Ministero dell'Economia e delle Finanze

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THE WORLD ECONOMY

1. INTRODUCTION

The Update of Italy's Stability Programme is carried out in fulfilment of Article 4 of the European Council Regulation 1466/97.

This year's Update, here unofficially translated into English, is based on the *Forecasting and Planning Report (RPP)* for 2004, on the *Finance Bill* for 2004, on the law decree n.269/2003 and on the *Update to the Economic and Financial Planning Document (DPEF)* for 2004−2007 presented to Parliament on September 30, 2003.

The Update outlines the macroeconomic framework for 2003 and the following four years and sets out the Government's public finance objectives for the years 2003 to 2007. It also examines the 2004 Budget and its effects on the deficit and debt to GDP ratios.

The Update also includes a sensitivity analysis of public finances according to different macroeconomic scenarios.

In compliance with the Code of Conduct adopted by the European Union's Council on July 10, 2001 and in line with the strategy outlined by the Government in the *DPEF 2004-2007,* the present document describes the structural improvements in public finances in the medium term, taking into consideration the lack of a multi-year budgetary process in the Italian institutional framework.

Finally, the document analyses the impact of the population's ageing trends on public finances up to 2050 and indicates a set of preliminary estimates for the public sector's asset and liability balance sheet.

2. THE MACROECONOMIC FRAMEWORK

In 2003 the world economy has shown clear signs of improvement, driven primarily by a recovery in the United States, Japan and other Asian countries. The economic recovery in the Euro Area has been slower: in the first half of the year growth practically stalled, posting a modest recovery in the third quarter.

In line with the rest of Europe, Italy's economic activity declined slightly in the first half of the year due to weak foreign demand and investments. The turning point took place in the third quarter when GDP growth rose by 0.5 percent. The disappointing performance of investments and exports in 2003 was offset by a more satisfactory trend in consumption, reflecting growth in employment and salaries. Private consumption is expected to rise by 1.8 percent in 2003. Recent estimates published by international and national organisations confirm the RPP 2004 forecast of a 0.5 percent GDP growth rate in 2004.

In contrast to other European countries, in Italy employment has continued to rise (cfr. Table 1 and Figure 1). In particular, in the Mezzogiorno the unemployment rate fell to 16.8 percent, the lowest level since 1993.

Inflation has continued to decline but at a slower rate than expected. Adverse climatic conditions, relatively high oil prices and a lack of competition in domestic sectors are among the factors that have prevented a faster decline in inflation. Inflation is expected to average 2.6 percent in 2003, with a considerable deceleration by the end of 2003.

The pace of recovery in Italy should accelerate in the coming months. Private consumption is expected to grow by 2.3 percent in 2004 due to the decline of inflation and steady improvement of the economy and a further strengthening of the labour market. Employment is expected to grow by 0.9 percent in 2004 while the unemployment rate is expected to drop to 8.4 percent from 8.7 percent in 2003. Additional stimuli are expected from the recovery in the investment cycle and foreign sector. Despite the appreciation of the euro, strong foreign demand is expected to boost Italian exports by over 5 percentage points after the decline posted in 2003.

The progressive decline of inflationary pressures which appeared in 2003 and a rise in productivity deriving from the recovery, will lead to a further decline in inflation which is expected to average 1.7 percent in 2004.

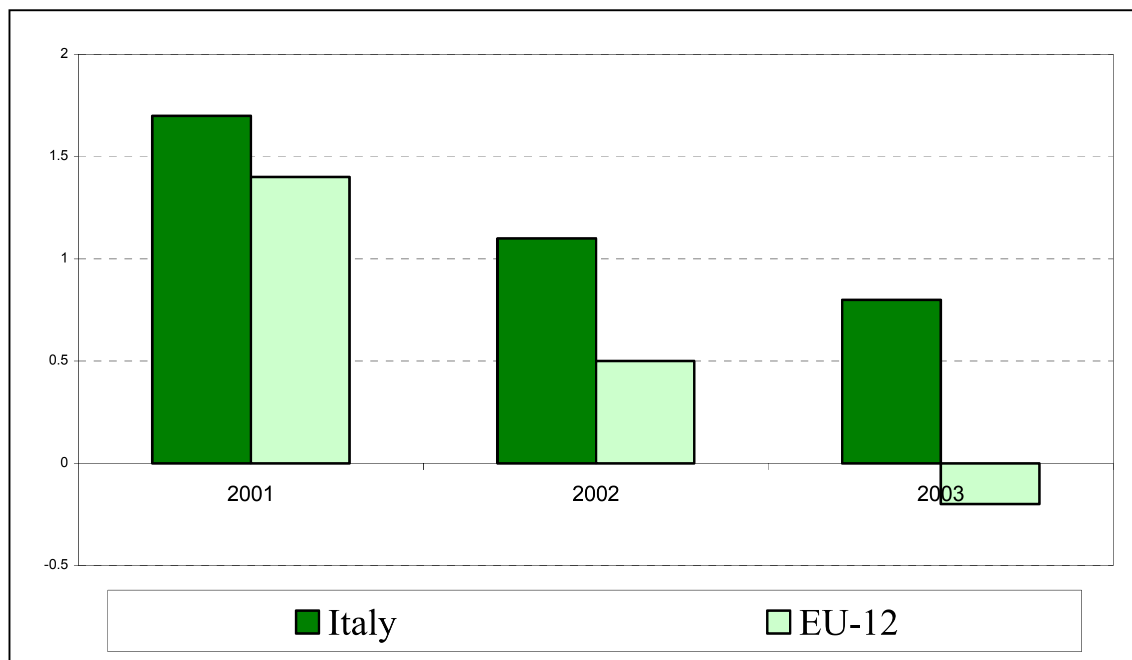
Table 1 THE MACROECONOMIC FRAMEWORK

	2002	2003	2004	2005	2006	2007
GDP growth at constant market prices	0.4	0.5	1.9	2.2	2.5	2.6
GDP level at current market prices (billions of euro)	1258	1300	1352	1407	1467	1530
Growth rate of GDP deflator	2.7	2.8	2.1	1.8	1.7	1.7
Inflation rate [(1)]	2.4	2.6	1.7	1.5	1.4	1.4
Growth rate of employment [(2)]	1.1	0.6	0.9	1.0	1.2	1.2
Unemployment rate	9.0	8.7	8.4	8.1	7.7	7.4
Growth rate of labour productivity[(3)]	-0.7	-0.1	1.0	1.1	1.3	1.3
Composition of GDP growth (percentage change)						
Private consumption expediture	0.4	1.8	2.3	2.2	2.4	2.4
Government consumption and NPISH expenditure[(4)]	1.7	1.4	0.9	0.6	0.4	0.4
Gross fixed capital formation	0.5	-0.6	3.5	4.4	4.9	5.2
Exports of goods and services	-1.0	-1.5	5.6	6.8	7.2	7.3
Imports of goods and services	1.5	2.0	7.4	7.2	7.4	7.6
Contribution to GDP growth (percentage of GDP)						
Final domestic demand	0.7	1.2	2.4	2.4	2.6	2.7
Change in inventories	0.4	0.3	0.2	0.0	0.0	0.1
External balance of goods and services	-0.7	-1.0	-0.5	-0.2	-0.1	-0.2

(1) Consumer price index (CPI), source *RPP* 2004. The harmonised index of consumer prices (HICP) shows a growth rate of 2.6 percent in 2002, 2.8 in 2003, 1.8 in 2004 and for the other years coincides with the CPI.
(2) National accounts definition.
(3) GDP growth at constant prices per labour unit.
(4) NPISH= non-profit institution serving households

Italy's growth rate should accelerate over 2005-2007. The new growth cycle should be boosted by the recovery of private consumption, helped by an increase in purchasing power, a favourable evolution of the labour market and the improved economic outlook. The new expansionary phase of the world economy and the need to address growing international competition are expected to lead to solid investment growth even in Italy.

Figure 1 **EMPLOYMENT GROWTH RATE**[1]
(Percentage change)



(1) Source: European Commission, *Autumn Forecast* (2003).

World trade is expected to grow by around 8 percent in 2005-2007, fuelling the increase in Italian exports. However, the contribution of the foreign sector to GDP growth should remain slightly negative over the period, as imports are expected to grow even faster because the elasticity of imports to domestic demands remains high even though lower than in previous years.

The situation of the labour market is expected to improve steadily with employment increasing by about 1 percent per annum in the next few years, while the unemployment rate is expected to drop to 7.4 percent by the end of the forecasted period.

Inflation is forecast to abate from 2005 to 2007, converging towards values close to 1.5 percent.

Potential GDP grew by 1.9 percent in 2002 and is forecast to grow by 1.7 percent in 2003. Following the slowdown forecast for the 2002-2004 period, potential GDP will show a slight but progressive acceleration from 2005 (see Table 4, paragraph 3.2).

3. NET BORROWING AND PUBLIC DEBT

3.1 General government net borrowing

Unfavourable economic conditions over the 2002-2003 period severely constrained economic policies and impacted public finances, leading to a revision of the forecasts presented in the 2002 Stability Programme Update.

In April 2003, on occasion of the Update to the *Forecasting and Planning Report* (RPP), the Government revised its deficit forecasts for the current year taking into consideration a delay in the global recovery. The forecast for the Italian economy was halved, while the target for the deficit to GDP ratio was raised to 2.3 percent from an initial 1.5 percent.

