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DECEMBER 2005 UPDATE
OF THE STABILITY PROGRAMME OF ITALY
(2005-2009)
AN ASSESSMENT

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SUMMARY AND CONCLUSIONS¹

The Italian authorities submitted the seventh update of the stability programme covering the period 2005-2009 on 23 December 2005, three weeks later than the deadline of 1 December specified in the code of conduct. The late submission of the programme was due to the authorities' wish to incorporate the final version of the 2006 Budget Law, which was approved by the Italian parliament on 22 December 2005. The programme deviates on some material points from the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct².

In its opinion of 17 February 2005 on the previous update of the stability programme, the Council invited Italy to: ensure the achievement of the 2005 deficit target; achieve a budgetary position of close to balance by 2008; and, ensure that the debt-to-GDP ratio diminishes at a more rapid pace, paying particular attention to debt-increasing factors other than net borrowing. On 28 July 2005, the Council decided that Italy was in excessive deficit. According to the Council recommendation under Article 104(7) of the same date, the excessive deficit has to be corrected by 2007. On 22 February, the Commission adopted a communication concluding that the actions taken by Italy before the 12 January 2006 deadline set by the Council, if fully implemented, would be consistent with the consolidation path contained in the Council recommendation.

Between 1995 and 2004, Italian GDP grew at an average rate of 1½% per year, below the 2% of the euro area. Over the last decade, Italy has experienced a marked slowdown of productivity growth, a progressive deterioration in competitiveness, leading to a steady loss of export market shares and, since 2000, a significant contraction in manufacturing activity. Italy undertook significant fiscal consolidation efforts during the 1990s, reducing the government deficit from almost 12% of GDP in 1990 to below 2% at the end of the decade. However, the deficit rose again above 3% of GDP in 2001, 2003 and 2004, remaining close to it only thanks to significant one-off measures³. The primary surplus, from 5% of GDP in 1999, fell to 1.8% of GDP in 2004, and the decline in the debt-to-GDP ratio, which had peaked at 125% in 1994, slowed down considerably. At the end of 2004, the debt was 106½% of GDP.

¹ This technical analysis, which is based on information available up to 14 February 2005, accompanies the recommendation by the Commission for a Council opinion on the update of the stability programme, which the College adopted on 22 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 Lucia Piana (lucia.piana@cec.eu.int) or Massimo Suardi (massimo.suardi@cec.eu.int). The analysis takes into account (i) the Commission services' autumn 2005 forecast, (ii) the code of conduct ("Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005), (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances and (iv) the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008.

² In particular, the chapter on "institutional features of public finance" is missing, and the programme has also gaps in the compulsory and optional data prescribed by the new code of conduct (especially, there is no breakdown of the budget consistent with the deficit targets for the years 2007-2009).

³ The budgetary impact of one-off measures amounted to 0.6% of GDP in 2001, 1.9% in 2003 and 1.4% in 2004. In 2002, the deficit was at 2.7% of GDP, with 1.3% of GDP of one-offs.

The programme projects GDP growth to recover from zero in 2005 to 1½% in 2006 and 2007, and then to mildly accelerate until 2009. As a result, the output gap is projected to narrow, but remain negative, over the programme period. HICP inflation is expected to fall to 2%, supported by decelerating unit labour costs. Such projections are overall plausible.

The 2005 deficit is estimated at 4.3% of GDP, against a target of 2.7% of GDP set in the previous update. The target was missed due to: (i) a shortfall in GDP growth; (ii) slippages in primary expenditure and sale of real estate, only partially compensated by higher revenues and lower interest expenditure; and, (iii) carry-over effects from 2004, essentially due to statistical revisions.

The budgetary strategy outlined in the programme aims at reducing the deficit below 3% of GDP by 2007 and at pursuing further fiscal consolidation towards a balanced budget in subsequent years. The composition of the fiscal adjustment is detailed only for the year 2006. For the years 2007-2009, the information is limited to the size of the correction required to achieve the budgetary targets relative to trend deficits based on unchanged legislation. The contribution of one-off measures should decline from ½% of GDP in 2005 to zero in 2007. Compared with the previous programme, the new update slightly frontloads the planned adjustment against a less favourable macroeconomic scenario. However, the new deficit target for 2008 is 1.2% of GDP worse than in the previous update, as the frontloading does not fully offset the effect of a much weaker 2005 starting position.

According to the calculations carried out by the Commission services on the basis of the programme and the commonly agreed methodology, the structural balance (the balance in cyclically-adjusted terms and net of one-off and other temporary measures) would improve from -4% of GDP in 2005 to -1¼% in 2009. Following the projected correction of the excessive deficit in 2007, the update envisages an annual improvement of ½% of GDP in structural terms until 2009. The update clearly identifies a medium-term objective (MTO) for the budgetary position as meant in the Stability and Growth Pact as a balanced budget in structural terms, but it does not aim to achieve it within the programme's period. As the programme's MTO is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. However, the minimum benchmark would only be achieved in 2009. The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

Overall, the risks to the budgetary projections in the programme appear to be on the negative side. There are significant uncertainties regarding the implementation of the 2006 budget, in particular of the sizeable expenditure savings⁴. Beyond 2006, there is no information on the measures envisaged and the size of the needed fiscal correction may be underestimated.

⁴ An amnesty on unpaid social contributions of the agricultural sector currently debated in the Italian Parliament, if eventually approved and subject to statistical verification, might produce a limited upward revision for the deficit and/or the debt ratio.

Taking the 2006 budget at face value, and assuming that it will be fully implemented and effective, the implied structural effort would be consistent with the minimum requirement of 0.8% of GDP in 2006 in the Council recommendation under Article 104(7). As regards 2007, the planned 0.9% of GDP structural adjustment would also be in line with the Council recommendation. However, the lack of information about the broad corrective measures to be taken in 2007 and beyond prevents an assessment of the path and the composition of the planned adjustment. Taking into account the balance of risks, the correction of the excessive deficit by the 2007 deadline set by the Council crucially relies upon a full and effective implementation of the 2006 budget and the specification and implementation of substantial corrective measures for 2007. The achievement of the safety margin in 2009 also hinges on these risks and on the specification and implementation of corrective measures for the years beyond 2007.

At 108½%, the debt-to-GDP ratio is planned to increase in 2005 for the first time since 1994. The debt ratio is projected to fall just below 102% in 2009, mainly driven by rising primary surpluses and by ambitious privatisation plans in 2006 and 2007. The debt-increasing operations included in the stock-flow adjustment should cease hampering debt reduction as from 2007. All the above elements are subject to significant uncertainties. In view of this risk assessment, a further strengthening of the budgetary position seems necessary to achieve a sufficiently diminishing debt ratio towards the reference value.

With regard to the sustainability of public finances, Italy appears to be at medium risk on grounds of the projected budgetary costs of an ageing population. Past reforms have helped to contain future rises in public expenditure and their full implementation, notably of the 2004 pension reform, will be crucial to obtain the expected results. The currently high level of gross debt and the weak budgetary position indicate the necessity for strong consolidation of public finances over the medium-term as a resolute debt reduction would reduce risks to public finance sustainability.

The envisaged measures in the area of public finances are partly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, while Italy is taking action to correct the excessive deficit, it would be appropriate to envisage a more rapid pace of government debt reduction, notably by strengthening the adjustment path towards the MTO.

The National Reform Programme of Italy, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, identifies five challenges: extending the area of free choice for citizens and companies; granting incentives for scientific research and technological innovation; strengthening education and training; upgrading infrastructure; protecting the environment. With regard to public finances, a sixth priority, long-term fiscal sustainability, is addressed in the Economic and Financial Planning Document (DPEF) of July 2005. The measures in the area of public finance envisaged in the NRP and the DPEF are broadly in line with the actions foreseen in the stability programme. The update outlines measures to reduce social contributions, encourage private pension savings and reduce health care deficits.

In view of the above assessment, the programme can be considered as consistent with a correction of the excessive deficit by 2007, subject to a full and effective implementation of the 2006 budget and the adoption of further measures for 2007. In the light of the recommendations made by the Council under Article 104(7) of the Treaty on 28 July 2005, and in order to strengthen the sustainability of public finances, it would be appropriate for Italy to:

(i) Achieve the structural efforts envisaged in the programme for 2006 and 2007 in order to ensure the correction of the excessive deficit by 2007 in a credible and sustainable manner;

(ii) spell out the broad measures underlying the adjustment path in the outer years of the programme and strengthen the adjustment towards the medium-term objective;

(iii) ensure that the debt-to-GDP ratio is declining towards the 60% of GDP Treaty reference value at a more rapid pace including by paying particular attention to factors other than net borrowing which contribute to the change in debt levels; and

(iv) improve the budgetary process, by increasing its transparency and by an effective implementation of the past and new mechanisms to monitor, control and report expenditure.

Comparison of key macroeconomic and budgetary projections*

		2004	2005	2006	2007	2008	2009
Real GDP (% change)	SP December 2005	1.2	0.0	1.5	1.5	1.7	1.8
	COM Nov 2005 ⁵	1.2	0.2	1.5	1.4	n.a.	n.a.
	SP November 2004	1.2	2.1	2.2	2.3	2.3	n.a.
HICP inflation (%)	SP December 2005	2.3	2.3	2.3	2.2	2.0	2.0
	COM Nov 2005	2.3	2.2	2.1	1.9	n.a.	n.a.
	SP November 2004	2.2	1.6	1.5	1.4	1.4	n.a.
Output gap (% of potential GDP)	SP December 2005¹	-0.4	-1.5	-1.2	-1.0	-0.8	-0.6
	COM Nov 2005 ⁶	-0.5	-1.5	-1.2	-1.2	n.a.	n.a.
	SP November 2004 ¹	-1.6	-1.2	-0.8	-0.3	0.0	n.a.
General government balance (% of GDP)	SP December 2005	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
	COM Nov 2005	-3.2	-4.3	-4.2	-4.6	n.a.	n.a.
	SP November 2004	-2.9	-2.7	-2.0	-1.4	-0.9	n.a.
Primary balance (% of GDP)	SP December 2005	1.8	0.6	1.3	1.9	2.6	3.2
	COM Nov 2005	1.8	0.6	0.6	0.3	n.a.	n.a.
	SP November 2004	2.4	2.4	3.3	4.0	4.7	n.a.
Cyclically-adjusted balance (% of GDP)	SP December 2005¹	-3.0	-3.5	-2.9	-2.3	-1.7	-1.2
	COM Nov 2005	-3.0	-3.5	-3.6	-4.0	n.a.	n.a.
	SP November 2004 ¹	-2.1	-2.1	-1.6	-1.2	-1.0	n.a.
Structural balance ² (% of GDP)	SP December 2005³	-4.4	-4.1	-3.2	-2.3	-1.7	-1.2
	COM Nov 2005 ⁴	-4.4	-4.0	-4.0	-4.0	n.a.	n.a.
	SP November 2004	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	SP December 2005	106.5	108.5	108.0	106.1	104.4	101.7
	COM Nov 2005	106.5	108.6	108.3	107.9	n.a.	n.a.
	SP November 2004	106.0	104.1	101.9	99.2	98.0	n.a.

Notes:

*The Commission services' autumn 2005 forecast was based on information available up to the cut-off date of 7 November 2005. Therefore, it was based on a draft version of the 2006 budget.

¹Commission services calculations on the basis of the information in the programme

²Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures

³One-off and other temporary measures as calculated by the Commission services (1.4% of GDP in 2004, 0.6% in 2005, and 0.3% of GDP in 2006; deficit-reducing)

⁴One-off and other temporary measures taken from the Commission services' autumn 2005 forecast (1.4% of GDP in 2004, 0.5% in 2005, and 0.4% in 2006; all deficit-reducing)

⁵The Commission services' interim forecast of 21 February 2006 projects growth of 1.3% in 2006.

⁶Based on estimated potential growth of 1.4%, 1.2%, 1.2% and 1.3% respectively in the period 2004-2007.

Source:

Stability programme (SP); Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

INTRODUCTION

The Italian authorities submitted the seventh update of the stability programme in the original language on 23 December 2005, later than the deadline of 1 December specified in the code of conduct⁵. The late submission of the programme was due to the need to incorporate the final version of the 2006 budget law, which was approved by the Italian Parliament on 22 December 2005. The programme covers the period from 2005 through 2009.

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. Usually, the macroeconomic projections and fiscal targets presented in the programme are those adopted by the government and the Parliament in the context of the national budgetary process, and more specifically 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. This year, however, the budgetary target for 2006 in the programme reflects the lower deficit target of the 2006 Budget Law.

The programme deviates on some material points from the model structure and data provision requirements for stability and convergence programmes specified in the new code of conduct.⁶ In particular, the chapter on "institutional features of public finance" is missing, and the programme has also gaps in the compulsory and optional data prescribed by the new code of conduct. In particular, there is no breakdown of the budget consistent with the deficit targets for the years 2007-2009 (see Section 3 below). Annex 2 provides a detailed overview of all aspects of compliance with the new code of conduct.

⁵ The English translation was submitted on 24 January 2006.

⁶ The full list of missing data is as follows (see also Annex 1):

Compulsory data: in Table 1c "Labour market developments", items 1 (Employment, person) and 4 (Labour productivity, persons) are missing. The data reported relate to the full-time equivalent definition; in Table 1d "Sectoral balances", item 1 (Net lending/borrowing vis-à-vis the rest of the world) is missing (the data reported refer only to the current account and are not compiled in accordance with ESA 95). In the same table, item 4 (Statistical discrepancies) of the year 2004 is missing. In Table 2 "General government budgetary prospects", items 6 (Total revenue), 7 (Total expenditure) and their components for the years after X+1 are not the planned ones, but those based on unchanged legislation (i.e., the programme does not provide a breakdown of the budget consistent with the deficit targets).

Optional data: in Table 1c "Labour market developments", items 2 (Employment, hours worked) and 5 (Labour productivity, hours worked) are missing (see above); in Table 1d "Sectoral balances", capital account, items 2 (Net lending/borrowing of the private sector) and 3 (Net lending/borrowing of the general government) are missing. In the same table, item 4 (Statistical discrepancy) after year 2004 is missing; Table 3 "General government expenditure by function" is missing; in Table 4 "General government debt developments", components under item 5 (Stock-flow adjustment), Differences between cash and accruals, Net accumulation of financial assets, and Valuation effects and other, years after 2006 are missing, as well as Privatisation proceeds after year 2007. In the same table, Liquid financial assets and Net financial debt are missing. In Table 7 "Long-term sustainability of public finance", total expenditure, interest expenditure and total revenue are missing.

1. ECONOMIC OUTLOOK

Between 1995 and 2004, GDP in Italy grew by 1½% per year on average, compared to 2% for the euro area as a whole. Over the same period, GDP per head increased by an average 1.4% per year in Italy and 1.7% in the euro area. As a result, Italy's per capita GDP has fallen from 103.5% to 96.9% of the euro area average (in PPPs). Low output growth in Italy has gone hand in hand with a progressive deterioration in international cost and price competitiveness, a steady loss of export market shares and, since 2000, a contraction in manufacturing activity. The unsatisfactory economic performance of the country can be largely ascribed to weak productivity growth and a specialisation model still skewed towards traditional sectors. Italy's estimated rate of potential output growth has fallen to a meagre 1¼ percentage points, also below the euro area's estimate (around 2%). Growth accounting calculations, which take into account the trend decline in hours worked and the evolution in the capital-labour ratio, show a steep fall in total factor productivity (TFP) growth, from 1% in the first half of the 1990s to about 0.3% in 2000-2004. Italy's dismal productivity performance can be tracked back to a number of structural factors, including insufficient competition in some key product and services sectors, red tape and regulatory failures, limited innovative capacity (related to low investment in R&D and a relative scarcity of skilled human resources), and obstacles to the reallocation of productive factors between sectors.

