EUROPEAN COMMISSION
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ECONOMIC ASSESSMENT OF THE STABILITY PROGRAMME OF ITALY (UPDATE OF DECEMBER 2006)

The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called "stability programme" for countries that have adopted the euro as their currency and "convergence programme" for those that have not. The most recent update of Italy's stability programme was submitted on 4 December 2006.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs of the European Commission, was finalised on 22 January 2007. Comments should be sent to Laura Bardone and Lucia Piana (Laura.Bardone@ec.europa.eu, Lucia.Piana@ec.europa.eu). The main aim of the technical analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 23 January 2007. The ECOFIN Council is expected to adopt its opinion on the programme on 27 February 2007.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm

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SUMMARY AND CONCLUSIONS[1]

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Italy, has to submit a stability programme and annual updates thereof. The most recent programme, covering the period 2006-2011, was submitted on 4 December 2006. Under the corrective arm of the Pact, Italy was placed in excessive deficit by the Council in July 2005. The deadline for correcting the excessive deficit is 2007.

Structural weaknesses feeding into very low productivity growth and a loss of external competitiveness are at the root of Italy's dismal growth performance over the past decade. Real GDP growth has been below the euro area average since the mid 1990s and potential growth is estimated to have fallen from above 2% in the early 1990s to 1¼% in the 2000s. Despite weak growth, inflation has remained slightly higher than the euro area average. On the positive side, Italy is one of the few countries to have enjoyed robust employment growth since the turn of the century and its unemployment rate has fallen substantially. However, while there remains a long way to go before Italy catches up with the EU average in terms of employment rates, the odd combination of dynamic employment growth and sluggish GDP growth highlights Italy's productivity problem. On the public finances front, the general government deficit has been above the 3 percent of GDP Treaty reference value since 2003 and the debt-to-GDP ratio remains very high and, after decreasing for ten years, it increased again in 2005 to over 106% of GDP. The cyclically-adjusted primary balance has steadily deteriorated since 1998 and the ratio of current primary expenditure to GDP has not ceased to increase since 2001.

Against this background, the Italian public finances face important challenges. First, a stabilisation challenge, because the strain on public finances limits the ability of fiscal policy to allow automatic stabilisers to work effectively. In addition, the high level of public debt and the persistently weak budgetary position make Italy vulnerable to increases in interest rates and to market sentiment, increasing economic uncertainty. Second, there is a challenge of efficiency. The structural weaknesses that are at the root of Italy's deteriorating competitiveness and poor growth performance in recent years require an economic policy strategy that creates a virtuous circle between macro-economic stability, micro-economic reforms aimed at boosting total factor productivity and measures aimed at raising labour market participation. Consolidation of public finances is a necessary pre-condition for this strategy, as it would help reduce economic uncertainty, create more favourable conditions for investment and make room for enhanced expenditure on knowledge, human capital and infrastructure. Finally, over the longer term, a rapidly ageing population will put heavy pressure on pension and health care spending, thus putting at risk the long-term sustainability of public finances. Past pension reforms will help to contain rises in public expenditure, provided they are fully implemented. The success of the pension reforms, both in terms of financial sustainability and social adequacy, will also depend on further progress in increasing employment rates, particularly among women and older workers, and on the development of supplementary pension entitlements. In the area of health care, measures

[1]The analysis takes into account (i) the Commission services' autumn 2006 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) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

to contain expenditure growth have failed to prove effective and expenditure slippages are partly responsible for the upward drift of general government deficit.

The macroeconomic scenario underlying the updated stability programme envisages that real GDP growth will initially decline from 1.6% in 2006 to 1.3% in 2007, essentially reflecting the expected slowdown in the external environment. Afterwards, also thanks to the planned economic reforms and the increased confidence stemming from the improved situation of public finances, economic growth would gradually pick up, to reach 1.7% in 2011. Domestic demand is projected to continue being the main driver of growth throughout the programme period. The contribution of net exports to real GDP growth is expected to turn broadly neutral as from 2008, after the very mildly positive contribution in 2006 and 2007. This would represent a clear discontinuity relative to the previous decade, when the external sector acted as a drag to economic growth. For the period beyond 2008, the projected real GDP growth in the programme exceeds only slightly the estimated potential growth in the Commission services' autumn forecast. The programme projects full-time equivalent employment growth at 1% in 2006, ½% in 2007 and ¾% over 2008-2011. These projections imply a moderation of the employment content of growth from the high values of the recent past, with a consequent rebound in labour productivity growth from 2006 onwards. Overall, the programme features plausible macroeconomic assumptions. Given the projected negative output gap over the entire programme period, Italy can still be considered in economic "bad" times, with some improvement towards the end of the period.

The 2006 stability programme update projects the 2006 deficit at 5.7% of GDP[2]. This contrasts with the 4.7% of GDP in the Commission services’ autumn 2006 forecast. The Commission scenario does not take account of the 0.9% of GDP slippage due to the cancellation of railway company's debt related to the high speed project (*Ferrovie dello Stato – RFI/TAV*)[3], following a decision by the government in the final phase of the budgetary process. In turn, the Commission services' autumn forecast for the general government deficit is higher than the 3.5% of GDP set in the previous update of the stability programme. The 1.2% of GDP difference is essentially explained by the different impact of one-offs (0.8% of GDP) and the permanent negative impact of the European Court of Justice's ruling on VAT on company cars (around 0.4% of GDP). However, available data point to a budgetary outcome in 2006 significantly better than projected in the programme.

The budgetary strategy in the programme aims at correcting the excessive deficit in 2007, when, on account of an essentially revenue-based correction, the deficit is planned to decline to 2.8% of GDP. Thereafter, the government balance is planned to continue improving steadily, to turn into a positive 0.1% of GDP in 2011. Beyond 2007, the information is limited to the size of the correction required to achieve the budgetary targets relative to trends. Thanks to a steady improvement of the primary balance, the

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2 The tables in the 2006 Stability Programme do not incorporate the 0.9% of GDP higher one-off government expenditure due to the cancellation of the railway company's debt, which the programme text refers to. This additional expenditure brings the targeted deficit for 2006 to 5.7% of GDP, from the 4.8% reported in the tables, and also affects other budgetary data.

3 Following a Eurostat decision of 23 May 2005 (see Eurostat News Release N° 65/2005), according to which this railway company's debt was already booked as government liability, the government decision has no impact on the debt.

government gross debt is officially projected to gradually decline from above 107% to below 100% of GDP in 2011.

The structural balance (i.e. the cyclically-adjusted balance net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to improve from a deficit of around 4% of GDP in 2006 to a surplus of ¼% in 2011. With an output gap estimated to remain negative, albeit closing, the planned stance of fiscal policy is restrictive over the entire programme period. In line with the Pact, the medium-term objective (MTO) for the budgetary position presented in the programme is a balanced budget in structural terms, which the programme aims to achieve by the end programme period.

Although considerable risks are attached to the effectiveness of several measures included in the 2007 budget, the better-than-projected carry-over from 2006 should allow achieving a deficit clearly below 3% of GDP in 2007. In the medium term, negative risks to public finances cannot be excluded, in particular stemming from the repeated overruns in health care expenditure. In addition, the lack of details on the adjustment strategy after 2007 increases the risks attached to the planned fiscal consolidation. The dynamics of the debt ratio is subject to the same risks highlighted for the achievement of the budgetary targets. In view of this risk assessment, the budgetary strategy in the programme seems broadly consistent with a correction of the excessive deficit by 2007 as recommended by the Council. In the years following the envisaged correction of the excessive deficit, the pace of the adjustment towards the MTO implied by the programme is broadly in line with the Stability and Growth Pact. However, it may not provide a sufficient safety margin (i.e. a structural deficit below 1½% of GDP) against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations before 2010. Furthermore, it may not be sufficient to ensure that the MTO (i.e. a balanced budget) is achieved within the programme period. Similarly, the debt ratio may be not be sufficiently diminishing towards the reference value over the programme period.

Italy appears to be at medium risk with regard to the sustainability of public finances. The projected moderate increase in age-related expenditure in the long-term on which this assessment is based hinges upon the full implementation of the pension reforms, including the planned periodical actuarial adjustment in line with life expectancy and the sharp tightening of eligibility conditions for seniority pensions as from 2008. As mentioned above, increasing the employment rate, notably of older workers, would improve workers' pensions in the future and contribute to the success of the pension reforms. The initial budgetary position constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Moreover, reducing the very high level of debt will require high primary surpluses to be achieved and maintained over a long period.

The Implementation Report of the National Reform Programme (NRP) of Italy, provided in the context of the renewed Lisbon strategy for growth and jobs, identified the following key challenges/priorities: ensuring long-term fiscal sustainability; 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. The Commission's assessment of this programme (adopted as part of its December 2006 Annual Progress Report[4]) showed

[4] Communication from the Commission to the Spring European Council, "Implementing the renewed Lisbon strategy for growth and jobs – A year of delivery", 12.12.2006, COM(2006)816.

that, compared to the 2005 NRP, the Italian Implementation report presents a clearer strategy, covering all policy areas and the synergies between them and is thus more ambitious. In particular, the Implementation Report acknowledges that consolidation of public finances is central to a comprehensive strategy to remedy the weaknesses of the Italian economy and to raise its growth potential. Strategies and measures proposed in the macro area are generally appropriate but implementation is crucial. Progress is most extensive in the micro-economic field, while employment policy needs to be reinforced in certain key areas. Against the background of the identified strengths and weaknesses, Italy was recommended to take action in the areas of: long-term sustainability of public finances; competition in products and service markets; regional disparities in employment; and lifelong learning and education. The Implementation Report and the stability programme are to some extent integrated. In particular, both programmes address the issue of fiscal sustainability and envisage the gradual implementation of a cut in the labour tax wedge with a view to supporting employment growth, reducing regional disparities and recovering competitiveness.

The overall conclusion is that the updated stability programme is broadly consistent with a correction of the excessive deficit by 2007, subject to the full and effective implementation of the 2007 Budget. After 2007, the planned adjustment is in line with the requirements of the Stability and Growth Pact and would allow reaching the MTO by the end of the programme period. However, no details are given on the adjustment strategy, which itself represents a risk for the achievement of the budgetary targets after 2007 and hinders a proper assessment of the planned consolidation and quality of public finances. Past successive pension reforms will help to contain rises in public expenditure, but their full implementation remains crucial to obtain the expected results.

Comparison of key macroeconomic and budgetary projections

		2005	2006	2007	2008	2009	2010	2011
Real GDP (% change)	**SP Dec 2006**	**0.0**	**1.6**	**1.3**	**1.5**	**1.6**	**1.7**	**1.7**
	COM Nov 2006	0.0	1.7	1.4	1.4	n.a.	n.a.	n.a.
	SP Dec 2005	*0.0*	*1.5*	*1.5*	*1.7*	*1.8*	*n.a.*	*n.a.*
HICP inflation (%)	**SP Dec 2006**	**2.2**	**2.2**	**2.1**	**1.7**	**1.5**	**1.5**	**1.5**
	COM Nov 2006	2.2	2.3	2.0	1.9	n.a.	n.a.	n.a.
	SP Dec 2005	*2.3*	*2.3*	*2.2*	*2.0*	*2.0*	*n.a.*	*n.a.*
Output gap (% of potential GDP)	**SP Dec 2006**[1]	**-1.3**	**-0.9**	**-0.9**	**-0.8**	**-0.7**	**-0.5**	**-0.5**
	COM Nov 2006[5]	-1.4	-1.0	-1.0	-1.1	n.a.	n.a.	n.a.
	SP Dec 2005[1]	*-1.5*	*-1.2*	*-1.0*	*-0.8*	*-0.6*	*n.a.*	*n.a.*
General government balance (% of GDP)	**SP Dec 2006**[7]	**-4.1**	**-5.7**	**-2.8**	**-2.2**	**-1.5**	**-0.7**	**0.1**
	COM Nov 2006	-4.1	-4.7	-2.9	-3.1	n.a.	n.a.	n.a.
	SP Dec 2005	*-4.3*	*-3.5*	*-2.8*	*-2.1*	*-1.5*	*n.a.*	*n.a.*
Primary balance[6] (% of GDP)	**SP Dec 2006**[7]	**0.7**	**-0.9**	**2.2**	**2.8**	**3.4**	**4.2**	**5.0**
	COM Nov 2006	0.5	-0.1	1.8	1.7	n.a.	n.a.	n.a.
	SP Dec 2005	*0.6*	*1.3*	*1.9*	*2.6*	*3.2*	*n.a.*	*n.a.*
Cyclically-adjusted balance (% of GDP)	**SP Dec 2006**[1 7]	**-3.5**	**-5.3**	**-2.3**	**-1.8**	**-1.2**	**-0.4**	**0.3**
	COM Nov 2006	-3.4	-4.1	-2.4	-2.5	n.a.	n.a.	n.a.
	SP Dec 2005[1]	*-3.5*	*-2.9*	*-2.3*	*-1.7*	*-1.2*	*n.a.*	*n.a.*
Structural balance[2] (% of GDP)	**SP Dec 2006**[1 3]	**-4.0**	**-3.9**	**-2.5**	**-1.9**	**-1.2**	**-0.4**	**0.3**
	COM Nov 2006[4]	-3.9	-3.6	-2.5	-2.6	n.a.	n.a.	n.a.
	SP Dec 2005[1]	*-4.1*	*-3.2*	*-2.3*	*-1.7*	*-1.2*	*n.a.*	*n.a.*
Government gross debt (% of GDP)	**SP Dec 2006**	**106.6**	**107.6**	**106.9**	**105.4**	**103.5**	**100.7**	**97.8**
	COM Nov 2006	106.6	107.2	105.9	105.7	n.a.	n.a.	n.a.
	SP Dec 2005	*108.5*	*108.0*	*106.1*	*104.4*	*101.7*	*n.a.*	*n.a.*

Notes:

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

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

[3]One-off and other temporary measures taken from the programme (0.5% of GDP in 2005, 0.1% in 2007 and 2008; deficit-reducing. In 2006, 1.4% of GDP deficit-increasing)

[4]One-off and other temporary measures taken from the Commission services' autumn 2006 forecast (0.5% of GDP in 2005, 0.1% in 2007 and 2008; deficit-reducing. In 2006, 0.5% of GDP deficit-increasing).

[5]Based on estimated potential growth of 1.2%, 1.3%, 1.4% and 1.5% respectively in the period 2005-2008.

[6]Data on the primary balance in the programme and in the Commission services' forecasts are not directly comparable because of a different treatment of FISIM. Data in the programme follow the definitions required by the code of conduct. To be comparable with data in the programme, Commission data on the primary balance need to be adjusted by around +0.2% of GDP.

[7]The budgetary data in the programme for 2006 have been amended to include 0.9% of GDP of expenditure due to the cancellation by the State of the railway company's debt related to the high-speed project, announced in the stability programme and approved with the final amendment to the 2007 Budget Law.

Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

1. INTRODUCTION

The Italian authorities submitted the eighth update of the stability programme in the original language on 4 December 2006, only one working day later than the deadline of 1 December specified in the code of conduct[5]. The programme incorporates the first version of the 2007 draft Budget Law, which was adopted by government on 29 September, but does not take account of the amendments incorporated in the final version of the Budget Law. The programme covers the period from 2006 to 2011.

In Italy the programme is edited by the Ministry of Economy and Finance. It is not adopted by the government and is presented to Parliament for information only. 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 medium-term economic and financial planning document (*Documento di programmazione economico-finanziaria – DPEF*), which was presented on 7 July and successively updated in connection with the presentation of the first draft of the 2007 Budget Law at the end of September.

The programme adheres to the model structure requirement for stability and convergence programmes specified in the new code of conduct, but presents gaps in the prescribed compulsory and optional data. In particular, there is no breakdown of the budget consistent with the deficit targets for the years 2008-2011 (see Section 4 below). Annex 3 provides a detailed overview of all aspects of compliance with the new code of conduct.

2. ECONOMIC TRENDS AND POLICY CHALLENGES

The section is in five parts. The first provides a brief overview of the Italian macroeconomic performance in terms of growth and other major macro-variables. The second presents the results of a growth accounting exercise and tries to identify the main drivers of Italy's growth performance vis-à-vis the euro area. The third looks at the volatility of growth and other key macroeconomic variables and the stabilising or destabilising role of macro-policies. The fourth part focuses on trends in public finances. Based on the picture outlined in the first four parts, the final part identifies major economic challenges with fiscal policy implications.

2.1. Economic performance

Economic growth in Italy has consistently underperformed the euro area average since the late 1980s. Over the period 1995-2005, real GDP growth averaged 1.4%, as against 2.1% for the euro area and 2.3% for the EU as a whole. Within this period, the growth rate in Italy has been particularly low between 2001 and 2005, at just 0.6%, in the context of a dismal growth performance for the euro area (1.4%). As a result, the country's relative income position has been steadily weakening. In 2004, income per capita, expressed in purchasing power standards, fell below the euro area average, and decreased further in 2005, down to just below 98%. The income gap is particularly large in Southern regions and the islands, where GDP per capita is 70% or less than the country average. Structural weaknesses feeding into dismal total factor productivity growth appear to be at the root of these problems, weighing on the country's growth potential. The latter is estimated to have gradually fallen from 2½% in the 1980s to 1¼%

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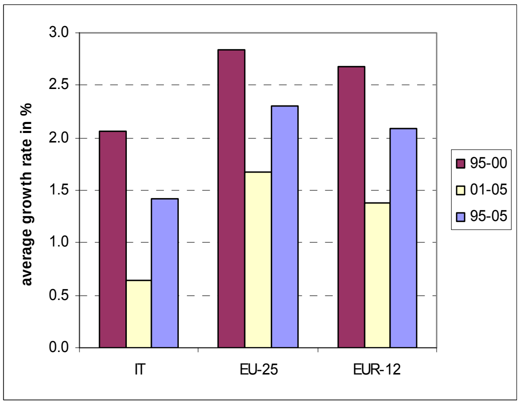
5 The English translation was submitted on 16 January 2007.

in the 2000s. Since then, a negative growth gap with the euro area average has stabilized at just below ¾ of a percentage point.

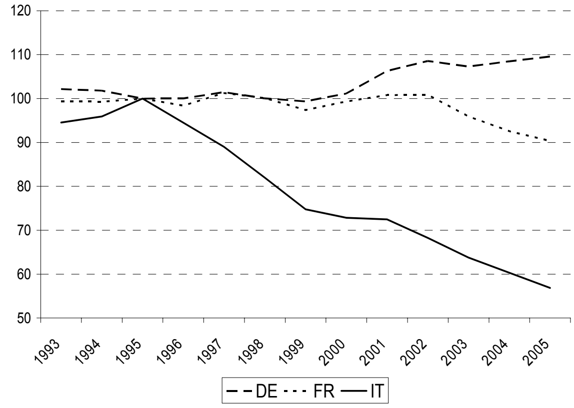
Despite sluggish growth, inflation has remained slightly higher than the euro area average until 2005 and the external balance has been steadily deteriorating. On the public finances front, the general government deficit has been above the 3 percent of GDP Treaty reference value since 2003 and the debt-to-GDP ratio remains very high and has started increasing again in 2005, to 106.6% of GDP.

Figure 1: Average GDP growth: Italy vs. EU25 and Euro area



Source: Commission services

Figure 2: Export performance relative to market growth (1995=100)



Note: Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets.

Source: Commission services

On the positive side, slow economic growth over the past decade went along with a healthy rate of job creation, partly reflecting the effect of the labour market policies and reforms implemented since the early 1990s that helped restrain labour costs while at the same time enhancing the flexibility in the use of labour input. The unemployment rate fell below the euro area average already in 2003 and, in spite of negative cyclical conditions, continued declining to attain 7.7% in 2005, down from above 11% in the mid-1990s. The employment rate gradually increased to 57.6% of the working age population in 2005, up from 51% in 1995, mainly thanks to the entry of women into the labour market. Still, there remains a long way to go before Italy catches up with the EU average in terms of employment rates, especially for specific groups like women, older workers and youth. Furthermore, regional disparities remain important as the gap between southern and centre-northern regions has widened, with the latter having recorded brisker growth rates.

As will be shown later, dismal TFP growth underlies the odd combination of dynamic employment growth and sluggish GDP growth. One consequence has been that, although wages in the private sector have grown relatively little in nominal terms, unit labour costs have risen quite significantly since 2001. Italy has thus been losing cost competitiveness vis-à-vis its trade partners, and between 2001 and 2004 particularly sharply against non-euro area countries as the euro strengthened. Adding up to the rapid erosion in 1995-96 of the cost competitiveness[6] gained from the devaluations of the lira in the three preceding years, this led to a contraction of the country's market shares in real terms by some 40% over the past decade, in stark contrast with the development of market shares in, for example, Germany and France (Figure 2).[7] However, when measured at current prices, the contraction of market shares is more contained and only slightly below that of other euro area countries. If, on the one hand, high export prices reflect high production costs and, therefore, loss of competitiveness, on the other hand, the apparently anomalous price-setting behaviour of exporters would point to a qualitative upgrading of the Italian traditional export segments in response to competitive pressures of low-cost countries.

Indeed, beyond cost factors, the export performance of Italian products seems to be greatly affected by an unfavourable product specialisation. The export specialisation of Italian manufacturing industries remain strong in traditional, low technology sectors, for example textile, clothing and leather, for which global demand is growing below average and competition from low-cost countries is higher. An analysis of the specialisation of exports by their technological content based on OECD trade data[8] shows that over the past two decades Italy has hardly changed its specialisation pattern in reaction to global economic developments; if at all, this pattern has strengthened somewhat as specialisation in the low-tech segment has slightly increased whereas the disadvantage in high technology and ICT manufactures has amplified.

This accentuation of the Italian specialisation pattern could be seen as the strengthening of Italy's comparative advantage. ISAE (2006) notes that in-between the two extremes of the specialisation pattern, Italian exports have outperformed those of the major European partners in the food industry, paper, printing and publishing, some intermediate goods as well as, more recently, the car industry. It is however too early to assess whether these structural changes have completed and, above all, if they would warrant a recovery of the country's competitiveness performance.

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6 As measured by unit labour costs adjusted for the exchange rate.

7 For a more in-depth discussion of this issue, see Larch, M. (2005) “Stuck in a rut? Italy’s weak export performance and unfavourable product specialisation” *DG ECFIN Country Focus* Vol. II, Issue 9. See also Faini, R. and A. Sapir (2005) “Un modello obsoleto? Crescita e specializzazione dell'economia italiana” in T. Boeri, R. Faini, A. Ichino, G. Pisauro, C. Scarpa Ed., “*Oltre il declino*”, Il Mulino, Bologna.

