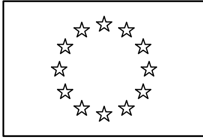

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

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# 2003 UPDATE
# OF THE STABILITY PROGRAMME OF ITALY (2003-2007)

## AN ASSESSMENT

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## SUMMARY AND CONCLUSIONS[1]

The Italian authorities submitted the fifth update of the stability programme, covering the period 2003-2007, on 1 December 2003. The programme largely complies with the "Code of Conduct on the content and format of Stability and Convergence Programmes"[2]. As was the case with all previous updates of the Italian stability programme, the "future measures" bridging the difference between the "current legislation" projections and the budgetary targets are not specified. Although consistent with the Italian budget process, this makes it difficult to determine whether the correction takes place on the expenditure and/or the revenue side and therefore to assess with precision the path and composition of the adjustment.

For 2003, the latest Commission estimate points to a general government deficit of 2.6% of GDP, with a contribution of well over 1½ percentage points of GDP from one-off measures. The cyclically-adjusted balance is estimated to have improved by 0.2 percentage point of GDP, but the deterioration in the cyclically-adjusted primary balance would suggest a more expansionary thrust of fiscal policy. The divergence with the original nominal deficit target is in the order of 1.1 percentage points of GDP, with lower than expected economic growth estimated to account for the major part of the slippage. Economic growth in 2003 fell clearly short of expectations and is likely to average ½ % for the year as a whole, almost 2 percentage points lower than in the macroeconomic forecast underpinning budgetary targets set out in the 2002 update. However, the growth effect also includes a significant element of excessive optimism in the growth outlook underpinning the original budgetary target, which was already perceived at the time of the presentation of the November 2002 programme update and highlighted in the Commission assessment. A non-negligible component of the total slippage can be attributed to an overestimation of revenues for the given growth assumptions and a higher than assumed deficit outturn in 2002.

In the medium term, the macroeconomic framework presented in the programme assumes a gradual acceleration of economic growth from 1.9% in 2004 to 2.6% in 2007. While less buoyant than in previous editions of the programme, the medium-term growth outlook appears to be optimistic. Investment is projected to expand at historically high rates, coupled with sustained export growth in the face of a strong euro and Italy's unfavourable trade specialization. Following the sharp deterioration in the past several years, the macroeconomic scenario implies a recovery in potential growth from 1.7% in 2003 to around 2.3% in 2007. This compares with a more cautious Commission assessment which estimates potential output growth to remain essentially unchanged at 1.5% over the coming years.

The updated programme revises the budgetary objectives for all the years which overlap with the previous programme period, namely 2003-2006. The government targets a general government deficit of 2.2% of GDP in 2004, compared to an expected deficit of 2.5% in 2003. In cyclically-adjusted terms, based on Commission calculations on the programme projections according to the commonly agreed methodology, there is an

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[1] This assessment has been carried out on the basis of information available as of 22 January 2004.

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

estimated improvement by 0.2 percentage point to 1.6% of GDP. For 2005, 2006 and 2007, the projections are for headline deficits of 1.5% and 0.7% of GDP and a balance in the final year, respectively. In cyclically-adjusted terms, in those years there would be an improvement of around half a percentage point of GDP on average. One-off measures, which accounted for a large part of the budgetary correction in the past few years, are planned to be progressively reduced and phased out by 2006.

The budgetary adjustment of the programme is backloaded and there is a lack of information on the measures envisaged. From 2005 onwards, the programme expenditure projections are based on legislation currently in force and hence do not take into account future increases in compensation of employees (due to the renewal of contracts) and the impact of new future investment projects. Therefore, the "true" path of expenditure is likely to be higher than in the programme "current legislation" projections. In turn, this would increase the amount of unspecified further measures necessary to achieve the budgetary targets beyond 2004. Given the government's stated policy intention to reduce the tax and social security contributions burden, the driving force of the adjustment would appear to be the reduction in the primary expenditure ratio, assuming that corrective measures would be concentrated on the expenditure side. The overall reduction in the primary expenditure share between 2004 and 2007 implied by the programme would be of unprecedented magnitude, in the order of 4% of GDP. The fact that this is to be achieved with a progressive replacement of the one-off measures bolstering the previous years' targets provides a measure of the degree of (future) ambition underlying the programme targets.

Checking the plausibility of the targets against the Commission forecasts, it emerges that in 2004 the nominal deficit would approximate the 3% of GDP threshold, despite the impact of the corrective measures set out in the Budget law for 2004; in cyclically-adjusted terms the deficit would increase compared to 2003 and would not allow for a safety margin. The difference with the programme target is due to a more cautious growth assumption, a marginal re-assessment of the corrective measures and a less optimistic evaluation of underlying fiscal trends. In essence, all this implies that the stated size of the planned correction is insufficient to achieve the budgetary targets. The size of the adjustment effort required in the outer years of the programme is highlighted when the official targets are set against the Commission's "current legislation" forecast for 2005 (i.e. a scenario incorporating a worse starting position inherited from 2004, somewhat weaker growth in 2005 and the expiry of temporary measures implemented in 2004), in which the deficit in both nominal and cyclically-adjusted terms would overshoot the 3%-of-GDP threshold. Hence the "close-to-balance" position would be reached later than envisaged in the programme.

It also needs stressing that since 1999, the *fabbisogno di cassa delle amministrazioni pubbliche* (cash borrowing of the general government - a deficit measure based on cash flows and including transactions with financial assets but excluding proceeds from privatisation) has tended to exceed the Maastricht-definition deficit (on an accruals basis and excluding financial transactions) by about 1.5% of GDP on average. The cash borrowing in 2003 is likely to end up around 4% of GDP. Although this would be half a percentage point below the official estimates released during the year, it would still signify an increase of around 1 percentage point in the cash borrowing compared to 2002. An analysis of the programme figures shows that the achievement of the close-to-balance objective in terms of the Maastricht-definition deficit would co-exist with a cash borrowing in the order of 2½ percentage points of GDP in 2007. Such a worrying and

large difference between the two definitions of deficit appears to indicate the presence of significant “below the line” spending.

The persisting high levels of the general government cash borrowing, together with a marked deceleration in the process of disposal of financial assets, slowed the pace of debt reduction in recent years. In 2003 the debt ratio, still well above 100% of GDP, is expected to decrease by about 2 percentage points to around 105% of GDP, a better development than envisaged in the programme. The decrease is obtained largely thanks to a resumption of privatisations, a sizeable reduction in cash assets held by the government with the Bank of Italy, a favourable exchange rate effect and extraordinary operations ensuing from the transformation of the *Cassa Depositi e Prestiti* (the government’s savings and loans bank) into a joint-stock company at the end of 2003. This transformation would entail a statistical reclassification, still to be examined by Eurostat.

If the improvement in the debt ratio outturn in 2003 compared to plans is confirmed, this is likely to affect the path of debt reduction envisaged in the programme. However, the general considerations on the programme’s strategy of debt reduction retain validity. Sustained nominal GDP growth and recovering primary surpluses are the driving forces behind the reduction in the debt ratio projected by the Italian authorities, which is also conditional on sizeable annual disposals of financial assets, slightly exceeding on an annual average those carried out in the 1995-2000 period. The risks to the programme deficit targets may imply a corresponding deterioration in the debt ratios.

On the basis of current policies, there are risks with regard to the long-term sustainability of public finances. Commission indicators show that the conditions for the debt to GDP ratio to decline to 60% of GDP over the next 20 years are stringent, set against the slow progress in securing durable budgetary consolidation. The budgetary strategy outlined in the programme, mainly based on achieving and maintaining sustained primary surpluses to run down the debt before the impact of ageing takes place, is compatible with improving the sustainability of public finances. A contribution would also come from the pension reform proposal, which goes in the direction of increasing participation rates among elderly people and correcting pension expenditure trends. However, this conclusion needs to be qualified in the light of the risks attached to the programme’s budgetary strategy, and of the broader public finance strategy of the government.

The economic policies as reflected in the updated programme are partly consistent with the recommendations of the Broad Economic Policy Guidelines for the 2003-2005 period[3], specifically those with budgetary implications. In particular, doubts persist about the planned replacement of one-off measures, the implementation of structural expenditure cuts and the pace of reduction in the debt ratio. Finally, the government pension reform proposal, while potentially dampening the projected increase in the ratio of pension expenditure to GDP over the next twenty years, is subject to non-negligible political risks, *inter alia* because steps to curb pension expenditure trends are deferred to 2008.

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[3] Council recommendation of 25 June 2003 on the *Broad guidelines of the economic policies of the Member States and of the Community (for the 2003-05 period).*

# 1 INTRODUCTION

The Italian authorities submitted the fifth update of the stability programme, covering the period 2003-2007, on 1 December 2003.[4] The previous update, examined by the Economic and Financial Committee on 15 January 2003 and by the Ecofin Council in its opinion of 21 January 2003, covered the years 2002-2006.

The strategy of consolidation of public finances hinges on a recovering primary surplus over the programme period. In a setting of considerably weaker output growth over the years from 2003 to 2006 than assumed in the previous update, the budgetary deficit targets are revised upwards and the balanced budget is now planned to be achieved in 2007. In the same year, the new planned path of debt reduction projects the achievement of a debt ratio below 100% of GDP, two years later than in the previous programme update.

# 2 MACROECONOMIC ASSESSMENT

## 2.1 Macroeconomic developments in 2003

In contrast with previous expectations, the economic slowdown continued throughout the first half of 2003, alongside a similar trend in the rest of the euro area. Real GDP growth was negative in the first and second quarter of the year, before returning into positive territory in the three months up to September. Based on the available evidence on economic activity in the final quarter, growth is likely to be around ½ % in 2003 as a whole. This is almost 2 percentage points lower than in the macroeconomic forecast underpinning budgetary targets set out in the November 2002 update.