The deficit forecast for this year reflected the revision of data on public finances for the preceding years. In particular a 0.4 percent upward revision of the 2001 deficit to GDP ratio, and a variation in the allocation of public administration expenditure for 2002 . Despite these revisions, the DPEF 2004-2007 reconfirmed the deficit to GDP target for 2003 at 2.3 percent. The target was revised up to 2.5 percent in September with the 2004 RPP (Table 2).

The difference between the forecast presented last year and the current Update of the Stability Programme results from a number of contrasting factors, including slower growth of around 1.8 percentage points less than expected. The revenue short fall is estimated at 0.3 percentage points of GDP – because of a 1.1 percentage point fall in tax revenues, partially offset by a 0.8 percentage point increase in other types of revenues (including tax amnesties). In contrast, a 0.7 percentage point increase in expenditure, due to higher health and investments (due to the postponement to 2004 of a large part of real estate sales), was partially counterbalanced by lower interest rates.

Table 2 DIFFERENCES WITH THE PREVIOUS STABILITY PROGRAMME UPDATE

	2002	2003	2004	2005	2006
GDP growth					
Stability Programme 2002	0.6	2.3	2.9	3.0	3.0
Stability Programme 2003	0.4	0.5	1.9	2.2	2.5
Difference	-0.2	-1.8	-1.0	-0.8	-0.5
Net borrowing (% of GDP)					
Stability Programme 2002	-2.1	-1.5	-0.6	-0.2	0.1
Stability Programme 2003	-2.3	-2.5	-2.2	-1.5	-0.7
Difference	-0.2	-1.0	-1.6	-1.3	-0.8
Public debt (% of GDP)					
Stability Programme 2002	109.4	105.0	100.4	98.4	96.4
Stability Programme 2003	106.7	106.0	105.0	103.0	100.9
Difference	-2.7	1.0	4.6	4.6	4.5

The current forecast for 2003 shows a 0.2 percentage point increase in the deficit to GDP ratio from 2002. The higher deficit is due to an increase in the ratio between total expenditure as a ratio to GDP of 0.9 percentage points and of total revenues to GDP of around 0.6 percentage points.

A proper comparison with 2002 excludes the effect of real estate sales (0.7 percent of GDP). Accordingly, the impact of primary expenditure on GDP is expected to increase by around half a percentage point in 2003 from 2002.

For 2004, the deficit to GDP target was raised to 2.2 percent, from the 0.6 percent indicated in the previous Stability Programme. The deficit target for 2004 had already been revised to 1.8 percent in the *DPEF 2004-2007.* The overall revision of the targets reflects the weaker growth expected in 2003-2004.

The net debt of the general government is expected to decrease steadily in 2005-2007, in line with the acceleration of economic growth and the progressive narrowing of the output gap. The deficit should decline to 0.7 percent of GDP in 2006 and disappear altogether in 2007.

Table 3 GOVERNMENT BUDGET[(1)]
(percentages of GDP)

	2002	2003	2004	2005	2006	2007
Net lending by sector						
General government	-2.3	-2.5	-2.2	-1.5	-0.7	0.0
Future measures:				1.5	1.9	2.2
of which: permanent				1.0	1.9	2.2
one-offs				0.5		
Central government	-2.4	-2.3	-2.5	-2.9	-2.5	-2.1
Local government	-0.6	-0.5	-0.6	-0.6	-0.5	-0.4
Social security institutions	0.7	0.3	0.8	0.4	0.4	0.3
General government						
Total receipts	45.2	45.8	45.1	44.6	44.4	44.0
Total expenditure	47.5	48.4	47.3	47.6	47.0	46.2
Future measures				1.5	1.9	2.2
Net borrowing	-2.3	-2.5	-2.2	-1.5	-0.7	0.0
Interest payments	5.7	5.3	5.1	5.0	5.1	5.1
Primary balance (2)	3.4	2.8	2.9	3.5	4.4	5.1
Components of revenues						
Tax revenues	28.8	28.1	28.2	28.4	28.4	28.2
Social security contributions	12.7	12.8	12.9	12.8	12.7	12.6
Interest income	0.1	0.2	0.2	0.2	0.2	0.2
Other receipts	3.6	4.8	3.9	3.1	3.1	3.0
Total receipts	45.2	45.8	45.1	44.6	44.4	44.0
Components of expenditures						
Collective consumption	7.1	7.2	7.0	7.1	6.9	6.8
Social transfers in kind	11.8	11.8	11.8	11.7	11.6	11.4
Social transfers other than in kind	17.1	17.3	17.3	17.1	17.1	16.9
Interest payments	5.7	5.3	5.1	5.0	5.1	5.1
Subsidies	1.0	1.0	1.0	0.9	0.9	0.8
Gross fixed capital formation	1.8	2.6	2.2	2.6	2.6	2.5
Other expenditure	3.0	3.1	2.9	3.1	2.9	2.7
Total expenditure	47.5	48.4	47.3	47.6	47.0	46.2

(1) Details may not add, due to rounding.
(2) Net borrowing less gross interest payments.

The forecasts for 2005-2007 include the effects of the structural measures indicated in the 2004 Budget. The annual targets set by the DPEF will be achieved by implementing additional measures (consistent with public accounting norms), as specified by the Budget laws for the next years. The one-off measures will be gradually replaced by permanent measures as indicated in Table 3.

3.2 The cyclically-adjusted budget

A cyclically-adjusted budget, or structural budget, measures the government accounts net of the impact of economic fluctuations – the so-called "cyclical component". The cyclical component of the budget is measured by calculating the output gap and elasticity of the budget to economic growth. The output gap is a measure of the discrepancy between actual GDP and potential GDP. The elasticity parameters are set by the European Union, for Italy it is equal to 0.45 percent. Therefore, an increase in the output gap of one percentage point of GDP increases the cyclical component of the deficit by 0.45 percentage points.

The trend of the output gap and the profile of potential GDP shown in Table 4 were obtained by applying the EU method to the forecasts of the DPEF 2004-2007 and the RPP 2004.

Table 4 CYCLICALLY-ADJUSTED PUBLIC FINANCE [1]
(percentages of GDP)

	2002	2003	2004	2005	2006	2007
GDP growth rate at constant prices	0.4	0.5	1.9	2.2	2.5	2.6
Net borrowing	-2.3	-2.5	-2.2	-1.5	-0.7	0.0
Interest payments	5.7	5.3	5.1	5.0	5.1	5.1
Potential output growth rate[2]	1.9	1.7	1.7	1.8	2.0	2.3
Output gap[2]	-0.3	-1.5	-1.3	-0.9	-0.5	-0.1
Cyclical budgetary component[2]	-0.1	-0.7	-0.6	-0.4	-0.2	-0.1
Cyclically adjusted budget balance[2]	-2.2	-1.9	-1.6	-1.1	-0.5	0.1
Cyclically adjusted primary balance[2]	3.5	3.4	3.5	3.9	4.6	5.2

(1) Decimals may not add, due to rounding.
(2) Data obtained by applying the production function method agreed to with the European Union to the forecasts of the RPP and DPEF 2004-2007. Therefore a direct comparison with the forecasts of the previous Stability Programme is not possible.

The expected deficit for 2003 is 2.5 percent of GDP or 1.9 percent of GDP if adjusted for cyclical factors, 0.3 percentage points less than in 2002. The balance, adjusted for cyclical factors, should continue to fall by another 0.3 percentage points in 2004 and by 0.5-0.6 percentage points a year before reaching a slight surplus in 2007.

3.3 Public debt

In 2002 the debt to GDP ratio diminished to 106.7 percent, below what was forecast in the previous Stability Programme Update. The reduction reflected the bond swap operation with the Bank of Italy carried out in December 2002 according to law 483/93. However, even without that operation the debt to GDP ratio would have been reduced by around 0.9 percentage points, thanks to measures introduced to control spending in the public sector.

Table 5 DEBT/GDP RATIO[(1)]

	2002	2003	2004	2005	2006	2007
Public debt						
Level	106.7	106.0	105.0	103.0	100.9	98.6
Change	-2.8	-0.7	-1.0	-2.0	-2.1	-2.3
Factors influencing changes in debt/GDP ratio (% of GDP)						
Primary balance	-3.4	-2.8	-2.9	-3.5	-4.4	-5.1
Interest payments	5.7	5.3	5.1	5.0	5.1	5.1
Nominal GDP growth rate	3.1	3.3	4.0	4.1	4.2	4.3
Other factors	-2.0	0.1	0.8	0.6	1.4	2.0
of which: privatization receipts	-0.1	-0.3	-1.1	-1.1	-0.7	-0.7
Implicit interest rate on debt	5.3	5.0	4.9	4.9	5.0	5.2

(1) The average cost of the debt has been calculated by applying annual inflation rates to average annual debt.

The debt to GDP ratio is expected to decline to 106 percent, in 2003 one percentage point above the target set out in the previous Stability Programme Update (Table 5). The difference is due to lower economic growth (previously, GDP growth was forecast at 4.1 percent, instead of the current 3.3 percent). Furthermore, the primary

surplus is expected to reach 2.8 percent in 2003 (rather than 4.5 percent as indicated in the previous Stability Programme Update). Such a reduction is only partially compensated by lower the previously expected interest expenditure. Finally, the privatisations forecast for 2003 amounted to only 0.3 percent of GDP, instead of the 1.7 percent forecast in the last Stability Programme Update.