GDP per person employed in Italy grew on average ¾% per year in 1995-2004, much below the euro area average of 1¼%. Part of the decline in labour productivity growth is likely to be of a cyclical nature, and part of it could also be related to the labour market reforms enacted since the mid-1990s, which have favoured the employment of less skilled workers. In a context of relative wage moderation - real wages in the manufacturing sector increased by 0.4% on average in 1995-2004 - weak productivity growth appears to be the main cause of the more rapid increase in unit labour costs in Italy than in its trade partners, which is at the roots of an around 20% appreciation in the real exchange rate over the period.⁷ Considering the weak cyclical conditions, especially in the last five years, HICP inflation has remained stubbornly high in Italy, averaging 2.5% in 2000-2004 (2.2% in the euro area). In spite of low output and productivity growth, job creation has been robust in recent years and the unemployment rate has fallen to 8% in 2004. These developments reflect the effect of the labour market reforms successively implemented since the mid-1990s, but also some statistical effects from the regularisation of immigrant workers. However, employment rates remain significantly below the EU averages, especially for women and older workers,⁸ and regional disparities in the labour market are the largest in the EU. While the unemployment rates in the North and the Centre of the country in 2004 were, respectively, 4.3% and 6.5%, the unemployment rate in the South was 15.0%.

The macroeconomic scenario of the update reproduces the one presented in the DPEF of 15 July 2005. It assumes a recovery from zero GDP growth in 2005 to 1½% in 2006 and 2007, followed by a mild acceleration to 1¾% in the last two years of the programme (see Table 1). The projected acceleration in GDP growth in 2008-2009, to rates above current estimates of potential output growth, would be partly related to the growth-

⁷ Real exchange rate based on ULC in manufacturing, against a group of 34 trading partners.

⁸ In 2004: total: 57.6%; women: 45.2%; 55-64 year old people: 30.5%, compared to EU-25 averages of, respectively 63.3%, 55.7% and 41.0%.

enhancing policies enacted by the government. These projections imply a gradual narrowing of the negative output gap, which however would still be negative at the end of the programme's period. Domestic demand is expected to be the main driver of growth, supplemented by a modest but persistent contribution from stock-building. Net exports are projected to act as a slight drag throughout the programme period (except in 2006), as a gradual recovery in competitiveness and exports is expected to be more than offset by a domestic-demand induced acceleration in imports.

Table 1: Comparison of macroeconomic developments and forecasts

	2005		2006		2007		2008	2009
	COM	SP	COM	SP	COM	SP	SP	SP
Real GDP (% change)	0.2	0.0	1.5	1.5	1.4	1.5	1.7	1.8
<i>Contributions:</i>								
- Final domestic demand	0.7	0.4	1.6	1.1	1.5	1.4	1.8	1.9
- Change in inventories	0.1	-0.1	0.0	0.3	0.0	0.2	0.1	0.1
- External balance on g&s	-0.6	-0.4	0.0	0.0	-0.2	-0.1	-0.2	-0.2
Output gap ¹	-1.5	-1.5	-1.2	-1.2	-1.2	-1.0	-0.8	-0.6
Employment ² (% change)	0.5	0.4	0.6	0.6	0.6	0.7	0.8	0.7
Unemployment rate (%)	7.7	7.7	7.6	7.6	7.5	7.5	7.4	7.3
Labour productivity growth ² (%)	-0.3	-0.5	0.9	0.9	0.8	0.8	0.9	1.1
HICP inflation (%)	2.2	2.3	2.1	2.3	1.9	2.2	2.0	2.0
GDP deflator (% change)	2.4	2.4	2.2	2.2	2.2	2.2	2.0	2.0
Compensation of employees ² (% change)	2.9	3.5	2.6	2.3	2.7	2.5	2.5	2.5
External balance (% of GDP)	-1.1	n.a.	-1.1	n.a.	-0.9	n.a.	n.a.	n.a.
<u>Note:</u>								
¹ In percent of potential GDP, with potential GDP growth as reported in Table 2 below.								
² Full-time equivalent definition.								
<u>Source:</u>								
Commission services' autumn 2005 economic forecasts (COM); stability programme update (SP)								

Overall, the programme features plausible growth assumptions. In particular, the projected economic recovery in 2006-2007 is in line with the Commission services' autumn 2005 forecast. In terms of the composition of demand, however, the Commission services project stronger consumption growth, stronger export and import growth and negligible contribution to growth from stock-building. As to the medium term, the data presented in the programme imply a rate of potential output growth rising to 1½% towards the end of the programme period⁹, from the current level of 1¼%.

The external assumptions underpinning the programme differ in several respects from those underlying the Commission services' autumn 2005 forecast. The most notable differences are: a somewhat lower projected growth of world GDP and EU export markets; lower projected interest rates and oil prices; and, a stronger euro exchange rate. The assumptions on oil prices and interest rates appear to be markedly favourable compared to both current levels and the common external assumptions.

The programme projects employment growth at ¾% per year over 2006-2009. In the context of the expected recovery in GDP growth from 2006, these projections for employment growth, which are very similar to those of the Commission services up to 2007, imply a normalisation of the employment content of growth from the recent unusually high values, and a rebound in labour productivity growth from 2006 onwards.

⁹ Based on Commission services' calculations according to the commonly agreed methodology.

The unemployment rate is expected to attain 7¼% in 2009, continuing the decline started in 1998.

The programme is slightly more pessimistic than the Commission services on short-term inflation prospects. Headline HICP inflation is expected to remain above 2% in 2006 and 2007. Inflation is then projected to fall to 2% in the last two years of the programme, supported by the gradual deceleration in unit labour costs.

Table 2 presents the potential growth estimates on the basis of the Commission services calculations according to the commonly agreed methodology, based on the information in the programme. The estimated rates of potential growth are identical to those obtained on the basis of the Commission services' autumn 2005 forecast up to 2007 (about 1¼%). In 2008 and 2009, potential GDP growth is estimated to increase to 1½%, mainly supported by higher total factor productivity (TFP) growth.

The programme projects the current account to improve from a deficit of 1½% of GDP in 2005 to a deficit of ¾% of GDP in 2009. Although the update does not provide details on sectoral balances, the much larger improvement in the general government deficit (from 4¼% to 1½% of GDP) implies a shrinking private sector net lending.

Table 2: Sources of potential output growth

	2005		2006		2007		2008	2009
	COM	SP ²	COM	SP ²	COM	SP ²	SP ²	SP ²
Potential GDP growth ¹	1.2	1.2	1.2	1.2	1.3	1.3	1.5	1.6
<i>Contributions:</i>								
- Labour	0.3	0.3	0.3	0.2	0.3	0.3	0.3	0.2
- Capital accumulation	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.7
- TFP	0.6	0.3	0.3	0.4	0.4	0.5	0.6	0.7
Notes:								
¹ based on the production function method for calculating potential output growth								
² Commission services' calculations on the basis of the information in the programme								
Source:								
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations								

2. GENERAL GOVERNMENT BALANCE

This section is in four parts. The first briefly compares the targets for the general government balance in the new update with those presented in previous stability programmes. It also discusses budgetary implementation in the year 2005. The second part describes the budgetary strategy in the new update, including the programme's medium-term objective. The third provides the analysis of the risks attached to the budgetary targets and assesses the country's position in relation to the budgetary objectives of the Treaty and the Stability and Growth Pact. The final part discusses the results of a sensitivity analysis.

2.1. Targets in successive programmes and implementation in 2005

The programme envisages to reduce the deficit from 4.3% of GDP in 2005 to below 3% in 2007, as requested by the Council recommendation under Article 104(7), and to gradually achieve further consolidation in the following years, lowering the deficit to 1.5% of GDP in 2009. Comparisons with the 2004 and 2003 updates reveal that budgetary objectives have been repeatedly missed (see Table 3 and Figure 1). For instance, the nominal deficit figures for the 2005-2007 period are now planned to be on average 1.5 and 2.8 percentage points higher than in the 2004 and 2003 updates, respectively. In this respect, it should be noted that in 2005 the Italian institute of statistics (ISTAT) revised upwards the deficit figures in 2001-2004 by on average half a percentage point of GDP per year. These revisions implied some carry-over effect on the 2005 deficit (see below). The higher deficit targets for 2006-2008 compared to the November 2004 update mainly reflect the level effect of the considerably worse-than-planned 2005 deficit outcome (4.3% of GDP versus the planned 2.7% of GDP), as well as more cautious GDP growth projections.

The 2004 update targeted a general government deficit of 2.7% of GDP and projected GDP growth at 2.1%. The deficit target was revised upward twice during 2005. At the end of April, with a new GDP growth projection of 1.2%, the target was revised to a range of 2.9-3.5% of GDP. The upper bound of the range anticipated possible budgetary slippages and some carry-over effects from the statistical revisions of the deficit figures for the previous years. A second revision occurred in July, when, in line with the upper limit that the Council recommendation under article 104(7) considered as compatible with the rigorous implementation of the 2005 budget, the deficit target was set at 4.3% of GDP, under the assumption of nil GDP growth. To guarantee the attainment of the target, in October the government introduced new spending cuts and revenue increases amounting to some 0.1% of GDP¹⁰. The current programme confirms this target. The Commission services' autumn 2005 forecasts projected the same 4.3% of GDP deficit, although with GDP growth at 0.2%. Recent cash data on the State sector borrowing requirement suggest that the 2005 deficit target is likely to be achieved.

Negative carry-over effects from 2004, essentially due to statistical revisions, account for some 0.2% of GDP of the difference between the expected 2005 outcome and the target set in the 2004 update. Slippages in primary expenditure amounted to around 0.4% of GDP. In particular, the increase in nominal primary expenditure of general government

¹⁰ These measures, introduced by the Law Decree 211/2005 of 17 October 2005, have then been incorporated in the 2006 Budget Law.

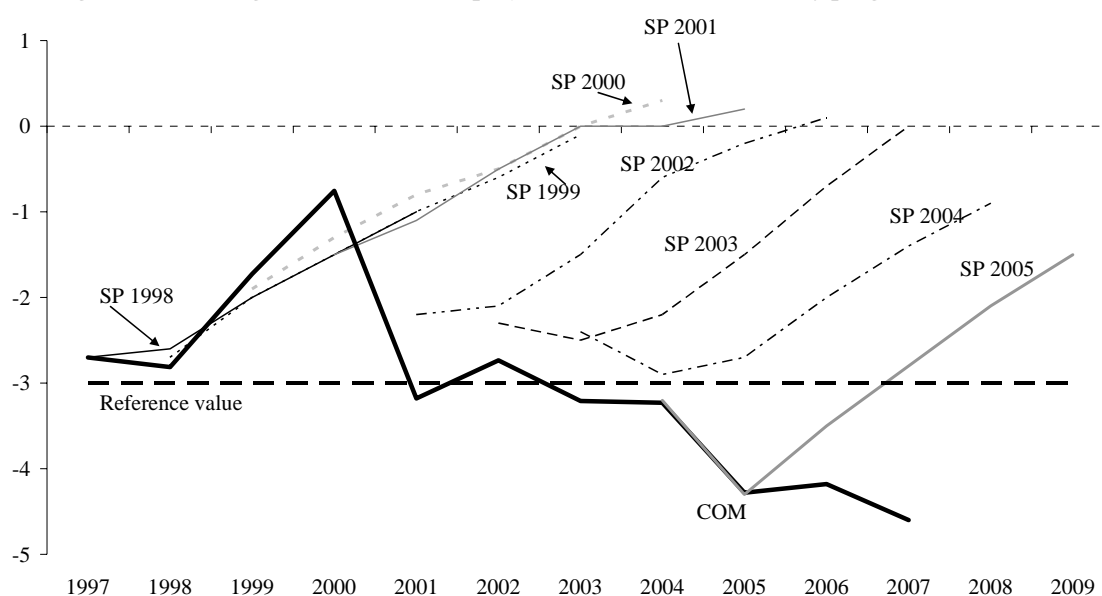
(excluding transfers other than in kind) exceeded the 2% cap set in the 2005 Budget Law. In addition, sales of real estate fell 0.4% of GDP short of the budgeted amount and, contrary to plans, the 0.15% of GDP capital expenditure of ANAS, the state-owned company in charge of road maintenance, remained within the general government account. Another percentage point of GDP of the difference in the expenditure-to-GDP ratio is explained by lower real economic growth. On the other hand, the decline in the revenue-to-GDP ratio was around 0.3 percentage point lower than planned. Positive surprises came both from some one-off measures introduced by the 2004 and 2005 Budget Laws and from the phasing in of several tax reforms entered into force recently. A positive contribution to the budget balance (0.2% of GDP) came from lower-than-expected interest expenditure.

Table 3: Evolution of budgetary targets in successive programmes

		2004	2005	2006	2007	2008	2009
General government balance (% of GDP)	SP December 2005	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
	SP November 2004	-2.9	-2.7	-2.0	-1.4	-0.9	n.a.
	SP November 2003	-2.2	-1.5	-0.7	0.0	n.a.	n.a.
	COM Nov 2005	-3.2	-4.3	-4.2	-4.6	n.a.	n.a.
General government expenditure (% of GDP)	SP December 2005	48.6	49.2	48.4	n.a.	n.a.	n.a.
	SP November 2004	48.5	47.5	n.a.	n.a.	n.a.	n.a.
	SP November 2003	47.3	n.a.	n.a.	n.a.	n.a.	n.a.
	COM Nov 2005	48.6	49.2	48.8	48.9	n.a.	n.a.
General government revenues (% of GDP)	SP December 2005	45.3	44.9	45.0	n.a.	n.a.	n.a.
	SP November 2004	45.6	44.8	n.a.	n.a.	n.a.	n.a.
	SP November 2003	45.1	n.a.	n.a.	n.a.	n.a.	n.a.
	COM Nov 2005	45.3	44.9	44.6	44.4	n.a.	n.a.
Real GDP (% change)	SP December 2005	1.2	0.0	1.5	1.5	1.7	1.8
	SP November 2004	1.2	2.1	2.2	2.3	2.3	n.a.
	SP November 2003	1.9	2.2	2.5	2.6	n.a.	n.a.
	COM Nov 2005	1.2	0.2	1.5	1.4	n.a.	n.a.

Source:
Stability programmes (SP) and Commission services' autumn 2005 economic forecasts (COM)

Figure 1: General government balance projections in successive stability programmes (% of GDP)



Source: Commission services' autumn 2005 forecast (COM) and successive stability programmes

Box 1: The excessive deficit procedure for Italy

On 28 July 2005, the Council decided that Italy had an excessive deficit. At the same time, the Council addressed a recommendation under Article 104(7) specifying that the excessive deficit had to be corrected by 2007. In particular, Italy was recommended to implement with rigour the 2005 budget; reduce the structural deficit by a minimum 1.6% of GDP by 2007 relative to its level in 2005, with at least half of this correction taking place in 2006; and, ensure that the debt-to-GDP ratio diminishes and approaches the reference value at a satisfactory pace.

On 22 February, the Commission adopted a communication concluding that the actions taken by Italy, if fully implemented and effective, would be consistent with the Council recommendation. However, implementation uncertainties persist, which will require continuous monitoring.

2.2. The programme's medium-term budgetary strategy

This section covers in turn the following aspects of the medium-term budgetary strategy outlined in the programme: (i) the main goal of the budgetary strategy; (ii) the composition of the budgetary adjustment, including the broad measures envisaged; and (iii) the programme's medium-term objective and the adjustment path towards it in structural terms.