8 The pattern and degree of specialisation of exports is measured here by the Balassa index, defined as the ratio of a country's share in global exports of a given sector and the country's share in global exports of the economy as a whole. The technological content of exports was obtained based on a taxonomy developed by the OECD that regroups ISIC sectors into high, medium-high, medium –low, and low manufactures on the basis of the ratio of R&D expenditure in value added, following an OECD taxonomy.

2.2. Anatomy of medium-term growth

A traditional growth accounting exercise allows dissecting the sources of low average growth in Italy as well as possible differences in average economic growth vis-à-vis the euro area. In Figures 3 and 4, the evolution of real GDP over the period 1996-2005 is decomposed into six variables of supply-side determinants of growth. Four of these variables – the working age population, average hours worked, participation and unemployment rates - can be combined to measure total labour input; and the latter two variables – total factor productivity and capital deepening - measure labour productivity.[9]

Figure 3: Real GDP growth and its components

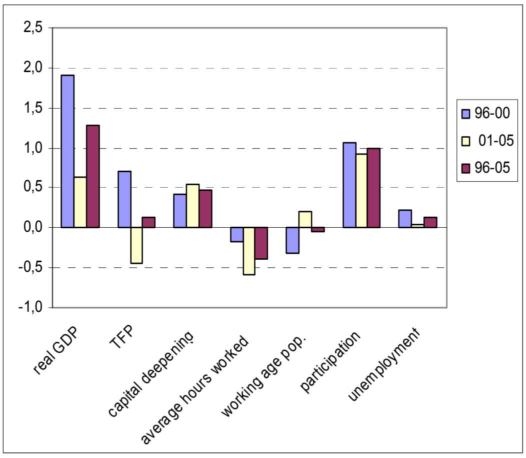
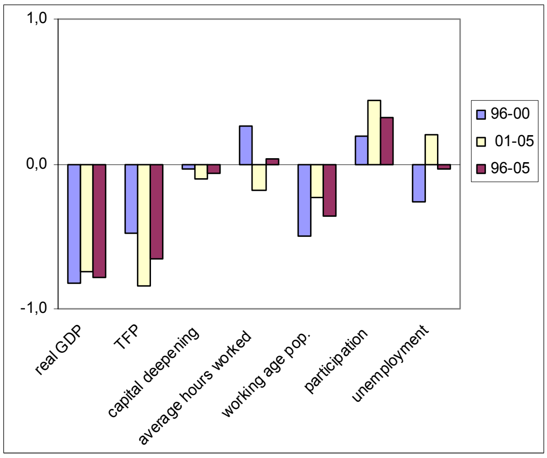


Figure 4: Real GDP growth and its components: Difference vis-à-vis Euro area average



Note:

Assuming a Cobb-Douglas-production function $Y = A(L \cdot H)^{\alpha} K^{1-\alpha}$ where Y denotes the level of *GDP*, L employment, H the average hours worked per person employed, K the capital stock and α the labour share in income, real GDP can be written as $Y = \frac{Y}{H \cdot L} H \cdot L = A \cdot \left(\frac{K}{H \cdot L}\right)^{1-\alpha} H \cdot WP \cdot PART \cdot (1-ur)$ where WP stands for working age population, $PART$ denotes the participation ratio as a share of WP and ur the rate of unemployment. In terms of growth rates g this is:

$$g_Y = g_A + (1-\alpha)(g_K - g_L - g_H) + g_H + g_{WP} + g_{PART} - g_{ur} \cdot \frac{ur}{1-ur}$$

The expression $(g_K - g_L - g_H)$ is referred to as capital deepening, i.e. the increase in the capital labour ratio.

Source: Commission services

Figure 3 shows that the contribution of labour input to real GDP growth has been of slightly more than ½ as the increase in participation rates and, to a lesser extent,

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9 An accounting exercise on Italy’s low growth is carried out in Bassanetti, A., Döpke, J., Torrini, R. and R. Zissa (2006) "Capital, labour and productivity: What role do they play in the potential GDP weakness of France, Germany and Italy?" Deutsche Bundesbank Discussion Paper Series, No. 9, Frankfurt; and Daveri, F. and C. Jona-Lasinio "Italy's decline: getting the facts right", Giornale degli Economisti e Annali di Economia, Vol. 64 – N. 4, December 2005. See also Larch, M. (2004) “Relegated to the league of laggards? Roots of Italy’s slow potential growth creation” *ECFIN Country Focus* Vol. I, Issue 8, European Commission, Directorate General for Economic and Financial Affairs, Brussels.

declining unemployment largely offset the decline in average hours worked and in working age population. This contrasts with the small or even negative support of labour input to growth of the previous decade. Labour productivity accounted for almost half of growth. The picture for the whole period 1995-2005 masks important developments within the period. Notably, the contribution of TFP growth to economic growth has turned negative in the 2000s, reflecting a sharp drop in this variable. Coupled with a stable contribution of capital deepening, this has implied that the contribution of labour productivity to real GDP growth has declined markedly since the turn of the century.

The comparison with the euro area highlights the TFP problem of the Italian economy (Figure 4).While for the euro area average TFP growth has given the most decisive contribution to growth, this was not the case for Italy. On the contrary, in the most recent years, it even acted as a drag on growth. Together with the adverse demographic developments, it explains most of the growth differential with the euro area. On the other hand, Italy outperforms the euro area in terms of the contribution of labour input, driven by the increase in participation rates, particularly so in the 2000s.

In sum, the dismal growth performance recorded in Italy vis-à-vis the euro area does not stem from the dynamics of factor accumulation, but is mostly caused by a declining TFP, which essentially indicates a disappointing absorption of new technologies. A widespread view is that structural factors that limit the organisational efficiency and ability to innovate of the Italian industry, insufficient competition, especially in the services sector, and low human capital accumulation are amongst the determinants of the marked slowdown in TFP.

Turning to the demand composition of growth over the period 1995-2005 under observation, the external sector deducted 0.2 of a percentage point per year on average from real GDP growth, mirroring the steady deterioration in competitiveness that is examined above. The dismal performance of net exports explains most of the growth differential with the euro area average. Within domestic demand, private consumption has been the main driver of growth. Still, lower private consumption growth explains another quarter of the growth gap with the euro area over the period 1995-2005. In line with the euro area, gross fixed capital formation contributed by just ½ of a percentage point, with a visible deceleration from the turn of the century as the slowdown in equipment investment growth was only partially offset by a recovery of construction investment. As for public consumption, its contribution to real GDP growth has been consistently positive since 1996 and averaged 0.2 of a percentage point over the period 1995-2005.

2.3. Macro policies against the backdrop of the economic cycle

The Italian economy has been operating below potential between 1992 and 1999 and then again since 2003. In 2005, the output gap is estimated to have reached -1.4% of potential GDP, below the euro area average. This, even if potential growth gradually fell well below the euro area average, to 1¼%. Indeed, the growth performance following the cyclical peak in late 2000 has been very disappointing. It can be viewed as a prolonged period of stagnation, only interrupted by small and short-lived recoveries in the second half of 2002 and then again in the first part of 2004.

Figure 5: Output gap and fiscal stance

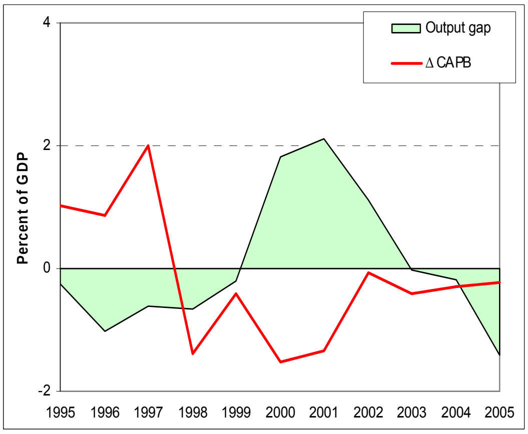
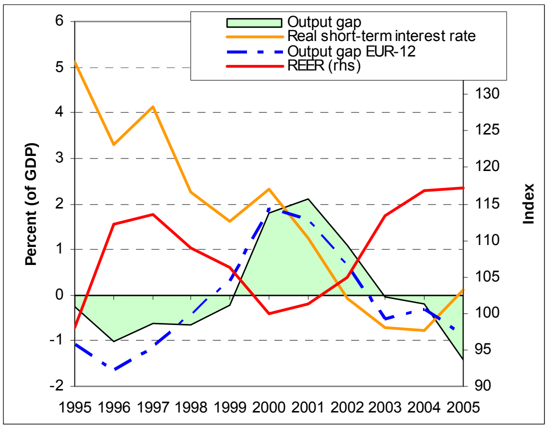


Figure 6: Output gap and monetary conditions



Note:
ΔCAPB denotes the change in the cyclically-adjusted primary budget balance

Source: Commission services

Source: Commission services

The run-up to EMU was characterised by an overall pro-cyclical restrictive policy mix that prompted an adjustment in terms of both fiscal consolidation and disinflation. During the period 1992-1997, the cyclically-adjusted primary balance increased by almost 9 percentage points of GDP, allowing Italy to put its debt-to-GDP ratio on a downward path and meet the Maastricht criteria on the fiscal front. In parallel, an extraordinary disinflation effort was achieved thanks to restrictive monetary conditions. The latter was supported by the wage moderation attained through the agreement reached with the social partners in 1992, which effectively interrupted a pervasive wage-price-spiral. The annual rate of HICP inflation fell from 6.2% in 1990 to 1.9% in 1997, only slightly above the euro area average.

The contractionary stance of macroeconomic policy on aggregate demand led some commentators to conclude that the slowdown in potential growth experienced by Italy during the 1990s was temporary and that growth would resume after the fading out of the short-term negative effect of the adjustment. However, the structural factors behind Italy's sluggish growth became evident as the economic slowdown persisted despite the relaxation of both monetary conditions and the fiscal stance in the years that followed the adoption of the euro.

The fiscal stance during the period 2000-2002 of positive output gap was markedly pro-cyclical. Italy thus lost the opportunity to improve its underlying budgetary position as economic conditions were favourable. In the following years, with an output gap that had turned negative, the fiscal stance continued to be expansive, whereas sizeable one-off measures helped to contain the deterioration of the cyclically-adjusted primary balance (Figure 5). Net of the effect of one-offs, the cyclically-adjusted primary balance improved in 2004 for the first time since 1998.

As expected, the adoption of the euro led to a considerable easing of monetary conditions, but it also brought about the loss of the exchange rate as an instrument for improving the contribution to growth of the external balance. In the absence of independent monetary and exchange rate policies, low productivity growth is largely responsible for the appreciation of the real effective exchange rate (Figure 6).

2.4. Public finances

In the run-up to EMU and immediately afterwards, Italy's fiscal accounts improved remarkably. By 1999, the general government deficit reached 1.7% of GDP, mainly thanks to increasing revenues and declining interest expenditure. This virtuous trend was reversed the following year when, despite the very buoyant real GDP growth (3.6%), the deficit decreased to 0.8% only thanks to one-off UMTS licence proceeds worth 1.2% of GDP. Then in 2001 the deficit rose above the 3 percent of GDP Treaty reference value and it has remained above that threshold since 2003. In 2005, when GDP stagnated, the deficit attained 4.1% of GDP and the primary surplus was almost fully eroded at 0.4% of GDP, down from above 5% of GDP at the end of the 1990s. As a result, the debt-to-GDP ratio increased for the first time in ten years, to 106.6%. The cyclically-adjusted primary balance has also steadily deteriorated since 1998 and the ratio of current primary expenditure to GDP has not ceased to increase since 2001[10]. In July 2005, Italy was placed in excessive deficit procedure and is now required to bring the deficit below 3% of GDP by 2007.

Figure 7 shows that the budgetary targets set out in the stability programme updates presented by the Italian government since 2000 have been repeatedly missed. Namely, the nominal deficit targets for 2001 and 2005 that were set in the stability programme updates of the respective previous years were exceeded by more than 2 percentage points of GDP. Similarly, the deficit outturn of 3.5% of GDP in 2003 and 3.4% in 2004 contrasts with targeted deficits of 1.5% and 2.2% of GDP set in the programme updates of 2002 and 2003 respectively. In this respect, it should be noted that the Italian institute of statistics (ISTAT) revised upwards on successive occasions the deficit figures for 2001-2004. The repeated shortfalls of the deficit outturn with respect to government plans reflect both falling revenues and primary expenditure overruns, particularly in 2001, 2003 and 2005, due to the absence of effective enforcement mechanisms to control expenditure, especially at local level and in the area of health care. A large part of the slippages relative to the official projections can be explained by the fact that until the 2004 update the government regularly built its budget upon an over-optimistic potential growth outlook. This led it to project a higher level of structural revenues, thus allowing to budget a higher level of expenditure and tax cuts. Overall, expenditure developments and the discretionary reduction in structural revenues relative to GDP more than offset the savings from lower interest payments as well as the impact of the sizeable one-off measures between 2002 and 2004 (see above).

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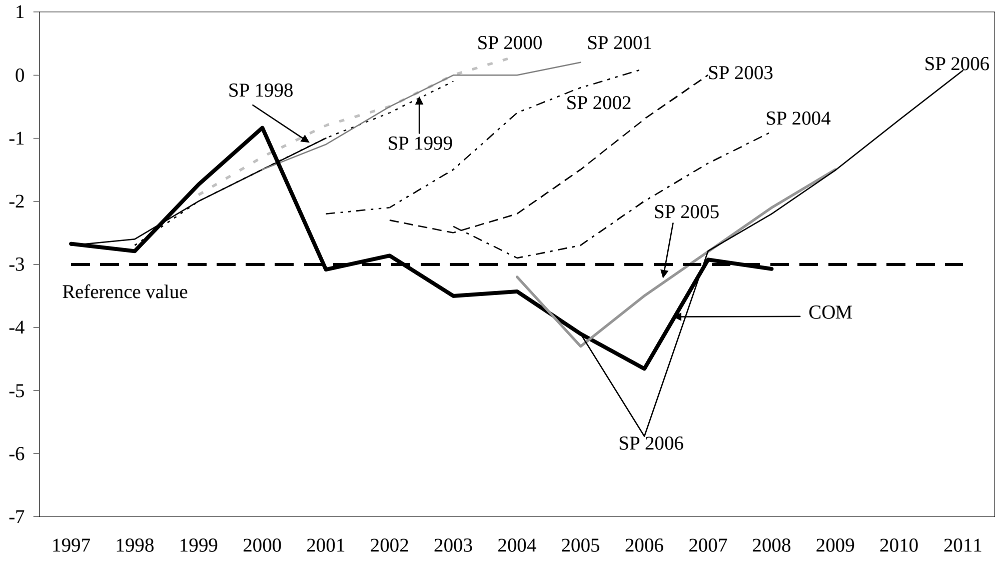
[10] For an account of the change and composition of government expenditure since 1990, see Box 5 in "December 2005 update of the stability programme of Italy (2005-2009): an assessment", Commission Services Working Document.

Figure 7: General government balance projections in successive stability programmes (% of GDP)



Source: Commission services' autumn 2006 forecast (COM) and successive stability programmes

On the long-term sustainability front, the heavy pressure put on pension and health care spending by a rapidly ageing population is a major risk. Successive pension reforms will contribute to enhance the sustainability of public finances but their full implementation remains crucial to obtain the expected results. In particular, the first 10-yearly revision of the actuarial coefficients in line with life expectancy, due in 2005 and which would help to reduce pressure on pension spending, has been repeatedly postponed. As for health care, a set of measures have been adopted to promote its financial sustainability, including ceilings on state transfers to the regions and controls on pharmaceuticals' prices. Yet, these measures have failed to prove effective and slippages in health care expenditure not necessarily related to demographic factors are of great concern. Furthermore, the persistently high level of debt and the weak budgetary position add up to ageing to weaken public finance sustainability.

In their latest assessment of long-term sustainability of public finances based on the 2005/6 update of the Stability Programme, the Commission and the Council placed Italy at medium risk. This assessment is heavily conditional upon both fiscal consolidation, so as to bring the debt-to-GDP ratio on a declining path, and the full implementation of the adopted pension reforms. For a more in-depth discussion on the long-term sustainability of public finances in Italy, see section 5.2.

2.5. Medium and long-term policy challenges for public finances

In Italy, structural weaknesses feeding into low productivity growth and a loss of external competitiveness appear to be at the root of the country's dismal growth performance. Real GDP growth has been below the euro area average since the mid 1990s and potential growth is estimated to have fallen from above 2% up to the early 1990s to 1¼% in the 2000s. Despite weak growth, inflation has remained slightly higher than the euro area average until 2005. On the positive side, Italy is one of the few countries to have enjoyed robust employment growth since the turn of the century and its unemployment rate has fallen substantially. But, while there remains a long way to go before Italy catches up the EU average in terms of employment rates, the odd combination of dynamic employment growth and sluggish GDP growth highlights Italy's productivity problem. On the public finances front, the general government deficit has been above the 3 percent of GDP Treaty reference value since 2003 and the debt-to-GDP ratio remains very high and has started increasing again in 2005, to 106.6% of GDP. The cyclically-adjusted primary balance has steadily deteriorated since 1998 and the ratio of current primary expenditure to GDP has not ceased to increase since 2001.

Against this background, the Italian public finances face the following challenges:

- First, the stabilisation challenge: A key problem in the Italian economy is the situation of public finances. The strain on public finances limits the ability of fiscal policy to allow automatic stabilisers to work effectively. In addition, the high level of public debt and the persistently weak budgetary position make Italy vulnerable to increases in interest rates and to market sentiment, increasing economic uncertainty.

- The efficiency challenge: The structural weaknesses that are at the root of Italy's deteriorating competitiveness and poor growth performance in recent years require an economic policy strategy that creates a virtuous circle between macro-economic stability, micro-economic reforms aimed at boosting total factor productivity and measures aimed at raising labour market participation. Consolidation of public finances is a necessary pre-condition for this strategy, as it would help reduce economic uncertainty, create more favourable conditions for investment and make room for enhanced expenditure on knowledge, human capital and infrastructure.

- Finally, over the longer term, a rapidly ageing population will put heavy pressure on pension and health care spending, thus putting at risk the long-term sustainability of public finances. Past successive pension reforms will help to contain rises in public expenditure, but their full implementation remains crucial to obtain the expected results. The success of the pension reforms, both in terms of financial sustainability and social adequacy, will also depend on further progress in increasing employment rates, particularly among women and older workers, and on the development of supplementary pension entitlements. In the area of health care, measures to contain expenditure growth have failed to prove effective and expenditure slippages are partly responsible for the upward drift of general government deficit.

Table 1: Key economic indicators

	Italy						Euro area					
	Averages						Averages					
	'96 - '05	'96 - '00	'01 - '05	2003	2004	2005	'96 - '05	'96 - '00	'01 - '05	2003	2004	2005
Economic activity												
Real GDP (% change)	1.3	1.9	0.6	0.0	1.1	0.0	2.1	2.7	1.4	0.8	2.0	1.4
Contributions to real GDP growth:												
Domestic demand	1.7	2.4	1.0	0.9	0.9	0.2	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	-0.4	-0.5	-0.4	-0.8	0.1	-0.3	0.1	0.1	0.1	-0.7	0.2	-0.2
Prices, costs and labour market												
HICP inflation (% change)	2.4	2.4	2.4	2.8	2.3	2.2	1.9	1.7	2.2	2.1	2.1	2.2
Labour productivity (% change)	0.5	1.1	0.0	-0.6	1.0	0.4	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs (% change)	-0.4	-1.1	0.3	1.2	-0.5	0.4	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Employment (% change)	1.3	1.0	1.7	3.0	0.3	0.6	1.2	1.5	0.9	0.7	0.7	0.8
Unemployment rate (% of labour force)	9.7	11.0	8.4	8.4	8.0	7.7	9.1	9.8	8.5	8.7	8.9	8.6
Competitiveness and external position												
Real effective exchange rate (% change) (1)	2.2	0.9	3.5	7.8	3.2	1.0	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance (% change) (2)	-5.5	-6.1	-4.8	-6.6	-5.4	-5.7	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance (% of GDP)	0.8	2.0	-0.4	-0.7	-0.4	-0.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances												
General government balance (% of GDP)	-3.2	-3.0	-3.4	-3.5	-3.4	-4.1	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt (% of GDP)	110.5	115.3	105.8	104.3	103.9	106.6	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance (% of GDP) (3)	n.a.	n.a.	n.a.	-5.2	-4.6	-3.9	n.a.	n.a.	n.a.	-3.2	-2.9	-2.0
Financial indicators (4)												
Long term real interest rate (%) (5)	2.5	3.5	1.5	1.2	1.3	1.5	3.1	4.1	2.1	2.0	2.2	1.5
Household debt (% of GDP) (6)	23.0	20.1	26.0	25.3	27.6	30.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt (% of GDP) (7)	55.6	51.6	59.6	59.8	60.3	62.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:
More detailed tables summarising the economic performance of the country are included in Annex 4.
(1) Unit labour costs relative to rest of a group of industrialised countries (USD): EU24 (=EU25 excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and NZ.
(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets.
(3) Cyclically-adjusted budget balance net of one-off and other temporary measures.
(4) Data available up to 2004.
(5) Using GDP deflator.
(6) Households' and non-profit institutions serving households' debt, defined as loans and securities other than shares.
(7) Non-financial corporate sector debt, defined as loans and securities other than shares.
Source:
Commission services

3. MACROECONOMIC OUTLOOK

This section is in seven parts, six of which refer to various dimensions of the macroeconomic scenario, notably: the external assumptions, overall economic growth, the labour market, costs and prices, sectoral balances and potential output growth. The final part summarises the assessment and includes (i) an overall judgement on the plausibility of the macroeconomic scenario and (ii) an indication of whether economic conditions over the programme period can be characterised as economic ‘good’ or ‘bad’ times.

3.1. External assumptions

The external assumptions underpinning the programme's macroeconomic scenario are broadly in line with those underlying the Commission services' autumn forecast, with some negligible divergences. For the years 2006 and 2007, the programme assumes higher oil prices but lower short term interest rates and a lower nominal effective exchange rate for the euro area. In terms of their impact on real GDP growth, such divergences balance each other out.

3.2. Economic activity

After stagnating in 2005, the Italian economy has regained dynamism in the first part of 2006. Real GDP in the first two quarters of 2006 grew by 0.8% and 0.6% respectively over the previous quarters; it slowed down in the third quarter of the year, to 0.3% q-o-q. For real GDP growth in 2006 as a whole, the carry-over after the first three quarters of the year is of 1.7%, adjusted for working days.

In 2006, the macroeconomic scenario of the update assumes real GDP growth to average 1.6%[11]. In 2007, economic growth is projected to slow down to 1.3%. This would be followed by a mild but steady acceleration throughout the remainder of the programme period, whereby real GDP is expected to grow by 1.5% in 2008, 1.6% in 2009 and 1.7% in 2010 and 2011. Domestic demand is projected to continue being the main driver of growth throughout the programme period. Both private consumption and gross fixed capital formation will slow down in 2007 to pick up in the following years. The contribution of net exports to real GDP growth is expected to turn broadly neutral as from 2008, after the very mildly positive contribution in 2006 and 2007.