From 2004 onward the reduction of the debt to GDP ratio will accelerate (even though at a lower rate than forecast in the last Stability Programme Update) due to stronger economic growth, progressive increase of the primary surplus and asset sales. To guarantee a more efficient management of public assets a new corporate entity, Patrimonio dello Stato S.p.A, has been established with the task to identify all of the State's assets and improve their management and profitability. The goal to reduce the debt to GDP ratio to below 100 percent will be achieved in 2007.

3.4 Asset Management[1]

Italy's public sector owns a vast amount of assets: financial, tangible and intangible. Information on these assets is still incomplete. Excluding state-controlled companies, the cataloguing and valuation of public assets (especially receivables, concessions and tangible assets such as real estate and infrastructure) is unsatisfactory. In contrast, the assessment of Italy's public debt (its market value, risk profile and cost) is very precise and the market for government bonds is one of the most efficient in the world.

Obviously it is quite important to reorganise, in a transparent way, the State's assets with the objective to manage them more efficiently and help reduce public debt. To this effect, the Ministry of the Economy and Finance is developing a Public Sector Balance Sheet based on the best accounting practices. While not required by Eurostat such a balance sheet is recommended by the IMF and the OECD.[2]

[1] The data included in this paragraph are preliminary estimates and are subject to revision. They are not official.

[2] IMF (1968), *A Manual on Government Finance Statistics*, Washington; OECD (1993), *Accounting for what: the Value of Accrual Accounting to the Public Sector*, Paris.

The accounting standards utilised are those indicated by the *International Financial Reporting Standards* and adopted by the European Union in June 2002 (EU Rule n.1606/2002) as a base to produce consolidated balance sheets in the private sector, and to be progressively introduced in member country accounting methods.

The compilation of Italy's balance sheet is still based on preliminary data and is therefore subject to revision (Table 6).

Table 6 PUBLIC SECTOR BALANCE SHEET IN 2002[1]
(millions of euro)

	Central Government	Local government	Public Sector
	Adjusted Value	*Adjusted Value*	*Adjusted Value*
Assets			
Liquid Funds	187,031	44,981	232,011
Receivables	42,799	45,306	88,105
Advances	45,693	-	45,693
Other Account Receivable	1,180	975	2,155
Equity Investments	103,416	77,300	180,716
Intangible Fixed Assets	5	57,817	57,822
Tangible Fixed Assets	586,136	545,911	1,132,047
of which: infrastructures	-	*180,000*	-
Other	-	*56,000*	-
Total Assets	**966,259**	**772,289**	**1,738,548**
Liabilities			
Provision for Future Risks and Charges	10,589	-	10,589
Payables	1,363,286	46,399	1,409,685
Accrued Expenses and Deferred Income, with a Detail of Discounts on Loans	8,449	-	8,449
Total Liabilities	**1,382,324**	**46,399**	**1,428,723**
Net Equity (Deficit)	**-416,065**	**725,890**	**309,825**

(1) The data included in this table are preliminary estimates and are subject to revision. They are not official.

Table 7 shows some key financial ratios; in particular the relationship between assets and liabilities of the central government is currently at 0.7, while the ratio for the entire public sector is 1.2. Such ratios are broadly in line with those countries which have adopted similar accounting criteria (UK, Sweden, US and New Zealand).

In the past years, the operations finalised at improving the efficient use of public assets – such as privatisations, the sale of residential real estate belonging to welfare bodies and the securitisation of credits – have been well received by the markets and have helped reduce public debt.

Within this framework, it is necessary to present the value of the public assets together with the liabilities. It is only through a similar approach that it is possible to have a comprehensive and multi-year picture that shows the dynamics of the State's future revenues and debts.

A balance sheet based on the accounting principles used in the private sector provides the foundation for enhancing the value of the assets, facilitates privatisations and helps reduce the public debt.

A system of management that takes both assets and liabilities into consideration has to be based on criteria of efficiency and equity, and be compatible with market conditions. The focus shifts away from short-term management to long-term objectives taking in consideration all of the State's assets.

Table 7 PUBLIC SECTOR RATIOS IN 2002[(1)]

	Central Government	Public Sector
Total Assets / Total Liabilities	0.70	1.22
Disposable Assets / Total Assets	0.62	0.63
Financial Assets / Fixed Assets	0.56	0.46
Listed Assets / Total Assets	0.04	0.02
Shareholdings / Total Assets	0.12	0.10
Fixed Assets / Total Assets	0.64	0.68
Current Assets / Current Liabilities	0.29	0.38

(1) The data included in this Table are preliminary estimates and are subject to revision. They are not official

4. SENSITIVITY ANALYSIS

The public finance targets indicated in Chapter 3.1 hinge on the macroeconomic scenario presented in Chapter 2. To evaluate the impact of different macroeconomic scenarios on public finance some simulations have been performed making different assumptions concerning growth rates (Section 4.1) and interest rates (Section 4.2).

4.1 Sensitivity to growth

Two alternatives to the baseline macroeconomic scenario, described in Chapter 2, and the public finance scenario outlined in Chapter 3, have been considered. In the high-growth scenario the GDP rate has been increased by 0.5 percentage points per annum throughout 2007. The slow-growth scenario assumes that the GDP rate will be reduced by half a percentage point per annum. The simulations were performed by changing the value of some international variables.

The high-growth scenario is based on the assumption that for the 2004-2007 period international trade will grow at around 9.0 percent and the U.S. economy at 4.4 percent. This determines a strengthening of the dollar against the euro and an increase in exports and investments; accordingly, the Italian economy grows by 0.5 percentage points more per annum than in the baseline scenario.

Despite the pick up in inflation (0.2 percentage points more), private consumption also increases due to the effects of "confidence" that derives from a stronger economy.

On the supply side, the increase in exports and investments is expected to boost employment by 0.2 percentage points more than in the baseline scenario.

The low-growth scenario assumes that during 2004-2007 growth will be reduced by weaker world trade (around 6.0 percent instead of the 8.0 percent forecast in the baseline scenario).

Over the simulation period, the U.S. growth rate is on average 0.5 percentage points lower than in the baseline scenario, determining a weaker dollar against the euro. The growth rate of the Italian economy is 0.5 percent less per annum due to lower exports and investments. Despite slower inflation (by an average 0.2 percentage points), there is a contraction in private consumption due to slower economic growth. On the supply side, the weaker growth in exports impacts industrial production and services, with a negative repercussion on employment (around 0.4 percent less a year).

In both scenarios the different growth rates also affect the growth potential[3] permanently and temporarily. Accordingly, the potential output of the two scenarios, calculated by applying the production function methodology established by the EU, varies compared to that of the baseline scenario. The output gap changes according to the new effective and potential GDPs.

It is assumed that a change in GDP growth is reflected on public finances through a variation in the primary surplus both in its structural and in its cyclical component[4]. The structural part of the primary surplus is defined by analysing separately revenues and expenditure. Revenues react to a variation in GDP growth with an elasticity equal to 0.9 percent. Structural expenditures are assumed to remain unchanged with respect to variations in the potential GDP as indicated in the two scenarios. Finally, it is assumed that the cyclical component of the primary surplus varies according to the elasticity that the European Union has determined to be 0.45 percent for Italy.

The results of the simulations indicates that, higher growth rates of 0.5 percentage points per annum, increase potential growth by 0.3-0.4 percentage points, above the baseline scenario (Table 8). Lower growth by 0.5 percentage points per annum, reduced potential growth by 0.3-0.4 percentage points.

In the high-growth scenario, the deficit improves by 0.1 percentage points in 2004, by 0.4 in 2005, 0.5 in 2006 and 0.8 in 2007 (Figure 2). In 2007 a surplus is reached.

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[3] Simulations of potential GDP makes this sensitivity analysis incomparable to previous Stability Programmes in which the high and lower growth forecasts were based only on cyclical factors.

[4] The simulations for 2005-2007 have been separated into higher revenues and savings relative to their share to the contribution to GDP of current revenues and expenditures during the same period.

Table 8 SENSITIVITY TO GDP GROWTH [(1)]
(percentage values)

		2004	2005	2006	2007
	High-growth scenario	2.4	2.7	3.0	3.1
GDP growth rate at constant prices	Baseline scenario	1.9	2.2	2.5	2.6
	Low-growth scenario	1.4	1.7	2.0	2.1
	High-growth scenario	2.0	2.2	2.3	2.7
Potential output growth rate	Baseline scenario	1.7	1.8	2.0	2.3
	Low-growth scenario	1.4	1.5	1.6	1.9
	High-growth scenario	-1.4	-1.0	-0.4	0.0
Output gap	Baseline scenario	-1.3	-0.9	-0.5	-0.1
	Low-growth scenario	-1.0	-0.9	-0.5	-0.3
	High-growth scenario	-2.1	-1.1	-0.2	0.8
Net borrowing	Baseline scenario	-2.2	-1.5	-0.7	0.0
	Low-growth scenario	-2.5	-1.9	-1.5	-0.9
	High-growth scenario	-1.4	-0.6	0.0	0.8
Cyclically adjusted budget balance	Baseline scenario	-1.6	-1.1	-0.5	0.1
	Low-growth scenario	-2.1	-1.5	-1.2	-0.8

(1) Details may not add, due to rounding

In the lower-growth scenario, the deficit to GDP ratio worsens in 2004 by around 0.3 percentage points in comparison to the baseline scenario. In the following years the deficit would continue to decrease at a slower rate that in the baseline scenario; from 1.9 percent in 2005 to 1.5 percent in 2006 and 0.9 percent of GDP in 2007.