Table 4: Composition of the budgetary adjustment

(% of GDP)	2004	2005	2006	2007	2008	2009	Change: 2009-2005
Revenues¹	45.3	44.9	45.0	<i>44.3</i>	<i>44.2</i>	<i>43.9</i>	<i>-1.0</i>
<i>of which:</i>							
- Taxes & social contributions	41.8	41.3	41.3	40.7	40.6	40.3	-1.0
- Other (residual)	3.5	3.6	3.6	3.6	3.6	3.5	-0.1
Expenditure¹	48.6	49.2	48.4	<i>47.6</i>	<i>47.5</i>	<i>47.0</i>	<i>-2.3</i>
<i>of which:</i>							
- Primary expenditure	43.5	44.3	43.7	43.0	42.8	42.3	-2.0
<i>of which:</i>							
Consumption	19.2	19.7	19.2	18.5	18.3	18.1	-1.5
Transfers other than in kind & subsidies	18.4	18.6	18.6	18.5	18.6	18.3	-0.2
Gross fixed capital formation	2.6	2.7	2.8	2.8	2.8	2.8	0.2
Other (residual)	3.3	3.4	3.1	3.2	3.1	3.0	-0.4
- Interest expenditure	5.1	4.9	4.7	4.7	4.7	4.7	-0.3
General government balance (GGB)	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5	2.9
Primary balance	1.8	0.6	1.3	1.9	2.6	3.2	2.6
One-off and other temporary measures	1.4	0.6	0.3				-0.6
GGB excl. one-off & other temporary measures	-4.6	-4.9	-3.8	-2.8	-2.1	-1.5	3.5

¹The programme does not provide targets for revenues and expenditure (and their components) after 2006. The figures indicated in italics are the official trends based on unchanged legislation.

Source:
Stability programme update; Commission services' calculations

2.2.1. The main goal of the programme's budgetary strategy

The budgetary strategy outlined in the programme aims at reducing the deficit below the 3% of GDP reference value by 2007, in line with the Council recommendation under Article 104(7), and at pursuing further fiscal consolidation towards the medium-term objective of a balanced budget in subsequent years.

The general government deficit has been above the 3% of GDP Treaty reference value in most years since 2001, with the structural deficit consistently in excess of 4% of GDP. The programme forecasts the nominal deficit to peak at 4.3% of GDP in 2005, up from 3.2% of GDP in 2004, and to decrease thereafter. The correction is moderately front-loaded. In line with the final version of the 2006 Budget Law approved on 22 December 2005, the programme targets a deficit of 3.5% of GDP in 2006. Thereafter, the deficit is planned to gradually decline to 2.8% of GDP in 2007, 2.1% in 2008 and 1.5% of GDP in 2009. The primary surplus, which has fallen from 5% of GDP in 1999 to ½% of GDP in 2005, is planned to start recovering in 2006 and to reach 3.2% of GDP in 2009 (see Table 4).

Compared with the previous programme, the new update slightly frontloads the planned adjustment against a much higher-than-expected 2005 deficit and a less favourable macroeconomic scenario. However, the new deficit target for 2008 is 1.2% of GDP worse than in the previous update, as the frontloading does not fully offset the level effect of the higher 2005 deficit.

2.2.2. The composition of the budgetary adjustment in the programme

As in previous updates, the composition of the needed fiscal adjustment is detailed only for the year 2006. For the years 2007-2009, the information is limited to the size of the correction required to achieve the budgetary targets relative to trends. The breakdown of the budget for the outer years of the programme reflects the unchanged legislation scenario and hence is not consistent with the budgetary targets. This makes it impossible to assess the path and the composition of the planned adjustment. A description of the measures on the government's agenda beyond 2006 is required by the Stability and Growth Pact¹¹ and the new code of conduct and would have been particularly desirable in the light of the Council request to correct the excessive deficit by 2007. The programme notes that the measures to achieve the budgetary targets will be defined year by year in the budget law, as required by Italy's fiscal policy legislation.

According to the 2005 update, the 2006 budget is expected to lead to an improvement in the general government balance by 0.8% of GDP relative to 2005, mainly thanks to expenditure cuts. Primary expenditure of the general government is set to fall by 0.6% of GDP in 2006, thus almost offsetting the 0.7% of GDP increase in 2005. More specifically, increases in social transfers other than in kind (0.2% of GDP) are set to be more than compensated by savings in other current expenditure items: government consumption, excluding wages, should fall by 0.4% of GDP¹²; net of the impact of disposal of real estate assets, public investment expenditure should remain stable at the 2005 level; other expenditure, which includes capital transfers, should decrease by 0.3% of GDP. Interest expenditure is projected to decrease by 0.2% of GDP relative to 2005. As for revenues, following a cumulative decrease of over one percentage point in 2004-2005 essentially due to reduced one-offs, the revenue-to-GDP ratio is set to rise slightly in 2006. As the budgetary impact of temporary revenues is projected to decrease

¹¹ Council Regulation (EC) No 1466/97 – Article 3 § 2(c).

¹² This corresponds to a 0.6% annual fall in nominal government consumption excluding compensation of employees. The resulting increase in total nominal government consumption would be 1.2%. However, the macroeconomic scenario in the programme projects a zero annual increase in real government and NPISH consumption expenditure and a 1.8% fall in its deflator.

to 0.3% of GDP from 0.4% in 2005, the permanent revenue increase would be around 0.2% of GDP. Although the bulk of the 2006 correction is imputed to the central government deficit (0.5% of GDP), cuts in local government deficits are also planned to contribute to the adjustment (by 0.3% of GDP).

Box 2: The budget for 2006

The 2006 budget has gone through significant changes between its adoption by the government at the end of September and its approval by Parliament on 22 December (hence after the 7 November cut-off date of the Commission services' autumn 2005 forecasts). While the draft budget targeted a deficit of 3.8% of GDP in 2006, the final version adopted by the Parliament lowered the deficit target to 3.5% of GDP and at the same time strengthened expenditure control mechanisms.

More in detail, the 2006 budget contains ½% of GDP of growth-supporting measures, including a general reduction in social contributions, prolongation of some tax breaks in the agricultural and construction sectors, a new fund to support households, measures to support investment, funds for the renewal of public sector contracts in 2006-2007, and other smaller measures. These measures will be more than offset by nearly 2% of GDP of deficit-reducing measures with respect to the unchanged legislation trend deficit (see Box 3). The funding would come mainly from expenditure cuts relative to the trend amounting to more than 1% of GDP. In particular, savings on intermediate consumption of central government and local administrations amount to around 0.4% of GDP relative to trends, while the trend of capital expenditure and of other expenditure is reduced by 0.6% of GDP. Additional savings amounting to 0.2% of GDP are planned from the health care sector, under the regions' responsibility. Expenditure cuts are supplemented by more than 0.7% of GDP of additional revenues, of which slightly more than 0.1% of GDP of one-offs.

Savings on regional and local government trend expenditure take the form of a further extensive revision of the "domestic stability pact" introduced in 1999. Regions are requested to cut current expenditure by 3.8% relative to the level recorded in 2004, whereas the growth of capital expenditure is capped at 4.8% above the 2004 level. For provinces and municipalities with more than 5,000 inhabitants the ceilings are defined in terms of average past performance. In particular, for provinces and municipalities whose average current per-head expenditure was lower than the average of all local governments with similar demographic characteristics in the 2002-2004 period, the ceiling for current expenditure net of social transfers in 2006 is the 2004 level less 6.5%. For less virtuous provinces and municipalities, the required cut on the 2004 level is 8%.

In order to realise the ambitious expenditure cuts, the budget introduces new control mechanisms, ranging from limits to the monthly appropriation of central government expenditure to an enhanced role of the Court of Auditors in the monitoring of the domestic stability pact. The budget also includes provisions aimed at addressing the recurring overshooting of health care expenditure ceilings (see Section 5).

Beyond 2006, the programme projects the unchanged legislation deficit (see Box 3 below) to drop to 3.3% of GDP in 2007, from the 3.5% of GDP deficit targeted in 2006. Even without additional corrective measures being adopted, the programme projects a 0.7% of GDP decrease in primary expenditure in 2007, largely as a result of an assumed fall in compensation of employees that does not fully take into account the future renewals of wage contracts. Revenues are projected to fall by 0.6% of GDP, of which 0.3% of GDP due to the fading out of the effect of temporary revenue measures. Undisclosed permanent deficit-reducing measures worth 0.5% of GDP to be adopted with the 2007 Budget Law are planned to bridge the gap between the 3.3% of GDP trend deficit based on unchanged legislation and the 2.8% of GDP deficit objective for 2006. With current primary expenditure continuing to match the decline in revenues

(particularly large in the outer years of the programme), the 2.1% and 1.5% of GDP deficit targets for 2008 and 2009 are planned to be achieved thanks to unspecified additional permanent measures amounting to 0.7% and 0.4% of GDP, respectively.

2.2.3. *The programme's medium-term objective (MTO) and the adjustment path in structural terms*

Table 5: Output gaps, cyclically-adjusted and structural balances

	2004		2005		2006		2007		2008	2009	Change: 2009-2005
	COM	SP ¹	COM	SP ¹	COM	SP ¹	COM	SP ¹	SP ¹	SP ¹	SP ¹
Gen. gov't balance	-3.2	-3.2	-4.3	-4.3	-4.2	-3.5	-4.6	-2.8	-2.1	-1.5	2.9
One-offs ²	1.4	1.4	0.5	0.6	0.4	0.3	-	-	-	-	-0.6
Output gap ³	-0.5	-0.4	-1.5	-1.5	-1.2	-1.2	-1.2	-1.0	-0.8	-0.6	1.0
CAB ⁴	-3.0	-3.0	-3.5	-3.5	-3.6	-2.9	-4.0	-2.3	-1.7	-1.2	2.3
change in CAB	0.0	0.0	-0.5	-0.5	-0.1	0.6	-0.4	0.6	0.6	0.5	-
CAPB ⁴	2.1	2.0	1.4	1.4	1.2	1.8	0.9	2.4	3.0	3.5	2.1
Structural balance ⁵	-4.4	-4.4	-4.0	-4.1	-4.0	-3.2	-4.0	-2.3	-1.7	-1.2	2.9
change in struct. bal.	0.5	0.5	0.4	0.3	0.0	0.9	0.0	0.9	0.6	0.5	-
Struct. prim. bal. ⁶	0.7	0.7	0.9	0.8	0.8	1.5	0.9	2.4	3.0	3.5	2.6

Notes:

¹Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme

²One-off and other temporary measures as calculated by the Commission services

³In percent of potential GDP

⁴CAB = cyclically-adjusted balance; CAPB = cyclically-adjusted primary balance

⁵CAB excluding one-off and other temporary measures

⁶Structural primary balance = CAPB excluding one-off and other temporary measures

Source:

Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations

According to the Stability and Growth Pact, stability and convergence programmes should present a medium-term objective (MTO) for the budgetary position. The MTO should be differentiated for individual Member States, to take into account the diversity of economic and budgetary positions and developments as well as of fiscal risk to the sustainability of public finances. The country-specific MTO is defined in structural terms (i.e. cyclically-adjusted, net of one-off and other temporary measures) and should fulfil a triple aim, namely (i) provide a safety margin with respect to the 3% of GDP deficit limit; (ii) ensure rapid progress towards sustainability; and (iii), taking (i) and (ii) into account, allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct (Section I thereof) further specifies that, as long as the methodology for incorporating implicit liabilities is not fully developed and agreed by the Council, the country-specific MTOs are set taking into account the current government debt ratio and potential growth (in a long-term perspective), while preserving a sufficient margin against breaching the deficit reference value of 3% of GDP. Member States are free to set an MTO that is more demanding than strictly required to achieve the triple aim of MTOs.

The update sets an MTO of a balanced general government budget, which, however, it does not target to achieve within the programme period.

Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the output gap is estimated to progressively narrow but to remain negative over the programme period. The estimated structural budget balance would improve from -4% of GDP in 2005 to -1¼% of GDP in 2009. In line with the need to put the situation of excessive deficit to an end by 2007, the correction is somewhat front-loaded. Specifically, the decline in the structural deficit would be larger than ¾% of GDP in both 2006 and 2007, with a cumulative decline in the structural deficit of around 1¾% of GDP over the two years. Contributing to the structural adjustment is a declining impact of one-offs measures, which falls from 0.6% of GDP in 2005 to zero in 2007. The adjustment towards the MTO is more gradual after 2007 (½% of GDP per year) when the output gap remains negative but it becomes considerably smaller.

2.3. Assessment

This assessment is in three parts. The first assesses the appropriateness of the programme's medium-term objective. The second analyses risks attached to the budgetary targets and the third examines whether the budgetary strategy laid down in the programme is consistent with the budgetary objectives of the Treaty and the Stability and Growth Pact.

2.3.1. Appropriateness of the programme's medium-term objective

As the programme's medium term objective (MTO) is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), its achievement should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit.

The programme's MTO is at an appropriate level because it lies within the range indicated for euro area and ERM II Member States in the Stability and Growth Pact and the code of conduct and adequately reflects the debt ratio and average potential output growth in the long term.

2.3.2. Risks attached to the budgetary targets

Overall, the risks to the budgetary projections in the programme appear to be on the negative side.

Compared with the Commission services' autumn 2005 forecast (see Table 5), projections for economic growth in 2005, 2006 and 2007 appear plausible. Limited downside macroeconomic risks only concern 2008 and 2009, when GDP growth is forecast to exceed current estimates of potential growth.

Recent information on cash data points to the possibility of a 2005 deficit outcome lower than the official target of 4.3% of GDP, related to a better-than-planned state sector cash borrowing requirement. The exact impact on national accounts figures, however, is difficult to estimate at this stage. At any rate, the possible permanent carry-over effect on 2006 is likely to be minimal, as the higher-than-expected revenue also includes one-off components.

The Commission services' autumn 2005 forecast for the general government balance in 2006 and 2007 does not provide a fully appropriate reference for assessing the

plausibility of the deficit targets in the 2005 update, as they were based on a draft version of the 2006 Budget Law which has been subject to significant changes after the cut-off date of the forecast (see Box 2). The changes increased the size of the fiscal correction and strengthened expenditure control mechanisms.

There are significant uncertainties regarding the implementation of the 2006 budget. A sizeable part (0.6% of GDP) of the planned correction relative to trends is expected to come from savings in health care expenditure and other government consumption, both of which have proved to be very rigid in the past. The new mechanisms introduced by the 2006 Budget Law in order to control these expenditure items will have to prove their effectiveness in reversing a record of regular overruns in the past. Further elements of risk attached to the savings foreseen by the 2006 budget concern the very large cuts in transfers to state-owned companies in charge of railways and of maintenance of state roads. On the revenue side, risks are more limited, although there are uncertainties about the outturn of a new tax agreement with self-employed professionals and small firms, linked to a tax amnesty for 2003 and 2004.

Table 6: Assessment of tax projections

	2006		2007		2008	2009	p.m.: OECD ¹
	COM	SP	COM ²	SP	SP	SP	
Total taxes							
Change in tax-to-GDP ratio	-0.1	0.1	-0.2	-0.5	-0.2	-0.3	/
<i>Difference</i>		0.1		-0.3	/	/	/
<i>of which³: - elasticity component</i>		0.2		-0.3	/	/	/
<i>- composition component</i>		0.0		0.0	/	/	/
p.m.: Observed elasticity to GDP	1.0	1.0	0.8	0.7	0.9	0.8	1.2
Notes:							
¹ OECD ex-ante elasticity relative to GDP							
² On a no-policy change basis							
³ The decomposition is explained in Annex 4							
Source:							
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)							

Tax projections for 2006 are broadly in line with the Commission services' autumn 2005 forecast (see Table 6), also considering that the programme's figures include around 0.2% of GDP of additional revenues adopted after the cut-off date of the autumn forecast.

Beyond 2006, risks that the deficit may be worse than targeted arise from the lack of information on the measures envisaged and from the likely underestimation of the size of the corrective measures needed to achieve the budgetary targets. As in the previous updates, the use of trend projections based on unchanged legislation results in an underestimation of expenditure projections compared to those derived on the basis of a no-policy change criterion (see Box 3). In particular, unchanged legislation projections do not fully take into account future wage increases in the public sector. The current update projects expenditure for compensation of employees to drop by 0.6% of GDP between 2006 and 2007, and to decrease further in 2008 and 2009, although by a lesser extent. As a result, the programme presents a 2007 trend deficit, based on unchanged legislation, 0.2% of GDP lower than in 2006. As a point of reference, the Commission services' autumn 2005 forecast, based on a no-policy change assumption, projected a 0.4% of GDP increase in the deficit in 2007.