While a significant part of that difference reflects expectations prevailing at the time of economic activity picking up right from the beginning of 2003, there was an additional element of optimism in the official forecast. In fact, the Commission 2002 Autumn projection for real GDP growth in 2003 was 1.8%, i.e. ½ % lower than the official growth projection.[5]

In the face of much lower than expected economic growth, the labour market showed remarkable resilience, with the rate of unemployment declining below 9% in the year on average, in line with the government's projections. This is an important element for the assessment of budgetary developments, implying that the adverse cyclical conditions should not have affected the expenditure side of the budget, as the cycle is generally assumed to work through the channel of unemployment benefits, which in Italy constitute in any case a marginal share of total public expenditure.

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[4] The programme is available on the Ministry of Economics website (http:\\www.tesoro.it) and on the DG Ecfin website (http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm).

[5] This incidentally was also the consensus forecast (1.7-1.8%). The optimism in the official forecast compared to the Commission view also reflects a difference in information sets. Although presented in November, the 2002 update of the stability programme had been based on evidence up until mid-September of the same year. As a result, it did not incorporate the clear deterioration in the economic outlook taking hold in the two to three months ahead of the presentation of the programme. The issue of different information sets between the Commission forecast and the stability programme was outlined in the Commission assessment of last year.

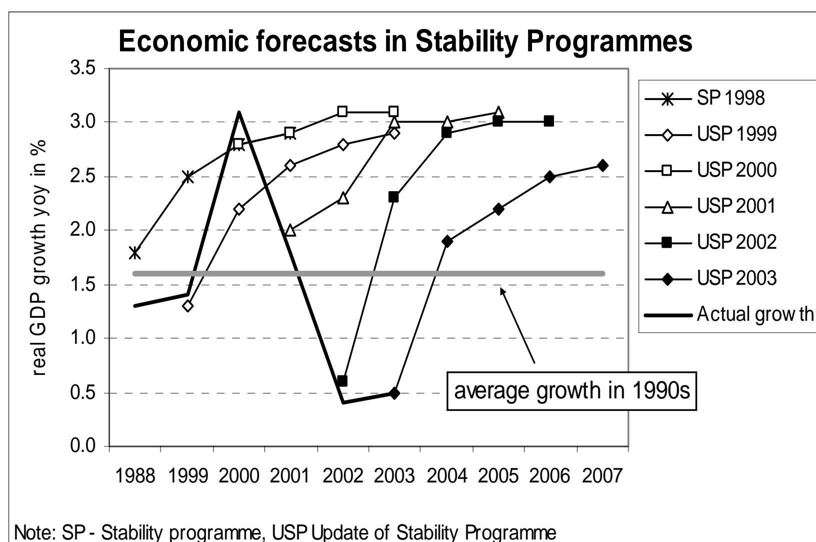
## 2.2 External economic assumptions

The programme presents and discusses the assumptions on the external economic environment. The presentation is fully in line with the data requirement outlined in the "Code of Conduct on the content and format of Stability and Convergence Programmes". These are derived together with the domestic macroeconomic scenario from the forecasting and programming report (*Relazione previsionale e programmatica - RPP*) released at the end of September in connection with the draft budget for 2004. The programme also highlights most recent developments in the USA and in Europe up until the end of November, taking it as evidence that the projected global recovery is already under way.

For the most part, the scenario of the external environment is close to the set of assumptions provided by the Commission in connection with the 2003 Autumn forecast.[6] The programme assumes an acceleration of global economic activity as measured by growth of world import volumes in 2004 compared to 2003, followed by essentially stable rates of expansion throughout the remaining part of the programme period of above 8% per year, with no or little pressure on commodity prices.

On the whole, the only noteworthy difference with the Commission 2003 Autumn forecast refers to the exchange rate projection. The assumed path for the US$/€ rate is even below the projection presented by the Commission at the end of October, hence not including the strengthening of the common European currency.

## 2.3 Macroeconomic scenario



Note: SP - Stability programme, USP Update of Stability Programme

As already indicated, the macroeconomic framework for the national economy outlined in the programme confirms the projections presented together with the draft budget for 2004. The downward revision with respect to the November 2002 update is significant, both over the short and the medium term. Over the short term, as highlighted above, it largely reflects the at the time generalised expectation of an imminent improvement in economic conditions, in addition to some degree of structural optimism. With regard to the medium term, the downward revision probably reflects the series of negative growth surprises experienced over the past several years. Nevertheless, the projected acceleration of real GDP growth

6 According to the" Code of Conduct", Member States *"[…] should endeavour to use […]* the set of external assumption provided by the Commission. The corresponding note was sent to the EFC in October 2003 (ECFIN/365/03-EN *External assumptions*, Note for the attention of the Economic and Financial Committee).

to 2.6% in 2007 may still be on the high side. It largely rests on a comparatively optimistic assumption about investment expenditure and exports.

Concerning investment, the projected acceleration of economic growth throughout the programme period assumes a sharp recovery of gross fixed capital formation in the very short term, which in the light of the available evidence (low rate of capacity utilisation in the manufacturing industry) appears unlikely. The swift short-term revival is followed by a further sustained acceleration of total investment expenditure towards annual rates of around 5%, well above the long term average.

While there is evidence that export growth has started picking up around mid-year 2003, the recovery is likely to be more gradual both in the short and medium term than presented in the programme. The macroeconomic scenario assumes that, starting from 2004, the volume of exports of goods and services would generally outpace the projected expansion of export markets, implicitly expecting a gradual gain in market shares. While part of that may be explained by the fact that export markets refer to goods only, Italy's export performance observed over the recent past warrants a much more cautious outlook. In particular, the programme would not appear to take fully into account Italy's unfavourable international specialisation into goods, the demand for which expands less than global demand, even when exchange rates are stable. On top of that, the customary price sensitivity of Italy's foreign sales is likely to act as an additional drag on account of the strengthening euro.

Consumer price inflation as measured by the CPI is planned to fall sharply from 2.6% in 2003 to 1.7% in 2004. A further, more gradual, easing is projected in the outer years of the programme with CPI inflation planned to reach 1.4% in 2007. When reading these figures it has to be borne in mind that rather than forecasts they represent a policy benchmark for inflationary expectations in the wage negotiating process, and thus generally assume a rapid easing of inflation. However, in recent years the persisting stickiness of inflation would appear to have affected the credibility of these benchmarks.

With regard to Italy's growth potential, the programme assumes a gradual acceleration from 1.7% in 2003 to around 2.3% in 2007. The estimates are reported to result from applying the commonly agreed method by the ECOFIN Council on 12 July 2002. Apart from marginal differences, this is confirmed by the Commission's own calculations (see Table 1). The assumed pickup in potential growth compares with a more cautious assessment based on the macroeconomic scenario of the Commission 2003 Autumn forecast, according to which potential growth is projected to remain essentially unchanged at 1.5% over the coming years.

In terms of its underlying forces, the acceleration of potential growth prospected in the programme is the combined effect of a marked pick up in the pace of capital accumulation and a recovery of total factor productivity. The contribution from labour is projected to decline over the course of the programme period, in spite of a rising trend in labour force participation and a declining NAIRU, as the negative demographic effect on working age population is gaining increasingly weight.

The critical difference compared to the estimates derived from the Commission 2003 Autumn forecast is the expected buoyancy of capital accumulation. The scenario presented in the programme builds on the assumption that the contribution to potential output growth coming from investment expenditure would swiftly rise to historically high levels. More specifically, the projected contribution is above the levels recorded

during the fiscally induced[7] investment boom in the two years until end-2002. The programme does not explicitly provide an explanation for the optimistic investment profile. Based on the information contained in preceding official documents released in 2003, notably the Economic and financial planning document (*Documento di programmazione economico-finanziaria - DPEF*) and the forecasting and planning report (RPP), it can be inferred that accelerating growth is expected to ensue from the implementation of the government reform plan agenda. However, it has to be borne in mind that so far the government has only partially implemented the planned structural reforms, and that benefits of such reforms take generally time to fully materialise.

As a conclusion, the risks to the medium-term growth outlook would appear to be skewed to the downside. This is somewhat problematic especially in the light of the fact that, as highlighted below, the bulk of the budgetary correction is planned for the outer years of the programme period.

**Table 1: Macroeconomic developments**

| | 2003 | | 2004 | | 2005 | | 2006 | | 2007 | |
|---|---|---|---|---|---|---|---|---|---|---|
| annual % change | **COM*** | **USP 2003**** | **COM*** | **USP 2003**** | **COM*** | **USP 2003**** | **COM*** | **USP 2003**** | **COM*** | **USP 2003**** |
| Real GDP growth | 0.3 | 0.5 | 1.5 | 1.9 | 1.9 | 2.2 | - | 2.5 | - | 2.6 |
| *Contribution to GDP growth* | | | | | | | | | - | |
| *Final domestic demand* | *1.0* | *1.2* | *1.7* | *2.4* | *2.0* | *2.4* | - | *2.6* | - | *2.7* |
| *Change in inventories* | *0.5* | *0.3* | *0.0* | *0.2* | *0.0* | *0.0* | - | *0.0* | - | *0.1* |
| *External balance of trade* | *-1.2* | *-1.0* | *-0.3* | *-0.5* | *-0.1* | *-0.2* | - | *-0.1* | | *-0.2* |
| HICP | 2.8 | 2.8 | 2.3 | 1.8 | 1.9 | 1.5 | - | 1.4 | | 1.4 |
| Employment growth | 0.8 | 0.6 | 0.5 | 0.9 | 0.7 | 1.0 | - | 1.2 | | 1.2 |
| Potential GDP growth | 1.5 | 1.7 | 1.5 | 1.8 | 1.5 | 1.9 | 1.5 | 2.0 | 1.5 | 2.1 |
| *of which: Labour contribution* | *0.6* | *0.7* | *0.6* | *0.7* | *0.6* | *0.7* | *0.5* | *0.7* | *0.5* | *0.6* |
| *Capital accumulation contrib.* | *0.6* | *0.7* | *0.7* | *0.7* | *0.7* | *0.8* | *0.7* | *0.8* | *0.6* | *0.9* |
| *TFP contribution* | *0.2* | *0.3* | *0.2* | *0.4* | *0.3* | *0.4* | *0.3* | *0.5* | *0.4* | *0.6* |
| Output gap *** | -1.2 | -1.5 | -1.2 | -1.4 | -0.8 | -1.1 | - | -0.6 | - | -0.2 |

* Commission 2003 Autumn forecasts.
** Italy's stability programme update (Dec. 2003). Potential GDP obtained from Commission services' calculations on USP2003.
*** In % of potential output (Commission 2003 Autumn forecasts and Commission services estimates).
*Source: Commission 2003 Autumn Forecasts, Commission services' calculations on USP2003*

## 2.4 Sectoral balances

Information provided in the programme allows for an approximate assessment of sectoral balances, with the aim to identifying gross inconsistencies in the macroeconomic scenarios.[8] In particular, the analysis of sectoral balances in terms of general government deficit vis-à-vis the rest of the world and the private sector should provide additional insights into whether the projected composition of expenditure growth is consistent.