In the higher-growth scenario, the structural deficit will be 0.2 percentage points lower than in the baseline scenario in 2004. Over the following years, the structural deficit will diminish by 0.6-0.8 percentage points up to 2007. In the low-growth scenario, the structural deficit is expected to worsen by 0.5 percentage points in 2004 compared to the baseline scenario. From 2004 to 2007, the reduction of the structural deficit is almost halved as compared to the high-growth scenario. In both scenarios, the deficit, adjusted for cyclical factors, shows continuous improvement throughout 2007 (Figure 3).

Figure 2 **SENSITIVITY OF THE ACTUAL BUDGET BALANCE TO GDP GROWTH**
(percentages of GDP)

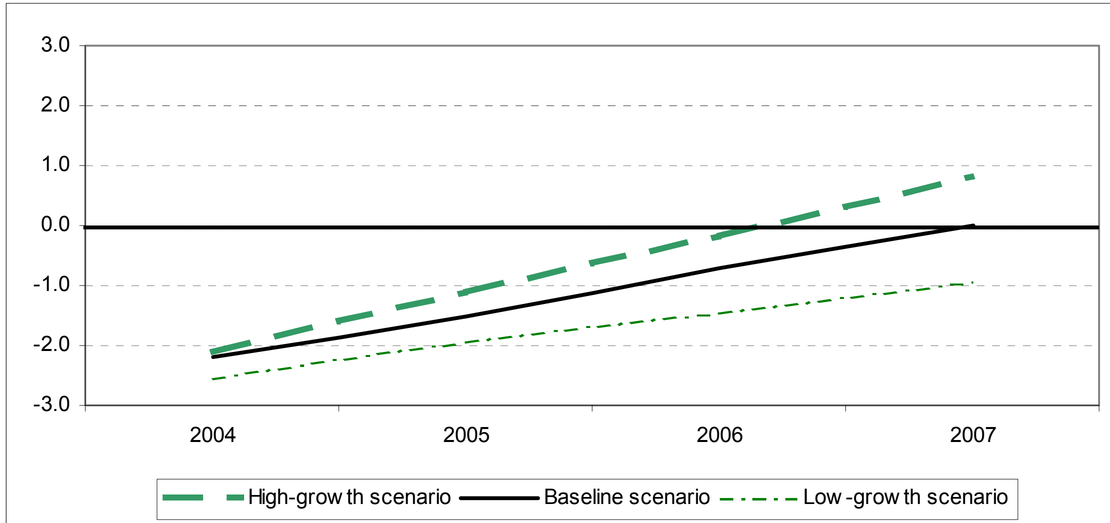
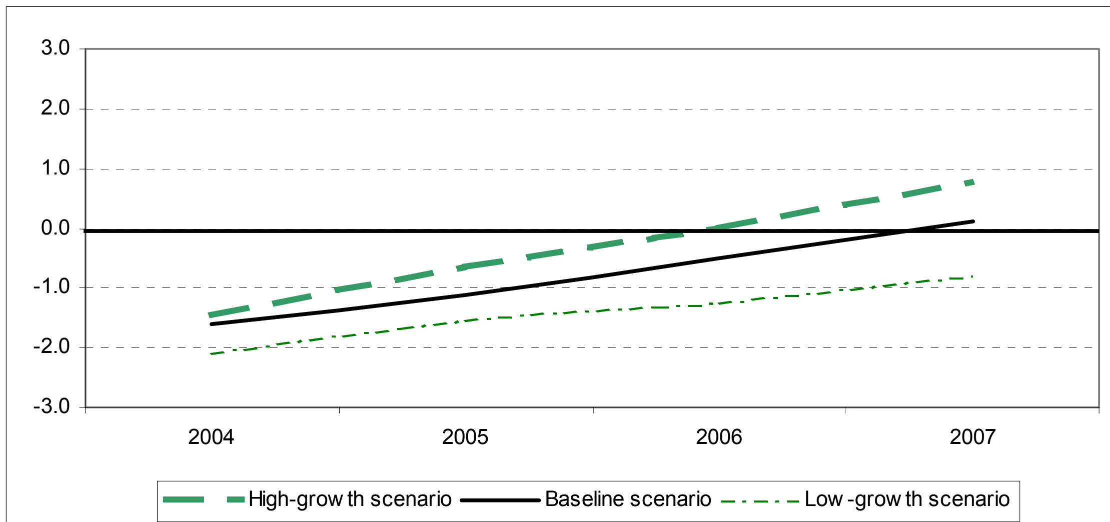


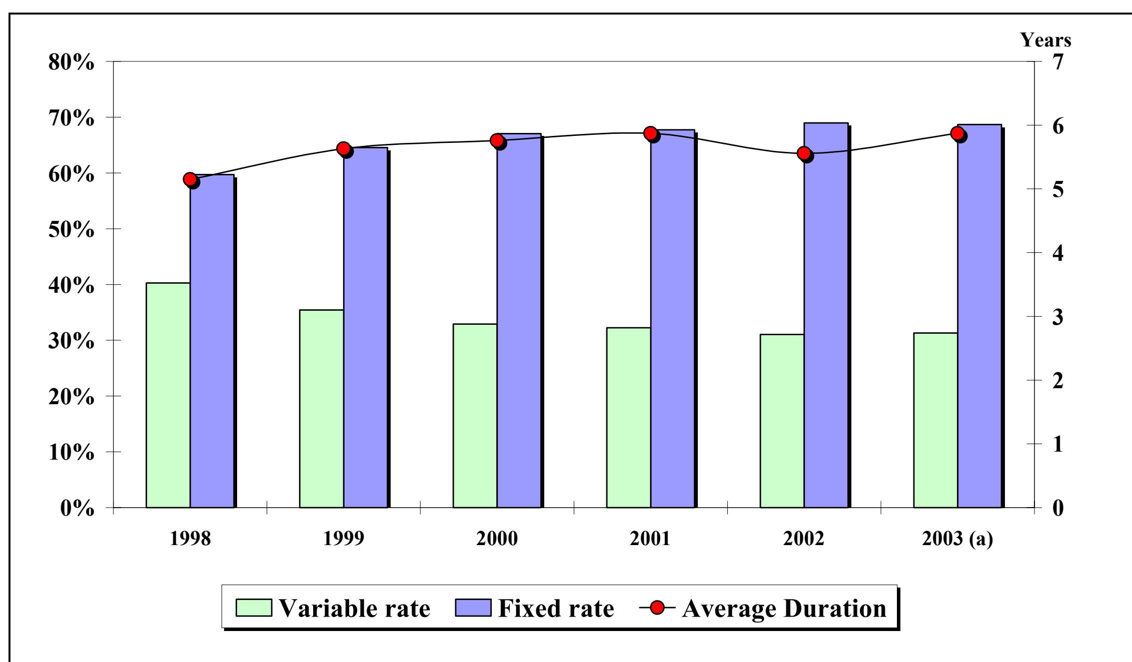
Figure 3 **SENSITIVITY OF THE CYCLICALLY ADJUSTED BUDGET BALANCE TO GDP GROWTH**
(percent of GDP)



4.2. Sensitivity to interest rates

This section examines the effects of alternative interest rate scenarios on the debt. The key factor in the simulation is the maturity structure of the debt and its average duration. At the end of September 2003, Italy's debt consists mostly of fixed-rate bonds (about 69 percent of the total) (Figure 4), with a maturity of 5.9 years (Figure 4). Duration is about 3.6 years.

Figure 4 **COMPOSITION OF ITALY'S PUBLIC DEBT** (1)
(percentage values)



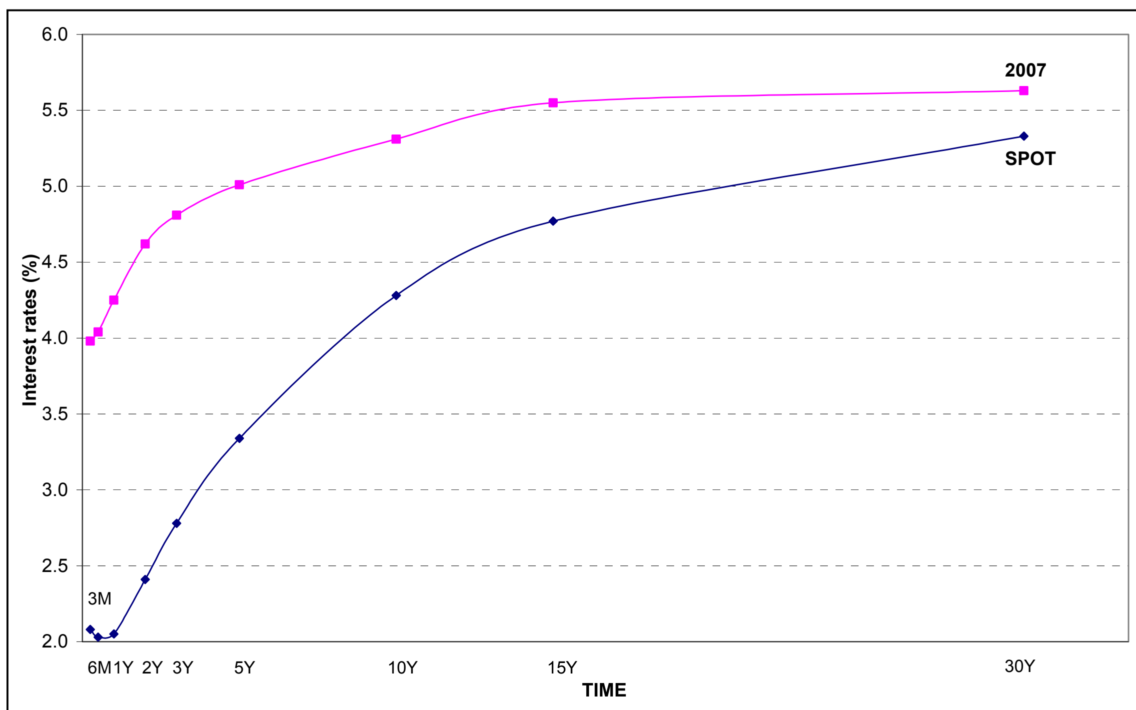
(1) Data up to 30/09/2003. The left scale refers to interest rates, the right scale refers to average duration.