Box 3: The trend scenario: “unchanged legislation” vs. “no-policy change”

The projection of deficit figures beyond the horizon of the already approved budget is a problematic issue. In particular, while certain budgetary items, such as interest expenditure, respond almost automatically to variables that are outside government control, the development of other items is more directly linked to future government behaviour. Hence, the trend projections are heavily dependent on the technical assumptions concerning future government conduct. Two main criteria for these assumptions can be used:

1. The unchanged legislation criterion, used by the Italian authorities, assumes that future expenditure and revenue will reflect only legislation already approved by the Parliament. However, only a subset of expenditure laws specifies in detail the amount of future expenditure. Other expenditure laws defer the exact quantification of expenditure to future decision, either explicitly or implicitly. For instance, the compensation for public employees is determined by laws that establish the parameters to be followed to compute the total amount of public wages; nevertheless, these parameters are affected by future renewals of public wages contracts and thus will give rise to a different budgetary impact compared to the one based on unchanged parameters. Another example is investment expenditure, where funds are typically allocated to specific projects with a limited time span. However, once the projects are completed, funds are normally re-allocated to new projects.
2. The no-policy change criterion, used by the Commission services, assumes a continuity of present trends for all expenditure items which are not yet known in sufficient detail (e.g. compensation of employees is assumed to grow in line with inflation). In addition the no-policy change criterion also includes budgetary measures officially announced by the government that are known in sufficient detail at the time of the completion of the forecast.

Tax trends in the programme for the years beyond 2006 appear somewhat conservative (see Table 6). The tax revenue-to-GDP ratio is particularly low in 2007, when it is projected to decrease by 0.5 percentage points, compared to 0.2 percentage points in the Commission services' autumn 2005 forecasts. Part of this difference is explained by the one-off revenues in the programme in 2006 (0.3% of GDP) compared to the amount incorporated in the Commission services' forecasts (0.1% of GDP). The remainder seems to be due to the fact that budgetary trends in the programme are on an unchanged legislation basis (see Box 3 above). More specifically, the projected 2.1% annual decrease in public employees' compensation would not seem to be consistent with the 3.3% annual increase in the total economy compensation of employees foreseen in the macroeconomic scenario. This would result in a lower tax base for both the personal income tax and social contributions, which in turn implies an underestimation of tax revenues. Nevertheless, the underestimation of tax revenues from public employees would be only around a half of the underestimation of the corresponding expenditure. The assessment of the tax trends in the programme from 2008 onwards points to a conservative assumption about the reaction of indirect taxation relative to the projected development of private consumption, implying a positive risk to the programme's budgetary projections.

The evaluation of one-off measures does not raise major issues. The programme's projection and the Commission services' autumn 2005 forecast of the budgetary impact of one-off measures differ only for the measures introduced after the cut-off date of the forecast and for a dissimilar treatment of part of the sale of real estate. In 2006, one-offs are planned to include only revenue from substitute taxes on re-evaluation of corporate assets and a new tax amnesty linked to a tax agreement with professional self-employed and small firms (slightly less than 0.3% of GDP of which around 0.1% of GDP from the 2006 Budget Law). A decrease in capital expenditure is planned from sale of real estate

(less than 0.1% of GDP), although the update does not recognise this lower expenditure¹³ as one-offs. According to the programme, there should be no one-offs from 2007 onwards.

2.3.3. Compliance with the budgetary requirements of the Treaty and the Stability and Growth Pact

The deficit outturn expected in 2005 and the budgetary corrections planned for 2006 and 2007 are consistent with the Council recommendation under Article 104(7). Taking the 2006 budget at face value, and assuming that it will be fully implemented, the implied structural effort would be consistent with the required effort of at least 0.8% of GDP in 2006. However, some of the planned measures present significant implementation uncertainties and might prove less effective than officially projected. As regards 2007, the planned 0.9% of GDP structural adjustment would also be in line with the Council recommendation under Article 104(7). However, there is no indication in the programme of the measures planned to achieve the 2007 target. Furthermore, the use of a trend deficit based on unchanged legislation results in an underestimation of the size of the corrective measures needed to achieve the adjustment.

Table 7: Assessment of tax elasticities

	2006		2007	
	COM (observed)	ex-ante ¹	COM ² (observed)	ex-ante ¹
Total taxes				
Change in tax-to-GDP ratio	-0.1	0.2	-0.2	0.3
<i>Difference</i>				
of which ³ : - elasticity component		-0.3		-0.5
- composition component		-0.2		-0.5
		-0.1		0.0
p.m.: Elasticity to GDP	1.0	1.2	0.8	1.2
Notes:				
¹ Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD				
² On a no-policy change basis				
³ The decomposition is explained in Annex 4				
Source:				
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)				

Both the Commission services' and the update's tax elasticities are below the *ex-ante* standard elasticity estimated by the OECD (see Table 7). The lower tax revenue in the Commission services' forecast relative to the *ex ante* standard elasticity mainly reflects the decrease in personal income taxes envisaged in the 2005 Budget Law and the cut in social contributions foreseen by the 2006 Budget Law.

Following the planned correction of the excessive deficit, the programme targets an annual improvement of the structural balance of ½ % of GDP. While this is in line with the minimum requirement of the SGP, the planned adjustment is subject to the risks outlined above. As regards the MTO set in the programme, it will be reached only well after the end of the programme period (the programme does not indicate a target date for

¹³ According to the ESA95 conventions, sales of real estate are recorded as negative expenditure, not as revenue.

the achievement of the MTO). Taking into account the balance of risks, the correction of the excessive deficit by the 2007 deadline set by the Council is predicated upon an effective implementation of the 2006 budget and the specification and implementation of substantial corrective measures for 2007. The achievement of the safety margin against breaching the 3% of GDP threshold in 2009 also hinges on these risks and on the specification and implementation of corrective measures for the years beyond 2007.

The strategy for the general government balance outlined in the programme is partly consistent with the broad economic policy guidelines in the area of public finance. In particular, while Italy is taking action to correct the excessive deficit, it would be appropriate to envisage a more rapid pace of government debt reduction, in particular by strengthening the adjustment path towards the MTO.

2.4. Sensitivity analysis

The programme examines the budgetary impact of two alternative growth scenarios, which assume that over the 2006-2009 period, annual GDP growth is either permanently lower or higher than in the baseline by 0.5 percentage point each year in function of variations of some unspecified key external variables. The less (more) favourable evolution of these variables relative to the baseline scenario would imply weaker (stronger) export and consumption growth, with knock-on effects on investment and employment. In both cases, the programme assumes that productivity and potential GDP growth would also be affected. The programme makes explicit the assumptions on how government revenues and expenditure are expected to react in the alternative growth scenarios.¹⁴ In case the low growth scenario materialised, the cyclically-adjusted balance would not respect the safety margin (estimated at -1.5% of GDP) against breaching the 3% of GDP deficit threshold at the end of the programme's period. In the high growth scenario, the safety margin would be respected one year earlier (in 2008) than in the baseline scenario.

This conclusion is confirmed by a simulation carried out by the Commission services. Assuming (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2005-2009 period; (ii) trend output based on the HP-filter¹⁵ and (iii) no policy response (notably, the expenditure level is as in the central scenario¹⁶), reveal that, by 2009, the cyclically-adjusted balance is some ¾ of a percentage point of GDP above/below the central scenario. Hence, in the case of

¹⁴ For the cyclical component, the standard elasticity of the primary balance (0.5 in the case of Italy) is applied. For the structural component, the programme first assumes that the corrections will be split proportionally between current revenue and expenditure, and then (i) holds expenditure at the calculated levels, and (ii) adjusts revenues according to their standard elasticity to growth (1.2).

¹⁵ In the absence of a fully-specified macroeconomic scenario that would underlie such deviations, it is obviously impossible to derive new estimates of potential growth from the agreed production function method.

¹⁶ The effect of lower/higher growth on revenues is captured by using the conventional sensitivity parameters adopted in cyclical adjustment procedures.

persistently lower real growth, additional measures of a corresponding size would be necessary to keep the public finances on the path targeted in the central scenario.¹⁷

The programme also provides an analysis of the sensitivity of interest expenditure to changes in interest rates. As a result of the increased duration of Italy's debt, the short-term impact would be smaller than in the past. An immediate and permanent upward shift in the entire yield curve by one percentage point is estimated to increase interest expenditure by 0.2% of GDP in 2006, 0.4% in 2007, 0.5% in 2008 and 0.6% in 2009.

¹⁷ Unexpected changes in inflation are not assumed to affect the expenditure-to-GDP ratio as nominal expenditure should broadly move in lockstep with the price level.

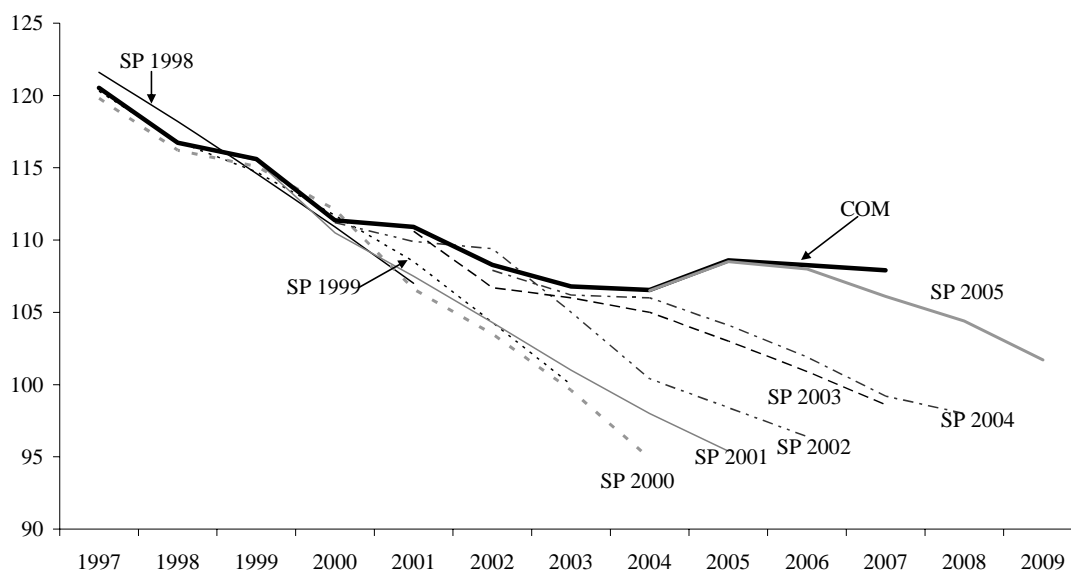
3. GENERAL GOVERNMENT GROSS DEBT

This section is in two parts: the first describes the debt path envisaged in the programme and the second contains the assessment.

3.1. Debt developments in the programme

The 2005 update projects a gradual reduction in the debt-to-GDP ratio from 108½% at the end of 2005 to just below 102% at the end of the programme period. Rising primary surpluses over the programme's period are projected to more than offset the adverse “snow-ball” effect of still high interest expenditure and relatively low real GDP growth. Specifically, the debt-to-GDP ratio is planned to fall slightly in 2006 and then to decline more substantially, by about 2 percentage points per year, in 2007 and 2008. In 2009 the debt ratio is projected to decline at a more rapid pace (2¾ percentage points) thanks to a primary surplus planned to be above 3% of GDP. Compared to the November 2004 update, the reduced speed of debt reduction from 2006 onwards is essentially due to a significantly lower primary balance. In contrast, thanks to lower interest expenditure, the “snow-ball” effect is projected to be less severe than in the 2004 update. Concerning the stock-flow adjustment, privatisation plans have been revised downward dramatically. Proceeds from privatisation are now assumed to reduce the debt by 0.7% of GDP in both 2006 and 2007 (compared to around 2% of GDP in the 2004 update), and are projected to be nil in both 2008 (0.6% of GDP in the 2004 update) and in 2009. In spite of this, the projected stock-flow adjustment is smaller than in the 2004 update, as a consequence of reduced plans for debt-increasing transactions recorded below the line. In particular, in 2006 the accumulation of financial assets (excluding privatisation proceeds) is projected to be only ¼% of GDP and the cash/accruals difference is now estimated to be ½% of GDP, while the 2004 update assumed a debt-increasing contribution of 1% of GDP from each of these two items. Although the programme does not provide details on the composition of the stock-flow adjustment for years after 2006 (apart from the privatisations in 2007), the projected total stock-flow adjustment suggests that debt-increasing transactions recorded below the line should cease as from 2007.

Figure 2: Debt projections in successive stability programmes (% of GDP)



Source: Commission services' autumn 2005 forecast (COM) and successive stability programmes

Table 8: Debt dynamics

	average 2000-2004	2005		2006		2007		2008	2009
	COM	COM	SP	COM	SP	COM	SP	SP	SP
Government gross debt ratio	108.8	108.6	108.5	108.3	108.0	107.9	106.1	104.4	101.7
Change in debt ratio (1 = 2+3+4)	-1.8	2.1	2.0	-0.3	-0.5	-0.4	-1.9	-1.7	-2.7
<i>Contributions:</i>									
- Primary balance (2)	-3.2	-0.6	-0.6	-0.6	-1.3	-0.3	-1.9	-2.6	-3.2
- “Snow-ball” effect (3)	1.5	2.3	2.4	0.8	0.8	1.0	0.8	0.9	0.8
- Interest expenditure	5.8	4.9	4.9	4.7	4.7	4.8	4.7	4.7	4.7
- Real GDP growth	-1.4	-0.2	0.0	-1.6	-1.6	-1.4	-1.6	-1.7	-1.8
- Inflation (GDP deflator)	-2.9	-2.5	-2.5	-2.4	-2.3	-2.4	-2.3	-2.1	-2.1
- Stock-flow adjustment (4)	-0.1	0.4	0.2	-0.5	0.0	-1.1	-0.8	0.0	-0.3
- Cash/accruals	0.4	0.2	0.1	0.3	0.5				
- Accumulation of financial assets	0.0	0.2	0.0	-0.8	-0.5				
<i>of which: Privatisation proceeds</i>	-0.5	-0.3	-0.3	-1.0	-0.7	-1.0	-0.7	0.0	0.0
- Valuation effects & residual adj.	-0.5	0.0	0.1	0.0	0.0				
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.									
Source: <i>Stability programme update (SP); Commission services’ autumn 2005 economic forecasts (COM); Commission services’ calculations</i>									

The expected 108½% debt-to-GDP outcome for 2005 is significantly higher than the 104% planned in the November 2004 update and marks the first increase in the debt ratio since 1994. Apart from the ½% of GDP carry-over effect from 2004, the difference between last year's and the current update is explained by a much lower-than-planned primary surplus (0.6% of GDP instead of 2.4%) and real GDP growth (nil compared with the previously projected 2.1%). Despite much lower-than-planned privatisation proceeds (0.3% of GDP instead of 2.1%), the total stock-flow adjustment is projected to increase the debt by only 0.2% of GDP (-0.1% in the 2004 update), because of lower debt-increasing transactions recorded below the line.

It is worth noting that the 2005 State sector cash borrowing requirement turned out better than expected, by around 0.4% of GDP. This could also imply a better-than-expected debt outcome. Moreover, an upward revision of the GDP level by around 2 percentage points recently carried out by the Italian institute of statistics (ISTAT) for years 1992-2000, including *inter alia* the sectoral allocation of FISIM, has reduced the debt-to-GDP ratio by 2.3 percentage points in 2000. A revision of a similar magnitude is expected for the years after 2000 in the next ISTAT release scheduled for 1 March 2005.