Overall, the programme features plausible growth assumptions. In particular, the profile of economic growth in 2006-2007, with a deceleration in 2007, is in line with the Commission services' autumn 2006 forecast, if not slightly more pessimistic. The composition of growth is also broadly similar, with only some minor differences in terms of trends of export and import volumes. Some divergences appear in 2008, with the programme posting slightly higher growth and especially a different underlying composition of demand. Gross fixed capital formation is expected to grow by 2.8% as against 2% according to the Commission services. The pace of private consumption growth is also expected to be more dynamic. However, the contribution of net exports to real GDP growth is similar, although the growth pace of both exports and imports is expected to be more subdued in the programme. For the period beyond 2008, the

[11] Unadjusted for working days, as in the Commission services' forecasts. In 2006 there have been 2 working days less than in 2005.

projected real GDP growth in the programme slightly exceeds the estimated potential growth in the Commission services' autumn forecast.

Table 2: Comparison of macroeconomic developments and forecasts

	2006		2007		2008		2009	2010	2011
	COM	SP	COM	SP	COM	SP	SP	SP	SP
Real GDP (% change)	1.7	1.6	1.4	1.3	1.4	1.5	1.6	1.7	1.7
Private consumption (% change)	1.6	1.6	1.0	1.0	1.3	1.5	1.6	1.7	1.6
Gross fixed capital formation (% change)	3.3	2.8	2.2	2.3	2.0	2.8	3.0	3.1	3.0
Exports of goods and services (% change)	5.9	5.3	4.1	4.2	4.0	3.5	3.4	3.4	3.5
Imports of goods and services (% change)	4.6	4.8	3.9	3.5	3.9	3.4	3.5	3.4	3.3
Contributions:									
- Final domestic demand	1.7	1.7	1.2	1.1	1.3	1.5	1.6	1.7	1.7
- Change in inventories	-0.3	-0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0
- External balance on g&s	0.4	0.1	0.0	0.2	0.0	0.0	0.0	0.0	0.0
Output gap[1]	-1.0	-0.9	-1.0	-0.9	-1.1	-0.8	-0.7	-0.5	-0.5
Employment (% change)[2]	1.3	1.0	0.5	0.5	0.5	0.7	0.7	0.7	0.7
Unemployment rate (%)	7.1	6.9	7.0	6.7	7.0	6.3	6.0	5.9	5.7
Labour productivity growth (%)[2]	0.4	0.7	0.9	0.8	0.9	0.8	0.9	1.0	1.0
HICP inflation (%)	2.3	2.2	2.0	2.1	1.9	1.7	1.5	1.5	1.5
GDP deflator (% change)	2.2	1.9	2.2	1.5	2.2	1.8	1.8	1.9	1.8
Comp. of employees (% change)	4.6	4.6	3.6	2.7	3.3	2.7	3.0	2.9	3.0
Real unit labour costs (% change)[2]	0.4	0.7	-0.3	-0.3	-0.7	-0.6	-0.5	-0.8	-0.7
External balance (% of GDP)[3]	-1.4	-2.3	-1.1	-2.0	-0.8	-2.0	-2.0	-1.9	-1.8

Note:
[1]In percent of potential GDP, with potential GDP growth as reported in Table 4 below. Commission services calculations on the basis of the information in the programme.
[2] In full time equivalents.
[3] Current account. The figures in the SP are not according to ESA95 definition.

Source:
Commission services' autumn 2006 economic forecasts (COM); Stability programme

The growth projections of the programme imply a gradual narrowing of the currently negative output gap, which would however remain negative at the end of the programme period. For 2006 and 2007, there are no significant differences between the recalculated output gap estimates implied by the data in programme and the Commission services' autumn forecast. In 2008, the projections in the stability programme imply a slightly more favourable evolution of the output gap[12].

Table 3 compares the latest available estimate of the output gap for the first three years of the programme period with the estimates for the same years made in previous forecast rounds/programmes. It is interesting to note that, after the 2004 update, the perception of economic conditions is characterised by a higher degree of realism. As a result,

12 The recalculations of the output gap by the Commission services on the basis of the information in the programme imply a substantially higher level of this indicator compared to the figures presented in the programme, but the output gap evolution throughout the programme period remains broadly similar. The output gap presented in the programme decreases from -1.6% of potential output in 2006 to -1.1% in 2011; the corresponding figures in the recalculations by the Commission services are -0.9% and -0.5. The differences in level are imputable to the fact that the update's calculations of potential output do not take account of hours worked.

consistency between the Commission services' forecasts and the updates' estimates has improved.

Table 3: Output gap estimates in successive Commission services' forecasts and stability programmes

	2006		2007		2008	
	COM	**SP[1]**	**COM**	**SP[1]**	**COM**	**SP[1]**
Dec-06	-	-0.9	-	-0.9	-	-0.8
Autumn 2006	-1.0	-	-1.0	-	-1.1	-
Spring 2006	-1.3	-	-1.4	-	-	-
Dec-05	-	-1.2	-	-1.0	-	-0.8
Autumn 2005	-1.2	-	-1.2	-	-	-
Spring 2005	-1.4	-	-	-	-	-
Dec-2004	-	-0.9	-	-0.3	-	0.2

Note:
[1] Commission services' calculations according to the commonly agreed method based on the information in the programme.

Source: Commission services' forecasts, national Stability programme and Commission services.

3.3. Potential growth and its determinants

Table 4 presents the Commission services' recalculations of potential growth according to the commonly agreed methodology, based on the information in the programme. The estimated rates of potential growth are in line with those of the Commission services' autumn 2006 forecast up to 2008. In the period 2009-2011, potential GDP growth is estimated to increase, to reach 1.7% in 2011.

Table 4: Sources of potential output growth

	2006		2007		2008		2009	2010	2011
	COM	**SP[2]**	**COM**	**SP[2]**	**COM**	**SP[2]**	**SP[2]**	**SP[2]**	**SP[2]**
Potential GDP growth[1]	1.3	1.3	1.4	1.3	1.5	1.4	1.5	1.6	1.7
Contributions:									
- Labour	0.4	0.4	0.3	0.3	0.3	0.4	0.3	0.3	0.3
- Capital accumulation	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
- TFP	0.3	0.2	0.4	0.3	0.5	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 2006 economic forecasts (COM); Commission services' calculations

For the three years of the programme period for which Commission services' estimates are available, the composition of potential growth in the two sets of projections is broadly similar. In both scenarios, the contribution of total factor productivity (TFP) growth is estimated to increase steadily. This would represent an improvement with the recent past when TFP growth contributed only marginally to potential growth.

3.4. Labour market developments

The programme projects full-time equivalent employment growth at 1% in 2006, ½% in 2007 and ¾% over 2008-2011. These projections imply a moderation of the employment content of growth from the high values of the recent past, with a consequent rebound in labour productivity growth from 2006 onwards. The unemployment rate is expected to continue decreasing to below 6% in 2010 and 2011.

The projections for employment growth in full time equivalents are very similar to those of the Commission services, although for 2006 the projection of the programme is lower, at 1% as opposed to 1.3%, implying a decline in employment in the last quarter of the year or a revision of past figures. The decrease in the unemployment rate is expected to be more pronounced in the programme than in the Commission services' forecast.

3.5. Costs and price developments

The programme projects consumer price inflation in 2006 at 2.2%, slightly lower than the Commission services (at 2.3%) but overall in line with the observed developments in the first eleven months of the year. HICP inflation is projected to decrease slightly in 2007 and then more appreciably in 2008 and 2009, when it is expected to reach 1.5% year-on-year, and to remain at that level in 2010 and 2011. On the other hand, inflation measured by the GDP deflator would slow down significantly already in 2007, to 1.5% from 1.9% in 2006, presumably under the effect of the containment of labour cost growth, as a result of the planned cut in the fiscal tax wedge on labour, and also driven by an expected marked decline (-0.9%) in the public consumption deflator and a projected slow down in the export deflator.

Compensation of employees are estimated to accelerate in 2006, to 4.6%, under the impact of the renewal of contracts and significant employment growth, and to slow down markedly in 2007, to 2.7%. In the later years of programme, labour cost is projected to increase slightly to 3%, probably as a result of the tightening of labour markets implied by rising employment and declining unemployment.

Compared to the Commission services' forecast, the slowdown in compensation of employees projected in the programme for 2007 is more marked. This is because the programme projections incorporate in this item the cut of the labour tax wedge foreseen in the 2007 draft budget that actually implies a reduction of the labour cost-related base of the regional tax on productive activity (IRAP). Excluding the IRAP adjustment, the projected growth in compensation of employees in the programme would be more in line with that in the Commission services' autumn forecast, yet still lower (at around 3% in 2007 and 2008).

On the back of moderating labour costs and an improving productivity, real unit labour costs are estimated to decrease over the programme period. In both sets of projections, slowing unit labour costs are consistent with an improvement in the competitiveness of the country.

3.6. Sectoral balances

The programme projects the current account to improve by 0.3% of GDP between 2006 and 2008, whereas in Commission services' autumn forecast the improvement is more marked (0.6% of GDP). In the following years, the update projects a further reduction in the current account deficit by only 0.2% of GDP despite the 2.3% planned improvement in the government balance. This would imply a marked shift in the private sector balance, which would reverse from net lending to net borrowing.

3.7. Assessment

The assessment of the macroeconomic outlook covers two questions: first, whether the macroeconomic scenario is plausible, and, second, whether the economy should be considered to be in economic ‘good’ or ‘bad’ times.

3.7.1. Plausibility of the macroeconomic scenario

Overall, the programme features plausible if not prudent growth assumptions in the first two years of the programme period. The projected economic growth rate for 2006 and 2007 is broadly in line with the Commission services' autumn forecast. The mild acceleration projected for the years 2008-2011 likely postulates a favourable effect of the product and services market reforms and growth-enhancing measures foreseen in the DPEF and in the context of the Lisbon Strategy, which could be realistic provided the commitment to reform is effectively translated into action. The macroeconomic projections for 2008 are generally more optimistic in the programme than in the Commission services' autumn forecast, particularly concerning the contribution to growth by domestic demand, largely thanks to higher gross fixed capital formation, and concerning the labour market scenario, with higher employment growth, a more favourable evolution of the unemployment rate and more subdued labour costs growth. After 2008, real economic growth is projected slightly above the average potential growth estimate in the Commission services' autumn forecast.

3.7.2. Economic good vs. bad times

The output gap is projected to remain negative throughout the horizon of the Commission services autumn forecast and, according to the Commission services' estimates implied by the data in the programme, also in the years up to 2011, although with some improvement. This goes hand in hand with a higher rate of economic growth and a steady decline in the rate of unemployment. However, real GDP growth remains modest, well below the euro area average, and the decline in unemployment is more of a structural nature. Thus, given the projected negative output gap over the entire programme period, Italy can still be considered in economic "bad" times, with some improvement towards the end of the period. Looking at a broader set of macroeconomic indicators can temper the negative assessment of the country's cyclical conditions but does not significantly modify it.

4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2006 and the second presents the budgetary strategy in the new update, including the programme’s medium-term objective (MTO) for the budgetary position. The third analyses the risks attached to the budgetary targets in the programme. The final part contains the assessment of the fiscal stance and of the country’s position in relation to the budgetary objectives of the Stability and Growth Pact.

4.1. Budgetary implementation in 2006

The 2006 stability programme update projects the 2006 deficit at 5.7% of GDP[13], which includes the 4.8% of GDP deficit figure that was stated in the DPEF update and an additional 0.9% of GDP stemming from the cancellation of railway company's debt related to the high-speed project (*Ferrovie dello Stato – RFI/TAV*)[14]. The deficit projection for 2006 in the current update contrasts with the 3.5% of GDP deficit target that was set in the 2005 update, while projecting a slightly lower real GDP growth (1.5% as against 1.6% in the current update).

The deficit target for 2006 was revised upwards five times during 2006. In April, the Quarterly Cash Report (RTC) revised the official deficit projection for 2006 up to 3.8% of GDP, also as a result of a downward revision of real GDP growth to 1.3% but despite a better carry-over from 2005. Retaining the same 1.3% growth assumption, in June, a task force set up by the new government (*due diligence*) estimated the deficit projection for 2006 at 4.1% of GDP, also highlighting considerable risks which could bring the deficit up to 4.6% of GDP. In July, the Economic and Financial Planning Document (DPEF), revising again real GDP growth up to 1.5%, set the objective of a 4.0% of GDP deficit for 2006. This new target also included the positive effect of the mid-year budget officially estimated at 0.1% of GDP for 2006. At the end of September, together with the draft 2007 budget, the Italian government adopted an update of the DPEF for the years 2007-2011. The latter revised real GDP growth for 2006 up to 1.6% and projected the year's deficit at 4.8% of GDP. Compared with the July version, this upward revision of the deficit was essentially due to the negative impact of the European Court of Justice's (ECJ) ruling on VAT on company cars[15], which was estimated at around 1.3% of GDP, only partly offset by higher-than-expected tax revenues than assumed in the July's version of the DPEF, officially projected at about ½% of GDP, of which ¼% considered structural.

The 3.5% of GDP deficit target in the 2005 update also contrasts with the Commission services' autumn forecast of 4.7% of GDP. Neither scenario takes account of the 0.9% of GDP slippage due to the above mentioned debt cancellation. The 1.2% of GDP

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[13] The standard tables in the programme present the 2006 deficit at 4.8% of GDP, 0.1 of a p.p. higher than the Commission services autumn 2006 forecast. In practice, and in a rather opaque manner, the programme projects the 2006 deficit at 5.7% of GDP, as it refers to an additional 0.9% of GDP higher deficit stemming from the assumption by the State of railway company's debt related to the high-speed project.

[14] The Italian government decided to cancel the railway company's debt related to the high-speed project. This deficit-increasing measure was approved with the final amendment to the 2007 Budget Law. According to a Eurostat decision of 23 May 2005 (see Eurostat News Release N° 65/2005), such debt was already booked as government liability. This means that, instead of a debt owed by the railway company (*RFI-TAV*) to financial markets, national accounts recorded a debt from the *RFI-TAV* to government and a debt from government to bond holders ('on-lending'). Therefore, the government decision to take over the railway company's debt has no impact on the government debt and the transaction is treated as debt cancellation and not debt assumption.

[15] The ECJ ruled on 14 September 2006 against Italy's law provision derogating on the legal entitlement to deduct VAT on certain car and fuel purchases made by enterprises for the purposes of their taxable transactions. This law provision was deemed incompatible with the Sixth Council Directive 77/388/EEC on the harmonisation of Member States' legislation relating to turnover taxes. The ruling entails the refunding of unduly paid VAT over 2003-2005 and lower VAT revenue as from 2006.

difference is essentially explained by the different impact of one-offs (0.8% of GDP) and the permanent effect of the ECJ ruling on VAT (0.4% of GDP).

Concerning in particular the 0.8% of GDP different impact of one-offs, the 2005 update projected deficit-reducing one-off measures amounting to 0.3% of GDP in 2006 (0.2% of GDP substitutive taxes on the revaluation of company's assets and 0.1% of GDP sales of real assets), whereas the Commission services' forecast incorporates deficit-increasing one-off measures amounting to 0.5% of GDP in 2006. The latter results from: (i) 0.9% of GDP one-off expenditure, consisting of 1.0% of GDP from Court rulings and of -0.1% from sales of real estate; and (ii) 0.4% one-off revenue from substitutive taxes on the revaluation of companies' assets.

Box 1: The mid-year 2006 budget

On 30 June 2006, the Italian government approved a Decree-Law aimed at reducing the deficit and enhancing growth by liberalising some specific business areas. The package contains deficit-reducing revenue measures, which are partly compensated by some measures increasing expenditure. The net deficit-reducing effect is officially estimated at about 0.1% of GDP in 2006 and 0.4% of GDP in 2007.

On the revenue side, a wide range of measures aim at reducing tax evasion/avoidance in various sectors, among which the real estate sector. Expenditure cuts mainly consist of additional savings on intermediate consumption at central level. Part of the difference in the budgetary impact between 2006 and 2007 is due to additional capital expenditure authorised for the road maintenance state company (ANAS) and the capital transfers to the railway state-owned company (*Ferrovie dello Stato*) only in 2006, for a total of around 0.2% of GDP.

As for budget composition, a comparison between the Commission services' autumn forecast and the 2005 stability programme update is problematic because of the statistical revisions of historical data (including of FISIM) that have taken place in-between the two projection exercises. It also has to take account of the adoption of a mid-year budget (see Box 1) at the end of June 2006. Broadly speaking, the Commission services autumn forecast incorporates faster growth in interest expenditure, by more than 0.1% of GDP, and stronger-than-projected dynamics in primary expenditure, by around ¾% of GDP. In particular, slippages are expected in health care and local government expenditure for which the 2005 update planned ambitious savings, whereas the enforcement mechanisms introduced in the 2006 budget to limit central government intermediate consumption appear to have been effective. On the other hand, the Commission services' forecast for 2006 takes account of the stronger-than-expected increase in permanent revenue by more than ½% of GDP, compared to the conservative projections in the 2005 update. In particular, the reform of corporate taxation, entered into force in 2004 and additional measures on corporate taxation introduced with the amendments to the 2006 draft budget yielded more than originally budgeted. More-tax-friendly macroeconomic developments also contributed to higher tax revenue. Finally, the Commission services' forecast incorporates the positive effects (more than ¼% of GDP) stemming from: (i) the higher real GDP growth in 2006 (1.7% instead of 1.5%), and (ii) a better carryover from 2005, in part due to the significant upward revision of the nominal GDP series carried out by ISTAT in March 2006 (+2.8% in 2004).

Recent evidence on budgetary developments in 2006 suggest that the 2006 deficit is likely to turn out significantly lower than the targeted 5.7% of GDP. According to ISTAT, the general government deficit in the first nine months of 2006 was similar to the one recorded in the same period of 2005, even though the data already include the higher capital expenditure related to the refunding of unduly paid VAT from 2003 up to mid-September 2006 (1.2% of GDP). However, it does not yet reflect the above-mentioned 0.9% of GDP capital expenditure stemming from the cancellation of the railway company's debt related to the high-speed project, which pertains to the last quarter. Buoyant current revenues and a reduction in gross fixed capital formation outweighed the increase in current primary expenditure that resulted from the renewal of public employment contracts. In 2006, the State-sector cash borrowing requirement, which was not affected by the ECJ's ruling on VAT nor by the debt cancellation operation, was around 1.7 p.p. of GDP lower than in 2005. Developments for the total government borrowing requirement in cash terms in the first ten months of 2006 have been less positive, but still significantly lower than in the corresponding period of 2005, by around 1.3 p.p. of GDP.

The underlying position in 2006, i.e. the deficit excluding one-offs, is thus likely to be better than targeted in the 2006 update and than assumed in the Commission services' autumn forecast. In particular, expenditure overruns could be lower than forecast. This would imply a favourable base effect for the budgetary outcome in 2007.

Table 5: Evolution of budgetary targets in successive programmes

		2005	2006	2007	2008	2009	2010	2011
General government balance (% of GDP)	**SP Dec 2006**[1]	-4.1	-5.7	-2.8	-2.2	-1.5	-0.7	0.1
	SP Dec 2005	-4.3	-3.5	-2.8	-2.1	-1.5	n.a.	n.a.
	SP Dec 2004	*-2.7*	*-2.0*	*-1.4*	*-0.9*	*n.a.*	*n.a.*	*n.a.*
	COM Nov 2006	-4.1	-4.7	-2.9	-3.1	n.a.	n.a.	n.a.
General government expenditure (% of GDP)	**SP Dec 2006**[1]	48.1	50.7	49.0	48.9	48.6	48.0	47.5
	SP Dec 2005	49.2	48.4	47.6	47.5	47.0	n.a.	n.a.
	SP Dec 2004	*47.5*	*47.6*	*47.1*	*46.7*	*n.a.*	*n.a.*	*n.a.*
	COM Nov 2006	48.1	49.5	48.6	48.6	n.a.	n.a.	n.a.
General government revenues (% of GDP)	**SP Dec 2006**	44.0	45.0	46.2	46.0	45.9	45.7	45.4
	SP Dec 2005	44.9	45.0	44.3	44.2	43.9	n.a.	n.a.
	SP Dec 2004	*44.8*	*44.4*	*44.1*	*43.9*	*n.a.*	*n.a.*	*n.a.*
	COM Nov 2006	44.0	44.9	45.7	45.5	n.a.	n.a.	n.a.
Real GDP (% change)	**SP Dec 2006**	0.0	1.6	1.3	1.5	1.6	1.7	1.7
	SP Dec 2005	0.0	1.5	1.5	1.7	1.8	n.a.	n.a.
	SP Dec 2004	*2.1*	*2.2*	*2.3*	*2.3*	*n.a.*	*n.a.*	*n.a.*
	COM Nov 2006	0.0	1.7	1.4	1.4	n.a.	n.a.	n.a.

Note:
[1] The budgetary data in the programme for 2006 have been amended to include 0.9% of GDP of expenditure due to the cancellation by the State of the railway company's debt related to the high-speed project, announced in the stability programme and approved with the final amendment to the 2007 Budget Law.
Source:
Stability programme (SP); Commission services' autumn 2006 economic forecasts (COM)

4.2. 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.

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

The programme plans to reduce the deficit below the 3% of GDP reference value in 2007, in line with the Council recommendation under Article 104(7), and to pursue fiscal consolidation thereafter towards the medium term objective (MTO) of a balanced budget in structural terms, which is planned to be reached in 2010.

Box 2: The excessive deficit procedure for Italy

According to the excessive deficit procedure (EDP), the Commission and the Council monitor the development of the budgetary position in each Member State, notably in relation to the reference values of 3% of GDP for the deficit and 60% of GDP for the debt, in order to assess the existence (or risk) of an excessive deficit and to ensure its correction. The EDP is laid down in Article 104 of the Treaty and further clarified in the Stability and Growth Pact.

On 28 July 2005, the Council adopted a decision stating that Italy had an excessive deficit in accordance with Article 104(6). 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 2006, 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 require continuous monitoring.

4.2.2. The composition of the budgetary adjustment

As in previous updates, the composition of the needed fiscal adjustment is detailed only for the year following the update, i.e. 2007. Beyond 2007, the information is limited to the size of the correction required to achieve the budgetary targets relative to trends. The specification of the composition of the budget in these years reflects the unchanged legislation scenario and hence is not consistent with the budgetary targets. The programme notes that the measures to achieve the budgetary targets are defined year by year in the Budget Law, in compliance with Italy's fiscal policy legislation. This is in contrast with the Stability and Growth Pact[16] and the new code of conduct, which require a description of the broad measures backing the budgetary targets throughout the programme period.