The debt issuance policy is based on the following guidelines: to maintain a ratio between short-term and variable rates paper between 25 and 30 percent, and a level of maturity which guarantees the lowest debt costs, given the current level of interest rates.

The estimates relative to interest expenditure contained in this document are based on implicit rates in the Italian government paper yield curve at the end of September (Figure 5)

On the basis of these rates, in the case of a sudden increase of a percentage point of all the yield curves used for the estimates contained in this Update, the impact on interest expenditure as a ratio of GDP would be equal to 0.23 percent in 2004, to 0.41 percent in 2005 and to 0.51 percent in 2006[5]. The full impact of rate increases is felt after 5.3 years[6].

Figure 5 **YIELD CURVE**
(as of September 26, 2003)



[5] It should be noted that this exercise focuses on interest spending gross of withholding tax. Specifically, we do not take account of the effects of rate changes either on economic activity or on tax revenues deriving from investment income (the tax on interest income from bonds and bank deposits, which is correlated to the rate increases). Therefore it is not possible to immediately identify the sensitivity of the overall budget balance to interest-rate changes.

[6] This period does not coincide with the average maturity of the debt owing to the features of floating-rate Treasury Credit Certificates, which have a semi-annual coupon.

5. THE QUALITY OF PUBLIC FINANCES

The key economic objective of the government is to create the conditions to spur growth through structural reforms. The measures enacted with the previous Budgets aimed at enhancing the quality of public finances: stability, growth and fairness; these principles also inspire the 2004 Budget.

This chapter summarizes the 2004 Budget and the other measures which define the government's economic policy. The chapter also describes some measures that aim to improve the efficiency of the Public Administration while guaranteeing that the macroeconomic and public finance goals are respected as well as the quality of measures implemented.

5.1 The 2004 Budget

The 2004 Budget includes the Finance Law and the measures introduced through a law decree (D.L. 269/2003 which became Law n.326/2003) whose aim is to boost economic growth and consolidate public finances. The use of a law decree reflects the need to ensure a speedy implementation of some planned measures and to take immediate action to boost the economy. The policies enacted with the decree aim at stimulating investments, in particular for infrastructure, research and development, and to support private consumption, within the framework of the financial commitments undertaken with the European Union.

The measures have been integrated by a new project to reform the pension system in addition to the foreseen amendment to the proposed law n.2145/2001. The goal is to achieve significant reductions in expenditure from 2008, without waiting for the long transitional period as envisaged by the current system.

Due to the postponement in the recovery, the budget relies on a number of one-off measures; which will be progressively substituted by permanent ones in the following years. Specifically, one third of the corrective measures envisaged in 2004 concerns

permanent measures; this ratio will increase to two-thirds the following year. By 2005 all the corrective measures will be of a structural nature.

For 2004, the total amount of corrective measures will be around 16 billion euros, 6 of which are structural and 10 are temporary, 5 billion will be used to spur growth projects (Table 9).

5.1.1 Growth measures

The measures aimed at enhancing growth include tax cuts of about 1.2 billion euros and 3.6 billion euros in additional spending.

The fiscal measures include; the reduction of corporate tax (IRAP) and in V.A.T., tax cuts in the agriculture sector, and the extension of the tax relief offered for home improvements.

Other measures aim at encouraging research and development by exempting from taxes up to 10 percent of these expenditures from taxes. Also exempted are the costs of; attending trade fairs abroad, student stages and listing new companies on the stock exchange, as well as the costs of enticing the return of Italian researchers working abroad.

Higher than expected additional expenditure concerns measures to support the income of families rearing children, who will receive 1.000 euros for each additional child, and the increase in the Fund for social policies.

Further expenditure concerns extra resources for schools, as well as the allocation of funds for public employee salaries following contract renewals.

Within the framework of fiscal reform, changes have been introduced for corporate taxes. From January 1, 2004 the IRPEG tax will be replaced by the IRES, which has only one tax bracket at 33 percent (one percent lower than before). The new tax regime brings Italy in line with European standards, increasing national competition and the ability to attract foreign direct investment.

5.1.2 Corrective measures

The structural and one-off measures amount to 16 billion euros of which 9 billion are in higher revenues and 7 billion in lower expenditure.

Permanent measures to increase revenue are based on the anticipation of a special tax system; the so-called *concordato preventivo* for the period spanning 2003-2004, ahead of the schedule indicated in the tax reform law. The increase in the proceeds is estimated at around 3.6 billion euros. Such an agreement, while regularizing the relationship between taxpayers and tax authorities, encourages the emersion of a tax base (cfr. Pargraph 5.2).

Additional revenues are expected from the introduction of a tax on videogames and betting (for around 0.7 billion euros), and an increase in social security contributions for "parasubordinati" (a felexible working arrangement) for a further 0.7 billion euros.

A significant increase in the revenue forecast for 2004 derives from the settlements for breaching zoning regulations , as well as the extension of the tax amnesty included in the 2003 Budget. These proceeds are expected to amount to over 4 billion euros.

A permanent reduction in expenditure is expected from the transformation of the Cassa Depositi e Prestiti into a private company still under government control. The exclusion of the Cassa from public finances is expected to save 0.8 billion euros from 2004 onwards.

The freeze on hiring in the public sector has been confirmed. However, some exceptions are allowed, for the use of short-term contracts or other more flexible employment that has lead to more than 0.5 billion euros in savings.

Further measures concern the securitisation of public real estate and the transfer of buildings rented for government use, through the creation of special purpose vehicles (SPVs) – with the eventual participation of local and regional governments. These measures aim at raising the value of the state's real estate. The sales of such assets,

based on national accounting rules, are accounted in the Budget as reductions in investments and should bring savings of around 5.5 billion euros in 2004.

The total amount of permanent savings amounts to around 6 billion euros in the *DPEF 2004-2007*.

Table 9 The 2004 budget
(in million euros)

	2004	2005	2006
Growth Measures	***4,806***	***4,877***	***5,145***
Lower Revenues	***1,235***	***796***	***299***
- Tax Cuts	1,205	137	50
- Tax Exemptions for R&D Investments	30	659	249
Higher Expenditures	***3,571***	***4,081***	***4,846***
- Staff Costs (net values)	1,115	1,713	1,781
- Missions Abroad	200		
- Extension of LSU education contracts	350	25	
- Family incentives	438	363	113
- Infrastructure investments	147	502	837
- Other investments	1,151	1,308	1,945
- Other	170	170	170
Corrective Measures	***16,100***	***8,570***	***8,950***
Higher revenues	***9,216***	***6,155***	***6,498***
- Pre-defined tax scheme (Concordato fiscale preventivo)	3,584		-162
- Zoning regulation amnesty and back dated unemployment benefits	3,130	170	
- Extension of tax amnesty	872		
- Videogames and betting	666	1,364	1,427
- Enhancement of fiscal controls		3,017	3,531
- Higher contributions	748	819	916
- Other	216	785	786
Lower expenditures	***6,884***	***2,415***	***2,452***
- Privatisation and raising value of public goods	4,000		
- Government real estate sales	1,500	1,000	1,000
- Cassa DD.PP	800	800	800
- Sace	92	250	250
- Other	492	365	402
Net impact	***11,294***	***3,693***	***3,805***
% of GDP	*0.8*	*0.3*	*0.3*

5.2 Measures in favour of efficiency and quality

Within the framework of the 2004 Budget, there are a number of measures that aim at increasing the efficiency of the economy and to produce long-term effects on public finances.

5.2.1 Concordato fiscale preventivo

The introduction of the pre-defined tax scheme (*concordato preventivo*) allows a simpler and more straight-forward determination of income tax liabilities. Furthermore, it offers a vast amount of tax payers the chance to benefit ahead of time from the lower tax rates foreseen by the tax reform.

This simplified tax regime is limited to company owners and the self-employed and provides them with the possibility to pre-determine their tax liabilities for 2003-2004 on the basis of guidelines which have been established by the tax authorities for each sector and/or profession.

The minimum level of revenue or income has to be consistent with those declared the year before, and the guidelines of sector studies, increased by 9 percent in 2003 and by a further 4.5 percent in 2004.

The introduction of the concordato is expected to benefit public finances starting in 2004. The basic goal of the measure is to permanently widen the tax base and to offer to the tax payer conditions of greater certainty regarding his liabilities. Furthermore, the tax authorities will be able to focus their assessment on taxpayers who have not agreed to the concordato, with obvious advantages to public finances in the medium to long term.

5.2.2 Cassa Depositi e Prestiti

Historically the Cassa Depositi e Prestiti has acted as a financial agency of the central government, with the aim to finance, through postal savings, investments of public entities especially at a local level.

In the past five years the institutional relations between local governments and government agencies have changed, leading to a much higher degree of independence, both organisational and financial. This process has lead to the changed legal status of the Cassa, to the transformation of the National Post service from a government agency to a private corporate entity (S.p.A), as well as the widespread outsourcing in the public sector.