The analysis carried out on the programme data confirms the overall internal consistency of the macroeconomic scenario. The gradual reduction of general government borrowing over the programme period is absorbed by a decline in private lending, resulting from the assumed acceleration of private consumption expenditure and investment.

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7 The *Tremonti law* tax incentive scheme.

8 The analysis of sectoral balances relies on a series of simplifying assumptions: (i) no change in the capital income in the current accounts; (ii) export prices increase in line with the GDP deflator; (iii) import prices increase in line with the import price deflator presented in the DPEF 2004-2007.

# 3 FISCAL TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES

## 3.1 Programme overview

The updated programme revises the budgetary objectives for all the years which overlap with the previous programme period, namely 2003-2006. The budget is planned to reach a balance in actual terms in 2007, two years later than in the previous programme. Together with the budgetary targets, the programme provides expenditure and revenue projections based on the legislation in force (the so-called "current legislation" projections). These projections, reported in Table 2, do not therefore constitute expenditure/revenue objectives, yet they allow insight for the assessment of the budgetary targets.

As was the case with all previous updates of the Italian stability programme, the "future measures" bridging the difference between the "current legislation" projections and the budgetary targets are not specified. This makes it difficult to determine whether the correction takes place on the expenditure and/or the revenue side and therefore to assess with precision the path and composition of the adjustment. Even though not required by the Italian budgetary process, quantitative estimates for the measures on the government's agenda beyond 2004 would have been desirable, also in the light of the intention to reduce reliance on transitory measures.

An additional difficulty in assessing the programme strategy arises because the amount indicated in the programme as "future measures" understates the size of the correction required from 2005 onwards to achieve the budgetary objectives.[9] This is due to the fact that the "current legislation" expenditure forecasts are based only on legislation presently in force, and hence do not take into account future increases in compensation of employees (due to renewal of contracts) and the impact of new future investment projects. The programme "current legislation" expenditure projections thus underestimate the "true" profile of expenditure.

Finally, the assessment of the programme strategy is also complicated by the presence of measures with a sizeable but temporary budgetary impact, such as sales of publicly-owned real assets (which are recorded as reducing capital expenditure) and receipts from tax amnesties (which increase capital revenues). The impact of one-off measures is estimated to exceed 1% of GDP in 2004.[10] After 2004, the composition of the "future measures", required to reach the budgetary objectives is asserted to be increasingly structural, with the one-off component fading out by 2006. This would comply with the recommendation in the Broad Economic Policy Guidelines for the 2003-2005 period (*BEPG 2003-2005),* that one-off measures be replaced by measures of a more permanent character. However, in so far as it is not clearly stated what steps will be taken in 2005 to replace temporary measures in force in 2004, this commitment remains untested, even assuming that the "current legislation" projections do not implicitly incorporate the effect of sales of real assets or other temporary measures.

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[9] Future interventions are a quantification of future adjustment seen from the present day perspective. When a fiscal package for 2005 is adopted, the size of "future interventions" in 2006 and 2007 will vary accordingly.

[10] This assumes that sales of publicly-owned real assets planned for 2003, but ultimately not carried out, have been postponed to 2004 and come on top of the additional disposal of real estate programmed in the Budget. See section 4 for the definition of one-off measures.

**Table 2: Composition of the adjustment in public finances**

| in % of GDP | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2007-03 |
|---|---|---|---|---|---|---|---|
| CURRENT LEGISLATION | | | | | | | |
| ***Total revenues*** | ***45.2*** | ***45.8*** | ***45.1*** | ***44.6*** | ***44.4*** | ***44.0*** | ***-1.8*** |
| ***Total expenditure*** | ***47.5*** | ***48.4*** | ***47.3*** | ***47.6*** | ***47.0*** | ***46.2*** | ***-2.2*** |
| Primary expenditure | 41.8 | 43.1 | 42.2 | 42.6 | 41.9 | 41.1 | -2.0 |
| of which: Gross fixed capital formation | 1.8 | 2.6 | 2.2 | 2.6 | 2.6 | 2.5 | -0.1 |
| *p.m. primary expenditure excluding sales of real assets* | *42.7* | *43.2* | *42.8* | *42.7* | *42.0* | *41.1* | *-2.1* |
| Interest expenditure | 5.7 | 5.3 | 5.1 | 5.0 | 5.1 | 5.1 | -0.2 |
| ***Primary balance*** | ***3.4*** | ***2.8*** | ***2.9*** | ***2.0*** | ***2.5*** | ***2.9*** | ***0.1*** |
| ***Government budget balance*** | ***-2.3*** | ***-2.5*** | ***-2.2*** | ***-3.0*** | ***-2.6*** | ***-2.2*** | ***0.3*** |
| TARGETS | | | | | | | |
| **Net impact of future measures** | | | | **1.5** | **1.9** | **2.2** | |
| **Primary balance** | **3.4** | **2.8** | **2.9** | **3.5** | **4.4** | **5.1** | **2.3** |
| **Government budget balance** | **-2.3** | **-2.5** | **-2.2** | **-1.5** | **-0.7** | **0.0** | **2.5** |
| *Source: Commission services' calculations on USP 2003* | | | | | | | |

An overview of the programme budgetary framework is provided in Table 2. After peaking in 2003, as an effect of the tax amnesty, the "current legislation" revenue ratio is foreseen to decline steadily until 2007. Until and including 2005, this reflects the expiration of tax amnesties, as well as the effect of legislation currently in force, arguably with a degree of overestimation tax receipts. As the programme projections are based on legislation currently in place, any further reductions in the tax and social security contributions burden would lower the revenue ratio after 2004.

As for the decline in primary expenditure projections, as explained above, it is overstated by the "current legislation" approach, which depresses both current primary expenditure and capital expenditure.[11] The "true" path of primary expenditure, therefore, is likely to be higher. In turn, this would increase the amount of unspecified further measures necessary to achieve the budgetary targets beyond 2004. Assuming that such measures would be concentrated on the expenditure side, given the government's stated policy intention to reduce the tax and social security contributions burden, the overall reduction in the primary expenditure share between 2004 and 2007 (netting out the impact of sales of real assets in 2004) would be of virtually unprecedented magnitude (in the order of 4% of GDP or more, if further tax cuts are implemented).[12]

The programme presents cyclically-adjusted budget balances (CAB), resulting from the application of the commonly agreed methodology. The CAB shows an improvement of 0.2% of GDP in 2004, increasing in subsequent years to half a percentage point of GDP on average. The "close-to-balance" position is achieved in 2006 and consolidated in

[11] With regard to the former, the impact of future contract renewals is not included after 2004. Concerning capital expenditure, the path in Table 2 would seem in essence flat, netting out the impact of sizeable sales publicly-owned real estate in 2004 and assuming no further significant sales of real assets thereafter. As figures based on legislation currently in force do not include the impact of future investment projects after 2005, this leads to conclude that the "true" profile of government investment expenditure is likely to be higher, although the operations of *Infrastrutture spa* may exert a dampening impact which cannot be gauged.

[12] In cyclically-adjusted terms, the reduction in the primary expenditure to potential GDP ratio between 2004 and 2007 would be of around 3.4 percentage points.

2007. The backloading of the adjustment is even more evident if one considers the targets for the cyclically-adjusted primary balance (CAPB), where an overall improvement of 1.7 percentage points (the same order of magnitude as the improvement in the CAB) occurs entirely after 2004. The fact that this is to be achieved with a progressive replacement of all the one-offs bolstering the previous years' targets provides a measure of the degree of (future) ambition underlying the programme projections.

**Table 3. Cyclically-adjusted balances**

| in % of GDP | **Output gap** (in % of pot. GDP)* | | **Budget balance** | | **Primary balance** | | **Cyclically-adjusted budget balance** | | **Cyclically-adjusted primary balance** | |
|---|---|---|---|---|---|---|---|---|---|---|
| | **USP 2003** | **COM** | **USP 2003**** | **COM** | **USP 2003**** | **COM** | **USP 2003**** | **COM** | **USP 2003**** | **COM** |
| **2001** | 1.1 | 1.3 | -2.6 | -2.6 | 3.8 | 3.8 | -3.1 | -3.2 | 3.3 | 3.2 |
| **2002** | -0.3 | 0.0 | -2.3 | -2.3 | 3.4 | 3.4 | -2.2 | -2.3 | 3.5 | 3.4 |
| **2003** | -1.5 | -1.2 | -2.5 | -2.6 | 2.8 | 2.7 | -1.8 | -2.1 | 3.5 | 3.2 |
| **2004** | -1.4 | -1.2 | -2.2 | -2.8 | 2.9 | 2.2 | -1.6 | -2.3 | 3.5 | 2.7 |
| **2005** | -1.1 | -0.8 | -1.5 | -3.5 | 3.5 | 1.6 | -1.0 | -3.2 | 4.0 | 2.0 |
| **2006** | -0.6 | | -0.7 | | 4.4 | | -0.4 | | 4.7 | |
| **2007** | -0.2 | | -0.0 | | 5.1 | | 0.1 | | 5.2 | |

* Potential GDP obtained from Commission services' calculations on USP2003.
** Including "future measures" amounting to 1.5% of GDP in 2005, 1.9% of GDP in 2006 and 2.2% of GDP in 2007.
*Source: Commission services calculations on USP 2003 and Commission 2003 Autumn forecast*

## 3.2 Implementation of the 2002 updated programme and budgetary developments in 2003

In the stability programme update of November 2002, the budgetary target for 2003 was a deficit of 1.5% of GDP. The latest official budgetary estimate for 2003, announced at the end of September in the *Forecasting and Programming Report* (*RPP*) and confirmed in the programme, is a deficit of 2.5% of GDP. Similarly, the Commission 2003 Autumn forecast projects a general government deficit of 2.6% of GDP, conditional upon receipts from a generalised amnesty for underdeclaration of past tax liabilities materialising as estimated in the official forecast.