3.2. Assessment

The ½ of a percentage point reduction in the debt-to-GDP ratio projected for 2006 is slightly higher than the Commission services’ autumn 2005 forecast (¼% of GDP). The difference reflects the combined effect of a lower primary balance (see Section 3) and a

more favourable assumption on the stock-flow adjustment in the autumn 2005 forecast, which incorporated the official projection made in July 2005 (in particular, privatisation plans have since been reduced to 0.7% of GDP, down from 1.0% of GDP in July 2005). Although still ambitious, the new privatisation target seems to be achievable, also taking into account the present market value of the government's stakes in joint-stock companies. Concerning the debt-increasing transactions included in the stock-flow adjustment, they reflect: (i) the cash/accruals difference linked to the actual payment of interest on postal bonds, which accrued (and were properly recorded as expenditure) in the past but are paid only when the bonds are redeemed¹⁸; (ii) the postponed cash disbursements related to the end-2005 renewals of public sector contractual wages will also affect the cash/accruals difference in 2006; and (iii) accumulation of financial assets (excluding privatisation precedes) amounting to 0.2% of GDP¹⁹. Abstracting from a specific analysis possible only ex post, the planned magnitude of the debt-increasing transactions included in the stock-flow adjustment in 2006 does not appear particularly worrying.

The 1.9 percentage point reduction in the debt-to-GDP ratio targeted for 2007 would be achieved thanks to a planned primary surplus of the same magnitude. The projected proceeds from privatisation, amounting to 0.7% of GDP would offset the "snow-ball" effect. The planned debt reduction compares with a more modest 0.4 percentage point decrease in the Commission services' autumn 2005 forecasts. The 1.5 percentage point difference mainly reflects different estimates of the primary surplus (based on a no-policy change assumption in the autumn 2005 forecast). Smaller differences due to the "snow-ball" effect and the stock-flow adjustment cancel each other out.

The path of debt reduction envisaged in the programme is conditional on the achievement of the budgetary targets. As recalled in Section 3 of this assessment, there are risks linked to the achievement of the 2006 target, and the programme does not provide any indications on the additional measures needed to achieve the budgetary targets in the following years. Additional risks to the debt targets are related to the realisation of the privatisation plans and to the effective scaling back of debt-increasing transactions recorded below the line, which would represent a clear discontinuity vis-à-vis the recent past.

Overall, the debt reduction planned for 2006 and 2007, if achieved, would be consistent with the Council recommendation in accordance with Article 104(7). Nevertheless, also taking into account the risks highlighted above, the planned debt ratio is not sufficiently diminishing over the program period. This essentially reflects the current low levels of the primary surplus and potential output growth in Italy. In order to strengthen Italian public finances in view of an ageing population, as required in the broad economic policy guidelines, it would seem appropriate to envisage a more rapid pace of government debt reduction, in particular by strengthening the adjustment path towards the MTO.

¹⁸ The amount of accrued but no yet paid interest (which constitute a liability that is not recorded as 'Maastricht' debt) was more than 5% of GDP at the end of the 2004. It will gradually translate into actual payments and contribute to increase the 'Maastricht' debt over the next 15-20 years as these postal bonds expire.

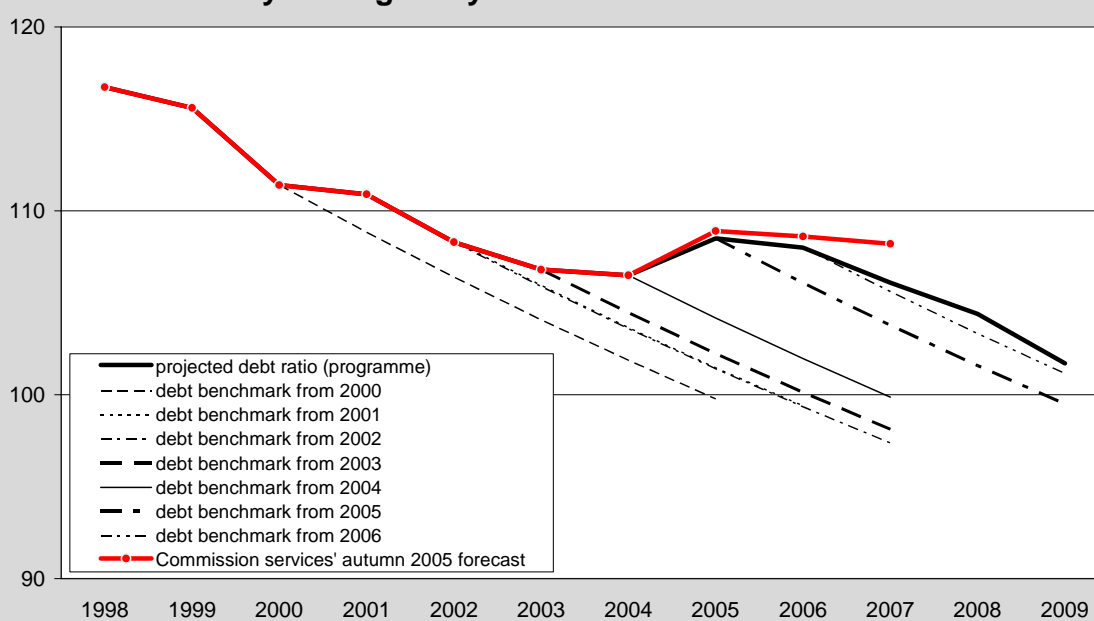
¹⁹ This figure may include the positive effect of planned reductions in the liquid assets held with the Bank of Italy at the end of the year.

Box 4: The rolling debt reduction benchmark

At the time of the presentation of the initial stability programme in 1998 the debt ratio was already well above the 60% of GDP reference value. A tentative assessment of the pace of debt reduction over a medium-term horizon is presented in the accompanying graph. It shows historical data, the Commission services' autumn 2005 forecasts until 2007 (which are on a no-policy change scenario) and the multi-annual debt projections in the update and compares them with the paths obtained by applying an illustrative "rolling debt reduction benchmark" (see Annex 5). The benchmark reflects the idea that a minimum debt reduction should be ensured not year after year but over a medium-term horizon (five years in the graph). For instance, the debt projection for 2005 is compared with the value obtained for the same year by applying the formula starting in 2000. Debt level projections in the programme exceeding those obtained by applying the benchmark are taken as an indicator of a slow reduction in the debt ratio.

The graph clearly shows that the planned reduction of the debt ratio in the update is less than implied by the five-year rolling debt reduction benchmark.

Italy: rolling five-year debt benchmark



Source: Stability programme and Commission services

4. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES

The programme presents the content of the 2006 Budget Law and its accompanying legislation (Law 248/2005) and the National Reform Programme submitted on 14 October 2005 in the context of the Lisbon strategy. However, the update does not provide a chapter on institutional features of public finances, nor does it present data on the functional breakdown of expenditure.

The NRP does not specify actions in the area of public finances. However, a general reduction of the social contributions rate by up to 1 percent was included in the 2006 Budget Law in order to strengthen growth potential. Furthermore, in November, the government approved some enacting legislation of the 2004 framework pension reform, aimed at creating a second pillar pension scheme. Nevertheless, its implementation has been postponed to 2008.

With regard to one-off measures, in contrast with the previous update's plans to have them phased out already in 2006, the 2005 update envisages a deficit-reducing contribution of 0.3% of GDP (see Section 3.3.2).

After the disappointing development of 2005, when the increase in nominal primary expenditure of general government (excluding transfers other than in kind) significantly exceeded the 2% cap set in the 2005 Budget Law, the 2006 Budget law introduced new legislative provisions to improve expenditure control. The monthly appropriation of non-obligatory central government expenditure has been limited to 1/12 of the total annual allocation. Furthermore, each Minister is required to freeze the expenditure under his/her responsibility if the state general accounting office (*Ragioneria Generale dello Stato*) indicates an overshooting of the target. Some enhancement in the role of the Public Information Services Agency (*Consip*), in charge of rationalising public procurement, aims at reducing intermediate consumption of both central and local governments, while additional controls performed by the Court of Auditors (*Corte dei Conti*) are intended to strengthen the enforcement of the tightened ceilings for local government expenditure (see Box 2).

A series of new measures tries to address the recurrent deficits of the health care sector, which is under the regions' responsibility. Regional tax rates on personal income (IRPEF) and on productive activities (IRAP) should be automatically increased in regions that do not take effective action to address their health structural deficit before 31 May 2006. In addition, the state funding of part of past slippages is contingent on a specific agreement between the state and each concerned region on the implementation of the required correction of their health care structural deficit. Finally, the development of pharmaceutical expenditure will be monitored monthly and the accountability of doctors and pharmacists increased, *inter alia* by introducing electronic recording of medicament/analysis prescriptions (via the early introduction of a new electronic card for patients).

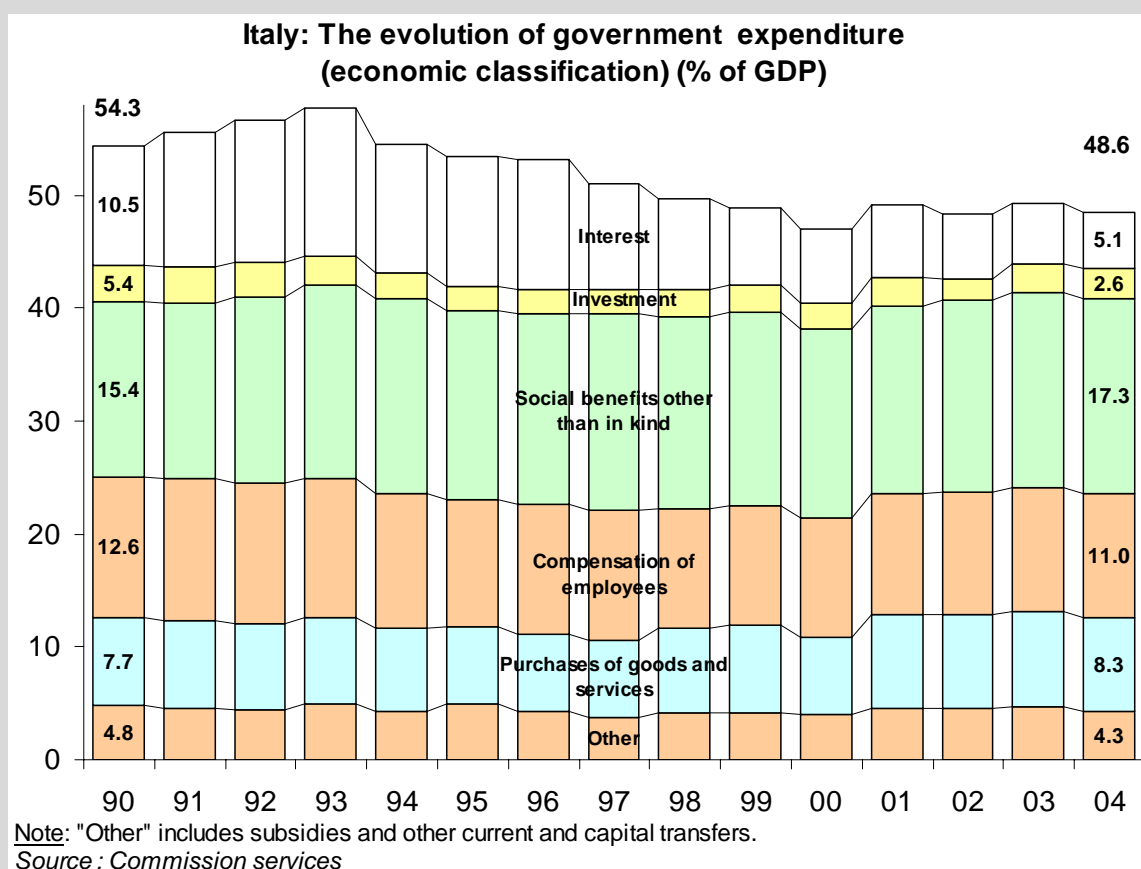
A reduction in tax evasion is sought both by involving municipalities in tax assessments and by increasing tax administration staff. Besides, tax revenue collection is to be reformed by assigning it to a new state-owned company (*Riscossione Spa*).

The cut of social contributions included in the 2006 Budget Law is directed towards strengthening the growth potential of the economy. In addition, the establishment of a second pillar pension scheme and the measures aiming at controlling health care

expenditure represent steps towards safeguarding economic and fiscal sustainability. However, overall there is no major reallocation of public expenditure towards growth-enhancing items compared to the past. Furthermore, in view of the challenge of an aging population, it would have been appropriate to implement early the second pillar pension scheme and design a more organic reform of health care. Hence, the measures presented in the programme are only in part consistent with the broad economic policy guidelines in the area of public finances.

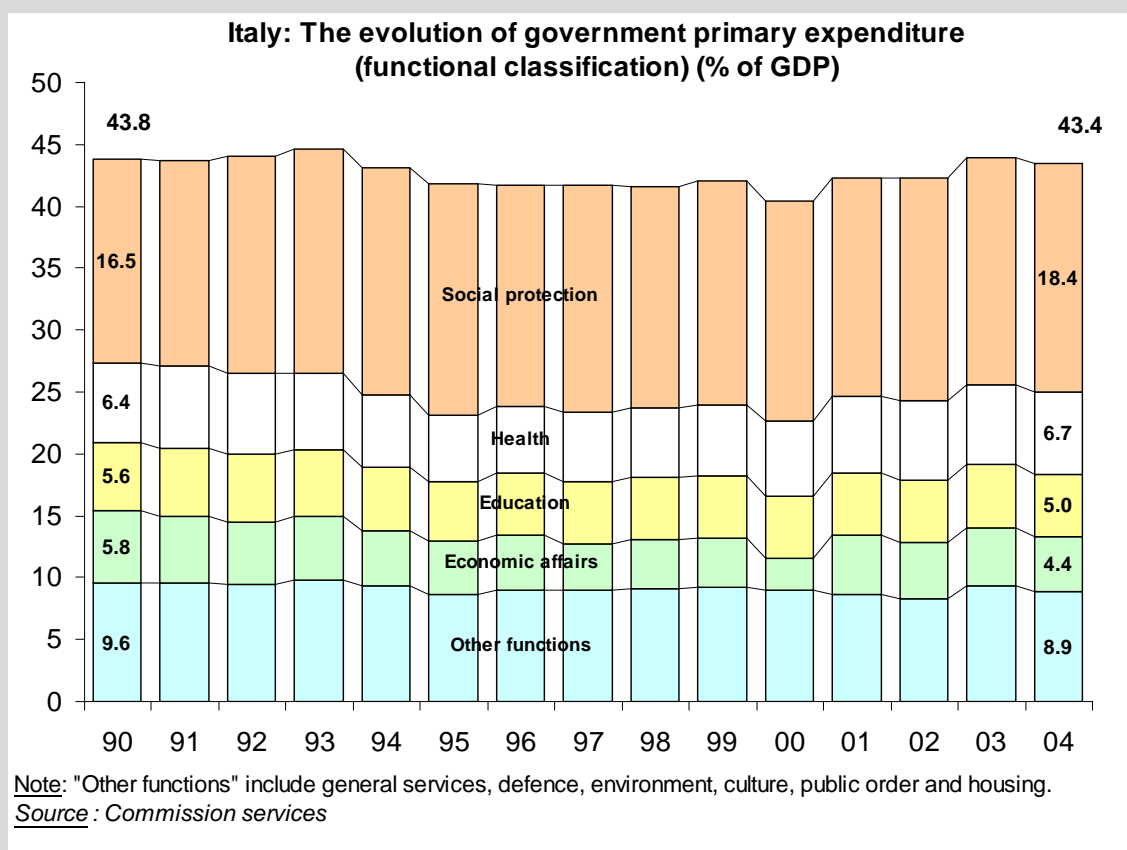
Box 5: The level and composition of government expenditure in Italy since 1990

The evolution of the level and composition of government expenditure in Italy over the last 15 years shows that the sizeable decline in the expenditure-to-GDP ratio essentially reflects reduced interest expenditure. In order to abstract from cyclical effects on the expenditure share, a comparison of two years with similar cyclical conditions, notably 1992 and 2004 is appropriate. In 1992, total government expenditure and interest expenditure amounted to 56.7% and 12.6% of GDP, respectively. Both were the second highest in the group of countries that now constitute the euro area. Twelve years later, total expenditure had declined to 48.6% of GDP, which compares with a euro area average of 47.8%. Out of the total 8.1 percentage points decline in expenditure, 7.6 percentage points consist of lower interest expenditure. Although considerably lower than in 1990, given the high debt ratio, interest expenditure in terms of GDP in Italy still ranks second in the euro area.



