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DECEMBER 2004 UPDATE
OF THE STABILITY PROGRAMME OF ITALY
(2004-2008)
AN ASSESSMENT

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SUMMARY AND CONCLUSIONS[1]

The Italian authorities submitted the sixth update of the stability programme on 1 December 2004. The programme, covering the period from 2004 through 2008, partly complies with the code of conduct.[2]

The macroeconomic scenario presented in the programme portrays a gradual and domestic-demand-driven acceleration of economic activity up until 2006 when real GDP growth is expected to stabilise at around 2.3% per year. The scenario incorporates the information set available at around mid-year 2004. Developments emerging after the presentation of the medium term economic and financial framework (*Documento di programmazione economico-finanziaria – DPEF*) at the end of July 2004 are not reflected. As a result, the short-term growth assumption would appear to be somewhat favourable compared to the Commission 2004 autumn forecast. The same holds for the medium-term outlook. Based on Commission services calculations according to the commonly agreed methodology potential output growth is estimated at around 1¾ % per year as opposed to 1¼ % in the Commission 2004 autumn forecast.

The programme aims at gradually reducing the nominal budget deficit from an expected outturn of 2.9% of GDP in 2004, via a deficit target of 2.7% of GDP in 2005 to 0.9% of GDP in 2008. Hence, the programme does no longer target a medium term close to balance or in surplus position. Compared to the previous update the deficit figures are more than one percentage point higher and the planned adjustment is back-loaded against a somewhat less favourable macroeconomic scenario. However, since the cyclical conditions, as measured by the output gap, are almost unchanged the largest part of the revision of the deficit can be taken to be structural.

In cyclically-adjusted terms the budget balance is projected to improve by 1.1 percentage points over the programme period, with the bulk of the adjustment (0.5 percentage point) expected to take place in 2006. No improvement in cyclically-adjusted terms is expected in 2005.

The assessment of the stability programme highlights clear risks that the budgetary outcome could be worse than projected in the programme. The budgetary objectives are built upon a somewhat favourable macroeconomic outlook, especially in 2005. In parallel, there are several uncertainties

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[1] This technical analysis, which is based on information available up to 26 January 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 2 February 2005. It has been carried out by the staff of and under the responsibility of the Directorate-General for Economic and Financial Affairs of the European Commission. Comments should be sent to Martin Larch (martin.LARCH@cec.eu.int) or Lucia Piana (lucia.PIANA@cec.eu.int).

[2] For the years 2006 and beyond the programme does not detail the policy measures necessary to achieve the budgetary objectives as required by the Code of Conduct (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 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001). Only the size of the future fiscal corrections is indicated not its composition. Thus, the breakdown of the budget is not consistent with the budgetary targets presented in the programme. This hampers a complete assessment of the fiscal adjustment.

linked to the implementation of the 2005 budget including the classification of ANAS, the company in charge of road maintenance, as well as of a number of temporary revenue increasing measures. Further uncertainties refer to 2006, the year in which the largest improvement in cyclically-adjusted terms is projected to take place and when the Government plans to fully replace one-off measures with measures of a permanent nature. The programme does not provide information about how the adjustment is expected to be achieved. Given past experience, it cannot be excluded that in the years 2006 and beyond the gap between the unchanged legislation deficit and the deficit target presented in the programme underestimates the required fiscal consolidation.

Overall, the budgetary targets in the programme do not provide a sufficient safety margin against breaching the 3% of GDP threshold with normal cyclical fluctuations at least up until 2006. In view of the downside risks to the macroeconomic scenario as well as the risks attached to the implementation of the 2005 budget, additional measures may be required to achieve the nominal deficit target and, more specifically, to prevent the nominal deficit to exceed the 3% of GDP reference value in 2005. Additional measures may also be required in 2006 and beyond.

In 2004 the debt-to-GDP ratio, which still stands at 106%, is expected to decline only marginally in spite of significant privatisation proceeds. The virtual standstill compared to 2003 results from a slippage in the primary balance and significant debt increasing operations other than the deficit. The pace of debt reduction is expected to pick up again over the 2005-2008 period on the back of the projected improvement in the primary balance, an ambitious privatisation programme and the gradual acceleration of economic growth. However, the positive impact of the planned privatisation proceeds is largely offset by unspecified debt-increasing below-the-line operations. The debt-to-GDP ratio is projected to fall below the 100% threshold only in 2007, four years later than the 2003 deadline to which Italy had committed itself in 1998 with a view to the entry into the third stage of EMU.

The fiscal strategy in the programme is dominated by the need to significantly curb current primary expenditures in order to achieve fiscal consolidation and at the same time allow for a reduction of taxes. While officially expected to be deficit neutral, the 2005 tax reform risks having a negative effect on the budget balance. Similarly, the 2% cap on the annual increase in primary expenditure as well as a further revision of the internal stability pact are not entirely bolstered by credible enforcement mechanisms. The framework law on the pension reform adopted in 2004 is an important step towards addressing the budgetary consequences of aging population. A full implementation of the reform is expected to reduce expenditure by around 0.6-0.7% of GDP between 2011 and 2033 with the tightening of eligibility conditions scheduled to take effect only in 2008 taking the form of a sudden and sharp increase of the retirement age required for seniority pensions. The programme also includes a plan for the disposal of financial assets of on average 1.6% of GDP per year without however providing the relevant details. Finally, several budgetary measures produce a beneficial effect in the short run at the expense of gradually reversing the impact in the future.

With regard to the long-term sustainability of public finances, Italy appears to be at some risk. Conditional on the full implementation of the budgetary targets and the recently adopted pension reform, Italy would achieve a sustainable path. Hence, in view of the risks to the budgetary targets a prompt correction of any departure from the strategy of running large primary surpluses is instrumental to ensure the long-term sustainability of public finances.

The economic policies outlined in the update are partly consistent with the country-specific Broad Economic Policy Guidelines in the area of public finances. First, the programme does not envisage a medium-term close to balance or in surplus position. Second, the budgetary targets do not ensure an improvement in cyclically-adjusted terms of at least 0.5 percentage point per year. Third, in 2005 the planned tax cut is not fully financed through structural cuts in current primary expenditure. Finally, the programme does not provide sufficient information on how the mechanisms for strengthening expenditure control would work nor does it outline a clear source of financing regional expenditure.

In view of the above assessment it would be appropriate for Italy to (i) do the necessary to ensure the achievement of the 2005 deficit target, (ii) make the necessary effort in structural terms in 2006 and beyond to achieve a budgetary position of close to balance by the end of the period covered by the programme (iii) ensure that the debt-to-GDP ratio is declining towards the 60% of GDP Treaty reference value at a more rapid pace, paying particular attention to factor other than net borrowing which contribute to the change in debt levels.

Comparison of key macroeconomic and budgetary projections

		2004	2005	2006	2007	2008
Real GDP (% change)	**SP 2004**	**1.2**	**2.1**	**2.2**	**2.3**	**2.3**
	COM	1.3	1.8	1.8	-	-
	SP 2003	1.9	2.2	2.5	2.6	
HICP inflation (%)	**SP 2004**[1]	**2.2**	**1.6**	**1.5**	**1.4**	**1.4**
	COM	2.3	2.3	2.0	-	-
	SP 2003	1.8	1.5	1.4	1.4	-
General government balance (% of GDP)	**SP 2004**	**-2.9**	**-2.7**	**-2.0**	**-1.4**	**-0.9**
	COM	-3.0	-3.0	-3.6	-	-
	SP 2003	-2.2	-1.5	-0.7	0.0	-
Primary balance (% of GDP)	**SP 2004**	**2.4**	**2.4**	**3.3**	**4.0**	**4.7**
	COM	2.0	2.1	1.5	-	-
	SP 2003	2.9	3.5	4.4	5.1	-
Cyclically-adjusted balance (% of GDP)	**SP 2004**[2]	**-2.1**	**-2.1**	**-1.6**	**-1.2**	**-1.0**
	COM	-2.4	-2.6	-3.4	-	-
	SP 2003[2]	-1.6	-1.0	-0.4	0.1	-
Government gross debt (% of GDP)	**SP 2004**	**106.0**	**104.1**	**101.9**	**99.2**	**98.0**
	COM	106.0	104.6	104.4	-	-
	SP 2003	105.0	103.0	100.9	98.6	-

Note:
[1] *Planned inflation from 2005 onwards.*
[2] *Commission services calculations on the basis of the information in the programme.*

Sources:
Stability programme (SP); Commission services autumn 2004 economic forecasts (COM); Commission services calculations

1. INTRODUCTION

The Italian authorities submitted the sixth update of the stability programme in the original language on 1 December 2004. The programme covers the period from 2004 through 2008.

In Italy the programme is edited by the Ministry of the Economy and Finance. It is not adopted by the Government and is presented to the Parliament for information only. The macroeconomic projections and fiscal targets presented in the programme must not deviate from those adopted by the Government and the Parliament in the context of the national budgetary process. Specifically, the programme refers to projections and targets announced in the updated medium-term economic and financial framework (*Documento di programmazione economico-finanziaria – DPEF*), generally presented at the end of June of each year and successively updated at the end of September in connection with the presentation of the draft budget law.

The programme partly complies with the data requirements of the code of conduct.[3] Specifically, for the years 2006 and beyond the programme does not detail the policy measures necessary to achieve the budgetary objectives as required by the Code of Conduct. Only the size of the future fiscal correction is indicated not its composition. Thus, the breakdown of the budget is not consistent with the budgetary targets presented in the programme. This hampers a complete assessment of the budgetary strategy.

2. MACROECONOMIC DEVELOPMENTS

The macroeconomic scenario in the programme is the one presented in the updated DPEF of 29 September 2004, which in turn confirmed the outlook delineated two months earlier in the DPEF of 31 July 2004. It assumes an accelerating profile of economic growth up until 2006 followed by a stabilisation at around 2.3% per year, i.e. well above the average observed over the past 15 years of 1.4% per annum. Domestic demand is expected to be the main driver of growth supplemented by a modest but persistent contribution from stock-building. The external side is projected to act as a drag throughout the programme period reflecting the persistent problem of Italian exporters to compete on foreign markets.

The economic growth projection is said to incorporate the effects of the 2005 tax cut adopted by the Government at the end of November 2004. The effect is estimated at 0.2 percentage point per year and the expected feedback on government revenues is part of the financing of the 2005 tax cut. The size of the growth effect would seem to be on the high side taking into consideration that (i) the tax cut is only 0.4-0.5 percentage point of GDP and (ii) it is chiefly financed by higher revenues.