The divergence of the budgetary outturn in 2003 (as assumed in the Commission 2003 Autumn forecast) from the target in the November 2002 programme (USP 2002) results from two elements, which had already played a role in determining the higher deficit in 2002 than projected in the USP 2002, namely: (i) an overestimation of economic growth, and (ii) an overestimation of current revenue dynamics, for the given growth assumptions. On the other hand, the underestimation of primary expenditure was more than offset by higher than expected savings in interest expenditure.[13]

During the year, the composition and impact of the fiscal package for 2003 changed, with significantly higher than expected receipts from the generalised tax amnesty offsetting the scaling down of planned sales of real assets. A measure adopted at the end of the year (a mandatory levy on tax collectors), not announced at the time of the Commission 2003 Autumn forecast, helped rein in the cash deficit and possibly also the Maastricht-definition accruals deficit by an estimated 0.2 percentage point of GDP.

[13] See Table 4, last column.

In terms of cyclically-adjusted budget balance, the improvement compared to 2002 is estimated to have been around 0.2 percentage point of GDP (0.4 in the official estimates), in contrast with the recommendation of the BEPGs to ensure a reduction in the cyclically-adjusted deficit of at least 0.5 percentage point of GDP per year until a medium-term budget position close to balance or in surplus is achieved. The cyclically adjusted primary surplus is expected to have edged down by 0.2 percentage point of GDP in the Commission forecast (flat in the official forecast), pointing to a more expansionary thrust of fiscal policy.[14]

An assessment of the implementation of the previous programme based on the CAB and the CAPB, however, is less straightforward than may appear, as both the level and the change in the cyclically-adjusted balances are affected by revisions in the estimate of potential GDP, which in turn result from revisions in real GDP. In this connection, overoptimistic growth forecasts underlying the budget can be seen as a means to overstate the adjustment in the structural balance that is planned and to subsequently overplay the role of unexpectedly unfavourable growth in the budgetary slippage evidenced by the outturn figures.

Table 4 examines the differences with the government plans for 2003, presented in the USP 2002, of the Commission 2002 Autumn forecast (COM 2002) and of the Commission 2003 Autumn forecast (COM 2003). The aim is to allow a more in-depth analysis of the determinants of the likely budgetary slippage in 2003, specifically how much of it can be attributed to an unexpected deterioration in growth conditions. The revision in the Commission's real GDP projections between Autumn 2002 and Autumn 2003 is taken as a measure of the growth shortfall that could not have been anticipated on the basis of the information available at the time of the presentation of the programme.[15]

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[14] Netting out the effect of one-off measures, the CAB would be deteriorating slightly in the Commission services' forecast (flat in the official forecast), and the CAPB would deteriorate by 0.6 percentage point (by 0.4 in the official forecast).

[15] The accuracy of Commission growth forecasts is well documented, showing in particular that economic growth projections are unbiased (see Keereman, F., (1999) *The accuracy of the Commission Forecast*, European Economy, Economic Paper No. 137). Conversely, the results of similar accuracy checks show that official forecasts underpinning budget plans of some EU Member States have a clear upward bias (see Larch, M. and Salto, M. (2003), *Fiscal Rules, Inertia and Discretionary Fiscal Policy*, European Economy, Economic Paper No. 194).

**Table 4. Budgetary developments in 2003: stability programme 2002 updated (USP 2002) versus Commission 2003 Autumn forecast (COM 2003)**

| in % of GDP | USP 2002* | COM 2002** | COM 2003 | Difference COM 2002** - USP 2002 | | | Difference COM 2003 – COM 2002** | | | Total difference COM 2003 – USP 2002 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Total | Due to different real GDP*** | Residual | Total | Due to different real GDP*** | Residual | Total | Due to different real GDP*** | Residual |
| | (1) | (2) | (3) | (4=2-1) | (5) | (6=4-5) | (7=3-2) | (8) | (9=7-8) | (4+7) | (5+8) | (6+9) |
| - Taxes and social security contributions | 42.0 | 41.3 | 40.9 | -0.7 | 0.0 | -0.7 | -0.4 | 0.0 | -0.4 | -1.1 | 0.0 | -1.1 |
| - Other revenue | 4.4 | 4.3 | 5.0 | -0.1 | 0.0 | -0.1 | 0.7 | 0.0 | 0.7 | 0.6 | 0.0 | 0.6 |
| **Total revenue** | **46.4** | **45.7** | **45.9** | **-0.7** | **0.0** | **-0.7** | **0.2** | **0.0** | **0.2** | **-0.5** | **0.0** | **-0.5** |
| *Cyclical component of revenue* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* |
| ***Cyclically-adjusted revenue (CAR)***** | ***46.4*** | ***45.7*** | ***45.9*** | ***-0.7*** | ***0.0*** | ***-0.7*** | ***0.2*** | ***0.0*** | ***0.2*** | ***-0.5*** | ***0.0*** | ***-0.5*** |
| - Primary expenditure | 41.9 | 42.3 | 43.2 | 0.4 | 0.3 | 0.1 | 0.9 | 0.5 | 0.5 | 1.3 | 0.7 | 0.6 |
| of which: Gross fixed capital formation | 1.9 | 2.0 | 2.6 | 0.1 | - | - | 0.6 | - | - | 0.7 | - | - |
| - Interest expenditure | 6.0 | 5.6 | 5.3 | -0.4 | 0.0 | -0.5 | -0.3 | 0.1 | -0.3 | -0.7 | 0.1 | -0.8 |
| **Total expenditure** | **47.9** | **47.8** | **48.5** | **-0.1** | **0.3** | **-0.4** | **0.7** | **0.5** | **0.1** | **0.6** | **0.8** | **-0.2** |
| *Cyclical component* | *0.6* | *0.5* | *0.5* | *-0.1* | *-0.1* | *0.0* | *0.0* | *0.0* | *0.0* | *-0.1* | *-0.1* | *0.0* |
| ***Cyclically-adjusted expenditure (CAE)***** | ***47.3*** | ***47.3*** | ***48.0*** | ***0.1*** | ***0.4*** | ***-0.4*** | ***0.6*** | ***0.5*** | ***0.1*** | ***0.7*** | ***0.9*** | ***-0.2*** |
| **Government budget balance** | **-1.5** | **-2.2** | **-2.6** | **-0.7** | **-0.3** | **-0.4** | **-0.4** | **-0.5** | **0.1** | **-1.1** | **-0.8** | **-0.3** |
| *Cyclical component of the budget balance* | *-0.6* | *-0.5* | *-0.5* | *0.1* | *0.1* | *0.0* | *0.0* | *0.0* | *0.0* | *0.1* | *0.1* | *0.0* |
| ***Cyclically-adjusted budget balance (CAB)***** | ***-0.9*** | ***-1.6*** | ***-2.1*** | ***-0.8*** | ***-0.4*** | ***-0.3*** | ***-0.4*** | ***-0.5*** | ***0.1*** | ***-1.2*** | ***-0.9*** | ***-0.3*** |
| *p.m. CAB change (2003-2002)* | *0.5* | *0.2* | *0.2* | *-0.3* | | | *0.0* | | | *-0.3* | | |

* Commission calculations on USP 2002 to ensure consistency with EU Regulation n. 1500/2000.
** Commission 2002 Autumn forecast.
*** Assuming inertia in the level of planned non-cyclical expenditure with respect to real GDP.
**** In % of potential GDP, production function method.
*Source: Commission services calculations on USP 2002 and Commission 2002 and 2003 Autumn forecasts*

The difference between plans (USP 2002) and expected outcome (COM 2003) in the expenditure, revenue and deficit to GDP ratio is broken down, based on simplifying assumptions, into two components: i) a component attributable to the difference in real GDP (and hence the underlying potential GDP and the output gap for the calculation of the cyclical adjusted figures) and ii) a residual component ensuing from either a discretionary policy change or underestimation/overestimation of expenditure/revenues in the planning phase of the budget.[16] The same exercise is repeated for the difference between the two Commission forecasts.

The main conclusions that can be gathered from the examination of Table 4 are:

1) Looking first at the overall estimated slippage in the actual balance (1.1 percentage points of GDP), a large part (0.8 percentage point) appears to be explained by the revision in real GDP. The revision in the growth scenario chiefly resulted in a lower potential output, with the cyclical component virtually unchanged. Hence, the growth effect on the budget is estimated to be mainly structural.

2) While even the Commission 2002 Autumn growth forecast turned out to be on the high side, the official forecasts at the time had an additional element of optimism, accounting for almost half of the growth effect (0.3 percentage point), already perceived at the time of the presentation of the USP2002.

3) Finally, a non-negligible component of the total slippage (0.3 percentage point of GDP) can be attributed to a discretionary policy change and an overestimation of the tax content of growth and *ex post* revisions of revenue and expenditure trends.[17]

Overall, roughly half of the total budgetary slippage in 2003, comprising both discretionary and growth effect, was already discernable at the time of presentation of the November 2002 programme, and cannot be linked to uncertainty in economic developments. In particular, the size of the residual part of the slippage has remained broadly unchanged across Commission forecasts. In fact, Table 4 shows that the residual difference compared to the official target is almost the same.

### 3.3 Public finances in 2004

The Italian authorities aim to achieve a deficit in actual terms of 2.2% of GDP in 2004, thanks to a fiscal package whose net impact is officially estimated at around 0.8% of

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[16] The key assumption underlying the decomposition reported in Table 4 is that on the expenditure side the government fully implements non-cyclical expenditure plans set out in the programme, regardless of economic developments. This may appear at first sight to be a strong assumption, but it is a reasonably good approximation in the light of the high degree of inertia, i.e. of adherence to plans, in the budgetary implementation process. On the revenue side, on the other hand, the standard hypothesis applies, i.e. that there is a stable relationship between revenues and economic growth. In the case of Italy this relationship is captured by a tax elasticity close to 1. On account of the assumption of adherence to plans, the deficit to GDP ratio deteriorates simply because economic growth turns out lower than expected, affecting the denominator of the expenditure ratio.

