223/96 on government expenditure and revenue, implemented by Commission regulation n. 1500/2000 of 10 July 2000. To allow comparison between the programme figures, figures of the previous programme, historical data and Commission projections, all budgetary figures had to be computed according to the national definition used in the USP 2002.

adjustment towards a “close-to-balance” position is projected to take place through successive reductions in the cyclically-adjusted deficit of around 0.5% of GDP. In 2003 the adjustment is achieved with substantial temporary measures. Even assuming that such one-off measures yield the expected results, achieving the 2003 budgetary target may prove difficult, on account of the risks to the trend budgetary projections, particularly on the revenue side. The cyclically-adjusted budget position may therefore fail to improve as planned. Taking into account such risks, the Commission 2002 Autumn forecast foresees only a marginal improvement in both the actual and cyclically-adjusted deficits. Irrespective of the risks to the 2003 budgetary projections, no significant improvement over the 2002 estimated outcome can be expected in the underlying deficit (calculated by deducting from the cyclically-adjusted balance the effect of the above-mentioned one-off measures). This does not appear to be in line with a minimal adjustment of 0.5% of GDP. The underlying balance would remain significantly distant from the “close-to-balance” objective of the Stability and Growth Pact.

The programme complies only in part with the Broad Economic Policy Guidelines for 2002, specifically, the recommendation in the BEPG that Italy’s budgetary policies should ensure “the respect of a steady path of deficit reduction, in order to achieve a close to balance budget in 2003.”

The decisive year in the programme is 2004, as the close-to-balance objective crucially hinges on replacing the main one-off measures implemented in 2003 with permanent measures, together with an additional correction in structural terms. Combining a more prudent assessment of public finance trends with lower growth assumptions, as in the Commission forecast, leads to the conclusion that in the absence of corrective measures the deficit might breach 3% of GDP. The size of the structural correction that would be needed in 2004 (of the order of 2% of GDP) is such as to make achievement of the close-to-balance objective by that year very unlikely. The credibility of the targets in the remaining years of the programme is correspondingly undermined. As a consequence, the programme does not fulfil the requirements of the Stability and Growth Pact.

The upward shift in the path of reduction of the government debt ratio compared to the previous programme, results from a substantially higher level of debt in 2001 and 2002. The commitment made in 1998 to bring the debt ratio below 100% of GDP in 2003 is now postponed to 2005. In the first years of the programme, the planned pace of debt reduction benefits from financial transactions, but unspecified below the line operations, in particular in the final years, act as a drag on the debt dynamics. More generally, the vulnerability of the budgetary targets to economic growth and the effectiveness of the planned budgetary measures has clear repercussions on the pace of debt reduction.

ANNEX 1. SUMMARY TABLES FROM THE 2002 UPDATED STABILITY PROGRAMME

Table A 0: Basic assumptions

	2002	2003	2004	2005	2006
Euro area short-term interest rate (annual average)	3.2	3.5	3.9	4.7	4.8
Euro area long-term interest rate (annual average)	4.8	5.0	5.3	5.4	5.5
USA: short-term (3-month money market)	1.6	1.9	2.7	3.4	3.9
USA: long term (10-year government bonds)	4.7	4.4	4.8	5.1	5.4
US\$/€exchange rate (annual average)	0.95	0.99	0.99	0.99	0.99
World GDP growth rate	2.8	3.7	4.4	4.3	4.3
World excluding EU, GDP growth	3.2	4.1	4.8	4.7	4.8
USA GDP growth	2.2	2.6	3.8	3.5	3.5
Japan GDP growth	-0.5	1.1	1.7	1.7	1.8
EU-15 GDP growth	1.1	2.3	2.8	2.7	2.7
Growth relevant foreign markets	1.2	7.3	7.6	7.8	7.8
World import volumes, excluding EU	6.0	7.5	8.8	8.6	8.6
World import prices (manufactured goods in USD)	3.0	4.8	1.0	1.0	1.0
Oil prices (Brent USD/barrel)	23.9	24.4	23.0	23.0	23.0
Non-oil commodities prices (in USD)	-0.9	4.5	2.5	2.5	2.5