The transformation of the Cassa Depositi e Prestiti into a private company transforms its management according to business principles while still preserving its focus to serve the public and general interest.

The transformation of the Cassa into a private company has the primary objectives of: 1) increasing significantly its efficiency in allocating credits to local borrowers; 2) offer a wider range of professional services including financial assistance and consulting; 3) enhancing local economic activity by outsourcing public services, through the organisation of an adequate financial structure; 4) developing more efficient and diversified sources of financing in addition to existing products, such as pension related instruments.

The need to develop a market oriented activity in addition to its traditional lending to the public sector, especially to local governments, has lead to the establishment of two distinct sections within the new Cassa. The first section, which operates under a substantial degree of independence, has the task of lending to local and central governments.

Even the new section, the "autonomous section", conforms to the traditional guidelines for what concerns its mission and modus operandi, and is still subjected to the supervision of the Ministry of the Economy and Finance. The "autonomous section" should guarantee that the activities of the new Cassa Depositi e Prestiti do not breech market rules in two fundamental aspects; the recipient of the loans of the "autonomous

section" is not a corporate entity and therefore does not fall under EU regulations forbidding state aid. This also prevents the transfer of the benefits to third parties which would be against existing market and competition regulations.

In principle, the activities of the "autonomous section" of the Cassa Depositi e Prestiti do not compete against other market players.

The second section – the so-called "ordinary section" – lends to public utilities. The transition towards an competitive utilities sector, is taking place at a local level, through the transformation of municipal companies into public companies. These changes aim at transferring the control of networks and facilities to companies owned by public bodies and encouraging mergers to increase competition for the loans.

The active presence on the market of lenders specialised in financing investments in infrastructure should enhance competition and reduce the cost of services while improving efficiency.

While Infrastrutture S.p.a. is responsible for financing large projects of national interest and requires the involvement of several governments, at all levels, in the decision making process (which could lead to the provision of state guarantees) the new Cassa Depositi e Prestiti focuses on lending to a specific sector, i.e. local public utilities, where the value of the investments are more appreciated by market participants.

The positive outcome of this initiative depends on the ability to acquire a high degree of specialisation, possible only by focussing on a specific market and if backed by an adequate regulatory framework.

Separate accounting for the two activities of the Cassa, i.e. financing local governments and financing public utilities, is in line with EU directives concerning transparency and the most recent decisions by the Commission requiring separate accounting in order to ensure that resources allocated to general interest purposes are not used to finance commercial activities.

6. THE SUSTAINABILTY OF PUBLIC FINANCES

In the next decades the ageing of the Italian population will accelerate and will put significant pressure on public finances. This chapter will deal with the financial long-term trends for public spending that will be particularly affected by the demographic changes. The sustainability of public finances will also be analysed as well as the main features of the proposed reform of the pension system and its potential impact on public finances will be outlined.

6.1 The impact of the ageing population on public spending (2002-2050)

The changes in demography that will take place in the next decades will have significant effects on various components of public expenditure as shown by the forecasts presented here on pensions, health, education and unemployment benefits throughout 2050.

The inclusion of expenditure trends for education and unemployment benefits represents a novelty compared to the previous Programme Update. The expenditure on education is included in the analysis because of a steady decline in the scholastic population, while expenditure for unemployment benefits are taken in consideration because of the decrease in the working population.

The methodology and assumptions underpinning the forecasts are based on the guidelines of the Ageing Working Group of the Economic Policy Committee (EPC-WGA)[7]. The approach chosen, which assumes that policies are unchanged, highlights the effect of demographic pressures on various expenditures. It is necessary to specify that expenditure on education includes all levels of education, from pre-school to university, with the exclusion of adult education, while the expenditure for unemployment benefits does not include some important labour market policies, such as active labour market policies.

In addition to demographic trends, the key assumptions underlying the exercise concern the participation rate, the occupation rate and the productivity trends (Table 10).

Table 10 **PUBLIC EXPENDITURE ON HEALTH CARE, EDUCATION, UNEMPLOYMENT AND PENSION (2002-2050)** [(1)]

	2002	2005	2010	2020	2030	2040	2050
Pension expenditure[2]	14.1	14.1	14.0	14.7	15.8	15.6	14.1
Health care expenditure[2,3]	6.3	6.3	6.5	7.0	7.5	7.9	8.1
Education expenditure[2,4,5]	4.9	4.7	4.5	4.3	4.1	4.2	4.2
Unemployment benefits expenditure[2,6]	0.3	0.4	0.4	0.4	0.4	0.4	0.3
Total[2]	25.5	25.5	25.4	26.3	27.7	28.0	26.8
Assumptions							
Labour productivity growth	-0.7	1.9	1.9	1.8	1.8	1.8	1.8
Real GDP growth	0.4	2.4	1.9	1.5	0.7	1.0	1.2
Male participation rate (20-64)	78.9	80.2	81.0	81.3	80.0	79.3	79.2
Female participation rate (20-64)	50.8	53.4	54.8	56.4	60.5	67.4	71.0
Total participation rate (20-64)	64.8	66.8	68.0	69.0	70.4	73.5	75.2
Unemployment rate	9.0	8.5	8.0	7.6	7.4	7.2	7.0

(1) The figures are rounded-off to the first decimal point and therefore the sum of the figures could not add up.
(2) As a percent of GDP.
(3) Includes health spending for assistance of the elderly
(4) Does not include adult education.
(5) Data slightly different from EPC-WGA which does not incorporate an upward revision of expenditure and education relative to levels of higher education acquired in October 2003, as well as an increase in education levels recorded in 2002. Further more there is the effect on different economic growth in 2003 and its breakdown between occupation and productivity.
(6) Data slightly different from EPC-WGA, which, by not taking into full consideration the increased measure of unemployment benefits of law decree 848 bis, show a saving at the end of the period of 0.1 percent.

From 2002 to 2050 life expectancy is expected to increase from 75.9 to 81.0 years for men and from 81.9 to 85.9 for women. For the old-age dependency ratio[8] there is an increase from 29.7 to 66.8 percent. The young dependency ratio[9], which was 31.3

[7] Up to2003 the macroeconomic framework includes forecasts from *RPP 2004*.
[8] The old age dependency ratio is given as a ratio between the population that is over 65 and that between 20 and 64.
[9] The young dependency ratio is given as a ratio between the population that is under 19 years old and those between 20-64.

percent in 2002, is expected to decline to 32.7 percent in 2050. The participation rate is expected to increase by more than 10 percentage points, from 64.8 in 2002 to 75.2 in 2050, largely as a result of the increase in female participation[10]. The unemployment rate is expected to decline from 9.0 percent in 2002 to 7.0 percent in 2050[11], while labour productivity is expected to increase slightly less than 2 percent annually over the same period. Consequently, GDP at constant prices should increase by two percentage points a year up to 2004 before declining.

Based on the assumptions described above and assuming no change in economic policies, pension expenditure as a percentage of GDP would increase from 14.1 percent in 2002 to 15.8 percent in 2030; it will peak at 16.1 percent in 2034, and decrease to 14.1 percent in 2050 (Figure 6). Health spending as a ratio of GDP shows a gradual increase from 6.3 percent in 2002 to 8.1 percent at the end of the period (Figure 6).

An opposite trend is expected for education expenditure, which will decline as a result of a fall in the school population. Expenditure in education is expected to decline from 4.9 percent in 2002 to 4.2 percent in 2050 (Figure 6). Finally, expenditure for unemployment benefits will stabilise at around 0.3 percent in 2050 (Figure 6).

Overall, the savings on education, 0.7 percent less of GDP between 2002 and 2050, will not be sufficient to offset the rise in health expenditure, expected to rise 1.8 percent of GDP. From 2002 to 2050 the overall increase will amount to around 1.3 percentage points of GDP. In the first part of the period under consideration the pressure on public finances will be even stronger (increasing by 2.7 percent of GDP between 2002 and 2035) especially due to the trend in pension expenditure.

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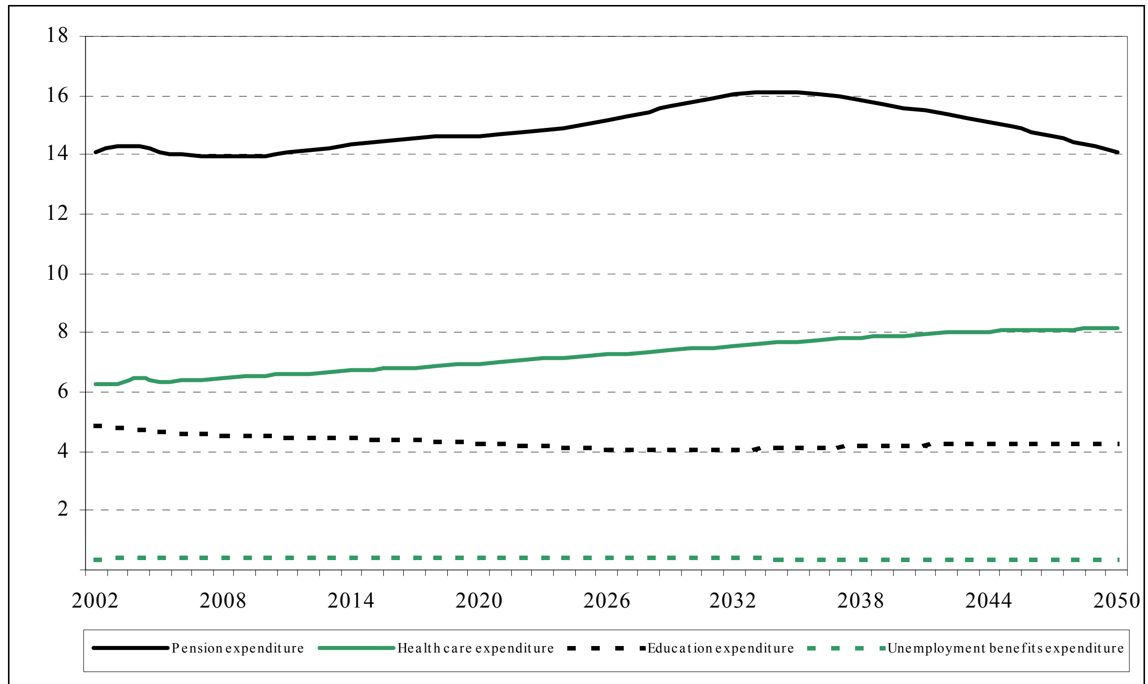
[10] The female participation rate forecast by the EPC-WGA scenario is prudent in comparison to the trend set in the past ten years.