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

According to the update, the general government balance would improve by 2.9% of GDP in 2007 relative to 2006. The decline in the deficit would come from the expiring of the negative effects of Court rulings (one-off and permanent – see Box 3 on the 2007 budget) and of the higher capital expenditure due to the cancellation of debt linked to the high-speed project, totalling around 2% of GDP. Net of the impact of the latter expenditure, the fiscal correction is expected to come from a steep increase in the revenue-to-GDP ratio, which is projected to increase by a further 1.2% in 2007, after the 1% increase expected in 2006. More specifically, the phasing out of the 0.4% of GDP one-off revenue recorded in 2006 is projected to be more than compensated by an increase in other taxes and in social contributions, including the TFR diversion (see Box 4). This will be partially offset by the projected increase in total expenditures. Specifically, primary expenditure is expected to increase by 0.1% of GDP relative to 2006 while interest expenditure would rise by 0.2% of GDP.

Local governments are expected to contribute to the correction of the 2007 deficit by 0.2% of GDP, mainly thanks to the projected decline in compensation of employee expenditure. Although no substantial measures are planned on this expenditure item, local government expenditure for compensation of employees on GDP is projected to decline in 2007, as the payment of significant arrears stemming from the delayed contract renewal recorded in 2006 will not repeat in 2007.

Table 6: Composition of the budgetary adjustment

(% GDP)	**2005**	**2006**	**2007**	**2008**[1]	**2009**[1]	**2010**[1]	**2011**[1]	**Change: 2011-06**
Revenues	44.0	45.0	46.2	*46.0*	*45.9*	*45.7*	*45.4*	***0.4***
of which:								
- Taxes & social contributions	40.6	41.6	42.9	*42.6*	*42.5*	*42.3*	*42.0*	***0.4***
- Other (residual)	3.4	3.4	3.4	*3.4*	*3.4*	*3.4*	*3.4*	***0.0***
Expenditure[2]	48.1	50.7	49.0	*48.9*	*48.6*	*48.0*	*47.5*	***-3.3***
of which:								
- Primary expenditure [2]	43.3	46.0	44.0	*43.9*	*43.6*	*43.0*	*42.4*	***-3.5***
of which:								
Consumption	20.1	20.1	19.5	*19.5*	*19.3*	*18.9*	*18.7*	***-1.4***
Transfers other than in kind & subsidies	18.0	18.2	18.6	*18.6*	*18.5*	*18.3*	*18.3*	***0.1***
Gross fixed capital formation	2.4	2.6	2.8	*2.8*	*2.9*	*2.8*	*2.7*	***0.1***
Other (residual) [2]	2.9	5.1	3.1	*3.1*	*3.0*	*2.9*	*2.8*	***-2.3***
- Interest expenditure	4.8	4.8	5.0	*5.0*	*5.0*	*5.0*	*5.0*	***0.2***
General government balance (GGB) [2]	**-4.1**	**-5.7**	**-2.8**	**-2.2**	**-1.5**	**-0.7**	**0.1**	**5.8**
Primary balance [2]	**0.7**	**-0.9**	**2.2**	**2.8**	**3.4**	**4.2**	**5.0**	**5.9**
One-offs [2]	0.5	-1.4	0.1	0.1	0.0	0.0	0.0	1.4
GGB excl. one-offs	**-4.6**	**-4.3**	**-2.9**	**-2.3**	**-1.5**	**-0.7**	**0.1**	**4.4**

[1]The programme does not provide targets for revenues and expenditure (and their components) after 2007. The figures indicated in italics are the official trends based on unchanged legislation.
[2] The budgetary data in the programme for 2006 have been amended to include 0.9% of GDP of expenditure due to the cancellation by the State of the railway company's debt related to the high-speed project, announced in the stability programme and approved with the final amendment to the 2007 Budget Law.

Source:
Stability programme update; Commission services' calculations

Box 3: The budget for 2007

The 2007 draft budget was adopted by the government at the end of September 2006. While the targeted deficit of 2.8% of GDP in 2007 was not amended during the Parliamentary discussion, some provisions have been changed compared to the original draft adopted by the government, on which both the Commission services' autumn 2006 forecasts and the 2006 Stability Programme update are based. On top of the State budget and the Budget Law, this year the budgetary package is composed of a Decree Law that, among other measures, compensates for the permanent loss in VAT revenues linked to the ECJ ruling and of a Framework Law that lays the basis for the harmonisation of taxation on households' income from financial assets. Parliament approved the Decree Law on 23 November and the Budget Law on 21 December. The adoption of the Framework Law, which is expected to yield around 0.1% of GDP higher revenue included in the 2007 budget, has been postponed to 2007.

The 2007 budget contains almost 1½% of GDP redistributive and growth-enhancing measures, including deductions from the labour tax base of the regional tax on productive activities (IRAP) aimed at reducing the labour tax wedge, tax relieves for family charges, tax breaks in different sectors, transfers to the state-owned railway company, funds for increasing compensation of employees and other smaller measures. Overall, growth-enhancing measures are planned to increase expenditure by around 1% of GDP and reduce revenue by around ½% of GDP. The negative budgetary effect of these measures will be more than offset by nearly 2½% of GDP of deficit-reducing measures with respect to the trend deficit at unchanged legislation. The funding would come mainly from more than 1¾% of GDP additional revenue. In particular, the single most important measure, planned to yield almost 0.4% of GDP, is the partial diversion of the accumulation of the severance pay scheme of private sector employees – the TFR – from enterprises to the national social security institute INPS (net of the benefits paid, administrative costs and also the compensatory measures for the enterprises, the budgeted impact of this measures in 2007 is around 0.3% of GDP - see Box 4). Additional revenues are supplemented by around ¾% of GDP expenditure cuts, distributed between central and local governments (the further revision of the domestic stability pact designed to deliver the planned savings is outlined in Section 6).

Table: Main measures in the budget for 2007

Revenue measures*	**Expenditure measures****
o TFR diversion to INPS (0.4% of GDP)	o Cuts to central government expenditure (-0.3% of GDP)
o Higher social contributions (0.3% of GDP)	o Cuts to local government expenditure (-0.2% of GDP)
o Fight of tax evasion/elusion (0.3% of GDP)	o Transfers to the railways (0.2% of GDP)
o Deduction from IRAP tax base (-0.2% of GDP)	o Social transfers (0.2% of GDP)
o Increase of local and regional taxes (0.2% of GDP)	o Higher compensation of employees (0.1% of GDP)
o Increase of the tax base of the self-employed and small firms (0.2% of GDP)	o Peace keeping operations (0.1% of GDP)
o Tax relief for family charges (-0.1% of GDP)	o Savings on health care expenditure (-0.1% of GDP)
o Annual extension of special tax provisions (-0.1% of GDP)	
o Change personal income break tax (0.1% of GDP)	
o Harmonisation of taxation on households' financial assets (0.1% of GDP)	

* Officially estimated impact on general government revenues.
** Officially estimated impact on general government expenditure.
Sources: Commission services and Italy's Ministry of Economy and Finance.

Box 4: The diversion of the severance pay scheme (TFR) to INPS

The 2007 Budget Law proposes to change the current discipline governing severance pay (*Trattamento di Fine Rapporto* - TFR) for dependent workers in the private sector. This box describes the relevant regulations and discusses their accounting treatment as well as the implications for fiscal consolidation and long-term sustainability of the new provision in the budget.

The TFR scheme: current and planned discipline

The current discipline governing severance pay (TFR) applies to all dependent workers in the private sector. Each year, employers are obliged to accumulate as book reserves about one month worth of salary per worker, which is returned to workers at the end of the employment relationship (because of retirement, resignation or layoff) or, in exceptional circumstances (i.e. the purchase of a dwelling or health care), during the working relationship. The TFR funds accrue a yearly return of 1.5% plus ¾ of the inflation rate. Given higher market interest rates and relatively difficult credit conditions, particularly for small firms, the TFR funds have typically represented a source of low-cost and easy financing for enterprises. In 2005, legislation enacting the pension reform of 2004, intended to kick-start the privately-funded pension pillar, established that from 1st January 2008 all dependent workers in the private sector will have the opportunity to choose whether to continue accumulating the severance pay fund by the employer or to direct future flows to a private pension fund. The choice of the latter option may be expressed by the employee by tacit means ("silence as assent").

The 2007 draft Budget Law envisages anticipating to 1 January 2007 the regulations regarding the use of TFR flows for the constitution of private pension funds. At the same time, it lays down that employers with at least 50 employees have to divert the funds that employees decide not to transfer to private pension funds towards a new scheme set up within the Italian social security institute INPS. The flows paid each year into the new scheme by employers (on behalf of their employees) would have the immediate effect to reduce the general government deficit. The amounts accumulated into the scheme and which will be eventually paid back to employees as severance pay will be used by the government for funding infrastructure investment and for other government purposes.

In its original formulation in the draft Budget Law, the provision concerned all firms, including those with less than 50 employees, and envisaged the transfer of just half the TFR flows that employees would decide not to destine to private pension plans. The draft provision was modified in the way described above following protests by employers of small enterprises.

The accounting treatment of the TFR

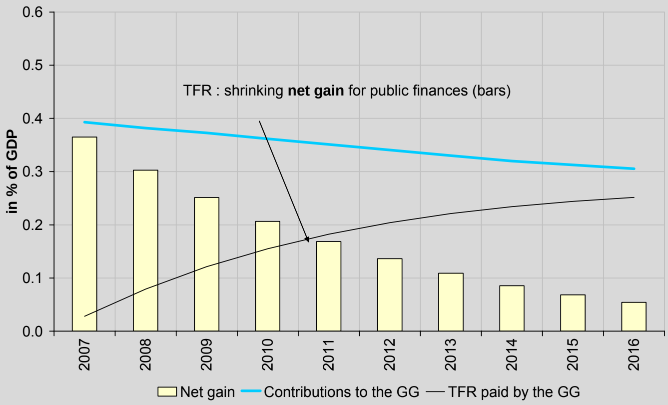
The current severance pay system managed by firms in the private sector is classified in Italian national accounts as "non-autonomous private funded social insurance schemes". The scheme is considered "non-autonomous" and "funded" because employers build up reserves by legal obligation, for the exclusive and explicit purpose of paying severance to their employees, without however constituting separate institutional units from the employers. The flows into the segregated reserves are recorded as employers' social contributions, whereas the severance payments to employees are recorded as social benefits. An analogous scheme for civil servants, managed by the social security unit INPDAP, is also classified as social security scheme, though it is recorded as unfunded in line with ESA95 rules.

The Budget Law makes the use of the amounts accumulated into the new public scheme conditional upon validation by Eurostat of the accounting treatment of the relevant in-flows as government revenue. According to the government, the new provision in the 2007 Budget Law implies a change in the institutional sector that manages the scheme – from the corporate sector to the government sector –¬ but does not affect the accounting classification of the relevant in- an out-flows. Hence, the new scheme should be considered as a social security scheme. Flows from employees (via their firms) to INPS will be recorded as government revenue (i.e., social contributions) that reduces the deficit, whereas severance payments from the government to employees (social benefits) will increase the deficit.

Implications for fiscal consolidation and long-term sustainability: an assessment

The government estimates that the additional revenue stemming from the TFR diversion in 2007 and the following years will amount to around or just below 0.4% of GDP per year. In 2007, the net gain from the measure, after taking account of contributions received, benefits paid, administrative costs and also the compensatory measures in the way of fiscal advantages to firms, is officially estimated at more than 0.3% of GDP. There are considerable risks attached to this estimation, as it requires assumptions on decisions of employees that cannot be easily anticipated. Despite the substantial amendment by Parliament referred to above, the official estimation of the budgetary impact of the measure in the final version of the Budget Law has remained unchanged at the level originally presented in the draft budget. This estimation hinges upon the assumption that more than 60% of employees in the concerned firms would explicitly refuse the transferral of their funds to the private pension schemes. Especially given that employees can opt for the private pension funds by tacit means, the officially projected budgetary impact of the measure appears to be at risk. This is all the more true for the years after 2007, when the pace of participation in private pension schemes could increase more rapidly than assumed. The high estimation of the budgetary impact of the measure also appears to be in contrast with the declared intention by the Government to promote private pension funds through information campaigns, as a way to help workers preserve adequacy of their future pensions.

There are also concerns as to the fact that the deficit-reducing impact of this provision will decrease over time. While in the first years of its operation revenues will largely exceed the benefits paid out, the positive impact on the budget balance is officially estimated to progressively fade away over the next 8-9 years, when additional revenues and expenditure will balance out.



Finally, although the transfer of the TFR-related flows will imply an improvement in the fiscal position of the government for some years to come, the additional revenue does not improve the sustainability of public finances as it implies additional future expenditure (see also Section 5).

4.2.3. The medium-term objective (MTO) and the structural adjustment

The medium term objective (MTO) put forward in the programme is a balanced budget in structural terms (i.e. cyclically-adjusted and net of one-off and other temporary measures), to be achieved as from 2010. However, when recalculated by the Commission services on the basis of the programme[17], the structural balance in 2010 would still be negative, at -½% of GDP and would turn slightly positive in 2011. The previous update of the programme also planned a MTO of balanced budget, but it did not plan to reach it within the programme period (which stopped in 2009).

Table 7: Output gaps and cyclically-adjusted and structural balances

% of GDP	2005		2006		2007		2008		2009	2010	2011	Change: 2011-2006
	COM	SP[1]	COM	SP[1]	COM	SP[1]	COM	SP[1]	SP[1]	SP[1]	SP[1]	SP[1]
Gen. gov't balance [7]	-4.1	-4.1	-4.7	-5.7	-2.9	-2.8	-3.1	-2.2	-1.5	-0.7	0.1	5.8
One-offs[2 7]	0.5	0.5	-0.5	-1.4	0.1	0.1	0.1	0.1	0.0	0.0	0.0	1.4
Output gap[3]	-1.4	-1.3	-1.0	-0.9	-1.0	-0.9	-1.1	-0.8	-0.7	-0.5	-0.5	0.4
CAB[4 7]	-3.4	-3.5	-4.1	-5.3	-2.4	-2.3	-2.5	-1.8	-1.2	-0.4	0.3	5.6
change in CAB [7]	0.0	-0.1	-0.8	-1.8	1.7	2.0	-0.1	0.5	0.6	0.7	0.8	-
CAPB[4 6 7]	1.2	1.3	0.5	-0.5	2.4	2.7	2.2	3.2	3.7	4.5	5.2	5.7
Structural balance[5]	-3.9	-4.0	-3.6	-3.9	-2.5	-2.5	-2.6	-1.9	-1.2	-0.4	0.3	4.2
change in struct. bal.	0.7	0.6	0.3	0.1	1.1	1.4	-0.1	0.6	0.7	0.7	0.8	-
Struct. prim. bal.[5 6]	0.6	0.8	1.0	0.9	2.3	2.5	2.2	3.1	3.7	4.5	5.2	4.3

Notes:
[1] Output gaps and cyclical adjustment according to the stability programme (SP) as recalculated by Commission services on the basis of the information in the programme.
[2] One-off and other temporary measures.
[3] In percent of potential GDP. See Table 2 above.
[4] CA(P)B = cyclically-adjusted (primary) balance.
[5] Structural (primary) balance = CA(P)B excluding one-offs and other temporary measures.
[6] Data on the primary balance in the programme and in the Commission services' forecasts are not directly comparable because of a different treatment of FISIM. Data in the programme follow the definitions required by the code of conduct. To be comparable with data in the programme, Commission data on the primary balance need to be adjusted by around +0.2% of GDP.
[7] The budgetary data in the programme for 2006 have been amended to include 0.9% of GDP of expenditure due to the cancellation by the State of the railway company's debt related to the high-speed project, announced in the stability programme and approved with the final amendment to the 2007 Budget Law.

Source:
Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

[17] See above Footnote 12.

Box 5: The medium-term objective (MTO) for the budgetary position

According to the Stability and Growth Pact, stability and convergence programmes must present a medium-term objective (MTO) for the budgetary position. The MTO is country-specific 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 MTO should fulfil a triple aim. First, it should provide a safety margin with respect to the 3% of GDP deficit limit. Second, it should ensure rapid progress towards sustainability. Third, taking into account the first two goals, it should allow room for budgetary manoeuvre, considering in particular the needs for public investment. The code of conduct 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 3% of GDP deficit reference value. Member States are free to set an MTO that is more demanding than strictly required by these provisions.

The MTO is defined in structural terms, i.e. it is adjusted for the cycle and one-off and other temporary measures are excluded. For countries belonging to the euro area or participating in the exchange-rate mechanism (ERM II), the MTO should be in a range between a deficit of 1% of GDP and balance or surplus (in structural terms).

The MTO is at an appropriate level. First, it is more demanding than the minimum benchmark (estimated at a deficit of around 1½% of GDP), i.e. the estimated budgetary position in cyclically-adjusted terms that provides a sufficient safety margin for automatic stabilisers to operate freely during normal economic downturns, without breaching the 3% of GDP deficit reference value. Second, it lies within the range indicated for euro area and ERM II Member States in the SGP and the code of conduct. Finally, the MTO adequately reflects the debt ratio and average potential growth in the long run.

4.3. Risk assessment

This section discusses the plausibility of the programme’s budgetary projections by analysing various risk factors. For the period until 2008, standard Table 8 compares the detailed revenue and expenditure projections in the Commission services’ autumn 2006 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

Compared with the Commission services' autumn 2006 forecasts (see Section 3), projections for economic growth over 2006-2008 appear plausible. Limited downside macroeconomic risks only concern the outer years of the programme, when real GDP growth is forecast to slightly exceed potential growth estimated in the Commission services' forecasts.

Cash figures and national accounts data for the first nine months of 2006 point to the likelihood of a 2006 deficit sensibly lower than the projected 5.7% of GDP; hence, to a possible better carry-over effect into 2007 (see Section 4.1).

Concerning 2007, the Commission services’ autumn 2006 forecast projects the deficit slightly above the targeted 2.8% of GDP. Tax dynamics in the 2007 draft budget are higher than in the Commission services’ autumn 2006 forecasts, as the latter assesses more prudently the measures aimed at fighting tax evasion in the 2007 budget. Also the Commission services' forecast is subject to the mentioned positive risk of a better carry-over from 2006. However, there are also risks that the outturn could be worse than forecast. First, the size of the additional revenues stemming from the diversion of the severance payment scheme TFR (see Box 4) is subject to considerable uncertainty, as it depends on how many employees decide not to opt for a private pension scheme. An amendment to the 2007 draft Budget Law, which exempts firms with less than 50 employees from diverting the TFR to INPS, increased the risk that revenue from this provision turns out lower than budgeted. Other amendments weakened somewhat the provision aimed at broadening the tax base among the self-employed and small firms. Finally, the approval of the Framework Law aimed at raising additional revenue (0.1% of GDP in 2007) through the harmonisation of taxation on households' financial assets has been postponed.

Table 8: Comparison of budgetary developments and projection

(% of GDP)	2005	2006		2007		2008		2009	2010	2011
		COM	SP	COM	SP	COM[1]	SP[4]	SP[4]	SP[4]	SP[4]
Revenues	**44.0**	**44.9**	**45.0**	**45.7**	**46.2**	**45.5**	***46.0***	***45.9***	***45.7***	***45.4***
of which:										
- Taxes & social contributions	40.6	41.6	41.6	42.4	42.9	42.2	*42.6*	*42.5*	*42.3*	*42.0*
- Other (residual)	3.4	3.3	3.4	3.3	3.4	3.3	*3.4*	*3.4*	*3.4*	*3.4*
Expenditure [5]	**48.1**	**49.5**	**50.7**	**48.6**	**49.0**	**48.6**	***48.9***	***48.6***	***48.0***	***47.5***
of which:										
- Primary expenditure [3 5]	43.3	44.9	46.0	43.9	44.0	43.9	*43.9*	*43.6*	*43.0*	*42.4*
of which:										
Consumption	20.1	20.3	20.1	20.0	19.5	19.9	*19.5*	*19.3*	*18.9*	*18.7*
Transfers other than in kind & subsidies	18.0	18.1	18.2	18.3	18.6	18.4	*18.6*	*18.5*	*18.3*	*18.3*
Gross fixed capital formation	2.4	2.5	2.6	2.6	2.8	2.6	*2.8*	*2.9*	*2.8*	*2.7*
Other (residual) [5]	2.9	4.0	5.1	3.0	3.1	3.0	*3.1*	*3.0*	*2.9*	*2.8*
- Interest expenditure [3]	4.8	4.6	4.8	4.8	5.0	4.7	*5.0*	*5.0*	*5.0*	*5.0*
GGB [5]	**-4.1**	**-4.7**	**-5.7**	**-2.9**	**-2.8**	**-3.1**	**-2.2**	**-1.5**	**-0.7**	**0.1**
Primary balance [3 5]	**0.7**	**-0.1**	**-0.9**	**1.8**	**2.3**	**1.7**	**2.8**	**3.4**	**4.2**	**5.0**
One-offs [2 5]	0.5	-0.5	-1.4	0.1	0.1	0.1	0.1	0.0	0.0	0.0
GGB excl. one-offs	**-4.6**	**-4.2**	**-4.3**	**-3.0**	**-2.9**	**-3.1**	**-2.3**	**-1.5**	**-0.7**	**0.1**

Notes:

[1] On a no-policy change basis.
[2] One-offs and other temporary measures.
[3] Data on the primary balance in the programme and in the Commission services' forecasts are not directly comparable because of a different treatment of FISIM. Data in the programme follow the definitions required by the code of conduct. To be comparable with data in the programme, Commission data on the primary balance need to be adjusted by +0.2% of GDP.
[4] The programme does not provide targets for revenues and expenditure (and their components) after 2007. The figures indicated in italics are the official trends based on unchanged legislation.
[5] The budgetary data in the programme for 2006 have been amended to include 0.9% of GDP of expenditure due to the cancellation by the State of the railway company's debt related to the high-speed project, announced in the stability programme and approved with the final amendment to the 2007 Budget Law.

Source:
Commission services' autumn 2006 economic forecast (COM); Stability programme update (SP); Commission services' calculations

On the expenditure side, enforcement mechanisms foreseen in the new domestic stability pact for municipalities and provinces remain weak. In particular, the automatic increase in local taxation foreseen in the 2007 Budget Law in case of slippages would be effective only as from 2008. The government decision to assume the railway company's debt linked to the high-speed project highlights the risk of future additional government expenditure to fund this project. Other risks are linked to possible slippages in health care expenditure, also in the light of the fact that the automatic increase in private co-payments to finance pharmaceutical expenditure in regions with a structural deficit in health care accounts, originally foreseen in the draft Budget Law, has been dropped. Overall, track records point to possible expenditure overruns.