Table A 1. Growth and associated factors

	2001	2002	2003	2004	2005	2006
GDP growth at constant market prices (7+8+9)	1.8	0.6	2.3	2.9	3.0	3.0
GDP level at current market prices (€bn.)	1217	1253	1305	1366	1431	1501
GDP deflator	2.6	2.4	1.8	1.8	1.8	1.8
HICP change	2.7	2.6	1.9	1.3	1.2	1.2
Employment growth²⁹	1.6	0.9	1.3	1.6	1.6	1.6
Unemployment rate	9.5	9.1	8.7	8.0	7.5	6.9
Labour productivity growth ³⁰	0.2	-0.3	0.9	1.3	1.3	1.4
Sources of growth: percentage changes at constant prices						
1. Household consumption expenditure	1.1	0.3	2.5	2.8	3.0	3.1
2. Government and NPISHs consumption expenditure	2.3	1.5	0.5	0.4	0.3	0.6
3. Gross fixed capital formation	2.4	-1.4	2.3	4.8	5.1	5.2
4. Changes in inventories and net acquisition of valuables³¹	0.0	0.4	0.1	0.1	0.1	0.1
5. Exports of goods and services	0.8	0.1	7.0	7.7	7.7	7.6
6. Imports of goods and services	0.2	-0.1	7.1	8.1	8.1	8.0
Contribution to GDP growth						
7. Final domestic demand	1.6	0.1	2.0	2.8	2.9	2.9
8. Change in inventories and net acquisition of valuables	0.0	0.4	0.1	0.1	0.1	0.1
9. External balance of G&S	0.2	0.1	0.1	0.0	0.0	0.0

²⁹ Full-time equivalent, national accounts

³⁰ Growth of GDP at market constant prices per labour unit

³¹ Contribution to GDP growth

Table A 2. General government budgetary developments

In % of GDP	2001	2002	2003	2004	2005	2006
Net lending by sub-sectors						
General government ³²	-2.2	-2.1	-1.5	-0.6	-0.2	0.1
Central government	-3.0	-3.5	-2.9	-3.1	-2.4	-1.5
State government						
Local government	0.4	0.5	0.5	0.5	0.5	0.4
Social security funds	0.4	0.9	1.0	0.4	0.3	0.3
General government						
Total receipts	45.9	46.0	46.1	44.9	44.8	44.6
Total expenditures	48.1	48.1	47.6	47.1	46.3	45.4
Budget balance ⁴	-2.2	-2.1	-1.5	-0.6	-0.2	0.1
Net interest payments ³³	6.2	5.8	5.8	5.5	5.4	5.3
Primary balance ³⁴	4.0	3.6	4.3	4.9	5.2	5.3
Components of revenues						
Taxes	29.7	29.5	29.1	28.6	28.7	28.7
Social contributions	12.7	12.8	12.8	12.7	12.5	12.4
Interest income	0.2	0.2	0.2	0.2	0.2	0.2
Other	3.3	3.5	4.0	3.4	3.3	3.3
Total receipts	45.9	46.0	46.1	44.9	44.8	44.6
Components of expenditures						
Collective consumption	6.9	6.8	6.7	6.7	6.7	6.6
Social transfers in kind	11.5	11.7	11.6	11.3	11.0	10.7
Social transfers other than in kind	16.7	17.2	17.2	17.0	16.6	16.4
Interest payments	6.3	6.0	6.0	5.6	5.5	5.4
Subsidies	1.1	1.1	1.1	1.1	1.1	1.1
Gross fixed capital formation ³⁵	2.5	2.1	1.9	2.5	2.7	2.6
Other	2.9	3.3	3.1	2.9	2.7	2.6
Total expenditures	48.1	48.1	47.6	47.1	46.3	45.4

Table A 3. General government debt developments

In % of GDP	2001	2002	2003	2004	2005	2006
Gross debt level	109.9	109.4	105.0	100.4	98.4	96.4
Change in gross debt	-0.7	-0.5	-4.4	-4.6	-2.0	-2.0
Contributions to change in gross debt						
Primary balance	-4.4	-3.8	-4.5	-5.0	-5.3	-5.5
Interest payments	6.3	6.0	6.0	5.6	5.5	5.4
Nominal GDP growth	4.4	3.0	4.1	4.7	4.8	4.8
<i>Other factors influencing the debt ratio</i>	1.8	0.3	-1.8	-0.5	2.6	2.9
<i>Of which: Privatisation receipts</i>	-1.1	-0.4	-1.7	-1.7	0.0	0.0
<i>p.m. implicit interest rate on debt</i>	5.73	5.48	5.71	5.58	5.59	5.60

³² Including "future measures" (+1.6% of GDP in 2004, +1.4% of GDP in 2005 and +0.8% of GDP in 2006).