[3] 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 27.06.2001 endorsed by the ECOFIN Council of 10.07.2001.

Table 1: Comparison of macroeconomic developments and forecasts

	2004		2005		2006		2007	2008
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	1.3	1.2	1.8	2.1	1.8	2.2	2.3	2.3
Contributions:								
- Final domestic demand	1.8	1.5	1.8	2.1	1.9	2.4	2.5	2.5
- Change in inventories	-0.4	-0.2	0.1	0.2	0.0	0.1	0.1	0.1
- External balance on g&s	-0.2	-0.1	-0.1	-0.2	-0.1	-0.3	-0.3	-0.3
Employment (% change)	0.8	0.6	0.7	0.9	0.6	1.0	0.9	1.0
Unemployment rate (%)	8.1	8.1	7.9	7.6	7.8	7.1	6.8	6.6
HICP inflation (%)	2.3	2.2	2.3	1.6	2.0	1.5	1.4	1.4
GDP deflator (% change)	2.9	2.9	2.3	2.3	2.1	2.2	2.1	2.1
Current account (% of GDP)	-1.0	-	-0.9	-	-0.7	-	-	-

Sources:
Commission services autumn 2004 economic forecasts (COM); stability programme (SP)

As to the external assumptions, the macroeconomic scenario is embedded in a gradual slowdown of global trade and economic growth over the programme period in line with the set of common external assumptions provided by the Commission.[4] Only the assumption for the price of oil is decidedly on the optimistic side compared to both current levels and the common external assumptions. The large difference is acknowledged in the programme and justified by the specificity of the national budgetary process according to which an update compared to the *DPEF* - generally released in June of each year - would have to go through Parliament. However, the government has the possibility to change the scenario when presenting the draft budget at the end of September via the *update of the DPEF (aggiornamento al DPEF)*. It did not do so in 2004. The macroeconomic scenario of the *DPEF* of July 2004 was explicitly confirmed in the *update of the DPEF* at the end September 2004.

Table 2: Sources of potential output growth

	2004		2005		2006		2007	2008
	COM	SP	COM	SP[3]	COM	SP[3]	SP[3]	SP[3]
Potential GDP growth[1]	1.5	1.7	1.2	1.6	1.3	1.8	1.7	1.7
Contributions:								
- Labour	0.8	0.8	0.4	0.6	0.4	0.7	0.5	0.4
- Capital accumulation	0.7	0.7	0.7	0.7	0.7	0.7	0.8	0.8
- TFP	0.1	0.2	0.1	0.3	0.2	0.4	0.5	0.5
Output gap[1,2]	-1.5	-1.7	-0.7	-1.3	-0.5	-0.9	-0.3	0.2

Notes:
[1]Based on the production function method for calculating potential output growth
[2]In percent of potential GDP
[3]Commission services calculations on the basis of the information in the stability programme update (SP)
Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

[4] In accordance with the code of conduct the Commission provides a set of assumption for the main extra-EU variables. Member States should endeavour to use either the common assumption or present sensitivity analysis based on the common assumptions where differences are significant.

Overall, the programme features a somewhat favourable macroeconomic outlook. In particular, the current economic recovery is expected to accelerate more strongly and to extend further into 2005 than in the Commission services autumn 2004 forecast. As to the medium term, the data presented in the programme imply a rate of potential output growth which essentially stays at around 1¾ % over the programme period.[5] This compares with a more cautious estimate of 1¼ % of the Commission services autumn 2004 forecast.

3. BUDGETARY IMPLEMENTATION IN 2004

In the stability programme update of November 2003, the budgetary target for 2004 was a deficit of 2.2% of GDP. The target was revised in May 2004 to 2.9% and confirmed in the programme.

The revision was triggered by increasing awareness of the risk of breaching the 3% of GDP reference value. In April, the Commission services spring 2004 forecast projected that in the absence of additional measures the 2004 deficit would reach 3.2% of GDP. At the ECOFIN Council of May the Italian Government made the commitment to implement additional corrections of a permanent nature to keep the deficit below the 3% of GDP reference value. The commitment was confirmed at the ECOFIN Council of 5 July, when Italy also provided an outline of the additional budgetary corrections. As a result, the Council decided not to vote the Commission recommendation for an early warning to Italy. In mid-July, the Italian Government eventually adopted the additional corrective measures officially estimated at € 7.6 billion (0.6% of GDP). They consisted of additional revenues and expenditure savings of € 5.5 billion and of administrative measures of around € 2 billion. The first part took immediately effect in July. The administrative measures were adopted on 26 November taking the form of a decree law. In contrast with the commitment of 5 July, the administrative measures were only partly structural. Moreover, they largely consist of advances by the financial sector on 2005 tax collections. The question is whether those advances can be classified as 2004 revenues or simply as a debt increasing loan from the financial to the government sector. Finally, the decree law of 26 November also impacts on the size of the fiscal correction of the 2004 budget by postponing expected revenues to 2005, without saying how the revenue shortfall in 2004 will be compensated.[6]

The Commission services autumn 2004 forecast projects a deficit of 3.0% of GDP in 2004. Netting out the cyclical effects the deficit is expected by the Commission to be at 2.4% of GDP as compared to 1.6% of GDP in the 2003 update of the stability programme. According to the

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[5] Based on the Commission services calculations according to the commonly agreed methodology. The Commission calculations give slightly different results compared to the figures presented in the programme (potential output growth is 0.2 percentage point lower in 2008) due to different employment data. The Italian authorities use the results of the new labour force survey released by the national institute of statistics (ISTAT) in 2004. By contrast, the Commission services use EUROSTAT figures which do not yet incorporate the results of the new labour force survey.

[6] The 2004 budget included around €3.1 billion of temporary revenues from the amnesty of zoning code violations. The decree law determines that two out of the three instalments foreseen by the amnesty will be collected and recorded in 2005 instead of 2004 and that the corresponding amount of € 2.2 billion is allocated to a special fund. On the basis of this change, the 2005 budget draws on this special fund to finance part of the tax cut in 2005.

analysis carried out by the Commission the divergence of 0.8 percentage point is explained by two different factors (i) an overestimation of potential output accounting for 0.4 percentage point, of which 0.3 percentage point had already been expected in the Commission services autumn 2003 forecast, and (ii) a slippage in the implementation of the 2004 budget of around 0.4% of GDP, of which 0.3 percentage point had also been anticipated in the Commission services autumn 2003 forecast.

A further risk to the deficit outcome in 2004, not incorporated in the Commission services forecast, stems from uncertainties attached to the outturn of a disposal of real estate. By the end of 2004 only € 3.3 billion out of the officially planned € 6.5 billion had been realised through a sale and lease back operation. Moreover, there are uncertainties concerning the statistical classification of the operation.

4. BUDGETARY TARGETS AND THE MEDIUM-TERM PATH OF THE PUBLIC FINANCES

4.1. Evolution of budgetary targets in successive programmes

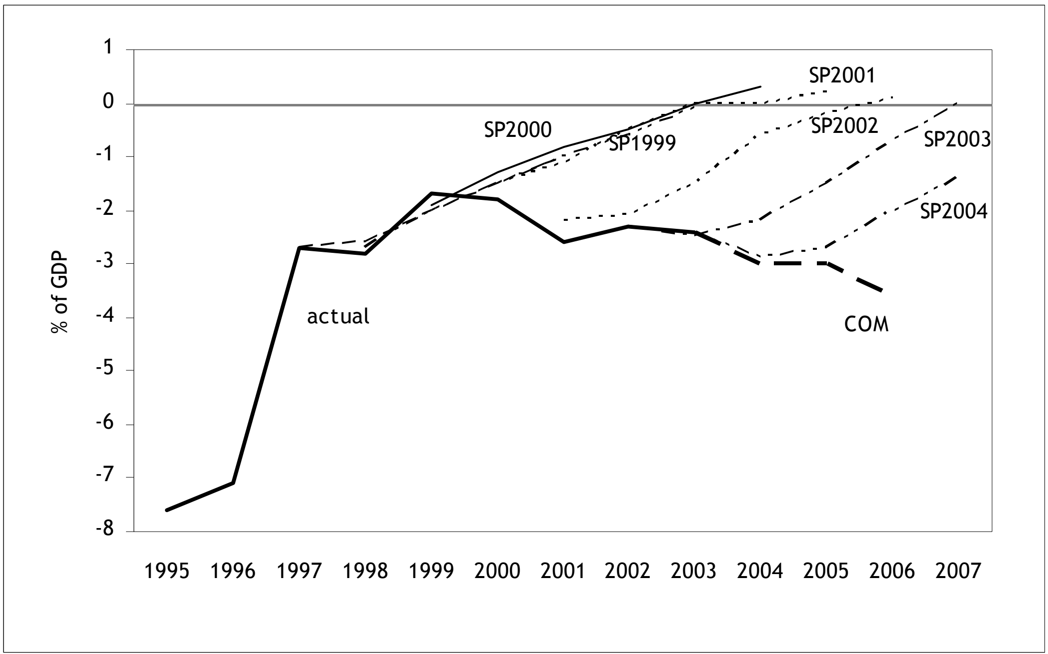
The budgetary targets in the programme involve a significant revision compared to the previous two updates. The nominal deficit figures for the 2005-2008 period are now planned to be more than one full percentage point higher than in 2003 update. The revision exceeds two percentage points of GDP when compared to the 2002 update. A large part of the revision can be taken to be structural, since the cyclical conditions, as measured by the output gap, only explain at most half a percentage point.