The path of the expenditure-to-GDP ratio was uneven over the 1990-2004 period. Also due to a significant negative cyclical effect, the total expenditure-to-GDP ratio peaked in 1993, when it reached 57.7 percentage points. From 1994 to 2000, a reduction in primary expenditure contributed to the consolidation of public finance. The 10.7 percentage points of GDP decline in total expenditure achieved in 2000 as compared to the 1993 peak exceeded by more than 4 percentage points the decrease in interest expenditure over the same years. However, the decreasing path of expenditure was interrupted in 2001, when, with similar cyclical conditions

compared to 2000, primary expenditure increased abruptly by around 2 percentage points of GDP. Since then, in spite of an uninterrupted decrease in interest expenditure in terms of GDP, total expenditure has oscillated in the range of 48½-49¼% of GDP.



The evolution of government expenditure can also be considered by looking at the functional classification of expenditure. Data in the above chart reveal that in the first half of the 1990s an ageing population was already affecting the dynamics of primary expenditure. Over the 1990-1995 period, expenditure on social protection, which largely consists of pensions, increased by 2.2 percentage points of GDP, while expenditure on education declined by 0.7 of a percentage point of GDP. After 1995, expenditure on social protection followed an uneven path to attain 18.4% of GDP in 2004, still lower than in the euro area (19.9% of GDP in 2003), as in Italy higher expenditure on pensions is offset by lower unemployment benefits. Expenditure on education stabilised at around 5% of GDP from 1996 onwards, slightly below the euro area average (5.2% of GDP in 2003). Expenditure on health, after declining between 1990 and 1995, it started increasing in 1997 to reach 6.7% of GDP in 2004. Expenditure on health in Italy has been above the euro area average (6.3% of GDP in 2003) since 2001.

The National Reform Programme of Italy, submitted on 14 October 2005 in the context of the renewed Lisbon strategy for growth and jobs, does not identify challenges with significant implications for public finances, referring instead to the plans in the Economic and Financial Planning Document (DPEF) of July 2005. The measures in the area of public finances envisaged in the stability programme are broadly in line with the actions foreseen in the DPEF. The 2006 Budget Law makes the additional NRP expenditure (almost 1% of GDP) conditional on future additional financial resources "...verified with the European Commission in terms of consistency with the targets presented in the update of the Italian stability ...programme." Hence, it does not impact on the budgetary targets for 2006-2009 set in the update.

Box 6: Transparency of the budgetary process

In spite of several past reforms^{*}, the process that leads to the formulation of the Italian budget and the monitoring of its execution is still based on numerous documents which use different institutional aggregation and accounting methods. This situation, as well as delays in the presentation of some planning and reporting documents, reduce the transparency of the budgetary process and hamper the monitoring of budgetary developments.

The budgetary process in Italy typically starts at the end of June, with the publication of the Economic and Financial Planning Document (*Documento di Programmazione Economica e Finanziaria* - DPEF), which covers the following four years. The DPEF includes the official macroeconomic and budgetary trends at unchanged legislation (see Box 3), the budgetary plans, and any other envisaged economic policy measure that can be expected to have substantial impact on macroeconomic and public finance developments. Concerning budgetary plans, the DPEF indicates the targets for the deficit and the debt but it does not quantify policy targets for the different expenditure components and tax burden. This approach is then reflected in Italy's stability programme. Although the Parliament is called to endorse the DPEF, this does not become a law.

At the end of September, the government presents to the Parliament, for approval by 31 December, (i) a draft comprising a detailed annual and a less detailed multi-annual state budget under unchanged legislation (*Bilancio dello Stato a legislazione vigente*) and (ii) a draft Budget Law (*Disegno di legge finanziaria*) including the corrective measures (with respect to (i)) judged necessary to reach the budgetary targets set in the DPEF. Possible accompanying bills to the Budget Law (*Disegni di legge collegati alla finanziaria*) can be submitted by 15 November. A multi-annual state budget based on plans is also transmitted to Parliament, but it is not voted. Although overwhelming, the amount of information included in the budget is insufficient to provide a comprehensive and clear picture of Italian public finances. First, the budget is structured in about one thousand budget forecasting units (*Unità previsionali di base*), which reflects the fragmented administration behind the various activities rather than the policy targets. Second, the budget includes only expenditure and revenue pertaining to the state rather than to the general government. The difference between these two aggregates, especially in the light of the process of decentralisation, is widening. Finally, although presented both in cash and accrual terms, the budget is not compiled according to ESA95. The only document that presents the official view of the budgetary implication of the Budget Law in line with ESA95 and referring to the general government is therefore the "second section" of the planning and forecasting document (*Relazione previsionale e programmatica* - RPP), which should be presented to the Parliament together with the budget. This key document was made available only with a considerable delay in the 2006 budgetary process.

Together with a reshuffling of the budget, each year the Budget Law envisages a correction meant to bridge the gap between the target for the next year's general government balance and the trend deficit at unchanged legislation as projected in the DPEF. This complex and legalistic way of measuring the size of the correction carries risks, as highlighted by the stepwise presentation of the 2006 Budget Law. The original draft budget law and the accompanying legislation presented to Parliament on 4 October projected a correction of around €12 billion (0.8% of GDP) bridging the gap between the unchanged legislation deficit estimated at 4.7% of GDP and the deficit target of 3.8% of GDP set in DPEF. However, in late October, i.e. almost one month after the government's adoption of the draft Budget Law and three month after the DPEF publication, it became evident that an overestimation of the sales of real assets in 2006 resulted in an underestimation of the 2006 trend deficit. Although partially offset by higher estimates of dividends from state-owned companies, the downward revision to real estate sales worsened the trend deficit projection by around 0.3% of GDP and triggered the adoption of corresponding corrective measures. Subsequently, the government further increased the size of the correction in order to target a lower structural deficit which would be in line with the Council recommendation under Article 104(7) of the Treaty. In this last round of changes, the government

also revised significantly upwards the projected revenue-to-GDP ratio with respect to the DPEF, without giving any explanation for the revision**.

Documents which would allow the monitoring of budgetary development in cash terms, namely the Report on the state sector cash borrowing requirement (*Relazione sulla stima del fabbisogno del settore statale*) and the Report on the outcomes of the cash management of the state budget and of the Treasury account (*Relazione sui risultati conseguiti dalle gestioni di cassa del bilancio statale e della Ragioneria*) are regularly presented well after the statutory deadlines. This is an obstacle to the prompt identification of budgetary slippages. This problem is compounded by the fact that data related to local and regional finances are available with considerable delay. The establishment of the Information System on the Operations of Government Bodies (SIOPE), which collects online information on budgetary transaction made by public administrations, aims at addressing this shortcoming.

To sum up, the present budgetary process in Italy is unduly complex, not transparent and not in line with ESA95 national account rules. It may be appropriate to consider a reform to correct this situation, so as to raise the efficiency and the effectiveness of the budgetary process and the accountability of the fiscal authorities.

* In particular, laws 468/1978, 362/1988, 94/1997, and 208/1999.

** This is not a criticism to the new revenue projections, which are assessed in the main text.

5. THE SUSTAINABILITY OF THE PUBLIC FINANCES

The assessment of the sustainability of Italy's public finances is based on an overall judgement of the results of quantitative indicators and qualitative features. The debt projections and sustainability indicators are calculated according to two different scenarios, to take into account different budgetary developments over the medium term. The "programme" scenario assumes that the medium-term budgetary plans set up in the programme are actually achieved. The "2005" scenario assumes that the structural primary balance²⁰ remains unchanged at the 2005 level throughout the programme period.

The long-term projections in the programme have been made using the agreed assumptions in the current EPC projections (see Table A1 in Annex 6). On the basis of this information, age-related expenditure is foreseen to increase by 1.3% of GDP between 2009 and 2050, to which health care expenditure contributes by 0.9% of GDP (see Table A1 in the Annex 6). The Commission services' analysis is based on the set of government expenditure items covered by the common projections carried out by the Economic Policy Committee²¹ (see Table A2 in the Annex 6).

The gross debt-to-GDP ratio is currently significantly above the reference value of 60% of GDP, at 108.5% of GDP. According to the '2005' scenario, the debt/GDP ratio is expected to increase throughout the projection period, especially after 2020²². In the 'programme' scenario, however, the debt ratio is projected to be on a declining path throughout the projection period, falling below 60% of GDP around 2025 (see Table A4 in the Annex 6).

In the '2005' scenario, the sustainability gap (S1) that assures reaching the debt ratio of 60% of GDP by 2050 would be 2.4% of GDP. The sustainability gap (S2) which satisfies the inter-temporal budget constraint would be 2% of GDP. The initial budgetary position is not sufficiently high to offset the future impact of increasing age-related expenditure due to an ageing population up to 2050.

According to both sustainability gaps, the impact of ageing is limited, in particular, thanks to the pension reform measures enacted in recent years. However, the large structural government deficit prevents a rapid reduction of the debt ratio. The need to consolidate the current budgetary position is therefore a priority.

This is reflected in the programme that includes a structural budgetary consolidation of 2.9% of GDP between 2005 and 2009, which, however, is subject to significant uncertainties. If it is achieved, such consolidation would appreciably reduce risks to long-term sustainability of public finances by eliminating both sustainability gaps. The

²⁰ The primary balance where the effect of the cycle and any one-off or temporary measures have been netted out.

²¹ Namely, government expenditure on pension, health care, long-term care, education and unemployment benefits. Other expenditure items and revenues are assumed to remain constant as a share of GDP over the projection period.

²² 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 should not be seen as a forecast.

required primary balance (RPB) is almost 3% of GDP²³, somewhat lower than the structural primary balance of about 3.5% of GDP of the last year of the programme's period.²⁴

Table 9: Sustainability indicators and the required primary balance

	Sustainability indicators and RPB					
	2005 Scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value (of which)	2.4	2.0	2.9	-0.5	-0.8	2.8
<i>initial budgetary position</i>	1.0	1.0		-1.8	-1.8	
<i>debt requirement in 2050</i>	0.8	:		0.7	:	
<i>future changes in budgetary position</i>	0.7	1.0		0.7	1.0	

Note: The S1 indicator shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current revenue ratio. The S2 indicator, which shows the difference, the sustainability gap, between the constant revenue ratio as a share of GDP that guarantees the respect of the inter-temporal budget constraint of the government, i.e. that equates the actualized flow of revenues and expenses over an infinite horizon, and the current revenue ratio²⁵. The Required Primary Balance (RPB) measures the average primary balance over the first five years of the projection period that results from a permanent budgetary adjustment carried out to comply fully with the inter-temporal budget constraint. See European Commission (2005), European Economy, 'Public finances in EMU – 2005, Section II.3 for a further description.

In interpreting these results, several factors need to be taken into account.

The underlying assumptions used when making the long-term projections are those commonly agreed and used by the EPC in the current common projections exercise.

The high level of the current debt-to-GDP ratio and, even more, the unsatisfactory pace of its reduction require a cautious assessment of the sustainability of Italian public finances. The 2005 update projects a debt still above 100% of GDP in 2009 (see Section 4). A more rapid reduction in the debt ratio would seem to be necessary to create more room for manoeuvre in the future, also considering the already relatively high level of the tax burden in Italy. In this context, as well as in the light of the budgetary burden represented by ageing, it is necessary to achieve high primary balances for a prolonged period of time.

²³ It must be noted that about a half of the downward revision of the RPB compared to the previous assessment is due to the new interest rate assumptions agreed by the EPC-AWG. In addition, the long-term projections of the age-related expenditure in the update point to a lower increase over the entire projection period compared with the previous stability programme. In particular, pension expenditure as a share of GDP has been revised upwards in the present update in the beginning of the projection period (by 0.7% of GDP in 2010), while pension spending in 2050 has been revised upwards less (by 0.3% of GDP).

²⁴ Moreover, the sustainability gap, as measured by the S2 indicator, would in the '2005' scenario – i.e. assuming no budgetary consolidation during the programme period - increase by around ¼% GDP if the (budgetary or structural) adjustment was to be postponed by 5 years. This highlights the importance of budgetary consolidation, as in the 'programme' scenario the sustainability gap, and cost-of-delay, would be eliminated (see the sensitivity test in Table A3 in Annex 6).

²⁵ The sustainability gap indicators (S1, S2) do not necessarily suggest that taxes should be increased; strengthening the fiscal position by permanently reducing the level of non-age related primary spending could be preferable and has the same impact.

The pension expenditure projection presented in the programme includes the full implementation of the 1990s reforms. These incorporate a new system based on a “notional defined contribution” method of calculation. Pensions in the new system would result from the sum of contributions capitalised at the (5-year average) annual GDP growth rate and actuarially adjusted every 10 years on the basis of the average life expectancy at retirement. Thus, the presented moderate dynamics of the long-term pension expenditure hinges upon the implementation of the planned periodical actuarial updates, the first of which was due in 2005.

Furthermore, as in the 2004 update, data on pension expenditure in the 2005 update incorporate the impact of the reform approved in July 2004. Pension expenditure is projected to be below the pre-reform scenario by 0.6-0.7% of GDP for around thirty years. As already noted in the assessment of the November 2004 update, the reform goes in the right direction. However, the reform tightens sharply eligibility conditions for seniority pensions as from 2008. Deferring to 2008 the implementation of the 2004 reform entails risks as strong pressures to water it down may not be excluded as this turning point approaches.

Additional risks to the long-term projections are related to the expected development of health care expenditure, as the realisation of the savings foreseen in the 2006 Budget Law and incorporated in the update health care projections presents some uncertainties (see Section 3).

With regard to the sustainability of public finances, Italy appears to be at medium risk on grounds of the projected budgetary costs of an ageing population. The currently very high level of gross debt and the weak budgetary position indicate the need for consolidation of public finances over the medium term as a resolute debt reduction would significantly reduce risks to public finance sustainability. While the projected increase in age-related expenditure in the period up to 2050 is moderate, it is important to rigorously implement the 2004 and past pension reforms, as the projected reform savings hinge upon their full implementation.