[17] More specifically, current tax and social security contributions were strongly overestimated in the November 2002 programme. *Ex post* this was partially compensated by the higher than expected outturn from the tax amnesty. Focussing on primary expenditure, plans were not respected. *Inter alia*, due to difficulties in setting up the securitisation operations, sales of real assets were cut back drastically. On the other hand, the beneficial effect of lower than forecast interest rates on interest expenditure more than offset the large slippage on primary expenditure.

GDP. The expansionary side of the fiscal package is fairly contained. On top of measures already decided in the past, the 2004 Budget Law foresees tax breaks to support R&D investment and funding for renewals of contracts for public sector employees. The budgetary correction comprises securitisation and sales of publicly-owned real assets (0.4% of GDP, in addition to the 0.2% of GDP presumably already included in the pre-budget current legislation figures)[18], a tax amnesty for zoning regulation violations (0.2% of GDP), an extension of the terms of the tax amnesty introduced in 2003 (0.1% of GDP). In addition, small savings in expenditure are to be achieved as a result of the privatisation of the *Cassa Depositi e Prestiti,* the formerly public deposits and loans bank.[19]

The Commission 2003 Autumn forecast projects an increase in the deficit to 2.8% of GDP in 2004. The differences between the Commission and the official forecasts are shown in Table 5. The estimated cyclical component is almost the same in the two scenarios. In the main, the divergence results in broadly equal terms from a more cautious growth assumption, on the one hand, and a marginal re-assessment of the corrective measures of Budget Law for 2004, coupled with a less optimistic evaluation of underlying fiscal trends, on the other hand. In essence, all this implies that the stated size of the planned correction is insufficient to achieve the budgetary target.

**Table 5. Budgetary developments in 2004: Government plans (USP 2003) and Commission 2003 Autumn forecast (COM)**

| in % of GDP | USP 2003 | COM | Difference (COM-USP 2003) | | |
|---|---|---|---|---|---|
| | | | Total | Due to different real GDP** | Residual |
| - Taxes and social security contributions | 41.1 | 40.9 | -0.2 | 0.0 | -0.2 |
| - Other revenue | 4.0 | 4.0 | 0.0 | 0.0 | 0.0 |
| **Total revenue** | **45.1** | **44.9** | **-0.2** | **0.0** | **-0.2** |
| *Cyclical component* | *0.0* | *0.0* | *0.0* | *0.0* | *0.0* |
| ***Cyclically-adjusted revenue (CAR)**** | ***45.1*** | ***44.9*** | ***-0.2*** | ***0.0*** | ***-0.2*** |
| - Primary expenditure | 42.2 | 42.7 | 0.5 | 0.2 | 0.3 |
| of which: Gross fixed capital formation | 2.2 | 2.4 | 0.2 | - | - |
| - Interest expenditure | 5.1 | 5.0 | -0.1 | 0.0 | -0.1 |
| **Total expenditure** | **47.3** | **47.7** | **0.4** | **0.3** | **0.1** |
| *Cyclical component* | *0.6* | *0.5* | *-0.1* | *-0.1* | *0.0* |
| ***Cyclically-adjusted expenditure (CAE)**** | ***46.7*** | ***47.2*** | ***0.5*** | ***0.4*** | ***0.1*** |
| **Government budget balance** | **-2.2** | **-2.8** | **-0.6** | **-0.3** | **-0.3** |
| *Cyclical component of the budget balance* | *-0.6* | *-0.5* | *0.1* | *0.1* | *0.0* |
| ***Cyclically-adjusted budget balance (CAB)**** | ***-1.6*** | ***-2.3*** | ***-0.7*** | ***-0.4*** | ***-0.3*** |
| *p.m. CAB change (2004-2003)* | *0.2* | *-0.2* | *-0.4* | | |
| *p.m. CABP change (2004-2003)* | *0.0* | *-0.5* | *-0.5* | | |

* In % of potential GDP, production function method.
** Assuming inertia in the level of planned non-cyclical expenditure with respect to real GDP.
*Source: Commission services calculations on USP 2003 and Commission 2003 Autumn forecast*

[18] See footnote 10.

[19] The operation is examined in more detail in section 3.6.1.

In 2004 the programme implies a cyclically-adjusted budget deficit of 1.6% of GDP, slightly above the "safety margin" (estimated at 1.5% of GDP) against breaching the 3% of GDP deficit threshold, with a slow movement towards the "close to balance" (see Table 5). By contrast, in the Commission evaluation the CAB would largely exceed the safety margin. According to the programme, the decrease in the cyclically-adjusted deficit wouls fall short of the suggested minimal improvement of 0.5% of GDP recommended in the BEPG 2003-2005; according to the Commission evaluation it would actually deteriorate.

The impact of one-off measures in 2004 is expected to decrease by around half a percentage point of GDP compared to 2003, but remains important: based on the definition adopted by the Commission services (see section 4), the order of magnitude of one-off measures is around 1.2% of GDP in the official projections, and slightly below 1% in the Commission Autumn forecast.[20] Assessing such projections presents obvious difficulties.[21] A repeat of developments in 2003 is possible, when the composition of the adjustment in terms of one-off measures, as well as the budgetary impact of the measures, changed significantly in the course of the year compared to budget plans.

### 3.4 Targets and adjustment in 2005 and beyond

As already highlighted, the budgetary objectives for 2005 and beyond rely on the phasing out and subsequent full replacement of the sizeable one-off measures implemented in previous years and on additional structural corrective measures, which the programme, as customary, does not illustrate. In cyclically-adjusted terms, the budgetary targets imply that the "close-to-balance" position is reached in 2006 and consolidated in 2007. Hence the backloaded profile of the adjustment and the lack of information on the measures envisaged detract from the credibility of the programme.

The size of the effort required is highlighted when the official targets are set against the Commission's "current legislation" forecast for 2005, i.e. a scenario incorporating a worse starting position inherited from 2004 and somewhat weaker growth in 2005 and reflecting also the expiry of temporary measures implemented in 2004, in which the deficit in nominal terms would overshoot the 3%-of-GDP threshold. In cyclically-adjusted terms, the Commission "current legislation" estimates point to a distance from the "close-to-balance" position of over 2½ % of GDP in 2005.[22] Hence, also considering that the programme economic growth scenario may still be on the high side, even at the planned pace of adjustment the achievement of the "close-to-balance" position would be reached some years later than envisaged.

### 3.5 Sensitivity analysis

Acknowledging that the public finance objectives are conditional on the macroeconomic scenario, the programme dedicates a full section to the sensitivity analysis. The focus is

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[20] This implies that if the impact of one-offs is netted out, the CAB and the CAPB would show an improvement in 2004 in both the official and the Commission scenario.

[21] This could be the case if the projections for the receipts from tax amnesties turned out to be on the low side, specifically, the expected receipts from the extension to the 2002 fiscal year of the tax amnesty for underdeclaration of past tax liabilities and of the tax amnesty on zoning regulation violations.

[22] In practice, the required correction would be even larger because the "current legislation" projection underestimates expenditure trends in public sector wages and investment (see footnote11).

on two separate simulations. The first refers to the sensitivity of public finance to economic growth, the second to the interest rate.

### *3.5.1 Sensitivity to economic growth*

The programme examines the budgetary impact of two alternative growth scenarios, which assume that for the entire programme period, that is 2004-2007, annual GDP growth is either lower or higher than the baseline by 0.5 percentage points each year. Unlike in previous updates, when deviations in growth were assumed to be fully cyclical and hence not to affect the underlying budgetary position, the sensitivity analysis presented in the 2003 update of the stability programme recognises that variations in actual growth will also affect potential output growth.

More specifically, the analysis builds on the assumption that nominal non-cyclical expenditure will be invariant with respect to changes in the level of potential GDP across the alternative growth scenarios. Taking into account that revenues will automatically follow changes in the tax base, in the case of Italy with an elasticity close to 1[23], the assumed inertia on the expenditure side entails a significant variation in the cyclically-adjusted budget balance in the event of higher or lower than expected growth. Independently of its degree of realism, assuming expenditure inertia has an evident advantage compared to other assumptions. It gives the possibility to gauge the adjustment gap, i.e. the greater or lesser discretionary effort required to maintain the official budgetary objectives set out in the central scenario.

**Table 6. Sensitivity to GDP growth**

| in % of GDP | Central scenario | | Low-growth scenario* | High-growth scenario* |
|---|---|---|---|---|
| | Targeted budget balance | CAB** | CAB** | CAB** |
| **2004** | -2.2 | -1.6 | -2.1 | -1.4 |
| **2005** | -1.5 | -1.1 | -1.5 | -0.6 |
| **2006** | -0.7 | -0.5 | -1.2 | 0.0 |
| **2007** | 0.0 | 0.1 | -0.8 | 0.8 |

* In the 2004-2007 period real GDP annual growth rate is 0.5pp lower/higher each year than in the central scenario.
**Figures from USP 2003.
*Source: USP 2003*

The results of the sensitivity analysis are reported in Table 6. Apart from negligible differences, they are identical to those obtained by the Commission services. In particular, the cyclically-adjusted budget balance is estimated to deteriorate by some cumulative 0.9 percentage points of GDP in the final year of the programme compared to the central scenario, if the lower growth scenario were to materialise. As a result, the close to balance or in surplus position would be postponed and the annual budgetary corrections would be lower than 0.5% of GDP. Put differently, additional measures in the order of 0.9 percentage points of GDP would be necessary to keep public finance on the path targeted in the central scenario. Conversely, in the event the economy embarked on the high growth path, the close to balance position in cyclically-adjusted terms would be achieved in 2006.

[23] The tax elasticity of 0.95 is estimated by the OECD and is a key input to the calculation of the cyclically adjusted budget balance as outlined in the technical note in European Economy No. 60, 1995.

Taking into account the conclusions reached in section 2.3, namely that the risks to the macroeconomic framework of the programme are mainly to the downside, and considering that the Commission's own growth projections are pretty much in line with the low growth alternative considered in the sensitivity analysis of the programme, the achievement of the budgetary targets would require significantly greater fiscal effort than assumed in the programme.