³³ Interest payments net of interest income.

³⁴ Actual balance less net interest payments.

³⁵ Includes sales of real assets.

Table A 4. Cyclical developments

In % of GDP	2001	2002	2003	2004	2005	2006
GDP growth at constant prices	1.8	0.6	2.3	2.9	3.0	3.0
Actual balance	-2.2	-2.1	-1.5	-0.6	-0.2	0.1
Interest payments	6.3	6.0	6.0	5.6	5.5	5.4
Potential GDP growth ³⁶	2.3	2.3	2.4	2.2	2.3	2.3
Output gap	-0.3	-1.9	-2.0	-1.3	-0.5	0.2
Cyclical budgetary component	-0.1	-0.9	-0.9	-0.6	-0.2	0.1
Cyclically-adjusted balance	-2.1	-1.2	-0.5	0.0	0.0	0.0
Cyclically-adjusted primary balance	4.3	4.7	5.4	5.6	5.5	5.4
Potential GDP growth ³⁷	2.4	2.4	2.2	2.4	2.6	2.6
Output gap	-1.4	-3.1	-3.0	-2.5	-2.2	-1.8
Cyclical budgetary component	-0.6	-1.4	-1.4	-1.1	-1.0	-0.8
Cyclically-adjusted balance	-1.6	-0.7	0.1	0.5	0.7	0.9
Cyclically-adjusted primary balance	4.8	5.2	5.9	6.1	6.3	6.3
Potential GDP growth ³⁸	1.8	2.0	2.0	-	-	-
Output gap	-1.0	-2.4	-2.1	-	-	-
Cyclical budgetary component	-0.5	-1.1	-0.9	-	-	-
Cyclically-adjusted balance	-1.8	-1.0	-0.6	-	-	-
Cyclically-adjusted primary balance	4.6	4.9	5.4	-	-	-

Table A 5. Divergence from previous update

In % of GDP	2001	2002	2003	2004	2005
GDP growth					
Previous update	2.0	2.3	3.0	3.0	3.1
Latest update	1.8	0.6	2.3	2.9	3.0
Difference	-0.2	-1.7	-0.7	-0.1	-0.1
Actual budget balance					
Previous update	-1.1	-0.5	0.0	0.0	0.2
Latest update	-2.2	-2.1	-1.5	-0.6	-0.2
Difference	-1.1	-1.6	-1.5	-0.6	-0.4
Gross debt levels					
Previous update	107.5	104.3	101.0	98.0	95.4
Latest update	109.9	109.4	105.0	100.4	98.4
Difference	2.4	5.1	4.0	2.4	3.0

³⁶ Under this scenario the estimated potential output growth correspond to those implicit in the Spring Forecasts 2002 of the European Commission.

³⁷ Under this scenario the estimated potential output growth correspond to those of the OECD (MTB 2002 and Economic Outlook June 2002).

³⁸ Under this scenario the estimated potential output growth correspond to those implicit in the last IMF forecasts (WEO September 2002).

Table A 6. Long-term sustainability of public finances ³⁹

In % of GDP	2001	2005	2010	2020	2030	2040	2050
Total expenditure							
Old age pensions ⁴⁰	13.8	13.9	13.8	14.5	15.7	15.6	14.1
Health care (including care for elderly)	6.0	5.9	6.1	6.5	7.0	7.4	7.6
Interest payments							
Assumptions							
Labour productivity growth	-0.3	1.9	1.9	1.8	1.8	1.8	1.8
Real GDP growth	1.8	2.4	1.9	1.4	0.7	1.0	1.2
Participation rates males (aged 20-64)	78.5	80.0	80.9	80.9	79.3	79.0	79.0
Participation rates females (aged 20-64)	50.0	53.7	55.0	56.4	59.7	65.8	68.7
Total participation rates (aged 20-64)	64.2	66.9	68.0	68.8	69.7	72.6	74.0
Unemployment rate	9.5	9.3	8.9	8.4	7.9	7.3	7.0

³⁹ EPC-WGA baseline scenario

⁴⁰ Old age and seniority

ANNEX 2. A QUANTITATIVE ASSESSMENT OF THE SUSTAINABILITY OF PUBLIC FINANCES

This is the second assessment of the sustainability of Italian public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the EPC Ageing Working Group.⁴¹

The Italian stability programme contains a section assessing the sustainability of public finances and includes national budgetary projections for public expenditures on pensions and health care (including public health care expenditure for the elderly). Compared with the EPC projections, they have been updated to take account of recently adopted measures and also a review of so-called ‘dormant positions’ within the social security administration’s data banks. As indicated on the table below, there are only marginal differences in the projections vis à vis the EPC results, and consequently the Commission used the national projections when running the sustainability indicators.