[11] This is a prudent forecast if compared with the macroeconomic scenario presented in Chapter 2 which forecasts an unemployment rate of 7.4 percent already in 2007.

Figure 6 **EXPENDITURE ON PENSIONS, HEALTH CARE, EDUCATION AND UNEMPLOYMENT BENEFITS**
(percent of GDP)



Current projections for pension and health-care expenditure, compared with the forecasts in the previous Stability Programme Update, include the latest macroeconomic and public finance data up to 2003 and take into consideration the variations that have been included in the 2004 Budget and in the law decree n.269/2003.

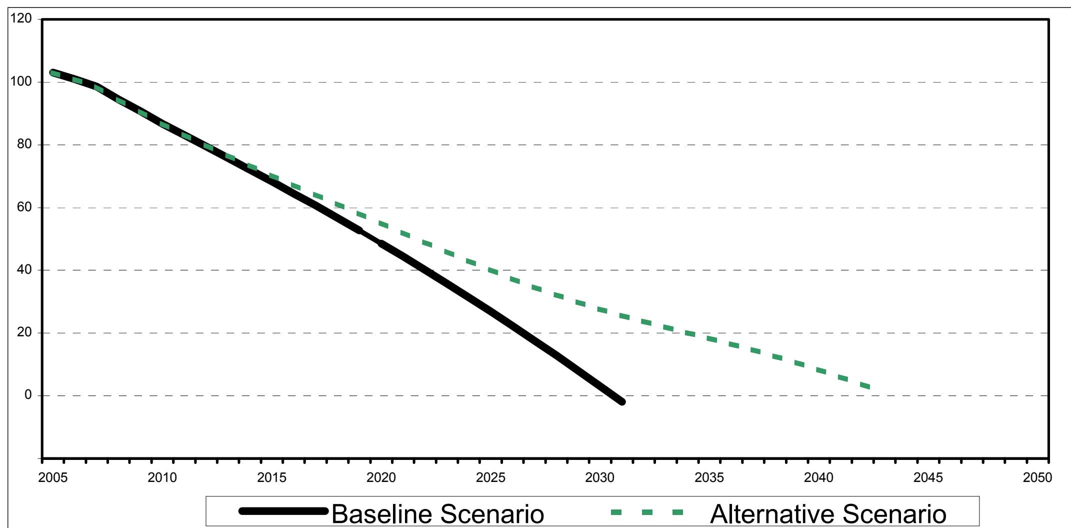
Health-care expenditure, in the first years considered, are slightly higher than in last year's Programme due to a change in the GDP and productivity forecasts (adjusted for the reasons mentioned above).

Furthermore, the data on health-care expenditure takes into consideration the financial impact of the renewal of labour contracts for 2002-2003 that have yet to be implemented because of the delay in enacting the necessary measures. These changes have led to an initial increase in health expenditure although it remains constant over the period under consideration.

6.2 The sustainability of public finances

The sensitivity of expenditure to demographic changes is particularly relevant to analyse the sustainability of public finances. Accordingly, in order to gauge the sustainability of public finances in the long term, different simulations were carried out on the debt to GDP ratio (Figures 7 and 8)[12,13].

Figure 7 **PUBLIC DEBT**
(percentage of GDP)



In the "baseline scenario", it is assumed that during the period from 2008 to 2050 the primary surplus remains constant at levels forecast for 2007 (i.e. 5.1 percent of GDP). Implicitly, it is assumed that the changes in total expenditure for pensions, health care, education and unemployment benefits outlined in the previous paragraph are offset

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[12] The assumptions correspond to the demographic and macroeconomic scenario agreed to within the EPC-WGA and described earlier (Table 10).
[13] The comparison of the results presented here with those from the 2002 Stability Programme Update is not possible because of the inclusion of expenditure on education and unemployment benefits which were not included in the previous year's Stability Programme Update.

by greater revenues and/or minor expenditures. Accordingly, the average adjustment in the primary balance from 2008-2050 would be 1.4 percentage points of GDP.

The “alternative scenario” assumes that the expenditures deriving from the ageing population outlined in paragraph 6.1 will not be offset by greater revenues or lower expenditures. The primary surplus, therefore, would vary in line with the trend in expenditure on pensions, health care, education and unemployment benefits.

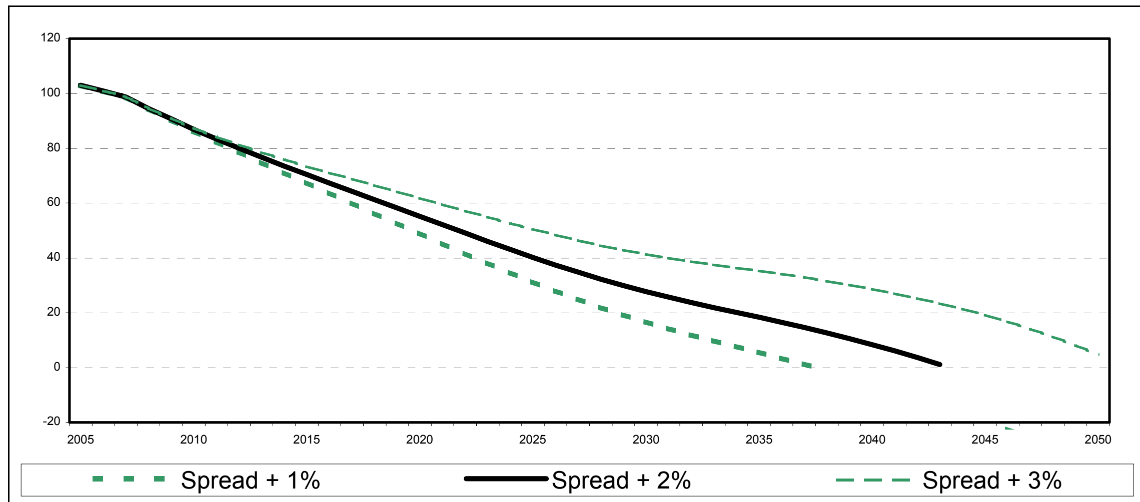
In the baseline scenario, the debt to GDP ratio steadily decreases over the whole period analysed and drops to under 60 percent in 2018.

A steady reduction trend of the debt to GDP ratio is also achieved in the alternative scenario. However, in this case, the debt to GDP ratio drops to under 60 percent in 2019 because of the worsening primary surplus.

Due to the large amount of interest payments for the debt, it was deemed appropriate to also carry out a sensitivity analysis on public debt at various levels of interest rates. In last year’s simulations it was assumed that the spread between nominal interest rates and the GDP growth rate would converge at 2 percent starting from 2007 and over the next ten years. Taking as a starting point the “alternative simulation” presented earlier in which it was assumed that the primary surplus varies according to the dynamics of age-related expenditures, the hypothesis of a spread between the interest rate and the growth rate at 2 percent is modified assuming that such a spread converges at 1 percent (optimistic hypothesis) or alternatively at 3 percent (pessimistic hypothesis).

Both in the pessimistic and optimistic case the debt to GDP ratio shows a constantly decreasing trend (Figure 8). With a differential equal to 3 percent the 60 percent debt to GDP level will be reached in 2021, two years later than the “alternative scenario”. With a differential equal to 1 percent the same value will be reached in 2017, two years before the key scenario (of reference).

Figure 8 PUBLIC DEBT SENSITIVITY TO INTEREST RATES[1]
(percentage of GDP)



(1) The spread equal to 2 percentage points is equal to the alternative scenario.

Finally, the sensitivity of the alternative scenario (the one with no adjustments) to a variety of primary surpluses in 2008 was analysed(Table 11).

The results illustrate that by reducing the primary surplus from 5.1 percent to 4.0 percent, the debt to GDP ratio decreases under 60 percent in 2029, 10 years later than the reference case. The debt to GDP ratio keeps on its downward trend to below 60 percent if the primary surplus level does not fall below 3.9 percent of GDP. Under this threshold, the downward trend still continues but the debt to GDP ratio never falls below 60 percent. Adopting a more pessimistic hypothesis on the primary surplus, long-term trends of a debt to GDP ratio are unsustainable.