Annex 1: Summary tables from the stability programme update

*Provision of data on variables in bold characters is a requirement.
Provision of data on other variables is optional but highly desirable.*

Table 1a. Macroeconomic prospects

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Real GDP	B1* g	1052	1.2	0.0	1.5	1.5	1.7	1.8
2. Nominal GDP	B1* g	1351	3.9	2.4	3.7	3.8	3.7	3.9
Components of real GDP								
3. Private consumption expenditure (excluding HPISH)	P.3	633	1.0	0.8	1.1	1.3	1.8	1.8
4. Government consumption expenditure (including NPISH)	P.3	193	0.7	1.2	0.0	0.2	0.3	0.3
5. Gross fixed capital formation	P.51	216	2.1	-1.0	2.3	2.7	3.1	3.4
6. Changes in inventories and net acquisition of valuables (Contributions to real GDP growth)	P.52 + P.53	4	-0.1	-0.1	0.3	0.2	0.1	0.1
7. Exports of goods and services	P.6	301	3.2	-0.1	2.8	3.3	3.7	3.8
8. Imports of goods and services	P.7	297	2.5	1.4	2.7	3.6	4.3	4.3
Contributions to real GDP growth								
9. Final domestic demand		-	1.1	0.4	1.1	1.4	1.8	1.9
10. Changes in inventories and net acquisition of valuables	P.52 + P.53	-	-0.1	-0.1	0.3	0.2	0.1	0.1
11. External balance of goods and services	B.11	-	0.2	-0.4	0.0	-0.1	-0.2	-0.2

Table 1b. Price developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. GDP deflator			2.7	2.4	2.2	2.2	2.0	2.0
2. Private consumption deflator			2.2	2.1	2.3	2.2	2.0	2.1
3. HICP			2.3	2.3	2.3	2.2	2.0	2.0
4. Public consumption deflator			2.1	4.2	-1.8	0.7	0.8	1.0
5. Investment deflator			3.1	3.7	3.8	2.4	2.2	2.1
6. Export price deflator (goods and services)			3.8	5.4	2.8	2.0	1.8	1.8
7. Import price deflator (goods and services)			3.7	6.2	1.8	1.3	1.5	1.6

Table 1c. Labour market developments

	ESA Code	2004	2004	2005	2006	2007	2008	2009
		Level	rate of change	rate of change	rate of change	rate of change	rate of change	rate of change
1. Employment, (full-time equivalents instead of persons)²⁶			0.8	0.4	0.6	0.7	0.8	0.7
2. Employment, hours worked ²⁷								
3. Unemployment rate (%)²⁸			8.0	7.7	7.6	7.5	7.4	7.3
4. Labour productivity, (full-time equivalents instead of persons)²⁹			0.4	-0.5	0.9	0.8	0.9	1.1
5. Labour productivity, hours worked ³⁰								
6. Compensation of employees	D.1		3.4	4.3	3.0	3.3	3.3	3.3

Table 1d. Sectoral balances

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Net lending/borrowing vis-à-vis the rest of the world[*]	B.9	-0.9	-1.4	-0.9	-0.8	-0.7	-0.7
of which:							
- Balance on goods and services		0.8	0.2	0.6	0.7	0.6	0.5
- Balance of primary incomes and transfers		-1.7	-1.6	-1.5	-1.4	-1.3	-1.2
- Capital account							
2. Net lending/borrowing of the private sector	B.9/ EDP B.9						
3. Net lending/borrowing of general government	B.9						
4. Statistical discrepancy			Optional	Optional	Optional	Optional	Optional
[*] Net capital account							

²⁶ Occupied population, domestic concept national accounts definition.

²⁷ National accounts definition.

²⁸ Harmonised definition, Eurostat; levels.

²⁹ Real GDP per person employed.

³⁰ Real GDP per hour worked.

Table 2. General government budgetary prospects

	ESA code	2004	2004	2005	2006	2007	2008	2009
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector								
1. General government	S.13	-43,652	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
Future measures						0.5	0.7	0.4
2. Central government	S.1311	-36,664	-2.7	-3.9	-3.4	-3.1	-3.2	-3.1
3. State government	S.1312	-36,104	-2.7	-3.6	-3.1	-2.8	-2.8	-2.7
4. Local government	S.1313	-12,652	-0.9	-0.8	-0.6	-0.7	-0.6	-0.5
5. Social security funds	S.1314	5,664	0.4	0.4	0.4	0.5	0.4	0.5
General government (S13)								
6. Total revenue	TR	612,466	45.3	44.9	45.0	44.3	44.2	43.9
7. Total expenditure	TE ³¹	656,118	48.6	49.2	48.4	47.6	47.5	47.0
Future measures						0.5	0.7	0.4
8. Net lending/borrowing	EDP B.9	-43,652	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	68,434	5.1	4.9	4.7	4.7	4.7	4.7
pm: 9a. FISIM		453	0.03	0.03	0.03	0.02	0.02	0.01
10. Primary balance	³²	24,782	1.8	0.6	1.3	1.9	2.6	3.2
Selected components of revenue								
11. Total taxes (11=11a+11b+11c)		390,156	28.9	28.2	28.3	27.9	27.8	27.6
11a. Taxes on production and imports	D.2	195,207	14.4	14.4	14.4	14.3	14.2	14.0
11b. Current taxes on income, wealth, etc	D.5	185,377	13.7	13.7	13.8	13.6	13.6	13.6
11c. Capital taxes	D.91	9,572	0.7	0.1	0.1	0.0	0.0	0.0
12. Social contributions	D.61	174,756	12.9	13.1	13.0	12.8	12.8	12.7
13. Property income	D.4	8,319	0.6	0.8	0.7	0.6	0.6	0.6
14. Other (14=15-(11+12+13))		39,235	2.9	2.8	3.0	3.0	2.9	2.9
15=6. Total revenue	TR	612,466	45.3	44.9	45.0	44.3	44.2	43.9
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995)³³			41.8	41.3	41.3	40.7	40.6	40.3
Selected components of expenditure								
16. Collective consumption	P.32	98,169	7.3	7.3	7.1	6.7	6.7	6.6
17. Total social transfers	D.62 + D.63	396,075	29.3	29.9	29.7	29.3	29.3	29.0
17a. Social transfers in kind	P.31 =D.63	161,894	12.0	12.4	12.1	11.7	11.7	11.6
17b. Social transfers other than in kind	D.62	234,181	17.3	17.5	17.7	17.6	17.7	17.4
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	68,434	5.1	4.9	4.7	4.7	4.7	4.7
19. Subsidies	D.3	14,471	1.1	1.1	1.0	0.9	0.9	0.9
20. Gross fixed capital formation	P.51	34,875	2.6	2.7	2.8	2.8	2.8	2.8
21. Other (21=22-(16+17+18+19+20))		44,094	3.3	3.4	3.1	3.2	3.1	3.0
22=7. Total expenditure	TE ³⁴	656,118	48.6	49.2	48.4	47.6	47.5	47.0
Pm: compensation of employees	D.1	148,248	11.0	11.2	11.1	10.5	10.3	10.1

³¹ Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

³² The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).

³³ Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.

³⁴ Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2003	2008
1. General public services	1		
2. Defence	2		
3. Public order and safety	3		
4. Economic affairs	4		
5. Environmental protection	5		
6. Housing and community amenities	6		
7. Health	7		
8. Recreation, culture and religion	8		
9. Education	9		
10. Social protection	10		
11. Total expenditure (= item 7=26 in Table 2)	TE		

Table 4. General government debt developments

% of GDP		2004	2005	2006	2007	2008	2009
1. Gross debt³⁵		106.5	108.5	108.0	106.1	104.4	101.7
2. Change in gross debt ratio		-0.3	2.0	-0.5	-1.9	-1.7	-2.7
Contributions to changes in gross debt							
3. Primary balance³⁶		-1.8	-0.6	-1.3	-1.9	-2.6	-3.2
4. Interest expenditure (incl. FISIM)³⁷		5.1	4.9	4.7	4.7	4.7	4.7
5. Stock-flow adjustment		0.4	0.2	0.0	-0.8	0.0	-0.3
of which:							
- Differences between cash and accruals ³⁸		-0.2	0.1	0.5			
- Net accumulation of financial assets ³⁹		0.8	0.0	-0.5			
of which:							
- privatisation proceeds		-0.6	-0.3	-0.7	-0.7		
- Valuation effects and other ⁴⁰		-0.3	0.1	0.0			
p.m. implicit interest rate on debt⁴¹		5.0	4.8	4.5	4.5	4.6	4.7
Other relevant variables							
6. Liquid financial assets ⁴²							
7. Net financial debt (7=1-6)							

³⁵ As defined in Regulation 3605/93 (not an ESA concept).

³⁶ Cf. item 10 in Table 2.

³⁷ Cf. item 9 in Table 2.

³⁸ The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

³⁹ Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

⁴⁰ Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

⁴¹ Proxied by interest expenditure (incl. FISIM recorded as consumption) divided by the debt level of the previous year.

⁴² AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

Table 5. Cyclical developments*

% of GDP	ESA Code	2004	2005	2006	2007	2008	2009
1. Real GDP growth (%)		1.2	0.0	1.5	1.5	1.7	1.8
2. Net lending of general government	EDP B.9	-3.2	-4.3	-3.5	-2.8	-2.1	-1.5
3. Interest expenditure (incl. FISIM recorded as consumption)	EDPD .41+FI SIM	5.1	4.9	4.7	4.7	4.7	4.7
4. Potential GDP growth (%) (1) **		1.4	1.2	1.2	1.3	1.4	1.6
contributions:							
- labour		0.8	0.6	0.5	0.5	0.5	0.5
- capital		0.6	0.6	0.6	0.6	0.6	0.7
- total factor productivity		0.0	0.0	0.0	0.2	0.3	0.4
5. Output gap**		-0.5	-1.7	-1.4	-1.3	-1.0	-0.8
6. Cyclical budgetary component**		-0.3	-0.9	-0.7	-0.6	-0.5	-0.4
7. Cyclically-adjusted balance (2-6) **		-3.0	-3.5	-2.8	-2.2	-1.6	-1.1
8. Cyclically-adjusted primary balance (7-3) **		2.1	1.5	2.0	2.5	3.1	3.6
Additional information provided in the programme							
One-off measures		1.3	0.5	0.3	-	-	-
Cyclically-adjusted balance excluding one-offs**		-4.2	-3.9	-3.0	-2.2	-1.6	-1.1
Cyclically-adjusted primary balance excluding one-offs**		0.8	1.0	1.7	2.5	3.1	3.6
Change in cyclically-adjusted balance excluding one-offs			-0.3	-0.9	-0.8	-0.6	-0.5
* Decimals may not add, due to rounding.							
**Taking into account the smoothing of the active population series in order to reduce the hike in 2004 caused by the legalisation of immigrant workers.							

(1) Until an agreement on the Production Function Method is reached, Member States can use their own figures (SP)

Table 6. Divergence from previous update

	ESA Code	2004	2005	2006	2007	2008
Real GDP growth (%)						
Previous update		1.2	2.1	2.2	2.3	2.3
Current update		1.2	0.0	1.5	1.5	1.7
Difference		0.0	-2.1	-0.7	-0.8	-0.6
General government net lending (% of GDP)	EDP B.9					
Previous update		-2.9	-2.7	-2.0	-1.4	-0.9
Current update		-3.2	-4.3	-3.5	-2.8	-2.1
Difference		-0.3	-1.6	-1.5	-1.4	-1.2
General government gross debt (% of GDP)						
Previous update		106,0	104,1	101,9	99,2	98,0
Current update		106,5	108,5	108,0	106,1	104,4
Difference		0,5	4,4	6,1	6,9	6,4

Table 7. Long-term sustainability of public finances*

% of GDP	2000	2004	2005	2010	2020	2030	2040	2050
Total expenditure								
Of which: age-related expenditures	24.5	25.9	26.3	25.7	25.6	26.8	28.0	27.2
Pension expenditure	13.8	14.3	14.4	14.2	14.1	15.1	15.9	14.7
Social security pension	13.8	14.3	14.4	14.2	14.1	15.1	15.9	14.7
(of which) Old-age and early pensions		14.0	14.1	13.9	13.9	14.9	15.8	14.5
(of which) Other pensions (disability, survivors)		0.3	0.3	0.3	0.2	0.2	0.2	0.2
Occupational pensions (if in general government)								
Health care (dynamic scenario – including long-term care)	5.8	6.5	6.7	6.8	7.0	7.4	7.8	8.1
Long-term care (<i>this was earlier included in the health care</i>) **		0.8	0.8	0.8	0.9	0.9	1.0	1.1
Education expenditure***	4.6	4.7	4.8	4.4	4.2	4.0	4.0	4.1
Unemployment benefits	0.3	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Other age-related expenditures								
Interest expenditure								
Total revenue								
Of which: property income								
<i>of which: from pensions contributions (or social contributions if appropriate)</i>								
Pension reserve fund assets								
Of which: consolidated public pension fund assets (assets other than government liabilities)								
Assumptions								
Labour productivity growth		0.4	-0.5	1.2	1.7	1.7	1.7	1.7
Real GDP growth		1.2	0.0	1.9	1.6	0.9	0.8	1.2
Participation rate males (aged 20-64)		79.3	80.4	81.3	82.7	82.2	83.5	84.3
Participation rates females (aged 20-64)		53.7	54.4	58.3	62.0	63.2	64.1	64.9
Total participation rates (aged 20-64)		66.4	67.3	69.8	72.4	72.8	73.9	74.7
Unemployment rate		8.0	7.7	7.2	6.4	6.4	6.4	6.4
Population aged 65+ over total population		31.2	31.9	33.9	39.4	48.0	62.1	67.4
* The figures are rounded-off to the first decimal point and therefore the sum of the figures could not add up.								
** Provided separately.								
*** Does not include adult education expenditure (continuous training).								

Table 8. Basic assumptions

This table should preferably be included in the programme itself; if not, these assumptions should be transmitted to the Council and the Commission together with the programme.

	2004	2005	2006	2007	2008	2009
Short-term interest rate ⁴³ (annual average)	2.0	2.4	2.6	3.0	3.2	2.0
Long-term interest rate (annual average)	3.5	3.7	3.8	4.0	4.0	3.5
USD/€exchange rate (annual average) (euro area and ERM II countries)	1255	1255	1255	1255	1255	1255
Nominal effective exchange rate (for countries not in euro area or ERM II) exchange rate vis-à-vis the €(annual average)	-0.2	-1.0	-0.3	0.0	0.0	-0.2
World excluding EU, GDP growth	4.7	4.7	4.4	4.4	4.4	4.7
EU GDP growth	1.5	2.0	2.4	2.5	2.5	1.5
Growth of relevant foreign markets	4.7	5.8	5.8	5.8	5.8	4.7
World import volumes, excluding EU	9.0	8.0	7.9	7.9	7.9	9.0
Oil prices, (Brent, USD/barrel)	55.0	58.0	55.0	53.0	53.0	55.0

⁴³ If necessary, purely technical assumptions.

Annex 2: Compliance with the code of conduct

The table below provides a detailed assessment of whether the programme respects the requirements of Section II of the new code of conduct. It is in four parts, covering compliance with (i) the window for the date of submission of the programme; (ii) the model structure (table of contents) in Annex 1 of the code; (iii) the data requirements (model tables) in Annex 2 of the code; and (iv) other information requirements. In the main text, points (ii) and (iii) are grouped into the “format” requirements of the code, whereas point (iv) refers to its “content” requirements.