Table 3: Evolution of budgetary targets in successive programmes

		2003	2004	2005	2006	2007	2008
General government balance (% of GDP)	**SP November 2004**	**-2.4**	**-2.9**	**-2.7**	**-2.0**	**-1.4**	**-0.9**
	SP November 2003	-2.5	-2.2	-1.5	-0.7	0.0	-
	SP November 2002	*-1.5*	*-0.6*	*-0.2*	*0.1*	-	-
General government expenditure (% of GDP)	**SP November 2004**	**48.9**	**48.5**	**47.5**	**47.6**	**47.1**	**46.7**
	SP November 2003	48.4	47.3	47.6	47.0	46.2	-
	SP November 2002	47.6	47.1	46.3	45.4	-	-
General government revenues (% of GDP)	**SP November 2004**	**46.4**	**45.6**	**44.8**	**44.4**	**44.1**	**43.9**
	SP November 2003	45.8	45.1	44.6	44.4	44.0	-
	SP November 2002	46.1	44.9	44.8	44.6	-	-
Net impact of future measures (% of GDP)	**SP November 2004**	**-**	**-**	**-**	**1.3**	**1.6**	**1.9**
	SP November 2003	-	-	1.5	1.9	2.2	-
	SP November 2002	-	1.6	1.4	0.8	-	-
Real GDP (% change)	**SP November 2004**	**0.3**	**1.2**	**2.1**	**2.2**	**2.3**	**2.3**
	SP November 2003	0.5	1.9	2.2	2.5	2.6	-
	SP November 2002	2.3	2.9	3.0	3.0	-	-
Sources: *Stability programmes (SP)*							

Looking further back in time, there has been a consistent degree of optimism concerning the medium-term budgetary targets. Since 1999 the actual budgetary outturn has constantly and significantly diverged from the improving path targeted in the successive programmes, reflecting both optimistic economic growth assumptions and budgetary slippages (see graph 1). For instance, the budgetary target for 2004 presented in the 2000 updated stability programme was a surplus of 0.3% of GDP compared to the Commission services autumn 2004 forecast of a deficit of 3.0% of GDP.

Graph 1: Deficit targets in the successive stability programmes



4.2. Budgetary targets in the updated programme

The programme confirms the budgetary targets presented in the updated medium-term economic and financial framework (*aggiornamento al DPEF*) of 29 September 2004. It aims at gradually reducing the nominal budget deficit by 2 percentage points, from an expected outturn of 2.9% of GDP in 2004 to 0.9% of GDP in 2008. Hence, the 2004 update does not target a close to balance or in surplus position at the end of the programme period.

Almost one percentage point of the targeted improvement between 2004 and 2008 is expected to come from the projected cyclical recovery, implying a reduction of the cyclically-adjusted deficit of 1.1 percentage points in four years. The improvement of the primary balance net of cyclical factors is slightly higher, 1.4 percentage points, due to the expected increase in interest payments. Focusing on the budget net of one-off measures based on Commission estimates, the projected improvement in the cyclically-adjusted primary balance would amount to 2½ % of GDP in four years.

Concerning the time profile of the fiscal consolidation, it is largely concentrated in 2006 when the government also plans to fully replace temporary measures with measures of a permanent nature. Specifically, the primary surplus net of cyclical factors is projected to marginally decline in 2005 and to improve by 0.7 percentage point of GDP in 2006.

Table 4: Composition of the budgetary adjustment net of tax cuts

(% of GDP)	2003	2004	2005	2006	2007	2008	Change: 2008-2004
Revenues	**46.5**	**45.6**	**44.8**	**44.4**	**44.1**	**43.9**	**-1.7**
of which:							
- Taxes & social security contributions	41.4	41.4	41.2	41.0	40.6	40.6	-0.8
- Other (residual)	5.0	4.2	3.6	3.4	3.5	3.3	-0.9
Expenditure	**48.9**	**48.5**	**47.5**	**47.6**	**47.1**	**46.7**	**-1.8**
of which:							
- Primary expenditure	43.6	43.2	42.4	42.3	41.7	41.1	-2.1
of which:							
Gross fixed capital formation	2.6	2.3	2.1	2.5	2.4	2.4	0.1
Collective consumption	7.4	7.2	7.0	6.9	6.9	6.9	-0.3
Social transfers in kind	12.1	12.4	12.0	11.8	11.5	11.3	-1.1
Social transfers other than in kind & subsidies	18.3	18.4	18.2	18.1	18.0	17.9	-0.5
Other (residual)	3.1	2.9	3.0	3.0	2.9	2.6	-0.3
- Interest payments	5.3	5.3	5.1	5.3	5.4	5.6	0.3
Net impact of future measures				**1.3**	**1.6**	**1.9**	**1.9**
Budget balance	**-2.4**	**-2.9**	**-2.7**	**-2.0**	**-1.4**	**-0.9**	**2.0**
Primary balance	**2.9**	**2.4**	**2.4**	**3.3**	**4.0**	**4.7**	**2.3**
Sources:							
Stability programme update; Commission services calculations							

As in previous updates, the composition of the fiscal adjustment is detailed only for the year for which the measures are specified in the budget, namely, 2005. The future measures required to achieve the budgetary targets in 2006 through 2008 are not detailed; only the size is given. The breakdown of the budget reflects the unchanged legislation scenario and hence is not consistent with the budgetary targets. This makes it difficult to determine whether the correction takes place on the expenditure and/or the revenue side of the budget and hampers the assessment of the path and composition of the adjustment. Estimates for the measures on the government's agenda beyond 2005 would have been desirable, also in the light of the fact that the bulk of the adjustment is planned to take place in 2006.

In 2005, the budget law aims at bridging the gap between the unchanged legislation deficit estimated at 4.4% of GDP and the target of 2.7% of GDP through a correction of around € 24 billion. In parallel, the Government plans to implement a deficit neutral tax cut of around 0.4% of GDP. Hence, the total fiscal package for 2005 amounts to more than 2¼ % of GDP. A detailed description, of the 2005 budget is given in Box 1 below. As a general point, the fragmented presentation of the 2005 budget as well as amendments to the 2004 budget producing repercussions on 2005 adopted after the submission of the programme hamper the assessment of the budgetary developments.

Table 5: Output gaps and cyclically-adjusted (primary) balances (CA(P)B)

	2003		2004		2005		2006		2007	2008	Change: 2008-2004
	COM	SP	COM	SP	COM	SP	COM	SP[4]	SP[4]	SP[4]	SP[4]
Budget balance[2]	-2.4	-2.4	**-3.0**	-2.9	**-3.0**	-2.7	-3.6	-2.0	-1.4	-0.9	2.0
Output gap[1,3]	-1.2	-1.2	**-1.5**	-1.7	**-0.9**	-1.3	-0.5	-0.9	-0.3	0.2	1.9
CAB[1,2]	-1.9	-1.9	**-2.4**	-2.1	**-2.6**	-2.1	-3.4	-1.6	-1.2	-1.0	1.1
CAPB[1,2]	3.4	3.4	**2.6**	3.2	**2.5**	3.0	1.8	3.7	4.2	4.6	1.4

Notes:
[1]SP (stability programme): Commission services calculations on the basis of the information in the programme
[2]In percent of GDP
[3]In percent of potential GDP
[4]Including the net impact of unspecified future measures amounting to 1.3% of GDP in 2006, 1.6% in 2007 and 1.9% in 2008.

Sources:
Commission services autumn 2004 economic forecasts (COM); Commission services calculations

Nevertheless, in the light of the available evidence and of past experience, the 2005 deficit risks to turn out higher than targeted in the programme. To begin with, the budgetary objective is predicated on a somewhat favourable macroeconomic outlook. Taking the Commission services autumn 2004 forecast as a reference, the budgetary risk attached to economic growth amounts to one decimal point of GDP. Although the downside risk to the economic growth scenario may not involve a dramatic shortfall it is still important as the nominal budgetary target for 2005 is close to the 3% of GDP reference value. Moreover, national accounts data up until the third quarter of 2004 show an export led recovery and much weaker than expected domestic demand. If this pattern continues in 2005 the tax content of growth could turn out lower than projected. The second element of risk worth 0.2 percentage point of GDP refers to the classification of ANAS, the public company in charge of road maintenance. At this stage it seems unlikely that ANAS will meet the ESA95 conditions to qualify as part of the private sector in 2005.7 These two elements, economic growth and ANAS, alone are already sufficient to bring the deficit ratio at the 3% of GDP reference value.

On top of that there are risks attached to the implementation of the budget, especially in view of the fact that the original draft adopted by the Government at the end of September was somewhat softened in Parliament.8 Moreover, a very large part of the budgetary correction (around 0.6% of

7 EUROSTAT will take a decision on the issue on the basis of the first EDP notification following the closure of the respective financial year i.e. in March 2006.

8 Three modifications to the original draft budget are worth to be mentioned: (i) expenditures of small municipalities have been excluded from the 2% ceiling on the annual nominal increase in primary expenditures, (ii) the recruitment freeze at the local and the regional level was lifted; (iii) the broadening of the tax base of self-employed has been limited. Moreover, a high Commission in charge of monitoring the implementation of the 2% cap, which had been introduced during the parliamentary works, was subsequently removed.

Box 1: The budget for 2005

The 2005 budget has gone through significant changes between its adoption by the government on 29 September and its approval by Parliament at the end of December. Consequently, the information provided in the programme does not portray the final picture. The many amendments only affected the composition of the budget. The aggregate deficit target of 2.7% of GDP remained unchanged compared to the update of the medium term economic and financial framework (*aggiornamento al DPEF*).

The original draft budget law presented at the end of September projected a correction of € 24 billion (1.7% of GDP) bridging the gap between the unchanged legislation deficit estimated at 4.4% of GDP and the deficit target of 2.7% of GDP. The largest contribution to the correction, namely 0.7%, is expected to come from expenditure savings, including a new 2% ceiling on the annual nominal increase of primary expenditure excluding pensions and transfers to the EU. The expenditure cuts were supplemented by 0.5% of GDP of additional revenues and by another 0.5% of GDP of new one-off measures, mainly sales of roads and sale and lease back operations.

Following a long political struggle among the coalition parties, on 26 November the government eventually adopted a tax cut together with additional expenditures. The measures were presented as an amendment to the original budget plan. The budgetary impact in 2005 of 0.4% of GDP (€ 4.3 billion for the tax cut and of € 0.7 billion for higher expenditure) are projected to be financed as follows: (i) additional expenditure savings of around 0.14 % of GDP, (ii) higher revenues in the order of 0.2% of GDP including one-off receipts originally recorded in the 2004 budget, (iii) self-financing through the feedback on higher growth and higher revenues of around 0.05% of GDP.

Mid-December the government adopted a further major amendment to the draft budget (*maxi-emendamento*) integrating the previously staged tax cuts and foreseeing further additional expenditures, covered by additional revenues, of around € 2 billion. The budget was eventually approved by Parliament on 29 December 2004.

Regrettably, the programme does not provide an integrated view of the composition of the overall 2005 fiscal package. The presentation is in two different parts. First, there is a breakdown into expenditure and revenue components of the budgetary correction as it was portrayed in the draft budget presented to Parliament at the end of September when there was still no agreement on the tax cut. Second, the programme provides a separate yet less detailed description of the tax cut as adopted by the Government on 26 November, 4 days before the presentation of the programme. This kind of segmented presentation hampers a thorough assessment of the budget. Moreover, the programme does not include the effects of the so called *maxi-amendment* to the draft 2005 budget adopted mid-December.