### *3.5.2 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 essentially the same sensitivity in the entire programme period compared to the previous update, reflecting the intention to maintain the current structure of the debt.

## 3.6 The general government debt

### *3.6.1 Debt developments up to 2003*

In the 1997-2002 period, the debt ratio declined on average by 2.7 percentage points of GDP per year. More recently, the pace of debt reduction was slowed by a marked deceleration in the process of disposal of financial assets and, more importantly, by persisting high levels of the general government cash borrowing (*fabbisogno di cassa delle amministrazioni pubbliche* - a deficit measure for the based on cash flows and including transactions with financial assets but excluding proceeds from privatisations), which since 1999 has tended to exceed the Maastricht definition of general government deficit by about 1.5% of GDP on average. Low economic growth did not, on the other hand, depress the denominator of the ratio, since lower than envisaged real growth was broadly offset by a higher than projected deflator.

In 2002 the debt ratio fell by about 3 percentage points to reach 106.7% of GDP (although an upward revision of around 0.3 pp of GDP is in the cards), a result achieved chiefly through an extraordinary debt conversion operation[24]. In 2003 the debt ratio is expected to decrease by around 2 percentage points of GDP to around 105% of GDP. This is a better development than foreseen in both the Commission and the official forecasts (see Table 7).

The general government cash borrowing is likely to end up at around 4% of GDP in 2003. Although this would be around half a percentage point below the official estimate published in April[25], it would still be around 1 percentage point higher than in 2002, when sizeable one-off operations temporarily compressed cash borrowing dynamics.[26] The decrease in the debt ratio is therefore obtained largely thanks to a resumption of privatisations, a sizeable reduction in cash assets held by the government with the Bank of Italy, a favourable exchange rate effect and extraordinary operations linked to the

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[24] This consisted in a large transaction between the Italian Treasury and the Bank of Italy, substituting non-marketable government debt held in the latter's asset sheet, and resulting in a one-off reduction in outstanding government debt of 1.9% of GDP.

[25] *Relazione trimestrale di cassa al 31 dicembre 2002.*

[26] Hence the gap between the general government cash and EDP deficit widened again in 2003 and is likely to be in the order of 1¼-1½ % of GDP.

transformation of the *Cassa Depositi e Prestiti* (the government's savings and loans bank) into a joint-stock company at the end of 2003 and its subsequent exit from the general government sector, subject to Eurostat's opinion.[27]

### *3.6.2 The path of debt reduction 2004-2007*

The postponement of the budgetary adjustment has implications for the decrease in the debt ratio, which is projected to fall below the 100% of GDP threshold only by 2007, four years later than the 2003 deadline to which Italy committed as a pre-condition for its entry into EMU in 1998. Over the programme period, the debt ratio is projected to decrease by a cumulative 7.4 percentage points of GDP.

If the improvement in the debt ratio outturn in 2003 compared to plans is confirmed, this is likely to affect the path of debt reduction envisaged in the programme. However, the general considerations on the programme's strategy of debt reduction should retain validity[28]. Nominal GDP growth and recovering primary surpluses are the driving forces behind the reduction in the debt ratio projected by the Italian authorities. The reduction in the debt ratio is also conditional on sizeable annual disposals of financial assets (0.9% of GDP on average throughout the programme period). The planned privatisations would therefore slightly exceed on an annual average those carried out in the 1995-2000 period.

The planned path of decline in the public debt must be viewed in connection with the evolution in the cash-based, as opposed to the accruals-based, measure of the general government borrowing requirement. Explicit estimates of this aggregate cannot be found either in the programme or in other official documents. However, it is possible to estimate the cash borrowing requirement "implicitly", by using the change in the debt level between two periods and netting out components conventionally not included in the cash general government borrowing requirement, as monitored by the Italian Treasury.

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[27] The positive net impact on the debt ratio of the transformation of the *Cassa Depositi e Prestiti* into a joint-stock company is officially quantified at around 1% of GDP. This is essentially due to an indirect privatisation, achieved through the injection by the Treasury of part of its stakes in formerly national monopolies (Enel S.p.A., ENI S.p.A. and Poste S.p.A) into the capital of the new *Cassa Depositi e Prestiti* S.p.A. At the same time, the Treasury has sold the 30% of its shares of the new company to publicly-controlled bank foundations, controlling the local savings bank system. A broad overview of the *Cassa* operation, based on preliminary information, was submitted to Eurostat for prior agreement in the Autumn. Eurostat marked its agreement in principle, but reserved its final opinion to an *ex post* examination of the final text of the Law modifying the nature and functions of the *Cassa Depositi e Prestiti* and of the technical aspects of the operation.

[28] It is not clear whether the transfer of Treasury stakes in Enel, ENI and Poste to the *Cassa* in the brings forward future planned privatisation or if it constitutes a net increase in the volume of planned privatisations.

**Table 7. Decomposition of changes in the government debt ratio**

| | Mean 1997-2002 | 2003 | | 2004 | | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|---|
| | | COM 2003 | USP 2003 | COM 2003 | USP 2003 | USP 2003 | USP 2003 | USP 2003 |
| **Level of government debt ratio** | | **106.4** | **106.0** | **106.1** | **105.0** | **103.0** | **100.9** | **98.6** |
| **Change in government debt ratio** | **-2.7** | **-0.3** | **-0.7** | **-0.3** | **-1.0** | **-2.0** | **-2.1** | **-2.3** |
| ***of which contributions from:*** | | | | | | | | |
| 1. Primary balance | -4.8 | -2.7 | -2.8 | -2.2 | -2.9 | -3.5 | -4.4 | -5.1 |
| 2. Interest expenditure | 7.2 | 5.3 | 5.3 | 5.0 | 5.1 | 5.0 | 5.1 | 5.1 |
| 3. Real GDP growth | -2.0 | -0.4 | -0.5 | -1.5 | -1.9 | -2.2 | -2.5 | -2.5 |
| 4. GDP deflator growth | -2.7 | -3.1 | -2.9 | -2.6 | -2.2 | -1.9 | -1.7 | -1.7 |
| 5. Stock-flow adjustment *of which:* | -0.4 | 0.7 | 0.2 | 1.0 | 0.9 | 0.6 | 1.4 | 1.9 |
| *6. UMTS, privatization and sales of assets* | -0.9 | *-0.2* | *-0.3* | *-1.1* | *-1.1* | *-1.1* | *-0.7* | *-0.7* |
| *7. change in cash balances held with Bank of Italy* | -0.1 | *-0.9* | *-1.1* | - | - | - | - | - |
| *8. exchange rate and other financial transactions* | -0.3 | *-0.3* | *-0.3* | *-0.1* | *-0.1* | - | - | - |
| 9. Stock-flow adjustment excluding 6, 7 and 8 | 1.0 | 2.0 | 1.9 | 2.2 | 2.0 | 1.7 | 2.1 | 2.5 |
| **10.Implicit cash borrowing requirement (1+2+9)** | **3.4** | **4.6** | **4.4** | **4.9** | **4.3** | **3.2** | **2.8** | **2.5** |
| **11.Net borrowing EDP (excluding UMTS) (1+2)** | **2.4** | **2.6** | **2.5** | **2.8** | **2.2** | **1.5** | **0.7** | **0.0** |

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 2003 and Commission 2003 Autumn forecasts*

The results, reported in Table 7, show that in the view of the Italian authorities, the achievement of a balance in terms of the Maastricht-definition deficit could co-exist with a cash borrowing in the order of 2½ percentage points of GDP. As already noted, such a persistently high divergence between the two definitions of deficit appears to be a regular feature of Italian public accounts, with the cash-based deficit measure substantially exceeding the accruals measure. This divergence is even expected to widen over the programme period, implying the continued existence of significant undisclosed "below the line operations" (transactions with financial assets and settlements of payables outstanding), affecting the planned path of debt reduction and the credibility of the fiscal targets.

## 4 QUALITY OF PUBLIC FINANCES

Given the government's intention to ease the tax and social security contributions burden and to implement a vast programme of infrastructure development, the adjustment strategy outlined in the programme entails a very considerable reduction in the current primary expenditure ratio[29]. This approach would appear to respect the empirically evidenced conditions for a durable non-contractionary fiscal consolidation. However, the necessary pre-condition for this to happen is that economic agents perceive the current

[29] Assuming that capital expenditure evolves as indicated in the "current legislation" scenario (Table 2), the reduction in the cyclically-adjusted current primary expenditure to potential GDP ratio would be of around 3 percentage points. Clearly, if capital expenditure, for the reasons explained in Section 3.1, were higher, then *ceteris paribus* the reduction in the current primary expenditure ratio would be even more ambitious. Hence there is a risk that, as in the past, there may be a temptation to achieve the budgetary adjustment through a compression of capital expenditure.

and future measures underlying the adjustment as credible. For this to be the case, a number of critical issues will need to be addressed.

In the first place, the reduction in the current primary expenditure ratio implied by the programme is to take place after a decade in which the ratio has displayed a marked degree of downward rigidity.[30] Despite ongoing improvements in expenditure management and control, both as regards the increase in the timeliness of availability of information on expenditure developments at all levels of government and the introduction of instruments allowing rapid action when overruns are detected, difficulties persist in implementing structural expenditure cuts, notably in areas requiring a more organic reform approach.[31] Furthermore, the existence of an expected sizeable implicit cash borrowing requirement up until 2007, appears to indicate the presence of significant "below the line" spending.[32]

A second issue concerns the strong reliance on one-off measures, which in the programme is shown to progressively diminish after 2003. Recourse to temporary measures cannot be sanctioned *per se*, in that they may enhance efficiency or impede recourse to pro-cyclical policies in a period of low growth. However, the persistent recourse to measures of this kind postpones lasting correction and reduces the credibility of the fiscal adjustment framework. One-off measures are here assumed to consist in the sales of publicly-owned real assets and receipts from tax amnesties and from *ad hoc* taxes on the re-evaluation of corporate assets.[33] Based on this definition, the impact of temporary measures in the programme projections would decline by about a third in 2004 compared to the previous year's record high of well over 1½ % of GDP. The continued gradual replacement of one-off measures with permanent measures in 2005 and 2006 is a welcome goal. However, lack of information on the permanent measures envisaged does not allow to gauge the firmness of this intention.