To sum up, the sustainability of public finances appear to be guaranteed by adopting a public finance scenario presented in this Programme Update. In particular, the simulations show the profile of the debt to GDP ratio is constantly decreasing over the whole period examined (2008-2050) whatever the scenario assumed for the spread between interest rates and growth rates. Problems of public finance sustainability over the long term emerge in the case of the primary surplus worsen considerably.

Table 11 PUBLIC DEBT SENSITIVITY TO THE 2008 PRIMARY SURPLUS
(percentage of GDP)

	2010	2015	2020	2030	2040	2050
Primary Surplus in 2008			**Public debt**			
5.1	86.8	70.4	55.2	27.7	8.4	-21.9
4.0	90.2	79.7	71.2	59.1	58.4	50.6
3.5	91.7	84.0	78.5	73.4	81.1	83.5
3.0	93.2	88.3	85.7	87.6	103.8	116.5
2.5	94.7	92.5	93.0	101.9	126.5	149.4

6.3 The pension system reform plan

Recently the Government has presented to Parliament a reform plan for the pension system that incorporates the proposed enabling act law decree currently being assessed by the Senate[14]. The primary goal is to avoid the problems caused by an excessively long transition period of the 1995 reform. From 2008, workers will be able to retire at 65 if they are men and 60 if female, or if they have contributed to the pension system for 40 years. It will still be possible to access old-age pensions under current conditions only with considerable penalties because the pension will be based solely on the contribution system.

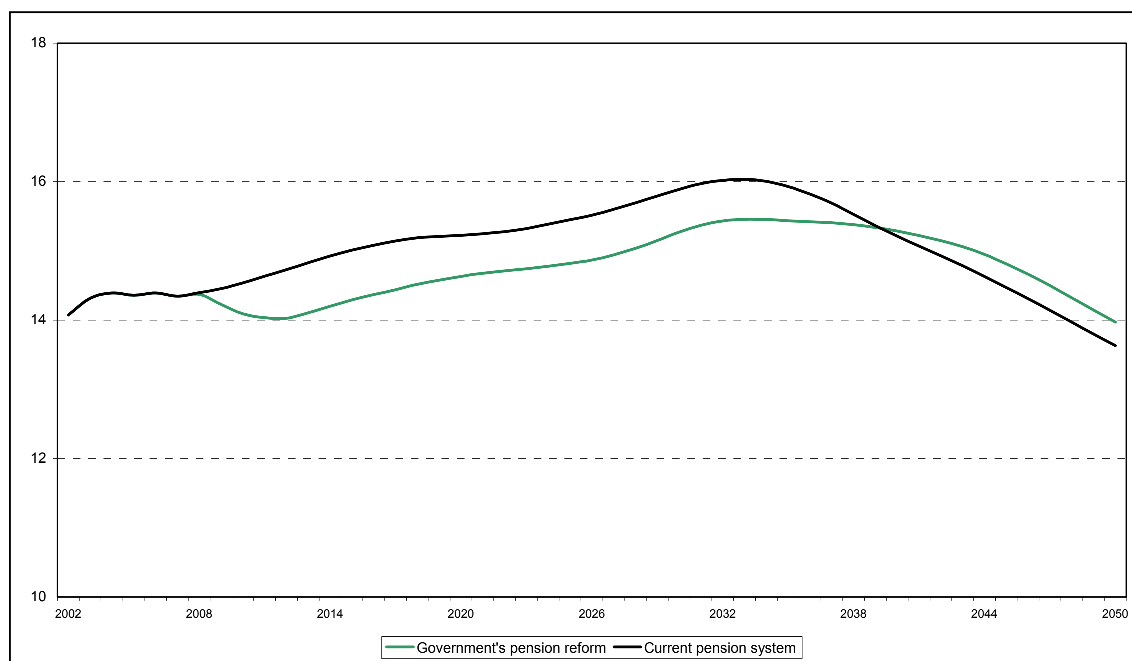
Between 2004-2007, private sector employees[15] who opt to delay retirement will receive a pay/salary increase which amounts to the value of the contributions they would currently pay to the pension body INPS, i.e. some 32.7 percent of the pay slip.

[14] Senate Act 2058.

[15] The extension of this incentive to public sector employees is foreseen depending on an agreement between trade unions, employers and local governments and taking into account the characteristics of the different sectors and public interest linked to labour organisation and the need for administrative efficiency.

This increase is tax-free and therefore the net pay increase amounts to more than 40 percent. The effects of the incentives on public accounts are slightly positive (around 230 million euros in 2004-2007).

Figure 9 IMPACT OF REFORM ON PENSION EXPENDITURE (1)
(percentage of GDP)



(1) These values are not directly comparable to those outlined in paragraph 6.1 because they are based on the national scenario which is slightly different from the EPC-WGE one.

The effects of the proposed reform will be progressively visible from 2008. The pension expenditure to GDP ratio will diminish up to a maximum of 0.7 percentage points in comparison to what was forecast prior to the reform. In the first years a decrease in the ratio is expected. However, after 2040 the ratio is expected to rise slightly in comparison to the scenario prior to the reform due to the lengthening of the working life.

The reform proposal diminishes the pressure of pension expenditure on public finances in the long term[16]. In fact, to maintain primary surplus constant at 2007 levels (5.1 percent of GDP) for the whole period up to 2050, fiscal adjustments are necessary of some 0.8 percent of GDP, instead of a 1.2 percent adjustment required if the reform were not to be implemented. (see Section 6.2). In regard to the public debt, the reform would lead to a reduction to under 60 percent of GDP in 2018, two years earlier than if the current pension system were to be maintained.

Further benefits of the reform include the raising of pension benefits due to the lengthening of working life and the possibility to use TFR (a type of deferred wage) to develop private pension schemes and provide incentives for new-hires through contribution relief.

[16] The comparison with data included in section 6.2 is not possible because the assumptions on pension expenditure are slightly different (see Figure 9)

ANNEX
THE WORLD ECONOMY

In the first half of 2003 important recovery signs have been recorded in all the key economic areas of the world, except for Europe.

In the United States the annual GDP growth rate, which already progressively accelerated in the first half of the year, reached 8.2 percent - surpassing the highest forecasts. The push came from all the components of domestic demand: private consumption (always dynamic even in a recession), an increase in defence spending, and of even greater importance, a pick-up in the investment cycle. The data for Japan have stopped at the second quarter and appear particularly favourable in comparison to the recent past. However, the current recovery appears to be nearly entirely driven by foreign trade; internal demand remains weak and problems linked to deflation, while decreasing, continue. Other East Asian economies have resumed to grow at a sustained pace; the effects of SARS have been short lived. The whole area seems to have quickly caught onto the international recovery. The Chinese economy, which continued to grow at rates of 7-8 percent through the worst phases of the international economy, now appears to be expanding even more rapidly. From 2004, the world economy should resume to grow at its potential rate of around 4 percent.

The outlook for the European economy, while improving, is not as good. The first signs of recovery were recorded in the third quarter with Germany, France and Italy growing by 0.2, 0.3 and 0.5 percent respectively. The strong recovery of exports meant that Germany was able to compensate for its continuing weak internal demand. The German government’s proposal to anticipate to 2004 its tax relief programme could trigger a recovery in consumption. The improvement of Germany’s economic outlook can only have a positive effect on its European counterparts and in particular on Italy. In France the key cause of the GDP contraction recorded in the second quarter was due to the decline in consumption due to factors such as the strikes staged in protest of pension reforms. A slightly expansive fiscal policy and no strikes should lead to a slow recovery in coming months.

Europe's GDP should grow by around 0.8 percent in 2003 and accelerate to 2.0 and 2.5 percent in 2004 and 2005 respectively. Despite the strengthening of the recovery a further decline in inflation is expected due to the appreciation of the euro and an increase in productivity. Therefore, a shift in the ECB's rate policy is not expected in the near term.

The key risk factors for the world economy concern the growing imbalance in the US deficit and its trade balance that could trigger a brisk fall in the dollar and a Federal Reserve rate hike.

Table 12 ASSUMPTIONS ON INTERNATIONAL ECONOMIC VARIABLES
(percentages unless otherwise specified)(1)

	2003	2004	2005	2006	2007
Short-term interest rate, euro area	2.2	2.5	3.3	3.9	4.2
Long-term interest rate, euro area	4.1	4.4	4.7	5.0	5.2
Short-term interest rate, US (3-month money market)	1.4	2.0	3.3	4.4	5.0
Long-term interest rate, US (10-year government bonds)	4.4	4.8	5.2	5.5	5.7
USD/euro exchange rate	1.10	1.09	1.09	1.09	1.09
World GDP growth rate	3.2	4.0	4.2	4.1	4.1
Industrialized countries GDP growth rate	1.8	2.9	2.9	2.8	2.8
World GDP growth rate excluding EU	3.7	4.5	4.5	4.4	4.6
US GDP growth rate	2.6	3.9	3.5	3.4	3.4
Japan GDP growth rate	2.0	1.4	1.2	1.3	1.3
EU GDP growth rate	0.8	2.0	2.5	2.3	2.3
Growth rate of significant Italian export markets	2.7	5.1	6.8	6.5	6.5
World import volume growth rate (excluding EU)	6.4	8.5	8.8	8.6	8.9
World import price growth rate (goods, in USD)	-5.3	2.5	1.0	1.2	1.2
Oil price (Brent USD/barrel)	27.6	25.0	25.0	25.0	25.0
Non-oil commodity price growth rate (in USD)	9.4	2.7	0.2	0.2	0.2

(1) The assumptions on the international variables (extra-EU) are not significantly different from the last European Commission forecasts available at the end of September (*Spring Forecasts*).