Based on the information provided in the programme, the 2005 fiscal package net of tax cuts is expected to leave the primary balance unchanged compared to 2004, as total revenues and primary expenditure are both planned to decrease by 0.8 percent of GDP. On the expenditure side the largest contribution is expected to come from social transfers in kind, mostly healthcare, followed by collective consumption and social benefits other than in kind. The projected decline in gross fixed capital formation essentially reflects the classification of ANAS, the public company in charge of road maintenance, outside the government sector. The expected improvement in the overall budget balance to -2.7% of GDP in 2005 from -2.9% of GDP in 2004 reflects the projected decline in interest payments. Based on Commission calculations the impact of one-off measures in 2005 is expected to decline to ¾ percentage point, down from 1 ½ percentage points in 2004.

GDP) is expected to come from savings on healthcare expenditure and collective consumption, two items which in the past several years have shown a considerable downward rigidity giving rise to regular overruns compared to plans. The degree of ambition is further heightened by the additional expenditure savings foreseen to cover part of the 2005 tax cuts.

Further elements of risk attached to the implementation of the 2005 budget refer to one-off measures. First, there are uncertainties about the outturn of the amnesty of zoning code violations officially estimated to yield € 2.2 billion. Second, the Government plans to sell state roads to Infrastrutture SPA, a state owned enterprise classified outside the general government sector. However, subject to EUROSTAT's assessment of the operation, Infrastrutture SPA may loose its status of 'market company' producing a deficit increasing effect. Third, there is a possibility that EUROSTAT may raise doubts about the deficit reducing impact of a sale and lease back operation of government office buildings projected to yield € 4 billion.

As regards the years 2006 through 2008, the size of the fiscal correction bridging the gap between the unchanged legislation deficit and the deficit target is likely to be underestimated. As in the past, projections for gross fixed capital formation presented in the programme do not include expenditure on ongoing investment projects the formal allocation of which requires legislation to be passed in the future. Similarly, unchanged legislation projections do not take into account future wage increases. Moreover, the breakdown of the unchanged legislation budget (see Table 4) shows a declining trend in social transfers in kind (chiefly expenditure for healthcare and education) expressed in percent of GDP. This sharply contrasts with past experience.

On the whole, the balance of risk would seem to be towards higher than officially targeted deficits throughout the programme period.

The analysis of the fiscal strategy for the 2005-2008 period supports the following conclusions: (i) the reliance on temporary measures against the background of permanently lower growth over the past several years has produced a significant backlog of fiscal consolidation as the gap between structural revenues and expenditures has continued to increase; even if fully implemented, the incisive budgetary correction planned in 2005 merely prevents a worsening of the fiscal position; (ii) in spite of the important size of the fiscal packages envisaged throughout the programme period, the deficit targets do not provide a sufficient safety margin against breaching the 3% of GDP threshold with normal cyclical fluctuations at least up until 2006; (iii) additional measures are likely to be required to achieve the nominal deficit targets *inter alia* in view of the downside risks to the macroeconomic scenario; in particular, there is a risk of breaching the 3% of GDP reference value in 2005; (iv) in contrast with the country specific BEPGs in the area of public finance the programme does neither target a close to balance or in surplus position over the planned time horizon nor ensure an improvement in the cyclically-adjusted budget balance by at least 0.5 percent point per year; (v) also in contrast with the country-specific BEPGs, in 2005 the tax cut is not to fully financed through structural cuts in current primary expenditure.

5. SENSITIVITY ANALYSIS

The programme examines the budgetary impact of two alternative growth scenarios, which assume that over the 2005-2008 period, annual GDP growth is either permanently lower or higher than the baseline by 0.5 percentage points each year.

The low growth scenario is very close to the Commission services autumn 2004 forecast. It features Brent oil at around US$ 40 per barrel over the next 3 years and real GDP growth of around 1.8% per year in the medium term as opposed to 2.3% in the central scenario. In case the low growth scenario materialised, the cyclically-adjusted deficit would remain well above the safety margin (estimated at 1.5% of GDP) against breaching the 3% of GDP deficit threshold up until 2007.

This conclusion is confirmed by a simulation carried out by the Commission services. Assuming (i) a sustained 0.5 percentage point deviation from the growth targets in the programme over the 2004-2008 period; (ii) trend output based on the HP-filter; and (iii) no policy response i.e. notably, the expenditure level is as in the central scenario the simulation reveals that by 2008, in the case of persistently lower growth the cyclically-adjusted budget balance would be 0.8 percentage point lower than in the central scenario. Hence, additional measures of that size would be necessary to keep the public finances on the path targeted in the central scenario.

Overall, taking into account the conclusions reached in Section 2 above, namely that the risks to the macroeconomic framework of the programme are mainly to the downside, and considering that the Commission services' own growth projections are pretty much in line with the simulated low growth scenario in the programme, the achievement of the budgetary targets would require a greater fiscal effort than envisaged in the programme.

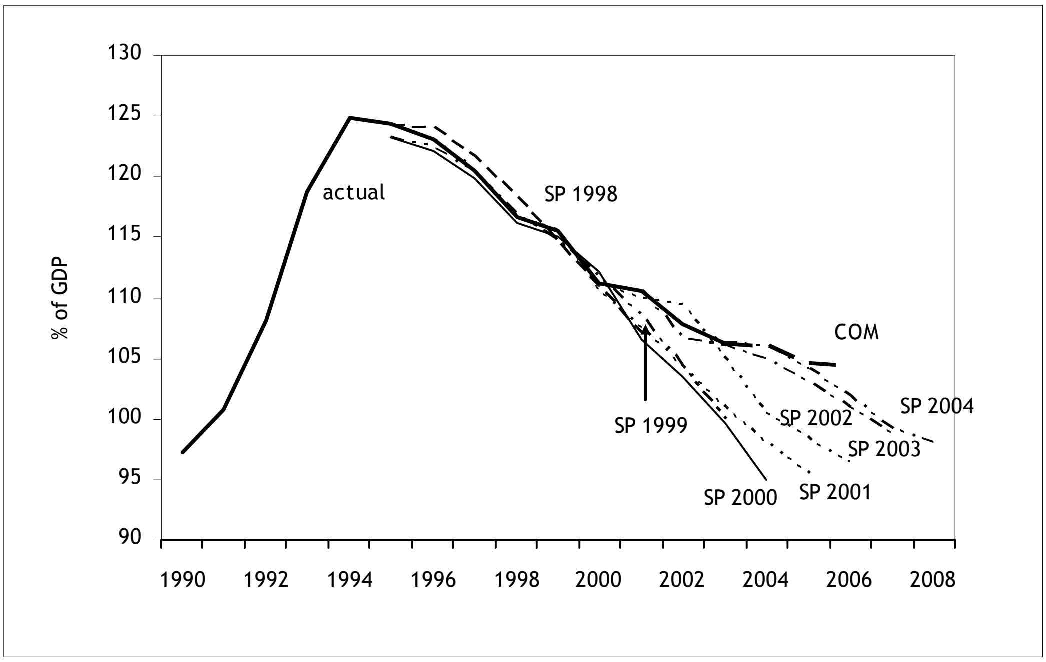
The programme also provides an analysis of the sensitivity of interest expenditure as a percentage of GDP to changes in interest rates. An upward/downward shift in the entire yield curve by one percentage point over the period is assessed to determine a marginally lower sensitivity in the entire programme period compared to the previous update, reflecting the increased average maturity of the debt.

6. EVOLUTION OF THE DEBT RATIO

The slowdown of the pace of debt reduction and the consistent departure from the path presented in the successive stability programmes observed since the year 2000 (see graph 2) continued in 2004. According to the programme as well as to the Commission services autumn 2004 forecast the debt-to-GDP ratio is expected to decline by merely 0.2 percentage points to 106%, as opposed to a projection of 105% of GDP in the 2003 update, in spite of privatisation proceeds totalling 0.6% of GDP and nominal GDP growth essentially in line with official projections.

Apart from the slippage in the primary surplus (2.4% instead of 2.9% of GDP) the virtual standstill of the debt-to-GDP ratio in 2004 is largely explained by the high levels of the cash borrowing requirement (*fabbisogno*), which has always exceeded the Maastricht definition of general government deficit over the past several years (see Box 2 for a more detailed presentation). In 2004, the difference was officially estimated at over 2% of GDP.[9] In the light of the better than expected borrowing requirement of the state sector released on 3 January 2005, the difference between the cash borrowing requirement and the Maastricht deficit could be lower.

Graph 2: Path of debt reduction in the successive stability programmes



From 2005 onwards the pace of debt reduction is projected to accelerate again chiefly thanks to an ambitious privatisation programme coupled with the targeted increase in the primary surplus from 2006 onwards and a revival of economic growth. The debt-to-GDP ratio is expected to fall below the 100% threshold by 2007, four years later than the 2003 deadline to which Italy had committed itself in 1998 with a view to its entry into the third stage of EMU. Over the whole programme period, the debt ratio is projected to decrease by a cumulative 8 percentage points of GDP.

A more rapid pace of debt reduction is hampered by debt increasing below-the-line operations amounting to more than 2 percentage points of GDP on average per year, confirming that the pattern observed over the past several years is projected to continue in the future (see Box 2). This can be inferred from the fact, that the stock-flow adjustment is expected to remain positive in spite of the ambitious privatisations plans.

In the years overlapping with the programme period (2004-2006), the Commission services autumn 2004 forecast projects a somewhat slower pace of debt reduction than the 2004 update, largely due to a more cautious outlook for nominal growth and the unchanged legislation assumption for the primary balance in 2006.

[9] Based on the information presented in the Quarterly report of cash accounts (*Relazione Trimestrale di Cassa*) presented on 7 May 2004.