Beyond the temporal scope of the updated programme, primary expenditure trends could be curbed by the implementation of the government's new pension reform proposals,

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[30] Between 1993 and 1998 a reduction of about 1.5 percentage points was achieved in the cyclically-adjusted current primary expenditure to potential GDP ratio, which however was subsequently partially reversed, as the ratio increased again by ½ percentage point between 1998 and 2003. In parallel, the capital expenditure ratio contracted by 0.4 percentage points between 1993 and 1998, subsequently returning to its 1993 level (netting out the impact of sales of real assets).

[31] This applies in particular to healthcare expenditure, which should be viewed in the context of a clear redefinition of means, instruments, competencies and objectives at all levels of government.

[32] The quarterly report on the cash borrowing requirement - *Relazione trimestrale di cassa al 31 dicembre 2002* - shows that in the 2000-2002 period both total receipts and spending in cash terms (including transactions with financial assets and settlements of payables outstanding) are higher than in the ESA95 definition, but the difference is always greater for spending. This means that the Italian government has accumulated financial assets such as loans and shares vis-à-vis the private sector and public enterprises.

[33] There is no commonly agreed definition of "one-off measure". While generally the impact of fiscal measures persists in time (e.g. a change in a tax rate), some measures lead to temporary (and hence fully reversible) deteriorations or improvements in the budget balance (e.g. an ad hoc tax such as the Euro-tax introduced in 1997 in order to meet the requirements for adoption of the euro). The critical feature is a significant, transitory and identifiable impact on the public accounts, outweighing any possible lasting effect ensuing from the measure. In particular, it cannot be excluded that tax amnesties may lead to a permanently broader tax base and hence would not be purely one-off. However, the impact effect in the year in which the tax amnesty receipts accrue can be certainly qualified as temporary.

unveiled in late 2003. By tightening the conditions required to benefit from seniority pensions as of 2008, the proposed reform would generate savings in pension expenditure estimated by the Treasury at up to 0.7% of GDP per year compared to the present system. Savings would taper off after around 2030, as a longer contribution period would entail a higher average pension for all new pensioners concerned by the measure, which will be required to work for a longer period. The proposal leaves open a number of critical issues, such as the long interval between scheduled reviews of the parameters of the system. Moreover, the plan is subject to non-negligible political risks, not least as its application is deferred to 2008.

Finally, the programme presents the first results of a comprehensive cataloguing and valuation of public assets, indicating an assets-to-liabilities ratio of 1.22. The main part of total assets is made up of disposable assets. On the basis of the information available in the programme, it is not possible to determine what these assets consist of, nor, as a result, whether they can be easily converted into liquidity. A better asset management would entail evident gains in efficiency, also through the reduction in the stock of public debt, creating room for improving the quality of expenditure. The disposal of real assets should however be viewed as an opportunity to favour a reduction of the debt, rather than as a way to postpone lasting deficit consolidation.

# 5 SUSTAINABILITY OF PUBLIC FINANCES

## 5.1 Quantitative indicators

The assessment of the sustainability of public finances is based on both quantitative and qualitative indicators. The quantitative indicators are run on the basis of a commonly agreed methodology by the Economic Policy Committee[34]. The purpose of the indicators is to signal possible imbalances on the basis of current policies and projected age-related expenditure trends. However, the limitations of this exercise are clear and results of these quantitative indicators need to be interpreted with caution. Being a mechanical, partial equilibrium analysis, projections are in some cases bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels is not a forecast of possible or even likely outcomes and should not be taken at face value. Instead, the indicators are a tool to facilitate policy debate and at best provide an indication of the timing and scale of emerging budgetary challenges that could occur on the basis of "no policy change".

The quantitative indicators project debt and budget balance development according to two different scenarios, to take into account uncertainties over the medium term. The programme scenario is calculated on the following basis:

- Macroeconomic assumptions on GDP growth from 2008 onwards, interest rates and inflation are based on the agreed assumptions used in the EPC report of October 2003;
- The projections for age-related expenditure come from the stability programme.

[34] See the Report "The impact of ageing populations on public finances: overview of analysis carried out at EU level and proposals for a future work programme" (October 2003), available at http://europa.eu.int/comm/economy_finance/epc/documents/2003/pensionmaster_en.pdf

- The projections for government revenues come from the programme; they are kept constant at the (cyclically adjusted) ratio in 2007.

- The starting point for gross debt and primary balance are the 2007 ratios reported in the programme.

An alternative "2003 position" scenario is based on the budgetary data for 2003 in the programme. Gross debt ratios are extrapolated from 2008 to 2050 assuming that no budgetary consolidation is achieved, i.e. the cyclically adjusted primary balance ratio in 2007 remains the same as the 2003 level and no stock-flow operations take place.

Table 8 presents debt and the budget balance developments according to the two different scenarios. Projections are based on national projections on pensions, healthcare, education and unemployment benefits. Overall, age-related expenditure is foreseen to increase by 1.3% of GDP between 2008 and 2050. The increase in healthcare expenditure will be partially offset by the savings foreseen in education. Pension expenditure at the end of the projection period is expected to be at the current level, after having reached a peak between 2030 and 2040.

In the case of Italy, the debt ratio should be primarily run down to reach the 60% reference value of the Treaty. Failure to rapidly achieve and maintain this result would *a priori* indicate that there may be a risk of budgetary imbalances emerging in the light of ageing population and that measures may be required to place public finances on a more sustainable footing.

**Table 8. Long-term sustainability: summary results for Italy**

| Main assumptions - baseline scenario (as % GDP) | 2008 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Total age-related spending* | 25.4 | 25.4 | 26.4 | 27.8 | 28.1 | 26.7 | 1.3 |
| Pensions | 14.0 | 14.0 | 14.7 | 15.8 | 15.6 | 14.1 | 0.1 |
| Health | 6.4 | 6.5 | 7.0 | 7.5 | 7.9 | 8.1 | 1.7 |
| Education | 4.6 | 4.5 | 4.3 | 4.1 | 4.2 | 4.2 | -0.4 |
| Unemployment benefits | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | -0.1 |
| *Total primary non age-related spending** | 13.4 | | | | | | |
| *Total revenues** | 44.1 | | | | | | |

* constant

| Results (as % GDP) | 2008 | 2010 | 2020 | 2030 | 2040 | 2050 | changes |
|---|---|---|---|---|---|---|---|
| *Programme scenario* | | | | | | | |
| Debt | 94.4 | 86.6 | 53.8 | 28.9 | 7.2 | -27.8 | -122.2 |
| Net borrowing | 0.0 | 0.4 | 1.2 | 1.2 | 2.0 | 5.2 | 5.2 |
| *2003 position scenario* | | | | | | | |
| Debt | 96.2 | 92.0 | 80.2 | 82.7 | 97.4 | 107.8 | 11.6 |
| Net borrowing | -1.8 | -1.6 | -1.8 | -3.3 | -4.5 | -3.7 | -2.0 |

| Sustainability gap | S1* | S2** |
|---|---|---|
| Programme scenario | -0.7 | -0.7 |
| 2003 position scenario | 1.1 | 1.3 |

* S1 measures the difference between the current tax ratio and the tax ratio that would ensure a debt level in 2050 as resulting from a balance budget position over the projection period. A positive sustainability gap indicates that there is a financing gap to reach this debt level in 2050. P.m. debt to GDP ratio at the end of the period: 25.2%

** S2 indicates the change needed in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.

According to the quantitative indicators, the sustainability of public finances in Italy is at risk. If a close to balance position were achieved at the end of the program period through an improvement of the cyclically adjusted primary balance and the primary surplus were to remain high over the next 20 years (at least above 4% of GDP), the gross debt would be run down at a fast pace. However, if Italy fails to consolidate, the "2003 scenario" shows that the debt to GDP ratio would not fall below 60% and after a slight

decrease it would start increasing again, once the impact of ageing takes fully place. At the end of the projection period the debt ratio would still be at similar levels as those reached during the 1990s. A sustainability gap will therefore arise if consolidation does not take place in the next few years (see indicators S1 and S2 for the "2003 scenario" in Table 8).

### 5.2 Additional qualitative features

As underlined in the aforementioned EPC report of October 2003, several qualitative factors should be taken on board to avoid a mechanistic interpretation of the quantitative indicators. On the positive side, surveillance on long term trends has been strengthened through a detailed and accurate analysis of long term sustainability which includes sensitivity analysis. This kind of approach increases transparency on possible budgetary risks in the future. Furthermore, the Italian authorities are considering possible pension reforms to smooth the increase of pension expenditure during the peak years.

However, several factors warrant attention. First, the level of the debt to GDP ratio is well above 100% of GDP, hence still very distant from the Treaty reference value of 60%. In order to run it down, high primary surpluses are needed in the coming years. As recognised by the Italian authorities, a failure to do so will considerably deteriorate the long-term sustainability of public finances. Second, debt developments in recent years have been affected by debt-increasing financial operations. Should these continue, the foreseen rate of reduction of the debt to GDP ratio may be at risk. Third, the expected savings in education are questionable: as in other EU countries, education expenditure could even increase in the medium to long term to meet the higher demand for skilled workers and as an effect of some inertia in adjusting the cost structure. Fourth, the healthcare expenditure ratio is assumed to remain broadly constant until 2010, while it grew by around ¾ percentage point of GDP between 1999 and 2002. Fifth, the increase in the female participation rate is expected to accelerate significantly at the end of the projection period, from around 3 percentage points over the next 15 years to more than 10 percentage points between 2030 and 2050.

### 5.3 Overall assessment of sustainability

On the basis of current policies, there are risks of unsustainable public finances for Italy. The quantitative indicators run by the Commission services show that the debt to GDP ratio would fall steadily if the medium term deficit target were achieved through an increase of the cyclically adjusted primary balance, a high primary surplus were maintained over the next 20 years, savings in education materialised and the foreseen increase in female participation rates also materialized. These results must be interpreted with caution and, as stressed at the outset, should not be taken at face value. A less optimistic scenario over the medium term shows that debt to GDP ratios are unlikely to converge towards the Treaty requirement on debt.