Budgetary expenditures projections for period 2005-2050 included in the Italian stability programme

	2005	2010	2020	2030	2040	2050	change 2005-50
Pensions	13,9	13,8	14,5	15,7	15,6	14,1	0,2
Health and care for the elderly	5,9	6,1	6,5	7	7,4	7,6	1,7
Total age-related spending	19,8	19,9	21	22,7	23	21,7	1,9
Difference vis à vis EPC projections*	0,2	0,0	-0,2	0,1	0,1	0,2	0,2

* a ‘+’ result indicates that the projected spending in the stability programme is higher than in the EPC report

Source: EPC(2001) and Italy’s stability programme, updated November 2002

The programme budgetary projections were carried out within the agreed parameters established by the EPC. The relatively small projected increase in public spending on pensions is based on the assumption of a large increase in participation rates, and in particular a 20 percentage point increase in the participation rates of women. For such an increase to come about, substantial policy measures may be required. If the assumed increases in participation rates do not materialise, then the projected evolution of pension spending could be different. An additional factor driving projected pension expenditures is the full application of existing provisions regarding the indexation of entitlements to prices (which contributes to large decline in average pension benefits relative to average wages), and the full actuarial adjustment of pension entitlements to take account of projected increases in life expectancy (in effect, this shifts the budgetary impact of increased life expectancy from the government to the individual). Failure to apply these provisions in full could have important effects on the projected level of pension expenditures as a share of GDP.

The table below presents the debt and budget balance development according to two different scenarios, a “programme scenario” and a “2002 situation scenario”. The “programme scenario” is calculated on the following basis:

- the projections for age-related expenditures come from the stability programme;

⁴¹ ‘How the sustainability of public finances was assessed using the 2001 updates of stability and convergence programmes: recommendations for improvements in future years’, Note from the AWG to the EPC, EPC/ECFIN/396-02 of 23 July 2002.

- government revenues are held constant at the ratio projected for 2006;
- the starting point for gross debt and the primary surplus are the 2006 levels reported in the programme.

The “2002 situation scenario” is based on the 2002 budgetary data in the programme and assumes that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2006. This allows to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme.

The difference in results between the two scenarios is striking. On the basis of the “programme scenario”, public finances appear to be sustainable in terms of respect of SGP requirements. Reaching a balanced budget position in underlying terms by 2006 would result in a continuous fall in debt levels up to 2050. Note that this is based on an assumption of no debt-increasing financial operations. In contrast, the “2002 situation scenario” points to the risk of unsustainable public finance positions. A failure to improve the underlying budget position would imply a much slower pace of debt reduction (in fact, the debt level would not fall below the 60% of GDP). By the end of the projection period, debt levels would be on an upward trajectory towards 100% of GDP.

Quantitative indicators of the sustainability of public finances

Main assumptions - baseline scenario (as % GDP)	2006	2010	2020	2030	2040	2050	changes
Total age-related spending	19.8	19.9	21.0	22.7	23.0	21.7	1.9
Pensions	13.9	13.8	14.5	15.7	15.6	14.1	0.2
Health care	5.9	6.1	6.5	7.0	7.4	7.6	1.7
Other age related expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total non age-related spending*	19.4						
Total revenues*	44.6						

* constant

Results (as % GDP)	2006	2010	2020	2030	2040	2050	changes
<i>Programme scenario</i>							
Debt	88.9	77.3	42.9	17.3	-4.2	-37.8	-126.7
Net borrowing	0.1	0.7	1.8	1.5	2.3	5.4	5.3
<i>2002 situation scenario</i>							
Debt	94.5	87.8	72.3	71.5	83.4	90.8	-3.7
Net borrowing	-1.7	-1.3	-1.2	-2.8	-3.8	-3.0	-1.3

Tax gaps	T1*	T2**	T3***
Programme scenario	-0.8	-1.0	0.3
2002 situation scenario	0.9	0.6	1.9

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 23.3

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

***It indicates the change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

Source: 2002 update of the Italian Stability programme and Commission calculations