Beyond 2007, the lack of information on the composition of the planned adjustment is itself a major element of risk, especially in view of its size. Besides, risks that the deficit may be worse than targeted arise 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 projections based on unchanged legislation results in an underestimation of expenditure trends compared to the projections derived on the basis of a no-policy change criterion[18]. Unchanged legislation projections do not fully take account of, for instance, future wage increases in the public sector. Specifically, the current update projects compensation of employees to drop by 0.5% of GDP between 2007 and 2011. Overall, the 2011 trend deficit, based on unchanged legislation, is 0.6% of GDP lower in 2011 than in 2007.

Table 9: Assessment of tax projections

	2007			2008			2009	2010	2011
	SP	**COM**	**OECD[3]**	**SP**	**COM[1]**	**OECD[3]**	**SP**	**SP**	**SP**
Change in tax-to-GDP ratio (total taxes)[4]	1.6	1.2	0.2	-0.2	-0.1	0.0	-0.1	-0.2	0.0
Difference (SP – COM)	0.4		/	-0.1		/	/	/	/
of which[2]:									
- discretionary and elasticity component	0.9		/	0.0		/	/	/	/
- composition component	0.0		/	0.0		/	/	/	/
Difference (COM - OECD)	/	1.0		/	-0.4		/	/	/
of which[2]:									
- discretionary and elasticity component	/	0.8		/	-0.3		/	/	/
- composition component	/	0.1		/	-0.1		/	/	/
p.m.: Elasticity to GDP	2.4	1.8	1.2	0.9	0.9	1.2	0.9	0.8	0.0

Notes:
[1] On a no-policy change basis.
[2] The decomposition is explained in Annex 5.
[3] OECD ex-ante elasticity relative to GDP.
[4] Excluding one-offs

Source:

Commission services' autumn 2006 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 dynamics in 2008 are similar to the Commission services' autumn 2006 forecasts. The programme projections for 2008 can be assessed and compared with the Commission services' forecasts since neither includes the planned adjustment. Afterwards, the tax ratio is projected to gradually decline. However, the assessment of tax trends in the programme has to take account of an optimistic assumption about the elasticity of direct taxes to GDP in 2007, which would be the result of improved tax collection. This implies some risks to the programme's budgetary projections.

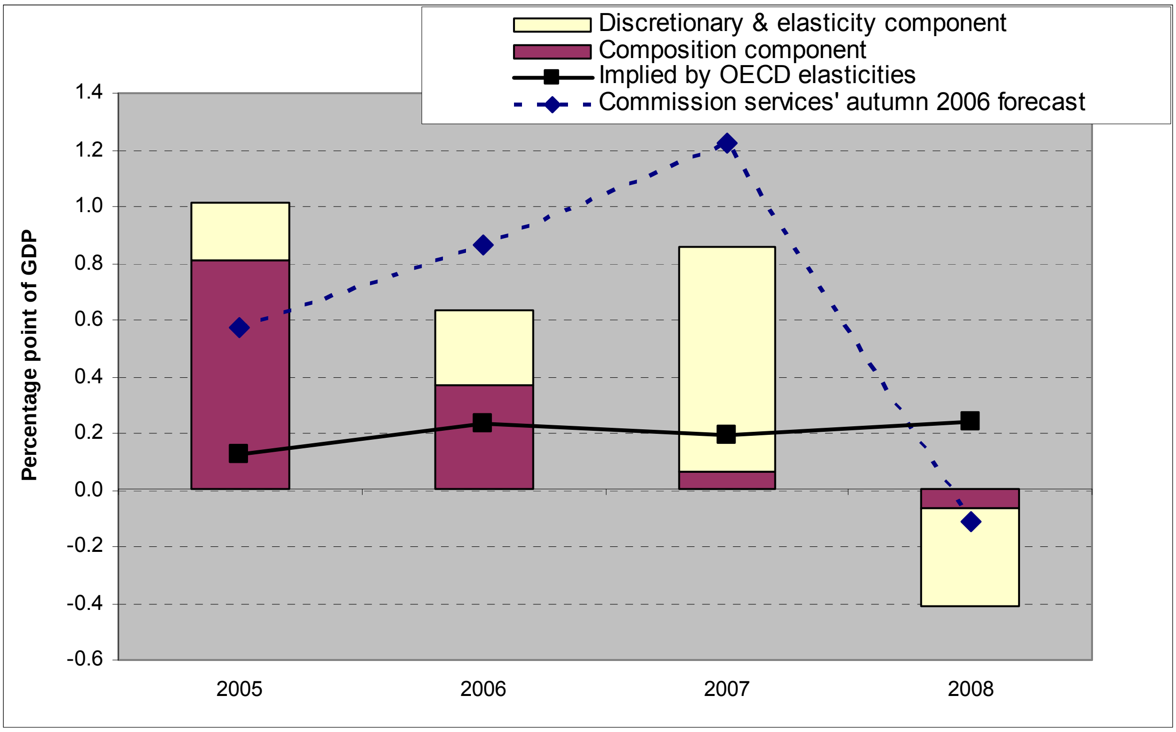
[18] The differences between unchanged legislation and no-policy change trend scenarios are described in Box 3 in the Commission services technical assessment of the 2005 update. In brief, the no-policy change criterion assumes a continuity of present trends for all budgetary items which are not yet known in sufficient detail. Instead, the unchanged legislation criterion assumes that future expenditure and revenue will reflect only legislation already approved by the government. However, only a subset of expenditure laws specifies in detail the amount of future expenditure; expenditure whose quantification is deferred to future decision is not included in the unchanged legislation scenario.

Furthermore, an amendment introduced by Parliament to the draft 2007 budget aims at lowering taxes as from 2008, on the back of the possible higher permanent revenue stemming from the envisaged increased fight to tax evasion. The amendment requires the Ministry of Economy and Finance to estimate by 30 September 2007 the extent of the additional permanent revenue recorded in 2007 as a result of the enhanced tax collection. The government will then decide whether to use the full amount of these tax revenues or part of it to cut taxation in 2008.

The evaluation of other one-off measures does not raise major issues, as the only temporary measures planned are sale of real estate yielding 0.1% of GDP in 2007 and 2008.

Overall, after 2007, there are risks that the budgetary outcomes will be worse than targeted in the programme.

Figure 8: Changes in the tax-to-GDP ratio: actual/projected changes vs. changes implied by OECD elasticity



Note: The dashed line displays the change in the tax ratio in the Commission services' autumn 2006 forecast, for 2008, on a no-policy-change basis. The solid line shows the change in the tax ratio implied by the ex-ante OECD elasticity with respect to GDP. The difference between the two is explained by the bars. The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags, variations of taxable income that do not necessarily move in line with GDP e.g. capital gains. Both components may not add up to the total difference because of a residual component, which is generally small. The decomposition is explained in detail in Annex 5.

Source:
Commission services

4.4. Assessment of the fiscal stance and budgetary strategy

Table 10 below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value is made (middle column) and, second, the final assessment that also takes into account risks (final column).

The programme can be considered consistent with a correction of the excessive deficit by 2007, subject to the full and effective implementation of the 2007 budget. The structural budgetary correction of around 1½% of GDP planned over 2006-2007 would be broadly in line with the Council recommendation under Article 104(7), which required an effort of at least 1.6% of GDP. Contrary to the Council requirement that at least half of the correction take place in 2006, according to the Commission forecast, the correction is being backloaded, as the structural deficit is estimated to improve by around ¼% of GDP in 2006 and 1¼% of GDP in 2007. However, excluding the permanent impact of the ECJ ruling on VAT, in 2006 the structural adjustment would be over ½% of GDP and available information points to a better-than-forecast 2006 deficit outturn. As for 2007, almost one third of this substantial adjustment relies on the 0.4% of GDP additional revenue planned from the diversion of the severance pay scheme TFR to INPS (see Box 4). However, the deficit-reducing effect of this measure is set to progressively decrease over time, as the additional revenue stemming from it will have to be paid back to employees as social benefits.

Table 10: Overview of compliance with the Stability and Growth Pact

	Based on programme[3] (with targets taken at face value)	**Assessment** (taking into account risks to targets)
a. Consistency with correction of excessive deficit by 2007 deadline	Yes, but structural adjustment backloaded due to the negative permanent effect of ECJ's ruling on VAT	Yes
b. Safety margin against breaching 3% of GDP deficit limit[1]	from 2009	Possibly only from 2010 or 2011
c. Achievement of the MTO	By the end of the programme (2011)	Possibly not within the programme period
d. Adjustment towards MTO in line with the Pact (after the correction of the excessive deficit)[2]?	fully in line	Broadly in line

Notes:
[1]The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the above mentioned minimum benchmark (estimated as a deficit of around 1½% of GDP for Italy). These benchmarks represent estimates and as such need to be interpreted with caution.
[2]The Stability and Growth Pact requires Member States to make progress towards their MTO (for countries in the euro area or in ERM II, this has been quantified as an annual improvement in the structural balance of at least 0.5% of GDP as a benchmark). In addition, the structural adjustment should be higher in good times, whereas it may be more limited in bad times.
[3]Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.

Source:
Commission services

Against the risks identified above, and especially the lack of information on the composition of the fiscal consolidation beyond 2007, it is difficult to assess the plausibility of the achievement of the safety margin against breaching the 3% of GDP deficit limit, planned for the 4th year of the programme, as well as of the MTO, planned for the 5th year. As to the progress towards the MTO after 2007 (i.e. after the correction of the excessive deficit to an end by 2007) the planned structural adjustment based on the programme targets taken at face value is fully in line with the Stability and Growth Pact, averaging ¾% of GDP, despite the 'bad times' expected throughout the programme period. The tax elasticity to GDP in the first years of the programme is high. This is in part due to the effect of discretionary measures increasing tax rates and the tax base, while it reflects the optimistic assumption on the effectiveness of the fight to tax evasion. Based on Commission services' calculations on the basis of the programme according to the commonly agreed methodology, the output gap is estimated to remain negative, albeit closing, over the programme period (see Section 3). Once risks are taken into account, progress towards the MTO should be considered to be broadly in line with the Pact.

The planned stance of fiscal policy is restrictive over all the programme period. However, aggregate demand is expected to somewhat benefit from the reimbursements of unduly paid VAT on companies' cars stemming from the ECJ ruling, which would be cashed to taxpayers over 2007-2009, as well as from the reduction of the labour tax wedge foreseen in the 2007 Budget Law (see Section 6).

5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

Government debt is the result of the financing needs of government over the years. It corresponds primarily to an accumulation of deficits, although the build-up of financial assets and other adjustments may also play a role[19]. The reform of the Stability and Growth Pact has raised attention to the crucial importance of government debt and of sustainability in fiscal surveillance.

This section is in two parts: a first part describes recent developments and the medium-term prospects for government gross debt; it describes the stability programme targets, compares them with the Commission services' forecast and assesses the associated risks. A second part looks into the government debt from a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

5.1. Recent debt developments and medium-term prospects

5.1.1. Debt projections in the programme

The government debt-to-GDP ratio decreased gradually from a peak of over 121% in 1994 to around 104% in 2004. Until 2000, the main contributor to the debt reduction was a healthy primary surplus averaging more than 5% of GDP. Also privatisation proceeds at around ¾% of GDP, on average, played a significant role. Afterwards, however, a shrinking primary surplus and a dismal real GDP growth affected the pace of debt reduction, which slowed down considerably despite some extraordinary operations[20]. In 2005, with zero real GDP growth, a slim primary surplus and sizeable accumulation of

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19 On the factors other than the deficit which explain the evolution of the government debt, see "The dynamics of government debt: decomposing the stock-flow adjustment", chapter II.2.2 of *Public Finances in EMU 2005,* European Economy, N°3/2005.

20 They mainly consisted of (i) privatisation proceeds realised thanks to the classification of *Cassa Depositi e Prestiti* (the state-owned savings and loans bank) outside the general government sector in 2003, and (ii) an exceptional conversion of Treasury bonds held by the Bank of Italy in 2002.

financial assets[21] recorded in the stock-flow adjustment, the debt ratio increased for the first time after 10 years. The 2005 update projected a slight decrease in the debt-to-GDP ratio in 2006. By contrast, essentially because of the accumulation of liquid assets to finance part of the reimbursement due to the ECJ's ruling on VAT (see Section 4), both the 2006 update and the Commission services' forecast expect a further increase in the debt-to-GDP ratio to 107½% and 107¼%, respectively (from 106½% in 2005). However, considering the positive developments in the cash borrowing requirement, a better result for the debt ratio at end 2006 appears likely.

Table 11: Debt dynamics

(% of GDP)	average 2000-04	2005	2006		2007		2008		2009	2010	2011
			COM	SP	COM	SP	COM	SP	SP	SP	SP
Gross debt ratio [1]	**103.9**	**106.6**	**107.2**	**107.6**	**105.9**	**106.9**	**105.7**	**105.4**	**103.5**	**100.7**	**97.8**
Change in the ratio	-2.0	2.7	0.6	1.0	-1.3	-0.7	-0.3	-1.5	-1.9	-2.8	-2.9
Contributions [2]:											
Primary balance [3 4]	-2.9	-0.5	0.1	0.9	-1.8	-2.2	-1.7	-2.8	-3.4	-4.2	-5.0
"Snow-ball" effect [3]	1.2	2.5	0.6	1.1	1.1	2.0	1.0	1.5	1.4	1.3	1.4
Of which:											
Interest expenditure [3]	5.6	4.6	4.6	4.8	4.8	5.0	4.7	5.0	4.9	4.9	4.9
Growth effect (real GDP)	-1.4	0.0	-1.8	-1.7	-1.4	-1.4	-1.4	-1.6	-1.7	-1.7	-1.7
Inflation (GDP deflator)	-3.0	-2.1	-2.3	-2.0	-2.3	-1.6	-2.3	-1.9	-1.9	-1.9	-1.8
Stock-flow adjustment[4]	-0.3	0.7	0.0	-1.0	-0.5	-0.5	0.4	-0.2	0.1	0.1	0.6
Of which:											
Cash/accruals diff.	0.2	-0.4	-1.0	-1.1	-0.2	-0.5	0.1	-	-	-	-
Acc. financial assets[4]	-0.1	1.0	1.0	-0.1	-0.4	0.0	0.3	-	-	-	-
Privatisation	*-0.5*	*-0.3*	-	-	-	-	-	-	-	-	-
Val. effect & residual	-0.4	0.1	-	0.2	-	0.1	-	-	-	-	-

Notes:
[1] End of period.
[2] 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 (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.
[3] Data on the primary balance in the programme and in the Commission services' forecasts are not directly comparable because of a different treatment of FISIM. Data in the programme follow the definitions required by the code of conduct. To be comparable with data in the programme, Commission data on the primary balance need to be adjusted by around +0.2% of GDP.
[4] The budgetary data in the programme for 2006 have been amended to include 0.9% of GDP of expenditure due to the cancellation by the State of the railway company's debt related to the high-speed project, announced in the stability programme and approved with the final amendment to the 2007 Budget Law.
Source:
Stability programme update (SP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations

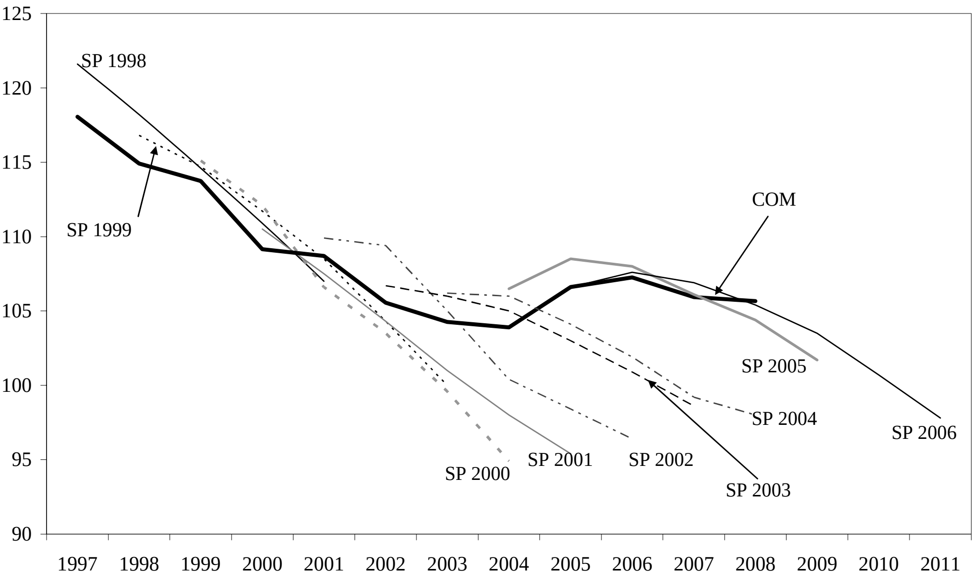
[21] In particular, in 2005 net government loans granted to other sectors amounted to more than 0.6% of GDP, of which 0.3 p.p. related to the financing of the railway high-speed project (0.5% of GDP in 2004 - see Footnote 14). Government investment in liquid assets and in securities other than shares increased by around 0.5% and 0.1% of GDP, respectively.

It is worth noting that the 0.9% of GDP State's assumption of the railway company's debt linked to the high-speed project (*RFI/TAV*) mentioned in Section 4 does not add to the government debt; in the stability programme 2006 scenario, the reconciliation between the deficit and debt in relation to this operation takes place in the stock-flow adjustment, as a decrease in financial assets[22].

The successive updates of the Italian stability programme (see Figure 9) projected a steady decline in the debt-to-GDP ratio but the actual outcome has systematically been less favourable than assumed. In particular, the 1999 and the 2000 updates planned the debt at or below 100% of GDP as from end 2003. This objective has been postponed in each of the following updates and, despite the positive denominator effect due to the upward revision of the nominal GDP series by around 2¾% carried out in March 2006, the 2006 update now projects the debt ratio below 100% of GDP only in 2011, i.e., eight years later than originally planned.

After the increase in the previous two years and thanks to a significant planned increase in the primary balance, the present update projects a slight reduction in the debt ratio in 2007, though the so-called "snow-ball" effect is expected to be less benign than in 2006 as interest expenditure is increasing and nominal GDP is decelerating. The pace of debt reduction is then projected to accelerate over the outer years of the programme as the targeted primary surplus continues increasing steadily, reaching 5% of GDP in 2011. Given the planned stable interest expenditure and nominal GDP growth, the negative "snow ball" effect would remain at around 1½% of GDP over 2008-2011. As for the stock-flow adjustment, the programme does not project any particular below-the-line debt-increasing operation, nor privatisation proceeds.

Figure 9: Debt projections in successive stability programmes (% of GDP)



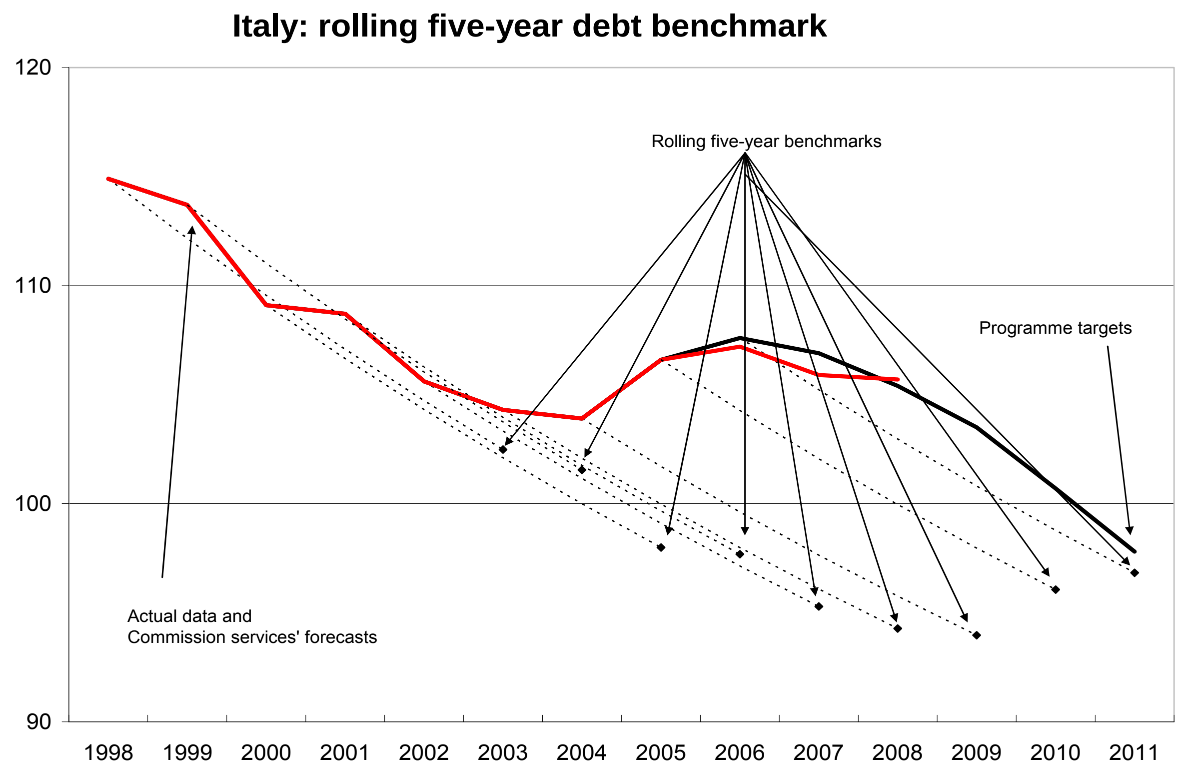
Source : Commission services' autumn 2006 forecast (COM) and successive convergence programmes

22 See above Footnotes 14 and 21.

Box 6: 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 2006 forecasts until 2008 (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" (*). 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 2007 is compared with the value obtained for the same year by applying the formula starting in 2002. 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 shows that, despite the acceleration projected in the final years of the programme, the planned reduction of the debt ratio in 2011 is still less than implied by the five-year rolling debt reduction benchmark.



Source: *Stability programme and Commission services*

(*) The rolling debt reduction benchmark for successive five-year periods is defined as a reduction in the difference between the debt ratio and the 60% of GDP reference value of 5 percent per year:

$\left(\frac{D_t}{Y_t}\right)_{benchmark} = \left(\frac{D_t}{Y_t}\right)_{benchmark} - 5\% \times \left[\left(\frac{D_t}{Y_t}\right)_{benchmark} - 60\right]$, where t is a time subscript and D and Y are the stock of government debt and nominal GDP, respectively. In the first year of the five-year period, the debt ratio in the previous year is the actual debt ratio. Given the usual approximation of the change in the debt ratio $\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{DEF_t}{Y_t} - \frac{y_t}{1+y_t} \times \frac{D_{t-1}}{Y_{t-1}} \cong \frac{DEF_t}{Y_t} - y_t \times \frac{D_{t-1}}{Y_{t-1}}$ and assuming that the stock-flow adjustment is zero, it is easy to show that 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%. In other words, the 5 percent per year benchmark is the value that makes consistent a continuous respect of the 3% of GDP deficit threshold and an asymptotic respect of the 60% of GDP debt reference value.