Guidelines in the new code of conduct	Yes	No	Comments
1. Submission of the programme			
Programme was submitted not earlier than mid-October and not later than 1 December ¹ .		X	Need to incorporate the final version of the 2006 budget
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.		X	Chapter on “institutional features of public finance” missing.
3. Model tables (so-called data requirements)			
The quantitative information is presented following the standardised set of tables (Annex 2 of the code of conduct).	X		
The programme provides all compulsory information in these tables.		X	
The programme provides all optional information in these tables.		X	
The concepts used are in line with the European system of accounts (ESA).		X	Government consumption (including NPISH) and external sector data
4. Other information requirements			
a. Involvement of Parliament			
The programme mentions its status vis-à-vis the national Parliament.	X		
The programme indicates whether the Council opinion on the previous programme has been presented to the national Parliament.		X	
b. Economic outlook			
Euro area and ERM II Member States uses the “common external assumptions” on the main extra-EU variables.		X	
Significant divergences between the national and the Commission services’ economic forecasts are explained ² .			not applicable
The possible upside and downside risks to the economic outlook are brought out.	X		
The outlook for sectoral balances and, especially for countries with a high external deficit, the external balance is analysed.		X	
c. Monetary/exchange rate policy			
The <u>convergence</u> programme presents the medium-term			not applicable

Guidelines in the new code of conduct	Yes	No	Comments
monetary policy objectives and their relationship to price and exchange rate stability.			
<i>d. Budgetary strategy</i>			
The programme presents budgetary targets for the general government balance in relation to the MTO, and the projected path for the debt ratio.	X		
In case a new government has taken office, the programme shows continuity with respect to the budgetary targets endorsed by the Council.			not applicable
When applicable, the programme explains the reasons for possible deviations from previous targets and, in case of substantial deviations, whether measures are taken to rectify the situation, and provide information on them.	X		
The budgetary targets are backed by an indication of the broad measures necessary to achieve them and an assessment of their quantitative effects on the general government balance is analysed.		X	
Information is provided on one-off and other temporary measures.	X		
The state of implementation of the measures (enacted versus planned) presented in the programme is specified.	X		
If for a country that uses the transition period for the classification of second-pillar funded pension schemes, the programme presents information on the impact on the public finances.			not applicable
<i>e. "Major structural reforms"</i>			
If the MTO is not yet reached or a temporary deviation is planned from the achieved MTO, the programme includes comprehensive information on the economic and budgetary effects of possible 'major structural reforms' over time.			not applicable
The programme includes a quantitative cost-benefit analysis of the short-term costs and long-term benefits of such reforms.			not applicable
<i>f. Sensitivity analysis</i>			
The programme includes comprehensive sensitivity analyses and/or develops alternative scenarios showing the effect on the budgetary and debt position of: a) changes in the main economic assumptions b) different interest rate assumptions c) for non-participating Member States, different exchange rate assumptions d) if the common external assumptions are not used, changes in assumptions for the main extra-EU variables.	X X X		not applicable
In case of such "major structural reforms", the programme provides an analysis of how changes in the assumptions would affect the effects on the budget and potential growth.			not applicable
<i>g. Broad economic policy guidelines</i>			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.		X	
<i>h. Quality of public finances</i>			
The programme describes measures aimed at improving the quality of public finances on both the revenue and expenditure side (e.g. tax reform, value-for-money initiatives, measures to improve tax collection efficiency and expenditure control).	X		
<i>i. Long-term sustainability</i>			

Guidelines in the new code of conduct	Yes	No	Comments
The programme outlines the country's strategies to ensure the sustainability of public finances, especially in light of the economic and budgetary impact of ageing populations.		X	
Common budgetary projections by the AWG are included in the programme. The programme includes all the necessary additional information. (...) To this end, information included in programmes should focus on new relevant information that is not fully reflected in the latest common EPC projections.	X		
<i>j. Other information (optional)</i>			
The programme includes information on the implementation of existing national budgetary rules (expenditure rules, etc.), as well as on other institutional features of the public finances, in particular budgetary procedures and public finance statistical governance.		X	
<u>Notes:</u> ¹ The code of conduct allows for the following exceptions: (i) Ireland should be regarded as complying with the deadline in case of submission on "budget day", i.e. traditionally the first Wednesday of December, (ii) the UK should submit as close as possible to its autumn pre-budget report; and (iii) Austria and Portugal cannot comply with the deadline but will submit no later than 15 December. ² To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme.			

Annex 3: Consistency with the broad economic policy guidelines

The table below provides an overview of whether the strategy and policy measures in the programme are consistent with the broad economic policy guidelines in the area of public finances included in the integrated guidelines for the period 2005-2008.

Integrated guidelines	Yes	No	Not applicable
1. To secure economic stability			
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it ¹ .		X	
– Member States should avoid pro-cyclical fiscal policies ² .			X
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits ³ .	X		
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.			X
2. To safeguard economic and fiscal sustainability			
In view of the projected costs of ageing populations,			
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.		X	
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (...)	X		
3. To promote a growth- and employment-orientated and efficient allocation of resources			
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.		X	
Notes:			
¹ As further specified in the Stability and Growth Pact and the new code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States.			
² As further specified in the Stability and Growth Pact and the new code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”.			
³ As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure.			

Annex 4: Assessment of tax projections

Table 6 compares the tax projections of the programme with those of the Commission services' autumn 2005 forecast and Table 7 those of the Commission services' autumn forecast with tax projections obtained by using standard ex-ante elasticities, as estimated by the OECD. The tables summarise the results for the total tax-to-GDP ratio. The underlying analysis is carried out exploiting information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see tables below)⁴⁴. Conceptually, the analysis draws on the definition of a semi-elasticity, which measures the change in a ratio vis-à-vis the relative change in the denominator. The semi-elasticity of the tax-to-GDP ratio of the *i*-th tax $\frac{T_i}{Y}$ can be written as:

$$\eta_i = \frac{d\left(\frac{T_i}{Y}\right)}{dY} Y = \left(\frac{dT_i}{dY} \frac{Y}{T_i} - 1\right) \frac{T_i}{Y} = \left(\frac{dT_i}{dB_i} \frac{B_i}{T_i} \frac{dB_i}{dY} \frac{Y}{B_i} - 1\right) \frac{T_i}{Y} = (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y}$$

where ε_{T_i, B_i} and $\varepsilon_{B_i, Y}$ denote the elasticity of the *i*-th tax T_i relative to its tax base B_i and the elasticity of the tax base B_i relative to aggregate GDP Y respectively.

To the extent that ε_{T_i, B_i} is derived from observed or projected data, it will typically reflect (i) the effect of discretionary measures (including one-offs) and (ii) the tax elasticity⁴⁵. By contrast, if ε_{T_i, B_i} is the standard *ex-ante* elasticity, as estimated by the OECD, it will be net of discretionary measures.

The second elasticity $\varepsilon_{B_i, Y}$ can be used as an indicator of the tax intensity of GDP growth; for instance, a higher elasticity of consumption relative to GDP means that for the same GDP growth indirect taxes will be higher.

The definition of a semi-elasticity has two practical implications. First, any change in the tax-to-GDP ratio of the *i*-th tax can be written as the product of the semi-elasticity and GDP growth:

$$d\left(\frac{T_i}{Y}\right) = \eta_i \cdot \frac{dY}{Y}$$

and the change in the total tax-to-GDP ratio is the sum:

⁴⁴Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2005 forecast. Only the aggregate, direct income taxes, is given. For the purpose of this exercise the breakdown is obtained using the average shares over the past ten years, i.e. the composition of direct taxes is assumed to stay constant.

⁴⁵The observed or projected elasticity (ex-post elasticity) of the *i*-th tax also includes the effect of other factors (OF) such as discretionary measures: $\frac{\Delta T_i}{T_i} = \varepsilon_{T_i, B_i, ex\,ante} \frac{dB_i}{B_i} + \frac{OF_i}{T_i} = \varepsilon_{T_i, B_i, ex\,post} \frac{dB_i}{B_i}$.

$$\sum_i d\left(\frac{T_i}{Y}\right) = \sum_i \eta_i \frac{dY}{Y}.$$

Second, differences between two tax projections can be decomposed into an elasticity component and a composition component:

$$d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[(\varepsilon_{T_i, B_i}' \varepsilon_{B_i, Y}' - 1) \frac{T_i}{Y} - (\varepsilon_{T_i, B_i} \varepsilon_{B_i, Y} - 1) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

If $(\varepsilon_{T_i, B_i}' - \varepsilon_{T_i, B_i}) = \alpha_i$; $(\varepsilon_{B_i, Y}' - \varepsilon_{B_i, Y}) = \beta_i$,

$$\text{then } d\left(\frac{T_i}{Y}\right)' - d\left(\frac{T_i}{Y}\right) \approx \left[(\alpha_i \varepsilon_{B_i, Y} + \beta_i \varepsilon_{T_i, B_i} + \alpha_i \beta_i) \frac{T_i}{Y} \right] \frac{dY}{Y}$$

where $\alpha_i \varepsilon_{B_i, Y} \frac{T_i}{Y} \frac{dY}{Y}$ determines the elasticity component and $\beta_i \varepsilon_{T_i, B_i} \frac{T_i}{Y} \frac{dY}{Y}$ the composition component. The third component in the equation $\alpha_i \beta_i \frac{T_i}{Y} \frac{dY}{Y}$ measures the interaction of the elasticity and the composition components. It is generally small but can become important in some cases. The tax elasticity relative to GDP of total taxes is obtained as $\varepsilon = \sum_i w_i \varepsilon_{T_i, B_i} \varepsilon_{B_i, Y}$ with w_i the share of the *i*-th tax in the overall tax burden.

The tables below report the results of the assessment of the tax projections presented in the programme by major tax category, which, as mentioned above, are the basis for the aggregated results reported in Tables 6 and 7.

Assessment of tax projections by major tax category

	2006		2007		2008	2009	p.m.: OECD ¹
	COM	SP	COM ²	SP	SP	SP	
Taxes on production and imports:							
Change in tax-to-GDP ratio	0.0	0.0	0.0	-0.1	-0.2	-0.2	/
<i>Difference</i>	0.0		0.0		/	/	/
<i>of which</i> ³ : - elasticity component	0.0		0.0		/	/	/
- composition component	0.0		0.0		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base ⁴	1.0	1.0	1.0	0.9	0.7	0.6	1.0
- of tax base ⁴ to GDP	0.9	0.9	1.0	0.9	1.0	1.0	1.0
Social contributions:							
Change in tax-to-GDP ratio	-0.2	0.0	-0.1	-0.2	0.0	-0.1	/
<i>Difference</i>	0.1		-0.2		/	/	/
<i>of which</i> ³ : - elasticity component	0.1		-0.1		/	/	/
- composition component	0.0		0.0		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base ⁵	0.8	1.1	0.9	0.6	1.1	1.0	1.0
- of tax base ⁵ to GDP	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Personal income tax⁶:							
Change in tax-to-GDP ratio	0.1	0.1	-0.1	-0.2	0.0	0.0	/
<i>Difference</i>	0.0		-0.1		/	/	/
<i>of which</i> ³ : - elasticity component	0.0		-0.1		/	/	/
- composition component	0.0		0.0		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base ⁵	1.6	1.6	0.9	0.6	1.2	1.1	2.0
- of tax base ⁵ to GDP	0.8	0.8	0.9	0.9	0.9	0.9	0.9
Corporate income tax⁶:							
Change in tax-to-GDP ratio	0.0	0.0	0.0	-0.1	0.0	0.0	/
<i>Difference</i>	0.0		0.0		/	/	/
<i>of which</i> ³ : - elasticity component	0.0		0.0		/	/	/
- composition component	0.0		0.0		/	/	/
p.m.: Observed elasticity:							
- of taxes to tax base ⁷	1.2	1.1	0.8	0.5	1.0	0.9	1.0
- of tax base ⁷ to GDP	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Notes:							
¹ OECD ex-ante elasticities							
² On a no-policy change basis							
³ The decomposition is explained in the text above							
⁴ Tax base = private consumption expenditure							
⁵ Tax base = compensation of employees							
⁶ Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period							
⁷ Tax base = gross operating surplus							
Source:							
Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)							

Assessment of tax elasticities by major tax category

	2006		2007	
	COM (observed)	ex-ante ¹	COM ² (observed)	ex-ante ¹
Taxes on production and imports:				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0
<i>Difference</i>	0.0		0.0	
<i>of which³: - elasticity component</i>	0.0		0.0	
<i>- composition component</i>	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base ⁴	1.0	1.0	1.0	1.0
- of tax base ⁴ to GDP	0.9	1.0	1.0	1.0
Social contributions:				
Change in tax-to-GDP ratio	-0.2	-0.1	-0.1	-0.1
<i>Difference</i>	-0.1		0.0	
<i>of which³: - elasticity component</i>	-0.1		0.0	
<i>- composition component</i>	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base ⁵	0.8	1.0	0.9	1.0
- of tax base ⁵ to GDP	0.8	0.9	0.9	0.9
Personal income tax⁶:				
Change in tax-to-GDP ratio	0.1	0.3	-0.1	0.3
<i>Difference</i>	-0.2		-0.4	
<i>of which³: - elasticity component</i>	-0.2		-0.4	
<i>- composition component</i>	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base ⁵	1.6	2.0	0.9	2.0
- of tax base ⁵ to GDP	0.8	0.9	0.9	0.9
Corporate income tax⁶:				
Change in tax-to-GDP ratio	0.0	0.0	0.0	0.0
<i>Difference</i>	0.0		0.0	
<i>of which³: - elasticity component</i>	0.0		0.0	
<i>- composition component</i>	0.0		0.0	
p.m.: Observed elasticity:				
- of taxes to tax base ⁷	1.2	1.0	0.8	1.0
- of tax base ⁷ to GDP	1.1	1.1	1.1	1.1
Notes:	¹ Tax projections obtained by applying ex-ante standard tax elasticities estimated by the OECD ² On a no-policy change basis ³ The decomposition is explained in the text above ⁴ Tax base = private consumption expenditure ⁵ Tax base = compensation of employees ⁶ Taxes on income and wealth are split into private and corporate income tax using the average tax share over the past ten years, i.e. the share is assumed to be constant over the programme period ⁷ Tax base = gross operating surplus			
Source:	<i>Commission services' autumn 2005 economic forecasts (COM); Commission services' calculations and OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434)</i>			

Annex 5: The rolling debt reduction benchmark

The rolling debt reduction benchmark discussed in Box 4 is calculated for successive five-year periods through a recursive application of the formula:

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

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):

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

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 benchmark describes the path for convergence of the debt ratio towards 60% of GDP, which would take place with the deficit at 3% of GDP and nominal GDP growth at 5%. For nominal GDP growth rates higher than 5%, the benchmark can be respected with deficits in excess of 3% of GDP; for nominal GDP growth rates lower than 5%, respect of the benchmark necessitates deficits lower than 3% of GDP.

Annex 6: Indicators of long-term sustainability

Table A1: Underlying assumptions compared

% of GDP	2010		2020		2030		2050	
	EPC	SCP	EPC	SCP	EPC	SCP	EPC	SCP
Labour productivity growth	1.2	1.2	1.7	1.7	1.7	1.7	1.7	1.7
Real GDP growth	1.9	1.9	1.6	1.6	0.9	0.9	1.2	1.2
Participation rate males (aged 20-64)	81.3	81.3	82.7	82.7	82.2	82.2	84.3	84.3
Participation rates females (aged 20-64)	58.3	58.3	62.0	62.0	63.2	63.2	64.9	64.9
Total participation rates (aged 20-64)	69.8	69.8	72.4	72.4	72.8	72.8	74.7	74.7
Unemployment rate	7.3	7.2	6.5	6.4	6.5	6.4	6.5	6.4
Population aged 65+ over total population	20.6	20.6	23.2	23.2	27.1	27.1	33.9	33.9

Table A2: Long-term projections

Main assumptions - programme scenario (as % GDP)	2009	2010	2020	2030	2040	2050	changes	Impact on S2
<i>Total age-related spending</i>	25.9	25.8	25.6	26.8	28.0	27.2	1.3	1.0
Pensions	14.2	14.2	14.1	15.1	15.9	14.7	0.5	0.5
Health care	6.0	6.0	6.1	6.4	6.7	6.9	0.9	0.6
Long-term care	0.8	0.8	0.9	1.0	1.1	1.2	0.4	0.3
Education	4.5	4.4	4.2	4.0	4.0	4.1	-0.4	-0.4
Unemployment benefits	0.4	0.4	0.3	0.3	0.3	0.3	-0.1	-0.1
<i>Total primary non age-related spending</i>	15.6	15.6	15.6	15.6	15.6	15.6	0.0	0.0
<i>Total revenues</i>	45.0	45.0	45.0	45.0	45.0	45.0	0.0	0.0

Table A3: The cost of a five-year delay in adjusting the budgetary position according to the S1 and S2

	S1	S2
2005 scenario	0.5	0.2
Programme scenario	-0.1	-0.1

Note: the cost of a delay shows the increase of the S1 and S2 indicators if they were calculated five years later.

Table A4: Debt development

Results (as % GDP)	2009	2010	2020	2030	2040	2050	changes
<i>Programme scenario</i>							
Gross debt	101.7	99.1	72.4	51.4	41.6	30.7	-71.0
<i>Gross debt, i + 1*</i>	101.7	100.1	82.9	72.0	74.6	78.7	-23.0
<i>Gross debt, i - 1*</i>	101.7	98.2	62.9	34.9	18.4	1.5	-100.2
<i>2005 Scenario</i>							
Gross debt	108.7	108.9	111.9	127.6	164.9	208.9	100.2
<i>Gross debt, i + 1*</i>	108.7	110.0	125.0	157.4	221.0	303.7	195.0
<i>Gross debt, i - 1*</i>	108.7	107.9	100.1	103.1	123.0	144.3	35.6

* $i + 1$ and $i - 1$ represents the evolution of debt under the assumption of the nominal interest rate being 100 basis points higher or lower throughout the projection period.