Table 6: Debt dynamics

	average 2000-2003	2004		2005		2006		2007	2008
		COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	**109.0**	**106.0**	**106.0**	**104.6**	**104.1**	**104.4**	**101.9**	**99.2**	**98.0**
Change in debt ratio (1 = 2+3+4)	-2.3	-0.2	-0.2	-1.4	-1.9	-0.2	-2.2	-2.7	-1.2
Contributions:									
- **Primary balance** (2)	**-4.0**	**-2.0**	**-2.4**	**-2.1**	**-2.4**	**-1.5**	**-3.3**	**-4.0**	**-4.7**
- **"Snow-ball" effect** (3)	**1.6**	**0.8**	**1.2**	**0.9**	**0.6**	**1.3**	**0.9**	**1.1**	**1.4**
- Interest expenditure	6.0	5.0	5.3	5.0	5.1	5.2	5.3	5.4	5.6
- Real GDP growth	-1.5	-1.3	-1.2	-1.8	-2.1	-1.8	-2.2	-2.2	-2.2
- Inflation (GDP deflator)	-2.9	-3.0	-2.9	-2.3	-2.4	-2.1	-2.3	-2.1	-2.0
- **Stock-flow adjustment** (4)	**0.1**	**1.0**	**1.0**	**-0.2**	**-0.1**	**0.1**	**0.2**	**0.2**	**2.1**
- Cash/accruals	0.6				0.9		1.0	1.1	
- Accumulation of financial assets	0.0				-1.1		-0.9	-0.9	
of which: Privatisation proceeds	-0.6	-0.7	-1.4	-2.1	-2.1	-2.0	-2.0	-1.9	-0.6
- Valuation effects & residual adj.	-0.5				0.0		0.1	0.1	

Note:
The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{PD_t}{Y_t}+\left(\frac{D_{t-1}}{Y_{t-1}}*\frac{i_t-y_t}{1+y_t}\right)+\frac{SF_t}{Y_t}$$

where t is a time subscript; D, PD, Y and SF are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and i and y represent the average cost of debt and nominal GDP growth. The term in parentheses represents the "snow-ball" effect.

Sources:

Stability programme update (SP); Commission services autumn 2004 economic forecasts (COM); Ministry of the Economy and Finance; ECFIN calculations

A tentative assessment of the pace of debt reduction is presented in graph 3. It compares historical data and data in the programme with two *alternative* paths obtained by applying an illustrative "rolling debt reduction rule" [10]. This rule describes a minimum reduction over a number of years;

[10] The "rolling debt reduction rule" in the graph is shown for successive five-year periods through a recursive application of the formula:

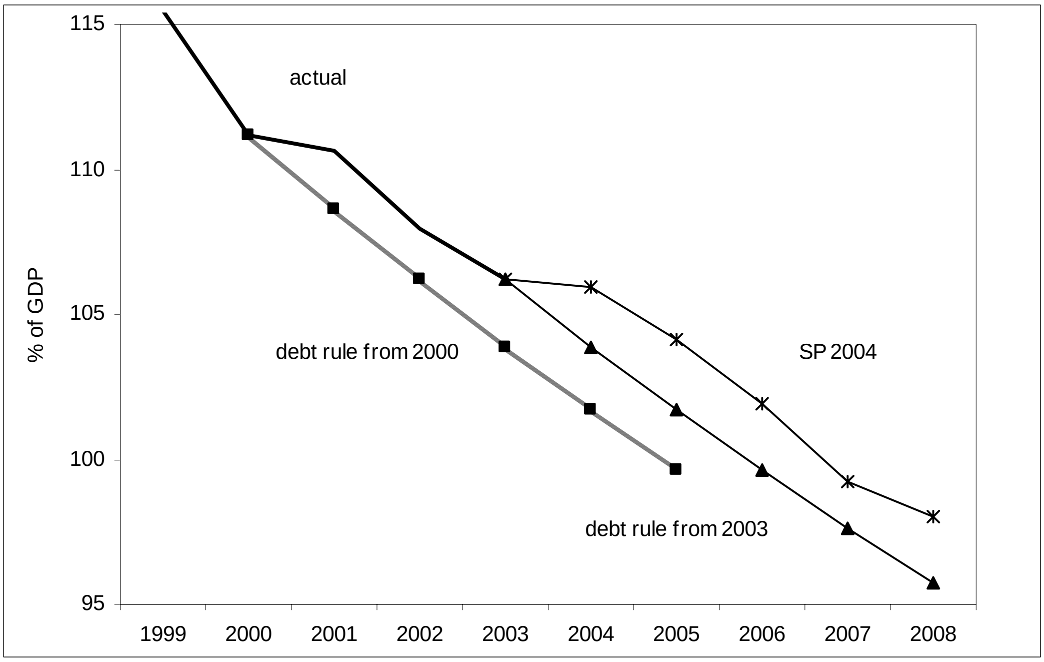
$$\left(\frac{D_t}{Y_t}\right)_{rule}=0.05*\left[60-\left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule}\right]+\left(\frac{D_{t-1}}{Y_{t-1}}\right)_{rule}$$

where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively (note that, in the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio). The change in the debt ratio can be decomposed as follows (assuming that the stock-flow adjustment is equal to zero):

$$\frac{D_t}{Y_t}-\frac{D_{t-1}}{Y_{t-1}}=\frac{DEF_t}{Y_t}-\left(\frac{y_t}{1+y_t}\right)*\left(\frac{D_{t-1}}{Y_{t-1}}\right)\cong\frac{DEF_t}{Y_t}-y_t*\left(\frac{D_{t-1}}{Y_{t-1}}\right)$$

5 in the graph. For instance, the projections for 2005 are compared with the values obtained for the same year by applying the formula starting in 2000. If the actual or projected debt levels exceed those obtained by applying the rule, this is taken as an indicator of a slow reduction in the debt ratio. This is consistent with the idea that the minimum debt reduction should be ensured not year after year but over a medium-term horizon. The graph clearly shows that in Italy the debt ratio is diminishing by less than implied by the 5-year rolling debt reduction rule; this is true both for the period starting from 2000 as well as for the period starting from 2003. This seems to contrast with one of the country-specific recommendation of the 2003-2005 BEPGs according to which Italy should *ensure that the debt ratio is diminishing at a satisfactory pace towards the 60 per cent of GDP threshold*.

Graph 3: Rolling five-year debt rule



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where *DEF* is the government deficit and *y* represents nominal GDP growth. Noting that 0.05*60 = 3, the formula for the "rolling debt reduction rule" describes the path for convergence of the debt ratio towards the 60% of GDP debt reference value consistent with a deficit equal to the 3% of GDP reference value. Consistency is achieved for a nominal GDP growth rate of 5% of GDP. For nominal GDP growth rates higher than 5%, the minimum debt reduction rule can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the minimum debt reduction rule necessitates deficits lower than 3% of GDP.

Box 2: Stock-flow adjustment and the pace of debt reduction

Since the late 1990s the pace of debt reduction in Italy has been slower than warranted by the size of the primary surplus and privatisation proceeds. The inertia chiefly reflects persistent debt increasing components in the so called stock-flow adjustment (SFA). The SFA is the difference between the Maastricht deficit, which is recorded in accrual terms, and the change in the government debt, which is recorded in cash terms and gross of financial transactions. A positive SFA is the normal outcome for low-debt countries with a surplus, as they invest their surpluses and accumulate financial assets. By contrast persistent debt-increasing components in the SFA are cause of concern in a high-debt and deficit country like Italy.

To understand the underlying debt dynamics it is essential to analyse the different components of the SFA, not the overall level. To start with, the SFA can be divided into three aggregate components: (a) difference due to time of recording i.e. cash versus accruals; (b) accumulation of financial assets; and (c) valuation effects and residual adjustments. The table below provides a detailed breakdown of the actual SFA in Italy over the 2000-2003 period. It also includes the available indications about the future SFA presented in the programme and made available by the Ministry of the Economy.

GENERAL GOVERNMENT: decomposition of STOCK-FLOW adjustment (in % of GDP)

ITALY	2000	2001	2002	2003	2004*	stability programme				Average	
						2005	2006	2007	2008	2000-2003	2004-2008
Difference due to time of recording: cash and accruals											
1. Differences in the recording of revenue and primary expenditure (accounts receivable and payable) and statistical discrepancies	1.4	1.3	0.9	1.0	0.4	0.9	0.9	0.9		**1.2**	
2. Difference between cash and accruals interest expenditure	-0.5	-0.5	-0.7	-0.5	-0.2	0.0	0.2	0.2	-0.2	**-0.5**	**0.0**
3. Total (1+2)	**1.0**	**0.8**	**0.2**	**0.5**	**0.2**	**0.9**	**1.0**	**1.1**		**0.6**	
Accumulation of financial assets											
4. Liquidities	-0.7	0.3	0.0	-0.6	0.2	0.0	0.0	0.0		**-0.2**	**0.1**
5. Securities other than shares	0.1	-0.2	0.0	0.0		0.0	0.0	0.0		**-0.1**	
6. Loans	0.4	0.6	0.4	0.3		0.4	0.6	0.7		**0.4**	
7. Capital injections in state-owned companies	0.3	0.4	0.3	0.3	0.2	0.5	0.5	0.3		**0.3**	
8. Privatisation proceeds	-0.4	-0.4	-0.2	-1.3	-0.6	-2.1	-2.0	-1.9	-0.6	**-0.6**	**-1.4**
9. Other shares and equity	0.1	0.0	0.0	0.2		0.1	0.0	0.0		**0.1**	
10. Total (4+5+6+7+8+9)	**-0.2**	**0.7**	**0.5**	**-1.0**		**-1.1**	**-0.9**	**-0.9**		**0.0**	
Valuation effects and residual adjustments											
11. Redemption effects	0.0	0.0	-1.7	0.0		0.0	0.0	0.0		**-0.4**	
12. Exchange rate adjustment	0.1	0.0	-0.3	-0.3		0.0	0.1	0.1		**-0.1**	
13. Other	0.0	0.0	0.0	0.0		0.0	0.0	0.0		**0.0**	
14. Total (11+12+13)	**0.1**	**0.0**	**-2.0**	**-0.3**	**0.3**	**0.0**	**0.1**	**0.1**		**-0.5**	
15. STOCK-FLOW adjustment (3+10+14)	**0.9**	**1.5**	**-1.3**	**-0.8**	**1.0**	**-0.1**	**0.2**	**0.2**	**2.1**	**0.1**	**0.7**
16. SFA excluding changes in liquidities, privatization proceeds, and valuation effects and residual adjustments (15-4-8-14)	**1.9**	**1.5**	**0.9**	**1.4**	**1.1**	**2.0**	**2.1**	**2.0**	**2.7**	**1.4**	**2.0**

***Source:** ECFIN calculations on September 2004 reporting of government deficits and debt levels (Table 3A), information provided by the Ministry of the Economy and Finance, and 2004 updated stability programme.*