5.1.2. *Assessment*

The debt-to-GDP projection for 2007 is 1 p.p. of GDP higher than the Commission services' autumn 2006 forecast. This is due to differences in the denominator. More specifically, the expected increase in the GDP deflator over 2006-2007 in the programme is much lower than in the Commission services' forecast. In 2008, the debt reduction in the programme benefits from the planned significantly higher primary surplus (see Section 4), whereas the autumn forecast for the debt in 2008 is based on a no-policy change scenario.

The achievement of the planned primary surplus represents the main risk to the programme's debt targets. In particular, as already mentioned, the programme does not spell out the corrective measures needed to achieve the budgetary targets in the years beyond 2007. In addition, the programme does not envisage any significant stock-flow adjustment, but the planned absence of debt-increasing operations would represent a healthy discontinuity relative to past experience. On the positive side, possible privatisation proceeds not included in the programme could improve the final gross debt outcome. Nevertheless, their positive impact is expected to be very small, as the market value of stakes in listed joint-stock companies directly owned by the State was estimated at just around 2% of GDP in the July's DPEF and most of them were considered at a level "just above" the necessary one to ensure a qualified influence of the State in strategic sectors such as energy and defence.

Concerning the cost of servicing the debt, the increasing share of fixed coupon bonds (amounting to around 67% in State bonds at the end of October 2006) and their increasing duration would help limit risks on market interest rates. In particular, the update argues that a 1% unexpected immediate and permanent increase in the yield curve would increase interest expenditure by less than 0.2% of GDP in 2007, by 0.35% in 2008 and by around 0.5% in 2010.

The planned decrease in the debt-to-GDP ratio is conditional upon the budgetary adjustments leading to the MTO by the end of the programme period. However, in the first years of the programme, the pace of debt reduction appears insufficient due to the still low primary surplus. A satisfactory pace of debt reduction is planned to be achieved only in the final years of the programme. Nevertheless, even if taken at face value, the annual average debt reduction over 2007-2011 would continue to be less satisfactory than implied by the five-year rolling debt reduction benchmark (see Box 6), also because of the low potential growth.

Overall, the debt reduction strategy based on an increasing primary surplus and with no particular debt increasing below-the-line operations appears to be consistent with the Council recommendation of July 2005 under Article 104(7), subject to the same risks highlighted above for the achievement of the budgetary targets.

5.2. Long-term debt projections and the sustainability of public finances

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run.[23]

Debt sustainability is derived from the government's *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is fulfilled, current policies are sustainable.

The approach adopted by the Commission services and the Ageing Working Group of the Economic Policy Committee (EPC) is to project the debt, and to calculate the associated sustainability indicators (See Box 7), on the basis of two different scenarios. The first scenario assumes that the structural primary balance will remain unchanged from 2006 through 2011, the final year of the stability programme; it is called the "2006 scenario". Debt projections in this scenario start in 2007. The second scenario assumes that the macroeconomic and budgetary plans until 2011 provided in the stability programme will be fully respected. This is the "programme scenario". Debt and primary balance projections in this scenario start in 2012. Both projections assume zero stock-flow adjustments. In addition to this quantitative analysis, other relevant factors are taken into account which allows to better qualify the assessment with regard to where the main risks are likely to stem from and to reach an overall assessment.

5.2.1. Sustainability indicators and long-term debt projections

Table 12 shows the evolution of age-related government spending on pensions, health care, long-term care for the elderly, education and unemployment benefits according to the EPC's projections[24]. Non age-related primary expenditure and revenue are assumed to remain constant as a share of GDP.

Table 12: Long-term age-related expenditure: main projections

(% of GDP)	**2004**	**2010**	**2020**	**2030**	**2040**	**2050**	**changes**
Total age-related spending	26.2	25.7	25.9	27.3	28.7	28.0	1.7
Pensions	14.2	14.0	14.0	15.0	15.9	14.7	0.4
Health care	5.8	6.0	6.3	6.7	7.0	7.1	1.3
Long-term care	1.5	1.5	1.6	1.7	1.9	2.2	0.7
Education	4.3	3.9	3.7	3.5	3.6	3.7	-0.6
Unemployment benefits	0.4	0.4	0.3	0.3	0.3	0.3	-0.1

Source: Economic Policy Committee and Commission services.

[23] For a detailed analysis of long-term sustainability issues, see "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006 (hereinafter Sustainability Report).

[24] These assumptions cover labour productivity growth, real GDP growth, participation rates, unemployment rate, demographic developments, government spending in pensions, health care, long-term care for the elderly, education and unemployment benefits. See Economic Policy Committee and European Commission (DG ECFIN) (2006), "The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)", European Economy, Special Report No 1, 2006 (hereinafter Ageing Report).

The projected increase in age-related spending in Italy is below the average of the EU; rising by 1.7 percentage points of GDP between 2004 and 2050. The increase in expenditure on pensions is projected to be limited in Italy, rising by only 0.4 p.p. of GDP, due to extensive reforms enacted in the past, including the reform approved in 2004. The projections crucially hinge upon the implementation of the planned ten-yearly actuarial updates that adjust pension entitlements to life expectancy. The first of these adjustments was due in 2005, but was postponed. The age-related increase in health care expenditure is projected to be 1.3 p.p. of GDP, lower than on average in the EU, while for long-term care an increase of 0.4 p.p. of GDP is projected, close to the average in the EU.

The stability programme presents revised long-term age-related expenditure projections that are slightly different from those of the EPC. Such projections incorporate in particular an upward revision in the GDP series. The programme also considers some relevant provisions contained in the 2007 Budget Law, notably the higher pension contribution rates for the "*parasubordinati*" (an intermediate contract between that of dependent employee and that of self-employed) and the self-employed (which will lead to higher pensions for these groups in the future), as well as the impact of the health care expenditure control mechanisms. They also feature a more detailed modelling for long-term care. However, these projections would only marginally increase age-related expenditure in Italy, as compared to the Ageing Report.[25]

Based on the long-term budgetary projections, sustainability indicators can be calculated.

[25] Age-related expenditure is projected to increase by 2.3 p.p. of GDP between 2010 and 2050 in the Ageing report while it is projected to increase by 2.6 p.p. of GDP over the same period in the update of the programme.

Box 7 – Sustainability indicators*

- The **sustainability gap S1** shows the permanent budgetary adjustment (often presented as an increase in the tax burden**) required to reach a debt ratio in 2050 of 60% of GDP.
- The **sustainability gap S2**, shows the permanent budgetary adjustment that guarantees the respect of the intertemporal budget constraint of the government. In order to estimate S2, the revenue and expenditure ratios (age-related and non age-related) after 2050 are assumed to remain constant at the 2050 level.
- The sustainability indicators can be decomposed into the***: (i) **Initial Budgetary Position (IBP)**; and, (ii) **Long-Term Change in the budgetary position (LTC)**;
- In addition, the **required primary balance (RPB)** can be derived from the S2 indicator. It measures the average primary balance over the first five years after the programme horizon (i.e. 2012-2016) that results from a permanent budgetary adjustment carried out to comply fully with the S2 indicator.

Summarizing the sustainability indicators

	Impact of		
	Initial budgetary position		**Long-term changes in the primary balance**
S1*=**	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *up to 2050*
S2=	Gap to the debt-stabilizing primary balance	+	Additional adjustment required to finance the increase in public expenditure *over an infinite horizon*

* For a complete description of the sustainability indicators, see Annex I of the "The Long Term Sustainability of Public Finances – A report by the Commission services", European Economy n°4/2006, published in October 2006.

** Although the sustainability gap indicators (S1, S2) are usually defined as differences between revenue ratios, this does not mean that countries are asked to increase taxes to reach sustainability.. There are several ways to ensure sustainability and governments typically choose a combination of budget consolidation over the medium term (either through expenditure reduction and/or tax hikes) and the implementation of structural reforms aiming at curbing long-term public spending (e.g. pension reforms).

*** Moreover, in the case of S1, the decomposition also separates the impact of the debt position (60% of GDP in 2050); the debt requirement in 2050 (DR). In particular, if the current debt/GDP ratio is below 60% of GDP debt is allowed to rise and this component reduces the sustainability gap as measured by the S1 indicator, and

Table 13: Sustainability indicators and the required primary balance

	2006 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	3.4	3.0	3.9	-1.4	-1.5	3.6
of which:						
Initial budgetary position	1.0	1.1	-	-3.5	-3.5	-
Debt requirement in 2050	0.9	-	-	0.7	-	-
Future changes in budgetary position	1.5	2.0	-	1.5	2.0	-
<u>Source:</u> Commission services.						

Table 13 shows the sustainability indicators for the two scenarios. In the "2006 scenario", the sustainability gap (S1) that ensures reaching the debt ratio of 60% of GDP by 2050 would be 3.4% of GDP. The sustainability gap (S2) that satisfies the inter-temporal budget constraint would be 3.0% of GDP. The sustainability gaps are very close to the results in the Commission's Sustainability Report.

The initial budgetary position is thus not sound and there is a risk of unsustainable public finances even before considering the long-term budgetary impact of ageing. Actually, the projected long-term budgetary impact of ageing is relatively limited in particular thanks to the pension reform measures adopted in recent years

The programme plans an improvement in the structural balance by 4.3 p.p. of GDP between 2006 and 2011. If achieved, such a consolidation would appreciably reduce risks to long-term sustainability of public finances by eliminating both sustainability gaps (see “programme scenario" in Table 13). The difference between the initial budgetary position in the 2006 scenario and the programme scenario illustrates how the full respect of the stability programme targets would contribute to tackling the budgetary challenges raised by demographic developments.

The required primary balance (RPB) is about 3¾% of GDP, significantly higher than the structural primary balance of about 0.9% of GDP in 2006. It should be noted that this required primary balance, if reached, would not yet ensure a rapid reduction of debt.

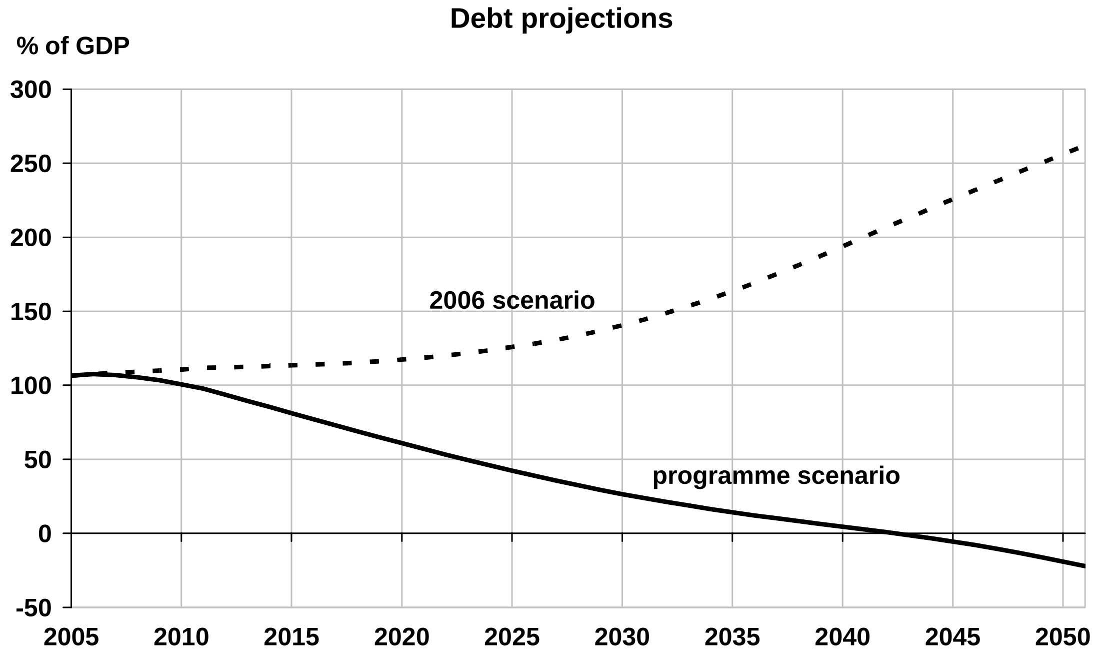
The sustainability gap indicators would increase by up to ½% of GDP if the planned adjustment was to be postponed by 5 years, highlighting that savings can be made over time if action is taken sooner rather than later.

Another way to look at the prospects for long-term public finance sustainability is to project the debt/GDP ratio over the long-term using the two scenarios as in the calculations of S1 and S2. The long-term projections for government debt under the two scenarios are shown in Figure 10.

The gross debt ratio is currently significantly above the 60% of GDP reference value, estimated in the programme at 107.6% of GDP in 2006. According to the “2006 scenario”, the debt ratio is projected to increase substantially over the next decades to reach 250% of GDP in 2050. In the “programme scenario”, the debt would fall below 60% of GDP at around 2020 and remain so over the rest of the projection period. [26]

[26] It should be recalled, however, that being based on a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services’ short-term forecasts, but as an indication of the risks faced by Member States.

Figure 10: Long-term projections for the government debt ratio



Note: The government debt ratio is usually compiled in gross terms, that is assets are not netted from government liabilities. Therefore, the gross debt can never be negative. In this chart, the negative values for the debt ratio should be understood as accumulation of financial assets. This issue has no implications on the conclusions drawn from the sustainability assessment.
Source: Commission's services

5.2.2. Additional factors

To draw an overall assessment of the sustainability of public finances and better identify the source of possible risks, other relevant issues must be taken into account.

First, Italy's current level of debt is very high and has been increasing in recent years. A steady reduction of debt, which implies high primary surpluses to be achieved and maintained over a long period, would strengthen the resilience of public finances to adverse shocks and reduce risks to public finance sustainability.

Second, medium-term risks to public finances cannot be excluded, in particular concerning health care expenditure. Measures to contain expenditure growth in this area by the responsible regional authorities have failed to prove effective and repeated overruns in expenditure, which has increased by 1.6 p.p. of GDP over the last decade, are partly responsible for the upward drift of the general government deficit.

Third, the pension expenditure projection of the Ageing report (2006) includes the reforms enacted at the end of 2005. As such, it hinges upon:

- the implementation of the planned periodical actuarial updates, the first of which was due in 2005 but has not taken place yet; and

- the sharp tightening of eligibility conditions for seniority pensions as from 2008 foreseen in the 2004 pension reform, which is expected to be discussed by the new government and the social partners in a new negotiation round between January and March 2007.

The limited increase in age-related expenditure over the long-term is therefore conditional upon the full implementation of the already adopted reforms or the adoption and subsequent implementation of measures with an equivalent budgetary impact: failing to implement the periodical actuarial update or the 2004 pension reform would entail substantially higher pension expenditure than in the Ageing Report. Indeed, according to the projections in the stability programme (Figure 6), the lack of periodical revisions of the actuarial coefficients would increase pension expenditure by around 1 p.p. of GDP in 2035 and 2 p.p. of GDP in 2050, whereas in the absence of the tightening of eligibility conditions as in the 2004 reform pension expenditure would be more than ½ p.p. of GDP higher over the period 2010-2035[27].

Fourth, the benefit ratio in Italy is projected to decrease relatively markedly, by around 30 p.p. in the period to 2050, despite a projected large increase in the employment rate of older workers. Although employment rates of older workers are currently lower in Italy (29%) than on average in the EU (40%), the gap is projected to narrow in the future. A greater increase in employment rates than assumed in the projections, particularly of older workers, would mean that the benefit ratio would decrease less markedly, since it would foster GDP growth and ensure that workers accumulate enough pension rights to limit the decrease in the benefit ratio. This would reduce the risks of possible pressures on public expenditure emerging in the future.

Finally, the new discipline governing severance pay (TFR - see Box 4) deserves a mention in the context of the long-term sustainability of public finances. The relevant provision in the 2007 Budget Law envisages that TFR-related contributions will be transferred:

- partly, to private pension schemes: this will contribute to improve pension entitlements in the future and therefore partly compensate for the decrease in the public benefit ratio;

- partly, to the national social security institute (INPS). This budgetary measure (2007) improves the budget balance over the short- to medium-term, but is neutral in terms of long-term sustainability of public finances since the increase in public revenue will be matched by future social benefit. Thus, the current net gain of the measure for the general government balance will progressively vanish over the next 8-9 years (according to the official estimations) as the new system matures. In the "programme" scenario the calculations for the sustainability indicators do not take into account the full future increase in TFR-related expenditure and, as such, slightly underestimate the size of the sustainability challenge.

5.2.3. Assessment

The long-term budgetary impact of ageing in Italy is lower than the EU average, with pension expenditure showing a more limited increase than on average in the EU, thanks to the pension reforms adopted. This assumes that such reforms are fully implemented, notably including the planned periodical actuarial adjustment in line with life expectancy, or that measures with an equivalent budgetary impact are adopted and

[27] See Italy country fiche to the Ageing working group.
http://ec.europa.eu/economy_finance/epc/documents/2006/ageing_italy_fiche_en.pdf

subsequently implemented. Increasing employment rates, notably of older workers, would improve workers' pensions in the future and contribute to the success of the pension reforms.

The initial budgetary position with a large structural deficit in 2006, albeit slightly improved compared with 2005, constitutes a risk to sustainable public finances even before the long-term budgetary impact of an ageing population is considered. Moreover, the current level of gross debt is well above the Treaty reference value and reducing it will require high primary surpluses to be achieved and maintained over a long period.

Overall, Italy appears to be at medium risk with regard to the sustainability of public finances.

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

With regard to the quality of public finances, the programme refers to the medium-term strategy outlined in the DPEF, that combines the search for fiscal consolidation in structural terms with the ambition to redirect public expenditure in support of growth and social equity.

The 2007 Budget Law envisages measures worth 1¼% of GDP to finance growth-enhancing and redistributive measures. These include part of the measures foreseen in the Implementation Report of the National Reform Programme in the context of the Lisbon Strategy (see Section 7), such as the establishment of a Fund for Competitiveness and Development and one for scientific research, as well as the cut in the labour tax wedge for workers on permanent contracts with a view to supporting employment, reducing regional disparities and recovering competitiveness. This provision allows for part of the labour cost borne by employers to be deducted from the tax base for the purposes of IRAP (Italian regional production tax), via: (*a*) the deduction of social security charges, and (*b*) an additional €5,000 deduction for each employee, which is increased up to €10,000 in the regions of Southern Italy (but subject to some limits deriving from the application of already existing tax credits). The deductions only concern workers employed on a permanent basis and do not affect the banking and insurance sector. Costs in relation to apprenticeships and staff engaged in research and development are also deductible for tax purposes. The budgetary impact of this measure, in the form of lower indirect taxes, is estimated at below 0.2% of GDP in 2007 and will increase to around 0.3% of GDP as from 2008. Additional lower revenues that are presented as a reduction of the labour tax wedge weighing on employees take the form of tax relieves for family charges. These are officially estimated to account for 0.1% of GDP in 2007. These measures are accompanied by an increase in contributions to be paid in respect of para-subordinate employment and the self-employed (with additional revenues estimated at around 0.3% of GDP), for whom social insurance coverage is rather limited.

With regard to one-off measures, the programme plans to have them fully phased out as from 2009, whereas in 2006 the net budgetary impact of one-off and temporary measures in 2006 is estimated to increase the deficit by around ½% of GDP. In 2007 and 2008, the planned one-off and temporary measures are very limited (0.1% of GDP, see Section 4).

Concerning changes in the institutional features of public finances aimed at improving transparency of the budgetary process, the programme refers again to the broad guidelines set out in the DPEF. A first step in this direction is the establishment, foreseen in the 2007 Budget Law, of a permanent technical committee within the Ministry of Economy and Finance. This committee has the role to put forward proposals aimed at enhancing transparency in the allocation of resources and the distribution of budgetary responsibility among the different levels of government; improving monitoring of budgetary developments; and facilitating the consolidation of the budgets of all the public entities.

The programme also reports on the envisaged reinforcement of some existing budgetary rules aimed at improving expenditure control. Namely, the 2007 Budget Law further revises the domestic stability pact introduced in 1999[28]. Specifically, financial balance rather than expenditure becomes the most important measurement criterion with increased fiscal independence for municipalities and provinces. The required improvement in the budgetary balance is differentiated across local governments on the basis of indicators, namely current spending and deficit. In the event of the pre-established restrictions being breached, automatic mechanisms are envisaged that centre on increasing local taxation. However, it must be noted that sanctions for provinces that did not respect in 2006 expenditure ceilings foreseen by the previous budget have been abolished. The stability pact with regional authorities, which excludes health care, is also based for a test period on the financial balance. However, during the test period, the expenditure ceilings already in force are largely confirmed. In the area of health care, a new agreement signed by the Italian government and the responsible regional authorities on 22 September 2006 is aimed at stabilizing health care spending as from 2007. For regions which fail to meet the agreed objectives, co-operation measures are confirmed, as are the automatic increases in the rates for regional taxes introduced with the 2006 Budget Law. The original draft Budget Law also proposed to increase or introduce patients’ co-payments for some kinds of care, as a way to control expenditure by increasing cost-awareness among patients. However, these co-payments were reduced in the final version of the budget.

The revision of the domestic stability pact presented above could have the result to increase fiscal pressure rather than leading to expenditure savings. However, increasing local administrators' responsibility for budgetary outcomes goes into the right direction. Concerning health care, the recent track record of expenditure trends in this sector is one of major slippages in government primary expenditure. The September 2006 health care agreement increased substantially transfers to regions also to fund the sizeable overruns recorded in 2006, without substantial additional enforcement mechanisms. The implementation of the new agreement at regional level in 2007 will be key to test the possibility to control health expenditure dynamics. In light of this, the Commission services highlighted the risks of expenditure overruns in these areas that are attached to the 2006 autumn forecast for 2007 and 2008.

Finally, on the revenue side, the 2007 Budget Law also includes a set of measures aimed at strengthening the fight against tax evasion and tax avoidance. The new regulations would tackle a variety of areas and sectors of economic activity. In particular, the new

[28] For a thorough description of the Domestic Stability Pact, which provides the framework for local government public finances, see Box 3 in the Technical Assessment of the 2004 update (http://ec.europa.eu/economy_finance/about/activities/sgp/country/commwd/it/com_it20042005.pdf).

provisions envisage: (i) more frequent revisions of the scheme (*studi di settore*) to determine taxes to be paid by the self-employed and small firms; (ii) improving the tax control and collection system; and (iii) changing the tax convenient "agriculture" destination of properties no longer used for this purpose. Also with respect to the effectiveness of these provisions, the Commission services are more prudent in their autumn forecast than the official projection. Provisions relating to the sector studies have been weakened in the final version of the 2007 budget.