The budgetary strategy outlined in the programme, mainly based on achieving and maintaining sustained primary surpluses to run down the debt before the impact of ageing takes place, if respected would be compatible with improving the sustainability of public finances. Moreover, a pension reform that goes in the direction of increasing participation rates among elderly people and correcting pension expenditure trends is envisaged. However, this conclusion needs to be qualified in the light of the risks attached to the programme's budgetary strategy, and to the broader public finance strategy of the government, which have been highlighted in this Assessment.

## ANNEX - SUMMARY TABLES FROM THE 2003 UPDATED STABILITY PROGRAMME

### Table A 0: Basic assumptions

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| **Euro area short-term interest rate (annual average)** | **2.2** | **2.5** | **3.3** | **3.9** | **4.2** |
| **Euro area long-term interest rate (annual average)** | **4.1** | **4.4** | **4.7** | **5.0** | **5.2** |
| USA: short-term (3-month money market) | 1.4 | 2.0 | 3.3 | 4.4 | 5.0 |
| USA: long term (10-year government bonds) | 4.4 | 4.8 | 5.2 | 5.5 | 5.7 |
| **US$/€exchange rate (annual average)** | **1.10** | **1.09** | **1.09** | **1.09** | **1.09** |
| World GDP growth rate | 3.2 | 4.0 | 4.2 | 4.1 | 4.1 |
| **World excluding EU, GDP growth** | **3.7** | **4.5** | **4.5** | **4.4** | **4.6** |
| USA GDP growth | 2.6 | 3.9 | 3.5 | 3.4 | 3.4 |
| Japan GDP growth | 2.0 | 1.4 | 1.2 | 1.3 | 1.3 |
| **EU-15 GDP growth** | **0.8** | **2.0** | **2.5** | **2.3** | **2.3** |
| **Growth relevant foreign markets** | **2.7** | **5.1** | **6.8** | **6.5** | **6.5** |
| **World import volumes, excluding EU** | **6.4** | **8.5** | **8.8** | **8.6** | **8.9** |
| World import prices (manufactured goods in USD) | -5.3 | 2.5 | 1.0 | 1.2 | 1.2 |
| **Oil prices (Brent USD/barrel)** | **27.6** | **25.0** | **25.0** | **25.0** | **25.0** |
| Non-oil commodities prices (in USD) | 9.4 | 2.7 | 0.2 | 0.2 | 0.2 |

### Table A 1. Growth and associated factors

| | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|
| **GDP growth at constant market prices (7+8+9)** | **0.4** | **0.5** | **1.9** | **2.2** | **2.5** | **2.6** |
| **GDP *level* at current market prices (€bn.)** | 1258 | 1300 | 1352 | 1407 | 1467 | 1530 |
| **GDP deflator** | 2.7 | 2.8 | 2.1 | 1.8 | 1.7 | 1.7 |
| HICP change | 2.6 | 2.8 | 1.8 | 1.5 | 1.4 | 1.4 |
| **Employment growth** [35] | **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 |
| Labour productivity growth [36] | -0.7 | -0.1 | 1.0 | 1.1 | 1.3 | 1.3 |
| **Sources of growth: percentage changes at constant prices** | | | | | | |
| **1. Household consumption expenditure** | **0.4** | **1.8** | **2.3** | **2.2** | **2.4** | **2.4** |
| **2. Government and NPISHs consumption expenditure** | **1.7** | **1.4** | **0.9** | **0.6** | **0.4** | **0.4** |
| **3. Gross fixed capital formation** | **0.5** | **-0.6** | **3.5** | **4.4** | **4.9** | **5.2** |
| **4. Changes in inventories and net acquisition of valuables** [37] | **0.4** | **0.3** | **0.2** | **0.0** | **0.0** | **0.1** |
| **5. Exports of goods and services** | **-1.0** | **-1.5** | **5.6** | **6.8** | **7.2** | **7.3** |
| **6. Imports of goods and services** | **1.5** | **2.0** | **7.4** | **7.2** | **7.4** | **7.6** |
| **Contribution to GDP growth** | | | | | | |
| **7. Final domestic demand** | **0.7** | **1.2** | **2.4** | **2.4** | **2.6** | **2.7** |
| **8. Change in inventories and net acquisition of valuables** | **0.4** | **0.3** | **0.2** | **0.0** | **0.0** | **0.1** |
| **9. External balance of G&S** | **-0.7** | **-1.0** | **-0.5** | **-0.2** | **-0.1** | **-0.2** |

[35] Full-time equivalent, national accounts.

[36] Growth of GDP at market constant prices per labour unit.

[37] Contribution to GDP growth.

## Table A 2. General government budgetary developments

| in % of GDP | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|
| **Net lending by sub-sectors** | | | | | | |
| **General government [38]** | **-2.3** | **-2.5** | **-2.2** | **-1.5** | **-0.7** | **0.0** |
| **Central government** | **-2.4** | **-2.3** | **-2.5** | **-2.9** | **-2.5** | **-2.1** |
| **State government** | | | | | | |
| **Local government** | **-0.6** | **-0.5** | **-0.6** | **-0.6** | **-0.5** | **-0.4** |
| **Social security funds** | **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** |
| **Budget balance [38]** | **-2.3** | **-2.5** | **-2.2** | **-1.5** | **-0.7** | **0.0** |
| **Interest expenditure** | **5.7** | **5.3** | **5.1** | **5.0** | **5.1** | **5.1** |
| **Primary balance [38]** | **3.4** | **2.8** | **2.9** | **3.5** | **4.4** | **5.1** |
| **Components of revenues** | | | | | | |
| Taxes | 28.8 | 28.1 | 28.2 | 28.4 | 28.4 | 28.2 |
| Social 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 | 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 expenditure** | | | | | | |
| 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 expenditure | 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[39] | 1.8 | 2.6 | 2.2 | 2.6 | 2.6 | 2.5 |
| Other | 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 |

## Table A 3. General government debt developments

| in % of GDP | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|
| **Gross debt level** | **106.7** | **106.0** | **105.0** | **103.0** | **100.9** | **98.6** |
| **Change in gross debt** | -2.8 | -0.7 | -1.0 | -2.0 | -2.1 | -2.3 |
| **Contributions to change in gross debt** | | | | | | |
| **Primary balance** | -3.4 | -2.8 | -2.9 | -3.5 | -4.4 | -5.1 |
| **Interest expenditure** | 5.7 | 5.3 | 5.1 | 5.0 | 5.1 | 5.1 |
| **Nominal GDP growth** | 3.1 | 3.3 | 4.0 | 4.1 | 4.2 | 4.3 |
| Other factors influencing the debt ratio | -2.0 | 0.1 | 0.8 | 0.6 | 1.4 | 2.0 |
| *of which: Privatisation receipts* | *-0.1* | *-0.3* | *-1.1* | *-1.1* | *-0.7* | *-0.7* |
| *p.m. implicit interest rate on debt* | *5.3* | *5.0* | *4.9* | *4.9* | *5.0* | *5.2* |

[38] Including "future measures" (+1.5% of GDP in 2005 of which 0.5% one-offs, +1.9% of GDP in 2006 and +2.2% of GDP in 2007).

[39] Includes sales of real assets.

### Table A 4. Cyclical developments

| in % of GDP | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|
| **GDP growth at constant prices** | **0.4** | **0.5** | **1.9** | **2.2** | **2.5** | **2.6** |
| **Actual balance** | **-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 GDP growth | 1.9 | 1.7 | 1.7 | 1.8 | 2.0 | 2.3 |
| Output gap | -0.3 | -1.5 | -1.3 | -0.9 | -0.5 | -0.1 |
| Cyclical budgetary component | -0.1 | -0.7 | -0.6 | -0.4 | -0.2 | -0.1 |
| Cyclically-adjusted balance | -2.2 | -1.9 | -1.6 | -1.1 | -0.5 | 0.1 |
| Cyclically-adjusted primary balance | 3.5 | 3.4 | 3.5 | 3.9 | 4.6 | 5.2 |

### Table A 5. Divergence from previous update

| in % of GDP | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| **GDP growth** | | | | | |
| **Previous update** | 0.6 | 2.3 | 2.9 | 3.0 | 3.0 |
| **Latest update** | 0.4 | 0.5 | 1.9 | 2.2 | 2.5 |
| **Difference** | -0.2 | -1.8 | -1.0 | -0.8 | -0.5 |
| **Actual budget balance** | | | | | |
| **Previous update** | -2.1 | -1.5 | -0.6 | -0.2 | 0.1 |
| **Latest update** | -2.3 | -2.5 | -2.2 | -1.5 | -0.7 |
| **Difference** | -0.2 | -1.0 | -1.6 | -1.3 | -0.8 |
| **Gross debt levels** | | | | | |
| **Previous update** | 109.4 | 105.0 | 100.4 | 98.4 | 96.4 |
| **Latest update** | 106.7 | 106.0 | 105.0 | 103.0 | 100.9 |
| **Difference** | -2.7 | 1.0 | 4.6 | 4.6 | 4.5 |

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

| in % of GDP | 2002 | 2005 | 2010 | 2020 | 2030 | 2040 | 2050 |
|---|---|---|---|---|---|---|---|
| Old age pensions [40] | 14.1 | 14.1 | 14.0 | 14.7 | 15.8 | 15.6 | 14.1 |
| Health care (including care for elderly) | 6.3 | 6.3 | 6.5 | 7.0 | 7.5 | 7.9 | 8.1 |
| Education | 4.9 | 4.7 | 4.5 | 4.3 | 4.1 | 4.2 | 4.2 |
| Unemployment benefits | 0.3 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 |
| Total | 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 |
| Participation rates males (aged 20-64) | 78.9 | 80.2 | 81.0 | 81.3 | 80.0 | 79.3 | 79.2 |
| Participation rates females (aged 20-64) | 50.8 | 53.4 | 54.8 | 56.4 | 60.5 | 67.4 | 71.0 |
| Total participation rates (aged 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 |

[40] Old age and seniority.