** Estimated outcome for some components of the SFA*

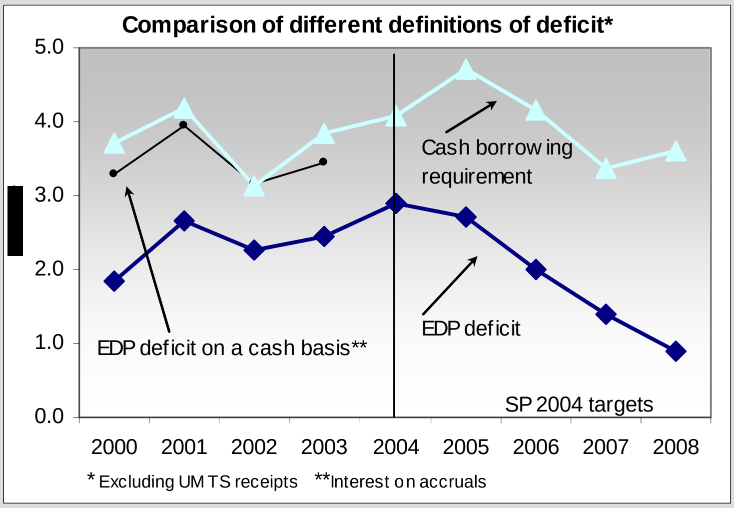
Concerning the recent past, the data show that in the 2000-2003 period the debt reducing components of the SFA amounted on average to 1 ¾ % of GDP per year. They chiefly consisted of (i) privatisation proceeds realised in part thanks to the classification of *Cassa Depositi e Prestiti* (the state-owned savings and loans bank) outside the general government sector in 2003, (ii) an exceptional conversion of Treasury bonds held by the Bank of Italy in 2002, and (iii) interest expenditure accrued but not yet paid on postal bonds.

The debt-reducing effect has been more than offset by components producing the opposite result. Specifically, over the 2000-2003 period the debt-increasing components of the SFA amounted on average to 2 percentage points per year. More than half of that figure was due to the difference between cash versus accrual accounting in primary items. The primary balances in cash terms have fallen short the primary balances relevant for the Maastricht deficit by more than 1 percentage point per year. This is particularly striking as the difference merely ensues from different times of recording and hence should in large part cancel out over the medium term.

The second most important debt increasing component in the SFA refers to the accumulation of financial assets. In parallel to its privatisation programme Italy has been acquiring capital of publicly-owned companies (which at the same time received subsidies to balance the books) and granting loans to private entities. Over the 2000-2003 period this kind of operation reached on average 0.8 percentage point per year. Although the recording of capital injections might be in line with the ESA95 accounting rules, the exclusion from the deficit of this kind of investment may be questionable from an economic point of view. In any case, in a high debt country like Italy, the debt reducing effect of privatisation proceeds should not be counterbalanced by debt increasing transactions. As regards loans to private entities further clarifications are required.

The available indications about future years suggest that the pattern observed over the recent past is expected to persist. In particular, accumulation of financial assets (excluding privatisations proceeds) and cash versus accrual accounting in primary items are expected to continue producing a debt-increasing effect at least up until 2007.

An indicator gauging the actual debt dynamics is the so called cash borrowing requirement (*Fabbisogno delle Amministrazioni Pubbliche*). It is regularly used by the Italian Ministry of the Economy and Finance. On top of the Maastricht deficit, the indicator includes the difference between cash and accrual accounting and the accumulation of financial assets excluding privatisation proceeds. As shown in the graph the cash borrowing requirement has been above the 3% of GDP reference value over the recent past.



Comparison of different definitions of deficit*

Concerning future years, the data provided in the programme can be used to calculate the implicit cash borrowing requirement foreseen for the 2005-2008 period. This is done by excluding from the projected change in the gross debt level the effect of the privatisation proceeds envisaged in the programme. The thus derived indicator continues to stay significantly above the targeted EDP deficit (see graph). The difference would even seem to increase at the end of the programme period.

In conclusion, if the persisting difference between the deficit and the cash borrowing requirement continued to be as high as implicitly forecast in the programme it would represents a serious cause of concern for the quality of statistical indicators and above all for the sustainability of public finances over the long run.

7. STRUCTURAL REFORM AND THE QUALITY OF PUBLIC FINANCES

The programme highlights a series of reforms aimed at improving the quality of public finances as well as the fundamentals of the Italian economy, notably, the pension reform adopted in 2004, a new expenditure rule, a revision of the domestic stability pact to be implemented by the 2005 budget, a further cut of the personal income tax to take effect in 2005, and, finally, an ambitious privatisation programme of around € 100 billion from 2005 to 2008.

The pension reform approved in July 2004 is expected to reduce expenditure by 0.6-0.7% of GDP per year between 2011 and 2033. Afterwards, the trend reverses as savings from later retirement are going to be outweighed by the higher pensions to be paid because of the longer contribution period. The reform goes in the direction of the country specific recommendation of the 2003-2005 BEPGs in the area of public finances asking Italy to reduce the long transition period to the new contributions-based system. However, deferring tighter eligibility conditions to 2008 entails risks. Workers already entitled to receive a seniority pension face a strong incentive to take advantage of this opportunity in the next three years. To address this problem the reform includes a tax incentive for eligible individuals who continue to work. However, as the eligibility criteria tighten sharply between 2007 and 2008, strong pressures to water down the reform may not be excluded as this turning point approaches.

The tax reform, which will be implemented in 2005, reduces the number of personal income tax rates from five (23%, 29%, 31%, 39%, 45%) to three (23%, 33% and 39%) with the addition of a 4% 'solidarity tax' for an annual income higher than € 100 000. Tax deductions are also increased, mainly for families with children. While officially estimated to be deficit neutral, the Commission services estimate a negative budgetary impact from 2005 onwards. Hence, the country specific recommendations of the 2003-2005 BEPGs in the area of public finances requiring Italy to *finance further reductions in the tax burden through structural cuts in current primary expenditure* would be violated on two grounds: (i) the tax cut is, based on the Commission services' assessment, not fully financed (ii) the planned financing is not through lower primary expenditure.

The 2005 budget law includes a 2% cap on the annual nominal increase of primary expenditure excluding pensions and transfers to the EU as well as a reform of the domestic stability pact. The two measures are intertwined, as the revised domestic stability pact explicitly requires local governments and the regions to respect the expenditure ceiling in line with the 2% cap. A detailed discussion of the domestic stability pact is in Box 3. Although aiming at the right target, both the new expenditure rule and the domestic stability pact suffer from a major weakness. Specifically, the 2% cap is imposed without amending the legislation that determines expenditure trends thereby weakening its enforcement Overall, these measures fall short of requirements as prescribed by the country-specific recommendation of the 2003-2005 BEPGs requiring Italy to ensure adequate and transparent enforcement mechanisms for fiscal discipline.

Although decreasing from the record high of more than 2% of GDP in 2003, temporary measures remain important in 2004 and 2005; around 1½ % and ¾ % of GDP respectively. In 2005, one-off measures include the sale of roads and a sale and lease back operation of government buildings, swap operations on active interest proceeds and receipts from the amnesty of zoning code violations and the repetition of an *ad hoc* tax on the re-evaluation of corporate assets.

Box 3: The experience of the domestic stability pact

Since the late 1990s, Italy has striven to solve the problem of ensuring consistency between the country's obligations in the framework of the Stability and Growth Pact (SGP) and financial management of sub-national governments (regions, provinces, and municipalities) which are responsible for the provision of an increasingly wide array of services mostly relying on government transfers. Local authorities carry out a substantive share of public expenditure (about a third of general government primary expenditure or around 15% of GDP in 2003) with a limited tax levying capacity. In 2003, own revenues covered about 58% of their expenditures.

With a view to involving sub-national governments, the Budget Law for 1999 introduced a "domestic stability pact". In the original formulation the pact aimed at improving the balances (deficits) of the local governments by fixing targets for the reduction of their trend deficits, where the relevant deficit was defined in cash terms as the difference between revenues (net of transfers from the State and of receipts from the sale of financial activities, but including revenue from sale of real estate) and current primary expenditure. The required improvement in 1999 was of the order of 1% of trend current primary expenditure in 1998, with the understanding that any overrun in 1999 would have to be compensated in 2000. The exclusion of state transfers from the definition of the relevant deficit, together with the existence of limits to the increase in the tax levying power, was meant to spur local governments to pursue efficiency gains and improve own tax collection.

Since then, the domestic stability pact has been revised almost every year of its existence and has substantially changed its features. In particular, continued healthcare overruns, resulting also from the practice of systematic underfunding of the healthcare system on the part of the central government, lead to exclude healthcare outlays from the definition of the relevant deficit for the domestic stability pact in 2000. Health care expenditure, which accounted for 6.3% of GDP in 2003, became the object of a separate agreement.

The 2005 Budget Law includes further extensive amendments to domestic stability pact. Instead of fixing limits for the overall deficit, the new version imposes a complex system of ceilings on the annual increase of nominal local expenditure differentiated by type of government and by expenditure items. Differently from the past, the constraints also apply to capital expenditure. With regard to regions, expenditure in 2005 should not exceed the 2003 level by more than 4.8%. For provinces and municipalities the ceilings are defined in terms of the average past performance. In particular, provinces and municipalities whose average current per-head expenditure was lower than the average of all local governments with similar demographic characteristics in the 2001-2003 period will be allowed in 2005 to spend up to 11.5% more than the average total expenditure registered over the same period. The less virtuous provinces and municipalities will be permitted to increase this level of expenditure by 10%. The new pact extends to all municipalities with more than 3 000 inhabitants, as compared to more than 5 000 inhabitants in the previous version.

Health care expenditure and compensations for employees are subject to different provisions. For health care, the 2005 budget sets a maximum level of € 88.2 billion, €1.5 billion less than the estimated outturn in 2004. With regard to total compensations for employees, the Constitutional Court ruled in December that the central state cannot impose quantitative limits on the number of staff of local administrations. Before that ruling, the draft budget foresaw that local governments could replace only 20% of the employees retired in the previous year. The provision finally approved by Parliament requires regions, provinces and municipalities to reduce overall compensations for employees by around € 0.4 billion in 2005 and € 1.2 billion in 2006, i.e. around 0.7% and 1.2% of public wages of local governments in 2003. This constitutes a sharp break compared to past trends compares as compensations of employees increased by around 4% in 2002 and by more than 2% in 2003. The measures securing the savings are subject to an agreement between the government, the regions, the provinces and the municipalities.