7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES

In response to the Commission's opinion expressed in its 2006 Annual Progress Report (APR), the Implementation report of the National Reform Programme (IR-NRP) of Italy, submitted in October 2006 in the context of the renewed Lisbon strategy, confirms and emphasises the consolidation and long-term sustainability of public finances as central to a comprehensive strategy to remedy the weaknesses of the Italian economy and raise its growth potential. Like the stability programme, the macroeconomic projections and fiscal targets presented in the IR-NRP are those presented in the updated economic and financial planning document (DPEF). Likewise, the composition of the adjustment that is envisaged for 2007 refers to the 2007 draft Budget Law adopted by the government on 29 September. Thus, budgetary developments and the fiscal policy strategy presented in the IR-NRP are in line with those described, in more detail, in the Stability Programme, with the notable exception of the 0.9% of GDP additional deficit stemming from the railway company's debt assumption operation, which was not anticipated in the IR-NRP.

The stability programme also provides, in a separate section, detailed information on the direct budgetary costs associated with the main reforms envisaged in the NRP. However, the budgetary projections in the programme do not explicitly take into account the public finance implications of the actions envisaged in the IR-NRP and their budgetary cost is estimated over the whole period 2006-2008, without indicating its allocation in each of the three years. An identification of the actions foreseen in the IR-NRP in the planned adjustment for 2007 as detailed in the Stability Programme is therefore not possible, also because their categorization in the relevant section of the programme reflects the priorities of the National Reform Programme, with no direct links with the constituent items describing the composition of the budgetary adjustment in Table 6. For 2008, the lack of detail on the composition of the targeted adjustment does not allow to establish link between the budgetary cost of the measures envisaged in the IR-NRP and the foreseen budgetary adjustment.

The budgetary cost of the actions foreseen in the IR-NRP is estimated at around €60mn over the three years 2006-2008. With the qualifications made above, it can reasonably be argued that this amount is overall consistent with the public finances adjustment foreseen in the Stability Programme.

Table 14 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, which are included in the integrated guidelines for the period 2005-2008. The assessment of guideline 1 corresponds to the evaluation in Section 4.4 above, whereas that of the pace of debt reduction in guideline 2 (relevant for high-debt countries only) is covered in Section 5.1.2 above. Information on the different elements covered by the remaining guidelines in the table can be found in Sections 5.2 and 6.

Overall, the budgetary strategy in the stability programme is broadly consistent with the broad economic policy guidelines, subject to the full and effective implementation of the 2007 budget and of the fiscal consolidation strategy outlined in the programme for the years after 2007.

Box 8: The Commission assessment of the implementation report of the National Reform Programme

The implementation report of the National Reform Programme of Italy, provided in the context of the renewed Lisbon strategy for growth and jobs, was submitted on 19 October 2006. The Commission's assessment of this report, which was adopted on 12 December 2006 as part of its Annual Progress Report, can be summarised as follows:

"The six priorities that were highlighted in the 2005-2008 National Reform Programme (NRP) have been largely confirmed this year. These are: ensuring long-term fiscal sustainability; 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. In its 2006 Annual Progress Report (APR), the Commission pointed out that stronger measures were needed: on fiscal sustainability; to boost competition, especially in network industries and services; and to increase labour supply and raise employment rates, including by tackling regional disparities.

Compared to last year's National Reform Programme, the Italian Implementation report presents a clearer strategy, covering all policy areas and the synergies between them and is thus more ambitious. Progress is most extensive in the micro-economic field. Strategies and measures proposed in the macro area are generally appropriate but implementation is crucial. Employment policy needs to be reinforced in certain key areas. Progress has been mixed on meeting the commitments agreed at the 2006 Spring European Council.

Among the strengths shown by the Italian Implementation Report are: measures to enhance competition in professional and other services; initiatives to expand the use of ICT; and measures to step up the co-ordination of action to improve the business environment.

The policy areas in the Italian National Reform Programme where weaknesses need to be tackled with the highest priority are: fiscal sustainability, where commitment needs to be translated into effective action; competition in product and services markets, where the vigorous implementation of proposed reforms should be an initial basis for progress; increasing formal employment; and improving education and lifelong learning. Against this background it is recommended that Italy:

- rigorously pursue fiscal consolidation so as to put the debt-to-GDP ratio on a declining path and fully implement the pension reforms with a view to improving the long-term sustainability of public finances;
- pursue the implementation of recently announced reforms aiming at increasing competition in products and services markets;
- reduce regional disparities in employment by tackling undeclared work, increasing childcare provision and ensuring the efficient operation of the employment services throughout the country;
- develop a comprehensive lifelong learning strategy and improve quality and labour market relevance of education.

In addition, it will be important for Italy over the period of the National Reform Programme to focus on: R&D, where despite welcome policy developments in specific areas, the overall strategy is still incomplete; effective measures to improve the sustainability of health care provision, while preserving quality and accessibility; implementing plans to improve infrastructure; and establishing a comprehensive system of impact assessment for proposed regulation."

Table 14: Consistency with the broad economic policy guidelines

Broad economic policy guidelines	Yes	Steps in right direction	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 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 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.

Source:
Commission services

Annex 1: Glossary

Automatic stabilisers Various features of the tax and spending regime which tend to have a dampening effect on economic fluctuations without requiring a discretionary intervention of the fiscal authorities. As a result, the budget balance in percent of GDP tends to improve in years of high growth and deteriorate during economic slowdowns. See also *cyclically-adjusted balance*, *structural balance* and *minimum benchmark*.

Broad economic policy guidelines (BEPGs) Guidelines for the economic and budgetary policies of the Member States. Together with the Employment Guidelines, they form the Integrated Guidelines, prepared by the Commission and adopted by the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN). See also *Lisbon strategy*.

Budget balance The balance between total public revenue and expenditure (according to *ESA95*); with a positive balance indicating a surplus (also know as *government net lending*) and a negative balance indicating a deficit (also known as *government net borrowing*). For the monitoring of Member States' budgetary positions, the EU uses *general government* aggregates. See also *cyclically-adjusted balance, primary balance, structural balance* and *reference values*.

Budget constraint A basic condition applying to the public finances, according to which total public expenditure in any one year must be financed by taxation, borrowing or changes in the monetary base; the latter is prohibited in the EU. See also *stock-flow adjustment* and *long-term sustainability*.

Budgetary sensitivity The variation in the *budget balance* brought about by a change in the *output gap*. In the EU, it is estimated to be 0.5 on average, i.e. for any percentage point of GDP below or above potential, the budget-balance-to-GDP ratio deteriorates or improves by half a percentage point. The size of the budgetary sensitivity essentially reflects (i) the revenue and expenditure elasticities of the budget and (ii) the size of discretionary government expenditure. See also *cyclically-adjusted balance, structural balance* and *tax elasticity*.

Code of conduct Policy document adopted by the Economic and Financial Committee (an advisory committee gathering high-level officials from national governments, national central banks, the European Central Bank and the European Commission which prepares the meetings of the Council of Ministers responsible for Economic and Financial Affairs (ECOFIN)) and endorsed by the ECOFIN Council in October 2005, containing specifications on the implementation of the *Stability and Growth Pact* and guidelines on the format and content of *stability programmes* and *convergence programmes*.

Contingent liabilities A possible government obligation to pay, the existence of which will be confirmed by the occurrence of one or more uncertain events in the future not wholly under the control of the government. For instance, government guarantees on debt issued by private or public companies are contingent liabilities since the government obligation to pay depends on the non-ability of the original debtor to honour its obligations. See also *implicit liabilities*.

Convergence programme Medium-term budgetary strategy presented by each Member State that has not yet adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *stability programme*, *code of conduct* and *medium-term objective*.

Cyclically-adjusted balance The *budget balance* adjusted for its cyclical component (which captures the part of public revenue and expenditure that is linked to the *output gap*), i.e. the budget balance that would prevail if GDP were at its potential level. See also *structural balance*, *budgetary sensitivity* and *output gap*.

Cyclically-adjusted primary balance The *cyclically-adjusted balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Debt dynamics The evolution of *government debt* as a ratio to GDP; it depends on the primary deficit, the debt-increasing impact of interest payments, the dampening effect of GDP growth on the ratio and the *stock-flow adjustment*.

EDP notification See *notification of deficit and debt.*

ERM II Exchange rate mechanism linking some currencies of non-euro Member States to the euro, which is the centre of the mechanism. For the currency of each Member State participating in the mechanism, a central rate against the euro and a standard fluctuation band of ±15% are defined.

ESA95 European accounting standards for the compilation and reporting of macroeconomic (including budgetary) data by the EU Member States.

Excessive deficit procedure (EDP) A procedure, laid down in the EC Treaty, according to which the Commission and the Council monitor the development of national *budget balances* and *public debt* in relation to the *reference values,* in order to assess the existence (or risk) of an excessive deficit in each Member State and to ensure its correction. Its application has been further clarified in the *Stability and Growth Pact*.

Fiscal stance A measure of the thrust of discretionary fiscal policy such as, in this document, the change in the *structural balance* (or in the *structural primary balance*) relative to the preceding year. When the change is positive (negative) the fiscal stance is said to be restrictive (expansionary).

Funded pension scheme Pension system in which current pension expenditures are financed by running down assets accumulated over the years on the basis of contributions by the scheme beneficiaries. According to *ESA95*, defined-contribution funded pension schemes are not considered as part of the *general government* sector. See also *pay-as-you-go pension scheme*.

Government debt See *public debt*.

General government The focus of EU budgetary surveillance under the *Stability and Growth Pact* and the *excessive deficit procedure* is on general government aggregates, with the general government sector covering national, regional and local government, as well as social security. In principle, public enterprises are excluded.

Government net lending/borrowing See *budget balance*.

Implicit liabilities Future government expenditure which has not yet been funded, even when future expenditure is not backed by law or contractual obligations, but is simply grounded in strong expectations of the public. To be meaningful for economic analysis, implicit liabilities should be assessed net of future revenue assuming that the government will keep collecting taxes (and other non-tax revenue) at rates comparable to current levels. See also *contingent liabilities*.

Interest burden *General government* interest expenditure on *government debt* as a share of GDP.

Intertemporal budget constraint A basic condition imposing that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, be covered by the discounted value of future government revenue.

Lisbon strategy Partnership between the EU and Member States for growth and more and better jobs. Originally approved in 2000, the Lisbon Strategy was revamped in 2005. Based on the Integrated Guidelines (merger of the *broad economic policy guidelines* and the employment guidelines, dealing with macro-economic, micro-economic and employment issues) for the period 2005-2008, Member States drew up 3-year national reform programmes in autumn 2005. They reported on the implementation of the national reform programmes for the first time in autumn 2006. The Commission analyses and summarises these reports in an EU Annual Progress Report each year, in time for the Spring European Council.

Long-term sustainability A combination of *budget balance* and *public debt* that ensures that the latter does not grow without bound. While conceptually intuitive, an agreed operational definition of sustainability has proven difficult to achieve.

Maturity structure of public debt The profile of *public debt* in terms of when it is due to be paid back. Interest rate changes affect the *budget balance* directly to the extent that the *general government* sector has debt with a relatively short maturity structure. Long maturities reduce the sensitivity of the *budget balance* to changes in the prevailing interest rate. See also *interest burden*.

Medium-term objective (MTO) According to the *Stability and Growth Pact*, *stability programmes* and *convergence programmes* must present a medium-term objective for the budgetary position. It is country-specific 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, and is defined in structural terms (see *structural balance*).

Minimum benchmark Estimated budgetary position (in *cyclically-adjusted* terms) that provides a "safety margin" that is enough for the *automatic stabilisers* to operate freely during normal economic slowdowns without breaching the 3% of GDP deficit *reference value*. The minimum benchmarks are estimated by the European Commission. They do not cater for other risks such as unexpected budgetary developments and interest rate shocks.

National reform programme (NRP) See *Lisbon strategy*.

Notification of deficit and debt (EDP notification) Twice a year (by 1 April and 1 October), EU Member States have to notify their *general government* deficit and debt figures (and a number of associated data) to the Commission, the quality of which is then checked by Eurostat, the Commission department in charge of statistics. See also *budget balance* and *public debt*.

One-off and temporary measures Government transactions having a transitory budgetary effect that does not lead to a sustained change in the intertemporal budgetary position. See also *structural balance*.

Output gap The difference between actual GDP and potential GDP in any given year, usually expressed as a percent of potential GDP. Potential GDP is an unobserved variable and needs to be estimated from actual data. It is the level of real GDP in a given year that is consistent with a stable rate of inflation. If actual output rises above its potential level, then constraints on capacity begin to bind and inflationary pressures build; if output falls below potential, then resources are lying idle and inflationary pressures abate. See also *production function method*.

Pay-as-you-go pension scheme (PAYG) Pension system in which current pension expenditures are financed by the contributions of current employees. Also known as *unfunded pension scheme*. See also *funded pension scheme*.

Primary balance The *budget balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Pro-cyclical fiscal policy A *fiscal stance* which amplifies the economic cycle by lowering the *structural balance* when the *output gap* is positive or improving, or by increasing the *structural balance* when the *output gap* is negative or widening, as opposed to a counter-cyclical fiscal policy stance. A neutral fiscal policy keeps the *structural balance* unchanged over the economic cycle by letting the *automatic stabilisers* work.

Production function method A method to estimate potential GDP typically based on a Cobb-Douglas production function. Potential GDP is estimated as the level of GDP consistent with a full utilisation of capital, an unemployment rate that does not accelerate inflation and factor productivity at its trend level. See also *output gap, cyclically-adjusted balance, budgetary sensitivity*.

Public debt (or government debt) Consolidated gross debt for the *general government* sector. It includes the total nominal value of all debt owed by government units, except that part of the debt which is owed to government units in the same Member State. It is a gross debt measure meaning that government financial assets on other sectors are not netted out. See also *debt dynamics* and *reference values*.

Public investment The component of total public expenditure which consists in the acquisition of durable assets and through which governments increase and improve the stock of capital employed in the production of the goods and services they provide. Also known as government gross fixed capital formation (GFCF).

Public-private partnerships (PPP) Agreements between government and corporations according to which the latter build and operate public-use infrastructure (roads, tunnels, bridges, but also hospitals, prisons, concert halls, etc.) which were traditionally directly controlled by government. In exploiting the infrastructure, the corporation receives prices paid by final users, rentals or fees from the government or both. Infrastructure built under PPPs is considered as either *public investment* or corporate investment depending on a number of specific criteria.

Quality of public finances A multi-dimensional concept which refers to the contribution that public finances make to the efficient allocation of resources in the economy and to achieving the government's strategic objectives (sustainable growth, macroeconomic stability, competitiveness, social cohesion etc.). It concerns notably the overall level of expenditure and taxation, their composition, the budgeting and control mechanisms and the institutional arrangements for deciding on public finance issues.

Reference values for public deficit and debt Respectively, a 3 percent *general government* deficit-to-GDP ratio and a 60 percent *general government* debt-to-GDP ratio. See also *excessive deficit procedure, government debt* and *budget balance*.

Sensitivity analysis An econometric or statistical simulation designed to test the robustness of an estimated economic relationship or projection to changes in the underlying assumptions.

'Snow-ball' effect The self-reinforcing effect of *public debt* accumulation or decumulation arising from a positive or negative differential between the implicit interest rate on public debt and the GDP growth rate. See also *debt dynamics*.

Stability and Growth Pact (SGP) Approved in 1997 and reformed in 2005, the SGP clarifies the provisions on budgetary surveillance in the EC Treaty. The "preventive" arm of the SGP obliges Member States to submit annual *stability programmes* or *convergence programmes*, while the "corrective" arm of the SGP clarifies and speeds up the *excessive deficit procedure*.

Stability programme Medium-term budgetary strategy presented by each Member State that has already adopted the euro; updated annually, according to the provisions of the *Stability and Growth Pact*. See also *convergence programme, code of conduct* and *medium-term objective*.

Stock-flow adjustment (SFA) The stock-flow adjustment (also known as the debt-deficit adjustment) ensures consistency between *government net borrowing*, which is a flow variable, and the variation in *government debt*, which is a stock variable. It includes differences between cash and accrual accounting, accumulation of financial assets, changes in the value of debt denominated in foreign currency and remaining statistical adjustments. See also *debt dynamics.*

Structural balance The *budget balance* in *cyclically-adjusted* terms and excluding *one-off and temporary measures*. See also *fiscal stance*.

Structural primary balance The *structural balance* net of interest expenditure on *general government* debt. See also *interest burden*.

Tax elasticity A parameter measuring the relative change in tax revenues with respect to a relative change in GDP. The tax elasticity is an input to the *budgetary sensitivity*.

Annex 2: Summary tables from the programme update

The tables below present the information provided in the programme in the format prescribed by the code of conduct (Annex 2 thereof).

N.B.: The tables in the 2006 Stability Programme for Italy, which are reported below, do not incorporate the 0.9% of GDP higher one-off government expenditure due to the cancellation of the railway company's debt related to the high-speed project, which the programme text announces. This additional expenditure brings the targeted deficit for 2006 to 5.7% of GDP, from the 4.8% reported in the tables below, and also affects other budgetary data. The tables in the Commission's Technical Assessment proper present amended budgetary figures for the programme projections in 2006.

Table 1a. Macroeconomic prospects

	ESA Code	2005 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. Real GDP	**B1*g**	**1229.6**	**0.0**	**1.6**	**1.3**	**1.5**	**1.6**	1.7	1.7
2. Nominal GDP	**B1*g**	**1417.2**	**2.0**	**3.6**	**2.8**	**3.4**	**3.4**	3.6	3.6
Components of real GDP									
3. Private consumption expenditure (excluding NPISH)	**P.3**	**727.2**	**0.1**	**1.6**	**1.0**	**1.5**	**1.6**	1.7	1.6
4. Government consumption expenditure (including NPISH)	**P.3**	**246.0**	**1.2**	**0.7**	**0.0**	**0.0**	**0.2**	0.2	0.2
5. Gross fixed capital formation	**P.51**	**257.6**	**-0.6**	**2.8**	**2.3**	**2.8**	**3.0**	3.1	3.0
6. Changes in inventories and net acquisition of valuables (Contribution to real GDP growth)	**P.52 + P.53**	**9.2**	**0.1**	**-0.1**	**0.1**	**0.0**	**0.0**	0.0	0.0
7. Exports of goods and services	**P.6**	**313.2**	**0.3**	**5.3**	**4.2**	**3.5**	**3.4**	3.4	3.5
8. Imports of goods and services	**P.7**	**323.8**	**1.4**	**4.8**	**3.5**	**3.4**	**3.5**	3.4	3.3
Contributions to real GDP growth									
9. Final domestic demand			**0.1**	**1.7**	**1.1**	**1.5**	**1.6**	1.7	1.7
10. Changes in inventories and net acquisition of valuables	**P.52 + P.53**		**0.1**	**-0.1**	**0.1**	**0.0**	**0.0**	0.0	0.0
11. External balance of goods and services	**B.11**		**-0.3**	**0.1**	**0.2**	**0.0**	**0.0**	0.0	0.0

Table 1b. Price developments

	ESA Code	2005 level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. GDP deflator			**2.1**	**1.9**	**1.5**	**1.8**	**1.8**	1.9	1.8
2. Private consumption deflator			2.3	2.6	2.0	1.9	1.9	1.9	1.8
3. HICP [1]			2.2	2.2	2.1	1.7	1.5	1.5	1.5
4. Public consumption deflator			3.2	3.4	-0.9	1.5	1.0	1.2	1.2
5. Investment deflator			2.5	2.8	1.9	1.8	1.7	1.7	1.7
6. Export price deflator (goods and services)			**5.7**	**5.4**	**2.4**	**1.9**	**1.9**	2.0	2.0
7. Import price deflator (goods and services)			**7.7**	**9.2**	**2.2**	**2.0**	**2.0**	2.0	2.0

[1] Optional for Stability programmes.

Table 1c. Labour market developments

	ESA Code	2005 Level	2005 rate of change	2006 rate of change	2007 rate of change	2008 rate of change	2009 rate of change	2010 rate of change	2011 rate of change
1. Employment, FTE [1]			**-0.4**	**1.0**	**0.5**	**0.7**	**0.7**	0.7	0.7
2. Employment, hours worked[2]									
3. Unemployment rate (%)[3]			**7.7**	**6.9**	**6.7**	**6.3**	**6.0**	5.9	5.7
4. Labour productivity, FTE [4]			**0.4**	**0.7**	**0.8**	**0.8**	**0.9**	1.0	1.0
5. Labour productivity, hours worked[5]									
6. Compensation of employees	D.1		**4.3**	**4.6**	**2.7**	**2.7**	**3.0**	2.9	3.0

[1] Occupied population, domestic concept national accounts definition (full-time equivalents instead of persons).

[2] National accounts definition.

[3] Harmonised definition, Eurostat; levels.

[4] Real GDP per FTE (instead of person).

[5] Real GDP per hour worked.

Table 1d. Sectoral balances

% of GDP	ESA Code	2005	2006	2007	2008	2009	2010	2011
1. Net lending/borrowing vis-à-vis the rest of the world [1]	**B.9**	**-1.6**	**-2.3**	**-2.0**	**-2.0**	**-2.0**	-1.9	-1.8
of which:								
- Balance on goods and services		-0.1	-0.9	-0.7	-0.7	-0.8	-0.8	-0.8
- Balance of primary incomes and transfers		-1.5	-1.4	-1.4	-1.3	-1.2	-1.2	-1.1
- 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	Optional

[1] Excluding capital account - non ESA95 definition

Table 2. General government budgetary prospects

	ESA code	2005 Level	2005 % of GDP	2006 % of GDP	2007 % of GDP	2008 % of GDP [5]	2009 % of GDP [5]	2010 % of GDP [5]	2011 % of GDP [5]
Net lending (EDP B.9) by sub-sector									
1. General government	S.13	**-58163**	**-4.1**	**-4.8**	**-2.8**	**-2.2**	**-1.5**	-0.7	0.1
Future measures [6]						0.7	0.5	0.5	0.6
2. Central government	S.1311	**-53170**	**-3.8**	**-4.4**	**-2.8**	**-2.9**	**-2.8**	-2.4	-2.1
3. State government	S.1312	**-52855**	**-3.7**	**-4.5**	**-2.8**	**-3.0**	**-2.9**	-2.6	-2.5
4. Local government	S.1313	**-10291**	**-0.7**	**-0.8**	**-0.6**	**-0.6**	**-0.5**	-0.5	-0.4
5. Social security funds	S.1314	**5298**	**0.4**	**0.4**	**0.6**	**0.6**	**0.6**	0.5	0.5
General government (S13)									
6. Total revenue	TR	**623482**	**44.0**	**45.0**	**46.2**	**46.0**	**45.9**	45.7	45.4
7. Total expenditure	TE [1]	**681645**	**48.1**	**49.9**	**49.0**	**48.9**	**48.6**	48.0	47.5
8. Net lending/borrowing	EDP B.9	**-58163**	**-4.1**	**-4.8**	**-2.8**	**-2.2**	**-1.5**	-0.7	0.1
9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	**67948**	**4.8**	**4.8**	**5.0**	**5.0**	**5.0**	5.0	5.0
pm: 9a. FISIM		**3399**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	0.2	0.2
10. Primary balance	[2]	**9785**	**0.7**	**0.0**	**2.3**	**2.8**	**3.5**	4.3	5.1
Selected components of revenue									
11. Total taxes (11=11a+11b+11c)		**392719**	**27.7**	**28.8**	**29.4**	**29.2**	**29.1**	28.9	28.8
11a. Taxes on production and imports	D.2	**201859**	**14.2**	**14.5**	**14.5**	**14.4**	**14.3**	14.2	14.0
11b. Current taxes on income, wealth, etc	D.5	**189052**	**13.3**	**13.9**	**14.8**	**14.7**	**14.8**	14.8	14.8
11c. Capital taxes	D.91	**1808**	**0.1**	**0.4**	**0.1**	**0.0**	**0.0**	0.0	0.0
12. Social contributions	D.61	**182416**	**12.9**	**12.8**	**13.5**	**13.5**	**13.4**	13.3	13.2
13. Property income	D.4	**8118**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	0.6	0.6
14. Other (14=15-(11+12+13))		**40229**	**2.8**	**2.8**	**2.8**	**2.8**	**2.8**	2.8	2.7
15=6. Total revenue	TR	**623482**	**44.0**	**45.0**	**46.2**	**46.0**	**45.9**	45.7	45.4
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) [3]			**40.6**	**41.6**	**42.9**	**42.6**	**42.5**	42.3	42.0
Selected components of expenditure									
16. Collective consumption	P.32	**116023**	**8.2**	**8.3**	**8.1**	**8.1**	**8.0**	7.9	7.8
17. Total social transfers	D.62 + D.63	**409828**	**28.9**	**29.0**	**29.0**	**29.1**	**28.8**	28.5	28.3
17a. Social transfers in kind	P.31 = D.63	168136	11.9	11.8	11.4	11.4	11.3	11.1	11.0
17b. Social transfers other than in kind	D.62	241692	17.1	17.2	17.5	17.7	17.5	17.4	17.4
18.=9. Interest expenditure (incl. FISIM)	EDP D.41 incl. FISIM	**67948**	**4.8**	**4.8**	**5.0**	**5.0**	**5.0**	5.0	5.0
19. Subsidies	D.3	**13201**	**0.9**	**1.0**	**1.0**	**0.9**	**0.9**	0.9	0.9
20. Gross fixed capital formation	P.51	**33499**	**2.4**	**2.6**	**2.8**	**2.8**	**2.9**	2.8	2.7
21. Other (21=22-(16+17+18+19+20))		**41146**	**2.9**	**4.2**	**3.1**	**3.1**	**3.0**	2.9	2.8
22=7. Total expenditure	TE[4]	**681645**	**48.1**	**49.9**	**49.0**	**48.9**	**48.6**	48.0	47.5
Pm: compensation of employees	D.1	155533	11.0	11.1	10.8	10.8	10.6	10.5	10.3

[1] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[2] The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41 + FISIM recorded as intermediate consumption, item 9).
[3] Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.
[4] Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.
[5] The programme does not provide targets for revenues and expenditure (and their components) after 2007. The figures are the official trends based on unchanged legislation.
[6] The cumulated future adjustment to achieve the planned budgetary targets is officially estimated at 1.2% of GDP in 2008, 1.7% in 2010 and 2.3% in 2011.

Table 3. General government expenditure by function

% of GDP	COFOG Code	2004	2009
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[1]		

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

Table 4. General government debt developments

% of GDP		2005	2006	2007	2008	2009	2010	2011
1. Gross debt[1]		**106.6**	**107.6**	**106.9**	**105.4**	**103.5**	100.7	97.8
2. Change in gross debt ratio		**2.7**	**1.0**	**-0.7**	**-1.5**	**-1.9**	-2.8	-2.9
Contributions to changes in gross debt								
3. Primary balance[2]		**-0.7**	**0.0**	**-2.2**	**-2.8**	**-3.4**	-4.2	-5.0
4. Interest expenditure (incl. FISIM) [3]		**4.8**	**4.8**	**5.0**	**5.0**	**4.9**	4.9	4.9
5. Stock-flow adjustment		**0.7**	**-0.2**	**-0.5**	**-0.2**	**0.1**	0.1	0.7
- Differences between cash and accruals[4]		-0.4	-1.1	-0.5	-	-	-	-
- Net accumulation of financial assets[5]		1.2	0.8	0.0	-	-	-	-
of which - privatisation proceeds		*-0.3*	-	-	-	-	-	-
- Valuation effects and other[6]		-0.1	0.2	0.1	-	-	-	-
p.m. implicit interest rate on debt[7]		**4.7**	**4.7**	**4.8**	**4.8**	**4.9**	4.9	5.0
Other relevant variables								
6. Liquid financial assets[8]		-	-	-	-	-	-	-
7. Net financial debt (7=1-6)		-	-	-	-	-	-	-

[1] As defined in Regulation 3605/93 (not an ESA concept).

[2] Cf. item 10 in Table 2.

[3] Cf. item 9 in Table 2.

[4] The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

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

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

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

[8] 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	2005	2006	2007	2008	2009	2010	2011
1. Real GDP growth (%)		**0.0**	**1.6**	**1.3**	**1.5**	**1.6**	1.7	1.7
2. Net lending of general government	**EDP B.9**	**-4.1**	**-4.8**	**-2.8**	**-2.2**	**-1.5**	-0.7	0.1
3. Interest expenditure (incl. FISIM recorded as consumption)	**EDPD.41 + FISIM**	**4.8**	**4.8**	**5.0**	**5.0**	**4.9**	4.9	4.9
4. Potential GDP growth (%)[1]		1.3	1.4	1.3	1.4	1.5	1.6	1.7
contributions:								
- labour		0.6	0.7	0.6	0.6	0.5	0.5	0.5
- capital		0.6	0.7	0.7	0.7	0.7	0.7	0.7
- total factor productivity		0.0	0.0	0.0	0.1	0.2	0.3	0.4
5. Output gap		-1.8	-1.6	-1.5	-1.4	-1.2	-1.1	-1.1
6. Cyclical budgetary component		-0.9	-0.8	-0.8	-0.7	-0.6	-0.5	-0.5
7. Cyclically-adjusted balance (2-6)		-3.2	-4.1	-2.1	-1.5	-0.9	-0.1	0.7
8. Cyclically-adjusted primary balance (7-3)		1.6	0.7	3.0	3.5	4.0	4.8	5.5

[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	2005	2006	2007	2008	2009	2010	2011
Real GDP growth (%)								
Previous update		**0.0**	**1.5**	**1.5**	**1.7**	**1.8**		
Current update		**0.0**	**1.6**	**1.3**	**1.5**	**1.6**	1.7	1.7
Difference		**0.0**	**0.1**	**-0.2**	**-0.2**	**-0.2**		
General government net lending (% of GDP)	**EDP B.9**							
Previous update		**-4.3**	**-3.5**	**-2.8**	**-2.1**	**-1.5**		
Current update		**-4.1**	**-4.8**	**-2.8**	**-2.2**	**-1.5**	-0.7	0.1
Difference		**0.2**	**-1.3**	**0.0**	**-0.1**	**0.0**		
General government gross debt (% of GDP)								
Previous update		**108.5**	**108.0**	**106.1**	**104.4**	**101.7**		
Current update		**106.6**	**107.6**	**106.9**	**105.4**	**103.5**	100.7	97.8
Difference		**-1.9**	**-0.4**	**0.8**	**1.0**	**1.8**		

Table 7. Long-term sustainability of public finances

% of GDP	2000	2005	2010	2020	2030	2040	2050
Total primary expenditure		-	-	42.0	43.2	44.6	43.8
Of which: age-related expenditures		26.2	25.9	26.3	27.6	29.1	28.5
Pension expenditure		14.0	14.0	14.1	15.0	15.7	14.5
Social security pension							
Old-age and early pensions		13.7	13.7	13.9	14.8	15.6	14.4
Other pensions (disability, survivors)		0.3	0.3	0.2	0.2	0.1	0.1
Occupational pensions (if in general government)							
Health care		6.7	6.8	7.2	7.7	8.2	8.6
Long-term care *(this was earlier included in the health care)*		0.8	0.8	0.9	1.0	1.1	1.3
Education expenditure		4.3	3.9	3.8	3.6	3.6	3.7
Other age-related expenditures - Unemployment benefits		0.4	0.4	0.4	0.4	0.4	0.4
Interest expenditure		4.6	4.7	3.0	1.2	-0.2	-1.6
Total revenue		-	-	47.0	47.0	47.0	47.0
Of which: property income		-	-	-	-	-	-
of which: from pensions contributions (or social contributions if appropriate)		-	-	-	-	-	-
Pension reserve fund assets		-	-	-	-	-	-
Of which: consolidated public pension fund assets (assets other than government liabilities)		-	-	-	-	-	-
Assumptions							
Labour productivity growth		0.4	1.1	1.7	1.7	1.7	1.7
Real GDP growth		0.0	1.9	1.6	0.9	0.8	1.2
Participation rate males (aged 20-64)		79.2	81.7	82.9	83.2	84.1	84.4
Participation rates females (aged 20-64)		53.6	57.4	61.7	62.3	63.5	64.7
Total participation rates (aged 20-64)		66.4	69.6	72.3	72.8	73.9	74.7
Unemployment rate		7.7	6.7	6.4	6.4	6.4	6.4
Population aged 65+ over total population		19.5	20.6	23.2	27.1	32.3	33.9

Table 8. Basic assumptions

	2005	2006	2007	2008	2009	2010	2011
Short-term interest rate[1] (annual average)	-	**2.7**	**3.1**	**3.7**	**3.7**	3.7	3.7
Long-term interest rate (annual average)	-	**4.0**	**4.1**	**4.3**	**4.5**	4.5	4.5
USD/€ exchange rate (annual average) (euro area and ERM II countries)	-	**1.25**	**1.28**	**1.28**	**1.28**	1.28	1.28
Nominal effective exchange rate	-	**0.6**	**0.5**	**0.0**	**0.0**	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	-						
World excluding EU, GDP growth	-	**5.6**	**5.4**	**4.7**	**4.6**	4.6	4.6
EU GDP growth	-	**2.7**	**2.3**	**2.5**	**2.5**	2.5	2.5
Growth of relevant foreign markets	-	**9.7**	**7.3**	**6.4**	**6.3**	6.3	6.3
World import volumes, excluding EU	-	**8.6**	**8.0**	**7.2**	**7.1**	7.1	7.1
Oil prices, (Brent, USD/barrel)	-	**70.0**	**69.0**	**69.0**	**69.0**	69.0	69.0

[1] If necessary, purely technical assumptions.

Annex 3: 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 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.

Guidelines in the 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		
2. Model structure			
The model structure for the programmes in Annex 1 of the code of conduct has been followed.	X		
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		
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].	X		
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 convergence programme presents the medium-term monetary policy objectives and their relationship to price and exchange rate stability.			not applicable
d. Budgetary strategy			
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.	X		
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	From 2008
Information is provided on one-off and other temporary measures.	X		

Guidelines in the code of conduct	Yes	No	Comments
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
e. "Major structural reforms"			
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
f. Sensitivity analysis			
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		
In case of "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
g. Broad economic policy guidelines			
The programme provides information on the consistency with the broad economic policy guidelines of the budgetary objectives and the measures to achieve them.	X		
h. Quality of public finances			
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. Long-term sustainability			
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		
j. Other information (optional)			
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		

Notes:
[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.

Source:
Commission services

Annex 4: Key economic indicators of past economic performance

This Annex includes two tables. The first displays key economic indicators that summarise the economic performance of the country. To put the country's performance into perspective, the second table displays the same set of indicators for the euro area.

Table A41. Italy

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	1.3	1.9	0.6	0.0	1.1	0.0
Private consumption % change	1.5	2.5	0.5	1.0	0.6	0.1
Government consumption % change	1.4	0.9	1.9	2.0	0.5	1.2
Investment % change	2.4	3.5	1.3	-1.7	2.2	-0.6
Exports % change	0.9	2.4	-0.5	-2.4	3.0	0.3
Imports % change	2.9	5.0	0.8	0.8	2.5	1.4
Contributions to real GDP growth						
Demand						
Domestic demand	1.7	2.4	1.0	0.9	0.9	0.2
Net exports	-0.4	-0.5	-0.4	-0.8	0.1	-0.3
Output gap	0.1	-0.1	0.3	0.0	-0.2	-1.4
Prices and costs						
HICP inflation % change	2.4	2.4	2.4	2.8	2.3	2.2
Unit labour costs % change	2.4	1.6	3.2	4.3	2.4	2.5
Labour productivity % change	0.5	1.1	0.0	-0.6	1.0	0.4
Real unit labour costs % change	-0.4	-1.1	0.3	1.2	-0.5	0.4
Comparative price levels (EUR25=100)	95.1	92.6	97.7	98.9	99.6	100.6
Labour market						
Employment % change	1.3	1.0	1.7	3.0	0.3	0.6
Employment % of pop work age	59.4	56.8	61.9	63.0	62.7	62.8
Unemployment rate in %	9.7	11.0	8.4	8.4	8.0	7.7
NAIRU in %	9.3	10.0	8.6	8.6	8.3	7.9
Participation rate in %	65.3	63.4	67.2	68.3	67.8	67.7
Working age population % change	0.0	-0.3	0.2	0.4	0.7	0.4
Competitiveness and external position						
Real effective exchange rate % change (1)	2.2	0.9	3.5	7.8	3.2	1.0
Export performance % change (2)	-5.5	-6.1	-4.8	-6.6	-5.4	-5.7
External balance of g & s	1.8	2.9	0.7	0.6	0.7	-0.1
Net borrowing v-à-v RoW	0.8	2.0	-0.4	-0.7	-0.4	-0.9
FDI	n.a.	n.a.	n.a.	1.1	1.0	1.1
Public finances						
Total expenditure % of GDP	48.6	49.3	47.9	48.3	47.8	48.2
Total revenue % of GDP	45.3	46.2	44.5	44.8	44.3	44.0
General government balance % of GDP	-3.2	-3.0	-3.4	-3.5	-3.4	-4.1
General government debt % of GDP	110.5	115.3	105.8	104.3	103.9	106.6
Structural budget balance % of GDP	n.a.	n.a.	n.a.	-5.2	-4.6	-3.9
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	1.3	2.7	0.0	-0.7	-0.8	0.1
Long term real interest rate (4)	2.5	3.5	1.5	1.2	1.3	1.5
Household credit % change	n.a.	n.a.	n.a.	9.3	13.7	12.9
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	6.6	4.9	6.3
Household debt in % of GDP	n.a.	n.a.	n.a.	25.3	27.6	30.6
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	59.8	60.3	62.8

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Table A4.2: The euro area

	Averages			2003	2004	2005
	1996 – 2005	1996 – 2000	2001 - 2005			
Economic activity						
Real GDP (% change)	2.1	2.7	1.4	0.8	2.0	1.4
Private consumption % change	2.0	2.6	1.4	1.2	1.5	1.3
Government consumption % change	1.7	1.7	1.7	1.8	1.2	1.4
Investment % change	2.6	4.3	1.0	1.0	2.2	2.5
Exports % change	5.8	8.1	3.5	1.1	6.8	4.3
Imports % change	5.9	8.4	3.4	3.1	6.7	5.3
Contributions to real GDP growth						
Demand						
Domestic demand	2.0	2.7	1.3	1.4	1.8	1.6
Net exports	0.1	0.1	0.1	-0.7	0.2	-0.2
Output gap	-0.1	-0.1	0.0	-0.6	-0.5	-1.1
Prices and costs						
HICP inflation % change	1.9	1.7	2.2	2.1	2.1	2.2
Unit labour costs % change	1.3	0.8	1.7	2.0	0.9	1.0
Labour productivity % change	1.2	1.5	0.8	0.8	1.6	0.9
Real unit labour costs % change	-0.5	-0.6	-0.5	-0.1	-1.0	-0.8
Comparative price levels (EUR25=100)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Labour market						
Employment % change	1.2	1.5	0.9	0.7	0.7	0.8
Employment % of pop work age	63.7	62.0	65.4	65.4	65.6	65.8
Unemployment rate in %	9.1	9.8	8.5	8.7	8.9	8.6
NAIRU in %	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Participation rate in %	69.9	68.5	71.2	71.4	71.7	71.8
Working age population % change	0.3	0.2	0.4	0.5	0.5	0.5
Competitiveness and external position						
Real effective exchange rate % change (1)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Export performance % change (2)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
External balance of g & s	1.9	1.7	2.0	2.1	2.1	1.5
Net borrowing v-à-v RoW	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
FDI	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Public finances						
Total expenditure % of GDP	48.2	48.7	47.7	48.2	47.6	47.6
Total revenue % of GDP	45.8	46.5	45.1	45.1	44.8	45.1
General government balance % of GDP	-2.3	-2.1	-2.5	-3.1	-2.8	-2.4
General government debt % of GDP	70.9	72.5	69.3	69.3	69.8	70.8
Structural budget balance % of GDP	#N/A	#N/A	#N/A	-3.2	-2.9	-2.0
Fin.a.ncial indicators (3)						
Short term real interest rate (4)	1.7	2.7	0.7	0.2	0.2	0.3
Long term real interest rate (4)	3.1	4.1	2.1	2.0	2.2	1.5
Household credit % change	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector credit % change (5)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Household debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Corporate sector debt in % of GDP	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes:

(1) ulc relative to rest of a group of industrialised countries (usd): EUR24 (excl. LU), BG, RO, TR, CH, NR, US, CA, JP, AU, MX and

(2) Market performance of exports of goods and services on export weighted imports of goods and services of 35 industrial markets (2000=100).

(3) Data available up to 2004

(4) Using GDP deflator

(5) Households' and non-profit institutions serving households' debt defined as loans and securities other than shares

(6) Non-financial corporate sector debt, defined as loans and securities other than shares

Annex 5: Assessment of tax projections

Table 9 in the main text compares the tax projections of the programme with those of the Commission services' autumn 2006 forecast and those obtained by using standard ex-ante elasticities, as estimated by the OECD. It summarises the results for the total tax-to-GDP ratio. The underlying analysis exploits information for the four major tax categories, i.e. indirect taxes, corporate and private income taxes and social contributions (see results in the table below)[29].

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 elasticity[30]. 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:

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

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

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

[29] Private and corporate income taxes are generally not provided, neither in the programme nor in the Commission services' autumn 2006 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.

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

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

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

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.

Assessment of tax projections by major tax category

	2007			2008			2009	2010	2011
	SP/CP	COM	OECD[1]	SP/CP	COM[2]	OECD[1]	SP/CP	SP/CP	SP/CP
Taxes on production and imports:									
Change in tax-to-GDP ratio	0.0	-0.2	0.0	-0.1	0.0	0.0	-0.1	-0.1	-0.1
Difference SP – COM	0.2			-0.1			/	/	/
of which [3]:									
- discretionary & elasticity component	0.1			-0.1			/	/	/
- composition component	0.1			0.1			/	/	/
Difference COM – OECD	/	-0.2		/	0.0		/	/	/
of which [3]:									
- discretionary & elasticity component	/	-0.1		/	0.0		/	/	/
- composition component	/	-0.1		/	-0.1		/	/	/
p.m.: Elasticity									
- of taxes to tax base[4]	0.9	0.7	1.0	0.8	1.1	1.0	0.8	0.7	0.8
- of tax base[4] to GDP	1.1	0.9	1.0	1.0	0.9	1.0	1.0	1.0	1.0
Social contributions:									
Change in tax-to-GDP ratio	0.7	0.7	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1
Difference SP – COM	0.1		/	0.0		/	/	/	/
of which [3]:									
- discretionary & elasticity component	0.3		/	0.1		/	/	/	/
- composition component	-0.1		/	0.0		/	/	/	/
Difference COM – OECD	/	0.7		/	0.0		/	/	/
of which [3]:									
- discretionary & elasticity component	/	0.6		/	0.0		/	/	/
- composition component	/	0.0		/	0.0		/	/	/
p.m.: Elasticity									
- of taxes to tax base[5]	3.2	2.5	1.0	1.2	1.0	1.0	1.0	1.0	0.9
- of tax base[5] to GDP	1.0	1.0	0.9	0.8	0.9	0.9	0.9	0.8	0.8
Personal income tax[6]:									
Change in tax-to-GDP ratio	0.7	0.6	0.2	0.0	0.0	0.3	0.0	0.0	0.0
Difference SP – COM	0.1		/	0.0		/	/	/	/
of which [3] :									
- discretionary & elasticity component	0.4		/	0.0		/	/	/	/
- composition component	-0.1		/	0.0		/	/	/	/
Difference COM – OECD	/	0.3		/	-0.3		/	/	/
of which [3] :									
- discretionary & elasticity component	/	0.1		/	-0.4		/	/	/
- composition component	/	0.1		/	0.0		/	/	/
p.m.: Elasticity									
- of taxes to tax base[5]	3.4	2.4	2.0	1.1	1.0	2.0	1.2	1.2	1.2
- of tax base[5] to GDP	1.0	1.0	0.9	0.8	0.9	0.9	0.9	0.8	0.8
Corporate income tax[6] :									
Change in tax-to-GDP ratio	0.2	0.1	-0.1	0.0	0.0	-0.1	0.0	0.0	0.0
Difference SP – COM	0.0		/	0.0		/	/	/	/
of which [3] :									
- discretionary & elasticity component	0.1		/	0.0		/	/	/	/
- composition component	0.0		/	0.0		/	/	/	/
Difference COM – OECD	/	0.7		/	0.0		/	/	/
of which [3] :									
- discretionary & elasticity component	/	0.6		/	0.0		/	/	/
- composition component	/	0.0		/	0.0		/	/	/
p.m.: Elasticity									
-of taxes to tax base[7]	3.2	2.4	1.0	0.8	0.9	1.0	1.0	0.9	0.9
-of tax base[7] to GDP	1.0	1.0	0.9	1.1	1.1	0.9	1.1	1.1	1.1

Notes:

[1]Based on 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 2006 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)