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The new domestic stability pact also includes provisions for monitoring expenditure developments, differentiated by population. Regions, provinces and municipalities with more than 30 000 inhabitants are required to submit to the Ministry of the Economy and Finance information on the cash and accrual accounts on a quarterly basis. Provinces and municipalities with more than 5 000 inhabitants have the obligation to prepare a forecast of their quarterly cash flows coherent with the annual expenditure ceiling by February 2005. Municipalities with less than 5 000 inhabitants are called to forecast cash flows for the two semesters by March 2005. By the end of the month following each reporting quarter or semester, the auditor committee of the local government verifies the accounts and communicates the results to the Ministry of the Economy and Finance. In case of overruns, the local government is required to reduce payments in the following quarter/semester. The auditor committees are also called to check the respect of the annual targets both in accrual and cash terms. In case of non-compliance, in 2006 local governments cannot: (i) exceed the expenditure of the previous year; (ii) recruit new staff; (iii) rise debt to finance investment. These provisions also apply to provinces and municipalities with more than 5 000 inhabitants which have violated the domestic stability in 2004. As of 2006, only regions, provinces and municipalities that complied with the domestic stability pact in the past can issue bonds or take up loans.

There is widespread agreement that the monitoring of budgetary developments at the sub-national level are highly welcomed, especially because the current accounting system is still characterised by a delayed availability of data compared to the closure of the reporting period and by the heterogeneous quality of data across government institutions.

However, the domestic stability pact including the latest amendment can be criticised on a number of grounds. First, the credibility of sanctions is rather weak, as they have never been applied in the past in the face of overruns. In particular, the recurring failure to respect the provisions on health care expenditure has always been followed by an increase in transfers from the central state highlighting the issue of underfunding. Second, the quarterly monitoring can have a positive impact on the cash accounts, yet could give rise to hidden debts by delaying payments to suppliers. Third, the combination of different rules for different kind of expenditure does neither increase transparency nor accountability and gives increasingly rise to conflicts between local and central governments. A further source of complication lies in the fact that the measures aimed at reducing compensations of employees are subject to a future agreement between the government, regions, provinces and municipalities, involving difficult and time consuming negotiations.

Several measures included in the 2005 budget produce a beneficial effect in the short term at the expense of increasing primary expenditure or reducing revenues over the longer term. This will be the case for the sale and lease back operation of government buildings, the sale of state roads followed by the payment of shadow tolls, the transformation of subsidies into soft loans and a swap operation on active interest payments.

With a view to enhancing the management and increasing the financial return of general government assets the Italian government launched a comprehensive stock-taking exercise in 2002. The balance sheet provided in the programme estimates, for 2003, the assets at around € 1 770 billion (137% of GDP) of which 40% are said to be potentially disposable. However, the programme also acknowledges that due to legal issues even potentially disposable assets may have a limited economic value. The programme lacks a clear commitment towards using the disposal of real assets as an opportunity to accelerate debt reduction, as opposed to using them as a reservoir of one-off measures aimed at postponing lasting fiscal consolidation.

8. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Italian public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The quantitative indicators project debt development according to two different scenarios, to take into account budgetary developments over the medium term. The "programme" scenario (baseline) assumes that the medium-term objective set up in the programme is actually achieved, while the "2004 programme" scenario assumes that the underlying primary balance remains throughout the programme period at the 2004 level.

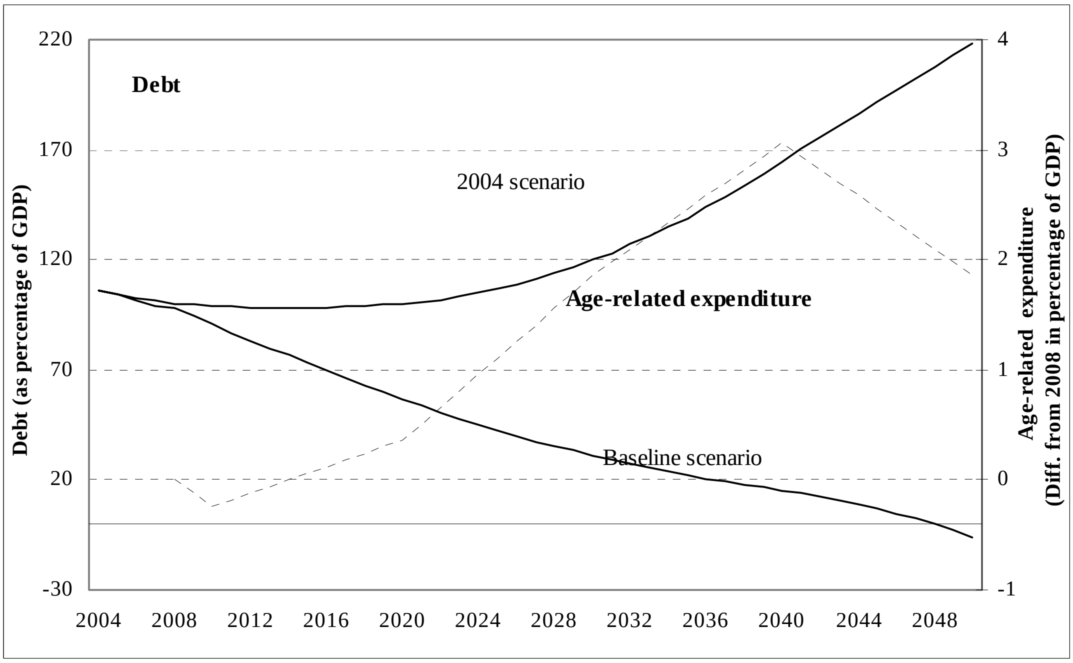
Graph 4 presents the gross debt development according to the two different scenarios. On the basis of the programme, gross debt is projected to decline substantially in the next decade, reach the 60% reference value by 2020 and approach zero in 2050. However, a completely different profile emerges if the consolidation plans do not materialize in the medium-term. Given the very low underlying primary balance included in the programme for the year 2004 (1.6% of GDP), debt ratios would show an explosive path once the impact of ageing population kicks in.[11]

On the basis of the debt projections, it is possible to calculate a set of sustainability indicators to measure the gap between the current policies and a sustainable one. The S1 indicator shows the permanent change in the primary balance in order to have a debt-to-GDP ratio in line with the Maastricht Treaty reference value in the very long run (year 2050).[12] S2 shows the gap between current tax policies and those that would ensure respect of the intertemporal budget constraint given the future impact of aging on public expenditure, namely the change in the tax ratio that would equate the present discounted value of future primary balances to the current stock of gross debt. According to S2, Italy could reduce its tax ratio by some 0.9 percentage points compared with the one targeted at the end of the programme period (4.7% of GDP). However, if the planned budgetary consolidation up to 2008 does not materialise, there is a gap of more than 2% of GDP compared to the level of the primary balance needed to satisfy the intertemporal budget constraint A gap arises also if Italy wants to ensure the debt ratio close to 60% of GDP in 2050. The budgetary effort over the first five years of the projections (i.e. after the end of the programme period) to respect the intertemporal budget constraint requires a primary surplus of around 4% of GDP on average.

Graph 4: Long-term sustainability: summary results

[11] It should be recalled that, 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 likely outcomes and should not be taken at face value.

[12] The respect of the underlying debt path does not ensure sustainability over an infinite horizon, but only that debt remains below 60% up to 2050. In most cases, this would imply an increasing trend and possible unbalances after the end of the projection period.



Sustainability indicators

	S1*	S2**	RPB***
Baseline scenario	-0,9	-0,9	4,0
2004 scenario	2,2	2,3	4,0

Notes:

* It indicates the required change in tax revenues as a share of GDP over the projection period that guarantees to reach debt to GDP ratio of 60% of GDP in 2050.

** It indicates the required change in tax revenues as a share of GDP that guarantees the respect of the intertemporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon to the debt as existing at the outset of the projection period; p.m. debt to GDP ratio in 2050: 54.3%.

*** Based on S2, the Required Primary Balance (RPB) indicates the average minimum required cyclically adjusted primary balance as a share of GDP *over the first five years* of the projection period that guarantees the respect of the intertemporal budget constraint of the government for this period.

In interpreting these results, several factors must be taken into account. First, GDP growth rates in the next 10 years appear relatively high compared with the common EPC projections. This clearly determines a higher acceleration of the debt dynamic. Second, the actual level of the debt-to-GDP ratio requires high primary balances for the next 10 to 15 years in order to keep the debt dynamic on a sustainable path. As shown in the "2004" scenario, a failure to do so will considerably increase the sustainability risks. Third, data on pension expenditures incorporates the impact of the reform approved in July 2004 which, as mentioned in section 7 entails tangible risks. Risks arise for health care expenditures too. The relatively constant expenditure ratio recorded in the last few years is in part the result of the substantial recentralisation of regional financing pursued in the recent past. However, the greater autonomy of regions foreseen by the recent constitutional reform will weaken the ability of the government to continue such policies. A strict monitoring of health-care expenditure trends is therefore needed.

In conclusion, the long-term sustainability of public finances is conditional on the full implementation of the budgetary targets presented in the programme and of the recently adopted pension reform. A failure in achieving the budgetary targets would definitely put sustainability at risk, even when assuming a full impact of the pension reform and no additional costs from health-care.

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ANNEX 1: SUMMARY TABLES FROM THE STABILITY PROGRAMME UPDATE

Table A 0: Basic assumptions

	2004	2005	2006	2007	2008
Euro area short-term interest rate (annual average)	**2.2**	**2.8**	**3.6**	**4.1**	**4.5**
Euro area long-term interest rate (annual average)	**4.6**	**4.8**	**5.1**	**5.4**	**5.5**
USA: short-term (3-month money market)	1.5	2.8	4.0	4.7	5.0
USA: long term (10-year government bonds)	4.7	5.2	5.6	5.9	6.1
US$/€ exchange rate (annual average)	**1.223**	**1.213**	**1.213**	**1.213**	**1.213**
Nominal effective exchange rate (euro area)	**-**	**-**	**-**	**-**	**-**
Nominal effective exchange rate (EU)	-	-	-	-	-
World GDP growth rate	4.9	4.4	4.1	4.1	4.1
Industrialised countries GDP growth rate	3.7	3.1	2.8	2.8	2.8
World excluding EU, GDP growth	**5.3**	**4.6**	**4.3**	**4.5**	**4.5**
USA GDP growth	4.3	3.5	3.3	3.3	3.3
Japan GDP growth	4.4	2.3	1.1	0.9	0.9
EU - GDP growth	**2.4**	**2.5**	**2.5**	**2.6**	**2.6**
Growth of relevant foreign markets	**6.9**	**6.5**	**6.2**	**6.3**	**6.3**
World import volumes, excluding EU	**10.7**	**8.3**	**8.1**	**8.1**	**8.1**
World import prices, (goods, in euro)	1.1	2.2	2.3	2.0	1.5
Oil prices (Brent USD/barrel)	**36.7**	**37.5**	**34.5**	**32.5**	**31.5**
Non-oil commodities prices (in USD)	18.2	-0.3	3.2	3.2	3.2

Table A 1. Growth and associated factors

	2003	2004	2005	2006	2007	2008
GDP growth at constant market prices (7+8+9)	**0.3**	**1.2**	**2.1**	**2.2**	**2.3**	**2.3**
GDP *level* at current market prices (€ bn.)	**1300**	**1353**	**1413**	**1476**	**1541**	**1610**
GDP deflator	**2.9**	**2.9**	**2.3**	**2.2**	**2.1**	**2.1**
HICP change	2.8	2.2	1.6	1.5	1.4	1.4
Employment growth [13]	**0.4**	**0.6**	**0.9**	**1.0**	**0.9**	**1.0**
Unemployment rate	8.4	8.1	7.6	7.1	6.8	6.6
Labour productivity growth [14]	-0.2	0.6	1.2	1.2	1.4	1.3
Sources of growth: percentage changes at constant prices						
1. Household consumption expenditure	**1.3**	**1.4**	**2.0**	**2.4**	**2.5**	**2.4**
2. Government and NPISHs consumption expenditure	**2.2**	**0.7**	**0.6**	**0.3**	**0.4**	**0.6**
3. Gross fixed capital formation	**-2.1**	**2.7**	**4.0**	**4.0**	**4.2**	**4.0**
4. Changes in inventories and net acquisition of valuables [15]	**0.5**	**-0.2**	**0.2**	**0.1**	**0.1**	**0.1**
5. Exports of goods and services	**-3.9**	**2.8**	**5.7**	**6.1**	**6.1**	**6.2**
6. Imports of goods and services	**-0.6**	**3.3**	**6.5**	**7.0**	**7.0**	**6.9**
Contribution to GDP growth						
7. Final domestic demand	**0.7**	**1.5**	**2.1**	**2.4**	**2.5**	**2.5**
8. Change in inventories and net acquisition of valuables	**0.5**	**-0.2**	**0.2**	**0.1**	**0.1**	**0.1**
9. External balance of G&S	**-0.9**	**-0.1**	**-0.2**	**-0.3**	**-0.3**	**-0.3**

[13] Full-time equivalent, national accounts.

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

[15] Contribution to GDP growth.

Table A 2. General government budgetary developments

in % of GDP	2003	2004	2005	2006	2007	2008
Net lending by sub-sectors						
General government [16]	**-2.4**	**-2.9**	**-2.7**	**-2.0**	**-1.4**	**-0.9**
Future measures				1.3	1.6	1.9
Central government	**-2.4**	**-2.9**	**-3.0**	**-3.7**	**-3.5**	**-3.3**
State government	**-**	**-**	**-**	**-**	**-**	**-**
Local government	**-0.2**	**-0.3**	**0.0**	**0.0**	**0.0**	**0.0**
Social security funds	**0.2**	**0.3**	**0.4**	**0.4**	**0.5**	**0.5**
General government						
Total receipts	**46.4**	**45.6**	**44.8**	**44.4**	**44.1**	**43.9**
Total expenditure	**48.9**	**48.5**	**47.5**	**47.6**	**47.1**	**46.7**
Future measures				1.3	1.6	1.9
Budget balance	**-2.4**	**-2.9**	**-2.7**	**-2.0**	**-1.4**	**-0.9**
Interest expenditure	**5.3**	**5.3**	**5.1**	**5.3**	**5.4**	**5.6**
Primary balance	**2.9**	**2.4**	**2.4**	**3.3**	**4.0**	**4.7**
Components of revenues						
Taxes	28.2	28.2	28.2	28.1	27.9	27.9
Social contributions	13.1	13.2	13.0	12.9	12.7	12.6
Interest income	0.2	0.2	0.3	0.2	0.3	0.3
Other	4.8	4.1	3.3	3.2	3.2	3.1
Total receipts	46.4	45.6	44.8	44.4	44.1	43.9
Components of expenditure						
Collective consumption	7.4	7.2	7.0	6.9	6.9	6.9
Social transfers in kind	12.1	12.4	12.0	11.8	11.5	11.3
Social transfers other than in kind	17.2	17.3	17.1	17.1	17.0	17.0
Interest expenditure	5.3	5.3	5.1	5.3	5.4	5.6
Subsidies	1.1	1.1	1.1	1.0	1.0	0.9
Gross fixed capital formation[17]	2.6	2.3	2.1	2.5	2.4	2.4
Other	3.1	2.9	3.0	3.0	2.9	2.6
Total expenditure	48.9	48.5	47.5	47.6	47.1	46.7

16 Including “future measures”

17 Including sales of real assets

Table A 3. General government debt developments

in % of GDP	2003	2004	2005	2006	2007	2008
Gross debt level	**106.2**	**106.0**	**104.1**	**101.9**	**99.2**	**98.0**
Change in gross debt	**-1.7**	**-0.2**	**-1.9**	**-2.2**	**-2.7**	**-1.2**
Contributions to change in gross debt						
Primary balance	**-2.9**	**-2.4**	**-2.4**	**-3.3**	**-4.0**	**-4.7**
Interest expenditure	**5.3**	**5.3**	**5.1**	**5.3**	**5.4**	**5.6**
Nominal GDP growth [18]	**3.2**	**4.1**	**4.4**	**4.5**	**4.4**	**4.4**
Other factors influencing the debt ratio	0.9	1.0	-0.2	0.3	0.3	2.3
of which: Privatisation receipts	*-1.3*	*-1.4*	*-2.1*	*-2.0*	*-1.9*	*-0.6*
p.m. implicit interest rate on debt	*5.1*	*5.1*	*5.0*	*5.2*	*5.5*	*5.8*

Table A 4. Cyclical developments

in % of GDP	2003	2004	2005	2006	2007	2008
GDP growth at constant prices	**0.3**	**1.2**	**2.1**	**2.2**	**2.3**	**2.3**
Actual balance	**-2.4**	**-2.9**	**-2.7**	**-2.0**	**-1.4**	**-0.9**
Interest payments	**5.3**	**5.3**	**5.1**	**5.3**	**5.4**	**5.6**
Potential GDP growth	1.6	1.6	1.7	1.8	1.8	1.9
Output gap	-1.2	-1.6	-1.2	-0.8	-0.3	0.0
Cyclical budgetary component	-0.6	-0.7	-0.5	-0.4	-0.2	0.0
Cyclically-adjusted balance	-1.8	-2.2	-2.2	-1.6	-1.2	-0.9
Cyclically-adjusted primary balance	3.5	3.1	2.9	3.7	4.2	4.7

Table A 5. Divergence from previous update

in % of GDP	2003	2004	2005	2006	2007
GDP growth					
Previous update	**0.5**	**1.9**	**2.2**	**2.5**	**2.6**
Latest update	**0.3**	**1.2**	**2.1**	**2.2**	**2.3**
Difference	**-0.2**	**-0.7**	**-0.1**	**-0.3**	**-0.3**
Actual budget balance					
Previous update	**-2.5**	**-2.2**	**-1.5**	**-0.7**	**0.0**
Latest update	**-2.4**	**-2.9**	**-2.7**	**-2.0**	**-1.4**
Difference	**0.1**	**-0.7**	**-1.2**	**-1.3**	**-1.4**
Gross debt levels					
Previous update	**106.0**	**105.0**	**103.0**	**100.9**	**98.6**
Latest update	**106.2**	**106.0**	**104.1**	**101.9**	**99.2**
Difference	**0.2**	**1.0**	**1.1**	**1.0**	**0.6**

18 The annual % growths are indicated instead of the contributions to change in gross debt ratio

Table A 6. Long-term sustainability of public finances

in % of GDP	**2003**	**2005**	**2010**	**2020**	**2030**	**2040**	**2050**
Old age pensions [19]	14.2	14.1	13.5	14.0	15.2	15.8	14.4
Health care (including care for elderly)	6.3	6.3	6.5	6.9	7.4	7.9	8.1
Health care – alternative hypothesis [20] (including care for elderly)	6.3	6.3	6.5	6.8	7.3	7.6	7.8
Education	4.9	4.7	4.5	4.2	4.0	4.1	4.2
Unemployment benefits	0.3	0.4	0.4	0.4	0.4	0.4	0.3
Total	25.8	25.5	24.9	25.5	27.0	28.1	27.0
Assumptions							
Labour productivity growth	-0.2	1.9	1.9	1.8	1.8	1.8	1.8
Real GDP growth	0.3	2.6	2.5	1.4	0.8	0.8	1.2
Participation rates males (aged 15-64)	74.9	75.9	77.9	79.3	78.7	78.3	77.6
Participation rates females (aged 15-64)	50.9	52.3	53.9	56.2	60.5	67.0	69.7
Total participation rates (aged 15-64)	62.9	64.1	66	67.9	69.7	72.8	73.8
Unemployment rate	8.4	7.9	7.4	7.1	7.1	6.8	6.7

ANNEX 2: INDICATORS OF LONG-TERM SUSTAINABILITY

[19] Old age and seniority

[20] According the so called "death-related costs"

Main assumptions - baseline scenario (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	25,0	24,9	25,5	27,0	28,2	27,0	2,0
Pensions	13,6	13,5	14,0	15,2	15,8	14,4	0,8
Health care	6,5	6,5	6,9	7,4	7,9	8,1	1,6
Education	4,5	4,5	4,2	4,0	4,1	4,2	-0,3
Unemployment benefits	0,4	0,4	0,4	0,4	0,4	0,3	-0,1
*Total primary non age-related spending**	14,1						
*Total revenues**	43,9						

* constant

Results (as % GDP)	**2009**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Baseline scenario							
Gross debt	94,5	90,7	56,7	31,2	15,4	-5,7	-100,2
i + 0.5*	95,0	91,6	61,9	40,4	29,2	13,1	-81,9
2004 scenario							
Gross debt	99,7	99,1	100,1	119,8	164,6	218,0	118,3
i + 0.5*	100,2	100,1	106,6	134,0	191,6	264,2	164,0

* i + 0.5 represents the evolution of debt under the assumption of the nominal interest rate being 50 basis points higher throughout the projection period.